FOUR INDONESIAS

William H. Overholt
Vice President
Political Assessment Group

PAG/295/1-D 4 November, 1986

FOUR INDONESIAS

Summary

Indonesia has come to a great turning point in its political and economic history. It is coming to the end of a political cycle and, more quickly, also to the end of an economic cycle. The future cannot be an orderly continuation of the past. The country faces a Toynbeean challenge which, if surmounted, will lead to a new great phase of development and the emergence of Indonesia as the dominant power of Southeast Asia. But if it is not surmounted Indonesia will become, along with the Philippines, the sick man of Southeast Asia. Indonesia has the option to buy a few years with half measures, but eventually it must face its challenge.

A review of Indonesia's record to date shows that the country has been achieving enormous progress from a low base. Its progress is even more impressive in structural terms than in income terms. In contrast to Mexico and many other Latin American countries, it has repeatedly made defensive budget-tightening moves well before a crisis, and done more rather than less than was necessary to avoid a crisis. It has made structural reforms because the leadership wanted the country to progress rather than under pressure from the IMF in a financial crisis. This contrasts sharply with the situations of Nigeria, Mexico, and Venezuela. This is why Indonesia, just as dependent on oil revenues as its counterparts elsewhere, has stayed afloat and the others have undertaken forced reschedulings.

As oil prices decline, Indonesia nonetheless faces a severe dilemma. What is required in the next few years is not just further belt tightening, nor just a continuation of past reforms, but a major change of strategy from oil to non-oil exports, from heavy industry to light, from import substitution to export-led growth. Indonesia's record to date inspires optimism that it can rise to the occasion. But the magnitude of the task, the political clout of the interests opposed to the change of strategy, and the intensity of conflict over the proposed reforms raise important doubts.

A betting man would bet that President Suharto will recognize that the survival of his regime and of his personal reputation as the country's Father of Development are at stake. Everything in his career to date argues that he will then act in the national interest. But there is a significant risk that the recognition will come late or be inhibited by age or political concerns.

In this situation, an extremely risk averse institution should not increase its risk assets and indeed should decrease them. While doing this, and institution which wants to bet for the long run on countries with future prospects as bright as Indonesia's should -- without compromising in any way its efforts to reduce risk assets -- seek ways to retain a presence and meanwhile to make money in secure ways so as to be ready when and if the situation improves.

Indonesia I: From Independence to the Present

Indonesia emerged from the post-World War II independence struggle as the most helpless of the major new nations. It was impoverished to an extent that can only be compared with some of today's less fortunate African nations. It was divided into more than 15,000 islands almost devoid of modern communications, with a population speaking over three hundred mutually unintelligible languages and dialects. It had no modern administration. Except for a narrow elite, it had no sense of nationhood.

Since that time, Indonesia's development has gone through two phases. Each has proved immensely beneficial for national development. Each has paid a price for its successes that called into question the ability of the nation to maintain the momentum of development.

In the first phase, Sukarno created a political nation. He and his colleagues expelled the Dutch, unified the national territory, created a national language, invented a national ideology (Pancasila), and established Indonesia as a significant force in global diplomacy. Sukarno achieved his goal by defeating the Dutch, castigating the Western powers (particularly the United States), and rejecting the economic shackles that the Western economy placed on Indonesia. He maintained his ability to do this through an incredible political balancing act in which he used nationalists, religious groups, and the Communist Party to keep each other under control. Through these means he created a nation.

But the new political nation paid a price: Rejection of all the economic rules of the game led to a hyperinflation that peaked at a 12,000 percent annual rate and to what was at the time history's greatest financial rescheduling. His political balancing act teetered into a Communist coup and reprisals that cost 300,000 - 500,000 deaths.

In the second phase, Suharto has created an economic nation. He imposed government by technocracy and cleared the way for the technocracy to develop the economy by defeating the communist threat from the left and controlling the Muslim threat from the right. He built a national army. He built a national administration. He fostered a national rice surplus that ensures Indonesia's impoverished peasantry of what it needs most desperately, a plenitude of cheap rice. Using oil revenues, he created highly diversified heavy industry. Now the country that could hardly feed its people two generations ago makes its own steel, cement, and petrochemicals.

But the new economic nation paid a price: The national administration adopted the Dutch colonial theory, reinforced by some socialist ideas and by the desire to use the state to take economic control away from the Chinese community, that anything not specifically permitted by law required a license. The result was a hideous, and hideously expensive, bureaucracy. The heavy industry was protected by tariffs and quotas, fostered through monopolies, and funded through massive subsidies. From these roots arose a hothouse economy, dependent on huge oil revenue subsidies and on continued protection from outside competition. Aside from raw materials and foods, this hothouse economy could not export, because the protected heavy industries drained the nation's resources and raised its costs while the administrative octopus strangled initiative and further multiplied costs.

Indonesia II: Treading Water

Now oil price declines have removed the huge subsidy for development and for inefficient protected industry. The potential benefits of emphasis on heavy industry have been exhausted. Without non-oil exports, the country will not be able to pay its bills.

The country has one of the world's most serious unemployment problems, and unemployment is worsening because of austerity programs. To redress this problem, Indonesia must increase labor-intensive manufacturing, but such manufacturing has been declining because the system channels resources elsewhere.

To reduce unemployment and keep its companies viable, the economy must grow, and there is no strong basis of growth other than exports. But high tariffs and inefficient heavy industries make inputs for most products so expensive that potential exporters cannot compete. An extraordinary bureaucracy and licensing system, together with the world's highest transportation costs, make this problem far worse. So unemployment is worsening, companies' financial positions are deteriorating, and the quality of banks' assets is deteriorating.

To cope with this situation, the government has taken extensive defensive measures. Ever since 1983, successive austerity programs have squeezed down government expenditures and imports; huge numbers of major projects have been curtailed although these cutbacks damage close associates of the President, the development budget has been drastically cut although this hurts virtually all government employees, and subsidies of key products have been curtailed although these affect politically important constituencies. In addition, major devaluations (1978, 1983, 1986) have kept imports under control and given limited encouragement to exports.

These reforms, plus a major overhaul of the tax system and a major liberalization of the financial system, have prevented Indonesia from going the way of its OPEC counterparts Mexico, Venezuela, and Nigeria. In its pursuit of sound economic management, Indonesia has repeatedly demonstrated its willingness to accept political costs that elsewhere would be considered intolerable. In sharp contrast with Mexico, Indonesia's develuations have been timely and have preceded and prevented major capital flight. Also in sharp contrast with Mexico, Indonesia's recent history includes a series of major, market-oriented reforms that point in the direction of fundamental, market-oriented restructuring of the economy -- and these have been taken without the stimulus of a prior crisis of international liquidity.

But reforms to date have been primarily defensive (austerity, devaluation), and the offensive reforms (taxes, banking) have not fundamentally changed the basic structure of the system: highly protected and subsidized industry (primarily capital intensive heavy industry) organized through a system of export monopolies, import monopolies, and production monopolies. This system is worse than its counterpart in Mexico and at least as inefficient as the gridlock of monopolies created in the Marcos Philippines.

Moreover, this basic system is becoming worse rather than better. Over time, the sectors subject to monopolies have increased, the industries bought up by conglomerates funded by monopoly profits have multiplied, and the ownership of the principal monopolies has become more concentrated in the hands of close associates of the President.

Indonesia III: Failure of Reform

Assuming a continuation of oil prices at or around current levels, if the Indonesian government continues to rely primarily on defensive measures, the economy will eventually experience the same kind of financial crisis that has affected other oil-export-dependent, high population economies. It will be the best managed of the OPEC failures but an OPEC failure nonetheless.

An economic failure scenario could have more far-reaching political consequences than in Mexico or Venezuela. Indonesia's population is far more diverse than those two countries. Its ethnic tensions, between Java and other regions, and between the Chinese minority and the pribumi majority, are far more severe. Its political system is more dependent on one man, although the unity and professionalism of the military and of key parts of the government make Indonesia far more stable and progressive than Nigeria. Its legitimacy is almost wholly dependent on its record to date of extraordinary economic success. It would come under sharp attack from a variety of groups. There would be anti-Chinese riots, spreading Islamic fundamentalist movements, rising attacks from groups denouncing dictatorship and corruption, and possibly the emergence of strong nationalist sentiments that would want to repudiate the history to date of Western oriented reform and financial responsibility. President Suharto would lose his prestige as the father of development and would be repudiated, at least temporarily, as merely another corrupt dictator.

In short, without fundamental reform, Indonesia could find itself in a Latin American financial situation, a Philippine economic situation, and a worse-than-Latin American political situation. Until and unless this was resolved in favor of reestablishment of political stability and market-oriented reform. There would be significant risk that fundamental reform and solvency would delayed for many years.

Given Indonesia's past record in reforms, one would not assume that it would accept such a scenario. But there is an argument for worrying about it. While Indonesia has been willing to accept political pain, the reforms required now imply substantially greater political pain. While Indonesia has implemented reforms, those reforms have not previously involved fundamental change in the basic strategy of heavy-industry-oriented, import substitution-driven development. The president is older now. His relatives and associates have consolidated their positions to an extent never true before and their takeover of the economy is proceeding at an accelerated rate. While the economic technocrats who have designed past reforms still have prestige, they are less unified than ever before and have less direct access to the President than ever before. Announcement of the devaluation was followed by riots in North Jakarta, Surabaya, and other locations, indicating a very tense social situation.

In short, the struggle over reform is more intense than before. Key advocates of reform have lost their jobs. One of the country's leading newspapers, **Sinar Harapan,** was closed down for predicting further reform. The President initially rejected most of a broad package of reforms. Thus there is a risk that, however impressive its past record, Indonesia will stumble this time.

Indonesia IV: Reformist Takeoff

If Indonesia lives up to its past record, it could achieve an impressive turnaround and subsequent takeoff. Recent years have seen a variety of major reforms:

Severe austerity programs in 1983 and each subsequent year that substantially exceeded the requirements of avoiding financial difficulties. The cutbacks affected projects of the immediate family and closest friends of President Suharto -- to the tune of billions of dollars. This should be compared with Mexican behavior in 1981-'82 and Philippine behavior in 1983, when a similar risk led the leading families to undertake a massive effort to get their capital out of the country.

Major devaluations in 1978, 1983, and 1986. Each was timely and effective, and none was allowed to lose force through domestic inflation and rising wages. Again, compare Mexico in 1981-'82, Venezuela in the early 1980s, and Nigeria from the early 1980s through the summer of 1986.

Reduction or elimination of subsidies on fuel, rice, and other basic commodities. Such programs have probed immensely difficult elsewhere, including Thailand.

Liberalization of the banking system in 1983. Further reforms are expected.

Customs was reformed by abolishing most of the corrupt local customs service's most important functions and turning them over to the Swiss firm SGS in 1984.

A thorough tax reform in the mid-1980s.

A reform of the oil marketing system in 1986.

Another instructive comparison is with the United States. President Reagan is acknowledged to have worked a "revolution" in American economic policy, the greatest set of budget, management and tax changes since Franklin Roosevelt. Any single year of Suharto's programs in the 1980s contains far more government mandated structural change than Reagan's entire legislative program.

The key issue, however, is whether the government has the acumen and political will to proceed with a major strategic change of the kind described earlier. This would involve a package of four policies:

1. Devaluation, to block imports and promote non-oil exports.

2. Trade liberalization, to promote exports by reducing the costs of imported inputs needed to produce those exports, and to enhance competition in the export sector.

3. Decontrol of domestic monopolies, to promote exports by reducing the costs of domestically produced inputs (e.g., decontrol the steel monopoly to reduce the price of steel for motorcycles that are a potential export).

4. Promote mining of non-oil minerals.

Such a package was presented to President Suharto, and he initially rejected three of the four items, accepting only the devaluation. In the struggle over the decision, key figures who pressed too hard for reform lost their jobs. Leading figures in the Indonesian business community and government attributed the decision to pressures on the President from relatives who wish to expand their monopoly profits and from close associates who want to ensure future monopolies of non-oil mining. While the devaluation has useful short-run effects, decreasing imports and enhancing exports, it adds another layer of protection to the protected economy and thereby, if not supplemented with other reforms, worsens the larger problem of the high cost economy.

On the other hand, the country has acknowledged the problem it faces and has made important steps forward. In addition to devaluation, these include two important 1986 packages:

In May, the government announced reforms whose central intent was to provide potential exporters with inputs at world market prices. This has been implemented in spotty fashion, and an array of proposed exceptions would have gutted the reform. But some implementation has proceeded, and the impact has been greatly strengthened by the subsequent package.

In October, the government reduced tariffs, abolished monopolies on 165 items, including some very important ones, provided unlimited swap facilities for banks, and for the first time permitted foreign investors to own up to 95 percent of a new export-oriented company and to purchase shares in existing export-oriented companies. The tariff reduction is less important than the monopoly abolition, since Indonesian tariffs, at an average around 20 percent, are already very low and the primary control mechanisms are quotas and licenses.

These are, even if fully implemented, only a beginning, but, together with the previous reforms, they are a very substantial beginning.

The economic reforms have been accompanied by a far more important political reform, which will strengthen the ability of the government to implement its policies.

The greatest apparent threat to the government has long been Muslim fundamentalism. Its manifestations have ranged from armed guerrilla movements to widespread, unorganized expressions of discontent. Islamic fundamentalism is everywhere a reaction to a sense of inequality and social humiliation, and in Indonesia it is specifically anti-Chinese. These anti-Chinese sentiments quickly turn into denunciations of the privileged Chinese businessmen who are close associates of the President and hence to anti-government demonstrations. Sukarno crushed the threatening Darul Islam movement and instituted a state that proclaimed faith in God but was specifically not an Islamic state.

Under Suharto, there has been a Muslim political party, the Development Party or PPP, which articulated the interests of moderate Muslims in a way that the government felt it could control. (Naturally, PPP activities have been widely supplemented by fiery teachings and other expressions of discontent.) One of Suharto's most cherished goals has been to institutionalize the secular state by requiring all organizations, including the PPP, to organize itself on the basis of the national ideology, Pancasila. This evoked powerful Muslim resentment and, particularly when the country's largest Muslim organization, Nahdatul Ulama (NU), withdrew its support from PPP, seemed to threaten the future of Suharto's carefully constructed system of tame parties.

However, in what amounts to a social revolution, a group of devoted but moderate Muslim leaders, most notably Abdulrahman Wahid of the NU, withdrew the largest and most representative of the Muslim movements from direct involvement in politics, denounced the idea of an Islamic state, rejected the idea of having the government legislate Muslim laws since that would set Muslims against non-Muslims, and promoted the revitalization of Islam as a purely social movement. In support of his goals, he and his associates have rejuvenated the leadership of the Islamic movements with younger leaders who understand the modern world and in most cases have some knowledge of economics.

This made Islam non-threatening to the state. Suharto responded by promoting Muslim generals and police chiefs to top positions for the first time and by allowing thousands of village leaders simultaneously to serve as NU officials.

Because both the Islamic movements and the government have won, the Abdulrahman Wahid revolution has staying power. The NU leader is a

Khomeini in reverse; he has defused the threat of an Islamic collision with the state. This does not completely remove the threat of Islamic fundamentalism; if the government or economy were to break down in some fundamental sense, then some strong cultural reaction would ensue. In a predominantly Muslim society, that reaction would inevitably take the form of Islamic fundamentalism. But, short of such extreme situations, the Abdulrahman Wahid revolution has changed the course of Indonesian history and made the job of governing Indonesia far more manageable. This development is as fundamental to the future of Indonesian society as the deal made at the U.S. Constitutional Convention which allowed the small states and the large ones to coexist.

Overview

Indonesia has so many problems, and now faces such a fundamental choice, that a risk-averse institution must necessarily be wary of the risks over the next few years. At the same time, the record of progress, and especially of structural reform within both the economy and the polity, is so strong, both in the long-term perspective of the past two generations and in short-term perspective of the past year, that it is difficult not to be optimistic about the prospects for the 1990s.

To accommodate the short-term risk, it is appropriate to reduce exposure decisively and to monitor the situation with unusual attentiveness.

To take advantage of the auspicious momentum of development, it is appropriate to seek out strategies that would keep Bankers Trust in position, making money but taking no additional risks.