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3 The Political Economy Factors in Policymaking

3.1 Introduction

The economic chaos of 1958–65 left such a deep impression on the institutional memory of the new Soeharto government that it has followed a "balanced" budget rule since 1968. In reality, this rule amounts to refusing to finance the deficit through money creation and limiting the deficit to the availability of foreign loans, which are officially described as foreign "revenue". Another consequence of the chaos was the recognition that the exchange rate is an extremely potent policy instrument which can effect large-scale, economy-wide resource reallocation and income redistribution.

The aim of this chapter is to show how the institutional memory has interacted with political economy factors to shape Indonesian economic management since 1965. In short, this chapter attempts to illuminate how the dead hand of history sets the constraints within which the invisible hand of economics operates. An emphasis on political factors should certainly be an important part of any discussion about external debt management. In the final analysis, it is these political considerations which determine whether a country will continue austerity measures in order to service its debts or will choose to repudiate its debts.[1]

In the case of Indonesia, an understanding of the political alignment and economic interests of the different constituencies is necessary in order to make sense out of the seemingly contradictory policies of the 1980s. For example, in March 1983 when it was clear that oil prices would be unlikely to soon recover, the Indonesian currency was devalued by 38 percent against the dollar in order to promote nonoil exports. The devaluation was followed by several fundamental reforms with the stated goal of liberalizing the economy in order to improve resource allocation which would then lead to higher long-term growth. The financial sector was thoroughly deregulated; the traditional instruments of monetary control—interest rate ceilings and credit rationing—were abandoned for more market-oriented financial instruments. The tax system was completely restructured: the tax code simplified, the tax base broadened, and marginal tax rates slashed.

Economic liberalization was nevertheless not the overall thrust of Indonesian economic policies. At the time that the liberalizing measures were introduced, an avalanche of import restrictions was imposed. The new import restrictions generally took the form of monopoly licensing. The right to import was granted either to an individual, to a small group of firms, or to import-competing firms. The stated aim was the same as that for the liberalizing reforms—to achieve higher long-term growth. The means in this case were industrialization and the development of sectoral linkages. Furthermore, since many of the monopoly licenses were for important industrial materials which were inputs to many export industries, these new trade policies ran counter to the purpose of the March 1983 devaluation.

Given that all of the policies adopted in 1983 were drastic departures from past norms, one may be puzzled by the absence of a clear direction in the new economic strategy. We attribute this curious mix of liberalizing steps and protectionist decrees to two factors: one, the existence of two groups of economic advisors who represent very different interests and ideological perspectives; and, two, the delicate role of the president in Indonesian politics as the supreme arbiter of the distribution of economic benefits.[2]

3.2 The Dead Hand of History

Indonesia is an authoritarian state which practices implicit corporatism.[3] President Soeharto has been in power since October 1965 and has not faced any serious challenges to his rule since the Malari riots of January 1974. Parliament is dominated by the government party, GOLKAR, which is an umbrella organization of civil service unions, trade associations, and youth, veteran, and women's groups. GOLKAR was created by Soeharto and hence it does not formulate the national agenda to be implemented by the president. The opposition parties are in such disarray that they actually receive annual government subsidies in order to maintain their operations. The plight of the opposition parties is as much due to government intimidation as to their record for ineffectiveness and squabbling during the early days of the Republic.

Although Soeharto is a former army general and the army is the backbone of GOLKAR, Indonesia is not a military state. The military does not have "important centers of power independent of the central authority" and the president does not engage in "a continuous process of bargaining with other officers" (Sundhaussen 1978, 78). The army supports Soeharto but it, like GOLKAR, does not set the national agenda.

We pay particular attention to Soeharto's preferences because of the unusual degree of decision making concentrated in, and the broad executive powers granted to, this one individual. Since the authoritarian nature of the state renders the medium-run accountability of the president's actions to be very low, and there are substantial differences in interests and ideology within the implicit coalition, Soeharto must be considered an independent force rather than merely the compromise byproduct of competition among the elite groups. One way of describing the economic policymaking process is the following: The different lobbies and advisory groups propose policy initiatives, and the president adopts those which are either compatible with his innate preferences or vital to maintaining his position as the overarching patron. It is, therefore, only natural that we begin the task of explaining the choice of economic strategy in Indonesia by studying the events and forces which shaped Soeharto's views on economic management.

Indonesia was in a state of total economic chaos when Soeharto assumed formal executive power in March 1966. The economy had grown unsteadily at an annual average rate of 1.8 percent between 1960 and 1965. Since the annual population growth rate was 2.5 percent, per capita income declined over this period. The inflation rate was also accelerating. It was 128 percent in 1963, 135 percent in 1964, and 595 percent in 1965. In addition, Indonesia had defaulted on its external debts in 1965.

The economic stagnation was inevitable given the many microeconomic distortions and the huge macroeconomic imbalances. An exchange rate that was overvalued for a prolonged period of time had caused the decline of the export industries, the most productive sector of the economy. The import-competing industries, kept alive by high tariffs, were notoriously inefficient. Extensive price controls which discouraged production, a complex tax system with high marginal rates, and a corrupt administrative structure also helped to cripple economic growth.

The high inflation rate was the result of the monetization of the swingeing budget deficits and the government-ordered extension of central bank credit to state enterprises and to favored members of the private sector. Central government expenditure was 103 percent larger than its revenue in 1963, 140 percent in 1964, and 163 percent in 1965. The rapid expansion of money (M1) in circulation reflected this fiscal mismanagement. The money stock increased 94 percent in 1963, 156 percent in 1964, and 283 percent in 1965. The inflation rates in 1963 and 1965 were actually higher than the money growth rates, 129 percent and 595 percent, respectively, producing a situation where money was rapidly losing its function as a medium of exchange.[4]

On 3 October 1966 the new Indonesian government announced a stabilization and rehabilitation program.[5] The central plank of the stabilization program was an unequivocal commitment to end the printing of money to finance government budget deficits. The government pledged that it would adhere to a "balanced" budget policy from 1967 on. In official Indonesian usage this meant that government expenditure was limited to the sum of domestic revenue and *external loans*. Since the Indonesian government was shut off from the external private credit market in 1966, such a budget rule was effective in limiting government expenditure because of the inelastic supply of foreign concessionary loans. Furthermore, central bank credit to state and private enterprises was severely curtailed and placed under strict supervision.

The trend toward a demonetized economy was immediately reversed—prices in 1967 rose only 112 percent when the currency stock went up by 132 percent. After two years of balanced budgets and continued credit restraint, the restoration of confidence in the rupiah was complete. In 1969 prices rose only 17 percent in the face of a 61 percent increase in the currency stock. Inflation reached the extraordinarily low rate of 4 percent in 1971 despite a nearly 30 percent rise in the amount of currency in circulation. Soeharto obviously understood his first lesson in macroeconomic management because the balanced budget principle has never been compromised during his administration. To Soeharto, a prudent fiscal policy is the prerequisite for preventing runaway inflation, and fiscal prudence is understood to mean a "balanced" budget.

The rehabilitation part of the October 1966 program was to allow market forces a greater (but by no means unrestricted) role in resource allocation. To reverse the trend toward subsistence farming in the agricultural sector and, in particular, to improve the balance of payments, the government devalued the rupiah from 10 rupiahs/dollar to 100 rupiahs/dollar.[6] Price controls on many commodities were removed to encourage their production. The government subsequently showed no reluctance to allow the rupiah to depreciate according to market conditions. The rupiah stood at 326 to the dollar at the end of 1968.

Real nonoil exports (measured in foreign purchasing power) increased by 12 percent between 1965 and 1968.[7] This is an underestimate because there was a large upsurge in smuggling to evade unauthorized taxes levied by corrupt officials who attempted to scoop some of the gains of the devaluation for themselves (see Penny and Thalib 1967). This export growth is still impressive, however, because this was a period of slow growth in the industrialized economies.[8] The surge in agricultural exports came from increased production by the small holders rather than by the estates. The production of farm nonfood crops increased by 19 percent compared to a 7 percent increase in estate output (World Bank 1975, table 2.2). The rehabilitation program really took effect in 1968 when real GDP increased by an unprecedented 11 percent. There was an annual average growth rate of over 8 percent from 1969 until the 1973 OPEC price increase.

The distributional aspects of the devaluation are clear. Since the prices of commodities are set in dollars, a devaluation of the rupiah translated directly into increased income for the small agricultural producers. It would belittle Soeharto's ability if we were to believe that he was not aware of either the political economy of the 1966 devaluation or its effectiveness as a policy instrument. Since then, devaluation has been a frequently used instrument; the rupiah was devalued in 1978 even when there was no balance-of-payments crisis! Competitive exchange rate management alongside the balanced budget are the two constants in Soeharto's economic policymaking, and they directly result from the memory of the economic chaos of the Soekarno years and of the 1966 economic program.

3.3 Agrarian Radicalism, Separatism, and the Peasant Background of Soeharto

It would be helpful at this point to use the issue of exchange rate management to lay out the political environment within which decisions are made about the goals of economic policies and the choice of instruments with which to implement them. The considerations that render Soeharto immune to a commitment to a strong (read "overvalued") currency are the same ones that dictate budgetary choices during times when total spending has to be restrained to match lower revenue growth. Soeharto's attitude to the exchange rate after observing the distributional impact of the 1966 devaluation is rooted in two political concerns and a strong personal commitment.

The first political concern is to avoid conditions favorable to the resuscitation of the PKI. In 1965 Indonesia had "the strongest communist party outside the communist bloc, with a membership of over three million and affiliated mass organizations of farmers, workers, women, and students that claimed over 20 million followers" (Dake 1973, 1–2). The fact that its members were largely landless peasants in Central and East Java indicates that any prolonged impoverishment of the rural heartland could lead to the resurgence of the PKI. Soeharto is personally opposed to the communist ideology, and he has had two bloody encounters with the PKI. The first run-in was the internecine Madiun Affair in 1948 when the PKI tried to hijack the leadership of the independence movement. The second showdown was the 1965–66 aftermath of the abortive communist coup of September 30.[9] The official casualty figure for the latter event is half a million, though unofficial reports of the period put it at one million. The political lesson is clear: the spectre of communism can be exorcised only by improvements in the lives of the rural population.

Soeharto's second political concern is the diversity of the ethnic groups which live in the 13,000 islands which make up Indonesia—"There are over three hundred different ethnic groups in Indonesia, each with its own cultural identity, and more than two hundred and fifty distinct languages are spoken in the archipelago. Religious beliefs, too, are varied" (Geertz 1963, 24). This diversity resulted in numerous secession attempts in the 1950s. Soeharto was personally involved in squashing a rebellion in Sulawesi in 1950. The sense of alienation in the Outer Islands has not been helped by the fact that the inner circles of the government have been dominated by the Javanese since independence in 1949. It has, hence, been necessary to assuage feelings of discrimination among the non-Javanese by proffering to them tangible economic benefits. The government has had to do more than raise living standards as it did in rural Java, it has also had to make it clear that inter-island (regional) equity is a primary goal of the Soeharto government. This has meant that spending for regional development has been a high priority, reinforcing Soeharto's readiness to devalue the currency. Most of the import-substitution industries, whose products are practically nontradables because of cost inefficiency, are located in Java, and a devaluation always turns the regional terms of trade in favor of the agricultural-commodity-exporting Outer Islands.

On the personal level, Soeharto has never downplayed his peasant origin.[10] From the earliest days of his presidency, he has consistently emphasized the need to improve the living standard in rural areas. Even if one were to dismiss Soeharto's avowed commitment to alleviating rural poverty as political opportunism, the critic must concede that all this symbolism testifies to the importance which Soeharto places on rural development.[11] It may have been more than "mere" symbolism that the agricultural sector was singled out for attention in the first development plan, Repelita 1. This agricultural emphasis has been continued in subsequent development plans.

It is the combination of the three factors—concern about the traditional peasant base of PKI, experience with secessionist movements, and a personal commitment to rural development—that explains a great deal of the observed allocation of government expenditure in particular, and the conduct of economic management in general. The first and third concerns imply the need to improve the *absolute* level of the standard of living in rural areas, while the second concern implies the need to improve (or bring to par) the *relative* standard of living in the Outer Islands. Together these three factors focus attention on development of the agricultural sector, that is, rice in Java and agricultural commodities in the Outer Islands.[12] The general INPRES programs (development funds funneled directly at the president's discretion through decrees, *Instruksi Presiden,* to the local level), fertilizer subsidies, irrigation projects, and maintenance of a competitive exchange rate are the most explicit manifestations of the high priority placed on developing the agricultural sector.

3.4 Economic Nationalism, Political Patronage, *Pribumi*-ism, and the Military Background of Soeharto

Attention to its agricultural sector does not mean a strong overall agricultural bias in Indonesian economic policies. Rather, the bias is toward the industrial sector. There is widespread popular sentiment for, significant intellectual support of, and powerful special interests clamoring for the rapid development of a large and diversified industrial base. The president himself is sympathetic to this view because of his experience in the war for independence. As we explained in chapter 1, Dutch economic policies were seen as designed to impose a plantation economy on Indonesia to serve the needs of Dutch manufacturing industries for raw materials and to drain

Indonesia of its wealth through profit repatriation. In reaction, the generation of 1945 regards industrialization as the key to economic prosperity because technological advancements were, supposedly, less likely to occur in the agricultural sector. They see the repatriation of profits to Holland as an additional reason for the absence of investment in manufacturing.

So it is understandable that economic nationalism in postcolonial Indonesia took the form of state support for industrialization programs and intolerance for foreign ownership of capital (except in extractive industries in the Outer Islands where the capital requirements were immense). The policy translations of economic nationalism are high trade barriers to induce the development of a manufacturing sector and foreign investment laws (which still are) stricter than those of neighboring countries. It is Soeharto's economic nationalism which explains the vacillating attitude toward laissez-faire. The simultaneous introduction in 1983 of liberalizing measures, such as financial deregulation, together with interventionist measures, such as additional nontariff barriers, illustrates this ambiguity.

Setting up inefficient industries behind trade barriers may reflect more than the fact that the army is the bastion of economic nationalism or the belief that industrial development is the long-run solution to rural poverty. An institutional legacy from the past may have been equally important. During the war for independence, the various army units were self-supporting by circumstances, as there was no functioning central government to make budget allocations. In the Soekarno years, army generals were expected to continue supporting their troops by raising outside revenue to supplement their budget allocations. Joint business ventures involving senior army generals and the private sector were common. This practice has been expanded under the Soeharto regime, and the use of army personnel in business management has been justified by the doctrine of *dwifungsi.*[13] The imposition of trade barriers to give a monopoly position to manufacturing enterprises with army connections thus serves the dual purpose of catering to the army's economic nationalism and providing additional funds to the armed forces.[14] The second purpose is an important reason Indonesian manufacturing industries are oriented toward internal rather than external markets. Competition in external markets may make production more efficient, but it also makes funding for the army more uncertain. This also helps to explain why quotas rather than tariffs are the favored form of import restriction.[15] The granting of quota rights is a faster way of transferring funds to selected groups like the army, bypassing the laborious budgetary process. The result is that the budget understates the revenue and expenditure of the public sector.

The widespread use of monopoly import licensing since 1982 serves in most cases the same transfer-of-funds function as quotas. Since the license holders are usually family members of government officials and political supporters, it is clear that the trade barriers were erected more for rent-seeking purposes than for infant industry reasons.[16] What is being revealed is the political patronage side and not the economic nationalist side of the Indonesian state.

It has been argued that this privatization of public funds was actually a form of privatization of public works rather than the fruits of political patronage. According to Bustanil Arifin, the minister of cooperatives, the profits of the monopoly import licensing system are "being used to develop small industries, build mosques and churches and run public health programs."[17] The point is that given the considerable overlap of personnel in the public and private sectors (a practice sanctioned by *dwifungsi*), the line between these two sectors is blurred in Indonesia. Since private firms are expected to contribute for nonbudgeted public projects, it is perhaps not surprising that when the biggest cement company, Indocement, ran into financial difficulties in July 1985, the government reciprocated by spending over U.S. $325 million to bail it out.

The ways in which Soeharto's background has influenced his style of economic management have presented occasional problems for the budget. Perhaps, being a military man, it is natural that Soeharto shows impatience at the bureaucratic implementation of government programs. What is surprising is that instead of trying to streamline the bureaucracy, he regards its inefficiency as endemic. Two events reveal this attitude very clearly. Through INPRES since 1969, a sizable amount of development spending is directly channelled to the village and county levels, bypassing the usual disbursement mechanism. More recently, in 1985, the entire Indonesian customs service, well known for its corruption and delay, was put on indefinite paid leave. A private Swiss firm (Société Générale de Surveillance S.A. of Geneva) was hired in its place to clear the goods at their foreign ports of departure. In the eighteen years of his rule, Soeharto had plenty of time to revamp the customs service but he chose not to. And when he did respond to its inefficiency, the action reflected his pessimism about bureaucratic reform.

While Soeharto highly valued the advice of his capable economic technocrats, he saw their penchant for detailed financial assessment and accountability as a drag on the pace of development. Soeharto's appointments of, first, General Ibnu Sutowo, and then Technology Minister Habibie, as the czars of national industrialization, arise from his perception that the problems of a desperately poor country like Indonesia are obvious and what is needed are quick, decisive actions initiated and enforced by a capable and dedicated individual. Quick actions necessarily dictate that the individual be unconstrained by the usual bureaucratic checks which, after all, are meant only for men of lesser talent and dedication.

Soeharto's practice of allowing the "dynamiser" a free rein follows from his own experiences as the Central Java regional commander in the 1950s. Again, it was a time when military commanders had to generate substantial revenue to supplement the budget allocation in order to maintain the army units, the force that was preventing the disintegration of the new country into regional republics. Soeharto met this challenge with a series of very successful business ventures. In addition to the usual transportation and trading activities, Soeharto's military command was the only one with a Development Contribution Fund financed by levies on the local business community.

Soeharto's style of granting broad discretionary powers to his industrialization czars resulted in the Pertamina crisis in February 1975. General Ibnu Sutowo, who in 1966 became head of the state oil company, Pertamina, expanded its nonoil investments tremendously. To finance this proliferation of activities, Pertamina borrowed heavily in the international credit market. A significant portion of Pertamina's external debt was in short-term borrowing because the technocrats resented the evolution of Pertamina into an independent development agency and had, with the help of major aid donors, pressured Soeharto to restrict Pertamina's borrowing in the medium-term credit market.

It was this borrowing in the short-term market which precipitated the Pertamina crisis. In 1973 and 1974 Pertamina found itself paying higher and higher interest payments on the debt it was continually rolling over. (The interest rate rose because the central banks in the industrialized countries were stomping on their monetary brakes in order to dampen aggregate demand to offset the supply-side inflation caused by the OPEC-I price increases.) The increased debt-service burden proved too much for Pertamina. In February 1975 it defaulted on a short-term loan, and Bank Indonesia had to take over Pertamina's debt. Bank Indonesia's foreign exchange reserves fell from $1.6 billion in January 1975 to $0.5 billion in September 1975, while at the same time its foreign liabilities rose from (nearly) zero to $0.8 billion, a reflection of the tremendous external borrowing required to meet Pertamina's obligations during those seven months.[18] The big diversion of resources led to the scaling back of development expenditure in 1976/77 and 1977/78.

It would be wrong to attribute the fiscal problems arising from the Pertamina affair entirely to Soeharto's predilection for getting things done quickly. Special interests and ideology were also important in shaping events. The huge revenue generated by rapid development of the petroleum sector was very important to the Soeharto government in the early days of its administration because it obviated the unpopular steps of raising taxes to pay for routine government expenditures.[19] Since the Ministry of Finance had no knowledge of the amount of oil taxes and royalties that Pertamina had collected on the Ministry's behalf, Pertamina retained part of the revenue for extrabudgetary activities. These activities helped to consolidate Soeharto's power base by channelling resources to key constituents to meet what Karl Jackson (1978b) has called their "nonservice goals." It is highly likely that the armed forces, which had their official budget capped in order to convince external aid donors of the commitment by the Indonesian government to development, were a big recipient of extrabudgetary allowances from Pertamina. Given these extra functions, it was no surprise therefore that Sutowo adopted a management style which "ensured that few people apart from himself even had a rough overall picture of the finances of operations of the company" (McCawley 1978, 5). Nothing illustrated this attempt at obfuscation better than the fact that Pertamina had six uncoordinated accounting departments.[20]

Ideology also plays an important role in explaining the Pertamina affair because there was a sizable group of intellectuals who concluded that the establishment of more quasi-state conglomerates à la Pertamina was essential for political stability. An underlying resentment among many indigenous Indonesians *(pribumis)* was that the Chinese Indonesians *(peranakan* and *totok)* wielded economic power disproportionate to their 3 percent share of the population. It was widely felt that this state of affairs originated from the victimization of the pribumis by Dutch colonial policies.[21] This resentment against the Chinese led to occasional mob destruction of Chinese property.

These intellectuals were pessimistic about the ability of laissez-faire to change this inequality drastically and quickly enough to be politically acceptable. They proposed that Chinese domination of business be reduced by launching large, state-sponsored enterprises, each headed by one of the small number of talented *pribumi* entrepreneurs in existence. By regarding these Indonesian *zaibatsu* as holding their capital in trust for the *pribumis,* the share of indigenous ownership of capital would be considerably increased very rapidly.[22] This method of defusing racial tension received enthusiastic support from the economic nationalists within the army, the key constituency in Soeharto's regime, making it easier for Soeharto to follow his preference for quick action.

3.5 The Embodiment of the Different Concerns at the Policymaking Level

The primary reason Indonesia sometimes pursues a contradictory mix of liberalizing and protectionist policies is because of these ideological, pecuniary, and personal elements working themselves through two groups of contending presidential economic adivsors, popularly referred to as the technocrats and the technicians.[23] The technocrats are mostly economists of neoclassical persuasion who work at the Ministry of Finance and the National Planning Body (BAPPENAS). Their acceptance of the comparative advantage principle leads them to emphasize the development of nonoil export industries, particularly agricultural commodities and labor-intensive manufactured goods. This has meant a favorable treatment of the agricultural sector because it supplied 82 percent of nonoil exports in 1970 and 75 percent in 1980. Exchange rate devaluations, rather than the removal of trade restrictions on imported inputs, are used to promote exports because the technocrats control the ministries that oversee macroeconomic policies but not the Ministry of Trade and the Ministry of Industry which have authority over trade restrictions.

The technocrats do not have much of a domestic constituency outside of the universities. Consistently strong sources of support for their market-oriented policies are the foreign aid donors, the World Bank, the International Monetary Fund, and IGGI.[24] This foreign backing helped in the early years to establish the role and power of the technocrats because of Indonesia's dependency at that time on foreign concessionary loans.[25] This aspect was very well illustrated by the strategy the technocrats adopted to rein in Pertamina when it was intruding upon the economic policymaking turf.[26] In March 1972 the minister of finance chose to enter into another standby agreement with the IMF, even though in the agreement document the IMF had concluded that:

> [the] proposed fiscal and credit policies, the recent depreciation in the effective exchange rate of the rupiah, the expected substantial increase in net receipts from crude oil exports *should* make possible the achievement [of the Indonesian goals which were] to achieve a higher rate of economic growth in conditions of relative price stability, and to *increase net international reserves*. (emphasis added)

The result of this extreme aversion of the Ministry of Finance to the possibility of a balance-of-payments crisis led to the IMF setting a ceiling on medium-term external borrowing of $145 million for 1972/73 as part of the standby agreement. A decree was issued in October 1972 requiring all state bodies to seek approval from the Ministry of Finance before contracting medium-term foreign loans. When Pertamina ignored this decree, the United States (the biggest donor) suspended its aid. Pertamina then started borrowing in the short-term market to finance its long-term investments. As noted earlier, this switch led to the 1975 Pertamina debt crisis, after which the firm was taken over by army personnel sympathetic to the technocrats.

Despite the big decline in the importance of foreign aid after the oil boom, the technocrats have maintained their influence on economic policies because of their proven competence. They designed and implemented the 1966 stabilization program, restructured Pertamina's debts, and introduced a new professionalism into economic management. This explains why the president remains their patron.

The second group of economic advisors, the technicians, is an amorphous collection of technicians-turned-managers, military advisors, and economists with structuralist inclinations.[27] The technicians are united by their common belief in the general validity of the infant industry argument and by their common rejection of foreign capital ownership. They see state enterprises like Pertamina (until its downfall) as vehicles to achieve these two objectives.[28] This position allies the technicians with members of the intelligentsia who see state enterprises as the way to counterbalance Chinese domination of the corporate sector.

The technicians' control of the Ministry of Trade has allowed them to encourage domestic production of manufactured goods, including airplanes. Given the strong sense of economic nationalism in Indonesia and the widespread belief that only industrialization (regardless of whether it is import-competing or export-oriented) holds the key to a higher standard of living, the technicians enjoy popular support among the Indonesian elite. Furthermore, their import-substitution industrialization has won them the support of the army, the most powerful constituency in the country. Thanks to the *dwifungsi* doctrine, the expansion of state enterprises translates directly into more managerial positions for senior military personnel. It must be noted that since most of the import-competing industries were set up in urban Java, the higher prices of manufactured goods represented an implicit tax on residents of the rural sector and the Outer Islands.

In looking at the political setting within which policies are chosen, we have identified an important political coalition of technocrats, Outer Islanders, and rural residents which favors a political package emphasizing the maintenance of a competitive exchange rate. The fact that there exists a strong institutional memory about the economically destructive effects of an overvalued exchange rate means that the government is naturally disposed to the arguments for a competitive exchange rate. Since a debt crisis occurs when a government runs out of foreign reserves, this emphasis on avoiding prolonged exchange rate overvaluation reduces the probability of a debt crisis by keeping the (foreign exchange earning) nonoil export sector healthy and capital flight low. We shall show in subsequent chapters how these political and economic factors have influenced the setting of economic policies and, hence, the performance of the economy.

4 The Fiscal System

4.1 Introduction

The two arguments we are developing in this monograph are that appropriate exchange rate management was fundamental to why a debt crisis did not appear during 1982–84 and that the exchange rate policy was heavily influenced by political considerations. The aim of this chapter is to test the