10-15-1993

Deregulation and Trade Liberalization: The Indonesia Reform Program

Scott Fausti
South Dakota State University

Rony Bishry
South Dakota State University

DEREGULATION AND TRADE LIBERALIZATION

THE INDONESIA REFORM PROGRAM

by

Scott W. Fausti and Rony Bishry*

Economics Staff Paper 93-10

October 1993

*Dr. Fausti is an assistant professor of economics at South Dakota State University. Dr. Bishry is an economist at BBP(Teknologi in Jakarta, Indonesia. The authors wish to thank Dr. Don Taylor, Dr. John Sondey, and Dr. Bashir Qasmi for their comments. Any remaining errors are the responsibility of the authors.

DEREGULATION AND TRADE LIBERALIZATION:

THE INDONESIAN REFORM PROGRAM

by

Scott W. Fausti and Rony Bishry

ABSTRACT

Beginning in the early 1980s, Indonesia embarked on the most comprehensive trade liberalization program in its history. The long-term goal of the reform program is to replace Indonesia's industrial development strategy of import substitution industrialization with one of export oriented industrial growth. The issues to be discussed in this paper are: 1) the historical context from which the current liberalization program evolved, 2) the recent reform measures implemented by the Indonesian government, 3) the pattern of liberalization with respect to the sequencing and speed of reforms, and 4) the successes and failures of the new trade regime.

DEREGULATION AND TRADE LIBERALIZATION:

THE INDONESIAN REFORM PROGRAM

I. Introduction

To appreciate the present initiative of the Indonesian government to deregulate and liberalize the Indonesian economy, one should consider the present efforts at reform within an historical context. Since independence, the Indonesian economy has gone through five distinct phases, roughly delineated by the years 1950-57, 1958-65, 1966-71, 1972-1982, and 1983 to the present.[1] The first two phases spanned a period of rising nationalist sentiment against foreign influence. This nationalistic fervor helped advance a government policy of import substitution and self sufficiency. During this period the Indonesian government, for the most part, followed an inward looking development strategy which relied on government intervention in the private sector and state enterprises. Industrial development was promoted at the expense of agriculture and the economic development programs implemented by the government had little success. Consequently, the economy stagnated while fiscal and monetary policy mismanagement pushed the inflation rate into triple digits.

In September of 1965, a new government came to power as a result of a failed coup. In 1966, a program of macro economic stabilization and trade liberalization was instituted. The liberalization program focused on stimulating private sector investment and de-emphasized government investment initiatives. Passage of the Foreign Investment Law (1967) and the Domestic Investment Law (1968) created a package of fiscal and tariff incentives that spurred new investment in the private sector. In 1969, the Indo Rupiah was made fully

---

[1]See Pitt (1981) for a detailed discussion of the first four phases.

convertible. In August 1971, Indonesia pegged its exchange rate to the U.S. dollar and eliminated virtually all government restrictions on capital movements. In November of 1978, the Indonesian government ended the rupiah-dollar link in favor of a managed float exchange rate policy.

These reforms helped to increase average annual real GDP growth from 1.7% in the 1960-66 period to 7.6% in the 1967-73 period, while reducing the rate of inflation from 85% in 1968 to 6.4% in 1972.[2] However, the government continued its policy of import substitution, favoring the import competing sector over the export sector. Evidence of disproportional protection during this period is provided by Pitt (1981).[3] Pitt calculated the 1971 average effective protection rates (ERP) and found that Indonesia's import competing sector ERP to be 66% and the export sector ERP to be -11%.[4]

The 1972-82 era was marked by raising protectionist barriers. A complicated system of tariffs and non-tariff barriers (NTB) evolved. These NTB included an import licensing system, quotas, import bans, and various informal quantitative restrictions. Informal quantitative restrictions took the form of complex port and customs clearance procedures. It is the general conclusion of economists that this strategy was counter productive; fostering a number of high

---

[2]Data on and discussion of Indonesian macro economic performance during this period can be found on Booth (1992) and Warr (1992).

[3]See Pitt (1981), p. 208.

[4]The effective rate of protection is the percentage increase in value added resulting from the assistance structure. It therefore measures net assistance by taking into account input assistance (e.g. subsidies) and input penalties (e.g. tariffs) on the activities inputs.

cost, inefficient industries at the expense of more efficient labor intensive final product industries and reduced non-oil exports.[5]

The problems that usually accompany this type of trade regime, such as a balance of payment deficit and/or government budget deficit were alleviated by the rapid increase in world oil prices during this period. During the 1972-82 period, Indonesia became increasingly dependent on oil exports for tax revenues. In 1969 80% of tax revenue was derived from non-oil sources; by 1981, the proportion had declined to 27%.[6] When world demand for oil decreased in the early 1980s, the price of oil collapsed. The decline in export tax revenue led to a widening trade and budget deficit for Indonesia. Faced with financial crisis, the government retreated further from the gains attained through trade liberalization (1966-71) and began to restrict imports. It was during this period, however, that deregulation of the financial sector of the economy began.[9] In 1983, the rupiah was devalued, and in 1984 tax reform laws were passed.

As import restrictions tightened, a debate arose over the wisdom of continuing to support an import substitution industrialization policy.[7] Economists argued that the potential gains from this policy had been exhausted and it was time to begin the transition to an export oriented trade regime and emulate the success of the other Pacific Rim nations.

In 1985 it had finally become clear to Indonesian government officials that the inward looking bias of their trade regime had created a high cost economy vulnerable to macro economic instability driven by fluctuations in world oil

---

[5]A more detailed discussion can be found in a study by the World Bank (1988b), pp. 56-58.

[6]Asher and Booth (1992), p. 49.

[7]For a detailed discussion of deregulation of the financial sector in Indonesia during this period see Cole and Slade (1992).

prices.[8] The resulting economic instability impaired the government's ability to meet its general economic goals of promoting 1) economic growth, 2) employment, 3) income, and 4) greater equity in income distribution.

II. Deregulation and Trade Liberalization: Indonesia in the 1980s

The most extensive trade liberalization program in Indonesian history was initiated in March of 1985. The long-term goal of the reform program was to reverse Indonesian industrial development strategy from import substitution industrialization to export oriented industrial growth. Between March of 1985 and May of 1990, 22 major reform measures were implemented to liberalize Indonesia's trade regime and further deregulate the financial and real (production) sectors of the economy.[9] A brief outline of the major reform measures is given below.

In March of 1985, the government began a comprehensive reform of the tariff schedule.[10] The tariff ceiling was reduced from 225% to 60% and the number of tariff categories was reduced from 25 to 11. The reforms reduced the proportion of imports subject to tariff rates greater than 30% from 41% to 18%. However, the effectiveness of this reform was partially offset by the increased use of import licensing restrictions.

In April of 1985, the government completely reorganized the customs, ports, and shipping operation procedures in order to remove informal quantitative

[8]A detailed discussion of the debate can be found in the paper by M. Hadi Soesastro (1989).

[9]For a discussion of the impact world oil price instability had on the Indonesian economy during the 1970s and 1980s, see Warr (1992).

[10]A complete description of the reform measures can be found in GATT's Trade Policy Review: Indonesia 1991, Vol I.

restrictions to trade.[11] In May of 1986, the government implemented reform measures to reduce the use of import licensing restrictions. In January of 1987, the government instituted adjustments in tariffs and surcharges to compensate domestic producers for the removal of import licensing restrictions. In December of 1987, the government removed or simplified the regulations directly affecting exporters. In October of 1988, further deregulation of the financial sector was implemented with a sweeping reform of the banking system. In November, the government replaced NTB on 301 items with tariffs. In December, private securities markets were established. In January of 1989, the Harmonized System of Trade Classification replaced the CCCN system. In May of 1990, 374 NTB were abolished and tariffs on 2363 items were lowered.[12] Indonesia has made great progress in both restructuring its economy and fulfilling its commitments to GATT and ASEAN through its liberalization program. Before October 1986, 32% of all import items, representing 41% of total domestic production, were subject to import licensing restrictions. By December of 1990, import licensing restrictions were reduced to 14% of all items imported; representing 25% of total domestic production (see table I).

The reduction in NTB restrictions allows tariffs to play the major role in determining the level and pattern of imports. Tariff rates in 1990 are applied on an "most favored nation" (m.f.n.) basis to over 90% of the total value of Indonesian imports. The average m.f.n. tariff rate in 1990 has been lowered to 22% (simple average), down from 37% in 1984 (see tables II & III).[13]

---

[11]World Bank (1988b), p. 58.

[12]World Bank (1988b), p. 59.

[13]GATT (1991) Vol. I, pp. 244-48.

Table I. Percentage Coverage of Import Licensing Restrictions in Indonesia, 1986-90

	Mid-1986	End-1987	End-1988	Early-1990	End-1990
CCCN/HS items	32	22	16	17	14
Import values	43	25	21	17	15
Domestic production	41	38	29	28	25
- manufacturing	68	58	45	38	33
- agriculture	54	53	41	40	38
- mining and minerals	0	0	0	0	0

Source: GATT Trade Policy Review 1991: Indonesia, Vol. I, p. 86.

Table II. The Structure of the Indonesian Tariff Since 1983

	1983-85	1985[a]	1988[b]	1989[c]	1990[d]
Average Tariff Rates (per cent)[e] Unweighted	37.3	27.0	24.0	27.0	22.2
Weighted					
- by domestic production[f]	29.0	19.0	18.0	19.0	16.8
- by import value	22.0	13.0	14.5	12.0	10.0
Index of dispersion (percentage points)	61.5	107.8	90.0	92.7	89.0

a Following the reform package of March 1985.
b Following the reform package of November 1988.
c The HS introduced on 1 January 1989.
d Following the reform package of May 1990.
e Including important surcharges where applicable.
f Based on a sample of 1,200 tariff positions.

Source: GATT Trade Policy Review 1991: Indonesia, Vol. I, p. 62.

Table III. Structure of Import Duty Tariff Before and After May 1990 Reform

Import duty tariff	Total number of tariff items	
	Before May '90	After May '90
0 - 10	2956	2908
15 - 20	1036	1116
25 - 30	1431	1706
35 - 40	447	
45 - 60	1505	88
> 60	103	74
Total	7431	7176

Source: GATT Trade Policy Review 1991: Indonesia, Vol. II, p. 25.

III. Trade Liberalization: The Sequencing and Speed of Reform

Deregulation and liberalization of the Indonesian economy has followed a long-run, piecemeal process. Economic reform emerged as a byproduct of the political reform that followed the failed 1965 coup. The first permanent major reform in the process was the liberalization of the capital account in 1971. Attempts during this period to permanently liberalize the current account however failed. The next major economic reform program did not begin until 1982, sparked by the onset of the oil crisis which fueled public concern over the future of the economy. These reform measures focused on the financial sector of the Indonesian economy. It is the general consensus that this round of reforms was begun in the financial sector because the political opposition to reform was weakest in this area. After financial sector reforms were implemented, it became clear that reform effort would be futile if deregulation of the real (production) sector of the economy did not follow.[14] In 1985, reform and deregulation of the real sector began. In 1986, liberalization of the current account began. The effect was encouraging, as non-oil exports expanded rapidly, sending a signal that the economy responded favorably to the reform measures.

The success of the reform measures allowed the proponents of change to gain greater influence over economic policy when the 5th Development Cabinet took office in March of 1988. The new cabinet promptly began another round of reform measures focusing first on the financial sector of the economy. The government first deregulated the banking system in October of 1988, and then allowed the establishment of private securities markets in December of 1988. Government officials, following the successful pattern of reform set in the mid 1980's, then implemented additional reforms in the real and international sectors of the economy.

In conclusion, the lessons learned from Indonesia's experience with economic reform suggests a gradual approach to deregulation and trade liberalization, focusing on liberalizing the capital account first. Next, reforms in the financial, production and international sectors of the economy, should commence in the sector which has the greatest ability to adjust in the shortest period of time. Deregulation should proceed in steps to avoid excess stress on the economy. In the Indonesian case, reform is an ongoing process that has evolved over the last ten years.

[14]GATT (1991), Vol I, p. 4.

IV. The Economic Impact of Deregulation and Trade Liberalization on the Indonesian Economy

The value (in constant US dollars) of Indonesia's non-oil exports doubled in the 1985-89 period. Non-oil export growth was led by the industrial sector, which has experienced an annual growth rate trend of 34.4%. This explosion in non-oil exports has increased the share of non-oil exports in the total value of exports from 31% to 61% (see table IV). The importance of the timing of the reforms becomes evident when one realizes that the non-oil export boom has offset the steep decline in the value of oil and gas exports. Without the reforms, the average annual real GDP growth rate of 5.7% experienced in the 1986-89 period would have been reduced and probably would have been closer to the 1.4% growth rate experienced in 1975-84 period.[15]

[15]For a discussion of this issue see Soesastro (1989).

Table IV. Indonesia's Exports by Sector (FOB, constant US dollars, 1987=100)

	1985	1986	1987	1988	1989	Trend %
Agriculture	1,449,259	1,808,490	1,636,118	1,837,515	1,790,907	4.92
Industry	4,319,618	4,654,585	6,696,392	8,913,755	10,164,101	34.40
Mining	214,380	261,429	240,477	339,742	466,804	27.20
Non-Oil Exports	6,216,949	6,737,255	8,579,600	11,103,850	12,424,055	26.99
Oil and Gas	13,472,246	8,541,383	8,566,000	7,393,263	7,998,802	-8.98
Total Exports	19,689,301	15,278,638	17,135,600	18,497,113	20,422,857	0.238
Non-Oil Exports to Total Exports	.315	.44	.50	.60	.61	23.81

Data Source: GATT Trade Policy Review 1991: Indonesia, Vol. II, p. 50-56. Nominal values transformed into real values using the U.S. GDP Implicit Price Deflator statistics reported in the 1993 Economic Report to the President, p. 352. Trend statistics calculated by regressing the precentage change from the base year for all export sector variables on time.

Growth of Indonesia's export sector under the new trade regime has been impressive. However, many of the undesirable features of the old trade regime still exist. According to a recent study by Wymenga (1991), NTB protection in 1989 was still biased in favor of import competing non-oil manufacturing. As a percentage of value, NTB protection allotted to the non-oil export and import competing manufacturing in 1989 was 12.78% and 38.06% respectively (see table V).

Average ERP for the non-oil manufacturing sector also continues to be high relative to the other sectors of the economy. However, average ERP has declined from 73.2% in 1987 to 63.6% in 1989 to 60% in 1990. The ERP rate for the import competing sector declined from 66% in 1971 to 44.4% in 1989. For the export

Table V. Percentage Coverage of Sector Production by NTB in 1989.

	Coverage of Import Licensing	Coverage of Export Restrictions	Coverage of All NTBS
Agriculture	39.98	18.17	58.15
Mining	.04	78.84	74.88
All Manufacturing	29.56	17.51	47.07
Non-oil Manufacturing	38.06	12.78	50.84
All Tradeables	27.85	27.21	55.06

Source: Wymenga (1991), p. 129.

sector, the ERP rate increased from -11% in 1971 to -6.4% in 1989.[16] For all tradeable goods, the ERP rate declined from 33% in 1971, to 15% in 1989, and to 12% in 1990 (see table VI).

Table VI. Percetage Coverage of Average ERP for Aggregated Sectors for 1971, 1989, and 1990.

	ERP 1971[a]	ERP 1989[b]	ERP 1990[c]
Import-Competing	66	44.4	NA
Export Sector	-11	- 6.4	NA
Agriculture	NA	13.9	13.0
Mining-Oil	NA	- 0.7	NA
Non-Oil Manufacturing	NA	63.6	60
All Tradeables	33	15.0	12

Source: a. Pitt (1981), p. 208
b. Wymenga (1991), p 138
c. GATT Trade Policy Review 1991: Indonesia, Vol. I, p. 126

[16]GATT (1991), Vol. I, p. 190.

Indonesian ERP rates in table VI reveal that protection is not evenly applied across all sectors of the economy. The disparity in ERP rates among sectors has decreased, however, under the new trade regime. Nevertheless, the current level of disparity is sufficient to distort the allocation of productive resources within and between sectors. The non-oil manufacturing sector remains protected at the expense of the agricultural sector, and the exporting sector is penalized in favor of the import competing sector. Despite the continued commercial policy distortions, the Indonesian government has placed the economy on a non-oil export industrial growth path based firmly on the fundamental principle of free trade. However, the real sector distortion resulting from errant policy prescription, represents a serious impediment to the government's policy objective of improving Indonesia's international competitiveness.[17]

V. Summary

Deregulation and trade liberalization in the 1980s have enabled the replacement of the import substitution development strategy with one of export led growth. Indonesia's new trade regime has spurred export growth in all sectors of the economy and assisted in increasing the average annual real GDP growth rate above the depressed 1975-84 average. Commercial policy distortions continue under the new trade regime, but they are gradually being reduced. The greatest progress has been in the area of tarrification.

The resurgence of the Indonesian economy suggests that the recent reforms are working. However, the domestic production distortions produced by uneven ERP between and within sectors of the Indonesian economy will retard progress toward international competitiveness by impairing efficient resource allocation within and between sectors of the economy. The success of the current reforms suggests

---

[17]A negative ERP implies production is in effect being taxed.

that it is vital to Indonesia's long-run economic goals that deregulation continues in the real sector of the economy.

References

Asher, M.G., and Booth, A., 1992, "Fiscal Policy", in Anne Booth et al. (eds.), The Oil Boom and After: Indonesian Economic Policy and Performance in the Soeharto Era., NY: Oxford University Press, pp. 39-76.

Booth, A., 1992, "Introduction", in Anne Booth et al. (eds.), The Oil Boom and After: Indonesian Economic Policy and Performance in the Soeharto Era., NY: Oxford University Press, pp. 1-38.

Cole, D.C. and Slade, B.F., 1992, "Financial Development in Indonesia", in Anne Booth et al. (eds.), The Oil Boom and After: Indonesian Economic Policy and Performance in the Soeharto Era., NY: Oxford University Press, pp. 77-101.

GATT, 1991, Trade Policy Review: Indonesia, Vol I & II, Geneva.

Pitt, M.M., 1981, "Alternative Trade Strategies and Employment in Indonesia", in Anne O. Krueger et al. (eds.), Trade and Employment in Developing Countries, Vol 1, Chicago: University of Chicago Press for the NBER, pp. 181-236.

Soesastro, M. H., 1989, "The Political Economy of Deregulation in Indonesia", Asian Survey, 29(9), pp. 853-869.

U.S. GPO, 1993, Economic Report of the President, Washington, DC.

Warr, P.G., 1992, "Exchange Rate Policy, Petroleum Prices, and the Balance of Payments", in Anne Booth et al. (eds.), The Oil Boom and After: Indonesian Economic Policy and Performance in the Soeharto Era., NY: Oxford University Press, pp. 132-158.

World Bank, 1987, World Development Report, Washington, DC.

_____, 1988a, World Development Report, Washington, DC.

_____, 1988b, "Indonesia, Adjustment, Growth and Sustainable Development: A World Bank Country Study", Washington, DC.

_____, 1989, World Development Report, Washington, DC.

_____, 1990, World Development Report, Washington, DC.

_____, 1991, World Development Report, Washington, DC.

_____, 1992, World Development Report, Washington, DC.

Wymenga, P.S., 1991, "The Structure of Protection in Indonesia in 1989", Bulletin of Indonesian Economic Studies, Vol.27, No 1, pp. 127-153.