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Executive Summary

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INDONESIA'S ECONOMIC AND POLITICAL CRISIS: A CHALLENGE FOR U.S. LEADERSHIP IN ASIA

JOHN T. DORI

Indonesia is calm now after riots in May that claimed over 1,000 lives and hastened the end of President Suharto's 32-year reign. The rioting began as peaceful demonstrations against the Indonesian government's handling of the severe economic effects of the Asian economic crisis. Despite the conclusion of four economic stabilization agreements between the International Monetary Fund and the Indonesian government, economic privation persists. Unemployment is likely to be running at more than 40 percent. Inflation could reach 100 percent this year. Indonesia's currency has lost so much of its value that many Indonesians no longer can afford food and basic necessities. The economy has ground to a halt because Indonesians cannot afford the raw materials to produce, and international investors have pulled out and have yet to return. Thus, it is not surprising that half the population has slipped below the poverty line and that, by year's end, Indonesia's economy will have shrunk by 15 to 30 percent. To make matters worse, predictions of severe food shortages later this year have raised fears of renewed social unrest.

There are still reasons for hope, however. Indonesia possesses great natural resources, including oil, natural gas, timber, minerals, and rich farmland. It has an impressive transport infrastructure, a large consumer market, and a young and well-educated work force that is very attractive to manufacturers. Moreover, under new President B. J. Habibie, Indonesia has made progress toward the political reforms necessary to restore investor confidence, spark renewed growth, and lead to a democratic political system. Habibie has called for new parliamentary elections in mid-1999, allowed the formation of political parties, relaxed press restrictions, released political prisoners, and started to resolve the issues of East Timor and the role of the military in Indonesian society.

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But much remains to be done. Before prosperity and stability can return, Indonesia must overcome its long legacy of corruption and "crony capitalism." This corruption and favoritism must cease so that Indonesia's economy can operate on a level playing field guided by the rule of law. This will rebuild international confidence and attract investors. A good first step would be reform of Indonesia's legal system to create an independent judiciary and make clear that the law applies to everyone. Indonesia also could create a better business environment by reducing its barriers to trade, which Suharto used to benefit the business interests of his family and friends. Agricultural reform is necessary: Production subsidies must be reduced and price controls eliminated to enhance farm productivity and create incentives for production. Finally, Indonesia must attempt to regain the trust of its ethnic Chinese minority, which controls more than 70 percent of Indonesia's wealth and comprises an important part of the distribution system. Indonesia has a history of mistreating its Chinese population, and many Chinese fled the country when targeted by violence during the May riots. Habibie must allay the fears of the Chinese: If they are willing to reinvest in Indonesia, international financiers are likely to follow suit.

The United States has a great interest in a prosperous and stable Indonesia that continues to evolve toward democracy. By assisting Indonesia to recover economically, the United States could foster a broader economic recovery in Asia as well. This would be vital to U.S. interests because, by some estimates, Asia's financial crisis could slash $120 billion from U.S. gross domestic product by next year. Indonesia is important to the United States in terms of Asian security, too. It sits astride vital sea lanes through which 40 percent of the world's shipping passes, including 80 percent of Japan's oil supply and 70 percent of South Korea's. And Indonesia, the world's largest Muslim state, has acted as a moderate force in the Islamic world.

To facilitate reforms to revive Indonesia's economy and encourage its transition to a democratic political system, the United States should:

- Invite Indonesia's President to Washington after sufficient progress has been made toward reform.
- Accelerate delivery of food aid to forestall the possibility that widespread shortages will lead to renewed rioting, setting Indonesia back further and wiping out the gains already made.
- Urge Indonesia to increase economic and legal transparency to establish confidence in the rule of law.
- Urge Indonesia to open its banking system to fuller disclosure and to strengthen supervision so that future crises can be averted. The United States could share the hard-won lessons of its savings and loan crisis of the late 1980s both in liquidating insolvent banks and effectively regulating those that survive.
- Urge Indonesia to remove barriers to trade and investment so that investors might return and the economy can start moving again.
- Offer Indonesia the benefit of U.S. experience in building democracy as it engages in political party-building activities in preparation for next year's elections.
- Promote reforms within Indonesia's military and rebuild U.S.–Indonesia military ties. Restoration of the International Military Education and Training program would encourage respect for human rights and an evolution toward civilian control in Indonesia.

Just as Indonesia's economic crisis has caused tremendous suffering, it also offers the opportunity to adopt a far better economic and political order. By offering its assistance, the United States can help Indonesians emerge from their crisis and perhaps build the world's third-largest democracy. An economically reformed and democratic Indonesia would make a worthy strategic partner for the United States in Asia.

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Indonesia's Economic and Political Crisis: A Challenge for U.S. Leadership in Asia

John T. Dori

Indonesia, the country hardest hit by the Asian economic crisis, is relatively calm now. Last May, however, violent demonstrations and looting resulted in more than 1,000 deaths and hastened the end of President Suharto's 32-year reign. These disturbances had begun as peaceful demonstrations against the Indonesian government's insufficient response to the hardships of the economic crisis. A monetary crisis that began in the summer of 1997 exposed broader financial weakness, causing investors to flee Indonesia's financial markets and leading to the collapse of the country's financial system. This year, Indonesia's economy may contract by 30 percent; unemployment is running at upward of 40 percent.

President B. J. Habibie, Suharto's hand-picked successor, has had to grapple with the enormous challenges of promoting broad economic and political reform simultaneously. He has committed to holding national elections next year, and new political parties are forming in response to his early moves to create a more open political system. Even the students whose protests helped to force out Suharto seem ready to give Habibie a chance.

But the current calm could prove illusory. Predictions of dire food shortages as early as this fall raise the prospect of renewed violence and rioting that could lead to a second Indonesian political crisis. The United States should do what it can to help Indonesia to avoid further economic dislocation and violence, and to safeguard and advance the tentative steps toward economic and political reform that have been made since President Suharto's ouster.

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To minimize the chances of widespread hunger leading to renewed social chaos in this strategically important country, the United States should accelerate delivery of emergency humanitarian food assistance. More important, to reduce the possibility even more of future crises, including food shortages, the Clinton Administration should offer Indonesia guidance on sorely needed free-market economic reforms and democratic political reforms. It also should move to rebuild ties with Indonesia's politically important military to encourage its evolution toward civilian rule and increased respect for human rights. Finally, if Indonesia continues on a path of positive economic and political reform, U.S. President Bill Clinton should invite President Habibie to visit Washington, both to express support for the positive strides Indonesia has made and to encourage continuation of the process. By setting Indonesia on the path toward political freedom and renewed economic prosperity, the United States will foster the growth and development of a potential strategic ally and partner in the critically important Southeast Asia region.

INDONESIA'S ECONOMIC COLLAPSE

Indonesia's current economic crisis can be traced to Thailand, in early 1997, where Asia's economic crisis first manifested itself. Thailand's currency, the baht, was the first regional currency to crumble, as a result of several factors including imprudent domestic lending practices, an imbalance between short-term and long-term financing, and an unrealistic exchange rate pegged to the U.S. dollar. International Monetary Fund (IMF) recommendations that Thailand devalue the baht also contributed to this process by undermining confidence in the value of the currency. Currency speculators began a run on the baht when doubts grew about Thailand's ability to maintain the dollar peg. The Bank of Thailand, the country's central bank, attempted to support the value of the baht; but, by early July, its foreign reserves all but depleted, the bank decided to let the baht float. The baht fell quickly by 10 percent and continued to weaken, prompted by a lack of confidence in the fundamental health of Thailand's economy, primarily its banking and financial sectors.

Indonesia's experience was similar. By August 1997, currency speculators had begun to recognize in Indonesia many of the same vulnerabilities that had appeared in Thailand, especially an unhealthy reliance on short-term debt financing. After the fall of oil prices in the late 1980s, Indonesia removed controls on the flow of capital, but moved slowly to deregulate financial services. Some 200 small, private banks were created during this period, but they were poorly managed and prone to make risky or politically motivated loans.

During the 1990s, Indonesian companies took advantage of good economic times to rack up foreign debt, which quickly ballooned to about $80 billion with the rapid depreciation of Indonesia's currency, the rupiah. These loans financed speculative investments in such areas of Indonesia's economy as real estate. Unfortunately for Indonesia, a high proportion of this debt was short-term, carrying an average maturity of 18 months. Such short-term debt arrangements as these are not necessarily risky so long as economic growth and stability proceed apace. After more than 30 years of steady economic progress, businesses did not seem to fear an economic downturn or, least of all, a devaluation of the rupiah, which would make it more difficult for them to repay their short-term, dollar-denominated debt obligations.

But in the wake of Thailand's currency devaluation, Indonesian borrowers came to question the continued strength of the rupiah. They attempted to limit their exposure by selling rupiahs and buying dollars. The rapid flight out of rupiahs and into dollars put a great deal of downward pressure on the value of Indonesia's currency. As was the case in Thailand, Indonesia's central bank at first attempted to prevent the fall of the rupiah's value. But with its foreign reserves dwindling, the central bank eventually decided to let the rupiah float. This set off a rapid depreciation in the value of the rupiah, undoubtedly exacerbated by Indonesia's uncertain political future under President Suharto and a lack of confidence that the corruption-ridden government could deal effectively with the burgeoning crisis.

The collapse of Indonesia's currency brought the country's economy to a standstill that essentially persists to this day. Borrowers are unable to repay their debts. Indonesian banks cannot secure foreign loans. As a result, banks are pushed into insolvency and are unable to provide the credit that could spark economic activity and foster growth. Without access to export financing, exporters are unable to earn hard currency by selling their products abroad. Manufacturers and producers no longer can afford the inputs and raw materials required to assemble their products. Because these manufacturers and producers earn no money from production, they cannot service their debts to banks and other creditors, and the process begins again.

CONTINUING HARDSHIP FOR INDONESIA

Although political conditions have stabilized somewhat since President Suharto's resignation, Indonesia's near-term economic forecast remains grim. The economy is set to contract by some 15 percent to 30 percent in 1998.[1] Inflation is likely to reach 80 percent to 100 percent this year.[2] Unemployment probably has passed 40 percent. The rupiah has lost so much of its value that most of the country's banks technically are insolvent and its businesses bankrupt because of their inability to repay their debts. And despite the conclusion of four economic stabilization agreements with the IMF since autumn 1997, Indonesia's economy remains in a state of financial collapse. The fall of the rupiah, along with IMF-inspired rates of interest as high as 50 percent to 60 percent, has made credit prohibitively expensive, further depressing economic activity in the country.[3] Even well-run Indonesian companies have been forced into insolvency by the high rates of interest. It is not surprising, therefore, that half the population has slipped below the poverty line, and that many Indonesians are unable to afford even basic necessities.

In addition, there is the possibility of food shortages. A serious drought last year severely damaged rice production. By early 1998, there were alarming predictions that Indonesia would need 4 to 5 million tons of rice by next year to prevent starvation in some areas.[4] Although the government has imported rice to meet current needs, weather problems may cause further shortages into next year. The government predicts a rice shortfall this year of over 3 million tons; others, however, estimate that shortages may exceed 10 million tons.[5] Indonesia has welcomed food aid. Australia has extended $130 million in humanitarian assistance since 1997. Japan has pledged to give 1 million tons of rice, and the United States has pledged 1.5 million tons of wheat.

But there are hopeful indicators, too. Indonesia possesses great natural resources: oil, natural gas, timber, minerals, and good farmland. Indonesia has built an impressive transport, communications, and education infrastructure, and offers a large consumer market. Indonesia also has a young, well-educated workforce that is very attractive to manufacturing industries. The rupiah, which acts as a barometer of international confidence in Indonesia's financial prospects, has become stronger recently: After bottoming out at more than 17,000 to the dollar under President Suharto, the rupiah has been increasing in value since President Habibie assumed power, reaching the 13,000 mark. Although this level is far from what Indonesia's economy needs to function normally, it demonstrates that international financial markets are prepared to reward Indonesia for demonstrated progress toward economic and political reform and social stability.

NEEDED REFORMS

President Habibie has made some progress toward reforming Indonesia's economy. For example, on July 24, Indonesia's Parliament passed a new bankruptcy measure that will update the country's archaic and inefficient bankruptcy procedures and bring them more closely into

1. By comparison, during the Great Depression, the U.S. economy contracted 25 percent over four years.
2. Robin Wright, "Indonesia Facing Economic Meltdown, Experts Warn," *The Los Angeles Times,* July 31, 1998, p. A1.
3. A consistent hallmark of the various IMF stabilization agreements with Indonesia has been the insistence on keeping interest rates high in an attempt to attract investment and restore the value of the rupiah. The actual effect, however, has been to choke off economic activity because interest rates were set prohibitively high, with attendant negative consequences for investment.
4. Bernard Estrade, "Spectre of Famine Haunts Suharto Regime," *Agence France Presse,* February 24, 1998.
5. "Rice Shortage May Reach 10 Million Tons; Scientist," *Jakarta Post,* July 24, 1998.

REVISED IMF PROGRAM FOR INDONESIA

June 24, 1998

Fiscal Policy

- To quicken the drive toward increased government transparency, provisions of the Non-tax Revenue Law of May 1997 were accelerated to require all off-budget funds to be incorporated in budget within three years (instead of five years).

Monetary and Banking Policy

- The minimum capital requirements for existing banks were reduced.
- All restrictions on bank lending were eliminated except for prudential reasons or to support cooperatives or small-scale enterprises.

Financial Services Sector

- An independent review committee was established to enhance the transparency and credibility of the Indonesian Banks Restructuring Agency's (IBRA) operations. Also, it was announced that the issuance of a presidential decree was expected by mid-July 1998 to provide appropriate legal powers to IBRA, including its asset management unit. Plans were to be prepared for the sale of at least one-quarter of IBRA banks in 1999. And it was announced that IBRA will continue to take control of or freeze additional banks that fail to meet liquidity or solvency criteria.
- Six private banks were declared insolvent and their shareholder equity written down.
- A plan was to be announced for restructuring state banks through mergers, transfers of assets and liabilities, or recapitalization prior to privatization.
- All banks were to undergo financial reviews by internationally recognized audit firms.
- A draft law institutionalizing the autonomy of the Bank of Indonesia (BI), Indonesia's central bank, was to be submitted to Parliament. Also, BI credits to public agencies and public sector enterprises were to be limited and phased out. Additionally, BI's bank supervision department was to be strengthened in order to strengthen enforcement of regulations. A program was to be established for divestiture of BI's interests in private banks.
- A deposit insurance plan was to be introduced.

Privatization

- Forest concessions were to be auctioned and concession periods lengthened.
- A draft amendment to the banking law, incorporating procedures for the privatization of state banks, was to be submitted to Parliament.
- A clear framework for the reform of all 164 state enterprises, including privatization and restructuring, was to be established. A plan was to be developed for closing nonviable public enterprises.
- Initial sales of additional shares of listed state enterprises, including the domestic and international telecom corporations, were to begin after mid-July 1998.

Trade and Investment Liberalization and Competition Policy

- The list of activities closed to foreign investors was to be revised and shortened.
- Submissions to Parliament were to propose eliminating restrictions on foreign investments in listed banks and removing limits on private ownership of banks.
- Quotas limiting the sale of livestock were to be abolished.
- A draft law on competition to prevent the abuse of dominant position and practices that restrict or distort free competition was to be submitted to Parliament.
- Nonviable public enterprises were to be audited.
- All export restrictions were to be eliminated. Remaining import restrictions and other non-tariff barriers were to be phased out, as was the local content program for motor vehicles. Tariffs on non-food agricultural products were to be gradually reduced to a maximum of ten percent.

accord with those of the United States.[6] It appears, however, that President Habibie's interest in economic reform is geared primarily toward meeting the minimum requirements for the continuation of international financial assistance, which includes a $43 billion IMF financial assistance package tied to an economic reform program. The World Bank and over 30 countries comprising the Consultative Group on Indonesia have pledged another $7.9 billion in aid to Indonesia.[7]

Continued large-scale foreign assistance, however, cannot provide a lasting solution to Indonesia's economic crisis. Suharto's government continually hedged or refused to advance needed economic reforms while the IMF and other aid agencies continued to provide assistance. Indeed, organizations like the World Bank reportedly knew their loans to Indonesia were being funneled to Suharto family businesses. The World Bank also turned a blind eye toward corruption in projects it funded and accepted false government economic statistics to allow Indonesia to get better credit ratings.[8] The real answers to Indonesia's economic crisis are to be found in responding to the economy's need for broad reform in its financial, legal, trade, and agricultural sectors. These reforms are needed to respond to the stifling policies of the Suharto years that allowed selected cronies to act above the law, maintain market-distorting monopolies, and sustain unsound banks. The Suharto family is estimated to be worth over $30 billion; President Suharto's allies still remain in control of substantial portions of Indonesia's economy.[9] Significant reforms are needed in the following areas:

Financial Sector Reform

Key to Indonesia's eventual recovery is the reform and rebuilding of its financial sector, which is the heart of the economy, pumping the credit needed to sustain economic activity. But prior to the onset of the current crisis, Indonesia's banking sector was weak. Easy access to foreign capital in the late 1980s spurred the creation of about 200 small, private banks, in addition to a much smaller number of large banks. This, it now seems, was too many banks for Indonesia's market to sustain, and many were managed poorly and prone to making risky and politically motivated loans. Lax enforcement of central bank rules pointed to a lack of transparency and disguised the fact that many banks were undercapitalized or insolvent even before the onset of the financial crisis. The credibility of the banking system suffered. When the government closed 16 insolvent banks in November 1997, instead of instilling confidence, it led to a run on banks by depositors. This, in turn, caused foreign lenders to deny credit to Indonesian banks, severely depressing economic activity.

Although Indonesia's banking sector does require liquidity, or the ability to make loans, the fundamental requirement is for structural reform to restore foreign confidence and lending. The Indonesian government's closing of 16 insolvent banks last year caused a run on other banks, but it was the correct move to begin banking sector restructuring. Last January, the Indonesia Bank Restructuring Agency (IBRA) was created to rehabilitate unsound banks. The IBRA also is helping to consolidate banks so that Indonesia will have fewer, but more viable, banks. Another IBRA goal is to increase transparency in the banking

6. For an overview of the strengths and weaknesses of Indonesia's new bankruptcy law, see Frank Taira Supit, "Indonesia's Phoenix?" *Far Eastern Economic Review,* July 9, 1998, p. 26. Supit argues that, even though severe deficiencies exist with the new procedures, they will prove ultimately to be a positive force for Indonesia's economy by promoting entrepreneurship and preventing the recurrence of "past excesses."
7. "Main Points of Donors Statement on Aid for Indonesia," *Agence France Presse,* July 30, 1998.
8. Marcus W. Brauchli, "Why the World Bank Failed to Anticipate Indonesia's Deep Crisis," *The Wall Street Journal,* July 16, 1998, p. A1.
9. Keith B. Richburg, "Cashing in on Years in Power; Billions Flowed to 'Suharto, Inc.,'" *The Washington Post,* May 22, 1998, p. A40.

Map 1 B 1214

sector, a goal that may be promoted by a recent decision to have the central bank led by a collective board rather than by an individual governor who could be vulnerable to political influence.[10]

Legal Reform

Success in financial sector reform depends heavily on reform of the legal system. For example, even though Indonesia has long had a bankruptcy law, it was very difficult to get enforcement from the courts. Politically connected businessmen could not fail, and thus had less of an incentive to invest responsibly. Average Indonesian citizens, as well as foreign corporations, need to know that one law applies to all. For too long, the family and friends of the Suhartos operated above the law, obtaining special treatment for themselves and their business interests. Even at the provincial level, the economic and political power of the Suharto clan stifled business and job creation.[11]

Under President Habibie, legal reform has not received a high priority.[12] Opposition leader Amien Rais noted in early July that the "law applies only to those who are weak."[13] As part of the Ministry of Justice, Indonesia's judges lack independence from the bureaucracy. They also are underpaid, which invites corruption.[14] An independent judiciary would go far to promote the rule of law and greater confidence in Indonesia's economy.

Reducing Trade Barriers

Under the Suharto regime, Indonesia maintained a number of tariff and nontariff barriers to trade. It is important to reduce or eliminate these barriers to create a better business environment for Indonesians as well as for foreign investors. As a participant in the Association of Southeast Asian Nations (ASEAN) Free Trade Area, Indonesia has pledged to reduce most tariffs on imports to about

10. "Bank of Indonesia to Be Led by Board of Governors," *Asia Pulse,* July 31, 1998.

11. Margot Cohen, "Reforming the little Suhartos," *Far Eastern Economic Review,* July 8, 1998, p. A13.

12. "Law Experts Pessimistic About Legal Reform," *Jakarta Post,* July 15, 1998.

13. "Amien Sets Out His Agenda for Total Reform," *Jakarta Post,* July 1, 1998.

14. "Better Salary Key to Boosting Judges' Integrity and Quality," *Jakarta Post,* May 4, 1998.

5 percent by 2003. U.S. industries, however, have complained about tariffs and taxes that reduce their competitiveness in motorcycles, toys, wine, films, videos, and air conditioning equipment.[15] Licensing requirements have acted as a de facto import ban on such items as motorcycles, wine, films, and videos.

President Suharto used barriers and restrictions, including tariffs and monopolies, to benefit the business interests of his family and political allies. Many Suharto family members ran conglomerates, which, when viewed in total, touched almost every aspect of Indonesia's economy. In one celebrated case that Indonesia lost before the World Trade Organization (WTO), the country was ruled as having broken WTO rules by giving tax breaks to President Suharto's son, Hutomo Mandala Putra (also known as Tommy Suharto) to allow him to import Korean cars, thereby putting all other car importers at a disadvantage.[16] Long-time Suharto ally "Bob" Hasan had a virtual monopoly on the lucrative plywood trade. Such intervention in the market on behalf of a chosen few denies opportunity to new and potentially more competitive companies, which, over time, weakens a country's competitiveness.

Agricultural Reform

It is essential that Indonesia's government tackle the difficult task of reducing its role in the agricultural sector and giving more power to market forces. That agriculture employs 55 percent of the Indonesian workforce[17] makes such reforms politically sensitive. The Suharto regime promoted self-sufficiency in food grains like rice as a nationalist goal, which served also to promote employment in agriculture. To keep rice prices low, the government shouldered expensive subsidies for such inputs as fertilizer and fuel. These subsidies now are a major burden for the government, but they form the basis of a critical economic safety net. By keeping rice prices low, the government also creates a disincentive to production[18] because farmers' profits are limited by price controls. Although reductions in subsidies should be phased in over time to avoid a political backlash, a program that allows the market gradually to set rice prices will increase farm incomes, creating incentives to expand production, promoting the use of private finance sources, and, in turn, strengthening the banking sector. Greater farm incomes also will serve to reduce the need for expensive subsidies.

Reviving the Confidence of Indonesia's Chinese Community

During the current crisis, Chinese businesses and individual Chinese have been targets of violence in Indonesia. Although there is long-standing racial resentment against them, Indonesia's ethnic Chinese are critical to the functioning of the country's economy. Comprising only 2 percent of the population, the ethnic Chinese control upward of 70 percent of the wealth and are a large part of the country's merchant distribution system. President Habibie has handled the ethnic Chinese issue poorly. On the one hand, he said that he welcomed the return of the Chinese, many of whom fled Indonesia because of the violence directed against them; on the other, President Habibie declared that Indonesia could get by without them. It is important for Indonesia's economic recovery that the government work to regain the trust of the ethnic Chinese. If they are willing to reinvest in Indonesia, international financiers may follow their lead.[19]

POLITICAL REFORM

Indonesia's challenge is compounded by the fact that it must overhaul its political system at the same time that it seeks to revive its economy. Since

15. United States Trade Representative, *1998 National Trade Estimate Report On Foreign Trade Barriers*, Washington, D.C., 1998, p. 176.

16. "WTO Ruling Has No Effect on Timor Car, Analysts Say," *Jakarta Post*, March 28, 1998.

17. Central Intelligence Agency, *The World Fact Book, 1997–98*, p. 233.

18. "Agriculture Needs Market-Oriented Policy," *Jakarta Post*, June 9, 1998.

taking power, President Habibie has made progress in advancing political reform, changing the role of the military, and addressing the contentious issue of the status of East Timor. Perhaps most important, he has called for new parliamentary elections to be held in mid-1999. President Habibie also has allowed the formation of new political parties, released some political prisoners, and relaxed press restrictions. The pace of change has been rapid: Already more than 40 political parties have sprung up, and there are predictions that the total could reach 100. Eventually, however, observers expect three or four large groups to emerge: the ruling GOLKAR[20] Party; a new opposition party led by Suharto opponent Megawati Sukarnoputri; a large Islamic-oriented party led by Amien Rais; and perhaps another large Muslim group led by Abdurrahman Wahid, possibly acting in alliance with Megawati Sukarnoputri.

Even the students whose anti-Suharto demonstrations led to the first change of regime in Indonesia in 32 years seem willing to give President Habibie's reforms a chance. Large-scale demonstrations against the regime have ceased while the students assess the new political environment and see just how far the reform process will proceed. Empowered by their street protests this past spring, Indonesian students are likely to become more organized and willing to resume protests should President Habibie stray significantly from the path of reform.

But even though a great deal of progress has been made, Indonesia faces a daunting task as it prepares for next year's elections to Parliament. As the International Republican Institute points out in a review of Indonesia's political reform process,

> The tasks necessary to overhaul the entire Indonesian electoral and political system are monumental. Some of the many tasks include the drawing of constituency boundaries, registration of over 100 million voters spread across 12,000 islands, registering as many as 100 new political parties and verifying signatures of millions of party supporters, nationwide civic education on the new electoral system and the organizational and operational development of viable, new political parties.[21]

After the mammoth undertaking of electing a new Parliament, a great deal of work will remain. Indonesia's 1945 Constitution needs to be revised and updated to legalize political parties, regularize the President's term of office, perhaps institute a more federal system of government that would allocate enhanced power to provincial and local governments, and address the special status of the military in Indonesian society.

Previously the key pillar of President Suharto's rule, Indonesia's military, usually called the ABRI,[22] is evolving toward greater civilian control. President Suharto's son-in-law, the former commander of an elite special forces unit and once one of the country's most powerful military leaders, currently is under investigation in connection with the disappearances of political activists in the months leading up to President Suharto's resignation. ABRI leader General Wiranto is removing from key military positions many supporters of the former President.[23] Many observers expect that the formal role of the ABRI in the government will be diminished, although any such attempt may prove controversial. Although the high command

19. Wealthy Chinese that could help Indonesia are angry. On July 28, Wang You-theng, chairman of the General Chamber of Commerce of the Republic of China, called for a suspension of Taiwanese investment in Indonesia to protest violence against ethnic Chinese. For a sober and enlightening assessment of the future role of ethnic Chinese in Indonesian society, see Jusuf Wanandi, "The Road Ahead," *Far Eastern Economic Review*, July 30, 1998, p. 35.

20. GOLKAR is an abbreviation for Golongan Karya, which means, literally, "Functional Group."

21. International Republican Institute, "Indonesia Political Situation Update," July 15, 1998.

22. ABRI is the commonly used acronym for Angkatan Bersenjata Republik Indonesia, which translates to "Armed Forces of the Republic of Indonesia."

23. "Army Purge," *Far Eastern Economic Review*, June 18, 1998, p. 8.

is moderately supportive of efforts to redefine the role of the ABRI in Indonesian society, there is the good chance that other military leaders will be reluctant to cede too much of its power and position.

President Habibie has offered wide-ranging negotiations toward an autonomy plan for East Timor, which Indonesia annexed in 1976. The government has been accused of numerous human rights abuses in East Timor, a largely Christian enclave that was a colony of Portugal. Although Jakarta did develop East Timor economically, there has been considerable internal opposition to Indonesian rule, including armed resistance. Portugal and other states have led international opposition to Indonesia's annexation. Even though Jakarta opposes complete independence—long sought by opponents to Indonesian rule—President Habibie appears ready to allow local rule except in the areas of foreign policy, external defense, and monetary and fiscal policy.[24] In a show of good faith, President Habibie withdrew 1,000 troops from East Timor in late July and early August. There are fears, however, that too rapid a government withdrawal from East Timor could lead to violence among competing factions.[25]

AN IMPORTANT FRIEND OF THE UNITED STATES

The United States has a significant interest in an economically prosperous, politically stable, and democratic Indonesia. Indonesia was the 23rd largest trading partner of the United States in 1997. It purchased more than $4.5 billion in U.S. exports last year, in the process supporting more than 60,000 American jobs. Helping Indonesia's economic recovery also will revive U.S.–Indonesia trade, which will decline precipitously this year. Helping Indonesia's recovery also could assist broader economic recovery in Asia, which is in the interest of the United States as well. There are estimates that the economic downturn in Asia will have a negative effect on the U.S. economy. According to William W. Beach, John M. Olin Senior Fellow in Economics and director of The Heritage Foundation's Center for Data Analysis, Asia's economic crisis could lead to a $120 billion loss in U.S. gross domestic product by the end of 1999.[26] This means fewer U.S. exports and over 1 million fewer U.S. jobs.[27]

Indonesia is important as well to the security of the United States. Indonesia sits astride strategic sea lanes connecting the Indian and Pacific Oceans through which passes 40 percent of the world's shipping, including 80 percent of Japan's oil supply and 70 percent of South Korea's. Indonesia has been suspicious of China's intentions in the region and has worked within ASEAN to convince China to modify its claims to most of the South China Sea. In recent years, the United States and Indonesia have affirmed their interest in regional security by engaging in military exercises, some in Australia. And, as the world's largest Muslim state, Indonesia has been a welcome moderating force in the Islamic world.

The United States should champion reforms that revive Indonesia's economy and encourage its transition to a democratic political system. To facilitate these changes more effectively, the United States should:

- **Invite Indonesia's President to Washington after more progress has been made toward political reform.** The United States should send a clear message to the Indonesian people

24. Portugal and the United Nations have been working with Indonesia to promote an autonomy arrangement for East Timor. See, for example, John M. Goshko, "Progress Made in East Timor Dispute; Indonesia, Portugal Pledge to Pursue 'Wide-Ranging Autonomy' for Territory," *The Washington Post*, August 6, 1998, p. A22.
25. José Manuel Tesoro, "A Legacy of Bitterness," *Asiaweek*, August 7, 1998, p. 32.
26. William W. Beach, "What a Worsening of the Asian Crisis Might Mean for U.S. Economic Performance," charts distributed at an Asian Studies Center symposium on the East Asian economic crisis held at The Heritage Foundation on July 13, 1998.
27. *Ibid*.

that Americans support their desire for democratic and economic reform. After Indonesia has completed such planned reforms as a new political party or election law, possibly by the end of the year, the Clinton Administration should invite President Habibie to visit Washington. Such a visit could help to provide a much-needed boost to confidence; it also would offer U.S. officials the opportunity to encourage President Habibie to continue economic and political reforms—which are needed much more in order to rebuild foreign investor and broader economic confidence in Indonesia.

- **Accelerate delivery of humanitarian food aid while pressing Indonesia to free its agricultural markets.** The Clinton Administration's commitment of up to 1.5 million tons of wheat and 50,000 tons of rice was a good first step. The delivery of this food aid should be stepped up, however, to ensure that it reaches Indonesia before expected shortages become acute later this year or early next year. Providing such aid is a relatively easy way for the United States to develop good will with the Indonesian people and help Indonesia to alleviate tensions that could lead to renewed political unrest. Along with this food aid, the United States should urge Indonesia over time to introduce market forces into its agricultural sector, such as decontrolling rice prices. Even though this could cause farm prices to rise, affecting consumers, it also would give incentives to farmers to plant more, which could prevent future shortages.
- **Urge Indonesia to increase economic and legal transparency.** Greater transparency in Indonesia's economy potentially could have prevented the spread of the financial crisis to Indonesia in the first place. If attention had been called sooner to the increasingly vulnerable international borrowing positions of Indonesian businesses, the effects of the crisis could have been mitigated, at the very least. To enhance transparency, the United States should urge Indonesia to adopt Generally Accepted Accounting Principles and financial disclosure statements comparable to U.S. standards. It is especially important that Indonesia adopt these more stringent standards as it attempts to regain international confidence in the wake of its long history of corruption and favoritism associated with "crony capitalism." It is critical, too, that Indonesia institute and enforce laws that prevent monopoly domination of specific areas of economic activity by single companies or groups. Of course, reform of the legal system, to include rooting out corruption and creating a truly independent judiciary, is the foundation on which every other reform—economic, political, or social—will be built.
- **Urge Indonesia to open its banking system to fuller disclosure and to strengthen prudential supervision.** Because many banks were in a precarious financial condition even before the crisis began, it stands to reason that fuller disclosure in the banking sector also could have mitigated or headed off entirely the effects of the crisis. Enhanced disclosure would minimize the likelihood of debilitating system-wide runs on banks by helping the public to discriminate between solvent and insolvent banks. But increased disclosure in and of itself is not sufficient: Indonesia's history of corruption and favoritism makes it imperative that regulatory officials examine the books of banks and other financial services firms regularly to identify fraud, self-dealing, and risk-management problems before they grow so large as to threaten insolvency. Increased disclosure and supervision could have the effect of aggravating the banking crisis in the short term, as the true financial condition of poorly run banks is revealed, but these measures are essential to creating the financial superstructure on which future growth can occur.
- **Offer the benefit of U.S. experience in liquidating insolvent banks.** The U.S. savings and loan crisis of the 1980s generated a wealth of experience in dealing with the types of issues currently confronting Indonesia. As it struggles to increase the degree of transparency in its economy, Indonesia could benefit from

U.S. banking and financial regulatory experience. Indonesia should take advantage of the experience of the United States in these areas to avoid errors and pitfalls that could deepen the crisis and prolong recovery.

- **Urge Indonesia to remove barriers to trade and investment.** Indonesia is in desperate need of trade and investment as it struggles to emerge from its economic morass. Increased hard currency earnings from these activities could mean the difference between continued paralysis and economic recovery. Therefore, Indonesia should remove, to the maximum extent possible, such restrictions on foreign trade and investment as tariffs, quotas, export taxes, nontariff barriers, and prohibitions against foreign ownership or investment. The United States should praise Indonesia's commitment to lower tariffs as part of the ASEAN Free Trade Area and urge Indonesia to fulfill scheduled tariff reductions by 2003.

- **Offer Indonesia the benefit of U.S. experience in building democracy.** New political parties are springing up daily in Indonesia, but they all lack experience in the functioning of a genuine democratic political systems due to the severe restrictions on political activity of the Suharto era. The National Endowment for Democracy should provide such American organizations as the International Republican Institute and the National Democratic Institute to help teach new Indonesian parties democratic skills. These and other organizations with electoral experience and expertise also could offer to serve as election monitors to assure that next year's elections to Parliament are free and fair.

- **Promote reforms in Indonesia's military and rebuild U.S.–Indonesia military ties.** Considering the important role of the military in Indonesian society, the United States should build good relations with the ABRI and, where appropriate, promote greater professionalism and evolution toward civilian control. It should urge Indonesia's government to investigate past military abuses, especially in East Timor and during unrest earlier this year. In addition, the United States should not cooperate or conduct exercises with the Indonesian special forces units suspected of conducting these abuses. It should cooperate, however, with less political branches of Indonesia's military, like the air force and the navy. The United States also should praise Indonesian efforts to place the military under greater civilian control. One way to promote military reform would be the restoration of the U.S. International Military Education and Training program with Indonesia. This program allows foreign military officers to study in the United States and witness firsthand the relationship between the U.S. military and civil society. President Suharto suspended Indonesian participation in this program in June 1997 because of U.S. congressional criticisms of human rights abuses in East Timor. Both the Clinton Administration and Congress should make clear their interest in resuming this program.

CONCLUSION

Indonesia's present economic and political crisis presents a key challenge to U.S. leadership in Asia. Indonesia has been devastated by an economic crisis comparable to the U.S. Great Depression. At the same time, Indonesia is beginning a political reform process that many Indonesians hope will reverse the effects of years of strict political authoritarianism and economic autocracy. By offering targeted assistance, the United States can help Indonesians to emerge from their crisis and perhaps to build the world's third-largest democracy. By helping in Indonesia's economic recovery, the United States can lessen the impact of Asia's economic crisis on the U.S. economy. Although offering humanitarian food assistance and necessary economic advice to prevent a second Indonesian political crisis, the United States also should encourage Indonesians to consolidate free-market economic reforms that promote transparency in the financial sector and reduce the government's role in the economy. The United States also can offer advice to help new political parties to learn democratic skills. Just as important, it should rebuild ties to Indonesia's military as it promotes reform in that institution.

Just as Indonesia's economic crisis has caused tremendous suffering, it also has presented the prospect of a far better economic and political order. Indonesia has tremendous potential in its resources, educated workforce, and large consumer market. As a strategically located country with the world's fourth-largest population, an economically reformed and democratic Indonesia would be a worthy strategic partner of the United States in East Asia.

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