Southeast Asian Economic Series No. 9402

Indonesia's Policy Reform: An Overview

by
Yana van der Meulen Rodgers

Department of Economics
The College of William and Mary

October 1994

Chung-Hua Institution for Economic Research

75 Chang-Hsing St., Taipei, Taiwan 106

Republic of China

YANA VAN DER MEULEN RODGERS

Indonesia's Policy Reform: An Overview*

Abstract

This paper offers a comprehensive discussion of policy evolution in Indonesia since 1970, and it highlights recent developments in Indonesian Political economy. While growing rapidly, the literature has surprisingly consolidated, chronological accounts of Indonesian policy reforms across sectors from 1970 to the early 1990s. Also, no existing study surveys the major themes which have emerged in the excellent political economy research done in the last five years. This article fills both gaps and transformation. My objective is to examine the progression of Indonesia's market liberalization and the involvement of interest groups in the operational scheme.

* I am indebted to Susan Collins, John Fei, Jeffrey Lewis, William Rodgers, Michael Roemer, and Henry Rosovsky for their useful suggestions. Correspondence to Yana van der Meulen Rodgers, Economic Department, College of William and Mary, Williamburg, VA, 23187. Tel 804-221-2376; Fax 804-221-2390; EMail yvrodg@mail.wm.edu.

I. Introduction

Major oil markets shocks and exchange rate realignments after 1982 forced Indonesia to launch a comprehensive restructuring of its oil-based economy toward non-oil exports and private investment. The shocks prompted a successful use of policy to transform Indonesia from a primary commodity exporter with inward-oriented industrial and trade policies to a potential Asian NIC. The country's policy reforms increased non-oil export competitiveness by cutting input costs, lowering transaction times, improving access to financial services, and encouraging investment.

Indonesia's experience raises several interesting questions. How did conflicts of interest between key players involved in policy making affect the direction of economic reform? Do governments in other developing economies need to have similarly ironclad control in order to emulate Indonesia's deregulation experience? This paper offers a comprehensive discussion of policy evolution in Indonesia since 1970, and it highlights recent developments in Indonesian political economy. While growing rapidly, the literature has surprisingly consolidated, chronological accounts of Indonesian policy reforms across sectors from 1970 to the early 1990s. Also, no existing study surveys the major themes which have emerged in the excellent political economy research done in the last five years. This article fills both gaps and improves our understanding of political processes in Indonesia's economic transformation. My objective is to examine the progression of indonesia's market liberalization and the involvement of interest groups in the operational scheme.

Section II examines Indonesia's institutional background to establish a context for subsequent policy reforms. Section III classifies Indonesian policy evolution from 1970 to 1993 into three distinct stages that correspond with oil market conditions. Section IV highlights emerging themes in Indonesian political economy. The Appendix provides a detailed outline of policy changes by sector.

II. Institutional Background

The new Suharto regime in 1966 inherited enormous budget deficits, high inflation, stagnant real exports and per capita income, and depleted foreign exchange reserves.[1] Late in 1966, Indonesia participated in debt negotiations with major creditors, which resulted in rescheduling of all debt, except short-term commercial loans, at favorable terms, with aid and supervision from the IMF, the "Order" government began a stabilization and long term recovery program which called for revision of the multi-tiered exchange rate system, liberalization of trade restrictions, tighter central bank credit, elimination of budget deficits, and international aid for liquidity purposes. To facilitate new foreign borrowing, representatives from industrial countries and world aid organizations formed the Inter-Governmental Group on Indonesia (IGGI) in 1967.[2] To signal its commitment to monetary and fiscal discipline, the Suharto government formally instituted a balanced budget requirement in 1968 which stated that any government budget deficits must be financed by foreign loans, not by domestic credit creation or an inflation tax.

---

[1] General Suharto gained executive power in March 1966 following an attempted coup to overthrow President Sukarno on September 30, 1965. Suharto was elected Acting President in March 1967 and President in March 1968. Suharto has been re-elected President, with accompanying Cabinet shifts, every 5 years since 1968. For details on The Sukarno and early Suharto regimes, see J. Bresnan. Managing Indonesia: The Modern Political Economy. (New York: Columbia University Press, 1993); M. Pit, "Indonesia," in *Liberalizing Foreign Trade: The Experience of Indonesia, Pakistan, and Sri Lanka*, Vol. 5, D. Papageorgiou, M. Michaely, and A. Choksi (eds.). (Cambridge, MA: Basil Blackwell, 1991), pp. 1-196; M. Ricklefs. *A History of Modern Indonesia Since c. 1300.* (Stanford, CA: Stanford University Press, 1993); U.S. Department of the Army. *Indonesia Army Area handbook* (Washington, D.C.: U.S. Department of Commerce, National Trade Data Bank, 1994); and W. Woo and A. Nasution, "Indonesian Economic Policies and Their Relation to External Debt Management," in *Developing Country Debt and Economic Performance* Vol. 3, J. Sachs and S. Collins (eds.). (Chicago: The University of Chicago Press, 1989), pp. 17-149.

[2] IGGI met annually to determine the amount and terms of aid for Indonesia. The Consultative Group on Indonesia (CGI) replaced the Dutch-led IGGI in 1992 following Indonesian frustration with Dutch links between aid and human rights conditions.

The government continued to follow this balance budget rule up to the present. It also continued a prudent debt strategy, which emphasized acquisition of foreign loans at conscessional terms, long-term maturities, and maintenance of punctual debt repayments. The process of undergoing debt negotiations and a forced stabilization program under the IMF arguably left a strong institutional commitment to pursue any necessary policies to avoid another disastrous economic situation.

One of the most distinctive features of Indonesia's institutional developments is the emergence of several economists, from the University of Indonesia, to powerful economic positions in the government. The original team of Mohammad Sadli, Emil Salim, Subroto, Ali Wardhana, and Widjojo Nitisastro, nicknamed the "Berkeley Mafia" for the source of three of their doctorates, attained influential positions as cabinet members and Suharto's personal economic advisors.[3] Indonesia certainly does not stand alone among developing countries in turning to the expertise of economic advisors, often called technocrats, to design national policies. However, the Indonesian technocrats are unique in the length of time they maintained their influence and in their exceptional educational attainment relative to the large population. The team's leading role in formulating the late 1960s recovery program marked the beginning of their work, later with other economists, to shape Indonesia's development agenda and to convince Suharto adopt market based reforms.

III. Stages of Policy Evolution

a. Restricted Market Entry (1970-1981)

Continuity of sound fiscal and monetary policies but increasingly restrictive trade and industrial policies characterized the 1970 to 1981 period. The government instituted several major financial policy changes, and it began to actively manage the exchange rate in 1978 to improve incentives for domestic producers of tradeable goods. Overall though, the government relied increasingly on oil revenues and market entry restrictions on foreigners in order to promote industrialization.

---

[3] See Bresnan (1993) on positions which the technocrats filled.

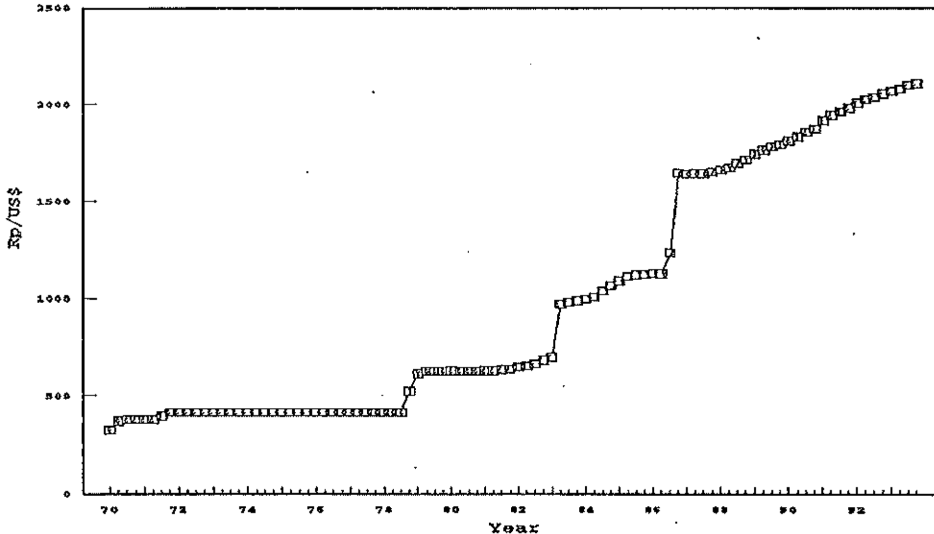
Compared to most other developing countries at the time, the Indonesian government took a bold step early in 1971 by permitting free capital convertibility. The government made all capital transactions, including profit and dividend remittances, freely convertible, and it unified, devalued, ad fixed, and fixed the exchange rate.[4] To operate its monetary policy in the early 1970s, Bank Indonesia (the central bank) extended long-term credits to commercial banks and firms. The system provided Bank Indonesia with little flexibility in controlling the money supply, so in 1974 it switched to the imposition of lending ceilings and reserve requirements on commercial banks, and it set domestic bank interest rates on loans and deposits. The credit ceilings evolved into a selective system of subsidized credit for favored projects and groups.

Bank Indonesia's open capital system and fixed exchange rate encouraged firms and banks to borrow or invest funds abroad, which limited the potency of monetary policy instruments. These instruments could not control the significant growth in Indonesia's money supply caused by oil revenues. Dollar oil earnings boomed following the 1973 oil price hike; converted into rupiah at the fixed exchange rate, the oil boom led to an average annual inflation rate of 22 percent between 1973 and 1978. Figure 1 illustrates that the government devalued the rupiah by 51 percent in 1978 to reverse the harmful effects of real exchange rate appreciation on non-oil exports. It also changed the exchange rate regime to a managed float with periodic large devaluations, and it pegged the rupiah to a basket of currencies of Indonesia's major trade partners.[5]

---

[4] Non-oil exporters, however, had to pay a 10 percent exchange tax on the sale of foreign exchange earnings. In 1974 Bank Indonesia replaced the exchange tax with an export tax which, along with subsidies on the sale of foreign aid funds, stayed in place until 1979. Until 1982, non-oil exporters could only sell their foreign exchange earnings to Bank Indonesia.

[5] The exchange rate is quoted as Rp/US$ and rupiah exchange rates with other currencies are calculated with US$ cross exchange rates.



Source: International Monetary Fund, *International Financial Statistics*, Washington, D.C.: IMF.

Figure 1: Nominal Rp/US$ Exchange Rate, 1970-1993

By 1974, international commercial banks and donors outside of IGGI had dropped lending restrictions on Indonesia due to their increased petrodollar supply and Indonesia's improved credit-worthiness. Willing creditors and insufficient monitoring of state owned enterprise debt led to a near disaster with the Pertamina debt crisis in 1975. Pertamina, the state owned oil company, had accumulated over $10.5 billion in short and medium-term foreign debt without government approval.[6] Early in 1975 Pertamina defaulted on a $40 million loan payment, and the Indonesian government took responsibility for the oil company's external debt. Following the bailout, any foreign loans by the government and by state owned enterprises had to be approved and processed by Bank Indonesia and the Finance Ministry. The incident led to an abrupt end to Indonesia's short-term borrowing until the late 1980s.

As part of its inward-oriented industrialization strategy, the

[6] See Bresnan (1993) and Woo and Nasution (1989) on the Pertamina affair.

government increased trade and investment barriers. In 1974, following Indonesia riots largely against the expanding role of Japanese investment and aid in Indonesia's economy, the newly formed Capital Investment Coordinating Board (BKPM) imposed stricter foreign ownership restrictions in order to nationalize the country's industrial base. BKPM required all foreign investors to participate in joint ventures, and it closed many sectors to foreign investment. By the end of the 1970s BKPM had constructed an extensive and complex priority list of sectors and projects open to domestic and foreign investment.

The government did take limited steps to promote non-oil exports in the late 1970s. It offered subsidized interest rates and tax rebates to non-oil exporters, especially in textiles and garments, and it invested heavily in agricultural infrastructure. However, the long run effects of these promotional schemes remained quite limited as increased trade regulation caused large price distortions.

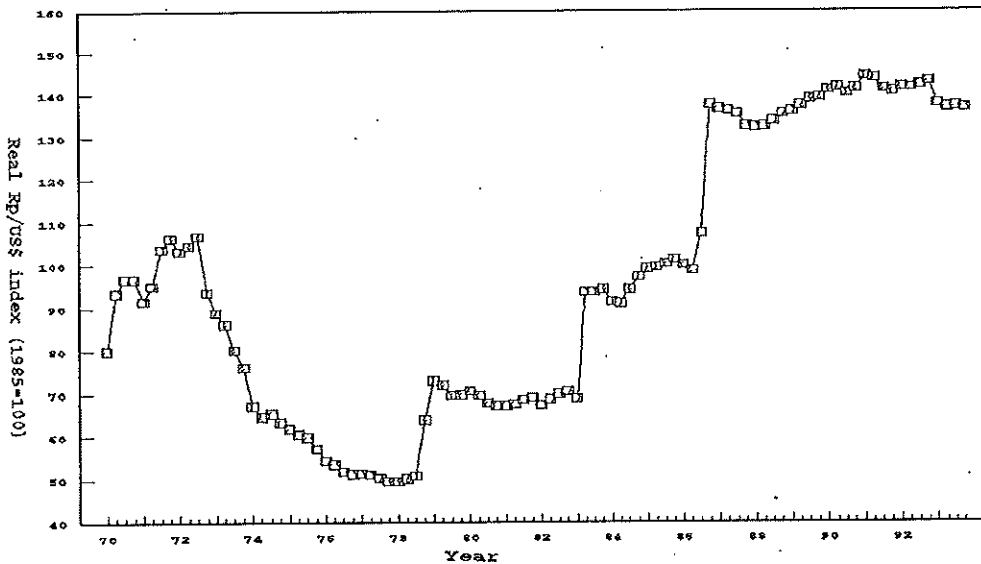
b. Mixed Signals (1982-1985)

During the *Mixed Signals* Period, the government took some preliminary steps to reform taxes, deregulate the financial sector, and promote non-oil exporters as the oil price fell dramatically. Figure 2 illustrates that increased inflation following the second oil boom in 1979 caused the real exchange rate to appreciate again, so in 1983 the government announced a second major devaluation of 39 percent. At the same time, though, it widened the scope of import and investment restrictions.

By 1981, the government relied on oil and gas earnings for almost three quarters of its revenues. The oil price decline in 1982 prompted fiscal policy reform, which served three parallel objectives: adjust spending to lower oil revenues but maintain expenditures on vital sectors, improve public saving, and control inflation to help maintain the exchange rate's real value. In 1983, the Finance Ministry postponed or canceled expenditures on major capital intensive projects, while it limited expenditures cuts on education, health, and public sector wages. New budgets also contained a favorable bias toward the Outer Islands to help promote agricultural exports and improve inter-island income distribution.[7]

---

[7] See E. Thorbecke, "Adjustment, Growth and Income Distribution in Indonesia," *World Development* 19:11 91991), 1595-1614; and Woo ad Nasution (1989) on expenditure cuts and the importance of monetary and fiscal discipline.



Source: International Monetary Fund, *International Financial Statistics*, Washington, D.C.: IMF.

Figure 2 Real Rp/US$ Exchange Rate Index, 1970-1993

Major reforms to broaden the tax base started in 1984. The Finance Ministry simplified the individual and corporate income tax code to base rates of 15, 25, and 35 percent. It improved tax collection methods by requiring corporations to withhold taxes and by replacing individual firm negotiations with self-assessments, subject to more extensive audits. To provide incentives for people to file returns, the government shortened the time it would take for refunds, and it forgave arreared tax payments for individuals who registered by a specified date. Finally, the Finance Ministry replaced the complex seven-rate sales tax with 10 percent value added tax (VAT), which was less regressive than a sales tax since lower income groups had proportionately higher expenditures on unprocessed commodities. The early success of the VAT remained limited as less than one half of registered VAT payers actually made the required monthly payments.[8]

---

[8] See Woo and Nasution (1989, p. 73).

Banking deregulation in the early 1980s had the three objectives: to improve Bank Indonesia's control over the money supply, mobilize private savings, and increase efficiency of credit allocation. In 1983, Bank Indonesia abolished the credit ceilings, permitted banks to set their own interest rates, and reduced the amount of subsidized Central Bank credit. Because the reforms left Bank Indonesia with no viable policy instrument to target money supply besides changing the reserve requirement, in Februaiy 1984 Bank Indonesia reissued Central Bank Certificates (SBIs).[9] Bank Indonesia could sell these short-term instruments to commercial banks to withdraw reserves from the banking system. A severe liquidity squeeze prompted the introduction in February 1985 of money market instruments (SBPUs) which Bank Indonesia could purchase from commercial banks to add reserve money to the system. Bank Indonesia also traded unrestricted amounts of foreign exchange and rupiah, tax-free and subsidy-free, with foreign exchange banks, non-bank financial institutions, and other licensed foreign exchange dealers.[10] Hence Bank Indonesia coordinated monetary policy by setting the SBI and SBPU discount rates, the foreign exchange swap rate, and the exchange rate; and by selling or buying reserve money from banks.

Banking deregulation also occurred in the rural sector. In 1984, the government introduced rural credit program which created a network of village banking stations to provide wide-spread financial services in accessible locations. The program differed from other central government rural credit schemes because it did not use subsidized funds to target specific developments needs. The rural banking program constitutes an example of change from the highly regulated rural financial schemes to a

---

[9] Bank Indonesia had first introduced SBIs in 1970 but stopped their issue as commercial banks invested in foreign assets. See D. Cole and B. Slade, "Reform of Financial Systems," in *Reforming Economic Systems in Developing Countries*, D. Perkins nd M. Roemer (eds.). (Cambridge, MA: Harvard University Press, 1991), pp. 313-340; A. Nasution, "Reforms of the Financial Sector in Indonesia, 1983-1991," *The Indonesian Quarterly* 21:3 (1993), 284-310; and Woo and Nasution (1989) on Indonesia's monetary policy.

[10] However, only the licensed foreign exchange banks were allowed to perform foreign exchange transactions for export and import purposes. In 1988 Bank Indonesia reduced restrictions on the amount banks could borrow abroad.

more market oriented system of small banks.[11]

In 1982, the Trade Ministry introduced an Approved Importers Scheme which increased the number of quantitative import restrictions according to a variety of license types shown in Table 1. Most products categories could only be imported under one license type, and the Trade Ministry decided which license would cover each commodity, which firms would receive the licenses, and the amount of a product each firm could import. Indonesian consumers did not gain from the redistribution of quota rents since the government did not auction the quotas. Moving in tandem with restrictive trade policy, BKPM forced firms to increase the local content of their finished products through "deletion programs," regardless of the competitiveness of domestic components. Further investment regulations imposed by the Industry Ministry often protected existing domestic firms by regulating industrial capacity and preventing entry. The opportunity to gain a domestic monopoly through a combination of favorable licenses from the Ministries of Industry and Trade created extensive rent seeking behavior, and rents accrued to a select group of large producers powerful or lucky enough to gain the licenses. Returns from rent seeking often surpassed, by a factor of almost two, total investment by recipient firms, making rent seeking more profitable than other more productive activities.[12]

The import license system reduced the transparency of the government's trade policy, generating uncertainty on the part of international producers and domestic firms who did not benefit from close contact with government officials. Although quantitative import controls covered many finished consumer products, especially textiles, paper, and processed foods, restrictions on some intermediates, including steel, plastics, and raw textile fibers, squeezed the profits of Indonesian producers

---

[11] On rural banking reform, see D. Snodgrass and R. Patten, "Reform of Rural Credit in Indonesia: Inducing Bureaucracies to Behave Competitively," in *Reforming Economic Systems in Developing Countries*, D. Perkins and M. Roemer (eds.). (Cambridge, MA: Harvard University Press, 1991), pp. 341-363.

[12] On rent seeking behavior and restrictive microeconomic policies, see R. Barichello and F. Flatters, "Trade Policy Reform in Indonesia," in *Reforming Economic Systems in Developing Countries*, D. Perkins and M. Roemer (eds.). (Cambridge, MA: Harvard University Press, 1991), pp. 271-291.

of tradeable goods.[13] By early 1986 almost 1500 import categories, over 40 percent of domestic production and total imports by value, fell under a licensing restriction. In addition, tariff rates ranged from 0 to over 200 percent and included specific rates. Sales taxes on import often exceeded rates on the same domestic goods and contributed to the ad hoc nature of trade regulation.

The government sent its first strong signal of trade reform in 1985 by replacing the corrupt and inefficient Indonesian customs agency with a foreign surveying company (SGS). Evidence indicates the SGS replacement considerably reduced the time and financial costs of customs clearance.[14] Port and shipping deregulation complemented the customs replacement to further cut transactions costs and lags. The government took its first step toward tariff reform by lowering average tariff rates and reducing the variance in rates between categories.

Table 1 Indonesia's Import License System in the 1980s

License Type	Name	Description	Firm Ownership
General Importer	IU	Few restrictions	Private, State
Importer Producer	IP	Rights for producers to import inputs unavailable domestically	Private, State
Registered Importer	IT	Sole importing rights, mainly for consumer goods.	State
Producer Importers	PI	Sole importing rights of goods Which compete with own output	Private, State
Sole Agents	AT	Trade monopoly and national distribution rights for individual products; appointed by ministry of Industry	Private, State

Source:General Agreement on Tariffs & Trade(1991), *Trade Policy Review: Indonesia, Geneva: GATT.*

---

[13] Many exporters also had to undergo complex export licensing procedures. Goods which were restricted abroad, such as textiles, clothing, and coffee, required export licenses. The government set registration rules on plywood, rattan, and spice exports, and it supervised agricultural exports such as rice and soybeans.

[14] On customs reform, see Lazard Freres et Cie, Lehman Brothers, and S. G. Warburg & Co. Ltd., "The Republic of Indonesia," Mimeo (1990); and Barichello and Flatters (1991).

c. Structural Overhaul (1986-1993)

Beginning in 1986 with the bottoming oil export earnings, the government promoted a structural overhaul of its trade, investment, and financial sector policies while it continued sensible fiscal and monetary policies from earlier years. Many policies used to promote non-oil export growth achieved the dual objective of maintaining punctual debt payments, despite large shocks to the oil price, world interest rates, and yen/US$ exchange rate realignments. However, strong state control persisted, with slow implementation and several highly restrictive measures to promote industrialization in strategic sectors.

The government devalued the rupiah again by 45 percent in 1986 in response to the oil price crash. Free capital convertibility exacerbated speculative money flows in response to expectations of rupiah devaluation, since firms used the open capital market to buy foreign exchange or to participate in forward swaps.[15] Bank Indonesia curtailed two speculative runs on the rupiah, in June 1987 and February 1991, with large contractions of the money supply, sending strong signals about its intent to support the exchange rate. It also increased the use of regular mini-adjustments to correct for inflation differentials with trade partners.

Between 1986 and 1993 the government launched ten deregulations packages in trade, investment, and finance, which aimed to increase non-oil exports and private investment.[16] The large 1986 devaluation, together with austere fiscal policies, supported the subsequent dismantling of trade barriers by encouraging tradeable goods production, and it helped to correct real exchange rate distortions caused by non-tariff barriers.[17] Domestic

---

[15] For example, between 1971 and 1986 the interval between devaluations declined from seven years to five to three. After the 1986 devaluation, speculators expected a one year interval, and in 1987 capital flight activity rose. For capital flight estimates, see Y. Rodgers, "Indonesia's Macroeconomic and Trade Performance," Harvard Institute for International Development, Development Discussion Paper No. 495 (Cambridge, MA, July 1994).

[16] The government passed the reform packages in May 1986, October 1986, January 1987, December 1987, November 1988, May 1990, June 1991, July 1992, June 1993, and October 1993.

[17] See Woo and Nasution(1989) for estimates of the relative price distortions.

producers of tradeables gained higher rupiah proceeds from the devaluation, and the fiscal retrenchment policies limited increases in real wages and other non-tradeables' prices.

The first package in May 1986 replaced a controversial export subsidy program with a new "duty drawback" system, which allowed exporters to purchase imported inputs directly themselves, without having to go through licensed importers who raised importing costs. The new facility also granted export firms exemption from or rebates on import duties and sales taxes, allowing them to purchase imported capital goods and intermediate inputs at world prices, as long as the imports were used in export production. The new system allowed the exporting firms to bargain with domestic suppliers for inputs at world prices, promoting competition in upstream supply markets. The duty drawback facility provided Indonesian firms the opportunity to operate under similar conditions as the free trade zones in the Philippines, Malaysia, and Singapore. Already in 1988, 36 percent of textile exports, 29 percent of garment exports, and 86 percent of footwear exports by value contained inputs purchased through the facility, exceeding an average 24 percent for manufactured exports.[18]

Further trade reform packages changed the direction of import substitution policies by eliminating almost two thirds of non-tariff barriers and continuing tariff reform. The packages affected most sectors, including textiles, agricultural products, plastics, chemicals, steel, and machinery and equipment. However, Table 2 shows that in 1990 restrictive import licenses still covered almost 15 percent of tariff items, and more striking, one third of manufacturing production and 38 percent of agriculture production. The share of tariff categories covered by an import license fell more than the share of domestic production covered, which suggests that political opposition hindered trade deregulation: import items which were deregulated offered relatively less competition to domestic producers. In particular, strategic sectors such as cars, rice, and other categories of steel and agricultural products remained covered by non-tariff barriers or prohibitive tariffs into the mid-1990s.

---

[18] See p. 120 in H. Hill, "The Emperor's Clothes Can Now be Made in Indonesia," Bulletin of Indonesian Economic Studies 27:3 (1991), 89-127.

Table 2 Percent Coverage of Import Licenses, 1986-1990

	Mid-1986	End 1987	End 1988	Early 1990	End 1990
Tariff Items	32	22	16	17	14
Import Values	43	25	21	17	15
Domestic Production	41	38	29	28	25
Manufacturing	68	58	45	38	33
Agriculture	54	53	41	40	38
Mining	0	0	0	0	0

Source: GATT(1991), p. 86.

Did trade reforms change the structure of protection? The reform decrees switched licenses to less restrictive categories but often raised tariffs to compensate firms that lost non-tariff barrier protection. For example, both the December 1987 and the November 1988 deregulation packages included tariff rate increases and surcharges to replace non-tariff barriers on textiles, chemicals, and processed agricultural goods. In addition, tariffs on imported inputs sometimes declined while protection on the final goods remained the same or actually rose, causing the effective rate of protection (ERP) to increase. The tariff reductions on raw materials in the November 1988 package led to such ERP increases. Table 3 indicates a slow decline in non-oil manufacturing and agricultural ERPs, but in 1990 the trade system still distorted widely incentives across sectors. Other pockets of regulation remained. The Trade Ministry increased quantitative export controls over unprocessed and semi-processed tropical logs, sawnwood, rattan, latex, and cloves. It used these bans to increase domestic value added in downstream industries, and indirectly, to gain monopoly power in world markets for the processes good.

Table 3 Effective Rates of Protection, Selected years

	1987	1989	1990
Non-Oil Manufacturing	80	64	60
Agriculture	19	14	13
Mining	-1	-1	0

Sources: GATT(1991); Fane, G. and C. Phillips(1991), "Effective Protection in Indonesia in 1987," *Bulletin of Indonesian Economic Studies* 27(1): 105-125; Wymenga, p. (1991), "The Structure of Protection in Indonesia in 1989," *Bulletin of Indonesian Economic Studies 27(1): 127-153.*

The government added industrial policy to its reform agenda. In 1986, BKPM officially recognized the benefits of direct foreign investment. It relaxed requirements for local ownership, especially for capital intensive and high technology projects. BKPM reduced the number of sectors with investment restrictions, particularly in export oriented industries, and it promoted new industrial estates and improved infrastructure. Further changes in 1989 include the introduction of a simplified "Negative List" that contained only closed sectors rather than a complex list of all open sectors. Despite the move toward market based reforms, in 1989 President Suharto created a board chaired by a leading proponent of state control, B.J. Habibie, to regulate strategic high technology sectors, including steel, weapons, and airplanes. The early 1990s saw further industrial policy deregulation, partly in response to competition from China and other Asian countries in attracting foreign investors.

Finally, a comprehensive set of financial policy reforms after 1987 opened the banking sector and capital market to increased competition. The reforms encouraged new channels for financial intermediation, subject to clarified and improved regulations. The reforms introduced an auction and secondary market for Bank Indonesia's money market instruments, permitted non-bank financial institutions to issue money market certificates, and reduced the special privileges of state owned banks. Consumers and firms could take advantage of new financial services such as credit cards, venture capital, and securities underwriting, offered by increasing numbers of bank branches and joint ventures. Capital market deregulation allowed foreign participation in the securities market and improved the method of issuing new stocks and licensing brokers.

IV. Political Economy Highlights

Political economy work on Indonesia has grown rapidly in the last five years. Major developments in the literature embrace four major themes, each demonstrating the extensive involvement of Suharto's highly

authoritarian regime in the Indonesian economy.[19] The first theme centers on the reasons for mixed signals in the government's reform agenda. Table 4 indicates that a number of government bodies formulated and implemented Indonesian trade and industrial policies through a variety of legal instruments. The technocrats, concentrated in Finance, the National Planning Body (BAPPENAS), and the Coordinating Ministry (EKUIN), favored a more open trade regime and diversification of the oil-based economy, especially toward agriculture and labor-intensive manufactured exports. Other government officials (many with engineering backgrounds) centered in Trade, Industry and the Investment Board, favored a more inward-looking approach. These officials often promoted import and foreign investment restrictions to encourage indigenous businesses and develop Indonesia's industrial base. Suharto adeptly employed the policy advice of both groups, balancing economic constraints with political considerations.

Other political forces impeded change. Private firms and industry groups had little political power, although individuals with the right connections could gain highly favorable economic policies which granted them industrial monopolies and rents from imports restrictions. Eliminating protection for companies controlled by prominent business leaders with strong ties to Suharto proved particularly difficult. This extensive system of political patronage, the distribution of power in setting trade and industrial policies across ministries, no modern commercial laws (Indonesia still used a code implemented by the Dutch in 1847), and the

[19] Excellent contributions include Barichello and Flatters (1991); Bresnan (1993); H. Crouch and H. Hill (eds.). *Indonesian Assessment 1992: Political Perspectives on the 1990s*. (Canberra: Australian National University, Research School of Pacific Studies, 1992); H. Hill (ed.). Indonesian Assessment 1991. (Canberra: Australian National University, Research School of Pacific Studies, 1991); W. Liddle, "The Politics of Development Policy," *World Development* 20:6 (1992), 793-807; A. MacIntyre, "Indonesia in 1993: Increasing Political Movement?" *Asian Survey* 34:2 (1994), 111-118; C. Manning, "Structural Change and Industrial Relations During the Soeharto Period: An Approaching Crisis?" *Bulletin of Indonesian Economics Studies* 29:2 (1993), 59-95; C. Manning and J. Hardjono (eds.). Indonesian Assessment 1993: Labour: Sharing in the Benefits of Growth?. (Canberra: Australian National University, Research School of Pacific Studies, 1993)); D. McKendrick, "Indonesia in 1991: Growth, Privilege, and Rules," *Asian Survey* 32:2 (1992), 103-110; Ricklefs (1993); M. Vatikiotis. *Indonesian Politics Under Suharto: Order, Development and Pressure for Change*. (London and New York: Routledge, 1993); and Woo and Nasution 1989).

Table 4 Indonesian Trade and Industrial Policy Makers

Ministry	Composition	Responsibility
Finance	Technicians	Set and administrate government expenditures and tax policy
Coordinating Ministry for all economic affairs (EKUIN)	Technicians	Provide general guidance and coordination
National Planning Body (BAPPENAS)	Technicians	Participation in trade and Industrial policy
Industry	Engineers	Promote industrial development and help set trade & industrial policy
Trade	Engineers	Control trade regulation and issue licenses
Capital Investment Coordinating Board (BKPM)	Engineers	Issue investment licenses and administer incentives; close and open sectors to investment

Notes: In 1993 EKUIN was split into the Coordinating Ministry for Economy, Finance and Development Supersion, and the Coordinating Ministry for Trade and Industry. Also in 1993, leadership at BAPPENAS switched to an engineer.

importance of agreement and compromise among Indonesian officials, all impeded the progress of reform.

Understanding the economic rationale behind deregulation and the political forces against them, the technocrats planned a gradual reform sequence that began with devaluation, fiscal reform, and banking deregulation. The oil price crash after 1982 and exchange rate realignments added external pressures to dismantle Indonesia's high cost economy, develop market based incentives, and improve the competitiveness of tradeable goods. The technocrats designed trade and industrial deregulation after 1986 in steps to minimize resistance and to give time for reform measures to gain support. Suharto's recognition that some trade and industrial policies hindered economic growth, and a cabinet shift in 1988 that replaced BKPM's top administrators, both facilitated

policy reform.[20]

A closely related theme focuses on the growing Indonesian discontent over the high concentration of ethnic Chinese, led by Liem Sioe Liong, and Suharto's family members, within the top income group. Various studies have found that Indonesian income distribution and poverty indicators improved between the 1960s and 1980s.[21] However, public discontentment with the distribution of wealth grew after the mid-1980s as the media and academic research documented the enormous levels of protection, kickbacks, credit facilities, and government contracts that well connected business leaders received. Financial disclosures by the conglomerates as they listed shares on the thriving Jakarta stock exchange provided further information on their wealth. To relieve growing tensions, in 1990 President Suharto required domestic banks to target 20 percent of loans to small-scale indigenous firms and cooperatives. The policy complemented Suharto's call for conglomerates, almost all owned by ethnic Chinese, to transfer up to one quarter of their listed shares to Indonesian cooperatives, and to guide and support small indigenous businesses.

A third emerging theme in Indonesia's political economy that has drawn international attention centers on industrial labor relations. In 1973, the Suharto regime replaced existing trade unions with one officially sanctioned intersectoral union, the All Indonesia Workers Union (formerly FBSI and now SPSI), and it requested that all worker organizations at the firm level join the SPSI. Dissatisfaction with the official union as tightly controlled arm of the government led to the creation of independent unions, which the government closely monitored and did not legally recognize. By the end of 1991 under 6 percent of Indonesia's labor force (76 millions workers) belonged to a union.[22] The perception that only well connected individuals enjoyed the benefits of Indonesia's income growth led to rapid growth in labor disputes after 1990 when the government legalized strikes.

---

[20] See Bresnan (1993) and Liddle (1992).

[21] See Bresnan (1993) and U.S. Department of the Army (1994) for reviews of Indonesian equity studies.

[22] U.S. Department of State, "Country Reports on Economic Policy and Trade practices; Indonesia," (Washington, D.C.: U.S. Department of Commerce, National Trade Data Bank, 1992).

Strikes mostly targeted companies in the manufacturing sector that offered a sub-minimum wage, no overtime rates, and poor working conditions. Indonesian military intervention and the arrest of labor leaders prompted calls by the American Federation of Labor and other human rights groups for the United States to revoke Indonesian trade privileges under the Generalized System of Preferences. These high profile events overshadowed considerable gains made by Indonesian workers in employment, education, and productivity across sectors.[23]

A fourth major theme in Indonesia's political economy focuses on the sustainability and momentum of deregulation. Most views fall in between a "steady footwork" perspective, where Indonesia's policy sequence represents credible steps toward a more open economy, and a "temporary patchwork" perspective, where the government implemented market based reforms just to help the economy through large exogenous shocks. A more drastic interpretation is that Suharto cleverly sequenced reform with the objective of maintaining foreign aid and investment flows to maximize his chances of staying in power. Evidence for the steady footwork view includes free capital and convertibility since 1971 as a signal of Indonesia's commitment to open its economy and participate in international markets. The avoidance of the inflation tax and prudent external debt management for a quarter century serve as additional indications of reform's sustainability. Institutional change, particularly the sudden replacement of Indonesian customs with a foreign company, further signal the government's long-term commitment to develop market based economic incentives.

However, slow reform implementation and examples of re-regulation suggest that continuous reform is not sustainable and the government may retrogress to stricter regulation of the economy. The export bans, banking requirements to lend to indigenous corporations, the continuation of prohibitive import restrictions in key sectors, and the creation of a new department to control nationally strategic industries, each led to an increased state role in the economy. The government's implementation of most reforms as decrees and presidential instructions, rather than laws, further signals the temporary nature of market oriented policies.

Continued signs of re-regulation, the reform's lack of legal

---

[23] See Manning (1993) and Manning and Hardjono (1993) on Indonesia's labor market.

permanence, and a slowdown in momentum make a firm conclusion on the direction of industrial and trade policy reform quesswork at best. In addition, the 1993 cabinet shift led to greater influence of Indonesia's most prominent engineer, B.J. Habibie; the appointment of an engineer, Ginandjar Kartasasmita, as chair of BAPPENAS; and the retirement of long-serving technocrats Radius Prawiro and J.B. Sumarlin. Uncertainty surrounding the political influence of their replacements, Saleh Afiff (Coordinating Minister for Economy, Finance, and Development Supervision), Hartarto (Coordinating Minister for Trade and Industry), and Mar'ie Muhammad (Finance Minister), adds to the inability to firmly judge the sustainability of trade and industrial policy reform. However, deregulation has led to the creation of powerful constituents who support reform, particularly non-oil exporters, domestic and foreign investors, and consumers of wide-spread banking services. The government could encounter even greater opposition from slow re-regulation of trade and investment than from the continuation of steady, gradualized reform.

Appendix

Policy Reform Overview, 1970-1993[24]

Exchange Rate Policy

Aug 1971	Allow free capital convertibility; unify and fix exchange rate at 415 Rp/US$
Nov 1978	Devalue 51%, from 415 Rp/US$ to 625 Rp/US$ Change from fixed rate to manage float with periodic devaluations Replace the US dollar peg with a basket of foreign currencies
Mar 1983	Devalue 39%, from 698 Rp/US$ to 970 Rp/US$
Sep 1986	Devalue 45%, from 1134 Rp/US$ to 1641 Rp/US$ Maintain the depreciation rate relative to the US dollar at about 3.3 percent annually

Fiscal Policy

1970s-	Continue balanced budget policy; cover deficits with Present foreign loans Maintains punctual foreign debt repayments Invest heavily in agricultural infrastructure and subsidies
May 1983	Eliminate planned expenditures on large capital intensive projects

---

[24] Entries are drawn from almost every source already cited. Additional sources include G. Fane, "Survey of Recent Developments," *Bulletin of Indonesian Economic Studies* 30:1 (1994), 3-38; R. McLeod, "Indonesia's New Banking Law," Bulletin of Indonesian Economic Studies 28:3 (1992), 107-122; Office of the United States Trade Representative. *Foreign Trade Barriers*. (Washington, D.C.: Department of Commerce, various issues; T. tomich, "Survey of Recent Developments," *Bulletin of Indonesian Economic Studies* 28:3 91992): 3-39; and P. van der Eng, "Survey of Recent Developments," *Bulletin of Indonesian Economic Studies* 29:3 (1993), 3-35.

Jan 1984	Revise income tax code; simplify basic rates to 15%, 25%, and 35% and limit deductions; apply to individuals and corporations Improve tax collection; simplify appeals and refunds Remove tax holidays and other tax-based investment incentives Allow accelerated capital depreciation
Apr 1985	Replace sales tax with 10% value added tax (VAT) on manufactured goods and some services, and impose sales tax on luxury goods
Jan 1986	Add broad-based land & Property tax
Jan 1989	Remove pesticide subsidies and announce progressive reduction of fertilizer subsidies
Apr 1989	Extend VAT to services and improve VAT collection
Oct 1991	postpone four large oil sectors projects, worth up to $10 billion Restrict foreign loans for state related projects through new Cabinet-level committee
May 1992	Replace Dutch led Inter-Governmental Group on Indonesia with the World Bank led Consultative Group on Indonesia

Monetary and Financial Policy

Apr 1974	Use credit ceilings on banks to control money supply
Aug 1977	Permit first share issue to be listed on Jakarta Stock Exchange
Jan 1982	Lift requirements for exporters to sell foreign exchange earnings to Central Bank
Jun 1983	Abolish all quantitative ceilings on bank credit Permit state banks to set interests rates on most loans deposits Reduce subsidized credit from Central Bank
Jan 1984	Introduce rural lending program through village banking units
Feb 1984	Issue Central Bank Certificates of Deposit (SBIs) and introduce two rediscount facilities
Feb 1985	Introduce new money market instruments (SBPUs) based on commercial bank portfolios
Oct 1986	Remove limits on access to foreign exchange swap facility

July 1987	Introduce auction and secondary market for Central Bank instruments
Dec 1987	Improve regulations on Jakarta Stock Exchange; establish a parallel securities market Permit foreign investors to purchase Indonesian shares
Oct 1988	Allow opening of new private domestic banks, and simplify bank branch establishment Allow foreign banks to start joint ventures in Indonesia Lower the reserve requirement from 15% to 2% Cut special privileges of state owned financial institutions Permit non-bank financial institutions to issue money market instruments Lessen bank restrictions to borrow abroad Improve Central Bank's foreign exchange swap mechanism Allow banks and non-bank financial institutions to issue shares on the stock market Impose 15% withholding tax on interest from time deposits and certificates of deposit
Dec 1988	Allow private regional stock exchanges; clarify capital market regulations Offer licenses for range of new financial services such as credit cards, venture capital, and securities dealing and underwriting; allow foreign joint ventures in these services Deregulate insurance industry
Sep 1989	Permit foreign investors to buy up to 49% of listed issues Require foreign banks to allocate 50% of loans to export activities
Oct 1989	Abolish controls on price fluctuations at securities market Establish procedures for new stock issues and licensing of broker and underwriters Promote inter-bank foreign exchange transactions by reducing Central Bank hours of financial transactions
Dec 1989	Privatize the Jakarta Stock Exchange
Jan 1990	Phase out liquidity credit scheme and remove interest rate subsidies Require all domestic banks to target 20% of loans to small indigenous businesses

Feb 1991	Require banks to have capital adequacy ratios of 8 percent by December 1993, following Bank for Inter-national Settlements standards; enforce new bank regulations
Nov 1991	Further improve the foreign exchange swap facility
Feb 1992	Replace the 1967 Banking Law with laws treating state banks similarly to privatize banks; allow foreigners to purchase shares in domestic banks.
Dec 1993	further promote inter-bank foreign exchange transactions by doubling the spread between Bank Indonesia's buy and sell prices.

Trade Policy: Imports

1970s	Increase tariff and non-tariff barriers (NTBs)
Nov 1982	Increase NTBs in Approved Importers Scheme covering such items as processed foods, chemicals, equipment, and consumer products
Oct 1984	Limit imports of plastics to 3 state trading companies
Apr 1985	Replace Indonesian Customs with private foreign company (SGS) Deregulate shipping and improve port operations Reduce number of tariff categories; lower top rates from 225% to 60%
Oct 1986	Simplify import procedures for electrical, electronic, chemicals, metal products, machinery, and spare parts Remove NTBs on 329 categories and compensate half the producers with tariffs impose "temporary" import surcharges on 33 items, including some textiles, synthetic fibers, chemicals, iron & steel, and some foods Reduce tariffs on inputs not produced locally
Jan 1987	Simplify import procedures for raw materials Change import licensing for 616 categories, such as textiles, steel, cars, and machinery Remove NTBs for 99 categories Cut tariffs to below 10% on 55 Items, such as machinery and industrial materials

Dec 1987	Remove NTBs for 111 categories, including steel and aluminum products, food and beverages, electronics, chemicals, heavy equipment, machinery, cars, and parts Reduce number of sole agent import licenses from 278 to 70 Raise tariffs on 91 items, reduce on 65 items, and place surcharges on 51 items
Nov 1988	Remove NTBs on 301 items, including textiles, chemicals, and agricultural products Remove import monopolies on plastics and many iron & steel products Increase tariff rates on 72 items, and reduce tariffs on 86 items, mostly raw materials Further deregulate shipping
Jan 1989	Replace many specific tariffs with lower and valorem rates Increase import surcharges and tariff splits on paper, processed agricultural goods, footwear, iron & steel products, and tools
May 1990	Reduce tariffs on 2481 categories, mostly industrial products Replace NTBs on 100 items with tariffs, including medicine Remove NTBs on 374 products, including produce, fish, meat, foods, cement, fertilizer, steel, synthetic yarns, machines, electronics, and some pharmaceuticals Remove import surcharges on 170 out of 526 surcharge items
1991	Renew contract with SGS, and require SGS to train the Indonesian Customs Bureau
Jun 1991	Replace 322 NTBs with tariffs, including steel, meat, and fish; lower top tariff rates on finished goods from 40 to 30 percent, and on intermediate inputs to 15 percent
Jul 1992	Cut two thirds of tariff surcharges, and replace NTBs with tariffs, mostly on batiks and some agricultural products; simplify import procedures for some capital goods
Jun 1993	Cut tariffs on over 220 items; reduce tariff surcharges on 76 items Replace surcharge on soybean meal with an NTB Replace NTBs on automobiles with prohibitive tariffs
Oct 1993	Cut tariffs on almost 200 items by 5 to 15 percent, lower surcharges on 27 goods, and eliminate surcharges on 92 categories, including steel and some agricultural products

Trade Policy: Exports

1970s	Introduce export subsidy program; reduce interest rates on export credits Remove some export taxes
1981	Restrict log exports; allow only those concession holders developing downstream production facilities to export logs
Jan 1982	Start Counterpurchase Agreements with foreign contractors Provide exporters with export credit guarantee and insurance facilities
1985	Begin complete ban on all log exports
Feb 1985	Sign GATT code on Subsidies and Countervailing Duties
1986	Ban raw rattan exports
May 1986	Replace export subsidy program with duty drawback system Grant exporters exemptions and rebates on import duties; firms with 85% or more exports may purchase imported inputs directly, duty-free Establish new administrative group to oversee the system
Dec 1987	Lower requirement under duty drawback system for exporters to import inputs directly from 85% to 65% export production Deregulate export license procedure Offer tax rebates on domestic purchases used in export production and exemption from tariffs and sales taxes on any imported capital goods used for export production Establish more container terminals and customs facilities at export production sites
Aug 1988	Ban semi-processed rattan export
Oct 1989	Place prohibitive export tax on sawnwood
May 1990	Remove export prohibitions on nutmeg, cassia vera, other agricultural products, and some finished wood products Lift requirements on coffee exporters to join marketing groups improve textiles and garments quota allocation system
Oct 1990	Ban cement exports
May 1992	Replace export bans on timber, leather, and rattan with

	prohibitive export taxes
Jun 1993	Streamline exporters' acquisition of duty exemptions for capital and unprocessed inputs
Oct 1993	Allow export firms to establish bonded factories and bypass the duty drawback facility

Industrial Policy

1974-	Require all foreign investment in joint ventures early Close sectors to investment
1980s	Impose local content laws through "deletion programs"
Apr 1985	Reduce requirements for investment approval
May 1986	Relax local ownership requirements, especially for capital intensive projects, and open sectors to foreign investment Extend foreign investment licenses Improve joint venture access to local markets and banks Develop new industrial estates and bonded trade zones; improve infrastructure
Jun 1987	Reduce requirements on licensing and use of production capacity
Dec 1987	Further reduce restrictions on foreign investors in access to state banks and local markets, domestic ownership, and export marketing Ease foreign employment restrictions Deregulate investment in tourism industry
May 1989	Open sectors to investment and introduce simplified "Negative List" of closed sectors
1989	Create the Strategic Industry Administration Board to protect state owned enterprises in strategic sectors, including steel, airplanes, munitions, and ships
May 1980	Reduce foreign investment restrictions in pharmaceuticals Simplify licensing in pharmaceutical, fish, and meat sectors
Jun 1991	Open more sectors to investment
Apr 1992	Allow completely foreign owned companies under certain

	conditions
Jul 1992	Open more sectors to investment Simplify procedures for foreigners to acquire work permits Allow 30 year land use permits, with possible renewals, for foreign joint ventures
Oct 1993	Ease the establishment of initially 100 percent foreign owned firms if they produce intermediate inputs change ceilings on foreign equity shares in joint ventures, and permit foreign companies to publicly divest their shares on the stock market Permit foreign firms located in industrial and export zones to sell a share of their production in Indonesia (up to one quarter of their export) Revise contract bidding

Southeast Asian Economic Series

1. Yana van der Meulen Rodgers, "A Research Guide on the Indonesian Economy," July 1994. (No.9401)
2. Yana van der Meulen Rodgers, "Indonesia's Policy Reform: An Overview," October 1994. (No.9402)