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THE INDONESIAN ECONOMY



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THE INDONESIAN ECONOMY

ENTERING A NEW ERA

EDITED BY

ARIS ANANTA • MULJANA SOEKARNI • SJAMSUL ARIFIN



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Cover photo: The two statues are the so-called “Tugu Selamat Datang” (Welcome Statues) erected in 1962, to welcome visitors to Jakarta. The seven-metre high statue, sketched by Henk Ngantung and constructed by Edhi Sunarso, depict a young man and woman greeting visitors with flowers.

Photo credit: Courtesy of Muljana Soekarni and Abdul Hamid.

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MESSAGE from the Deputy Governor of Bank Indonesia

I am indeed delighted to provide a Message to this distinguished book, *The Indonesian Economy: Entering a New Era*.

This book, in my view, is issued at an appropriate moment against the backdrop of the global financial crisis of unprecedented scale since the Great Depression. I notice a number of significant changes in the global economy and financial environment that have significant bearing on emerging economies, including Indonesia, such as the unsynchronized global economic recovery in tandem with the closer link between macroeconomic and financial stability. Despite the recent turmoil, Indonesia, as part of the Asian region, has proved to be more resilient than earlier anticipated though not entirely unscathed from the global crisis. However, global challenges have not entirely abated. In fact, new risks have emerged as the Fed launched the quantitative easing two (QE2) which has heightened the volatility of capital flows.

My commendation on this book mainly rests on the wide range in topic, rigour in analyses, and novelty in policy recommendation, thanks to the collaborative work of authors from Bank Indonesia as well as other academicians and scholars who add exceptional value to this book. In terms of coverage of topic, while it focuses on macroeconomic and financial issues, mainly reflecting a central bank's purview, it does not lose sight of other areas shaping Indonesia's economic development. It also looks backward at the era beginning with the New Order government, as a reflection of the past successes and existing constraints, while also looking forward towards the future challenges. Other areas exhaustively addressed in this book include population dynamics, industrial relation, domestic regional trade, governance in both micro and macro levels, and the readiness of Indonesia in entering the new era of the ASEAN Economic Community 2015.

The rigour of the analyses is reflected in the various models the researchers employ to unravel empirical findings such as the computable general equilibrium (CGE) model in assessing the effectiveness of fiscal stimulus. Structural equation modeling (SEM) has also been applied to measure the impact of the quality of governance on economic growth and per capita GDP.

Given the changing global economic and financial environment as well as the structural changes in Indonesia's economy, this book attempts to seek a new development paradigm as the basis of policy recommendations to reinvigorate Indonesia's economy by laying the foundation for a more sustainable development. Seeking to explore beyond the conventional paradigm, instead of focusing on growth, it proposes three development objectives, namely: people-centered development, environmentally friendly development, and good governance. To this end, it calls for the support of a financial architecture which reduces speculative activities.

On behalf of Bank Indonesia, I wish to express my appreciation to ISEAS for giving the researchers at Bank Indonesia the opportunity to take part in the publication of this book. I am confident that readers will find this book an important reference for both policy studies and further scholarly researches.

Hopefully the valuable experience gained from such a mutually beneficial collaboration will be followed by other forthcoming topics which will be beneficial to all of us.

*Dr Hartadi A. Sarwono
Deputy Governor
Bank Indonesia*

Message from the Director of the Institute of Southeast Asian Studies

The Institute of Southeast Asian Studies (ISEAS) produces research and policy papers on social, political, and economic issues in the region. As part of its work, it interacts with scholars outside ISEAS, including those in regional institutions. This interaction widens and deepens the studies that ISEAS conducts. For a country study, it works with experts from the country concerned.

This book is the result of our collaboration with Bank Indonesia (BI), the Central Bank of Indonesia, which shared with us not only expertise but also the financing of the research.

This book is important because Indonesia is ASEAN's biggest country in terms of population and national income. It has become an attractive market and production base in ASEAN and, indeed, in the rest of the world. The 1997–98 Asian crisis and the recent 2008–09 global crisis have affected Indonesia in different ways. Indonesia today is different from Indonesia forty years ago or even ten years ago. Moreover, what Indonesia does can have significant social, political, and economic implications for the region and the rest of the world.

This book does not discuss all issues relating to the Indonesian economy but contributes to better insights into the direction in which the Indonesian economy is moving. Reflecting cross-border collaboration, it is a product of formal seminars, meetings and conferences conducted in both Singapore and Jakarta, in addition to many informal meetings held among the three editors in Singapore and Jakarta. Comments on the draft of the book came

from ISEAS, BI and other institutions. The fact that some of the authors are involved in policy-making in Indonesia gives this book added importance as a contribution to research and policy-making.

I would like to thank Aris Ananta, an economist and Indonesianist at ISEAS, who coordinated the research and is one of the editors of the book. My appreciation also goes to Bapak Muljana Soekarni, who initiated this collaboration and is also one of the co-editors. I would also like to acknowledge the contributions of Bapak Sjamsul Arifin, who joined the team of editors.

*Ambassador K. Kesavapany
Director
Institute of Southeast Asian Studies*

Foreword

Very few observers in the international community fully appreciate the fundamental transformations that have occurred in Indonesia since the late 1990s, just as there has been a tendency to prematurely write off the country's prospects in the past. At the time of independence, there were doubts that the sprawling archipelago would hold together. Yet it has, decisively, unlike some other highly diverse nation states such as the former USSR, the former Yugoslavia, and Pakistan. By the mid-1960s, the standard development economics textbook of the time, by long-time Indonesia expert Benjamin Higgins, characterized the country as a "chronic dropout". Gunnar Myrdal, in his classic *Asian Drama*, observed that, "As things look at the beginning of 1966, there seems to be little prospect of rapid economic growth in Indonesia." History was not kind to either observation, as income per capita quadrupled in the next three decades through to the late 1990s. In the early 1990s, the World Bank classified it as one of the "miracle economies".

There were similarly gloomy prognostications in 1998: *Indonesia: From showcase to basket case* was one of the more sensational titles at that time. The economy seemed to be in free fall, the formal banking system had collapsed, the demise of the Soeharto regime had left a political and institutional vacuum, ugly ethnic violence was widespread, and even the nation's territorial integrity appeared to be under threat. Thirteen years later, Indonesia has been transformed. It is now the most vibrant democracy in Southeast Asia, with two rounds of peaceful, legitimizing nationwide elections at the central and regional levels. The economy has bounced back strongly to rates of growth not far short of those of the Soeharto era. It successfully navigated the global financial crisis, with just a very small decline in growth momentum. Growth returned to above 6.0 per cent in 2010. Commencing in 2001, there has

been a bold, “big-bang” decentralization, which has transferred administrative authority and financial resources to the *kabupaten* (districts). The painful separation of East Timor proceeded smoothly, and the two countries enjoy a harmonious, productive relationship. Indonesia has also begun to look outwards again, to the great benefit of its immediate ASEAN neighbours. It is widely regarded as a leader of the moderate Moslem world, and it has also joined the pre-eminent international forum, the G20. Inventive authors are currently debating modifications to the “BRIC” acronym that accommodate Indonesia, and possibly other major developing economies in the G20 club.

The authors of this comprehensive and authoritative volume, a fruitful collaboration between researchers at Bank Indonesia and the Institute of Southeast Asian Studies, examine these and many other developments over the past decade. The timing is good. A decade after this great transformation, and well into the second SBY presidency, Indonesia’s “new normal” and its development challenges are becoming a lot clearer.

Part I of the volume provides an overview of economic development during the Soeharto era, 1966–98. Part II consists of four chapters that focused on the various aspects of macroeconomic policy, consistent with the core mandate of Bank Indonesia, the country’s central bank. Parts III and IV are broader in focus, raising *inter alia* whether, going forward, Indonesia needs a new development paradigm.

The authors are surely correct, harking back to the work of J.M. Keynes, that major global events of the type that occurred in 2008–09 call for a fundamental rethink of institutions and policies, especially in the current context with respect to financial market regulation and international financial architecture. More speculatively, the authors wonder whether ASEAN might adopt a common currency. I have the impression that, if such an initiative were ever adopted, it would most likely also involve the larger Northeast Asian economies. Presumably this would in turn entail anchoring the region to the monetary policy of the largest economy, namely China, as is the case with Germany in the EU. Whether the rest of East Asia is prepared to accept this reality remains to be seen. The current problems with the European Monetary Union also caution against such an approach without fully coordinated fiscal policy and deeply integrated markets. Thus a common currency seems more like a distant option than an immediate policy concern. But it is precisely the sort of issue that this forward-looking volume should examine.

Standing back from the volume, comparing the Soeharto and *Reformasi* eras, one is reminded of both the many continuities and the differences. This

is a very wide subject, and the emphasis will vary among observers. To this author at least, the following stand out.

Among the continuities, first, there is a consensus in Indonesia on the desirability of growth. Members of parliament and the informed commentariat may disagree on a lot, but it seems clear now that administrations and political parties that do not deliver on this objective will be rejected by voters. Second, Indonesia stands out as a reasonably prudent macroeconomic manager. Since this objective is central to the mandate of Bank Indonesia, several contributors dissect this issue. A significant achievement in the wake of the Asian financial crisis has been central bank independence. Although life for successive governors has been extremely challenging, and Indonesia still struggles to contain inflation at a rate comparable to its neighbours and major trading partners, this major institutional reform, combined with the gradual adoption of inflation targetting and a floating exchange rate regime, must be counted as a major achievement.

Third, Indonesia remains a reasonably open economy. It did not close up in response to the Asian financial crisis, and in spite of the rough treatment it received from the IMF and donors. It might still be regarded as “precariously open” in some respects, given the widespread anti-globalization critiques in the domestic media. But the policy settings appear to be durable. No doubt having the best Minister for Trade in the Asia-Pacific region helps. As does the oft-heard quip that “with 17,000 islands, Indonesia was made by God for free trade”! A final continuity is that, as in many countries, and for similar reasons, Indonesia still struggles to achieve microeconomic reform. For the reformers, it ranks uncomfortably low on various international ranking exercises, such as Doing Business, Transparency International, Economic Freedom, and the Global Competitiveness Report. On reforms of regulations, the civil service, state enterprises, the judiciary, and corruption, the policy agenda remains a daunting one.

The differences between the two periods are also striking. Here, too, at least four stand out to this author. First, as described in detail in this volume, economic policy-making processes have been completely transformed. The days of Hadi Soesastro’s “low politics”, of the technocrats going directly to the president to persuade him of the case for reform, have gone forever. This is the notion, developed in Hadi Soesastro’s classic 1989 article, “The Political Economy of Deregulation in Indonesia” in *Asian Review*, that Indonesia’s successful 1980s reforms were based on a strategy adroitly developed and implemented by the technocrats that deliberately eschewed grand ideological debates in public, which in all likelihood they would have lost. Rather, they formulated a series of trade and investment reform packages, and sold them

quietly and directly to the president as a pragmatic means of promoting economic recovery and employment growth in the wake of the threatening collapse in international energy prices in the early and mid-1980s.

The government now has to deal with many actors, some highly vocal. In the authors' understated words, parliament can be "difficult". The president of course does not directly command a majority in either house. The cabinet is a "rainbow" coalition. There is a vibrant civil society and an unshackled media. More than 500 sub-national governments, some very wealthy and independent-minded, have to be heard.

Second, although the political rules of the game are becoming clearer, the investment climate remains uncertain in some respects. The observation that "the only thing worse than organized corruption is disorganized corruption" appears to be apposite. It also explains why investment projects with long time horizons or uncertain yields are under-supplied. Real estate and shopping malls are more attractive than infrastructure and mining, even though the former is badly needed and more of the latter should be occurring in an era of unusually high commodity prices.

A third difference concerns the regulation of factor markets. Prior to the Asian financial crisis, Indonesia was a very light regulator of both its financial and labour markets. Both are now much more heavily regulated. In the case of the former, the tighter regulation is clearly desirable, even if much remains to be completed, including reform of the state-owned banks. The increased labour market regulation is more contentious. Obviously the greater protection of workers and the freedom to organize are major advances. But Indonesia's severance laws are among Asia's most restrictive, and they appear to be a central explanation for the jobless industrial growth that has been evident since 1999.

Finally, environmental issues now assume much greater significance in policy debates. This rise reflects the greater activism of NGO's, rising regional and international concerns, and the fact that the country's rapid deforestation places it among the world's major CO₂ emitters. Whether international cooperation will deliver much — poor countries like Indonesia should not be expected to shoulder the burden of providing international public goods — remains to be seen.

The authors of this volume canvass many of the most challenging contemporary development issues, and they are not afraid of advocacy in the cause of furthering the debate. Inevitably, readers will not necessarily agree with everything. For example, the authors maintain that Indonesia should be "less dependent on export promotion and financial liberalization". Should it? Clearly, small open economies like Singapore and Malaysia were badly

affected by the contraction in global trade and investment in 2008–09, and it is therefore tempting to point to Indonesia's much smaller economic shock than as extolling the virtues of being less trade-dependent. Nevertheless, notwithstanding the very successful trade and investment reforms of the 1980s, Indonesia is arguably the least open among the six major ASEAN economies, and it has missed out on profitable opportunities for employment creation. Notable examples include the global production and buying chains, particularly centred on the electronics and automotive industries, where Indonesia is a surprisingly minor actor. In automotives, Thai industry policy has been more nimble, resulting in it becoming the major automotive producer in ASEAN, a goal to which Indonesia could have aspired, building on its large domestic market. Equally, the country's disastrous experience with premature financial liberalization of the 1980s, which was a precursor to the banking collapse in 1997–98, underscores the importance of high-quality financial regulation. Yet it is not obvious that Indonesia currently has the sort of financial sector it requires to support a modern, market economy.

As the authors emphasize, Indonesia's development strategies are continuously evolving. The Yudhoyono administrations have emphasized the importance of a "pro-growth, pro-poor, pro-employment" programme, as well as ambitious anti-corruption initiatives. There have been some notable successes in all four dimensions: growth is back, employment is growing again, poverty is declining, and there has been some progress in the fight against corruption. But it remains a "glass half-full, half-empty" story. Growth has not yet got back to Soeharto era rates, much less those of China and now India. Poverty appears to be declining more slowly, in that it has become less growth-elastic. (Perhaps because removing the last 10–15 per cent of hardcore poverty is more difficult.) Employment growth is still not fast enough to absorb both the new workforce entrants and the existing pool of unemployed. And for every "big fish" that is caught in the anti-corruption drive, others seem to slip through the net all too easily.

There is much to chew over in this stimulating volume, and I commend it to you the readers. *Selamat membaca!*

Hal Hill
H. W. Arndt Professor of Southeast Asian Economies
Australian National University

Preface

Indonesia and the world have changed rapidly, particularly in the first decade of the twenty-first century. The Asian financial crisis in 1997–98 has also dramatically changed the course of Indonesian development, switching Indonesia from an authoritarian era to a democratizing one. Economic issues can no longer be discussed in a social and political vacuum. This book is an attempt to see Indonesian economy in the changing era, to examine Indonesian economy beyond the conventional macroeconomic variables. It is also expected to trigger a new debate in the creation of a new development paradigm for Indonesia and the world.

This book is a result of a collaboration between the Institute of Southeast Asian Studies (ISEAS) in Singapore and the Centre for Central Banking Studies, Bank Indonesia (BI) in Indonesia. The draft has been discussed in three stages. In each stage it has its own discussants. The first draft was discussed in a closed door conference in ISEAS, Singapore, on 24 June 2009, followed by a public seminar on “Indonesia’s Response to the Global Financial Crisis” with three speakers: Made Sukada (BI), Halim Alamsyah (BI), and Marleen Dieleman (National University of Singapore) on 25 June 2009. We would like to thank the following discussants in the conference: Evi Nurvidya Arifin (ISEAS), Richard Barichello (University of British Columbia), Aekapol Chongvilaivan (ISEAS), Rizal A. Djaafara (BI), Melanie S. Milo (ASEAN Secretariat, formerly with ISEAS), and Yohanes Eko Riyanto (Nanyang Technological University).

The second draft was examined in an internal meeting with the authors and staff of the Centre for Central Banking Studies (PPSK), BI, and some invited discussants in Jakarta on 3 and 4 September 2009. We owed the comments and questions on the drafts from Mas Achmad Daniri (National

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