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RESEARCH ARTICLE **the rest** *volume 9, number 1, winter 2019*

Indonesian Political Economy: A Historical Analysis

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ABSTRACT

Indonesia is one of the largest countries in the world in demographic, geographical and economic terms. Rich in natural resources, it is a member of the G20 and one of the fastest-growing economies in the world. From its independence in 1949, Indonesia lived dramatic changes in its political and economic system, moving from being an authoritarian state with a quasi-planned economy to being a (albeit flawed) democracy with a free market system. This paper is aimed to analyse briefly the most important phases of the post-colonial development path of the country, trying to highlight the events which mainly changed Indonesian economy and from this understand which are its sources of strength and weakness.
The paper is therefore divided into three main parts. The first covers the most salient events that occurred in the country from its independence till mid-1990s, with a particular emphasis on Suharto's "New Order" regime. The second part mainly focuses on the Asian Financial Crisis, explaining its causes and its political and economic effects on Indonesia. Finally, the last part deals with Indonesia in XXI century, focusing on the similarities and differences with the previous period and on the effects of the Global Financial Crisis on Indonesia.

Indonesian economy from independence to the "Asian Tigers" phase

Indonesia declared its independence from the Netherlands on August 17th, 1949, even if the Dutch had no real control on the archipelago at least from 1942, when it was occupied by Japan. Japanese occupation first, and the subsequent liberation war between Indonesian and Dutch forces left the country's economy in extremely bad conditions. By 1950, Indonesian national income was far below the level of 1940 (Lindblad, 2006). In the first years of independence, Indonesian economy did well in comparison with other Third World countries; however, this did not happen because of a process of modernization of the country, but it was made possible by the colonial economic structure inherited by the Dutch rule. These first years were marked by severe political instability in Indonesia, with 17 cabinets between 1945 and 1958. These cabinets were mainly led by non-Communist parties, which, looking for popular support following the strengthening of the PKI (Communist Party of Indonesia), adopted populist policies, failing to achieve an economic development based on indigenous wealth (Rosser, 2007).

In 1956, Sukarno proclaimed the beginning of the "Guided Democracy" system, a non-democratic form of government in which the interests of the most important social groups (namely, the army, the Islamic groups and the communists) were represented. Despite the consensus working method adopted during the Guided Democracy years, Indonesia witnessed a strong shift to leftist radical policies (Legge, 1972), the most important of which were the nationalisation of British and American assets and the new agrarian laws. Different explanations were given to explain the radicalisation of Indonesian economic policies; according to Emil Salim, for example, "the desire to guide economy and eliminate liberalism in the Indonesian economy is a desire which emerges naturally if it is remembered how greatly the Indonesian have suffered from economic liberalism in colonial times." (VV.AA, 1978). These transformations caused mediocre GDP growth rates during the 1960s, which did not match the increase of population, leading to a contraction of GPD per capita, as it can be seen in Table 1. The lower personal incomes, together with the high inflation (which, according to the World Bank data, was about 1000% in 1965), had a tremendous impact on the overall status of economy.

Major political developments took place at the end of the 1960s. Unhappy with the economic performance of the country and with the increasing importance of the communists (who attempted to organise a coup in 1965), the army took the power in 1967, and in 1968 general Suharto was appointed president. Suharto's period in power, which lasted until 1998, is generally known as "New Order" (*Orde Baru* in Indonesian) and, in contrast with the previous decade, it was marked by economic pragmatism, financial stability and reforms aimed to attract foreign capital. This was obtained through the appointment of the so-called "Berkley Mafia", a group of economic technocrats who formed in the United States. During the 1970s, Indonesia experienced incredible economic growth, as can be seen in Table 2. But New Order economic policies were just one of the factors that led to this incredible development. An important role was played by the shock in oil prices after 1973 (see Figure 1). As Lewis noted, "Indonesia (...) shifted virtually overnight from predominantly agriculture economies to hydrocarbon exporters" (Lewis, 2007). Moreover, an important role was played by the external geopolitical events, and in particular by the war in Viet Nam: in accordance with the the so-called "domino theory", the U.S. feared that the victory of Hanoi in the war in Indochina would have led to the expansion of communism in South East Asian countries. Because of that, the United States strongly supported the anti-communist regimes in the area with large sums of development aids; during the 1970s, Indonesia was among the top 10 recipients for development assistance (Rosser, 2007). The economic growth continued during the 1980s, even if it slowed down, mainly because of the drop of oil prices in 1982 and in 1985. This was possible thanks to the important reforms that the government carried out in the wake of the world recession that took place in the early 1980s. Suharto's economists pushed for a devaluation of the rupiah, for the cut of food and fuel subsides, for a tax reform and for a liberalization of the financial system (Lewis, 2007). Other similar policies of liberalization were undertaken also in 1986, after the second fall of oil prices. Moreover, the proximity to Japan and the other Asian "dragons" was fundamental. In general, it can be said that Indonesia reacted effectively to the exogenous shocks of the 1980s, keeping growth rates usually higher than world average, but at the same time controlling inflation. Due to the remarkable development experienced during the first two decades of the New Order, in 1993 the World Bank listed Indonesia among the so-called "Asian Tigers", a group of 8 high-performing Asian economies (namely, Indonesia, Taiwan, the Republic of Korea, Hong Kong, Malaysia, Japan, Singapore and Thailand) which "stabilized their economies with sound development policies that led to fast growth. They were committed to sharing the new prosperity by making income distribution more equitable. Their public policies promoted rapid capital accumulation by making banks more reliable and encouraging high levels of domestic savings. They increased the skilled labour force by providing universal primary schooling and better primary and secondary education" (World Bank, 1993). The first half of the last decade of the XX century marked another period of growth for Indonesia. This was initially made possible by a new increase in world oil prices following the invasion of Kuwait by Iraq. But this time, thanks to the more accommodating policies initiated in the previous decade and to the fact that oil revenues were mainly used for the modernization of the infrastructures, Indonesia started attracting a huge amount of foreign capital: the direct foreign investment, according to the World Bank, jumped from 1.03% of GDP in 1990 to 2.74% of GDP in 1996. Moreover, Indonesia found itself better integrated with the world market, which, in a period of growing international trade, made Indonesian non-oil export soar.

Summing up, the New Order decades proved to be a period of robust transformation for Indonesia under every aspect. In 1984, according to World Bank data, 70.3% of the population lived with less than $1.90 a day (2011, PPP). In 1996, 45.9% lived in the same conditions. As can be noted in Figure 2, Indonesia, between 1970 and 1996, outperformed every region in the world in terms of growth. But serious socio-economic problems were still present: corruption was high; the popular requests for more social justice were rising; infrastructures, despite the great developments, were still insufficient; the flow of foreign capital generated strong nationalistic feelings among the population; inefficient State-owned were still too powerful; banking system was weak; and others. All of these problems will play a central role in the following years, when the Asian Financial Crisis hit Indonesia.

The Asian Financial Crisis

Only four years after the famous report by the World Bank in which South-East Asian economic growth was defined "a miracle", the region was hit by its most dramatic financial crisis. The trigger of the crisis came from Japan, which depreciated the Yan against the US dollar as a policy of monetary expansion, needed to deal with the country's banking difficulties and its stagnating economy (Tyers, 2012). This had a strong impact on Thailand and Indonesia, which, since the 1980s, received extensive foreign direct investment from Japan (Tyers & Azwar, 2015). The Japanese move, moreover, made Indonesian and Thai goods towards Japan less competitive; this directed the attention on the problems with Bangkok and Jakarta's US dollar pegs. These pegs were unsustainable; Thailand first, and Indonesia later, eventually devalued their currencies. This led to high inflation and the public debt surged. Five main economic policies were adopted as a response to the crises (Basri, 2013):

- Strict monetary policy, with very high interest rate levels;
- Large budget deficit;
- Closure of 16 banks;
- Weak prudential banking regulations;
- Economic liberalization, in particular getting rid of monopolies.

These policies, together with the strong export contraction, made the GDP drop and the unemployment soar. The most important macroeconomic data during the Asian Financial Crisis (AFC) can be seen in Table 3. Indonesia was finally rescued by the International Monetary Fund. In October 1997, Suharto and the IMF signed a 43 billion dollars deal which required strict monetary policies and, more importantly, extensive sectoral and institutional changes that targeted the avenues of patronage favoured by the regime (Lewis, 2007). These reforms proved to be extremely unpopular, in particular within the elites closer to the President. In the face of growing discontent, including significant popular protests in the capital and the loss of traditional sources of support, including the Indonesian Armed Forces, on May 21st, 1998, he resigned (Harris & Foresti, 2010). His departure was followed by a fast process of democratization and liberalization in the cultural and political field; in June 1999 the first elections in years were held, and Suharto's party, *Golkar*, came second, preceded by the Indonesian Democratic Party of Struggle (PDI-P), led by Sukarno's daughter; Abdurrahman Wahid was elected president by the Parliament, and Indonesia moved towards a new page of its history.

Suharto's regime had contrasting effects on Indonesian economy. As it has been noted earlier, under his rule Indonesia experienced remarkable economic growth, with beneficial effect for the majority of the population. According to World Bank data, in 1967, when Suharto's got to power, Indonesia ranked 32nd in terms of GDP; three decades later, before the Asian Financial Crisis, Indonesia ranked 21st. This incredible transformation was possible because of exogenous factors – namely, the rising oil prices, the growth of Japan and the geopolitical environment in South East Asia – but an important role was played by the skilful economic management carried out by the technocrats employed by the regime. On the other hand, Suharto authoritarian rule suffered of the typical problems of other similar systems: rent-seeking behaviour, institutional weakness, inability to change, resource dependence, clientilism, corruption and patrimonialism. The legacy left to the subsequent democratic governments was, therefore, particularly hard to manage.

Indonesia in the XXI century: democracy and transformations

The years following Suharto's regime were marked by radical transformations in Indonesia. After the Asian Financial Crisis, economy started recovering quite quickly, albeit at slower rates than under Suharto. The country was marked by an initial period of high political instability: it had five presidents in six years, it saw its territorial integrity threatened (with the eventual independence of East Timor) and it was victim of a series of terroristic attacks and riots (Hill, et al., 2012). The transition from authoritarianism to democracy had a profound impact on the process of policymaking, including the economic one. Indonesian political system, through the so-called *Reformasi* era, went from "a highly centralised political and policy decision system with a powerful and dominant president, who held power for 32 years, to a more pluralistic, diffused and evolving system with an increasingly active parliament" (Datta, et al., 2011). For the first time in decades, the Parliament emerged more and more as an independent institution, making political negotiation fundamental; the judiciary power became autonomous, even if the process for its transformation was slow and in many occasion ineffective; civil society sprung to life; a "big bang" decentralization was carried out. In the economic field, the first governments proved to be ineffective in developing an autonomous agenda; the guidelines for economic policy were set out by the IMF, the World Bank, the United States and other bilateral donors (Lewis, 2007), but the government was not able in implementing the required reforms. However, in the economic sphere, there were some continuities with the New Order era; Hill (Hill, et al., 2012) identifies four of them:

- prudent macroeconomic management
- a broadly open economy
- slow administrative reform
- equity outcomes

Following the rupiah depreciation and the bank crisis, also the Bank of Indonesia was reformed. In 1999, an act was passed, making the bank independent and giving it the authority to formulate and implement monetary policy (whose aim has to be the stability of the rupiah) considering the inflation target set by the bank (Kinkyo, et al., 2012).

An important consequence of the Asian Financial Crisis was the strengthening of the economic regional initiative in Eastern and South-eastern Asia. The first project launched went under the name of "Manila Framework Group", created in 1997. Fourteen states took part to the initiative aimed at establish mechanisms of regional economic surveillance, crisis management and financial stability (Das, 2005). The second initiative was the creation of the ASEAN Surveillance Process, intended to improve macroeconomic and financial surveillance among the organization's member States. Finally, in October 1998 Japan Ministry of Finance launched the so-called "New Miyazawa Initiative", consisting in a series of bilateral support mechanisms offered from Japan to other Asian countries. Other ambitious projects were proposed, like the Asian counterpart of the IMF, the Asian Monetary Fund, but these have never been practically realized. These initiatives played a fundamental role in allowing Indonesian recovery, as they provided huge amount of capital and aids.

The situation of chaos in Indonesia started to improve during Megawati Sukarnoputri's term (2001-2004). Despite the rising security problems Indonesia lived under her presidency (in particular, separatist challenges and religious violence), Megawati was able to enhance different progresses in the economic field. Firstly, she replaced the previous economic team with technocrats (going back to the "Berkley Mafia" tradition); moreover, she had a more conciliatory position with Indonesia international creditor: following more closely the requests coming from the IMF and the World Bank, Megawati was able to restore market confidence in Jakarta, and in December 2003 Indonesia stopped borrowing from the IMF Extended Fund Facility. Finally, she restarted the privatization process, in particular with regard to PT Telkom and Indosat. As can be noted in Table 4, under her term GDP growth rate accelerated, also thanks to the rising oil prices. In 2004 presidential elections, the first free direct elections for the president, Megawati Sukarnoputri was defeated by Susilo Bambang Yudhoyono, from the Democratic Party. In spite of the political change, the macroeconomic lines remained the same: reduction of the deficit, recapitalization of the banking system, appreciation of the rupiah and lowering of the interest rates (Hill, et al., 2012).

In 2008, exactly ten years after the most acute moment of the Asian Financial Crisis, another crisis hit the world, with effects much more dramatic than the 1997 depression. On September 15, 2008, the investment bank Lehman Brothers collapsed, marking the beginning of the Global Financial Crisis, which dragged the world into the Great Recession. But for Indonesia, the years from 2008 to 2012 will not be critical; in fact, its economy will even grow. While world GDP growth, according to the World Bank, dramatically slowed down from 4.3% in 2007 to -1.7% in 2009, Indonesian growth rates, as can be noted in Table 4, were slightly reduced, coming back to the pre-crisis levels already in 2010. Since then, Indonesian economy has always done well compared to the the rest of the world, maintaining its rates on average 2% point over world values. How could have been possible that Indonesia, which a decade earlier was completely crushed by a much smaller recession, reacted so well to the Global Financial Crisis? Basri (Basri, 2013) identifies four main differences between the Indonesian approach and relation to the two crisis:

1. In 1998, the financial system of Indonesia was particularly weak, with a ratio of Non-Performing Loans (NPL) around 27%. In 2008, Indonesian banks were in healthier conditions (also thanks to the Asian Financial Crisis), and their NPL ratio was less than 4%;
2. In 1998, Indonesia was applying a managed floating exchange system, which collapsed on the wake of the Asian Financial Crisis. The transition to a free floating system caught economic players unprepared. In 2008, they got used to this exchange rate system and they learned how to diversify their risks;
3. In 1998, the policy responses to the crises, as noted above, proved to be ineffective. In 2008 Indonesia adopted a different approach, incrementing liquidity, lowering taxes and providing a social safety net, thus mitigating the impact of the crisis on the poorest segment of society;
4. Finally, the last difference regards the different economic structure of Indonesia. In 1998, according to the World Bank, exports accounted for over 50% of Indonesian GDP; in 2008, it accounted only for 29%. Due to this, Global Recession had a smaller impact on the country, in

particular compared to the other G20 countries. Also thanks to a flourishing domestic market, Indonesia was able to maintain high growth rates even during 2008.

According to Tyers and Azwar (Tyers & Azwar, 2015), there is also another difference to keep on mind: the different political situation. In 1998, the coincidence of the Asian Financial Crisis and of political upheaval led to the collapse of the country's economy. In 2008, although different problems in the State stability were still present, the political context was radically different.

After the Global Financial Crisis, Indonesia's growth has been high and steady, in particular if compared to the other big economies. Since 2008, it has always been among the five best performing States among the G20 countries; in 2012, it came second, just behind China; in 2016, it came third, behind China and India. In 2017, according to the IMF, Indonesia shared 2.56% of world GDP (PPP); in 2008, the share was roughly 2% (in comparison, in the same years the United States fell from 18.2 to 15.3%). In the same period of time, Indonesia went from being the 21st economy in terms of GDP PPP to being the 16th. To conclude, in these last years, Indonesian economic growth has been remarkable, even more if it seen in comparison with the current global situation. Political and economic problems, as it will be noted in the next part, still persist, but at the current state of affairs, Indonesia is on the right path to become a more and more important player in world economy.

Conclusions

Indonesia has experienced radical transformations since its independence. Its economy, as can be noted in Table 5, deeply changed its structure, going from being a predominantly rural economy to being one more oriented towards the secondary and tertiary sectors. As van Leeuwen and Földári (Leeuwen & Földvári, 2016) noted, this, together with technological and scientific development, caused an increase in labour productivity in agriculture, and thus a decrease in rural-urban inequality. Inequality is a fundamental factor to consider when analysing Indonesian economic system: despite the rapid economic growth, the strong regional differences and the fact that Indonesia is rich in hydrocarbon (which in many countries is associated with high inequality rates), the country has always managed to have a GINI coefficient way lower than the world average (in 2013, its GINI coefficient was 39.5, while the American one was 41.0). In its developmental path, Indonesia was able to maintain comparatively low levels of inequality and drag a huge amount of people out of poverty. Basri and Hill (Basri & Hill, 2011) identify five main challenges that will define Indonesia's future:

1. Demography: Indonesia has a youthful population, and the situation will not change for at least 10 years. Thanks to this, it will see its economy keep growing, due to the expected increment in consumption rates. This will help Indonesia in closing the gap with developed economies. However, after this period the country will face a rapid aging population; because of this, it needs to create a sustainable economy for the decades to come.
2. Government-party relations: after the Asian Financial Crisis, Indonesia faced a transition from authoritarianism to democracy, improving the quality of the policy making process. However, huge political problems are still present, the most important of which is the fact that, so far, the President has never enjoyed a stable majority in the Parliament, thus leading to tensions between the Executive and the legislature. To experience sustainable growth, Indonesia needs to improve its good governance.
3. Corruption: like in many other authoritarian and personalised regime, Indonesia under Suharto's rule was characterized by widespread and endemic corruption. Progresses have been made in this sector, but much has yet to be done.
4. Decentralization: despite the many benefits of the decentralization reform carried out in 2001, many problems arose from it. In particular, central government policies are becoming less and less effective because of the principal-agent issue.
5. Infrastructures: in a huge archipelago like Indonesia, infrastructures are fundamentally important. The low quality of the current system erodes Indonesian competitiveness, as transition costs are higher than in other similar economies.

To conclude, Indonesia has radically changed its position in the international economic system, going from being at the periphery of it to getting closer to the centre. As the focus of international economy and politics moves towards Asia, if the country addresses in the right way the problems and challenges ahead, it will probably become one of the most important actors of this century.

Appendix: tables and figures

***Table 1: Indonesian macro-economic performance during Sukarno's Guided Democracy* (source: World Bank)**

	1961	1962	1963	1964	1965	1966	1967
GDP variation (%)	5.7	1.8	-2.2	3.5	1.1	2.8	1.4
GDP per capita variation (%)	2.9	-0.8	-4.8	0.7	-1.6	0.1	-1.3
Inflation (%)	13.7	131.4	145.9	108.9	306.8	1,136.2	106.0

***Table 2: Indonesian macro-economic performance, 1973-1980* (source: World Bank)**

	1973	1974	1975	1976	1977	1978	1979	1980
GDP variation (%)	8.1	7.6	5.0	6.9	8.8	6.8	7.3	9.9
GDP per capita variation (%)	5.3	4.9	2.3	4.3	6.1	4.2	4.8	7.3
Inflation (%)	31.0	40.6	19.0	19.9	11.0	8.1	16.2	18.0

***Table 3: macroeconomic data during the Asian Financial Crisis, 1996-1999* (Source: World Bank, International Monetary Fund)**

	1996	1997	1998	1999
GDP (Billion, current $)	227.37	215.75	95.46	140.00
GDP variation (%)	7.8	4.7	-13.1	0.8
GDP per capita variation (%)	6.2	3.2	-14.4	-0.7
Inflation (%)	8.0	6.2	58.4	20.5
Official rupiah exchange rate (per US$)	2,342.30	2,909.38	10,013.62	7,855.15
Unemployment rate (%)	4.4	4.7	5.5	6.3
Poverty headcount ratio at $1.90 a day (%)	45.9	N/A	65.3	40
Public debt (% of GDP)	27.5	26.4	72.5	95.9

Table 4: Indonesian macro-economic performance during XXI century, 2000-2017 **(source: World Bank, International Monetary Fund)**

	GDP (Billion, current $)	GDP variation (%)	GDP per capita variation vvariavariation (%)	Inflation (%)	Unemplo y-ment rate (%)	headcount ratio at $1.90 a	Public debt (% of GDP)
2000	165.02	4.9	3.5	3.7	6.1	39.8	87.4
2001	160.45	3.6	2.2	11.5	8.1	36	73.7
2002	195.66	4.5	3.1	11.9	9.1	23.4	62.3
2003	234.77	4.8	3.3	6.7	9.5	23.3	55.6
2004	256.84	5.0	3.6	6.2	9.9	24.4	51.3
2005	285.87	5.7	4.3	10.5	11.3	21.6	42.6
2006	364.57	5.5	4.1	13.1	10.3	28	35.9
2007	432.21	6.4	4.9	6.4	9.1	22.8	32.3
2008	510.23	6.0	4.6	9.8	8.4	21.6	30.3
2009	539.58	4.6	3.3	4.8	7.9	18.4	26.5
2010	755.10	6.2	4.8	5.1	7.1	15.9	24.5
2011	892.97	6.2	4.8	5.4	6.6	13.6	23.1
2012	917.87	6.0	4.7	4.3	6.1	11.8	23.0
2013	912.54	5.6	4.3	6.4	6.2	9.8	24.9
2014	890.82	5.0	3.7	6.4	5.9	8.3	24.7
2015	861.26	4.9	3.7	6.4	6.2	7.5	27.3
2016	932.26	5.0	3.8	3.5	5.6	6.8	27.9
2017	1016.00	5.1	3.9	3.8	4.2	5.7	28.3

Table 5: average sectoral share of GDP in Indonesia **(Source: Hayashi, 2005)**

	Agriculture (%)	Industry (%)	Service (%)
1966-1970	42.4	17.6	40.0
1970-1981	34.5	23.7	41.8
1981-1986	27.8	26.6	45.6
1986-1996	21.8	32.8	45.4
1996-2000	17.9	38.9	43.2
2000-2016	14.1	44.4	41.5

Figure 1: Oil prices and Indonesian oil rents **(sources: World Bank, Plains All Americans Pipeline)**

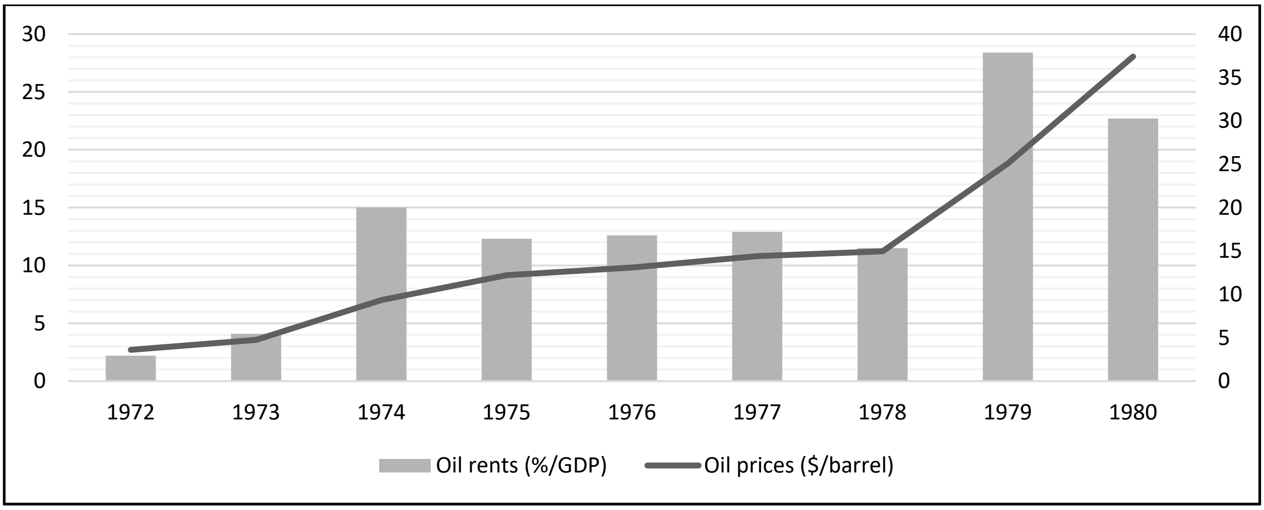
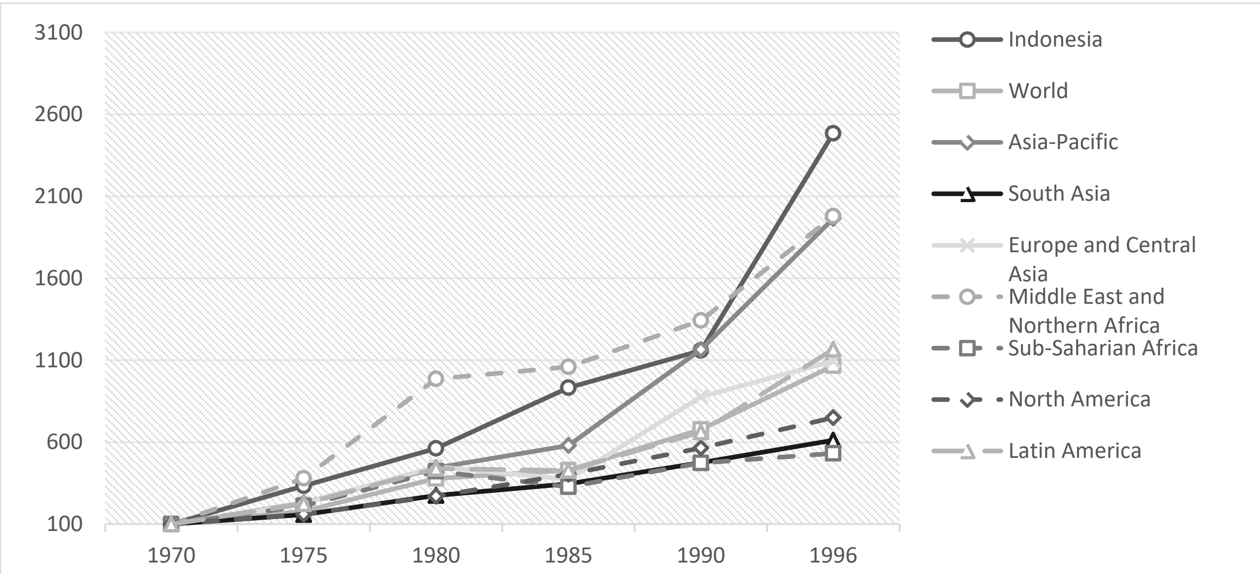


Figure 2: GDP variations in Indonesia and in the world macro-regions, 1970-1996, base year 1970 **(Source: personal elaboration on World Bank data)**



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