

## INDONESIA

**D**uring the first seven months of 2001, policymakers in Indonesia were distracted from economic matters by an extended conflict between Parliament and then President Wahid and by the program of decentralization initiated on 1 January. The deteriorating world economic climate, especially after the attacks on the US on 11 September, will limit short-term economic prospects. The installation of President Megawati in July 2001 now frees the Government to focus on economic issues. A substantial reform agenda needs to be addressed.

Economic Indicator (percent)	1998	1999	2000	2001		2002	
				Current	ADO 2001	Current	ADO 2001
GDP growth	-13.2	0.9	4.8	3.2	4.2	3.9	4.5
Inflation rate	77.6	2.1	9.3	11.0	9.0	9.0	6.0
Current account/GDP	4.3	4.1	5.2	2.1	2.9	0.6	1.3

**Economic Assessment.** In the first half of 2001, GDP growth slowed to 3.4 percent from 4.8 percent in the same period in 2000 mainly because of continued household and public sector spending and a modest recovery in private investment. Government expenditure—although hampered by debt-repayment needs—rose by an average of 5.9 percent in the first two quarters (relative to the respective year-earlier period) and household spending grew by 5.3 percent. By sector, growth was most striking in manufacturing—averaging 4.2 percent in the two quarters—as well as in some services, particularly utilities and transport. The improvement in manufacturing was relatively broad based, following moderate increases in demand from households, businesses, and the external sector. Financial services showed only modest expansion, reflecting the still weak financial capacity of most banks. Offsetting some of this relatively good performance, imports were 34.6 percent higher than in the same two quarters of 2000, accelerating at more than twice the pace of exports, which rose by 14.3 percent. The import surge represents some rebound in consumer and business demand after income and production recovered somewhat in 2000 from the Asian financial crisis. Assuming a reasonable performance in the agriculture sector (on the basis of normal weather conditions), but faced with a more protracted global slowdown and uncertainties generated by the attacks on the US, the economy could show 3.2 percent growth for the whole of 2001, compared with the earlier forecast of 4.2 percent made at the time of ADO 2001 in April this year.

The 2001 inflation rate is higher than called for under the previous IMF agreement and recommitted to as late as 15 June 2001 in the revision to the 2001 budget. Inflation moved to double digits after February 2001 and continued to run at 10 percent or more on an annual basis through September, when the 12-month price change was 13.0 percent with relatively large increases in housing and transport services. A weaker domestic currency, accommodative monetary policy, and increases for price-administered

goods and services, such as oil and electricity, all contributed to increased inflation. The new IMF-supported macro-stabilization program, finalized in September 2001, targets lower inflation and calls for a more anti-inflationary monetary policy.

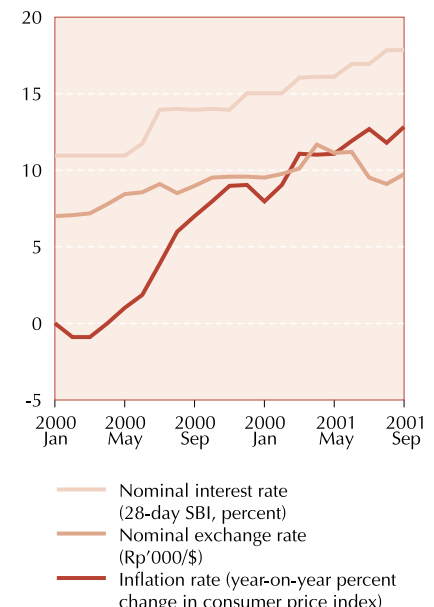
The rupiah weakened significantly in the first six months of the year, and by June 2001 stood at Rp11,400/\$, or 30.6 percent weaker than in June 2000. Political uncertainties at the end of April briefly forced it to below Rp12,000/\$, but it recovered significantly in early August to Rp8,400/\$ as the political situation appeared to stabilize. After this brief spike, continued expectations of depreciation, due to the corporate sector's need to service external debts and to pay for imports in the coming months and the international uncertainties beginning in September, caused the rupiah to fall again. On 24 October, it stood at Rp10,245/\$. Continued weakening of the rupiah, as seen in the third quarter of 2001, will complicate the monetary authorities' task of meeting the inflation commitment.

Indonesian exports rely heavily on Organisation for Economic Co-operation and Development (OECD) markets. Exports to the US and Japan will likely account for approximately 35 percent of total exports in 2001. Any further slowdown in the OECD economies will have a strong impact on the external trade balance. While monthly movements have been somewhat hard to interpret because of the extreme volatility of the oil and gas components, overall recent export levels are little different from those of a year earlier, suggesting that the export surge in early 2000 has not continued into 2001. Import growth has, on the contrary, shown some pickup as repressed household demand and some strength in investment occurred in late 2000 and early 2001. Exports fell by 0.3 percent in the first six months of 2001 while imports grew by 28.4 percent. As a result, the merchandise trade surplus fell by 25.6 percent in the first half of 2001 relative to the same period in 2000.

The shrinking trade surplus constitutes a clear risk for any strong recovery of the economy. After the emergence of the financial crisis in 1997, exports rebounded faster than imports, providing a positive trade balance and cushioning the economy against continued private capital outflows and a deficit on the services account. The events of 11 September are likely to have an impact on Indonesia's service flows in the near term as tourism has fallen off due to heightened security concerns, insurance payments have increased, and risk premiums on both sovereign and private debt have risen. With the changing trade figures, the current account surplus as a whole fell by approximately 25 percent on a year-on-year basis in the first half of 2001. This decline is expected to continue with the moderation in the trade surplus, which is likely to end the year at around \$3.5 billion, down from \$8.0 billion in 2000.

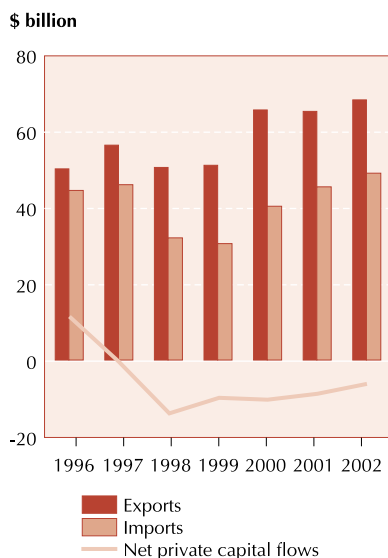
Unlike other crisis-affected economies, Indonesia's foreign investment flows have not recovered from the collapse in 1997/98. Unresolved political uncertainties have discouraged capital inflows, while foreign investor confidence is low due to perceptions that the country is suffering from political or governance problems. This year, foreign investors have noted, in particular: security problems affecting mining and oil and gas companies, such as

**A weaker currency and an accommodative monetary policy contributed to increased inflation**



Source: [www.bi.go.id/bank\\_indonesia2](http://www.bi.go.id/bank_indonesia2)

**Exports rebounded faster than imports after the 1997 financial crisis, cushioning the economy against continued private capital outflows**



Sources: Bank Indonesia Annual Report 2000, World Bank Consultative Group on Indonesia document for 2000, staff estimates

ExxonMobil in Aceh; political interference in the asset sales process of the Indonesian Bank Restructuring Agency (IBRA); and an uncertain judicial environment as shown in the Manulife case (which involved officials from the police and judiciary conniving in attempted extortion against a foreign-owned subsidiary during a sale of government assets). A slowdown in official development assistance, reflecting especially the end of the crisis programs, is an additional factor in the balance-of-payments picture. Finally, the negative publicity resulting from political demonstrations in Indonesia related to ongoing world political tension and military conflict in Afghanistan will likely further reduce the potential for investment flows into Indonesia and perhaps exacerbate capital flight from the country.

Besides political and security concerns, a more demanding labor movement might be another factor behind capital outflows. Labor unrest in mid-June 2001 convinced the Government to rethink its plans to implement administrative decrees relating to severance or termination pay by private employers. These decrees aimed to reverse an earlier decree that mandated payouts upon severance. The business community regarded these payouts as unreasonably high—yet labor in their turn considered the subsequent plans unreasonable.

Indonesia's external debt increased in early 2001. At the end of April, total external debt was estimated to be \$139.1 billion, with the public sector accounting for just over half.

Privatization and asset sales are expected to contribute Rp34.4 trillion in calendar year 2001, or 12.0 percent of total government revenue, a target that will be a challenge. In the past, opposition from political groups and vested interests has combined to frustrate public asset sales. By 31 July this year, IBRA had realized only 50 percent of its planned asset sales and the Government had not begun the planned but difficult process of privatizing 16 SOEs.

As well as encouraging asset sales, the Government needs to continue to strengthen the banking system—it was the risk of systemic failure in the banking system that led to the Government's assumption of debt and assets during the financial crisis. As part of the present moves at strengthening the system, Bank Indonesia has mandated that, by the end of 2001, banks meet (i) an 8.0 percent capital-adequacy ratio target and (ii) a ceiling on maximum nonperforming loans of 5.0 percent. Through the transfer of troubled loans to IBRA, the aggregate nonperforming loans of all commercial banks fell to 23 percent by the first quarter of 2001 from 50 percent at the beginning of 1999, still far above the 5.0 percent target. In October 2001, Bank Indonesia and IBRA took the step of closing one bank because its capital-adequacy ratio was negative; they were also likely to merge another four banks.

**Economic Management Issues.** Domestic economic weakness resulting from the financial crisis has limited the extent to which the authorities can use fiscal and monetary policy to boost domestic demand in the wake of the current slowdown in export growth. A relatively loose monetary stance has aggravated the inflationary and exchange rate picture. Bank Indonesia has

moved to limit international transactions of the rupiah (other than those related to trade and payments) but this measure is unlikely to have much impact by itself. The basic problem has been relatively rapid growth in the monetary aggregates. From August 2000 through August 2001, narrow money grew by 22.2 percent and broad money by 12.9 percent. Although volatile on a month-to-month basis, the overall results are above government targets. Interest-rate movements might seem to indicate some evidence of tighter monetary policy. The central bank's one-month bill rate in August 2001 was more than 316 basis points higher than in December 2000. However, real interest rates showed no definite increase in the first half of 2001 and, as a result of the more rapid price increases in June and July, real interest rates fell during those months.

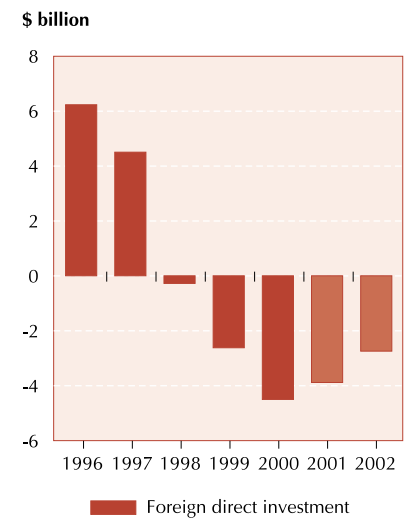
The 2001 budget has been revised several times as economic conditions have changed, particularly as regards the weakening rupiah and higher domestic interest rates. The latest budget revision, approved on 15 June 2001, targeted a 3.7 percent budget deficit. Central government spending is limited by large foreign and domestic public sector debts and softening world oil and gas prices. The very large domestic debt resulted from bank restructuring and associated public sector costs in the wake of the financial crisis. To meet deficit targets in the face of slack revenue mobilization, targeted current expenditures in 2001 were lowered in June 2001 from 17.9 percent of 2000 GDP to 14.5 percent. More than 91 percent of current expenditures are allocated to interest payments (6.1 percent of GDP), subsidies (4.5 percent), and public sector personnel expenditures (2.6 percent). Development expenditures are limited to 3.1 percent of GDP; approximately 90 percent of these are to be financed by official development assistance loans. As part of the revised 2001 budget plan, the Government increased the VAT rate from 10 to 12 percent, widened the tax base, and increased luxury and excise taxes.

The revised 2001 budget and the easing of political uncertainties in August paved the way for a new agreement with IMF over a stabilization program. The delay in this had heightened investor concerns and put at risk last year's Paris Club agreement. IMF had postponed the third disbursement under its extended fund facility to Indonesia, originally planned for September 2000. The IMF executive board reviewed the program in September 2001 and approved the disbursement of \$395 million in new lending.

Through the end of August 2001, the Government has been quite careful in its fiscal affairs. Revenue collections are slightly ahead of targets, and expenditures close to targets. A report by the Ministry of Finance to Parliament revealed that 62.7 percent of expected total revenues and 55.0 percent of planned expenditures for the calendar year were realized by 31 August 2001. The actual budget deficit for the period was Rp7.8 trillion or 14.5 percent of the total planned deficit for the year (Rp54.3 trillion).

The 2002 budget was approved on 23 October after a six-week review by Parliament. The 2002 budget calls for total expenditures to fall from 23.2 percent of GDP in the 2001 budget to 19.6 percent. Development spending, still wholly financed by the central Government, will fall from 3.1 percent of GDP in 2001 to 2.8 percent in 2002. In her budget speech to

**Foreign investment flows have not recovered from the collapse in 1997/98**



Sources: Bank Indonesia Annual Report 2000, World Bank Consultative Group on Indonesia document for 2000, staff estimates

Parliament, President Megawati noted the importance of decreasing public subsidies for fuel by raising retail fuel prices. The Government has also announced that it will continue with plans to increase electricity prices in order to reduce the operating losses by the state electricity company. The overall government budget deficit is projected to fall to 2.5 percent of GDP in 2002 from 3.7 percent in 2001. Foreign funding is expected to account for 52 percent of next year's budget gap.

The installation of a new government and a new economic team must now be accompanied by efforts to stabilize the economy and relaunch reforms. Failure to meet the privatization and asset sales targets will jeopardize recovery prospects and further restrict development investment. To meet nontax revenue targets, many aspects of IBRA operations need attention, including a conflict of interest among IBRA employees who are also commissioners in companies to be restructured by the Agency. This is one aspect of the difficulties in overcoming vested interests in public sector privatization cases. Another is that there is no widespread political support for privatization, and outright opposition ranges from nationalist factions to those who resent the low postcrisis prices that might be attached to the many publicly held assets.

An important goal for the new Government is to improve governance generally, but specifically to make the legal and judicial system more effective in the context of the ongoing decentralization process. The commitment of the Government, at the highest levels, to address issues of corruption, collusion, and nepotism, known widely in Indonesia by the local-language abbreviation KKN, is strong. However, it is proving quite difficult for the authorities to show clear and significant progress.

**Forecast.** In 2002, GDP growth is likely to pick up to around 3.9 percent on the back of a gradual global recovery. Realization of this forecast would depend on an oil price of around \$20 a barrel in 2002, and on prices of non-oil commodities staying at similar levels to 2001. Higher growth would be possible with significant improvements in political and security conditions.

Scheduled increases in administered prices of goods and services, plus the growing introduction of regional taxes, will put upward pressure on prices. Against this, the agreement with IMF on a more aggressive anti-inflationary stance for monetary policy calls for inflation in 2002 to be below double-digit levels. Success in this will require somewhat aggressive tightening of monetary policy, continued reforms in the banking sector, and some stabilization of the exchange rate. Continued slow growth of the global economy and the moderate economic recovery in Indonesia will reduce the trade surplus—higher import growth will likely accompany lower export growth. A smaller merchandise trade surplus plus the scheduled payment of external debts will virtually dissipate the current account surplus.