INDONESIA'S ECONOMIC CRISES AND THE PROSPECTS FOR RAPID AND SUSTAINED GROWTH[1][2]

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ABSTRACT

This paper discusses the four economic crises that have been experienced by Indonesia since independence: the deep economic crisis of the mid-1960s, the economic slowdown after the oil boom in 1982, the deep economic crisis during the Asian financial crisis of 1997–98, and the adverse effects of the global financial crisis (GFC). Even though the effect of the GFC on the Indonesian economy was relatively mild compared with the devastation of the Asian financial crisis, the Indonesian economy slowed down in 2008 and 2009. Indonesia's prospects for a resumption of rapid and sustained growth will be discussed at the end of the paper.

Keywords: *financial crisis, economic crisis, growth*
JEL classification: N150

I. INTRODUCTION

This paper discusses the serious economic crises experienced by Indonesia since independence, specifically the economic crisis of the mid-1960s, the post-oil boom shock in 1982, the deep economic crisis of 1997–98 caused by the Asian financial and economic crisis, and the most recent economic crisis caused by the global financial crisis (GFC), which erupted in full in 2008 after the bankruptcy of Lehman Brothers. Although the effects of the GFC on the Indonesian economy was not as devastating as during the Asian financial crisis, it did affect the Indonesian economy adversely, which grew much more slowly than during 2007 and 2008, and is likely to grow at a slower rate over the next two years. The reason for this is that, unlike during the Asian financial crisis, the world economy is currently in recession and is likely to grow at a sluggish rate in the next few years.

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Except for the crisis of the mid-1960s, which was caused by internal factors, that is, the utter neglect of sound economic policies, the three following crises were caused by external shocks. The vulnerability of the Indonesian economy to external shocks was primarily caused by the fact that, since the advent of the New Order era, the Indonesian economy was reintegrated with the world economy with all its advantages and disadvantages.

On the one hand, reintegration with the world economy enabled Indonesia to reap the benefits of increased foreign trade and foreign direct investment and the associated benefits of technology transfer. On the other hand, it made Indonesian economy more vulnerable to the vicissitudes of the world economy, particularly since 1972 when the Indonesian Government introduced an pen capital account. Because of this, short-term capital flows (portfolio capital and short-term loans) could flow into and out of the country without any restrictions. Moreover, Indonesia's oil and gas exports still play an important role in the Indonesian economy, even though their relative importance has declined after the end of the oil boom era in 1982. Hence, sharp fluctuations in the world price of oil still affect the Indonesian economy greatly, particularly as sharp rises in the price of oil also increase the government's considerable fuel subsidies.

The post-oil boom shock in 1982 was caused by the steep decline in the world price of oil when the world oil market weakened because of the recession in the advanced countries. As a result, the Indonesian Government had to defer or cancel a number of ambitious public sector projects, devalue the currency, and introduce a series of deregulation measures and trade reforms to promote non-oil exports.

The Asian financial crisis of 1997–1998 was when the Indonesian rupiah, in the wake of the depreciation of the Thai baht, the Malaysian ringgit and the Philippine peso, through a process of contagion, started to depreciate rapidly as foreign portfolio investors and credits ran for the exit to reduce their exposure to these countries' currencies.

The global financial crisis (GFC) hit Indonesia (and the other East Asian economies) after the collapse of Lehman Brothers in late September 2008 and sparked massive sell-offs in its stock exchange and foreign exchange market, reflecting a flight to safety by investors. Fortunately, Indonesia, like Malaysia, Thailand, and the Philippines, withstood the financial turbulence well; they were better prepared for external shocks because they had learned a lot from the Asian financial crisis of 1997–98.

To better prepare itself for future external crises, the Indonesian Government has put even greater emphasis on pursuing sound macroeconomic policies, including putting a maximum cap of 3 per cent on its budget deficit, and Bank Indonesia has pursued a monetary policy aimed at preventing inflation. The Indonesian Government has also strengthened its external balances, greatly increased its foreign exchange reserves to cushion future external shocks, steadily reduced government debt as a percentage of GDP to ensure fiscal sustainability, and improved banking supervision. Stricter banking regulations have also made Indonesia's banks much healthier than they were before the Asian financial crisis.

After reviewing the four economic crises that have hit Indonesia since independence, this paper will conclude some thoughts about Indonesia's economic prospects for a resumption of rapid and sustained economic growth.

II. THE ECONOMIC CRISIS OF THE MID-1960S

By the mid-1960s, the Indonesian economy was experiencing an unprecedented economic breakdown. The chronic inflation that had plagued Indonesia since the early 1950s had, as a result of a rapid acceleration in monetary expansion since the early 1960s, turned into a crippling hyperinflation, which reached 135 per cent in 1964 and almost 600 per cent in 1965 (Grenville, 1991: 102, 108).

At its establishment as Indonesia's central bank in 1953, Bank Indonesia enjoyed a level of independence from political decision-making. However, following the decline of parliamentary democracy in 1957, and particularly since the introduction of Guided Democracy and Guided Economy by President Soekarno in July 1959, Bank Indonesia's independence came to an end. Bank Indonesia subsequently became a de facto instrument of the central government when in the early 1960s it started printing increasing amounts of money to finance the rapidly growing budget deficit, thus violating the restrictions on deficit spending. Henceforth, government spending increased rapidly without corresponding increases in government revenues (Prawiro, 1998: 3). Indonesia was also in default of a large foreign debt, which by the end of 1965 amounted to almost US$2.4 billion (around 25 per cent of Indonesia's GDP). This foreign debt amounted to 524 per cent of total exports (Hill, 1996: 5). By the mid-1960s, the Indonesian economy had contracted by 3 per cent (World Bank, 1998: I.1).

The economic breakdown of the mid-1960s was the logical outcome of the reckless disregard of sound economic policies, which had become a major feature of government policy since the late 1950s. Despite the official rhetoric of building a 'just and prosperous society', there was increasing evidence that declining per capita income was accompanied by widening economic disparities between rich and poor, particularly in Jakarta and the other big cities (Thee, 2009: 6). This declining per capita income during the early 1960s was caused by population growth outpacing output growth.

The Soeharto Government, which took over in 1966, immediately set about restoring macroeconomic stability and rehabilitating the dilapidated physical infrastructure and productive apparatus. With the assistance of the IGGI (Intra-governmental Group on Geographic Information), the new international aid consortium chaired by the Netherlands, Indonesia was able to receive new foreign aid to rehabilitate the economy. Indonesia also welcomed new foreign direct investment (FDI), particularly in resource-oriented projects and in the manufacturing sector. The outcome was rapid and sustained growth at an average annual rate of 7 per cent, which lasted through 1996 until Indonesia was hit by the Asian economic crisis of 1997–98.

III. THE POST-OIL BOOM SHOCK

In 1982, only three years after the second oil boom of 1979–80, the Indonesian economy was hit by an unexpected external shock, that is, the steep decline in the world price of oil. This steep decline was caused by a sudden weakening of the world oil market and heralded the end of the oil boom era for Indonesia.

The oil booms of 1973–74 and 1979–80 and the post-oil boom shock of 1982–83 underlined the vulnerability of the Indonesian economy to domestic and external shocks. The domestic exogenous shock was a severe drought in 1982, which adversely affected most of the main rice-growing areas. As a result, rice output was estimated to have declined by 5 to 10 per cent in 1983 (McCawley, 1983: 1).

However, compared with the deep economic crises of the mid-1960s and the late 1990s, the post-oil boom crisis of 1982–83 was relatively minor. This crisis may even be regarded as a successfully 'averted' crisis (Hill, 2009: 4) because the Indonesian Government in early 1983 speedily initiated a broad-based adjustment program to restore macroeconomic stability. To deal with the rising current account deficit, the government devalued the rupiah in March 1983. In response to the tightened fiscal position, the government pursued tight fiscal policies by deferring or cancelling several ambitious public sector projects and by severely reducing unnecessary government expenditure. In December 1983, a new tax law was introduced aimed at increasing non-oil taxes, particularly personal and corporate income taxes, and a new value-added tax was put into effect to offset the decline in oil company taxes. The government also initiated a series of deregulation measures to improve the investment climate for private, including foreign, investors.

In response to a steep drop in the price of oil in 1986, the Government also introduced a series of trade reforms aimed at reducing the 'anti-export bias' of its trade regime. These trade reforms included measures to provide intermediate inputs, locally procured or imported, at international prices to export-oriented companies (initially defined as those exporting at least 85 per cent of their output but later lowered to 65 per cent). To implement this scheme, a duty drawback facility was established to enable indirect exporters to reclaim import duties (World Bank, 1989: 59).

In addition to these trade reforms, the Indonesian government also pursued a supportive exchange rate policy to maintain the international competitiveness of non-oil exports, including manufactured exports. By keeping inflationary pressures under control and pursuing an actively managed float, the government was able to keep the real effective exchange rate from appreciating, and to keep the local costs in line with those of Indonesia's major international competitors (Pangestu, 1996: 19).

The stabilisation measures and structural reforms soon bore fruit, as domestic and foreign direct investment in export-oriented projects rose steadily. Consequently, non-oil exports, particularly manufactured exports, rose rapidly with the result that in 1996 manufactured exports accounted for more than 50 per cent of Indonesia's total exports, compared with only 5 per cent in 1981, the last year of the oil boom. Hence, within a relatively short time, the manufacturing sector had replaced the oil sector as the major source of export revenues as well as being the major engine of growth.

IV. THE ASIAN FINANCIAL AND ECONOMIC CRISIS OF 1997–1998

Unlike Indonesia's financial crisis of the mid-1960s, which many people had predicted because of the reckless disregard of sound economic policies, the financial and economic crisis of the late 1990s was unexpected. Unlike the sluggish growth during the early 1960s, the Indonesian economy during the period from 1989 to 1996 grew at an average annual rate of 8 per cent, led by strong investment growth. Macroeconomic fundamentals also appeared to be strong with inflation at 10 per cent a year and, although a little higher than the other East Asian economies, it was still low by developing-country standards. The overall fiscal balance was in surplus after 1992 and public debt as a share of GDP had fallen because the government used privatisation proceeds to repay a large amount of foreign debt (IMF, 2003: 11).

However, following the depreciation of the Thai baht, the Malaysian ringgit and the Philippine peso, the Indonesian rupiah, through a process of contagion, also started to depreciate rapidly, even after it was floated in August 1997, as foreign investors and creditors scrambled to reduce their financial exposure to Indonesia. As the rupiah continued to depreciate, the Indonesian Government in late October 1997 turned to the IMF for financial assistance. In return for a large standby loan offered by the IMF, the government in its Letter of Intent to the IMF pledged to implement a comprehensive reform program involving sound macroeconomic policies, restructure of the financial sector, and other structural reforms. It was hoped that with the availability of the IMF standby loan, confidence in rupiah would be restored (Sadli, 1999: 17).

The involvement of IMF, however, failed to stem the downward slide of rupiah and the ensuing economic crisis because President Soeharto seemed reluctant to implement the agreed reforms vigorously, particularly the structural reforms, which he perceived to be aimed at harming the business interests of his children. Moreover, IMF recovery program, with its 'one size fits all' recipe previously designed for debt-ridden Latin-American countries, was overloaded with too many provisions imposed on the Indonesian Government that did not deal directly with the weakening rupiah. Its recipe for tight fiscal and monetary policies was inappropriate because the government's budget had a fiscal surplus and inflation was relatively low.

The inability of the government to deal effectively and speedily with the serious financial and economic crisis led to a serious political crisis, which forced President Soeharto to resign after a 32-year reign. Hence, within one year, Indonesia had turned from a booming economy, extolled by the international aid community and many foreign economists as a development model worthy of emulation by other developing countries, into a 'melted down' economy that was contracting by an unprecedented 13.1 per cent and dependent for its survival on the charity of the international aid community (Thee, 2003: 184).

However, in 1998 the economy recovered slightly when it grew at a positive, though minuscule, 0.8 per cent. With a strong macroeconomic recovery since 2004, the economy has grown steadily though at lower rates than the average annual rates of 7 per cent achieved during the Soeharto era. By 2005, per capita real GDP for the first time exceeded the level reached in 1997 and in 2007 economic growth was 6.3 per cent, approaching the average annual growth rates of 7 per cent during the Soeharto era. Because of the effect of the global financial crisis, economic growth in 2008 declined slightly to a still respectable 6.1 per cent.

Because of sound macroeconomic management, fiscal sustainability was strengthened with a steady decline in the public debt to GDP ratio from 102.5 per cent in 1999 to 30.0 per cent in 2008. From a high budget deficit of almost 3.0 per cent in 2000, it declined to only 0.1 per cent of

GDP in 2008, as falling oil prices reduced pressures on the oil subsidies. The lower inflation in 2008 was the result of a strong response by Bank Indonesia, and by April 2009 annual inflation had eased to 6.3 per cent as pressures from food prices abated and the rupiah strengthened. Indonesia's economic recovery also enabled the government to leave the IMF-imposed reform program at the end of 2003 and replace it with its own reform program as stipulated in its 'White Paper'.

As a result of the crisis, the poverty rate increased from 17.6 per cent of the population in 1996 to 23.4 per cent in 1999. However, because of the steady economic recovery since then, the poverty rate declined again to 16.0 per cent in 2005 (World Bank, 2006: ix, based on Statistics Indonesia data). To lessen the adverse effects of the crisis on the poor, the government also launched several social protection schemes, including a rice for the poor scheme (RASKIN), an operational assistance scheme (BOS) to enable children from poor families to attend school, direct cash transfers to poor households (BLT), and the national community empowerment scheme (PNPM).

4.1 The Effects of the Global Financial Crisis

Early in 2008, the East Asian economies, including Indonesia, were tackling rising inflation caused by the surge in food and fuel prices. The collapse of Lehman Brothers in the USA on 15 September 2008 sparked massive sell-offs on stock exchanges and foreign exchange markets around the world (reflecting a flight to safety). After the fall of Lehman Brothers, these East Asian economies were all confronted by an acceleration in the financial turbulence that had started in mid-2007.

Fortunately, Indonesia, like other middle-income Southeast Asian countries; Malaysia, Thailand, and the Philippines withstood the financial turbulence well because they were better prepared for this shock after their experiences of the Asian financial crisis of 1997–98. Over the past decade, these countries, including Indonesia, have strengthened their external balances, increased their foreign exchange reserves, reduced government debt to ensure fiscal sustainability, and improved banking supervision (World Bank, 2009a: 6).

In the fourth quarter of 2008, disruption in the global economy hit Indonesia through the trade channel as export-oriented industries contracted sharply, with adverse effects on employment. The strong growth of non-oil and gas exports ended abruptly in the fourth (October–December) quarter of 2008, as did imports. The drop in exports, especially of non-oil and gas exports, was most evident in Indonesia's exports to China, which recorded the largest contraction: 22.1 per cent. Exports to Japan, the USA, the EU, and the other ASEAN countries also declined (Patunru and Zetha, 2009: 3). Because Indonesia's exports are still dominated by primary commodities, the agricultural sector has also been adversely affected (Patunru and Zetha, 2009: 18).

However, in general, Indonesia has thus far only suffered relatively mild effects from the global financial crisis (GFC). Together with China and India, Indonesia is one of the only three Asian countries recording positive growth. Its economy grew at 4 per cent in the year to June 2009, displaying more resilience than some of its neighbours (Resosudarmo and Yusuf, 2009: 287). Although there was a mild decline in economic growth compared with the preceding seven years, this decline was lower than the global average (Hill, 2009: 5) and that of Indonesia's neighbours, including Malaysia, Singapore, and Thailand, which are much more export-oriented than Indonesia because Indonesia's exports to GDP ratio is only 17 per cent (Resosudarmo and Yusuf, 2009: 289). Indonesia's economic performance during the GFC has also been much better than during the Asian financial crisis (Kuncoro, Widodo, and McLeod, 2009: 151).

There are three reasons why Indonesia's vulnerability to the effects of the GFC was less than that of its East Asian neighbours. First, its relatively low share of manufactures in its total exports; second, the relatively low share of inter-regional trade in total trade; and third, the relatively low degree of 'export-led' growth.

Compared with its Southeast Asian neighbours, the share of Indonesia's manufactured exports in its total exports during the period 2005–6 was rather low, only 12.5 per cent of its GDP, compared with Singapore's 156.8 per cent, Malaysia's 75.4 per cent, the Philippines' 34.7 per cent, and Thailand's 47.7 per cent. On the other hand, Indonesia's share of primary exports in its total merchandise exports was the highest; 43.7 per cent compared with Malaysia's 17.8 per cent, the Philippines' 7.3 per cent and Thailand's 11.7 per cent (Goldstein and Xie, 2009: 26).

The reason why Indonesia's relatively low dependence on manufactured exports made it less vulnerable to the GFC was that manufactured exports have much higher income elasticities than primary exports. Hence, the demand for manufactured exports falls sharply during recessions in the major export markets (Goldstein and Xie, 2009: 27), as was the case with Indonesia's Southeast Asian neighbours.

A second reason why Indonesia was not as hard hit by the GFC as were the other Southeast Asian countries was that it had not participated in a major way in the regional product fragmentation trade, the cross-border dispersion of parts and components production within vertically integrated production processes. This product fragmentation has been the outcome of the rapid expansion of the involvement of transnational corporations (TNC) in the world economy. In East Asia it has been Japanese TNCs that have been largely involved in the regional product fragmentation trade (Athukorala, 2007: 72, 88).

Indonesia's low involvement in the regional product fragmentation trade is shown by the fact that in 2003 the share of parts and components (including automobile parts and electronic components) in Indonesia's manufactured exports was only 18.5 per cent, but Malaysia's, the Philippines', Singapore's ,and Thailand's shares were respectively, 55.7 per cent, 63.1 per cent, 49.2 per cent, and 32.5 per cent (Athukorala, 2007: 82–83). The major reason for Indonesia's poor performance was its ambiguous attitude towards foreign direct investment (FDI) which made it a relatively unattractive place for foreign investors.

However, when the GFC struck, Malaysia, the Philippines, Singapore, and Thailand were much harder hit than Indonesia, which was less export-oriented than these four countries. In a sense, Indonesia's better performance during the GFC was to some extent more by default than by design.

A third reason why Indonesia was not as vulnerable to the transmission of the GFC was that Indonesia's economic growth was not as export-led as its Southeast Asian neighbours. First of all, Indonesia's net exports, as a percentage of GDP, in 2006 were only 9.6 per cent compared with Malaysia's 13.1 per cent, Singapore's 20.4 per cent, and Thailand's 15.4 per cent. For this reason, the share of Indonesia's net exports' contribution to growth, that is, its net exports to average GDP growth during 2000–08, was only 7.7 compared with the Philippines' 20, Singapore's 27.3, and Thailand's 10.4 (Goldstein and Xie (2009: 29). In other words, the contribution to growth of domestic expenditures, including consumption (private and government) and investment, was larger than for Indonesia's Southeast Asian neighbours.

From the point of view of financial integration, a fourth reason why Indonesia was less vulnerable to the transmission of the GFC was that it benefited from not increasing its exposure (relative to its GDP) to banks in the USA, the EU and Japan in the decade preceding the GFC. Instead, it had relied more although not too successfully, on relatively more stable FDI inflows, and from having avoided large credit exposures to sub-prime loans and securities originating in the USA (Goldstein and Xie, 2009: 38).

Fiscal stimulus measures, including tax cuts, skilful monetary policy, and direct cash transfers to the poor, have also significantly contributed to softening the adverse effects of the crisis. The parliamentary elections in April 2009 and the presidential elections in July 2009 provided further economic stimulus. Election-related spending by parliamentary candidates on voters also contributed to household incomes, particularly of the poor. These stimulus measures helped maintain employment in the formal sector and the proportion of casual workers in the labour force (Resosudarmo and Yusuf, 2009: 287).

However, Indonesia's economic slowdown may last a little longer than people expect. The reason is the slowdown in the world, particularly the USA, the EU and Japan, which used to be the main drivers of world economic growth. With the global economy in recession, global trade and capital have naturally declined, hence causing emerging markets, including Indonesia, to scramble to attract any form of capital (Hill, 2009: 8). In contrast, in 1998 the world economy, including the US economy, was growing strongly, enabling the crisis-affected countries, except Indonesia, to recover relatively quickly.

4.2 Prospects for A Resumption of Rapid and Sustainable Growth

Despite the fact that Indonesia's economic performance during the GFC has been better than its Southeast Asian neighbours, this is no reason for complacency. It was argued above that this better performance has to some extent been more by default than by design because Indonesia is less export-oriented than its Southeast Asian neighbours.

A worrisome feature of Indonesia's growth after Asian economic crisis is that the domestic sectors have been growing more rapidly than the export sectors. Among the export sectors, the performance of the manufacturing sector in particular has been disappointing. Whereas, during Soeharto era, the manufacturing sector had been growing at double-digit rates, after Asian economic crisis the manufacturing sector has only been growing at low, single-digit rates. For instance, in late June 2009, the year-on-year growth (at 2000 prices) of the manufacturing sector was only 1.5 per cent, with the non-oil and gas manufacturing sub-sector only growing at 1.8 per cent (Resosudarmo and Yusuf, 2008: 293).

Manufacturing growth, fuelled by manufactured exports, has been particularly important after the oil boom era in 1982, when the manufacturing sector since the late 1980s not only emerged as the largest source of export revenues, but also as the major engine of growth. In the late 1980s, when low-skill, labour-intensive industries were established by foreign and domestic investors, the manufacturing sector also generated considerable employment in that sector. Hence, a resumption of rapid growth of the manufacturing sector, including labour-intensive industries, is essential to fuelling rapid economic growth, generating employment and reducing poverty, as China's experience has shown.

With growth estimated to be 4.5 per cent in 2009 (World Bank, 2009c: 10), Indonesia faces the possibility that it will only be able to achieve a respectable growth of 6 per cent plus, and at best 7 per cent, in the coming years, slightly less than it recorded during Soeharto era. Because the manufacturing sector, fuelled by manufactured exports, emerged as the major engine of growth after the oil boom in the early 1980s, the sluggish growth of manufactured exports in recent years is worrisome. The reasons for this sluggish growth are the diminished prospects for labour-intensive manufactured exports, lack of progress in developing skill-intensive manufactured exports, and the great reliance on natural resource-intensive sectors (Coxhead and Li, 2008: 233). In fact, although the growth of manufactured exports, with a few exceptions, has been sluggish, Indonesia's primary exports, including palm oil and coal, have been growing rapidly, at least until the onset of the GFC. As a result, primary exports have again emerged as an important source of export revenues, just as it was during the Dutch colonial period. However, relying mainly on commodity exports exposes the economy to the vicissitudes of the world economy and the adverse effects of the 'Dutch disease'.

A more serious aspect of relying too much on Indonesia's natural resource base for export revenues is that it deflects the attention of policy-makers from focusing on efforts to build an internationally competitive manufacturing sector. As argued earlier, efforts to promote export-oriented industries were only made after the oil boom era in 1982. It is not surprising that the resource-poor Northeast Asian countries, including Japan, South Korea, and Taiwan, were able to develop a highly efficient, internationally competitive manufacturing sector because this was the only sector that could generate the needed foreign exchange revenues.

An even more serious aspect is that resource exploitation, which generates resource rents, led to a proliferation of rent-seeking activities, not only during the Soeharto era, but also currently. Although corruption takes place all over world, it is no surprise that the vast resource rents generated by resource exploitation, which were not adequately captured in resource rent taxes by the Indonesian state but diverted to the pockets of government officials and their business cronies, have contributed significantly to make Indonesia one of the most corrupt countries in the Asia–Pacific region.

In the late 1960s and early 1970s, considerable oil rents were diverted from the Ministry of Finance to finance the operations, several of dubious economic value, of the state-owned oil company, Pertamina. Since the mid-1970s, unsound forestry policies have generated considerable forest rents; private logging companies were undercharged for their concessions and royalties in return for their financing of several development projects, some of little economic value, that had been prioritised by President Soeharto (Ascher, 1998: 38).

Unfortunately, the continued over-exploitation of Indonesia's precious tropical hardwood forests has continued unabated up to the present because of weak government control. Because of this, Indonesia is facing a major problem of suffering large losses from the adverse effects of climate change. Deforestation, peat land degradation and forest fires have put Indonesia among the top three emitters of greenhouse gasses in the world after China and USA. Emissions from deforestation and forest fires are five times those from non-forestry emissions (World Bank, 2007: 1).

Although deforestation and forest fires have occurred during the Soeharto era, particularly since the early 1990s, and affected the health of the people of Sumatra, Kalimantan, and neighbouring countries, particularly Malaysia and Singapore, they have arguably become worse in recent years as forests have been felled to make way for the oil palm plantations that have expanded all over Indonesia.

Indonesia will experience significant losses because of climate change. Being an archipelago, Indonesia is very vulnerable to the adverse effects of climate change. Prolonged droughts, increased frequency of extreme weather conditions, and heavy rainfall leading to big floods, are some of the glaring consequences of climate change. These may lead to unforeseen effects on agriculture, fishery and forestry, and result in serious threats to food security and livelihoods (World Bank, 2007: 1).

At the Conference on Climate Change in Copenhagen in December 2009 which was sponsored by the United Nations, Indonesia committed itself to reducing its green-house gas emissions by 26 per cent by 2020, and even by 41 per cent if it receives international aid. One important step to reduce its emissions caused by deforestation will be the moratorium on the expansion of oil palm plantations, and the close monitoring of the operations of logging companies lest they fell trees in protected forests.

To strengthen its natural resource sector, Indonesia should endeavour to establish its own, efficient, resource-processing industries, if necessary with foreign investment. For example, instead of exporting crude oil only, Indonesia should establish more and efficient oil refineries, so that it would not have to rely on imports of refined oil from Singapore.

Although boosting the labour-intensive industries is crucial to Indonesia because it can still draw on a large labour surplus in the rural areas, developing skill-intensive industries in line with the growth of a skilled labour force is essential to sustain rapid industrial and economic growth. To this end, top priority should be given to training to ensure a skilled labour force, including managers, engineers, technicians and shop floor workers. The industrial and technological upgrading of the manufacturing sector also very much depends on attracting new foreign direct investment (FDI). However, to achieve this, the government needs to make a much greater effort to improve the investment climate, which, despite some efforts by the government, is still relatively unattractive compared with the other Southeast Asian countries.

With the global economy expected to grow sluggishly in the next few years, it would be imprudent for the manufacturing sector to rely mainly on exports. With rising per capita incomes, there would also be a significant domestic market for Indonesia's manufacturing industries. To ensure that their products are accessible to Indonesia's consumers, the manufacturing industries should endeavour to produce high quality products at the lowest price possible, goods that should be easily accessible to consumers all over Indonesia by better logistics, including more efficient container terminals and more efficient inter-island shipping. Hence, in deciding on an appropriate industrial strategy, it is not merely a matter of choosing between export-oriented and import-substituting industrialisation, but ensuring efficient industrialisation, that is, efficient export-oriented as well as efficient import-substituting industrialisation. This implies that excessive import protection and export subsidies should be eschewed; if not they will not only cost the country dear, but perpetuate inefficiencies in manufacturing sector.

Tackling the dilapidated physical infrastructure is crucial to attracting more FDI, as well as simplifying the still cumbersome administrative requirements, strengthening legal certainty and ensuring proper law enforcement, and making the rigid labour market more flexible. During the Soeharto era, considerable investment took place in the rehabilitation and expansion of physical infrastructure, including roads, bridges, harbours, electricity, communications and irrigation networks, but since the Asian financial crisis, investment in infrastructure has lagged. In fact, Indonesia's investment-to-GDP ratio is currently lower than its East Asian neighbours (OECD, 2008: 42). As a result, physical infrastructure has been crumbling at an alarming rate, and is one of the major impediments to attract more domestic and foreign direct investment to Indonesia.

To the extent that the prospects for the product fragmentation trade are still good once the global economy recovers, it would be indeed be imperative for Indonesia to improve its investment climate for foreign investors. In fact, it has been these foreign investors who established the supporting industries that produce automobile parts, electronic components and components for the electrical goods industries in Malaysia, the Philippines, Singapore and Thailand. One of the weak links in Indonesia's industrial structure is that it has not been successful in past decades in establishing a broad and strong layer of supporting industries.

The steady appreciation of rupiah vis-à-vis the US dollar since April 2009 was mainly the result of Indonesia's strong trade balance caused by the relatively good performance of the non-oil and gas exports (Resosudarmo and Yusuf, 2009: 299). However, a strong US recovery and rebounding of the US dollar against a basket of currencies could exert renewed pressure on the rupiah to US dollar exchange rate, which has been following the broader strengthening and weakening of the US dollar very closely since the onset of the GFC (World Bank, 2009b: 8). Because the swings in the external value of rupiah adversely affect the competitiveness of Indonesia's exports, including its manufactured exports, Bank Indonesia has been at pains to keep the real effective exchange rate competitive by keeping inflation under control.

To realise its potential to rise further in the ranks of dynamic, middle-income economies, Indonesia can, just like India, benefit from a 'demographic dividend'. The reason is that with declining fertility rates and with the fraction of elderly persons yet to rise sharply, Indonesia has still a relatively young population. This implies that the working-age population is still increasing relative to the rest of the population (World Bank, 2009c: 29).

In conclusion, one can state that Indonesia's challenge in the foreseeable future is how to guard itself against future external shocks. The recurrence of internal shocks is unlikely; sound macroeconomic policies have been firmly in place from the beginning of Soeharto era up to the present. However, guarding against external shocks is much more difficult because Indonesia is now firmly embedded within the global economy with all its advantages, but also its risks of being affected by adverse external shocks, including the recent GFC. To guard against a recurrence of such an external shock, Indonesia by virtue of its membership in the G20 countries could help formulate the policies required to strengthen regulations that monitor and better regulate the financial institutions that were responsible for the GFC and help design the policies required to liberalise international trade more by reviving the stalled Doha Round and eschewing beggar-thy-neighbour protectionist policies, which would aggravate the global economic crisis.

5.1 Final, Speculative-Comparative, Long-Term Perspective

Despite its emergence as the third-largest democracy in the world after India and USA, and its steady economic progress and inclusion in the G20 biggest economies, Indonesia is still beset with doubts about its ability to achieve its national objective of becoming an economically strong, modern, and technologically advanced country by 2030, if not 2025. This is, for instance, reflected in the grave concerns about the adverse effects of the ASEAN–China Free Trade Agreement that went into effect on 1 January 2010.

To achieve its national objective, Indonesia should put its house in order: establish or strengthen its institutions, remove the sources of lucrative, rent-seeking activities and corrosive corruption, and address its structural weaknesses, such as its weakness in formulating and implementing sound policies, its poor investment climate, its dilapidated physical infrastructure, its uncompetitive manufacturing industries, and its failure to develop strong, highly skilled, and highly motivated human resources.

If these goals are not achieved, Indonesia could well become 'a country with enormous potential which would always remain a country with enormous potential'. It could become a country like Argentina, which at the beginning of the 20th century was one of the two richest countries in the world according to a book by Tim Duncan and John Fogarty: Australia and Argentina: on parallel paths. Although Australia, a resource-rich country, forged ahead, though not spectacularly, during the 20th century and by the early 21st century had remained one of the most prosperous countries in the world; Argentina, another resource-rich country, has up to the present remained 'an emerging economy' with a per capita income about one-sixth that of Australia because it persisted in continuing its protectionist, inefficient, import-substituting industrialisation. It is up to us, the Indonesian Government and the Indonesian people, whether by 2025 or 2030, to be more like Australia than Argentina!

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