2. Development Policies and Performance

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2.1. Introduction

During the past half century, Indonesia has experienced pronounced swings in its development policies, priorities, processes, and outcomes, on a scale matched by few other developing countries. For these reasons, economic historians tend to characterize its development as one of missed opportunities (Booth 1998, Dick et al. 2002). The key dates are March 1966, signaling the transition from Sukarno to Suharto, and May 1998, when Suharto stepped down in the face of widespread public protests and the country abruptly swung from authoritarian to democratic rule.

Thus, from 1960 to 2010 there were three distinct periods. The first of these, the remaining years of the "Guided Economy," is not covered in any detail in this volume, but it is useful to be cognizant of them. They were characterized by economic stagnation, hyperinflation, and growing political instability. The country was increasingly isolated regionally and internationally. The government withdrew from most international organizations, vowed to crush the newly formed state of Malaysia, and saw its priorities increasingly aligned to the so-called "Beijing–Pyongyang–Ha Noi–Phnom Penh–Jakarta axis" and other "new emerging forces." The leading economic development textbook of the period characterized the country as a "chronic economic dropout," and saw little prospect for economic development (Higgins 1968).[1] Gunnar Myrdal's (1968) *Asian Drama* offered a similarly gloomy prognosis. The country's development plan for the period 1960–1968 had 1,945 paragraphs, 17 chapters, and 8 volumes to symbolize the country's independence date. The central bank's note printing facility broke down under the pressure to print ever more worthless bank notes.

This chapter is organized around two main sections. Section 2.2 provides a broadly chronological narrative of economic development and the policy settings, drawing attention to both the changes and the continuities,

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[1] This judgment was authoritative, as the author worked in Indonesia for several years in the 1950s.

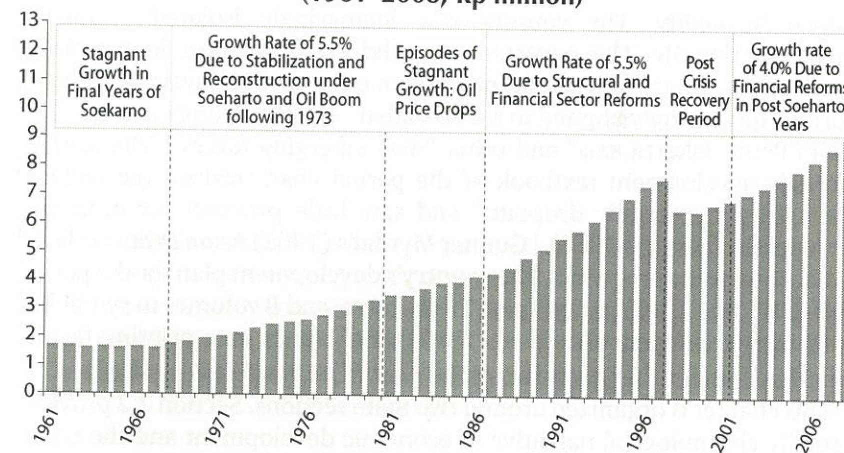
and distinguishing between the Suharto and post-1998 periods. Section 2.3 examines several dimensions of this development record, including structural change, regional (subnational) development, and comparative outcomes.

2.2. A Development Narrative

2.2.1. The Suharto Era

The Suharto era constituted the first period of sustained economic growth in the country's recorded history. Rudimentary estimates of 20th century economic growth in Indonesia prepared by van der Eng (2002) indicate that the country's per capita gross domestic product (GDP) in 1966 was about 80% of what it was in 1913, when the first national accounts estimates were prepared. Thereafter, under Suharto, per capita income more than quadrupled (Figure 2.1), and Indonesia became one of the "East Asian miracles" (World Bank 1993). Under Suharto, the constants were a commitment to growth, prudent macroeconomic management, concern with equity, and a more "orderly" process of government. The administration emphasized the *trilogi pembangunan*—the "development trilogy" of growth, stability, and equity. Five-year plans were developed, beginning in 1969, and five-yearly elections followed, commencing in 1971.

Figure 2.1: Indonesia's Economic History—Per Capita Real GDP (1961–2008, Rp million)



GDP = gross domestic product.
Source: World Bank, WDI, accessed 25 March 2010.

Notwithstanding the constants, the Suharto era was also episodal in some respects, as a result of its own policies and priorities, and

international developments over which it had no control. These 32 years are conventionally divided into subperiods, corresponding to particular development challenges and emphases. It is important to emphasize that these periods do not accord with the five-year plans. In fact, most of the plan documents were quickly overtaken by external events. The plans, known as Repelitas (an abbreviation of *rencana pembangunan lima tahun*—five-year development plans), therefore should be regarded primarily as broad statements of philosophical intent at the time they were drafted.

Rehabilitation and Recovery: 1966–1971. The government had four broad objectives during these years. The first was to bring the government's finances under control, and hence extinguish the soaring inflation that had arisen from the monetization of its deficits. The government was remarkably successful at this goal, with inflation returning to single digits by 1969. The multiple foreign exchange rates, which had been a source of endemic corruption, were also progressively removed, and in 1971 the government took the bold step of opening the international capital account. Second, the government adopted a very welcoming attitude toward domestic and foreign investment. The foreign investment law of 1967 provided generous investment incentives and few restrictions. The government also announced its intention to return the foreign property that had been appropriated during the 1958–1965 period. A domestic investment law followed in 1968 with similarly generous provisions. It was directed particularly to the dominant ethnic Chinese business community, whose members had left the country in increasing numbers during the preceding years.

The third objective was to reengage with the West. The government dropped its objections to the formation of Malaysia and severed ties with the communist bloc. It rejoined the International Monetary Fund (IMF) and the World Bank, and quickly developed major programs with both institutions. For several years it was in fact the World Bank's largest borrower. It also reengaged with Japan and the United States (US). Propelled by the cold war, and the fear of falling Asian "dominoes," both quickly became major donors and investors. For many years to follow, Indonesia was to be Japan's largest recipient of both foreign direct investment and official development assistance (ODA). The fourth objective was the restoration of the country's infrastructure, including roads, power, ports, telecommunications, and irrigation, all of which had been badly run down during the previous decade and more, and for which much of the newly received development assistance was mobilized.

The Oil Boom: 1972–1980. The economy was already growing strongly in the early 1970s, and it received a massive boost as the international price of oil and other commodities began to increase rapidly. The quadrupling of oil prices transformed the country's near-term prospects. With aid and foreign investment flows already at record levels, the country's fiscal and

balance-of-payment constraints were effectively removed. Agriculture was also growing very rapidly, owing to the delayed but successful adoption, from the late 1960s, of high-yielding rice varieties and the government's vigorous promotion of them through rural infrastructure and generous input subsidies. The government also announced ambitious heavy industry projects in fertilizer, steel, cement, and petrochemicals; as a result, the state-owned enterprises (SOEs), which the government had hitherto been divesting, received renewed emphasis.

As is often the case, however, the resource boom proved to be a mixed blessing. In early 1976, Pertamina, the state-owned oil company, which had been given authority to manage the country's oil resources and had been operating more or less independently of the government, announced that it was about to default on its overseas borrowings to finance its many ambitious investment projects. It had accumulated debts of over $10 billion, then equivalent to about one-third of the country's GDP. Inflation was also rising again, to an annual rate of about 40%, resulting in a sharp appreciation of the real exchange rate given that the nominal rate remained pegged to the US dollar. Thus the non-oil tradable sectors were under great competitive pressures. In response to these concerns, and fearing that the oil boom period was about to end, in November 1978 the government depreciated the currency by 45%. However this decision was also overtaken by external events, with the oil prices again rising sharply in response to renewed conflict in the Middle East.

Adjusting to Lower Oil Prices: 1981–1985. Oil prices remained high until the early 1980s, but then began to fall sharply. This factor, combined with rising global interest rates in response to US monetary policies and reckless investment projects in many resource-rich economies, precipitated the third world debt crisis of the 1980s and led to a "lost decade" for many of them. There was every prospect that Indonesia would join their ranks. Although not possessing petroleum resources on the scale of the Middle Eastern economies, Indonesia was in some respects a "petroleum economy." In the early 1980s, three-quarters of its merchandise exports and two-thirds of its government revenues came from oil and associated energy products. By this period also, the government had embarked on many ambitious investment projects, particularly in heavy industry, and so its external debt was rising quickly.

That Indonesia did not succumb to the debt crisis is testimony to the government's adept economic management. The initial response took the form of several macroeconomic measures: the government trimmed its own spending, postponed major investment projects, devalued the currency in 1983, and sought emergency relief from donors. These measures ensured that the economy was not engulfed by the first-round effects of the debt

crisis. However, the government's microeconomic response was muted, and the needed reforms in that area were not undertaken.

Low Oil Prices and Decisive Reform: 1986–1990. It took another round of declining commodity prices, in 1985, to push the government into further reform. The effective macroeconomic policy and another large currency depreciation in 1986 were now accompanied by the much-needed microeconomic reform: the government liberalized the trade regime significantly; enacted regulatory reforms, particularly removing the complex barriers to import–export procedures; simplified the foreign and domestic investment regimes; promulgated a major tax reform; and introduced banking reforms (too quickly, in retrospect). As a result, non-oil exports began to grow very quickly and, aided by the massive relocation of labor-intensive manufacturing activity from Northeast Asia, for the first time in its history Indonesia became a major exporter of labor-intensive manufactures. The reforms also had the beneficial effect of accelerating the reduction in poverty incidence, which had already been declining rapidly owing to fast growth and rapidly rising agricultural incomes.

The 1980s decade was, therefore a period of great achievement for Indonesia. It was one of the few resource rich developing economies to avoid a debt crisis, as is clearly illustrated in the comparative analysis of Gelb and Associates (1988). Indonesia achieved rice self-sufficiency, only a decade after being the world's largest rice importer. And most social indicators improved rapidly, from poverty incidence to education and nutrition, while expenditure inequality remained relatively low.

Slowing Reform and Growing into Crisis: 1991–1998. There seemed every prospect that this development momentum would be maintained as Indonesia entered the 1990s. Growth and investment levels were buoyant, and there was great business confidence. But, as in the good times of the 1970s, problems began to emerge. President Suharto downgraded the role of the technocrats in his 1993 cabinet and promoted his technology minister (and later, briefly, president), B.J. Habibie, and his ambitious high-tech projects. As a result, the reform momentum slowed markedly. In fact there were no major policy reforms during this period. The technocrats were now effectively sidelined and unable to complete many of the major 1980s reforms, including in the finance sector. Corruption appeared to worsen, and was centered mostly around the egregious business empires of the Suharto children. Investment inflows were at record levels, but productivity and export growth began to slow. With growing disaffection toward President Suharto, the country was not well prepared to manage the contagion that inevitably spread quickly from Thailand in mid-1997.

2.2.2. The Asian Financial Crisis and the Transition to Democracy

This brings us to the second key turning point in the country's post-independence period, in 1998, in the wake of, and triggered by, the country's deep economic crisis. Indonesia was the most severely affected by the Asian financial crisis, with the economy contracting by over 13% in 1998. Moreover, like the Philippines in the mid-1980s, it experienced twin crises. The economy contracted sharply, the currency became almost worthless, the banking system imploded, and the country very reluctantly entered into negotiations with the IMF. At the same time there was political and institutional collapse, with a long-serving, authoritarian leader suddenly exiting. Indonesia then entered a highly fluid and uncertain period. It had five presidents in 6 years, its territorial integrity was threatened (and the province of East Timor opted for independence in bloody circumstances in 1999–2000), there were nasty ethnic disputes in several regions off-Java, and some major terrorist incidents erupted. The literature of the time reflected the prevailing pessimism: "From showcase to basket case" was one of the titles (Pincus and Ramli 1998).

In the event, economic growth was restored quite quickly, albeit at a slower rate than under Suharto, and an effectively functioning democracy was established remarkably quickly. By 2010, Indonesia's economic policy landscape had changed dramatically. The following are the key differences compared with the Suharto era with respect to policies, processes, and priorities:

The Presidency. First, the presidency is at once both empowered by the mandate and legitimacy of direct elections and is operationally weaker because there are many more checks and balances on the exercise of authority, and the president's party cannot expect to have a majority in the Parliament—the People's Representative Assembly (Dewan Perwakilan Rakyat—DPR). The inability to directly control the DPR in turn leads to a second difference, namely a "rainbow coalition" in cabinet (*kabinet pelanggi*); as the president builds a coalition of parties to constitute a working majority, the quid pro quo is an allocation of cabinet portfolios to the other parties. Thus, unlike the Suharto era, although the cabinet is appointed by the president, it rarely speaks with one voice. It now consists typically of three groups: those loyal to the president, as members of his party or closely aligned to it; technical nonparty ministers in a few key portfolios (such as finance, foreign affairs, and trade); and members from coalition parties, who have at best short-term loyalty to the administration. Overt differences of opinion are quite common.

The Executive Branch. The nature of the executive has also changed. During the Suharto era, it was accountable primarily to the all-powerful presidency, and largely immune to civil society pressures. In the democratic

era, the executive is far more accountable. Senior bureaucrats are regularly called before the DPR. Ministers may have to spend up to one-third of their time there to get important bills passed. These bureaucrats also have to be responsive to civil society, especially the press and nongovernment organizations. Many have been subject to legal action; a substantial number have been incarcerated, including ministers and heads of key statutory authorities such as the central bank (Bank Indonesia) and the Corruption Eradication Commission (Komisi Pemberantas Korupsi—KPK). The result is that the bureaucracy has become extremely cautious and hesitant to take key decisions that may result in corruption allegations (for example concerning major infrastructure projects).

The Legislature. The role of the legislature has also changed fundamentally. During the Suharto era, it operated as a rubber stamp, run by the government's Golkar Party, with only two timid, loyalist "opposition parties" allowed to participate, and heavily scripted general elections with predictable results. Since 1999, however, Indonesia has quickly made the transition to a vibrant democracy. Although there are no major ideological differences between the parties, they are free to establish, organize, and engage in political activities. New parties have emerged on the scene, most prominently, President Yudhoyono's own Partai Demokrat, now the largest single group in the DPR, albeit well short of a majority. These parties are frequently unpredictable. Lacking a coherent ideology, personal and regional loyalties together with blatant money politics are the keys to the passage of legislation.

The Judiciary and Independent Authorities. A fourth tier of governance is the judiciary. Here too the changes have been dramatic. During the Suharto era, the judiciary was essentially irrelevant in determining the outcome of any significant case: political (and often military) power was the principal arbiter of outcomes. In 1998, however, the institutional vacuum created by the regime collapse put great pressure on a legal system completely unprepared to resolve many pressing cases. Most of the corporate and financial workouts required a legal resolution, but the courts were generally unable to function effectively. Many major corruption cases that had been ignored or shelved resurfaced, as did complaints toward the police and military. Ethnic violence flared in several regions, and there were "payback" cases (i.e, the settlement of unresolved grievances, sometimes through extra-judicial means) over land and other disputes. The fear was that, without an adequately functioning legal system, the "parliament of the streets" would become the forum for dispute resolution, with all the dangers inherent in such a system. Hence, the development of an effective, trusted, clean legal system became a high priority, but one where progress has understandably been slow (Lindsey 2004).

Related, there have been attempts to establish independent authorities that are designed to operate free from daily political interference, and to act as a check on government. Thus, for example, Bank Indonesia is now an independent agency, an anticorruption commission has been established, and a competition commission (Komisi Pengawas Persaingan Usaha—KPPU) has been created. Here too it will take time for these agencies to become operationally effective. Bank Indonesia is regarded as a reasonably credible body, but it has had difficulty holding inflation down to that of Indonesia's major trading partners, and some of its governors and senior executives have been the subject of legal action. The KPPU had some early successes in handling complex competition cases, but its recent appointments have become politicized. The KPK has instituted some high profile (and highly popular) cases, but it too has become embroiled in controversy, and its director has been imprisoned (see Chapter 5).

Decentralization. A fifth major difference concerns decentralization. Indonesia was a highly centralized state under Suharto, with little scope for local authority and autonomy. Then, in a dramatic initiative, in May 1999 the government announced a "big bang" decentralization, to take effect from 1 January 2001. The scheme was radical in its intent, with major revenue and administrative authority being passed down to the subprovincial levels of government—the municipalities (*kotamadya*) and districts, also termed "regencies" (*kabupaten*) (Brojonegoro 2004). The fear of territorial disintegration, involving Aceh, Maluku, Papua, Timor, and other outlying regions, was undoubtedly a key motivation for the hasty action. The reforms were to be accompanied by democratization, with direct elections for local leaders as well as the assemblies. As a result, Indonesia now has elections for all 500 of its national, provincial, and subprovincial authorities. The decentralization has more or less worked, in the sense that the nation's territorial integrity has been preserved, and the functions of government have been maintained. But major challenges remain, in the proliferation of subprovincial jurisdictions, in coordinating the many local governments, and in the highly variable quality of local governance (see Chapter 11, and Fengler and Hofman 2009).

The Press, Civil Society, and International Finance Organizations. A sixth difference between the democratic and Suharto eras concerns the role of extra-government actors. Two in particular stand out. First, civil society, long suppressed during the Suharto period, has sprung to life. Indonesia has a vibrant, if unpredictable, press and civil society. Thus, the checks on government, at the national and local level, are now much greater. However, it is not yet obvious that the quality of public administration is any better. Here too, it takes time for these relationships to mature. A second actor is the international development community. As noted, relations between the development community and the Suharto regime were generally very close.

A consortium known as the Consultative Group on Indonesia met annually. In times of crisis, prior to the mid-1990s, Jakarta turned to the international financial institutions and (especially) to Japan. This relationship has cooled considerably since the late 1990s. The Consultative Group on Indonesia has since been abolished, at Indonesia's instigation. The Indonesian government has a rather cool official relationship with the IMF in particular. Its program with the World Bank has been scaled back, and the country is now repaying more (on past loans) that it receives in new money. The Jakarta–Tokyo nexus is much less significant, on both sides. With ODA now just 0.4% of GDP, and probably declining, this is likely to become a permanent feature of the institutional landscape.

2.2.3. Some Continuities

Having drawn attention to the differences between the Suharto and current eras, it is important by way of conclusion to mention the similarities across the entire period since 1966. At least four warrant mention.

Prudent Macroeconomic Management. First, as outlined in Chapter 5, macroeconomic management has continued to be reasonably prudent. On the fiscal side, under Suharto a de facto "balanced budget" rule applied, meaning that the government could spend no more than the sum of its own revenues and international development assistance. Since 2003, a fiscal law has applied, with a broadly similar effect. Indonesia has effectively adopted—and, unlike the European Union, has consistently implemented—the Maastricht principle, that deficits should not exceed 3% of GDP, and public debt should be less than 60% of GDP (Boediono 2005). This has also made Bank Indonesia's task of monetary policy management a good deal more manageable, and inflation has therefore rarely gotten out of control.

A Broadly Open Economy. Second, Indonesia has remained a broadly open economy for the entire period. As noted, the pendulum has swung between more and less open postures, and there has been considerable reservation toward liberalism and globalization in influential community opinion. In some respects, the country might be precariously open (Basri and Hill 2004), but it seems reasonable to assume that this state of affairs will continue. Being surrounded by open economies helps in this respect, as do the various regional agreements, most important the Association of Southeast Asian Nations (ASEAN) Free Trade Area agreement.

Slow Administrative Reform and Institution Building. Third, the process of administrative reform and institution building has been a very slow one. There has yet to be a major reform of the civil service, for example. Its remuneration structures remain highly complex, and uncompetitive at senior levels. The link between performance and reward is weak. Mobility and opportunities for long-term professional development are limited

(McLeod 2005). Moreover, SOE reform has proceeded very slowly. There is powerful resistance to divesting the SOEs, even though it is well known that they are highly politicized and inefficient. The absence of reform has also complicated the task of combating corruption. All available evidence suggests that corruption is just as serious in its magnitudes as it was in the Suharto era. The only difference, perhaps, is that it has been "democratized and decentralized," as press commentary frequently remarks. This has resulted in a more "disorganized" form of corruption, which by its nature increases commercial uncertainty, compared with the Suharto era practices, where the parameters were clearly defined (McLeod and MacIntyre 2007).

Equity Outcomes. A fourth continuity is that Indonesia performs reasonably well with regard to equity outcomes. Expenditure inequality has not risen appreciably since it was first measured fairly accurately in the early 1970s (Chapter 9).[2] Access to basic education and (to a lesser extent) health services has been expanded (Chapter 8). The country performed surprisingly well with regard to the rapid introduction of social protection measures in the wake of the Asian financial crisis, especially given the severe fiscal crisis and weak institutions then prevailing (Manning and Sudarno 2011). Moreover, in spite of the very large regional differences, all available evidence suggests that interregional inequality has remained fairly stable since the 1970s, in notable contrast to the People's Republic of China in particular and other large developing nations (Hill, Resosudarmo, and Vidyattama 2008).

2.3. Dimensions of Development

2.3.1. The Comparative Record

This section looks more closely at various aspects of Indonesia's growth dynamics. In comparative perspective, Indonesia's growth record resembles that of its neighbors in some respects (Tables 2.1 and 2.2). After lagging in the 1960s, it grew strongly in the 1970s; grew moderately fast in the 1980s (with a dip in the middle of the decade); and maintained positive growth in the 1990s, notwithstanding the deep crisis. For the latest period, Indonesia actually recorded the highest growth among the original five members of ASEAN,[3] reflecting the fact that it was the least affected by the global financial crisis. These growth rates are reflected in the relative per capita incomes over time. Thus for example, in 1980 Indonesia's per capita income was about half that of Thailand and almost one-fifth that of Malaysia. By 2009, these relativities were broadly similar. At current growth trends, Indonesia will take about 23 years to catch up to Thailand's current per capita income.

[2] However, income inequality, which is not well measured, has probably increased.

[3] Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

Table 2.1: Per Capita GDP (in 2000 $)

Country	1980	1990	2000	2001	2002	2003	2004	2005	2006	2007	2008
Indonesia	397	612	800	818	844	872	904	943	983	1,033	1,083
Malaysia	1,919	2,608	4,030	3,965	4,096	4,251	4,455	4,609	4,789	5,009	5,155
Philippines	989	901	977	975	999	1,028	1,073	1,106	1,143	1,202	1,225
Singapore	9,043	14,658	23,019	21,869	22,571	23,704	25,651	26,886	28,234	29,185	27,991
Thailand	789	1,400	1,968	1,991	2,072	2,193	2,305	2,387	2,490	2,594	2,645

GDP = gross domestic product.
Source: Estimates based on World Bank, WDI, accessed 25 March 2010.

Table 2.2: Annual Average Growth Rate of Real Per Capita GDP (%)

Period	Indonesia	Malaysia	Philippines	Singapore	Thailand
1951–1960	4.0	3.6	3.3	5.4	5.7
1961–1970	1.9	3.5	1.8	7.4	5.0
1971–1980	5.4	5.3	3.1	7.2	4.4
1981–1990	4.5	3.2	-0.8	5.0	6.0
1991–2000	2.9	4.6	0.8	4.7	3.6
2001–2008	3.9	3.1	2.9	2.6	3.8

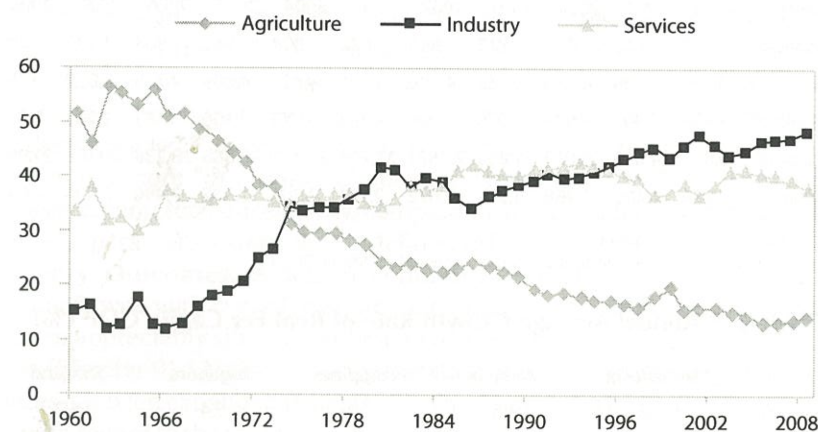
GDP = gross domestic product.
Source: Estimates for 1951–1960 based on IMF, IFS, accessed 25 March 2010 and for other years, World Bank, WDI, accessed 25 March 2010.

The one major difference concerns the Philippines. In 1980, Indonesia's per capita income was less than half that of its archipelagic neighbor. But, owing to the latter's deep 1980s crisis, Indonesia had actually overtaken it by the mid-1990s, before succumbing to the Asian financial crisis. By 2009, the two countries' per capita incomes were very similar.

2.3.2. Structural Change

Indonesia's rapid economic growth has resulted in major structural change. While agriculture, industry, and services have all expanded, consistent with the theory of economic development, agriculture's share of GDP has fallen sharply (Figure 2.2). At the onset of rapid growth in the mid-1960s, agriculture accounted for almost 60% of GDP and employed an even larger share of the workforce. The rest of the economy was about evenly distributed between the industry and services sectors. By 2009, industry was the largest sector of the economy, followed by services. Agriculture had shrunk to just 15% of GDP.

Figure 2.2: Sector Shares in GDP (1960–2008)



GDP = gross domestic product
Source: World Bank, WDI, accessed on 25 March 2010.

Notwithstanding this major structural change, all economic sectors have expanded. Table 2.3 shows average sectoral growth rates by decade, and each sector's contribution to aggregate economic growth. Table 2.4 shows the same data for manufacturing, the most dynamic sector in the 1970s and 1980s, together with nonmanufacturing industries.

Table 2.3: Annual Average Real GDP Growth and Contribution of Major Production Sectors to GDP Growth (%)

		Agriculture		Industry		Services	
Period	GDP Growth Rate	Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth
1961–1970	4.1	2.8	30.4	7.2	43.3	3.5	26.3
1971–1980	7.9	4.5	16.8	10.3	44.5	8.7	38.6
1981–1990	6.4	3.7	14.5	7.4	21.9	7.1	61.8
1991–2000	4.2	2.0	9.0	5.4	57.9	4.0	34.2
2001–2008	5.2	3.4	10.1	4.0	35.0	7.0	54.8

GDP = gross domestic product.
Source: Estimates based on World Bank, WDI, accessed 25 March 2010.

Table 2.4: Annual Average Real GDP Growth and Contribution of Manufacturing and Nonmanufacturing Industry Subsectors to GDP Growth (%)

	Manufacturing			Nonmanufacturing Industry		
Period	Growth Rate	Share in GDP	Contribution to GDP Growth Rate	Growth Rate	Share in GDP	Contribution to GDP Growth Rate
1961–1970	4.6	7.2	7.2	8.2	15.9	41.5
1971–1980	14.0	9.5	18.8	8.7	26.1	26.8
1981–1990	12.2	17.8	35.0	3.6	20.5	12.0
1991–2000	6.6	25.2	41.7	3.8	19.1	16.0
2001–2008	4.7	27.8	24.8	2.9	16.8	9.5

GDP = gross domestic product.
Source: World Bank, WDI, accessed May 2010.

Agriculture grew strongly in the 1970s and into the 1980s, boosted by the rapid adoption of high-yielding varieties, the major investments in rural infrastructure, and generous input subsidies. It also grew quite strongly in the 2000s, with the main driver on this occasion being high prices for tropical cash crops, particularly palm oil. Thus, agriculture has always been a significant driver of Indonesia's economic growth. Even in the most recent decade, when agriculture's share had shrunk, it contributed 10% of the growth.

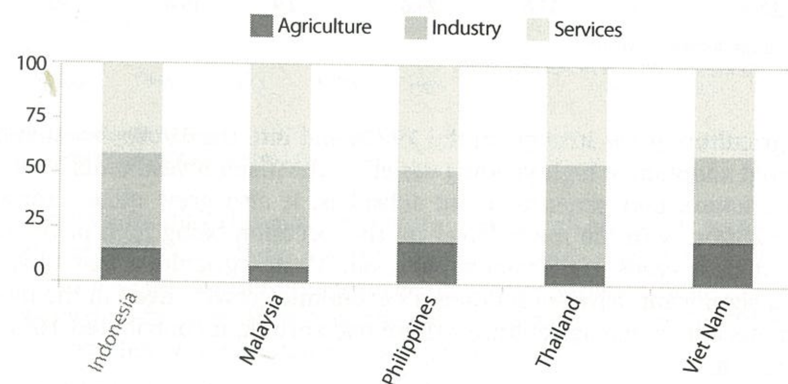
Manufacturing grew at double-digit rates almost continuously throughout the Suharto era, with the result that its share of GDP more than tripled. During the 1970s, as noted in Chapter 6, import substitution was the main driver, whereas export orientation became increasingly important during and after the 1980s. In the 1980s, manufacturing became the major engine of economic growth, contributing over one-third of the country's economic expansion and rising to over 40% in the crisis decade that followed. However, manufacturing has failed to regain its dynamism since the late 1990s, and for the past decade it has expanded at only about one-third of the rate in the boom decades of the 1970s and 1980s. The industry sector of which it is part grew more slowly for most of the period. That is, the mining, construction, and utilities subsectors grew more slowly in all decades after the 1960s.

The services sector grew steadily throughout the period, with the fastest growth evident in the oil boom decade of the 1970s and through to the 1980s, as the proceeds were distributed into sectors such as telecommunications, transport, finance, trade, and the government. The services sector's growth accelerated again in the 2000s as major liberalizations resulted in rapid

growth of telecommunications, transport, and trade. In the 2000s, services contributed almost half the aggregate economic expansion.

Indonesia's structural change is more or less comparable with that of its middle-income neighbors, adjusting for differences in per capita incomes. Its share of agriculture, averaging about 15% during the 2001–2009 period, is higher than in Malaysia and Thailand, but lower than in the Philippines and Viet Nam (Figure 2.3). Its industry share, at 44%, is similar to Malaysia and Thailand, being boosted by the larger mining sector, and is higher than the shares of the other two countries.

Figure 2.3: Average Shares of Major Production Sectors in GDP (2001–2008, %)



GDP = gross domestic product.
Notes: Based on current market prices. Estimates for Malaysia, Thailand, and Viet Nam are for 2001–2007.
Source: Estimates based on World Bank, WDI, accessed 25 March 2010.

2.3.3 Major Expenditure Components

There has been some variability in expenditure shares, driven by growth, crises, and exogenous shocks. Consumption has been the major expenditure component throughout the period, in the range of 48%–60% of GDP (Tables 2.5 and 2.6). In the wake of economic slowdowns, consumption has generally risen, as expected, thus explaining the higher figure in the 2000s and the decline in the 1970s as compared with the previous decade. During the crisis decade of the 1990s, consumption contributed to most of the growth, as investment fell sharply. The government share has been consistently in the 7%–10% range, rising slightly in the 1980s in the wake of the oil boom.

Investment and exports have displayed greater volatility. The share of investment grew strongly as economic growth took root, with the 1980s share more than triple that of the 1960s. However, it fell sharply following the Asian financial crisis and has recovered very slowly thereafter. The

Table 2.5: Share of Expenditure Components in GDP (%)

Period	Consumption		Government		Investment		Exports		Imports	
	Growth Rate	Share of GDP	Growth Rate	Share of GDP	Growth Rate	Share of GDP	Growth Rate	Share of GDP	Growth Rate	Share of GDP
1961–1970	4.3	55.8	0.7	6.4	8.3	9.2	4.0	45.7	5.6	–13.1
1971–1980	6.3	48.0	13.1	7.8	17.7	19.5	9.2	60.1	17.4	–28.1
1981–1990	7.8	56.4	5.3	9.9	8.4	30.2	0.9	35.7	4.3	–32.8
1991–2000	5.9	55.7	0.8	7.4	–0.3	31.9	6.6	39.0	5.2	–33.2
2001–2008	4.7	60.0	8.1	7.6	6.1	23.0	7.7	43.3	8.8	–33.9

GDP = gross domestic product.
Source: Estimates based on World Bank, WDI, accessed 25 March 2010.

Table 2.6: Contribution to GDP Growth by Expenditure Component (%)

Period	Consumption		Government		Investment				
	Growth Rate	Contribution to GDP Growth Rate	Growth Rate	Contribution to GDP Growth Rate	Growth Rate	Contribution to GDP Growth Rate	Exports Growth Rate	Imports Growth Rate	Net Exports Contribution to GDP Growth Rate
1961–1970	4.3	54.1	0.7	3.0	8.3	14.6	4.0	5.6	33.5
1971–1980	6.3	40.1	13.1	14.0	17.7	43.5	9.2	17.4	8.1
1981–1990	7.8	42.2	5.3	7.5	8.4	41.3	0.9	4.3	11.7
1991–2000	5.9	84.6	0.8	0.5	-0.3	-9.8	6.6	5.2	21.6
2001–2008	4.7	53.3	8.1	11.2	6.1	25.2	7.7	8.8	10.4

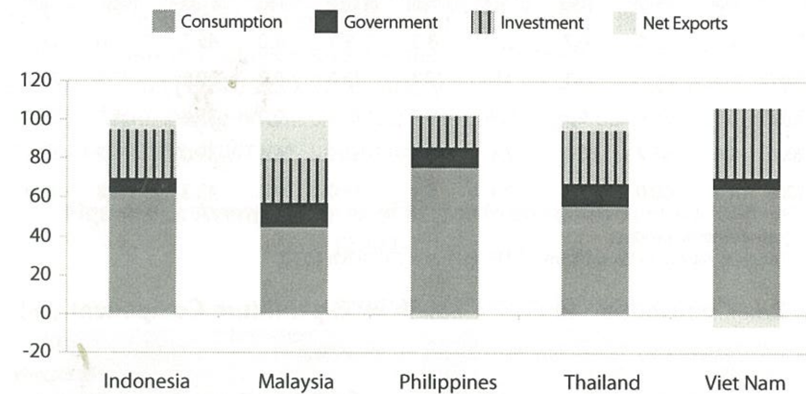
GDP = gross domestic product.
Source: World Bank, WDI, accessed March 2010.

export share has been volatile, peaking in the 1970s oil boom at 60% of GDP, but then falling to almost half this share in the next decade as oil prices collapsed. The share has gradually risen since the late 1990s in response to high commodity prices.[4]

These shares are also broadly comparable to those of Indonesia's neighbors during the last decade (Figure 2.4). The consumption and investment shares are close to the regional norm, above the share for Malaysia and below that for the Philippines, the regional outliers. That Indonesia's share of net exports is lower than Malaysia's reflects the fact that Malaysia is running a very large positive trade balance, in contrast to the negative net trade balance for Viet Nam.

[4] These volatile export shares serve as a reminder that this conventional indicator of economic openness can produce very misleading results for Indonesia. The 1970s, for example, coincided with the imposition of increasingly restrictive trade and investment regulations, as previously noted.

Figure 2.4: Average Shares of Major Expenditure Components in GDP (2001–2008, %)



GDP = gross domestic product.
Notes: Based on current market prices. Estimates for Malaysia, Thailand, and Viet Nam are for 2001–2007.
Source: World Bank, WDI, accessed on 25 March 2010.

2.3.4. Regional Diversity

Any analysis of Indonesian growth dynamics has to take account of the country's regional diversity. This chapter follows the conventional approach of classifying the country according to its five major island groups: Java–Bali, Kalimantan, Sulawesi, Sumatra, and the rest of Eastern Indonesia.[5] Java–Bali dominates Indonesia's economy, with 61%–62% of GDP (Table 2.7) and a similar share of the population. Because the six provinces that constitute this grouping have grown faster than the country as a whole in recent years (indeed since the 1970s), their contribution to GDP growth is somewhat higher. The shares for Sumatra and Kalimantan have been about 22% and 9%, respectively. The natural resource sector is a larger share of these regional economies, and thus their growth, and therefore their contribution to national growth, has fluctuated. Sulawesi and the other Eastern provinces account for about 7%–8% of the national economy. Here also the contribution to national economic growth has been variable owing to the natural resource sector, particularly that of Papua.

[5] Official definitions of Eastern Indonesia typically add Sulawesi and sometimes the eastern parts of Kalimantan to Nusa Tenggara, Maluku, and Papua.

Table 2.7: Regional Contributions to GDP and GDP Growth (%)

Year	Sumatra	Bali and Java	Kalimantan	Sulawesi	Eastern Provinces (Maluku, Nusa Tenggara, and Papua)
GRDP: Regional Shares					
2000	22.6	60.1	9.6	4.2	3.5
2001	22.2	60.3	9.6	4.3	3.6
2002	22.6	60.3	9.6	4.3	3.3
2003	22.5	60.3	9.4	4.3	3.5
2004	22.2	60.9	9.3	4.3	3.2
2005	21.9	61.2	9.2	4.4	3.4
2006	21.9	61.5	9.0	4.5	3.1
2007	21.7	61.8	8.9	4.5	3.1
2008	21.6	62.0	8.8	4.6	3.0
GRDP: Contribution to Growth					
2000–2001	11.8	65.9	10.8	5.4	6.2
2001–2002	31.7	58.0	9.2	4.7	–3.6
2002–2003	21.0	60.9	5.4	4.6	8.0
2003–2004	15.5	76.4	6.7	5.7	–4.3
2004–2005	14.8	65.1	6.8	5.1	8.2
2005–2006	22.2	68.0	6.7	5.8	–2.7
2006–2007	19.1	67.1	5.6	5.4	2.8
2007–2008	19.1	65.0	8.3	6.2	1.3

GDP = gross domestic product, GRDP = gross regional domestic product.
Source: Estimates based on BPS Website, accessed March 2010.

2.3.5 Productivity Growth

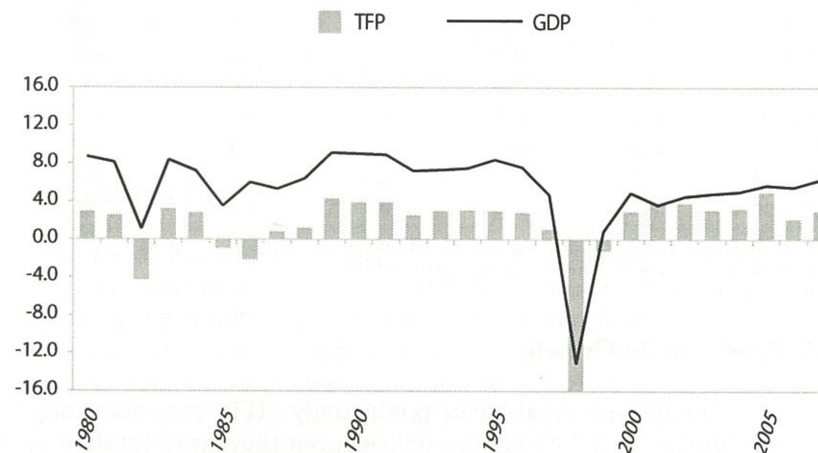
Estimates of Indonesia's total factor productivity (TFP) vary according to the methodologies and data bases employed, but they typically show that the trends follow that of the GDP. Table 2.8 reports one set of estimates for Indonesia and its middle-income ASEAN neighbors prepared by the Asian Productivity Organization for the period 1980–2000. The estimates suggest that much of Indonesia's growth was input driven, with positive TFP growth only in the 1990s. The other Southeast Asian countries are estimated to have registered positive growth for most of the period, except obviously for the Philippines. However, comprehensive and updated estimates prepared recently (OECD 2008) show a brighter picture, with TFP growth being positive in most years and following that of GDP quite closely (Figure 2.5). In particular, TFP appears to have been responsive to the 1980s reforms, with strong growth in 1986–1996. Growth in the 2000s was similarly positive and quite strong for most of the decade.

Table 2.8: Contribution of Total Factor Productivity to GDP Growth (%)

Period	Indonesia	Malaysia	Philippines	Thailand	Viet Nam
1980–1984	−0.32	−0.03	−2.34	0.37	—
1985–1989	−0.47	0.20	0.49	3.66	2.09
1990–1994	0.82	3.36	−1.68	2.14	4.31
1995–1999	3.67	0.32	1.03	−2.16	3.36
1980–2000	−0.80	1.16	−0.37	1.00	3.41

— = not available, GDP = gross domestic product.
Notes: The analysis for Malaysia is for 1981–2000; Thailand, for 1980–1999; and for Viet Nam, 1986–2000.
Source: APO (2004).

Figure 2.5: Trends in GDP and Total Factor Productivity Growth Rate (1980-2006, %)



GDP = gross domestic product, TFP = total factor productivity.
Sources: GDP from World Bank, WDI, accessed 25 March 2010. Others from OECD (2008).

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3. Critical Constraints to Growth

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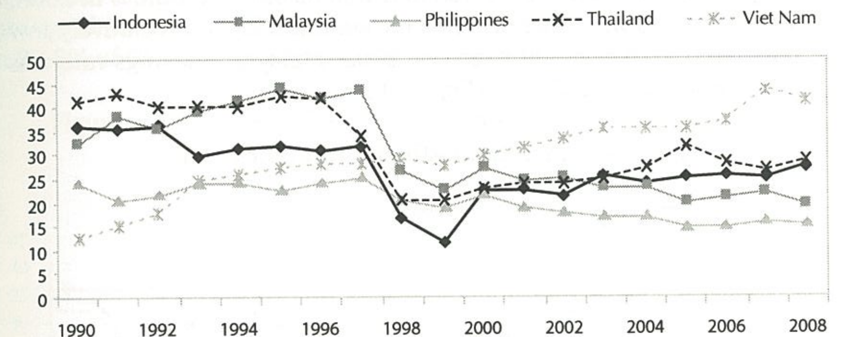
Indonesia's investment level was 30%–32% of gross domestic product (GDP) during 1990–1997 but the level plummeted to 11% of GDP in 1999 following the Asian financial crisis. The investment level has since recovered somewhat and was about 25% of GDP in 2007 and 2008 (Figure 3.1). However, as in the case of GDP growth, the recovery fell well short of the level that prevailed prior to the crisis. Moreover, it does not compare favorably with the region's faster growing economies—e.g., Viet Nam's 41.1% of GDP and Thailand's 28.8% in 2008.

Figure 3.1: Investment Rate/Gross Domestic Capital Formation (% of GDP)



GDP = gross domestic product.
Source: IMF, IFS, accessed May 2010.

Attaining the pre-crisis pace of GDP growth may not be possible unless investment is revived to that period's level. The private sector will need to be the driver of growth in the medium to long term. Public investment will also need to be boosted to address constraints related to the availability, reliability, and efficiency of infrastructure, and to meet the human capital