Chapter 1

A BRIEF OVERVIEW OF ECONOMIC GROWTH AND POVERTY IN INDONESIA DURING THE NEW ORDER AND AFTER THE ASIAN ECONOMIC CRISIS

Thee Kian Wie

The Asian economic crisis of 1997–98 had devastating effects on Indonesia’s poor and near poor, the numbers of whom increased rapidly as a result. This development was particularly tragic since much progress had been made in poverty alleviation during thirty-two years of rapid and sustained economic growth under the New Order government (1966–98). To put adverse developments, particularly the rise in the incidence of poverty, in proper perspective, it might be helpful to have a brief historical overview of Indonesia’s economic development and its impact on poverty during the three decades preceding the onset of the crisis and in the decade following it.

1 ECONOMIC GROWTH AND POVERTY ALLEVIATION DURING THE NEW ORDER 1966–98

As a result of political turmoil and the utter neglect of sound economic policies after the late 1950s, the Indonesian economy in the early 1960s experienced steadily rising inflation. As a
consequence of the unrestrained printing of money to finance the rising government budget deficit, this spiraled into hyperinflation, which had reached almost 600 per cent by 1965. The economy had stagnated during the 1961–64 period; the modest growth that occurred in 1965 reflected only a good agricultural season (Hill 1996: 2). Since population growth exceeded economic growth in the early 1960s, per capita income declined during this period, particularly in 1962–63, with the economy contracting by three per cent in 1963 (World Bank 1998: 2.1).

With the deterioration in economic conditions, absolute poverty was quite high in the mid-1960s. In Java, 61 per cent of the population was very poor, while outside Java the very poor accounted for 52 per cent of the population. In 1961 no less than 68 per cent of the total population had no schooling at all, while only 0.1 per cent had enjoyed a tertiary education (Hill 1996:5). The available evidence also shows that per capita income in Indonesia in the mid-1960s was well below that of other Southeast Asian economies for which reliable data are available, and below even that of India. Indonesia’s real per capita GDP in 1966 is estimated to have been only 535 international dollars (1985 prices), compared with US$650 in India (Booth 2000: 74).¹

After recovering from the serious economic crisis and the traumatic political dislocations of the mid-1960s, the Indonesian economy under the New Order government embarked on a period of rapid growth that averaged around seven per cent annually and was sustained for three decades. Rapid industrialization transformed Indonesia’s economy from one that was agricultural to one in which the manufacturing sector became increasingly important, to the point where it overtook agriculture in the mid-1990s. In view of this impressive economic performance, Indonesia was classified in 1993 as one of the eight “high-performing Asian economies” (HPAEs) by the World Bank in its well-known and controversial report *The East Asian Economic Miracle* (1993a). The World Bank classified these eight East Asian countries as HPAEs
because since 1960 (in the case of Indonesia, the late 1960s) these economies had grown more than twice as fast as those of the rest of East Asia, roughly three times as fast as those of Latin America and South Asia and five times faster than those of countries in Sub-Saharan Africa. They also significantly outperformed the advanced industrial economies and the oil-rich Middle East-North Africa region (World Bank 1993a: 1–2).

As in the other HPAEs, rapid economic growth in Indonesia was accompanied by significant advances in social development, indicated by steadily increasing educational enrollments at all levels but particularly at the primary level, an improved adult literacy rate, and improved nutritional intake, as well as improvements in various indicators of health status such as infant mortality rate, life expectancy at birth, and per capita daily calorie supply (Thee 2002: 201–3). By East Asian standards, however, some of Indonesia’s social indicators continued to lag somewhat (Hill 1999: 5). The likely reason for this lag is that in Indonesia, as in most other developing countries, social development followed in the wake of economic development. The fact that Indonesia started its economic development about one decade later than its ASEAN neighbours and the East Asian Tigers (South Korea, Taiwan, Hong Kong, and Singapore) helps to explain why Indonesia’s social development was in general behind that of these other countries (Thee 2002: 203).

A more striking aspect of Indonesia’s social development, however, was its success in poverty alleviation. As in the other HPAEs, Indonesia’s rapid and sustained economic growth was accompanied by a decline in the incidence of absolute poverty in both urban and rural areas. According to Indonesia’s Central Bureau of Statistics (BPS), absolute poverty had steadily decreased from 53.6 per cent in urban areas and 38.7 per cent in rural areas in 1970 to 9.7 per cent and 12.3 per cent respectively in 1996 (Booth 2000: 78). For Indonesia as a whole, the incidence of absolute poverty declined from 40.1 per cent of the total population in
1976 to 11.3 per cent in 1996 (Table 1.1). The corresponding number of people in poverty fell from around 54 million in 1976 to less than 23 million in 1996 (BPS 1998: 576).

The sharp reduction in poverty during the New Order was remarkable when compared to the rate in most other developing countries. A comparative study by the World Bank on poverty alleviation in several developing countries found that over the 1970–1987 period Indonesia had been the most successful in reducing absolute poverty, as indicated by its achievement of the highest annual reduction in the two key indicators of poverty, namely, the headcount index and the under-five mortality rate (World Bank 1990: 45).

Thus in Indonesia no “immiserizing growth” took place during the New Order, since people did not become poorer as growth proceeded, as some critics have alleged. Indonesia’s success in reducing absolute poverty can be attributed to the government’s

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<th>Year</th>
<th>Percentage below Poverty Line</th>
<th>Numbers in Poverty (millions)</th>
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<tbody>
<tr>
<td></td>
<td>Urban</td>
<td>Rural</td>
</tr>
<tr>
<td>1970</td>
<td>53.6*</td>
<td>38.7*</td>
</tr>
<tr>
<td>1976</td>
<td>38.8</td>
<td>40.4</td>
</tr>
<tr>
<td>1978</td>
<td>30.8</td>
<td>33.3</td>
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<td>29.0</td>
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<td>26.5</td>
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<tr>
<td>1984</td>
<td>23.1</td>
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<td>1987</td>
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<td>16.4</td>
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<td>1990</td>
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<tr>
<td>1996</td>
<td>9.7</td>
<td>12.3</td>
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Note: * The 1970 estimates were derived from a poverty line based on 1976 BPS poverty lines.
Source: Booth (2000, Table 3; based on BPS data)
commitment to a broad-based rural development strategy, which targeted the rural areas where most of Indonesia’s poor were living and working. The emphasis on rural and agricultural development, particularly during the first two decades of the New Order, led to rapid expansion in agricultural production, particularly of rice. This rapid agricultural growth in the 1970s and early 1980s stemmed from the successful dissemination of new production technologies in the food crop sector, which created new employment opportunities in agricultural processing, transport, and commerce and also contributed to the rapid growth of the construction and manufacturing sectors in both rural and urban Java. Higher wage incomes contributed to higher household incomes and thus reduced poverty (Booth 1992: 639).

The steep decline in the incidence of absolute poverty in Indonesia’s rural areas during the 1970s was an outstanding achievement, particularly by comparison with the experiences of other oil-exporting countries with large agricultural sectors. Although this decline cannot be attributed solely to government policy, the oil boom did lead to increased government expenditure, although little of this increase was explicitly targeted at the poor. Similarly, the regional development grants (Instruksi Presiden or Inpres grants) were not specifically designed to alleviate poverty but rather were intended to give provincial and district governments a better opportunity to implement much needed rehabilitation and development of infrastructure. In fact, after the mid-1970s the employment generated by Inpres programs fell steadily. After the mid-1970s, however, the sharp decline in poverty was due in part to the successful stabilization of food prices which meant, particularly in Java, that the poor experienced a lower rate of inflation than the rich (Booth 2000: 80–1).

Although the end of the oil boom in 1982 forced the Indonesian Government to cut its budget expenditures severely, the greatest cuts were carried out in the more capital-intensive sectors and programs, including energy, transmigration, and
subsidies to state-owned enterprises. As they did not have a large adverse effect on employment (Booth 2000: 85), there was no impact on poverty. Rapid economic growth resumed after 1987 and was sustained up to the time of the Asian economic crisis, in response to a series of deregulation measures designed to increase non-oil exports. But in spite of the resumption of rapid growth, absolute poverty declined more slowly during the 1987–1996 period.

Three hypotheses have been advanced by Professor Booth to account for this slowdown. First, after 1987 development policies became less pro-poor since the manufacturing and modern services sectors received greater policy emphasis and thus emerged as the main engines of growth. The agricultural sector on the other hand was relegated to a secondary role in policy debates. Secondly, policy-makers held that the persistence of poverty was due to the fact that poverty was mainly located outside of Java and in isolated poverty traps, which in turn meant that the poor in these regions were not able to benefit from the rapid manufacturing growth taking place in Java. Thirdly, in spite of the rapid growth in educational enrollments at all levels in Indonesia, access to good quality secondary education and in particular to high quality tertiary education was still severely limited in the late 1980s and early 1990s, so the rents were not dissipated through increased supply (Booth 2000: 89–90).

Despite the slower decline in the incidence of poverty in the 1980s and early 1990s, the available data show a clear downward trend in poverty throughout the New Order up to the time of the Asian economic crisis. It should be borne in mind, however, that the poverty estimates based on the official poverty line, at least in a comparative sense, understate the incidence of absolute poverty. For instance, Indonesia’s official poverty line is not only lower than that of the Philippines, which has about the same per capita income as Indonesia, but is also lower than those of some of the poorest countries in the world (Booth 1992: 637). Even
so, higher poverty lines for Indonesia would still show a clear downward trend in the incidence of absolute poverty, although a higher poverty line, such as the one developed by the World Bank, would naturally show a higher incidence of absolute poverty than Indonesia’s official poverty line does.

2 GROWTH AND POVERTY AFTER THE ASIAN ECONOMIC CRISIS 1997–2007

2.1 The Onset of the Crisis

During the early 1990s the Indonesian economy was performing quite well. The economy was growing at an average annual rate of 7.7 per cent, while inflation was only 6.6 per cent, a sizable fiscal surplus was maintained, and approved domestic and foreign direct investment and foreign exchange reserves were growing rapidly. Moreover, large prepayments of high-interest, public external debts were continued (McLeod 1998: 6–10; World Bank 1997: xxi). For this reason the World Bank, in its annual report on the Indonesian economy in May 1997, released a fairly upbeat assessment of the economy, projecting, with some qualifications, that it would continue to achieve a robust growth of 7.8 per cent for the remainder of the 1990s (World Bank 1997: 29). In fact, a year earlier Indonesia’s good economic performance had also been hailed by Professor Jeffrey Sachs of Harvard University who, in a report on economic competitiveness released at the World Economic Forum in May 1996, ranked Indonesia fifteenth, up from thirtieth a year earlier and slightly outranking China and Thailand (Sadli 1999: 16).

By July 1997, however, only two months after the release of this report, the Indonesian economy suddenly experienced a severe shock when, in the wake of the depreciation of the Thai baht in July 1997, the Malaysian ringgit, the Philippine peso, and the Indonesian rupiah also started to depreciate steadily through
the “contagion” effect. As in the other Southeast Asian countries, foreign creditors to Indonesian corporations and foreign investors scrambled to reduce their exposure by withdrawing their funds from Indonesia (Thee 2003: 186).

When the rupiah continued to depreciate even after Bank Indonesia had widened its intervention band, Bank Indonesia abandoned the band and floated the rupiah on 14 August 1997 while also tightening monetary policy. For a while the rupiah strengthened, but it soon resumed its downward slide. Demand for foreign exchange rose sharply as corporations sought to get dollars to cover their unhedged exposure, while new private capital inflows dried up. As the panic rose, the rupiah depreciated to around Rp 3,500 to the U.S. dollar (Sadli 1999: 17).

Increasingly concerned about the continuing depreciation of the rupiah, the Indonesian Government turned to the International Monetary Fund (IMF) for financial assistance in late October 1997. In return for a large stand-by loan offered by the IMF, the Indonesian Government in its Letter of Intent (LOI) to the IMF pledged to implement a comprehensive reform program, involving sound macroeconomic policies, a restructuring of the financial sector, and structural reforms, including the disbandment of various monopolies sanctioned by the government. It was hoped that, with the availability of the IMF loan backed by a credible reform program, confidence in the rupiah would be restored (Sadli 1999: 17).

The involvement of the IMF, however, failed to stem the downward slide of the rupiah and the ensuing economic crisis, as the Indonesian Government seemed unwilling to implement the agreed-upon reform program, particularly the structural reforms, in a vigorous manner. The inability of the Indonesian Government to deal effectively with the financial and economic crisis led to a serious political crisis that forced President Soeharto to step down after a reign of thirty-two years. Thus, within a time span of only one year, Indonesia had turned from a booming
economy, extolled by the international aid community and many foreign economists as a development model worthy of emulation, into a “melted-down” economy that was dependent for its very survival on the charity of the international aid community and its bilateral donors.

2.2 The Socioeconomic Impact of the Crisis

Although the financial crisis had hit Indonesia in mid-1997, its full economic impact was felt only in 1998 when the economy contracted by an unprecedented 13.1 per cent, with manufacturing, construction, the financial sector and business services, trade, hotels and restaurants, and transport and communications recording the sharpest declines. Only the agricultural sector and public utilities recorded slight growth. This economic contraction was much worse than the one that had occurred in 1963, when the economy had contracted by 3.0 per cent (World Bank 1998: 2.1).

Besides the severe financial and economic crisis, which became known as the *krismon* (from the words *krisis moneter*, or “monetary crisis”), Indonesia was also affected by an extremely bad drought caused by the El Nino of 1997 and 1998. The drought was not only severe but occurred twice, first in July/August 1997 and again in March 1998 (World Bank 1998: 1.11). Because of this drought, total rice production fell by 4 per cent in 1997, causing the agricultural sector to grow by only 0.6 per cent in that year (Johnson 1998: 16–7). To make matters worse, during this period the international price of oil also experienced a sharp decline, which hurt Indonesia’s exports and government revenues.

By 1999, however, macroeconomic stability was slowly being restored, as inflation, the exchange rate, and interest rates all responded well to tight monetary policies (World Bank 1999: 1.1–2.1). As a consequence the economy began to recover slightly in 1999, when it recorded a positive, albeit minuscule, growth rate
of 0.8 per cent. In the next few years economic growth picked up, with the economy growing at 4.8 per cent in 2000, 3.8 per cent in 2001, 4.3 per cent in 2002, 4.8 per cent in 2003, 5.1 per cent in 2004, 5.6 per cent in 2005, and 6.1 per cent in 2006.

The severe economic crisis of 1998 had a devastating effect on the welfare of the Indonesian population. The socioeconomic effects of this crisis were transmitted through two channels. First, there was the impact of capital outflows, the steep depreciation of the rupiah, and the contractionary effects of tight monetary and fiscal policies on the economy. The sharp contraction of sectors located in urban areas, including the manufacturing, construction, and financial sectors, led to many lay-offs. Second, there were shifts in relative prices when the prices of tradable goods such as manufactured products rose steeply vis-à-vis non-tradable goods and services as a result of the steep depreciation of the rupiah, which in turn led to a sharp increase in inflation (Daimon and Thorbecke 1999: 2).

The adverse impacts passed on through these two channels suggest that the urban population was affected more severely than the rural population. First, the sectors hit hardest by the crisis were mostly located in urban areas, which adversely affected employment in these areas. Second, the sharp rate of inflation adversely affected net purchasers of foodstuffs (mostly urban dwellers) because of the steep increase in food prices in 1998 (Daimon and Thorbecke 1999: 2–3). Thus urban households may have suffered more than rural households, particularly farm households growing their own food. As the impact of the economic crisis intensified in the course of 1998, many workers in the formal sector, particularly in the urban-based manufacturing, construction, and modern services sectors, were indeed laid off. Nevertheless, the open unemployment rate increased only slightly to around six per cent, since the informal labour market was much better able to absorb those who were laid off in the formal sector (Cameron 1999: 15).
In both urban and rural areas the numbers of employed workers classified as “family workers” increased, which seems to confirm the assumption that people who had lost their wage jobs as well as new entrants to the labour force who were unable to find wage employment were absorbed into jobs in family enterprises (Booth 1999: 4.1).

Data from the National Socio-Economic Survey (SUSENAS) of February 1998 show that employment in manufacturing had fallen by 13 per cent, in finance by 7 per cent, and in electricity by 27 per cent. But as some sectors such as finance were employing only a small part of the labour force, even a large reduction in employment in these sectors had only a relatively small impact on employment (Poppele, Sumarto, and Pritchett 1999: 20). Employment in agriculture and in the urban informal sector expanded because the labour market and the social structures in these sectors were sufficiently flexible to reabsorb the workers laid off in formal sector activities.

The loss of jobs in the formal sector, the shift to low income activities in the informal sector, and the hyperinflation of 1998, which was accompanied by a drop in purchasing power, all led to a significant increase in the incidence of absolute poverty in both urban and rural areas. As a result, poverty rose from 17.6 per cent in 1996 (according to the revised method of estimating poverty used by BPS) to 23.4 per cent in 1998 (World Bank 2006: ix).

Nevertheless, with a gradual but steady economic recovery from 1999 onwards and the restoration of macroeconomic stability in 2000, the poverty rate declined steadily from its peak in 1999 to 16.0 per cent in February 2005 (World Bank 2006: ix), which was lower than the pre-crisis rate of 17.6 per cent. This sharp decline in the poverty rate was primarily due to rising incomes and a decline in food prices, particularly of rice. By March 2006, however, the poverty rate had gone up again to 17.8 per cent, corresponding to an increase in the number of poor people from 35 million to 39 million over this period. This rise in early 2006 was the
second time since the crisis that poverty had increased again after experiencing a steady decline in the preceding period.

The poverty level, which had increased by over one third during the crisis, was back to the pre-crisis level by early 2006 (Table 1.2). In fact, although the crisis had made millions of Indonesians poor again and turned Indonesia into a low-income country once more as in the early and mid-1960s, the recent economic recovery has made Indonesia once again one of the world’s emerging middle-income countries (World Bank 2006: ix).

The data in Table 1.2, however, also show that while the poverty level had declined from 17.8 per cent in 2006 to 16.6 per cent in 2007, there were still 37.2 million people living in absolute poverty in that year, which is almost three million more than in 1996. Moreover, despite the steady decline in the poverty level, a large percentage of the population remains vulnerable to poverty, since a large number of households are clustered around the poverty line. Hence, small price changes in the basic wage goods such as rice have a disproportionate effect on the proportion of households classified as poor (World Bank 2007: 19).

According to a recent World Bank study of poverty, three quarters of the additional four million people who fell below the poverty line in early 2006 did so as a consequence of the 33 per cent rise in rice prices between February 2005 and March 2006 (World Bank 2006: ix) rather than the jump in fuel prices in October 2005, as has been asserted by some politicians and a number of economists belonging to the “Indonesia Awakes Team” (Tim Indonesia Bangkit) (Basri and Patunru 2006: 308). Meanwhile, the increase in rice prices was caused mainly by the ban on rice imports (World Bank 2006: x).

The World Bank view of the ban on rice imports is supported in a study by Peter Warr, who has used a general equilibrium model to analyse food policy and poverty in Indonesia (Warr 2005: 429, 445). Warr’s quantitative analysis found that a rice import ban
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raises the domestic price of rice relative to the import price by an amount equivalent to a 125 per cent tariff. As a result of this import ban, the poverty rate rises by a little under one per cent of the population, with an increase occurring in both urban and rural areas. Among farmers, only the richest gain from the rice import ban, since they have smaller shares of rice in their total expenditures and are less reliant on their own labour as a source of income. Hence they are less affected by the increase in the price of rice and the decline in real wages that this causes.

3 CONCLUSION

This brief historical account of economic growth and the evolution of absolute poverty in Indonesia indicates that, despite the progress achieved over the past four decades, absolute poverty is still a

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<tr>
<th>Year</th>
<th>Population under Poverty Line (%)</th>
<th>Number of People under Poverty Line (millions)</th>
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<tbody>
<tr>
<td>1996*</td>
<td>17.6</td>
<td>34.5</td>
</tr>
<tr>
<td>1999</td>
<td>23.5</td>
<td>48.4</td>
</tr>
<tr>
<td>2001</td>
<td>19.0</td>
<td>37.3</td>
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<tr>
<td>2002</td>
<td>18.4</td>
<td>38.4</td>
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<td>2003</td>
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<td>2004</td>
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<tr>
<td>2007</td>
<td>16.6</td>
<td>37.2</td>
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</tbody>
</table>

Note: *As of 1996, BPS has used a revised method to estimate absolute poverty (referred to as the “new” definition of poverty), which resulted in a higher estimate of the incidence of poverty than the poverty figure for that year, as recorded in Table 1.1 above. Source: World Bank 2005 Table 1 derived from BPS data and World Bank 2007, Fig. 12.
major national problem and is in fact the most serious problem facing Indonesia. During times of severe economic stress, as during the Asian economic crisis, the number of poor people increases, since many people who are just above the poverty line — that is, the near poor — will fall below the poverty line.

For that reason, at the start of its term in late 2004 the current government set an admirable target of reducing absolute poverty from 18.4 per cent in 2002 to 8.2 per cent by late 2009, when its term ends. The government is unlikely to achieve its stated target, however, since the growth elasticity of poverty in Indonesia is estimated at only 0.7 (Balisacan et al. 2003: 346). Assuming that this figure still holds in the next two years, an average annual growth rate of 6 per cent would lead the poverty rate to fall to 15.7 per cent by late 2009 (Lindblad and Thee 2007: 29–30). Even if economic growth were to increase to 7 per cent in 2008 and 2009 (an unlikely prospect because of the adverse effects of the steep rise in oil prices in the world oil market and the predicted global economic slowdown because of the sub-prime crisis), the poverty rate is very unlikely to decline to 8.2 per cent by late 2009.

Note

1. Real per capita GDP figures in international dollars means that the figures have been adjusted for differences in purchasing power parities across countries. They are also adjusted for changes in the terms of trade (Booth 2000: 97).