

# Half a Century of Indonesian Economic Development: Trends, Conjectures, Questions

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## How to characterize Indonesian economic development?

'Indonesia is a chronic economic dropout. ... Indonesia must surely be accounted the number one failure among the major underdeveloped countries.' (Higgins, 1968.)

'As things look at the beginning of 1966, there seems to be little prospect of rapid economic growth in Indonesia.' (Gunnar Myrdal, Asian Drama, 1968.)

Also:

'An economic miracle' (World Bank)

'A history of missed opportunities' (Booth)

'A showcase state' (Mortimer)

'An improbable nation' (Pisani)

'Indonesia: from showcase to basket case' (Pincus and Ramli, 1998)

## **Fact #1: How common is rapid sustained growth?**

A relatively rare phenomenon – only 13/about 150 countries in last 100 years

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China	1961-2010
Hong Kong	1960-1997
Indonesia	1966-1997
Japan	1950-1983
Korea	1960-2001
Malaysia	1967-1997
Singapore	1967-2002
Taiwan	1965-2002
Thailand	1960-1997
Botswana	1960-2009
Brazil	1950-1980
Malta	1963-1994
Oman	1960-1999

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Source: World Bank, Growth Commission  
Report

## Fact #2: Long-term East Asian economic growth

Ratio of GDP per capita, 2010/1961:

China	12.4
Korea	15.6
Singapore	12.4
Malaysia	7.9
Thailand	8.2
Indonesia	5.5
Vietnam	5.0
Philippines	2.1

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**But:** Mainly want to focus on knowledge gaps, areas of contention, conjectures.

## 2. Setting the Scene

Acemoglu and Robinson (2012):

‘Dutch colonialism fundamentally changed [Indonesia’s] economic and political development. The people ... stopped trading, turned inward. ... In the next two centuries, they would be in no position to take advantage of the innovations that would spring up in the industrial revolution.’

The Peking-Pyongyang-Hanoi-Phnom Penh-Jakarta axis of ‘NEFO’s’.

Sultan Hamengkubuwono IX (1966):

‘Any person who entertains the idea that Indonesian society is experiencing a favourable economic situation is guilty of lack of intensive study. ... If we fulfill all our [foreign debt] obligations, we have no foreign exchange left for our routine needs. ... In 1965 prices rose by more than 500% ... and the state budget deficit soared to 300% of receipts.’

Pierre van der Eng:

Indonesian per capita income in 1965 was lower than that 50 years earlier.

Heinz Arndt:

‘A decade of ever-increasing economic mismanagement [in Indonesia] had brought a degree of economic breakdown with few parallels in modern history. The country was literally bankrupt, unable to meet payments due to foreign debt... Export earnings had fallen to a level where they were barely sufficient to finance half the country’s minimum requirements, excluding debt service.’

Around 1960 Indonesia one of the poorest countries in the world, with shockingly low social indicators (Table 1).

Table 1. Southeast Asia's: 'Initial conditions', c1960

Country	GDP per capita (constant 2010 \$)	Trade (% of GDP)	Years of schooling, for aged 15 and above	Years of schooling, for aged 25 and above	Life expectancy at birth (years)	Infant mortality (deaths per 1,000 lives)
Indonesia	577	11.6	1.57	1.11	47.0	166.7
Malaysia	1,408	85.7	2.83	2.26	57.9	81.1
Philippines	1,059	38.3	3.46	3.01	57.1	86.5
Thailand	571	34.9	2.55	2.07	53.3	108.9



## **Some legacies of history**

(The prisms through which to view economic development and policy.)

Inflation aversion.

Concern about preservation of territorial integrity.

Skepticism towards 'liberalism' (including Article 33 of the Constitution).

Basri (2012): 'Indonesia was born a free trader [owing to its geography] yet is consistently reluctant to accept globalization.'

The challenge of catching up; 2,000 university graduates in 1945.

Ethnic segmentation.

Institutions and property rights: colonial destructions and their aftermath.

## **Some legacies of history** (cont)

And pragmatism:

Sadli:

‘When we started out attracting foreign investment in 1967 everything and everybody was welcome. We did not dare to refuse; we did not even ask for bonafidity of credentials.’

Sumitro (1984):

‘In 1954/55 [as Finance Minister], I was a strong protagonist of foreign exchange controls. ... Then I saw what happened under ... Sukarno. I know how easy it is to smuggle goods, and I know that those who are close to the sources of power will get their hands on the foreign exchange.’

# The long-term growth record

Figure 1: 'Path dependence refuted'!

Pre-1965, +/-2%

1966-96, 7.3%

1998, -13.4%

2000+, 5.1%

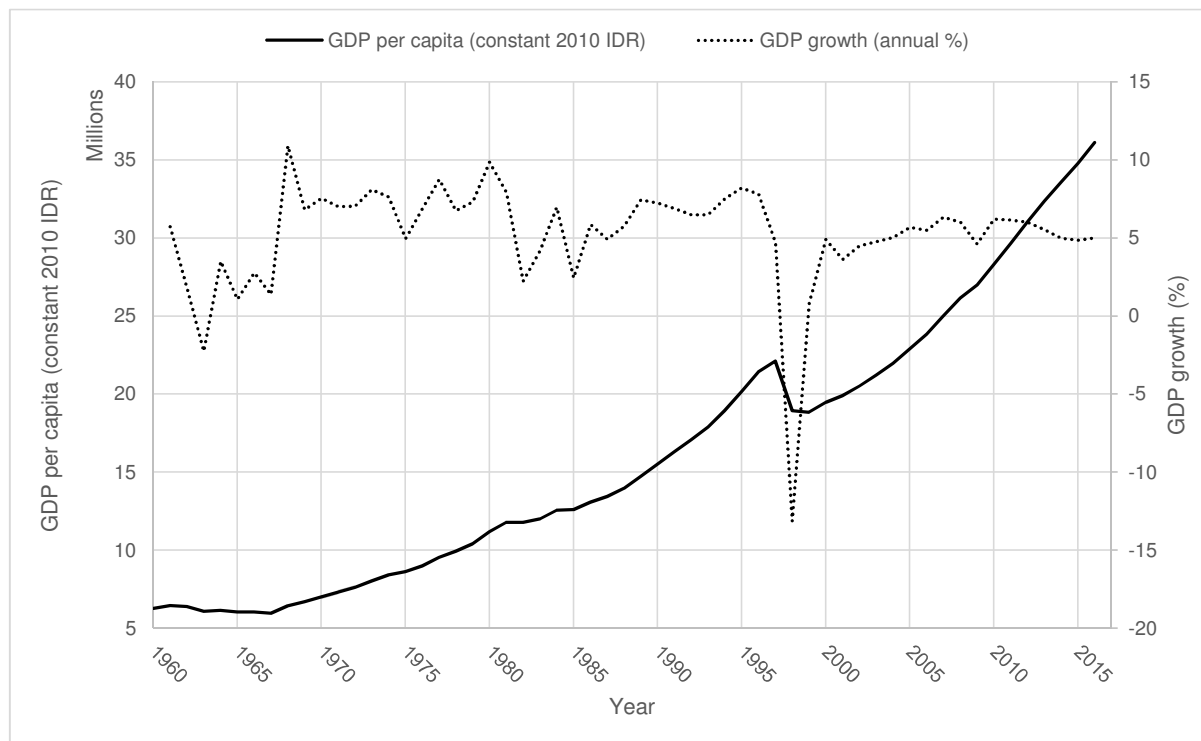
A Krugman 'myth'?

No: TFP growth has been positive, broadly tracked GDP growth.

Achieved at the cost of running down stock of natural capital?

'Green growth' slower than GDP growth. But doesn't invalidate main conclusions.

Figure 1: Economic Growth and Per Capita GDP



## **The long-term growth record** (cont)

### Investment and Savings

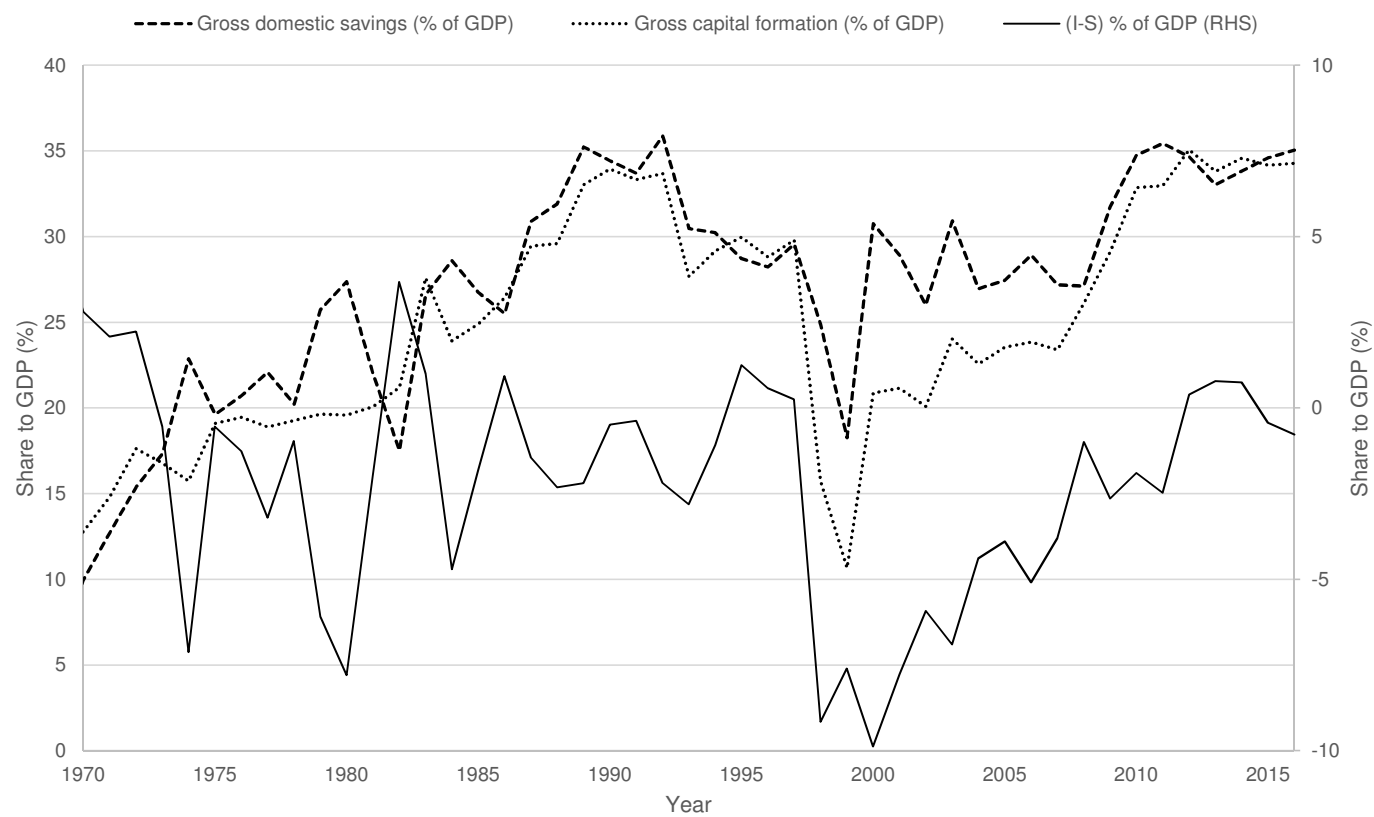
A virtuous circle of growth, savings and investment. Figure 5.

Dramatic increases in savings and investment, from <10% of GDP prior to 1966 to 20-30% as growth took hold. Persistent but moderate CAD's.

AFC/krismon shocked the system: savings fell as a survival strategy; little incentive to invest; foreign resources dried up (so swing from current account deficit to surplus; irony).

Gradual return of higher savings and investment; though persistent CA surpluses for much of the post-crisis period. (Why?)

Figure 5:



## **The long-term growth record** (cont)

International comparisons?

No obvious comparator. (Not Nigeria!)

Two major World Bank studies.

Figure 2. Overtaken by China (like everybody else).

Conclusions from earlier slides.

The record of crisis management? 4 major events since the 1960's.

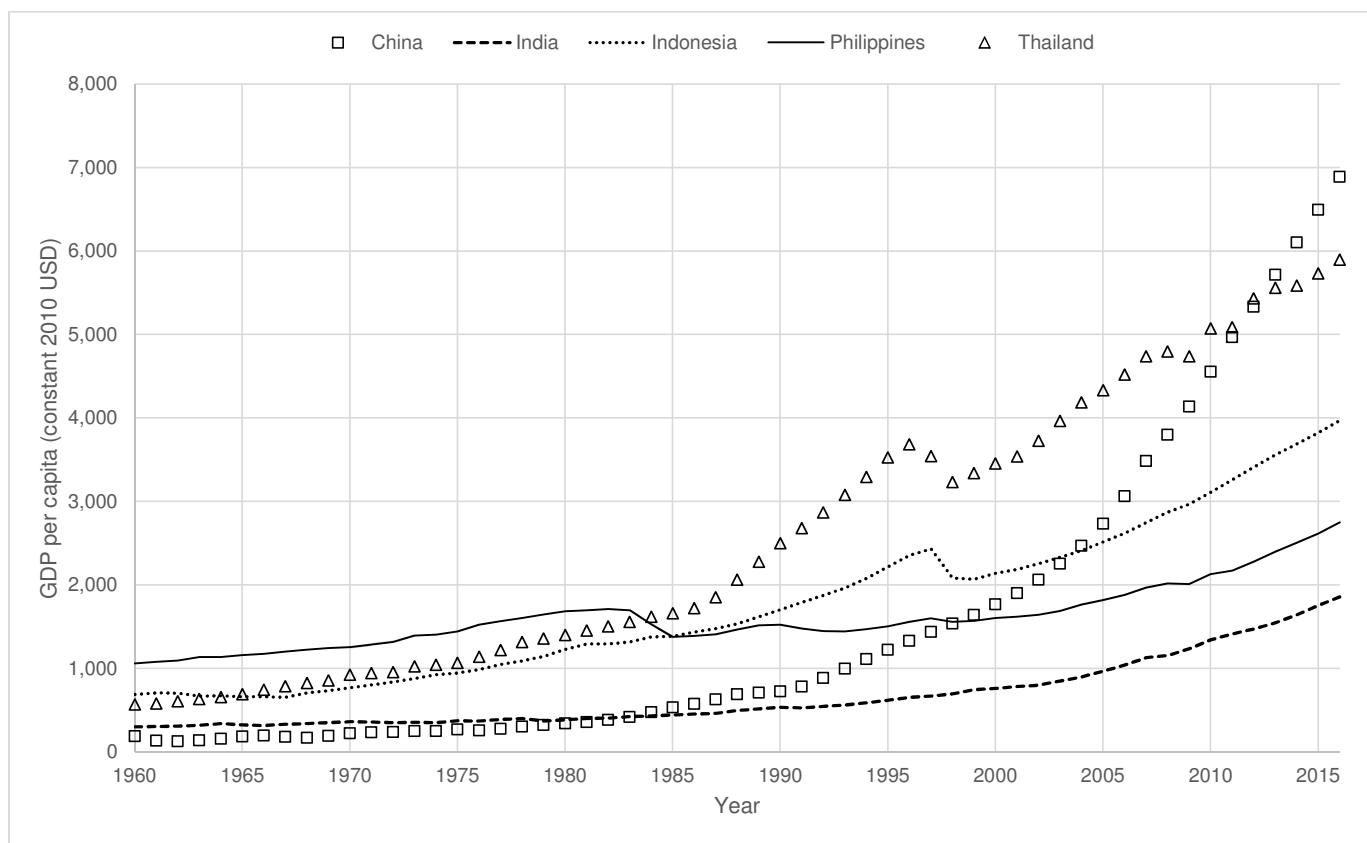
Mid 1960's: home grown; resolved with brutal regime change.

Mid 1980's: among the very few developing country energy exporters to avoid the debt crisis. Effective domestic reform.

1997-98: AFC/krismon – the one major interruption to growth. More below.

2008-09: GFC – navigated effectively (see slide). Lessons learned from krismon. Good policy, and some luck.

Figure 2:





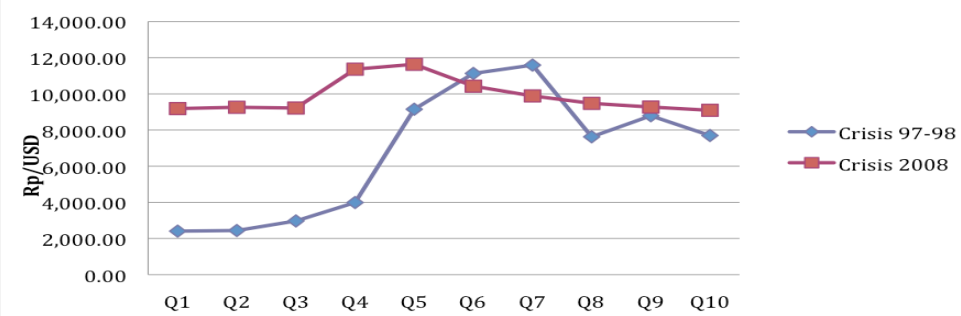
**Figure 10a**

**Indonesia: Growth\_Quarterly**



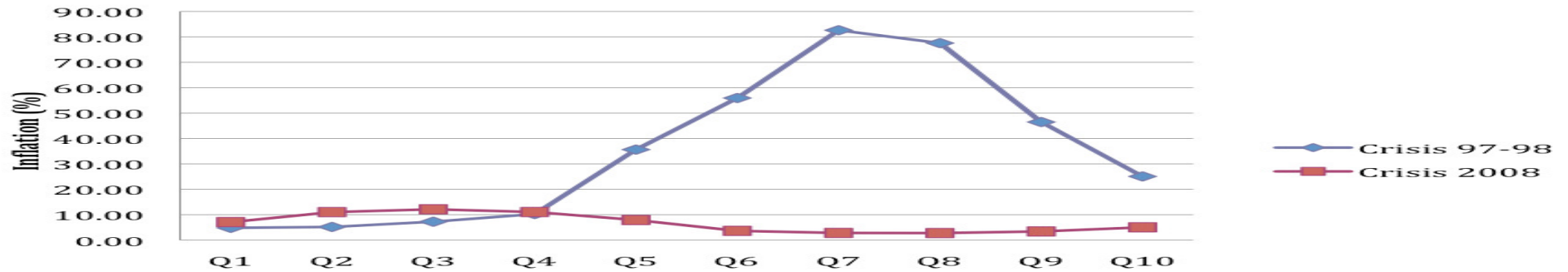
Notes: For Crisis 1997-1998, Q1 begins in Q1 year 1997 while for crisis 2008, Q1 begins in Q1 2008.

**Indonesia: Exchange Rate\_Quarterly**



Notes: For Crisis 1997-1998, Q1 begins in Q1 year 1997 while for crisis 2008, Q1 begins in Q1 2008.

**Indonesia: Inflation\_Quarterly**



Notes: For Crisis 1997-1998, Q1 begins in Q1 year 1997 while for crisis 2008, Q1 begins in Q1 2008.

### **3. The Sectors and Structural Change**

A largely conventional story, with one major exception.

See Figures 3 & 4.

Rapid agricultural growth, even as agriculture share shrank. (A missing story in the 'Miracle' literature.)

Rapid industrial growth through to mid 1990's, then slowdown, especially in manufacturing.

Consistently rising services share, especially this century.

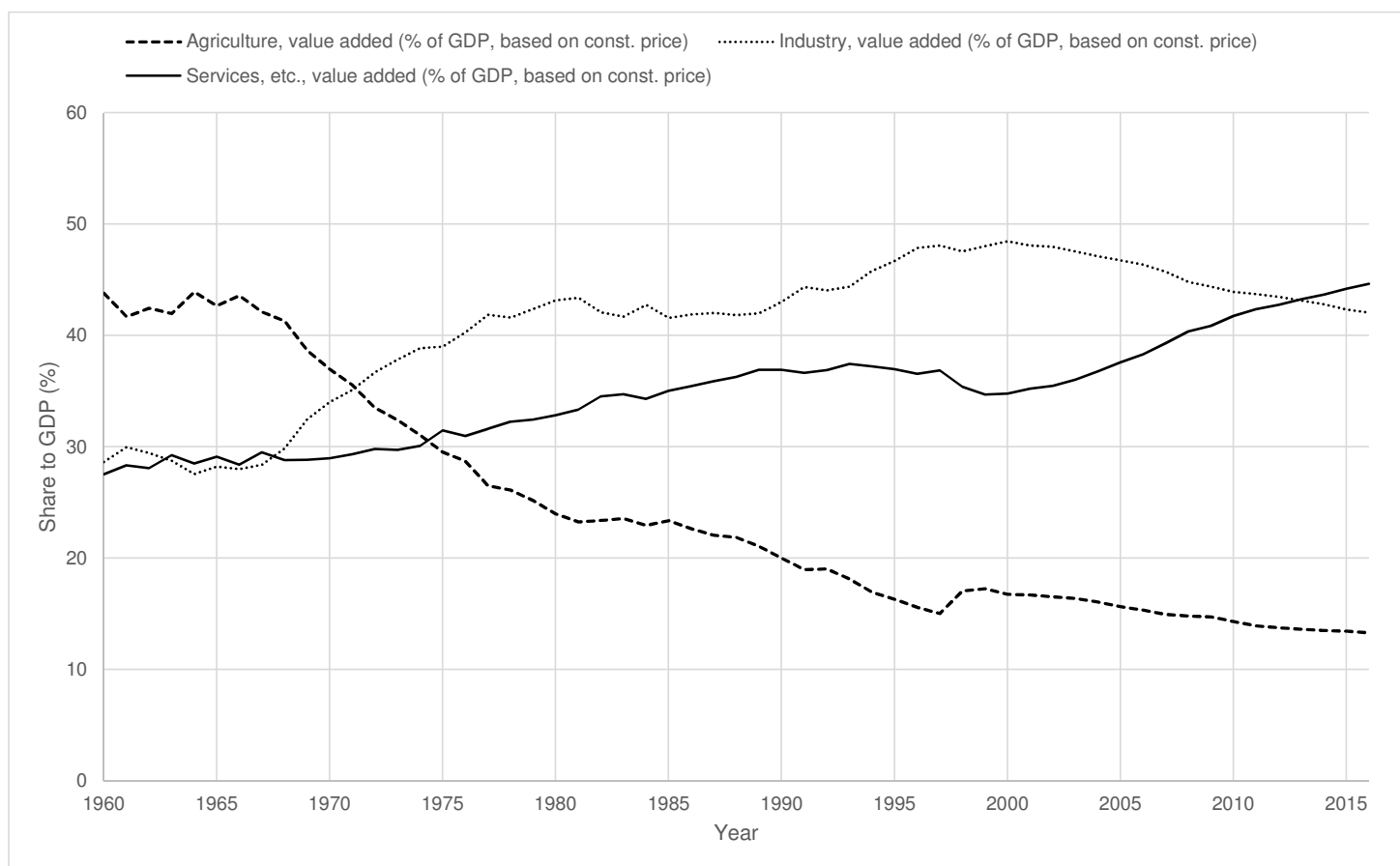
Outcomes also shaped by Indonesia's natural resource endowments.

Two major commodity booms, with direct and indirect effects on structural change.

Figure 3:



Figure 4:



Why has manufacturing growth slowed down sharply since the 1990's?

Three likely explanations:

- a. Commodity boom, squeezing non-commodity sectors, both in statistical and Dutch Disease sense.  
(But need to explain why no manufacturing slowdown in the 1970's.)
- b. The global general equilibrium consequences of China's rise as the factory to the world, lowering general manufacturing prices.
- c. Aspects of the Indonesian policy regime have hindered the competitiveness of internationally-oriented manufacturing. Missing out on global production networks. See below: FDI regime, labour market regulations, logistics.

## 5. International Dimensions

Central paradox: like East Asia in general, Indonesia has benefitted from global engagements (liberalizations, commodity booms), but widespread ambivalence towards globalization.

Rising economic openness from late 1960's, like neighbours. Figures 6A, 6B.

(Though caution with interpretation – commodity booms, AFC, etc.)

Export composition: interplay of changing comparative advantage, commodity booms and bust, policy reform. Figure 6C.

Eg, manufacturing exports in 1980's increased rapidly: policy reform, REER (Figure 7), declining commodity prices.

Reverse factors at work in 2000's. Plus policy regime unable to adjust to the requirements of GPN's. (Why?)

Figure 6A: International Trade Shares, Indonesia and Comparators, 1960-2016

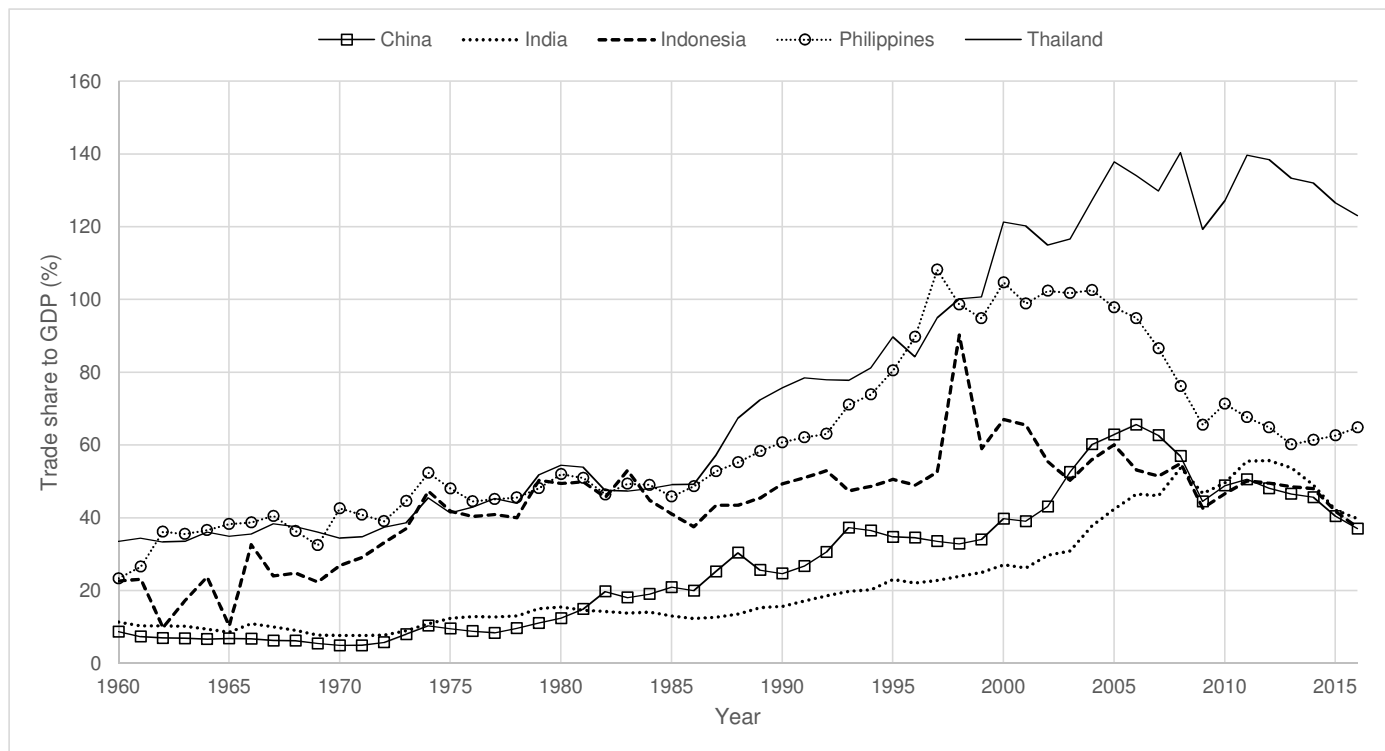


Figure 6b: FDI Shares, Indonesia and Comparators, 1960-2016

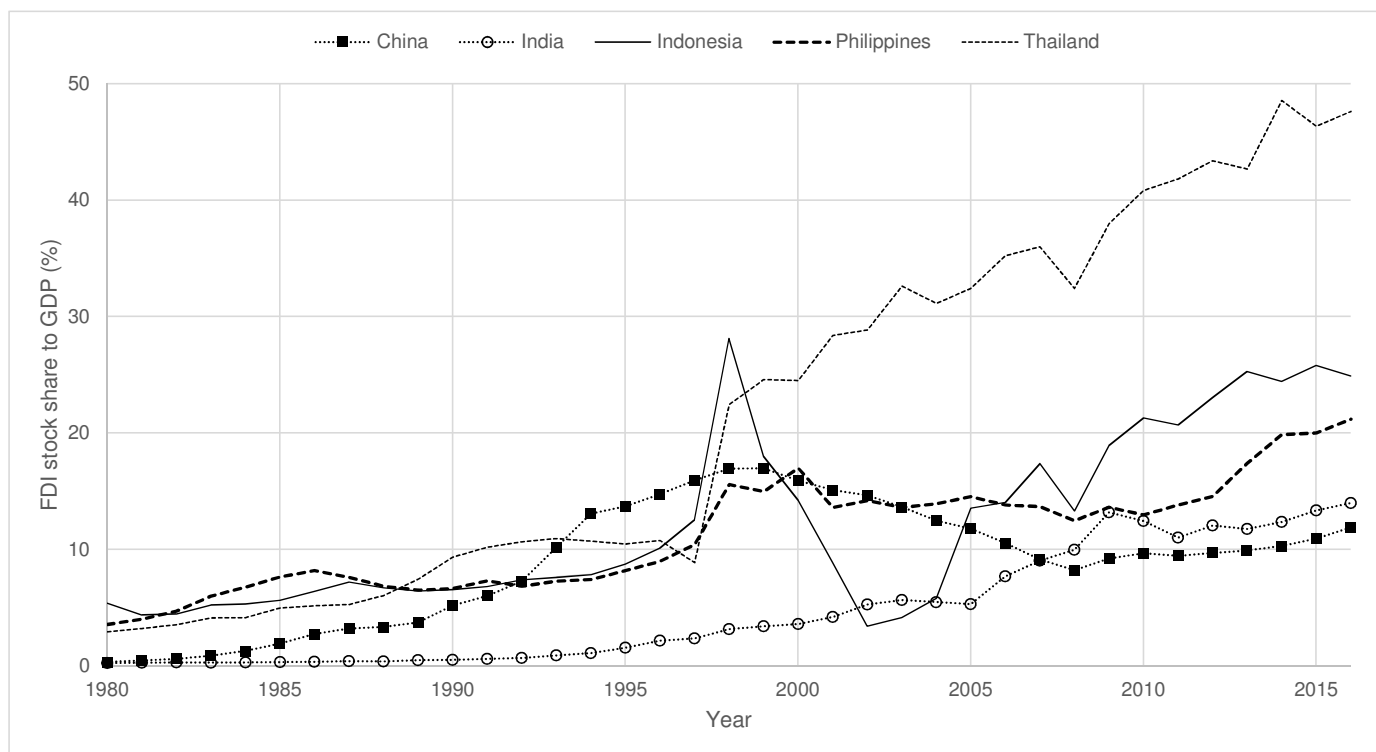




Figure 6C: Indonesian Export Composition, 1970-2016

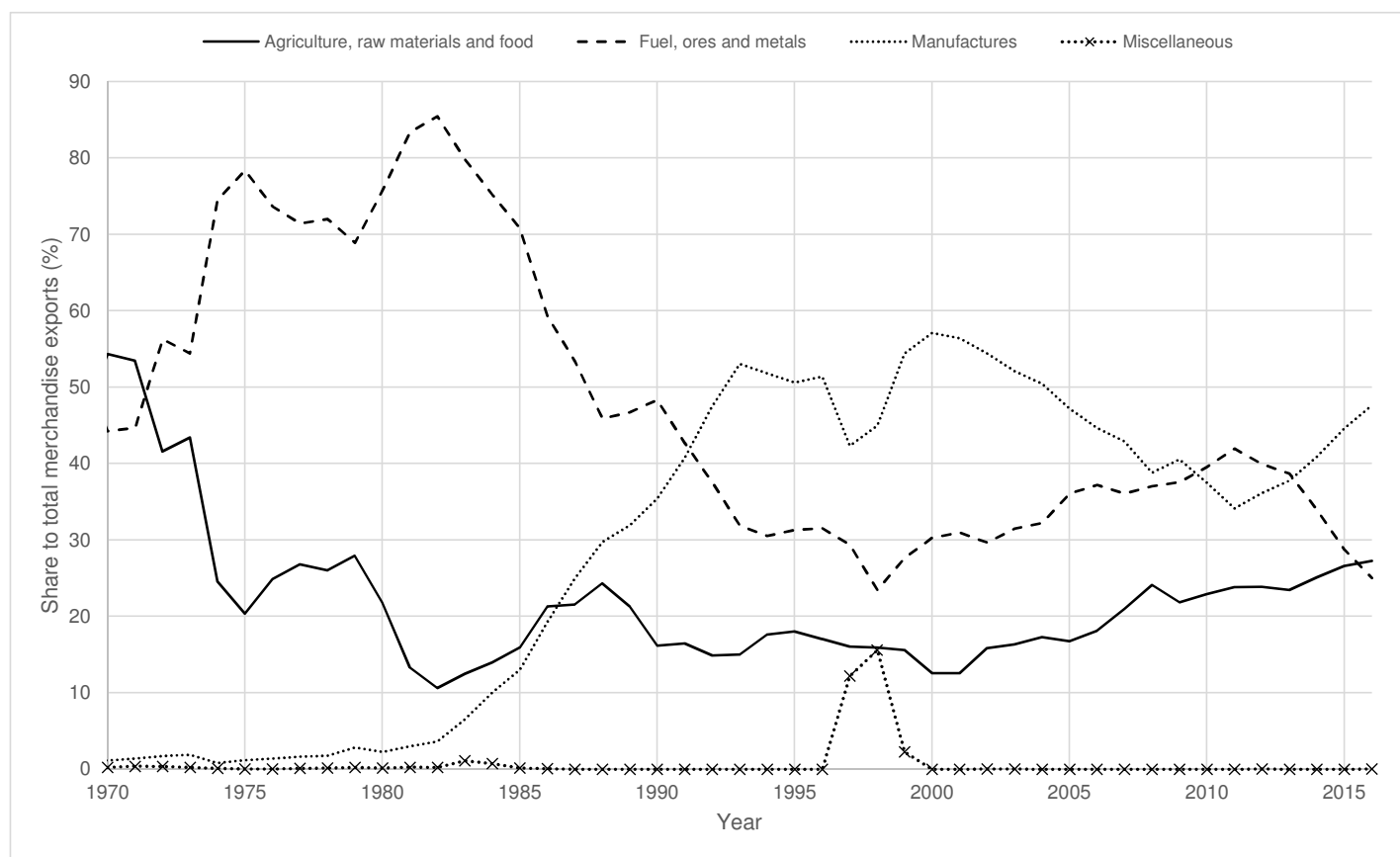
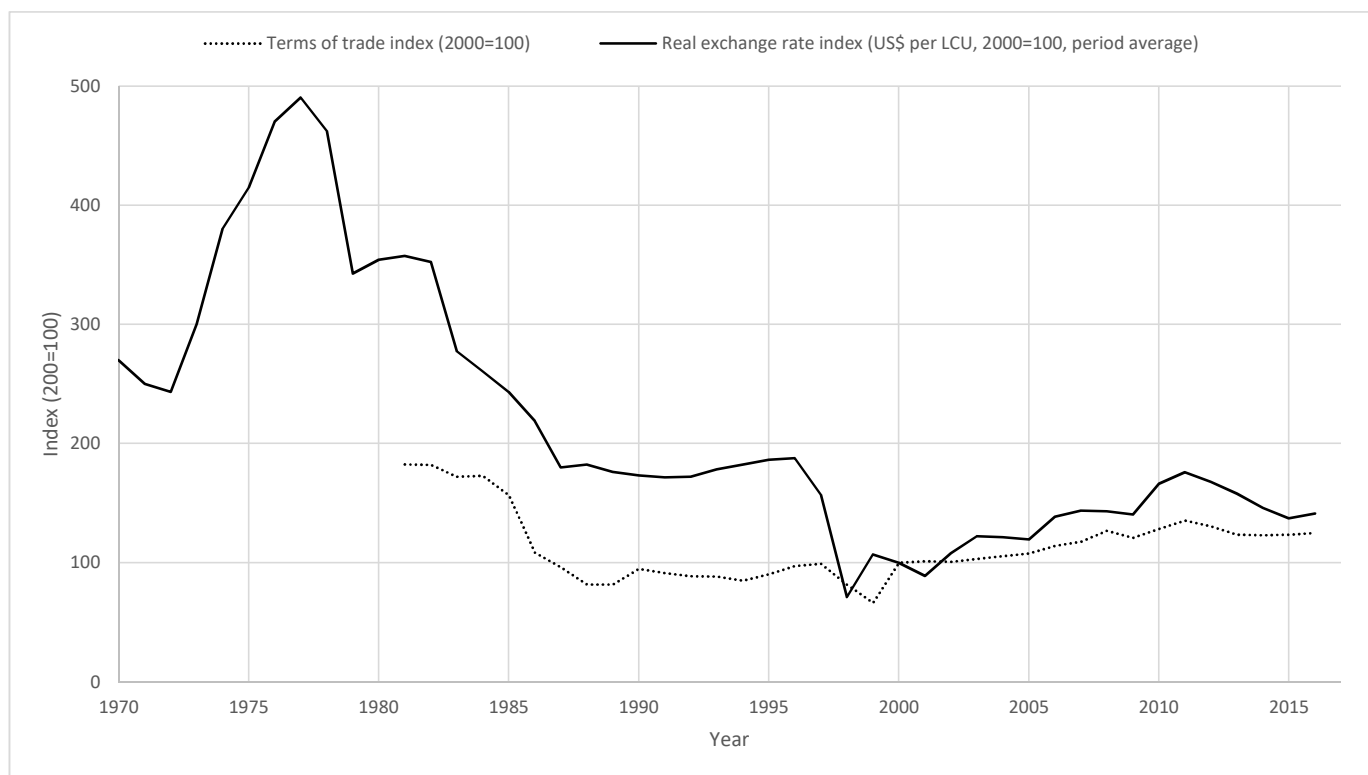


Figure 7: The Terms of Trade and the Real Exchange Rate



## 6. Macroeconomic Management (and Crises)

Generally a success story, apart from one major exception, the AFC/krismon.

A legacy of history, reinforced by positive neighbourhood effects.

Origins in prudent fiscal policy – balanced budget rule (Soeharto era), Fiscal Law (democratic era).

Unusual policy settings from 1971 (open capital account), but Bank Indonesia competent; independent from 1999.

See Figures 7-9.

The one major exception: ‘everything went wrong at once’.

Domestic policy settings – fixed/adjustable exchange rate and limited financial supervision – failed to adjust to the new international environment of high capital mobility.

IMF misdiagnosed and mishandled the rescue package.

Indonesian leadership unable to adapt, and reassure investor community.

Importantly, lessons learnt, and applied during the 2008-09 GFC.

Figure 8: Inflation and Exchange Rate, 1960-2016

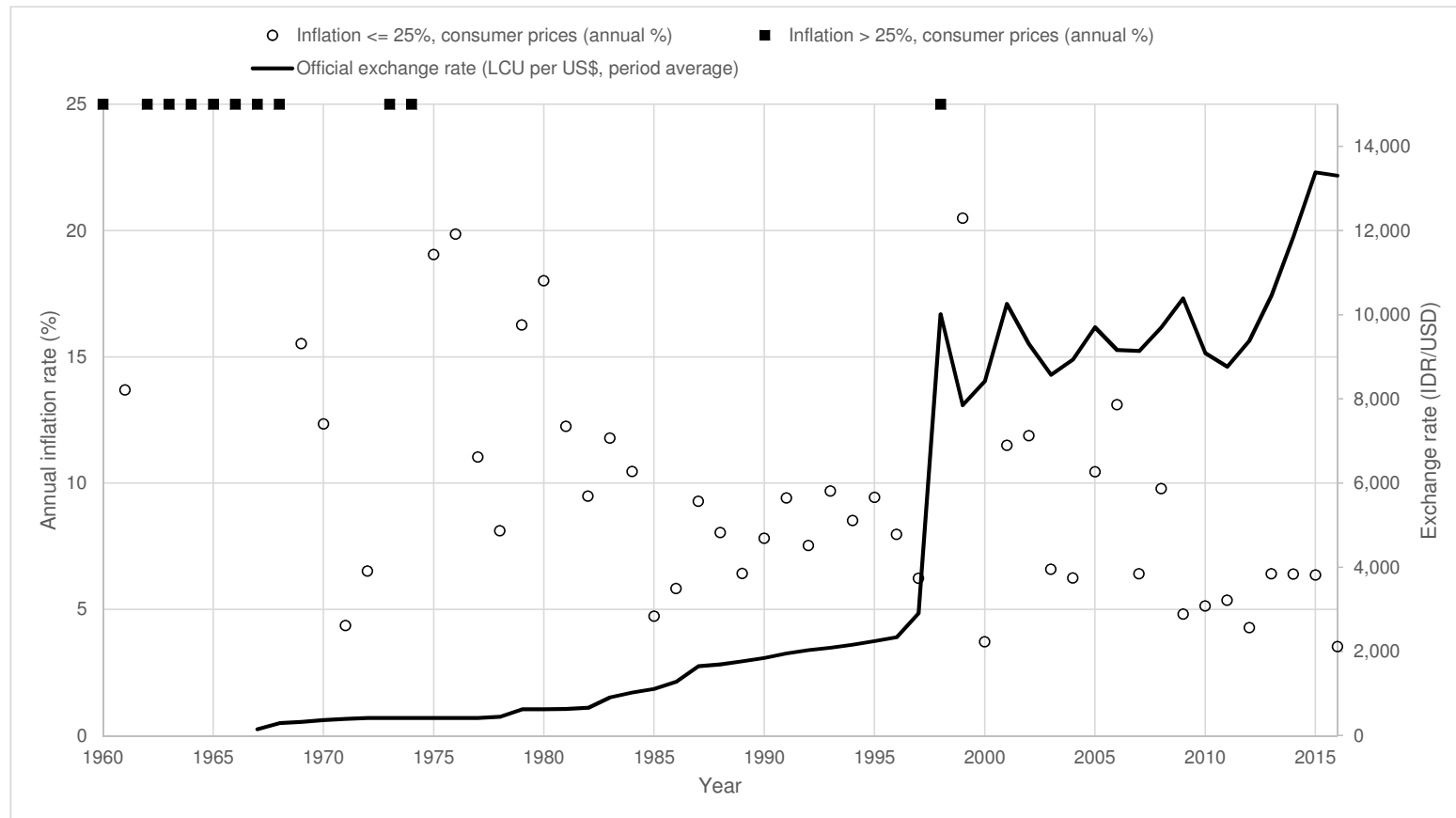
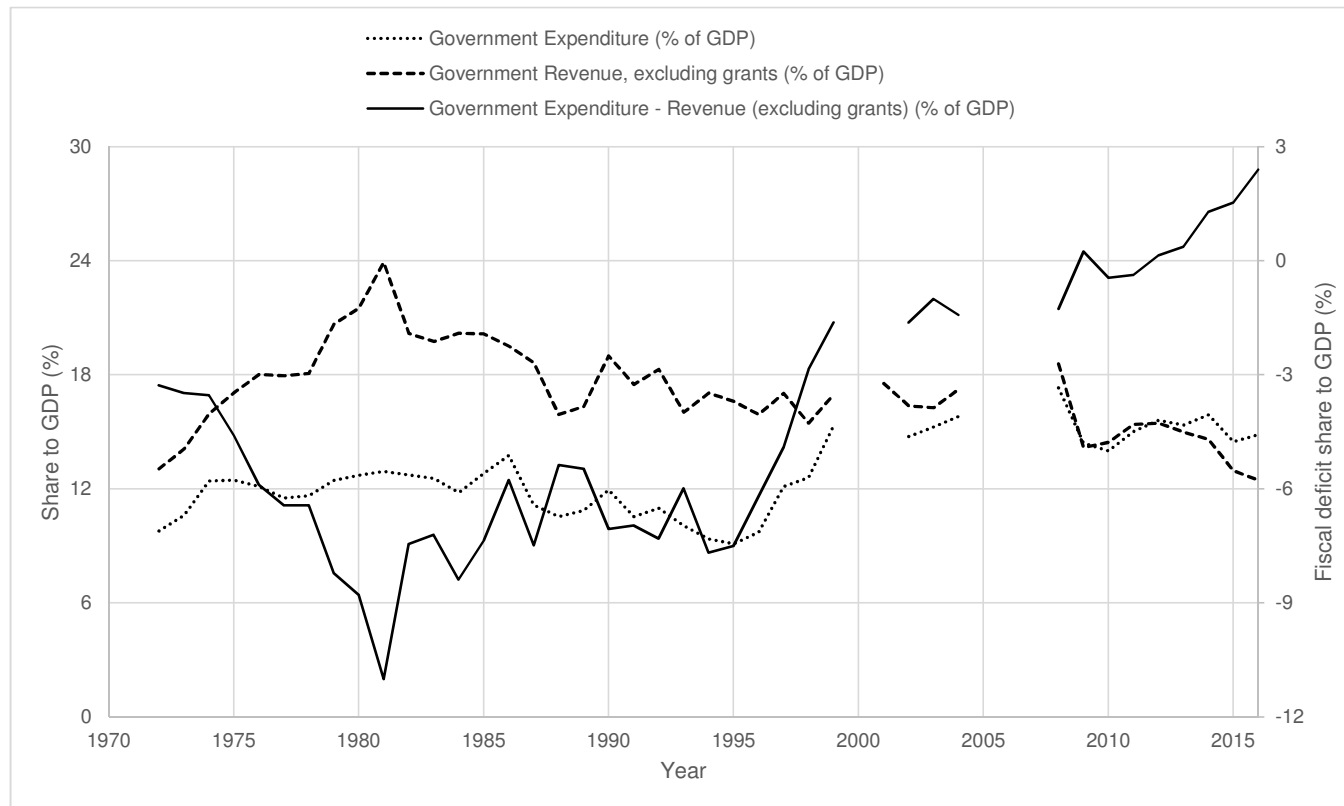


Figure 9: The Budget, 1960-2016



## 6. Macroeconomic Management (cont)

In spite of success, still some major macro policy challenges. Eg:

Fiscal:

Tax effort: many initiatives over several decades, but tax revenue too low for community expenditure expectations. Low tax buoyancy also.

Little progressivity in the tax system.

Misdirected expenditures (especially subsidies).

Reforming centre-local government relations.

Monetary:

Historically inflation too high, hence constant need for nominal depreciations to restore competitiveness.

Managing the open capital account, especially volatile short-term flows.

Should BI target the current account deficit? If so, how?

## 7. Sub-national Development Dynamics

These matter more than in most other countries.

Holding the country together – a success story. (Not a 'Yugoslavia'!)

Patterns of subnational comparative advantage well established.

As best as can be measured, regional inequality quite stable (unlike China, and probably India).

Figure. Though at district level, less clear?

Traditional East-West divide remains, but gap not widening. (?)

Papua arguably the biggest subnational development challenge?

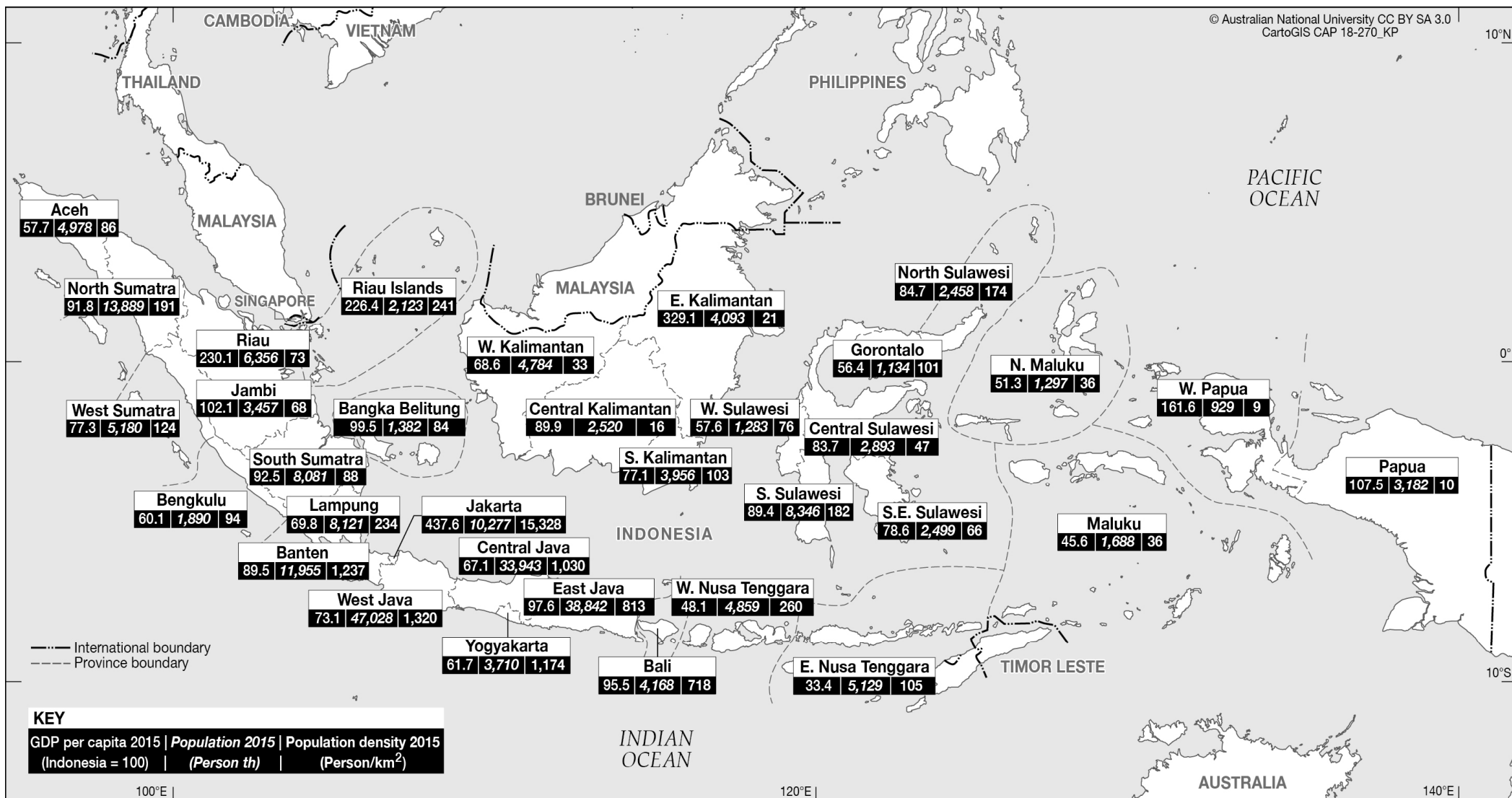
Although the 2001 'big bang' decentralization is working, the principal regional challenge is making otonomi daerah work better. Eg:

Large vertical fiscal imbalances, so LG's have little incentive to increase OSR.

Can the central government build in incentives to the fiscal flows to improve performance?

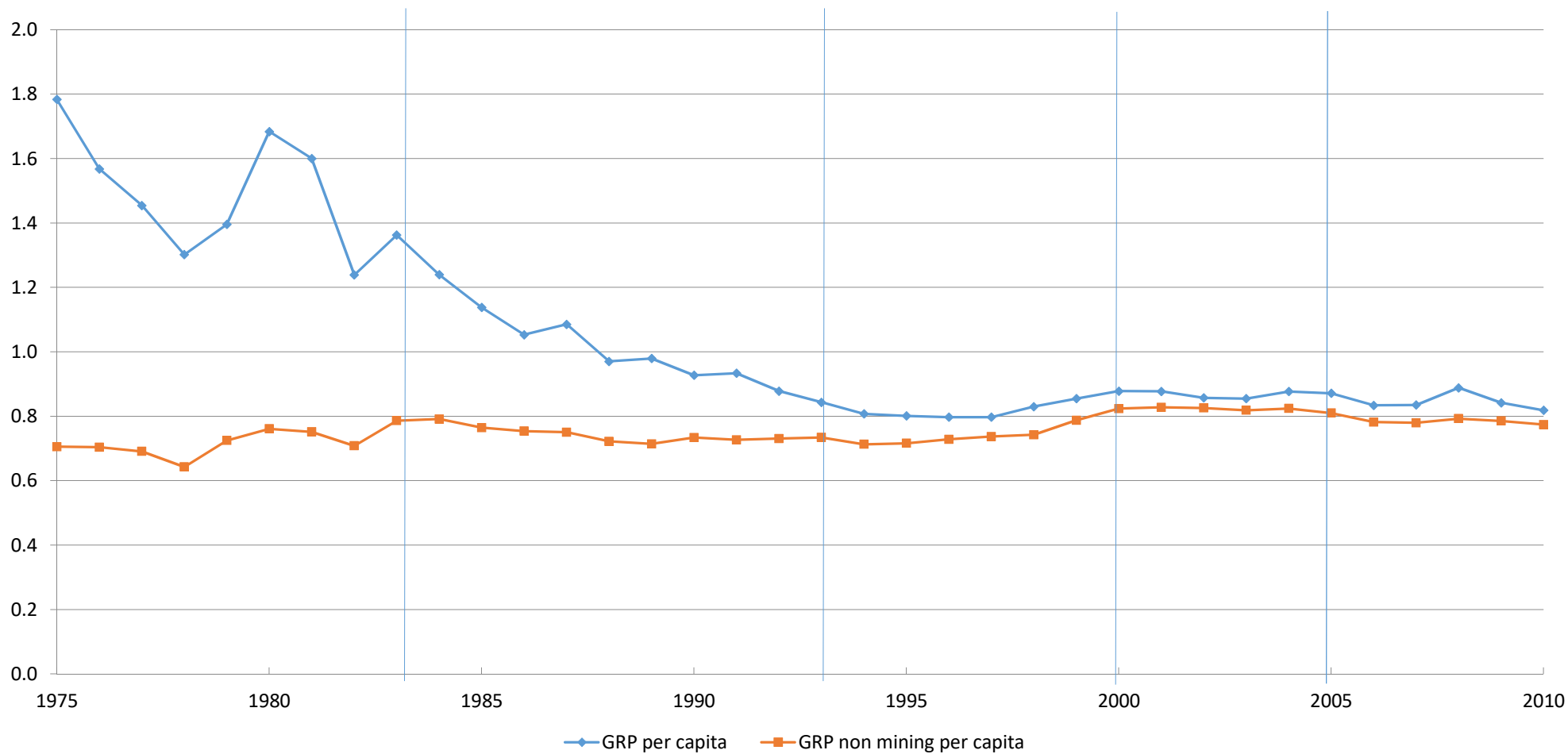
Incentives for pemekaran still significant.

Any evidence that 'fiscal federalism' principle working, ie, that footloose resources moving to better governed regions?





# Regional Inequality (Williamson Index)



## 8. Living Standards

(Drawing heavily on Smeru research. Here's where I really need your guidance!)

Another success story, apart from rising inequality and deteriorating environmental amenities.

### Poverty:

Rapid decline in the 'headline' (headcount) incidence, from 60+% in 1960s, to 10% now.

More rapid decline in Soeharto era: faster growth, poverty a bit more growth-responsive.

Sharp increase in poverty incidence during the AFC, then returning to pre-crisis levels within a decade.

Caveats/issues:

(i) Major issue now is the 'near poor', vulnerable, dealing with catastrophes. A lot of 'churning'.

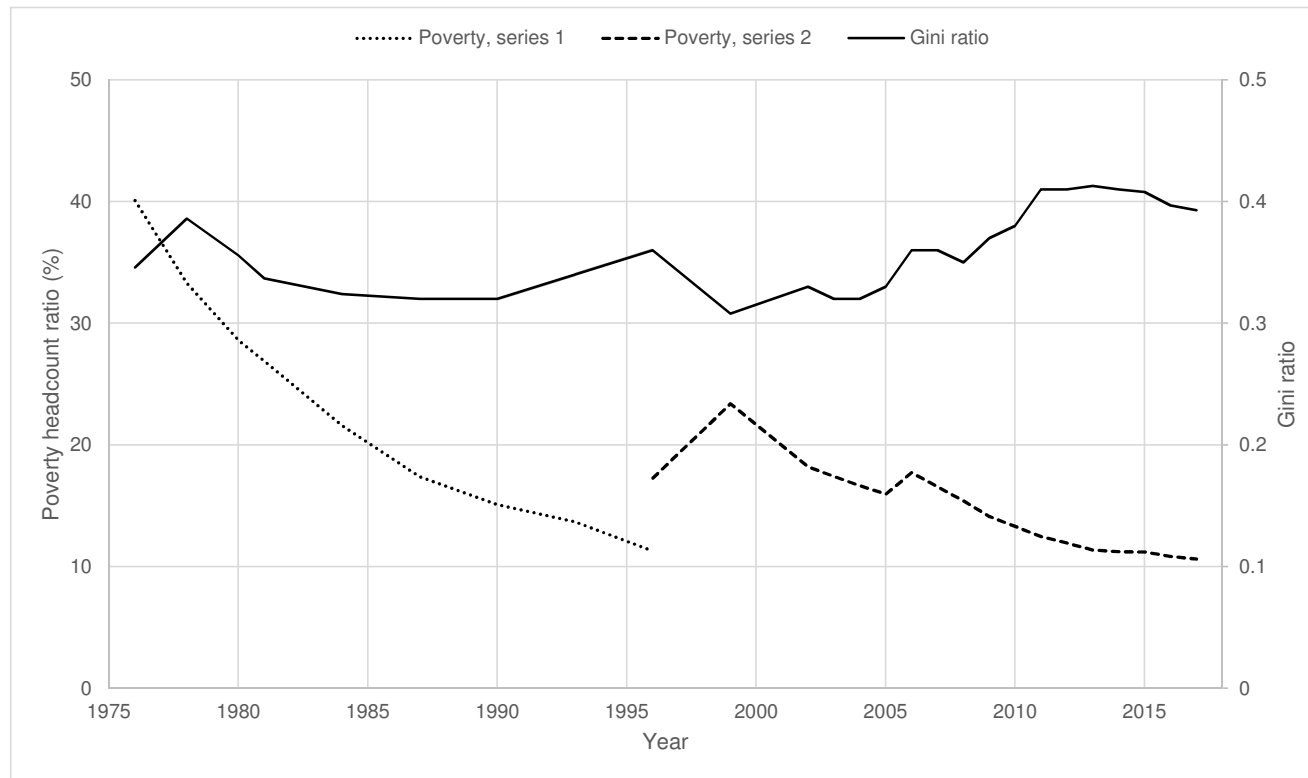
(ii) Poverty traps not amenable to growth: regions, gender, elderly, malnourished.

(iii) Which poverty line should be used?

(iv) Data quality – consistent over time, missing top and bottom, etc?

(v) How effective is the SSN targeting? What's the best methodology? Have RCT's helped?

Figure 10: Poverty and Inequality, 1976-2017



## 8. Living Standards (cont)

### Inequality:

Historical legacies.

Explaining the 1980's adjustment success (contrary to much of the literature).

Some debate about indicators. Gini ratio v. 'top incomes' approach (eg Leigh & van der Eng)

One of the largest increases in inequality in developing Asia in the 21<sup>st</sup> century.

Why? Hypotheses:

Labour market: end of labour-intensive growth, especially in food crops and manufacturing.

Commodity boom: in principle unequalizing; mixed evidence.

Rise of high-end incomes, global services, etc.

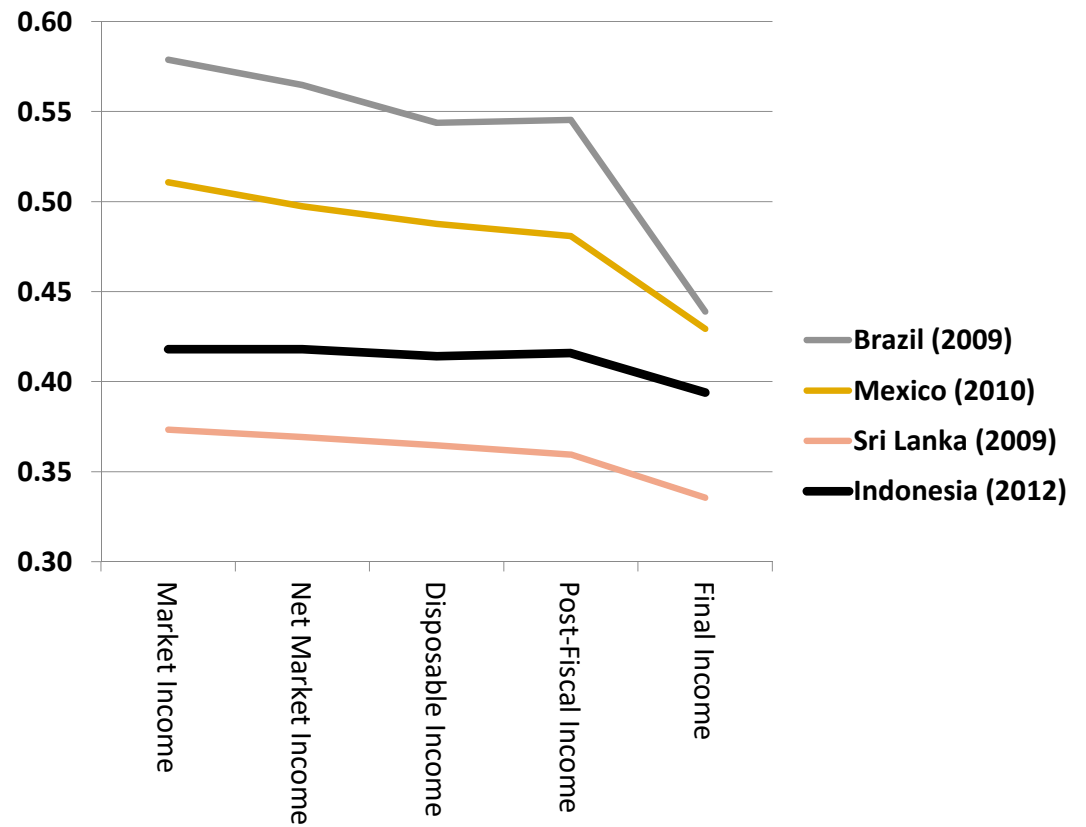
Decentralization (2001) and regional inequality: no clear picture.

Little tax progressivity; some (limited) targetting of (small) social expenditures.

Is there an industrial organization story (barriers to SME start ups, etc)?

## Fiscal Policies - Expenditure

Gini Index taking into account  
different types of income



Source: Afkar, Jellema and Wai-Poi

## 8. Living Standards (cont)

### Education and Health

Impressive quantitative improvements in education, near universal basic literacy.

Years of schooling; enrolment ratios; moderate but still significant gender imbalances.

Good strategy in 1970s-80's to overcome severe backlog from colonial and early independence eras.

Constitutional requirement of 20% budget allocations relieves budget constraints.

But:

On quality indicators (TIMMS, PISA) lagging, no relative improvement.

Education outcomes (scholastic performance, dropout rates) highly correlated with socio-economic status (Suryadarma).

Higher education: rapid growth, but comparative indicators not compatible with an upper middle income economy. Needs a radical reform overhaul and more funding.

Also, an education-labour market mismatch, combined with major change in labour market regulations since 2000. Rising labour market dualism?

Health indicators – similar story; quite serious stunting, etc; public spending lags, not well targeted.

## Comparative indicators, c2015

Country	GDP per capita (constant 2010 \$)	Trade (% of GDP)	Years of schooling, for aged 15 and above	Years of schooling, for aged 25 and above	Life expectancy at birth (years)	Infant mortality (deaths per 1,000 lives)
Indonesia	3,834	41.9	7.61	7.26	68.6	25.0
Malaysia	10,878	134.2	10.44	9.75	74.5	6.8
Philippines	2,640	63.0	8.43	8.18	68.0	23.2
Thailand	5,775	126.8	7.99	7.30	74.1	11.2

## 8. Living Standards (cont)

### The labour market:

Quite marked discontinuities between the two periods (Manning).

**Soeharto era:** rapid structural transformation – shift from A to M, S sectors; increasing formalization; labour-intensive growth path, in food crops, labour-intensive manufactures (from 1980s), construction, etc; labour productivity, and real wages in the formal sector both rising quite strongly.

In context of authoritarian labour policies, restricted labour freedom, limited regulations.

**Democratic era:** greater labour freedom; more populist labour market policies (especially minimum wages, severance pay).

Results: weaker formal sector employment growth; increased labour market dualism; rising unit labour costs (outstripping productivity). No end in sight to the Lewis surplus labour?

Gender gap less than many comparators, but still significant. No clear trend?



## 9. Environmental Dimensions

Indonesia a textbook case of the 'Environmental Kuznets Curve' (Resosudarmo).

Difficult to get clear long-term series, but general picture clear enough (Figure 11): deforestation, floods, air quality, loss of unique flora and fauna species, marine ecology endangered, etc.

Some of these issues have global ramifications (especially deforestation) and therefore require collaborative global action.

Estimates of 'green national income' indicative, very approximate; but broadly plausible.

Solutions?

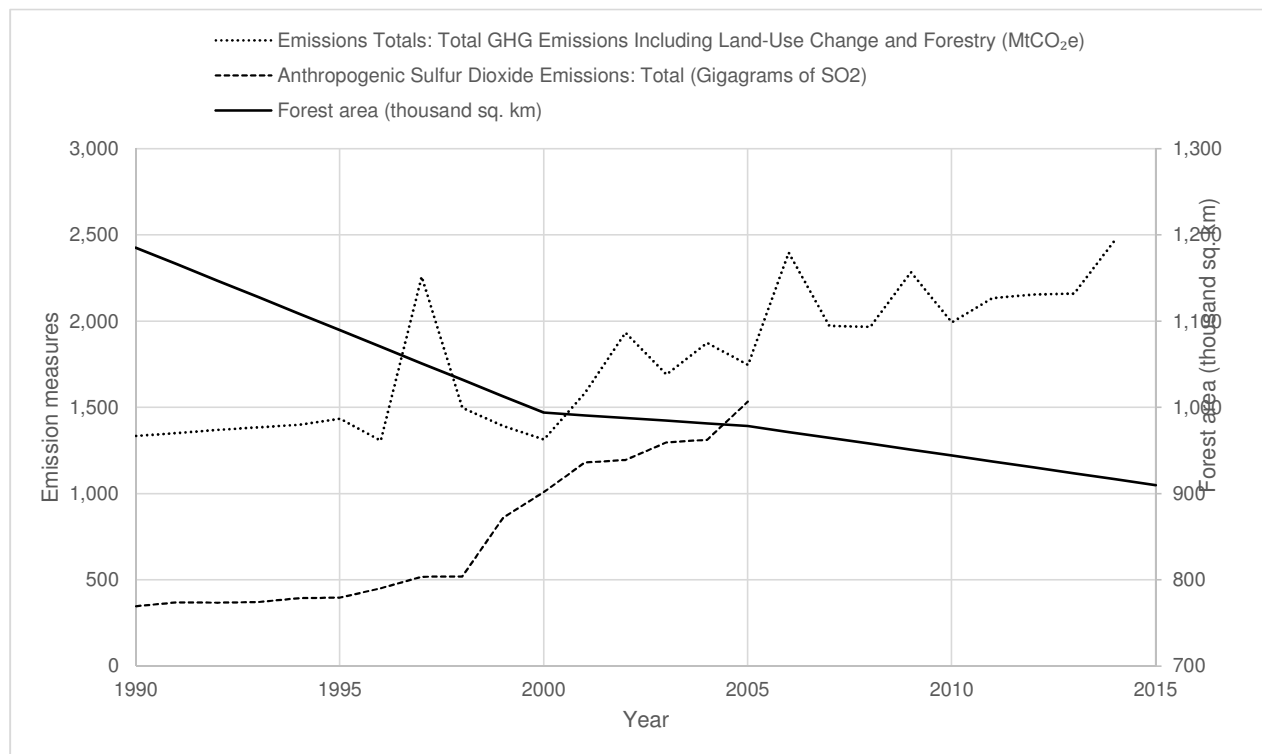
Remove carbon subsidies; better to subsidize urban mass transit.

Transparency on loss of commons (forests, marine, air & water quality).

Coordinated global and regional action. (Was REDD helpful?)

Rising incomes and increased service sector share are positives?

Figure 11: Deforestation and Emissions Indicators



## 10. Institutions and Governance

Do 'institutions rule'?

Have they led or lagged Indonesian economic development?

What difference has democracy made?

Measuring formal institutions is subjective and approximate (Table 3). No credible long-term series.

Most estimates suggest that Indonesian governance rankings similar to that of its PCI.

An obvious sharp improvement in voice & accountability.

No clear trend in government effectiveness and various business indicators.

Table 3: Comparative Institutional and Governance Indicators

Indicator	China	India	Indonesia	Philippines	Thailand
CPI (rank / # of countries)					
1995	40/41	35/41	41/41	36/41	34/41
2016	79/176	79/176	90/176	101/176	101/176
LPI (rank / # of countries)					
2007	30/150	39/150	43/150	65/150	31/150
2016	27/160	35/160	63/160	71/160	45/160
EODB (rank / # of countries)					
2004	72/140	133/140	131/140	109/140	30/140
2018	78/190	100/190	72/190	113/190	26/190
WGI - GE (rank / # of countries)					
1996	105/184	85/184	141/184	102/184	73/184
2016	68/209	90/209	98/209	101/209	71/209
WGI - V&A (rank / # of countries)					
1996	177/201	73/201	160/201	84/201	80/201
2016	190/204	85/204	102/204	101/204	162/204

## 10. Institutions and Governance (cont)

Case study material provides insights. Some examples:

### 1. Policy reform:

Analytical framework: identify the key policy actors, their objectives and their relative power.

Mediated by the 'power of ideas', bureaucratic capabilities, particular institutions, etc.

Soeharto era: the growth imperative, 'Soeharto was **the** institution'; general economic conditions (especially commodity booms and busts) the deciding factor.

Hence major reforms in the late 1960's and 1980's; regress in the 1970's and 1990's.

Reform modalities mattered. Hadi Soesastro's 'low politics', etc.

Democratic era: in search of an analytical framework.

The major macro reforms in place. But microeconomic reform slower, much more difficult, because more diffused power, many more policy actors. 'Small steps' (Chatib Basri).

Not yet clear that there is an inverse correlation between commodity booms and reform progress.

## 10. Institutions and Governance (cont)

### 2. The persistence of corruption:

Centralized v. 'democratized and decentralized'.

No necessary relationship between corruption and growth. (A generalized Asian story.)

Important to develop a taxonomy. Eg, rent-seeking v. bribery; petty v. grand, etc.

Mediating factors: regulatory complexity, economic openness, civil service remuneration, the likelihood of detection and prosecution, the role of the media, the lifestyles of the politically powerful, etc.

The effects of democracy:

'The only thing worse than organized corruption is disorganized corruption'.

Distributional consequences (as above).

Greater risk of detection and prosecution (KPK). The tip of the iceberg?

## 10. Institutions and Governance (cont)

### 3. A workable division between state and market:

That is, how much progress in defining the public and collective goods that only governments can provide, and what's best left to the market?

Where arguably there is 'not enough government': the legal system, the police service, levels of criminality, checks on government (KPK, KPPU, etc), protecting the environmental commons, local-level service delivery (mainly local governments), basic R&D.

Where arguably there is 'too much government':

Industry policy (defined as non-neutral inter-industry and inter-firm incentives).

'Losers are good at picking governments, but governments aren't very good at picking winners.'

Agricultural policy: the shift from productivity to rents?

**Summing up:**

**The two major periods – continuities and changes**



## **CONTINUITIES**

1. Moderately strong economic growth ...
2. Rapid structural change ...
3. Reasonably prudent macroeconomic policy, both fiscal and monetary ...
4. Persistent ambivalence towards globalization (and markets in general), pendulum swinging back and forth, though never closed off since 1966.

## **CHANGES**

1. But about 2% points slower since 2000.
2. Though drivers of growth have changed, from industry to services.
3. Though institutional mechanisms for achieving these goals have changed. Improved economic crisis management capacities.

## CONTINUITIES

### 5. Sector policies:

- a) Strong industry policy rhetoric, but interventions rarely successful.

### 6. Managing natural resources:

- a) Difficult to tax/manage resource rents.
- b) Reasonably effective macroeconomic management of commodity booms.

## CHANGES

### 5. Sector policies:

- a) Strong pro-agricultural productivity policies under Soeharto; since then policies more about price interventions and rents.
- b) Strong infrastructure priority under Soeharto; weak since then.

### 6. Managing natural resources:

- a) The proceeds of the 1970's commodity boom more effectively managed/recycled (?). Though different kinds of booms.

## **CONTINUITIES**

### **7. Institutions:**

- a) KKN a continuing problem; albeit from 'organized' to 'disorganized', and rise of KPK led to more vigorous prosecutions.
- b) Bureaucratic reform and licensing deregulation proceeding slowly.
- c) SOE's remain popular; yet largely unreformed.

### **9. Ownership and Corporate Structures:**

- a) Continuing debate about Article 33 of the Constitution.
- b) Strong SME policy rhetoric, but interventions rarely successful.
- c) Continued prominence of non-Pribumi enterprises in the formal sector.
- d) Substantial foreign ownership, alongside continuing reservations towards FDI.

## **CHANGES**

### **7. Institutions:**

- a) The rise of a vibrant democracy, with attendant political economy implications (especially for reform).
- b) Greatly increased regional autonomy.
- c) A more independent (though less predictable) legal system.

### **9. Ownership and Corporate Structures:**

- a) Political connections remain crucial for conglomerates, but more diffused business-political relationships since 2000.

## **CONTINUITIES**

### **8. Social policies and outcomes:**

- a) Education – commitment to quantity; but quality lagging.
- b) Continuing underinvestment in health; lagging health indicators.
- c) Declining poverty.
- d) Fairly stable inter-regional inequality; continuing East-West development divide.

## **CHANGES**

### **8. Social policies and outcomes:**

- a) Rising inequality after 2000 (also in mid 1990's).
- b) Labour market regulation intensifies; formal sector employment growth weakens.
- c) Poverty decline faster under Soeharto, owing to (i) faster growth, (ii) poverty more growth responsive.
- d) Beginnings of basic SSN programs.

Terima kasih banyak!