

Thee, Kian Wie

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## **ADB Institute Discussion Paper No. 46**

# **Policies for Private Sector Development in Indonesia**

THEE Kian Wie

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Thee Kian Wie is Senior Economist, Economic Research Centre, Indonesian Institute of Sciences (P2E-LIPI), Jakarta (e-mail: [theekw@cbn.net.id](mailto:theekw@cbn.net.id)). This paper was written when he was a Visiting Fellow at ADB Institute.

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## **1. Introduction**

Private sector development and investment in the sense of tapping private sector efforts and investment for promoting economic development is crucial to spurring economic growth and reducing absolute poverty. Combined with public sector efforts, private investment, particularly in competitive markets, has great potential to contribute to growth (World Bank, 2005b: 273). Private markets function as the engine of economic growth, creating productive jobs and higher incomes. With the government playing a complimentary role of regulation, funding, and provision of services, private initiative and investment can help provide the basic services and conditions that empower the poor by improving health, education and infrastructure (World Bank, 2005b: 273).

Since the 1980s development thinking among the multilateral aid agencies, particularly the World Bank and the regional development banks, including the Asian Development Bank (ADB), has therefore shifted from an early emphasis on the central role of the state to the importance of the private sector to raising economic growth. This recognition of the importance of private sector development was based on the observation that market forces and competition turned out to be more efficient, more productive and more conducive to economic dynamism. Privatisation of state-owned enterprises (SOEs), strengthening market forces, increasing competition and refocusing the role of the state became the new catchwords among the policy recommendations offered by these multilateral aid agencies (Schulpen & Gibbon, 2002: 1).

Following in the footsteps of the multilateral aid agencies, a number of bilateral aid donor agencies were also attracted by the private sector development model. Consequently, they either adopted new aid programs aimed at strengthening the recipient country's private sector, reworked and strengthened existing private sector development programs, or redesignated their aid programs as related to private sector development, which had earlier been classified under different headings. In fact, the private sector development programs of several individual donor countries have actually had a stronger focus on developing the private sector in the recipient developing countries, while the multilateral aid agencies have often focused more on structural reforms (Schulpen & Gibbon, 2002: 1)

### **1.1 Private sector development in Indonesia**

In Indonesia the focus on private sector development came in fits and starts. The reason was that there was a long-standing distrust of private capital in Indonesia, which had arisen during the period of Dutch colonial rule (Hollinger, 1996: 8). During the early independence period in the first half of the 1950s, the Indonesian government introduced an affirmative program to promote the development of indigenous Indonesian entrepreneurs.

With the introduction of 'Guided Democracy' and 'Guided Economy' in the late 1950s with its emphasis on 'Indonesian-style socialism', government focus shifted to building a national industrial economy around state-owned capital, that is state-owned enterprises (SOEs). State-owned trading firms were given a monopoly on the import of essential commodities and were provided with state credit. On the other hand, the private sector, including indigenous and ethnic Chinese firms, were excluded from the most lucrative

trading monopolies, and were not provided with lavish credit as the SOEs were (Robison, 1986: 80).

With the coming to power of Soeharto's 'New Order' regime with staked its political legitimacy on economic development, the pendulum swung back again to a favourable stance towards private enterprise. This was reflected in the introduction of a new foreign investment law and a domestic investment law, which provided various incentives and guarantees to foreign and domestic investment.

The two oil booms of the 1970s, however, provided the government with considerable resource rent taxes, which enabled the government to make a start with an ambitious state-led industrialization. This industrial program involved the establishment of large-scale, capital-intensive, basic industries. However, the oil boom era ended in 1982 when the price of oil tumbled in the world oil market as a result of the recession in the advanced industrial countries.

With a considerably diminished fiscal capacity, the government once again attempted to promote the development of a more efficient private sector through the introduction of a series of deregulation measures to improve the investment climate for private entrepreneurs. This policy was maintained up to the onset of the Asian economic crisis in 1997.

The Asian economic crisis, which led to the fall of President Soeharto in May 1998, had a considerable adverse impact on private enterprises, including domestic as well as foreign, as they were burdened by huge foreign debts which they could not repay because of the steep depreciation of the *rupiah*. Export-oriented firms faced difficulties importing intermediate inputs, as foreign banks refused to accept the letters of credit issued by Indonesian banks.

With the recent mild economic recovery, private enterprises are in a position again to undertake some new investments, which are needed to sustain economic growth, although these investments are still much smaller than the investments during the boom times of the first half of the 1990s. However because the country's investment climate has deteriorated considerably, encouraging new investment, both domestic and foreign direct investment (FDI), has been difficult, even though domestic and FDI has slightly increased since 2004.

Indonesian government policies towards the private sector have been a major determinant of this sector's development and often been ambiguous, as outlined above. For this reason, an overview will first be given of these policies, which have greatly affected private sector development in Indonesia. This overview is important to understand how and why development of the private sector has occurred as it has.

To better understand these policies, it is helpful to distinguish between the three major elements of the private sector, including the conglomerates and large companies, mostly but not exclusively owned or controlled by ethnic Chinese businessmen; the small- and medium-scale enterprises (SME), mostly owned by indigenous (*pribumi*) businessmen, but also by a sizable number of ethnic Chinese businessmen; and foreign-invested enterprises.

Since independence policies towards the private sector have often been influenced by the consideration to promote the development of indigenous (*pribumi*) Indonesian entrepreneurship. These policies involved affirmative policies to promote *pribumi* entrepreneurship by restricting, occasionally even banning, the economic activities of the ethnic Chinese. For this reason a section in this paper will discuss the government policies on limiting the economic activities of the ethnic Chinese.

The rapid growth of large private conglomerates which emerged and thrived under the patronage of Soeharto's 'New Order' regime has been discussed extensively by foreign and Indonesian writers, and will therefore not be discussed in this paper. Instead, the discussion will focus on the two other elements of the private sector, namely the foreign investment sub-sector in view of its expected role in revitalizing the Indonesian economy, and the SME sub-sector which, despite its great potential and importance for the Indonesian economy, has not developed as expected.

## **2. Government policies towards Indonesia's private sector: A historical overview**

To a large extent the economic policies pursued by successive Indonesian governments since the early years of independence up to the present have been shaped by the interplay of the major economic challenges faced by Indonesia at the time and the economic ideas of the major policy-makers. Because of Indonesia's colonial past and the perceived economic dominance of the ethnic Chinese minority in the economy, government policies have also been influenced by economic nationalism. Paraphrasing the late Harry Johnson, professor of economics at the University of Chicago, economic nationalism in newly independent nations emerging from colonial rule is defined as 'the national aspiration to having property owned and controlled by nationals and having economic functions performed by nationals (Johnson, 1972: 26). For this reason since the early years of independence until the end of President Soeharto's 'New Order' regime in May 1998, the development of the private sector, including the large private enterprises, small- and medium-scale enterprises (SMEs) and foreign-invested enterprises, has been greatly affected, more often than not adversely, by misguided and extensive state intervention.

### **2.1 The early independence period, 1950 - 1965**

In the early years of independence in the 1950s Indonesia's political leaders, including the major economic policy-makers were, on account of their bitter experience during the Dutch colonial period, quite averse to capitalism, including a market economy and private enterprise. Instead, many of these leaders were attracted to socialism in its various forms, including Fabian socialism, although in general not to Marxism-Leninism or other radical leftist ideologies, save for the communists, who in the 1950s were still relatively small in number.

Besides an aversion to capitalism and to quote, President Sukarno, 'free fight liberalism', economic policies in Indonesia since independence up to the present have also been

strongly influenced by the force of economic nationalism. During the early post-revolutionary years in the 1950s economic nationalism was particularly strong, even aggressive, because of the continuing dominance and control of Dutch business and to a lesser extent of Chinese business, over the Indonesian economy. In fact, it was estimated that the modern sector of the economy, generating about 25 per cent of Indonesia's GDP at the time, was still dominated by Dutch firms and a few American and British transnational corporations. Moreover, many senior positions in the fledgling public service were occupied by Dutch officials, whose loyalty to newly-independent Indonesia could not readily be taken for granted (Higgins, 1990: 40). No wonder that during this period many Indonesian nationalists called for a 'transformation of the colonial economy into a national economy'.

In the 1950s the force of economic nationalism in Indonesia could be easily understood. Under the terms of the the Financial-Economic Agreement (Finec), reached at the Round Table Conference in The Hague in late 1949, the Netherlands' agreement to transfer sovereignty speedily to Indonesia was accompanied by a commitment by the Indonesian government that the legal rights and interests of Dutch enterprises operating in independent Indonesia would be protected. In other words, they could continue to operate without any hindrance, just like during the colonial period, although as foreign companies they were now operating in a less conducive, even hostile political environment.

Even though most Indonesian nationalists disliked this agreement, during the first half of the 1950s strong economic nationalism was tempered by a pragmatic recognition of economic realities. In particular, it was recognised that the continued operations of Dutch business was essential to rebuilding the war-ravaged economy, in particular the large estates and mines which were to yield much needed foreign exchange.

Despite the constraints imposed by the Finec, the pragmatic economic policy-makers were nevertheless determined to match Indonesia's hard-won political independence with meaningful economic independence. As under the provisions of Finec nationalisation of a number of vitally important economic institutions and enterprises was allowed, albeit with certain conditions attached. For instance, nationalisation required the consent of both the Indonesian and Dutch governments, as well as the enterprise to be nationalised.

To counter Dutch economic dominance, the Indonesian government took several measures, notably the nationalisation of the Java Bank in 1951. The Java Bank had been the bank of circulation during the Dutch colonial period and because of its strategic economic position was the obvious first target of nationalisation. In 1953 the Java Bank was made the central bank of Indonesia under its new name, Bank Indonesia. Subsequently, other Dutch companies operating in important fields were also nationalised, including the public utilities and railways.

After the mid-1950s relations between Indonesia and the Netherlands, never cordial since Indonesia's independence, rapidly deteriorated because of the dispute over the status of West Irian (currently named Papua province). Viewing Indonesia as the natural inheritor of the Netherlands Indies, of which West Irian had been a part, the Indonesian government demanded that sovereignty over this territory also be handed over to Indonesia. The Dutch government refused, arguing that racially, culturally, and linguistically the Papua

population inhabiting West Irian was not part of the Indonesian nation. When an Indonesian motion to the United Nations Assembly in November 1957 urging the Dutch government to reach a settlement with Indonesia on the West Irian dispute, was defeated, anti-Dutch demonstrations broke out in Jakarta. Militant labour unions affiliated with the Indonesian Communist Party and the Indonesian Nationalist Party took over the head offices of Dutch companies in Jakarta and other big cities. In the following two weeks similar take-overs of Dutch companies took place all over the country.

Although the Indonesian government had not initiated these take-overs, it did not resist them either. To forestall economic and political chaos, the army put these taken-over enterprises under its control. In early 1959 the Indonesian government officially nationalised all Dutch enterprises, and turned them into state-owned enterprises (SOEs). The management of most of these new SOEs were entrusted to senior military officers. The nationalisation of all Dutch enterprises went a long way towards satisfying Indonesia's economic nationalism, that is its aspiration 'to own and control the productive assets formerly owned and controlled by foreigners', and 'to fill those economic functions formerly played by foreigners'.

The nationalisation of all Dutch enterprises, however, did not fully satisfy Indonesia's economic nationalism because various important economic activities affecting the livelihood of the Indonesian population were still controlled by ethnic Chinese. These included the important intermediate trade, rice mills and money lending. In fact, as a result of the nationalisation of all Dutch enterprises in 1959, the ethnic Chinese community emerged as the strongest element in the economy, aside from the government itself. Particularly in the rural areas the Chinese had since the Dutch colonial period built a position of dominance in retail trade, in rice milling and in rural finance (Mackie, 1971: 9).

In dealing with the ethnic Chinese business community, however, the problem was complicated by the fact that the ethnic Chinese community consisted of both Indonesian citizens and foreign nationals, most of them citizens of the People's Republic of China and a much smaller group loyal to the government in Taipei, China. In the case of the ethnic Chinese, economic nationalism was also tempered by the aversion of many Indonesian political leaders to practice overt ethnic or racial discrimination because of their long struggle against Dutch colonial rule and its implied racial discrimination (Sadli, 1988: 359).

Dealing radically with Chinese economic activities was also complicated by the fact that the economic activities of the ethnic Chinese, particularly in the rural areas, was intertwined with the economic activities of the indigenous Indonesian rural population. There was concern that trying to eliminate the Chinese economic activities too hastily might hurt the indigenous Indonesians. On the other hand, precisely because of the close contact of the rural population with the Chinese intermediate traders, who bought up their farm produce to be sold to the Dutch trading companies and who sold them various consumer goods which had been imported by these companies, resentment of the Chinese was much more intense than with the Dutch, as they often felt cheated by the Chinese traders. Moreover, these Chinese intermediate traders also often functioned as money lenders, who were disliked because of what the rural population considered usurious interest rates charged by these money lenders.

Despite some concern about the possible adverse economic effects of dealing too harshly with the Chinese traders, successive Indonesian cabinets felt compelled to take measures to reduce Chinese economic dominance and foster the growth of an indigenous Indonesian business class. To this end, Djuanda, Minister of Welfare, in April 1950 issued a regulation which gave priority to indigenous businessmen to import goods from abroad. To facilitate this import trade, indigenous businessmen were given easy access to cheap credit. This program was called the '*Benteng*' (Fortress) program (Siahaan, 1996: 168). Actually, the major purpose of the Benteng program was to try and set up a counter-force to Dutch business interests, particularly the monopolies of the 'Big Five' Dutch trading companies (Sumitro, 2003: 59).

Choosing the import trade as the first major economic activity, on which policies to promote indigenous entrepreneurship would be focused, was understandable because at the time almost all the export and import trade were in the hands of the Dutch and the Chinese (Suhadi, 1967: 218). Focusing on the import trade to secure indigenous Indonesian dominance appeared to be the most feasible, because this trade seemed to be most responsive to state direction through controls over the allocation of import licenses (Robison, 1986: 44). The import trade also appeared the most accessible to indigenous businessmen, because they could easily set up their business with a minimum of overhead investment, could concentrate on products sufficiently standardized, which only required a minimum of business experience, and could deal in goods that enjoyed a seller's market because of import restrictions (Anspach, 1969: 168).

The Benteng program attracted a lot of interest. While in 1951 some 250 businessmen had registered with this program, in 1952 this number had increased to 741, and to 1,500 in 1953 and to over 2,200 in 1954 (Siahaan, 1996: 168). As a result, the percentage of total government foreign exchange credit allocated to the Benteng importers increased from 37 per cent in 1952-53 to over 76 per cent in late 1954 (Robison, 1986: 45).

From the time that the new indigenous importers had started receiving preferential treatment under the Benteng program, with several of them lacking capital or business experience or both, they engaged in business practices which, although not in violation of the letter of the law, did offend ethical standards. There were of course other new indigenous importers who had established a *bona fide* cooperation between their indigenous companies and non-indigenous or foreign companies. However, there were many more cases which could hardly be named *bona fide* enterprises, in which indigenous importers and ethnic Chinese businessmen (whether Indonesian citizens or foreign nationals) had set up so-called 'Ali-Baba' concerns. In fact, 'shotgun weddings between the new indigenous importing companies and the older import companies of ethnic Chinese businessmen proliferated under various forms, such as fronts and straw men and the selling of import licenses to genuine, mostly ethnic Chinese, importers (Sutter, 1959: 1027). Hence, the Benteng program did not foster a strong, self-reliant indigenous merchant class, but a group of licensed, but unproductive rent-seekers. Not surprisingly, these importers were often referred to as 'briefcase importers' (*importir aktentas*), whose only 'qualification' as an importer was that they carried a briefcase (Siahaan, 1998: 168).

To eliminate bogus importers, the government in 1953 started screening officially registered indigenous importers. As a result the number of registered importers was



reduced by more than half from about 4,300 to about 2,000 (Burger, 1975: 171). This measure, however, turned out to be ineffective. In August 1954 the Central Office of Imports estimated that about 90 per cent of the registered national importers were not bonafide. This estimate was confirmed by another screening in 1955 ordered by Roosseno, the new Minister of Economic Affairs, who had replaced Iskaq, the former Minister of Economic Affairs. However, even Iskaq, who had been a strong supporter of the Benteng program, acknowledged that import licenses were being sold at 200 to 250 per cent of their nominal value (Anspach, 1969: 174).

Thus Indonesia's experience with its first affirmative program to promote a strong and self-reliant indigenous business class proved to be a failure, and in the second half of the 1950s came to an inglorious end, even though this program was never officially abolished.

Other measures directed at reducing the economic dominance of the Chinese in other fields included a government regulation in 1954 which decreed that the ownership of existing rice mills owned by Chinese had to be transferred to indigenous Indonesians. The regulation also stipulated no new licensing for running rice mills would be issued to foreigners (Suryadinata, 1992: 132). As at the time many ethnic Chinese were still Chinese citizens, this decree could be applied to these rice mill owners. However, like the Benteng Program, the implementation of this regulation also proved difficult because of the shortage of experienced indigenous rice mill operators. Hence, the deadline for implementing this regulation had to be continuously extended (Anspach, 1969: 184).

Another important measure in the 1950s to break Chinese control of the intermediate and retail trade in the rural areas was the Government Decree no. 10 of 1959 issued in November 1959. This decree stipulated that as from 1 January 1960 foreign nationals would be banned from rural trade and would have to transfer their business to Indonesian nationals (Suryadinata, 1992: 135). Although on paper Indonesian nationals benefiting from this Decree could also include Indonesian citizens of Chinese descent, the government hoped that much of the rural trade run by the 'foreign' Chinese would be taken over by cooperatives and businesses owned and run by indigenous Indonesians.

Since neither cooperatives nor indigenous businessmen were fully equipped to replace the Chinese traders, or to engage in rural trade with equal efficiency, the ban caused considerable economic disruption. At least in the short run, the ban caused more hardship to the villagers it was supposed to help (Somers, 1964: 28). Realising the danger to both the country's economy and his own power by continuing the anti-Chinese campaign, President Sukarno succeeded in curbing anti-Chinese measures. Although Government Decree no. 10 was never lifted, its further implementation was temporarily suspended. (Suryadinata, 1992: 137).

As economic conditions continued to deteriorate since the late 1950s and Sukarno's and the army's attention were increasingly focused on reclaiming West Irian from the Dutch, further implementation of Government Decree no. 10 was discontinued. Moreover, with the emphasis on Indonesian-style socialism with the introduction of President Sukarno's Guided Democracy and Guided Economy in 1959, new affirmative programs to promote indigenous private businessmen were not considered anymore. Henceforth, government policy gave priority to state enterprises, which would own and control the important

branches of production. Private enterprises would henceforth only be allowed to operate in those economic activities which did not control the supply of the basic wage goods of the people (Rice, 1983: 60).

The Guided Democracy and Guided Economy period (1959 – 1966) ushered in a period of rising hostility towards both domestic private capital and what remained of foreign direct investment, which included mostly American and British investment. With foreign loans, including from the US and Japan, a number of state-owned basic industries were built, including fertiliser, cement, paper, chemicals, spinning and shipbuilding, while private enterprise was regulated and supervised through designated industry associations (Dick, 2002: 186-7). New foreign direct investment, never popular during the 1950s, was given a clear sign that it was not welcome, when the new Foreign Investment Law, just enacted in 1957, was repealed in 1958 when anti-foreign feelings were running high after the take-over of all Dutch enterprises.

However, food crop and cash crop smallholder agriculture as well as cottage and small-scale enterprises remained privately owned (Dick, 2002: 187). Obviously, Indonesian-style socialism never envisaged collectivisation of agriculture as carried out in the communist countries nor nationalisation of cottage and small enterprises, which were mostly owned by rural, indigenous, petty entrepreneurs.

## **2.2 The New Order period, 1966 - 1998**

### *Shifting government policies towards the private sector*

The advent of Soeharto's New Order regime in 1966 heralded a new turn in government-business relations. Inheriting a bankrupt economy which was in shambles because of the utter neglect of economic considerations by the Sukarno government, the Soeharto government gave top priority to economic recovery. This was achieved by quickly restoring macroeconomic stability to control hyperinflation which was reaching more than 600 per cent in 1966, and by rehabilitating the dilapidated physical infrastructure.

The New Order government also reversed the socialist policies of the Sukarno government. Etatist policies, under which the state had to play the dominant role in the economy, were abandoned. To this end, the new government removed most controls on private investment and curtailed the activities of the state-owned enterprises (SOEs) and the various industry associations. By ending government subsidies and preferential access to credit by state-owned banks and foreign exchange allocations to the SOEs, a more level playing field for private enterprises was created, while the import monopolies of the SOEs were abolished. Facing the requirement to operate more efficiently, the SOEs were relieved of the burden of having to sell their products at below market prices (McCawley, 1981: 64; Robison, 1986: 137).

To encourage the private sector, including foreign private enterprise, to play a bigger role in the economy, the stigma of private enterprise of the late Sukarno period was removed (Sadli, 1988: 358). To this end the hostile foreign investment policy of the Sukarno government was overturned by enacting a new Foreign Investment Law in 1967, which

opened the country to new foreign direct investment (FDI). This Law contained various attractive incentives, including generous tax concessions (e.g. tax holidays, duty free imports of capital goods) and guarantees, including the free transfer of dividends and profits and a guarantee against arbitrary nationalisation of foreign enterprises (Sadli, 1972: 204). To administer the new inflows of foreign investment, a Technical Team for Foreign Investment (which later became the Capital Investment Coordinating Agency, BKPM) was established, which was also put in charge of foreign investment promotion (Sadli, 2003: 128). This new law signaled an open-door policy to foreign direct investment which, however, lasted only for a few years because restrictive regulations were imposed on new foreign investment in the mid-1970s.

In 1968 the New Order government also reversed the restrictive policies of the Sukarno government to private domestic businessmen by enacting a Domestic Investment Law, which not only provided the same incentives and guarantees to private domestic investors, but a few additional incentives. For instance, no questions were asked about the legitimacy of the origin of the funds to be invested in Indonesia. This meant that back taxes would not be imposed on these funds (Sadli, 1997: 244-45). Since this Domestic Investment Law did not only apply to indigenous Indonesian businessmen, but also to the Sino-Indonesian businessmen, this whitewash policy was successful as new domestic investment, along with foreign direct investment, increased rapidly during the first years after these liberal investment policies were enacted.

Although in principle the Domestic Investment Law provided the domestic investors with the same incentives and guarantees as the Foreign Investment Law, initially the domestic investors were in some important ways still at a disadvantage. For instance, the Capital Investment Coordinating Board (BKPM) required that both foreign and domestic companies applying for incentives under the Foreign or Domestic Investment Laws were required to deposit 25 per cent of their planned investment as collateral in state-owned banks. For non-priority sectors, mostly those outside agriculture, forestry or import-substituting industries, the required collateral was even higher, namely 50 per cent (Robison, 1986: 139). During the late 1960s and early 1970s few domestic firms, particularly the indigenous-owned firms, possessed many liquid assets after the hyperinflation and economic chaos of the late Sukarno era.

However, as a result of the favourable investment climate for private investment, domestic investment, along with foreign investment, gradually increased and over time rose rapidly, including in medium- and large scale industries. Investment in the manufacturing sector became attractive because of the protectionist import-substitution policies pursued during the early New Order era. During this period several domestic business groups began to emerge under the political patronage of senior government officials and senior military officers. They operated in various sectors, including textiles, electronics, transport equipment and pharmaceuticals, often as joint ventures with foreign investors (Robison, 1986: 144). However, most of private domestic enterprise and employment in manufacturing operated in cottage and small-scale industries, including food products, textiles, garments, rubber milling, weaving, brick making, roof tiles, clove cigarettes, and furniture.

The liberal trade and investment policies, however, did not last long. By the mid-1970s the pendulum swung back towards more interventionist policies. The immediate cause for the re-emergence of interventionist policies was the steep rise in international oil prices in late 1973 and again in late 1978. This oil boom vastly increased the financial resources of the Indonesian government, which allowed the Indonesian government, particularly Mr. Soehardjo, the dynamic Minister of Industry, to embark on an ambitious state-led, second stage import-substituting industrialization effort, involving the establishment of large-scale, state-owned, basic industries.

The government also reversed its liberal foreign investment policy in response to rising economic nationalism. This economic nationalism was reflected by violent anti-Japanese riots in January 1974 directed at the so-called 'over-presence' of Japanese investment projects. Henceforth, the New Order government pursued a more restrictive policy towards foreign investment. This was, amongst others, reflected by the requirement that new foreign investment projects would only be allowed in the form of joint ventures with Indonesian businessmen or companies, in which the majority equity share was owned by indigenous Indonesian businessmen and/or where the majority of the executive board members of the company were indigenous nationals. Foreign partners in joint ventures were also required to divest their majority equity holdings to their Indonesian partners or to the Indonesian public by floating their shares in the Jakarta Stock Exchange within a specified period of time (initially 10 years after the start of commercial production). The trend towards more restrictive regulations on foreign investment intensified following the second oil boom in 1978 (MacIntyre, 1994b: 250).

Another important influence on industrial policy in Indonesia emerged when in 1978 a new Minister of State for Research and Technology, Dr. B.J. Habibie, a German-trained aeronautical engineer, was appointed. Under his leadership Indonesia initiated the development of a range of state-owned, 'strategic industries', including a 'hi-tech' aircraft assembling company, a shipbuilding company, and eight other SOEs, deemed crucial for Indonesia in view of their strategic importance.

The end of the oil boom in 1982 as a result of the weakening world oil market once again forced the government to shift back to a liberal trade and foreign investment regime. Because of the government's much reduced fiscal capacity to fund new investment projects and the need to generate new non-oil export revenues and non-oil tax revenues, the government introduced a series of deregulation measures designed to improve the investment climate for private, including foreign, investors. The government also introduced a series of trade reforms aimed at reducing the 'anti-export bias' of its highly protectionist regime. As a result, domestic and foreign investment since the mid-1980s increased rapidly, particularly in export-oriented projects. Most of the new export-oriented foreign investment projects, particularly in labour-intensive manufacturing industries, were carried out by Korean and Taiwanese investors (Thee, 1991: 55). The boom in foreign as well as domestic investment lasted until Indonesia was hit by the Asian economic crisis in 1997.

It is important to recognize that while government policies towards the private sector were often motivated by economic nationalism, considerations of national interest and sustaining economic growth were also paramount during the first two decades of New

Order rule. However, since the late 1980s economic policies were often undermined by the political elite's interests, particularly the business interests of the President's family and their cronies. This was reflected in blatant corruption among the government bureaucracy, particularly at the top levels of the bureaucracy, collusive relationships between the political elite and their business cronies, mostly ethnic Chinese tycoons, and nepotistic policies of President Soeharto to benefit his childrens' business interests. These policies distorted market incentives and rewarded unproductive rent-seeking activities, which only rewarded corrupt officials and their business cronies and, instead greatly hurt the interests of poor farmers.

A case in point was the monopsony/monopoly rights given to Soeharto's second son to purchase the citrus grown by citrus farmers in West Kalimantan and then sell these citrus at monopoly prices. Another blatant example was the creation of a similar monopsony/monopoly consortium headed by Soeharto's youngest son to purchase and sell cloves grown by clove farmers. Like with the citrus farmers, clove farmers were greatly hurt by these extortionary policies. In addition, several projects were initiated, the economic viability of which were very doubtful, such as the so-called 'national car' project of Soeharto's youngest son. Without prudent policies that took proper account of Indonesia's resource constraints, these projects would become devouring 'tapeworms', as one critical economist put it (Nasution, 1995: 3-4). These practices undermined the economic resilience of the country and contributed to the erosion of the legitimacy of the New Order regime.

#### *Policies towards the ethnic Chinese*

Despite the strong anti-Chinese sentiments among wide sections of the public, which erupted in anti-Chinese riots after the fall of the Sukarno government, pragmatic considerations again gained the upper hand. Because of the New Order regime's key policy objective of pushing economic growth (Booth, 1998: 325), it was realised that the ethnic Chinese were an essential element to achieve this goal. It was therefore necessary to abolish various restrictions on the economic activities of the Chinese which had been introduced during the Sukarno era.

While the Chinese were given wide opportunity in the economic field, in other fields, such as politics and culture, their activities were severely restricted, in some cases even banned. Celebrating Chinese New Year in public was prohibited, while Chinese schools and Chinese language newspapers were banned. To minimise the ethnic identity of the ethnic Chinese, the New Order regime issued a decree urging Sino-Indonesians to change their Chinese names into indigenous Indonesian names. This policy reflected the need to minimise social differences, which in the past had often erupted in anti-Chinese riots, and strive for social harmony (Elson, 2001: 161), an important policy objective for the new New Order government.

Despite the gloomy outlook for the ethnic Chinese, including the Sino-Indonesians, at the beginning of the New Order era, the regime's emphasis on economic development opened new economic opportunities to the Chinese. With their long commercial experience, better access to capital, managerial and technical skills, and their contacts with the Chinese

business networks in Southeast and East Asia and, in some instances, their mutually profitable contacts with the indigenous (*pribumi*) power holders, the Chinese were able to move into various economic activities on a large scale. The result was that the ethnic Chinese community prospered to a much greater degree than during the Dutch colonial period, the Japanese occupation, and the early period of Indonesian independence. This was not only the case with the relatively few Chinese business tycoons who, patronised by *pribumi* senior government officials and military officers, were able to establish large conglomerates. Many medium and small entrepreneurs too were able to prosper because of rapid economic growth. However, they were only able to survive and prosper through their persistence and hard work.

The New Order government was determined to boost economic growth by encouraging direct investment by 'domestic foreign capital', that is domestic capital which had been 'parked' abroad by many ethnic Chinese during the final tumultuous years of the Sukarno government. Nevertheless, explicit and implicit discrimination in various forms against the ethnic Chinese continued. As a result, many ethnic Chinese businessmen were forced to collaborate with *pribumi* businessmen, who held the required business licenses (Suryadinata, 1999: 140-41). In this sense not much had changed from the Sukarno era. In fact, over time the 'Ali Baba' system of the Sukarno era was 'improved' and grew into the hated, well-connected conglomerates, which gave rise to renewed anti-Chinese sentiments and riots in the late New Order era.

The New Order government also took several measures to help the *pribumi* businessmen advance faster in response to the anti-Japanese student riots of January 1974. These riots were actually also directed at the government, which was held responsible for the perceived rising inequities arising from the government's liberal and open-door policies. Besides the earlier-mentioned measure to require new foreign investment projects to be joint ventures with Indonesian partners, since 1974 state banks were required to provide only investment credits to domestic companies. The favoured companies were those in which the majority share ownership (at least 51 per cent) was held by *pribumi* businessmen, and where the majority of the board of directors and the supervisory board would also be *pribumi* Indonesians (Sadli, 1988: 359).

However, just like with the affirmative Benteng program in the 1950s, this measure was again undermined by the same 'Ali-Baba partnerships'. In these partnerships the *pribumi* businessmen (the 'Alis') fulfilled the majority requirements, while the ethnic Chinese 'Babas' controlled the operations. While the state banks were of course aware of these practices, they were resigned to these practices as otherwise too few companies would be able to meet the minimum own capital requirements to qualify for these bank loans (Sadli, 1988: 360).

Increased government revenues from the second oil boom of 1978/79 gave the government another opportunity to promote *pribumi* businessmen by introducing a new affirmative program. To this end President Soeharto issued two consecutive Presidential Decrees in 1979 respectively 1980. These Decrees stipulated that government contracts of up to Rp. 20 million (US\$ 31,898 at the prevailing exchange rate) were only reserved for

businessmen from the 'economically weak groups in society'<sup>1</sup>. While contracts up to Rp. 100 million had to be awarded by tender, preferential treatment would still be given to businessmen from the 'economically weak groups in society', if their tenders were up to 10 per cent higher than the others (Daroestan, 1981: 15).

To qualify as a businessman from the economically weak groups, at least 50 per cent of his/her company would have to be owned by *pribumi* businessmen, while more than half of the board of management would have to be *pribumi*. Moreover, the amount of capital and net assets of the company would have to be less than Rp. 25 million in the case of a trading company or related activities, or Rp. 100 million in the case of a manufacturing or construction company. Local cooperatives would also qualify as an economic entity owned by members of the economically weak groups (Daroestan, 1981: 15). Despite some similarities with the ill-fated Benteng program, these Presidential Decrees were more successful, as over time a relatively large group of successful *pribumi* entrepreneurs emerged, such as the entrepreneurs of the Kodel group.

In the late 1980s, discontent rose about the perceived widening gap between the privileged rich and the large group of poor people, specifically between the visibly rich ethnic Chinese business tycoons and the *pribumi* majority. Aware of this resentment, President Soeharto in March 1990 convened a meeting at his large ranch near Bogor with the heads of the leading conglomerates, many of them ethnic Chinese tycoons. These conglomerates, including the conglomerates owned and controlled by his own children, had grown very rapidly during the New Order. Their rapid growth was possible because of the patronage of the powerful political elite, particularly President Soeharto. Under this patronage, the conglomerates enjoyed preferential treatment, including large subsidized credits from the state banks, protection, and monopoly positions, and assured government procurement. The actual size of these conglomerates only became evident after some of their subsidiaries had gone public after the stock exchange boom in 1989.

Suharto used this meeting not only to deflect rising criticism of the blatant preferential treatment given to the businesses of his children, but also to reduce rising public anger about the visible role of the ethnic Chinese conglomerates. To this end he portrayed himself as one of the 'little people' (*wong cilik*) (Elson, 2001: 268). On national television Soeharto used this meeting to urge the assembled tycoons to assist cooperatives (mostly, if not all, owned by members of the economically weak groups) by transferring a quarter of their vast assets to the cooperatives and to give an opportunity to the cooperatives to buy shares in the private companies as a suitable means of narrowing the gap between rich and poor. This equal sharing of the nation's wealth would emerge as a constant theme in Soeharto's speeches throughout the 1990s (Elson, 2001: 268).

As was to be expected, Soeharto's appeal was an empty gesture. Beyond some minor token steps, none of the conglomerates was prepared to transfer their assets to cooperatives or allow the latter to buy shares in their business holdings, even if the

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<sup>1</sup> Since overly racist references to the ethnic Chinese were, just like during the Sukarno era, frowned upon, the government and the public, specifically the mass media, used the euphemistic term 'economically strong groups in society' to refer to the ethnic Chinese, even though many ethnic Chinese were small businessmen rather than tycoons.

cooperatives were financially able to do so. They only made token gestures in participating in the government's 'Foster Father scheme'. Under this scheme, large enterprises (referred to as 'Foster Fathers'), were urged to establish partnerships with cooperatives and small enterprises, largely owned by members of the economically weak groups in society. Naturally these schemes were unworkable and ineffective in raising the economic viability of these cooperatives and small enterprises, as they were not motivated by market considerations, but in effect amounted to forced marriages.

### **2.3 The post-Soeharto period**

The Asian financial and economic crisis of 1997/98 led to a sharp contraction of Indonesia's GDP of almost -14 per cent in 1998. Unlike the two other worst-affected countries in East Asia, South Korea and Thailand, which were better able to deal with the crisis, the Indonesian government was unable to respond speedily and effectively to the crisis. As a result, the economic crisis worsened and spiraled into a serious political crisis, which led to the fall of President Soeharto who had ruled the country for 32 years.

The unsettled conditions and political unrest led to severe anti-Chinese riots, which erupted in Indonesia just before Soeharto's fall, and led to substantial capital flight, particularly to Singapore. Because of the serious economic crisis, many companies suffered great losses. Major companies, many owned by ethnic Chinese tycoons, as well the banks owned by the ethnic Chinese and *pribumi* conglomerates, went bankrupt and were either taken over by the government's Indonesian Banking Restructuring Agency (IBRA) or sold to foreign investors.

At present anti-Chinese sentiments have abated, perhaps because of the collapse of the debt-ridden Chinese conglomerates and the fall of their powerful patron, President Soeharto. In spite of their collapse, there was concern that these conglomerates, after undergoing restructuring, would be able to regain control through their proxies over their former companies. These companies were taken over by IBRA as collateral in return for Bank Indonesia's liquidity credits to bail out the banks they owned.

After the crisis the highly indebted ethnic Chinese conglomerates were forced to restructure their businesses through a series of divestments (both forced and voluntary) or by attempts to establish strategic alliances with the new political elite, as the Salim group, the biggest ethnic Chinese conglomerate during the Soeharto era, has done (Sato, 2004: 40). Considering the public resentment over the collusive relationships between the Chinese conglomerates and their political patrons, both the leaner conglomerates and their new political patrons, need to tread very carefully lest new anti-Chinese riots erupt.

Many conglomerates, including the Salim business group, have also shifted from a high degree of diversification during the Soeharto era to a sharp focus on their core business. On the other hand, smaller conglomerates, which had mainly grown on the basis of capable management rather than relying on political patrons, and which had not accumulated huge debts, have emerged as buyers of the assets sold by the indebted large conglomerates. In fact, a few of them have tied up with new *pribumi* and foreign investors to expand their business (Sato, 2004: 41-42).



Because of the sensitivity about the perceived economic dominance of the ethnic Chinese, any Indonesian government, including the present government of President Susilo Bambang Yudhoyono, has to take account of the difficult trade-off between the important need to satisfy the legitimate aspirations of the *pribumi* majority for greater equity and the equally important need to reassure the ethnic Chinese business community lest the mass flight of Chinese capital adversely affects economic growth.

Despite controversial statements by Jusuf Kalla, the current Vice-President, that affirmative policies to promote *pribumi* businessmen are imperative in order to prevent further anti-Chinese riots, thus far the government has refrained from pursuing discriminatory policies against the Chinese. Hence, like during the Sukarno as well as Soeharto eras, pragmatic considerations have again prevailed over economic nationalism. However, like the previous governments steps are taken to promote *pribumi* business, particularly small- and medium-scale enterprises (SMEs), which are mostly owned by *pribumi* businessmen.

For their part, the more prosperous ethnic Chinese economic community, particularly the businessmen, need to realise that the long-term security in their country of birth can only be achieved if the economic gap between them and the *pribumi* majority is steadily narrowed. This goal cannot be achieved by the government alone, but need to be achieved by the efforts of the ethnic Chinese community itself, particularly by faster social and economic integration with the *pribumi* majority. For instance, a serious effort need to be made to establish real partnerships with *pribumi* businessmen which do not amount to the infamous 'Ali-Baba' partnerships of yore. More philanthropic foundations could also be established to fund the establishment and operations of good schools at all levels to meet the needs of private business for skilled personnel.

Looking to the future, two important issues need to be addressed to promote the development of an efficient and competitive private sector. The first is the need to attract more foreign direct investment. The second concerns the steps to be taken to develop a viable and competitive SME sub-sector. Viable and efficient SMEs would promote *pribumi* entrepreneurship and strengthen Indonesia's industrial structure by opening opportunities for supplier firms to the large downstream assembling industries. The next two sections will discuss these two issues in greater detail.

### **3. Indonesia's Investment Climate and Foreign Direct Investment after the Asian Economic Crisis**

Since the late 1980s up to the onset of the Asian economic crisis Indonesia experienced a surge in domestic and foreign direct investment. This surge was attributable to the successive deregulation measures which the Indonesian government had introduced after the end of the oil boom in 1982 to improve the investment climate for both domestic and foreign private investors. It was hoped that with a better investment climate, a more dynamic and efficient private sector would develop which would function as a new engine

of growth and major source of non-oil export revenues to offset the fall in oil export revenues.

Besides these deregulation measures, the government also introduced a series of trade reforms to reduce the strong anti-export bias of the protectionist trade regime. These trade reforms were intended to shift the import-substituting pattern of industrialisation during the oil boom era of the 1970s to an export-promoting one. The aim was to encourage the non-oil and gas sectors, particularly the manufacturing sector, to generate an expanding stream of non-oil exports to offset the decline in oil exports as well as an expanding stream of non-oil taxes to offset the decline in oil tax revenues.

As a result of the improvement in the investment climate and the reduction in the anti-export bias of the trade regime, export-oriented domestic and foreign direct investment (FDI) inflows since the late 1980s rose rapidly. Most of the export-oriented FDI came from the four East Asian newly-industrialising economies (NIEs), particularly from South Korea and Taipei, China. Since the late 1980s many Korean and Taiwanese were relocating their labour-intensive operations to lower-wage countries in Southeast Asia, including Indonesia. The reason was that wages in their countries had risen rapidly and their currencies appreciated steeply, thus causing their labour-intensive industries to lose their comparative advantage (Thee, 1991: 55).

The surge of FDI into Indonesia since the late 1980s through 1996 occurred in two waves. The first wave occurred in 1988-90 when Indonesia's textile sector (including the garment and footwear sub-sectors) received large amounts of export-oriented FDI from the East Asian NIEs. That investment led to the trebling of textile and garment exports in the four years to 1992/93 when they were Indonesia's largest non-oil exports (World Bank, 1996: 12).

The second wave of FDI inflows started in early 1994. This wave was in part driven by a worldwide boom in FDI. By late 1994/early 1995 FDI inflows also rose rapidly as a result of the significant liberalisation of the foreign investment regime in June 1994. This liberalisation was intended to attract more export-oriented FDI to sustain the growth of Indonesia's manufactured exports (World Bank, 1994: 12).

However, after the Asian economic crisis, domestic investment and FDI declined steeply, largely as a result of the deteriorating investment climate. As investment is crucial to raising economic growth, improving the investment climate is arguably Indonesia's key economic priority (World Bank, 2005a: iv). Thus far economic growth is still largely driven by consumption growth. Even though investment, including both domestic and foreign, has slightly picked up in 2004 and 2005, in the long term the current situation is not sustainable.

This section will first discuss Indonesia's recent growth and investment performance since the late Soeharto era in the mid-1990s. It will then discuss Indonesia's poor investment climate, and the measures which the current government has to undertake to improve the investment climate.

### 3.1 Economic and investment growth

The severe economic contraction in 1998 was slightly reversed in 1999, when the economy grew again, though at a miniscule 0.8 per cent. From 2000 through 2003 economic growth was mainly driven by private and public consumption, while fixed investment, just like in the preceding years after the crisis, remained sluggish. As a result of sluggish investment growth, the investment to GDP ratio in 2003 dropped to 17.8 per cent in 2003, the lowest level since the early 1970s (World Bank, 2004: 2). During the late Soeharto era the investment to GDP ratio was around 30 per cent.

However, in 2004 for the first time after the Asian crisis GDP growth just exceeded 5 per cent. This time growth was not only driven by consumption, but also by investment, the growth of which for the first time after the crisis grew at double digits, namely 15.7 per cent. Export growth at 8.5 per cent was also higher than in 2002 and 2003. During the first and second quarters of 2005 fixed investment continued its double-digit growth (Table 1).

Table 1 GDP growth by expenditure, 2002-2005 (Q1-Q2)  
(in percentages compared to previous year)

	2002	2003	2004	2005 (1 <sup>st</sup> quarter)	2005 (2 <sup>nd</sup> quarter)
GDP	4.3	4.5	5.1	6.3	5.5
Private consumption	3.8	3.9	4.9	3.2	3.5
Public consumption	13.0	10.0	1.9	- 8.5	- 5.6
<b>Fixed investment</b>	<b>2.2</b>	<b>1.9</b>	<b>15.7</b>	<b>15.0</b>	<b>13.2</b>
Exports	- 1.0	6.6	8.5	13.4	7.3
Imports	- 4.0	2.8	24.9	15.4	10.1

Source: For the period 2002 – 2004: Badan Pusat Statistik (BPS), Jakarta;  
For the first quarter of 2005: Ross McLeod, Survey of Recent Developments, p. 135.

Investment growth in 2004, however, was just like in the preceding years, mainly driven by investment in new property, accounting for 80 per cent of total fixed investment. But an expansion in the output of the capital goods industries and machinery imports also indicated that productive investment was gradually increasing (World Bank, 2005: 2). In fact, since the first quarter of 2004 through the first quarter of 2005 the double digit investment growth in machinery and equipment was far higher than investment in construction, which during this same period was only growing at single digits (McLeod, 2005: 135).

In general, however, both domestic investment and FDI remain sluggish. Domestic investment in the coming years is likely to stagnate in the coming years because after the

Asian financial crisis banks prefer to provide credit for consumption rather than for riskier investment. They also lack the long-term resources to finance growth in Indonesia. The reason is that more than 90 per cent of bank deposits are three month or less in maturity (World Bank, 2005c: 66, 88).

### **3.2 FDI in Indonesia after the Asian economic crisis**

In view of the sluggish growth of domestic investment, new FDI inflows are needed for Indonesia's economic recovery and future growth. However, in contrast to Thailand and particularly Korea, into which new FDI flowed again not long after the Asian crisis (World Bank, 2000: 6), Indonesia experienced continuous net FDI outflows since 1998 through 2003. The sluggish growth in FDI in Indonesia is a source of concern for the government. New FDI inflows not only strengthen the host country's currency, but can also promote corporate restructuring, and allow infusions of new technologies and management methods (World Bank, 2000: 6) to revitalize the manufacturing sector.

A reflection of the lower competitiveness of Indonesia as a suitable location for FDI is that during 2002, more than 40 Korean firms and 10 Japanese firms left Indonesia to relocate to countries with a more favorable investment climate. The large majority of Korean firms left primarily because of frequent labor disputes and rapid increases in wages due to the annual mandatory rise in minimum wages. Many of these Korean firms relocated to Southeast Asian countries with lower wages, including Vietnam (Kinoshita, 2003: 4). Since then more foreign firms, including Sony, and a number of export-oriented domestic firms, have also left Indonesia.

Data on net FDI flows into or from Indonesia can be found in Bank Indonesia's bilingual monthly *Indonesian Financial Statistics (Statistik Ekonomi dan Keuangan Indonesia)*, specifically the section on the balance of payments (BOP). These data on net FDI flows monitored and recorded by Bank Indonesia (BI) are arguably the best source of information on realised FDI in Indonesia (table 2). For this reason both the IMF and UNCTAD in its annual *World Investment Report* use these BI data as the basis of their own data on realised FDI in Indonesia. However, while these BI data are quite reliable, they do not provide a complete picture of FDI in Indonesia, as they do not include the reinvestment of the profits earned by FDI firms. These net FDI outflows data also do not only include real capital flight by foreign investors, but also the debt service payments for long-term loans provided by their foreign principals in the home countries to their FDI projects in Indonesia.

**Table 2** Net FDI flows to Indonesia, 1987 – 2005 (Q1-2)  
(millions of US\$)

<u>Year</u>	<u>Net FDI in- and outflows</u>
1987	385
1988	576
1989	682
1990	1,093
1991	1,482
1992	1,777
1993	2,004
1994	2,109
1995	4,346
1996	6,194
1997	4,667
1998	- <b>356</b>
1999	<b>-2,745</b>
2000	<b>-4,550</b>
2001	<b>-2,978</b>
2002	145
2003	- <b>597</b>
2004	1,023
2005 (Q1-2)	2,568

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Source: Bank Indonesia: Indonesian Financial  
Statistics, successive issues through October 2005.

There was great concern when over the period 1998 – 2003 Indonesia experienced net FDI outflows, although in 2002 a small net FDI inflow took place. To a large extent the net FDI outflows since 1998 through 2003 were caused by the fact that FDI inflows in the form of equity and long term loans to FDI projects as well as the proceeds from privatisation and banking restructuring were exceeded by the amount of repayments by FDI projects of long term loans to their principal overseas or to a foreign bank

However, in 2004 and the first half of 2005 net FDI inflows were again recorded. These net FDI inflows, though still smaller than during the investment boom years of the early 1990s, indicate that perceptions of foreign investors about Indonesia's investment climate, though still unfavourable, have slightly improved after the election of President Susilo Bambang Yudhoyono in 2004. However, these net FDI inflows should not be a reason for complacency as Indonesia's investment climate is still regarded as the worst in Southeast Asia.

### 3.3 FDI in Indonesia in regional perspective

The downturn in FDI in Indonesia after the Asian economic crisis is also evident if FDI flows to Indonesia after the Asian economic crisis are compared to the FDI flows to the other East Asian countries (table 3). Despite the weak investment climate of the past few years after the Asian economic crisis, most East Asian countries except Indonesia experienced positive FDI inflows. The contrast between Indonesia on the one hand and on the other Thailand and South Korea, the two other East Asian countries most severely affected by the Asian economic crisis, is evident. The latter two countries never experienced net FDI outflows at any one year after the crisis. Hence, Indonesia has shown the worst experience of any large country in the East Asian region during the post-Asian economic crisis period (Castle, 2004: 72).

**Table 3** FDI inflows into selected East Asian countries, 1992 – 2003  
(rounded figures, billions of US\$)

<b>ASEAN-5</b>	1992-97 average annual	1998	1999	2000	2001	2002	2003
<b>Indonesia</b>	<b>3.5</b>	<b>-0.2</b>	<b>-1.8</b>	<b>-4.5</b>	<b>-2.9</b>	<b>0.1</b>	<b>-0.6</b>
Malaysia	5.8	2.7	3.9	3.8	0.5	3.2	2.5
Philippines	13	2.2	1.7	1.3	0.9	1.8	0.3
Singapore	8.3	7.7	16.1	17.2	15.0	5.7	11.4
Thailand	2.3	7.5	6.1	3.4	3.8	1.1	1.8
<b>N.E Asia</b>							
<b>PRC</b>	<b>32.8</b>	<b>45.5</b>	<b>40.3</b>	<b>40.7</b>	<b>46.9</b>	<b>52.7</b>	<b>53.5</b>
South Korea	1.3	5.0	9.4	8.6	3.7	2.9	3.8
Taipei, China	1.5	0.2	2.9	4.9	4.1	1.4	0.5

Source: UNCTAD: World Investment Report 2004, United Nations, New York and Geneva, 2004, Annex table B.1, p. 370.

It is clear that for the past decade the People's Republic of China (PRC) has drawn by far the largest amount of FDI inflows, dwarfing the combined FDI inflows of all the other East Asian countries. Hence, these East Asian countries, particularly Indonesia, have to make a serious effort to improve their relative attractiveness as a suitable location for FDI. This need takes on added importance as the drive to attract FDI is significantly more competitive globally at present than at any time in the past decade (Castle, 2004: 74).

While PRC is indeed a formidable competitor in attracting large FDI inflows, the data on FDI inflows into PRC should be qualified. The FDI inflows into PRC are based on officially recorded FDI inflows which give an upward bias to PRC's position. It is widely assumed that 'round-tripping', that is the export of domestically generated funds and its return to its country of origin as FDI, is more significant in PRC than elsewhere (Weiss, 2004: 6-7). Three reasons have been advanced to explain the phenomenon of 'round-tripping' in PRC, namely that the reinvestment of flight capital may have had its origins in the 'black' economy; that there is a preference to register enterprises as FDI to take advantage of tax incentives not available to local firms; and that there is a preference to incorporate companies abroad (particularly in Hong Kong, China) to take advantage of better legal protection, a better reputation and corporate governance, and superior financial services (Weiss, 2004: 7).

Despite serious concern that the FDI inflows into PRC will have an adverse effect on the FDI inflows into the other Asian countries, this is not necessarily the case for all Asian countries. A recent study by Barry Eichengreen and Hui Tong found that FDI into PRC provides a larger boost to FDI into high-income Asian countries that are producing components and capital equipment for production and assembly operations in PRC. Unfortunately, this is not the case with low-income Asian countries, including Indonesia, which do not make components and capital equipment for PRC's production and assembly operations (Eichengreen & Tong, 2005: 10). This is confirmed by the findings of the latest survey on Japanese-affiliated manufacturers in Asia, conducted annually by the Japan External Trade Organization (JETRO), which found that the imported materials/parts cost ratio for these manufacturers was 71 per cent or more. This figure was higher than in Malaysia, the Philippines, and Thailand, where the materials/parts cost ratio ranged between 50-70 per cent. The reason for the higher materials/parts cost ratio in Indonesia is that its domestic supporting industries are relatively underdeveloped. Consequently, Japanese manufacturers engaged in assembling operations have to import a lot of their materials and parts and components (JETRO, 2005: 17). Hence, for low income Asian countries, such as Indonesia, PRC is indeed a formidable competitor in attracting FDI.

### **3.4 Indonesia's current investment climate**

In its review of the economic prospects for 2004, the National Development Planning Agency (Bappenas) listed the major domestic impediments to investment which have adversely affected Indonesia's investment climate in the post-Soeharto period.<sup>2</sup> These factors have in general also been mentioned by other observers of foreign investment in Indonesia. In a seminar in Jakarta in October 2004, Professor Toshihiko Kinoshita also

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<sup>2</sup> These adverse factors include complicated licensing procedures; overlapping policies of the central and regional governments on investment; lack of legal certainty and weak law enforcement, labour market problems, security disturbances in some regions; an inefficient and corrupt tax system; and increased competition from other East Asian countries, particularly PRC and Vietnam, to attract foreign investment (Bappenas, 2003: I-13 – I.14).

pointed out largely similar impediments to investment, particularly FDI<sup>3</sup>. However, he also pointed out that foreign investors still tend to view Indonesia as a country with big potential. This potential would be enhanced by AFTA and the free trade agreements it will sign with a number of important non-ASEAN countries.

A better idea of Indonesia's competitiveness in regard to its investment climate compared to that of the other Southeast Asian countries is presented in table 4.

**Table 4** Selected investment climate indicators of selected Southeast Asian countries and PRC (percentage of firm responses) \*

Country	Policy uncertainty	Corruption	Courts	Crime	Bureaucracy	Electricity	Labour
	Major constraint (%)	Major constraint (%)	Lack confidence courts uphold property rights (%)	Major constraint (%)	Average time to clear customs days	Major constraint (%)	Regulation (major constraint, %)
<b>Indonesia (2004)</b>	<b>48</b>	<b>42</b>	<b>41</b>	<b>22</b>	<b>6</b>	<b>22</b>	<b>17</b>
Malaysia (2003)	22	15	19	11	4	15	15
Philippines (2003)	30	35	34	27	3	33	25
PRC (2002/03)	33	27	18	20	8	30	21

Note: All data, with the exception of 'Bureaucracy' refer to percentages.

Source: World Bank: World Development Indicators, 2005, Development Data Center, Washington, D.C., table 5.2, pp. 274-6.

The above data were obtained from World Bank-sponsored Investment Climate Surveys in 53 developing countries, including Indonesia, for 2001-2003. These surveys were held to help the governments in these countries to design good investment policies, since a good investment climate requires government policies that provides an environment in which both domestic and foreign firms and entrepreneurs can invest productively, create jobs, and contribute to growth and poverty reduction (World Bank, 2005b: 277). Hence, the ultimate goal is to create an investment climate that benefits society as a whole, not just individual firms or entrepreneurs or a group of firms or entrepreneurs.

<sup>3</sup> These impediments include socio-economic unpredictability; a weak legal and judicial framework and implementation; business-unfriendly labour regulations, deteriorating physical infrastructure; rampant corruption in getting necessary licenses and taxation and customs clearance; and confusion by the unclear demarcation of authority between the central and regional governments after regional autonomy was introduced in early 2001 (Kinoshita, 2004: 9).



The data in table 4 show that as regards policy uncertainty, corruption and the lack of confidence in the courts to uphold property rights, Indonesia's investment climate is worse than in Malaysia and the Philippines, even though the Philippines is not known for its favourable investment climate. Firms in developing countries, whether domestic or foreign, rate economic and regulatory policy uncertainty, as their dominant concern among investment climate constraints. Hence, the high percentage of the responding firms which rated policy uncertainty in Indonesia as their dominant concern deserves serious attention from the government. This also applies to the problem of corruption, where the percentage of firms operating in Indonesia rating corruption as their major constraint is much higher than in the other countries. As good and dependable courts reduce the risks which firms face, particularly when the number of large and complex long-term transaction increase (World Bank, 2005b: 277), the high percentage of firms in Indonesia rating this problem as their major constraint also deserve serious attention by the government.

Even though in regard to some indicators, the difference between PRC's investment climate and that of Indonesia is not large, PRC has been able to attract vastly more FDI than Indonesia. This suggest that besides a country's investment climate, the country's growth prospects and the lure of a vast, rapidly growing market and of a suitable export base because of relatively low wages, such as PRC has, are also important 'pull' factors in attracting FDI inflows, as Indonesia itself experienced from the late 1980s up to the Asian economic crisis.

A look at the views of Japanese manufacturers on the relative attractiveness of various potential host countries, including Indonesia, is of interest, as they are the largest foreign investors in Indonesia's manufacturing sector (table 5).

Table 5 Most attractive host countries for FDI in the mid-term as viewed by Japanese manufacturers, 2004

Ranking	Country/region	Number of firms	Percentage giving top ranking
1	PRC	453	91
2	Thailand	151	30
3	India	117	24
5	United States	100	20
6	Russia	49	10
<b>7</b>	<b>Indonesia</b>	<b>48</b>	<b>10</b>
8	R.of. Korea	44	9
9	Taipei,China	41	8
10	Malaysia	28	6
11/11	Singapore/Germany	17/17	3/3
13/13	Brasil/Philippines	16/16	3/3

Source: Toshihiko Kinoshita, 2005, table 2, p. 9.

The data in table 5 confirm that PRC in the medium term is currently by far the most attractive host country for FDI by Japanese manufacturers, far outranking Indonesia. However, as this table reflects the views for the medium term rather than the short term, these unfavourable views on Indonesia may change in the near future if the Indonesian government is capable of improving the investment climate.

According to the World Bank, governments in developing countries in general face four primary challenges in improving the investment climate and achieving a proper balance between providing firms with incentives to invest and the interests of society. These challenges are:

1. Establishing credibility by maintaining economic and political stability and restraining arbitrary behaviour by the key agencies of the state;
2. Restraining corruption by public officials, firms and other interest groups.
3. Fostering public trust and legitimacy through participatory policy-making, transparency, and equity.
4. Ensuring that government policies realistically reflect current conditions and adapt to changing economic and business conditions (World Bank, 2005b: 277).

#### *Improving the investment climate*

To a larger extent than has been the case with the previous post-Soeharto administrations, the current administration has realized that raising the country's growth rate to 7 percent by 2009 requires a substantial increase in new investment. The government realises that to achieve this, a substantial improvement in Indonesia's investment climate is crucial. The government is also quite aware that an important weakness of the previous administrations was their inability to make significant progress in improving the country's investment climate. This failure was not so much due to economic policy, but due to weaknesses in legal certainty and law enforcement, corrupt tax and customs officials, and labour laws and regulations (Sadli, 2004).

Hence, the current challenge facing the government is to create a strong political will and to do its 'homework' by tackling the problems deemed as constraints to investing in Indonesia (Kinoshita, 2005: 2). The determination of the government to achieve significant progress in improving the country's investment climate is evident from the President's recent instruction that the time taken to obtain investment approvals should be reduced to one month from the current 151 days. This has to be achieved by reducing the licensing procedures to start up and operate businesses to the same level of efficiency as those of the other ASEAN countries. In addition, the government is also focusing its efforts on reducing the high costs of handling exports and imports in the ports and customs areas. In its medium-term development plan for 2004-2009, the government has also set a goal of achieving at least half of the five-year targets for improving the investment climate within the first three years (Citigroup, 2005: 1-3).

Aburizal Bakri, the then Coordinating Minister for Economic Affairs, in 2004 stated that the government is preparing to change the role of the Capital Investment Coordinating Board (BKPM) from an investment approval agency to an investment promotion agency. Once this transformation of BKPM's role has been accomplished, private investors, including foreign investors, will not need to obtain licenses any more from BKPM. Instead, they would only need to obtain the services of a notary, who would then contact the Department of Justice and the relevant technical departments to inform these agencies of the planned investments. Once this has been done, the investors can start investing in their planned project (Kompas, 2005: 13).

Although caution is warranted in expecting too much from the government plan to improve Indonesia's investment climate, there is reason for hope as this government is the first post-Soeharto government which has staked its reputation on improving the investment climate. Judged by outcomes, the past year has seen relative success, as the rate of investment has risen significantly since 2004 and this lasted through the first two quarters of 2005 (table 2 above). As a result the rate of investment has reached 22 per cent of GDP in the second quarter of 2005 after remaining flat at around 20 per cent of GDP for most of the time after the crisis. During the previous Megawati administration's 'Year of Investment for 2003-2004' the investment rate fell to below 19 per cent. However, as PRC's current investment rate is 45 per cent, while that of Vietnam is over 30 percent (Sen & Steer, 2005: 291), more determined and focused measures need to be taken to increase the investment rate further.

Unlike the previous three years, when new investment was heavily concentrated in real estate development, which had reached 83 per cent in 2003 from around 70 per cent in the early 1990s (Ishihara & Marks, 2005), since 2004 more investment has taken place in non-property activities, such as machinery and transport. These figures indicate an expansion in production capacity (Sen & Steer, 2005: 291). This is a positive development, because during the past few years investment was not forthcoming because of the poor investment climate. This is even though capacity utilization levels had reached high levels, estimated at an average of around 70 per cent by the Central Agency for Statistics (BPS), which should have triggered new investment (Ishihara & Marks, 2005). In fact, at the end of 2004 capacity utilization was higher than at any time since Indonesia was hit by the economic crisis in 1997/98. In some sectors there was, for the first time since the crisis, no possibility of expanding output without new investment (Sen & Steer, 2005: 292). That investment has finally increased, though rather slightly, thus indicates a renewed sense of confidence on the part of domestic and foreign investors in the future of the country.

#### **4. SME Promotion Policies for Indonesia**

The Indonesian government has for a long time been concerned with the development of small- and medium-scale enterprises (SMEs). Like in other countries, SMEs are the main players in the production, distribution and service sectors of the Indonesian economy. Since SMEs are often directly exposed to ever-changing market conditions, they are quick to react to such change, as was the case when the economic crisis struck Indonesia. SMEs tend to have a more flexible organisation and quicker decision-making processes than large

enterprises. SMEs can also, through their exports, play a role in improving the balance of payments (Urata, 2000: 3-9). According to the Central Agency of Statistics (BPS), the proportion of SME exports to total non-oil and –gas exports after the Asian economic crisis varied between 4.6 to 7.5 per cent, although a study conducted for the ADB estimates that the contribution of SMEs to total exports is higher, almost 11 per cent (Asian Development Bank, 2004: 10).

The proportion of SMEs is high in all sectors of the Indonesian economy.<sup>4</sup> If all forms of enterprise, formal and informal, are included in all sectors, there were an estimated 40 million SMEs operating in Indonesia in 2000, employing approximately 73 million people. However, most of these enterprises are micro or cottage enterprises rather than SMEs in the strict sense of the word and the largest percentage are in the agricultural sector (PPTA & The Asia Foundation, 2005: 25).

Indonesia's SMEs are regionally dispersed, and are mostly located in the rural areas. They therefore have the potential to exert a favourable influence on rural and regional development and on income distribution, as the experience of Taipei, China has indicated. SMEs in Indonesia, specifically the dynamic and modern small and medium-scale industries, can also provide a good training ground for developing the managerial and organizational skills of small entrepreneurs and the technical skills of workers and can also contribute to manufactured exports. As producers of parts and components, technically competent small firms can also function as supplier firms to the large, downstream assembling industries.

Since the economic crisis SMEs in Indonesia have received renewed attention, as many of these SMEs turned out to be more resilient than the highly indebted conglomerates. However, many less viable SMEs experienced great difficulties and had to go out of business. Nonetheless many SMEs dependent on local inputs rather than expensive foreign inputs could survive and several of them were able to turn to export markets to take advantage of the steep depreciation of the *rupiah*. Hence, these firms and others able to survive during the crisis were seen as being more viable than the discredited conglomerates. These conglomerates were only able to thrive because of the various facilities and protection they received from the government.

Despite the often stated government concern about SME development, during the Soeharto era SMEs were actually not considered a vital part of the economy. Rather than viewing SMEs as important economic actors and an important part of a vibrant economy, many Indonesian policy-makers viewed them primarily as a *social* group, which needed assistance based on *welfare* or *equity* considerations rather than *efficiency* considerations (Hill, 1997: 266; PPTA & The Asia Foundation, 2005: 32). These welfare or equity considerations were based on the not quite correct perception that the SMEs, specifically the small enterprises, were owned and run by indigenous (*pribumi*) Indonesians, who were equated with the economically weak groups (*golongan ekonomi lemah*) in society. On the other hand, the non-indigenous (*non-pribumi*) Sino-Indonesians were equated with the economically strong groups (*golongan ekonomi kuat*) in society, who owned and ran most of the large enterprises (LEs) or conglomerates in the country. This distinction is not correct, because the large

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<sup>4</sup> The term 'small enterprises' should be treated with some caution, as sometimes micro or cottage enterprises are sometimes also included in the category of small enterprises.

majority of Sino-Indonesian businessmen do not own large enterprises, but are engaged in SMEs. A major reason for sticking to this distinction is that overtly racist or ethnic affirmative policies in favour of the *pribumi* Indonesians is frowned upon in Indonesia, so that affirmative policies are couched in these euphemistic terms.

For this reason government policy toward SMEs, or specifically small enterprises, assumes that these small enterprises need protection from competition. This is for instance reflected in article 50h of Indonesia's Competition Law, which exempts small-scale enterprises from the provisions of the Law. Apparently, the people who drafted the Law believed that small enterprises need additional support, and that exempting small enterprises from the provisions of the Law would contribute to their development (Thee, 2002: 339). However, the reverse is true, as SMEs, just like large firms, can also engage in anti-competitive behaviour against other small firms. By taking firm and consistent action against anti-competitive behaviour by either dominant large or by small firms, the Law should be able to protect SMEs against the abuse of market power at their expense. Hence, exempting SMEs from the provisions of the Law will not give them any significant competitive advantage over the large enterprises (Thee, 2002: 33.9). All that may be achieved is to give a green light to well-connected SMEs to engage in anti-competitive behaviour at the expense of other SMEs who are not well-connected.

Another scheme to assist or protect small firms was the *reservation scheme* which, just like in India, reserved certain sectors or sub-sectors for small-scale enterprises. Large- and medium-scale enterprises could not enter these sectors or sub-sectors, unless they established a partnership with small-scale enterprises. However, this decree was not very effective in helping the small-scale enterprises, as these joint ventures or partnerships enabled the larger firms to dominate the sectors or sub-sectors reserved for small firms, which often ended up as producers producing only for a larger partner (PPTA & The Asia Foundation, 2005: 32-3).

Another important problem with the SME promotion policies is that the various policies do not make a clear distinction between cottage or household enterprises with little economic potential and the small- and medium-scale enterprises with growth potential. As a result, government promotion policies were directed indiscriminately at an unmanageably large target group that included more than 95 per cent of all enterprises in Indonesia (PPTA & The Asia Foundation, 2005: 32). Although many officials were aware of this problem, no steps were taken to make a clear distinction between the huge number of cottage enterprises, mostly operating in the rural areas, and the potentially dynamic small- and medium-scale enterprises (SMEs). Unlike the practice in the other Southeast Asian countries, in Indonesia a distinction is made between small enterprises, which are often lumped together with cottage enterprises on the one hand, and medium- and large-scale enterprises on the other. As a result, confusion arises when SME policies are designed, which are, in fact, only directed at small enterprises. More effective and better targeted SME promotion programs should therefore solve this problem first by combining small and medium-scale enterprises in one clearly defined category.

Since this section deals only with the SMEs operating in the non-agricultural sectors, it is important to give an idea of the total number of SMEs operating in these sectors. Table 6

below shows the distribution of the non-agricultural, small and medium-scale enterprises in Indonesia, as classified by the number of workers.

Table 6 Distribution of non-agricultural firms in Indonesia by number of workers, 2001

<b>No. of workers, incl. Owners</b>	<b>Legal</b>	<b>Personal</b>	<b>Total</b>
1*	14,027	7,444, 410	7,458,437
2 – 4	65,130	6,650,669	6,715,799
5 – 19	103,496	554,840	<b>658,336</b>
20 or more	56,755	10,726	<b>67,481</b>
Total	239,408	14, 660,645	14,900,053

Source: PPTA & The Asia Foundation: Provincial SME Development – Draft Final Report, Part I: Provincial SME Development in Indonesia, Jakarta, August, 2005, Table 1, p. 25.

Because of the different definitions of the agencies in charge of implementing SME promotion programs, it is virtually impossible to assess the real impact of the SME programs. Too broad definitions of what constitute SMEs are not useful for policy purposes, as they do not distinguish between subgroups of SMEs which may have different characteristics and which may require different policy interventions. Without a common and consistent definition of the SMEs, coordinating the various SME programs carried out by different agencies is quite difficult. Moreover, with too broad and expansive definitions of SMEs, it is difficult to assess whether specific programs are effective or not (PPTA & The Asia Foundation, 2005: 25).

Not only government agencies do not have one over-riding definition of SMEs, but most external aid agencies, such as the World Bank and the ADB, also do not have a single accepted definition of SMEs. For instance, the World Bank's Small and Medium Enterprise Development acknowledges there is no single accepted definition of SMEs nor does it attempt to offer one. Other external aid agencies having SME programs do not have a common definition of SMEs either. However, these agencies do define SMEs for their specific operations in order to define the limits of the scope of their projects and the eligibility criteria for aid. To this end, it usually incorporates some part of a country's definition of SMEs (Asian Development Bank, 2004: 5).

#### **4.1 SME promotion programs during the Soeharto era: an assessment**

With these caveats in mind, the major SME programs implemented during the Soeharto era are reviewed. One has to bear in mind, however, that these SME programs were often directed at small-scale enterprises only, rather than at promoting SMEs as a whole.

In Indonesia the concern with the development of SMEs was reflected in various *direct* promotion policies and special programs. initiated by the Soeharto government. Most of these promotional policies and programs for SMEs were aimed at assisting these SMEs in

overcoming the major constraints to their growth, namely low levels of technology and managerial skills, poor marketing, and difficulty in accessing the financial institutions aimed at providing credit to SMEs. The major direct assistance programs for SMEs included special credit programs, including subsidised credit programs, (non-financial) business development services programs, particularly industrial extension services and training, and the above-mentioned reservation of selected sectors or sub-sectors to small enterprises (Asian Development Bank 2000: 14).

#### *Credit programs for SMEs*

The two major nation-wide credit programs for SMEs included the Small Enterprises Development Program (KIK/KMKP program) and the Small Enterprises Credit (KUK) program. The following table presents the major features of these programs (table 7).

**Table 7** Nation-wide credit programs for SMEs during the Soeharto era

<b>Credit program</b>	<b>Interest rate</b>	<b>Nature of credit</b>	<b>Implementing banks</b>
Small enterprises development (KIK/KMKP) program (1973-1990)	Subsidised	Provision of investment capital (KIK) and working capital (KMKP)	Five-state-owned banks, Indonesian Development Bank (Bapindo), all regional development banks and 14 private banks
Small enterprises credit (KUK) program (1990 – 1998)	Market rates	Allocation of at least 20 per cent of a commercial bank's loan portfolio to SMEs for investment and working capital needs	All commercial state and private banks

The KIK/KMKP program, launched in 1973, was the first major nation-wide subsidized credit program in terms of the volume of credit provided to SMEs. The scheme was aimed at helping small, indigenous (*pribumi*) enterprises, including cottage enterprises, to obtain subsidized credits for investment and working capital purposes. The bulk of the funds was provided by the Bank of Indonesia, which also coordinated the implementation of this program. The actual provision of credit was handled by Indonesia's five state-owned commercial bank, the Indonesian Development Bank (Bapindo), all Regional Development Banks, and 14 private banks, which around the mid-1980s had more than 1,000 branch offices throughout the country (Thee, 1994: 102).

While the KIK/KMKP credits were intended for both investment and working capital purposes, the bulk of credits provided was used for working purposes to keep the operations of these SMEs going, rather than for investment purposes, such as purchasing new equipment or expansion purposes. Small manufacturing enterprises, however, received 13 per cent of KIK (investment) credits, and 11 per cent of KMKP (working capital) credits (Poot, Kuyvenhoven, & Jansen, 1990). These figures suggest that, unlike the majority of SMEs, small manufacturing firms used slightly more of their credit for investment.

By the late 1980s the sustainability of the KIK/KMKP program became increasingly in doubt, as arrears and collection problems had driven the default rate to more than 27 per cent. This high default rate and serious collection problems were most likely caused by various factors, including inadequate training of bank staff, unofficial payments to corrupt bank staff, mismanagement of the funds, and inadequate penalties for default or incentives for the bank staff to be diligent in the collection of loan repayments (Grizzell, 1988). Because of the high default rate, the KIK/KMKP program was terminated in 1990.

To replace the KIK/KMKP program, the government in 1990 introduced the Small Enterprise Credit (*Kredit Usaha Kecil, KUK*) program. Under this program all commercial banks, including state-owned and private banks, were required to allocate 20 per cent of their loan portfolio to small enterprises (defined as enterprises with assets amounting to a maximum of Rp. 600 million (roughly US\$ 3.3 million at the prevailing exchange rate), excluding the value of land and buildings) and cooperatives at market interest rates.

The implementation of the KUK program did not proceed satisfactorily because the banks either found it difficult or were reluctant to provide 20 per cent of their loans to SMEs. To meet the requirement of providing 20 per cent of their loans to SMEs, the banks often extended credits to the owners of SMEs for consumption rather than for business purposes. Moreover, in view of the rather broad definition of SMEs (enterprises with a capital investment of less than Rp. 600 million), it has been the larger SMEs rather than the small SMEs which have benefited from this program.

The available data also show that it has been SMEs in Java, and particularly in the Jakarta Capital Region, which have benefited the most from this program (respectively 67 per cent and 27 per cent of the total). The data also show that the state-owned banks provided more KUK loans than the private banks (FIAS, 1996: 53-4). As a result of the lack of success of the KUK program in promoting the development of viable SMEs, this credit program too was discontinued after the Asian economic crisis.

#### *Technical assistance programs for SMEs*

Among the technical assistance programs for SMEs, the Small Industries Development (*Program Pembinaan dan Pengembangan Industri Kecil, BIPIK*) program, initiated in 1980 by the Department of Industry, was by far the most important program. This program provided training and extension services to SMEs and was also carried out by the Department of Industry (Thee, 1994: 108).



The BIPIK program was a coordinated program of input provision for SMEs, under which technical assistance is provided to clusters of firms. This concept of clusters is a major element of the BIPIK program which actually dates back to the 1950s when the government established Industrial Centres (*Induk Industri*) to provide technical assistance, particularly to the indigenous (*pribumi*)-owned weaving industry. However, insufficient funding and reluctance on the part of the small entrepreneurs to utilise the facilities of the Industrial Centres accounted for the lack of success of this early technical assistance program in the 1950s (Grizzell, 1988).

Despite these early failures, the BIPIK program again focused on the development of *industrial clusters* or *centres* of SMEs, specifically small and medium-scale industries. These centres generally consist of 50 to 100 small manufacturing establishments, including cottage establishments. These small industry clusters were supported by Technical Service Centres (*Unit Pelayanan Teknis, UPT*), which provided extension and technical services and occasionally raw materials (Departemen Perindustrian, 1982).

Since the late 1970s, Small Industry Estates (*Lingkungan Industri Kecil, LIK*) were established in some regions with a relatively large concentration of small industries and where specific skills appropriate to them were available. The two major facilities available in these Small Industry Estates were facilities for education and training and facilities for improving the quality of products (Departemen Perindustrian, 1982). However, these Technical Service Centres and Small Industry Estates were not successful. Occupancy of these facilities was relatively low, and the productivity of the firms in these facilities low. The reason was that in general the field extension officers had little or no technical and business experience. Moreover, training and subsidised inputs were provided according to a schedule determined by central planners rather than by the real needs of the small entrepreneurs (Grizzell, 1988).

That the BIPIK program was not successful is evident from the findings of an impact assessment study conducted by ILO. Of the 200 enterprises interviewed, 100 had participated in the BIPIK program and another 100 had not. The study found that there was *no difference in performance* between enterprises in the two groups. The study also found that while in some clusters where the BIPIK program had established common facilities, the enterprises had benefited, they did not feel responsible for maintaining these facilities. Not surprisingly, these facilities deteriorated (PPTA & The Asia Foundation, 2005: 35). Another important finding of this study was that growing firms were most likely to seek support, suggesting that they did so because they were growing but not that they were growing because they were supported. Hence, this study concluded that this broad, general support BIPIK program had not led to the growth of SMEs (PPTA & The Asia Foundation, 2005: 35).

The account of the credit programs has shown that even after many years of implementation, these programs were on the whole not successful and cost-effective in developing economically viable SMEs. The continued ineffectiveness of government credit programs in reaching SMEs is, for instance, reflected by the fact that in 1998 total credit extended to SMEs by state banks amounted to less than 15 per cent of their loan portfolio. Research sponsored by the Jakarta Office of The Asia Foundation found that only around 17 per cent of the SMEs ever turned to the formal banking system to obtain credit (The Asia Foundation 2000).

Similarly, the various (non-financial) business development services programs, particularly the Small Industries Development (*BIPIK*) Program administered by the Department of Industry, have not been effective either in raising the technical capabilities of SMEs, because these programs suffered from poor design or deficient implementation (Thee 1994: 105-6; Asian Development Bank 2000: 14).

Past experience with *supply-driven* business development services provided by government agencies has thus indicated that these services, often provided on a cost-free basis, were not effective in meeting the needs of the SMEs. Because there is no market test for the provision of these services, there is no way of verifying whether these services met the real needs of SMEs. Moreover, in view of the weak capacities of the government agencies providing business development services, there were no mechanisms to ensure the quality of the business development services provided to the SMEs (Hillebrand 1999: 1).

The lack of success of the government SME programs can be attributed to lack of coordination between the agencies in charge of SME programs, poor program design, and inadequate monitoring and evaluation (World Bank, 2001: 2.16). During the past decade there were at least two government agencies directly concerned with SME development, namely the Directorate-General of Small-Scale Industry, Department of Industry, and the Office of the State Minister for Cooperatives and Small Enterprises. Between these two major agencies concerned with SME development there was little communication to delineate a clear division of their respective responsibilities.

There has also been a proliferation of other government subsidised credit schemes extended to small enterprises administered by various government agencies, many of which inevitably overlapped with one another. This has often led to a wasteful use and misallocation of scarce financial resources, which became more serious after the economic crisis because of the large government budget deficit. Because of the government's fiscal constraints, large government subsidised credit programs will not be easy to finance despite numerous calls from politicians, NGOs and populist academics.

In view of the general lack of success with these direct assistance programs, the government in the early 1990s turned to *indirect* assistance programs, notably the *Foster Father-Business Partner Linkage* scheme. Under this scheme a large private or state-owned enterprise (SOE), the so-called Foster Father, were pressured to assist their Business Partner, the small enterprise, in raising their capabilities in management, technology, marketing, and in accessing finance (Suhardi 1992).

As part of this Partnership and Linkage Scheme, since November 1989 state-owned enterprises (SOEs) were also required to set aside one to five per cent of their net profits to assist small enterprises in improving their performance. Aside from the assistance given also by private large enterprises, these SOEs were also expected to act as guarantors of SMEs in their loan applications (Suhardi 1992). This financial assistance would terminate once the small enterprises had improved their financial and commercial performance to such an extent that they would be able to obtain bank loans on their own without needing the guarantees provided by the SOEs.

There was from the outset great skepticism about the effectiveness of this scheme. Forced (non-market) partnerships were unlikely to be viable in the long run, particularly as the large firm obtained little or no benefit from this scheme, except perhaps some political goodwill (Thee 1994: 106-7; 114). The experience of the past decade has confirmed that these forced Partnership and Linkage Programs have not been successful. Generally they were difficult to implement because the large enterprise experienced difficulties in finding a suitable SME partner. Because these schemes were not based on proper commercial considerations, there was little incentive for the large enterprises to make a serious effort to make this scheme work. In some instances these schemes also encouraged rent-seeking behaviour (Asian Development Bank 2000: 14).

With regard to the financial assistance provided by SOEs, a study by the Department of Finance on the results of the financial assistance provided by SOEs under the jurisdiction of the Department of Finance found that this type of financial assistance had not led to improved performance of the small enterprises. The reason for this was that these SOEs had only limited themselves to allocating the stipulated percentage of profits to small enterprises. Aside from this, they did not bother to provide managerial or technical assistance. Aside from the lack of proper incentive to provide assistance to the SMEs, these SOEs lacked the proper skills and experience with SMEs to provide the latter with the assistance relevant to their needs (Thee, 2000).

The reason that these SME programs have in general not been successful is that these programs have, like in the other Southeast Asian countries, been based on 'welfare' or 'equity' rather than on 'efficiency' considerations. SME programs based on 'welfare' considerations assume that SMEs are inherently disadvantaged by the unfettered operation of markets, and that therefore these SMEs deserve special preferential treatment (Hill 1997a: 267). In other words, SME programs have in general been based on the view that SMEs are inherently weak, and therefore need to be subsidised or protected (The Asian Foundation 2000).

In view of these considerations the main policy thrust of these SME programs has not been clearly focused on the encouragement of entrepreneurship and healthy growth of viable and competitive SMEs. On the other hand, macroeconomic policies, public investment decisions, and public administration systems have not created a favourable business environment conducive to the emergence of new entrepreneurs and the growth of viable SMEs (Ahmed 1999: 1-2). Like in the other ASEAN countries, government policies and practices in Indonesia have often been discriminatory in nature against SMEs. For instance, in Indonesia as elsewhere in the region, fiscal incentives have been given to large investments. As a result, larger enterprises have received greater tax benefits than small enterprises (Chee 1987: 4-6).

With regard to licensing requirements and regulatory policies, both large as well as small enterprises often have to pay bribes to officials to obtain the necessary licenses and permits. These 'unofficial' payments obviously mean a big burden for small enterprises. A study sponsored by The Asia Foundation, Jakarta Office, found that onerous licensing procedures on the average added up to 30 per cent to the start-up costs of SMEs in Indonesia (The Asia Foundation 1999: 1).

## 4.2 Developments in the post-Soeharto period

Statistics on industrial production in the aftermath of the crisis showed that growth in industrial production, which only reflects the production of larger enterprises, was falling. However, output of non-oil and gas manufacturing remained positive. The difference in these two trends suggests that the output of small manufacturing enterprises, which is captured in manufacturing statistics, was holding up better than that of the larger enterprises. This is confirmed by the data on credit, which show that growth in credit to SMEs was high until the first quarter of 2002, although it has leveled off since then (World Bank, 2003: 4).

It has been the success of these SMEs, particularly export-oriented SMEs, which has led to the perception that the SMEs, unlike the debt-ridden large enterprises, had weathered the severe economic crisis better than the large enterprises (Cameron, 1999). The crisis, however, had a differential impact on the various SMEs depending on the sector in which they were operating. Largely export-oriented SMEs in the manufacturing sector or which competed with imports and did not rely on raw materials or capital goods imports fared much better than domestic market-oriented SMEs which relied on raw material and capital goods imports (Berry, et.al., 1999: 12). These SMEs as well as many SMEs in other sectors were doing poorly after the crisis.

In view of widespread support for a more vigorous development of SMEs, the successive post-Soeharto governments confirmed their commitment to promote a more rapid development of SMEs. However, because of the lack of success of past SME promotion programs, after the crisis a number of policy-makers, including officials in the Department of Industry, Indonesian academic economists, experts in the multilateral and bilateral aid organizations, and foreign foundations engaged in SME development, stated that these preferential and protectionist programs were ineffective in nurturing viable SMEs. They argued that 'welfare-oriented' SME programs should be replaced by *market-oriented, demand-driven* programs based on '*efficiency*' considerations, that is programs based on the stated needs of the SMEs themselves rather than based on the perceptions of officials. This view was based on the consideration that a healthy growth of SMEs depends on a steady rise in their productivity. As this depends to a great extent on the policy environment, Indonesia's new SME programs should aim at promoting the sustainable growth of viable SMEs (Asian Development Bank 2000: 14).

A strong case for *market-oriented* and *demand-driven* SME programs was made at a National Seminar on Small and Medium Enterprise which was held in Jakarta on 8 and 9 December 1999, and which was jointly sponsored by the Asian Development Bank (ADB), the World Bank, the International Labour Organization (ILO), and Bappenas, Indonesia's National Planning Board.

The proposed *new, market-oriented and demand-driven* SME programs included four major elements, namely:

- The establishment of an enabling or conducive business environment for SMEs;
- The development of financial institutions which can provide finance to SMEs on an open and accessible basis;

- The effective provision of (non-financial) business development services to SMEs;
- The formation of strategic alliances between SMEs themselves or with domestic or foreign, large firms.

To what extent, however, the current government is committed and able to introduce and implement truly market-oriented and demand-driven SME programs depends great deal on the outcome of a still on-going debate within government circles, the political elites, academics, and the small and medium entrepreneurs themselves, about the merits and demerits of the proposed market-oriented SME programs. Despite the clear evidence that the 'subsidise and protect' SME programs have not worked in the past, many policy-makers, politicians, academics, and small and medium entrepreneurs still adhere to the view that SMEs are weak and therefore should be assisted and protected against the much stronger large enterprises. The case for continuing SME programs based on 'welfare' or 'equity' considerations would be strengthened politically, if the proposed market-oriented and demand-driven SME programs are depicted as intellectual concepts proposed to or imposed on a weak Indonesian government by foreign experts and international or foreign aid organizations. Against these arguments, proponents of market-oriented, demand-driven programs could argue that '*supply-driven*' programs, such as the unsuccessful BIPIK technical assistance program, had failed.

However, during the past few years there has been a rising public awareness about the adverse effects of trade and investment barriers on the activities of SMEs which was highlighted in several seminars and meetings by SME owners from various regions. In various regions these SME owners have formed a regional forum (*Forum Daerah, FORDA*) to articulate the needs and problems faced by SMEs, including problems caused by cumbersome and time-consuming government regulations. Through regular consultations between government officials, SME owners, concerned academics and foreign experts from donor agencies, workable and effective *market-oriented* and *demand-driven* SME programs could be formulated and implemented given the political will of the government.

The findings of a recent study on the development of Indonesia's SMEs acting as subcontractors to the large assembling firms (Hayashi 2002), indicated that *market-oriented, demand-and private sector-driven* SME promotion programs have been more effective in developing viable SMEs, including raising their technological capabilities, than the 'subsidise and protect' SME programs motivated by 'welfare' or 'equity' considerations. The findings of other surveys have also indicated that SMEs in general rated government assistance as low, meaning that these programs were viewed as ineffective in raising their technological, managerial, marketing, and financial capabilities.

Following the Indonesian government's decision in August 2003 not to renew its IMF supported program by the end of 2003, on 15 September 2003 it issued an 'Economic Policy Package Pre and Post IMF' or White Paper. In this White Paper the government outlined the various measures it would take to maintain macro-economic stability; restructure and reform the financial sector; and increase investment, exports, and employment (World Bank, 2003b: 7-8).

In the White Paper the government also outlined steps which were more in tune with market-oriented, demand-driven SME promotion policies rather than the largely unsuccessful supply-driven, protectionist SME policies of the past. To this end, the government positively steered the policy direction of developing SMEs by improving land certification in order to give SMEs better access to credit instead of subsidising various SME promotion schemes. Improving land certification is very important, as the experience of many SMEs has indicated that although many of them have land, they could not use this as collateral to get bank loans as obtaining certificates is very difficult. In fact, less than 25 per cent of holders of rural land parcels have a formal land certificate, a figure which is much lower than in PRC and Vietnam (World Bank, 2005: 71). For this reason, simplifying the procedures required by the government's National Land Agency (*Badan Pertanahan Nasional, BPN*) would be necessary. Recent experience has indicated the benefit of land certification, as it has improved the credit flow in rural areas (World Bank, 2003: 38).

In the Road Map, prepared by the Indonesian Chamber of Commerce and Industry (KADIN) in August 2004, and submitted to the in-coming government of President Susilo Bambang Yudhoyono, KADIN stressed the need to empower the private sector, amongst others by promoting the development of SMEs. In this regard, KADIN also pointed out the difficulties faced by SMEs in accessing bank loans because of various administrative hurdles and the requirement to provide collateral (KADIN, 2004).

#### **4.3 Concluding remarks on SME programs.**

At present it is too early to tell, whether the current government will vigorously pursue the market-oriented, demand-driven SME policies to develop viable and efficient SMEs or will still continue SME policies guided by populist or 'welfare considerations', particularly by providing large amounts of subsidised credit to SMEs. Certainly among many government officials, politicians, NGOs concerned with SME development, and social scientists there is still a strong tendency to channel large amounts of credit to SMEs. If this view prevails, the resulting policies are unlikely, as in the past, to lead to the growth of viable SMEs.

If however, new market-oriented and demand-driven SME programs are adopted, a *two-pronged approach* essential to developing viable and competitive SMEs should be pursued, namely:

- Establishing an *enabling business environment for SMEs*, particularly by removing the various policy and procedural impediments currently hampering the efficient operations of SMEs;

- Providing efficient, demand-driven financial and non-financial business development services to SMEs which are truly responsive to the real needs of the SMEs. These services should preferably be provided by the private sector, complimented (but not dominated) by government agencies if necessary, which have failed in the past in providing effective business development services relevant to the actual needs of the SMEs. Private sector assistance has turned out to be more effective in raising the technological, managerial, marketing, and financial capabilities of SMEs, if this assistance is based on mutual trust and mutual profitability of the private sector providers and the recipient SMEs.

## 5. Conclusions.

The above account of private sector development in Indonesia has indicated that government policies towards the private sector have often been ambivalent and inconsistent. During the early years of independence in the 1950s policies were mainly aimed at countering the economic dominance of Dutch business and ethnic Chinese economic interests. During the early 1950s these efforts were accompanied by measures to advance the interests of indigenous (*pribumi*) Indonesian entrepreneurs through affirmative programs. However, with the introduction of President Sukarno's Guided Democracy and Guided Economy, advancing the interests of private businessmen was discontinued, while state-owned enterprises (SOEs) were promoted as the pillars of an Indonesian-style socialist economy.

During the Soeharto era the role of private businessmen, including ethnic Chinese, was again promoted in view of the New Order regime's emphasis on economic growth. However, instead of fostering a healthy development of the private sector, through patronage the New Order nurtured the growth of a dependent capitalist class of client businessmen. Preferential treatment given to favoured businessmen, including the children of the President, their cronies and a number of favoured ethnic Chinese businessmen, over time led to the rapid growth of large conglomerates. In the Republic of Korea preferential treatment was based on the 'reciprocity principle', that is preferential treatment was tied to the export performance of the favoured enterprises. This was not the case in Indonesia where preferential treatment to favoured enterprises was not based on a similar 'reciprocity principle'. Not surprisingly, this led to the development of large, domestic market-oriented enterprises which were not internationally competitive.

To emphasize the government's continuing commitment to promote the development of SMEs to advance the welfare of the economically weak groups in society, since the early 1970s the government launched several nation-wide SME promotion programs. These programs were, as we have seen, largely unsuccessful in nurturing a healthy development of viable SMEs.

During the New Order era SOEs operating in various economic activities were given an important role in the economy, particularly in the 'commanding heights of the economy'. These SOEs were seen as a strong counterweight to the economic dominance of the

ethnic Chinese, but because of political intervention and corruption in general were inefficient and uncompetitive. Although after the Asian economic crisis privatization of these SOEs was promoted, in practice this was hampered by economic nationalism and the opposition of vested interests with a stake in these SOEs.

Unlike the Sukarno government, the New Order government in the beginning pursued an open door policy towards foreign direct investment (FDI). Over time, however, increasingly restrictive policies towards FDI were introduced, particularly after the oil booms of the 1970s when the government was awash in oil revenues. These restrictive measures were again reversed after the end of the oil boom in 1982. These shifts in FDI policy indicated that the government did not have a clear and consistent view of the expected role of FDI. Hence, unlike Singapore, Indonesia has not been able to reap the full benefits of the FDI presence, including effective technology transfer and the industrial and technological upgrading of the economy.

Given sound economic policies, vigorous private sector development will promote rapid and sustained economic growth. The lack of success in promoting healthy private sector development requires a decisive shift away from past failed policies in favour of new policies. These new policies should not be driven by primordial or xenophobic considerations, but by rational economic considerations. This involves the establishment of a favourable and non-discriminatory investment climate that does not discriminate on the basis of ethnic origin (*pribumi* versus *non-pribumi*), size (small versus large firms) or source (domestic investment versus FDI). This can be supported by effective competition policies, including the proper enforcement of the New Competition Law of 1999. Basically, however, a healthy development of the private sector depends on the development of good governance which is likely to take a long time.



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