GARUDA RISES AGAIN

REPORT ON THE INDONESIAN ECONOMY 2007

SYED MUNTASIR MAMUN

JAKARTA, REPUBLIK INDONESIA

MONDAY, MAY 07, 2007

FOR ANY FURTHER CLARIFICATION, AUTHENTICATION, AND INFORMATION, PLEASE CALL MUNTASIR AT +88-01911-060506, OR, +6281395221398, OR MAIL TO: SYEDMUNTASIR@YAHOO.COM, OR WRITE TO: SYED MUNTASIR MAMUN; 345 DOHS BARIDHARA, DHAKA CANTONMENT, DHAKA, BANGLADESH

Table of Contents

List of Figures

List of Tables

Indonesian Economy in Brief

GDP (purchasing power parity):	$935 billion (2006 est.)
GDP (official exchange rate):	$264.4 billion (2006 est.)
GDP - real growth rate:	5.4% (2006 est.)
GDP - per capita (PPP):	$3,800 (2006 est.)
GDP - composition by sector:	Agriculture: 13.1%, industry: 46%, services: 41% (2006 est.)
Labor force:	108.2 million (2006 est.)
Labor force - by occupation:	Agriculture: 43.3%, industry: 18%, services: 38.7% (2004 est.)
Unemployment rate:	12.5% (2006 est.)
Population below poverty line:	17.8% (2006)
Household income or consumption by percentage share:	Lowest 10%: 3.6%, highest 10%: 28.5% (2002)
Distribution of family income – Gini index:	34.8 (2004)
Inflation rate (consumer prices):	13.2% (2006 est.)
Investment (gross fixed):	20.3% of GDP (2006 est.)
Budget:	Revenues: $75.58 billion Expenditures: $79.45 billion; Including capital expenditures of $NA (2006 est.)
Public debt:	43.8% of GDP (2006 est.)
Agriculture - products:	Rice, cassava (tapioca), peanuts, rubber, cocoa, coffee, palm oil, copra; poultry, beef, pork, eggs
Industries:	Petroleum and natural gas, textiles, apparel, footwear, mining, cement, chemical fertilizers, plywood, rubber, food, tourism
Industrial production growth rate:	2.6% (2006 est.)
Electricity - production:	123.4 billion kWh (2005 est.)
Electricity - consumption:	107.7 billion kWh (2005 est.)
Oil - production:	1.136 million bbl/day (2005 est.)
Oil - consumption:	1.168 million bbl/day (2005 est.)
Oil - exports:	474,000 bbl/day (2005 est.)
Oil - imports:	424,000 bbl/day (2005 est.)
Oil - proved reserves:	4.85 billion bbl (2006 est.)
Natural gas - production:	76 billion cu m (2005 est.)
Natural gas - consumption:	39.4 billion cu m (2005 est.)
Natural gas - exports:	36.29 billion cu m (2005 est.)
Natural gas - proved reserves:	2.76 trillion cu m (31 December 2005 est.)
Current-account balance:	$1.636 billion (2006 est.)
Exports:	$102.3 billion f.o.b. (2006 est.)
Exports - commodities:	Oil and gas, electrical appliances, plywood, textiles, rubber
Exports - partners:	Japan 21.1%, US 11.5%, Singapore 9.2%, South Korea 8.3%, China 7.8%, Malaysia 4% (2005)
Imports:	$77.73 billion f.o.b. (2006 est.)
Imports - commodities:	Machinery and equipment, chemicals, fuels, foodstuffs
Imports - partners:	Singapore 16.4%, Japan 12%, China 10.1%, US 6.7%, Thailand 6%, South Korea 5%, Saudi Arabia 4.7%, Australia 4.4% (2005)
Reserves of foreign exchange and gold:	$43.04 billion (2006 est.)
Debt - external:	$130.4 billion (2006 est.)
Economic aid - recipient[1]:	ODA, $67 billion (2006 est.)
Currency (code):	Indonesian Rupiah (IDR)
Exchange rates:	Indonesian Rupiah per US dollar - 9,159.3 (2006), 9,704.7 (2005), 8,938.9 (2004), 8,577.1 (2003), 9,311.2 (2002)
Fiscal year:	Calendar year

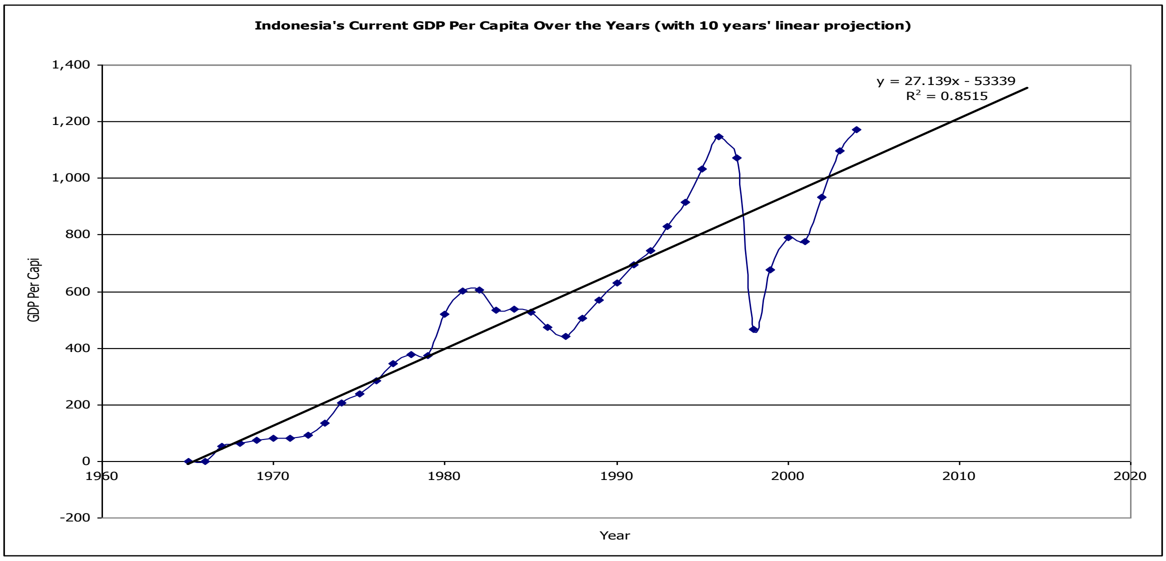
[1] note: Indonesia ended 2006 with $67 billion in official foreign debt (about 25% of GDP), with Japan ($25 billion), the World Bank ($8.5 billion) and the Asian Development Bank ($8.4 billion) as the largest creditors; about $6 billion in grant assistance was pledged to rebuild Aceh after the December 2004 tsunami; President YUDHYONO ended the Consultative Group on Indonesia forum in January 2007

1. Introduction

"Nations are not individuals. Nations live in a state of nature. There is no higher authority to protect them. If they do not protect themselves, they die. Ignoring one's interests, squandering one's resources in fits of altruism, is the fastest road to national disaster…" (Charles Krauthammer, TIME Magazine, May 17, 1993, pp. 74)

Indonesia has a market-based economy in which the government plays a significant role. It owns more than 164 state-owned enterprises and administers prices on several basic goods, including fuel[2], rice, and electricity. In the aftermath of the financial and economic crisis that began in mid-1997, the government took custody of a significant portion of private sector assets through acquisition of nonperforming bank loans and corporate assets through the debt restructuring process.

Figure 1: Indonesia's GDP Growth-1965 to 2017 (Projection)



Current GDP per capita grew an astonishing 545% in the Seventies fuelled by oil demand. But this proved unsustainable and growth fell sharply to a manageable 20% in the Eighties and 13% in the Nineties. During the thirty years of President Soeharto's "New Order" government, Indonesia's economy grew from a per capita GDP of $70 to more than $1,000 by 1996. Through prudent monetary and fiscal policies, inflation was held in the 5%–10% range, the Rupiah was

[2] Indonesia is the only Asian member of the Organization of Petroleum Exporting Countries (OPEC) outside of the Middle East, and is the only OPEC member that is a net oil importer. In early 2005, Indonesian crude oil and condensate output was 1.07 million barrels per day. This is a substantial decline from the 1990s, due primarily to aging oil fields and a lack of investment in oil production equipment. In 1999, Crude and condensate output averaged 1.5 million barrels (240,000 m³) per day, and in the 1998 calendar year the oil and gas sector, including refining, contributed approximately 9% to GDP. This decline in production since the 1990s has been accompanied by a substantial increase in domestic consumption, about 5.4% per year, leading to an expected US$1.2 billion cost for importing oil in 2005.

The state owns all petroleum and mineral rights. Foreign firms participate through production-sharing and work contracts. Oil and gas contractors are required to finance all exploration, production, and development costs in their contract areas; they are entitled to recover operating, exploration, and development costs out of the oil and gas produced. According to President Susilo Bambang Yudhoyono, the nation is expected to deplete its crude oil reserves in about 2020.

Indonesia is the world's largest tin market. Although minerals production traditionally centered on bauxite, silver, and tin production, Indonesia is expanding its copper, nickel, gold, and coal output for export markets. In mid-1993, the Department of Mines and Energy reopened the coal sector to foreign investment, with the result that the leading Indonesian coal producer now is a joint venture between UK firms BP and Rio Tinto. Total coal production reached 74 million metric tons in 1999, including exports of 55 million tons. The Indonesian Government hopes to surpass 100 million metric tons of coal production in 2002. Two US firms operate three copper/gold mines in Indonesia, with a Canadian and British firm holding significant other investments in nickel and gold, respectively. In 1998, the value of Indonesian gold producer was $1 billion and copper, $843 million. Receipts from gold, copper, and coal comprised 84% of the $3 billion. Earned in 1998 by the mineral mining sector.

Indonesia's fuel production has declined significantly over the years, owing to aging oil fields and lack of investment in new equipment. As a result, despite being an exporter of crude oil, Indonesia is now a net importer of oil and had previously subsidized fuel prices to keep prices low, costing US$ 7 billion in 2004. The current president has mandated a significant reduction of government subsidy of fuel prices in several stages. In order to alleviate economic hardships, the government has offered one-time subsidies to qualified citizens. The economy is now undergoing a process of rebuilding after the tsunami that struck in December of 2004. The government has stated the cuts in subsidies are aimed at reducing the budget deficit to 1% of gross domestic product (GDP) this year, down from around 1.6% last year.

stable and predictable, and the government avoided domestic financing of budget deficits. Much of the development budget was financed by concessional foreign aid.

In the mid-1980s, the government began eliminating regulatory obstacles to economic activity. The steps were aimed primarily at the external and financial sectors and were designed to stimulate employment and growth in the non-oil export sector. Annual real GDP growth averaged nearly 7% from 1987–1997 and most analysts recognized Indonesia as a newly industrializing economy and emerging major market. High levels of economic growth from 1987–1997 masked a number of structural weaknesses in Indonesia's economy. The legal system was very weak, and there was and is no effective way to enforce contracts, collect debts, or sue for bankruptcy. Banking practices were much unsophisticated, with collateral-based lending the norm and widespread violation of prudential regulations, including limits on connected lending. Non-tariff barriers, rent-seeking by state-owned enterprises, domestic subsidies, barriers to domestic trade, and export restrictions all created economic distortions.

The regional financial problems that swept into Indonesia in late 1997 quickly became an economic and political crisis. Indonesia's initial response was to float the Rupiah, raise key domestic interest rates, and tighten fiscal policy. In October 1997, Indonesia and the International Monetary Fund (IMF) reached agreement on an economic reform program aimed at macroeconomic stabilization and elimination of some of the country's most damaging economic policies, such as the National Car Program and the clove monopoly, both involving family members of President Soeharto. The Rupiah failed to stabilize for any significant period of time, however, and President Soeharto was forced to resign in May 1998. In August 1998, Indonesia and the IMF agreed on an Extended Fund Facility (EFF) under President B.J Habibie that included significant structural reform targets. President Abdurrahman Wahid took office in October 1999, and Indonesia and the IMF signed another EFF in January 2000. The new program also has a range of economic, structural reform, and governance targets.

The effects of the financial and economic crisis were severe. In 1998, real GDP contracted by an estimated 13.7%. The economy bottomed out in mid-1999, and real GDP growth for the year was an anemic 0.3%. Inflation reached 77%in 1998 but slowed to 2% in 1999. The Rupiah, which had been in the Rp 2,400/USD1 range in 1997 reached Rp 17,000/USD1 at the height of the 1998 violence, returned to the Rp 6,500–8,000/USD1 range in late 1998. It has traded in the Rp 6,500–9,000/USD1 range since, with significant volatility. Although a severe drought in 1997–1998 forced Indonesia to import record amounts of rice, overall imports dropped precipitously in the early stage of the crisis in response to the unfavorable exchange rate, reduced domestic demand, and absence of new investment. Although reliable unemployment data are not available, formal sector employment contracted significantly.

In late 2005 Indonesia faced a 'mini-crisis' due to international oil prices rises and imports. The currency reached Rp 12,000/USD1 before stabilizing. The government was forced to cut its massive fuel subsidies, which were to cost $14 billion for 2005, in October. This led to a more than doubling in the price of consumer fuels, resulting in double-digit inflation. The situation has stabilized, but the economy continues to struggle with inflation at 17% in January 2006. To mitigate consequent economic hardship, the government has offered one-time subsidies to eligible citizens, effectively becoming Indonesia's first significant government-funded social security benefit scheme.

As of early 2006, Indonesia's economic outlook is more positive. Economic growth accelerated to 5.1% in 2004 and reached 5.6% in 2005. Real per capita income has reached pre-crisis levels. Growth is driven primarily by domestic consumption, which accounts for roughly three-fourths of Indonesia's gross domestic product. The Jakarta Stock Exchange was the best performing market in Asia in 2004, up some 42%. Problems that continue to put a drag on growth include low foreign investment levels, bureaucratic red tape, and widespread corruption [3]. However,

[3] Since the late 1980s, Indonesia has made significant changes to its regulatory framework to encourage economic growth. This growth was financed largely from private investment, both foreign and domestic. U.S. investors dominated the oil and gas sector and undertook some of Indonesia's largest mining projects. In addition, the presence of US banks, manufacturers, and service providers expanded, especially after the industrial and financial sector reforms of the 1980s. Other major foreign investors included Japan, the United Kingdom, Singapore, the Netherlands, Hong Kong, Taiwan, and South Korea.

The economic crisis made continued private financing imperative but problematic. New foreign investment approvals fell by almost two-thirds between 1997 and 1999. The crisis further highlighted areas where additional reform was needed. Frequently cited areas for improving the investment climate were establishment of a functioning legal and judicial system, adherence to competitive processes, and adoption of internationally acceptable accounting and disclosure standards. Despite improvements in the laws in recent years, Indonesia's intellectual property rights regime remains weak; lack of effective enforcement is a major concern. Under Soeharto, Indonesia had moved toward private provision of public infrastructure, including electric power, toll roads, and telecommunications. The financial crisis brought to light serious weaknesses in the process of dispute resolution, however, particularly in the area of private infrastructure projects. Although Indonesia continued to have the advantages of a large labor force, abundant natural resources and modern infrastructure, private investment in new projects largely ceased during the crisis.

there is very strong optimism with the conclusion of peaceful elections during the year 2004 and the election of the reformist president Susilo Bambang Yudhoyono.

2. Aim

This paper aims at strengthening a deeper understanding of the Indonesian economy, its historical roots and trends, its trials and tribulations, and as it posits itself now – at the middle of year 2007. This is a personal journey to the discovery of a new face of an ancient economy.

3. Scope

The paper will encompass the following:

(a) Indonesia – a Short Primer: dealing with the history, composition, and context of Indonesia in the present world order as the country relates to it from antiquity

(b) Indonesian Economy – A Brief History: outlining the Structuralist superstructure of the Indonesian economy

(c) Indonesian Economy – What Went Wrong and Where: dealing with the following aspects of the economy in terms of:

   i. A Brief History of the Banking System
   ii. Inherent Weaknesses
   iii. Government Intervention
   iv. External or Foreign Factors: Foreign Investors
   v. Currency Speculators
   vi. IMF's Role

(d) Indonesian Economy – The Changing Paradigm: outlining the response patterns that grew from a combination of both domestic policies and international pressure groups. The sequence is as follows:

   i. Initial Response (to the economic crises)
   ii. Bank Closures and Consolidation (in two phases)
   iii. Bank Recapitalization (with state intervention)

(e) Indonesian Economy in 2007 (with policy/strategy reviews by the experts)

(f) Indonesian Economy – Policy Suggestions (with focus on generic formulations)

4. Methodology

Only secondary information have been researched and utilized for the purpose of the paper.

5. Indonesia – Short Primer

Indonesia, officially the Republic of Indonesia (Indonesian: Republik Indonesia), is a nation of about 17,500 islands in South East Asia, and the world's largest archipelagic state. With a population of over 200 million, it is the world's fourth most populous country and the most populous Muslim-majority nation. With a democratically elected parliament and president, Indonesia is considered the world's third largest democracy (after India and the United States). Its capital is Jakarta, and the country shares land borders with Papua New Guinea, East Timor, and Malaysia and by sea Indonesia neighbors Singapore, The Philippines and Australia. The Indonesian archipelago, home of the Spice Islands, has been an important trade destination since at least the time of the Srivijaya Kingdom with whom seventh century Chinese sailors traded. Indonesia's history has been influenced by numerous foreign powers that were drawn to the archipelago by its wealth of natural resources; these have included Indians, under whose influence Hindu and Buddhist kingdoms flourished beginning in the early centuries CE, Muslim traders who spread Islam from the thirteenth century, and Europeans who fought for monopolization of the spice trade during the European Age of Exploration. A Dutch colonial presence existed in Indonesia for over three centuries; however, Indonesian independence was declared in 1945, which received official international recognition four years later. Indonesia's post-independence history has been turbulent, with political instability including separatism and corruption, periods of rapid economic growth and decline, natural disaster, and a democratization process since 1998.

In May 2004, an Indonesian court may have compounded the country's troubles attracting foreign investment when it ruled in favor of a petition by Indonesian chemical company, Tri Polyta, that a bond issue be declared illegal and nullified, freeing that company of its obligation to repay its debts.

Figure 2: Map of Indonesia

Indonesia, a vast polyglot nation, has struggled to overcome the Asian financial crisis, and still grapples with persistent poverty and unemployment, inadequate infrastructure, endemic corruption, a fragile banking sector, a poor investment climate, and unequal resource distribution among regions. The country continues the slow work of rebuilding from the devastating December 2004 tsunami and from an earthquake in central Java in May 2006 that caused over $3 billion in damage and losses. Declining oil production and lack of new exploration investment turned Indonesia into a net oil importer in 2004. The cost of subsidizing domestic fuel placed increasing strain on the budget in 2005, and combined with indecisive monetary policy, contributed to a run on the currency in August, prompting the government to enact a 126% average fuel price hike in October. The resulting inflation and interest rate hikes dampened growth through mid-2006, while large increases in rice prices pushed millions more people under the national poverty line. Economic reformers introduced three policy packages in 2006 to improve the investment climate, infrastructure, and the financial sector, but translating them into reality has not been easy. Keys to future growth remain internal reform, building up the confidence of international and domestic investors, and strong global economic growth. Significant progress has been made in rebuilding Aceh after the devastating December 2004 tsunami, and the province now shows more economic activity than before the disaster. Unfortunately, Indonesia suffered new disasters in 2006 and early 2007 including: a major earthquake near Yogyakarta, an industrial accident in Sidoarjo, East Java that created a "mud volcano," a tsunami in South Java, and major flooding in Jakarta, all of which caused additional damages in the billions of dollars. Donors are assisting Indonesia with its disaster mitigation and early warning efforts.

6. Indonesian Economy – A Brief History

The economy of Indonesia has of late been one of drastic changes, and the growth has been relatively unstructured, and has not followed exactly an economic model. However, there are three general development models from which an economy can model itself- the Neoliberal, the Structuralist, and the Dependency. The model that most accurately fits the economic structure of Indonesia is the Structuralist, which is made up of the following components:

- ❖ A more genuine and equitable distribution of productive land
- ❖ A more diversified economy less reliant on primary commodity exports
- ❖ Government policies that realistically address the problem of poverty and income distribution
- ❖ An active role for government in the economy
- ❖ Strong environmental policies
- ❖ Relief from the burden of external debt

Changes in the international trading and financial system designed to bring about a more equitable integration of developing countries into the global economy. (Economics, p 497) When analyzing the Indonesian economy, these Structuralist characteristics come across in the economy itself and the government that regulates the economy[4].

[4] A very important reading on the structural association of the Indonesian communities by Farchan Bulkin, titld, "State and Society: Indonesian Politics Under the New Order, 1966-1978" – which was a PhD dissertation under the University of Washington (1983).

The country of Indonesia was controlled by both the Portuguese and the Dutch since the beginning of the 16th century through the 18th century. In the 18th century, the Portuguese left the area, and the area was controlled by the Dutch until World War II, at which time it was taken over by Japan. Throughout these different owners, the economy remained agriculturally based. The modern day Indonesia, however, uses only ten percent of its land for agricultural production, and the goods produced from that land only account for 18.8 percent of the country's GDP. The country produces tobacco, rubber, palm oil, tea, coffee, rice, corn and cassava. The primary export in terms of raw materials is rubber. Following the Structuralist model, Indonesia's economy has largely shifted away from these primary goods as its primary source of income- over 40 percent of the Indonesian GDP is from "services," and another 40 percent comes from "Industrial production." (World Factbook 1999) The countries to which Indonesia exports the most are Japan, the EU, US, Singapore, South Korea, Hong Kong, and China. Their total exports are approximately 49 billion dollars annually (as of 1998), while their imports are only 24 billion, meaning that they are much more reliant on foreign purchasing of goods than they are on foreign production. (www.odci.gov) Indonesia's reliance on purchases in foreign markets played a pivotal role in the 1997 Asian Financial Crisis (to be discussed later). The labor force that is able to work in Indonesia is, to a large extent, employed- the country only has an unemployment of approximately 5.5 percent, despite the Asian Financial Crisis. (www.bps.go.id) This is close the internationally accepted rate of 5% unemployment being at "full employment." Out of a work force of approximately 87 million workers, approximately 39 million work in the agricultural professions, 16 million are in wholesale trade, restaurants and hotels, and 12 million work in "community, social and personal services." Many of the industrial markets in Indonesia are state-owned, and so the state has a deep-seated interest in making sure that the economy is running smoothly. (Britannica)

From the beginning of the military coup in 1965, the government has exercised enormous amounts of control over the country's economy. As soon as Soeharto placed himself into power, his first order of business was restructuring the flailing economy. The Rupiah (the Indonesian currency) was stabilized as of 1957, and a new emphasis was put on oil extraction through Pertamena, which was (is) the state-owned oil company starting in 1959. During the mid-1980s, a drop in oil prices created a shift from oil manufacturing to the private sector investment and manufactured exports. (Britannica) Because many of the companies in Indonesia are owned by the state, many of the policies that the government adopts are geared towards the market's stability. A primary principle in the Indonesian economic policy is that they maintain a balanced budget, as required of them in their Constitution. They are able to maintain this "through a broad-based tax regime supplemented by foreign aid which is diminishing in its relative contribution to national development." The purpose of this Structuralist factor is so the government is not dependent upon other countries for financial support in the form of loans and allows for unhindered growth. (Millennium, p 292).

One of the most prevalent economic structures in the Indonesian economy is "cooperatives," which set up agreements between companies to work together instead of competing against one another (setting up a near-trust-like system in the economy). The government of Indonesia plays a large role in the existence of these cooperatives, for it not only allows for cooperatives to be created, but actually encourages them; in Article 33 of the Constitution, it states that "the development of a cooperative economy is to become the political doctrine of our nation."

Bulkin's main argument was that Indonesia was trapped within the structures of "peripheral capitalism," a concept borrowed from the noted scholar of the Indian sub-continent, Hamza Alavi (1972; 1982). For Bulkin, peripheral capitalism had a colonial character, being overly reliant on primary production "with the result that manufactured goods required for domestic consumption had to be imported." It was dependent as well on the export of raw materials, causing vulnerability to international market fluctuations, and was distinguished by the fact that economic power remained in the hands of foreign corporations that repatriated profits overseas. The New Order, according to Bulkin, represented the reassertion of a peripheral capitalism damaged previously by war and economic depression—"with respect to the external dependence upon the international market and capital financing sources, economic structure and institutions." The residual influences of dependency theory were clearly displayed in Bulkin's work, as they were in Alavi's.

Among the other arguments proposed by Bulkin was that the New Order "was forced to legitimize and rationalize the objective conditions of peripheral capitalism" because its narrowly developmentalist economic policies alienated large sections of the population, including critical "middle class groups." He suggested that this placed its leaders in a contradictory situation: their "economic policies especially tended to delegitimize the regime, but to maintain a political structure in which they could pursue their economic interests required political legitimacy." The "essence of the problem," as Bulkin put it, was to "legitimize the conditions of peripheral capitalism for the sake of political stability and the social acceptance of the regime." Therefore, the "chief political projects" of the New Order were to create a political system that was "programmatic and pragmatic," and to maintain "a viable electorate machinery.…" Nevertheless, it was also continuously concerned with the "cooptation of political, economic, and bureaucratic forces," as well as the "maintenance of political and bureaucratic institutions for repression and coercion."

For Bulkin, these projects had real and ideological repercussions. Foremost was the reification of a bureaucratically defined Pancasila as state ideology. This ultimately entailed the imposition of such ideas as the "dual function" of the armed forces, corporatism and organicism, developmentalism, and opposition to mass-based politics. These ideological manipulations concealed the "reconsolidation of the structure of peripheral capitalism" upon which bureaucratic and regime interests were dependent.

(Millennium, p 308). Although historically there was a nationalization of products that was encouraged by the Indonesian government, they opened up their markets to foreign companies through a 1996 deregulation package. This package included reduction of tariff levels, which will decrease tariff levels to less than 5 percent by the year 2003. Since Indonesia is a member of the Association of Southeast Asian Nations (ASEAN), these tariff reductions are in compliance with the agreements that Indonesia made with its other fellow countries. The government also agreed to remove all import charges on items specified in the "Uruguay Round" (an international meeting of major trading countries) (products such as automobiles, iron, steel, and some agriculture) by the year 2005. (National Trade Estimate) These government deregulations have made the

The only unappealing factor of the Indonesian government's to foreign investors is its strict regulations on environmental cleanliness (yet another requirement of the Structuralist development model). The environment is heavily regulated by the Environmental Impact Management Agency (BAPEDAL), and many investors have been lost to Indonesia because they choose to go to other countries such as China, which has much more relaxed environmental codes. However, the Indonesian investors and banks do not worry, claiming that Indonesia "Has better facilities, and more advanced supporting elements such as law, middle management, free foreign exchange regime and banking system, which will create its own market." (Markus Parmadi, President Director of Lippo Bank) While much of the country is advancing into industry, there are still many people in the country that are still within the agricultural market. The agricultural sector gets just as much government assistance as the industrial sector, the government tries to make economic policies that will help distribute the workable land and income (a third Structuralist factor) in this area of the population. One of the primary programs that were set up by Soeharto was the "backward villages program," (also known as the IDT program). In this program, the government gave a sum between 20 million and 60 million Rupiah (between three thousand and ten thousand US dollars)(in a country where even the high-paying mine industry average weekly income is 25 dollars) (www.bps.go.id) to each small village (numbering approximately 28,000) in the country. In order to get this money, however, each village had to set up its own economic regulatory group that would decide how the money would be best used for the good of the community. The program was supposed to give "empowerment [to] poor people by providing business capital to manage themselves according to their capabilities." The government further helped the people in agriculture by making land surrounding the villages that was government-owned cheaper to purchase through the communal funds, and so the usable land was given out equitably in the community. (Millennium, p 318) Another program was set up by the Department of Agriculture that raised the incomes of "farmers and small fishermen" in different areas of Indonesia. The Indonesian government also has implemented programs to help the smaller businessman who might not necessarily be dealing with imports or exports. Through cooperatives of private companies and state-owned firms (given the Indonesian acronym BUMNs), the government set up a program where up to 5 percent of the larger companies net profits annually would be available to smaller business owners at no interest. (Millennium, p 321) With all of these different programs implemented by the government in conjunction with large private corporations, it is no surprise that Indonesia was, for about three decades, used as an example of prosperity in the Asian marketplace. The country had an average growth rate of seven point one percent, a GDP of seven point eight percent, and there was a reduction of poverty of nearly fifty-percent. (World Bank) However, nothing, not even this pillar of government-created economic security, could have been prepared for the disaster of the Asian economic crisis in 1997, which left everyone in Asia, including Indonesia, in its wake.

7. Indonesian Economy – What Went Wrong and Where

Destroying the achievements of decades of development, the Asian Financial crisis shook the global confidence in the Southeast Asian economies, but also revealed an unexpected structural weakness in Indonesia. Though the contagion effects of the Asian Financial crisis and internal weaknesses of Asian economies have typically been cited as reasons for the current economic collapse, the case of Indonesia is decidedly different. Unlike the abuses occurring in other countries, Indonesia had the singularity of a weak financial system whose vulnerability resulted from various forms of "excess." Too many political favors, too much liberalization, and too few regulations all left the Indonesian financial sector waiting to fall. Thus when investors started to panic and loans went bad, banks began to default and no safety net existed to stop the economy's free-fall. The factors underlying the creation of this weak system intensified the Thai-transmitted crisis, and can be classified as the structure of the Indonesian banking system, the government's intervention, and a myriad of external or foreign factors.

7.1. A Brief History of the Banking System

After decades of general turmoil, Indonesia finally embarked on the road to stability in 1966 under the leadership of President Soeharto, who introduced a comprehensive economic stabilization program. The program included restraints on bank credit, reductions in the fiscal deficit and a floating exchange rate, and was all aimed at firming up the developing economy. After years of hyperinflation, the country sought stability and adopted measures such as tight fiscal and financial policy to ensure their goal. The 1980s brought a change in the government's view of the financial sector, as the IMF made repeated suggestions of liberalization, especially in regards to banking. A series of reforms ensued and helped set the stage for creating an insidiously weak financial sector, by granting unsupervised freedom to banks on lending decisions, fundraising and in bank establishment. As a result, the number of banks mushroomed from 108 to 232 between 1988 and 1993[5]. On the positive side, these reforms did reduce intermediary costs and the need for state intervention, but the central bank did not, or could not, keep abreast of these changes. Thus the government set the banking sector up for a fall as a result of its inherent structural vulnerability.

Additional decisions of the government had further undermining repercussions for the banking sector, such as a 15% reduction in the reserve ratio, a step that encouraged lending, but set a dangerous precedent[6]. Miraculously, the weak position of the financial system escaped discovery during the oil shocks and early 80s crises, and Indonesia weathered both quite well, while seeking support from neither the World Bank nor the International Monetary Fund. But this rite of passage turned out to be a result more of Soeharto's manipulation than of financial reliability. Thus, by 1992 the excess of financial freedom had led to a startling number of banks swamped with unpayable loans and a net of short-term debt. The structural problems latent in the country's financial system had started to manifest themselves slightly by the early 90s and by 1997 had begun to unravel the achievements of the "Indonesian miracle"[7]

7.2. Inherent Weaknesses

Given the weak and vulnerable structure of the financial sector, the banking system became prone to several internal weaknesses, which included weak management, excessive credit concentration and non-transparent information. Weak management seemed to stem from the government's decision to have banks operate on a self-regulatory basis. No specific oversight mechanism existed, and thus abuses of authority by the politically well-connected few went unchecked. The result of these abuses came in the form of excessive credit concentration or bad lending decisions. Loans were being ordered to many companies who, despite their political ties, were a high-risk investment. It was these loans that ended up defaulting and forcing banks to violate their reserve ratio requirements of 5% in order to continue operations. Given the banks had such poor management and there was no guarantee on deposits, rushes became more frequent, resulting in the revocation of the licenses of 16 unviable banks in 1997. The government saw this act as an exercise of their perspicacity and authority, but the public viewed it with panic.

Without sufficient information on the quality of banks and general disrupt, the public had lost much of its confidence and capital flight became rampant. As the situation worsened, so did the degree of bank violations, with liquidity and capital adequacy ratios (CARs) becoming dangerously low. CAR is the ratio between a bank's capital and risk-weighted assets, and the lower it is, the more risky the bank's situation. With only rumors to guide them, people performed a "flight to quality," as they rushed from "unreliable" banks to "reliable" ones, although many times the banks being left were the ones in the best financial condition. These shortcomings were all a result of the "liberalization without regulation" decisions of the government and set up the economy for a "boom or bust" syndrome. The banking sector reforms in the 1980s set a rickety initiative of allowing banks to take on various risky projects, establish loan rates and follow their own self-governance. Although they managed to attract plenty of foreign investors, as part of the "boom" portion of the cycle, they also set themselves up for the "bust" portion, which was latent in the accumulation of short-term debt. This short-term debt materialized at a disturbing rate from 17.7 % of total debt in 1994 to 20.9% in 1995 and 24.8 percent in 1996[8]. Thus the banking system, despite apparent early success, had been primed for disaster because of its vulnerable underlying structure.

7.3. Government Intervention

In terms of governance, nepotism and cronyism characterized President Soeharto's reign, as financial decisions were largely based on political agendas. This was particularly true with the banking sector, where banks were essentially coerced into making loans to unreliable companies

[5] Steven Radelet, "Indonesia's Implosion," Harvard Asia Pacific Review September 30, 1998: 2

[6] David C. Cole, Building a modern financial system: The Indonesian experience (Great Britain: Cambridge University Press, 1996), xxiv

[7] Paul Bluestein, "World Bank Cites Own Failures in Indonesia," The Washington Post February 12, 1999: A10
[8] Manuel F. Montes and Muhammad Ali Abdusalamov, Indonesia: Reaping the Market (St. Martin's Press, 1998), 175.

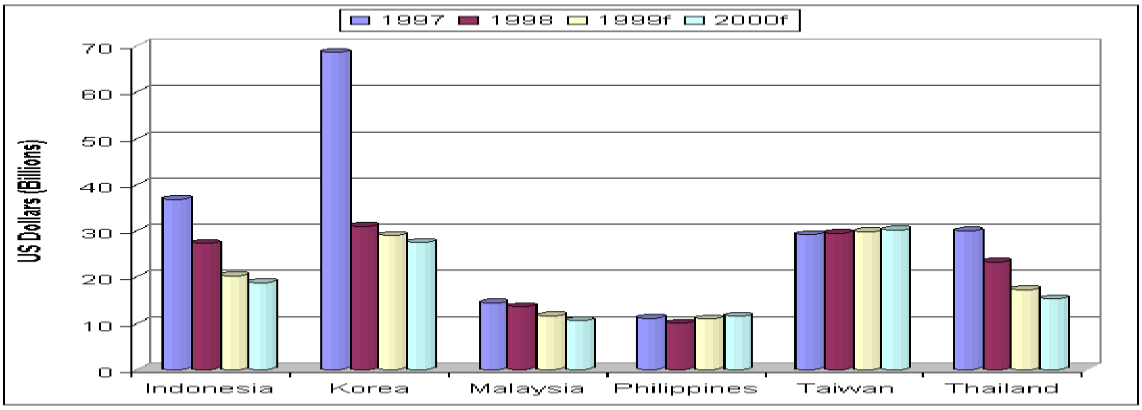
who ended up defaulting. On top of defaulting, the non-transparency of the system heightened social unrest, which led to riots and rushes on the banks.

Besides politically directing these loans to friends and family of the corrupt Soeharto regime, the government also set many unsound financial sector policies. These included the 1980s bank liberalization reforms and a particularly ambitious restructuring package in October of 1988. By increasing the self-regulatory freedom of banks without taking into account their vulnerable positions, the package allowed a reduction in the reserve requirement from 15 to 2 percent and allowed banks to raise equity capital in the stock markets. The government also became the facilitator of increasing vulnerability to global factors. In 1992, a unified Banking Law deregulated the ownership restrictions to permit foreigners to purchase up to 49% of the shares of stock of commercial banks. All of this liberalization naturally led to a lending boom, but that in turn, when coupled with political pressures, led to riskier loans for non-tradable investments and property development. Opening up the banking sector internationally made apparent that changes in the Rupiah could affect the entire banking sector. A drop in the international value of the Rupiah would bring to bear debt-servicing problems that were being tenuously covered by the current capital inflows.

7.4. External or Foreign Factors: Foreign Investors

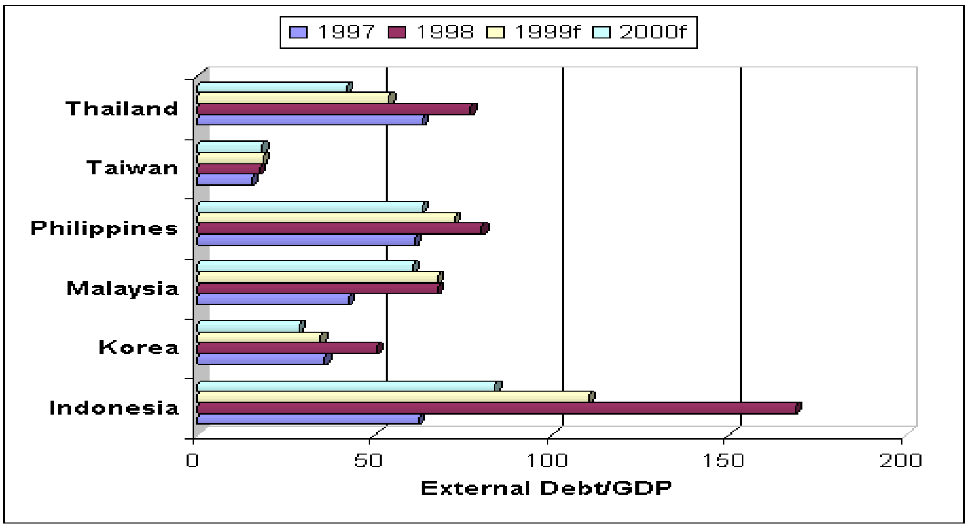
Part of the general trend towards globalization has been the specific movement towards financial globalization. Indonesia, as part of their bank liberalization-induced boom, could offer high returns on short-term investments, but in the process became increasingly dependent on these capital inflows. As can be seen in the following figure, the amount of short-term foreign debt in US dollars reached a high of 36.8 billion dollars in 1997 alone.

Figure 3: Short-Term Foreign Debt in USD)



This total was second only to Korea's amount of short-term debt, 68.6 billion dollars, but both are expected to drop to manageable rates over time. These figures take on an even greater significance when viewed in terms of external debt as a percentage of GDP (see figure below) which for Indonesia was 62.3% in 1997 and 168.6% in 1998.

Figure 4: External Debt (As a Percentage of GDP)



This foreign involvement of capital inflows, once reversed, would have devastating effects on the financial sector. An illustration of this panicked flight can be gauged when observing the net private capital inflows, as assessed by the Institute of International Finance, into Thailand, Indonesia, Korea, Malaysia and the Philippines, which went from US$97 billion inflows in 1996 to $US12 billion outflows in 1997. A $US109 billion change in capital flows would only topple an already tremulous financial sector[9]. Due to this cycle of short-term debt, banks became increasingly reliant on foreign capital inflows to continue financing this balancing act. But many investors practiced a "brinkmanship" type of behavior known as moral hazard, where they invest haphazardly without consideration to consequences, relying on the IMF to provide some sort of bailout. In addition, few regulations existed on capital inflows and none existed on outflows, further setting the stage for a massive capital flight. This vulnerability only required investor panic and herding behavior to hurl the banks into default[10].

The effects were transmitted primarily through the following ways:
(i) The sharp depreciation of the Rupiah suddenly blew up the Rupiah value of banks' liabilities denominated in foreign currencies and put the banks with short position in serious problems;
(ii) The economic crisis put banks' customers (debtors) in problems which depressed the value of banks' assets; and
(iii) The tight monetary policy to stabilize inflation and exchange rates, and the concomitant high interest rates, resulted in negative spreads for the banks[11].

Figure 5:List of "Significant Risks" Identified by the World Bank, May 1997

List of "Significant Risks" Identified by the World Bank, May 1997

Domestic Factors	International Factors
High core inflation and key administrated prices (energy and foodstuff) not raised for a long period	Widening current account deficit, despite high international oil prices
Lost momentum on deregulation	Noticeable slowdown in non-oil exports
Weak banking sector with exposure to property market on the rise	Rapidly increasing private external debt

SOURCE: World Bank, *Indonesia—Sustaining High Growth with Equity*, May 30, 1997, p. xxi.

7.5. Currency Speculators

One of the more subversive external elements that contributed to the vulnerable state of Indonesia's financial sector was the existence of currency speculators. By hedging their purchases of Rupiah based on expectations for the real exchange rate, they exacerbated the short-term debt problems faced by the banks. Once the inflow of capital slowed and default loomed on the horizon, the scene was set for currency speculators to profit from a collapse in currency values. Since the fall of 1997, the dollars per Rupiah exchange rate has fallen by 72.5%, securing high profits for speculators. This had especially painful ramifications for the banking sector because it not only reaffirmed the panicked investors' decisions to exit, but the depreciation inflated the Rupiah value of the currency debt, making the liquidity problem worse. By threatening the Rupiah, speculators induced the government into following a destructive policy of tight liquidity in order to defend the currency, which only led to more capital withdraws.

7.6. IMF's Role

Prior to the crisis, the IMF was guilty of being silent and either not seeing or refusing to address the structural problems in Indonesia's banking system. The IMF and the World Bank considered Indonesia's success story to be renowned, which could explain their reticence to find fault with their star pupil. But, it was the IMF's broad advice to the government to liberalize that rendered the financial sector vulnerable. Furthermore, once the banking sector was

[9] Steven Radelet, Sachs Radelet and Jefferey D. Radelet, "Towards a New Strategy for Asian Recovery," Singapore Straight-Times July 26, 1998": 2
[10] C.P. Chandrasekhaar and Jayati Ghosh, "Hubris, Hysteria, Hope: Crisis and Response in Southeast Asia," Tigers in Trouble: 68

[11] Mr. Sabirin discusses recent developments in the Indonesian economy; Presentation by Dr Syahril Sabirin, Governor of Bank Indonesia, at the Banque de France, Paris in March 1999.

damaged, the IMF not only prescribed the wrong medicine of tight fiscal and monetary conditions, but also withheld funds until the banking sector was almost overwhelmed by non-performing loans and bad debt. By failing to recognize the unique nature of this crisis and the precarious liquidity and debt problems faced by the banks, the IMF finished up the damage started by the nervous investors and hostile speculators[12].

8. Indonesian Economy – The Changing Paradigm

8.1. Initial Response

Against this background of instability, the Indonesian government has made efforts at reform to revive the banking sector. One of the first responses was to recommend the creation of the Deposits Insurance Scheme, which would require banks to place a certain portion of deposits on reserve at the central bank as an insurance measure. The scheme was coupled with the revocation of the licenses of 16 banks in March of 1998[13]. Additionally, the government placed its own backing behind bank loans, in efforts to restore financial sector confidence[14]. Another directive aimed at increasing confidence came in January 1998 when Soeharto authorized the creation of the Indonesian Bank Restructuring Agency, IBRA, with the purpose of handling the administration of the guaranty granted earlier by the government to help commercial banks[15].

The most comprehensive effort made by the government at reform was a four-fold plan focused on economic reform and bank restructuring. The first goal was to bulk up the internal stability and control of the banks by raising the minimum capital requirements, and enhancing transparency of information by publicizing financial reports. The second goal was to encourage rule enforcement by strengthening supervision in terms of management and internal bank structure and organization. The third was to clarify rules and their enforcement in terms of the legal policy and the establishment of a Deposit Insurance Institution. The ultimate goal of the plan was to generally improve the soundness of the banking sector, and subtly take aim at eliminating high-fault politically connected loans. These primary goals were the foundation upon which the two major decisions of bank closures and recapitalization have occurred.

8.2. Bank Closures and Consolidation

Indonesia's second round of bank closures, in efforts to quash rumors of further political favoritism and padding of the banking sector, shut the doors of 38 debt-ridden banks. As part of the restructuring of the more than 200 commercial banks, Indonesia continues to pursue another $1 billion loan from the International Monetary Fund. The current plan for the banking sector, as unveiled by Finance Minister Bambang Subianto, would take over seven of the floundering banks and help rehabilitate nine others by recapitalizing them. Such a move on the part of the Indonesian government is viewed as a step in the right direction towards transparent and unbiased decision making[16].

Originally, the bank closures were scheduled for February 27, 1999, but Ginandjar Kartasasmita, Indonesia's State Coordinating Minister for economy, finance and industry, delayed the event for two weeks. It was this decision to delay that sparked criticism of the government and rumors of saving politically connected banks by allowing them more time to recapitalize and thus avoid liquidation[17]. Though progress continues to be made by the Indonesian government, the problems of reserve ratio requirements and liquidity still exist. As evidenced in the following figure, collated by Bank Indonesia/Data Consult, banks continue to deal with huge amounts of bad debts, which have skyrocketed from 9.5 trillion Rupiah at the end of 1996 to 312 trillion Rupiah at the end of 1998.

[12] Jefferey D Sachs, "The Wrong Medicine for Asia," New York Times November 3, 1997: 3

[13] The Central Bank of the Republic of Indonesia, "The Most Current Banking Developments," Policies: http://www.bi.go.id/intl/policies/bankingcurrent.htm

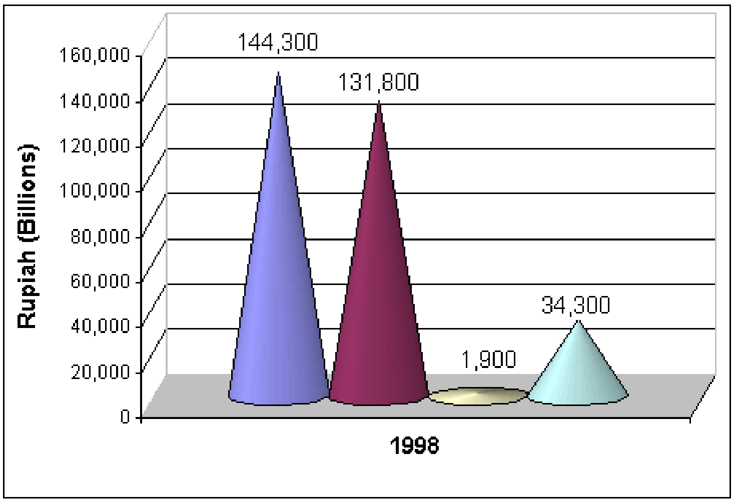
[14] The President of the Republic of Indonesia, "Guaranty for Commercial Bank Repayment Obligation," January 26, 1998: Presidential Decree No. 26/1998: http://www.dfa-deplu.go.id/archives/new/Decreeno27.htm

[15] The President of the Republic of Indonesia, "Establishment of the Indonesian Bank Restructuring Agency," January 26, 1998: Presidential Decree No. 27/1998: http://www.dfa-deplu.go.id/archives/new/27.htm.

[16] Atika Shubert, "Indonesia Closes 38 Debt-Ridden Banks as Part of Economic Recovery Plan," The Washington Post, March 14, 1999: A34

[17] "Government to submit a new letter of intent to IMF soon," The Jakarta Post March 11, 1999: http://www.dfa-deplu.go.id/current/march99/imf-11maret99.htm

Figure 6: Non-Performing Loans



This is linked not only to the unhealthy and politically connected nature of the loans, but also attests to the drop in profitability of the banks as interest revenue has dropped. The closures aim at increasing confidence, synchronization and efficiency of the banking system. By giving incentives to clarify information on legal lending limits, enforcing regulations and formally establishing the Deposit Institution, the government hopes to restore economic stability. The new structure resulting from a reduction in the number of banks should reduce the inefficiency, low competition and supervisory difficulties created by large number of small banks. Thus the government is encouraging mergers which, coupled with the creation of the Deposits Insurance Institution and other regulatory guidelines, should help restore the sector's viability[18].

8.3. Bank Recapitalization

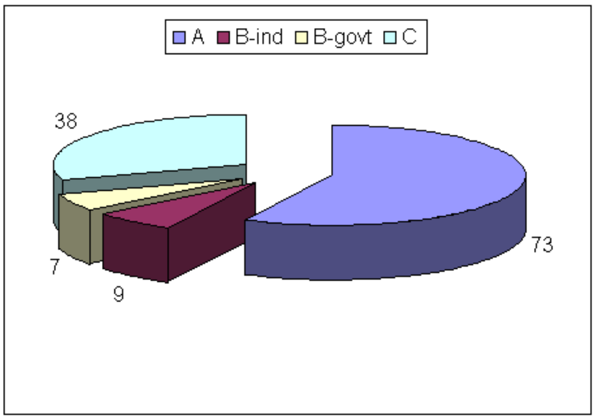
With this recent decision to close indebted banks, a forthcoming letter of intent is expected in the hopes of securing another $1 billion from the IMF. The purpose of the loan would be to help further the recapitalization of the banks and economic reform programs. To date, the IMF has organized a $43 billion bailout fund, $9 billion of which has already been released to the country. Indonesia's recapitalization proposal involves 80% of the funding to derive from the issuance of government bonds with the remaining 20% to be provided by the banks' shareholders. The interest on the bonds for the 1999/2000 fiscal year will amount to 34 trillion Rupiah, which breaks down to 17 trillion covered by the budget and 17 trillion coming from asset sales of liquidated banks[19]. Such an ambitious plan is necessary for the economy's recovery, but controversy still exists over whether the government has finished vacillating on banking decisions. Concerns exist that even though the cost of recapitalization, estimated at 330 trillion Rupiah, is less than of liquidation, estimated at 500 trillion Rupiah, protecting unhealthy banks will result in more long-term harm[20]. Plans for the 128 remaining private domestic banks, as seen in the following figure, are to separate them into four categories.

[18] "Indonesian Banks in Desperate Straits," Indonesian Commercial Newsletter March 16, 1999: Edition #263: http://www.datacon.co.id/icnfoc.htm

[19] "Government to submit new letter of intent to IMF soon"

[20] "Indonesian Banks in Desperate Straits"

Figure 7: Status of Indonesian Banks (as n March 1999)



Categories A banks, numbering 73, meet the minimum capital adequacy requirements and have proven they can compete without public financial assistance. Category B banks, 9 in total, are seen as viable for recapitalization which should bring their CARs up to the government levels and have been given until April 21, 1999 to provide at least 20% of the necessary capital to which the government will then cover the remaining 80%. The 7 other category B banks are those that have been taken over by IBRA and are now under government ownership. Management will be replaced and the banks' structure will be speedily restructured to prepare them for privatization. The remaining banks are the 38 that were closed earlier in March 1999 are composed of 17 category Cs which are deeply insolvent and 21 remaining category Bs whose prospects of regaining viability are dim. The government continues to back the bank's deposits, as it decreed in January 1998.

9. Indonesian Economy in 2007

Although the failure of the banking system alone cannot take the entire responsibility for Indonesia's economic collapse, it does highlight the dangerous problem of excess. Many countries have been able to indulge in indiscretions successfully, while delaying or avoiding serious repercussions, but typically their actions catch up with them eventually. If only one of the contributing factors to the vulnerability of the banking sector had existed, then perhaps only a structural adjustment would have been required instead of an extensive systematic overhaul. But it is the very combination and intensity of these factors that did succeed in crippling the financial sector. No one aspect can take the majority of the blame, as it was the combination of a pre-existing weak structure that was mishandled by the government and opened up to the rest of the world for further exploitation that led to the sector's collapse. Though a crisis of this magnitude after the wealth of the "Asian Miracle" is particularly painful, Indonesia will have to learn to balance its spectacular success with a spectacular loss, and come out of this with a better sense of non-excessive balance[21].

In the last few months, several indicators of the Indonesian Economy display a better performance[22]. However, this should not make us unaware, since it could either mislead or bias in interpreting data or just temporary fashion. Principally, all sorts of economic indicators keep dynamically shifting. The economic growth in the previous years depicts an improved trend, though it is not as better as prior to crisis of 1998. In the 2000-2006 periods, the least growth was found in 2001 accounted for 3.83%. This could happen owing to the combination of high inflation (11.50%) and high interest rate (17.63%). Political condition as well as un-conducive domestic security was other factors causing those weak performances. It has been discussed that the Indonesian economic growth was predominantly driven by consumption (consumption driven economy) which is arduous to control its sustainability. For that reason, the government attempts to alter the track to turn into an investment driven economy by carrying out campaign of infrastructure development in order to attract and also as a sweetener for investors. Nevertheless, so far those efforts have not come to the results, since the development of infrastructures not only needs the great amount of funds, but also the time lag to benefit the outcome.

The government target to achieve the economic growth of 5.8% is considered unrealistic, it is aggravated by the fact that in the first semester of 2006 the GDP growth was only accounted for 4.97%; contributed from 4.59% and 5.22% growth in the first and second quarter respectively.

---

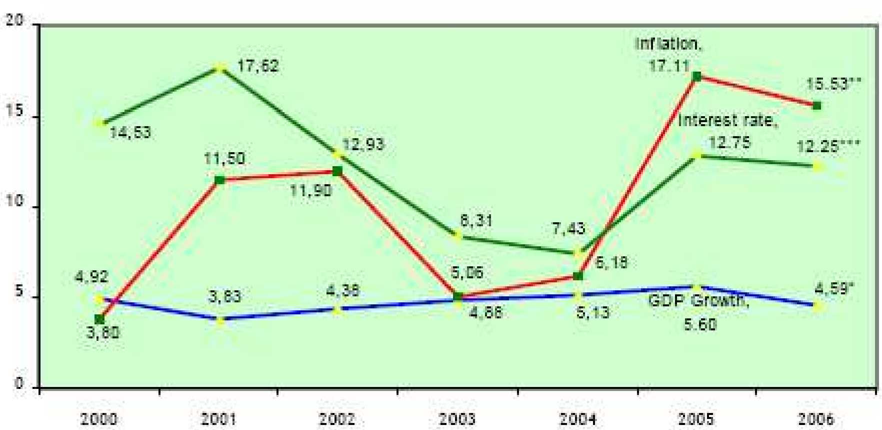
[21] "Everything Not in Moderation: Indonesia's Excess The Undermining of the Indonesian Banking System", by Amanda Creed

[22] Retrieved from the summary of economic speech of Dr. A. Tony Prasetiantono at BNI, 8 August 2006, titled The Indonesian Economy : Recent Development and Outlook 2007 (summarized by Adhy Basar)

Meanwhile, it is forecasted that the government assumption of economic growth in 2007 which is 6.3% is a long way to be attained, in light of real sector condition that need to be supported chiefly by financing from banking sector that is unfortunately hampered by several factors.

In the meantime, the allocation of government expenditure in the national budget (APBN) still focus on subsidies and other financial support, thereby the spending allocation for infrastructure improvement has not been optimal. As compensation, the government has to encourage non-government investment (foreign of domestic investors) in infrastructure sectors by providing permit and tax incentive. The government commitment to achieve a high economic growth, which is undertaken by encouraging real sector, infrastructure refinement and improving the bank function as an intermediation institution, has not obtained the optimal results until the first semester of 2006.

Figure 8: Main Indicators of Macro-Economy (2000-2006)[23]



The consequence of the relatively low economic growth can be detected from the development of unemployment rate. Throughout year 2005, the Indonesian economy was only able to absorb around 1.23 million of new workforces or still far below all new work forces, which is 1.83 million. Therefore, there is a spur of unemployment around 600 thousand people.

By means of economic growth rate of 5.8% in year 2006 (it is a government projection, but it is foreseen difficult to be attained), it is forecasted could absorb approximately 1.7 to 1.8 million of new work forces. However, with these conditions the unemployment still can be brought to an end, on the contrary it creates unemployment made up 300 to 400 thousands new labor forces. In 2007, with the economic growth projection of 6.3% (as stated in the national budget plan-RAPBN 2007) the absorption of new work forces is hoped will reach 1.9 million.

The government policy, which intends to increase the expenditure, would increase a budget deficit as a consequence, and focus on its spending upon sectors that absorb more labor forces would slow down the rate of unemployment. Besides, the enhancement of investment climate can support the real sector, so that the unemployment rate can decrease.

Ideally, the Indonesian economy should be pushed to grow 7% at minimal, with the intention that it can be soaked up most of the new work forces entering the market, which is 2.1 people per year. The number of open unemployment is predicted to reach 10.85 million workers comprising of the labor force that can be taken up every year accumulated with unemployment from the previous year. If it is added up with disguise unemployment and under unemployment, it will account for 40 million people.

[23] Source: Central Bank, 2006. Notation: (*) GDP position (yoy) March 2006; (**) inflation (yoy) June 2006; (***) BI rate July 2006

Table 1: Workforce and Unemployment (Millions) [24]

Year	Workforces	New work forces	Number of working people	New Field of endeavour	Open unemployment
1996	88.19	3.96	83.90	3.79	4.29
1999	94.85	2.11	88.82	1.14	6.03
2000	95.65	0.94	89.84	1.00	5.81
2001	98.81	3.16	90.81	0.97	8.00
2002	100.78	1.97	91.65	0.84	9.13
2003	102.63	1.85	92.81	1.16	9.82
2004	103.97	1.34	93.72	0.91	10.25
2005	105.80	1.83	94.95	1.23	10.85

The other indicator that needs to be scrutinized is the Central Bank (BI) rate movement. In the 2000-2006 periods, the BI rate showed fluctuated trend with the fairly wide range. In 2000, the BI rate reached 14.53% as a response to the high inflation. This condition kept lasting until 2001. The upsurge of inflation in year 2001 triggered the increase of the BI rate as one of BI instrument in controlling inflation via monetary mechanism. In the 2001-2004 period, the BI rate steadily decreased and reached the lowest level at 7.43% in 2004. This condition happened due to the stable economy and the declining trend of inflation. Along with the inflation rate in 2005, which is arrived at 17.11% owing to the significant boost of domestic fuel price on 1 October 2005, the BI rate was forced to rise to 12.75%. In 2006, in conjunction with the stable Rupiah currency and the increase of foreign exchange reserve (USD 43 billion), the BI rate gradually decreased and on August touched the level of 11.75%. The further declining is still waiting for several things, including external factor such as world oil price and international interest rate, mainly the Fed rate.
For the year 2007, the government has an assumption that BI rate will be buoyant at level of 8.5%. This assumption is clearly difficult to be realized, in light of the susceptible variables both internal and external that beyond our control.

In 2005, the inflation rate (from January to December 2005) has reached 17.11% triggered by the hike of domestic fuel price up to approximately 100% as a response to the upsurge of world oil price. The proliferation fuel price in 2005 was carried out twice; Firstly in March and secondly in October which gave the multiplier effect on the price (inflation). In October it was happened just before festive day and the end of the year, so it contributed a high impact on inflation, even it was only one shot inflation and did not cause a worse spiral effect inflation. Up to July 2006, the inflation rate accounted for 3.29%, and the highest rate appeared in January, which is 1.36% that carried over from year 2005. The average inflation for the February - July period was only 0.31% per month. The low inflation at that time could be interpreted as the lessening of purchasing power after having prices increased in October 2005. In 2007, the government set the quite low inflation target at level of 6.5%, with several basic assumptions including the stable of domestic fuel price and basic electricity tariff (TDL). Once more, these assumptions only could be reached if there is no major shift in economic indicators either internal or external, such as world oil price and international interest rate variables. The world oil price as an external factor should be paid more attention by utilizing mechanism of fiscal transmission (APBN) since it has enormous influence over the Indonesian economy. In year 2006, the escalation trend of world oil price keep going on and reached the highest record in July at level of USD 78 per barrel. The condition was mainly caused by the combination of demand and supply. In terms of demand, there was a significant increase since some countries experienced a high economic growth such as China and India.

On the other hand in terms of supply aspect, regional conflicts happened in the Middle East involving Iran and Iraq ultimately affected the world oil supply as both countries are main world oil producers. It was deteriorated by Israel military aggression in to Lebanon, which caused the Middle East region as the world oil suppliers as well as the imperative stripe of world oil distribution experienced uncertainty.

In 2007, the government set up the oil price assumption for USD 65 per barrel. The assumption seems proper, considering that the oil price would not plunge again into USD 30 per barrel as happened in the beginning of 2005, and with regard to the highest price at level of USD 78 per barrel in July 2006. Currently, the demand for world oil has reached 85 million kilolitres per day or grows one million kilolitres per day compare to the previous quarter particularly due to the increase of demand from China and India. The world oil demand mainly dominated by the USA

[24] Source: BPS, 2006.

importing 13.8 million barrels per day. Whilst, the world oil reserve prevails in the Middle East region is 685 billion barrels (56.5 % of the total world reserve). Facing the fourth quarter, the demands are foreseen would reach 86 million kilolitres per day owing to the winter season in northern world that traditionally could push the world oil price up. Indonesian currently is member of OPEC as well as the net oil importer country. This happens given that the crude oil production which is produced by Indonesia requires the mixture of other oil in its refining process to make usable fuel. The production of Indonesian crude oil is just 1.05 million barrels per day, while the national oil consumption is about 1.3 million barrels per day, so that the deficit is about 250 thousands barrels per day.

In order to get a holistic understanding about the national petroleum map, it should be examined the ratio of petroleum production to the number of population. In the era 1980, Indonesia was able to reach the peak of production which was 1.6 million barrels per day despite the fact that the Indonesian population just about 130 million people. In 2006, the situation deteriorated when Indonesia can only produce 1.05 million barrels per day in spite of the increased population up to 230 million people. The condition depicts that the high domestic consumption and the decrease of oil production would burden the government in providing oil subsidization. Brunei as a comparison has population of 350,000 people but is able to produce 300,000 barrels oil per day. It means that every Brunei people can enjoy almost one oil barrel per day.

The government endeavor to accelerate the development of infrastructure, which eventually can attract the investors (foreign and domestic), is an excellent breakthrough that should be consistently undertaken. Meanwhile, the banking sector is eager for the concrete and operational action of the government mainly to provide a more space and leniency for state-owned banks –i.e. BNI Bank and Mandiri Bank- to rescue and recover their non-performing loans. Devoid of concrete and operational action, both the state-owned banks' largest lenders by asset have to keep struggling with their Net Performing Loan and finding the proper solution.

10. Indonesian Economy – Policy Suggestions

Political scientists who study the developing countries of Asia and Africa have been especially interested in the relationship between the state and the economy. Most of these countries are poor, and economic develop-ment is a high priority. Debate about the role of the state in development has tended to focus on two issues. The first has to do with whether and in what ways the state should intervene in the economy. Is a relatively free mar-ket economy or a more regulated economy better for development? The second issue has to do with the most suitable form of government. Is a democracy or an authoritarian regime more likely to lead to development? There are probably no definitive answers to either of these questions. Much depends on how the terms of the debate are defined, which is a con-troversial subject among political scientists, and on the particular context and circumstances of individual countries, which vary tremendously in size, location, resources, population, cultural and social structural patterns, his-torical experiences, and many other variables. The Indonesian case, how-ever, is relatively clear. Free markets and authoritarianism had a lot to do with Indonesia's developmental success during Soeharto's New Order pe-riod from the late 1960s to the late 1990s.

Indonesia has a large place for the government in its economy; the government has helped largely in bringing the country away from primary commodity exports to industrial production and services. The government also has implemented strong environmental policies, and has put together social programs to distribute the land as equitably as possible among those who use it for agricultural production, and by doing so has addressed the problem of poverty and income distribution in the country. The Constitution of the country itself does not allow for external debts, and through deregulation of outside influences there is room for developing countries to possibly get a cut of the agricultural and mining opportunities in Indonesia. When combined, these different aspects of Indonesia's economic structure come together as the Structuralist model of economic growth.

On the negative side, it is important to remember that, in contrast to other East Asian and Southeast Asian countries, the modern economic base is yet to reach a mature footing in Indonesia, the starting point somewhat later, and the growth rate slower. Moreover, members of the tiny Sino-Indonesian minority, still culturally quite distinct from the indigenous Indonesians, were the best po-sitioned to take advantage of economic opportunities. The new middle and upper class is thus relatively small and disproportionately Sino-Indonesian. Most worrying, however, is its lack of political experience, organization, and democratic commitment. Soeharto's New Order, though a right-wing mili-tary dictatorship, was similar to a Communist regime in its suppression of all independent interest groups as well as political parties. Independent business, labor, and other interest organizations have begun to develop since the fall of Soeharto, but they are still weak compared to the state. Moreover, their support for democracy appears to be largely instrumental, dependent on the government's ability to deliver

economic progress. This is particularly true of the Sino-Indonesians, who constitute a majority of the business elite. Should the economy not improve, while religious, regional, ethnic, and perhaps class tensions worsen, many Indonesians may turn once again to the armed forces for a solution.

Nevertheless, as noted earlier, it is impossible to offer a single agreed-upon counterfactual to evaluate the past success of industrial policy targeted to individual industries. Thus there have been a number of research strategies pursued to provide an empirical evaluation of industrial policy. These have been reviewed in Noland and Pack (2003). Not all of the methods have been explored for all countries. Researchers have examined, inter alia, the impact of: (1) trade protection; (2) subsidies to R&D; (3) general subsidies; and (4) preferential lending rates on the evolution of productivity and capital accumulation. Empirical analyses find that sectoral targeting has been particularly effective[25].

11. References

1. Agriculture: Foreign Investment up 300 Percent Antara- the Indonesian National News Agency, May 31, 1999
2. Alavi, Hamza. 1972. "The State in Post-Colonial Societies: Pakistan and Bangladesh." New Left Review 74 (July/August): 59-81.
3. Alavi, Hamza. 1982. "State and Class Under Peripheral Capitalism." In Introduction to the Sociology of Developing Societies, edited by Hamza Alavi and Teodor Shanin. London: Macmillan and New York: Monthly Review Press.
4. Animal Husbandry: Indonesia's Meat Exports Reach 956 Tons in 10 Months Antara- the Indonesian National News Agency, October 27, 1999
5. Alfaro, Laura and Andres Rodríguez-Clare, 2004. "Multinationals, Linkages, and Economic Development." Economia, Spring, 113-169.
6. Bagwell, Kyle and Robert W. Staiger, 1989. "The Role of Export Subsidies When Product Quality is Unknown." Journal of International Economics 27: 69-89
7. Balasubramanyam, V and Ahalya Balasubramanyam (1997). "International Trade in Services: The Case of india's Computer Software." The World Economy, v.20, no.6 (September 1997), pp.829-843.
8. Barboza, David, 2004, "In Roaring China, Sweaters are Wests of Socks City," New York Times, December 24.
9. Bardhan, Pranab, 1971. "On Optimum Subsidy to a Learning Industry: An Aspect of the Theory of Infant-Industry Protection." International Economic Review 12: 54-70.
10. Barrios, Salvador, Holger Gorg, and Eric Strobl, 2004. "FDI, Competition, and Industrial Development in the Host Country." CORE discussion paper 2004/11.
11. Business Week, October 11, 1999, p 30
12. Ernst, Dieter, 2002, "Global Production Networks in East Asia's Electronics Industry, East-West Center, Honolulu, Hawaii
13. Hill, Hal The Indonesian Economy Since 1966- Southeast Asia's Emerging Giant Cambridge University Press, 1996
14. http://news.bbc.co.uk/hi/english/world/asia-pacific/newsidWahid Faces Economic Mountain, November 16, 1999
15. http://wbln0018.worldbank.org/eap/ea…/4678a7c
16. IMF May Lend to Indonesia Before Bank Bali Case Closed Bloomberg News, November 1, 1999
17. Indonesia's Economy: Entering the Third Millennium Copyright 1997 by International Quality Publications
18. Investment- Foreign and Domestic Projects Declined Antara- the Indonesian National News Agency, April 4, 1999
19. Jackson, Karl. 1978. "Bureaucratic Polity: A Theoretical Framework for the Analysis of Power and Communications in Indonesia." In Political Power and Communications in Indonesia, edited by Karl Jackson and Lucien W. Pye. Berkeley: University of California Press.
20. King, Dwight Y. 1978. "Social Mobilisation, Societal Life, Interest Representation and Political Cleavage in Indonesia." PhD diss., University of Chicago.
21. Landler, Mark In Indonesia, All Eyes on Economy New York Times October 23, 1999 Col 4, p 8 13
22. New Perspectives Quarterly Summer 1999 v. 15
23. O'Donnell, Guillermo. 1973. Modernization and Bureaucratic Authoritarianism: Studies in South American Politics. Berkeley: Institute of International Studies.
24. Pack Howard and Kamal Saggi, 2001. "Vertical Technology Transfer via International Outsourcing." Journal of Development Economics 65: 389-415
25. Purba, Kornelius Japan Assures Gus Dur of Economic Help The Jakarta Post, November 11, 1999
26. Rhee, Yung W., 1990, "The Catalyst Model of Development: Lessons from Bangladesh's Success with Garment Exports," World Development, vol. 18, no. 2, February 1990, pp. 333-46
27. Rodriguez-Clare, Andres, 2004a. "Microeconomic Interventions After the Washington Consensus." Inter-American Development Bank, Washington DC
28. Riggs, Fred. 1966. Thailand: The Modernization of a Bureaucratic Polity. Honolulu: East-West Center.
29. Robison, Richard. 1986. Indonesia: The Rise of Capital. Sydney: Allen and Unwin.
30. Schmitter, Philip C. 1974. "Still the Century of Corporatism." In The New Corporatism: Social Political Structure in the Iberian World, edited by Frederick B. Pike and Thomas Stritch. Notre Dame: Notre Dame University Press.
31. Schwarz, Adam A Nation In Waiting: Indonesia in the 1990s Westveiw Press, 1994
32. Wall Street Journal February 4, 1999

[25] Noland, Marcus and Howard Pack, 2003. Industrial Policy in an Era of Globalization: Lessons from Asia, Washington, D.C. Institute for International Economics, 2003

33. Winters, Jeffrey A. 1996. Power in Motion: Capital Mobility and the Indonesian State. Ithaca, NY: Cornell University Press.
34. www.bps.go.id
35. www.economist.com
36. www.encyclopediabrittanica.com
37. www.oanda.com/converter/cc
38. www.pttimah.com/news
39. www.worldbank.org/data/countrydata/aag/idn_ang.pdf
40. www.worldbank.org/html/extdr/eap/id2.htm