Economic Trends and Macroeconomic Management In Indonesia: 1960s-1980s

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ABSTRAK

Tulisan ini membahas mengenai mekanisme penggerak ekonomi makro di Indonesia selama dua periode yakni periode 1960-1965 yang merupakan tahun-tahun yang berbahaya bagi Indonesia dan periode 1966-1989 yang merupakan tahun-tahun keberuntungan bagi perekonomian Indonesia. Indikator utama ekonomi makro menunjukkan kinerja yang mengesankan selama tahun-tahunter sebut. Penyesuaian dalam ekonomi makro memainkan peranan penting dalam menangani situasi yang kacau yang terjadi pada awal periode 1966-1989 serta goncangan baik internal maupun eksternal. Sistem dan pengawasan keuangan yang buruk serta masalah informasi asimetris. seperti kebijakan industri yang bias, kapitalisme, dan memuncaknya pinjaman cepat yang beresiko. Masalah pasar keuangan dan respon yang kurang tanggap membuat Indonesia rentan terhadap goncangan yang akan berdampak negatif pada sentimen pasar terhadap Negara.

Kata Kunci: *manajemen makroekonomi. pendapatan nasional. inflasi, money supply, kebijakan fiscal. kebijakan moneter, nilai tukar mata uang.*

ABSTRACT

This paper discusses the mechanisms of macro-economic drivers in Indonesia during the two periods; the period 1960-1965 which is a dangerous years for Indonesia and the period 1966-1989 which isa miracle years for the Indonesian economy. The main macroeconomic indicators showed an impressive performance over the years. Adjustments in macroeconomic plays an important role in dealing with the chaotic situation that occurred at the beginning of the period 1966-1989 as well as both internal and external shocks. Poor financial system and poor supervision and asymmetric information problems, such as industrial policy bias, capitalism, and rising up risky loans. Financial market issues and less-responsive responses madeIndonesia vulnerable to shocks that would bring a negative impact on market sentiment against the State.

Keyword: *macroeconomic management, capital income. inflation, money supply, fiscal policy, monetary policy. exchange rate.*

INTRODUCTION

Indonesia's economic development started under Soekarno's regime. However, the economic performance led to a disastrous combination of huge budget deficits and hyperinflation. The stagnant economic growth peaked in 1965, which Soekarno called `the year of living dangerously', and this economic turmoil ended his presidential administration. Soeharto's 'New Order' policy followed and the need for economic stabilization program and political-social stability enforcement became crucial for providing a primary base for economic growth. The stabilization program played a remarkable role in the economic growth of the 1970s. Inflation was successfully controlled; the inflation rate was kept stable. While economic development under Pelita (five years development plan) programs continued, several macroeconomic policy responses were quite successful in dealing with the shocks in the 1980s. In effect, GDP growth was high compared to previous decades and stayed at a high level. Fiscal imbalances declined and inflation was stable, while the real exchange rate was kept at a level that strengthened non-oil exports.

This paper presents stylized facts on the Indonesian economy. We take a broad view on mechanisms driven Indonesia's macro economy and financial system, and try to draw lessons from it. In particular we investigate the stylized facts on the basis of two periods, i.e., the 1960-1989 period consisting of the years of living dangerously 1960-1965 and the miracle years 1966-19896. This chronology allows a presentation of the country's boom and bust cycles associated with the shock experiences. During the period 1960s-1980s, the Indonesian economy experienced several shocks: (i) negative domestic political shocks, 1960-1965, (ii) two positive external oil shocks, 1973-1980, (iii) the collapse of the state oil company, 1975-1976, and (iv) adverse global recession, 1982-1983. All these shocks and many other factors have added additional cycles to the country's macroeconomic-financial performance and complicated economic policy management.

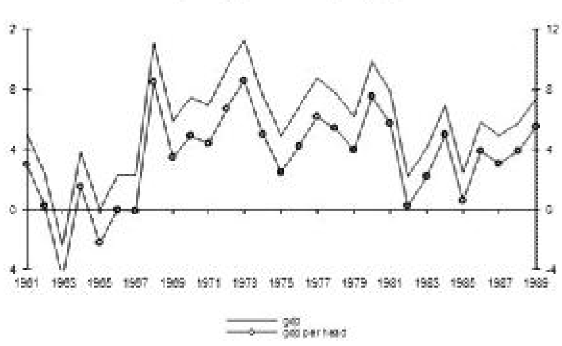
This paper is structured as follows. The first section is introduction. The transition of Indonesia economy from the years of living dangerously to the miracle years is presented in sections 2 and 3. It overviews key changes in macroeconomic performance and policy. And the final section offers concluding comments.

SHOCKS AND ADJUSTMENT MEASURES: 1960S - 1980S

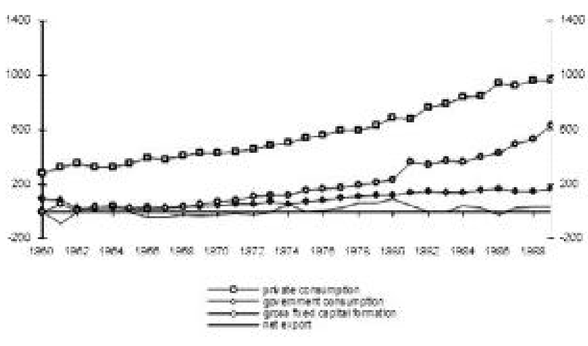
The most obvious features of Indonesian economic development since 1960 are rapid growth in total and per capita income and rapid industrialization. There are few other countries, if any, in which the variations in economic trends, policy and external conditions are as wide as those which have occurred in Indonesia through three decades, 1960s-1980s. The bad domestic economic situation leads to a turning point in the country's politics in 1965, achieving remarkably steady economic performance under the New Order regime.

Oil prices have boomed and busted. Trade policies vary between strong protectionism and relative openness. Macroeconomic policies vary between conservative orthodoxy and hyperinflation. Finally, a repressed financial market is liberalized to more competitive structure. This section reviews Indonesia's economic trends related to macro-financial policies. All descriptions in the following sub-sections are based on summary data on major macroeconomic variables given in Figure 1, except other figures that are mentioned across the sub-sections.

Indonesia: gdp and gdp per head at 1980 prices (% p.a.), 1960-1989

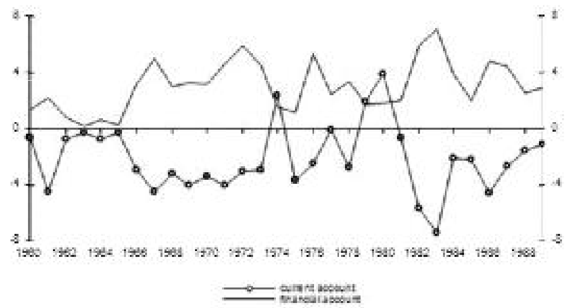


Indonesia: composition of gdp at 1980 prices (billions of IDR), 1960-1989

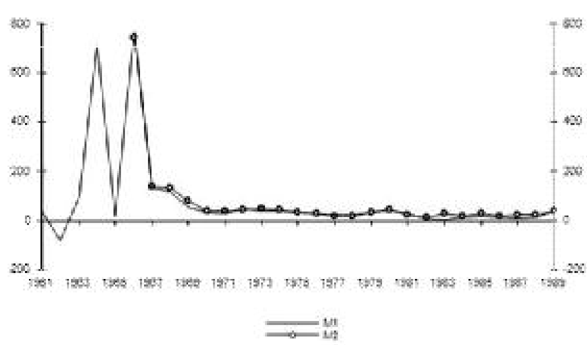


Indonesia: composition of trade balance (% of gdp at market prices), 1960-1989

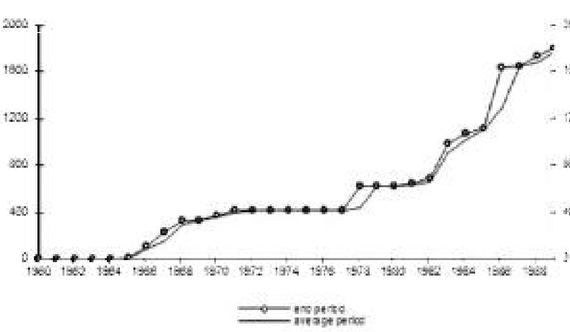
Indonesia: current account and financial account (% of gdp at market prices), 1960-1989



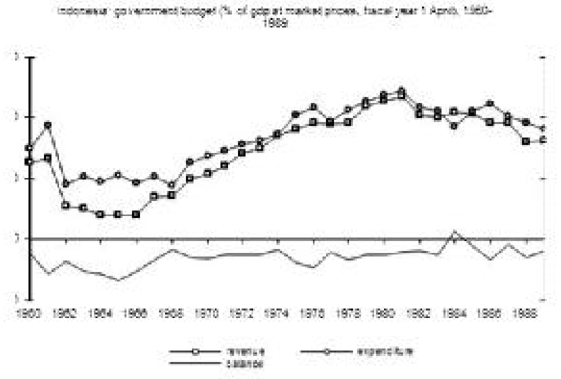
Indonesia: M1, 1960-1989 and M2, 1968-1989 (% p.a.)



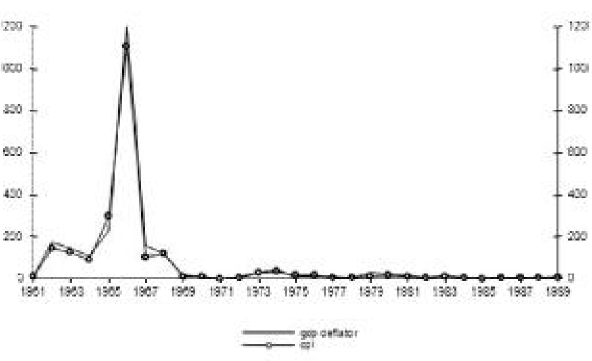
Indonesia: nominal exchange rates (idr per usd), 1960-1989



Indonesia: government budget (% of gdp at market prices, fiscal year 1 April), 1960-1989



Indonesia: gdp deflator and cpi at 1990 prices (% p.a.), 1960-1989



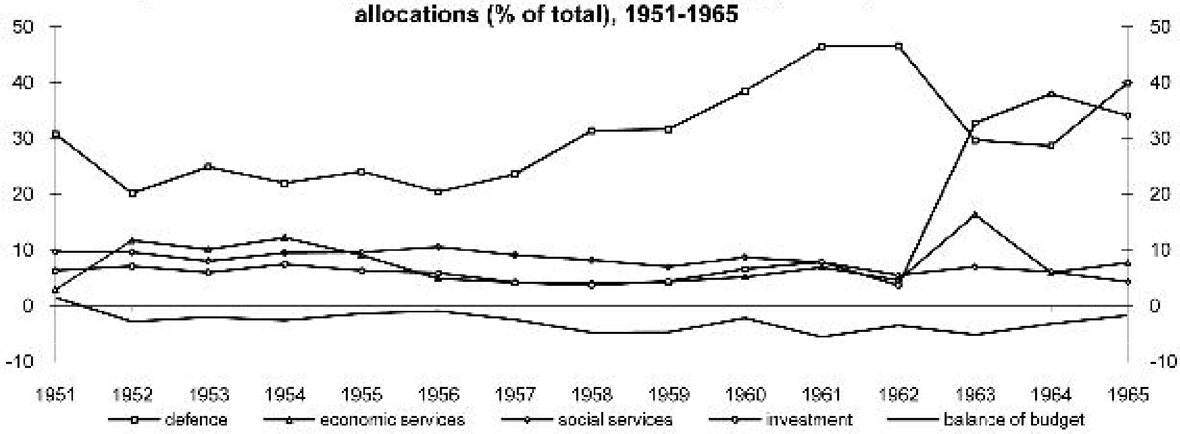
Source: IMF, *International Financial Statistics.*

Sky-Rocketing Inflation and Exchange Rate Controls: 1960-1965

In the 1960-1965, the Indonesia economy was overhauled. The rise of economic and political nationalism as a reaction to colonialism and neocolonialism bolstered the idea of isolationist economic policy. The policy episode began under the Soekarno regime with a series of ambitious development strategies, the so-called 'guided democracy-economy' programs. The programs had several objectives: (i) to increase state control over means of production; (ii) to use quantitative restrictions and multiple exchange rates regime to address balance of payments deficits generated by macroeconomics imbalances; (iii) to achieve rapid industrialization and to construct giant showcase projects; and (v) to expand the military apparatus. The policies consisted of aggressive, nationalistic policies and were financed by monetary financing (Woo, et al., 1994; Hill, 1995). This type of economic management inevitably led to huge economic problems in the mid-1960s. The government began to use its massive control over means of production by nationalizing Dutch and other Western companies. By withdrawing from international organizations, World Bank, the IMF and the UN, the country cut off foreign resources and became increasingly more isolated. The result was that economic management became more diffuse.

From the early 1950s to the mid-1960s, the regime relied increasingly on advances from the central bank to finance government's budget deficits. Figure 2 shows the government budget deficits and the expenditure allocations. Although political turmoil brought frequent changes in the economic policy regime, the Soekarno's administration maintained fiscal discipline. The budget deficits averaged only 1.5 percent of GDP in the period 1951-1957. This figure was remarkably small compared to the annual average budget deficits of 5 percent during the 1958-1965. Several attempts to halt inflation were made. In August 1959, the values of 500 and 1000 rupiah were cut by 90 percent respectively which reduced the volume of money supply by a third. In May 1963, controls on bank lending were tightened and government introduced an austerity budget. Apart from the continuing of the 'guided democracy-economy' programs, the confrontation with Malaysia in 1965 provides additional impetus to inflation acceleration through bank credit expansion.

Figure 2. Indonesia: government budget deficits (% of gdp) and expenditure allocations (% of total), 1951-1965



Source: Woo *et al.*, 1994 and World Bank.

The country's economy suffered from hyperinflation in 1965, and government had to introduce new rupiah with value 1 rupiah from its previous value, 1000 rupiah. During this hyperinflation period, Indonesian's rupiah was depreciating slightly and hence became greatly overvalued. The high excess demand for foreign exchange at the official rate forced the government to ration foreign exchange by using multiple exchange system.

Overall, the 'guided democracy-economy' programs produced inflation rates of 315 percent on average between 1960-1966, Hill (1994) indicates that the inflation rate was reached of almost 1500 percent in mid-1966, Corden (1996) cites 1000 percent in the second quarter of 1966, while McLeod (1997) records an annual rate of 636 percent in 1966. The World Bank and IMF data show an annual inflation rate of around 1200 percent in 1966 caused by printing money. In the same period the fiscal deficit was 4.8 percent of GDP on average. The government allocated funds to defense expenditures rather than building infrastructures projects (see Figure 2), which destabilized the economy. The consequence of these measures was a slowdown in real GDP growth, reaching on average 1.9 percent per year between 1960 and 1966; in the same period population growth was 2.2 percent a year. So, the country experienced a period of economic stagnation in terms of growth of GDP per capita. In relations with trading partners, the country was restricted by high tariff and non-tariff barriers, including import and export licensing and exchange control with multiple exchange rates.

Inflation Stabilization and Oil Boom: Mid-1960s - 1970s

In the chaotic economic situation in mid-1960s, Soeharto's 'New Order' government restored economic stability. The new government was willing (i) to implement a program of fiscal austerity in order to balance government's budget and control inflation, and (ii) to reestablish Indonesia's financial links with the West in order to attract loans, foreign grants, and investments. After having reached an agreement with Western creditors - Inter-Governmental Group for Indonesia (IGGI), the IMF and the World Bank - on external resources, debt relief and new loans, a relatively orthodox macroeconomic policy was adopted to control the inflation rate. By implementing conservative fiscal and monetary policies, the government committed itself to never monetizing its budget deficits, to enlarge role for market forces, a welcoming attitude to foreign direct investment, and to set a realistic exchange rate. In addition, the central bank stopped granting credits to state enterprises.[1] The impact of this change of macroeconomic policy was large. The fiscal imbalance fell to around 3 and 2.5 percent in 1970 and 1971, respectively. The reduction in the budget deficit and the associated in the rate of creation of money resulted in inflation being brought rapidly under control. In 1971 inflation was down to 2.7 percent from a three-digit figure during the 1960-1966.

Along with a policy of controlling inflation, the government carried out active trade and exchange rate management. On the external side, all quantitative restrictions on imports were abolished, the multiple exchange rate system was abandoned and an export incentive system with foreign exchange certificates was introduced. These changes boosted exports among other things through a dramatic reduction of unlawful exports. As a result, exports grew considerably, on average to 7.7 percent of GDP in 1960-1968 to 14 percent and 16.3 percent in 1971 and 1972, respectively. Because imports remained stable,

[1] This stabilization program was drawn up with IMF assistance in 1966.

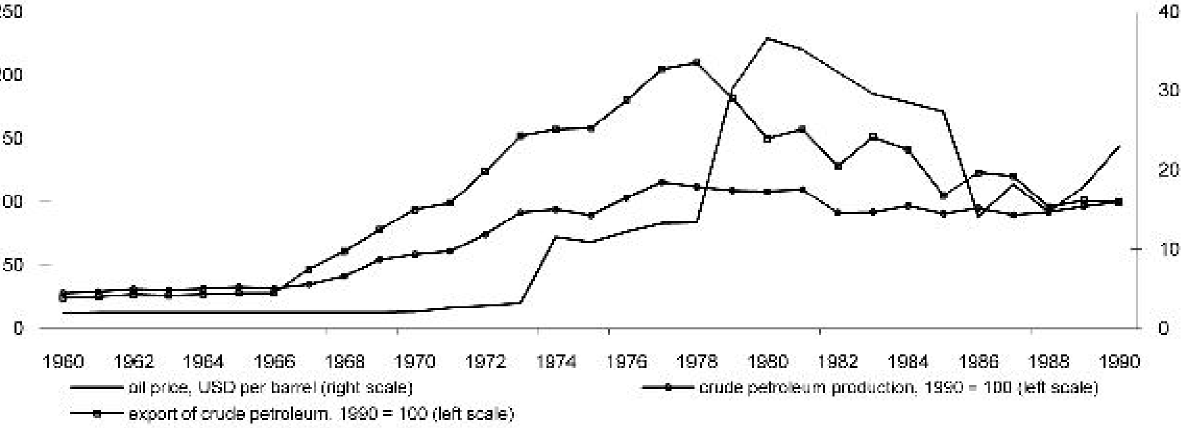
this export performance improved the balance of payments and the budget deficit.

As part of monetary policy, the central bank tightened automatic credits to state firms. The central bank credits were no longer available to state enterprises and competition with private enterprises began to emerge. Furthermore, the control interest rate (the inter-call bank interest rate) was raised - the rate about doubled during the 1967-1970 period – to eliminate negative real rates in the real sector. A new type of fiscal policy was introduced: the so-called `balanced budget', where the deficit between revenues and expenditures had to be matched by foreign debts.[2] The combination of monetary and fiscal policy resulted in a sizeable drop of the growth rate of the money stock, M1, from 764 percent in 1966 to 33.9 percent in 1970 and 29.9 percent in 1971. This in turn triggered a further decrease of the inflation rate to respectively 2.7 percent and 4.4 percent in terms of the implicit GDP deflator and CPI in 1971.The most outstanding feature of the overall stabilization and structural adjustment program in 1966 was the fact that economic recovery rather than slump accompanied the dramatic drop in inflation. Real GDP expanded steadily by more than 8 percent per year during 1968-1972, proving that the program was successful in achieving high productivity through better allocation of resources and thus providing the path of sustained economic growth. This background encouraged Western creditors to form the IGGI for monitoring the Indonesia economic development and policy issues and providing a steady stream of loans in exchange of the cost of policy changes. The government was also pursuing further market-oriented microeconomic policies, such as embarking export processing zones and rehabilitation of physical infrastructure to support infant industries.

In the second half of the 1960s the Indonesian economy tried to benefit from its oil resources. This type of policy was promoted by the state-owned oil company, Pertamina, which was funded by commercial bank credits and oil earnings. Figure 3 depicts oil activity of the country. The capacity of oil sector was expanded steadily by around 113 percent during 1967-1972. Over the same period exports of crude oil increased remarkably to the level of 163.9 percent. This relieved the fiscal balance and balance of payments performance, and the inflation rate reached its lowest level in 1971. More importantly, these oil revenues took away the pre-1965 pressure of the money stock explosion and international reserves depletion on fiscal imbalance.

[2]The balanced budget rule which is contained in the Guidelines of State Policy was initially adopted in 1968. It requires that annual total budgetary expenditures should be equal to budgeted revenues, defined to include all foreign grants and loans. The rule also requires that domestic revenues be sufficient to cover current expenditure, including amortization of government debt and a portion of development expenditure. To the extent that development expenditures exceed public savings, the gap may normally only be filled by external borrowing.

Figure 3. Indonesia: exports-production of crude petroleum and oil prices, 1960-1990



Source: IMF, *International Financial Statistics*.

The outbreak of YomKippur war shocked oil prices in 1973-1974. This first OPEC shock created an almost six-fold increase of oil prices, the price of oil was USD 2.7 per barrel in 1971 and rose to USD 11.6 in 1974. This oil windfall allowed the government to finance investment in infrastructure and to promote industrial development by supplementing or replacing foreign and domestic private investment in manufacturing.[3] The industries that emerged were highly import-dependent and reliant on tariff protection. Pertamina took advantage for this policy of industrial promotion. The state oil company intensified its oil exploration activities and succeeded in borrowing loans from international financial markets. The corporation became a giant conglomerate complex with a lot of activities unrelated to the oil sector. It gained a position similar to the government development and planning agency (Bappenas). Unfortunately, many of the company operations were not controlled by the government and were financed by secretive spending. In 1975 Pertamina could no longer to roll over its short-term loans which amounted to more than USD 10 billion (30 percent of GDP), so the company defaulted. The central bank had to take over its debts which resulted in a depletion of international reserves. This rescue process had a great impact on external borrowing. The debt to export ratio jumped from 85 percent in 1974 to 114 percent in 1975. The question arises whether the Pertamina crisis had a short-term impact on macroeconomic performance, particularly whether it had a negative impact on government investment. Government expenditure indeed increased by 31 percent in 1976. The government tried to obtain new long-term debts to pay off Pertamina debts and additional loans to expand its investment programs. This investment had a counter-cyclical effect on economic activity (McCawley, 1978).

Another phenomenon, the Dutch disease, appeared at a very mild level in the aftermath of the first OPEC shock. The windfall profits from the oil price shock led to declined prices of traded goods relative to non-traded goods. This price adjustment caused a reduction in the output of traded goods along with an increase in the output of non-traded goods. In addition, the currency appreciated in real terms, so the export competitiveness worsened (Corden,

[3] In the late 1970s and early 1980s, government raised trade barriers for protecting these new state-owned enterprises, most of which were import-substituting industries. From mid the mid-1970s onwards, there was a greater government's control on foreign direct investment.

1984; van Wijnbergen, 1984; Usui, 1997). The first response of the government was to use monetary policy to sterilize the windfall profits rather than a contracting fiscal policy. In the absence of monetary control instruments - the bond and equity markets were virtually nonexistent – the central bank used two instruments to sterilize oil earnings: direct allocation of central bank credits to state and private corporations; and credit ceilings. Both instruments were ineffective in sterilizing the oil earnings. The domestic money supply, as measured by either M1 or M2, grew at 32.9 percent and 37.3 in 1975, respectively. Although the public spending grew along with oil revenues, the government kept the budget deficit (as a percentage of GDP) low. The country deliberately accumulated oil revenues, and avoided the potentially expansionary effects to be brought about by abundant oil revenues. Indonesia succeeded to sterilize part of the windfall oil revenues.

In 1978 the rupiah was devalued by 50 percent because policy makers feared that the real appreciation due to the inflow of oil revenues would harm the traded goods sector. In addition the managed floating system was adopted. This decision came as a surprise; the country's balance of payments was sound. Indonesia's foreign exchange reserves stood at 5.1 percent of GDP and the trade balance showed a surplus of 5.2 percent of GDP during 1978. Other explanations for the devaluation decision are concerns over oil resources depletion and fear of increasing unemployment in the traded sector (Woo, et al., 1994; Azis, 1999). Moreover, Warr (1986) argued that the decision was motivated primarily to improve the profitability of the tradable sector, which had been under increasing cost pressure due to higher inflation under the fixed exchange rate. The devaluation gave a sound boost to the country's non-oil exports. The current account showed a sharp surplus of 192.4 percent in 1980. So, the 1978 devaluation ameliorated the negative impact of the Dutch disease following the first OPEC shock.

The second oil price shock in 1979-1980, which resulted from the Iraq-Iran crisis, had more or less the same impact as the first one. High surpluses in the current account were reached with figures of 1.9 and 3.9 percent of GDP in 1979 and 1980, respectively, against a deficit level of 2.7 percent in 1978. Meanwhile GDP growth accelerated and approached 8 percent in 1980. In terms of the balance budget principle that had been followed consistently since 1969, the windfall profits from this oil boom were treated similarly as foreign debts. Both increased the account of government deposits at the central bank. This unspent account sterilized the shock. As a result, the inflation rate was stable in the following year. This improved exchange rate competitiveness and non-oil exports still increased despite the existence of the Dutch disease.

Adverse External Shocks and Structural Reforms: 1980s

In the first half of the 1980s, a series of external shocks hit the Indonesian economy and also marked the beginning of period of economic reform. The first negative shock appeared when the world economic recession became noticeable. The collapse in international commodity prices including oil deteriorated the country's terms of trade (exchange rate shock) and caused the current account deficit to rise. The deficit became also higher as a result of higher borrowing rates. Although most of the country's long and medium debts were imposed with fixed interest rates, change in terms of trade and interest rates, however raised the country's external borrowing.

The overall effect of this external shock was a drop the GDP growth rate to 2.3 percent in 1982. This event changed the country's economic policy perspective completely. The key elements of the reform were policy measures in the macroeconomic policy mix (exchange rate, monetary, and fiscal policy) aimed at economic stability, trade and investment deregulation, and domestic financial liberalization. These liberalization policies aimed at structural reforms and growth, such as the removal of relative-price distortions and the reduction of state intervention. Table 1 summarizes the chronology of these economic reforms.

In response to this combined exchange rate and interest rate shock, monetary policies were tightened and the authorities postponed many major public projects and vigorously promoting non-oil exports. In fear of a balance of payment crisis 28 percent devaluation was announced in March 1983. The exchange rate was set to the level after the 1978 devaluation to push up non-oil exports and to increase revenues in the budget. In the same year, new export incentives were introduced and import barriers in the form of quantitative restrictions were raised. Efforts to increasing domestic tax revenues were also undertaken by initiating a reform of the tax system in 1983-1984. The most important changes were the elimination of tax holidays on new investment projects, and the introduction of a value added tax effectively in 1986, in place of the former sales tax which had applied to manufactures and a few services.

Table 1. Indonesia: Major Macroeconomic Reforms and Financial Liberalizations, 1960s-1990s

	Dates	Events
Exchange rate management	1960-1965	Floating exchange rate regime
	1974-1997	Managed floating system
	August 1997	Floating exchange rate system
	November 1978	50 percent devaluation
	March 1983	28 percent devaluation
	September 1986	31 percent devaluation
Trade and capital account openness	Since 1960s	Open capital account
	March 1985	Implementation of an across-the-board reduction in nominal tariffs
	May 1986	Measures to provide internationally priced inputs to exporters
	April 1985 November 1989	Lifting subsidies, reformed customs, port handling and shipping procedures in two sets of reform packages
	October 1986 January and December 1987 November 1988	Significant reduction in import licensing restrictions initiated through a series of measures
	December 1987	Reduction of anti-export bias of trade policy by reducing regulatory restrictions for exporters
	May 1990 June 1991	Elimination industrial, commodities and import administrative regulations, and reduction of the total number of tariffs
	July 1992	Measures to increase competitiveness of manufactured exports and improve the domestic investment environment
Money and finance	June 1983	Elimination of bank credit ceiling and state bank interest rates on deposits and loans
	February 1984	Phased removal of a wide range of loan categories from access to the Central Bank liquidity credits, introduction of rediscount facilities and the SBI (Bank of Indonesia certificates) as new tools for monetary control

	Dates	Events
	February 1985	Introduction of new money market instruments, money market paper (SBPU)
	During 1988	Relaxation of entry requirements of domestic and joint venture banks and introduction of a new set of financial measures to enhance financial sector efficiency and developing capital markets
	Early 1990s	Imposing new rules on capital adequacy and restrictions on commercial bank involvement in equity market
Fiscal	Since 1968	Balanced budget system
	May 1983	Large capital and import intensive projects re-phased.
	Since 1983	Cutbacks in government real capital expenditures. Control on the use of non concession import related credits
	January 1984	Tax reform initiated. Tightening and modernization of tax system administration. Holidays from company tax on new investment projects were abolished, a value added tax was introduced, and property taxation was reformed. Follow-up steps to reinforce tax administration and restraints on civil service employment and salaries

Sources: Dekle and Pradhan (1999), Barichello and Flatters (1991), Fane and Condon (1996), Ahmed and Kapur (1990), and Fane (1999).

Before the exchange rate shock Indonesia's financial markets were under repression. The combination of five factors led to highly segregated and inefficient financial markets (Hanna, 1994; Montgomery, 1997): (i) extensive state ownership; (ii) a guaranteed income to state banks for their disbursement function; (iii) the imposition of entry barriers to protect the dominant position of state banks, (iv) credit controls that subsidized interest loans; and (v) the directive that normal risk appraisal procedures be waived (state banks tended to waive the normal risk appraisal procedures for bad credit). The financial sector had relied on the recycling of the government's oil income through the banking system. When the price of oil decreased and the worldwide recession undermined the country's balance of payments and fiscal balance, financial resource mobilization was also stressed. The authorities were under pressure to promote domestic savings to maintain investments, and were also concerned to reform the banking system to improve credit allocation flexibility and efficiency of credit use.

The financial reform process began in 1983 when the central bank removed ceilings on time deposit rates at state banks and also the lending controls on all banks. Although these reforms increased the flexibility of pricing and credit allocation, entry conditions were not eased. Financial repression remained overwhelming since the state banks still kept the advantage of their dominance. Since 1983 a series of measures resulted in an extensive liberalization in the financial sector. The government also enacted a number of economic reforms designed to boost both domestic and foreign investments and to stimulate non-oil exports. In 1988, restrictions on the extension of bank's branch network were removed, as were those on the establishment of new banks, other than purely foreign owned banks. The 1988 reforms also reduced the legal lending limits of non-interest bearing reserves to deposits from 15 to 2 percent (Fane, 1999).

A second negative external shock hit the Indonesian economy in 1986, when the plunge of the oil price caused growth to stagnate, with the peak of budget crisis. Foreign debt also increased, as the Japanese yen appreciated in 1985. The worsening of current account, large national debt, and a slowing of economic activity made the government to devaluate rupiah by the 31 percent in September 1986. Extensive trade regulations followed, aimed at restoring the balance of payments. A further step in trade and investment regulations tried to diversify the economy away from oil and gas exports by focusing on other non-oil export-oriented industries especially those involving the processing of raw materials. Export regulations were streamlined and a host of non-tariff barriers were removed.[4] Measures taken by the government to raise the competitiveness of non-oil and gas exports proved successful. In 1989, exports of non-oil and gas increased significantly by 12.4 percent of GDP. For the first time in 15 years the values of non-oil and gas exports exceeded the value of oil and gas exports (see Figure 4). A further policy response was a fiscal contraction. Government spending was cut, subsidies were reduced, and capital formation slowed. In the financial sector the government lowered entry barriers to increase the competition between state and private banks and between banks and other financial intermediaries.

In conclusion, responding to a series of severe external shocks, the evidence indicates that macroeconomic stabilization and structural reform programs executed by the government during the 1980s succeeded in restoring macroeconomic balances and strengthening growth by promoting the non-oil sector. Despite the large external debt and the constraints that it imposes on the Indonesian economy, the country was able to keep growing while the annual inflation rate has remained fairly stable and at moderate level during most of part the 1980s. Overall, Indonesia's economic authorities have been able to avoid major imbalances despite the limited room they have to maneuver. In part this has been the result of pursuing sound exchange rate, fiscal and monetary policies. Also, they did not hesitate to implement the required adjustment policies whenever necessary.

[4]Fane and Gordon (1996) estimate that the real effective of protection for manufacturing, including oil refining, fell from 27 percent in 1987 to 11 percent in 1995; for manufacturing, excluding oil refining, the fall was from 59 percent to 10 percent; and for agriculture from 9 percent to 4 percent.

Economic Structure and Growth: 1960s-1980s

Growth Record and Structural Change

Between 1960 and 1990 economic growth and growth in income per head averaged respectively 5.8 percent and 3.6 percent per annum. High economic growth was accompanied by a rapid decline in the incidence of poverty and income inequality. In addition to equitable and poverty reducing growth, Indonesia achieved food self-sufficiency, a rapid decline in the population growth, and an equally impressive spread of basic education and literacy.

The growth rates and structure of production achieved during 1960s until 1980s are given in Table 2 and 3. The first table shows the associations between adjustment policies and growth. The growth achievement in terms of 20 years economic planning under the New Order government is shown in Table 3. Up to the mid-1960s, Indonesia was regarded as a chronic dropout, whose economic problems ware as serious as those of low-income developing countries. After the latter part of Soekarno's presidency, Indonesia's average rate of GDP growth over the period 1960 to 1966 was only 1.8 percent and GDP per capita busted to minus 0.3 percent a year. The growth of total GDP then rebounded sharply to 8.7 percent during the major stabilization and rehabilitation period of 1967-1973. It fell slightly to 7.8 percent in the whole oil boom period, 1973-1981. However, in the period of adverse external shocks, the economy activities slumped to the growth amounted 4.5 percent a year. In the early deregulation period, 1987-1993, annual GDP growth recovered to 6.5 percent.

Table 2.Indonesia: Sectoral Composition of GDP (% p.a) by the Periods of Adjustment Policy, 1960-1993

Major sectors	1960-1966* early development	1967-72* stabilization and rehabilitation	1973-1981** oil boom I and II	1982-87** slower growth	1987-1993** early deregulation
Agriculture	1.9	4.3	3.6	3.0	3.2
Industry					
Manufacturing	1.8	10.2	14.2	11.4	9.9
Non-oil and gas	-	-	-	11.4	11.1
Construction	1.0	24.7	13.5	3.2	10.9
Services					
Trade, hotels and restaurants	2.4	11.9	7.8	5.0	7.7
Transport & communication	0.8	9.9	12.9	7.6	8.7
Banking and finance	- 2.3	27.9	13.7	15.5	11.0
Dwellings and real estate	2.1	8.1	12.2	6.5	4.2
Public and government	5.5	6.0	13.0	8.3	4.3
Private services	2.3	2.1	2.4	3.6	6.0
GDP***	1.8	8.7	7.9	4.5	6.5
GDP per capita***	- 0,3	5.3	5.5	2.5	4.6

Note: * at constant1960 prices, ** at constant 1983 prices, and *** at constant 1990 prices.
IMF, *International Financial Statistic*, Central Bureau of Statistics Indonesia, Woo et al. (1994), and Marning (1999).

Since the end of 1960s, Indonesian economic policies were characterized by prudent macroeconomic policies and structural economic reforms, which have transformed the structure of the economy. Table 3 makes clear that during four steps of five years development plan, the share of primary sector (agriculture and mining) in Indonesia's GDP declined from 53 percent in the first step to 39 percent during the fourth step. Agricultural production significantly dropped from 45 percent to 25 percent over the same period. Although the contribution of secondary sector experienced a rapid increase, these measures are relative small compared to the reduction of agriculture production share. The contribution of manufacturing in total output has increased moderately, particularly in the period of the sharp rise in oil prices. Thus during this high growth period the country changed from an agricultural based economy toward an industrial-manufacturing led economy.

The agricultural sector grew steadily during the stabilization and rehabilitation periods (1967-1981). With concentration in rice cultivation, agricultural growth expanded about 4 percent (Table 2) and the country achieved rice self-sufficiency by 1985 (Booth, 1989; Campos and Root, 1996). This impressive performance can be attributed to considerable degree of macroeconomic policies, such as, the subsidized credit programs, the financial sector constraint relaxation, and liberalization of foreign and trade regimes. The latter policy has a huge impact on farmer opportunities for agricultural trade (Woo, et al., 1994). During the period of oil boom (1973-1981), the manufacturing sector surpassed the agricultural sector and started to be an engine of growth for the country's economy. The two oil shocks provided the availability of financial capital for public and private sectors to rise aggregate demand. The domestic oil and gas industries played an active role in managing investments financed by the oil boom. Following the two devaluations and the economic reforms in the 1980, the non-oil manufacture sector was the impulsion behind the growth in the early deregulation periods. The annual growth of non-oil manufactured output in 1987-1993 at 11.1 percent was kept steady compared with the slower growth periods. Moreover, the 15.2 percent contribution of non-oil output to GDP in 1989 made this sector almost as important as the oil sector to drive the country's economic activity (Woo, et al., 1994).

Table 3. Indonesia: Sectoral Composition of GDP by the Periods of Pelita (%), 1968-1989

Sector	1968/69 1973/74 Pelita I *		1974/75 1978/79 Pelita II *		1979/80 1983/84 Pelita III **		1988/85 1988/89 Pelita IV **	
	share	growth rate	share	growth rate	share	growth rate	share	growth rate
Total primary production	52.8	6.6	51.0	3.4	45.3	0.7	39.2	2.4
Agriculture	44.6	4.3	31.2	3.0	24.5	4.3	24.6	3.6
Mining	8.2	17.7	19.8	5.0	20.8	- 2.9	14.6	0.7
Oil and gas	-	-	-	-	19.8	- 3.2	13.9	0.5
Non-oil and gas	-	-	-	-	1	7.2	0.7	5.3
Total secondary production	12.6	15.9	14.2	14.2	17.8	10.1	19.1	7.3
Industry								
Oil and gas	9.2	13.3	9.3	13.7	11.9	10.3	13.6	9.9
Non-oil and gas	-	-	-	-	2.5	3.9	9.7	20.2
Construction	-	-	-	-	9.4	9.7	3.9	6.1
	3.4	24.8	4.9	15.2	5.8	9.8	5.5	2.3
Total service production	34.6	9.4	34.8	9.5	36.9	8.5	41.7	5.2
Total	100	8.6	100	7.2	100	4.9	100	4.4

Note: Pelita (Five Years Development Plan), * at constant 1973 prices, and ** at constant 1983 prices.
Source: Bank of Indonesia, and Central Bureau of Statistics Indonesia.

Output Allocation and Decomposition

The pattern of Indonesian GDP allocation has also changed significantly over 1960s -1980s. Table 4 shows the savings and investments trends in terms of periods of development planning. The excess savings over investments reached only in the periods of third steps of five years development plan when the world oil price was boomed. In the periods of negative spread of saving and investment gap, the country has to maintain investment level by obtaining debts and grants.

By looking at the impacts of different policy regimes on the composition of GDP, Table 5 shows that both the savings and the investment rates increased over time. Each rate increased by more than 21 percent between the period of early development (1960-1966) and 1982-1989. The surge in the domestic investment rate in the period 1982-1989 was caused by a tremendous increase in private investment. The government, however, reduced public investment quite sharply in response to the revenue shortfall created by the oil price decline. The cause of these reverse trends in public and private investment was that the capital formation was only expanded only 8 percent per year during the slower growth period, compared with the oil boom period which amounted 11 percent annually. This decline in capital formation was the most main reason for the slowdown in the growth rate between the periods.

Table 4. Indonesia: Consumption, Saving and Investment by Periods of Pelita (% of GDP), 1968-1989

	1968/69 – 1973/74 Pelita I *	1974/75 – 1978/79 Pelita II *	1979/80 – 1983/84 Pelita III **	1988/85 – 1988/89 Pelita IV **
National savings	11,6	20,3	27.2	22
Domestic investment	15.4	22.2	26.3	25
Investment-saving gap	- 3.7	- 1.9	0.9	-2

: Pelita (Five Years Development Plan), * at constant 1973 prices, and ** at constant 1983 prices.
Source: Bank of Indonesia and Central Bureau of Statistics Indonesia.

Table 5. Indonesia: saving and investment by periods of adjustment policy (% of GDP), 1968-1989

	1960-1966*	1967-1972*	1973-1981**	1982-1989***
	early development	stabilization and rehabilitation	oil boom I and II	slower growth
National savings	4.7	6.6	22.8	26.4
Domestic investment	7.9	12.8	22.3	29.6
Factor income abroad	1.1	1.8	3.8	4.4

Note: * at constant 1960 prices, ** at constant 1973 prices, and *** at constant 1983 prices.
Source: Woo, et al. (1994) and World Bank.

Table 6. Indonesia: decomposition of growth in oil and non-oil GDP (%), 1970-1991

		1970-1982 oil boom	1982-1986. slower growth	1986-1991 early deregulation
Oil GDP	Labor	2.4	5.3	2.5
	Capital	5.6	6.8	7.2
	Total factor productivity	3.7	0.7	3.4
Non-oil GDP*	Labor	1.4	1.3	-
	Capital	5.7	4.0	-
	Total factor productivity	0.9	- 0.7	-

Note: * 1973-1981 for oil boom period and 1982-1988 for slower growth period
Sources: Woo et al. (1994) and Azis and Kuncoro (2000).

In the growth accounting exercise done by Woo, et al. (1994) and Azis and Kuncoro (2000) shown in Table 6, we can learn the effects of policy and external shocks on Indonesia's total factor productivity (TFP). The TFP contribution to non-oil growth rate during the oil boom period was low; it amounted by 0.9 percent. The low TFP value suggests that gross inefficiency existed in the Indonesia economy. When the oil role takes into account in the growth decomposition, the TFP was relatively high. The 3.7 percent of TFP contribution indicate that government policies to use the proceeds from oil windfall revenues to develop basic infrastructure appear to have positive impact on TFP. In the fall of oil prices TFP plunged and took respectively minus 0.7 percent and 0.65 percent off the non-oil and oil growth rate. Even the contribution of labor fell. Major cause of this TFP slowdown is the weak performance of the sectors that relied profoundly on government's oil revenues. The TFP recovered to 3.4 percent in 1986-1991 as consequence of reforms that relied on more market forces and non-oil export-led growth.

CONCLUDING REMARKS

This paper overviewed various issues related to the macro-financial and economic growth record in Indonesia from the early 1950s - 1980s. Our starting point was the beginning of the Soekarno regime. In the spirit of nationalism the regime withdrew from international organizations. They invested in projects that were unfavorable for economic development. This strategy trapped the economy into turmoil, and the Soeharto administration took over. From the mid-1960s to the mid-1990s, the 'New Order' development strategy brought the economy to high economic growth. Macroeconomic indicators were strong and the political and social environment was stable.

At least three strategies were effective in dealing with the chaotic situation that existed at the beginning of the Soeharto period: (i) macroeconomic policies to control inflation, (ii) open access to foreign funds, and (iii) infrastructure enlargement and upgrading. In the prosperous period of economic development that followed, Indonesia experienced two oil booms and one internal shock (Pertamina crisis). Surprisingly, the government decided to currency devaluation after the first oil price shock in fear of increasing unemployment in the tradable sector. In the early 1980s the negative oil price shocks led to a remarkably comprehensive structural adjustment. Two devaluations were inaugurated in 1983 and 1986 and the government engaged in public expenditure restraint, mainly by rephrasing large-capital intensive projects. Moreover, government took several liberalization measures in the financial and the trade sector. Through the adjustment process, exports of manufactures boomed, and the economy recovered from stagnant growth in 1982.

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