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# The Politics of Economic Reform Implementation

## An Analysis of the Indonesian and the South Korean Implementation of IMF Reforms during the Asian Economic Crisis 1997-98

**Thale Berg Husby**

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Department of Political Science,
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5th of March 2002

## Abbreviations

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| ADB | Asian Development Bank |
| APEC | Asia-Pacific Economic Cooperation |
| BAPPENAS | The National Planning Board in Indonesia |
| BULOG | Badan Urusan Logistik (National Logistics Agency in Indonesia) |
| EPB | Economic Planning Board in South Korea |
| FDI | Foreign Direct Investment |
| FEER | Far Eastern Economic Review |
| GDP | Gross Domestic Product |
| IBRA | Indonesian Bank Restructuring Agency |
| IMF | International Monetary Fund |
| IPTN | Industri Pesawat Terbang Nusantara |
| MITI | Ministry of International Trade and Industry in Japan |
| MOFE | Ministry of Finance and Economy in South Korea |
| NICs | Newly Industrialised Countries |
| SEA | Southeast Asia |
| SOE | State-owned Enterprise |
| USD | American Dollars |
| VAT | Value Added Tax |
| WB | The World Bank |
| WTO | World Trade Organization |

## CHAPTER 1 INTRODUCTION

During the summer of 1997 the world witnessed an economic crisis in Asia that came as a surprise to many observers. Few had predicted that the apparently successful economies in the Asian region would suddenly experience severe problems in the late 1990s.[1] The countries of the Asian region had for many years been very successful, and one had often heard expressions like 'look to Japan' and 'the East Asian miracle', in relation to this region's impressive economic growth. It was clear from the start that the economic crisis in 1997 had serious impacts on the states affected, both in terms of economic consequences and not at least in social costs. There were many attempts to explain the causes of the Asian economic crisis, and scholars disagreed about what went wrong. Quite a few blamed the crisis on the 'Asian way' of economic development and the tight relationship between the business sector and the state.[2] Other commentators saw the globalised economy and international financial panic to be the main causes.[3] What surprised me about this discussion was the seeming lack of concern for the domestic *political* aspects of the crisis management and the subsequent implementation of the International Monetary Fund's (IMF) economic and structural reforms.[4] Many commentators have payed a great deal of attention to the macroeconomics of the reforms, while most scholars tend to ignore the political aspects of the crisis management and the following implementation of economic reforms.[5] Few have commented on this particular aspect, and rather stressed political factors as *causes* to the crisis in using vague terms like 'crony capitalism', 'weak political leadership' and 'autocratic governments'.

### 1.1 The theme

When one witnessed how differently the Asian governments responded to the crisis in terms of effectiveness, questions concerning domestic politics and the political institutional structures of these countries seem central. This observation is my point of departure, and I will in this thesis explore **how national political factors influence governments' implementation of IMF reforms.** This thesis' research design is build around how national political actors, like the bureaucracy, the presidency, and various social groups, can influence the implementation of IMF reforms. The question of how politics affect economic policy decision-making is a much-debated

[1] Asian region is here defined as East Asia and South East Asia. Central and South Asia are excepted from this definition
[2] See, for example Rudolph & Arumugam 2000 and The Economist 1998
[3] See for example Wade & Venoroso 1998 and Radlet & Sachs 1998
[4] When I in the following refer to IMF's **economic** reforms, it includes both structural and economic reforms
[5] There are mainly two books that have been concerned with the political economy of the Asian Crisis, see Haggard (2000) and T.J.Pempel (1999)

theme and there is an open discussion whether economic policy making can be separated from its political context. Following the strand of 'political economy', I seek to examine the interaction between economics and politics through focusing on the political processes in which decisions about economic policies are made. The underlying argument in this thesis is that the political and economic spheres are interwoven, and in order to understand the politics of reform implementation it is important to explore how political institutions and political processes promote a special kind of economic development (Törnquist 1999:14).

### 1.1.2 Two cases: Indonesia and South Korea

To be able to examine the issue of economic reform implementation better, I have chosen to explore the Indonesian and South Korean experiences in relation to the economic crisis in Asia in 1997-98. I focus mainly on the initiation phase of the implementation process, that is to say the formulation and announcement of the IMF reforms and the management of the initial reactions to them. I have chosen to limit my thesis and will not discuss the further reform implementation process following Indonesia's president Suharto's step down from power on the 21st of May 1998. With the shift of president, the Indonesian political landscape changed towards a more democratic political structure.[6] I will compare my findings in the Indonesian case with the South Korean experience, because these two countries were affected by the same regional economic crisis, and both countries sought the assistance of the IMF. Nevertheless, Indonesia and South Korea stand out as two contrasting cases: Whereas the implementation of the IMF reforms in South Korea is normally seen to be the successful case, the Indonesian reform implementation is mostly generally perceived as a failure (Haggard 2000, MacIntyre 1999a). My aim is to explore *how* their different experiences with the implementation of IMF reforms can be explained in terms of their respective national political characteristics through discussing the following four relevant factors:(i) bureaucratic organization; (ii) features associated with the relationship between the government and the business sector; (iii) the possibility of decisive political action within the political-institutional framework; (iv) how popular support and interest articulation are incorporated into the national political institutional structure. It should be underlined that I do not seek to enter into the normative debate over the economic or social wisdom of the IMF reforms as such, nor is my aim to give a comprehensive account of the crisis itself and its causes. My task is

[6] Stephan Haggard (2000) gives a thorough and detailed analysis of the further implementation of IMF reforms during the Habibie presidency from May 1998 until the end of 2000.

rather to examine empirically and analytically the politics of economic reform implementation in Indonesia and South Korea during the Asian economic crisis in 1997-98.

### 1.2 The international context: How governments handle demands from the IMF to implement economic reforms

This study of the implementation of the IMF reforms in Indonesia and South Korea is set in the framework of an economic crisis, where the two countries call upon the IMF for assistance in the form of emergency loans in managing their national economic crises. In this thesis the interplay between the IMF and the recipient governments represents the **context** in which the further implementation process within these two countries should be understood. Two important issues concerning this context must be discussed as they represent a premise for the following analysis of the relevant national political factors. First, a common dilemma for a country undergoing an IMF programme occurs when its government on the one hand seeks to recover from the crisis with the assistance of the IMF, and on the other hand has to deal with social, political and economic consequences of the required IMF reforms, consequences that may generate political and social instability. This dilemma becomes serious when the national government experiences that IMF has a fundamentally different economic ideological approach to the needed reforms (Kahler 1993). The second issue of importance in relation to the interaction between the IMF and the recipient government is how the Fund can engage in strategies that attempt to shape the incentives of their counterparts by influencing the national political level that surrounds an implementation process (ibid: 377).[7] The IMF can undertake a campaign of persuasion within a government but also outside of the government to encourage the formation of a supportive domestic coalition or to shore up an existing one. These two issues, a recipient government's dilemma of adhering to the IMF demands when they contradict with national considerations, and the transnational alliances between recipient country's political actors and the IMF, are not rooted in any specific theoretical tradition, but they are important questions based on empirical experiences in relation to the implementation of structural adjustment programmes (Nelson 1990, Kahler 1993).

### 1.3 Theoretical approaches

A number of different theories and empirical research focus on different aspects of the process of economic reform implementation in general, but none of them provide an overarching conceptual

[7] The 'Fund' refers to the International Monetary Fund and will be used interchangeably with the term IMF.

scheme or theory.[8] This lack of a general theory has led me to design this study around two different theoretical perspectives, or set of concepts, that focus on national political systems' *capacity* to implement reforms. I will briefly introduce the two approaches, which will be discussed more thoroughly in chapter 2. The **state capacity** perspective is chosen in order to gain a better understanding of the technical and administrative capacity of states to formulate and implement reforms (Nelson 1990:18). Much of the argument on state capacity draws upon literature on the so-called 'developmental state', and two topics are important.[9] First, the issue of state organization, where the focus is on a competent and autonomous bureaucracy that successfully implements policies (Evans 1995). Second, the idea that the ability of states to implement reforms is a result of a close relationship between the government and the business sector, where the former exercises a certain level of control in order to assist and to discipline the latter (Weiss 1998). In this thesis the issue of state capacity relates to (i) the expertise of the bureaucracy, and (ii) how the relationship between the government and the business sector can be organised in ways that indicate high or low administrative and technical capacity to implement reforms.

The second theoretical approach chosen focuses on **regime capacity**, how certain political institutional structures can facilitate effective reform implementation. In this study I will use the theoretical approach of regime capacity to explore two important issues. First, how different regime types can be said to have varying regime capacity when it comes to implementing reforms (MacIntyre 1999a).[10] Second, how state-society relations are incorporated in political institutional structures as to enhance or weaken regime capacity in reform implementation (Killick 1998). In this thesis the issue of regime capacity relates to (i) the possibility of decisive political action within the political-institutional framework, and (ii) how popular support and interest articulation are incorporated into the national political structure.

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[8] Robert Putnam (1988) describes how the national and international level of analysis can be combined as to better understand the bargaining process about the design of a structural adjustment program between a country and the IMF, and quite a few students have examined the issue of structural adjustment programs using Putnam's theoretical approach. I have chosen not to do so, because his approach focuses on the *bargaining* process between the IMF and a specific country, which is not the issue under study in this thesis. Another factor that makes it difficult to use Putnam's approach is that in his analysis an important actor is the person that conducts the negotiation between the recipient country and the IMF. Both in the cases of Indonesia and South Korea there were not much room for negotiations because the economic crisis was escalating, and the IMF programmes were more or less introduced without any bargaining between the two parties involved.

[9] The East Asian countries Japan, Taiwan, Hong Kong and South Korea were considered to be developmental states, where economic growth was seen as due to extensive intervention by the state in the national economy. I will elaborate further on characteristics and theories concerning the developmental state in part 2.1

[10] Political regime refers to how the political decision-making process is organized within a given territory. An obvious example is the distinction between a democracy and an authoritarian regime (Østerud *et al.* 1997:234).

The two suggested theoretical approaches are not seen as competitive explanations that I set out to test, but they are rather meant to complement each other as they focus on different political factors relevant to my analysis. To combine the two perspectives of state and regime capacity I will be able to explore ways that institutional design can facilitate or hinder effective reform implementation, while at the same time considering how regime capacity can influence economic policy management. Both perspectives draw upon the institutional approach in political science, where the focus is on the 'formal and informal rules of enforcement mechanisms that influence the behaviour of organisations and individuals in society' (Burki & Perry 1998).

### 1.4 The analytical framework

The issue of the politics of reform implementation is wide and intricate. However, the reason for writing this thesis is a wish to explore more thoroughly exactly this complex topic through discussing how national political factors in Indonesia and South Korea influenced the implementation of IMF reforms during the economic crisis in 1997-98. The lack of an overarching theory on this issue has left me with the ability to choose a wide approach in my thesis. The theoretical approaches and the independent variables are carefully chosen on the basis of how they can be said to relate to the topic under study. Important in this matter have been to combine elements that relate to Asian economic development prior to the crisis in 1997-98, with issues that are relevant in literature concerned with the implementation of structural adjustment programs in general.

#### 1.4.1 The dependent variable: The implementation of IMF reforms by the national government

A dependent variable can be defined as a phenomenon that varies along some dimension, and it represents the topic that one seeks to explore (Becker 1992:206). In this study the dependent variable is *implementation of IMF reforms by the national government.* An economic crisis can be seen as an extreme case of economic policy failure, and the implementation of economic reforms is usually necessary to get the economy 'back on track'. Economic reforms can be defined as any programme or package of measures designed to enact a significant economic change (Drazen 2000:615). The difference between economic reforms and ordinary economic changes is related to the scope, where economic reforms include a significant number of policy changes that must be undertaken for the implementation to be successful. Reforms can vary in their nature, organizational intensity, and the required implementation skills. To conduct a study of the implementation of IMF reforms is necessary because failures to meet agreed targets occur too often and can reflect implementation difficulties (Nelson 1990:16). Through suggesting a framework of how political factors can influence the outcome of an implementation process I hope to explore the issue of the politics of economic reform implementation further. However, I am fully aware that it is difficult to *measure* exactly how a government implements IMF reforms, and there will be different opinions as to whether the implementation can be considered to be a success or a failure. Nevertheless, I see this as an interesting topic to explore further.

### 1.4.2 The independent variables

An independent variable can be defined as ‘a factor’s variation that influences the variation in the dependent variable’ (Becker 1992:206). In my thesis I have chosen to focus on four political factors that I see as relevant independent variables. The independent variables are all on the national political level and I will interpret them in the context of the interplay between the Indonesian and the South Korean governments and the IMF. I have chosen this particular four independent variables, because they relate to explanations of the successful implementation of economic reforms in the Asian region prior to the crisis, as well as they are associated with analyses of implementation of IMF reforms in general (Nelson:1990:18).[11]

Theories on **state capacity** emphasize the following two independent variables as important when discussing reform implementation:

1. *Weberian characteristics of the bureaucracy*. Important here is to what extent the bureaucracy is autonomous and insulated from particularistic interests, and whether the bureaucracy can be considered an elite service with meritocratic recruitment and predictable career ladders.
2. *Features associated with the relationship between the government and business sector.* The focus here is to which degree is there an institutionalized relationship between these two sectors that enables the government to direct the business sector to work towards a common national goal.

[11] I am fully aware that a thorough analysis of the implementation process in Indonesia and South Korea should include an independent variable that focus on the variation in the nature of the economic crisis in the respective countries (Nelson 1990:18). When I began to write this thesis, I included an economic variable in addition to the other four in my analysis. However, this proved to be too difficult because the economic explanations of the Asian crisis tend to be very detailed and very technical, and to include this variable in the further analysis would simply take up to much space. In order to make up for this I have in chapter 3 incorporated different explanations of the Asian crisis in general, as well as for Indonesia and South Korea, in order to show how the crisis differed in the two countries.

The perspective of **regime capacity** stresses the following two independent variables when exploring the issue of reform implementation:

3. *Authoritarian & democratic regimes' decisiveness*. The important question here is how different political structures are institutionalised in the respective regimes as to create efficiency in policy implementation.

4. *Popular support and interest articulation*. Important here is how a regime's support-base influences regime capacity to undertake reforms. Another aspect to consider is how the political institutional structure incorporates the state-society relationship as to increase regime capacity in implementing reforms.

The following figure exemplifies the analytical framework to be used in this thesis:

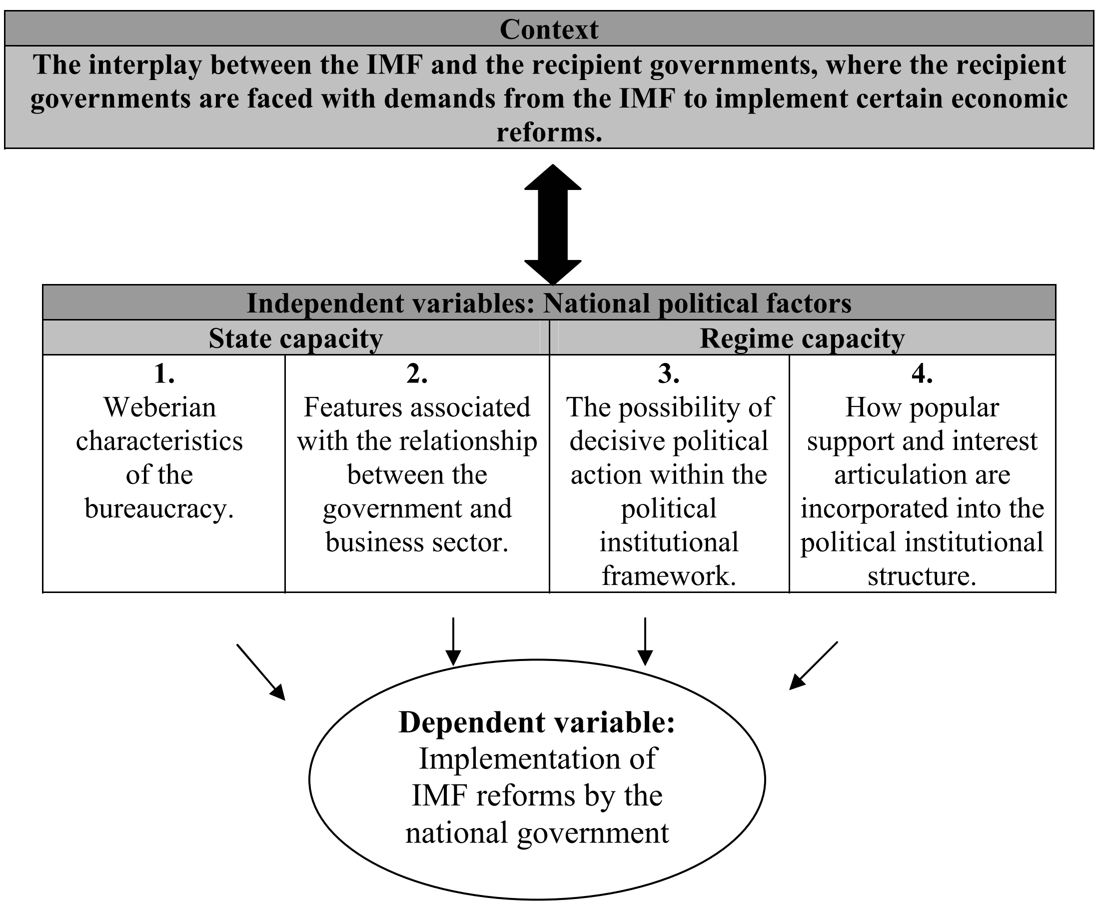


**Figure 1.** Analytical framework

As the above figure illustrates I have incorporated the influence of the IMF into the analysis without treating it as an independent variable. The interplay between the IMF and the Indonesian and South Korean governments rather represents the *context* that the further analyses builds upon. I have structured my study around the four independent variables divided into two categories with respect to their theoretical approaches; state capacity and regime capacity. The independent variables are not seen as excluding each other in the sense of explanations, but rather meant to complete each other to get a fuller picture of the complex implementation process.

## 1.5 Methodological considerations

Little research has been done to evaluate how political factors influenced the process of implementation of IMF reforms in Indonesia and South Korea in 1997-98, nor is there a general theory about the implementation of IMF reforms. This indicates that an open approach towards this topic is needed. The methodological design of a study 'is an effort to deal in one way or another with the influence of the subject on the object and with the consequences of this influence for the process of knowing and the knowledge yielded' (Ellen 1984:14).[12] This includes making decisions concerning methodological technique and approach, as well as to secure the robustness of the methodological design.

### 1.5.1 Case study

My object of study, how national political factors influenced the Indonesian and South Korean governments' implementation of IMF reforms during the Asian economic crisis, is an empirical event set within a complex framework where the IMF played an important role. I have chosen to use the *case study approach* to better analyse this 'particular contemporary phenomenon where the boundaries between the phenomenon and the context are not clearly evident' (Yin 1994:13). The case study approach is not a methodological choice, but a specific *technique* to study an object. Case studies typically examine the interplay of all variables in order to provide a complete understanding of an event or situation. This thesis is structured around three separate, but intertwined empirical focuses: (i) the context where the interplay between the IMF and the

[12] Researchers generally choose between two main types of methods to answer their empirical questions; the *quantitative* or the *qualitative* method. They differ as to **how** they find the pattern of the empirical material that is analysed. My analysis of the IMF implementation processes in Indonesia and South Korea has a qualitative approach to the issue, because it is based on my *interpretations* and impressions of the data that I have explored, and I do not intend to systemise or express my findings numerically.

recipient governments takes place (ii) the Indonesian and the South Korean state capacity to implement IMF reforms; (iii) the Indonesian and the South Korean regime capacity to implement IMF reforms.

Andersen (1997:61) divides case studies into three different categories depending on how they relate to theory in their design. The first category is *A-theoretical* case studies, where the aim is not to use concepts or theories, or to understand some abstract construct or a general problem. The case under study is not chosen because it illustrates a particular trait or problem, but rather because of the uniqueness of the case itself. The second category is *interpretative* case studies. Case studies in this category use concepts and theoretical approaches to explore how conditions influence a certain event or phenomenon. One does not seek to generalise one's findings in order to develop a theory, but rather uses theoretical perspectives as conceptual structures or as advanced organisers. The third and last category of case studies is concerned with *generating theory*, where the aim is to provide insight into an issue through refinement of theory. The case itself is of secondary interest, but it plays a supportive role in facilitating the theoretical understanding of a phenomenon through the testing of hypotheses.

My analysis of political factors that have influenced the economic reform implementation in Indonesia and South Korea 1997-98 is an *interpretive* case study, and fits Andersen's second category.[13] I seek to explore *how* national political factors influenced the IMF reform implementation process, based on an empirical study of the Indonesian and South Korean experience. I use the theoretical approach of state capacity and regime capacity in order to structure my analysis, and I do not seek to verify or disprove hypotheses. Nor is my aim to generalise my findings in order to *develop* or test a theory. I rather seek to explore whether the analytical framework (the variables and the theoretical approaches) that I propose is important to the degree that it can be used as a 'building block'. Meaning that in one way or another my analysis can offer insights that can be used to ask fruitful questions in other cases on the topic of the politics of economic reform implementation (Nelson 1990:17).

[13] If I had just explored the Indonesian case I could have conducted an A-theoretical case study. However, I have chosen to compare two entities to better examine how they relate to the suggested theoretical perspectives, and thus my analysis fits Andersen's second category of case studies, the interpretive case study.

### 1.5.2 Methodological approach: Comparative case study

My study is comparative, which means that my methodological design is based on a comparison between two cases, Indonesia and South Korea.[14] Through comparing Indonesia and South Korea I can explore more thoroughly how these cases relate to the theoretical perspectives proposed, and thus gain a better understanding of the common and diverging features of the two cases. The aim of the comparison is to explore how two governments with different political institutional characteristics handled the implementation of IMF reforms in 1997-98. The Indonesian and the South Korean cases are seen as unique, but they enhance some common characteristics that make it possible to compare them. The similarity between Indonesia and South Korea is that both countries experienced serious economic problems stemming from the same regional economic crisis of 1997-98, and both sought the assistance of the IMF and received 'rescue packages' with requirements for wide-ranging reform programs. Both countries also belong to a region that has experienced a high rate of economic growth the last 30 years, which many argue was due to an interventionist state (Wade 1990, Johnson 1982, Amsden 1989). An additional characteristic is that authoritarian leaders have ruled both Indonesia and South Korea, and largely legitimised their rule by developing authoritarian political ideologies and delivered rapid economic growth. However, the major difference between these two cases important to this study, is their different experience in relation to the implementation of IMF reforms.[15] The international community and the IMF applauded South Korea's crisis management and reform implementation, while Indonesia was perceived as the 'basket case' where an authoritarian political system was unable to deal with the crisis and the following implementation of the required IMF reforms.

I will explore the Indonesian case in more detail, because I find that the politics of reform implementation is best illustrated in this case. Indonesia had experienced economic crises previously in the 1970s and 1980s, but at that time president Suharto dealt with the problems quite effectively. So the question is what went 'wrong' in Indonesia during the crisis of 1997-98?

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[14] In my study I use an inductive approach, because I reason from the outcome of the reform implementation process in Indonesia and South Korea *back to* prior events through exploring my suggested independent variables. However, my study is not purely inductive, since my choice of independent variables is deducted from my theoretical perspectives of state and regime capacity. To pursue a thorough deductive strategy would prove very difficult in my case, because there is no comprehensive theory on economic reform implementation to deduct hypotheses from.

[15] There are also other differences between these countries, like Indonesia for instance was still under the authoritarian rule of president Suharto when the Asian economic crisis broke in 1997, while South Korea was considered being in 'democratic transition' after the first democratic elections held in 1987. These countries also differ with respect to their economic policies during their economic high growth period. While South Korea was considered a developmental state, many argued that Indonesia never quite fitted into this category (Önis 1991, Moon & Prashad 1994).

Despite a seemingly quick response to the crisis and a rapid implementation of macro-economic reforms in the wake of the crisis, Indonesia was soon the country in Asia that was hardest hit. My interest is how a focus on national political factors can help understand this swift development in Indonesia from seemingly successful crisis management to an obvious basket case.

Apart from making comparisons between the two entities, Indonesia and South Korea, I will also compare the Indonesian reform process in 1997-98 to Suharto's earlier successful reform implementation. Important in this matter is the implementation of the economic reforms aimed at liberalisation of the Indonesian economy in the 1980s. However, this comparison will not be as systematically undertaken as the comparison between the Indonesian and the South Korean experiences. Nevertheless a comparison over time is valuable for a better understanding of what went 'wrong' in Indonesia in 1997-98.

### 1.5.3 Sources and collection of data

Three methods of data collection have been used in this thesis: the examination of documents, the observation method and the interview method.[16] I have examined primary sources like IMF and World Bank documents. However, most of my understanding of the Indonesian and South Korean experiences is based on secondary literature and documents; that is books published in English by relevant western and Asian specialists, newspapers, magazines, academic and journal articles, and websites concerned with information and discussion about the Asian crisis. There is a great variety on material available concerning the Asian crisis and the political economy of Indonesia and South Korea. However, to make up for the lack of studies focusing on the *political* aspects of the handling of the Asian crisis and the following reform implementation, I have examined relevant literature on political aspects of economic crisis management in general, and particularly studies that focus on IMF assistance in relation to this.

I have also used the observation and the interview method in preparing this thesis. I visited Indonesia in January 2001 and made 15 interviews with academics, government officials, business representatives and NGO activists.[17] During my stay in Indonesia I had the possibility to

[16] The main types of exploration methods are taken from Andersen & Gamdrup (1994:63-74) where they are labelled 'dokumentariske metoder', 'observerende metoder' og 'spørgende metoder'.

[17] The interviews were structured around 6 central questions that I had prepared beforehand: (i) how do you see the present economic situation in Indonesia in relation to the economic development in Indonesia prior to the Asian crisis; (ii) what do you see as the main cause of the Indonesian economic crisis in 1997-98; (iii) what is your opinion of the

discuss the ideas developed in this thesis with scholarly experts on Indonesian politics and economy. My stay in Jakarta and Yogyakarta also provided me with the valuable opportunity to observe the context in which the events in Indonesia had taken place. My interviews and the observation of the Indonesian context proved to be important sources for my understanding and reasoning about my case. However, the character of my interviews was a way of testing ideas I had at the time of the interviews and to develop new ideas confirming my argument. The information that I gathered from the interviews has been important in narrowing down the topic under study, rather than using the interviews as primary sources in my analysis.

### 1.5.4 Evaluation of the sources: The reliability and validity of the data

When using a particular methodological design it is important to judge the *quality* of this design. Questions concerning validity and reliability of the study are important in this matter.[18] The validity of a study depends on what is measured and concerns whether the measured phenomenon is *relevant* to what is being studied (Hellevik 1991:159). Reliability refers to how the data is measured and the *precision* with which such measurements are carried out (ibid.).

A valid study indicates that there is a relevant connection between the theoretical approach and the empirical data that is studied. The question that I seek to answer in this thesis is *how national political factors influence governments' implementation of IMF reforms*. I am fully aware that it is difficult to *measure* which national political factors that have been **relevant** to the implementation process. Politics focuses on many different levels and it can be difficult to judge how certain political factors influence economic processes or outcomes. External factors like international investors' response to the IMF reforms, international prices on export and import goods, and bad weather conditions, can influence the implementation process irrelevant of the national political factors that I see as relevant. In order to make up for my problem concerning the validity of my analysis, I have used the strategy of 'theory triangulation' (Johnson 1997). The overriding purpose of triangulation is to combine different sources and research procedures to crosscheck information and conclusions. To secure the validity of this study I have examined

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role of IMF in handling the crisis in Indonesia in 1997-98; (iv) why was the implementation of IMF reforms problematic in Indonesia; (v) what do you think is the main difference between the Indonesian and the South Korean implementation of the IMF reforms; (vi) who do you think made the political decisions in relation to the crisis management in 1997-98. However, I adjusted the questioning to the situation, and the interviews usually lasted about one hour. I taped all the interviews so that the information I gathered can be checked if required.

[18] The term 'validity' has traditionally been attached to quantitative research tradition, and some qualitative researchers have argued that this concept should not be applied to qualitative research because this term is not relevant to the epistemological and ontological assumptions of qualitative research (Johnson 1997).

various theoretical approaches, like different economic perspectives, public administration theories and social group approaches, to see which political factors they see as *relevant* for their understanding of how governments can influence the implementation of economic reforms. I have compared the different political factors emphasised within the various theoretical approaches, and the independent variables suggested in this thesis are based on this theory triangulation.

A possible weakness concerning the reliability of my thesis is that most of my data is based on secondary literature, which implies that I rely to a large degree on other researchers' interpretations. It represents a problem, because I have no guarantee that their interpretations are reliable. In order to accommodate this problem I have used the technique of 'data triangulation' through exploring secondary literature from various academic disciplines. I have also tried to be as accurate as possible, using correct citations and always referring to my sources when using their arguments, so that the quotations could be checked with the original source to understand the context in which they are stated.

### 1.6 The structure of the thesis

In the next chapter, chapter 2, I will proceed with a thorough presentation of the theoretical perspectives used in this study. I will give a brief description of features of the so-called 'developmental state', to show how the impressive economic growth in some Asian states was explained. Then I will proceed with an introduction to theories concerned with **state capacity**, where the focus is on bureaucratic organisation and the tight relationship between the government and the business sector. Through discussing different regime types' political institutional structure and the incorporation of popular support and interest articulation in the political structure I will explore the issue of **regime capacity** in reform implementation. In the last part of chapter 2 I will discuss issues that are relevant with regard to the interplay between the IMF and the recipient government in order to better understand the context that this interaction creates. In chapter 2 I will finally present a model where I have developed five relevant empirical questions derived from the theoretical arguments made in this chapter.

Chapter 3 will provide background information about the Indonesian and the South Korean economic development prior to the crisis. In this chapter I will also briefly discuss the Asian economic crisis and consider two different approaches interpreting the causes of the crisis in general, and more specifically for Indonesia and South Korea.

Chapters 4 to 6 present the analysis of the Indonesian and the South Korean implementation of IMF reforms. In chapter 4 I will discuss the context that creates the framework for governments' actions when they are faced with demands from the IMF to implement certain economic reforms. In chapter 5 and 6 I focus on the four national political factors that I have defined as independent variables, in order to discuss the question that my thesis examines: *How national political factors influence governments' implementation of IMF reforms*. In chapter 5 I will use the theoretical perspective of **state capacity** to explore the workings and the characteristics of the bureaucracy both prior to and during the crisis in the two countries. This chapter will also address features of the relationship between the government and the business sector in order to explore different reform implementation strategies in Indonesia and South Korea. In chapter 6 I will discuss how the theoretical perspective of **regime capacity** can help to explore the possibility of decisive political action within the political institutional structures. I will also consider the issues of popular support and interest articulation in relation to how they can influence the reform implementation process with regards to regime capacity.

In my conclusion, chapter 7, I will compare and summarise my empirical findings and evaluate the theoretical framework that I have proposed.

## CHAPTER 2 THEORETICAL TERRAIN

As I said in the introduction there is no comprehensive theory on the topic of economic reform implementation. A number of different theories and research issues are relevant to different aspects of the implementation process, but no theory provides an encompassing conceptual scheme or theory. In my theoretical approach I have taken this into consideration, and I will present *two* theoretical perspectives concerned with the issue of the *capacity* of national political systems to implement reforms. First, the **state capacity** perspective is chosen in order to gain a better understanding of the technical and administrative capacity of states to implement reforms. The second approach involving **regime capacity** builds upon theories concerned with how certain political institutional structures can facilitate effective reform implementation. Combining these two perspectives I hope to get a better overall picture of the implementation processes in Indonesia and South Korea. I can explore the way political institutional design can facilitate or hinder *effective* reform implementation, and at the same consider how regime capacity can facilitate economic policy *management*.

This chapter is divided into five parts. In the first part I will briefly discuss two important characteristics of the developmental state: the autonomous bureaucracy with a commitment to national development, and the institutionalised relationship between the government and the business sector. The issue of the developmental state is important because it suggests an approach to the study of the economic growth in the Asian region. In the second part of this chapter I will explore two arguments based within the tradition of state capacity: First, that a bureaucracy with Weberian characteristics is necessary for a successful reform implementation. Second, that an 'embedded' relationship between the government and the business sector is crucial for the ability of the state to undertake sudden shifts in the economy.[19] In the third part of this chapter I will explore how regime capacity is related to theoretical approaches concerned with the relevance of the structure of political institutions. In doing so I will be examining how a decisive political institutional structure can be said to relate to certain political regime types, and how popular support and interest articulation are incorporated in the structure of political institutions as to increase regime capacity. In the fourth part of this chapter I will focus on the international context

[19] Embedded relationships refer to informal interactions and institutional linkages between the state and important actors in the private sector (Evans 1995:59).

that often surrounds a reform implementation, and I will discuss issues that relate to tensions between the recipient-country and the IMF regarding reform implementation. In the final part I will present five empirical questions that I see as relevant for the further analysis, based on the theoretical arguments made in this chapter.

## 2.1 The developmental state

In the first part of this chapter I will briefly examine two features concerning the developmental state: the autonomous bureaucracy and the close government and business relations. Charmers Johnson (1982) was the first to refer to the Asian states as 'capitalist developmental states'. According to him the economic development in Japan, South Korea and Taiwan had an underlying commitment to private property and the market in order to develop private capitalism. A special thing about the developmental East Asian states, however, was that state intervention superseded this commitment by influencing private business decisions using persuasion, coercion, and by manipulating the parameters of private decision-making in order to best implement economic reforms.[20] The strategic power of the East Asian developmental states depended on state intervention through institutional links between the political insulated state agencies and major private sector firms (Önis 1991:114). In short, the following two aspects characterize the developmental state with regard to its successful economic reform implementation aspects (Ibid:111).[21] First, an autonomous bureaucracy with one political objective: national economic development. Second, specific institutional structures where the government cooperated with the business sector in order to reach national economic goals.

### 2.1.1 An autonomous bureaucracy

The model of the developmental state entails a strong and determined state that protects a powerful and competent bureaucracy that largely shapes and directs development policy. During the early stages of the developmental state, the bureaucracy had a relatively clear and given

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[20] The developmental states' economic development must be understood *politically,* in which the state's defined national goal has been economic growth inspired by political and nationalist objectives of the late developer, concerned to protect and promote itself. Political factors have shaped the thrust and pace of the developmental strategies through the structures of the state (Leftwich 1994:421).

[21] For a more thorough review of the characteristics of developmental states, see Leftwich (1994) where he identifies six features of the developmental state; a determined developmental elite; a relatively autonomous state; a powerful, competent and insulated economic bureaucracy; a weak and subordinated civil society; the effective management of non-state economic interests; and last, performance based legitimacy.

problem definition of ‘catching up’ and played an important role as a vital instrument for the state leadership to achieve its objects and goals in relation to national economic development. The bureaucracy operated in a strict top-down hierarchy driven by the need for efficiency, but more importantly held together by a commitment to a clear mission: national economic growth. Bureaucratic action was guided by general, politically pre-established formal legal rules along Weberian lines (Koh 1997:119). An important question within the literature concerned with the developmental state is why the effective and well-functioning bureaucracy was directed towards national goals, and not towards rent seeking.[22] Extremely meritocratic form of recruitment is stressed in relation to this. Rigorous standards of entry not only ensured a high degree of bureaucratic capacity but also generated a sense of unity and common identity on the part of the bureaucratic elite. The bureaucrats were imbued with a sense of mission and identified themselves with national goals derived from their high status position in the society.

Another central feature of the developmental states’ bureaucratic organisation was the power and the autonomy of the *elite* bureaucracy that were centred in certain key ministries. A pilot agency, like the Ministry of International Trade and Industry (MITI) in Japan, played a crucial role in the strategic planning of policy formulation and implementation. Through its control and power over a few selected strategic sectors of the economy, it had the ability to direct and assist these sectors in accordance with national economic goals (Johnson 1982).

### 2.1.2 Government and business relations

The unusual degree of institutionalised government-business relations was also important in understanding the ability of the East Asian states to direct the business sector towards the defined national economic goals. Amsden's (1989) study of the South Korean state’s economic policy implementation from the 1960s until the mid-1980s, stressed subsidy allocation as the most important tool for the government to ‘control’ the business sector. The state was not a banker, but used subsidies to decide what, when, and how much to produce and which strategic industries to favour. In an economy built upon a system of subsidies, Amsden argues that the government

[22] Rent- seeking refers to the possibility for earning economic rent created by governmental action, for example through issuing licenses or permits to engage in various forms of economic activity (Meier & Rauch 2000:434). Rent seeking activities can be legal, but is also refers to actions which involves illegal activity like bribery, corruption, smuggling and black markets.

controls the private enterprises through granting or withholding industrial licenses, bank loans and advanced technology. The government does not only subsidize industries to stimulate growth, but also sets stringent performance criteria in exchange for these subsidies. If firms turn out to be unprofitable, the state has no obligation to bail them out, so the subsidies do not lead to a waste of resources in the long run. Amsden argues that the ability of the state to discipline firms must be seen in relation to the power and autonomy of the state. In the early 1960s in South Korea, there were no financiers to challenge the government's power because the banking system of the colonial period was renationalised, the business community was as weak as the financial community and dependent on the state for access to resources, the working classes were small in number and there were few large landholders. The lack of interest groups that could challenge the power and authority of the state increased the autonomy of the South Korean state, and enhanced its ability to direct the private sector towards national goals.[23]

### 2.2 State capacity

In this second part of this chapter I will discuss the theoretical approach of state capacity. The study of state capacity has been influenced by the impressive economic development in East Asia during the 1970s, and the focus is on the technical and administrative capacity of states to successfully formulate and implement economic reforms. Following in the tradition of the literature about the developmental state, an important argument is that a well functional bureaucracy along Weberian lines is a significant feature of high state capacity (Evans 1995, Weiss 1998). In addition to a 'Weberian' bureaucracy, the state apparatus and the government should also have the administrative and technical capacity to direct the business sector towards

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[23] Inherent in many of the theses about the developmental state is the notion of the 'irony of state strength', implying that state autonomy erodes through time (Lauridsen 1995:31). The argument of 'the irony of state strength' is that strategic state intervention will generate powerful societal interests that will seek to challenge the influence of the state, because of its 'need' to be independent of it. Thus the more effective the state's involvement in the economy is, the more it increases the independence and power of private capital, and the more the state undermines its own viability. This way, the state ends up 'digging its own grave' by being developmentally effective. Thus, the state is likely to lose its unity and its capacity to 'direct' the business sector without adequate links between the state and the business sector, or the ability of the state to interact with interest groups and social forces. Evans (1995:230) argues that this has been the case in South Korea, where the successful industrialisation had bred a strong, independent class of industrialists anxious to pull free of the state's tightening strings. He shows that the allies of the elites and those who were politically excluded from the institutionalised networks that combined the state and society acquired an interest in curtailing the institutionalised relationship that made the developmental states so successful in the first place. In South Korea there was no kind of innovation in the state-society relations that would incorporate the wider society and the developmental state's special institutional advantages seemed destined to erode.

the state's national economic goals, and the ability of the state to allocate financial resources into desired sectors is crucial.

### 2.2.1 Mobilizing the bureaucracy for economic change

The role of the bureaucracy in facilitating economic growth has been a debated issue since Max Weber's (1947) classic argument that the bureaucracy was one of the fundamental institutions for capitalist growth. Weber's ideal bureaucracy is a public administrative organization characterized by meritocratic recruitment and predictable, long term rewards. The state apparatus is to be guided by an impersonal use of legislature, predictable outcomes, specialised expertise, authority on the basis of formal criteria, as well as the notion that entry and promotion into the civil service depend on formal standards of achievement. This would in turn reinforce informal peer networks that placed a high value on performance and organizational goals and not on personal qualifications (Evans & Rauch 1999). This model of the ideal state apparatus is based on the argument that the government should develop national economic goals, while the state apparatus is the neutral and effective apparatus that carries out the decisions. Using a recent and original data set, Evans & Rauch (ibid) examined the characteristics of the economic bureaucratic agencies and the growth records of a sample of 35 developing countries for the 1970-1990 period. They argue that Weberian characteristics of the bureaucracy significantly enhance prospects for economic growth, when controlled for initial levels of Gross Domestic Product (GDP) per capita and human capital. A Weberian bureaucracy is seen as efficient and loyal to the government and sufficiently powerful to prefer long-term national goals to short-term political advantages and particularistic interests. There are especially two components that are important in this matter. First, that meritocratic recruitment ideally based on some combination of education and examination secures a minimal competence. It also helps to generate corporate coherence and the identification with the bureaucrat role that again can influence the motivation of individual office holders. Meritocratic recruitment can also lead to more internalised shared norms and goals that can increase the 'esprit de corps'. This kind of identification with colleagues and the state organization generate norms where corrupt activities are seen as subverting national goals thus increasing the effectiveness of monitoring. Second, the bureaucracy is built upon a predictable, rewarding career ladder, which increases the competence and the coherence of the state apparatus in the long run. This argument is based on the observation that the cost of breaking organisational norms is also directly proportional to the expected durability of membership in the organization and the expected rewards.[24]

### 2.2.3 Embedded government and business relations

In theories concerning the developmental state many scholars stress the notion of a separation between the state and the society (Brødsgård & Young 2000:3). The state was seen as powerful because of its autonomy, and thus able to formulate and *impose* policies upon the society. Peter Evans (1995:59) challenges the notion that state capacity equals insulation from the private sector or interest groups. He argues that high state capacity *requires* informal interactions and institutional linkages between the state and important actors in the private sector. His concept of 'embedded autonomy' captures the combination of internal coherence within the state and the bureaucracy along with an external connectedness with the private sector. Embedded autonomy is important in two respects. First, that policy networks that link business and government is seen as positive because they increase the flow of information thus improving the quality of policymaking. Second, some kind of connectedness between the state and the business sector is needed because the state relies on the private sector for implementation of their policies. Weiss (1998) agrees with Evans and develops his argument further into a concept that she refers to as 'governed interdependence'. Governed interdependence refers to 'a negotiated relationship, in which public and private participants maintain their autonomy, yet which is nevertheless

[24] As a counterweight to the Weberian understanding of the bureaucracy, the neo-liberalists focus on rent-seeking and corrupt bureaucrats as an obstacle to successful reform implementation. A general definition of corruption is the use of public office for private gain. This includes bribery and extortion, which necessarily involve at least two parties, and other types of malfeasance that a public official can carry out alone, including fraud and embezzlement (World Bank 1997). Bureaucratic performance is by the neo-liberalists explained in terms of a principal-agent relationship, where the bureaucracy and the state are powerful and determined outside agents, and the principal is the populace (Geddes 1994:40). The 'agent' takes action on behalf of a 'principal' where the optimal action from the principals' point of view depends on the information available only to the agent. The principal- agent relationship is characterised by differences in interests concerning intentions and actions as both parts seek to maximise expected utility (Drazeen 2000:30). Neo-liberalists stress that there will always be a chance that the state will act on the grounds of self interest, rather than in the interest of the population, because of lacking monitoring and implementation strategies (Krueger 1990:20). This argument must be seen in relation to their view that the state as an institution cannot resist becoming a tool for special interest groups and their various demands. Instead of serving the public interests, the state ends up serving particularist interest groups, who it is expected to regulate. Government failure with regard to economic reform implementation is explained in terms of the bureaucrats rent-seeking activity. Rents will be generated only in circumstances where the licenses or the permits effectively restrict economic activity below what it would be in their absence. Government failure is a result of the tendency of state officials to endorse restrictions on economic activity for the main purpose of creating rents, which they can capture through rent-seeking bribery, or allocate to family, friends or political cronies.

governed by broader goals set and monitored by the state' (ibid:38). The linkage between the state and the private sector enables the state to disperse information and to interact with various interest groups and social forces. The institutional linkages between the state and the private sector provides constant interaction and feedback of information, which gives the bureaucracy a more realistic picture of the overall economic process, and enhances their chances for taking effective action. This increases the state's central position in guiding the market, but also shows a basic reciprocity and agreement between the state and two or more parties for advancing common interests. The co-ordination and long-term calculation is seen as essential to successful economic policy implementation, and secures high state capacity. However, Weiss (ibid.) stresses that this relationship is characterised by a mutual *dependence* and does not require a 'strong' state in the developmental state meaning, where the state had power enough to *impose* its policies on the private sector. The concept of governed interdependence focuses on the government and business relationships as they *together* develop national goals and cooperate in order to reach them.

## 2.3 Regime capacity

Within the developmental state literature an important argument is that the Asian states were able to impose their policies on the society and the business sector because of their *authoritarian* political institutional structure. This argument follows in the tradition that sees regimes' capacity to implement reforms as rooted in the structure of political institutions. One heavily debated issue within this theoretical approach of regime capacity has been the decisiveness and effectiveness in reform implementation of authoritarian versus democratic regimes. Another important topic has been to see how popular support and interest articulation can be incorporated in the political institutional structure as to contribute to increasing regime capacity in reform implementation.

### 2.3.1 The decisiveness of political regimes

Sachs (1990) argues that authoritarian regimes are more successful than democratic ones in implementing economic reforms, because their leaders can act effectively without fear of being voted out of office by those who experience short-term negative effects such as job loss, lower incomes and reduced social services. This enables authoritarian regimes to make decisions according to technical criteria of economic rationality and to maintain reform programmes long enough to produce positive growth. During the 1990s the thesis regarding the effectiveness in reform implementation of authoritarian regimes was questioned, and empirical evidence showed that there was no obvious causal relationship between capacity to implement economic reforms and regime type (Geddes 1995). Now democratic governments were considered to be better at creating support in the populace for their reforms thus enabling them to sustain policies over time. In relation to authoritarian regimes Geddes stresses that they had a greater tendency not to initiate and implement reforms that threatened the interests of the political and business elite who benefited from the protective tariffs, contracts, subsidies, licenses and tax breaks. Authoritarian regimes did not necessarily guarantee the autonomy required to impose unpopular economic reforms, nor did the electoral process of electoral democracy necessarily obstruct them.[25]

One important aspect of the debate about political regimes has been to examine what type of institutional design that best facilitates or hinders decisiveness in the policy process and in the implementation of reforms. Decisiveness refers to how various institutional configurations can influence the extent to which political regimes promote qualities such as efficiency in policymaking (MacIntyre 1999a:5). Important in this respect is the number of veto points, that is, the ability of political institutions like the legislature and independent regulatory agencies, to veto policy proposals. The argument is that few veto points indicates an effective and decisive political institutional structure. Criticisms against this argument rather point out *credibility* of policy commitments as being more important than a decisive political institutional structure for a successful implementation of reforms. If governments are subject to little or no constraints (few veto points) their policy promises have little credibility, because policies can easily be reversed and make the economic climate unstable and unpredictable. This implies that regimes with a decisive political institutional structure carry the risk of being interpreted as unpredictable and thus not credible. The argument of those that rather focus on credibility than decisiveness of political institutions is that successful policy implementation requires cooperation or approval of other political institutions, because such political structures create a stable and predictable economic and political environment that can increase investments in the economy (ibid.).

[25] Formally, hierarchical systems like the Philippine one-party state during the Marcos era show that complex networks of patronage can weaken the coherence of policy, and penetrate authoritarian states (Haggard 1992:227).

### 2.3.2 Popular support and interest articulation

One important feature of the Asian authoritarian states was the suppression of civil society and the ability of the state to override particular interests groups. But how is the issue of popular support and interest articulation incorporated in theories about the capacity of regimes to implement reforms? There are two themes that are important in relation to this. First, if the national government is seen as a rational actor that seeks to remain in power, the level of support for the government is seen as important in explaining to which degree the government chooses to undertake reforms. Second, that the political institutional feature of corporatism shows how interest articulation is incorporated into the political institutional structure in order to increase regime capacity to implement reforms.

The level of *support* for the government is important in explanations that see the state as being headed by rational political leaders that seek to remain in office (Geddes 1994:7, Killick 1998:152). The argument is that governments behave according to the result of calculations of the likely cost and benefits of implementing reforms, and they act when they perceive it to be in their interest. If support from one particular group is important for the government, a difficult situation can occur if implementation of economic reforms will seriously harm this particular group. For example governments depending mainly on labour and popular support are more likely to take considerations towards these groups than governments relying on business and financial support (Nelson 1990:25). However, if the government experiences broad support for their reform implementation this can lead to effective implementation, because the government has ‘nothing to lose’. Governments facing upcoming electoral challenges have been reluctant to impose unpopular programmes, while incoming governments (both democratic and authoritarian) have taken advantage of a ‘honeymoon’ period (Haggard 1992).[26] According to this view authoritarian regimes are better off in economic reform implementation, because they do not have to take into account a forthcoming election. Democratic political institutions that consist of fragmented interests and a lack of political consensus can be more likely not to implement reforms.

[26] The honeymoon hypothesis states that economic reformers are likely to enjoy greater freedom of political manoeuvre immediately after they take office, when difficult decisions can be blamed as the legacy of the outgoing government (Williamson & Haggard 1994:571).

Following from the arguments presented above concerning the role of popular support for a government's policies, an important question is how interest representation is incorporated into the structure of political institutions in order to increase the capacity of regimes to implement reforms. The issue of corporatism is important in this matter. Corporatism refers to how a political system organises the relationship between the state and society. The basis of corporatist political structures is the notion that organised consensus and cooperation is needed, in contrast to competition and conflict oriented interest based models of organization that see politics as a battle between *rational* actors that make up groups that seek to maximise their self interest (Unger & Chan 1996:96). Corporatism can be divided into two different categories: state or societal corporatism (Weiss 1998:24). State corporatism is where a regime tends to have a 'top down' structure, where political institutions are set up to manage the 'masses', especially groups like labour and religious movements (Østerud 1991:82). The state is seen as strong, and social groups are highly organised by the state and used as instruments to channel public policies rather than being negotiating partners (Weiss 1998:37). The other form of corporatism, societal corporatism, describes a state that seeks to include social groups in the decision-making process in order to increase its capacity to develop and implement policies. The leaders of the participating social groups in a societal-corporatist state are beholden to their members and not to the state. Moreover the state is not in a position to dictate the terms of agreements between the various social groups and the state. The state compensates for its lacking ability to dictate through its institutionalisation of negotiations, which can be effective in order to mobilise wide support and agreement over the implementation of policies, hence binding central societal actors to important policy agreements. This issue also relates to credibility of political institutions, because as social corporatism enhances the support of reforms and policy implementation, this political institutional structure can increase the predictability of the economic environment, which again can attract investors that favour a predictable and credible economic environment.

The common denominator in both the state and societal form of corporatism is institutionalised public - private cooperation in the process of policy formulation and implementation. Corporatism relates to regimes' capacity to implement reforms either by stressing that state corporatism can be effective because the leaders can push through their reforms without taking any considerations for the public's interests, because there are no groups that can oppose their actions. On the other hand one can argue that societal corporatism can increase regimes' capacity to undertake reforms, because the participation and the bargaining process between the state and social groups secures legitimacy and support for reforms, which eases the implementation.[27]

## 2.4 The role of IMF and economic reform implementation

This thesis is concerned with how political factors can influence the implementation of economic reforms by the Indonesian and the South Korean governments during the economic crisis in Asia in 1997-98. However, the implementation of reforms by the national governments cannot be understood properly unless one also focuses on the international **context** where the national implementation process occurs. In this fourth section of this chapter I will introduce issues that relate to the interplay between the IMF and the recipient governments when governments are faced with demands to implement economic reforms. The support of international actors plays an important role when states need urgent help during an economic or financial crisis. When a country experiences a severe economic crisis and calls upon the assistance of an international financial organization, the process of designing an adjustment programme starts. In the case of the IMF it takes the form of a structural adjustment programme, where loan support is based on the principle of conditionality.[28] This means that IMF assistance is only granted if a country accepts the negotiated adjustment plan that contains certain policy commitments and performance criteria.[29] The idea of multilateral financial support is justified on the grounds that the multilateral

[27] The developmental states were often described in terms of state corporatism, where authoritarian corporatist structures were necessary in order to overcome obstacles related to being a 'late developer' and to direct the economy towards heavy export promotion. A part of the East Asian strategy of export-led industrialisation meant that labour unions had to be kept passive and excluded from interest representation (Deyo 1989). The system of state corporatism proved to be a suitable political structure for this purpose, like in South Korea where the government introduced legislation in 1961 requiring all labour unions to be legally recognised by the government. Unger & Chan (1996:99) argue that the state corporatist structure in East Asia was facilitated by historical circumstances. The East Asian states were strong states at the beginning of the industrialisation and the state was autonomous from interest group pressures, which enabled the state to legitimise state corporatism in the name of national development. Some stress that the East Asian states also have shared a cultural bias favourable of corporatist structures (Leftwich 1994, Unger & Chan 1996). In Confucian teachings, which prevailed in the East Asian cultures, private interests were viewed as equivalent to selfishness. The greater good was ideally manifested in a consensus overseen by the moral authority of the leadership, reflected in a top-down paternalism, which was suited for a political structure based on state corporatism.

[28] The structural adjustment programme requires changes in macroeconomic policies, including the exchange rate regime, interest rates, price policies and budgetary stance. IMF also calls for transformations of the regulatory regime and improved incentives to the private sector as well as the acceptance of a commitment to privatise significant segments of the public sector. Structural adjustments can be characterized as a mixture of economic stabilization, liberalization and reducing state economic activities often based on a neo-liberal economic ideology.

[29] 'Moral hazard' is a concept that is used in connection with over-provision of loans or slack conditionality. According to the view that governments are rational actors, one can argue that the government will seek to minimize the costs of the adjustment programme, both politically and economically. In a situation with weak conditionality, the government can seek to relax their adjustment efforts or to divert resources into financing consumption. This can also occur if IMF recognizes that the country seeking assistance is a strategically important country, thereby offering loans under very

organizations act in the interest of world welfare in order to prevent financial crises from spreading to the international market. Their mandate for assistance is based on the following two arguments. First, that international private creditors are not able to afford the kind of conditional loans that are needed in a reform process. Second, that international organizations as lenders can allocate national resources effectively on the international arena, so that countries affected by crises will not have to compete against each other in the process of reaching bilateral agreements, which could slow down and ruin the reform process. From this, the implications of IMF's mandate can be seen from two different aspects. First, that the IMF can 'force' a government to implement certain economic reforms, even though they might contradict governments' own interests. Second, that the cooperation between the recipient government and the IMF in relation to reform implementation increase the credibility of the government on a national as well as an international level.

### 2.4.1 National resentment towards the IMF

The ability of the IMF to stipulate the key elements of a recipient government's policies can be a source of national resentment, not least because it may be an unwanted reminder of the unequal distribution of power between the two parties (Killick 1998:93). As noted above, some see IMF's mandate as an opportunity to 'force' a government to implement certain economic reforms even though they might contradict the governments' own interests. Concerning this issue of erosion of national sovereignty, a common dilemma is when the recipient country's government on the one hand seeks to recover from a crisis through the assistance of the IMF, and on the other hand has to deal with the social, political and economic consequences of the required reforms that can cause political and social instability. This dilemma becomes serious when the national government experiences that the IMF has a fundamental different ideological approach to the needed economic reforms (Kahler 1993). There can be a perception that the reforms suggested by the IMF reflects a subordination of national policies to external forces, and the government can be

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loose conditions, regardless of the government's commitment to adjustment. To prevent the 'moral hazard' problem the IMF now to a larger degree that earlier **insists** on a closer monitoring of the recipient countries, on policy actions prior to the negotiation of a loan, greater specificity and scope in the description of conditions and a tighter cross-conditionality among the multilateral institutions and bilateral donors. On the other hand, if the conditions are too demanding, programmes may cause social unrest that can undermine the adjustment process as well as cause politically unstable conditions.

seen as an agent for western interests and ideology if they choose to implement the agreed economic reforms (ibid).[30]

### 2.4.2 The IMF and domestic alliances

In order to successfully implement a programme the IMF often engages in strategies that attempt to shape the incentives of their counterparts by influencing the national political level that surrounds the implementation of an agreement (Kahler 1993). The IMF can undertake a campaign of suasion within a government but also outside of the government to encourage the formation of a supportive domestic coalition or to shore up an existing one. Kahler (ibid.) sees the most important trans-national alliance as between the IMF and domestic bureaucrats working in the finance ministry and the Central Bank. Such an alliance is facilitated by the fact that those persons that hold important positions within these sectors often are educated at British or American universities and share the economic ideology of the IMF. The IMF can also seek to make domestic alliances that include groups outside the usual circle of finance ministry and the Central Bank if they are essential to the programme. However, Kahler (1992:128) argues that such trans-national alliances are not sufficient for the *implementation* of a structural adjustment programme, it is only viable for reaching an *agreement* between the IMF and the recipient country. According to Kahler, key persons within the government have to agree with IMF policies for a successful implementation.

## 2.5 Summing up my theoretical perspectives

In this chapter I have presented the theoretical perspectives that I will draw upon in the further analysis. I have discussed the issue of state capacity in order to examine how the technical and administrative capacities of states influence the implementation process. I have also discussed regime capacity that focuses on how the structure of political institutions can influence the decisiveness of regimes and how popular support and interest articulation are incorporated in political institutions in order to facilitate capacity. In this chapter I finally looked at important questions that arise in relation to how national governments handle demands from the IMF to

[30] When reforms are being implemented in an intrusive way, the imposition and monitoring of economic policies can lead to strong pressures from groups inside as well as outside government to shake off those constraints. This again may lower the government's legitimacy and its ability to implement the required policies.

implement reforms. Based on the theoretical arguments (left column) made in this chapter I have developed a model where I suggest five empirical questions (the right column) that will guide my further analysis.

| Theoretical arguments | Empirical questions |
|---|---|
| Agreement over proper economic reforms between the IMF and the recipient country | How did conflict and cooperation between the IMF and the recipient government concerning the properness of economic reforms manifest itself in the implementation process? |
| Weberian characteristics of the bureaucracy | How did bureaucratic conditions influence the reform implementation in Indonesia and South Korea? |
| Embedded government and business relations | How did features associated with the relationship between the Indonesian and South Korean governments and the business sector hinder, or promote these governments in implementing IMF reforms? |
| Political-institutional structures and power relations that promote decisive government action | To which degree did the political-institutional frameworks in Indonesia and South Korea increase the possibility of decisive action in the implementation of IMF reforms? |
| Incorporation of popular support and interest articulation in the political institutional structure | How did the Indonesian and South Korean political systems incorporate popular support and interest articulation so as to successfully implement reforms? |

**Figure 2** Theoretical arguments and guiding questions

For example, in the first cell in the left column it is claimed that for successful reform implementation it is necessary to have a context where there is an agreement between the IMF and the recipient government about what the proper economic reforms should be. Thus my analysis in Chapter 4 that deals with the context where the interplay between the IMF and the Indonesian and South Korean governments takes place, will be centred around the question *'How did conflict and cooperation between the IMF and the recipient government concerning the properness of economic reforms manifest itself in the implementation process?'* In the second cell in the left column it is stated that Weberian characteristics of the bureaucracy is crucial for successful implementation of reforms. Then, my guiding question for the analysis of the Indonesian and the South Korean experiences in relation to the issue of bureaucratic organisation in Chapter 5 is concerned with '*How did bureaucratic conditions influence the reform* *implementation in Indonesia and South Korea?'* The following three empirical questions are designed in the same way.

## CHAPTER 3 ASIAN ECONOMIES: FROM MIRACLE TO CRISIS

Not many had predicted that the earlier so successful Asian economies would experience serious economic problems in the late 1990s. In search for causes of the crisis, a common argument was that the crisis was the result of policy failure. Either that the market forces had been allowed to govern too much or that the state had intervened too extensively in the economy. In order to understand the design of the IMF reforms in Indonesia and South Korea in 1997-98, it is necessary to know what the IMF saw as the causes of the crisis, and how they interpreted the political economy of the Asian states prior to the crisis in 1997. The present chapter is divided into five parts. In the first section I will discuss two different explanations of the 'Asian miracle', the neo-liberal and the statist. In the second section of this chapter I will discuss features of the Asian crisis and show different interpretations of its causes.[31] In part three and four I am going to show how, and discuss why Indonesia and South Korea were hit by the Asian crisis. In the fifth and final part I will sum up the arguments made in this chapter

### 3.1. The Asian Miracle: Magic ingredients?

In the late 1970s and the early 1980s the high performance of the Asian economies was usually explained in terms of neo-liberal economic theory, with a focus on a growth strategy based on the workings of the free market forces (Little 1981, Belassa *et al.* 1982) The economic growth was explained in terms of the response of private entrepreneurs to market stimuli, and the Asian states' comparative advantage with a combination of extensive access to natural resources and a hard working, well educated, disciplined and cheap labour force.[32] The relevance of export was also an important part of the neo-liberalist explanation of the rapid economic growth in the Asian region (Balassa 1988:280-281).[33]

[31] For a more detailed analysis of various different explanations of the causes of the Asian crisis, see Burkett & Hart-Landsberg (1998).

[32] A comparative advantage implies that countries produce what is optimal for them in relation to a country's access to raw material and other important resources.

[33] First, export contributed to resource allocation according to the comparative advantage. Gains would cumulate over time as the efficiency of new investment was enhanced through its orientation towards industries that relied on the comparative advantage. Second, exports enabled the Asian countries to enter the international market when their domestic market was too small for an optimal use of resources. Third, national industry had to be innovative to keep up with the international trends in the export market. This led to a healthy competition between domestic producers of technology that in turn developed the country's national industry and improved their position to compete in the international market. This optimal environment for private enterprise was achieved due to 'getting the price right', through trade liberalization and exchange rate reform.

However, during the 1980s within the tradition of developmental studies and with the increasing literature about the developmental state, the explanation of the 'Asian miracle' became more state oriented.[34] The statist perspective emerged as criticism of the neo-liberal explanation. Instead of emphasizing the workings of the free market, export and the importance of private enterprise, they rather focused on the strategic role of the state in taming international and national market forces so as to make them work in ways to reach national ends and to overcome obstacles to 'late industrialization'.[35] The argument was that the state had successfully intervened in the Asian economies through macroeconomic incentives and *guided* the private sector in order to develop successful industrial policies. Economic growth was not seen as the outcome of adjustment to naturally given static comparative advantage determined by existing pool of resources, labour supply and workers' skills- rather as a dynamic comparative advantage
created by the state through its interventions in the market.[36]

[34] In the early 1990s, the intervention by the state in the Asian market was also to a certain degree acknowledged by 'mainstream' theorists, among others represented in the World Bank report 'The East Asian Miracle' in 1993.

[35] Late industrialization refers to a situation where state intervention is seen as necessary to overcome the imperfections of the free market and the various bottlenecks of industrialization (Amsden 1989).

[36] When one talks about the impressive economic growth in the Asian region before the economic crisis in 1997, the impression can be that all the Asian miracle economies have followed the same path to economic growth. However, one usually makes a distinction between the first generation of NICs, (-South Korea, Taiwan, Hong Kong and Singapore), and the second generation South East Asian NICs, (-Indonesia, Malaysia and Thailand) An economic development based on industrial protection and export was of particular importance to the first generation NICs, because their access to natural resources was scarce. The economies of the East Asian states encouraged the systematic borrowing of foreign technology, and an important aspect of their industrial policy was the licensing of technology, often initiated by the state (Thompson 1996:630). The second generation NICs, adopted a more outward looking economic policy. The strong growth rates of the Southeast Asian (SEA) countries were largely based upon primary resource export and import substituting industrialisation. Rich natural resource endowments, and the foreign exchange earnings arising from their export, enabled the SEA governments to maintain import substitution arrangements for much longer than what was the case in resource-poor Taiwan and South Korea. Another important difference between the first and second generation NICs relates to the fact that the business community in the SEA states was overwhelmingly made up of people with Chinese decent. Due to many instances of official harassment of Chinese minorities in these countries, the Chinese have avoided high profile collective political action, and instead relied on clientilism as a form of political representation. In return for protection and policy favours, Chinese business people provided cash, stocks and company directorships to powerful members of the political elite. The first and second generation NICs are also different when it comes to state intervention in the economy. The Northeast Asian NICs significantly increased the scope for intervention in the market place. Their governments intervened extensively in an attempt to guide corporate behaviour and ultimately the pattern of industrial development. The SEA states have not attempted to involve themselves in governing the behaviour of firms to a similar extent as the first generation NICs. Or if they have, like in the case of Indonesia, intervention has been poorly coordinated and subject to extensive manipulation by business people with powerful patrons in the government. The states of the second generation NICs also appear much less 'strong' compared to the first generation NICs. The east Asian states were known for the ability of the state elite to formulate economic policy without becoming captive to rent seeking activity as well as being relatively independent of distributional pressures from business. Both South Korea and Taiwan had centrally coordinated and disciplined elite bureaucrats that were less prone to problems of inefficiency, incompetence and official corruption. Bureaucratic agencies in the SEA countries have generally appeared to be less competent and less disciplined compared to their Northeast Asian counterparts. SEA bureaucracies have not been as insulated from distributional pressures nor as coherent and well educated as their counterparts in the first generation NICs. In relation to FDIs, the first generation NICs imposed limits on direct foreign investment. Until the 1990s FDIs played a minor role in the economic growth in South Korea and a modest role in Taiwan, while FDI played a significant role for economic growth and industrialisation in all the three SEA countries. Although foreign capital was important in funding rapid industrialisation in South Korea, it primarily took the form of debt rather than equity. Foreign finance and

## 3.2 Asian economic crisis: Tigers adrift

During the early to mid-1990s there were few signs that the Asian economies would experience severe economic distress in the years to come. First, most of the countries in the region were at, or near, fiscal balance at the time of the crisis. Monetary policy seemed responsible and the government debt was not problematic. Second, with the exception of Thailand, current account deficits were not particularly large and the countries in the region had well developed export sectors. When Thailand's government had to devaluate the bath on the 2nd of July 1997, due to capital flight and exchange rate speculation, more or less the entire region was soon affected.[37] The crisis spread from Thailand to the Philippines, Taiwan and Hong Kong, before hitting Indonesia and Malaysia and finally South Korea and Japan. A better understanding of the crisis in Indonesia and South Korea must involve two elements: First, identifying the factors that made most of the Asian economies vulnerable to the financial crisis in 1997. Second, exploring how the crisis affected Indonesia and South Korea against the background of their previous economic development.

### 3.2.1 Common features of the Asian economies

As said earlier, there are different explanations to the causes of the economic crisis in Asia in 1997-1998. However, most literature concerned with the Asian economic crisis agrees that there are three common characteristics of the Asian economies that made them more vulnerable to an economic crisis. First, there was a strong increase in international capital flows prior to the crisis, not only in the form of FDIs and long term bank lending, but also portfolio investment and short term bank lending (less than one year maturity). This created a volatile situation where foreign investors swiftly could reverse their investments through the non-renewal of loans or selling away of securities denominated in the national currency. This made the Asian economies more vulnerable to financial panic in 1997, resulting in a sudden withdrawal of investments.[38] Second, the Asian economies were vulnerable because they had liberalized cross border capital movements. Haggard & McIntyre (1998:385) argue that often when countries liberalize their

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technology were purchased, but multinational corporations were not admitted in large numbers to set up direct operations.

[37] The cause of the devaluation of the bath must be seen in relation to the overvalued exchange rate. The conditions prior to the devaluation was a trend in which financial institutions took up loans abroad, then to pursue their lending activities in the domestic market at higher interest rates. When the bath came under attack from international traders, the government could no longer defend its currency, and the crisis broke.

[38] The scale of destabilisation caused by the panic is indicated by the figures: From a net inflow of USD 93 billion in 1996, private capital flow into the five most troubled Asian economies turned into a net outflow of USD 12 billion in 1997 (Bello 1998a).

capital accounts, governments do not have the personnel or the capacity to supervise banks adequately. Lacking the ability to evaluate risk, believing that they would automatically be shielded from it, or simply intoxicated by asset market and investment booms, domestic commercial and merchant banks engage in highly risky lending. If foreign lending then slows down, banks engage in further risky behaviour in hope to save themselves, and an economic crisis is likely to occur.[39] Finally, the exchange rate in most of the Asian countries was 'quasi' pegged to the US dollar, meaning that it was allowed some flexibility in its value. When the dollar strengthened its position in 1995-1997, it made the Asian economies more vulnerable to speculative attacks from foreign investors. Domestic inflation in a context of quasi-pegged exchange rates made Asian exports increasingly uncompetitive in world markets and slowed down the economy (Noble & Ravenhill 2000:7).[40]

### 3.2.2 Different explanations of the Asian crisis

When explaining the Asian economic crisis many tend to concentrate on the element of 'policy making'. Either by stressing the negative effects of state intervention in policy implementation, or by emphasizing the policy of letting the free market forces govern too much. While agreeing with the above mentioned characteristics of the vulnerability of the Asian economies, neo-liberal scholars and policymakers, like the IMF, have more or less understood the Asian crisis in terms of the inevitable breakdown of economies in which governments attempt to resist the rationality of markets (Camdessus 1997). To the neo-liberalists the crisis arose not because governments had liberalized their financial systems, but because they had not liberalized them enough. The costs of resisting markets had become too highly reflected in the overvalued assets, poor investment decisions and burgeoning debt. State intervention in the eyes of neo-liberalists had caused 'Crony Capitalism', a system that emphasize political connections rather than the workings of the free market. Above all, the system of preferential lending and close ties between the state and the

[39] However, even though the institutions are capable of managing the liberalisation, a problem can occur when the outstanding foreign debt is bigger than the total currency reserves, as was the case in Indonesia, Thailand and South Korea prior to the crisis (Radelet & Sachs 1998).

[40] Most governments found it impossible to protect local economies from the impact of increased inflows of foreign capital. With currency restrictions ruled out and capital inflow fed into the money supply, this fuelled inflationary pressures. Financial institutions and other borrowers had little incentive to insure against the exchange risk when borrowing in foreign currencies, because of their fixed exchange rate of their home countries. Hedging their loans would have cut considerably into their profit margins, but unhedged borrowing might put the entire financial system at risk when the exchange rate depreciated. Domestic financial institutions were simply unable to service their loans. It has also been argued that the level of short term debt in relation to foreign exchange reserves was one reason why the crisis was much worse in Indonesia, South Korea and Thailand than in the Philippines and Malaysia, which had implemented a series of reforms in the financial sector to avoid this from happening.

business sector had to be dissolved because it had explicitly encouraged businesses to engage in excessively risky behaviours.

While the neo-liberalists explained the Asian crisis in terms of state intervention causing a distorted ‘free market’, others rather focused on the role of international finance, especially the activities of the international traders, and the premature liberalization of domestic capital markets as causes of the Asian economic crisis. These arguments are based on the observation that when important banking institutions withdrew their loans they caused a capital flight and a following decrease in the exchange rate. This again caused panic among the international financial actors, where the only rational action became to withdraw their loans. The economic crisis was explained as being a result of the inability of the governments to regulate capital inflows rather than excessive investment caused by moral hazard. The main cause of the crisis, as for example the statists saw it, was the hasty liberalisation process in the 1990s that had ruined the institutional foundation that was needed for the government to continue its successful developmental state strategy and to meet the challenges that global finance and international trading brought (Chang 1998b). The statist approach agreed that the Asian governments had done some errors prior to the crisis, but they still argued that state intervention was needed in order to control international finance to avoid crises like the one witnessed in 1997.

### 3.3 The Indonesian experience: From go-go to yo-yo

In the third section of this chapter I will discuss how and why Indonesia was hit by the Asian economic crisis. The architects of Suharto’s New Order government defined their main mission as the need to re-establish *order* in the Indonesian society when they officially gained power in 1966.[41] The experience with parliamentary democracy in the 1950s and the misled economic development under president Sukarno had convinced many in the military of the need for a much stronger government (Schwarz 1994:28). To Suharto and the new powerful military leaders, economic development and political ‘order’ were seen as two sides of the same coin. Thus, the state gained complete control over political and economic resources in order to achieve material development. During Suharto’s New Order regime a narrow elite, composed primarily of a small number of military officers, ruled Indonesia. Its dependent supporters were Chinese business partners and members of the administrative corps. The role of foreign aid reinforced the narrow support-base of the New Order regime, because external resources were channelled directly to the

[41] Suharto led a military coup in 1965, but he officially gained power when he (with the assistance of the army) moved in and effectively deposing Sukarno in mid-March 1966.

state elites, and the state did not have to rely on the general population for revenues. The elite business linkages and the clientilistic considerations controlled the government's policies even when initiated by technocrats.[42] Suharto's New Order regime from 1966 until 1997 experienced economic growth largely due to oil revenues, generous foreign aid and the location advantage of being part of an increasingly integrated and rapidly growing region.[43]

Indonesia had prior to the Asian crisis carried out two earlier programmes of economic stabilization. The first was from the early start of the Suharto regime in 1966 set to handle hyperinflation, currency collapse and bankruptcy of the country's banking system. With renewed support from foreign creditors these stabilization policies were successful. The second programme of stabilization was initiated 1983 and accelerated in 1988-89. The reason for the poor economic performance at this time was the collapse in oil prices and pressure from foreign donors and balance of payment crisis in 1983 and 1986. The financial reforms consisted of deregulation and liberalization, and included the liberalization of freed interest rates, the end of subsidized lending, elimination of branching restrictions for domestic banks, and the diminished role of the state banks. However, during the 1990s worries had been expressed regarding the micro-economic conditions of the Indonesian economy, especially the prevalence of a special treatment for a relatively small number of conglomerates owned by members of the first family and their close associates. It was known that these companies did not have to compete for prime government contracts, because they were already granted more or less exclusive access to important areas of economic activity and admission to cheap funds from the state banks.

### 3.3.1 Different explanations of why Indonesia was hit

McLeod (1999:234) argues that the main reason for the Indonesian economic crisis was that the Indonesian government had intervened in the foreign exchange market as a buyer to prevent exchange rate appreciation from happening. McLeod claims that this kind of intervention was unsustainable, because through becoming a large borrower of foreign exchange in the domestic market, the Central Bank forced private sector borrowers abroad, thus encouraging more capital inflow, which in its turn compelled the Central Bank to intervene in the foreign exchange market

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[42] Patron-Client relations are based on mutual personal exchange of goods and services between unequal partners. Political clientilism is often associated with bosses and officials that offer favourable treatment to business and large landowners and receive economic and political support in return (Törnquist 1999:57).

[43] Since the 1980s the annual economic growth in Indonesia had been about 8% and inflation average was under 6%, the budget was carefully watched and the exchange rate maintained its slow and controlled depreciation of about 4% a year. The only issue of worry was the growing foreign debt, especially short-term debt.

to prevent the rupiah (the Indonesian currency) from appreciating. As a result, Indonesia's international reserves increased enormously during the 1990s. Private sector's foreign borrowing was unnecessarily increased as a result. Another important issue referred to in neo-liberal explanations of the Indonesian crisis was the issue of moral hazard in the bank sector. The argument was that the lack of regulations, like for example bankruptcy laws, and the extensive preferential lending led to a situation where banks paid little attention to risk. Private enterprises did not have enough information or alternatives to withdrawing deposits in banks that engaged in risky lending behaviour. As a consequence, there was a deterioration of the financial system. Along these lines was also the argument that crony capitalism and widespread corruption was an important cause of the crisis in Indonesia.[44]

Alternatives to the neo-liberal perspective saw the liberalisation process in the 1980s where business and financial sectors expanded with few restrictions on their activity, as the main cause of the economic crisis in Indonesia. Due to the collapse in oil prices in the mid 1980s the government relaxed restrictions on foreign investment and ownership, lowering trade barriers and deregulated banking and finance sectors. The former public monopolies were transferred to private hands, mainly to Chinese businessmen but also to an increasing extent involving members of the Suharto family. Protected from international competition by restrictive trade, licensing and investment policies and guaranteed privileged access to state funds and facilities, the powerful Suharto family and their followers could extend their activities from forestry and trade into manufacturing industry, property and oil distribution. Banking systems and capital markets were also liberalised to accommodate new private sector interests. While the liberalisation reforms in the 1980s were applauded by the international financial community, some claimed that these reforms ‘contained the seed for Indonesia’s present economic crisis’ (Robison & Rosser 1998:1598). By the early 1990s Indonesia had one of the most liberalised banking systems in the world, and the lack of legal framework and supervisory capacity in the financial sector were seen as major contributors to the crisis in 1997-98 (Pincus & Ramli 1998:725). Especially the increase in non-performing loans was important in this matter, where well-connected conglomerates were able to raise large loans from state banks by colluding with state bank officials and then avoided

[44] However, worth noting is that there were no obvious breaks in the general direction of policy in 1997 and most investors knew the corruption beforehand. The argument that crony capitalism was the major cause of the crisis needs an answer to the question of why the corruption in the Indonesian economy was tolerable for the investors in July but suddenly not in August the same year.

paying them.[45] Moreover, because prudential banking regulations were weak, many private banks were able to concentrate their lending on other companies within the same groups (Robison & Rosser 1998:1599). The extensive deregulation in the 1980s and early 1990s had left the government with few remaining instruments to manage the economy and adjust to external shocks. Having surrendered control over capital movements, interest rates, credit creation and to a large extent fiscal policy, the monetary authorities were left with interest rates on the Central Bank's securities and the exchange rate as main levers of macroeconomic adjustment. This lack of control over monetary policy was seen by many as the cause of the crisis and used to explain the inability of the Indonesian government to manage the crisis (Pinkus & Ramli 1998:731).

### 3.4 The South Korean experience: The shattered miracle

In the fourth section of this chapter I will discuss how and why South Korea was hit by the Asian economic crisis. The political and economic development in South Korea has often been referred to as a coalition between the state and the Chaebols (large South Korean business conglomerates), where the state gave the Chaebols access to economic rents in exchange for political donations. Since the 1960s the South Korean economy had been growing fast. After the military coup in 1961 there was a centralization of the economic management, and the Economic Planning Board (EPB) was established.[46] Its main task was to define and plan policies in accordance with national economic goals. Its centrality in hierarchical interministerial co-ordination as well as its control over the budget and monetary policy allowed EPB and the Ministry of Finance and Economy (MOFE) to exert vast power over economic decision-making. As said earlier, an important feature of the developmental state, and accordingly also the South Korean state, was the co-operation between the private sector and state officials in working towards a common national goal. State control over important sources of subsidy, especially cheap credit from the state controlled bank, allowed the state to discipline the Chaebols. Productive investment was rewarded through access to cheap credit and tariff protection, while poor performance was penalized by withholding these goods. During the 1970s and 1980s the state orchestrated large private firms towards heavy and chemical industrialization involving steel, non-ferrous metals, petrochemicals, machinery, automobiles, shipbuilding and electronics. The state gave priority to

[45] According to World Bank estimates (1997:128) non-performing loans exceeded 12 billion dollars.

[46] Syngman Rhee, South Korea's first president was removed by a military 'revolution' in 1961, followed by Park Chung Hee in 1964. Park was assassinated in 1979 and another military coup in 1980 placed Chun Doo Hwan in the presidency.

implementation of industrial reforms and economic growth, rather than creating economic stability and redistribution.

By the 1990s two major changes are worth noting in relation to the South Korean economic development. First, in the beginning of the 1990s the EPB in South Korea was increasingly marginalized and finally abolished in 1993 (but later absorbed into the Ministry of Finance and Economy) due to continuing disagreements with the MOFE about the government's wish for capital market opening. The weakening of the bureaucrats' influence and the liberalisation of the economy in the 1990s were seen by many as a sign that the South Korean developmental state was in decline. Second, the Chaebols gradually assumed a more independent position towards the state beginning in the late 1980s. This was due to the increasing internationalisation of finance, which eased the access to international funding for the big South Korean companies, and they were no longer reliant of access to state-allocated finance. In 1996 South Korea experienced decrease in export, followed by a worsening of its current account position.[47] However, the current account deficit began to lessen in the first half of 1997, and in June South Korea showed a trade surplus. By mid 1997 fundamental problems in the economy, like over-investment by major business groups and the accumulation of non-performing loans by financial institutions surfaced. There was a closedown of one of South Korea's powerful Chaebols, the Hanbo, in January 1997, an episode that many interpreted as a sign that the South Korean economy was in serious distress. When the Asian crisis hit the South East Asian countries during the summer of 1997, South Korea experienced a substantial capital flight and suffered a severe liquidity crunch. American and European banks failed to roll over short-term debts and the collapse in stock prices constrained the ability of banks in Japan to extend credit. In December 1997 South Korea had to ask the IMF to provide a USD 57 billion rescue package.[48]

### 3.4.1 Different explanations of why South Korea was hit

If the real economy in South Korea was relatively sound at the time when the crisis broke, why was South Korea affected? According to the statist approach, the reason for the crisis in South Korea was the weakened state capacity in relation to bureaucratic organization and the ability of

[47] The slowing of export was caused by the yen starting to depreciate against the US Dollar in 1995, and as the South Korean won was tied closely to the dollar, this eroded the competitiveness of Koran exports. The price of semiconductors also played a particularly important role in the second half of 1996, as nearly a quarter of South Korea's total export consisted of semiconductor devices.

[48] The package consisted of USD 21 billion in IMF loans, a 10 billion loan from the World Bank, and a 20 billion back-up loan from other industrial nations (10 billions from Japan and 5 billions from the US, and 5 billions from other loans including one from Asian Development Bank, ADB).

the government to allocate finance in order to direct the business sector towards desired national goals. The statists argue that the most important cause of the economic crisis in South Korea was that the state bureaucracy had lost its centrality in directing the long-term sectoral industrial policy and overseeing the economic development. The bureaucratic segmentation had led to inconsistent policy management, seen in the mismanagement of the cases concerning the Hanbo 'scandal' and the nationalisation of the KIA Chaebol.[49] The statist approach argues that the bureaucracy's capacity to rapidly implement policies had diminished because of the changes within the state apparatus that left the South Korean state in a large degree of distress when faced with the economic crisis in 1997. Another important explanation for the statists was that the earlier so effective developmental state had in their eyes been reduced because of a poorly designed liberalization process that had been implemented after Kim Young Sam came in office. The state had lost its control over the financial allocation that had enabled the South Korean state so successfully to direct the business sector towards desired goals. The deregulation in the financial sector included interest rate deregulation, abolition of policy loans, granting of more managerial autonomy to the banks, reduction of entry barriers to financial activities and most important substantial capital account liberalization (Chang 1998b:439). With the drastic relaxation of regulations regarding foreign borrowing, especially short-term borrowing, the South Korean banks and financial institutions engaged in rapid massive foreign borrowing. The South Korean currency had been overvalued since 1995 as a means to control the inflation, because currency devaluation would make debt repayment unbearable.

On the other hand, the more neo-liberal oriented explanations see the immediate causes of the South Korean crisis as due to corruption, crony capitalism and nepotism. The Hanbo and the KIA cases showed a close connection between the state, Chaebols and banks that had given rise to problems of moral hazard. Preferential lending, where the government decided which firms that were allowed loans in order to encourage industrialization within certain sectors, was seen as bad, because the government treated banks as tools for its industrial policy, directing them to lend to favored sectors of the economy at cheap rates (The Economist 1998). Thus political lending

[49] The Hanbo Chaebol was South Korea's 14th biggest industry company, and when the company went bankrupt in January 1997, it revealed a web of corruption involving bank loan decisions that involved some of president Kim Young Sam's close aides and his son. (None of them were later officially charged for corruption with regard to the 'Hanbo scandal'.) The Kim Young Sam government also showed indecisiveness in relation to its decisions about the fate of KIA, another big Chaebol. The question was whether the larger Samsung Chaebol (where the president and his family had economic interests) would buy up KIA, or whether it would be nationalised. After a time of back and forth decision-making, the government nationalized KIA.

became an obstacle to a free and healthy competition between equal partners. The firms had also come to expect the government to bail them out if needed, which again encouraged them to borrow too much and to invest recklessly.

### 3.5 Summing up the chapter

This chapter has attempted to shed some light on the causes of the economic growth and subsequent crisis in Asia. The aim has been to provide a better understanding of the design of the IMF reforms in Indonesia and South Korea. According to neo-liberals, the Asian 'miracle' was the result of the workings of free market forces. Others pointed to the strategic role of the state in taming international and national market forces as the most important ingredients in the Asian miracle. Similarly, there are different explanations of the Asian economic crisis. Neo-liberalists argued that the main cause of the crisis was that the liberalisation process had not been allowed to go far enough. Instead state intervention had created a 'distorted' free market that was unable to function as it should. From a 'statist' point of view the blame was put on the liberalisation process. As it turned out the state and the political and economic institutions were unable to control the effects of global finance and international trading. In the final part of this chapter I discussed how and why Indonesia and South Korea were hit by the crisis, and showed different explanations of the causes of the crisis in these two countries.

## CHAPTER 4 THE INTERNATIONAL CONTEXT: THE IMF PROVIDING A BITTER MEDICINE FOR SICK TIGERS?

As discussed in the previous chapter the IMF saw the causes of the Asian crisis as being due to flaws inherent in the structures of the Asian economies with its tight relationship between the state and the business sector. Common for the assistance from the IMF to both Indonesia and South Korea was that it was accompanied by demands for limits upon state budgets, and that the reforms in both countries aimed at breaking up the tight relationship between the state and the business sector. In the Indonesian package there was emphasis on dissolving private and state monopolies and strengthening governance. In the South Korean IMF package the focus was on forcing open the capital accounts, breaking up the patterns of cooperation between the banks, government and Chaebols within the framework of industry policy, as well as implementing reforms that aimed at increasing the 'flexibility of the workforce' (IMF 1999a).

When discussing how national political factors influence the implementation of IMF reforms, it is crucial to explore the **context** where the interaction between the IMF and the recipient country takes place. This chapter is concerned with an analysis of the contextual framework where the interplay between the IMF and the recipient governments takes place, within which the further implementation process has to be understood. As said earlier concerning structural adjustment programmes, the recipient country's government often experiences a dilemma because it on the one hand seeks to recover from the crisis through the assistance of the IMF, and on the other hand has to deal with the social, political and economic consequences of the required reforms that can generate political and social instability. To gain a better understanding of the reform implementation processes in Indonesia and South Korea during the Asian crisis, I have chosen to focus on this dilemma in this chapter. The guiding question for the analysis in this chapter is: *How did conflict and cooperation between the IMF and the recipient government concerning the properness of economic reforms manifest itself in the implementation process?* In the case of Indonesia I will discuss Suharto's dilemma of how to adhere to the IMF reforms at a certain level so as to secure the IMF bailout and to restore investors' confidence in the Indonesian economy, while at the same time considering the outcome of the reforms for his own family's economic interests as well as the socio-political effects of the reforms. In South Korea the dilemma between adhering to the IMF reforms and taking national considerations was not as obvious as in the Indonesian case. The main reason was that the South Korean government under Kim Dae Jung and the IMF had relatively similar understandings of the South Korean economic crisis and to a large degree shared the view on how to best restructure the South Korean economy. However, Kim Dae Jung experienced a dilemma when he was faced with the task of restructuring the workforce. Not only did he have to increase the 'flexibility of the workforce' as the IMF required. He also had to accommodate the labour unions in order to avoid serious strikes that would further damage the economy.

As I said in the introduction, most of my analysis will be centred around a discussion of the Indonesian case. This chapter consists of five parts where the three first parts will be concerned with the Indonesian experience, while the last part will explore the South Korean case. In part 4.1 I will show which reforms the IMF required implemented in Indonesia, and see how Suharto handled the above mentioned dilemma in relation to the implementation of these reforms. In part 4.2 I will be looking more closely at how the Indonesian government expressed ideological resistance to IMF's prescriptions, as the reforms clearly contradicted with their views of what the proper economic reforms should be. In part 4.3 I will explore how Suharto in some respect challenged the authority of the IMF in order to avoid the perception that he was willing to subordinate national considerations to external interests. In the fourth part of this chapter I will briefly describe the IMF reforms in South Korea and discuss how the South Korean case relates to the dilemma of facilitating implementation of IMF reforms *and* taking national considerations at the same time. In the final part of this chapter I will summarise the arguments made in this chapter and see how they relate to the question proposed above.

## 4.1 Struggles over economic policy

In the first part of this chapter I will present the reforms that the IMF required implemented in Indonesia in 1997-98. I have structured this part into sections that cover each of the three IMF rescue packages in Indonesia from October 1997 until May 1998. After each section I will examine Suharto's dilemma in relation to the implementation of relevant IMF reforms, as the required reforms clearly contradicted both with national considerations and the president's private economic interests.

### 4.1.1 The first reform package

When the IMF entered the scene in Indonesia in October 1997 it was with an understanding of the Asian and Indonesian crisis as something being caused by structural errors in the Asian economies, largely due to state intervention in the economy. The Indonesian rescue package consisted of 43 billion USD in international assistance and was shared between the IMF, Japan, Singapore, the USA, Malaysia, Australia, Brunei, China and Hong Kong. The IMF contributed 23 billion USD and as a condition for their assistance they required a number of economic and structural reforms in the financial and corporate sector.[50]

The aim of the first IMF program for Indonesia was not only to restrain budget expenditure and close insolvent financial institutions, but also to 'dismantle frameworks of industry policy and state control within which collusive relationships between banks, the government and business were established and networks of cronyism sustained' (IMF 1999a).[51] The programme included (a) trade policy reforms with trade deregulation for various commodities via the elimination of BULOG's (The Indonesian National Logistics Agency) monopoly on wheat, wheat flour, soybeans and garlic by January the 1st 1998; (b) A gradual reduction of import tariffs on chemical products, iron and steel, and fisheries products; (c) Industry policy reform, such as the elimination of local content programme for automobiles by year 2000 and the implementation of the World Trade Organization's (WTO) decision concerning the Indonesian National Car project by 2000;[52] (d) Macroeconomic policy targets for economic growth, the inflation rate, current account deficits and fiscal balance, as well as the restructuring of financial institutions; (e) Fiscal measures included cutting low priority expenditures, including postponing or rescheduling major state enterprise infrastructure projects, removing government subsidies, eliminating VAT exemptions, and adjusting administered prices including the prices of electricity and petroleum products (Sharma 2001).[53]

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[50] The entire agreement was to be implemented over a period of three years and would be carefully monitored by the Indonesian government and the IMF including experts from the World Bank and Asian Development Bank (ADB).

[51] The Letter of Intent (LOI) signed on 31. October 1997 included 48 policy measures that the Indonesian government had agreed to implement.

[52] WTO was investigating the Indonesian National car project to see if it was against their regulations, because the cars, called Timor, were manufactured in South Korea but was exempt from payment of import and luxury taxes. This allowed the Timor to undercut the prices of its Japanese, American and other competitors on the Indonesian car market. Moreover, to boost the sale of the car, the public sector was required to purchase it (New York Times 1998b).

[53] The most important component of the IMF package was the commitment to restructuring the financial sector, and especially to 'clean up' the banking sector. This included the closing down of insolvent banks, some partly owned by members of the Indonesian president's family. The aim was to distinguish among banks that were merely illiquid and those that were fundamentally insolvent with high non-performing ratios. The structural reforms also aimed at increasing competition in the banking sector, through making it easier for foreign investors to invest through lifting the restrictions on foreign owned banks and foreign ownership of local banks. New banking laws were required to increase disclosure requirements and to rationalize prudential regulations and penalties.

*4.1.1.1 Suharto's dilemma*

There were three incidents in relation to the first IMF agreement that showed Suharto's dilemma of taking national considerations while also implementing IMF reforms. First, that on November the 1st Suharto signed a decree giving green light to eight of the large state funded projects that were postponed in September in order to reduce public spending. These projects were not explicitly prohibited under the IMF package, but the fact that they were allowed to go ahead were interpreted as a sign that Suharto was not fully committed to implementing the IMF reforms. The act was further controversial because all of the rescued projects were joint ventures between the state and close business associates of president Suharto. Besides, Suharto declined to abolish the Indonesian National Car project, nor was the IMF able to persuade the Indonesian government to abolish IPTN's costly jet airplane project, although the government had agreed to 'review the investment and expenditure for state-owned enterprises, and strategic industries'[54] (Asiaweek 1998).

The second incident that showed Suharto's dilemma was when he prioritised family interests over IMF requirements in a controversial bank restructuring. On the 1st of November, less than twenty-four hours after reaching the agreement with the IMF, the Indonesian government abruptly suspended the operating licences of the sixteen banks, in effect, closing them down. However, closing banks in the middle of an economic crisis can be a risky strategy, because it can signal to foreign investors that the government lacks supervision of the national banks, and further cause a bank panic that deteriorates the confidence in the economy. It soon became clear that this happened in the Indonesian case, and from an internal IMF note later leaked to the press, the IMF was aware that their criteria for bank closures had not been very well articulated (New York Times 1998a). Sharma (2001) argues that the problem was not the closure of these weak banks per se, but the manner in which it was done. The agreement that was negotiated between the IMF and the Indonesian government said that there were 50 banks that would be closed down. The problem was that after the closing of the initial 16 banks, the remaining 34 were not identified, which created uncertainty among the general public regarding which banks would be next. As for Suharto, he agreed to close down the banks in order to show his commitment to the IMF and to attract foreign investors back to Indonesia. The fact that three of the 16 banks belonged to the Suharto family just reinforced the picture that he was willing to take measures even against his

[54] IPTN stands for Industri Pesawat Terbang Nusantara and is the state-owned Indonesian aircraft manufacturer that was established in 1976, created and run by B.J. Habibie, then Research and Technology Minister and later following Suharto as president in May 1998.

own family.[55] A few days after the closing of the banks, Suharto's son Bambang, and Suharto's half brother said that they would sue both the Central Bank governor and the Minister of Finance for closing down their banks. Suharto's dilemma was clear when Bambang, after losing his Bank Andromeda, was permitted to reopen his bank, although under a new name, Bank Alfa.[56] Suharto later justified Bambang's 're-opening' by arguing that his son had not been responsible for the misdeeds of the closed down bank. However, Probosutejo, Suharto's step brother, was not able to re-open his bank because the High Court issued a letter demanding that the earlier approval for a new bank made by the Jakarta State Administrative Court, had to be cancelled (Robison & Rosser 1998).

The third incident that showed Suharto's dilemma was the release of the annual budget in January 1998. The IMF required a 1% surplus, a demand that many have argued was unrealistic due to decline in the spending power caused by the economic crisis. Suharto had to deal with the IMF requirement of 1% surplus in the budget in the midst of a serious economic crisis. On the one hand he had to show his adherence to the IMF reforms in order to attract foreign investors and to restore faith in the Indonesian economy. On the other hand, it was clear that these demands would imply two things: First, that in the current economic climate, a contractionary budget would force many Indonesian companies, including some owned by the president's family and his close business associates, into bankruptcy. Second, that unless current levels of spending on items such as food and fuel subsidies were maintained, there might be an increase in rioting, demonstrations and other forms of social unrest as a reaction to increased fuel and food prices. Suharto's dilemma was clear; if he chose to follow IMF requirements concerning the annual budget, the economy might recover, but it would also imply that he would harm both his own business interests as well as taking the risk of causing social and political unrest. If he chose to take national considerations and oppose the IMF requirements, he reinforced the perception that he was not committed to the IMF reforms. When Suharto announced the budget he referred to substantial increases in state subsidies for petrol, rice and fertilizer and an overall 32% increase in government spending. He gave no hint of how the government would manage the slashing in subsides that the IMF required. Suharto prioritised national considerations, which caused a massive fall in the value of rupiah from 7,000 to 10,000 to the USD just within two days. The international response to the annual budget that Suharto presented was negative and international

[55] Of the closed down banks Bank Industri was owned by Suharto's daughter Siti Hediati Prabowo, Bank Jakarta was partially owned by Suharto's half brother Probosutejo, and Bank Andromeda belonged to Suharto's son Bambang (Tommy) Trihatmodjo.

[56] Bambang used the same building and same employees as he had with Bank Andromeda. He also received a new foreign exchange licence issued by the Central Bank.

observers questioned whether the Indonesian president understood the seriousness of the economic crisis that was unfolding.[57]

### 4.1.2 The second reform package

When the second IMF package was negotiated in mid January 1998, the Indonesian economy was in greater distress than in October, and the Indonesian government faced a strong international demand that they had to adhere to the IMF reforms. The IMF also increased its pressure on the Indonesian government, and Stanley Fisher, senior deputy head of the IMF said that the Fund 'would like to accelerate the program and strengthen it, because a lot of people believe that the Indonesian government is not really committed to the program' (Bresnan 1999:93). The second IMF programme was revised in comparison to the first, where fiscal policy was adjusted to accommodate the continuing crisis. Given the sharp depreciation of the rupiah and the deterioration of the economy, it was no longer feasible to aim at a surplus of 1% of GDP. The second IMF agreement settled for a deficit at 1% of GDP. The main focus of the second IMF rescue package was: (a) Structural reforms aiming to dismantle cartels, monopolies, and taxes that directly benefited Suharto, his family and his business associates. The IMF continued its demand that the Indonesian government had to cancel 12 major infrastructure projects that had been restrained in November, as well as the withdrawal of taxation privileges to the National Car Project and for the IPTN's jet airline projects; (b) The abolition of state trading monopolies in flour, sugar, soybeans and other basic commodities, as well as limiting the monopoly of BULOG solely to rice distribution.[58] In addition, the IMF required a phased elimination of subsidies for fuel and electricity, and an elimination of the clove monopoly;[59] (c) Bank and corporate sector restructuring, including subsequent announcement of a process to put in place a framework for creditors and debtors to deal on a voluntary, case by case basis with the external debt problems of Indonesian corporations. A new regulatory body for the banking industry, the Indonesian Bank Restructuring Agency (IBRA), was established under a presidential decree for a period of five

[57] An important objection against the 1998 budget that Suharto presented was that the calculations regarding the exchange, inflation and growth rate as well as the oil prices were seen as quite unrealistic. The exchange rate was stipulated to 4,000 rupiah to the USD, while the currency was already 7,500 to the USD when the budget was issued. A 4% GDP growth rate was also calculated, despite analysts' predictions of 3%-5% contraction and a 9% inflation rate (Far Eastern Economic Review 1998c).

[58] The aim was to deregulate domestic trade in agricultural production, eliminating restrictive market arrangements and measures to alleviate the suffering caused by the drought.

[59] Cloves are an important spice in Indonesia as they are the key ingredient in the country's distinctive kretek cigarettes. The second package also contained a great deal of liberalization of both trade and foreign investment. The IMF reforms also included demands to establish proper bidding processes for government contracts, and to adopt transparent means of evaluating unsolicited private sector proposals for projects funded or supported by the government.

years.[60] According to the IMF reforms the Central Bank was also to be given independence in formulating and implementing monetary policies. With regard to finance, the restrictions on foreign investment in the wholesale and the retail trade were to be removed.

Despite the broad scope of the second IMF program the rupiah started to slide again. McLeod (1999:226) argues that this was inevitable, because the second IMF package only consisted of reforms of secondary importance. He argues that the most crucial question that needed answering was whether the international investors' loans were going to be repaid in full and on time. Nothing in the second IMF package provided any concrete solutions to the immediate problems of banking and currency crisis. It mainly focused on structural reforms rather than fiscal matters.

*4.1.2.1 Suharto's dilemma*

When the second Letter Of Intent had been signed in January 1998, president Suharto personally conducted the negotiation. Djiwandono (2000:63) argues that the president chose to deal with the IMF himself because he had become impatient with the way the crisis was developing, and also because he no longer trusted the Central Bank governor or the Minister of Finance. Due to the massive fall in the value of rupiah, president Suharto started to investigate the possibility to create a currency board.[61] The idea of establishing a currency board system must be seen in relation to the dilemma Suharto was experiencing. The IMF reforms had failed to restore the investors' confidence in the Indonesian economy. So what were Suharto's options? If he still wanted to secure his own economic interests, it was not likely that he could do so *and* implement the IMF reforms at the same time. A currency board appeared as a way for Suharto to stabilise the rupiah in order to make investors return without the help of the IMF. Prior to the economic crisis it had not been any hinder for investors that an interventionist state and an authoritarian president dominated the Indonesian political and economic system. If the government could convince investors that political stability would be guaranteed, and assure profitable investments, the Indonesian economy could recover without implementing the IMF reforms. However, international observers saw the currency board proposal as a sign that the president was searching for a simple solution to stabilize the rupiah without tackling the structural problems of the

[60] IBRA was to be an 'independent' agency, reporting to the Minister of Finance. Its mandate was to restructure the banking sector, through taking over and rehabilitating weak banks and administering the government's guarantee program for bank debts. IBRA started by taking over 14 banks, seven large and seven small banks. The bank takeovers were applauded by the IMF and described as 'a difficult and courageous action that also demonstrated political independence as well as operational capacity' (IMF 1998c).

[61] This means that the rupiah would be tied rigidly to USD and the government would have no independent monetary policy at all. The currency board would have to buy or sell USD at the specified peg rate, regardless of the effect that these transactions would have on the money supply.

economy (FEER 1998b). Although the bill favouring a currency board was already drafted by a number of Bank Indonesia (The Indonesian Central Bank) officials and senior officials from the ministry of Finance, Suharto abandoned the idea due to considerable international pressure that urged Indonesia to adhere to the IMF-supported programme.

In addition to the controversy surrounding the currency board proposal, Suharto's commitment to the IMF seemed at an even lower level, as it became obvious that he did not implement the required reforms that targeted monopolies that belonged to his business associates. He had officially said that he would do so, but it soon appeared that the cartels and the monopolies were still operating.[62]

### 4.1.3 The third rescue package

A third round of negotiations between the IMF and the Indonesian government started on the 17th of March 1998. The IMF was now more flexible in their demands for two reasons. First, the IMF had been challenged by Suharto's attempt to establish a currency board, which gave Suharto an opportunity to enhance his position towards the IMF (FEER 1998a). Second, as the crisis unfolded it was clear that Suharto was facing domestic problems with rising prices on basic necessities (especially rice), due to the earlier removal of some of the subsidies and the increased import costs. This created a situation that could easily drift into social unrest, and gave Suharto strength in his claim that the IMF should revise its policies towards Indonesia. One of the previous requirements of the IMF was that the Indonesian government had to cut tariffs on over 500 food items to a maximum of 5%. However, now Suharto was allowed to continue the subsidies on imports of basic commodities and to keep BULOG in existence. The IMF was also agreeing on a budget deficit of 3.2% of GDP (Sharma 2001). As regards fiscal matters, the aim of the reforms in the third package was still to develop a strong monetary policy to ensure stabilisation of the rupiah. When it came to financial restructuring, IBRA was to continue its take-over and closure of weak or unviable financial institutions.[63]

[62] Like his close friend Bob Hasan's plywood cartel that still operated through its control of exporters dependent on the cartel for services in plywood shipping. For timber companies it was difficult to operate outside the plywood cartel and they continued to pay fees and adhere to the cartel's pricing policies, even though this was against the IMF reforms requiring that no firms should pay fees or commissions to a joint marketing organization (IMF 1998b).
[63] They were also allowed to issue bonds to finance the restoration of financial viability to qualified financial institutions and to eliminate existing foreign ownership restrictions on banks and they issued a new bankruptcy law.

Even though the IMF had been more flexible in their demands in the third rescue package, there was still a comprehensive agenda for structural reforms. Reforms included measures to increase competition and efficiency in the economy, reinforcing the commitments made in January and including further privatisation of six major state enterprises and the identification of seven new enterprises for privatisation in 1998/99. The IMF also required that state-owned shares would be available to private investment in six listed companies, the privatisation of seven other state-owned enterprises within twelve months, the ending of allocation of monopoly privileges, the introduction of new commercial court laws, as well as liberalisation of trade and foreign ownership in wholesale and palm oil exports.

*4.1.3.1. Suharto's dilemma*

One of the objections to most IMF structural adjustment programmes has been the lack of concern for the consequences of groups in the society that have been worst hit by the crisis. In Indonesia, an important component of the third IMF program concerned subsidy cuts that had serious social consequences. On the 1st of April the price of sugar, wheat flour, corn, soybeans and fishmeal was increased because of the gradual ending of subsidies that was to be completed by October the 1st 1998. The required cuts in subsidies of fuel and electricity prices were left less precise and it was not clear whether the IMF wanted the measures to be implemented incrementally or at once. The Suharto government implemented the measures at once on the 4th of May, which led to an increase of 70 % in the price of gasoline and severely affecting the vast majority of Indonesians. Suharto's quick action was interpreted as an indication that he was under strong pressure and needed to adhere to IMF demands. Others regarded the removal of fuel subsides as an attempt to improve the economic position of the state-led oil company which was short of cash due to the crisis (Bresnan 1999:98). However, the price increase was reversed on the 17th of May with the blessing of the IMF, due to serious violence and rioting in large parts of Indonesia. Suharto claimed that further implementation of the IMF reforms would cause a threat to the political and social stability in the country. Just prior to the rise in fuel and electricity prices, the government announced that it had met the first deadlines for the implementation agreed on in the third Letter Of Intent. They had removed the ban on palm oil export and replaced an export tax of 40%. The government claimed that it was more devoted to the IMF reforms than before. Suharto's dilemma did not appear to be as evident as it had been in the earlier rescue packages. At this point Suharto was allowed to take domestic considerations with a continuing subsidy of basic food necessities. As opposed to the earlier rescue packages, the government now openly claimed their adherence to the IMF reforms.[64]

### 4.2 Love the rupiah. Reject the IMF!

The above discussed dilemma of adhering to IMF reforms while at the same time taking domestic considerations can also be examined in relation to the issue of erosion of sovereignty. Recipient governments can often experience that the IMF overrides the interests of the national government and that the prescribed reforms contradict what is viewed as proper economic policies in the recipient country. The IMF reforms introduced to Indonesia and South Korea in 1997-98 were wide in scope, and rather than focusing on the macroeconomics required for restoring market confidence, the aim was a fundamental restructuring of the Indonesian and the South Korean economies favouring liberalisation and the workings of the free market.[65] In this second part of this chapter I will focus on the resistance from the Indonesian political elite towards IMF prescriptions. This includes objections to the Fund's economic ideology that is based on the value of free market forces and a liberalisation of the economy.

In Indonesia one could identify strong resentment against the IMF reforms among the political elite. The policies of the reforms were seen by many as 'western' principles that were not in tune with the Indonesian national economic ideology. Suharto also claimed that there was a conflict between the 'liberal' economic principles of the IMF reforms and Article 33 of the Indonesian constitution, which assigns the state and cooperatives a significant role in developing the Indonesian economy (Liddle 1999:25). Suharto's youngest son Hutomo followed his father's rhetoric and claimed, "I believe this is a part of the new colonialism" comparing the demands of the IMF and those of Indonesia's former colonial masters, the Dutch and the Japanese (New York Times 1998b). The IMF was especially seen as acting on the behalf of powerful American

[64] Since I have chosen to limit my thesis to the implementations of the IMF reforms until the 21th of May when Suharto stepped down from his presidency, I will not be discussing further reform implementation and agreements between the IMF and the Indonesian government. However, following what I have said here about the third rescue package, it could seem like the future reform process would be successful. This has not been the case. In the time of writing this, February 2002, Indonesia has still not completed the implementation of the required IMF reforms, nor has the economy recovered to a desired level.

[65] Hill (2000) among others argues that the IMF should rather have been concerned with core problems concerning the financial and foreign exchange collapse in order to get the market working again. He argues that it was not relevant for international investors if Indonesian leaders were corrupt with serious personal interest in the national economy. The investors had happily invested money in Indonesia prior to the crisis, and would continue to do so just as long as there were favourable economic conditions that could give them profit.

interests, using the reforms to contest the policies and power-base of the political elites in the Asian region. Higgott (2000:255) argues that the Asian crisis was not just an economic crisis, it also has to be seen as an 'idea battle' between the Asian and the Anglo-Saxon way of organising capitalist production. The long-standing criticism of statism inherent in the neo-classical literature, as well as the economic ideology of the IMF and western countries, is seen to be vindicated by the Asian crisis. The IMF was considered by many observers to be the principal instrument in eliminating the Asian model with its emphasis on state intervention, and rather imposing an open, liberalised economic order with few restrictions on foreign capital (Beeson 1999, Robison & Rosser 1998).

As negotiations between the IMF and Indonesia proceeded, it was clear that the Fund only would assist Indonesia if they agreed to implement neo-liberal reforms. Recovery of the Indonesian economy was linked to Western markets and their perceptions of the Indonesian political economy (Kivimäki 2000). This can become a problem when the recipient country's government perceives the IMF reforms as harming the economy and not being in tune with the national economic ideology of this particular country. This proved to be important in the Indonesian case. Suharto seemed to disagree with the IMF in its understanding of Indonesia's economic crisis. He was continuously blaming international investors saying that they had ruined the Indonesian economy through their financial speculations. The heavy stress from the IMF on structural reforms must be seen in relation to the powerful position of the USA in the IMF. The USA staged an ultimatum for further funding to the IMF that the structure of the political economy in Indonesia had to be addressed in the reforms (ibid.). Indonesia had earlier experienced both economic and political support from the USA, because of her role as an important ally in the battle against the communists in the Asian region (Anderson 1998).[66] Because of the new global power structure that followed after the end of the cold war, the relationship between Indonesia and the USA had changed. The removal of the cold war context created a setting where the importance of Indonesia as a strategic partner for the USA was reduced, and this weakened Indonesia's bargaining power towards the IMF and the USA during the Asian economic crisis.

[66] The USA, together with Japan and the leading western European countries, were active in the Intergovernmental Group for Indonesia, a consortium that provided a vast and steady infusion to Indonesia's development budget until the 1990s. Anderson (1998) claims that in return for the economic support, a secret agreement was made between the USA and Indonesia, permitting American nuclear submarines to pass through Indonesian waters without surfacing for the tracking eyes of the Soviet satellites.

### 4.3 Suharto challenges the IMF

As discussed earlier in Chapter 2, a common perception among governments that receive structural adjustment programs is that an implementation of the required reforms represents a subordination of national policies to external forces. With this in mind it is natural to discuss what are the means at hand for a government when it tries to show its sovereignty in the negotiating process? In this third part of Chapter 4 I will show how this perception took the form in Indonesia of a president challenging the IMF, demonstrating that he was not willing to let the IMF dictate the entire restructuring process. As said earlier in relation to reform implementation, the recipient government can be seen as an agent for western interests and ideology if it chooses to implement the prescribed reforms. Furthermore, I will discuss how Suharto challenged the authority of the IMF by showing that he was not a ‘tool for foreign interests’. Kahler (1993) argues that the appearance of subordination to IMF directives may lower a government’s legitimacy, and the following three incidents concerning the Indonesian experience are explored with this argument in mind.

First, when Suharto announced in March 1998 that B. J. Habibie was to become his vice president, the value of rupiah fell drastically. The main reason was the international market’s dissatisfaction with Habibie’s nationalist economic ideology favouring state intervention. The kind of economic policies that Habibie represented were just what the IMF wanted to fight through their reforms. Suharto’s appointment of Habibie as vice president was interpreted as an indication of his willingness to fight the liberal economic ideology of the IMF and embrace the economic ideology that Habibie represented. It was also no secret that the IMF and the USA did not want Habibie to become vice president just on these grounds (Sharma 2001). The announcement of Habibie as vice president also increased the impression that Suharto sought to protect his family’s business interests. It was well known that the president’s family and Habibie shared interests in various private enterprises.

Second, as I have said earlier, Suharto’s idea to establish a currency board was interpreted by many international observers as an attempt to stabilise the rupiah without making structural changes in the Indonesian economy. The currency board controversy also showed a power struggle between the IMF and Suharto, where a lot of prestige was involved for the IMF in making the Indonesian government accept their policy prescriptions. If Suharto had gone through with his currency board proposal and stabilised the rupiah, the credibility of IMF policies would have been badly weakened.[67] Obviously this was something that the IMF sought to prevent. Accordingly it was important that they made Suharto adhere to their interpretation of what the proper macroeconomic policies would be.

Third, as Suharto announced his new government after his re-election as president in March 1998, he attracted negative attention because of the following controversial cabinet appointments. The power and importance of the Suharto family dynasty became even clearer with the appointment of the president's first daughter, Siti Hardiyanti Rukmana, to the position of Minister for Social Affairs. The appointment of the new Minister of Industry and Trade, Bob Hasan, was also controversial because he was one of the president's closest business associates and one of the richest men in Indonesia with great personal interests in the Indonesian economy. Bob Hasan also owned many of the cartels and the monopolies that the IMF sought to abolish. When Suharto announced the new cabinet the declining influence of the economic technocrats that agreed with the IMF was also apparent as they were removed from their positions as Minster of Finance and the Co-ordinating Minister for Economy and Development. The new Minister of Finance was Fuad Bawaizer, a former tax official known as a business associate of Suharto's children. These controversial cabinet appointments were by many interpreted as a last attempt from Suharto to show the Indonesian population and the international community that he was willing to fight the IMF, and that the interests of the nation came first (McLeod 1999, Bresnan 2000). The camp hostile to the IMF especially interpreted the appointment of Bob Hasan, Suharto's close friend and business associate, positively. Hasan was seen as 'a fixer' and 'the only person who can push things through', implying that Hasan was a good nationalist that would prevent the IMF from 'taking over' Indonesia. (FEER 1998b) These actions by the Indonesian president can be seen as a strategy for preventing an image of the Indonesian government as being subordinated to IMF directives. As the economic crisis erupted in Indonesia, Suharto's bargaining power towards the IMF declined. The announcement of Habibie as vice minister, the currency board plans and the cabinet appointments in 1998 enhanced the picture that Suharto was willing to fight the IMF, or at least that he was not entirely enthusiastic to be dictated by an external actor with regard to *national* politics and economy.

67 However, the IMF argued that they were not against a currency board per se, because such arrangements had been successfully adopted in a number of IMF stabilization efforts prior to the Asian crisis (IMF 1999b). But in the case of Indonesia, IMF argued that it was important to implement the required economic reforms *before* establishing a currency board. This was based on the following economic reasoning; that a currency board arrangement can only work effectively if the banking system has the capacity to tolerate significant movements in domestic interest rates. Without this capacity, a currency board arrangement will induce a conversion of deposits into foreign exchange, further shrink the monetary base and greatly increase interest rates (Sharma 2001:102).

### 4.4 The South Korean experience

As discussed so far in this chapter, the relationship between the IMF and the Indonesian government did not seem trouble-free when it came to the implementation of the IMF reforms. In this fourth section of this chapter I will analyze the South Korean experience in relation to the context where the interaction between the IMF and the South Korean government took place. As the IMF saw the Asian crisis, the cure to South Korea's economic problems was to ditch the defunct state-directed economic system of the developmental state and instead create 'true' market economy, with an emphasis on liberalization of finance, international trade and the labour market (Chang 1998a). How did the South Korean government handle these requirements? The important feature of the relationship between South Korea and the IMF was the agreement between the two parties on which reforms were appropriate to restore the South Korean economy. President Kim Dae Jung was backed by the IMF and used the crisis to attack the Chaebols and to push through financial and corporate restructuring. In the first section of this fourth part of Chapter 4 I will give a brief overview of the IMF reforms in South Korea, and show which dilemma Kim Dae Jung was facing in relation to implementing IMF reforms when they contradicted with national interests. In the last part of this section I will see whether the national opposition in South Korea against the IMF reforms and the Fund's economic ideology can be compared to the Indonesian case.

#### 4.4.1 The IMF reforms in South Korea

The first agreement between the IMF and the South Korean government was signed in December 1997, and addressed mainly two economic matters (Tatsuno 2000). First, fiscal matters were important to ease the burden of capital flight on the private sector. Second, structural reforms were required to stop capital outflows, and to restore foreign investors' confidence. The government also agreed on a major restructuring of the Chaebols, as well as current and capital account liberalization.

In the initial agreement between the IMF and South Korea, the growth rate was stipulated to 2.5% in 1998 (IMF 1997). Fiscal policies was ascribed a rather modest role in these programmes at the time, because the need for external current account adjustment was seen as relatively small. The budget surplus was to be about 2 % of the GDP to make room for the costs of restructuring the financial industry. The fiscal measures required to accomplish this included a widening of the bases for corporate, income and value added taxes, along with reductions in government expenditure. Regarding monetary policy the IMF agreement reached its main objective, namely to curb the depreciation-inflation spiral. However, this also brought by a serious economic recession with a high rate of unemployment.

Financial restructuring was the most important task that the IMF set up for South Korea in its reform agenda, and two issues were important (Shin &Ha 1999:71). First, the weakness in the balance sheets of financial institutions had to be addressed. Second, the financial system had to be restructured to minimize the likelihood of recurrence through introducing clear and firm exit policies for financial institutions, strong market and supervisory discipline, along with independence of the Central Bank. The structural adjustment plans also included reforms aimed at establishing efficient and transparent ties among the government, banks and businesses in order to upgrade their accounting, auditing, and disclosure standards. This required corporate financial statements to be publicized on a consolidated basis and they had to be certified by external auditors. Trade would be liberalized in line with WTO standards, with the elimination of trade-related subsidies. The capital account was to be liberalized through opening up the national money, bond and equity markets to capital inflows, as well as liberalizing restrictions on FDIs. Labour market reforms were also demanded to facilitate the re-employment of labour.

### 4.4.2 Kim Dae Jung’s dilemma: I M F(ired)!

Although the wide scope of the required reforms, the one attracting most attention was the one aiming at increasing the ’flexibility of the workforce’; meaning eliminating regulations that protected employment (Kim 2000). During, and prior to the crisis, international investors argued that it was not profitable for them to invest in South Korean companies if they could not lay off workers in order to restructure their firms when this was necessary. This was a sensitive issue, because there had already been some laxation on restrictions concerning layoffs in a reform issued in March 1998.[68] President Kim’s dilemma in relation to the implementation of the labour reforms, was how to attract foreign investments, while at the same time securing labour rights for South Korean workers (Haggard 2000:211). Labour Unions had supported Kim Dae Jung during the presidential election in 1997, and the IMF reforms concerning labour regulations was of course not well received within these groups. Kim Dae Jung’s solution was to establish a tripartite

[68] But due to strong labour opposition against these reforms, the government put a two-year hold on the implementation.

committee where the two largest labour unions were represented together with representatives from the Chaebols and the government. After months of negotiations, the committee faced a historic agreement where the labour unions accepted new labour laws implying more permissive rules on layoffs and the employment of temporary workers. In return for the labour unions' cooperation, the government committed itself to introduce unemployment benefits, like public work programmes, subsidies to unemployed workers and an extensive social net, as well as allowing freedom for union organization and the right to establish political parties.

Implicit in Kim Dae Jung's dilemma was the problem of dealing with the social implications of the required labour reforms (Chang 1998a). This meant that the earlier arrangements of the workforce as 'belonging' to a Chaebol had to be changed. To the South Koreans their workplace plays a very important role, because the corporation they work for often also supplies housing, hospitals and education. A restructuring of the Chaebols implied that the current system of 'quasi-lifetime' employment had to be abandoned. This would require great changes in the South Korean attitudes and institutions regarding job security, taxation, corporate recruitment and pay structure and industrial training. However, as a way of handling and prepare such changes, Kim Dae Jung allowed the labour unions to participate in the tripartite committee to reach a kind of consensus between the involved parties concerning the further restructuring (Shin & Ha 1999:93).

### 4.4.3 Implementation of IMF reforms vs. national considerations

During the spring of 1998 the South Korean economy seemed to recover from the crisis. The won appreciated gradually to the USD, and led the South Korean monetary authorities to further decrease interest rates. The South Korean government successfully issued a global sovereign bond, with a significant amount of capital flowing into the domestic financial market, and the foreign reserves available exceeded outstanding short-term debt. The structural reform agenda, financial restructuring, capital account and trade liberalization were further accelerated. This positive development of the national economy quieted some of the protests against the IMF reforms in South Korea. In the western world, Kim Dae Jung was considered as 'The IMF man in Seoul' and there were few open disputes between president Kim Dae Jung and the IMF over economic policies (Bello et.al. 1998b:2). The main difference between Indonesia and South Korea in relation to the context where the reform implementation took place was that in South Korea, the IMF and Kim Dae Jung shared the same vision of how to best restructure the economy, while in Indonesia Suharto strongly opposed the reforms suggested by the IMF.

Compared to Indonesia, the democratic election of president Kim Dae Jung in 1997 also strengthened his position in terms of the people supporting his reform agenda, even though one of his slogans prior to his election was that it was necessary to renegotiate the IMF agreement. Kim Dae Jung also differed from Suharto with respect to private economic interests in the national economy. Kim Dae Jung relied on the support of medium and small enterprises and was seen as 'their man' in breaking up the tight relationship between the Chaebols and the state. This did not prove to be an obstacle in the reform implementation, rather the opposite, as reducing the powerful role of the Chaebols was at the top of the IMF's agenda. Suharto on the other hand sought to protect the strong position of the powerful private enterprises, especially those that belonged to his close family and business associates.

### 4.5 Concluding remarks

How did conflict and cooperation between the IMF and the recipient government concerning the properness of economic reforms manifest itself in the implementation process? In this chapter I have explored two quite different cases in relation to this question. In Indonesia president Suharto seemed to disagree with the IMF both about the cause of the crisis as well as the prescribed reforms. South Korea proves a different experience because president Kim Dae Jung and the IMF had similar understandings of the causes of the South Korean crisis and of how to best restructure the national economy. It was also important that president Kim was an 'outsider' and elected as president with promises of economic reforms that mainly targeted the close relationship between the state and Chaebols.

In this chapter I have discussed how both Indonesia and South Korea faced a dilemma in dealing with IMF requirements when these contradicted with national considerations. Suharto experienced this dilemma in two areas. First in relation to his own family's interest in the Indonesian national economy, where the implementation of the IMF reforms would harm his personal economic interests. Second, that the implementation of some of the reforms, like the abolition of the subsidies on fuel and food, would have serious consequences for the population, and especially the poor. When faced with these dilemmas Suharto chose to give priority to national and family interests over the implementation of IMF reforms. In South Korea, Kim Dae Jung experienced a dilemma concerning how to deal with the IMF reforms that aimed at increasing 'flexibility in the workforce'. However, Kim Dae Jung negotiated with labour unions and managed to make a deal with them making it easier to lay off workers. In return for their cooperation the president promised the labour unions concessions in forms of unemployment benefits, freedom for union organization and the right for labour unions to establish political parties. South Korea's strength in comparison with Indonesia concerning the reform implementation was that Kim Dae Jung managed to mobilise groups that shared his views on how the economic development in South Korea ought to be. This made the South Korean state more autonomous than the Indonesian, in the meaning that Kim Dae Jung's support-base and his legitimacy gave him better room for manoeuvre than Suharto experienced.

## CHAPTER 5 STATE CAPACITY

In the previous chapter I discussed the implementation process with regard to the context where the interplay between the IMF and the Indonesian and the South Korean governments took place. In the present and in the next chapter, I will be discussing how *national political factors* influenced the governments' implementation of IMF reforms in Indonesia and South Korea. The Asian states were known for their successful implementation of economic policies prior to the Asian crisis, often explained in terms of an effective bureaucracy and a close relationship between the government and the business sector. The theoretical perspective of **state capacity** has been influenced by analyses of the impressive economic development in East Asia during the 1970s, and the focus is on the technical and administrative capacity of states to successfully formulate and implement economic reforms. Following the literature about the Asian developmental states, an important argument is that a well functional bureaucracy along Weberian lines is a significant feature of high state capacity to implement reforms (Evans 1995, Weiss 1998). In addition to a 'Weberian' bureaucracy, the state should also have the administrative and technical capacity to direct the business sector towards national economic goals.

Drawing on theories concerned with state capacity the aim of this chapter is to explore how (i) bureaucratic organisation and (ii) features associated with the relationship between the government and business sector influenced the Indonesian and South Korean implementation of IMF reforms in 1997-1998. This chapter is divided into four parts. In the first part I will examine the role that the bureaucracy in Indonesia played in policymaking and in the implementation of economic reforms prior to, and during the Asian economic crisis. My guiding question in this first part of this chapter is: *How did bureaucratic conditions influence the reform implementation in Indonesia?* In the second part of this chapter I will discuss the ability of governments and the state apparatus to guide the business sector towards national goals in order to successfully implement policies. The guiding question when dealing with this issue is: *How did features associated with the relationship between the Indonesian government and the business sector hinder, or promote the Indonesian government in implementing reforms?* In the third part of this chapter I will discuss how the concept of state capacity can be used to explore the South Korean experience concerning the two issues, bureaucratic organization and features associated with the relationship between the state and the business sector as far as the implementation of IMF reforms in 1997-98 is concerned. In the final section I will sum up the arguments made in this chapter and discuss how they relate to the two questions proposed above.

## 5.1 Bureaucratic organization in Indonesia

The role of the Indonesian bureaucrats in managing the crisis has not attracted much attention in discussions about the Asian economic crisis, even though the bureaucracy is usually seen as an important part of the state apparatus when economic policies are developed and sought implemented. The literature concerning state capacity argue that a high degree of administrative and technical capacity to implement reforms is much due to a bureaucracy working along Weberian lines. In this first part of Chapter 5 I will look closer at the role of the bureaucracy in Indonesia and explore how it can be said to relate to 'Weberian' features, like insulation from particularistic interests and with a meritocratic recruitment and predictable career ladders. I will discuss how the Indonesian bureaucracy can be said to be divided between the technocrats favouring economic liberalisation (later referred to as the economists) and technocrats favouring state intervention in the economy (a group that I will refer to as the nationalists). The aim of the first part of this chapter is to explore whether the Indonesian bureaucracy can be said to have low or high state capacity in reform implementation.

### 5.1.1 The makers of policy

The part of the Indonesian bureaucracy that deals with economic policymaking and implementation is often described as lacking bureaucratic autonomy, because of two substantial groups that have been competing for influence; the economists who favoured economic liberalisation, and the nationalists, favouring state intervention in the economy (Hill 1996, Schwarz 1994). The economists have traditionally lacked any solid domestic power-base, but they have been important in securing economic aid from western financial institutions as well as for maintaining international investor confidence through their adherence to 'western' economic ideology, stressing the importance of free market forces and the limited role of the state. The nationalists on the other hand have been committed to the idea that an interventionist state was needed in order to catch up with the industrialised countries. It was also important for them that the government should help indigenous Indonesian businessmen to challenge the powerful position of their Chinese-Indonesian counterparts. The nationalists have traditionally had its power-base in the Ministry of Industry, the Investment Board, the Ministry of Research and Technology, as well as in important state-owned enterprises such as the oil company Pertamina.

The economists have traditionally been employed in the Ministry of Finance and in the Central Bank (MacIntyre 1993:157).

When Suharto officially came to power in 1966 he gave the 'Berkley mafia', a group of American trained economists, the task of reforming the economy. In the beginning of the New Order, the economists experienced substantial power in directing economic policies, and within a few years they had stabilized the economy with the assistance from international donors. Suharto gave the economists enough leeway to open up the financial sector, lower import tariffs, to remove some non-tariff barriers and to take other steps to improve Indonesia's investment climate. In addition, the economists controlled the Bappenas, the Indonesian national planning board, as well as the finance and the monetary portfolios. However, during the 1970s two instances undermined the influence of the economists, and gave rise to the influence of the nationalists. First, rising oil prices in 1973 led to a sharp increase in the income available to the Indonesian state. The oil wealth was used to subsidise new industries like steel, cement, chemicals, fertilisers, aluminium and machine tools. Second, riots in 1974 had showed a large degree of dissatisfaction from the public towards the rising economic influence of international investors and Chinese-Indonesian businessmen. The availability of oil money now provided the opportunity for the nationalists to introduce a variety of programmes that advanced Pribumi's (native Indonesians) businesses, from preferential awarding of contracts to bank lending.

As the economists' influence had declined with the increased access to oil money, their influence started to rise again as oil prices dropped in 1982. In order to recover from the decline in oil prices, wide-ranging liberalisation reforms were introduced in the 1980s and import-substituting industrialisation was gradually transformed into an export-oriented pattern of development, while international investors were again welcomed. During the liberalisation of the Indonesian economy in the 1980s, Pinkus & Ramli (1998) argue that the economic bureaucrats' efforts to liberalize was not just driven by their ideological conviction, but also because it turned out to be a way to limit the growing power of the political and business elite. The problem with the Indonesian economy as the economists saw it, was that the preferential lending system provided by the state-owned banks often went to political elites, especially Suharto's family, with no guarantee for profits. The result was a large increase in non-performing loans. In order to introduce more competition in the financial sector, financial reforms in 1983 and 1988 turned Indonesia into one of the world's most liberalized financial systems, with minimal state regulations on new banking establishments, interest rates or reserve requirements. The privatisation of the financial sector led to a large increase in lending activity, with an annual increase of 40% from 1988 to 1996 (ibid: 725). The result of the liberal reforms was a financial sector made up of a large number of small banks with risky lending procedures and with lacking regulations on financial sector activities, like non-existent bankruptcy laws. The effort of the economists to deregulate the financial sector in order to reduce the preferential lending of the state banks towards the political elite, had rather turned into a situation where the political elite enjoyed privileges from an under-regulated financial sector.

When the economy started to grow again in the early 1990s the influence of the bureaucrats belonging to the nationalist camp again increased. A sign of the declining influence of the economists was that Suharto transferred the control over SOEs and banks from economist controlled ministries to the state secretariat and the Minister for Research and Technology B.J.Habibie, who was known for his close business connections with the Suharto family and for favouring state intervention in the economy (Soesastro 1999). Particularof the baSuharto's re-election as president in 1993, the relative influence of the nationalist camp was clear. When Suharto introduced his new government in 1993 it was the first time that an economist did not hold the position of Co-ordinating Minister of Economics and Development (Haggard 2000:44). Another example of the economists' diminished influence was the neglects from the political elite concerning the Central Bank's introduction of stronger legal lending limits in 1993. Even though the Central Bank governor threatened to take legal action against those banks that broke the limits, nothing ever eventuated (Schwarz 1994:77). During the mid 1990s, the economists still made efforts to further liberalize the economy through launching reforms that sought to dismantle the protection of steel, automotive and agriculture sectors. They also sought to control foreign borrowings to stem up the growth of Indonesia's foreign debt.[69]

### 5.1.2 How did bureaucratic conditions influence the implementation of IMF reforms in Indonesia in 1997-98?

From the above one can see that even though the bureaucracy has been divided, it has played an important part in developing and directing the economy and successfully implemented economic

[69] However, the entire board that was set up to manage this task was replaced when they protested over a decision that allowed a petrochemical project, Chandra Astri (where a number of Suharto's business partners were involved) massive borrowing abroad. Finally in 1997 the team's authority was reduced when the government eliminated the ceiling on private borrowings (Robison & Rosser 1998).

reforms prior to the Asian crisis. So how did the bureaucracy influence the implementation of IMF reforms during the Asian crisis? In the initial stages of the crisis, and prior to the assistance of the IMF, the economists in the bureaucracy, in an attempt to restore the balance of payment, introduced fiscal and monetary measures to cope with the sliding exchange rate. They also cancelled numerous large government and private infrastructure projects belonging to Suharto's family. Soesastro (1999) argues that in the beginning the crisis was seen as a major opportunity by the economists within the bureaucracy to address the structural problems in the Indonesian economy and to continue the deregulation process that in their eyes had been delayed during the last decade. The IMF, the World Bank and the Asian Development Bank (ADB) backed the economists, but due to their weak position during the 1990s they lacked any real domestic power-base and relied on the IMF to keep them in positions of influence (Hill 2000).

As discussed in Chapter 2, three factors are important for successful reform implementation in relation to bureaucratic organisation. First, that the bureaucracy is autonomous, meaning isolated from particularistic interests. Second that the bureaucracy has Weberian characteristics like meritocratic recruitment and predictable career ladders, and third that trans-national alliances between the recipient government and the IMF should be established. Neither of these premises was apparent in the Indonesian case, and I will below explore each of the three characteristics in relation to the Indonesian experience. First, the Indonesian bureaucracy is not known for being autonomous. It is rather described as having clientelistic characteristics, where corruption has been an important feature. There have been many instances where bureaucrats have helped favoured businessmen, for example by providing them with credit from state banks (Schwarz 1994:133).[70] According to the Weberian ideal bureaucracy there should be a separation between the politicians and the bureaucracy. The aim is that difficult and contentious policy problems can be solved by removing them from the hands of politicians, insulating them from group pressures and assigning them to knowledgeable and well-socialised technocrats. To a certain degree this was the case in Indonesia. The workings of the bureaucracy have been isolated from collective group pressures in *general*, although with a serious exception of the pressures from the small, but very powerful political and business elites close to the president and his family. However, the

[70] A case that attracted much attention in relation to this was the Eddie Tanzill case. A state-owned bank, Bank Bapindo, gave a huge credit equal 430 millions USD to politically connected businessman Eddie Tanzill for a textile enterprise, Kanindo. The project turned out to be grossly overfinanced and much of the money from the loan disappeared forcing Bank Bapindo to write off the credit as bad debt (Rachibibi 1999:33). Following queries and revelations, Tanzill was convicted of bribing officials at Bank Bapindo to obtain the loan. Tanzill was in the end jailed, but is thought to have bribed his way out of prion and his whereabouts remain unknown (Haggard 2000:26).

important point is that the 'difficult and contentious' policy problems are removed from the hands of the politicians *as long as* the president is guaranteed that the outcome is in line with his wishes. The case of Indonesia shows that during the Asian crisis, those bureaucrats that opposed the president's actions and favoured IMF reforms were easily ignored. One example is the dismissal of the Central Bank governor, Soesdrdjad Djiwandono, because of his opposition to the currency board idea. The dismissal of the governor was not against the law, but it was highly controversial, especially in times when the international community was watching Suharto's moves.[71] Earlier, in December 1997, Suharto had also dismissed four out of seven managing directors in the Central Bank, and replaced them with officials of his own choosing without consulting the governor first. By mid April 1998 all the senior management in the Central Bank had been changed, and among the new managing directors, barely half had former experience from the Central Bank (Sharma 2001:101). Suharto also fired the head of IBRA around the same time as he dismissed he Central Bank governor. Sharma (ibid.) argues that a part of the problem of the perception that IBRA was just a 'paper tiger', was a result of Suharto undermining their efforts through not publicizing the operations of IBRA. This gave him more legitimacy in dismissing the head of IBRA as opposed to a situation where the workings and operations of IBRA were better known. This example shows that the president had great power in deciding who would inhabit the various positions in the bureaucracy as well as controlling economic policies himself. In this way he also showed that he was not interested in leaving the responsibility of difficult and contentious policy problems into the hands of the bureaucracy alone.

Second, the Indonesian bureaucracy does neither have the characteristics of a Weberian bureaucracy in that it is an elite service that succeeds in attracting highly trained and motivated graduates (MacIntyre 1994:261). In Indonesia there is a genuine shortage of well-educated bureaucrats. About one fourth of those who have a college or university degree do never attain a rank corresponding to their educational level, and an average of about 40% of civil servants have an individual grade below the grade required for the position that they hold (King 1998). The correspondence between a civil servant's formal education and his agency of employment also varies (ibid). This may imply that the technical capacity of the bureaucrats that is necessary to have high state capacity in reform implementation, may not have been at the desired level. However, this does not necessarily explain why the implementation of the IMF reforms in 1997-

71 Since 1983 the Governor of Bank Indonesia holds the status as a cabinet member and thereby it is legal to dismiss the governor as a cabinet member. However, the law stipulates that the president can *only* dismiss the governor before the end of a five year term, in the following circumstances: at the personal wish of the governor, on the governor's death, or when for some reason the governor cannot serve in office (Article 17 of Law No 13, 1968, on Central banking).

98 failed, because the Indonesian bureaucracy had experienced successful implementations of economic reforms prior to the Asian crisis. The characteristics of the bureaucracy have not changed dramatically since then.

A third factor that is important when discussing the influence of the Indonesian bureaucrats on the implementation of IMF reforms, is once again to consider the context where the interplay between the IMF and the recipient governments take place. An important part of reform implementation literature focuses on the need for IMF to make alliances with domestic groups that can support their reforms. The IMF can engage in strategies that attempt to shape the incentives of their domestic counterparts by influencing the domestic political level that surrounds the implementation in various ways. According to Kahler (1993) it is crucial for the IMF to develop a trans-national alliance between IMF staff and domestic political actors in order to successfully implement the reforms. Potential alliance partners are found in government ministries that share IMF's policy preferences, like in the Ministry of Finance and the Central Bank. In Indonesia this proved quite difficult. The IMF faced a difficult task in order to develop trans-national alliances, because the group that sympathised with their reform agenda, the economists, did not exercise much influence in Indonesian economy at the time of the crisis. The existing economic policy was more in line with the nationalists' standing, favouring state intervention. Although there were sections within the bureaucracy that favoured the IMF reforms, Suharto still had the power and authority to remove people who disagreed with him, as seen in the earlier discussed dismissal of the Central Bank governor.

### 5.2 The relationship between the government and the business sector in Indonesia

An important feature of the Indonesian management of the Asian crisis was the opposition from powerful business interests towards the IMF reforms. According to structural adjustment literature, the opposite has rather been the situation in other cases (Haggard 1995). Traditionally the business sector is seen as favouring IMF reforms because it implies liberalisation of trade and cuts in taxes that benefit private enterprises. So why did the powerful business interests not oppose the implementation of IMF reforms in Indonesia? As pointed out earlier, an important part of a successful reform implementation in the Asian states prior to the Asian crisis was the ability of the state to discipline the business sector to work towards national economic goals, where the allocation of financial resources was an important means to achieve this. Within the tradition of state capacity it is not only the ability of the state to control the business sector that is important, but for a successful reform implementation an 'embedded' relationship between the state and the business sector is necessary. Embeddedness is important in two respects: First, that institutionalised networks that link business and government are seen as positive because they increase the flow of information thus improving the quality of policymaking. Second, that some kind of connectedness between the state and the business sector is needed because the state relies on the private sector for implementation of their policies.

In the second section of this chapter I will look closer at the Indonesian experience and discuss whether the relationship between the government and the business sector in Indonesia can be said to be 'embedded'. I will argue that although the Indonesian business sector is closely related to the government, this relationship cannot be described as 'embedded' in Peter Evans' (1995) terms. The relationship between the government and the business sector in Indonesia is rather characterised by a business sector that is dependent on the government for *access* to privileges. The liberalisation of the economy in the 1980s further increased this dependency. I will discuss whether this feature of the relationship between the government and the business sector in Indonesia might explain why there was so little opposition from the business sector when Suharto showed unwillingness to implement the IMF reforms. More specific is the question that I seek to examine in this second section of this chapter: *How did features associated with the relationship between the Indonesian government and the business sector hinder, or promote the Indonesian government in implementing IMF reforms?*

### 5.2.1 The business sector in Indonesia

As discussed earlier in this chapter, Indonesia has a long history of economic nationalism, where state intervention was seen by some as necessary in order to guide and manage industrial development.[72] During the 1950s the state was giving out subsidies of different kinds and it was necessary for businessmen to have personal ties with the politicians and the bureaucrats to access these subsidies. It was especially important for the Chinese-Indonesians to gain these benefits as they sought protection and patronage of influential politicians in return for cash and shares or joint ventures. When president Sukarno introduced 'Guided Democracy' in 1957, he confiscated all Dutch assets and all Dutch firms were taken over by the state. The number of SOEs increased

[72] One factor contributing to the favouring of state intervention can be the country's long colonial experience where the new Indonesian national leaders saw capitalism as associated with colonialism and exploitation (MacIntyre 1994). Another important factor was that when Indonesia became independent from the Dutch in 1945, the local business community was made up of Chinese rather than indigenous Indonesians. Political leaders thought that it was necessary for the state to intervene in markets to secure the indigenous majority a satisfactory share of the economic benefits.

due to foreign borrowing and income from the oil industry. The banking system was also brought under control by the state and credit was being channelled to the expanding public sector. When Suharto officially took power in 1966, it was clear that the economic adventures of Sukarno had failed. So with the assistance of the IMF and the World Bank (among others), Suharto implemented a stabilisation program aimed at liberalising the economy. Spendings on SOEs were cut down, trade barriers lowered, investment laws were loosened up to attract foreign investments. However, as I showed in the first part of this chapter, the boom in oil prices in the 1970s opened up for a new state-led industrial development, and gave the government an opportunity to invest in key industries. State intervention also emerged in the financial sector, where state-owned banks started to dominate the financial sector and lending activities were heavily influenced by government intervention.

During the liberalisation process in the 1980s, private business enjoyed a spectacular growth, along with the rise of a new generation of young native Indonesian businessmen, many of whom were the children of high ranking military officers and especially the children of president Suharto. When Suharto's family entered the business arena, most major state companies were locked into joint ventures with the Suharto family’s private business conglomerates. These included the state-owned oil company Pertamina, its subsidiaries, public works construction companies, state-owned pharmaceutical companies, state-owned telecommunication and satellite communication companies (Schwarz 1994). The growth in number of conglomerates was very closely related to government support through the allocation of credit.

As said earlier the Chinese-Indonesian businessmen had a privileged position in Indonesia. Given Indonesia’s volatile political history and periodic violence against the Chinese-Indonesians, they naturally had incentives to form political alliances that could offer protection, including with the military. At the same time their minority status and wealth made them highly reluctant to engage in any overt political activity, political relationships were more likely to be personal, clientelistic and non-transparent. Suharto and lower-level politician and military leaders had to balance lucrative relationships with private Chinese-Indonesian businesses, while at the same time having to respond to the wishes of native Indonesian businessmen.

### 5.2.2 The politics of liberalisation

As I have argued earlier in Chapter 4, the reason for the lack of commitment from Suharto in implementing the IMF reforms must be seen in relation to his vested personal interests in the Indonesian economy. The IMF reforms targeted Suharto's personal economic interests and the reforms required structural changes in the Indonesian economy. In this section I will discuss how the close relationship between the state and the business sector enabled Suharto to expand his private business empire in the 1980s. It was not a relationship characterised by 'embeddedness' and mutual dependence as can indicate high state capacity, it was rather a situation where the government's members had strong personal interests in the national economy and where the business sector was dependent on the state for getting access to subsidies or lucrative deals.

Following the oil-boom period of 1973-1982 and heavy state intervention, important state monopolies developed within sectors such as banking, television, electricity, toll road construction and telecommunication. As discussed earlier, the interventionist Indonesian state withdrew from many of its interventionist practices in the early 1980s. The main task was to liberalise the economy through reducing bank regulations, toning down the earlier preferential bank lending, liberalising and streamlining local and foreign investment laws, lower tariff barriers, and to abolish several import and public sector industry monopolies (MacIntyre 1994). Rapidly increasing and highly mobile capital flows meant that the old macro economic framework had to be adjusted to fit the new policies, but as shown earlier in this chapter the supervision of the financial liberalisation was not a prioritised task. Haggard (2000:32) argues that the economic liberalisation in the 1980s must be characterised as 'captured liberalisation' where the economic reforms were implemented without the adequate legal, administrative, or informational capacity to check private ineptitude, malfeasance or fraud. The liberalisation process represented an important shift in political and social power, and a powerful coalition emerged between private business interests and political and bureaucratic powerholders that gained from these reforms (Robison & Rosser 1998:1595). There was a shift of power away from state managers to private interests and from the harnessing of state authority to private agendas. In Indonesia the new business elite consisted of people from the bureaucracy and their families, and notably Suharto's children. Instead of a free market after liberal economic principles, the rise of new business interests were linked to the opening of former public monopolies and the establishment of an open banking system and capital market. Clientilism and connections to the political elite were factors that determined business success rather than free competition in a functioning market.

An important part of the literature concerning state capacity stresses that the degree of capacity in reform implementation varies with the ability of the state to direct the business sector towards preferred sectors. The important means to achieve this, is through allocating credit on the basis of preferential lending programmes. The Indonesian state had intervened in the financial markets from the early days of the 1970s. However, MacIntyre (1993:151) argues that there are four factors that make it reasonable to assume that the allocation of finance has enhanced 'captured liberalism' and thus shown the lacking technical and administrative capacity of the government to direct business into desired sectors. First, Indonesia lacked the bureaucratic expertise to monitor and enforce the complex system of preferential credit.[73] Second, the entire system of preferential credit opened up for malpractice and corruption where the patrimonial needs of the political leaders often took precedence over the official hierarchy of priority borrowers. Third, the transaction costs involved with small scale subsidized lending was very high, due to a high level of no repayment, and much of the credit earmarked for small borrowers went to large borrowers instead. Last, the effort to concentrate credit towards priority borrowers was weakened by the fact that Indonesia since 1971 had had an open capital account. When large domestic firms could not gain access to cheap credit in Indonesia, they went offshore to raise capital instead.

Hamilton-Hart (2000:110) argues in relation to the liberalization process in the 1980s that prudential regulations and financial liberalization require different political conditions. The benefits of financial deregulation in the context of an open capital account are relatively concentrated, while the costs and risks are diffuse. Therefore, deregulatory reforms, at least in the financial sector, are politically easier than prudential regulations, particularly if circumstantial factors such as balance of payments crisis make status quo untenable. In Indonesia the rapid growth in the deregulated private banking sector gave the business and political elite an opportunity to take advantage of the financial liberalisation and the preferential lending programmes. The argument about the Indonesian government's prudential failure brings up the question of political preconditions. Indonesia's governing institutions under Suharto can be seen as an example of a strong government accompanied by unrestrained extremes. The state-dominated New Order ideology was a result of a manipulation of public policy in the interest of regime maintenance and private agendas of those with personal ties to the president. Suharto was

[73] This could for example be seen in the role of the Central Bank in relation to preferential lending. There were elaborate lists of priority categories in the Central Bank, but not only had they little or no idea of the purpose of providing cheap loans, they also lacked the oversight and the ability to monitor whether subsidised loans ever reached the targets groups.

able to develop the governing institutions through an effective security apparatus so that they suited his interests as well as meeting the developmental goals needed for political stability. A personalized clientelistic bureaucratic system was compatible with his objectives. Indonesia becomes a case where the lack of an embedded relationship between the state and the private sector has developed into a situation where the strong state controls the business sector, not by disciplining business towards national goals, but rather to secure the political elites' own personal economic interests.

### 5.2.3 How did features associated with the relationship between the Indonesian government and the business sector hinder, or promote the government in implementing IMF reforms?

The Indonesian experience shows an authoritarian state that has been able to minimize collective action by business groups, but it has not been able to insulate itself from particularist interests stemming from clientelistic connections. This was evident in the failure to implement IMF reforms that harmed the economic interests of Suharto's family or their business associates. However, the Indonesian state can be said to have been clientelistic since the early 1950s, but still been successful in implementing reforms. The important point here, is that the policies implemented earlier did not threaten the economic interests of the political elites like the IMF reforms did in 1997-98. When the government was faced with the requirement to implement the IMF reforms that would change the structure of the Indonesian political economy, they chose not to do so. This reluctance to introduce reforms that might hurt personal economic interests had also happened earlier in the 1990s, as shown in section 5.1.1 in the case of Chandra Astri and the disregard of the Central Bank's introduction of stronger legal lending limits in 1993.

The Indonesian liberalisation process in the 1980s had been an opportunity for Suharto and his business associates to engage in new business activities where access to preferential credit, lucrative state monopolies or subsidies almost guaranteed economic success. This feature of the government and business sector relations is important in understanding the failure to implement IMF reforms in Indonesia. As long as the president and the government had serious personal economic interests in the Indonesian economy, along with the authority to control the business sector, the reforms that sought to break up this relationship were not implemented.

### 5.3 The South Korean experience

In the third section of this chapter I will explore how the IMF reform implementation in South Korea can be said to be more successful than the Indonesian through discussing the technical and administrative capacity of the bureaucracy and features associated with the relationship between the state and the business sector. In the first part of this section I will show that the South Korean bureaucracy played an important role in the reform implementation process during the Asian crisis in two respects. First, through the special committees that Kim Dae Jung set up to manage the implementation of the IMF reforms. Second, that an increasing part of the bureaucrats supported Dae Jung's reform agenda. Features associated with the relationship between the government and the business sector before and during the implementation process in 1997-98, is interesting for two reasons: First, the South Korean economy was liberalised in the 1990s with an aim of breaking up the tight relationship between the Chaebols and the government. The required IMF reforms fitted well into this restructuring process. Second, the fact that Kim Dae Jung was not dependent upon the support of the Chaebols for his presidency, put him in a position where he did not have to give any concessions to the Chaebols when it came to implementing the IMF reforms.

#### 5.3.1 The decline of the developmental state

As shown earlier in the case of Indonesia, one also witnessed in South Korea a turn towards a more liberal economic approach in the mid 1980s, and many argue that this marked an important shift away from the developmental state model.[74] A number of private banks were privatised and the financial market was partially liberalised. The capacity of the state to coordinate investment though the control over credit was weakened because of changes in the financial sector that led to large inflows of portfolio investment along the privatisation of state banks (Weiss 2000:31). With the introduction of the 'Industrial Development Law' in 1986, the industrial policy shifted from selected sectors towards more functional or market-oriented sectors.

Another important feature of the developmental state model had been the importance of a pilot agency within the bureaucracy that oversaw the national economic development. In the early 1990s the EPB in South Korea was increasingly marginalised and finally abolished in 1993 (but later absorbed into the Ministry of Finance and Economy), because of continuing disagreements

[74] The liberalisation process in the 1980s has to be seen in relation to South Korea's prospect of becoming a OECD member, where USA demanded that the South Korean government had to open the capital market in order to gain membership, which they finally did in 1996.

concerning the government's wish for capital market opening. To many this was interpreted as the final sign that the South Korean state could no longer be considered a developmental state.

### 5.3.2 The role of the bureaucracy in the implementation process

An important aspect of the implementation of the IMF reforms in South Korea in 1997-98 was the way the president enhanced his power over the state apparatus, in order to limit the opposition within the bureaucracy towards the reforms. Kim Dae Jung formally reorganised the government so as to create the Budget and Planning Bureau, which he made directly subordinate to the president. He also established the Financial Supervisory Board, which he placed outside of the Ministry of Finance and Economy. The president used these two agencies rather than the MOFE as key agents of reform in order to avoid opposition from bureaucrats that did not share his view on which reforms were necessary for recovery. To secure the implementation of the IMF reforms, Kim Dae Jung filled every key position in the Budget and Planning Bureau and the Financial Supervisory Board with officials either from his home region or with bureaucrats who were sympathetic to his reform programme (Mo & Moon 1999). Because of this, speculations were that Kim Dae Jung wished to weaken the influence of the bureaucrats that were known to have strong relations to the Chaebols or sympathies to the past regime. So why was it that necessary for Dae Jung to control the bureaucracy? An important reason was that changes in the economic ideological preferences of the bureaucrats during the 1980s had led to a conflict within the earlier autonomous bureaucracy over the role and scope of the state in the economy (Weiss & Hobson 2000). The increasing number of elite bureaucrats and academics who got advanced degrees from the USA meant that there were more and more people inside and outside the government who were convinced of the virtues of the free market and consequently viewed the developmental state as a backward and mistaken ideology.[75] This disagreement within the bureaucracy was seen as an obstacle to the implementation IMF reforms, and it was necessary for president Kim Dae Jung to staff these new agencies with bureaucrats sympathetic to his views of how to best restructure the South Korean economy.

[75] All the 35 employees at the powerful semi-governmental 'think-tank', Korea Development Institute, held Ph.Ds from American Universities (Woo 1991:192).

### 5.3.3 The relationship between the government and the business sector: Concerned Chaebols

The aim for the South Korean government in the 1990s had been to loosen up the tight relationship between the state and the Chaebols in order to improve the Chaebols' position in the international market. A diversification of core industries and a phasing out of non-core businesses seemed necessary to reduce Cheabols' indebtedness (Haggard & Mo 2000). But instead of upgrading their production along these lines, the Chaebols expanded their capacity to get a larger market-share. This made the Chaebols more vulnerable to economic crises, and they were largely blamed for being the cause of the economic problems in South Korea during the Asian crisis.

In addition to the labour unions it was necessary for the government to have groups related to the Chaebols to adhere to the corporate restructuring as required by the IMF. The Chaebols had a quite powerful position in South Korea prior to the crisis, although their influence was not what it used to be at the height of the developmental state. Why did they not try to oppose the implementation process, like the powerful conglomerates did in Indonesia? Mo & Moon (1999) stress that the social environment fostered by the crisis helped to reduce the political and the social opposition against the reforms. The banking and finance sector was too weak to organise any political opposition, and the Chaebols were unable to act because of their weak economic situation after the crisis. They had also spent a large amount of money in supporting Kim Dae Jung's opponent Lee Hoi Chang in the presidential election in 1997, which made it hard to lobby for their view on the Dae Jung government. In addition to this the Chaebols were blamed for the economic crisis, so they were not in a position to argue their case. The public supported the change of president and gave Kim Dae Jung benefits in dealing with labour and the Chaebols. There was a widely shared social consensus that failure to implement reforms could have serious consequences for the future of the entire South Korean economy.

Another important feature of the government-business relations in South Korea was that Kim Dae Jung's ties to and dependence on the private sector was much weaker than that of his predecessors. His reform agenda must be seen in relation to both economic as well as political reasons. Kim Dae Jung did not have to give any concessions to the Chaebols, which made implementing the IMF reforms less troublesome. The weakened position of the Chaebols made it easier for Kim Dae Jung to develop a 'quasi-embedded' relationship between the government and the business sector, where the government relied on the private sector for implementation of their policies and the Chaebols relied on the government for help to recover from the crisis.

### 5.4 Concluding remarks

In this chapter I have discussed how the mismanagement of the implementation of IMF reforms in Indonesia partially can be understood through focusing on bureaucratic conditions. I have argued that the Indonesian bureaucracy can not be considered to be autonomous, nor is it staffed by well-educated and specialised bureaucrats. According to the theoretical perspective of state capacity, an important aspect of bureaucratic capacity to implement reforms is the separation between the politicians and the bureaucrats, where difficult and contentious policy problems are solved through removing them from the hands of politicians and leaving them with the high-qualified bureaucrats. I have shown that in Indonesia, this was not how the bureaucracy worked. Suharto rather sought to remove policy problems from the hands of the bureaucrats when they contradicted with his own interests - either by circumventing reforms himself, or by dismissing bureaucrats that opposed him. The South Korean case is different from the Indonesian. South Korea experienced a high degree of bureaucratic autonomy, because Kim Dae Jung gained support for his reforms from sympathetic bureaucrats, whom he effectively put in a powerful position where they could oversee and secure the implementation of the IMF reforms.

Another question that has been addressed in this chapter is whether features associated with the relationship between the government and the business sector can hinder, or promote implementation of IMF reforms. Indonesia illustrates a case where the business sector is dependent on the government for access to subsidies or privileged monopolies, and the administrative capacity to guide the business sector towards national goals depends on what those goals *are*. As long as the reforms are in tune with the political or bureaucratic elite's interests they can be accomplished, but when they contradict with the power holders' wishes they are not implemented. In the case of South Korea I also discussed whether there could be said to be features associated with the relationship between the government and the business sector that might hinder, or promote the government in its implementation of IMF reforms. The situation in South Korea proved different from the Indonesian, because here the Chaebols were seen as the major cause of the crisis. This gave Kim Dae Jung legitimacy to implement IMF reforms that aimed at breaking up the close relationship between the government and the business sector. To secure support for his reform agenda, Kim Dae Jung established consultative mechanisms between the government, the business sector and labour unions. However, these institutionalised relations between the government and the business sector were not based on the kind of mutual relationship that characterizes ‘embedded’ relations. The situation was more that of a government that had the power and legitimacy to explain to the Chaebols their options.

## CHAPTER 6 REGIME CAPACITY

As pointed out in the previous two chapters, the Indonesian and the South Korean experiences in relation to the implementation of IMF reforms turned out quite differently. During the Asian crisis the international press discussed whether their dissimilar experiences could be due to their different regime forms, authoritarian vs democratic. As the Indonesian crisis erupted, conventional economic measures as promoted by the IMF did not work. As a result some scholars and observers began to argue that the basic problem was political rather than economic. The seeming success of the democratic South Korean implementation further enhanced this picture. However, the success of democratic regimes in the implementation of economic reforms stands in contrast to the developmental state literature where an important argument is that the Asian states were able to impose their policies on the society and the business sector because of their *authoritarian* political structure. This argument was also used in the case of Indonesia at the onset of the crisis, when Suharto was applauded for his initial quick response to the crisis. As the crisis developed, the focus shifted to viewing Suharto's authoritarian New Order regime as the major obstacle to successful implementation of IMF reforms. This argument follows the tradition that sees **regime capacity** to implement economic reforms as related to particular structures of political institutions. More precisely, a focus on regime capacity does tell how the political institutional design facilitates or impedes decisive policy action and thus influences economic policy management. One debated issue within the theoretical approach that focuses on regime capacity has been whether democracies or authoritarian regimes are more decisive and effective in reform implementation. Decisiveness refers to the speed in which the government can act, in other words to what extent political institutions promote qualities such as efficiency in policy-making, implementation and the ability to make and carry out difficult but necessary policy decisions in a timely fashion (MacIntyre 1999a:4). The present chapter is divided into four parts. In the first part of this chapter my guiding question in relation to regime capacity will be *'to which degree did the political-institutional framework in Indonesia increase the possibility of decisive action in the implementation of IMF reforms?'*

Another important topic within the perspective of regime capacity has been to see how popular support and interest articulation are incorporated in the political institutional structure to increase regime capacity. The successful South Korean implementation of the IMF reforms during the crisis showed that popular support and legitimacy of the president's reform agenda was an important feature. However, prior to the crisis the Asian states were known for their state corporatism, where interest articulation was institutionalised into the political structure in order to control interest groups and hinder opposition against the state's policies. Important in this respect is to discuss why state corporatism had proved effective prior to the Asian crisis, while it proved not to be so in the case of Indonesia in 1997-98. In the second part of this chapter I will design my analysis around the question *'How did the Indonesian political system incorporate popular support and interest articulation so as to successfully implement reforms?*

In the third part of this chapter I will discuss the issues of decisiveness within the political institutional structure and the role of popular support and interest articulation, in order to explore the South Korean regime's capacity to implement IMF reforms. In the final part I will summarise the arguments made in this chapter, and discuss how they relate to the two questions proposed above.

### 6.1 Democratic vs. authoritarian regimes' decisiveness

In the first part of this chapter my focus is on the political-institutional framework in Indonesia and the degree in which it might increase the possibility for decisive action in the implementation of IMF reforms. One of the things to consider in relation to this is the number of veto points, i.e. the number of institutions and agencies that may veto policy proposals, thus forcing a status quo. Veto points can include the president, the legislature, a second chamber of legislature, a committee within a legislature, or the courts; in authoritarian regimes it may include the military. The preferences of these veto points may be more or less solely aligned. Thus the president and legislature may represent distinct veto points, but may either be of the same party (unified government) or of different parties (divided governments) (Haggard 2000:49). A government that faces many veto points can be indecisive, while few veto gates may make policy implementation more effective. I will show that Indonesia had a very decisive political structure with no institutional constraints on the president's actions. In relation to the implementation of IMF reforms this political institutional structure enabled Suharto to effectively implement reforms, but at the same time the decisive political institutional structure meant that Suharto did not need the approval of other political institutions for his actions. I will in the following discuss how this became relevant for the implementation of IMF reforms as Suharto was in a position where he could reverse his policy commitments when he chose to, due to the lack of institutional checks on his power.

### 6.1.1 A decisive Indonesian political institutional structure

In Indonesia the party and electoral systems, the state corporatist framework and the support of the president from the armed forces, had reduced the ability for political participation and enhanced the president's power. Although there was a constitutional separation of the powers between the presidency and the legislature at the time of the crisis, in practice there was only a weak division of governmental powers, with the presidential branch thoroughly dominating the legislature and the judiciary. Lines of executive accountability were very clear, with bureaucrats only responsible to the presidency, and the presidency was only weakly accountable to the parliament (MacIntyre 1999b:274). Indonesia had developed a political system where executive authority was highly centralized around the presidency, and the absence of any effective independent veto points on the president’s power produced a highly decisive structure of government.

This centralisation of executive authority enabled the government to act quite quickly and decisively when the signs of a crisis emerged during the summer of 1997. Even before the rupiah came under attack the government moved to widen the band within which the currency traded as pre-emptive measure. As the crisis intensified regionally, the authorities cut the rupiah completely free, drove up interest rates, scrapped foreign ownership limits on the stock exchange, reduced tariffs and froze a range of high-cost infrastructure projects. The Indonesian government acted quickly and won praise in the international community for doing so. Why then was the Indonesian economy so badly hit a few months later? As discussed in chapter 4, after the introduction of the first IMF package, Suharto announced that the controversial import monopolies on wheat, soybeans, and garlic would be abolished. He also agreed to close down 16 small banks where his family had great interests, as well as cutting tariffs in industries affecting his business associates’ firms. Implementing these reforms implied that the president was willing to take quick action and signal his willingness to cut back on privileges belonging to his business associates as well as his family. However, as I discussed earlier, just shortly after he had announced his commitment to the IMF reforms, he gave mixed signals concerning the implementation. As I have shown in 4.1.1.1, this included the 'ok' to continue eight large investment projects postponed in September, the reopening of Suharto's son’s bank, and an annual budget that did not satisfy the IMF requirements. The decisive political institutional structure that had enabled Suharto to take effective action in the beginning of the crisis now gave him the opportunity to reverse his IMF commitments as he pleased. So why did not the decisive Indonesian political institutional structure facilitate successful reform implementation as the

Asian crisis deepened? Jaquette (1998:223) argues that Suharto's earlier success in handling economic crises and the implementation of reforms in the late 1960 and in the mid 1980s can be understood as these crises did not threaten the president's personal economic interests in the way that was the case in 1997-98. After the initial successful and effective actions, the advantages of an authoritarian political institutional structure in relation to decisiveness rather came out as an erratic behaviour of the chief executive.

The very concentration of authority and the decisiveness of the Indonesian political structure ultimately generated profound uncertainty about the economic situation. The issue of credibility of policy commitments is important in this matter. If governments are subject to little or no constraints (few veto points) their policy promises have little credibility, because policies can easily be reversed and consequently make the economic climate unstable and unpredictable. This implies that regimes with a decisive political institutional structure carry the risk of being interpreted as unpredictable and not credible. Credibility implies political institutional structures that create a stable environment where economic policies cannot be changed within a short period of time. A large number of veto points are important, because it makes it hard to reverse a policy decision and therefore creates a predictable economic development. As stated earlier, the Indonesian political system is institutionally centralized and with few veto points, and thus vulnerable to credibility problems because it is easy for the president to reverse his policy commitments. An important feature of the Indonesian implementation of IMF reforms was that Suharto lacked credibility in his commitments to the IMF. His credibility suffered both through his actions when reversing earlier agreed IMF policies, but also through the currency board controversy, the announcement of the new ‘crony’ Cabinet in March 98, and the appointment of B. J. Habibie as his vice president. The impression was that the economic climate was unstable, much due to a president that changed his mind seemingly randomly.

The Indonesian implementation of IMF reforms lacked credibility of policy commitments due to the decisive structure of the political institutions. Yet, prior to the Asian economic crisis Indonesia managed to sustain investor confidence although the political authority was centralised and unconstrained. Why then did international investors withdraw in 1997-98? The important issue here is what kind of economic policy and political economy that was perceived as credible for further economic development. A significant feature of the IMF reforms was the aim to open up and to attract international investments to Indonesia. The lack of credibility of Suharto's commitment to the IMF and the unpredictable policy environment that this created meant that investors were further reluctant to invest. Moreover, as the Asian crisis unfolded, and the causes of the crisis were more and more frequently interpreted in terms of flaws inherent in 'Asian capitalism', the IMF's economic ideology was seen as the *only* sustainable and credible economic policy that would lead to recovery. This further reinforced the investors' impression that any economic policy that was not in line with the IMF ideology was not credible, and consequently a potential risk to their investments. As a result Suharto had less credibility. Not only was he perceived as someone who was creating an unpredictable policy environment through his reversals of policy commitments to the IMF, he was also blamed for giving priority to 'Asian capitalism' rather than to the IMF reforms based on 'credible' economic policies.

### 6.1.2 To which degree did the political-institutional framework in Indonesia increase the possibility of decisive action in reform implementation?

The concepts of credibility and decisiveness of political institutions are not mutually exclusive, but their institutional foundations might be. For a government to be decisive there have to be few institutionalised restrictions on the president's power, while the institutional foundation for high credibility is many veto points that makes it harder to reverse policy commitments. During the Asian crisis Indonesia had a decisive authoritarian political institutional structure with few constraints on the president's power. But in relation to credibility of policy commitments, its decisiveness always carried the risk of policy uncertainties. The decisiveness of the Indonesian political structure proved to be an advantage at the beginning of the crisis. However, the decisiveness of the Indonesian authoritarian regime did not seem to benefit implementation as long as the political structure enhanced Suharto's lack of will to implement the reforms that were not in his interest. The Indonesian case shows that a decisive political institutional structure facilitates implementation when the president approves of the reforms. If the reforms contradict the president's intentions, a decisive authoritarian regime becomes an obstacle to implementation.

## 6.2 Popular support and interest articulation

One important feature of the authoritarian Asian states was the suppression of civil society and the ability of the state to override particular interests groups. The successful implementation of economic reforms in the Asian states prior to the crisis in 1997 is often explained in terms of the lack of civil society groups that were allowed to take part in the policy making process. When one discusses the incorporation of popular support and interest articulation into the political structure, and their ability to increase regimes' capacity to implement reforms, there are two important issues worth noting: First, that the level of support for the government may influence the degree in which the government chooses to undertake reforms. Second, that the institutional feature of corporatism demonstrates how interest articulation can be incorporated into the political institutional structure to increase regime capacity.

In the second part of this chapter I will focus on the Indonesian regime's capacity to implement IMF reforms and the degree of popular support and interest articulation incorporated into the political institutional structure. First, I will discuss how the Indonesian political structure can be characterized as a kind of state corporatism, where political institutions have been used as a means to depoliticise the Indonesian society, thus facilitating the successful implementation of economic reforms. Second, I will show how this lack of political channels available for interest articulation influenced the implementation of IMF reforms, and that popular opposition towards Suharto in the end forced him to step down from his presidency. The guiding question for my analysis in this second part of this chapter is: *'How did the Indonesian political system incorporate popular support and interest articulation so as to successfully implement reforms?*

## 6.2.1 Social groups in Indonesia: Depoliticisation of the society through state corporatism

After Suharto officially took power in 1966, many gave little credence to Suharto's political skills and viewed him as an officer that could not stay in power for long. However, by the early 1970s he had outmanoeuvred political contenders within the military and consolidated his own position and built the presidency into the most important political institution in the country. The 'mainstream' interpretation of Indonesian politics during Suharto's New Order has been to focus on state-society relations as being grounded in clientilism.[76] The essence of clientilism is the pyramid-like networks of patron-client relationships, where the client is dependent on his patron for dispensing material rewards and opportunities for political influence. Thus, politics is not a result of contesting actors over policy issues, but rather a competition over material rewards and influence. The interests of the 'people' are repressed and so the state is not responsive to outside interests or pressures. MacIntyre (1991:12) argues that the political institutionalised structure of

[76]Andrew MacIntyre (1991:6-18) gives an introduction to six different perspectives that can be distinguished in the literature of Indonesian politics. These are: The state-qua-state, The bureaucratic Polity and patrimonial cluster, Bureaucratic pluralism, Bureaucratic authoritarianism, a Structuralist approach and finally, restricted pluralism. MacIntyre argues that the mainstream understanding of Indonesian politics is inspired by theories concerning patrimonalism and clientilism.

clientilism in Indonesia is a kind of state corporatism, where the authoritarian regime has a 'top down' structure, and political institutions are set up to manage the masses, especially groups like labour and religious movements. Political parties in Indonesia do not function as an institutionalised link between the state and the society because the electoral process has little effect on government policies. There is a very strong and systematic bias in the rules that govern parties and the electoral process that largely predetermines the outcome.[77] After 1973 there were only three political parties allowed. Two of the legal political parties, PPP and PDI, had little independent political life or policy agenda.[78] They attracted little support from either business or labour, and never obtained more than a modest share of the votes. The third party, Golkar, was the government's electoral vehicle Golongan Karya, (functional groups) which during the New Order always 'won' the elections. In the early 1970s, for instance, all civil servants were required to sign a letter committing their loyalty to Golkar, and those who declined to sign, were subject to dismissal (MacIntyre 1999b:265).

State corporatism in Indonesia has been a way for the state to control and to penetrate interest associations, like trade unions, student associations, women's organisations and religious congregations with an aim to limit rather than facilitate interest representation. The government both initiated the formation of new organizations and sponsored those already existing, providing them with official recognition and funding. In exchange the organisations were obliged to channel the government's policies and political aspirations to their members and to give political support to Golkar (Eklöf 1999:8). This state corporatist strategy has served to exclude interest representation from the shaping of public policy, but increased the regime capacity to implement reforms.

### 6.2.2 Suharto forced to step down

I have shown in the previous chapters that as the Asian crisis unfolded and Suharto showed his reluctance to implement the IMF reforms that came into conflict with his family and business associates' interests, the political system in Indonesia was viewed internationally and nationally as a part of the 'problem' of the crisis. From the time of the re-election of Suharto as president in March 1998 and the appointment of his 'crony cabinet' the same month there were great protests

[77] There are formal exit controls on political parties. The president can legally dissolve any party that is not compatible with state goals (as defined by the president) or any party representing less than 25 % of the population.
[78] PPP stands for Partai Persatuan Pembangunan (the United Development Party), and PDI stands for Partei Democrasi Indonesia (the Indonesian Democratic Party).

from student movements against Suharto. In March and April the student movements increased their demonstrations against the political elite, and by the end of April at every University of the country there were students demanding economic and political change. In addition to the student demonstrations, the serious rise in food and fuel prices around this time sparked riots and street violence in a number of Indonesian cities. The political elite used the military to try to stop the riots and the protests from the students, but after the killing of four students at the prestigious Trisakti University in Jakarta, riots spread all over Indonesia and over 1,000 people lost their lives. On the 21st of May 1998 Suharto stepped down from his presidency due to strong opposition, and former Minister of Research and Technology and vice president B. J. Habibie became Indonesia's next president.

The state corporatist political structure in Indonesia proved during the Asian crisis to be a political system with no institutionalised channels for showing opposition and with a lacking ability to solve the conflicts that arose between those who opposed Suharto and his followers. As said earlier, an authoritarian political structure can be seen as having one advantage in reform implementation, because the political leader is not dependent upon political support, and thus he does not have to accommodate the publics' interests to remain in power. This was the case in Indonesia during the Asian crisis, but still the reform implementation was not successful. The important question is then for how long a state corporatist structure can be an advantage in policy implementation. Since 1966 Suharto had ruled Indonesia with success in terms of economic development. However, as the New Order developed, Suharto's authoritarian regime did not allow any substantial political participation. Eklöf (1999:220) argues that this created a political system with a gap between the regime and a range of new social and political aspirations that had emerged in the wake of the economic development. The state corporatist framework had no channels for expressing these and others different views, and during the crisis the opposition towards Suharto proved too strong for him to remain in power. However, it is worth stressing that due to over thirty years of depoliticisation of the society there was no group formally representing the opposition that could take over when Suharto stepped down from his presidency. The state corporatist organisation of interest representation had effectively suppressed any opposition, and had hindered social groups to build a supportive power-base outside the state structure.

The issue of interest representation is also interesting in relation to the IMF and their wish to make trans-national alliances, as earlier discussed in chapter 5.1.2. Kahler (1993) argues that the

IMF often tries to make supportive coalitions both within and outside the government.[79] There are various reasons for domestic groups to cooperate with the IMF. First, it pays off to be sympathetic towards the IMF reforms if one belongs to a group that can gain politically, socially or economically from the reforms. Second, taking the side of the IMF may give access to the policy making process for groups that usually do not take part or have access to the political arena. In Indonesia the problem was not a lack of people agreeing with the IMF reforms. It was rather a lack of opportunity or access to political institutions where they could show their opposition towards Suharto and their support to the IMF. As I have discussed in the previous chapter, those groups within the government and the state apparatus that supported the IMF were set aside when they openly disagreed with Suharto. The IMF was not successful in making alliances with groups outside the government. Taking Indonesia's authoritarian political structure into consideration the question is rather if the IMF would have *gained* anything from making domestic alliances, due to the repressive nature of the New Order regime. As long as there are no formal institutions in which groups can show their opposition, it would have been hard for the IMF to get domestic social groups to promote views that contradicted Suharto's.

## 6.3 The South Korean experience

In the third part of this chapter I will look at the South Korean experience in relation to the issue of regime capacity in reform implementation during the Asian economic crisis. First, I will discuss how the South Korean political institutional structure proved to be less decisive than the Indonesian. I will argue that in exploring the successful South Korean experience it is important to focus on Kim Dae Jung's credibility in his commitment to implement the IMF reforms. I will also discuss how popular support and the incorporation of interest groups into the decision-making process enhanced South Korea's regime capacity in implementing the IMF reforms.

### 6.3.1 Decisiveness and policy predictability

In relation to decisiveness of the political institutional structure, the presidency in South Korea is not as centralised as in Indonesia, although the president is quite powerful with a fixed term in office and substantial scope for legislative initiative. The Asian economic crisis hit South Korea at a time leading up to presidential election. Then president Kim Young Sam was facing an opposition that gained support because of the lacking ability of the president to manage the

[79] Like Putnam (1988) showed under the Italian negotiations for a stand-by agreement in 1977, where the IMF consulted directly with the labour unions and the socialist party, and revised its reform proposal in order to win their support.

economic crisis. As discussed in chapter 3.4.1. Kim Young Sam's handling of the Hanbo ‘scandal’ and the nationalisation of the KIA Chaebol earlier that year had generated doubts about the president's ability to manage the South Korean economy. The indecisiveness of the Kim Young Sam government in dealing with the Asian crisis was especially evident when they failed to pass a financial reform bill in the parliament in October 1997, much due to the lack of cooperation between the ruling party and the opposition. As discussed earlier, a democratic regime can be reluctant to implement economic reforms that could harm important groups that the regime relies on for support, particularly before an election. In South Korea this proved to be the case at the beginning of the crisis. The ruling party had serious doubts about the political cost of forcing the necessary economic reforms through. It appeared that Kim Young Sam wanted to avoid the reforms becoming a campaign issue for the opposition before the election. The opposition had also few incentives to cooperate, because if they signed on, they would be associated with the potentially costly effects of the reforms, whereas if they postponed their assent, any negative economic effects would be laid at the feet of the president and the ruling party. This reasoning shows how democratic regimes can be said to have lower regime capacity than authoritarian regimes in implementing reforms. However, democracies like South Korea have one advantage compared to their authoritarian counterparts: the ability of the opposition to mobilize support for a new government to take office that can initiate new reforms with electoral and legislative support. In South Korea this was the case where the opposition leader, Kim Dae Jung, won the presidential election after making an alliance with one of the other presidential candidates, Kim Jong Pil. Because the South Korean political system allows for special sessions of the National assembly, Dae Jung exploited the period between his election victory on the 18$^{th}$ of December and his instalment in February 1998 to successfully pass the economic reform package that the National Assembly under Kim Young Sam had failed to pass some months earlier.

Compared to the Indonesian case the credibility of Kim Dae Jung's commitment to implementing IMF reforms was high. Kim Dae Jung had won the election much because of his appeal to people through his demands for a restructuring of the South Korean economy. Kim Dae Jung also came into office with strong credentials as an economic expert. He was considered as one of few South Korean politicians with a clearly defined economic agenda, where he emphasised the importance of small and medium private enterprises and market competition. He had support from the groups hardest hit by the crisis, and he gained credibility for his reforms as he targeted the powerful position of the Chaebols and sought to restructure the financial sector. His ideas of how to cure the South Korean economy coincided with IMF's liberal economic ideology, which gave him a good starting point for dealing with the Fund and increased his legitimacy in the international community. In contrast to the Indonesian president, Kim Dae Jung was credible in the eyes of foreign investors.

However, credibility of policy commitments can be said to be costly. Mo & Moon (1999), argue that in order to implement the IMF reforms the South Korean president increased the government's decisive action by circumventing the democratic procedures. They argue that the decisiveness of Kim Dae Jung's government has shown that the president has too much formal and informal power at the expense of the legislature, political parties and other formal institutions. The powerful role of the two agencies discussed in the previous chapter, the Budget and Planning Bureau and the Financial Supervisory Board, has been a sensitive issue with regard to South Korea's democratic future. Although these informal committees were officially only advisory bodies to the president without any legal authority to make binding decisions, they have assumed great influence- principally because of their proximity to the president. To some, the use of such informal agencies is highly questionable, even though their decisions are not legally binding.[80] Most of the negotiations with the Chaebol leaders have also been similarly informal and closed (Kim 2000).

### 6.3.2 Popular support and interest articulation in South Korea

An important feature of the successful implementation of IMF reforms in South Korea was the legitimacy from broad groups in the society towards the implementation of the reforms. The South Korean political institutional structure allows interest representation to a much larger extent than the Indonesian political structure does, and it is an important feature of the country's democratic structure. An example of this was that prior to his inauguration Kim Dae Jung constituted a 'transition team' that would map out reform measures to cope with the IMF conditions. The transition team served as a legitimate forum for societal stakeholders to take the lead in advising both the new government and the public about the reforms (Shin & Ha 1999). The team was acting as a kind of deliberative body. It held numerous hearings, examined reform issues, and discussed various proposals for how to best restructure the economy.

[80] That the decisions were not legally binding was a disappointment to the labour unions, who had hoped for a more formal access to the decision-making process. The Kim Dae Jung administration did not actually have the authority to offer such reforms to labour; only the elected legislature, The National Assembly, can enact such rules (Mo & Moon 1999).

There was one important social group that was particularly affected by the IMF reforms: workers in the corporate sector. As discussed in chapter 4, one obstacle to implementing corporate reforms was strict regulations making it difficult to lay off workers (Mo &Moon 1999). This was a sensitive issue to Kim Dae Jung, and with a sharp rise in the overall employment because of the economic crisis, the climate for reaching an agreement looked even worse (Haggard 2000:197). Labour unions were against a deterioration of workers' rights, and it seemed difficult to implement the IMF reforms without the consent of the affected groups. In the middle of the crisis the government could not risk another wave of strikes, so it was crucial that the government cooperated with the labour unions about the reforms. To fend off labour protests the government invited the mainstream South Korean Foundation of Trade Unions and the more radical South Korean Federation of Trade Unions to participate in a tripartite committee where labour, the government and the Chaebols were represented. After months of negotiations the committee reached an agreement where the labour unions agreed to more permissive rules for layoffs and employment of temporary workers. In return for their cooperation, the government pledged to improve labour rights and fight unemployment through public work programmes, as well as to give subsidies to unemployed workers, and to develop extensive social safety nets (Mo & Moon 1999:155). The South Korean case showed that a more societal corporatist oriented institutional structure proved successful as it incorporated interest groups in the political decision-making process and thus provided more legitimacy for state policies, which again increased the ability of the South Korean government to implement the IMF reforms.

## 6.4 Concluding remarks

A regime with a decisive institutional political structure has the ability to follow its own agenda, without having to take 'popular' interests into consideration. The Indonesian case showed that an authoritarian political institutional structure is more decisive than a democratic, but in relation to the implementation of the IMF reforms, it proved not to be an advantage. As the lack of political institutions that could veto Suharto's decisions increased the decisiveness of the Indonesian regime, it also weakened the credibility of Suharto's commitment to the IMF as he could easily reverse his policy commitments. The Indonesian case shows that as the IMF reforms contradicted the interests of the political power-holders, a decisive political structure with few veto points proved to be an obstacle to the implementation of IMF reforms. In the case of South Korea the decisiveness of the political institutional structure was not as obvious as the Indonesian. However, Kim Dae Jung took advantage of his position as incoming president with a political mandate to change the status quo, and decisively formed executive committees although with a questionable mandate. It is important to remember that the concept of credibility of policy commitments does not say that democratic decisions are credible per se. If Kim Dae Jung had not been elected, South Korea would have been ruled by a president who was not seen as credible in his policy commitments to the IMF, even though South Korea still had a democratic political institutional structure. This chapter has shown that credibility of policy commitments is related to the credibility of a government's will to *adhere* to reforms, not to the political structure that facilitates credibility as such.

In relation to how popular support and interest articulation can be incorporated into the political institutional structure to increase regime capacity to implement reforms, the Indonesian case shows that cooperation between large social groups to resolve the crisis was not possible. The authoritarian institutional structure with a state corporatist framework for interest articulation had effectively suppressed interest groups and there were no formalised institutions where opposing groups could participate in the decision-making process. The Indonesian case indicates that a state corporatist institutional structure can be effective in reform implementation as long as the reforms coincide with the wishes of the president. If the reforms contradict the president's interests, state corporatism tends to obstruct implementation. On the other hand, the South Korean case illustrated how societal corporatism incorporated interest groups in the political structure, and the bargaining process between the various groups affected by the reforms opened up for the ability of the government to make concessions to the groups hardest hit by the reforms. Thus the South Korean government gained support and legitimacy for further implementation of IMF reforms.

# CHAPTER 7 CONCLUDING REMARKS: THE POLITICS OF ECONOMIC REFORM IMPLEMENTATION

Most literature about the Asian economic crisis has been concerned with explaining the causes of the crisis itself or discussing the properness of the IMF reforms. Few have focused on the national political aspects of the Asian states' crisis management, and how political factors influenced the following implementation of the IMF reforms. This is perhaps not surprising as the issue of the politics of reform implementation is wide and intricate. However, the reason for writing this thesis was a wish to explore more thoroughly exactly this complex topic through discussing how national political factors in Indonesia and South Korea influenced the implementation of IMF reforms during the economic crisis in 1997-98.

The lack of an overarching theory on this subject provided me with an opportunity to choose a wide approach in this thesis. To use a wide approach has proved to have both advantages and disadvantages. The methodological technique of the case study approach has allowed me to examine the interplay of three separate, but intertwined empirical focuses in order to provide a complete understanding of the politics of economic reform implementation.[81] The strength of my approach has been that it clearly illustrates how national political factors set in an international framework influence the implementation of IMF reforms. However, using a wide approach also indicates that there has been a lack of a comprehensive theory that I can compare my findings to. Existing literature could not direct me to a specific theoretical approach, nor to a set of independent variables that I could test. To accommodate this lack of an overarching theory of the politics of economic reform implementation, I designed an analytical framework where I combined two relevant theoretical approaches and four independent variables.

## 7.1 How do national political factors influence governments' implementation of IMF reforms?

In order to explore this thesis' main question, **how national political factors influence governments' implementation of IMF reforms,** I chose to focus on four political factors (i) bureaucratic organization; (ii) features associated with the relationship between the government and the business sector; (iii) the possibility of decisive political action within the political-institutional framework; (iv) how popular support and interest articulation are incorporated into the political institutional structure. In chapter 2 I introduced five empirical questions derived from the theoretical approaches of state and regime capacity and from

[81] The three empirical focuses have been (i) the context where the interplay between the IMF and the recipient governments takes place (ii) the Indonesian and the South Korean state capacity to implement IMF reforms; (iii) the Indonesian and the South Korean regime capacity to implement IMF reforms.

literature concerned with the implementation of IMF reforms, that this thesis has been designed around.

### 7.1.1 State capacity

In chapter 5 I examined the theoretical approach of state capacity and discussed whether it could be used to explore: *'How bureaucratic conditions influenced the reform implementation in Indonesia and South Korea'*. My first finding in this thesis showed that through discussing how the technical and administrative capacity of the bureaucracy can influence the implementation of IMF reforms, one could identify quite different experiences in Indonesia and South Korea. The Indonesian bureaucracy could not be considered an autonomous bureaucracy at the time of the Asian economic crisis, and the clientelistic aspect of the Indonesian state apparatus has hindered the bureaucracy in developing an independent power-base that could challenge Suharto's polices when he chose not to implement the IMF reforms. This can indicate that a less autonomous and clientilistic bureaucracy has weakened capacity to implement reforms if the reforms contradict with the president's wishes. Conversely, the South Korean experience showed an autonomous bureaucracy isolated from particularist interests that successfully implemented reforms. The important feature of the South Korean bureaucracy was that the bureaucrats that were left with the task of implementing the reforms, agreed with IMF policies and shared Kim Dae Jung's view on how to best restructure the economy. This can indicate that in order to successfully implement reforms it is necessary to have an autonomous bureaucracy where bureaucrats within important key ministries agree with the president's reform agenda.

The second question that I set out to examine in chapter 5 was: *'How features associated with the relationship between the Indonesian and South Korean governments and the business sector could hinder, or promote the implementation of IMF reforms'*. My second finding in this thesis was that instead of an 'embedded' relationship in Peter Evans' (1995) terms between the business sector and the Indonesian government, my analysis shows that the former was rather dependent upon patrons within the state for gaining access to beneficial deals. I have found that this ability of certain sections of the state to control the business sector has enabled the Indonesian political and bureaucratic elite to use their position to advance their private economic interests in the national economy. I have argued that the task of the IMF to restructure the Indonesian economy in 1997-98 proved difficult because Suharto was concerned with protecting his family's and his business associates' personal interests in the economy. This can indicate that the implementation of IMF reforms in Indonesia was hindered both because of the great private economic interests that Suharto had in the economy, as well as the fact that the business sector had not been able to develop its own power-base that would have enabled them to challenge Suharto's decisions. This has compromised the Indonesian state's capacity to create and implement policies in the 'national interest' that do not enrich the politically powerful. On the other hand, the South Korean experience showed that 'embedded' relations through institutionalised consultative mechanisms between the government and the Chaebols increased the support for the reforms and the likelihood of successful reform implementation.

Through focusing on state capacity I have gained a better understanding of the technical and the administrative capacity of states to implement reforms. The approach of state capacity has been useful in which it focuses on how the implementation process has been *managed.* It has also been important because it draws ones attention to how bureaucratic organization and the relationship between the business sector and the government have developed historically. This underlines an important argument made in this thesis, that in order to understand the politics of economic reform implementation it is important to consider how political institutions and political processes have developed as to create a certain kind of national political economy.

### 7.1.2 Regime capacity

When I chose to compare the Indonesian and South Korean experiences during the Asian economic crisis, I did so because I was interested in exploring whether different kinds of political regimes could be said to have different regime capacity to implement economic reforms. In chapter 6 I sought to examine: *'To which degree the political-institutional frameworks in Indonesia and South Korea increased the possibility of decisive action in reform implementation'*. My empirical finding in relation to this issue was that the argument of whether authoritarian regimes are more effective than non-authoritarian in implementing economic reforms, cannot be applied to the Indonesian case during the Asian crisis in 1997-98. My analysis shows that while the Indonesian political system had a decisive authoritarian institutional structure, it also created an unpredictable environment where Suharto could easily reverse policies due to lack of institutional constraints on his power and authority. This can indicate that when certain required economic reforms contradicted with the interests of the president, a decisive institutional political structure can be used to hinder implementation of these reforms. The South Korean case on the other hand, showed a government that was effective in implementing reforms despite a less decisive political institutional structure. South Korea's successful implementation of the IMF reforms must rather be seen in relation to the credibility of Kim Dae Jung's commitment to the IMF, and the fact that his reform agenda aiming at breaking up the tight relationship between the state and the Chaebols, pleased international observers and investors. The South Korean democratic institutional structure also enabled the voters to throw out a president that was not committed to implementing the IMF reforms, and instead support a president candidate that had on top of his agenda the task of restructuring the South Korean economy.

An important aspect of regime capacity is to focus on how popular support and interest articulation are best incorporated into the political institutional structure to facilitate effective reform implementation. The last part of chapter 6 was designed around this issue and the question that I set out to explore was: '*How did the Indonesian and South Korean political systems incorporate popular support and interest articulation so as to successfully implement reforms?'* My empirical finding in relation to this question was that state corporatism in Indonesia proved an effective political structure as long as the reforms that were implemented were in accordance with the political elites' interests. My analysis shows that the Indonesian institutional structure of state corporatism did not allow any collective action by the business community, nor did any other social group have any noteworthy influence in the economic policy-making process. This lack of institutionalised opposition enabled the government to hinder the implementation of IMF reforms without any noteworthy opposition. This indicates that the repressive political institutional structure of state corporatism in Indonesia has made the state autonomous against collective action, but still responsive to particular interests of the political elite because of its clientelistic structure. In contrast to the Indonesian experience the South Korean case shows how a somewhat more societal oriented corporatism proved to be an advantage in the implementation of IMF reforms. As seen during the tripartite negotiations, societal corporatism in South Korea opened up for the ability of the affected groups, such as organised labour, to bargain with the government. In return for labour unions' support the government gave compensations to the groups affected by the reforms, which enhanced the legitimacy and the support of the government's implementation. This can indicate that a government relying on labour support is in a better position to implement economic reforms than a government that would have based its support on the business sector. Due to president Kim Dae Jung's background as an opposition politician that had challenged the position of the powerful Chaebols, labour groups to a larger degree accepted the reforms because they didn't think that Kim Dae Jung would 'fool' them for the benefit of the Chaebols. Thus Kim Dae Jung did not have to face opposition from distrustful labour unions, which gave him greater leeway in implementing IMF reforms and especially the reforms that aimed at increasing the 'flexibility of the workforce'.

The theoretical perspective of regime capacity has proven fruitful in this thesis as it has drawn the attention to how formal political institutions have influenced the behaviour of governments. The approach of regime capacity underlines the main argument made in this thesis, that in order to understand the politics of economic reform implementation it is important to explore how political institutions and political processes promote a special kind of economic development.

### 7.2 How do governments handle demands from the IMF to implement economic reforms?

Apart from just exploring how national political factors influenced the implementation of the IMF reforms, an important part of the model that I developed focused on the context where the interplay between IMF and the recipient governments took place. In chapter 4 I sought to examine: *'How did conflict and cooperation between the IMF and the recipient government concerning the properness of economic reforms manifest itself in the implementation process?'* My empirical findings indicate that this was an important question in at least in two respects: First, that a part of the successful implementation of IMF reforms in South Korea seemed to rely on a common understanding between the IMF and Kim Dae Jung about the causes of the crisis and the required economic reforms. On the other hand, in Indonesia, Suharto's understanding of the crisis and the needed reforms were not similar to IMF's, and it became a hinder to the further implementation. Second, the Indonesian case shows that without some kind of alliance between the IMF and domestic political agents, such as government members, technocrats, business interests and other powerful groups, the implementation process becomes difficult.

It seems obvious that a discussion of IMF's role in the Asian economic crisis implies a broader discussion about the future role of the IMF. According to my empirical findings the IMF stands out as an actor that has increased its role as a global political and economic actor during 1997-98. The Fund has to a larger extent become politicised through its demands of massive liberalisation of the Asian economies, as well as its focus on the implementation of economic and structural reforms aimed at developing 'good governance'. Implicit in IMF's technical rhetoric was the contention that Asian economic growth was based on crony capitalism with a corrupt preferential lending system. As the Asian crisis erupted, the mainstream view was that the only viable alternative for restoring the Asian economies, and for further economic growth was adherence to liberalist oriented economic ideology, as preferred by the IMF and the USA. As my analysis discusses, the IMF was not considered in Indonesia and to some degree in South Korea as an independent international financial institution providing 'objective' macroeconomic assistance in a time of crisis. The IMF was rather perceived as a western institution imposing a western liberal ideology ‘disguised’ as economic assistance.

The aim of this thesis has not been to develop or test any general theory, but rather to design an analytical model that could help to explore the complex issue of the politics of economic reform implementation. The model developed in this thesis is made up of four national political factors interpreted in the context of the interplay between the IMF and the recipient governments. The model has been useful as this thesis clearly shows that in order to gain a comprehensive understanding of the politics of economic reform implementation it is necessary to conduct a complex analysis of the national and international political factors involved. And although my model has shed some light on the complicated interplay of the political factors at stake, one is still far from developing a general theory of the politics of economic reform implementation.

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