CHAPTER I

INTRODUCTION

This chapter is going to explain about essential things about this thesis. It explains briefly the problem background which causes the appearance of the problem. Then the writer will explore about the theory which is used to answer the research question and finally get the hypothesis. This chapter I also explains purpose and benefit of research, research method, range of research and system of writing.

A. Problem Background

The International Monetary Fund (IMF) was established to rebuild international goods and capital markets, as well as the war–torn economies of Western Europe.[1] In July 1944, the representatives from 45 countries assembled in Bretton Woods, New Hampshire, to plan the terms of postwar international economic cooperation. The economic devastation of the Great Depression in the 1930s followed by the ravages of the Second World War had led to the collapse of international financial markets and precipitous declines in the volume of international trade.[2]

IMF was responsible for monitoring and stabilizing the international financial system through the short-term financing of balance of payments deficits. The

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[1]Michael P. Todaro, *Economic Development seventh edition*, London, Addison Wesley Longman

increasing interdependence between developed and developing countries has served to intensify the interaction between these international financial institutions and the third world countries. Consequently, the IMF now plays critical and evolving roles in the development process.

Indonesia is one of Third World countries. Indonesia got its independence in 1945 from the Netherlands and Japan Colonialism. After its Independence, the founding fathers of Indonesia focused to fix the economic condition. During the Old Order era (1945-1966), Indonesia was led by the founding President, Soekarno. He argued that Liberalism System had caused too much damage during Netherlands Colonialism age in Indonesia.[3]. In 1959, he constitutionally rejected Liberalism thoughts after reclaiming UUD 1945 as the foundation of the national economic system. He implemented "Sistem Ekonomi Komando" like what Commnunist countries (Soviet Union, China, and Eastern European Countries) have done toward their economic system. With this type of economic system, all economic plans and policies have to be determined by central government. In Sukiman's Cabinet of Ministry (April 1951-February 1952), Soekarno has nationalized De Javasche Bank become Bank Indonesia (BI).[4] In 1957, Soekarno announced Guided Economic System (Sistem Ekonomi Terpimpin) strengthening "Sistem Ekonomi Komando" and during 1957-1958, he nationalized almost all Netherlands Companies. At that time, Soekarno

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[3] Tulus Tambunan (2006). *Perekonomian Indonesia Sejak Orde lama Hingga Pasca Krisis*

extremely prohibited Individualism principles, free trade and market, and also privatization.

All Actions of Anti-Western thoughts had put Indonesia in hard position to get financial aid from western countries. On the other hand, Indonesia needed financial aid to reconstruct economic sector and to finance economic planning.[5] Soekarno's regime was overthrown in 1966, after G 30. S/ PKI movement. And Soekarno released SUPERSEMAR signing the end of Soekarno's era and the beginning of Soeharto' regime.

In the New Order era (1966-1998), under Soeharto's regime, Indonesia's economic system totally changed. Soeharto had changed the system, which tends to Socialism in old order, become anti-Socialism and pro-Liberalism. He started to make close relation with western countries especially the USA. Indonesia rejoined the United Nations, and other multilateral institutions like International Monetary Fund (IMF) and World Bank (1967). By those policies, Indonesia finally accepted fund relief to reconstruct its economic condition and was able to formulate economic plans (PELITA). The Indonesian Government also issued *UU Penanaman Modal Asing* in 1967 and *UU Penanaman Modal Dalam Negeri* in 1968. To support both policies, the government also issued deregulation for some business which related with economy and investment. In the mid 1980s, the government began eliminating regulatory obstacles to economic activity. These steps were directed mainly at the external and financial sectors and were formulated to stimulate the growth of non-oil exports and revenues and to strip away import substitution barriers. These policies have resulted in 11% annual increase in foreign direct investment over the past decade and an increase in non oil export earnings to their current level of 74% of total export.[6]

The Indonesian government had done the endeavors to increase the number of Foreign Direct Investment. From 1967 through 1993, the Capital Investment Coordinating Board (BKPM) approved foreign direct investment applications worth more than $60 billion; over half were approved after 1988. Foreign Investment approvals reached $10.3 billion in 1992 and then dropped to $8.0 billion in 1996.[7] The United States is the largest participant in the oil and gas sector and Japan remains the biggest foreign investor in Indonesia. Those efforts could significantly increase the number of foreign direct investment.

The economic development of Indonesia is based on foreign loan. The major reason for Indonesia and other third world countries in accepting the loan is clearly economic. It is an essential ingredient in the development process, and it contributes to the achievement of the Third World takeoffs into self sustaining economic growth

Foreign loan may produce dividens for donor countries.[8] It is one of the reasons why the donors give loan. Rising per capita incomes and expanding markets in the LDCs(Less-Developed Countries) are good for the exports, national incomes, and employment in the developed countries[9]. The USA became the one of the biggest donor countries to help Indonesia getting off from the crisis. The US government also endorsed the birth of IMF, IBRD, and USAID which provide fund relief for Indonesia. 25 percent of the first capital of IMF ($8,800 millions) is financed by the US government.[10] USA also donated 35 percent of the first capital to the World Bank ($9,100 millions).[11] Indonesia needed huge number of loan for economic recovery after the old order and for financing REPELITA. Indonesia spent the loan to finance the development of the infrastructure which could support the economic growth rapidly.

During the New Order era, Indonesian Economy was more dependent on foreign loan and foreign investment.[12] Those were essential ingredients to endorse Indonesian economic development. Indonesia also depended on the IMF's financial assistance. In 1967, IMF gave US$ 174 million to Indonesia to help indonesian economy.[13] Then in 1987, Indonesian government received US$ 462.9 million (see on appendix 3,

[8] Peter Hess, & Clark Ross, *Economic Development: Theories, Evidence and Policies*, Texas, Harcourt Brace College Publishers, 1997, p. 500.

[9] Ibid., p. 500.

[10] Departemen Luar Negeri Amerika Serikat, *Garis Besar Ekonomi Amerika Serikat, USA, Lembaga Penerangan Amerika Serikat, page 165.*

[11] Ibid, *167.*

[12] Tulus Tambunan, Op. Cit., 23.

[13] *Mengulas Jejak IMF di Indonesia, Intervensi Tanpa Henti* (accessed on May 12, 2008); available from http://kau.or.id/index.php?option=com_content&task=view&id=84

Indonesia: Transactions with the Fund from May 01, 1984 to January 31, 2008). It was the latest transaction before economic crisis happened in 1997. IMF had role in establishment of Inter-Government Group on Indonesia (IGGI) in late of 1960s.[14] IMF facilitated the establishment of IGGI, IGGI is a group of developed countries which provide financial assistance to finance the Indonesian economy. In 1966, IMF also helped the Indonesian government to reschedule the repayment of Indonesian foreign loan; it was US$ 534 million.[15]

When Indonesia got Economic Crisis in 1997, Indonesian Government officially stated to ask for aid to IMF on October 8th, 1997. The total fund relief that IMF gave at that time was USD 40 billion and it would be given gradually.[16] The first grade was given in November 1997, it was USD 3 billion. Indonesia and IMF then signed Letter of Intent (LoI), which was formulated by IMF as an agreement of both sides and also the requirement for recipient country (Indonesia) to get aid from IMF. This aid helped Indonesian Government find the way out for the crisis and get its credibility back from domestic and foreign investors in running the economy of Indonesia.

The core probem of Indonesian Economic crisis in 1997 was the crisis of credibility, both from foreign investors and local investors to invest their money in

[14] Tulus Tambunan, Op. Cit., p. 21.

[15] *Mengulas Jejak IMF di Indonesia, Intervensi Tanpa Henti* (accessed on May 12, 2008); available from http://kau.or.id/index.php?option=com_content&task=view&id=84

Indonesia. They had no trust to the government anymore in maintaining economic stability. Moreover, after new order was overthrown in May 21th, 1998, there were so many KKN Cases (Coruption, Collusion and Nepotism done by the government) were successfully uncovered to public. It made the investors lost of trust toward the Government. Those facts above become some of reasons the Indonesian government engaged IMF to handle the crisis.

The financial aid from IMF to Indonesia is still running until now. The facts above have described that the dependence of Indonesian economic development and industrialization to IMF has been influencing Indonesian Economic policies

B. Research Question

Based on the Background above, the research question is: **How does IMF influence Indonesian economic policies, between Indonesian economic crisis 1997 to 2007?**

C. Theoretical Framework

To answer the research question above the writer will analyze using Structural Power Theory as follows:

Structural Power Theory

Structural power is the power to shape and determine the structures of the global political economy within which other states, their political institutions, their economic enterprises and (not least) their scientist and other professional people have to operate. This structural power, means rather than the power to set the agenda of discussion or to design the international regimes of rules and customs that are supposed to govern international economic relations.[17]

[17] Susan Strange, *States and Markets* (London: Printer Publishers Limited, 1989), 24-25

There are 4 sources of structural power, they are:

1. Security Structure

The IMF can not provide security directly, but the donor countries can provide it. The security structure in a political economy is the framework of power created by the provision of security by some human beings for others.[18] The protectors will get a certain power to determine and even limit the range of choices. By using this power, the provider of security may incidentally achieve special advantages in the production, or consumption of wealth and special rights in social relations. Then the security structure inevitably has an impact on the who-gets-what of the economy.[19]

Security is most essential of basic needs. If someone would kill us, we will not immediately need the other needs. Drive to survive is nature of human being. In fear of death, most human beings are ready to sacrifice wealth, to abandon social status or political position, and to accept injustice and the loss of freedom.

International political system provides security to the world economy. Security to the economy of the states is a must. The First World countries dominate in the bodies of IMF; they master security and being protectors or providers of security in the relations between states. IMF can secure and maintain the stability of global trade, so that IMF has capability to make sure that one country can conduct its economic activities with other countries safely.

2. Production Structure

A production structure can be defined as the sum of all the arrangements determining what is produced, by whom and for whom, by what method and on what terms. It is about people at work are organized and what they are producing. The production structure is what creates the wealth in a political economy. The production has been the foundation of international political economies.[20]

Multi National Corporations are in vital part in world trade. They have been the dominant production-organizing institution. They have structural power over production, because they can earn production and create wealth. The first world countries tend to reinvest their surplus of wealth in profit making enterprises abroad. Two-thirds of the foreign affiliates of MNCs headquartered in the First World (the United States, Western Europe, and Japan). The 350 largest corporations now control more than 40% of world trade and dominate the production, distribution, and sale of many goods from developing countries.[21] The MNCs also help IMF to run the projects which have planned by World Bank (the crucial partner of IMF) over the recipient countries in order to accelerate economic growth program. So the MNCs are ideal and effective institutions to create wealth and able to produce human being's basic needs

[20] Ibid, 62.
[21] Michael P. Todaro., Op.Cit., p.579.

in a huge capacity. The operation of MNCs that require human resources in a huge number is one thing needed by third world countries to decrease their number of joblessness. We know that poverty is big problem for mostly third world countries. so the existence of MNCs in third world countries are fully needed by those developing countries.

3. Financial Structure

Financial Structure can be defined as the sum of all the arrangements governing the availability of credit plus all the factors determining the terms on which currencies are exchanged for one another. By having financial structure, it is possible to create credit, or in another words, there is a power to allow or to deny other people the possibility of spending today and paying back tomorrow. The power will let them exercise purchasing power and then influence markets for production, and also the power to manage or mismanage the currency in which credit is denominated, thus affecting rates of exchange with credit denominated in other currencies.[22] For those tasks IMF was created. IMF has a right to determine whether one country is qualified or not to get financial assistance. Then, IMF's reference is sent to The World Bank to give the credit. The Bank provides loans to finance economic development. The World Bank's role has been increasing as the provider of financial resources which is not only limited to the fund to the government and other institutions but also plays a role in generating financial flows from other resources.[23]

World Bank gets its money from donor countries contributions and its investment in financial markets. The greatest contributions come from the First World countries. The United States is the largest contributor, providing over $50 billion since 1944. Although its total share has decreased, the United States still provides more than 17% of the total funds.[24] Several bodies who govern the bank are dominated by the First World. Those are included a twenty-five-member executive directorate (with the five largest donors-the United States, Japan, Germany, France, and Great Britain holding permanent seats), and a President, who is by tradition an American.[25] The same thing also happens in the body of IMF. The decision makers of IMF come from the major donor countries.

With the domination of the developed countries in the bodies IMF, there is no wonder that the policies of that institution are in line with the First World countries political and economic Interests. Therefore the Letter of Intent and Washington Consensus are a must; those have to be implemented by recipient countries as the requirement to get aid. Their efforts to create open-market and minimize the intervention of government upon market are successful.

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[23] Ibid 122.

[24] Alexander DeFonde, Richard Dean Burns, and Fredrik Logevall Editors in Chief. Louis B. Katz, Executive Editor, *Encyclopedia of American Foreign Policy Second Edition Vol 2 E-N.* New

4. Knowledge Structure

If a production structure determines what is produced, by what means, by whose efforts and on what terms, so a knowledge structure determines what knowledge is discovered, how it is stored, and who communicates it by what means to whom and on what terms.[26]

Knowledge is a power. The First World countries have advanced knowledge and technology, while the Third World that most of their people are still living in poverty and they get many obstacles in increasing the quality of human resources. The poverty in the Third World has prevented to advance knowledge, communication and technology.

IMF is dominated by people who come from the First World. It is possible for both institutions to gain and develop knowledge and technology, or those may also prevent others countries in accessing knowledge. IMF is center of study and research. The professional of economists, engineers, and other professionals around the world work together to produce highly valued country studies, sectoral analyses and influential research publications on issues such as debt, capital flows and trade liberalization.[27] The IMF is also actively asked for planning and implementing projects, giving technical advice to governments, and engaging in policy dialogue

IMF has those 4 sources of Structural Power. Those have power to shape and determine the structure of political economic of one country. Those sources are totally required by developing countries to endorse their economic development. Those are essential ingredients to develop the economy of one country. Economic needs and expectations today are acute and widespread among more than 65 percents of the world's population. Economic development and industrialization are among the main objectives of public policy in all countries, but many nations cannot hope to achieve these goals without the assistance of those societies that can provide the development of capital and technological skill.[28] Capital and technological skill are totally owned by IMF which is supported by the First World countries. The recipients, including Indonesia, will receive money, loans, materials, and knowledge, from which they hope to fashion a modern economy, political stability or military security.[29]

One state or one institution which has structural power will easily drive political economy of other countries based on their obsession. IMF has the power to determine the economic future of recipient countries. There is no historical evidence to advice that donor countries assist others without expecting some benefits in return. The major motivations of foreign aid from donor countries are in political and economic sector. The United States has viewed foreign aid under Marshal Plan, which aimed at reconstructing the economic of Western Europe, as a means to prevent the international spread of communism. Foreign aid programs of the developed countries have had a strong economic rationale. This is especially true for Japan, which directs most of its aid to neighboring Asian countries where it has substantial private investments and expanding trade.[30] The reason why less-developed country recipients accept aid is clearly economic. The foreign aid is an important ingredient in the development process. It increases scarce domestic resources, it helps transform the economy structurally, and it contributes to the achievement of LDC takeoffs into self sustaining economic growth.[31] Then for this economic reason the less-developed countries require aid to promote their economic development.

Indonesia, one of Less-Developed Countries and Foreign loan-based country in development process, had to turn to the IMF for a $43 billion bailout package to rescue its slumping economy and its plunging Rupiah, when economic crisis hit in November 1997. IMF encouraged the Structural Adjustment Programs as the recipe to overcome the economic crisis. The vital areas of Indonesian economy were privatized, the government's fiscal burden was reduced, and state spending can then increase in education and health.

The more dependent of indonesian economic development toward foreign loan and the emerge of economic crisis 1997-1998 forced Indonesian Government to implement Structural Adjustment Programs of IMF. Structural Adjustment Programs (SAPs) is IMF's economic reform packages or conditionality to receive financial assistance. It is offered by them when their team and Indonesian government conducted the discussions to overcome the economic crisis. SAPs reflects that IMF has 4 sources of structural power. IMF has power to force Indonesia to do what they order. As the demand of the IMF, the Indonesian government must put the results of the discussion into the Letter of Intent (LoI) as the requirement to get financial aid. LoI contains intentions of the Indonesian government to implement the economic policies based on IMF's Structural Adjustment Programs. Those weaken the role of Indonesian government to manage its economy, because those imposes to privatize its state-enterprises, apply trade-liberalization, deregulation-where government should eliminate the regulation which prevents new international corporations to enter and restrict competition in Indonesia and increase number of Foreign Investment.

D. Hypothesis

IMF is able to influence Indonesian economic policies by using Structural Adjustment Programs (SAPs) as the requirement to receive financial assistance.

E. Purpose and Benefit of Research

1. To explain the way of IMF influence Indonesian economic policies from

2. To describe the process of Indonesian Economic crisis and the rise of IMF's role in handling the crisis.
3. To examine the economic policies of Indonesia which is influenced IMF and,
4. To forecast the future of Indonesian economic.

F. Research Method

This thesis is based on deductive logic. In the science, there are two important elements: logical integrity and empirical verification. In deductive logic, the theoretical expectations were born out by empirical reality.[32]

To explain the problems and verify the hypothesis based on empirical reality, the writer will use library research method. The writer will get the information from collected references in forms of books, encyclopedia, magazines, newspapers, and Journals. In addition, the write will also use various data from internet since some information and data dealing with the topic forwarded are only available through the internet. Then, the data collected will be analyzed by using some theories preferred.

G. Range of Research

The writer will limit the time in which the research held. In this thesis, the writer will focus on the beginning of implementation of SAPs, between economic crisis

[32] Earl R. Babbie, *The Practice of Social Research* (USA: Wadsworth Publishing Company Inc

1997 up to 2007, and the writer will research the economic policies also which have been released by Indonesian government.

H. System of Writing

Chapter I contends the Introduction of this thesis. It will explain about the Problem Background, Research Question, Theoretical Framework, Hypothesis, Purpose and Benefit of Research, Research Method, Range of Research and System of Writing.

Chapter II will explore more about the IMF. This will give profile of that international institution, the origins of the IMF, its organizational structure and political process, and also its function as the international economic institution.

Chapter III will examine the Indonesian economic history, from the old order and new order era. Then it studies the appearance of the economic crisis and the last it will explain the rise of IMF's role after the crisis came.

Chapter IV focuses on proofing the hypothesis, about the way of IMF to influence Indonesian economic crisis. How Structural Adjustment Programs is able to Influence the Indonesian Economic Policy. It also research IMF and World Bank Factor in the Indonesian Economic Policy-Making Process.

On the Chapter V, the writer will give the conclusion of this thesis. It is the