Growth and Adjustment in Indonesia: A Case Study in Economic Management (*)

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Introductory remarks

What is perhaps most fascinating about Indonesia is the sheer speed at which our country is evolving, together with the scope of change taking place as this evolution continues. In part, the changes have been thrust upon us by powerful forces in the world around us. As an economy still in its early developmental stages, we are especially vulnerable to external economic shocks. At the same time, however, many of the changes taking place in Indonesia in recent years have been deliberate and self-determined. We are, in effect, writing our own history. We are purposefully changing and shaping the structures and institutions of our country - both to bring them into step with the imperatives of the modern world and also to serve the unique needs of Indonesia.

To illustrate how this has occurred, I have chosen to devote my remarks to reviewing the economic changes that have taken place in Indonesia - particularly in the past six years. I hope in this way to give some insight as to how an oil-exporting - yet still developing - country has adjusted to a series of severe external shocks, while simultaneously embarking on a major programme to restructure, modernize and diversify its economy. The lessons from this chapter in our history provide a valuable clue as to Indonesia's future niche in the global economy, and may also help shed some light on the economic management issues affecting other countries in the developing world today.

In order to place these recent developments into a meaningful context, I would like to reflect briefly on the key elements shaping the Indonesian economy in its early stages.

Nearly 25 years ago, in a brief but turbulent change, our country

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(*) Address by Dr. Arifin M. Siregar, Minister of Trade of the Republic of Indonesia, at the 69th "Liebesmahl" of the Ost-Asiatischer Verein, Hamburg, on March 3rd, 1989. Left out are the introductory and the concluding remarks in which the Minister referred to his studies in Germany in the early 1960s.

brought an end to two decades of political and economic instability which occured following national independence in 1945. The ascendency of President Soeharto's Government in 1966 represented Indonesia's rejection of extremism in internal affairs - whether political, religious or economic. Ever since, our goals have been grounded in the belief that the country's welfare is best achieved through political and social stability and a consistent strategy of development.

The basic principles of economic management put in place at that time have remained virtually unchanged. As our economy has evolved, specific regulations or policy instruments have been altered or fine-tuned many times to meet changing needs - especially during the past few challenging years. But the underlying features of our economic system have remained consistent. Let me list five important guiding principles: First, we operate as a "mixed economy": both the private sector, including cooperatives, and state-owned enterprises have a role to play; second, based on our experience, we believe that monetary stability is a necessary condition for sound economic development; third, we have a foreign exchange system which is free of any restrictions. In addition our central bank, Bank Indonesia, is responsible for ensuring a realistic exchange rate of our national currency, the Rupiah; fourth, Indonesia actively seeks to expand trading links with countries throughout the world. As a signatory to the General Agreement on Tariffs and Trade (GATT), Indonesia supports fair pricing and free access to world markets; and fifth, Indonesia welcomes and encourages the participation of foreign direct investment in various sectors of the domestic economy. Overseas investors are given wide freedoms, with rights clearly set out and protected by law.

Guided over 20 years by these basic priciples, Indonesia has succeeded in moving forward, step by step, toward developing a modern and diversified economy. We are by no means at the end of our journey; indeed, we still have a long way to go. But if you consider where we were when this process began, the magnitude of our progress to date takes on considerably greater significance.

Starting the economic development

The Indonesia of 1965-1966 was a country with an economy at barely the most rudimentary stages of development. It was also a time when hyper-inflation was the order of the day. Virtually all our capital goods requirements and many kinds of raw materials were furnished by imports - the small amount of foreign exchange we had was earned by commodity exports - and our per capita Gross Domestic Product (GDP) was less than US-Dollar 80 per year. More than 50 percent of our GDP was based on agriculture - in many cases subsistance agriculture - and our infrastructure, such as electricity, irrigation, transportation and communication, left much to be desired.

With this as our starting-point, the transformation and "filling-out" of the Indonesian economy has been an enormous task indeed. To use an analogy, it has been rather like starting with a vast canvass, and little paint - yet setting out to create a masterpiece!

First, monetary stability had to be restored. Capital had to be found and carefully allocated, marketing and distribution channels had to be established, industrial inter-linkages had to be slowly and gradually put into place. In addition, an entire institutional structure had to be created to bind the system together.

Our overall goal was to bring about a sequential deepening of the domestic economic infrastructure. To achieve this, our five year development plans called for growth in successive stages. First, increasing and expanding agricultural production, then, building upstream industrial capabilities, reducing our dependence on imports by encouraging foreign investors - together with our own fledgling entrepreneurs - to serve our domestic markets.

This strategy proved successful. Relative monetary stability was achieved; our inflation which was as high as 635 percent in 1966 was brought under control. Stimulated by sharp oil price increases in 1973/74 and 1979/80 the development efforts during the 1970s and early 1980s succeeded in achieving an annual rate of growth of between 7 and 8 percent. As a consequence, per capita GPD, which was less than US-Dollar 80 in 1965, increased by about 600 percent. Moreover, the balance of payments improved substantially; the central bank accumulated large official exchange reserves; the long sought goal of self-sufficiency in rice was essentially attained in the early 1980s; the nation maintained low current account and fiscal deficits; and, despite a notable set-back in the mid-seventies, we managed to hold down our debt service burden.

In broad structural terms, the development efforts coupled with oil price increases affected our economy in five different ways: First, the inflow of capital to develop the energy industry brought vast changes and improvements to all aspects of Indonesia's physical infrastructure; second, the "ecosystem effect" - that is, a core industry creating conditions suitable for new, supporting, industries to grow up around it - served as a powerful spur for the greater industrialization of the country as a whole; third, the surge in state revenues generated by oil heralded a new era in government spending capabilities; this in turn enabled Indonesia to make major advances in essential development projects - most notably, education, health care, agricultural infrastructure and communications; fourth, the heightened economic activity spurred by oil brought with it the need for rapid growth in institutional and regulatory capabilities. This ranged across the complete spectrum of economic activity - including banking and finance, foreign investment, disbursement of development funds, import and export controls; and fifth, the new surge in capital flows transformed the economic landscape of Indonesia, creating new challenges in fiscal and monetary management, and inflation.

However, this period of rapid growth had a number of disquieting features that turned out to have a significant bearing on the required adjustment efforts in later years. For example, in an attempt to exploit the financial gains accruing from the oil boom, a considerable effort was made to promote import substitution by pushing industrialization upstream. Most industries relied to a very high degree on the domestic market. At least in the early stages of their development, many of these fledgling industries were judged to require protection from foreign competition. In addition, special facilities and subsidies in various forms were given to a number of enterprises. By the 1980s this policy had contributed in a significant way to Indonesia being a relatively high cost economy, despite its low wage level. Moreover, the Government's budget became heavily dependent upon oil revenues; non-oil taxes fell to a low of 5 percent of GDP and accounted for only 24 percent of total tax revenues in 1981/82. Also, foreign exchange earnings were dominated by oil and gas exports. Less easy to quantify, but nevertheless of fundamental importance, was the attitude of many Indonesians, who having enjoyed the benefits of an oil-driven economy for almost a decade, had come to believe that this source of stimulus was likely to last indefinitely.

When world growth and commodity prices, especially oil, unexspectedly turned downward in the early 1980s, Indonesia realized that it should take adjustment measures in order to ensure the success of its longer term development efforts.

Rather than describing the key developments of the past six years in a chronological time sequence I feel it would be more instructive to discuss these changes and developments by dividing them onto "themes" or "categories". In this way, I can isolate individual economic issues, describe where problems existed, explain the steps that were taken, and attempt to show the results.

The fact is, of course, in the complex matrix of economic inter-relationships, few factors are ever completely isolated; actions in one area inevitably impact on others as well. So, bearing in mind that we will find many areas of overlap, let us proceed to examine the main themes of Indonesian reform over the past six years.

Budgetary needs in response to decline in state revenues

The first theme is this: How did Indonesia adjust its budgetary needs in response to the sharp decline in state revenues caused by the drop in oil prices and sustained weakness in commodities?

What cannot be over-emphasized is the extent to which Indonesia had come to rely on oil payments during the 1970s and early 1980s as the main contributor to government revenues. In the fiscal year 1982-83 - the peak year - oil earnings accounted for about 80 percent of Indonesia's foreign exchange and more than 65 percent of total government domestic revenues. Two successive drops in oil prices - the first in 1983 and the second in 1986 - left Indonesia with its foreign exchange earnings and government revenue base slashed in half. Simultaneously, weak pricing levels for many of Indonesia's other prime export commodities - both mineral and agricultural products - further worsened this already critical balance of payments and government revenue gap.

The solution of this problem involved a number of complex and interlocking steps. Here, not necessarily in the order in which they occurred, are the steps that were taken:

1) Budget austerity

During successive years, Indonesia pared back spending to reflect the reality of reduced government revenue. Steps included the cancelling or rephasing of a number of large development projects, freezing the salaries of govenment employees and reducing government subsidies.

2) Increasing non-oil tax revenues

The complete reform of Indonesia's Tax Law, enacted in 1984 and 1985, provided Indonesia with an effective system of income and corporate taxation and added an imported source of revenue through a new Value Added Tax (VAT). Subsequently, emphasis has been placed on stepped-up enforcement and more effective tax collection. In addition, new taxes have been added (such as the 15 percent flat tax on bank term deposits) and existing taxes further extended - for example, VAT is now levied at the wholesale level. As a result of these changes, non-oil tax revenues have grown appreciably, this year contributing 60 percent of government domestic revenues.

3) Devaluation of the currency
To improve the balance of payments - and to promote competitiveness of Indonesian export products - Indonesia responded to each major drop in oil prices with a sharp one-time adjustment of the Rupiah, devaluing by 28 percent in 1983 and 31 percent in 1986.

4) Increased foreign borrowing
Both to avoid "over-crowding" in the limited domestic capital market and to adhere to the principle of "balanced budget", Indonesia has a policy of not drawing funds from domestic financial markets - through bonds, debentures, Treasury Bills and the like. Nor does it want to finance its expenditures by resorting to central bank's financing. It has been the policy of the Government to give the highest priority to grants and external loans on concessionary terms. In case such loans are insufficient to meet the needs, semi-concessional loans, such as export credits from specialized agencies, can, up to a certain amount, be resorted to. Loans from foreign commercial banks have in principle been limited to serve specific purposes under special circumstances. Owing to insufficient revenues since 1982/83, the Government has increased its foreign borrowing, especially in the form of concessional loans both from bilateral and multilateral institutions.

While on the subject of foreign loans, I would be remiss if I did not comment further on the matter of repayment. As you know, debt repayment has become a particularly irksome issue for Indonesia at the present time in view of the sharp depreciation of the US-Dollar against other leading currencies - especially the German Mark and the Yen - following the Plaza Accord of 1985.

With a substantial proportion of our current loan portfolio denominated in non-Dollar currencies, while the bulk of our export earnings are priced in Dollars, our debt repayment burden - expressed in US-Dollar -

is particularly onerous at the present time. Debt repayments consume at the present time more than 50 percent of our annual government routine expenditures. Our projection, however, along with the World Bank and other leading multilateral financial institutions, is that Indonesia's debt repayment burden has already peaked, and that it will begin to run down substantially as we enter the 1990s.

I will add that it is a cardinal principle of economic management in Indonesia that our debt will neither be defaulted nor rescheduled. In spite of the difficulties we have faced during these past few stressful years, we have kept that trust, and we will continue to do so. Having said that, I cannot deny that our debt burden does place severe constraints on our financial maneuverability and that, for at least the next two years, it mandates careful budgeting.

5) Banking and financial reforms

An essential aspect of mobilizing capital during a period of scarce resources is the promotion of liquidity within the banking system. Successive reforms in the banking and financial sector - beginning in 1983 and conntinuing in 1988 - have encouraged the flow of savings into the domestic banking system, strengthened monetary management tools by the Central Bank and ensured a realistic exchange rate of the Rupiah.

The combined result of all these measures is that Indonesia, at the macro-economic level, has successfully weathered the worst potential financial storm we have ever faced, with our budget and our credibility firmly intact.

What I have decribed so far are measures at the macro-economic level designed primarily to keep the Indonesian economy on an even keel in the immediate aftermath of the oil-price shock.

But that is by no means the end of the story. With a workforce expanding by more than 2 million new job-seekers every year, and an educational system rapidly increasing the skills - and raising expectations - among our growing population, Indonesia cannot afford a stagnant economy. By our own estimates, we require aggregate economic growth of five percent annually merely to keep up with the underlying expansion of our population.

Hence the second great challenge faced by Indonesian policy-makers during the turbulent 1980s has been to explore additional measures and effective tools to stimulate economic growth on a broader scale. Faced with scarcity of government resources, the main engine for this growth, clearly, has have to come from the private sector.

Among the many benefits accruing to Indonesia during the decade of the oil boom was what I referred to earlier as the "ecosystem effect" - the creation of secondary, supporting, or inter-linking industries which grow up "under the shadow" of certain core industries. In our case, the initial catalyst was oil and gas, but later included textiles, chemicals, automotive and steel as well. Nurtured by these industrial pace-setters, the Indonesian private sector now has capabilities in scores of secondary manufacturing operations.

At the same time, however, the system that helped these industries grow in the first place - in particular, Indonesia's highly protected domestic market - was becoming an impediment to their future growth. By the mid-1980s, the same protectionism that got them started was now adding to their costs, diminishing their quality, and rendering them unfit for competition, not just in needed export markets, but even in competion with imported goods in the domestic market. In effect, many of the capabilities were in place, but something, clearly, had to be done to make the system work better and get our industries into competitive shape.

Hence, in my review of recent developments in Indonesia, the second major area I will touch on is the structural reforms of the past six years targeted at promoting the activity of the private sector.

Structural reforms

These can be broken into four areas of activity: manufacturing, trade, investment, and the financial sector.

Before describing the changes in these four important sectors, I would like, in passing to note a matter of "terminology". At present, we in Indonesia find ourselves caught up in the current vogue of "deregulation". To hear some say it, deregulation is the answer to every economic ill - indeed, that mere deregulation can itself create economic growth. This, of course, is an exaggeration. Deregulation, in isolation, has no meaning; it has meaning and power only in the context of the regulatory environment that preceded it - and even then, only if it is carefully and judiciously applied. I would like to emphasize that in Indonesia's case, the many reform measures we have introduced over the past several years divide about equally between "deregulation", in the strict sense, and what might properly be called "policy adjudments".

In whatever form the changes we have introduced have had certain core goals: greater business flexibility and entrepreneurship through the removal of bureaucratic impediments - enhanced competitiveness, both domestic and international, through a lowering of cost-inputs - and improved quality and efficiency through greater exposure to competition.

Central to our strategy for increased industrial growth and stepped-up job-creation is growth through exports - and, specifically, non-oil exports. For this reason, in outlining our recent programme of reforms, I will describe the measures affecting manufacturing and trade simultaneously.

The question is: What has Indonesia done to improve the operation environment for business, enhance its competitiveness, alleviate the "high cost" economy and push deeper into export markets?

Many measures have been introduced over the past six years to address each of these important, and interlocking, concerns. The most concentrated period of business reform in Indonesia has actually occurred during the past three years, through a steady stream of measures introduced in what we call "packages", made of several reforms announced together. The first of these, in 1986 - known as "The May 6th Package" - has since been followed by additional "packages" of varying size and scope. Improvements touching the manufacturing and trade sectors include the following:

1) Lowered cost inputs

As a direct incentive to manufacturers of goods for export, Indonesia now provides full access to components of internationally competitive prices. Wherever locally-made parts or components are available, more expensive, or of inferior quality, parts and components may be imported free of duty - provided the final product is intended for export.

In a related move beneficial to all exporters - not just manufacturers of goods for exports - we have also moved to eliminate other protective mechanisms and non-tariff barriers (NTBs) previously restricting or adding to the cost of imports. In particular, an earlier system of import monopolies and sole distributorships has now been substantially reduced or even abolished in a number of cases.

2) Unencumbered production flexibility

We have entangled and eliminated a complex system of production licensing requirements. We had allowed this system to grow up during the years when we believed that monitoring and regulating manufacturing output could avoid market distortions. Now, though we still require manufacturers to obtain an initial license to produce certain broad categories of goods, they are free to increase production to meet surges in demand and to modify or extend product lines.

3) Reform of customs and ports procedures
This was an important early reform, preceding any of the "packages" I described before. We moved in 1985 to tackle one of the areas for which we received most frequent criticism from our business community, our foreign investors and our trading partners - and that was red tape and inefficiency in our ports and customs service.

Since then, cooperating closely with Societe Generale de Surveillance (SGS), the Swiss inspection firm, in performing our customs works, our imports and exports now flow smoothly, and we have a customs service well suited to handle our rapidly increasing flows in trade.

In addition to these reforms, targeted directly at our manufacturing and trade sectors, there have been other improvements as well. Among the changes I mentioned earlier while discussing our overall macro-economic management policies, I would have to include our most recent currency devaluation, as providing measurable benefits to our manufacturing and export sectors. In the case of the 1986 devaluation, it is worth noting that we have succeeded in containing domestic inflation to such an extent that we have maintained the competitive advantage of the Rupiah at virtually the same level as the targeted level at the time of the devaluation. As an indication of the effectiveness of these changes, Indonesia has been experiencing a substantial increase in both manufacturing output and non-oil exports. In the 1987-88 Fiscal Year, the value of our non-oil exports surpassed oil and gas shipments for the first time since the start of the oil boom in 1973/74. In the current 1988-89 Fiscal Year, ending this month [March 1989, the Editor], we are projecting our non-oil exports will climb still higher, reaching US-Dollar 11.2 billion, or about 60 percent of Indonesia's total exports, compared with only 21 percent in 1982/83.

Compared with the "pre-oil" years, what is especially noteworthy about today's non-oil exports is the increased range of products they entail. Gone are the days when Indonesia's export picture reflected a country little more than a "hewer of wood and drawer of water". Fifteen years ago, what we supplied were commodities either grown on our land or dug from the ground such as tea, coffee, spices, rubber, lumber, tin and copper. Today although these commodities still maintain a place of pride among our export products, they are being outstripped in value by a completely new generation of Indonesian exports, comprising processed, semi-processed and manufactured goods.

Just to give you an idea: where once we shipped logs, today we are using our forests to produce furniture and are the world's leading exporter of plywood; where once we exported raw rubber, today we are exporting gloves, footwear and automotive tires; where once our transportation infrastructure was underdeveloped, today we are exporting bicycles, motor-cycles, cars and aircraft components. Equally striking, we are also starting to export a range of products which, frankly, a few years ago, were not even competitive on our own domestic market such as steel, cement, fertilizers and chemicals.

In short, the past six years have witnessed a remarkable transformation in the manufacturing base - and hence, the very structure - of the Indonesian economy. It should also be noted that we have had success in developing an indigenous class of Indonesian entrepreneurs and technical experts. Nevertheless, we continue to need enormous infusions of new capital and technical expertise from overseas investors.

Foreign Investments

Let me, in this context, also deal with another question: How has Indonesia moved in recent years to improve its attractiveness in the face of todays increasingly agressive global competition to attract foreign investments? In answering this question, I would like first to point out that Indonesia has succeeded in attracting foreign investment in the past few years. One reason for this is that more than 20 years ago - in 1967, to be exact - we introduced a foreign investment law, under which a number of incentives and a firm legal framework for investors were established. Since that time, specific regulations have been altered, but the " bottom line" for foreign investment in Indonesia has remained unchanged. Under this system, which was supported by an improved business climate, foreign investment has flourished in Indonesia.

Between 1967 and the end of 1988, approved foreign investment in our manufacturing and agricultural sectors had reached a total of US-Dollar

21.3 billion. This figure does not include additional participation in our "specialty sectors" - energy and finance - for which the procedures for investment are different. When this is added in today's cumulative total of overseas involvement in Indonesia's private sector economy is substantially higher.

Having said that, it must also be acknowledged that during the hectic 1970s and early 1980s, our investment environment became prone to developing what we might call "bureaucratic hardening of the arteries" with a rapid proliferation of rules, regulations and permits.

Recognizing that this situation was not endearing us to the world's investment community, we set about cleaning house in our investment sector, just as we did in manufacturing and in trade. We began this process in 1983 by simplifying investment application procedures by BKPM, our investment coordination board. In subsequent reforms - notably in the "May 6th Package" of 1986 - we introduced a number of other changes aimed at improving our investment climate.

Reform of the Financial Sector

Allow me now to touch on the final area of reform in Indonesia which I would like to describe - and that is the reform of our financial sector. Let me just mention a few points by answering the question: What has Indonesia done to equip its financial markets to meet the nation's growing capital requirements?

Our record of monetary management, our control of inflation, our maintenance of foreign reserves and the management of our exchange rate system are all indicative of a financial system that is effectively managed and carefully implemented. The fact that we have maintained relative monetary stability while operating a foreign exchange system which is free of any restrictions, is a further indication of our consistent macro-economic policy.

We also operate a banking system that has played a dominant role in financing the private sector. Seven large state banks, about seventy domestic banks and a select handful - eleven, to be exact - of major overseas banks provide individual and corporate borrowers in Indonesia with banking services.

In certain other respects, however, our financial system still is at a relatively junior stage of maturity. Our regional banking system - and with it, our ability to fully mobilize public savings - is still at an early stage of development. Our non-bank financial markets, together with the range of additional financial options they bring, are also small and relatively underdeveloped. There is indeed still great room - and need - for our financial system to grow.

In addressing our country's expanding financial requirements, we have acted over the past five years across a wide range of fronts to bring improvements to our financial sector. The past two years have been especially productive in terms of our efforts to breathe greater life into Indonesia's financial markets in the widest sense. Our most recent intiative in this important area have comprised both deregulatory measures as well as new policy initiatives.

On the banking side, we have opened a new window for foreign banks to enter Indonesia - the first opening in about 20 years. We are also allowing foreign banks to open branches in cities outside Jakarta - another first. In addition, there is now an opportunity to establish new domestic private banks. In all these measures, our objectives are to strengthen the banking system - both by increased competition and increased banking reach. We are hopeful that these measures will not only draw greater liquidity into the banking system by mobilizing greater public savings, but will also provide faster, and ultimately, cheaper sources of funding to meet borrowers' needs.

In an equally important set of new measures, we have also taken steps to improve and strengthen the operation of Indonesia's capital market. We are aware that for business expansion to occur in Indonesia as fast as we would like, our businesses need access to equity as well as debt-financing to meet their capital requirements, and we see an activated stock market as the best way of bringing this about. Accordingly, through deregulation, we eliminated a number of earlier restrictions which had weakened the Jarkarta Stock Exchange, and we set up a Parallel Bourse for over-the-counter trading.

Overall the financial sector has received a great deal of attention from Indonesia's policy-makers over the past six years, and many improvements have been made.

Final Remarks

I have talked - at great length it seems - about Indonesia, about the country's recent economic developments, and about our new momentum for adjustment, renewal and reform. In bringing my remarks to a close, I would like to take a final moment to cast outside Indonesia's boundaries and to reflect on our role, as we see it, in the larger world around us.

Indonesia has been active in cooperating with various countries through a number of associations and multilateral institutions. In particular, geography and shared characteristics give us close ties with our neighbouring countries in the Association of the South East Asian Nations (ASEAN).

We also, of course, place great value on the warm relations we enjoy with the world's industrialized nations. We will go about the task of national development at our own pace, and in our own style, but it can also be said that we look to many dimensions of Western economic progress as a model to us in our search to develop institutions and economic frameworks of our own.

Most of all, we see great complementarities and opportunities, now and in the future, in our economic relations with the industrialized world - bringing enormous benefits to both sides. The message I have tried to impart is that the contemporary Indonesia is a self-reliant nation which would like to cooperate with other countries on a mutually beneficial basis. We have a clear vision of the economic future we seek, and we hope we can achieve it by means of our human and natural resources. In relation with foreign countries, we have been making continuous efforts to ensure that we are always a reliable partner.

As you rise to meet the challenges and opportunities of a unified European market early in the next decade, it is our hope that Germany, and all the nations of Europe, will look carefully at the potential benefits of closer links with South East Asia. Whether as a market for our technology-based products and services - as a source of cost-competitive imports - or an offshore base for your global manuacturing enterprises, you will find South East Asia - and certainly Indonesia - offering wealth of competitive advantages.

Above all, I appeal to you - both as an Indonesian and as a member of the ASEAN group - to keep your markets open to receive our products, wherever they are competitive. Continued access to your markets forms the life-blood of our future economic growth and the sustenance we need to reach maturity as global economic partners.