

CER:INO 2004-22



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# COUNTRY ECONOMIC REVIEW

*INDONESIA*

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*December 2004*

## CURRENCY EQUIVALENTS

(as of 6 December 2004)

|               |   |             |
|---------------|---|-------------|
| Currency Unit | – | rupiah (Rp) |
| Rp1.00        | = | \$0.0001    |
| \$1.00        | = | Rp8,900     |

## ABBREVIATIONS

|      |   |                                      |
|------|---|--------------------------------------|
| ADB  | – | Asian Development Bank               |
| BDB  | – | Bank Dagang Bali                     |
| BI   | – | Bank of Indonesia                    |
| BPS  | – | Badan Pusat Statistik                |
| GDP  | – | gross domestic product               |
| IBRA | – | Indonesian Bank Restructuring Agency |
| MDG  | – | Millennium Development Goals         |
| MOF  | – | Ministry of Finance                  |

## NOTES

- (i) Until 2000, the fiscal year was from 1 April to 31 March of the following year. In 2000, the fiscal year was 1 April-31 December 2000. After 2000, the fiscal year was the calendar year.
- (ii) In this report, "\$" refers to US dollars.

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## **EXECUTIVE SUMMARY**

Indonesia's modest yet stable growth performance over the last 3 years has shifted the growth debate from its focus on recovery and stability to the challenges of attaining higher and sustainable growth levels. The 2004 Presidential elections will be a landmark in Indonesia's history, with the country of over 210 million selecting its President directly in relatively smooth elections. President Susilo Bambang Yudhoyono has prioritized fostering economic growth through greater investments in development, tackling corruption, and enhancing security as the key items of his vision for Indonesia over 2004-09. The macroeconomic stability coupled with greater political certainty is bound to increase consumer confidence, and combined with the new administration's proposed policy measures, it could facilitate revival of investments in Indonesia and provide an impetus to economic growth.

The most impressive outcome on the policy front is Indonesia's success in the fiscal consolidation process. The Ministry of Finance's prudence in expenditure management and its efforts to improve revenue administration have facilitated progress in this regard. The fiscal deficit is likely to be 1.5% of gross domestic product in 2004, down from 2.1% in 2002. While the focus on deficit reduction has been at the cost of foregone development spending for social and physical infrastructure, it has nevertheless put in place a sense of realism that was needed in the transition phase to accommodate the massive costs of economic and financial sector restructuring over the last 6-7 years. To be added to Indonesia's credit is also its success in finally managing to restructure the financial sector, albeit at a slow and staggered pace. This has led to a gradual but significant divestment of state ownership in commercial banks.

A few key development challenges, however, have subdued the growth performance thus far. Of key concern has been the weak investment climate, which has been adversely affected by the lack of policy, legal and regulatory clarity, compounded by controversial court cases threatening the existence of a few otherwise sound foreign companies and eroding investor confidence. Furthermore, the involvement of local governments has made investment regulations cumbersome. Besides, the unfolding process of decentralization and weaknesses surrounding the intergovernmental fiscal transfer mechanisms to finance local government priorities have impacted on the efficiency of public service delivery mechanisms.

The new Government has set itself a target of 6% real GDP growth on average per year during the next 5 years of its term. For this to be realized, Indonesia needs to attract greater foreign and domestic investments to offset the infrastructure shortfalls that have economy wide implications. Strategically, the Government's policy focus on the energy sector will be watched closely for two reasons. It needs to boost oil and gas production, through catching up on investments that have steadily declined over the last 10 years. At the same time, the Government also needs to address the politically sensitive issue of reducing the burgeoning domestic subsidies on oil.

Moving forward, there is a need to strengthen policy coordination within the Government to ensure adequate focus on development priorities, enhance Indonesia's competitiveness, revitalize infrastructure spending, and improve the implementation of fiscal decentralization to achieve balanced development.

In the short run, the new Government is aiming to achieve some quick results and build public trust and confidence. However, public expectations are high and may not be fully met, particularly given the magnitude of the economic and political challenges. The Government is in an unenviable position of working with a Parliament in which the President's Democratic Party

or the other parties that supported his election do not have a majority. At best, this may lead to delays, and at worst may result in political stalemates or unhealthy compromises on policy and legal fronts. Yet, this is the first time that Indonesia has a President who has the direct mandate of the people. This advantage should help the President move forward on tasks that are within the scope of the executive branch.

This Review forecasts real GDP growth at about 4.9% in 2004 and in the range of 5.2-5.5% in 2005. Bank Indonesia's commitment to maintain price stability will ensure moderate inflation of no higher than 7% over the coming year. The currency will stay in a fairly narrow margin around Rp9,000 to \$1.



## I. RECENT ECONOMIC DEVELOPMENTS

### A. Growth Trends and its Composition

1. Indonesia has experienced stable and moderate growth performance over the last 3 years. Key indicators over 2001-04 underscore the resilience of the economy, which has weathered a series of exogenous shocks including the terrorist attacks in Bali in 2002 and Jakarta in August 2003, and the regional spread of the severe acute respiratory syndrome in early 2003. Against these odds, the Indonesian economy grew by 4.5% in 2003, up significantly from 3.7% in the previous year, but it is yet to show promise of turning in the higher growth rates needed for employment generation and sustainable poverty reduction

2. Recent forecasts of Indonesia's economic growth have been conditioned by the uncertainty over the parliamentary elections in April 2004 and the first ever, direct presidential elections, held in two rounds, over July to September 2004. Supported by the possible emergence of certainty and stability after the first round presidential elections in July and early outturns in the second round in September, the real gross domestic product (GDP) continued to grow by 4.9% over the first 9 months of 2004, relative to the same period in 2003. Growth remained resilient despite the terrorist attack at the Australian embassy in Jakarta in early August 2004, though security still remains a concern. The smooth conclusion of the electoral process is likely to enhance public and investor confidence. Key indicators of growth are presented in Table 1.

**Table 1. Real GDP Growth**  
(year-on-year growth in %, using 2000 as base year)

| GDP and Components            | 2002              | 2003       | 2004       |
|-------------------------------|-------------------|------------|------------|
|                               | January-September |            |            |
| <b>Gross Domestic Product</b> | <b>3.7</b>        | <b>4.1</b> | <b>4.9</b> |
| <b>By Expenditure</b>         |                   |            |            |
| Private Consumption           | 6.4               | 4.7        | 5.3        |
| Public Consumption            | 11.9              | 9.9        | 3.8        |
| Fixed Investment              | (3.7)             | 2.5        | 11.3       |
| Exports                       | (4.0)             | 0.6        | 8.3        |
| Imports                       | 18.2              | 0.2        | 24.1       |
| <b>By Economic Sector</b>     |                   |            |            |
| Agriculture                   | 4.2               | 2.8        | 3.2        |
| Mining                        | 0.6               | 4.1        | (5.5)      |
| Manufacturing                 | 3.6               | 2.5        | 5.6        |
| Construction                  | 3.9               | 6.4        | 8.1        |
| Finance                       | 3.4               | 5.9        | 5.4        |
| Transport                     | 7.9               | 9.2        | 13.6       |
| Retail Trade                  | 4.2               | 4.3        | 8.0        |
| Services                      | 1.9               | 2.4        | 4.7        |

Source(s): Ministry of Finance; Badan Pusat Statistik (BPS) - National Statistics Agency

3. As in much of Southeast Asia, strong domestic demand has driven growth in Indonesia over the last few years. Robust personal consumption, in particular, has remained the principal driver of growth since the 1997–1998 Asian financial crisis. There has been a strong recovery in fixed investments, which grew at 11.3% during the first 9 months of the year over the same period in 2003, growing from a low base in 2002-2003, although business investment as a whole has been declining in relation to GDP. A noteworthy recent development has been the

decline in public spending in 2004, which grew by a mere 3.8% during January-September 2004 over the same period in 2003. In terms of the components of growth, personal consumption accounted for 3.0 percentage points in the first nine months of 2004, boosted by higher spending stemming from the parliamentary and presidential elections. Government consumption contributed 0.4 percentage point and investments contributed 1.1 percentage points, while net exports contributed 0.4 percentage point of the GDP expansion. Construction, transportation, and retail activity picked up, and the sectors with the greatest impact on jobs strengthened somewhat more modestly, with agriculture growing by 3.2% and manufacturing by 5.6%.

## **B. Employment, Wages and Poverty**

4. Stable but modest economic recovery over the last few years has helped in gradually improving the welfare of the population. Real GDP growth rates of 4.0% to 4.5% per annum have reduced poverty and unemployment levels in relation to the crisis period. However, they have been insufficient to absorb the additional 2-3 million entrants to the workforce each year. The annual labor force survey (*Sakernas*) indicates that the unemployment rate increased from 9.1% in August 2002 to 9.3% in August 2003, though latest quarterly surveys<sup>1</sup> show that unemployment has been falling from 8.5% in August 2003 and further to 7.4% in May 2004. This trend appears to be largely because of growth in opportunities in the informal sector.

5. Until 2001, expanding labor-intensive industries such as footwear absorbed surplus labor and reduced unemployment. But, in the last two years, jobs have been shifted out at an alarming rate from factories to farms and fisheries where productivity and wage growth are much slower.<sup>2</sup> From 2002 to 2003, jobs in the manufacturing sector fell by 9.8% to 10.9 million and jobs in the footwear sector fell by almost 60% as factories closed or relocated out of Indonesia, due to constraining labor regulations and increasing minimum wages. In Jakarta, for instance, the nominal monthly wage has jumped from Rp231,000 in 1999, to over Rp670,000 in 2004. In real terms, the minimum wage increased by about 40% over the five years.

6. Overall labor costs have risen sharply in recent years, particularly in the manufacturing sector (Figure 1). Costs in 2002-03 were about 35% higher than the pre-crisis levels. While this increase took place from very low post-crisis levels and in itself would not have significantly reduced competitiveness, labor-intensive manufacturing industries catering to export markets appear to have borne the brunt of increasing unit labor costs. Partly explained by the increase in labor costs, there is evidence that growth in labor productivity has contributed evenly to GDP growth since 1990. For instance, total factor productivity accounted for 0.9 percentage points of the average annual GDP expansion of 7.4% during 1990–1997. The bulk of the expansion came from growth in capital stock, accounting for 3 percentage points of the average annual GDP growth. This trend has continued after the crisis, with total factor productivity during 1998–2003 accounting for 0.8 percentage points of the average annual GDP expansion of 3.2%.<sup>3</sup> This is notable, given the deceleration in investments post-crisis.

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<sup>1</sup> Strictly, these surveys are not entirely comparable. The annual survey is a snapshot of the labor market in August every year and is nationwide, while the quarterly surveys are conducted in 3-monthly cycles from February every year on a smaller sample with a varying coverage of provinces.

<sup>2</sup> Based on 2003 National Labor Force Survey (*Sakernas*) conducted by the Central Statistics Agency.

<sup>3</sup> Haryo Aswicahyono, June 2004. *Indonesia's Strategy for Industrial Upgrading*, United Nations Support Facility for Indonesian Recovery. See also World Bank. November 2004, *Economic and Social Update*, Jakarta.



7. Labor market data indicate that the proportion of the unemployed among those with higher levels of education has increased. One reason is that better paying jobs are not expanding sufficiently, but it may also be that better educated individuals are waiting longer to accept job offers, which may reflect improving family support and declining poverty.

8. Indonesia has made significant progress in reducing poverty since the 1997 financial crisis, which had a devastating effect on the lives of millions of people. The incidence of poverty, calculated from 2003 Susenas household survey, has dropped from 19.1% in 2000 to 16.6% in early 2004—lower than the level immediately preceding the Crisis. The incidence of urban poverty was 12.6%, while in rural areas it was 19.5%. There are, however, challenges to alleviating poverty and achieving other Millennium Development Goals (MDGs), especially in health and education, as highlighted in the Government's progress report on the MDGs, released in June 2004. The report documents substantial regional disparities in the progress towards these targets. Table 2 summarizes the key issues.

**Table 2: Indonesia's Progress in Meeting the MDGs**

| Millennium Development Goals                           | Outcomes – Progress and Challenges   |
|--|--|
| Goal 1: Eradicating extreme poverty and hunger         | Indonesia is on track to achieving a poverty level of 7.5% by 2015, or half of the 1990 level. However, adequate progress is not likely to be made in reducing severe malnutrition. Regional disparities in poverty incidence are another key challenge.   |
| Goal 2: Achieving universal basic education            | Indonesia is on track for all children to complete basic education of 9 years, although a key challenge is to increase the quality of education and the efficiency of resource management in the sector, in particular at the district levels, where provision of resources is uneven.                         |
| Goal 3: Promoting gender equality and empowering women | Indonesia has achieved sound progress in reducing gender disparity in literacy and education. Yet equal access in labor force participation is of concern.   |
| Goal 4: Reducing child mortality                       | Under-5 mortality has been declining steadily and the goal of halving this rate to 30 per 1,000 live births by 2015 is likely to be met. However, comparisons with other countries and regional disparities within Indonesia present a negative picture, with Indonesia lagging behind regional neighbors.     |
| Goal 5: Improving maternal health                      | The target of the reducing the maternal mortality ratio by three quarters between 1990 and 2015 is unlikely to be met, as it declined only from over 400 to 307 in the 12-year period from 1990 to 2002. Moreover, Indonesia also needs to address the regional disparities within the country moving forward. |

| Millennium Development Goals  | Outcomes – Progress and Challenges  |
|---|---|
| Goal 6: Combating HIV/AIDS, Malaria and other communicable diseases | Indonesia faces significant challenges in meeting this goal, with malaria and tuberculosis incidence quite serious in some regions. About 30 million malaria cases are expected every year. Indonesia ranks third in the world in the number of TB cases. Indonesia also faces the risk of a large scale HIV/AIDS epidemic unless concerted efforts are made. |
| Goal 7: Ensuring environmental sustainability                       | Progress thus far is mixed and future progress is uncertain. Sustainable and responsible resource management is emerging only slowly. Less than 20% of the population has access to piped water, and less than 50% has access to improved water sources.  |

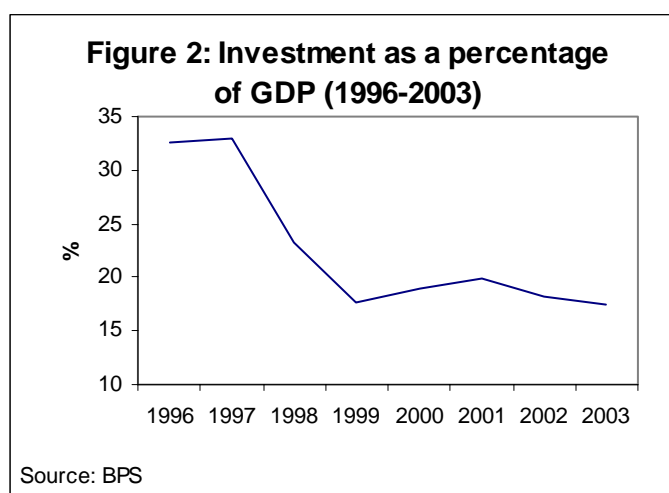
HIV/AIDS – Human Immunodeficiency Virus/Acquired Immuno Deficiency Syndrome; TB - Tuberculosis

Source(s): Indonesia: Progress Report on the Millennium Development Goals, February 2004, Bappenas.

9. Over the last few years, the Government's policy direction has been to integrate poverty reduction with medium-term planning and budgeting instruments. It has attempted to base poverty reduction on comprehensive analyses of current and future needs, targets and overall macroeconomic and fiscal realities. However, effective integration of pro-poor elements into the planning and budgeting process needs more consistent initiatives at the central Government level, and more importantly at the local levels.

### C. Investments

10. Recent economic stability and moderate growth rates have not come alongside strong investment spending in Indonesia in recent years, and this trend has continued into 2003. Overall, actual investments grew only by a small 2.2% and the investment-to-GDP ratio has fallen to its lowest level since the early 1970s. It declined from 18.2% in 2002 to 17.8% in 2003, and further to 17.4% in the first quarter of 2004, as the increase in total business spending failed to keep pace with GDP growth (Figure 2). The Capital Investments Coordinating Board reported that \$13.2 billion equivalent in foreign investment projects (up from \$9.8 billion in 2002) and \$5.8 billion equivalent in domestic investments (up from \$3 billion) were approved in 2003. The approvals covered 468 foreign and 182 domestic investment projects. In terms of realization, however, actual foreign investments amounted only to \$4.9 billion or 37.6% of approvals, while domestic investments came to \$2.3 billion, or 39.2% of the approvals during 2003.



11. There is, however, some indication that investment spending has begun to recover in 2004. Particularly noteworthy is the recovery in fixed investments, which grew by 8.3% in the first half of 2004 and further by 13.1% in the third quarter over the same period in 2003. In the

first nine months of 2004, the Capital Investments Coordinating Board has thus far approved \$8.0 billion equivalent in foreign investments, a rise of 24% in comparison with the corresponding period in 2003, and \$2.8 billion equivalent in domestic investments, representing a 44% increase over the same period in 2003. In terms of composition, while property investments were strong—growing at 7% year-on-year—investments in machinery and transport equipment also increased. In particular, capital goods imports increased by over a third year-on-year during January-August of 2004.

12. While the investment recovery so far in 2004 is clearly a positive sign, only an overall conducive investment climate as demonstrated by legal and regulatory certainty and improved enforceability of contractual obligations will encourage this trend to continue. The recovery needs to be propped up by a swift resolution of the ongoing high profile and high value investment disputes, including those between the Karaha Bodas Company of the United States and the State-owned oil monopoly Pertamina, and the Cemex Company of Mexico and the State-owned cement company PT Semen Gresik.

#### **D. Fiscal Developments**

13. The most significant economic policy developments during the course of 2004 have been on the fiscal front. Following the enactment of the State Finance Law (Law 17/2003) in March 2003, Parliament endorsed five major laws in 2004: the State Treasury Law (Law 1/2004) in January, the State Audit Law (Law 15/2004) in June, the Law on National Development Planning (Law 25/2004) in July, and amendments to the Law on Regional Autonomy (Law 32/2004) and the Law on Regional Fiscal Balance (Law 33/2004) in September 2004. They provide an overall framework for all planning, budgeting and administrative aspects of public expenditure management, and guide intergovernmental fiscal relations in Indonesia. The Ministry of Finance (MOF) has completed the new functional classification system for the budget—replacing the old sectoral classification, and sound progress has been achieved in unifying the development and recurrent budgets. The Government has also finalized key regulations on the Government work plan and budgeting, which will facilitate a proper alignment between functional needs of various institutions, their performance, and budgetary allocations. At the core of all these reforms is the reorganization of MOF, designed to establish modern budget and treasury management systems. However, as outlined in Section II below, the overall intergovernmental fiscal framework remains weak, due primarily to lack of clarity on the assignment of expenditure responsibilities between different levels of Government. It is further aggravated by the absence of clear rule-based mechanisms guiding the allocation of resources in an equitable and efficient manner to meet overall development needs and priorities.

14. Over the course of 2003, the Government continued its policy of prudent fiscal consolidation, in line with its goal of balancing the budget by 2007. The revised budget for 2003 had projected an overall fiscal deficit of 1.9% of GDP, compared with 1.7% in 2002. However, the actual deficit leveled off at 2.1% of GDP in 2003, largely as a result of lower tax revenues and somewhat higher expenditures than anticipated. In terms of resources, domestic bank financing and privatization resulted in budgetary inflows equivalent to about 2% of GDP.

15. Oil prices have been a major determinant of public budgets everywhere in 2004, and Indonesia has been no exception. However, Indonesia being an oil producer and net exporter, oil prices affect revenues and expenditures in nearly equal ways, resulting in a marginal net impact on the budget. The original 2004 budget projected a deficit of 1.2% of GDP, on the basis of an average oil price of \$22 per barrel. In August 2004, the outgoing Parliament revised both revenue and expenditure forecasts, and raised the oil price assumption to \$36 per barrel. The

net impact of the oil price increase itself on the deficit is almost zero, and the deficit target was only marginally revised upwards to 1.3%, because of the almost equivalent impact of higher oil prices on revenues and expenditures. The gross impact of higher oil prices is significant with an increase in fuel subsidies to Rp59.2 trillion, close to the overall development expenditures. Table 3 summarizes the budget. The issues related to oil production, exports and subsidies are described in Box 1.

|  | 2003 (P) | 2004 (R) | 2005 (P) |
|--|----------|----------|----------|
| <b>Revenues</b>                          | 16.3     | 17.6     | 17.8     |
| Tax Revenues                             | 13.8     | 13.6     | 13.6     |
| Oil and gas Revenues                     | 3.9      | 4.7      | 2.2      |
| <b>Expenditures</b>                      | 18.2     | 18.9     | 18.0     |
| Subsidies                                | 1.7      | 3.0      | 1.0      |
| Development Expenditures                 | 3.2      | 3.5      | 3.6      |
| <b>Overall balance</b>                   | (1.8)    | (1.2)    | (0.8)    |
| <b>Gross Financing Needs<sup>1</sup></b> | 2.9      | 4.4      | 3.8      |
| Domestic Financing                       | 1.7      | 2.2      | 1.7      |
| Amortization                             | (0.3)    | (1.0)    | (0.9)    |
| Foreign Financing                        | 0.1      | (0.8)    | (0.9)    |
| Gross Disbursement                       | 0.9      | 1.4      | 1.2      |
| Amortization                             | (0.8)    | (2.2)    | (2.1)    |
| <b>Budgetary Assumptions</b>             |          |          |          |
| GDP Growth Rate                          | 4.5      | 4.8      | 5.4      |
| Inflation                                | 6.0      | 6.5      | 5.5      |
| Exchange Rate                            | 8,500    | 8,600    | 8,600    |
| Oil Price per Barrel                     | \$28     | \$36     | \$24     |

2003 (P):Preliminary outturn; 2004 (R): August revision; 2005 (P):Proposed  
1. Sum of overall budget balance and repayment of principal debt.  
Source: MOF.

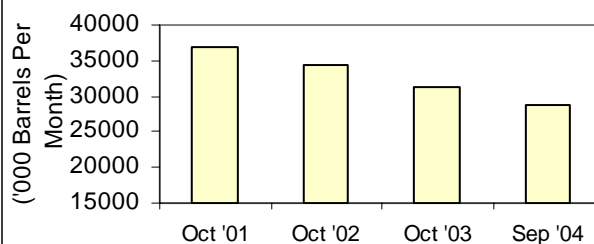
16. To finance the deficit in the 2004 budget, the Government set out to issue domestic and foreign bonds to raise Rp32 trillion. In March 2004, on the back of strong global demand, the Government issued \$1.0 billion worth of global bonds for the first time since 1996, with 10-year maturity and a weighted average yield of 6.8%, or 227 basis points over the U.S. Treasury rate. This compares favorably with the recent sovereign bond issuance by the Philippines, which had a yield of 8.8%. The remaining Rp23 trillion has been raised through the issuance of domestic bonds, a target the Government has met with the last issuance in November 2004. Since 1997, the Government has issued domestic bonds worth over Rp650 trillion (\$70 billion), primarily to support bank restructuring. As these bonds have started maturing, the Government has focused its efforts over 2003–2004 on raising resources by issuing new bonds to refinance previous ones. The 2004 budget allocates Rp41.3 trillion (\$4.8 billion) to service the domestic bonds.

17. The overall stock of total external debt at end-2003 leveled off at \$135 billion or 65% of GDP, with public external debt accounting for 38.6% of GDP. Outstanding domestic debt stood at Rp624 trillion (\$72.6 billion) at the end of 2003, or 35% of GDP, most of it public. Debt management operations, especially bond swaps, resulted in a debt reduction of Rp20 trillion during the course of 2003. The Government debt to GDP ratio has declined from 59% at the end of 2003 to 53% in June 2004. From levels above 90% during the crisis, the level of public debt is scheduled to decline gradually to sustainable levels of around 50% over 2005–2007.

### Box 1: Impact of Higher Oil Prices on the Indonesian Economy

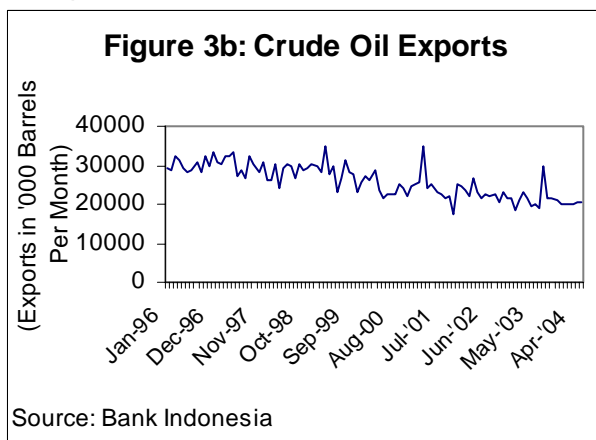
Although an oil-producing and exporting country, Indonesia has not been able to reap the rewards of oil price increases because of its commitment to subsidize fuel prices and its inability to boost oil exports, which in turn have been affected by declining production. Indonesia's oil output has declined from close to 1.3 million barrels per day (bpd) in 1999 to about 0.96 million bpd as of September 2004 (Figure 3a), well below the 1.4 million bpd quota set by the Organization of Petroleum Exporting Countries. As a result, Indonesia became a net oil importer in March-April 2004, although the trend has subsequently reversed.

**Figure 3a: Declining Crude Oil Production**



Source: OPEC Market Indicators

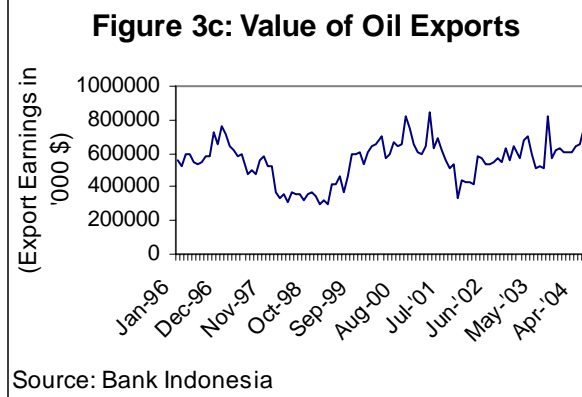
According to the Ministry of Energy and Natural Resources, Indonesia has failed to catalyze adequate investments in the oil sector over the last 10 years, leading to significant loss in production and revenues. A key impediment to new investments has been the delay in formulating clear implementing regulations for the Law on Oil and Gas (Law 22/2001). This law unbundled the oil and gas sector, separating the regulatory functions from the state-run Pertamina to BP Migas, an agency reporting directly to the President. The law also aimed to end Pertamina's monopoly control of the domestic distribution of fuel and oil derivatives with effect from 1 January 2005, with local and foreign private investors allowed to enter refining, transportation and storage as well as retail sales. However, the implementing



regulations do not clearly define Pertamina's new role. Given its vast assets and distribution channels, Pertamina will continue to be a dominant player. In an effort to boost oil production, the Government has recently awarded 15 new oil and gas contracts that will lead to new investments of \$160 million. While this is encouraging, significantly larger investments are needed to boost production.

As a result of declining production, Indonesia's oil export performance has deteriorated over the years (Figure 3b). In 1996, it was exporting about 1 million bpd, but exports had declined by more than a third by 2004. Its export earnings (Figure 3c) declined during the crisis and again in 2002, before gradually recovering to pre-crisis levels in 2004, though most of the recovery on this front has been due to price increases rather than to production gains. The Indonesian public sector as a whole benefits from oil price increases, through tax and non-tax revenues. However, while a \$1 increase in the price of oil is estimated to increase budgetary revenues by Rp3.8 trillion, fuel subsidies increase by about Rp3.1 trillion and the oil revenues that are shared with the oil-producing regions of Indonesia increase by Rp0.6 trillion. Thus, the overall budgetary balance will increase only by a relatively small Rp100 billion.

While subsidies are the responsibility of the central Government, oil and gas revenues are shared with all the regional governments of Indonesia. Under the Regional Fiscal Balance Law 25/1999 (subsequently amended in 2004 to Law 33/2004), regions are entitled to a 15% share of oil and a 30% share of natural gas produced locally. These shares will increase to 15.5% and 30.5%, respectively, with effect from 2009. Aceh and Papua receive 70% of their oil and gas revenues because of their special autonomous status.



Indonesian oil prices are linked to the Singapore gasoline benchmark price, in order to determine wholesale prices and the subsidies. A comparison of the prices reveals the extent of the subsidy burden in Indonesia. At the beginning of 2004, Singapore prices were about 27% higher than the retail price in Indonesia. By October 2004, Singapore prices had risen by over 27% in dollar terms and by 39% in rupiah terms. However, retail prices in Indonesia were raised only for the premium variety by 5.8-6.5%. A Government study (*Oil and Gas Sector Study*, Ministry of Energy and Natural Resources, 2000) estimated the subsidy burden at around \$36 billion between 2000 and 2005. As a result of the oil price increases, in 2004 alone, the subsidy is likely to be higher by Rp44.7 trillion (\$4.9 billion) than envisaged. Given that it is the rich who mostly enjoy the benefits of the gasoline subsidies, the new Government is committed to gradually reducing the subsidies. A compensation fund is being envisaged to help cushion the poor against any shocks of price increases.

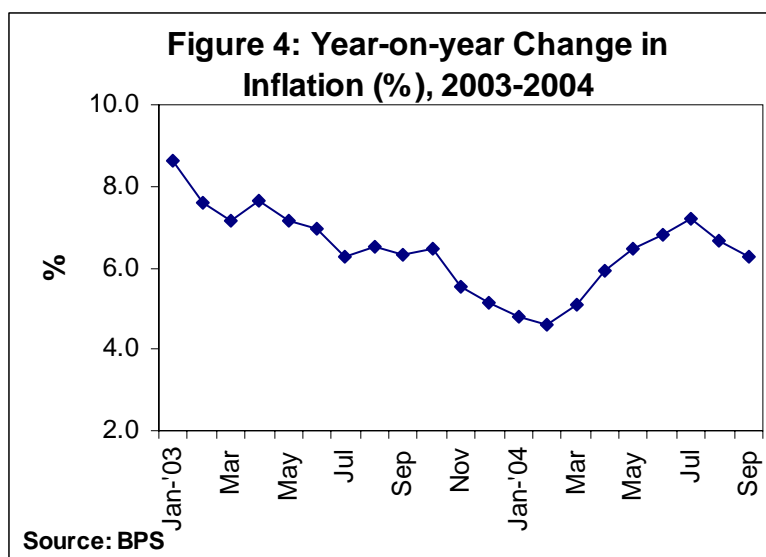
## E. Monetary and Price Developments

18. Following the appreciation of the rupiah in early 2003 from around Rp9,000 to \$1, the exchange rate remained stable in the range of Rp8,300–8,600 from mid-2003 to April 2004. However, election-related uncertainties, the rising price of oil and the stronger demand for dollars put downward pressures on the rupiah since the end of April 2004, making it the weakest-performing currency in Asia this year so far. It reached its lowest level over the last 20 months in early June, at Rp9,600 to \$1, losing 11% of its value since January.

19. In the first part of 2004, supported by a stronger rupiah and declining food prices, overall inflation continued the declining trend seen since early 2002, when inflation ran at levels near 15%. Although oil prices to the Indonesian domestic consumer are insulated by substantial subsidies from the Government, the weaker rupiah and rising global oil prices exerted upward pressures on consumer prices in the second and third quarters of 2004 through imports of food and other commodities. As a result, consumer price inflation increased to 7.2% in July, before declining to 6.3% year-on-year as of September 2004 (Figure 4).

20. The generally modest increase in inflation enabled Bank Indonesia (BI) to ease the BI reference rate, the rate on the 1-month BI certificate of deposit, from close to 10% in mid-2003 to 7.2% in September 2004. While BI has announced its intention to maintain inflation between 6% and 7%, it has not yet resorted to any interest rate increases in 2004, given the likely impact

of any increase on the modest macroeconomic recovery that is underway.<sup>4</sup> However, BI may not be able to avoid increasing the interest rate if inflationary pressures remain after November 2004.



21. BI's efforts to lower interest rates have been facilitated by what appears to be excess liquidity in the banking system, estimated by BI at Rp40 trillion (about \$4.3 billion) as of April 2004. These excess balances may also have funded speculative purchases of dollars in the second quarter of 2004. BI views the recent depreciation of the rupiah and the mild increase in inflation to be temporary phenomena, and has yet not tightened its monetary policy. However, in mid-2004 BI announced a series of measures to mop up the excess liquidity by: (i) increasing the current rupiah deposit reserve requirements from 5% to 8-10%; and (ii) creating a 7-day intervention facility, under which BI could borrow rupiah funds from commercial banks at 7%, on par with the current rate on the BI certificates of deposit.

22. On the portfolio side, market confidence has remained robust through the course of 2004, despite election-related uncertainties. The Jakarta Stock Exchange index, which stood at 650 at end-2003, rose to 824 the day after the first round of presidential elections in early July 2004. The negative market reaction to the Australian embassy bombing on 9 September was confined to a 3% decline on that day, from which the market recovered the next day. After a peaceful second round of presidential elections in September, the Jakarta Stock Exchange index remained strong at around 850, before hitting a 2-year high of 880 in early November and touching the 1,000 mark in late November. At present, it is at 980, indicating a significant improvement in market performance and investor confidence relative to the index value of 690 at the end of 2003.

## F. Financial Sector Developments

23. After recovering about 28% of the \$60 billion assets entrusted to the Indonesian Bank Restructuring Agency (IBRA), the Government closed its operations in February 2004. IBRA

<sup>4</sup> A recent World Bank assessment for the mid-year consultative group on Indonesia meeting showed that a 1% point increase in the BI policy rate would lower the growth rate by 0.9 percentage points. See World Bank. *Economic and Social Update, Mid-Year CGI Review Meeting*, 2 June 2004, p.8.

met its annual revenue target for 2004 of Rp5 trillion before it was closed. The Government established an asset management company<sup>5</sup> to manage IBRA's unsold assets, valued at Rp15.1 trillion. These assets are divided into two categories: (i) assets that are "free and clear" in terms of legality, whose market value is Rp10.8 trillion (against a book value of Rp108.5 trillion); and (ii) assets that are not, with a market value of Rp4.3 trillion (against a book value of Rp165.8 trillion). Unlike IBRA, the asset management company does not have to fulfill any annual fiscal targets. However, the Government needs to pursue the unfinished activities of IBRA, including liquidation of closed banks, resolution of shareholders' obligations, audits of IBRA by public accountants and the Supreme Audit Agency, and the settlement of ongoing business transactions. The Supreme Audit Agency is expected to complete its audit of IBRA's accounts within 2004.

24. The Government has made significant progress in bank privatization, selling an additional 10% of its shares in Bank Mandiri for Rp2.3 trillion (\$258 million), following an earlier divestment of 20% in July 2003. It has also sold 51% of Bank Permata to a consortium of Standard Chartered Bank and Astra International. Taking a strategic approach, the Government has prioritized the sale of banks, and some of the larger real sector entities, to meet budgetary needs over 2002–2004 (Table 4).

| <b>State-Owned Enterprise</b>                    | <b>% sold</b> | <b>Government Revenue (Rp trillion)</b> |
|--|---------------|---|
| Indosat  | 51.0          | 4.3                                     |
| Perusahaan Gas Negara                            | 39.0          | 1.2                                     |
| Indocement                                       | 16.7          | 1.2                                     |
| Bank Mandiri                                     | 30.0          | 5.4                                     |
| Bank Rakyat Indonesia                            | 40.5          | 2.5                                     |
| Bank Central Asia                                | 93.5          | 6.5                                     |
| Bank Danamon                                     | 75.0          | 6.1                                     |
| Bank Internasional Indonesia                     | 70.0          | 2.0                                     |
| Bank Niaga                                       | 67.0          | 2.1                                     |
| Bank Lippo                                       | 52.1          | 1.2                                     |
| Bank Permata                                     | 51.0          | 2.1                                     |
| <b>Total Privatization Proceeds in 2002-2004</b> |               | <b>34.6 (\$3.8 billion)</b>             |

Source(s): MOF

25. Partly supported by a surge in private consumption as well as the recovery in lending for investment purposes, the banking sector grew strongly in 2004. Banking stocks have been among the best performing on the Jakarta Stock Exchange. The top 10 banks improved their return on equity to 36.3% in June 2004 from 24.5% in June 2003, their net interest margin to 6.9% from 4.7% over the same period, and their loans-to-deposit ratio to 49.5% from 43.1%. There has been a healthy loan growth in the sector primarily supported by consumer and lower tier corporate lending, with state-owned banks expanding by 24% and private banks by 32% year-on-year by September 2004. At the same time, gross non-performing loans have remained high in relation to total loans, with state-owned banks reporting a ratio 7% and private banks with 4% in September 2004. However, banks have also increased their provisioning to cover the non-performing loans from around 100% in June 2002 to 132% in June 2004 for state-owned

<sup>5</sup> Perusahaan Pengelola Asset.

banks, and from 92% in June 2002 to 126% in June 2004 for private banks. It is also noteworthy that the state-owned banks have seen a decline in their deposits by 3% year-on-year by September 2004, partly due to disintermediation of the deposit-base caused by a recent surge in investments in mutual funds. Table 5 presents the key indicators for the top 10 banks in the country.

**Table 5: Financial Performance of the Top 10 Banks in Indonesia, 2003–2004**

| Bank                          | Total Assets   |            | Return on Assets |            | Return on Equity |             | Loans–Deposit Ratio |             | Net Interest Margin |            |  |
|-------------------------------|----------------|------------|------------------|------------|------------------|-------------|---------------------|-------------|---------------------|------------|--|
|                               | Rp             | %          | 2003             | 2004       | 2003             | 2004        | 2003                | 2004        | 2003                | 2004       |  |
|                               | trillion       |            |                  |            |                  |             |                     |             |                     |            |  |
| Bank Mandiri                  | 234.7          | -9.0       | 2.4              | 3.8        | 29.3             | 31.6        | 35.4                | 46.3        | 3.0                 | 4.6        |  |
| BCA                           | 141.7          | 21.1       | 2.5              | 3.1        | 20.9             | 31.2        | 21.7                | 27.1        | 5.0                 | 5.2        |  |
| BNI                           | 128.6          | 2.6        | 0.7              | 2.4        | 10.6             | 29.8        | 43.6                | 50.8        | 3.9                 | 5.5        |  |
| BRI                           | 99.3           | 8.2        | 4.0              | 5.3        | 44.9             | 40.6        | 58.5                | 69.1        | 8.9                 | 11.7       |  |
| Bank Danamon                  | 53.1           | 7.5        | 2.7              | 4.2        | 24.8             | 35.2        | 59.2                | 63.2        | 4.4                 | 6.7        |  |
| Bank Internasional            | 35.1           | 1.6        | 0.8              | 2.5        | 17.5             | 41.6        | 29.3                | 42.3        | 1.9                 | 5.3        |  |
| Bank Permata                  | 30.5           | 5.4        | 1.0              | 2.0        | 16.7             | 41.9        | 36.2                | 48.7        | 3.9                 | 5.7        |  |
| Bank Lippo                    | 27.3           | 18.0       | 0.8              | 0.8        | 4.6              | 25.8        | 23.7                | 20.4        | 4.3                 | 4.0        |  |
| Bank Niaga                    | 25.4           | 17.0       | 2.3              | 3.3        | 37.2             | 39.8        | 64.1                | 78.7        | 4.3                 | 6.2        |  |
| Citibank                      | 24.1           | 17.5       | 5.7              | 5.7        | 38.9             | 45.1        | 58.8                | 48.5        | 7.2                 | 13.8       |  |
| <b>Total 10 banks</b>         | <b>799.8</b>   | <b>3.9</b> | <b>2.3</b>       | <b>3.3</b> | <b>24.5</b>      | <b>36.3</b> | <b>43.1</b>         | <b>49.5</b> | <b>4.7</b>          | <b>6.9</b> |  |
| <b>Overall Banking System</b> | <b>1,189.7</b> | <b>7.5</b> | <b>2.3</b>       | <b>3.0</b> | <b>16.1</b>      | <b>19.7</b> | <b>62.7</b>         | <b>72.0</b> | <b>5.3</b>          | <b>7.1</b> |  |

BCA – Bank Central Asia; BNI – Bank Negara Indonesia; BRI – Bank Rakyat Indonesia.

Source: Info Bank, No.308, November 2004.

26. With the closure of IBRA, which also managed the Government's blanket guarantee scheme covering all deposits and almost all other claims on banks, including those resulting from inter-bank transactions, the need to adopt a sound legal framework has become more critical. The Government submitted a draft law on deposit insurance in late 2003, which was adopted by Parliament in June 2004. The law provides for a risk-based premium structure, to be fully adopted after an initial period of 1-2 years during which the premium rate will be a flat 0.1% of the banks' third party funds. The deposit insurance scheme will cover only small depositors with deposits under Rp100 million (\$11,200). The premiums would range from 0.1% to 0.6%. Under the current blanket guarantee program, which provides government guarantees on deposits and savings at national banks, IBRA had set the premium rate at 0.25% of the banks' third party liabilities. Annual premium flows have been about Rp2 trillion (\$235 million). The deposit insurance scheme will replace the existing blanket guarantee program, which is to be phased out beginning July 2005. To replace the role of IBRA in implementing the blanket guarantee program, MOF has set up a temporary special unit until the deposit insurance agency is established.

27. On the regulatory front, BI closed two banks during 2004. Bank Dagang Bali (BDB) had been a model institution with a long history in microfinance lending. Several foreign banks and venture capital funds had invested in BDB. However, BDB's business relations with Bank Asiatic, compounded by personal relations between the families of the two principal shareholders of the two institutions, appear to have contributed to financial problems and mismanagement in both institutions. Poor governance and irregularities in lending practices over the past 2 years in BDB and Bank Asiatic led to losses of Rp1.2 trillion (\$140 million). The 2 banks are relatively small, with their combined liabilities totaling \$400 million and third-party

deposits close to \$280 million, in relation to total banking system assets of about \$132 billion. BI closed the banks in April 2004, after monitoring them for 1 year and replacing some directors and requiring an additional cash injection from the owners in the interim. The Government is settling the third-party obligations of both banks under the blanket guarantee.

28. With regard to financial sector oversight, upon assuming office in October 2004 the new Government has taken a key decision to consolidate the pension, insurance and finance company supervisory functions with the Capital Market Supervisory Agency, in an effort to enhance institutional coordination and to pave way for the eventual establishment of an integrated Financial Services Authority. The new nonbank financial sector regulatory body is likely to be established by mid-2005.

29. The long awaited amendments to the Bankruptcy Law were enacted by Parliament in August 2004, aimed at allaying investors' concerns following a damaging episode where the Jakarta Commercial Court declared the profitable and solvent Indonesian subsidiary of Prudential PLC of the United Kingdom to be bankrupt in April 2004. While the verdict was overturned by the Supreme Court in June 2004, the similarities of the Prudential case with the bankruptcy case involving the Indonesian subsidiary of Manulife Company of Canada in 2002 have eroded the already fragile investor confidence. The enactment of amendments to the Bankruptcy Law had been delayed due to disputes over the determination of solvency of a firm involved in a bankruptcy case. In particular, there had been concerns whether a company that is otherwise financially sound and solvent should be brought to bankruptcy in case of failure to pay a small claim. While there had been public opinions that courts should use solvency tests to determine bankruptcy, the amended law does not provide for solvency testing, because of the complexity of such tests. Partly in response, however, the amended law stipulates that regulators, such as MOF, BI, and the Capital Market Supervisory Agency, have to rule first on the solvency of companies, particularly those dealing with public funds.

## **G. External Trade and Balance of Payments**

30. Both exports and imports substantially increased in the first 9 months of 2004. Overall exports grew by 11.4% compared with the same period in 2003 to \$50.5 billion. Oil and gas exports rose 10.1% to \$11.5 billion and accounted for 22.6% of total exports. This was little changed from 2003, clearly demonstrating Indonesia's inability to capitalize on the oil price increases because of low domestic production. Imports surged by 26.6% during the same period to \$31.4 billion, contributing to a 20% decline in the trade surplus to \$19.1 billion. A noteworthy trend has been the increase in capital goods imports, which grew by 35% during January-September 2004, in contrast to the 14% decline in the whole of 2003 relative to 2002.

31. While trade balance has declined, external risks have become more manageable over the last few years. Gross foreign reserves have steadily increased to \$34.8 billion by August 2004 from \$29 billion in 2000. In addition to the declining debt-to-GDP ratio as reported earlier, around 96% of the external debt is noncommercial, long-term and based on fixed-interest rates, thus confining the risks only to those stemming from any currency depreciation. In particular, the ratio of short-term external debt to foreign reserves has been declining and is about 45%, indicating that the external position remains much less vulnerable now than immediately following the post-crisis period.

## II. PROGRESS OF REFORMS IN THE WHITE PAPER

32. The previous administration of President Megawati adopted a White Paper to guide macroeconomic and key sector reforms in the period following Indonesia's exit from programs supported by the International Monetary Fund (IMF).<sup>6</sup> Designed to bridge a possible "credibility gap" in the post-IMF period, the White Paper had a total of 167 policy, legal and regulatory actions. As of August 2004, the Government reported that 76%, or 127, of the actions had been completed in the three focal areas of maintaining macroeconomic stability; reforming the financial sector; and increasing investments, exports and employment.

33. Overall, the Government has made commendable efforts to use the White Paper as a genuine vehicle for driving reforms over the last year. More importantly, there has been transparent reporting and significant public debate. Coordinating a task of this nature has been complex, especially the need to establish consensus quickly for a wide variety of policies during an unprecedented period of national elections. Yet concerns have been expressed that the Government has focused more on output (quantity) than on outcomes (quality).

34. **Maintaining Macroeconomic Stability.** The policy and legal measures under this component and the overall macroeconomic trends over 2002—2004 have enabled the Government to move away from addressing macroeconomic recovery or sustainability issues towards the challenges of attaining higher growth. A number of individual measures can be cited that represent solid accomplishments, including a concerted effort to contain the deficit; adoption of the three key fiscal laws; introduction of a functional classification system for the budget; and adoption of revenue enhancing measures, including a broadening of the tax base and expansion of offices for large tax payers. A key issue pending is the planned revision to tax and tax administration laws. While there has been significant progress on many fronts, there are concerns about the quality of outcomes in several areas.

35. In line with the White Paper, amendments to the Regional Autonomy Law (Law 32/2004) and the Regional Fiscal Balance Law (Law 33/2004) were adopted in September 2004. Overall, the implementation of decentralization in Indonesia has proceeded without any major disruptions to public service delivery. However, several major issues remain to be addressed, relating to lack of clarity in policy, inequity in intergovernmental transfers and inefficiency in institutional coordination. At the policy level, there is no clarity with regard to functional assignments to different levels of government, even 5 years after the introduction of decentralization. Thus, there is a risk, for instance, that minimum norms on public service delivery may be formulated in a manner inconsistent with the fiscal capacity of local governments. There has been no clear policy directive on intergovernmental debt restructuring, despite significant analysis and assessment of options, and efforts have focused only on short-term exemptions without addressing longstanding issues. With regard to institutional arrangements, intergovernmental coordination has been weak at both central and local levels. There is no impartial institutional mechanism, nor a sound rule-based methodology to determine fiscal transfers, and as a result, resource allocations across the regions are neither equitable nor efficient. For instance, the richest local government received over 10 times more revenue per capita through transfers than the poorest. As a result, there are continuing disparities in development across the regions. While the Regional Fiscal Balance Law proposes a small increase in general purpose transfers, the formulae to determine allocation are to be defined in subsequent implementing regulations. The establishment of the Regional Representative

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<sup>6</sup> For background details, see ADB. 2003. *Country Economic Review, Indonesia*. Manila (CER: INO 2003-27, October 2003).

Council in Parliament is a promising development, but its role and influence in decision-making remain to be seen.

36. **Financial Sector Restructuring.** Several significant developments have taken place, including privatization of banks, move towards establishing a financial safety net, and amendments to the BI Law, providing for greater oversight of its functions. However, various key issues remain to be addressed, including (i) improving governance of state banks and financial institutions; (ii) enhancing financial intermediation, to support real sector growth besides just consumer lending; (iii) strengthening capital markets to encourage financing of long-term corporate growth; (iv) formulating a sound implementation plan for the Indonesian banking architecture announced by BI; and (v) consolidating financial sector supervision and strengthening the governance of oversight institutions.

37. **Increasing Investments, Exports and Employment.** This has been the most complex part of the White Paper reform agenda. While good progress has been made in a few areas (e.g. finalization of Supreme Court blueprints; and adoption of labor and state-owned enterprise laws), the difficulty in clearly defining benchmarks and outcomes has considerably slowed progress. Taking into account the complexity of the issues involved, the following problems are noted:

- (i) **Weak policy, legal and regulatory framework on investments.** A high-level National Investment and Export Promotion Team, chaired by the President, was established by the previous administration to coordinate business promotion. Several other complementary measures were initiated on taxes, customs, etc. Yet, there is continuing lack of clarity in the legal and regulatory environment. There are concerns about the draft Investment Law in several areas, including the balance of incentives to foreign and domestic investors. While a decree on the “one roof facility” for investment approvals has been released, there has been indecision about which level of Government should administer it. Other major concerns relating to investor protection and enforceability of contractual rights, among others, continue to dampen investor confidence.
- (ii) **Supporting legal framework on labor and social security.** A key concern has been the lack of progress in adopting implementing regulations on the labor law and the industrial disputes law. Concerns have also been expressed on the recently enacted law on social security. While it is desirable to enhance and expand social security coverage, particularly for the vulnerable, the implementation of a law of this nature should be grounded on strong actuarial assessments and the Government’s ability to ensure fiscal sustainability. Equally important is the prevalent assessment that the provisions in the law are likely to increase labor costs and erode Indonesia’s already declining competitiveness.
- (iii) **Competitiveness.** The outgoing administration had prioritized a few sectors for export promotion. Recent measures to attract investments are yet to have an impact on reversing the decline in foreign direct investment, which has historically played a catalytic role in export promotion and maintaining Indonesia’s competitive edge. Partly due to lack of investments and partly because of greater competition from its regional neighbors, Indonesia’s export growth over the last few years has been lagging behind that of its major competitors. In addition to increasing wage costs and slow increase in labor productivity, other transaction costs due to corruption and weak coordination

within the Government have reduced Indonesia's competitiveness. For instance, over 2000–2003, Indonesian exports to the People's Republic of China increased by 30% to \$5.8 billion. Over the same period, Malaysia almost tripled its exports to \$14 billion, and Singapore and Thailand doubled their exports to \$10.5 billion and \$8.8 billion, respectively. The new Government has to rethink Indonesia's trade and competition policy, including the introduction of measures to revamp the import licensing system completely, as the import bans introduced in early 2004 on rice and sugar imports appear to have distorted trade and increased smuggling.

### III. SHORT- AND MEDIUM-TERM ECONOMIC PROSPECTS AND POLICY ISSUES

38. The first direct presidential elections will be a landmark in Indonesian history, with a country with a population of over 215 million electing its president smoothly and peacefully. Having obtained a strong mandate with 61% of the vote, President Susilo Bambang Yudhoyono has prioritized fostering economic growth, tacking corruption and enhancing security over 2004–2009. His intention is to boost economic growth to an average of 6% per year during his 5-year term. The peaceful elections and the greater political certainty are bound to increase consumer confidence further, and, coupled with the new administration's proposed economic policy measures, they could also facilitate at least a short-term revival of investments. However, one of the key challenges facing the new administration will be a relatively hostile Parliament, where almost half of the 550 seats are occupied by the five-party coalition that backed former President Megawati Soekarnoputri. Early tensions have already been evident in the negotiations between the parliamentary factions about forming parliamentary commissions to guide and oversee the Government's performance.

39. At its inauguration, the new Government unveiled its reform agenda for its first 100 days (20 October 2004 – 30 January 2005), as part of a broader framework for the 5-year development program that will be formulated in the next few months (Table 6). The 100-day reform agenda comprises three main elements: (i) ensuring security and peace; (ii) enhancing justice and democracy; and (iii) strengthening the foundations for prosperity. This agenda is based on (i) identifying key issues quickly, setting priorities and achieving some tangible outcomes within the first 100 days; (ii) adopting a "shock-therapy" approach to reduce corruption; and (c) restoring public trust in the government through well-defined reforms that go beyond the routine activities with minimum possible burden on the budget.

40. The Government is likely to continue the fiscal consolidation measures adopted by the previous administration. The 2005 budget approved by the outgoing Parliament will be revised by the Government in consultations with Parliament. The earlier deficit target of 0.8% of GDP is likely to be revised upwards to 1% of GDP. The most pressing and challenging decision facing the new Government is the reduction of fuel subsidies. The 2005 budget projects a decline in subsidies to 1% of GDP (see Table 3), down from 1.7% in 2003 and the 3% that is projected for 2004. However, the Government has stressed that some subsidies will continue, for instance for household kerosene, with a better targeting mechanism to be put in place. Another key challenge facing the Government is its gross financing needs, which are projected to be 3.3% of GDP, or about \$10 billion, in the absence of any privatization proceeds through IBRA or foreign debt rescheduling arrangements. The Government's successful re-profiling of its domestic debt by lengthening the average maturity to 7.8 years from 4.4 years is expected to ease the amortization burden somewhat.

**Table 6: New Government's 100-Day Plan**

| Objectives                      | Key Actions   |
|---------------------------------|---|
| Ensuring Security and Peace     | <ul style="list-style-type: none"> <li>• Speedily resolve conflicts in Aceh and Papua, and prevent escalation of conflicts in Poso, Maluku, and North Maluku</li> <li>• To facilitate the above, focus on rehabilitating infrastructure, and ensuring adequate autonomy laws</li> <li>• Ban exports from illegal logging and fishing</li> </ul>   |
| Promoting Justice and Democracy | <ul style="list-style-type: none"> <li>• Combat corruption, and demonstrate commitment by empowering the Anti-Corruption Court, and concluding a few high profile corruption cases expeditiously</li> <li>• Focus on poverty reduction, complete a strategic document on poverty reduction and prepare a comprehensive poverty map to guide future interventions</li> <li>• Strengthen public services in education and health (through scholarships for books, teacher training, more staff and free services to the poor at health facilities, adoption of a law on medical practice)</li> </ul>  |
| Promoting Prosperity            | <ul style="list-style-type: none"> <li>• Put in place a business-friendly tax system, with focus on an accelerated depreciation schedule, investment allowances, extending the carry-forward period for losses, and reducing tax on dividends</li> <li>• Ensure budgetary needs in 2004 are met, through tighter tax collection and divestment of minority share ownership of the Government in some banks, and review 2005 budget to align priorities with resources</li> <li>• Improve labor regulations related to recruitment, wages, lay-offs and separation pay</li> <li>• Support the small and medium-sized enterprise sector through debt forgiveness from state-owned banks and other support mechanisms through state-owned enterprises</li> </ul> |

Source: Coordinating Ministry of Economic Affairs

41. On the strength of the election outcomes and positive expectations from the Government, the Asian Development Bank's projection for real GDP growth has been revised upwards from the earlier Asian Development Outlook forecast of 4.5% to about 4.9% for 2004 and 5.3–5.5% in 2005. Inflation remains moderate, further declining in September 2004 to 6.3% year-on-year from 6.7% in August, and this trend is expected to continue for the rest of 2004, supported by a stronger rupiah, although holiday-related spending may push prices up somewhat. Overall inflation is likely to be less than 7% at the end of 2004. The Government's decision on fuel subsidies will largely dictate inflation performance in 2005. It has been estimated that a 10% increase in fuel prices will lead to a 0.6% increase in the overall inflation.<sup>7</sup>

42. BI is expected to continue its present monetary stance. The recent weakness in the rupiah is of some continued concern, as well as the need to reduce excess liquidity. However, actions to raise interest rates are likely to be cautiously taken, and the impact of higher borrowing costs on growth will need to be carefully assessed. BI's options on the interest rate front will also be dictated by the trends in inflationary following any fuel subsidy reductions.

43. In general, the external environment is likely to remain favorable, although Indonesia's ability to reap any rewards from higher oil prices will be contingent on its ability to increase its oil output. The Government's 100-day program aims to increase the production of crude oil to above 1 million barrels per day, liberalize the domestic market for fuel and natural gas and rationalize fuel prices. These targets, while desirable, are ambitious and will need significant political will. Indonesia's import demands are likely to expand further, particularly if there is

<sup>7</sup> *Economic and Social Update*, November 2004, World Bank, Indonesia.

recovery in investment spending. As a result, and partly due to the eroding competitiveness in sectors such as textiles, Indonesia's trade surplus is set to decline over the next 2-3 years.

44. Looking ahead, greater emphasis needs to be placed on improving Indonesia's growth prospects. The President has set a target of an average annual growth rate of 6% over 2005–2009, which is not unrealistic given Indonesia's vast potential and natural resources. In the short-run, a post-election investment rise may emerge. However, over the longer-term the challenges are significant. At the outset, legal and regulatory certainty is critical. The new Government's anti-corruption drive may increase regulatory clarity, but its efforts need to be even and sustained at all levels.

45. In order to carry out any reforms, the new Government needs to work effectively with Parliament to establish the resources available over the next 5 years and to link them to priorities. Two key challenges await the Government. At the central level, it has to face a Parliament that may not always be receptive, and a new Regional Representative Council that will raise a host of issues relating to programs and policies that impact at the local level and seek the Government's attention and resources to ensure greater balance and equity across regions. At the local level, the recent amendments to the Law on Regional Autonomy (Law 32/2004) have paved the way for direct elections by the heads of districts who, supported by a larger mandate, may seek to exert greater influence. The central Government needs to find the right balance for ensuring local level accountability through the institution of the provincial governors. A satisfactory resolution of these challenges will depend on effectively implementing regulations for the Law on Regional Autonomy (Law 32/2004), an area with uneven progress in the past.

46. President Susilo Bambang Yudhoyono has placed significant emphasis on improving the investment climate, given the serious problems faced by investors on a number of fronts. The Government's own policy initiatives are being finalized as part of the 100-day agenda. The Consultative Group on Indonesia, comprising multilateral agencies and bilateral donors supporting Indonesia, constituted a working group on the investment climate in 2002. The group, in consultation with domestic and foreign investors, submitted an action plan (see Appendix 1)<sup>8</sup> to the Government, outlining priority issues relating to taxation, customs and tariffs, labor, infrastructure and investment policy, and promotion of small and medium enterprises. Separately, the Indonesian Chamber of Commerce and Industry has presented its road map for revitalizing industry and investment, focusing on strengthening the macroeconomic framework; improving the policy and regulatory environment to support investments; revamping of old and provision of new infrastructure; and institutional development aimed at better governance and empowerment of the private sector. Much of what is important to do is known and has been discussed. The key question is whether the political environment will support the Government's efforts.

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<sup>8</sup> Creating Jobs through Investments: Suggestions from Donor Community on Improving Indonesia's Investment Climate, Jakarta, October 2004.

**IMPROVING INDONESIA'S INVESTMENT CLIMATE  
PROPOSALS TO THE NEW GOVERNMENT**  
(Submitted by the Joint Donor Working Group on Investment)

| Item                    | Short-term Actions<br>(within the first year)   | Medium-term Actions<br>(2–5 Years)  |
|-------------------------|---|---|
| (1) Taxation            | <ul style="list-style-type: none"> <li>a. Announce and implement a package of tax reform measures of particular relevance to investors (variable income tax rates for subcontracted processing and other activities, depreciation schedules, etc.).</li> <li>b. Establish an independent assessment appeals process to improve transparency in tax audits and deter arbitrary assessments.</li> <li>c. Conduct an intensive campaign to make the Code of Conduct and Taxpayers' Bill of Rights socially acceptable, including by distributing them to tax officials and educating them about the implications for their work.</li> <li>d. Reduce the period of time for VAT verifications and refunds.</li> </ul> | <ul style="list-style-type: none"> <li>a. Announce and implement a comprehensive tax reform plan, including a review of pending tax legislation.</li> <li>b. Revise necessary regulations and guidelines to implement a self-assessment system as practiced internationally.</li> <li>c. Fully enforce the Code of Conduct and Taxpayers Bill of Rights through administrative and legal measures.</li> </ul>         |
| (2) Customs and Tariffs | <ul style="list-style-type: none"> <li>a. Review the Code of Conduct for Customs Officials, distribute it to customs officials and educate them about the Code's implications for their work.</li> <li>b. Improve the quality of customs services and the time it takes for shipments to clear customs (e.g. address current delays in weekend services).</li> <li>c. Compile a "Customs Rule Book," a collection of laws and regulations in force to be updated annually.</li> <li>d. Establish an independent body to monitor the implementation of promised customs reforms and report to the public.</li> </ul>   | <ul style="list-style-type: none"> <li>a. Fully enforce the Code of Conduct through administrative and legal measures.</li> <li>b. Revise customs administration laws and regulations to deter arbitrary assessments.</li> </ul>  |
| (3) Labor               | <ul style="list-style-type: none"> <li>a. Announce and implement revisions to Ministry of Manpower Decree 150 and initiate a review of the Manpower Law.</li> <li>b. Establish more constructive mechanisms for determining minimum wages</li> </ul>  | <ul style="list-style-type: none"> <li>a. Announce and seek legislative approval of reforms to the Manpower Law designed to increase job growth.</li> <li>b. Establish a national licensing system of specific skills through standardized national tests.</li> <li>c. Establish public facilities and services, including a public job information center, to improve labor productivity and flexibility.</li> </ul> |
| (4) Infrastructure      | <ul style="list-style-type: none"> <li>a. Prepare a medium-term strategy for infrastructure development.</li> <li>b. Issue revisions to Presidential Decree 7/1998 on Public-Private Cooperation in Infrastructure Provision.</li> </ul>  | <ul style="list-style-type: none"> <li>a. Implement the medium-term strategy and monitor its progress.</li> <li>b. Develop financial instruments and schemes through which domestic savings can be leveraged for</li> </ul>   |

| Item                                | Short-term Actions<br>(within the first year)   | Medium-term Actions<br>(2–5 Years)   |
|-------------------------------------|---|--|
|                                     |   | infrastructure financing.  |
|                                     | <ul style="list-style-type: none"> <li>c. Remove bottlenecks impeding one or more pending investments.</li> <li>d. Develop and announce a plan for tackling the land acquisition issue.</li> </ul>  | <ul style="list-style-type: none"> <li>c. Enhance the review and oversight mechanisms for infrastructure projects.</li> <li>d. Establish independent regulatory bodies in key infrastructure sectors.</li> </ul> |
| (5) Investment policy/SME promotion | <ul style="list-style-type: none"> <li>a. Enact an investment law that embodies the principle of equal treatment for domestic and foreign investors.</li> <li>b. Streamline the regulatory framework for implementing one-stop-shop investor services.</li> <li>c. Compile "Investment Rule Books" that serve as a source of information and official procedural guide for both officials and investors.</li> </ul> | <ul style="list-style-type: none"> <li>a. Establish public facilities for SME human resource development.</li> <li>b. Introduce nationally approved, local-level SME training systems.</li> </ul>                |