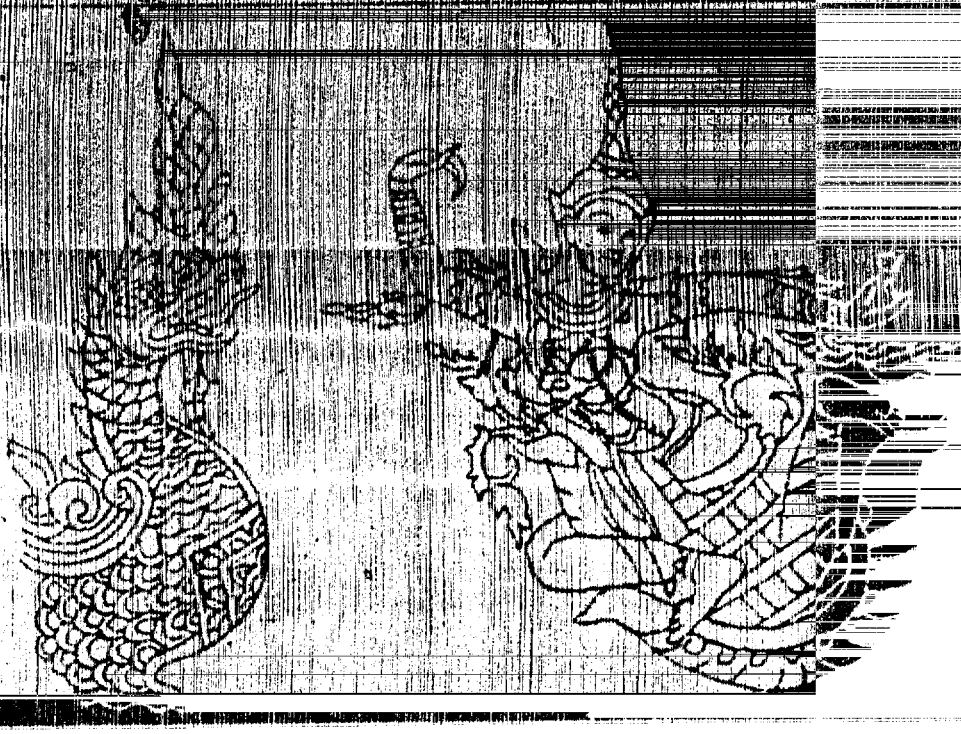
# THE LESSONS OF EAST ASIA

## INDONESIA
## Development Transformation and Public Policy



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## Indonesia

*Development Transformation and Public Policy*

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The World Bank
Washington, D.C.

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# FOREWORD

Policymakers everywhere are searching for lessons from East Asia's enormous success in economic development. A number of recent cross-country and thematic studies have sought to identify and analyze the policies behind this success. Among them is *The East Asian Miracle*, a recent World Bank publication, which draws in part on the Lessons of East Asia project. Study teams, including in-country nationals, examined in some depth the experiences of the highly successful East Asian economies and the public policies underpinning them.

Several clear contributions emerge from this set of country studies. The research:

- Highlights considerable variation in approaches within the group of East Asian economies. For example, some economies chose a substantial degree of government intervention; others did not. The studies dispel the notion that there is a single or uniform East Asian model of success.

- Demonstrates that a core set of good economic policies -- such as macroeconomic discipline, outward orientation, and human resource development -- laid the foundation for East Asia's success. Pragmatic policymaking -- understood as being nonideological and reversible -- seems to be at the heart of these policies and merits replication.

- Dispels some of the myths about the more idiosyncratic interventions, such as "picking winners" in industry, which sometimes produced the desired result and sometimes did not. Because presence or absence of institutional features seems to have affected the outcomes of these interventions, applications to other regional contexts must be approached cautiously. A dominant finding of the studies is that serious diversions from macroeconomic equilibrium were largely avoided, even by strong interventionists. At the same time, the later generation of industrializers were more successful when they avoided these industrial policies.

A question not easily answered is why East Asian governments adopted fundamentally sound policies and were apparently able to achieve better results from their active policies and to incur lower costs from errors. In this connection, the studies touch on such dimensions of policymaking as the role of the state, leadership, and the bureaucracy. It is one thing to describe the institutional features accompanying a successful episode, however, and quite another to know why and how those features came about. For instance, why did East Asian leaders apparently hold themselves more accountable for economic performance than has been the experience elsewhere? How did the governments manage to gain sufficient national consensus to put difficult policies into effect? These aspects of political economy cannot be ignored. Our analytic tools, however, are severely limited in penetrating these issues, in assessing their impacts, and in assigning credit to them. These country studies are only one step, although a significant one, in deepening our understanding of the experience of East Asia. It is hoped that they will prompt additional work on the institutional foundations of rapid growth.

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# EXECUTIVE SUMMARY

## Development Strategy and Macroeconomic Performance

From a position as one of the world's poorest nations, Indonesia has recorded rapid and sustained growth over the past 25 years. During 1965-90, GDP increased at an average rate of nearly 7 percent per year. There have been sharp reductions in the incidence and severity of poverty and significant improvements in a range of other social indicators. The economy has also undergone substantial structural change, led by an oil and commodity boom in the 1970s and more recently by an expansion in manufacturing. The share of agriculture in total output has been halved, and there has been a significant shift towards the private sector and a greater involvement in trade.

Following the accession of President Soeharto in 1967, there have been three broad phases in the government's approach to development. The period 1967-73 was one of adjustment and liberalization. Under former President Soekarno, attempts at state-led import substitution had failed, creating a stagnant economy with significant trade and budget deficits. The new government moved to restore macroeconomic stability, passing a balanced-budget law, and introduced market-oriented reforms. The exchange rate was devalued and unified, the fiscal deficit was eliminated and import licensing largely abolished. Having achieved stabilization, the government addressed longer-term goals through the first five-year development plan, which stressed agriculture, social sectors and infrastructure.

Following sharp increases in oil and other commodity earnings, the government was able to intensify its development efforts in the 1970s. Although it continued to pursue a sound macroeconomic strategy, several other policies marked a reversal from the liberalization of the late 1960s. The government promoted a policy of industrial upgrading, granting state-owned enterprises (SOEs) a dominant role in many sectors and increasing controls on investment (particularly foreign investment) through a comprehensive licensing system. By 1980, Indonesia had developed a restrictive trade regime, characterized by a multitude of tariff and quantitative barriers, creating a strong bias against exports. Resources were drawn into capital-intensive industries and the more efficient labor-intensive activities were penalized. The economy became heavily dependent on oil revenues, and the competitiveness of the non-oil economy was eroded by a rise in the real exchange rate (a classic example of the "Dutch disease").

In the 1980s, the Indonesian economy suffered severe external shocks, creating the need for two rounds of adjustment, in 1982-85 and again in 1985-88. These shocks were caused by a sharp decline in the terms of trade, as oil prices fell, and by the depreciation of the U.S. dollar, which increased Indonesia's external debt burden. Adjustment has involved exchange rate devaluation, reductions in public expenditure and comprehensive tax and financial reforms. Following the second series of shocks, the government also embarked on a program of trade and other regulatory reforms which significantly reduced its role in the economy. Import controls have been removed and restrictions on foreign investment relaxed. A duty exemption scheme has been introduced for imported inputs, offsetting the anti-export bias of earlier policies. By the late 1980s, rapid growth had resumed, based on the expansion of labor-intensive exports and private investment. Foreign capital has played an important role in this expansion; foreign investment approvals increased tenfold during 1986-91 and 70 percent of this total was export-oriented.

Government policies toward the financial sector have supported the broad framework of development strategy. The importance of state-owned banks, which have long dominated the financial sector, increased during the oil boom, as government revenues were channeled into the economy through directed credit subsidies and allocations. In the 1980s, successive structural adjustments have led to financial deregulation, including the removal of entry barriers and reductions in a wide range of interest rate controls and credit subsidies. There has been a rapid expansion in the number of banks and in the products and services that they offer, although at a cost of introducing some instability into the financial system.

While there have been significant changes in development strategy over time, the government remains consistent in its pursuit of certain policies. These include macroeconomic stability, agricultural and rural development, and public investment in infrastructure and human resources. The combination of balanced budgets, an open capital account and, for the most part, prudent external borrowing has created a stable macroeconomic environment. In addition, the government has managed the exchange rate to maintain international competitiveness, particularly in the 1980s. The government has sustained an impressive growth rate in agricultural output through continued investments in rural infrastructure and services and by maintaining favorable incentives. On average, 40 percent of development expenditure has been allocated to infrastructure provision, producing impressive increases in power, communications and transport capacity. Successful human resource development programs have involved family planning, infant survival and education. For the latter, massive state spending on school building, teacher training and fee grants during the 1970s and 1980s enabled Indonesia to achieve universal primary education.

Estimates of productivity change and capital efficiency provide some indication of the impact that government policy has had on economic development. During 1967-73, rapid growth was associated with productivity improvements and a low incremental capital-output ratio, suggesting that policy was well-designed. In the 1980s, attempts to promote investment behind protective barriers led to declines in total factor productivity (TFP) and capital efficiency. For the most part, the SOEs created in this period have performed poorly. Following the reforms of 1985-88, when policy concentrated on promoting labor-intensive activities, there has been a turnaround in productivity and efficiency indicators. TFP growth in 1988-91 was matched only by its performance during 1967-73.

**Institutions and Governance**

Indonesia is governed by a bureaucratic and military elite, organized around strong presidential leadership, which has adopted a corporatist strategy to ensure that policy making remains above direct societal pressures. Organizations whose leadership is overseen by the state have been established to represent mass groupings of the population, including labor, women, youth, peasants and fishermen. The state promotes social consensus by requiring all social and political organizations to adopt the official ideology of Pancasila, which is based on five communal and humanitarian principles. Nevertheless, recent years have seen increasing dissent from parliament, the media, and business and labor organizations.

The insulation of the bureaucracy enabled economic technocrats to exercise leeway in the design of development policy. These individuals are grouped in a number of policy-making institutions, such as the Economic Stabilization Council, the Economic Coordinating Ministry and the Monetary Board. In practice, policies are often approved in a series of informal meetings among senior bureaucrats, allowing the economic ministries to present a cohesive package of proposals to the President. Following their initial success designing policy in the early years of the Soeharto regime, economists have retained the confidence of the political leadership and thus exert considerable influence. They played an important role in the liberalizing reforms of the late 1980s. The government has also welcomed the advice of a series of external agencies when designing development strategy. Despite its success, however, Indonesian institutions are still evolving and the country faces hurdles in a number of key sectors.

# I. INTRODUCTION

Indonesia straddles the equator spread across an archipelago of more than 13,000 islands with an area of more than 2 million sq.km. With a population of 184 million in 1992, it is the world's fifth most populous nation. The five big islands -- Java, Sumatra, Sulawesi, Kalimantan and Irian Jaya -- account for 92% of the area and 94% of the population. Two-thirds of the population live on Java, which has one of the highest population densities in the world. Some 95% of the population are Malay; 90% are followers of Islam; but there are more than 300 ethnic and linguistic groups. Like other South East Asian economies, Indonesia has an ethnic Chinese minority. It comprises 2.5% of the population but plays a disproportionate role in trade, services and industry.

Like Malaysia, but unlike the East Asian countries of the north, Indonesia has a rich and diverse base of natural resources. Java has extremely fertile soil and the outer islands are well suited for tree crops. Farming is well developed, comprising of rice, tree crops, spices and fisheries. Indonesia is also rich in mineral resources, including oil.

Indonesia's history and development after Independence has two parts: the years under the helm of President Soekarno (1948-65), often referred to as the Old Order; and the period under President Soeharto, or the New Order Period, which has spanned the last twenty-five years. Economic activity picked up after Independence, but gradually lost momentum, and then declined in the final years of the Soekarno era. Since then Indonesia has had rapid and sustained growth, aided in part by the oil boom of the 1970s.

This paper analyzes Indonesia's transformation over the past twenty-five years and the role that public policy has played in bringing this about. The next section reviews the trends underlying this transformation. Section III reviews the key elements of the policy and institutional framework. Section IV analyzes the reform process, and Section V summarizes the main conclusions.

# II. DEVELOPMENT TRANSFORMATION SINCE 1965

## Long-Term Development Trends

Twenty-five years ago, Indonesia was one of the poorest countries in the world. Its per capita income in 1967 was only $50, about half that of Bangladesh, Nepal and Nigeria. Poverty was widespread; estimates suggest that, in 1970, 60% of the population (or 70 million people) were living in absolute poverty. Infant mortality was among the highest in the world, and life expectancy was lower than other low-income countries in Asia. Indonesia was also lagging behind in education, with a substantially higher adult illiteracy rate and considerably lower primary and secondary enrollment rates than those of its neighbors.

Figure 1

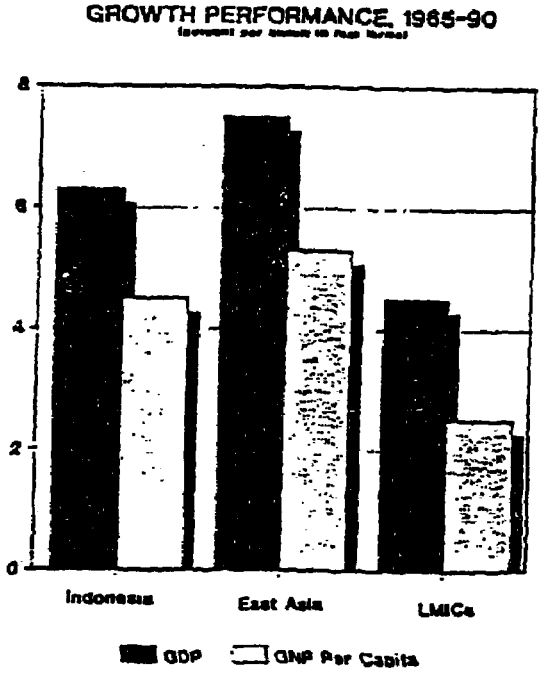



Figure 2

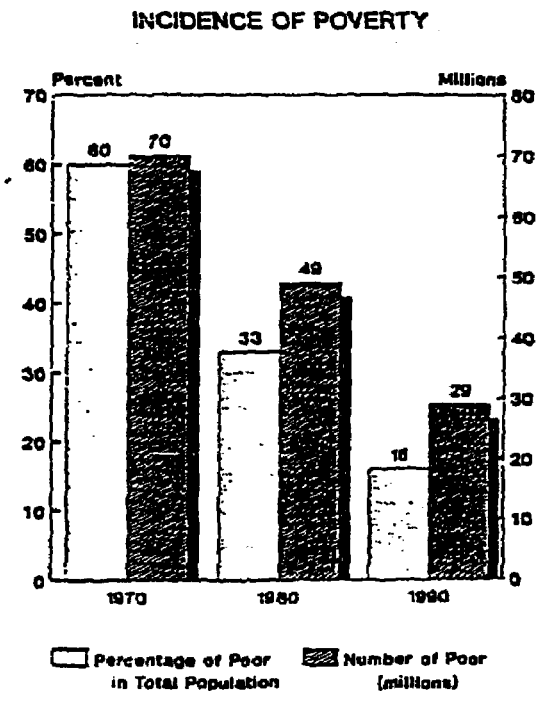


Table 1: HUMAN RESOURCE DEVELOPMENT - 1960-1990

| | Life expectancy at birth (years) | | Infant mortality rate /a | | Adult illiteracy rate /b | | Primary enrollment ratio /c | | Secondary enrollment ratio /d | | Population per physician | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1960 | 1990 | 1960 | 1989 | 1960 | 1990 | 1960 | 1989 | 1960 | 1989 | 1960 | 1984 |
| Indonesia | 41 | 61 | 225 | 64 | 61 | 23 | 71 | 118 | 6 | 47 | 46,780 | 9,410 |
| East Asia & Pacific | | | | | | | | | | | | |
| - Philippines | 53 | 64 | 134 | 42 | 28 | 10 | 95 | 111 | 26 | 73 | na | 6,570 |
| - Malaysia | 54 | 70 | 105 | 22 | 42 | 22 | 96 | 96 | 19 | 59 | 7,020 | 1,930 |
| - Thailand | 52 | 66 | 149 | 28 | 32 | 7 | 83 | 86 | 13 | 28 | 7,950 | 6,290 |
| - South Korea | 54 | 71 | 120 | 23 | 29 | 4 | 94 | 108 | 27 | 86 | 3,540 | 1,160 |
| South Asia | | | | | | | | | | | | |
| - India | 43 | 59 | 165 | 95 | 72 | 52 | 61 | 98 | 20 | 43 | 4,850 | 2,520 |
| - Sri Lanka | 62 | 71 | 71 | 20 | 25 | 12 | 95 | 107 | 27 | 74 | 4,490 | 5,520 |
| All Developing Countries | 46 | 63 | 233 | 65 | na | 40 | na | 105 | na | 43 | na | 4,980 |

/a Number of infants per thousand live births, in a given year, who die before reaching one year of age.

/b Proportion of the population over the age of fifteen who cannot, with understanding, read and write a short, simple statement on their everyday life. Illiteracy rate is for 1960 except for the following: Indonesia and India (1961); Malaysia (1970); and Sri Lanka (1963).

/c Gross enrollment of all ages at primary level as a percentage of primary school-age children.

/d Computed in the same manner as the primary enrollment ratio.

Since then, Indonesia has made substantial progress. It achieved GDP growth of almost 7% per annum in 1965-90, far above the average for low- and middle-income developing countries and comparable to other East Asian economies. Even during the 1980s -- when Indonesia was hit by a series of external shocks -- it managed to growth in excess of 5% a year. Over the past 25 years, per capita income increased at an average annual rate of 4.5%. The percentage of poor, the absolute number of poor and the severity of poverty have all fallen sharply, which Indonesia having the sharpest annual reduction in the incidence of poverty among the countries analyzed in the 1991 World Development Report. At the same time, infant mortality has fallen sharply, and life expectancy has increased by 20 years. Universal primary education was achieved, secondary and tertiary enrollment has risen sharply and the adult illiteracy rate has fallen by almost two thirds.

The economy has also undergone substantial structural change (Table 2). First, it has become much more open, with total trade flows now accounting for more than 50% of GDP. The growing openness of the economy was spurred by the oil and commodity boom of the 1970s and, more recently, by the acceleration of non-oil exports. Second, investment and savings rates rose steadily from their low levels of the early and mid-1960s to a peak in 1981, but then declined a little in the aftermath of external shocks. Third, there has been a rapid change in the composition of output. The share of agriculture has been more than halved. Oil and mining was the dominant sector during the 1970s, but manufacturing has since emerged as a major sector, making the largest contribution to overall growth in the second half

of the 1980s. Fourth, with the stagnation in oil output and the sharp decline in oil prices in the 1980s, the reliance on oil revenues has diminished both in terms of foreign exchange earnings and budgetary contribution. Fifth, there has been a significant shift towards the private sector following the reforms of the 1980s. Its share of total investment has increased, and the private sector is estimated to have contributed 73% of overall growth since 1983. Lastly, the level of external debt which was reduced during the 1970s, has risen sharply during the 1980s so that Indonesia is among the five largest developing country borrowers in the world.

Table 2: STRUCTURAL CHANGE

| | 1965 | 1970 | 1980 | 1990 |
|---|---|---|---|---|
| As Percent of GDP | | | | |
| Openness | | | | |
| Total Trade | 14.0 | 22.2 | 46.8 | 54.7 |
| Non-Oil Exports | 4.0 | 7.0 | 11.5 | 15.7 |
| Imports | 7.5 | 10.6 | 15.5 | 26.3 |
| Gross Domestic Investment | 8.0 | 10.8 | 18.7 | 24.6 |
| Gross National Savings | 7.9 | 9.5 | 32.8 | 26.3 |
| Sectoral Shares | | | | |
| Agriculture | 55.0 | 47.5 | 24.3 | 35.9 |
| Manufacturing | 8.5 | 10.9 | 13.4 | 18.8 |
| Other Industry | 6.5 | 8.9 | 29.7 | 19.1 |
| Services, etc. | 30.0 | 32.7 | 32.1 | 39.1 |
| External Debt | 50.0 | 32.5 | 30.0 | 66.6 |
| As Percent of Exports | | | | |
| Oil LNG Exports | 40.0 | 40.5 | 78.5 | 44.8 |
| Debt Service | 11.0 | 6.0 | 13.9 | 27.3 |
| Memo: Private Investment as percent of total | .. | .. | 51.0 | 64.7 |

Source: Central Bureau of Statistics (BPS) and World Bank Staff Estimates.

These longer-term trends have been influenced by: (i) big shifts in Indonesia's external environment; and (ii) the evolution of policy. Indonesia benefitted from the oil and commodity boom of the 1970s, with a terms of trade effect that amounted to 12% of GDP by 1981. In contrast, Indonesia was adversely affected by sharp declines in oil and commodity prices as well as exchange rate movements during the 1980s. Together these led to negative external shocks of 15% of GDP by 1988.

Government policy has also changed over time partly in response to the changes in the external environment (Table 3). The Soekarno era following Independence in 1948, and, in particular, the period

of guided economic development (1958-65), was characterized by growing inward orientation and government control. Next came the initial years of the New Order Government of President Soeharto (1967-73), during which macroeconomic stability was restored, the Government liberalized the trade and payments regime and there was a more favorable stance towards domestic and foreign private investment. The third phase was the oil and commodity boom period of 1973-81. While the Government maintained generally sound macroeconomic policies and continued to pursue its longer-term development objectives, the trade and investment regime became increasingly inward looking and subject to government control. Then came the decline in oil prices and associated shocks in 1982. Between then and 1985, the Government restored macroeconomic stability, initiated key fiscal and financial reforms, but continued to pursue strongly inward and state policies. In 1986, Indonesia suffered a second and even sharper decline in oil prices as well as a rise in debt service payments due to the depreciation of the U.S. dollar. In response, the Government adopted a second round of stabilization measures (1986-88). It also embarked upon some structural reforms designed to create a more outward oriented and competitive economy. Since 1988, growth has been led by non-oil exports. External imbalances persist but they are due to the resurgence of private investment and consumer demand. The Government has extended and deepened the reform process but at a slower pace.

The remainder of this section describes the main developments in each of these periods. A detailed analysis of the policy framework is provided in Section III.

Soekarno Era, 1949-65. In the period after Independence, economic policy was characterized by a strong sense of nationalism rooted in anti-colonial, anti-Chinese sentiment. Despite several early attempts at liberalization, the policy regime became increasingly inward oriented and interventionist (Pitt, 1991; Glassburner, 1971). A pervasive regime of import and investment licenses was established, which promoted a new group of Indonesian importers and traders who earned substantial rents and became a powerful lobby for trade restrictions.

Following the centralization of power in 1958 after the regions' unsuccessful attempts to secede, Soekarno expounded a populist platform of "Guided Democracy and Guided Economy" based on direct state control of production and trade. Dutch interests were nationalized, and state enterprises took over all aspects of the economy including the import monopolies established in the earlier period.

The result was chaotic. Inflation accelerated to 1000% by 1965, foreign exchange reserves dwindled and debt service exceeded foreign exchange earnings. The increased external borrowing and expansion of money supply were the direct outcome of military adventures, including a confrontation with Malaysia, and showcase projects. In these conditions, economic growth stagnated. Per capita income fell by 15% between 1958 and 1965, so poverty (which was already widespread) increased further.

New Order Government: The Initial Years, 1967-73. A coup attempt in September 1965 led to the demise of the Old Order of Guided Democracy. Following a turbulent period, when thousands of people died, a New Order Government emerged under the leadership of Soeharto, although Soekarno remained formally as President until 1967.

Table 3: TRENDS IN KEY ECONOMIC AGGREGATES
(real growth; percent per annum)

| | 1960-67 | 1967-73 | 1973-81 | 1982-88 | 1988-91 |
|---|---|---|---|---|---|
| GDP | 1.7 | 7.9 | 7.5 | 3.3 | 7.1 |
| Non-oil GDP | 1.7 | 7.3 | 8.0 | 4.3 | 7.7 |
| Agriculture | 1.6 | 4.1 | 3.4 | 2.9 | 3.0 |
| Manufacturing | 1.0 | 9.5 | 14.1 | 5.2 | 11.0 |
| Services | 2.0 | 9.0 | 10.0 | 5.0 | 7.8 |
| Fixed Investment | 1.1 | 23.5 | 11.7 | -0.5 | 13.5 |
| Public | .. | .. | 11.0 | -2.0 | 8.2 |
| Private | .. | .. | 12.3 | 0.7 | 16.9 |
| Non-oil Exports | 2.1 | 25.6 | 0.0 | 7.6 | 16.5 |
| Per Capita GDP | -0.5 | 5.5 | 5.2 | 1.3 | 5.3 |
| Per Capita Income | -0.4 | 5.6 | 9.1 | -0.2 | 5.1 |
| Per Capita Consumption | -0.6 | 3.0 | 5.5 | 1.4 | 5.0 |

Source: BPS and World Bank staff estimates.

Despite its tenuous position, the New Order Government moved early and decisively to restore macroeconomic stability and introduce market-minded reforms (World Bank, 1968; Pitt, 1991). It eliminated the fiscal deficit through drastic expenditure cuts and passed a "balanced-budget" law in 1967 prohibiting domestic financing of the budget either in the form of debt or money creation. It also adopted a stringent monetary program to bring down inflationary pressures. The exchange rate was adjusted to realistic levels through large devaluations, and the administered system of foreign exchange allocation was gradually replaced by a market mechanism. Following the unification of the exchange rate in 1970 and a further devaluation in 1971, the capital account was fully liberalized.

In paraliel the government made sweeping changes in the trade and incentive regime, taking a more favorable line on private investment including foreign investment. It abolished the import licensing system, and while there were some increase in tariffs in 1968, it considerably reduced import protection. It also removed most domestic price controls, and returned some nationalized enterprises to previous owners. A new Foreign Investment Law, giving a 30-year guarantee of non-nationalization and compensation, was enacted in 1967. Indonesia rejoined the IMF and the World Bank, which enabled it to receive substantial foreign assistance for its adjustment program and work out arrangements to reschedule its debt.

The stabilization and adjustment program was successful in restoring macroeconomic stability and spurring recovery. By 1969, inflation had been reduced to below 20% and the external accounts were brought into balance.

With this success, the Government's policy focus shifted to long-term development. The first five year plan (REPELITA I) was formulated in 1969, with emphasis on agriculture, social sectors, infrastructure and on industry to support agricultural production. In many ways, this plan established the long-term development objectives of by the New Order Government for the next twenty years.

The Oil and Commodity Boom, 1973-81. Indonesia benefitted from the first and second oil booms of the 1970s as well as from the boom in other commodity prices. Net oil and LNG earnings rose from $0.6 billion in 1973/74 to a peak of $10.6 billion in 1980/81. In that year, oil/LNG accounted for 75% of export earnings and 70% of budget revenues. The surge in oil earnings provided the Government with the opportunity to intensify its development efforts; it also posed the familiar "Dutch disease" problem – how to protect the competitiveness of the non-oil economy from the adverse consequences of oil windfalls.

Compared with many oil exporters, Indonesia used its extra resources well (Gelb, 1988). It achieved economic growth averaging close to 8% per year based on a strong expansion of public and private investment (see Table 4). The non-oil economy remained buoyant, especially agriculture and manufacturing. Indonesia also had sound macroeconomic management, and, following the Pertamina crisis of the mid-1970s (where the state-owned oil company defaulted on foreign loans), a conservative strategy for borrowing. By the end of the decade, the current account of the balance of payments was in surplus and debt-service payments were below 13% of exports.

Table 4: ECONOMIC PERFORMANCE DURING THE OIL BOOM, 1973-82
(real growth rates, % p.a.)

| | 1973 | 1974-78 | 1979 | 1980 | 1981 | Average 1973-81 |
|---|---|---|---|---|---|---|
| Economic Activity | | | | | | |
| GDP | 11.7 | 6.9 | 7.8 | 7.9 | 7.4 | 7.5 |
| Non-oil GDP | - | 7.3 | 9.5 | 9.2 | 8.7 | 8.0 |
| Gross National Income | 11.4 | 9.2 | 12.4 | 19.2 | 14.0 | 11.4 |
| Fixed Investment | 12.0 | 11.1 | 8.7 | 15.4 | 12.0 | 11.7 |
| Public | - | 10.6 | -10.0 | 46.0 | 8.5 | 11.0 |
| Private | - | 12.5 | 13.0 | -2.0 | 16.4 | 12.3 |
| External Trade | | | | | | |
| Non-oil Exports | - | 4.5 | 8.6 | -9.0 | 19.0 | 0.0 |
| Non-oil Imports | - | 8.4 | 6.5 | 14.4 | 21.3 | 10.5 |
| Other Indicators /a | | | | | | |
| Domestic Inflation | 30.6 | 19.2 | 20.4 | 17.0 | 10.2 | 17.9 |
| Overall Public Sector Balance/GDP | -2.6 | 0.0 | 2.2 | 1.8 | -1.3 | |
| Current Account/GNP (%) | -4.0 | -2.0 | 3.9 | 2.7 | -2.9 | |
| Debt Service Ratio (%) | 11.3 | 21.5 | 14.5 | 10.1 | 10.4 | |

/a For the last year of multi-year periods.
Source: Central Bureau of Statistics and World Bank staff estimates

Major progress was also made in reducing poverty, improving living standards and expanding infrastructure. The Government's commitment to rural development was clear in its heavy spending on agriculture (especially rice) and rural infrastructure. The Government also did much to improve the availability of education, health and family planning services. As a result of these physical and social investments, Indonesia was able to make extremely rapid progress during the 1970s on reducing poverty and improving social indicators.

Despite these impressive achievements, there were various policies that marked a reversal from the liberalization of the late 1960s and that accentuated the adjustment challenges that emerged in the 1980s. First, the incentive regime became progressively inward oriented and complex, creating a substantial bias against exports and in favor of rent-seeking. Second, the distortions in the trade regime were reinforced by investment licensing, and by credit allocation at subsidized interest rates. Third, the public sector expanded substantially. Public enterprises assumed a dominant role in many sectors and public investment moved into heavy industries, petrochemicals and mining. The civil service expanded rapidly, as did the scope of bureaucratic interventions. Fourth, the economy became heavily dependent on oil revenues, and competitiveness of the non-oil economy was eroded through a rise in the real exchange rate.

External Shocks of the 1980s. Indonesia experienced major external shocks during 1982-88, from two main sources: (i) a sharp decline in the external terms of trade, largely due to the fall in oil prices and to a lesser extent in commodity prices; and (ii) the depreciation of the US dollar vis-a-vis major currencies during 1985-88, which added substantially to Indonesia's external debt burden.

The magnitude and trend of external shocks are shown in Table 5. They prompted two periods of adjustment: first from 1982 to 1985, and then from 1986 to 1988. During the first period, the negative external shocks averaged 3% of GDP (Ahmed, 1989). During the second, the external shocks were much larger, averaging 15% of GDP.

First Adjustment Period, 1982-85. The first period of stabilization followed the weakening of oil prices in 1982, the onset of a worldwide recession, and the decline in the prices of several important primary exports (e.g., rubber, palm oil and tin). By 1982/83, Indonesia's current account deficit had widened to US$7.2 billion (7.8% of GNP). In response, the Government began a broad-based adjustment program, designed to achieve external balance and fiscal stability, while reducing the economy's dependence on oil revenues. To restrain imports and improve the competitiveness of Indonesia's non-oil exports, the Rupiah was devalued by 28% in March 1983 and thereafter was managed flexibly. Public expenditure was sharply reduced through the rephasing of many large projects and cuts in subsidies. At the same time, the Government encouraged savings through comprehensive financial and tax reforms, and made major efficiency improvements in customs, ports and shipping. However, trade and industrial policies became even more inward oriented and subject to government intervention.

Table 5: IMPACT OF EXTERNAL SHOCKS, 1983/84-1988/89
(Percent of GNP)

| | Actual | | | | | | Average |
|---|---|---|---|---|---|---|---|
| | 1983/84 | 1984/85 | 1985/86 | 1986/87 | 1987/88 | 1988/89 | 1983-88 |
| Loss of income | | | | | | | |
| Terms of trade effect (1981 prices) | 2.5 | 2.0 | 5.7 | 15.6 | 13.3 | 14.1 | 8.9 |
| Exchange rate effect (1981 exchange rate) | -0.2 | -0.3 | -0.4 | 0.3 | 0.9 | 1.5 | 0.3 |
| Interest rate effect | 0.6 | 0.4 | 0.1 | 0.0 | -0.5 | 0.0 | 0.1 |
| Total effect | 2.9 | 2.1 | 5.4 | 15.9 | 13.7 | 15.6 | 9.3 |

Source: IMF and World Bank staff estimates.

By 1985/86, the macroeconomic measures had restored financial stability (Table 6). The current account deficit declined to US$1.9 billion (2.4% GNP) in 1985/86, and inflation came down which was brought below 5%. These adjustments, however, led to short-term costs in the form of slower growth of output and incomes, reduced private and public investment, low rates of capacity utilization, and financial difficulties for industrial enterprises.

Table 6: ECONOMIC PERFORMANCE DURING THE ADJUSTMENT PERIOD
(real growth rates, % p.a.)

| | ACTUAL | | | | | | ESTIMATES | |
|---|---|---|---|---|---|---|---|---|
| | 1982 | 1984-85 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
| Economic Activity | | | | | | | | |
| GDP | -0.3 | 4.6 | 5.9 | 5.0 | 5.6 | 7.4 | 7.1 | 6.5 |
| Non-oil | 4.2 | 5.2 | 6.2 | 5.8 | 7.3 | 8.2 | 7.8 | 7.1 |
| Gross National Income | -0.9 | 4.0 | -0.5 | 5.9 | 6.2 | 7.7 | 8.2 | 7.2 |
| Fixed Investment | 8.7 | -5.8 | -5.5 | 2.6 | 10.3 | 13.0 | 16.2 | 11.5 |
| Public | 18.2 | -2.9 | -19.1 | -4.5 | 10.3 | 6.8 | 9.6 | 5.6 |
| Private | -0.1 | -8.6 | 8.7 | 8.1 | 11.4 | 16.8 | 19.9 | 13.7 |
| External Trade | | | | | | | | |
| Non-oil Exports | -0.5 | 10.4 | 4.1 | 25.3 | 14.2 | 21.5 | 6.7 | 12.2 |
| Non-oil Imports | 14.2 | -11.8 | -13.6 | 5.0 | 8.0 | 18.9 | 25.4 | 6.7 |
| Other Indicators /a | | | | | | | | |
| Domestic Inflation /b | 7.6 | 8.1 | 5.8 | 9.6 | 9.3 | 6.3 | 7.9 | 8.5 |
| Overall Public Sector Balance/GDP | -4.3 | -3.0 | -4.1 | -2.8 | -3.1 | -1.3 | 1.8 | -1.0 |
| Current Account/GNP (%) | -7.8 | -2.6 | -5.8 | -2.3 | -2.3 | -2.0 | -3.8 | -4.1 |
| Debt Service Ratio (%) /c | 16.8 | 24.6 | 39.7 | 34.8 | 34.4 | 31.6 | 27.3 | 31.2 |

/a For last year of multi-year periods.
/b As measured by the 17 cities consumer price index (adjusted).
/c Debt service excludes prepayments.
Source: Central Bureau of Statistics (BPS) and World Bank staff estimates.

The Second Adjustment Period, 1985-88. In 1986, the economy again suffered a series of setbacks. This led to a 34% deterioration in the terms of trade and a jump in the debt-service ratio from 26% in 1985 to 37% in 1986. Once again, the Government took timely actions to restore macroeconomic stability. These included: (a) the introduction of an austere budget for FY86/87, with investment cut by one quarter in real terms; and (b) a 31% devaluation of the Rupiah in September.

The Government also embarked upon a program of trade and other regulatory reforms that marked a break from the policies of the previous fifteen years. It aimed to stimulate non-oil exports and investment by reducing trade restrictions and other regulations that had led to a "high cost" economy. Its first package, announced in October 1986 eliminated import licensing for 197 items accounting for 19% of import value. Later reforms included: (a) a reduction in non-tariff barriers as well as in tariffs (b) investment delicensing and the relaxation of controls on foreign investment; (c) financial deregulation that built on the 1983 reforms by lowering entry barriers, increasing competitive pressures and reducing the role of subsidized credits; and (d) deregulation in other bottleneck areas such as shipping. These measures are discussed in further detail in Section IV.

As a result of this programs, good progress was made in restoring financial stability. The current account deficit fell from 5.8% of GNP in 1986 to 2% by 1990 and the fiscal deficit from 4.1% of GDP to 1.3%. Inflation declined to below 7% in 1989. The debt service ratio, which had risen sharply in 1986, began to decline briskly due to the strong performance of non-oil exports. Overall growth was exceptionally strong (more than 6% p.a. for non-oil GDP) given the magnitude of external shocks.

Non-oil Export Led Recovery. The pace of economic growth quickened in 1989 led by non-oil exports and private investment. However, this has led to substantial excess demand, exacerbated by an easing of monetary policies in late 1989 and early 1990. Consequently, imports surged and exports decelerated, leading to a widening of the current account deficit, a surge in external borrowing, and an acceleration of inflation. The Government has responded by tightening monetary policy and curbing external borrowing for public and quasi-public sector projects. These measures are gradually beginning to take effect. Investment and output growth have decelerated slightly in 1992, but still remained in excess of 5% per annum.

## Impact on Economic Outcomes

Table 7 summarizes the trends in key economic aggregates since 1960. After the stagnation of the early 1960s, growth accelerated following the reforms of 1966. The growth momentum was sustained by the oil boom of the 1970s. Growth decelerated sharply in the 1980s in the face of adverse external shocks, but never turned into decline. Policy adjustment led to a recovery of growth in the closing years of the decade.

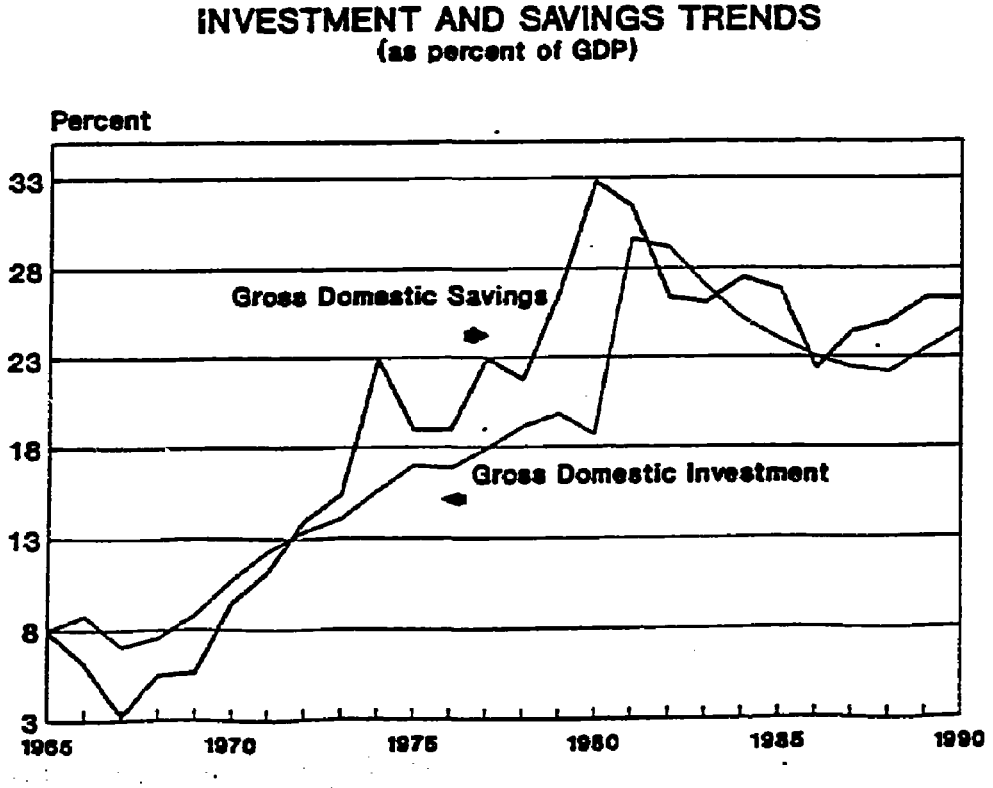
Investment and Savings. Figure 3 shows the trends in investment and savings rates since 1965. Starting from very low levels, both increased rapidly following the policy reforms of 1966. The sharp increase in savings during the 1970s reflected the growth in oil earnings. Investment rose as well, but with a lag and not to the same extent. The high savings and investment rates during this period reflect the fact that Indonesia was relatively prudent in its use of oil revenues, saving a larger proportion as well as directing more resources to investment. The end of the oil boom inevitably led to a decline in national savings. Since 1987, however, positive real interest rates and economic recovery have reversed the decline in national savings, despite a much larger burden of debt service payments.

Table 7: TRENDS IN KEY ECONOMIC AGGREGATES
(real growth; percent per annum)

| | 1960-67 | 1967-73 | 1973-81 | 1982-88 | 1988-91 |
|---|---|---|---|---|---|
| GDP | 1.7 | 7.9 | 7.5 | 3.3 | 7.1 |
| Non-oil GDP | 1.7 | 7.3 | 8.0 | 4.3 | 7.7 |
| Agriculture | 1.6 | 4.1 | 3.4 | 2.9 | 3.0 |
| Manufacturing | 1.0 | 9.5 | 14.1 | 5.2 | 11.0 |
| Services | 2.0 | 9.0 | 10.0 | 5.0 | 7.8 |
| Fixed Investment | 1.1 | 23.5 | 11.7 | -0.5 | 13.5 |
| Public | - | - | 11.0 | -2.0 | 8.2 |
| Private | - | - | 12.3 | 0.7 | 16.9 |
| Non-oil Exports | 2.1 | 25.6 | 0.0 | 7.6 | 16.5 |
| Per Capita GDP | -0.5 | 5.5 | 5.2 | 1.3 | 5.3 |
| Per Capita Income | -0.4 | 5.6 | 9.1 | -0.2 | 5.1 |
| Per Capita Consumption | -0.6 | 3.0 | 5.5 | 1.4 | 5.0 |

Source BPS and World Bank staff estimates.

Figure 3:



The investment rate also declined sharply between 1982 and 1987. This was due to a fall in public investment and was the direct outcome of the Government's fiscal adjustment in response to falling oil revenues. Private investment declined as a share of GDP, but did not fall in real terms. Gross domestic investment has recovered since 1987, spurred by the sharp increase in private investment after deregulation and other reforms. Consequently, the share of private investment in total investment has risen from 52% in 1981 to 63% in 1990.

Export Performance. The stabilization and liberalization measures of the late 1960s stimulated a recovery in non-oil exports. At the time, non-oil exports were largely primary commodities; together with oil, they accounted for 97% of total exports.Even more than Thailand and Malaysia, Indonesia was a resource based economy until the 1980s, and this was reflected in the structure of its exports.

During the 1970s, the surge in oil revenues dominated earnings from other exports. But primary commodity exports also grew rapidly, despite the appreciation of the exchange rate, because of the boom in world prices. When world commodity prices began to decline in 1980, commodity exports fell. This decline was reinforced by a ban on log exports introduced in 1981. However, the ban on plywood exports was successful in stimulating the development of the plywood industry. It became Indonesia's first major manufactured export and is still today its largest. In addition to plywood, textiles became a significant export item during the first half of the 1980s.

But the major boost to manufactured exports, and to non-oil exports in general, came after the exchange rate adjustment and the reforms of 1986. The major improvement in competitiveness that followed boosted all non-oil exports, including primary commodities; but manufactured exports grew especially rapidly. Within manufactured exports, plywood and textiles remained the largest items, but other labor-intensive manufactures grew even faster. Manufactured exports rose from only 12% of total exports in 1985 to 45% in 1991, surpassing both oil and primary commodities.

Efficiency and Productivity Growth. Indonesia's investment and growth have been strongly influenced by external conditions and shifts in the policy stance. To disentangle the effects of external influences from underlying performance, Table 8 analyzes the pattern of various aggregate efficiency indicators.

The table shows that rapid growth during 1967-73 was spurred by its investment - its growth, as well as its efficiency induced by the policy reforms of 1966. This can be seen from the high return on investment, the low incremental capital-output ratio (ICOR) and the magnitude of the change in total factor productivity (TFP).

The substantial increase in investment, financed through the oil boom, also fueled the growth of the non-oil economy during 1973-81. Given the low initial capital base, these investments continued to yield a still fairly high average return. But as investment went into more capital-intensive areas, the ICOR rose. Economy wide efficiency also declined as policy became more inward-oriented.

Table 8: AGGREGATE EFFICIENCY INDICATORS, 1973-88

| | 1967-73 | 1973-81 | 1982-85 | 1985-87 | 1988-91 |
|---|---|---|---|---|---|
| A. Rate of return on investment (% p.a.)[a] | 53.4 | 31.4 | 13.1 | 26.0 | 17.0 |
| B. Incremental Capital Output Ratio (ICOR) | 1.8 | 2.8 | 7.8 | 5.3 | 3.7 |
| C. Total factor productivity (TFP) Change | | | | | |
| Growth rate of: | | | | | |
| Value added[b] | 7.8 | 8.0 | 4.0 | 5.9 | 7.5 |
| Factor inputs | | | | | |
| - Labor | 2.8 | 3.0 | 2.8 | 7.3 | 2.1 |
| - Capital[c] | 7.6 | 10.7 | 9.8 | 6.8 | 8.4 |
| Total factor productivity[d] | 2.1 | 0.9 | -2.5 | -1.1 | 2.2 |

[a] Rate of growth of non-oil GDP as a percentage of average investment rate during the period.
[b] Using non-oil GDP.
[c] Capital stock derived by using the "perpetual inventory method."
[d] TFP change is calculated as the difference between rates of growth of value-added and factor inputs (labor and capital); the inputs are weighted by their income shares.

Source: World Bank staff estimates.

The legacy of promoting investment behind protective barriers became more apparent in the early-1980s, after the collapse of oil prices. The Government's initial response was to protect industry even more, through a proliferation of NTBs. Capital productivity fell sharply during 1982-85, as did the rate of return on investment and TFP.

Following the reforms of the mid-1980s, there has been a turnaround in productivity and efficiency indicators. ICOR levels have fallen steadily as more labor intensive export industries have emerged as the engine of growth. The decline in TFP was reversed, and its growth in 1988-91 was matched only by its performance during 1967-73.

# III. CONTINUITY AND CHANGE IN THE POLICY FRAMEWORK

## Overview of Policy Directions

Over the past twenty-five years, Indonesian policy has been marked by continuity. Not surprisingly, the areas of continuity are those where there was an early and clear consensus among the country's leadership. These areas are: (i) macroeconomic stability; (ii) agricultural and rural development; (iii) improvement in social conditions and human resource development; and (iv) infrastructure. The emphasis on agriculture, improvements in social welfare and upgrading the nation's extremely weak infrastructure base was shared by a broad group of leaders. Their views on agriculture were reinforced by the food crisis of 1974-75, when Indonesia was unable to buy enough rice in the international market. As for the emphasis on macroeconomic stability, it came from the chaotic experience of the mid-1960s: the hyperinflation of the 1965-66, from which emerged the balanced budget law of 1967; the capital flight, and the complete erosion of investor confidence, from which stemmed the decision to open the capital account; and the debt difficulties and rescheduling in the early years of the New Order Government (1968-69) and the Pertamina debt crisis of 1975, which led to caution on external borrowing.

There were, in contrast, two areas where government policy was more ambivalent. The first was a willingness to rely on the market economy. Although the New Order Government took some steps during the late 1960s to liberalize the economy, they did not last; they were overtaken by concerns about the concentration of ownership in the Chinese minority, distrust of foreign investment, and a desire to regulate private activity towards desired social ends. The rapid expansion of the Government machinery during the 1970s was itself a powerful force for boosting the role of the state in ownership and control.

The second area of policy volatility involved the tradeoff between growth and equity. Social and regional equity have been a shared concern of both the Old Order and the New Order Governments. During the oil boom, it was easier for the Government to manage the tradeoff, because it could afford to expand rural and social infrastructure. During the reforms of the 1980s, however, the social cost of adjustment has been a continuing theme. The Government managed the tradeoff between growth and equity by protecting social expenditures and creating an early supply response. Even so, and despite strong economic growth, many people concerned about the equity and regional impact of the new prosperity. They fear that the new liberalization has created vested interest groups. In response, the Government has continued to use suasion and regulation in an attempt to meet social and equity objectives.

## Macroeconomic Policies

The combination of a balanced budget, an open capital account and generally cautious external borrowing has created a prudent and responsive macroeconomic framework. The open capital account has kept a check on monetary expansion through its influence on external reserves. At the same time, although external borrowing and the drawdown/build-up of Government deposits have allowed fiscal policy to deviate from a strict balanced budget rule, the absence of domestic borrowing and money creation have ensured that Indonesia avoided the fiscal excesses common in many other developing countries. The fiscal rule also provided an impetus to undertake longer-term fiscal reforms during the

1980s, on both revenue and expenditure. An added feature of macroeconomic policy was active exchange rate management as an instrument to maintain the competitiveness of the non-oil economy.

Fiscal Policy. During the 1970s, government spending grew very rapidly. However, oil revenues were so large that the Government was able to build up a substantial stock of assets. During the 1980s, fiscal policy had to change, to achieve macroeconomic stabilization and less reliance on oil revenues. The Government was largely successful in achieving both of these objectives. Initially, it did so by cutting investment. Many large capital intensive projects were rephased in 1983, and public investment continued to decline in real terms until 1987. In addition, the Government undertook a sweeping tax reform in 1984-86, to boost non-oil tax revenues and improve the efficiency of the tax system (Ahmed, 1989; Asher, 1991). As a result, non-oil taxes as percent of non-oil GDP rose from 8.3% in 1982/83 to 13.2% in 1991/92. The Government also reduced current outlays through a three-year freeze on civil salaries (1986-88) and much slower growth in the civil service. These steps turned a public sector deficit of 4.9% of GDP in 1982/83 into a surplus after 1990. The unexpected surge in private investment since 1988 has created extra demand pressures requiring an even more cautious fiscal stance.

Monetary Policy. Fiscal policy was complemented by monetary and financial policies to contain inflationary pressures, prevent capital flight, boost savings and improve the allocation of financial resources. When monetary policy was lax, as in late 1989, the open capital account provided an immediate signal of inconsistent policies, and the Government was prompt to respond. Reserve money growth as well as growth of monetary aggregates have been substantially reduced over the adjustment period. The ability to bring down inflation and preserve depreciation in the real exchange rate is testimony to the soundness of fiscal and monetary management albeit at the cost of high interest rates in periods such as 1990-92.

Exchange Rate Management. Indonesia has pursued a more active exchange rate policy than other Southeast Asian economies, particularly during the 1980s. After several devaluations in the late 1960s, the nominal exchange rate remained unchanged for a long period after 1971. With the surge in oil revenues, the result was a real appreciation of currency. This prompted growing concerns about the competitiveness of the non-oil economy. The Government responded with a 34% devaluation of the exchange rate, even though there were no balance of payments pressures. The devaluation was eroded over the next eighteen months, because of the second oil price increase of 1979-80 (Pitt, 1991). Without the devaluation, however, the real exchange rate would have appreciated even more.

Indonesia had two maxi devaluations during the 1980s – one in March 1983 at the start of the first stabilization period, and the second in September 1986. Whereas the first devaluation was primarily aimed at closing the large current account deficit, the second was specifically intended to improve the competitiveness of the non-oil economy. Indonesia changed to a managed float system after the 1978 devaluation, but the float was applied actively only from 1988.

As a result of these policies, Indonesia has been able to sustain a real depreciation of 55% since 1983. This has contributed to successful adjustment in four ways: (i) stimulating a strong export response that reduced the transitional costs of adjustment; (ii) restraining imports; (iii) facilitating trade liberalization; and (iv) improving competitiveness and thereby supporting a strong recovery of private investment.

External Borrowing. Indonesia has gone through several cycles of external borrowing. It borrowed excessively in the early 1960s, which led to the debt reschedulings of the late 1960s. As

shown in Fig. 6, there was a second surge in borrowing in 1975, partly driven by the state oil company (Pertamina). Following the resolution of the Pertamina crisis, the Government brought in strict controls on public enterprise borrowing and used the windfalls to reduce external indebtedness. By 1980, the debt service ratio was down to 13%.

However, in the early 1980s, the Government turned to commercial borrowing to finance several large public sector investments. When oil prices declined in 1982, it borrowed even more to meet the financing gap. Much of this increased borrowing was yen-denominated; so when the yen appreciated in 1986-87, the level of debt and debt service rose considerably.[1]

When oil prices declined again in 1986, external borrowing was more prudently managed than in the first adjustment period. The Government relied on concessional official financing rather than commercial financing to support the balance of payments. Although borrowing rose after 1986, the debt service ratio declined from 40% in 1986/87 to 30% in 1991/92, thanks to the recovery of non-oil exports. A third surge in external borrowing occurred in 1990, this time largely due to private sector investment. A growing number of large public and quasi-public projects also added to borrowing pressures. In response, the Government moved to restrain aggregate demand, and set up a ministerial team to establish borrowing ceilings for public and quasi-public entities.

In general, Indonesia's external borrowing over the past twenty-five years has been prudent. It has been used to finance development expenditure and to facilitate smooth adjustment. Nonetheless, the scale of external borrowing in the 1980s has left Indonesia with a debt burden that is significantly larger than that of other East Asian economies and which has largely offset the "oil advantage" that Indonesia had previously enjoyed. In 1991, public debt service totalled $8.5 billion, more than the revenues received from oil (excluding LNG).

## Trade and Regulatory Policies

Initial Liberalization, 1966-71. Despite three liberalization attempts in 1951, 1955, and 1957, the Indonesian economy became progressively inward oriented and regulated during the Soekarno period. The first major liberalization occurred during 1966-71, when the New Order Government dismantled the import licensing system, removed most price controls, eliminated direct allocations of foreign exchange, and opened the economy to foreign investment (Pitt, 1991). These changes were introduced with extraordinary speed, unlike the reforms of the 1980s, and against a backdrop of chaotic macroeconomic and social conditions. However, although the import licensing system was eliminated, not much change was made to the protective structure of tariffs. And it was notable that improvement in incentives to exporters came before the liberalization of the payments system for imports.

Inward Orientation and Regulation, 1973-85. The appreciation of the real exchange rate after 1971 led to increased pressures to protect industry. By 1980, Indonesia's import regime was characterized by disparate tariff rates, and a range of non-tariff barriers (NTBs). The NTBs included an importer licensing system, import bans and quotas, and various informal quantitative restrictions (e.g., the complex port and customs clearance procedures). During the early 1980s, the government expanded the role of import licensing controls with the intention of boosting import-substitution in such basic goods as cement, chemicals, fertilizers, synthetic fibers, and iron and steel. The Ministry of Trade issued

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[1] Depreciation of the U.S. dollar added $12.1 billion (31 percent) to Indonesia's public debt between 1985 and 1988.

several decrees in late 1982 and early 1983 increasing the number of products requiring an "approved-importer" license.[2] It also cut the number of approved traders was reduced, often to as few as two or three (usually state-owned) companies. Besides nominating who may import, some decrees also established the Department of Trade's authority to fix formal quotas. For manufactured goods, these decisions were based on consultation with the Department of Industry, and were often linked to local content programs. These programs, designed to increase the local content of various domestic assembly activities, initially covered motor vehicles, tractors, diesel engines, and motorcycles, but were then extended to construction equipment, diesel engines, home appliances and electronic goods.

By 1985 a plethora of decrees had brought a wide range of products under different forms of import control. This made it extremely difficult for potential investors or policy makers to get a clear picture of the impact of the existing trade regime on the economy. It is estimated that in 1985 some 1,484 CCCN items (28% of the total) were restricted to holders of an approved-importer license. These items accounted for about 26% of total import value and 32% of domestic value added (excluding construction and services).[3] However, the level of protection for domestic producers varied significantly. In the most restrictive cases (e.g., some iron and steel, plastics and agricultural products), imports were channeled through a sole importer, often accompanied by a binding quota. In other cases, where licenses were restricted to a few approved traders, imports may have been informally controlled through approval of the annual import plan by the Department of Trade. At the other end of the spectrum, there were the approved-importer quotas. Of the 1,484 items under approved-importer license, less than one quarter were subject to formal quotas. In addition, there were 24 products where imports were banned. They included automobiles, motorcycles, Tvs and radios in CBU condition.

The combination of NTBs and high tariffs produced high rates of protection in many manufacturing activities. Overall, the regime favored import-substitution over exports. It also favored "basic" or "upstream" industries over "final product" or "downstream" industries. As a result, resources were drawn into relatively inefficient capital-intensive activities supplying the domestic market. The more labor intensive/efficient downstream producers were penalized and export growth was reduced.

Domestic Regulations and Foreign Investment Policies. The private sector in the 1970s and the early 1980s was not just hindered by trade-related regulations but also by a multitude of domestic controls and procedures. The combination stifled competition, inhibited flexibility, encouraged "rent seeking" and held back productivity improvements. The main elements of the regulatory framework were: a restrictive investment and capacity licensing system; extensive controls on foreign investment; a proliferation of provincial and local regulations; cumbersome land and labor laws; and an increasingly outmoded framework of corporate law.

The main instrument of investment licensing was the Investment priority (DSP) list, which regulated entry into specific industries for both foreign and domestic investors. The DSP list specified four categories of investment: those open to foreign investment; those open to domestic firms seeking

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2 This restricted the right to import such goods to designated traders or producers. The actual degree of restriction depended on such factors as the number of license holders and whether a quota was in effect.

3 These calculations include oil and petroleum products, for which there are very few license restrictions. Excluding these items would increase the coverage of license restrictions to 30% of import value and 53% of domestic value added (excluding construction and services).

incentives;[4] those open to small and medium scale industry and domestic investors without incentives; and those closed to further investment. The DSP list often indicated the number of projects for which licenses would be given, as well as the permitted capacity.

Apart from the investment license, a firm had to obtain several other licenses and permits, including many at the provincial or local level, before it could commence operation. These included: the import and export licenses described earlier, a domestic trading license, a storage permit, land rights, location permit, nuisance license (including pollution control approval), building permit, safety permit, tax registration and permanent operating license. Although many of these licenses served legitimate regulatory concerns, the procedures for obtaining them were complex. They represented a significant barrier to entry in terms of time, money and uncertainty. The entire process of getting approval often took more than two years from the investment proposal stage.

Foreign firms wishing to invest in Indonesia were subject to even tougher rules than domestic firms. These included (a) generally more restrictive investment licensing criteria; (b) minimum initial requirements for local ownership, plus specified phasing for the transfer of the company from foreign ownership to local ownership; (c) a ban on domestic trading of outputs and marketing of Indonesian exports as well as restrictions on what domestic inputs could be purchased; (d) limitations on land lease; and (e) limited access to domestic capital including export finance.

Public Enterprises. Investment by public enterprise (PE) rose sharply in the 1970s and early 1980s supported by burgeoning oil revenues. By the mid-1980s, there were 214 centrally owned PEs plus many others at the provincial and local public levels. The central enterprises range widely in agriculture, manufacturing, trading, banking, other services and public utilities, and are supervised by 14 ministries. The stated objectives of PEs are: (a) to earn profits and contribute to government revenues; (b) to contribute to national economic development; (c) to provide public utility services; (d) to undertake pioneering activities that the private sector would not; and (e) to provide guidance to the private sector and cooperatives, and to complement their overall activities. PEs are required to prepare corporate plans on a rolling basis, though less than half have complied with this condition. The annual budgets of PEs are examined by their supervising (technical) ministries and the Ministry of Finance (MOF), which provides finance for them in the government budget. PEs are required to submit monthly financial reports to their supervising ministries and MOF. The audit of PE accounts is undertaken by an independent audit agency (BPKP).

The PEs in Indonesia have suffered from two systemic weaknesses. First, their financial performance has been poor because of overstaffing, multiplicity of objectives, insufficient autonomy and management weaknesses. Second, they have been concentrated in sectors that faced limited domestic or import competition. Consequently, their outputs were often priced well above world prices, putting a burden on other segments of the economy.

Deregulation and Outward Orientation, 1985-91. Beginning in 1985, the Government started to reduce and simplify regulations in order to encourage the private sector. Deregulation has gathered momentum over the past six years, culminating in major reforms of trade policy, investment licensing and transport.

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[4] The incentives provided to domestic investors in this category (and to all foreign investors) are exemptions from import duties on capital equipment and the equivalent of two year's supply of raw materials.

In March 1985, the Government announced an across-the-board reduction in the range and level of import tariffs. The tariff ceiling was reduced from 225% to 60%, with tariff rates for most products ranging from 5% to 35%. The number of tariff levels was also reduced from 25 to 11, although the full benefit of this rationalization was mitigated by the proliferation of license restrictions. Second, the Government overhauled customs, parts and shipping operations, and placed the sensitive job of certifying imports in the hands of private surveyors (SGS). As a result, the time and cost of customs clearance were reduced considerably.

During 1986, the Government moved to the next stage of trade policy reform. It insulated exporters from the adverse effects of the import regime, and it began to dismantle the import licensing system. In May, it announced measures that gave major exporters access to unrestricted and duty-free imports. In October, following the 31% devaluation of the exchange rate, it took the first steps to dismantle the complex import licensing system. The intention was to phase out non-tariff barriers (NTBs) and move towards an import regime based solely on tariffs. Since then, the Government has announced five further trade packages to reduce NTBs, reform the tariff structure, and reduce some export restrictions.

Reform of NTBs. As shown in Table 9, the share of imports subject to NTBs fell from 43% in 1986 to 13% in June 1991, and the proportion of domestic production protected by NTBs has declined from 41% to 22%. The NTB coverage of domestic production of tradeables is lower, covering only covers 8% of total production value. Nevertheless, some important subsectors in manufacturing such as engineering goods, paper products and food processing and a significant proportion of agricultural goods remain subject to NTBs.

Table 9: IMPACT OF REFORM PACKAGES ON IMPORT LICENSING COVERAGE SINCE 1986/a

| | Mid-1986 | End-1988 | June 1991 |
|---|---|---|---|
| NTB coverage as: | | | |
| % of CCCN items | 32 | 16 | - |
| % of HS items | - | - | 10 |
| % of import value | 43 | 21 | 13 |
| % of total production value | 41 | 29 | 22 |
| Memo items: | | | |
| % of domestic production coverage of NTBs: | | | |
| - Manufacturing | 68 | 45 | 32 |
| - Agriculture | 54 | 41 | 30 |
| - Mining and minerals /b | 0.2 | 0.2 | 0.2 |

/a There is a discontinuity in the series from end-1988 due to two causes: the shift from CCCN to the HS system of tariffs; and the update from 1985 to 1987 production weights for calculating production coverage ratios of NTBs. However, this discontinuity does not change the trends since 1986. It should be noted that the food, beverages and tobacco industries are included in the manufacturing sector.

/b Including oil and gas.

Source: World Bank staff estimates.

Table 10: CHANGES IN THE TARIFF SCHEDULE /a

| | Pre-1985 | 1989 | 1991 |
|---|---|---|---|
| Average tariff rates (%) | | | |
| Unweighted | 37 | 27 | 20 |
| Weighted | | | |
| - by import value | 22 | 12 | 10 |
| - by domestic production | 29 | 19 | 15 |
| Index of dispersion /b | 62 | 93 | 83 |

/a Includes surcharges.

/b Measured by the coefficient of variation.

Source: World Bank staff estimates.

Tariff Reforms. The average level and dispersion of tariffs have also fallen considerably (Table 10). The (unweighted) average tariff is now 20%, compared with 37% before 1985. The latest reforms have concentrated on cutting tariff rates above 35%, as part of the general move towards a tariff structure with a ceiling of 30-35%. At present, around 83% of all items have tariff rates at or below this range. In line with the Government's efforts to promote an open economy, the reforms in the tariff structure have ensured that over half of the domestic output from import competing sectors have tariffs of 10% or less.

Reform of the Export Regime. One big change in export incentives was the creation of a duty exemption and drawback facility in May 1986. This facility partially protects exporters from the anti-export bias that still exists in the economy, by allowing them to import their inputs free of duty, and by allowing them to bypass the import license restriction[5] (for those products under NTBs). In addition, the provision of pre-shipment export finance guarantee (PEFG) and export credit insurance/guarantee (ECI) have been valuable moves for exporters. Even so, less has been done to improve export incentives than to liberalize imports. Over one quarter of domestic tradeables are still subject to some form of export control.

Other Regulatory Reforms. Beginning in 1985, the Government began to liberalize the investment licensing system, initially through the streamlining of licenses and approval procedures. In 1989 it went much further, replacing a partial and complex positive list with a short negative list of activities closed to private investment. Virtually all areas of manufacturing that were open to domestic investors were also opened to foreign investment. Since 1989, the Government has continued to reduce the scope of the negative list.

As a result of these reforms, investment licensing is no longer a significant barrier to entry of firms in the tradeable goods sectors. Investors are largely free to respond to the more competitive environment. The deregulation has also meant a much greater degree of competition from foreign firms. This trend has been assisted by other measures to reduce impediments to foreign investment. In particular, divestiture requirements have been relaxed, and virtually eliminated for export-oriented investment, and the differential treatment between domestic and foreign firms in trade and access to finance has been considerably reduced.

A third area where major regulatory reforms were introduced in 1989 was shipping which plays a particularly important role in Indonesia. The 1989 reforms transformed the industry from being highly regulated into one of the most liberal in the world.

Effects on Effective Rates of Protection and Competition. The scale of the trade reforms can be gauged from the effective rates of protection (ERPs). Although the estimates for 1975 in Table 11 are not strictly comparable with those for 1987 and 1990 because of differences in methodology, they suggest that the level and dispersion of effective protection, as well as the anti-export bias, have been substantially reduced since the 1970s and the 1980s. ERPs remain high for engineering and food industries, which are also the ones with NTBs. Despite the reforms, the level and dispersion of ERPs are still high compared with countries that have completed comprehensive trade liberalization, and there is a continuing bias against exports.

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[5] Import duty and VAT exemptions can be given for either a firm's total imported inputs--if the firm exports 65% or more of total production--or on a consignment basis (where a particular import order is directly linked to an export order).

Table 11: EFFECTIVE RATES OF PROTECTION IN MANUFACTURING

| | EFFECTIVE RATE OF PROTECTION (%) | | |
|---|---|---|---|
| INDUSTRY | 1975 | 1987 | 1990 |
| Basic Industries | 38.7 | 8.0 | 5.0 |
| Non-oil | - | -1.0 | 1.0 |
| Oil refining | - | -1.0 | -1.0 |
| Iron and steel basic industries | 18.2 | 13.0 | 10.0 |
| Chemicals | 28.4 | 14.0 | 13.0 |
| Cement | 63.6 | 60.2 | 53.6 |
| Capital Goods Industries | 15.3 | 150.0 | 97.0 |
| Engineering goods | - | 152.0 | 139.0 |
| Intermediate Goods Industries | 49.0 | 42.0 | 40.0 |
| Wood and cork products | -1.2 | 25.0 | 33.0 |
| Rubber and plastic products | 426.0 | 57.0 | 48.0 |
| Consumer Goods Industries | 116.2 | 87.0 | 64.6 |
| Food, beverages and tobacco | 336.2 | 122.0 | 124.0 |
| Paper and paper products | 87.3 | 31.0 | 20.0 |
| Textiles, cloth and footwear | 231.8 | 102.0 | 35.0 |
| Manufacturing Total (excluding oil refining) | 74.1 | 68.0 | 59.0 |
| All Tradeables (excluding oil sector) | 29.7 | 26.0 | 24.0 |
| Import-competing sector | 61.0 | 39.0 | 35.0 |
| Export-competing sector | -6.0 | -2.0 | -1.0 |

The trade and regulatory reforms also appear to have led to an increase in competitive pressures. Table 12 presents three types of evidence on the degree of competition. First, the four-firm concentration ratio is an indication of the degree of competition between domestic firms in the domestic market. Second, the import penetration ratio (percent of imports as a percent of output available in the total domestic market) indicates the degree of competition posed by imports. Third, the export share measures how far firms are subject to competition in foreign markets.

Overall, competition appears to have been promoted most in textiles, wood products and other manufacturing. The areas where competition is still limited tend to be dominated by the public sector and by conglomerate interests. This is also an important reason why there has been less progress on import deregulation and domestic competition in these sectors.

Table 12: THE EFFECTS OF THE REFORMS ON COMPETITION IN THE INDUSTRIAL SECTOR (in %)

| Sector | 1985 /a | | | | | 1989 /c | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Govt /b Share | Conc. Ratio | Import Penet. | ERP | Export Share | Govt /b Share | Conc. Ratio | Import Penet. | ERP | Export Share |
| Food,Bev.& Tob. | 22.1 | 60.2 | 4.4 | 122.0 | 8.4 | 16.8 | 39.7 | 6.2 | 149.5 | 6.3 |
| Textiles | 30.2 | 40.6 | 5.8 | 102.0 | 11.5 | 4.7 | 13.8 | 8.7 | 79.1 | 16.7 |
| Wood & Wood | 22.6 | 18.8 | 0.6 | 25.0 | 28.0 | 3.2 | 11.9 | 0.7 | -2.9 | 34.6 |
| Paper & Paper Prod. | 33.1 | 45.3 | 25.2 | 31.0 | 1.9 | 16.9 | 33.1 | 21.6 | 16.8 | 5.7 |
| Chemicals & Plastics | 51.2 | 49.7 | 33.2 | 14.0 | 3.0 | 30.4 | 18.3 | 33.0 | 39.6 | 4.7 |
| Non-metallic Minerals | 65.5 | 60.2 | 12.0 | 57.0 | 2.2 | 36.5 | 34.2 | 12.6 | 63.3 | 8.9 |
| Basic Metals | 84.6 | 87.1 | 42.0 | 13.0 | 19.0 | 82.7 | 88.1 | 37.8 | 8.3 | 25.0 |
| Machinery & Equip. | 37.7 | 49.7 | 54.0 | 152.0 | 1.8 | 18.7 | 30.0 | 48.4 | 148.0 | 2.8 |
| Other Manufacturing | 39.1 | 75.5 | 35.6 | 124.0 | 19.9 | 0.09 | 32.6 | 33.9 | 86.1 | 32.0 |
| Average (unweighted) | 42.9 | 54.1 | 23.6 | 71.1 | 10.6 | 23.3 | 32.5 | 22.5 | 65.3 | 15.2 |
| 2 sectors with highest public presence | 75.0 | 73.6 | 27.0 | 35.0 | 10.6 | 60.0 | 61.1 | 25.2 | 35.8 | 16.9 |
| 2 sectors with lowest public presence | 22.4 | 39.5 | 2.5 | 73.5 | 18.2 | 4.0 | 12.8 | 4.7 | 38.1 | 25.6 |

/a Import penetration and export shares have been calculated ror 1986.
/b Includes joint ventures.
/c Government share and concentration ratios as % of value-added by sector.

Source: BPS: Census of Manufacturing Industry and World Bank staff estimates.

## Financial Markets and Policies

In the New Order period, the role of government in financial market and policies has changed from extreme intervention to a more market oriented approach. As with deregulation elsewhere in the economy, the turning points in policy are related to the fall in oil prices.

Initial Conditions. During the Old Order period, more and more of the financial sector came under government control. As Woo et al (1992) point out, this was mainly due to an ideology that was averse to financial capitalism. By 1965, government control was extensive. After a series of nationalizations, the financial system was dominated by state banks acting as commercial, savings and development banks. There were the 5 units of Bank Negara Indonesia (BNI unit I functioned as the Central Bank), Bank Dagang Negara (state commercial bank), 23 development banks (1 state owned Bappindo and 22 regional development banks), 2 private savings bank and 87 private commercial banks.

As pointed out by Nasution (1983), the Central Bank also served to implement government spending, since the government borrowed from it in excess of the stipulated 30% of treasury reserves.

Pre Oil Boom Period: rehabilitation and consolidation. At the beginning of the New Order period, the immediate concern was to reestablish the financial institutions as part of the rehabilitation

program. In 1967 the government permitted foreign banks to operate in Indonesia through subsidiary branches, though they could not offer savings deposits, were limited to two branches and could not lend outside Jakarta. Foreign banks were allowed in on a full branch basis up until 1969, then entry was closed.

Second, the government restructured the state owned financial institutions through a series of laws in 1967-69. BNI I became Bank Indonesia, the central bank, and the other units became four independent state-owned banks: Bank Rakyat Indonesia, BNI 1946, Bank Export Import Indonesia and Bank Bumi Daya. Together with Bank Dagang Negara there were 5 state commercial banks, each with its own area of specialization, arranged so that at least two of the state banks covered each major economic sector.

Bank Negara Indonesia 1946: industry/transportation, agriculture/livestock and export producing sectors
Bank Rakyat Indonesia: cooperatives, agriculture/livestock, fishery and rural development
Bank Dagang Negara: mining and export production
Bank Bumi Daya: mining, export production and plantations
Bank Ekspor Impor Indonesia: export production and marketing, plantations

The state owned development bank, Bappindo, was given the task of providing long term development funds; and Bank Tabungan Nasional remained the main savings bank. Altogether, there were eleven types of banks differentiated by ownership and function.

State banks were also given certain privileges that strengthened their position vis-a-vis private banks: access to BI, implicit government guarantee and extensive network of branches, and the fact that state-owned enterprises were required to deposit government funds in state banks. This favoritism had several reasons behind it. First, state banks were the dominant players and had the bigger branch networks. Second, the Government wanted a strong presence in the economy, based on Article 33 of the Constitution. The usual interpretation of the article is that economic activities which affect the daily life of the people should be controlled by the government through state enterprises.

The central bank also played an influential role in the country's financial development, by extending credits to non financial institutions that were mainly government related. Nasution (1983) notes that the official reason for its actions goes beyond the lender of last resort function; the Central Bank has a broader mandate "to finance the implementation of government programs". As such, direct credit was used to support large projects that could not be financed by commercial banks and also to "hide" subsidies paid by the government to stabilize food item prices.

In 1968, the dominance of the state in the financial system was quite plain. State banks held 74% of the total assets of deposit taking banks, and Bank Indonesia and the State banks between them accounted for 93% of total commercial bank credit. The large number of private domestic banks (10 foreign exchange banks and 112 non-foreign exchange banks) accounted only for 25% of assets and 6.3% of credit.

The development of the financial sector and the improving investment climate led to the inflow of the capital needed to rehabilitate the economy. However, the banking sector remained underdeveloped: in 1970, the M1/GDP and M2/GDP ratios remained low, at 7.1% and 9.37%.

Woo and Nasution (1989) and Suwidjana (1984) suggest that the system of credit allocation determined the structure of the banking system, because Bank Indonesia could set the shares assigned to any bank. The ceilings also acted to minimize entry into the banking system.

As for the securities market, up to 1982 its was not very active and provided only a small proportion of total credit. A large number of the companies that went public were foreign, and did so to comply with the divestment requirements and to take advantage of generous tax concessions.

What have been the effects of this financial system? First, investments financed by credits contributed to overall economic growth, but their productivity was poor. Allocation of credit ensured the growing state participation in the economy, notably in the industry. State owned enterprises received 52% of total credit in 1978, and 37% in 1982.

Second, as pointed out by Woo et al (1992) non market credit allocation allowed subsidized credit to increase its coverage, and on even more generous terms. This occurred because of pressure from various interest groups such as estates sugar plantations and construction firms.

Third, an efficient banking system did not develop. State banks did not mobilize savings, then lend and perform their intermediation function. Instead, their main function was to channel money: they were provided low cost and captive funds, and told which sectors to lend to and at what interest rates. As Woo (1992) points out the state banks (unlike the private banks) usually did not use all of their credit allocations. This could have been due to bureaucratic difficulties in obtaining a loan from state banks, inability of bank officers to select acceptable projects, and/or that officers of state banks may have demanded side payments from prospective borrowers. In fact state banks did indeed have problems of mismanagement and high default rates during this period. In 1977 the government had to bail out one of the state banks, Bank Bumi Daya. As for private banks, their ability to intermediate between lender and borrowers was limited by the their credit ceilings.

Fourth, real interest rates on state bank deposits were negative throughout the period of regulated interest rates. The ratio of money supply to GDP remained low and did not increase very much. For MI, it rose from 7.1% in 1974 to 11.36% in 1982, and for M2 from 9.37% to 17.68%.

Fifth, the credit ceilings were not successful in sterilizing the inflow of money from the oil revenues. This was because of leakages from foreign borrowing themselves due to the open capital account. There were practical problems associated with adjusting ceilings quickly and by the right amount.

Initial Oil Price Decline: First Phase Financial Reforms. The response to the initial oil price decline in the early 1980s was to deregulate the financial sector recognizing the need for greater domestic savings to finance further development. In part, the move was also aimed at increasing the efficiency and competitiveness of the financial sector. The main reforms were:

i) the removal of all credit ceilings
ii) a reduction in the number of credit categories financed by liquidity credit
iii) the removal of controls on deposit and lending rates (outside of those still being refinanced by Bank Indonesia) of state banks
iv) the removal of remaining subsidies on deposit rates paid by state banks

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The consequences of the deregulation were as expected. The removal of interest rate controls led to an immediate rise in interest rates and deposits. Real interest rates turned positive, especially for state banks (see figure 1). Total time deposits increased substantially, but barely demand deposits barely changed. Thus the M1/GDP ratio declined after the 1983 reform, while the M2/GDP ratio increased dramatically, from 17.7% in 1982 to 29.6% in 1988.

At the same time, the assets of the banking system and the value of credit given continued to increase rapidly, particularly for private domestic banks. Their share of total assets rose from 12.3% in 1982 to 26.4% in 1988 and of total credit of commercial banks from 12.1% to 25%. And banking became more competitive: the interest-rate spread of state banks fell from 3.3% to 2.3%, and of private banks from 7.6% to 6.6%.[8]

In a more competitive environment, the sluggishness of the state banks was due to their size and the fact that they still functioned as state owned enterprises. They did try to adjust: for instance, BNI 1946 retrenched some 600 people, many state banks offered early retirement, and all went in for substantial training and upgrading. However, they were still subject to the regulations and structure of any other state owned enterprise, so their ability to change has been limited.

Second External Shock: Liberalization of the Financial Sector. The second external shock in 1986 prompted an extensive reform of the financial sector between 1988 and 1992. The October 1988 deregulation removed most of the entry barriers. New banks, whether joint ventures or domestic, can be set up with capital requirements of Rp.50 and Rp. 10 billion respectively, and sound domestic private banks are eligible for a foreign exchange license. Regulations on opening new branches were was substantially relaxed and foreign banks were allowed to open up one sub branch in 6 other major cities. State owned enterprises were also allowed to deposit 50% of their funds in private banks. Reserve requirements, which were thought to be high by international standards and were thus increasing the cost of bank services, were drastically reduced. They fell from 15% for demand deposits and 10% for saving and time deposits to 2% of deposit liabilities. Other measures included the establishment of legal lending limits for loans to a single borrower and to groups of borrowers; banks were allowed to issue shares; and the tax exemption on interest on time deposits was also removed, to equalize the treatment of interest payments and of dividends.

Later, several other policy changes were made in the financial sector. In December 1988, some capital markets deregulation eased the requirements for companies to go public, eliminated the limits on price fluctuations, and gave priority to Danareksa. Foreign joint ventures and local companies were allowed to become securities companies. In mid 1989, the percentage of foreign participation was set at 49% (except for purchase of bank shares), a change that promoted a surge of overseas interest. The equalizing of the treatment of dividends and interest payments also boosted the attractiveness of shares.

Other measures followed, intended primarily to clarify the meaning of various rules. In March 1989 the authorities set out the definition of bank capital, stipulated that banks could not invest in stocks, and replaced foreign borrowing ceilings by a net open position of 25% of equity. This was followed in February 1991 by detailed criteria for bank soundness, higher professional standards for bank directors and commissioners, and a ruling that banks had to meet the BIS Capital Adequacy requirements of 8% by the end of 1993.

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[8] See Chant and Pangestu (1987).

Finally the new banking law was passed in July 1992 and ratified in October. It laid down that there are no more specialized banks, and only two types of banks: general banks and peoples banks. Peoples banks are not allowed to provide demand deposits, or participate in the clearing process and foreign exchange services. Foreigners can now purchase bank shares. The legal status of state banks was changed to a limited liability company, to allow them more autonomy and to be managed as a private corporation. In October 1992, the capital requirements to set up domestic and joint venture banks were raised by five times for the former and by double for the latter. This move appears to have been motivated by the wish to limit the number of new banks. Liquidity credits were also reduced as from April 1990, a change related to the deadline given by GATT to Indonesia to remove the subsidized export credit scheme by April 1991.

What have been the effects of such extensive liberalization? Since 1988 the growth of the financial sector has been dramatic. The number of new banks increased from 61 to 119 in 1991, and the number of foreign banks increased from 11 to 29. The relaxation of branching requirements led to a big increase in the number of bank offices, especially of private domestic banks whose branches expanded from just 559 in 1988 to 2639 by end of 1991.

The range of new products and services has also increased. Various types of savings schemes tied to lottery prizes and gifts were introduced, so saving deposits outside of the government programs increased from Rp.605 billion in 1988 to Rp.9064 billion by June 1992. There was also stiff competition for qualified staff.

The shares of the state banks in assets and credit fell to 50% and 54% respectively by 1991; state banks are still dominant but no longer predominant. They faced strong competition for deposits as well as credit to prime customers, and this pressure initially led to an increase in the deposit rate but very little increase in the lending rate. Later, as deposits increased and banks became very liquid, deposit rates also started to come down. This combination led to an unprecedented increase in credits. They were given not just for production, but also for consumer loans, real estate and reportedly also for the stock market. The share of total credit going to "other" sectors outside of agriculture, industry, service and trade, increased from 6% in 1988 to 12% in 1990. Monetary growth was very high during this period: 40% in 1989 for M1 and M2, and 18% for M1 and 44% for M2 in 1990. As a result GDP growth was also rapid, reaching an average of 7.4% p.a in 1989-90. Inflation also rose, reaching almost 10% in 1990, and the current account deficit increased.

In response, the Central Bank began to reduce liquidity credits in 1990, and tightened its monetary stance. This led to some banks experiencing liquidity problems. As a result deposit rates began to rise dramatically as banks competed for deposits to offset their tight liquidity. Banks and non banks also began to borrow abroad.

In 1990, some banks had a run on their deposits after rumors that they were in difficulty. The mood was aggravated when in August 1990, it was revealed that Bank Duta, one of the ten biggest domestic foreign exchange banks had made losses of US$400 million on foreign exchange dealings. It became clear that at the time Bank Duta went public earlier in the year, the losses had already been made. The fact that the financial statements did not reveal this to the public was considered to be fraudulent, and added to the growing lack of confidence in the stock market.

By the beginning of 1991, money supply growth was high and inflationary concerns were increasing. This led to the Second Sumarlin Shock in February 1991, when Rp. 8 trillion (US$4.2 billion) of deposits of state enterprises were withdrawn from the banks and shifted into SBI (Bank

Indonesia Certificates). As a result deposit rates were increased by four to five percent, which did at least stave off further speculation. At the same time the Government brought in tougher regulations on bank soundness, such as capital adequacy requirements and loan to deposit ratios, with strict deadlines for meeting the requirements.

By June 1991, interest rates offered by state banks on time deposits ranged from 22% to 25%, and the highest interest rate offered by private banks was 28%. In July 1991, the Minister of Finance attempted to "talk down" interest rates by calling a meeting of 68 state and private banks to urge them to lower interest rates. This resulted in some reduction in official interest rates, prompting the banks to turn to non interest competition. They offered time, savings and demand deposits with lottery features and gifts, and some informally agreed negotiable rates with large deposit holders. The effective interest rate is thought to have remained high, and there was the undesirable result that announced interest rates did not provide the correct information to the public. Furthermore the lending rate did not fall in line with the deposit rate.

In September 1991, the banking system was hit by another set of regulations aimed at correcting the balance of payments deficit and curbing the inflow of capital so as to control monetary growth and inflation. The government imposed ceilings on the borrowing of public-sector projects and borrowing by banks, amounting to $5-6 billion over five years.

These "three shocks" - tight money, prudential regulations and offshore borrowing ceilings - have caused considerable problems for the banking system. The tight liquidity position has been relaxed and interest rates on SBI and deposits have fallen. However, the interest rate on lending has not come down in tandem, partly because of the usual lag but also because of increased provisions for problem loans.

Furthermore despite some monetary easing, banks are still slow to increase their lending. They have been constrained by the need to satisfy their capital adequacy ratios (CAR) by the rule that 20% of credit must go to small business, and by the slowdown in the economy. Banks are placing the money they raised in deposits into Bank Indonesia certificates and SBI, their value outstanding has increased dramatically from Rp.9 trillion at the end of the first quarter of 1991 to Rp. 15.5 trillion by mid 1992 and almost Rp. 18 trillion as of October 1992. Banks are willing to place their funds in SBI at a loss because it is classified as a non risky asset and thus, does not affect their CAR. The central bank governor also recently announced that part of the increase in SBI sales was purchases by foreigners in search of high interest rates. It should also be noted that some of the increase in credit reflects the increase in banks lending to customers with problem loans in order to service their debt.

At present there are signs of some financial instability in the banking sector, although it is difficult to say on what scale. Some banks with problems have already emerged and have been "rescued" by arranging for a merger or takeover by another bank. The problem loans appear to have arisen in the period of rapid expansion after the deregulation. Strengthening of supervision is crucial in dealing with the new competitive environment. It remains to be seen whether there will be any further fallout of new banks and whether the central bank can avoid a financial crisis.

On the other hand there are some signs of financial strength. Fixed investment has grown more rapidly than the credit extended by banks, which suggests that the non financial sector is able to

obtain the finance it needs.[9] This is partly due to the explosive growth in the capital markets. Since the 1988 deregulation, the market capitalization expanded from just Rp. 482 billion to Rp. 15.8 trillion by April 1991. The number of companies listed jumped from 24 to 128 by the end of April 1991. Share prices increased rapidly in 1989-90, reaching a peak in . They then plummeted in 1991, reaching a low of ... at the beginning of 1992. They have since recovered, but not back to their earlier peaks.

## Agricultural Development

Indonesia's long-term agricultural growth of 4 percent per annum over 1965-90 compares favorably with most other developing countries, and helped to underpin its overall growth. At the heart of Indonesia's agricultural transformation was the drive for self sufficiency in rice. Based on a strategy of massive investments in agricultural infrastructure and services, a favorable incentive regime (including large and growing subsidies for fertilizers) and strong central direction, rice output grew by 4 percent a year between 1965 and 1990, compared with 2.2 percent for Thailand, 0.6 percent for Malaysia and 2.6 percent for the Philippines.

For the rest, non-farm food crops, tree crops (in the outer islands) and livestock have been the main contributors to agricultural growth. The Government played a major role in the development of tree crops, starting with the nationalization of colonial enterprises and followed by a major expansion of smallholder plots. These were linked to nuclear or large estates, and financed by highly subsidized credit. These measures were not as successful the ones for rice, being more expensive and often not achieving planned yields. Nevertheless, the area and production of palm oil, copra/coconut oil, tea and coffee expanded during the 1970s and 1980s. Like Malaysia and Thailand, and unlike most other developing country producers, Indonesia was thus able to maintain its income terms of trade for primary exports in the face of declining prices. Since tree crops are produced mainly in the outer islands, the strategy has fostered more balanced regional development.

In addition to its interventions in rice and treecrops, the Government has sought to promote a diversification of farm crops through area controls and special programs (e.g., sugarcane and soybeans). These policies have not been successful (Tabor, 1991) suggesting that the "rice model" is not readily applicable to other crops.

Agricultural growth slowed during the 1980s, as a result of the limits to irrigation expansion, near-complete adoption of high yielding varieties and depressed commodity prices. Rice output has decelerated further in the late 1980s but estate crops, livestock and fisheries continue to expand at over 4 percent p.a. and are now bigger contributors to agricultural growth.

## Manufacturing

Indonesia's manufacturing output grew by more than 12 percent a year in 1965-90, a record exceeded only by the four "East Asian NIEs". Although this growth took place from an exceptionally low base, Indonesia's industry has nevertheless been transformed. The share of manufacturing in GDP increased from 8.5 per cent in 1965 to 19 percent in 1990 and will surpass agriculture as the largest sector in the economy by 1995.

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9 See Chant and Pangetsu (1992).

The stabilization and liberalization program of the late 1960s provided the first stimulus to manufacturing growth. Companies benefitted from the resurgence of consumer demand, the dismantling of controls on foreign exchange, and improved access to inputs (Hill, 1991).

During the next phase, which lasted from 1973 to 1985, the Government sought to accelerate the pace of industrialization through a combination of import substitution policies, regulation of investment and state ownership. Indonesia was more successful than other oil exporters in moderating the rise of its real exchange rate. Nevertheless, in the face of a gradual erosion of competitiveness and pressures from domestic interests, the trade regime became increasingly protectionist. Government began to rely more on investment licensing to regulate domestic and foreign private investment as well as to invest in capital-intensive and resource-intensive industries such as oil refining, LNG, chemicals, pulp and paper, fertilizer, cement and steel. The result was that although industrial growth accelerated in the 1970s, it became increasingly inefficient. An added policy intervention that had a significant impact was the ban on log exports in the 1981 aimed at boosting the development of wood-based industries.

The high cost structure of industry and the end of the oil boom prompted a reassessment of industrial strategy in the early 1980s. Although REPELITA IV proposed a further push to heavy industry, economic circumstances strengthened the hands of policy makers who favored a different approach. As part of the fiscal adjustment of 1983, several large public projects were cut back or shelved. But the big shift in strategy came after the second oil shock of 1986. An export incentive package was introduced in May 1986, with the aim of boosting non-oil exports. Then it became clear that more comprehensive reforms were needed to achieve that objective, so the Government announced a large devaluation in September 1986 and the first of a series of trade reforms in October 1986. Just as had happened in the late 1960s, the stabilization and adjustment program of the mid-1980s boosted manufacturing output, exports and investment. What was particularly striking was the speed with which manufacturers responded to the reforms.

The rapid growth of manufacturing production has brought about large structural changes, but in ways that are different from other East Asian economies. Unlike these economies, Indonesia's manufacturing industry has been primarily based on the exploitation of natural resources. As shown in Table 13, 60 percent of output and 90 percent of exports in 1977 were resource based.[10] By 1988, the proportion of output was still more than 50 percent, but there had been a noteworthy shift in exports to labor intensive goods. In contrast to exports, imports are relatively skill and technology intensive, reflecting Indonesia's liberal policy on technology imports and foreign investment.

These trends suggest that Indonesia has moved to a labor intensive path of export-led growth at a much later stage than other East Asian countries. The devaluation of 1986 and the sharp appreciation of the yen boosted Indonesia's comparative advantage in labor intensive production,[11] making it the cheapest source of unskilled labor in the region, apart from China.

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[10] If agriculture and oil are included, the resource-based structure of production is even more striking.

[11] The Rupiah was devalued by 31 percent against the dollar in September, but when combined with the depreciation of the dollar against the yen, the rupiah's competitiveness vis-a-vis the yen improved by a massive 65 percent.

**Table 13: INDUSTRIAL OUTPUT, EXPORTS, IMPORTS, BY FACTOR INTENSITY: SELECTED PERIODS /a**
**(in % of period total)**

| By Factor Intensity | Output | | Exports | | Imports | |
|---|---|---|---|---|---|---|
| | 1977 | 1988 | 1977 | 1988 | 1977 | 1988 |
| Resource Based | 59.2 | 54.0 | 89.5 | 63.1 | 27.2 | 14.2 |
| - Agriculture | 46.2 | 30.1 | 67.3 | 15.6 | 20.5 | 6.4 |
| - Timber products | 4.6 | 16.0 | 4.8 | 32.5 | 2.2 | 3.7 |
| - Minerals | 8.4 | 7.9 | 17.4 | 15.0 | 4.5 | 4.1 |
| Unskilled Labor | 22.9 | 26.2 | 1.8 | 22.9 | 9.6 | 10.7 |
| Technology | 6.9 | 10.7 | 4.3 | 6.8 | 28.6 | 40.5 |
| Skilled Labor | 11.0 | 9.0 | 4.5 | 7.2 | 34.5 | 34.6 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

/a Medium and large scale enterprises only.

Source: World Bank staff estimates.

Both foreign and domestic firms have responded to these attractions, helped by the deregulation of imports and of investment licensing. Foreign investment approvals increased ten-fold between 1986 and 1991 to over $8 billion; and domestic investment rose by a similar proportion, to $30 billion. The approval data also show that 70% of foreign investment approved was export-oriented, compared with 38% in 1986. Although the share of labor intensive sectors in these investment plans is higher than in the past, capital intensive resource based investments still account for a significant share of total investment. The share of engineering goods, although rising, is much smaller than in other East Asian economies.

## Infrastructure

In addition to stimulating agricultural growth and developing human resources expanding and upgrading infrastructure was one of the early priorities of the New Order Government. This was reflected in the Guidelines of State Policy and successive five-year development plans. The expansion and improvement of infrastructure had two objectives: to provide the conditions for sustaining economic growth; and to integrate and foster equitable development of the regions and rural areas.

This emphasis on infrastructure is reflected in the large share that it received in the budget. On average, 40 percent of Government development expenditure has been allocated to economic infrastructure. Even during the 1980s, when the Government had to cut real spending on everything, it boosted infrastructure's share. With the recovery of growth, and the surge in private investment, the Government is placing renewed emphasis on infrastructure. But it is now opening up many areas of infrastructure investment to the private sector (e.g., power, telecommunications, ports, roads).

The stress on infrastructure has paid rich dividends (see Table 14). For example, the installed capacity of the state electricity company (PLN) has increased eighteen-fold since 1970; the number of telephone lines rose seven-fold; and the length of paved roads increased almost six-fold, nearly eighty percent of which was at the district level. In telecommunications, Indonesia became the first developing country to install a domestic satellite system.

Table 14: EXPANSION OF SELECTED INFRASTRUCTURE, 1970-90
(% p.a.)

| | 1970-75 | 1975-80 | 1980-85 | 1985-90 |
|---|---|---|---|---|
| Power | | | | |
| PLN sales | 11.5 | 18.1 | 14.2 | 16.0 |
| Telecommunications | | | | |
| Telephone lines | 4.6 | 15.4 | 7.5 | 13.2 |
| Transport | | | | |
| Paved roads | 10.2 | 11.3 | 8.0 | - |
| Water | | | | |
| Land under irrigation | 2.9 | 1.8 | 5.0 | 1.0 |

Source: Various GOI publications and World Bank Staff estimates.

## Human Resource Development

Section I highlighted Indonesia's impressive progress in human resource development. This was the direct result of a government commitment at the highest levels, which ensured the establishment of successful institutions for the delivery of basic services and the allocation of substantial resources (financed in part by the oil boom of the 1970s) through special programs. The measures underlying the progress in each of the main areas are described below.

Family Planning. Indonesia's success in family planning is largely due to BKKBN, a centrally directed but community oriented coordinating ministry created to promote family planning and community welfare. BKKBN was successful in making safe and affordable contraceptive methods available in villages and involving the community in adopting these methods. As a result, contraceptive use rose from 10% in the 1960s to 50% in 1991, matching countries with much higher per capita levels of income so this was reflected in a near halving of the fertility rate, from 5.6 to 3.1.

Nutrition and Infant Mortality. Indonesia has done much to reduce the incidence of malnutrition among children. The growth of food production and rural incomes has been a leading cause, but government programs (including nutrition education and distribution of Vitamin A capsules) have played their part. These gains, along with fertility declines have, contributed to a sharp reduction in infant mortality, as have government programs of immunization against childhood diseases. Access to

health services expanded during the 1980s, with the establishment of a network of nearly 6000 health centers, each serving several sub-centers and 40 village-level health stations.

Basic Education. A massive program of school building, teacher training and subsidy (abolition of official fees) during the 1970s and 1980s enabled Indonesia to achieve universal primary education for boys and girls. There are currently 26.5 million students being served by 146,000 schools and 1.1 million primary school teachers. This effort helped boost adult literacy from 56% in 1970 to almost 80% by 1990. Government programs have also brought about large increases in secondary level enrollment during the 1970s and 1980s, so that primary and secondary enrollment rates compare favorably with countries with higher per capita incomes.

Tertiary Education. Indonesia has also done so much to expand tertiary education. Enrollments rose from 2% in 1970 to 9% by 1990, with most of this increase coming from private institutions. Private universities and colleges now account for two-thirds of post-secondary enrollment.

# IV. THE INSTITUTIONAL FRAMEWORK AND IMPLEMENTATION OF REFORMS

A country's institutional set-up covers the rules that affect the behavior of people or groups - rules which can be in the form of formal institutions or can work more informally (Campos (1992)). In addition it is crucial to understand the dynamic between groups. The aim of this section is to explain the main elements of the institutional set-up underlying policy making in Indonesia, and then to analyze how this ties in with other factors to explain the policy outcomes discussed in earlier sections.

## The Political System and State Autonomy [12]

The dominance of a single political party in East Asia is often thought to be a reason for the state's ability to adopt and implement long term public policy, because potential conflicts can be internalized. In most cases there is a mechanism through which society's wishes can be made known, but the dominant party has control (Campos (1992)).

The essential characteristics of Indonesia's system are as follows.

First, the election of the Indonesian political elite is largely unaffected by financial contributions from certain groups in society. Most decision makers are not elected politicians but bureaucrats. For most of the New Order period, abundant oil revenues ensured that the government was not beholden to individual business groups.

Second, the adoption of a corporatist strategy has ensured that policy making occurs without direct societal pressure. The approach to the restructuring of the political system in the new order period was greatly influenced by the experience of the mass political mobilization of the Soekarno years. The result was a network of functionally-based representative organizations which would serve as the conduits for channeling societal aspirations upwards to state leaders and which would be imbued with a collectivist spirit. It was seen as both an indigenous and, more broadly, an Asian alternative to what was regarded as the divisive Western capitalist and liberal democratic thinking associated with a pluralism and competitive party system". (MacIntyre (1991), p.24.)

Such a strategy entailed centralizing power, which was justified on grounds of national security. Part of the strategy involved the establishment of a single body to represent various groups in society, especially the five mass organizations of labor, youth, women, peasants and fishermen. The leadership of these strategic groups was overseen by the state. In the same spirit, the nine opposition political parties were merged into two parties: the Development Unity Party (PPP) which combined the former Muslim parties; and the Indonesian Democratic Party (PDI) which combined the other nationalist and Christian parties. Another part of the strategy was to prevent the establishment of party offices in the villages and small towns, to limit the reach of the opposition parties. This rule was removed at the last election in May 1992.

Third, control within the state itself was achieved in several ways. The civil servants were put under the Civil Servants Corp. (KORPRI); and since they were integrated into of GOLKAR, they provided a reliable part of the voting population. Civil servants, such as village heads, could "campaign" in the villages. The army was also reorganized to reduce the power of regional commanders.

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[12] The section below analyzing the Indonesian situation draws from MacIntyre (1991).

MacIntyre (1991) characterizes the structure that developed as one which was managed "by a military and bureaucratic elite" in which Golkar, KORPRI and the armed forces were instruments. The development of this structure culminated in a 1985 law requiring all social and political organizations to adopt the state ideology of Pancasila. This is based on five social and humanitarian principles, but is used by the government to head off factional interests. As such, in the largest Moslem country in the world, there is no political party carrying a religious banner. Conflict within the state was effectively defused and a national political consensus achieved, at through a consultative process between the state and the corporatist representatives.

## The Process of Economic Policy Making

Indonesia's economic stabilization and rehabilitation in the mid 1960s did much to influence the policy making process. The structure of the process, the existence of capable technocrats, and the pragmatic leadership of the President were all important in ensuring that economic policy remained largely insulated from outside pressures.

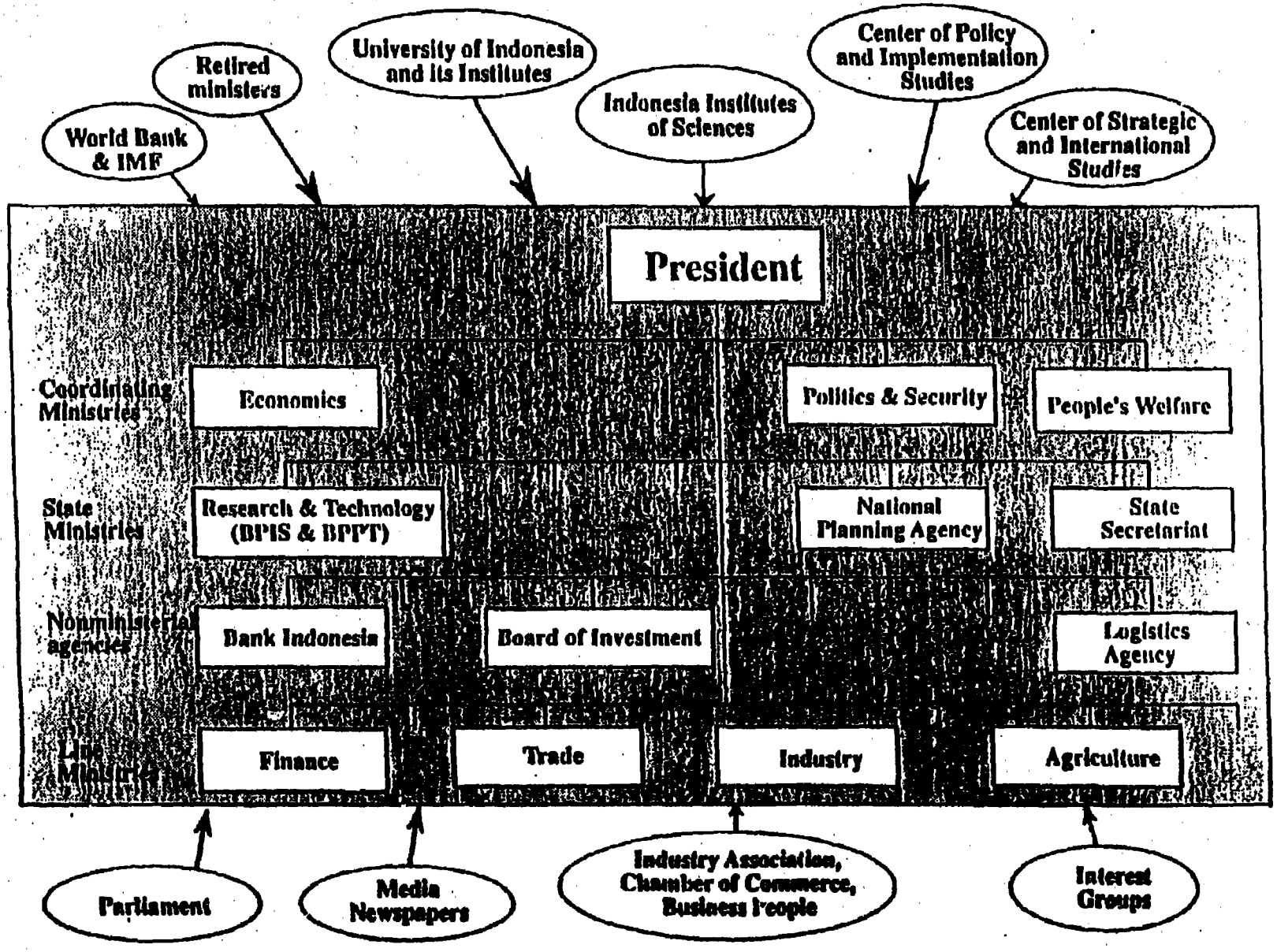
The official decision making process has several layers (see Figure 4). One, the Economic Stabilization Council, which is chaired by the President, was formed in 1968 to oversee the economic rehabilitation program. The members are the governor of the central bank, Coordinating Minister of State for Economic, Financial and Industrial Affairs; Chairman of the National Planning Agency (Bappenas); and the Ministers of Agriculture, Finance, Trade, Industry and Cooperatives, Transport and Communication, Mining and Energy, Junior Minister of Co-operatives and Chairman of Bulog. The council gradually came to involve all ministries which fall under the Economic Coordinating Ministry (EKUIN).

Two, the cabinet on economic affairs, which meets every first Wednesday in the month, and more often if there are special issues to be tackled. Policy proposals come from the relevant ministries, and are discussed at these meetings. For policies requiring Presidential decrees, and recommendations to the President must be channeled through the Cabinet Secretary.

Three, the Monetary Board, which is chaired by the Minister of Finance. The Governor of Bank Indonesia is Vice-Chairman, with other board members being the Ministers of Trade and National Planning Agency as well as some non government advisors. The Monetary Board discusses monetary and financial policies. In addition an intra-Ministerial Team (COLT) for the monitoring and management of external debt was set up in 1991.

In practice, however, policies are approved away from these meetings. The minister or ministers will coordinate discussion and pursue the issue it with the President in a bilateral meeting. Only when a policy has the "green light" is it formally presented rather than discussed at these meetings. Thus a crucial component in policy making is the informal meetings that take place outside the cabinet meetings. The cohesiveness of the economic ministries is essential for the smooth coordination and cooperation on economic issues. Indeed the main economic ministers meet on the Monday before the Wednesday cabinet coordination meeting and also through the Monetary Board, to discuss macroeconomic issues. These meetings are used to sort out differences so that a consensus can be presented to the President.

Figure 4


World Bank & IMF
Retired ministers
University of Indonesia and its Institutes
Indonesia Institutes of Sciences
Center of Policy and Implementation Studies
Center of Strategic and International Studies
President
Coordinating Ministries
Economics
Politics & Security
People's Welfare
State Ministries
Research & Technology (BPIS & BPPT)
National Planning Agency
State Secretariat
Nonministerial agencies
Bank Indonesia
Board of Investment
Logistics Agency
Line Ministries
Finance
Trade
Industry
Agriculture
Parliament
Media Newspapers
Industry Association, Chamber of Commerce, Business People
Interest Groups

## The Dynamics of the Cabinet

Economist members of the cabinet have played an important role since the beginning of the New Order period. Many of them came from the Faculty of Economics, University of Indonesia (FEUI). The role of the economists in the cabinet can be traced through several developments which began towards the end of the Old Order period.

First was the return of a group of Western trained economists in the early 1960s. Until then the prevailing ideology was not market minded; it stressed planning and the strong role of government in directing the economy, and it was based on the Indian model of planning. No doubt this kind of thinking influenced the five year plans that characterize Indonesian economic planning from the beginning of the New Order period.[13]

Second was the beginning of the close relationship between the Commander of the Staff and Command School of the Army (SESKOAD) in Bandung and the FEUI economists. The economists were invited to teach at the School. At SESKOAD fifty percent of the courses consisted of non military subjects, and the FEUI economists taught the economics courses.[14] These non military courses were deemed necessary to prepare the Armed forces for its dual function (Dwifungsi): its military role, and its socio-political role. President Soeharto was one of the senior army officers in the School at the time. The relationship between the army and the FEUI academics was gradually institutionalized and extended to the navy and air force. It became an influential ingredient in the removal of the Old Order government.

The basis of economic policy of the New Order government was discussed at the Second Army Seminar in August 1966. The economists presented the Army leadership with "a 'cookbook' to rehabilitate the country. General Soeharto as the Army top commander did not only accept the cookbook but also wanted the 'cooks' to become his economic advisers" (Sadli, as quoted in Thee (forthcoming)).

The influence of economists in policy making can be explained as follows. First, their ability to work as a team came from their institutional link with FEUI, long standing relations with one another, and their similarity in outlook. Second, they had early success in renegotiating Indonesia's debt, obtaining foreign aid from the West as well as Japan, and creating the Intergovernmental Group on Indonesia (IGGI). The group, and particularly Economic Expert Team of the President of the Republic of Indonesia (Tim Ahli Ekonomi President Republik Indonesia) did much to restore Indonesia's international creditworthiness at the beginning of the New Order period. In all their work, the President gave them with full support, shielding them from political and military pressures.

Other than the inner group,[15] the technocrats would come together at times of crisis. The Pertamina affair was one example. In the mid-1970s, the state oil company borrowed heavily abroad for its projects, which were not controlled by the government. In early 1975, it announced it was unable to

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13 See Thee Khan Wie "Mohamad Sadli: Recollections of my Career", BIES forthcoming.

14 Law Faculty members of Padjadjaran University, Bandung were asked to teach law and the Political Science Faculty members at Gadjahmada University, Yogyakarta were asked to teach political science.

15 The members of the inner group were the Minister of Finance, the Central Bank Governor and the Head of the National Planning Agency (Bappenas).

repay some of its short term debts. Despite the fact that Pertamina had been controlled by the army, President Soeharto did not protect the company for that reason. In fact he supported the technocrats, as he saw the necessity to protect state revenues for the long run interests of the country. After the resolution of the crisis, the technocrats prepared a new law to manage Pertamina. It involves monitoring by the government through a Board of Supervisors, and requires Pertamina to hand over oil revenues directly to the Government.

Even after leaving the Cabinet, some technocrats remained influential in their official role as external advisers. Their successors in the cabinet were initially from FEUI. But since the early 1980s, economists from other institutions (such as the Faculty of Economics, University of Gadjahmada) have become part of the team.

Other groups in the cabinet have also affected the direction of economic policy. The first group comprises the engineers and nationalists who basically believe that the costs of protection are justified to acquire technological capability and develop domestic industries. Beginning in the mid 1970s the Ministry of Industry was heavily protectionist, following import substitution and the development of strategic industries by the state. Its approval led to the usual phasing of import substitution, from final to intermediate and capital goods, and to the development of state owned enterprises in steel, fertilizer and cement. From the late 1970s until the mid 1980s the Ministry wanted to "deepen" (through backward and forward linkages) the industrial structure and local content policies. During the oil boom years the economists were willing to follow this basic import substitution strategy; but when oil prices fell, they were strongly pro deregulation. However, they lost the argument: the first response to the fall in oil prices was to increase protection. A new junior ministry was created in 1983, the Ministry for the Utilization of Domestic Components.

A second influence on economic policy has been the Ministry of Research and Technology, which wants Indonesia to enter high-tech industries. Theoretically it covered nine industries. In the mid 1970s, the Minister embarked on several "high tech" projects to develop an aircraft and shipping industry. The justification was both technological development ("leap frogging") and strategic interest. During the oil boom, when state oil revenues were buoyant, the technocrats had little ability to prevent these projects. Indeed, as recent as 1989 the Ministry's mandate was expanded, with the creation of the Agency for the Development of Strategic Industries. Ten state owned enterprises were moved from the control and management of the Ministry of Industry and put under the Ministry of Technology.

In general, however, the deterioration in Indonesia's environment has provided more support for reforms and a market based approach. For instance, the Minister of Industry has become one of the most active proponents for deregulation and the Ministry for the Utilization of Domestic components was no longer thought to be necessary in the 1988 cabinet.

## External Influence over Policy

Although policy making is centrally directed by the President through the cabinet, there are other channels of influence over policy.

Formal Policy Inputs. The strength of the research departments in individual ministries varies, depending on the availability of researchers and the coordination within and between ministries and agencies. The government has also used on external consultants, although the core group of economic ministers and their advisers have produced most of the policy ideas and provided the push for reforms. The external agencies involved in advisory work include the Harvard Advisory Group (which later became the Harvard Institute for International Development), the World Bank and the IMF.

Academics, independent research agencies (e.g.. Center for Strategic and International Studies (CSIS), CPIS and LIPI) and domestic consultants have not had a much influence on policy. However, given the close links between the university and the government, many academics are seconded to the government as senior officials.

External Influence over Policy.[16] The main sources of pressure for policy change are Parliament, the press, business associations (especially the umbrella organization of the Chamber of Commerce and Industry) and labor unions. Their influence has varied over time, but has grown in the post reform era of the mid 1980s.

Parliament. It consists of two bodies: the Peoples Consultative Assembly (MPR) and the House of Representatives (DPR). The MPR is the highest authority in the country: it selects the President and sets the GBHN. However, in practice it is government controlled, since more than half of its members are government appointed and meet only once every five years.

The DPR, the main legislative body has had some impact on policy. MacIntyre (1991) points out that its role is often underestimated. It is dominated by the government and centers around the President and his ministers, none of whom is a member of parliament. The list of potential and incumbent members of DPR is controlled by the government at every election. Even so, it has had some influence through its various committees, by delaying or forcing changes in government legislation. Policy debates in Committee hearings are also important. Although committees cannot compel government officials to provide information, their hearings receive wide press coverage, so officials have to take them seriously.

The Press. The press operates under self censorship as well as formal censorship. Self censorship means the tacit understanding that certain sensitive issues (security, religion and ethnic issues) will not be reported irresponsibly.

However, MacIntyre (1991) points out that press commentary and letters to the editor play a useful role in public debate. Furthermore, despite constraints, the press has maintained a critical and lively debate on political as well as economic issues. There are many recent examples of the media acting as a forum for public debate such as throughout the clove monopoly controversy and the automotive deregulation. Different groups within the state also use the media to influence the shaping of public policy.

Business-Government Relations. The main "official" representative of business interests is the Indonesian Chamber of Commerce and Industry (KADIN). Its leaders have close ties with the government. They are often seen as a tool of government rather than as representing government interests directly.

Substantive business-government are conducted through individual industry associations. Roughly 350 of them are registered in Indonesia and two-thirds are members of KADIN. By and large they are not active in representing their sectoral interests, although some have influenced policy. Two examples are the Association of Plywood and Wood Manufacturers and the textile associations.

The associations of the processed wood industries has been influential in the introduction of export bans, restrictions and taxes on the downstream products. The growth of the sector can also be

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16 See MacIntyre (1991) for more details.

attributed to the priority credits it received. The association has run a cartel like operation to control the amount and price of plywood exports (its has the right to veto an exporter that does not comply), bring forward regulations on the banning of raw and semi processed rattan, impose prohibitive taxes and control the distribution and production of rattan goods.

The textile associations have also successfully lobbied for policy changes. For instance, the Spinning Industry Joint Secretariat managed to have the import monopoly on cotton removed. Apart from direct lobbying, the association has used the press effectively. Other than associations, big business groups rely on their own close relationships with the decision makers.[17]

Labor Groups. The term labor (perburuhan) has acquired negative connotations for the New Order government, because it was long associated with communist motivated labor organizations. As Sadli, the first Minister of Manpower, points out, the New Order government wanted to depoliticize the labor unions. It favored industry-wide unions, which should not be affiliated to political parties. It adopted the German model of collective labor agreements. Thus in 1973 the All Indonesia Labor Federation (Serikat Perkerja Seluruh Indonesia or SPSI) was formed, closely following the German model of labor unions. Although the law allows the freedom to form unions, in practice the state controls worker organizations and strictly supervises the establishment of unions. Furthermore, strikes were illegal until 1990. Since then there has been an increase in strikes, with 61 in 1990 and 130 in 1991. Legally, a strike is allowed only if the Ministry of Manpower team in charge of the settlement of labor disputes fails to resolve the case and permission is granted to strike. The government also sets minimum wages, which are differentiated by area and reviewed periodically.

## Other Important Institutional Factors

Bureaucracy. In general, policy making has been highly centralized. The autonomy of the state and of individual ministers in carrying out economic policy is clear. Although state intervention was pervasive in the pre-reform period of the 1980s, the government lacked the capacity to monitor and implement the complex system of regulations. It is commonly observed that Indonesia's top decision makers are of the highest quality but the bureaucracy as a whole is weak.

The bureaucracy has not been able to attract the best people because of low pay and an emphasis on seniority rather than performance. The government has periodically tried to correct these systemic weaknesses. In general, an important consideration in the design of policy reforms was simpler rules and reduced scope for the discretionary power of bureaucrats.

Legal System. There are major deficiencies in Indonesia's framework of law and its accounting system. These deficiencies are most felt by banking and by large and medium-scale businesses (especially foreign investors). The country also has a poor record in its legal system due to delays in court, contradictory judgments, corruption and difficulties in enforcing decisions. There is also a shortage of information on laws and regulations, which creates great uncertainty. For instance, there is no reliable information on land records and transactions, on property or security, or on public credit. Although the absence of an efficient legal system does not prevent commercial activity, it creates entry barriers and adds to the costs of doing business in Indonesia.

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[17] MacIntyre (1991), p.44.

## Continuity and Changes in Government Policy

Indonesia has had mixed success with government intervention, especially where the issues concerned have produced no clear consensus. However, the general institutional factors that led to the adoption of the "right policies" have been first, the strong leadership provided by President Soeharto. It was development oriented, pragmatic and had a central vision. Second, strong central authority has allowed state to undertake painful economic reforms especially since 1986.

Third is the astute use of external agencies and consultants. They have provided valuable policy advice and technical support, which have helped to fill an analytical gap though they have hardly influenced the actual decisions to undertake reforms. However, the government has created a deliberate impression of "external pressure" to adopt reforms, especially after the second external shock in 1986. For example, in past few years major deregulation packages were announced just before the annual meeting of donors to discuss Indonesia's foreign aid. This approach causes less domestic political fallout and creates a sense of irreversibility.

To understand these factors and the institutional framework have interacted on the implementation of policy, it is helpful to look at each area in turn.

Macroeconomic Policy. Macro stabilization has long been the top priority in Indonesia, a principle that emerged from the Old Order period. The New Order government inherited hyper-inflation, large budget deficits and external debt. Macro stabilization is enshrined in various written and unwritten rules, such as the balanced budget law, an open capital account, inflation in single digit, reserves at a minimum of five months' imports, and limits on government related debt.

The influence of economists has been particularly powerful in the conduct of macro economic policy, and it has not been challenged by other groups in the cabinet. Their analytical capacity has been used to explain the continuous stress on macro stabilization, and the appropriate responses in the form of devaluation, austerity measures and management of the external debt. Although macro economic measures are easier to implement than structural adjustment measures affecting certain groups, the fact that there was broad agreement on macro policy (including the firm support of the president) explains the government's ability to conduct successful macroeconomic policy.

Industrial policy. Indonesia has had mixed success with industrial policy - the phrase being used to describe attempts to promote or favor a certain sector.

Rice is an example of successful targeting. Broad based support came not from the decision makers but from the society as a whole. But in the case of industry, there are no comparable achievements to record. Based on various rationales such as strategic industries, increase in value added, and increased local content - industries such as cement, fertilizers, steel, aircraft, plywood and automotive have received government support and protection. As already discussed, the efficiency and productivity of these investments are still in question.

# V. CONCLUSIONS

Indonesia's transformation since 1965 highlights not only its development success, but also the differences in its structure, initial conditions and strategy compared with those of other East Asian economies. The main differences are: (i) size (with a population of 182 million, Indonesia is larger than Thailand, Malaysia and the Philippines combined); (ii) low-income status (Indonesia started from a much lower base than other East Asian countries); (iii) natural resources (Indonesia has a much richer resource base than other East Asian economies, including oil); and (iv) as a result, unlike the other East Asian economies, Indonesia has until recently pursued a resource-intensive and home market oriented industrialization strategy rather than one based on labor-intensive export-led production.

Public policy and institutions have played a central role in Indonesia's success. However, the record on state intervention is varied. Policies have been successful in promoting desired outcomes macroeconomic management, agriculture, human resources and infrastructure development. But intervention in the financial and industrial sectors did not yield the hoped for results, and required later measures to undo its legacy.

Macroeconomic Management. Indonesia's record on macroeconomic management has been one of its strongest assets. Although its sequencing of reforms does not match conventional wisdom, the open capital account has exerted financial discipline and enabled Indonesia to avoid many of the problems faced by other developing countries, particularly oil exporters. However, the open capital account combined with the potential volatility of export earnings and incipient weaknesses in the financial system have led to long periods of high real interest rates.

Agricultural Strategy. The attainment of self-sufficiency in rice was perhaps the most valuable achievement. It was based on a judicious combination of incentives and central direction. Public investments in supporting infrastructure and agricultural services were crucial to Indonesia's success. The substantial expansion of treecrops in the 1980s was also based on state intervention, but with less good results. Public programs in other areas of agriculture have generally not been successful, creating distortions that must now be removed without offsetting dynamic gains.

Human Resource Development. Indonesia has closed the gap in social indicators with other countries in the region, largely thanks to aggressive programs in family planning, health and education. Combined with the success on rice, they have achieved one of the fastest reductions in poverty and improvements in key social indicators among all developing countries.

Infrastructure Development. Government intervention was successful in accelerating and upgrading the country's infrastructure. The development of public institutions in key sub-sectors was an important ingredient underlying this success. The expansion of infrastructure, in turn, has supported sustained and broad-based economic growth.

Financial Sector. Selective government interventions - such as credit allocation, credit ceilings and interest rate ceilings - have been largely ineffective and inefficient tools for promoting development. The failure was due to the multiplicity of objectives, weak management of credit allocation and the damage done to efficient financial intermediation. In fact, the Government has done much more to boost the financial sector through deregulation and an emphasis on competition and efficiency. There is, however, a clear need for a Government role in bank supervision, setting and improving prudential regulations, and improving the legal framework.

Industrialization Strategy. The record of the past twenty-five years in Indonesia suggests that inward orientation and selective interventions have generally not been successful in promoting industry. In the 1970s the results were disappointing. Although a lot of industrial investment was made behind protective barriers and under public ownership, the productivity of these investments was low and the investments were a burden on the rest of the economy. In contrast, as shown in Figure 5, manufacturing grew most rapidly during the two major liberalizations of the 1960s and the 1980s, when exports recovered and private investment surged. In the reforms of the 1980s, when the industrial structure was more developed, much of the extra investment went to new labor-intensive export industries. This suggests that functional interventions, rather than selective interventions, are likely to be the most effective in developing industry.

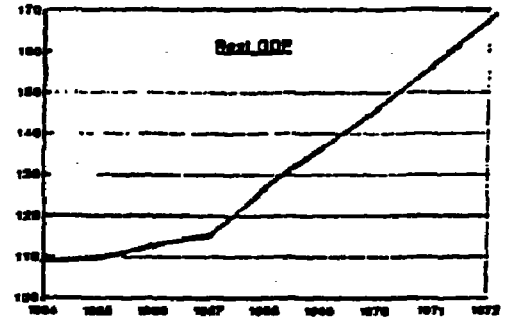
Institutional Setup. One lesson from Indonesia is that strong leadership and a cohesive team can work well in a crisis and ensure continuity of policy. A second lesson is that the limitations of the bureaucracy necessarily limit the scope for government interventions. Scarce managerial and administrative resources in the public sector need to be used to strengthen capacity in core functions such as macroeconomic management, legal and regulatory reforms, and the delivery of basic services. A final lesson is that although direct public intervention has been crucial in some sectors, the state's role will become increasingly an indirect one as the private sector assumes more and more power and responsibility.

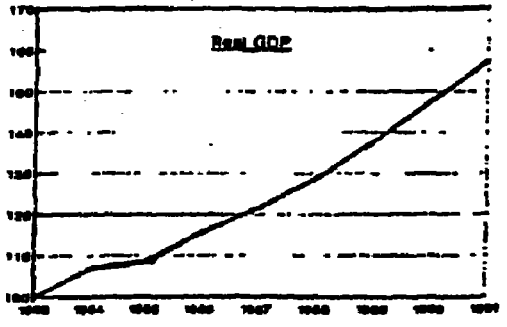
Figure 5

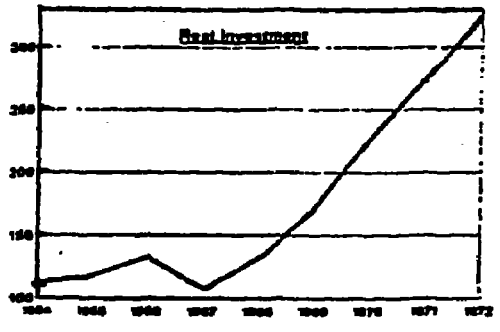
## Liberalization and Supply Response: Experience of Two Episodes

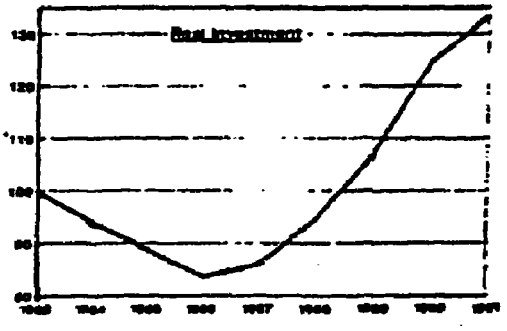
Reform in the 1960's
Index 1965=100

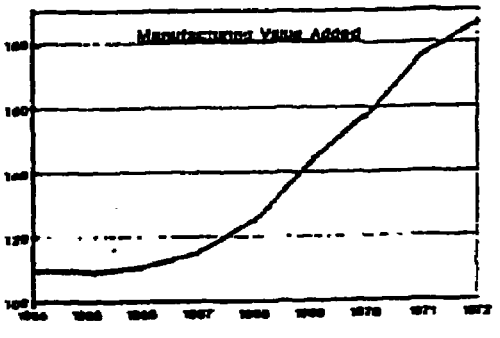
Reform in the 1980's
Index 1983=100

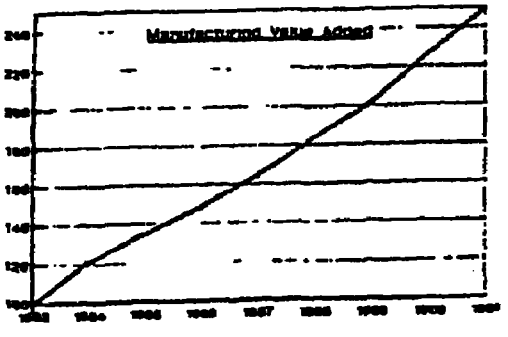


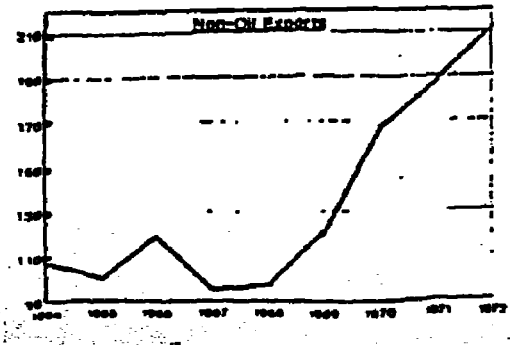



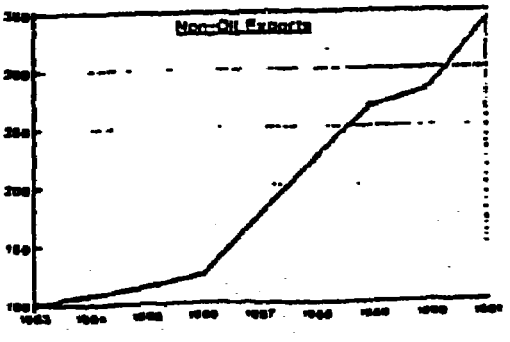



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