

May 25 1998

Emerging Markets
Research GroupWilliam H. Overholt
Head of Asia Research
65-390-0550
woverholt@bkb.comJie Hu
Vice President
65-390-4749
jhu@bkb.comJain Praveen
Vice President
65-390-4747
jpraveen@bkb.comHariharan Sundaresan
Vice President
65-390-4744
shariharan@bkb.comEmerging Markets
Sales, Trading &
Research.150 Beach Road
#07-00 Gateway West
Singapore 189720**INDONESIA AFTER SUHARTO****William H Overholt**

What comes after Suharto? In our opinion the political situation greatly resembles the aftermath of the first IMF package: a great deal of progress, substantial backsliding, the worst outcomes avoided, but further crises ahead.

To understand where we are, it is useful to review where we have just been. Indonesia has had two fathers, both imperfect but both great men. The original post-colonial leader, Sukarno, was a fiery anti-colonial fighter whose wild rhetoric and sometimes almost crazy anti-colonial posturing defeated the Dutch and created a national consciousness where only fragments of such an idea had existed before. In the process, he alienated the West, aligned inappropriately with the communists on many issues, failed to build the economy, wrecked much of the economy Indonesia already had, failed completely to construct a competent government administration, and left the country dangerously polarized between a Muslim movement inclined toward an Islamic state and the world's third largest communist party. But for all his incredible flaws Sukarno created a nation where one had not existed before.

Suharto was the perfect complement to Sukarno. Suharto created an economy where none had existed before, and he moderated Indonesia's polarized polity. Suharto ran the army division with the best logistics and the best funding--the best funding because, in an army then funded primarily by smuggling, he had the best smuggler, the former Chinese cook and later premier business crony Liem Sioe Leong. Suharto created a national administration where there had been none. He created a national infrastructure where there had been very little. Supported by the World Bank, the IMF, and the Harvard Institute for International Development, he put a group of market-oriented U.S.-trained experts, the so-called Berkeley Mafia, in charge of most economic policy. Under their guidance, the finance ministry and the central bank became competent institutions, the country's exports successfully diversified away from their initial almost total dependence on oil, the economy became much more open and diversified, and the number of Indonesians condemned to absolute poverty declined from most of the population to a very small percentage of the population. When Suharto took over, the traveler around Indonesia saw skinny, hungry, poorly clothed people trudging long distances on foot in desperation to find a living. By the mid-1980s this was a country of

reasonably well-fed, reasonably well-clothed, increasingly educated people riding motorbikes to much better jobs.

Politically, Suharto eradicated the communists by force, seduced the Muslim groups into supportive moderation (there were no real fundamentalists by (1990), and created an army with deep roots in the people--Asia's finest counter-guerrilla military.

But Suharto was a traditional man from traditional society. In traditional society, the patriarch built the country and his family's fortune without doing modern calculations of conflict of interest. The patriarch ruled by mandate from the gods and from his own wit, not by mandate of the voters. The leader who had achieved his place in history by standing on the shoulders of the country's most efficient smuggler didn't employ the counterparts of investment banks' Compliance departments and didn't understand what they did. It is worthless to speculate on how much more could have been achieved if Indonesia had possessed a leader since 1966 with modern sensibilities about conflicts of interest. In such a backward society, there was no possibility of such a leader arising. The appropriate comparison for Suharto is with the leaders of Ghana and Nigeria, similarly traditional societies which in 1966 were incomparably better off than Indonesia but failed to find leaders who would move them forward as Indonesia's did.

The world changed on Suharto, and Suharto didn't know when to leave. For all his intelligence and all his concern for his country, he didn't have the wisdom of Singapore's Lee Kwan Yew or of China's Deng Xiaoping in knowing when to step back to the second line. Like other Asian autocrats, he earned political support by delivering the goods. Unlike the other successful Asian autocrats, he remained in power until a time when the machine he had created ceased, at least temporarily, to deliver the goods. This was his undoing.

Compared with Lee Kwan Yew, Park Chung Hee, Chiang Ching Kuo, Prem Tinsulanonda, and the other creators of the Asian miracles, Suharto was a borderline case. Like them, he sought office for a place in the history books, for the joy of building his country, not primarily to build a fortune. Like them, he left his country much better than he found it. In all this he was the opposite of a Ferdinand Marcos, who sought office primarily in order to amass a fortune and spent his time degrading Philippine institutions and impoverishing Filipinos in order to achieve his overriding pecuniary objectives. One cannot repeat too often that, whereas Marcos and his ilk left their country with weaker institutions, more polarization, and more poverty, Suharto left his people better off in all these respects. But within the class of real nation builders Suharto was far greedier and haughtier and far less conscious of the cycle of mortality and the needs of maintaining legitimacy and of creating successors for a world

different than the one in which he came to power.

Suharto responded to aging and to political and economic pressures by circling the wagons. Even within the overall trend toward a more open and competitive economy, he extended the fiefdoms and monopolies and his relatives and business supporters, and over the span of a 32 year reign these became enormous business empires which the great man had no intention of dismantling. As early as four years ago, leading businessmen, bankers appointed by the president himself, and political figures who had helped install Suharto in Sukarno's place were saying that corruption was becoming intolerable and that it was time for the old man to step down.

In politics, the circling of the wagons was even more blatant. He had himself elected for yet another term and sidelined those who advised him otherwise. He positioned his daughter as a likely successor and a fervent loyalist, Habibie, as a backup. He ensconced his son-in-law, General Prabowo, as the commander of the powerful strategic and reserve command, with ultimate control of the garrison in Jakarta. It is appropriate to contrast this with Deng Xiaoping, who made no effort to appoint his children or relatives as successors and who gradually stepped back from top jobs as he aged, toward the end leading China through sheer prestige and moral authority and holding office only as Honorary Chairman of the Chinese Bridge Players Association.

The regional economic crisis brought the festering succession issue to a head. Initially Suharto reacted as he always had, attempting to implement reforms faster and more decisively than most other leaders. How quickly the world has forgotten that only last October Suharto was Asia's hero of proactive reform. Whereas Thailand and South Korea just let the crisis roll over them without foresight and then pleaded for the IMF to pick them up, Suharto's Indonesia tightened its budget by cancelling \$36 billion of projects and proclaimed some banking and property reforms, then with dignity asked the IMF to provide backup in order to prevent a looming crisis. At the time, investors all over the world were buying Indonesia's currency and selling the currencies of its less responsible neighbors.

But the regional crisis and the IMF program destroyed the proud economy. Indonesia's national debt and the financial positions of its principal companies turned out to be the worst in the region, a guarantee of financial collapse, and, if any additional assurance of national financial panic were needed, the IMF's prescription of the sudden closure of 16 banks and its failure to address the central problem of private sector debt provided that assurance. The IMF's stabilization package segued immediately into catastrophic destabilization. Suharto's backtracking was partly responsible. The IMF's package was partly responsible. Suharto felt betrayed by the IMF, and the IMF felt betrayed by Suharto. Both were right. The sense of betrayal led to a fateful change of

course by the Suharto regime. Indonesian economic policymakers had long been divided between the Technocrats, also called the Berkeley Mafia, and the Engineers. The technocrats, led by a succession of economists with doctorates from the best American universities and guidance from the World Bank and IMF, consistently albeit gradually led the economy toward greater openness, competition, and fiscal discipline. Under their guidance the country achieved three decades of growth and, having benefited from their advice, Suharto relied primarily upon them. They were continually challenged by the Engineers, who advocated plunging into high technology and heavy industry projects, employing whatever degree of protectionism and monopoly was necessary to insulate those projects, and rejecting the fiscal disciplines insisted upon by the technocrats even if they inhibited the projects of national grandeur. The Engineers had their counterparts among the Brazilian military and civilian planners of the 1960s and 1970s who pushed national airplanes, national nuclear projects, huge dams, and a grand new capital. The defining project of the Engineers was the national aircraft industry, and the leader of the Engineers was Minister of Technology B.J. Habibie.

In the battle between the Technocrats and the Engineers, there seemed to be no contest. The technocrats were universally acknowledged as the architects of success. They had more support from the president, and they had the empathy of the leading military officers, whereas both civilian and military leaders tended to be highly skeptical of the grandiose plans of the Engineers and the political ambitions of B.J. Habibie. With the financial collapse and the failure of the initial IMF package, however, Suharto's sense of betrayal visited itself upon the technocrats to the benefit of B.J. Habibie. Suharto defiantly created a cabinet that for the first time in modern history almost eliminated the technocrats, and he elevated Habibie to the vice presidency. The regional crisis and the IMF helped the Engineers, at least for a time, to snatch victory from the jaws of defeat. The rise of Habibie was further facilitated by his leadership of the Indonesian Association of Muslim Intellectuals, which Suharto used as a counterweight to pressures from more modern groups that potentially threatened the position of his family.

The struggle over succession was complicated by Suharto's being both an archaic autocrat and one of the fathers of his country. Anger over his autocracy and corruption mobilized anger against him and neutralized many who would otherwise have been supporters. But respect for his achievements led much of the civilian population to a qualified respect for his position, and it induced military determination that the succession should not be humiliating and that instability should not be allowed to jeopardize the accomplishments of Suharto's generation. Had Suharto been a one-dimensional figure like Ferdinand Marcos, it would have been much easier. As it was, the country faced both the risk of a student-military confrontation in the mode of Tiananmen Square and the risk that the military would fragment into a shooting

match between adamant supporters of the Suharto regime and those more willing to bend their wills to the inexorable winds of history.

To understand what followed, one has to put aside the media clichés. It never was true that the Indonesian military was an unqualified supporter of Suharto, although a few generals, notably General Prabowo, did fit this caricature. While all generals were determined to prevent national instability and disintegration, the military was in its center of gravity loyal primarily to the country rather than to any individual. However much Suharto tried toward the end to manipulate and suborn the top leadership, the professionalisation of the Indonesian military was ultimately, albeit ironically, one of the most important achievements of Suharto's better days.

Likewise, the famous media description of Suharto as shameless was false at its core, albeit accurate in some exciting but peripheral economic details. When pressed to the wall, Suharto had a long history of putting his country first. Indicative of this was the contrast between his behavior and that of Ferdinand Marcos in the 1980s. When both countries were squeezed, Marcos encouraged his family and cronies to make the best of their last chance to spend and steal the country's assets. Suharto in contrast tightened fiscal discipline by cancelling some \$10 billion of projects, most of which were destined for the benefit of the first family and first friends. This was a deeply flawed leader but one centered on the most profound patriotism.

When the inevitable confrontation with the students came, the killing of a few students shifted the middle class from conflicted passivity to outright opposition. The leaders of the country's most respected Muslim organizations, which happen to be the world's two largest Muslim associations, Muhammadiyah and the Nahdatul Ulama, both called for the president's resignation. The speaker of the national parliament, an old-time Suharto loyalist, called for a change of leader. The military was unwilling to have a Tiananmen Square and the president did not order one. While General Wiranto guaranteed Suharto's safety, he refused to guarantee Suharto's power. When the president compromised, the Muslim leaders called off their confrontation and the students divided. (Indonesia's Muslim leaders are wise, moderate and modern figures. There isn't a rigid or fundamentalist bone in the body of Abdulrahman Wahid, leader of the Nahdatul Ulama, and Amien Rais, the Muhammadiyah leader, although politically ambitious and perhaps inclined toward an Islamic state, has been a restrained and moderate opposition leader. Again, and this time with minimal irony, Suharto's mid-1980s success at bringing the Muslim leaders into a broad elite partnership, and thereby encouraging the rise of the moderates and the demise of the fundamentalists, was one of his greatest achievements.) While some students were brutally killed, there were in the aftermath of compromise widespread scenes of students hugging and kissing the soldiers who were rounding them up.

Frequently, the soldiers' stern efforts to herd the students were interrupted for high-fives and laughter. It was not like this in Kwangju 1980, in Beijing 1989, or in Bangkok 1976 or 1992.

The compromise removed key leaders but did not overthrow the regime. The leadership changes were decisive but will ultimately be judged insufficient. The worst scenario has been avoided but there will almost certainly be future confrontations. The key victory for peace was that President Suharto was forced out without fatally dividing the military or opening a fatal schism between the military and the civilians. In the penultimate days, all of Southeast Asia fearfully awaited a clash between General Prabowo's powerful forces and the more moderate majority army leadership under General Wiranto. Army leader Wiranto was by no interpretation an opponent of Suharto; indeed, he was chosen partly out of a presumption of loyalty to the president. But close observers agreed that he and most of his colleagues would put the country first. In the event, General Prabowo apparently was blamed inside the army with responsibility for the shootings of students and transferred from combat command to leadership of a military college; his face was nominally preserved by a transparently phony explanation that this was normal rotation although he had his command for only a few months. Having sidelined General Prabowo and implicitly blamed him for the student deaths, General Wiranto apologized to the students for the shootings of their colleagues.

This deal was just as essential to the avoidance of civil war and national division as the resignation of the president. It preserves the army's role as the ultimate arbiter of Indonesian politics although henceforth the army can exercise that authority only within broad limits set by the risk of provoking a renewed Muslim/student/middle class reaction. The sidelining of General Prabowo, together with General Wiranto's public apology for the students' deaths, preserves an ambience of nervous mutual respect between the military and the students, averting the hitherto overwhelming risk of mutual hatred.

The avoidance of much more serious bloodshed, the avoidance of deep new schisms in the body politic such as would have occurred in a Tiananmen Square scenario, and the empowerment of a leadership committed to continue the economic reforms all constitute triumphs of the first order. The untold story of the Indonesian upheaval is that so far all sides except the urban looters have behaved with greater restraint than might have been expected.

Having avoided the worst, Indonesia must now find its road forward. The road is likely to be quite bumpy. The situation is Javanese in its contradictions and complexities:

Suharto is gone, Prabowo is demoted, and the first daughter and first friend have left the cabinet, but the regime is largely intact. Most of the

cabinet comprises holdovers from Suharto's cabinet, and almost all generals are in the positions to which Suharto appointed them. Habibie is Suharto's man.

President Habibie has committed himself forcefully to implement the IMF reform program. But his whole career and value system stand in opposition to the market-oriented, open, competitive, gradualist, fiscally restrained economy that the IMF and the technocrats demand. Will he change what he has always stood for, or will he reinterpret the commitments?

The country needs peace and harmony but it also needs catharsis. Implementation of the needed painful reforms and austerities will provoke distrust and unrest unless this is done by a government with a broad popular mandate which has repudiated the nepotism and elitism of the Suharto regime.

The country needs ethnic and social reconciliation, but Habibie and his Indonesian Association of Muslim Intellectuals are widely perceived, fairly or unfairly, as having contributed to the vilification of Chinese, Christians and technocrats during the recent crisis.

Negotiations over the fate of the private sector debt will determine the fate of the leading Indonesian companies, a large proportion of which are connected to the first family. Whether bluntly or subtly, these negotiations will choose which firms will live and which will die. They will decide inter alia how much debt relief will be given and which firms will be given access to subsidized rupiah exchange rates. Unless the process appears objective, markets and political groups will react badly, but making the process appear objective will require replacing or damaging the interests of virtually every official who has hitherto been involved.

Just as the original IMF economic reform program got into trouble because it was inadequately conceived and inadequately implemented, the political reform could easily give way to crisis for the same reasons. Without a fuller catharsis, the political tensions will persist. Without more fresh faces and the legitimacy that comes from an election, every demand for popular economic sacrifice could be met with an angry response that corrupt billionaires are being unfairly sheltered and should make the first and largest sacrifices. In Thailand and South Korea, the ascendancy of a new leadership legitimated the sacrifices. In Indonesia, the critical problem was not the higher fuel prices but the lack of legitimacy of those imposing the decisions. That problem will persist. Initially Suharto understood that and proposed to hold new elections under different rules. News reports say that Habibie feared that approach and begged Suharto to simply step down in favor of Habibie. The impatience of the demonstrators

for Suharto's departure played into the hands of Habibie's supporters. While investors too are impatient for a fix, this fix, like the original IMF program, will need to be fixed.

President Habibie faces tough options. He must either (a) hold the election that he previously feared so much and almost certainly curtail his time in office; or (b) dramatically repudiate almost all the personal loyalties and economic policies that he has upheld for a lifetime; or (3) seek military support (which probably would prove unattainable) for a ruthless effort to suppress the forces of change.

William H. Overholt
Singapore

Information herein has been obtained from sources believed to be reliable, but BankBoston, N.A. Singapore Branch (BKBS) does not warrant its completeness or accuracy. Prices, opinions and estimates reflect BKBS's judgment on the date hereof and are subject to change without notice. This document is not an offer or solicitation for the purchase or sale of any security or financial instruments ("financial instruments"). Financial instruments mentioned herein may not be suitable for all investors. BKBS or an affiliate may act as an advisor or lender to issuers mentioned herein or may have positions or act as a market maker in financial instruments mentioned herein (or derivatives related to those instruments). BKBS, its employees or affiliates may have positions or effect transactions in financial instruments mentioned herein (or derivatives related to those instruments), or serve as directors of issuers mentioned herein. Additional information is available upon request. If this document has been issued in the U.K. it is intended for dissemination only to that type of person enumerated within the meaning of Article 1(3) of the Financial Services Act of 1986 (Investment Advertisements) (Exemptions) Order 1995 (SI 1995/1266), and is intended solely for use by the recipient and may not be copied or distributed to any other person. Financial instruments purchased through BKBS are not deposits but rather are obligations of the issuer of those financial instruments. Copyright © 1998 BankBoston, N.A. Singapore Branch.