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Making Economic Policy in Weak, Democratic, Post-crisis States: An Indonesian Case Study

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Summary. — Economic crises in developing countries differ in their causes, severity and recovery trajectories. The literature on the causes and immediate management of these crises is well developed. However, it is more difficult to develop an *a priori* framework which facilitates an analytical interpretation of how crises affect economic policy and hence recovery. This is especially so in the commonly occurring "twin crises," in which an economic crisis interacts with regime collapse. Country studies are needed to contribute to the development of such a framework. This paper addresses these issues with reference to Indonesia's deep economic and political crisis of 1997–98.

Key words — Asia, Indonesia, crises, economic policy, political economy

1. INTRODUCTION

There is a large literature on the consequences of economic and financial crises in developing countries. This focuses on economic decline and recovery trajectories, financial sector collapse and workouts, rising indebtedness and debt restructuring, and social impacts, among other topics. A parallel strand examines political ramifications, including possibly the reshaping of institutions and significant changes in policy direction.

Crises obviously differ in their causes, severity and recovery trajectories. A number of "stylized facts" are typically identifiable: a sharp exchange rate depreciation, a substantial contraction in domestic demand, the cessation of much modern sector financial activity, complex corporate restructuring, and rising public and private indebtedness. However, it is much more difficult to develop an *a priori* framework which facilitates an understanding of political and institutional changes in the wake of a crisis, and how this affects economic policy and recovery. In some cases, crises trigger massive upheaval, regime change, and even institutional paralysis. In other cases, the policy settings, institutions, and the business environment hardly change.

The former case, of what may be termed "twin crises," is common to many developing crises. It is analytically both more interesting and more elusive. While the economic effects of a crisis are broadly predictable and amenable to empirical testing, it is much more difficult to develop a framework which facilitates an understanding of the impacts of institutional collapse and policy uncertainty. This is because so much of the story is inevitably country-specific and *sui generis*. Moreover, the very uncertainty of the commercial environment in the wake of a crisis introduces a range of parameters that are likely to have both aggregate and sector-specific impacts.

The purpose of this paper is to address these issues with reference to Indonesia during and after its 1997–98 crisis. Both the issue and the country are well suited to such a case study, and both have wider implications for other crisis-affected countries. Indonesia experienced three decades of virtually continuous rapid economic development from 1968. It was then deeply affected by the economic crisis of 1997–98. Its economic contraction in 1998, of over 13%, was the sharpest among the four crisis-affected East Asian economies. The country also experienced "twin crises," in the sense that the economic crisis was accompanied by and indeed precipitated regime collapse, resulting in the departure of President Soeharto in May 1998 after 32 years of authoritarian rule, and ushering in a period of political instability. Its territorial integrity was for a period threatened. From 1998 to 2004, Indonesia had five presidents, and there was a major reworking of its political institutions. As a result, the once stable and predictable commercial environment became much less certain. Nevertheless, Indonesia's recovery has more resembled the East Asian (and Mexican) "V" than the "L" of the former Soviet Union and much of Eastern Europe for a decade from the late 1980s. Its per capita income has now recovered to pre-crisis levels, as have most social indicators.

Our organization is as follows. Section 2 provides the context: the changing political and institutional environment in Indonesia, a summary examination of the country's recovery trajectory since 1998, and a brief review of Indonesia's recovery in comparative context. Section 3, the major part of the paper examines the Indonesian record in detail, focusing in

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particular on the main economic policy variables, how they have changed as a result of the crisis, and how these changes have impacted on development outcomes. Particular attention is given to four main case studies of how the post-crisis environment has affected the investment climate, commercial policy, trade policy and exports, and labor policy. Section 4 summarizes our main arguments, assesses the Indonesian experience in light of other post-crisis episodes, and raises some broader implications.

2. INDONESIA IN CRISIS AND TRANSITION

(a) *Changing political economy*

Following the crisis and overthrow of Soeharto, Indonesia's political environment changed radically, from a "hard," authoritarian, corrupt but growth-oriented state delivering broad-based, rapidly improving living standards, to a weakened, democratic, corrupt state, with the political leadership not yet able to provide a clear and unambiguous commitment to economic growth. [1]

Specifically, the economic policy-making environment has changed in at least seven important respects. First, there is a weakened presidency, subject to a variety of checks and balances. Particularly in the second half of his rule, Soeharto was "in supreme control," in the words of Mackie and MacIntyre (1994). In the six years 1998–2004, Indonesia had five presidents. Following the direct presidential election of 2004, and the victory of the current president, S.B. Yudhoyono, the authority of the office has been somewhat restored, though it is still much weaker than the Soeharto era.

A second feature is significantly weaker cabinet unity. Members are drawn from a variety of political and technical backgrounds, they owe their allegiance to disparate power sources, and public disagreements are not uncommon.

Third, the legislature (the Indonesian parliament is known by its acronym the DPR) has become much more powerful. During the Soeharto era, the parliament was essentially a rubber stamp for all government legislation. In the new arrangements, the president's party is in the minority, and members of parliament need to be persuaded or bought off. Government bills are frequently delayed, amended, and even rejected.

Fourth, civil society has become much more active. Long suppressed under Soeharto, think tanks have proliferated, a free press flourished, and street protests are common and occasionally influential.

Fifth, the role of the bureaucracy has changed. During the Soeharto era, it was an arm of the president, accountable directly to him, and subject to few pressures from the parliament and civil society. The bureaucracy continues to be a powerful organ of the state, but it is subject to a wide range of checks and balances, and some departments have become heavily influenced by particular political parties. Moreover, high-profile corruption allegations, and some prosecutions, have resulted in a cautious bureaucracy, sometimes unable to take hard decisions for fear of retribution.

A sixth feature is that the historically underdeveloped legal system is not yet able to perform the heavy responsibilities suddenly thrust upon it after the crisis. This applies particularly to the application of commercial law in cases of debt default, bankruptcies, and commercial disputes. During the Soeharto era, major cases in this realm were routinely decided at top political levels, and the legal system was by-passed.

Finally, a major decentralization program was introduced in January 2001, shifting power and resources from the central government to the second-level districts (*kabupaten* and *kota*). This is a long-term process that could transform the country's economic and political geography.

The implications of these changes for economic policy reform are profound, as will be demonstrated in Section 3. They have also been explicitly written into constitutional amendments, which empower the legislature and judiciary at the expense of the executive and bureaucracy, and the regional governments at the expense of the center. Three general points need to be highlighted at this stage.

The first is that during the Soeharto era, in the words of Soesastro (1989), economic reformers employed a strategy of "low politics." That is, they decided on a particular objective (e.g., trade liberalization, and tax reform) and the mechanics for its implementation, and then sought to persuade the president. Once that approval had been obtained, the reforms could be introduced without opposition. However, with these new post-crisis political economy constellations, a constituency has to be won over. There are battles to be fought in the arena of public opinion, in parliament, in the cabinet, and sometimes also in the bureaucracy and in particular regions.

The second is the emergence of a large range of economic policy players. Many have low levels of economic literacy, are influential, and in some cases have an incentive to lobby for policies that are contrary to the national interest of sound economic policy. Table 1 provides a summary of these actors, their influence and their objectives. The core economics ministries (together with the central bank) have high levels of analytical expertise, their mandate and objective is sound economic policy, but they have limited influence outside of macroeconomic policy. With the exception of a small number of academic think tanks, no other policy actor in the system has a similar combination of expertise and objectives. Most of the other players have limited analytical capacity, moderate to high influence over policy, and an objective function dominated by narrow sectional interests, firm, sector, project, or region-specific. This is the central explanation for the schism between macro and microeconomic policies, to be examined shortly.

Third, as a consequence, policy-making processes are generally long and uncertain, with the significant possibility of poor

Table 1. *Major post-crisis economic policy actors in Indonesia*

Actor	Analytical expertise	Rents from poor policies	Authority/influence
Economics ministries	High	Low	Limited outside macroeconomics
Line/technical ministries	Weak, apart from sector-specific knowledge	High	Generally high
Local govts.	Generally weak	Potentially high	High
Parliament	Generally weak	High	High
Academics, think tanks	Variable; some high	Low	Moderate
Vested Interests	Weak, apart from sector-specific knowledge	High	Moderate, variable
Media, civil society	Generally weak	Variable	High