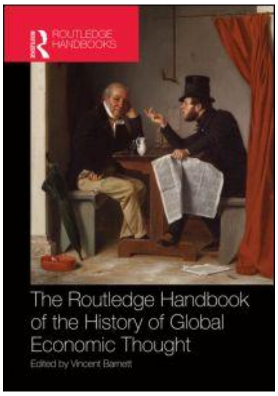

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Southeast Asia

Indonesia and Malaysia

Cassey Lee and Thee Kian Wie

The early history of "classical" development economics is closely intertwined with the experiences of developing countries during the period from the 1940s to the 1960s. This was a period which witnessed the decolonization of many Southeast Asian countries. Much of the economic thought that emerged in these countries during this period was very much related to the economic challenges faced by these countries after gaining independence. These challenges include rebuilding of infrastructure and the productive apparatus, poverty eradication, expansion of education and health facilities, and economic diversification away from its agricultural sector towards manufacturing. Economic ideas about development also evolved as these countries underwent political and structural changes in subsequent years.

In the case of Southeast Asia, there have been relatively few studies that have attempted to review how economic thought has evolved. The main purpose of this chapter is to address this gap by providing a concise narrative of what can be termed as a brief history of economic thought in Indonesia and Malaysia. The reader might ask: why Indonesia and Malaysia? In a sense, there is an element of arbitrariness in this choice – the two contributors specialize in Indonesia and Malaysia. However, the two countries provide a useful opportunity for a comparative study of economic thought in two geographically proximate states. Whilst the national languages of the two countries are very similar ("Bahasa" in Indonesia and Malaysia), the economic and political trajectories have been very different since the countries' independence, and were also rather distinct before this time. The structure of the chapter is as follows. The first section will provide a brief historical background that will serve as a context for the history of economic thought in the two countries. The second section dwells briefly on economic thought in the pre-independence period. The core of the chapter then focuses on post-independence economic thought, while a final section concludes.

Brief background

Indonesia and Malaysia are two neighboring countries that have sometimes been collectively grouped together into what is known as the Malay Archipelago. The basis for the term "Malay Archipelago" could have been language and/or ethnicity (Pribumi/Bumiputra). Of the two, Indonesia is by far the larger country, both in terms of land size (1.9 million sq. km compared to 0.3 million sq. km) and total population (243.8 million against 28.8 million in 2013). However, Malaysia's current income per capita is about twice that of Indonesia. The political and historical trajectories of both countries were also very different.

The total territory of Indonesia was a Dutch colony (when it was referred to as the Netherlands Indies) since 1815. On March 8, 1942, the Commander of the Royal Netherlands Indies Army, General ter Poorten, signed the act of surrender to the Japanese Commander in Subang, a small town in the province of West Java. Subsequently, Indonesia was occupied by Japan until August 15, 1945, when Japan surrendered unconditionally to the Allied Forces. Indonesia's two foremost nationalist leaders, Sukarno and Mohammad Hatta, seized the opportunity to proclaim Indonesia's independence on August 17, 1945 after Japan's surrender, whilst the British resumed their rule of Malaya (Peninsular Malaysia prior to the formation of Malaysia in 1965) until August 31, 1957, when Britain granted it its independence. The Malayan peninsula and Northeast Borneo were occupied by Britain for 117 years.

There were some similarities in the economic challenges encountered by Indonesia and Malaysia in the countries' early post-independence years. Infrastructure development and achieving a more balanced structure of the economy (away from an overdependence on the export-oriented agricultural and mining sectors) were priority areas for both countries. Both countries shared similar concerns over the dominance of foreign-owned firms as well as Chinese-owned firms in these economies.

Another major area of focus was the development of the manufacturing sector – especially the need to enhance the sector's production to meet domestic needs. Whilst both countries began with import substitution industrialization, the duration of these policies differed – Indonesia from the early 1950s until the early 1980s (after the first oil boom ended) and Malaysia from the 1950s to the 1960s.

For Indonesia, macroeconomic stabilization was of greater importance following economic instability during the period from the mid-1950s to the mid-1960s, involving the twin deficits (balance of payments and budget) and hyperinflation, which had reached a staggering 600 percent in 1965 (Thee, 2012). Greater economic stability and more sustained growth was only achieved in Indonesia in the first decade of Suharto's New Order Era (1966–98). The two oil booms in the 1970s enabled the Indonesian government to undertake significant investments in physical infrastructure and in health and education facilities, particularly in primary education, as well as support for the agricultural and manufacturing sectors.

However, the first oil boom, which ended in 1982, had the unfortunate effect of the resource curse, which adversely affected exporting activities as Indonesia's real exchange rate appreciated. However, after the price of oil dropped steeply in early 1986, the Indonesian government finally embarked on a more determined path of export-oriented industrialization. This scheme turned out to be very successful, as from 1987 manufactured exports rose very rapidly, thus following in the footsteps of the East Asian newly industrialized economies.

Malaysia's oil boom came much later in the mid-1990s with important discoveries in the East Coast of Peninsular Malaysia and in East Malaysia. As in the case of Indonesia, Malaysia also used its windfall earnings from oil to undertake a second round of import-substitution by focusing on heavy industries (automotive, steel and cement). Despite this new emphasis, export manufacturing activities continue to be important in Indonesia and Malaysia. The Asian financial crisis in 1997/98 had a significant adverse impact, especially on Indonesia. The sharp economic contraction in 1998 was followed by the downfall of Suharto on May 21, 1998. In Malaysia, the Mahathir administration survived the crisis by shielding domestic capital via exchange controls and bailouts in the banking sector.

Pre-independence economic thought

It is useful to briefly examine the cultural/business traditions and economic thought that existed prior to the Second World War. Documentation relating to these topics is relatively scarce, especially before the colonial period. Much of what exists is the work of historians/economic historians. Then there is the problem of how far back should we look. A useful starting point or benchmark is the publication of Adam Smith's *Wealth of Nations* in 1776 or circa the late eighteenth century. This was a period which saw the early history of colonial rule in the region. Two points of view are of relevance here – those of the Colonial office/officers (British and Dutch) and the indigenous population.

In the case of Indonesia, Arndt (1981) has opined that the Dutch were purely interested in trade and profit-seeking. It is less clear whether the views of the Dutch were driven by mercantilist theories. Whilst the extraction of resources (such as spices) for trade did benefit the Dutch, Indonesia (Java, primarily) was not yet targeted as a market for manufactured goods (ibid.). This was rather different from Malaya (Peninsular Malaysia), where mercantilist-type thinking may have informed colonial policy and where raw materials (tin, rubber) were exported from Malaya and manufactured goods were imported from Britain (Li, 1982).

Perhaps a more important idea related to development that has received some attention relates to the nature of the indigenous population within Southeast Asia. For example, Arndt (1981) discussed the "theory of dualism" propounded by J.H. Boeke, who argued that Indonesian people lacked the desire to improve their material (economic) welfare. Boeke's "theory of dualism" argued that there were major differences between Western and non-Western economic cultures and objectives at a fundamental level. This theory, which was subsequently rejected by many later development economists, had parallels in the sociology literature in the form of the "myth of the lazy native" (Alatas, 1977). Related to such studies are the historical examinations of the material culture of indigenous societies in the Southeast Asian region (Reid, 1988).

There are likely to be much fewer records pertaining to economic ideas and reactions of the indigenous population (compared to colonial records and views). Also, the "indigenous population" in these countries was not an entirely homogenous group. One important indigenous group was the local rulers (sultans/kings). Another was the nationalists. In the much-cited work by Gullick (1988), indigenous political leaders within the feudal system extracted an economic surplus (via taxation) to maintain their political power. There is no evidence on how "Western economic theories" influenced such practices, if they did at all. As for the nationalists, their main concern was for overcoming relative economic backwardness (Roff, 1967). Some of these concerns were manifested as part of a more general concern for inequality, sometimes under the influence of early socialist ideas (Boestaman, 2004). Overall, pre-independence economic thought amongst the indigenous population in Indonesia and Malaya is a relatively unexplored topic, and therefore more research needs to be carried out on the pre-independence and pre-colonial periods.

Early post-independence contributions: 1950s/1960s

The economic debates and policy orientation in Indonesia and Malaysia during the early post-independence were strongly influenced by their decolonization experiences, economic performance, and economic structure. In 1949, the Dutch had attempted, successfully, to protect its commercial interests in Indonesia as part of the negotiations to recognize Indonesia's independence during the Round Table Conference in The Hague in the autumn of 1949. This was achieved when the Dutch delegation insisted on including a Financial-Economic Agreement

(Finec) in the Round Table Conference (RTC) Agreement, which guaranteed that all the Dutch firms could continue their business operations as usual, including the remittance of profits (Meier, 1994, 157).

Nationalization of the Dutch enterprises required mutual agreement, with compensation to be determined by a judge on the basis of their actual worth (Meier, 1994, 46). On December 15, 1951, the Indonesian government nationalized the Java Bank, which was the bank of circulation during the Netherlands Indies, by purchasing all the shares of the Java Bank held by Dutchmen and other foreigners. The sale of the shares of the Java Bank proceeded smoothly (Saubari, 2003, 27). Thereafter the Java Bank was renamed Bank Indonesia, which became Indonesia's central bank. It is unclear whether any economic theories were articulated to support these actions.

In the case of Malaya, the process of gaining independence and transfer of power was peaceful and more gradual. Whilst the studies of foreign ownership were important – by scholars such as James Puthucheary – no nationalization policies were implemented in Malaya during the 1950s. Large-scale takeover (via equity purchase) of British-owned enterprises operating in Malaysia were only undertaken by government-linked corporations (GLCs) in the early 1980s. There is more documentation on the theories that have influenced the work on ownership in Malaysia. Puthucheary (1960) argues that foreign capital was primarily focused on primary industries and thus had limited impact on industrialization in developing countries. This idea was influenced by the works of Hans Singer and Gunnar Myrdal from the 1950s.

Debates about ownership in the modern sector (distributive trade and manufacturing) also took on an ethnic dimension. In Indonesia, this took the form of the *Benteng (Fortress) Program* which was introduced in 1950 to develop indigenous entrepreneurs (Thee, 2012). This was achieved by giving preferential treatment to indigenous Indonesia importers. There were other programs aimed at constraining ethnic Chinese businesses which were implemented in 1954, such as ownership restrictions in weaving mills, rice mills, and port services. Such policies were supported by some economists (Sumitro Djojohadikusumo, who from 1950 to 1957 was the Dean of the Faculty of Economics, University of Indonesia), whilst they were rejected by others (Sjafruddin Prawiranegara, the first Indonesian Governor of Bank Indonesia).

Ownership debates were also intense in Malaysia but took place after the late 1960s. The race riots on May 13, 1969 were the key event that triggered the implementation of the *New Economic Policy* (NEP) which was to become the most important affirmative-action based policy in Malaysia. The Policy was formulated during the period 1969–70. There was a major disagreement on economic thought within the circle of policy makers on NEP (Faaland et al., 1990). The "EPU School," representing key planning and policy-making agencies such as the Economic Planning Unit (EPU), the Treasury and Bank Negara (central bank), emphasized economic growth: most likely, the Keynesian-inspired growth theories of Harrod, Domar, and Solow. The "DNU School" (Department of National Unity) favored a more radical approach involving more direct government intervention to correct the ethnic imbalance in income, employment and ownership of assets and capital (ibid., 32). The approach of this school was underpinned more by political economy considerations (equality and political stability) than by any identifiable economic theories. The subsequent implementation of NEP, which signified the "victory" of the DNU School, was very much reminiscent of the dominance of the history-minded leaders (or solidarity makers) over the economics-minded (administrators) in the 1950s in Indonesia (Thee, 2012, 44–5).

In hindsight, the EPU school's emphasis is understandable, based on the economics literature in the 1950s and 1960s, which focused much more on economic growth and structural change. This was a period that witnessed the development of various growth theories by Harrod (1939), Domar (1946), Lewis (1955), Robinson (1956), and Solow (1956). This literature did influence the economic studies in both Indonesia and Malaya, albeit gradually and indirectly. In the case of Malaya, there was much emphasis on factor accumulation in terms of population growth and investment – both of which were seen as key factors driving the growth of the economy (Silcock, 1961). During this period, economists emphasized the open economy nature of economies of Indonesia and Malaya and how this impacted on economic growth. More specifically, economic growth was seen as being driven primarily by demand for primary commodities, such as rubber and tin.

Industry studies on rubber and tin also became important during this period. In the case of the Malaysian rubber industry, the focus of these studies has mainly been on the production structure (cost, smallholding versus plantation, replanting), government regulation, ownership (foreign versus local, ethnic groups), and the competition between natural and synthetic rubber. Important contributors in the 1950s and 1960s include P.T. Bauer and T.H. Silcock. Due to the nature of tin production – the most important topics studied in the tin industry were the nature and role of capital accumulation (tin being a capital-intensive industry) and commodity control agreements. Major contributors in this literature include K.E. Knorr, Siew Nim-Chee, Yip Yat-Hoong, and Ooi Jin-Bee. The heavy dependence on exports of primary commodities also led to discussions on the need for export diversification. This coincided with the theories of export pessimism associated with Raúl Prebisch and Hans Singer, who argued that development strategies based on exporting of primary commodities suffered from declining terms of trade. As a consequence, developing countries should undertake the development of their manufacturing sector via import-substitution strategies.

Finally, starting after March 11, 1966 (when President Sukarno authorized General Suharto to take control of the government), General Suharto turned to a group of US and Canadian-trained economists at the Faculty of Economics, University of Indonesia (FEUI), referred to as the "Berkeley Mafia" (although not all had studied at the Department of Economics, University of California, Berkeley) for policy advice. The group include Widjojo Nitisastro (PhD, Berkeley, 1961), Ali Wardhana (PhD, Berkeley, 1962), Emil Salim (Berkeley, 1964), Moh, Sadli (M.Sc. MIT, Doctor in Economic Science, FEUI, 1957), and Subroto (M.A. McGill and Doctor of Economic Science, FEUI, 1957).

This group of economic advisers, even though it was not associated with any strong singular ideological orientation, was regarded by some as instrumental in the implementation of market-oriented policies, such as the removal of price controls and trade liberalization (Yasui, 2002). It is plausible that the thinking of the "Berkeley Mafia" evolved over time from one focused on Keynesian thinking (the Harrod-Domar model) and development planning (Mahalanobis), to a more market-oriented approach (Sadli, 1993).

Oil boom years and economic reforms: 1970s/1980s

The two oil shocks in the 1970s and the stagflation that followed had significant impact on mainstream debates on Western macroeconomics (e.g. the Phillips curve), but the impact of the oil shocks was a bit different for oil-producing countries such as Indonesia and Malaysia. The rise in oil prices marked the beginning of the oil-boom years in these countries which provided more resources for development programs.

In Indonesia, the impacts of the oil booms were more destabilizing. Economists such as Arndt and Sadli were quick to point out that the gains from the first oil boom (1973/74) were quickly dissipated with the bankruptcy and bailout of the country's national oil company, Pertamina, due to poor governance structures. The Indonesian rupiah was also devalued by 50 percent in 1978 just prior to the onset of the second oil boom (1979) to deal with the "Dutch Disease" problem from the first oil boom. During the second oil boom period (1978/79), policy-making was likely dominated by economic nationalists (rather than the economic technocrats belonging to the "Berkeley Mafia"). A manifestation of this is the implementation of a new industrial strategy based on a second round of import-substitution, which focused on state-owned enterprise, up-stream, basic, and resource-processing industries (Thee, 2012, 100). The economic arguments that were put forward by A.R. Soehoed (from 1978 to 1983 Minister of Industry) to support the strategy were premised upon market failures in the presence of the required high capital intensity, gestation period, and physical infrastructure. These arguments aside, the strategy was prematurely terminated with the end of the oil boom in the early 1980s.

In Malaysia, economic discussions and policy focused on the formulation of integrated regional development programs that would serve to achieve the objectives of the New Economic Policy. Interests in this approach to development were partly in response to the failure of aggregative Harrod-type growth models in bringing about more equitable growth (Higgins, 1982). By the early 1980s to mid-1980s, economists began writing extensively on the implications and impact of NEP. These studies emphasized the importance of achieving high-growth rates in order to achieve the NEP targets without zero-sum effects on other ethnic communities (Young et al., 1980; Snodgrass, 1980). The implementation of NEP also motivated a number of major economic studies on income distribution in Malaysia in the late 1970s and early 1980s (Meerman, 1979; Tan, 1982). In addition to these studies, there were also class-based approaches to interpreting economic development and the NEP (Hua, 1983; Jomo, 1986).

The end of the oil boom in 1982 (due to a weakening of the world oil market) and the economic slowdown in the mid-1980s shifted economic debates and policy focus to trade and policy reforms in both countries. Whilst these developments coincided with the advent of neo-liberal economic ideas and policy reforms in the US and UK, the economic performance in Indonesia and Malaysia as well as external pressures were the main drivers of trade and policy reforms since the mid-1980s. In Indonesia, the rapidly deteriorating economy finally convinced the government to implement policy reforms that were advocated by efficiency-minded economists in the country (Pangetsu, 1996). Later works such as Feridhanusetyawan and Pangetsu (2003) highlighted the role of external events such as the Uruguay Round Agreement and the World Trade Organization in providing an impetus to trade liberalization during this period.

Malaysia also underwent significant change shifts in economic policy orientation beginning in the early 1980s. A second phase of import-substitution focusing on the development of heavy industries was pursued under the leadership of Mahathir Mohamad. This approach was heavily influenced by the industrialization strategies adopted in Japan and South Korea, although a minority of economists was openly critical of this approach (Chee, 1985). Other economists during this period were more concerned about technological development and transfer in the manufacturing sector (Fong, 1986; Ali, 1992). The Mahathir administration also embarked on an extensive privatization and liberalization program, and it took another ten years before comprehensive and often critical reviews of privatization programs emerged.

The Asian financial crisis and regional integration: 1990s/2000s

The literature on privatization in Malaysia emerged beginning in the mid-1990s – more than ten years after the privatization was implemented. The early study by the World Bank

(Galal et al., 1994) had a positive review of the privatization outcomes (MAS, KCT and Sports Toto). Later studies by Malaysian academics were more critical of privatization programs (Jomo, 1995; Tan, 2008). These studies were part of the larger emerging literature on political economy in Malaysia, emphasizing the rent-seeking nature of the ruling coalition party in Malaysia (Gomez and Jomo, 1997). The literature on privatization in Indonesia is sparse as little progress was made in this area despite the announcement of ambitious plans in the late 1980s (McLeod, 2002).

The key economic event in the 1990s was, without doubt, the Asian financial crisis in 1997. Analyses of the financial crisis have attributed the crisis to both economic factors (exchange rate system, private debt levels, and a weak financial system) which were compounded by political factors (Hill, 1999; MacIntyre, 1999). In the case of Malaysia, short-term capital flows, high leverage, and an equity bubble have been identified as factors contributing to the economy's vulnerability during this period (Athukorala, 2001). Factually, the impact of the crisis was more severe for Indonesia than on Malaysia. The different policy responses in Indonesia and Malaysia brought to light economic debates on the pro-market ideas dubbed the "Washington Consensus" (advocated by International Monetary Fund (IMF)/World Bank) as well as the role of political economy in development. Indonesia was forced to implement the IMF/World Bank's structural adjustment policies, which later brought about severe political crisis and the end of the Suharto regime. In Malaysia, a different policy response was adopted involving greater state intervention via capital controls, which was regarded as going against IMF-type policy prescriptions (Mahani, 2002; Dornbusch, 2002).

Political economists have also entered the debate by highlighting the role of politics (e.g. governing coalitions) in explaining the different policy response and subsequent developments (Pepinsky, 2009). The slower pace of growth in the period after the 1997 financial crisis has also prompted further analyses, especially on the role of institutions and politics. For example, the rent-seeking critique of government policies continues to have significant traction in the political economy literature in Malaysia (Hill et al., 2012). This trend is perhaps consistent with increasing interest amongst mainstream economists in the role of institutions and politics in long-term economic growth (Acemoglu et al., 2005).

Conclusion

Economic thought in Indonesia and Malaysia has, in the past, evolved in response to the countries' colonization experiences and subsequent post-independent developmental challenges. What emerges from this broad and short survey is a sense that there is no singular or identifiable school of thought in these countries. Much of the writings that have emerged in the past fifty to sixty years were primarily driven by challenges posed by prevailing economic and political problems. By undertaking a survey of economic thought/problems side-by-side, this comparative study argues that there are both similarities and differences in emphases over time.

Early economic writings were pre-occupied by similar problems associated with the inheritance of colonial economies – post-war reconstruction and ownership. The ethnic dimension in development – involving an inequality in wealth between the indigenous and ethnic Chinese communities – has featured prominently in both countries. The resulting debates and others in the 1950s/1960s have often pitched professional economists (adhering to conventional economic thinking) against other non-economist groups (nationalists, politicians). After the Asian financial crisis in 1997, there was perhaps greater convergence as economists have begun looking more deeply into the role of institutions and politics in generating and sustaining long-term growth.

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