

# Agribusiness in Indonesia after the 1997 Financial Crisis

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## Abstract

The paper provides an overview of recent developments in Indonesian agribusiness in the aftermath of the East Asian economic crisis. A conceptual framework is developed that identifies areas of industry structure that are likely to change and the potential new roles for the Indonesian government in facilitating development in agribusiness. Particular emphasis is placed on the role of government in a facilitating role in conjunction with markets rather than, as it has in the past, as a market participant.

## Introduction

The purpose of this paper is to provide an overview of recent developments in agribusiness in Indonesia in the aftermath of the East Asian financial crisis and to make some forecasts for the medium-term future. In this respect, two inter-linked themes are important in consideration of the future and both will form the basis of this paper. First, at the heart of any business undertaking is the concept of comparative advantage. That is, trade, or exchange, reflects differences in endowments of resources between the people involved. For Indonesia, the future of agribusiness will be driven by its endowment of unskilled labour and by its endowment of raw materials. Second, all business occurs in the context of a policy framework provided by government. Governments provide the institutional framework for exchange and respond to developments in both domestic and global arenas. Such responses have profound effects on industry.

At the moment, there are two dominant developments: first, the aftermath of the East Asian financial crisis and, second, pressures for liberalisation of trade through Association of Southeast Asian Nations (ASEAN) and the Asian Free Trade Agreement (AFTA). It will be argued that how Indonesian agribusiness manages its comparative advantage in trade in a changing global environment and how its government responds to social, political and economic effects of the crisis are intimately linked.

Indonesia's economic development before the economic crisis was remarkably successful. Over the past three decades of development process (1966-96), real economic growth has averaged seven percent a year, comparable to other super-achievers of East

Asia. Indonesia's impressive economic growth is exemplified by the increase in per capita income, from less than US\$100 in 1966 to over US\$1,000 in 1996.

With Indonesia's strong economic growth driven by manufacturing and services and structural change in production, the position of agriculture in the economy has declined in relative terms. Despite the relative decline of agriculture as a share of total output, the contribution of agriculture in total output is still significant. In 1960 agriculture accounted for over 50 percent of GDP and by 1997 this sector's share has fallen to around 20 percent of GDP with agriculture-related manufacturing and services accounted for 63 percent of GDP (Pryor and Holt, 1998). The agriculture sector remains the largest sector in terms of employment (around 50 percent of the workforce in 1997). In addition, the agriculture sector plays a vital role in export earnings (around 12 percent of merchandise exports or about 30 percent of non-oil and non-gas merchandise exports). Also, many of Indonesia's main manufacturing industries are agriculture based.

Smallholders mainly located on Java dominate the structure of Indonesian agricultural production. Indonesian agriculture relies heavily on a large number of small farms most of which produce foodcrops. The average farm size is less than a hectare. Rice production tends to dominate all aspects of Indonesian agriculture, especially government support policies and smallholder production of rice is mainly for domestic consumption. While production of rice and other food crops are strongly influenced by policy, cash crops tend to be market driven reflecting Indonesia's comparative advantage in such production. Cash crops are predominantly established in the outer islands and are important commodities in Indonesian agriculture, providing foreign exchange, raw materials for the manufacturing sector and meeting domestic needs. Large estate production tends to be oriented almost completely to exports, while smallholder production is directed at both internal and external markets. However, there is technological divergence between smallholder and estate production. This is evidenced by the lack of technological progress in smallholder production, while estates have made significant advances in this arena.

In Section 2 the economic effects of the crisis are discussed; in Section 3, the policy framework; in Section 4, current trends in Indonesian agribusiness; in Section 5, challenges facing agribusiness as it adjusts to a new economic environment and, in Section 6, some conclusions are drawn.

### **Immediate Effects of the Crisis on Indonesian Agribusiness**

Since the latter half of 1997 Indonesia has experienced one of the twentieth century's worst economic collapses, surpassing in severity that experienced by developed countries during the Great Depression of the 1930s.

The World Bank (1998a) attributed the East Asian financial crisis, as it affected Indonesia, to:

- rapid build-up of short-term unhedged private external debt,
- weak banking system and financial sector,
- severe drought associated with the El Nino phenomenon,

- low international oil prices,
- collapses in regional demands for Indonesian exports, and
- corruption.

The crisis had a range of economic impacts on the Indonesian agribusiness sector. Most obvious of these has been the fall in the wages of labour in the unskilled and semi-skilled categories and increased unemployment. Indonesians faced falling incomes, increasing prices and rising unemployment. The World Bank (1998b) estimated that the number of people living in poverty increased from ten percent in mid-1997 to 14 percent by mid-1998.

Less obvious to ordinary citizens than wage reductions, but arguably of greater importance to the economy as a whole, has been the radical depreciation of the rupiah which devalued by more than 80 percent at the height of the crisis. The devalued rupiah has three important first-round effects that are likely to bring about dramatic restructuring in Indonesian agriculture.

First, returns to export activities, in domestic currency terms, have increased by a factor of two to three. This means that export markets that previously were either unviable (or only marginally viable) are now potentially very profitable for Indonesian exporters. In the same spirit, markets that were already viable before the crisis have become far more profitable than previously. A direct result of this has been expansion, despite the drought, in output of non-food crops such as rubber and forestry products and food products such as fish, coffee, tea and cocoa beans. In essence, this means that incomes of firms and individuals in the agricultural export sector have increased relative to those in the rest of the economy. It follows that this group is likely to be increasingly important as a source of investment capital in the future.

The second effect of the devaluation has been to boost returns in the import-competing sector. With competition from imported agricultural products now almost non-existent except for emergency imports of rice and a few luxury food categories, the import-competing sector is generating much higher profits than previously.

Finally, the devaluation means that competition by domestic consumers for exportable agribusiness products is now severely checked by high export prices and incentives for export diversion of stocks previously destined for domestic consumption. This has resulted in re-structuring of markets and, inevitably, hardship amongst domestic consumers. The Consumer Price Index (CPI) for food increased from 50 percent between June 1997 and March 1998 against a general CPI rise of 38 percent over the same period.

It seems likely that the shift in internal terms of trade facing the agricultural sector in Indonesia will be the most profound of all the outcomes of the East Asian financial crisis in the long term. It will result in expansion of agricultural output in some sub-sectors and contractions in others with, on balance, agricultural production increasing. This effect will be exacerbated when emergency imports of food, particularly rice, decline, and domestic consumers become more dependent on domestic food production and less on imports.

Some evidence for the relative advantages conferred on the agricultural sector by the crisis are apparent. In employment terms, the crisis has hit urban populations harder than the rural populations with around half of the crisis-induced unemployment coming from the heavily industrialised Jabotabek area (Jakarta and environs) and with lesser impacts in outer island provinces (Sumarto, Wetterberg and Pritchett, 1998).<sup>1</sup>

The following discussion is devoted to the roles that the Indonesian government and agribusiness sector will play in adjustment to the new terms of trade that have arisen since the crisis began. It is argued that the agribusiness sector that emerges in the next decade will be quite different from that which existed in the Soeharto era. The differences will lie not only in changes in food policy which have already started but also in the new culture that will emerge in Indonesian agribusiness.

### **Policy Background**

Governments should perform two vital tasks in the agribusiness sector. First, they should determine the rules about ownership and decide how these rules are to be enforced. Second, governments should contribute to the social and economic stability which is essential for market growth. It is useful to consider these roles of government in the context of the Indonesian agribusiness sector from both short-term and long-term perspectives.

In the short term, government has the potential to be a source of uncertainty. The political aftermath of the financial crisis has created a great deal of uncertainty for people at all levels in the agribusiness system. Investors need to know that the rules determining their rights in exchange processes will not change dramatically. If instability prevails, investment will be directed elsewhere, including overseas, and production, and, ultimately, consumption, disrupted. The economic chaos following immediately after the 1997 crisis seems to have given way to political uncertainties. At time of writing, important issues regarding the resolution of sovereignty issues in Timor and Aceh, the future role of the military and the appointment of President Wahid are attracting media attention. However, all the important economic indicators such as the exchange and inflation rates, unemployment and the like seem to have settled down and a 'business as usual', economic environment, albeit with the economy on very different settings to previously, seems to have emerged despite political uncertainties.

Going beyond the short-term to a longer-term perspective, government must provide the institutions necessary to ensure that trade liberalisation, both domestic and global, can occur in an orderly fashion. That is, the economy must provide price incentives so that firms are rewarded on the basis of the value of their production where value is determined by relative scarcity. One of the limitations of the cronyism associated with the Soeharto regime was that incentives were likely to be distorted by politically motivated transfers and side-payments resulting in mis-allocation of resources. This was particularly so in domestic food markets where prices were used to prop up various (usually urban) constituencies rather than to indicate scarcity and encourage adjustments in pro-

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<sup>1</sup> However, all poor people were hit hard with wages even in the outer island provinces down 40 percent from mid-1997 (Cameron, 1999) and domestic food shortages exacerbated by drought (van Diermen, 1998).

duction and consumption. The success of trade liberalisation hinges on resources being efficiently allocated to their most valued end-uses and only good government policy that supports a 'clean' price system can ensure this actually happens. This is particularly so with the change in the internal terms of trade that has occurred. The resultant expansion in trade is likely to continue for some years and appropriate policies will be needed if the gains from comparative advantage are to be fully realised.

The two government tasks of creating a stable investment environment and encouraging and supporting globalisation of the economy are intimately linked and highly interdependent. Stability is necessary if investment in sectors favoured by the change in terms of trade is to occur. However, stability itself is dependent on the nature and character of the globalisation process. On the one hand, with more than 60 percent of the population working on small holdings, large estates or in agribusiness, expansion of the agriculture sector will favour employment, and by implication, political and social stability. Alternatively, Indonesian food policy, as previously embodied in BULOG (and other arrangements) and currently in subsidised rice imports, can, if administered inappropriately, undermine expansion of the sector. In particular, the diversion of oil export wealth, transformed by the Indonesian government into rice, into domestic food markets will partially undermine expansion of markets in the domestic agribusiness sector. Hence, the Indonesian government must strike a balance between: (1) winding back food subsidies and hence allowing expansion of the agribusiness sector, and (2) avoiding instability resulting from hunger amongst the urban population. Part of the solution to this puzzle will lie in identifying the 'right' policy instruments. A better policy than directly subsidising and supplying food may be cash transfers to the poor as occurs in most developed countries. This has been implicit in recommendations from the World Bank (1998b) for a phasing out of rice subsidies once the agricultural sector has returned to normal production levels following the drought and other disruptions.

On 1 December 1998, presumably reflecting external pressures, a raft of reforms in food policy was announced. Rice could be privately imported, subsidised rice sales were to be restricted to those below the poverty line, rice production subsidies were to be reduced once agricultural production had reached previous levels, food subsidies for commodities other than rice were to be eliminated and fertiliser subsidies were to be removed. If all of these changes eventuate, they will represent a new balance between food policy and trade policy for the Indonesian economy.

### **Trends in Agribusiness**

What are the emerging trends in the Indonesian agribusiness sector that we see today? The most important trends are global in nature and concern decision makers in all major food producing countries, particularly in the developing world. The most prominent is the push for trade liberalisation. In Asia, this is embodied in arrangements such as AFTA. This agreement has parallels in other parts of the world; most conspicuously in Europe with the Economic Union but also in the Americas with the North American Free Trade Agreement (NAFTA) proposal.

AFTA has had an uncertain future since 1994 because some countries, such as Indonesia, are concerned about the effect of import competition on employment in key growth sectors and the potential for political instability if changes occur too rapidly. With the policy environment being more volatile than previously, it is not clear how

strong pressures for trade liberalisation will be in the immediate future. However, looking a few years ahead, it seems hard to believe that these pressures will disappear. Implementation of similar agreements in other parts of the world is likely to force Asia to respond in kind. Whether AFTA remains the vehicle for such policy or ASEAN develops a new proposal remains to be seen.

The second trend is towards greater regulation of international financial markets where volatility is now viewed by many as a global problem. In 1997 and 1998, a number of countries suffered speculative attacks that either successfully destabilised their financial systems or caused huge costs for central banks defending their currencies. In Australia, an attack over a two-week period in 1998 drove the Australian dollar from 63 cents (against the US dollar) to 54.5 cents. Fortunately, the Australian Reserve Bank was able to defend the dollar successfully, with help from the American Federal Reserve; however, the episode was disruptive. Similar problems arose with the Indonesian, Thai and Malaysian currencies in 1997 where problems were compounded by poor domestic regulation of banks. The rupiah devalued against the US dollar by a massive 80 percent at the height of the crisis. While some of this 'meltdown' was a legitimate adjustment to changing fundamentals in the wake of the crisis, the subsequent partial recovery of the rupiah indicates that a significant component was purely speculative.

The result of these financial crises has been far greater sympathy for the notion of regulation of international financial markets, pressure from IMF for stricter regulation of domestic banking systems and a general reassessment of the usefulness of speculators. It seems likely that new global financial regulations will be prominent over the next five years. Just how these new regulations affect trade in agricultural goods remains to be seen; however, a more stable trading environment should, other things being equal, favour further investment.

It is reasonable to ask whether greater financial regulation will work against or in favour of trade liberalisation policy initiatives such as AFTA. While regulation appears to be a negative for such policies, which are supposed to remove regulations, it may turn out that new, strong and effective financial controls actually work in favour of trade reform. Above all else, trading systems need stability and, hence, appropriate new regulations may well engender greater trust and predictability in the global economy, resulting in bolder consideration of removal of trade barriers.

### **The Challenges for Agribusiness**

The two pressures for change discussed so far, globalisation and terms of trade effects, are likely to cause changes in the structure of Indonesian agribusiness and the way that business is 'done'. In particular, there is likely to be a continuation of the trend towards large exporting corporations with strong international links, including foreign ownership, and well diversified trading bases. The traditional Indonesian exporting firms, emphasising family ownership, financial involvement with government and 'special relationships' with trading partners, is likely to change. There are a number of reasons for this. First, increasing acceptance of World Trade Organisation (WTO) principles and rules, second, a likely increase in power of the WTO after the 1999 WTO (previously GATT) round of negotiations (Howard, 1999) and, third, evidence from the crisis that 'tightly knit' trading groups may not have much flexibility when markets turn against them.

If the Indonesian agribusiness sector is to adjust, then it faces a number of challenges. The first of these has arguably already been undertaken. That is, recognition that the Indonesian comparative advantage lies in agricultural raw materials and unskilled labour and that agriculture will be a major factor in development in the foreseeable future. The love affair with secondary industrial development, embedded deeply in the economic psyche during the Soeharto regime, is likely to be dropped from political rhetoric and policies in this area are likely to be abandoned or at least watered down. This is not to say that secondary industry will not have any priority with government since, after all, such industry provides employment for a significant proportion of the urban population. However, pressures for microeconomic reform explicit in IMF demands (and implicit in joining a future version of AFTA) are likely to reduce the deliberate distortion of the economy through trade protection and food policy in favour of secondary development. One might speculate that policy to reduce these distortions and shift resource allocation towards a free-market equilibrium will be reflected in a new rhetoric which emphasises agribusiness.

In terms of facilitating expansion from within the agribusiness sector, there are practical challenges outlined below and discussed in Trewin (1999) and Trewin and Johnston (1999). Interestingly, while these are direct challenges for the private sector, most of them involve government in one form or another.

#### *Identification of Key Markets*

The role of government is likely to be central in the identification and penetration of new markets for Indonesian agribusiness. Government can sponsor business forums, facilitate discussion on trade and industry, remove unnecessarily restrictive regulations, use bilateral government arrangements where necessary in foreign markets and be a source of information on regulatory regimes of other countries.

#### *Positioning and Differentiating the Product*

To set up sustainable, long-term market structures, products have to be differentiated. This involves consideration and understanding of the following factors: product, quality, meeting market requirements, reliable supply, credit arrangements for specific trades, promotion, retail training and brand identification and product presentation.

#### *Reducing Costs*

A large part of competition in markets consists of vigilance in keeping costs as low as possible. This means that companies need clear goals and guidelines in the containment of costs. Areas that are particularly relevant in an era of trade liberalisation are streamlining border crossing costs, streamlining of domestic institutional arrangements and adoption of new cost-saving technologies.

#### *Joint Ventures and Investment*

Trade liberalisation means that Indonesian companies will be interacting with an even broader range of cultures than they do presently. Partners from customer or input-supplying countries not only facilitate communication across the 'culture gap' but also

allow complementarities. Comparative advantages in things like labour costs and technical knowledge can often be better exploited when firms from different countries cooperate. There is also scope for sharing of technologies and improved controls on quality, presentation and distribution.

### *Understanding the Market*

Market intelligence, market evaluation and identification of key players are central to planning in any commercial sector. Agribusiness systems can be extremely complicated, hence 'understanding the market' is a major challenge for successful ventures. This means that technical analysts with appropriate training and education must not only be available but must also be viewed as essential 'factors' for success. The roles of universities in providing such education and of government as a 'gatherer' of information are paramount in this.

### **Direction of Future Government Policy**

Throughout this paper it has been stressed that government is a key player in agribusiness and has special responsibilities and challenges. Paramount amongst these challenges are keeping markets open, containing costs of regulations, protecting human capital and developing a dynamic agricultural sector.

### *Keeping Markets 'Open'*

Markets need to be kept open so that the best, most cost-effective, firms can trade in them. Most developed countries have well developed competition policies and anti-trust legislation and it is important that these types of policies are implemented effectively in Indonesia. Without these policies, markets will always end up being monopolised by large inefficient firms. In this regard, anti-trust legislation in developed countries is usually directed at the private sector. However, its principles are also relevant to publicly owned corporations such as BULOG which, acting as monopolists, become inefficient in the absence of competition and managed to support political ends.

The IMF loan agreement in 1997 is important in the context of keeping markets open since it resulted in significant progress in removing government monopolies:

- BULOG's monopoly was limited to rice, and its sugar and wheat flour import and distribution powers were eliminated in February 1998,
- most other restrictive marketing arrangements were abolished in February 1998, leaving firms to decide what to produce and export,
- all formal and informal restrictions on investment in palm-oil plantations were removed in February 1998,
- bans on palm-oil product imports were removed in April 1998 and replaced with an export tax of 40 percent and
- elimination of the Indonesian Plywood Association and Clove Marketing Board which held monopolies over plywood and cloves from June 1998.

### *Containing Costs of Regulation*

Government also faces challenges to reduce the costs of regulation. Regulations are necessary for business to thrive. However, there are many ways to bring about policy ends and governments need to consider alternatives. Such consideration must be based on measurement of the burdens that the regulations create for firms, consumers and tax payers. In this context, governments should be able to express the cost of a policy as a percentage of its economic benefit. Clearly, a policy that scores in excess of 100 percent should not be adopted!

### *Protecting Human Capital*

There is a major challenge for government in protecting and nurturing human capital. The success of the Indonesian agribusiness sector in the future depends ultimately on having a group of people who have the special expertise to undertake trade. This group of people must be valued appropriately and their skills must be acknowledged regardless of ethnic or political differences. Educational and training programs are clearly central to success in facing this challenge.

Indonesia has a history of persecution of the Chinese ethnic minority and, under the Soeharto regime, policies to stem this were arguably successful. However, during late 1997 and 1998 such violence flared up again in a number of areas. Humanitarian considerations aside, this minority group provides much of the skill and ingenuity needed by the Indonesian economy to develop new markets and to expand old markets in line with future trade liberalisation. In an increasingly globalised economy, where flight of both skilled people and capital is becoming commonplace, policies to protect the Indonesian Chinese ethnic group are essential.

### *Developing a Dynamic Agricultural Sector*

Finally, the success of the Indonesian agribusiness sector depends on development of a dynamic agricultural sector. Under the open-market system agriculture can help substantially in expanding trade and boosting income and employment while reducing poverty and food insecurity. In response to market-driven opportunities a dynamic agriculture should be cast beyond important production objectives to include the broader range of agribusiness-related linkages dealing with information technology, high-quality input supply, post-harvest handling, agroprocessing and marketing systems, and related manufacturing and industrial uses of agricultural products (Bathrick, 1998). However, Bathrick (1998) notes that most developing-country farmers are ill prepared to respond adequately to the new challenges. With aggressive reforms, Indonesia could facilitate greater efficiency and private investment in agriculture and agribusiness sectors.

## **Conclusions**

In this paper, themes have been developed that are relevant to development in the agribusiness sector in Indonesia. These themes concern how markets work and how major groups in the sector, particularly firms and government, interact.

It has been stressed that the role of government is important because of what the future is likely to hold for all agricultural exporting countries. That is, trade liberalisation on a global basis and new regulations in the domestic and international finance sectors. For Indonesia, these developments will offer challenges and opportunities which can only be met with appropriate policies.

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