외교학석사 학위논문

IMF 정책 이행의 정치경제: 1997~1998 한국과 인도네시아의 경제위기 사례

Political Economy of IMF Policy Implementation: The Cases of 1997-1998 Economic Crises of Korea and Indonesia

2014 년 8 월

서울대학교 대학원

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Abstract

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The 1997 Asian financial crisis that hit Southeast and East Asian countries began in Thailand with the devaluation of the Thai Bath, which spread a sudden panic to neighboring countries, included South Korea and Indonesia. Thus, it caused a loss of market confidence and led to a massive capital outflow from Korea and Indonesia. Governments in both countries responded by requesting for International Monetary Fund (IMF) assistance which was followed by several economic recovery prescriptions focusing on macroeconomic, monetary and fiscal, banking system and management improvement plans, and corporate restructuring initiatives. The IMF plan was created to restore market confidence and return the countries to a state of economic development. However, the recoveries in the two countries

were very different and had different impacts on both countries' economic and political conditions. After a three-year period of policies implementation, South Korea showed more positive results and recovered faster than Indonesia. In comparison to South Korea, the impact of the IMF programs in Indonesia was slow, and even to this day the country has not been able to recover from all the aftereffects of the crisis.

There is scholarly debate on the causes of this issue, but this paper will analyze deeply the obstacles and differences between South Korean and Indonesia's experiences in regards to implementation of IMF programs and why did they differ, using the framework of institutional capacity and good governance on the economic development in such crisis. From this thesis, we can see that Indonesia faced several difficulties and challenges due to its political transition which induced by social and political instability, that influenced the capacity and capability of its new and weak cabinet, caused the new governance system to be unable to restore its economic downturn. This will further validate the theory of institutional capacity and good governance through a new comparative case.

Key words: South Korea; Indonesia; IMF; Asian crisis; Economic recovery; Market confidence, Monetary and fiscal policy, Macroeconomic restructuring programs, Banking restructuring policy, Economic development, Institutional capacity, Good governance

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I. Introduction

1.1 Background

The 1997 Asian Financial Crisis started in Thailand with the collapse of the Thai Baht;[1] it turned market sentiment against the region and it spread to other Southeast and East Asian countries, including Indonesia and South Korea. In fact, these two nations had enjoyed rapid economic growth before the crisis had occurred. South Korea was one of the most rapidly developing economies in the world at that time, showing an incredible amount of economic growth over three or four decades. Indicative of this was the fact that Korea had raised its annual income from 80 USD in 1960 to 10.000 USD in 1996.[2] However, the impressive economic

South Korea whose the economy was dependent on the Chaebols, the businesses and and the small families of owners of industrial conglomerates who almost exclusively control all the industries of South Korea, such as Chung Ju Yung of Hyundai, Lee Byung Chul of Samsung, Kim Woo Choong of Daewoo and Koo in Hwoi of Lucky-Goldstar. They had earned not only billions of dollars for themselves but also for thousands of Korean employees and for the economy itself. Unwittingly, it made the

[1] Kaufman, *the Asian Financial Crisis: Origins, Implications and Solutions*. (Springer. ISBN 0-7923-8472-5, 1995)
[2] Seung-Hun Chun, *Korea's Foreign Aid Policy and Poverty Alleviation*, (Korea International Cooperation Agency: 1998), p.2

Korean economy more vulnerable and dependent on those businesses. In the latter, when the crisis influenced the Korean economy, the investors in Korea lost their confidence and it cause the abrupt loss of capital flow as foreign banks refused to finance the economy and a massive withdrawal of foreign investors and their capital began. As the result, 11 Chaebols collapsed in 1997, and 10 more out of 50 largest Chaebols were at risk of bankruptcy. Bankrupt businesses cost South Korea 100 billion USD, 20% of the country's half-trillion-dollar economy.[3] The bankruptcy of the Chaebols was shocking to all economists in the country, increasing the unemployment rate in a short of period of time. In the automaker business, Kia was one of the biggest auto car producers that also experienced the pain of the financial crisis and ultimately collapsed with 10.7 billion USD of debt,[4] which put 60,000 jobs in jeopardy.

The devaluation of the Korean won pushed its value down as it reached 1,900 KRW per USD. In November 1997, the value of the won was 900 KRW per $1. It began to decrease even after the end of November 1997. As a consequence, more than 30% of Korean people dropped below the poverty line as a direct impact of the financial crisis that time. A significant number of Korean businesses became insolvent, which subsequently

[3] Keun S. Lee, *Financial Crisis in Korea and IMF Analysis and Perspective* (the Merrill Lynch Center for Study of International Finance Services and Markets: 1998)

[4] Kim Kihwan, *The 1997-1998 Korean Financial Crisis: Cause, Policy Response, and Lessons*, at the High Level Seminar on Crisis Prevention in Emerging Markets (Singapore, July 2006) p1

constrained the companies' ability to recruit and led to redundancies as unemployment figures rose.

A similar situation occurred in Indonesia; this nation achieved a remarkable economic performance 30 years before the crisis. However, despite this impressive achievement, and the high-level of economic growth in the short-term, poverty reduction and maintenance of its macroeconomic stability, Indonesia was also suffering from a vulnerable banking system, balance of payment structure and several other weaknesses. These conditions had been worsening since the crisis hit Indonesia in 1997. After markets had lost confidence in the Indonesian economy, it suffered from huge and sudden capital outflows. Investors' panic caused creditors to ask to repay debts that led to severe capital account deficit.

Indonesia's per capita income had reached 1,155 USD in 1996 and was 1,088 USD in early 1997, but it dropped to 610 USD in 1998. The International Labor Organization (ILO) claimed that two thirds of the Indonesian population was in a very poor condition in 1999.[5] The Indonesian currency, the rupiah, had been devalued by 90%. From January 23-26, 1998, the value of the rupiah dropped to over 14,000 IDR per 1 USD,[6] and the exchange rate, which had been around 2300 IDR to 1 USD,

[5] Bank of Indonesia, see www.bi.go.id , *Krisis Global dan Penyelamatan Perbankan Indonesia.*(accessed on 14 March 2014)
[6] John Strauss, *Indonesia Living Standard Before and After Crisis*. (Singapore, 2004) p2

dropped to over 17,000 IDR to 1 USD.[7] Home industries collapsed, as people were not able to earn money or pay for their basic daily needs. The 1997 financial crisis was the worst economic crisis Indonesia had experienced since its independence from Japan in 1945, for the Korean government the 1997 Asian Financial Crisis was also the worst national disgrace since the Korean War in the early 1950s even though this economic downturn was not the only crisis ever hit both nations.

In order to overcome the crisis, South Korea and Indonesia both had no other choice but to request assistance from the IMF. Indonesia officially made its request on November 5, 1997, and in Korean case, the Executive Board of the IMF approved its request on December 3, 1997, thus Korea and the IMF signed a three year Stand-By Arrangement, to address the fundamental causes of its current financial difficulties, thereby restoring and sustaining market confidence and returning the economy to a path of strong sustainable growth.[8] The IMF's executive board approved a three-year stand-by arrangement of almost 21 billion USD,[9] and included loans from the World Bank, the Asian Development Bank, Bank of America, Chase, Citibank, Japanese Sanwa Bank, Deutsche Bank and some others became a

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[7] Kompasiana. 2010. *The Causes of Financial Crisis, Sebab-sebab Terjadinya Krisis Ekonomi.*(Jakarta: Kompasiana,19 December 2010)

[8] International Monetary Fund, see: http://www.imf.org/external/np/loi/120397.htm *on Items on Letter of Intent of The Government of Korea.* (accessed on 13 April 2014)

[9] See http://www.lawteacher.net/finance-law/essays/imf-and-financial-crisis.php. *IMF and Financial Crisis. "International Monetary Fund and Developing Countries"*, (accessed on 13 April 2014)

total 58,2 billion USD, the largest rescue in the history of the Korean economy.

This loan plan was designed under the emergency financing mechanism of the IMF and contained a package of economic recovery programs. Korea agreed to address the IMF initiatives to build a strong macroeconomic as well as a comprehensive strategy to improve financing and corporate structure. The IMF recommendation was focused on tightening macroeconomics through a high interest rates policy to restore the confidence of investors and creditors to return to the market. The government of Korea started to struggle to persuade foreign creditors to roll-over short-term debt, meanwhile the IMF also recommended that the government restructure its financial sectors and restructure their severe merchant banks. One of problems that triggered the financial crisis in Korea was the banking system that was full of corruption and coalition with the groups of leveraged Chaebols.

The IMF program's implementation in South Korea led to many changes. Macroeconomic fundamentals improved and the economy's vulnerability to a balance of payments crisis was sharply reduced. Unemployment was reduced during three-year stand-by arrangement with the IMF that expired on December 3, 2000. As well as this, exports developed strongly; foreign reserves were built to record levels, and foreign

direct investments increased markedly.[10] The Korean government was successful in restructuring their corporate and governance systems by presenting five main guidelines for Chaebols reform in January 1998. They were (1) enhancement of the transparency of business management, (2) ending mutual debt guarantees between affiliate companies, (3) improvement of financial structure, (4) reducing the core business areas large conglomerates and encouraging their cooperative ties with SMEs, and (5) increasing the responsibility of controlling shareholders and its management.[11] The Korean government was also following the programs of the IMF by liberating its trade system to adjust to the international standard.

Like South Korea, Indonesia was implementing the same rescue package from the IMF by imposing high interest rate, restructuring the banking system and restoring the troubled-banks, the Fund recommended the Indonesian government to restructure corporate financial and corporate sectors and several other crisis rescue programs. The focus of the economic prescription of the IMF was on restoring market confidence and stabilizing the Indonesian Rupiah through tight monetary and fiscal policies. As well as this, another was to achieve a strong economic performance through several IMF-designed programs to build a healthy financial sector by adopting an

[10] Ajai Copra, Kenneth Kang, Metal Karasulu, Hong Liang, Henry Ma, and Anthony Richards: *From Crisis to Recovery in Korea: Strategy, Achievement, and Lessons.*(Washington DC, 2002) p 13

[11] Yun Jong Wang and Hyuongsoo Zang, *Adjustment Reforms in Korea Since the Financial Crisis*, December 1997-June 1998,(Seoul: KIEP, 1998) p117

international standard for its banking management system and closing troubled banks.

However, the recoveries in the two countries were very different and had different effects on the two nations' economic and political conditions. In comparison to South Korea, the impact of the IMF programs in Indonesia seemed to be very slow, and to this day the country has not been able to recover from all the aftereffects of the crisis. Particularly after the government of Indonesia imposed high rate interest from 20% to 80% per annum, causing many small and medium businesses to not be able to be productive, because of high production costs and more than a doubling of prices for all products in the market, including oil and other basic goods. Thus, followed by a devaluation of the Rupiah, dramatically caused the Indonesian people to slump to an even worse level of poverty.

1.2 Research Question

Since the financial crisis hit in the middle of 1997, both the Indonesian and South Korean governments were addressing all programs from the IMF, however South Korea seemed to show much better result. Even though some programs had several weaknesses, the IMF-supported programs were very successful in restoring confidence and stabilizing the financial market, and also in laying the foundation for a sustained recovery

in the real economy and lowering the chances of future crises.[12] The banking restructuring reduced the risk management system after the program was accomplished as bank management is placing an increased emphasis on profitability rather than asset growth.[13]

On the other hand, the IMF implementation programs seemed to show that the financial crisis that hit Indonesian was not due to its crisis, but it happened as the result of aspects of the economic system in Indonesia were wrongly built and had been so for several decades prior to the crisis. Indonesia was facing a downturn of economic condition that threatened to deteriorate fiscal strength and the IMF had already suggested Indonesia to cut expenditure and generate 1% GDP budget surplus of fiscal for a year. Nevertheless, this suggestion caused a huge collapse in domestic aggregate demand in 1998; the economy of Indonesia was leading to a more severe crisis.

The crisis not only affected the Indonesian economy, but it also triggered its political instability. As the government was seen to not be able to deal with the chaos of economic decline, opposition parties emerged to take chance to topple the authoritarian regime of President Soeharto, and roused the demand of democracy. Politicians and democratic activists enforced the government to change its political and governmental system in

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[12] Eduardo Borenszteinand Jong-Wha Lee, "*Financial Crisis and Credit Crunch in Korea: Evidence From Firm Level Data"*, (IMF Working Paper 00/25, 2000)
[13] Karasulu, *For An Empirical Analysis of the Profitability of the Banking Sector in Korea*, (Washington DC: 2001) p15

a more democratic way, turmoil occurred in almost all the territories of Indonesia, creating social and political instability, causing the economic recovery to be even more difficult to achieve. The dictatorship of Soeharto regime for more than 30 years left Indonesia with an extreme amount of debt and poor corporate governance system. The success of the IMF recovery package was dependent of highly support of its government and its institutional parliaments; however, as they were new and had little experience dealing with the crumbled economic and political crises, Indonesia was unable to overcome its entire crisis even though they applied the same rescue suggestions from the IMF.

Therefore, in order to explain the past and to suggest to Indonesia in the future a real policy action and not only a discourse, the main research question of this thesis are: what are the obstacles and differences between South Korean and Indonesia's experience with regards to the implementation of the IMF programs and why did they differ? This research is looking at descriptions of the situation before the crisis, what triggered the crisis – to be able to clearly analyze the IMF programs' implementations in the two countries – and why the two differed in terms of recovery time. Here, this thesis focuses on the recovery of their economies from the crisis up to today, using indicators like their respective currency values, unemployment rates, poverty lines, GDP and all of which should be better than before crisis.

This research question of this thesis is very important because it can contribute to international political economy in two ways: (1) academically, this research can look a new set of comparative case studies on certain policies that can result in different outcomes. Here, I chose Korea as a comparison case for Indonesia, the case selection for this thesis was very difficult and challenging because there are many differences between Korea and Indonesia that can make case selection for this thesis not clear. South Korea is different from Indonesia not only in the size of its territory and population, but also South Korea is a quite homogenous country while Indonesia has more than hundreds of ethnic groups that make Indonesia to be immensely heterogeneous. Looking at their cultures, South Korea and Indonesia have various contrasts to each other, mainly in the language, life style, and religion. In the economic sector, these two nations also have plentiful of dissimilarities. South Korea which the economy is developed through industrial businesses different from Indonesia, that its economy is based on agriculture and tourism.

However the paper argues that if we narrow down to some aspects in the sector of economics and politics, this is reasonable to compare South Korea and Indonesia and thus choose them for being researched in this issue. South Korea and Indonesia both were very poor countries however these two nations experienced similar economic changes several decades before its economic crisis hit, mainly after 1980. The economic growth of South

Korea started to increase and develop rapidly. Same as Korea, Indonesia also showed an impressive economic growth and reached its remarkable economic achievement by poverty reduction and its export rate. These countries' economies were dependent on the export sectors that made their economies vulnerable and susceptible to any shocks from outside of the countries. Another similarity between South Korea and Indonesia that time which was one of the causes that triggered the 1997-1998 financial crisis is not only Korea that had problem with the ties among big groups of industrial business holders, chaebols with its government; but also Indonesian economy was really fragile because of President Soeharto's family and friends network in almost all national businesses.

This is also the reason why this paper doesn't take Thailand which also suffered from its currency crisis in 1997, because there are not enough similarities that can make Thailand could be compared for this case. Besides that, only South Korea and Indonesia that were suffering from the foreign debts and current account deficit due to the relations of governments and business conglomerates. If we focus more on their banking and corporate system, these two nations was suffering from banking and corporate structure. The government of South Korea and Indonesia gave a special privilege for chaebols and Soeharto's allies to get free access to finance them and let the foreign banks to lend their money easily that turned out to be the crucial cause of 1997-1998 crises in both states. Different with

Thailand that hit by the crisis due to the speculative activities particularly on the real estate lending[14], the main cause of the crisis in Korea and Indonesia was the escalation of foreign debts in several years prior to the crisis. Foreign debts in Korea rose from 44 billion USD to 120 billion USD with 67% of its short-term in nature.[15] Like Korea, the foreign debts in Indonesia increased double to triple during the same years that made the economy of its country become very vulnerable.[16] Therefore, with all of these similarities, this thesis determined to choose South Korea and Indonesia to be compared in the term of their economic recovery through the IMF prescriptions not only because both countries are victims of the systemic impact of the financial crisis in Asia and adopted IMF policies to resolve the crisis. Thus, this paper will try to find the reason that leads to different outcomes of the economic performances of South Korea and Indonesia after the two nations have implemented the recovery package of the IMF programs.

Furthermore, even though there are many researches tried to explore The Asian Financial Crisis in such countries, there are no many research that comparatively analyzes both countries deeply from the aspect of its recovery process related to IMF programs from a political, policy-relevant

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[14] Joseph E. Stiglitz, *Globalization and Its Discontents*, (New York: WW Norton & Co, 2003) p 198

[15] Mark Weisbrot, Ten Years After: The Lasting Impact of the Asian Financial Crisis, in Ten Years After: Revisiting the Asian Financial Crisis, (Washington DC: Woodrow Wilson International Center for Scholars, 2003) pp 105-107

[16] Radelet and Sachs (1998), *the Onset of the Asian Financial Crisis*. (Harvard Institute For International Development, 1998) p3

and political channel perspective on the capacity of institutional foundation and through the theory of good governance. Most research only examines on causes and recovery progresses without drawing conclusive comparisons between the two nations. (2) Realistically, through this research I would also like to provide a deeper understanding of the crisis so that it can provide lessons on how to prevent a similar occurrence as well as give some suggestions and solutions for countries facing such a crisis in the future. Learning from other countries' experiences will help states' decision makers to avoid such mistakes and make better decision for their economics.

1.3 Hypotheses

The differences in performance in the implementation of IMF policies in South Korea and Indonesia were mainly due to:

1. **A difference in the South Korean and Indonesian government's capacity and capability in addressing policy had a significant influence to the success of policy implementation.**

Compared to South Korea, the Indonesian government did not have the capacity and capability to adjust an appropriate policy in order to restore its market confidence and recover from its economic downturn. The concept of government's capacity should be described as a bureaucratic efficiency that demonstrates the government's leadership in a certain condition, while its capability can show how the ability of such governments in accommodating the changes, which in this case is how the ability of such governments could

create a good economic performance by identifying problems and choosing the most appropriate and effective policies in resolving the economic crisis. The Indonesian government also had a low commitment to the economic growth that led Indonesia to have a worse crisis. The IMF programs that previous government dealt with confused new governments since their capability to address those policies was low. However, the Korean government showed a good level of capacity, capability and a high commitment to create a strong economic crisis recovery team, while Kim Dae-Jung's plans also called for a prolonged period of economic recovery team, the first stage of which would involve 'close, cooperative' relations while maintaining two different systems, states, military structures and foreign policies. His team worked rapidly to overcome the devaluation of the won and the debt problem by implementing the four main programs mandated by the IMF. In the end, Kim Dae-jung was able to overcome the foreign exchange crisis in 1997.

2. **The fact that the IMF programs were much more strict in Indonesia than in Korea had a significant influence to the success of policy implementation.**

There were several programs that were very strict for the Indonesian economic condition of that time - such as banking sector restructuring, a tight monetary policy, military reform, constitution reform and almost one hundred amendments that the IMF recommended to Indonesia. For the

monetary policy, the IMF requested the Indonesian governments to increase almost 80% of interest rate that led domestic businesses to collapse, not only causing the rising of unemployment rate, but also sent the Indonesian people to live under poverty line where people were not able to buy even ordinary products. In Korea, the IMF only suggested Korea to raise its interest rate to almost 30% which was not as strict as the IMF recovery program compared in Indonesia. Besides that, for the banking restructuring program, previously, there was only one bank in Indonesia that had been closed by the government in the history of Indonesia, but after the IMF forced governments to close more than fifteen banks simultaneously, banking confidence dropped, people could not trust the investment and bank capability of the institutions, which had caused high inflation as consumer confidence decreased and led to a more difficult crisis. In Korea after restructuring their banking system, President Kim Dae Jung forced out insolvent financial institutions and the Korea First Bank and Seoul Bank were nationalized. As well as this, all troubled banks were given time and funds to rehabilitate, themselves and it led their banking system to improve in terms of efficiency, risk management and helped to create a market and banking confidence not only domestically but also internationally, helped to promote foreign investments and trade into and out of Korea.

3. **The issues of political transition in democratization period had a significant influence in the government's capability and in resulting impacts of the IMF policy implementation.**

In Indonesia, the democracy process led to the emergence of many new parliaments and parties, made the decision making process more difficult and took a much longer time. Sudden democratization caused significant and radical demonstrations all over the country, after the 32-year-long dictatorship of President Soeharto collapsed; the new government had to deal with instability in the political environment, which frequently hampered the effort of the national government to solve or manage the risks of the economic crisis, and led the recovery very slow. However, democratization in Korea occurred several years before the crisis hit its country and it actually helped the country to be closer to global economy as it encouraged more export and investments. Checks and balances in the system were improving at a government level and companies-related levels during democratization in Korea and in the crisis. This condition is related to the ability of new governments to rapidly fix the economic destruction and create significant improvement, choosing the right programs, and maintaining a recovery process. In the case of Indonesia, during the Asian financial crisis, more than four new leaders came and left the presidential office. Very radical changes after the military authoritarian leadership led to an inexperienced cabinet with a lack of knowledge and understanding of economics and weak leaders that threaten the implementation of IMF plans.

All of these conditions influenced capacity and capability of Indonesian government in making crucial decisions during the crisis. However in Korea, there was no extreme political transition during the 1997-1998 Asian financial crises.

1.4 Methodology and Resources

The comparative research method in social science is simply described as a method that tries to compare two or more things with a view to discover a social phenomenon. This thesis will also focus on explaining the comparative case studies based on a descriptive analytic method, a research methodology that looks at a particular phenomenon in order to explain the aspects relevant to the observed phenomena, describing the characteristics and various aspects of the subject.[17] Here, I am trying to answer what brought South Korea and Indonesia into crisis in order to give a clear description of what exactly happened during the years directly before and after the crisis and what made the economic performances in the two nations were very different. I base this paper on the qualitative research of reliable data that can show the result of economic and political changes due to the implications of the IMF policies.

The difference between the comparative and the non-comparative wings of social science lies more in the range of variation considered that in

[17] Indrianto dan Supomo, *Methodology of Business Research*, (Jakarta: Bima Sakti, 1999) p 27

distinctive methodologies.[18] As Przeworski and Teune point out, "if we accept the residual nature of names of social systems, we can then attempt to replace these names by variables. When we find that societies differ with regard to a particular characteristic, we can ask what it is about these societies that cause differences."[19] Based on this understanding, this thesis is trying to explain why similar programs could give different outcomes when applied in different cultures, societies, and economic and political conditions. It will also analyze why, even though both countries implemented IMF policies, the results were different.

This thesis will not only contribute to the academic field related to financial crises in Indonesia and Korea due to the historical description and the data that can distinguish the differences between Korea and Indonesia in the terms of the IMF programs, but also this thesis can be useful to understand such crises and find better solutions for the future.

The resources that are used in this thesis were collected from those related to the issue of financial crisis and its recovery in South Korea and Indonesia. All resources that were used to answer my research question are based on the statements and documents from the IMF reports and the individuals, researchers and governments, as well as related books,

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[18] Donald. P. Warwick, *Comparative Research Methods*, (New Jersey: Prentice Hall, Inc, 1973). p6

[19] A. Przeworski and H. Teune, *The Logic of Comparative Social Inquiry*, (New York: Wiley-Interscience, 1970)

newspapers, papers, data, files and journals. The resources of this thesis consist of:

- Economic resources, such as papers, books, research files, and journals from other scholars, IMF reports, the World Bank, some international institutions, the Korea Banks, and the Bank of Indonesia.
- Official government statements and documents.
- Media sources: New York Times, National Geographic, the Economists, Korea Joongang Daily, Chosun Ilbo, Kompas Newspaper, Kompasiana etc.
- Books, draft papers and websites related to IMF Programs, recovery from the crisis in Korea and Indonesia.

1.5 Thesis Outline

This thesis will consist of six chapters; chapter two will provide several views of other scholars who have been researched in the 1997-1998 financial crises in both nations. This paper will elaborate what other scholars tried to answer about what triggered the crisis in South Korea and Indonesia, how the IMF programs were implemented during those period. I will also explore some concepts that are related to this issue in order to give a clearer answer of why South Korea and Indonesia seemed to show very

different result in addressing the rescue package from the IMF. The concepts that this paper will provide are institutions and institutional capacity as well as good governance.

Through this table below, the paper will show the summary of this thesis.

	Economic Condition	Political Condition	Regime Stability	.Leader's Capacity & Capability	Economic Performance
South Korea	Korea was one of the most rapidly developing economies in the world before crisis occurred. Its economy depended on its industrial export. Korea was suffering particularly on banking and corporate sectors.	Before 1997-98 crisis hit Korea, its government gave privilege access to chaebols to finance their businesses easily through national and foreign banks and in return, chaebols used to fund the governments' campaign and programs.	There was no extreme regime change during the crisis. The new government was elected right in the time schedule. Under Kim Dae Jung administration, Korea was focusing on the economic recovery	Without any extreme political transition, the new government of Korea Kim Dae Jung could perform well. The government of Korea identified problems and causes that triggered the economic crisis and created national economic recovery team in order to produce appropriate policies in solving the	South Korea could recover from the aftereffect of this crisis during three years of the IMF implementation programs. The economic growth started to increase again, the number of unemployment rate dropped, the banking management could follow international standard.

				impact of 1997-98 crises.	
Indonesia	Several decades prior to the crisis, Indonesia also experienced rapid economic growth, and started to increase the level of its export. Despite this impressive achievement, Indonesia also was suffering from several weaknesses, mainly on its	Under Soeharto reign, almost all national businesses were controlled by Soeharto and his cronies. The military forced was also given a special privilege in national political system. In one hand Soeharto's cronies and the military forced played big role in the	Authoritarian regime for more than 32 years under Soeharto collapsed in May 1998. During this political transition, conflicts among political elites emerged; more than 50 big riots took place as consequence.	The impact of democratization after a long period of dictatorship regime influence not only to economic and political stability in Indonesia, but also to the society. All consequences affected to performance of its government. Government of Indonesia had more difficulties to create and implement	Even after several years the crisis hit Indonesia, its government is still facing the impacts of 1997-98 crisis such as the rate of unemployment rate, poverty line, foreign debts etc.

	banking and corporate system.	political side, and in another hand they could easily finance themselves.		economic recovery programs since there was plentiful of political competition inside the new regime.	

In the chapter three, the crisis and political power, this paper will give some description of the history before and during the crisis occurred. I will also provide some data that can show the political situation in Korea and Indonesia during the implementation of the IMF programs. Chapter three will give a clear picture of how the power transition process happened in the two nations, and how it influenced the process and progress of the adjustment reforms of IMF programs.

Chapter four will provide more facts and data about Korea's and Indonesia's reform, not only in the economic reform, but also in its political reforms with its focus on the governments' capacity and capability in addressing the IMF policies. How economic reform started, what kind of economic reforms that Korea and Indonesia did in order to overcome the huge crisis in 1997. How the IMF prescription programs were implemented in the companies, societies and also corporate sectors based on both governments' ability. This chapter will look at every IMF program

implemented during the period of agreement between the government of South Korea and the IMF and also Indonesia and the IMF. What the governments of two nations did to reform its political system will also be elaborated in this chapter.

The next chapter will discuss why both countries have different results in implementing the same rescue package from the IMF. This chapter will show what factors influenced the impact and results of the implementation IMF programs. This chapter will be divided into two sections, the first will provide comparison of the reform progress from both states, and the second section will give comparison of their economic recovery, with several economic indications, I will try to show the differences between the economic recovery in Korea and Indonesia after the three-year Stand-by Arrangement was accomplished. The last chapter will give a conclusion of this paper, what triggered the crisis, how the implementation programs were addressed in both states, how the reforms in the economic and political system in South Korea and Indonesia during that time were enacted and what made the result of the implementation of the IMF programs in Korea and Indonesia to be very different even though both applied the same rescue package from the IMF.

II. Literature Review

In analyzing both countries' IMF policy implementation processes, This paper will utilize the concepts of "institutional capacity", "good governance" and "economic development" in order to gain a clear picture of the crises to find the answers of my research question. Many scholars have conducted and published research on the Asian Financial Crisis of 1997, its causes and the implementation and role of IMF, terms of institutions, and even researches on governance. Yet, not many have researched on the government's capacity as the institution responsible for appropriate policy decision-making.

Not many have combined the concepts of institutional capacity and good governance principles that can influence economic policy related to IMF implementation programs. Most scholars are concerned with nations' economic conditions that led to such crisis. But this paper focuses on the cause of success and failure of the economic recovery on the comparative method between the case of Korea's and Indonesia's recovery on IMF policy implementation that also include the socio-political aspects such as democracy and institutional capacity. Politicians and economists claim that economic condition was the cause of its recovery.

2.1 Concepts

2.1.1 Institution and Institutional Capacity

Many social science scholars use the concept of institution as government. Therefore we must understand what institution is and why it is really important to the result of government decisions and policies. However, institution is often discussed without being defined at all, or after having defined only casually. Robert Keohane asserts that institution may refer to a general pattern or categorization of activity or to a particular human-constructed arrangement, formally or informally organized.[20] When we speak about a country, institution is its government itself. Institution involves persistent and connected sets of rules (formal or informal) that prescribe behavioral roles, constrain activity and shape expectation.

Douglass North defines institutions as 'rules, enforcement characteristics of rules, and norms of behavior that structure repeated human interaction."[21] He adds that institutions can bring a positive line to economic growth. The ideas of the importance of institutions emerged from neo-institutional scholars such as Mancur Olsen and Douglass North; several cross-national empirical studies have found a positive relationship between the quality of institution and governance structure and economic growth.[22] It

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[20] Robert Keohane, *International Institutions: Two Approaches*, (International Studies Quarterly 32, 1998) p379.
[21] Douglass North, *Institutions, Institutional Change and Economic Performance*, (Cambridge: Cambridge University Press, 1987) p6
[22] Knack and Keefer, *Does Social Capital Have An Economic Pay off? A Cross-Country Investigations,* (University of Maryland at College Park, 1996)

is not only them who believe that a good institution can build and improve an economic growth in their countries, many other scholars such as Mauro also agrees with this statement. He argues that if one state wants to increase its nation's economic growth, the leader needs to protect and improve his institution in the beginning stage.

Alternatively, a significant number of studies discredited the relations between institution and economic growth. Some claim the new political economy of growth still lacks a proper grasp of channel through which institutions affect growth, and of the political sources of good institutions. The skeptical school believes that there is no systematic between democracy, institutions and economic development.[23]

Besides institutions, a significant number of international relations scholars have studied institutional capacity. The concept of institutional capacity itself sheds light on the broader notion of capacity. Institutions are not only a discrete organization like government agencies. Capacity is also required in all phases of the policy process: for instance, a strong monitoring and reviewing system are needed to enhance the effectiveness of any policy.[24] Thus institutional capacity according to Stephnne Willems represents an "enabling environment" that can show how the process of

[23] Feng, Y, *Democracy, Governance and Economic Performance: Theory and Evidence*, (Cambridge: MA, MIT Press, 2003)
[24] Stephnne Willems and Kevin Baumets, *Institutional Capacity and Climate Action*. OECD, p4

such institutions' policies can be sustained over time. Institution and institutional capacity may play a key role in the process of creating good economic performance by affecting the ability of governments to accommodate the changes.[25]

Nevertheless, not many scholars have recognized that politics and institutions play a really big role in economic growth. Furthermore, the UNDP has stated that institution- or capacity-building, making improvements in an organization's ability to carry out appropriate tasks requires improvements in the ability to identify problems, consider the alternatives available, formulate effective policies, and implement and sustain activities appropriate to give effect to the socio-economic development.[26] Alesia demonstrates that institutional quality, as measured by bureaucratic efficiency, absence of corruption, protection of property rights, and the rule of law, is important for growth.[27] Other interesting research by Chong and Calderon, applying a more rigorous approach to causality, found strong evidence of causation running in both directions:

[25] Inter-America Development Banks (IADB), *Facing Up to Inequality in Latin America: Economic and Social Progress in Latin America 1998-1999*, (Washington DC: IADB, 1999)

[26] UNDP, United Nations Development Programs, *Towards Human Resilience: Sustaining MDG Progress in An Age of Economic Uncertainity.* (1995)

[27] A vast number of works documents the critical role of institutions for economic performance. See among others, (La Porta et al. 1998, Hall and Jones, 1999).

from institutions to growth and from growth to institutional capacity and its quality.[28]

2.1.2 Good Governance

Research on governance and its relations to economic growth exploded in the last couple of decades; hundreds of scholars have been trying to explore the correlation between governance and economic development. A growing literature stresses that governance, broadly defined as the traditions and institutions that determine how authority is exercised in a country, matter to economic development as Kaufmann mentions.[29] He also believes that there is no doubt that per capita income and the quality of governance are strongly positively correlated across countries. Before we go too far, we better understand the definition of governance at first. Governance according to OECD, governance denotes "the use of political authority and exercise of control in a society in relation to the management of its resources for social and economic development.[30] It describes how government manages and controls his citizens, social welfare, economic growth, military defense etc.

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[28] Chong and Calderon C, *On the Casuality and Feedback Between Institutional Measures and Economic Growth, Economics and Politics*, (12 (1), 2000) p 75

[29] Kaufmann *D., Kray, A. and Zoido-Lobaton, P. Governance Matters: From Measurement to Action, Finance and Development*, (Washington DC, 2000) p37

[30] OECD, *Participatory Development and Good Governance*, (France, 1995) pp1-29

The UN Secretary-General claims that good governance is "ensuring respect for human rights and the rule of law; strengthening democracy; promoting transparency and capacity in public administration". Governance will consist of the process of selecting, monitoring, and replacing governments, the capacity to formulate and implement sound policies and deliver public services and the respect of citizens and the state for the institutions that govern economic and social interactions among them.

In "The IMF, Good Governance and Middle-Income Countries" by Ben Thirkell-White it is mentioned that good governance has the potential to enhance market confidence in a context of increasingly liberalized capital account.[31] Another scientist adds that a government that has the ability to be good at governance must know how to improve the management of the public sector resources' and support the development and maintenance of a transparent and stable economic and regulatory environment.[32]

On the other hand, poor governance is defined as government inability to control such problems inside the country. International financial institutions argued that corruption and cronyism had made these non-democratic regimes vulnerable to financial breakdown.[33] Therefore during

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[31] Ben Thirkell-White, *The IMF, Good Governance, and Middle-Income Countries*, (The European Journal of Development Research, Vol. 15, No. 1., June 2003), pp.99-125

[32] Lancaster, C, *Governance and Development: the Views from Washington*, (IDS Bulletin, Vol 124, 1993) p. 2

[33] R. Wade, *'From Miracle to Cronyism: Explaining the Great Asian Slump'*, (Cambridge Journal of Economics, 22 (6), 1998) pp.693-706

the crises in 1997-1998, in the Philippines, Thailand and Indonesia middle class-based societal movements have tried to topple democratic leaders in the name of better governance. However, it led debates about the governance have also resulted political instability. Then the governments that failed to deliver rapid economic growth were disliked even if they were legitimated by democratic vote.[34]

2.1.3 Economic Development

There is significant literature on economic development in international studies; many scholars describe economic development as the increasing of nation's wealth and improvement of people's quality of life. David A. Sampson, a secretary of Economic Development of US Economic Development of Commerce describes economic development as a process that influences growth and restructuring of an economy to enhance the economic wellbeing of a community.[35] In an international relations sense, economic development encompasses three major areas. Other scholar such as Adam Smith in his book 'The Wealth of Nations' emphasize the need for economic development through different types of production. He explains how governments can create functions in the market and points out the role

[34] Mark R. Thompson, *Pacific Asia After "Asian Values": Authoritarianism, Democracy, and Good Governance*, (Third World Quarterly, Vol. 25, No. 6, 2004) p 1089

[35] David, A. Sampson, Definition of Economic Development, International Economic Development Council, see http://www.eda.gov/AboutEDA/AbtEDA.xml (accessed on 10 April 2014)

of self-interest. He believes that the importance of markets is the fundamental of nation's economic development.

Firstly, policies that a government undertakes to meet broad economic objectives including inflation control, high employment, and sustainable growth. A government is the actor that should be responsible for making decisions related to control inflation rates in its country and creates a large number of employment opportunities for their citizens to provide a sustainable growth to their economy.

Secondly, policies and programs to provide services, including building highways, public facilities, such as schools, higher educations and health facilities. Thirdly, policies and programs explicitly directed at improving the business climate through specific efforts, business finance, marketing, neighborhood development, business retention and expansion, technology transfer and other developments.

2.2 Reviews on Asian Financial Crisis Literature

Since the financial crisis hit Asia in 1997 and caused the economic collapse of many countries, attention for this huge sudden crisis exploded from all over the world. Most economists and political scientists focused on what triggered the crisis and how governments struggled to solve this problem. Here, I will focus on such reviews about how the implementation of IMF programs in Korea and Indonesia occurred.

2.2.1 IMF Implementation in Korea

With a sudden surge of economic crash and collapse of consecutive bankruptcies of several large of Korean industrial conglomerates, the so-called Chaebols, it was inevitable that this subject has been discussed and explored by many scholars. Most of scholars believe that the decision to request the fund from the IMF was the best choice for the Korean government to solve such problems; weakened investor confidence in Korea, Korea's foreign exchange reserves were almost depleted, number of unemployment increased and etc. There was no choice except to ask for a rescue package from the International Monetary Fund. Scholars such as David T. Coe and Se-Ji Kim agreed with IMF rescue programs in Korea at that time.

The Korean government agreed to the five Letters of Intent for economic restructuring programs, dated from December 3, 1997. From the outbreak of the crisis the Korean government prioritized rescheduling Korea's short-term external debts and stabilizing the foreign exchange market as the top policy objective. The IMF implementation programs were focusing on: restructuring their macroeconomic policy and increasing their rate policy; restructuring the financial sector such as banking by strengthening regulations and information as well as its transparency; corporate restructuring and its corporate government restructuring; improving trade liberalization together with its capital account liberalization.

YunJong Wang and Hyoungsoo Zang assert that since the Korean government has focused on attracting foreign capital to resolve the currencies crisis at hand, as a result, a usable reserves increased from under USD 7 billion at the end of November 1997, when the currency crisis had reached its critical point, to USD 37.04 billion as of the end of June 1998.[36] They believe it the surplus of foreign reserve is the combined result of the USD 25 billion support from international financial institution and a current account surplus, which has been continuously growing since November 1997 as the Korean government followed the recommendation of the IMF programs.

Other scholars, Ajai Chopra, Kenneth Kang and Anthony Richards, have concluded that the recovery in 1999 and 2000, with average growth of 10 percent per year, was also much faster and steeper than expected, and the large output gap was closed by late 1999 were all caused by IMF implementations.[37] To facilitate economic restructuring, Korea stepped up its trade liberalization plans by promoting the following issues in accordance with the WTO concession plan, abolishing trade-related subsidies such as abolishing restrictions on 25 imports in December 1997 under the Import Diversification Act. Some economists mentioned that,

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[36] Yunjong Wang and Hyoungsoo Zang, *Adjustment Reforms in Korea Since the Financial Crisis*, Korea Institute for International Economic Policy,(Seoul: KIEP,1998) p 86

[37] Ajai Chopra, Kenneth Kang, Anthony Richards, *From Crisis to Recovery in Korea: Strategy, Achievement and Lessons in Korean Crisis and Recovery,* (Washington DC and Seoul, 2002) pp. 13-104

"thanks to the help of IM, Korea was able to avoid the worst possible scenario."[38]

However, some scholars also argued that the restructuring of the banking sector and trade liberalization were not necessary for Korea at that time. Paul Krugman states that the Korean government also made several mistakes as they adopted a high interest rates and a tight monetary policy, which set domestic interest rates far above those of the world market, and firms were unable to raise new equity capital on the stock market and had to resort to borrowing.[39]

2.2.2 IMF Implementation in Indonesia

Indonesia was also one of the states that experienced the crisis; this encouraged many scholars to explore the financial crisis in that country. Some scholars believe that Indonesia could not escape from the economic crisis in 1997 due to the economic problems that were very complicated and had been entrenched in the Indonesian economy for decades. Other researchers argue that Indonesia was hit by this crisis due to its dependency on international financial institutions such as the IMF, World Bank, and others.

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[38] Kim Kihwan, *1997-98 Korean Financial Crisis: Causes, Policy Response, and Lessons*, At The Level-Seminar On Crisis Prevention In Emerging Market Organized by International Monetary Fund and The Government of Singapore, (Singapore July 2006)

[39] Paul Krugman, *What Happened to Asia,* p. 34 (1998) Available at http://web.mit.edu/krugman/www/DISINTER.html (accessed on February 15, 2014)

Like Korea, Indonesia also requested the rescue package from the International Monetary Fund after it suffered a reserve net-capital outflow of more than $13.8 billion in 1998. The Indonesian government signed a three-year Stand-by arrangement for almost $10 billion after the IMF's executive board approved the request on November 5, 1997.[40] In Indonesia, similar programs from the IMF were adjusted. The government of Indonesia created The Indonesian Bank Restructuring Agency (IBRA) to rescue the Indonesian banking system. However, many scholars believe that the IMF programs were not appropriate for Indonesia's economic and political condition of that time. It did not lead to a better recovery, but it created more problems for Indonesia in the sectors of politics and economy.

Scholars like Rizal Ramli, argue that involving the IMF in Indonesia's recovery program would inevitably plunge the country into a deeper economic crisis, adding, "I felt that it was more likely that the IMF would act as surgeon rather than savior, severing limbs from the Indonesian economy and sending the country a large bill for its services.[41] Following the IMF suggestions, Indonesia must convert the private debt into public debt, whereas prior to the crisis Indonesia had no domestic public sector debt, under IMF policies the government's domestic debt swelled to US$65 billion. Meanwhile, the public sector international debt rose from US$54 to

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[40] See http://www.lawteacher.net/finance-law/essays/imf-and-financial-crisis.php, *IMF and Financial Crisis. "International Monetary Fund and Developing Countries"*, (accessed 13 April 2014)

[41] Rizal Ramli, *The IMF's Indonesia Myths*, (Jakarta: 2008)

$74 billion. As a consequence of the financial crisis and IMF policies, Indonesia's debt doubled over a period of just four years.

Others also agreed with this statement, economists and politicians such as Stephen Granville and Sri Mulyani Indrawati asserted that the IMF programs and its policies did not work well for Indonesia. The IMF arrived and suggested several policies including the structuring of corporate governance. The impact was a more fragile government system that led to big demonstrations, complete with political instability that caused more complicated economic troubles.[42] Sri Mulyani Indrawati, the former Ministry of Economy of Indonesia who is currently a Managing Director of the World Bank argues that the IMF plan was designed to regain and restore the market by imposing wide-ranging programs, but the designated recovery steps are not without criticism.[43] Not little number of economists and politicians believe that the IMF programs were not suitable for Indonesia that time.

However several other scholars argue that because of IMF fund, Indonesia did not experience worst condition. The impact of the collapse of investors' confidence spread out to not only on an economic level for the people in Indonesia, however the stability of government dictatorship of Soeharto in 1998. Even though some programs seemed to not show a

[42] Stephen Granville, *The IMF and The Indonesian Crisis*, (May 2004) pp1-24
[43] Sri Mulyani Indrawati, *Indonesian economic Recovery Process and the Role of Government*, (Journal of Asian Economics, 2002) p 577

positive result for the recovery, Steven Radelet believes that without help from International Monetary Fund, Indonesia that time would not be able to recover at any level.[44] However, there is no debate on the comparative case of Korea and Indonesia in implementing the IMF recovery programs from a political, policy-relevant and political channel view on the capacity of the institutional and good governance theory.

[44] Steven Radelet, *Indonesia: Long Road to Recovery,* (Harvard Institute for International Development, 1999) p 14

III. The Crisis and Political Power

3.1 The Crisis and Political Transition in Korea

Korea's rapid growth during the 30 years before the 1997-98 crisis was an amazing achievement for the Korean government. Over three decades their annual income grew over 8 percent. South Korea, in the 1950s, was one of the poorest countries in the world. The GDP of South Korea in the 1950s was 1.5 billion USD, which means their per capita was only 70 USD in the year 1954. Starting from 1962, the Korean government announced its five year plan for economic development of Korea by implementation of industrialization projects. This plan was launched in order to develop their economic growth and recover from its devastated-economy after the two Korean brothers' war in 1950-1953. After the first economic development plan was completed in 1967, increasing exports became the keynote of the second five-year development plan.[45]

The government of South Korea tried to manifest itself in export-oriented industrialization strategy to compete in the international market; the government encouraged domestic businesses to release themselves from their dependency with international aid, especially from the United State of America. They focused on export promotion and import substitutions which, in the end, helped South Korea to increase its GDP and build their economic independency. The GDP of Korea increased by 949.7 billion USD and its

[45] Ho-Jin Kim, *The Theory of Korean Politics*, (Seoul: Park Young-Sa, 1990), p135

GDP per capita reached 19.624 USD in the year 2007. However, this rapid economic growth that was based on export oriented strategy caused Korea to become fragile to any international economic shocks. During their industrialization period, Korea experienced rapid income growth, which resulted in higher rates of inflation, a loss of international competitiveness, and slower economic growth.[46]

Table 3.1
Wage Growth in Korea

Years	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Wage Growth (%)	9.2	8.2	10.1	15.5	21.1	18.8	17.5	15.2	12.2	12.7

Source: Ministry of Labor, Maewŏl nodong t'onggye chosa bogosŏ (labor statistics monthly report), from 1985 to 1994.

The condition of Korea at that time led to many instabilities of its economy to any crisis. Yet, this situation became a real disaster, starting from July 2nd 1997, after Thailand's currency Baht devalued and spread its sudden shock to other neighboring countries, including Korea. Korea quickly lost its market confidence, causing many investors to withdraw all its credits. Eleven large Chaebols collapsed in 1997; starting with the bankruptcy of Hanbo Steel, as the 14th largest industrial conglomerate~~s~~ in

[46] Won-Dok Lee, *Labor Movement in Korea After 1987*, (Seoul: Korea Labor Institute, 2000) p15

Korea. Hanbo Steel was one of biggest steel producers in Korea; this bankruptcy was followed by another steel produce, Sammi Group.

Not long after its collapse, Jinro, the 19th largest Chaebols, went into bankruptcy, and in July 1997, Kia Motor, as the third largest auto maker in the country, could not stand this sudden hit and also collapsed with USD 10 billion of debt. The bankrupt businesses cost South Korea 100 billion USD, 20% of country's half-trillion-dollar economy.[47] These bankruptcies were the biggest loss of Korea in history.

Before the collapse of Chaebols and its risk of others 50 largest Chaebols to experience collapse, the crisis started with a current account deficit widened from 2% of its GNP in 1995 to 5% in 1996. The export of Korea since the 1960s has been one of the most rapid and successful economic growths compared to other states. But it began to slowdown from 31% to a half, which was 15%, and it led the GNP of South Korea to decline from a high level of almost 15% to only 7.1%. This slowdown of Korean export was caused by: a loss of Korean currency value due to the drastic decline of the Yen, as an impact of recession that happened in Japan and Europe. The world prices in some export products that Korea was focusing on, such as in chips, automobile, and computers, also became a reason of the export slump.

[47] Lee Keun S, *Financial Crisis in Korea and IMF Analysis and Perspective*. (Washington DC: 1998)

Due to the slowdown of their export, the rate of growth of exports fell to an average of 14% annually between 1990 and 1996 as compared to 20% between 1985 and 1990;[48] The trade deficit doubled between 1990 and 1995; while the current account deficit quadrupled. Then, when the currency attack on the Korean Won started, Korea made a futile attempt to defend its overvalued exchange rate, losing about 20 billion USD in the process. By the end of 1997, Korea's net usable foreign exchange reserves had dwindled to about 12 billion USD,[49] or about three weeks' worth of imports and about 60% of debt falling due**.**

In addition, the devaluation of the won increased the debt burden on Korea's banks and corporations dramatically.[50] Following this condition, in the early November, won devalued from 844 KRW per 1 USD to 1000 KRW per 1 USD, and almost reached 2000 KRW per USD in December 1997. However, the value of Korean won rose to 1600 KRW per dollar in February 1998.[51]

The Korean government did not want to have a long discussion regarding the way out of the crisis. There were some policies in the sector of economy and politics following the recovery prescription from the

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[48] Thurow Lester, *Asia: The Collapse and Cure*, (New York Times, February 5 1998)
[49] Fisher Stanley, *The Asian Crisis: A View From The IMF*, (Washington DC: 1998) p 4
[50] Irma Adelman and Song Byung Nak*, The Korean Financial Crisis of 1997-98*, p 9
[51] Gong Chen, *The Looming Financial Crisis in China, The China Strategic Review*, (1998) pp. 11-19

International Monetary Fund. The Korean government directly requested the rescue packages from IMF for a three year Stand-by arrangement program. The purpose of the bailout was to provide a bridging finance to reduce current-account deficits, keeping inflation in check by restricting domestic demands.[52]

Additionally, following the IMF programs of economic recovery, Korea had to restructure its corporate governance. One of the causes of the crisis in 1997-1998 was the bad governance and its corrupt-relations between government and Chaebols. The Korean government was trying to clean the government institution and its political relations with Chaebols. In order to strengthen the governance of financial institutions many measures have been taken. They include allowing foreigners to own commercial banks and become bank executives in December 1997 and May 1998, respectively, improving governance of financial institutions and strengthening the right of commercial bank minority shareholders in January 2000, raising the limit of bank ownership of domestic actors.

Nevertheless, there was no political transition from authoritarian regimes to democratic ones. Korea experienced the transition from 1987. All of the movement of democratic voices appeared during authoritarian regimes. Even though they have been through a rapid growth and increased its export, Korea was building a very crucial political problem within. It

[52] Ibid, 272

made Korean people thirsty for freedom of speech and for a democratic leader. Thousands of people came down to the street to protest against the Chun government and to request a direct election for the next president. Therefore, in June 29, 1987, the government made an announcement to transition to a democracy which included: 1) direct election of president, 2) guarantee of human right, 3) guarantee of freedom of speech, 4) local autonomy, and 5) securing freedom of political parties.[53]

Under the new democratic system, there were many positive effects, such as human rights improvement, public opinion in policy making, fair election and what people hoped since Korea's independance day, freedom of speech. But, it also created several potential problems for the future. Since it turned to be a democratic state, a labor union was built in order to protect labor's interests. However, the labor union that enhanced labor rights, led to very high wage hikes, making Korean wages much higher than other countries. Such as in the US during the same period, when Korea increased its wage from 9.2% to be 12.7% in 1994, US increased its salary by 0.1%. Korean wages even doubled some European countries at that time. As I explained above, it finally became one of the reasons of the 1997 financial crisis.

[53] Kim Hyun-Sheup, *The Grim Promise to Build the Great Father Land*, (Seoul: 1989) p. 3

Under the Roh Tae-woo administration, emphasis on equity and balance enhanced the social welfare system through housing policies and the national health care plan.[54] However, the tied relations between government-politicians and businessmen caused the vulnerable situation in the political and economic sector of Korea. Politicians pressured banks to give loans to export oriented business, especially chaebols. Politicians helped chaebol gain access to many loans freely and chaebol illegally helped the politicians' campaigns and contributed to political policies in return. To cut the political and business ties, and create a transparent transaction, the Kim Young Sam administration adopted the financial transaction policies.

Kim Young Sam was followed by Kim Dae-Jung, who won the presidential election and started his official responsibility as the 15th president of Korea on February 25th 1998. The Kim government announced the new strict policy regarding the government-business ties. The political prescriptions by the IMF strongly recommended the Kim government to restructure the chaebol system and ill-performing financial institutions.[55] Therefore, during the 1997-1998 financial crises, there was little political

[54] Seong-Ryeol Cho, *Economic Reform and National Strategic Change of the Roh Tae-woo Administration*, (Seoul: Korea Political Science Association Review, Vol. 30, 1996), p. 196

[55] Tong Whan Park, *South Korea in 1997: Clearing the Last Hurdle to Political-economic Maturation*, (Asian Survey Vol 38) p3

instability in Korea. The Government was changed right in the time of the presidential election schedule.

After the Kim Dae-Jung regime, president Roh Moo Hyun continued holding the presidential position. He was the fourth president since Korea announced its democractic system. He was unexpectedly elected and was a different kind of president.[56] The other two previous presidents had been democracy activists.[57] But this new president was constrained only by the boundary of constitutional rights and did not try to control other political institutions. During his presidency, he just focused on the economic recovery based on IMF recommendation prescriptions. He concentrated to continue the policies on economic reform and in the same time kept making progress on political reform to clean up the bad governance performance.

3.2 The Crisis and Political Transition in Indonesia

The economic crisis that hit Indonesia in 1997 became a memorable event for the Indonesian people. This event devastated the Indonesian economy. A similar condition to Korea also occurred in Indonesia; the

[56] Uk Heo, Hongcheul Jeon, Hayam Kim and Okjin Kim, *The Political Economy of South Korea: Economic Growth, Democratization, and Financial Cri*sis, (United States: Wisconsin,) p. 24

[57] Sung Deuk Hahm, and Dong Seong Lee, *Consolidation of Democracy in South Korea: Evaluation of the Roh Moo Hyun Administration, 2003-2008.* Presented at the Annual Meeting of the America Political Science Association (Chicago,2007) p. 7

crisis started from the devaluation of the Thailand Baht.[58] From around June 1997, the crisis spread within months to several countries of the South-East Region. Indonesia per capita income had reached 1,155 USD in 1996 and was 1,088 USD in early 1997, but it dropped to only 610 USD in 1998. From 1990 to 1996, Indonesia's recorded annual GDP growth was 7.3%, decreased to only 4.5% at the end of 1997, and continued to drop to even a mere 0.9% in the year 1999.[59]

The International Labor Organization (ILO) claimed that two thirds of the Indonesian population was in a very poor condition in 1999.[60] The Indonesian currency was suddenly attacked, caused a sudden outflow of funds, which was a result of panic behavior of many investors due to the devaluation of the Thai Baht.[61] The Indonesian currency, the Rupiah, was devalued by 90%. From January 23-26, 1998, the Value of the Rupiah dropped to over 14,000 per USD,[62] and the exchange rate, which had been around 2,300 Rupiah per USD, dropped to over 17,000 per USD.[63]

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[58] Kaufman, *The Asian Financial Crisis: Origins, Implications, and Solutions*. Springer. ISBN 0-7923-8472-5 (1998)
[59] Jayasankar Krishnamurty, *Learning From the 1997-1998 Asian Financial Crises: The ILO Experience in Thailand and Indonesia,* (Geneva, 2009) p15
[60] Bank of Indonesia, see. www.bi.go.id, *Krisis Global dan Penyelamatan Perbankan Indonesia "Global Crisis and Indonesian Banking Rescue"* (accessed on 15 February 2014)
[61] Radalet and Sachs, *The Onset of The Asian Financial Crisis*, Harvard Institute For International Development, (Cambridge: Harvard University Press, 1998) p22
[62] John Strauss, *Indonesia Living Standard Before and After Crisis*, (Singapore, 2004) p2
[63] Kompasiana, *The Cuases of Financial Crisis, Sebab-sebab Terjadinya Krisis Ekonomi*, (27 Januari 2010).

Before the crisis hit Indonesia in 1997, Indonesia was one of the countries enjoying rapid economic growth. The export and its economic development produced reduction in poverty and improvement in social welfare indicators, low inflation, a relatively modest current account deficit, and growing international currency reserves. However, the crisis lead Indonesia to experience a high rate of unemployment with many Indonesian people losing their jobs and ending up in poverty since the prices of goods and services increased double and even dramatically increased triple.

Indonesia now is much more vulnerable to any economic shocks than, say, thirty years ago, for a number of reasons.[64] First, since economic reforms started in the 1980s toward trade, banking, investment, and capital account liberalizations, the Indonesian economy has become more integrated with the world economy. Second, though at a decreasing rate, Indonesia is still dependent on exports of many primary commodities, i.e. mining and agriculture. This means that its economy is still sensitive to any world price/demand instability for those commodities. Third, Indonesia has become increasingly dependent on imports of a number of food items such as rice, food grains, cereals, wheat, corn, meat, dairy, vegetables and fruits, and even oil. Any increases or instabilities of world prices or the world production failures of these commodities will have big effects on domestic consumption and food security in Indonesia. Fourth, more of the Indonesian

[64] Tulus Tambunan, *The Two Big Economic Crises: The Indonesian Experience*, (Jakarta: 2008) p. 2

working population, including women, go abroad as migrant workers, and hence livelihoods in many villages in Indonesia have become increasingly dependent on remittances from abroad.

These vulnerabilities of the Indonesian economy were created during the authoritarian regime under the second president, Soeharto. Soeharto began his administration as to what he called the New Order regime in 1965. Under this new Soeharto administration, Indonesia experienced a very difficult and unhealthy economic structure that might have influenced the economic decline for future generations of Indonesia**.** Soeharto was really famous for his corruption activities. Soeharto used tax payers' money on his electoral campaign, and he also used funds which were supposed to be used to finance public infrastructure, such as deforestation, to finance his Minister's Research and Technology's projects.[65]

The New Order was a very strict dictatorship and presidential regime; during Soeharto's administration, political activists, university students, and opposite actors were kidnapped and killed. Starting from the crisis, students and activists gathered to deliver a movement for one Indonesia under democracy law. They came down to the street, demanding a transparent government, who is far from any corrupt behaviors. People

[65] Pincus and Ramli, *Indonesia: From Showcase to Basket Case,* (Cambridge: *Cambridge Journal of Economy,* 1998) pp723-733

were really angry towards Soeharto, his family, and his cronies who hold almost all big business entities in Indonesia.

Suharto era, in which the military played the dominant role in Indonesian politics, was still in place. Most of the ordinary people in Indonesia were not aware that Suharto's regime created a lot of problems for Indonesians, including human suffering, corruption, collusion, nepotism, economic dependency on foreign debt, and economic collapse.[66] Apart from that, during the Suharto period, there was no political freedom for the citizens. People began to ask the democratic system to rule Indonesia and for freedom of speech in public. However, there were some activists who disagreed with the plan to change Indonesia into a democractic country. One NGO activist states that: "Democracy is a project of capitalism to secure free-market competition. Democracy does not solve the unjust economic exploitation of the poor by the economically rich. We do not need democracy, we need socialism. In essence, democracy is only needed by a small number of elites and political scientists in Jakarta, but not by the majority of the poor people.[67]

The discussion about democracy in Indonesia was getting hotter; more and more demonstrations occurred all over the country. This economy

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[66] Ikrar Nusa Bhakti, *The Transition to Democracy in Indonesia: Some Outstanding Problems,* (Jakarta: 2010) p.2

[67] See the conference of Transition Towards Democracy in Indonesia, Hotel Santika, (Jakarta 18 October 2012)

declined, and it not only led to conflict inside government agencies but it also led to huge and massive social unrest, riots, ethnic conflicts, separatists' movements, as well as crime and interpersonal violence.[68] A demonstration that was headed by Indonesian student movements, ultimately occupied the parliament building in May 1998. More than a thousand students gathered after police shot several students from Trisakti University on May 12th 1998, which they called the Trisakti Tragedy of 1998, forcing Suharto to step down from his position as president of Indonesia after more than 30 years dominated by military support. Finally Soeharto stepped down on May 21st 1998, and Indonesia started a new democratic system. This change toward a democratic regime, created various distributed groups, parliaments that represent different political parties, many emerging NGOs and other influential organizations.

After the regime of Soeharto collapsed, he transferred his presidency to BJ. Habibie.[69] Habibie with his new presidential rule not only had to bring Indonesia into an accountable and transparent constitution, freedom from corruption, collusion and nepotism, but also in the same time had to deal with IMF programs with the Indonesian economic condition which was still declining and sending Indonesian people into a deeper poverty. Even though Habibie could produce a more political liberalization,

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[68] Wee, V, *Social Fragmentation In Indonesia: A Crisis From Soeharto's New Order*, Southeast Asia Research Center, (City University of Hongkong, 2002) p 2

[69] Geoff Forrester, *The Fall of Soeharto, Bathurs,* (Australia: Crawford House Publishing , 1998) p78

he failed to maintain his power. During his short legacy, domestic conflicts and separatism movements emerged; Indonesia in 1999 lost one province after Habibie gave a chance to Timor Leste people to choose to be a part of Indonesia or be independent.

Through the 1999 presidential election, which was quite fair, Megawati Soekarno Putri, a daughter of Soekarno, first became president of Indonesia through winning the election, but the national assembly mandated Abdurrahman Wahid as the fourth president of Indonesia. Although Megawati won the election, she could not form the government; she was just holding the Vice-President position that caused much anger among her supporters. Demonstrations during that period colored the daily life of Indonesian people. Conflicts, social unrest, and separatist movements in several regions occurred especially in the East part of Indonesia, such as Maluku, Ambon and Papua, created social instability.

The crisis of leadership was brought to a point of no return by some government group scandal, leading to opposition in the parliament.[70] In the middle of 2001, the parliament pushed Gus Dur to transfer his presidency to Megawati. With many complicated and unfinished problems from the previous administrations, Megawati administration had to deal with the

[70] Kompas, *A Scandal relating to operations of centralized state purchasing and distribution agency, the Bureau of Logistic (Bulog)*, (Jakarta: Kompas Newspaper, 20 July 2002)

unstable political instability, separatism, terrorism, domestic conflicts, and the yet to be recovered economic crisis. Not only were these clashes among parties and parliament members, there many conflicts related to constitutional amendment.

Under the Megawati administration, the real meaning of democracy disappeared. Indonesia's democracy transition is marked by a situation in which democracy procedures take place but the substantial democracy is ignored. Several laws were amended with the new government system, many new regulations and laws were created, and some of them were related to problems of terrorism in many regions all over Indonesia. Several bombings in Bali Island pushed foreigners to leave Bali. Yet, several other bombings in Jakarta and other cities also endangered the democracy process in Indonesia. It led to worse relations in Indonesia and other states. Bombing, social unrest, and demonstrations created more difficulties and challenges for the new government to solve the economic crisis during those years. High inflation, low value of Indonesian currency, high rate of unemployment, and the prices of goods and services that did not decrease, caused the number of people in poverty in Indonesia kept increasing.

IV. Government's Capacity and Capability

4.1 Korean Government's Capacity and Capability on Economic and Political Reform

South Korean government officially made a request on the helps from the International Monetary Fund on November 21, 1997 in order to rescue the economic decline, after almost all foreign reserves were depleted. After the request was submitted, the Executive Board of the IMF approved the three year Stand-by Arrangement on December 3, 1997, equipped with the memorandum of economic program. Through the Stand-by Arrangement, the member country of the IMF can get support from that international financial institution, under the direction of the Managing Director of IMF, who leads the IMF plan of economic recovery support through a Letter of Intent.

The three year Stand-by Agreement that Korea signed in the end of 1997 was the 17th Stand-by Agreement since the year 1965. To overcome the financial crisis that began in the mid-1997, the Korean government intended to address the fundamental causes of its crisis and restore the market confidence and recover its economic growth with not only one Letter of Intent but six Letters of Intent. The first Letter of Intent was signed by both parties in the end of that year, contained of several commitments to implement such programs:

1. The Macroeconomic policy which included exchange rates, fiscal policy, foreign reserves, external debt management, and money supply.
2. Restructuring of financial sector.
3. Corporate restructuring.
4. Trade liberalization.
5. Liberalization of capital account.
6. Restructuring of Labor Market.

For the macroeconomic policy, IMF suggested the Korean government to increase their interest rates and tighten the aggregate demand. It was proposed as an effort to maintain tight monetary policy to restore and sustain calm in the market and contain the inflationary impact of the recent won depreciation.[71] In the fourth Letter of Intent, on January 7, 1998, was written that high interest rate policy is crucial for stabilization of the foreign exchange market.[72] However this high interest rate caused more and larger business bankruptcies during that period. High interest rates showed worse result for Korean businesses, 123 companies on the average failed each day- a 1000% increased from a year earlier.[73] In the fact the leveraged conglomerates bankruptcy remained for several factors since the beginning

[71] Yujong Wang and Hyungsoo Zang, *AdjustmentRreforms In Korea Since the Financial Crisis*, (Seoul: KIEP, 1999)
[72] See: Letter of Intent between Korea and the IMF in 1997
[73] Keun S. Lee, *Financial Crisis in Korea: Analysis and Perspectives*, (The Merryll Lynch Center for The Study of International Financial Services and Markets, 1998)

of the year 1997, including the depression of export prices and devalued of Korean currency Won. The bankruptcies spilled over into a sharp increase in nonperforming loans (defined according to international standards) to 32 trillion KRW (7 percent of GDP) by end-September, about double their level at end-1996.[74]

Therefore to cope with this exigent situation, since February 7, 1998, Korean government requested to have more flexible stance toward the high interest rates. The government of Korea saw this tight monetary policy would not increase the value of Korean won and avoid speculative activities, however would bring the economy of Korea to a worse economic brink. After the Korean government started to lower its interest rates from above 30% to 15%, the stability of Korean currency Won could be reverted and the number of bankruptcy started to decrease.

Table 4.1
Korean Exchange Rate to USD In 1997-1998

Months	Interest Rate (%)		Average Market Exchange Rate (KRW/USD)
	Call Rate (brokerage trading)	Corporate Bonds	
July 1997	11.90	11.90	890.5
August	12.91	12.16	895.9
September	14.22	12.60	909.5
October	13.06	12.60	921.9
November	12.10	15.10	1025.6
December	31.32	28.98	1,484.3

[74] See: the attachment of Korea-Memorandum Economic Program that Korean government submitted to the IMF on 3rd December 1997

January 1998	27.21	18.50	1,706.8
February	24.27	20.50	1,623.1
March	22.05	18.28	1,505.3
April	18.04	17.70	1,335.2
May	16.71	18.82	1,410.8
June	14.4	16.0	1,385.2

Sources: The Ministry of Finance and Economy, Economic Indicators, 1998
The Bank of Korea, Financial and Economic Trends, 1998

The purpose to tighten monetary condition was to restore the market and limit inflation on 5 percent in the year 1998, government put high expectation through this tightness monetary policy the depreciation of Won could be controlled. Since 1998, the tightened monetary policy was reduced in order to produce a more flexible exchange rate policy. In the graph below, the value of won dropped to almost 2000 per USD in the end of 1997, thus the downward of won could be controlled to around 1100 KRW per USD in the middle of 2000.

Graph 4.1
Korean Exchange Rate to USD In 1997-2000

Sources: Trading Economics

The government of Korea also struggled to limit government and bank intervention on the market with the purpose to smooth the operation of the market. Its government's commitment to healing the business system in Korea began with giving the access for business actors to explore and develop their markets. Government would not intervene much, however still would control those companies and investors with the objective to produce a healthy business management and system, thus in the near future could demolish monopoly of big industrial conglomerates inside the country. Many large and small businesses enjoyed their operation and expansion during this time. Besides, the government also cut the expenditure budget. This policy was designed to maintain the fiscal to be always in balance. This budget they used it for restructuring the financial sector that became mass up and declined.

Table 4.2
The Letter of Intent on Monetary Policies

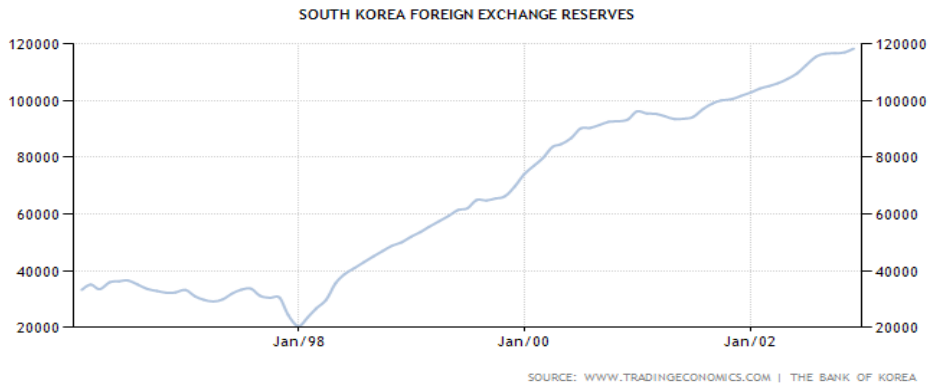
Objectives	Measures Taken	Measures Planned
A. Maintenance of A Sound Fiscal Basis		
-Maintain a strict fiscal policy in 1998 to remove the strains on monetary policies and finance the restructuring in the financial sector.	-Increased revenues and implemented measures to cut expenditures in order to maintain a sound fiscal basis. -Announced a tax rate adjustment proposal on December 3, 1997. -Supplementary budget proposal submitted to the Special Session of the National Assembly in	-Enforce measures to increase tax revenues and cut expenditures.

	February 1998. -Cut in tax expenditures: KRW 8.4 trillion. -Expansion of tax revenues: KRW 4 trillion.	
-Raise KRW 24 trillion to satisfy the Basle minimum capital requirements. For this purpose, the budget will reflect KRW 3.6 trillion of interest (0.8 percent of GDP), incurred from the borrowing of public funds.	-Announced the plan to issue KRW 24 trillion of bonds through the Deposit Insurance Fund and Non-Performing Loan Management Fund, and the government's intent to guarantee the repayment of, and interest on the bonds from the budget on December 10, 1997. -The National Assembly passed the Proposal of Payment Guarantee Agreement on December 29, 1997.	-Issue bonds.
-A 1.2 percent consolidated central government deficit is predicted because of a slow-down in growth for 1998 and the rise of KRW/USD exchange rate. However, the IMF has approved a budget deficit of up to 1.75 percent due to the fall in growth and effects of the restructuring.	-Expenditure on construction of a social safety net in expectation of a rise in unemployment is to increase up to KRW 7.9 trillion (1.7 percent of GDP).	

Sources: The Letter of Intent between Korea and the International Monetary Fund 1997-1998, see: Adjustment Reforms in Korea Since the Financial Crisis, Korea Institute For International Economic Policy

All of these solutions showed a positive result in June 1998, after the foreign reserves increased up to five times from under 7 billion USD in the end of 1997 to 37.04 billion. In the mid of 2002, the foreign reserve of Korea had already reached to over 120 Billion. See the graph below.

Graph 4.2
Korea Foreign Exchange Reserve



Sources: Trading Economics from the Bank of Korea Data
Unit: Million US Dollar

The Korean government was intended to address its financial sector with the objective to rebuild healthy financial institutions that would affect the financial system including the weak and troubled financial institutions, deal with its management based on international financial standard and be more transparent to its public. To execute this plan, the International Monetary Fund recommended Korea to make some restructuring on its banks. Korea was suggested to establish an independent central bank with the primary function of controlling inflation, since the inflation rate was really high during the current crisis.

In order to cut the ties between governments and chaebols, government also demanded a creation of consolidated supervisory body with jurisdiction over all financial and corporate operations. From that time, all companies must report their financial status, firms report audited and the

entire business enterprises must follow the new regulations on transparency and clean business operation with government. Government started to enforce the financial institutions and banks that have problems to recapitalize, and eliminate the government loans. The objective of this program was to stress more on transparency in the transaction of each banking system.

Under the new presidential administration, Kim Dae Jung officially started from February 1998, the central banks was allowed to increase the money supply to lower interest rates, and fiscal targets were progressively relaxed to accommodate the cyclical downturn in revenues. The goal of financial reform itself was to strengthen the regulatory framework of Korean financial standard and promote private effort for bank recapitalization. Government regulated all troubled banks and corporations to conform the government target of healthy banks and corporations. All the commercial banks and other financial institutions were monitored by Financial Supervisory Committee (FSC) that was established in April 1998. The government also forced to revise the Bank of Korea Act to provide for central bank independence with price stability as its main mandate.[75]

These banking restructuring should be accomplished to get the function of financial markets to work properly as before the crisis and to

[75] Lee, Jang-Yung, "*Financial Sector Reform in Korea: A Systemic Risk Approach,*" Korea Institute of Finance, (Seoul, April, 2003)

resolve the problem of credit crunch which occurred since the beginning of 1997. This program was an attempt to enable the Korean banks to compete with large foreign banks and to create a new system in Korean banking. After the restructuring has been completed, there were three categories:[76] the large banks were created through merger among large banks, the medium-sized banks will manage the retail banking and the last category was for small banks in specific areas.

The shape of new banking system showed a more transparent management. It was an effort to convince the domestic and foreign investors to get their confidence back in Korean market and industry. FSC in the same year required disclosure to bank's internal management to be strengthened. They suggested an establishment of credit-screening capacity and introduced developing risk management and tightening internal control system for all banks. Since the government built the standard for the Korean unhealthy banks, in the end of 1998 only 14 merchant banks were still operating. However for those troubled banks, the government did not leave it only through closing them, thus they would implement the rehabilitation plan for a specified time. And to increase the bank management efficiency, banks such as KEB and Chohung Bank improved their productivity by reducing expenses through cutting the number of inefficient workers and improving their system of internal bank management.

[76] Dookyung Kim, *Bank Restructuring in Korea*, p 155

Besides the FSC as an independent consolidated supervisory authority for banks, security houses and insurance companies, government also introduced the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC), to clean up the non-performing loans and strengthen the capital base of banks. The funds spent by those corporations reached about 128 billion USD (at the exchange rate of 1200 Korean Won to one U.S. dollar) 29 percent of Korea's GDP in 2000, as of September 2001.[77] In the meanwhile, government gave permission for foreign investor to play role on Korean financial sectors.

On the trade sector, Korean government agreed to liberalize its trade to meet international standards. To continue its policy, Korea had abolished restriction on 25 imports in December 1997 under the Import Diversification Act, and continued by June 1998 an additional abolishing for 40 items under the same program. The government took several following actions such as eliminating the Import Certification Procedures and abolishing trade- related subsidies in the same time promoting transparency of Import Certificate Procedures to make it more harmonious with international trade and market practices, in the same time lowered the tariff on manufacture goods to around 6 percent. Through this plan, its government was planning to increase their export rate and for domestic

[77] Crotty, James and Lee, Kang-Kook, "*Economic Performance in Post-Crisis Korea: A Critical Perspective on Neoliberal Restructuring,*" (Seoul: Seoul Journal of Economics, Vol.14, No.2, Summer 2001), pp183-242

business, to expand and encourage its competitions which also could improve Korean products quality in national and international markets.

Regarding the liberalization of capital account, the government has done some following measures:

1. Raised the aggregate foreign ownership of some shares to 55% from the previous sharing was only 26% till the end of 1998.
2. Increased the individual ownership by foreigner to 50%.
3. Government successfully erased the restriction on foreign access to domestic money market instruments and the corporate bond market.
4. Removed all remaining restrictions on corporate borrowings, including loans with one- to three-year maturities, by end-1998.

Table 4.3
Korea Economic Indicator

	1996	1997	1998	1999	2000	2001	2002 Jan-June
Real GDP growth rate	6.8	5.0	–6.7	10.9	9.3	3.0	6.1
Consolidated fiscal balance (A)	1.1	–7.0	–18.8	–13.1	6.5	7.3	16.1
(Ratio to nominal GDP)	0.3	–1.5	–4.2	–2.7	1.3	1.3	–
Social security funds balance (B)	5.3	5.9	6.1	7.4	12.5	15.5	9.4
Excluding social security funds (A/B)	–4.2	–2.9	–24.9	–20.5	–6.0	–8.2	6.7
(Ratio to nominal GDP)	–1.0	–2.8	–5.6	–4.2	–1.1	–1.5	–

Sources: Ministry of Finance and Economy; The Bank of Korea.

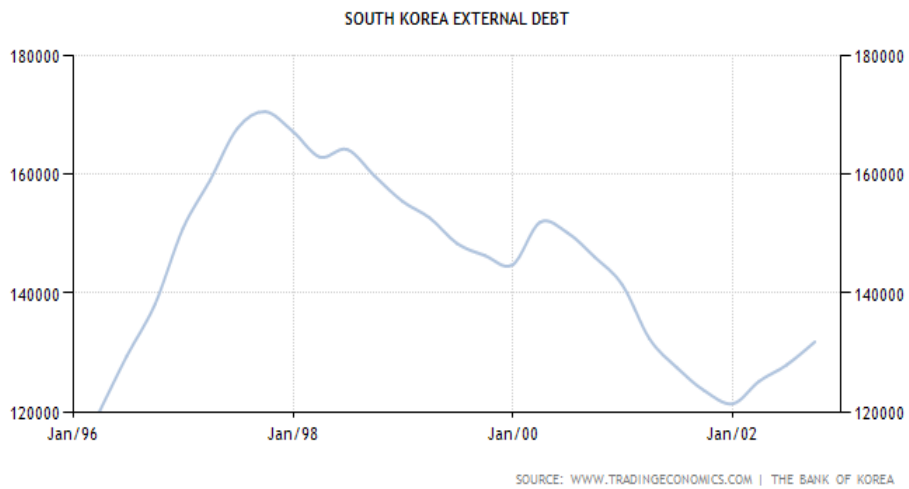
The result of the macroeconomic restructuring programs could be seen through its economic indicators such as inflation rates, debt-GNP ration, current account deficits, government budget deficits, unemployment

rate, poverty rate and its export growth. The unemployment rate in Korea abruptly climbed after several leveraged business conglomerates went to experienced severe insolvent. A wide-scale of reduction on number of employees, its rate of unemployment in Korea up in short period of time, however after the economic recovery prescription from the IMF was completed, and unemployment rate in Korea showed an incredible number of reductions. As we see in the graph below, the unemployment rate in Korea in 1999 rose to over 7% and the number of unemployment rate in the July 2001 showed more than 50% reduction to about 3,5%. See the graph below.

Graph 4.3
Korea Unemployment Rate

Its external debts were also decreased in the period of three years stand-by arrangement program. See the graph below. South Korea's external debts advanced to more than doubled in the year 1997 and 1998.

Graph 4.4
Korea External Debt



Sources: Trading Economic from data of the Bank of Korea
Unit: Million US Dollar

The unhealthy relation between Korean industrial conglomerates and government officers was one of the biggest causes that triggered Korea's currency crisis in 1997-1998. The IMF pointed on the need for such restructuring related to this issue. By following the IMF prescription, the Korean government need to stress on the corporate restructuring programs, in which program should be based on market principles, where the government should have a non-intervention policy. This issue is an important policy task for the government of South Korea during that period, since it was not only standing as a politics issue but also correlated to the

financial restructuring program, they should take place simultaneously because causes and effects would run both ways. Corporate weaknesses would lead to financial weaknesses, while vulnerability of the financial sector would lead to a credit crunch, which in turn causes inaccessibility of funds to the companies.[78]

Hence, since January 1998 there were five main guidelines for Chaebols to follow with the objective to restore the health and courage the competitiveness among corporate sectors. Its strategy consisted of promoting competition and improving corporate governance, capital structure, and profitability.[79] The five guidelines contained several important programs:

1. Enhancement of the transparency of business management.
2. Ending mutual debt guarantees between affiliate companies
3. Improvement of financial structure,
4. Reducing the core business areas of large conglomerates and encouraging their cooperative ties with SMEs
5. Increasing the responsibilities of controlling shareholders and management.

[78] Ibid, p 117
[79] Chopra, Ajai; Kang, Kenneth; Karasulu, Meral; Liang, Hong; Ma, Henry; and Richards, Anthony, "*From Crisis to Recovery in Korea: Strategy, Achievements, and Lessons*" in David T. Coe and Se-Jik Kim (eds), Korean Crisis and Recovery, International Monetary 18 Fund and Korea Institute for International Economic Policy, IMF, (Washington, D.C., 2002) p18

In the Letter of Intent, there was new policy for Korean government not to intervene any bailout for industrial business conglomerates anymore, since 1998 creditor banks will be an independent decision maker. Through this policy, the IMF hopes the corporate and government restructuring program will improve the transparency management as an attempt to reduce mutual debt guarantees among them. By improving a corporate management that is based on transparency, it could lead to accountability among conglomerate businesses; then further it required the industrial companies to follow the international accountability standard.

In the 6th Letter of Intent that has been signed on May 2, 1998, IMF stressed on several principles of corporate restructuring policies, including first, all corporate restructuring should be voluntary and market oriented, second; public funds will not be used to bail out corporations. Government also required Chaebols to be monitored, they also must disclose all liabilities, publish financial statements by external auditors in accordance with international standards.[80]

Regarding this corporate reforms, government took priority on reforming the industrial structure. The first step of these policies was The Ministry of Finance and Economy created a corporate restructuring scheme which they called "the Big Deals" under the Kim Dae Jung administration.

[80] See the 6th Letter of Intent between Korean government and the International Monetary Fund, signed on May 2, 1998.

Through this scheme, government attempted to relieve one of the main contributing factors of Korean economy recession since Chaebols put on a heavy excessive investment for several years and built a huge amount of debt that triggered the crisis in the Korean economy.

Kim Dae Jung administration has pushed the Chaebols into mergers and asset swap to try to raise its specialization and reap the benefit of consolidation and scale economies.[81] Government in the same time also established a deal with the top five of Korean industrial leaders such as Hyundai, Samsung, LG, Daewoo and SK. These five biggest Chaebols were required to restructure its financial and operational in order to achieve the government target on debt/equity ratios. This policy ends to a positive result in the end of year 2000. The average debt/equity ratio decreased below the international norm of 200% from prevailing 400%.

The crisis also restrained its government to focus on reversion of unhealthy corporate sectors with the purpose to build good corporate governance and the strategy to upgrade its competitiveness. Transparency must be the standard for Korean companies in creating their businesses. The ownership must be shared widely and the system should be accountable to shareholder. Through this plan, its government tried to promote such

[81] The series of mergers include, among others, one between two of the world's largest memory-chip makers (Hyundai Electronics Industries Co. and LG Semi-con Co.), which will be the world's second-largest DRAM chip maker; among the Samsung, Daewoo, and Hyundai groups to combine their aerospace operations; and among the Hyundai, Daewoo, and Hanjin groups to consolidate their train-manufacturing businesses.

programs, (1) improvement of government structure on the institutional investors' voting right for big companies; (2) strengthen the rights of minority shareholders; (3) increasing the corporate sectors based on the standards of transparency, all must be known by public, and all firms must report their financial statements; (4) one of most important initiatives is by liberalizing the domestic mergers through elimination of mandatory tender offer the requirements.

These programs up to today, showed a good image of Korean companies and governments banned any activities to fund political campaign and programs through the budget of Korean companies. Therefore, right now the system of eradiating corruption in institutions, government and companies showed with successful results. Korean governments could control the transparency of such companies, and in the same time, industrial businesses have their access to compete in international and domestic market with good image. The improvement in the sector of corporate governance also provided contribution on its economic recovery. Its economic growth and industries have been soared to an advance economic performance.

4.2 Indonesian Government's Capacity and Capability on Economic and Political Reform

In October 1997, before the Korean government signed their agreement with the International Monetary Fund, Indonesian government has requested funding aid for their own crisis. The IMF suggested several restructuring programs on the macroeconomic sector and demanded some political restructuring policies. The first recovery agreement between Indonesia and IMF was signed in the last day of October 1997. These programs were focused on four sectors:

1. Restructuring financial sector
2. Fiscal policy
3. Monetary policy
4. Structural adjustment

In order to provide these programs, the IMF allocated a Stand-by credit of around 11.3 billion USD for the three to five year period of the program. In addition to the IMF, the government of Indonesia also requested aid from several other international financial institutions such as World Bank, Asia Development Bank, as well as from neighboring countries. The total of Indonesia foreign debt that time was 37 billion USD.[82]

[82] Richard, Barry, *Guide to Financial Services Regulation, 3rdEdition*, (CCH Inc.Illinois, USA,1998) p35

The second negotiation between Indonesia and IMF was held as an attempt to revise the agreement since the Indonesian government faced many difficulties while putting the policies ordered by the IMF into effect. The new Letter of Intent was signed in the middle of January 1998 with the purpose to build the confidence of investors and Indonesian citizens in Indonesia's economic condition in order to restore the value of Indonesian Rupiah. In this Letter of Intent, the government stressed the macroeconomic policy which focused on fiscal policy and monetary and currency recovery programs. The government was also ordered to restructure its financial sector including a restricted banking program featuring new control and management systems.

An economic downturn which threatened to further deteriorate Indonesia's fiscal condition made the IMF to order Indonesia to cut its expenditures and increase revenues immediately. A new policy was created based on the suggestion of IMF which erased fuel and electricity subsidies, a program which the government had already found to be a large and crucial burden. The Indonesian government started to apply this program from May 4, 1998. Despite the government's predictions, the sudden implementation of this policy induced many serious problems not only for poor people but also for domestic businesses, leading to unstable social conditions and generating multiple social and political conflicts on both the local and national levels.

Many activists criticized this initiative, arguing that the government should have considered the possible conflicts and social turmoil which could have, and ultimately did, appear before actually implementing any programs. As a consequence, a large number of demonstrations and riots arose in big cities and spread to small ones. Nonetheless, in the following months the government once again diminished the subsidy on foods and basic goods. During those difficult years, the government of Indonesia could not identify the problems based on citizen interests. Its government kept continuing to implement every suggestion of the IMF without a deep consideration on its possibility of the unexpected impacts to Indonesian people.

The Bank of Indonesia mentioned that the government needed to restore the currency value to a normal level before they could measure what level of subsidy they needed to provide.[83] On one side, the IMF approved the government to provide some funding to social safety programs. However, this deflation of subsidies had the potential to cause side effects to both social and economic stability. Those policies could destroy macro-economic policy, particularly regarding currency and inflation stability.[84] Additionally, during this period companies laid off more than 50% of their employees, leading to a sharp rise in the unemployment rate.

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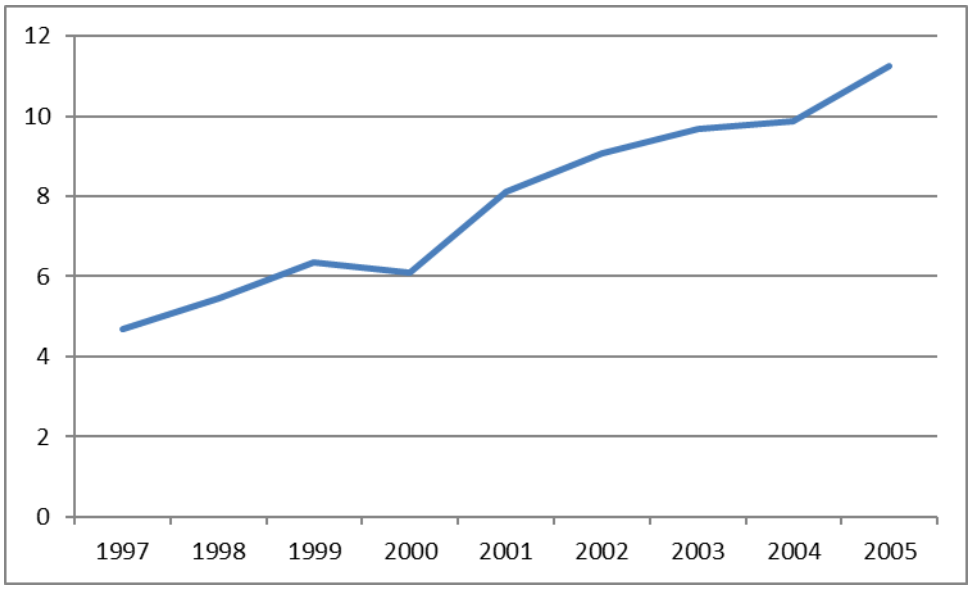
[83] Bank of Indonesia, see: www.bi.go.id (accessed on April 2014)
[84] Sri Mulyani, *Krisis Moneter Indonesia: Sebab, Dampak, Peran IMF dan Saran: "Indonesia's Monetary Crisis: Cause, Impacts, IMF Roles and Suggestions",* (Department of Economics, Jakarta: University of Indonesia) p72

Graph 4 .5
Indonesia Unemployment Rate



Sources: Bank of Indonesia

The government was also ordered to tighten its monetary system in order to protect Indonesia from any speculative attack by raising the interest rate to over 80% from 20%, the highest increase in an interest rate level in the history of the Indonesian economy. Not long after the government announced the rising interest rate, a massive wave of bankruptcies swept through the country. Not only did the sudden increase in production costs lead to bankruptcy in small businesses but also many medium-sized companies went insolvent due to the extremely tight monetary policy. This time, the government of Indonesia should produce an appropriate policy to restore its market and return back the investors' confidence, however this

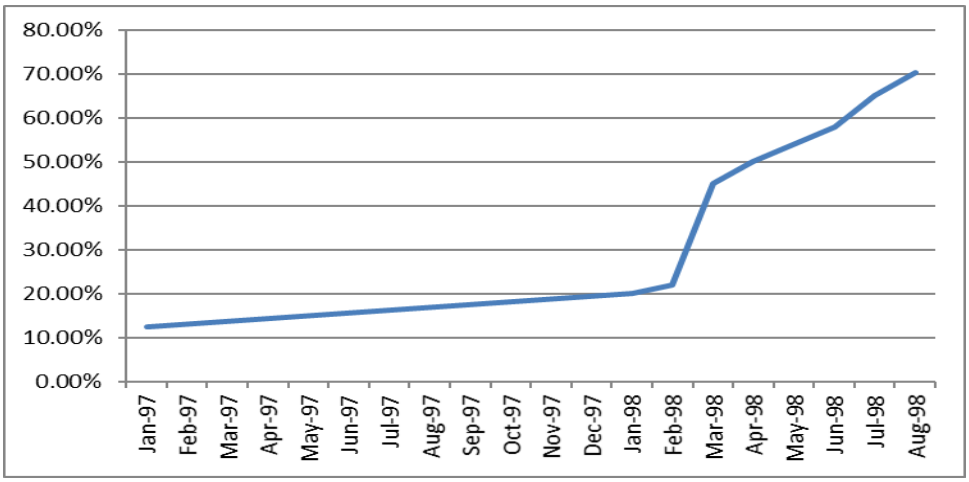
policy did not show a positive result, and unexpectedly it destroyed national businesses, mainly small and medium businesses.

After the Bank of Indonesia increased its interest rate to this high level, the government continued squeezing the liquidity. As a consequence, several banks, ranging in size from small-middle to large, experienced liquidity problems. These banks experienced clearing payment failures since they violated the reserve requirement regulation. Besides that, Jakarta Stock Indices (IHSG BEJ) fell sharply from 740.8 on July 8, 1997 to 493 on August 29, 1997, approximately a 37 percent drop due to the increasing of the deposit interest rate.[85]

The stock exchange had slowed down as investors preferred depositing their money in banks over investing in stocks. This deposit interest rate automatically produced a higher lending interest rate of over 40 percent followed by credit card interest and loan interest for housing. As outcome, this created a risk for banks since debtors had liquidity problems when repaying their loans. See the graph below.

[85] Hendri Saparini, *Policy Response to Overcome Crisis: A Lesson From Indonesian Case,* (Jakarta, 2010) p5

Graph 4.6
Indonesia Interest Rate



Sources: Bank of Indonesia

The IMF also demanded that the government must not intervene in the internal banking system. Before this the banking system was largely controlled by the Indonesian government which in turn relied on the budget from the banks. This tight relationship between the government and the banks led to wide spread corruption in the government-banking system.

The IMF suggested closing several troubled banks with the goal of healing the Indonesian banking system. Without knowing the possible result of such an initiative, the government closed many commercial banks over a short period of time. As such, the Bank of Indonesia closed 16 banks in November 1997.

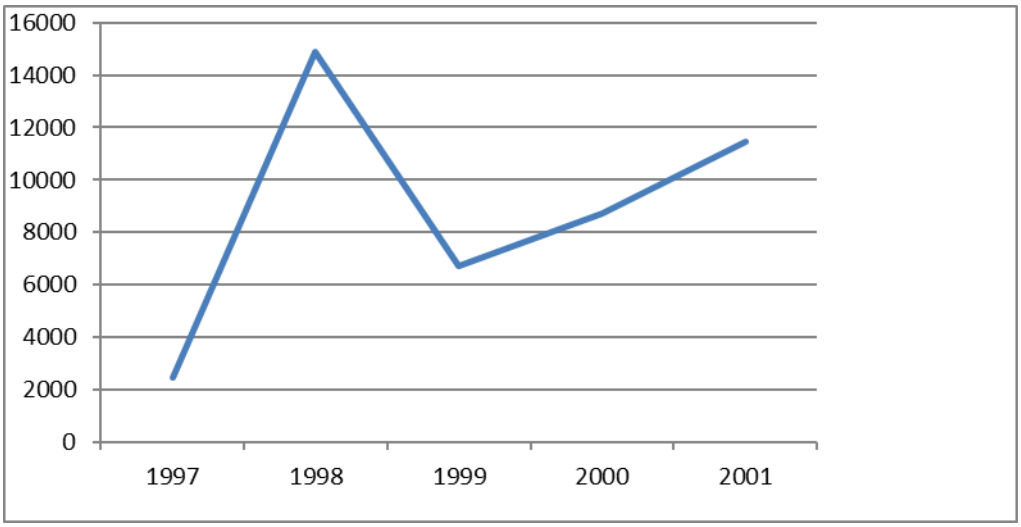
This decision was made by the prescription of International Monetary Fund. However other consequences challenged the government to

create a more appropriate response. Sudden bank liquidation had ruined the public trust in national banks. This in turn caused citizens to lose their confidence in the Bank of Indonesia and in local banks, deepening the economic crisis. A massive withdrawal of equity from both national banks and especially local commercial banks and into foreign banks occurred from the beginning of December 1997, causing an acute liquidity crisis in national banking. This policy had also made the national banking system collapse and the rupiah value drop against US dollar.

The Indonesian currency, the Rupiah, was devalued by 90%. From January 23-26 1998, the value of the rupiah dropped to over 14,000 per USD and the exchange rate, which had been around 2300 rupiah to 1 USD, dropped to reach 15,000 per USD in June 1998. This value has been difficult task for the Indonesian government to restore and even after 14 years the exchange rate is still on 11.542 IDR to 1 USD as of April 29, 2014.[86]

[86] Bank of Indonesia, see: www.bi.go.id, Rupiah to Dollar 29 April 2014 (accessed on 23 April 2014)

Graph 4.7
Indonesian Exchange Rate to USD in 1997-2001



Sources: Bank of Indonesia

The Letter of Intent that was signed in the early of 1998 contains 50 items. However, only after five months the Indonesian government asked for new negotiations due to its challenges and obstacles in implementing the programs. The new memorandum covered larger sectors and programs than the two previous agreements. In this new agreement, they added programs to address the problem of Indonesian private companies' foreign debt. The total foreign debt of Indonesia in 1997 reached 135 billion USD, including both government and private sector debt. This huge amount of debt was one of the factors that triggered the turmoil in the exchange rate and caused the economic decline of that time. Without enough information and monitoring systems for foreign debts, private sectors' debts could increase market demand for the US dollar, thus leading to a further currency crisis.

Hence, the IMF believed with these new ideas, Indonesia could stabilize its currency. The strategies of the new supplementary memorandum included the following programs:

1. Stabilizing the value of Indonesian currency Rupiah
2. Strengthening and fastening the banking system restructure
3. Strengthening the implementation of structural reform for building an efficient economy of the nation
4. Creating framework to solve foreign debt by private companies
5. Increasing the number of export to support the domestic industries

Soon after these reforms were announced, the International Monetary Fund recommended the Indonesian government liberalize all economic sectors and establish confidence of foreign investment in order to obtain more foreign capital flow. The liberalization reforms included giving opportunities to foreigners and foreign companies to have 100% ownership in national businesses, such as banks and stocks. However, after the launch of the liberalization of national businesses to foreigners, the domestic industries lost their percentage in having and enlarging the national industries. Local business men were left without adequate business.

The government requested national economists to rethink the appropriate programs to recover from this crumbled crisis. The only strategy to resolve all impacts of 1997-1998 financial crises was to stabilize the

Indonesian currency value, restructure banking, and reschedule payments of foreign debt.[87] World Bank also gave several recommendations to build and increase confidence in the Rupiah through several main policies, such as private company debt restructuring programs, banking reform, improving "the governance" and protection of fiscal and monetary stability during the transition period.[88] All of those economic reforms that IMF already suggested were seen as vague initiatives that they applied to all countries without analyzing the real economic and political conditions in the receiver countries. Consequently, these programs were observed by foreign and domestic economists as not appropriate for Indonesia.

In the political sector, its government dealt with some reforms with the objective to create healthy and clean governance. Therefore, the political reform in Indonesia had undergone several stages. The regime under Soeharto's leadership, which had a strong relationship with the armed forces for almost four decades, remained not only an authoritarian but also centralized political system with the only a single truly influential party; the *Golongan Karya* Party. The crisis in 1997-98 and the emergence of new civilian political elites drove the number of student movements in the name of democracy and for the future of Indonesia which spread across almost all territories in Indonesia. Thousands of students gathered and called for the

[87] Kompas, *Krisis Ekonomi Tanggung Jawab Pemerintah*, (Jakarta: Kompas Newspaper, 9 April 1998)
[88] World Bank, *East Asia: The Road to Recovery*, (1998) p22

fall of Soeharto, fueled by almost a year of economic crisis and the government remaining unable to deal with various emerging impacts.

The Soeharto regime ultimately ended through a large escalation of protest and a massive brutal student movement, leading to the emerging of multiple civilian democratic parties. Soeharto was abdicated his crown on May 20, 1998 after a huge number of demonstrators successfully took over the national legislature building. There are several arguments from international politicians regarding the resignation of Soeharto. Soeharto's fall was the result of "a dramatic change in the structures of political authority that began in the mid-1980s" with economic reform and led to weakening of loyalty of his allies.[89] Soeharto's fall can also be at least partly attributed to his old age (seventy-seven), which impaired his ability to identify and rationally solve the problems associated with the economic crisis.[90] The fall of the New Order administration in terms of the fatal flaws and sources of tension within the Soeharto regime that accelerated its disintegration in the context of economic crisis.[91]

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[89] Benjamin Smith, "'*If I Do These Things, They Will Throw Me Out': Economic Reform and the Collapse of Indonesia's New Order*," (Journal of International Affairs 57, no. 1, 2003): 113–28.

[90] See William Liddle, *"Indonesia's Unexpected Failure of Leadership," in The Politics of Post-Suharto Indonesia,* edited by Adam Schwarz and Jonathan Paris (New York: Council on Foreign Relations, 1999).

[91] Richard Robison and Vedi R. Hadiz, *Reorganising Power in Indonesia: The Politics of Oligarchy in an Age of Markets* (London: RoutledgeCurzon, 2004), p. 165.

The fall of Soeharto did not mean the reformation of new democratic system was closed completely. The new government still faced many challenges. The violent crackdowns of the dictatorship regime led to turmoil in the capital city which precipitated civil unrest all over the country. One of the biggest riots in the history of Indonesia took place in Jakarta on May 15, 1998. Within a period of 33 hours, the riot claimed the lives of many Indonesian people of Chinese descent. Not a small number of homes and vehicles were burned and many Indonesian-Chinese women were abused and raped. However, this tragedy is still covered by the government until today.[92]

During this period the political situation in Indonesia was uncontrolled and promiscuous. The fall of the authoritarian regime allowed new political parties to contribute in the national political arena. 48 political parties participated in the 1999 presidential elections, the largest number of political parties in a single election in Indonesia's history.[93] Most of the new political parties that emerged during the financial crisis were dominated by new political actors but the big five parties that were still chaired by senior political elites.

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[92] Leo Suryadinata, *Etnis Tionghoa dan Nasionalisme Indonesia "The Chinese Ethnic and Nationalism of Indonesia",* (Jakarta, 2010), p125

[93] Kompasiana, *Pemilu Indonesia 1999 Diikuti oleh 48 Partai Politik (48 Political Parties Participated The Indonesian Election 1999*), see Kompasiana, (Jakarta: 30 May 1999).

Before Soeharto vacated his presidential position, Habibie stood as Vice President of Indonesia, thus directly after Soeharto was forced to leave the president office, the new democratic government was continued by new President Habibie whose background as a scientist. Habibie, who lacked experience in the political arena, carried on ruling Indonesia as the economic situation deteriorated. This new government had a very big task in front of it: to reform its wrecked regime, the so called New-Order.

During the "reform period" under Habibie's administration, Indonesia launched many initiatives to reform the armed forces which, under Soeharto's reign, had already ruled Indonesia for over 30 years. In November 1998 four students at Trisaksi University were killed during a demonstration. Called "the Trisaksi Tragedy", this event triggered massive roits which lasted for three days. In the wake this, thousands of Indonesian activists and a huge number of students insisted the government change its military bodies based on a political system that adjusted to democratization. This student movement forced the government to remove all New Order Regime-related elites and resisted the abolition of dual function of the Indonesian armed forces.[94] Indonesia's politics soon descended into one of the most difficult political crisis the country had faced since 1965.[95] Human right groups and most of Indonesian democratic activists pressured the

[94] Muhammad Umar Syadat, *Revolusi Politik Kaum Muda "Political Revolution by Young Generation*", (Jakarta, 2008) p116
[95] Rizal Sukma, *The Military and Democratic Reform in Indonesia,* p 118

government to reform its military forces, as well as the nation judicial system, electoral mechanism, government representatives' bodies, and the withdrawal of all Soeharto related political comrades from the political system they used to hold before the crisis. The people insisted that the new system should be based on civilian decision which should be from citizen to citizen.

The political reform in Indonesia was focused on military reform and its political system. During the Soeharto administration, the armed forces such as the TNI (the Indonesian National Military) occupied much power over political activities and had a huge influence on the decision making process. The TNI was given a large role in Indonesia's institutional interest by the central government on both the national and local level. Soeharto and his political cronies had used a large amount of the national budget to fund their military programs, policies, and activities. The TNI began to preserve its dual function as the guardian of the nation and the protector of Soeharto's regime through their participation in political issues. More importantly, they believed that the TNI had gone too far in its implementation of dual function doctrine and needed to restore its previous image as the people's armed forces.[96]

[96] Jun Honna, *Military Politics and Democratization in Indonesia*, (London: Routledge Curzon, 2003)

Along with this insistence on military reform, the new Indonesian government experienced pressure to democratize its military bodies by working to de-politicize the TNI's power in the political system. The TNI was also found to be massively corrupt and much of its income came from illegal and semi-legal activities including prostitution, drug-dealing, environmentally destructive logging, and trafficking in people.[97] Besides the internal reform of armed forces, the government also pledged reform regarding human rights in the armed forces. One of the biggest causes that triggered the anger of the Indonesian people during the Soeharto regime was the abuse of military power. The people who disagreed with any activities of Soeharto and his governors were arrested, with some being kidnapped and never heard from again. Since the fall of Soeharto, the new President Habibie pushed all armed forces to resolve this problem; to follow Western democratic way. Nevertheless, the reform of the armed forces was still far from what the citizen had hoped due to President Habibie's personal interests.

Another launching of political reform under President Habibie's supervision was the general election with participation of multiparty. This concession seemed to give citizens more freedom with regard to speech, allowing them to have a saying in electing their next leader. Habibie chaired Indonesia for a very short period from May 1998 to October 1999 and failed

[97] East Timor Action Network/ US, *"Members of Congress Oppose US Assistance to Unreformed, 'Corrupt' Indonesian Military,"* (Press Release, 2004)

to continue his presidential role after an unsuccessful reelection campaign. During his rule, many important decisions were made but, equally significantly, opportunities were missed.[98] His initiatives along with his reformation agenda relied on interdependence between his governance and the military body. The government relied on the armed forces' support on the implementation of government programs including the election campaigns. As such, complete reform inside the military couldn't be achieved. On one hand, President Habibie need military forces to control the unrest and conflicts on both the national and local level, but on another hand, the military elites depended on the president's support on budget funding permits to maintain its special privilege.

This interdependency provided crucial privilege for senior military actors, allowing them to keep having influence on national politics and government institutions. They were permitted to adjust its own reform agenda, which was supposed to be civilian controlled. The deal brought several tasks for military forces to support President Habibie's campaign for 1999 general election. In November 1998, the TNI was requested to disperse thousands of civilian demonstrators to back Habibie's plan to

[98] Marcus Mietzner, *The Politics of Military Reform in Post-Suharto Indonesia: Elite Conflict, Nationalism, and Institutional Resistance,* Washington: East West Center, p 10

legalize his leadership in special session of People's Consultative Assembly.[99]

In order to further his personal interests, President Habibie appointed General Wiranto as the leader of the national armed forces, instructing him to create his own objectives for the military reform which preserved military power. The framework of this new military reform consisted four of points: (1) the military was content not to be in the forefront of all national affairs; (2) the previous approach of occupying political positions was changed into influencing politics from a distance; (3) this influence was to be exerted indirectly rather than directly; and (4) the armed forces acknowledge the necessity of role-sharing with other national forces.[100] The concepts initiated by General Wiranto were seen as not going far enough, reaping much criticism from the citizens. For several decades the TNI performed a special dual function: to function as a national defense institution while at the same time having influence on and controlling the national political system. This new concept, the so-called "New Paradigm", was in content and wording identical with reform ideas formulated by progressive officers in 1996 and 1997.[101] The crucial and mistaken function that the government must

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[99] Ian McFarling, *The Dual Functions of the Indonesian Armed Forces: Military Politics in Indonesia* (Canberra: Australian Defense Studies Center, 1996).p25

[100] "Paradigma Baru Dwifungsi ABRI," Tiras, April 24, 1997; "*Pangab: ABRI Kembangkan Empat Paradigma Peran Sosial Politik Baru,"* (Jakarta: Republika, July 18, 1998).

[101] Honna, Military Politics and Democratization in Indonesia. London and New York: Routledge-Curzon, (New York: June 2003)

remove from the military institution was its authority inside national political process.

The reformation program continued through the concept of separation of military officers from national politics. One of the crucial challenges that Indonesia faced in the course of authoritarian polity was the intervention of military elites on the decision of government on every program implementation. The tempestuous protests broke out mostly in the capital city, creating a more unstable social and political condition in 1998-1999. Not only did riots and demonstrations take place but conflicts among ethnic groups lead to a more complicated and non-conducive social crisis. More than 50 riots occurred from 1998 to 1999 in all territories in Indonesia.[102] Separatist groups endangered the unity of Indonesia, starting from the independence of East Timor during Habibie's administration period, followed by independence requests in Aceh, Ambon, Poso and Papua Province. The TNI once again dealt with the separatism in East Timor using violence and when East Timor voted for independence, the armed forces rampaged through the region, killing more than 1300 people.[103] The devastation of East Timor was a consistent extension of the

[102] Kompas, *Kerusuhan Tahun 1998-1999 Terjadi Di Seluruh Pelosok Negeri, "1998-1999 Riots Happened In All Over Country",* (Jakarta, 19 September 1999).
[103] Kammen, Douglas, *"The Trouble with Normal: The Indonesian Military, Paramilitaries and the Final Solution in East Timor."* In Anderson, Benedict R. O'G. ed., Violence and the State in Suharto's Indonesia Ithaca, (New York: Southeast Asia Program Publications, Cornell University, 2001), pp 156–88

‘culture of violence’, an inherent feature of TNI’s thinking and operational behavior.[104]

As a consequence, the TNI was forced to overcome the problem of human rights and its image. Due to activist pressure, government had no choice but to implement a new policy where military officers could no longer be active in bureaucracy. Even though the TNI still had the power to create their own reform targets without civilian oversight, they were forced to reduce their representative number in the national parliament and local legislature. TNI reduced its delegations from 75 to only 38 delegates in the national assembly. In local legislature, military forces also gradually reduced the percentage military delegates. However, even up to the 1999 election, the involvement of the military in national politics remained a crucial influence. The TNI’s continued representation in parliament, albeit reduced, endowed “the military with ‘reserve powers’ that might be invoked to frustrate a democratic mandate.”[105]

Military reform was still an ongoing issue during Abdurrahman Wahid administration which began in 1999. He mandated the removal of several important generals from the armed forces, including Wiranto. He also asserted that Indonesia must deal seriously with the dual function

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[104] Geoffrey Robinson, *“Indonesia: On a New Course?” In Alagappa, Muthiah, ed. Coercion and Governance. The Declining Political Role of the Military in Asia,* (Stanford: Stanford University Press, 2001) pp 226–58

[105] Richard Gunther, *“Opening a Dialogue on Institutional Choice in Indonesia: Presidential, Parliamentary and Semipresidential Systems.”* In Liddle, R. William, ed. Crafting Indonesian Democracy, (Bandung: Mizan, 2001) pp149-178.

system in which the TNI operated, separating them from the legislature on both the national and local level. He lost the support and cooperation of military bodies after clashing with senior military elites, seriously crippling his agenda to cut the territorial command structure in military groups. The new reforms proposed by President Wahid were not appropriate for the current situation; at the same time he lost the support of military forces he also had difficulties winning the sympathies of the citizens. The armed forces were only in a position to oppose presidential authority when political circumstances allowed them to do so.[106] His presidency collapsed under massive conflicts within the elites and further unrest around the country. The impacts of the financial crisis still continued until the end of Wahid's reign. Governance was still unable to deal with the high prices of goods, the unemployment and poverty rates just kept increasing. This coincided with a rise in criminality starting from, 1998until the demonstration that destroyed the domestic businesses and economies.

The agenda to create good governance was continued by Megawati from 2001 through 2004. Military reform was not the only problem facing the government but fixing the corrupt government and its political actors became a complicated and high priority issue for the Megawati administration. This culture of corruption was not limited to the political elite in high positions of authority but permitted all government institutions

[106]Doowon Lee, *Korea Briefing 1997-1999: Challenges and Change at the Turn of the Century,*(2000)

and bodies, although this was not a new issue for Indonesia. Government officers often spent national budget on personal interests or the national budget simply went into their own pockets. Furthermore, leaders were used to sharing these benefits with their employees. Government officers would often ask local businesses for some nominal donation in order to facilitate the issuing of enterprises permits. Political actors and government officers had virtually unrestricted access to the national and domestic budgets for such programs as reduction of poverty, national health care, education for poor kids, religion activities, and other public services.

Though the International Monetary Fund and other international institutions also couldn't make any large contributions to Indonesia's political reform, the IMF did require the Indonesian government establish a commission to combat corruption. The Corruption Eradication Commission was established in 2003. This commission was created in order to develop good governance based on transparency and accountability of political institutions. Indonesian political institutions and its governing bodies should produce accountability in the terms of an effective, transparent, and publicly accountable system for expenditure control and cash management as well as an external audit system.[107] Many senior politicians were jailed for embezzlement of national budgets but the level of government corruption was still high. In 2002, Indonesia was ranked 118th in the World Corruption

[107] See: IFAD, Executive Board Seventh-Session, *Good Governance: An Overview*, (Rome: September 1999) p3

Rankings. Until 2010, Indonesia was experiencing issues with national corruption that led to a rank of 110 in the World Corruption Ranking with a relatively low score of 2.8.

Table 4.4
World Corruption Ranking 2002

RANK	COUNTRY
1	Denmark
2	Finland
3	New Zealand
108	Philippine
118	Indonesia

Sources: Indonesia Hari Ini, Juni 2002

Table 4.5

World Corruption Ranking 2009-2010

	CPI score 2010	CPI rank 2010	CPI rank 2009
		(178 countries)	(180 countries)
New Zealand	9.3	1	1
Japan	7.8	17	17
Brazil	3.7	69	75
China	3.5	78	79
India	3.3	87	84
Indonesia	2.8	110	111
Russia	2.1	154	146

Sources: Euromonitor International

Note: Score is based on a scale from 0 (perceived to be highly corrupt) to 10 (perceived to have low levels of corruption).

Besides all these problems, Indonesia also had to deal with collusive networks and patronage structures which remained in place along with their New Order-era politicians, bureaucrats, military personnel, lawyers, and policemen, all of whom were deeply entrenched in Indonesia's state apparatus and economy. Indonesia continued to launch another reform initiative focusing on bureaucratic reform by establishing rules and constraints aimed at controlling politicians' and civil servants' authority and behavior. This agenda tried to change the culture of Indonesia bureaucracy to be based on good governance, transparency, and civilian related purpose. Concretely, not just the degree of separation between political and bureaucratic accountability but also the extent of political institutionalization at the time of independence are said to determine whether a country is likely to adopt reform initiatives of the promotional kind.

The stagnation of political reform to adjust democratization continued after the rising of terrorism. Megawati not only had to deal with a significantly strengthened military but also was confronted with several domestic and international trends that were hardly of her making.[108] Multiple bombings in several cities, including in front of the Australian

[108] Muhammad Qodari, *"Indonesia's Quest for Accountable Governance."* (Journal of Democracy, 16 (2), 2005) p85

Embassy, created an unstable social, political, and economic situation in Indonesia. It devastated the confidence of foreigners to invest in Indonesia. After the Bali bombing, the economic condition fell into crisis. Bali, as one of Indonesia's largest tourism destination, was one of the economic scopes that were not influenced by the 1998-1999 crises.

Thus, after suicide bombings in several areas, the government had an even more complicated economic decline. Megawati seemed not able to improve the Indonesian economy significantly and consequently failed to win voters during the 2004 presidential election. The new President, Susilo Bambang Yudhoyono is currently serving their second term in office. Yudhoyono was a senior in the military. In the era of Yudhoyono's administration, the economic growth showed a better nominal. In addition to continuing the anti-corruption programs on government level, Yudhoyono also focused on constitutional and electoral reforms aimed at introducing constitutional checks and balances. His government seemed to be better equipped to deal with Indonesia's political situation and showed significantly improved economic growth since 2005.

V. DISCUSSION AND EXPLANATION OF THE DIFFERENCE

5.1 Comparison on the Reform Progress

The Asian Financial Crisis took place in Thailand in the middle of 1997, spreading to neighboring countries and reached South Korea and Indonesia through a sudden drop of their currency values. The crisis emerged against the South Korea's and Indonesia's weak financial systems, large external deficits, immediately extinguished the confidence of investors, leading to a massive capital outflow, and creating the biggest national bankruptcies in both states.

The two countries requested economic funds from international financial institutions, including the International Monetary Fund. South Korea and Indonesia signed the Three Years Stand-by Arrangement and agreed to follow the economic recovery suggestions from the IMF. The IMF approved to help not only South Korea and Indonesia, but also to Thailand, the three countries most affected by the crisis through arrangement policies of economic reform that its objectives were to restore the confidence of investors and overcome the impact of economic downturn.

Table 5.1
The Commitment of IMF in Response to 1997 Crisis

Commitments of the International Community and Disbursements of the IMF in Response to the Asian Crisis, as of July 23, 1998[1]
(Billions of U.S. dollars)

Country	Commitments				IMF Disbursements
	IMF	Multilateral[2]	Bilateral[3]	Total	
Indonesia	11.2	10.0	21.1[4]	42.3	5.0
Korea	20.9	14.0	23.3	58.2	17.0
Thailand	4.0	2.7	10.5	17.2	2.8
Total	**36.1**	**26.7**	**54.9[4]**	**117.7**	**24.8**

[1]IMF commitments to the Philippines are not included.
[2]World Bank and Asian Development Bank.
[3]Bilateral contributions to Indonesia and Korea were a contingent second line of defense.
[4]Estimate; amount of new commitments not finalized as of July 23, 1998.

Sources: see IMF website

Table 5.2
GDP Growth of South Korea and Indonesia before Crisis

	Investment as a Proportion of GDP [(a)]	Gross Savings Rate	Trade as a Proportion of GDP [(b)]	Share of World GDP	Real GDP Growth	Consumer Inflation
Hong Kong	31.3%	30.6%	122.9%	0.6%	4.9%	6.0%
Indonesia	32.1%	31.2%	20.4%	0.8%	8.0%	7.9%
Malaysia	42.2%	42.6%	78.9%	0.4%	8.6%	3.5%
Philippines	23.2%	15.6%	31.2%	0.3%	5.7%	8.4%
Singapore	36.5%	50.1%	.. ..	0.3%	6.9%	1.4%
South Korea	36.8%	35.2%	28.9%	1.8%	7.1%	4.9%
Taiwan	21.2%	25.1%	40.1%	1.0%	5.7%	3.1%
Thailand	42.2%	35.9%	34.9%	0.7%	5.5%	5.8%

Sources: Goldman Sachs, "International Economics Analyst", February/March 1998 p xii; IMF, "World Economic Outlook", May 1998 tables 5 & A2; BIS, "68th Annual Report", 1998 table III.2; IMF, "World Economic Outlook: Interim Assessment", December 1997 table A1; ROC Council for Economic Planning and Development,

Before crisis hit Asia in 1997, South Korea and Indonesia experienced incredible economic growth and export rate. South Korea appeared as one of the industrial economic states particularly on automobile,

steel, telecommunication equipment and etc. Nevertheless, this miracle economic growth was not accompanied with strong banking system and adequate economic foundation, were really fragile to any economic shocks.

The Letter of Intent in those two agreements among South Korean government and the IMF and Indonesian government with the IMF focused on comprehensive policy packages with the objectives to restore market confidence, bring back foreign investor inside the countries, limit the downturn of economic growth, reduce current account deficit that has already rose since massive capital outflow during the crisis, restructure and recapitalize insolvent financial institutions to be free from any intervention of political elites and market-oriented, improve its corporate governance to adjust transparency and accountability, and liberalize its economies and trade.

In the middle of 1998, a dictatorship reign under Soeharto administration collapsed after more than 30 years ruled Indonesia, leading to a new government system behind democratic values. Compared to South Korea, the new government of Indonesia was not capable to choose a right program and recovery strategy that time; lack cohesion on political program and platform, confusion division of responsibilities and functions among different level of government. These conditions were influenced by the impacts of political transition during democratization. The inexperienced new cabinet suddenly should deal with the economic downturn and in the

same time many of demonstration and big riots took place in almost all territory of Indonesia. It caused unemployment rate increased and poverty line raised to over 30 percent.

Meanwhile, the power shift, from the Kim Young-sam to Kim Dae-jung in Korea brought the power to implement the IMF policies to the Kim Dae-jung government. The government of Korea performed with a high capacity to apply and deal with the IMF suggestions, especially in the banking restructuration. In fact, no other political leader was better positioned than Kim to truly change the Korean system and recover from the crisis since he was able to involve cooperation among governments, businessmen and citizens. Moral hazard reduced foreign trade and investment raised, and unemployment rate decreased from 8.6% in February 1999 to 3.4% in July 2000.

5.1.1 Comparison on Monetary Reform Progress

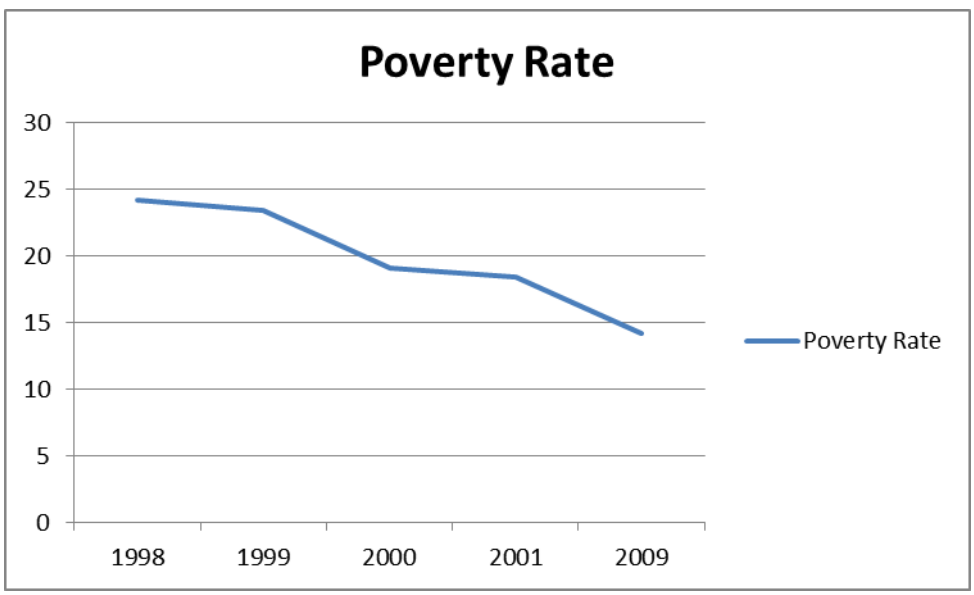
The reform started at the end of 1997 by implementing high interest rate policy. A sudden rise of high interest rate brought a massive bankruptcy in both countries. In South Korea, this policy triggered at least 11 national industrial businesses to become insolvent and another 50 leveraged business conglomerates were at risk of bankruptcy. Started with the bankruptcy of Hanbo Steel, one of the biggest steel producers in South Korea during those years, not a long period after, followed by the collapsed of other industrial

businesses, such as Sammi group and Jinro. Kia Motors, as one of the biggest the automobile manufactures also experienced the bankruptcy. Business bankruptcy cost 20% of country's half trillion dollar, increasing a huge number of unemployment rate in 1997-1998. In Indonesia, the tight monetary policy through high interest rate over 80% also induced national bankruptcy not only to big national businesses but also domestic small-medium size enterprises. Companies at a national and local level began to cut the number of their employees, leading to a massive and acute unemployment rate even until several years.

The Korean government took a fast decision on creating a more flexible exchange rate and interest rate policies soon after the bankruptcy increased. In another side, the government of Indonesia kept increasing its rate to over 80%, causing an escalation of the poverty rate in that state. The Indonesian government tried to change the amendment of the content of letter of intent, however the ineffective and inefficient bureaucracy made the decision took longer time to be achieved. Especially after political instability started to emerge, the government under the dictatorship of Soeharto had their focus not on the economic recovery but on how the regime could be maintained. The government of Indonesia was not able to make fast decisions on the impact of interest rate policy; its government could not run its function as the institution that must be responsible to produce an appropriate response based on its capacity in the good

governance framework. Even though a high poverty rate in Indonesia was not a new problem, yet this challenge still remained a big homework for its government even after one decade passed. In 1998, the poverty rate in Indonesia reached almost 25% of its population, and after three years of the IMF recovery package, Indonesia still had 20% of its population in poverty.

Graph 5.1
Poverty Rate in Indonesia in 1998-2009



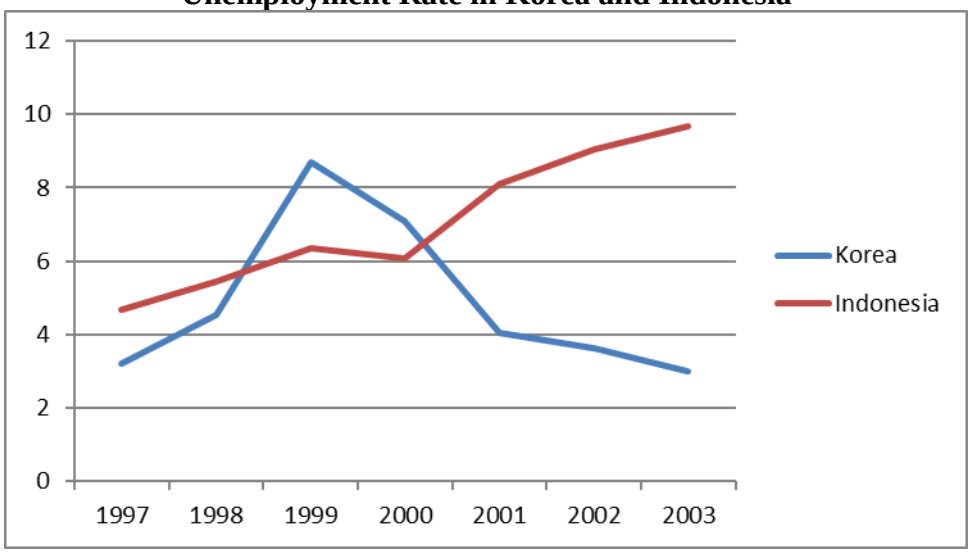
With tightened monetary policy which was more strict for Indonesia compared to the monetary policy that the IMF suggested to South Korea, Indonesian economy experienced a severe contraction on both aggregate demand and aggregate supply. The IMF requested South Korea to increase almost 30% of interest rate, while in Indonesia the director of IMF forced

Indonesia to rise almost more than fourth times higher, which was from 20% to be 80%. This policy was seen as a wrong decision after the impacts destroyed the national business and caused a worse economic crisis.

Instability on political condition during democratization transition brought a huge influence to its economy. Domestic demand fell to negative 17.2%, followed with a depression of public consumption that signified a drop of market confidence in 1998. Indonesia also suffered with rising of private capital outflow of more than 20.7 billion dollar. The progress of its monetary policy did not show a positive result for Indonesian economy, pushing its government to amend the recovery prescription from the International Monetary Fund for several times. Another problem with the IMF assistance was the delayed of the release of its fund amount.

The IMF for several times holds the funds for some reasons, creating its program implementation was hampered. Another outcome of monetary policy application was the unemployment rate in Indonesia that kept increasing even after several years of crisis, in Korean case, the unemployment rate decreased sharply, particularly in the year of 2003. See the graph below.

Graph 5.2
Unemployment Rate in Korea and Indonesia



Sources: the Bank of Korea and Bank of Indonesia

If we look at the exchange rate in Indonesia and Korea in the previous chapters, the exchange rate of the Korean Won decreased to only 1050 per USD in the year 2000 from the worst devalue of won in 1997, which was almost reached 2000 per USD. But for the Indonesian currency Rupiah, with the highest on almost 17.000 per USD in 1998, and the value increased to 12.000 per USD in the year 2000, which means the currency restore was only around 30%, and till today the value of Rupiah to 1 USD is still above 11.000. The devaluing of the Rupiah that time was clear evidence of failure fiscal policy remained with very high prices for basic goods. Brutally demonstration and the pillage during riots in 1998 caused supply of national goods declined, leading to triple prices of daily needs.

5.1.2 Comparison on Banking Restructuring Reform

The progress of banking restructuring programs in South Korea showed a positive result after the Korean government and the IMF agreed on the 8 percent Bank of International Settlement (BIS) capital adequacy ratio as standard of insolvency. A bad banking system and its tight relationship with business conglomerates enforced government to cut the ties among them. All banks should be based on international accounting standard, not only in order to produce healthy banks but also to restore the confidence and trust of citizens in national banks. The difference with the actions of the Indonesian government during the crisis, instead of liquidating the troubled banks, Korean government decided to privatize them following their re-capitalization with government funds, the first two banks that addressed this policy were the Seoul Bank and the Korea First Bank. Both banks received 1.5 trillion KRW for capital investment from government and could obtain international public auction and received its confidence abroad. The other banks that had problems also were given a period of time to rehabilitate its system and were granted some amount of national funds to restore troubles and restart its banking function.

By observing the Indonesian banking system before the crisis, we would know how badly the internal system inside the banks; those banks had problems since the management was very poor. Not different with Korean banks that time; in Indonesia the banks also had tight relations with

their government. The government used to intervene and fund their personal businesses by using the foreign debts. Therefore since the IMF's prescription to close 16 troubled banks in a sudden time, the effect was not like in Korea. This immediate banks liquidity crisis had caused a massive withdrawal of money and transferring to foreign banks due the vanishing of trust to national banks, leading to a more complicated economic decline by the devalue of the Indonesian Rupiah. The Indonesian government once more time was seen as an unable and inexperienced institution that could not produce a right policy to overcome the crisis. Looking at this banking program, the government of Indonesia also could not predict the possibility that could emerge if they closed several banks in the same time.

The government of Indonesia also set the standard of recapitalization for national and commercial banks. Banks with over 4% capital adequacy ratio was able to operate, the banks with below 4% to -25%, were supposed to be recapitalized and the banks below -25% must be closed. Closing more than 16 banks, merged all state-owned banks to be only four was an obvious evidence of too big to fail policy[109]. This policy indirectly increased the state-owned banks to 72%, eliminating the number of private banks from 160 to only 81, extinguished citizens' trust to national banks. People started to withdraw their money in national and local banks and thus moved it to

[109] Sri Mulyani, *Indonesian Economic Recovery Process and the Role of Government*, (Journal of Asian Economics, 2002) p4

foreign banks. The confidence of national banks dropped, leading to reduction of investor's confidence.

In Korea, the commercial banks tried to compete with foreign banks by improving their internal management system. Especially after Korean government announced to suspend nine merchant banks on December 1997 and continued by suspension of 5 other banks, government requested those banks to have management rehabilitation with the deadline one month. The Korean government at the same time provided support by giving capital amount for them. This policy would not decrease the confidence of banks in the national level; citizen also still had its trust to use their national banks instead of using and moving their capital to foreign banks. Government promised to give accountable and best solution for the bank-restructuring program, both for the banks and for the citizens. This condition was totally different to the banking restructuring policy that only led to the brink crisis.

This thesis shows how the decision was made, how the Korean government responded to the IMF suggestions and how the Indonesian government for several times was unable to choose an effective policy that would restore public confidence. Here, several programs that the its government made, did not produce a better economic condition, on the contrary established brink of public confidence to its government's bodies and in the same time created social instability.

5.2 Comparison of the Economic Recovery

The recovery on the economic sectors in South Korea showed a very positive result, the government could fully finished the recovery programs and pay back to the IMF only in three years. Unemployment rate decreased sharply, export started to continue, and banking system became healthier. In Indonesian case, the unemployment rate kept increasing to today, it reached over 9 percent. When crisis hit Korea and Indonesia, the economic indicator in South Korea and Indonesia experienced very bad level. See the table below.

Table 5.3
Korea Economic Indicator in the Crisis

Korea: Selected Economic Indicators, as of July 23, 1998

	1995	1996	1997	1998[1]
		Percent change		
Real GDP growth	8.9	7.1	5.5	–1 to –2
Consumer prices (end of period)	4.7	4.9	6.6	8.2
	Percent of GDP; a minus sign signifies a deficit			
Central government balance	0.3	0.3	0.0	–1.7
Current account balance	–1.9	–4.7	–1.9	7.3
		Billions of U.S. dollars		
External debt	119.7	157.5	154.4	163.3
Of which: short-term debt	78.7	100.0	68.4	39.6
		Percent of GDP		
External debt	26.4	32.5	34.9	51.5

Data: Korean authorities; and IMF staff estimates. Data are for financial years (January 1 to December 31).
[1]May 1998 program.

Table 5.4
Indonesia Economic Indicator in the Crisis

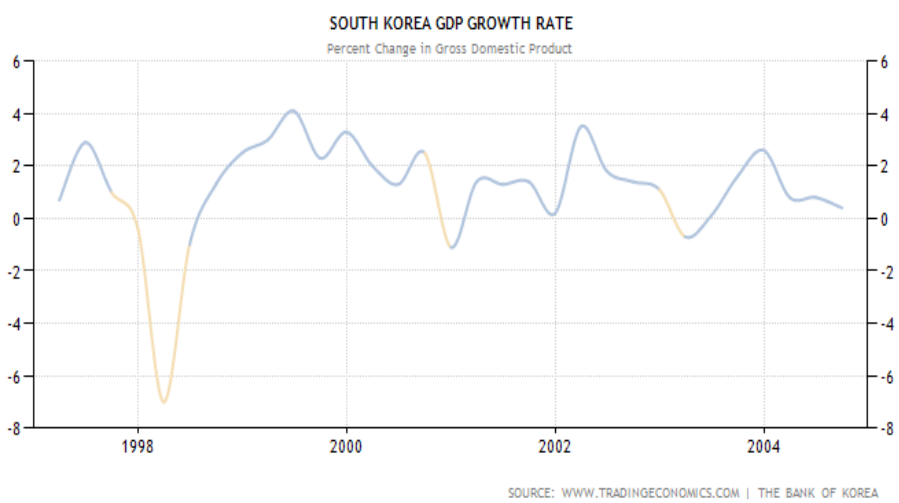
Indonesia: Selected Economic Indicators, as of July 23, 1998

	1995	1996	1997[1]	1998[2]
		Percent change		
Real GDP growth	8.2	8.0	4.6	–13 to –14
Consumer prices (end of period)	9.0	6.6	11.6	80.6
		Percent of GDP; a minus sign signifies a deficit		
Central government balance	0.9	1.2	–0.9	–8.5
Current account balance	–3.2	–3.3	–1.8	1.6
		Billions of U.S. dollars		
External debt	107.8	110.2	136.1	135.0
Of which: short-term debt	9.5	13.4	18.8	. . .
		Percent of GDP		
External debt	53.3	48.5	64.5	162.7

Data: Indonesian authorities; and IMF staff estimates. Fiscal and external sector data are for Indonesian fiscal years (April 1 to March 31).
[1]Estimate.
[2]June 1998 program.

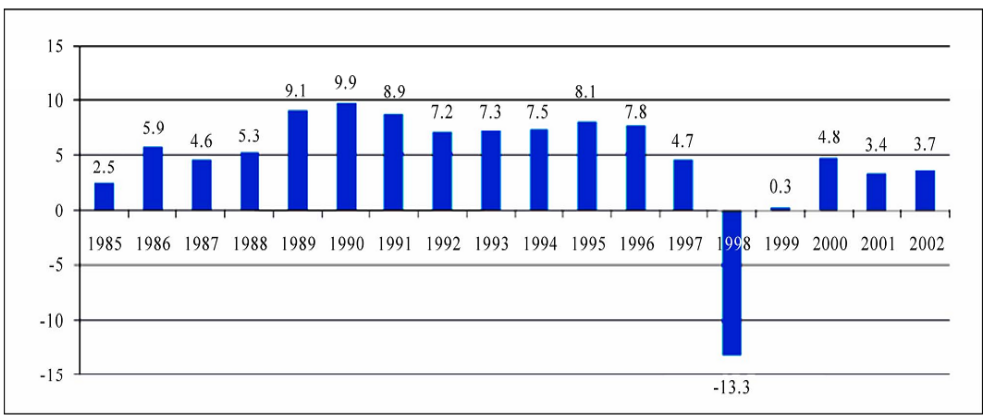
After several months IMF recovery prescription began to apply, South Korea GDP growth rate rose to a positive number, particularly after the year 2000, the GDP of South Korea began to reach above 0 percent, an evidence of such recovery of the economic growth.

Graph 5.3
Korea GDP Growth Rate



In Indonesia the income per capita did not show positive number, however after 7 years of the crisis, government started to deal with the crisis and the economic growth began to increase.

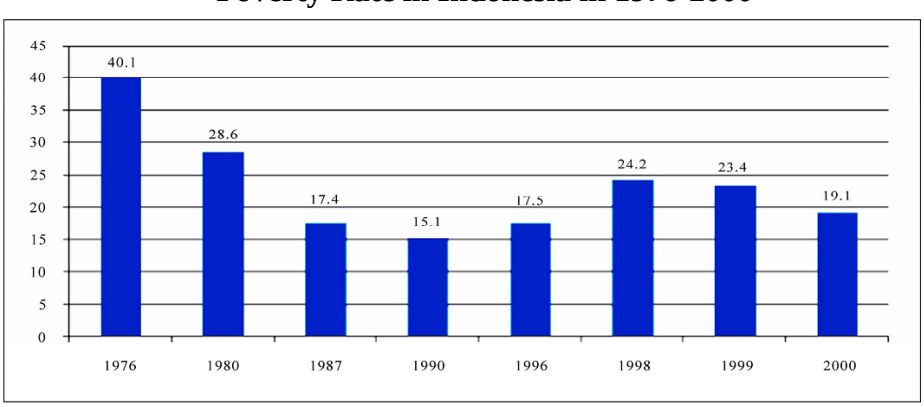
Graph 5.4
Indonesia GDP Growth



Sources: Statistical Yearbook of Indonesia (various years), Indonesian National Agency of Statistics (BPS) (www.bps.go.id).)

Even though the economic condition on trade and growth were seen better year by year, however the number of poverty rate in Indonesia remained really high. See the table below

Graph 5.5
Poverty Rate in Indonesia in 1976-2000



Sources: Statistical Yearbook of Indonesia (various years), Indonesian National Agency of Statistics (BPS) (www.bps.go.id).)

Through the description and data in chapter four, we can see that the crisis that hit Asia in 1997 not only contributed to political transition in Indonesia, but this transition also produced some difficulties for the Indonesian government to address the objectives of economic recovery from the IMF. With new government system that was supposed to be under civilian control forced Indonesia to restore its economic condition over a short period, however this new government system, after many decades of rule under an authoritarian administration remained a weak political system throughout its judicial, parliaments and decision making process. Despite dealing with a new government with limited experience, the IMF approached by pushing more unrealistic programs, during the administration of new President Habibie. The IMF and the Indonesian government agreed to further signing more than a hundred new policies. Through these new policy actions, President Habibie followed the IMF Managing Director to publish new laws on banking, central banks, bankruptcy, and many other laws that were not prepared and created serious confusion for the next government who would implement them.

Compared to South Korea, that did not have a serious political transition; the Indonesian government faced more obstacles since the transition from an authoritarian to democratic system created instability in

both economic and political sectors. More than 50 riots emerged as a consequence, and the emergence of new political parties appeared with several programs that were not based on public interest, but on a preference to get more public support in achieving personal goals to hold new governance in the next general election. Started from the military reform that was supposed to be reform due to its tight relationship with the previous government, however in reality, the new President still could not maximize its function to control the agenda of military reform. The Indonesian government kept using the dual functions of the armed forces to legalize its new administration. Government that should implement the good governance principles, again in the Indonesian case that time was not able to address it.

In addition, the capability of the Indonesian government to provide a proper strategy was also one of the factors that made the recovery slower than that in Korea. With its new multi parties and weak parliaments, the decision making process took a longer time and ended with very complicated process. In a normal condition, governments need a long time to produce one policy to overcome such a crisis, however in the situation that there was chaos with instability in social, economic and politics, government faced more difficulties to achieve one voice to address the correct policy in order to resolve its crisis. Therefore, the economic recovery in Indonesia was slow compared to South Korea.

VI. CONCLUSION

One of the world's most unforgettable economic crises took place in 1997. It began with the collapsed of Thai Bath, spreading investor panic, leading to a massive withdrawal that caused a sudden financial crisis in neighboring countries, including Hong Kong, Taiwan, South Korea, Malaysia, and Indonesia. Among those affected countries, South Korea, Indonesia and Thailand requested assistance from the IMF that year. Indonesia officially made a request on November 5, followed by South Korea in the end of November 1997.

South Korea and the IMF signed the Three Years Stand-by Agreement and started to implement the letter of Intent on economic recovery programs. This letter of intent contained such programs focusing on restructuring policy on macroeconomic sectors, monetary and fiscal policies, banking restructuring programs, trade liberalization and restructuring on governance and corporate sectors. No different from South Korea, the government of Indonesia had similar programs based on the recommendation of the IMF.

The programs started with the application of very tight monetary policy through a very high interest rate policy. As soon as the governments of both states announced the policy, the unexpected effect emerged. As

consequences, 11 business conglomerates in Korea went into bankruptcies, beginning with the collapsed of steel manufactures companies, followed by the collapsed of KIA, one of the biggest automobile companies in South Korea. With even higher interest rates than those in South Korea, the government of Indonesia announced an increase of interest rates to reach 80 percent by the end of 1997 that caused national massive bankruptcies. Not only big companies, small and medium size firms also experienced insolvency.

In South Korea, its government continued with restructuring corporate sectors since in the past decades the Korean governments had very tight relationship with business conglomerates. These tight ties created a corrupt system in the body of banks and companies. Governments used to fund their political campaign with the support of Chaebols, and on the other hand, Chaebols could easily access to the banks in obtain both domestic and foreign debt, one of the factors that created a weak economic system in Korea, and triggered the crisis. Governments ordered all companies, particularly big industrial companies, to audit their financial status, and thus reported to government institutions in order to have control of a healthy company system. These programs showed a really positive result for Korean companies right now, those companies have been competing to achieve global standard in order to get a good image in foreign market and keep the image inside the country.

In Indonesia, this policy was also implemented, especially as an attempt to cut government ties with banks, the banking system was really corrupt as the government used to fund their activities and personal interests through national banks, getting huge access to get foreign debt and used it for their political interest. Government made decisions based on the IMF prescription by closing 16 troubled banks by the end of 1997. However, unexpectedly, the effects spread to all citizens' confidence of national banks. In a short period people withdrew their money and moved it to foreign banks, creating a huge shock and another liquidity crisis. This economic downturn caused more crumbled economic crisis, people started to loss their trust on government's ability in overcoming the crisis, and banks had no enough money to operate, led to a devaluation of the Indonesian Rupiah as it dropped to under 14.000 per USD, induced double to triple increasing of basic goods and foods prices. Demonstrations began to break out all over the territory of Indonesia.

Conflicts amongst political elites emerged as a consequence, the opposition party started to encourage young people to call for democratization for a better Indonesia. Several big riots took place; particularly in the capital city as student movements and democratic activists ordered the president to leave the position after over three decades ruled Indonesia with authoritarian system. Governments were seen as a institutions that were incapable of taking Indonesia out of the crisis, caused

by their nepotism, collusion, corruption in all government institutions both at a national and local level – most significantly in the armed forces, as the right hand of president Soeharto's that had served as his regime protector. The military body since the beginning of Soeharto's reign was given a special right to run its dual functions. On the one hand, they stood as a national defense institution and on the other they had a big influence and played a huge role in the national political process and its system. Soeharto's regime collapsed after thousands of university students expropriated the national legislature building on 20 May, 1998. Vice President Habibie continued to rule Indonesia and dealt with the impacts of financial crisis. However, the political reform in Indonesia faced many challenges and its obstacle since the military reform ended with an interdependency between new president Habibie and the armed forces, so called-TNI.

The interdependency among them provided a crucial privilege for senior military actors maintaining their influence on a national political level and government institutions. They were permitted to adjust their own reform agenda, which was supposed to be civilian controlled. The deal brought several tasks for military forces to support President Habibie's campaign for 1999 general election. In November 1998, TNI was requested to mobilize thousands of civilian demonstrators to back Habibie's plan to legalize his leadership in special session of People's Consultative Assembly.

Another political transition continued after Habibie was unable to win people's sympathy in the 1999 general election. Indonesia continued to have several political changes under the administrations of Wahid, Megawati and followed by Yudhoyono today. Indonesia kept addressing several reforms in the military sectors, government institutions, constitutions and its court. However, even today, its governments still have difficulties, mainly after the emergence of separatist groups and its loss of East Timor. Indonesia has more difficulties in implementing economic reforms since the governments do not have enough capability to address good governance system that is supposed to be transparent about how the policies and decisions are taken, accountability, has its capacity in creating governing body to be effective, and thus lack civilian control and are not clean of corruption.

In the case of South Korea, its government did not have many challenges since there was no political transition from an authoritarian regime to a democratic system. The government focused on the economic impacts on national business, industrial, trade, and how to restore the Korean Won. There was no big turmoil during the 1997-1998 crises as the South Korean government seemed to have strong capability in overcoming the Asian financial crisis through a recovery of its export rate, Korea has shown positive and high economic growth even until today. South Korea successfully recovered from the crisis in three years; however the

Indonesian governments still have much homework to fully recover from its effects, the unemployment rate that remained very high, number of poverty that couldn't be decreased and its political turmoil that still emerges today and should be a consideration of the Indonesian government for the next several years.

This government with its new cabinet was not ready with all the complicated impacts of the crisis. Government, which should be an institution that produces appropriate recovery policies were not able to choose the best decision for overcoming the financial downturn. In normal conditions, bureaucracy usually takes a long period of time to create a program for the purpose of restoring a significant economic growth, and in the new cabinet after a long dictatorship; the government seemed not to be able to recover from its economic downfall. The emergence of new political parties in the new cabinet with its weak institution and constitution need more time to produce stability in economy and politics. Its government also faced some challenges since the new parliaments and political parties showed intense competition inside its new cabinet. The new parties went into competition to get higher support and become famous in front of its citizen, it forced them to produce a policy that was not based on national economic and political condition, and instead based on policy that can create more supporters.

Compared to South Korea, as an institution, the government of Indonesia did not have a good capacity and credibility to implement the economic and political reforms to adjust economic recovery. The biggest obstacle was the political turmoil that was caused by the political transition under a democratic system that was supposed to produce public interest; however the implementation found it dependent on new parliaments that were weak and unable to grasp the root causes that triggered the crisis. The government of South Korea, in a short period, built several institutions with its objective to recover from the crisis. In Indonesia, its government also established several institutions whose functions were to control private assets and restore its economy; however with new parliaments and political parties these institutions were seen as targets to get access to financial resources.

Besides that, after the three years IMF programs were applied to both countries, we could see that the IMF suggested the same policies to both countries without monitoring and looking to each country's economic and political conditions at the first stage. Most of the programs that they applied to Indonesia were much more strict compared to the economic recommendation in South Korea. This is a crucial requirement before the government addresses any program. Researcher sees this as a fatal mistake that makes the economic recovery more difficult to be achieved. All of these

reasons were behind the unsuccessfulness of the Indonesian government's in overcoming the 1997-1998 crisis compared to South Korea; however the most crucial cause was the political transition from three decade of authoritarian regime to democracy that brought instability in both political and economic sectors during that period, which become the factor that influenced capacity and capability of Indonesian government in resolving the economic downturn.

This condition caused many instabilities in national level in Indonesia, creating more difficulties for Indonesian government in implementing the economic prescription. The emergence of political conflicts inside new cabinet and political elites made the decision making process took longer time and couldn't be maximized. Many numbers of separatism, local conflicts and riots in almost all territory of Indonesia also influenced the performance of its governments. The government of Indonesia in one hand must face the impacts of democratization and in another hand, must be efficient and fast in producing right solutions for the instability of economics and politics. Thus, the new and inexperienced government was unable to overcome all the aftereffects of 1997-1998 crises. This paper also validates that the theory of institutional capacity, where the government should have its capability and credibility to choose an appropriate policy that should be based on the principles of good governance in order to solve the economic crisis and produce a significant economic development.

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요약

1997 금융위기는 태국에서 타이 “bath” 평가절하로 인해 발생하였으며 대한민국과 인도네시아를 비롯하여 동남아시아와 동아시아의 인국에게 큰 영향을 끼쳤습니다. 즉 1997 금융위기는 대한민국과 인도네시아 경제에 대한 대외신뢰도 손실과 대량 자본 유출을 일으켰습니다. 그렇기 때문에 대한민국과 인도네시아 정부는 국제통화기금(IMF)의 지원을 받아 거시경제, 통화제도, 재정제도, 은행제도, 관리개선계획과 지배구조조정전략 개발에 중점을 두었습니다. IMF 계획은 경제를 극복하고 경제에 대한 대외신뢰를 얻기 위하여 실시됐습니다.

그런데 대한민국과 인도네시아는 경제적인 그리고 정치적인 여건들이 다르기 때문에 극복과정이 달랐습니다. 극복정책이 시행한지 3 년 이후 대한민국은 인도네시아와 비하여 많은 성공을 해왔습니다. 즉 인도네시아는 대한민국과 달리 IMF 의 극복정책을 실시했음에도 불구하고 1997 금융위기에서 완전 극복할 수 있는 여건을 가지지 못했습니다. 1997 금융위기관련해서는 논란이 많은 걸로 알려져 있는데 이 논문은 대한민국과 인도네시아가 1997 금육위기에서 극복하기 위해 실행해 온 IMF 프로그램 또한 과정에 대한 차이를 분석했습니다.

연구결과는 인도네시아가 1997 금융위기에서 극복할 때 사회적 또한 정치적 불안정성이 사회적 역량에 많은 영향을 미쳤기 때문에 많은 어려움을 겪어 온 것으로 나타났습니다. 이 결과와 비교연구를 통하여 사회적 역량과 지배구조 관련된 이론을 세웠습니다.