Investment decisions and the puzzle of share price movements in capital markets: a case study

Ngurah Arya Putrasemadhi
University of Wollongong
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INVESTMENT DECISIONS AND THE PUZZLE OF SHARE PRICE MOVEMENTS IN CAPITAL MARKETS: A CASE STUDY

A thesis submitted in fulfilment of the requirements for the award of the degree Doctor of Philosophy from

UNIVERSITY OF WOLLONGONG

BY

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Drs (Gajah Mada, Indonesia) in Accy, MCom (Hons) in Accy (Wollongong, Australia)

The Department of Accounting and Finance
April 1997
Declaration

I hereby declare that this thesis has never previously been submitted for any degree and is the result of my own independent research.

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Ngurah Arya Putrasemadhi
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ACKNOWLEDGMENTS

While undertaking my first research concerning the corporate reporting practices in a case study of the capital markets in Indonesia, I wondered whether I could finish my research with merit. Although this research study has been analyzed and tested by using advanced statistical methods, I feel that there is something mistaken concerning the research approach I used. After being involved in the activities of capital markets for quite long periods, this feeling became real. In reality, investors did not use financial reports as a primary source for making their investment decisions in the capital market.

Considering this condition, and with regard to the previous accounting researchers' studies (especially by my supervisor, Prof MJR Gaffikin) that suggested the use of an alternative research approach for expanding our knowledge concerning the phenomena under study, a new model totally different from the first research study was developed. An interpretive approach is used to better understand the real situation of the behaviour of investors in the capital markets of Indonesia.

Also I acknowledge that this dissertation would not exist without the generous help of many people. Firstly, I would like to recognize and express my sincere gratitude to those within the Department of Accounting and Finance University of Wollongong, NSW, Australia. Special thanks go to its Head of Department and my supervisor, Prof MJR Gaffikin who has encouraged me for more than five years. Secondly, I would like to express my special thanks also to Mr Marzuki Usman MA, Prof Sukanto and Mr Bacelius Ruru, Chairman of BAPEPAM, for their support while I was carrying out my research study in the capital markets of Indonesia.
ABSTRACT

Information criteria is critical in the study of users' information needs. Most previous studies concerning the role of information examined the financial statement preparation process and measured the usefulness of information in terms of its adequacy and accuracy as disclosed in financial statements. In this study, the role of information is based on users' perceptions by analyzing public information along some sort of information criteria ie, political economic and socio-economic, and examining them with regard to users' attitudes in the capital market.

This study argues that in the area of a less mature capital market, most investors rely on political economy information for the reliability of information in making economic decisions in the capital market. This study also supports previous research concerning the role of information. These study show that information disclosed in financial statements prepared in developing countries is relatively less reliable than information contained in financial statements prepared in economically developed countries.
1.1. THE AREA OF INTEREST

In the past few decades there has been a tremendous increase in the extent of business activities. The formation and expansion of corporations into big or multinational corporations has influenced the development of accounting practices. The role of accounting as a service activity which is mainly concerned with a process of aggregating and communicating financial information, is regarded as being partly sufficient. The need for a broader understanding of accounting in its action, when the extent of business activities becomes complex, is considered to be more important by the users of accounting information.

From an accounting perspective, this need has generated a substantial body of research. A quiet revolution has taken place in the work of accounting researchers, academicians and practicing accountants during the past three decades. The revolution primarily concerns the notion of accounting i.e. the role of accounting information in the decision making process. Many researchers argue that the limitations of our understanding the role of accounting arise because accounting has been studied in isolation. They tend to study accounting in such a manner that it has been seen as an object which is separated from its subject. The subject has not been seen as an important part of the world of accounting so as to constitute the role of accounting in the real world.

The development of accounting seems not to have finished. From an accounting research perspective, the role of accounting can also be understood by developing a philosophical assumption underlying accounting theory. Accounting researchers, such as Wai
Fong Chua (1986), argued that mainstream accounting is grounded in a common set of philosophical assumptions about knowledge, the empirical world and the relationship between theory and practice. This particular world view, with its emphasis on hypothetico deductivism and technical control, according to Chua (1986) possesses a certain strength but has restricted the range of the problems studied and the use of research methods. By changing this set of assumptions, which is fundamentally different, potentially rich research insights are obtained. Accordingly, Chua (1986) argues that there are two other alternative world views underlying the assumptions, namely, the interpretive and the critical.

The attention of many researchers to the development of accounting thought has been supported by many previous research studies which range from the domain of the accounting and reporting environment, to the properties of reported accounting numbers, the behavioural research in accounting, the research on the use of information in capital markets and the research on socio political aspects of accounting. Most of those previous studies had been developed partly in the form of case by case research studies. Mostly, the same phenomena had been studied separately in a different construction of the studies. In some cases, this condition provided some limitations in our understanding of the world wide problems of accounting.

The need for the development of accounting, is also implied in the statement of The American Accounting Association's (1977), "Statement of Accounting Theory and Theory Acceptance". The American Accounting Association (AAA) concluded that there was no generally accepted theory of external reporting. Instead there was proliferation of the paradigm that offered only limited guidance to policy makers. Moreover in the Statement of Financial of Accounting Concept (SFAC) No.1, "The Objectives of Financial Reporting By Business Enterprises", the Financial Accounting Standard Board (1978, para.34) states that the principal objective of financial reporting is to "provide information that is useful to potential investors and creditors and other users in making rational investments, credit and similar decisions".
Further, The Financial Accounting Standard Board (FASB) Concept Statement No.2, "The Qualitative Characteristics of Accounting Information", presents a hierarchy of qualities that should be inherent in a useful financial information. Based on those statements it can be concluded that the FASB is also concerned with the development of accounting. The FASB is committed to a "better understanding" (emphasis added) of how financial information can be used by decision makers. It was logical because the development of accounting could not be separated from the development of economics. The more complex the development of economics the more complex the accounting would be. Accordingly, the need for the development of accounting will not end.

Whatever has been achieved in the last few years, the fact that there are many research studies still questioning the usefulness of financial information to investors and creditors and how they use that information for making economic decisions is still an issue with accounting researchers. More specifically, there is a need to study the phenomena related to the role of accounting, the role of investors and the role of the capital market, in order to develop or complement, and to extend the results of previous studies.

Some factors influencing investors in the decision-making process are the main basis of this study. Attention will be directed to the criteria of information and how investors perceive that information in the capital market of Indonesia. An interpretive approach in this study will be consistent with the alternative world view of accounting proposed by Chua (1986) and other researchers. However, the approach on this study is totally different from other previous studies. Those studies were mostly concerned with the role of information in the financial statement preparation process. They examined such a process and measured the usefulness of information in terms of the adequacy and accuracy of information disclosed in financial statements. In this study, the role of information is based on users' perceptions by analysing public information along some sort of information criteria, ie. economic, political and social, and these were compared with the users' attitude in the capital market.
1.2. THE PURPOSE OF THE STUDY

The central objective of this study is to come to a better understanding of the factors that influence investors in making their decisions. For this purpose it makes use of both existing propositions in the literature and the empirical evidence of the role of information in the actual investors' decision making process, whether in developed or in developing countries. As indicated in the previous section accounting researchers largely emphasise the role of accounting information in the financial statement process and examine those processes of the users of information in the capital market. The reporting system and disclosure practices and the usefulness of annual reports and accounting numbers are the main objects of the previous studies.

Due to the lack of the breadth of accounting research study in the past, the role of information is associated with the role of impersonal factors and the role of investors in the decision making process. This study attempts to find the implication of the role of investors in utilising information in making decisions in the capital market. Three distinct issues which are closely related to the study are:

1. What is the role of information in the capital market and to what extent does this role influence investors in the decision making process?

2. What is the role of investors and to what extent does this role influence the development of the capital market in Indonesia?

3. What is the role of the capital market and to what extent is this role influenced by the environmental conditions in Indonesia?

1.3. THE RELEVANCE OF THE RESEARCH

The research is based on a field investigation of a number of investors and others who are considered as representative respondents in this study. Due to the approach of this study as an interpretive one, the findings and conclusions may be pertinent not only to the problem
under study, but also to the problem of its research methods. In this approach, narrative records are one of the documents used as a point of reference in developing an argument. A development of the historical analysis and its logical association with the phenomena under study is a strategy in examining the data. To some extent this study is similar to those studies using the interpretive approach. The differences to other studies will be in how to see the object of study and what strategy and tactics will be used. In analysing the data, an interpretive approach to this study will provide a better understanding of the role of information, the role of the capital market and how investors utilise this information in the capital market.

In an accounting context, this study provides empirical evidence for many assumptions made in accounting and also in other disciplines related to the study. In some respects this study also contributes to organisation theory (eg. agency theory), financial management theory (eg. market efficiency theory) and other theories which are related to physiological and sociological studies in that it provides empirical evidence for some of their concepts.

1.4. THE LIMITATIONS OF THE STUDY

As will be seen, previous studies do not invalidate the need for the work undertaken in this study. They are presented to indicate some cautions which should be applied to the results and subsequent discussion. Considering the nature and the case of this study, a number of important limitations are apparent.

The limitations of this study are: 1. it concentrates on those factors (political economic and socio-economic factors such as the external factors of investors) that influence the investors' decision making process and the way in which this process will be measured. Some internal factors, such as the personality of investors and individual differences of investors, are not the main discussion of this study. 2. it concentrates on certain periods in the historical development of the capital market, that is from the time the capital market was reorganised by the New Order to the periods when the SEC(the BAEPAM) implemented the law enforcement programs and full disclosure concept in the beginning of 1990. Even though there are other
several historical developments before the New Order reorganised the market, these
development are purposed to complement the historical development of the capital market
under this study.

1.5. THE STRUCTURE OF THIS STUDY

This field research study is presented in five identifiable parts. The first part (Chapters
1 to 3), contains the background characteristics of the research in perspective. Chapter 1
provides a description of the area of interest, the purpose of the study, the relevance of the
research, and the limitations of the study. Chapter 2 provides a general overview of the issues.
In this chapter, the development of research themes is attempted. Chapter 3 contains the
general research methodology which covers the approach of the study, the samples, the
research procedures and the limitations of the study.

The second part (Chapters 4, 5 and 6) deals with some more specific characteristics of
the phenomena under study. Chapter 4 discusses the role of information in Indonesia as the
main variables related to the decision making process. Chapter 5 discusses the role of
investors who are active in organising and processing information so that it becomes useful for
investment decisions. However, as mentioned in previous sections, this study does not concern
itself with how investors utilise the information. The scope of the discussion in this chapter only
relates to some general characteristics of investors' decisions in the capital market. Chapter 6
discusses the role of the capital market and where investors and the information are placed in
trading activities.

The Third Part (Chapters 7 and 8) deals with symptoms as antecedent variables
which describe the situational condition of the phenomena under study. This part will discuss
the development of politics, and socio-economics in a country such as Indonesia. Chapter 7
discusses the nature of political economy development in Indonesia using an historical
approach and chapter 8 discusses the nature of its socio-economic development. The use of
the historical approach in this study provides the reader with a logical sequence and
consistency in analysing the data relating to the role of information and the role of the capital market in investment decisions.

The Fourth Part (Chapters 9, 10 and 11) provides additional data concerning the historical development of information and reporting practices in Indonesia. Chapter 9 deals with the historical development of the Indonesian capital market. Chapter 10 deals with the historical development of accounting information provided by the Accounting Association in Indonesia. Due to the role of mandatory regulations being considered important in this study, the discussion in this Part is completed by the description of the role of the Securities Exchange Commission or Badan Pengawas Pasar Modal (BAPEPAM) as indicated in Chapter 11.

The Fifth Part (Chapters 12 and 13) deals with analysing and summarising the data. Chapter 12 relates to analysing data which refers to the statement of problems and some findings of this study. Chapter 13 relates to the summary, the conclusion, the implication and some recommendations for the development of capital market in Indonesia and a suggestion for further research issues.
CHAPTER TWO

GENERAL OVERVIEW OF THE LITERATURE AND DEVELOPMENT OF RESEARCH THEMES

As already stated in the first chapter, the main area of investigation of this study is the impact of information generated from socio-economic and politico-economic factors on the investors' decision-making process in the capital market of Indonesia. This study also examines the importance of financial information provided by corporate reporting practices and the role of capital market agency i.e. the Securities Exchange Commission in regulating, motivating and maintaining sound practices in the capital market of Indonesia.

The aim of this chapter is to examine the state of issues and then to develop a research framework for this study. This research framework attempts to make clear the factors that influenced the investment decisions so that the subsequent parts of this chapter contain both theories and practices that relate to the phenomena under study. This chapter tries to lay a broad foundation for them, so that one can get a better understanding of what is to follow.

2.1. THE DEVELOPMENT OF THE RESEARCH THEME

As mentioned earlier, there is considerable discussion about the role of information and the investors' behaviour in making economic decisions in the capital market. The aim of this part of the study is to show the background of the theories that constitute the basis of this study. These theories are discussed in relation to some issues, for example, the development of general purpose financial reporting, the role of information, the role of investors and the role of capital market.

2.1.1. The Development of General Purpose Financial Reporting

Generally, the development of accounting and financial reporting is largely dictated by accounting professional bodies and their predecessors. In the case of the
capital market, the Securities Exchange Commission of the United States is one of the mandatory bodies that dictates the requirements of financial reporting practices in the capital market. The main requirements of these mandatory bodies relate to financial reporting practices. Disclosure of non financial information has become discretionary information by companies. This condition leads to a lack of uniformity of information disclosure in annual reports. Such a condition exists apparently because there is no consensus between providers and the mandatory bodies concerning the non financial information.

In the USA there were efforts to develop a consensus between external users of the financial reports for a long time before the Financial Accounting Standard Board (FASB) promulgated the Statement of Financial Accounting Concepts No.1: 'The Objective of Financial Reporting by Business Enterprises'. The American Institute of Certified Public Accountants (AICPA) approached the problem of objectives financial reports tangentially in Accounting Research Studies Nos.1 and No. 3. - "The Basic Postulates of Accounting and A Tentative Set of Board Accounting Principles for Business Enterprises", and more directly through the Report of the Study Group on Objectives of Financial Statements - the Trueblood Report. The Accounting Principles Board (APB) addressed the subject in Statement No.4 : "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", and the American Accounting Association (AAA) discussed broad objectives in "A Statement of Basic Accounting Theory". Thus the issuance of SFAC No.1 must be seen as the culmination of consensus among different parties in the realm of the accounting profession.

However, the development of consensus between the accounting profession and external users concerning information needs has not yet been resolved. For the last few years this problem has been studied by many researchers. Chandra (1974), for instance, studied the consensus on disclosure among public accountants and security analysts. He found that there was a lack of consensus between the two parties. Accountants generally do not value information for equity investment decisions in the
same way that securities analysts do. This condition causes the annual report to vary among companies and the optimal need for external users to obtain the information is still in question.

In the international accounting context, such consensus is more difficult to build. A harmonisation of interest in reporting practices seems varied among countries. On the other hand, the general purpose of financial reporting under the FASB has been established in the context of certain environmental conditions: conditions in developed countries which are more stable and well regulated. Governments and society act equally as agents of development and control each other through the democratic system in these countries. However, in developing countries, most regulation is dictated by the government. The power of the government dominates the process of regulation in such countries. Such power influences the entire area of activities and business depends on how far the government is involved. In the extreme case, most regulations of government are mandatory. The lack of discretionary regulation in some cases arise only if the government is facing a certain situation, for example, an unstable political condition in which it is not possible for the government to rely on discretionary regulation in the society.

Furthermore, the objectives of financial reporting specify that financial reporting should achieve three goals. Financial reporting should provide information that is useful to investors, creditors and other users for: (1) making rational investments, credit and similar decisions (para. 34); (2) assessing the amount, timing and uncertainty of prospective cash flows (para.37) and (3) evaluating the economic resources of enterprises, and the claims to those resources (para.40). This objective attempts to find the likely interest of all parties. This common interest is proudly assumed as general purpose financial reporting.

The overriding objective of financial reporting implied in the SFAC No.1 stated that financial reporting should provide information that is useful to present and potential
investors and creditors and other users in making rational investment, credit, and similar decisions (para.34); and in the SFAC No.2, the FASB stated that the characteristics of accounting information that make it useful to investors, creditors and other users. In the SFAC No.2. "Qualitative Characteristics of Accounting Information", the statement presents a hierarchy of qualities that should be inherent in useful financial information. Furthermore the statement claims that relevance and reliability are of the primary importance in that hierarchy. Those qualities are constrained, however, by two factors specific to individual users: cost and the benefit test. Financial information is also required by the Board to be understandable by those who have a reasonable understanding of business and economic activities and are willing to study information with reasonable diligence.

Fulfilling certain user needs is apparently viewed as the predominant reporting objective by those parties involved in business, finance and also in accounting. This sentiment is in close harmony with the SFAC No.1. Extensive due process procedures of the Board are likely to bring about general acceptance of such views. Continuous efforts by the Board to educate the public about its work should also achieve a certain consensus of opinion.

2.1.2 The Role of Information Issues

This part explores some issues concerning the use of financial information and the development of accounting and reporting standards from the perspective of research in accounting, psychology and other behavioural sciences. In the context of the behavioural sciences, a systematic review was conducted of the key findings on the behaviour of investors, managers and others, the findings of which are considered relevant to this study. On the other hand, in the context of accounting studies, these provide some evidence of the role of information in its association with usefulness of accounting information. In some of the research findings, accounting researchers also found that accounting information can be used as a predictive value of future events.
However, statistical properties of reported accounting numbers and ratios are criticised in this study.

The issue of the usefulness of accounting information can be associated with the statement of FASB (1978) that financial reporting is generally recognised as not being an end in itself, but rather as being intended to provide information that is useful in business and economic decisions. Using this point of view, many empirical studies have been conducted to investigate the usefulness of corporate financial reporting by shareholders' surveys or by investors' surveys and an efficiency market hypothesis test of annual report information. A review of this study indicates that there is inconsistency in the results of those researchers. The inconsistency of these studies has been discussed by Hines (1982) in her study of the anomaly between the efficient market hypothesis and shareholders' surveys. She found that annual reports are issued too late to be useful to shareholders.

On the order hand, Beaver (1968), for example, provides evidence that the information content of annual earnings announcements significantly affects stock exchange prices. However, some empirical studies on private shareholders by researchers such as Lee and Tweedie (1977), Wilton and Tab (1978) and Chenhall and Juchau (1977) provide evidence that private shareholders generally have a low level of interest in and understanding of, annual reports. Indeed stockbrokers, the financial press, tips and rumours were found to be a more dominant sources of private shareholders' information than annual reports.

In some developing countries, the studies by Abdelsalam and Satin (1988), Niarcos and Georgakopulos (1986) and Deakin et al. (1974) provide evidence that the earnings announcements do not significantly affect stock exchange prices. These studies contrast with Beaver's (1968) price reaction study.
In other studies, some researchers attempt to explore the association between annual reports (or interim reports) and price changes. Benston (1969) examined a regressive relationship between unexpected security returns and unexpected earnings and sales data. He found that the responsiveness of price changes to earnings change was small. However, despite the low response of security prices to accounting data, both earnings and sales variables were statistically significant as explanatory factors in the regression equation.

Ball and Brown (1968) examined unexpected security returns measured over 12 months before annual earnings announcements. Unexpected annual earnings were measured dichotomously as either good news (positive unexpected earnings) or bad news (negative unexpected earnings). Ball and Brown found that good news firms increased in price by roughly 7.3 percent in the 12 months before the earnings announcement, while the firm with bad news declined by 9.5 percent in the same 12 months. They also observed that prices anticipated the annual earnings announcement by many months. Ball and Brown (1968, p.175) state, "... of the value of information contained in reported income, no more than about 10 to 15 percent... has not been anticipated ...".

The Ball and Brown approach has been evaluated in numerous contexts with similar results. Alternative research designs were examined by Beaver, Lambert and Morse (1980), Gonedes (1974), Brown (1970), Deakin et al. (1974) and Firth (1976). Beaver, et. al. (1980) expanded the set of annual earnings variables to price earning ratio models and Gonedes (1974) expanded the set of accounting ratios to include variables other than earnings. On the other hand, Brown (1970) studied the Australian stock market, Deakin et al. (1974) examined the Tokyo exchange and Firth (1976) investigated firms in the United Kingdom.

In utilising the interim reports data, some researchers such as Brown and Kennelly (1972), Foster (1977) explored the association between price changes and
quarterly earnings changes. Brown and Kennelly (1972) demonstrated that monthly returns and unexpected quarterly earnings are correlated, even in the month that quarterly results are announced. Foster (1977) extends the analysis using daily unexpected return data and refined models of quarterly earnings expectations. Foster reports that firms with positive unexpected changes in quarterly earnings experienced positive abnormal returns, and vice versa.

Others researchers, such as Joy, Litzenberger and McNally (1977), Brown (1970), Watts (1975) have examined the association between stock prices and the announcement of quarterly earnings. They concluded that the adjustment of prices to quarterly information is somehow delayed, thereby raising the possibility of market inefficiency. Further, Watts (1975 p. 146) also argues that deficiencies in the capital asset pricing model cannot be accepted as an explanation of the observed abnormal returns. Foster and Olsen (1984) suggest that differential firm size and dividend yield may account for a good portion of the drift, thus implying that the previous research may have been deficient in its estimation of unexpected returns.

Other groups of researchers, in order to understand the role of information, utilise information content which is ascribed to accounting numbers. This idea is simpler than the correlation analysis described in the preceding paragraph. This simpler approach, which researchers call a nominal test, makes no distinction between the positive and negative implications of the impact of the announcement. The only issue to come from in this group of researchers is whether the securities market's response at the time of announcement is greater than the response of the market in a period during which no announcement is made. The inference is that the larger price responses observed are a result of the information conveyed in the announcement. Beaver (1968) provides the earliest application of this research procedure. According to him a residual return variation for the non calendar-year for NYSE firms was shown to be 67 percent greater in the week of the annual earnings announcement than the residual return variation in the other weeks. In other words, unexpected price changes
were noticeably larger when the market learned of reported annual earnings relative to other times of the year.

The Beaver study has been replicated many times by some researchers such as Foster (1977), Gonedes (1975 and 1978), and Griffin (1977). Griffin (1977) examined the earnings component information available to investors in association with forecasting. Griffin (1977) found that the security prices of NYSE firms with extensive segmental data were adjusted to the future earnings announcements of the firms.

Other researchers such as Foster (1977), Gonedes (1975), Eskew and Wright (1976) also examined the component of earnings but in association with stock prices. Foster (1977) showed that investors react in a way that recognises the components of the earnings of OTC-listed insurance companies. Gonedes (1975), however, found that investors did not make a significant distinction between operating and non-operating income in assessing security returns. Gonedes argues that differences between his 1975 and 1978 results were mainly in the definition of extraordinary items. Eskew and Wright (1976) examined interrelationships among unexpected security returns, unexpected operating earnings and the signs of extraordinary items. They found that the response of the market to extraordinary items was low relative to the response of the market to unexpected earnings. Investors, apparently, were not sensitive to the type of extraordinary item reported.

The role of information was also associated with other approaches of disclosure practices by companies. Some of the studies explored the association between disclosure practices and the characteristics of the companies. Singhvi and Desai (1971) found that the corporation which disclosed inadequate information was likely to be small in size, small in number of stockholders, free from listing requirements, audited by a small CPA firm, and provided a lesser rate of return and a less earnings margin. Also they found that there is a positive correlation between the
quality of information disclosed and the number of stockholders, the rate of return and
the earning margin.

Other studies, such as those by McNally (1982), Buzby (1974), also reported
that there is an association between characteristics of companies and the quality of
information disclosure. Even though the scope of these studies was slightly different,
the association between some characteristics of companies and the quality of
information disclosure is statistically significant. Other studies in developing countries,
such as those by Abdelsalam and Satin (1988), Niarcos and Georgakopulos (1986) and
Ngurah (1991) reported that the role of regulatory bodies has a significant impact on
the quality of information disclosure. They found that there is no significant association
between the characteristics of companies and the disclosure information. From those
studies it can be concluded that there are some inconsistencies among researchers in
both developed and developing countries, concerning the association between those
characteristics with respect to disclosure practices.

2.1.3. The Role of Investors’ Issues

Several authors and researchers have commented on the study of corporate
reporting by exploring the role of investors in the capital market. A brief review of their
reports provides some insight into their roles and contexts. Foster (1986, p. 300) states
that the focus of an investor’s role is on selecting a portfolio of equity securities, bonds
and other investments for an individual, firm or institution. Based on this description,
this study discusses issues which are related to the selection of portfolio securities
such as abnormal profit and risk aversion.

As a rational human being an investor always attempts to get an abnormal
return from selecting portfolio securities in the capital market. However, investors
cannot easily hope for this by using information provided by the companies issuing
shares in the market. Accordingly, investors may utilise other information from different
resources. Chang, Most and Brain (1983) study the perceived usefulness of information sources. They found that corporate annual reports are considered very important by investors and financial analysts in the USA. Other information sources, such as newspapers and magazines, advisory services, stockbrokers' advice, proxy statements and much other information are considered less important in this study. Even though the perceived importance of information between individual investors, institutional investors and financial analysts in the UK and NZ are significantly different, in fact they all use information in making their rational decisions to get abnormal returns.

Other studies of corporate reporting imply that investors look for specific information in order to get an abnormal return. These studies discuss how investors are involved in inside information in order to get a non-zero abnormal return in the capital market. Even though there is agreement among researchers that a prohibition on insider trading is needed to develop markets into efficiency markets, research by Hogan (1989) and Kripke (1980) provides evidence that insider trading does not affect the return on investment. Foster (1986, p. 303) argues that, in the case where there is insider trading, the less informed outside parties set up a mechanism to protect themselves when trading with the insider.

These studies also imply that investors are risk-averse. In investment decisions, rational investors prefer higher expected returns to lower expected returns for a given level portfolio variation and prefer lower variation to higher variation of portfolio returns for a given level of expected returns. In order to achieve this objective, some strategies used in investment decisions by investors are diversification of portfolio and risk control strategy. In diversification strategy, rational investors will diversify their portfolio rather than hold a single asset with the highest expected return. The aim of this strategy is to reduce the risk on the realised return. Foster (1986, p. 311) argues that one relatively cheap way of attaining a diversified equity investment portfolio is by investing in index funds. These funds attempt to match the return on a chosen index, for example, Standard & Poor's 500 index.
However, studies of individual investors show rather limited diversification. Blume and Friend (1978), for instance, note that the median number of stocks held by a stock-owning family, exclusive of mutual funds and personal trusts, was less than four. Seventy-seven percent of families held nine stocks or fewer. Similar results are presented in the report of the Advisory Committee on Corporate Disclosure (1977). Fifty-one percent of individual investor respondents held 10 stocks or fewer. Sixty-seven percent did not hold a mutual fund stock. Lease, Lewellen, and Schalarbaum (1974) however, report that about 10-15 stocks are the average holding in their individual investor sample, and mutual fund stocks were held by a majority of the subjects in that study.

Another strategy used by investors in investment decisions is risk control strategy. In this case, investors consider that the market will not provide expected returns similar to what investors expected. Accordingly, it would take additional activities to control the risk. In the short selling strategy, for example, investors construct a less than fully diversified portfolio with a risk higher than that of the market and then sell the securities immediately when they perceive that the portfolio provide a return.

The role of investors can also be understood by studying some accounting research in behavioural sciences. Dermer Jerry D. (1973) argues that most researchers are interested in a relationship between cognitive factors and information usage. Little empirical study (emphasis added) has been made of the role that cognitive factors may play in accounting. It is possible that the characteristics of an information user may affect his perception of what information is important and, hence, may affect how information influences his ultimate behaviour. This model was supported in the psychological literature on human information processing.

Schroder et al. (1969), on human information processing, argue that members of the team differ in their levels of conceptual abstractness. The relationship between
abstractness of conceptual functioning and group performance was also studied by Driver (1975) in a complex decision making environment. He argued that the source of information used related to the conceptual structures of the team member. He found that the cognitive simpler subjects relied more heavily on information handed down by an external authority.

Those research, in human information processing, is done in the laboratory research, but in the domain of accounting research, such as in Dermer's study, these phenomena were studied in field research. He also argues that information usage is a subjectively determined process. The relationship between individual cognitive style and the amount and type of information usage he perceives to be relevant.

2.1.4. The Role of Capital Market Issues

A market is a place where individuals can exchange economic goods and services. The motive for the exchange is the belief that both participating persons will be better off than they were before the exchange took place. If this condition were not met by both parties, then there would be no inducement for them to participate in the exchange. How will these parties be better off than before? It depends on the market conditions. People have to understand the market condition or situation in which they will be involved.

From an accounting perspective, capital market research studies originally arose in response to allegations from the professional investment community and critics of financial accounting. These studies have theorised the market into some capital market conditions, that is efficient and inefficient capital market. Causally, a securities market is efficient with respect to an information system only if security prices act as if everyone knows that system. If this condition is met, prices are said to fully reflect the information system. Fama (1970, p. 383) stated that a securities market is efficient if security prices fully reflect the available information.
The development of this conceptual model apparently is not simply recognised. There are some studies related to these models either in the form of theory construction or in the form of evidence which describes the condition of this market. A considerable awareness of the testing of the descriptive validity of the efficiency markets model is very difficult in order to examine the theoretical construction of this model. Foster (1986, p. 315) argues that a major reason for this difficulty is that our existing analytical models of efficient markets do not map well into the institutional domain in which actual capital markets operate. These actual markets are characterised by the non-instantaneous availability of information, non-zero information costs and non-homogenous expectation. However, Beaver (1981) argues that the problem in capital market efficiency hypotheses is not simply that the concepts are difficult to test empirically, a pervasive phenomenon not unique to the efficient market literature, rather, the problem is that, at a conceptual level, prior to empirical testing, it is unclear what is meant by the term 'market efficiency'.

There are some studies which relate to the problem of theoretical construction of this model, such as those of Hines (1982), Williams, Chapman, and Findlay (1974) and Foster (1986). Hines (1982) studies the usefulness of annual reports and market efficiency anomalies. She concludes that investors' surveys indicate that shareholders perform a fundamental analysis of annual reports. The Efficient Market Hypotheses (EMH) implies, however, that annual reports are issued too late to be of use to shareholders, and the lack of short-term market reaction to their release has been interpreted as indicative of annual reports possessing no informational value. Williams, Chapman and Findly (1974, p. 371) also argue that by the time one reads new information, it is too late to profit from it. Accordingly, the investor will consider other information which is relevant to his decisions. An extensive testing of the efficiency markets hypothesis by Foster (1986) in recent years has produced results which are generally consistent with those studies. He argues that efficient market models based on a more realistic set of assumptions could well explain those empirical results. The
implication of this evidence is that annual reports cannot be used by shareholders to make abnormal profits in the case of an inefficient market. Adoption of active investment management styles is the only one way in which investment decisions can be used.

Several factors have been cited as important in describing the role of capital markets. One is adequate disclosure of information provided in financial reporting. Singhvi and Desai (1971, p.136) stated that adequate disclosure of information minimises ignorance in the market and causes the market price to reflect the true value of the security. Dawson (1984, p.153) noted that a common explanation for the less frequent findings of market efficiency (in the less developed exchanges) included less stringent information disclosure requirements, less information released by companies and less rigorous accounting regulations. On the other hand Jaggi (1975, p. 84), in his study of the impact of cultural environment on financial disclosure, found that as a result of managerial value orientations, the reliability of financial statements in developing countries is likely be low. This study also indicates that cultural differences within the economically developed countries will dictate differences in the development of accounting principles in those countries.

A second issue cited as an important influence on the degree of information efficiency is the legal prohibition against insider trading. There are some arguments that inside information will be more rapidly incorporated into the price if legal prohibitions are lifted. Kripe (1980, p. 20) for example, argues that if market participants are legally restricted from using inside information, market prices can not impound it. Furthermore, in the absence of differences in information conveyed to different investors, there will be no arbitrary opportunities, and securities markets will necessarily be thin. Thus inhibitions on the use of inside information impair both the speed and accuracy of the market. However, Foster (1986, p.303) argues that one factor which is not considered by those arguments is the incentive of the less informed outside parties to set up a mechanism to protect themselves when trading with an
2.2. THE RESEARCH FRAMEWORK

So far there are three main areas of interest which have been identified: (1) the role of information in the capital market, (2) the role of the investor in selecting, selling and keeping shares in the capital market; and (3) the role of the capital market itself as a place for trading the securities of listed companies. These are the three areas of inquiry already mentioned on which the study is brought to bear. The aim of this section is to provide an outline of the research framework to locate the areas of inquiry within this framework.

In the domain of the investors' decision making process, where knowledge of investor behaviour in utilising information is very limited, the main thrust of this kind of research has been protocol or verbal research. Under this research method, the aim of this study is to observe, describe and measure how investors utilise information in the capital market and to investigate some factors that influence investors in making economic decisions. It will then consider the applicability of existing conceptual and empirical propositions to that reality. This approach will provide some new insights into the roles of information, the capital market and investors' information processing in the capital market. The development of such research studies in the capital markets of Indonesia will also provide a better understanding of the role of the capital market and of how government is involved in the process of developing capital markets and also how societies (especially investors) use the information provided to the public for making economic decisions.

An examination of such research framework reveals a planned approach to the acquisition of knowledge concerning the role of investors in the capital market. It embodies three related research areas which encompass the most important variables, and carries the study of investment decisions and the factors that influence investors, from its origin to its final effect on investors' behaviour in the decision making process. It may be interesting to note, however, that the research which is conducted on a model of inquiry is qualitative and descriptive in nature. This kind of research is the domain under of interpretive studies.
2.2.1. The Development of a Model in The Study

As mentioned above the development of a research framework under this kind of interpretive study is one of suitable methodology inquiry. Lacker and Lessig (1983, p. 74) indicate that "if the research goal is understanding a subject's cognitive process, a process tracing procedure seems to be required". Chua (1986, p. 615) argues that the aim of the interpretive scientist is to enrich people's understanding of the meaning of their actions; thus increasing the possibility of mutual communication and influence. By showing what people are doing it makes it possible for us to comprehend a new language and form of life. Therefore the roles of information, of investors and of the capital market in the situational context of developing countries are examined. For further discussion see Appendix No.1: The Use of Case Study Research in Studying Investment Decisions and the Puzzle of Share Price Movements.

It was thought necessary to identify some factors that influence investors in the decision making process by using a model. The model is illustrated as follows:

\[ Do = f (Se, Pe) \]

where

\[ Do \quad \text{Decision output} \]
\[ f \quad \text{a function, a symbolic interaction model} \]
\[ Se \quad \text{Socio-economic factors} \]
\[ Pe \quad \text{Political-economic factors} \]

This model is developed on the basis that these factors are not mutually exclusive. Socio-economic factors are those in the social welfare system that are much influenced by economic conditions in a country. Such factors are education, population, labor forces, employment, income distribution and poverty, but exclude the cultural domain. Political-economic factors on the other hand are those related to state of the art ideology, and which are implemented in the form of policies and social order.
Investment Decisions and the Puzzle of Share Price Movements

These include investment policies, monetary policies, fiscal policies and some other governmental policies.

This model, which is mainly concerned with the impersonal factors that influence the decision making process, is considered in this study to be quite representative for understanding the total factors that influence investors in making economic decisions in the capital market. Most previous studies on human information processing discussed the role of personal factors, namely, individual differences and other cognitive styles, in making economic decisions. The role of others factors, which related to impersonal factors did not attract much attention by the researchers. These factors, such as the problem of contingency factors in management accounting theory, have been discussed in isolation.

2.2.2. Structure of The Research Framework

The emphasis of the research on subjective perceptions of information based on an interpretive study, means that it is only feasible to take a small number of potential investors and some others as representative of this study. Due to the approach of this study being interpretive, an examination of the historical development of information for quite long periods is needed. An archaeology of the sources of information during a certain period of capital market development will provide a better understanding of the problem of information used by investors.

Five sources of information that constituted the perceived importance of information were classified into two. The first classification will relate to the information provided by government. In this classification, this study attempts to describe government policies, especially those related to political-economic policies which are supported by all government departments such as the Board of Coordinating Investment (Badan Koordinasi Penanaman Modal), the Central National Bank (Bank Indonesia), the Ministry of Finance (Menteri Keuangan) and the Tax Regulating
Department-Directorate of Taxes (Dirjen. Pajak). In the realm of social-economic policies, those departments will be the Department of Education, the Department of Labor Force, the Department of Health, etc. The second classification will relate to the information provided by society. This information comes from politicians, economists, anthropologists, academics and others.

Referring to such classifications, information can be divided into two. Firstly, information coming from government institutions is classified into publicly formal information. This information usually follows rumours. Accordingly, from the viewpoint of investors, this information before it becomes public is mostly insider information. Secondly, there is information provided by society, which is classified into public formal information and public informal information. Analysis of this information depends on the value-orientation of investors. This information society is presumed to be public information when it was published in the news and other public releases. Such public information to be formal if the information provided by the legal organisation society and vice versa.

An analysis of this information from the news, day by day, for about five years into a classification of economic, political and social culture, by using a tabular methods, provides some insight into the association between public information and share price movements in the capital market. Structure of this study is designed in Figure 2.2.2.1. This figure provides a description of the association between political economic policies and socio-economic factors relating to investment decisions. In this study, it can be argued that initially, in a situation context, the government provides the political economic policies in which such policies will influence the political economic factors and the socio-economic nature in this country.

In some cases, these policies were absorbed by the public domain and simultaneously created public opinion under the realm of information provided by the government and the society. This public opinion is implemented in the form
Investment Decisions and the Puzzle of Share Price Movements

of formal public information. For further discussion see Appendix No.2: The Development of Economic Policies in Indonesia and its Impact on the Development of the Capital Market.

Figure 2.1 The impact of political economic policies on political and socio-economic factors.

In addition, Figure 2.2 provides an illustration of how information is considered important by investors. This figure shows that information provided by government and society in the public domain was censored and created in the public domain vis-à-vis information criteria needed by investors. Further discussion concerning the information criteria and how investors perceived this information was illustrated in the following sections.
2.2.3. Information Criteria as Dependent Variables

Information criteria are critical in the study of users' information needs. Most previous studies concerning the role of information examine the financial statement preparation process and measure the usefulness of information in terms of adequacy and accuracy of the information disclosed in financial statements. Information is considered useful if the users rely on it in making their decisions. To be reliable, information must include relevant and important dimensions of events which are essentials in making these events understandable to the users of the information.

From the viewpoint of the users, information can be divided into two criteria. Firstly, the information is provided in and for the public domain via public news or mass media information and secondly, the information is provided for certain people or certain users of information. This information is considered as "un-public information".
As the type of information is pervasive, in a certain period of time, the “un-public” information, at last, becomes public information. However, this information is considered less useful after it becomes available in the public. On the other hand, information can be divided into economic, political and socio-economic information, or a combination of these. Due to difficulties in identifying this information, this study divides this information into basic political economic and social economic information.

In the domain of the economy theory, such information can be divided into macro and micro economic spheres. Macro economic information mostly relates to information concerning gross domestic product (GDP), income per capita, money supply, inflation rates etc. and micro economic information relates to information concerning dividend yields, earnings per share, share price movements of company etc. On the other hand, information can also be associated with information concerning the political climate and social welfare issues, such as population, employment and poverty. The information also becomes the main variable of socio-economic indicators in this study.

2.2.4. Value Orientation of Investors as an Intervening Variable

Research findings in social sciences have demonstrated that the modal value orientation of individuals is, to a great extent, the product of cultural environment of a given society. The term “value orientation” according to Clyde Kluckhonhn (1951, p. 86) is used in the sense of “a selective orientation toward experience, implying deep commitment or repudiation which influences the order of choices between possible alternatives in action”. The differences in value orientation of individuals have been examined by Parsons and Shils (1950). One of the basic tenets postulated by these authors in their general theory of action relates to universalism versus particularism. The particular value is of specific relevance to this study. In broad terms, Zurcher et.al. (1965, p. 539-48) stated that universalism has been explained as a value orientation.
Investment Decisions and the Puzzle of Share Price Movements

toward institutionalised obligations of society and in particular is a value orientation toward institutionalised obligations of friendship.

In this study, as indicated in Figure 2.2.4, the value orientation of information is to perceive the importance of information in the decision-making process by the users. The value orientation of individuals and the value orientation of information are considered closely related in this study. Most value orientation of information is derived from the value orientation of individuals. The value of information is the product of the value of the individual in the context of social culture.

Jaggi (1975) stated that the universal value orientation will be predominant in societies which exhibit complex technology, emphasise individual independence and mobility, and value competition and achieved status. Furthermore, he stated that in these societies, friendship is valued mainly in terms of material or status gain. Individuals are expected to be impersonal in their relations with other individuals, and they are supposed to be loyal to the firm and honour their obligations to society.

Societies which have less individual independence and mobility and which are have less complex technology and are not as fair are considered to be predominantly particularistic. The main cultural characteristics of those societies are exhibited in the expanded family system, and the lack of responsibility of societal obligations. The societies of developing countries such as Indonesia are considered to exemplify this kind of particularistics. From this point of view, the value orientation of information is subjective in nature. People tend not to use this information in the decision making process. Accordingly this study argues that the only information used by the investors in the capital market is public formal information, such as political-economic information issued by the government.

Moreover, it is generally recognised that information disclosed in financial statements prepared in developing countries is relatively less reliable than information
Investment Decisions and the Puzzle of Share Price Movements

contained in financial statements prepared in economically developed countries. This lack of reliability has been explained by some researchers such as Mahon (1965), Wilkinson (1969), Jaggi (1975) and Scott (1970). In the absence of well developed capital markets, the need for reliable information does not become critical. As the market becomes developed a crucial need emerges and this leads to the production of reliable information.

In developing countries, such as Indonesia, observations show that the above argument does not fully explain the existing lack of reliable information. Although the capital markets and financial institutions are steadily developing, reliability of information provided in the capital market through audits or annual reports is not showing much progress. This condition indicates that there are other forces which play an important role in the generation of reliable information.

An empirical study conducted in Indonesia concluded that the reliability of information measured by users' perceptions is dependent on the factors that constitute the value orientation of the users. Financial information is considered not reliable for making economic decisions in the capital market. This conclusion implies that the investors rely more on non-financial information. A study dealing with non-financial information in developing countries like Indonesia indicates that there are also differences concerning the value orientation of investors on the non-financial information. The differences exist due to the differences in situations that investors face in the capital market. These situations then create some strategies used in the market.

In human information strategy - the strategy is used in handling the shares - investors will consider certain external factors such as market trends, political factors. In the short selling strategy, for instance, because investors consider that the public information is too late for making economic decisions and less reliable, the investors will use "un-public" information in investment decisions. Investors will be influenced by the market sentiment, that is, the information provided by the market. In portfolio
strategy, however, consideration is given to the public information which is related to the political economic information in the country. The relationship between those variables is described in figure 2.2.4.

**Relationship Between Information Criteria, Value Orientation of Information and Decision Output**

<table>
<thead>
<tr>
<th>Information Criteria (IC)</th>
<th>Value Orientation of Information (VOI)</th>
<th>Human Information Processing (HIP)</th>
<th>Decision Output (DO)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Source of Information</strong></td>
<td><strong>Perceived Importance</strong></td>
<td><strong>Strategy</strong></td>
<td><strong>Products</strong></td>
</tr>
<tr>
<td>Govern. Inst</td>
<td>Reliable Info.</td>
<td>Short Selling</td>
<td>Share Price</td>
</tr>
<tr>
<td>The Associations</td>
<td>and valid Info.</td>
<td>Holding</td>
<td>Capitalisation</td>
</tr>
<tr>
<td>The Public</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Type of Info.</strong></td>
<td><strong>Personality</strong></td>
<td><strong>Portfolio Strategy</strong></td>
<td><strong>Trend</strong></td>
</tr>
<tr>
<td>Publicly informal info.</td>
<td>Individual differences</td>
<td>Diversities in shares</td>
<td>Increase/Decrease</td>
</tr>
<tr>
<td>Publicly Formal Info.</td>
<td>Cognitive Style</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unpublicly Info.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inside Info</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Classification</strong></td>
<td><strong>Classification</strong></td>
<td><strong>Classification</strong></td>
<td></td>
</tr>
<tr>
<td>Economic info.</td>
<td>Rational/irrational opportunities</td>
<td>short-term invest.</td>
<td>Selling</td>
</tr>
<tr>
<td>Political info.</td>
<td></td>
<td>longterm invest.</td>
<td>Buying</td>
</tr>
<tr>
<td>Socio-info</td>
<td></td>
<td></td>
<td>holding</td>
</tr>
<tr>
<td>Financial/non-financial</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Figure 2.2.4.** Relationship between Information Criteria (IC), Value Orientation of Information (VOI) and Decision Output (DO)
2.3. SUMMARY

This chapter lays a broad foundation for the theory, background and testing of the validity of this study. This study, firstly, discusses the role of information, investors and the environmental conditions that exist in a capital market and then provides a general review of the three specific areas of interest: the characteristics of environmental conditions, the characteristics of investors and the association between those characteristics on decision making. The main findings in reviewing the previous studies may be summarised as follows:

1. There is considerable discussion of the role of information, investors and the role of the capital market. In the finance and accounting literature, the roles of information, investors and the capital market have been extensively discussed but much of it seems poorly focused on a subject perspective. Furthermore, most theory of financial reporting, investment decisions and the capital market have been developed under the normative perspective.

2. In the domain of accounting research, there is very little study focused on the discussion of the factors which influence investors in making their decisions and how investors process their information. Most researchers examined the role of information in the capital market in its association with the usefulness of information for the users in the decision-making process, the share pricing movements and also its association with the anomalies of the market efficiency hypothesis. This condition causes the problem about share pricing movements and other problems in investment decisions in the capital market not to be well understood.

3. A review of these previous studies also provides some conflicts and inconsistencies in the results. These conflicts and inconsistencies can be explained due to the differences in the research method and methodology and also differences in the environmental conditions such as developed and developing countries.

4. This study argues that information criteria and the value orientation of information are the variables that influence investors in making economic decisions. Moreover, it has been
stated in the previous sections that the personal factor is another variable that influences investors in making economic decisions. However, this variable is excluded in this study.
CHAPTER THREE

THE RESEARCH METHODOLOGY

Chapter two described a developed model and provided a theoretical framework for the evaluation of the characteristics of environment and the role of investors in developing countries, such as Indonesia. A review of the relevant literature was made to indicate the nature of major streams of thoughts which were relevant to this study. The selected elements of the study were specified and an integrative perspective was presented. In this chapter, the methodology and related analytical issues will be explained.

3.1. THE APPROACH OF THE STUDY

As mentioned in the previous section, the research was conducted in the field which is under interpretive study and which is considered the most suitable approach in order to understand the phenomena being studied. Accordingly, the approach of this study is considered to be a phenomenological one. Bogdan and Taylor (1973, p.2) argue that, since the positivist and the phenomenologist approach different problems and seek different answers, their research will typically demand different methodologies. Furthermore, they argue that the positivist searches for "facts" and "causes" through methods such as survey questionnaires, inventories and demographic analyses, produce quantitative data and allow him or her to statistically prove relationships between operationally-defined variables. The phenomenologist, on the other hand, seeks understanding through such qualitative methods as participant observation, open ended interviewing, and personal documents. These methods yield descriptive data which enable the phenomenologist to see the world as a subject.

As the objective of the study is to know the reality of what investors are doing, data in this study will be examined by using cross sectional studies. Data from some information sources are examined in the form of logical association for a long period of study. Those data come from personal documents which were generated from field studies under unstructured...
interviews and participation. This personal document also comes from library data provided by external sources such as public information, either formal or informal. By using tabular data, the public information were analysed and the association of the data were examined.

Due to the lack of public information provided by listing companies, this study also used other public information media such as news, journals and other public releases. There are many other considerations, as to why the news, journals and other public releases become an alternative sources for this study. Firstly, the study argues that from infancy to an emergent capital market, this market becomes neither more nor less efficient. The lack of regulation, the strong demands or influences of government on the capital market diminish the rational economic considerations. Secondly, it can be argued that investors do not use the public information provided by listing companies and the main thrust of this study will be other information that exists in the public domain. Thirdly, in every developed capital market investors tend to use that market as an alternative source of capital gain. However, in developing or less mature capital markets, most investors considered the market as a source for the investor to get an abnormal return.

Accordingly, in every market condition investors get such gain or avoid losses by employing a cut loss strategy when the market is considered unfavourable. The need for a quick decision, due to the lack of information provided by listed companies and the weakness of the reliability and validity of the data, cause the investors to use other public information which is provided in the market. Those data usually come from the news, or rumours.

3.2. THE SAMPLE

One of the most rigorous strategies used in the field research under study relates to a sampling strategy. Most researchers argue that sampling strategy will ensure the researchers obtain reliable and valid data. This strategy relates to the selection of location, size, type of sample and also the methodology used under study.
3.2.1 Location.

Data were collected in Jakarta. Jakarta is the capital city of Indonesia and the centre of commercial activities. As the centre of business and government activities, Jakarta is the busiest city. More than 50% of the country's money is circulated in Jakarta. It is also noted that Jakarta is the largest population centre. The population has a complex social structure and a wide variety of attitudes to social welfare. Generally, people in Jakarta are considered to be more aggressive and competitive then those in other parts of the country and have highly efficient informal information networks. Accordingly, a study concerning the role of information and investors in Jakarta's capital market can be considered as representative of most people in the capital market.

3.2.2 Size.

The sample of this study is open-ended. Respondents, who are considered to have a relationship to the factors that influence investors in the decision-making process in the Jakarta's capital market will be studied. This model is similar to that suggested by the interpretive researchers.

3.2.3 Selection Criteria

By considering the research problem, the respondents of this study were selected and divided into two groups. Most were investors, either institutional or individual. The rest were economists, sociologists, psychologists, historians, academics, theologists and government officers. The second group of these respondents were also asked to answer the questions which are related to the factors associated with the capital market. Most of the questions were a familiar series of questions - who, what, where, how, and why. "How" or "why" questions were asked
about a contemporary set of events, over which the investigator had little or no control. This is a distinct advantage over other research strategies.

On the other side, besides the respondents, the information was selected and classified into some categories: politico-economic and socio-economic that can be associated with the events that happened during the periods of study. The tabular methods as mentioned in previous paragraph are used to support the argument of this study.

### 3.3. THE RESEARCH PROCEDURE

In order to meet the constructive validity and reliability test of this study, a research procedure that relates to some principles of data collection has been developed. Firstly, this study uses multiple sources of evidence such as documents, archival records, interviews, direct observation and physical artefacts. Secondly, this study will create a case study data base - case study notes, case study documents and tabular materials which have been described in the previous sections.

Some sources of evidence were not easy to obtain. In developing countries, such as Indonesia access for undertaking some research is a problem. Firstly, a researcher must have permission from a person, who is in charge of the area of study. Such permission is a bureaucratic matter in this country. In the case of the capital market, the permission comes from the Chairman of the Stock Exchange Commission (BAPEPAM). Secondly, because of the methodology of research underlying this study is interpretive studies, the study will be more rigorous than that carried out under mainstream empirical research, which would be based on structured interviews or questionnaires. The use of un-structured interviews or protocol research in this study can only be achieved if the researcher has a good strategy for communication and a good memory for data collection. Some of the respondents could not be formally interviewed due to secrecy or suspicions. Accordingly, the researcher
should be well prepared with knowledge of the phenomena and have some research strategies. The researcher should be prepared well before he/she comes to the field.

In utilising the data collection and the data from the literature review, the researcher should create a case study data base. A computer program can be designed to create tabular materials or a data base of documents or notes. Yin (1989) argues that the preparation of data collection may lead some readers to conclude that fieldwork is merely execution of a carefully developed plan. A case study design is not something only completed at the outset of a study. The design can be altered and revised after the initial stages of a study, but only under stringent circumstances.

3.4. THE LIMITATIONS OF THE STUDY

It is a truism that all studies of this nature have their limitations. Some are limited by design, some by available tools and others simply by the inherent nature of the problem. This study has all these problems. The study was an empirical one, a field research study under the interpretive approach. Investigations of this nature are common in social sciences and business studies. Their common defects and advantages are well known and have been adequately discussed in many available research studies such as Chua (1986), Bruns (1989), and Smith et. al. (1988).

3.4.1. The Causality

Key methodological issues of special importance to this study have already been addressed. Other principle limitations to be mentioned are causality, measurement and limitation of data. With regard to causality, it is emphasised here that, though the theoretical proposition in this study appeared causal in nature, this is a correlation study and that any inference of causality must therefore be tentative. Such inferences are outside the scope of this study and must be subjected to verification by further experimental studies.
3.4.2. The Measurement or Test

Measurement reliability and validity are important issues that have to be addressed in any study. In this study, since all the major instruments used have previously been well tested, used and widely reported in several well known publications, their reliability and validity have been adequately demonstrated and these will not be repeated here. However, because of the differences in the environment of study, between developed and developing countries, and also in methodological study there might be problems if the study in developed countries were replicated in developing countries. Accordingly, the different perspective of this study must be clearly defined and examined.

Clearly, in these instances, the issues of validity and reliability are problems. There are some strategies and tactics to counter threats to validity and reliability in field research. McKinnon (1988, p. 39) provides three strategies and five tactics to overcome these problems. Those strategies are: (1) the amount of time the researcher spends in the research setting, (2) the use of multiple methods and multiple observations and (3) the researcher's social behaviour while in the setting. The five tactics that have been addressed by McKinnon (1988, p.45) are: (1) approach to note taking, (2) choice of type of participant observation; (3) the use of team research, (4) informant and respondent interviewing; and (5) probing questions. Under this study, the field work has been done for more than five years. Most of the tactics under this study are similar to those suggested by McKinnon (1985) As this study is an individual research study, the use of team research is not possible.

In this study the problems concerning validity and reliability of data are examined in the form of a historical-logical-sequence. Association between information and investment decisions which are represented in the stock price movements in the capital market, were examined by analysing the possible information used during the long term periods of study concerning the product of investment decisions in capital
market activities. The use of narrative records and tabular methods which were complemented by some documentary evidence are a part of the techniques used in this study. The multiple observation of social behaviour of investors and the direct involvement in the field of study together with those techniques used in this study are considered as methods and tactics that can be used for examine the reliability and validity of the data.
PART 2. AN OVERVIEW OF THE ROLE OF INFORMATION, INVESTORS AND THE CAPITAL MARKET

CHAPTER FOUR

THE ROLE OF INFORMATION

The purpose of this and the next chapter is to examine the previous theoretical empirical work concerning the role of information, the role of the capital market and the role of investors in making their decisions in the capital market, and the applicability of existing theory to the findings. In this chapter, the role of information is identified and examined. The role of the demand by parties concerned for information and a discussion of factors that affect the supply of information are the main concerns of this chapter. The following chapters of this study explains the capital market theory which emphasises the role of investors and the capital market in deriving equilibrium stock prices.

4.1. THE DEMAND FOR INFORMATION

As a ramification of economic theory, the theory of accounting and reporting can be described in the basic form of economic theory, namely, the theory of the demand for and supply of information. It can be argued that this theory is the product of a diverse set of demand and supply forces. Accordingly, a study concerning the role of information is a study of the demand for and the supply of information and how the demand and the supply are manipulated in order to get an equilibrium of information.

For many decades, the role of information has been considered important by the accounting bodies and the stock exchange commission as mandatory regulators in developing accounting and reporting practices for external users. In Indonesia, the development of accounting and reporting practices is laid down by the Indonesia Accounting Association (IAI) and the Supervisory Executive Board (BAPEPAM). This study argues that the two regulatory
bodies are too late in anticipating the development of the capital market, due to the fast growth of the business activities and the development of the capital market.

This chapter discusses the demand and supply forces and how the content of information and the timing of their release affects decisions of external users, namely, investors in the capital market. The first part of this section discusses the demand side of information and the second discusses the supply side. The third part of this chapter discusses the association between the demand for and the supply of information and its affect on the decisions of external users.

4.1.1. The Parties Demanding Information

There are long discussions in the accounting literature concerning parties demanding information. Those parties are (1) shareholders, (2) investors, (3) managers, (4) creditors, (5) employees, (6) customers, (7) government or regulatory agencies.

(1). Shareholders are parties who are either individuals or institutions, such as insurance companies and mutual funds which have a certain number of company shares. These parties are major recipients of information (either financial or non financial) provided by the company. These parties are concerned with monitoring the behaviour of management and attempting to affect its behaviour in a way deemed appropriate. Before the Indonesian capital market was reopened, most of the big company shares belonged to private individuals. The development of the capital market is supposedly to distribute the shares of the companies to the public. However, in their history, the Indonesian privately held companies become pseudo-public companies, with only a few of companies' shares being sold on the stock market. Ngurah (1991) found that only about 35 percent of the listed companies' shares in the market belonged to the public. Accordingly, the public cannot control the listed
By 1993, the chairman of BAPEPAM stated that the listed companies' shares owned by the public increased to less than 40 percent.

Investors are parties who are either individual or institutional. In investment studies, activities of these parties emphasise the choosing of portfolio securities that are consistent with the preferences of the investors for risk, return, dividend yield, liquidity and so on. The decisions made by these parties include the amount, the type and the timing of shares to buy, retain and sell. It's recognised that these investors demand information provided by the company. However, due to the type of listed companies as mentioned in the above paragraphs, that is mostly privately held companies or pseudo public companies, the demand for information by investors cannot be fully satisfied. The accounting and reporting practices of those companies cannot fully disclose important information, as there are no benefits for them. The market is heavily weighted towards the supply side of shares in the market. Much evidence shows that listed companies are experiencing oversubscription.

One of internal parties demanding information on financial statements is the manager. It is generally recognised that demand for information by managers rises because there are some contracts or compensation based on financial statement variables such as earnings, earnings per share, or earnings to shareholders equity ratio. Managers also utilise financial statement information for such purposes as in financing capital assets, investment decisions on the capital market and in many other operating decisions. However, in reality Indonesian companies are still privately owned, and the need for information for accountability purposes is becoming a pro forma matter. In other words, from the viewpoint of the agency relationship, this relationship cannot really be implemented for privately owned companies or for pseudo-public companies as the managers are the owners.

It was recognised that demand for information can also arise from employees. The employees have an interest in the financial statements in order to
know whether their company has potential current and future profitability and other factors which relate to their welfare. In some cases, there is a contract between employees and the company based on variables included in the financial statement. In developing countries such as Indonesia, the demand for financial information cannot come from employees. Mostly there is no contract between them. In Indonesia, most of the employees act as servants of their employers, due to the excessive labour force and the low quality of labour in the country. Even though employees can have such information, the reports are considered just for knowledge. The employees can not use the reports to raise their means, such as to increase their salaries. So the reports are provided only for external purposes.

(5). Creditors, either financial or non financial agencies, have an interest in the financial statement information of the company. This information will be used at the initial loan granting stage and also after the loan has been approved. At the initial loan granting stage, the role of financial statements is important in order to evaluate whether the company can feasibly finance a project. If the decision to grant a loan is made, the role of financial statements will be considered an important factor in monitoring the loan agreement and business activities of the company. Theoretically, creditors can force the companies to provide certain information. However, when there is no well-developed banking system in a country, the loan officer tend to create the financial report in order to get a benefit for him or her self. The reports are created in such a manner as to pass a requirement of credit analysis.

(6). Good relationships between a company and its customers or its potential customers may take several forms. One of these exists in the form of the continuing attention of the company to the needs of customers with regard to financial information. This financial information is used by the customers to monitor the financial viability of company. In this case, the financial statements provided to customers are a medium for keeping the customers informed on company activities. However, in most privately owned companies, the need by customers for financial reports is not considered
important. Those customers are considered external parties who are not allowed to be too involved in the activities of the companies.

(7). Demand for financial statements also comes from government or regulatory agencies which use those financial statements for many purposes, such as revenue raising and political matters. In revenue raising, for example, the role of financial statements is important in determining the amount and the rate of tax of the company. However, due to there being differences in the recognition of revenue and expense accounts between the tax agent and the accounting professional, the differences are often used by the tax agent for refusing the accountant audited reports for tax purposes. In some cases, such a condition is manipulated by the tax agent, so that he or she can get involved privately in determining the burden of income tax for the companies. This condition has been generally recognised by the business people before 1990s. However, since the government issued the decision of Minister of Finance in 1992, that allowed the government to ask professional associations such as public accountants to help the government in raising such revenue, the problem of such manipulate has diminished. In this condition, the accountant acts formally as a government officer to verify the additional tax for the government.

In political matters, the role of financial statements is also important when there is a company bankruptcy. The government will act as a guarantor to back up the company in such case in order to maintain the affairs of company. However, up to now, in developing countries like Indonesia, there has been no consideration concerning political matters in relation to financial statement production. There are some companies going bankrupt, such as Bank Modjopahit and Bank Summa, that the government cannot do anything about although the financial statements have been accepted and declared “fair” in its financial report.

(8). Other parties, such as academicians, labour unions and other special interest groups are also demanding financial statement information from companies.
Some companies do pay attention to these requests, especially, for public financial statements and non-financial data, but some others do not.

4.1.2. The Factors Affecting Demand For Information

It has been widely recognised that the complexity of business activities may force parties demanding more information to improve their decision-making process. In accounting studies, Foster (1986) argues that there are two factors affecting demand for financial statement information, namely, potential for the information to reduce uncertainty and availability of competing information sources. In economic theory, there is a model that states that demand for goods and services depends on the customers' income, the availability of substitution goods and services and the quality of goods and services. By referring to this fundamental model, this study argues that demand for financial information depends on the perceived usefulness of information, the availability of competing information sources and the accessibility of financial information. Notationally, this model can be expressed as:

\[ D = f(U, S, R) \]

where:
\[ D = \text{demand for information} \]
\[ f = \text{a function, a symbolic interaction model.} \]
\[ U = \text{usefulness of information provided} \]
\[ S = \text{availability of substitute or competing information} \]
\[ R = \text{accessibility for financial information} \]

(a). Usefulness of Information provided. One of the main discussions among accounting researchers is about the usefulness of information for external decision makers. One of the arguments is that the information provided by financial reports can reduce uncertainty in the future with regard to such matters as its profitability, quality of management and ability to fulfil obligations to external parties, especially suppliers and
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Many researchers argue that the usefulness of information depends on the timing of the information release, and the quality of information disclosed. However, some accounting researchers argue that the information provided in the accounting domain is common information needed by the users. There will be further discussions concerning the usefulness of information and the value orientation of investors in Chapter 8.

(b). Availability of Substitute or Competing Information. From an accounting perspective, financial information (the annual report) is one of the many information sources available to the parties as it was outlined in Section 4.1.1. Other sources include corporate interim reports, stockbrokers advice, advisory services, newspapers and magazines, proxy statements, corporate press releases, prospectuses, communication with management, advice of friends, and tips and rumours. Chang, Most and Brain (1983) found that there are differences between investors and financial analysts in the United States, United Kingdom and New Zealand on the perceived usefulness of information sources. All of those parties agree that corporate annual reports are the most consistently high ranking sources of importance. Furthermore, this study found that the income statement was the item in the annual report with the most consistently high rank of importance.

(c). Accessibility of financial information. Demand for information also depends on the accessibility of financial information to users. The accessibility of financial information can be measured from the number of parties involved in ownership interest of the companies. This condition can be identified from the number of shares owned by the public and the interdependencies between the company and the external parties. The stockholders, creditors, and government are parties which have high accessibility to financial information on a company. In developing countries such as Indonesia, other parties such as customers, employees and other external parties, have less ability to access information from a company. In developing countries, generally, stockholders are the managers, even in the limited companies,
the stockholders fully control the managers. The role of agency relationship only partly exists in this country. The implication from this is that only a little information is available in the public domain.

4.1.3. The Conflicting Interest Among Diverse Parties.

There is a wide recognition that conflict of interest exists because there are different interests among diverse parties. Actions taken by one or more of the parties can result in a redistribution of wealth among those parties. However, the existence of conflicts of interest does not solely mean that each party will necessarily take actions that disadvantage other parties. In the first stage, conflicting parties may seek ways to make their interests congruent. If there is no solution, the issue will be brought to court.

The existence of conflicts among parties has been recognised by courts for many years since the owners and management have different interest. One of the symptoms of the conflicting interest between management and owners is the lack of information about financial conditions. In some cases, there are no financial statements provided by management by way of reporting the results of its actions as agent to the stockholders. In other cases, management creates financial information which departs from the generally accepted accounting principles.

In other situations, conflict between diverse parties may increase the reliability of information. Chow (1982) provides evidence of such conflict. He (1982, p.287) concluded that a major reason for hiring an external auditor was to help control the conflict of interest among firm managers, shareholders and bondholders.

4.1.4. The Management Discretion Information

As mentioned earlier, the preparation of financial statements is a primary means for management to report the results of its actions as agent to the principal - the
stockholders. A secondary means is related to the obligation of management to external users as required by the law. As the distribution of the ownership of company shares is limited in an emerging capital market, management has a discretion to provide information to the users. In accounting studies the discretion of management relates to the selection of accounting methods which comply with generally accepted accounting principles.

Many studies provide evidence that the selection of accounting principles depends on many factors. In some cases, it depends on the relationship between management and stockholders. In other cases, it depends on the types of capital market. Cerf (1984, p. 6) argues that, if management perceives the market to be efficient among all users of financial statements, then a firm's selection of accounting principles would be arbitrary. If management perceives that the market is not efficient among all users, then there would exist an incentive for management to “adjust” certain items such as net earning, earning per share.

Foster (1986, p. 223) argues that a common perspective in the financial press is that management “manages” or “smoothes” the behaviour of reported earnings overtime. The smoothing theory rests on the premise that management attempts, through selection of accounting principles, to provide smooth reported earnings. This satisfaction stems from the smoothing of the variability of earnings, which, in turn, reduces the risk of the stockholder's return. If their risk is reduced, the stockholders would be satisfied with a smaller return on their investment, and therefore, would be less critical of management.

More recently, research into the selection of accounting principles by some researchers such as Dhaliwal (1980 and 1982), Watts and Zimmerman (1978) and Hagerman and Zmijewski (1979) have focused on firm characteristics. These studies follow the premise that firms select accounting principles in response to that firm's characteristics rather than to smooth reported earnings. These studies have provided
some evidence that firm characteristics influence the choice of accounting principles. Management’s discretion of select accounting exists because there are many accounting methods which can be followed by the companies. Companies choose any accounting method used as long as it complies with general accounting principles.

4.2. THE SUPPLY OF FINANCIAL INFORMATION

This section focuses on factors that affect the supply of financial statement information provided to external parties. Factors that are considered to be important in this study are the role of regulatory bodies, market forces and the awareness of companies to provide information to external users. Notationally, these factors can be expressed as follows:

\[ S = f(R, F, M) \]

Where:

- \( S \) = supply of information
- \( f \) = a function, a symbolic interaction model
- \( R \) = statutory requirement
- \( F \) = market forces
- \( M \) = motivation

4.2.1. The Role of Regulatory Agencies.

A common feature of the corporate environment in many countries is the existence of regulations that affect the disclosure decisions of companies. In some cases, specific legislation governing the content and timing of financial reports exists in Companies Codes or Acts. In other cases, legislation associated with corporate taxation and the capital market are important determinants in relation to the content and timing of financial statements. This section describes both the structure of the law
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and the existing institutional framework for financial reporting in Indonesia and how they influence the supply of financial information.

Figure 4.2.1.1 represents an overview of the existing framework governing the law in Indonesia. Three levels of law are described as follows:

- **Constitution (UUD 1945)**
- **Code or Act (UU)**
- **Decree (Kep Pres, In Pres, Kep Men, Etc)**

Figure 4.2.1.1. The Framework Governing Law in Indonesia

a) Constitution 1945. All Regulations, Codes, Acts and Decrees should be in conformity with the Constitution of 1945 which has been established as the Basic Fundamental Law by the people of Indonesia. In the case where there is no law that can be implemented to any existing case in Indonesia, according to section 2 of the amendments to the Constitution, the matter can be resolved on the basis of common law or the regulations as existing in Indonesia. Accordingly, Dutch Regulations in the last period of colonialism such as "Wetboek van Koophandel 1929 (Company Law) and
Faillissements Verordening S 1905-217 jo 1906-398 (Bankruptcy Acts) are still used in Indonesia.

(b) Code or Act. The second level of the legal structure in Indonesia is the Code or Act. Each Code or Act should be in conformity with the Constitution. The task of establishing a Code or Act, according to the Constitution is that of the House of Representatives (Dewan Perwakilan Rakyat).

(c) Decree. By way of operation of the Code or Act, the executive branch of government issues a decree. There are many agencies under the executive branch of the Indonesian government such as the Minister of Finance and the Minister of Justice. In corporate reporting in Indonesia, the role of the Minister of Finance is important. A decree of the Minister of Finance must be in conformity with the Presidential decree. It can be indicated in "consideration section" of the Minister of Finance Decree. For example, in the Minister of Finance Decree no. 859/KMK.01/1987, the decree refers to the President decree no. 45/M/1983 and other Codes or Acts, such as section 23 Stb 1347 of the company or commercial law and Act no. 52, 1973 concerning the capital market.

(d) Other Regulations. There are many other regulations issued by other government regulatory agencies. These regulations are set forth to operationalise, in more detail the decrees. For example, the Stock Exchange Commission, in connection with the Minister of Finance decree no. 859/KMK. 01/1987, issued decree no. Kep. 02/PM/1988 concerning the regulation of the stock exchange market. The Ministers' decree requires a listed company to file its reports to the capital market executive agency and this agency, in its schedule V, provides guidance on how the reports are to be filed. The implementation of this regulation will help the regulator and also other parties involved to interpret the content of this regulation.
Figure 4.2.1.2. The institutional framework governing corporate reporting in Indonesia

Figure 4.2.1.2. represents an overview of the existing framework governing financial reporting in Indonesia. Five levels of the framework are distinguished as follows:

(a) Level One, consist of the legislative, executive and judicial branches of government. The legislative branch is the House of Representative (DPR). This institution has the most important role in making regulations. All of Acts or Codes must be approved by this institution before they issue and become law. The executive and
the judicial branches can exert influence in a proactive way. The executive branch consists of the President and his Cabinet or Ministers. The judicial branch is the Supreme Court (MA) which exerts influence via its rulings.

b) Level Two, includes governmental regulatory bodies such as the Capital Market Executive Agency (BAPEPAM) and the Department of the Treasury (Dir. Jen. Moneter).

(c) Level Three includes private sector regulatory bodies such as the Indonesia Accounting Association, The Jakarta Stock Exchange, the Surabaya Stock Exchange etc.

(d) Level Four includes lobbying groups that attempt to influence decisions made by parties in level one to three. These groups consist of investors clubs (JIC), financial analyst federations and stockbroker associations.

From figure 4.2.1.2. it can be concluded that all four levels in the framework influence financial reporting decisions made by companies. The existing framework governing corporate reporting in Indonesia is similar to other countries and is best viewed as a joint effort between public sector (government) and private sector institutions.

The role of regulatory bodies at levels 1, 2 and 3 are significantly important in developing corporate reporting in Indonesia. In some cases, there is strong evidence that specific disclosures are best explained by regulatory bodies: the Minister of Finance, the Capital Market Executive Agency and the Indonesian Accounting Association. For example, the Minister of Finance under section 21 decree no. 859/KMK.01/1987 mandates that firms should file their audited financial reports within 120 days after the end of the fiscal year. Schedule V of the Capital Market Executive Agency decree no. SE 24/PM/1987 requires companies to disclose any relevant items pertaining to the affairs of the company in accordance with the generally accepted
accounting principles issued by the Indonesian Accounting Association, but also with statutory requirements issued by the Capital Market Executive Agency.

4.2.2. The Market Forces and the Supply of Financial Information

Foster (1986, p. 31) argued that there are three market forces affecting the content and timing of financial statement disclosure: (a) the capital market (b) the labour market and (c) the corporate control market.

(a) Capital Market Forces will exert pressure on companies to provide financial information to external users. These pressures exist for various reasons. Firstly, there is uncertainty about the quality of shares or bonds issued in the market. Secondly, there is a need to distinguish the public interest from the companies interest. In some cases, it will be beneficial for the market if the SEC made law enforcement and full disclosure requirements for the listed companies.

b) Labour Market Forces. As mentioned earlier, stockholders have a vested interest in monitoring the behaviour of management, because managers have an incentive to improve their own welfare. This incentive causes the shareholders and the managers to consider financial statements to reduce those incentives. Labour market forces can arise from both external sources (eg. marketability of executives) and internal sources (eg. changes in payment scheme). On the condition that there is marketability, a manager who is of higher quality will have the incentive to institutionalise financial statements that facilitate their being distinguished in the labour market from lower quality management. Changes in payment schemes also cause the manager to ask for financial statements.

c) Corporate Control Market Forces. The corporate control market force is another factor that affects the supply of information. Managers seem to have the ability to counter any attempt from outsiders to take control of the company. One tactic that
management can use in such circumstances is releasing financial information that they perceive will increase the image of their capability to control the company.

4.2.3. The Management motivation

Another variable which is also studied in corporate reporting is management motivation to disclose financial information. Many studies imply this variable. However, no study directly discusses this variable in cost benefit analysis. In cost benefit analysis, management considers the disclosure problem in two ways. Firstly, if the benefit for providing information is considered higher than the cost of information, the company will tend to disclose more information; and secondly, the company will disclose less information if it feels that the cost will be higher than the benefit.

Kross and Schroeder (1984) found that firms with good news to announce are more likely to respond earlier than their expected reporting date, whereas firms with bad news are more likely to announce it after their expected reporting date. One explanation for this is that management doesn't see any benefit in announcing bad news. Management systematically suppresses the release of negative information. Furthermore, Patel and Walfson (1982) found that good news is released during trading, while bad news is held until after the market closes.

Management consistently cites as important in disclosure decisions the cost associated with those disclosures. Foster (1986, p. 35) states that these costs include collection and processing costs, litigation costs, political costs, competitive disadvantages costs and additional constraint on management decisions. All types of cost may reduce disclosure by the company. Furthermore, Foster (1986, p.41) argues that political cost is an important variable in disclosure decisions. Management will attempt to reduce these costs via changes in the content or timing of its disclosure.
Other studies, such as Singhvi and Desai (1972) and Buzby (1975) also argue that disclosure can be associated with pressure. Companies are less pressured from outside, by government and other regulatory bodies and the public, to provide more disclosure in their financial reports. Those companies appear to be large in size. Watts and Zimmerman (1978) argue that the magnitude of the political cost is highly dependent on firm size. In this study, it is argued that pressure is a form of economic sacrifice which can be associated with cost, as with competitive disadvantage costs and constraints on managerial behaviour costs.

4.2.4. The Voluntary Disclosure

Other behaviour of management in respect to financial information is that management provides some types of voluntary disclosure to the public which are not required by the regulatory bodies. Foster (1986, p. 30) provides some models of voluntary disclosure in the supply of financial statements. These models are: (a) the company releases public financial statements before the formation of the major regulatory forces of the SEC, (b) the financial statements are voluntarily issued by companies not under the jurisdiction of the SEC, (c) some companies issue financial statements at more frequent time intervals than is mandated by regulatory bodies, and (d) some companies release considerably more information in their financial statements than is mandated by regulatory bodies.

4.3. THE MARKET EQUILIBRIUM OF INFORMATION

Singhvi and Desai (1971, p. 136) stated that adequate disclosure of information minimises ignorance in the market and causes the market price to reflect the true value of the security. The term "adequate disclosure", has been cited as an important requirement in explaining the fair value of security prices. Many of the studies state that an overwhelming amount of information will increase the cost associated with that information.
4.3.1. The Model of Market Equilibrium Information (MEI)

This study assumes that an adequate information disclosure will provide an equilibrium of information (EI) in the market. It discusses the mechanism of such equilibrium (EI) and some other factors related to this mechanism. The contents and timing of information are major parts of the discussion that constitute the equilibrium of information. By assuming such equilibrium equals adequate disclosure of information, the market equilibrium of information (MEI) will be addressed in a model as follows:

\[ E_I = f(S_I/D_I) \]

where:

- \( E_I \) = Equilibrium of information
- \( f \) = a function, a symbolic interaction model
- \( S_I \) = Supply of information
- \( D_I \) = Demand of information

Under this model, equilibrium of information will exist if the supply of information equals the demand for information. Figure 4.3.1. describes the mechanism of market equilibrium information in various situations. The abscissa, the vertical line in this figure, describes the quality of information and the ordinate, the horizontal line, is the periods of time that information exists in the market.

Assuming that \( t \) is the periods that information is released and considered important by the investors and \( q \) is the contents of information that describe quality of information needed, then based on these assumption, the figure can be described as follow:

First, at point \( t - 1 \) demand of information is \( Q_a \); but supply of information is \( Q_c \). At this point there is an excess demand of information. Investors will ask for more
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information than that provided by the company. The only information used by investors is information which is not provided by companies in the public domain.

Second, at point $t + 1$, supply of information ($Qc'$) exceeded the demand for information ($Qa'$). However, the supply of annual reports is not considered to have provided much for the investors in investment decisions. Consider the study by Hines (1982) and Williams and Findlay (1974). The information provided in the public domain is considered too late. Accordingly, it can be concluded that investors did not use information provided by the companies.

Third, at point $t$ investors will consider that information existing in the public domain is adequate. However, adequacy of information is a matter of judgment and subjective in nature. Much of the study implies that determining an equilibrium of information is a difficult task due to the differences in timing and quality of information provided by the listed companies.

![Figure 4.3.1, The Market Equilibrium of Information (MEI)](image-url)
Disclosure is the process through which an entity communicates with the outside world. The need for increasing the quality of information disclosed is considered to be important by some researchers. However, William J Baumol (1965) states: "The significance of proper and adequate corporate disclosure can not be over emphasised in a free economy where the market allocated the resources to different sectors of the economy. Lack of adequate disclosure can create ignorance in the securities market and can result in mis-allocation of resources in the economy". A review of the studies on corporate reporting indicate that they have touched upon a variety of issues concerning disclosure. Only a few, have attempted to examine the proper and adequate disclosure in annual reports.

Moreover, recent developments in corporate reporting practices provide evidence that there is a tendency for companies to move into a summary annual report. This summary annual report contains condensed financial statements omitting or condensing many of the traditional footnotes required by generally accepted accounting principles but with a broader financial review incorporated into the management discussion and analysis. Such summary annual report has been endorsed by the Financial Executives Institute (FEI) and recently has been adopted by Mc Kesson Corporation and others within a frame work first proposed by General Motor Corporation (GM). This condition provides evidence that the problem of corporate reporting has still not been resolved. This problem tends to be more complex as the organisation of companies becomes complex. Accordingly the crucial problem of corporate reporting is how to set up certain quality disclosures which are generally accepted by external users.

In developing such quality of disclosure it has been realised that participation has become the core of such an objective. The standards or requirements will not
work without participation. Such participation should be developed under the umbrella of the common interest of all parties involved in this mission. This interest can be achieved by motivating all parties, at least the members of the stock exchange markets and investors. This condition will create full disclosure information in annual reports and fair market mechanisms can be maintained.

By referring to the model of market equilibrium and the development of corporate reporting in the current year, it can be concluded that the possible approach to making corporate reports involved the role of mandated regulatory bodies in the capital market and motivated companies to comply with the statutory requirements. The role of other parties involved in the capital market is also important in the mechanism of the efficiency of the market. However, there is not much evidence to support this argument. There is further discussion of the role of information in the capital market is in Chapter 6.

4.4. SUMMARY

(1) Demand for financial information arises from diverse parties each of whom has his or her own focus of attention and it is likely, that all parties agree that information provided by corporate reporting is not adequate. Accordingly, in making an economic decision, all parties will also consider other sources of information.

(2) The complexities of business activities forces parties to demand more financial information to improve their decision making process. Those factors that affect demand for financial information are the perceived usefulness of information provided, the availability of substitutes or competing information and the accessibility of financial statements.

(3) The role of regulatory bodies, the role of market forces and the awareness of companies to provide full disclosure information are factors affecting the supply of information.
(4) In corporate reporting practices, there are two bodies that are directly involved in providing business activities with a standard for accounting and reporting practices. These bodies are, the government regulatory bodies and the private bodies. Accordingly, the corporate reporting can be best viewed as a joint effort between the public and the private sectors.

(5) In order to achieve equilibrium of information, economic theory suggests that supply of and demand for information, the content and the timing of information release are the constraint used for market equilibrium information.
CHAPTER FIVE

THE ROLE OF INVESTORS IN THE CAPITAL MARKET

In the last chapter we examined both the supply of and the demand for financial information and its implication to the content and timing in the market equilibrium of information. The purpose of this chapter is to examine the role of investors in the capital market. The term "the role of investors" is used to denote the nature and activities of investors in the capital market, therefore this chapter discusses how investors select securities in the capital market and how they use the information provided by corporate financial reporting.

Several authors and researchers have studied corporate reporting by exploring the role of the investor in the capital market. A brief review of their reports provide some insight into their role in selecting a portfolio of equity securities, bonds and other investments for an individual, firm or institution. Based on this description, this study discusses some issues which relate to the selection of a portfolio of securities such as an active investment style, an abnormal return issue, a risk averse issue and a political issue.

5.1 THE INVESTMENT STYLE

It is generally recognised that people will provide themselves with some analytical methods that are considered important in making economic decisions in the capital market. An active investment style indicates that the market is inefficient. An inefficient capital market necessitates investors adopt a style that they perceive will provide some information concerning mispricing of shares in the capital market. Theoretically, there are three approaches that can be used with respect to the lack of information provided in public domain and the lack of reliable information provided by the corporate reporting practices. Those approach are: technical analysis, market timing and fundamental analysis.
5.1.1. Technical Analysis

Technical analysis is an approach to the analysis of stock and future markets and their future trends which examines the technical factors of market activity such as rates of change, price change and change in volume trading. This approach assumes that there is a systematic pattern of information in the past sequence that can be exploited to yield an abnormal return.

Kendall (1953), for instance, reported that there are systematic dependencies in security returns. Kendall (1953) argues that technical analysis also can be used not only in the secondary market but also in the Initial Public Offering (IPO) stages. Investors, generally, recognise that there is mispricing of securities in the primary market (Initial Public Offerings stages). In primary markets, the markets are considered more efficient due to the existence of mandatory regulations promoting the disclosure of information affecting the share prices in the market. However, this primary market is not a real market because the market forces and the demand for and supply of forces exist without any interference from outside the markets. Investors also can detect mispricing securities after the IPO stages.

Further, Kendall (1953) argues that after the IPO stages, the larger the over-subscription of stocks the larger the possibility of investors getting abnormal returns and the longer the possibility of investors getting such abnormal return. For further discussion see Appendix No.3: The Influence of Political Economic Policies on Listed Companies: A Case Study on PT Indocement.

5.1.2. Market Timing

Market timing is a modification of technical analysis in which the aim is to identify turning points and other systematic patterns in the overall markets. Investors that used a market timing approach exploited a composite index number in every
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period of transactions. As a technical analysis, the financial statement of specific firms typically do not play a major role. Investors tend to use past information data concerning the index share prices and trading activities for making their investment decisions.

5.1.3. Fundamental Analysis

This approach assumes that each security has an intrinsic value that can be determined on the basis of such fundamental as earnings, dividend, capital structure and growth potential. Investors can use financial statement to determine the intrinsic value of the shares and compare such value with the current market prices in order to detect that there is a mispricing of securities in the capital market.

Arnold and Moizer (1984), and Chugh and Meador (1984) reported that fundamental analysis is the primary approach used by securities analysts. Although they focused much of their analysis on corporate financial statement information, however, they also stress the importance of understanding the economics of each firm's industry. According to them, in some fundamental analysis, the primary focuses is on issues such as the likely introduction of new successful products and the likely discovery of lower-cost production technologies.

Further they argued that after developing prediction on such issues, a fundamentalist seeks to identify those cases where the market has not already fully impounded these implications into the current security price. However, the lack of information provided by listed companies in the capital market and less reliable information provided by corporate reporting practices, in less developed capital market, mean this approach can not become a proper method in selecting portfolio securities in the capital market. There is some evidence, in the capital market of Indonesia, to indicate that some companies have financial difficulties before their
listed in the market. There is evident from events after their listing, such as a low rate of dividend announced and current share prices that fall below the initial price offering. For further descriptions see Appendix No. 3: The Influence of Political Economic Policies on Listed Companies: A Case Study on PT Indocement.

5.2 THE ABNORMAL RETURN ISSUE

As indicated in previous chapters, investors always attempt to get an abnormal return from selecting a portfolio of securities in the capital market. However, investors cannot easily hope to obtain this expectation by using information provided by the companies issuing shares in the market. Accordingly, investors may utilise other information from different sources. The study by Chang, Most and Brain (1983) studied the perceived usefulness of information sources. They found that corporate annual reports were considered very important by investors and financial analysts in the USA. Other information sources, such as newspapers and magazines, advisory services, stockbroker advises, proxy statements and much other information are considered less important in this study. Even though, the perceived importance of information between individual investors, institutional investors and financial analysts in the UK and NZ are significantly different, in fact they all use information in making their rational decisions to obtain an abnormal return. The phrase "abnormal return" in this case is the difference between the actual returns from an investment strategy and the returns predicted to be earned. These returns can be classified into two parts viz capital gain and dividend earned. There are only a few studies on investors' preferences to these two type of returns.

A review of the study of dividend policy in the capital market of developing countries like Indonesia, provides evidence that there is no association between the dividend earned and stock prices. Investors tend to think more about the capital gain than the dividend earned. Ngurah (1991) found that the impact of dividend announcements on stock prices was not consistent. The trend of stock prices, a week before (P1) and a week after a dividend announcement (P2) is used to understand the impact of the dividend announcement on stock prices. Table 5.2.1 indicates that the stock prices vary a week before and after the
5.3. THE RISK AVERSE ISSUE

There is another important issue in portfolio theory, that investors are risk averse. Therefore investors are considered to prefer higher expected returns to lower expected returns for a given level of portfolio variance, and prefer lower variance to higher variance of portfolio returns for a given level expected return. In order to achieve this objective strategies are used by investors such as diversification of portfolio and risk control strategies. In diversification strategy, rational investors will diversify their portfolio rather than hold a single set asset with the highest expected return. The aim of this strategy is to reduce the possible risk in the future. Foster (1986, p.311) argues that one relatively cheap way of attaining a diversified equity investment portfolio is by investing in index funds. These funds attempt to match the return on a chosen index, for example Standard and Poor's 500 Index.

As indicated in the previous chapters, investors will use a strategy in order to minimise their losses from capital market activities. In investment decisions, this strategy is recognised as a risk control strategy. In this case, investors consider that the market will not provide the expected returns similar to what investors expected. Accordingly, investors will take additional precautions to control the risk. In the short selling strategy, for example, investors construct a less than fully diversified portfolio with a risk higher than that of the market and then sell the securities immediately when they perceive that the portfolio will provide a return.

In the case of the Indonesian capital market, the risk averse issue can be explained as follows:

After a period of stagnation (that was in 1970/1980) some investors consistently bought shares in the market due to their assumption that there was a possibility that the bullish market would continue. In this period, the strategy used by investors was diversification of shares in order to minimise unexpected losses. However, in the period of the bearish market, after the periods of market boom in 1990, the only strategy used by investors was a cut loss strategy. Some investors had great losses during such periods because the price of shares dropped by more than 50 percent. These investors were mostly individual investors and some institutional
investors. The individual investors had great losses due to the market sentiment, and this kind of investor was the uniform investor. On the other hand, the institutional investors also had great losses due to the political factors. For further explanation see Appendix No.3, The Influence of Political Economic Policies on Listed Companies: A Case Study on PT Indocement and Appendix No.4: The Influence of Political Economic Policies on Listed Companies: A Case Study on PT Bank Duta.

5.4. THE POLITICAL ISSUE

One can argue that share prices tend to move due to the supply of and the demand for shares in the market. However, as mentioned in the last paragraph, there is evidence that political factors influence investors in the market. This study argues that the nature of the market, makes possible the influence of political factors on investment decisions. In this case, if the market is inefficient, a rational investor would make an irrational economic investment decision when the political factors came into force in the investment decision process in capital market. Investors will not consider whether in the near future they will get an abnormal return or losses. The main aim for buying securities was simply for political reasons such as relaxing the market from a market sentiment (psychological aspects).

This condition can be described as follows: During the period of 1988 to 1990, the government of Indonesia directed all efforts to develop a capital market as an alternative for financing the continuing development in the country. The strong commitment of the government to this objective can be traced to the government efforts in making policy reforms related to the financial sectors and the capital market regulations. The strong faith of government in the capital market was that the market should attract quite a number of companies, if the market was to develop. Some policies that were implemented by the government were: (1) provide some incentives to the potential companies and (2) loosening all merits requirements that had been implemented in the past by PT Danareksa (the only Trust Funds authorised by the government). As results, there was a significant increase in the number of companies listed in the market. On the other hand, the loosening requirements
caused some market abuse in the market. Consider the market abuses by Bank Duta, the second largest private banking in Indonesia. This bank had great financial crisis soon after it was listed in the capital market. The government then via its public companies such as PT ASTEK, PT TASPEN, asked for the companies to buy those shares in order to keep the performance of the company in the market. For further discussion see Appendix No.3, The Influence of Political Economic Policies on Listed Companies: A Case Study on PT Indocement and Appendix No.4: The Influence of Political Economic Policies on Listed Companies: A Case Study on PT Bank Duta

5.4. SUMMARY

(1) There are three important issues relating to the role of information: abnormal return issue, risk averse issues and political issues.

(2) As rational human being, investors tend to consider non-zero abnormal returns rather than the dividend yield. This condition has been explained in the case of bullish market during the periods of 1990.

(3) Generally, in inefficient capital markets active investors consider these three issues. However, the evidence showed that some investors considered political factors more than others.
CHAPTER SIX

THE ROLE OF THE CAPITAL MARKET

The main purpose of this chapter is to describe the role of the capital market in mobilising funds for investment. The capital market is a market for trading securities of listed companies and provides a mean by which investors and companies can be brought together for their mutual benefit. These securities can then be bought and sold in the market-place at competitive prices which reflect current levels of supply and demand. These prices are widely recognised as the market equilibrium prices of the securities (See p. 58). One criterion for making a success of any capital market is that the stock exchange market should be considered for the mutual benefit of both investors and companies. It is widely recognised that the trend of share prices in the capital market can increase or decrease depending on supply and demand. If the demand for securities is larger than the supply of shares, the share prices tend to increase and, vice versa, if the supply of shares is larger than the demand the price of shares tends to decrease.

In developing countries such as Indonesia, however, this criterion apparently is not looked at closely. Consider the decreasing amount of initial stock prices for a sizeable proportion of share prices of company shares (Info Bank, October 1990). In September 1990, share prices of almost 40% of companies listed on the Indonesian capital market dropped below their initial prices. The role of the market as alternative financing for companies apparently cannot be expected. However, the Indonesian stock exchange market still survives. The following sections of this chapter discuss the role of the capital market in making equilibrium prices both in market efficiency and in market inefficiency.

6.1. CAPITAL MARKET EFFICIENCY

One theory of corporate reporting that discusses the usefulness of annual reports in the decision-making process is the market efficiency theory. Fama (1970, p. 383) stated that a
securities market is efficient if security "price fully reflect the available information". He classified the evidence on market efficiency into one of three categories, depending on the information set that is fully reflected in security prices. Those are: (a) weak form - the information set is the past sequence of security prices, (b) semi strong form - the information set is publicly available information and (c) strong form - the information set is all information including inside information. Foster (1986, p. 300) expressed this theory of market efficiency as follow:

\[ F(R_{i,t}, R_{j,t}, \ldots l, Q_{m,t-1}) = f(R_{i,t}, R_{j,t}, \ldots l, Q^a_{t-1}, Q^m_{t-1}) \]

where as:

- \( F(\ldots ) \) = a probability distribution function
- \( R_{i,t} \) = the return on security "i" in period "t"
- \( R_{j,t} \) = the return on security "j" in period of "t"
- \( Q^m_{t-1} \) = the information set used by the market t-1
- \( Q^a_{t-1} \) = the specific information item placed in the public domain at t-1

One of the problems that exists in the market efficiency theory is the problem of the empirical testing of this theory. Foster (1986, p. 313) states that there are some difficulties in empirical testing of this theory. One of these arises with respect to the specific information item placed in the public domain at t-1. One of these difficulties includes issues concerning who has access to it and when the specific information will be released. Further, Foster (1986, p. 303) stated that market information efficiency is best viewed as untested hypotheses. He stated that early theoretical discussion of market efficiency (for example Fama 1970), by-passed many problems that arise in empirical research by concentrating on an extreme set of conditions when discussing the specific information item placed in the public domain. He argued that there was the unambiguous prediction that when specific information is placed in the public domain, the capital market reaction will be instantaneously unbiased. Once these assumptions are relaxed, even defining specific information or the public domain becomes a difficult task.
There is now considerable awareness that testing the descriptive validity of the efficiency market model is a very difficult endeavour. Foster (1986, p. 315) argues that a major reason for this difficulty is that our existing analytical models of efficient markets do not map well into the institutional domain in which actual capital markets operate. These actual markets are characterised by the non-instantaneous availability of information, zero information costs and homogeneous expectations.

An extensive testing of the efficient market hypothesis by Foster (1986), in recent years has produced results which are generally consistent with those studies. Efficient market models based on a more realistic set of assumptions could well explain those empirical results. The implication of this evidence is that annual reports cannot be used by shareholders to make abnormal profits. Hines (1982) studied the usefulness of annual reports and market efficiency anomalies. She provided a rationalisation for the usefulness of annual reports. Firstly, annual report content is publicly available information, and as such it is impounded unbiasedly in market prices immediately it becomes available, thus eliminating the possibility of purchase or sale of shares based upon such information at a price which would yield an abnormal return. Secondly, even if this were not the case, its content has already been conveyed to the market by the more timely preliminary final report. Much of the information in this report can also be anticipated by the market from other information sources such as leakages, statements by corporate officials, releases issued by brokerage firms, releases issued by market news letter services etc. Williams and Findlay (1974, p. 371) also argue that by the time one reads some new information, it is also too late to profit from it. Accordingly, the investors will consider other information which is relevant to the investors' decisions. Adoption of active investment management styles is the only one way in which investors can be used in investment decisions.

6.2. THE MECHANISM BY WHICH EFFICIENCY IS ATTAINED.

There are major explanations offered in the academic literature concerning the mechanism by which market efficiency is attained, namely, competitive activities of security
analysts, the large number of security analysts, adequate disclosure of information and legal prohibitions against insider trading. These mechanisms are explained as follows:

(1) Competitive activities of security analysts. Security analysts are some of the external users of information in the capital market. A major function of security analyst is to serve investors with information about securities of companies. Each analyst seeks to detect misprised securities and to advise investors in portfolio securities with zero net investments but non zero expected returns. The competitive activities of security analysts in examining the information increases the likelihood that significant information items will be rapidly impounded into the current market share price.

(2) The large number of security analysts. A second explanation related to market efficiency is the law of the large number of securities. Each individual analyst can make mistakes of judgment concerning the share prices of companies. If these mistakes are independent across security analysts, there will be an efficient market. However, if there are no or little mistakes due to consensus among security analysts, the market will be inefficient. In other words, the larger the number of analysts and the lower the correlation between the mistakes of judgment made by the individual analysts, the more efficient will be the market.

(3) Adequate Disclosure of Information. In addition to these two explanations, several factors have been cited as important in affecting the degree of information efficiency. One of these is the adequate disclosure of information provided in financial reporting. Singhvi and Desai (1971, p. 136) stated that adequate disclosure of information minimises ignorance in the market and causes the market price to reflect the true value of the security. This factor is often presented by advocates of mandated regulatory bodies for increased disclosure by firms.

(4) Legal Prohibition Against Insider Trading. A second factor cited as important in influencing the degree of information efficiency is the legal prohibition against insider trading. There are some arguments that inside information will be more rapidly incorporated into the price if legal prohibitions are lifted. Kripe (1980, p. 20) for example, argued that if market
participants are legally restricted from using inside information, such information cannot be impound into the security prices. Furthermore, in the absence of differences in information conveyed to different investors, there will be no arbitrary opportunities and securities markets will necessarily be thin. Thus inhibitions on the use of inside information impair both the speed and accuracy of the market. However, Foster (1986, p. 303) argued that one factor not considered in those arguments is the incentives of the less informed outside parties to set up mechanisms to protect themselves when trading with insiders. He stated further that, in the limit, they could simply refuse to trade in markets known to have few restrictions against insider trading or limited policing of laws against such trading.

6.3. CAPITAL MARKET INEFFECTIVENESS

Another model of the capital market, that probably exists in the market is the capital market inefficiency model. This model is also an abstraction of reality in the capital market. Based on the description of capital market efficiency in previous sections, it is argued that an inefficient market probably exists in developing capital markets. Dawson (1984, p.153) noted that common explanations for the less frequent findings of market efficiency, in the less developed exchanges, included less stringent information disclosure requirements, less information released by companies and less rigorous accounting regulations.

Referring to those conditions, there are two specific investment approaches that explicitly or implicitly assume that substantial market information inefficiencies exist and can be exploited for investment purposes. These approaches are fundamental analysis and technical analysis. A fundamental analysis approach examines firm-industry and economy-related information. In this analysis financial statements play a major role. This approach assumes that each security has an intrinsic value that can be determined on the basis of such fundamental things as earnings, dividends, capital structure and growth potential. An analyst determines the intrinsic value on the basis of these fundamentals and compares this value with the current market prices to determine if the security is under or over valued. Many
researchers, such as Arnold and Moizer (1984), Chugh and Meador (1984) found that fundamental analysis is the primary approach used by security analysts.

On the other hand, technical analysis aims to detect misprised securities by examining trends in security prices, security trading volume and other related variables. In this analysis financial statements typically are not examined. This approach considers that there are systematic dependencies in security returns that can be exploited to yield abnormal returns. Trend analysis, relative strength analysis and random walk models are commonly used in this analysis. Fama (1965) used this model analysis to examine the daily returns for each of the 30 Dow Jones Industrial over the 1957 - 1962 period. Fama concluded that a random walk model provided a good approximation of the process generating daily security returns of Dow Jones stocks. This study was supported by Granger (1972) after a review of studies covering security returns in the UK, USA, Greece and Australia. Granger (1972, p. 478) concluded that the majority of the studies found the random walk hypothesis, in one form or another, to give at least an extremely good approximation of what-ever might be the truth.

Other researchers such as Keim (1983), and Gibbons and Hess (1981) found that there are seasonal security market returns that can also be exploited to yield an abnormal return. Keim (1983) reports that daily abnormal return distributions in January have large (positive) means relative to the remaining eleven months. Gibbon and Hess (1981) report that there are strong and persistent negative returns on Monday for stock. Patel and Wolfson (1984, p. 241) report that in consecutive price changes, reversal occur slightly more than twice as often as continuation. They note, however, that as the sampling interval increases, the reversal frequency decreases markedly; 56.8% of the one-hour price changes are reversals in comparison to only 50.5% of the three-hour price changes.

6.4. SUMMARY

(1) One theory in financial accounting that has been long recognised by researchers is the theory of capital market efficiency. This theory argues that a securities market is considered
efficient if securities prices fully reflect the available information

(2) This theory is considered a normative rather than a pragmatic prescription. Consequently, there are many problems with the empirical testing of this theory. Due to the difficulties of validity of the market efficiency theory, there is a need to consider another model of market efficiency theory which matches the real situation of the market. This consideration has been supported by Foster (1986) and others researching the anomalies of market efficiency.

(3) A mutual benefit is argued as the important consideration in developing a capital market. The essence of this mutual benefit exists in the initial offer of stock prices. If in any initial offering stage there is no expected future return, this indicates that there is no benefit to invest money in capital market.

(4) The large number of security analysts and competing activities between analysts, the legal prohibitions for insider trading and the requirements for adequate disclosure are some major factors which should be considered in developing market efficiency.
PART 3. THE SITUATIONAL CONTEXT OF THIS STUDY

CHAPTER SEVEN

THE NATURE OF THE POLITICAL-ECONOMIC SITUATION IN INDONESIA


The aim of this and the next chapter is to look closely at the issue of situationally determined roles. The first chapter, therefore, is concerned with the nature of the political-economic situation in this country. This chapter provide some pictures about the role of government in shaping the economic development. The second chapter is concerned with the socio-economic situation which is influenced by the political economic factor.

7.1. THE ROLE OF GOVERNMENT IN ECONOMIC DEVELOPMENT

The role of government policy in the process of economic development has become more and more appreciated. A good policy has been associated with the fast growth of the economy and with the ability to transform poor countries into prosperous ones. On the other hand, a bad policy results in economic stagnation and deterioration in the standard of living and can turn the country toward economic and political decay.
In the context of securities market development a country's economic policy plays a crucial role. Modigliani and Perotti (1991), for instance, argued that consistent policy and long-term macro-economic stability will enhance investors' confidence to do business in securities markets. Uncertainty of policies damages investors' confidence in committing themselves to a long-term investment in the market. In the development of a stock market, the market is also sensitive to monetary policies such as moderate inflation and reasonable interest rates. Good management of exchange rates, fully convertible currency and a free movement of capital will attract foreign investors and thus increase market liquidity. Fisher (1930) argued that the degree to which inflation affects a stock market is subject to dispute among economists. Furthermore, Fisher (1930) argued that the rate of return on common stock moves directly with the rate of inflation. This means that common stock could be effectively used as a hedge against inflation. However, some other studies such as by Nelson (1976) Cohn and Lessard (1981) found that stock does not always provide a hedge against inflation. The repercussion of such findings is that investors tend to reduce their financial exposure on the stock market during an inflationary period and divert most of their resources to other types of investment.

In the case of developing countries where inflation rates sometimes reach double or triple digits, it is most likely that such a situation inhibits the development of a stock market. Most of all, a high inflation rate wipes out the real value of fixed-price debt securities and discourages investors from putting their surplus into domestic denominated financial assets, including corporate stocks. Indeed, an inflationary economy, especially in the case of runaway or hyper-inflation, tends to tap the vitality of economic enterprises as a whole. Gillis (1985) argued that in a highly inflationary economy investors tend to put their savings in inflation-hedge assets such as gold, land and other valuable real properties or to send their surplus abroad.

The next important factor which must be considered in economic government policy is that of interest rates. McKinnon (1992) states that artificially low interest rates achieved under a financially repressed regime may hinder securities market development. For instance, lower interest rate charges on bank loans or credit subsidies encourage companies to rely on the
banking system for their capital needs instead of seeking capital through public offerings which demand tougher requirements such as public disclosure and potential dilution of management control.

On the other hand, if bank interest rates are determined by a market mechanism, the rates would be competitively high. In these circumstances companies may be forced to seek equity finance to balance their capital structure. Drake (1977) argues that if securities markets are to be developed to any worthwhile extent, government must abstain from interfering with interest rates, security prices and dividend yields. Those will be determined freely by the forces of supply and demand.

Allowing foreign participation also enhances the prospect of fast growth for the securities market. Such a policy could alleviate to some degree the constraints that usually hinders the development of the securities market in developing countries. Errunza (1977), for instance, suggests that stock markets in developing countries have great potential for attracting foreign portfolio investments as a pool of savings in developed countries which are looking for opportunities to invest abroad as parts of their global portfolio diversification. The Wall Street Journal (1992) indicates that the Mexican Stock Exchange in mid 1992 had a foreign portfolio investment amounting to US $25 billion.

Fiscal policy is another means that government uses in order to develop a securities market. If interest received from a bank deposit is subject to tax exemption while a dividend is subject to withholding tax, this will put the equities investment in a disadvantaged position. Unless the risk adjusted return from the equity market is high enough to offset the burden of the tax, there is no incentive for investors to engage in the market and thus the securities market development is stifled. On the other hand, a favourable tax treatment could be used as a powerful incentive to promote the development of a securities market. Many types of tax incentives could be used both to stimulate supply and to attract demand for securities. For instance, lower rates of corporate tax for public companies and not for privately held
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supply of equities. This policy is productive in the context of developing countries for at least one reason. The tax administration in developing countries such as Indonesia according to Gray (1991) is generally so inefficient that it allows companies not to pay tax according to the law. Thus, although listed companies pay a lower rate of tax, the government is compensated by the advantages of disclosure which reduce the likelihood of tax evasion.

Tax exemption on capital gains and dividends as well as a tax credit for individuals and companies who invest in securities of publicly held firms could also make securities more attractive. Several countries have used this kind of tax incentive to promote their capital markets. Walter (1974) reported that the Brazilian government used a broad range of tax incentives to promote its capital markets. This effort resulted in the fast growth of the Brazilian equities market in the 1960s and the 1970s, ahead of many other developing countries. Shin (1983) also reported that Korea used the same policy in the 1960s to promote the development of its equity market.

However, Wai and Patrick (1971) warn that using a tax incentive as a means to promote the market requires a careful cost-benefit analysis. Otherwise, it may be too expensive for the society to bear the cost and may even lead to a waste of resources. Specifically, the opportunity costs of foregone tax income may exceed the benefit derived from the securities market.

7.2. AN OVERVIEW OF THE POLITICAL-ECONOMIC POLICIES IN INDONESIA

By the mid 1960's, when Sukarno was the president of the country, the Indonesian economy was in its worst condition ever. Gillis (1984) described the inflation rate at that time at over 600 percent per year, investment stagnated due to lack of savings, domestic output growth was negative in per capita terms, and the infrastructure deteriorated. Under the new regime of President Suharto, the first priority was the restoration of economic stability and the initiation of a systematic economic development program. The new government pursued a totally different approach in economic management. Under the old regime, the government
strongly adopted self sustaining policies. The nationalistic approach and massive government interventions in the economy as practiced by the old regime, were largely abandoned. That massive government intervention in the economy prior to 1966 was perceived as the source of problems that stifled the initiative of private entrepreneurs in all sectors of the economy.

In the early years, the New Order government had a strong faith in the role of the private sector and a more liberal economic system. This included a willingness to develop the country with foreign aid capital which previously was either prohibited or tightly regulated. Gillis and Dapice (1988) stated that since Suharto came to power, the Indonesian government has liberally utilised all forms of foreign capital such as foreign aid, direct foreign investment. Accordingly, since 1973, such foreign commercial borrowing supports the development economy in Indonesia.

The open door policy, however, was not well accepted by some segments of the population. By the early 1970s, critics began to argue that foreign policy had benefited only a small number of people. Kuntjoro Jakti (1981) noted that the benefit of economic development during the New Order has been unevenly distributed. The Chinese Indonesians (non-pribumi) gained more benefit than the indigenous people (pribumi). Most of the domestic investments under the Domestic Investment Law or Penanaman Modal Dalam Negeri (PMDN) law, which received tax facilities and credit priority at subsidised interest rates from the state bank, belong to the Chinese Indonesians. Under the old regime the Chinese did not have the opportunity of acting as an agent of development in economic activities. They were suspected of what previously the Dutch and Japanese had done in Indonesia.

The issue of economic inequalities between nonpribumi and pribumi grew intensely and became a severe political pressure on the new government. This culminated in early 1974 with the outbreak of a violent demonstration against foreign investment. Originally this was a student demonstration to protest against foreign investment policy during the official visit of Japanese Prime Minister to Jakarta. The demonstration was then joined by tens of thousands of Jakarta’s inhabitants which turned into a destructive mob. Japanese-made cars were attacked
and burned. A shopping centre complex was set on fire and more than a dozen people were killed.

Robinson (1986) noted that this demonstration was part of a power struggle among the competing political elite and related to the strategy of economic development. In particular, it was a competition between the President's advisers who consisted of two groups of people which, for the sake of simplicity, will be called the economist technocrats and the nationalist bureaucrats. The economist technocrats, primarily western-trained economists, proposed a rational economic policy based on the principle of comparative advantage. They preferred a free market mechanism, an open door policy and minimum government intervention as strategies in promoting economic growth. The nationalist group consisting of several army generals, some intellectuals and bureaucrats raised into power through the bureaucracy, perceived that the open door and free market policies would do more harm than good to the country. They proposed instead that the Indonesian economy be developed based on a state-led industrial policy with heavy government intervention.

Many observers have analysed the dynamics of economic policy making in Indonesia within the framework of this power struggle. The observers assumed that the President would stand in the middle of these two groups. When the resources were plentiful and the economy doing well the nationalist bureaucrats gained more influence with the President and therefore the policy became more interventionist. When the resources were scarce and the economy turned downwards the President would listen to the advice of the technocrats. Due to the severe political ramifications of the Malari affair, and to dampen criticisms against foreign investment policy, on 24 January 1974 the Council for National Stabilisation led by president Suharto made a major change to credit and investment policy which increased the economic role of Indigenous Indonesians. As far as investment policy was concerned, the council decided that all new foreign investments had to form a joint-venture with Indonesian partners and, after ten years of operation, the foreign-owned companies were required to transfer their majority shares to Indonesian nationals.
The foreign firms subjected to these requirements could choose either to transfer their majority shares through private placement, (generally to offer the shares to their domestic partners), or transfer them via public offerings. However, to provide some guarantee that the transferred shares would really benefit to the indigenous people, the government preferred the foreign owned companies to transfer their equities through public offerings. With the “offer to the public” plan, the government, with regulation and intervention, expected to influence the allocation of shares to the advantage of indigenous people. For that purpose the government reactivated the capital market and created a national investment trust, PT Danareksa, to represent the interests of indigenous people in the market.

Table 7.2.1
Trend of Exports and Imports 1957-1993
(million US $)

Please see print copy for image

As indicated in Table 7.2.1, during the 1970s and early 1980s, Indonesia was in a favourable economic state. A substantial benefit resulted, especially from the increase in oil prices in 1973 and 1979. The price of Indonesian oil jumped from less than US $4 a barrel in early 1973 to US $26 in December 1979 and then reached a peak of about $35 in 1981. With this oil boom Indonesia enjoyed a substantial increase in both foreign exchange revenues and budgetary income. The value of oil and gas exports rose from US $965 million in 1972/1973 to US $18,824 million in the 1981/1982 budget year.

As a result of these conditions, the economic policy leaned more toward nationalistic ideas, and the nationalist voices within the bureaucracy carried more weight in the policy-making process. Thus, the relatively liberal economic policy adopted by Suharto's government in its early years of power began to lose its supporters within the administration. Instead, a protective, discriminatory and nationalistic biased policy grew more dominant. The state became more and more involved in the economy. Shin (1989) distinguished state involvement into three forms: the state as a producer of economic goods, the state as a regulator of economic activities and the state as a patronage source for development of pseudo private sector or bureaucratic capitalism. Most domestic investments during this period were carried out by the state and the role of state owned enterprises in the economy became more dominant than previously. Shin (1989) stated that, during the 1970s, the role of the state as a producer of economic goods had increased very rapidly from 13.5 percent of Gross Domestic Product (GDP) in 1968 to 40.9 percent in 1983.

During this period, investment policy also became more restrictive and discriminatory. Certain sectors of the economy were closed to new investment. In other sectors of the economy where new investments were still permitted, a preference was given to indigenous people or other domestic investors. However, the latter had more opportunities. In 1976, the Investment Coordinating Board or Badan Koordinasi Penanaman Modal (BKPM) for the first time issued a list of investment priorities which itemised and categorised about a thousand industries in each of which certain investors were simply disallowed, allowed or encouraged to invest. The list also specified conditions attached to allowable investments, including the type
of production, permitted location, requirements for domestic participation (for foreign investment), relevant taxes and other incentives.

The oil boom apparently has had far reaching effects on the Indonesian economy, because it not only provided much of the capital needed but also put the state into a dominant position economically. The main issue at that time was not how to generate enough capital, but rather how to allocate this additional money to speed up economic development and to achieve other non-economic objectives. Two policies were set up by the government. Firstly, to allocate the additional money to beneficial investment and secondly, to open the stock market as a tool for mobilisation of that money.

During this period the government, via monetary policy, provided a credit liquidity policy and a credit ceiling policy. Credit liquidity is a policy in which government indirectly subsidised credits into sectors of the economy that receive high priority within the state's industrial policy. The government set a detailed list of businesses and industries that are regarded as having high priority. The higher the priority of certain businesses in the government's list, the more favourable the terms of loans they were able to receive from state banks. The Central Bank (Bank Indonesia) provided finance or credit liquidity to state banks in order to expand the government program in financing to those targeted sectors. The role of the banking system at that time was more an extension of the bureaucracy that distributed credits to designated targets rather than purely that of mobilise and allocation of capital within the economy.

The credit ceiling policy, on the other hand, is a scheme wherein the monetary authority sets a maximum amount of credit by which the banking system may expand within a year. The total amount is then distributed to individual banks according to a formula, based mainly on the bank's performance in the past and its plans for the forthcoming year. A bank that expanded credit beyond the ceiling was subjected to a fine from the central bank. This policy was directed to prevent excessive domestic monetary growth from banking activities.
Under such circumstances, the government also reopened the stock exchange market in 1977 for mobilisation of the money. Unfortunately, when the market began to expand in 1982-1983, the oil prices started to decline. Therefore, the government did not succeed in supporting the capital market development, especially in order to support the ability to finance the indigenous program and to provide generous tax incentives for companies that wanted to go public.

In addition to a decline in oil prices, the recession in the world economy which started in the early of 1980s also negatively affected the prices of Indonesian primary export commodities and, in turn, weakened the country's foreign exchange earnings. Compared to the fiscal year 1984, by the end of 1986 the price of palm oil, for instance, decreased by 66 percent, tea by 45 percent and tin by 46 percent. The index of 33 Indonesian non-oil commodities, based on the data from Bank Indonesia as reported by Tempo in 20 December 1986 declined from 100 in 1984 to 83 in 1987.

Furthermore, the depreciation of the US dollar vis-à-vis other major international currencies starting in the mid 1980s also hurt Indonesia. This is because a substantial part of the Indonesian foreign debt was dominated by currencies other than the US dollar. By 1988 the Indonesian debt in US dollars was only 37 percent, the rest consisting of other currencies that appreciated vis-à-vis the US dollar. The degree of appreciation, based on a World Bank report of May 1989 about Indonesia (Strategy for Growth and Structural Change) was substantial. From 1985 to the end of 1987 the Japanese Yen appreciated about 51 percent. The German Deutsche Mark, the Dutch Guilder and the French Franc which dominated the Indonesian debt also appreciated up to 48, 49 and 41 percent respectively. As a result of those appreciations the total Indonesian debt in dollar terms increased dramatically and caused the burden of debt service payment to become heavier.

By the end of 1988 those appreciations inflated external debt by 12.6 billion dollars or about 31 percent of total debt. The overall impact of these external shocks to the Indonesian economy was enormous. According to the World Bank report of 1989, the loss of income to
Indonesia during 1983-1988 on the average was 9.3 percent of GNP equivalent per year. This massive income loss has not only widened the balance of payment deficit, and dried up oil-based tax inflows to government funding, but has also threatened the very foundations of the Indonesian economy. Due to decreasing public revenues combined with the increasing burden of debt repayment, those conditions substantially weakened the government's financial capability. The capacity of the state to be directly involved in the economy was impaired by the significant decline in government savings. In 1981 the government saving was 10.4 percent of the Gross Domestic Product (GDP), 8.8 percent in 1986 and 7.4 percent in 1989. Therefore, the general model of economic development that was adopted since the mid 1970s, characterised by the massive government interventions and centrally-directed industrial policy in order to achieve a nationally-oriented import substitution industry, became unsustainable.

Realising the magnitude of the potential economic crisis, the government beginning in 1983, undertook several adjustment policies to put the economy back on a sound footing. Those adjustments have been intensified since the collapse of oil prices in 1986. To overcome severe budget and balance of payment deficits, austerity programs were implemented. The programs included reducing government spending and demand for imports via devaluations and other measures such as cancelling many government-sponsored capital intensive projects in May 1983. According to the World Bank report of 1984, this strategy saved foreign exchange of more than US $10 billion. The government also cut its capital spending, and froze civil service employment and salaries for three years from 1986.

In March 1983 the rupiah was devalued by 28 percent from Rp 690 to Rp 950 per US $1. Since then the exchange rate has been flexibly-managed to keep the value of the rupiah from overvaluation. However, in 1986 the rupiah was again devalued about 31 percent from Rp1,125 to Rp 1,620 per US $1. This last effort was intended to give more incentive for non-oil exports. By lowering the value of the rupiah, Indonesian goods became more competitive in international markets. Further, a new tax law enhanced non-oil tax collection and was put into the effect in 1984.
The objectives of those adjustment programs were two fold. In the short term they aimed to restore financial stability and in the long run to diversify the economy away from heavy dependence on oil. As the World Bank reported (May 1989), the key elements of this structural adjustment program included a range of measures to strengthen domestic resource mobilisation, to expand non-oil exports and to promote a more competitive and dynamic non-oil economy.

7.3. THE DEVELOPMENT OF INVESTMENT POLICIES IN INDONESIA

Investment constitutes a major element in the economic development of a country. In order to achieve economic growth at a desired rate, a certain amount of investment is required, which is financed by domestic and foreign investment. Domestic investment comes through the national savings generated by domestic investors in this country. When-ever the national savings at the disposal of the country are insufficient, government policy tends to open possibilities for foreign investors to invest their money. Competition between developing countries in an attempt to draw foreign capital is becoming increasingly intense in 1990s. China is trying to attract as many investors as possible, followed by Vietnam which is very aggressive in seeking foreign capital.

The main motive for the government inviting foreign capital to Indonesia is to tap the potential of the natural and human resources of the country so as to strengthen the national economy. Such policies are closely connected with a process of industrialisation in this country. The process of industrialisation is expected to develop along with the process of the transfer of technology, the transfer of ownership, expansion of job opportunities, and be accompanied by the enhancement of expertise and skills. However, domination of the national economy by foreign capital is supposed to be avoided.

Foreign capital is capital that is invested in other countries for the exploitation of natural resources with the motive of profit making. Kojima (1981) divided this motive into four types, namely: (1). Natural resources oriented foreign investments; (2). Labour foreign
Investment Decisions and the Puzzle of Share Price Movements

Investments; (3) Market oriented foreign investment; (4). Oligopolistic market oriented foreign investments. The first and second types are obviously trade oriented, the third type is oriented to trade if import substitution shifts smoothly to export orientation, and the fourth is anti trade in nature. All the above types describe the motivation of foreign investment or Penanaman Modal Asing (PMA) operations in other countries for their market expansion.

7.3.1. Foreign Investment Policies.

Foreign investment can be directly considered as a source of capital in the economic development of a country. All nations following the open economic system generally need foreign investment (PMA), particularly the companies producing goods and services for export. Even in advanced countries such as the US, PMA remain important to stimulate economic growth, avoid market sluggishness and create job opportunities. Naturally, in developing countries like Indonesia, PMA are needed owing to insufficient investments at home. For this purpose, various PMA policies have been pursued by the government to encourage foreign investor operations in Indonesia. Such policies refer to the Law No. 1/1967 on PMA and the Law No. 11/1970 which amended and supplemented the Law No.1/1967. Since 1 June 1983 the law was enacted with a series of policy packages within the framework of deregulation. The law was supposedly to attract foreign capital for economics development in Indonesia.

When Law No. 1/1967 first came into force, foreign investors were only interested in the natural resources sectors like fishery, forestry and mining. In 1967 only two Japanese companies were licensed to operate a fishery, viz. PT Maluku Pearls Development and PT Toyo Fishing Industry Co. In the following year nine companies were licensed, six of which operated in the exploitation of natural resources. In 1969 seven others were engaged in the same operation. In the three-year period, only 13 companies were engaged in manufacturing industry.
In terms of value, foreign investments approved in 1967 reached US$207 million. In the following years the figures indicating PMA value varied but they generally were below US$ 1 billion up to 1981. Some people argued that the few number of foreign investments in this country was due to the political incidents at home country like the Malari student rioting in 1974. On the other hand, the political and economic upheavals overseas also influenced PMA fluctuations in Indonesia.

In 1989, there were 256 new PMA projects approved. In terms of money these PMA were valued at 4,718.80 million rupiahs. Compared with the new PMA approved in 1990, the new PMA increased by nearly 100%. In 1991, the value of the new investment was relatively stable. However, in 1992, the investment increased by almost 50%. The sharp increase existed because of the government continued to implement its deregulation policies, such as Pakjan (Policy package of 15 January), Pakjun (of 12 June) and Pakdes (of 24 December) 1987. They were intended to create a conducive business climate for private capital investment activities by simplifying licensing procedures.

In term of units, in 1990, the new PMA projects approved by the government reached their peak of 432 units, but in the following year the total declined to 376, and further to 294 in 1992 and 292 in 1993. But the decrease was not so marked because the number of foreign investments in the past two years remained high enough compared with the 1990 period. The PMA record in 1990 and the big figures in the following years were closely related to the previous government's policy packages. They were Pakto (policy package of 27 October) and Pakdes (of 20 December) 1988, the later presidential Decree No.53 and the Decision of the Chairman of BKPM no. 16/1989. The above policies sufficiently contributed to the creation of a conducive business climate to attract foreign capital to Indonesia.
Table 7.3.1
Approved Foreign Investment Projects by Field of Activity
(million of $)

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</thead>
<tbody>
<tr>
<td>1. Agriculture, forestry and</td>
<td>173,10</td>
<td>191,60</td>
<td>26,00</td>
<td>231,40</td>
<td>160,10</td>
</tr>
<tr>
<td>fishery</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Agriculture</td>
<td>121,70</td>
<td>169,70</td>
<td>14,30</td>
<td>65,90</td>
<td>138,20</td>
</tr>
<tr>
<td>- Forestry</td>
<td>4,40</td>
<td>2,40</td>
<td>0,70</td>
<td>137,60</td>
<td>0,00</td>
</tr>
<tr>
<td>- Fishery</td>
<td>47,00</td>
<td>19,50</td>
<td>11,00</td>
<td>27,90</td>
<td>21,90</td>
</tr>
<tr>
<td>2. Mining</td>
<td>0,00</td>
<td>115,00</td>
<td>0,00</td>
<td>2,312,00</td>
<td>0,00</td>
</tr>
<tr>
<td>3. Industry</td>
<td>4,246,10</td>
<td>5,646,90</td>
<td>3,970,50</td>
<td>5,669,50</td>
<td>3,422,80</td>
</tr>
<tr>
<td>- Foodstuffs</td>
<td>222,90</td>
<td>98,90</td>
<td>381,90</td>
<td>212,80</td>
<td>141,10</td>
</tr>
<tr>
<td>- Textiles</td>
<td>581,10</td>
<td>1,094,20</td>
<td>532,30</td>
<td>591,30</td>
<td>419,40</td>
</tr>
<tr>
<td>- Wood and Products</td>
<td>105,90</td>
<td>217,60</td>
<td>62,20</td>
<td>33,50</td>
<td>50,50</td>
</tr>
<tr>
<td>- Paper</td>
<td>211,40</td>
<td>730,20</td>
<td>822,10</td>
<td>666,40</td>
<td>201,60</td>
</tr>
<tr>
<td>- Chemical, pharmacy</td>
<td>2,512,40</td>
<td>1,968,00</td>
<td>925,50</td>
<td>2,342,60</td>
<td>1,182,80</td>
</tr>
<tr>
<td>- Non-metal minerals</td>
<td>183,90</td>
<td>124,80</td>
<td>133,40</td>
<td>841,20</td>
<td>97,80</td>
</tr>
<tr>
<td>- Basic Metals</td>
<td>105,70</td>
<td>824,50</td>
<td>197,20</td>
<td>46,60</td>
<td>185,90</td>
</tr>
<tr>
<td>- Metal Products</td>
<td>292,30</td>
<td>460,10</td>
<td>856,20</td>
<td>862,80</td>
<td>1,114,00</td>
</tr>
<tr>
<td>- Others</td>
<td>30,50</td>
<td>98,60</td>
<td>59,70</td>
<td>52,30</td>
<td>30,00</td>
</tr>
<tr>
<td>4. Construction</td>
<td>15,90</td>
<td>76,80</td>
<td>26,40</td>
<td>41,20</td>
<td>96,90</td>
</tr>
<tr>
<td>5. Hotels</td>
<td>97,80</td>
<td>874,40</td>
<td>4,018,90</td>
<td>919,20</td>
<td>394,40</td>
</tr>
<tr>
<td>6. Transportation</td>
<td>4,50</td>
<td>803,00</td>
<td>166,80</td>
<td>14,20</td>
<td>85,40</td>
</tr>
<tr>
<td>7. Housing and Offices</td>
<td>66,60</td>
<td>901,70</td>
<td>402,70</td>
<td>715,80</td>
<td>598,00</td>
</tr>
<tr>
<td>8. Others Service</td>
<td>114,80</td>
<td>140,20</td>
<td>166,90</td>
<td>419,90</td>
<td>3,386,60</td>
</tr>
<tr>
<td>TOTAL</td>
<td>4,718,80</td>
<td>8,750,10</td>
<td>8,778,20</td>
<td>10,323,20</td>
<td>8,144,20</td>
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</table>

Source: BPS various issues

As indicated in Table 7.3.1 and Table 7.3.2, up to 1993, the cumulative total of foreign investments (PMA) approved by the government reached $US8,144.20 million, while domestic investments (PMDN) totaled 39,450.40 billion rupiahs. The increased foreign investment in Indonesia, according to the government, was due to external factors such as the economic growth in advanced countries and the competition posed by other PMA recipient countries, as well as internal factors like the domestic political situation and the government policies related to the investment opportunities. At present, Japan is the biggest foreign investor in Indonesia, followed by Hongkong, Taiwan, Singapore and the US.
From the viewpoint of investment-originating countries, Japan occupied first place in both total projects and the value of investments. Up to 1993, Japan's investments amounted to US$14.3 billion or over one fifth of total foreign investments in the country. It was followed by Hongkong, Taiwan, Singapore, the US, South Korea and Britain. The interesting aspect is that investments from four "Asian Tigers" (Hongkong, Taiwan, South Korea and Singapore) increased very sharply during the 1980s and early 1990s. The four combined contributed more than a quarter of Japan's investment value.

Up to the present, foreign investments have generally operated in the chemical, construction and non oil mining sectors. Nevertheless, lots of PMA have also been engaged in the textile, paper, base metal, metal goods and office equipment industries. It means that their activities are mostly in the import substitution sector to meet domestic market demand and also in the production of commodities for exports. Investments in agribusiness are now apparently less popular in the eyes of foreign investors than those in the manufacturing industry.

Japan is the only country with investments worth above US$10 billion, while the other countries generally register less than US$5 billion, the US's investment is only US$3.7 billion. Since early in the 1970s, Japanese investments have shifted from natural resources exploitation to industrial operations, particularly textiles, chemical/pharmaceutical industries and the metal and construction industries. Japan's concentration on the manufacturing industry is maintained up to the present and will continue.

Jakarta is the centre of all kinds of operations from government to economic activities, so that the capital city has quite a heavy burden in rendering service to all business affairs in its region. Its facilities and infrastructures are relatively adequate, thus prompting many domestic and foreign entrepreneurs to operate only in Jakarta. The main motive of businessmen for investing their capital in Jakarta is a rational
calculation, owing to its proximity to the hubs of activities described above. This fact has had a positive impact on the economy of Jakarta but nationally it has also produced a negative impact, because it has widened the socio-economic gap with other regions, particularly those provinces outside Java. Various policies to stimulate investors to make investments especially in Eastern Indonesian territories have been introduced by the government, but businessmen apparently still prefer to invest their capital in Java.

Information or data on PMA since the enforcement of the PMA Law of 1987 have shown that in the five-Pelita (five-year development) period PMA projects approved in Jakarta totaled 683 or around 28% of national figures while their value reached US$5.1 billion or 15% of total investments. The data indicate that, during the period of PJPT I (the first long term development), most foreign investors preferred Jakarta for their operations but, due to limited land and political pressure regions close to and sharing borders with Jakarta were chosen, viz. West Jawa (Botabek i.e. the Bogor, Tangerang and Bekasi regions),

Jakarta's position in attracting foreign investors since the enforcement of the PMA Law of 1967 has been very significant because during Pelita I over 37 percent of PMA projects were located in Jakarta, more than in West Java and 25 other provinces combined. Thereafter, PMA projects in Jakarta relatively declined in number and investment value. But in general the decrease was not so significant because nominally there was still an increase. It means that the new PMA increase outside Jakarta has been faster than that within the capital. One possible reason is the fairly flexible government policy of encouraging foreign investment outside Jakarta through different incentives and facilities.

In the five-Pelita term, the number of new PMA projects in West Java reached 924 or 38% of the total in the period, with over US$12 billion worth of investments or about 35% of total PMA value. These projects were centred in the Botabek territory,
where facilities and infrastructures are relatively better owing to the considerable support of the Jakarta regional administration. Their choice of West Java was solely based on rational economic considerations so that the Jakarta regional apparatus has now been prompted to continue to create a climate conducive to new and expanding projects of PMA in the city.

Meanwhile, new PMA in the other 25 provinces during the five-Pelita term numbered 810 units or one third of the total in the period, valued at US$17.6 billion or half of the total foreign investments in Indonesia. The projects in the 25 regions were still less in number than those in West Java, but more than the total in Jakarta; yet the investment value was greater than that in West Java. Both the number and value of projects in the 25 regions in the same term constituted one third of the total expansion, almost equal to the figures registered by Jakarta and West Java. This reality indicates that the map of PMA in Indonesia is made up of three parts, namely Jakarta, West Java, and the other 25 provinces combined.

This fact gives reason for concern because of the fairly striking disparity between provinces resulting from foreign investors' preference to operate in regions close to markets, centre of bureaucracy and human resources. On the other hand, regions a long way from Jakarta, especially those in the Eastern Indonesian zone, which in fact are in bad need of foreign investors' support, are less appealing for investments owing to various factors. Viewed from the point of PMA expansion projects approved, i.e. the expansion of foreign investments already set up in previous years, there were 290 units worth US$6.2 billion in Jakarta in the five-Pelita term. West Java meanwhile registered 413 projects and the other 25 provinces 331 projects, with investments worth respectively US$4.8 billion and US$5.8 billion.

Of the many foreign investors operating in Jakarta, some apparently deemed it necessary to expand their business activities. In 1991 they applied for the expansion of their investments and were approved by the government at a value of US$3.6 billion.
Of this amount, a fairly dominant portion involved expansion in the hotel business sector. The PMA expansion approved also included the metal goods industry. The other fields proposed for expansion were the chemical, construction and textile industries.

The above illustration is interesting in analysing the possible causes of foreign investors' interest in expanding their business operations. One reason may be that the PMA expansion in Jakarta has been based on the decision to strengthen their existing business position. In addition, there has also been a rise in the proportion of new PMA investments and expansion in Jakarta. Japanese entrepreneurs, for instance, through existing companies, have continued to seek domination of certain sectors by increasing capital.

7.3.2. Domestic Investment Policies

For several years, the Indonesian economic situation has been marked by a continuous decline in people's buying power and the conspicuously growing differences in living standards. Such a distressing situation should not be allowed to continue. In halting the economic situation and in accomplishing economic development, the government issued a series of policies related to investment. These policies, according to basic Indonesian development principles, should be based upon the capability and capacity of the Indonesian people themselves. Yet these principles must not give rise to a reluctance to utilise the money and the skills of foreigners, as long as the foreigners are truly devoted to serving the economic interest of Indonesia without creating a dependence on foreign countries.

Based on this rational and realistic starting point, the government of Indonesia for the first time issued Law No.6 of 1968 concerning domestic investment. Like Law no.1 of 1967, Law No. 6 of 1968 granted exemptions/ concessions on taxes and other facilities to investors who wished to invest their capital in Indonesia. This Law was
amended on 7 August 1970 by Law No. 12 of 1970. In order to carry out government policies in the field of investment, the Chairman of the Investment Coordinating Board deemed it necessary to issue regulations concerning the application procedures of investment. By a decision of the Chairman, No. 1 of 1977 was simplified by No. 10/SK/1985 on 25 April 1985. This policy was in conformity with other policies relating to the debureaucratisation in this country.

Table 7.3.2
Approved Domestic Investment Projects by Field of Activity
(Billions of Rupiah)

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<tbody>
<tr>
<td>1. Agriculture, forestry and fishery</td>
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<td></td>
</tr>
<tr>
<td>- Agriculture</td>
<td>3,667.60</td>
<td>9,403.90</td>
<td>4,939.80</td>
<td>2,465.00</td>
<td>3,092.50</td>
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<td>178.70</td>
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<td>147.10</td>
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<td>1,487.10</td>
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<td>12,612.00</td>
<td>3,647.90</td>
<td>2,538.90</td>
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<td>773.10</td>
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<td>5,639.90</td>
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<td>8,534.50</td>
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<td>146.10</td>
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<td>4. Construction</td>
<td></td>
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<td>5. Hotels</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Transportation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Housing and Offices</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Others Service</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>TOTAL</td>
<td>19,583.90</td>
<td>59,878.30</td>
<td>41,084.80</td>
<td>29,341.62</td>
<td>39,450.40</td>
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</tbody>
</table>

Source: BPS various issues

After the issue of Law No. 6/1968 and the decision of the Chairman of the Investment Board in April 1985, investment in Indonesia showed much progress. In 1968 there were 26 investment projects approved by the Government. This approval increased sharply from 1970 to 1990. As indicated in Table 7.3.2, from the beginning of
1991 to 1993 the number of investments approved by the government declined. A prudent-conservative investment policy was taken by the government due to the economic overheating by the last December of 1990.

7.4. THE DEVELOPMENT OF FISCAL POLICIES

As discussed in previous sections, tax policy had been widely used to encourage firms to go public. Those incentives had indeed been perceived by the corporate community as the only advantage in listing on the stock market. However, in 1984 a new tax law was enacted, replacing the old tax code that was inherited from the Dutch colonial government. A series of new tax laws that were enacted in 1984 were: (1) Law No. 6, 1983 on the General Principle and Procedures of Taxation. (2) Law No. 7, 1983 on Income Tax. (3) Law No. 8, 1983 on Value Added Tax and Sales Tax on Luxury Goods.

Those Laws were supplemented by an array of implementing regulations consisting of Government Regulations, Presidential Decrees and Minister of Finance Decrees. The immediate goal of these new laws was to enhance the mobilisation of public domestic resources, especially in increasing tax collection from the non-oil sectors to compensate for the substantial loss of government income from the oil sector because of declining oil prices in the international market. In the long-term, this law was intended to provide the country with a fair, simple and effective tax law based on modern principles of taxation.

Before the enactment of the new tax law, the government's tax revenue from the non-oil sectors had been nominal. According to the World Bank report of 1990, in 1983 revenue from non-oil taxes was only equivalent to 7.1 percent of GDP, the lowest among ASEAN countries. In the same year, Malaysia was 19.7 percent, Thailand 14.6 percent and the Philippines 10.4 percent. In 1988, the non-oil tax revenues in Indonesia had increased to 10.1 percent of GDP.
Because of the slim revenue from the oil sector, the government could not afford to subsidise the stock exchange any more. Based on Law No. 7, 1983, tax incentives that had been generously granted to listed firms were cancelled until the end of 1984. Therefore, after 1984, all firms that operated in Indonesia, regardless of their status, were subjected to a uniform rate of tax. The new law simplified tax administration by removing most types of tax incentives that were provided under the old law. However, the law also reduced the maximum rate of income tax from 45 to 35 percent.

By this tax incentive the government encouraged firms to go public. In 1983 there were 23 companies that went public. By 1984 the companies to go public totalled 24. The only firm listed on the capital market was PT Prodenta Indonesia, a subsidiary of a Dutch Company. This firm actually had prepared to go public for a long time but was unable to list its shares in 1983. After that, no more companies came on to the market until 1989. Some analysts argue that this is because, in 1984, the government granted tax relief for interest income from savings deposits by postponing the implementation of the provison of the new tax that stated interest to be taxable income.

The cancellation of tax incentives made the exchange uncompetitive from a corporate standpoint. Government policy in the same year exempted interest on bank deposits from income tax while imposing witholding tax on dividend income. With this policy, the government made investment in securities unattractive from an investors point of view. Thus, in 1984 the government had not only removed tax incentives that had encouraged firms to go public, but also imposed a substantial tax disincentives that hindered further development of the securities market.

As mentioned in previous paragraphs, since 1984 the government imposed a different tax treatment on dividend income and interest income. Dividend income was subjected to 15 percent witholding tax while interest income was subjected to tax exemption. This condition made the investment in listed equities less attractive to those of savings deposits. In October 1988, the government reversed this policy. A 15 percent witholding tax was assessed on
income from savings deposits, except on small scale deposits such as a savings plan that is sponsored by the Central Bank and generally used by small depositors; and a saving plan run by a rural banking network and generally used by small savers in rural area. These forms of saving were recognised as Tabungan Nasional (TABANAS) and Simpanan Pedesaan (SIMPEDES). By imposing withholding tax on interest income, the tax bias against equity investment was removed. This created a level of competition between savings deposits and equity investment as far as withholding tax was concerned. Furthermore, based on Peraturan Pemerintah (PP) No. 33, 1993, the government also imposed withholding tax on interest income and dividends from securities activities. Article 13 in this PP stated that bond interest and dividends earned from securities activities in capital markets were subject to tax exemption. This article provided the maximum income that was to be excluded from this kind of tax. This was a refinement of PP No. 7, 1991.

In order to collect more tax revenue, the government issued Peraturan Pemerintah (PP) or Act No. 28, 1988. In this PP the object of value added tax was extended to other objects. By this PP, imported goods and the rendering of goods by producers and primary agents were extended to whole salers. In services activities, the government extended its tax roles from tax for building constructions to almost all service activities rendered by the companies. These decrees were enacted on 1 April 1989. Besides the extension of the tax object, the government issued PP No. 29, 1988 related to tariffs. In PP no. 29, the tariff for goods and services was adjusted with a view to the current economic conditions in Indonesia. This PP was enacted on 15 January 1989. In order to complement these PP’s, the government, based on President Decree No. 56, 1988, ordered all government departments to become the tax collection agencies for any activities related to the government. This decree was also amended by the Decree of the Minister of Finance No. 301/KMK.04/1989.

Furthermore, in order to motivate gas and oil exploration activities, the government issued Ministry of Finance Decree No. 572/KMK.01/1989, relating to Deferred Tax Payments on Value Added Tax with relation to the rendering of services during exploration for mineral, oil and gas resources. With regard to this decree, the government provided a deferred tax
payment to the value added taxes for gas and mineral exploration companies until they had economically productive activities.

In order to provide a competitive advantage to the development of the vehicle industries in this country, the government provided tax and procedures facilities in order to tap the local content in this country. For this reason, the government issued PP No. 36, 1993 as refining PP No. 22, 1985 and other PP's which were refined by PP No. 76, 1991. In the new PP, the government provided lower tariffs for the producers using more local content than others, and also for local products in preference to imported products, except those for public use. Furthermore, in order to stimulate investment and increase the export of non-oil products, the government issued Presidential Decree no. 53, 1993. This decree provided, tax facilities and leniency procedures for importing products for export purposes. This decree was then refined by Presidential Decree No. 95, 1993.

7.5 THE DEVELOPMENT OF MONETARY POLICIES

During the 1970s and early 1980s the government of Indonesia was extensively involved in economics especially in intervention in financial markets. This involvement was intended to support various sectors of the economy that were considered high priorities within the government's industrial policy. In 1981, for instance, the Central Bank of Indonesia (Bank Indonesia) reported that the government provided concessionaire loans for 21 sectors of the economy which covered a wide range of economic activities. These included the production of food, cement, textiles, and paper; the promotion of tourism; printing and publishing businesses; and the production of export goods. The annual interest rates charged on those loans ranged between 9 and 15 percent, while the interest rates for non-priority credit were between 21 and 22 percent. The availability of this concessionaire credit substantially reduced business demand for capital from other sources, including the securities markets.

In addition, the funds that were provided to priority sectors might have also spilled-over to non-priority sectors, thus reducing the overall demand for capital from other financial
providers. The possibility of the spill-over of funds from targeted sectors to non-targeted sectors has been widely discussed in the literature. Von Pischke and Adams (1980) implied that considering the fungibility nature of capital caused the government difficulty in achieving a specific goal with concessionary and targeted loans. It is easily conceivable, for instance, that the Salim Group, the largest conglomerate in Indonesia, received concessionary credit from the government program ostensibly for its cement and food production industries but diverted the funds for other non-targeted industries which were still controlled by the same group.

After 1983, when government involvement in the financial market was somewhat reduced, the economy was struck by unfavourable external conditions. The decline in oil prices in 1982 met with a government response which included austerity programs that turned the economy toward domestic recession. Decreasing domestic government spending caused a decline in aggregate demand within the economy. Total domestic government spending in budget year 1981/1982 reduced in budget year 1982/1983 from Rp 11.3 trillion to Rp 10.7 trillion. Considering the dominant role of government spending in generating aggregate demand, the decline of such spending resulted in a contraction of aggregate demand. As a result, all sectors of the economy became stagnant. During this period many factories were reported producing at less than 50 percent of capacity. McCawley (1985) argues that, since most industries were committed to import substitution purposes, declining domestic demand had devastating results on them. The gloomy economic conditions and slow economic growth during this period created the need for a decrease in additional capital for some business enterprises. For those who needed capital, the overly liquid banking institutions were ready to provide them with almost unlimited funds.

The structure of the Indonesian banking system was highly uncompetitive until 1988. Bank Indonesia's annual report in 1989 stated that five state-owned commercial banks and a state development bank dominated over 70 percent of all banking financial assets. Such a condition led to an uneven credit distribution where "powerful customers" had unlimited access to credit. Warta Ekonomi on 14 April 1990, reported that various big corporations could get access to loans on a scale of billions of rupiah from state banks with just one telephone call.
Until the end of 1988 there was no legal lending limit applicable for banks in extending credit to any single customer. Various powerful businessmen created conglomerations of companies and largely tapped banking credits to finance them. By 1990, the conglomerations of companies became a common feature of the Indonesian corporate landscape, without any statutory limitations. Shin (1989) reported that in 1986 the forty-one largest private groups of companies controlled 1,630 affiliates. Some of these groups of companies also reported on their own banking subsidiaries. For instance, Salim group, the biggest conglomerate in Indonesia, controls BCA, the biggest private bank in the country. Panin Group controls a bank with the same name, Panin Bank.

Since there was no law governing the relationship between a parent company and its banking affiliates, those banks were generally used as private corporate cashiers by their parents. Simanjuntak (1989) stated that there was practically no restriction on the formation of conglomerates in Indonesia. Banks were free to extend as much credit as they liked to the members of their own group. Most of the large private national banks in Indonesia existed to cater for the needs of their own group, in addition to accepting deposits from the public. Under these circumstances, therefore, raising capital through in-house banking was much easier as well as cheaper than through the securities market.

It has already been noted that many big Indonesian firms also had access to overseas funds, especially debt capital from various international banking institutions. Under an open foreign exchange system, Indonesian private corporations could easily borrow money abroad, primarily from two nearby financial centres: Singapore and Hong Kong. The degree of dependency of these firms on international capital is significant. As indicated in table 7.5.1 in the budget year 1988/1989 the external private sector debt stood at US$8.6 billion. This number grew in 1992/1993, and reached US$ 14.7 billion. The International Monetary Fund (IMF - 1989) reported that most of this debt was borrowed by non-bank Indonesian firms.

As a result of over exposure to foreign denominated funds, without sufficient swap protection, PT Indocement, an affiliate of the giant conglomerate Salim Group, experienced a
severe financial crisis in 1985 which required government intervention to bail it out. Robinson (1987) reported the bailout cost the government almost half a billion dollars: about US$350 million in terms of equity injection and US$120 million in term of loans from state banks that were used to retire Indocement's expensive dollar debt and replace it with a rupiah loan. On 11 June 1991, the Asian Wall Street Journal reported that PT Bentoel, one of the biggest cigarette makers in Indonesia, also encountered a financial crisis deriving from over exposure to foreign funds. The firm was unable to repay its foreign debt amounting to US$ 370 million.

Table 7.5.1
Indonesia's Outstanding External Debt 1989-1993
(millions of US$)

Source: Bank Indonesia (1995)

With the open exchange system and fully convertible currency the government has limited ability to curb these overseas borrowing's, even if it wanted to do so for macroeconomic and balance-of-payment considerations. The only policy tool which may be used in manipulating foreign borrowing is the premium of exchange rate swap. From October 1988, the government began to change the premium of swap from a fixed rate to a market based
formula. With this change the premium of swap is set as the difference between the average domestic deposits and the corresponding US dollar LIBOR interest rate. This policy of course has a very limited application.

At the end of 1991, the government decided to intervene directly in curbing foreign borrowing's by the Indonesian private sector because of the balance of payments considerations. However, this intervention was also ineffective because firms exploited the loophole of the regulation. One Indonesian firm that was subjected to the foreign borrowing ceiling decided to set up an affiliate company abroad, borrowed the money off-shore and then repatriated it to Indonesia as direct foreign investment that was not subject to any ceilings.

On 27 October 1988 the government adopted a new policy to further reform the financial system. This reform is well-known as the policy package of October 1988 (Pakto 1988). Three broad policy issues are covered in the Pakto decision. Firstly, it includes a wide range of measures for deregulation and liberalisation of financial markets. These include permitting new entrants into banking and other financial services, relaxing branching restrictions for banks and non bank financial institutions (NBFIs), allowing state owned enterprises to put their financial assets in private banks, and lowering the reserve requirements for the banking system.

As results, the member of banks and bank offices in Indonesia increased significantly, as indicated in Table 7.5.2. An effect of this development was interest in deposit in the banking industries increased significantly due to the strong competitiveness in the banking industries. This condition in turn increase the interest in loans as indicated in Table 7.5.3. Secondly, the Pakto 88 introduced a new rule regarding the legal lending limit for banks and non-bank financial institutions (NBFIs). In addition, the Pakto also imposed a withholding tax on interest on banking deposits. These last two policies had a great positive effect on the development of the securities markets.
Table 7.5.2
Number of Banks and Bank Offices in Indonesia (1987-1991)

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<tr>
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</tr>
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<td>- State Comm. Banks</td>
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<td>Number of Banks</td>
<td>793</td>
<td>815</td>
<td>876</td>
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<td>960</td>
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<td>- Private Nat/Comm</td>
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<td>88</td>
<td>106</td>
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<td>3. Saving Bank</td>
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<tr>
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<td>1</td>
</tr>
<tr>
<td>Number of Banks</td>
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<td>20</td>
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</tr>
<tr>
<td>- Private Dev. Bank</td>
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<td>2</td>
<td>2</td>
<td>2</td>
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<tr>
<td>Number of Banks</td>
<td>28</td>
<td>28</td>
<td>71</td>
<td>79</td>
<td>84</td>
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<tr>
<td>4. Total (Excluded the rural Banks)</td>
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<td>148</td>
<td>171</td>
<td>192</td>
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<td>Number of Banks</td>
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<td>1,728</td>
<td>2,578</td>
<td>3,553</td>
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</table>

Source: BPS various issues

Table 7.5.3
Interest Rate Percent per annum

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<th>End of Period</th>
<th>Lending Rate</th>
<th>Deposits Time Rate (3 months)</th>
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<td>Working Capital</td>
<td>Investment</td>
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<tr>
<td>1989</td>
<td>21,00</td>
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<tr>
<td>1990</td>
<td>23,40</td>
<td>20,18</td>
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<tr>
<td>1991</td>
<td>25,10</td>
<td>19,28</td>
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<td>1992</td>
<td>22,10</td>
<td>18,44</td>
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<tr>
<td>1993</td>
<td>17,95</td>
<td>15,95</td>
</tr>
</tbody>
</table>

Source: BPS various issues
To a single borrower, the maximum loan that can be extended under the new law is up to 20 percent of the lender's equity. To a group of borrowers the limit is 50 percent of the lender's equity. This regulation also spells out restrictions on extending credit to the bank's board of directors, commissioners, share-holders and their family members. According to Circular letter of Bank Indonesia No. 21/18/BPPP/1989, the lending limits to Directors, Commissioners, shareholders and their family members are 5 percent of the lender's capital to each individual and each firm he/she owns; and 15 percent to each individual and group of companies he/she owns.

The legal limit rule sets a maximum ceiling to which a bank or NBFI can extend credit to a single borrower or a group of borrowers. The law defines borrowers as a group if the borrower's companies are interrelated either in terms of ownership, management or finance. The Decision of the Board of Bank Indonesia No. 21/51/KEP/DIR on 27 October 1988 and the elaboration through Circular Letter (Surat Edaran) Bank Indonesia, SE. No. 21/18/BPPP on 25 March 1989 stated that the full criteria of what is considered as a group of borrowers are: (a) if 35 percent of the ownership of two or more firms is controlled by the same person or the same family members; or 35 percent of one firm's equity is controlled by another firm; (b) if the executive officer of one firm also serves as executive officer in another firm; (c) if one firm acts as a credit guarantor on a loan received by another firm, or if one firm provides loan subordination or other types of credit to another firm.

The legal limits rule is actually a regulation enacted for prudent lending reasons. It prevents lending institutions from over-exposure to a single borrower or group of companies (conglomerate) which may create an unreasonable concentration of risks. In addition, the law also prevents banking affiliates or big corporations from excessive internal dealings. Therefore, the use of public funds by banking institutions has become more transparent and diversified.

The impact of the legal limits rule on the securities market is positive. It may force many big firms, especially groups of companies that may experience difficulty in raising
sufficient capital from lending institutions, to seek other sources of finance, particularly raising equity capital from the securities markets.

7.6. SUMMARY

This chapter lays down a brief history of the nature of political-economic policies in Indonesia. In this study, the role of government in shaping the economic development in this country was analysed based on some basic policies. Three main policies i.e. investment policy, fiscal policy and monetary are considered important in this study. The main findings may be summarised as follows:

1). By the 1960s, when Soekarno was the president of the country, the Indonesian government implemented a massive intervention in the development of the economy. A nationalistic approach became the ideology of such development. The government strongly adopted self sustaining policies. Accordingly, the role of foreign investors was not considered important.

2). After this period, the new government pursued a totally different approach in political economic policies. The role of foreign investors was more appreciated. The new government had a strong faith in the role of the private sector and a more liberal economic system. However, in this period the open door policies, for the first time, were not well accepted due to the oil boom.

3). After the 1970s, when the oil prices went down, development continued, and the need for foreign investors became more obvious. The tax policies were expected to be another source for financing the development program. Moreover, the government considered that the capital market became an alternative source to financing development from the private sectors.
4). Without any doubt, by 1980 the government considered that more liberal economic policies had to be adopted, and more deregulation packages in both the financial and non-financial sectors were issued and the development of the capital market was stimulated.

5). Under such policies, Indonesia's economic performance has been one of the best in the developing world. Sustaining macro economic stability, high growth and poverty reduction have become an economic development program for this country.
CHAPTER EIGHT

THE NATURE OF SOCIO-ECONOMIC POLICIES IN INDONESIA

This chapter discusses the role of society in the process of economic development in Indonesia. Since a stock market is considered a product of socio-economic development, where this market provides a facility for the trading of investments the need for information concerning a favourable socio-economic environment is one of the determinant factors for its success. This study argues that the stability of the political climate is a modal value for continuing development in a country.

A part of this study discusses, the historical development of policies which relate to the social-economic development in Indonesia. Some points relate to population and the labour force, employment and unemployment conditions, education and some other variables which are considered important.

8.1 THE POPULATION AND THE FAMILY PLANNING PROGRAMS

The Republic of Indonesia is an archipelago of over 13,000 islands extending in a 3,200 mile arc from Sumatra in the Northwest to Irian Jaya in the East. In 1990 the country was divided into twenty-seven provinces. Indonesia has experienced relatively high rates of population growth over the past two centuries. Population in 1800 was estimated at 3 to 5 million. During the nineteenth century the country grew, on average, between 1-2 percent annually. The population in 1905 was 37 million. Crop failures, epidemics and war dampened population growth rates during the first half of the twentieth century, but these rates have since averaged somewhat over 2 percent per year (Hull, et al, 1977). In 1961-1971, for instance, the average rate of population growth increased to 2.1 percent annually. The economic crisis, and the population boom during the past decades, are considered to be accelerating for the next few years. In order to understand the government policies concerning family planning, the following sections will discuss the historical development of policies and the impact of those policies on population size and growth.
8.1.1 The Historical Development of Family Planning Policies in Indonesia.

As mentioned in the above paragraphs, during the 20th century, Indonesia has had a considerable population and a significant growth every year. This conditions existed because there was no family planning policies that were undertaken by the government in 1960s. On the other hand, Indonesia was facing an economic crisis, a deterioration of its infrastructure and political instability. Considering such conditions rather than tackling each of these problems separately, the New Order Government in 1966 initiated the first of a series of five-year development plans to provide Indonesia with the social, and economic welfare to become a fully modern nation. One of the keys to Indonesia's success today has been the nation's ability to integrate family planning into a large program of education and health care.

Based on this consideration, Indonesia's Family Planning Program then was launched in 1970 by Presidential Decree with the establishment of the National Family Planning Coordinating Board or Badan Koordinasi Keluarga Berencana Nasional (BKKBN). As its name implies, BKKBN's primary responsibility was to coordinate the activities of other offices such as the Ministries of Health, Home Affairs, Religious Affairs, and so on, in spreading family planning messages and providing family planning assistance to the Indonesian people. From its beginning, BKKBN has defined family planning in terms of education and motivation, rather than just implementing a medical program.

The need for family planning was already felt in the late 1950s by local health service providers, particularly those working at the Maternal and Child Health Centre who were attending high-risk pregnant mothers and their children. To limit child bearing, these mothers were introduced to simple methods by a private organisation, Indonesian Planned Parenthood Association or Persatuan Keluarga Berencana Indonesia (PKBI), which was established in 1957 with the support of the International Planned Parenthood Federation. PKBI was the pioneer
in the family planning movement in Indonesia. Since inception, its operation has been limited to face-to-face contacts. It was not until 1969 that a semi-governmental institution, Lembaga Keluarga Berencana Nasional, was founded by the New Order Government. The process of implementation, however, was slow. In 1970 the government decided that family planning program management should become the government's responsibility; thus BKKBN was established.

As Java and Bali constituted the most densely populated areas, the six provinces of these two islands were the first-stage target of the family planning program. In its second stage (1974-1979), the program was expanded to 10 additional provinces on the islands of Sumatra, Kalimantan, Sulawesi and Nusa Tenggara. In the third stage (1979-1984) it was extended to the country's remaining 11 provinces.

During its first stage, the program employed a clinic-based design and was highly dependent on Ministry of Health inputs (Hull and Hull 1986). Family Planning outreach services were provided by mobile teams staffed by medical and paramedical personnel. Even at this early stage, the program made use of locally-recruited field workers, primarily women who had direct contact with potential clients and whose duties involved motivation of family planning and education about characteristics, side effects and supply of available methods, and the organisation of mobile team visits.

After the implementation of the second five year plan in 1974, BKKBN became more community-based. Under the current system, each village has a village contraceptive distribution center (VCDC). The VCDC is a community-level delivery mode that supplies non-clinical contraceptives, primarily pills and condoms. Its operations are supervised by the family planning field workers. It is often run by the wife of the village head on a voluntary basis. She is typically assisted by members of the Family Welfare Group or Pusat Kesejahteraan Keluarga (PKK), other community volunteers, and acceptor group members (Suyono and Shutt, 1988).
In 1986, the Government began encouraging partial privatization of the National Family Planning Program. This new strategy is known as KB Mandiri or "Family Planning Self-sufficiency". Elements of this program include greater responsibility for private physicians and midwives in providing contraceptive information and supplies, the social marketing of condoms, and higher community involvement in funding and implementing family planning efforts. As the design for Keluarga Berencana (KB) Mandiri now stands, those groups and communities which can afford to pay for family planning will be fully self-supporting, those with fewer resources would receive partial government support, and those totally without means would still receive a full government subsidy. KB Mandiri strives to redirect the attitudes and behaviour patterns of individual family members, so that they can take the initiative for providing for their own family planning needs.

Another new orientation is the Gerakan Masyarakat Keluarga Berencana or the "Community Family Planning Movement". As authorised by the 1988 State Policy Guidelines, BKKBN will develop a program whereby community members such as village heads, religious and cultural leaders, youth and women promote family planning activities. Its members will functionally resemble the current volunteers, but their responsibility will be confined to family planning.

Over more than two decades, the family planning program in Indonesia has established some basic tenets regarding the realisation of the small, happy and prosperous family idea. Based on this progress, and in order to anticipate the challenges of the future, the National Family Planning Coordinating Board (BKKBN) and the State Minister's Office for Population and the Environment proposed a law on Population and the Development of the Prosperous Family. This law was passed by the House of Representatives and the President on April 16, 1992.

Future population and family development policies will be based on this law. Population and family development policies are intended to address the
quality/number of the population, and to turn Indonesia's human resources into a national development strength, effective in improving the quality of community life. The implementation of the population and family development policies is meant to achieve a harmonious, proportional balance between the quantity, quality and distribution of the population on one hand, and the capacity of the environment to accommodate family development on the other. Family planning is not merely for spacing births but is also aimed at creating prosperous and happy families. Population and family development efforts are based on awareness, responsibility and voluntary participation taking into account the religious values and social and behavioural norms. This objective was stated in article 16, paragraph 1, of the new Population Law and the need for participation by the community was stated in article 24 of this Law.

In Article 16, Paragraph 1, of the new Population Law it is stated that the aim of organised family planning is to create small and prosperous families. The development of small and prosperous families is carried out in stages, related to its goals, activities and time frame. The law emphasises that the arrangement or spacing of births has to take into account human dignity and status, and must consider the religious and socio-cultural values of the community. Moreover, in Article 24 of this Law, it stated that the participation of the community in population and the development of prosperous families is imperative, seeing that the program to develop the population and prosperous families cannot be implemented solely by the government. The participation of the community is needed so that the burden can be borne jointly by the government and the community. An environment needs to be created that can further enhance the active and dynamic role of the entire population in implementing national development. Community participation can be carried out voluntarily in accordance with existing capacity.

8.1.2 The Population, Its Size and Growth

Indonesia has achieved one of the most impressive records in fertility reduction over the past two decades. The country's total fertility rate has declined from an

Many observers credit Indonesia’s National Family Planning Coordinating Board (BKKBN) as instrumental in this fertility reduction and slowdown of population growth (Hull et al, 1977; Sinquefield and Sungkono 1979; Chernichovsky and Meessok 1981). Key reasons for the success of BKKBN’s program include its community-based distribution system, involvement of local community leaders in promoting family planning, administrative decentralisation, and an effective reporting, recording and monitory system. However, the need for a further decline in population growth is considered by some observers as still important. According to Prescott et al (1986), the World Bank suggests that further declines in population growth to replacement level by the year 2010 can most feasibly be achieved through raising contraceptive use.

With 179 million people registered in the 1990 National census, Indonesia today ranks as the world’s fourth most populous nation after China, India, and the United States. However, through the successful, long-term undertaking of an array of family planning initiatives, integrated with education and health policies, this ranking stands to change. According to projections by the United States Census Bureau, by the year 2050 Indonesia’s population will have dropped to sixth place after China, India, Nigeria, Pakistan and Brazil.

A part of Indonesia’s family planning success can be measured in statistics. Based on the 1991 Indonesia Demographic and Health Survey, Indonesian couples have an average of 3.0 children versus an average of 5.6 children less than two decades ago, a decline of about 46 percent. The average population growth rate during the past ten years was 1.97 percent, with the goal of 1.6 percent expected to be realised as soon as
In May 1992, the total number of active contraceptive users reached 20,300,597 couples, or 62 percent of all married Indonesians of child bearing age. Today, nearly 95 percent of all married women in Indonesia are aware of at least one modern contraceptive method, and virtually all those who are aware of at least one method also know where to obtain it. Even more encouraging are the widespread attitudinal changes in Indonesia. According to the 1991 Indonesia Demographic and Health Survey, half of all married Indonesian women do not desire any more children, and of those women desiring children, more than half wish to have another child only after two years. These accomplishments are all the more impressive when placed into a historical context.

According to the World Bank report (1993), since the fifth year development program Indonesia has been among the world's most successful countries in reducing absolute poverty. The percentage of the population below the poverty line has been reduced from 60 percent in 1970 to about 14 percent in 1993 according to official estimates. Social indicators show substantial improvement. For example, over the same period, the population growth fell from 2.4 percent to 1.7 percent per annum, infant mortality from 118 per thousand births to 58 and the adult illiteracy rate from about 50 percent to 23 percent. This improvement has continued for the second Long Term Year Plan, which commenced in the 1993/199 budget year.

Prospective population growth rates are determined by developments in fertility and mortality. Based on extrapolation of past trends in fertility and mortality and the experience of other countries with similar emphasis on family planning and health services, the World Bank (1982) has prepared a population projection up to the year 2000. According to this projection, by the year 2000 the growth rate is expected to have gradually tapered off to 1.7 percent. By that year the Indonesian population will have reached 217 million people. A recent BPS projection envisages a somewhat lower decline in population growth till about 1.9 per annum in the period 1995 to 2000, and a total population of 223 million in the year 2000. If current trends of urbanisation
continue, an appreciable share of between one half and two-thirds of the population increase will take place in urban areas.

From the BPS statistical data, as indicated in Table 8.1.2.1, it can also be seen that the population is highly unevenly distributed over the 13,700 islands which comprise Indonesia. In 1980, about 91 million people, i.e. 62 percent of the population
was concentrated on Java, which covers only 7 percent of the land area of Indonesia. The other large but much less populous islands are Sumatra, Sulawesi and Kalimantan with 28 million people, 10.4 million and 6.7 million people respectively.

The spatial distribution of the population is subject to regional movements and rural-urban migration. The government has taken an active role in attempting to correct the imbalances of the regional distribution of the population through its transmigration program. Arndt (1983) estimates that up to 1980 close to 1 million persons were resettled from Java in the Outer Islands, of which Sumatra is the most important destination. There is also a substantial amount of spontaneous migration from Java to the Outer Islands involving another 1 million persons over the same period. On the other hand, more than 1 million people moved from other islands to Java. On balance, however, interregional migration has not been large enough to affect substantially the regional distribution of the population and in particular the population pressure on Java.

Based on place of residence, 30.9 percent of Indonesian people live in urban areas. Urbanisation levels, increased nationally 8.5 percent in 1990 compared to 1980. The highest urbanisation is into Jakarta since the progress of development in this province is fast. East Timor, as the youngest province has only 8 percent of the population living in urban areas. The urbanisation mobility can be seen in the provinces of Java island. During the period 1971-1980 in DKI Jakarta, there was an increase of sex ratio that showed male migration into Jakarta had increased rapidly. The largest increase of sex ratio in 1990 was in West Java, that means that economy dynamics in this province has generated interest.

8.2. THE LABOR FORCE, EMPLOYMENT AND THE POLICIES

Another measurement concerning the social economic condition in this country is a labour force condition. The measurement of the labour force possesses serious problems in a developing country such as Indonesia. It is often difficult to distinguish between work activities.
and non-work activities for members of households which operate household enterprises, either in the rural or in the informal urban sector. Moreover, much of the work is of a seasonal or otherwise temporary nature, especially in the agricultural sector. Thus, the size of the labour force will vary depending on the length of the reference period over which it is measured and the time of the year to which the reference period refers. In addition, the specification of a minimum time period for working during the reference period can affect the size of the labour force.

8.2.1. The Labour Force and The Employment Policies

After about twenty years of family planning as a national program, the government of Indonesia now faces several challenges. Past high fertility rates have created a growing number of young people entering productive age who need job opportunities. On the other hand, a high concentration of population at non-productive ages tends to generate high social costs. The dependent groups of population are usually children (under 15 years of age) and old people (over 60). Much cost needs to be allocated to take care of them. The need for job opportunities and, in turn, the income generated from these jobs, are considered important by the government. In order to overcome these problems, some integrated policies were addressed by the government two decades ago. There are, at least, two policies to discuss in this study. These relate to the problems of the labour force and employment.

This policy was brought into a Labour Law of 1948. However, dualism existed at this time as a result of the government implementing two kinds of labour law, i.e. the former regions of the Member State of the Republic of Indonesia were subject to the labour laws of the Republic of Indonesia while Jakarta, the former States of Eastern Indonesia, Eastern Sumatra and West Kalimantan were subject to the labour laws of the United States of the Republic of Indonesia. With the founding of the Unitary Republic of Indonesia in 1951, such conditions could not be accepted as, there could only be one law effective within a State. As there was no labour legislation which
conformed to the present conditions, the government selected one of those laws which most closely approached the principles and goals of the Indonesian State. The Labour Act of the former Member States of the Republic of Indonesia was technically as well as politically imperfect, but it was clear that it approached more closely the principles of the Pancasila, the pillars of Indonesian State, than the labor law of the United States of Indonesia which was generally an extension of colonial law. For this reason the government brought the Labour Act of the former Member States of the Republic of Indonesia (Labour Act no. 12 of 1948) into operation throughout Indonesia under Act no. 1 of 1951.

After this period, the development of policies was initialised by issuing a series of Acts, Act no. 3, 1953, Act no. 21, 1954, Act no. 22, 1957 and Act no. 14, 1969 in order to regulate and enforce the existing labour force. In Act No.3, 1953, the government promulgated a provision concerning rights of labor inspection government officials to make inquiries in order to supervise the enforcement of labour Acts and Regulations. In Act No. 21, 1954, the government regulated collective labor agreements between trade unions and employers in order to prescribe provisions relating to agreements respecting labor conditions between those parties. In Act No. 22, 1957, the government regulated the labour disputes. In Act. No. 12, 1964, the government regulated the termination of employment in private undertaking, and Act No. 14, 1969 relates to the basic provisions respecting manpower in Indonesia.

It can be argued that the development of the labour force during the past two decades was the first stage of development in the labour process. In this first stage, the government concentrated its efforts on organisation. It was based on a brief history of the Department of Man Power of the Republic Indonesia issued by the Bureau of Public Relations Department of Manpower (1986). Since Indonesia proclaimed its independence in 1945 and, up to the 1980's, the name of the Department of Manpower was changed several times. This indicates that the government was in a period of trial and error in making the development of the Labour Force a priority in the country. This
is no longer so, since the Development of Cabinet IV announced on 17 March 1983 that labour force affairs were to be under the Department of Manpower, and it was separated from the Department of Transmigration and also the Department of Cooperatives.

On the other hand, the development of labour affairs by the Department of Manpower can also be associated with the population in that period. A large population and work force, as well as a high population growth became a matter of concern due to the fact that the country's economy could not effectively meet the various needs of the people, including providing job opportunities. On the eve of the fourth Five-Year Development Program, 1984-1988, Indonesia encountered a burdensome challenge caused by a protracted worldwide recession. Economic growth in Indonesia declined to below 5 percent a year. The country's exports decreased and prices of natural oil dropped sharply, affecting its balance of trade, depleting its foreign exchange and in turn reducing its revenues. There were drastic decreases in appropriations for capital outlay, including those for manpower. Considering these conditions, since that, the need for further development of the labour force into an asset for development were considered crucial.

The Fourth Five-Year Development Program (Reptile IV), initialised development of the labour force more seriously and rigorously. The government set up the framework to improve integrated planning of manpower by introducing various policies namely, codes 3, 5 and 7. These codes described the roles, programs and priorities of development. By these codes, the role of the Department of Manpower was directed into three areas: 1) developing a disciplined and productive labour force, 2) developing an industrial relations based on Pancasila, and 3) developing the welfare, safety and occupational health of its manpower. The five programs were directed to 1) organisational consolidation and development of the Department of Manpower, 2) extension of work, 3) Pancasila industrial relations, 4) improving Vocational Training and National Productivity, and 5) enhancing the welfare, safety and occupational health
of its manpower. The seven priorities in the development of the labour force into an asset for development were 1) adoption of the new organisation structure of the Department of Manpower, 2) labor market information, and the mechanism for national and regional manpower planning, 3) overseas employment, 4) handling the boom in high school graduates, 5) training of Pancasila perceptions and practices for employer and trade union leaders and the development of harmonious firmness and peace in industrial relations, 6) workers' welfare through cooperative extended worker social insurance programs and other productivity efforts.

During the fifth Five-Year Development Plan, 1989-1994, the population of Indonesia was projected to increase from about 179.6 million to 198.7 million or at an annual rate of 2 percent. In conjunction with the population increase, the male labour force will increase from 46.6 million to 52.7 million while the female labour force will go up from 28.2 million to 40 million. During this five year period, the labor force will increase by 11.9 million annually or at the rate of 3 percent a year. Meanwhile, during the same period, the economy is estimated to grow at about 5 percent a year. The situation compares with the fourth Five-Year Development Program, when job opportunities did not match growth in the labour force. Therefore, efforts at increasing employment opportunities during the fifth Five Year Development Program were more intense than during the fourth Five-year development Plan.

Some policies undertaken by the government in the fifth Five-Year Development Plan mostly continued implementing the previous policies. Those policies were directed to 1) expansion of job opportunities, 2) the informal sector, 3) manpower distribution, 4) manpower planning, 5) business climate and industrial relations.

8.2.2. The Development of the Labour Force and Employment

One of indicators that shows the successful development of a labour force and employment is related to the ratio between the active and inactive persons. According
to BPS statistical data (1985), in 1971 the dependency ratio was about 87.0. This indicates that 100 active persons had to support 87 in-active persons. This figure is notably high. Over the 1971-1990 period, after some of those policies were implemented, the ratio underwent a substantial decline to 79.1 by 1980, 74.7 by 1985 and 67.8 by 1990. However, the decline of the dependency ratio was caused not only by the change in the labour force and employment policies, but also probably by the family planning policies.

BPS Report (1989) shows a statistical development in population, the work force and underemployment during 1980/1988. The table shows that, although the level of declared unemployment is low (approximately 1.7 percent in 1980 and 2.8 percent in 1988) the number of underemployed people is high. Of the 72.8 million working people in 1988, only 44.3 million or 60.9 percent were fully employed. The remaining 28.5 million or 39.1 percent work fewer than 35 hours a week. Cosmas, the Minister of Manpower (1991) stated that among working people, there are the disguised unemployed whose productivity and earnings are low. Many people work 40 hours a week but only some of them are truly engaged effectively. Many people put in the same number of hours but their productivity is low because they either fail to meet the job requirements or are not supported by the necessary equipment and resources.

With regard to provincial distribution, in 1985 DKI Jakarta had the lowest ratio of about 58.5 and Southeast Sulawesi had the highest ratio, of about 96.9. In 1990, Jakarta as a business city had the lowest dependency ratio, that is 50.6. This was caused by more productive groups living in Jakarta. Unfortunately, the percentage of people who are employed tends to decrease. This indicates that the rapid increase in the labour force is out of balance with the availability of job opportunities.

In the medium term, the growth of the labour force is influenced by changes in labour force participation rates and by the growth of the working age population. As far as labour force participation rates are concerned several factors are at work.
Continuing urbanisation has a negative effect on labour force participation rates as urban labour force participation rates are lower than those in the rural areas. Increasing school attendance by young people will also reduce labor force participation rates.

On the other hand, female labour force participation may show a tendency to rise. The overall net effect is therefore difficult to predict. It is unlikely, however, that in the medium term labour force participation rates will change dramatically, and changes in the "working age population" will remain the most important factor in determining the growth of the labour force. The growth of this segment of the population will follow that of the total population but with a time lag. On the whole, therefore, it seems plausible to project for the remaining years of the 1990s a labor growth rate not much different from that experienced in the recent past, declining slowly in the longer term.

As most of the population lives in Java, a substantial number of the labour force also reside in Java. In 1987, East Java and Central Java had the largest numbers of the labor force, namely 14.9 million and 12.9 million and in 1992 it became 15.8 million and 13.9 million respectively. From 1987 to 1992 East Timor appears to have had the smallest labour force of only about 0.3 million. It is clear that uneven distribution of the labour force by province follows the partial imbalance of population distribution.

During the period 1985-1986, labour force participation rates increased from 53.0 percent in 1985 to 57.4 percent in 1987. BPS data (1980-1990) shows that the labour force tends to increase while the labour force participation rate tends to be stable at 57 percent. Variation in the labour force participation rate can partly be explained by variation in the general level of development.

Projections of the labor force by the Indonesian Bureau of Statistics (BPS, 1983) forecast an annual rate of growth of 2.8 percent up to the year 2000. An
important basis for such a persistently high estimate is the assumption that female labour force participation rates will increase significantly to 48.7 percent in the year 2000. The World Bank (1984) projected a growth rates of 2.7 percent in the 1980s declining to 2.0 percent in the 1990s, followed by a lag in the decline in population growth. It is clear that in the coming years a substantial number of people will be added to the labour force.

As shown by the BPS population census (1971-1982), the unemployment rate is very low in Indonesia, which is not surprising in a situation where only those who can rely on family support can afford to be unemployed. The need for income forces people to engage in any type of work, however low its remuneration. Given the large population and the still low incomes for a large majority, it can be expected that the working population hides a substantial group of under-employed. These under-employed may include persons who are working less hours than they are willing or able to work, as well as persons who work full time, but earn a low income. Moreover, in a situation where jobs are scarce, there may be a substantial group of persons who has lost hope of being able to find work, so that they are not included in the labour force.

Evidence with regard to the size of the problem of underemployment and hidden unemployment in Indonesia is scarce. The BPS population census (1971-1982) included information on workers who would like to work more. This group is quite substantial, comprising 7.3 percent of the employed. The percentage of workers who would like to work more is higher in rural than in urban areas, and is higher for males than for females. A labour force survey, held by BPS in 1977, found that as much as 35 percent of the employed are available for more work.

The most salient feature regarding the structure of employment is that, in spite of the strongly declining share of agriculture in GDP, this sector continues to dominate the employment scene. As shown in BPS Population Census (1971-1982), agriculture still accounted for 56 percent of total employment in 1980. Service and commerce are
the next important employers, each employing close to 14 percent of the working population. The manufacturing sector accounts for 9 percent of the employed.

The importance of the tertiary sector including trade and services is most prominently revealed when examining the growth of employment in the period 1971 to 1980. In this period the tertiary sector accounted for close to 50 percent of the total employment growth in Indonesia. The contribution of agriculture to employment growth is particularly disappointing when compared with its much more impressive production performance. The introduction of labour-saving techniques in agriculture was a major factor in explaining its low employment growth rate. Also the contribution of the manufacturing sector to employment generation has been limited, for which the capital-intensive nature of industrial development can be held responsible. On balance, total employment increased by 2.8 percent per year between 1971 and 1980, which is not much different from the rate of growth of the labour force over the same period.

A further desegregation of the employment structure according to urban-rural location and sex is presented in BPS population census (1971/1980). A major point to note is the dominance of the tertiary sector in urban employment where trade and services account for 62 percent of the total employment. This dominance is even more important for females, namely 75 percent. Female also constitute a significant proportion of employment in agriculture and manufacturing.

Furthermore, what is striking is the relatively rapid rate of growth of employment in urban areas, a rate which is, more or less, shared by most sectors. Of course, the dates do not provide any insight into the productivity of employment or to what extent the increased employment creation has taken place in lowly-paid work in the informal urban sector. In any case, the opportunity to find work may have been an important factor in explaining the rapid urbanisation during the 1970s.
In rural areas, the most important change in the structure of employment occurred for females, whose employment in agriculture largely stagnated. The introduction of labour-saving techniques in agriculture affects work done by females in particular. At the same time female employment in the tertiary sector rapidly expanded, in 1980 accounting for close to one quarter of female employment in rural areas as compared to 16 percent in 1971. On the whole, however, female employment growth lagged behind male employment growth in rural areas.

Based on BPS population census (1971-1980), the high employment creation achieved in the tertiary sector was also reflected by the relatively high employment elasticity of close to 0.60 for this sector. On the other hand, for the agriculture sector this elasticity, at 0.26, is extraordinarily low. For the Indonesian economy as a whole an employment elasticity of 0.35 was realised in the 1970s.

These elasticities may also be used to illustrate prospective developments in employment assuming that the pattern of development does not undergo significant changes. Application of these elasticity's to the projected increase of sectoral GDP as presented in the previous section results in estimates of employment growth as shown in World Bank report (1984); Bappenas - Repelita IV (1984 to 1990). It can be seen that the growth of the labor force is substantially higher than the projected growth of employment. In 1990 the shortfall in employment with respect to the supply of labour was projected to increase to over 6 million people or 9 percent of the labour force. Unless labour absorption can be increased significantly, the problem of unemployment is therefore likely to take on even more serious proportions in the coming years.

The substantial amount of unemployment and especially under employment, as well as the high growth of the labour force, makes the creation of productive employment one of the most important challenges to economic development. Tackling the unemployment problem in Indonesia also requires improving the quality of the human resources. Levels of educational attainment of the labour force are generally
low. According to the 1980 BPS census, 29 percent of the population was still illiterate. In that year only 12 percent of the labour force had achieved an educational level beyond primary education. Educational attainments are much lower in rural than in urban areas, and lower for females as compared to males. For example, the illiteracy rate in rural areas is 33 percent as compared to 14 percent in urban areas, and the share of the rural labour force with more than primary education is only 7 percent for women as compared to 14 percent for men. However, in the coming years substantial improvements can be envisaged. Basic education is now almost universal, with close to 90 percent of the primary school age population attending school. Enrollment rates in institutions of higher education have also improved significantly. For junior secondary schools the enrolment rate is 60 percent, for senior secondary schools 31 percent, and for tertiary education almost 9 percent.

As the coverage of the educational system has vastly expanded, the priorities in educational development are shifting towards improvements in quality. A recent World Bank report (1982) especially recommended improvements in primary education and both further expansion and improvement in secondary education. Furthermore, the need to expand vocational training and skill development was emphasised. Indirectly, the quality of the human resources is strongly affected by such factors as health, nutrition, shelter and safe water supply. In Indonesia the level of most of these facilities is low relative to its income level, in spite of the improvements achieved in recent years.

8.3 THE EDUCATION, LITERACY AND THE POLICIES

Equal opportunity to receiving an education, as stated in “Eight Paths to Equity” of the Third Five Year Development Plan, is considered to be a high priority by the Indonesian people. Broadly speaking, education is recognised as a catalyst for development. Without educational development program, it is unlikely to have a successful development as a whole. In Indonesia, the terms of development have very broad meaning including mental
Among the many dimensions of human needs, education is one that leads towards personal self fulfilment. It is also widely recognised that education through schooling will enhance social participation in development. Schooling improves specific knowledge and develops general reasoning skills. It also induces changes in beliefs, values and attitudes towards work. In Indonesia, the educational condition is very encouraging. This section discusses some issues of education, such as literacy, educational attainment, etc.

8.3.1. The Policies

In Indonesia's first 25-year development plan, educational policy focused on increasing access to schooling opportunities, centred on an extensive school building program and the development of a 6 years requirement for schooling programs. Currently, there is a 10 year requirement for schooling programs for the young generation. At the level of labour forces programs, the development of education policies relates to the improvement of labour quality in relation to human resources development. Such development has become one of the programs of the Department of Manpower.

As pointed out earlier, the first problem encountered by the government two decades ago was the low level of education among the majority of the Indonesian labor force. In the past, educational programs in Indonesia appeared to have placed emphasis on equitable distribution and quantity rather than on quality. Consequently, there was a relatively wide gap between the qualifications of prospective workers and the requirements of jobs today and possibly in the near future. Accordingly a training program was introduced by the government for about two decades ago. By such programs, the gaps between the qualifications and such requirements can be minimised. On the other hand, the need for such programs also was strengthened by the rapid growth of technology. Programs and curricula of formal education are less flexible in adjusting to the changes. Training programs are therefore expected to
provide manpower qualifications to meet the requirements of jobs which utilise sophisticated technology

8.3.2 The Result

To see the educational level of people in general, literacy and illiteracy rates are used. Illiteracy rate means the percentage of population 10 years of age and over who are not able to read or write a simple sentence. The BPS statistical report (1989) shows that in 1985 the literacy rate in urban areas was greater than in rural areas, as the percentage of the literacy rate was 90.5 in urban areas and 77.4 in rural areas. On the other hand, illiteracy rates between urban and rural areas were 9.5 percent and 22.6 percent respectively. This indicates that the population in rural areas was left behind in education.

In the BPS statistical report (1993), the percentage of people 10 years old and over not attending school anymore was more than half, that is 63.3 percent in urban areas and 62.7 percent in rural areas. On the other hand, the percentage of people attending school was 21.3 percent (28.0 in urban and 18.0 in rural). The rest of the people, 8.8 percent and 19.3 percent respectively never attended school. Progress in school participation can also be seen from the net enrolment ratio (NER), and the gross enrollment ratio (GER). For primary school children aged 7-12 years, the NER was 88.6 in 1993 a significant increase compared to 1987 when it was only about 65 percent. In the school age group of 13-15 years, the NER for junior high school was 10.5 per-cent in 1987 and 42 per-cent in 1993. The NER for senior high school and graduate school students was 9.1 per-cent in 1987 and 37.9 per-cent in 1993. The NER in urban areas was higher than in rural areas, because the availability of educational facilities in urban areas was greater. Economic conditions and the awareness of the importance of education also influenced the rate.
At the tertiary level, gross enrollment ratio (GER) of 10.5 percent was achieved in part by making available at least one public university in each of Indonesia's 27 provinces. According to the World Bank report (1984) these achievements in raising enrollments compared favourably with Asia as a whole and with other East Asian countries.

Notwithstanding past attainments, major education challenges lie ahead. About 23 percent of those who enter grade 1 (mostly children of poor families) according to the World Bank Report (1984) never complete their primary education; every year, 1.2 million children drop out of primary education; every year 1.2 million primary graduates do not continue to secondary schools; secondary school intake has been faltering in the past five years, resulting in sluggish enrolments at the junior and senior secondary levels; and, in higher education, low quality and efficiency are a concern.

8.6. SUMMARY

This chapter lays out a brief history of the nature of socio-economic development in Indonesia. The role of government in shaping the process of socio-economic development in this country were outlined in this chapter. Three main variables that are considered important by this study are the population, the labour force and education and illiteracy. These variables have been discussed in the form of historical perspective's.

The main findings of this study are:

1). Indonesia has achieved one of the most impressive records in fertility reduction over the past two decades. This fertility reduction happened as a result the government's effective the family planning policies over 25 years. Although the idea of family planning emerged in the late 1950s from the private sector, but, due to political instability and the economic crisis, these programs did not work smoothly.
2). In the labour force and employment, the government can expand the job opportunities and the quality of employment by training programs. Over 25 years, the growth of economic development measured by domestic products exceeded the growth of the population. This means that the government, in general, succeeded in the program of labour force and employment. However, as mentioned by the observer, for the near future, the government will face a globalization process. This condition needs more quality improvement in the labor force and expansion for job opportunities.

3). In the sector of education, the records showed that net enrollment for primary, secondary, and tertiary levels were higher. This indicates that the people of Indonesia realized that better education was needed for facing the scarcity of job opportunities. Even though the government has pointed out the benefits of having better education by introducing the schooling programs however, major educational challenges lie ahead. About 23 percent of those who enter grade one according to the World Bank report (1994), never complete their primary education; every year 1.2 million children drop out of primary education, and about 1.2 million primary graduates do not continue to secondary schools.