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Indonesian economic development: Mirage or miracle?

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ABSTRACT

This paper focuses on a few major developments that took place during the three decades from the late 1960s to the Asian financial crisis. The study finds, in retrospect, that many of the Indonesian economy's weaknesses—now so glaringly apparent—were there all the time. The paper concludes that the Indonesian banking crisis was primarily domestic in nature, more so than the crises in Korea and Thailand. The extent of the failure was much more widespread and probably resulted from a chain of bank runs and bank closings, reinforced by uncertainty and lack of faith in the government's commitment to the IMF program and IMF fumbling.

1. Introduction

In the beginning of 1967, Indonesia embarked on a period of rapid economic growth that raised living standards, reduced poverty and transformed the country from a poor economy, primarily dependent on agriculture, to a major producer of industrial products in Southeast Asia. From 1967 to 1995, income per capita rose more than fourfold; the incidence of poverty fell from 64.3% in 1975 to 11.4% in 1995 (using a US$1/day poverty level); domestic investment as a share of GDP increased from less than 10% in the 1960s to over 30% in the 1990s; and agriculture's share of GDP fell from over 50% in the 1960s to less than 20% by 1997. Indonesia went from being a basket case in the 1960s, a country that noted development economist Benjamin Higgins had dubbed the "number one failure among the major underdeveloped countries,"[1] to become the darling of the World Bank in the late 1980s and early 1990s. When asked to name the number one example of the success of development policies in the era following the second oil shock (1979–1981), the World Bank invariably pointed to Indonesia.

This paper focuses on a few major developments that took place during the three decades from the late 1960s to the Asian financial crisis rather than on the complete details of the development process. The study finds, in retrospect, that many of the Indonesian economy's weaknesses—now so glaringly apparent—were there all the time, but they were glossed over by most development economists who were anxious to believe that the macroeconomic policies recommended by the economics profession and implemented in large measure by the Indonesian government were indeed bearing fruit.

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[1] As quoted in Hill (2000).

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Table 1
Global exports (US$ billions).

Country	1985	1995	2001	% increase 1985–2001
China	31.3	232.6	415.8	1328
Indonesia	19.6	47.8	63.1	321
Korea	25.2	117.9	163.6	412
Malaysia	17.9	86.2	111.4	622
Philippines	6.1	19.7	42.8	701
Singapore	17.1	88.6	93.2	545
Taiwan	33.6	122.9	151.9	452
Thailand	7.7	54.8	72.7	944
Vietnam	0.4	6.2	14.8	3700

Source: IMF direction of trade statistics, quoted in Ng and Yeats (2003).

2. Institutions, policies and performance

Indonesia's extraordinary growth and its dramatic structural transformation are all the more remarkable when placed in perspective with the performance of other countries in the region, as Indonesia came from far back in the pack. The early years of the Suharto regime followed the disastrous economic experience under President Sukarno—a period characterized by slow growth and hyperinflation. In 1967, Indonesia compared poorly with its neighbors: it had a much lower level of per capita income, lower enrollment rates at all educational levels, lower life expectancy and a miniscule industrial sector (Temple, 2003). Furthermore, its level of socioeconomic development also compared poorly with its neighbors: Indonesia had a smaller middle class, a larger rural sector (with the exception of Thailand), more limited social mobility, lower adult literacy and a more firmly entrenched traditional outlook. Much of this traditional approach to social conventions derived from its low level of development, but also drew on historical roots in Islamic tradition and Javanese culture (Adelman & Morris, 1967; Temple, 2003).

Temple (2003) drew attention to five aspects of Indonesian society that are important for understanding its subsequent evolution. First, Indonesia has an abundance of natural resources, primarily oil but also natural gas, lumber and other agricultural products including rubber and palm oil. This natural resource base distinguished Indonesia from the other economies of Southeast Asia (with the exception of Malaysia), which were primarily exporters of agricultural products. Oil has been both a blessing and a curse for Indonesia, as it has been for many other oil exporters. We will not go into these issues in depth, noting only that Indonesia has avoided many of the pitfalls of the "Dutch disease" that have plagued other resource-rich economies selling their products in global markets.[2] At the same time, the availability of oil has arguably served to stunt the growth and exports of the nascent industrial sector.

Second, and related to the first, is the slow growth of the industrial sector. In the early years of the Suharto regime, agriculture and mining comprised the bulk of value added. This shift from agriculture and mining to industrial production and exports of manufactured goods changed only slowly. Between 1985 and 2001, Indonesian exports increased from just under US$20 billion to just over US$60 billion, slightly more than a threefold increase. By contrast, Singapore and Taiwan's exports increased fivefold, Malaysia's exports increased more than sixfold, the Philippines sevenfold, and Thailand ninefold. Vietnam, starting from a small base, increased its exports over 30-fold (Table 1).

Third, the role of the state in Indonesia is somewhat larger than in other Southeast Asian countries. Hill (2000) estimated that in the late 1980s, as much as 40% of nonagricultural GDP was accounted for by government entities. In addition, government control over banks and the banking system was the norm until reforms in the late 1980s and early 1990s. This strong role of the state derives from the historical break with the Dutch colonial past under Suharto, the lingering distrust of "capitalists," and the need for the Suharto regime to maintain control of a number of industries in which rents could be extorted its political machine. Furthermore, the private sector that emerged during this era was, and still is, largely controlled by families from the minority Chinese population. This aspect of the Suharto regime is discussed further in the next section.

Fourth, the power of the presidency under Suharto was much greater than the formal governmental institutions—which included a judicial system, a legislature and an election process—would indicate. President Suharto was, for all intents and purposes, a dictator with wide-ranging powers not subject to judicial or legislative review. The situation was similar to the Marcos autocracy that emerged in the Philippines. One key difference was that President Marcos did not have a power base in the military, and therefore his basis of power was always subject to advice and consent from the military. Furthermore, Marcos and his wife Imelda led a flamboyant and highly visible life style, flaunting their riches in the media. Suharto provides a sharp contrast, as he retained a low profile despite accumulating enormous wealth from a wide range of businesses and government corporations.

[2] One simple model of "Dutch disease" has increases in the foreign demand for domestic resource-intensive products bidding up the exchange rate. The currency appreciation reduces foreign demand for the exports products of other sectors, typically manufacturing.