

Economic Development in Indonesia from Independence until the Crises in the 90s

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Indonesia is becoming an ever more decisive factor of the global economy due to the lasting growth and reforms introduced in the last decades. Nowadays, following China and India, Indonesia is the fastest growing economy in Asia; its GDP measured at purchasing power parity had exceeded 2.8 thousand million US\$ in 2015. Accordingly, it is the eight biggest economy in the world. Today it covers almost 2.5 percent of the total production/gross output globally, however, this share will probably further increase in the future. With its 256 million inhabitants, Indonesia is the fourth most populated country in the world after China, India and the US, and the second in East-Asia after China. In addition, its population is relatively young, and the proportion of children and the elders compared to the working-age population is low, and the share of working-age population is increasing. These demographic features – considering appropriate workplaces – creates the opportunity for further GDP growth in the country in the next two decades (Elias-Noone, 2011).

1. The framework of development

One of the main research areas of international economics is the examination of what causes the changes in the economic performance of certain countries, and how these changes are effected. Due to the turning points and dramatic changes in the country's economic performance over the decades, an overview of Indonesia's economic development can provide economic researchers, as well as economic decision-makers of developing countries useful information and insights.

In the two decades following the proclamation of independence (August 19, 1945) Indonesia was considered to be a poor and insignificant country. However, by the middle of the 60s, as a consequence of the inward-looking, self-sufficient and anti-western politics of President Sukarno, the economic problems of the country became serious. Influential economists and prestigious experts of international organizations

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gave up on any possibility of economic development regarding Indonesia, prejudging the situation as hopeless as in the case of the least developed countries (LDC) of Asia and Africa. From this desperate economic situation, the period of the New Order economic policy, named after President Suharto led out the country from the abyss, and Indonesia produced a speedy recovery thanks to the sharply declining inflation and sustained growth. The revenues from the oil sector also contributed to the recovery and the impressive poverty reduction in the 70s. After the two decade-long economic growth and the reforms of the 80s and the 90s, the financial and economic collapse of the country in the Asian crises of 1997-1998 surprised both academic researchers and analysts of international organizations. The crises affected several Asian tigers, but it made the most enduring effect on the Indonesian economy, which then turned to be from being a "star transition country" to a "sick man" (Stern, 2003).

This chapter introduces the economic development and the evolution of the economic policy of Indonesia from the independence till the Asian crises of 1997, primarily focusing on the government actions during the period of the New Order. It examines how Indonesia has switched over from a relatively closed, strongly domestic industry protecting economy to an open economic model and has become more and more competitive on the global market. According to the World Bank evaluation Indonesia thus became - one of the newly industrializing economies (NIEs) (together with Malaysia and Thailand) that successfully carried out export promoting industrial policy. In addition, the analysis of the processes leading to the outbreak of the crises provides us with further important lessons.

2. The early phase of independence (1949-1965)

It was only after an armed fight lasting for four years, under the presidency of Sukarno,¹ who was leading the wars against the Dutch, that Indonesia won its independence from the Netherlands on December 27, 1949. After gaining independence, the new nation was facing serious economic and political problems. The Japanese

¹ President Sukarno, originally called Kusno Sosrodihardjo (1901-1970): the first president of the Republic of Indonesia that became independent from the Dutch colonial fate after World War II. He was serving as a president from 18 August 1945 until 12 March 1967. He studied in a Dutch school, and was fighting for independence since his youth. He was a founding member of the Indonesian National Party in 1927. During the Japanese occupation, he and his partners were cooperating with the invaders against the Dutch. By the end of the war in 1945, he realized that there was a reasonable chance for Indonesian independence. With the compliance of Japan, he established the committee preparing the independence, then on 17 August, 1945, with the company of Mohammad Hatta, he proclaimed Indonesian Independence, which was acknowledged by the Netherlands on 27 December, 1949

occupation under World War II (1942-1945) and the war of independence against the Dutch (1945-1949) significantly impoverished the population. The main objective of the new political leadership was therefore the increase in the living standards of the population, the rebuilding of the physical infrastructure, the reconstruction of the production base and the incentive of the commercial and industrial activities. The central budget was struggling with permanent deficit, and the repayment of the huge foreign debt received from the Dutch government put an excessive pressure on the country (Kian Wie, 2003). The latitude of the economic policy was heavily limited by the fact that the government was unable to control any important segment of the economy, because gaining political independence did not come along with the achievement of economic independence. The prevalence of foreign economic interests is well illustrated by the estimate, according to which 60 percent of the export of consumer goods was carried out by eight Dutch enterprises in Indonesia (Kian Wie, 2012).

The 15 years following the declaration of Independence can be divided into two phases; the period of parliamentary democracy (1950-1959) and the controlled democracy (1959-1965). During the period of parliamentary democracy, the economic policy of Indonesia was determined by pragmatic politicians of different political parties, who were trained abroad (Mohammad Hatta, Sumitro Djojohadikusumo, Sjafruddin Prawiranegara and Djuanda Kartawidajja). Although they were attracted to the socialist ideology, they did not join any rigid ideology. The economic stability and the aim to create the conditions of rebuilding the infrastructure and economic base constituted their priorities (Kian Wie, 2003). As a result of their policies, illiteracy among the population under 40 was eradicated within almost one decade, however, due to the under-qualification of local workforce and the lack of deliberate economic policy strategy breakthrough results could not be reached in the economy (György, 2008). The controlled democracy basically differed from the parliamentary democracy concerning its power structure and political relations. With the exception of the Indonesian Communist Party (PKI), the rest of the political parties lost influence, the parliament did not play a role in decision-making, and the political power was divided between President Sukarno and the army (Redfern, 2010). The abolition of foreign supervision over the Indonesian economic resources was a major target of the political leadership, which they found to be attainable by two means: firstly, by the establishment of state enterprises, secondly by the strengthening of private enterprises in the hands of native Indonesian owners (pribumi) (Kian Wie, 2012).

2.1. The nationalization of Dutch enterprises

In the 50s, one of the main goals was the birth of Dutch economic diplomacy. In the Financial-Economic Agreement (Finec) accepted in 1949 on The Hague roundtable meetings, the government of Indonesia guaranteed that the Dutch enterprises could continue their activities in Indonesia without any obstacles. However, as the Finec was ensuring the legal framework of the nationalization besides special conditions² the Indonesian government soon made steps towards the nationalization of economic institutions with key importance and enterprises with strategic importance. The first nationalized institution was the Dutch Java Bank, which had a decisive role during the colonial period. The nationalization was achieved through the acquisitions of shares, which went smoothly. On 6 December 1951, the law on the nationalization of Java Bank was officially accepted and the bank became the reserve bank of Indonesia under the name of Sentral Republik Indonesia.

The nationalization affected other Dutch enterprises as well, which had key importance in the Indonesian economy: the energy- and gas supplier companies were nationalized in 1945, and they were concentrated into two companies (Perusahaan Listrik Negara, PLN and Perusahaan Gas Negara, PGN). The Javanese Railways were re-established under the name of Indonesian State Railway Company (Perusahaan Negara Kereta Api, PNKA). The air transport moved from the Dutch airline to the Garuda Indonesia Airlines, which in the beginning worked as the joint venture of the Indonesian government and the KLM Royal Dutch Airlines (Koninklijke Luchtvaart Maatschappij). However, in 1954 it became fully controlled by the Indonesian government. The nationalization of the company dominating the domestic shipping market, KLM did not take place at the end, so in 1952 the Indonesian government established the Indonesian National Shipping Company (Pelayaran Nasional Indonesia, PELNI) with 200 million rupees of registered capital. Thanks to the financial assistance of the Indonesian government, the state-owned shipping company steadily increased its stakes in the trucking, as well as in the passenger transport industry. The establishment of the Central Trading Company, in 1947 the CTC could also be seen as an effort to reduce the Dutch economic influence. It was established as the first government trading company of Indonesia and was meant to restrict the monopoly of the "Big Fives" (the five biggest Dutch trading company) in the export and import trade of Indonesia (Kian Wie, 2012).

² The agreement only allowed the nationalization of Dutch enterprises on condition that it is in Indonesia's fundamental national interest, and mutually acceptable for both sides. In this case, the amount of compensation for nationalization was determined by a court based on the real value of the nationalized enterprise (Kian Wie 2012).

The relations between the Netherlands and Indonesia deteriorated from the mid-50s as the Dutch government rejected the discussion of the status of the West New Guinea (Indonesian terminology: West-Irian, currently Papua Province). Subsequently, as the Indonesian government in 1957 failed to convince the UN Council to adopt a resolution in which they pressurize the Netherlands to regulate the issue, anti-Dutch demonstrations broke out in Jakarta. On 3 December 1957, militant unions and the activists of the Indonesian National Party captured the Jakarta seat of KPM shipping company that was considered to be the main symbol of the Dutch economy. In the following weeks, similar actions occurred in the suburbs, as well. Even though the Indonesian government was not encouraging these steps, it neither tried to stop them. Because of the economic and political mess due to the seat reservations, Sukarno – to maintain the internal order and in return of political support – surrendered the seized companies to the hands of the leaders of the army, who thereby assumed a key role in the economy besides their original function. In December 1958, the government created the legal basis of the nationalization of Dutch-seized enterprises, which took place in the first half of 1959. This single drastic move ended the Dutch presence in Indonesian business, which was established in the second half of the 19th century, and the economy had been left basically without local competence and management-expertise (Kian Wie, 2012; Kian Wie, 2003). A political system of patronage was established in cases where the seized companies were the biggest obstacle for the change-over to export-driven economic growth, because the import substitution and industrial relations with foreign countries – with the lack of competences – meant a more secure income resource for the supporters of Sukarno. While the nationalization of the Javanese Bank and other Dutch enterprises was based on a consensus in the beginning of the 50s during the time of democracy, in 1959, after the expansion of politically radical powers, nationalization became a unilateral measure taken by the Indonesian authorities, which indicated the devaluation of the Dutch-Indonesian relations (György, 2008).

2.2. Attempts to reduce the Chinese economic influence

The Indonesian government took a significant step with the nationalization of Dutch enterprises with the aim of converting the colonial economy into a national one. However, the transformation was not completed with this step, because – similarly to Singapore and Thailand – the Chinese settlers had also played a dominant role in the economy besides the Dutch since the colonial times, especially in the intermediary trade, rice husking and lending.³ Thus, after the restriction of the Dutch role in economic activities, the Indonesian government also took steps to reduce the Chinese influence. In order to achieve this aim, a decree was issued in 1954, according to

which the Chinese rice husking mills had to be given over to the native Indonesians.³ Another regulation with a similar objective was restricting the Chinese enterprises dealing with loading, port traffic and storage. Nevertheless, the measures on the restrictions of Chinese economic activities proved to be less effective than the abolition of the Dutch economic interests, because the Chinese outnumbered the Dutch, and their economic activities (intermediary trade, loaning) in the rural areas were more interwoven with the economic activities of native Indonesians than those of the Dutch. Besides, the large number of Chinese ethnicity consisted of Indonesian citizens, citizens of the Democratic People's Republic of Korea (DPRK), and a smaller group of citizens from Taiwan. The government simply could not take measures that affected all Chinese decent actors. Due to the difficulties in implementing the two aforementioned decrees had never taken force.

The most important regulation concerning the Chinese economic influence was issued after the expansion of radical political powers in 1959. It aimed at removing all foreign-born Chinese from the retail sector in rural areas, forcing them to hand over their business enterprises to Indonesian citizens by 1 January 1960. By the end of 1959 the army started the violent eviction of the Chinese population from the rural areas to the cities of Java, which then was followed by the repatriation of more than one hundred thousand Chinese citizens to the DPRK in the following years. As the business sector of native Indonesians and the developing cooperative system were not able to substitute the Chinese merchants efficiently, the decree resulted in great economic confusion in the supply of the rural areas. Although the 1959 regulation has never been revoked officially, its application was temporarily suspended. The informal role of the Chinese in Indonesian economy had not decreased substantially before Sukarno, or during his presidency (Kian Wie, 2012; György, 2008).

2.3. The Benteng program

In parallel with curtailing the Dutch and the Chinese economic dominance, there was an increasingly powerful attempt from the government to prioritize native Indonesian (pribumi)⁴ entrepreneurs whose economic activity was limited to agriculture, small

³ To characterize the way the Chinese and Dutch economic democracy affected the modern sectors of the economy (agriculture, mining, manufacturing, bank system and public utility service) in the field of intermediary trade, Everett Hawkins – American professor, researcher of Indonesia – used the concept of “double colonization” in connection with Indonesia (Kian Wie, 2012).

⁴ The pribumi is the Bahasa translation of the Dutch word of inlander (inhabitant). The Dutch colonial administration differentiated between three ethnic groups; the Europeans, the “Eastern foreigners”

production, retail and small-scale industries (the art of batik, production of clove cigarettes). The government launched the so-called Benteng (fort) Program in April 1950, which besides the creation of strong domestic entrepreneurs, also aimed at breaking the monopoly of the Dutch trading house ("Big Fives") through the national control of import. The government gave a preferential treatment to native Indonesian importers within the framework of the program by limiting the issuance of import licenses – in a small number of easily sellable products (the so-called benteng products, eg.: yarn, fabric, paper, stationery, matches et) – exclusively for them. In order to facilitate their trading activities, the inhabitant entrepreneurs got cheap credits granted for them by the newly established Bank Negara Indonesia (BNI, Indonesian State Bank). The government hoped that through the trade activities, native Indonesians would accumulate capital that later could be invested in other sectors. As a result of the program, although 70 percent of the import trade was conducted by native Indonesian businessmen in the beginning of the 50s, the goals could not be reached due to several reasons. The major reason of the failure was that in most cases domestic importers receiving preferential treatment were closely related to political decision-makers. Many of them lacked capital or experience in business, therefore they simply sold their import licenses for the 200-250 percent of the nominal value or in the form of agency contracts to the companies of Chinese importers. As a result, the first strategic objective of Indonesia failed by the second half of the 50s, though it was never abolished. With the introduction of controlled democracy and controlled economy as well as with the call for the establishment of an Indonesian kind of socialism by President Sukarno, the assistance of native Indonesian private entrepreneurs faded into the background, because new state companies emerged from the expropriated Dutch enterprises aspiring to play a leading role in several sectors of the economy.

2.4. Economic decline during the controlled democracy phase (1959-1965)

In the beginning of the 50s, economic and political crises broke out in Indonesia. In 1956 two resource-rich regions with significant export earnings (West-Sumatra and North-Celebes) revolted against the central government. They decided not to transfer their foreign exchange earnings to the budget, therefore the foreign exchange reserves of the central bank drastically decreased. In March 1958, the two regions declared their independence (Woo-Glassburner-Nasution, 1994). Due to the economic crises and the national disintegration, President Sukarno proclaimed a state of

(Chinese, Arabians, Indians and the inhabitants (pribumis), because the partial privileges for certain groups helped to maintain the order and the political stability of the colonial society (György, 2008).

emergency making his control over the army complete. The gradual elimination of parliamentary democracy had started, which reached its peak on 5 July 1959 with the dissolution of the legally elected parliament and the constituent assembly. President Sukarno further strengthened his political leadership and with the restoration of the 1945 constitution, he became the head of state and the Prime Minister in one person. With the support of the army and the strengthening Indonesian Communist Party, President Sukarno introduced the program of controlled democracy and controlled economy (*Demokrasi Terpimpin, Ekonomi Terpimpin*) (1959-1965).⁵ Indonesia was following the socialist path of development, aiming to be self-sufficient. Its foreign policy was characterized by an increasing and conscious turning towards anti-West and anti-capitalist behavior, as well as by a commitment to the countries of the Soviet block and the Democratic People's Republic of Korea (Kian Wie, 2012; Booth, 1998). By 1959, the possibility of external supervision of the Indonesian economy was practically eliminated and the autarky-oriented country quit the UN, the World Bank and Monetary Fund, too. From the beginning of 1961, the Indonesian Central Bank was ordered not to publish its weekly, monthly and annual report on the state of the economy. The implementation of the program of controlled economy barely met with resistance, because its first point was the nationalization of Dutch enterprises, however, other parts of the program remained unclear, which made the drafting of critiques difficult (Woo-Glassburner-Nasution, 1994; György, 2008).

The last years of Sukarno's presidency were characterized by an excessive deterioration of economic conditions. Poverty and starvation were general phenomena, and the infrastructure was crumbling. The most fundamental problem was the alarming pace of inflation, which increased from 19 percent in 1960 to 137 percent in 1964, and by 1966 it exceeded 600 percent causing the impoverishment of the population. The hyperinflation came about as a result of the increasing budget deficit, which the government attempted to finance by money printing (Kian Wie, 2003). The government spending was increasing in the 60s due to several reasons: partly because of military actions, as President Sukarno started two invasions stressing the ideology of "fulfilling of a national revolution" to regain West New-Guinea from the Netherlands in 1961-1962, then against Malaysia in 1963-1966. The expenditures on rice import (the

⁵ As the inner circles of the government essentially consisted of Javanese people after the independence of 1949, the inhabitants of Outer Islands (every island outside Java and Madura) many times felt themselves neglected and robbed (György, 2008).

The program of controlled economy basically meant increasing state control over the means of production, prioritizing policies aiming at self-sufficiency during the industrialization, managing the current account deficit with quantitative restrictions and multiple exchange rate, financing the increased budget deficit - due to prestige investments and military actions - through money printing (Woo-Glassburner-Nasution, 1994).

production volume of rice and other cereals was not sufficient for the nourishment of the population) and expenses of prestige investments and payments for political supporters of President Sukarno all contributed to the overspendings. Moreover, the growth of government spending was not matched by an increase of national budget revenues. During the 50s the government revenues mostly originated from the taxation of foreign trade, nevertheless, these incomes diminished by the early 60s, because of the weakening of the world demand for rubber (the main export item of Indonesia) and other export products. The other problem was related to the overvaluation of the rupee exchange rate (Kian Wie, 2012; György, 2008).

In the beginning of the 60s, the production and investment in most branches of the government declined continuously, except for government services. In the beginning of the 20th century, the production of sugar – considered to be the most important export item of Indonesia – had been sharply declining, and in the decades after the war it only added up 3 percent of the country's export revenues. Without significant investments in the sector (better quality of seed, the reparation of the irrigation system, the broadening of refining capacity), there was little chance of significantly increasing the performance. The development of the manufacturing industry, that added up to less than 10 percent of the GDP, was quite slow compared to other Asian countries, because, due to the low foreign exchange earnings, Indonesia was not able to finance the import needs of the sector (raw material and spare parts).⁶ Only the volume of crude oil production increased mainly because the significant investments of Caltex, one of the biggest oil companies.

In the first part of the 60s, the average growth of the Indonesian economy was lower than in the 50s. According to the data of the Indonesian Statistical Office, the annual average growth rate of net national product between 1958 and 1965 was only 1,7 percent, which lagged behind the 2-2,2 percent population growth rate. Thus, the GDP per capita declined gradually and continuously during the mentioned period, and in 1965 it was lower than it had been in the last year of the Dutch colonial era.

The economic crisis of Indonesia in the mid-1960s took place in the last years of Sukarno's presidency, and was mainly caused by domestic factors, first of all the dominance of political interests over economic considerations. The economic crisis was also followed by a deep political crisis, which caused the fall of the first

⁶ However, the manufacturing was characterized by a significant overcapacity as, according to the estimations, it only utilized 30 percent of production opportunities in the middle of the 60s (Kian Wie, 2012).

Indonesian president: in March 1966, General Suharto took the power from him with a military coup, and on 12 March 1966, he also took the presidency (Kian Wie, 2012).

3. The economic development of Indonesia during the period of the “New Order” (1966-1998)

General Suharto⁷ inherited a nearly bankrupt economy from his predecessor. In 1966, the economy of Indonesia was characterized by 600 percent inflation, dramatically reduced foreign exchange reserves, and external debts of more than US\$ 2 billion owed primarily to the Soviet Union and socialist countries. Besides the troubled political affairs, the creation of relative material wealth – higher incomes – seemed to be the only tool for keeping the power (György, 2008). Facing the serious economic problems requiring urgent treatment, Suharto turned to five young economists of the Economic Faculty of the Indonesian University (Widjojo Ali Wardhana, Sadli Subroto and Emil Salim) for economic advice. The literature usually refers to the advisory group as the, “Berkeley Mafia”, because many of them were studying at the Californian Berkeley University, but the “economic technocrats” appellation also spread, as they were led primarily by rational considerations during the planning of the economic policies⁸ (Kian Wie, 2003).

Besides the “technocrats”, responsible for the macroeconomic policies, the group of engineers or “technologists” (managers with engineering, military advisory and economist background), responsible for the industrialization and economic development had a major influence. The technocrats had neoclassical principles and – relying on the theory of comparative advantages – supported the export sectors in addition to the oil production (the labor-intensive sectors, e.g.: agriculture and manufacturing). At the same time, the “engineers” considered the import substitution economic policies to be efficient and represented the reinforcement of state enterprises in the interest of the Chinese predominance of private economy. The “technocrats” led the Ministry of Finance and the National Planning Board (Bappenas), while the “engineers” managed the Ministry of Commerce, the Ministry of Industry and the National Investment

⁷ Haji Mohammad Suharto (1921-2008): the second president of Indonesia, who was in power for almost 31 years, from 12 March 1967 until 21 May 1998.

⁸ Young economists could successfully implement their ideas, because they had a special connection with President Suharto: Suharto unconditionally trusted them, since he had studied economics from them in the Command and General Staff School. Widjojo was the real leader of the group, he was the most determined figure during the elaboration of the economic policy of the New Order (Kian Wie, 2003).

Coordination Committee. The often contradictory economic policy of Indonesia, seen in the period of 1966-1998, was the consequence of the fact that two groups, following cross-purposes, were in charge of the two separate areas of economic management. While the decision-making mechanism of the Suharto-era wanted to position the foreign creditors and investors through the technocrats, the internal elite gained power through the engineers (György, 2008).

3.1. The program of stabilization and reconstruction (1966)

After Suharto gained power, he asked for the elaboration of a stabilization program from the group of technocrats. The main aim of the stabilization program was to cut and manage the high inflation. The economic advisory group wanted to reach this objective by a balanced budget policy. They fixed the principle by law, that the government cannot use the tool of printing money in order to finance the deficit (Kian Wie, 2003). In 1973, the government also abolished all restrictions concerning foreign currency transactions, because the open capital account was expected to make the monetary policy more flexible, considering that the foreign exchange outflow immediately unveils the poor fiscal management (Stern, 2003). A further step of the stabilization in 1966 was to change the compulsory reserve ratio requirement and to freeze soft loans given to state enterprises by the central bank, to increase interest rates, to liberalize the prices of the consumer products, and to abolish the quantitative import restrictions (György, 2008; Woo-Glassburner-Nasution, 1994).

The government of the New Order gave up the inward-looking policies of the previous cabinet and its anti-Western attitude. They rebuilt the good political relations with the Western countries and Japan, which was crucial in terms of the repayment of the huge foreign debt inherited from Sukarno's government. Therefore, they managed to obtain further foreign aids and attract FDI. In December 1966, the new government signed an agreement in Paris with the Western countries and Japan on the rescheduling of debt payment obligations. With the initiation of the Dutch government in 1967, they established an international aid consortium for Indonesia.

The new government gave up the conviction of the Sukarno government, according to which the state was a dominant actor in the economy. In order to support further economic growth and employment, private entrepreneurs were encouraged (both locals and foreigners) to invest in different fields of the economy. In accordance with the changing attitude towards foreign direct investment, in January 1967 a new law came into force that included different incentives and guarantees for foreign investors. This

opening up policy resulted in significant FDI flows into the oil industry, mining and manufacturing, but the law also comprised several restrictions, which were only slowly abolished later. In 1968, a law came into force concerning local investments. As investments were needed for the revival of the economy, the authorities made the legalization of incomes possible for the new local investors, primarily in order to encourage Chinese businessmen with Indonesian citizenship to bring back their harbored home capital during Sukarno's presidency. This "legalization policy" seemed to be efficient in the stimulus of local investments (Kian Wie, 2003).

After the devaluation of the national currency, the government was striving to maintain the actual value of the rupee and introduced an adjustable fixed exchange rate system. This system was aimed at the exchange rate stability together with the preservation of some flexibility. The nominal exchange rate of the rupee was based on its weighted average against the American dollar, the Japanese yen and the German mark.

This exchange rate system granted enough flexibility for the Indonesian management in the beginning, however, in 1973, 1983 and 1986, significant modifications became necessary due to the changes in the world prices of the oil industry. Nevertheless, after the devaluation of 1986, further significant adjustments of the rupee's exchange rate proved to be avoidable (Stern, 2003; Booth, 1998).

While the stabilization program was aimed at preventing hyperinflation, the reconstruction program targeted the rebuilding of the physical infrastructure and production capacities. The government treated the reconstruction of the infrastructure related to food production and distribution as a priority, namely the reparation of roads, bridges and irrigation systems. In this period, the government devoted greater attention not to the manufacturing, but to the agriculture, especially to the subsidization of grain growing (Kian Wie, 2003).

However, the economic policies of the technocrats could not be coherent completely, due to the conviction that the "engineers" are responsible for microeconomic policies. For instance, the technocrats could prevent neither the creation of the import subsidies' system, nor the state luxury investments. Thanks to the economic prosperity, the "engineers" succeeded also in spending the increased budget revenues on raising the state offices' remuneration and on food subsidies (primarily rice petrol and kerosene for poorer classes) (György, 2008).

3.2. The uneven impacts of the oil price explosion in the 70s

Between 1974 and 1981 the Indonesian economy increased with a 7.7 percent high and sustainable annual rate, which was mostly due to the favorable terms of trade development caused by the sudden increase of oil prices. Calculated at nominal value, the price of the Indonesian crude oil increased from US\$ 1.60 per barrel in 1970 to US\$ 35 by 1980. The growing global demand significantly raised the value of Indonesia's net energy export from the US\$ 1 billion in 1973 increased to US\$ 13.3 billion by 1980. Besides, the country also benefited from the higher oil prices through the growing tax revenues paid by foreign oil companies.

The oil boom changed the prospect of Indonesia not only for a short term, but also for a medium term. The monetary restrictions and exchange rate controls that used to impede the room for maneuver of government budgetary policy disappeared. In addition, large sums of foreign development aid arrived in the country in this period. The improving financial circumstances made the launching of several ambitious development programs possible: the physical infrastructure expanded in the remote regions of the archipelago too. Furthermore, the establishment of state-owned heavy industries started and an increasing share of the budgetary receipts were used to promote social development, especially in education, healthcare and programs on family planning. Government spending also increased on sugar- fertilizer- and rice subsidies, further reducing poverty. On the other hand, the increase in the revenues originating from oil had negative effects as well. The oil boom speeded the inflation up, made the maintenance of the budgetary discipline harder and took the wind out of the sails of reform initiatives concerning government taxation, given that 70 percent of the domestic budget revenue originated from the taxes paid by oil companies. The increasing dependency of Indonesia on oil- and gas products raised another concern about the declining export of non-oil products in the same time (Kian Wie, 2012; Booth, 1998).

3.3. Effects of the oil price drop: reforms of the 80s

The sudden plummeting of the oil's world price in 1982 made the vulnerability of Indonesian economy quite clear. The falling oil prices drew attention to the dependency of Indonesian economy on oil revenues. This development was an incentive for the introduction of economic policy reforms, the elimination of restrictive rules on economic activities.

The Indonesian government reacted quickly to the deteriorating external conditions: in the beginning of 1983, a far-reaching adjustment program was introduced, which aimed at the restoration of economic stability. In order to moderate the current account deficit, the government devaluated the rupee in March 1983. The budgetary problems were also expected to be stabilized by the shutdown or postponement of many large-scale public projects (building of strategic industries, government constructions). The reforms of the 80s targeted three areas: the increase of budget revenues; the liberalization of foreign economic relations as well as financial markets; and the promotion of non-oil derivatives export sectors and job creation (Stern, 2003; György, 2008; Kian Wie, 2012).

The fiscal reforms were also aimed at modernizing the tax-system. The government realized that the situation of the budget heavily depends on the tax revenues from oil companies, which meant a significant risk. Thus, in December 1984 a new tax system was elaborated, the aim of which was to increase taxes from non-oil sectors (e.g.: personal income tax, corporate income tax, value-added tax and property tax) and to establish a new tax system that is less dependent on the energy sector. As a response to the budget deficit, the government curbed its spending: it stopped several public constructions, postponed or finally deleted the implementation of many large-scale state projects, and decided on the reduction and cancellation of several aids for poor people (e.g.: agriculture subsidies). The most disputed step of the tax reforms was the elimination of the tax relief provided for foreign investors, however, after the initial decline, the FDI inflows increased and dynamically expanded similarly to other Asian economies that, however, still provided tax reliefs. Despite the deficiencies of the budget reform, the above-mentioned provisions significantly increased the government revenues and led to the diversification of income sources. Probably the most remarkable change was the growing share of the non-oil and gas industry revenues in the percentage of GDP, which were at around 8 percent in 1985-86, and by 1994-95 increased to 12 percent. During the same period, the income tax revenue increased tenfold, exceeding the oil and gas sector revenues (Kian Wie, 2012; Stern, 2003).

The reform in the financial sector started in 1983, when several deregulation measures were introduced in order to improve the bank system's efficiency. The bank system of Indonesia was based on the dominance of state-owned banks, and only those market actors could get loans who had political influence. As a consequence of the reform, the state banks could decide freely on their interest rates, while the restrictions of loan distribution were eliminated and credit ceilings increased. At the end of 1988, the government initiated the deregulation of financial markets. They facilitated the licensing procedure for establishing new private banks and they authorized the

market entrances of foreign banks in the form of joint ventures. These reforms basically changed the growth potential and structure of the banking system. The less strict conditions concerning ownership and the relatively small capital that was necessary for the establishment of banks brought about an increase in the numbers of banks and a significant decline in the market share of state-owned banks. Several new financial services appeared, and the privileges and responsibilities of state-owned financial institutions declined. The deregulation contributed to the growth of national savings, and the larger deposits managed by banks gave further dynamism for investments (Stern, 2003).

The third group of the reform measures targeted the liberalization of the trading system. By the middle of the 80s, Indonesia was following the road of import substitution,⁹ which sought to rule out competitive foreign products either by high tariffs (the value-based import duties spread from zero till 200 percent) or several non-tariff barriers. These measures affected almost 35 percent of the import's total value. At the same time, the export of several products was limited, partly in order to stimulate domestic processing (for example in the case of rattan). This trading system gave no opportunity for the growth of the manufacturing exports, therefore Indonesia remained strongly dependent on revenues coming from the export of oil and gas products.

As the result of a considerable decline of oil revenues between 1982 and 1986, the government was forced to eliminate the highly protectionist, anti-export trading system. The aim of the adopted deregulation measures was to increase the export of non-oil (especially manufacturing) products, stimulate the development of an efficient and competitive private sector and to boost the efficiency of the economy. The reforms included the general decrease of tariffs and the licensing of import activities of export oriented companies¹⁰ that were introduced in May 1986. The latter regulation allowed the producing exporters to import raw materials without tariffs and tax liabilities. Moreover, the government adopted several regulations concerning the facilitation of administrative headquarters' export-, and import activities (Stern, 2003). The efficiency of the trade reforms was supported by the exchange rate policy,

⁹ After the phase of the "easy" import substitution of the mid 70s – during which the aim was to subsidize the already imported consumer goods with local products – at the end of the decade, Indonesia started its second, more ambitious phase of import substitution. However, due to the decrease in the oil revenues in the beginning of the 80s, the government had no other choice than convert to an export promotion industrial strategy (Kian Wie, 2012).

¹⁰ Initially, an export oriented company was the one that exported 85 percent of its production, however, later this proportion was decreased to 65 percent (Stern, 2003).

too, and the 4-5 percent annual devaluation of rupee optimized the export's international price competitiveness.

The other group of deregulation measures was aimed at improving the investment climate. It included the rationalization of the regulatory environment both in the case of domestic and foreign investors in order to promote the activities of the private sector. The revived confidence in the private sector's investments was accompanied by the decrease of budget revenues. The government eliminated the restrictions on foreign investments to stimulate the inflows of more export oriented investments to the country. The deregulation measures proved to be successful, and after 1986, the number of local and foreign enterprises producing for export continuously grew, and the export of manufacturing goods showed a spectacular growth. While the manufacturing export only added up to 4 percent of Indonesia's total export, by 1996, it added more than 50 percent. Since the end of the 80s, the export was pulled by manufacturing, especially the labor-intensive sectors requiring low-skilled workers, such as the textile, clothing and shoe industry that Indonesia had a comparative advantage in. Until the Asian economic crises, the manufacturing export further expanded, though later at a slower pace. The sector then, in a relatively short time became the main engine of economic growth (Kian Wie, 2012).

3.4. The results of the "New Order" economic policy

The stabilization and reconstruction program of the 60s resulted in a remarkable economic growth in Indonesia. The hyperinflation was brought under control partly thanks to the strict fiscal and monetary policy, and partly to the large amount of foreign loans. The inflation rate dropped back from an annual 636 percent in 1966 to 9 percent by 1970 (Woo-Nasution-Glassburner, 1994). After the restoration of economic stability, the country entered the path of rapid economic growth, which could be maintained throughout three decades, until the outbreak of the Asian economic crisis of 1997. The sustainable growth of the gross domestic investments – made possible by the high rate of domestic savings – formed the basis of the sustained economic growth between 1967 and 1997. A crucial factor behind the 4.7 percent annual average GDP per capita growth was the successful family planning program, due to which the population growth rate did not exceed the rate of economic expansion.¹¹

¹¹ The population growth rate of 2.4 percent between 1965 and 1980 dropped to 1.8 percent in the period of 1980-1996, so for the whole period the population growth rate was 2 percent (Kian Wie, 2012).

The rapid economic growth was followed by the constantly decreasing share of the population living in absolute poverty, both in the rural and the urban areas (Table 1). While 40 percent of the population was living below the poverty line in 1976, this rate fell to 11 percent by 1996. Given the population growth, the number of people living below the poverty line decreased from 54.2 million to 22.5 million during the examined period¹² (Kian Wie, 2012).

Table 1

The reduction of absolute poverty in Indonesia (1976-1996)
The percentage of people living below the poverty line compared to the total population (%)

	Urban areas	Rural areas	Total
1976	38.8	40.4	40.1
1978	30.8	33.3	33.3
1980	29.0	28.4	28.6
1981	28.1	26.5	26.9
1984	23.1	21.2	21.6
1987	20.1	16.1	17.4
1990	16.8	14.3	15.1
1993	13.5	13.8	13.7
1996	9.7	12.3	11.3

Source: Statistics Indonesia (BPS, Badan Pusat Statistik)
www.bps.go.id

The significant reduction of poverty at the end of the 70s and the beginning of the 80s was partly the result of the successful stabilization of food prices (especially that of rice). In this period, the government treated rural development as a priority, which also contributed to the success of poverty reduction policies. The spread of new production technologies led to the continuous growth of crop production (especially rice production) and resulted in new employment opportunities. The two oil-booms of the 70s (1973-1974 and 1978-1979) also had an effect on the changes in the number of

¹² Despite the impressive statistics concerning the reduction in the number of poor people, several analysts think that the data do not mirror reality and the sustained economic growth barely did anything to improve the situation of the poor. However, several other index numbers (the increase in life expectancy at birth, the reduction in infant mortality, the increased access to health services and to healthy drinking water, the decrease in the rate of illiteracy, the increase in enrollment rates, etc.) support the process of social development. An explanation for this contradiction can be that the poverty threshold in Indonesia is admittedly low, lower than the 1 USD/ day poverty threshold of the World Bank. Thus, even besides a significant reduction in the number of people living below the poverty line, many households in Indonesia still have to face extremely difficult circumstances. Despite the methodological shortcomings of the Indonesian poverty estimates, it is still this source that is the best to examine the prevalence of poverty, because the measurements in the long run (from 1970 till today) use consistent definition and estimation techniques (Stern, 2003).

people living below the poverty line. The additional revenues from oil exports made it possible for the government to spend an even larger sum of money on rural development (Kian Wie, 2012; György, 2008).

The number of people living below the poverty line continued to decline even after the drop of oil revenues in 1982, but – especially in the rural areas – at a lower rate. One reason for this is that due to the smaller oil revenues, the government was forced to resort to a strict fiscal and monetary policy in order to maintain economic stability. On the other hand, during that period, the development of capital- and technology-intensive manufacturing gained priority, and the support for agriculture fell considerably. Besides the reduction of poverty, several other indexes indicated (enrollment rates, infant mortality rate, the proportion of the population accessing healthy drinking water) that Indonesia was able to redistribute resources coming from the rapid and sustainable economic growth (primarily from the increase of oil revenues) to promote social development during the Suharto-period.

During the three-decade all three sectors of the economy (agriculture, manufacturing and services) experienced rapid growth. The greatest expansion was produced by the manufacturing sector, while the other two branches expanded in a more modest scale (Table 2).

Table 2

Economic growth in Indonesia in the period of 1965-1996 (Average annual growth rates, %)

	1965-1980	1980-1990	1990-1996
Agriculture	4.3	3.4	2.8
Manufacturing	12.0	12.6	11.1
Services	7.3	7.0	7.4
GDP	7.0	6.1	7.7

Source: Kian Wie 2012, p. 72. (The World Bank, based on the database of World Development Indicators)

Manufacturing underwent a more rapid growth than the rest of the economy, and the economy went through a significant structural change and slowly became a newly industrialized country (NIE) by the beginning of the 90s. The manufacturing industry's contribution to the GDP also reflects this structural transformation, and its share increased from 8 percent of 1965 to 25 percent by 1996, while during the same period, the agriculture's contribution to the GDP decreased from more than 45 percent to 16 percent. Due to the sustainable double-digit growth in manufacturing for three decades, the manufacturing sector of Indonesia became one of the most significant in Southeast Asia. The manufacturing industry's contributions to export revenues also

increased substantially: while in 1965 it only added up to 4 percent of Indonesia's total export, this share increased to 51 percent by 1996. As a result of the considerable restructuring of the export structure, the manufacturing industry became the main source of export revenues in just one decade. This change was due to those deregulation measures the government had introduced after the declining of oil revenues from 1982, in order to modify the highly protectionist trade regime (Kian Wie, 2012).

3.5. The mistakes and problems of the "New Order" period

Despite the considerable results in the field of economic and social developments, the New Order regime of Suharto had several problems and led to growing concerns. One of these problems was the increasing level of corruption. In order to handle this issue a committee for investigation was set up. However, President Suharto was reluctant to support it fully and eliminate the abuses, because he was afraid of losing his political supporters. The corruption became even more widespread by the 80s: the KKN abbreviation (Korupsi, Kolusi, Nepotisme that is corruption, collusion, nepotism) became a synonym of the New Order both in the Indonesian common parlance and in the language of economics. The financial abuses of state enterprises (e.g.: the Pertamina state oil company, the Perhutani state forestry company) became natural, as well as the abuse of power by generals close to Suharto. There were strong interconnections between the political and economic elite. In addition, the restrictions introduced by the regional governments on domestic competition and trade also multiplied (e.g.: requirements for industrial licensing procedures, the illegal taxes on trade within the country). These issues and measures increased the cost of doing business, reduced efficiency and limited the production and economic opportunities for bona fide entrepreneurs, primarily for the small and medium-sized enterprises. Since businessmen with strong political connections (many of whom were Chinese-Indonesian tycoons) got preferential treatment, and profitable activities were provided for them, market initiatives also became distorted. Large conglomerates were established, which – differently than the Korean chaebolos – were not internationally competitive, because most of their production was sold in the protected domestic market. These conglomerates rapidly expanded their interests in several sectors (e.g.: forestry, land resources, manufacturing, banking, real estate market) and were meshing the economy like an octopus. The rapid growth of large conglomerates strengthened the perception of the population that the income gap was increasing between the poor and the rich, and between the Chinese-Indonesian minority and the native (pribumi) majority, which started to undermine the social cohesion necessary for political stability and national development.

As in other East Asian countries, the rapid economic development during the New Order took place in a highly centralized, authoritarian and an increasingly repressive environment in Indonesia as well. The corruption and the utilization of public funds could not be openly criticized because of the lack of political freedom. The student protests to protect democracy and the media outlets reporting on corruption issues were banned claiming that they were threatening the political stability and the government's authority. Although the results regarding the economic and social development of the New Order government were indisputable, the mass violation of human rights, the concentration of political power in one hand and the economic wealth in few hands, led to an increasing public discontent and (e.g.: in Aceh and Papua provinces) therefore separatist movements became stronger. Finally, it was not the anti-regime forces that caused the fall of President Suharto in May 1998, but the Asian financial and economic crisis, which the authoritarian state could not handle. As a consequence of the lax fiscal policy during the 90s and the political and economic crisis, the country that foreign analysts considered to be a model for other developing countries, became a country, whose survival once again depended on international loans and aids (Kian Wie, 2003).

4. The end of the Suharto era: the outbreak of the Asian economic crisis of 1997-1998

Unlike the economic crisis in the mid-1960s, which was caused by internal factors and whose outbreak was predictable as a consequence of the complete neglect of rational economic policies, the Asian economic crisis triggered by external factors was surprisingly not anticipated by international organizations and analysts dealing with the region. The economic growth reached an average annual growth rate of 8 percent due to a strong investment activity during the period of 1989 and 1996, and the most important economic indicators of the country also seemed stable: the budget balance produced a surplus since 1992, while the national debt was reduced as a percentage of GDP, because the government spent the revenues coming from the privatization on the repayment of large sums of foreign debt. Looking back, some indicators can be identified that could have provided an explanation for the protracted crisis. Such was the rapid increase of the private sector's borrowings in the 90s: the great differences between the domestic and the foreign interest rate under the adjustable fixed exchange rate regime made overseas lending attractive to Indonesian enterprises. Consequently, by 1996 more than 40 percent of the debts of Indonesian enterprises were foreign currency denominated and more than the half of it (20 percent of the total debt) was short-term. Although in the second quarter of 1997 Indonesia's foreign exchange reserves

were sufficient to cover three months' import, the sum of short-term foreign debts (US\$ 34.7 billion) made the country vulnerable to external shocks given that foreign exchange reserves amounted only to (US\$ 20.3 billion) (Kian Wie, 2012).

The immediate triggering factor of Indonesia's financial and economic crises of 1997-1998 was the Thailand currency crisis, which spread to more Southeast Asian countries (to Malaysia, to the Philippines). By the end of July, the Indonesian rupee was under an excessive pressure since first the foreign creditors and investors, and then the Indonesian companies, too withdrew their capital from the country. After that no attempts of the Indonesian Central Bank (e.g. raising interest rates or the floating of the rupee's exchange rate) could bring under control the continuous devaluation of the rupee, the government in October 1997 turned to the IMF for financial support. In exchange for the IMF standby credit, the Indonesian government started to implement a comprehensive reform program. The program included strict monetary and fiscal policies, the restructuring of the financial sector and the implementation of structural reforms (cutting government spending, increasing taxes, and maintaining high interest rates). Given this backdrop, the government had reduced, for example, the petrol, kerosene and food price subsidies for the poor. At the same time these measures led to riots (György, 2008).

However, the involvement of the IMF did not stop the rupee devaluation and the ensuing economic crisis. The market confidence did not recover even when the government decided to close sixteen insolvent private banks in accordance with the IMF program in 1997. In fact, this measure only worsened the situation and led to the destabilization of the financial system. The evolving bank-run then was expected to cause the whole banking system's insolvency rapidly. This way the currency crisis was coupled very soon with a serious banking crisis. Finally, the Indonesian Central Bank prevented the collapse of other banks by providing emergency loans. Meanwhile, the rupee devaluation continued (it had dropped to one-seventh of the value before the crisis compared to the dollar), in spite of the fact that President Suharto turned to the IMF again in January 1998. It became increasingly obvious that the recovery from the crisis was prevented by the president's reluctant efforts to implement the reform program suggested by the IMF, because several requirements conflicted with the business interests of his family. While the currency exchange rates stabilized and the stock markets began to recover in the Southeast Asian countries affected by the crisis by March-April 1998, the market confidence in the rupee had not recovered. The government was unable to deal with the crisis in an effective way, which by that time had become a political crisis along with the long lasting economic crisis, and led to the resignation of President Suharto in May 1998 (Kian Wie, 2012).

5. Conclusions

For developing countries, economic growth is one of the most efficient tools to reduce poverty and to improve the quality of life. However, the rapid and sustainable development is insufficient in itself to eradicate poverty (see the example of India). Indonesia went through a period of stable and sustainable economic growth from the middle of the 1960s until 1997 and its benefits – made visible by for instance, the declining poverty rates and other indicators of social development – were successfully spread to several regions, sectors and socially marginalized groups.

The results achieved in the area of economic and social development were primarily due to a talented team, experienced in crisis management, which is referred to as the “Berkeley Mafia” in literature. The other essential component of the success was the considerable financial support to Indonesia provided by international financial institutions (IMF, World Bank, Asian Development Bank) for three decades. Besides the competent economic policy and the support of international organizations, the stable political background and some luck also contributed to the remarkable economic results. The two oil booms of the 70s secured a substantial fiscal revenue surplus for the country with huge reserves (György, 2008; Kian Wie, 2003).

The most significant achievement of the economic technocrats was without doubt the stabilization and reconstruction program in the end of the 60s. The hyperinflation could be controlled and the economic system started to operate again. As a result of the friendly relations between the Western countries and Japan, the rescheduling of foreign debt inherited from the Sukarno-period became possible, and the country could also obtain new loans. With the liberalization of foreign direct investments, the country could attract fresh capital into the country. The favorable economic outcome was also supported by the promotion of family planning which contributed to the slowing down of the population growth. The prestige of the technocrats was further strengthened with the management of Pertamina crisis in 1975, when it turned out that a huge state-owned oil company had accumulated a US\$ 10,5 billion worth foreign debt (out of which 1,5 billion was a short-term debt) (Woo–Nasution–Glassburner, 1994). The third political success of the economic technocrats was the economic adjustment and structural reform program implemented in the first half of the 80s, in response to the worsening trade balance as a result of the steep fall of oil prices between 1982 and 1986. The economic stability was basically achieved by 1985-1986, and several deregulation measures were introduced in the regulation of trade and foreign investments. This contributed to the successful diversification of the unilateral structure of the economy and export.

The stabilization and reconstruction program of the 60s and the wide-ranging reforms of the 80s mitigated the most serious distortions restraining Indonesia's economic growth. At the same time, these measures completely transformed the economic structure. The rapid expansion of the manufacturing industry was the key element in transforming an essentially agribusiness country into a newly industrialized one by the beginning of the 90s. The reforms had completely changed the functioning of the economy, but, on the whole, they were not strong and resilient enough against unexpected and sudden changes such as the devastating impact of the Asian financial crisis (Stern, 2003).

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