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The Indonesian Economy a Decade after the Crisis (and Some Philippine Parallels)

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Abstract

Indonesia was deeply affected by the 1997–98 crisis, more so than its East Asian neighbors. Its economic contraction was deeper and more prolonged. It was the only one to experience a (temporary) loss of macroeconomic control. It also suffered "twin crises," in the sense that its serious economic and financial problems were accompanied by regime collapse. Consequently, recovery has been a slow and complex process, as new institutions have had to be created, and old ones reformed. Although growth has yet to return to pre-crisis levels, by 2004 per capita income and poverty incidence had recovered to levels prevailing in the mid 1990s, and in the circumstances economic recovery has proceeded about as quickly as could reasonably have been expected.

The paper concludes with a comparative assessment of two crises: Indonesia in 1997–98 and the Philippines in 1985–86.

1. Introduction

Indonesia was deeply affected by the economic crisis of 1997–98. Its economic contraction in 1998, of over 13%, was the sharpest decline among all four crisis-affected East Asian economies.[1] This followed three decades of virtually uninterrupted, rapid economic growth, the first such occurrence in the country's history. Indonesia also experienced 'twin crises,' in the sense that the economic crisis was accompanied by regime collapse, resulting in the departure of President Soeharto in May 1998 after 32 years of authoritarian rule. In this respect, Indonesia has more in common with the Philippines in 1985–86 and Mexico in 1994–95 than its East Asian neighbours in 1997–98. Moreover, and as a result of the second factor, its crisis resolution has been complicated by weak and unstable government, at least through until 2004, and by a slower recovery trajectory.

Nevertheless, and notwithstanding the immense challenges, Indonesia's recovery has more resembled the East Asian (and Mexican) 'V' than the 'L' of the former Soviet Union and much of Eastern Europe from the late 1980s. Its per capita income has now recovered to pre-crisis levels, as have most social indicators. The country has in effect 'lost' a decade of growth which, had it been sustained at pre-crisis rates, would have resulted now in a much higher per capita income, closer to $2,000 than $1,000. In

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* I wish to thank Yogi Vidyattama, a PhD student at the Australian National University, for valuable research assistance, and my ANU colleagues, Ross McLeod and Chris Manning, for helpful advice.

[1] To provide some historical context for Indonesia, the decline was also greater than that experienced during the decade commencing with the great depression in 1929.

addition, growth remains more subdued, at around 5% rather than the 7% and more prior to 1997.

Having navigated this difficult post-reform period, culminating in remarkably successful presidential and general elections in 2004, the principal economic policy question now is whether growth can be restored to pre-crisis, if not ‘China,’ levels. Or is the country now consigned to what may be termed the ‘archipelagic Southeast Asian’ growth rate of around the current figure? That is, a growth rate similar to that of the Philippines in recent years, and for largely similar reasons. These economies are largely open and deliver reasonable macroeconomic outcomes (at least in terms of inflation), but they have more difficulty providing efficiency-enhancing supply-side investments (infrastructure, education) and legal/regulatory certainty to elevate the growth rates a few percentage points higher.

This paper is organized as follows. We review trends in key economic and social indicators since the mid 1990s, focusing in particular on the crisis impacts and immediate resolution. We then survey the main economic policy challenges, consistent with an analytical framework which identifies the principal drivers of growth as competent macroeconomic management, an open economy, broad-based social outcomes, and institutional arrangements which support a secure and predictable business environment. These are discussed in the context of Indonesia’s radically changed political environment, the shift from a ‘hard,’ authoritarian, corrupt but growth-oriented state delivering broad-based, rapidly improving living standards, to a ‘messy,’ weakened, democratic, corrupt state, with the political leadership not yet able to provide a clear and unambiguous commitment to growth . The economic policy-making environment has changed, in some cases profoundly, in at least seven key respects:

- a weakened presidency, though it was somewhat strengthened by the direct election process in 2004;
- significantly weaker cabinet unity;
- a newly assertive but unpredictable parliament;
- a suddenly noisy and influential civil society;
- a still powerful but circumscribed bureaucracy;
- a legal system not yet able to perform the heavy responsibilities suddenly thrust upon it; and
- the shift of power and resources from the centre to the regions.

It also needs to be noted that Indonesia’s recovery has taken place against a generally benign, and some respects conducive, international environment. The world economy has continued to grow, sometimes strongly through and since the crisis period. The two most relevant international prices for Indonesia – global interest rates and commodity prices – have been exceptionally favourable for most of the period. (The absence of a significant domestic supply response to the latter is an issue to which we return below.) Global competition may be tougher, but China is as much a regional locomotive as a competitor. Indonesia faces no serious export market access problems, and at the margin receives (appropriately) favourably treatment owing to its newly democratic credentials and moderate Islam. Post Soeharto regimes have had a difficult relationship with the IMF, but aid flows have resumed, with magnitudes probably at about as much as the country realistically wishes to receive. In other words, recovery has proceeded against a benign backdrop, and the pace of recovery is now overwhelmingly dependent on policies and reforms at home.

2. Macroeconomic survey[2]

Economic growth: The Indonesian economy began to decline precipitously in the fourth quarter of 1997, and recorded negative growth of over 13% (or 15% in per capita terms) in 1998 (Figure 1). Growth was negligible in 1999, but recovered to nearly 5% in 2000. For the period 2000–05, growth has averaged 4.5%, in contrast to the 7.3% recorded over the pre-crisis period 1990–96. Figure 1 suggests a V-shaped recovery, though this is somewhat misleading. Per capita growth has almost halved, from nearly 6% for the decade from 1986 to around 3%.

The production and expenditure components are not shown in detail here, but two points deserve attention. On the production side, the share of agriculture rose in the immediate aftermath of the crisis, as a survival strategy following the collapse of much urban-based modern sector activity, and as a result of the competitive boost to agricultural exports from the sharp exchange rate depreciation. The expenditure accounts are dominated by the sharp decline in investment after 1998, and the rising share of consumption. The latter, like the rising agriculture share, was an effective social cushion during the crisis. The share of investment in GDP declined by over 10 percentage points between 1997 and 1999 (32% to 20%, see Figure 2), before gradually recovering, albeit to levels well below those pre-crisis. In addition to the massive flight of short-term capital, which was the proximate trigger for the onset of the crisis, foreign direct investment turned sharply negative. Averaging $2.7 billion per year 1990–96, net outflows have been about $1.4 billion since 2000. Most important of all, domestic investment has also been anaemic. We return to the issue of the business climate in the next section.

Among other expenditure components, the public sector has played a largely neutral role in the growth process, since the rapid escalation of debt constrained the capacity of governments to employ fiscal stimulus strategies. Exports responded strongly to the 1997–98 exchange rate collapse, with a lag, but performance since 2000 has been indifferent.

Exchange rate and inflation: For much of this period, the exchange rate has been driven by the capital account. Prior to the crisis, the central bank ran a heavily managed

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[2] I draw on a wide variety of material in this section. The most important source is the four-monthly 'Survey of Recent Developments' in the *Bulletin of Indonesian Economic Studies*. Also useful are the annual World Bank reports. The semi autobiographical analysis of Djiwandono (2004) examines macroeconomic and political economy dimensions. The postscript to Hill (2000) documents the crisis and immediate post-crisis developments.

regime. Essentially it was targetting a fixed effective exchange rate against the US dollar. That is, the Rupiah was depreciating against the dollar by a rate similar to the inflation differential between the two countries (Figure 3), in the context of a gradually widening intervention band. As the crisis hit, and conscious of the futile attempt in Thailand to hang on to a fixed rate, the government quickly allowed the Rupiah to float. The rate then became the major barometer of political conditions. By January 1998, the Rupiah/dollar rate had fallen from 2,500 to 17,500, by far the largest depreciation among the crisis economies. It then recovered following Soeharto's exit in May 1998, but with each bout of significant political instability it has deteriorated. With the apparent return of political stability since October 2004 under the Yudhoyono presidency, the rate has stabilized, generally within the 9,000–10,000 range. However, Indonesia's persistently high inflation rate continues to put pressure on the exchange rate.

Although Indonesia's nominal exchange rate has fallen far more than that of the other crisis-affected economies, the depreciation of the real effective rate has been comparable owing to its much higher inflation. This factor, combined with deteriorating physical infrastructure, increased administrative complexities affecting international trade, negative foreign investment (especially in key export-oriented industries such as electronics), and an inability to take advantage of high commodity prices, explain why export performance has been inferior to some other crisis-affected economies (Athukorala, 2006).

The monetary authorities temporarily lost control of monetary aggregates in the first half of 1998, as the government injected liquidity into the banking system. This attempt by Bank Indonesia to keep the banks operating was the BLBI scheme (Bank Indonesia liquidity support). These injections were on a massive scale, at the time equivalent to more than half of GDP, and they explain the sudden increase in both domestic public debt and inflation in 1998.

Inflation on an annualized basis was running at 100% during the first half of 1998, but during the second half of the year it was quickly brought under control again, and was just 2% in 1999 (Figure 4). Since 2000, inflation has averaged 10.1%, compared to the 1990–96 figure of 8.4%. In this respect, Indonesia after the crisis resembles that of the Soeharto era: prices rarely get out of control, but it is a relatively high inflation economy. Unlike its three consistently low-inflation neighbours, Indonesia's central bank has difficulty getting inflation below 5%, and keeping it there.[3] Interest rates, the principal monetary policy tool, have generally remained marginally positive in real terms, providing a rather weak incentive to save.

In spite of these problems, there have been notable macroeconomic policy achievements. The central bank was granted independence after the crisis as part of the LOI with the IMF.[4] It has shifted towards a regime of inflation targeting and a managed float. Underpinned by fiscal prudence, the new arrangements have worked reasonably well in highly challenging circumstances. Indeed, the float has worked as a kind of

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[3] The smaller spike in inflation in 2005 has a different explanation. The government delayed adjusting domestic fuel prices to international levels for so long that the increases were so large as to have major one-off effects on the general price level.

[4] Although its governor was under house arrest for some time!

economic policy discipline, in much the same way as the opening of the capital account did in the early 1970s. That is, the technocrats persuaded President Soeharto to open the capital account as a means of attracting nervous investors and as a check on policy excesses. The advent of the float has also served as a form of 'policy discipline.'

Macroeconomic balances: Fiscal and current account balances have moved in opposite directions since the crisis (Figure 5). The fiscal balance has swung from a small positive percentage of GDP to generally modest deficits. Meanwhile, the current account has shifted from a deficit of around 3% of GDP in the pre-crisis 1990s to a surplus of similar (but declining) magnitude. These trends are consistent with the experience of economies in crisis. The current account outcomes are explained by three main factors. There is expenditure switching (ie, the exchange rate effects of boosting exports and inhibiting imports), declining absorption (ie, declining imports in response to slower growth), and declining capital inflows. The latter occurs because, in effect, foreigners are much less willing to invest their savings in Indonesia. In the case of fiscal policy, the outcome is principally the effect of the 'automatic stabilizers' at work. Lower growth means both reduced revenues and increased expenditures, the latter in the form of both social welfare spending and financial bailouts. It is important to emphasize that the magnitudes have been relatively small in all cases. Indonesia's current account deficits pre-crisis were less than its crisis-affected neighbours, as have its surpluses since. And the swing in fiscal balances has been surprisingly small in such calamitous circumstances.

Fiscal policy and public debt: As noted, in spite of the deep economic crisis, a weakened central government, an ambitious decentralization program, increased pressure to step up social expenditure, and widespread anti-IMF sentiment, the government brought fiscal deficits under control surprisingly quickly. The fiscal deficit had fallen to less than 2% of GDP by 2000, and it has remained there since for most years (Figure 5).

As a consequence, public debt as a proportion of GDP has fallen quickly, much more so than was expected around the year 2000. Government debt prior to the crisis was almost entirely foreign, owing to the 'balanced budget rule' which the technocrats had persuaded Soeharto to sign on to early in his rule. In the immediate aftermath of the crisis, both foreign and domestic debt rose alarmingly, the former principally owing to exchange rate movements (that is the shrinking denominator measured in US dollars), the latter owing to the newly floated recapitalization bonds to finance the bank and corporate debts which were frequently transferred to the public sector. However, since 2001, these ratios have fallen quickly: in aggregate from 75% to 43%, and with both components trending downwards at similar rates (Figure 6). Three main factors explain this encouraging picture: very modest fiscal deficits, as noted; stronger economic growth, enabling the government to grow its way out of debt; and lower interest rates. The debt maturity profile has also been stretched significantly, providing the government with more room to move on fiscal policy.

This is a major economic policy achievement, and much of the credit goes to the Minister of Finance in the Megawati administration (and the president herself for supporting him). It reaffirms a tradition in Indonesia of a relatively strong finance ministry, notwithstanding much corruption within the department (especially in customs and tax) and surrounding it (in 'off-budget deals'). Essentially the Minister was able to 'sell' to the president the importance of adopting a formal fiscal policy framework, especially with the near-term prospect of exiting the IMF program. A 'cordon sanitaire' was placed around fiscal deficits, as the government adopted a similar principle to that of the EU, under which fiscal deficits should not exceed 2% of GDP, and the debt/GDP ratio should be below 60%. In the event, the government has performed a good deal better than most of the EU. Fiscal prudence has also lowered the cost of borrowing significantly, and therefore the interest cost to the government.[5]

Of course, the aggregate fiscal balances are only part of the story, and the fiscal picture becomes more complex as it is unpackaged. First, fiscal deficits have been low in part because government officials are becoming increasingly apprehensive about the prospect of being caught up, however innocently, in corruption scandals. Ironically, the anti-corruption campaign is stymieing both 'good' and 'bad' projects. Infrastructure projects are a particular problem.

Second, the finance ministry has much less control over expenditure and revenue components than it does over the aggregates. This is clearly illustrated in the case of fuel subsidies. At their peak in 2004, subsidies totalled Rp74 trillion (almost $8 billion), more than the central government's total development budget. In fact, in that year, and illustrative of the government's limited capacity to initiate development projects, 63% of its expenditure went on regional transfers, interest payments, and subsidies.

Third, there is arguably a case for the government gradually relaxing its fiscal stringency, to the extent that it probably could borrow more on concessional rates for major projects with high social returns. Infrastructure is particularly important, given major looming supply-side constraints. This too is a complex issue, and it needs to be recognized that the cautionary arguments are powerful. Keynesian-style fiscal stimuli are essentially short-term in nature, and Indonesia is almost a decade beyond the demand collapse of the crisis. Fiscal prudence is extremely difficult to achieve and, once relaxed, there is an understandable fear that deficits could get out of control. Funds could also be found for these high-priority projects from a stronger revenue-collection effort (this too has improved since 2001, though it needs further strengthening) and more carefully targeted expenditures. Finally, major projects are almost certain to be highly corruption-prone, and they would require cooperation between the central and regional governments; yet relations between the three tiers of government are still in a state of flux (see below).

IMF mismanagement?: It is beyond the scope of this paper to dwell in detail on who were the primary culprits of Indonesia's slow and difficult recovery. But two points stand out. First, macroeconomic management has been largely effective, much more so than was generally expected in the immediate wake of the crisis. A new macro policy framework has been instituted, and gradually implemented, in the most difficult of circumstances. Second, it is simplistic to look for scapegoats and single explanations. This argument applies especially to the IMF recovery package, where the polemics divide sharply. There can be no doubt that the Fund made mistakes, particularly in the early

[5] In late July 2006, Indonesian government bonds paid a spread a little over 200 basis points (2%) above US Treasury bonds, slightly higher than the average for emerging markets. Among East Asian economies, the Indonesian spread is a little lower than the Philippines, but more than double that of Malaysia and about four times that of China. (Economist, July 29, 2006.)

stages of the crisis. It applied a one-size-fits-all prescription, which included fiscal prudence when none was needed. It overdid conditionality, introducing an excessive number of requirements in successive packages, extending well beyond the immediate imperative of recovery to areas such as the environment. And at a time of heightened nationalist sentiment, the public 'atmospherics' were badly wrong on occasion, especially the famous January 1998 Jakarta signing ceremony.

But it would be misleading to assign primary responsibility to the Fund, as for example Stiglitz (2002) and others have. Indonesia was not in a Fund program prior to the crisis. In fact, the Fund's involvement with the country had been tapering off since the late 1980s, by which time Indonesia had successfully navigated its way through the 1980s debt crisis, occasioned by falling oil prices. Thus, the Soeharto economic team was very much in command as the crisis hit. Second, one could hardly blame the Fund for Soeharto's increasingly erratic economic policy leadership from late 1997, including for example his flirtation with a currency board, in the face of strong opposition from his central bank governor. Third, at least some of the excessive conditionality appears to have been domestically inspired, from reformers who had been increasingly by-passed in the 1990s. Finally, the Fund modified its approach fairly quickly, at the time of Soeharto's exit, and from that point on it had a benign, though rather peripheral, influence. One legacy of the Fund's early heavy-handed approach was to bequeath an understandable and strongly nationalist anti-borrowing syndrome, which culminated in a hasty exit from the Fund program, in 2004.

3. Trade Policy and the Commercial Environment

Trade policy: Indonesia was a broadly open economy at the time of the crisis (Fane and Condon, 1995). Average levels of import protection had declined since the major 1980s reforms, and most sectors received quite low protection, except where politically influential lobby groups and individuals were able to resist the liberalization. There was further liberalization as part of the LOI with the IMF. Although the country has exited this program, there has been no major backtracking since then, even though protectionist pressures have intensified in certain agricultural products. Thus the Fane-Condon estimates, surprisingly the most recent available, still provide the best summary picture.

In passing, it is useful to dwell on the political economy reasons as to why Indonesia did not turn inward after the crisis (and Thailand too, for that matter), even with the resurgence of strongly 'nationalist' sentiment.[6] This is an important issue since it partly explains the economy's underlying resilience. At least six factors appear to be relevant. First, in the immediate post-crisis period, the IMF LOI played a role, and some of the dismantled protection (eg, Tommy Soeharto's national car project and clove monopolies) was popular. Second, the very large depreciation of the Rupiah provided some exchange rate protection for tradables. Moreover, recovery is dependent on the growth of the export sector, which is politically empowered, and of course opposed to

[6] See Basri and Soesastro (2005) and Basri and Hill (2004) for discussion of this issue.

protection. Third, finance ministries are typically central to the resolution of a crisis, and these now more powerful agencies are generally more likely to favour lower protection. Fourth, the major 1980s liberalizations were still a recent memory at the time of the crisis, and thus an unwinding of successful reforms was likely to be resisted. Fifth, the global trend towards liberalization now has strong intellectual appeal, particularly with the example of the increasingly open Asian giants, China and India, and in contrast to the earlier appeal of Northeast Asian-style guided, export-oriented, industry policy. Finally, at the margin, Indonesia was a signatory to various regional trade agreements – WTO and AFTA in particular – which provided a mild barrier to increased protectionism.

Although Indonesia has remained open since the crisis, there are a number of serious trade policy challenges. First, the principal source of protectionist pressure now emanates from the agriculture sector, in contrast to earlier periods when manufacturing was the main beneficiary. With democratization, rural votes matter, and politicians are able to exploit this factor along with appeal to sentimental notions of food self-sufficiency. Moreover, it is now easier to introduce protection for agriculture than manufactures owing to various loopholes (quarantine, etc) and to the fact that the OECD north is extremely slow to liberalize its own agricultural protection.

A second challenge may be termed ‘trade plus’ issues. This refers to the proposition that liberalization is a necessary but not sufficient condition for successful internationally-oriented growth. We discuss aspects of Indonesia’s commercial policy environment shortly. Two key factors relevant for the export story since the crisis has been the increasingly complex export-import procedures (here the sweeping 1980s reforms have been undone) and the exodus of FDI. The latter is particularly important in rapidly expanding industries such as electronics, where vertically integrated MNEs dominate (Kimura, 2006). Indonesia’s performance in this industry has lagged its neighbours (including the Philippines) largely for this reason (Athukorala, 2006). One consequence of these incomplete reforms is the growing popularity of export zones, which offer simpler administrative procedures and (sometimes) freer trade. Their proliferation should be interpreted as a failure of policy makers to achieve further first-best, economy-wide liberalization.

Third, trade policy making still remains in an institutional vacuum. The ad hoc inter-departmental Team Tariff sets tariffs on an informal basis, without reference to clear objectives and rigorous analytical research , and in a largely non-transparent manner. It has no control over other trade barriers, principally non-tariff barriers, and here the more protectionist line ministries (mainly Agriculture and Industry) seek to by-pass the Team. Such a policy making structure worked well in the 1980s when the technocrats were in control, the main game was to persuade the all-powerful president, and the strategy of ‘low politics’ (a termed coined by Soesastro (1989) in an influential paper) guided policy reform. But it is much less well suited to an era of assertive legislatures and noisy civil society, where vocal elements of both are predisposed to protectionism, and where a constituency has to be won over by argument.

Finally, domestic trade barriers have emerged as just as, if not more, important than international barriers. These take the form of arbitrary, ad hoc and often illegal charges to internal trade. Some are simply opportunistic exactions levied on passing traffic by the military and police. There are cases of local authorities in coastal regions in effect introducing their own, privatized customs services. Other charges are introduced by the local governments following the 2001 decentralization. Some of these local government charges may be legal, but many are not, and there is a tendency for local authorities to simply snub Jakarta. These barriers reflect the weakened authority of the central government and the absence of a clear framework for centre-regional fiscal responsibilities and authority. While in aggregate these charges may not be large,[7] they increase the sense of unpredictability in the commercial environment, and the revenue losses are large relative to local government resources.

There is thus an uneasy stalemate on trade and industry policy. Elite opinion in Indonesia has always been uneasy about notions of liberalism. This sentiment understandably originated in the colonial era. Ethnic divisions, including non-pribumi dominance of much of the modern business sector, have been a sensitive topic. Soeharto and the technocrats always used the term 'deregulation,' and never 'liberalization,' when the economy was opened up in the 1980s. The country's perceived heavy handling by the IMF and donors in 1997–98 further encouraged these sentiments. Liberally inclined economics commentators find it difficult to have a voice in the media today, including the 'quality press.'

Conversely, Indonesia has an unhappy experience with industry policy. Former technology minister and president, B.J. Habibie, has little to show for the estimated $3 billion allocated to his prestige, high-tech projects over two decades (although in fairness there was a significant training element). The government has rarely had success in 'picking winners.'[8] In fact, most industries which have received assistance have been dominated by politically influential individuals, and the industries have tended to under-perform by the usual benchmarks (Hill, 1996). Meanwhile, the government has tended to under-invest in education and, with the partial exception of agriculture, most extension and R&D support programs have had little effect.

Competition and the corporate landscape: The crisis deeply affected Indonesia's modern financial and corporate sectors. Both have recovered slowly, more so than in the other crisis-affected economies, reflecting both the magnitude of the exchange rate collapse and the absence of clear institutional structures and work-out processes.

Reflecting its political economy structures and its still relatively small modern sector economy, Indonesia has high levels of corporate conglomeration and seller concentration. There has not been any detailed empirical research on these issues since the late Soeharto period, but it is probable that the general findings from the mid 1990s still apply.[9]

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[7] For one set of estimates, see Montgomery et al (2002).

[8] Although, as my former student, Dr M.C. Basri, is fond of stating, 'governments may not be very good at picking winners, but losers are good at picking governments'!

[9] Bird (1999) found high levels of industrial concentration, with the simple average 4-firm concentration ratio about 54%. He also found it was declining over time, and the ratio fell significantly once allowance was made for imports. Regarding corporate conglomeration, Claessens et al's (2000) survey of nine East Asian economies in 1996 found that Indonesia had the most concentrated ownership patterns in 1996, with the top family owning 16.6% of listed corporate assets, and the top 10 families owning 57.7% of the total.

It is very likely that competitive pressures have increased since the crisis, for at least five reasons. First, this has been a period of corporate volatility and restructuring. The major Soeharto-linked business empires (Bimantara, Humpus, etc) have collapsed, while many of the major private sector conglomerates have experienced significant changes, either related to financial work-outs, or the loss of crony privileges, or both. Foreign ownership shares have increased in most major industries, and this has generally (though not always) led to increased competition. Second, as noted above, levels of import protection are generally low and have very likely declined. Third, there has been some, though limited, additional deregulation in key, mainly SOE-dominated, sectors. Notable examples include domestic civil aviation and telecommunications. Moreover, the establishment of a Competition Commission (the KPPU) in 1999 has probably increased competition. The Commission has maintained an active scrutiny of collusive arrangements, and in general has operated in an apolitical manner, more effectively than many observers (this author included) had expected.[10] Fourth although, as will be argued shortly, corruption is probably as serious a problem now as in the Soeharto era, there is arguably less entrenched, systemic, and blatant 'palace corruption' of the type which proliferated in the late Soeharto era. In effect, it has been 'decentralized and democratized.' Finally, as will be discussed shortly, the decentralization initiative of 2001 has shifted power away from the centre, and with it the concentration of regulatory authority and bureaucratic rents. The effects are probably thus far quite limited, and local monopolies may have meanwhile increased. But, over time, there is likely to be increased competition for business investment among regions, and this will probably on balance be conducive to increased competition in aggregate. That is, there is no longer a centralized monopoly dispenser of rents. For example, the authority to issue business licences has been transferred to regional (kabupaten and kota) governments.

One would not want to overstate the importance of these developments, but they do all point in the direction of a modest increase in competitive pressures.

The regulatory regime: Indonesia's business regulatory regime remains complex, opaque and costly. Most comparative business surveys now rank Indonesia quite poorly, by East Asian and international yardsticks. Corruption levels are high, and licensing procedures lengthy and unpredictable. For example, the World Bank's *Cost of Doing Business Survey* reports that it take 80 days to register a business. Even if this is an overstatement (which it probably is), alternative estimates suggest the figure is still one of the highest in the world.

According to all available (and admittedly patchy) evidence, corruption is just as serious a problem now as it was during the Soeharto era. In some cases it has been documented to be worse, as in illegal logging. The key difference now is that this corruption occurs in the context of slower economic growth, and it is more unpredictable. That is, abstracting from considerations of morality, and following Shleifer and Vishny (1993) and others, businesses are likely to be deterred by a system where there is greater uncertainty regarding the likely returns from corrupt payments. Under Soeharto, especially during the second half of his tenure, the rules of the game were generally clear, in the sense that the points of payment, or the preferred business partners, were well

[10] See Thee (2006) for an early assessment of its operations.

known. Thus, the business climate is now considerably less attractive than before, owing to slower economic growth, greater unpredictability, combined with other challenges, notably labour regulations (see below) and emerging infrastructure constraints.[11]

These developments have three implications. First, as noted, investment is a good deal lower than pre-crisis levels. Foreigners are less interested in the country. The state has less capacity to maintain its large state enterprise sector, although it continues to block privatization, especially when influential stake-holders are affected. But most important, it is domestic investors who are holding back.

A second implication is that the composition of investment has changed. Investors are now tending to eschew longer term projects in favour of short term investments which can be more easily liquidated. Thus for example, as shown in Figures 2 and 3, the Jakarta stock exchange has increased more quickly than foreign direct investment (evidence of a preference for portfolio investment), and real estate and shopping mall projects have boomed in recent years. Meanwhile, there has been much less interest in major sectors with longer time horizons. Two notable examples are infrastructure and mining. The government has had little success in attracting private sector interest in infrastructure, in spite of a major summit on the subject. Several high-profile disputes and uncertainty regarding pricing are significant deterrents. Mining investment remains anaemic in spite of record commodity prices. International surveys of the mining investment climate (for example by the Canadian-based Fraser Institute) rank Indonesia among the lowest in the world, not far above Zimbabwe and Venezuela.

A third implication concerns policy. Attempts to overcome these constraints inevitably have focused on the second best. A notable example is in trade policy where, despite a generally open economy, exporters experience difficulties with customs, labour and infrastructure. This has led to recent initiatives to extend the operation of special economic zones which, apart from the special case of Batam-Bintan, have never worked as successfully as in neighbouring countries. Another example concerns privatization of the country's large and inefficient SOE sector. Here the best hope for policy makers is probably, a la China, to enforce a hard budget constraint, make the subsidies visible, and ensure that these firms have to operate in a level playing field. Over time, and with growth, the share of the SOE sector will decline, even if it remains about the same size in absolute terms.

Decentralization: Indonesia introduced a 'big bang' decentralization in 2001, after a hasty announcement and passage of two bills through parliament in May 1999.[12] Centre-regional relations during the Soeharto era were highly concentrated in Jakarta, but the government was always sensitive to its regional constituency. Much of the oil boom revenues were recycled to massive infrastructure investments throughout the country. There was no increase in spatial inequality during the Soeharto era, a remarkable achievement for such a diverse archipelagic nation subject to frequent, region-specific

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[11] As is invariably the case, regulatory complexity has undesirable efficiency and equity implications. In the Indonesian case, the latter has been carefully documented by several researchers (for example, Thee, 1994), including the finding that regulatory/compliance costs bear proportionately more heavily on smaller firms.

[12] See Brodjonegoro (2004) for a survey of the early years of the program.

exogenous shocks. Indonesia was unique in this respect among the world's very large developing nations.

The process of decentralization had begun, slowly, in the late Soeharto era, and further measures were in the pipeline. But the threat of territorial disintegration – problems in Timor, Aceh, Papua and elsewhere – hastened the process. Although it remains a unitary state, major revenue, expenditure and administrative authority has been devolved to the regions, principally to the now more than 450 (and increasing!) second-tier districts, kota (cities) and kabupaten. Resource-rich regions have been the major beneficiaries, since they are now allowed to keep most of the locally generated revenue which formerly went to the centre. Direct elections for leaders and parliaments at the regional level are being progressively introduced, thus changing the nation's political and institutional landscape profoundly.

This major reform is still in its infancy, and it is premature to attempt a definitive assessment of its achievements.[13] In principle, the reforms make sense: it is virtually impossible to govern a hugely diverse nation like Indonesia in a centralized manner. If democracy is to be introduced in the centre, then it obviously ought to be in the regions as well. It is also desirable to bring governance closer to the stake-holders, on the principles that local accountability can be introduced, and that 'voice and exit' mechanisms will over time lift the standard of local governance. That is, the better performing jurisdictions will be rewarded with more employment and investment.

Thus far, the evidence is understandably mixed, and a number of clear lessons have emerged for managing the process. First, local-level economic progress still depends overwhelmingly on the national picture. Even the best managed decentralized program is unlikely to stimulate growth at the regional level if national policies are not also conducive to growth. Second, it is probable that regional inequality will increase. The new financial allocation formulae favour the richer regions, and these are also better able to connect to the global economy. Third, and perhaps paradoxically, devolution requires a strong central government. The rules of the game have to be clearly specified and enforced. Indonesia decentralized at an extremely difficult time, when the central government was greatly weakened, administratively and financially. Regional governments have responded to this vacuum at the centre by introducing many regulations which are contrary to the spirit and effective functioning of an integrated national economy. (For example, the trade barriers referred to above.) Fourth, the significant decline in infrastructure investment since the crisis further imperils national economic integration. In an open economy with deteriorating infrastructure and rising internal barriers to trade, the danger is that Indonesia could return to the situation in the 1950s, where certain regions were better connected to the global economy than to the rest of the country. Finally, decentralization may have taken some of the steam out of the demands for even regional autonomy, but its contribution to the resolution of the country's most serious cases of regional disaffection, such as Aceh and Papua, has been limited. The lesson here is that special presidential initiatives are the key factor, as has

[13] It is worth noting in passing that the Philippines introduced a decentralization program, also in similar circumstances (in the wake of a deep crisis and regime collapse) a decade earlier, and it is only now possible to begin to make a serious assessment of the program. See Balisacan and Hill (eds, 2007).

been successfully demonstrated in Aceh since the tsunami, and will hopefully be applied soon to Papua.

The financial sector: The financial sector was at the heart of the deep economic crisis of 1997–98. Many banks failed, perhaps inevitably given the nature of the stresses on a system which had been liberalized in a 'big bang' fashion a decade earlier, but in which the prudential supervisory framework to manage a competitive, resilient financial sector had not been put in place (Grenville, 2004).

Over the past nine years, the following six outcomes have been observed. First, the banking sector has been essentially cleaned up and is now functioning reasonably effectively. Non-performing loans in the commercial banking sector remain too high, but they have declined significantly from the post-crisis peak of 33% in 1999 to about 8%. Firms which have an established record of operations do not appear to be significantly credit-constrained. Most business surveys rank other problems more highly (labour, infrastructure, unpredictable corruption, etc).

Second, as noted above, the cost of the clean up has been massive, although never accurately measured. The banks wrote off much of their debts and, especially through the BLBI fiasco in 1997–98, much of that debt was transferred to tax payers. In effect, private debt was socialized.

Third, the key actors have changed. Whereas before the crisis the domestic private sector was the largest single group, and expanding, since 1998 the banking sector has been effectively re-nationalized, returning it to something more nearly resembling the pre-liberalization structure. The government has also found it difficult to divest itself of these newly acquired banks. The share of foreign banks has risen gradually, but they have been constrained from playing a larger role in the clean-up (and in lifting regulatory standards) owing to nationalist resistance to the sale of 'distressed assets' to foreigners. These banks have played a limited role in the work-outs, as compared to Argentina and some other crisis economies (Grenville, 2004).

Fourth, the crisis really hit the modern financial sector most of all. The small-scale credit programs have mostly continue to operate successfully. Patten et al (2001) refer to the largest of these, managed by Bank Rakyat Indonesia, as a case of 'Microfinance Success Amidst Macroeconomic Failure.' In all the calls for special assistance to the SME sector in Indonesia, it is puzzling that this quiet success story attracts so little attention.

Fifth, weaknesses in the general legal and commercial environment continue to inhibit financial development. For example, land titles and ownership remain poorly defined, and this adversely affects the ability of small borrowers in particular to provide the collateral required by the lower interest formal banking sector. Moreover, banks understandably do not trust the legal system to protect their interests in the event of a major dispute. Wherever possible, for large projects they will prefer to have legal disputation resolved in a foreign jurisdiction. They are also forced to be perhaps excessively cautious and prudent in their lending activities.

Sixth, the remaining financial fragilities are principally located in the state-owned sector. Two of them still have serious NPL problems. These banks have been slower to complete the process of work-outs, mainly because of extensive government interference, fear of corruption allegations, and resistance to foreign take-overs. It is unlikely that foreign banks would anyway be interested in them under current arrangements. The also continue to be bedevilled by the practice of 'command lending.'

4. Social Trends and Policies

The crisis, together with the sudden swing to democracy, has had important implications for social progress and policies. Broadly speaking, social outcomes have been dominated by economic conditions. But democratic pressures have become increasingly important arbiters of social policy, nowhere more so than in the case of labour market interventions.

The incidence of poverty is the most widely used indicator of social conditions in the short-term. As shown in Table 1, trends in the proportion of the population below the national poverty line have closely followed growth rates. There was a marked increase in 1998, with the number of poor increasing by about 15 million people, equivalent to about a 50% increase in their number. The sharpest increase, both in absolute and percentage terms, was in urban areas, confirming the picture that this was primarily a crisis affecting the modern urban sector of the economy. Thereafter, poverty incidence has declined more or less continually, with inflation (particularly for food) being the main determinant of short-term departures from this trend. (Occasional misguided attempts to prohibit rice imports as a means of achieving self-sufficiency have of course hurt the poor.) The proportion of the population below the poverty line had returned to pre-crisis levels by 2003, in both urban and rural areas, reflecting the fact that per capita income levels had by then approximately returned to those of 1996.

The poverty record is of course a good deal more complicated than this summary picture. The crisis and slower growth have increased the number of 'near poor' and the sense of vulnerability among those just above the poverty line. Serious social, ethnic and religious conflict in certain regions, mainly off-Java, have resulted in as many as one million internally displaced persons for periods, and much social distress. So too, naturally, has the series of terrible natural disasters (most especially the Aceh tsunami of December 2004) and terrorist attacks (with Bali in October 2002 the worst). Most other social indicators move more slowly, and trends are evident only over the longer term.[14]

It is useful to identify four broad areas of social policy in the post-crisis period: emergency humanitarian relief at the peak of the crisis and its aftermath; pension and other social welfare schemes; labour market policies; and 'welfarist' SME promotion programs.

In extremely difficult circumstances, the central government has performed about as well as could be reasonably expected in the first area, including the distribution of free

[14] Despite the social problems, one can definitely assert that Indonesia's indicators have trended more like its East Asian neighbours than for example the former USSR, where life expectancy fell sharply during the 1990s, by about 10 years (Pomfret, 2002). Russia's male life expectancy is now less than 59 years, and its population is declining by about 750,000 persons per year.

or heavily subsidized food, various public works schemes, and programs to keep the children of poor families in school. Evaluations of these schemes suggest target success rates have been approximately 50%, which is satisfactory by international standards, and an impressive outcome considering the fiscal crisis and the greatly weakened administrative authority in 1998–99.

In the second area, populist pressures have pushed the government into potentially costly social welfare programs. Late in the Megawati administration, the parliament passed a social security law, promising comprehensive health insurance, a pension and old age benefits. These are to be financed from compulsory payroll taxes, at least for workers in the formal sector. The pensions are to be 'defined benefit' schemes, presumably with the government underwriting the program. These initiatives are obviously laudable in principle, while neighbouring Malaysia and Singapore have demonstrated that compulsory savings program can be an effective means of mobilizing savings and providing for old age retirement. However, the more common experience of these schemes in developing countries is that funding is inadequate for the objectives, resulting either in under-provision of services, or large unfunded mandates having to be met by the government, or both. As the Philippine experience illustrates, from a scheme originating in somewhat similar circumstances, the unbudgeted costs to the government can be very large, moreover at a time of general fiscal fragility.[15]

Thirdly, the most damaging social policy interventions have arguably occurred in the labour market. During the Soeharto era, Indonesia's employment patterns very much conformed to the 'East Asian model' of rapid growth and structural change, rising real wages, minimal interference in the operation of the labour market, and very limited labour freedoms (Manning, 1998). Since 1998, there has been a welcome improvement in the freedom of labour to organize and negotiate. Moreover, another desirable outcome was that, initially, labour market flexibility enabled the labour market adjustment to the crisis to occur mainly on the price (ie, real wages) rather than the quantity (ie, employment), and thus there was not a major increase in open unemployment. But in other respects, labour market policies and outcomes have deteriorated. Labour market populism has resulted in mandated minimum wages rising sharply, while employment regulations have become among the most restrictive in East Asia, and on a par with India. For example, the regulated minimum wage series increased by over 90% in the three years, 1999–2002. Severance pay entitlements have also been increased, and are now among the highest in East Asia (Manning and Roesad, 2006). There has also been pressure to convert contract workers into permanent employees.

The results have been largely predictable. Employment in the modern ('formal') sector has declined, while informal sector employment, typically lower paid and less secure, has been rising.[16] Most of the quantitative work has found a negative and statistically significant impact on employment in the urban formal sector. These negative effects are greater for female, young and less educated workers, who are thereby forced

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[15] This paragraph draws on Box 1 prepared by Kelly Bird for the *BIES* "Survey of Recent Developments." December 2004, pp. 290-1. He reports that the Philippine defined benefit pension scheme had accumulated unfunded liabilities of about $21 billion by 2000, equivalent to about one-quarter of GDP.

[16] See Manning and Roesad (2006) and several other papers by the first author.

to relocate in the informal sector with its lower wages and poorer working conditions. Moreover, as a result of these labour policies, and combined with the increased regulatory complexity in international trade, Indonesia has become a less attractive location in intensively competitive, footloose labour-intensive industries.[17]

Finally, concerning SME programs, these have long been an article of faith among Indonesian policy makers, concerned with the poor and with measures to address ethnic imbalances. There are also some notable examples of SME dynamism, such as the Bali garment export success and the Jepara furniture industry. These have typically been ‘accidental’ cases of industrialization, fostered by a supportive macroeconomic environment, reasonably good physical infrastructure, and mechanisms connecting these producers to international buyers and export markets. Despite much official rhetoric, and a government department designed to support these enterprises, there is little evidence that the success stories resulted from any deliberate government promotional measures. Moreover, as Thee (1994) and others have illustrated, further deregulations will work to the benefit of SMEs. This is because there are pecuniary economies of scale in dealing with a complex licensing regime, which in effect operate to the detriment of these firms. The case for targeted SME assistance programs is unpersuasive. If welfare objectives are the main concern, there are more effective policy instruments, especially in public education and health.

It also needs to be noted that, contrary to widespread impressions, size was not an important explanatory variable in firm survival and recovery following the 1997–98 economic crisis. This is clearly illustrated in the important firm-level investigations of Narjoko (2006). He concluded that foreign ownership and prior export orientation were the two main explanatory variables, and that they were especially significant in their interactive effects. The effects of size were generally inconclusive; if anything, larger firms seemed to manage better.[18]

5. Summing Up

Indonesia has learned some bitter lessons from the crisis of 1997–98. A once impregnable regime was toppled. The global economy and its institutions, seemingly benign for the previous three decades, delivered some unpleasant medicine. There has been much personal hardship and corporate distress. A series of terrorist incidents, some nasty communal violence, and a string of natural disasters have compounded the problems.

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[17] Singapore’s Lew Kuan Yew summarized the problems in characteristically forceful language:

> “They (Indonesian policy makers) know that their labour laws are driving away investors. But the moment the government proposes an amendment, the unions riot. Why? I think they haven’t understood what the world is. They think, ‘This is my minimum wage; you have to do this, you have to do that.’ Meanwhile, there’s massive unemployment and no investments.” (*Australian Financial Review*, May 17, 2006)

[18] It should be noted that these results refer to firms with at least 20 employees. It is possible that firms in the cottage industry sector behaved differently, but I am unaware of data for this group.

There are lessons to be learned from these events. In the words of the most influential economic policy maker in the post-Soeharto era: ‘Beware of possible disharmony between politics and economics … Never take economic stability for granted. … Institutions and governance should receive the highest priority in the overall strategy.’ (Boediono, 2005, p. 323)

But Indonesia is not in any sense a ‘failed state.’ It is now the world’s third largest democracy, having navigated the transition from authoritarian rule with remarkable success. Moreover, it has the immense advantage of having achieved rapid economic growth for 30 years. Policy makers understand what is required to achieve this again. The community understands the benefits of growth, in reducing poverty incidence from over 50% to a little over 10%.

Growth has returned. In the circumstances, economic management has been surprisingly good once the immediate crisis passed. They key has been the quick return to prudent macroeconomic management and maintaining a broadly open economy. The strategy of inflation targeting and a managed float of the exchange rate is working quite well. Public debt remains high, but growth and modest fiscal deficits are together bringing the ratios down to manageable levels.

A repeat of anything like the 1997–98 crisis is highly unlikely. Indonesia remains highly indebted; both its public debt and external debt to GDP ratios are high. But they have fallen substantially since the crisis. There have been current account surpluses almost continuously since 1998 and fiscal deficits are low. The floating rate regime should ensure that there is no serious currency misalignment (though over-shooting can occur from time to time). Banks and creditors have learned to be more cautious, although as noted the problems in the state banking sector have yet to be overcome. International credit ratings have improved, and international financial institutions have learned better how to respond to such crises.

To restore and embed high growth, the main challenges now are more to do with institutions, the business environment, and the supply side constraints in infrastructure and education. Business confidence is returning, but slowly, and investors are still shunning projects with long time horizons. The country is missing out on a rare opportunity to convert record commodity prices into future growth and welfare improvements. The benefits of growth could be spread more equitably with greater targetting of social expenditure and more inclusive labour market policies.

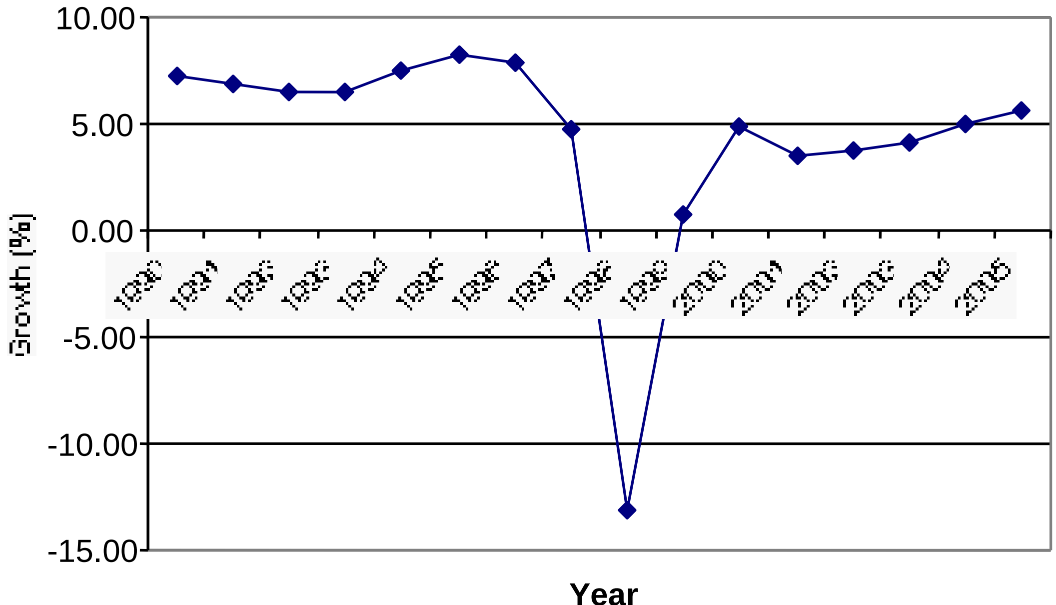
A new political economy strategy to achieve reform is required. As Hadi Soesastro (1989) demonstrated, in the Soeharto era ‘low politics’ worked effectively during the highly successful 1980s reforms. The key was for the technocrats to convince Soeharto of the case for reform, and then develop and implement a coherent program. This was the reason why Indonesia did not follow Mexico, Nigeria and others into a debt crisis as oil prices collapsed in the first half of the 1980s. But in Indonesia’s new political economy, ‘low politics’ will no longer work. Parliament has to be persuaded, by one means or another. A noisy civil society, much of it predisposed towards populism, has to be convinced. Regions will now no longer follow Jakarta dictates. Cabinet solidarity is no longer assured, given its ‘rainbow’ composition. Thus the reformers need to not only fashion a coherent economic reform strategy, but they have to win the public debates and play clever politics, all at once.

Table 1. Poverty in Indonesia, 1996–2004

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

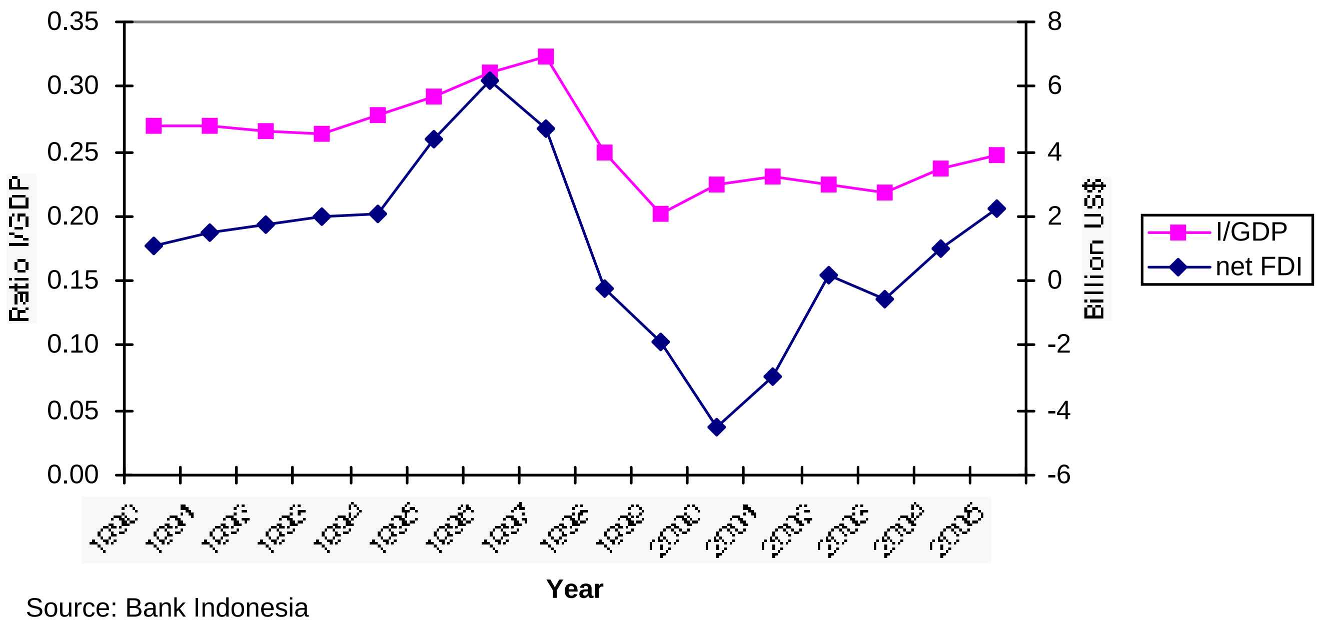
Source: Central Board of Statistics

Figure 1: Economic Growth, 1990-2005



Source: CEIC Asia Database

Figure 2: Investment, 1990-2005



Source: Bank Indonesia

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

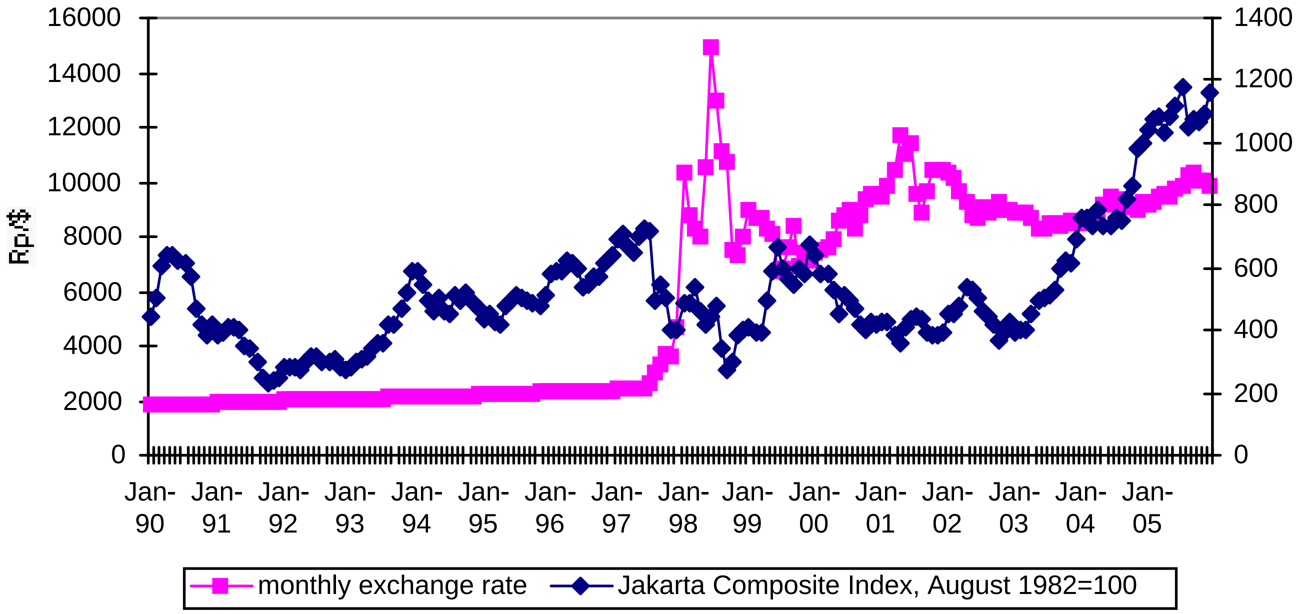
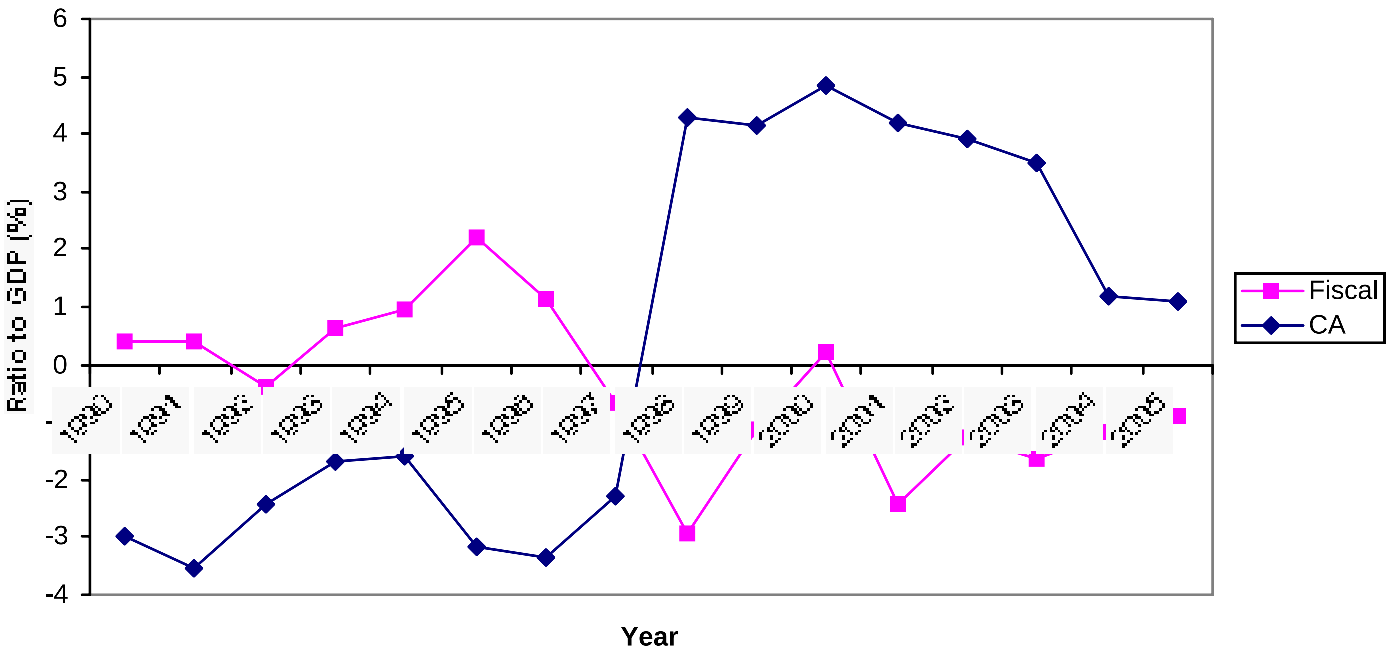
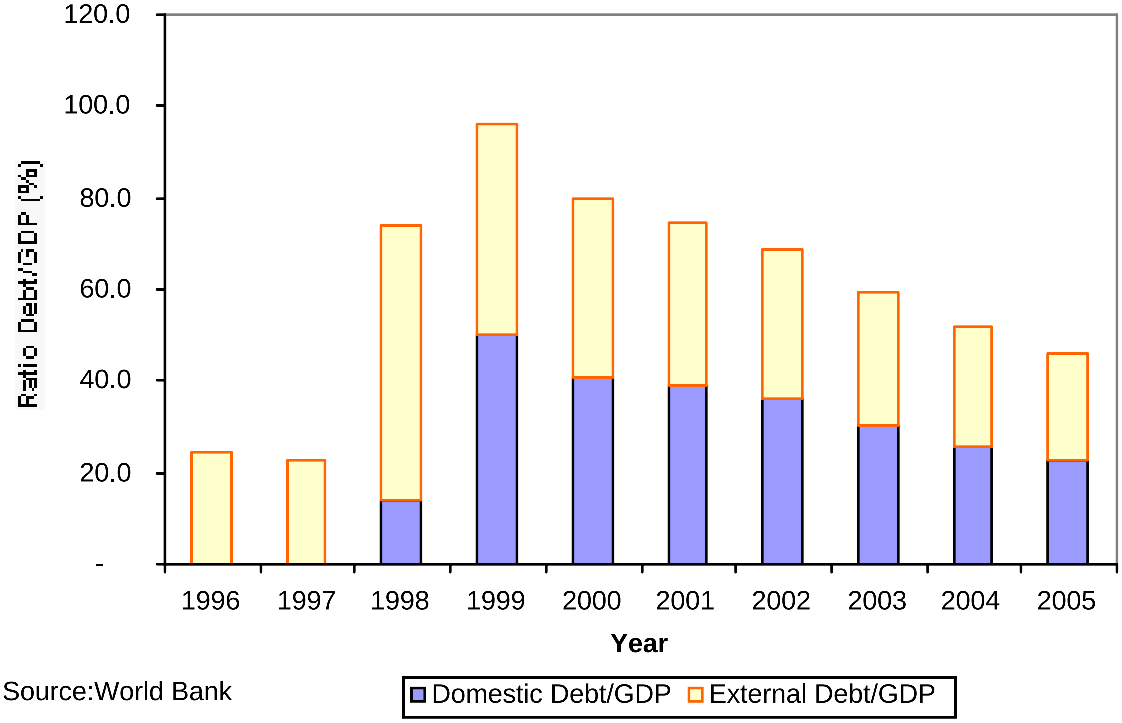


Figure 5: Fiscal and Current Account Balances, 1990-2005



Source: World Development Indicators

Figure 6: Government Debt, 1996-2005



Source:World Bank

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