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Indonesia: Rapid Growth, Weak Institutions

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Executive Summary

This paper reviews Indonesia's development experience over the last 35 years. It documents the From 1967 to 1997, in the pro-growth environment of Soeharto's New Order, Indonesia's GDP grew by an average of 7 percent per annum. Rapid growth was accompanied by significant gains in the development of human capital and a diversification of the economy away from agriculture, while poverty fell from more than 70 percent in the mid-1960s to 11 percent in 1996.

The "economic miracle" was built on strong macroeconomic policies, support for agriculture, investment in physical and human capital, and increasingly liberal policies in the financial sector, trade, and foreign investment. Economic policies were largely managed by a group of technocrats isolated from the political sphere, who used windows of opportunity to push through reforms and make "good policies in bad times." At the same time, the country's underlying financial, legal, and political institutions did not keep pace with the reforms, or with Indonesia's increasingly complex and open economy. This lack of functioning institutions made the country vulnerable to shocks. Lack of appropriate controls and oversight had weakened the financial sector and increased external vulnerability, while corruption undermined the credibility of economic policies.

When the Asian crisis hit in 1997, the absence of strong institutions made managing the crisis and recovering from it more difficult and more costly for Indonesia than for other crisis-affected countries. The absence of functioning politics prevented consensus-building on measures to fight the crisis, and a weak judiciary could play no role in the restructuring of the economy.

After the crisis, Indonesia again embarked on major reforms, this time of its institutions, including constitutional and electoral reforms, the establishment of an independent central bank and independent judiciary, decentralization, and liberalization of the press and civil society.

Economic policies 1967–97

A select group of economists from the University of Indonesia, later known as the technocrats, was able to determine key features of economic policy in relative isolation from day-to-day politics. Macroeconomic stabilization, the first phase of economic liberalization, proceeded through several steps:

- *Restoration of external viability*: debt rescheduling, adoption of a unified, fully convertible fixed exchange rate
- *Fiscal constraints*: austerity measures, including reduction in government spending, subsidies to state-owned enterprises, elimination of most price controls and subsidies, and adoption of a balanced budget policy
- *Restoration of the banking system*: creation of national central bank, improved access to credit, authorized establishment of foreign bank branches and private domestic banks
- *Liberalization of the investment regime:* incentives and assurances to new foreign investors, return of previously nationalized foreign-owned industrial and trading properties

- *Food security:* achieving self-sufficiency in rice production, price stabilization and other agricultural support programs.

With the growth of oil revenues in 1973 and 1974, the government reverted to a public-sector-dominated economic strategy emphasizing import substitution and the public financing of a limited number of capital-intensive projects. Indonesia's system began to develop into one of "bureaucratic capitalism," in which powerful public figures, especially in the military, gained control of potentially lucrative offices and used them as personal fiefs. Private-sector resources were misallocated, and distortions depressed the overall level of private-sector investment. Small and medium-sized enterprises, with their employment-generating benefits, were neglected and hindered by the lack of availability of financial services (traceable to the imposition of a credit ceiling on commercial banks).

In 1980, government revenues from the oil industry accounted for 70 percent of total revenues. Over the next decade, as oil prices fell, Indonesia faced a rapid decline in government and export revenues, triggering a series of adjustments, including banking and finance sector deregulation, trade reforms, and liberalization of the investment regime to integrate Indonesia into the international financial markets. Adjustment challenges that emerged from the price shocks reflected structural problems that resulted primarily from the government's regulatory framework. The first macro and banking policy reforms were implemented in 1983. The overall effect was to raise interest rates on deposits and loans, and increase freedom for banks to mobilize deposits in support of new lending. The investment-approval process was streamlined, and investment controls relaxed

In 1988, to enhance financial sector efficiency and increase the availability of long-term finance, banks were further deregulated by encouraging competition and promoting the development of a capital market. These changes required new regulatory measures, but serious weaknesses in the system were left unaddressed. By the early 1990s a series of banking scandals demonstrated that regulation and supervision had become problems for the banking system—a problem matched only by that of political interference.

Institutional underpinnings

Soeharto's New Order asserted that a strong state, capable of suppressing antagonisms based on ethnicity, religion, or geography, was a precondition for industrialization. The military became the key instrument for eradicating subversive and "destabilizing" forces within society, and the administration severely limited popular participation in politics. Opposition from other sections of society, including students, was dealt with harshly, leading the government to clamp down on free speech and restrict public meetings and political activity. At the local and provincial level the central government also asserted control over the political process, imposing a uniform model of administration in 1979 on villages throughout the country. Local community representatives were frequently replaced by nonlocal bureaucrats. Community loss of control over land and resources often resulted in decreased self-sufficiency and correspondingly higher dependence on allocations from the central government, counter to the government's stated aim of raising development levels. However, the Village Law did create of a series of units to coordinate development activities at the provincial, district, and village levels, which led to the creation of employment and basic infrastructure (roads and irrigation systems) in rural areas.

The judiciary's decline began well before Soeharto took office, but the New Order led to the breakdown of the core of the judicial system. A system of merit-based personnel management and continuous internal assessment was abandoned outright in the late 1960s. During the oil boom of the 1970s, judges were exposed to political pressures and manipulation. Patronage networks emerged; an institutional atmosphere of deference and sycophancy was established; and the independence of the judicial system was undermined. Systemic underfunding of the judiciary became inextricably linked to corruption. Economic actors bypassed the courts, due to the lack of certain and equitable dispute resolution, and turned to informal institutions such as family and friends or community and religious leaders to solve disputes. The frequency of vigilante and mob justice for alleged thieves, land disputes, and adultery testified to the weaknesses of governing institutions, particularly the weak judiciary and law enforcement.

While modest by standards of other Southeast Asian countries, the civil service expanded rapidly during the 1970s to support the government's heavy investments in education, health, and physical infrastructure. A scarcity of skilled and experienced technicians and managers led to highly centralized decision making, which reduced accountability, retarded the development of public infrastructure, adversely affected rates of return on public sector projects, and constrained the development of local institutions. The complex and opaque system of civil-service salaries, and the significant wage differential between private and public employees with similar education and experience, contributed to underfunding that undermined the quality and integrity of the civil service. Low base salaries contributed to "projectism" (neglect or reformulation of routine activities that do not attract a bonus or allowance), "moonlighting," and corruption.

The 1990s saw a growing perception among Indonesians that deregulation and economic growth were benefiting only a small segment of the population—the segment tied to political elites. Most Indonesians were better off, but they also confronted mounting injustice in their daily lives. As the economy grew, the financial markets became more abundant, and the influence of the technocrats diminished, the magnitude and number of "egregious projects" and "misadventures" increased. Corruption appeared to be at the root of the problems

The crisis and the clean-up

Contagion from the Thai Baht crisis in July 1997 triggered a currency crisis in Indonesia, which rapidly turned into a financial crisis, an economic crisis, and then a political crisis. GDP fell by 14 percent in 1998, poverty doubled to almost 28 percent of the population at the height of the crisis, inflation peaked at 80 percent, and much of the banking system and corporate Indonesia was left in bankruptcy. Soeharto was forced to step down in May 1998, and his successor gave way to the first democratically elected president in 1999.

Now, more than six years after the onset of the crisis, Indonesia's GDP has not yet fully recovered to precrisis levels, GDP per capita remains some 10 percent below the 1997 level, and the government racked up debt equal to some 50 percent of GDP to recapitalize the banking system. Since 1998, the country has continued its difficult transition from a centralized, autocratic regime to a more decentralized democratic system of governance. It is now rebuilding the institutions needed for a market

economy. At the end of 2003, more than six years after the onset of the Asian Crisis, Indonesia was the last of the former crisis countries to graduate from the IMF-supported stabilization program.

By October 1998, a comprehensive solution for the banking system started to emerge, with the Indonesia Bank Restructuring Agency (IBRA) playing a leading role—but weaknesses in IBRA's legal underpinnings of prevented quick implementation. After the enactment of reforms, IBRA emerged as the largest creditor in the country, controlling assets that at one point had a face value equal to 36 percent of GDP. Due diligence revealed extensive abuse of liquidity support as well as numerous offenses against the banking laws, most notably against limits on insider lending and loan concentration. Government, through IBRA, agreed on out-of-court settlements of the claims of the state against former bank owners because the weak legal system made it highly unlikely that the former bank owners could be brought to justice or be forced to redeem some of the losses of the state. Restructuring and asset sales also ran into significant delays and legal and political problems. In 2001 large portfolios of nonperforming debts were auctioned off at any price above a minimum set by the agency. Bidders often seem to have a fine nose for what the minimum price had to be. Corporate debt amounted to about $120 billion by the end of June 2000. Agreements with international creditors and efforts to facilitate debt workouts on a voluntary basis have had some successes but were hampered by numerous legal and financial factors.

The crisis cost the State some 40 percent of GDP for bailing out the banking system—probably the most expensive financial crisis ever recorded. The weak legal system protracted the clean-up after the crisis, aggravated the losses to the state because of lack of a legal threat to bad debtors, and delayed the economic recovery substantially. It also greatly damaged the sense of justice among Indonesians, who saw most of those who had ravaged the financial system, and most of the corruptors of the New Order era, left unpunished.

Lessons for Shanghai

In terms of the Shanghai framework, Indonesia's development experience offers many lessons. The country's commitment to macroeconomic stability was embedded in a balanced budget, open capital account, competitive exchange-rate system, and liberalization of investment laws.

Institutional innovation included:

- Depending on economically well-versed technocrats to take over in bad times, providing investors the confidence that sound policies would prevail, despite regular set-backs in trade and investment policies
- Packaging small reform together in a major policy move with clear political benefits and strong signaling effects
- Using pragmatic approaches (rather than ideological policy stances) to address pressing issues such as food security or fuel subsidies
- Adapting existing institutions into appropriate policy tools, including the world-class microfinance institution, BRI, which evolved out of an unsustainable agricultural subsidy scheme, and the Kecamatan Development Program, which evolved from an earmarked grant to villages.

Indonesia also benefited from the roles played in times of crisis by the international community—including donors, the Paris Club, GATT, IGGI, and Harvard University.

A different lesson from the Indonesia experience is that institutions and policies sometimes have an expiration date:

- Without rule of law, an increasingly complex economy is hard to manage.
- Without an independent supervisor, the financial sector needed for a modern economy can become an accident waiting to happen.
- Without popular participation in political decision-making, the increasingly difficult choices a government must make may lack the legitimacy needed to make these decisions effective.
- And without a clean, efficient civil service, implementation of those policies and their effects may diverge strongly from what policymakers intended.

Strong institutions are most needed when they matter most—in times of crises. If there is one final lesson that the Indonesian experience offers it is that a country cannot start early enough with the building and nurturing of strong institutions.

> "The tragedy of…the New Order is that political and institutional developments were not tackled while there was the opportunity and resources to do so."
>
> —Howard Dick (2002:214)

1. Introduction

Soeharto's *New Order* government produced a remarkable 3 decades of rapid growth. From 1967 to 1997, Indonesia GDP grew by an average of 7 percent per annum. As a result, in 1995 Indonesia's per capita income hit $1,100, over 4 times the 1967 level (Booth, 2002), and poverty declined from over 60 percent of the population in 1965 to 11 percent in 1996.[1] This success was built on a pragmatic approach to economic policies, with good macroeconomic policies, heavy investment in infrastructure and education and health, support for agriculture, and increasingly liberal industrial and financial policies. Indonesia's remarkable economic success was reason enough for the World Bank (1993) to include the country in the group of the High Performing Asian Economies (HPAEs). Although some pointed to the weak financial sector, lack of rule of law, and rising corruption as factors that could undermine the country's success, it was, as one observer remarked, "hard to argue with 7 percent growth."[2]

The widespread praise for Indonesia's economic success made the shock of the economic crisis all the larger. Contagion from the Thai Baht crisis in July 1997 triggered a currency crisis, which rapidly turned into a financial crisis, an economic crisis, and then a political crisis. GDP fell with 14 percent in 1998, poverty doubled to almost 28 percent of the population at the height of the crisis, inflation peaked at 80 percent, and much of the banking system and corporate Indonesia was left in bankruptcy. Soeharto was forced to step down in May 1998, and his successor gave way to the first democratically elected president in 1999. Now, almost 7 years after the onset of the crisis, Indonesia's GDP has only just recovered to pre-crisis levels, GDP per capita (Atlas method) remains some 30 percent below the 1997 level, and the Government incurred some 50 percent of GDP in debt to recapitalize the banking system. Since 1998, the country is going through a difficult transition from a centralized, autocratic regime to a more decentralized democratic system of governance, and is only slowly rebuilding the institutions needed for a market economy. At the end of 2003, more than six years after the onset of the Asian Crisis, Indonesia was the last of the former crisis countries to graduate from the IMF supported stabilization program.

Since the 1997 Asian Economic Crisis, political scientists and economists have commented on Indonesia lack of institutions – economic, political, and legal – that contributed to the collapse of Indonesia's miracle growth and underlies its haphazard recovery. A common refrain is that the economic crisis revealed weaknesses in the nation's institutions that had been disguised by, or ignored in light of, rapid rates of growth. Recent studies indeed suggest that

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[1] According to BPS Methodology. The World Bank uses a slightly different methodology, which results in a somewhat higher poverty headcount.

[2] Personal communication of a World Bank economist working in Indonesia.

institutions dominate everything else in explaining growth in cross-country panel data.[3] (Rodrik, Subramanian and Trebbi 2002; and Alcala and Ciccine 2002). At the same time, Indonesia does not seem to fit this pattern: indeed growth before the crisis was extremely high, despite the weakness of the country's institutions. The country's development history seems to fit better Rodrik's (1999) explanation that countries with strong institutions (and homogeneous population and relatively equal income distribution) manage crisis better that those without it. How countries manage crisis, according to Rodrick, determines their long-term growth performance. Thus, countries with weak institutions can grow rapidly for quite some time, but their incapability of managing a serious crisis can set them back such that their long-term growth record is poorer than of countries with strong institutions.

This is unlikely to be the full story as far as Indonesia is concerned. Indeed, before the 1997 crisis, the country had managed several crises very well, even with weak institutions—or some would say because of weak institutions. The economic crisis of the mid-1960s, the 1975 Pertamina crisis, and the economic crises in the early 1980s after the oil price collapse were managed in an exemplary manner, with the implementation of swift measures to restore macroeconomic balance and structural reforms to rekindle growth. The absence of organized political opposition, concentration of powers in the hands of the president, a weak civil service unable to defend its vested interest, and a business community closely aligned with political powers all enabled swift implementation of good policies. The absence of an ideological debate and the dire economic conditions after Soekarno left office in 1966 may also have contributed to the pragmatic approach to the economic policies implemented in the Soeharto era.[4]

What had changed by the 1990s were the complexity of the economy, the external environment, and the nature of the Soeharto regime. The reforms of the 1980 had made Indonesia a much more diversified, private sector led economy with a rapidly developing financial sector in need of a stronger legal system and strong supervisory institutions—and both were lacking. The surge in international capital flows had, in hindsight, made two cornerstones of macroeconomic policy less appropriate: the managed exchange rate combined with an extremely open capital account gave firms strong incentives to borrow abroad, and left the currency vulnerable to speculative attacks. But perhaps most importantly was the change in the nature of the regime, which had become increasingly prone to corruption, thereby undermining the legitimacy of the regime, and in turn the credibility of its policies, a feature of paramount importance in the "modern" capital account crisis of the 1990s. Indeed, the issue of governance colored the perception of how Indonesia would *manage* the crisis, and the lack of confidence appears to have been the main reason why Indonesia was hit harder than other countries affected by the Asian crisis (World Bank 1998:1.10 and 1.11).

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[3] The growth literature attributes economic development to three factors, broadly speaking: geography (natural resources and endowments), integration (trade and openness); and institutions (rules, norms and social capital).

[4] We are grateful to Sir Tim Lancaster for this thought expressed in a speech in Jakarta comparing Indonesia's and India's development paths.

After the crisis, and after a change in the political regime, Indonesia is rapidly rebuilding the institutions it was lacking in the run-up to and during the crisis. Since 1998, three constitutional changes have taken place, a radical decentralization program has been implemented, an independent central bank and judiciary have been established, and anti-corruption commission has been created, and a free press and a vibrant civil society and free press have emerged. While many of the newly-created institutions are still struggling, one could claim that Indonesia continues to use times of crisis as opportunities of reforms.

Dollar and Kraay (2002) argue that the recent growth studies based on "cross-country variation in institutions, trade and their geographical determinants is not very informative about the partial effects of these variables on long-run growth." However, they argue, combing this approach with more microeconomic evidence, case studies, and descriptions of historical episodes constitutes a fruitful research agenda (2002:20). This paper aims to be just that—a case study in the evolving literature on growth and the primacy of institutions. The contribution of this paper to the Shanghai conference is to detail significant episodes in Indonesia's economic policy making, and to track the development of Indonesia's key institutions, including the banking and finance system, the judiciary, the civil service, and the political system. The paper details the policies that led to the countries' remarkable growth record, and document the evolution of institutional weaknesses in the New Order years and the corruption that increasingly undermined the legitimacy of the regime, and that in the end undermined its success.

The weak institutions that, as this paper argues, aggravated the crisis, can hardly be solely ascribed to the New Order period. Indeed, those weaknesses sometimes date back to colonial times, and even pre-colonial time. Before Soeharto, Soekarno had already started to undermine the political institutions and the judiciary at a time when these only just emerged from the colonial regime, which allowed no political activity, and left large parts of justice administration to traditional leaders rather than courts. And corruption in the Dutch civil service and the indigenous civil service had been a permanent fixture during the colonial administration, and indeed is blamed by many to have caused the once-ruling Dutch East India Company to collapse at the end of the 19th century.[5] Increasingly, these long roots of institutions—including population density in colonies and land distribution at early statehood—are recognized as being important, if not decisive (See Hoff, 2003:205ff. for a recent survey). This paper hardly does justice to this strand of the literature, and is by and large limited to the Soeharto years. Temple (2001) has explored similar themes in his paper on Indonesia, but by and large restricts himself to the pre-crisis years.[6]

The paper will proceed as follows: Section 2 summarizes Indonesia's record of growth and poverty reduction in the period 1967-1997. Section 3 reviews Indonesia's economic policy record over the same period. Section 4 documents the development of key institutions, including

[5] See for instance: J.J.P. De Jong (1999) on the Dutch East India Company, L. De Jong (1984) on the Public Administration and indigenous rulers during colonial times. Ong Hok Ham for an Indonesian perspective on power relations in pre-colonial and colonial times.
[6] The authors are grateful to Tamar Manuelyan for pointing out this paper in her comments on the first draft of this paper.

the political process, civil service, judiciary, and civil society, and describes the rising corruption during the Soeharto regime. Sections 5 and 6 describe how the lack of institutions aggravated the 1997 economic crisis, and hampered the recovery from the crisis. The final section summarizes Indonesia's experience within the analytical framework of the Shanghai conference.

2. Indonesia's growth miracle

Soeharto's *New Order* government, which took over from Soekarno in 1966 after the abortive September 30th 1965 coup, inherited an economy in crisis. Soekarno's *Guided Democracy and Guided Economy* had focused on the political development of the country, had nationalized the extensive remaining Dutch economic interests in 1958, and had spent an unsustainable amount of government resources on the conflict with the Dutch over Irian Jaya and the military confrontation with Malaysia. As a result, chronic budget deficits financed by the central bank had driven inflation up to over 600 percent by the mid-1960s, black market premium on the Rupiah had skyrocketed to 800 percent, the country had defaulted on its international debt, and growth had come to a halt.

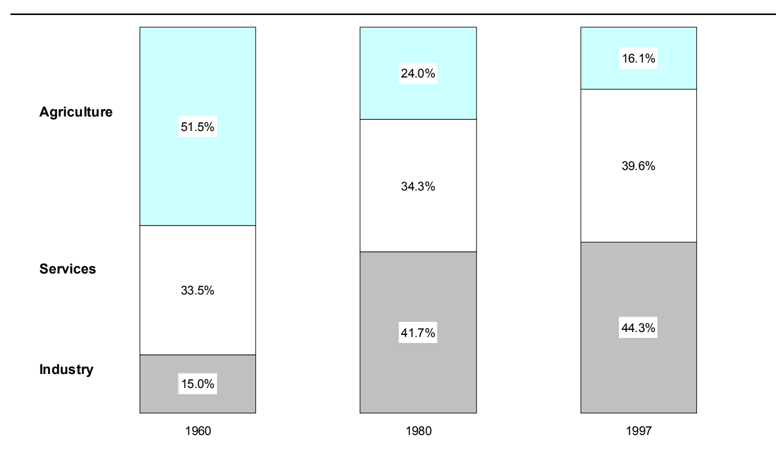
Table 2.1. Indonesia Growth Accounting

	1961-2000	1961-1970	1971-1980	1981-1990	1990-1997
GDP growth	**5.5**	**4.0**	**7.6**	**6.2**	**7.4**
Capital Stock	1.2	-1.9	2.0	2.7	2.9
Labor force	1.8	1.4	1.9	2.0	1.9
Years of Schooling	0.6	0.9	0.6	0.2	0.6
TFP	**1.9**	**3.6**	**3.2**	**1.2**	**2.0**

Source: staff estimates based on Summers and Heston GDP Data, and Barro.

From these ruins of the *Old Order*, Soeharto's reign built an Indonesia that grew on average with 7 percent per year over the next 30 years. The level as well as the quality of Indonesia's growth was impressive. A considerable part of growth can be explained by increases in productivity (Table 2.1.),[7] as the country moved from a predominantly agricultural production base to a more industrialized base. The wealth of the oil boom was in part invested in a vast expansion of the education and

Figure 2.1. Structural Change



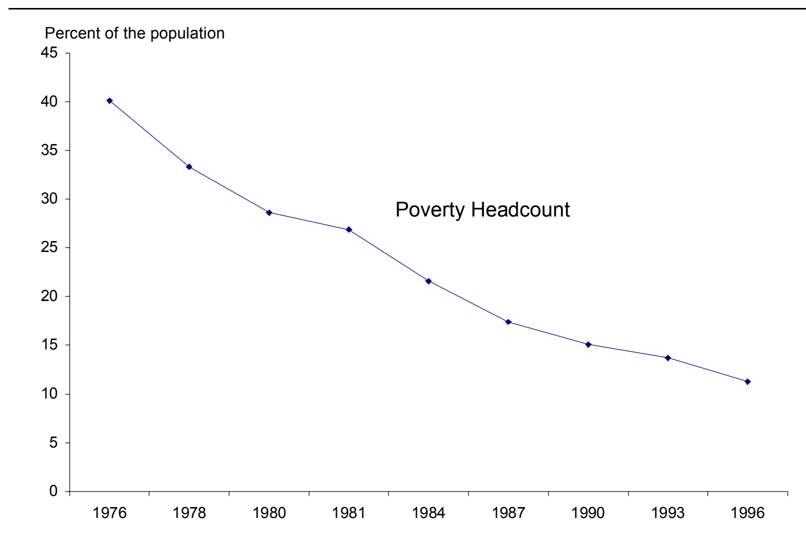
Source: BPS.

[7] There are numerous studies on the contribution of productivity to growth in Indonesia, with different approaches yielding widely different results. See Stiglitz and Yusuf (2001), for an overview.

health system during the 1970s and 1980s, and the resulting increase in years of schooling in the labor force contributed to growth as well. The decade before the crisis saw accelerated growth, but also increasingly capital intensive growth caused by considerable investments in capital intensive industry, fed by credit from a liberalized banking sector, and increasingly by private sector borrowing from abroad.

The structure of the economy experienced rapid change (Figure 2.1.). Although agriculture, services and manufacturing all showed steady growth, that of manufacturing far outpaced the others. As a result, the share of agriculture declined from an estimated 51 percent in 1960 to 17 percent by 1997, whereas the share of industry rose from 28 percent to 42 percent over the same time frame.

Figure 2.2. Poverty Headcount, 1976-1996



Growth benefited a broad range of the population. Per capita income grew from $817 to $3346 in PPP dollars from 1965 to 1995 – an annual average growth rate of 4.4 percent. Poverty, which had affected the majority of the population in the mid-1960, fell to 11 percent by 1996 (Figure 2.2.), and a wide range of human development indicators saw impressive progress. The income of the bottom 20 percent income earners by and large grew at the same pace as overall income (Timmer. 2004) making Indonesia's growth highly pro-poor. Even during the high growth years the Indonesia's (expenditure) Gini Index rose only slightly from 0.32 in 1987 to 0.36 in 1996[8] indicating that by international standards, Indonesia's income distribution was and remained moderately equal.[9] In the mid-1990s Indonesia's per capita income level reached $1,100 and in 1995 the number of inhabitants living on $1 a day had declined to 21.9 million from 87.2 million in 1970. In 1996 15.7 percent of the population fell below the poverty line, down from an estimated 40.4 percent in 1976 and a probable over 70 percent in the mid-1960s (Booth, 1998:128).

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[8] This increase in the national Gini Index reflects the rise in inequity in urban areas. Rural areas remained almost constant with the index moving only from .26 to .27. In the wake of the 1997 crisis, the Gini index moved relatively little, so some work has been undertaken recently to access the possibility of measurement errors.

[9] Source: Biro Pusat Statistik. There is significant doubt about the income distribution numbers, however.

Table 2.2. Indonesia Social Indicators

	1970	1980	1990	2000
Adult literacy	57	70	80	87
Primary School enrollment	80	107	112	110
Secondary school enrollment	16.1	29.1	44.0	57
Life expectancy	47.9	54.8	61.7	66
Infant mortality (per 000 births)	118.0	90.0	60.0	40.9
Population growth rate	2.1	2.0	1.8	1.4

Source: World Development Indicators.

Indonesia's social development was almost as impressive as the country's growth record (Table 2.2.). Booming oil revenues in the 1970s financed large increase in government expenditures on new health and education systems that realized precipitous gains in infant mortality and primary school enrollment levels. A successful birth control program without the coercive elements that discredited similar programs in other countries realized precipitous reductions in the population growth rate. While some social indicators, notably maternal mortality were lagging, and increasingly the quality of education became an issue in the 1990s (World Bank 2003) these indicators are nevertheless impressive.

3. Economic Policies, 1967-1997

A. Overview

Indonesia's success was built on a combination of policies that set the macroeconomic and structural conditions for rapid growth, while linking the poor rural population with that rapid growth by investment in infrastructure, agriculture, and education and health (Timmer 2004). Indonesia's economic policies in the three decades of the Soeharto government can perhaps best be summarized in Hall Hills' line as "Good Policies in Bad Times." The Government maintained its focus on macroeconomic stability throughout, and it built some strong institutions to do so. In times of macroeconomic difficulties, the microeconomic policies pursued were by and large aimed at liberalization—which was duly rewarded with renewed growth. But microeconomic policies deteriorated in times of relative macroeconomic stability, and by the 1990s increasingly fell victim to the crony capitalism of the first family and their affiliates. This section documents these policies, distinguishing macroeconomic, agricultural, industrial, and financial sector policies, and broadly distinguishing between the periods identified in Figure 3.1. (See the annex table for a detailed listing of Indonesia's economic history and policy measures from 1966-2000).

The policies that created the New Order economic miracle were in large parts designed by a select group of economists from the University of Indonesia that became known as the "technocrats."[10] Throughout the New Order, with ebbs and floods, this group of people, and their affiliates, were able to determine key features of economic policy in relative isolation from the

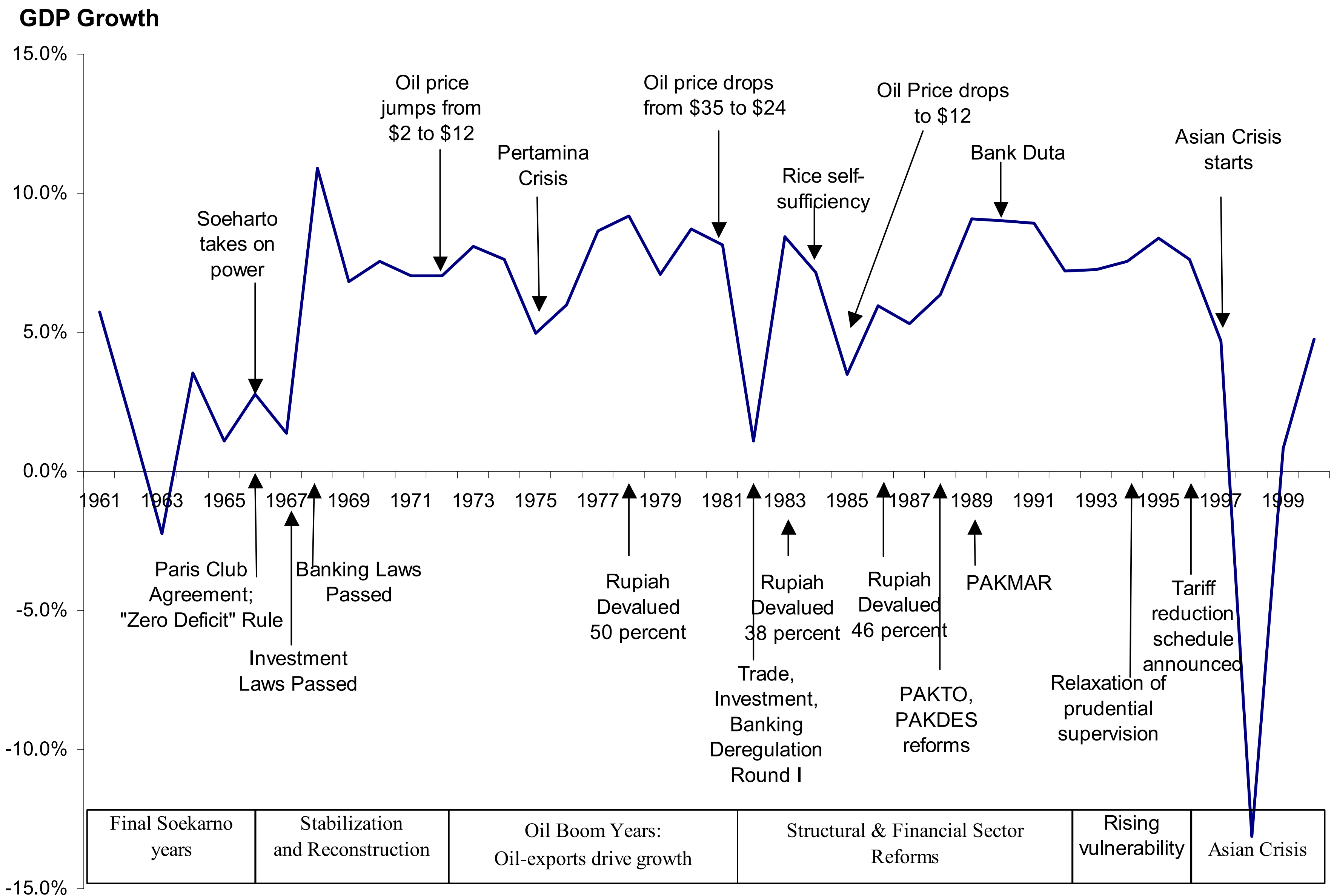
[10] See Thee Kian Wie (ed.) 2003, *Recollections: The Indonesian Economy 1950s-1990s*, Institute of South East Asian Studies, Singapore, for a collection of interviews with some of the key technocrats.

day-to-day politics. They owed their reputation from the first years of the Soeharto presidency, as their "3 October" 1966 plan rapidly stabilized the economy, and delivered growth.[11] As the *East Asia Miracle* (p.170) recounts "each [of the HPAEs] boasts at least a small ideologically consistent technocratic core that answers directly to the top leaders and therefore has some independence from the legislature and other sources of political pressures." A key vehicle for the technocrats was the strong planning agency, Badan Perencanaan Nasional, or *Bappenas*. Key tools, the 25 year plan, the five year plan and the annual budget—legitimized by the *GBHM* or "Broad Guidelines on Government Policies" issued by the MPR, the highest constitutional body—provided a strong framework for development planning and finance. And through a *Monetary Board* fiscal, monetary, and external borrowing policies were coordinated, and targeted at development. All these institutions were dominated by the technocrats for most of Soeharto's reign..

The influence of the technocrats was, however, repeatedly undermined by others, including the "technologists" who saw aggressive industrial policy based on increasingly high tech projects as the best way to develop Indonesia, army generals who provided the political backbone of the Soeharto regime and who were long accustomed to arbitrary rent-seeking behavior in their business dealings' (Elson P.151) and the "cronies" who increasingly used the state for personal gains.[12] It is probably fair to say that "In times of economic distress …[the technocrats] have enjoyed a broad mandate to determine policies. At other times, their influence has been more restricted" (Schwarz, 1994:52), but the technocrats did hold influential economic policy posts since the early days of the New Order—and some are still economic advisors to the current president, Megawati Soekarnoputri.

[11] Soeharto was acquainted with them because of the courses in economics they had delivered at the army training school in the late Soekarno period (Mohammad Sadli in Thee, 2003: 126).
[12] For further characterization of these groups see Schwarz, 1994.

Figure 3.1. Indonesia Economic History, 1961-2000



Source: Authors' compilation from various sources, BPS.

B. Macroeconomic Policies

In 1966, the first order of business for the incoming Soeharto Government[13] was to stabilize the economy. A plan for macroeconomic stabilization was developed, and the comprehensive changes in economic policy marked the beginning of a first phase of economic liberalization and entailed the restoration of external viability, fiscal constraints, restoration of the banking system, and liberalization of the investment regime. During the stabilization period, several core institutions of economic management were to be established that lasted throughout the New Order, including an open capital account, a competitive exchange rate, and a balanced budget rule.

External Policies. The Paris Club Debt Settlement in 1966 gave temporary relief from payments over Indonesia's $3.1 billion external debt (more than half of it owned to the Eastern Block), whereas the 1969 30 year rescheduling of the Soekarno era debt, brokered by the Intergovernmental Group in Indonesia (IGGI), restored Indonesia's external viability. Over the course of four years, Indonesia moved to a unified, fully convertible fixed exchange rate, with only limited capital controls—a first on the developing world (Prawiro 1998, Slade and Cole 1996, World Bank 1968). This exchange rate arrangement did not only assure foreign investors that they would be able to repatriate their earnings, but also became a disciplining device on the government's macroeconomic policies. Abolishment of exchange controls also gave a strong boost to exports, which showed growth of about 10 percent per year during the stabilization years 1966-1970. At the same time, it sharply curbed the incentive for smuggling, and revenues from trade taxes surged from Rp. 0.4 billion or six percent in revenues in 1965 to Rp. 13 billion or over 40 percent of revenues in 1967 (Woo et.al. 1994:49).

Fiscal Restraint. On the fiscal front, the new government undertook a series of austerity measures to reign in government spending, a policy agenda, which stood in stark, contrast to that of Soekarno. These measures included the cancellation of subsidies to the regions and state-owned enterprises, rescheduling or canceling of all "non-essential" projects, and a reduction in personnel costs in the civil and military services – at the time the government was the largest employer outside the agricultural sector. The policies eliminated most price controls and subsidies, except for petroleum products, electric power, urban transport and drinking water. A key institution of fiscal restraint was the Balanced Budget rule. This was announced in December 1966 with the statement that the Government's expenditures would be limited by the State's revenues, so that the deficit could be eliminated "as much as possible" (Prawiro 1998:17 and 23-34). This rule effectively limited deficits to those that could be financed by foreign borrowing from the IGGI donors. Donor financing was substantial: it accounted for over 30 percent of government expenditures in 1967, after which it gradually declined, but was still 24 percent of expenditures in 1970 (Woo et.al. 1994:47). Donor financing was accounted for as "development

[13] Soeharto became de-facto President in March 1966 (by means of the "Supersemar" document in which Soekarno, still President, handed all day-to-day responsibilities to Soeharto. One year later, Soeharto was appointed Acting President by the MSPR, the consultative assembly and highest constitutional body of the country. In March 1968, Soeharto was sworn in as full President.

revenues" in the budget. Throughout the Soeharto years the government was careful to demonstrate compliance with the balanced budget rule. However, over the years the practice of off-budget spending became increasingly prominent as a means of covertly circumventing the constraints of a balanced budget without tripping alarms (Nasution 1995:4-5 MacIntyre 2000:159).

With macro-stabilization measures Indonesia achieved an almost unparalleled reduction in inflation coupled with growth. Inflation fell to 113 percent in 1967, 85 percent in 1968 and 10 percent in 1969. Simultaneously, output began to recover with GNP realizing 9 percent annual growth rate between 1968 and 1973. The reduction was considered so remarkable that a World Bank report commented ten years later, "the Indonesian stabilization-with-growth is still viewed as a model of effective policy making in a hyper-inflation situation" (1979:1.19). While "orthodox" elements such as a balanced budget and trade deregulation played an important role, the package as a whole was not a standard liberalization policy. In fact, with the dismantling of the exchange rate restrictions and abolishment of import licensing the trend to lower tariffs came to a halt, and was in fact partially reversed (Woo et al, 1994: 49). Moreover, the support for agriculture was achieved by directed credits and market intervention. These measures, however, probably made the package as a whole politically more acceptable, while also ensuring an early output response to the stabilization measures.

Managing the oil boom. During the 1970's Indonesia experienced rapid growth of income, consumption and investment financed by a windfall of revenues from oil-exports. Between 1971 and 1973 Indonesia's oil production increased by almost 50 percent (World Bank 1979:1.14) with the oil boom years taking off in 1973 when OPEC[14] initiated the Oil Embargo. The embargo effectively quadrupled oil prices, increasing prices to the United States and Western European allies by 70 percent.[15] Indonesia's net oil revenues jumped from $0.4 billion in 1973 to $2.6 billion in 1975 – at which point the net oil revenues surpassed the total value of all non-oil exports.[16] In 1978 oil prices jumped for a second time in response to the turmoil in Iran that resulted in the Revolution in early 1979. Indonesia's net oil revenues for the year 1978 equaled $4.4 billion. The windfall in oil revenues generated current account surpluses and increased budgetary revenues. Between the years 1973 and 1977 government consumption and private consumption grew at rates of 9.8 percent and 7 percent respectively, allowing large investments in infrastructure, education and health, but also in industrial activity and subsidized credits that later turned out to be ineffective, and in the end unsustainable.[17]

The inflow of foreign exchange revenues fed inflationary pressures in the economy, and CPI inflation averaged 24 percent between 1973 and 1977. Fearing the return of unfettered inflation, the central bank imposed credit ceilings on commercial banks in April 1974 in an attempt to control the growth of credit and the money supply. Other options for controlling

[14] Indonesia became a member of OPEC in 1962.
[15] (Malby 2003, Trumbore 2000).
[16] Annex, Table 3.1, "Balance of Payments 1971/72 – 1977/78," Source: Bank Indonesia in World Bank Report 2093-IND, 1979, p. 176.
[17] Annex Table 2.7, "Average Growth Rates 1068-1977," World Bank Report 2093-IND, 1979, p. 174.

inflation, including raising bank reserve requirements to higher levels or permitting an appreciation of the exchange rate were considered but ultimately rejected. Additionally interest rates on deposits and loans were set below the inflation rate, which had the effect of suppressing bank deposits relative to GDP. While Indonesia continued to have ample sources of financing on the whole, the negative real interest rates and a repression of domestic banking instruments meant that large sections of the economy were underserved by formal institutions (Slade and Cole 1996:19).

Avoiding the Dutch Disease. Unlike many other oil exporters, Indonesia largely succeeded in preventing its agriculture and manufacturing sectors from lagging behind the rest of the economy, thus avoiding a Dutch Disease. The investments in infrastructure and agriculture played a key role in this, as did a dramatic exchange rate depreciation at the end of the decade. In a surprise move, Government devalued the Rupiah by 50 percent in November 1978. The government undertook the devaluation to restore the country's international competitiveness, which had been undermined by the inflow of oil revenues, and the ensuing inflation, and which had regained importance in light of the need to build down excessive debt in the aftermath of the Pertamina crisis. The devaluation was undertaken from a position of strength, with healthy reserves and annual inflation of 3 percent, and was supportive of structural changes to reduce dependence on oil as an end to the oil boom years loomed. Another devaluation would take place in 1983 to promote exports, before the exchange rate regime was converted in 1986 to a crawling peg, tied to the US dollar. In part, this depreciation was a reaction to the *Pertamina* crisis (Box 3.1.), which necessitated larger current account surpluses to maintain external debt sustainability. In part, however, it reflected the profound insights of the technocrats who realized that oil revenues alone were no basis for long-term development.

Oil Bust and Adjustment measures. The 1980s are marked by Indonesia's efforts to adjust to a rapid decline in oil revenues. In 1980, government revenues from the oil industry accounted for 70 percent of total revenues[18]. In 1981 oil prices began to decline and severely constricted GOI's budgetary revenues. From a 1982 peak of $34.3 per barrel oil price fell to $25 by 1986 and bottomed out at $12.6 in 1988[19] (World Bank 1989:1,2). Unlike large oil countries such as Nigeria and Mexico, which were unable to adjust in a timely manner to lower oil prices, Indonesia turned the threat into an opportunity for growth. The adjustment would be accompanied by a series of banking and finance sector deregulations, trade reforms, and liberalization of the investment regime that would set the stage for Indonesia's integration into the international financial markets.

Macroeconomic balance was restored by a combination of fiscal and eternal policies. To maintain fiscal balance the cut back on public expenditures for large projects, and introduced a major tax reform, including the introduction of a value added tax (VAT) and a global income tax with simplified rate structure and full self assessment in September 1983. Together with a reform in the property tax collection this greatly increased non-oil tax revenues. The exchange rate played again a key role in the adjustment policies. To effectuate the needed real exchange rate

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[18] Prawiro 1998:104.
[19] Real price is in 1981 US$.

depreciation in the aftermath of the terms of trade deterioration, the Government twice implemented a large depreciation The first was a 38.5 percent depreciation in March 1983, and the second a 45 percent depreciation in September 1986. Possible inflationary impact of the first depreciation was limited because of the fiscal retrenchment measures implemented at the dame time. The impact of the second depreciation was limited because of a policy that became known as the "*Sumarlin Shock*" after the then-finance minister. This policy arranged for a sharp monetary tightening by shifting the deposits of state enterprises to the central bank, and at the same time requiring banks to buy back their money market notes (so-called SPBUs) from the central bank.

Box 3.1. The Pertamina Crisis

The 1975 Pertamina crisis marked the first massive bailout of a state-run enterprise by the new Bank Indonesia. Between 1973 and 1975, the national oil company, run by General Ibnu Sutowo,[1] took out a vast array of new projects, incurring international debt obligations of $10 billion, largely in short term debt so as to avoid the restrictions imposed on public sector firms in long term borrowing from abroad. As international money markets tightened, Pertamina met with serious liquidity problems. It began to withhold legally obligatory payments to the government, and failed to meet payments on short-term loans owed to both domestic and foreign creditors. Prospects of future default posed serious threats to the budgetary position and external credit standing of the government. In March 1975, the Government decided to step in and Bank Indonesia was forced to take over payments on many of Pertamina's foreign debts. After the crisis, the government required that in the future all state enterprises would refrain from independent borrowing abroad and Bank Indonesia and the Ministry of Finance were made responsible for raising funds from international lenders on their behalf. (World Bank 1979:1.17).

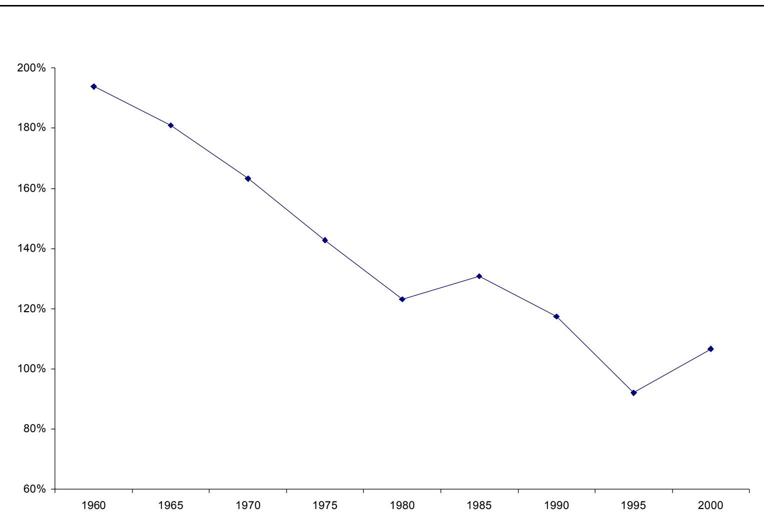
The regular, radical depreciations that Indonesia used as a tool to adjust absorption and restore competitiveness are remarkable. Unlike other countries that held off such measures until considerable loss of foreign reserves had occurred, Indonesia used this tool in a timely manner, and as we saw, even preventively. Woo et. al. 1994 points out the importance of the exchange rate played in Indonesia's macroeconomic policy mix, and explains the lack of opposition against these moves with the relatively large share of tradable goods in the economy. Indeed, although declining rapidly over the course of the Soeharto era, the tradable goods sector dominated the economy until the 1990s (Figure 3.2.), making a depreciation—which is beneficial for tradable goods producers, a rather popular policy. Because of the regional distribution of tradable goods producers, notably farmers and natural resource producers, the depreciations also helped in maintaining regional balance between Java and the outer islands, and between urban and rural economies.

C. Agricultural Policies

When in 1968 *Repelita I* (The First Five-Year Development Plan) for 1969/70 – 1973/74 was being prepared, the technocrats, with the full support of President Soeharto, decided to give first priority to agricultural development. In practice, however, agricultural policy was focused on one over-riding goal, namely the achievement of self-sufficiency in rice, as the government from the outset realized the great importance of adequate rice supplies. Hence, food policy during this period was rice policy. However, in Repelita III (1979/80 – 83/84) the rice self-sufficiency objective was, at least formally, replaced by a broader policy, which emphasized all aspects of food self-sufficiency (Prawiro, 1998: 127; Mears & Moeljono, 1981: 23, 29).

Rice is the staple for most Indonesians, except in a few sparsely populated provinces in Eastern Indonesia, and in the late 1960s had a weight of 31 percent in the Jakarta 62-commodity Consumer Price Index (CPI). For this reason the price and availability of rice was very important to maintain price stability as well as political stability, particularly at a time when the New Order government's hold on power was still fragile (Hill, 1996: 123, 128), and support for the communist party in the country side had been significant.

Figure 3.2. Tradables Dominate (tradables as a percentage of non-tradables in GDP)



Note: Tradables: Agriculture, Mining and quarrying, Manufacturing sectors; Non-tradables: Power, construction, trade, transportation and communication. Reclassifying trade and transportation yields similar trends in the ratio depicted.
Source: Authors' calculation base on BPS data.

To raise rice output, the government decided to first improve the implementation of the *Bimas (Bimbingan Massal*, Mass Guidance) program, an agricultural intensification program that had been introduced by the Sukarno government. This *Bimas* program had originally been initiated by the Faculty of Agriculture, University of Indonesia (later to become the Bogor Institute of Agriculture (IPB) in 1963 (Mears & Moeljono, 1981: 25). Various changes were introduced in the Bimas programs to facilitate the financing of inputs. The *Bank Rakyat Indonesia (BRI*, Indonesian People's Bank, see Box 3.2), at the time still called the *Bank Koperasi Tani dan Nelayan* (Cooperative Bank for Farmers and Fishermen) needed assistance to help meet the rapidly increasing demand for loans for small farmers. To this end, *Kolognas*, a body established to handle the logistics of the distribution of essential commodities, was tasked to finance participants in the Bimas program through the

governors and district heads in some of the provinces where the Bimas program was concentrated (Mears & Moeljono, 1981: 29).

In 1967 Kolognas was abolished and replaced by *Bulog (Badan Urusan Logistik*, Food Logistics Agency see Box 3.3). Bulog was charged to defend the rice floor price through government purchases of *gabah* (unmilled rice) and milled rice. It also had to stabilize the consumer price of rice by injecting stored or imported rice supplies into domestic markets when

Box 3.2. Bank Rakyat Indonesia's Unit Desa: From subsidy outlet to sustainable microfinance

One of the outstanding development successes of Indonesia is its rural microfinance. It is home to the largest unsubsidized microfinance institution in the world, Bank Rakyat Indonesia's microfinance unit, serving 16 million savers across the archipelago, with a portfolio of 2.7 million outstanding loans in 2000 showing a repayment rate consistently over 95 percent, and turning in a profit ever since 1987, including the crisis years. BRI has its roots in colonial times, and started as a bank for indigenous civil servants. In the 1970s, Bank Rakyat Indonesia started to expand its "Unit Desa" outlets at the sub-district level in order to better implement the subsidized credits of the *BIMAS* scheme for rice cultivation. During the 1970s and early 1980s additional subsidized schemes were added, totaling some 350 by 1983, with borrowers selected primarily by government officials rather than by commercially oriented credit officers. The Unit Desa only provided one savings product, with interest below inflation. Not surprisingly, little savings were mobilized, and with lending rates 3 percentage points below savings rates, and default rates that gradually crept up to 50 percent, BRI incurred heavy losses. By 1983, the bank had some 3600 outlets across the archipelago. When the decision was made to end BIMAS in 1983, a change in culture took place within BRI, in part enabled by the 1983 financial sector reforms that deregulated interest rates. BRI developed a commercial loan product (KUPEDES) targeted at low income borrowers, with terms flexible enough to accommodate individual borrowers, for instance by timing the repayment of farm loans until after the harvest. Each unit became a profit center, and unit desa staff received equal treatment to that of the rest of BRI. Reporting from unit desa to branch office was greatly simplified and improved. The Government continued to provide subsidized credits—KUT—but these were no longer available at the Unit Desa level, but at the branch level of BRI. In parallel, the bank started to experiment with 3 types of savings instruments each with positive real interest rates. By 1989, all KUPEDES credits were funded by savings mobilized through the unit desa's, and they have been ever since. Government subsidies have stopped since 1986, with the exception of technical assistance for further development of the system. This remarkable transformation was due in part to the changing financial sector policies, but also due to the recognition at the political level that the unit desa network was a valuable organization that, once relieved of the burden of subsidies, could be a profitable venture highly beneficial to rural development.

Source: Robinson (2002).

shortages caused the price of rice to rise excessively. Carrying out these tasks required large and ongoing subsidies from the government budget and through the credit system, but in general Bulog over the years was successful in maintaining appropriate rice prices (Pearson & Monke, 1991: 2-3). Despite the efforts to keep rice prices low, a severe rice shortage arose in late 1967 due to a sharp decline of the dry season harvest, causing rice prices to double. In response the government decided to pay farmers an incentive price for their surplus rice based on the *Rumus Tani* (farmer's formula). According to this formula, the prices of milled rice and urea fertilizer for farmers should rise in roughly the same magnitude (Timmer, 1981: 37).

In the 1970s the evolution of rice policy was closely related to the government's larger effort in development planning. In mid-1970 a more incentive-oriented 'perfected Bimas'

program was introduced, which was organized around 'village units'. This program focused on providing farmers with subsidized inputs (High Yield Varieties, fertilizer and pesticides), subsidized credits and information, and letting them decide whether and how much to decide. Fertilizer distribution was partially turned over to the private sector, which was obliged to sell both urea and tri-sodium phosphate (TSP) at a stipulated ceiling price (Timmer, 1981:38). A second innovation in rice policy was to implement an effective floor price for stalk paddy. By setting a national fertilizer price ceiling, it became possible to set a national floor price for rice (Timmer, 1981:38).

Box 3.3. Bulog

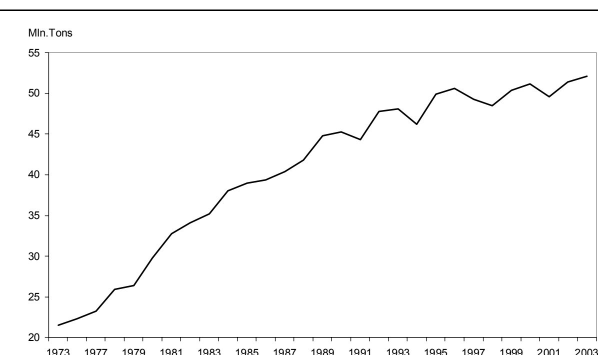
A national logistics agency, BULOG, was set up to oversee rice policy, and to stabilize rice prices. This agency was crucial in establishing food security, but over time it became more politicized, and increasingly abused. Rice policy, like agricultural policies in other countries, became increasingly distortionary, and by the mid-1990s the procurement price for rice was some 40 percent above world market price, giving rise to widespread smuggling. BULOG had become involved in other agricultural commodities such as sugar and wheat, which were far less essential than rice, but lucrative to trade. The agency had become involved in the corrupt deals of the latter Soeharto period, and its money and resources became a source of corruption. And after Soeharto's fall a former chairman, the chairman of the MPR, the consultative assembly, and a son of Soeharto were all convicted of corruption cases involving BULOG.

During the first half of the 1980s rice output grew rapidly as a result of good weather and the rapid spread of 'green revolution' technology. In fact, between 1975 and 1985 the share of farmers using new High Yield Varieties rose from 50 to 85 percent. Extensive government investment in irrigation, made possible by vastly increased oil revenues, facilitated area expansion and rice intensification. The oil boom of the 1970s also enabled the government to make large investments in the improvement and expansion of infrastructure, including roads, transport and communications facilities, grain storage facilities, and fertilizer plants (Tabor, 1992:172-3). These investments allowed for increases in the farm gate prices without undue increases in the consumer price. Investment in physical infrastructure was complemented by development of public sector institutions that provided the rice economy with financial, marketing and extension services. These institutional innovations served as an important link between expanding production possibilities and improved physical infrastructure by providing the financial and educational prerequisites for technological innovation (Tabor, 1992:173-4). Thus, as the education level of the rural population increased, a more sophisticated rice policy was gradually introduced.

These intense efforts to raise rice production, regardless of cost, bore fruit. Although in one, two years rice production was lower than the previous year, this drop was caused poor harvests due to bad weather. In general, however, throughout the New Order era rice production rose steadily, and paddy production increased by over 150 percent in the period 1970-1995 (Figure 3.3.). According to Booth's study, yields growth accounted for 71 per cent to the growth of rice output cultivated on irrigated rice fields in Indonesia during the period 1971/75 through 1981/85, while growth in harvested area contributed the remaining 29 percent. Clearly, the very rapid growth in rice production, particularly on Java, after 1970 was largely due to yields growth,

which accelerated during the period, particularly in the years after 1979 (Booth, 1988: 39-41). The above figures clearly show the successful outcome of the rice intensification program pursued vigorously by the New Order government, as reflected by the relatively great importance of the contribution of yields growth to rice production over the period 1970-1990 (Table 3.1).

Figure 3.3. Production of dry, unmilled rice (paddy), 1973 – 2003 (millions of tons)



Source: Badan Pusat Statistik: Statistical Yearbook of Indonesia, successive issues.

Over the period of the 1980s the decline in the contribution of yields growth was largely due to the considerable area expansion that took place outside Java (Hill, 1996: 135). While the provision of subsidized inputs and subsidized credit to farmers undoubtedly accounted for the success of Indonesia's rice policy, the fiscal costs of these subsidies grew faster than the government's ability to mobilize domestic resources. Financing these subsidies became even more burdensome after the end of the oil boom and when development objectives shifted to encouraging industrial development. Equally important were the adverse consequences of chronic market distortions, which, over time, reduced the economic effectiveness and efficiency of subsidies as food policy tools (Tabor, 1992:178). Aside from these problems, the single-minded focus on raising rice output led to a relative neglect of the other food crops, called *palawija*, including maize, cassava, sweet potato, and soybeans. It was only during Repelita III (1979/80-1983/84) that the government made a greater effort to raise *palawija* crop production. However, only maize proved to be responsive to the introduction of technological innovations, and as a result maize production began to rise rapidly since the late 1970s (Hill, 1996: 136). The performance of the other *palawija* crops have been more spotty. Production of peanuts and soybeans rose very rapidly from a small base, but the success of the latter crop was only made possible by prohibitively high import protection. Production of cassava and sweet potato, however, has steadily declined as both crops are regarded as inferior (Hill, 1996: 136-7).

Table 3.1. Contribution of yields growth to growth of rice production in Indonesia, 1970-90
(percent of increase)

	1970-80	1980-90	1970-90
Total Indonesia	75	66	68
Java	76	74	74
Outer Islands	74	61	67

Source: Hill, 1996, Table 7.2, p.135.

D. Industrial and Trade Policies

During the three decades before Indonesia was hit by the Asian economic crisis, the country experienced an unprecedented economic and industrial transformation. When the New Order

government assumed power in 1966, Indonesia's miniscule manufacturing sector was in poor shape, just like the rest of the economy, because of the poor economic policies pursued by the previous government of President Sukarno. As a result, in 1965 Indonesia was still the least industrialized among the five original ASEAN countries if measured by the percentage share of manufacturing in GDP. However, by 1993 Indonesia, along with Malaysia and Thailand, was named one of the three 'newly industrializing economies' (NIEs) of Southeast Asia by the World Bank in its famous 'East Asian Miracle' study (World Bank, 1993: 1). While Indonesia in 1970 had in absolute terms the second-smallest manufacturing sector among the ASEAN-4 countries, a quarter of a century later it had the largest (Table 3.2.). While in 1965 Indonesia's manufacturing sector only generated a miniscule 8 per cent of GDP, by 1998 it generated more than a quarter of GDP. With a manufacturing share of more than 20 percent of GDP, Indonesia had become a 'semi-industrial' country. As an exporter of manufactured products, Indonesia's performance was certainly the most remarkable, as in 1980 manufactured exports only accounted for a miniscule 2 percent of total exports, but in 1997 their contribution had risen to no less than 42 percent.

Table 3.2. Indonesia's Industrial Transformation in ASEAN perspective, 1975 – 1998

	Manufacturing Value Added (US$ millions)		Manufacturing (% of GDP)		Manufacturing exports (As % of total exports)	
	1970	1996	1965	1998	1980	1997
Indonesia	994	58,244	8	26	2	42
Malaysia	500	34,030	9	34	19	76
Philippines	1,622	18,908	20	22	21	45
Thailand	1,130	51,525	14	29	25	71

Source: World Bank: World Development Indicators, successive issues.

Industrial and trade policies by no means followed a straight path towards more liberalization. In fact, these policies were the main battleground of policy direction. This was in part because control of the measures constituting trade and industry policies was dispersed over numerous line ministries. Moreover, implementation of trade policies was to a large extent in the hands of the customs service, an organization that has had a history of corruption, making the effective tariffs very different from the stated ones. Liberalization of the 1960s was followed by a more protectionist stance in the 1970s, which again was succeeded by a more liberal stance during the 1980s.

Initial liberalization. The economic policies of the New Order government which started this remarkable industrial transformation included (McCawley, 1981: 64) the 1966 stabilization measures already discussed as well as a liberalization and simplification of the foreign trade regime; a reduction of the preferential treatment for State Enterprises (SOEs) and foster the growth of the private sector along with the state sector; and the enactment of a new Foreign Investment Law in 1967 and a Domestic Investment Law in 1968, which provided the same incentives to domestic investors as offered to foreign investors. These policies were successful in fostering broad-based industrial growth in Indonesia for the first time since its independence.

Since the late 1960s many industries, including many newly established and older industries, grew quite rapidly. As a result, the contribution of manufacturing to GDP increased from 9 percent in 1970 to 12 percent in 1977, despite the impact of the oil boom (McCawley, 1981: 64). This absolute as well as relative expansion of the manufacturing sector appears to indicate that the Indonesian economy was hardly affected by the 'Dutch disease'.

Over the period 1967-1975 manufacturing grew quite rapidly for several reasons. For one thing, in the late 1960s and early 1970s there was a pent-up demand for many manufactured products, which had not been met during the years of scarcity during the late Sukarno period. Secondly, because of the under-utilization of industrial capacity during the late Sukarno period, there were few capacity constraints holding back sharp increases in supply. Thirdly, the quite liberal Foreign and Domestic Investment Laws signified a new investment climate, which was quite favorable to private, including foreign, investors. As a result, an investment boom took place, particularly in mining and manufacturing (McCawley, 1981: 64). The 1967 stabilization package included a key foreign investment law (Law 1, 1967), which marked a 180-degree turnaround from the policies of Soekarno. The law granted incentives and assurances to new foreign investors and provided for the return to their owners of foreign-owned industrial and trading properties that had been nationalized in 1965.[20] Foreign investors responded to the new policy with a number of substantive investments, particularly in oil and mining for which Indonesia lacked the technologies and other capacities for exploration and extraction. In return the government gleaned extensive and vital tax revenues on which it would depend over the coming three decades[21].

Policy reversal. However, after the mid-1970s industrial growth began to slow down as the limits of the growth of the domestic market had been reached. The slowdown in industrial growth caused by the completion of the phase of 'easy import substitution' and the onset of the oil boom in the mid-1970s led to a fundamental reappraisal of industrial policy objectives. This reappraisal led to a new phase of state-directed industrialization (Hill, 1997: 28). During this period the government began to abandon its relatively liberal trade regime, as more tariffs were introduced and steadily more non-tariff trade barriers (NTBs) were introduced. It also led to a more restrictive foreign investment regime as a partial response to rising nationalism in the aftermath of the 1974 *Malari Incident*. Moreover, some of the oil revenues were recycled into state enterprises (Hill, 1997: 28).

[20] At this time an agreement for nationalized Dutch enterprises already had been reached, but did not entail the return of former Dutch banks.

[21] As a case in point, Freeport McMoRan was allowed to operate in Irian Jaya in 1967[21] and signed its first mining "contract of work" with the Soeharto government in 1973. Today, the US based mining company is Indonesia's largest single private tax payer; it contributed an average of $180 million in taxes per year between 1991 and 2001 (UNDP Human Development Report 2002). In May 1991, the company renewed its contract reserving the right to continue operation through 2025. The 1967 Freeport agreement doubled as a key measure of territorial control. In 1968 the status of Irian Jaya was still undecided. It wasn't until 1969 that a referendum and UN Resolution mandated that the territory become a part of Indonesia sovereign territory. The appropriation of wealth by Java from Papuan resources lies at the center of the on-going conflict between the Free Papua Movement and the Indonesian government today.

With the appointment of a new and highly articulate Minister of Industry in early 1978 (Mr. A.R. Soehoed), and with the strong support of Soeharto, the state-directed, second phase of import substitution was pursued more systematically. This strategy was based on Soehoed's view that import-substituting industrialization during Repelita I and II had only led to a widening of a shallow industrial structure, rather than the deepening of the industrial structure (Soehoed, 1981: 6-7). To rectify this perceived imbalance in Indonesia's industrial structure, the establishment of key upstream industries was required, including basic and engineering goods industries, to strengthen and support the already existing downstream assembly industries. Based on these views, Soehoed articulated a long-range development strategy to establish a whole range of basic, upstream resource-processing industries. These basic industries were to be undertaken and financed by the government (which at the time was awash in oil money) as well as foreign aid on soft terms. The downstream assembling industries would still be left to private enterprise. All in all, 52 key basic industries were to be undertaken by state-owned enterprises (SOEs), including the Krakatau Steel Mill and the Aluminium Smelter plant in Asahan, North Sumatra, which were completed during this period. The underlying considerations to entrust the 52 key basic industries to SOEs were the huge capital costs involved, which the private sector was unlikely to command at the time, and the long gestation period and the estimated smaller profit margins, which were unlikely to be attractive to private investors (Soehoed, 2003: 91).

While the oil boom lasted, this industrial strategy of what an American economist called ' *a massive exercise in import substitution' (Gray, 1982: 41-2)*. The government reverted to a public sector dominated economic strategy emphasizing import substitution and the public financing of highly capital-intensive projects. Effective tariff protection went up, especially in import substituting industries (World Bank 1981). The share of government development expenditures in total domestic investment increased from 28 percent for the years 1968-1974, to approximately 60 percent in the years 1974 to 1979. Not surprisingly, efficiency-minded economists were greatly concerned about this planned highly inward-looking, second stage import substituting pattern industrialization, as it ignored comparison of production costs with border prices as applied to different industries with varying production functions and scale economies (Gray, 1882: 41). In a 1978 article, political scientist Richard Robison wrote that Indonesia's system had developed into "bureaucratic capitalism," a system in which powerful public figures, especially in the military, had gained control of potentially lucrative offices and used them as personal fiefs.[22] Private sector resources were misallocated and distortions depressed the overall level of private sector investment (World Bank 1989:57).

Renewed liberalization. However, once the oil boom had ended in 1982, the Indonesian government could no longer afford to pursue this import-substituting pattern of industrializing, as it had now to pursue a more outward-looking, export promoting industrialization strategy (Thee, 1989: 150). Faced with the need to develop alternative sources of export revenues and a new engine of growth for the Indonesian economy to replace the declining role of the oil sector, the government shifted its inward-looking industrial strategy to an export-promoting strategy, albeit

[22] Originally found in Country Studies US (Library of Congress) – need to find original reference if possible.

initially with some hesitation. However, after an even steeper price in the price of oil in early 1986, the government finally made a more determined effort at export promotion, including the introduction of a series of deregulation measures to improve the investment climate for private businessmen, whether domestic or foreign.

The government introduced a series of trade reforms aimed at reducing the 'anti-export bias' of its protectionist trade regimes. A major trade reform was the introduction of a 'duty exemption and drawback scheme' in the deregulation package of May 1986. This scheme exempted export-oriented firms (defined as those exporting 85 percent of their output (later reduced to 65 percent) from all import duties and regulations on importing their inputs (Muir, 1986: 22). This facility was later expanded to bonded warehouse facilities.

Starting in 1985 measures were taken to streamline the investment approval process and relax investment controls. Previously, investment licenses had served as an important regulatory function, but the complexity and cost of the process posed series barriers to entry, not to mention "rent-seeking" opportunities. In 1985 application requirements were reduced to 13 steps from 26 in 1984 and 35 in 1977; and the Capital Investment Coordination Board (BKPM) was created as a "one-stop" service with the executive authority to issue most major licenses to foreign and domestic investors. In addition the investment package announced in May of that year marked a fundamental shift in investment licensing. Rather than listing areas open to investment on a rather long, incomplete and *ad hoc* roster, the government formulated a negative list with a limited number of restricted sectors for which the government would continue to regulate investment (World Bank 1995:41).[23] These investment reforms help to systematize the relaxation of licensing, increased transparency, and reduced the scope for discretion. However, changes at the national level did not translate well to the local level where differing provincial practices and limited administrative capacity inhibited reforms (World Bank 1989:69-73).

Institutional Innovation. Two institutional innovations helped the technocrats regain control over policy in this area: The Tariff Team (*Tim Tarif*) and the outsourcing of the customs service. Tim Tarif, set up in 1985, centralized controls over the tariff setting process. Composed of a representatives of a number of ministries, the team was to advise the Minister of Finance on tariffs, and ensured that all perspectives on any tariff proposal was heard, rather than the parochial interest of one Ministry. The most controversial and strikingly effective measure was the reform of the notoriously corrupt Directorate-General of Customs. The investigation and clearance of import consignments worth more than $ 5,000 was transferred to the Swiss firm, Societe Generale de Surveillance' (SGS) and custom controls over exports and inter-island trade were abolished altogether (Nasution 1985:11). According to some estimates, clearance costs

[23] In the May 1995 package, ten sectors were dropped from the negative investment list for the stated purposes on increasing business opportunities, domestic supplies of the affected products, value added and technology transfer – although 100 percent foreign ownership was still restricted. These sectors were cooking oil, block board, rattan, utility boilers, motor vehicles, machines for producing white cigarettes, disposable gas lighters, prescription medicines, aircraft repair, and advertising. In the same package five sectors were added for environmental purposes which included prohibition of investment in finished and semi-finished mangrove wood, cyclamate and saccharine, sulfite-based pulp production; chloro-alkali industries using mercury processing, and chloro-fluorocarbon industries. (World Bank 1995:41).

dropped immediately to one-fifth of their former level (Dick, 1985:10), giving a strong boost to trade and tariff revenues alike.

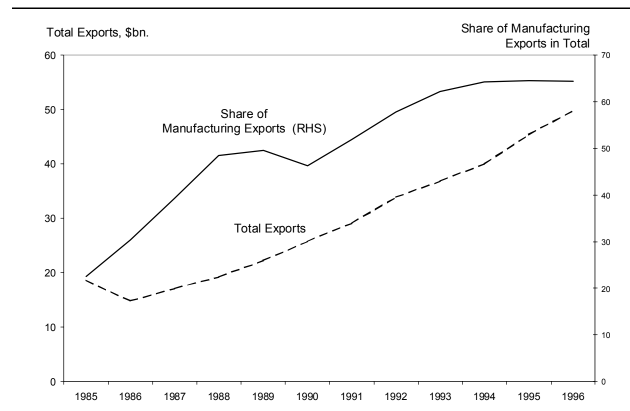
As a result of the improvement in the investment climate made possible by the successive deregulation measures, foreign and domestic direct investment started rising rapidly in the late 1980s. Most of the new foreign investors entering the country were investors from the East Asian newly-industrializing countries, notably from Korea and Taiwan, who were relocating their labor-intensive operations to lower cost and lower wage countries in Southeast Asia. Unlike the domestic market oriented foreign direct investment of the 1970s and early 1980s, these new foreign investors were attracted to establish export-oriented operations in Indonesia in response to the trade reforms which had reduced the 'anti-export bias' of the trade regime (Thee, 1992: 234-8). As mentioned before, in addition to these trade and investment reforms, the government also pursued a supportive exchange rate policy to keep the real effective exchange rate competitive.

The above measures led since the late 1980s to a surge of manufactured exports for the first time in Indonesia's modern economic history. Since 1987 through 1992 manufactured exports increased at an average annual rate of 27 percent (HIID, 1995:1 and Figure 3.4.). The surge in manufactured export, however, proved to be short-lived when the growth in manufactured exports started to slow down since 1993. In part this slowdown was to be expected, as the growth rates in the late 1980s were very high as they started from a very small base. In addition, the global recession in the early 1990s reduced the growth of world trade, including exports from Indonesia (HIID, 1995:1). As the world economy recovered, Indonesia's manufactured exports were expected to grow again.

The slowdown in manufactured exports in 1993 and 1994 was a matter of great concern to Indonesian policy-makers, as since the end of the oil boom the manufacturing sector had emerged as the engine of economic growth. In turn, the rapid growth of the manufacturing sector was largely driven by the growth in manufactured exports. Unfortunately, the government's response to the slowdown in manufactured exports, proved to be rather schizophrenic, as two contending parties vied to implement an industrial strategy to sustain the growth in manufactured exports. On the one hand, the Department of Trade and Industry pursued a 'broad spectrum' strategy of outward-looking industrial strategy, which emphasized the promotion of all export-oriented industries. On the other hand, Dr. Habibie, an ambitious Minister of State for Research and Technology, stressed the need to promote a range of 10 highly costly 'strategic industries', notably a hi-tech aircraft assembling industry, which were expected in due

Figure 3.4. Rapid Expansion of Manufacturing Exports

(Exports and Share of Manufacturing Exports, 1985-1996, US$ billion and percent)



Source: Badan Pusat Statistik: Statistical Yearbook of Indonesia, successive issues.

course to generate the bulk of manufactured exports in lieu of labor-intensive industries which, in the view of Habibie, were sunset industries (Thee & Pangestu, 1998: 262). However, until Indonesia was hit by the Asian economic crisis, none of the 'strategic industries' had made any significant contribution to manufactured exports.

E. Financial Sector Policies

Financial sector liberalization was a latecomer in Indonesia's reforms. Soekarno had monopolized the banking system into one bank that performed both central bank and commercial bank functions, and the first order of business was to reconstitute the system. However, that system was an important tool for government policies until well in the 1980s, dominated by State Banks into the 1990s. When liberalization took off in earnest in the 1986 reforms, it was perhaps too rapid, and insufficiently matched with the development of an independent, strong supervisory capacity. As a result, the sector became to be the center of the economic crisis after 1997.

Reconstituting the Financial Sector. To redefine the roles of banks and improve access to credit parliament passed Law 14/1967 on the Principles of Banking. The law characterized the banking system as an instrument of national development to improve economic growth, equitable distribution of wealth, and national stability. Depending on a banks core business, banks were classified under the law as Development Banks, Commercial Banks and Regional Development Banks. The law also authorized the establishment of branches of foreign banks and designated approved private domestic banks – essentially credit institutions – as "foreign exchange banks" which enabled them to deal in foreign currencies. (World Bank 1968:32, Bank Indonesia 2002). Strong incentives were offered for people to deposit their savings in the banks, as hyperinflation had depleted deposits. Monthly interest rates of up to 6 percent on 12-months deposits were offered, enough to draw back money into the banks, and to dramatically increase the savings rate (Table 3.3.) and subsequently the investment rate.

A Dependent Central Bank. Law no. 13/1968 created Bank Indonesia as the national Central Bank. Under the law, six new state banks were chartered from those that had been amalgamated into the central bank institution under Soekarno[24]. At the apex of the banking structure lay the Monetary Board that was chaired by the Minister of Finance, with government representatives constituting a majority of the board. The law stipulated that if the Governor of Bank Indonesia disagreed with the position of the Board and was not supported by the cabinet, he could publish his views. However the cabinet held the right to veto the publication in order to protect national interests. Second, the law required Bank Indonesia to lend money to the Treasury on demand. The act stated, "the Bank shall, whenever the Minister of Finance deems it necessary to temporarily strengthen the Treasury funds, be bound to advance the Republic of Indonesia monies in current account against sufficient treasury bonds." Lending limits originally were set at

[24] These included Bank Rakyat Indonesia (BRI) and Bank Ekspor Impor Indonesia (Exim).

30 percent of Treasury revenue (in the previous budgetary year), but this limit was raised to 50 percent and then ignored in practice (World Bank 1968:34).[25]

Credit Controls. Directed credit was an integral part of the Government's industrial policies until the 1980s. Directed credits, channeled through State Banks, and re-financed by the central bank, made up some 50 percent of total credits outstanding by 1982, and 70 percent of the State Bank liabilities were central bank liquidity credits that refinanced these credits (Sitorus and Srinivas. 2004). Meanwhile, deposit interest rates were controlled, and sometimes negative in real terms, which resulted in only limited resource mobilization through the banking system. In 1982, broad money over GDP was only 33 percent (Sitorus and Srinivas. 2004). Credit policies to control inflation in the 1970s further constrained the development of SMEs. The credit ceilings did not hinder the availability of financial service for larger firms that simply shifted their financial activities offshore (Cole and Slade 1996:19). However, small and medium sized enterprises in the private sector and housing sector, particularly in rural areas, suffered from limited access to credit.[26]

Lacking Access. In 1972, to compensate for a lack of service by formal financial institutions to small businesses, the government introduced a nation-wide subsidized credit scheme for small enterprises, the KIK/KMKP scheme, which provided both working capital and investment capital to small enterprises. The selective credit programs of Bank Indonesia run through the state banks accounted for just 2.8 percent and 3.5 percent respectively of total domestic credit outstanding to the private sectors in 1978. In 1990 this scheme was discontinued because many lenders had defaulted on their loans. Instead, the government introduced the KUK (Small Enterprise Credit Scheme) that required commercial banks to allocate 20 percent of their loan portfolio to small enterprise at market interest rates. However, this scheme also proved to be unsuccessful, as the banks were reluctant to provide loans to small enterprises without collateral. Where loans were disbursed, much of these loans were used for consumptive rather than productive purposes.

Table 3.3. Savings and Investment (percent of GDP)

	1965	1970	1980	1995
Savings	8.0		24.0	32
Investment	8.0		30.0	33

Source: Dick, et al, 2002: p.200 and BPS.

[25] The lack of independence of the Bank Indonesia from the Government of Indonesia would raise alarms repeatedly as banking and financial developments became more complex over the next 31 years. In fact recommendations to create an independent Central Bank feature regularly in World Bank reports issued between 1968 and May 1997. In the end, an independent Central Bank was not created until May 17, 1999 (Law No. 23/1999 on Bank Indonesia) after the damage was done.

[26] In 1972 the government introduced a nation-wide subsidized credit scheme for small enterprises, the KIK/KMKP scheme which provided both working capital and investment capital to small enterprises. The selective credit programs of Bank Indonesia run through the state banks accounted for just 2.8 percent and 3.5 percent respectively of total domestic credit outstanding to the private sectors in 1978. In 1990 this scheme was discontinued because many lenders had defaulted on their loans. Instead, the government introduced the KUK (Small Enterprise Credit Scheme) which required commercial banks to allocate 20 per cent of their loan portfolio to small enterprise at market interest rates. However, this scheme also proved to be unsuccessful, as the banks were reluctant to provide loans to small enterprises without collateral. Where loans were disbursed, much of these loans were used for consumptive rather than productive purposes.

Initial Reforms. On June 1, 1983 the first banking deregulation package was issued. This included (a) the lifting of credit ceiling for all banks that had been imposed in 1974, (b) the elimination of deposit interest rate controls on state banks, and (c) the phasing out of Bank Indonesia liquidity credit. The overall effect of these banking reforms was a rise in interest rates on deposits and loans, and increased freedom for banks to mobilize deposits in support of new lending (Bank Indonesia, 2002). Real deposit rates increased from –10.7 in 1981 to 9.1 in 1988. Financial assets held by the banking system rose from 18 percent of GDP in 1982 to 29 percent of GDP in 1987 (World Bank 1989:16,78) and private domestic banks increased their share of total bank assets from 11.2 percent in March 1983 to 24 percent in December 1988 (Cole and Slade 1996:23).[27]

Major Reforms. October 27, 1988 marked the second major package for bank deregulation. Known as the *PAKTO* Reforms, their main goal was to enhance financial sector efficiency by encouraging competition and increasing the availability of long-term finance by promoting the development of a capital market. The package entailed (a) an easing of restrictions on the opening of new private banks, bank offices, and non-bank financial institutions. This included permitting joint ventures with foreign banks, allowing domestic banks to open offices throughout Indonesia and foreign banks to open offices in major cities, and permitting rural banks to establish themselves on districts outside the provincial capital; (b) another significant banking policy enabled state-owned enterprises to place up to 50 percent of their total deposits with private banks and NBFIs. Removing barriers to entry resulted in the opening of a large number of new private banks, both domestic and joint venture that would compete with public financial institutions. Just 4 months later licenses had been approved for 7 new national commercial banks, 3 joint ventures with foreign banks and 47 secondary banks (World Bank 1989:79); and (c) The package included a reduction in the required reserve ratios from multiple set rates that averaged 11 percent to a uniform level of 2 percent of all third-party liabilities. This very low capital requirement reduced the intermediation costs for banks and increased the potential monetary expansion from any given increase in reserve money (Cole and Slade, 1996:23). PAKTO was followed by PAKDES (December 1988) and PAKMAR (March 1989) that aimed for more rapid capital market development. The reforms contributed to a burst of financial system activity. Domestic credit jumped from Rp. 3.9 trillion in 1988 to 6.2 trillion in 1989 and 9.3 trillion in 1990 (up from just Rp. 1 billion in 1984). M2 increased in these years at a rate of 13 percent, 20 percent and 26 percent respectively.[28] And the number of banks increased from 111 in 1988 to 171 in 1990 and 240 in 1994 (Sitorus and Srinivas, 2004:Table 1a).

Lagging Regulation and Supervision. These extensive banking liberalization measures required new regulatory measures. In addition to prudential regulations, which would be forthcoming between 1990 and 1992, it emphasized the need to clearly define Bank Indonesia's capacity to intervene in a problem situation prior to solvency, the need to strengthen Bank Indonesia's ability to supervise the growing number of banking and financial institutions, and the

[27] Because banks were sluggish to remove loan ceilings, there was no large increase in bank credit, domestic spending or inflation (Cole and Slade 1996:23).
[28] ADB Key Indicators, 2002.

need for a more independent position of the central bank. Many of these issues had not been addressed when the crisis broke, and it is no surprise that banking trouble was already rife well before the crisis (Box 3.4). In 1993, a joint Bank Indonesia-World Bank team reviewed the portfolios of the state banks in the context of a sectoral adjustment loan. The team found that the loan itself ($400 million) would probably cover less than 10 percent of the capital needed to reach the 8 percent capital adequacy ratio of the Basle core standards. Some corrective actions were announced, but by 1996, lack of implementation and continued regulatory forbearance by the central bank led the World Bank to cancel the loan. In a report that year, the Bank wrote:

> Without doubt the financial deregulation drive since 1983 has been an important factor behind Indonesia's excellent growth performance of recent years. But the pace of change (and the weakness of the starting point) has raised doubts about the fundamental health of the sector. In particular, there is a concern that –in a worse case scenario—the sector would magnify any serious disturbance, spreading shockwaves throughout the economy, with destabilizing feedback effects on the macro economy. *(World Bank 1996 as quoted in Kenward, 2002).*

Box 3.4. Banking Troubles

Regulation and supervision became a problem for the banking system—a problem only matched by that of political interference. Three scandals in the early 1990s illustrate this point.[1] In August 1990, Bank Duta, majority-owned by three foundations chaired by the President himself, reported extensive losses, caused by foreign exchange speculation. The losses were all the more shocking because only months before the bank had made an initial public offering, but apparently either the auditors nor the stock exchange, nor the capital markets supervisor had noticed the irregularities. The losses had been building up for more than a year, but had not been noticed by the central bank. Two business partners of Soeharto bailed out Bank Duta, with funds borrowed from a state bank.[1] Bank Summa ran into trouble in 1991, after it had quadrupled its lending after the PAKTO reforms, largely to real estate. When real estate prices dropped, the bank ran into trouble. Contrary to the assurances given during the PAKTO reforms, government decided to guarantee deposits up to Rp. 10 million ($5,000). Although the owner had to pay about one third of the costs of that guarantee, the central bank and state banks covered the rest of the losses. In the liquidation process, the former owner of the bank had to sell a prized asset, Astra International, a holding company of which car producer Astra Toyota was part. The buyers were the businessmen that had bailed out Bank Duta two years before. Finally, the state-owned bank Bapindo in 1993 had extended a loan of $420 million to the Golden Key Company, for building chemical manufacturing plants. Rather than building plants, the loan was in part used to buy out one of the shareholders—a son of Soeharto. The loan far exceeded the loan concentration limits set by the central bank, but supervisors had not noticed. Directors of the bank and company, but not Soeharto's son, were sentenced to jail. A case where a supervisor did notice was BCA, owned by the Salim group, which was financing a cement plant owned by the group with a loan that exceeded insider lending limits. When the director of supervision objected, he was fired. These troubles in the banks and their resolution gave the impression that connections counted, also in banking, and that the state would step in, if trouble emerged.

The technocrats that designed the liberalization policies of the 1980s were aware of the risks inherent in the financial sector reforms. They realized that the legal framework and bank supervision were not up to standards with the type of economy that would result from the reforms. At the same time, they saw the economic difficulties caused by the decline in oil prices as a window of opportunity to push through beneficial reforms. Not taking such an opportunity,

while waiting for the institutional framework to catch up with the needs was not considered an option.

F. Crony Capitalism Rising

The 1990s saw a growing perception among Indonesians that deregulation and economic growth were benefiting on a small percentage of the population who had ties to politically elite circles. Additionally, deregulation seemed to reduce bureaucratic hurdles for big companies but not for small firms (Schwarz borrowing from economist Rizal Ramli 1994:79). Animosities grew toward those in the merchant and trade industries who appeared to be benefiting from the liberalization measures, namely ethnic Chinese, as opposed to indigenous Indonesian *pribumi* entrepreneurs. Additionally, technocrats had designed the banking deregulations in consultation with international experts, and viewed new laws on par with international standards as important building blocks for improving Indonesia's competitiveness in the world economy. Thus, some nationalistic groups accused the government of creating a business environment to benefit international investors rather than indigenous Indonesians.[29] The 1990s also saw a declining influence of the technocrats in the Soeharto government. They had been given room to improve Indonesia's growth and investment climate by opening up the financial sector, lowering import tariffs, and removing some non-trade barriers. However, Soeharto gave the technocrats only a limited mandate to carry out economic reforms, which resulted in a lack of cooperation and coordination between the economic ministries and other cabinet branches that ultimately undermined the policies being implemented.

Amid a host of ills was one impiety that appeared to be at the root of the problems – corruption. Growth was driving poverty numbers down as opposed to fundamental changes and reform in the delivery of services and management of resources that would benefit the poor. Pockets of neglect and degradation undercut the vigor of otherwise great gains. For example, while Indonesia's infant mortality rate had dropped to 40 per 1,000 live births in by the year 2000 (from 118 in 1960), West Nusa Tenggara's rate was still over 100, rural South Kalimantan's was 93, and rural Central Sulawesi was 84.

[29] Some put significance on the 1993 cabinet change. Under public pressure to alter the economic administrations' image, in creating his new cabinet in March 1993, Soeharto dismissed three leading (Christian) technocrats and replaced them with Muslim economists (Schwarz 1994:80-81). Two economic advisors see this move as less significant, but acknowledge the generally declining influence of the technocrats in the 1990s.

Box 3.5. High profile cases of crony capitalism

1987 Siti Hardiyanti Rukmana , Soeharto's daughter nicknamed "Tutut", is granted concessions to build a toll road in Jakarta through her firm The Citra Lamtoro Gung Group. Concessions were extended in 1995 to last through 2024.

1988 Bambang Trihatmojo's, Soeharto's son, pay-television service RCTI, begins broadcasting.

1990 Tommy Soeharto, Soeharto's son, is granted a monopoly on the clove trade.

1991 Tutut is granted permission to use the state-run television station, TVRI, with out charge in order to operate her new television network, TPI.

1992 Mohamad "Bob" Hasan, Soeharto's, former trade minister and Soeharto's gulf partner, acquires 80 percent of the Nusamba Corporation (with interests in finance, paper mills, and mining) with no clear record of how the transaction was financed. Hasan amassed between $2 and $8 billion in wealth between 1991 and 1997.[1]

1994 Tommy Soeharto borrows $100 million from Bank Bumi Daya to found the Goro Supermarket chain and the Central Village Cooperative. The funds were never repaid.

1994 Soeharto creates new Tariff and Fiscal Team that granted protection to Chandra Asri, through the imposition of a surcharge on competing imports. This avoided the creation of a real tariff. Chandra Asri was owned by Bambang Trihatmodjo, Liem Sioe Liong (head of the Salim Group) and Prajogo Pangestu (a timber baron)[1].

1995 Soeharto creates the Self-Reliant Welfare Fund Foundation (Yayasan Dana Sejahtera Mandiri – YDSM)[1]. Under the scheme state funds collected as "donations" were shifted into private management, and Bob Hasan would profit as the supplier, purchaser and marketer of commodities produced by poor farmers using state finance.[1]

1995 Soeharto approves the development of a $2 billion commercial jet-airplane following the successful test-flight of the Indonesian-designed and manufactured plane, the N250. The N250 cost the state-run aircraft company, run by Vice-President B.J. Habibie, $1 billion to development and build.[1]

Soeharto and Habibie set up PT Dua Satu Tiga Puluh, an aircraft development company and urged the Indonesian people to buy stocks to help pay for the project.[1]

1996 Wealthy businessman Eddy Tansil, incarcerated under corruption charges in 1994, escapes from jail under suspicious circumstances.

1997 Soeharto issues Presidential Decision (Keppres) No.42/1996, which declared the "Timor" car the national car of Indonesia, and its producer PT TPN (Timor Putra National) owned by Tommy Soeharto, exempt from import tariffs and luxury taxes.[1]

1997 Ari Sigit Soeharto, a grand son, begins plans for a "national shoe" project, which would require Indonesian children to buy uniform school shoes from his company.

1997 Reuters declares the Soeharto family to be the 9th richest in Asia, up from 93rd in 1996. *Forbes* ranks Soeharto family as 16th wealthiest in world. Combined family fortune is estimated at between $4 and $6.3 billion in 1998 (at US$1 = Rp. 15,000).[1]

O'Rourke wrote in 2002 that "rather than serving the public, most functions of the state apparatus were concerned primarily with upholding rent-seeking structures… Most Indonesians were growing better off, but they also confronted mounting injustice in their daily lives" (2002:6). As the economy grew, the financial markets became more abundant, and the influence of the technocrats diminished, the magnitude and number of "egregious projects" and "misadventures" escalated (Slade and Cole 1996:343). Box 3.5 outlines some of the high profile cases of

corruption and cronyism between 1987 and 1997 that would underwrite the *Reformasi* demonstrators' calls to end corruption, collusion and nepotism (KKN).

At a time of increasing popular resentment directed at the rich, especially those of Chinese descent and Soeharto's family, Soeharto made a move to bolster the government's social justice credentials. Indeed, despite the gains in income, over 50 percent of the population still lived on less than 2 dollars a day in 1996 (World Bank 2002). Moreover, despite the statistics, the 1990s saw a growing perception among Indonesians that deregulation and economic growth were benefiting only the small percentage of the population who had ties to politically elite circles.[30] Rather than raising taxes on the top bracket, Soeharto founded the Self-Reliant Welfare Fund Foundation (Yayasan Dana Sejahtera Mandiri –YDSM) in December 1995 as a private foundation with a mission to collect 2 percent of the after-tax revenue of Indonesia's top 11,025 taxpayers. These "donations" were to be distributed to the small farmers and business people and the poor. From the start, YDSM's intentions were circumspect as it served largely as mechanism for diverting public money into private hands with no transparency mechanisms to account for the use of funds. Soeharto served as chairman and high-level bureaucrats and some of the biggest names in Indonesian business, not usually associated with social welfare, served on the board, including billionaire Liem Sioe Liong (head of the Salim Group), real estate baron Eka Tjipta Widjaya, and timber cartel operators Bob Hasan and Prajogo Pangestu. Soeharto's second son, Bambang Trihatmodjo, was treasurer. The effect of the episode was to demonstrate that "even the objective of social justice is subject to the politics of patronage" (Bourchier and Chalmers 1996).

4. Institutional Underpinnings

In contrast to the successes in economic policy, Indonesia's institutions—with the exception of the Presidency and the Military—suffered decline during the New Order era. Soeharto saw social and political order and economic development as two sides of the same coin (Schwarz 1994:24-39), and he shaped Indonesia's institutions accordingly. The New Order administration asserted that a strong state, with the capability of suppressing (as opposed to diffusing) antagonisms based on ethnicity, religion, or geography, was a pre-condition for industrialization. The military became the key instrument for eradicating subversive and "destabilizing" forces within society and the administration severely limited popular participation in politics.[31] The latter would be achieved not by disbanding all civilian political activity,[32] but by restructuring "the political

[30] A persistent problem with household survey based income inequality numbers is the non-response of higher incomes. To illustrate, the (income) Gini coefficient based on the 2002 SUSENAS is 0.41. However, if the upper 1 percentage point of households is assigned an income ten times larger than the measured Rp, 2.5 million (about $300) per month, the Gini would rise to 0.68—comparable to a country such as south Africa.

[31] Schwarz referencing Ruth McVey, "The Case for the Disappearing Decade," a paper delivered to the Conference on Indonesian Democracy, 1950s and 1990s, Monash University, 17-20, December 1992, p. 5, 8.

[32] Soeharto's administration channeled civilian political activity into a limited number of sanctioned social and cultural organizations that came under the governments direct control and would be used to implement policies and political agendas. Non-governmental organizations were given some leeway to operate but

system in such a way that it could no longer compete with the executive office for power. The forms of government would stay, but those outside, the executive branch would be steadily drained of influence[33]” (Schwarz 1994:30).

Indonesia’s political debate became increasingly subdued, and often actively suppressed under the New Order. After the violent suppression of actual and alleged communists during 1965-66, Golkar, Soeharto’s political vehicle, increasingly dominated the political landscape. The multitude of parties were “simplified” in the 1970s and limited to three. Limitations on press freedom and on civil society, combined with *Pancasila*, the country’s state philosophy, stifled the political debate, making it, at least in the eyes of outside observers, increasingly less free (Figure 4.1.), in contrast to that of the other HPAEs, which gradually eased political restrictions.

A. A “Simplified” Political Landscape

All-Embracing Golkar. During the Soeharto years *Golkar dominated the political landscape.* Built upon an army-organized alliance of anti-communist groups that had been set up in 1964 in the late Soekarno period, Golkar was designed not as a political party, but rather as an umbrella organization for hundreds of functional groups (*Golongan Karya*—shortened to *Golkar*) of peasants, workers, students, women, small-scale entrepreneurs, and others. These individual associations soon lost their identities, as they were absorbed into the larger Golkar 'family'. Golkar's drew its cadres drawn from three groups: the military (first and foremost), the bureaucracy, and its own various civilian wings. (Schwarz 1994:31). Golkar was effectively Soeharto's political vehicle from the outset, and dominated the Indonesian political scene until the 1999 election.

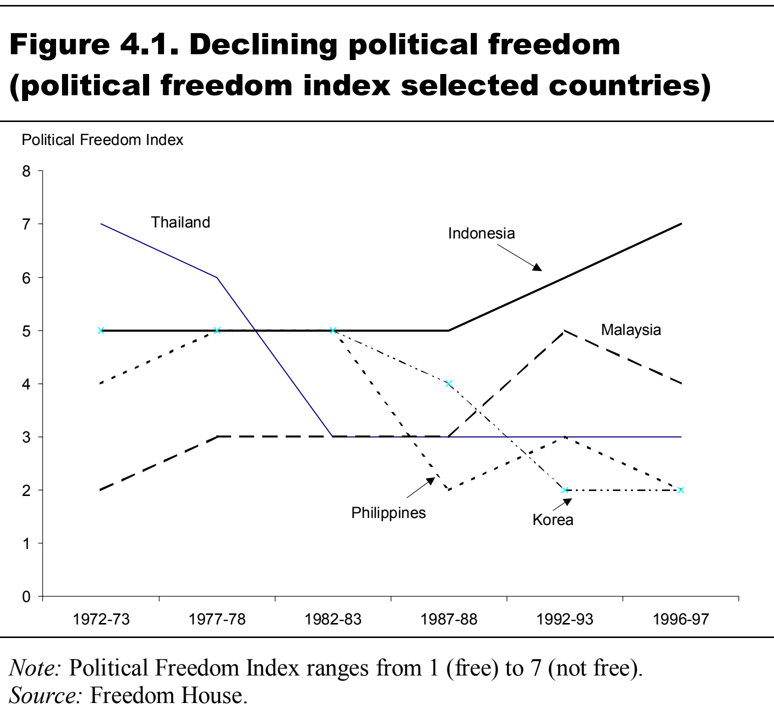


Figure 4.1. Declining political freedom (political freedom index selected countries)

Note: Political Freedom Index ranges from 1 (free) to 7 (not free).
Source: Freedom House.

always were subject to dissolution. Other efforts at controlling popular political participation included the de-politicizing of university campuses and the closing of “offending” publications which were considered “harmful to development.”

[33] The structure of power in Indonesia, as outlined by Biro Pusat Statistik Jakarta (1975) describes the following hierarchical order of powers: 1) Pancasila, 2) Preamble of the 1945 Constitution, 3) 1945 Constitution, 4) House of Representatives (MPR). The following branches hold parallel powers under MPR: the President/Executive, the People’s Representatives, the Supreme Court, the Supreme Advisory Council, the Supreme Audit Board. The development Cabinet fall under the direct jurisdiction of the President.

Golkar and its cadres were accorded a host of special privileges, not the least of which was that as 'non-party' status, meaning Golkar was simply exempt from many of the restrictions that were later placed on other political parties.

Golkar also offered the military (ABRI) a natural arena through which to participate in the country's political affairs. Whether by design or not, Golkar lent legitimacy to the “Dual Function” (*dwifungsi)* concept, whereby ABRI garnered a significant political role in addition to its traditional defense function. This dual role had existed in practice since Soeharto came to power in March 1966, but the policy of *dwifungsi* was officially enshrined in law until 1982 with the passage of the bill entitled "Basic Provisions for the Defense and Security of the Republic of Indonesia."[34] The inception of Golkar guaranteed the military a sizeable bloc of seats in parliament[35], as well as access to high-level civil service jobs in both Jakarta and the provinces. Vatikiotis (1993:70-71) describes the process known as *kekaryaan*, or cadre-isation of the civil service, which took place in the early years of Soeharto's rule. The process entailed the large-scale transfer of active military men into civilian posts in the central and local government bureaucracy, including the state-owned enterprises. According to ABRI, kekaryaan was undertaken in order to demonstrate to the people that ABRI was capable of participating in all aspects of government. As Vatikiotis points out in the same passage, "this hindered the development of a strong civilian bureaucracy."

In the months following the September 30, 1965 abortive coup, the armed forces waged an intensive campaign against suspected members of PKI (the Indonesian Communist Party), the government officially held responsible for the coup attempt. Hundreds of thousands of people – some reports say up to a million – were killed in the operation, which often devolved into a chaotic and violent rampage. While the army executed some of the massacres, in many instances civilian vigilante groups and Islamic groups such as the Ansor youth wing of the Nadhlatul Ulama were supplied with weapons and given a free reign (Schwarz 1993:20-21). After the campaign had died down, the army returned its attention to the perceived threat posed by organized Islamic groups, some which had separatist agendas, but most of which were feared simply because of their ability to mobilize large numbers of people.

One way in which the regime attempted to constrain political activism was through the concept of a "floating mass" of voters. The idea, first forwarded after the 1971 elections, was that people would be allowed to vote every five years, but that apart from a brief campaign period

[34] The very fact that the armed forces were given a legitimate role in running the country, plus a share in its economic resources, helped to neutralize any threat of a military takeover of the government during the New Order. This, in turn, helped to ensure political stability and create conditions conducive to economic and social development.

[35] Until 1967, the political parties dominated the People's Consultative Assembly (MPR), the body that is charged with selecting—and also impeaching—the president. In order to increase its control of the MPR, the government then granted itself the right to appoint a third of the members of the MPR, as well as over a fifth of the seats in the DPR (parliament). (Schwarz 1994:31). In addition to ABRI representatives, these government-appointed legislators included regional representatives from around the country and delegates from various interest groups such as the professions. The intention was to secure representation from the widest possible cross-section of society, and avoid the "tyranny of the majority" that was feared would result from a wholly elected MPR and DPR.

prior to elections, political activities would otherwise be banned. In the words of Leo Suryadinata (1979:70), this effectively "depoliticized the Indonesian population." Boileau (1983:70) explains further that, "It was thought that political involvement caused people to neglect the necessities of daily life and interfered with developmental efforts. If development, the number one priority of the New Order, was to proceed unhindered then the people in the villages had to be freed from the restraints of political party manipulation, which would allow them to devote their energies to economic development." The 1970s Golkar slogan "*Politik tidak, Pembangunan ya*" (Politics no, Development yes)[36] puts it more succinctly. While Golkar was nominally covered by the same rules as the political parties in this respect, it was able to circumvent the restrictions thanks to its dominance in local government organizations down to the village level.[37] In addition, Golkar was able to rely on the military personnel stationed in almost every village and hamlet around the archipelago to help keep the Golkar flag flying.

Limiting Political Parties. Soon after the first elections of the New Order in 1971, the political landscape was simplified. PPP was formed in 1973 through the forced amalgamation of the four Islamic parties that had contested the 1971 election (Parmusi, Perti, PSII and the Nahdlatul Ulama Party). At the same time, five secular parties (Soekarno's Indonesian Nationalist Party or PNI, two smaller nationalist parties, and the Protestant and Catholic parties) were combined to form PDI (the Indonesian Democratic Party). Buoyed by its 63 percent showing in the 1971 election (Schwarz 1993:32), Golkar saw an opportunity to consolidate its political dominance by 'simplifying' Indonesia's political party system so that it consisted of just three factions: Golkar, PDI and PPP. This exercise effectively subverted the democratic process and undermined political opposition, but some argued, "simplification of the political system has avoided the electoral instability that has plagued Indonesia in the past." (Boileau 1983:69). The 1973 Political Parties and Golkar Bill (Vatikiotis 1993:94) that provided the basis for the 'rationalization' of the party system was not actually legalized until 1975 when, following fierce debate, Law no. 3/1975 on the Political Parties and Golkar was passed.

Pancacila. Golkar and ABRI were also tasked with disseminating the philosophy of *Pancasila*, a creation of Soekarno's that the New Order succeeded in turning into the national ideology.[38] *Pancasila* comprises five "pillars" namely (1) belief in one God; (2) just and civilized humanitarianism; (3) a united Indonesia; (4) democracy guided by wisdom, through consultation and representation; and (5) social justice for all the Indonesian people. These ideals, which have now been drummed into two generations of schoolchildren, university students and civil servants, have been used quite successfully to express the unity of an uncommonly diverse people, while avoiding any reference to Islam as a national identity. Taught by rote as a set of near-sacred tenets that must not be questioned and were barely discussed, *Pancasila* has traditionally occupied a relatively large portion of the curriculum at all levels of the national education system. The lack of emphasis on Islam, and the fact that God is referred to as the *Maha Esa* (Supreme Being)

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[36] Boileau (1983:110), citing *Prisma no. 8, August 1979, p. 64.*

[37] When Korpri (the civil servants' organization) was formed in 1971, all civil servants (and their families) were required to become members, and thereby also members of Golkar.

[38] These tenets form part of the preamble to the 1945 constitution.

rather than as *Allah*,[39] caused considerable resentment among devout Muslims. When Soeharto issued a presidential decree in 1984 stipulating that all socio-political organizations, including the political parties, must adopt *Pancasila* as their sole ideology (*asas tunggal*) several waves of rioting and unrest ensued, notably the September 1984 Tanjung Priok riots and a wave of bombings and arson attacks in 1985. Naturally, the only Islamic party permitted by the New Order, PPP (the United Development Party), took particular exception to this directive, and quickly became a symbol of opposition to the regime.

B. Suppressed Civil Society

The New Order often dealt harshly with opposition from other sections of society, including students, urban elite, organized social groups, and the press. This further stifled public debate and hampered the emergence of more participatory politics. While the students were generally supportive of Soeharto during the early years of his rule, by 1973, they became impatient with Soeharto's apparent disinclination to stem corruption. They were also angry about the rapidly rising level of foreign (and particularly Japanese) investment in the country and the attendant enrichment of certain military officers and ethnic-Chinese businessmen at the expense of the now uncompetitive *pribumi* businesses and their workers. In January 1974, in what became known as the *Malari* incident, thousands of students in Jakarta staged demonstrations during a visit by the Japanese Prime Minister, Kakuei Tanaka. The marches escalated into riots that were accompanied by burning and looting, and around a dozen people were shot dead. Alarmed by the events, the government started to clamp down on free speech, closing 12 newspapers and magazines, and placing restrictions on public meetings. The students continued their protests, however, until the government eventually responded by issuing the 1978 *Campus Normalization Law*, which essentially put a stop to all political activity within the student community. (Schwarz 1994:33-36). Subjects with a "political" content were removed from the curriculum, and replaced by classes that taught national stability, national development and economic growth. Political research of any kind was also banned. This law remained in effect throughout the Soeharto years.

Elite resistance. In 1979, the Petition of Fifty, a group of retired military officers, former political leaders and intellectuals (also known as the Group of Fifty) began to protest government policies and to call for fair elections. In May 1980, they issued a letter criticizing the roles of Soeharto and the armed forces in the government. While Soeharto stopped short of throwing the group's members in jail, he did slap travel bans on them, prevented the press from printing their comments and, in some cases, confiscated their businesses. It is likely that because the petitioners were a group of well-respected and elderly public figures, many of them veterans from the independence struggle against the Dutch, Soeharto probably realized that stronger punishment would only cause a backlash and fan the flames of opposition.

Freedom of the press eroded. Since Indonesia's first newspaper was published in 1744 not a single era of Indonesian history, from Dutch colonialism to Japanese military occupation, to

[39] *Pancasila,* and thereby the state, recognizes five religions: Islam, Catholicism, Protestantism, Hinduism and Buddhism.

the end of the New Order, fully guaranteed freedom of the press. Degrees of government pressure varied from relative freedom to draconian clampdowns depending on the degree of political openness being experimented with at a given time. The Soeharto era was no exception, and the period from 1965 to the banning of periodicals after the *Malari* incident are sometimes referred to as the honeymoon period for freedom of the press (Astraatmadja 2004). Although, as Astramaatmadja suggests that these years are over romanticized in light of the government's closing of 46 left-wing newspapers in 1966 that were charged with the Indonesian Communist Party (PKI). In the period 1989 and 1994 openness (*Keterbukaan)* also saw some lifting of press restrictions, but for most of the Soeharto era, the media was tightly controlled.

Regulating the press was the responsibility of the Department of Information (DEPPEN) – which initially sought to control sensitive information that might provoke social tensions, but whose mandate grew to include the criminalization of dissent. DEPPEN issued and revoked press, television and broadcast licenses; oversaw the daily state-run radio news broadcasts; regulated foreign periodicals and monitored foreign journalists; and censored books. In the five decades following independence, the government issued only 289 publishing licenses. In just the 12 months following Soeharto's resignation it issued 718 licenses (Tesoro 2000).

With state monopolies on television and radio broadcasting, the print media which offered the greatest challenge to state authorities, became the target of intimidation campaigns and banning efforts -- most notably in 1981 following the Petition of 50 incident; and in 1994 when Soeharto ended *keterbukaan,* a period of "openness," with the abrupt closing of three magazines, *Tempo* (the standard bearer for hard-hitting journalism), *Detik* (a political tabloid) and *Editor*. Around the same time, the *International Herald Tribune*'s distribution was suspended, a *New York Times* correspondent who wrote about Soeharto family interests was banned from Indonesia, and journalists who had formed an independent union were jailed.

C. Weakened Grassroots

While the New Order government sought to control the national political system, is also had designs at the local level. In the name of national unity and the acceleration of development, the government implemented Law no. 5/1979 on Village Governance, which imposed a uniform Javanese model of administration on 63,000 villages throughout the country. This law designated each village a *desa* in the Javanese fashion, and swept aside existing traditional systems of administration and decision-making. The Village Law served to complement and reinforce Law no. 5/1974 on Regional Governance, and completed the process of formalizing the division of power and responsibility between the central government and all the levels below. The law on Regional Governance had been designed to "give the provinces a reasonable amount of local decision making and autonomy while retaining the central government's overall control." However, it was only implemented on an experimental basis starting in 1996, and was superseded by a much more radical decentralization law in 1999.

The 1979 Village Law was frequently viewed outside Java as a deliberate attempt to destroy the traditional indigenous customs and values (*adat*). These had been respected by

previous regimes, including the Dutch colonial regime, and that had served those communities well in the past. [40] The central government evidently regarded *adat* systems as inferior, even as obstacles to development, and acted in the belief that it needed to exert political control over the villages in order to promote national security and economic development. It is therefore unsurprising that the invalidation of *adat* leaders and institutions led to an increasing sense of disenfranchisement and injustice in the regions, and in many places engendered strong feelings of hatred towards the 'imperialist' Javanese.

In many cases, the new law required that small villages be regrouped into larger administrative units, which sometimes necessitated resettlement of their inhabitants. In other instances, the amalgamation of several far-flung communities into a single 'village' meant that people no longer had any connection with their village heads. Moreover, the *lurah* (village head) previously elected by the local population was now replaced by a civil servant with the same title, who was appointed by the regional governor on the advice of the district head. The villagers were instead permitted to elect a *kepala desa*, who was active in village affairs but lacked the formal authority of the *lurah* (MacAndrews 1986:39). In other words, villages were no longer run by their own community representatives, but by bureaucrats, many of who were not locals. The central government stripped local communities of their control over land and resources. For psychological as well as practical reasons, this often resulted in decreased self-sufficiency and correspondingly higher dependence on allocations from the central government—which ran counter to the government's stated aim of raising development levels.

One positive aspect of the Village Law was that, in combination with the 1974 decentralization law, it set out the parameters for creating a series of units to co-ordinate development activities at the provincial, district and village levels. *Bappeda* (Regional Development Planning Boards) were established in each of the country's provinces[41] and districts,[42] while corresponding coordinating offices were set up in the sub-districts (UDKP)[43] and villages (LKMD).[44] Starting in 1969, development funds to the different levels of local government were distributed via the *Inpres* programs (there were also sectoral *Inpres* programs for the improvement of primary schools, roads, markets etc.). The two main intentions behind these programs were to (a) create employment in rural areas, and (b) to provide basic infrastructure such as roads and irrigation systems. The *Inpres Desa* program, which was set up to administer village-level projects, accounted for 7 percent of the total *Inpres* funds allocated between 1969/70 and 1983/84. (MacAndrews 1986: 67-71). The *Inpres Desa* gave birth to a special program for underdeveloped villages (*Inpres Desa Tertinggal)* and later the *Village*

[40] Ethnic identities remain very strong, even in modern-day Indonesia; most Indonesians still define themselves according to their region of origin in the first instance.
[41] A *Bappeda* was established in each province by Inpres No. 15/1974. Their organization structure was later clarified by a regulation of the Ministry of Home Affairs, No. 185/1980. (MacAndrews 1986:38).
[42] The district-level *Bappeda* were established by Inpres No. 27/1980. (MacAndrews 1986:38).
[43] The *Unit Daerah Kerja Pembangunan* (UDKP) were established by Keppres No. 13/1972. (MacAndrews 1986:38).
[44] Each village now had a Village Security Institution (*Lembaga Ketahanan Masyarakat Desa* - LKMD) to coordinate development activities. These were established by Keppres No. 28/1980. The LKMD replaced the Village Social Institutions (*Lembaga Sosial Desa* - LSD). (MacAndrews 1986:38).

Improvement Program, which in turn became the inspiration for the *Kecamatan Development Program* (see separate case study). Village development came at a price, however. Anecdotally, villages that supported *Golkar* in the elections were rewarded with development programs. In addition, it was common practice for Golkar to give village heads (*lurah* or *kepala desa*) incentives in the form of cash or, more often, land or agricultural produce such as ducks, goats or rice to ensure that everyone in their communities voted for Golkar (or, where appropriate, for one of the permitted political parties).

D. A Marginalized Judiciary

The judiciary had started its decline well before the New Order government took office. In the years following independence, the justice system became a tool of the furthering the revolution but any pretense of an independent judiciary was abandoned under "Guided Democracy," the political system put in place by Soekarno in the late 1950s. Daniel Lev wrote in 1965 that, "the skills of judges gradually lost their significance in the evolving political system of Independent Indonesia. Courts were shunted aside as instruments of institutional control… They (judges) have resigned themselves to what they feel to be a much reduced role in government and society" (Lev, 1965:190). By the late 60's, the salaries of Supreme Court Justice had fallen to equal those of second rank civil servants. The struggle to secure judges salaries in distinct legislation as a means of maintaining the integrity of the courts would continue until 1994 when Chief Justice Purwoto Gandasubrata finally secured by the legislation (World Bank 2003a). Sinking salaries in the judiciary reflected the growing disregard in independent Indonesia for judges as service providers and the legal system as a crucial and fundamental national institution.

During the New Order, the breakdown of the judiciary extended beyond under-funding and low salaries to the core professional practices of the judicial system. A system of merit-based personnel management and continuous internal assessment, *eksaminasi*, was abandoned outright in the late 1960s. This caused decisions on advancement and transfer to become much more discretionary. *Eksaminasi* was an internal assessment by which senior judges evaluated decisions of junior judges through rounds of debate and instruction, and the outcomes, which were published, would be consulted when it came time to grant promotions and transfers to new jurisdictions. The termination of *eksaminasi* was a key catalyst for the decline in the legal culture of intellectual debate and openness. Additionally, this period saw the elimination of a system of differentiated functions that helped promoted a diverse skill-set within the judiciary. "The system of differentiate functions was replaced by a uniform hierarchical concept, in which advancement and seniority in the court hierarchy became identical" (Pompe 2003:16). The judiciary was further hit by a growing absence of professionals that could speak Dutch, the language in which still many of the laws, and much of the legal tradition was drafted. The language was eliminated form the education system in 1957, and by the 1970s a generation that had never known that language, and therefore had no link to its own legal tradition, started their professional career.[45]

[45] Personal Communication, Nono Makarim.

As the economy started to take off in the 1970s with the onset of the oil boom, the discretionary system of advancement and irregular rotations began to take their toll on the integrity of the legal system. Judges were exposed to political pressures and manipulation, and some feared being transferred to unfavorable locations, while others began occupying coveted positions for extended periods of time. The overall effect of these developments was three fold. First, patronage networks emerged in the judiciary; second, an institutional atmosphere of deference and sycophancy emerged; and third the independence of the judicial system was undermined (Pompe 2003:17). In fact, the judiciary did not find the State guilty in a single major case brought before the courts until *Reformasi,*[46] often times because Soeharto himself played judge and jury for important cases.[47] In 1972, corruption rose to the level of the Supreme Court for the first time, where as it previously had occurred only in lower-level courts.

Investing in the legal system was perhaps one of the greatest missed opportunities of the 1970s. While the windfall of oil revenues were pumped into health, education and infrastructure, the judicial system was left to decay, literally. A fact-finding mission conducted by parliament in the late 1970's found that the physical infrastructure suffered from severe dilapidation. They were found to be missing typewrites, toilets, and even roofs. In some jurisdictions courtrooms were absent all together, leaving judges to hold court in borrowed space; and some judges were effectively homeless, so had little choice but to live in their offices (Pompe 2003:20). Systemic under-funding of the judiciary took its toll on the "soft" infrastructure of the legal apparatus – the skills, integrity and accountability of its professionals. Judges lacked basic reference materials[48] and a court library;[49] there was no system of professional upgrading and training; and routine transfers could not be afforded, thus increasing the *ad hoc* and incidental nature of personnel management. Under funding became inextricably linked to corruption. Estimates suggest that state funds cover only 30 to 40 percent of the judicial systems routine budget[50], and thus court personnel were forced to rely on other off-budget funding sources - gifts, bribes, and levies - to meet institutional needs. Indeed, the judiciary is still considered as one of the most corrupt institutions in the country.[51] Finally, under-funding negated the need for a formal budget and thus undermined short and long-term planning, the efficient allocation of resources, and the judicial system's accountability to the central government and its constituents for the use of funds.

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[46] An early attempt to expose corruption in government foundered under pressure from the President. In January 1969, Soeharto appointed a "Commission of Four" to investigate corruption in government (Pertamina was a primary focus). A few months later, the press leaked results that corruption was widespread throughout government which prompted Soeharto to announce that (only) two corruption cases would be tired in court after which he closed the anti-corruption commission.

[47] For example, on the heals of the Pertamina debacle Soeharto honorably dismissed Ibnu Sutowo, and seven other directors, but Adam Schwarz writes that it was only Soeharto's personal loyalty to Sutowo that saved him from being prosecuted for the mismanagement of public funds (Schwarz 1994:44). In July 1978 the Attorney General's office concluded it's investigations of Pertamina and Ibnu Sutowo was not charged.

[48] "In almost four decades, since independence the courts only received books twice." (Pompe 2003:20).

[49] The courts lack a library until 1985, when on e was begun under a Dutch legal assistance program. (Pompe 2003:20).

[50] Pompe 2003:21 footnote 27.

[51] See Chapter 5, World Bank 2003.

Institutional arrangements further undermined judicial autonomy. In 1970 an important step was made to consolidate and update the 1964 statutes regulating the judiciary. Article No. 14 of the new Basic Law on Justice emphasized the principle of independence to a greater extent than before by prohibiting “all interference in judicial matters by persons outside the Judiciary, unless authorized by the Constitution itself” (Thoolen, 1987). Unfortunately, four realities negated the reform’s practical impact. First, the courts still fell under the jurisdiction of the Executive branch, which, through the Ministry of Justice, controlled the courts’ budgets and the posting, transfer and promotion of court members. Second, the president had broadened the scope of powers of the Operational Command for the Restoration of Security and Order (KOPKAMTIB), making it the most powerful actor in the legal landscape. KOPKAMTIB had authority across a wide range of civil law, including the prerogative to imprison and interrogate. Third, the president established with Presidential Decision No. 82 of 1971, the mandatory membership of public officials in a professional function group (KORPRI), which put judges under the supervision of a second ministry, Home Affairs. Finally, the military became increasingly involved in the legal system, not with enforcement, but in the most authoritative courts themselves. In 1987 a study by the International Commission of Jurists found that former military officers constituted one-third of the 47-member Supreme Court branch (Thoolen 1987:61-62). These institutional arrangements made it almost impossible for judges to act autonomously in cases unpopular with the government.

As the private sector began to grow in the 80s, requiring a more rules based society, economic actors by-passed the courts, due to the lack of certain and equitable dispute resolution. (World Bank 1989:75 and 1997:136, 137). According to a 2002 survey of businesses and households regarding the Indonesian legal system, of business respondents who had settled disputes in the last five years, a little over a quarter of businesses reported using the courts and business association and less than 20 percent used formal mediators or lawyers. While formal institutions played a role in conflict mediation, informal institutions were relied upon with more frequency such that 41 percent or business respondents had relied on family and friends to solve disputes and 27 percent had relied on community and religious leaders. Over the decades Indonesian society had learned not to rely upon the legal system for dispute resolution and frequently turned to informal community and religious leaders to resolve disagreements. The sidestepping of the court-system resulted in the government’s loss of its monopoly on the use of violence. The frequency of vigilante and mob justice for alleged thieves, land disputes and adultery testified to the weaknesses of governing institutions, particularly the weak judiciary and law enforcement (Welsh 2003).

The lack of trust and credibility in the legal system are directly related to corruption. According to a survey 44 percent of business enterprises ranked the high unofficial costs as the most significant obstacle to using the courts. By comparison, 42 percent of households cited “judges would make unfair decisions” (Partnership 2003:22, 23). Beyond business interests, lack of legal certainty also hurt the poor who were at the mercy of corrupt police, prosecutors, and court officials, and whose voice would not carry as far in the local elite dominated informal dispute resolution mechanism that most Indonesians relied on because of the inadequate justice sector (World Bank 2003e:5).

Aside from the judiciary itself, the legal framework needed for an increasingly sophisticated economy that ensued after the 1980s reforms only slowly came about. Most basic laws, including the Commercial, Penal and Civil Procedure Codes dated back to the colonial period with periodic updates formulated latently in response to changing economic conditions. Indonesia's Commercial law was grounded in the Dutch Commercial Code of 1847 – the *Kitab Undang-Undang Hukum Dagang*. It was supplemented by new and revised statutes like the Financial Institutions Decree in 1988, the Banking Law in 1992, Company Law in 1995, Capital Market Law in 1995, and Small Business Law in 1995. These fundamental legal guidelines for market activity came after, not in advance of, or in tandem with, the financial liberalization policies of PAKTO, PAKDES and PAKMAR (1987 to 1989). When it came to resolving insolvency disputes, investors could only rely on the archaic Dutch bankruptcy law of 1905, and as would be expected, they relied on the provision only rarely. A new bankruptcy law was not instated until 1998. Other notable gaps existed in the accounting framework for financial institutions and meaningful provisions for intellectual property rights, competition, and secured transactions. Lagging legal provisions were due in part to an antagonistic relationship between the ministries of economics and the ministry of justice. The lack of cooperation between these ministries lead to poor sequencing of needed regulation and legal codes for economic activity.[52]

When the National Planning Board (Bappenas) led a comprehensive assessment of the Indonesian justice system in 1996, Bappenas concluded that the situation was "desperate, but not hopeless" (Kassum 2003). That year, a noted human rights lawyer, Trimoelja D. Soerjadi, estimated that over 90 percent of judges were corrupt; and a High Court judge, Adi Andojo Soetjipto, who had exposed corruption within the court system through a leaked memo, was threatened with dismissal by High Court Chief Soerjono. Soerjono had made a recommendation for Soeharto to dismiss Soetjipto.[53] When considering the severe problems within Indonesia's legal system, it is important to remember that practices and not the legal statutes emaciated the authority of the law and the judiciary. The legal precedent for the independence of judicial power, "free from government interference," and the status of judges as "guaranteed by law" in fact are protected by Articles 24 and 25 of the 1945 Constitution.[54]

E. An Underfunded Civil Service

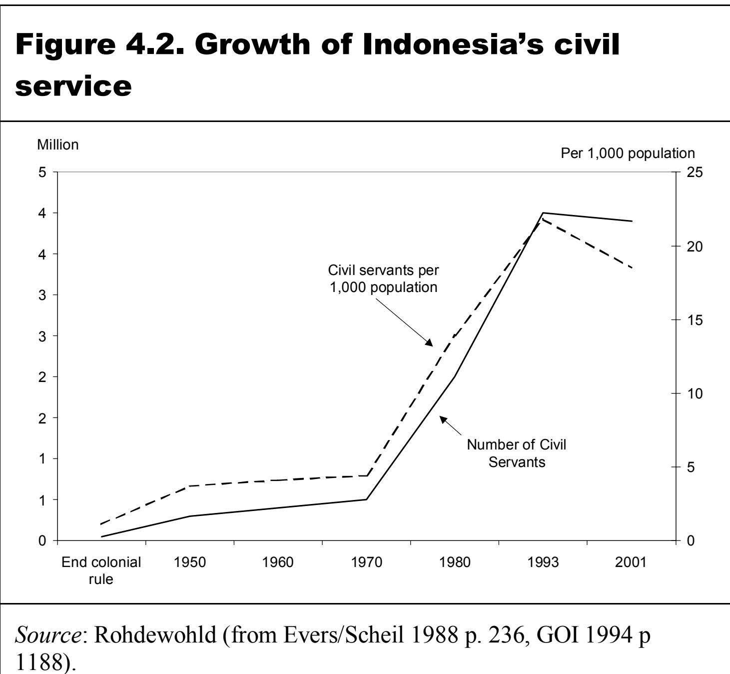
As with the judiciary, problems of under-funding undermined the quality and integrity of the rest of the civil service. However, in the 1970s the government appeared to be a munificent benefactor of the fledgling service. Law number 8 of 1974, created the legal basis for the civil service, and signified a move away from the politicized civil service of the Soekarno era. The law describes the rights and obligations of personnel who are divided into three categories – central government civil servants, civil servants of the autonomous regional governments, and other civil servants (Rohdewohld 1995: 93-94). The growth of the civil service was linked to specific

[52] Interview with an Indonesian economic policy maker.
[53] *Inside Indonesia* 1996.
[54] "The 1945 Constitution of the Republic of Indonesia," Department of Information , Republic of Indonesia 1989

political and economic periods and reflects the changing patterns of the states activities (Rohdewohld 1995:98). The civil service expanded rapidly during the 1970s as the government made heavy investments in education, health and physical infrastructure. Increases in the recruitment of teachers, medical doctors and engineers had an enormous impact on the ranks, which swelled from 525,000 people in 1970 to 2 million in 1980. By the standards of other countries in Southeast Asia, the size of Indonesia's civil service remained modest. In its peak year, 1993, the Indonesian government employed 4 million civil servants, or 21.8 people per 1,000 inhabitants; compared to 393,000 civil servants, or 4.1 people per 1,000 inhabitants, in 1960 (Rohdewohld 1995: 98, and Figure 4.2). By the standards of other countries in Southeast Asia, the size of Indonesia's civil service, excluding the military and the police, is a relatively small percentage of the population (2 percent), but it is proportionately the same size as the civil service of the other larger Asian developing countries, India and China (World Bank 2003:1).[55]

After almost ten years of rapid expansion both in the economy and the civil service, the World Bank's 1979 report on patterns of growth and social progress commented that "the bureaucracy has not overcome the deficiencies of the previous regime, and is dealing with an expanded and more complex economy, vastly increased levels of government spending and increased responsibilities which followed in the wake of financial crisis of Pertamina." The report goes on to state "it requires little exaggeration to say that the need to raise the general level of efficiency and reliability of the government bureaucracy remains one of the highest national development priorities. Discussion of Indonesia's development needs without drawing attention to this important constraint would be futile" (World Bank 1979:18-20).

Figure 4.2. Growth of Indonesia's civil service



Source: Rohdewohld (from Evers/Scheil 1988 p. 236, GOI 1994 p 1188).

Skills deficit. The civil service suffered from a scarcity of skilled and experienced technicians and managers, which helps explain a second trait; highly centralized decision making of a top-down nature. Combined, these factors contributed to the over-burdening of a limited number of top officials and thus a tendency to prioritize 'short-term issues management' over 'long-term planning.' The lack of bureaucratic, civil managers also benefited the military. The

[55] Since the end of the oil boom, however, the Indonesian government reduced the intake of new entrants into the labor force. As a result, unemployment of high school and university graduates increased rapidly, as they could not be absorbed rapidly in the private sector.

military regarded itself as an apparatus trained in management, and maneuvered to run to civil service jurisdictions, like customs, tax collection and state owned enterprises, as was previously mentioned in the discussion of *kekaryaan*, or cadre-isation of the civil service. .

Centralized decision making. Highly centralized decision making contributed to reduced accountability, retarded the development of public infrastructure, adversely effected rates of return on public sector projects, and constrained the development of local institutions (World Bank 1993:1). It also had the effect of stifling initiative and the development of decision-making capacity at the lower levels of service. The loyalty to the Government was enforced through obligatory membership in KORPRI, the sole civil service union, through which each a civil servant automatically became a member of Golkar. As the oil boom years came to a close and the economy was restructured toward non-oil export-led growth, the rapidly evolving economic landscape and the need to better service the country's diverse regions exerted additional pressure on the limited number of top managers and decision makers in the centralized structure. Beginning in 1987 *ad hoc* adjustments were made, which mainly saw a modest increase in the number of mid-level managers. However, it was not until Soeharto's 1992 Budget Speech and through a regulation on regional autonomy issued in August 1992 that the government indicated it was interested in developing a coherent decentralization program (World Bank 1993:3) to broaden the scope for managing the affairs of a large, geographically and ethnically diverse state.[56] Major progress on the devolution of authority was not realized until 1999 with the passing of decentralization laws 22/1999 and 25/1999.

Salaries. A complex and opaque system of base salaries and other monetary and in kind supplements constituted the civil service salary structure. The salary structure was built upon a base-line salary to which bonuses (for example for Idul Fitri), benefits (like rice and medical care) and non-standardized allowances (cash and in kind supplements such as rice) and project management fees were added. The complexity and lack of transparency in the remuneration system made calculating the government's exact expenditure and the actual value of wages received difficult. The civil service constitutes the second largest component of the central government budget's expenditures, but estimates suggest that in order to arrive at the real value of government expenditures on personnel, 30 to 40 percent of Development expenditures must also be added to the official budgetary figures. These development project funds are used to finance short-term undertakings, and to provide allowances and other honoraria, which augment the base-line salaries (World Bank 1993:21 and Rohdewohld 1995:100).

One source of the low quality bureaucracy was the wage differential between private and public employees with similar education and experience. Higher salaries hold the potential to attract professional and skilled candidates to the private sector, away from the public sector. According to 1998 salary data collected by *Asiaweek,* Indonesia's civil servants earn approximately 40 percent of what employees with similar backgrounds make in the private sector. By comparison, this is more than China's civil servants who earn approximately 20 percent of that offered in the private sector (20 percent), but less than Malaysia, the Philippines and South Korea

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[56] Repelita III (1979/80 to 1983/89) indicates that the government intended to strengthen local authorities by giving them added responsibilities for the formulation and execution of development projects.

(70 percent) and Thailand (60 percent).[57] The low salaries were in part reflective of the prevailing development philosophy: the wage bill was part of the recurrent budget, and keeping it low would enable more spending on "development."[58]

Low base salaries contributed to "projectism," "moonlighting" and corruption. *Projectism* refers to the neglect or reformulation of routine activities, which do not attract a bonus or allowance, in pursuit of *proyeks* that do. It leads to a "rather erratic, incremental and spontaneous way of work which is dictated by the supply of domestic or foreign project funds" (Rohdewohld 1995:102. Moonlighting refers to the undertaking of profit-oriented activities outside the workplace, or even in the workplace using government provided facilities for private business. This is in direct violation of Government Regulation No. 30/1980 and is a particular problem in the provision of health services (World Bank 1994). Third, low salaries also increase incentives for taking illegal surcharges and levies for the provision of standard administrative services, such as birth certificates and drivers licenses.

As banking and financial activity surged, expert recommendations continued to focus on macroeconomic, trade, banking and financial policies but also focused on the "hidden cost of doing business." In May 1997 a Bank report on economic development made a useful distinction, emphasizing the need for both quality "hard" and "soft" infrastructure to sustain development. It characterized "soft infrastructure" as the incentive framework, business practices and legal and other institutional arrangements. Soft infrastructure determines the risks and rewards of various activities and thus investment, employment and the efficiency with which resources and technology are used. Decreasing the cost of doing business in Indonesia would be a lengthy process entailing a combination of policy and institutional reform to improve the accountability, openness, and transparency of business practices and of the civil service. In addition, emphasis fell on the need for good governance, and the need to upgrade the legal system and the civil service in order to further trade deregulation, improvements in the financial and banking institutions, and better management of natural resources. These were not new recommendations, but they attained new urgency as economic developments outpaced the quality of institutional underpinnings.

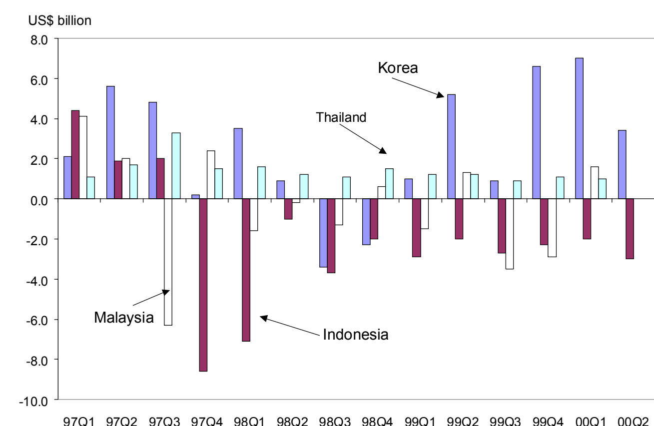
[57] Note that the 1998 numbers are distorted by exchange rates. Thus, one can only tentatively make a comparison across countries in terms of civil service salaries in relation to private sector salaries, *not* a comparison in absolute amounts.
[58] Filmer, based on 2001 data on civil service salaries and labor market data, finds no difference between the civil service and the general labor force, once corrected for education and experience. This could explain why also in the private sector it s common to use one's office for private gains beyond ones' salary.

5. The Crisis

Few predicted the Indonesian crisis, and none its severity. While some observers expressed concerns about the economy's growing vulnerability, rising debt, and appreciating currency, this concern was far from predictive of a crisis. Moreover, it was hard to argue with Indonesia's growth, which amounted to more than 7.5 percent in 1996. Indeed, until just before the crisis, the authorities' were concerned about the strength rather than the weakness of the Rupiah, which had kept close to the lower end of the intervention band (Figure 5.1.). But what started as contagion from the speculative attack on the Thai Baht soon became the deepest crisis of Indonesia's history. Indonesia was singled out for special punishment by the capital markets, and nowhere was the reversal in capital flows so sharp, and so prolonged as in Indonesia (Figure 5.2.).

The crisis deepened despite the early corrective actions that the authorities took to stem the growing outflow of capital. Unlike in some other crisis countries, these measures which at the time were first seen as yet another example of the skillful macroeconomic management for which Indonesia was known, came well before the country ran out of foreign exchange reserves. In reaction to the increasing pressure on the Rupiah, the authorities first increased the intervention band from 8 percent to 12 percent on July 11, 1997, and when this did relieve pressure on the currency, the Rupiah was floated on August 11. The newly floated currency fell to a level of Rp. 3000 to US$1, or a depreciation of some 30 percent compared to the pre-crisis level. At the same time, a monetary contraction -- in part induced by the move of state enterprises deposits to the central bank in a repeat of the 1988 "*Sumarlin Shock*"-- drove up interbank interest rates to over 80 percent. Additionally prudent fiscal constraint was demonstrate with the announcement that some 150 large scale public investment projects, including power plants and highways, would be postponed.

Figure 5.2. Private Capital Flow to Asian Crisis Countries, 1997-2000 (US$ billion, selected countries)

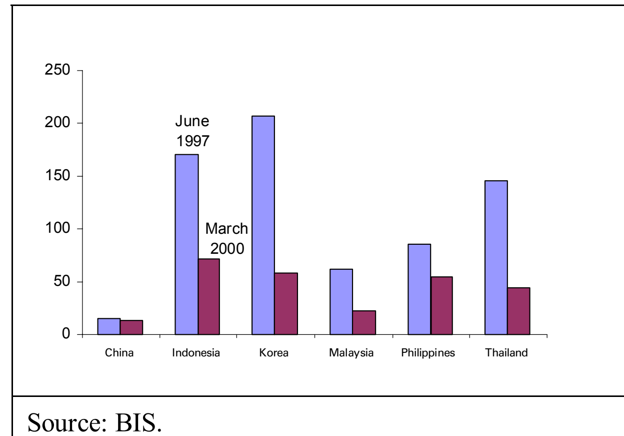


Source: BI, CEIC.

The measures did not stem the outflow of capital. The driving force at that stage was the need for heavily indebted enterprises to cover their unhedged foreign exchange exposure. A decade of relatively stable exchange rates, combined with high domestic interest rates (due to a policy of sterilization of foreign capital inflows) had greatly increased foreign debt, and an increasing share was short term. After Korea, Indonesia had the highest share of short term debt to reserves of the Asian crisis countries (Figure 5.3.), and with the floating of the Rupiah and the halt of

renewed capital inflows, firms were scrambling for exchange risk cover, which put continued pressure on the Rupiah. However, the authorities were not aware of the extent of exposure of firms: indeed Indonesia's capital account had been so open so as to not require registration of foreign borrowing by private firms. In addition, the contraction of liquidity in the banking system failed, as many banks were unable to meet their interbank clearing obligations, and had to be supported through BI liquidity facilities. With hindsight, the exchange rate policies followed by Indonesia for over three decades—first a fixed exchange rate, later a crawling peg in a band—may have been no longer suited for the early 1990s, which saw a sharp increase in international capital flows. Indonesia, as many other countries, did not try to restore a fixed or pegged system after the crisis, and the conventional wisdom has become that a country should either have an irrevocably fixed exchange rate—such as Hong Kong—or a freely floating one.

Figure 5.3. Vulnerable at the onset (short-term external debt as a percentage of international reserves)

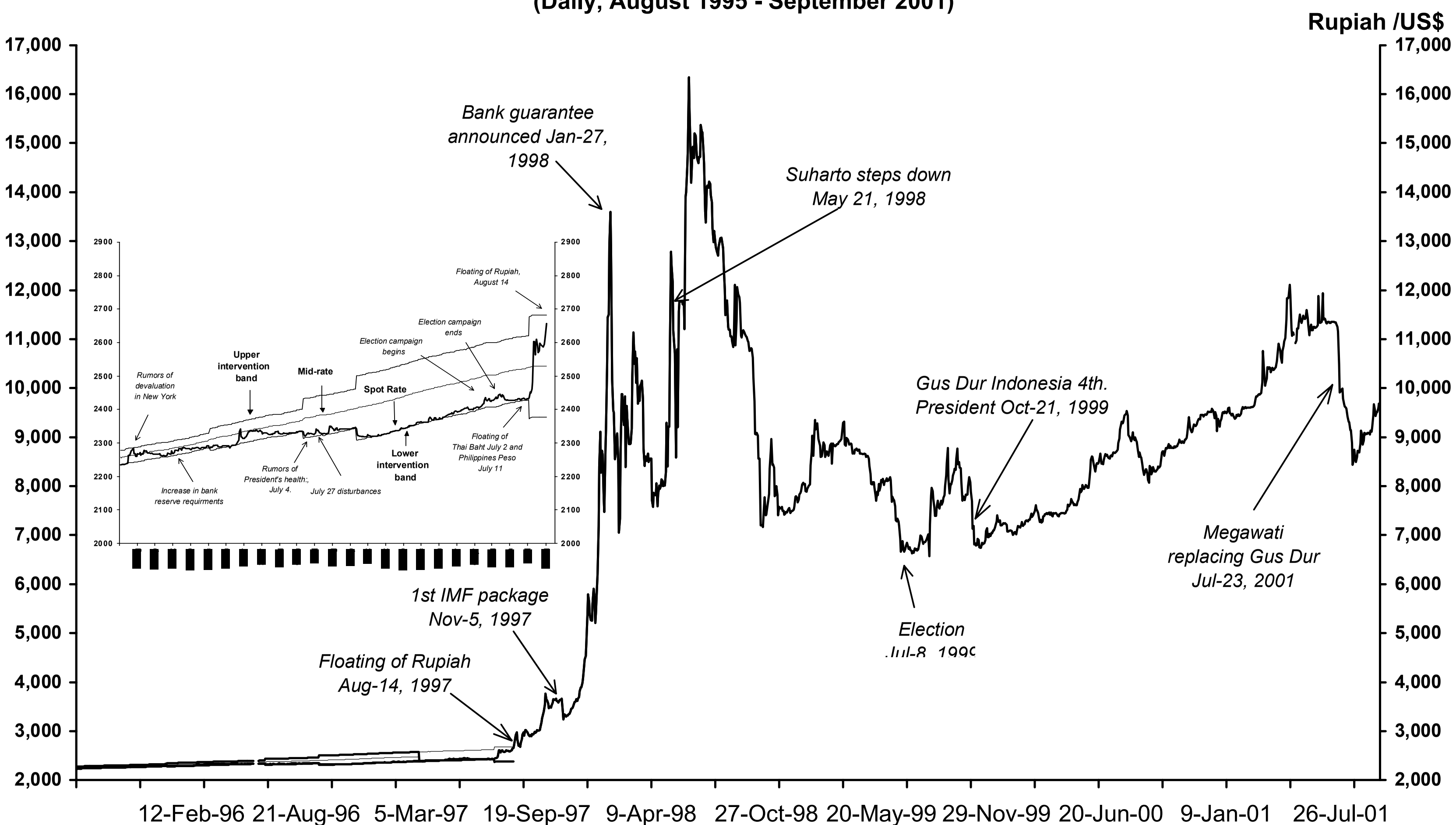


Source: BIS.

The first IMF program. Early October 1997, it was decided to call in the IMF for program support, for the first time since 1973.[59] The first IMF program was agreed upon on October 31, and approved on November 5, 1997. The program aimed for a modest tightening of fiscal and monetary policy, while structural measures focused on resolving weaknesses in the banking system.[60] An investigative team identified that out of 264 banks in Indonesia, 50 were vulnerable, among which 34 were insolvent, including 26 private banks, 2 state banks, and 6 regional development banks (IMF IEO, p. 126). Under the November program, 16 banks were to be closed, including one bank owned by Soeharto's son, while some 34 others were to continue their "nursing arrangements" with BI. BI had claimed that these agreements could not be broken. With the closure of the banks, a limited deposit guarantee was announced, which covered all deposits up to Rp. 20 million, or about $6,000 at the prevailing exchange rate. The bank closures themselves were carried out smoothly, and the package gave temporary relief to the Rupiah, which recovered slightly. But then the program rapidly unraveled.

[59] Of course, the IMF had advised the authorities on a number of occasions in the past, but never had there been a formal IMF-supported program in Indonesia.
[60] See IMF IOD, 2003, IMF and Recent Capital Account Crises, Indonesia, Korea, Brazil, Washington DC, July. The Letter of Intent to go with this program was never published.

Figure 5.1. Indonesia's crisis as seen through the lens of the Rupiah



Source: Bank Indonesia.

Source: World Bank 1998 and Update.

Policy Reversal. The trigger for the failure of the first IMF supported program was most likely the effective reopening of one of the closed banks—the one owned by Soeharto's son. The operations of his Bank Andromena were effectively shifted to a newly acquired small bank, Bank Alpha. This shed doubts on the authorities' resolve to forcefully address the weaknesses in the financial system, doubts that were further fed by an announcement by the Finance Minister by end-November that no more bank closures were to take place. In addition, the public knew that more banks in the system were bad, but did not know *which ones*, nor was it made clear to them that the reason why these banks were not closed was the "nursing agreement" which was supposed to bring these banks back to health—this was stated in the LOI, but this document was not public (Enoch et al, p.31). This uncertainty combined with the limited deposit guarantee, caused a massive withdrawal of deposits from private domestic banks, which were largely transferred to state owned banks that were seen to be implicitly guaranteed by the State,[61] in addition to being used for further speculation against the Rupiah.

Political Concerns. Rupiah selling accelerated in mid-December, when the President cancelled an overseas trip, and rumors about his health started to circulate. As the World Bank wrote (World Bank 1998:p1.8) "The combination of a financial crisis, an upcoming election, and an ageing sick President ratcheted uncertainty to yet an unprecedented level." The issue of Soeharto's succession may have played a broader role in the crisis. While no data are available on this, it may well be that a significant part of the Rupiah selling came from people closely connected to the Soeharto regime, which started to prepare for a life without him. Indeed, even before the crisis, this had already induced capital outflows of connected businessmen on a moderate scale, at that time under the banner of "international diversification."[62] Soeharto himself had been aware of the problem of succession before, and in 1996 he had expressed that "there is a need for a need to prepare a new leader" (Elson, 2001, 289), but had not acted upon it. Soeharto's decision to run for a sixth term on January 20 1998 cost the Rupiah some 10 percent in value, although part of this loss may have been explained by the announcement on the same day of the Vice Presidential candidate, B.J. Habibie, a "technologist" known for his expensive high-tech ventures, notably the national plane project.

Fueling Rupiah Speculation. Pressure on the Rupiah was fed by the liquidity support the central bank gave the ailing banking system. By the end of November 1997, two thirds of all banks had experienced withdrawals of deposits in an amount surpassing their available liquidity (IMF IEO, 2003, 127), and in order to keep them open, Bank Indonesia had provided them with liquidity credits, which amounted to a total of some Rp. 128 trillion between November 1997 and March 1998, almost three times the size of base money in mid-1997. Contrary to prevailing regulations, much of the liquidity support was not backed by proper collateral. Furthermore, the receiving banks abused much of the support: an investigation by the supreme auditor in the year 2000 concluded that Rp. 138 trillion of the liquidity support was uncollectable, and Rp. 84.5 trillion was improperly used (Table 5.1.).

[61] To a lesser extent foreign banks also benefited from the "flight to safety"
[62] Interview with an Indonesian economic policy maker.

Table 5.1. Irregularities found in the use of liquidity credits

Type of Irregularity	Rp. trillion
Payment of derivative contracts	22.5
Payment of liabilities to related parties	20.4
Cost of financing credit expansion/withdrawal of commitments	16.8
Amount spent on financing other items	10.1
Amount spent on interbank money market placements	9.8
Payment of third parties funds violating the stipulation	4.4

Source: BPK Audit, as quoted in Kouw (2002).

Attempts to restore credibility. The second IMF-supported program was designed to restore the credibility of the Government. This credibility had received another blow in the draft budget published on January 6, 1998, which was considered by many to be based on unrealistic assumptions (World Bank 1998: 1.6). The program included wide-ranging measures to address the distortions in the economy created to the benefit of Soeharto's family and business partners. Unlike the November 1997 LOI, which had included some of the same measures, the January LOI contained strict timetables for implementation. Among others, the tax benefits for the National Car project of one of the President's sons, the subsidies to the national airplane industry, the clove monopoly, BULOG's import monopoly on wheat and sugar, and the plywood monopoly were all announced to be abolished. The President himself signed the letter of intent on January 15. The reasoning behind the program was that Soeharto should be seen to be willing to cut into the interest of his close associates and family members in order to save the economy. But the program failed to turn around expectations, either because the markets felt that Soeharto would not live up to his promises, or because "the absence of corporate and banking reform in the new policy package did not help" (World Bank 1998: 1.7).

Bank Restructuring. Bank restructuring plans were presented two weeks later, on January 27. The measures included a blanket guarantee for all depositors and bank creditors (except shareholder and sub-ordinate debt), the set up of the Indonesia Bank Restructuring Agency (IBRA), which was to assume responsibility for financially distressed banks, manage the assets acquired in restructuring, and implement the government guarantee scheme. The central bank also announced a more limited access to liquidity credits. By mid-February, IBRA took oversight over 54 banks that had heavily borrowed from BI, and by March took direct control over 7 of the banks, which accounted for over 70 percent of the use of liquidity credits, and closed a further 6 (Enoch, 2001:34). These steps had to be taken in the context of a "contract" with the bank owners as legal powers of IBRA and for that matter the central bank, were lacking, and an outright take-over was deemed to be impossible by the authorities. The blanket guarantee announcement immediately strengthened the Rupiah, which gained further grounds when rumors on a possible

currency board arrangement for the currency became stronger.[63] But the Rupiah fell to new depths when Soeharto's reign came to an end.

Fall of Soeharto. Soeharto's re-election on March 11, 1997, Habibie's Vice-Presidency, and the appointment of several of Soeharto's closest associates (including his eldest daughter and Bob Hasan, a close business associate) at first did not bode well. However, the "crony cabinet" showed a surprising performance in implementing the measures agreed with the IMF, and a third LOI was signed on April 6. Part of the agreement was the gradual abolishment of fuel subsidies, with an expectation that the first step to do so would occur in June, with some 5-10 percent (O'Rourke, 2002:87). Instead the President announced on May 4 a fuel price increase of 70 percent, and a concurrent bus fare increase of 67 percent, to be implemented the next day. This triggered widespread protests across the country, and in Jakarta. During one of these protests organized by the Trisakti University students, four students were shot and killed, apparently by military. This triggered three days of rioting in Jakarta, in which hundreds of people died; property, especially that of Sino-Indonesians was damaged, and unknown numbers of women were raped. In an unprecedented move, the rubber-stamp parliament called for Soeharto's resignation, and on May 21, he stepped down, making Habibie president. What had started as a financial crisis had turned into an economic, social and political crisis.

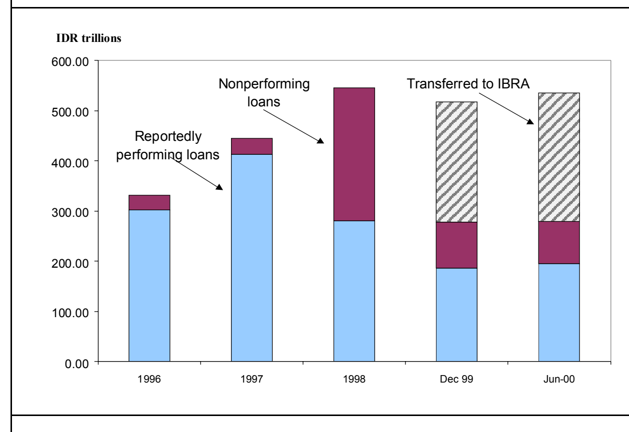
At that point, the economy was in a freefall, with GDP declining at a rate of 20 percent year-on-year. Even exports, which should have benefited from the steep fall of the Rupiah, had collapsed because of the virtual absence of trade credit. Inflation had shot up to nearly 100 percent, with even higher price increases for rice and other staples for the poor, and as a result, the poverty headcount doubled to over 27 percent. While it can be debated whether the second IMF supported programs should have addressed the broad range of interests of parties connected to the President,[64] even the narrower October 1997 program was caught in delays and policy reversals because of the interests of Soeharto and his associates. The lack of a political system outside the President aggravated the crisis when he fell ill in December, because the markets (and the cronies) could not manage the uncertainty entailed in a possible succession or change of political system altogether. It also undermined the credibility of the stabilization program itself, and thus the reversal of capital flows (upon which stabilization critically relies) never occurred while Soeharto was in power. Finally, the decay in social cohesion under the New Order can at least in part explain the widespread rioting and emergence of conflicts that had been suppressed for decades. Temple (2001) points out that one reason why participatory political systems handle crises better is because they handle political transitions better—and it seems indeed that the depth of the crisis can be explained by the difficult transition to a post-Soeharto era.

[63] The Governor of the central bank had been fired because of his opposition against the plan.
[64] IMF IEO p. 75 concludes these measures were not helpful in restoring credibility, because it is hard to demonstrate commitment to such measures in the short run. See also Blustein 2001:212.

6. Cleaning Up

After the political transition, Indonesia started to take on the difficult task of cleaning up after the crisis. Several special institutions were tasked with the clean-up, but these could not be effectively isolated from the general environment of weak institutions, and were only partially effective. By October 1998, a comprehensive solution for the banking system started to emerge. Banks that had capital adequacy ratios (CARs) of lower than –25 percent were to be closed. Those with CARS between –25 percent and 4 percent were to be recapitalized, by the state for state banks and banks taken over, and with the owners contributing 20 percent of the recapitalization for other weak banks. IBRA would take out all “category 5” debts from the banks, and the state would place bonds in the banks to recapitalize them. Due diligence showed that more than half of the bank credits fell into category 5 (Figure 6.1.), up and up to 80 percent for some state banks. The CAR rule was not applied to State Banks, which were all recapitalized, although some of them were merged, and 7 private banks taken over by IBRA also did not meet the –25 percent minimum CAR, but were recapitalized at the state’s expense because of their importance to the banking system. Weaknesses in the legal underpinnings of IBRA prevented a quick implementation, though. It took until March 1999, and a new banking law and implementing regulations before the solution could be implemented. IBRA received special powers in the course of these legal changes, which gave it the right to take over loans from failed banks without borrowers’ consent, and the right to seize assets of former bank owners, and impose travel bans on them. The latter rights were not used.

Figure 6.1. Indonesia: Banking System Loan Assets



As a result of the banking reforms, IBRA emerged as the largest creditor in the country, and owner of significant assets in banks, property, and at its peak in late 1999, IBRA had control over assets with a face value of Rp. 441 trillion, or some 36 percent of GDP. These consisted of non-performing loans taken over form banks (Rp. 234 trillion), assets pledged by former bank shareholders (Rp. 112 trillion) and investments in recapitalized banks (an estimated Rp. 94 trillion). The State also emerged as the dominant player in the banking system. In addition to the over 20 percent of deposits in the 12 IBRA banks, the state banks controlled another 50 percent of deposits. Thus, almost three quarters of the banking system was in state hands. In total, some 86 banks had been closed during and in the aftermath of the crisis, but by June 2000 there were still 161 banks left (Table 6.1).

Table 6.1. Before and After the Structure of Indonesia's Banking System

	Number of Banks		Share of Deposits (percent)	
	June 1997	June 2000	June 1997	June 2000
State Owned *	34	44	37	70
Private	160	78	57	18
Foreign and Joint Venture	43	39	6	12
	237	161	100	100

Shareholders' Settlement. Due diligence on closed banks and banks taken over by IBRA had revealed a large extent of abuse of liquidity support as well as numerous offences against the banking laws, most notably against insider lending limits and loan concentration limits. Rather than opting for criminal prosecution or civil procedures against the offending bank owners, Government, through IBRA, agreed on out-of-court settlements of the claims of the state against former bank owners. Altogether IBRA entered into 9 so-called shareholder settlement agreements. In the agreements, former bank owners pledged financial and real assets in exchange for a "release and discharge" upon settlement of their obligations. The key reason for the settlements was the weak legal system, which made it highly unlikely that the former bank owners could be brought to justice, or be forced to redeem some of the losses of the state. At the same time, it was believed that forcing the former owners to settle their claims by means of selling assets amidst the economic crisis would result in heavy losses, and sub-optimal recovery for the state. In the event, severe losses to the state occurred in any case, and the settlement of the agreements became highly contentious. The valuation of the assets pledged proved to be far off the realizable value. Moreover, ownership of the assets was not handed over to IBRA, but rather to holding companies that were jointly managed by IBRA and the former bank owners. Such a construction was deemed necessary to retain management expertise of the owners, but may have encouraged asset stripping.

Restructuring and Asset Sales. IBRA had the massive task of managing, restructuring, and selling the assets. In total, some 175,000 loan accounts were inherited from the banking system, and the sheer logistics of taking these over and administering them took some time. IBRA was quick to sell the so-called noncore assets (buildings, cars, etc.) but faced significant delays in selling off other assets. First, the legal right to sell the assets at a discount had to be settled, and impediments form the tax law had to be removed. When this was done, small loan accounts and credit card debt were sold off quickly. In addition, a special program for small and medium enterprises was set up, which gave those debtors a one-off discount on their loans gone bad. For the largest 200 accounts, IBRA planned to restructure the debts itself, but ran into the limitations of the legal system. Over 50 bankruptcy procedures were started, but IBRA lost all of them.

The failure to restructure was also due to the political support that the big debtors received. Among others, President Abdurachman Wahid, elected successor of Habibie, declared some of the biggest debtors to IBRA as "National Assets." At that time tow of the three were under investigation from the attorney general's office for abuse. The biggest debtor of IBRA, with total debt over $3.5 billion stood accused of abusing $1.7 billion from a BI facility for export

credits for buying foreign companies—which subsequently were stripped from the balance sheet. A second "National Asset" was the largest user of liquidity credits, the former owners of bank BDNI, who had drawn some $3.8 billion from the BI facility, of which BPK determined that 40 percent was abused. Political interference was also evident in the frequent change of IBRA management, and in the 5 years of its existence, the organization had no less than 7 chairmen, some not lasting more than a few months.

With the ascent of the 7th chairman of IBRA in 2001, the plans to have IBRA restructure the bigger debtors were abandoned. Instead, large portfolios of non-performing debts were auctioned off at any price above a minimum price set by the agency in the so-called mass sales programs. Bidders often seem to have a fine nose for what the minimum price had to be. Moreover, in some of the auctions, IBRA had ordered the loan packages by individual debtors, and it was rumored that several debtors bought back their loans at steep discounts, using front companies to circumvent the ban on such practices, and even finding banks willing to finance the operation. In other auctions, some banks themselves participated, and bought back the nonperforming loans with the aim to restructure. State Owned Bank Mandiri, which bought such loans, admitted after one year that it had been unable to restructure the loans, and was about to classify them as non-performing again, thereby reducing its profits, and dividends to the State. In the end, IBRA recovered about 103 trillion (excluding bonds recovery), or about 25 percent of the book value of the assets taken over from the banking system and pledged in the shareholders' settlement (Table 6.2.). At end-2003, two months away from IBRA's closure, some Rp. 100 trillion in assets still remain in IBRA, and the plans are to place these assets in holding companies after IBRA's closure.

Table 6.2. IBRA Loan Sale Program until August 2003 (Rp. trillion)

Year	Disposal Program	Book Value	Proceeds	Recovery Rate
1999	Credit card	0.1	0.0	51.2%
2000	CLS I, II and SME	7.5	2.9	38.7%
2001	CCAS III, IV-1, 2, direct selling	19.7	9.3	47.3%
2002	CCAS IV, V, PPAK, PPAK-PPL, P3AK, direct selling	110.3	28.1	25.5%
2003	PPAK 3	27.0	3.4	12.7%
	Total	**164.6**	**43.8**	**26.6%**

Note: CLS (Corporate Loan Sales) and CCAS (Corporate Core Asset Sales) are disposal of restructured loans through an open action. PPAK, P3AK are loan asset sales program.
Source: IBRA.

Table 6.3. Debtors and creditors (as of June 2000, US$ billion)

	State banks	IBRA	other local banks	Foreign banks	Securities holders	Total
State enterprises	3.5	1.7	0.5	5.3	1.0	*12.1*
Large private corporations	4.0	22.9	3.4	50.7	4.1	*85.0*
SMEs	7.2	4.2	8.3	2.4	0.5	*22.6*
Total	*14.7*	*28.8*	*12.2*	*58.4*	*5.6*	***119.7***

Source: JITF, staff estimates.

Corporate Debt Restructuring. Corporate Indonesia was deeply in debt after the crisis. Corporate debts to all creditors still amounted to about $120 billion by end-June 2000,[65] almost half of this due to foreign creditors (Table 6.3.). Three-quarters of corporate debt was distressed and in need of restructuring. Of the 233 JSX-listed non-financial companies 135 were "highly indebted" companies, and they accounted for almost three quarters of all corporate debt.[66] Discussions with international creditors to Indonesia's private companies resulted in the so-called Frankfurt Agreement of June 1998. Included in this agreement were the Indonesia Debt Restructuring Agency, INDRA, and an agreement on interbank debt. The mainstay of the agreement was to provide exchange rate guarantees on repayments on restructured debt of Indonesian corporates and banks. In the end, little use was made of the facility, as the appreciating exchange rate after the agreement rendered the terms under the agreement relatively unattractive.

In addition, the Jakarta Initiative Task Force (JITF) that was to do facilitate debt workouts on a voluntary basis was set up in November 1998. Overall, JITF is seen as one of the few successes resulting from the crisis. Over its lifetime, the Jakarta Initiative facilitated the restructuring of 102 companies with distressed debts totaling $26.91 billion. As of December 2003, JITF has successfully completed debt restructuring mediation of 96 cases with a total debt of $20.5 billion. However, this is only about one sixth of all corporate debt at the onset of the crisis. JITF was used by some of the debtors to avoid, or at least delay restructuring, and the power to refer non-cooperative debtors to the Attorney General Office, through a political oversight body, was never used.

Conclusion. At the end of 2003, Indonesia was the last country affected by the Asian crisis to graduate from the IMF program. Political stability has returned, macroeconomic stability is settling in, and growth is a hesitant 3-4 percent of GDP, still a far cry from the 7-8 percent pre-crisis growth. GDP is back to the level achieved before the crisis, but income per capita still

[65] The focus is on corporate loans of Rp 50 billion or more, which excludes commercial loans of Rp 5-50 billion and SME loans of Rp 1-5 billion as well as smaller retail loans.
[66] Defined here as companies with liabilities/equity ratios of 200 percent of more. Attainment of a 200 percent liabilities/equity ratio within 18 months was one benchmark imposed on Korea's largest chaebols by that country's Financial Supervisory Commission (FSC). Liabilities/equity is a relatively simplistic measure and it would be desirable to consider additional measures for Indonesian corporations (e.g.,

hovers 10 percent below pre-crisis levels, and GDP per capita in Atlas terms is still some 25 percent below pre-crisis peaks. The recovery also has lagged behind that of other crisis-affected countries (Figure 6.2.). The crisis has cost the State, and therefore the taxpayer on net some 40 percent of GDP for bailing out the banking system, probably the most expensive financial crisis ever recorded. The weak legal system protracted the clean up after the crisis, aggravated the losses to the state because there was no legal threat to bad debtors, and delayed the economic recovery substantially. It had also greatly damaged the sense of justice among Indonesians, who saw that most of the corrupters of the New Order era and most of those who had ravaged the financial system were outside the reach of justice.

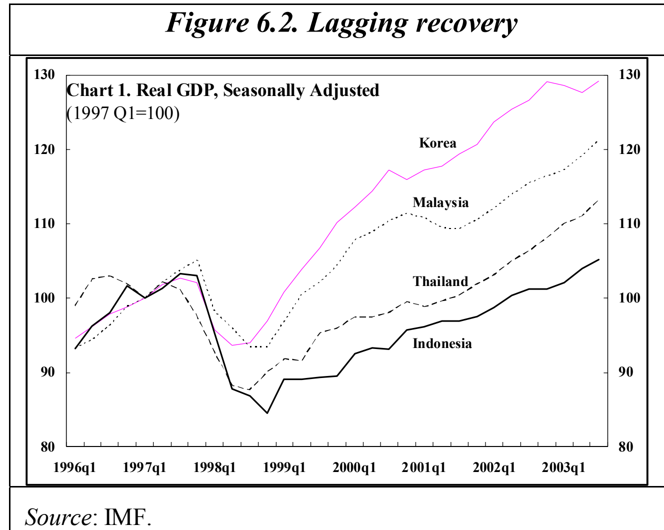


Figure 6.2. Lagging recovery

Source: IMF.

7. Lessons for Shanghai

Indonesia's development experience has numerous lessons to offer. In terms of the Shanghai framework (Table 7.1.), Indonesia was far better in providing a conducive investment climate than it was at social inclusion, although the latter was not neglected.

The country's growth success in the thirty years since 1966 was built on policies and institutions that promoted a generally conducive investment climate, although problems occurred from time to time. The country's commitment to macroeconomic stability was embedded in several key policy rules—balanced budget, open capital account—that lasted throughout the New Order. The presence of economically well-versed technocrats who could be relied upon to took over in bad times, and who were by and large isolated form political interests, provided investors the confidence that sound policies would prevail, despite regular set-backs in trade and investment policies. When the President appeared to have turned his back on the technocrats, this confidence unraveled in the crisis.

The way Indonesia reformed its economy is also of interest to other countries. First, although it has its risks, using bad economic times as a window of opportunity to get good policies in place is likely to increase a country's chance of success. Second, "packaging" measures that by themselves are insignificant, but that taken together imply a major policy move, could be attractive for other countries, they have clear political benefits, and strong signaling

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profitability, returns on investment, interest coverage), but currently available JSX data do not permit this analysis.

effects. Third, using pragmatic approaches to pressing issues—such as food security in the 1960s and 70s, or fuel subsidies during the crisis—may be preferable to more ideological policy stances.

While no star performer, Indonesia did undertake numerous policies to include broader layers of the population in its success. A prime example is the expansion of education and health services during the 1970s, as well as the agricultural development policies in the 1960s and 70s. The Village grant program (Inpres Desa) started in the 1970s is a further example of this, as well as a case of innovation and adaptation. The program, which started as a top-down grant for centrally prescribed expenditures at the village level evolved into the village improvement program (VIP) which in turn was the inspiration of the Kecamatan Development Program, the largest successful community development program in the world (see separate case study). The microfinance success of BRI, built upon the rubbles of an unsustainable subsidized credit scheme is further evidence of remarkable inventiveness of Indonesia's authorities. Rather than abandoning the 3000 BRI branches in the early 1980s, the authorities saw the value of this network, and put it to work for a better purpose: giving the rural poor access to sustainable finance.

Table 7.1. The Shanghai Framework—Lessons from Indonesia

	What to do	
How to do it	Investment Climate	Social Inclusion
Commitment and political economy	Balanced budget rule Open capital account Exchange rate system "PAKT" packaging of reforms Investment laws	Food security policy Investment in primary education, health care Direct support for villages
Institutional Innovation	Technocrats-isolation of economic policymakers from politics Paket Deregulasi (Selling small measures of reforms together) SGS (foreign company running customs)	BULOG INPRES Desa (Village Grant) BRI Microfinance Exchange rate depreciation used to benefit farmers, outer regions.
Learning and Experimentation	Using bad times for good policies Gradual introduction of major reforms Using "windows of opportunity"	From INPRS DESA to Village Improvement Program to KDP
External catalysts	IGGI/CGI Paris Club Debt Settlement Harvard Group GATT as a tool for liberalization	

Source: Authors compilation from text.

Little recognized, but perhaps as important for rural development as targeted programs, was the maintenance of a competitive exchange rate. The regular devaluations used to realign absorption also gave a boost to tradable sector incomes, and farmers and Indonesia's outer islands that relied to a much larger extent than Java on resources rather than manufacturing, benefited from the move (Woo et. al. 1994).

Finally, at critical points in time, the international community played a role. The stabilization program of the 1960s owed much to the support received by the IGGI donor group and the Paris Club. Again during the Asian crisis, rescheduling of Indonesia's debt, and large pledges by donors was critical in jump-starting Indonesia's recovery. But also in more normal times the partnership with the donor community, and policy discussions during the annual donor meeting, did contribute to Indonesia's policies and programs. It is no coincidence that the 1980s reform packages were often announced briefly before the annual donor meeting. In addition to official donors, others in the international community played a role as well. This includes the Ford Foundation that provided the scholarships by which many of the technocrats afforded their economics study in the United States back in the 1950s and 60s. And it includes a group of advisors from the Harvard Institute of Development, who, hired by the Indonesian government and based in the Ministry of Finance, advised on many of the economic reforms implemented in the 1980s and 1990s.

A different lesson from the Indonesia experience is that institutions and policies sometimes have an expiration date on them. At some time, they may work well, but external or internal circumstances may change such that their usefulness declines. A prime example is Indonesia's fixed exchange rate system, which—after the crisis—is no longer considered appropriate for developing countries in an era of increased capital flows. Another is perhaps BULOG, an agency that was highly instrumental in shaping Indonesia's successful food security policies, but became a problem because it was prone to abuse in an increasingly weak governance environment. BULOG demonstrates that it is hard to phase out such an institution even though it had lost its primary purpose. Additionally, even the extremely open capital account that served Indonesia well in the past is now openly debated, and some believe that limited restrictions on capital inflows in normal times and on outflows during a crisis should at least be considered.

Although the crisis is still to recent to draw definite lessons from, the core lesson seems to be that strong institutions matter in development in general, and during a crisis in particular. Without rule of law, an increasingly complex economy is hard to manage. Without independent oversight, the financial sector, which is required for a modern economy, becomes an inevitable disaster. Without popular participation in political decision-making, the increasingly difficult choices a government must make may lack the legitimacy needed to assure their effectiveness. And without a clean, efficient civil service, implementation of those policies and their effects may diverge strongly from what policymakers intended. As noted before, strong institutions are most needed when they matter most—in times of crises. Absence of strong institutions outside the President undermined Indonesia's ability to manage the crisis, and as a result Indonesia's crisis became deeper and costlier than in other affected countries. The stopgap institutions to manage

the crisis—IBRA, commercial courts—had to operated in the weak institutional environment, and as a consequence, they were only partially effective.

The new institutions set up in the aftermath of the crisis will take time to gain credibility. Indonesia is now in a difficult transition to a democratic, more decentralized state, and it is building the institutions that go with it, and remarkable progress has already been achieved. Free elections were held in 1999, and a new President was elected in November of that same year by Parliament. The constitution has been amended three times, limiting presidential powers, and providing for a completely new political system. For 2004, direct presidential elections are planned for the first time in the country's history. The military will no longer hold reserved seats in the Parliament for which elections were held in April of this year. Additionally the police are no longer part of the military. A radical decentralization program took off in 2001, handing much of the responsibilities of the state to the over 400 local governments. With decentralization, the much-derided village law of 1979 was abolished. An anti-corruption commission has just taken office, and all state officials are now required to report their wealth. New laws on the judiciary will make it independent from government, and judges are to be selected by a judiciary commission rather than being appointed by the President. New laws on state finances aim for more transparency and accountability in the way government manages taxpayers money, and new banking laws and a new central bank law that grants independence to this key institution give some assurance that abuses of the past are less likely to happen in the future. A free press and media are thriving, and a wide range of civil society organizations and NGOs has sprung to life.

Implementing all these legislative changes has proven to be difficult, and not without setbacks. Indonesia is still known as one of the most corrupt countries in the world, ranking 96 out of 106 countries in Transparency International's 2003 report. The judiciary is seen as widely corrupt, and capable of protecting its own. Decentralization has handed power to local officials, many of who are remnants of the New Order, and some of who see their newly gained powers and finances as an opportunity to enrich themselves. Indeed, corruption and absence of rule of law are the main barriers to investment, which the country needs in order to grow faster. And while the banks are stronger than before, they have recently been rocked by several scandals that seem not unfamiliar to the days of the New Order. With a free press eagerly reporting on all of the deficiencies in the new Indonesia, one could easily get the mistaken impression that things are worse than before. In fact, the problem is that the level of accountability that is characteristic of well-functioning institutions has yet to match the present level of transparency.

All of this is hardly surprising, as over thirty years of neglect cannot remedied in just a few years. If there is one final lesson that the Indonesian experience offers it is that a country cannot start early enough with the building and nurturing of strong institutions. As one cabinet minister expressed pointedly, "Lasting investor confidence comes from strong institutions…There is no such thing as *development first, institutions later,* development *is* the development of institutions."[67]

[67] Laksamana Sukardi, Minister of State Enterprises at the Euromoney Conference. Bali, December 6-7 2003.

Annex Table: Chronology of Indonesia's Major Economic and Political Events, 1965-2003

1965	
September 30	Attempted coup by "September 30" movement
October 14	Soeharto appointed army commander
1966	
March 11	Soekarno hands over power to Soeharto through the "Supersemar" decree
July 27	Ampera Cabinet,
September 28	Indonesia readmitted to United Nations
October 3	Economic stabilization plan. Reduction in fiscal deficit, devaluation, dual exchange rate market, credit limits
	First Paris Club rescheduling
1967	
January 10	Foreign Investment Law
February 22	Soeharto Acting President
	Banking Law
August	Indonesia founding member of ASEAN
September 17	Multilateral conference in Tokyo on Indonesia's debt
1968	
March 27	Soeharto sworn in as President
June 6	First "Development" cabinet sworn in
	Central Bank Law
	Foreign bank branches allowed
	Increases in time deposit interest rates
	Domestic Investment Law, providing similar incentives to domestic investors as
	Foreign investors
1969	
April 1	First Five Year Development Plan
September 16	West Irian declared autonomous region of Indonesia
November 22	General Elections Law Passed
	Investment credit program established
1970	
January	Student protest against corruption
January 31	"Commission of Four" against corruption appointed
April	Removal of foreign capital and exchange controls, exchange rate unified,
June 21	Soekarno dies
	Paris Club Agreement based on "Abs report" reschedules $3 billion Soekarno era debt for 30 years
	Basic law on judicial powers. Implementing regulations not completed until 1994.

1971	
July 5	First New Order elections. Golkar wins with 63 percent of the vote
	Social insurance schemes for civil service, army, general public established
1972	Nonbank financial institutions established
1973	First OPEC price hike
January 8	Muslim parties merged into PPP
January 10	Non-muslim parties merged into PDI
March 23	Soeharto elected for second term by MPR
March 27	Second Development Cabinet sworn in
August 5	Anti-Chinese rallies in Bandung
	Bahana established to provide seed capital for indigenous Indonesian entrepreneurs
	Law on State Audit passed
1974	
January 15	Malari riots against foreign investment during Japan prime minister Tanaka's visit.
February 15	Regulation on foreign leasing companies
April	Credit ceilings on banks
	Civil service Law passed (Law 8/74)
	Decentralization law passed (Law 5/1974, never implemented)
	Closure of 12 publications, including newspaper *Indonesia Raya* and *Pedoman*
1975	
February	Pertamina crisis starts. Total debt over $10 billion
December 7	Invasion of East Timor
1976	
March 3	Director of Pertamina dismissed
July 17	East Timor "integrated" in Indonesia
December	Investment Coordination Board BAPEPAM established
1977	
May 2	Second New Order election. Golkar wins with 62 percent of the vote
August 10	Jakarta Stock Exchange opens
December	Reduction in Bank reserve ratio from 30 to 15 percent
1978	
January 20	Closure of leading newspapers, troops sent on campuses
March 22	Soeharto elected for 3rd term
March 29	Third Development Cabinet appointed
November 15	Devaluation of the Rupiah with 50 percent against the US$
	Campus Normalization Law
1979	Second OPEC oil price hike
1980	
May 13	Petition of 50 former generals criticizing Soeharto
1982	Decline in oil prices
March 18	Election riots

May 4	Third New Order elections. Golkar wins with 64 percent of the vote.
1983	
January	Budgetary retrenchment measures to scale back large investment projects
March	Beginning of "Petrus" killings of alleged criminals
March 11	Soeharto elected for fourth term, named "Father of Development" by MPR
March 16	Fourth Development Cabinet appointed
March 30	Devaluation of Rupiah by 38.5 percent against US$.
June 1	Elimination of bank credit ceilings and
July	Interbank market established
September	Tax reforms. VAT, global income tax introduced
	First bonds listed on stock exchange
1984	
January	Introduction of central bank certificates (SBIs) as money market instrument
September 12	Tanjung Priok shooting kills dozens
1985	
March	Membership of GATT
May	All social organizations required to adopt Pancasila as sole foundation
	Introduction of SBPU (short term money market instrument) rediscount facility at central bank. State-owned Export Insurance Company established
November 14	Soeharto addresses FAO. Honored for Indonesia's achievement of food self-sufficiency
1986	Oil prices decline
April	Transfer of customs transactions above $5000 to Societe Generale de Surveillance (SGS) through PT Surveyor, a state-owned company.
May	PAKMEI, reforms including simplification of investment approval process from 26 to 13 licenses, foreign ownership up to 95 percent, introduction of a duty exemption and drawback scheme to promote non-oil exports.
September 12	Devaluation of Rupiah by 45 percent
	Popular newspaper *Sinar Harapan* banned
1987	
April 23	Fourth New Order Elections. Golkar wins with 73 percent of the vote.
June	"Sumarlin shock" banks required to buy back SBPUs, state enterprises required to put deposits at central bank.
December 23	PAKDES I, deregulation of industry, trade, investment, and capital markets.
1988	
March 11	Soeharto President for fifth term
March	Fifth Development Cabinet Appointed
October 27	PAKTO major banking reform and deregulation. Reserve requirements dropped from 8 to 2 percent.
December 20	PAKDES II: NBFIs authorized and regulated. Foreign ownership in securities companies allowed, State-owned investment bank Danareksa's privileges limited.
1989	
March	PAKMAR refines and adjusts PAKTO. Surabaya stock exchange established.
May 1.	Bank and NBFI foreign borrowing limit abolished, net open position regulated

October	Establishment of TPPM to oversee capital market
	Establishment of censorship board
1990	
January	PAKJAN, reduction in subsidized credit programs, domestic banks required to lend 20 percent of total to small and medium enterprises
August	Bank Duta, owned by Soeharto-chaired foundations, reveals losses, bailed out by Soeharto business partners
August 8	Normalization of relations with China
December 5	ICMI, organization of Islamic intellectuals established, led by Research and Technology Minister Habibie
1991	
April	Establishment of Democracy Forum, a group of Soeharto critics led by Abdurachman Wahid, chairman of NU
February 27	PAKFEB, tighter banking supervision measures issued
June	Soeharto undertakes pilgrimage to Mekka
September	Loan team established to limit overseas' borrowing of State Owned firms
November	Ceilings imposed on foreign borrowing by banks
December	Bank Summa, owned by Astra group, collapses; Astra falls in hands of Soeharto business partners that bailed out Bank Duta
1992	
March	Banking Law enacted
June	Fifth New Order elections, Golkar wins with 68 percent of the vote
July	Jakarta Stock Exchange privatized
October	Cooperatives Law approved
	IGGI abolished by Soeharto after criticism by the Dutch chairman. Consultative Group Indonesia, chaired by World Bank, becomes successor
1993	
March	Soeharto elected by MPR for 6th term
March	Sixth Development Cabinet appointed, key (Christian) technocrats removed from cabinet
May 29	PAKMEI, prudential regulations on banks introduced by PAKFEB relaxed. Central bank head of supervision fired.
	JAMSOSTEK (workers' social security) Law approved
December	Megawati Soekarnoputri elected chairperson of PDI
1994	
June 22	Banning of leading newspapers and magazines (*Tempo, De Tik, Editor*)
	New investment law allows for 100 percent foreign-owned companies, except for negative list.
	Establishment of Tariff and Fiscal Team, imposes "surcharge" on imports competing with Chandra Asri Chemicals, owned by son of Soeharto.
1995	
March	Company Law approved
October	Capital Markets law approved
1996	

February	Bank reserve requirements raised from 2 to 3 percent
April	Customs takes back duties form SGS
April 28	Death of Soeharto's wife
June 22	Megawati ousted as PDI chair, riots in Jakarta
June	AFTA Tariff reduction schedule announced (but policy slippage in implementation)
September	Reserve requirements announced to be raised to 5 percent
1997	
January 30	Anti-Chinese riot in several cities and towns in Java
January-February	Dayak massacres of Madurese in West Kalimantan
May 23	Election riot in Banjermasin, killing over 100 people in fire.
May 29	Sixth New Order Election, Golkar wins with 74 percent of the vote
July 2	Thai Baht floated
July 11	Philippines Peso floated
August 14	Rupiah Floated, discretionary budget spending restricted, foreign ownership of firms widened, second "Sumarlin shock" to reduce liquidity, interest rates soar
August 30	Limit on forward transaction with non-residents of $5 million
September 3	Policy statement announcing stabilization measures, fiscal restraint, deregulation, closure of insolvent banks. Central bank eases monetary policy.
September 16	Postponement of 81 mega projects announced (Keppres 39/1997)
September 18	"Clarification" by the Finance Minister that some projects could go ahead
September	Annual meetings of IMF and World Bank in Hong Kong, discussion on possible "precautionary" program
October	IMF program mission in Jakarta
October 30	First letter of intent (LOI) to IMF
November 5	Approval of IMF Package. 16 banks closed, limited deposit guarantee
November	Gradual run on banks, extensive liquidity support from BI
December	Soeharto suffers mild stroke, Rupiah hits 14,000
1998	
January 6	Budget 1998/99 announced, seen to be based on unrealistic assumptions
January 15	Second IMF supported program signed by Soeharto
January 27	Bank restructuring measures announced, IBRA set up (Subianto first chairman)
March 11	Soeharto elected by MPR for 7th term. Habibie Vice-President
March 14	IBRA closes 6 banks, takes over 7
March	Seventh Development Cabinet announced, the "crony cabinet," including timber Baron Bob Hasan, Soeharto's daughter Tutut, and Fuad Bawazier
April 6	Third LOI. Fiscal deficit of 3.5 percent of GDP planned
April 25	Riots in Medan
May 4	Hike in fuel prices triggers widespread protests
May 12	Four students killed by snipers in protest at Trisakti University
May 13-15	Violent riots in Jakarta, hundreds killed
May 14-15	Central bank suspends clearing

May 15	Soeharto partially reverses fuel price hikes
May 18	Parliament (DPR) chairman Harmoko calls for Soeharto's resignation
May 21	Soeharto resigns, Habibie President
May	Run on BCA, owned by the Soeharto-affiliated Salim group
June 1	Technocrats (Widjojo, Wardhana) appointed economic advisors to Habibie
June 4	Frankfurt Agreement with international banks on debt restructuring. INDRA established
June 25	Fourth LOI, fiscal deficit of 8.5 percent of GDP planned
July 30	Consultative Group Indonesia raises $8 billion in external budget financing, in addition to the $6 billon of "special assistance" raised by the IMF
August	Liquidation of 7 banks taken over by IBRA in April. Merger of four state banks in one (Bank Mandiri)
October	New banking law passed (Law 10/98), underpins IBRA, supervisory powers
	JITF established
1999	
March	Shareholder's settlement agreements with former bank owners signed
May 17	Central bank law (Law 23/99) grants independence to central bank
June	Decentralization laws passed (Law 22 and 25/99)
July 8	Parliamentary elections, Golkar received 22 percent of the vote, PDI-P wins with 33 percent of the vote
September	Law on Judiciary passed, granting independence of judiciary from government within 5 years. Anti-corruption laws passed (Law 28 and 31/99), requiring an anti-corruption commission (established 2003)
October 21	Abdurrachman Wahid elected president
October	1st constitutional amendment restricts powers of the president
2000	
September 28	Corruption charges against Soeharto dismissed on grounds of ill health
2001	
January	Decentralization implemented
August	Run on Bank BII due to their large exposure to Asia Pulp and Paper. Both Bank and company are owned by the Widjaja group.
2002	
February 13	Central bank governor convicted in Bank Bali case; acquitted on appeal in August.
July 2	Tommy Soeharto convicted to 15 years in jail for instigating murder of Supreme Court judge, who had convicted him on appeal of a corruption case involving a land swap with BULOG
September 4	Chairman of the MPR convicted of corruption in a case involving BULOG. Free pending appeal
December	Law on Anticorruption Commission passed
December	Review of compliance with shareholders' settlement starts
	Three central bank directors convicted of abuse of central bank liquidity credits
2003	
March	State Finances Law passed (Law 17/2003)
December	Closure of JITF, establishment of Anti-corruption Commission
December	Graduation from IMF supported program

2004	
February	Closure of IBRA

Sources: Cole and Slade, 1996; Elson, 2001, Prawiro, 1998, Kenward, 2002, Enoch et al. 2001; Blustein, 2001, O'Rourke, 2002, World Bank 1998, 1999, 2000, 2001, 2002, 2003.

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