ECONOMIC BRIEF
NO. 2

ASEAN COUNTRY PROFILE
INDONESIA: A SLEEPING GIANT NO LONGER
The PITO Economic Brief Series

The Private Investment and Trade Opportunities (PITO) project seeks to expand and enhance business ties between the U.S. and ASEAN private sectors. PITO is funded by a grant from the United States Agency for International Development (AID) with contributions from the U.S. and ASEAN public and private sectors.

The PITO Economic Brief series, which is published under this project, is designed to address and analyze timely and important policy issues in the ASEAN region that are of interest to the private sectors in the United States and ASEAN. It is also intended to familiarize the U.S. private sector with the ASEAN region, identify growth sectors, and anticipate economic trends. The PITO Economic Brief series is edited and published by the Institute for Economic Development and Policy of the East-West Center, which coordinates the Trade Policy and Problem Resolution component of PITO.

To obtain a copy of a PITO Economic Brief, please write to:
Editor
Institute for Economic Development and Policy
East-West Center
1777 East-West Road
Honolulu, HI 96848
United States of America
INTRODUCTION: BASIC FACTS

All countries have unique aspects, but Indonesia is more unique than most. Like the Philippines, it is a country made up of thousands of islands, but Indonesia exists on a grander scale. Its archipelago is composed of more than 13,000 islands and is spread over 3,000 miles east to west. Indonesia’s land area consists of almost 2 million square kilometers and its territorial waterways make up another 3 million square kilometers (Table 1). Both its land area and its population of approximately 180 million are far larger than all of the ASEAN countries combined. The capital city of Jakarta is home to about 9 million people, and the population in four other cities top one million. As of the 1980 census, Indonesia’s population was still largely rural (with only 22 percent living in urban areas), young (40 percent are under 15 years of age), concentrated (with Java, Madura, and Bali accounting for almost 65 percent of the population and just 7 percent of the land area), and growing relatively rapidly (at 2.7 percent per year).

The national language is Bahasa Indonesia, but English has replaced Dutch as the primary second language and is used in business and government circles. Although Indonesia is a Muslim country, significant Christian, Hindu, Confucian, Buddhist, and other religious minorities exist in relative harmony. The government historically has been secular. Ethnically, Malays make up over 90 percent of the total population, although Melanesians and
indigenous groups make up the majority on certain eastern islands, including Irian Jaya and Timor. Modest numbers of ethnic Chinese run businesses in urban areas, along with smaller groups of Indians and Arabs.

Table 1 Size of ASEAN Countries in 1989

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (millions)</th>
<th>Area (1,000 km$^2$)</th>
<th>GDP (US$m)</th>
<th>Per capita (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>179.1</td>
<td>1,919</td>
<td>82,726</td>
<td>471</td>
</tr>
<tr>
<td>Malaysia</td>
<td>17.4</td>
<td>330</td>
<td>37,453</td>
<td>2,152</td>
</tr>
<tr>
<td>Philippines</td>
<td>60.1</td>
<td>300</td>
<td>44,349</td>
<td>738</td>
</tr>
<tr>
<td>Singapore</td>
<td>2.7</td>
<td>1</td>
<td>28,360</td>
<td>10,582</td>
</tr>
<tr>
<td>Thailand</td>
<td>55.5</td>
<td>542</td>
<td>69,676</td>
<td>1,225</td>
</tr>
</tbody>
</table>

NOTE:

Gross domestic product per capita is a scanty US$470, but has been growing at a moderately robust pace of about 5 percent each year since 1960 (Table 2). However, regional income inequality has also been growing, with per capita income in the relatively rich islands of Bali and Java growing at more than 20 percent per year from 1980 to 1987, as opposed to just 4 percent in the poorest areas (Maluku and Irian Jaya). Real GDP grew between 5 and 6 percent per year from 1986–1988, and increased
by 7 percent in 1989. Indonesia’s GDP is now about US$90 billion (at the current exchange rate of 1,960 rupiah to the U.S. dollar).

Table 2 Basic Statistics of Indonesia

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth of real GDP</td>
<td>3.6a</td>
<td>7.8</td>
<td>5.5b</td>
<td>5.7</td>
<td>7.0</td>
<td>6.5</td>
<td>6.1</td>
<td>6.5</td>
</tr>
<tr>
<td>Export growth</td>
<td>-0.5</td>
<td>38.1</td>
<td>4.9</td>
<td>13.6</td>
<td>15.3</td>
<td>12.1</td>
<td>14.1</td>
<td>10.1</td>
</tr>
<tr>
<td>Import growth</td>
<td>7.0</td>
<td>26.3</td>
<td>10.8</td>
<td>2.8</td>
<td>23.5</td>
<td>14.7</td>
<td>13.2</td>
<td>11.5</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>na</td>
<td>17.1</td>
<td>9.6</td>
<td>8.0</td>
<td>6.5</td>
<td>7.9</td>
<td>6.7</td>
<td>6.2</td>
</tr>
<tr>
<td>Debt service ratio (period average)</td>
<td>na</td>
<td>17.5</td>
<td>24.0</td>
<td>39.8</td>
<td>34.0</td>
<td>29.0</td>
<td>27.0</td>
<td>26.0</td>
</tr>
<tr>
<td>DFI inflow (US$m) (period total)</td>
<td>20d</td>
<td>1,956</td>
<td>2,058e</td>
<td>2,498</td>
<td>4,720</td>
<td>8,900</td>
<td>7,000</td>
<td>9,000</td>
</tr>
</tbody>
</table>

NOTES:
na = Not available.
c. Estimate/projection.

In terms of production in Indonesia, the contribution of agriculture fell sharply in the 1970s, from nearly one-half of GDP to about one-quarter (Figure 1). Over the same period, which includes the two oil price shocks, mining (including oil) and construction (both not shown) rose rapidly. However, in the 1980s agriculture’s decline halted, and the rapid rise in services and
manufacturing took place at the expense of mining and construction.

In terms of social development, Indonesia's social, health, and educational characteristics reflect its late start on the road to economic growth and modernization (Table 3). Health and education indicators of Indonesia—such as life expectancy, literacy, and average education of the work force—lag behind those of other ASEAN countries, but exceed levels found in Indochina, China, and South Asia (with the exception of Sri Lanka). This is not because significant progress is not occurring, but rather it is due to the fact that the standards of achievement set by the East Asian economies (Hong Kong, Korea, Singapore, and Taiwan)
and the other ASEAN countries are quite high relative to the rest of the Third World.

Table 3  Indicators of Social Development in Indonesia

<table>
<thead>
<tr>
<th></th>
<th>1960</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life expectancy</td>
<td>41</td>
<td>61</td>
</tr>
<tr>
<td>Infant mortality rate (per 1,000 live births)</td>
<td>150</td>
<td>68</td>
</tr>
<tr>
<td>Literacy rate</td>
<td>39\textsuperscript{a}</td>
<td>74\textsuperscript{b}</td>
</tr>
</tbody>
</table>

NOTES:
\textsuperscript{a} 1961.
\textsuperscript{b} 1985.

Most of Indonesia's ethnic and social problems can be traced to one source—a perception that central government plans which emanate from Jakarta have short-changed outlying areas, particularly the East. Trade, investment, exchange rate, and even social policies are seen as benefiting and increasing the wealth in Java, with particular favor being accorded to large firms which are in urban areas and are disproportionately headed by ethnic Chinese. In the words of Australian economist Hal Hill:

In some respects, the system of industrial regulation and licensing has had even more powerful "Java centric" effects [than the trade regime].

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Thus far, the level of disturbance has been relatively mild, and the government does appear to be working to correct past imbalances. The reduction in regulation and central government control over the economy, which has been seen since 1985, has already begun to level the playing field. Yet there is a feeling that things will get worse before they get better, and rising expectations in rural areas may mean an intensification of dissent in the short run. Recent announcements, such as the "wish" that firms would eventually sell 25 percent of their shares to worker cooperatives, reflect the government's commitment to equity; but the hasty qualifier that no coercion or inducements will be used to achieve this end demonstrates the preeminence of reliance on the private sector and market mechanisms at this time.

Indonesia's political leader for the past 23 years is Suharto. It had been thought that Suharto and his "new-order" government would step down at the end of his current five-year term (which expires in 1993), and given Indonesia's meager experience with the peaceful turnover of power, a noisy if not bloody struggle for ascension had been anticipated. However, Suharto announced recently that he would like to continue leading the country past the expiration of his term.

Through the early 1980s, the military exerted a great deal of influence on domestic order and foreign policy matters. This influence has waned, and Indonesia has blossomed into a more open society because of it. The press is still not free, however, especially with regard to direct criticism of the government.
THE ECONOMIC REFORM MOVEMENT IN INDONESIA

The government of Indonesia has undertaken an ambitious reform and restructuring effort, and, in the space of a decade, it has completely turned around the prospects for its economy. From a country whose prospects and policies resembled those of India, fundamental tax and trade reforms, budget controls, and financial and exchange rate management policies have made the business environment more like the environment in the economies of the Asian success stories such as Thailand, Malaysia, and the East Asian tigers. Investment regulations have been streamlined and taxes lowered in a number of industries. This process has not gone unnoticed or unrewarded. Accolades have come from the World Bank, the Economist, the Far Eastern Economic Review, and the Asian Wall Street Journal. For example, the Economist notes:

Indonesia has, in the words of a flattering World Bank report printed last May, laid the foundations for "sustained and relatively rapid growth" over the next decade. It has done this by putting in place a structure of free-market policies whose lines are as clean and straight as any in Asia (Economist 1990, November 17).

More tangible results of these policy changes are seen in the rise in investments and in particular the growth of direct foreign investment (DFI). From US$4.7 billion in 1989 which was a record level for flows up to that time, DFI flows increased to US$7.4 billion in the first 10 months of 1990. Japan alone will have invested well over US$2 billion in Indonesia in 1990, while Taiwanese and Korean investors are becoming more prevalent. Sectors (and
regions) that have historically (1967–1985) been of interest to foreign investors include basic metals (North Sumatra), textiles (West Java), chemicals (West Java), metal goods (Jakarta), and nonmetallic minerals (West Java and Jakarta). However, since this data was collected, fundamental changes have taken place and these largely resource-based opportunities have been supplanted by a number of other manufacturing opportunities. For example, limited data on the pattern of foreign investments in 1989 show chemicals (47 percent) and textiles (12 percent) as the leading sectors, followed by metals, food processing, and paper products, with shares between 4 and 8 percent.

The changes in policy have also had significant impacts on the country’s trade. Indonesia’s manufacturing exports have boomed in the past ten years, increasing its share of total exports from 25 percent to over 40 percent. Joining basic metals, textiles, chemicals, metal goods, and nonmetallic minerals among the list of leading manufactured exports are clothing and forestry products, including plywood and paper. Non-oil exports must continue to grow, as their relatively intensive use of unskilled labor figures prominently in plans to gainfully employ Indonesia’s rapidly expanding labor force. Despite the dampening effects of higher schooling levels and decreased fertility, labor force growth will continue at about 3 percent per year at least through 1996. Open unemployment is low, but some 30 percent of the labor force languishes in underemployment, as evidenced by burgeoning growth of employment in the informal sector and the civil service. In this light, the slowdown in non-oil export growth that was
observed in the first half of 1990 is troubling, despite the government's ongoing commitment to export promotion policies. One way of measuring the extent of the success to date is that 80 percent of new manufacturing investment is now classified as export-oriented; this is up from just 25 percent in the early 1980s.

Indonesian imports are concentrated in machinery and equipment, and chemicals. Although Indonesia has strong trade ties with Japan, U.S. firms have captured a significant share of the chemical and nonelectric machinery markets (14 percent each). Transport equipment imports, and the U.S. component thereof, vary considerably from year to year. From 10 percent of a US$1 billion market in 1987, Boeing Co. alone garnered orders of US$1.1 billion in 1989 and US$0.7 billion in 1990 from the state-run Garuda Indonesia airlines.

In the arena of finance, inflation has been running at 5 to 9 percent from 1984–1990, although bouts of double-digit inflation have been common in the past. Reducing inflation is currently the government's number-one economic priority, and money supply growth has diminished since the end of 1989. A reduction in inflation would also allow interest rates to fall from their current lofty levels. Lending rates are high relative to other Asian countries, exceeding 20 percent. Total time and savings deposits nearly doubled between year-end 1987 and 1989, rising from 14 percent to over 20 percent of GDP in the process. Savings rates have increased in the 1980s, largely in response to macroeconomic reform and stability. From less than 24 percent of GDP in the 1970s, savings rates have climbed over 29 percent in the 1980s.
Indonesia's largest stock market, which is located in Jakarta, has a total capitalization of just US$1 billion, and trading has been sluggish.

Indonesia's external debt of about US$58 billion still amounts to over 60 percent of GDP (after peaking near 80 percent in 1987). Interest payments alone comprise 3–4 percent of GDP, despite the large component of concessional finance. This resource drain, which rivals that of the Philippines, slows the development process and increases the need for external funds. Yet Indonesia has always made its payments and the situation is improving. As long as high oil prices do not cripple the non-oil export sector, the total debt service ratio should fall steadily from its current level of nearly 40 percent. How the government manages oil revenues and the exchange rate will have a tremendous impact on non-oil export growth, financial flows, and the business climate, in general.

Oil: Halting the Decline?

Even before the price rise in mid-1990, crude oil generated more export revenue for Indonesia than any other sector. From a peak of US$17 billion in 1981, oil revenues fell to just US$5 billion in 1987. Estimates of reserves range from 9 billion to 50 billion barrels. Foreign firms account for virtually all actual production activities, but their contracts guarantee a portion of their output to the state oil company, Pertamina. Concern with falling capacity has prompted new contracts offering favorable terms for investments in remote or higher risk areas. Even among
investors not directly concerned with the oil industry, Indonesia's energy self-sufficiency strikes a responsive note in these uncertain times.

Forestry Products: Rapid Growth, with Some Reservations

Forests blanket two-thirds of Indonesia's land area, and forest products are the second most important tangible resource after oil. Exports of forestry products should top US$4 billion in 1990, up from US$2.5 billion in 1987-1988. Plywood accounts for two-thirds of total forestry exports, and Japan and the East Asian tigers take most of it. Multinational involvement in forestry is substantial, with the total value of foreign investments approaching US$500 million in 1987. But foreign investments were halted in 1989, in response to charges of foreign exploitation, although existing concerns continue to operate and domestic exploitation continues apace. A number of taxes and prohibitions on exports of sawn logs have been instituted since 1980 as part of a concerted effort to raise domestic value added by encouraging the development of the plywood, furniture, and paper industries. While these measures represent a break from the general policy of increasing reliance on market forces, they have met with some success in achieving their aims.

Textiles: Can Export-led Growth Continue?

From humble import substitution beginnings, the textile and garments industries grew into the second largest industrial employer, propelled by exports. Export growth fueled by duty
drawbacks and other promotion measures (particularly prior to the signing and implementation of the GATT agreement on tariffs and subsidies in 1985), in addition to the salutary effects of the general opening of the economy, pushed earnings to US$1.4 billion in 1988-1989. Continued growth in production, exports, and employment in what is becoming a centerpiece of Indonesia's non-oil export success story depends on expanding export markets, especially on reducing dependence on the United States and on cracking the tough Japanese and Australian markets.

TOWARDS THE FUTURE: PROBLEMS AND PROSPECTS

Continued economic success in Indonesia involves more than meeting its target of 5 percent economic growth per year through 1993. Macroeconomic stability must be maintained, consistency in policies must be sought, and issues of regional equity must be addressed. A key test case may be observed in Riau province, where the island of Bataam stands as part of a much ballyhooed "growth triangle" including Singapore and Jahor Baru, Malaysia. This small island has attracted US$1.5 billion in foreign investment since 1982, aided by the promotional efforts of the Singapore government, duty-free status, a five-year waiver on the domestic ownership requirement, and promises of infrastructural improvements, particularly in utilities and communications. Booms in tourism, electronics, and oil services, combined of course with attendant population and construction growth, promise to transform this sleepy region into a dynamic growth center, provided Indonesia makes good on its commitments to infrastruc-
ture improvement. The problems with transportation, communication, and utilities encountered here mirror those that will develop throughout Indonesia in the coming decades, and the government must show that they can be handled in this island test case in order to maintain its credibility.

It is vital the current oil price shock not disrupt the macro-economic stability that Indonesia has recently enjoyed or jar the country off of its reform path. Further reform efforts—such as the privatization of the stock market in January 1991—must go forward, even if the need for capital seems to have abated for the moment. So far, the political will to continue reforms appears to have held firm. In this light, numerous opportunities for heightened trade and investment activities are apparent. Investments that contribute to non-oil export growth and employment expansion will be welcomed, especially if a training or technology transfer element exists as well. Domestic investment rates should grow above their current 20–22 percent levels as oil income boost savings and the debt burden diminishes. Infrastructural improvements will be strongly demanded. The resulting demand for capital goods and equipment will be filled by a competitive but lucrative battle among suppliers in Japan, the United States, and the East Asian economies. The mobilization of consumers into a force to be reckoned with is still a decade or two away, but the size of the potential market is inducement enough to prepare for that eventuality.
Table Sources


No. 1 Is the United States Missing the Boat in ASEAN?
Pearl Imada, William E. James, and Michael Plummer
THE INSTITUTE FOR ECONOMIC DEVELOPMENT AND POLICY (IEDP) conducts cooperative research on issues of sustainable national economic development and international economic cooperation in the Asia-Pacific region. IEDP pursues this broad agenda through four programs: international trade and investment; regional economic cooperation; public policies and private economic initiative; and policies, politics, and economic change.

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