

## **Indonesia's Puzzling Crisis**

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### **Abstract**

Of all the states hit by the 1997-98 Asian economic crisis, Indonesia has suffered the most, and been the hardest case for economists to explain. This paper suggests that Indonesia's collapse was not unique, but part of a small class of economic catastrophes caused by the interaction of two factors: personalistic authoritarian rule and financial openness. It argues that the combination of these two factors tends to produce economic collapse when investors believe the regime will soon end.

To test the argument it develops an index of 45 personalistic regimes that ended between 1974 and 1999, ranks them according to an original index of financial openness, and examines their growth records during their final four years in office. It finds that those regimes that combined personalistic features with financial openness tended to suffer from unusually sharp economic reversals in their final two years. To illustrate the argument it uses the case of Indonesia, showing that investor panic was closely linked to rumors that Suharto was ill or would step down.

By themselves, personalistic rule and financial openness are each compatible with high growth rates. When combined, however, they create the preconditions for a calamitous economic reversal.

## **Introduction**

Most studies of the 1997-98 Asian financial crisis have had trouble explaining the case of Indonesia. On the eve of the crisis, Indonesia was in a strong economic position: it was completing its third decade of high growth with low inflation and balanced budgets; its currency did not appear to be overvalued; it had a smaller current account deficit, and less short-term debt, than either Thailand or South Korea; and the Suharto government had an excellent record of economic governance, particularly during times of crisis. Yet Indonesia's economic crisis has proved to be much deeper, and longer, than the crisis in the other states.

Indonesia's economic collapse was characterized by a sudden reversal of confidence in the Indonesian economy, which led to a collapse in the rupiah, a banking crisis, and the bankruptcy of hundreds of major corporations. But what caused the initial loss of confidence that led to Indonesia's collapse?

This paper argues that the loss of confidence was partly caused by the interaction of two factors: the growing perception that the end of the Suharto regime was near; and the regime's policy of financial openness. Investors correctly surmised that regimes like the Suharto government – which are highly personalistic, and rest on the authority of a single figure – tend to end in violence, upheaval, and economic chaos. At the same time, the government's exceptional level of financial openness allowed worried investors to move their money out of Indonesia quickly and easily, which they did in ruinous quantities. Ironically, the perception among investors that the Suharto regime would soon end became a self-fulfilling prophecy, as the resulting financial panic hastened Suharto's departure after 32 years of authoritarian rule.

This paper also makes a larger point. By themselves, personalistic rule and financial openness are each compatible with high growth rates. When combined, however, they create the preconditions for a calamitous economic reversal. Indonesia was the largest state to combine personalistic government and financial openness, but it was not the first. Other states with these two factors have suffered from similar disasters, including Nicaragua (1978-79), Panama (1988-89), and Liberia (twice, in 1979-80 and 1988-89).

This paper begins by describing Indonesia's economic collapse, focusing on the sudden loss of investor confidence between July 1997 and January 1998. Section two reviews economic explanations for Indonesia's collapse and suggests they are incomplete. Section three argues that underlying levels of political uncertainty, and hence investor confidence, are strongly influenced by regime types. It notes that personalistic authoritarian regimes – like Indonesia's Suharto regime – tend to end in violence and upheaval, and hence should produce rising levels of political uncertainty as their perceived end draws near. This rising level of political uncertainty should produce capital flight, provided that the government maintains a policy of financial openness. Section four offers a simple test of this argument by examining the economic records of all personalistic regimes that came to an end between 1974 and 1999. The last section describes the signs in 1997-98 that the Suharto regime would soon end, and shows that these signs were closely correlated with the financial panic.

## **1. Indonesia's Economic Collapse**

Between 1968 and 1996, the Indonesian economy grew at an annual rate of 7.5 percent. By all accounts, this growth was relatively equitable, effective in reducing poverty, and characterized by a modestly high rate of total factor productivity [Hill 2000; Booth 2000; Timmer 1999].

A 1994 World Bank study sought to explain why Indonesia's economic performance "far surpassed that of countries endowed with similar assets and subject to the same shocks." It found that much of the success was due to the government of President Suharto – a military officer who had seized power in 1965-66, when the economy was suffering from triple-digit inflation and negative growth. The study highlighted the Suharto government's "active exchange rate management," "prudent management of publicly guaranteed external debt," "willingness to implement bold measures and comprehensive market-oriented reforms," and noted "the presence of an able economic team that was experienced in crisis management and also had the trust of the president [Woo, Glassburner, and Nasution 1994, 145-8]." Many analysts agreed that the Indonesian government was exceptionally deft in crisis management; in Indonesia, "bad times made for good policies" [Emmerson 1998; MacIntyre 1992].

Shortly after the collapse of the Thai currency in July 1997, most analysts believed that Indonesia's robust economy faced little danger. In late August, the Economist Intelligence Unit adjusted its growth projections for Indonesia from 8 to 7.6 percent for 1997 and 8.2 to 7.3 percent for 1998. For the first four months of the crisis, the two leading credit rating agencies – Moody's and Standard and Poor – downgraded the credit ratings of Thailand and South Korea but left Indonesia's rating unchanged.

The initial confidence in Indonesia seemed well founded. It was in far better shape than Thailand: its current account deficit, as a fraction of GDP, was less than half the size of Thailand's; it held far less short-term debt; and unlike the overvalued Thai baht, the Indonesian rupiah had not been rigidly pegged to the yen, but was linked to the dollar and allowed to float within a band that was regularly adjusted for inflation. Moreover, shortly after the start of the baht crisis, the Suharto government took a number of precautionary measures: in mid-August 1997 it appointed a high-level crisis team, headed by a widely-respected economist, Widjono Nitisastro, who had both the President's ear and a record of guiding the economy through earlier crises; it first loosened, then abandoned its managed exchange rate, without squandering its currency reserves to defend the rupiah; in mid-September it announced a package of measures to boost investor confidence; and in early October it announced its intention to seek an IMF Stand-By Arrangement. According to the *Far Eastern Economic Review*, "many analysts see the soundness of the Indonesian fiscal stance as a step ahead of the region as a whole [McBeth 1997, 62]."

Yet for some reason these confidence-building efforts failed terribly. When the baht crisis began, the rupiah was valued at 2445 to the dollar; by October 31, when the IMF package was signed, it had dropped to 3650, a loss of almost fifty percent. Between November 1 and the end of January 1998 the rupiah lost three-quarters of its remaining value. The economy collapsed, touching off bank runs, food-buying panics, and the bankruptcy of all but a handful of the firms listed on the Jakarta Stock Exchange. Four months later, President Suharto resigned amidst massive protests.

Today it is plain that Indonesia has been more damaged by the Asian crisis than any other country: it has had the largest cumulative loss in per capita GDP; the highest inflation; and the sharpest and most prolonged drop in the value of its currency (Table 1).

TABLE ONE ABOUT HERE

## **2. Economic Explanations for the Indonesian Crisis**

Indonesia's crisis was not only the region's most severe, it was also the least expected (figure 1), and has been the hardest to explain. Thailand's crisis is now well understood as the result of an overvalued currency, an unsustainable current account deficit, a build-up of short-term debt, and a poorly-regulated, recently-liberalized financial sector.

Korea's crisis can also be explained as the result of the rapid growth of short-term debt, a shortage of international reserves, and a newly-deregulated financial sector. But a close look at Indonesia show a more enigmatic picture.

FIGURE ONE ABOUT HERE

The leading models designed to predict currency and banking crises have had the greatest difficulty accounting for the Indonesian crisis.<sup>1</sup> The World Bank's 1998 growth predictions for Indonesia were further off than its growth predictions for the other crisis states.<sup>2</sup> Even economists who monitored the Indonesian economy closely were taken aback by the severity of Indonesia's economic crisis. Lloyd Kenward, who was the World Bank's Senior Economist in Jakarta from June 1994 to August 1998, admitted,

“The broadest macroeconomic indicators were of virtually no help in presaging the crisis; neither were high-frequency financial indicators” [Kenward 1999, 71].

The most puzzling aspect of the Indonesian crisis was the loss of investor confidence between July 1997 and January 1998. Once we account for this loss of confidence – and the resulting capital flight – the rest of the crisis is easy to understand. The flight of capital and the drop in the rupiah’s value trapped Indonesia’s central bank between two conflicting roles: as a lender of last resort, it was under pressure to rescue the financial sector by providing liquidity (which would expand the money supply); yet as defender of the currency, it also had an interest in maintaining the value of the rupiah (which would require a tighter money supply). It ultimately chose the former path, allowing money and credit to grow rapidly, which led to a plummeting rupiah and a burst of inflation. Between July 1997 and January 1998, the rupiah lost 85 percent of its nominal value, and 70 percent of its real value, against the dollar. Most firms that had borrowed overseas could no longer repay their debts and went bankrupt.

But what caused the initial loss of confidence that led to this capital flight? And why were the efforts of the Suharto government to restore confidence – even with the financial backing of the IMF, the World Bank, the Asian Development Bank, and the governments of the U.S., Japan, and Singapore – fruitless?

Economists have identified six factors that might help explain the sudden loss in investor confidence. Most have important weaknesses.<sup>3</sup>

The first and most obvious explanation is the contagion effect from the Thai crisis. Classic forms of contagion occur when a financial crisis in one state forces firms to withdraw their assets from a second, to cover their losses. Trade and investment ties

between Thailand and Indonesia were weak, however, making this transmission mechanism implausible. A different form of contagion may have occurred if the baht crisis caused foreign portfolio managers to raise their risk perceptions for the entire region. Yet this is also a poor explanation: there is evidence that in Indonesia *domestic* capital flight occurred before foreign capital flight [Hill 2000, Soedradjad 2000]; and Dadush et al. [1999] show that region-wide economic effects can only explain a small fraction of Indonesia's plight.

A second common argument is that the collapse was due to corruption. Corruption was high in Indonesia prior to the crisis; it was annually ranked among the "most corrupt" states in international surveys. Yet corruption in Indonesia had been persistently high for decades. There is even good reason to think that corruption declined between 1980 and 1997, as the size of the most corruption-prone parts of the economy (the petroleum sector, state enterprises, and command lending at state-subsidized rates) dwindled relative to the overall economy, and trade barriers were lowered [Hill 2000].

A third possible cause might be Indonesia's current account deficit. Yet as Table 2 shows, Indonesia's current account deficit was the lowest of the crisis states in 1996, the final year in which figures were uninfluenced by the crisis. Moreover, just prior to the crisis the IMF noted that a growing fraction of Indonesia's current account deficit was caused by foreign direct investment, which showed a vote of confidence by foreign investors in the Indonesian economy [IMF 1997, 30-32].

TABLE 2 ABOUT HERE

A fourth argument is that Indonesia's crisis was the result of weaknesses in the financial sector caused by liberalization. There is now strong evidence that financial liberalization tends to precede financial crises [Diaz-Alejandro 1985; Kaminsky and Reinhart 1999]. Indonesia indeed had launched a series of financial sector reforms, which led to a credit boom and doubled the number of banks – but in October 1988, nine years before the crisis.

Moreover, there were indications that by early 1997 the government's oversight of financial sector had improved considerably. After allowing the number of commercial banks to double between 1988 and 1994, the government stopped authorizing new banks and took strong measures to reduce credit growth. As a result, the quantity of "substandard" and "doubtful" loans dropped from 10.9 percent to 7.1 percent of all bank lending between 1993 and July 1996 [IMF 1997].<sup>4</sup> On the eve of the crisis, the IMF reported gradual improvements in the government's oversight of the financial sector [IMF 1997]. Chronic weaknesses in the banking sector almost certainly made the crisis harder to resolve once it had begun. But why should reforms launched in 1988 cause a sudden loss of investor confidence in 1997?

A fifth commonly-cited cause was the magnitude of Indonesia's debt burden [Rodrik and Velasco 2000]. As a fraction of GDP, Indonesia's debt service was somewhat larger than the other crisis states; as a fraction of exports it was almost twice as large as Thailand's debt service, and more than three times as large as the other crisis states (Table 3).

TABLE 3 ABOUT HERE

Yet the problem of Indonesia's debt service also seems like an incomplete explanation for the 1997-98 panic. As Figure 2 shows, Indonesia's debt service burden peaked – both as a fraction of GDP and as a fraction of exports – in 1988; between 1988 and 1997, the debt burden remained stable and even fell slightly. Why should this have caused investors to suddenly lose confidence in the Indonesian economy in mid-1997 – especially at a time when the price of oil (Indonesia's leading export) was rising?

FIGURE 2 ABOUT HERE

Finally, some have blamed the loss of investor confidence on the Indonesian government's November 1 decision, prompted by the IMF, to close 16 small banks, several of them controlled by Suharto's relatives and cronies. Shortly after the closings a series of bank runs occurred. Many analysts have argued that even if closing the banks was the correct policy, it was carried out in a flawed manner [McLeod and Garnault 1998; Kenward 1999; Lane et al. 1999]. Some fault the government for failing to explain the criteria for selecting the banks, and hence providing little assurance to depositors that other banks would not be closed. Others have faulted the government for offering too little, or too much, of a guarantee to depositors. But it is not obvious that any of these alleged errors caused the bank runs.

The Suharto government had handled earlier banking crises without touching off bank runs. In early September 1997 it closed more than 400 bank offices around the country, and repaid more than 800,000 small depositors [Soedradjad 2000]. In September

and October the government repeatedly announced that insolvent banks would soon be closed, and that the holdings of small depositors would be guaranteed by the government. Why should the November 1 closure of 16 small banks – which held just three percent of all deposits – set off such panic?

Prior to July 1997, the Indonesian economy was fundamentally sound. Its main vulnerabilities were its inadequately regulated financial sector and its large debt burden; yet both had been features of the economic landscape for the previous decade, and were slowly improving. Once the crisis began, these weaknesses helped give the crisis its self-fulfilling quality; they also help explain why the economy has had trouble recovering. But they only partly explain why investors lost confidence in the first place.

### **3. Political Uncertainty and Regime Types**

A handful of scholars has argued that investors in Indonesia panicked, in part, because of a rise in political uncertainty after July 1997. This argument is broadly consistent with research that shows political uncertainty tends to harm economic performance [Dixit and Pindyck; Alesina et al. 1996; Leblang 1999]. But what caused this jump in political uncertainty? On one hand, Pincus and Ramli [1998] imply it was the crippling influence of patrimonialism – Suharto’s practice of giving economic privileges to his cronies and backers; on the other hand, Cole and Slade [1998] argue it was the prospect that patrimonialism would be removed, which threatened the stability of the business environment. According to MacIntyre [2001], it was the absence of constraints on Suharto, which gave investors little confidence in the credibility of his commitments to reform; by contrast, Hill [2000] faults the presence of constraints on Suharto (due to the

growing strength of vested interests), which impeded his ability to implement and sustain reforms.

These arguments raise a broader question: what factors systematically influence political uncertainty? I suggest here that different types of political regimes tend to produce different levels of political uncertainty; and that the end of personalistic authoritarian regimes produces unusually high levels of uncertainty.

Democracies should tend to produce low or medium levels of uncertainty; in Przeworski's phrase, democracy is "institutionalized uncertainty" – a system of government in which uncertainty over electoral outcomes is offset by the stability of electoral institutions.

Different types of authoritarian governments – including single-party regimes, military regimes, and personalistic regimes – should tend to produce different levels of uncertainty. Both one-party regimes and military regimes tend to produce regular changes in political officials officeholders at regular intervals, for example during party congresses or when officeholders reach a mandatory retirement age. When single-party or military regimes come to an end, they tend to produce negotiated – and hence, relatively stable and predictable – transitions to democracy [Geddes 1999].

The highest level of political uncertainty should be found in the waning days of personalistic regimes – also called neo-patrimonial, patrimonial, clientelistic, or sultanistic regimes.<sup>5</sup> In personalistic regimes, the chief executive's influence rests on "an extensive network of personal patronage, rather than... ideology or impersonal law [Snyder 1992, 379]." The longevity of a personalistic regime is usually tied to the longevity of the ruler himself, since his web of personal loyalties and financial

relationships – often built up over a decades-long career – cannot be easily appropriated by a successor. When a personalistic ruler departs, it tends to produce a change in every facet of the government: the bureaucracy, the ruling party or coalition, and often, the type of regime. Moreover, the timing of such changes is hard to predict.

Geddes suggests that in personalistic regimes, the level of political uncertainty changes over time: they tend to go through an early stage of uncertainty, a stable middle stage, and a highly unstable final stage. Of the three types of authoritarian government, Geddes finds that personalistic regimes are the most likely to end in popular uprisings, revolution, invasion, or assassination. Her findings are broadly consistent with earlier work by Goodwin and Skocpol [1994], and Chehabi and Linz [1996] that suggests that personalistic regimes are exceptionally likely to end in chaos or revolution.

Investors who have holdings in economies governed by personalistic regimes should hence be anxious to determine when the regime is likely to end, and how disruptive the end is likely to be. To determine this they might look for three signs. The first is the ruler's health. Of course, in authoritarian states this may be a closely-guarded secret.

The second is the economic behavior of the ruler, and those in the ruler's inner circle. When a self-interested autocrat expects to be in office a long time, he has an incentive to limit corruption to levels that do not inhibit economic growth [Przeworski et al. 2000; Clague et al. 1996]. According to Olson's [1993] metaphor, an autocrat with a long planning horizon is like a "stationary bandit": both have an interest in the ability of their victims to generate income for future appropriation. By contrast, autocrats who expect to be in power for only a short time are like "roving bandits" who gain nothing by

helping their victims generate future income; instead, they and their associates prefer to ransack the economy. Hence if observers note that an autocrat and his inner circle appear to move from long-term economic behavior (where corruption is constrained) to short-term economic behavior (where corruption grows less constrained), they may infer that the regime's inner circle believes the end is near.

Finally, investors should note whether or not the ruler has designated a credible successor. The presence of a credible successor should reduce the uncertainty caused by the incumbent ruler's demise; a weak or non-credible successor increases the likelihood of imminent strife.

If the end of a personalistic regime produces rising levels of political uncertainty, it should also produce capital flight. The magnitude of the capital flight – and the harm done to the economy – should depend on the economy's financial openness.

#### **4. Financial Openness and Regime Types**

Between 1974 and 1999, 46 regimes with personalistic features came to an end.<sup>6</sup> The financial openness of these regimes can be determined by observing whether they maintained multiple exchange rates, restrictions on current payments, or restrictions on capital account payments during each year of their life.<sup>7</sup> Regimes that have all three are relatively closed; regimes that lack all three are relatively open.

TABLES 4 AND 5 ABOUT HERE

Table 4 ranks 45 of these 46 regimes by their financial openness.<sup>8</sup> It also shows whether or not they suffered from negative growth in their final or penultimate year; and it lists the change in the average growth rate during their final two calendar years, compared with the prior two calendar years.<sup>9</sup> Table 5 summarizes the data in Table 4.

In general, these figures support the claim that personalistic regimes tend to end in economic downturns; and that financial openness makes these downturns more severe. Collectively, these states experienced a *drop* in their average growth rate of 1.8 percent in their final two calendar years, compared to their average growth rate in the previous two calendar years. The states that were more financially open generally suffered from sharper economic slumps. Those that were more open were also more likely to suffer from negative growth in one of their final two years. Indeed, personalistic regimes that were financially closed experienced no measurable hardships in their final two years: their economic performance was stable, and they were no more likely (in fact, somewhat less likely) to suffer from negative growth in their final two years than they were normally.

A closer look at the financially open regimes makes it possible to offer a more fine-grained analysis. The most financially open regimes were:

- Bolivia's 1971-78 Banzar regime;
- Liberia's 1944-80 Tubman/Tolbert regime and 1980-90 Doe regime;
- Nicaragua's 1936-79 Somoza regime;
- Panama's 1968-81 Torrijos regime and 1981-89 Noriega regime;
- and Indonesia's 1966-98 Suharto regime.

The regime that ended with the least economic anguish was Panama's Torrijos regime. A closer look explains why: Torrijos died unexpectedly in a plane crash – an event no investor could have anticipated.

In four of the remaining five cases (excluding Indonesia), investors did indeed flee in the final one to two years of the regime, in anticipation of the ruler's demise. In Liberia, the growing belief in 1979 that President Tolbert might soon fall – which he did, in an April 1980 coup – led to massive capital flight and triggered a liquidity crisis. The National Bank of Liberia's external assets dropped from \$55 million in 1979 to \$4 million in 1980, and the bank was unable to make payments on the government's imports and debt service [Whitaker 1985].

In the late 1980s, Liberia's Doe regime (which replaced the Tolbert regime) itself began to fall apart in a civil war. There is overwhelming evidence that the economy suffered from massive capital flight and an economic collapse in the late 1980s; unfortunately, between 1987 and 1991 the government stopped producing economic data [CIA 2001].

In Nicaragua, the anticipated fall of the Somoza dynasty – which eventually took place in July 1979 – also led to a financial crisis. Between 1960 and 1977 the Nicaraguan government placed few restrictions on foreign investment; but massive capital flight in the waning years of the Somoza regime forced the government to impose exchange controls and devalue the currency. Still, net private capital flows went from a surplus of \$126.4 million in 1977 to an officially-recorded deficit of \$2.2 million in 1979; the government later estimated the unofficial capital flight immediately preceding the final insurrection at \$518 million [Gibson 1987]. Economic growth went from 9.3

percent in 1977 to –6.8 percent in 1978 and –27.3 percent in 1979, while gross domestic fixed investment plummeted.

The Panamanian economy in the final years of the Noriega regime experienced a similar collapse. Noriega was plucked from office by a December 1989 U.S. invasion; for two years prior to his departure, however, the U.S. government pressed ever more strongly for his removal. The Panamanian economy suffered from massive capital flight in 1988-89, as private capital flows, gross domestic fixed investment, and economic growth dropped sharply in anticipation of Noriega's departure, and in response to U.S. economic pressures. Panama's exchange rate was unaffected: like Liberia, it uses the U.S. dollar as its official currency.

Of these five cases, only Bolivia's 1971-78 Banzer regime did not suffer from capital flight, or a collapse in growth rates, as its end drew near. There may be three reasons for this. First, during Banzer's seven-year rule, Bolivia never achieved much political or economic stability: his government was hobbled by a series of attempted coups, forcing Banzer to spend "most of his energies simply clinging to the formal trappings of power, not in active governing [Malloy and Gamarra 1988, 71]." The prospect of Banzer's removal may have hence produced no net increase in political instability, since instability was already so high. Second, as the end of Banzer's regime approached, the Bolivian economy was unexpectedly lifted by the oil shock of 1978-79, which boosted the value of Bolivia's mineral and hydrocarbon exports and may have counteracted any loss of confidence associated with Banzer's anticipated departure. Finally, most of the foreign investment in Bolivia at the time may have been in fixed assets in the mineral and hydrocarbon industry – and hence unable to flee.

## **5. The Indonesian Collapse**

Indonesia's Suharto regime was even more vulnerable to capital flight than similar regimes elsewhere, due to the economy's reliance on ethnic Chinese financiers. Between forty and seventy percent of Indonesia's "modern" private sector was owned by the ethnic Chinese minority, which constituted just three percent of the population. The Chinese had flourished economically through their patronage ties to Suharto, but they and their firms faced hostility from the population at large, and periodic anti-Chinese riots. To protect their families and assets, many Indonesian Chinese maintained homes and bank accounts abroad. Many no doubt remembered the last time Indonesia changed presidents, in 1965-66, when Sukarno's fall and Suharto's rise was accompanied by widespread social chaos and the massacre of perhaps half a million people. As the financial crisis unfolded, some ethnic Chinese businessmen carried open plane tickets in their pockets so they could flee at a moment's notice [Gilley 1998].

Like other personalistic regimes, the Suharto regime ran a centralized system of patronage and corruption. Investors who signed major government contracts typically paid kickbacks of eight to ten percent to Suharto through his wife or half-brother (in the 1970s and 1980s) or children (in the late 1980s and 1990s).<sup>10</sup> Many also gave equity in their firms, for a fraction of the market value, to Suharto allies in the military, Suharto's family members, or Suharto's ethnic Chinese business partners. In return, the firms would receive preferential access to government licenses and contracts, and protection from bureaucratic asphyxiation.<sup>11</sup>

These arrangements can be likened to implicit contracts, in which firms paid the Suharto regime for preferential government treatment. Yet because these contracts were negotiated with Suharto's inner circle, the fall of the Suharto regime would almost certainly end these arrangements; investors would be forced to either negotiate new contracts with a new regime, or face a much tougher business environment. If there was an anti-Suharto backlash in the post-Suharto era, the assets of well-connected firms could be endangered.<sup>12</sup>

In the mid-1990s, investors began to pay closer attention to signs about Suharto's health, the economic behavior of Suharto's inner circle, and Suharto's designated successor. These three factors help account for much of the rupiah's fall.

Since 1992 Suharto had often suggested that his sixth term as president – which would end in March 1998 – would be his last. Many thought he might die in office before then. In January and April 1995, rumors about Suharto's ill health sent shocks through the Jakarta Stock Exchange. In April 1996 Suharto's wife died; many speculated that without her support, Suharto would lose his desire to continue as president. In July 1996 the market was twice rocked by fresh rumors about Suharto's health, which were seemingly validated when he was flown to Germany for three days of medical tests.

On April 1 1997, Suharto gave a speech that reminded listeners of his advanced age (75), and again hinted that he would step down in March 1998. Over the next several days there were reports in the international press that Suharto had suffered a "minor heart ailment," sending yet another shock through the Jakarta Stock Exchange.<sup>13</sup> Although he later asserted he would accept a seventh term as president, many analysts believed that he would resign shortly after his new term began, so that he might turn over the presidency

to a hand-picked successor [McBeth 1998]. These fears may help explain the steady decline in the rupiah between mid-July and late October.

The final and most important health scare occurred in December 1997, when the economic crisis had already begun. On December 9, rumors that Suharto was gravely ill hit the stock and currency markets.<sup>14</sup> Between December 9 and 29, as reports about Suharto's health echoed through the business community, the rupiah lost fifty percent of its value. The plunge took on self-fulfilling qualities, when on December 22 Moody's Investor Service downgraded its rating for Indonesia to Ba1, a "junk" level. The downgrade set off fears that international banks would refuse to roll over their loans to Indonesian firms, touching off a further drop in the rupiah.

Investors may have also noticed a change in the economic behavior of the Suharto family. During the first four months of the 1997 crisis – like in earlier crises – Suharto placed the long-term health of the economy ahead of his short-term family interests: in September he adopted fiscal and tariff measures that hurt the interests of his inner circle; on October 31, his ministers governor signed an IMF agreement that set out a schedule for additional policy reforms, including many that would harm the interests of his children; and on November 1, his finance minister closed sixteen ailing private banks, including three that were partially owned by the Suharto family [Robison and Rosser 1998].

Yet beginning in November, Suharto and his relatives started to place their short-term economic interests ahead of the cause of economic stabilization. In early November, Suharto reinstated fifteen major government projects he had postponed in September; all of them involved relatives or close associates. Suharto's second son

Bambang Trihatmodjo, who partially owned one of the closed banks, was allowed to purchase the license of another bank and shift the assets of his closed bank into it.

On Christmas Day 1997, Singapore's Prime Minister Goh Chok Tong and former Prime Minister Lee Kwan Yew met with Suharto's eldest daughter, Siti Hardiyanti Rukmana (Tutut), at Lee's request. Lee told her that to restore investor confidence in the Indonesian economy she and her siblings would have to curtail their business interests. "I asked her point-blank whether she could get this message understood by her siblings," Lee later wrote. "She answered with equal frankness that she could not." The very next day she persuaded the government to overturn the postponement of a power station that she held an interest in.

Then-central bank governor Soedradjad [2000, 55] later recalled that due to these policy "flip-flops,"

The confidence problem shifted from being just an economic problem to being one of national leadership...market confidence in the government's commitment to the economic restructuring program evaporated. As a result, not only was the rupiah's slide difficult to stop, but the economic crisis was spiralling into a 'total crisis.'

On January 6, 1998 Suharto unveiled a new government budget that directly contradicted the IMF agreement and indicated that he was backtracking on his commitment to reform. Over the next six days, the rupiah – which had barely recovered from December's rumors about Suharto's stroke – dropped from 5550 to 11,200, a loss in value of over fifty percent. Once again, the initial loss in confidence took on self-fulfilling qualities, as the drop in the rupiah touched off fears of social unrest and led to panic buying in grocery stores, which further damaged market confidence.

The market's reaction to the budget forced the government to negotiate a new agreement with the IMF. The new accord – which was announced on January 15 – mandated a remarkably specific and far-reaching set of reforms, which would break up monopolies held by, and rescind benefits flowing to, Suharto's family and closest associates. The accord can be seen as the IMF's effort to restore confidence in the Indonesian economy by forcing Suharto to issue a pair of signals: first, that in the short term he would once again behave like a stationary bandit and restrict his family's corruption to economically sustainable levels; and second, in the medium term he would reduce his family's role in the economy to a point that a transition to a new, post-Suharto government would not be disruptive. For the next three days, the rupiah stabilized.

Yet investors were still worried by the prospect that Suharto would soon step down. When Finance Minister Mar'ie Muhammad spoke with business leaders in the U.S. in January, they only wanted to know who would be Suharto's successor [Van Klinken 1998]. On January 19, 1998 rumors began to circulate that Suharto would name B.J. Habibie as his vice president for his upcoming term in office. Two days later the government confirmed those rumors. A close Suharto protégé, Habibie was a German-trained engineer who was serving as minister of research and technology; he was viewed by investors as an economically naïve, big-spending technocrat. Since it was unlikely that Suharto would serve out his full five-year term – which would end when he was 81 – the decision seemed tantamount to naming Habibie as his successor. Yet analysts noted that Habibie lacked the support from the Indonesian military that was deemed essential to be a credible successor to Suharto. Moreover, if he did rule in a post-Suharto Indonesia, investors believed his penchant for economic nationalism would have a harmful impact

on the economy.<sup>15</sup> The rupiah dropped fourteen percent from January 19 to 21 on rumors of Habibie's selection. When the rumors were confirmed on January 21, it fell an additional forty-three percent over the next twenty-four hours. Once more, the drop in economic confidence had self-fulfilling qualities, as analysts began to focus on the inability of Indonesia's major firms to repay their debts at the new exchange rate; these fears were exacerbated when, on January 27, the Indonesian government announced a temporary freeze on debt payments.

By the end of January the Indonesian economy was in shambles. All but 22 of the 286 companies listed on the Jakarta Stock Exchange were technically bankrupt. The economic collapse, coupled with anti-Chinese riots, led much of the ethnic Chinese business class to flee the country. In February the rupiah first rallied, then fell, on news that Suharto was considering implementing a currency board that would fix the rupiah's value to the dollar. In March Suharto was unanimously re-elected by Indonesia's upper legislative body; four days later he named a new cabinet with few skilled technocrats but many close associates, including his daughter Tutut and his closest Chinese business partner, Mohamad "Bob" Hasan. As Sidel [1999, 176] observed, "Never before in New Order history had the uppermost echelons of the regime been captured by such a narrow cluster of palace cronies, henchmen, and crucially, relatives."

In April, Indonesia's economic collapse helped fuel student-led demonstrations on Java, Sumatra, Bali, and Sulawesi; in May, the protests grew dramatically in response to an IMF-mandated plan to lift fuel and utility subsidies and the shooting deaths of student demonstrators. On May 21, Suharto was forced to step down when members of his own cabinet, and longtime loyalists in the military and parliament, called for his resignation.

Ironically, the economic crisis – which was touched off by the anticipation of his departure – had taken on self-fulfilling properties, and hastened his removal.

### **Conclusion**

Indonesia's 1997-98 economic collapse fits poorly into most economic explanations of the asian economic crisis. But it was not *sui generis*: it belonged to a small class of economic reversals that have occurred in states that are governed by personalist rulers whose demise is believed to be imminent, and that maintain policies of financial openness.

By themselves, personalistic rule and financial openness are each compatible with high growth rates. When combined, however, they create the preconditions for an economic calamity – particularly in states like Indonesia, Nicaragua, Panama, and Liberia, that relied heavily on foreign investment.

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**Table 1: Economic Impact of the Asian Crisis**

	<b>Change in GDP/cap1996-99</b>	<b>Cumulative Inflation 1997-99</b>	<i>Currency Level 1/98 (1/97=100)</i>	<b>Currency Level 1/00 (1/97=100)</b>
<b>Thailand</b>	-12.2	14.0	57.38	80.11
<b>Malaysia</b>	-8.5	10.7	66.37	76.19
<b>Philippines</b>	-4.4	22.5	72.74	82.11
<b>S. Korea</b>	+3.2	12.7	57.23	83.06
<b>Indonesia</b>	-13.8	84.8	32.14	68.46

Source: World Bank, internal documents.. Currency levels are based on World Bank estimates of the real effective exchange rates.

**Table 2: Current Account Balance (% of GDP)**

	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>
<b>Thailand</b>	-5.1	-5.6	-8.1	-8.1	-2.0
<b>Malaysia</b>	-4.7	-6.2	-9.7	-4.6	-4.9
<b>Philippines</b>	-5.5	-4.6	-2.7	-4.8	-5.2
<b>S. Korea</b>	0.3	-1.0	-1.9	-4.7	-1.8
<b>Indonesia</b>	-1.3	-1.6	-3.2	-3.4	-2.3

Source: World Bank [1999]

**Table 3: Debt Service (% of exports)**

	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>
<b>Thailand</b>	13.0	13.4	11.6	12.6	15.4
<b>Malaysia</b>	8.7	8.9	7.0	9.0	7.5
<b>Philippines</b>	25.6	18.9	16.1	13.4	9.2
<b>S. Korea</b>	9.4	7.9	8.6	9.4	8.6
<b>Indonesia</b>	33.6	30.7	29.9	36.6	30.0

Source: World Bank [1999]

**Table 4: Personalistic Regimes, Financial Openness, and Economic Performance**

<b>Country</b>	<b>Years</b>	<b>Ruler</b>	<b>Open</b>	<b>Negative Growth?</b>	<b>Growth Change</b>
Bolivia	1971-78	Banzer	0.000	No	-2.55
Liberia	1944-80	Tubman/Tolbert	0.000	Yes	-3.6
Panama	1968-81	Torrijos	0.000	No	-1.95
Panama	1981-89	Noriega	0.000	Yes	-6.8
<b>Indonesia</b>	<b>1967-98</b>	<b>Suharto</b>	<b>0.069</b>	Yes	-12.15
Nicaragua*	1936-79	Somoza	0.143	Yes	-24.65
Liberia	1980-90	Doe	0.182	Yes	-
Haiti	1957-86	Duvalier	0.350	Yes	-0.5
Benin	1972-91	Kerekou	0.367	Yes	-2.3
Mali	1968-91	Traoré	0.417	Yes	-4.25

Burkina Faso	1966-80	Lamizana	0.455	No	-0.25
Burkina Faso	1983-87	Sankara	0.467	Yes	0.2
Niger	1974-93	Kountché/Saïbou	0.483	Yes	-3.15
Spain*	1939-79	Franco	0.524	Yes	-2.3
Chad	1960-75	Tombalbaye	0.552	No	10.65
Central African Republic	1966-79	Bokassa	0.561	Yes	-5.25
Central African Republic	1981-94	Kolingba	0.571	No	6.1
Sierra Leone	1992-96	Strasser	0.583	Yes	-4.3
Mauritania	1960-78	Daddah	0.629	Yes	-2.9
Philippines	1972-86	Marcos	0.644	Yes	0.75
Chad	1982-90	Habre	0.667	Yes	-9.2
Ethiopia	1974-91	Mengistu	0.667	Yes	-1.8
Madagascar	1975-93	Ratsiraka	0.667	No	3.25
Malawi	1964-94	Banda	0.667	Yes	-0.95
Myanmar	1962-88	Ne Win	0.667	Yes	-8.6
Pakistan	1977-78	Zia	0.667	No	1.25
Portugal*	1932-74	Salazar/Caetano	0.667	No	-1.15
Uganda	1971-79	Amin	0.667	-	-
Zaire/DR Congo	1965-97	Mobutu	0.678	Yes	-1.7
Pakistan	1971-77	Bhutto	0.714	No	0.7
Guinea-Bissau	1980-99	Vieira	0.729	Yes	-13
Dominican Republic	1966-78	Balaguer	0.744	No	-2.4
Paraguay	1954-93	Stroessner	0.762	No	0.15
Iraq	1968-79	Takriti clan	0.778	No	13.65
Chile	1973-89	Pinochet	0.784	No	2.85
Somalia	1969-90	Siad Barré	0.803	Yes	-3.1
Afghanistan	1973-78	Daoud	0.833	No	-0.85
Cambodia	1967-75	Lon Nol	0.833	-	-
Sudan	1969-85	Nimeiri	0.902	Yes	-6.25
Bangladesh	1971-75	Mujib	0.917	Yes	12
Ghana	1981-96	Rawlings	0.933	No	0.15
Bangladesh	1975-82	Zia	0.958	No	2.9
Bangladesh	1982-90	Ershad	1.000	No	1
Nigeria*	1993-99	Abacha/Abubakar	1.000	No	-2.1
Romania	1945-90	-	1.000	Yes	-3

The list of personalistic regimes is taken from Geddes [1999]. The **financial openness** score is calculated by determining whether the state had multiple exchange rates, restrictions on current payments, or restrictions on capital account payments for each calendar year a regime was in power, according to IMF [various]. Each of these three factors are coded 0 (if “no”) or 1 (if “yes”), summed and divided by the total number of observations. Lower scores indicate greater financial openness. **Negative Growth** indicates whether the state experienced negative GDP growth in either of the regime’s final two calendar years in power. **Growth Change** is the difference between in the average GDP growth in the regime’s final two calendar years and the average in the previous two years. A negative number indicates a drop in economic performance. Data on GDP growth is from World Bank [2001].

\*Data on openness is available for fewer than half of all possible observations.

**Table 5: Summary of Personalistic Regimes by Openness**

	<b>Open</b>	<b>Mostly Open</b>	<b>Partly Open</b>	<b>Mostly Closed</b>	<b>Closed</b>
<b>Total</b>	8	2	9	17	10
<b>Negative Growth</b>	71%	100%	67%	50%	44%
<b>Two Year Negative Growth Hazard</b>	45%	42%	49%	37%	51%
<b>Mean Growth Change</b>	-8.6	-1.4	-.28	-1.1	.26

Regimes are divided into one of five categories here by level of financial openness. The “open” states have openness scores of 0 to .2; “mostly open” from .2 to .4; “partly open” from .4 to .6; “mostly closed” from .6 to .8; and “closed” from .8 to 1. **Total** indicates the number of states in each quintile, regardless of whether economic data are available for each state. **Two Year Negative Growth Hazard** is the likelihood that the states in each quintile would exhibit negative growth over any two year period.

## Endnotes

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<sup>1</sup> Furman and Stiglitz [1998]; Kaminsky, Lizondo, and Reinhart [1998]; Kaminsky [1999]; Berg and Patillo [1999].

<sup>2</sup> Dadush, Riordan and Wolfe [1999] sought to explain the World Bank's forecast errors by accounting for unanticipated region-wide factors such as the influence of the Japanese recession, the regional downturn, and a drop in the terms of trade. They found that these additional variables could explain between 33 and 90 percent of the Bank's forecast errors for Thailand, Malaysia, South Korea, and the Philippines, but only 17 percent of the error for Indonesia.

<sup>3</sup> Economists generally agree that Indonesia's financial crisis was not a simple response to weak economic fundamentals (as modeled by Krugman 1979), but a self-fulfilling crisis in which the exchange rate had multiple equilibria. While it is possible for such a crisis to be triggered by a minor random event, Obstfeld [1996] suggests that underlying weaknesses in an economy make self-fulfilling crises more likely.

<sup>4</sup> Corsetti, Pesenti, and Roubini [1998] devised a 'Lending Boom Measure' to track the growth of credit between 1990 and 1996 in the Asian crisis states. The 'Lending Boom Measure' is the rate of growth between 1990 and 1996 of the ratio between the claims on the private sector of the deposit money banks and the nominal GDP. Their figures for the crisis states are: Thailand 58 percent; Malaysia 31 percent; Philippines 151 percent; South Korea 11 percent; and Indonesia 10 percent [Corsetti, Pesenti, and Roubini 1998].

<sup>5</sup> Scholars have long recognized personalistic regimes as a distinct category of authoritarian regimes. Important treatments include Weber [1968]; Scott [1972]; Snyder

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[1992]; Chehabi and Linz [1996]. Chehabi and Linz focus on “sultanistic” regimes, which they suggest are an extreme form of personalistic regime.

<sup>6</sup> I derive this figure from the Geddes database, which classifies authoritarian regimes by type. The Geddes database covers 1946-July 1999. I only look at regimes that ended after 1974, when the breakdown of the Bretton Woods currency arrangements led to the beginning of the current period of financial openness. To ensure the broadest possible coverage, I include regimes classified by Geddes as “personalistic,” “military/personalistic,” and “single-party/militaristic/personalistic.”

<sup>7</sup> The data on financial policies come from IMF [various]. I am grateful to Aart Kray for calling my attention to this data, and providing me with the data in an electronic format.

<sup>8</sup> Data on financial openness by one regime, Niger’s 1996-99 Mainassara regime, was unavailable.

<sup>9</sup> Because the Geddes database only lists the calendar year in which the regime ended, it is important to note the economic records of the final two years, rather than just the final year. A regime that ended on January 1, 1980 would be listed as ending in 1980, even though it should suffer economically in 1979, and might recover during 1980.

<sup>10</sup> For U.S. dollar contracts, the fee was sometimes lowered to five percent.

<sup>11</sup> There are many fine accounts of corruption under the Suharto regime, including Crouch, MacIntyre, Robison, Schwartz, etc.

<sup>12</sup> Fisman [2000] estimates the market value of political connections to the Suharto family for Indonesian firms in 1995-1997. It finds that for the best-connected firms, links to the ruling family accounted for as much as a quarter of the firms’ value.

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<sup>13</sup> International press accounts of Suharto's health, and the corresponding shocks in the Jakarta Stock Exchange, are documented in Fisman [2000].

<sup>14</sup> After Suharto resigned, it was revealed that he suffered a stroke in December 1997.

<sup>15</sup> Suharto later revealed that he himself had little faith in Habibie's ability to govern. On May 19, 1998, just two days before he resigned, Suharto warned that if Habibie became president the country would fall into civil war [Forrester and May, 8].