Fifty Years of Economic Transformation: The Indonesian Economy in Retrospect and Prospect

Mohammad Sadli

1. REASON FOR REJOICING

Celebrating this year the fiftieth anniversary of its independence does Indonesia have reasons for rejoicing?

In retrospect, it has been a daunting task to build a nation from a former colony of vast expanse but little cultural and social homogeneity. We Indonesians like portray the Dutch as having ruled the archipelago for three centuries, but in reality that was not true. In fact, they did not administer all of Indonesia until the turn of the 20th century. And certainly we should not jump to the conclusion that what the Dutch did in that much time, would not be difficult for the new republic to replicate in only a fraction of it.

Some of our present leaders maintain that the greatest achievement of the Republic thus far has been that it has managed to stay together, whereas the old colonies of the British and the French in Asia have fallen apart after or at independence. We hope that the most difficult part of nation building, that is literally staying together as one nation state, is past. But then, the recent turbulence in Yugoslavia and in the former Soviet Union, not to mention the new fashion in the West to endorse the right of self determination for ethnic minorities, remind us of the danger of resting on our laurels.

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During the first period of Indonesia's independence (from 1945 to 1966), the political economy was dominated by two thrusts; the transformation of a colonial structure into a national economy, and socialization. The emphasis was on righting political wrongs and on redistributional objectives. In the second period (from 1966 onwards), the primary emphasis was on economic growth - making the cake bigger, because only after this has been achieved will there be opportunities for distributional objectives.

Thus, the transformation of the national economy went through various stages and the economy has had to cope with different policy directives. After a painful period of experimenting with a socialist-inspired economy system more attuned to social equity than to economic growth - and losing 20 years in the process, we have become pragmatic, adopting the policy of Economic Development first, and leaving more things to the market mechanism rather than to state planning. This new orientation succeeded in cranking the economic growth machine. These developments are reviewed.

2. THE OLD ORDER

In the decolonization phase, say from 1950 to 1966, foreign and non-indigenous enterprises were discriminated against in favor of the development of an indigenous entrepreneurial class and the expansion of the public enterprise sector. The Dutch enterprises were taken over after a political row in 1957 and they became the nucleus of a nationalized sector of industrial and commercials enterprises, and modern plantations. Chinese residents with foreign nationality were ordered to vacate the countryside, pinching middlemen. Two times these Chinese were given the opportunity to either choose citizenship or repatriate.

Foreign investments were unwelcome, as these were seen as instruments of colonial powers. Non-Dutch enterprises were also 'taken over' (meaning not formally nationalized) in 1958 in the wake of the conflict with the Dutch over control of West Irian. Only foreign oil companies were allowed to continue their operations because the government needed the foreign exchange and it did not want to risk killing the goose laying the golden eggs. In view of a dearth of exploration incentives and because of the perceived political risk, the oil companies, mostly American, did not expand production. By the beginning of the New Order, however, the few hundred million dollars of foreign exchange earnings came mostly from oil exports.
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The government in the early 1950s promoted indigenous entrepreneurship by doling out import licenses to indigenous businessmen. Most of them were so-called ‘briefcase entrepreneurs’, who sold their quotas to the more established companies. Whether this policy was worthwhile or merely expensive cannot be answered categorically. Of the some five thousand ‘Benteng’ entrepreneurs, only a handful has survived and is doing well today.

This ‘affirmative action’ policy was continued in other forms, even under the New Order. No more special import licenses were given out, but Bapindo, the state development bank, extended term-lending credits at subsidized rates to build prioritized industries. At some point, notably since 1974, such credits were directed towards ‘indigenous enterprises’, i.e., those in which the majority of shares were held by indigenous Indonesians. The affirmative action policy could not prevent that in practice many companies actually owned by ethnic Chinese were converted into indigenous enterprises with the help of ‘sleeping partners’, the so-called Ali-Baba companies. This suited the interests of the state banks because they also feared that much money would otherwise be lost.

Because of several reasons—the struggle to defend the Republic against the Dutch, political strife and experimentation, and redistributional policies—the period between independence and 1966 saw little economic growth. The economy in 1966 was in a sad state of disrepair, with average incomes lower than they were at the end of the colonial period, runaway inflation and unserviceable international debt.

3. THE NEW ORDER

The New Order government reversed many of the old policies. It welcomed back foreign direct investment and aid from western countries. It stabilized the economy by sticking to a ‘balanced budget’ fiscal policy. It followed more market-friendly policies and reduced a number of subsidies. But it did not privatize the existing state enterprises. At best, it gave the management of such enterprises greater autonomy and directed them to adopt market-oriented policies and make profits. On the other hand, state enterprises were still obligated to play the role of ‘agents of development’. This dual obligation often led to extra costs.

The economy, however, grew by six to seven percent per year from 1967 to the mid-eighties, in spite of the still ubiquitous government controls. The economy was no longer run like a socialist planned
economy, but it remained nevertheless a managed economy. The ‘management’ however was much more rational and obeyed, to a great extent, the dictates of the markets. The new prosperity was based on large investments by the government, fueled by the oil windfalls between 1974 and 1981, the foreign direct investment in oil, mining and manufacturing, and the return of domestic capital that had fled the country during the Old Order. The Suharto government also attached top priority to raising productivity in the food (i.e., rice) agricultural sector. The country achieved self sufficiency, and with it rural prosperity as a by-product.

During the first five-year plan (1969-1974), the average growth of the economy was high, up to eight percent per annum, because the ravaged economy was still being rehabilitated. Subsequently, the growth rate went down and the capital-output ratio went up—as large-scale infrastructure projects and public sector industries were undertaken, partly financed by the oil money.

In the middle of the 1980s this pattern reached its natural limitation. Oil prices collapsed, the government had to start repaying its external debts, which were swollen by the Yen appreciation, and interest payments were also rising fast after periods of grace. The wave of industrialization based on domestic demand also ran into market saturation around 1983, when for the first time many textiles could no longer be sold on the domestic market. In retrospect, this state of exigency was a blessing in disguise. Economic policymaking of the Suharto government, especially macroeconomic policies, was often at its best in times of impending crises, when the government stood ‘with its back against the wall’. At that point, rationality reaches its peak and vested interests are pushed aside to make way for reform.

The reforms kicked off in 1983 with significant devaluation to bring domestic and foreign prices in line and to stimulate non-oil exports. In 1986 another financial crisis was looming, brought in by further collapse of oil prices and a whopping devaluation that shook the economy for a second time. The resulting undervaluation of the rupiah meant that non-oil exports soared, while investment in manufacturing industries since the 1983 devaluation began to pay off.

The wave of reforms that began in 1983 was called deregulation. The term ‘liberalization’ still carried a stigma because of its association with capitalism. Quite recently, however, the word ‘liberalization’ has been mentioned by some ministers and high officials without offense. Although the economy has become much more of a market economy, and
less centrally planned, domestic political circles have not been able to bring themselves to call the new system a capitalist. Old 'hang-ups' die hard.

Since the middle of the 1980s, that is, in the last ten years, the economy has been on an upswing, with important structural change, and is getting intrinsically stronger. It is now cruising at a growth speed of better than seven percent per annum, still less than the figures for Malaysia and Thailand, but good enough for Indonesia. At this speed the economy has begun to show signs of overheating, which is proof that more deregulation is required.

The new structure of the economy is important and has become the new source of strength. The two traditional major sectors of the economy i.e., agricultural and mining (read: oil and gas) have declined in relative importance - their combined contribution to the nation's gross domestic product has gone down from about one half to one third. Manufacturing industries and a number of modern services, such as banking and other financial services, telecommunications, tourism, modern commerce and construction, have become the new growth sectors, capable of pulling the future economic growth figure closer to what has been attained in Thailand and Malaysia. What makes the Malaysian (and Thai) growth rates still significantly higher is the higher saving rate attained in those countries. The net saving rate of Indonesia is difficult to estimate, but an educated guess would be 27% of GDP, while in Malaysia and Thailand this rate has exceeded 30%.

In the first period of reconstruction and early development, the low Incremental Capital Output Ratio (ICOR) and the high growth rate were achieved by intensifying the rice culture based in the new high-yielding varieties (HYVs) and by the fact that the economy started from a low base. The second period, that of large-scale industrialization and heavy infrastructure building, was made possible by the oil boom and by the consortium aid, extended under the auspices of the Intergovernmental Group on Indonesia (IGGI). During the rehabilitation period of the late 1960s and early 1970s, the economy achieved an eight percent growth rate. This rate declined to seven, six and five percent in the subsequent PELITAs (five-year plans) in which priority was given to physical infrastructure and large-scale industries under heavy protection.

The nagging problem for macroeconomists looking backward has been the growing ICOR, from a level of about three to over four and at time hitting five. Was our investment and growth machine then inefficient, in spite of BAPPENAS (the national planning agency) and the advice of the World Bank?
Was there too much waste in the system, or were the statistical figures not accurate enough in capturing additions to GDP in new endeavors such as services sectors? Finally, shouldn’t economists be much more careful in playing around with ICORs and too quickly drawing conclusions?

According to the new statistical time series for GDP the average economic growth rate during the last (i.e., fifth) five-year plan (1989-1994) turned out to be 8.3% per annum. That is much higher than the previously published figure of 7.1%. All of this has been the result of recalculating the figures by shifting the price relations from base year 1983 to 1993, which is in itself a legitimate exercise as time progresses. The big difference of 1993 prices compared with those of 1983 was the price of oil, which in 1983 was still about two times the price in 1993. Depending on prices, output and timing, the contribution to GDP of the oil and gas sector can range from 35% to 17%.

It is known that total investment in Indonesia in recent years has not exceeded 30% of GDP (national saving were 27% of GDP and the current account deficit was some 3% of GDP). If investments of 30% of GDP can produce more than 8% economic growth during the last PELITA, that is not bad at all with economists still sticking to their guns by insisting that since 1986 the Indonesian economy has shifted from government investment-led growth to the private sector and non-oil exports-led growth, and that the latter are a more efficient growth engine. At any rate, we are now basking in renewed confidence about high economic growth.

Macro and development economists, looking at aggregate figures, will tend to feel good about the achievements during the New Order. A five-fold increase of per capita income and economic growth rates averaging over six percent per annum have now produced a per capita income of about US $1000 per annum. The population growth rate has decline from 2.7 percent per annum 30 years ago to about 1.6 percent now, with the prospect of a further decline. Furthermore, the educated part of the population has increased by leaps and bounds. Virtually all children of the relevant age group attend primary school, although drop-outs are still numerous in poor areas because parents cannot afford the extra costs in excess of nominal tuition for keeping their children at school for seven to (now) nine years of compulsory education.

Social critics like to point at the increasing prosperity gaps between social classes and regions. These gaps, they insist, have widened recently. The government, however, maintains that it cannot cope with all the
prosperity gaps at the same time. It is concentrating on the eradication of absolute poverty below a certain poverty line. According to this criterion, the percentile of the population below this line has gone down in the last 30 years from 70 percent to 15 percent – but 15 percent still represents close to 30 million people. Absolute poverty is concentrated in a large number of villages on Java that are isolated and lack a resources base, and in the eastern part of the country. The government is thus concentrating on helping ‘village left behind’ (desa tertinggal) to catch up with the others, while also stimulating economic development in the eastern part of the archipelago through a special policy package.

The social critics, however, harp on relative poverty and what they see as the widening gap between the rich and the poor, especially in metropolitan centers, such as Jakarta. This sentiment has attained a racial bias because the new rich and super rich are identified with the Chinese business class. A minute fraction of them have grown rich so quickly in the past fifteen years that they now constitute the ‘conglomerates’, i.e., very large companies, each of more than two hundred individual enterprises but forming a group around a holding company controlled by the owner family. Even the foreign press maintains that the richest Chinese businessman in Indonesia (i.e., Liem Sioe Liong) is only a notch below the Sultan of Brunei in Southeast Asia.

Domestic social critics maintain that the meteoric growth of the fortunes of a few conglomerates has been the product of special favors and protection of the government and the state banks. These critics campaign for more equal treatment between all contenders in more transparent ways and without the bending of law and regulations. There has been a demand for an anti-monopoly or fair competition law, which the government so far is reluctant to consent to for fear that such legislation may lead to a witch hunt for scope and size, which the government considers still necessary for achieving productivity and competitiveness in overseas markets.

The government’s latest reply is the introduction of a draft law for supporting small business, with the assumption that what Indonesia needs is not the curbing of the growth of (big) business but the support and protection of small business in order for them to grow bigger. At the time of this writing the ‘collusion issue’ between big business and top government or bureaucracy’ is still a sensitive social concern coloring the political landscape.

Some of our neighbors are ahead of us. Singapore is no comparison because it has neither a large agricultural base nor an overpopulated
hinterland. But we are often envious of Malaysia and Thailand (in contrast to Myanmar and the Philippines). What caused those large differences? Neo-classical economists would answer that it was the quality of government policies, particularly macroeconomic policies. Political economists would stress the interaction of politics and economics. Other social scientists would stress the quality and the 'culture' of the private sector, especially if Asia is contrasted with the situation in Sub-Saharan Africa.

4. THE FUTURE

The future of Indonesia's economy seems right, as it is part of the bullish prospects for the whole East and Southeast Asia region. There is growth syndrome among these countries, one pulling the other. The Japanese used to call it the 'flying geese pattern', with Japan, of course, as the lead bird. But countries such as South Korea and Taiwan have become new growth poles, and soon Malaysia and Thailand will also become new dynamos. This regional growth can be attributed to high savings and capital formation, effective technology absorption, dynamic entrepreneurship and a vibrant private sector. Governments must redefine themselves as facilitators and keepers of peace and stability.

The usual limiting factors for the growth of developing countries are savings and investments, and technology. In the East-Asian growth euphoria, however, people and especially businessmen are optimistic (call it 'Asia-optimist' in contrast to Euro-pessimism) and believe that foreign financing and investments will come if only the projects are sound and the government's attitude remains friendly toward business. This will also be true for big infrastructure projects, traditionally financed by the government and the World Bank. Foreign technology will also come, forced by competition, and what matters will be the national capacity for absorption. The latter depends on human resources development and management, and friendly policies towards using expatriate know-how and expertise. Lesser developed countries have the choice of emulating the examples of Singapore, Taiwan or Korea. In a way, East Asia can further develop as a more or less self-contained big region in the world.

But the Indonesian economy remains vulnerable - first of all because of the high international debt burden. Present debt-service payments absorb 30 percent of merchandise exports and which will still increase (in dollar terms) because of the capital needs of the private sector. Hence, the
only way out is to take care that exports grow faster than debt-service payments. So far, so good—but it remains a tall order.

What foreign and domestic big business worry about is the eventual succession in the national leadership, i.e., can this be orchestrated peacefully and orderly, or will the traumatic experience of thirty years ago repeat itself? If in the next few years the mechanism of this transition can become transparent and the outcome predictable, that development may secure the long-term viability of the growth process.

Apart from the problem of succession, the unstoppable process of regional and global economic integration demand strengthened competitiveness of domestic industry. The dilemma here is that some domestic industry still feels itself weak and demands protection. On the other hand, protection will prolong the weakness.

There is also an equity or distributional problem on our hands that requires deft handling to keep the country together.

I would conclude by saying that not all sections of our society fell warm and bullish about the present and future. Some says whose future? But after all, in a fast moving society, not everybody can gain at the same time.

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