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POLICY REFORMS IN INDONESIA: A POLITICAL ECONOMY PERSPECTIVE

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During the 1970s the Indonesian economy grew at a rapid rate. This growth was primarily attributable to the government's oil revenue and massive expansion of public sector in Indonesia. However, the decline in oil price of the 1980s adversely affected the growth and stability of the economy. The government clearly recognized the fact that a restructuring of the economy was imperative. The present paper is a critical analysis of this restructuring effort. The paper argues that the restructuring was initiated with a view to enabling the private sector and non-oil exports to play a greater role in the expansion of employment and income. The reform program began in 1983 with political and economic agenda. The political agenda includes the issues of Pribumism and ethnic diversity and economic nationalism while the economic agenda addressed the privatization initiative, fiscal/monetary policies and trade/investment policies. The reform process that was initiated by the government was partially successful. This paper argues that the main reason for the reform not being fully successful is the corruption of the bureaucracy and too much political orientation of the policies.

Introduction

Throughout the 1970s, the Indonesian economy was performing well, yet some disquieting factors were prevailing there. First, on the average, the real exchange rate tended to appreciate. In conjunction with a substantial trade protection, this acted as an impediment toward export expansion. Second, a relatively high rate of inflation coupled with a largely administered interest rate policy often resulted in negative real rate of interest. This prompted capital flight

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and deteriorated the domestic private investment and unemployment situation in the country. Third, for much of the 1970s, the rapid increase in oil revenues caused a disproportionate growth in the size and role of the public sector in Indonesia. The expanded role of the public sector, combined with a strong orientation toward the domestic market and a philosophy of close guidance for the private sector led to an amassment of trade and investment restrictions. As a result, the performance of supporting services, especially in the financial and the transportation sectors, was adversely affected.

In the 1980s, with the decline of the oil price and its adverse impact on the growth and stability of the economy, the Indonesian government clearly recognized that the disquieting factors constituted a major source of disturbance. It also realized that a restructuring of the economy was imperative to enable the private sector and non-oil exports to play a greater role in the expansion of employment, incomes and exports. Accordingly, the government embarked upon a comprehensive reform program in 1983 with both political and economic agenda.

The main purpose of this paper is to analyze and examine the Indonesian reform process from a political economy point of view. It specifically focuses on the issues involving elements of the reform process, the role of domestic and foreign advisors in the implementation of the reform program, and a brief evaluation of its successes and failures.

Political Aspects of the Reform Process

Agrarian Radicalism and Soeharto's Political Strategy

One important concern of the Soeharto administration[1]

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[1] The present government.

is to arrest any further deterioration of economic conditions in the rural areas so as to prevent the resurrection of the Communist Party of Indonesia (PKI). In 1965, the PKI had three million members. Most of them were landless peasants living in desperate economic conditions in the countryside. Politically, the Soeharto Government cannot afford a further strengthening of the PKI. Therefore, it is one of the government's priorities to improve the socioeconomic status of the rural people in Indonesia and thereby prevent the growth of PKI.

Besides, President Soeharto was born and brought up in a remote rural area of Java. His childhood memory of the sufferings of the rural people of Indonesia clearly dominates his emphasis on rural development. He also strongly believes that keeping the rural people happy is a necessary though not a sufficient condition to remain in power. Historical evidence suggests that the rural people constitute the most reliable political support base for incumbent governments in Third World countries.

Regionalism and Regional Dualism

There has been a considerable amount of dissatisfaction among a large number of Indonesians about the government's practice of discriminatory policy based on regionalism. For instance, the critics of the Soeharto Administration allege that the inner circle of the Government is dominated by the Javanese. As a result, they claim, Java receives a disproportionately large allocation of public funds for economic development while most of the resources to finance development programs come from outside Java.

These misgivings give potential momentum to the separatist and secessionist forces in the country. In order to curb the secessionists' strength and growth, a more egalitarian regional development has been given high priority in the development planning of Indonesia. One of the justifications for the devaluation of the Indonesian rupiah is to eliminate regional disparity between Java and the rest of the country. The devaluation helps improve the terms of trade of the non-Javanese vis-a-vis the Javanese. Here, it should be mentioned that the non-Javanese mainly export primary products while import substituting industries are mainly located in Java.

Pribumism[2] and Ethnic Diversity

There is a growing concern among the indigenous people of Indonesia about the fact that the Chinese-Indonesians' economic power is disproportionately stronger than their share in the population. Rough estimates indicate that Chinese-Indonesians, who constitute about four percent of population, control about twenty percent of the resources. The Pribumis are outraged at this. It is widely believed that this state of affairs has its root in history Before the independence of Indonesia, the Dutch colonial policies were geared up to victimize the Pribumis and favor the Chinese-Indonesians. This sentiment against the Chinese-Indonesians is potentially very volatile and it erupts periodically, resulting in skirmishes and riots.[3]

Policymakers in Indonesia are very skeptical about the use of the market mechanism as a tool to resolve the inequality between the Pribumis and the Chinese-Indonesians. They propose that Chinese domination be reduced by establishing state-owned enterprises and by adopting

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[2] The Pribumis are the indigenous people of Indonesia. The concept of Pribumism represents government policies favoring the Pribumis over the Chinese-Indonesians.

[3] The racial riots against Chinese-Indonesians have occurred several times. In the early 1970s, in Bandung, a racial riot broke out after a Chinese-Indonesian figured in a traffic accident with an indigenous beca driver. This riot had spread out all over Java and resulted in collosal loss of lives and properties of both the Pribumis and the Chinese-Indonesians. The 1994 labor riot in Medan of North Sumatra also originated from racial tensions resulting in the death of some Chinese-Indonesian businessmen.

discriminatory policies biased toward the Pribumis.[4] The latter alternative finds strong support from the nationalist groups since it gives them both political patronage and financial resources.

Economic Nationalism

Economic nationalism mainly explains why the import substitution industrialization (ISI) strategy based upon a largely diversified industrial base or self-reliance in industrial product is a popular sentiment and significant intellectual support for the Soeharto Regime. Indonesian policymakers think that they can replicate the strategy of some East Asian countries such as South Korea which have successfully adopted the ISI at the first phase of industrialization and transformed themselves into important exporters in the world market. Indonesian authorities believe that with their oil revenues and resource-based natural endowment, they can continue to maintain the ISI strategy. The main problem with this strategy is that it needs a strong commitment from the middle class and upper middle class capitalists to increase investment and productive efficiency consistently. However, due to the weak commitment, discipline and planning, Indonesia failed to adopt the second phase of the ISI strategy.

Another factor which led to widespread support for economic nationalism traces back to the rice crisis of 1972 which not only swelled the inflation rate to 30 percent but also triggered a major social crisis (riots) in the mid-1970s. The rice crisis had convinced Indonesians of the need for self-reliance in rice production—a target it achieved in a relatively short period of time. The success story in

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[4] The Indonesian government's policy of providing special favors to the Pribumi businessmen virtually failed. Many unscrupulous Chinese businessmen got advantage of it just by showing that a Pribumi was a director in their business concerns.

achieving self-sufficiency in rice establishes the view that Indonesia should continue to achieve self-reliance in the production of other goods as well.

Economic Aspects of the Reform Process

Privatization Initiative

Under the reform program, Indonesia has been trying to privatize the economy slowly.[5] However, during the privatization process, many domestic activities remained in the public sector and were protected by the high tariff policy. The Soeharto Administration has been reluctant to release the public sector industries to the private sector for political reasons. It has kept some civilians and military officials happy with the government by giving them top positions in these industries, along with generous benefit packages. This has bred corrupt, counterproductive and inefficient administrators.[6]

In order to protect these industries from foreign competition, high tariffs have been imposed at appropriate levels. Due to high tariff and strict government control over these industries, Indonesians end up paying higher prices for the products of these industries than if they bought them in the international market.[7]

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[5] Privatization of the state-owned enterprises (SOEs) in Indonesia includes selling 10-15 percent of their shares to the public. The objective is to pay off the foreign debt.

[6] Generation and distribution of electricity was kept in the public sector and managed by the Soeharto family. Proof of their inefficiency in managing this industry is its production cost which is about 20 percent more than its counterparts in Malaysia and Thailand.

[7] Examples are sugar and wheat flour. In Indonesia, prices of sugar and wheat flour are about 75 and 38 percent higher than those of the world market, respectively.

On the other hand, the financial sector is being generously liberalized with some major real sectors being heavily protected. Thus the authorities have been bitterly criticized for being inconsistent and being driven by political motivation rather than economic rationale.

Fiscal and Monetary Policies

The Indonesian government has also adopted a comprehensive fiscal and monetary reform. In the fiscal area, it reduced the domestic budget deficit from 8 percent of GDP in 1981-1982 to 1-2 percent of GDP in 1985-86 by conducting tax reforms and restraint expenditure. Tax reforms have successfully reduced the dependency on oil revenues. The tax revenue now constitutes 80 percent of total revenue. In the monetary area, the Indonesian authorities have changed money supply management from direct credit to market mechanism management. Bank Indonesia has gradually reduced the liquidity credit which contributed to inflation and used the Open Market Operations in controlling money supply. On June 1, 1983, the government of Indonesia implemented financial reforms by allowing markets to determine interest rates and eliminating credit ceilings. The financial reform has continued with the abolition of entry barriers and the encouragement of the development of money and capital markets.

Trade and Investment Policies

Indonesia has also adopted reform policies in trade and investment. During the period 1982-85, there was a reversal of the trend in the context of the reform environment. Tariff levels were increased. These policies were adopted not for economic justifications but for political reasons, i.e., to win the political support of the domestic rent seekers in Indonesia. However, in 1986, when the oil price plummeted to $8 per barrel and the exchange rate realigned, the corrupt policymakers succeeded in convincing Soeharto and his associates that they had to liberalize the real sector in order to solve the outstanding economic problems of the country. The benefits that this engendered were that the cumbersome customs procedures were changed, and the corrupt and inefficient national customs agency was replaced by a Swiss Company for the collection of customs duties. Furthermore, the rules for foreign investment in Indonesia were simplified, thus allowing foreign ships to dock in any harbor of Indonesia. These policies were well received by many sectors of Indonesian society.

The Players of the Indonesian Reform

Domestic Advisors

There are two groups of people who have had a say on the Indonesian policy reforms. The first group consists of the technocrats or economists, while the second group is composed of the technicians or engineers and the nationalists. Both groups are equally accessible to the administration but are basically opposed to each other.

The technocrats, led by professor Widjojo Nitisastro[8] and Professor Ali Wardhana, control the National Planning Agency, the Central Bank of Indonesia, and the Ministry of Finance. They believe in the principle of comparative advantage in trade and puts emphasis on the development of non-oil exports, particularly labor intensive manufacturing and agricultural products. They also believe that the "trickle down effect" works if it is combined with the Basic Needs Approach to solve the poverty problem. They use exchange rate management and monetary policies as tools to promote growth and export and control the rate of inflation.

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[8] Professor Nitisastro served as minister in Soeharto's cabinet in 1966, and has served as Soeharto's economic advisor from 1978 up to the present.

The technocrats are not free market advocates. They believe that state intervention is the way to achieve other policy objectives besides economic efficiency. Though their influence over government continued to grow up until the early 1990s, these technocrats have never had the kind of authoritative autonomy enjoyed by their counterparts in Singapore. They wield only minimal control over some strategic industries such as Pertamina (state oil company) or Bulog (good agency). They share power with civilian and military rivals who have different development strategies and have control over the portfolio positions. Thus, many policies formulated by the technocrats have not been implemented by their rivals. The technocrats' relationship with the Soeharto Administration is such that when an economic crisis breaks out, the government seeks their advice but when the problem is over, the government ignores them.

The opponents of the technocrats are the technicians and the nationalists. Their principal leader is Habibie—the Cabinet Minister for Technology Affairs. Habibie's followers include technicians-cum-managers, military advisors, and some economists, united by their advocacy of the infant industry arguments and their dislike of foreign ownership of capital. The technicians and the nationalists hold the view that the development of state enterprises is one way to balance the Chinese domination of the private corporate sectors in Indonesia. (The anti-Habibie group, i.e. the technocrats, also control the Ministry of Trade, the Ministry of Industry and the National Investment Coordinating Board.) They are in favor of expanding the domestic manufacturing sector, including the manufacture of airplanes. They believe in the Big Push Theory and recognize the legitimacy of state intervention in the development of strategic industries. Even though the Habibie followers are opposed to the technocrats, there are some differences among themselves. The technicians emphasize high technology growth while the nationalists are committed to equity-based growth.

Foreign Advisors

Since the oil boom of 1973, the number of foreign advisors in Indonesia had increased significantly. Unfortunately, some of them were of low calibre and contributed little owing to inadequate knowledge and understanding of the Indonesian issues. However, to be fair, there were many cases where they introduced real innovations. Some policies such as the price stabilization initiative of the 1970s, and fiscal and financial reforms of the 1980s have been quite commendable.

The World Bank and the IMF have made significant contributions to the implementation of the economic aspects of the reform package in Indonesia. The domestic critics allege that the Indonesian authorities have sold the country's independence and sovereignty to the World Bank/IMF experts and have drawn up the reform policy upon the dictates of the latter. However, some observers counter that the Indonesian policymakers are stubborn and hardly pay any attention to what the the World Bank/IMF experts have to say.

It is not clear how independent the Indonesian authorities are in formulating the reform policies. However, there is no doubt that the reform package they put together is a result of their 25 years of learning the Indonesian development process. Thus, the idea of economic reforms in Indonesia might have been in place well before the IMF and the World Bank advisors had arrived.

Positive Impact of the Reform

On Growth

Indonesia had succeeded in avoiding a recession during 1982-83 and following a sustainable growth path as a result of the reform process. The economic growth moved from a five-percent path in 1983-86 to a six-percent path in 1986-90 and recently rose to nearly a seven-percent path during 1990-93 as shown in Table 1.

More interestingly, Indonesia also avoided the repercussions of the recession that prevailed in industrialized countries in the 1980s. There are two reasons for this success. First, it was able to effectively diversify the export market and second, strong growth and more equitable distribution of income had boosted domestic demand. Since 1990, domestic demand had contributed more than 60 percent of GDP growth (Anwar and Azis, 1995). On balance, the growth in Indonesia is attributable to the significant increase in availability of capital and improvement in the level of overall efficiency of the economy. Compared to the pre-reform situation, the oil and mining sectors grew significantly in the early 1990s. However, in the course the reform process, these two sectors began to lose their relative importance in the overall economy. During the reform period, the growth rate in the oil and mining sector either remained stable or declined slightly.

The agriculture, manufacturing and construction sectors recorded significant improvement in their growth rates. This reflects a structural shift in the economy from the traditional oil to non-oil sectors. Surprisingly, the services sector experienced a slight decline. The decline in the electricity sector may be partly explained by the fact that it has been under the control of the corrupt and inefficient Soeharto family.

On Mobilization of Savings

Table 2 shows that economic reforms left a positive impact on the domestic savings mobilization in Indonesia. Financial reforms have produced some positive impacts on gross national savings, making it at par with those of countries in East Asia.

Table 1 - Growth in GDP and Some Selected Sectors of the Indonesian Economy, 1980-93 (percent per annum)

Sectors	Before the reforms (1980-83)	During the reform years 1983-86	1986-90	1990-93
GDP	3.2	5.1	6.4	6.8
Oil	-4.0	3.3	2.5	2.9
Agriculture	2.6	3.7	3.4	3.5
Mining	-4.0	0.4	1.8	3.9
Manufacturing	3.6	14.0	11.0	10.0
Construction	6.1	0.1	10.0	10.2
Electricity	19.0	11.0	14.0	12.1
Services	8.2	5.8	7.4	7.3

Sources: CBS, the World Bank, Bank Indonesia and the author's estimates.

Table 2 - Mobilization of Savings in Indonesia, 1980-93 (percent per annum)

Measures	Before the reforms 1980-83	During the reform years 1983-86	1986-90	1990-93
Gross national savings	23	23	32	33
Private savings	11	15	22	20
Public savings	12	8	10	13

Sources: Same as Table 1.

Estimating private consumption as a function of aggregate disposable income, real rate of interest and lagged private consumption, Ikhsan (1991) showed that the financial reform in Indonesia increased the real rate of interest and thereby induced domestic private savings significantly. He also showed that the financial deepening indicator (M2/GDP) had risen significantly from 17.7 percent in 1982 to 40 percent in 1992. It not only reduced capital flight but also prompted repatriation of some capital flight.[9]

In a separate study, Hanna (1994) demonstrated that financial reform produced a positive impact on the efficiency of savings mobilization in Indonesia. However, due to restrictions and distortions in the real sector of the economy, private investors did not expand their business activities but put their profits in the bank to get higher return with lower risks. It seems that this situation occurred in 1983-1986 when domestic private investment grew by only 4.1 percent per annum. However, in the wake of the real sector reform that began in 1986, private investment soared to 25 percent per annum and resulted in high increases in GDP. This finding implies that the sequencing of economic reforms is important. When the financial sector was reformed while the real sector was protected, the results were unfavorable and financial crisis prevailed in the Indonesian economy.

On Aggregate Economic Efficiency

The overall level of economic efficiency also improved as a result of the reform process. This is depicted in Table 3. All aggregate efficiency indicators such as Incremental Capital Output Ratio (ICOR), Aggregate Rate of Return (Y/I) and Total Factor Productivity (TFP) show persistent improvement. Dasgupta, Hanson and Hulu (1995) found that

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[9] Capital flight is measured by non-official short-term capital flows.

during the period 1986-92, 30 percent of GDP per worker was due to increase in TFP, while 55 percent was due to increase in physical capital and the remainder due to improvements in human capital.

Table 3 - Aggregate Efficiency Measures in Indonesia

Measure	Before the reform 1973-81	During the reform years 1982-85	1986-90
Rate of return on investment	31.4	13.1	29.5
ICOR	2.8	7.8	3.9
Percent change in TFP (p.a)			
- Input growth	7.1	7.0	4.8
- Capital stock	10.7	9.8	6.7
- Labor	3.0	2.8	2.5
- TFP growth	0.9	-2.5	2.6
- Non-oil GDP growth	8.0	4.0	7.4

Source: Author's calculation and World Bank's staff estimates.

Some reasons may be advanced to explain the improvements in efficiency during the reform period. First, the devaluation of the rupiah has corrected the relative price ratio and reduced the imported capital goods prices. Second, along with financial reforms, devaluation also corrected the wage-capital ratio and induced the economy toward greater labor intensity in which Indonesia has comparative advantage. Third, financial reforms have removed the distortions in the financial market and induced more efficient use of capital. Fourth, trade reforms created a more competitive environment and made only the efficient industries survive. Trade reforms also allowed the domestic industries to exploit economies of scale to a great extent.

On Labor Productivity

The rapid transformation of the manufacturing sector from inward to outward orientation generated strong growth and labor productivity. Manufacturing employment grew by 7 percent per annum compared to 2.5 percent for the whole economy, contributing 30 percent of the total increase in employment during the period 1985-90. Labor productivity in manufacturing rose impressively as well during the period, averaging 6.6 percent per annum compared to 3.6 percent for the economy as a whole. However, real wages in manufacturing sector increased only 2.6 percent per annum during the same period.

On Income Distribution

These reform policies have done a remarkable job in ensuring that the benefits of economic development are widely shared. One concrete manifestation of this result is in the incidence of poverty which tapered to only 13.7 percent—about 25.2 million people in 1993 compared to about 54 million people in 1976. Other indicators also show considerable improvement. The share in consumption expenditure of the poorest quintile of population increased from 6.9 percent in 1970 to 8.9 percent in 1990. Compared to other developing countries, this record is relatively high. In Malaysia the share of the lowest quintile accounted only for 4.6 percent, in the Philippines only 5.5 percent, and in Sri Lanka only 4.6 percent. Also, the Gini Coefficient has declined from 0.38 in 1978 to 0.33 in 1993 showing an improvement in the distribution of income. Finally, during periods of adjustment, i.e. 1984-90, income per capita grew at 3.7 percent. Per capita income rose more rapidly in rural areas than in urban areas during this period. These all indicate that Indonesia's growth has benefited the lower income group.[10]

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[10] Despite the increase in the travel cost to Mecca for pilgrimage, a significant increase in the number of rural people wanting to go for pilgrimage at least partially validates this fact.

The Downside of the Reform Process

Failure to Control Inflation

Even though the reform program produced many good results, these were offset by yet several structural problems. One such problem facing the country is the inability of the government of Indonesia to reduce the rate of inflation to a target of 5 percent per annum. High inflation rate is not only bad for the domestic political economy of the country but also makes the country less competitive in the world market. The soaring inflation rate makes Indonesia lose its export market to its neigboring competitors—Thailand and Malaysia.

As to combating inflation in Indonesia, we first need to know the source of inflation, i.e., whether it is coming from excessive aggregate demand or from some structural deformities of the economy. Using a structuralist-monetarist inflation model, Ikhsan[11] estimated the inflation equation using annual data for 1973-92 and found that both cost-push and demand-pull factors had contributed to inflation in Indonesia.

Using beta coefficients, one may calculate which factors contributed more to inflation rates. Estimation results, both using GDP deflator and CPI as indicators of inflation, showed that 70 percent of inflation was caused by increases in rice price as expected wage and imported inflation. Only 30 percent was caused by demand factors such as output gap and money supply growth and fiscal deficit. This suggests that demand management cannot be used as a policy tool to combat inflation rates. The government should use structural reforms in order to relax the existing rigidities in domestic markets.

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[11] See Sadiq Ahmad and Ajay Chibber, "How Can Indonesia Maintain Credit Worthiness and Non Inflationary Growth?" *The World Bank PER Working Paper*, 1989, September, Washington, D.C.

Remnants of Protectionism

In spite of significant progress in liberalizing trade policies, effective rate of protection (ERP) represented by net effect of tariff and non-tariff barriers still remain high in Indonesia. According to Table 4, ERP for the manufacturing sector was as high as 52 percent in 1992. ERP of similar magnitude was found with the agricultural sector as well. It is worth noting that whenever a substantial reduction in protection takes place, the competitive position of the affected sector improves.

For example, reduction in the tariff in textile and garment industries in combination with deregulation in cotton imports has reduced ERP from 102 percent in 1987 to 34 percent in 1992 and has boosted export of this commodity by more than 30 percent per annum during 1987-92. In many other subsectors, including food processing, paper,

Table 4 - The Structure of Effective Rate of Protection (ERP) in Indonesia

Sectors	ERP 1987	ERP 1990	ERP 1992
Manufacturing	68	59	52
Food	122	126	120
Textile	102	35	34
Wood and Wood product	25	33	33
Paper	31	20	30
Chemical	14	13	12
Non Metal	57	49	44
Metal	13	10	10
Metal product	152	139	82
Others	124	79	80
Import-competing	39	35	32
Export-competing	-2	-1	-1
Anti-trade bias	41	36	33

Source: The World Bank staff estimates.

non-metal products, automotive and engineering industries, ERP still remains high. Trade policies thus continue to be severely biased against export. In addition to protecting high-cost domestic industries from competition, these policies go against the objective of stimulating non-oil export growth.

Bottlenecks with the Economic Infrastructure

Another problem in the supply side is that there are some bottlenecks in the availability and reliability of infrastructure such as electricity, roads, harbors, telecommunications etc. This is because of the shortage of funds to finance infrastructure development and the existence of state-monopoly or quasi-state-monopoly in infrastructure services in Indonesia. Inefficiency of state-owned enterprises in operating infrastructure services is not only due to internal inefficiency but also external pressures. For example, generation and distribution of electricity in Indonesia is under the control of the Soeharto family. Just because of the Soeharto connection, it is still in business even though it is 20 to 25 percent less cost–effective compared to its counterparts in Thailand and Malaysia (World Bank, 1993).

Regulation in the Banking Sector

The efficiency and robustness of a financial system depend on the quality and efficacy of the regulatory and legal framework under which the system operates. Efficient financial intermediation requires access to reliable information on borrowers which in turn necessitates clearly defined standards and auditing requirements. The Indonesian financial system, at present, falls short of many such requirements. The introduction of the so-called Prudential Banking Regulation has limited the capacity of authorities to effectively supervise financial institutions and regulate the money/capital market properly.

Inadequate laws governing the financial sector, lack of reliable information on borrowers, absence of proper accounting and auditing requirements and unenforceable security and collateral practices have not only increased the cost of doing business in Indonesia, but have also resulted in the concentration of credit to a small number of business groups. Concentration has been further perpetuated by the unscrupulous lending practices of state-owned banks in favor of large groups who hold strong political power in Indonesia. These practices are often in violation of legal lending limits, and the interlocking between banks and the real sector. An unpublished study by the World Bank showed that in 1992 76 percent of the loan disbursements by state-owned banks went to the large business groups, whereas other domestic private banks distributed only 54 percent of their loans to these large groups. The study also showed that the large groups had a high debt-equity ratio, i.e., 202 percent as opposed to 28 percent and 44 percent for small and medium size companies, respectively.

The financial system in Indonesia has other important weaknesses particularly in long-term financing. The capital market is developing but it is limited in size and depth. Indonesia's capital markets are one of the smallest in Asia, in terms of the number of companies listed, market capitalization, trading value and turnover, etc. In the banking sector, we find mismatches in maturity terms for the source and use of funds. The maturity of funds has been declining because of the reduced share of demand deposits, and the increased share of time deposits. In addition, maturity of time deposits is also shortened. However, maturity of credit demanded has been lengthened in line with the transformation of Indonesia's economy. This mismatch constitutes a serious problem for firms in financing their projects. They may roll over their loans but they are adversely affected by unfavorable terms of credit which may come about because of the unfavorable macroeconomic environment. This, in turn, makes them fail to pay their obligations. These structural problems have produced a fragile financial system on which depositors put a very high risk premium.

Concluding Remarks

Despite some undesirable outcomes, on balance, the policy reforms in Indonesia may be considered as a step forward toward economic growth, stability and equity. From an institutional point of view, it has also produced some interesting results. Although the role of the technocrats in Indonesian policymaking has recently been eroded, their view of economic deregulation gained significant support from other quarters who were previously opposed to deregulation.

It is widely believed in Indonesia that deregulating could be a major policy instrument to maintain long-term competitiveness in the international market and sustain growth in income and employment. With the protection regime in place now, agriculture in Indonesia cannot expand further because all Indonesian agro-based industries are lagging behind those of Thailand and Malaysia. Despite the fact that Indonesian agriculture enjoys an advantage compared to those of Thailand and Malaysia, the protectionist policy of providing subsidized inputs to agricultural products such as sugarcane, wheat, soybean etc. cannot make them economically viable.

The traditional power structure in the rural areas and a vested interest group have been quite critical about the reform process. The reform, at least to some degree, has ushered redistribution of income and power in favor of those who were hitherto left out from all sorts of development activities. The vested interest group did not or could not adjust themselves to this dynamics and are therefore unhappy with the reform program.

Another reason why some people oppose the reform program is social jealousy. Among them, widespread belief exists that the reform process has overwhelmingly benefitted the Chinese-Indonesian capitalists. The Chinese-Indonesian capitalists are adept in using the political leverage of the coalition between the Chinese-Indonesian military and Chinese-Indonesian bureaucrats toward fulfilling their business goals.

This group has a very effective lobby in the Soeharto Administration as well. However, objective analysis would suggest that the Chinese-Indonesians are far more efficient and enterprising in business than the Pribumis.

The reform policy suffers another major setback due to the internal strifes, corruption and weak personality of the reformers themselves. They also provide unscrupulous support to Soeharto's friends and family in their rent-seeking activities. Some members of the reform group also get involved in family businesses which are clear cases of conflict of interests. Some of them have also been implicated in the two big scandals that rocked the banking sector which involved one private bank and one state-owned bank. All these negative elements threaten the prospect of deregulation in the 1990s.[12]

For his 1993-98 term, President Soeharto changed his development strategy. His removal of the technocrats from the Central Planning Agency and the limiting of their authority to monetary and financial affairs produced repercussions in the private sector. The private sector's reaction to this decision became evident in the sudden plunge in the stock market index and the rise of short-term interest. The president responded quickly by reassigning the two important leaders of the technocrats—Widjojo Nitisastro and Ali Wardhana as the president's economic advisors.

Thus the sustainability and success of economic reforms in the 1990s will depend on the political will of the Soeharto regime which is often driven by the business interests of his family and close associates. Soeharto is reluctant to reduce the protection accorded to his friends and family. And thus the business community at large is skeptical about the future of the reform process in Indonesia.

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[12] For details, see A. Schwarz, *A Nation in Waiting: Indonesia in the 1990s*, 1994, Westview Press, Boulder, CO.

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