Trade Policy Adjustment in Indonesia

The Bank supported Indonesia's adjustment program with two trade policy adjustment loans (TPALs), approved in 1987 and 1988. Initial results are good, notes an OED audit of these loans. Reasons for the success include the productive policy dialogue between the Bank and the country authorities, backed by a solid program of Bank economic and sector work, and complementary support for the adjustment strategy through Bank project lending. Another important reason was the large inflows of concessional capital from other donors that were stimulated by the TPALs; these flows helped Indonesia restructure its external debt, enabling the adjustment process to be more gradual and a strong GDP growth rate to be maintained. The two Bank TPALs successfully furthered the adjustment strategy without the use of loan conditions.

Stabilization and adjustment

Indonesia's economic stabilization and adjustment program was begun in 1983 and intensified after the collapse in oil prices in 1986 caused a severe deterioration in the balance of payments and government budget. Its goals were:

(1) Macroeconomic stabilization, through monetary restraint, high interest rates, improved fiscal effort, lower government expenditure, removal of pricing-policy distortions, and competitive exchange rates.

(2) Restructuring of the economy, to reduce Indonesia's heavy dependence on oil as a source of foreign exchange and budgetary revenues, and to improve economic efficiency. The structural adjustment program included measures to strengthen domestic resource mobilization, expand non-oil exports, and promote a more competitive and dynamic non-oil economy. Policies to liberalize foreign trade and dismantle the complex regulatory environment played a major role.

Role of the Bank

The Bank supported the program with two Trade Policy Adjustment Loans (TPALs), each of $300 million, approved in March 1987 and August 1988.

Conditionality and program design

No policy conditions were attached to either loan, because actions had been taken
beforehand. The loans were granted in response to actions that the government had already taken, but these actions were understood to be part of a continuing reform program in whose design Bank economic and sector work had played a role. The government's strong record in economic management provided the basis for expecting that further policy measures would be taken in pursuit of the program's goals.

The loans succeeded without the use of conditionality for three main reasons:

- Productive policy dialogue supported by strong analysis: The assistance provided by a well-staffed resident mission, complemented by economists from Bank headquarters, facilitated an active policy dialogue between the Bank and Indonesia. For over a decade the Bank had carried out in-depth economic and sector work of high quality, even though at times the government had not made use of the policy recommendations that emerged.

- Political "window of opportunity": The economic crisis of 1986 gave the government an opportunity to implement adjustment measures that the Bank had proposed earlier but the government had postponed. Once the decision to adjust had been made, the Bank was able to complement it with technical and financial resources. ESW that had already been done by the Bank significantly helped the government's design of the adjustment strategy.

- Concentration on essentials: The Bank concentrated attention, in the policy dialogue, on the priority actions needed for a successful adjustment effort. It backed up its recommendations with technical assistance to the government's Trade and Industrial Policy Steering Committee to facilitate the implementation of reforms.

Coordinating the Assistance Strategy

The two adjustment loans provided valuable support when trade liberalization put the balance of payments under pressure. They also played a catalytic role in mobilizing donor support under the umbrella of the Intergovernmental Group for Indonesia. A significant part of this support was on concessional terms. Without it, the adjustment process would have been more painful, with greater hardship for the poor. With it, Indonesia was able to restructure its external debt obligations by paying off its commercial liabilities. Hence the debt is projected to remain manageable in the 1990s.

Support through projects

Simultaneously with the adjustment loans, the Bank financed a cluster of projects that supported the goals of growth and export diversification:

- a manpower development and training project to help establish a national vocational training system;

- two export development loans, to help diversify exports through provision of technical assistance and training facilities and long-term credit for export-oriented investments;
- an industrial restructuring project, providing financial and technical assistance to enterprises having difficulty adjusting to the increased competition;

- a loan for private sector development, to reinforce the goals of the TPALs and provide for close monitoring of the progress of the macroeconomic and trade policy reforms.

Collaboration with IMF

Indonesia has had no standby or extended arrangements with the Fund since 1973; its last purchase from the Fund was in 1987 under the Compensatory Financing Facility. The Bank and Fund consulted closely with respect to the TPALs, through informal exchanges and consultations during loan preparation.

Results

Growth and structural change

Progress thus far has been very encouraging. Provided that ongoing policy reforms are sustained, and some new policy changes undertaken in required areas, Indonesia can be expected to achieve sustained higher growth.

Reflecting the severe terms of trade loss, per capita income in 1989 was still lower than in 1981. But growth of real national income was maintained at 4 percent in 1987 and 1988, despite terms of trade shocks of 13-15 percent each year. Non-oil exports doubled from 1985/86 to 1988/89 and now finance 85 percent of non-oil imports.

At the macro level, successful adjustment was achieved through a combination of tight monetary and fiscal policy and a devaluation that did not get passed through into wages and nontraded prices, and therefore moved the real exchange rate. Inflation slowed down, budgetary and external current account deficits were reduced, and foreign exchange reserves strengthened. Though the debt service ratio remains high, prudent external debt management and the inflows of concessional capital have led to improvements in the debt to GDP ratio.

At the sectoral and micro level, important structural changes have occurred. In 1986 the government began to ease and rationalize industrial regulation in investment; substantial progress has been made in response. Two years later reforms were begun in the financial sector. Growth and exports in the non-oil economy, particularly the manufacturing sector, responded rapidly to trade liberalization measures which reduced the antiexport bias in the system, and to depreciation of the real effective exchange rate.

Social costs

The recovery in economic growth has helped to contain social costs, as have some reallocations of public spending. Because of the overall budget constraint, however, many basic services have been weakened.
Public expenditure cuts were concentrated on investment, rather than consumption. Shares of development expenditure for social services and agriculture were raised significantly in 1983-88, and an effort was made to protect regional transfers (normally used for small-scale and labor-intensive local infrastructure projects).

In labor markets the main burden of adjustment has fallen on earnings rather than employment. In agriculture and services, real labor earnings, and informal sector incomes, have probably stagnated or declined.

Conclusions and recommendations

Where the Bank and the country have an ongoing cooperative relationship and a constructive dialogue in policy questions, and the Bank can rely on the country's interest in maintaining that relationship, there appears to be little need to impose policy conditions on adjustment loans. Looking to the future in Indonesia, the share of investment in GDP should be raised, as the economy is reshaped along more outward and market-oriented lines. Investments are badly needed in health and education, to increase employment, and to prevent bottlenecks in economic infrastructure from constraining future growth. Action on these fronts will need careful preparation, regular monitoring, and further Bank support. The deregulation process has begun but requires rationalization of the tariff structure and the investment licensing system.

Strategy

- It is worthwhile for the Bank consistently to adhere to a schedule of policy and issue-oriented economic and sector work over time, despite variations in the quality of the country policy dialogue.

- Structural adjustment works better in a stable financial environment. Indonesia undertook economic stabilization two to three years before beginning structural adjustment through changes in trade policy.

- Structural adjustment is easier in a favorable environment for trade. In 1987 and 1988 Indonesia's exports benefited from high OECD economic growth rates, and from export difficulties in important competitor countries--Thailand (overheating of economy) and Taiwan, China (currency appreciation).

- Positive resource inflows are needed to ease the shocks imposed by adjustment in the period of high debt service. In Indonesia's case, large concessional inflows allowed the country to pay off its commercial debt and thus alleviate the debt service burden.

- An initial short pause in new investment during the adjustment process, while supporting consumption, may be a good policy choice, especially if preceded by recent intense investment activity. The pause may help investors to make the right decisions, given the changing policy environment, while the support of consumption during the
program period lessens social costs and enhances political acceptability. Following the initial phase of the program, Indonesia will need to pursue a higher level of investment.

Macroeconomic issues

- Periods of financial austerity associated with stabilization and adjustment should not be protracted, because of the adverse effects on social and economic infrastructure. In Indonesia, many worthwhile capital investments have been postponed or curtailed, deficits in power, transport, and telecommunications could become binding constraints on development and export growth, and more investments are needed in health and education. While it is right to expect the export sector to generate the savings needed for investment in the future capital stock, there is scope for raising savings through a better tax effort, better financial performance of state economic enterprises, and enhanced private savings.

- Adjustment programs must recognize the employment effects of reduced expenditure policies. To improve employment and earnings in Indonesia will require a higher investment/GDP ratio, and a careful choice of projects, supported by suitable technology, technical training, and revitalization of domestic financial markets.

Trade and investment policy

To consolidate the progress in trade and investment will require:

- Efforts to increase productive employment, which can only be done in an environment relatively free of regimentation and one that facilitates investment. Concessional capital flows cannot permanently sustain consumption and investment. Changes may be needed in fiscal strategies, interest rate policies, and financial intermediation processes.

- Further rationalization of the tariff system, to sensitize domestic producers to efficiency criteria, complemented by measures to make the trade regime more transparent.

- Further simplifying the regulatory system governing investment.

- Some reforms in the policy-making apparatus for trade protection. Ideally, the policy process should be formalized and backstopped by a working secretariat that is properly equipped and insulated from political interests. The goal should be to make decision making on policy and administration as simple as possible.