Indonesia

Despite its sound macroeconomic fundamentals, Indonesia suffered some of the worst consequences of the recent regional financial crisis. As a result, Indonesia is pursuing a comprehensive and credible economic reform program to address the economy's various weaknesses. The risk of stagflation in 1998 remains real. In the long run, one of the pressing politico-economic problems that the country will have to address is the economic disparity that is prevalent both among income groups as well as between regions.

RECENT TRENDS AND PROSPECTS

In terms of the extent of its currency depreciation, Indonesia is the most serious casualty of Asia's financial crisis. This is paradoxical, given the soundness of Indonesia's economic position in 1996 and the economy's good performance during the first half of 1997, which was supported by tight fiscal policies, prudent monetary policies, and an adequate exchange rate policy. The end result is that the crisis that has afflicted Southeast Asia since mid-1997 has radically changed Indonesia's economic position, with the rupiah suffering a severe depreciation of 80 percent between July 1997 and January 1998. As the private sector's creditworthiness fell concomitantly, many foreign creditors stopped renewing debt to Indonesian companies and capital inflows declined, thereby putting further pressure on the exchange rate.

The strong economic performance before the crisis was not, however, without its problems, and the apparent creditworthiness of Indonesian borrowers, coupled with low interest foreign commercial loans, increased their exposure to unhedged short-term external debt. The growth of non-oil exports had slowed, and oil exports grew sluggishly. The rupiah began to weaken in the second week of July 1997, immediately following the floating of the Thai baht. GDP growth for 1997 declined to slightly less than 5 percent. Growth in the manufacturing sector slowed to 6 percent because of liquidity constraints; the drought brought about by El Niño hampered agricultural performance, causing agricultural prices to rise; and at the same time, the forest fires in Sumatra and Kalimantan imposed severe costs on the economy and reduced tourism, the country's third largest export industry.

The steep decline in the rupiah's exchange rate since July 1997 affected the inflation rate. The consumer price index climbed 11.6 percent year-on-year by December (an annual average of 6.6 percent) despite tight monetary policy. Following the currency's depreciation, the prime lending rate reached 30 percent, compared with 20 percent in 1996.

Exports grew by 11.2 percent in 1997. Imports, after registering a growth rate of about 8 percent in 1996, decelerated to 4.8 percent in 1997. Most of the decline was in consumption goods. Capital goods imports slowed little, given the persistence of strong investment until mid-1997. Imports of intermediate goods also showed little in the way of a slowdown. Notable exceptions were synthetic fibers and some chemical products that are essential for the textiles industry, primarily because domestic textiles production increased. The current account showed a reduced deficit of 2.7 percent of GDP, and total

Table 2.7 Major Economic Indicators: Indonesia, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth	8.2	8.0	4.6	-3.0	1.0
Gross domestic investment/GDP	31.9	30.8	31.6	25.0	27.0
Gross domestic savings/GDP	30.6	30.2	31.0	24.0	25.0
Inflation rate (consumer price index)	9.5	7.9	6.6	20.0	15.0
Money supply (M2) growth	27.6	29.6	27.7	25.0	26.1
Fiscal balance/GDP	0.4	0.8	-0.2	0.0	3.0
Merchandise exports growth	18.0	5.8	11.2	5.0	7.0
Merchandise imports growth	26.6	8.1	4.8	-5.0	2.0
Current account balance/GDP	-3.2	-3.4	-2.7	-1.6	2.5
Debt service/exports	30.9	29.5	30.0	28.0	30.0

Sources: Bank Indonesia data, Bank Indonesia (1997), International Monetary Fund (1998), World Bank (1997d), and staff estimates.

external debt was 61 percent of GDP in 1997, of which the private sector accounted for half. The debt-service ratio was approximately 30 percent. International reserves are estimated to be $20 billion, including $3 billion drawn from the International Monetary Fund (IMF) standby facility in November 1997. In 1996 foreign reserves amounted to 5 months worth of imports, and by May 1997 had risen to 5.5 months worth of imports. Thus, the balance of payments showed few signs of any major weaknesses immediately prior to the currency crisis.

The exchange rate policy was designed to respond to increased capital inflows, including short-term portfolio capital and private debts. Since 1993 the monetary authorities have opted for a strategy of periodic widening of the nominal exchange rate band. In announcing the increase from 2 to 3 percent in December 1995, the monetary authorities stated that the move was meant to improve the effectiveness of monetary control and the stability of the exchange rate to anticipate future growth of capital flows. In 1996 they widened the band twice, the last of which was in July 1997, when it was increased from 8 to 12 percent (but this was short-lived since the rupiah was floated on 14 August).

Given the magnitude of the crisis, projections indicate that Indonesia will take about three years to recover fully. The most likely outcome is a decline in GDP of around 3 percent in 1998, followed by stabilization in 1999. Given the depreciation of the rupiah, inflation is projected to increase to 20 percent in 1998. Exports are expected to grow by 5 percent and imports to decline by 5 percent in 1998. The growth of non-oil exports is forecast to be around 12 percent in 1998, which is rather a low increase given the extent of the rupiah's depreciation. In 1998 oil exports are expected to stagnate; however, the prospects for export growth will be harmed unless the country can secure some form of international guarantee for its letters of credit.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

Even as the crisis unfolded during mid-1997, Indonesia's economy appeared robust. However, after the baht fell, the rupiah entered a phase during which international financial markets expected a rapid depreciation, and the rest was a self-fulfilling prophecy. The crisis did, however, magnify the adverse consequences of past policy mistakes.

In end-October 1997, Indonesia reached agreement with the IMF, which, with the participation of the Asian Development Bank, the World Bank, and various nations, came up with an economic assistance package of $23 billion. The package was linked

to a three-year IMF adjustment program whose tenets are fiscal and monetary discipline, banking sector restructuring, and acceleration of deregulation and trade reforms. A major step related to the agreement was the decision in November to liquidate 16 banks. After a few days of shake up, it soon became clear that market confidence had not been restored. The rupiah continued to fall and the stock market plummeted. The government revised the Letter of Intent to the IMF in January 1998, spelling out a deeper and wider reform program and a stronger macroeconomic agenda in response to the continuing economic crisis. This projects, among other things, zero growth in 1998; a year-on-year inflation rate of 20 percent; and a budget deficit of 1 percent of GDP, assuming an exchange rate of Rp5,000 per US dollar. However, given that this is an optimistic exchange rate, inflation could well end up in the neighborhood of 40 to 50 percent. Key reforms include restructuring and consolidating the banking sector, reducing import and export tariffs, removing trading monopolies for some key staple foods, allowing foreign companies to set up their own distribution wholesale outlets, dismantling monopolies, and imposing greater transparency. In addition, the government postponed or canceled several expensive infrastructure projects, especially energy and road projects.

Indonesia currently faces three related short-term problems. The first is the dual task of stabilizing the rupiah and bringing it to a new and more realistic level. In early February 1998 Indonesia announced its intent to establish a currency board. Under this arrangement, Indonesia would peg the rupiah at a fixed exchange rate (the level under discussion is around Rp5,500 per US dollar). If this were done, Indonesia's base money supply would be backed by dollar reserves at the fixed exchange rate. The most important economic policy implication is that the country would automatically lose its ability to use monetary policy. The advantage of such a scheme is that it would bring monetary and fiscal discipline to the country; for example, the government could not print money to finance a budget deficit unless it were backed by an equivalent amount of dollars at the fixed exchange rate. However, many observers believe that Indonesia does not currently meet the requirements for a currency board, because to succeed, the government would have to respect the currency board's two key features, namely, a commitment to exchange domestic currency for dollars at a fixed rate, and a commitment to issue currency only if it were backed by dollars. In addition, from a technical point of view, the country must have a sound banking system. The issue is that given the present level of political uncertainty, investors might perceive that the government would not keep its commitments. Also, Indonesia does not have a sound banking system. However, some of the banking system's problems are a result of the currency crisis and cannot be resolved without stabilizing the exchange rate. At the end of February the IMF and the government agreed to postpone the implementation of a currency board.

The second problem is the banking sector crisis. Although some issues are still unresolved, the IMF package outlines how the banking sector should be restructured, and the government has announced the establishment of the Indonesian Bank Restructuring Agency, which is to help restructure or take over troubled banks. The objective is to have fewer, more efficiently managed banks. The number of state banks will be reduced from 7 to 4, and the remaining 144 private banks will also have to face mergers and consolidations. The government has announced the provision of a guarantee to all depositors and creditors of locally incorporated banks for at least two years. Deregulation will also take place to encourage foreign participation, including granting permission to start full branching and removing the 49 percent cap on foreign ownership of publicly listed banks. Finally, the Central Bank will need to undergo institutional changes in light of its weaknesses in bank supervision. Reforms of the Central Bank will be the cornerstone of a healthy banking system.

The third problem—which is related to the stabilization of the rupiah—is the private sector debt crisis. Without a stable currency the foreign debt burden of the corporate sector will keep mounting, and without serious prospects for debt reduction, the currency will continue to be under pressure. So far no satisfactory solution has been found. The recent announcement of a voluntary, temporary freeze on corporate foreign debt repayments should ease pressure on the currency in the short term. However, this is not a durable solution. Uncertainty surrounding the resolution of the debt crisis means that investor sentiment will remain volatile. Because the private sector is responsible for most of the debt, ascertaining what role the government might play

is difficult. To date, attempts to register the amount of private debt and coordinate efforts between the government and private sector debtors have not succeeded. Indonesia must avoid defaults to prevent its international credibility from being eroded even further.

POLICY AND DEVELOPMENT ISSUES

While Indonesia has made impressive strides in poverty reduction in the last 30 years, the financial crisis has undone some of these gains. In January 1998, three quarters of the companies in Indonesia either had already or were in the process of having a large part of their workforce retrenched. The majority of these companies were in export sectors, such as textiles, garments, and shoes, that employ mostly women. According to some estimates, an additional 3 million workers will be unemployed in 1998, which would place the unemployment rate at 11 to 14 percent of the workforce of 95 million people. Those most likely to be most severely affected are the urban lower-middle-class, for whom little in the way of social safety nets is available. The increase in unemployment may fuel social unrest. The unemployment problem, which has been exacerbated by the recent financial crisis, is likely to be a major challenge for policymakers for some time to come.

Although the country has had some success in alleviating poverty, income distribution has been a pressing problem throughout the 1990s. The problem has perhaps been further compounded by the financial crisis, whose impact has been far from symmetrical across various social groups. The future challenge for policymakers will be to maintain macroeconomic balances, while at the same time improving the distribution of income to ensure that disadvantaged segments of society do not bear the brunt of the economic crisis.

Public expenditures directed at providing health, nutrition, and education to those in lower income groups could help address problems of inequality. Indeed, much has been done in this regard in the past; however, more needs to be done in the future in terms of policy changes and institutional reforms. The government needs to undertake supportive measures to promote small businesses. It also needs to correct major policy distortions in the economy that have arisen from the absence or lack of enforcement of antimonopoly laws and to introduce various institutional reforms to ensure that all segments of society have equal access to public resources.

Another long-run policy challenge is to address development imbalances between regions. Despite the strong economic growth of the last two decades, Indonesia has not achieved regionally balanced development. For example, disparities in economic development between Java and the rest of the country and between the eastern and western regions are considerable. The eastern region is generally less developed. Its lack of infrastructure and a sizable pool of skilled labor are frequently cited as factors hindering the region's further growth. Lack of geographical proximity to central levels of power in a system dominated by excessive bureaucracy may also have contributed to its backwardness.

The economic structure of the eastern region is quite different from that of the western region. In the 1990s, more than half of the gross regional domestic product in the eastern region still originated in the agriculture sector, compared with a mere 18 percent in the western region. Similarly, at 10 percent of GDP, manufacturing's share in the eastern region is less than half that in the western region. Furthermore, the eastern region has 21 percent of the country's small agricultural estates, but only 0.6 percent of large estates. Likewise, the eastern region has 6.7 percent of small and home-based manufacturing industries, but 2.6 percent of the country's medium and large industries. With a low level of industrialization, virtually all provinces in the eastern region have a low level of urbanization. Social indicators further demonstrate the relative deprivation of the eastern region: even though its share of the total population is 13.2 percent, it has 16.5 percent of the nation's poor. In many cases, isolation and difficult geographic conditions have left villages with inadequate transportation, communication, and other services.

All these differences between the two regions indicate an imbalance in regional development. The removal of the numerous regulations and unnecessary red tape and the nurturing of a market-friendly environment would have a considerable impact on the development of the eastern region. However, that may not be enough. The government may have to adopt special programs and policies in favor of the eastern region to redress the persistent regional imbalance.