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Abstract
This paper is to investigate the political economy behind the three economic reforms in Indonesia, the one in 1983-1991, in 1994-1997 and the reform under the IMF umbrella immediately after the 1998 economic crisis. The belief is that the Indonesia political economy setting during those periods was closely matched the Weberian patrimonialism setting, in which the patron-client system managed personally by Suharto. Our findings indicate that, during the initial period of initial development, economic reform can go along with the patron-client system, however, later on, they are not compatible anymore.

Keywords: Economic Development, Political Economy, Indonesian Economy
JEL: O10, P26, O53.

I. Introduction
Indonesia has come a long way from Higgins’s assertion in 1968 as being the number one failure among the major underdeveloped countries (Higgins, 1968). Various economic reforms have turned Indonesia into a very different country. Since the late 1970s, Indonesia experienced a rapid economic growth, which was sustained for the next three decades. The economy was transformed from being highly dependent on agriculture in 1960s into the one in which the manufacturing sector contribution was about a quarter of the Gross Domestic Product (GDP) in the mid-1990s. A rapid demographic transition and decline in absolute poverty soon followed. Strong economic
growth was accompanied by a relatively equal income distribution. Admittedly, however, after 30 years of economic development Indonesia is still a relatively poor country.

Indonesia achieved its independence in 1945; however, practically, there was not much room to implement any sort of economic development policy, let alone economic reforms, in the first 20 years of its independence. These years were spent in the consolidation of the unitary state and in strengthening the central government. In practice, economic development only began when Suharto came to power in 1966. This is why discussion of economic reforms in Indonesia cannot be separated from the ascension of Suharto to power.

Suharto’s political power emerged amid the chaos created by the failed coup in 1965, supposedly carried out by the Indonesian Communist Party. The left leaning Indonesian first president, Sukarno, was deposed by a conservative military backed regime led by Suharto. When Suharto took power, the Indonesian economy was in a shambles. Inflation ran at 600 percent per annum, production and trade were stagnant, and economic infrastructure was in disrepair. To a great extent this was actually a man-made calamity, caused by economic mismanagement from 1960 to 1966 as well as by hyperinflation caused by continuing monetary expansion to finance the government budget.

Suharto understood well that the key to sustained public support was to fix the economy. He turned to the group of western trained economists at the Faculty of Economics, University of Indonesia, led by Professor Widjojo Nitisastro, to design an economic stabilization policy, commencing in 1966. The primary concern of the government was to bring the inflation rate down. For this purpose, a balanced budgetary policy was announced in which the budget deficit was eliminated and the central bank was also forbidden to finance it. This was the hallmark of Suharto’s regime, which served to lower people expectations concerning inflation. In the area of the balance of payment policy, multiple exchange rates were abolished and the currency, the Rupiah, was devalued to its market value. Foreign trade was liberalized, allowing better access to raw materials and capital goods needed by the industrial sector. To make Indonesia more attractive to foreign investors, a new investment law was decreed in 1966, containing
generous tax concessions. Ties with the international donor community that were severed during the reign of Sukarno were re-established in 1965. This enabled Indonesia to borrow concessionary loans to rehabilitate its previously neglected physical infrastructure. These polices were finally able to turn the economy around and prevent disaster. The inflation rate decreased from approximately 636 percent in 1966 to approximately 9 percent in 1970, or approximately 57 percent per annum, while the gross domestic product (GDP) grew by 6.7 percent annually (Thee, 2003).

One cornerstone of the economic policies of the New Order government was the reintegration of Indonesia into the global economy. This was in contrast to the de-linking policies in the previous Sukarno government that were aimed to reduce links with the Western capitalist countries. As a consequence, trade and investment barriers were gradually reduced. This however, was not without risk since these policies ran counter to strongly held nationalists beliefs of a large proportion of the Indonesian people, including many political leaders and intellectuals. The distrust of the private sector and foreign capitalists has a root in the Dutch colonial era where a system was created to keep capital out of the hands of the indigenous population. Only Dutch (European) and Chinese had the legal right to own capital and thus the power to accumulate it. This distrust of capitalism has more or less been passed from one generation to another in the country’s constitution (Thee, 2001).

Another cornerstone of Suharto’s policies is to invest heavily on infrastructure, such as road, irrigation, school and health facilities, throughout the nation. The combination of reducing trade, financial, and investment barriers and heavy investment on infrastructure produced the rapid growth of Indonesian economy, no pronounce of increasing inequality of incomes among regions in the country, and significant poverty reduction during Suharto’s era. Improving the economic condition throughout the country eliminated tensions among ethnics in the country and generated a more solid integration among regions.

Maintaining public support by fixing the economy was not Suharto’s only strategy to cling to power— he also created a regime based on Weberian patrimonialism. Crouch (1979) was the first scholar to identify patron-client relations or Weberian patrimonialism as the principal means by which Suharto created and maintain his base for
political support. Liddle (1996) raised questions concerning the seemingly incompatibility between market-oriented policies and a political structure based on patron-client ties. The regime’s need for economic growth required bureaucratic values of predictability, regularity, order and rationality, which are just the opposite of the nature of patrimonialism, which is characterized by favoritism and arbitrariness. How Suharto managed these seemingly incompatible forces, reigning for three decades and producing three major economic reforms in this period is the focus of this paper.

II. Methodological Approach
The purpose of this paper is to investigate three reform periods, 1983-1991, 1994-1997 and the reform under the IMF umbrella immediately after the 1998 economic crisis, in particular in the aftermath of the Asian economic crisis. With a patron-client political structure, practically all economic reforms in Indonesia in the last thirty years were closely scrutinized by Suharto, before they could become actual policies. In this regard, one appropriate approach to studying economic reform in Indonesia is loosely to employ principles from the rational choice theory as demonstrated in Bates (1981). This analytical principle implies that all economic reforms in this period could be traced back to Suharto as an individual political leader making choices to build and maintain support in various situations and opportunities. In other words all economic reforms were political choices, rationally made in the context of multiple and flexible opportunities to create, mobilize and deploy political resources.

Liddle (1996) proposed an interesting hypothesis that Suharto’s economic policy decisions were influenced primarily by three variables. The most important was economic crisis, which played a substantial role in changing policy but always in the context of the other two factors, namely, ideology and the patrimonialistic nature of the regime. To be implemented, the design of economic reforms needed to meet certain conditions. First, it had to be persuasive enough for Suharto, it could not contradict Suharto’s ideological belief, and finally it could not jeopardize political support for the regime.

The significance of the economic crisis in inducing policy changes was well documented throughout the 30 year reign of the New Order regime. The first economic
reforms began in 1983 when the government started to deregulate non-oil sectors as a response to the fall in the oil price. The second reform in the 1994-1997 period was a response to the slackening of major economic indicators, primarily export and economic growth. This time around, the government announced the abolition of the limitation on foreign ownership, a reduction of the trade barrier in the form of tariff cuts, and the opening up of several previously closed sectors to foreign investment. The most recent economic reform in the aftermath of the 1997 currency crisis is under the umbrella of the IMF’s supervision. The IMF program contains the broad outline of economic policy, designed to lead the economy into recovery, which includes the framework for fiscal, monetary and balance of payment policies, financial sector reform, and trade and investment policy reforms. This reform also covers the social safety net for the poor, mainly to mitigate the adverse effect of price adjustment.

Any reform will produce winners and losers, so this paper will analyze the behaviour of interest groups before, during and after the reforms. The hypothesis is that the first two major economic reforms (in 1983 and in 1994) under the New-Order regime faced little opposition because of their ability to consolidate the political elite in the country under the patron-client system managed personally by Suharto. Losers were compensated up front in order not to derail reforms. The most recent IMF sponsored reform differs markedly from the first two because the ability of political and cultural institutions to gain consensus is now more limited due the fragmentation of the political elite. There are many more interest groups that need to be compensated up front before any program can proceed.

In general, the hypothesis can also be stated as that there is, in a way, a compatibility between market-oriented policies and patrimonialism in the initial stage of development of a market economy, as shown in the first two major economic reforms. Both economic reform and patrimonialism were the optimal choice for the elite and, most likely, for the rest of the stakeholders. However, in the later stage of development of a market economy, market-oriented policy became incompatible with patrimonialism, as shown in the IMF sponsored reform. The main reason for this incompatibility is that the implementation of market-oriented policy in the later stage of development requires the abolishment of patrimonialism in the country, since patrimonialism means slow reforms.
To be able to test the above hypothesis, the political structure, important players and the constellation of winner and losers need to be investigated before factors that determine the success and failure of reforms can be identified.

For each major reform program, the analysis basically comprises three complementary steps: Firstly, the provision of a well-documented description of reforms, processes and outcomes. Secondly, an analytical narrative will be conducted for the whole reform process. Thirdly, of particular emphasis is the analysis of causal factors or driving forces of reform with respect to the three central questions:

   a. Why: the driving forces of reforms,
   b. What: the factors affecting the shape of reforms (breadth, scope of reforms, winners, supporters, losers, and opponents,
   c. How well: the results of reforms.

III. Political Structure and Important Players

Crouch (1979) defined Weberian patrimonialism as a setting in which the government has the ability to rule in the interest of the elite without much concern for the general population because they are on the periphery, presumably poor, socially backward and politically passive. Politics operates only among different factions and cliques within a small circle of the elite. Political competition revolves around gaining favour with the ruler who determines the allocation of rewards. Suharto was aided by the fact that after the fall of Sukarno there was a power vacuum. Strong political institutions have never been the hallmark of Indonesia, so it was inevitable in this situation that the personal rule of Suharto materialized.

Gradually, this personal rule was replaced by the so-called New Order pyramid (Liddle, 1996). Although the president’s office was a still domineering force, the structure allowed the involvement of other players in the decision making process. In the inner circle of policy-makers there were three important players, the economists or the technocrats, the technicians (economic nationalists) and the patrimonialists, consisting of military personnel and the ruling GOLKAR party members. The technocrats were a group of Western-trained University of Indonesia economists, who embraced the neoclassical view. They were the proponents of conservative market oriented policies and
helped Suharto in designing the economic stabilization policy in 1966. The economists largely controlled the powerful offices of the Ministry of Finance and the National Planning Agency (BAPPENAS). The technocrats did not have a large domestic constituency outside the universities and state offices they controlled (Woo et al., 1994).

The technicians or economic nationalists on the other hand, were mostly engineers-turned-managers with little training in economics, and economists with structuralist inclinations. They were united by their belief in the general validity of the infant industry argument, and thus tended to favour a more protectionist policy and rapid state-led development that usually involved very large capital investment in areas like steel, cars, and aeroplanes. The technicians controlled the Ministry of Trade, the Ministry of Industry and the National Investment Coordinating Board. Their inclination towards a more protectionist industrial policy won them support from economic nationalists comprising indigenous capitalists, army officials and civilian bureaucrats; because of this they were often in direct and fundamental conflict with economists over development policy (Woo et al., 1994).

The main incentive for technocrats and engineers to in part of the pyramid was, probably, to be able to implement their ideological beliefs. Nevertheless, once they got closer to Suharto, they do enjoy having political power and prosperity.

Finally, the patrimonialists were in charge of distributing rewards to those within the political elite and possibly to some outside this small circle. At the same time, as punishment, they could also withhold rewards from those who threatened Suharto’s position. These officials were mostly located in the State Secretariat and the administrative area of the presidential office responsible for liaison with the central bureaucracy. Until 1970, the state oil company, PERTAMINA, was the primary source of presidential financial patronage, and much of this was funneled through the State Secretariat (Woo et al., 1994). Because PERTAMINA was headed by an ardent economic nationalist during this period, the State Secretariat or patrimonialists tended to be assumed to be allies of the economic nationalists. After the debt scandal in mid 1970s, the role of PERTAMINA as the sole source of patronage money was terminated; instead, in the last 15 years most patronage funds came from Sino-Indonesian business
community contributions, as well as from state agencies like the State Logistic Agency (BULOG) (McLeod, 2000).

Suharto also made extensive use of foundations or yayasan to accumulate wealth both for personal benefits as well for the patronage funds. Through a network of such foundations, Suharto and his family held stakes and a share of profits in dozens of large enterprises, including rice, textiles, and flour milling controlled by Liem Sioe Liong. One advantage of yayasan was that it is not subject to auditing and does not have to pay taxes, which was an ideal way to hide excessive personal wealth (McLeod, 2000).

One powerful institution besides Suharto himself was the military because it helped Suharto to secure power after the botched communist coup in 1965 that led to the ousting of Sukarno. Although officially the military, as an institution, stood outside the circle of policy-makers - Suharto, technocrats, technicians and patrimonialists - it had some influence on the course of policy-making through some of its members holding posts as cabinet ministers. Naturally, the cabinet members from the military tended to ally themselves with technicians and patrimonialists or were patrimonialists themselves.

Another important role of the military was that this institution helped Suharto controlled regional politics. During Suharto’s era most regional leaders were retired military personals. They were able to suppressed conflicts among ethnic regions, so that politics in the regions were relatively stable. Like Suharto, the military also used Yayasan for fund raising. In later years, foundations controlled by the military were often in conflict with those of Suharto (Kingsbury, 2001).

In the 70’s the main definition of the core interest group would consist of the economists, engineers, and patrimonialists. Due to ideological differences over development policy, the economists (the technocrats) encountered formidable opposition from the technicians or the economic nationalists. The economists had greater influence in difficult times or in times of economic crisis, while in times of plenty economic nationalists usually had the upper hand. The situation was made more difficult for the economists because Suharto was ideologically more inclined towards the economic nationalists, who were in favour of state intervention in economic development matters. Knowing this, the technocrats had to compromise on many occasions where there were competing interests, and sometimes the President simply rejected or ignored their
recommendations. In time, they mastered the skill of blending elements of the free market economy with state or government intervention in almost all problem situations (Vatikiotis, 1993). This explains why economic reforms tended to be more extensive in the financial than in the real sector, particularly in sectors considered to be strategic. Strategic industries like steel, oil and aircraft industries remained under state control, under the jurisdiction of the influential Minister of Technology, B.J. Habibie.

In an effort to balance the conflicting stances of the economists and the technicians, Suharto never made any reform measures into concrete standing law. Most economic reforms were enacted in the form of a “Presidential Decree” (KEPRES), which had lower legal status than laws (undang-undang). Presidential decrees could be reversed, and Suharto never hesitated to do this when he deemed it necessary. However, another practical reason why the use of the Presidential Decree as a means of introducing economic reforms was more prevalent than laws was the slowness of the legislation process. So, the Presidential Decree was just a way of bypassing the legislative process.

How Suharto commanded this baffling array of competing factions during the 70s and 80s was a remarkable achievement. He was convinced that, if properly managed, a system of political stratification built by the combination of military and civilian bureaucratic process was not incompatible with macroeconomic liberalization (Vatiokotis, 1993). Suharto’s logic was that pursuing economic development could be an effective legitimizing principle and could also serve as a source of support from many groups, including the military, the civilian bureaucracy and various other social groups. Suharto’s attitude towards macroeconomic liberalization and patron-client relationships was best demonstrated in the way he handled the conflicts between economists and technicians/patrimonialists. While at the macroeconomic level he embraced the wisdom of conservative fiscal and monetary policies, he also pursued protectionist polices in areas favoured by technicians, as well as giving special opportunities, trade and manufacturing monopolies, credit facilities and government contracts to his closest cronies, mostly Sino-Indonesian, and later to members of his own family.

However in the 90s the incompatibility between macroeconomic liberalization and patron-client relationships had become more and more difficult to be handled.
Conflicts between the economists and other members of the core group caused many economists had to move out Suharto’s core interest group.

Besides managing his group and working along the military institution, Suharto was also keen to defuse threats to his rule by buying off political challengers. For this he needed a lot of cash which was generated by various sources of presidential patronage money, among them state-owned enterprises like the state oil company (PERTAMINA) and later on, the state rice procurement agency (BULOG), as well as from the Sino-Indonesian business community. The logic of Suharto was clearly that the sources of presidential patronage money could be better sustained if the economy was growing. An increase in the level of domestic activity and international trade brought about by liberal economic policies could also enhance his political legitimacy (McLeod, 2003).

In 1970, the New Order government embarked on efforts to fashion a monolithic political organization to control political opposition. GOLKAR was created from the umbrella of anti-communist groups as “the government party,” although it was never officially declared a party, but only as a functional group. In similar fashion, Islamic parties were merged into the United Development Party, known as PPP in its Indonesian acronym. Nationalist and Christian parties were grouped under the banner of the Indonesian Democratic Party. In theory, these new grouping provided channels for political expression, but in reality it was the state that regulated the way people expressed their political aspirations. PPP and PDI were the only two legal “opposition” parties that were allowed to contest Indonesia’s New Order regime in the national election. From the start, both parties were subject to government interference, even in the choice of the parties’ leadership. Potentially troublesome candidates were almost certainly excluded from leadership contention. Unlike GOLKAR, until 1998 PPP and PDI were not allowed to campaign outside strictly limited election periods. This was an effort to depoliticize the general population so they would be able to concentrate on “the government-defined task of development,” without the unnecessary distraction of political participation (Kingsbury, 2001).

Apart from repression, the New Order regime used positive interest-based support, which had been built on relatively liberal economic policies, for political legitimacy. So, besides those within the small circle of the political structure, others in
the general population also benefited. At the forefront of the outer circle was the civilian bureaucracy. There were various ways in which it could reap rewards from the New Order regime. The primary distribution mechanism was arranged through the government budget. Although the base pay was low, there were plenty of opportunities to supplement income through the complex allowance system. The problem was that allowances were mostly based on a superior’s discretion, so that a network of patronage and personal loyalty emerged in every ministry and office, from the top echelons to lower level bureaucracy.

Besides poor performance management and dysfunctional pay policy, the root of corruption in the Indonesian civilian bureaucracy was that the whole power structure was built on the patron-client relationship. Bureaucracy built on the patron-client relationship suffered from various problems like non-transparency and the lack of a standard for performance appraisal, so corruption was inherently built into the system. Since some degree of corruption had to be tolerated to compensate for the low basic salaries, as well as to maintain the loyalty of subordinates, the government trod a fine line between tolerance and periodic crackdown. The corruption in this type of power structure was very centralized, and somewhat similar to the situation in Communist Russia (Shleifer and Vishny, 1993). Periodic crackdown was conducted only for public relations purposes, to assure the public of the commitment of the government to good governance. Punishment was reserved only for those who deviated from the agreed pattern of corruption.

Another form of corruption was the elaborate network of government-business relations, which revolved around the role of Cukong (Liddle 1996), a rather derogatory term for a Chinese businessman who is protected by a powerful official in exchange for a share of profits. Suharto and families were known for their connection with Liem Sioe Liong, reportedly one of the richest men in the world. This practice also spread to other high-ranking officials who granted Cukong-owned businesses with lucrative state contracts in exchange for handsome kickbacks.

In order to mobilize popular support, budgetary allotments were also used to benefit the general population (Liddle, 1996). The price of the staple food, rice, was kept low through subsidization of agricultural inputs like fertilizer, seeds and pesticide. In
addition, in times of drought, the state rice procurement agency was always ready to import foreign rice. The subsidy of kerosene eased the burden of urban and rural population alike. The rehabilitation and construction of irrigation systems, and the agricultural extension program along with subsidized agricultural inputs, also helped the landowner. The social capital program called INPRES was created to improve infrastructure at the village level. Roads, village halls, schools, health centers and markets, were constructed in rural areas. Although the major beneficiaries of the INPRES program were the landowners, its impact penetrated the rural community more than any previous government programs.

The oil boom from 1974 to 1982 provided Suharto with money to finance economic development and to increase his system of patronage, but it might also have instigated his eventual downfall. With this newfound wealth, Suharto felt that he could rely less on foreign investment and could pursue a more nationalistic approach to economic development. This translated into more restrictive economic policies, which allowed a small business circle, which included his children, and members of his extended family, to expand their business interests at the expense of others within the political structure, including the military. Both resentment and concern continued to grow as Indonesia entered the 1990s, and played a significant role in the eventual ousting of Suharto in 1998, in the midst of Indonesia’s biggest economic crisis.

One intriguing question was whether support would turn into opposition if the fund used to buy it dried up. This was not easy to answer, since buying up support was only one part of the equation, the other part being repression. It was possible the answer lay in the health of economy. As shown repeatedly in the 30 year reign of the New Order, providing the crisis was mild and the recovery relatively quick, it was very difficult to challenge Suharto.

The 1997-1998 crisis was different in terms of magnitude and duration, and it destroyed much of Suharto’s credibility. It took place at an unfortunate time for him, when he was perceived to distribute economic opportunities to his closest cronies, notably his own children. This tendency started after the oil boom in the early 1980s and became more pronounced in the 1990s. The biggest loser in this respect was the military, which found much of their economic empire eroded by the continuous intrusion of
Suharto’s cronies into its business empire. As an illustration, Presidential Decision number X, which decreed that portions of government contracts over 200 million rupiah had to be approved by a special team in the State Secretariat, had effectively removed the control of lucrative government tenders away from the military. Not only this, there was growing realization in the military circle that Suharto had employed his wealth to undermine their political influence. So, when economic hardship made many political groups demanded his resignation, the military practically did not lift a finger to protect him politically, though out of respect it continued to provide physical protection until recently.


4.1. Prelude to Reform

Between 1970 and 1981, the performance of the Indonesian economy was very impressive. The country’s GDP grew at an average annual rate of 7.4 percent. The annual inflation rate, although high in 1973 and 1974, remained relatively steady at below 20 percent (Figure 1). Exports, particularly oil exports, were the major engine of growth for the entire economy during this period. The two oil price booms of 1973 and 1979 provoked a major expansion of the economy.

![Graph showing annual rates of GDP growth and inflation from 1970 until 1981](image)

Source: World Bank Database.

Figure 1. Annual rates of GDP growth and inflation from 1970 until 1981 (in percentages).
From 1970 until 1981, exports grew at an annual rate of 23.6 percent. Export earnings from crude oil and petroleum products amounted to only 32.8 percent of total export earnings in 1970, but increased to approximately 79.8 percent of total export earnings in 1981 (Figure 2). In 1981, the total revenue from oil exports was approximately a quarter of the country’s GDP and 70 percent of total government domestic revenue.

[Graph showing total export and oil and petroleum products earnings from 1974 to 1985]

Source: World Bank Database.

Figure 2. Export earnings (in billion of USD).

On average, manufacturing sectors grew at a rate of 13.2 percent, service sectors at 8.9 percent, and agricultural sectors at 4.6 percent from 1970 until 1981. In agriculture sectors, growth was fuelled by the boom in paddy production; converting Indonesia from the largest rice-importing country in the world to virtual self-sufficiency by the mid-1980s. From 1978 to 1980, paddy production increased at an annual rate of 7.1 percent, thanks to the implementation of the food intensification program throughout the country. This program included the large-scale adoption of high-yielding modern seed varieties, development of irrigation systems, expansion of food crop producing areas, increased use of chemical fertilizers and pesticides, expansion of agricultural extension services, establishment of farmer cooperatives and input subsidies, and stabilization of national food crop prices (Oka, 1991; Hill, 2000).
The oil boom era proved to be triumphant days for economic nationalists (technicians) and patrimonialists. The sense of plenty had made economic nationalists more eager to pursue big-ticket projects like oil refineries, liquefied natural gas plants and the aircraft industry. Despite this, some resources were also poured into education, agriculture, communications, transportation, the development of import-substituting industry, official salaries, subsidization of agricultural inputs and urban consumer goods. These programs helped to strengthen the President’s performance legitimacy and political base to become much broader than the core combination of patrimonially connected military officers and civilian officials which he had started (Liddle, 1996). In the era of buoyant oil revenues, the influence of the economists in questioning the wisdom of pursuing massive capital-intensive projects had diminished, but they maintained their traditional influence regarding the necessity of maintaining a conservative fiscal and monetary policy to hold down inflationary pressures.

4.2 The Driving Forces of the Reform: Oil Crisis

Unfortunately, the impressive growth that boosted Indonesia’s economic performance in the 1970s only lasted less than ten years. Oil prices dropped in 1982 and revenue from this sector started to contract, drastically reducing the basis and prospects for economic growth. Figure 3 shows that the world price of crude oil decreased from approximately 37 USD per barrel in 1981 to 34 USD per barrel in 1982. Earnings from oil exports dropped from 10.6 billion USD in 1981/82 to 7.2 billion USD in 1982/83 (Thorbecke et al., 1992). Clearly, 1982 was a turning point from a regime of high, oil-fed growth to a new rhythm of decelerated growth and stabilization of the economy to reduce its vulnerability to external shocks (Woo et al., 1994).
Another blow to the Indonesian economy was the worldwide recession of the early 1980s that also adversely affected the demand for traditional Indonesian exports, mainly agricultural products. The term of trade for the country’s non-oil exports fell approximately 12 percent between 1979/80 and 1982/83, while non-oil export earnings declined from 6.2 billion USD in 1979/80 to 3.9 billion USD in 1982/83. The overall impact of these two external shocks was that, in 1982, GDP growth rate dropped to approximately only 1 percent (Figure 4).

Source: Energy Information Administration (www.eia.doe.gov).

Figure 3. World Prices of Crude Oil (in USD per barrel).

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Before 2000 the Indonesian government fiscal year was from April to March the following year, hence, “in 1979/80” means from April 1979 until March 1980.
The slide in oil prices continued until 1988, with a big drop in 1986. The world price of crude oil dropped from 27 USD per barrel in 1985 to 14 USD per barrel in 1986 (Figure 3). Meanwhile the export price for Indonesia’s crude fell from 25 USD per barrel in 1985/86 to slightly below 13 USD in 1986/1987 (Woo, et al., 1994).

Two other relatively minor external shocks also occurred during the 1982-86 period. First was the depreciation of the dollar from mid 1985 onwards, which had a significant indirect effect on Indonesia’s debt service payment (interest plus principal). Since a large proportion of its foreign debt was denominated in currencies, which appreciated vis-à-vis the dollar, the total dollar value of Indonesia’s foreign debt surged, as did the flow of debt service payments. Secondly, Indonesia was affected by higher international interest rates, though fairly marginally, both because of the highly concessionary and fixed interest rate structure of Indonesia’s debt composition, and because the surge in international interest rates occurred in 1979-81, a time-span during which Indonesia’s borrowing were small due to high oil earnings (Thorbecke et al., 1992).

Source: World Bank Database.

Figure 4. GDP Growth Rates (in percentage).

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4.3 The Reform:
The fall in the oil price in the 1980s brought a strong impetus for the change of development strategy. It was acknowledged that export revenues from oil and primary commodities were unreliable and there was a sense of urgency to develop and to diversify non-oil sectors in the economy, particularly manufacturing and agriculture. The economists started the reform program with measures to liberalize the banking sector and then gradually moved to trade and other regulatory reforms. Economic reform, or as it was called at the time, economic deregulation – which was implemented through structural adjustment packages – began in 1983. It covered four broad categories of measures relating to: (1) exchange rate management, (2) monetary and financial policies, (3) fiscal policy, and (4) trade policy and other regulatory reforms. In the end, reform of the financial sector was more pronounced than that of the real sector, where monopolies controlled by business interests close to Suharto were more prevalent.

Trade Policy and Other Regulatory Reforms
Indonesia adopted a series of measures that had the effect of significantly liberalizing trade. In January 1982, a package of policies was introduced to simplify export/import approval procedures, giving exporters greater freedom in the use of their export proceeds, providing subsidized export credit, and strengthening the obligations of foreign holders of government contracts to arrange export to the equivalent value of imported material used.

Tariffs were reduced across the board and the number of tariff categories was cut in March 1985. This was followed in May by an overhaul in the areas of shipping and customs which opened inter-island transport to international competition, reduced port charges and producers, and essentially disbanded the national customs service and replaced it with a Swiss-based foreign contractor (SGS or Société Général de Surveillance) operating under simplified customs regulations. In May 1986, those industries producing for export were allowed to purchase imported inputs without restriction and without import duties. In October 1986, the import licensing system was revamped and import restrictions were lifted from a wide range of products (Thorbecke et al., 1992).
Other major regulatory reforms were related to investments. In April 1985, approval procedures for foreign investments were simplified. The number of required documents was cut by half, application fees were discontinued, and the typical application processing time was reduced from more than six months to less than two months. In 1986, a package of reforms was introduced to provide foreign companies with the same privileges as domestic companies in securing local credit, flexibility in reinvesting profits and the right to distribute products directly rather than going through an Indonesian intermediary. The reforms also reduced foreign equity requirements, and relaxed the requirements for divesture.

In 1987 foreign investors were granted access to the stock market, foreign banks were allowed a larger role in the economy and foreign joint ventures were encouraged, as were foreign-owned export business. A key national resource industry, lumber, was opened to foreign investment (CIPE, 2001). In November 1988, substantial deregulation of maritime activities was announced to reduce costs and encourage private sector participation.

The most significant shortcoming of this program, however, has been in the area of privatization. State-owned industries continue to play a major role in the economy and have resisted any significant moves toward privatization (CIPE, 2001).

A major restructuring program directed toward reducing Indonesia’s heavy dependence on oil as a revenue source and improving the country’s overall economic efficiency was instituted. This reform program was designed to sustain a momentum of economic development over the medium- to long-term. Market-based reforms were an important element in this program and were directed at reducing the high level of regulations and administrative control that had long existed in the Indonesian economy (CIPE, 2001).

Exchange Rate Management
The Rupiah was devalued twice during the period under consideration. In March 1983, it was devalued by 38 percent and full currency convertibility was established. It was again devalued by 31 percent in September 1986, in direct response to the rapid decline in oil prices. Normally, the authorities targeted nominal depreciation of the Rupiah against the
dollar at 3-5 percent per annum (Thorbecke et al., 1992). The central bank (Bank Indonesia or BI) intervened in the foreign exchange market by buying and selling the rupiah in an “intervention band” around the central rate. Provided that the system was supported by other policies, the policy to stabilize the real exchange rate helped avoid major macroeconomic crises even in an inhospitable world economic environment (Nasution, 2000). The payments and transfers for current international transactions were also liberalized. The foreign exchange market was developed and the selling of swaps was liberalized (Saxena, 1998). In 1988, exchange rates were tied to a market-based formula.

Monetary and Financial Policies

Throughout the adjustment period, the government’s monetary policy was conservative and generally based on maintaining low rates of inflation. In 1983, a major reform of the banking system was undertaken to oblige banks to follow market principles in attracting deposits and allocating credit. Limits on both deposit rates and lending rates were removed, sectoral credit ceilings were lifted, and subsidized liquidity credits were abandoned. Interest income and that earned on bank deposits were excluded from tax liability. A market for corporate bonds was developed (Thorbecke et al., 1992).

In 1987, reforms concentrated on strengthening capital markets by introducing new instruments. The monetary authorities targeted international reserves; they were allowed to auction money market instruments daily and interest rates were market determined (Saxena, 1998).

In 1988, other reforms to improve the functioning of the banking system and develop the money market were implemented by issuing Pakto 27. Pakto 27 liberalized the financial sector by providing for new foreign bank entries; reopened the market to domestic private banks (including provision for new foreign exchange licenses); provided for easier branching for existing domestic and foreign banks; allowed private bank competition for the deposits of state-owned enterprises; instituted longer maturities and regular weekly auction sales for central bank liquidity instruments; introduced a 15 percent withholding tax on deposit interest rates to level the playing field vis-à-vis stock market dividends; established more flexible, but stronger bank regulation; and reduced
reserve requirements (Woo et al, 1994). As a result of this liberalization, at the end of 1988, the JSX (Jakarta Stock Exchange) index rose to a peak of 442 and then stabilized at 300 – an indication of a major increase in activity (CIPE, 2001).

Fiscal Policy

In its fiscal policy, the government undertook major changes in the level and pattern of expenditures and revenues. On the expenditure side, a major budget retrenchment effort was made. Government expenditures consist of routine expenditures and development expenditures. The former are, among other things, wages, government supply costs, subsidies, and debt services. Development expenditures include development and maintenance of infrastructure, such as transportation, electrical power, irrigation, education, and health, and investments in state enterprises and joint ventures. In general, expenditures on education, health and “other wages and salaries” were cut relatively less than subsidies and capital expenditures on investment projects in the various sectors. Several large public investment programs were cancelled or postponed, while smaller labor-intensive projects under the regional development INPRES Program were encouraged (Thorbecke et al., 1992). Fuel subsidy was cut dramatically. Wage expenditures declined due to a nominal wage freeze for government employees and a restraint of civil service employment. A tight control on the use of non-concessionary import related credit was also implemented (World Bank, 1989).

On the revenue side, a drastic fall in domestic revenue generated by the corporate tax on oil and gas, from about 68 percent at the outset of the oil crisis to about 49 percent in the period 1985/86-1987/88, was responded to by undertaking important reforms in corporate tax structure, which have been effective in raising non-oil tax revenues from 13 percent of the total domestic revenue before the crisis to more than 21 percent in 1985/86-1987/88 (Thorbecke et al., 1992). In January 1984, an income tax was introduced, based on three relatively low rates (15, 25, and 35 percent), and a substantial personal deduction, leaving only 10 to 15 percent of population subject to income tax (Woo et al., 1994). The tax provides for self-assessment of tax liability and withholding as the main form of tax collection. A value-added tax (VAT) replaced an old sales tax in April 1985. The basic VAT is 10 percent on manufacturing, construction, and petroleum
products and is imposed at the point of production or import. An additional tax of 10 to 20 percent is imposed on luxury goods. A new property tax (PBB) was introduced in January 1986, replacing several previous land and wealth taxes. PBB imposes a flat tax rate of 0.5 percent on a proportion of the assessed market value of land and buildings. Steps to strengthen tax administration then followed these tax reforms.

An important feature of Indonesian public finance is that the government is constitutionally obligated to maintain the equivalent of a balanced budget. This means that any excess of government expenditure over and above domestic revenue has to be financed from abroad and almost totally from project aid. This cumulative flow of essentially concessionary aid caused the Indonesian foreign debt to soar from roughly 21 billion USD in 1983 to 1 billion USD in 1987 (Thorbecke et al., 1992).

4.4 The Outcomes of the Reform
The primary objective of stimulating non-oil exports was achieved in a relatively short period of time. As a percentage of GDP, they grew from 4.2 percent in the fiscal 1982 to 9.4 percent in the fiscal 1986 and 15.9 percent in fiscal 1989. This brought the share of non-oil exports as a percentage of total exports to around 56.9 percent in 1990 from 17.8 percent in 1981 (Table 1). Garments and textiles were becoming the mainstay of manufacturing exports (Table 2). GDP growth bounced back from as low as 2.53 percent in 1985 to 7.24 percent in 1990 (Table 3). The manufacturing sector, which accounted for only 11.4 percent of the GDP in 1983 against agriculture’s 24 percent contribution, in 1990 increased to 19.4 percent, which equalled agriculture’s share of 19.4 percent (Table 4).

In term of government revenue, the reform has been able to reduce the government’s dependency on the revenue from oil and gas taxes. As it can be seen in Figure 5, the share of oil and gas taxes on the total government revenue reduced from approximately 62 percent in fiscal year 1982/83 to approximately 27 percent in 1991/92.

The good progress in many macroeconomic indicators was accompanied by the fall of the percentage of the population below the official poverty line, from 40 percent in 1976 to 17.4 percent in 1987 (Table 5).
There are several reasons behind the relative success of the 1986 Reform (or Deregulation):

- The financial liberalization program in 1983 led to an increase in banking intermediation, hence making private investment easier;
- The step-by-step investment and trade liberalization program not only improved the efficiency of the economy and attracted foreign investors to invest in Indonesia, but also supported national industrial development;
- Two devaluations in 1980s restored the competitiveness of non-oil tradable goods;
- Tight monetary control kept the inflation rate low, so capital flight was avoided;
- The new tax program increased government revenue, so that government expenditure for the development of infrastructure, education and health could be maintained.

Also worth mentioning is the fact that the Indonesian stabilization and structural adjustment programs in the 1980s were conducted without pressure from the IMF and the World Bank. The Indonesian government saw that the programs were needed to solve the crises.
<table>
<thead>
<tr>
<th>Year</th>
<th>Total Exports</th>
<th>Non-oil Exports</th>
<th>Manufacturing Exports</th>
<th>Share of Non-oil</th>
<th>Share of Manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>25264.5</td>
<td>4501.3</td>
<td>2666.6</td>
<td>17.8</td>
<td>10.6</td>
</tr>
<tr>
<td>1982</td>
<td>22328.3</td>
<td>3929.2</td>
<td>2466.1</td>
<td>17.6</td>
<td>11.0</td>
</tr>
<tr>
<td>1983</td>
<td>21145.9</td>
<td>5005.3</td>
<td>3219.7</td>
<td>23.7</td>
<td>15.2</td>
</tr>
<tr>
<td>1984</td>
<td>21887.8</td>
<td>5869.7</td>
<td>3982.5</td>
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</tr>
<tr>
<td>1985</td>
<td>18586.7</td>
<td>5868.8</td>
<td>4245.9</td>
<td>31.6</td>
<td>22.8</td>
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<tr>
<td>1986</td>
<td>14805</td>
<td>6528.4</td>
<td>4508.4</td>
<td>44.1</td>
<td>30.5</td>
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<tr>
<td>1987</td>
<td>17135.6</td>
<td>8579.6</td>
<td>6666.6</td>
<td>50.1</td>
<td>38.9</td>
</tr>
<tr>
<td>1988</td>
<td>19218.5</td>
<td>11537.1</td>
<td>9262</td>
<td>60.0</td>
<td>48.2</td>
</tr>
<tr>
<td>1989</td>
<td>22160.2</td>
<td>13460.4</td>
<td>11028.1</td>
<td>60.7</td>
<td>49.8</td>
</tr>
<tr>
<td>1990</td>
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<td>14604.1</td>
<td>11878.5</td>
<td>56.9</td>
<td>46.3</td>
</tr>
<tr>
<td>1991</td>
<td>29142</td>
<td>18247.1</td>
<td>15067.5</td>
<td>62.6</td>
<td>51.7</td>
</tr>
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<td>1992</td>
<td>33966.9</td>
<td>23296.2</td>
<td>19613.1</td>
<td>68.6</td>
<td>57.7</td>
</tr>
<tr>
<td>1993</td>
<td>36823</td>
<td>27077.1</td>
<td>22944</td>
<td>73.5</td>
<td>62.3</td>
</tr>
<tr>
<td>1994</td>
<td>40053.4</td>
<td>30359.7</td>
<td>25702.1</td>
<td>75.8</td>
<td>64.2</td>
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<tr>
<td>1995</td>
<td>45418</td>
<td>34953.4</td>
<td>29328.2</td>
<td>77.0</td>
<td>64.6</td>
</tr>
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<td>1996</td>
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<td>38092.9</td>
<td>32124.8</td>
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<td>64.5</td>
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<tr>
<td>1997</td>
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<td>41821.1</td>
<td>34985.2</td>
<td>78.3</td>
<td>65.5</td>
</tr>
<tr>
<td>1998</td>
<td>48847.6</td>
<td>40975.3</td>
<td>34593.2</td>
<td>83.9</td>
<td>70.8</td>
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<tr>
<td>1999</td>
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<td>38873.2</td>
<td>33332.4</td>
<td>79.9</td>
<td>68.5</td>
</tr>
<tr>
<td>2000</td>
<td>62124</td>
<td>47757.4</td>
<td>42003</td>
<td>76.9</td>
<td>67.6</td>
</tr>
<tr>
<td>2001</td>
<td>56320.9</td>
<td>43684.6</td>
<td>37671.1</td>
<td>77.6</td>
<td>66.9</td>
</tr>
</tbody>
</table>

Sources: Economic Indicators, Central Bureau of Statistics

4.5 Factors Affecting the Shape of Reforms: Political Economy of Decision Making

In the decision making circle, the competition between the economists and the technicians/economic nationalists was not openly known, both preferring the appearance of cooperation. In general, the economists were in a stronger position during the 1980s, but the technicians had the backing of Habibie, who had quite close ties with Suharto.

Table 2. Share of Industrial Exports in Non-Oil Exports.
<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
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<td>Plywood</td>
<td>3.59</td>
<td>15.35</td>
<td>18.66</td>
<td>12.24</td>
<td>9.44</td>
<td>5.80</td>
<td>4.21</td>
</tr>
<tr>
<td>Sawnwood</td>
<td>4.89</td>
<td>5.52</td>
<td>0.75</td>
<td>1.68</td>
<td>1.24</td>
<td>0.76</td>
<td>0.69</td>
</tr>
<tr>
<td>Others</td>
<td>0.80</td>
<td>0.85</td>
<td>3.36</td>
<td>3.18</td>
<td>2.79</td>
<td>3.20</td>
<td>2.58</td>
</tr>
<tr>
<td>Tin</td>
<td>10.04</td>
<td>2.28</td>
<td>1.19</td>
<td>0.39</td>
<td>0.73</td>
<td>0.64</td>
<td>0.44</td>
</tr>
<tr>
<td>Aluminium</td>
<td>0.02</td>
<td>3.02</td>
<td>1.80</td>
<td>1.06</td>
<td>1.11</td>
<td>0.71</td>
<td>0.93</td>
</tr>
<tr>
<td>Nickle</td>
<td>3.36</td>
<td>1.52</td>
<td>1.29</td>
<td>0.75</td>
<td>0.57</td>
<td>0.49</td>
<td>0.37</td>
</tr>
<tr>
<td>Garments</td>
<td>2.12</td>
<td>7.95</td>
<td>11.44</td>
<td>10.63</td>
<td>9.39</td>
<td>9.82</td>
<td>10.25</td>
</tr>
<tr>
<td>Other Textile</td>
<td>0.68</td>
<td>4.27</td>
<td>8.63</td>
<td>8.48</td>
<td>7.81</td>
<td>8.79</td>
<td>7.60</td>
</tr>
<tr>
<td>Processed Rubber</td>
<td>18.03</td>
<td>10.46</td>
<td>5.83</td>
<td>4.58</td>
<td>5.85</td>
<td>3.18</td>
<td>2.76</td>
</tr>
<tr>
<td>Cattle fodder</td>
<td>1.96</td>
<td>1.13</td>
<td>1.12</td>
<td>0.52</td>
<td>0.54</td>
<td>0.23</td>
<td>0.19</td>
</tr>
<tr>
<td>Essential oils</td>
<td>0.35</td>
<td>0.72</td>
<td>0.75</td>
<td>0.25</td>
<td>0.21</td>
<td>0.27</td>
<td>0.30</td>
</tr>
<tr>
<td>Palm oil</td>
<td>2.37</td>
<td>1.73</td>
<td>1.39</td>
<td>2.36</td>
<td>2.17</td>
<td>2.87</td>
<td>2.47</td>
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<tr>
<td>Fatty acids</td>
<td>0.25</td>
<td>0.51</td>
<td>0.55</td>
<td>0.80</td>
<td>0.55</td>
<td>0.46</td>
<td>0.28</td>
</tr>
<tr>
<td>Electrical apparatus</td>
<td>1.91</td>
<td>1.50</td>
<td>1.96</td>
<td>2.36</td>
<td>3.71</td>
<td>4.35</td>
<td>5.96</td>
</tr>
<tr>
<td>Processed food</td>
<td>1.43</td>
<td>1.25</td>
<td>2.00</td>
<td>2.68</td>
<td>2.53</td>
<td>2.47</td>
<td>2.39</td>
</tr>
<tr>
<td>Cement</td>
<td>0.43</td>
<td>0.61</td>
<td>0.66</td>
<td>0.10</td>
<td>0.05</td>
<td>0.35</td>
<td>0.37</td>
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<tr>
<td>Plaited articles</td>
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<td>0.27</td>
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<td>0.17</td>
<td>0.15</td>
<td>0.18</td>
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<td>Chemicals</td>
<td>0.68</td>
<td>0.79</td>
<td>0.77</td>
<td>1.15</td>
<td>1.45</td>
<td>2.54</td>
<td>2.83</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>0.10</td>
<td>1.95</td>
<td>1.33</td>
<td>0.59</td>
<td>0.71</td>
<td>0.48</td>
<td>0.30</td>
</tr>
<tr>
<td>Leather and leather goods</td>
<td>0.64</td>
<td>0.75</td>
<td>0.50</td>
<td>0.23</td>
<td>0.17</td>
<td>0.23</td>
<td>0.23</td>
</tr>
<tr>
<td>Paper and paper goods</td>
<td>0.02</td>
<td>0.49</td>
<td>1.07</td>
<td>2.21</td>
<td>2.51</td>
<td>5.06</td>
<td>4.66</td>
</tr>
<tr>
<td>Rattan</td>
<td>1.52</td>
<td>1.36</td>
<td>0.02</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Others</td>
<td>3.94</td>
<td>4.77</td>
<td>15.99</td>
<td>28.24</td>
<td>30.35</td>
<td>32.88</td>
<td>36.53</td>
</tr>
<tr>
<td>Total</td>
<td>59.24</td>
<td>69.06</td>
<td>81.34</td>
<td>84.66</td>
<td>84.33</td>
<td>85.75</td>
<td>86.23</td>
</tr>
</tbody>
</table>

Source: Economic Indicators, Central Bureau of Statistics

Monetary and exchange rate policies came from the technocrat group, but fiscal and trade policy in the 1980s was the result of compromises between these two groups. When the technocrats implemented monetary and exchange rate policies, there was almost no significant rejection from the other groups. The two devaluations of rupiah did not create any political instability in the country. The main reason could be that the engineers could also see the benefits from these devaluations.

Fiscal and trade policy during this period also reflected more the thinking of the technocrats. For example: in 1983 when the technocrats, through the Department of Finance, cut import tariffs across the board, the technicians, through the Department of Trade, were still able to maintain the quota system to protect their infant industries. When the technicians, through their import substitution strategy, succeeded in developing the paper, metal, rubber, cement and fertilizer industries, the technocrats also benefited by showing that the performance of the economy was improving. When the technocrats decided to cut the budget in the 1980s, the technicians managed to persuade them that more money should be allocated to the manufacturing sectors, unlike in the 1970s when the budget was primarily allocated to the agricultural sector. In 1986 and 1988, when the
technocrats argued to liberalize imports more, the technicians agreed and supported that program. The technicians liberalized commodities that they thought were ready for world competition. One program that gained support from both groups was that of export promotion. One certainly can conclude that what happened in the Indonesian economy during the 1980s, in fact also during the 1960s and the 1970s, was a mixture of liberalization and protection.

Table 3. Annual Growth Rate of GDP (in percentage).

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>Agriculture</td>
<td>4.22</td>
<td>2.55</td>
<td>3.32</td>
<td>2.00</td>
<td>1.60</td>
<td>1.42</td>
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<tr>
<td>Mining and Quarrying</td>
<td>-5.46</td>
<td>16.65</td>
<td>4.85</td>
<td>5.21</td>
<td>10.18</td>
<td>2.18</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>9.29</td>
<td>37.46</td>
<td>9.20</td>
<td>12.50</td>
<td>10.06</td>
<td>9.35</td>
</tr>
<tr>
<td>Utilities</td>
<td>8.10</td>
<td>-27.75</td>
<td>12.15</td>
<td>17.88</td>
<td>16.14</td>
<td>10.14</td>
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<tr>
<td>Construction</td>
<td>2.60</td>
<td>2.24</td>
<td>11.77</td>
<td>13.52</td>
<td>11.25</td>
<td>12.15</td>
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<tr>
<td>Trade, Hotel and Restaurant</td>
<td>2.44</td>
<td>7.98</td>
<td>10.74</td>
<td>7.10</td>
<td>5.43</td>
<td>8.76</td>
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<tr>
<td>Transportation and Telecommunication</td>
<td>0.89</td>
<td>4.16</td>
<td>11.51</td>
<td>9.57</td>
<td>7.88</td>
<td>9.89</td>
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<tr>
<td>Finance</td>
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<td>10.04</td>
<td>10.10</td>
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<td>10.27</td>
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<tr>
<td>Services</td>
<td>5.73</td>
<td>5.45</td>
<td>5.96</td>
<td>4.73</td>
<td>3.74</td>
<td>4.26</td>
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<tr>
<td><strong>Gross Domestic Products</strong></td>
<td><strong>2.53</strong></td>
<td><strong>12.35</strong></td>
<td><strong>7.46</strong></td>
<td><strong>7.24</strong></td>
<td><strong>6.95</strong></td>
<td><strong>6.50</strong></td>
</tr>
</tbody>
</table>

Sources: Economic Indicators, CBS

Table 4. Sectoral Share of GDP (in percentage).

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>24.01</td>
<td>21.88</td>
<td>19.40</td>
<td>17.59</td>
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<td>Mining and Quarrying</td>
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<td>18.12</td>
<td>15.22</td>
<td>13.86</td>
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<td>11.14</td>
<td>16.31</td>
<td>19.39</td>
<td>21.10</td>
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<tr>
<td>Utilities</td>
<td>0.71</td>
<td>0.48</td>
<td>0.63</td>
<td>0.73</td>
</tr>
<tr>
<td>Construction</td>
<td>6.24</td>
<td>5.12</td>
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<tr>
<td>Trade, Hotel and Restaurant</td>
<td>16.30</td>
<td>14.94</td>
<td>16.12</td>
<td>16.36</td>
</tr>
<tr>
<td>Transportation and Telecommunication</td>
<td>5.40</td>
<td>5.19</td>
<td>5.53</td>
<td>5.94</td>
</tr>
<tr>
<td>Finance</td>
<td>5.43</td>
<td>6.68</td>
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<td>7.50</td>
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<tr>
<td>Services</td>
<td>11.82</td>
<td>11.29</td>
<td>11.08</td>
<td>10.31</td>
</tr>
<tr>
<td><strong>Gross Domestic Products</strong></td>
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<td><strong>100.00</strong></td>
<td><strong>100.00</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

Sources: Economic Indicators, Central Bureau of Statistic

4.6 Winners and Losers

The first half of 1980s was difficult for Suharto. With the fall in the oil price, Indonesia’s source of income practically dried up, not only for the official budget, but also for patronage, on which he depended for political support. Suharto had no choice but to turn to the economists’ prescription to weather the crisis. The economists’ proposal was well
suited to Suharto’s overall political strategy. If state revenues could be increased and private sector activity could be rejuvenated to the pre-crisis level, legitimacy and political support would be restored and maintained. Patronage money could flow once again from the private sector, which benefited from the pre-crisis government policy to Suharto’s foundation.

This time around, economic reform was potentially more difficult for the following reasons: Firstly, after the oil boom, the economic nationalists and patrimonialists were more entrenched. Secondly, the president’s children had now become major beneficiaries of the government protectionist policies, and had become patrimonialists themselves. These two groups, together with the president’s predominantly Chinese business associates, constituted the core interest group. However, they did not have credible economic policies to offer. Even the president’s children had to give up some of their sources of income, but Indonesia’s having a vast state dominated economy meant other sources could easily be exploited in compensation. The interest groups, represented in the bureaucracy and the president’s business associates, had not always been happy with the pace of reform that might potentially eroded their monopolistic ways. But they understood that that their prosperity depended on economic recovery.

This also explained why the technocrats were very careful in touching the core interest group, especially in the most protected areas of trade like steel, oil refineries and petrochemicals. The core interest group was also very adept in finding ways to circumvent reforms. For example, when the monopoly of plastic importation was abolished in 1988, two Suharto’s sons moved from monopolizing import licenses for plastics to licensing petrochemical complexes making the same material in Indonesia by joint venturing with Japanese and German companies. Vatikiotis (1993) pointed out that the private sector, whether they were part of Suharto’s cronies or not, gradually came to favour the reform. Prior to the reforms, the relevant economic ministers always consulted business interests to minimize the risk of reform derailment by powerful lobbyists in the shape of the President’s business cronies. The concentration of economic reforms in the financial sector also preserved many monopolies in the real sector, at the same time creating new areas of expansion for the larger business group.
Apart from Suharto’s business associates, the direct beneficiaries of economic reform were private sectors involved in labour-intensive export oriented industries like garments and textiles, plywood and furniture, footwear, handicrafts, processed food and fisheries, and electrical products. This helped millions of Indonesians to escape from poverty. The percentage of population below the poverty line fell from 21.2 percent in 1984 to 13.8 percent in 1993 (Table 5). The earlier agricultural and manufacturing growth also had an impact on trade, transport and other services associated with these sectors. Indirectly, through growing incomes, it also provided strong consumption demand for services such as retail trade, housing and construction.

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage below the Poverty Line</th>
<th>Numbers in Poverty (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Urban</td>
<td>Rural</td>
</tr>
<tr>
<td>1976</td>
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<td>40.4</td>
</tr>
<tr>
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<tr>
<td>1998</td>
<td>21.9</td>
<td>25.7</td>
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</table>


Medium levels of bureaucrats in government banks, in the national custom services, in the National Board of Investment, and in the Department of Trade probably the main losers of this reform. The reform reduced opportunities to obtain informal incomes by cutting the bureaucratic red tape. These medium levels of bureaucrats did not have strong political powers to create political pressures against the implementation of the reform and, after a while, they were able to create other bureaucratic red tape to obtain informal incomes.

5.1. Prelude to the Reform

One of the more significant reforms in the late 1980s was the 1988 banking reform known as Pakto 27. Soon, however, it became apparent that this reform had its own troubles, as some sizable banks experienced insolvency. Many conceded that although the 1988 banking reform gave private national and foreign banks more freedom to operate, the supervisory side was totally inadequate, so it also planted the seeds of serious trouble which erupted in the 1997/1998 financial crisis. Bank expansion was so rapid that in only two years after October 1988 over forty new private banks were established. Many banks were simply the extension of large Chinese conglomerates, which used depositor money to extend credit to their own businesses, without proper evaluation. Besides raising money from domestic depositors, many new banks also borrowed heavily from foreign banks. As they expanded so rapidly, many foreign creditors began to worry about the soundness their assets.

By the end of 1989, the pace of reform had slowed. Only two economic reform packages were announced in 1990. In 1991, the good economic performance that marked the 1986-1991 period began to shown signs of levelling-off. Several macroeconomic indicators showed signs of slackening off. After managing to grow around 21 percent a year during 1985-1991, non-oil export growth fell to 16.23 percent in 1993 and 12.12 percent in 1994 (Table 1). This could be attributed to the disappointing performance of manufacturing exports, which recorded a 15 and 12 percent growth in 1992 and 1993 respectively, in comparison to an average growth of 23.5 percent per annum during 1985-1991.  

5.2 The Driving Forces behind the 1994 Reform

In April 1994, there was no looming crisis of the magnitude seen in the 1960s and 1980s, but concern for the apparent slowing down of non-oil exports became the focus of many observers. The government indicated its concern in April 1994 and started to establish an inter-Ministry team headed by the Coordinating Minister for Industry and

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2 Although there was good argument that the dismal performance of several economic indicators was caused by the slowdown of the pace of economic deregulation, there was also another argument to support the view that this downward trend was part of a global phenomenon. This argument was based on the observation that other Asian tigers like Malaysia, Thailand and South Korea also experienced a similar trend.
Trade to study the cause of the decline (Pangestu and Azis, 1994). Iqbal (1995), for example, argued that the reason behind the economic slowdown was the slowdown of the pace of deregulation. One indication was that the nominal tariff that showed a decreasing trend in the previous period hardly changed at all during the 1991-94 period. The same pattern could also be observed for products subject to import license.

There were also other possible explanations, notably economic recession in several major markets. The recession was not yet over in the Japanese and European economies, while the US the recovery had just started. Another possible cause was the decline in export-oriented investment. There was, however, no data separating export-oriented and non export-oriented activities. Data was available for the breakdown of investment approval into domestic and foreign origins. Assuming that the trend of export-oriented investment from East Asian economies would continue well into the 1990s, the economy also seemed to lose its attractiveness to foreign investors. There was a decline in total outward investment from Japan, one of Indonesia’s major sources of investment, and a significant diversion to China. After 1992, the value of new foreign investment continued to fall. In the first half of 1994 for example, the number of approved foreign investments declined by 43 percent compared to 1992. In 1992 and in 1993, the total value of approved foreign investments amounted to US $10.32 billion and 8.4 billion respectively. Approved domestic investments, on the other hand surged in 1993 after declining from a peak in 1990 (Azis and Pangestu, 1994).

Looking at the non-oil export items, the most significant decline was in textiles and garments. One plausible reason behind the slowdown of manufactured exports was the nature of the products, in that they were basically destined for low-end consumption and relied on low cost labour to be competitively priced. With the successive increases of national minimum wages, this competitiveness of Indonesian labour-intensive exports seemed to be eroded. From 1994 to 1996, garment firms in particular had been hard hit by the sharp increase in minimum wages and changes in wage regulations pertaining to temporary and permanent workers. These policies in effect raised wage cost by an estimated 50 to 60 percent in the above period. In 1996, the World Bank suggested that, from 1993 onwards, productivity increases might have become lower than wage increases. The erosion of competitiveness took place at a time when there was an increase
in competition from other lower cost producers such as China, Bangladesh, Sri Lanka, India and Vietnam (Pangestu, 1998).

5.3. The Reform
In 1994, in response to this situation, the government announced a bold economic deregulation, mainly related to investment and trade policies, which included the abolition of the limitation on foreign ownership, a reduction of the trade barrier in the form of tariff cuts, and the opening up of 10 previously closed sectors to foreign investment.

The divestment rule, which had been a major deterrent to foreign investors, was abolished. Under the new rule, foreign investors were allowed to form either a joint venture with 95 percent majority equity ownership without any further divestment obligation or to have full ownership (100 percent stake) of a business entity in Indonesia with the provision that within 10 years some unspecified divestment would take place in favour of Indonesian partners. In addition, firms 100 percent owned by foreigners were also allowed to invest in all areas in Indonesia.

The deregulation also eliminated the minimum investment requirements, which previously were set at USD 1 million. Another aspect of the deregulation was the opening up of nine sectors previously closed to foreign investment, which included sea ports; production, transmission and distribution of electricity; telecommunications; shipping; civil aviation; drinking water; railways; nuclear power generation; and the mass media. One sector that remained closed to foreign investment, despite much expression of interest, was domestic distribution and retailing.

Another trade reform, called the May package, was introduced in 1995. The package encompassed a significant and almost across the board reduction in tariffs, as well as a pre-announced schedule of further tariff reductions to the year 2003. Further, more transparent tariff surcharge was enacted to replace the remaining non-tariff barrier (NTB). This trade reform aimed to meet Indonesia’s international commitment and outlined the general target levels and schedules of tariff cuts on 6030 items (64 percent of the total), to be achieved by 2003. By that time, all tariffs except those on automotive

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3 In May 1989, this was lowered to US$ 250,000 for certain sectors such as distributions of the joint venture’s products.
components and products) would be set at a maximum of 10 percent with most falling in the 0-5 percent ranges. There was however no mention of the size and timing of the cut. The cut did not include items such as soybeans since BULOG whose responsibility also included the importation of foodstuff and agricultural products, had monopoly rights (Nasution, 1995). The special treatment given to automotive spare parts and products suggested that the government had not abandoned the plan to promote the development of Indonesia’s automotive industry.

The May package also changed the structure of import surcharges in conjunction with Indonesia’s commitment to GATT/WTO to remove it within the next 10 years. The reform, however, was carefully designed to maintain the levels of protection to the steel and petrochemical industries. It eliminated surcharges on 45 tariff lines, including tobacco products, steel sheets, and some steel products, but new surcharges of 5 to 10 percent were introduced on 69 tariff lines, including steel products, as a way to compensate the steel industry for tariff cuts. Surcharges were increased for 13 tariff lines, including alcohol related and petrochemical products, to protect the Chandra Asri Petrochemical Complex, controlled by one of the Suharto’s children. The May package also reduced the coverage of import licensing from 242 items to 189, without touching the monopoly and oligopoly rights of BULOG and BPPC (clove buffer stock and marketing board). BPPC was a particularly controversial one. It was owned by a consortium of private traders headed by the youngest son of Suharto and had the exclusive right to operate a buffer stock of cloves in Indonesia (Nasution, 1995).

Perhaps the best part of the May package was the components that improved trade, investment and business facilities. A simpler industrial permit replaced the permanent business permit. It also modified customs procedures by waiving pre-shipment inspection of imported goods transported by air. These could now be cleared through normal custom procedures at the airports. It also waived custom inspection of exports goods moved between bonded zones and entry ports. Finally, the package extended duty free treatment of capital goods and other imported inputs used in production to businesses that used at least 30 percent of their investment for restructuring or capacity expansion.
One obvious weakness of the May package was that it had little impact on high levels of protection afforded to domestically produced essential inputs by making imported inputs artificially more expensive. This was very detrimental to the competitiveness of Indonesian non-oil export items, many of which depended on those inputs. To remedy this problem, Indonesia adopted second best measures, comprising the provision of imported inputs at world prices, export finance, credit guarantees and insurance facilities. To ensure that exporters obtain inputs at competitive international price, the government adopted two schemes; prior duty exemption and duty drawback, and refunds of value added taxes (VAT) paid on domestic inputs used in export production. Although, this program had a positive impact in neutralizing the adverse impact of protection given to up-stream industries on input prices, it was administratively a long process and susceptible to fraud (Nasution, 1995).

5.4 The Outcomes of the Reform

Investors seemed to respond favorably to the 1994 economic reforms. This was reflected in the influx of foreign investment in the second half of 1994 such that at the end of the year, the value of foreign investment projects reached its all time high of USD 23.7 billion. The resurgence of flows of foreign investment continued well into the middle of 1997 when the currency crises hit Indonesia. In 1994, the value of approved new domestic investment projects exceeded approved foreign investment for the first time.

In the 1994-1996 periods, Indonesia’s short-term prospect looked good. GDP grew to average about 8 percent per annum (Table 6). However, this growth masked two important developments in the Indonesian economy. First, financial liberalization had attracted a huge capital inflow, in the form of corporate to corporate loans as well as through commercial banking. Second, after the departure of key technocrats from the cabinet, there was erosion in the fiscal discipline. Various deregulation measures announced in the 1994-1995 period changed many aspects of economic incentives including consumption and investment activities, and export-orientation versus the

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4 Unlike the previous investment boom in 1988-1992 where textiles, garments and footwear made up the bulk of total investment, the second investment boom was more diversified, ranging from electronic components, automotive parts, and chemicals, to food and beverages; also, most of the projects were destined to serve the Indonesian domestic market.
domestic market. At first glance, the figures of economic growth were impressive. Looking more deeply, however, the growth was hardly sustainable. Economic growth actually took place in non-tradable sectors such as residential and non-residential construction, which was intended to meet domestic demand and hence contributed very little to foreign exchange generation. Most capital inflows were used to finance expansion in these sectors, including housing and apartment complexes, industrial estates, shopping malls, commercial buildings, entertainment parks and golf courses. Between 1994 and 1996, construction grew at 12.84 percent per annum compared to 9.7 percent between 1986 and 1990 (Table 6). To complicate the matter, most of the expansion of non-tradable sectors was financed by short-term foreign commercial loans.\[5\] The growth of other supposedly more productive non-tradable sectors like transportation was a little slower. For example, transportation rose at 8.6 percent per annum in the 1994-96 periods, in comparison to 9.2 percent per annum between 1990 and 1993.

<table>
<thead>
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<td>3.03</td>
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</tr>
<tr>
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<td>7.36</td>
<td>-36.44</td>
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<td>5.34</td>
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<td>-3.85</td>
<td>1.94</td>
<td>2.04</td>
</tr>
<tr>
<td><strong>Gross Domestic Products</strong></td>
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<td><strong>4.70</strong></td>
<td><strong>-13.13</strong></td>
<td><strong>0.79</strong></td>
<td><strong>3.44</strong></td>
</tr>
</tbody>
</table>

Table 6. Sectoral GDP Growth

Source: Economic Indicators, Central Agency of Statistics (BPS).

In the area of social welfare, rapid growth seemed to be accompanied by a sustained reduction in the incidence of absolute poverty. Data from the Central Agency of Statistic showed that it declined from 13.7 percent of the population in 1993 to 11.3 percent in 1996 (Table 5). Much of this was attributable to poverty alleviation in Java, which saw expansion of off-farm employment opportunities for rural households. One

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\[5\] Overvalued Rupiah and high domestic interest rates made borrowing abroad cheaper.
caveat was that Indonesia’s absolute poverty line was lower than that of other countries comparable in income per capita, like The Philippines. However, this did not negate the fact that the absolute poverty had shown a declining trend in Indonesia, although the proportion of the population below the absolute poverty line would be greater under a higher poverty line.

A more debatable achievement of the New Order was in the area of income distribution. The extent to which it deviated from a perfectly equal distribution can be measured by the Gini ratio. In Indonesia, this ratio was calculated based on the consumers’ expenditure survey (SUSENAS). The data showed that income distribution remained fairly constant during the New Order era. The Gini ratio was 0.34 in 1976 and 0.37 in 1996. Despite this statistical evidence, there was a growing perception that economic disparities between the rich elite and the poor masses, as well as between urban and rural areas, and between western and eastern Indonesia, had widened. The dominance of Suharto’s predominantly Chinese business cronies and his extended family in lucrative business sectors in Indonesia did not help this matter and remained one tainted spot in his achievement in improving the welfare of the general population.

5.5 Factors Affecting the Shape of Reforms: Political Economy of Decision Making
The first half of the 1990s saw the waning of the technocrats’ ability to influence Suharto, either as a group or as an individual. Senior economists like Widjojo Nitisastro and Ali Wardhana had retired from the cabinet after long tenure, and were replaced by members of the technicians or economic nationalists. Recall that in the Sixth Development Cabinet (1993-1998) Hartarto was the Coordinating Minister for Industry and Trade, Ginandjar Kartasasmita was the head of BAPPENAS, and Mar’ie Muhammad was the Minister of Finance. Besides Habibie, Hartarto and Ginandjar Kartasasmita were important figures in the technician group. Mar’ie Muhammad is a bureaucrat with an economic nationalist perspective. This caused considerable concern among observers, since from past experience, in particular from their heydays in the oil boom era, technicians were more inclined to manipulate prices in the domestic market through various forms of taxes and subsidies.
The change of the balance of power in the policy making circle from the technocrats to the technicians was most likely planned by the president himself. He might have sensed that the time had come for the change in the development strategy, away from the technocrats’ comparative advantage, which was based on the free market and the export of labour intensive products, to a more interventionist industrial policy. Such change was expected to weaken cabinet resistance to the implementation of large scale, high technology projects favoured by Habibie.

The rising influence of technicians in policy-making was caused by the growing influence of B.J Habibie, the powerful Minister of State for Research and Technology, who had made public his vision on economic development. To him, this was about the physical appearance of the economy, which was meant the proliferation of enterprises, which made heavy use of high technology, seemingly regardless of the impact on national income or its distribution (McLeod, 1993). On the other hand, for the economist group, economic development meant increasing income-, especially to those poorer segments of the population.

Nevertheless, although the technicians were growing stronger, in a typically Suharto cautious approach, and perhaps also in a response to domestic and international concerns on the apparent demise of the technocrats’ influence, the president reappointed Widjojo and Ali Wardhana as advisors to the government. The president also did not lend Habibie a completely free hand. Hartarto, Ginandjar Kartasasmita, and Mar'ie Muhammad were technicians and economic nationalist who embraced trade liberalization and from time to time had showed willingness to oppose proposals for high technology and large-scale investment (McLeod, 1993). Hence, the Sixth Development Cabinet still maintained the key success to good economic performance success, developed by the technocrats, which was fiscal discipline. In particular, the government maintained the budget deficit at a level that could be financed by concessionary foreign loans. The cabinet was able to convince business communities and foreign investors that the successful polices of the last decade would continue. Most business communities and foreign investors therefore reacted positively to the 1994 and 1995 economic reforms.
The thinning rank of technocrats and the rise of technicians in the cabinet evidently had several significant impacts. First was the impact on the government off-budget. The government budget in Indonesia comprised two parts: official and off-budget transactions. While the former was publicly available, the latter transactions such as those of lower level government, quasi-government institutions, and state-owned enterprises, were unknown. Since there were only a few technocrats in the cabinet, the technicians were able to increase the amount of off-budget expenditures to support ‘strategic industries’ under the control of Habibie. The most publicized case was the use of nearly US$ 200 million of reforestation funds for a loan to the aircraft industry to fund the development of a prototype of its 75 passenger N-250 turbo-prop aircraft (Wahyuningsih, 1997). Public resources through off-budget transactions were also used to bail out the collapsed state owned enterprises like BAPINDO in 1994 and firms of politically well-connected groups such as Barito Pacific Timber Company in 1992 (Brown, 1999). Those transactions almost always involved the President family or his extended family.

Second was the impact on the nature of economic policies in 1990s. Certainly, there would be no blatant rush to the capital-intensive and high-tech development projects favored by technicians and perhaps also by Suharto himself. Outwardly, macroeconomic policies appeared as market friendly as ever, but at the microeconomic level it tended to be discriminative. This was demonstrated in the case of the 1994 and 1995 deregulations. The 1994 deregulation, although it slightly improved the trade, investment and business climate by simplifying ownership policy, it barely touched the business of the core interest group. The 1995 deregulation, the primary focus of which was to meet Indonesia’s commitments to market access under the GATT/WTO, AFTA (ASEAN Free Trade Area) and APEC (Asia-Pacific Economic Cooperation), towards a more neutral tariff regime, was to some extent shallower than that in 1986 and it went further by implying ambiguities. One example of such ambiguities was in the case of a steel maker PT Krakatau Steel, where a rise in the import surcharge on steel products was imposed to compensate for a cut in the tariff. In similar fashion, import surcharges on polypropylene and polyethylene had also been raised to protect domestic petrochemical companies, among them PT Chandra Asri, which was partially owned by
one of the Suharto’s children. The 1995 deregulation also did not remove the monopoly rights granted to politically connected business groups on essentials, and commodities and inputs (Stern, 2003).

5.6 Winners and Losers
As Indonesia entered the 1990s, it became apparent that, apart from the political and indirect economic benefits to the president, economic reforms could not proceed if they did not benefit the core group economically or at least did not interfere with their interests. This was not a problem during the earlier experience in 1986 or in 1966, since economic deregulations had been a vehicle to expand the business empire of the core interest group, including the president’s extended family and his Chinese business associates. In the 1990s, it can be observed that in non-trading sectors, such as the public sector (including state owned enterprises), some parts of agriculture and the import-substituting industry remained untouched by deregulation. In sectors such as road and electricity generation, deregulation only transferred monopoly rights from the state to private enterprises controlled by the president’s business cronies. The up-stream industries producing essential inputs for the down stream industries were also controlled by the president’s business associates, if not by his own children. The main winners of the 1994-1997 reform were clearly Suharto’s cronies and relatives. While the losers, in practical economic terms, perhaps were the down stream industries, many of them were also export-oriented, and it was the consumers of final goods that had to pay higher prices charged by the upstream industry controlled by Suharto’s relatives and cronies.

Suharto and his cronies were still politically too strong during this period. It was impossible for losers to demand any compensation. Nevertheless, in public discourse, there was a growing concern about the blatant corruption at all levels of government bureaucracy, collusive relationships between political power holders and their business cronies, and the proliferation of policy-created barriers to domestic competition (Thee, 2001). In essence there was widespread condemnation of KKN (corruption, collusion and nepotism) practices that rewarded rent-seeking activities rather than productive entrepreneurship. The fact that many of Suharto’s cronies were ethnic Chinese created another era of resentment toward Chinese minority.
Another important issue becoming more often appeared in public discussions was regional dissatisfactions with how the central government distributed the revenues from natural resources. Note that central government received most revenues from natural resources and used these revenues to finance the national budget, including regional budgets. There was no special treatment for regions with rich natural resources. This strategy was able to control inter-regional income inequality. Or at least, in general, inter-regional income inequality was not increasing since Suharto was in power. Rich natural resources-regions, however, felt that they should receive more transfer from the central government. Public then started to discuss the possibility for Indonesia adopting a more decentralized system of government.

Hence, although the mid-term prospect of the economy in the 1990s appeared to be good, all these negative factors, combined to create a sense that the country was going in the wrong direction.

6.1 The Prelude to the 1997/1998 Economic Crises
During the 1995-1996 period, the overall macroeconomic indicators seemed quite comfortable. The government’s budget was broadly in balance. Inflation was just single digit. The current account deficit, as a percentage of GDP, appeared manageable, the external debt-to-GDP ratio, although high, was gradually declining and was lower than that during the 1980’s reform period. Although export growth was fluctuating, there had been no sudden drop (Hill, 2000).

Looking deeper into the current account deficit situation, it soon became apparent that, in the aftermath of the 1994-1995 economic reforms, the domestic economy was in a state of overheating. The expansion of domestic aggregate demand was reflected in the increase in the current account deficit. Although as percentage of GDP it seemed manageable, it rose from US $ 2.9 billion in 1994 to US $ 7.9 billion in 1995, roughly a two and half times increase (Table 7). The increase of the deficit could be attributed to the rising imports of intermediate goods as a result of domestic demand expansion. The flood of foreign direct investment also contributed to a soaring current
account deficit, as a result of a rise in capital goods imports and a rising demand for foreign consultants, especially for setting up plants.

Table 7. Key Macroeconomics Indicators

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<td>8.95</td>
<td>17.3</td>
<td>-6761.0</td>
</tr>
<tr>
<td>1996</td>
<td>2368</td>
<td>5.12</td>
<td>17.1</td>
<td>-7799.0</td>
</tr>
<tr>
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<td>3989</td>
<td>10.31</td>
<td>26.1</td>
<td>-4999.0</td>
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<tr>
<td>1998</td>
<td>7625</td>
<td>77.63</td>
<td>52.3</td>
<td>4097.0</td>
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<tr>
<td>1999</td>
<td>7142</td>
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<td>2000</td>
<td>9506</td>
<td>9.35</td>
<td>13.2</td>
<td>7693.0</td>
</tr>
</tbody>
</table>

Source: Indonesian Financial Statistics

To contain this economic overheating, the monetary authority continued to pursue a tight monetary policy. At the same time, to maintain the competitiveness of non-oil exports, the central bank adopted a policy to depreciate the currency at the rate of 5 to 6 percent per annum. Within the targeted depreciation rate, the currency was allowed to fluctuate within a band. These policies proved to be inconsistent in the long run. High interest rates themselves attracted a huge capital inflow that had to be bought or sterilized by the central bank if the currency depreciation were to be maintained. This operation injected a new liquidity into the economy, which in turn had to be absorbed by high interest rates. Thus the central bank was burdened by two conflicting tasks, namely to maintain low inflation and to maintain a competitive exchange rate. As indicated by the purchasing power parity theorem, the combination of a high domestic interest rate and low expected currency depreciation produced an overvalued Rupiah, which made import activities and borrowing abroad artificially cheaper in the domestic
currency. Moreover, the high interest rate policy that led to the currency appreciation and the policy to depreciate the Rupiah required a timely intervention, which was itself susceptible to currency speculation.

The current account deficit reached approximately 4 percent of the GDP in 1996 and in 1997 reflected Indonesia’s vulnerability to external events. In the past, soft loans and foreign direct investment mainly financed the deficit. From 1991 onwards, portfolio investment that was lured by high domestic interest rate and a perception that Indonesia was a stable-booming economy was increasingly playing an important part in financing the deficit. Meanwhile, high domestic interest rates and an overvalued Rupiah currency encouraged the private sector to borrow heavily overseas to finance their domestic ventures. many of them were intended for the domestic market. For this reason, the deficit was also increasingly financed by short-term private loans. To make the matter worse, the predictability of the exchange rate movement with a steady depreciation of around 4 to 5 percent provided very little incentive for borrowers to hedge their foreign debt.


Various macroeconomic conditions such as a huge current account deficit, a mounting foreign debt and a weak banking system with large non-performing loans put Indonesia in the club of countries like Thailand and Korea and to a lesser extent like Malaysia and The Philippines. The 1994-1996 economic boom did not last very long, coming to an abrupt end in August 1997 and Indonesia sank into an economic crisis unprecedented in its history. It started as a currency crisis, when Thailand’s economic crisis triggered doubts concerning Indonesia’s economic stability (Nasution, 2000).

As the direction of capital inflows started to reverse, the external value of the Rupiah plummeted between June and November 1997, depreciating by 35 percent. It became apparent then that the monetary authority did not have sufficient reserves to defend the Rupiah. Instead, after increasing interest rates, it opted first to enlarge the band and finally to move to a free float system. Despite high interest rates, capital outflows continued to accelerate and as a result the currency continued to weaken. The
move toward a free float created a panic among domestic corporations with large exposure to overseas loans, and also international investors with Rupiah denominated assets. Due to the stability of the Rupiah in the past, these debts were largely unhedged. As they scrambled to buy USD, it put further pressure on the currency. The currency collapsed from 2,300 rupiah in June 1997 to more than 17,000 rupiah per USD by January 1998. Following this collapse, inflation in 1998 jumped to 78 percent (Table 7).

Although the economic crisis hit Indonesia in the second quarter of 1997, the economy still managed to grow by 4.6 percent in 1997. The full impact of the crisis was felt in 1998. The hardest hit was the construction sector, which recorded a negative growth of 36.44 percent in 1998. The financial sector followed next with a negative growth of 26.63 percent (Table 6). The manufacturing sector paid dearly for its high dependency on imported inputs. With soaring production costs due to the mega devaluation of the currency and the collapse of domestic demand, the sector grew by minus 11.44 percent. The overall GDP contracted by 13.13 percent.

The socioeconomic impact of the currency crisis was transmitted through two channels, aggregate demand and relative price (Thee, 2001). The sudden withdrawal of capital, the huge devaluation of the currency and the tight fiscal and monetary policies had caused considerable contraction in construction, banking and manufacturing that brought massive layoffs. The second channel was through the changes in relative price, as a result of the changes in price of imported goods and inputs. Between August 1997 and December 1998, the number of non-agricultural employees in the formal sector had fallen by 1,827,000. This was accompanied by an increase in employment in the informal sector of 2,803,000. It appeared that those laid-off from the formal sector had been absorbed by the informal sector, which usually involves a movement toward lower quality jobs. The Central Agency of Statistics (BPS) estimates suggested that the urban population below the poverty line in the urban areas rose from 9.7 percent in 1996 to 21.9 percent in 1998, while that of rural areas increased from 12.3 percent to 25.7 percent (Table 5). This brought the total number of population below the poverty line to 24.2 percent in 1998 or about 49.5 million out of the population of 210 million. However, this figure is still subject to lively debates since the non-food poverty line estimates in the calculations were not strictly comparable to the 1996 data (Booth, 1999).
6.3. IMF Sponsored Economic Reforms

Powerless to deal with the crisis, Indonesia turned to the IMF for assistance in October 1997. In return for a standby loan of US $ 43 billion, including US 12.3 billion from the IMF itself, the government agreed to the comprehensive economic reform program designed to bring the economy into the recovery path. The program encompassed the framework for fiscal, monetary and balance of payment policies, financial sector reform, and trade and investment policy reforms, which would be implemented over a three year period and monitored by experts from IMF. It was hoped that this would restore confidence in the currency.

The first step was the financial restructuring program, which was aimed at strengthening the weak banking system plagued by large non-performing loans. This step involved the closure of 16 private insolvent banks including some controlled by Suharto’s family and his business cronies. This was a risky strategy because, although it showed the government’s adherence to the reform, with no credible deposit insurance scheme, this only made an already panicking public and investors more desperate to abandon the Rupiah, pushing the value of the currency further downwards. Stabilization was achieved only after the government announced that it would guarantee all liabilities of the domestic banks.

The second step of the reform was announced in January 1998. The measure basically covered liberalization of both trade and foreign investment. The medium-term tariff reduction was broadened so that motor vehicles and alcohol products were the only categories remaining outside the general commitment to lower tariffs to a maximum of 10 percent by the year 2003. The tariff on most chemical products was lowered by 5 percent at the beginning of 1998, while the maximum tariff on food fell to 5 percent from the beginning of February. In the automotive industry, the range of special tax facilities enjoyed by Tommy Suharto’s national car were removed and the local content requirements for the automotive industry were to be phased out in two years. In the area of import licensing, the importation of basic food products such as wheat and wheat flour, garlic, sugar and soybeans was opened to general importers. In
the same spirit, export taxes on a wide range of products were also removed (Susastro and Basri, 1998).

In the area of domestic trade, restrictive marketing arrangements for manufactured goods such as cement, paper and plywood, and agricultural goods such as cloves, cashew nuts, oranges and vanilla were abolished, while the control on the pricing of cement was removed. The controversial clove marketing board (BPPC) operated by Tommy Suharto was also disbanded in mid 1998. In the case of investment policy, restrictions on foreign investment in the palm oil industry were removed in February 1998, and also the long awaited reform in the lucrative wholesale and retail trade sector was commenced with the opening of this sector to foreign investors (Susastro and Basri 1998).

In the field of governance, proper bidding processes for government contracts such as infrastructure development and a more transparent mechanism to evaluate private sector proposals for government projects was to be adopted. In the case of fiscal discipline, it was also decided to consolidate off-budget items spread all over government ministries into the budget. The use of reforestation funds for the financing of the aircraft and the national car industries were just a couple of examples of the improper off-budget transactions. The government also promised to conduct a more vigorous and genuine privatization program where the government would no longer retain interest in privatized enterprises (McLeod, 1999).

6.4 The Reform Outcomes

Looking at several indicators, by the beginning of 2003, there is no doubt that the economic crisis has bottomed out and the economy seems on the right track to recovery. However, the recovery process is still fragile and there is a danger that it could reverse. Three key stability indicators in the economy have shown encouraging signs. The contraction of the economy has come to an end with a modest GDP growth since the first quarter of 1999. The Rupiah stabilized at around 9,000 rupiah per USD since May 2002. The appreciation of Rupiah along with the constancy of food supply, have held inflation in check. Measured by the consumer price index (CPI), inflation reached its peak in 1998 at 82 percent per annum. The inflation rate in 2002 was 9.6 percent. The
rapid decline of inflationary expectation has helped the Central Bank to lower interest rates on SBI from a peak of 70 percent in late August 1998 to below 12 percent in mid 2003. In 2001 the economy grew by 3.4 percent and in 2002 by 4.0 percent, but this is insufficient to increase employment or to reduce poverty (MacIntyre and Resosudarmo, 2003).

There has been a growing public perception that except for exchange rate stability, the IMF reform program has not shown much progress in boosting economic growth and creating jobs. Since 1998, the recovery process has been slow and often painful, so that the reform has lost much of its credibility. The legislative body voted in 2002 not to extend the contract with the IMF beyond 2003. Bowing to political pressure, the government has totally given up on the idea of extending the contract with the IMF beyond 2003, instead opting for the so-called post-monitoring program, in which the IMF acts very much as advisors. What the impact of this policy will be beyond 2003 is hard to predict. The danger is that there are plenty of economic nationalists who are ready to exploit the growing public discontent with the IMF sponsored reform and to offer populist economic strategies that are not necessarily sustainable.

With power being much more diffused than in Suharto’s era, economic recovery itself takes a back seat to politics. As a consequence, consensus on policies is much harder to get. Rent-seeking activities did not die with the demise of Suharto. On the contrary, there are now many more interest groups that have to be compensated up front. There is really no single dominant party. The government and the legislative body are formed from a fragile coalition of the top four parties in which the party at the very top is very reluctance to share the rents from economic reform with others. Also the promise about future compensation is not credible enough. As a consequence, many reforms under the IMF umbrella that may potentially bring about the recovery of the economy are stalled in the legislative process. The economy has been growing modestly between 3 to 4 percent per annum. But investment spending, the primary source of economic growth in the past, has remained below the pre-crisis level (MacIntyre and Resosudarmo, 2003).
6.5. Factors Shaping the Political Economy of Decision Making

Unlike the economic reforms in 1986 and 1994, the IMF sponsored reform in 1998 threatened the dominant position of the core interest group, including Suharto himself. This reform attached a higher priority to microeconomic programs such as banking closure and trade and investment policy particularly the ones that had served the supporters of Suharto very well in the past and the mega projects favoured by technicians/economic nationalists like Habibie.

Once it became obvious that the IMF sponsored reform targeted the privileges of Suharto and the core interest group, they staged opposition in various forms. As a consequence, this reform faced strong opposition from the ruling elite, particularly at the implementation stage. It is true that there was never blatant opposition to the reform since Suharto still needed the IMF umbrella to restore the investors’ confidence. However, on several occasions at the beginning of 1998, the President made negative comments about the merit of the reform, and in a way tried to focus frustration with the economic crisis onto the IMF. Suharto also looked around for other alternatives.6

In March 1998, after his reelection, Suharto announced a new cabinet in which none of the members of the economist/technocrat camp were appointed. One surprising move by Suharto was that his eldest daughter and one of his closest business associates were among them. The composition of the new cabinet, which was dominated by technicians and patrimonialists signified the government’s silent opposition to the reform.

Suharto was well aware that if the reform was implemented fully his political survivability was not guaranteed, even if the economy eventually recovered. He also was perhaps not convinced that the reform would bring about a speedy economic recovery. So, given these choices, the only alternative for him was to try to preserve his economic privileges as much as possible by dragging down the reform, possibly for the sake of his children. Since he was already approaching 80s, he could have been reasoning that, if he could pick a trusted successor, his children’s economic future would be ensured.

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6 In early 1998 in the face of the continuously declining value of the Rupiah, Suharto was considering applying the currency board system
The priority on microeconomic reform, while it was desirable in the longer term, had little effect in stemming the crisis. It chose to confront the core interest group directly, so it was not too surprising that the pace of reforms slowed down because of resistance or foot-dragging. What the investors needed was reassurance that their loans would be repaid in full and on time. There was very little in the reform package that pointed in this direction. In the end it failed to impress the market at the crucial moment, when it was still possible to stem the crisis of confidence among investors.

The IMF response to this situation was to blame the government for its failure to fulfill its commitments and then to demand further reform measures in addition to those already agreed upon in the previous agreement. Around April 1998, market confidence had still not been restored, so the currency continued to slide until it had lost 80 percent of its original value.

Suharto made a political miscalculation by underestimating massive unemployment and huge price increases in early to mid 1998 that quickly undermined his performance legitimacy, which had helped him to stay in power for so long. His supporters and perhaps also the general population had been willing to look the other way in the face of increasingly blatant nepotism, cronyism and corruption as long as they also benefited from them. But as pessimism continued to spread, although people blamed the IMF for the economic hardship caused by the austerity policy, they also began to think of the president himself as detrimental to quick recovery. Implementation of government commitment to the IMF sponsored reforms might restore the investors’ confidence, which could serve as a basis for economic recovery, but it required sacrifice on the part of Suharto himself and the core interest group. There was, however, little sign that Suharto would embark on this direction.

As the crisis worsened, social unrest continued to spread and the political situation became inflammatory. In May 1998, a massive student demonstration protesting against the fuel price hike turned into large-scale riots, arson and mass looting in Jakarta, as four students were killed by unknown assailants. In the aftermath of the riot, under the threat of impeachment from no longer compliant leaders of the parliament, Suharto resigned from the presidency after 32 years in power. The military, whose interest had been sidelined by the core interest group and who faced the prospect
of having to quell mass unrest, was only happy to see the departure of Suharto, and was perhaps also actively involved in forcing Suharto to resign.

The resignation of Suharto made Habibie, who was the vice president at that time, the nation’s president. Habibie was powerless. He was pushed into agreeing to conduct a new election after one year. The political situation was inconclusive and most people’s attention was on the next year’s election.

The fall of Suharto also signified the transformation from an authoritarian regime towards a more democratic society. Much power shifted from the executive body to the legislative body, where the domination of the GOLKAR party was thing of the past. After the election in 1999, five parties (PDI Perjuangan, GOLKAR, PKB, PPP, and PAN) were now competing for the legislative leadership. The growing power of the legislature, without a dominant party, implies that it is harder to get consensus on important matters such as economic policy making. Although it is also shares the blame for the slow pace of reform, the legislature is increasingly impatient with the slowness of the IMF program to achieve economic recovery. The learning process towards democracy and a more open society has come with economic costs. Furthermore, exploiting the growing nationalist sentiment, the legislature is also becoming the strongest opponent to the privatization program suggested by the IMF. (MacIntyre and Resosudarmo, 2003).

It is important to note the changes in business activities after the Suharto era. The apparent better economic performance of Indonesia in the past, despite the problem of corruption, might be attributed to the fact that Indonesian corruption or rent-seeking activities were centralized and well managed, and thus were more predictable. The first family and the top military leadership in partnership with the ethnic Chinese conglomerates controlled corruption. Political stability reduced much of the uncertainty. Although firms were reported to complain about corruption and bureaucratic harassment, most costs associated with corruption and bureaucratic red tape could be predicted and calculated as part of transaction costs. At the national level, the involvement of Suharto’s children in many private businesses was also regarded as an effort on the part of entrepreneurs to reduce business uncertainties that might come from the harassment of lower level bureaucrats. With the departure of Suharto, this system has been replaced by a more fragmented system, with at least five dominant parties competing for power and
financial resources. The transaction costs caused by corruption, or even in generally conducting business, is now unpredictable.

The other interesting development after the fall of Suharto is the drive toward regional decentralization. The nature of centralized authority of the Suharto regime, which was centered on the relationship between the central and local government, was often criticized for undermining the regions’ initiative to explore their economic potential. As in the case of political affairs, the new atmosphere of freedom after the fall of the Suharto regime had created euphoria on the part of local governments (provinces and districts) and inspired them to demand greater autonomy to manage their own affairs. In response, the New Laws of Regional Decentralization (Law No. 22/1999 on Regional Government and Law No. 25/1999 on the Fiscal Balance between the Central Governments and Regions) were launched in May 1999. Greater authority is delegated to around 300 districts, including the fields of agriculture, industry, trade and investment (Alm et al., 2001).

Contrary to the initial goal of the law i.e. to distribute growth potential to localities, up until now, decentralization has resulted in the fragmentation of the integrated national economy and in the apparent increase of corruption and misuse of local authority. The immediate impact of the implementation of decentralization law was to increase conflict between the central government and the regions. This is particularly the case where the central government wants to keep key responsibilities. The case of oil resources is an example of a battle for power between the central government and the regions. In this case, the central government has been able to hold onto the key responsibility; hence 85 percent of revenue from this sector goes to them. However, the regions strongly demand higher responsibility in this sector. In other cases where the central government has lost most of its responsibility, it is common to observe resistance by its limited commitment to many aspects of the decentralization process (Resosudarmo and Dermawan, 2002).

The second immediate impact is the nature of corruption. The era of centralized political systems is over, replaced by a system where power and authority are more diffused. The nature of centralized corruption — one stop shopping – is also gone, replaced by a more fragmented bribe collection system where central government,
ministry, and local government officials and others, like military/police and legislative members, both at the national and local level, are demanding bribes. While in other countries decentralization may have nothing to do with corrupt behavior, in Indonesia, already burdened with the corruption problem in the Suharto’s era, it only makes corruption more fragmented. The complaints from the Indonesian chamber of commerce (KADIN) on the rise of corruption at the local government level, immediately after the enactment of the Law of decentralization in 2001, come from the fact that a number of new local regulations especially concerning taxes, levies and various type of permits, created many artificial complementary regulations.

The third immediate impact is that the decentralization policy creates a strong temptation for local governments to raise their own local revenues in various forms of nuisance taxes. The first reason for this tax creation is that local governments face increasing expenditure responsibilities. Although on one hand local governments are happy with the law of decentralization, they also feel overwhelmed to see their responsibilities increasing due to the transfer of several central government functions, such as payment of all civil servant salaries (including those of several thousand central government employees reassigned to regional level jobs) and providing full public services previously performed by the central government such as primary and secondary education, health clinics, local and regional roads, water supply and sewerage system.

Although officially the financing of all expenditures relating to the salaries of transferred government employees should come from the financial transfer from the central government called the general purpose fund (DAU or Dana Alokasi Umum), there is still great uncertainty with respect to the disbursement timing and the actual amount of money allocated to fund these new responsibilities. In many cases, district governments have to provide advance money to bridge the gap. Even if the DAU

7 The situation was perceived by the business community as very much detrimental to their business interests when in 2001 the Indonesian chamber of commerce (KADIN=Kamar Dagang Indonesia) created a new body as a watch dog, called the decentralization monitoring unit (DMU), more popularly known in its Indonesian acronym as KPPOD (Komisi Pengawasan Pelaksanaan Otonomi Daerah). The purpose of the creation of this new body is not to roll back the decentralization process. Rather, it is an attempt to monitor abusive practices towards private businesses. KPPOD has been publishing an annual watch list containing the attitude of local government in every district in Indonesia towards the business sector, which includes corruption, local taxes and levies, and local regulations. The intention is to induce local governments to be more business friendly.
money comes in time, sometimes it is only enough to pay salaries and not much is left for other expenses like maintenance and material expenditures. So most local governments have created various taxes to increase their revenue. Some district governments are aware that the creation of too many taxes and retributions will hurt the business sector but at the same time they are hard pressed to find extra revenue. The second reason for creating new taxes is that local governments are still overwhelmed by the euphoria resulting from the law of decentralization, and the obsession with creating new taxes as an indicator of “success” is still visible. The third reason is more related to the corrupt behaviour of some local officers.

Improving the interregional fiscal system, especially by allowing provinces and regencies to benefit more from locally generated revenue, seems to be the first step towards expanding their horizons so as to maintain the regions’ long-run competitiveness, rather than just being motivated by interest in their own welfare and emphasizing short-term revenue. This has not happened yet, and furthermore, it seems that the decentralization process has reduced the effectiveness of economic reform.

6.6 Winners and Losers

Under the IMF sponsored reforms, it is not that easy to identify winners and losers. Although the reform targeted the privileges of Suharto and the core interest group in doing business, it is not clear that they are the absolute losers.

Let us observe the case of the bank recapitalization program under the IMF sponsored economic reforms. The Indonesian Bank Restructuring Agency (IBRA) is the agency responsible for overseeing this process. Under this program, unhealthy banks, which many of them owned by Suharto’s friends and family, receive interest-bearing obligations from IBRA. The interest payments for recapitalized banks come from the government budget. In return, banks’ assets, including non-performing loans, are transferred to IBRA for resale in the market (Cameron, 1999). First, the original owners who have been reluctant to transfer ownership to IBRA, typically over estimated their assets. Second, the recapitalization program has foregone the opportunity to increase government development expenditure. The interest payments that are supposed to recapitalize banks come from the government budget. In 2000, the interest payment for
recapitalization amounted to 19 percent of the total budget and in 2001 fell slightly to 18 percent. Given the size of these expenditures, which in 2001 amounted to 332 trillion rupiah, this sum practically squeezes out other expenditure items. At the same time, the recovery rate of the banks’ asset sales was predicted only to reach 30 percent of the original value.

Third, due to various loopholes in the law as well as the lack of law reinforcement, through brokers and proxies the original owners of the recapitalized bank can often reacquire their business at a large discount. Therefore, there has been a growing perception that recapitalization has only amounted to the transfer of wealth from the general public to the wealthy elite who are the principal shareholders of private banks; i.e. Suharto’s friends. So even in this case there is a growing allegation that the winners of the IMF sponsored economic reform are the conglomerates.

Meanwhile, average Indonesians who are supposed to be the winners as a result of the reform, have had enormous costs imposed on them in the form of increasing unemployment and price increases because the reform was not able to achieve economic recovery quickly enough.

VII. Conclusion

The purpose of this paper has been to investigate three reform periods, 1986-1994, 1994-1997 and the IMF sponsored reforms in a response to the 1998 economic crisis. To a great extent, the 1986 and the IMF sponsored reforms discussed in this paper were initiated by external economic crises. Only the 1994-1995 reform was motivated more by the concern of declining competitiveness.

There is the question of the seeming incompatibility between market-oriented policies pursued by the Suharto’s New Order regime and a political structure based on patron-client ties. The regime’s need for economic growth required bureaucratic values of predictability, regularity, order and rationality, which are just the opposite of the nature of patrimonialism, which is characterized by favouritism and arbitrariness. How Suharto managed these seemingly incompatible forces during three decades was quite remarkable. As suggested by Liddle (1996), Suharto’s economic policy decisions were
influenced primarily by three variables. The most important variable was economic crisis, which played a substantial role in changing policy but always in the context of the other two factors, namely, ideology and the patrimonialistic nature of the regime. To be implemented by Suharto, the design of economic reforms had to meet certain conditions. First, it had to be persuasive enough, it also should not contradict his ideological belief, and finally it was not permitted to jeopardize political support for the regime.

In the New Order political structure, although the office of president was a still domineering force, the structure allowed other players to be involved in the decision making process. In the inner circle of policy makers there were three important players, the economists or the technocrats, the technicians (economic nationalist) and the patrimonialists, consisting of were military personnel and the ruling GOLKAR party members. The technocrats were a group of Western-trained University of Indonesia economists, who embraced the neoclassical view. This group was the proponent of conservative market oriented policies. The technicians or economic nationalists on the other hand, were mostly engineers-turned-managers with little training in economics, and economists with structuralist inclinations. Finally, the patrimonialists were in charge of distributing patronage money rewards to those within the political arena and possibly to those outside the small circle of elite.

Suharto believed that, properly managed, a patrimonialistic system built by the combination of military and civilian bureaucratic process was not incompatible with macroeconomic liberalization. Suharto’s political calculation was simply that economic development could serve as an effective legitimizing principle as well as a source of support from many groups, including the military, the civilian bureaucracy and various groups in society. His view of macroeconomic liberalization and patron-client relationships was better demonstrated in the way he handled the conflict between economists and economic nationalists/patrimonialists. While at the macroeconomic level he embraced the wisdom of conservative fiscal and monetary policies, he also felt at ease to adopt protectionist polices especially in the form of special concessions in trade and manufacturing monopolies, credit facilities and government contracts to his closest cronies, mostly Sino-Indonesian, and lately to members of his own family.
Since the mid 1980s, in the aftermath of the oil boom, the economic nationalists and the patrimonialists were more entrenched, while the president’s children had now become major beneficiaries of the government protectionist policies. The technocrats were very careful not to touch the core interest group, especially in the most protected areas of trade like steel, oil refineries and petrochemical. The core interest group was also very adept in finding ways of circumventing the reform, for example by moving from liberalized activities to other newly created protected ones.

As Indonesia entered the 1990s, it became apparent that, apart from the political and indirect economic benefits accrued to the president, economic reforms could not proceed if they did not benefit the core group economically or at least did not interfere with their interests. Contrary to earlier experience, economic deregulations in 1990s had been used to expand the business empire of the core interest group, including the president’s extended family and his Chinese business associates. In some sectors such as road and electricity generation, deregulation merely transferred monopoly rights from the state to private enterprises controlled by the president business cronies. The up-stream industries producing essential inputs for the down stream industries were also controlled by the president’s business associates, if not by his own children.

As shown several times during his 30 year reign, if the economic crisis was mild and the recovery relative quick, it was very difficult to challenge Suharto politically. The 1997-1998 crisis was different in terms of magnitude; it destroyed much of Suharto’s performance legitimacy. The IMF sponsored reform which was supposed to bring a quick economic recovery attached a high priority to removing the economic privilege microeconomics that served the supporters of Suharto and the core interest group very well in the past. As a consequence, the pace of reforms slowed down because of resistance or foot-dragging. In the end it failed to impress the market and the crisis continued to deepen with severe output contraction, massive lay-offs and increasing absolute poverty. The deepening of the crisis made recovery efforts more difficult.

This took place at an unfortunate time, when the president was perceived as more in favour of distributing economic opportunities to his closest cronies, notably his own children. This tendency was more pronounced in 1990s and alienated the military,
which found much of its economic empire eroded by the continuous intrusion of the Suharto’s. Not only this, there was growing realization in the military circle that Suharto had employed his wealth to undermine their political influence. So, when the economic hardship made many political groups demanded his resignation, the military was only happy to see Suharto go.

The other interesting development after the fall of Suharto is the drive towards regional decentralization. Greater authority is delegated to around 300 districts in many areas, including in the fields of agriculture, industry, trade and investment. Contrary to the initial goal of the law i.e. to distribute growth potential to localities, decentralization has created fragmentation of the integrated national economy. Many districts tend to maximize their own tax revenues by imposing barriers to interregional trade, investment, capital and labour movement. Furthermore, corruption and bureaucratic red tape are on the rise. From the political economy’s standpoint, decentralization has merely increased the number of interest groups to deal with or to be compensated. As a result of lack of consensus on important economic policies affecting taxation, investment is becoming harder and is taking longer to obtain.

Economic recovery itself remains of secondary importance to politics with power much more diffused than in the Suharto era. Rent-seeking activities have not disappeared with the demise of Suharto. On the contrary, there are now many more interest groups competing for power and financial resources. There is really no single dominant party. The government and the legislative body are formed from a fragile coalition of the top four parties in which the party at the very top is very reluctance to share the rents from the economic reform with others. As a consequence, many reforms under the IMF umbrella that may potentially bring the recovery of the economy are stalled in the legislative process because of squabbling over economic rents. The economy has been growing modestly between 3 to 4 percent per annum, but this is not enough to reduce huge unemployment and poverty significantly.

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