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**THE ILL-FATED CURRENCY
BOARD PROPOSAL FOR
INDONESIA**

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Johns Hopkins Institute for Applied Economics,
Global Health, and Study of Business Enterprise



The ill-fated currency board proposal for Indonesia

by Ross H. McLeod

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About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of the Institute for Applied Economics, Global Health and Study of Business Enterprise (hanke@jhu.edu).

About the Working Paper

In February 1998, President Soeharto's chief economic advisor, Professor Steve Hanke, proposed a currency board as the means to extract Indonesia from the Asian Financial Crisis. President Soeharto embraced Hanke's proposal and announced that he intended to implement it. The international, and eventually domestic, opposition was so vociferous that the currency board plan was aborted. Professor Ross McLeod's diagnosis of the state of Indonesia's economy concludes that most analysts failed to understand Indonesia's economic fundamentals; that the opposition to the currency board was ill-informed; that Soeharto's embrace of the currency board was sensible; and that the opposition to the currency board was motivated to a considerable extent by the desire to use the financial crisis to force a regime change in Indonesia.

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The ill-fated currency board proposal for Indonesia

Ross H. McLeod

In February 1998 Indonesia toyed briefly with the idea of introducing a currency board system as a means of extricating itself from the Asian financial crisis. Although the then president Soeharto announced his government's intention to implement such a system, international and domestic opposition was so vociferous that he aborted the plan. In my view this opposition was ill-informed. Moreover, it was motivated, to a considerable extent, by a desire to use the crisis to force a president widely disliked among the urban intelligentsia to discontinue some of his favoured economic policies—if not to bring about an end to his presidency—rather than giving top priority to dealing with the crisis itself. The nature of the crisis as it played out in Indonesia remains poorly understood, such that an analysis of the currency board proposal provides an opportunity to correct some misunderstandings and dispel some of the myths about this major episode in Indonesia's modern history. In this paper I argue that in fact Soeharto's embrace of the proposal was sensible, and that it was motivated by the desire to restore macroeconomic stability—which would have been not only to his own benefit but also that of Indonesia's citizens.

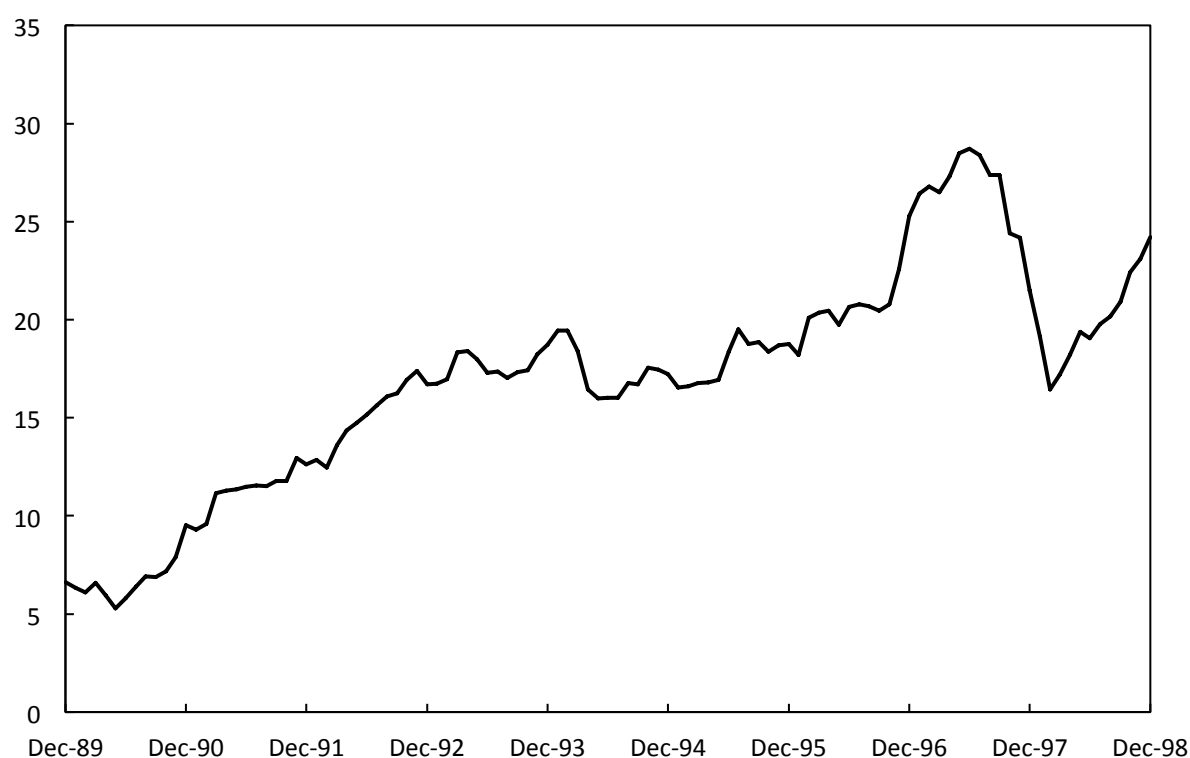
Background

The Asian financial crisis began to engulf Indonesia in July 1997. It had started in Thailand as a consequence of severe mismanagement of the balance of payments in that country. Specifically, Thailand had clung to a pegged exchange rate for many months in spite of rapidly dwindling foreign exchange reserves, a fact that it managed to hide from public view for some time by selling its reserves forward and failing to disclose this fact (King 2001: 441). When the inevitable could be postponed no longer, Thailand was forced to devalue its currency suddenly and without warning, causing shock and consternation among investors

worldwide who, until that time, had regarded the Southeast Asian region as a safe and profitable place in which to lend and invest.

Indonesia was tarred with the same brush, despite the fact that for many months its central bank had been fighting to prevent *appreciation* of the currency rather than *depreciation*, as a consequence of which it had accumulated very large international reserves (Figure 1) – quite the opposite of the Thai case. Moreover, Indonesia had operated its fiscal policy for decades in a highly responsible fashion, always spending broadly within its means. Inflation was running at only about 5% annually—a little higher than its neighbours, but at the low end of its usual 5–10% band. In short, the key macroeconomic variables in no way suggested the likelihood of imminent devaluation as had occurred in Thailand.

Figure 1 Indonesia's International Reserves
(\$US billion)



Devaluation of the baht jolted investors out of their complacency. Foreign institutions that had taken on large financial exposures to Indonesia—often without really knowing much

about the country—suddenly confronted the worrying prospect that if they had been so ill-informed about Thailand, perhaps the same might be true of Indonesia and other countries in the region. Without the luxury of having the time to undertake a more careful analysis, the prudent response to the threat of sudden devaluation was to withdraw funds as quickly as possible—which, of course, immediately brought about precisely that outcome, given that the authorities had quickly decided to allow the rupiah to float rather than attempt to maintain the pre-existing exchange rate (Lindblad 1997: 5). In such circumstances it is not just foreign entities with an exposure to the country in question that have an incentive to repatriate their funds. Domestic entities that have borrowed in foreign currency to finance their investments have the same incentive, because they face the prospect of the local currency value of their borrowings ballooning. To these groups must be added untold numbers who see in the looming crisis the opportunity to make a speculative profit by substituting foreign for domestic assets, or financial assets denominated in foreign rather than local currency, in their portfolios.

The extent of a run on any currency depends, implicitly, on private sector actors' expectations as to the authorities' response to the disturbance that precipitates it. Unfortunately, the track record of Indonesia's central bank, Bank Indonesia (BI), did little to engender confidence: Indonesia had experienced hyperinflation in the 1960s, together with a series of large devaluations (most recently just ten years earlier). In addition, the major decision to float the currency had been taken quickly, without any prior public debate, and with little attempt to reassure the public that this made good policy sense. At least in retrospect, then, it is unsurprising that capital began to flood out of Indonesia, regardless of the prior soundness of the macroeconomic fundamentals.

One important contributor to this panicked reaction was the possibility of regime change. Soeharto had been in power for over 30 years, and his regime had dominated economic policy and progress increasingly over that period. Economic performance had been of a very high standard, with growth averaging over 7% annually. On the other hand, the president had also abused his power to redistribute income and wealth in myriad ways in favour of his own family and business cronies, who had become fabulously wealthy as a result (McLeod 2000). They were well aware that if he were to fall, their own positions would be in grave danger. Soeharto was now well into his seventies, and there were signs his health may be failing (Sadli 1998: 273). These observations, in combination with the sudden loss of the political legitimacy that had accompanied almost uninterrupted economic progress over three decades, suggested to this group that it would be well advised to diversify its assets by shifting funds offshore (Cole and Slade 1998: 65). All the conditions were in place for a perfect financial storm.

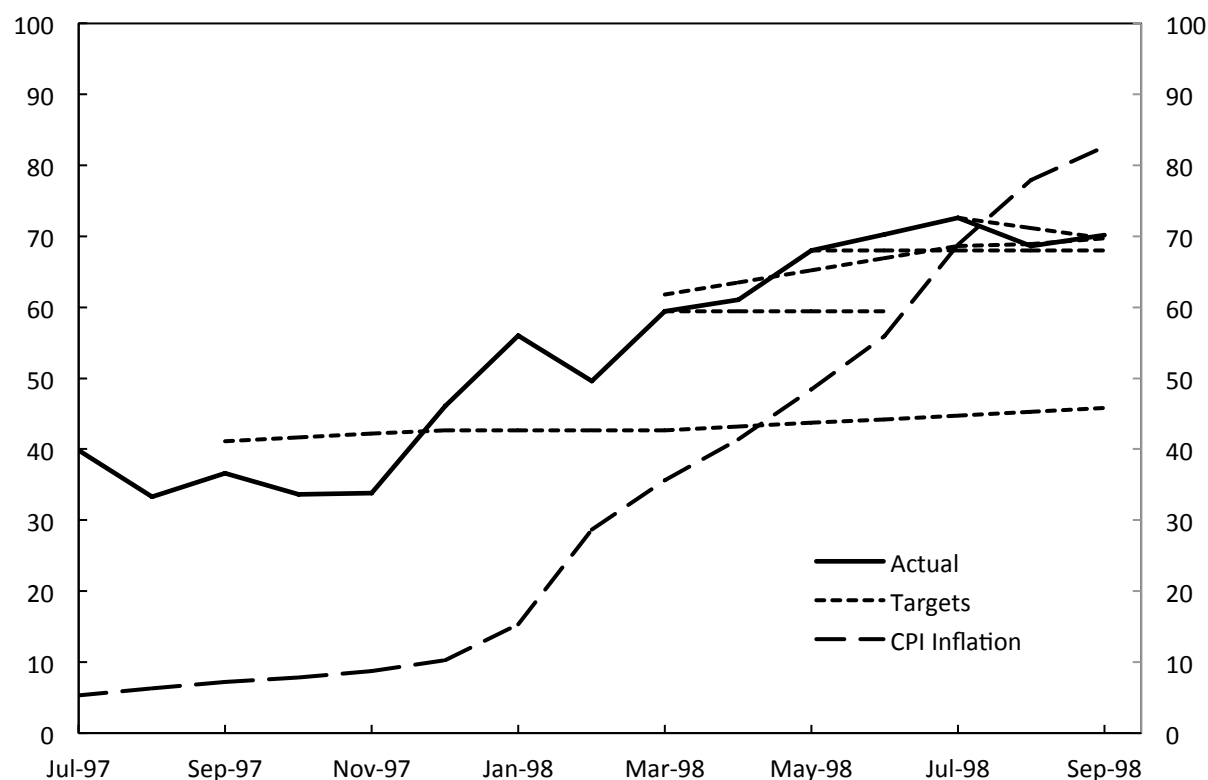
Floating the rupiah

In principle there was nothing wrong with the central bank's decision to float the currency in response to the sudden reversal of capital inflow. Nevertheless, it is clear in retrospect that there was little understanding of the further implications of this decision. For many years previously the *de facto* foundation of Indonesia's monetary policy had been a commitment to a slow and steady rate of depreciation against the US dollar—though this was never stated explicitly. This policy was itself based on the misconception of Indonesia as an inherently high inflation economy. Whereas other economies had little difficulty keeping inflation down to 1 or 2% per annum, the authorities—and even a number of academic economists in Indonesia—had persuaded themselves that there was some (never stated) special characteristic of the Indonesian economy that caused it to experience inflation at

more rapid rates. Knowing that if a country inflates more rapidly than its trading partners its tradable goods sectors will become increasingly uncompetitive in the world market, this outcome was to be avoided by steadily depreciating the rupiah, so as to keep the real exchange rate roughly constant (Nasution 1998: 455). From September 1986—the time of the most recent discrete devaluation of the currency—Bank Indonesia therefore ensured that the exchange rate depreciated steadily at about 3 to 5% per annum.

Although nobody spoke of it in these terms, the 3–5% depreciation rate became the implicit nominal anchor for monetary policy and, rather than being the necessary response to Indonesia's supposed inherently high rate of inflation, it served to ensure that indeed the inflation rate would always be unnecessarily high. The underlying mechanism was fairly straightforward. Exchange rate depreciation continued even though the balance of payments was typically in surplus, as indicated by the central bank continuously purchasing more and more foreign exchange in the market, adding steadily to its international reserves. By purchasing foreign exchange in the market at the artificially high price implied by the continuous depreciation policy, BI injected more and more base money into circulation; the rapid growth of the supply of base money then resulted in elevated levels of inflation (Figure 2). In short, the policy followed in response to the unfounded belief that Indonesia's inflation rate was inherently high itself generated the comparatively high levels of inflation on which that belief was based.

Figure 2 Base Money Growth and Inflation During Crisis
(Rp trillion, % p.a.)



The crucial problem accompanying BI's decision to float the rupiah was the failure to recognise that this amounted to abandoning what had served as the nominal anchor for monetary policy for at least the previous decade. In the months that followed there was no such nominal anchor. Money supply growth ran out of control, inflation and nominal interest rates surged, and the exchange rate depreciated beyond observers' wildest expectations.

At least at a superficial level, the reason for loss of control of money supply can be found in the conflict between the central bank's role as monetary policy maker and its role as prudential regulator of, and lender of last resort to, the commercial banks. The initial burst of speculation against the rupiah following devaluation of the Thai baht had significant consequences for many private sector corporations and their bankers. Many of the outstanding loans from banks to the private sector were denominated in US dollars, which

meant that borrowers now faced considerable losses because of the jump in the rupiah value of their liabilities. Failure to repay their borrowings then extended these losses to the banks, many of which had at best only a thin margin of capital with which to absorb them. As a consequence, the central bank found itself having to make emergency loans to the banks as lender of last resort, and it did this on such a huge scale that the supply of base money would more than double over the eight months through July 1998 (Figure 2). Accustomed as it was always to find something or someone else to blame for Indonesia's high inflation, rather than seeing this as the predictable consequence of its own policies (McLeod 1993: 122), BI seemed concerned only with its lender of last resort function, oblivious of the monetary impact. The consequences of this extraordinary lapse in the conduct of monetary policy rapidly became apparent.

Enter the IMF

In October 1997 the government had turned to the IMF for assistance. A rescue package was put together, the main feature of which was a large loan in combination with several international standby loans,¹ together with a commitment on the part of the government to change a number of its key economic policies (many of them entirely unrelated to the crisis).² One component of this package was a decision to close down 16 small private sector

¹ The effective size of this IMF rescue package was far less than the amount typically reported: \$43 billion (McLeod 1998a). At its peak the amount actually disbursed by the IMF itself was only about \$11 billion; the loan was fully repaid by October 2006.

² The first agreement ('Letter of Intent'), for example, required, among other things, the complete divestiture of seven presently unlisted state enterprises within the following 17 months; the reduction of export taxes on logs and sawn timber to 20 percent; submission to Parliament of a draft law on competition to prevent the abuse of dominant position and practices that restrict or distort free competition; and preparation of a mechanism for the regular adjustment of administered food prices.

banks³ that had become insolvent. Despite the government's earlier warnings that it did not guarantee deposits, it now promised that the vast majority of depositors would lose nothing, and that their deposits would be transferred to other banks. Indeed, this process was accomplished with very little difficulty.

The exercise ended in disaster, however. The problem was that although the promise of no losses extended to the vast majority of *depositors*, it did not apply to *deposits* above Rp 20 million (around US\$5,000 at the time) (Djiwandono 2004: 67). Unfortunately, a very large proportion of total deposits exceeded this ceiling—not only in the banks that were closed, but also in the banking sector more generally. The owners of large deposits held at all the private sector domestic banks therefore suddenly confronted the possibility that banks other than those that had just been closed were in danger of imminent failure (despite the government's reassurances to the contrary), and that they would be unlikely to be compensated by the government if such failures came to pass. Just as private sector entities had pre-emptively withdrawn funds from Indonesia after the Thai currency was devalued, large depositors now began to withdraw funds from Indonesia's private domestic banks. The resulting run on these banks created chaos in the banking system as a whole, and last resort lending by the central bank exploded.

The nature of this run on the banks remains little understood. The stereotypical image of a bank run features long lines of depositors queuing at the teller's window, hoping that they will be able to withdraw their savings before it is too late. Although there was some of this in the early phase of the crisis—particularly at the largest private sector bank, Bank Central Asia, owned by Soeharto's closest business associate Liem Sioe Liong and two of Soeharto's

³ Collectively, these banks accounted for about 3% of total commercial bank assets (Djiwandono 2004: 64).

children (Johnson 1998: 51)—it was no doubt tempered by the fact that the government had just closed some banks and had guaranteed no losses on small deposits. In fact, to a large extent the supposed bank run was not really a bank run at all, at least in later months. Rather, it was a fierce bout of speculation against the currency, financed by the central bank itself.

In the first step, much of this speculation was financed by domestic banks. Most of the private banks were part of one or other of the conglomerates that dominated the modern sector of Indonesia's economy. Although there were strict rules against banks lending to related entities, these rules were not properly enforced—not least because Soeharto's support made them effectively untouchable (Cole and Slade 1998: 65). As the crisis developed, banks rapidly increased their rupiah lending to affiliated firms, which then used these funds to purchase foreign exchange—perhaps in order to pay off their foreign borrowings, or perhaps in order to engage in outright speculation against the currency. This left those same banks with a severe liquidity shortage, exacerbating the shortage that resulted from the shifting of deposits to the state-owned and foreign banks (see below). This shifting of deposits enabled the state banks to become part of a similar process, and they increased their lending even more rapidly than the private banks during this period.

In short, at this time of rapidly deepening recession and a deeply uncertain economic and political outlook, the private banks still managed to increase their rupiah-denominated working capital loans at an annualised rate of some 16% in just the first quarter of March 1998, while the state-owned banks increased theirs at the extraordinarily rapid rate of 135%. It was this astonishing surge in bank lending, made possible by emergency loans from BI (which were to become famous as BLBI: *Bantuan Likuiditas Bank Indonesia*) (Djiwandono

2004), that explains the precipitous depreciation of the rupiah and the simultaneous surge in inflation around this time.

Interpreting Indonesia's crisis

Many observers have wrongly interpreted the high inflation in 1998 as a consequence of rapid depreciation of the rupiah. The correct interpretation, as just suggested, is that both depreciation and inflation at that time are readily explained by surging growth of base money. This, in turn, reflected BI's inability to reconcile its responsibility as monetary policy maker with its role as last resort lender, which saw the newly created base money injected through last resort lending remaining in circulation rather than being sterilised. The private sector responded to the excess supply of base money by both buying foreign exchange and reducing the supply of goods and services,⁴ thus pushing up both the exchange rate and prices.⁵

As just noted, the liquidity problems of private domestic banks at the time were to some extent the consequence of their depositors shifting funds to state-owned and foreign-owned banks, both of which were regarded as safe by virtue of their ownership: it seemed inconceivable that the government would allow its own banks to fail, while the foreign banks were small branches or subsidiaries of much larger institutions with international reputations to protect. This shifting of funds left the private domestic banks short of liquidity, but left the others—especially the state-owned banks—with a surplus. The appropriate response to this would have been to combine last resort lending to the private

⁴ If prices rise during a strong recession, this is more because of declining supply than increasing demand.

⁵ Under a purely floating exchange rate the central bank neither buys nor sells foreign exchange. In fact this was not a pure float: BI was a net seller of foreign exchange from October 1997 through February 1998, but then became a net buyer over the next 12 months (Figure 1).

banks with the issue of a similar amount of central bank certificates (SBIs) to the state-owned banks in order to soak up their surplus funds. The expansionary impact of last resort lending would then have been sterilised (just as the monetary impact of a balance of payments surplus can be sterilised using open market operations). But this was not done. Few seemed to appreciate the crucial importance of having a new nominal anchor—such as the money supply—to take the place of the previously fixed exchange rate.⁶

From crisis to cataclysm

The abrupt change in Indonesia's economic circumstances was extraordinary. In mid-1997 its rate of economic growth was very healthy, inflation was lower than it had been for years, international reserves were high and growing, foreign debt was low, and the budget was in good shape. By January 1998 the economy was heading rapidly into a deep recession, the price of foreign exchange had increased more than four-fold, and inflation was spiralling out of control. Drastic action seemed necessary in order to save the situation. So it was that the president found himself on January 15, 1998 under the stern gaze of Michel Camdessus, Managing Director of the IMF—like a naughty schoolboy who had been sent to the principal's office—as he put his signature to a new agreement under which many of his favoured economic policies were to be overturned.⁷

Another part of the agreement related to money supply management, with broad money targeted to grow by 16% in 1998 through control of base money growth. At least the IMF was conscious of the need for a new nominal anchor, but this aspect attracted virtually no

⁶ The steady depreciation policy implied a fixed exchange rate on any given day.

⁷ This included removing the restrictive trading arrangements relating to wheat and flour, paper and plywood, cloves and cement, and discontinuing a 'National Car' program, all of which had generated enormous rents for first family members and Soeharto cronies such as Liem Sioe Liong and Bob Hasan.

attention whatsoever—not least because the arcane matter of monetary policy had never really been regarded as important in Indonesia. There had long been a commitment to the so-called balanced budget, which really meant ensuring that the government had sufficient funds to finance its expenditures without any resort to borrowing from the central bank—thus removing the most common mechanism for inflationary growth of the money supply. But there had never been any real understanding of the fact that purchases of foreign exchange by the central bank have exactly the same monetary effect as lending to the government (McLeod 1993: 103). Even relatively sophisticated observers had no interest in the money growth targets in each new Letter of Intent from the government to the IMF, much less the journalists reporting on the evolving crisis. It is perhaps unsurprising, therefore, that the central bank itself basically ignored these targets, which would be exceeded by wide margins repeatedly over the next few months (Figure 2). Even the IMF seemed unconcerned about this, contenting itself to set out revised base money growth targets in each of several new Letters of Intent, but never putting any appreciable pressure on BI to meet them.

Soeharto's response

One can only imagine President Soeharto's mood at the time. His regime had recorded outstanding accomplishments over the previous three decades, maintaining an extraordinarily high rate of per capita income growth that resulted in remarkable improvements in living standards for the vast majority of Indonesians. In the main he had been well served (directly or indirectly) by a small team of technocrat ministers and international advisers, and Indonesia was regarded as one of the great developing country success stories among the World Bank's clients. And yet, in the twinkling of an eye this record of unbroken economic progress had been turned on its head, with nothing those

same ministers and advisers recommended coming even close to bringing the crisis to an end. On the contrary: the advisors had succeeded in persuading Soeharto to give way on many policy fronts at the expense of his own family and business associates, without any obvious impact on the rapidly worsening crisis. In such circumstances it is understandable that the president would look elsewhere for advice.

Indonesia is not the only country ever to have suffered the collapse of its currency, of course, so it was natural to look for lessons from other countries that have had to deal with this problem. A small number had done so, with considerable success, by replacing their central bank with a currency board. The study of currency boards constitutes a rather esoteric field of economics. Although many countries have had them in the rather distant past, they fell out of fashion (Hanke and Schuler 1994: 3), and most were replaced by central banks, making them a topic for courses in economic history rather than mainstream macroeconomics.

Not every economist took this view, however. In particular, Professor Steve Hanke, from Johns Hopkins University in the US, had had a long-standing interest in currency boards, and had long advocated them as the best way of dealing with collapsing currencies—most recently in expert testimony before the US House of Representatives on 30 January 1998, just before he was to advise Soeharto on the issue.⁸ The unfashionability of currency boards meant that Hanke was largely unknown to economists in Indonesia and elsewhere. This, combined with the fact that he had been invited to Indonesia at Soeharto's own initiative rather than at the behest of the IMF or the central bank, ensured an extraordinarily

⁸ Hanke's former student, Kurt Schuler, independently suggested the currency board as a potential solution to Indonesia's crisis in a series of articles translated into Indonesian and published in early February 1998 (Schuler 1998).

negative reception for the man and his ideas—notwithstanding his direct involvement in setting up currency board-type arrangements previously in Argentina (1991), Estonia (1992), Lithuania (1994) and, very recently, in Bosnia and Bulgaria (1997). To the shame of the economics profession in Indonesia and its international colleagues, there was a near total failure to consider these ideas objectively on their logical merits and their historical record. Although we cannot determine which economic policies are sound by taking an opinion poll of economists, it is revealing, nevertheless, that the Indonesian currency board naysayers were able to drown out the voices of such luminaries as Gary Becker, Rudiger Dornbusch, Milton Friedman, Merton Miller, Robert Mundell, and Sir Alan Walters (for citations, see Hanke 2002 :216). Walters, in particular, had played a key role in establishing Hong Kong's currency board in 1983.

Hanke would have been immediately able to diagnose Indonesia's economic problems for the president. In simple terms, the central bank had ignored the monetary impact of its lender of last resort activities. Its inability to appreciate the need for a new nominal anchor of monetary policy following its decision to float the currency resulted in chaos in the foreign exchange market, together with surging prices and nominal interest rates. Although it seems unlikely that Hanke explained it in these terms, establishing a currency board system would have had precisely the effect of re-establishing a nominal anchor, this time in the form of a permanently fixed exchange rate rather than the gently but steadily depreciating exchange rate of the pre-crisis years.

From the beginning of his presidency in the mid-1960s Soeharto had shown himself willing to listen to the views of trained economists on economic policy matters—particularly in the field of macroeconomic management. Indeed, he came to power at a time of economic crisis, and relied on these 'technocrats' to formulate and implement the policies needed to

restore stability and economic growth. The new crisis of 1997 was quite different from the earlier one (which had been driven by undisciplined *fiscal* policy), and these same technocrats and their successors demonstrably had not been able to come up with a solution to the new problem (which, as just explained, had been driven by undisciplined *monetary* policy in response to an external shock).

Worse still, from Soeharto's point of view, the technocrats could be seen to be taking advantage of the crisis—in league with the IMF and the World Bank—to try to force reform of a wide range of microeconomic policies intended to benefit his family and cronies. In these circumstances the simple and straightforward diagnosis and treatment proposed by Hanke would have seemed vastly preferable to the complex and wide-ranging policy package set out in the Letter of Intent to the IMF that Soeharto had signed just two weeks earlier. Implementing the currency board proposal would have relieved Indonesia of any need to beg the international community for assistance, thus obviating the requirement for it to go along with the long list of conditions relating to economic policies that had little or nothing to do with the crisis. In short, implementing the currency board proposal would have allowed Indonesia to solve its own problem, without any need for it to surrender its economic sovereignty or—to put it bluntly—for Soeharto to discontinue policies that favoured his family and business cronies at the expense of the general public. By repeatedly inviting Hanke into his own home for ongoing discussions (Torchia 1998), the president signalled clearly that he had lost confidence in his hitherto trusted advisors.

Currency board essentials

A currency board is an alternative to a central bank as the institution responsible for managing countries' monetary affairs. It is helpful to describe it in terms of its very simple balance sheet, dominated, on the assets side, by foreign exchange reserves, and on the

liabilities side by base money, which consists mainly of notes and coin in circulation (but excludes money in the form of bank deposits). By contrast, many central banks have other large assets and liabilities of various kinds (such as loans and borrowings). In particular, a currency board does not lend to either the government or the private sector.

A central feature of the system is that the board stands ready to convert the local currency it has issued for a particular foreign currency (such as the US dollar) at a permanently fixed rate of exchange. Moreover, it is required to maintain a level of foreign exchange reserves at least equal to the value of its base money liabilities (when converted at this fixed rate). Here lies a key difference from central banks: the latter may *promise* to hold their exchange rate fixed, but they do not always maintain sufficient reserves to be able to keep that promise. Thailand in 1997 is an example of this. Unlike a central bank, a currency board cannot run out of foreign exchange reserves: the private sector (including the commercial banks) will necessarily run out of the base money it needs in order to purchase foreign exchange from the board before the board runs out of foreign exchange.

Misunderstanding of this fundamental point is widespread. For example, an editorial in the highly respected *Financial Times* on 12 February 1998 argued—entirely incorrectly—that

Optimists blithely assume a currency board would be protected from speculative attack because the central bank's \$19bn hard currency reserves are triple the value of rupiah notes and coins at current exchange rates. This is nonsense. Notes and coins are only a tiny fraction of the total money supply. Moreover, the reserves are swamped by the country's \$137bn foreign debt—much of it short term and owed by private companies.

The crucial point that this writer and others at the time and later (e.g. Lakshmanan 1998, Singal 1999: 55) failed to understand was that the major part of the broad money supply—

bank deposits—cannot be used directly to purchase foreign exchange from the currency board, only base money (that is, currency in circulation and deposits of the commercial banks at the currency board). The board's only obligation is to hand over foreign exchange in return for its own monetary liabilities (base money), not the monetary liabilities of the commercial banks. Those who hold bank deposits of any kind must therefore first convert them to base money through transactions with some other entity in order to purchase foreign exchange from the board. What this means, in practice, is that when depositors write a cheque on their accounts and use them to purchase foreign exchange from the currency board, their banks' deposits with the currency board—and therefore the supply of base money—will decline by exactly that amount. Since banks' deposits with the currency board are a tiny fraction of the total of their customers' deposits, this process will necessarily come to a halt very quickly. Indeed, contrary to the belief of many, it is basically the value of notes and coins in circulation, relative to the amount of reserves, that matters. The currency board relies entirely on the market mechanism to maintain macroeconomic equilibrium. At times when there is a strong demand for it, sales of foreign exchange by the board result in a corresponding reduction in base money in circulation—in simple terms, a reduction in the liquidity of the economy—which raises interest rates. One consequence of this is that borrowing offshore tends to increase because it has now become relatively more attractive. The resulting increase in capital inflow (or decrease in outflow) tends to restore foreign exchange reserves and liquidity.⁹ A second consequence is that tightening liquidity

⁹ In fact, the authorities' initial reaction to the onset of capital flight following the Thai devaluation was to impose a drastic squeeze on base money, by forcing state-owned enterprises to shift their deposits to Bank Indonesia. But this was handled so ineptly that it created chaos in the money markets, resulting in the squeeze being reversed within a couple of weeks (Cole and Slade 1998: 62, McLeod 1998b: 922–3).

reduces the demand for goods, including imports, and encourages the supply of goods, including for export, again tending to restore foreign exchange reserves and liquidity. The bottom line is that monetary conditions are determined by conditions in the foreign exchange market, and thus by international trading conditions, investor sentiment and so on, but not by the authorities.

It is precisely this absence of control of monetary conditions on the part of policy makers that explains the preference of most countries to have a central bank rather than a currency board. Evidently, policymakers prefer to be in control, even though historical evidence suggests that macroeconomic outcomes are generally inferior (Hanke 1998: 297). No country with a currency board has ever experienced hyperinflation, for example, yet many countries with central banks have done so at one time or another. Scores more have experienced uncomfortably high inflation. Indonesia itself experienced hyperinflation in the mid-1960s, and moderately high inflation in the 1970s (McLeod 1993). Indeed, the chronic lack of success on the part of the central bank in managing monetary policy over several decades has led to the absurd situation described above, in which some observers regard Indonesia as an inherently high inflation economy—a phenomenon unknown in the study of economics.

Responses to the proposal

The initial market response to the currency board idea—even before it had been officially announced—was strongly positive. After having peaked at Rp 13,600/\$ on 26 January 1998 the exchange rate appreciated markedly around the time of Hanke's meetings with Soeharto, which were first reported in the international press on Tuesday 3 February 1998 (Solomon and Linebaugh 1998). Indeed, by 11 February the spot exchange rate had

strengthened to Rp7,050/\$—an appreciation of 93% in just over two weeks.¹⁰ The forward rate moved in unison with the spot rate, resulting in a dramatic decline in the implied one-year forward interest rate, puncturing the oft-voiced assertion that a currency board would result in soaring interest rates. In retrospect, all this should have been seen as an indicator that the proposal might be capable of extricating Indonesia from its predicament: after all, it was the negative market reaction to the authorities' responses to the initial shock that had provided cause for so much concern. If the market could see merit in this radically different policy approach, at the very least this surely suggested that it was worth considering on its merits. Instead, the response from the policy establishment—the technocrats and their advisors in the IMF and the World Bank—was intensely negative. As a later editorial in the *Far Eastern Economic Review* (2 July 1998) put it:

The counterattack was swift and massive, leaning more to blackmail and namecalling than reasoned disagreement. Mr Camdessus threatened to pull [the IMF] rescue package. Major news outfits took to referring to Mr Hanke as 'obscure'. It all reached fever pitch when [the high profile US economist] Paul Krugman attacked Mr Hanke as 'a snake-oil salesman' ...¹¹

Indeed, the IMF's Camdessus, in tandem with US President Bill Clinton, had threatened to urge suspension of its bailout package if Indonesia proceeded with the proposal (*Houston*

¹⁰ The data are difficult to interpret, because the government had also introduced a blanket guarantee of bank liabilities on January 26 (Djiwandono 2005: 122). This new policy was aimed to stop bank runs rather than capital flight, however.

¹¹ At the same time, Krugman is also reported to have said: 'I wish I could say that currency boards are a really stupid thing. They're not. They're just a way of preventing governments from just printing money' (*Dow Jones International News* 1998). That, of course, is precisely what Indonesia needed.

Chronicle 14 February 1998). Unfortunately for Indonesia, this bluff succeeded in persuading Soeharto to back away.

The obvious question that arises in this context is: was this remarkably strong opposition to the Hanke proposal driven by a fear that it would worsen Indonesia's crisis, or by a fear that it would bring it to an end? Currency boards have been introduced successfully in various countries when poor central bank policy-making has led to a currency collapse, so that the empirical track record speaks in their favour: there was no obvious reason to believe that this approach would be any less successful in Indonesia than it had been elsewhere. Bearing in mind the IMF's position, the latter explanation seems more plausible: successful introduction of a currency board would have meant an enormous loss of face for an institution struggling to persuade the world it still had a useful role to play, despite the fact that the global system of fixed exchange rates that provided its *raison d'être* no longer existed. In this regard, it is revealing that the IMF had supported the introduction of currency boards just months earlier in Bulgaria, and Bosnia and Herzegovina, and later in 1998 and in 1999 would give in-principle support for them in Russia and Brazil, respectively (although the latter two did not proceed) (Hanke 2002: 216).

On his retirement the following year, Camdessus is reported as saying: 'We created the conditions that obliged President Suharto to leave his job... [although that] was not our intention.' (Sanger 1999). Former Australian Prime Minister, Paul Keating, went on record to assert that 'The United States Treasury quite deliberately used the economic collapse as a means of bringing about the ouster of President Suharto' (*Agence France Presse*, 11 November 1999), a view supported by former US Secretary of State Lawrence Eagleberger:

‘We were fairly clever in that we supported the IMF as it overthrew [Soeharto]’ (*Agence France Presse*, 20 June 1998).¹²

Embarrassment for the IMF aside, the mood of the times was that the quasi-dictator Soeharto was highly vulnerable for the first time in decades, and that this was a golden opportunity, if not to put an end to his long reign as the virtually unchallengeable leader, then at least to overturn a number of his high profile policies that operated to the detriment of the Indonesian people. It was natural for the currency board proposal to be seen as the means by which the president might escape with both his position and his policies intact. Alternatively, it was widely imagined that the currency board could be used in the short term to at least protect the immense wealth that had been accumulated by the first family and their business associates, by creating a mechanism with which to move their assets offshore and out of reach of the government. As one commentator (Lakshmanan 1998) put it, some said the currency board proposal was

a selfish scheme engineered by Suharto’s children and friends—who [had] enriched themselves through countless national business projects—to save their fortunes by cashing in rupiah at an inflated exchange rate so they [could] pay off their dollar debts.

This view presumed that the currency board would be established with an unrealistically low exchange rate, and that this elite group would be afforded priority access to the limited international reserves that would be transferred to it from the central bank. In short, the

¹² Domestically, the replacement of the central bank with a currency board would also have resulted in extensive high level job losses within the former institution, the threat of which could also be expected to generate significant, strong opposition.

proposal was seen as the means by which Soeharto and the conglomerates could make one final raid on the public purse.

Establishing a currency board

This raises the crucial question as to what exchange rate would have been set for the new currency board, were the proposal to be implemented. It appears that Hanke gave little attention to this issue, presumably because he was more concerned to highlight the basic weakness of current policy (that is, the lack of any nominal anchor for monetary policy), and simply to explain the currency board concept, given that it was quite foreign to domestic policy makers and at best little understood by their foreign advisors. There were reports that Hanke had recommended a rate of Rp 5,000/\$, but this was not the case. In fact he merely stated that, '*on the basis of a back of the envelope calculation*', '5,000 (rupiah to the dollar) [looked] like a satisfactory number', going on to emphasise that 'it goes without saying that 5,000 is *not cut in stone*'.¹³

Moreover, it is not plausible that he would have recommended a rate that was unrealistically low, since this would have virtually guaranteed that the currency board would fail, at considerable cost to his professional reputation. Indeed, he was at pains to point out that when

going into one of these arrangements, the thing you can't do is to go with an overvaluation of the currency. You want to feel comfortable that it's priced appropriately and not overvalued or dramatically undervalued.

Nevertheless, many policy makers and commentators argued against establishing a currency board precisely because they thought that the chosen exchange rate would be set artificially

¹³ Hanke interview with *The Asian Wall Street Journal* (11 February 1998), 'A Case for a Currency Board', (emphasis added.)

low so as to benefit the Soeharto group. The crucial weakness in this argument is that the decision about the exchange rate is separate from the decision to establish a currency board. The inability or unwillingness of the policymakers and commentators to see the proposal as anything other than a means of saving Soeharto's skin meant that they failed to consider whether it might work if the chosen exchange rate was in fact realistic.

The mechanics of determining the exchange rate

Whereas most commentators simply assumed, first, that the exchange rate would be of the order of Rp 5,000–5,500/\$—and that this was unrealistically low given that the market exchange rate was closer to Rp 13,000/\$ at the time—in fact there was no need for policymakers to determine this rate. As Hanke was to say in an interview in *The New York Times* (20 March 1998):

I think the best thing to do is announce you are putting in a currency board, let the currency float for 30 days, and then lock in to the exchange rate. *That's exactly what we did in Bulgaria in 1997.* It worked very well, and I think that's probably what they should do in Indonesia [emphasis added].

That is, the best way to proceed is to announce the intention to establish a currency board, and then allow the market to set the rate during a short period of transition (say, one month), with the rate emerging at the end being adopted by the board. This requires that the central bank withdraws entirely from the foreign exchange market, and simultaneously commits to holding the supply of base money constant, during this transition period. In turn, this implies that private sector supply and demand for foreign exchange alone will determine the exchange rate throughout—and at the end of—the transition period.

During the transition, investors will compare the rupiah value of international reserves, converted at the current exchange rate, with the current supply of base money. Anyone

who believes that the rupiah price of dollars is lower (higher) than it will be at the end of the transition period—whether because reserves appear too low (high) relative to base money or for some other reason—will have an incentive to buy (sell) foreign exchange now, but the effect will be to push the rate towards this predicted ultimate level. Most of these speculative urges will work themselves out during the transition—indeed, that is precisely the purpose of *having* a period of transition—so that there will be minimal further speculation once the board is operational. In other words, the rate that emerges at the end of the transition could not be ‘unrealistic’, because it will reflect the market consensus as to the appropriate permanent currency board exchange rate, given the current level of reserves and base money.

Irony

If the currency board had been established, and its exchange rate determined in the manner just described, there would have been no possibility of Soeharto and those around him looting Indonesia’s international reserves, given that Bank Indonesia would have been precluded from selling them off to him or anybody else. The sad irony of Soeharto’s decision to fold in the face of the Camdessus-Clinton bluff is that this group was able to do so anyway, by different means. BI provided liquidity assistance in huge volumes to the private sector banks—the larger ones all owned by conglomerates, most of which were close to Soeharto. The government had then followed up with its blanket guarantee of all bank deposits. The consequence of this was that, directly and indirectly, it became extremely heavily exposed to the private banks—in addition, of course, to its own banks—which then proceeded to collapse. Ultimately, scores of banks were closed, with most of the larger ones—and their accumulated losses—taken over by the government.

The bailout of depositors under the blanket guarantee, and the need for the government to repay the banks' borrowings from BI, eventually cost the Indonesian public something in the order of US\$40–50 billion, or about half the value of Indonesia's annual GDP (Fane and McLeod 2002, Frécaut 2004). The main beneficiaries were the conglomerate owners, who had taken enormous loans from their own banks and/or from the state banks, before and during the crisis, which they then failed to repay.¹⁴ The weakness of the legal system (characterised by an incompetent and corrupt legal bureaucracy and judiciary), interfering presidents, and BI's ineffectiveness as supervisor of the banking system, ensured that they could get away with repaying only a very small part of what they had borrowed. One of the most egregious examples is that of Syamsul Nursalim, who was

arrested and accused of causing the state to suffer losses of US\$1.68 billion through the misuse of [BI] loans to his Bank Dagang Nasional Indonesia. However, he was released after one day in detention... Investigators estimate that Nursalim [eventually] repaid about 10% of the debt he owed to [the Indonesian Bank Restructuring Agency] (Collins 2007: 110).

Had Soeharto followed through with the currency board proposal, both base money supply growth and bank lending to finance speculation against the currency would immediately have been halted, the currency would have strengthened, and firms would have been in a better position to repay their borrowings from banks. BI's loans to the banking system

¹⁴ Although the owners of private banks lost most or all of their equity when the government took them over, the amounts they owed to these same banks was much greater and, provided they could avoid being forced to repay, they gained on balance. This is the reason why prudential regulations are supposed to ensure that banks lend very little to affiliated entities.

would have been much reduced, and the cost to the government of claims against its deposit guarantee likewise.

According to Hanke, as reported by Blustein (2001: 225), Soeharto

fretted about the inflation that would likely ignite as the result of the rupiah's collapse. ... 'They'll riot in the streets, I'll have to bring in the military, and it could potentially get quite bloody.'

Although the president's predictions would eventually turn out to be entirely accurate, ultimately he chose to stay with the IMF program rather than implement the currency board proposal. This can only be explained by lingering doubts on Soeharto's part as to the likely success of the currency board proposal. The IMF loan would not have counted as part of Indonesia's (unencumbered) reserves, so success of the proposal would not have depended on the IMF support package—nor be threatened by its withdrawal. The package was quite small relative to these reserves in any case, and their only real purpose was to persuade the private sector that the rupiah would not devalue further (McLeod 1998a: 40–41). It did 'get bloody'—so much so that in May 1998 Soeharto chose to resign (Johnson 1998: 6–9).

At least his detractors had the pleasure of witnessing his demise.

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