

ECONOMIC REFORM IN INDONESIA : THE TRANSITION FROM RESOURCE DEPENDENCE TO INTERNATIONAL COMPETITIVENESS

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Struktur ekonomi Indonesia selama 30 tahun terakhir telah mengalami perubahan yang luar biasa. Lima kebijakan pokok yang digunakan sebagai dasar percepatan pertumbuhan ekonomi, yaitu : reformasi stabilisasi, reformasi perpajakan, reformasi perdagangan, reformasi investasi asing, dan reformasi sektor keuangan. Pelaksanaan reformasi-reformasi tersebut telah menghasilkan pertumbuhan GDP yang significant selama periode 1973 – 1994. Peningkatan pertumbuhan ekonomi telah mendorong kenaikan lapangan kerja, dimana kontribusi terbesar pada penciptaan lapangan kerja di labor-intensive industries yang berorientasi ekspor. Pertumbuhan ekonomi juga telah menurunkan tingkat kemiskinan, bahkan dalam masa 1970 – 1987 Indonesia memiliki tingkat rata-rata penurunan kemiskinan yang tinggi menurut hasil studi World Bank.

Introduction

Over the past 30 years, Indonesia's economic structure has undergone a remarkable transition. In 1967, Indonesia was in chaos. Per capita income had declined to a level below that reached five years earlier, the economy was wracked by hyper-inflation, the agriculture sector could not produce sufficient food to feed the country, and poverty was the lot of the majority of the population.¹ Although the New Order Government moved quickly and decisively to establish some degree of economic order, even as recently as 1985, Indonesia showed little evidence of industrialization. At that time, Indonesia's exports still consisted largely of oil and gas with a variety of other primary products making up most of the rest. The agricultural sector still constituted some 24 percent of GDP while non-oil/gas manufacturing contributed less than 14 percent. Yet by 1994, real GDP had grown by an average of 7.6 percent per year for a decade and non-oil/gas manufacturing had grown to 20 percent of GDP. This level of economic

¹ See for example, Malcolm Gillis, "Episodes in Indonesian Economic Growth," in Arnold C. Harberger (ed) World Economic Growth, San Francisco, CA.: Institute for Contemporary Studies (1984) reports that inflation, measured the Jakarta consumer price index, reached all annual rate or 636% in 1996.

performance made Indonesia one of the countries included in the World Bank's East Asian Miracle volume.

The New Order Government has been committed to the trilogy of development: growth, equity and stability. For the past thirty years, the government has sought to improve equity while promoting growth. This has led a substantial reduction in poverty and a general movement toward and increased degree of income equality. Moreover, in order to attain growth and equity, the government has placed a strong emphasis on developing human, as well as physical, capital.

With a 1994 capita income of US\$ 877, Indonesia cannot yet claim to be a "developed country," but it has clearly demonstrated that rapid growth, combined with an improvement in equity and a reduction in poverty, is possible even in a large and populous country.² The details of the economic measures that transformed the Indonesian economy have been described elsewhere and little is to be gained by repeating them here.³ Rather the first section of this paper describes the five main policy actions that have laid the groundwork for the rapid growth of the past years: the stabilization policies of the late 1960s; tax reform; trade reform; foreign investment reform; and the financial sector reform.

Indonesia's policy-makers are often given high marks for focusing of the essential reforms needed to get the economy moving. And indeed, as is shown in the second section of this paper, by nearly any criteria it is fair to conclude that economic management has been successful. Yet the question remains why were the specific policy reforms chosen. At one level it could be argued that the reforms are no more than the standard prescription offered to all nations seeking to gain the benefits from global integration. But one must remember that these reform measures seemed much more risky and less obvious in the 1960s and 1980s than they do today. Indeed some of the reforms were considered radical. Why were these policy initiatives politically acceptable in Indonesia when numerous countries, even today, find it difficult to follow these same policy prescriptions? Additionally what reforms are still needed? These issues are addressed in the last section of this paper.

² See Appendix Tables 1 and 2 for the basic national account data. All data are at constant 1993 prices and where appropriate converted to US dollars at the average 1993 exchange rate. Conversion to constant 1993 performed by the author.

³ See for example Wing Thye Woo, Bruce Glass burner and Anwar Nasution, *Macroeconomic Policies Crisis, and Long-Term Growth in Indonesia, 1965-90*. Washington, DC: World Bank - Comparative Macroeconomic Studies (1994); Dwight H. Perkins and Michael Roemer (eds), *Reforming Economic System in Developing Countries*, Cambridge, MA. : Harvard Institute for International Development (1991)

The Major Reforms

Stabilization reforms.

Although the major reforms that underpinned Indonesia's transition to manufactured export-led growth were undertaken in the 1980s, the seeds of change were planted earlier. The New Order Government that came to power following the 1965 uprising faced a chaotic political and economic situation. The economic situation was so difficult as to leave little doubt that stabilization had to be the first order of business. The economic team, which was formed in March of 1966 moved quickly and forcefully to restore some semblance of economic order, realizing that only then could attention be turned to those reform measures that would allow the economy to grow. The first stabilization program was revealed in September 1966, after an initial agreement with the Western creditors on debt relief and new loans had been reached. At that time a number of measures were taken that tightened the money supply, ended subsidies for "key" consumer goods, abolished all quantitative restrictions on imports, and devalued the rupiah. One of the most remarkable aspects of the period that followed was that not only did the stabilization program succeed in reducing inflation, it also led to a real expansion, rather than a contraction, of GDP. This outcome had an important political effect. The initial success of the stabilization measures established the credentials of the economic team and gave them the necessary support that subsequently allowed them to dismantle other inefficient but politically popular programs and policies.

Two features of macroeconomic management adopted during the stabilization period have been instrumental in guiding the economy ever since. First, The New Order Government constrained its spending discretion by requiring a balanced budget each and every year. Although foreign borrowing was and is used to balance the budget, to the extent that the supply of official foreign credits is inelastic, the balanced budget rule serves to enforce a measure of budgetary discipline that protects the economy from inflationary excess. Second, in 1970, the government declared the rupiah to be fully a convertible currency, with no restrictions on the flow of foreign exchange into or out of Indonesia. This move was radical at that time and would still be considered radical today by some economists. They would argue that such a sequencing of policy reforms is of a full exchange rate and tariff reform, will bring in such capital inflows that the exchange rate will appreciate, undermining the efforts needed to promote non traditional

exports.⁴ Despite being warned that immediately removing controls on capital flows was extremely risky, the economic team went ahead because they realized that an open capital account was needed to place an external constraint on monetary policy. The open capital account constrains monetary policy by ensuring that any monetary mismanagement will show up almost immediately in an outflow of foreign exchange. Thus convertibility imposed the discipline needed to deal with monetary pressures whenever they arose.

These two policy anchors – the balanced budget rule and the open capital account – left the economic team no choice but to keep macroeconomic balances under close control at all times and served to strengthen their hand vis-à-vis others whose economic instincts might have been more expansionary.

Tax Reform

In the early 1980s the economy faced a serious crisis. A slowdown in world economic growth led to a fall in real exports of 9 percent in 1982 together with a decline of 0.3 percent in real GDP. At the same time the current account deficit rose from 1 to 6 percent of GDP. Various measures were taken to regain macroeconomic balance. The 1983 budget was an austere one, allowing for only a 6 percent nominal increase government expenditure. Construction of four major projects was stopped and other projects were put under review. Monetary policy was tightened and on March 30, 1983, the rupiah was devalued by 38 percent, bringing the real exchange rate back to the level set by the 1978 devaluation.⁵ Although these measures were severe, it is important to remember that by this time the economic team had sixteen years of experience in managing the economy through boom and bust and in the process had earned a considerable degree of respect and trust, both domestically and internationally.

⁴ See for example Vittorio Corbo, Jaime de Melo, and James Tybout, "What Went Wrong with the Recent Reforms in the Southern Cone," *Economic Development and Cultural Change*, Vol.34 (1986) pp. 607-640 and Sebastian Edwards, "Sequencing Economic Liberalization in Developing Countries," *Finance and Development*, (March 1987), pp. 26-29. While an opening of the capital account obviously can result in a major flow of returning capital that can create exchange rate management problems, Indonesia was not confronted with Substantial overseas holding and by domestic residents and so was not threatened with a massive return flow of capital. Moreover capital markets were less integrated in the 1970s than they are today so that foreign equity capital was not as likely to undermine the exchange rate.

⁵ Woo, et al., op cit.p.33

Resource mobilization was also stressed as a way of reducing pressure on the balance of payments. Various directed credit programs were discontinued and the State Banks were allowed to set their own banks which had already been exempted from interest rate regulations. But perhaps the most significant reform introduced at that time was the tax reform of December 1983.

It is often suggested that tax reform was a response to the 1983 decline in oil prices. While the oil certainly provided a rationale for its introduction, and made the reforms more acceptable that it might otherwise have been, planning for the reform had begun a number of years earlier. Thus, the rationale for tax reform was less an immediate crisis than a recognition that over the longer term Indonesia could not remain overly dependent on oil and gas revenues. The tax reform effort introduced a thoroughly modern tax system, which recognized that a highly complex system, with high marginal rates, was not only difficult to implement but was also destructive of economic efficiency. The new tax code reduced the number of tax rates to three - 15, 25, and 35 percent⁶ - and moved to a self-reporting income tax system. To make enforcement easier, the cutoff point for taxable income was doubled, reducing the proportion of the population subject to income tax from 15 to 10 percent.

In April 1985, this initial reform was followed by the introduction of a value-added tax of 10 percent. Here to Indonesia was a pioneer. It was not only the first developing country to adopt modern tax principles but it was the first country to introduce a value added tax system. The impact of these measures was to eliminate wasteful exemptions distributed. A few years later these reforms were followed by the introduction of a new property tax law that thoroughly revised that tax, placing it on a more equitable footing.

The tax reform led to a dramatic increase in the revenues derived from the non-oil and gas sector. As can be seen from the data in Table 1, non-oil/gas revenues rose from 5.5 percent of GDP in 1982/83 to 11.2 percent in 1993/1994, substantially offsetting the fall in oil and gas revenues.

Table 1 : Central Government Revenues : 1982/83 - 1993/94

Item	(Percent GDP)							
	82/83	85/86	86/87	89/90	90/91	91/92	92/93	93/94
Revenue (a)	18.2	19.7	15.1	16.6	20.2	17.9	17.1	17.8

⁶ The tax rates was reduced to 10, 15 and 30 percent in 1995

Oil and gas	11.9	11.3	5.9	6.4	8.6	6.6	5.8	4.2
Non-oil and gas	5.5	6.7	7.1	8.8	10.2	10.0	10.3	11.2

(a) Includes external grants.

Source: Based on Ministry of Finance data.

Trade Reform

Although macroeconomic management was generally sound throughout the oil boom period, the presence of oil-generated income hid the cost of substantial microeconomic mismanagement. Domestic industries, which flourished behind protective barriers of tariffs and myriad import controls, gave the impression of robust industrial development. In fact this was no more than the growth many countries experience in the initial stages of import substitution. Rent seeking behavior was rampant and the customs authority had become corrupt and inefficient, further contributing to high import costs, while exchange rate changes were infrequent and abrupt.⁷

These inefficiencies, which become known as the “high cost economy”, could be tolerated as long as oil revenues provided the resources needed for investment and growth. But with the collapse of oil prices in 1985, Indonesia faced another crisis: the need to stimulate non-traditional exports. In order to do this, the “high cost economy”, had to be tackled.

The seriousness of the effort to dismantle, or at least alleviate, the bottlenecks to improved export performance, is exemplified by INPRES (Presidential Instruction) No.4, issued in April 1985. This decree drastically reduced and simplified administrative procedures for imports and exports, allowed greater use of foreign shipping, extended port operations to twenty-four hours a day, and brought in a privately owned Swiss firm, Societe General de Surveillance (SGS), to provide customs clearance for all shipments valued in excess of \$5,000. Within months the ports became unclogged and tariff revenues rose, while the cost of importing fell noticeably.

In 1986, the first year when the fall in oil prices was reflected in lower oil revenues, two further reform measures were announced. In May 1986, the government established a duty free,

⁷ The rupiah, which is now managed against a basket of currencies, was devalued in 1966 to approximately Rp100/US\$ at the time the new rupiah was introduced, devalued again on March 30, 1983 to Rp909/US\$ and again on September 12, 1996 to Rp1.283/US\$.

and to import directly, regardless of the licensing restrictions that applied. The agency granting these special exporter facilities – BAPEKSTA – is a part of the Ministry of Finance. It quickly and efficiently implemented the duty drawback scheme, substantially reducing exporter's cost of doing business. In September of 1986 the rupiah was devalued by 45 percent and a more flexible exchange rate management system was introduced so that, until 1990, the real value of the rupiah, and hence the real incentive to exporters, was maintained.⁸

These trade related reforms enhanced the incentive for manufactured exports and gave firms that invested for export confidence that their profitability would not be impeded by government action. The result has been that non-oil exports grew from about US\$5.9 billion in 1985 to about US\$30.4 billion in 1994 – a more than five-fold increase over a nine year period. The annual growth rate of 20 percent was more than four times faster than world export growth. This development compares favorably with Korea's extraordinary growth in exports of about 23 percent per annum and to Taiwan's export growth of about 16 percent per annum between 1970 and 1980. The ratio of non-oil exports to GDP rose from 7 percent in 1985 to about 20 percent in 1994. Including oil and gas exports, the ratio of exports to GDP stood 22 percent in 1992, well above the average for all middle income countries (16%) and equal to the average for East Asian economies.⁹ The composition of non-oil exports also underwent a dramatic change. In 1985, primary products such a rubber, coffee, tea tin, and aluminum, accounted for close to one-half of total non-oil exports; by 1994 their share had fallen to about one-quarter even though their absolute value had increased. Exports of garments, textiles, footwear and plywood grew rapidly and more recently furniture, electrical products, and paper products, have further diversified the exports structure. By 1994, Indonesia was the third largest footwear exporter in the world, (behind Italy and China) was the 12th largest exporter of textile fibers and yarn and the 11th largest exporter of garments, the 13th largest exporter of furniture, and had achieved significant world markets shares, in excess of one percent, in such electronic products as VCRs and sound recording equipment, TV receivers, and radios.¹⁰

Creating an environment conducive to export development depends not only on improving the access by exporters to imported capital and intermediate goods, but also on a

⁸ Since 1990 the rupiah real exchange rate against the dollar has appreciated sharply but, given the depreciation of the dollar against most other currencies since 1990, the aggregate real exchange rate of the rupiah had been little changed until mid-1995. After mid-1995 the appreciation of the dollar against other currencies led to an appreciation of the aggregate real exchange rates.

⁹ See World Development Report, 1994, Washington DC.: World Bank

¹⁰ Based on United Nation trade data.

general rationalization of the tariff regime. It is by now well understood that tariff protection acts as an indirect tax on exports. The high rates of protection enjoyed by various industries were, in fact, equivalent to a high tax on exports. Beginning in 1986 a series of deregulation packages has gradually lowered tariffs and partially dismantled the non-tariff reform measures on the nominal and effective rates of protection are shown in Table 2. These data confirm that, on average, there has been a substantial reduction in the protection afforded all tradable goods sectors and that the decline in the nominal rates of protection have been accompanied by a reduction in the anti-export bias of the trade regime. The measured anti-trade bias of the commercial policy regime has fallen from 41 percent in 1987 to 31 percent in 1994 following the opening up of the economy.

Although the deregulation measures prior to 1995 reduced many tariffs and eliminated necessary non tariff barriers, much remained to be done. While the effective rate of protection for manufactures had fallen, it was then still the highest among some East Asian countries, including Malaysia and Korea. The high rate of effective protection not only created an anti- export bias but meant that protected firms were able to serve the domestic market but were not likely to become exporters. In May of 1995 a significant effort was made to resolve this problem. In what is known as Pakmei 95, tariffs were reduced on 96 percent of the tariff lines with tariffs in excess of 5% and 81 of 269 remaining NTBs were eliminated. More importantly, a 15 year schedule of tariff reductions was put into place that will lower nearly all tariffs to 10 percent or less by 2010, with nearly two-thirds of the lines being at 5 percent or less.

Foreign Investment

While foreign investors responded favorably to the trade and tax provisions of various deregulation packages, reform of investment regulations was required before full advantage could be taken of heightened investor interest. Until 1989, a set of complex restrictions limited the industries open to new investments and procedures for obtaining approval from the investments agency, BKPM, were cumbersome. In May 1989 these restrictions were substantially scrapped and a much shorter list of restricted industries was introduced.¹¹ The deregulation of investment provided another avenue to a more competitive and more productive economy. In addition the inflow of foreign investment helped transfer technology and to market exports. Realized foreign investment rose from \$0.4 billion in 1987 to \$1.7 billion in 1992, with most of the growth occurring

¹¹ Subsequent measures have opened up nearly all sectors to investment and eliminated the rule that foreign investors ultimately had to divest controlling interest in investment to local partners.

in manufacturing investments. Most important perhaps, even in sectors where trade barriers remain high, the freedom to invest has helped create a modicum of domestic competition and generated pressures to reduce cost and maintain productivity.

Since the early 1990s, there has been a progressive loosening of investment restrictions. In a series of deregulation packages, the sectors on the list of restricted industries has been substantially reduced and the regulations regarding the domestic ownership requirements and foreign ownership divestiture have been substantially liberalized. These further reforms have led to substantial further increases in foreign direct investment. By 1994, foreign investment approvals exceeded \$24 billion and in 1995 foreign investment approvals nearly reached \$40 billion.

Table 2 : Protection in Broadly Defined Economic Sectors
(Percent)

Item	<u>Nominal Rate of Protection</u>				<u>Effective Rate of Protection</u>			
	1987	1990	1992	1994	1987	1990	1992	1994
Agriculture	9	8	8	5	16	15	14	9
Mining and quarrying	0	0	0	2	-1	-1	-1	-1
Non-oil manufactures	13	10	9	9	39	34	29	20
All tradables	9	8	7	6	16	14	13	11
Import-competing	17	15	13	11	39	35	22	22
Export-competing	-1	-1	-1	-5	-2	-1	-3	-6
Anti-trade bias of commercial policy	41	36	34	31				

Source: For 1987 and 1990, George Fane, "Agricultural and Agro-Industrial Policy in Indonesia: a Survey, processed (March 1991) and for 1992, An Economic Assessment of the Food, Beverages and Tobacco Sector in Indonesia, processed (December 1992). The Data for 1987, 1990 and 1992, together with the estimates by Condon and Fane for 1994 are presented in Timothy Condon and George Fane, Measuring Trade Deregulation in Indonesia paper prepared for the conference on Building on Success: Maximizing the Gains from Deregulation Jakarta, Indonesia, April 1995.

Financial Sector Reform

Kebijakan Fiskal :Pemikiran, Konsep, dan Implementasi

The economic ream recognized that an expanding industrial base required a modern financial system to support its activities. Without a reasonably competitive financial structure, the investment opportunities opened up by the trade reforms could not be exploited. When the New Order Government came to power, the Dutch-owned banks that had dominated the financial system had been nationalized and eventually merged into one institution, Bank Negara Indonesia (BNI). This monolithic financial system, in 1968 a central bank, Bank Indonesia, was created and BNI was split in to five state banks.

These state banks continued to dominate the banking system while interest rates were controlled and credit was directly allocated to various banks and sectors. Indeed Bank Indonesia not only gave direct credits to certain enterprises, it also gave "liquidity" credits to the banking system, primarily state banks, to promote targeted activities. As a result Bank Indonesia and the state-owned banks supplied between 85 to 90 percent of all bank credits.

Credit reforms began in 1983, when the artificial restrictions on the allocation of bank credit and state bank interest rates were eliminated. Bank Indonesia also reduced its previously significant role in refinancing bank loans and introduced the Bank Indonesia Certificate (SBI) as a means of improving monetary control. The SBI was a short-term liability of the commercial banks and other financial institutions as a means of reducing the supply of reserve money.¹²

An immediate outcome of these reforms was to substantially increase interest rates paid on deposits and charged for loans, with an improvement in resource allocation, even though the state-owned banks continued to dominate the system.

It was not until October 1988 that the government turned its full attention to the problem of restructuring financial markets. The measures introduced the, referred to as Pakto 88, instituted a set of reforms designed to enhance competition within the financial sector by removing some of the barriers to entry that had remained in place, even after the 1983 reforms. Under Pakto 88 restrictions on the operations of foreign banks were eased, the procedures for establishing branch banks were simplified, and the requirements for becoming a foreign exchange bank were relaxed. The Pakto 88 also reduced the special privileges and responsibilities of the state-owned financial institutions and narrowed the differential tax treatment affecting various financial instruments.

¹² For a more complete description of the financial sector reforms, see David C. Cole and Betty F. Slade, "Reform of financial Systems," in Perkin and Roemer; op Cit as well as John Harris, F. Schiantarelli, and Miranda G. Siregar, "The Effect of Financial Liberalization, Capital Structure and Investment Decisions of Indonesian Manufacturing Establishments. The World Bank Economic Review, Vol.8, No.1 (January 1994) pp 17-47.

Finally, bank reserve requirements were lowered to a uniform 2 percent on all deposits, successfully reducing the spread between borrowing and lending rates. Bank Indonesia sterilized most of immediate expansionary effect of this change by forcing the banks to hold increased quantities of SBIs as secondary reserves. In mid-1989 and early 1990, monetary policy loosened and credit growth reach an annualized rate of 70 percent by the middle of 1990. The situation was however quickly brought under control by some monetary tightening.

The financial reforms had an almost an almost immediate impact on increasing bank deposits and loans although, with the open capital account, it is difficult to disentangle the effect of any financial change from a simple shifting of activity from offshore to onshore and vice versa. Between June 1983 and December 1987 the ratio of total bank assets to GNP rose from resulted from some combination of increased real savings, increased saving in the form of financial assets, and repatriation of past financial saving from overseas.

Pakto 88 was followed by further reforms that had as their objectives to enhance the competition of the financial system. Subsequent measures were designed to develop a securities market and create an environment conducive to the growth of a variety of other financial institutions and instruments, such as venture capital, leasing, and credit cards. Measures announced in March 1989 strengthened the legal lending limits and a January 1990 measure abolished the bulk of Bank Indonesia's liquidity credit arrangements.

As the banking system was expanding, it quickly became apparent that deregulation of banking could not mean an absence of regulation. Although some prudential regulations were put into place and substantial efforts made to ensure their implementation, serious weaknesses developed in the quality of banks' assets; weaknesses that led to the near failure of a major private bank in 1991 and the actual failure of the Bank Summa in 1992. These banking sector weaknesses contributed to higher risk premia for Indonesian borrowers in foreign markets. In response to these emerging problems, the government announced new regulations in February 1991 on loan loss provisioning and Basel Committee capital adequacy guidelines. Although progress has been made in reducing the ratio of non-performing assets to total earning assets, this ratio continues to be high for the state-owned banks. Further efforts must be made to improve the loan port-folios of the state-owned banks, something that may prove difficult until these banks are privatized.¹³ One lesson learned from the efforts, to reform the financial system is that it is often easier to deregulate

¹³ In early 1996, the government that year announced that BNI, of the oldest of the state-owned banks, would be privatized during 1996.

the financial system than it is to ensure that the newly deregulated system operates with a degree of financial prudence that will protect both savers and investors.

Table 3 : Credit Volume: 1980 - 1994 (Percent)

Item	1980	1982	1984	1986	1988	1990	1991	1992	1993	1994
Total credit as a percent of GDP	17	21	21	26	31	50	50	47	50	50
Manufacturing credit as percent of total credit	28	30	35	34	34	31	29	30	34	32
Total credits by source:										
State banks	55	62	71	67	65	55	53	56	48	42
Private banks	9	12	19	21	24	36	37	34	40	46
Foreign banks	5	5	6	5	4	6	7	8	10	10
Bank Indonesia	31	21	5	4	4	1	1	--	--	--

Source : Bank Indonesia

The December 1988 reforms permitted the opening, up to private securities markets while also clarifying regulations governing insider trading and other unsound and unfair practices. In May 1989, the Minister of Finance issued a decree permitting foreign shareholders to own 49 percent of the shares listed by any company, except commercial banks. This changes, plus the active promotion by BAPEPAM, the capital markets agency, of the stock market as a source of investment funds has brought new life to the previously moribund Jakarta Stock Exchange. At the end of 1988, only 24 stocks were listed on the exchange; today there are more than 237; while the capitalized value of the exchange has risen from \$249 million to over \$75 billion today. While the revitalized stock market opened up another channel for mobilizing investment resources, the boom also highlighted the need for regulations and procedures that will ensure a smooth and reliable functioning of the stock market, consistent with regulatory practices in other countries. Finally, a critical element of Indonesia's development strategy involves stimulating rural development, rural incomes, and rural employment. Because of this concern the financial reforms were also extended to the rural sector. Through the Unit Desa program of Bank Rakyat Indonesia, a state-owned bank, targeted and subsidized loan programs have been replaced with a rural savings and loans scheme base on market interest rates. Despite some initial skepticism, the BRI rural credit reforms have been remarkably successful. From the end of 1984, the first year of the reforms, through December 1995, the volume of rural credit outstanding from the Unit Desas has expanded 29-fold, while savings deposited with these units have multiplied 143-fold. The Unit Desas now constitute the most profitable of BRI's operations, mobilizing substantial savings while

providing small farmers and rural borrowers with needed funds.¹⁴ Here too the lesson learned is that reform and deregulation can benefit small farmers and entrepreneurs as much as they support large investments.¹⁵

The Results

Growth

Indonesia's economic growth has been strong throughout the past two decades, as the data in Table 4 show, but there was a clear accelerating of growth in the later reform period. In itself this does not justify the deregulation measures. Growth can be accelerated by raising investment levels although the sustainability of such all effort may be called into question. Indeed, Indonesia's fixed capital formation as a percentage of GDP rose from 23 percent in 1981 to 28 percent by 1994, giving it one of the highest capital formation proportion among developing countries.¹⁶

Table 4 : Gross Domestic Product: 1973 - 1994

(Rupiah billions: constant 1993 market Prices)

Item	1973	1985	1990	1994	73-85	85-90	90-94
1. Agriculture	28,759.6	44,646.3	53,056.2	59,153.8	3.7%	3.5%	2.8%
(a) Food crops	15,880.7	26,446.3	30,193.1	31,226.9	4.3%	2.7	0.8
(b) Other	12,878.9	18,200.0	22,863.1	27,929.9	2.9	4.7	5.1
2. Mining & quarrying	19,115.4	22,638.1	26,627.8	33,172.4	1.4	3.3	5.6
3. Manufacturing	6,753.6	32,144.0	54,210.5	81,690.3	13.9	11.0	10.8
(a) Non-oil							

¹⁴ See for example Richard H. Patten and Jay K. Rosengard. *Progress with Profits: The Development of Rural Banking in Indonesia*. San Francisco: CA.: International Center for Economic Growth (together with the Harvard Institute for International Development) (1991). Patten and Rosengard note the program's long-term loss ratio is about 3 percent.

¹⁵ In order to give further credibility to the stock market, the Government in 1995 enacted a new capital market law that codified much of the regulatory innovation that preceded it.

¹⁶ Because the stock estimate in the national accounts are a residual in the national income calculations it is restricted to the ratio of fixed capital/GDP.

gas	n.a	25,798.8	45,460.7	71,404.3	12.7	12.0	11.9
(b) Other					(a)		
	n.a	6,345.2	8,749.8	10,285.9	24.1	6.6	4.1
					(a)		
4. Electricity, gas & water	468.4	1,216.1	2,507.6	3,707.7	8.3	15.6	10.3
5. Construct-ion	3,145.4	9,856.4	15,225.6	25,824.6	10.0	9.1	14.1
6. Banking & finanfial services	1,051.0	5,613.3	10,102.4	15,732.7	15.0	12.5	11.7
7. Other services	30,043.2	5,613.3	10,102.4	134,692.2	7.6	12.5	7.3
GDP	89,336.6	188,412.4	263,261.9	353,973.4	6.4	6.9	7.7

Note : (a) For 1978 - 1985

Source : Derived from Statistical Office Data

Encouraging as this outcome is, what is more important is that total factor productivity increased after 1985, when the deregulation measures began in earnest. This is contrast to the period 1979-85, when there was no statistically significant increase in total factor productivity. More specifically : after 1985, GDP grew about 1.1 percentage points per year faster than can be explained by the inputs of capital, labor, and human capital.¹⁷ These results suggest that the increase in total investment and the improvements in resource allocation that occurred after the deregulation process began, led not only to more rapid growth based on applying larger quantities of capital and labor to the production process but ensured that the rapidly accumulated factors were more efficiently used. While this result is encouraging it is also worth noting that other analysts suggest that in Indonesia total factor productivity growth accounted for a smaller increase in per capita GDP Growth than elsewhere in Asia.¹⁸ Although it is difficult to pinpoint a reason for this result, it has been suggested that one explanation may be the low levels of learning achievement of the explanation may be the low levels of learning achievement of the Indonesian labor force relative to other East Asian countries. Whatever the reason it is fair to conclude that

¹⁷ Dipak Dagupta, James Hanson, and Edison Hulu, "The Rise in Total Factor Productivity During Deregulation: Indonesia 1985 - 1992", Building on Success; Maximizing the Gains from Deregulation, Paper presented at the conference commemorating the Golden Jubilee of the Republic of Indonesia, Jakarta (25-28 April 1995)..

¹⁸ See The East Asian Miracle. New York: Oxford University Press (1993) p.64.

the deregulation measures did contribute to the high rates of growth in Indonesia, a contribution that went beyond the increase in investment that followed the opening up of the economy.

Employment and Wages

The rapid growth experienced over the past twenty-five years, and especially over the decade, has led to a considerable increase in employment and thus reduced poverty. Manufacturing employment grew at an annual rate of 5.6 percent over the period 1971 to 1985, but at a rate of 7.2 percent over the next five years. A major contributor to the growth in employment has been the jobs created in the labor intensive export industries. While labor growth is likely to decelerate in the future, as the effects of slower population growth are felt, labor will continue to be in ample supply with a continued need for rapid employment creation. While wage policy must remain sensitive to need for employment creation, it must also recognize that higher wages for workers, are in a sense, the ultimate goal of economic development. Increased wages translate directly into higher incomes and reduced poverty and result in improved health and welfare. All indicators suggest that wages have risen rapidly in recent years. Indeed during 1980s, the increase in real wages and other compensation to manufacturing workers has been among the highest in the region. Real earnings grew especially quickly starting in 1988, partly as a result of the development strategy that focused on growth and equity, and relied on the development of labor-intensive industries.

Improved Welfare and Reduced Poverty

The ultimate goal of economic development is of course an improvement in the general welfare of the population. Rapid growth by itself is an insufficient criteria by which to judge success. Indonesia holds that successful development involves the attainment of three goals: growth, equity, and stability. It is therefore necessary to ask whether, and to what extent, have the deregulation measures contributed to these goals? As noted above, the deregulation has resulted in a high degree economic stability and growth but to what extent has greater been achieved.

Perhaps the most significant achievement of Indonesia's development strategy has been the substantial reduction in poverty. Only twenty-five years ago, poverty was widespread through the country. Some estimates suggest that almost 60 percent of the population, nearly 70 million people, were living in absolute poverty in 1970. Since then, poverty has declined steadily

and significantly. Indeed during the years 1970 to 1987, Indonesia has had the higher annual average reduction in the incidence of poverty among countries studied by the World Bank.¹⁹

There are several reasons for Indonesia's success in reducing poverty. Investment in economic and social infrastructure in the 1970s kept the non-oil economy, especially agriculture, viable. Even during periods of financial stringency, a serious attempt was made to protect fiscal allocations to programs which directly benefited the poor were sheltered.²⁰ In fact the severest development expenditure cuts were in the more capital-intensive industrial and mining sector projects.

Human resource development also has received strong emphasis in the development strategy, both as a means of raising living standards and to increase the capacity for growth. Over the period 1960 to 1990, Indonesia managed to raise life expectancy from 41 to 62 years; reduce infant mortality from 159/thousand live births to 61/thousand live births; decrease adult illiteracy from 61 percent to 23 percent and raise the primary school enrollment ratio from 71 to 118. Despite having a much lower income level, and starting from a much lower base than many of its East Asian neighbors, Indonesia's record in human resource development shows that it is catching up to other East Asian countries. More important, the provision of social services has not been limited to urban areas nor to the upper income groups. Indeed access to social services by the poorest 40 percent has been high and has increased during the past fifteen years. Improved access of the poor to basic education and health services has been an important factor in the reduction of poverty.

Evidence on the distribution of personal income is limited but the available data point to a gradual reduction in disparities. The share of personal expenditures by the poorest 20 percent of the population improved from 6.9 percent in 1970 to 8.9 percent in 1990.²¹ Indonesia's relatively low and declining level of inequality is also indicated by the trend in the Gini coefficient, estimated from the distribution of personal expenditures, which fell from 0.35 in 1970 to 0.32 in 1990. Although the evidence is not conclusive, it does not support the contention by some that the deregulation measures have benefited only the upper income groups or the conglomerates.

¹⁹ World Bank, *World Development Report*: New York: New York: Oxford University Press (July 1991) p.45.

²⁰ Martin Ravallion and Monika Huppi, "Measuring Changes in Poverty: A Methodological Case Study of Indonesia During An Adjustment Period", *World Bank Economic Review*, Vol.5 (1991) pp 52-82, report that "...although legitimate doubts can be raised about the size of the change involved, the analytic techniques adopted allow us to reach the unambiguous conclusion that poverty and under-nutrition in Indonesia continued to decline during the difficult period of the 1980s".

²¹ This compares to 5.5% in the Philippines and to 4.5% in Malaysia and Sri Lanka.

Despite this evidence, particular concern have been raised that the financial reforms, have increased access to the financial resources by the conglomerates. A recent analysis of the effects of financial liberalization suggests that "...small establishment, which previously lacked access to the financial system, benefited from improved access event at substantially higher interest rates.²² While there is evidence of a relatively high and growing concentration of ownership and market power in the modern business sector, there is little evidence to suggest that this trend was directly a result of the deregulation process.

Final Thoughts

There are two questions that remain to be addressed. What allowed Indonesia to carry out its economic reform process while maintaining a relatively good record on poverty alleviation and agricultural development? And what is the remaining reform agenda?

It has already provided a partial answer to the question of why the reform process was successful in Indonesia. First, the economic team won the confidence of the politicians, and indeed of the populace, by successfully stabilizing the economy after the chaos of 1965. Second, the policies maintained a relative balance between agriculture and industry, between rural and urban populations. In part this reflected the fact that Indonesia was, and to a large extent still is, a rural agrarian society. But it also reflects the strong agricultural roots of the national leadership. Whose concern for the rural poor is deep and genuine. Third, the reform process was carried out over a relatively long period of time. While the current fashion favors a more dramatic "shock" therapy. Indonesia's approach has been one of consistent moderate progress. The argument in favor of a big shock is that rapid and forceful deregulation allows the benefits of such measures to be felt before effective opposition to the reforms can be mounted.²³ Whether a more rapid series of deregulation measures would have been as successful as the more gradual approach followed in Indonesia is difficult to say. What is clear is that the impact of the deregulation measures, even under a gradual approach was substantial enough to continue to mobilize support for further measures. Moreover the Indonesian social context, a gradual approach was more acceptable than a dramatic series of sudden reforms. Finally, some have found it surprising that Indonesia, a

²² John R. Harris Fabio Shiantarelli, and Miranda G. Siregar, *op cit.*, p.37.

²³ For example, Balcerowitz and Gelb note that "...a radical approach involving forceful stabilization measures and rapid liberalization is almost surely the least risky option". See L. Balcerowitz and Alan Gelb, "Macropolicies in Transition to a Market Economy: A Three-Year Perspective Proceedings of the World Bank Annual Conference on Development" (1994) pp.21-57.

resource rich economy, could successfully carry out a deregulation process. There is, after all, a growing literature that suggests that the process of economic adjustment and reform is often less successful in resource-rich countries than in resource poor countries.²⁴ The important point to note here is that Indonesia is not as resource-rich as it seems. On a per capita basis, Indonesia's oil (and gas) reserves rank it among the poorest of the major oil and gas producing countries.²⁵ While it is true that oil exports formed an important part of total exports, it was also clear that the revenues earned from such exports were relatively small in comparison to Indonesia's total population. Given Indonesia's large population, Indonesia was forced to rely on more than its natural resources in order to develop.

What is the unfinished agenda? Perhaps most important is the need to ensure that current policies are effectively implemented. This requires further attention to the details of how deregulation measures affect individual decisions. In a number of cases legal and bureaucratic bottlenecks frustrate the intent of deregulation measures. Efforts to improve the legal and managerial framework are underway, but these efforts, like all efforts to strengthen the human capital base, take time. There is also a need to ensure that the economy becomes more competitive. Restrictions on market entry and exit, on equal access to financial and other resources, must be reduced. This is essential if Indonesia is to continue to expand its export base and remain competitive in the global market. In this regard the role of the state-owned enterprises must be further reduced. While there are a number of ways that public enterprise efficiency can be improved, an accelerated program of privatization, if carried out in the domestic stock market, would not only raise public funds but would substantially increase the market's capitalization and trading. Although, as noted, considerable effort has been made to improve the level of education, there is growing evidence that this effort needs to be extended and strengthened. Finally, skilled labor all levels remains scarce and a substantial effort is needed to increase the supply of scientific and managerial talent. Without such an increase in human capital, the long-term growth prospects are considerably less promising.

The challenge for the near-term is to increase the outward-orientation of the economy and strengthen the role of the private sector, so that rapid growth and poverty reduction can continue.

²⁴ CI, Alan Gelb et al. *Oil Windfalls: Blessing or Curse?* New York: Oxford University Press for the World Bank (1998); and Jeffrey D. Sachs and Andrew Warner, *Natural Resource Abundance and Economic Growth*. Cambridge, MA: National Bureau of Economic Research, Working Paper No.5398 (December 1995).

²⁵ In 1994 Indonesia had oil reserves equal to 33 barrels/per capita; Nigeria had 162 barrels/capita and Mexico oil reserves equal to 503 barrels/capita.

Continuing this record of progress, will depend on further change, carefully planned and effectively implemented.