SURVEY OF RECENT DEVELOPMENTS

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SUMMARY

Indonesia continues to move forward, albeit slowly. We see this as the defining characteristic of the period under review. There is continued macroeconomic improvement, and a more viable system of national government is emerging. These developments help to explain why the economy and the government were able in the first half of 2003 to weather without major disruption two potential international shocks (the Iraq war and the SARS epidemic) and a slowing of the world economy. But serious problems persist and there seem to be systemic limits to the ability of policy makers to create an attractive investment environment. We see this mixed judgement—continued progress, but slowly—as a probable pointer to what lies ahead over the next several years.

The electoral cycle is already heating up in preparation for next year’s multiple contests. Although not conducive to sound economic policy making, electoral politicking thus far shows little sign of seriously disturbing the economy. Also creating remarkably few ripples is the growing recognition that Indonesia is unlikely to renew its relationship with the IMF at the end of 2003. Fortunately too, thus far at least, Indonesia’s new war in Aceh has not had significant economic repercussions. The response to the Bali bombing is a modest boost to national confidence. On the other hand, the outbreak of SARS in other parts of East Asia has harmed inbound tourist travel.

The overall macroeconomic picture continues to improve. Year-on-year GDP growth of 3.4% recorded in the first quarter of 2003 exceeded many expectations. Public debt is still declining as a percentage of GDP, interest rates and inflation have also fallen and the currency has appreciated. And an important new state finance law lays an encouraging foundation for gradual overhaul of the management of public finance.

At the micro level the picture remains troubling. Investment trends continue to be weak, progress in banking recovery is slow, the revised labour law contains only modest improvements from an investor viewpoint and there are signs of creeping protectionism.

In the wider institutional environment for business, even though the legal system remains a void and much uncertainty still surrounds the devolution of power to regional governments, important progress has been made in straightening out the basic structure and dynamics of government at the national level. With these changes now largely in place, we can begin to think through the implications of the new framework for economic policy and future performance.

We see continued slow progress for Indonesia. In the short term this is satisfactory. But over the longer term, a 3–4% growth trajectory has worrying implications for unemployment, poverty and social stability.
Indonesia’s next electoral cycle is already heating up, even though legislative and presidential elections do not take place until mid next year. Alongside continued bargaining over the remaining constitutional and electoral law issues, the main game at this stage is strategic pre-positioning by presidential aspirants. In an odd contrast with the attention to these early electoral manoeuvres, the onset of formal military action by government troops in Aceh has had no major impact on the dynamics of national politics. On Aceh, political leaders seem largely to have adopted a nationalist insistence on the need to stamp out this challenge to the republic’s geographic integrity, even as it seems also to be tacitly recognised that this will be an unhappy and protracted business. Also interesting is the widespread (and entirely justified) pride at the extraordinary progress the police have made in pursuing the perpetrators of the Bali bombings. Although political leaders do not appear to have seen electoral advantage in playing this up, it is a development that helps to build international confidence in the strength of the Indonesian polity.

The electoral process is beginning earlier than in the past because of the new rules for presidential elections. The reality of a multiparty system, plus the requirement that parties nominate a candidate for both president and vice president, is forcing coalitional deals to be made up front. Also shaping the game is a new requirement (still to be finalised in implementing laws) that only political parties which clear a significant threshold in the legislative elections in April (probably 15–20% of the vote) will be entitled to put forward a presidential–vice presidential ticket. The most likely scenario is that voters will be presented with a choice of three tickets in the first presidential run-off.

The excitement at this early stage centres on party leaders. Barring some extraordinary circumstance, Megawati has the leadership of PDI-P (the Indonesian Democratic Party of Struggle) locked up. The focus is thus on Golkar (the government party under former president Soeharto), which, as the second largest party, is the key swing player: will it forge a coalition with PDI-P or not? This depends in part upon whom it chooses as party leader. In a little noticed irony of Indonesian politics, Golkar is emerging as one of the most internally democratic parties. Under a schedule adopted by the party, voting will take place this July in branches at district level across the country to identify a list of preferred candidates for party leader. This list will be narrowed to five candidates in October with another round of voting at the provincial level. A national party convention in February 2004 will choose one candidate from the list of five.

Given this long lead-time, and given that the PDI-P leadership is not open for contestation, all serious aspirants for the presidency (other than Megawati) need to be throwing their hats into the ring now. The names in circulation thus far for the Golkar leadership include incumbent party chair Akbar Tandjung, Coordinating Minister for People’s Welfare Jusuf Kalla, Minister of Transport (and former general) Agum Gumelar, Coordinating Minister for Political and Security Affairs (and former general) Susilo Bambang Yudhoyono, the Sultan of Yogyakarta, businessman Abu Rizal Bakrie, media tycoon Surya Paloh, and respected Muslim scholar Nurcholis Madjid.

Nurcholis declared his interest in the presidency in May, and although he did
not specify his preferred party affiliation, most commentators see Golkar as the only plausible option. A political ‘clean-skin’, his candidacy generated a flurry of excitement in the Jakarta media. Whether he can successfully navigate the real world of party preselection processes is another matter. Tempered by discussions with players of various sorts, our best guess at this stage is that the person ultimately chosen as Golkar leader will be either Akbar Tandjung or Jusuf Kalla, with the latter slightly more probable. The key to the contest between the two is likely to be Akbar’s legal fate (following his corruption conviction in September 2002 and ongoing appeal). In this regard, over the coming months BIES readers may wish to be on the lookout for reports on the decline or growth of a strategic alliance between Akbar and PDI-P political czar (and presidential spouse) Taufiq Kiemas.

As electoral positioning intensifies through this year, it is to be expected that economic policy debates will assume a more populist disposition. The most prominent manifestation of this during the first quarter of the year has been the emergence of the group known as Indonesia Bangkit (Indonesia Arises). This loose coalition of some 35 economists and other intellectuals under the leadership of the former economics coordinating minister, Rizal Ramli, has taken a strong position on Indonesia’s relationship with the IMF (we discuss this further below). Of more immediate consequence was the dramatic swing in January by the major political parties away from supporting an end to fuel price subsidies (Waslin 2003: 6). Key parties and their leaders had previously endorsed this fiscally responsible move, but in the face of focused public opposition their stances changed — with Megawati and PDI-P absorbing most of the criticism by virtue of having held ground the longest and, indeed, for having strongly defended the price rises just before reversing course. Almost all political parties have seen their support decline in public opinion polls (reflecting general unhappiness with the apparently self-serving nature of national political life). But prominent political analyst Rizal Mallarangeng, comparing polling data from November 2002 and February 2003, argues that public disillusionment is hitting Megawati and PDI-P most (Mallarangeng 2003).

In addition to this lengthy preparatory period for the elections in which leading figures seek to position themselves for party leadership posts, the country also faces a long formal electoral season next year. Legislative elections — for the House of Representatives (DPR), the new House of Regional Representatives (DPD) and the provincial and district legislatures (DPR-D) — will take place on 5 April. Campaigning will then continue for the two-stage presidential electoral process, with the first round ballot on 3 July and a second round in September if (as is almost certain) the first does not produce a majority winner. The inauguration of the new president is expected to take place around 20 October. Between now and then the political climate will be increasingly inimical to market-friendly legislative reform: leading lights in the business community will be seeking regulatory favours in return for contributions and (in almost poignant irony) all politicians will be wary of charges of ‘selling out’ to foreign interests. And, of course, blandishments of all sorts will be on offer from candidates competing for voter support — though the extent of pork-barrelling and outright vote buying is likely to be less than in some other countries in the East Asian region.
MACROECONOMIC DEVELOPMENTS AND TRADE
Recent Economic Shocks
As the political climate warmed up in preparation for next year’s election, the economy early this year experienced two significant external shocks. In early March 2003, public and political debate quickly became focused on the US decision to attack Iraq. The growing anti-US sentiment did not, however, translate into political turmoil, for two reasons. First, most politicians and religious leaders saw a stable relationship with the US as important, and persuaded Indonesians that the war in Iraq was a conflict between the US and Saddam Hussein, rather than an attack by the US on a Muslim society. Second, the war itself was of short duration.

As the conflict began, news emerged of the outbreak of a deadly viral illness, severe acute respiratory syndrome (SARS), in China, Hong Kong, Singapore and Canada. This was another blow to the Balinese economy following the bombings on 12 October 2002, and adversely affected tourism nationwide. The average hotel occupancy rate in Bali had recovered to approximately 47% by February 2003, after a fall of 80% in tourist arrivals between September and November 2002 (Waslin 2003: 14) and plummeting occupancy rates. In March, however, Bali’s average occupancy rate for three-star hotels and better fell again, to about 20%, while that for two-star hotels and below was down to only 10% (Gatra, 3/5/03). For the whole country, the number of international tourist arrivals declined by approximately 13% in the same month (Berita Kantor Menko Ekuin, 25/04/03).

In May there was another shock, when the government decided to conduct a military operation against the Free Aceh Movement (GAM, Gerakan Aceh Merdeka). If the war is brief, its
impact on national politics and the economy will be manageable. Even for a short war, it is estimated that the government will have to allocate approximately (probably at least) Rp 1.3 trillion to this military operation and the subsequent recovery program (Gatra, 13/5/03). However, if the war does not end quickly, as the number of human dead and injured increases and regionalist Acehnese sentiment intensifies, the pressures on the political environment could escalate and may cause political turmoil.

Hitherto, the impact on the national economy of all these factors—the lead-up to the election, the Iraq war, SARS, and the beginning of the military operation in Aceh—has been surprisingly mild. Continuing the trends of last year, inflation and interest rates have fallen, while the rupiah has strengthened against the dollar. The ratio of debt to GDP has continued to decline. Asset sales by IBRA (the Indonesian Bank Restructuring Agency) have reduced net capital outflow and boosted reserves. GDP growth in the first quarter of 2003 was almost the same as a year earlier. The economy certainly appears less vulnerable than it was 12 months ago, or after the Bali bombings in October 2002. Detailed observations on recent economic indicators follow.

**Inflation, the Exchange Rate and Interest Rates**

The annual inflation rate declined from approximately 14% per annum in February 2002 to 7% in April 2003 (figure 1). The much smaller than planned increases in fuel oil and electricity prices at the beginning of 2003 did not affect the inflation rate significantly. The decline in the rate of inflation was at least partly due to the successful efforts of the central bank to control the growth of base money (figure 2). Annual base money...
growth was reduced from over 15% at the beginning of 2002 to approximately 6% in February 2003. During that period there was one peak, in November 2002. The most likely contributors to this were attempts to soften the impact of the Bali bombing, and the Muslim Idul Fitri holiday in early December.

Nominal interest rates also fell during 2002 and early 2003. This was due in part to the declining inflation rate, since real interest rates—three-month SBI (Bank Indonesia Certificate) rates minus inflation—seem to have remained in the range 3–5% p.a. Lower nominal interest rates have contributed to an increase in lending by the banking sector. Bank credit outstanding rose from around Rp 302 trillion in January 2002 to Rp 420 trillion in March 2003. In general, the health of the sector improved over this period: the percentage of non-performing loans fell from 12% in January 2002 to 8% in March 2003, and the average capital adequacy ratio (CAR) increased to approximately 8% (ADB 2003: 12).

The exchange rate, which had strengthened from over Rp 10,000/$ at the end of 2001 to around Rp 9,000 just before the Bali bombings, weakened for a brief period towards the end of 2002 and then improved again to fall below Rp 8,500/$ in May 2003. In recent times the improvement has been due partly to the weakening of the dollar against all major world currencies. Despite these improved economic indicators, during the last quarter of 2002 and early 2003 the net flow of foreign direct investment (FDI) was still negative. Meanwhile, consumer spending, which had been the engine of growth in the last few years, faltered, increasingly constrained by consumer debt (World Bank 2003b: 1). Hence it is predicted that the annual GDP growth rate in 2003 will be similar to that for 2002, at approximately 3.5%. While by no means disastrous, this projected rate is the lowest among the larger East Asian economies other than Japan (World Bank 2003a: 1; ADB 2003: 20).1

Growth

The year-on-year GDP growth rates recorded in Q4 2002 and Q1 2003 were relatively modest (table 1), but higher than many expected. At around 3.5%, they were well above the rates in the same quarters a year earlier. The two main pillars of growth during these periods were government consumption and investment. The former is rather puzzling, since the central government had kept a tight rein on spending in this period. Interestingly, relatively high growth in government consumption has been evident since early 2001—the first year of the country’s decentralisation era—apart from the first half of 2002. The rise in government spending may have been due to higher expenditure by regional governments on salaries, possibly offset by lower government investment (World Bank 2003b: 2). Meanwhile, the high percentage increase in investment is partly explained by the low level of investment recorded last year. Significant increases in investment occurred in the construction sector, which contributed approximately 70% of total investment in 2002 (World Bank 2003b: 2).

Growth rates for exports and imports have increased markedly since the last quarter of 2001. Growth in imports became positive from mid 2002, peaking at an unusually high 20% at the end of that year. High growth rates are in part explained by the low level of imports recorded last year. Significant increases in investment occurred in the construction sector, which contributed approximately 70% of total investment in 2002 (World Bank 2003b: 2).
Survey of Recent Developments

TABLE 1  GDP Growth, Year-on-Year
(1993 prices, %)

<table>
<thead>
<tr>
<th></th>
<th>Dec-01</th>
<th>Mar-02</th>
<th>Jun-02</th>
<th>Sep-02</th>
<th>Dec-02</th>
<th>Mar-03</th>
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<td>1.7</td>
<td>2.7</td>
<td>3.9</td>
<td>4.3</td>
<td>3.8</td>
<td>3.4</td>
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<td></td>
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<tr>
<td>Private consumption</td>
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<td>4.9</td>
<td>3.9</td>
<td>4.5</td>
<td>3.9</td>
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<td>9.0</td>
<td>16.9</td>
<td>17.9</td>
<td>10.7</td>
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<td>-8.9</td>
<td>-4.6</td>
<td>4.6</td>
<td>8.9</td>
<td>6.4</td>
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<tr>
<td>Exports</td>
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<td>-6.5</td>
<td>2.6</td>
<td>4.4</td>
<td>0.7</td>
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<tr>
<td>Imports</td>
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<td>-25.7</td>
<td>-20.8</td>
<td>2.9</td>
<td>19.8</td>
<td>9.4</td>
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<td></td>
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<tr>
<td>Agriculture, livestock, forestry &amp; fisheries</td>
<td>-0.4</td>
<td>-3.1</td>
<td>3.9</td>
<td>3.8</td>
<td>2.4</td>
<td>3.2</td>
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<tr>
<td>Mining &amp; quarrying</td>
<td>-6.8</td>
<td>-1.5</td>
<td>2.2</td>
<td>2.7</td>
<td>5.7</td>
<td>1.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>3.1</td>
<td>5.6</td>
<td>3.9</td>
<td>4.1</td>
<td>2.4</td>
<td>2.7</td>
</tr>
<tr>
<td>Electricity, gas &amp; water supply</td>
<td>1.2</td>
<td>8.0</td>
<td>3.1</td>
<td>4.5</td>
<td>9.1</td>
<td>6.1</td>
</tr>
<tr>
<td>Construction</td>
<td>1.0</td>
<td>1.9</td>
<td>3.2</td>
<td>5.4</td>
<td>5.9</td>
<td>5.8</td>
</tr>
<tr>
<td>Trade, hotels &amp; restaurants</td>
<td>2.6</td>
<td>2.7</td>
<td>3.3</td>
<td>4.7</td>
<td>3.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Transport &amp; communications</td>
<td>8.8</td>
<td>8.9</td>
<td>8.8</td>
<td>7.5</td>
<td>6.2</td>
<td>6.2</td>
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<tr>
<td>Finance, rental &amp; business services</td>
<td>2.9</td>
<td>4.4</td>
<td>5.2</td>
<td>5.8</td>
<td>6.8</td>
<td>5.7</td>
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<tr>
<td>Services</td>
<td>2.8</td>
<td>2.7</td>
<td>1.8</td>
<td>1.6</td>
<td>1.8</td>
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</tr>
</tbody>
</table>

Source: CEIC Asia Database.

ed their equipment by purchasing imported goods. The increased demand for imports is probably due in part to a decline in import prices of selected goods such as electronics and processed foods.

On the production side, we see four largely non-tradable sectors—electricity, gas and water supply; construction; transport and communications; and finance, rental, and business services—showing strong growth, in several cases stronger in these last two quarters than in the previous four. All have been supported by government and private consumption. In the electricity, gas and water supply sector, this period saw a large number of new connections by households, but a less significant number by industrial entities. In construction, maintenance activities and the stimulus package in the wake of the Bali bombings are probably the main reasons for the improved growth rate.

The transport and communications sector is particularly interesting. In the last two quarters it grew more rapidly than most other sectors, but more slowly than it had in the previous four quarters. The Bali bombing and the war in Iraq were probably important contributors to this slowing of growth, reducing the demand for international flights. However, the fall in international demand caused airline companies to concentrate on increasing the sale of domestic flights by lowering prices. Competition among airlines pushed domestic air fares even lower, attracting domestic customers who normally travel by rail, road and water.
Among the sectors that did not perform well in the last two quarters were mining and manufacturing. In the mining sector, the bottleneck impeding higher growth has been the decline in oil and gas output since 2001. This was probably due partly to falling demand for oil by the petroleum refineries. Output of the latter had also declined in the same period, and hence affected the growth of total manufacturing output.

**Trade and the Balance of Payments**

The value of international trade increased during 2002 and early 2003 (figure 3). Nevertheless, total exports for most months during this period were lower than their average monthly level in 1997. Oil exports were more or less steady. The value of exports of spices, cotton seed, cocoa and palm oil doubled; of these four, palm oil contributed most to the increase in total exports. Meanwhile the value of textile exports declined, while exports of electronics and wood processing grew quite slowly over this period, at average rates of 3% and 1% respectively.

Imports also increased steadily in 2002 and early 2003. The value of foodcrops, processed food, fruit and vegetables, and machinery for metal processing rose most. This is consistent with the observation made above that household consumption of imported goods had increased, and that import-
ed equipment had replaced domestic production in several sectors.

When this survey was prepared, the latest information available on the balance of payments was for the last quarter of 2002. Significantly, the net capital account remained negative, despite relatively stable political conditions and improving macroeconomic performance, even though the negative numbers grew smaller throughout 2002, and the total for 2002 was much lower than that for 2001 (table 2). The main reason for the continuing negative capital account is that net FDI is still negative. Foreign investors continue to see Indonesia as a high-risk country, and this attitude is unlikely to change before the elections. Although falling steadily as a share of GDP, official debt repayment also continues to be high, and is likely to remain so for several years. Hence, the net capital account will probably be negative for several more quarters.

The good news from the balance of payments table is that other private capital flows became positive in the first quarter of 2002 and increased throughout that year. This has been due primarily to IBRA asset sales, and to renewed interest in investing on the Jakarta Stock Exchange.

### TABLE 2 The Balance of Payments ($ billion)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
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<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
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<tr>
<td>Exports</td>
<td>57.4</td>
<td>12.7</td>
</tr>
<tr>
<td>Non-oil &amp; gas</td>
<td>44.8</td>
<td>10.0</td>
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<tr>
<td>Oil &amp; gas</td>
<td>12.6</td>
<td>2.6</td>
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<tr>
<td>Imports</td>
<td>-34.7</td>
<td>-7.5</td>
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<tr>
<td>Merchandise trade balance</td>
<td>22.7</td>
<td>5.2</td>
</tr>
<tr>
<td>Services</td>
<td>-15.8</td>
<td>-3.5</td>
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<tr>
<td><strong>Current account</strong></td>
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<tr>
<td>Inflows</td>
<td>5.7</td>
<td>1.4</td>
</tr>
<tr>
<td>CGI (Consultative Group on Indonesia)</td>
<td>2.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Non-CGI</td>
<td>3.8</td>
<td>1.0</td>
</tr>
<tr>
<td>Debt repayment</td>
<td>-6.5</td>
<td>-1.8</td>
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<tr>
<td>Private capital</td>
<td>-8.3</td>
<td>-1.0</td>
</tr>
<tr>
<td>Direct investment</td>
<td>-5.9</td>
<td>-1.2</td>
</tr>
<tr>
<td>Other</td>
<td>-2.4</td>
<td>0.2</td>
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<tr>
<td><strong>Capital account</strong></td>
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<tr>
<td>Inflows</td>
<td>5.7</td>
<td>1.4</td>
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<td>Direct investment</td>
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<tr>
<td>Other</td>
<td>-2.4</td>
<td>0.2</td>
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<tr>
<td><strong>Overall balance</strong></td>
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<tr>
<td>Capital &amp; current account</td>
<td>-1.4</td>
<td>0.0</td>
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<tr>
<td>Errors &amp; omissions</td>
<td>-2.1</td>
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</tr>
<tr>
<td>Overall balance</td>
<td>0.7</td>
<td>-0.3</td>
</tr>
</tbody>
</table>

*Source: CEIC Asia Database.*
Two welcome developments from the viewpoint of economic policy were the passing of the State Finance Law and the appointment of Burhanuddin Abdullah and Hartadi Sarwono as Governor and Deputy Governor, respectively, of Bank Indonesia (BI) (see box 1 on the BI appointments). The little heralded State Finance Law (Undang-Undang No. 17/2003) has potentially positive macro-economic implications over the longer run. Amid other less helpful bumps and shocks of various kinds, this represents an important foundation for the task of overhauling the management of public finances in Indonesia. Submitted to the parliament last September, it was passed on 6 March. It is the first in a suite of three major laws, with two others (a State Treasury Law and a State Financial Audit Law) to follow.  

Perhaps the most important element of the framework is the establishment of the principle of a single consolidated budgetary fund, thereby prohibiting the...
deeply corrosive practice of off-budget fiscal activity. The law stipulates very clearly the legal responsibility of all relevant officials handling public monies, and their accountability obligations through the Supreme Audit Agency (BPK). Importantly, the law also clearly stipulates the relationships among various state institutions.

Most fundamentally, it makes very explicit the constitutional principle of the parliament’s role in drafting and approving the budget and holding the executive branch accountable for it. Similarly, the parliament’s co-approval is required for all foreign loans and grants (and any transfer of such funds to regional governments), the privatisation of state enterprises and the injection of state capital into any private enterprise. Some economists have complained that this will ‘reduce the government’s fiscal flexibility’ (JP, 10/3/03). Indeed, the new law leaves no doubt as to the pivotal role of the DPR in economic decision making in the new Indonesia. Finally, the law also establishes similar principles between the executive and legislative branches of government at the regional level, and the fiscal hierarchy at various levels of government.

These are historic changes in the fiscal governance of Indonesia. But will the reforms actually work? The answer is likely to be mixed, reflecting prevailing political realities. The enshrinement and specifications of the parliament’s power are likely to be fully enacted, because the political parties are the centre of power today and the parliament is the forum they all share. Less clear is the extent to which and the pace at which off-budget fiscal activity is going to be eliminated. As BPK Chairman Billy Joedono noted, without effective implementation, the new legislation will be toothless (JP, 8/3/03). The BPK recently revealed that it had identified some Rp 456.3 trillion (about $60 billion) in irregularities in the use of state funds during 2001–02, although nothing has yet been done to hold any of the individuals or agencies involved accountable.

As with many things in Indonesia during these years of transition, one can view this as a glass that is half full or as one that is half empty. The new legal framework makes these issues much more explicit, defining irregularities and specifying illegality and culpability. In short, it provides a clear and strong legislative foundation for public finance. This is important progress. But prosecution — particularly in certain domains — will be difficult. The most obvious case of this off-budget expenditure is activity by the armed forces (TNI). With some two-thirds of military expenditure being off-budget, it is simply inconceivable that all activity will suddenly be channelled through the Ministry of Finance. Indeed, this is such a basic problem that, in the interests of both the integrity of the new law and, even more fundamentally, the viability of Indonesia’s new democracy, a reasonable case can be made for adopting special legislation stipulating that, in the case of the TNI, the process of bringing all activities on-budget will be phased in over a specified period. (Significantly, the new law comes into effect on the eve of the TNI’s formal withdrawal from the national parliamentary arena.)

One final aspect of this important step forward in fiscal governance is the controversy that erupted over inter-agency responsibilities. The new law does not mention the national planning agency, Bappenas, and specifically stipulates the Ministry of Finance as the agency with managerial authority. This detail escaped public notice for some weeks, until development planning minister and Bappenas head Kwik Kian Gie publicly complained that his agency was
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being wiped out, perhaps as a result of ‘plotting’ by the World Bank (Tempo, 13/4/03; Tempo Interaktif, 9/4/03). While Bappenas’s continued existence is not currently in question, there can be no doubt that its role and authority in economic policy matters continues to decline under Megawati. Partly this reflects the dramatic rise of the DPR’s budgetary powers, as well as the new expansion of the finance ministry’s authority, and partly it reflects the relative political fortunes of different ministers.

INDONESIA AND THE IMF

Indonesia signed another Letter of Intent (LOI) with the IMF on 18 March 2003. The LOI and the accompanying Memorandum of Economic Policies outlined the progress Indonesia had made in the previous quarter with promised reforms, and specified new targets for the coming period (JP, 20/3/03). Following IMF acceptance, this resulted in a further $450 million in IMF lending being released to Indonesia.

It was not long ago that Indonesia’s fulfilment of such conditions and the disbursement of funds were subject to delay and controversy. This time the cycle went relatively unremarked. Instead, debate has intensified on the broader question of what form of engagement, if any, Indonesia should have with the IMF after the existing Extended Fund Facility expires in December this year. The debate is being driven not only by the approaching end-date, but also by a formal recommendation issued last year by the MPR (People’s Consultative Assembly) that a framework be developed for ending Indonesia’s dependence on the IMF.3

But the wider backdrop is a quietly growing nationalist mood in politics and public discourse more generally—a sense of concern about Western dominance and an inchoate desire for Indonesians to take greater control of their own affairs. In April former finance minister Bambang Sudibyo called publicly for the country to ‘look inwards’ (JP, 9/4/03). More concretely, there has been a small but growing number of policy moves in this direction; most recently a new visa requirement and charge for foreign tourists, a proposed new ban on all rice imports (JP, 17/5/03) and a restriction on sugar imports (see below).

In the debate about the IMF, this nationalist sentiment has been given intellectual embodiment with the emergence of the Indonesia Bangkit group. In addition to its coordinator, former economics coordinating minister Rizal Ramli, the group’s members include Sri Edi Swasono of the University of Indonesia, Umar Juoro of the Centre for Information and Development Studies (CIDES), Didik Rachbini of the Institute for Development of Economics and Finance (INDEF) and Elvyn Masasya of Financial Intelligence Research. Having worked behind the scenes lobbying all fraksi (parties) in the parliament late last year, Indonesia Bangkit took a high public profile early in 2003, campaigning strongly for a prompt and complete termination of engagement with the IMF. In essence, the group’s argument is that the IMF has served Indonesia poorly, that it constrains the country’s future growth prospects, and that with improved macroeconomic circumstances Indonesia can readily afford to repay its outstanding loan obligations promptly (Tempo Interaktif, 26/2/03; JP, 29/4/03).

The Indonesia Bangkit position has been seen as a direct challenge to the approach of the dominant group of economic ‘technocrats’—the successors of the New Order ‘Berkeley mafia’ economists led by Widjojo Nitisastro. A closer investigation suggests, however, that the challenge may be more political than philosophical, given the centrality Indo-
nesia Bangkit seems to give to orthodox macroeconomic management and the absence, for instance, of any grand protectionist industrial strategy. The question of the future form of Indonesia’s engagement came more sharply into focus in early May, when the Senior Advisor of the IMF’s Asia and Pacific Department, Daniel Citrin, publicly outlined three broad options for Indonesia upon the expiry of the existing program: a Standby Arrangement, a Precautionary Standby Arrangement and exiting the standby framework completely but engaging in a ‘post program dialogue’ (Kompas, 9/5/03). The first option is the most cautious in financial terms, for it would it allow Indonesia continued access to special IMF standby lending (on condition of policy reforms codified in a binding LOI), and thus keep open the possibility of requesting a further rescheduling of debt to creditor countries through the Paris Club.

The second option, a Precautionary Standby Arrangement, is a contingent facility in case new standby lending is needed. It involves LOI conditionality, but does not permit concessional financing through the Paris Club (since this requires participation in a full Standby Arrangement). The third of the outlined options would see Indonesia completely exit standby status but engage in a post-program dialogue with the IMF, forgoing any special IMF borrowing or Paris Club rescheduling. Indonesia would free itself from conditionality, but engage in voluntary and structured policy discussion with the IMF for another year or so.

Under all of these scenarios, Indonesia would pay off its loan obligations on the current schedule, which extends until 2012. A fourth possibility, not mentioned by Citrin but explicitly advocated by Indonesia Bangkit members, is, in effect, to exit the standby ‘cold-turkey’; that is, upon the expiry of the existing program at the end of 2003, Indonesia would decline even the option of structured but non-binding policy dialogue, and would pay off all remaining loan obligations immediately rather than spreading repayments over the current schedule.

The key dimensions along which the tradeoffs have to be decided are financing and conditionality. In financial terms, Indonesia can seek low cost IMF loans and Paris Club rescheduling (the latter is worth $3 billion in 2003), or it can seek to finance itself through a combination of substantially stepped up tax collection and special bilateral approaches to key creditor countries and development banks for increased support. In terms of conditionality, Indonesia can seek the discipline imposed by nominally binding LOI reform commitments (which, arguably, helps both to move reforms forward faster than would otherwise be possible and to boost market confidence about a country’s overall policy trajectory). Alternatively, it can seek to make its own sovereign policy choices, knowing that it must do so within the context of the wider discipline of market judgments.

There has already been much excited discussion about the IMF in the parliament and the media more broadly. Within the executive branch, an interagency team including the economics coordinating minister, the finance minister and the central bank governor is preparing advice for the president. There are serious questions to be addressed about the likely size of the financing gap that would be created by forgoing access to IMF and Paris Club assistance, about the actual potential for substantially increased tax collection and about the real value of IMF conditionality. Almost certainly, there will be
a significant cost to Indonesia in exiting. But the decision will in the end be based on calculations made by political leaders—that is, the president and other party leaders in the parliament—about likely macroeconomic conditions next year. Of special importance is the extent to which a strong anti-IMF stance will be rewarded by voters in both parliamentary and presidential elections.

At the time of writing, the prevailing mood among professional economists and market commentators in Jakarta seems to be one of acceptance that the most likely outcome is the third or perhaps the fourth of the scenarios described above. The driving consideration is a belief that it is politically (i.e. electorally) necessary for Indonesia to shake off IMF conditionality, and that current macroeconomic circumstances are sufficiently propitious to make this possible, albeit at some considerable short-term cost. Of the two, our expectation is that the third option is the most probable—as the fourth entails added cost and risk, with little clear advantage.

BIES readers who have not themselves recently been in Indonesia might be surprised by the sense of acceptance and even calm with which this is viewed. A few commentators argue for caution and continuity. But barring a major deterioration in economic circumstances this year, most believe it is almost a foregone conclusion that Indonesia will exit standby status.

All of this suggests that, should Indonesia relinquish its standby arrangement with the IMF, there is unlikely to be a dramatic market reaction. Further, if indeed this is the decision, one positive consequence is that it would end the charade of leaders using the IMF as a political scapegoat for tough economic decisions. An unfortunate by-product of the very close relationship with the IMF since the financial crisis is that politicians have been able to pretend that unpopular decisions were forced on Indonesia by the IMF. The country’s long-term economic health and maturation would be aided by politicians (and commentators) of all persuasions being forced to accept ownership of their policy preferences publicly.

INVESTMENT CLIMATE
The investment climate remains worryingly uncertain, and is clearly the area of greatest immediate concern in any overall assessment of the economy. There is general agreement on the primary domestic problems that continue to discourage investors: ongoing uncertainty about the implications of a systemically weak legal system, an inhospitable labour environment, and deep confusion about who holds authority over what—particularly outside Jakarta—as a result of the unfinished process of devolving power to regional governments. The net effect of these changes is uncertainty, higher costs and a welter of cross-cutting demands for bribes.

This translates into not just a very small flow of inbound investment, but also a significant outflow. For example, in March the Textile Producers Association reported that a large number of foreign firms had discontinued operations in West Java (Asia Times, 7/3/03). More recently, Proctor and Gamble joined several major multinationals that have abandoned Indonesia altogether (JP, 16/5/03). This continuing pattern of multinationals choosing to base their operations elsewhere is of major concern.

Monthly levels of both foreign and domestic approved investment in late 2002 and early 2003 were still far below average pre-crisis levels (figure 4). The level of actual investment was undoubtedly much lower still, since even those who are willing to invest are often forced
to postpone or cancel their plans for the reasons suggested above. The gap between the true and the approved levels will remain high for some time. The Tangguh LNG project in Papua is an example of a major approved investment that may not be realised. The main difficulty is finding buyers for its product, given a possibly unreliable delivery schedule from the remote Tangguh area, where security is a major problem (McBeth 2003).

Furthermore, much realised investment was probably directed to replacement of old equipment rather than to expanding operations, and thus did not generate increased output in the real economy. Lack of investment has begun to result in some sectors, particularly oil and gas, experiencing a decline in output (Business News, 25/4/03).

Overall, FDI flows in the balance of payments remain negative, reflecting the continuing perception of foreign capital that investment projects in Indonesia have a high risk of failure.

It is interesting to observe the influence of the domestic financial sector and the capital market on the level of investment in the country. Improved macroeconomic performance has reduced economic volatility and raised expectations of increased funds flowing into the financial sector, particularly from abroad. The level of deposits in domestic banks rose during the first quarter of 2003, but most deposits are still short term. Credit extension has therefore been concentrated mainly in consumer loans, where the probability of default is low and consumers are required to provide almost full collateral. Consumer credit rose about 37% in the year to December 2002, while working capital loans, mainly to small and medium enterprises, increased by 12%. Investment capital loans rose by 21% on a year-on-year basis in the same period. But most

FIGURE 4 Domestic and International Approved Investment
($ million)

Source: CEIC Asia Database.
of these were used to buy back assets under IBRA, and hence they did not contribute directly to business expansion (World Bank 2003b).

In the capital market, the stock index increased in early 2003, but the number and value of stock transactions did not rise, and the number of new initial public offerings (IPOs) was particularly limited. This suggests that the stock market is not yet contributing to expansion of the real economy.

In the bond market, on the other hand, the value and number of bonds, although low, increased throughout 2002 and 2003. Low bank interest rates have made bonds, with interest rates of around 15%, more attractive. However, one financial sector commentator suggested that companies issuing bonds have typically used this income to re-finance their debts rather than to undertake business expansion.

In sum, the financial and capital market sectors were recovering in late 2002 and early 2003, but were not yet able to attract sufficient investment to stimulate expansion in the real economy. How soon the investment climate will recover remains the big question for Indonesian economic development in the years to come. The launch by the president in late February of ‘Indonesian Investment Year 2003’ suggests that there is awareness of the problem at the highest levels of government. However, cosmetic changes such as a revised investment law urged by the president are hardly likely to make a significant difference. While fundamental changes to the political structure have helped (see below), other developments continue to undermine investor confidence. We look at the new labour law, at the tragic case of the Tanah Abang market fire, at the Lippo Bank asset management scandal and at the special case of protection in the sugar industry, as examples of the continuing administrative and political struggle to improve conditions for competitive investment in Indonesia.

The New Labour Law
A new labour protection law (Undang-Undang No. 13/2003) was finally passed on 25 February. Although less unfriendly to business than the previous regulatory framework, on key dimensions the new law still looks un-competitive compared to practices elsewhere in the region. It is an improved compromise on a vexatious issue, but will provide only a marginal fillip to investor confidence. The Manpower Law replaces some 13 older pieces of legislation, most notably Manpower Law No. 25/1997 (enacted under Soeharto) and Ministerial Decree No. 150/2000 (issued by Minister of Manpower Bomer Pasaribu during the Abdurrahman Wahid administration) (CSIS 2002, 2003). The 1997 statute had been the subject of bitter hostility from labour unions, while that of 2000 was a source of intense opposition from employer groups.

The new law was intended to strike a balance between the need to redress the long years of political repression for labour, and the mounting concerns among investors that Indonesia was no longer competitive for labour-intensive manufacturing. It has been accepted as a compromise by both the Indonesian Employers Association (Apindo) and major labour unions such as the All Indonesia Workers Union (Serikat Pekerja Seluruh Indonesia, SPSI), Reform SPSI and the Indonesia Prosperity Trade Union (Serikat Buruh Sejahtera Indonesia, SBSI). Significant concerns do, however, remain on both sides.

The new law includes the following key elements.

- It accepts the generous rates of severance and long service pay set out in
Ministerial Decree 150/2000 (Dick 2001: 29), with minor concessions to employers, such as maximum severance pay of 9 rather than 12 times a worker’s monthly salary. However, employers are not (any longer) required to provide severance pay to workers who resign voluntarily (including to take higher-paid employment elsewhere) or who are dismissed for committing crimes.

- The law retains a 40-hour working week at normal rates of pay (China and Vietnam both have 48-hour weeks.)
- The right to be paid while striking remains, provided the strike occurs at the place of employment and both the employer and the authorities are given advance notification. If striking workers violate specified procedures, the strike is illegal and without pay, and workers are liable to temporary lockout.
- The law places stricter limits on the use of temporary labour or outsourcing of core activities to contract labour.
- Minimum wages are set by provincial governors (not district heads), based on a ‘fitting’ standard of living.

In broad terms, the new law can be seen as winding back some of the gains that unions won under the statute of 2000. But from the viewpoint of employers, the previous framework was so severely pro-labour that employment conditions were costly and rigid compared even to those in countries such as Thailand—to say nothing of China or Vietnam. The revised framework is still viewed as one of the most anti-business in the region. The firms most sensitive to these problems have been the large labour-intensive manufacturers in the export sector, notably the footwear, garment and furniture manufacturers of Jakarta, Bandung and Surabaya. In addition to feeling pressured by labour unions, such firms have also been squeezed by the Ministry of Manpower aggressively extracting rents from firms by way of numerous regulatory requirements. (The scope for this is considerable, with the new law running to 18 chapters, 193 articles and close to 500 clauses, and extending over some 70 pages.)

On the labour side, while the larger unions declared themselves satisfied with the new law, dozens of smaller ones aligned to the NGOs and political reform agendas bitterly denounced it. These groups objected to the concessions it made, and also to the fact that they themselves were not viewed as serious enough players to be party to the tripartite consultations, as their larger and establishment brethren had been.

The substantive importance of the revised labour law aside, the process of legislative change on this issue is revealing. This has been an intensely controversial subject, with employer, labour and bureaucratic interests keenly contested over many months. But it was the parliament that ultimately had to decide the matter. A well placed source was able to confirm what one might expect given the new importance of the DPR: in order both to accelerate what had been a stalled process and to get an outcome closer to their own liking, business interests including Kadin (the peak business body, to which Apindo belongs) had to direct significant financial support to relevant legislators.

**Fire in Tanah Abang**

The investment climate depends partly on maintaining, as well as investing in, scarce physical and social infrastructure. It is difficult to restore confidence when natural (or man-made) disasters destroy public facilities on a regular basis. The most recent example was a fire which
destroyed the Tanah Abang market in Jakarta, an event that brought in its train an unpleasant transgression of press freedoms.

On 19 February 2003, the country’s largest wholesale textile market in Tanah Abang caught fire. Trading was reduced significantly for some time, with predicted losses of billions of rupiah, the market’s annual transaction value being approximately Rp 15 trillion (Bisnis Indonesia, 20/2/03).

Reported estimates of the fire’s impact on the economy included major job losses (Kompas, 22/2/03); significant distribution breakdowns in the textile industry, with many factories in Java unable to find other market destinations (Bisnis Indonesia, 22/2/03); a rise in non-performing loans; a decline of Rp 3 trillion in government tax revenue (Business News, 28/2/03); and a decline of Rp 33 billion in local government revenues from the city-owned market operator, PD Pasar Jaya (JP, 21/2/03). The likely economic consequences of the fire were thus substantial, even if they were not immediately discernible in national economic performance.

Probably as important was the subsequent conflict between Tomy Winata, owner of the Artha Graha conglomerate, and Tempo magazine over the Tanah Abang incident. A few days after the fire, Tempo published an article suggesting that Tomy’s people may have lit it deliberately, Tomy having previously submitted to the Jakarta regional government a proposal for total renovation of the Tanah Abang market (Tempo, 3/3/03). Tomy filed a defamation suit against the magazine, and his bodyguards attacked the Tempo office, dragged the editor before the local police chief, and tried to force him to declare his sources and retract the allegation.9

The Lippo Scandal
In late 2002 and early 2003, a scandal erupted over the actions of Lippo Bank, one of the first private banks to be recapitalised by IBRA in 1999 (Cameron 1999: 22), and now awaiting sale by IBRA (Waslin 2003: 20). The scandal involved a series of steps by which the bank’s management allegedly sought to mislead the public in such a way as to allow the former owner, the Lippo Group, to buy back a majority stake in the bank at a bargain price.

In late 2002, Lippo issued two different third quarter financial reports. The first gave the bank’s total assets as approximately Rp 24 trillion and its net profit as around Rp 98 billion; the second stated that total assets had fallen to only Rp 22.8 trillion and that the bank had posted a net loss of approximately Rp 1.3 trillion. The Lippo Bank management was accused by several observers of accounting manipulation.10

Despite this public allegation, the management and board of commissioners of Lippo Bank used the second financial report to conclude that the bank’s CAR was only 4.2%, and that a number of steps were needed to improve this ratio: (1) to conduct a reverse stock measure of 1 for 10, i.e. to reduce the number of shares by 1/10, so that 10 old shares (worth Rp 70 each) would become one new share with 10 times that value; (2) to inject more capital into the company by selling its takeover assets (the collateral taken over by the bank in bad loan cases); and (3) to conduct a rights issue (issuing additional shares and giving priority to existing shareholders at preferential prices).

The second aspect of the Lippo case was that the sale of the bank’s takeover assets was not transparent. There were strong suggestions among financial analysts that Lippo Bank sold the assets only
to companies within the Lippo Group. The third aspect was that the reverse stock measure and the existence of multiple buying and selling transactions at very low prices reduced market confidence in the stock and knocked down the price of Lippo Bank shares from around Rp 700 to Rp 300 per share.11 These events occurred in late 2002 and early 2003.

The last, and crucial, part of the action would see Lippo Bank’s former owners, the Lippo Group, in a position to buy all the new shares from the rights issue process at only Rp 300 per share, and become the majority holder of Lippo Bank stock. But before the bank had carried out the rights issue, a number of financial and capital market analysts and journalists wrote articles alleging systematic actions by the management of Lippo Bank to ensure that the Lippo Group would be able to become the bank’s majority shareholder for a relatively low price (see, for example, Wei 2003a, 2003b; Aipassa 2003; Trianto 2003). As a result the government, through IBRA, declined to approve the rights issue and changed the membership of Lippo Bank’s management and board of commissioners. Bapepam (Badan Pelaksana Pasar Modal, the Capital Market Supervisory Agency), along with Bank Indonesia, imposed on Lippo Bank’s management a fine for misleading reporting of Rp 2.5 billion (around $300,000), a penalty widely regarded as very mild.

The Lippo Bank scandal suggests that Indonesia is still far from achieving transparency and accountability in business, and from developing an institutional framework strong enough to prosecute powerful conglomerates that flout the law. All of these problems represent barriers to improvement in the investment climate.

Trade Barriers: The Case of Sugar
As mentioned in previous surveys (Athukorala 2002; Alisjahbana and Manning 2002), the pressure for increasing trade barriers in agriculture has intensified in the past few years, as producer interests have regrouped in the post-crisis period. When former finance minister Bambang Sudibyo called recently for Indonesia to become more inward looking, he proposed two strategies, one of which was increased protection in the agricultural sector (Kompas, 9/4/03).12 There were also reports that the Minister of Industry and Trade, Rini Suwandi, planned to issue a decree requiring all contractors on government projects to use locally made products (JP, 5/4/03).

The most recent problem to emerge in relation to protection concerns the sugar industry. At the beginning of April 2003, despite a recent fall in the world price of sugar, the domestic price suddenly rose from approximately Rp 3,800 to more than Rp 5,000 per kilogram. In several regions, the price reached Rp 10,000 per kilo, and it became very difficult to buy sugar in many areas. The main reason for the high price was clearly a supply shortage. The logistics agency Bulog (Badan Urusan Logistik) reacted by distributing 60,000 tonnes of sugar into the market, but the price of sugar remained close to Rp 5,000 per kilogram (Tempo, 27/4/03, 11/5/03).

The value of the tariff on sugar imports is approximately 30% for raw sugar and 35% for refined sugar, but the problem is not merely the tariff, which was introduced in 1999 and then modified in 2002.13 The Department of Industry had granted only five permits to import sugar—to Bulog and to four state enterprises. The latter argued in early April that they had encountered administrative problems with the Directorate
General for Customs and Excise which had prevented them from distributing imported sugar in the market. Customs and Excise claimed that the four importers had not fulfilled the administrative requirements. With so few importers in the sugar market there is a strong incentive for them to behave as an oligopoly and seek high profits at the expense of consumers. Hence, the suspicion arose that the importers and the Directorate General for Customs and Excise had disagreed over the division of this oligopolistic profit, leaving a significant quantity of imported sugar held up in the ports.

A proposal to reduce sugar import barriers by giving import permits to more companies did not receive wide support, and was strongly rejected by the association of sugar producers. Since the Minister for Agriculture, Bungaran Saragih, and the Minister for Industry, Rini Suwandi, do not appear keen to abolish entry barriers to sugar and controls over the distribution of imports, it is unlikely that protection of Indonesia’s sugar market will be reduced in the near future. Given that consumers are still having to bear the burden of the high cost of sugar, it would seem important that NGOs such as the Indonesian Consumers Organisation (Yayasan Lembaga Konsumen Indonesia, YLKI) become more active in this area. Meanwhile, Indonesia will have difficulty creating a favourable investment climate while it continues to exhibit the protectionist tendencies illustrated by this recent problem in the sugar industry.

THE NEW POLITICS OF ECONOMIC POLICY

It is widely understood that the confusion and uncertainty generated by the political changes of the past half decade, together with the systemic weaknesses of the legal system, are core factors contributing to the low level of investor confidence in Indonesia. Less well understood is the significant progress that has been made in sorting out a viable set of rules for structuring government at the national level. Although by no means a panacea for all of Indonesia’s problems, this is another substantial step in a positive direction. Furthermore, with the big building blocks of this restructuring of national level political life largely in place, we are now in a position to reflect on the significance of the new political system for economic policy.

The most fundamental changes came in the initial wave of reforms in the two years following Soeharto’s departure, which saw the freeing up of the political parties—and thus the legislature—and the decision to devolve significant powers to local government. This led to a dramatic decentralisation of power after the tight centralism of the Soeharto years. Power shifted sharply from the presidency to the legislature, with the president being beholden to the parties not just for cooperation in law making, but for his very survival.

Fortunately the reform process did not stop there, since this was a recipe for political chaos (of which we got some hint during Abdurrahman Wahid’s tenure). Subsequently the power balance swung back a little, initially on the basis of a type of honeymoon effect for Megawati under which the other parties could not contemplate removing her. Her position was then formally consolidated through constitutional reform which effectively gave her security of tenure and made her answerable only to the electorate. With the parties no longer able to remove the president, the office again becomes a force to be reckoned with. The occupants of the presidency are now in a position to exert at least some authority over cabinet, and better exercise le-
verage in bargaining with the DPR over legislation.

With the second wave of political reforms being bedded down under Megawati, her term provides something of a window onto the future. At the national level, while the personalities and relative support for individual parties may move around, the fundamental contours of the political landscape are unlikely to change dramatically over the next five years. This is because there is general acceptance (including by the military) that Indonesia is to be governed constitutionally for the foreseeable future; it is also because there is no sign of any shift in underlying social cleavages such as might cause a realignment of the party system.

In practical terms, this means we are looking at a world in which authority is no longer as fragmented and confused as it was in the latter part of the Habibie period and under Abdurrahman Wahid. Where it had once been extremely difficult to see scope for significant economic policy reform, the potential is now greater.

The political obstacles have been somewhat reduced, but the process is still not easy. The days of quick and decisive action on major policy reforms—which the Soeharto regime was sometimes capable of—are now a distant memory. The reality of policy making today is very much slower and messier. No significant reform can take place unless both the executive branch and a majority of the DPR agree. With multiple parties, this process is inevitably slow, and quite susceptible to derailment by vested interests that succeed in inducing key legislators to oppose a proposed reform.

Many observers view this emergent pattern of policy making with despair. In late May the pages of the Indonesian press were filled with commentaries marking the fifth anniversary of Soeharto’s fall, many of them focusing on continuing corruption, and on public disillusionment that reformasi has not delivered more. This is little wonder, given the steady stream of reports of politicians receiving money not just from commercial interests pushing a preferred position, but even from ministers seeking to have their departmental budgets approved expeditiously (uang lelah).

But it is important to keep these problems in some perspective. In the spectrum of developing country democracies, the emerging political architecture in Indonesia is markedly less bad than it might have been. As a result of the second and third wave of political reforms, the party system will probably be further consolidated. It is thus much less likely to undergo the sort of acute political fragmentation and legislative stalemates it experienced in the 1950s, or that Thailand, for example, suffered during the mid 1990s. And while there can be no denying the apparent appetite for cash among Indonesia’s politicians, the recent electoral and party reforms mean that Indonesia is unlikely to develop the acutely atomistic party practices evident in a country such as the Philippines.

While there are concerns about weak ties between representatives and voters, the net effect of the new rules is likely to make Indonesian parties more coherent. This can be helpful in facilitating legislative bargains (since parties mostly vote as a bloc rather than atomistically). It also means that there is much more scope for politicians to compete on the basis of their party’s brand-name, rather than on the basis of their own individual capacity to pass out special favours (including cash) at election time. Although relative, these gradations are not trivial.
At the national level we can expect some easing of the uncertainty that has bedevilled the investment climate. This will not be a dramatic swing from confusion to clarity. But at least some of the uncertainty will be removed as the new political system settles in, and as investors come to understand better where the veto points are and how the system functions in steady state. This is good news. And yet, overall, it is very difficult to be sanguine about the net economic effects of the emerging political equilibrium. Yes, it is definitely better than the situation a couple of years ago: progress with economic reform is at least now possible. But reform is likely to be slow. This means that we are unlikely to see a return to high growth.

There is a rough consensus on many of the policy ingredients that would be needed to re-ignite rapid economic growth: continued macroeconomic stability, accelerated reform of the financial sector and specific measures to improve the investment climate, especially in the labour-intensive export sector. The problem, of course, is forging agreement within and between the executive and legislative branches of government on enacting such reforms. While there are certainly grounds for optimism that some of this agenda is now more readily achievable, any such progress is likely to be slow and haphazard.

It is also likely to be accompanied by significant reversals on other fronts, such as the emergence of a countervailing trend towards quietly creeping protectionism. In principle, one might expect there to be equal difficulty involved in introducing both market-opening and market-restricting policy changes. But, in practice, the latter is likely to prove politically easier than the former, since support is almost always more forthcoming for measures with concentrated benefits than for those with diffuse benefits.

The obstacles to achieving a strongly pro-growth policy mix are reinforced by the fact that this is not something Indonesian voters are yet focusing on. The primary divisions around which the political parties are mobilised are socio-religious (Islamic versus secular, with geographic subdivisions). It is only a few very small parties that have economic issues at the core of their platforms (e.g. Sjahrir’s New Indonesia Party and the People’s Democratic Party).

The economic implications of the new political framework point towards a pattern of continued modest growth: of Indonesia continuing to make progress, but only slowly. Here again perspective is important, for this is probably best understood as a necessary stage along the way. There is no guarantee that Indonesia will continue in this direction and gradually sort out the institutional challenges associated with devolving power to the regions or, even further down the road, with bringing about systemic legal reform. But this is a necessary first step; without viable national government, nothing much at all is possible. So, while we recognise the limitations of the status quo, the significance of the progress thus far is that it is an essential foundation for stronger confidence in Indonesia, both domestically and abroad.

In a sense, we seem to be looking at something of a reversal of the developmental trajectory of the Soeharto years: instead of strong economic progress and political stagnation, the mix for the medium term is more one of progress in making democratic politics more workable, but limited economic lift. Over the short term this is not a problem. But increasingly the social costs of attaining only moderate economic growth are going to mount. Over the longer term,
the hope must be that further progress with institutional reform will lay the basis for increased investor confidence and stronger economic growth.

10 June 2003

NOTES
1 Japan is expected to grow at a rate of 0.6% (World Bank 2003a: 1).
2 For discussion of the new law see Ginting (2003); ‘Bill Passed to Help Curb Graft’, JP, 7/3/03; and ‘Milestone in Accountability’, JP, 10/3/03.
3 Ketetapan No. IV, MPR 2002.
4 Authors’ interview with Dr Rizal Ramli; see also formal statements such as Ramli (2002).
5 Some mainstream economic commentators in fact welcome this possibility (see, for example, Morgan Stanley Economists 2003).
6 However, total severance and long service payments remain much higher than those in most other Asian countries (e.g. twice those in Thailand for a worker employed 10 years or more and dismissed for economic cause).
7 According to previous drafts of the law, workers had to be paid while on strike, regardless of the time or location.
8 See, for example, ‘Labor Law to Woo Investment’, JP, 26/2/03; ‘New Labor Law’, JP, 26/2/03; ‘Employers Hail New Labor Bill, Unions Divided’, JP, 25/2/03.
9 Interestingly, the police chief did nothing to stop this harassment, nor did he interrogate Tomy about the case, let alone arrest him. The fact that Tomy was not called to account for this attack on Tempo sends a signal to the international community that law and order remains a problem in Indonesia.
10 The main critic was financial journalist Lin Che Wei (Wei 2003a, 2003b), who himself was threatened with a libel case by Rudi T. Bachrie, a member of Lippo Bank’s board of commissioners.
11 Prices shown are those prevailing after the reverse stock measure.
12 The other strategy he suggested was to increase the salaries of civil servants and labour.
13 After removal of all tariffs on sugar during hyperinflation in 1998, a 20% tariff on raw sugar and a 25% tariff on processed sugar were introduced in 1999. These were then modified to a flat rate duty in 2002, in an attempt to address the problem of under-invoicing of import prices.

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