Indonesia

Economic recovery, after nearly two years of recession, is essentially driven by the fiscal stimulus and remains fragile. Progress in structural reforms and an expected increase in export and investment demand will help consolidate this recovery in 2000. The new government is strongly committed to empowering local governments to promote broad-based growth.

RECENT TRENDS AND PROSPECTS

The crisis in Indonesia has bottomed out, and signs of recovery have appeared after nearly two years of financial and economic turmoil. GDP recorded a 0.2 percent increase in 1999, compared with a 13.2 percent contraction the previous year, and the crisis-induced surge in poverty appears to have peaked in early 1999. The recovery, initially underpinned by a rebound in agriculture, gradually spread to other sectors. However, strong growth of agricultural output in the first half of the year faded in the third quarter, and reached only 0.7 percent for the year.

The manufacturing sector expanded by 2.2 percent because of a rebound in the export-oriented oil and gas sector, while the construction sector grew by a modest 1.1 percent. The service sector, however, declined a further 1.5 percent in 1999 because of a contraction in banking and financial services. On the aggregate demand side, the recovery was initially aided by a rise in public spending, reflecting the government's fiscal stimulus to jump-start the economy. Growth of private consumption then led the recovery. Private investment activity, however, continued to contract due to inadequate progress in corporate debt restructuring.

The fragile recovery has not prevented further employment problems. Unemployment increased from 5.5 percent in 1998 to 6.3 percent by August 1999, and underemployment increased from 60 percent in 1998 to 63 percent in 1999. More significantly, although real wages went up in 1999, they remained 20-25 percent below the precrisis levels.

After averaging 58.5 percent in 1998, consumer price inflation came down to 20.5 percent in 1999. On a year-on-year basis, it plummeted to 2 percent at the end of December 1999, compared with 78 percent a year ago. While falling food prices, especially of rice, were the primary cause of declining inflation, the restoration of food distribution channels, the appreciation of the rupiah, and a tight monetary stance also helped. Despite volatility associated with political uncertainties, share prices in Indonesia rebounded because of considerably lower domestic inflation, greater exchange rate stability, and sharply reduced interest rates. Overall equity prices, as measured by the Jakarta Stock Market index, rose by 60 percent

Table 2.8 Major Economic Indicators, Indonesia, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	4.7	-13.2	0.2	4.0	5.0
Gross domestic investment/GDP	31.8	19.1	11.6	13.0	17.5
Gross national savings/GDP	29.4	23.2	13.2	15.2	18.0
Inflation rate (consumer price index)	6.6	58.5	20.5	6.0	5.0
Money supply (M2) growth	23.2	62.3	11.9	13.0	17.0
Fiscal balance/GDP[a]	0.0	-3.7	-2.3	-5.0	-3.1
Merchandise exports growth	12.2	-10.5	-7.4	8.1	9.0
Merchandise imports growth	4.5	-30.9	-10.8	7.5	14.0
Current account balance/GDP	-2.3	4.1	3.5	2.2	0.5
Debt service/exports[a]	37.8	39.1	34.8	—	—

— Not available.

a. Fiscal year ending 31 March.

Sources: Central Bureau of Statistics; Bank Indonesia (various years); Ministry of Finance; World Bank; staff estimates.

in 1999. Market capitalization climbed to $58 billion at the end of 1999 from $22 billion earlier in the year, still considerably below the precrisis level of $90 billion. The strengthened equity market, however, improved the outlook for the government privatization program and the Indonesian Bank Restructuring Agency's asset recovery effort.

Although market anxiety over structural reforms and political uncertainties continued to influence fluctuations in the rupiah, it strengthened substantially in 1999 and traded around Rp6,800-Rp9,500 per dollar, compared with Rp7,500-Rp17,000 the previous year. The stronger rupiah was in large part attributable to a steady buildup of reserves, high interest rates early in the year, and a tight overall monetary stance. The rupiah ended the year at Rp7,700 per dollar. Despite the appreciation of the nominal exchange rate, the real exchange rate remained around 30 percent below its precrisis level, giving Indonesian exporters a significant comparative advantage over its main regional competitors, Malaysia, Philippines, and Thailand.

The performance of the external sector, however, remained weak. Exports declined by 7.4 percent in 1999, and imports contracted by a further 10.8 percent, led by a decline in imports of capital goods. Despite the large real depreciation of the rupiah and stronger oil export prices, exports remained depressed because of problems associated with high corporate indebtedness and access to credit. The current account surplus, estimated at $4.9 billion in 1999 ($4.1 billion in 1998) was driven mainly by import compression, as in the previous year.

On the capital account, reduced inflows of net official finance were more than offset by lower net outflows of private capital due to loan rescheduling. As a result of the improved current account surplus and a smaller deficit in the capital account, gross foreign reserves increased to $27 billion (six months of import equivalent). At $16 billion, net foreign assets were also well above Bank Indonesia's monetary program floor of $14 billion. Although the debt-to-GDP ratio reached 95 percent (from 93 percent in mid-1998 and 56 percent in mid-1997), the debt-service ratio, after loan rescheduling, is estimated to have decreased to 35 percent in fiscal year 1999/00 (ending 31 March) from 39 percent in the previous fiscal year.

GDP growth should climb gradually in 2000. A moderate rise in investment, increased exports from

the nonprimary sectors, and strong agricultural production will lead to a GDP growth rate of around 4 percent in 2000 and 5 percent in 2001. The pace of recovery will, however, be constrained by continued liquidity problems and a massive overhang of corporate debt.

The budget will remain in deficit over the medium term, but will likely decline steadily from a projected 5 percent of GDP in 2000 to 3.1 percent the following year, as private sector activity picks up and outlays on subsidies decline. Imports will increase in 2000 as domestic demand rises, lowering the current account surplus to 2.2 percent, and then to 0.5 percent in 2001. This should, however, be offset by official financial flows and private capital inflows, and the import coverage of reserves will remain at about six months. The debt-to-GDP ratio is expected to gradually fall in 2000 because of declining interest rates, real exchange rate appreciation, and increased IBRA asset recovery. Inflation is likely to exceed the government forecast of 5 percent in 2000 by about 1 percent because of increases in wages and salaries, adjustments in fuel and electricity prices, and tariffs on rice and sugar. Inflation will decline to around 5 percent in 2001 as the domestic supply response improves further and import tariffs decrease.

With greater macroeconomic stability and adequate reserve cover, the exchange rate should remain stable at around Rp7,000-Rp7,500 per dollar in 2000, but will still be vulnerable to swings in market sentiment. However, with a strong increase in reserve growth and exports in 2001, it may drop below Rp7,000 per dollar. The Bank Indonesia Certificates interest rate is likely to fall—from an average of 23 percent in 1999 to 11 percent in 2000 and 10 percent in 2001. These forecasts assume that domestic political conditions in Indonesia will not deteriorate further and that the Asian economies will continue to rebound strongly.

ISSUES IN ECONOMIC MANAGEMENT

The government continued to maintain an expansionary fiscal stance to counteract the economic contraction; the budget for the fiscal year ending 31 March 2000 projected a deficit of 6.8 percent of GDP. However, the realized deficit is provisionally estimated at only 4 percent of GDP, because delays in project implementation will likely cause development expenditures to fall short of their target by nearly 30 percent. The budget deficit was unable to play its envisaged role in stimulating the economy.

The fiscal year 2000 budget covering the nine-month period April-December 2000 projects a deficit of 5 percent of GDP. Although this is smaller than the projected deficit of 6.8 percent the previous year, it reflects negative public savings (current expenditure exceeding domestic revenue) for the second time since the crisis began. Therefore, some development resources will be diverted to support current expenditures.

A major consequence of the crisis has been a sharp rise in public debt. At the end of March 2000, public debt is expected to increase to 95 percent of GDP from only 23 percent at the end of March 1998, a quadrupling in only two years. About 75 percent of the rise in public debt resulted from domestic bond issues to recapitalize banks and repay Bank Indonesia's liquidity support to the banking system after the crisis. Domestic public debt now totals $89 billion compared with $63 billion in external public debt. Outlays on domestic debt payments are projected to increase sharply to Rp42 trillion, more than twice the amount required to service public external debt, representing the interest on government recapitalization bonds.

Together, domestic and external debt-service expenditures make up 41 percent of total current expenditures and 61 percent of total tax revenues, and will drain public resources for the foreseeable future. As the recovery becomes sustainable, the emphasis of public policy must shift from fiscal stimulus to fiscal consolidation, and then to fiscal sustainability. Given the high level of debt and a weak revenue base, achieving this will require more effective and transparent use of resources and reduced borrowing.

Given this public debt scenario, the government faces several urgent imperatives. First, vigorous efforts are needed to speed up domestic resource mobilization through revenue-raising measures, including accelerating asset sales through privatization. Second, although outlay on the petroleum subsidy is projected to decline as the government increases electricity and fuel prices, other timely price adjustments are needed to reduce subsidies while the targeting of social subsi-

dies to the poor needs to be improved. Third, full transparency and accountability in the use of public resources are needed to ensure the greatest possible development effect and to eliminate leakage of funds. Fourth, careful programming of external assistance is required to prevent negative resource transfer.

In 1999, the deceleration of inflation and appreciation of the exchange rate permitted interest rates to drop. The key one-month Bank Indonesia Certificates interest rate declined from around 35 percent in early 1999 to 12.5 percent by the end of 1999, below the precrisis level. Bank lending rates also declined although not nearly as much, but bank lending remained extremely subdued. Due to the massive overhang of corporate sector debt and high levels of nonperforming loans, banks have adopted an extremely cautious approach to new lending, and are strengthening their capital adequacy ratios. Although further declines in inflation allow room for more reduction in interest rates, it is unlikely to be substantial, given risk perceptions and banking sector weakness.

The targets for monetary aggregates, especially net domestic assets and base money, need to be relaxed gradually to support economic recovery. However, this needs to be done cautiously as increases in government salaries and fuel and electricity prices in 2000 could exert inflationary pressures. The government's inflation target of 5 percent could prove difficult to achieve because of these factors.

Of all the crisis countries, Indonesia's financial and corporate problems have been the most acute. Nonperforming loans are estimated at 60-85 percent of all loans and bank recapitalization costs are estimated at a staggering Rp643 trillion (about $89 billion), or 60 percent of GDP. Restructuring efforts got off to a slow start because of political constraints, and it will likely take several years to restore the financial sector to health. The first major step toward recapitalization of private banks was in 1999, when independent audits—of all state banks, nationalized banks, regional banks, and private banks—ranked banks into three categories according to their capital adequacy ratio.

The banks in category C (those with a capital adequacy ratio of less than negative 25 percent) face liquidation, while some banks in category B (those with a ratio of negative 25 percent to less than 4 percent) will be eligible for recapitalization. All category A banks, those with a capital adequacy ratio of 4 percent or higher, are to continue in business. Seven private banks were recapitalized in 1999, and four state-owned banks comprising half of the assets of the banking sector were merged into one and recapitalized. Recapitalization and restructuring of the remaining state-owned banks will complete the first stage of banking sector reforms, and the next stage will involve modernizing regulatory systems and procedures.

Bank recapitalization is being financed by domestic bond issues, with the government and the recapitalized banks exchanging bonds for outstanding shares. The government plans to cover the interest costs of these bonds from the proceeds of privatization and asset sales of IBRA, which include an estimated Rp250 trillion in nonperforming loans transferred by the banking system in the restructuring process. The IBRA, in turn, faces a complex task of selling its assets. Such sales are critical in reducing the public debt. The devastating impact of the crisis on the banking system points to a strong need for developing the capital market to mobilize domestic savings and reduce the corporate sector's excessive reliance on bank borrowing.

To facilitate corporate restructuring, the government set up the Jakarta Initiative Task Force and the Indonesian Debt Restructuring Agency (INDRA). The Jakarta Initiative Task Force provided a platform for corporate debtors to seek voluntary resolution of their debt outside the judicial system, and the INDRA provided forward foreign exchange cover to restructured deals. Despite these initiatives, corporate debt restructuring has been slow. It is essential to improve implementation of the bankruptcy law, which was revised in 1998. Voluntary mechanisms for restructuring corporate debt will have greater appeal if creditors have reasonable expectations of being able to speedily enforce their claims against debtors through legal means, should voluntary methods fail. The government also needs to make greater efforts to address negative perceptions about governance in judicial processes, and to enhance the capacity of the judiciary to implement the bankruptcy law. The slow pace of corporate debt restructuring has impeded economic recovery.

POLICY AND DEVELOPMENT ISSUES

In Indonesia, decades of unaccountable and centralized administration have tended to degrade the quality and efficiency of several public institutions. Strong growth and rising prosperity for years before the crisis gave rise to a false sense of complacency, delaying necessary action on governance reforms. Poor governance was also responsible, in large part, for the magnitude of financial collapse and fiscal distress. Unless governance reform is accelerated and fundamental changes realized, future growth and development will be impeded. Major priorities in improving governance include combating corruption, improving decisionmaking and administrative structures, and strengthening public institutions.

The government took important steps in 1999 to combat corruption when it passed several new laws. The Clean Government Law requires public officials to declare their assets before assuming their posts and to agree to open their assets to official audit during and after their terms. The Eradication of Criminal Acts of Corruption Law defines corrupt practices that are harmful to the finances or the economy of the state, and establishes the basis for legal prosecution and criminal charges. It also provides for public participation in legal surveillance and the establishment of an independent anticorruption commission for legal enforcement.

New regulations to reform public procurement and project implementation practices are being finalized. While these are important steps, much more remains to be done to promote competition and efficient, transparent, and accountable public administration; encourage citizen participation; and strengthen legal reforms and the role of official oversight agencies. However, progressive institutional change across many sectors could meet significant resistance from vested interests.

Parliament's approval of the Law on Regional Autonomy and the Law on Fiscal Balances earlier in 1999 gave districts and provinces impetus to decentralize. This is intended to improve accountability of the government's decisionmaking process, strengthen participation of beneficiaries, and increase transparency. Implementing the government's wide-ranging decentralization agenda—which includes introducing new systems, structures, and procedures to transfer developmental and administrative functions and fiscal responsibilities to local levels—will pose difficult challenges. Among other things, this implies that many central government agencies will need to make their respective mandates consistent with a decentralized framework. It also implies substantial strengthening of capacity of the public institutions, especially at lower tiers of public administration.

Even before the crisis, poverty was a major concern in Indonesia. The crisis further exacerbated the poverty problem, reversing in a short period gains in social development that were achieved over decades. Even if the surge in poverty proves to be transient, its consequences are not. Moreover, many millions more subsist near the poverty line, and the country has long experienced regional economic disparities that could lead to serious sociopolitical discontent and instability.

Combating poverty remains the foremost development priority, and the new government has given this issue its greatest attention. Decentralization has potential for responding to poverty issues directly and sensitively. It could empower the poor and tap their creative energies, and help build a genuine partnership between government, civil society, and the poor to eradicate poverty. The anticorruption measures of the government will also support poverty reduction, by addressing corruption and inefficiency in public services, including delivery of services to the poor.

Indonesia doubtlessly faces daunting challenges in its path to recovery and sustained growth, and resolution of its problems is likely to take time. However, the arrival of democracy and a government committed to reform have provided new and historic opportunities for the country to confront its problems. It is crucial to seize this window of opportunity now.