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TRADE AND INDUSTRIAL POLICIES IN INDONESIA SINCE THE 1980s */

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Abstract

This document analyzes the past and present trade and industrial policies of Indonesia and their future evolution under the legal framework of the new world trading system. It tries to extract from its experience the essence of the appropriate role of the State in industrial an trade development and to identify its new role and available instruments, in conformity with the post-Uruguay Round trade regime.

This paper is divided in six chapters. After a brief introduction, Chapter I reviews economic performance of the country during the past three decades. Chapter II examines the country's industrial and trade policies for the period covering up to the conclusion of the Uruguay Round in December 1993 and beyond. Chapter III analyzes the range of future trade and industrial policies under the constraints of the new international trading system. Chapter IV identifies policy instruments that can be still sought and implemented by the Indonesia to enhance "endogenous" capabilities to develop under the GATT/WTO agreements and discusses the present institutions of industrial and trade policy making. Chapter V analyzes macroeconomic policies to support industrial and trade policies in Indonesia. The main conclusions of the paper are presented in the last section.

INTRODUCTION

The broad-based economic reform which has been adopted since the mid 1980s has changed development strategy of Indonesia from public sector led and import substitution industrialization (ISI) policy, with financial repression, to market-based policy led by private sector initiatives and export-oriented industrialization (EOI). The EOI strategy, as generally accepted among the neoclassical economists, is superior to that of ISI. The reason is because the EOI strategy enlarges market size and reduces fixed cost of industrialization, increases division of labor and access to foreign technologies and raises the tempo of market competition. As the openness to international markets exposes domestic producers to world prices for their inputs and products, the EOI strategy ensures efficient allocation of resources according to a country's comparative advantage (Bhagwati, 1990) and promotes both growth and more equitable distribution of income and wealth.

The impetus of economic adjustment was the world recession of 1981-83 which depressed the prices of Indonesia's export commodities, including oil and natural gas. The economy suffered particularly from the end of the oil boom as nearly a quarter of Indonesia's GDP, over four-fifth of the country's export revenues and over two-third of government tax revenue at that time were generated from oil and natural gas. The stagnant investment and growth and sharp decline in both exports and government revenues forced the country to reevaluate its development strategy. In the beginning, during 1982-1985, the government mainly used discretionary measures to repress domestic expenditures in order to improve external creditworthiness and the current account of the balance of payments in the short-run. As expected, these policies caused severe distortions in the incentive system with significant losses in non-oil exports and economic growth not necessarily accompanied by benefits in terms of equity.

Soon it became apparent that the short-run stabilization program alone would be insufficient to restore long-term growth. With the objective of getting prices right, the government changed its strategy in late 1986 by complementing the short-run stabilization program with broad-based structural reforms, covering both the supply and demand sides of the economy. As shown in Table 1, the reform in Indonesia covers nearly all sectors of the economy: the financial sector, the tax system, trade policy, investment policy, labor market, transport regulations and administrative reforms to reduce transaction costs. The adjustment program seeks to achieve both pro-growth and pro-equity objectives, by raising production and domestic savings at relatively stable prices, by improving resource allocation through a more efficient market system, and by generating a current account position consistent with the external resource flows. The reforms gradually reversed the *dirigiste* policies by eliminating distortions, correcting the export biased policy, courting FDI(Foreign Direct Investment), easing cross-border movements of goods and services, capital and labor. The pace of the reforms has been speeded up in order to meet Indonesia's commitments to regional and international arrangements. Indonesia is a founding member of AFTA-ASEAN Free Trade Area, APEC (Asia-Pacific Economic Cooperation) and the Uruguay Round/WTO. As it is well known, the Uruguay Round enlarged coverage of the negotiations from the traditional trade in goods to also include trade in services. The term "trade in services" applies to international transactions involving a wide range of fields such as distribution, tourism, banking, insurance, transport, telecommunications, construction and consulting engineering.

Table 1

CHRONOLOGY OF THE ADJUSTMENT PROGRAMME, 1983-1995

Policy Instrument	
Exchange Rate	1. Rupiah was devalued by 28 % against US dollar on March 30, 1983 from Rp. 703 to Rp. 907 per US dollar; since then the exchange rate has been made more flexible. 2. Rupiah was devalued by 31 % against the US dollar on September 12, 1986 from Rp 1.134 to Rp 1.644 per US dollar.
Fiscal Policy	1. Tight fiscal policy, since 1983, marked by: a. large capital and import intensive projects (particularly investment in manufacturing, petro-chemicals and mining) rephased in May 1983; b. major cutback in public real capital spending; c. more resources for social programmes; d. restraints on civil service employment and salaries. 2. Tax reform enacted in 1983-1985, involving simplifications of both tax structure and tax administration of all tax sources, excluding taxes on foreign trade.
Monetary and Financial Policy	1. Financial reform initiated on June 1, 1983, involving removal of credit and rate ceilings for state bank's operations, a reduction in the scope of credit programmes and introducing of new market-oriented instruments of monetary control. 2. New deregulation measures introduced in December 1987, October and December 1988, March 1989, February 1991 and May 1993 aimed at enhancing financial sector prudential standards and efficiency, and developing the capital market by, among others, removing barriers to entry. 3. Improved monetary management to control inflation and to curb exchange rate speculation. 4. Removal of central bank's direct credits ("liquidity credits") and major reduction of economic sectors covered by subsidized "priority credits" in January 1990 to curb inflationary pressures and credit fungibility. 5. New regulations introduced on March 14, 1991, which are aimed at strengthening the capital base of banks and tightening supervision over financial institutions. The new measures require the banking system to meet the BIS guidelines on capital adequacy ratio 8 % of the bank assets by December 1993. 6. Relaxation of prudential standards introduced in May 29, 1993 and the deadline to meet the CAR of 8 % was extended to December 1994.
Trade Policy	1. Across-the-board July 1993 and October 23, 1993 reductions in nominal tariffs introduced in April 1995, October 1986 and May 28th, 1990. 2. Measures to provide internationally priced inputs to exporters announced on May 6, 1986, and May 28, 1990, July 1993 and October 23, 1993. This scheme permits exporters and suppliers of input for exporters to bypass the import licensing system and import tariff or, if they cannot bypass the system, to reclaim import duties, although the cost imposed by the NTBs cannot be rebated. The import bias of the protective system had been lessened but not uniformly. 3. Major deregulation of import licencing system announced in December 25, 1986, January 15, 1987, May 28, 1990, and July 1992, and October 1993. 4. Additional measures to reduce anti-export bias announced in December 1987 by reducing regulatory framework for exporters. 5. Major removal of non tariff barriers, switch from non-tariff to tariff barriers, and general reduction of tariff rates on May 28, 1990 and July 1992, and October 1993. Also covering simplification of lisencing procedures in trade, manufacturing, health, and agricultural business, the policy package is aimed at reducing high cost economy. 6. Further removal of non-tariff barriers, general reduction of import tariffs and reopening of several business fields to new domestic and foreign investors was announced in June 2nd 1991, July 1992 and October 23, 1993. Several major features of the reform cover outright import bans of cold-rolled steel coils, and other steel products, abolition of the export quota system for for pal oil and copra, introduction of an import quota system on built up commercial vehicles and reopening of car component manufacture to new investors. 7. In June 1993, for the first time after 23 years, import ban built up passenger cars was replaced by prohibitive 300 % tariff rate, further reduction in tariff for other commodities, and relaxation of regulations in trade in agriculture products. Domestic automotive industry is, however, remained subject layers of protective measures.
Other Regulatory Framework	1. Reorganization of customs, shipping and ports operations announced in April 1985 to reduce handling and transport cost for exports and to simplify the administrative procedures governing inter island and foreign trade. Further deregulation of maritime activities announced on November 21, 1988 to reduce cost and encourage private sector participation, including foreign capital and foreign shipping companies. 2. Measures to reduce the investment and capacity lisencing requirements, relax foreign investment regulation and reduce the local content programme. 3. Measures announced on July 6, 1992 to allow joint venture firms to hold right to use the land and use them for credit collateral, liberalized import of used machinery, plant equipment and other capital goods, and liberalize expatriate works permits. 4. On June 10, 1993, the number of investment negative list reduced from 51 to 34.

I. MACROECONOMIC DEVELOPMENTS SINCE THE 1960s

Indonesia, over the past thirty years, has been hailed as one of Asia's success stories.1/ The economy was nearly collapsed when the present administration came to power in 1966. Inflation rate was soaring and peaked at over 635 percent in 1966 while international reserves were only $19 million, or equivalent to roughly 10 days of imports. The country was unable to service its external debt obligations which amounted to $ 530 million, as export earnings were only $679 million. Real GDP grew at an average 1.8 percent per annum in 1959-65 while population had grown 2.5 percent per year. Official statistics on unemployment rates are unreliable: open unemployment seems to be a rare phenomenon in Indonesia, except among the most highly educated.

A. ECONOMIC GROWTH AND STRUCTURAL CHANGES

The economic has changed drastically since then. The inflation rate came down swiftly from over 635 percent in 1966 to 112 percent in 1967 and to a moderate level at an annual average 20 percent in the 1970s and 10 percent in the 1980s. Since the late 1980s, it has been maintained at a single digit. Indonesia may be the only major oil producing country which skillfully avoided the 'Dutch disease' problem during the oil boom period in most of the 1970s and effectively invested the oil windfall to widen and deepen the productive base of her economy. In terms of real GDP, the economy grew at a rapid pace at an annual average rate of 7.7 percent during the years of 1971-1981, between 4 to 5 percent during the period of recession between 1982 and 1986 and has been growing again by over 7 percent since 1987 (Table 2). Whereas the rapid economic growth in the 1970s was fueled by buoyant oil revenues and good agricultural performance, the high growth since 1987 has been achieved with high rates of growth of private-sector investment and exports of non-oil manufactured products. This growth performances place Indonesia squarely in the group of fast-growing ASEAN and Asian Newly Industrialized Economies (ANIEs) which are characterized as the shining lights of the international economy.2/ The rapid rate of economic growth has been accompanied by what appears to be steady improvement in the eradication of poverty, even during the painful adjustment program in the 1980s. The population living below the official poverty line fell to 15 percent in 1990 from 29 percent in 1980 and 60 percent in 1970.

1/ Previously, in his book *Economic Development* (New York: W.W. Norton, 1968) Benjamin Higgins labeled Indonesia as: "The number one failure among the major underdeveloped countries".

2/ The World Bank. 1993. *The East Asian Miracle: Economic Growth and Public Policy.* New York: Oxford University Press.

Table 2
INDICATORS OF ECONOMIC GROWTH AND STRUCTURAL CHANGE, 1966-1995 a)

I. GROWTH INDICATORS	1966	1970-80	1981-90	1991-93	1994	1995
Average Growth (% p.a)						
1. GDP (real)	2.8	7.7	5.5	6.6	7.8	8.1
2. GDP per capita	0.3	5.5	3.3	4.7	5.7	6.4
3. Non-oil GDP	-	5.3	6.3	7.5	7.9	9
4. Manufacturing	-	14.1	9.9	9.1	12.5	11.1
5. Population	2.5	2.4	2.0	1.8	1.6	1.6
6. Inflation rate	736.0	17.5	8.6	9.0	9.2	8.6
7. Money Supply (M1)	636.0	35.1	16.9	15.6	23.3	17.7
8. Government Revenue (excluding foreign aid and borrowing) - as % of GDP	15.95	91.1	-31.3	-4.3	2.1	-0.7
9. Government Expenditure (as % of GDP)	35.72	69.8	-6.4	-6.1	-4.8	-4.3

II. STRUCTURAL CHANGE	1970	1980 b)	1985	1991	1993	1994	1995
1. Non Oil GDP	97.40	76.38	78.61	81.35	83.82	90.39	91.16
2. Agriculture	45.47	30.66	22.68	18.40	17.59	16.73	16.09
3. Manufacturing	8.40	15.30	15.80	19.88	21.10	23.34	24.00
4. Gross Domestic Investment	15.80	24.30	28.00	35.00	30.60	30.3	30.0
5. Gross National Savings	14.30	33.00	25.80	31.00	28.40	28.3	28.55
6. Current Account c)	-3.50	4.20	-2.20	-3.90	-1.40	-1.7	-3.6
7. Export of Goods & NFServices	13.40	30.47	22.20	27.37	25.86	25.54	25.45
Export of Goods Composition							
Petroleum and gas	n.a	82.04	68.42	37.39	26.47	24.20	23.04
Products of the agricultural sector	n.a	6.24	7.47	7.83	7.18	7.04	6.36
Products of the industrial sector	n.a	10.60	22.84	51.70	62.31	64.17	64.57
Products of the mining sector	n.a	0.81	1.05	3.05	3.98	4.49	5.92
Products of other sector	n.a	0.25	0.21	0.03	0.07	0.10	0.10
8. Import of Goods & NFServices	16.14	22.18	20.45	26.98	23.77	24.23	27.45
Import of Goods Composition							
Consumer goods	n.a	6.08	3.71	3.70	4.05	4.47	5.79
Raw materials	n.a	78.70	79.54	66.62	70.72	72.33	72.82
Capital goods	n.a	15.21	16.75	29.68	25.23	23.20	21.39

III. OFFICIAL ESTIMATES OF THE INCIDENCE OF POVERTY	1976	1984	1987	1990	1993	1996
Headcount index (percent)	40.08	21.64	17.42	15.82	13.67	11.3
Urban	38.79	23.14	20.14	16.12	13.45	9.7
Rural	40.37	21.18	16.44	15.68	13.79	12.3
Poverty line (Rp/capita/month) d)						
Urban	4522	13731	17381	20614	27905	n.a
Rural	2849	7746	10294	13295	18244	n.a

Notes :
a) PDB data before 1994 base on 1983 constant market prices. Since 1994, new series data base on 1993 constant market prices was introduced.
b) For Export/Import of Goods Composition data 1981
c) As % of GDP at current market prices
d) Base on minimal nominal expenditure to maintaned basic needs;including 2100 callories of food and expenditure on housing, clothing, and other goods and services

Sources:
1. World Bank, *World Development Reports*, various issues.
2. Central Bureau of Statistics (1993), *Kemiskinan dan Pemerataan Pendapatan di Indonesia*, Jakarta.

Rapid growth has also coincided with a major shift in the structure of the economy. Consistent with the general pattern of development elsewhere, the share of agriculture has declined, even with modernization and a relatively good performance both in the food sector as well as in cash crops. Once the world's largest importer of rice, Indonesia achieved self-sufficiency in this commodity in 1984. The most notable feature of sectoral growth has been the rapid rate of growth in the modern industrial sector, including manufacturing, which grew by 14 percent in the 1970s and 10 percent in the 1980s and the 1990s. The manufacturing industry accounted for 15 percent in 1980, 20 percent in 1991 and 24 percent in 1995 and the expansion in the share of this industry coincided with a decline in agriculture share. In 1990, the manufacturing sector overtook agriculture in the share of Indonesia's GDP. Along with the rapid growth in the manufacturing industry, its structure has shifted from one highly dependent on a small group of primary commodities, particularly oil and natural gas, to the present one with a wider range of manufactured products.

The share of services in GDP which ranges between 32-34 of annual GDP has barely changed, still exceeding the manufacturing industry's share. The service sector is, however, dominated by low-end highly labor-intensive retail activities such as retail trading and restaurants in the informal sector which requires small capital and little expertise. Indonesia has been a net importer of services which require capital and skills such as transportation and communications, financial and industrial services.

Changes in the pattern of ownership resulting from the economic reforms are evident in the manufacturing industry (Hill, 1995). The state is prominent in oil refining, LNG, sugar refining, cement, fertilizer, steel mills, aircraft and machine industries. Foreign investors are dominant in technology-related industries (electronics, synthetic fibers, automotive, and sheet glass), brand name products (white cigarettes, breweries, and pharmaceutics) and knowledge of international markets (footwear). Domestic private firms are prominent in wood based products, textile and garment, food processing and petrochemicals. The rapid growth of both domestic and foreign private investment in the manufacturing industry has raised their contributions to total value-added generated in this economic sector.

The shift in Indonesia's development strategy towards a more outward-looking industrialization has been also reflected in the increasing share of non-oil manufactured products in her total exports. The ratio rose rapidly from 3.9 percent in 1992 to 8.5 percent in 1983, 21.3 percent in 1987 and to further 50 percent in 1993. In 1996, 55 percent of export proceeds of Indonesia was generated from manufactured goods. The major increases were registered in more traditional labor-intensive and resource-based industries, particularly textiles and apparels, processed wood, pulp and rubber, and footwear.

Table 3. Employment by Main Industry, 1971-1990 a)

Main Industry	1971		1980		1990	
	million	%	million	%	million	%
Agriculture, forestry, hunting and fishery	26.5	64.2	28.0	54.8	35.5	50.1
Mining and quarrying	0.1	0.2	0.4	0.7	0.7	1.0
Manufacturing	2.7	6.5	4.4	8.5	8.2	11.6
Electricity, gas and water	0.0	0.1	0.1	0.2	0.1	0.1
Construction	0.7	1.6	1.6	3.1	2.8	4.0
Wholesale and retail trade & restaurants	4.3	10.3	6.6	12.9	10.6	15.0
Transportation, storage & telecommunications	1.0	2.3	1.5	2.9	2.7	3.8
Finance, insurance, real estate & business services	0.1	0.2	0.2	0.4	0.5	0.7
Public services	4.1	10.0	7.7	15.1	9.7	13.7
Others	1.9	4.6	0.7	1.4	0.0	0.0
Total	41.3	100.0	51.2	100.0	70.8	100.0

Note: a) Refers to population 10 years of age and above who worked during the week previous to the census.

Source: Central Bureau of Statistics, *Statistical Yearbook of Indonesia*, 1975, 1982, 1985 and *1990 Census*

Table 3 shows employment structure by main industry. Agriculture's share of the total labor force is declining but its fall laggs well behind the agriculture's declining share in national income. Its slow decline in employment coincides with a rise in the shares of manufacturing industry, public service, and service sector, particularly wholesale and retail trade and restaurants. The shares of employment in mining and quarrying and electricity, gas and water are relatively stable.

B. HIGH INVESTMENT AND DOMESTIC SAVINGS

The rapid growth of Indonesia's economy has been made possible because over the past three decades, on average, Indonesia has invested more than one quarter of its annual GDP to accumulate physical capital stock and improve human resources and technology. The bulk of resources required for investment have come from domestic savings. Sound macroeconomic policies adopted since 1966 have been crucial in raising domestic savings and fostering private investment. These policies provide a confidence effect which has led to a greater willingness of the public to hold the domestic currency rather than goods and foreign currencies. The core of the macroeconomic policy is a tight fiscal discipline and an open exchange rate system with a relatively stable effective exchange rate policy. Mobilization of domestic savings was easier during the 'oil boom' period, between 1973 and 1982.

The economic reforms which brought about openness to international markets give domestic agents access to foreign markets of goods and services, financial assets, skilled manpower and technologies. The openness to international trade is indicated by high export and import intensity indices, or the ratios of merchandise exports and imports to GDP. The high export index reflects the importance of the export sector (in comparison with domestic aggregate demand) as a source of GDP growth. After declining from 25.8 (1980-1994) to 22.7 (1985-1989), the annual average of export intensity index of Indonesia recuperated to 23.9 (1990-1995). During the same period, import intensity index declined from 16.5 (1980-1984) to 15 (1985-1989) and rapidly increased to 20 (1990-1995). The relatively high export and import intensity indices of Indonesia indicate the relatively high dependency of her economy on international trade.

As the openness to international trade enlarges market size, it encourages industrialization and development based on large fixed cost investments. Large market size, according to the big push model (Rosenstein-Rodan, 1943 and Murphy, Shleifer and Vishny, 1989), is critical in investment decisions as the large fixed costs will be spread over a large number of customers to reap the benefits of increasing returns to scale. Deregulation on regional scale has also forged economic links between ASEAN and East Asia through trade and foreign direct investment. Currency appreciation, jointly with rising wages and prices of land, forced the companies in Japan and ANIES to move up markets and relocate the labor-intensive, resources-based and standardized activities elsewhere, including into Indonesia.

Inflows of external resources, including Foreign Direct Investment (FDI), have been a welcome addition to the already high domestic savings. To attract more inflows of FDI, the authorities gradually liberalize investment policy by shortening 'the negative list' of sectors closed to private investors, relaxing the ownership and minimum capital requirements and eliminating other constraints such as domestic content requirements and deletion programs. FDI increases investment to modernize and broaden the productive base of the economy. FDI has also increased the technology, know-how, marketing and other skills of producers in this country. As much of the investment has been in export-oriented manufacturing industries, FDI helps spur export-led economic growth. The rapid industrial growth in Indonesia has, therefore, been induced more by private sector investment than the 'industrial policy' of the government.

Inflows of FDI from Japan have been increasing tremendously since the mid 1980s and ANIEs have started to become important sources since the end of that decade. Foreign companies have used capital goods and intermediate inputs imported either from the host countries or affiliates in other Asian countries. The outputs of these activities are, however, exported mainly to third countries outside the host and source Asian countries. As a result, FDI has led to a relocation of productive activities among the countries in this region and promoted division of labor among them along the "Flying Geese" pattern or shifting comparative advantage. Though this dynamic hypothesis is difficult to prove, "the individual observations of trading patterns are consistent with the hypothesis" (Lloyd, 1996, p. 15). Such a regional integration further promotes economic growth through greater efficiency driven by specialization and rising competition in domestic markets.

II. TRADE AND INDUSTRIAL POLICIES PRIOR TO CONCLUSION OF THE URUGUAY ROUND AND BEYOND

Indonesia has always had a high rate of effective protection compared with other East Asian economies (World Bank, 1994). Like most less developed countries, Indonesia has favored product market policies that implicitly tax agriculture (including forestry and fishery) and subsidize the manufacturing industry. Prior to the reform, initiated in March 1985, the trade and investment policy regimes to achieve these objectives were characterized by the use of numerous distortive policy instruments. These included exorbitant tariffs and subsidies, differentiated credit and interest rates, import prepayments, quantitative restrictions, outright bans on some imports, deletion programs and local content regulations, import licensing and government directives. To keep both consumer prices in domestic markets and prices received by producers well below international prices, a number of agriculturral products has been subject to either export bans or exorbitant tariffs or non-competitive marketing arrangements. Before SGS (a private Swiss based surveying company) was hired in April 1985 to inspect imports and exports at points origin, international trade was also restricted by port and custom valuation and procedures that caused delay and raised costs. Prior to the tax reform, introduced between 1983 and 1985, import check price and cascading import sales tax were other additional measures to provide protection to domestic industries.

Within the manufacturing industry, the structure of protection was gradually escalating in favor of upstream industries to make downstream and labor-intensive industries less competitive and retard growth of non-oil exports. The export-oriented exchange rate policy, subsidized credit, and low wages did not help much. As a result, the authorities ahve resorted to the use of second best policies for promotion of non-oil exports. These include drawback system and establishment of export processing zones.

A. THE FIRST GENERATION OF ISI

The boom in timber and oil prices during most of the 1970s raised domestic savings and narrowed both investment-savings gap and balance of payments gap. As the 'timber and oil money' were mainly injected into the national economy through government coffers, the boom made possible the revival of economic nationalism and patrimonialism and the state-driven heavy industrialization policy that had been loosened during the period of economic stabilization and rehabilitation program in the late 1960s. Having been cut during this stabilization period, a complicated anti-export biased trade policy, with high level and wide dispersion of effective rates of protection, began to intensity again in the 1970s.

The central feature of the new ISI policy has been the targeting of 'strategic' industries and companies for special assistance on the basis of their perceived potential for promoting industrialization, rapid technological change and international competitiveness particularly in non-oil sectors of the economy. Aside from redistribution, there are four other perceived objectives of the ISI policy. First, to either save foreign exchange or sell higher value-added resource products and skilled-based, income elastic manufactures products in international markets. This was regarded crucial to being able to acquire products that cannot be produced at home and to increase living standards particularly in anticipation of falling prices of oil. Second, to broaden and deepen industrial and skill base. Third, to speed up transfer of foreign technology and, fourth, to be of military significance.

In arguing for high protection and nurturing business conglomeration, the protectionists have misused development experiences of Japan and Korea as well as 'the infant industry' arguments of the new trade and competitive advantage theories on high technology (Krugman, 1984 and 1992). The vast geographical area and large number of population of Indonesia, according to the protectionist view, provides the country with ample domestic markets, including for commuter aircraft, all kinds of transportation and telecommunication equipment. Protection, they argue, provides domestic firms with a captive home market, leading to super normal profits which enable them to undertake higher rate of investment, to learn by doing and reduce costs and improve the quality of their products and thereby enable them to compete more effectively in international markets. Along the *zaibatsu* model of prewar Japan and the *chaebol* of Korea, the protectionists regard that the formation of large and diversified business conglomerates is crucial for exploitation of economies of scale and competition in international markets.

In reality, however, it is not very clear how the authorities set the criteria for choosing the targeted or 'strategic' industries and picking the firms to implement the ISI policy. Unlike in Korea, the state is not strong enough to steer the industrialization process and no bureaucratic agencies have the institutional capacity to monitor the use of government subsidy. There is no sign of the state attempting to impose performance standards on corporate recipients of preferential credit, selective trade policies and other subsidies along the lines that Amsden (1989) has described on Korea. The criteria for picking up the firms in Indonesia are likely based on non-economic considerations, such as patrimonialism, expansion of political patronage and outright corruption. Given the presently shallow industrial structure and weak base of technical skills and institutions in Indonesia, it is hard to imagine how the 'strategic industries' can increase technological adoption and technological progress. The highly distorted trade policy is likely to generate net losses to the economy instead of welfare gains (Battacharya and Pangestu, 1993). The literature of immeserizing growth indicates that FDI in this highly protected sector generates greater welfare losses because aside from producing negative value-added at international prices they also remove resources in the form of repatriated profits from the country (World Bank, 1991, p. 95).

Aside from the use of ISI policy, the targeted industries have been also promoted through a combination of regulation of investment and state-ownership (Hill, 1995). There were two groups of protected industries in the 1970s, namely: (1) a range of durable goods produced by downstream or assembly-type industries; and (2) a group of import-substituting and resource-based industries. To protect domestic processors and assembly plants, the govenment, for example, banned exports of low grades natural rubber, unprocessed logs and imports of built-up electrical appliances, televisions and radios, and textiles and apparel. Deletion programs were introduced to encourage local production of component parts of completely knocked-down kits. Such programs have been the cornerstone of government policy in automobile and motorcycle industries.

The targeted companies also receive additional economic rents in forms of special access to industrial licenses, inputs and source of energy at below market prices, special access to public procurements and monopoly and oligopoly rights. Government policies make sure that these companies pay low labor costs. Operating through the Central Bank and a group of dominant state-owned banks, the authorities have used the oil money and capital inflows to the public sector for financing a detailed ceiling-cum-selective credit policy with subsidized interest rates in loans. Injected into the Indonesian economy through government coffers, the oil money and foreign aid and loans were exclusively channeled through these state-owned banks. They and the public treasury are the main dispensers of low cost funds for financing the targeted industries and firms.

The ISI related investment expenditure was suspended temporarily with the financial crisis of the state-oil company, Pertamina, in February of 1975 when it was unable to pay $40 million of its debt service. Continuing speculating on the price of oil, without prior knowledge of the Ministry of Finance, Pertamina had accumulated about $10.5 billion in committed loans, or equivalent to nearly 30 percent of Indonesia's GDP at that time (McCawley, 1978). The external debt was used to expand its operations in both oil-related and non-oil activities. These included, harbor improvements, building of roads and hospitals, development of hotel, residential and commercial estate chains, tanker fleet, rice estates, telecommunication system, floating fertilizer plants, and rehabilitation and quadrupling of the production capacity of the abandoned Soviet steel mill project at Cilegon. A court case involving the second wife of one of the high ranking officials of Pertamina in Singapore in the 1980s alleged a widespread corruption in the company. To rescue Pertamina, the government took over its external debt, cut contracted prices, canceled some of the projects, and transferred the non-oil related projects to the relevant technical Ministries and state-owned companies.

B. RECENT ISI PROJECTS

The economic nationalism and patriotism regained momentum following the short-lived second 'oil boom' in 1979 and the early 1980s. In contrast to the 1970s, the driving force of the restrictive policy in the early 1980s was to cut domestic absorption to restore internal creditworthiness from detrimental effects of the external shocks.3/ Procurement of the public sector was tightly controlled and centralized at the state secretariat, directly under the Office of the President. A number of capital and foreign intensive public projects were shelved. Domestic production was partly raised by forcing the public sector to switch to sometimes low quality and higher priced locally made products. The lists of raw materials subject to export restrictions and bans and import quotas were expanded in the early 1980s.

The coverage and structure of protection was markedly changed in the 1980s. The first major change was the extension of the list of protected industries to include capital goods and intermediate goods industries. Second, the use of non-tariff barriers and exorbitant tariff rates spread out rapidly, partly because the more neutral uniform tariff and devaluation were regarded as inadequate to cut imports and protect domestic industries. There were four types of import licenses being used to limit imports, ranging in restrictiveness from Importer Producer or IP Licenses, available to domestic producers who use IP items as inputs into their production process, to Producer Importer (IP) licenses, which restrict PI items to domestic producers of the same product or to a designated sole importer. In addition, regulations of investment and ownership became more restrictive as the list of economic sectors declared off-limits to private sector investment was rapidly expanted. Licenses to operate the new generation of protected industries were mainly issued to state-owned enterprises and a small number of politically well-connected private conglomerates, both the *pribumi* and Chinese origins. Barriers to entry for foreign direct investment (FDI) were tightened, with larger amount of minimal initial investments and strict requirements for divestment and transfer of technology.

At present, the targeted industries are consisted of three groups, namely: (a) a group of import-substituting and resource-based industries; (b) a group of public utilities, and (c) technology and skill-based industries. The first group of industries includes steel, fertilizer, aluminum, wheat flour, cooking oil, oil refineries, petrochemicals, wood based industries (including pulp and paper) and cement. The second group of industries includes telecommunications, development and operation of ports and toll roads, and generation, transmission and distribution of commercial electricity. The projects under these two categories are controlled by state-owned enterprises and a small number of politically well-connected private conglomerates, both the *pribumi* and Chinese origins. The core of the third group of ISI industries

3/ In the early 1980s, the shocks included falling terms of trade, rising international interest rates and declining of net capital inflows. The drop in prices of oil and natural gas particularly hit the Indonesia's economy as they generated over 20 percent of GDP, over 80% revenues and over two-third of government domestic revenue in 1981. Following the Plaza Accord in Fall 1985, the shock included appreciation of Japanese Yen, the main vehicle currency of Indonesia's imports and external debt.

are the ten state-owned companies controlled by Dr. Habibie 4/ as the Chairman of BPIS *(Badan Pengelola Industri Strategis)*. The companies are: PT IPTN (aircraft); PT Krakatau Steel (steel mills); PT PAL (shipyards); PT Barata (heavy equipment); PT Boma Bima Indra (diesel engines); PT LEN (electronics); PT INTI (telecommunication equipment); PT Pindad (light armaments); PT INKA (locomotives and railway tracks and wagons); and PT Dahana (explosives). In general, market concentration ratios (4-firm level) have been declining following the economic reforms, except in wheat-flour food based industry, motor cycle assembling and automotive industries.

Despite international commitments and the progress of economic deregulation, the authorities introduced a controversial national car policy on 28 February 1996, adding it to the list of 'strategic' industries. The national car policy was promulgated in the Presidential Instruction Nr. 2/1996 which gives a 'pioneer' status to PT Timor Putra Nasional. This exclusive status exempts the company from paying 65% maximum import duties for car spareparts, 35% maximum import duty and luxury goods sales tax that make up over 60 percent of the cost of car production in Indonesia. While completing its own production and assembling capacity in Indonesia, the company is allowed to import the first 45,000 units of cars from Korea. To boost the sale of the car, the public sector is required to buy it. In return, the company promises to manufacture in stages the national car with the use of local components, beginning at 20 percent in the first year of its operation, over 40 percent in the second year and over 60 percent in the third year. Fully back-up by the Government and Bank Indonesia, the central bank, a consortium of 4 state-owned banks and 12 private domestic banks extended a $960 million credit to the company for building car production and assembly facilities. PT Timor Putra is jointly owned by Mr. Hutomo Mandala Putra, the youngest son of President Soeharto, and KIA Motors Corporation of South Korea.

C. MOVING TOWARDS EXPORT ORIENTED STRATEGY

The combination of economic, trade and investment deregulation has gradually improved the pattern of incentives and greatly increased the transparency of trade and investment regime. The economic reform has been implemented through a series of almost annual deregulation packages to undo the highly regulated and protected trade policy of the 1970s and 1980s. Across-the- board reduction in nominal tariffs was first introduced in April 1985, followed by the

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4/ In addition to the State Minister for Research and Technology Dr. B.J. Habibie is also wearing many other hats. These include the Chairman of the Agency for Development and Applications of Technology, the Chairman of Batam Development Authority, the Chairman of the Council for Developing the Eastern part of Indonesia, Member of Board of Commissioner of Pertamina and the Chairman of the Natuna Gas Project. As the Chairman of Golkar, the ruling Party of functional group and the Chairman of the Association of Indonesian Moslem Intellectuals, he is active in politics. His newly graduated son is now Managing Director of IPTN. His extended family is known to control some 40 companies in telecommunications, transport, tourism, fisheries, chemical production, and supplying the state-owned companies under his control.

introduction of measures to provide internationally priced inputs to exporters on 6 May 1986 and a major deregulation of import licensing system in December 1986. Reopening of business areas to new investors was initiated in June 1991. The deregulation packages announced since then have been major steps towards a neutral tariff regime and a more liberal investment regime in Indonesia, meeting at the same time its commitments on market access under the GATT/WTO, AFTA and APEC agreements.

Each package of the trade policy reforms that have been introduced since the mid 1980s addresses five principal areas: (a) non-tariff barriers; (b) tariffs; (c) duty free inputs for exporters; (d) subsidies; and (e) administrative reforms to reduce transaction costs. However, internal and external trade of some commodities remain heavily regulated and some sectors of the economy remain untouched by deregulation.5/ Access to contracts and procurements in the public sector, public financial institutions, and licensing system is still non-transparent. All of these, together with the 'neutral' technical factors, make the degree of market concentration remain high in some sectors of the economy. As a result, despite progress in deregulation, trade policy in Indonesia still has an anti-trade bias and the structure of incentives and protection has not been entirely neutral. According to the World Bank (1996), import protection by way of tariffs and non-tariff barriers accounts for two-thirds of the trade bias and export restrictions for the remainder. Warr (1992) finds that the most highly protected industries, damagingly, continue to be those in which its comparative advantage is least.

1. Non-Tariff Barriers

The more extensive use of NTBs in the early 1980s had contributed to the high level and variability of protection which were biased against exports and the labor-intensive downstream manufacturing industries. The high level of effective rates of protection, which amounted to implicit subsidies to producers in protected industries and economic rents to unproductive rent seekers, were extra costs paid by consumers and forgone government revenue from external trade.

The shift to replace quantitative restrictions for import with tariffs started in October 1986. Team Tariff, an interdepartmental committee that took the lead in setting import policies, set strict rules that made it quite difficult to establish new quotas. And in conjunction with several similar and closely linked deregulation teams, efforts were made to loosen import quotas (and zero quotas), and in a number of cases, the import licensing regulation was eliminated

5/ Assigned to stabilize prices of foodstuffs, Bulog, a quasi government agency, is authorized to control internal and external trade of such products as rice, wheat, sugar, soybean and cooking oil. Some other state-owned and private companies and the publicly sponsored cooperatives are given monopoly and oligopoly rights to control markets for certain goods. PT Bogasari, since 1969, has been granted an exclusive right to mill wheat solely imported by Bulog with a guaranteed milling fee. The government allows some industries such as cane sugar, spinning, plywood, paper, fertilizer, cement, and steel to act like cartels and fix prices. In the ASEAN summit meeting in Bangkok in December 1995, Indonesia asked to exempt 15 agricultural products which are handled by Bulog or the politically well-connected conglomerates from AFTA's tariff reduction liberalization schedule. These include cloves, garlic, sugar, soybean flower and meal, glutinous rice and milled rice, wheat flower an 'other milled products' and 'other processed grains' *(Asiaweek*, January 5, 1996).

completely. In many cases, tariff surcharges (and split tariffs) were applied to smooth the transitional adjustment for domestic producers.

As a part of the trade reform, the government has also modified its approach to local content or deletion programs. Until 1986, the following product groups were subject to local content programs: (a) motor vehicles (deletion for passenger vehicles was voluntary); (b) heavy equipment; (c) mini tractors; (d) engines; (e) consumer electronic equipment; (f) agriculture machinery; (g) professional electronic equipment; (h) machine tools; and (i) pumps. No new program has been established since then. Many of the existing ones (such as motor vehicles and electronics) have their time tables extended.

Modifications of the local content programs have been introduced to make them more flexible, for example, by allowing 'multi-sourcing' of parts. In addition, the Government has been responsive to industry concern about quality and quantity of locally made components in choosing items to be deleted. In most cases, final goods producers can opt to import any component subject to the payment of import duty (at a maximum rate of 60%). It is also now possible to import many of the final goods which are subject to local content plans both for final and component goods producers. High exorbitant export duties, however, have discouraged imports of final products. Imports of used machinery were liberalized in June 1992 and of used trawlers in July 1997.

The successive packages of trade policy reform have gradually reduced the share of production protected by NTBs. The programs had reduced the coverage of NTBs to 22 percent in 1992 from previously 41 percent in 1986 (Table 4). The removal of NTBs during that period had been greatest in manufacturing where the share of protected production fell from 68 percent in 1986 to 31 percent in 1992. During the same period, NTBs in the agricultural sector were removed at a slower pace, from 54 percent in 1986 to 30 percent in 1992. Since then, the removal of NTBs has been very slow and other sectors such as paper products and engineering, including steel and automobiles are highly protected by NTBs. Deregulation of June 1993 lifted the import ban on completely built-up passenger cars and commercial vehicles. The NTB on passenger cars was replaced by an exorbitant tariff rate of 275 percent. In reality, the Ministry of Industry and Trade has not granted a permit to import such completely built-up cars and commercial vehicles.

As of 1996, there were 206 nine-digit Harmonized Schedule (HS) tariff codes that were subject to some form of non-tariff import control. They were mainly concentrated in agricultural commodities and 'strategic industries'. Nearly 2,000 export items (mostly forest products and agricultural commodities) were subject to export restrictions.

Table 4. Coverage of Non-Tariff Barriers, 1986-1995
(percent)

	After trade policy reform packages of:									
	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Production coverage)*										
Gross production	41	38	29	28	25	22	22			
Manufacturing	68	58	45	38	33	32	31	31	31	30
Food & beverages				63	61	60	59			
Paper products				38	38	38	35			
Engineering				49	36	34	34			
Agriculture	54	53	41	40	39	30	30	35	35	35
Food crops				65	65	56	56			
Estate & other crops				26	65	56	56			
Import Coverage										
Import value	43	25	21	17	15	13	13			

Note: *) Production coverage estimates for 1986 are based on 1985 production weights. Estimates for subsequent years are based on 1987 weights.

Source: World Bank. 1993. *Indonesia Sustaining Development*. Report No. 11737-IND. March 25. Table 3.1. page 65 and World Bank. 1995. *Indonesia: Improving Efficiency and Equity Changes in the Public Sector's Role*. June 9.

2. Reform of Tariffs and Surcharges

The removal of NTBs raises the importance of tariffs as an instrument of protection. The measure to rationalize the tariff structure was introduced in March 1985 by an across-the-board reduction in the range and level of nominal tariffs. This tariff reform was a part of the 1984 tax reform to make the tariff system consistent with the new value-added tax. In January 1989, Indonesia adopted the Harmonized System of classifying traded goods. In the process, the number of items with a specific tariff was reduced significantly, improving the transparency of the tariff schedule.

In the beginning, the rapid opening of domestic market increased pressure to protect domestic industry against injury from imports by using tariff surcharges and split tariffs. These in turn increased the tariff dispersion and made the trade system less transparent. While the application of those measures has neutralized somewhat the reduction in protection arising from the removal of NTBs, they provided the authorities de facto anti-dumping and countervailing instruments. In reality, surcharges were created as an easy mechanism by which additional protection could be granted to domestic producers, not by way of an appropriate anti-dumping mechanism. The introduction of split-tariff positions has involved the sub-division of the tariff schedule into even finer product descriptions. These have been used to tailor protection for specific products.

Because of the existence of the surcharges, split tariffs and new forms of NTBs, the nominal tariff rate is an inadequate guide to the rate of effective protection. If these NTBs are taken into account, the rates of effective protection for some import-substituting agricultural products and manufacturing industries can be as high as 115-600% (Stephenson, 1995; Fane and Condon, 1995). Nonetheless, the country's high levels of protection have been reduced gradually, either voluntarily or through cuts made in successive deregulation packages. These have reduced the average tariff (plus surcharge) from 22 percent in 1990 to 19.5 percent in 1994, 15 percent in 1995, 13.1 percent in 1996 and 11.9 percent in July 1997.

To meet Indonesia's international commitments, each of the tariff reform programs announced annually since 1995 spells out general target levels and a schedule of tariff cuts on a large number of imported goods, to be achieved by 2003 (Table 5). By that year, all tariffs will be set at a maximum of 10%, with most falling in the 0-5% range. Exemptions are limited to automotive components and products, electronics-related (finished) products, chemicals, metal products, selected agricultural products6/ and alcoholic beverages. If implemented, the program will keep Indonesia's tariffs among the lowest for large developing countries. The program does not, however, specify the size or timing of cuts. It is worth nothing that most

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6/ Indonesia has recently withdrawn 15 'sensitive' agricultural products from its temporary exclusion list of the common effective preferential tariff (CEPT) scheme in the ASEAN Free Trade Agreement (AFTA) and placed these products instead on a list of sensitive (excluded) items. Indonesia reached a temporary compromise with its ASEAN partners that effectively extends the protection of the products (including rice, sugar, wheat flour, cloves, milk and dairy products) until the year of 2010.

Table 5. Schedule of Nominal Tariff Reductions, 1994-2003 *)
(ad valorem rates)

I. General Tariff Rates (except cars)

Early 1995	1995	1996	1997	1998	1999	2000	2001	2002	2003
0	0	0	0	0	0	0	0	0	0
5	5	5	5	5	5	5	5	5	5
10	5	5	5	5	5	5	5	5	5
15	10	10	5	5	5	5	5	5	5
20	15	15	10	10	5	5	5	5	5
25	20	15	15	10	10	10	10	10	10
30	25	20	20	15	15	10	10	10	10
35	30	25	25	20	20	15	15	10	10
40	30	25	25	20	20	15	15	10	10

II. Tariff Rates on Cars (%)

	Assembled Cars			Components for Locally Assembled Cars		
	1993	1995	2000	1993	1995	2000
Sedans	175	125	40	100	65	25
Pick-ups	60	50	30	40	25	15
Minibuses & jeeps	100	75	30	40	25	15
Light trucks	40	40	30	30	25	15
Heavy duty trucks	5	5	5	0	0	0

Note: *) Four groups of goods are exempt from this schedule: (a) selected agriculture products (125 items from Chapters 7-9 of the H-S code), (b) products of the automobile industry (mainly Chapter 87 of the HS code), (c) certain chemical and plastics (97 items from Chapter 39) and metal products (Chapter 72) (though these are still scheduled to have a maximum tariff of 10% by 2003), and (d) alcoholic beverages (Chapter 22).

Source: Ministry of Finance Press Release, 23 May 1995 and Ministry of Trade and Industry, Decree No. 133/MPP/Kep/1996 items on which tariffs are being lowered were already subject to the minimum rate of 0-5%. Others, such as textiles (except designer wear), orchids and sawn timber, are unlikely ever to become major import items. On the positive side, such a binding schedule of tariff cuts set out in the programs sends a clearer signal to the business community and provides greater certainty than the piecemeal tariff cuts of previous deregulation packages. The special treatment given to automotive spareparts and products indicates the government's intention to promote the development of Indonesia's automotive industry.

One week prior to the annual meeting of the consortium of its international creditors, Indonesia unveiled the latest economic deregulation package on July 7, 1997. The package includes import tariff cuts on 1,600 items, of which 1,461 are manufactured goods, 136 agricultural products and 3 medical and health-related products.

3. Administrative Reform to Reduce Transaction Costs

Since the mid 1980s, a number of administrative reforms have been introduced by the government, to reduce transaction costs in trade and investment. Among other things, procedures for obtaining general trade licenses and investment licenses have been simplified greatly. Beginning from April 1985, the Government hired a private surveying company (Societe Generale de Surveillance --- SGS) to clear imports at the point of origin. Estimation of the duty rate and value of imports is done at this point and the importer pays the duty directly to his bank. At the same time, the inter-island transportation has been deregulated which reduces documentation, rationalizes port fees, allows foreign carriers to operate and simplifies procedure for obtaining investment licenses.

4. Export Support Policies

The high level of protection placed on imported inputs has compelled Indonesia to adopt 'second best' schemes for export promotion. These schemes contain provisions for imported inputs at world prices, export finance, credit guarantees and insurance facilities. The indirect tax relief system for exporters employed in Indonesia consists of: (a) export processing zones (EPZs) and bonded manufacturing warehouses (BMWs); (b) prior duty exemption and duty drawback schemes; and (c) refunds of VAT paid on domestic inputs used in the export production. EPZs and BMWs are administered by the customs, and the last two facilities by Bapeksta. As in the case of all investments approved by the National Investment Coordinating Board (BKPM), export-oriented projects also benefit from being able to import machinery, equipment and inputs duty free for the first two years period of operation. The EPZs and BMWs are blanket incentives to manufacturing activities that produce exclusively for export markets.

The export support schemes are, however, inferior to tariff cuts as a way of promoting export growth and their effectiveness is hampered by budget constraints and the lack of qualified personnel to implement them efficiently. Besides, most of the schemes are non-transparent. The required time to process these transactions drives up inventory costs and delay can cause a loss of export orders. Additional costs are to be borne by companies in EPZs and BMWs as they are required to build the fence surrounding their premises and to build stations and provide meals and transportation facilities for custom officers who physically control their operations around the clock. The schemes are also subject to abuse, by both the business community and officials of administering agencies and banks officers. Recent reports suggest that some manufacturers have been falsely claiming import duty drawbacks and refunds of VAT of fictitious exports of textiles. In 1994, over 20 firms were suspected of having fabricated export invoices and claimed benefits on goods that had not in fact been exported; three were prosecuted and the rest were fined. The most commonly stated destination of the fake exports is Singapore, either because of its proximity to Indonesia or the practice in Singapore of not revealing record data on its economic transactions with Indonesia.

III. TRADE AND INDUSTRIAL POLICY UNDER THE NEW TRADING SYSTEM

A. INTRODUCTION

The prosperity of Indonesia depends on its association with a more liberal and rule-based multilateral trading system, as achieved during the Uruguay Round.7/ Only under this multilateral framework, Indonesia can tap inflows of foreign factors of production and penetrate international markets. The system, however, requires Indonesia to revise the protective trade and industrial policy and to make market work better by strengthening its infrastructure, particularly the legal and accounting system.

Indonesia was an active participant in the Uruguay Round of GATT negotiations in 1986-1994 and a signatory of The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations in Marrakesh, Morocco, in April 1994. The Final Act contains 28 Agreements and is appended by 26,000 pages of national tariff and services schedules. Signatories to the Final Act have to accept all the results of the Uruguay Round as a single undertaking, that is, countries cannot opt out from any of the agreements of the Uruguay Round. Legislation to enable the incorporation of the Uruguay Round Agreement into domestic law was put before the Indonesian Parliament *(DPR-Dewan Perwakilan Rakyat)* in September 1994. The Parliament gave its approval to the Uruguay Round Agreement on 12 October 1994 and the bill implementing the Agreement was subsequently signed into law by the President (Law No. 7 of 1994), making Indonesia a founding member of the World Trade Organisation (WTO) which came into existence on January 1, 1995.

As a founder and influential member of Non Alignment Movement (NAM), Indonesia, under the leadership of President Suharto, has been trying to change the philosophy of the organization on the North-South dialogue, from the confrontational attitude of the past to a more pragmatic approach to solve global problems. Indonesia has been also actively promoting South-South economic cooperation, encouraging free flows of trade and investment and transfer of technology (including interchanging of development experiences) among less developed countries.

On regional fronts, Indonesia signed a historic Declaration of the Fourth ASEAN Summit Meeting in Singapore in January 1992 to achieve an ASEAN Free Trade Area (AFTA). In their September 1995 meeting in Brunei, economic ministers of ASEAN agreed to speed up

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7/ The Uruguay Round Agreements, however, contain no constraint on the use of unilateral actions by a large country (such as the United States) or a large trading bloc (such as the European Union) to pressure other countries on their trade policies or even in their domestic policies (Deardorff, 1996.)

implementation of AFTA to lower tariffs at 5% level by the year of 2003. The AFTA agreement changes the philosophy of ASEAN economic cooperation from the unworkable import-substitution policy on a regional scale in the past to more open regional arrangements. Within ASEAN, Indonesia promotes sub-regional economic cooperation initiatives by forming 'growth triangle' (linking Johor state of Malaysia, Singapore, and the Riau Islands of Indonesia) and 'economic polygon' (covering the Eastern part of Indonesia, East Malaysia, Brunei Darussalam, and South Philippines). Moreover, the central government gives blessings to provinces in the Eastern Indonesia to have formal economic ties with their neighboring states of Australia.

Indonesia is a founding member of APEC (Asia Pacific Economic Cooperation). Established in 1989, the objective of APEC is to promote regional economic cooperation on the basis of "open regionalism". It rests on three foundations, namely, liberalization of trade and investment, facilitation and development cooperation. As APEC is not an arrangement to create a free trade area, its objectives are pursued through a combination of concerted unilateral actions, collective actions and multilateral actions. Any tangible results to facilitate trade and investment flows within APEC would be multilateralized on a MFN basis.

When she hosted the Annual Meeting of the APEC Economic Leaders Meeting in Bogor in November 1994, Indonesia was instrumental in producing a declaration which set the year 2020 as the target date for achieving of its goal of internal free and open trade and investment, with richer countries getting there by 2010. As the leader of NAM, Indonesia expects APEC will become a model of North-South economic cooperation. At Osaka Summit Meeting in 1996, the principle of open regionalism was made explicit by putting emphasis on their "resolute opposition to inward-looking trading block that would divert from the pursuit of global free trade, and we commit ourselves to firmly maintaining open regional cooperation."8/ Because it is neither a treaty nor an agreement, its decision is not binding in legal sense. The organization is supported by a modest secretariat and budget. APEC has no executive and administrative power and the role of its Secretariat is only limited to coordinate activities of various committees of the organization. Although they are not formally binding, the APEC decisions will reinforce WTO commitments to enhance political dynamics within individual member countries to speed up their respective deregulation programs. The reason is simply because all members of APEC realize that their prosperity is dependent on their adherence to a more liberal international system.

B. THE NEW RULES AND REGULATIONS

Thee Uruguay Round and AFTA Agreements and the APEC decisions liberalize global and regional trade and investment by a number of ways. They reduce both tariff and non-tariff barriers and expand the coverage of international transactions by the multilateral trading system. They also improve and harmonize rules and regulations governing competition within global and

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8/ Some countries see free trade as a boon for their citizens and favor free trade with non-members as well as with members. Others want to use the market opening as bargaining chips for open markets elsewhere.

regional trading regimes. Moreover, by improving intellectual property rights and the dispute settlement mechanism, the agreements and decisions also provide a more predictable climate for operations of multinational companies.

1. Market Access for Goods

One of the major achievements of the Uruguay Round is the commitment of the member countries to constrain the use of tariffs on imports. During the round, Indonesia was committed to: (a) bind its duties on imported goods at a ceiling rate of 40 percent; (b) replace NTBs on agricultural products with tariffs, (c) remove NTBs on bound tariff items; and (d) eliminate import surcharges on bound tariff items. Indonesia's commitments under the Uruguay Round negotiations are summarized in Table 6 and contained in the revised Schedule XXI of the Round Final Act.

Effective under the WTO, the general tariff bindings cover 95 percent of all tariff lines (8,878 out of 9,382 lines on an HS 9-digit basis) and 92 percent of all imports. On the tariffication and binding of agricultural products, Indonesia committed to reduce tariffs at least 10 percent per line item (24 percent overall) to be carried out in 10 years. Tariffs were bound at tariffied rates in the case of two products, namely: dairy items and cloves. Tariffs were bound at ceiling rates for the following items: rice, meat, some fruits and vegetables, tea, coffee and spices, margarine, coarse grains, sugar, alcoholic beverages and cigarettes. A guaranteed access threshold was established for rice imports of 70,000 tons annually at 90 percent tariff rate, effective immediately in 1995 while maintenance of current access was offered for milk and cream (quota of 414,700 tons of fresh milk equivalent offered at an in-quota tariff rate of 40 percent).

Indonesia is committed to remove 179 NTBs (out of a total 269 tariff lines with NTBs) within a 10-year time period. Of these, 81 apply to agricultural items and 98 to industrial products: these covered $358 million, or 6 percent of import value in 1992. A group of 504 product items, however, are outside of Indonesia's market access offer for which licenses will not have to be removed. These include salt, radio-active products, certain organic and inorganic chemicals, certain pharmaceuticals, explosives, certain plastics and rubber products, certain iron and steel products, aircraft and aircraft parts, certain ships, certain instruments, armaments and ammunitions and works of arts and antiques. These groups of exceptions corresponded to $2,285 million of imports in 1992, or 8.4 percent of total tariff lines. Of the product exception, 61 items are subject to tariff rates higher than 40 percent.

Table 6. Indonesia's Uruguay Round Market Access Offer

	Tariff Lines		Imports 1992	
	No	%	US$ million	%
A. Tariff Binding				
1. Total Bound Manufactures	7,537	80.3	22,529	82.6
Existing bindings	823	8.8	6,227	22.8
New bindings	6,714	71.6	16,302	59.8
2. Total Agriculture (All bound)	1,341	14.3	2,464	9.0
3. Exceptions	504	5.4	2,285	8.4
Total	9,382	100.0	27,279	100.0

B. Agriculture

1. Tariffication and binding of all items.
2. Duty reduction of 10% by tariff line over 10 years.
3. Elimination of local content requirement for milk products.
4. Agreed access of 70,000 tons of rice imports annually

C. Removal of Non-Tariff Barriers on Bound Tariff Items

NTBs on 98 industrial tariff lines affecting $358 million of imports to be removed within 10 years

D. Elimination of Import Surcharges on Bound Tariff Items

Surcharges varying between 5 and 25 percent on 159 tariff lines affecting $838 million of imports to be removed within 10 years.

Source: Ministry of Industry and Trade

There are three types of non-tariff barriers to be removed, namely: (a) the Importer Producer (IP) license, (b) the Approved importer (IT) license, and (c) the Approved Sole Agent (AT) license. The IP license applies to the following products: flat-rolled iron and steel; iron and steel tubes and pipes; engines and engine parts; forklift trucks; bulldozers; tractors; and electronic musical instruments. The IT permit applies to: sugar substitutes; certain hand tools; and disposal gas-filled cigarette lighters. The AT license applies to locomotive engines and import of certain lubricants.

Some of the commitments and even non-bound items have been already implemented and eliminated in the yearly unilateral trade-policy reform packages introduced since 1995. The deregulation packages of June 1994 reduced the bound items to 87 and the trade policy reform of May 1995 eliminated 51 NTBs on non-bound items. In July 1997, trawlers were removed from the list of NTBs.

By utilizing the WTO provisions which allow price stabilization measures, Indonesia did not commit to reduce domestic support measures on agriculture. The only constraint in the provisions is that the schemes do not exceed 10 percent of the value of domestic production in that product. All of the existing domestic support schemes are recorded in Schedule XXI under the "Green Box" or exemptions from reduction commitments. The buffer stock operations of Bulog, the Logistic Agency, for stabilizing food prices in domestic market and providing incentive for farmers, have been exempt from the commitment to reduce domestic support. The country is, however, committed to keep the subsidization of rice exports within a band of between \$27.6 million (1995) and \$21.5 million (2004) annually, covering a volume of between 295 and 257 thousand tons, respectively.

2. Services

As shown earlier in Chapter II, the service sector is statistically very important in the overall structure of the Indonesian economy. The sector is, however, dominated by low-end highly labor-intensive retail activities such as retail trading and restaurant in the informal sector which requires small capital and little expertise. Indonesia has been a net importer of internationally tradable services, particularly in sectors which require capital and skills such transportation and communications, financial, and industrial services and entertainment services (e.g., live and recorded music and motion picture).

The services are covered by the GATS can be divided into two broad groups, namely, financial and non-financial services. The latter includes the business services (such as advertising, shipping, shipping agent, stevedoring, road haulage, taxi and bus transport) and the professional services (such as medical, accountancy, surveying, architectural, consultancy and legal services).

The rapid changes in technology and increasing volume of international transactions in services have not changed the basic characteristics of service industries. Unlike trade in goods, trade in services basically do not cross national borders and services traded across national borders through modern technology are still difficult to observe. Because of these reasons, services are not subject to the same kinds of tariff and non-tariff barriers as are goods. As a result, the approach followed in the GATT to bring down gradually the barriers through negotiations is not applicable to services. Because of this, the GATS adopts a different approach based on three pillars (Table 7). The first pillar is the Agreement itself, which defines the obligations and disciplines accepted by Members of the Agreement: general rules and principles as non-discrimination (MFN), transparency, national treatment (NT) and specific commitments on market access. This requires services providers from all countries be subject to the same principles of MFN and NT.

The second pillar concerns the national schedules of commitments on market access and national treatment which are subject to successive rounds of negotiations of five-years intervals. The third is a group of eight annexes addressing the special situations of individual services sectors (e.g., movements of natural persons to provide services). These agreements contain the lists of services sectors to be liberalized by the individual member countries and not on services barriers.

Indonesia began to reform its financial system and investment policy towards the end of 1980s, prior to the conclusion of the Uruguay Round. The shipping industry was deregulated in April 1985 and November 1988. The financial sector reform began with the liberalization in security market in December 1987. The banking sector reform of October 1988 opened the domestic market of banking industry to foreign intermediaries, followed by market opening in several insurance sub-sectors in December 1988. The financial sector reforms covered all aspects of the system including market competitive measures, prudential measures and market infrastructure of both bank and non-bank financial industries. Other elements of the market-based system such as money market were created and developed (see, a.o., Nasution, 1995, and Cole and Slade, 1996). The investment policy reform shortened the list of business activities closed to foreign investment, reduced the minimum capital investment and divestment requirements and other distortive requirements such as transfer of technology and export of products. These reforms have made easier for Indonesia to meet its UR commitments on the service sector. As a matter of fact, Indonesia's offers in financial services basically guarantee existing market access in domestic market to foreign service suppliers from other WTO members in five specified sectors, namely: (a) telecommunications, (b) industrial services, (c) tourism, (d) non-bank financial services, and (e) banking services.

Indonesia's UR Commitments on trade in services are listed in Table 8. Because it is allowed in Article II, Indonesia has opted to take measures inconsistent with MFN treatment in all branches of the service sector. The transparency requirement, however, requires all relevant laws, regulations, and administrative guidelines affecting trade in services to be published. All foreign providers can only penetrate domestic markets in services through either joint operations with firms or joint venture companies. Foreign shipping or airline companies operating in Indonesia are required to appoint local firms as general agents. In the telecommunication sector, the number of foreign firms is restricted to five. Moreover, foreign companies or joint ventures are also discriminatorily required to have a higher paid up capital than that applied to domestic

Table 7. The Structure of the General Agreement on Trade in Services

	Framework
Preamble	
Part I	*Scope and Definition*
Article I	Scope and Definition
Part II	*General Obligations and Disciplines*
Article II	Most-Favored-Nation Treatment
Article III	Transparency
Article III *bis*	Disclosure of Confidential Information
Article IV	Increasing Participation of Developing Countries
Article V	Economic Integration
Article VI	Domestic Regulation
Article VII	Recognition
Article VIII	Monopolies and Exclusive Service Suppliers
Article IX	Business Practices
Article X	Emergency Safeguard Measures
Article XI	Payments and Transfers
Article XII	Restrictions to Safeguard Measures
Article XIII	Government Procurement
Article XIV	General Exceptions
Article XIV *bis*	Security Exceptions
Article XV	Subsidies
Part III	Specific Commitments
Article XVI	Market Access
Article XVII	National Treatment
Article XVIII	Additional Commitments
Part IV	Progressive Liberalization
Article XIX	Negotiation of Specific Commitments
Article XX	Schedules of Specific Commitments
Article XXI	Modification of Schedules
Part V	Institutional Provisions
Article XXII	Consultation
Article XXIII	Dispute Settlement and Enforcement
Article XXIV	Council for Trade in Services
Article XXV	Technical Co-operation
Article XXVI	Relationship with Other International Organisations
Part VI	Final Provisions
Article XXVII	Denial of Benefits
Article XXVIII	Definitions
Article XXIX	Annexes

Annexes

Annex on Article II Exemptions
Annex on Movement of Natural Persons Supplying Services under the Agreement
Annex on Financial Services
Second Annex on Financial Services
Annex on Telecommunications
Annex on Air Transport Services
Annex on Negotiations on Basic Telecommunications
Annex on Negotiations on Maritime Transport Services

Ministerial Decisions

Decision on Institutional Arrangements for the General Agreement on Trade in Services
Decision on Certain Dispute Settlement Procedures for the General Agreement on Trade in Services
Decision on Negotiations on Basic Telecommunications
Understanding on Commitments in Financial Services
Decision on Financial Services
Decision on Professional Services
Decision on Negotiations on Movement of Natural Persons
Decision on Trade in Services and the Environment
Decision on Negotiations on Maritime Transport Services

Source: Pierre Sauve, "Assessing the General Agreement on Trade In Services *Half-Full or Half-Empty?*", *Journal of World Trade*, 30(1) January 1996.

Table 8. Uruguay Round Commitments on Trade in Services By Indonesia

	Limitations on Indonesia's Commitments	
	A. Market Access	B. National Treatment
I. TELECOMMUNICATIONS		
Voice mail service	(3), (4)	(3),(4)
Electronic mail services	to all	to all
Computer time sharing services		
Videotex services		
Electronic mail box		
File transfer services		
Home telementing alarm		
Entertainment services		
Management information services		
II. INDUSTRIAL SERVICES		
Advisory and consultative	(3),(4)	(3),(4)
Engineering design services	to all.	to all
Project management services		
Consultancy services related to computer hardware		
Software implementation services		
Interdisciplinary R&D for industrial services		
Technical testing and analysis services		
Services of manufacturing		
Equipment and maintenance repair		
Architectural services		
Engineering services		
Integrated engineering services		
Urban planning services		
Construction work for building and for civil engineering & for pre-fabricated building		
Renting services for construction activities		
III. TOURISM SERVICES		
Hotel	(3),(4)	(3),(4)
Travel agent and tour operator	to all	to all
Tourist resort		
IV. FINANCIAL SERVICES		
Non-life insurance services	(3),(4)	(3),(4)
Reinsurance services	to all	to all
Life insurance services		
Insurance brokerage services		
Re-insurance brokerage services		
Financial lease services		
Securities business		

V. BANKING		
Commercial banking business*)	(3),(4)	(3),(4)
Bank lending of all types	to all	to all
Payments & money transmission services		
Guarantees & commitments		
Trading		
(Money market investments, foreign exchange, exchange rate instruments, transferable securities)		
Asset management		

Source: Sherry Stephenson and Mari Pangestu, *Indonesia and the Emerging Trading Environment*, a paper presented for the conference on Study of the Emerging Trading Environment and Developing Asia Conference on Country Study, ADB Headquarters, Manila, Philippines, 29-30 August 1996, Table II.2.

KEY: (1) Limitations on Cross Border Supply; (2) Limitations on Consumption Abroad; (3) Limitations on Commercial Presence (right of establishment), and (4) on the Presence of Natural Persons.
*) Limitation (1) also applies.

firms. The number of foreign banks which is allowed to open full branches in Indonesia has been limited to 10 since the early 1970s. Only intermediaries from countries that offer reciprocity are allowed to open branch offices and joint venture banks in the country. Foreign joint ventures in the insurance sector must be capitalized at up to five times the level of domestic firms and joint venture banks, securities, and underwriters are required to have initial capital twice the requirement for domestic institutions. The minimum Indonesian ownership in insurance is set at 20 percent and 15 percent in banking and security business, respectively.

On prudential measures, the Financial Services Annex of the Final Act provides for the right of parties prudential provisions, among others, the protection of investors, deposit holders and policy holders, therby ensuring the integrity and stability of the financial system. In the banking system, Indonesia has adopted the US style prudential regulations and supervisory framework called CAMEL (capital adequacy, asset quality, management, earnings, liquidity) system where liquidity, capital adequacy, and asset quality are the key variables. In line with the recommendations of the Bank for International Settlements, the new measures also raise the bank's capital adequacy ratio (CAR) which links the capital base of the lending institution to their risk-weighted assets. Indonesia has also harmonized the rules and regulations of non-bank financial industry with those applied in advanced countries.

Foreign films and videotapes are reserved to domestic companies and are subject to non-tariff and tariff barriers. They are subject to annual quotas while their importation and domestic distribution are reserved only to a cartel of domestic firms. Importation and in-country distribution of US films and videotapes is, for example, handled by a single organization, the European and American film importers'association (AIFEA).

C. NEW TRADE DISCIPLINES

1. <u>Intellectual Property Rights</u>

Indonesia joined the World Intellectual Property Organization (WIPO) in 1979. A number of laws and regulations protecting intellectual property rights (IPRs), such as copyright, patents, and trademark, were introduced in the late 1980s and early 1990s. An interdepartmental Commission on Trade in Intellectual Property Rights was formed in 1986 to prepare for the required changes in the existing legal regime to protect IPRs because of multilateral conventions and agreements, particularly the Uruguay Round Negotiations. Developing countries, including Indonesia, are required to implement the Trade-Related Aspects of Intellectual Property Rights (TRIPs) agreement by 1 January 2000.

The copyright law, first introduced in 1982, was revised in 1987 (Table 9). The patent law of 1989 was amended in 1991. The principle of trademark law in Indonesia shifted from 'the first use system' to the 'register system' in 1992. In the earlier system, which was enshrined in the Paris Convention and the Trademark Law of 1961, the trademark is given to the first to register the product or service. Under the 'register principle', the first to use the product or service is the one entitled to register the trademark. The Law of Industrial Design was introduced in 1984.

The TRIPs Agreement seeks to harmonize protection of intellectual property rights of the member countries and goes considerably beyond the MFN and NT principles of GATT and GATS (Deardorff, 1996). Like in any other developing nations, implementation of the laws concerning IPRs, is still weak in Indonesia. Confusion arises from the fact that a number of laws, rules and regulations are implemented before communicated to and fully understood by all the concerned administrative agencies. The implementing process of several laws, such as the Law of Industrial Design of 1984, has not finalized. As a result, there is a wide discretionary power of the executing officials in interpreting and implementing the laws and regulations. The poor protection of IPRs is indicated by a widespread of imitation and counterfeit products.9/ The patent system in Indonesia is still underdeveloped and patent inspection is problematic, while its investigation is time consuming.

2. Trade Related Investment Measures (TRIMs)

Multinational corporations, with substantial investment in many countries, are important players of international trade. As a result, the Uruguay Round included negotiations on policies not only on trade but also those that affect foreign direct investment. The TRIMs Agreement limits the policy measures available for government to influence the investment decisions of firms by restricting their international trade.10/ In particular, two categories of TRIMs --- local content requirement and trade balancing measures --- are identified as being inconsistent with GATT Article III (national treatment) and two others --- foreign exchange balancing restrictions and domestic sales requirements --- are identified as constituting quantitative restrictions, and therefore are inconsistent with Article XI.11/ Those measures falling into the four GATT-inconsistent categories, but notified within ninety days of the entry into force of the WTO, will benefit from a timetable for them to be phased out (two, five and seven for

9/ Mainly because of the pressures from the United States, the Indonesian government announced in April 1995 an action plan to intensify its enforcement efforts against copyright piracy. It required the government ministries to purchase only licensed computer software. In the following year, however, Indonesia was elevated from the "watch" list to the "priority watch list" status by the USTR office for its supposed lack of adequate intellectual property protection in those areas.

10/ Other types of investment performance and requirements are still untouched by the TRIMs Agreement. These include: export performance requirements, product mandating requirements, exchange restrictions, equity requirements. Most of these measures are concentrated in specific industrial sectors, namely: automotive, chemical and petrochemical, agricultural, and computer/informatics.

11/ From an economic point of view, a local content requirement is equivalent to a tax on intermediate goods, raising the price paid by both the final good producer and consumer. Foreign exchange balancing acts like a quantitative restriction on imports, while domestic sales requirements have a similar effect on exports.

Table 9. Major Changes in Laws and Regulations Regarding Intellectual Property Rights

Laws and Regulations pre UR	*Planned Changes and Amendments*
1. Copyright	
Copyright Law No. 6, 1982 and updated in Law No. 7, 1987 Implementing regulations: Government Regulation No. 14, 1986 regarding the creation of a Copyright Body and then improved in Government Regulation No. 7, 1989.	Amendment regarding neighboring rights to cover performers, producers of phonogram and broadcasting organizations. New addition regarding rental rights.
Government Regulation No. 1, 1989 regulates translations or reproduction of work for educational use, science, research and development.	
Presidential Instruction No. 17, 1988 to ratify the bilateral agreement between Indonesia and EC on voice recordings.	
A number of bilateral copyright protection agreements with the US, Australia and UK.	
2. Industrial Property	
(1) Patent (to protect technological discoveries) Law No. 9, 1989 effective August 1, 1991 with three implementing Government Regulations (Nos. 23, 33, and 34) on how to apply for a patent, temporary registration of the patent consultant, and importation of raw materials for pharmaceuticals which is not considered a violation.	Improvement in determination of new discovery in line with international practices; simplification of types of discoveries eligible for patent; extension of period of patent protection; patent to cover importation.
(2) Trademark Trademark Law No. 19, 1992 to replace Trademark Law No. 21, 1991	Trademark protection to include geographical and origin indicators; protection towards famous brands.
(3) Industrial Design Industrial Design Law No. 5, 1984, but to date no implementing regulations.	Implementing regulations to be prepared. Introduce industrial design law with regard to integrated circuits.

Source: Sherry Stephenson and Mari Pangestu, *ibid.*, Table IV.1

industrial, developing and least developed countries, respectively).12/ There is no transition period for TRIMs introduced after the end of June 1994.

In May 1995, Indonesia notified the TRIMs Committee of the WTO, which monitors the agreement. The notified products can be divided into four groups (motor vehicles, utility boilers, soybean cake and fresh milk) and mostly concern local content requirements. With this act the Indonesia Government has committed itself to phase out local content requirements in those products within five year period ending 2000.

As has been pointed out earlier, the authorities introduced the controversial National Car Program on 28 February 1996. The United States, European Union and Japan are currently contesting the program through the Dispute Settlement Body of the Geneva-based WTO. The program is a suspected violation of three principles of WTO. First, the luxury tax exemption violates national treatment. Second, duty free import of parts from one company (KIA) and designated country (South Korea) is against the MFN principle. Third, tariff reductions tied to local content ratio requirement violates Article 2 of the TRIMs Agreement. In addition, PT Timor Putra Nasional, the 'pioneer' of the national car program, also receives exclusive access to the public sector's market and special access to bank credit.

To back up the National Car Program, Indonesia has also introduced local content regulations applied to automobiles, motorcycles and construction equipment. The local content ratio is tied to the import tariff rate which escalates with low domestic content of the materials and parts. Table 10 illustrates local contents and tariff rates for spareparts of passenger car and motor cycle.

3. Competition Policy

At present, Indonesia has no competition policy, neither competition law nor a policy to expose firms to competition in the domestic market. Because of a number of factors, trade liberalization (in the sense of removing non-tariff barriers and lowering tariff rates) alone is regarded as insufficient to improve competition in the domestic market (Khemani, 1995). First, because a large portion of economic activity in any country relates to non-tradable sectors on which import competition tends to have little impact. Second, high transport costs and other barriers to entry can insulate domestic companies from foreign competition. Third, administrative barriers created by the government, such as permits, licenses, quotas, preferential procurement, and patents, are prominent.

12/ "Article 5.1 of the TRIMs Agreement provides for a 'one-time' notification, that members shall notify within 90 days of the date of entry into force of the WTO agreement, of all TRIMs they are applying that are not in conformity with the provisions of the agreement (despite the different elimination dates for different groups of members). However, so far the WTO secretariat only received such notifications from 35 TWO members and some of them were made after the 90-day limit" (UNCTAD, 1996, p.15).

Table 10. Local content and tariff rates for spareparts of passenger car and motorcycle in Indonesia

Passenger car parts		Motorcycle parts	
Local Content	Tariff rate	Local content	Tariff rate
60%	0%	40%	0%
40-60%	40%	30-40%	10%
30-40%	60%	20-30%	20%
20-30%	80%	0-20%	30%
0-20%	100%		

Source: The Ministry of Trade and Industry

The fourth reason is that certain types of anti-competitive arrangements and business practicies (such as anti-dumping policy) of private firms can dampen the effects of import competition.13/ Under such obstacles domestic firms remain sheltered from international competitors, even when border barriers are eliminated. As has been pointed out earlier, the Government of Indonesia has adopted a policy to foster a few large domestic state-owned enterprises and the well connected privately owned conglomerates to both exploit domestic market and act as 'national champions' in international market. They grant monopoly power to domestic firms and allow them to earn above-normal profits that they could not be able to earn if foreign firms could compete in their domestic markets. Such a policy of "picking winners" through high industrial concentration seems to be expensive and the correlation between firm size and economic performance seems to be very weak. This will be discussed further in Chapter IV.

An empirical study by Aswicahyono et.al. (1996) shows some significant impacts of economic liberalization in the manufacturing industry in Indonesia since the mid-1980s. Trade liberalization reduced significantly the share of the group of state-owned enterprises (SOEs) in the value-added of the manufacturing sector from 42 percent in 1986 to 37 percent in 1990. The SOEs group is still dominant in oil and gas, chemicals, non metallic minerals and basic metals. During the same period, while the share of foreign firms in industrial output increased marginally from 14 percent to 15 percent, their presence is particularly strong in two industry groups, namely paper products and metal products. The main beneficiaries of the reform are the group of domestic private firms whose share in industrial output rose from 44 percent in 1986 to 48 percent in 1990. The study indicates that the medium size firms grew significantly following the reform but liberalization had little impact on the spatial economy, as the industry remains concentrated around Jakarta and Surabaya on the island of Java. The more severe market competition may have contributed to the marked increase in total factor productivity. Because of the existence of a combination of barriers imposed by the government and the anti-competitive and collusive actions of firms, the degree of concentration remains high in some sub-sectors of the manufacturing industry.

Foreign firms and majority-owned foreign affiliates are not allowed to distribute products in the domestic market unless they are manufacturing the products in Indonesia. An Indonesian agent or distributor must be employed for wholesale distribution if the foreign company does not manufacture in Indonesia. Retail distribution and sales are reserved for Indonesian firms and individuals. Domestic markets of a number of products are subject to extensive government interventions and private sector anti-competitive arrangements that are sanctioned and even enforced by the government. The products include state-vended products such as rice, wheat flour, sugar, cement, steel, fertilizer, pulp/paper and glass (Guozhong and De Bruyn Kops, 1995).

13/ Other constraints on international market contestability are pointed out in Graham and Lawrence (1996): (i) those inherent in particular forms of market based competition and are inevitably present in certain production and activities, such as economies of scale, learning by doing and consumer loyalty; (ii) gains from long familiarity with local culture and other aspects of social system; and (iii) natural and geographical barriers that might only be overcome by advances in transportation and communications.

Exports of forest based products are handled by cartels, such as Apkindo (*Asosiasi Panel dan Kayu Indonesia)* for processed logs (see Table 11).

4. Rules and Contingent Protection

The Uruguay Round commitments call for improvements in trade facilitation and regulations to improve market transparency and reduce the costs of undesirable regulatory arbitrage.

(a) Custom Laws

As pointed out earlier, in April 1985, the Government transferred the authority to inspect imported goods from the Directorate General of Customs of the Ministry of Finance to Societe Generale de Surveillance (SGS). This also changed the basis of inspection and valuation of merchandise for calculating tariffs and export incentives. The basis of inspection was shifted from post-shipment or arrival basis to pre-shipment at the point of origin. The SGS contract was renewed every three years. The transfer shifted the method of assessment for calculating tariffs from check prices, as periodically set by the Government, to market prices.

While complying with the UR commitments, Indonesia has adopted a number of measures to restore the authority of the Customs office. PT Surveyor Indonesia, a joint venture company between the customs and SGS, was established in 1991 to undertake pre-shipment inspection. A new Customs Law (Law No. 10 of 1995) was passed in 1995, effective beginning in April 1996 with a transition period of one year. The method of assessment in the new Customs Law is based on self-assessment while the inspection of goods is based on selective physical examination. The inspection of goods based on post-shipment or on arrival has actually been allowed on a selective basis since 1995.

(b) Anti-dumping

Like its predecessor, the Final Act of the UR permits the use of anti-dumping (AD) duties under certain conditions. Dumping is defined as the export of a good for an unfairly low price, either at below the price on the exporter's home market or at below some definition of cost. Also like its predecessor, the Final Act only addresses how importing countries may respond to dumping. WTO, does not, however, prohibit dumping or asks the member countries to restrain the firm from doing it. When dumping causes injury, the Final Act allows importing countries to levy AD-import duties equal to the 'dumping margin', i.e. the difference between the actual and the perceived fair market price, to compensate for the injury to domestic industry.

Table 11. Selected Industry Market Structure in Indonesia

	Share in Manuf a)			Industrial Organization			Market Structure/Govt. Control b)				
	Production	Value Added	Export	Monopoly	Cartel	SOE ownership	Price	Regional quota	Export	Capacity	Entry
Wheat flour	0.1	0.1	0.1	yes		partial					yes
Noodle	0.4	0.4	0.0	yes							yes
Sugar	1.9	3.4	0.0		yes	dominant	yes				yes
Spinning	4.6	3.6	2.1		yes		yes				
Plywood	8.0	7.3	27.7		yes		yes		yes	yes	yes
Paper	3.3	4.0	32		yes		yes			yes	
Fertilizers	2.6	3.0	2.5		yes	dominant	yes		yes	yes	yes
Cement	1.5	1.9	0.2		yes	strong	yes	yes	yes	yes	yes
Steel	6.8	5.7	3.2		yes	dominant		yes			yes
Vehicle Assemb.	4.2	2.5	0.0								yes
Total	33.3	31.9	39.1								

Source: Adapted from Guozhong Xie and Oscar De Bruyn Kops, 1995. Table 1.

Notes: a) Based on 1991 BPS Industry Survey Data.

b) Based on subjective conclusions by the authors of either government regulation or informal arrangements that reach the same effect, excluding technological or financial barriers.

Finger et. al. (1993) point out that there has been a noticeable trend in the increase in the use of anti-dumping measures as an instrument of protection in developed countries. Despite improvements, the anti-dumping rules in the Final Act of the UR are still lax to assure the positive results of affirmative findings in the United Sates and Europe (Deardorff, 1996).

Articles 20 and 23 of the Customs Law of 1995 laid down foundations for using anti-dumping measures and levying countervailing duties in the Indonesian market. The Government Regulation No. 34 of June 1996 regulates the methodology and procedural rules for conducting dumping investigations. Two decrees (no 131 and 133) issued by the Ministry of Industry and Trade in 1996 set up the Anti-Dumping Committee whose members consist of officials from the Ministry of Trade and Industry and the Ministry of Finance. In early 1997, the Committee levied an anti-dumping duty on steel and steel products imported from former Socialist countries.

IV. MICROECONOMIC POLICIES TO GROOM DOMESTIC CAPABILITY

Economic policy to strengthen domestic capability can be distinguished between three intertwined policies: macroeconomic, microeconomic and social policy. The classic objective of macroeconomic policy is to attain both internal balance and external balance of the economy (Mundell, 1968). The first is directed at maintaining price level stability with sustainable employment and growth rates. The external balance concerns about the viability of the balance of payments and the stability of exchange rate. The policy instruments generally assigned to pursue these targets are fiscal policy, monetary policy and exchange rate policy.

Microeconomic policy is primarily concerned with allocation of resources across economic activities to improve efficiency and to build up national capability for improving international competitiveness. The policy instruments being used to influence this include competition policy, credit policy, industrial policy and market policy. Social policy is basically concerned with the distribution of resources between individuals and groups. A number of policy instruments can be deployed to affect this distribution. These include provision of health care and educational facilities, labor policy, and transfer payments to low income groups. As will be discussed further in the following Chapter, macroeconomic policies including the exchange rate policy also play a crucial role in attaining these microeconomic and social objectives.

Like any other members of WTO, Indonesia is committed to change the package of its policy interventions to make them consistent with the Final Act of the Uruguay Round of GATT. As has been discussed earlier, at present, the policy combines elements of dirigiste and laissez-faire. *Dirigiste* policy is characterized by activism or the visible hand of government. In contrast, *laissez-faire* is characterized by passivism and market imperfections are regarded trivial or transient, while the problems of externalities can be solved through efficient market infrastructure, such as the legal system. In the structuralist view, government intervention is pervasive to replace the market because the market failure is regarded pervasive. The government intervention is widely spread in inward-looking 'strategic industries' and in industries which produce 'state-vended products'.

GATT/WTO principles are close to the neoclassical philosophy. They acknowledge the existence of market imperfection and market failure. When they are found to exist, the policy maker should respond by assigning appropriate policy instruments to targets. Interventions according to this philosophy are based on the principles of effective market classification and optimal intervention. Failure to assign appropriate policy instruments to given distortions not only raises the costs of intervention but also may make the situation worse. In contrast to the structuralist view, the fundamental objective of the intervention is not to replace the market, but to augment it and make it work more efficiently. The GATT-consistent protection measures are tied mainly to these justifications.

The present chapter discusses the foundation of the role of state in the economy, how the state grooms state-owned enterprises, private sector conglomerates and trade organizations, and how policies are being implemented in labor market and to improve technology capability.

A. THE ROLE OF STATE IN RESOURCE ALLOCATION

As has been discussed earlier, the economic adjustment program does not necessarily mean that the authorities fully embrace the liberal neoclassical philosophy, and that they rely on market mechanisms alone to determine the course of the economic development in Indonesia.14/ Concurrently with the policy reforms, the authorities tighten rules and regulations on rights and obligations of the economic agents. Part of the regulatory framework is intended to improve market infrastructure and minimize transaction costs. When they are not existent, new markets are created. Some of the rules and regulations are instruments of state interventions to carry out its role as 'an agent of development' which has direct responsibility for correcting market failures to improve the efficiency of resources allocation, increase their productivity and improve distribution of income and wealth. Some other parts of the state interventions are, however, typical market manipulations to create a supportive environment for the ISI projects owned by politically well-connected big business conglomerates and some corrupt government officials that can be observed in any soft or patrimonial state.

The basis for the economic roles of the state for allocating resources is laid down in the presently adopted Constitution of 1945. Article 33 of the basic law proclaims that the economy be organized as a common endeavor based on the shared family ethos *('asas kekeluargaan')* and that branches of production important to the state which affect the life of most people be controlled by the state.15/ The cooperative is regarded as the main institutional vehicle to implement the *"kekeluargaan"* principle in economic life. In a mixed economic system such as that of Indonesia, the role of state-owned enterprises is very important. In addition, the *'dwifungsi'* doctrine gives the Armed Forces dual roles both in military and socio-political affairs. This justifies the use of military personnel in non-military functions, including social and political institutions, public administration, and business sector.

Traditionally, economic nationalism in Indonesia is strongly linked to *pribumi-ism* (including cooperatives) and state-owned enterprises which are regarded as the bastions against

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14/ The neoclassical virtue of economic policy based on free markets and sound financial policies as the key to economic development is claimed by the World Bank (1993,p.85) as the 'best' approach to economic development. Because this view was shared among most of the bankers, consultants, and decision makers who regularly meet in Washington, D.C., John Williamson of the Institute for International Economics (1993, p.1329) called it as 'the Washington consensus'.

15/ A brief history of state roles in the economy in Indonesia is summarized, among others, in Woo, Glassburner and Nasution (1994).

domination of Chinese and foreign ownership. It is widely felt that the strong economic power of Chinese Indonesian originates from the victimization of the *pribumi* (indigenous Indonesians) by the Dutch colonial policies. This traditional perception has been somewhat mellowed under the current administration of President Suharto. Despite its rhetoric, economic power of the Chinese group has been expanded rapidly during the past 30 years of his administration since 1966. Although less than 3 percent of the population, the Chinese group controls much of the modern commercial-business sector, especially the newly emerging business conglomerates. It is generally perceived that those economically successful Chinese conglomerates are closely linked to the first family and expand their influence somewhat at the costs of small- and medium-scale companies (Mackie, 1992 and Mclntrye, 1994).

The present regime adopts an indicative economic plan which provides the basis for allocating public-sector investment and gives guidance for the public sector's activities. The planning agency at the national level, planning bureaus at the ministries and regional planning boards at regional levels are the pivots of the government. Originally, the government's budget was intended to be as an annual implementation of the Five Year Development Plans. In reality, however, coordination between these two is lacking because government's revenues are difficult to predict. The main sources of government revenues, such as oil taxes, taxes on international trade, and foreign aid and borrowings, are beyond the control of the government. Furthermore, the external shocks, such as the decline in the prices of Indonesia's export commodities, the rising interest rates and the currency realignments in the 1980s have made more difficult the prediction of the government's capacity to service debt. These have made the five year development plans and even the annual budget documents obsolete as soon as they were announced.

B. STATE-OWNED ENTERPRISES

Through their own enterprises, the central and local governments directly provide private goods and services in nearly all sectors of the economy, including those outside the traditional public utilities. In 1995, the central government alone had 180 enterprises across all economic sectors, including agriculture (35), manufacturing industry (38), transportation (17), public works (19), finance (30), and other sectors (41). A large number of these companies are formerly Dutch firms nationalized in the 1960s and the rest were established by the government. As a group, they produced 15% of GDP, employed 1.4% of labor force and the book value of their assets amounted to Rp295 trillion or $140 billion (at exchange rate Rp2,160 per US$1) in 1994.16/ These figures represent enterprises in which the central government has a direct majority ownership, including joint ventures but excluding enterprises owned by quasi-governmental institutions (such as Bank Indonesia-the central bank- and Bulog-the Logistic Agency and cooperative units of various branches of government and military services). On paper, the state enterprises are independent and subject to the commercial law in the same manner as private

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16/ World Bank. 1995. Indonesia: *Dimensions of Growth*. Report No. 15383-IND. Country Department III. East Asia and Pacific Region. March 29.

firms. In reality, they are arm-length extensions of the government bureaucracies and their commercial performances are relatively poor.

Privatization in Indonesia is done through a combination of selling state-owned firms to politically well-connected buyers through non-transparent mechanisms, partial divestment, and concessions for stand-alone infrastructure projects. The progress of the divestment program is, however, very slow. As of now only five state-owned companies have been selling equities in domestic and international stock exchanges, namely: telecommunications (PT Indosat and PT Telkom); tin mining company (PT Tambang Timah); and two banks (PT Bank Tabungan Negara and PT Bank BNI). Indonesia uses part of the receipts from the offshore partial divestiture of nonbank companies to repay its external debt early. All of the infrastructure projects are awarded to the politically well-connected companies without a competitive tender.

C. BUSINESS CONGLOMERATION

The rise to prominence by conglomerates in the 1960s and 1970s was facilitated by monopoly rights, high effective rates of protection and special access to subsidized financial resources from the public sector, mainly the state-owned banks. In the early 1980s, the growth of conglomerates was fueled chiefly by import licenses. Their growth has been much faster following the reforms on privatization of public utilities and the increasing access to less poorly-regulated financial sector and state-owned non-bank financial institutions. Some of them emerge to capture economies of scale. A lot of them sprouted up to capture rents created by policy-induced market distortions. This often results in the sacrifice of consumer welfare maximization in favor of producers.

Through interlocking networks of ownership and business and management, most of the private financial institutions are closely connected to large business conglomerates that operate in the real sector of the economy. Those business groups which did not previously have banks have established new ones after the financial sector reforms in 1988. Conglomeration is also increasing in the financial industry as most private banks are now having subsidiaries dealing with insurance, leasing, factoring, underwriting, brokerage and trading of commercial papers and other forms of financial activities. From a microeconomic point of view, conglomeration is part of a company strategy to share information and scarce human resources, and may provide new sources of capital and business opportunities. The conglomerates are able to invest in technologies of increasing returns, because the fixed costs of these technologies can be spread over a larger number of users. Coordination is easier within a group of companies because it is cheaper for them to communicate with each other. The clientele of financial institutions of a business conglomerate is built around its sister companies and their suppliers, dealers and customers.

As long as all the companies within the conglomerate operate efficiently up to international standards, conglomeration provides synergy. The problem arises if the less efficient subsidiaries are carried along by sales to other companies in the same group. Moreover, large firms may lose the flexibility necessary to keep responding adequately to new challenges and changing business environments. The recent collapse of large conglomerates, such as PT Bentoel, PT Mantrust and PT Bank Summa, indicates that some sectors within conglomerates may become a burden than boon. Part of the problem is that most of the conglomerates have adopted a high leveraged strategy that may be suitable under the past era of subsidized interest rates and highly protected domestic markets, but not in the current period of deregulation.

D. TRADE ORGANIZATIONS

Kadin (the Indonesian Chamber of Commerce and Industry), established in 1967, is the apex of over 200 industrial and trade associations, which are the platforms for industry-government interaction and downstream and upstream producers. More of a product of the government rather than a private-sector initiative, Kadin was reorganized in 1987 to represent and harmonize interests of three business sectors of the economy: the state-owned enterprises, the private sector and the cooperatives (Sadli, 1991). Countries with significant business exposures in Indonesia have established their own chambers, like US-AMCHAM (American Chamber of Commerce), the German Ekonid, Japan Club and the Dutch INA. Supported by strong executive bodies, they have good relations with the government. By government decrees, foreign firms in Indonesia are required to be members of Kadin.

There is a division of labor between Kadin and associations in the sense that the first represents general interests of the business community, such as macro economic policies and general business climate. The function of associations is more focused on the particular industry or sectoral interests. Except Apkindo (the plywood industry association), Kadin and trade associations do not have strong executive bodies to influence major economic decisions by the government. However, Kadin and the sectoral associations are the formal venues for intra- and inter-industry bargaining and private-sector government interactions. Because of the strong presence of state-owned enterprises and high ranking officials from the line ministries, some associations have become formal venues for settling disputes and modifying arrangements. The latter include price, marketing and capacity controls. These include associations of producers of the following commodities: cement, fertilizers and other petrochemicals, pulp and paper, and cooking oil.

E. LABOR MARKET AND POLICY

Restrictive regulations on national and international migrations and labor unions keep wages low in the labor surplus economy of Indonesia. This is another type of economic rent enjoyed by companies operating in this country.17/ The labor supply is almost unlimited with an average rate of growth of new entrants to labor force at 4 percent per annum. Growing at a rate of 1.8 percent per annum (1985-1990), two thirds of the 180 million (1990) population live on the overcrowded islands of Java, Madura and Bali. For the most part recent labor migrations have moved in the direction of big cities such as Jakarta, Surabaya, Semarang and Medan, where the new jobs have been heavily concentrated. The expensive mass transmigration program sponsored by the government to move people from these highly densely populated islands to outer islands is constrained by a limited budget. Voluntary inter-island migration is restricted by difficulty in obtaining land titles and expensive transportation costs. The opportunity for mass international out migration is limited, because either of minimum skills or restrictive government regulations. The latter include the departure tax of Rp250,000 (equivalent to roughly $102 at exchange rate Rp2,450 per $1) and the airport or sea port tax. Indonesians workers overseas are also subject to various levies which include, among others, assessments designated to training and improving skills of those left behind.

The quantity of education (both formal pre-employment education and post-education, formal and on-the-job training) has been expanded rapidly with the extensive school building program during the past quarter of century. However, their quality has not improved much due to inadequate equipment, teaching materials, libraries and qualified teachers. The public learning institutions have little autonomy and flexibility in resource use and they have weak links with the industries. Largely financed by student fees, private schools and training institutions suffer from inadequate facilities. Despite economic rents, most of the domestic firms do not have good in-service training facilities. Courses in Indonesian schools and high learning institutions are mainly concentrated on social sciences and general subjects that require little capital investment. To improve the quality of education, starting from the current Sixth Five Year Development Plan (Pelita VI), 1994/95-1998/99, the government has put forward a plan to expand access to junior secondary education and to achieve universal 9-year compulsory education in 10 to 15 years. Given the present state of education system of Indonesia, this target is likely too ambitious.

Labor market in Indonesia can be divided into four main sectors: the civil service, public enterprises, large private firms and small- and medium-scale private enterprises. Average wages are higher in the first two sectors, but also are the educational and training requirements for the jobs that they offer. Small- and medium-scale private enterprises, which make up almost all of agricultural and service sectors and most of the manufacturing industry, employ the bulk of the work force. Labor unions are weak because of either the underlying economic factors or hostile laws. The economic factors include the rapidly increasing population growth, high labor mobility, low real income and sharp economic fluctuation. Tightly controlled by the government, trade unions are integrated to SPSI *(Serikat Pekerja Seluruh Indonesia)*- the Federation of All

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17/ According to an anonymous World Bank labor economist: "Labor costs in a typical enterprise have long represented a low 5% to 10% of total production costs. Only Bangladesh and Guatemala were cheaper" ('Indonesia: Suharto signals that he wants a seventh term', *Asiaweek*, 27 October 1995).

Indonesian Workers Union- the apex federation which belongs to Golkar, the ruling party.18/ Government policy prevents the emergence of cadre of skilled workers who could provide trade union leadership. To tame the labor unions, retired government officials and third rate politicians from Golkar are appointed as leaders of SPSI.

Instead of allowing workers to organize themselves and negotiate work benefits with employers, the government adopts superfluous and complex labor regulations which add costs and reduce operational flexibility of the firms. The regulations cover five main areas: (a) protection and supervision of workers that include specific regulations on hours, overtime, and minimum wages and worker welfare; (b) reporting requirements by the company; (c) safety and health standards; (d) hiring, retrenchment and movement of labor between provinces; and (e) employment of expatriate workers.

The minimum wage system has been introduced in most regions since the early 1970s. Set at little more than minimum subsistence living requirements or marginally above the wages paid by small- and medium-scale enterprises, the minimum wage is indexed to Consumer Price Index (CPI) and varies across economic sectors and sub-sectors and geographical regions. The legislated minimum wages is, however, effective only in the public sector and some of the large enterprises. The minimum wage regulations in a labor surplus economy, like in Indonesia, protects the existing workers but reduces probability of finding employment for unskilled new entrants to the labor force.

There are also regulations on work conditions and a compulsory social security *(Jamsostek-Jaminan Sosial Tenaga Kerja)* program for workers, which was introduced in 1992. The program covers life, injury, retirement benefits, free health care for workers and their families (spouse and up to three children) and worker's compensation insurance for work-related accidents and illnesses (McLeod, 1993). However, all of these labor legislation and regulations are far too ambitious and unenforceable at the present stage of Indonesia's economic development.

Work permits for foreign workers are restricted through various means. The permits are granted through block visas and relatively easy to obtain in various technical and highly specialized positions where the supply of Indonesian workers is relatively limited. Foreign workers are expected to train local workforce and required to contribute $100 per month to the development fund for improving skills of Indonesian workers. Some of the funds has been used to build physical building of vocational schools under the Ministry of Manpower. However, there is no adequate budget to run the schools and hire qualified instructors for improving the skills of local workers. As resident, a foreign worker is required to pay the Rp250,000 departure tax that can be deductible from his income tax.

18/ On the structure of labor market and labor policies in Indonesia, see, for example, Manning and Hardjono (1993) and Agarwal (1995).

F. TECHNOLOGY POLICY

Technological progress basically takes three forms: (a) an increased output per unit of input, i.e., process innovation; (b) a better quality product, i.e., quality improvement; and (c) a product that either replaces an existing product or creates and meets a new demand, i.e. product innovation (Ozawa, 1985). For a country which depends upon imported technology, like the case of Indonesia, the adoption of products and industries that exist in advanced industrial countries are more relevant to their technological progress than attempts to invent new products.

As development strategy is heavily biased towards agriculture, exploitation of natural resources, and the import-substituting manufacturing industry, technological progress in Indonesia has been mainly concentrated in these sectors. While they are relatively simple, capital-intensive technologies used in these sectors are not readily adapted to other sectors of the economy. Dissemination of technologies is further blocked by the enclave nature of the resource based and the 'strategic' industries. The exorbitant high rates of protection and the absence of both internal and external market competition have discouraged technological progress.

The Agency for Development of Strategic Industries (BIPIS), founded in 1989, acts as the holding company for the 10 state-owned companies that have been set up as vehicles to develop 'the strategic industries'. Chaired by the President of the Republic, the Council for Industrial Management sets policy guidelines for the BIPIS. The Minister of Science and Technology (MOST) is Vice Chairman of the Council whose member consists of seven Cabinet Ministers and the Chief of Staff of the Armed Forces. MOST is also the President Director of BIPIS and the Chairman of BPPT (the Agency for the Assessment and Application of Technology).

Created in 1978, the main purpose of BPPT is to develop industrial technology, particularly in the selection, assessment and application of the appropriate science and technology. The BPPT has been assisted by the existing research and high learning institutions such as the Institute for Science and Technology (LIPI) and the Center for Research, Science and Technology (PUSPITEK), in disseminating industrial technology information and providing support services to research and testing laboratories. There are also a number of industry specific R&D institutes under the Ministry of Industry and Trade. However, their capabilities in providing industrial extension services in the area of technology and management are limited due to lack of qualified manpower, budget and equipment.

Despite the progress, the capabilities of the local high learning and research institutions in Indonesia to tap, adapt and disseminate imported technology used in the manufacturing sector remain very weak. According to McKendrick (1992), the lack of specialized software consultants has been a major drawback in transferring information technology to Indonesian banks. The problems have become more acute as the government uses the scarce resources to support the wrong industrial sectors which are not quite relevant to improving productivity of the labor-intensive sectors where Indonesia has comparative advantage. The main weakness of the institutions is that the rapid improvements in physical facilities or the "hardware" part of the technologies (such as impressive buildings and sophisticated imported equipment in science parks) have not accompanied by the same progress in the "software" part. This is due to, among others, a small pool of skilled labor, lack of information resulting from insufficient library acquisitions and the absence of work incentives. Kazaku (1990) suggests that in order to be able to adopt and export high-technology products, a country needs about 30-40 percent college and university enrollment in the 20-24 age group. As the level of education in Indonesia is far below this standard as well as that of some other ASEAN countries and South Korea and Japan (Table 12), its ability to absorb and use and modify technologies is relatively limited.

The weaknesses of non-market mechanisms to transfer and disseminate technology through public institutions are partly corrected by the successive deregulation programs which increase openness of the economy to international markets and its access to foreign technologies. This reduces costs of transferring and disseminating technological capabilities or skills (technical, managerial and institutional) that are required by the firms to use equipment and information efficiently. By importing plants and equipment, concurrently, domestic and foreign investors bring in technology embodied in these physical goods as they are accompanied by operating instructions, designs and blueprints.

Much of technology transfer occurs through foreign direct investment and joint ventures (Eons, Lall and Yen, 1997). Technology is also transferred through sub-contracting, production sharing, franchising, buying licenses and patents, management and marketing contracts, and various kinds of technical assistance and technical cooperation. Technology is also transferred through in-house training and educational activities to meet plant and occupational requirements, collaboration contracts and through informal transfer of know-how, consultancy and interaction among expatriates, local workers and professionals in running the business activities. Although FDI can provide access to the most modern technologies, they transfer only those skills that can be absorbed by local companies.

In general the capability of local firms in Indonesia to absorb foreign technologies is still relatively weak. The main reason is that most of them do not invest sufficiently in the necessary information and capability to find, choose and negotiate the best imported technologies. This capability is very crucial because international technology market is imperfect: highly oligopolistic and fragmented and its transmission of information is asymmetric (Lall, 1993). Inability to buy the 'right' technology at the 'right' price, leads to high capital costs and low productive efficiency. The capabilities of the Indonesian firms to master the imported technologies properly are also relatively weak due to insufficient number of highly skilled manpower. The same reason weakens their capabilities to adapt or upgrade the imported technologies in coping with changing circumstances at home or technological progress outside. The capability to approach world technological frontiers is key to success in maintaining competitiveness in international markets. Undeniably, imports of foreign technologies and expatriates have contributed to enlarging deficit of the current account of the balance of payments.

Table 12
Indicators of Education, Selected Countries, 1965-1993

		Japan	Korea	Singa- pore	Malaysia	Thailand	Philip- pines	Indonesia
School Enrollment Ratio:								
Primary School	1965	100	101	105	90	78	113	72
	1980	101	110	108	93	99	113	107
	1993	102	101	107	93	98	111	114
Secondary School	1965	82	35	45	28	14	41	12
	1980	93	78	58	48	29	64	29
	1993	96	93	78	59	37	79	43
Tertiary School	1965	13	6	10	2	2	19	1
	1980	31	15	1	4	13	24	2
	1993	30	48	-	-	19	26	10
Age Efficiency Ratio (measured as percentage of net enrollment to gross enrollment)								
Primary	1980	-	64	-	-	-	89	82
	1993	-	60	-	-	-	88	85
Secondary	1980	100	90	-	-	-	70	-
	1993	100	94	-	-	-	70	86

Sources: World Bank, *Word Development Report*, various issues and *World Development Indicators 1997*.

Government interventions in industrial technology development not only fail to solve the market failures but also significantly add to inefficiency. The root of the government failures is because Dr. Habibie, the present State Minister of Research and Technology, is mainly interested in promoting local technological capabilities to support the unrealistic and costly 'strategic industries' under his command. As noted earlier, through non-tariff barriers, local consumers are being forced to buy such expensive but technologically inferior products.

Given the thin and narrow technological skill and industrial base at present in Indonesia, the 'strategic industries' are not likely to generate both pecuniary and technological ('Marshallian') externalities. The first type of externality affects prices of inputs and outputs of other firms, and is, therefore, transmitted through market transactions. Because of the low backward and forward linkages of these industries with other sectors of the economy, investment in them is not likely to produce the maximum multiplier effects in the Keynesian sense. The thinness of Indonesia's skill and industrial base, again, limits its capacity to absorb or transfer foreign technology and assimilate and diffuse it to produce the maximum effect of dynamic technical externalities, or the Schumpeterian efficiency for the national economy.

V. MACROECONOMIC ENVIRONMENT

Sound financial policy has been one of the basic ingredients of macroeconomic policy in Indonesia during the past three decades to maintain economic stability and promote mobilization of domestic savings. The policy provides a confidence effect which has led to a greater willingness of the public to hold domestic currency rather than goods and foreign currencies and to foster private sector investment. The core of the financial policy is an open exchange rate system with a relatively stable real effective exchange rate policy which is supported by a tight fiscal discipline and a repressed financial system.

The adjusting factors of such active management of the exchange rate have been rising domestic inflation rate and interest rate. The pressures from rising inflation rate has been partly suppressed by government policy to subsidize prices of state vended products and economic liberalisation which reduces prices of imports and raised productivity. Until recently, the authorities directly controlled allocation of banks, credit and deposit and lending interest rates. The selective credit policy allocated resources as set by the authorities, including those to the ISI projects and executing firms.

A. EXCHANGE RATE POLICY

Exchange rate is the most important relative price in the economy. In an open economy, like in Indonesia, monetary transmission operates through exchange-rate effects on net exports and interest rate effects of financial portfolio. The open exchange rate system introduced in October 1966 was further relaxed with a devaluation and unification of exchange rate in 1971. Since then, Indonesia has had a foreign exchange system that is free of restrictions on payments and transfers for current external transactions or no surrender requirements for export proceeds, tax, or subsidy on the purchase or sale of foreign exchange. Foreign nationals and Indonesian citizens are free to open accounts in Indonesia in the rupiah or foreign currencies with banks authorized to deal with foreign exchange transactions. These authorized banks are free to extend credit in foreign currencies with a percent withholding tax on interest rates. Indonesia has adopted such a liberal exchange rate system simply because it has no capable bureaucratic agencies to administer efficiently and effectively the capital control in such a vast archipelagic state which consists of over 17,000 small and large islands and in the middle of it lies Singapore, a major regional financial market.

The exchange rate policy in Indonesia, jointly with other policies, has been mainly used to help remove economic distortions and therefore encourages allocation of resources more towards the tradable sectors of the economy and promotes non-oil exports. The policy avoids the use of prolonged real exchange rate overvaluation as a principal instrument to suppress domestic inflation rate and lower interest rates. To offset the Dutch Disease effect of the oil boom in November 1978, the authorities devalued the rupiah and replaced the US dollar as its external anchor with an undisclosed basket of major currencies and moved to a managed floating exchange rate system. Bank Indonesia, the central bank, intervened in the foreign exchange market by buying and selling the rupiah in an 'intervention band' around the central rate. The steady rise in the real effective exchange rate (REER) indicates an active exchange rate policy in this country to improve Indonesia's international competitiveness. Such a policy to stabilize real exchange rate also helped avoid major macroeconomic crises even when the world economic environment proved inhospitable.

To allow market forces a greater role in setting the exchange rate, Bank Indonesia has widened intervention band six times since 1992 to the 6 percent level effective since July 1997. Greater exchange rate flexibility introduces uncertainty that may well discourage part of the purely speculative capital flows and allow higher degree of freedom for the monetary authorities to exercise control over monetary aggregates. On the other hand, too wider a band invites skepticism about the government commitment to defend the exchange rate policy. To defend its external reserves from strong speculative attacks, the authorities removed the intervention band in August 14, 1997 and adopted the free floating exchange rate regime.

To encourage inward capital inflows, from January 1979 to December 1991, a special exchange rate was made available to domestic borrowers by providing explicit subsidy on the exchange rate. The subsidy was extended through the exchange rate swap facility. Bank Indonesia, under this facility, provided forward cover to a foreign exchange borrowing contract or swap to banks and non-bank financial institutions as well as for their customers with a foreign-currency liability. The subsidy came about because of the time lag in either an upward adjustment of the swap premium or a nominal depreciation of the rupiah or a combination of both. The authorities also partly covered exchange rate and interest rate risks of foreign financing of large scale infrastructure projects by the private sector.

B. FISCAL POLICY

Fiscal discipline in Indonesia is solidified in the balanced budget policy which has been adopted since 1968. The essence of the policy is to cap the public budget deficit to the level that can be financed by external borrowings. Since the late 1960s, Indonesia's external borrowing strategy has been consistently to maximize the inflow of concessionary development aid from its Western and Asian creditors. The 'oil boom' of the 1970s did not change this strategy. Together with the resulting rise in real income, the oil boom only shifted Indonesia's position to a less concessional aid package. When it encountered the problem of rising debt repayments following the currency realignment in 1985-86, Indonesia also turned to its creditors, particularly Japanese. To ease the debt-servicing problem, since 1986 the donors have been providing 'special assistance loans' to Indonesia in the form of concessionary and untied, quickly disbursed loans, in order to support both the public budget and the balance of payments.

As the prospect for the slowdown in the growth of oil tax revenue became clear, the authorities reformed the tax system between 1983 and 1985 and further revised it in 1995. The new tax system brings simplicity, progressivity, certainty and closing of loopholes for tax evasion. The new system has generated public revenue from non-oil and non-foreign-trade sectors in a reasonably efficient, equitable and sustainable manner. The new tax system improves efficiency and equity of resource allocation as it has reduced severe distortions in economic incentives.

In response to the marked increase in net capital flows since the late 1980s, the authorities have changed the fiscal policy by adopting a 'budget surplus' policy. Extra revenues from unanticipated increases in the price of oil and part of the proceeds from privatization of state-owned enterprises are being used to repay early extensive external debt.

The expenditure side of the public budget carries most of the tasks for pursuing the equity objective of the fiscal system. Improving access of the low income groups to publicly provided basic human needs such as food, primary education, and health care (including family planning program) is an important element of government programs for reducing poverty. Adequate provision of health care and educational services to low-income groups improves their productivity and capabilities to respond to economic opportunities. Investment in this human resource, along with investment in economic infrastructure, is crucial for long-term growth.

C. FINANCIAL SECTOR AND MONETARY POLICY

During the long period of financial repression which lasted until late 1980s, the state banking system had been the main dispenser of the subsidized and low risk credit programs to finance the targeted economic sectors.19/ That favored import-substituting industries and politically well-connected private sector companies. Under this system of complicated and rigid ceilings *cum* selective credit policy with subsidized lending interest rates, the authorities directly allocated financial resources to selected beneficiaries. At the very low or even negative lending interest rates, the roles of non-price factors became more important as instruments for allocating bank credit.

Administration of the credit program is relatively easy as the group of state-owned banks is the central part of the banking system of Indonesia which, is, in turn, the core of the country's financial system. The banking system consists of Bank Indonesia, the central bank, and the commercial, saving and development banks, of which 7 are state-owned banks. Together, this group of banks held in 1991 over 90 percent of the gross assets of the financial system. At the peak of the 'oil boom' in 1980, over 80 percent of banks' credit was controlled by the group of

19/ These include the rice-related and export-oriented agriculture sectors. The availability of such credit, jointly with large public investment in rural infrastructure and modernization of technology through extension services, has enabled Indonesia to increase production of food and commercial corps. As noted earlier, having been the world's largest importer of rice in the early 1970s, Indonesia achieved self-sufficiency in this commodity in 1984.

state-owned banks. Other financial institutions are fast growing segments of the financial system, but as a group they are relatively small (see, a.o., Nasution, 1996). The money and capital markets are in the early stage of development and SBI *(Sertifikat Bank Indonesia)*, the central bank's certificate, is the most important instrument traded in the short-term money market.

Major reforms in banking, known as Pakto, began in October 1988,20/ followed by reforms of the capital market and privatization of stock exchanges, reforms of pension funds and other branches of financial sector in 1989. The aspects and coverage of banking sector policy reforms are shown in Table 13. The financial sector reforms have raised the tempo of market competition in the whole financial sector on both sides of their balance sheets,21/ through various mechanisms. First, by removing the former system of strict functional specialization of financial system22/ and allowing bank subsidiaries to engage in non-traditional commercial bank activities, such as securities underwriting, brokerage and trading. Second, by putting both commercial and merchant banks on equal footing. These banks are now subject to the same prudential rules and regulations administered by the same institution, namely, Bank Indonesia, the central bank. Third, by allowing new entry and relaxing branch power both for domestic and foreign institutions.23/ Fourth, by eliminating most of the credit ceilings, credit selectivity and

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20/ The first stage of deregulation in the banking industry took place on June 1, 1983. This involved the removal of most subsidized credit programs, and curtailment of the Central Bank's funding of state banks' credit programs. In the second stage, introduced in 1984, the Central Bank's facilities were further restructured and money market began to develop.

21/ In February 1991, over two years after the Pakto, the authorities tightened the regulatory frameworks governing the banking industry by adopting the more restrictive CAMEL (capital adequacy, asset quality, management, earnings, liquidity) system. Prior to this, the banking system was practically free and unregulated without responsibility. As suggested by the Basle Accord of the bank regulators in December 1987, the capital adequacy ratio is now set at 8%. The guidelines bring full range of on-and off-balance sheet assets into the risk based capital standards. A harmonized risk-weight system has been developed to assess the different degrees of risk associated with each category of assets. Risk-weighted assets, capital adequacy, asset quality and liquidity are the key variables in the CAMEL system. In addition, the authorities have introduced a new standard accounting and reporting system for banks. All of these are now parts of Indonesia's legal and accounting systems. Their contribution to improvement in the market infrastructure is dependent on the implementation of these systems.

22/ The status of existing special purpose institutions, such as development banks and saving banks, has automatically become commercial banks. All of the 12 non-bank financial institutions (NBFIs) or merchant banks took the option to become commercial banks in 1992.

23/ The mechanisms by which foreign banks can currently penetrate the domestic markets are, however, limited through buying a maximum 49% of the floated equity of national banks at local capital markets and joint ventures with local banks. The maximum share of foreign partners in a joint venture bank is set at 85%. As a joint venture bank directly obtains a license to deal with foreign partners exchange transactions, the initial minimum capital is set at Rp 100 billion (US$ 44.1 million at the exchange rate at Rp2,265 per US$ 1), twice of the amount required for a new domestic bank. National banks can open branch offices anywhere in Indonesia. Foreign and joint venture banks can open one sub-branch in each of the eight major cities (Medan, Batam, Jakarta, Bandung, Semarang, Surabaya, Denpasar, and Ujung Pandang).

control on deposit and loan interest rates. Fifth, by relaxing the special access of state-owned banks to public sector deposits and external borrowings.

The reforms have significantly reduced the market power of the state-owned banks group, as shown by a sharp drop in their Herfindahl index (Table 14). This was, however, accompanied by an increasing market power of certain dominant banks among the groups of private institutions, particularly those owned by business conglomerates. Traditionally, the state-owned banks group has a small capital base. As the main dispenser of credit programs of the past, this group of banks inherited low yield assets and highly problematic loans. Partly because of this and inflexible structural problems, the state banks group cannot meet requirements to raise capital by selling equity to the general public. The absence of competition during the long period of financial repression and heavy control of the government on their operations have suppressed innovation of new products, modernization of technology and made the quality of their personnel more suited to carry out bureaucratic works. Unconstrained by these problems, the private banks can raise capital by selling equity bonds and other commercial papers and modernize technology and improve products and human resources.

Deregulation has not, however, totally eliminated the power of the state to control allocation of bank credit (Nasution, 1996). Table 13 shows that credit policy remains segmented and pro-cyclical as the government retains a subsidized credit program which is refinanced by Bank Indonesia. The list of activities included in the program can be expanded at government will.24/ Allocation of bank credit and portfolio management became more complicated with the introduction of three new credit regulations in 1989 and 1990. The first rule applies a legal lending limit which restricts the aggregate amount of loans and advances to insiders, whether it be a single borrower (person or firm) or a group of borrowers such as a conglomerate. The rule is not applicable to all forms of the subsidized credit programs. The second rule requires new joint venture banks and branches of foreign banks operate outside Jakarta to allocate at least 50 percent of their loan portfolios to export-related activities. The third rule mandates domestic private and state-owned banks to allocate a minimum 20 percent of their loan portfolio to small-scale enterprises and cooperatives or *KUK-Kredit Usaha Kecil.*

24/ In the beginning, as of January 1990, the credit program was limited to four areas; rice production, marketing and buffer stock, and investment in the less developed regions in the Eastern part of Indonesia. At the end of that year, however, the concessionary credit was also made available to BPPC (*Badan Penyangga dan Pemasaran Cengkeh)* for financing buffer stock of cloves. Owned by a group of politically well-connected private traders headed by, again, Mr. Tommy Hutomo Mandala Putra, the youngest son of President Soeharto, BPPC has exclusive right to operate buffer stock of cloves, the main ingredient for making domestically popular clove cigarettes.

Table 13

REFORM IN THE BANKING INDUSTRY IN INDONESIA, 1983-1995

Policy Measures	Before Reform	After Reform	Date
I. COMPETITIVE MEASURES			
1. Entry of New Banks			
(a) Private banks	moratorium since 1970	permitted	October 1988
(b) Foreign banks	moratorium since 1970	permitted to enter as joint venture	October 1988
2. Branching Power			
(a) Private banks	restricted 1)	permitted to sound banks	October 1988
(b) Foreign banks	restricted to Jakarta	permitted to seven cities (later Batam)	October 1988
3. Foreign Exchange Licence	restricted 1)	eligible for sound banks	October 1988
4. Types of Loans			
(a) State banks	mainly the extended subsidized credit programs, as set and refinanced by Bank Indonesia	the scope and coverage of the subsidized credit programs reduced	June 1983, Jan. 27, 1990
(b) Private banks	free to set	20 % total credit must be extended to small business 2)	October, 1988
(c) Foreign banks	free to set	50 % total credit must be extended to export related activities	October, 1988
5. Types of Saving and Deposit Schemes			
(a) State banks	set by Bank Indonesia	free to set	June 1, 1983
(b) Private banks	free to set	free to set	
(c) Foreign banks	free to set	free to set	
6. Deposits of the Public Sector	restricted to state banks	restricted to state banks	October, 1988
7. Deposits of the State Enterprise	restricted to state banks	up to 50 % with private banks	October, 1988
8. Deposit rates			
(a) State banks	set by Bank Indonesia	free to set	June 1, 1983
(b) Private banks	free to set	free to set	
(c) Foreign banks	free to set	free to set	
9. Loan rates			
(a) State banks	controlled by Bank Indonesia	free to set	June 1, 1983
(b) Private banks	free to set	free to set	
(c) Foreign banks	free to set	free to set	
10. Credit Ceilings			
(a) State banks	set by Bank Indonesia	eliminated	June 1, 1983
(b) Private banks	set by Bank Indonesia	eliminated	June 1, 1983
(c) Foreign banks	set by Bank Indonesia	eliminated	June 1, 1983
11. Foreign Exchange Power (limited to licenced banks)	subjected to ceilings set by Bank Indonesia	net open position 3)	Nov. 1989
12. Reserve Requirements	15 % of deposits (differentiated between banks)	2 % of deposits	October, 1988
13. Entry to New Activities			Dec. 1985 4)
(a) Leasing	not regulated	subsidiary	
(b) Venture Capital	not regulated	subsidiary	
(c) Securities Trading	not regulated	not for own account, not as broker/ dealer	
(d) Factoring	not regulated	directly	
(e) Cosumer Finance	not regulated	directly	
(f) Credit Cards	not regulated	directly	
(g) Underwriting shares 5)	---	prohibited	
(h) Custodian	not regulated	approval required for capital market)	otherwise can do as
(i) Trustee and Guarantor	not regulated	approval required for capital market)	part of usual activities
(j) Securities Administrative Agency	not regulated	prohibited	
(k) Investment Manager	not regulated	subsidiaries	
II. PRUDENTIAL MEASURES			
1. Capital Requirements			
(a) General Banks			
(i) Private banks	---	Rp. 10 billion	October, 1988
		Rp. 50 billion	October, 1992
(ii) Joint Venture banks (minimum 15 % Indonesia ownership)	---	Rp. 50 billion	October, 1988
		Rp. 100 billion	October, 1992
(b) Bank Perkreditan Rakyat		Rp. 50 million	October, 1988

Continue

Policy Measures	Before Reform	After Reform	Date
2 Legal Lending Limits	none	1 Old credit (% of bank capital) Individual group 20 % | 50% 20 % | 50% 20 % | 50% 2. New credit 20 % for indiv & 20 % for group	May 29, 1993 by May 29, 1993 by Dec, 1995 by March, 1997
3. Loan to Deposit Ratio	none	110 percent	February, 1991 6)
4 Capital Adequacy Ratio	none	(% of risk-weighted assets) 5 % by March, 1992 7 % by March, 1993 8 % by Dec, 1993 7)	February, 1991
5 Net Open Position	none	25 % of capital	March, 1989
6 Accounting Standard	none	Standardized - *Standar Khusus Akuntansi Perbankan Indonesia (SKAPI)* - Accounting Standard for Indonesian Banks	January 1, 1993

y Market

Reintroduced in February 1984, SBI is the most important money market instrument at present. On June 1, 1993, the auction system of SBI changed from "cut-off rate" (COR) to "stop-out rate" (SOR). The private sector commercial paper (SBPU) introduced in January, 1985. Until now, the government has not floated treasury bonds in domestic market.

parency end Accountability of Reporting and Management

1. To improve banking supervision by (i) standardizing accounting and reporting system; (ii) requiring commercial bank to submit detailed business plans to the central bank and banning person involved in fraudulent transactions or defaulted on significant loans from becoming shareholders, executives or member of the board of commissioners of banks.	January, 1995
2. Banks are required to (i) submit detailed credit plan to Bank Indonesia and those with uncollectible amounted to 7.5% of total credit or more are required to submit credit recovery plans; (ii) standardize internal audit system and (iii) adopt standardized information system technology.	March, 1995

1) Permitted in principle, but economic and social requirements made it prohibited in practice; 2) Since May 29, can be channeled through other banks and BPRs; 3) Overseas borrowing for public sector is subject to ceilings set by TKPLLN (Coordinating Team for Management of Commercial Offshore Loans) since October 1991; 4) Item (g) to (j) are subject to Ministry of Finance's Decisions No. 1548 of 4 December 1990; 5) Can underwrite bonds and other debt instruments; 6) Since May 29, 1993 own capital; included in the denominator; 7) In May 29, 1993, this schedule was extended to December 1994.

1 Pakto 1988, Pakmar 1988, Pakjan 1990, Pakfeb 1991, Banking Law Number 7, 1992; Banking Regulation, May 29, 1993.
2 Nasution, Anwar, "Financial Institution and Policies in Indonesia" Singapore : ISEAS (1983).
3 David Cole and Betty F. Slade, "Development of Money Markets in Indonesia", Development Discussion Paper No. 371, Cambridge, MA : Harvard University, HIID,January, 1991.
4 John Chant and Mari Pangestu, "An Assesment of Financial Reform in Indonesia : 1983-90" in G. Caprio, Jr, et.all., Financial Reform : Theory and Experience, mimeo, 1992.

Table 14. Hirfindahl index of banking industry in Indonesia, 1981-1991 a)

Year	All banks b)			Private banks			Foreign banks			Regional dev. banks c)		
	Total Deposits	Loans	Assets	Total Deposits	Loans	Assets	Total Deposits	Loans	Assets	Total Deposits	Loans	Assets
1981	0.145	0.157	0.151	0.092	0.064	0.078	0.111	0.117	0.122			
1982	0.122	0.157	0.144	0.084	0.061	0.077	0.124	0.150	0.138			
1983	0.110	0.148	0.141	0.080	0.063	0.076	0.133	0.116	0.121			
1984	0.107	0.144	0.142	0.072	0.066	0.070	0.127	0.112	0.134			
1985	0.107	0.139	0.142	0.069	0.066	0.070	0.109	0.107	0.130			
1986	0.112	0.142	0.146	0.069	0.066	0.075	0.107	0.115	0.133	0.081	0.071	0.07
1987	0.103	0.132	0.131	0.067	0.066	0.072	0.124	0.129	0.120	0.078	0.074	0.07
1988	0.102	0.125	0.123	0.066	0.064	0.072	0.124	0.129	0.128	0.080	0.075	0.07
1989	0.088	0.110	0.105	0.077	0.068	0.072	0.143	0.141	0.137	0.083	0.095	0.08
1990	0.084	0.094	0.097	0.089	0.069	0.082	0.145	0.140	0.136	0.092	0.079	0.08
1991	0.074	0.084	0.083	0.096	0.091	0.087	0.133	0.117	0.120	0.089	0.080	0.09

Source: Perbanas, *Berita Perbanas*, various edition.

Notes: a) Hirfindahl index (HI) is the sum of quadratic market share of each bank in the sample: Σ (X,M) , i = 1.....n, where X is the size of the i-th bank, n is the total number of banks in the sample, and M is the total size of that sample banks. The Hirfindahl index takes a value between zero and unity. HI equals to unity corresponds to perfect concentration or monopoly and a value of zero corresponds to perfect competition.

b) The sample includes 41 banks (5 state-owned banks, 11 foreign banks and 25 private banks) for the period 1981-1990 and for 1991, 42 banks (6 state-owned banks, 11 foreign banks and 25 private banks).

c) Regional Development Banks (1986 to 1991) consists of 27 banks.

As has been rightly pointed out by Stiglitz (I 993), the restrictions on loans to insiders have encouraged reciprocity or cross financing. In this mechanism, the insiders of one bank make loans to the insiders of other banks, and conversely, at rates that do not reflect the true actual risk or default. The existence of information asymmetry makes banks allocate credit more to such business associates, long-term customers and to those who have political influence and collateral (Stiglitz and Weiss, 1981). The banks owned by the business conglomerates have also used the selective credit regulations for mainly financing suppliers and customers of their non-bank firms. This reinforces the control of business conglomerates of wide-range of economic activities, from production and imports, down to distribution, financing and insurance.

The state-controlled insurance companies and pension funds are now taking over the position of the financially weak state-owned banks as providers of cheap and low-risk state funds for financing the targeted ISI projects and the politically well-connected private business enterprises. Operating through Jakarta and Surabaya capital markets, these state-controlled financial institutions are investing heavily to support financially unattractive but politically well-connected stock issues. Those who had sold part of their equities at inflated prices in the newly liberalized and unproperly supervised capital markets have raised funds at zero costs without loosing control on the ownership. As has been pointed out earlier, the authorities gave rents through subsidized exchange rate swap facility at Bank Indonesia. Also, foreign financing of PT Chandra Asri and infrastructure projects owned by the politically well-connected private firms receive exchange rate and interest rate subsidies from the government. Bankability of most of these companies in international financial markets is heavily dependent on their links to public entities.

VI. CONCLUSION

Public policies adopted by strong leadership of President Suharto since the mid 1960s have played an important role in Indonesia's economic development. Under him there has been a cohesive teamwork of 'technocrats' who have successfully managed the macroeconomy well. This group of highly trained economists, who control the Ministry of Finance and the National Planning Board *(Bappenas)*, has been the proponent of broad-based economic reforms and the shift of economic management towards market orientation. The group can work well during the crises and take necessary measures at the right times. However, limitations of bureaucracy restrict the scope of government interventions. The limitations also delay the reforms in legal and regulatory systems which are required in a market-based economic system.

Sound economic management is the strongest asset of Indonesia. A combination of this with microeconomic reforms, first adopted in 1986, has boosted private sector investment, non-oil exports and economic growth. A relatively low inflation rate and stable real exchange rate raises private sector savings as it encourages the process of monetization and increases willingness of the general public to hold domestic currency rather than foreign moneys. Policies have been also successful in modernizing the agricultural sector, improving human resources and physical infrastructure. Government intervention to accelerate and upgrade physical infrastruture has supported sustained and broad-based economic growth. In contrast, the long period of financial repression as well as the inward-looking and selective intervention industrialization strategy have been largely ineffective.

The are three basic ingredients of Indonesia's macroeconomic policies, namely: 'balanced budget' policy, relatively open capital account, and rising real effective exchange rate policy. Under the first policy, deficit of the public budget is capped to the level that can be financed by external borrowings, preferably in forms of official development assistances from official sources. These policies have imposed financial discipline and enabled Indonesia to avoid 'Dutch Disease' or appreciation of national currency because of export boom and/or capital surges as have happened in oil exporting countries and capital importing nations. There are two objectives of such exchange rate policy. First, to encourage allocation of resources in the domestic economy, from the non-tradable sectors, with relatively low productivity, to tradable sectors with higher productivity. Second, to enhance competitiveness of the domestic economy in international markets. To help control domestic inflation pressures from such exchange rate policy, the authorities subsidize the prices of state-vended products. However, a combination of the open capital account, potential volatility of export earnings and capital flows and structural weakness in the domestic financial system has led to long periods of high real interest rates.

Sound macroeconomic management, jointly with the more liberal economic policy, fosters private sector investment. The more liberal policy enlarges market size, reduces fixed cost of industrialization, increases division of labor and raises competition in domestic markets, because deregulation, from a microeconomic point view, has had three aspects. They are: (a) lower barriers to market entry and openness of the domestic economy to international markets of goods and services, financial assets and labor: (b) relaxation of constraints on the activities of the private or business sector; and (c) limited privatization in the sense of transfer of enterprises from public ownership to private sector.

Until the mid-1980s, Indonesia adopted a resource-based and inward-looking industrial policy with selective interventions. The policy was intended to exploit the ample domestic market (with a population of 182 million but low income per capita at $1,100 in 1993) and relatively rich natural resources. While the policy has not been generally successful in promoting the manufacturing industry, the adjustment program has not covered some of the highly protected sectors. These include 'the strategic industries', automotive, petrochemicals and infrastructure projects, forest based industries, and state-vended products, under public ownership and ownership of a number of politically well-connected private companies. In some other sectors of the economy, privatization means transfers of monopoly rights from the state to the politically well-connected groups. These, jointly with the poor implementation of rules and regulations governing the financial sector, have expanded the roles of inward-oriented domestic conglomerates. As their productivity is generally low, these investments are a burden for the rest of the economy.

The rapid rate of industrial growth since the mid 1980s has been attributed more to both domestic private sector investment and FDI than industrial policy of the government. Inflows of FDI and greater access of domestic firms to foreign technologies following the reforms have also helped increase technological capabilities of this country. As most of them come from Japan and ANIEs, FDI has led to a relocation of productive activities in this region and promoted division of labor among them along the "Flying Geese" pattern of shifting dynamic comparative advantage.

The most valuable achievement of the agricultural policy has been the attainment of self-sufficiency in rice since the mid-1980s. The policy was based on a combination of provision of economic incentives and state interventions. The state has invested heavily in providing agricultural inputs (seeds, fertilizers, pesticides, fanning equipments, extension services and financing) and rural marketing infrastructure. Bulog (the Logistic Agency) plays a crucial role in providing price incentives. State intervention was less successful in other programs, such as the expansion of treecrops in the 1980s. Public policies create distortions in other areas of agriculture such as forestry, tangerine and marketing of palm-oil.

Indonesia has been pursuing aggressive programs in family planning, mass health care and primary schooling. These combined with the success on rice and labor intensive programs have enabled Indonesia to reduce poverty and improve social indicators.

Financial repressions, such as credit ceilings, credit allocation and interest controls, have been largely ineffective and inefficient tools for promoting economic development. The failure of credit programs can be attributed to the multiplicity of objectives, weak management of credit allocation and fungibility of money. Non-price allocation is subject to abuse. The absence of competition restaints efficiency of financial intermediation. In addition, the financial repressions pay less attention to the much needed improvements in market infrastructure as well as prudential rules and regulations of the banking system and their implementation.

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