

The Indonesian Economy in Transition: The International Context

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Introduction

The economic success of a nation is largely determined by internal factors. But external influences -- both ideas and events -- can affect economic performance significantly as well. Indeed, as Indonesia's recent experience demonstrates only too well, some external shocks can inflict great damage. And lessons can be learned from the experience of other countries as well. My comments today will focus on the interaction between external influences and domestic economic management. I will look at both Indonesia's own experience and experience in some other countries. The aim is to draw on lessons to consider a strategy for the future.

In brief, I will suggest that in some respects the current international economic environment appears to be a particularly challenging one for Indonesia. Later in the paper some lessons from the transition process in some other countries will be considered. One of the main conclusions is that it seems likely that in the future, Indonesia should consider working harder at economic diplomacy than in the past.

The paper will focus on the following questions:

- What are the main features of the international economic environment that Indonesia currently faces? In particular, how does the international environment today differ from the situation at the time of the last major transition in Indonesia when President Soeharto formed the New Order?
- What lessons can be learned from the experiences of other countries passing through a transition process?
- What are the implications of this range of different experiences for economic policy and for current planning in Indonesia?

The discussion will focus first on Indonesian experience. The latter part of the paper will outline experiences in some other countries passing through the transition process.

Transition: Sukarno to Soeharto

In the late 1960s, dramatic changes in the processes of government in Indonesia took place in the transition from the Sukarno to the Soeharto era. These changes within Indonesia were accompanied by a transformation of Indonesia's relations with the international community.

Previously, Indonesia had pursued inward-looking policies and in many respects had adopted positions that were antagonistic towards the international community, especially towards Western countries. These policies were quickly reversed when President Soeharto established the New Order in the late 1960s. During the following three decades, Indonesia's economic relations with the international community passed through several phases which may be characterized as reflecting, first, an initial enthusiasm during the 1970s, followed by a maturing of relations during the 1980s, culminating in a cooling during the 1990s.

The Enthusiasm of the 1970s

With hindsight, it would appear that the incoming President Soeharto was fortuitous enough to come to government at a time when the international environment provided considerable support for his approach as President.

For one thing, Soeharto's priorities fitted in well with the international priorities of the day. The strong emphasis on internal stability and economic growth stood in marked contrast to the continuing turmoil in nearby Viet Nam where the United States was endeavouring to contain the perceived threat of communism. The rest of the international community welcomed the domestic economic priorities of the new Soeharto Government as well, emphasizing as they did such things as fiscal responsibility and a more liberal approach to foreign investment. In response to the change of direction, Western donor countries signaled their support by establishing the Inter-Governmental Group on Indonesia (IGGI), promising increased aid, and actively stepping up diplomatic engagement with the new government.

A second form of important support came from the multilateral institutions that quickly expanded their activities in Indonesia after the change of government. The World Bank and International Monetary Fund, especially, established strong teams of advisers in Jakarta and began to develop programs to promote economic recovery and growth. A significant measure of the increasing importance that the international community gave to Indonesia is the fact that the new President of the World Bank, Robert McNamara, visited Indonesia in June 1968 on his first overseas journey as President of the Bank. The World Bank Resident Mission established shortly after McNamara's visit soon became a key component of Indonesia's economic relationship with the international community and represented a very considerable commitment of resources by the World Bank. (Thompson and Manning: 1974).

External economic factors impacted favourably on Indonesia in a third significant way during the 1970s when both the 1973-74 oil boom (and five years later, the second oil boom) and the Green Revolution provided substantially increased resources and key new technology to help underpin growth.

The 1980s: Maturing Relations

By the early 1980s, the relationship between the Indonesian Government and the international community had matured in important ways. Indonesia was seen by much of the international community as a country which still faced great challenges but which was making good economic progress and was playing an increasingly significant role in Southeast Asia (Severino: 2003).

During this period, Indonesia's official relations with the international community, including in economic and commercial relations, were generally effective. President Soeharto himself concentrated mainly on domestic policy issues, travelled overseas relatively infrequently, and showed little inclination to strengthen Indonesia's international profile. Indeed, few leaders of large nations can have been so little known overseas. The Indonesian bureaucracy followed the President's lead and adopted a policy of maintaining a relatively low profile overseas. The result was that for a large nation, Indonesia's role in international affairs was relatively modest. This, it might be noted, was no bad thing. The emphasis on domestic policy was seen by the international community as appropriate and, indeed, served to bolster international confidence in the Indonesian Government's approach.

However it is important to note that one factor that helped Indonesia adopt this low-key approach was the special degree of support that multilateral financial institutions such as the World Bank, the IMF and the Asian Development Bank provided to Indonesia. During the 1970s, the major international financial institutions had developed highly effective working relations with senior Indonesian leaders. Several features of the relationship are worth noting. One is that the close working relationship between Indonesia's senior economic policy makers and the international institutions received strong support from the bilateral donor community working through the IGGI, and from large donors such as Japan. Another feature of the relationship was that the major multilateral institutions played a key role in bolstering Indonesia's economic diplomacy. The major financial institutions provided, first, valuable assistance in helping formulate economic policy and then, second, provided much assistance to Indonesia in explaining these policies to the international community.

Nevertheless, despite the undoubted success of national economic policies, a daunting agenda of other problems was slowly attracting increasing attention (Elson: 2001). At home, issues such as corruption, poor government services, arbitrary bureaucracy, and the "lack of the rule of law" were matters of frequent comment. At the international level, the agenda of the donor community was widening away from the traditional focus on economic growth and a limited range of sectoral issues (agriculture, irrigation, transport and communications, power, manufacturing) into education, health, and environmental and gender issues.

Nevertheless throughout the 1980s economic growth in Indonesia remained high and, importantly, poverty levels declined markedly. The result was that the growing concerns about these and other issues were pushed into the background. It was hard to argue with such evident economic success. (Thee: 2003)

The 1990s: Cooling Relationships

During the 1990s, in the years leading up to the economic crisis, two major international developments reinforced growing discontent at home.

One was the collapse of the communist empire. As a result, the threat of international communism disappeared. The implications for the New Order approach to government were not immediately evident but the long-term consequence was that the strategic role that Soeharto had played as an anti-communist leader in Southeast Asia soon became much less important. (Masters: 2003)

A second change that soon became apparent was that the global development agenda which reflected donor priorities continued to change, tending to widen to include an increasing array of non-economic issues such as human rights, democracy, greater involvement of civil society in the development debate, gender, and so on. The record of the New Order Government was considerably less impressive in some of these areas than in the economic field. The changes in the global development agenda thus tended to encourage increasing criticism of the Indonesian government.

External developments affected the conduct of economic policy in Indonesia in other ways as well. Increased emphasis on liberalization, and on market-oriented approaches associated with increased international private sector financial flows in the early 1990s, had opened the door to a number of large doubtful deals in the power sector and to sharp increases in risky borrowings overseas. Within Indonesia there was some questioning of the wisdom of these approaches. However, the prevailing international thinking in favor of market-oriented policies was strong. In the event, Indonesia was swept along.

The 1997-98 Crisis and the Aftermath

The long period of the New Order Government ended dramatically during the 1997-98 crisis. The crisis itself was a special period of both external and internal turmoil. For the purposes of the discussion in this session it is enough to note that the crisis underscored the fact that changes in the external environment can have a dramatic impact on the domestic economy. (Thee: 2003b)

In the aftermath of the crisis, certain key changes in the international environment appear to have complicated the challenges of managing external affairs. Several deserve special attention.

First, the global development agenda has continued to grow and has become increasingly complex. Furthermore, the non-economic issues which have been added (e.g., human rights, democracy, corruption) encourage attention on areas where Indonesia is perceived to have been less successful.

In addition, the emergence of security and terrorism issues since the 9/11 terrorist attack in the US, combined with the quite marked increase in concerns about domestic security within Indonesia, has cast Indonesia in a less favorable light on the international stage than previously, especially in the US.

Further, the geographical focus of much of the global community has shifted since the 1997-98 crisis. Today, Indonesia is neither successful enough (such as China, India, and Viet Nam) nor insecure enough (such as Iraq, Afghanistan, and North Korea) to attract special attention. Indonesia is now no longer an economic star that attracts much attention (as was the case in the mid 1990s) nor a basket case that warrants special international support (as was the case at the end of the 1960s). Today, Indonesia is widely seen as just one more developing country struggling, with indifferent success, to confront major internal challenges.

In response to these various trends, the focus of international agencies has shifted as well. The special support that Indonesia received in the decades before the crisis has been replaced by a more usual relationship. The international agencies, for their part, have found that dealing with a highly pluralistic Indonesian society is a complex and time-consuming process. The Indonesian body politic, too, appears to have collectively decided that it is time to consider a readjustment in the relationship with the key multilateral economic institutions. The recent decision to conclude the standby arrangement with the IMF and enter into a post-program monitoring phase reflects the change in the mood in Indonesia.

Transition Economies

A second way of drawing lessons from international experience is to draw on the substantial debate about change in transitional economies (Mishra 2000). Many countries have passed, or are currently passing, through significant transition phases -- just a few of the countries which come to mind are the Philippines after the fall of Marcos, Russia during the past decade, Cambodia since the early 1990s, the People's Republic of China at various stages in its own reform process, and so on. In many cases, sharp transitions in these and other countries were triggered by a severe economic crisis following the downfall of a centralist regime. Often a period of political disruption followed accompanied by a breakdown in established social consensus.

It is important, in drawing on the debate about transitional economies, to distinguish between the different types of economic transition. The term "transition economy" has often been

used to describe the process of change in economies (such as in Eastern Europe) which are passing from a socialist economic system to a free market system based system on private property. However a second definition of "transition" which is more useful in the current context refers to the change from one type of market economy where patrimonial or patron-client relationships are widespread to a rules-based system of market relationships. Transition towards political pluralism and a rules-based market system has been a key feature of the transition in countries such as Indonesia, the Philippines, Cambodia, and Russia.

Within Southeast Asia, Hill and Sadli (2003) have recently compared experience in the Philippines and in Indonesia. They have drawn attention to the following similarities in these two countries as they passed through during the transition phase:

- Radical power shifts. A weakened presidency, a newly assertive but unpredictable legislature, a bureaucracy having to redefine its role, and a noisy but generally unsophisticated civil society.
- A fiscally incapacitated government. A rapidly rising public debt which absorbed 40% or more of public expenditure.
- An uncertain, and sometimes acrimonious, relationship with foreign debtors, further complicating economic recovery. "Nationalist" politicians found the IMF, in particular, an irresistible target.
- A weakened center, in response to pressure to extend democracy and fiscal authority to the regions too quickly.
- Populism in the labor market. Controls over trade unions were relaxed, and politicians vied for popularity by supporting unsustainable and widely flouted increases in regulated wages. This in turn impaired competitiveness and jeopardized recovery.
- Governments struggling with rising public debt and democratic demands for expenditure deferred major investments. When growth resumed, a half-decade or more of under-investment resulted in power shortages (chronic in the Philippines in the early 1990s).

More generally, some of the main lessons for Indonesia from surveying the wider literature on transition economics would seem to be the following (Mishra, 2000).

It would seem important to find ways of ameliorating the conflicts likely to emerge between social groups, and to attempt to build transparent and equitable social consensus. If this cannot be done, increasing social instability and a decline in internal security may well retard both domestic economic activity as well as programs of foreign assistance and investment.

Second, the transition from one form of market economy (patrimonial or discretionary) to another (rules based) can be slow and time-consuming. Political change often goes hand in hand with social and governance changes across a nation. New institutions need to be established; weak institutions need to be strengthened; and often the resources available to support the process are thinly spread over many competing demands.

In addition, potential losers can be expected to resist change. For example, in a number of transition economies it has proved very difficult to implement programs to reform or privatize state owned enterprises. Similarly, owners and managers of insolvent private sector conglomerates often adopt stratagems to avoid letting control pass to the state or to

administrators appointed to take over the firm. Neither is it always easy for policy-makers to decide on the best approach in settling the affairs of insolvent firms. Sometimes there are strong public interest arguments in favor of allowing firms to try to trade their way out of difficulty even when debt levels seem very high.

Lessons

What are the lessons to be learned from these brief surveys of Indonesia's experience and of experience in other countries in transition? Four seem to stand out.

First, throughout the last three decades, both ideas about economic policy as well as economic events in Indonesia have been significantly influenced by external economic influences.

In addition, for much of the period in the 30 years up to the crisis, in important respects the external environment was relatively favorable. But the external economic environment today is less favorable. The international development policy agenda has become complex and is focusing attention on challenges which are largely outside of Southeast Asia. In addition, there is intense global competition for financial resources. Indonesia will need to ensure that the domestic climate is as favorable as possible in order to encourage inflows of public and private sector capital.

Third, throughout the period, Indonesia placed much reliance on the major international institutions for the conduct of Indonesian economic diplomacy. Now that the priorities of the international community have changed it would be prudent for Indonesia to rely less on the multilateral system and to plan to strengthen the capacity of Indonesian institutions to conduct official economic diplomacy.

Finally, in an increasingly pluralistic policy environment, "second tier" civil institutions such as research agencies, think tanks, commercial groups, labor organizations, and so on, are expected to provide input into international and domestic policy debates (Weaver and Stares, 2001). Indonesia therefore needs to have a well-developed second tier capacity to interact with external economic actors such as bilateral donors and multilateral agencies, commercial and trade organizations, international think tanks, and private investors. Much of the high-level interaction during the period of the New Order rested, on the Indonesian side, with the economic technocrats. Today, faced with a new set of international conditions, it is in Indonesia's interests to widen the range of domestic economic institutions which can represent Indonesia's national interests effectively to the international community.

Policy Implications

These lessons provide useful pointers for practical policy. The main ones appear to be the following.

First, tendencies to turn inwards away from the international economic community would best be resisted. Indonesia has much to gain from an open and effective relationship with the outside world. It is therefore in Indonesia's interests to strengthen the mechanisms for dealing with the international economic community in a self-confident and open way.

Second, at the broadest level, the single best thing that Indonesia can do to protect national interests in dealing with the international economic community is to strengthen the fundamentals of government and economic management at home. When domestic economic performance is strong, there is little need to publicize the fact because the

international economic community quickly hears the news; but when the domestic economy is weak, even well-designed public relations programs are unlikely to be effective. The aim, as Ministers Dorojatun Kuntjoro-Jakti and Boediono have emphasized, must be to lift the annual economic growth rate towards the 6-7% range.

Third, lessons learned from the experiences of other countries passing through economic transition should inform economic policy-making in Indonesia. These include the desirability of ameliorating social conflicts that arise during the process; the need to recognize that the transitional process is likely to take considerable time; and the fact that losers can be expected to resist change.

Fourth, plans should be developed to strengthen the capacity of Indonesian institutions to conduct official economic diplomacy. The key messages that need to be conveyed to the international community should be defined. Target audiences for economic messages need to be identified. Appropriate delivery mechanisms (in person, print, electronic) should be used in a strategic way. (McCawley and Wallace, 2002.)

Finally, consideration might be given to ways to strengthen the network of second tier civil institutions which support both domestic debate about economic issues and Indonesia's interaction with the international economic community.

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