

The ill-fated currency board proposal for Indonesia

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Background

- AFC started in Thailand and spread to Indonesia in July 1997
- Thailand case was a classic devaluation forced by rapid loss of international reserves
- By contrast, Indonesia's BOP and macroeconomy had been very healthy
 - Solid growth (8% p.a. 1995-96)
 - Reserves increasing
 - Low inflation (steady at about 5% p.a.)
 - Budget under control
- Heavy foreign borrowing encouraged by low perceived risk of devaluation and moderately high interest rates
 - Slow, steady depreciation (3-5% p.a.)

Floating the rupiah

- Investors suddenly became nervous, causing rapid capital outflow
 - Partly a rush to safety
 - Partly an opportunity to profit from speculation
- Rupiah was unexpectedly floated on August 14, 1997
- A reasonable decision...
- ... but its implications not well understood
- Monetary policy requires commitment to one, and only one, **nominal anchor**
 - Money supply, or
 - Price level/inflation rate, or
 - Exchange rate/rate of depreciation

Floating the rupiah

- Steady depreciation had long been the nominal anchor
- Now there was *no anchor*, and within months:
 - Money supply ran out of control
 - Inflation and nominal interest rates surged
 - Rupiah depreciated wildly

Enter the IMF

- Having failed to stabilise the macroeconomy, government turned to the IMF in October
- Rescue package of \$43 billion was in fact far smaller
- In any case, no clear need for funds
 - Budget well managed
- Basically an attempt to bluff investors and speculators by boosting (gross) reserves
 - But the private sector guessed that BI just didn't understand what was going on
 - And it was right: BI subsequently ran a highly expansionary monetary policy
 - This was utterly incompatible with exchange rate stability

BI's Conflicting Roles

- Unrecognised conflict between BI's roles as *lender of last resort* and *monetary policy maker*
- Firms in trouble resulted in banks in trouble
- 16 small banks closed
- Deposits then shifted to 'safe' state banks and foreign banks
 - Private banks became illiquid
 - State and foreign banks became highly liquid
- Last resort lending boosted (base) money supply
 - No serious attempt to sterilise by issuing SBIs to safe banks
- In the midst of this banking crisis, banks started lending on a grand scale, rather than cutting back
- The 'bank run' was in fact a run on the currency, financed by the central bank itself

Interpreting Indonesia's crisis

- High inflation caused by depreciation?
- Both in fact were caused by excessive money supply growth
 - Private sector responded, predictably, by buying goods and services and foreign exchange
 - Prices rose, including price of FX

From crisis to cataclysm

- By January 1998
 - Economy rapidly heading to recession
 - Price of foreign exchange increased by more than four times
 - Inflation spiralling out of control
 - Hence a new LOI to the IMF on January 15



Soeharto's response

- Soeharto had always been development-oriented, and was highly successful in this
- Outstanding progress of three decades now suddenly halted
- Hanke: 'Soeharto fretted about the inflation that would likely ignite as the result of the rupiah's collapse. ...
 - "They'll riot in the streets, I'll have to bring in the military, and it could potentially get quite bloody." '

Soeharto's response

- Technocrat advisers/IMF had persuaded him to give way on many micro policies at the expense of his family and cronies
- Yet nothing in the IMF program succeeded in stabilising the economy
- Other countries had attacked currency crises by establishing currency board-like systems: why not Indonesia?
- Understandable Soeharto would look elsewhere for advice: Enter Steve Hanke...

Hanke with Soeharto at Cendana



The Currency Board Idea

- Currency boards are an alternative to central banks for managing monetary affairs
- They are not a new invention
 - Previously common
 - But mostly replaced by central banks in the post WWII era
- Rationale: currency boards do not allow discretion in monetary policy
- It is precisely the discretion available to central banks that has often led them to generate distinctly inferior outcomes
- In particular, they often fail to appreciate the impossibility of controlling domestic prices and exchange rates simultaneously (2 nominal anchors)
 - Hence Indonesia's chronic failure to meet inflation targets

Currency board essentials

Currency board balance sheet

Assets			Liabilities
Foreign exchange reserves	110	100	Base money (notes and coin)
		10	Equity

The currency board issues and redeems base money in return for foreign exchange. Such transactions are always at a fixed rate. (Not a *promise*, a *legal imperative*.)

The supply of base money therefore depends solely on the supply and demand for foreign exchange: there is *no discretion in relation to monetary policy*.

Currency board essentials

- Unlike a central bank, a currency board can never run out of foreign exchange reserves, since there is not enough *base money* in circulation to buy them all
- This point is frequently misunderstood...

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

Financial Times 12 February 1998

Responses to the proposal

- Initially strongly positive response from **markets**
 - 93% appreciation of rupiah in just over two weeks
- A strong suggestion the proposal should have been considered on its merits
- Instead, the response from the *policy establishment* was intensely negative

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

Far Eastern Economic Review 2 July 1998

At the same time, Krugman is also reported to have said: 'I wish I could say that currency boards are a really stupid thing. They're not. They're *just a way of preventing governments from just printing money.*' [Which of course was exactly what was required!]

Dow Jones International News 24 March 1998

Responses to the proposal

- Why such vociferous opposition?
 - Fear a currency board would worsen the crisis?
 - Suspicion that it was a devilish plan to allow Soeharto to rip off Indonesia one last time?
 - Or fear that it would *succeed in bringing crisis to an end* (leaving Soeharto and his policies in place)?
- Considerable evidence for the latter explanation
- Currency boards successful elsewhere
 - Supported by the IMF in Bulgaria, and Bosnia and Herzegovina in 1997, and later (in principle) in Russia and Brazil
- And had the support of many top economists
 - Becker, Dornbusch, Friedman, Miller, Mundell, and Sir Alan Walters (who had played a key role in establishing Hong Kong's currency board in 1983)

Statements by some key players/observers

- Michel Camdessus (former Managing Director of IMF):
 - We created the conditions that *obliged President Suharto to leave his job...* [although that] was not our intention.
- Paul Keating (former Australian PM):
 - The United States Treasury quite deliberately used the economic collapse as a means of *bringing about the ouster* of President Suharto.
- Lawrence Eagleberger (former US Secretary of State):
 - We were fairly clever in that we supported the IMF as it *overthrew* [Suharto].
- Merton Miller (Nobel Prize economist):
 - There was a feeling Suharto was just another Ferdinand Marcos and we *had to get rid of him*.

Currency Board as Soeharto Escape Route?

- Others saw the proposal as a scheme to save Soeharto, rather than to save Indonesia: e.g.

... a selfish scheme engineered by Suharto's children and friends ... to save their fortunes by cashing in rupiah at an inflated exchange rate so they [could] pay off their dollar debts.

I.A.R. Lakshmanan, *The Boston Globe*, 12 February 1998

- For Soeharto to 'take the money and run' would have been totally out of character
- Where to get the needed rupiah (i.e. base money)?
- What would have been the exchange rate?

Determining the Exchange Rate

Hanke made no recommendation on the CB exchange rate. On the contrary:

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

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

Market Determination of the Exchange Rate

During this period of transition, the central bank stays out of both the foreign exchange market and the money market (so that the supply of base money is held constant).

Market players will be guided by the current volumes of reserves and base money: the exchange rate can be expected to be close to the ratio of base money to reserves.

On this basis, in January 1998, reserves = \$19 billion, base money = Rp 56 trillion; suggested exchange rate is about Rp3,000/\$.

Irony

- A currency board would have *precluded* Soeharto and his circle from looting Indonesia's international reserves
 - foreign exchange could only have been purchased from other market players during the transition
- Keeping the central bank *allowed them* to loot the treasury, via the banks
 - Private and state-owned banks made big rupiah loans to conglomerates (recall lending surge)
 - These were used to purchase FX from BI
 - There was little or no intention to repay these loans
 - The banks went broke
 - Government took them over
 - Corrupt/incompetent legal system/bureaucracy allowed defaulters to escape repayment

Irony

- Soeharto allowed himself to be bluffed by IMF, US government and others (threat to withdraw IMF support)
- But the feared outcomes used to argue against the CB proposal were *precisely what came to pass*
 - GDP fell by 18% in year to Q4 1998
 - *Enormous wealth transfers* (\$50 billion?) from general public to Soeharto's circle through borrower defaults

Currency Boards vs. Central Banks

- BI should have realised what was happening
 - Banks were *lending* – in the middle of a worsening crisis! – and the loans were being used to *speculate* against the rupiah
 - FX purchases reduced bank liquidity, which was promptly restored by last resort lending
- A great case study of the case for *not* allowing discretion to a monetary authority
- BI needs to understand
 - the need for a *single* nominal anchor
 - the conflict between managing the exchange rate and controlling inflation (i.e. *two* nominal anchors)

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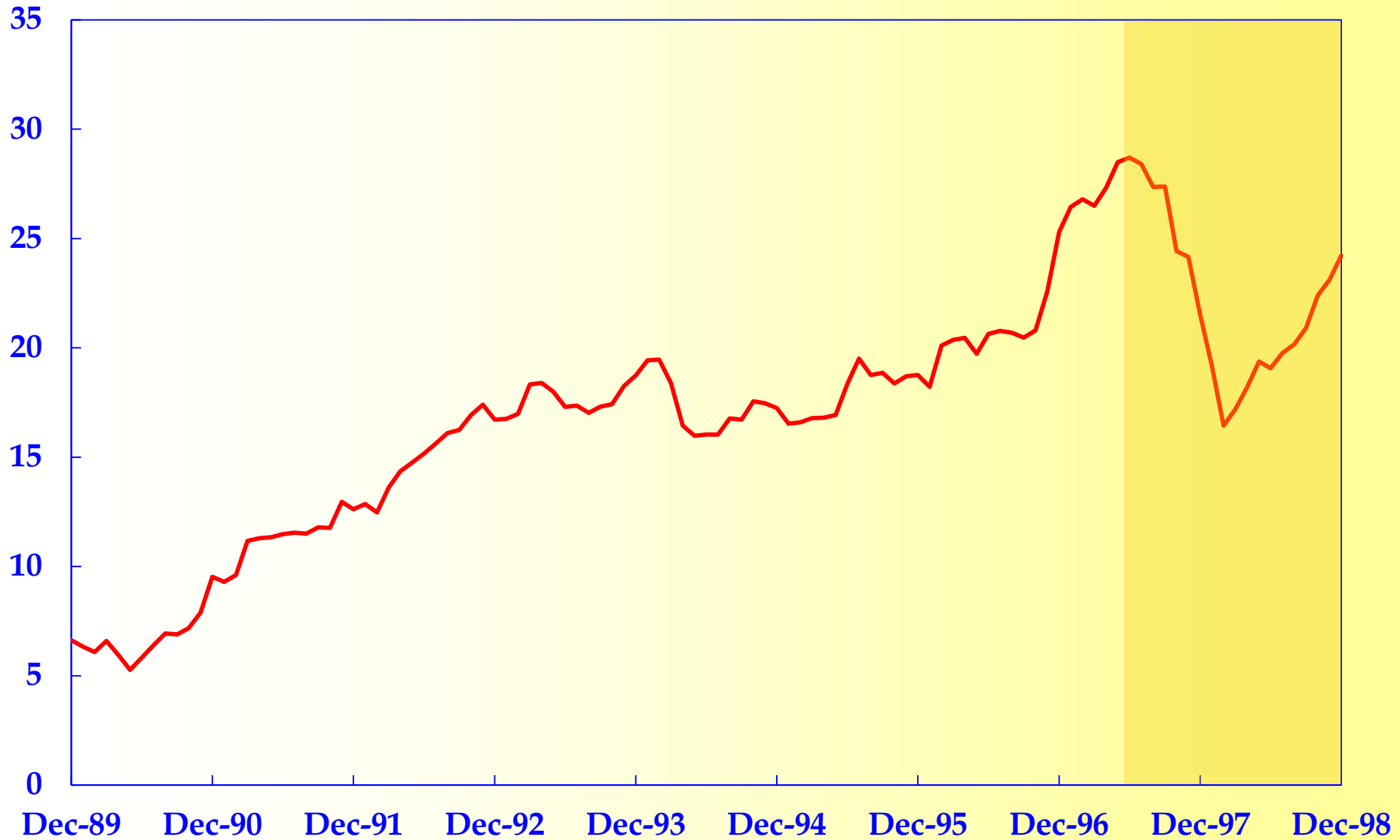
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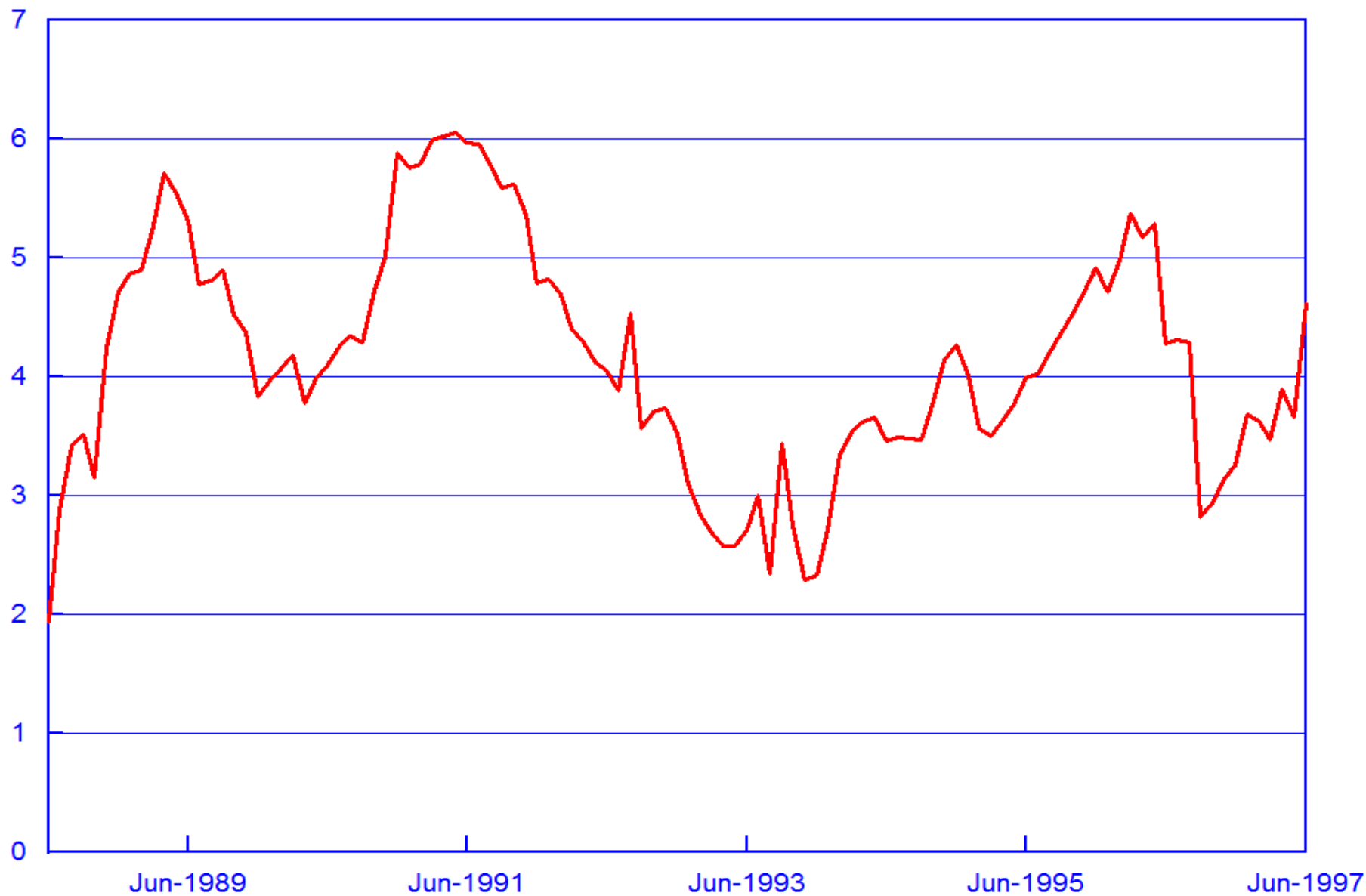
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Indonesia's International Reserves

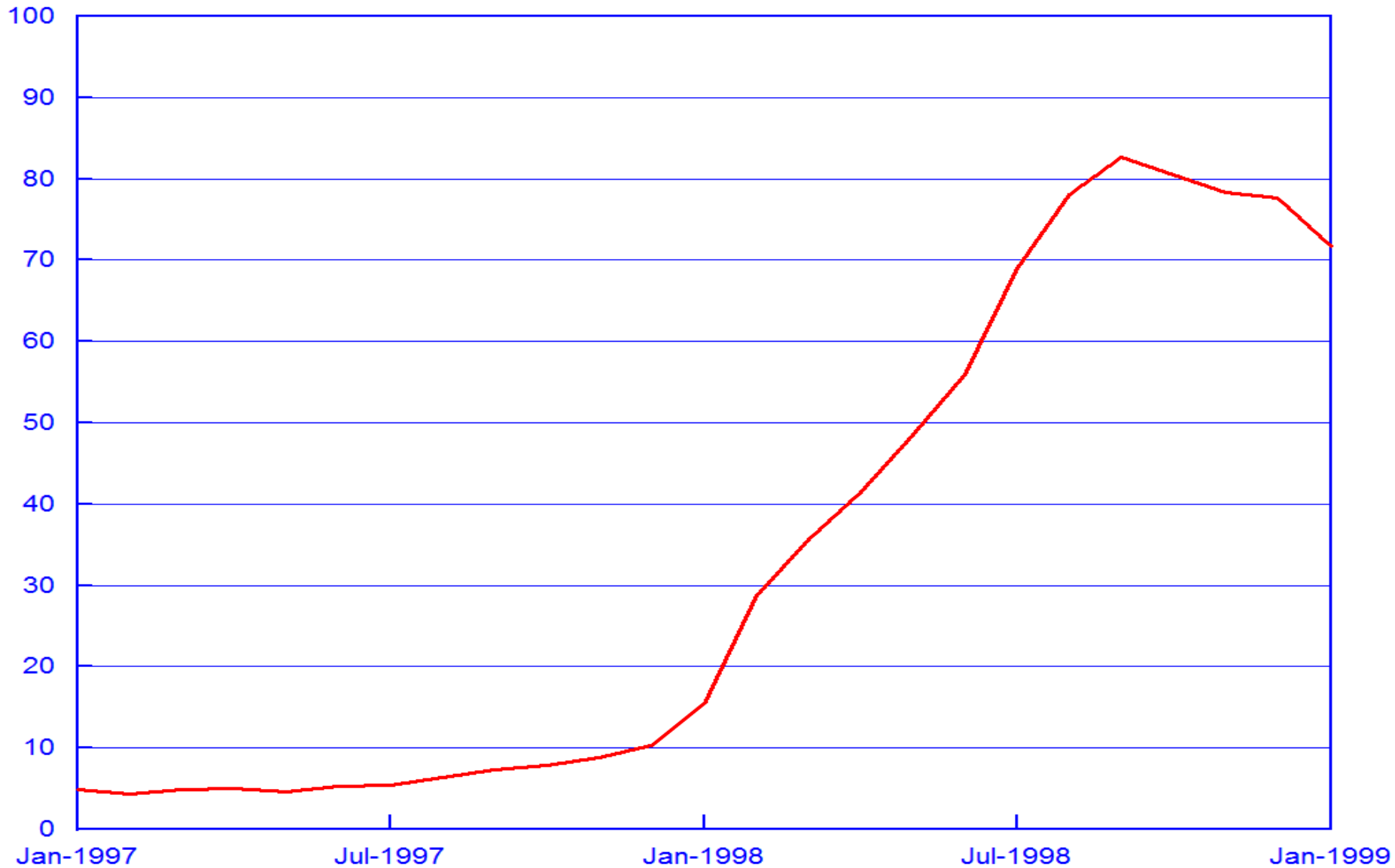
(\$US billion)



Exchange Rate as Nominal Anchor, Rp/\$ (%p.a.)

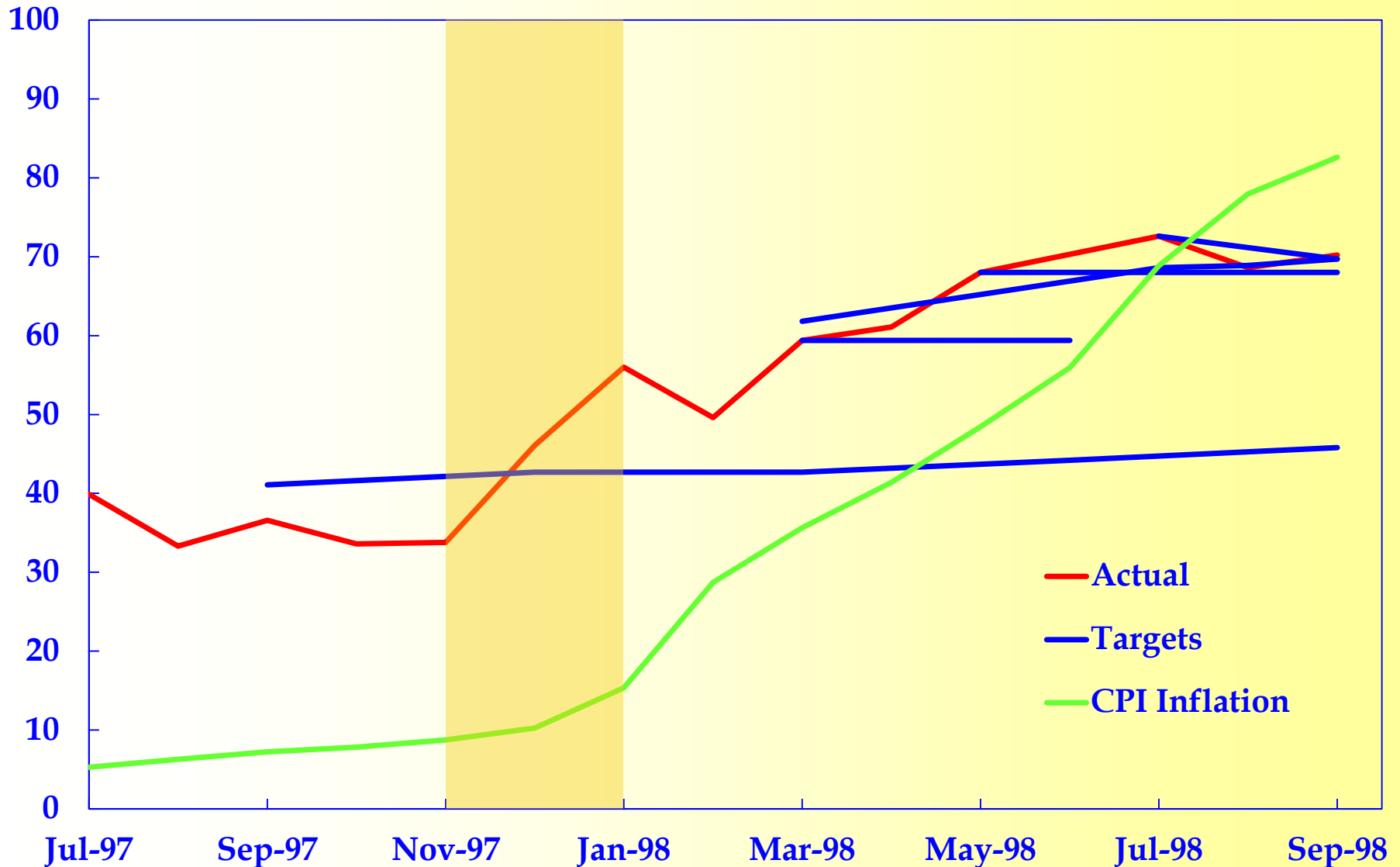


CPI Inflation (% p.a.)

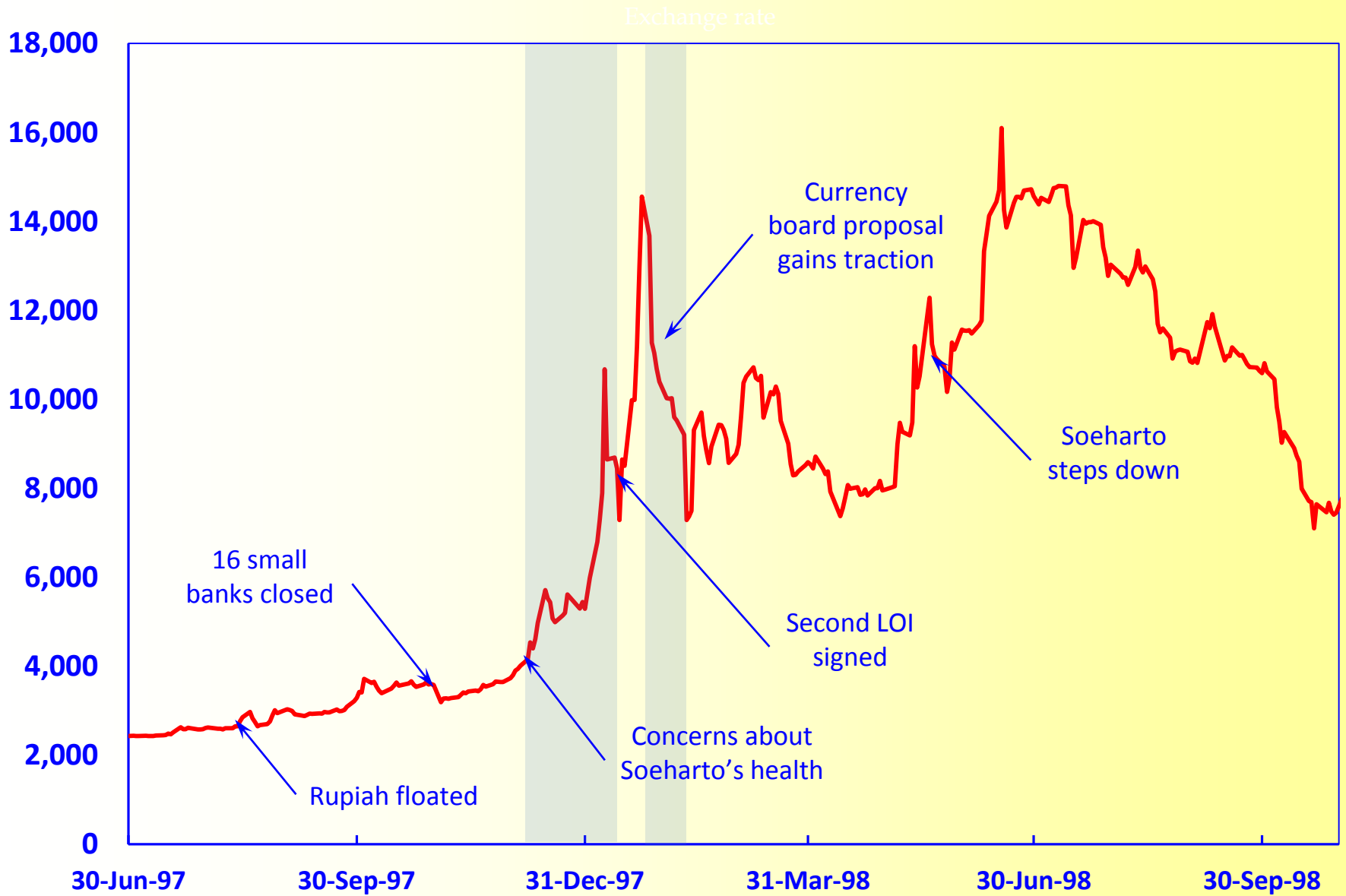


Base Money Growth and Inflation During Crisis

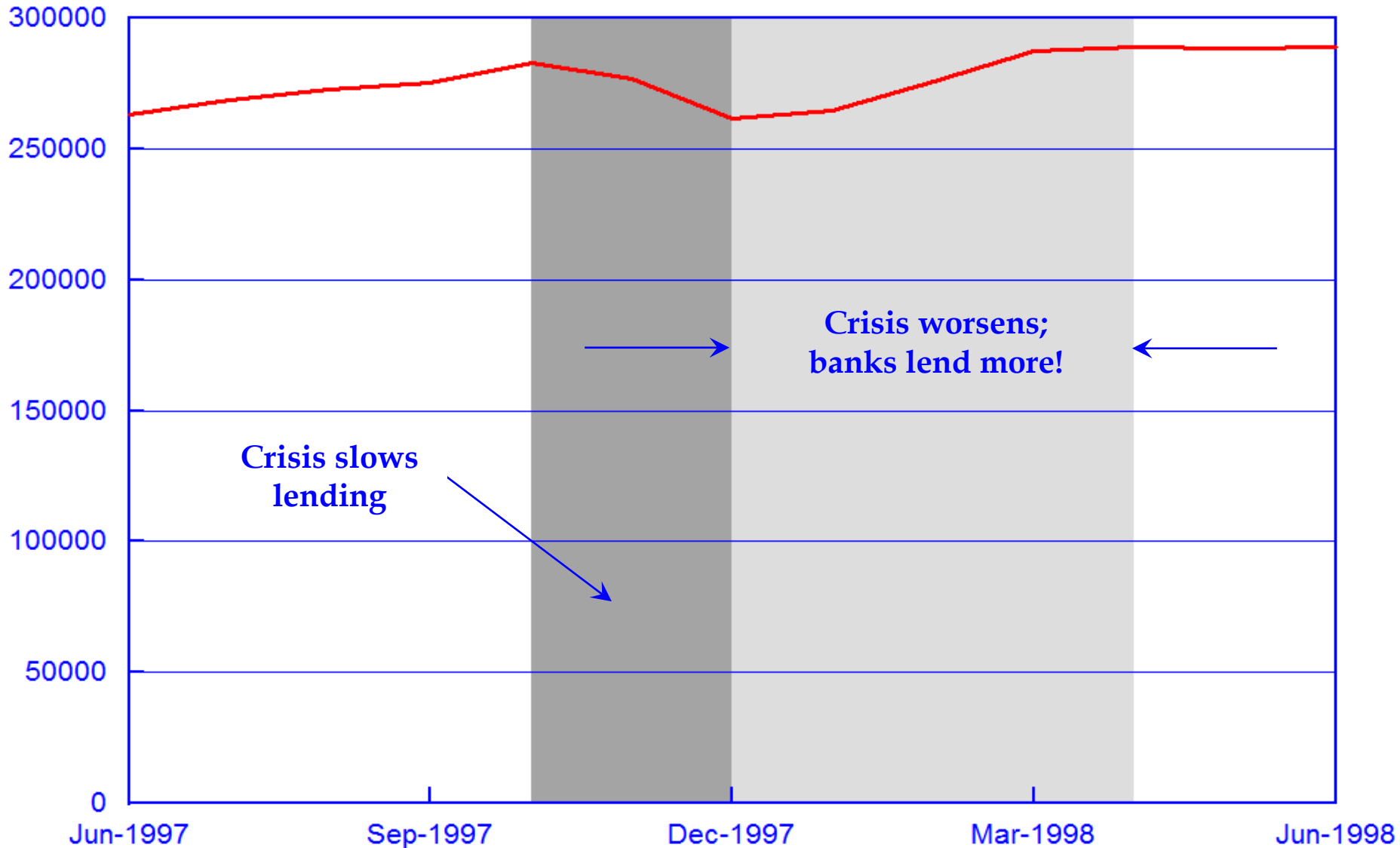
(Rp trillion, % p.a.)



Exchange Rate (Rp/\$)



Bank Lending in Rupiah (Rp Billion)



Bank Deposits (Rp trillion)

