THE INDONESIAN ECONOMY:
a decade after the crisis

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1. Introduction

Deep crisis in 1997-98; 13% contraction in GDP.

'Twin crises', ie, accompanied by regime collapse.

Now recovered to pre-crisis pci. But in absence of crisis would now be closer to $2,000 than $1,000 pci.

Moreover, growth slower, around 5-5.5% cf 7-7.5% pre-crisis.

Is it stuck at an 'archipelagic SE Asian rate' cf a 'China rate'?

Transformed from a hard, authoritarian, corrupt, but growth-oriented state to a 'messy', weakened, democratic, corrupt state; leadership not yet clearly, unambiguously committed to growth.

Major changes in economic policy making environment:

- Weakened presidency, though stronger after remarkable 2004 election achievements.
- Cabinet unity weakened.
- Newly assertive but unpredictable parliament.
- Noisy, influential, populist civil society.
- Still powerful but circumscribed bureaucracy.
- Legal system not yet able to perform many heavy responsibilities.
- Transfer of power and resources from centre to the regions.

Note also exceptionally favourable international economic circumstances in early 2000s; unlikely to be all repeated:

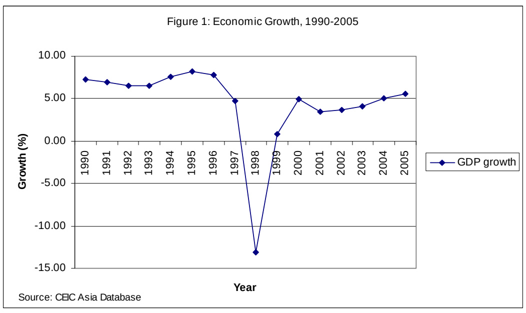
- Buoyant global economy.
- Record commodity prices.
- Very low interest rates.
- China locomotive factor exceeds competition impacts.
- No major export access problems.
- Support from west in view of Indonesia's democratic credentials and moderate Islam.

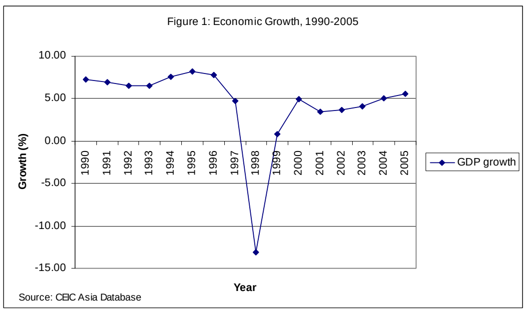
2. Macroeconomic Survey

Economic growth: See Figure 1. Recovery commenced in 2000; 2000-05 4.5%. Almost V-shaped; but pc growth about half 1986-96.

Production accounts: Agriculture rose 1997 - survival strategy, less affected by crisis, positive exchange rate effects.

Expenditure accounts: See Figure 2. Sharp decline in I/GDP; gradual recovery. ST cushion, LT concern. Both foreign & domestic.





Exchange rate and inflation: Pre-crisis, fixed but adjustable, widening intervention band. Then collapse, from Rp2,500 to low of Rp17,500 in 1/1998. See Figure 3.

Much larger depreciation than other crisis-affected economies. Though real depreciation only marginally greater, owing to higher inflation. Hence export sector unable to capitalize on the depreciation. Along with poorer infrastructure, rising X/M complexities, negative FDI, and problems in the natural resource sector (Athukorala, 2006).

Inflation: monetary authorities lost control of MS in first half of 1998; BLBI crisis, etc. Inflation peaked at 100% (also unique among crisis economies); quickly brought under control. But BI seems to have difficulty getting inflation down to 5% (McLeod). See Figure 4.

Though on balance the new macro framework of floating rate (with much intervention) and independent CB working reasonably well, in very difficult circumstances. The float acts as a 'policy discipline'.

Macroeconomic balances: Fiscal/current account balances have moved in opposite directions since the crisis. But modest. Figure 5.

Swing to CA surplus: expenditure switching, falling absorption, declining capital flows.

Fiscal deficits owing to slower growth, more debt & social spending.

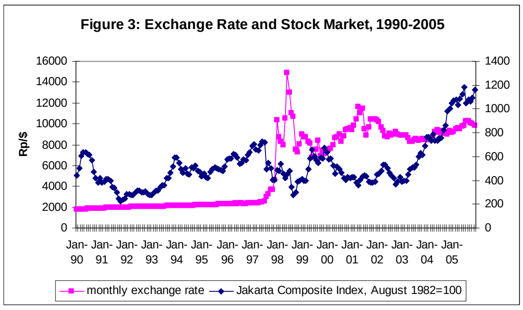


Figure 3: Exchange Rate and Stock Market, 1990-2005

Source: CEIC Asia Database

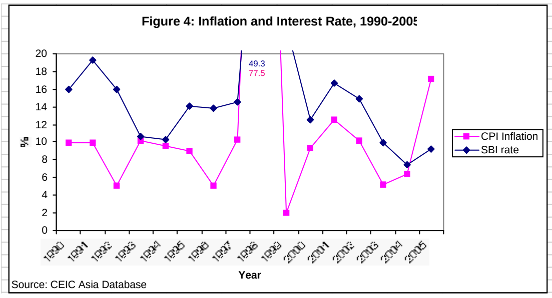


Figure 4: Inflation and Interest Rate, 1990-2005

Source: CEIC Asia Database

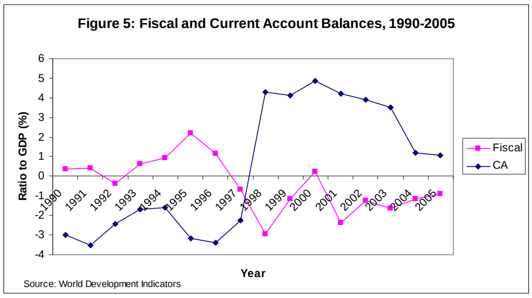


Figure 5: Fiscal and Current Account Balances, 1990-2005

Source: World Development Indicators

Fiscal policy & public debt: Pre-crisis, govt debt almost all foreign, owing to BB rule. From 1998, both foreign and public debt rose alarmingly. Former mainly an ER effect, and in spite of CA surpluses. Latter owing to recap bonds, to finance bank/corporate collapses.

Huge increase in public debt 1998-99.

Fiscal deficits quickly brought under control. See Figure 5. Notable achievement in view of weak govt, deep crisis, ambitious decentralization program, increased social spending, and widespread anti IMF sentiment.

Public debt/GDP ratio fallen significantly since 2000. See Figure 6. Owing to modest deficits, stronger growth, lower interest rates. Maturity profile also stretched. Now have a workable fiscal policy framework, more or less EU standard.

Though immense challenges: (a) low deficits in part owing to under-spending on crucial supply-side sectors (especially infra); (b) fuel subsidy still a serious problem. Should fiscal policy be looser?

IMF mismanagement?: Simplistic search for scapegoats. IMF clearly unhelpful in early period (fiscal, conditionality, atmospherics). But Indonesia not in a Fund program pre-crisis. Soeharto in complete control; then erratic behaviour from late 1997. Also, some of the over-conditionality apparently had domestic origins.

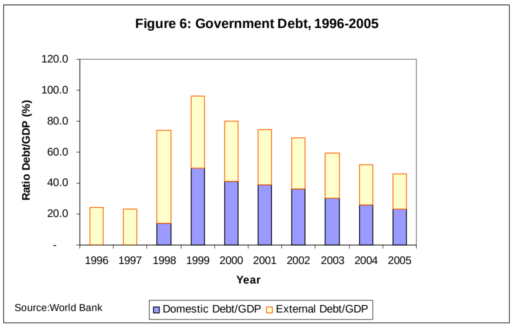


Figure 6: Government Debt, 1996-2005

Source:World Bank

3. Trade Policy and the Commercial Environment

Trade policy: Indonesia fairly open pre-crisis; largely remained so post-crisis, in spite of increased protectionist pressures.

Why remained opened? Interplay of several factors: LOI with IMF (some popular); Rupiah depreciation, X sector constituency; MOF more powerful; major, successful 1980s reforms a recent occurrence; global trend towards liberalization (esp China); WTO, AFTA, etc.

But major trade policy challenges remain:

a) Strong protectionist pressures, especially in agriculture.

b) 'Trade plus' issues: X/M procedures; FDI regime; infra.

c) An institutional vacuum for policy reform. Reformers need to win the public debates; cf technocrats' approach, of Hadi's 'low politics'.

d) Domestic trade barriers now serious; unpredictable.

Hence a policy stalemate; protectionist/populist pressures, at best partial reforms, eg, export zones.

Competition and the corporate landscape: Historically, high levels of seller concentration and corporate conglomeration. Crisis caused a major shakeout in corporate structures; though most of the major corporates still have Soeharto-era origins.

But competitive pressures almost certainly increased since the crisis:

a) Considerable corporate volatility; demise of much of Soeharto business empire.

b) Continuing low import barriers.

c) Some key liberalizations, mainly in SOE dominated sectors.

d) Competition Commission (KPPU), established 1999; small, but operating quite effectively.

e) Less blatant, concentrated 'palace corruption'.

f) Decentralization expanded range of rent dispensers/collectors.

The regulatory regime: Still complex, opaque, costly. Ranks poorly on comparative corruption, WB Doing Business surveys. Corruption probably as serious as before; but now also more unpredictable.

Hence, investors - both domestic and foreign - holding back.

Also clear preference for short-term, liquid projects. JSE v/s FDI. Particularly evident in two key sectors with long time horizons: mining (in spite of record prices) and infrastructure.

Hence also second-best measures, in trade, SOEs, etc.

Major new investment law introduced in March 2006; wait and see.

Decentralization: Hasty, big bang reform of 2001. Transferred much authority and resources to second-level govts (450 +); resource-rich regions major beneficiaries. Accompanied by direct regional elections. Could transform the political face of Indonesia.

In principle desirable; Indonesia too large to be highly centralized. Plus bring governance closer to local stakeholders, encourage governance competition, etc.

Still work-in-progress, too early to evaluate definitively. But note:

a) Local progress still depends mainly on national conditions.

b) Regional inequality likely to increase. Contrary to the 'Soeharto paradox'. Good or bad?

c) Successful devolution requires strong central govt, to set the rules. Indonesian decentralization occurred in context of greatly weakened centre.

d) Decentralization appears to have compounded infra under-investment. Implications for national economic integration of an open economy, deteriorating infra, and internal barriers to trade?

e) Serious regional trouble spots require more than decentralization. As illustrated by success in Aceh. Papua now the main regional challenge.

The financial sector: At the centre of the crisis. A case of major financial liberalization without the necessary policy follow up.

Major developments since the crisis:

a) Banking sector essentially cleaned up, operational. ·NPLs declined from 33% to 8% since 1999. High but manageable.

b) The cost to the public of the clean up was massive, and explains most of the sharp increase in govt domestic debt.

c) Key actors have changed. Sector essentially re-nationalized. Some increase in foreign ownership, though restricted by nationalist sentiment from playing a more useful role.

d) Major impacts felt in the modern sector; informal channels and small credit programs continue to operate effectively.

e) Finance sector still constrained by legal and other weaknesses. Eg, unclear land titles constrain use of collateral for loans; banks reluctant to trust the legal system in case of disputes.

f) Much of the current problems concentrated among the SOBs, which have the highest NPLs. Slow workouts, govt interference, reluctance to privatize.

4. Social Trends and Policies

Social outcomes dominated by economic trends. But democracy introduced new framework for social policies.

Poverty trends. See Table 1. Sharp increase after crisis, especially urban. Then declined, to pre-crisis levels by 2003. Though note incidence of 'near poor'; serious social conflicts, dislocation; local impacts of terrible natural disasters.

ST humanitarian programs: generally worked as well as could be expected. Reported targeted incidence around average, about 50%.

Low income welfare state: 2004 social security law; push for comprehensive health insurance, pension/old age defined benefits. To be funded by compulsory payroll taxes. Likely to result in large unfunded fiscal mandate.

Labour market intervention: Shift from Soeharto era 'East Asian' model - rapid, labour-intensive growth, mass education, little interference in labour markets, rising real wages, limited TU freedom.

Table 1. Poverty in Indonesia, 1996-2004

Year	Population Below the Poverty Line (million)			Population Below the Poverty Line (%)		
	Urban	Rural	Urban+Rural	Urban	Rural	Urban+Rural
1996	9.6	24.9	34.5	13.6	19.9	17.7
1998	17.6	31.9	49.5	21.9	25.7	24.2
1999	15.7	32.7	48.4	19.5	26.1	23.5
2000	12.3	26.4	38.7	14.6	22.4	19.1
2001	8.6	29.3	37.9	9.8	24.8	18.4
2002	13.3	25.1	38.4	14.5	21.1	18.2
2003	12.2	25.1	37.3	13.6	20.2	17.4
2004	11.4	24.8	36.1	12.1	20.1	16.7

Source: Central Board of Statistics

Flexible labour markets enabled effective adjustment to the crisis.

New approach: more TU freedom; but aggressive push for increased minimum wages, restrictive severance provisions.

Resulted in sluggish formal sector employment growth (more 'India' than 'China'); a factor in loss of FDI in footloose, labour-intensive industries; shift to informal sector, probable increase in wage inequality (see Manning, several papers).

SME programs: Increased pressure for promotion. But official, 'welfarist' programs have little connection to SME success stories (eg, Bali, Jepara). Complex regulations retard SME growth (Thee).

Moreover, contrary to widespread opinion, SMEs were not the key to post-crisis industrial recovery. More important were foreign ownership and export orientation (Narjoko PhD).

5. Summing Up

Many lessons from painful episode.

Boediono (2005, p. 323): 'Beware of possible disharmony between politics and economics … Never take economic stability for granted. … Institutions and governance should receive the highest priority in the overall strategy.'

Indonesia not a 'failed state'. Major achievement of democratic transition, following catastrophic economic contraction.

Plus a major advantage of having experienced 30 years of rapid growth. Including navigating potentially serious mid 1980s crisis.

Key achievement has been return to prudent macroeconomic management, maintenance of open economy.

Although public and external debt ratios are high, unlikely to be a repeat of 1997-98 crisis:

- debt ratios are declining;
- fiscal deficits are modest;
- Rupiah float working satisfactorily;
- banks and creditors are more cautious;
- the IFI's are wiser.

Key challenge is to get back to high growth; with institutions, business environment, and supply-side investments to encourage investors back.

Need a new political economy construct; ie, revision of Hadi's 'low politics'. Perhaps need to somehow insulate key economic policy decisions from political pressures.