CHAPTER 1
INTRODUCTION

1.1 Background

To most leaders in this world, economic growth is the sole objective of their economic policies. Most economists believe that when an economy grows, people's welfare is the consequence. During 1960-2000, real per-capita income in the developing world grew at an average rate of 2.3 % per annum, whereas rich countries were blessed with 2.7 % growth per annum (Rodrik, 2004). No wonder almost all nations pursue various policies to boost their growth. However, growth theory had not really come up to surface until Robert Solow put his pencil on a paper. His seminal work, "A Contribution to the Theory of Economic Growth", published over half a decade ago (Solow, 1956), has put a foundation to other major papers on innovations of growth theories, like Romer (1986) and Mankiw, Romer, and Weil (1992).

Despite various national policies to increase growth, there has been a consensus on general basic principles believed to be desirable everywhere. They are capital accumulation, specifically physical capital accumulation, human capital, property rights, rule of law, market-oriented incentives, sound money, and sustainable public policies. On the other hand, there is a controversy called 'Washington Consensus'. This consensus is composed of several policies: fiscal discipline, tax reform, trade and interest rate liberalization, privatization, deregulation, etc. Several African and Latin America countries seemed to follow it, even moved further in adopting part of liberalization. However, it has been critized as an inappropriate agenda, vindicated by failures of Sub Sahara African countries employing this agenda. Rodrik (2006) argues that the question now is not whether the Washington Consensus is dead or alive, but what will replace it.

In fact, not all policy makers in every country follow it, at least in some parts. China and India give a wonderful example in how not to take it for granted.

They succeeded to in boosting their economic performance following rather heterodox policies. China opened up to the world only in a partial way and underplayed property rights, for instance. India walks through the same vein. It adjusted to its own specific economic condition and environment. The government decided to liberalize their economy, while they also defended heavy protectionism in the same time. However, China and India's experiences do not necessarily rule out the need for following points in Washington Consensus. In fact, along with Vietnam, they adjust to policies in Washington Consensus, as implied by Rodrik (2004).

The moral message of it is that policies that work very well in some places may give same positive impacts on others. They may have negative or unintended consequences, though. Thus, policy makers of a certain nation are required to have a great deal of information and knowledge of economies they work on. They need to know which part of the economy that needs to be reformed partially or entirely. In other words, they need to perform a good diagnostic to prescribe the 'right medicine', as different economy might entail certain conditions.

If policy makers are somehow able to manage accumulation of information needed, the next intuitive question would be what harms economic growth? Numerous notable researchers have done abundant researches on this subject, such as Bruno and Easterly (1998), Sarel (1996), Barro, Fischer, etc. The findings vary. Some researchers argue that inflation is the main culprit, while others might say that it is low quality of institutions, and others suggest upheaval political condition.

Indonesian economy within two decades is one of the most interesting countries to study about its growth sustainability, its determinants and constraints. In fact, the most interesting part of modern Indonesian economy began in 1966, the year when political transition and economic disasters occurred, while, in the mean time, major search for economic reform strategies were in the making. Another interesting part began in 1982, the year when miracle expansion somehow slowed and tended to cease. Ever since, several reformative policies had been devised to boost economic growth, ranging from liberalizing the trade system and capital account to improving bureaucratic performance, but its economic performance somehow appeared to be rather unstable in different time paths.

During this period, Indonesian economy experienced several unforgettable, both in good and bad senses, economic phenomena. In early 1980s, it experienced a major reform, which took form in evolution of economic system moving from rather inward looking to outward looking, high economic growth averaging at 7-8 % in 1990s, a massive capital outflow resulting in a deep economic crisis in 1997/98 contracting Indonesian GDP for about 13 %, and several economic occurrences until 2005[1].

1.2 Main Problem

Indonesian economy during the period of 1980-2005 is a very interesting real laboratory for researchers to study. Its ups and downs have been heavily affected by interaction between politics and economic incentives. As suggested by Hausmann, Rodrik, and Velasco (2005, hereafter HRV) there might be unique problems and a set of policies for one economy. Similarly there might be unique set of problems and a set of policies for Indonesian economy, as well. The most interesting problem in Indonesian economy up to now has been institutions related ones.

Literature study conducted before by author suggests institutions in the New Order Era did not negatively affected state of economic incentives in Indonesian economy. Instead, institutions positively affected or insignificantly affected economic agents. This story does not continue to after crisis period. It is argued that institutions turned out to exhibit major nuisance to Indonesian economy onwards.

1.3 Research Questions

1. What was the most binding constraint to higher Indonesian economic growth?
2. Did the government target the right most binding constraint?

[1] Author limits the period for only 1982-2005 because this is to see the effects of reforms carried out several years before.

3. Could have Indonesian economy experienced higher economic growth had the government reformed the most binding constraints?
4. What are policy implications for Indonesian economy in the future?

1.4 The Purpose and Benefits of the Study

The main purpose of this study is to find the most binding constraints of Indonesian economy in a long-time period. This is very important as this is concerned with long-run trend of growth issue and, of course, national welfare reflected by income per capita. I fully expect that this study might generate benefits to other researchers and, hopefully, policy makers so that, in return, this could lead to a better and wealthier Indonesia in the future.

1.5 Hypotheses

There are few hypotheses regarding my research:

1. Quality of institutions, aside from macroeconomic stability, in Indonesia played a big role in Indonesian economic growth
2. Indonesian government did not perform properly in years of policy reform
3. Indonesia could have enjoyed higher and more stable economic growth

1.6 Methodology

In order to provide comparison I include seven other countries. Because economic growth diagnostics is really concerned with long-run trend issue, the time period used here spans for more than twenty years, from 1980-2005. The year 1980 is to be starting point as it marked two years prior to a major slump in oil prices that prompted an era of policy reform in Indonesia.

The main model used in this thesis is the one developed by Hausmann, Rodrik, and Velasco (2005), that is "growth diagnostic model". Mathematical model used in their paper is translated into econometric methodology to be able to wholly diagnose Indonesian economy during 1982-2002. Econometric methodology used in this thesis is fixed-effect model because it is very useful form comparison among countries and how each variable gives impact to growth.

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\begin{aligned}
&\log gdp = \alpha_1 + \alpha_i DUM\_COUNTRY_i + \beta_1 \log edu_{it} + \beta_2 reg\_qual_{it} \\
&+\beta_3 \log gov_{it} + \beta_4 acc\_som_{it} + \beta_5 log(open_{it}) + \beta_6 leg\_prop_{it} + \beta_7 dem_{it} \\
&+\gamma_i DUM\_COUNTRY_i * (\log edu_{it} + reg\_qual_{it} + \log gov_{it} \\
&+acc\_som_{it} + log(open_{it}) + leg\_prop_{it} + dem_{it}) + \varepsilon_{it} \qquad (1.1)
\end{aligned}
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The data used in this thesis is secondary data from both international institutions (International Monetary Fund and World Bank), local institutions (National Board of Statistics, Bank of Indonesia, Department of Finance, etc.), and other database providers (freetheworld, Penn World Tables, economic freedom).

1.7 Plan of the Thesis

This thesis is composed of six chapters, including chapter 1. Below is the brief description of each chapter. Chapter 1 consists of several stuff that might give some guidance to deeper understanding of the whole content of the thesis. Chapter 2 chapter consists of theoretical framework that gives associations to the whole story of this thesis. Theoretical fundamentals included in this chapter are growth diagnostics approach, institutions and Ramsey-Cass-Koopmans Growth Model. Chapter 3 briefly explains overview of Indonesian economy during the studied period. It puts more weight on policy reforms that occur in those years. Descriptive growth diagnostics following. Chapter 4 consists of econometrics methodology and sketched description of panel data and fixed effect model. Chapter 5 interprets and infers what happens to independent variables in economies selected based on given empirical evidence. Empirical analysis of growth diagnostics is delivered in this chapter.