

**No. 37**

**Indonesia and The Washington Consensus**

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**Institute of Defence and Strategic Studies**

**Singapore**

**OCTOBER 2002**

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## ABSTRACT

This paper seeks to assess Indonesia's economic record before and after the 1997 East Asian financial crisis in light of the 'Washington Consensus' prescriptions. Before the crisis, Indonesia was held up as a 'poster boy' by international financial institutions. Yet, when the crisis struck, Indonesia was the worst affected in Asia despite its sound macroeconomic fundamentals. What happened? Our analysis will be confined to Indonesia's industrial policy and its experience with capital account liberalisation. We also review the IMF's programme for Indonesia, assess its management of the crisis and examine the implications and policy options for Indonesia in the post-1997 East Asian crisis.

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# INDONESIA AND THE WASHINGTON CONSENSUS

## Introduction

Labelled a "chronic drop out" in the 1960s, Indonesia was in 1967, when President Soeharto assumed power, among the world's poorest countries with per capita GDP of US\$70, half that of India and Bangladesh. By 1996, Indonesia's per capita GDP at US\$1100 was more than double that of India and triple that of Bangladesh. Before the East Asian crisis struck in 1997, Indonesia's economy had been growing at an average of 6.5% for 30 years (1966 to 1996), more than double the world's average of 3%. Accompanying growth over this period were relatively low inflation and dramatic improvements in social indicators: life expectancy rose from 41 years in 1965 to 63 in 1994 and poverty rates fell from 60% in 1970 to 12% in 1996, even as the population swelled from 117 to 200 million (Singh, 1998:4).

The speed and magnitude of the collapse of the Indonesian economy in the 1997 East Asian crisis was stunning. In a single year, its GDP contracted almost 14% and it was the worst-affected country in East Asia (Radelet, 1999). Its GDP per capita fell by one-seventh in 1998. Significantly, the crisis has also undermined Indonesia's long-run growth momentum. This paper seeks to assess the Indonesian experience in light of the 'Washington Consensus' prescriptions - before and after the crisis - and to draw policy lessons for Indonesia (and other developing countries). Equally imperative is to address the role of international financial institutions (IFIs) such as the IMF and World Bank in formulating policies for developing countries, particularly as the number of financial crises in the world has increased in frequency and severity.

The paper is organised as follows. Section I presents an overview of Indonesia's economic standing before and after the crisis. Section II looks at Indonesia's economic record in light of the 'Washington Consensus'. Due to space constraints, the analysis will be confined to Indonesia's industrial policy and its experience with capital account liberalisation. Section III reviews the IMF's programme in Indonesia and assesses its management of the crisis. Section IV examines the implications and policy options for

Indonesia.

### **Indonesia's Economic Standing Before and After Crisis**

Just before the crisis, it was widely assessed that Indonesia's fundamentals were sound. In 1994, when Indonesia's nominal GDP and per capita GDP reached US\$ 175.5 billion and US\$920 respectively, the World Bank elevated Indonesia's status from one of the world's poorest countries to that of a low middle-income country. In 1996, a year before the crisis, Indonesia grew at 7.8%, much higher than most developed and developing countries. Its inflation rate had been in single digits since 1983. Its domestic savings rate, at 27.3%, was also relatively high. Its current account deficit hovered at a safe level at 2.6% of GDP. Its public sector finances were in surplus. Indonesia's fundamentals were better than Malaysia, Thailand and Korea (IMF, 1999).

Despite being in better shape, Indonesia was the worst affected in the 1997 Asian crisis. Its stock market crashed by more than 80% and its exchange rate by almost 75%. (Singh, 1998:7) The crisis disrupted the long-term growth rate of Indonesia, which has the fourth largest population (211 million) in the world. Notably, after the crisis, the World Bank has relegated Indonesia's status from a low-middle income country to a poor country (World Bank, 2001).

### **Indonesia and The Washington Consensus**

It is important to examine why Indonesia's economy, once held up as a model for other developing countries by the US, IMF and World Bank, collapsed so suddenly and why it has not recovered since. To do that, we need to examine Indonesia's economic record in light of the Washington Consensus, particularly in the area of industrial policy and capital account liberalisation.

The 'Washington Consensus' advocates the use of a small set of instruments including macroeconomic stability, liberalisation of trade and capital markets and

privatisation to achieve a relatively narrow goal of (economic growth) (Stiglitz, 2001:46)<sup>1</sup>.

### *Indonesia's industrial policy*

First, Indonesia's industrial policy. The neo-liberals argue inconsistently that Indonesia owes its economic success largely to the policies of the Washington consensus but its economic failure in 1997 to the "crony capitalism" model of development. They also argue that Indonesia's industrial policy was incoherent, subject to rent-seeking and irrelevant to Indonesia (Rock, 1999, Hill, 1996).

UNIDO (2000) analyses Indonesia's industrial record (see Table 1) in three phases: (i) Stabilisation and Renewal phase (1965-1975) (ii) Oil-financed Industrialisation phase (1975-1981) and (iii) Export-led Industrialisation phase (1982 to 1997).

Industrialisation began in the second phase (1975-1981) and emphasised import substitution. Helped by high oil prices, the government was active in financing, protecting and subsidising domestic industries, particularly heavy industries and resource projects in steel, natural gas, oil refining and aluminium. Manufacturing growth averaged 8% a year over this period. When oil revenues collapsed, the state-led drive to industrialise slowed considerably. Industrialisation emphasis shifted to exports in the third phase (1982-1997), and share of manufactured exports rose dramatically to about 50% of GDP (UNIDO, 2000).

Despite the success of the export sector, the balance of trade in manufactures remained consistently negative right up to the 1997 crisis (See Table 1), implying that export revenues were insufficient to pay the import bill. Consequently, Indonesia ran increasingly large deficits in its current account, from US\$2 billion in 1985-86 to US\$8 billion in 1996-97<sup>2</sup>. The current account deficit was offset by large inflows of private capital and external public borrowing (UNIDO, 2000). Also, growth in manufacturing

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<sup>1</sup> For macroeconomic stability, the emphasis is on low inflation, low budget deficit and current account deficit.

<sup>2</sup> The balance of trade in manufactures was in surplus in 1998 and 1999, but this was due to a collapse of imports, primarily capital goods, reflecting the drastic slowdown in investment in 1998 and 1999. It is highly likely that, when the economy and investments recover, the trade deficit in manufactures will reappear (UNIDO, 2000)

exports had begun to slow in 1994, pointing to a slowdown in the sector before the crisis.

UNIDO (2000) argues that Indonesia's rapid industrialisation had led to a relatively shallow industrial structure. The manufacturing sector was highly import dependent, indicating weak backward linkages in the domestic sector. Import content amounted to 42% for garments, 61% for shoes, 86% for pharmaceuticals, 62% for drugs and medicines, and 83% for vehicle components. Virtually all capital goods were imported, amounting to US\$20 billion per year in the 1990s or over 40% of total imports. Indonesia's trade patterns, and the fact that its oil and gas sector generated only limited net revenues, meant that Indonesia would suffer persistent imbalances in its balance of payments.

UNIDO's statistics also revealed that FDI brought limited benefits to Indonesia. Despite producing a quarter of the output of medium and large manufacturing firms in the late 1990s, FDI contributed only 3%-6% to total capital formation and 20% to net manufactured export revenues. Manufacturing FDI employed less than 1% of the Indonesian workforce. Its large propensity to import production inputs meant that FDI not only did not support the development of supplier and support industries but in fact contributed to the persistent deficit in manufacturing goods.

Indonesia's lack of structural depth arises partly from following the Washington Consensus. Depressed oil prices in the mid-1980s persuaded Soeharto on the advice of the 'Berkeley mafia' (a group of Indonesian technocrats with close links to Bretton Wood institutions) to start a process of deregulation and investment openness (Root, 1996). These technocrats focused mainly on macroeconomic stability without developing an overall development strategy. The downturn also prompted the government to seek larger IBRD and IGGI loans, making it increasingly susceptible to pressures to facilitate the entry of foreign capital, adopt free-market policies, and restructure the economy in a less protectionist environment (Djiwandono, 2001).

The 1997 crisis not only exposed Indonesia's structural weaknesses but also greatly weakened its indebted domestic corporations. Inward FDI too virtually dried up. The IMF-led restructuring programme further weakened Indonesia's industrial base. During the crisis, the IMF exerted pressure on Indonesia to rapidly liberalise its domestic market

further, flooding the domestic market with imported goods. There are now signs of de-industrialisation in Indonesia. Table 1 shows manufacturing output (value-added) falling sharply from 20% to -7% in a span of ten years (1989 to 1999).

The key issue is whether “de-industrialisation is something normal or does it signify some long-term structural disequilibrium. Singh (1989:108) argues that "rapid industrialisation is a compelling social imperative for developing countries" if they are to provide for the minimum basic needs of their people for food, shelter, education, health and employment. To do that, Singh (1989) assessed (based on past empirical relations and the very low GDP per capita in developing countries) that manufacturing production in developing countries need to grow nearly 10% per annum. By Singh's criteria, Indonesia's performance today is way below par. Its manufacturing sector shrunk drastically from 12% (between 1994-97) to -7% (between 1998-99) (UNIDO, 2000).

#### *Indonesia's capital account liberalisation*

Indonesia adhered faithfully to the 'Washington Consensus' in liberalising its capital account *completely*. IFIs such as the WTO, IMF and World Bank and G7 finance ministers encouraged Indonesia and other East Asian countries to open up their capital accounts and financial sectors to reap the full benefits of global capital (Lee, 1998).

Unfortunately, it was Kindleberger's (1996) story of ‘mania, panics and crashes’ that was borne out in Indonesia. Indonesia’s financial sector was extensively deregulated in 1988. Restrictions on activities of financial institutions were eased, entry of new and foreign joint-venture banks were encouraged, and the issue of short-term debt and foreign-exchange dealing were made much easier. The stock market too was liberalised to encourage foreign investors. Significantly, the absolute limit on external borrowing and the need for Bank Indonesia approval for offshore lending was eliminated. In effect, banks could borrow offshore freely so long as they lent domestically in foreign exchange or otherwise covered their position (Djiwandono, 2001). In this climate, the number of banks more than doubled to well over 200 between 1988 and 1993 and capital inflows averaged 4% of GDP between 1990 and 1996 (Radelet, 1999).

Foreign creditors were keen to lend as they believed Indonesia’s rapid growth



would continue. Indonesian companies happily borrowed foreign funds as US interest rates were much lower than domestic interest rates. They did not factor foreign exchange risk into their borrowing because exchange rates had been relatively stable over a long period of time. The government in turn did not appreciate the risks of pegging its exchange rate in the absence of capital controls.

But Indonesia's vulnerability was the maturity structure rather than the magnitude of the foreign borrowing. By 1997, Indonesia had far more short-term external debt than they had foreign reserves (Radelet, 1999). Many Indonesian companies erred in borrowing short-term loans for long-term projects. But they could not have done so with such impunity if the capital account had not been so open. The Washington Consensus prescription of full capital account liberalisation without proper regulations were tantamount to removing all traffic lights. It was a matter of time before an accident happened.

### **The IMF's Programme in Indonesia**

The sudden devaluation of the Thai baht on 2 July 1997 set off a panic that saw currencies and asset prices collapse in East Asian economies. On 8 October 1997, Indonesia was forced to call in the IMF to help stabilise its currency (Roubini, 1999).

The IMF approved a US\$18 billion package for Indonesia, including financing from the World Bank and ADB. It also arranged a contingency second line of defence of US\$18 billion from bilateral sources (IMF, 1999). In return, Indonesia had to agree to (i) tighten monetary policy; (ii) balance the government budget; (iii) restructure the financial sector (including closing 16 non-viable banks); and (iv) carry out structural reforms to enhance efficiency and transparency in the corporate sector (US Embassy in Jakarta, 2001).

The IMF financial package failed however to stabilise the rupiah. So long as Indonesia maintained an open capital account and floating exchange rate, the rupiah continued to be battered by negative sentiment and financial crises elsewhere in Asia. In late 1997, a Morgan Stanley economist commented that although "at these levels nearly

every regional currency is undervalued”, the market could still force them lower in the future. The danger, he said, is that the downward momentum will build up and become self-reinforcing as more jump on the bandwagon (Roubini, 1999).

Worries began to set in that the financial panic, if not resolved quickly, would soon spread to the banking and corporate sector. The spectre of soaring corporate bankruptcies, unemployment and inflation in turn weighed down the rupiah.

In January 1998, fears over the government’s commitment to the IMF programme and political instability caused the rupiah to crash to an all-time low of Rp 17,000 to the dollar before intervention pulled it back to Rp 11,800. These fears were not baseless – escalating prices culminated in rioting and looting that rocked Jakarta in May 1998. Soeharto resigned soon after. Since then rupiah had languished at low levels of Rp 8,000 to Rp 12,000 to the US dollar (more than 70% below its pre-crisis level of Rp 2500).

The IMF’s culpability in this was evident when Camdessus, IMF Managing Director during the Asian crisis, told The New York Times (10 November 1999) that "we created the conditions that obliged President Soeharto to leave his job". He quickly added that that was not their intention, but that soon after Soeharto's resignation, he had warned then Russian President Boris Yeltsin that “the same forces could end his control of Russia unless he acted to contain them".

#### *Critique of IMF's management of the Indonesian crisis*

The IMF programme for Indonesia attracted much criticism. The debate centred not only on the ‘wrong prescription’ by the IMF but also the role and the mandate of the IMF.

First, the closure of 16 banks on IMF’s insistence led to a turning point in Indonesia’s financial deterioration in November 1997. The IMF presumed the closures would show that the government was coming to grips with the problem of weak banks (Boorman, 1999). But it later admitted that this brought Indonesia’s already fragile banking sector to the brink of collapse (New York Times, 18 January 1998). It seems the IMF had not been wiser after the 1995 Mexican crisis when an IMF order to close banks

also resulted in bank runs. It blamed the worsening crisis on the Indonesian government for failing to enact the reforms promised in its letter of intent.

Second, the IMF austerity measures of raising interest rates and slashing government spending not only was inappropriate for Indonesia (which in 1997 had a surplus government budget, a current account deficit below 4% of GDP, high savings and sound macroeconomic policies) but probably exacerbated the economic downturn. The fiscal austerity was supposed to restore confidence, but the initial fiscal tightening added to the economic contraction, further undermining investor confidence in the short-term economic outlook and adding to the capital flight. Furthermore, higher interest rates had little effect on the exchange rate as hoped, but weakened the financial condition of both corporations and banks (Radelet, 1999). The IMF was later forced to admit that the budget targets were “predicated on a view of macroeconomic prospects that turned out, in hindsight, to be mistaken and the easing of policy could have come more promptly as circumstances changed.” (Boorman, 1999).

Third, IMF's conditionality was criticised for being too ambitious and unnecessary. Indeed, the revised IMF-Indonesia Agreement on 10 April 1998 laid out 117 policy commitments. A senior IMF official (Ahmed, 2001) recently admitted during an IMF Economic Forum that some of the 117 structural actions such as environment policy "were not a traditional area of concern for the IMF" and that "it was impossible (for Indonesia) to fulfil the promises". He also conceded that "there was no point at which Indonesia could say, okay, if we do these things, then we will be assured of drawing the money three months from now, or whenever. So there was an ambiguity that had crept into the whole process over time... it was making IMF conditionality very difficult to apply".

The expansion of the IMF role into structural and institutional reforms set off a debate about the role and mandate of the IMF. Camdessus (1998) made it clear that the “centrepiece” of the IMF programmes in Indonesia, Thailand and Korea “is not a set of austerity measures to restore macroeconomic balance, but a set of forceful, far-reaching structural reforms to strengthen financial systems, increase transparency, open markets and, in so doing, restore market confidence.”

Developing countries being less developed will of course suffer from poor transparency and lax regulation. As the IMF has diagnosed these characteristics of underdevelopment as causes of financial crises, it feels it has the mandate to impose structural and institutional reforms on countries that seek its assistance. Implicit in this new broader IMF reform agenda is that to prevent future financial crises, *all developing countries* should have their economic and industrial policies subsumed under the IMF or have IMF-style policies until a first-world financial infrastructure is in place. It thus appears that the IMF seeks to mutate its role from that of lender of last resort in financial panics to that of a global economic policeman.

More significantly, the imposition of far-reaching structural reforms by IMF leaves developing countries under IMF supervision little room to design their own development models. A former IMF official, Levinson (2001) noted that, in the past, the IMF and World Bank would concentrate on macroeconomic conditions related to the balance of payments and left countries room for different roads to development. The case now seems to be “an almost mindless insistence upon privatisation under any and all circumstances, regardless of how it's carried out.” The IFIs’ view also ignores the different history of the countries, which would require different paths to development.

Fourth, under IMF’s supervision, bank restructuring took the form of the Indonesian government assuming the banks’ non-performing loans and recapitalising the banks with government bonds. Consequently, public debt ballooned from 23% of GDP in 1996 to 83% in 2000 and 109% in 2001. Furthermore, debt service ate up one third of government revenues in 2001 and is expected to rise to 44% in 2002 (Asiaweek, 7 July 2000 and IHT, 12 January 2002). A World Bank report (2001:18) warned that Indonesia's high indebtedness is now a potential source of economic instability as it constrains government spending on development and poverty reduction programmes. It could also make the economy highly vulnerable to shocks while limiting the government’s ability to respond. Increasingly sinking into a debt trap, Indonesia has less funds to improve social welfare, let alone formulate an industrial policy.

## **Policy Implications and Options**

### *'Close' versus 'strategic' integration*

The Indonesian crisis sharpened the long-standing key policy difference between the 'Washington Consensus' school and heterodox economists over how open a developing country should be. The Washington Consensus, the nucleus of the IFIs' policy prescriptions, insists that to restore economic growth, developing countries should open up and seek close integration with the world. This implicitly assumes away market imperfections, an assumption that does not square with reality. Still, it continues to advise governments to 'get prices right' through dismantling trade and capital flow restrictions and to limit their role to maintaining macroeconomic stability and providing public goods, leaving the pursuit of growth to the private sector (World Bank, 1991, 1993). Heterodox economists such as Singh (1994) however cautions developing countries to seek "strategic" rather than "close" integration with the world economy (also see Chang, 1994 and Rodrik, 2001). Implicit too in the Washington Consensus is the notion that industrial policy is irrelevant, that governments should adopt a laissez-faire approach to development. This view is being pushed through even though there is no clear consensus on the right path to development.

Bound by the IMF straitjacket, Indonesia has had little room and funds to construct its own development strategy. Moreover, it has been forced to "integrate" with the world economy, to further liberalise its trade and markets under IMF conditionality. Yet extensive import liberalisation and unfocused FDI (that uses high import content) would exacerbate Indonesia's balance of payment constraint. The IMF programme also appears to be designed more to repay Indonesia's creditors than to return Indonesia to the path of high-growth. To service its debt and balance its budget, the government is under heavy pressure to accelerate its privatisation programme and IBRA<sup>3</sup> asset sales and to cut development expenditures. The World Bank recognises that these policies come "at some cost: the central government's development budget, for example, remains at 3.1 % of GDP

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<sup>3</sup> Indonesian Bank Restructuring Agency (IBRA) was established to manage corporate debt restructuring and assets following the crisis.

despite having been cut three previous years in a row - the state of Indonesia's infrastructure and declining quality in social services bear testimony to this.” Nevertheless, the World Bank aligned itself with the IMF, cancelling the second tranche of its Social Safety Net Adjustment Loan until the government complies with these policies (World Bank, 2001:11).

Ironically, the US, the biggest contributor to the IMF and World Bank and thus wields considerable influence over them, has an active industrial policy. It intervenes in industries such as aerospace, power equipment and pharmaceuticals (Nolan, 2001). This prompted some economists to ask if the US and other industrialised countries are "kicking away the ladder" of developing countries in discouraging them from having interventionist industrial policies (Chang, 2002).

#### *Regulating the capital account*

The most important implication arising from the crisis is that it is unwise to liberalise the capital account without proper financial regulation in place. The countries most affected by the Asian crisis - Indonesia, Thailand and South Korea had all liberalised their capital markets before putting in place prudent financial regulations. As Lee (1998) pointed out, Indonesia, Thailand, and Korea had savings rates averaging more than 30% of GDP in the 1990s, much higher than the 18% in Latin America. These savings were high enough to finance much of their investment needs. All they needed was to supplement these savings with FDI, which could “bring technology, management expertise, and access to export markets”. He added that Singapore was able to limit the impact of the Asian crisis partly by having strong financial regulations and keeping close tabs on private sector loans.

It should be stated that no country, not even the most prudent and well-regulated, could withstand a currency depreciation of more than 70% as in Indonesia. Had the IMF disbursed its funds quickly in 1997 to stem Indonesia's liquidity crisis, instead of insisting on the austerity measures that led to price hikes and rioting, perhaps the vicious cycle of political and currency instability might not have set in. Radelet (1999) pointed out that the first tranche of IMF aid of \$3 billion - and nothing else for at least five months - was woefully inadequate to stem a financial panic. The IMF conditionality with its emphasis

on medium and long-term structural reforms too indicates that the focus was not on immediate fund disbursement.

The rising number of crises did not deter the IMF board from considering in 1998 (while the crisis was still being played out in Indonesia) to make capital account liberalisation or efforts towards liberalisation a condition for receiving IMF assistance (Wood, 1998). Summers from the US Treasury argued that "the right response to (the Asian crisis) is much less to slow the pace of capital account liberalisation than to accelerate the pace of creating an environment in which capital will flow to its highest return... But both fast is better than both slow." (Wood, 1998).

### *Prognosis*

Perhaps, with the benefit of hindsight, very early on in the crisis, Indonesia should have considered imposing capital controls to give itself breathing space to work out remedies to battle the crisis. Today, with the rupiah at more than 70% below its pre-crisis value, it is too late to shut the barn door - the horse has bolted. The IMF's approach too is to keep the financial sector open while restructuring and strengthening it. But as this strengthening process may take years if not decades, what recourse does Indonesia have in the interim to protect itself from speculative attacks? The country continues to bleed capital. The World Bank estimated that US\$9 billion flowed out of Indonesia in the year ended March 31, 2000 (FEER, 2001). Hence, there is a strong case to put in place measures to limit speculative attacks. This issue gains urgency in the aftermath of the recent Argentinean collapse as the spectre is being raised over Indonesia's vulnerability to another bout of financial crisis.

Restructuring a virtually bankrupt corporate sector is part of the work ahead. More than 75% of Indonesia's corporate assets are under IBRA, a government agency charged with corporate and debt restructuring. The indebted corporations (mostly conglomerates) collectively represent the 'golden goose' that produced Indonesia's prosperity in the period 1975-1996. The longer their assets remain under government supervision, the less productive these assets are going to be and the more difficult it would be for economic recovery to take root.

Continued political instability had made the tasks ahead much more intractable. Since Soeharto's fall in May 1998, Indonesia has seen three leadership changes. What Indonesia, under the relatively stable Megawati's Administration, urgently needs to do is to fashion a long-term development strategy. It has to shape an industrial policy that puts it back on a sustainable growth path. Otherwise, the de-industrialisation phenomenon might lead to "informalising" of the economy. However, the wrenching terms of IMF aid, its debt overhang and fiscal imbalance are combining to create a situation that could deteriorate further even as protracted restructuring continues. Indonesia faces difficult policy dilemmas.



Table 1: Manufacturing Sector Performance (non-oil and gas), 1975 – 1999

	75-81 <sup>1</sup>	82-84	85-88	89-93	94-97	98-99
Average annual growth rates						
Manufacturing value-added	8	5	13	20	12	-7 <sup>2</sup>
Manufactured exports (SIT categories 5-8)	34	29	27	27	8	2
Export of plywood, textiles, garments, footwear	94	64	32	28	2	-7
Structural change (end of period)						
% Manufacturing value-added in GDP <sup>3</sup>	8	11	14	19	23	23
% Manufactures in total exports	4	11	31	54	50	57
Balance in manufactured trade (US\$ billion) <sup>4</sup>						
Exports	0.8	1.8	3.9	13.4	24.4	27.2
Imports	<u>6.3</u>	<u>10.3</u>	<u>8.8</u>	<u>18.6</u>	<u>29.5</u>	<u>16.9</u>
Balance	-5.5	-8.5	-4.9	-5.1	-5.1	10.3

Source: UNIDO, 2000

1. Manufacturing value-added: Large & medium Industrial Statistics, annual publication, CBS (Back-cast series; nominal value-added deflated by 3-digit industry-specific wholesale price index).
2. Exports and imports: Foreign Trade Statistics (in US\$), Central Bureau of Statistics.
3. GDP: national accounts, Central Bureau of Statistics.

Note:

1. 1978-81 instead of 1975-81 for exports, imports and trade balance.
2. Growth rate for 1998 only.
3. Manufacturing value-added from national accounts (includes household and small industries).
4. Annual average.

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