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3. Zainal Aznam Yusof, *Coping with the Recession in Malaysia,* 1987.

4. Mohammad Sadli, *Coping with the Recession in ASEAN: The Case of Indonesia,* 1987.

Coping with the Recession in ASEAN: The Case of Indonesia

Mohammad Sadli*

The Nature of the Recession

The recession in Indonesia started in 1982 when the GDP growth rate began to fall. Indonesia had a very good growth record ever since the new government came into power in 1966. At constant 1973 prices, the annual economic growth rate during the first Five Year Plan (PELITA) of 1969–73 was 8.79% on the average; during the second PELITA, (1974–78) about 7.11%, and during the third Plan approximately 6.02%. This last figure includes the low rate of 2.3% for the calendar year 1982. Comparing statistical growth figures for Indonesia can be somewhat confusing, as two series have been used: one has 1973 as the base year and the other has 1983 as the base year. The difference lies in the price of oil. For the more recent period, the 1983 series is more relevant. However, I do not have the time series for the three PELITAs growth in 1983 constant prices. For a longer time series, going back to PELITA I, the 1973 time series would be more relevant. The following table indicates the more recent growth rates based on the two time series.

	GDP Growth Figures at constant 1983 prices	1973 prices
1980	8.7%	9.9%
1981	7.1	7.9
1982	−0.3	2.3
1983	3.4	4.2
1984	6.1	5.2
1985	1.9	2.7

* An earlier version of this paper was presented orally in a talk sponsored by the Singapore Institute of International Affairs on 19 September 1986.

The PELITA I period was a period of rehabilitation from the economic disintegration of the previous regime. In that period of rehabilitation, starting from a low economic base line, it was not difficult to obtain high growth rates, for instance, by repairing infrastructures, concentrating government resource allocation on agriculture, making available more foreign exchange for imports, etc.

The second PELITA (1974–78) witnessed the first oil boom that was accompanied by much investment. Yet, why did GDP growth rates decline in this period? One reason was that it was the beginning of heavy investments in large scale projects that required a long maturity, which resulted in a rise of the capital-output ratio. This was also the period of the Pertamina crisis which was partly a consequence of unproductive investment. The average growth rate for the second PELITA at 7.11%, was comparatively still a good figure. The third PELITA (1979–83) received a big boost from the second oil boom, but the average growth rate shrank to 6.02%. This figure, however, was influenced by the low growth rate of 1982/83, the beginning of the recession.

Indonesian GDP growth figures are very dependent upon the growth of output of two major sectors, i.e., crude oil and natural gas, and agriculture. The peak of oil production was achieved in 1977, with almost 1.7 million barrels a day. Since then, production had slowed down and even declined in response to the market. At the moment, it is around 1.3 million barrels a day. The growth in the agricultural sector also lost its momentum due to the saturation of the domestic market, plus the policy-induced limitations of growth, such as the policy of the government to reduce and finally abolish the export of logs to encourage domestic processing.

Realizing the downward trend in average growth figures and looming resource limitations, the government planners projected for the fourth plan (REPELITA IV 1984–88) an average growth rate of (only) 5%. In reality, the growth rate will be significantly less because of the falling growth rates since 1982. In 1984, in response to international recovery, the GDP growth rate recovered and managed to achieve 6.1% based on 1983 constant prices, and 5.2% based on 1973 prices, but fell the following year to 1.9% (1983 base year) or 2.7% (1973 base year). The average annual GDP growth rate since 1982 has been 2.7% based on 1983 prices. On the basis of 1973 prices, the average growth rate is almost one percentage point higher. Anyway, in both series, it is much below the 5% target growth rate of REPELITA IV. (Note: REPELITA figures are planned figures, while PELITA figures are realized ones).

It should be noted that the Indonesian economic slowdown does not mean negative growth rates, but merely a phenomenon of low growth for a number of years.

The Indonesian recession has also been triggered by falling commodity prices, which means a reversal of the favourable terms of trade enjoyed during the previous decades.

The low growth performance of the Indonesian economy was also caused by a sharp levelling off of the growth rate of output in the manufacturing industries and in the construction sector. The growth rate of the manufacturing sector in the last PELITAs was above 10% per annum, but this figure has been halved since 1982. In 1982, the domestic market for the manufacturing industry suddenly became saturated. Exports, on the other hand, did not become an immediate viable option because most of these domestic industries grew up as less efficient import substituting industries under heavy protection.

The agricultural sector also experienced the same saturation syndrome after food self-sufficiency was attained. Food production is still the most important sub-sector in agriculture. A good growth performance of the agricultural sector would be an annual growth figure of 4% and above. Presently, this 4% growth figure will not be easily attained, unless other agriculture sub-sectors, such as estate crops, horticulture, fishery and forestry show very good growth by realizing their potential. The shrinking of oil prices has the most serious effect on the government budget which is predicated on revenues from oil and gas. Low growth rates would be very taxing on the maintenance of social stability, especially with the rise in the level of unemployment. A stagnant economy would be much more vulnerable to shocks. Could the Indonesian economy get back to its original growth rate without the benefit of strong and stable oil prices? This is now the major question which government economic planners have to address.

The economic deficiency is first of all related to the amount of investments required to sustain a high level of growth. During the years of the oil boom, total investments in the economy reached 30% of GDP, but more than half were government investments. These public investments have been seriously reduced to less than half of its previous peak. Could the private sector make up for the difference? Such is rather difficult to achieve in the short to intermediate term. The private sector has increased its investments more as a consequence of the oil revenue-induced investment boom. Moreover, with declining market prospects and growth rates, the propensity for private sector investments has also declined.

What is required is a different pattern of investments, whereby a lesser amount of new investments would produce a relatively higher economic growth rate. In other words, investments would have to be more efficient and labour absorptive. During the last years of the oil boom, the so-called capital-output ratio has exceeded 5, which means that over five units of investments are required to produce one unit of additional national income. A capital output ratio closer to 3 would help. Such investments could come from the private sector where the inclination to economize would be greater. Government investments have been prominent in the building of infrastructure and the financing of large industrial projects, which is partly why the capital-output ratio has become so high. However, compared to other OPEC and non-OPEC oil producing developing countries, Indonesia has invested its oil fortunes reasonably well.

At this stage, however, there is a relative excess of such infrastructure and industrial capacities that it probably will not hurt very much should the government, out of necessity, step back to let the private sector continue its investment role. But domestic and especially private investments have also decreased since the recession, due mainly to the poor prospects of the rates of return. There is probably a lot yet that could be improved in the general investment climate through appropriate policy actions, especially in the regulatory regime, such that even under prospects of lower GDP growth, more private investments could be attracted.

Coping with the Recession

Although the sharp drop in GDP growth rate began in 1982, both the government and the business sector did not adjust immediately, due mainly to the fact that the huge deficit in the current account was covered by commercial credits and the drawing on reserves. The signs of an economic downturn were seen as only temporary. Hence, the general public was oblivious to them. It was only in 1983 that the government began to take drastic actions. In that year, a number of very important policy measures were introduced which together constituted an economic package to cope with the recession.

First of all, measures were taken to trim the government budget, especially the capital budget. A number of large products totalling billions of

US dollars were "rescheduled", i.e., reduced in size or complexity, postponed until proper financing was available, or offered to private investors. The government also trimmed down the size of subsidies in the routine budget, the biggest was on the sale of fuel and fertilizers. The usual increases in salaries were not executed. Allowances for the use of office cars were severely curtailed. Instruction was given to government departments to reduce travel costs, expenditure on conferences and seminars, celebrations, etc.

The principle of a balanced budget was upheld. In Indonesia, a balanced budget is always interpreted as a budget which includes financing from foreign aid and commercial credits. During the previous period, the level of the budget showed increases from year to year, especially during oil boom periods. But now, it is at a stagnant level, and for the fiscal year 1986/87, even a reduction is accepted.

A major overhaul of the taxation regime has also taken place. The old system was quite elaborate in terms of tax rates, deductions, determination of tax liability, etc. The new tax system is more simplified. Corporate income and individual incomes are taxed according to the same rate, with a top rate of 35%. All accrued benefits are liable to income tax. No exceptions or reduction are given for incentive purposes. Income taxes should have, as a primary objective, the collection of revenues for the state, and if incentives should be given, they should be dealt with from the expenditures side. The determination of the tax liability is done by self-assessment (i.e., without interference from tax officials), a very revolutionary principle for a country like Indonesia. In the past, the income tax official would determine what was due, which led to practices of "haggling" and erosion of tax revenues for the government. In practice, during the hey days of the oil boom, the government was not too interested in collecting large tax revenues. This has changed since 1983, and enforcing tax compliance has become top priority. Because of these changes in the system, income tax revenue collection advanced very much since the introduction of the new system. The wealth and property tax were also very much simplified. A single rate, presently 0.5% annually based on market value, applies to immovable property (i.e. land and buildings), whereas movables are excluded. Of perhaps greater importance for revenue collection is the value added tax, at 10%, but for the time being it is restricted to manufacturing output, imports and constructing services.

The banking system was also reformed towards "deregulation". Under the old system, the large government banks which controlled up to 80% of credits acted as executors of government credit policy to finance development. Most of their resources came from large liquidity injections from the Central Bank (Bank Indonesia), with rates of interest below free market equilibrium rates. Since deregulation, these banks had to rely more on funds mobilized from the society, and for that, they were free to set the interest rates. Unfortunately, under the prevailing circumstances, these new rules have led to high rates of interest, e.g., 15% annually for time deposits and 18–19% for prime lending rates (and higher at domestic private banks). But at least, through this banking mechanism, a greater mobilization of domestic capital has resulted.

The rate of exchange of the rupiah to the dollar was to be set according to supply and demand and the rate was free to float. In practice, however, the decline in the value of the rupiah to the US dollar since the devaluation and the subsequent floating of the rupiah in 1983 was about 8% per annum, which created the impression that the float was not a clean one. The central bank and the government probably did not want to risk large swings which could trigger speculative flows of capital. Anticipating a very large current account deficit for 1986, the government felt compelled to devalue the rupiah substantially on 12 September 1986.

The monetary and budget policies during this period of coping with the recession remained conservative and restrictive, even to the point of becoming deflationary. No effort was made to reflate the economy by "deficit spending", as advocated by certain circles, because the Central Bank feared that the injection of extra rupiah liquidity would flow fast into imports which could precipitate a drain of foreign exchange resources. Because the outlook for the crude oil prices was gloomy, a reflationary policy to stimulate domestic demand was not seen as prudent.

The most difficult and controversial adjustment policies were in the realm of trade and industrial policies. The Indonesian recession has been induced by declining oil prices, which has created a serious balance of payments problem, and has been exacerbated by the domestic manufacturing industries incapable of further expansion on the basis of domestic markets.

The domestic industries have been growing under high protection, in terms of both tariffs and non-tariff barriers. When the objective is to save foreign exchange, the debate is between devaluation or raising tariff rates, applying quotas and other direct controls on imports. Before the devaluation debate, the controversy was between protagonists of import duties alone, or in conjunction with non-tariff barriers. The practice of applying import restrictions by controlling the trading channels got the overhand. There have been complaints from the industry about dumping practices by overseas suppliers, and hence quota restrictions have become more popular among the industrialists. On the other hand, these trade barriers have contributed to the high cost syndrome of domestic industries and their inability to export. Since the very recent 31% devaluation of the rupiah, the trade policy debate is not yet concluded. In the meantime, devaluation by itself has a protective effect on domestic industries.

The Presidential Instruction No. 4 of 1985 (INPRES-4) was another major reform oriented towards streamlining the flow of goods in the harbours, especially for imports and exports. The determination of the value of the goods for custom duties was entrusted to a foreign private company and to be executed abroad at the points of exports, so that custom clearance in Indonesian harbours could proceed faster. Shippers for exports have received a wider choice of transportation rates ever since the monopoly for domestic shipping companies was abolished.

Another policy reform, the May 6 1986 package, liberated exporters of manufactures and processed goods from the obligation to buy domestic supplies if imports are cheaper, especially those that are exempted from import duties. This measure is a consequence of the abolition of the old Export Certificate system (which included a subsidy), which was protested by the US because it created what was called market disruption effects. This May 6 package could be regarded as an interim measure in the trade policy reform because it really did not grapple with the high cost syndrome of domestic industries, but partially relieved exporting industries from the high cost.

How is the private sector reacting to the changed climate in the recession? There is hardly any reliable quantitative information. One can only make an assessment based on practical observations which could be biased.

Many enterprises were forced to review their operations, to trim and improve efficiency. There have been many layoffs even though they were frowned upon by the Minister of Labour and the government. Existing enterprises did not initiate many new investments. They tried, instead, to reduce their costs and operate their present capacities at higher levels. Most often they would apply for credits to reoutfit and modernize their plants. The government only acquiesced to lay-off workers when the alternative would be closure of the workplace.

The larger domestic companies diversified their operations. Large manufacturing companies even went into agro-business. Construction companies went into real estate and services. Manufacturing companies tried to export and often were marginally successful because of the subsidy element in the export certificate system. The government was forced to sign an agreement with GATT to phase out implicit subsidies, and consequently, many exports of manufacturing goods had to be terminated. Hopefully, the recent devaluation will provide an additional export incentive.

Banks went into financing of restructuring and had to involve themselves with the management and corporate strategies of their client companies, even taking equity. The large enterprises reduced their business cycle risks by diversification. On the other hand, there has been a great number of insolvencies and failures as well, especially among those smaller and medium scale businesses that have not diversified. Hence, banks are taking the raps as their non-performing assets grow in size and numbers.

The Rupiah Devaluation of 12 September 1986

The recent huge devaluation of the rupiah is probably the most shocking event in the series of adjustments to cope with the recession. The devaluation was an unpleasant surprise because the government kept insisting that no devaluation was necessary. Prior to the devaluation, all indicators including the rate of exchange, the reserve position, the consumers price index and the rates of interest were stable, and the foreign exchange market was quiet. Apparently, the government took the bold decision to devalue from a position of strength, when speculations of looming devaluation have temporarily died down. The government became very concerned about the state of the balance of payments. If the payments crisis were to last only for one year, it could be papered over by more commercial borrowings and drawing down on foreign exchange reserves. But what would happen if this exercise had to be continued beyond one year? There is not much confidence that the international oil prices will improve significantly in the near future. The debt service ratio is already exceeding 30% and government debt service payments is over US$4 billion. Hence (non-oil) imports, already low at about US$10 billion last year, would still have to be further compressed. A devaluation would do this and provide additional incentive for (non-oil) exports.

From a macro-economic perspective, the devaluation appears to be a sound and conservative strategy. However, if implemented, it would be very taxing on the lives of the people and disastrous for many business enterprises which had accumulated foreign debts. This devaluation would also prolong the recession, unless exports can really go up.

Prospects for Recovery

Since Indonesia is relatively an open economy and growth and investments depend on a large trade surplus and capital inflows, recovery must wait for a bullish international climate. The prospect for a recovery of oil prices approaching US$20 per barrel will be crucial. Should oil prices stay below US$15 per barrel, government revenues would be seriously impaired, while new explorations would be scarce. When and whether the prices will move into the US$15–20 per barrel bracket is as yet a matter of conjecture. This year (1986), oil exports will fall to almost the value of non-oil exports, that is about US$6 billion.* This signifies the importance of non-oil exports and the development of the "non-oil economy", even the importance of the "non-oil GDP". This non-oil GDP should grow at adequate rates, say 5% per year. How this could be achieved is now a major issue.

The agriculture sector should resume its growth on the basis of development of the non-rice sub-sectors, such as plantations, horticulture, aquaculture, forestry, etc. Manufacturing industries should grow with increasing export capabilities. The service sector, such as tourism, banking, trade and marketing, etc., should be more fully exploited as a vehicle for growth and for the creation of employment. There is a new prospect for the mining sector. There is now a flurry of exploration interest in gold mining, conducted mostly by the Australians, after the new discoveries in Papua New Guinea (P.N.G.).

There are still two economic objectives which have yet to be effectively realized, namely, the overhaul of the trade and industrialization policy, geared towards trade liberalization and export orientation, and the elimination of high cost elements in the economy and society. For both objectives, deregulations and debureaucratization are essential. With a state ideologically rooted in socialist traditions, this is indeed, a tall order. The alternative is to provide for a capable bureaucracy that has much initiative and dedication, and is reasonably "clean". That is

* Exports of oil and gas for 1986 turned out to be US$8.27 billions. (Information available in April 1987)

equally a tall order for a low-middle income developing country like Indonesia. Deregulation and the provision of greater competition appear to be more effective means to stimulate the economy.

QUESTIONS AND ANSWERS

Question

Protection, import monopolies and other types of trade restrictions seem to be a counter trend to the general macroeconomic reform that we have been seeing. I wonder if you could comment on that?

Professor Mohammad Sadli

Industrialisation requires appropriate trade policy. If you want to develop your domestic industries, you may want to give them protection, especially to the so-called infant industries. We have made great strides in industrialisation: even the World Bank has acknowledged the progress made. Before 1982, the growth rate of manufacturing industries in Indonesia was around 12-13% a year. Only one country in East Asia performed better and that was Korea which achieved a rate of 14% per year. Yet, why is the industrialisation in Indonesia now not at the same level as in the Philippines, Thailand or Malaysia, not to mention Singapore? The answer is that we are late comers. For us, this whole process started only in 1966. Between 1966 and 1982 we made a lot of progress, but that was due to the policy of protection, which should have been dismantled after 1983. However, the protection policy tends to assume its own life.

First, the history of protection in the Indonesian policy consisted mainly of tariff protection. There was a period when we had less Non-Tariff Protection (NTP). The NTP crept in probably during the last 5 years, and it coincided with the emergence of concentration of capital and ownership. Which is the chicken and which is the egg? This is a political question. I don't want to comment on it.

Now, the policy battle will be further continued. My friends in the government are in favour of deregulation, trying to do away with trade monopolies. They even offer higher tariff protection, and do away with NTP and monopolies.

Yesterday, I attended an afternoon seminar on fiscal policies in the ASEAN countries given by Dr Mukul Asher in the National University of Singapore. He said that Indonesia has actually lowered its average tariff duty. It is probably the lowest outside Singapore among the other ASEAN countries. What he did not mention is, there has been a lowering of tariff duties but an increasing amount of NTPs, and the total effective protection probably has increased. So the battle now is on the type of protection: tariff or NTPs? My hope is that after this devaluation, those industries demanding higher protection would already have obtained some advantage. A devaluation always gives higher protection to domestic industries.

Question

You mentioned that in the absence of a devaluation, there will probably be a current account deficit of about $6 billion out of which some $2.5 billion would be financiable in the usual way. Now, will a devaluation make that much of a difference to finance the remainder? Oil is priced in the US currency. That, in itself, will not have made a difference. Will the other export commodities really respond to a devaluation? Is there any assurance that domestic prices might not increase or the effect of the devaluation will be dissipated?

Professor Mohammad Sadli

To what extent will devaluation by itself reduce the $6 billion deficit? I doubt if the government can give you an answer, but of course you can always say after devaluation we will be going to save foreign currency. But by how much? Where will the reduction be? For sure, it will be in one category: imports. If, by making imports more expensive through devaluation, the level of imports goes down, say from a level of $10 billion to $8 billion, we would save $2 billion.

The other solution is to create additional incentives for non-oil exports. This may produce half or one billion dollars of additional exports. But, everything has a cost. The cost is: what does devaluation do to a society? In terms of redistribution of income, the salaried earner has to pay for the additional incentives and the gains accruing to the other groups of the society. This morning, I read in the Straits Times, a story on the Bandung Technical Institute Students' demonstration protesting against devaluation. You can sympathise with their feelings, considering that their parents are fixed income earners.

Concerning the problem of capital flight, the government hopes that at least $1 billion or $2 billion will flow back.

Can the government hold on to the price level? Yes, but of course, not on absolute terms. Import goods will go up by 45%. The government will hold the line on kerosene and other items but that again has a cost. The cost stems from the fact the government budget probably will not be assisted much by this devaluation.

Question

In view of the current recession and the devaluation, could you comment on what the outlook for foreign investment would be in Indonesia at present and in the next few years, and what sectors of the economy would be good for foreign investors to go into at this time?

Professor Mohammad Sadli

This is again another guessing game, and of course, we in Indonesia hope for the best. How shall I analyse this situation? We have to make certain assumptions. One popular assumption at home is as follows:

The Japanese are important, because they form the majority of foreign investment in manufacturing. They say, "make us, existing investors, happy first, then we will beat the drum for you outside."

Now comes the next question. Will the Japanese existing investors in Indonesia be happy with the devaluation? I don't think so. Nobody will be happy. The most unhappy Japanese investors would be those whose companies have a lot of yen and dollar credits not insured by what Indonesia calls "swap". Swap arrangement means you can buy an insurance with the Central Bank at 5.5% per annum, and your exchange rate is covered. The availability is not 100%, so you cannot buy a 100% coverage from the Central Bank in Indonesia. There is always a risk.

Japanese investments usually have a lot of Yen or US dollar credits. The so-called Japanese Sogo Sosha (trading houses) operating in Jakarta have been giving a lot of supplier credits to their Indonesian customers. They will get it back. But if because of devaluation, the recession will continue to impinge on all those clients, those Sogo Sosha trading houses will have to wait a long time before they are able to get back their money. Therefore, they would not be happy. At the present time, how could the Indonesian government make them reasonably happy? Well, the Chamber of Commerce is trying to lobby with the government to give, not only the Japanese, but everybody, tax reliefs to cope with the burden of recession.