Growth Collapses in Indonesia: A Comparison of the 1930s and the 1990s

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Introduction

Thanks largely to the work of Pierre van der Eng (1992, 2001, 2002), we now have quite a good picture of trends in growth of real GDP in Indonesia over the twentieth century. There were two periods, each of around three decades when growth was positive in per capita terms[1]. From 1900 to 1930, real GDP grew at 2.7 per cent per annum; if we assume that population grew over this period at around 1.2 per cent per annum, then annual growth in real per capita terms was 1.5 per cent per annum. This implies an increase over a 30-year period in per capita GDP of around 56 per cent. Beginning in 1929, there was a sustained growth collapse which continued through the early 1930s; real per capita GDP in 1934 was only 83 per cent of the 1928 level in 1934 (Table 1). Some recovery occurred in the latter part of the 1930s, and by 1941 per capita GDP had returned to roughly the 1928 level. But the 25 years from 1941 to 1966 were characterised by foreign occupation, revolutionary struggle, and, after 1949, considerable macroeconomic instability culminating in hyper-inflation in the early and mid-1960s. In 1967, per capita GDP was estimated by van der Eng to be only about 75 per cent of the 1928 figure.

The story of the "growth miracle" under Soeharto is very well-known and well documented. Beginning in 1968, the Indonesian economy grew at historically unprecedented rates, and although there was some slackening in the pace of growth in the years from 1982 to 1986, after 1987 Indonesia shared in the growth boom enjoyed by its ASEAN neighbours, Singapore, Malaysia and Thailand. These were the four "high-achieving" ASEAN economies which were compared with Japan, Taiwan, South Korea and Hong Kong in the now notorious "Asian Miracle" report of the World Bank (1993). Indonesian GDP over the entire period from 1967 to 1997 grew at a little over seven per cent per annum. Over the same period population growth was a little over two per cent per annum, so in per capita terms average GDP growth over these three decades was five per cent per annum. In 1997 per capita GDP was thus over four times the 1967 level.

[1] There were certainly shorter periods between 1945 and 1960 when positive growth was achieved. But these growth spurts at best brought per capita GDP back to the levels achieved prior to 1941. See Booth (1998, Chapter 2) and Dick (2001).

Table 1 Index of Trends in Real Per Capita GDP Growth, 1928-37 and 1996-2001

1928	100	1996	96.6
1929	99.6	1997	100
1930	98.4	1998	85.9
1931	92.2	1999	85.6
1932	88.3	2000	88.6
1933	85.4	2001	90
1934	83.0		
1935	83.8		
1936	87.2		
1937	93.2		

Sources: 1928-37: van der Eng (1992); 1996-2001: Bank Indonesia (2000), with additional data from the CBS web page.

At the beginning of July, 1997 the Thai government was forced to float the baht, and the rest is already history. The growth collapse experienced by Indonesia in 1998 was very severe; per capita GDP fell by over 14 per cent (Table 1). This was a much faster decline than that experienced in any one year between 1928 and 1934. But the collapse of the early 1930s dragged out over five years until the trough was reached in 1934, when per capita GDP was only 83 per cent of the 1928 figure. By contrast, recovery after 1998 has been much faster, so that by 2001, per capita GDP had returned to 90 per cent of the 1997 level (Table 1).

In this paper I want to examine in more detail the two Indonesian growth collapses of 1929-34 and 1997-98. In each case, I will look at the causes in terms of both domestic and international factors. I will also compare the policy responses, paying particular attention to exchange rate adjustments, and changes in fiscal policy. For both periods, some comparisons will also be made with neighbouring economies. But first, I want to briefly review the recent literature on growth collapses, which draws on cross-sectional evidence from a large number of economies at different levels of development.

Cross-sectional evidence on growth collapses

In recent years, the empirical literature comparing international growth experience seems to have undergone quite a marked shift in methodological approach. There has been a move away from attempts to break down "sources of growth" into growth of capital stock, the labour force and a residual proxying "technological progress" using the growth accounting approach. This is no doubt related to the intense criticism which such exercises have attracted on both empirical and conceptual grounds, especially when they have been used to explain why different parts of the developing world have experienced such different growth outcomes over the last four decades[2]. Instead we have seen a marked increase in the number of studies which use regression analysis, usually drawing on cross-sectional data from a large number of countries, to explore the factors which facilitate or impede sustained growth of GDP.

One recent such exercise by Rodrik (1999) tries to find reasons for the empirical observation that growth for a large number of developing countries in the years from 1960 to 1975 was a very poor predictor of growth in the same countries in the years from 1975 to 1989, especially when the high-performing East Asian economies were excluded from the sample. According to Rodrik (1999: 387), "the notion that countries can be neatly separated into high-, medium- and low-growth groups over the longer term is an illusion created by sustained high growth in a small sample of mostly East Asian countries". (He might have added that several of these East Asian economies themselves suffered significant growth collapses in the second part of the 1990s). Rodrik found that those economies in Latin America, the Middle East and Africa where growth slowed markedly and even became negative after 1975 were marked by domestic characteristics such as high income and asset inequalities, and high degrees of ethnic and linguistic fragmentation, as well as weak institutions of conflict management, proxied by lack of democratic rights, weak legal systems, few social safety nets etc. When these countries were hit by external shocks, the shocks interacted with latent social conflicts, caused by inequitable income distribution and by ethnic, linguistic and religious divisions, which the weak domestic institutions of conflict management were unable to cope with.

Rodrik's work seems to me to be illuminating precisely because he is trying to explain why growth rates vary over time, and why some countries seem to be able to cope with external shocks better than others. There is a large literature which relates both absolute levels of GDP and growth rates to factors such as linguistic diversity, ethnic fractionalization, and a weak and divided middle class. Some authors have argued that the relationship works via the effects which ethno-linguistic fragmentation has on the accumulation of public goods, including access to education (see Easterly 2001: 319). This literature is certainly relevant to the Indonesian story, but it does not help to explain why in an ethnically fragmented society with a recent history of secessionist rebellion and a very weak and ethnically segemented middle class, the Soeharto government in the late 1960s was able to lay the foundations for three decades of sustained growth.

At the same time, Rodrik's analysis does not really help us explain what seems to me to be the great puzzle of Indonesian growth over the last four decades. Why was Indonesia under Soeharto able to cope quite well with externally

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[2]The World Bank's Asian Miracle report pointed out that there were quite wide variations in TFP growth between the eight high performing Asian economies. Growth in Singapore, Malaysia and Indonesia was "investment driven" while elsewhere it was "productivity driven" (World Bank 1993: 54-60). The Singapore case has had much attention in the literature: Krugman (1994) examines the evidence. For a penetrating critique of the recent growth accounting literature in the Asian context see Felipe (1999).

generated shocks (generated through massive fluctautions in the world price of oil), in the 1970s and the 1980s, and yet, in the latter part of 1997, an apparently quite minor external shock, the decision of a neighbouring country to float its currency, led to a catastrophic growth collapse? Ethnic and linguistic fragmentation can hardly help explain this, as both were more pronounced in the early years of the Soeharto regime, mainly because access to education in the national language was still quite restricted in the 1960s. By 1995, the great majority of children were at least completing the primary cycle, almost 19 per cent of the population over five years of age was using the national language at home and in the workplace, and a further 68 per cent understood and were able to communicate in it[3].

I return to this paradox in the final part of the paper. But first, I look at the experience of the 1930s in more detail.

The 1930s and the 1990s: Similarities and Differences in the Policy Environment

In South East Asia, as in other parts of the world periphery, the economic problems of the 1930s were preceded, and in large measure caused, by problems in the core industrial economies. When the industrial world fell into a severe economic depression in the early 1930s, most parts of Asia, Africa, Latin America and the Caribbean were inevitably affected. The main channel through which the problems in the core industrial economies were transmitted to South East Asia was the price of key export staples. But in addition, as protectionism became more pervasive in the early 1930s, some producers found that they could no longer sell into markets where access was being restricted by quotas and other trade barriers. Indonesia was especially badly hit in this regard because the Netherlands (unlike Britain and France) did not control extensive colonial possessions in other parts of the world, and the domestic Dutch market for tropical products was quite small. Thus Javanese sugar producers lost markets in British colonies after 1930 which they could not replace, and were forced to cut production.

By contrast, the crisis of the 1990s hit several South East Asian economies at a time when the world economy was enjoying a sustained upswing, led by the long boom of the 1990s in the USA. By the latter part of the 1980s, all the major economies of South East Asia except Burma had managed to diversify their exports away from complete reliance on a narrow range of primary products. This was achieved by utilising their abundant reserves of labour to expand exports of a range of labour-intensive manufactures. Over the 1990s, the "high performing" Asian economies including several in South East Asia were very successful in increasing sales of a range of manufactured goods in the markets of the USA, Europe and the more developed countries of East Asia especially Japan. Because of this success, economies such as Thailand, Malaysia, the Philippines, Indonesia and Vietnam were no longer vulnerable to falls in the price of one or two primary products, such as rice, rubber, palm oil or petroleum. Thus the causes of the

[3] Data taken from Central Bureau of Statistics (1996), Table 20.3.

crisis which affected these economies in the latter part of the 1990s must be viewed as "home-grown" with the important caveat, discussed further below, that international capital flows played a highly destabilising role in several economies, including Indonesia, in the latter part of 1997, and 1998.

A second difference between the situation in the 1930s, and the 1990s, was that in the earlier period, most parts of South East Asia were still under colonial domination, and had little autonomy in framing or implementing economic policy. Only Thailand remained nominally independent, but even there the influence of foreign, especially British, economic advisers was considerable. Given the very different economic interests which the diverse colonial powers (Dutch, French, American and British) had in their South East Asian colonies, and given the widely differing nature of the economic links between colony and metropole, it was to be expected that the impact of the 1930s slump, and the policy responses which it provoked, would vary, and this indeed turned out to be the case. By the early 1980s, all the countries of South East Asia were sovereign states, and by the latter part of the 1990s, all were members of the regional grouping known as ASEAN (Association of South East Asian Nations). But that of course hardly meant that they were autonomous economic actors, and indeed one of the most controversial aspects of the crisis of the 1990s was the role played by the Bretton Woods organisations (of which all the ASEAN countries were members), and especially by the International Monetary Fund (IMF). But whatever ones views of the behaviour of the IMF, it could hardly be argued that it had the same *de jure* power over the economies of the region as the metropolitan governments had over their colonies in the 1930s.

But in spite of these apparent differences, there are some similarities in the debates which the two crises have provoked among economists in the Indonesian context. In the years from 1900 to 1930, and again from the early 1960s to 1996, the growth process in Indonesia can be viewed, if not as "export led", certainly as "export facilitated". In both periods governments endeavoured to pursue monetary, fiscal and exchange rate policies which encouraged investment in export-oriented sectors of the economy, by both domestic and foreign investors. Although in both the colonial and the post-colonial eras, government policies often discriminated in favour of particular groups of investors, both domestic and foreign, there can be little doubt that in both periods, governments were strongly committed to the pursuit of economic development as a policy goal, and what Myint (1967) termed "outward-looking" policies were seen as necessary to achieve that goal.

Inevitably in the wake of both crises, there was a re-evaluation in Indonesia of the virtues of economic openness, and debates about the the costs as well as the benefits of growing involvement in the international economy. Since early 1998, debates have taken place about the merits of pegged versus floating exchange rates, an open capital account versus capital controls and more broadly about the desirability of government regulation of both domestic and international trade. As both government and private indebtedness has mounted, there has been a growing awareness of the potential costs as well as the benefits of relying on external borrowing to finance investment expenditures. And as the full implications of the crisis for living standards of different regions and social classes has become more clear, there has been much discussion of the need for "social safety nets" to protect vulnerable groups from sudden and unanticipated macroeconomic downturns.

These debates are examined below. But first, I look at the policy responses to the growth collapse of the early 1930s.

The Growth Collapse of the 1930s: Consequences and Policy Responses

(a)Budgetary Policies By the 1920s, all the economies of South East Asia had developed significant export sectors, relative to national output (Table 2). This export dependence had important budgetary implications in Indonesia as elsewhere; taxes levied on exports and imports accounted for around 14 per cent of total budgetary revenues by the late 1920s (Creutzberg 1976, Table 4). Although the reliance on trade taxes was lower than in Burma or Vietnam (at least in part because of the importance of revenues from government utilities and monopolies), large export and import companies accounted for a considerable part of government revenues from corporate income taxes. Thus when prices of key export staples began to fall, government revenues were affected in several ways. Export tax revenues fell with falling world prices, and as import volume contracted so did revenues from import taxes. The decline in both the volume and value of exports and imports also affected corporate profits and thus revenues from income taxes. Although government expenditures were also reduced after 1929, especially capital expenditures, there was a substantial budget deficit from 1929 through to 1934 (Table 3).

Table 2 Trends in the Export/ GDP Ratio 1901-1938

(percentage)

Year	NEI	Thailand	Philippines	Vietnam	Burma
1901	12	n.a	28 (1902)	19	30
1906	16	n.a	n.a	16	42
1911	17	17 (1913)	n.a	18	41
1916	22	n.a	32 (1918)	18	35
1921	16	n.a	n.a	20	47
1926	26	22 (1929)	n.a	25	36
1931	16	n.a	n.a	14	40
1936	17	n.a	n.a	21	50
1938	17	25	34	22	48

Sources: NEI: export data from Korthals Altes (1991), Table 2B; nominal GDP data given to the author by Pierre van der Eng; Thailand: Sompop (1989: 251); Ingram (1971: 333-5);
Philippines: Hooley (1968); Vietnam: export data from Bassino and Huang (2000), Table 1; nominal GDP data given to the author by Jean-Pascal Bassino; Burma: Aye Hlaing (1964: 111)

Most colonies in South East Asia ran considerable budget deficits in the early 1930s. In both Vietnam and the Netherlands Indies, expenditures exceeded revenues by around fifty per cent in 1932 (Booth 2001: Table 6). This hardly reflected a conversion to Keynesian economics on the part of colonial officials, but rather an inability to reduce expenditures as rapidly as revenues fell, at least in part due to a reluctance to cut civil service pay or reduce numbers of public officials[4]. But the deficits must have had some expansionary impact on the domestic economy, especially in the early 1930s when the contraction of the sugar industry was causing unemployment and reduced purchasing power in Java. But large fiscal deficits were not viewed as sustainable and after 1933 they were reduced, although budgetary expenditures exceeded revenues for the rest of the decade (Table 3).

Table 3 Budget and Balance of Payments Balances, 1913-40,

($ million)

[4] Ironically it was in nominally independent Thailand that fiscal policy was most contractionary in the early 1930s. See Booth (2001a).

Year	Budget Balance	Current Account Balance
1913	-5.34	-2.81
1914	-25.66	9.24
1915	-14.90	74.50
1916	-12.15	41.46
1917	-24.18	24.59
1918	-50.09	-112.44
1919	-64.47	293.73
1920	-107.20	51.56
1921	-86.03	-170.68
1922	-40.04	-6.37
1923	-18.25	93.16
1924	15.18	108.46
1925	27.99	153.82
1926	23.33	61.04
1927	1.24	54.80
1928	-2.69	10.84
1929	-5.72	-55.60
1930	-50.56	-10.44
1931	-57.20	-26.40
1932	-74.64	-16.80
1933	-79.12	-14.71
1934	-81.14	24.83
1935	-46.28	17.57
1936	-36.28	58.97
1937	-19.40	87.36
1938	-29.67	-31.87
1939	-49.25	45.46

Sources: Creutzberg (1976); van Laanen (1980); Korthals Altes (1987)

(b) Exchange Rate Adjustments One of the main considerations which governed fiscal policy everywhere in South East Asia over the 1930s was the need to maintain exchange rate parities in terms of the metropolitan currency. In 1930, when the Indo-china piastre was given an exact value in gold equal to ten times that of the French franc, all the currencies in South East Asia were briefly on the gold standard[5]. Over the early part of the 1930s, the various South East Asian colonies followed their metropolitan masters in deciding to abandon, or stay with, the gold standard. Thus the British colonies left with sterling in September 1931, while the Netherlands Indies and Indochina stayed on gold with the Netherlands and France until 1936. The very different movements in exchange rates across the region after 1930 led to considerable nominal appreciations for the both guilder and the piastre relative to the sterling based currencies and to the Philippines peso, which was pegged to the US dollar. The Indonesian guilder underwent a sharp appreciation against the dollar until 1936 when the Netherlands finally decided to go off the gold standard.

All the currencies in South East Asia experienced some appreciation against the Japanese yen, which was an important reason for the rapid growth in Japanese exports into most parts of the region in the early 1930s[6]. By 1935, the yen had lost more than half its value against the various South East Asian currencies; the nominal devaluation was especially steep against the Indies guilder, and the Indochina piastre. There was a sharp deflation in Indonesia during the years from 1929 to 1936; by 1936 the cost of living for low income indigenous families in Batavia (Jakarta) was only half what it had been in 1929 (Booth 2000, Table 4.5). But given the magnitude of the nominal appreciation, the deflation was insufficient to restore the real value of the guilder against the yen (Booth 1994: Table 6.8). Between 1930 and 1934, Japanese exports to Indonesia more than doubled in terms of nominal yen, and amounted to almost 14 per cent of all Japanese exports to Asia (outside its own colonies)(Booth 2000: Table 14.3). Although some employers in Indonesia welcomed the availability of cheap wage goods, the flood of Japanese imports seriously alarmed the Dutch authorities and in 1934 they took action.

(c) Protecting Producers of Traded Goods By the 1920s, there were already considerable differences across South East Asia in trade regimes and in structures of protection (Booth 2001). The discriminatory trade regimes imposed by both the USA and France on their South East Asian colonies can be contrasted with the more liberal approach of the Dutch. Not only was there virtually no tariff or non-tariff discrimination against imports into Indonesia from any source after the reforms of the 1860s and 1870s, but there was also an open capital account facilitating the inflow of capital and the repatriation of profits. Although both specific and ad valorem import taxes were levied, both Dutch and foreign commentators emphasised that tariffs were purely for revenue purposes, and the idea of protection was totally foreign (Paulus 1909: 124; Fowler 1923: 399; Kuitenbrouwer 1991: 67). But in spite of the apparently non-discriminatory trade regime, the Netherlands continued to account for a much greater share of imports into the Indies than its share of total world trade would have justified. In the early 1930s, the Dutch share of imports into the Netherlands Indies was still almost eight times its share of world exports (Booth 2001: Table 8). It is likely that various forms of subtle discrimination against British and other importers persisted after 1870 through the dominance of Dutch

[5] See Bassino and Nakagawa (2000: 11-13) for a discussion of the debate surrounding the decision to put the piastre on the gold standard.

[6] The yen hadleft the gold standard in December 1931, after the Japanese had lost 675 million yen in gold in a vain attempt to defeat speculators, and thereafter depreciated rapidly against both the dollar and sterling, and the other currencies pegged to them (Kindleberger 1987: 163-4).

trading houses in the export-import sector, and of course through a Dutch commercial and legal system which would have advantaged Dutch merchants.

By 1934, all the European colonial powers in South East Asia were disturbed by the expansion of Japanese imports and Indonesia, together with British Malaya and the Philippines had all imposed tariff and quota restrictions on Japanese imports, with particular emphasis on curbing textile and garment imports from Japan in favour of metropolitan producers. This policy was not universally welcomed; large estate companies in both Malaysia and Indonesia wanted to maintain a flow of cheap imported wage goods in order to keep wage costs down, and did not much care where they came from[7]. In British Malaya, local businesspeople were opposed to any departure from free trade principles but the British administration turned down their objections in favour of imperial preference, which in effect meant taxing the Asian consumer in order to "aid Lancashire merchants and manufacturers who could no longer compete successfully with their rivals" (Emerson 1937: 369).

In Indonesia, trade restrictions took two forms. On the one hand trading links between the colony and the Netherlands were strengthened by policies designed to reserve a large share of the Dutch domestic market for imports of sugar, corn and vegetable oils. The policy of allowing colonial imports preferential access was intended to compensate Indonesia for the second set of protectionist policies which involved imposing quotas on imports into Indonesia. Some goods were subject to general quotas which allowed importers in the colony to purchase from the cheapest source (usually Japan) while other goods were subject to specific country quotas. Typically cheap wage goods were subject to general quotas, while superior textile products and more expensive household goods were subject to specific country quotas. The purpose of this system was to reserve a share of the colonial market for goods from the Netherlands and to a lesser extent other European producers (van Gelderen 1939: Chapter 3). While the protection introduced after 1934 was successful in reducing the Japanese share of total imports into Indonesia, it did not reduce their absolute value, which peaked in 1937, and fell only slightly thereafter (Booth 2000, Table 14.3 and Figure 14.6).

(d) Balance of Payments Trends and Government Debt After a decade when it was almost always in surplus, the balance of payments in Indonesia swung into deficit in 1929 (Table 3). The deficits were not large relative to GDP, and a current account surplus had emerged again by 1934. It is clear from Table 3 that only in one year (1929) was the deficit on the balance of payments larger than the budget deficit. Between 1934 and 1939, the balance of payments was in deficit for only one year (1938). It is thus clear that in most years over the 1930s, private sector savings in the domestic economy must have exceeded private investment, usually by a considerable margin[8]. It is probable that the real appreciation of the colonial guilder which took place in the early 1930s, together with the growth of world protectionism, deterred new investment in traded goods sectors.

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[7] See Brown (2000) for a discussion of the situation in British Malaya.
[8] This follows from the identity: X-M = (T-G) + (S-I)

Even after the metropolitan and colonial currencies were devalued in 1936, the investment climate remained uncertain, in part because of fears over Japanese expansion in the region, but also because by the latter part of the 1930s there were more profitable and less risky opportunities for investors from the Netherlands and elsewhere in other parts of the world. In the latter part of the decade the Dutch colonial authorities did succeed in attracting new investment into manufacturing industry in the Indies, but the amounts were not sufficient to send the current account back into deficit except for one year. In their analysis of exchange rate movements and economic recovery in the 1930s in Europe, Eichengreen and Sachs (1985) point out that those economies which devalued early, especially the UK and the Scandanavian countries, had faster rates of industrial growth up to 1935 than those which stayed on gold, including France and the Netherlands. It is likely that if the French and Dutch colonies in Asia had been able to devalue in 1930 or 1931, they would both have experienced faster growth and higher rates of investment over the rest of the decade than in fact turned out to be the case.

The continued large budget deficits through much of the inter-war period led to a sharp increase in the size of the government debt. By 1933, debt servicing charges accounted for twenty per cent of export revenues and 21 per cent of total budgetary expenditures (Table 4). These percentages fell by the end of the 1930s but were still higher than they had been prior to 1929.

(e) Regulation of export and import trade The crisis of the 1930s did not just lead to regulation of imports by individual governments through tariffs and quotas. In addition governments throughout South East Asia had to comply with a range of international commodity agreements for rubber, tin, quinine, kapok, tea, and sugar. For a number of these commodities, partial or voluntary agreements had been in place prior to 1930, but the severity of the world crisis of the 1930s was such that the agreements became more comprehensive in terms of coverage, and more binding on individual producing nations. This in turn involved the regulation by national governments not just of large producers such as estates, but also of millions of smalholders, scattered across huge distances. In Indonesia, the government faced the herculean task of trying to regulate production of millions of smallholder producers of export crops. An attempt to curb smallholder production of rubber by an export tax provoked substantial unrest and was replaced by a complex scheme of individual licenses (van Gelderen 1939: 51-58). The impact of these licenses on output and producer incomes varied greatly by crop and location, but for several crops they appear to have reduced output by the large estates relative to that of smallholders. By the latter part of the 1930s, smallholder rubber production was only slightly lower that of the estates, and smallholder coffee production exceeded that of the estates sector (Creutzberg 1975, Tables 10 and 12)[9].

[9] In the latter part of the 1930s, attempts were also made to regulate the domestic rice trade, and to foster labour intensive manufacturing. In 1937, a regulation board was established with wide powers to regulate production and trade across the entire range of industrial activity (Booth 1998: 156-7).

Table 4 Trends in Public Debt Interest Payments as a Percentage of Exports Earnings and Government Expenditures, 1911-2000

Year	Public Debt Payments as a Percentage of:	
	Exports[a]	Total Public Expenditures
1911	0.8	1.8
1914	0.8	1.7
1919	1.1	3.6
1923	5.7	11.9
1928	6.2	13.1
1933	20.0	20.8
1938	11.0	14.6
1980	5.4	6.7
1986	25.3	23.1
1990	25.3	27.1
1996	4.8	8.0
1998	4.8	19.0
2000	3.7	23.8

a After 1980, the figures refer to foreign debt service charges as a percentage of total exports of goods and services as shown in the national accounts.

Sources: 1911-38: Booth (1998), Table 4.4; 1980-2000: Bank Indonesia (2000), Table 32, Bank Indonesia, *Indonesian Financial Statistics* various issues.

The 1930s: A Summing Up

Given the magnitude of the problems in the world economy in the early 1930s, it was inevitable that an open economy such as Indonesia would be adversely affected by falling commodity prices and by growing world protectionism. In contrast to the Philippines where sugar producers were given preferential access to the American market, the Netherlands government was hardly in a position of offer such asssitance to the Javanese sugar industry. There can be little doubt that the contraction of the sugar industry in Java had a serious effect on employment, even if the land was returned to smallholder cultivation of foodcrops. Similarly, falling prices and contracting markets seriously affected incomes of both workers on the large estates and smallholder producers. Polak (1943: 81-3) has argued that the sharp decline in real income accruing to indigenous Indonesians outside Java after 1928 was entirely due to their involvement in export crop production. While the policy of running large budget deficits through the 1930s certainly would have helped to mitigate the impact of the crisis on the domestic economy, it is probable that the effect was felt more strongly on Java, where the "bureaucratic infrastructure" was concentrated, compared with Sumatra, Kalimantan or Eastern Indonesia.

But on the other hand the decision to keep the guilder on the gold standard was obviously damaging to traded goods producers in Indonesia. In spite of the severe deflation which occurred in the early part of the 1930s, there was a significant real appreciation of the Indies guilder against both sterling and the dollar, and an even faster appreciation against the yen. This must have adversely affected the domestic investment climate and been an important reason for the persistent tendency for private sector savings to exceed investment over the 1930s.

The Causes of the post-1997 Growth Collapse

We now take a leap in time to the latter part of the 1990s. Indonesia along with Thailand, Malaysia and Singapore had been enjoying historically unprecedented growth rates for three decades, and by the early 1990s even the Philippines was achieving respectable growth rates after a decade of stagnation. Vietnam was adopting more outward looking policies and growth was also accelerating there. To many observers in the multilateral organisations and in South East Asia itself, the rapid growth looked set to continue. The following extract from a World Bank report typifies the breezy optimism of the mid-1990s:

> Although looking into the future is always a risky business, some things are likely to be good bets. Rapid growth is likely to continue in East Asia, and the pace of change experienced by these economies should continue to be very impressive. East Asian economies are committed to an open and cooperative approach in the evolution of economic relations among themselves and with the rest of the world, and will use market-based and competitive means to achieve their goals (World Bank 1996: 126).

But by the latter part of 1996, these views began to be tempered with a growing concern about economic trends in several South East Asian countries. In what turned out to be a startlingly prescient article, the **Economist** of August 24, 1996 drew parallels between the Mexican economy in the run up to the crisis of late 1994, and emerging trends in

Thailand, Malaysia, Indonesia and the Philippines[10]. The concern was most pronounced over trends in Thailand, because in that economy the high balance of payments deficit relative to GDP was accompanied by a number of other worrying developments. After over a decade of very rapid export growth in Thailand, in 1996 commodity export earnings hardly grew at all, and earnings growth from invisibles such as tourism also slowed. There were several reasons for the slowdown; one was the appreciation of the baht against other regional currencies induced by the policy of pegging the baht to the US dollar. Another was the sharp increase in real wages which had occurred since the early 1990s. This together with a severe shortage of skilled and semi -skilled workers, due in turn to government neglect of the post-primary education system, induced many manufacturers to re-locate their plants to other parts of the region where unskilled labour was cheaper (such as China, Vietnam or Bangladesh) or where skilled workers were more readily available (Hong Kong, Singapore or Malaysia). There was also concern about over-supply in the commercial and residential property market, especially in Bangkok, and the impact which the bursting of the real estate bubble might have on the Thai financial system.

In other parts of the region, there appeared to be less cause for concern, at least on the economic front. The Philippine economic recovery under President Ramos was attributed to the "significant reforms of the real side of the economy in the 1980s" which were aimed at equalizing incentives across different sectors of the economy (Noland 2000). In addition in 1993-5 the Ramos administration was able to implement a number of reforms which increased the efficiency of the financial sector. In both Indonesia and Malaysia, the economic boom which had begun in the latter part of the 1980s showed few signs of slowing down. Although the political situation in Indonesia was attracting some negative comment by early 1997, with a number of anti-Chinese and anti-Christian riots in various parts of Java and serious disturbances in West Kalimantan, there was still considerable confidence in the strength of the Indonesian economy. Solomons (1997: 56) argued that "sound economic fundamentals" meant that the Indonesian economy continued to grow at a solid pace in spite of the political storm-clouds. He stressed the strong economic growth in 1996 (GDP growing by almost eight per cent), a "manageable balance of payments deficit of around four per cent of GDP", declining inflation (6.5 per cent per annum in 1996), strong investor confidence, symbolised by high levels of inward foreign investment, and an apparent determination on the part of President Soeharto to limit the growth of government expenditure. All these economic signals, according to Solomons, "have set investors alight". Kenward (1999: 73) writing well after the effects of the crisis were obvious in Indonesia, concurred that before July 1997, "virtually all of the broadest macro indicators were very reassuring". Other authors however have pointed to indicators of problems in the financial sector which should have been taken more seriously including the extent of "connected lending" by domestic banks, the high exposure to the real estate sector and the rapid growth in short-term lending abroad by several of the large conglomerates (Reisen 1998; see also Cole and Slade 1998).

[10] **The Economist**, August 24, 1996, pp. 67-8. The article drew especially on the work of Morris Goldstein at the Institute for International Economics in Washington. Goldstein (1998) discusses further which early warning indicators are most likely to predict financial crises.

But these analyses were to come later. In mid-1997, Solomons's views were widely shared in the Asian region, and as Thailand's problems became more obvious and more widely discussed, there appeared to be widespread agreement that "Thailand's maladies are painful, but probably not contagious"[11]. What then went wrong in Indonesia in the latter part of 1997? There seems to be little doubt that the key problem was a collapse of confidence on the part of both the domestic and foreign business communities in the ability of Soeharto and his key advisers to take decisions in the national interest. After the decision was taken to allow the rupiah to float freely in August 1997, purchases of dollars increased rapidly, driving the value of the rupiah downwards, and increasing the sense of panic. The decision to close sixteen banks in November 1997 led to a run on a number of small domestic banks as worried customers withdrew their money and either deposited it in "safe banks" (often branches of foreign banks) or converted it into foreign currency[12]. Many large businesses including those controlled by the Soeharto family were also sending large amounts out of the country in the latter part of 1997. Although Soeharto sought advice from several of the technocrats who had played an important role in the earlier years of his rule, there was a pervasive feeling that, as the crisis deepened, he was really only interested in protecting the interests of his family and their business associates.

Clearly there were other, more deep-seated reasons for the collapse of confidence and the consequential capital flight which occurred in Indonesia in the latter part of 1997, which I cannot explore further here[13]. What is obvious is that during 1998, the capital flight and collapse of the rupiah had very serious effects on the real economy. The contraction in real per capita GDP in 1998 was more severe than in any other part of the ASEAN region, and the recovery slower. The construction and financial sectors were especially severely hit, although all sectors of the economy except crop agriculture and utilities contracted in absolute terms (Bank Indonesia 2000, Table 2). The real decline in output was reflected on the expenditure side by a massive contraction of 33 per cent in investment expenditures. The contraction in private consumption expenditure was much less (6.2 per cent).

The 1998 Growth Collapse: Consequences and Policy Responses

(a) Floating the Exchange Rate One of the most obvious differences between the early 1930s and the latter part of the 1990s is in exchange rate management. Not only was the colonial guilder pegged to the metropolitan guilder in the 1930s, but both stayed on the gold standard until 1936. In August 1997, the Indonesian government decided to allow

[11] "Let This be a Lesson", **Far Eastern Economic Review**, June 12, 1997, p. 71.
[12] The International Monetary Fund has been blamed by some observers such as Jeffrey Sachs for casuing the panic by insisting on the clsoure of the sixteen banks. My own view is that even if the banks (most of which were known to be insolvent) had not been closed the run on the smaller domestic banks would have taken place anyway. In addition at least one of the banks which was closed was partly owned by one of Soeharto's sons and any attempt to keep it open would have looked like favouritism. In fact the bank was re-opened later under another name which further weakened confidence in the domestic banking system.
[13] Booth (2001b) discusses the reasons for the Indonesian collapse in more detail. In this paper I argue that changing public tolerance for corruption on the part of senior political figures and their families was a key reason for the collapse of confidence in the latter part of 1997.

the rupiah to float freely; by December of that year the rupiah's value had plunged to almost 5000 to the dollar, compared with 2500 to the dollar in July[14]. In late January 1998 as confidence in the ability of the Soeharto administration to manage the crisis further deteriorated, the rupiah briefly reached 17,000 to the dollar. After the departure of Soeharto, there was a gradual recovery and after the successful parliamentary elections in 1999, and the subsequent presidential elections, the rupiah recovered to around 7000 to the dollar in November 1999. But as confidence in the administration of President Wahid waned through 2000, the rupiah began to slide again, reaching 11,3000 to the dollar in June 2001. After President Wahid was ousted in favour of his vice-president, Megawati, later in 2001, the rupiah staged another recovery. But by early 2002, as doubts mounted about the capacity of the "dream team" of economics ministers appointed by Megawati to tackle the nation's economic ills, the rupiah was trading at around 10,500 to the dollar.

This roller coaster ride obviously reflected changing perceptions about Indonesia's economic prospects on the part of both domestic and foreign investors. In 1998 and 1999, net private capital flows to Indonesia were negative (i.e. more private funds were leaving the country than were coming in). In 1999, net outflows amounted to $8.9 billion (Asian Development Bank 2001: 80). Most observers agree that until there is a dramatic improvement in the investment climate in Indonesia, inward investment flows will remain small, and the rupiah weak. The weak and fluctuating rupiah in turn will add to investor uncertainty. By the end of 2001, there was little evidence that the billions of dollars which Indonesian residents had remitted abroad in 1997/98 were returning, and foreign investors showed little enthusiasm for initiating new projects. In addition, the weak rupiah was posing considerable problems for budgetary management.

On the other hand, the substantial real devaluation of the rupiah which took place between 1997 and 2000 did have a positive effect on the traded goods sectors of the economy, as would be expected. Non-oil export volume increased quite sharply; Rosner (2000: 85) has estimated that the volume increase between the second quarter of 1997 and the second quarter of 1999 was 24 per cent. The manufacturing sector showed the strongest growth. But because of the steep decline in prices, export value in dollar terms did not show much increase between 1997 and 1999. In the first semester of 2000, there was a marked increase in the dollar value of exports compared with the previous year (Bird 2001, Figure 4.5). Unfortunately this was not sustained into 2001, because of both falling world demand for Indonesian exports, and adverse trends in prices. Nevertheless the export volume growth achieved between 1997 and 2000 did indicate that in spite of trade finance problems, weak world demand and ongoing domestic political uncertainty, Indonesian exporters were successfully taking advantage of the boost in competitiveness from the large real devaluation of the rupiah.

[14] These figures refer to monthly averages; there were also considerable fluctuations within each month, especially in late 1997 and early 1998. Before July 1997, Indonesia's system of exchange rate management approximated to a crawling peg regime; see Williamson (1999) for more detail.

(**b) Balance of Payments Outturns** After 1929, both the balance of payments and the government budget swung into deficit. In contrast, after 1997 the balance of payments turned positive (Table 5). Given that the budget was in deficit, this meant that there was a large imbalance between private sector savings and investment which was remitted abroad; this indeed is confirmed by the data on private capital outflows. The main reason for the large current account surplus after 1997 is that private sector investment has slumped and this is reflected in a sharp drop in imports. According to the national accounts data, imports in real terms in 1999 were only 56 per cent of 1997 levels. There was some recovery in 2000 but in real terms imports were still well below 1997 levels, as indeed was investment.

Table 5 Budget and Balance of Payments Balances, 1990 -2000

($ billion)

Year	Budget Balance	Balance of Payments
1990	-0.97	-2.99
1991	-0.92	-4.26
1992	-1.57	-2.78
1993	-0.82	-2.11
1994	1.76	-2.79
1995	4.48	-6.43
1996	2.31	-7.66
1997	1.02	-5.10
1998	-1.62	4.10
1999	-3.98	5.78
2000	-1.78	7.83

Sources: Asian Development Bank (2001).

Comparing Tables 3 and 5, it seems legitimate to conclude that the private investment climate after the growth collapse of 1998 is even more pessimistic than was the case in the early 1930s. Even if many exporters did take advantage of the devaluation to boost export volume, it would appear that they did so using existing capacity. The import and investment collapse of 1998-9 indicated that few producers were sufficiently confident about either export or domestic market trends to expand capacity. Until now there is little evidence that the investment climate has improved. In this sense the medium term effects of the 1998 growth collapse may be more severe than was the case in the 1930s, especially if the recession in the USA and Japan is prolonged and recovery slower than is currently forecast.

(c) Fiscal Policy and the Growth in Public Debt As was the case in the early 1930s, the Indonesian budget post-1997 has been in deficit, although the deficits until 2001 did not exceed four per cent of GDP and are projected to decline, relative to GDP, in 2002 (Siregar 2002, Table 2). The deficits do not reflect a failure of domestic revenue policy; in fact non-oil domestic revenues have risen relative to GDP since 1997. Rather the deficits result from the sharp increase in routine expenditures, especially on two items: subsidies on the domestic price of petroleum products and interest payments. In 2000, interest payments on domestic and foreign debt amounted to almost 24 per cent of total budgetary expenditure compared with eight per cent in 1996 (Table 4). In 2001, preliminary budget outturns indicate that debt service charges increased to over 26 per cent of budgetary expenditures, and six per cent of GDP (Siregar 2002, Table 2). Interest payments and subsidies together accounted for over 45 per cent of all budgetary expenditures in 2001. Government expenditures on "development" in 2001 were reduced to 13 per cent of total expenditures, and only three per cent of GDP. Both these ratios were much lower than in the last phase of the Soeharto era.

There trends have caused great concern to both Indonesian policy makers and to foreign observers. But there are historical precedents. There was a similar sharp decline in government expenditures on development, and on capital works in the early 1930s; a comparative sudy showed that in 1931, only seven per cent of total ordinary budgetary expenditures in Indonesia were devoted to public works and the development of agriculture and commerce, compared with 18 per cent in the Philippines and 28 per cent in the Federated Malay States (Schwulst 1931: 57). The estimates prepared by Creutzberg (1977, Table 1) confirm that there was also a steep decline in expenditures on fixed assets, by both government and the corporate sector after 1930. And in the latter part of the 1980s, the government was forced to curtail development expenditures in order to accommodate the steep increase in foreign debt service charges, which was a consequence of the rupiah devaluation of 1986 (Table 4). The proportion of export earnings devoted to foreign debt service charges was in fact much higher in both the early 1930s and the latter part of the 1980s than in the post-1997 period (Tabel 4).

(d) The Social Safety Net Programme As concern about the effects of the crisis on living standards mounted in the second part of 1998, the Indonesian government with support from several multilateral and bilateral donors, launched an ambitious set of programmes intended to provide "social safety nets" *(jaring pengaman sosial)*. This term was new to the vocabulary of the Indonesian development discourse, as indeed were most of the programmes. Rather than build on existing programmes, the government decided to launch new initiatives. Given that fears of famine were widespread in the first part of 1998, food security programmes were an important part of the new social safety net programmes, especially the OPK *(operasi pasar khusus)* or special market operations which injected low quality, mainly imported rice into key markets across the country at a subsidised price (Rp 1,000 per kilo, or about ten US cents at the exchange rate prevailing in the latter part of 1998). Each eligible household was permitted to purchase 20kg at this price per month; since the programe began the criteria for eligibility were widened, and by mid-1999 250,000 tons of rice were still being sold at the subsidised price, even though most authorities agreed that the danger of widespread famine had passed[15].

Monitoring the impact of such a policy is obviously difficult, but an analysis of the 100 village survey carried out by SMERU indicated that, in at least some *kabupaten*, there was clear evidence that poor households had benefited from the programme, although plenty of non-poor households were also obtaining subsidised food (Suryahadi, Suharso and Sumarto 1999: 7-9). In August 1999, the Minister of Food and Horticulture, A.M. Saefudin was quoted in the press as saying that 17.5 million families still could not afford to eat twice a day[16]. He also stated that 350,000 tons of rice was in stock but only 250,000 tons could actually be distributed each month at the subsidised price. This implied that if each family took the full 20kg, then only about 12.5 million families were benefiting from the cheap rice, or only about 70 per cent of those households who were only able to eat once a day[17].

The school scholarship and block grant programmes appeared by late 1999 to have been reasonably successful in reaching poor families although the SMERU study found that the effectiveness of the targeting varied considerably by region (Suryahadi, Suharso and Sumarto 1999: Tables 5a and 5b). Although every *kabupaten* in the country received an allocation of both block grants and scholarships, the amount varied according to the "*kabupaten* poverty index". Allocation to *kecamatan* and individual schools was carried out by both the education authorities and non-government organisations, while within the school, scholarship recipients were selected by school committees of parents and teachers[18]. In the 1998/99 school year, amost four million scholarships were granted, and 131,975 block grants allocated[19]. Although comprehensive guidelines were produced on scholarship allocation, it was far from clear in 1998/99 to what extent they were being followed, and if so, what criteria local officials and parent-teacher groups were using to identify the most needy housholds. Certainly further analysis of the programme will be needed before any firm conclusions about its efficacy can be drawn.

Of the other social safety net programmes, the most ambitious and also the most highly criticised have been the employment creation schemes. It appears that, rather than expand existing INPRES (regional development) programmes, a decision was made to direct funds towards new programmes designed to create new jobs for workers in urban areas (where it was assumed millions would become unemployed) and rural areas which were especially affected

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15 A critical assessment of the use of food aid in late 1998 and early 1999 is given in Li Kheng Poh et al. (1999). This report argues that the cheap rice programme was targeted to cities and particular provinces as a means of "pacification" and to consolidate political support in the run-up to the 1999 parliamentary elections.

16 *Jakarta Post*, 21/8/99

17 Further analysis of the targeting of the cheap rice programme is given in Sumarto, Suryahadi and Pritchett (2000). They found that the sales were targeted to the "permanently poor" rather than to those households which had fallen into poverty after 1997.

18 A *kabupaten* is the level of government below the province; the *kecamatan* is the level of government between the *kabupaten* and the village.

19 Figures from officials in the Department of Education and Culture, September 1999.

by drought and harvest failure[20]. The urban programmes were much criticised and seem to have largely failed in their objectives; fewer workers became unemployed than was originally envisaged and many of those that did appear to have made their own arrangements for finding alternative employment. In addition it appears that several of the urban-based programmes paid above-market wages; had lower wages been paid more jobs could have been created, and they would have been better targeted to the very poor (Cameron 1999: 28). In rural areas, the *Kecamatan* Development Programme and the Village Infrastructure Programme were slow to get under way, at least partly because of donor demands regarding their implementation, although in some districts poorer households did benefit from some employment creation schemes[21].

Policy Debates in the Wake of the 1998 Growth Collapse

I pointed out above that it is very difficult to explain why the growth collapse occurred in Indonesia in 1998 after three decades of sustained growth. Over these three decades, the government had successfully weathered far more serious external shocks than the decision by the Thai authorities to float the baht in early July, 1997. I have suggested that changing tolerance for corruption on the part of a large segment of the population (especially the educated young) was one important reason for the rapid decline in public confidence in late 1997. But that of course begs deeper questions about why the Indonesian government was not more aware of these changes in public attitudes. I believe that the answer lies in the ossification of structures of government which occurred in the last phase of the Soeharto era.

Dick (2001: 214) has recently pointed out that "the tragedy of both the late colonial period and the New Order is that political and institutional development were not tackled while there was the opportunity and resources to do so" In both periods, the leadership was concerned with conserving the privileges of a narrowly based governing elite, and simply did not grasp the fact that broader political participation would be essential for sustained economic development. This failure was particularly unfortunate in the case of Suharto because (unlike the Dutch) he did undertand the importance of educational development for longer term economic development. It was indeed the beneficiaries of the educational expansion of the Soeharto era who finally brought him down. For the first time in its history, Indonesia now has many millions of citizens who are not only literate but who have enough wordly experience to make informed judgements about their country's longer term needs and aspirations. What is now needed is a political leadership who can harness these citizens to the goals of national development

[20] INPRES is an acronym for *Instruksi Presiden* (Presidential Instruction). The term is used to embrace a number of labour intensive public works programmes which were initiated between 1969 and 1975.

[21] Sumarto, Suryahadi and Pritchett (2000: 26) found that participants in the employment programmes were more likley to be from households which had experienced changes in income, rather than from permanently poor households. They also argued that the employment programmes were much less cost-effective than the cheap rice programmes, in terms of costs per dollar of benefit to the recipients.

Although there has been much discussion of economic issues in the Indonesian media since 1997, there has been surprisingly few challenges to the policies adopted by the government by parliamentarians, or by other political activists outside the main parties. Alternatives to policies such as the continual float of the rupiah and the open capital account have not been widely canvassed, in spite of the apparent success of the Malaysian policies of pegging the ringgit and controlling capital movements. For a few weeks in early 1998 it appeared that the Soeharto government was toying with the idea of introducing a currency board; to most informed observers this was little more than a cynical attempt by his family to move more assets abroad at a favourable exchange rate. Since then there has not been much support even for a returned to a managed float, let alone a hard peg to the dollar, or to any other currency. Neither has there been any serious discussion of capital controls. Most informed commentators feel that they would be unworkable, as indeed they proved in the early post-independence years, and would simply lead to more bureaucratic corruption.

Many debates about policy reform in Indonesia since May 1998 have tended to focus on non-economic issues such as corruption in the judiciary and amendments to the bankruptcy laws. More broadly there is a growing appreciation of the need for institutional development in its widest sense rather than more economic reforms, desirable though they may be. At the same time, many Indonesians still do not seem to realise that a great deal of rather messy political wrangling will be necessary before any real national consensus can emerge about appropriate changes in the institutions of government. Those who deplore the fact the the parliament is a "kindergarten" (to quote former President Wahid) and that many politicians are obviously venal and self-serving must realise that it will take time for parliamentary democracy to take root in the Indonesian context, and that fundamental constitutional change may be an essential pre-requisite for this to happen[22]. A return to some form of repressive regime might in the short-run accelerate economic reform (although that is far from certain in the current international climate) but it would also postpone for even longer the institutional development which is crucial for sustained economic growth. Over the next few years, Indonesia has little option but to struggle with the twin challenges of economic and political reform.

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[22] See Lindsey (2001) for a discussion of the state of the judiciary in post-Soeharto Indonesia and the need for constitutional reform. For a thoughtful analysis of the challenges confronting Thailand as it tried to manage its macroeconomy through a process of democratisation see Siamwalla (1997).

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