Executive Summary
The Macroeconomics of Poverty Reduction in Indonesia
An Independent Study Supported by the United Nations Development Programme

The Build-up to Crisis

From 1970 to 1996, the eve of the Asia financial crisis, Indonesia grew by about seven per cent a year and reduced poverty incidence from over 70 per cent to about one third of the population. The character of its growth was a big factor in its success in reducing poverty. The Government channelled considerable resources into agriculture and rural development and helped build up labour-intensive export-oriented industries that generated widespread employment.

When the financial crisis buffeted Indonesia in 1997, few analysts expected the country to be shaken to its roots. But the exchange rate plummeted as a result of a speculative attack, inflation soared and the banking sector collapsed. The financial de-regulation of the late 1980s and early 1990s was the chief reason for the economy's vulnerability. Left unregulated, private corporations had gone on a borrowing spree, accumulating a mountain of short-term external debt. Rich Indonesians quickly funnelled billions of dollars worth of capital out of the country, and reaped a handsome profit from the ensuing devaluation of the rupiah.

The contractionary fiscal and monetary policies that the Government implemented—due largely to external advice—only exacerbated the recession. As the economy began to go into a free fall, the Government stepped in to bail out the large banks and their elite corporate clients. A huge domestic debt piled up along with a large external debt and the Government had to assume the chief responsibility for paying them off.

During the crisis, poverty shot up by 50 per cent. The incomes of the near poor, i.e., those only moderately above the poverty line, slumped badly and vulnerability spread to about half of the population. As inflation shot up, real wages nose-dived by 40 per cent and a large share of

the workforce was pushed into low-paid under-employment in agriculture and the urban informal sector.

Meanwhile, the rich were big beneficiaries of colossal liquidity credits and hefty interest payments on recap bonds injected into their banks to keep them afloat. The Government 'nationalized', in effect, their debt and paid them for the privilege. The rich also benefited from capital flight and have been reluctant to return their money until "investor confidence" is restored—namely, the speculative rate of return on their money is much higher and their continued control over large corporate assets is assured.

When their banks or corporations end up on the selling block, they are the same circle of people who buy them back at fire sale prices. And the capitalization of the Government obligation to continue paying them interest when it sells off a bank usually exceeds the proceeds that the Government receives from the sale.

Slow Post-Crisis Recovery

Since 2000, Indonesia has been on the road to recovery, albeit at a slow pace. Its average annual rate of growth of GDP during 2000-2002 has been less than four per cent—a little over half its rate of growth during 1991-1996. In 2002, GDP growth was 3.7 per cent—a rate that could provide jobs to only about half of the new entrants into the labour force. As a result, unemployment continues to rise, as does the number of informal-sector jobs.

The recovery remains fragile since the main impetus for growth has been consumption. A troubling sign is that in 2003 consumption growth began to slow. At the same time, other components of aggregate demand do not provide an alternative source of growth. In 2002, gross domestic fixed capital formation declined by 0.2 per cent and shows no signs of recovering in

2003. Net exports contributed more to growth in 2002 than in 2001 but only because imports contracted by over eight per cent. Exports themselves declined by 1.2 per cent.

Growth of GDP and Its Components (2000-2002)

Item	2000	2001	2002
GDP	**4.9**	**3.4**	**3.7**
Consumption	**3.9**	**4.8**	**5.5**
Investment	**13.8**	**7.7**	**-0.2**
Exports	**26.5**	**1.9**	**-1.2**
Imports	**21.1**	**8.1**	**-8.3**

Growth of household consumption is propping up GDP growth. In 2002, this component grew by 4.7 per cent, accounting for about 90 per cent of GDP growth. Government consumption grew much faster than private consumption, especially in the wake of the Bali bombing, but made a much smaller contribution to overall growth. Recognizing the fragility of the recovery, the Government has provided another fiscal stimulus in 2003, mainly in the form of tax cuts. Yet, current projections suggest that economic growth will reach only 3.4 per cent in 2003, far too slow to boost employment or significantly reduce poverty.

According to World Bank estimates, the proportion of the population in poverty dropped from a high of 27 per cent in 1999, in the wake of the crisis, back down to 16 per cent in 2002—about the same level as that for 1996.Yet, estimates based on annual, but more limited, surveys suggest that poverty rose from 2001 to 2002, i.e., from 13.2 per cent to 14.5 per cent. Rising

inequality was part of the explanation. With growth slowing in 2003, poverty is likely to rise further, as unemployment and underemployment spread.

Every year, Indonesia suffers an employment deficit. Workers openly unemployed rose from 8.1 million in 2001 to 9.1 million in 2002. Underemployment has also been on the rise. Workers employed in the informal sector continued to rise in 2002, reaching 62.4 million compared to 53.7 million in 1997. Relative to the formal sector, the informal sector has been progressively increasing, accounting for 68.1 per cent of all jobs in 2002 compared to 62.8 per cent in 1997.

By some standard measures, the Government has made significant progress in the last few years in achieving macroeconomic stability. The public deficit has been reduced, the current account has achieved a surplus, international reserves are rising, the external debt to GDP ratio has come down, real rates of interest have declined, the exchange rate has strengthened and inflation continues to drop.

In 2002, CPI inflation was 10 per cent, down from 12.5 per cent in 2001. Despite a rise in government-administered prices and a reduction in fuel subsidies, annual inflation continued to subside in 2003, converging towards an average of six per cent late in the year. However, this is not necessarily a positive sign because of the slowdown in aggregate demand.

Private investment remains weak. In fact, in the first eight months of 2003, domestic investment approvals dropped by about 14 per cent. Although monetary policy has been geared in recent years to lower interest rates, lending rates of interest have remained stubbornly high. While deposit rates of interest have declined, contributing to the growth of consumption, banks have been reluctant to extend investment credits to the private sector. They are more inclined to

lend for consumer durables, such as automobiles and motorcycles, or for working capital for businesses.

As a result, corporations remain starved of long-term credit for productive investment. The reason is not a lack of domestic savings. During 2001-2002, gross domestic savings was 23 per cent of GDP while gross domestic investment was only about 16 per cent.

Gross Domestic Investment and Savings (as a Percentage of GDP)

	1995-1997	1998-2000	2001-2002
Gross Domestic Investment	**31.5**	**15.6**	**15.9**
Gross Domestic Savings	**30.7**	**24.1**	**23.0**

Public investment is constrained by the effort to reduce budget deficits. Capital expenditures by the Government, both central and local, plummeted from 6.5 per cent of GDP in 1997 to 4.8 per cent in 2002—a drop of over one quarter. The transfer of one quarter of central government revenue to local government has contributed, unfortunately, to this overall decline. An additional factor has been the Government's policy stance of increasing fiscal restraint.

The Government is concerned that its deficit will exceed two per cent of GDP in 2003. Its goal for 2004 is to reduce the deficit to close to one per cent of GDP and eliminate it by 2005. However, given the slowdown in private consumption, more fiscal stimulus, not less, is badly needed. In 2003, the Government has resorted to tax breaks for private businesses as a way of stimulating the economy, but this kind of stimulus is likely to be weak—generating certainly a much weaker multiplier impact on the economy than an increase in public investment.

Public Capital Expenditures

(as a Percentage of GDP)

1997	6.5%
2002	4.8%

Fortunately, the Government has begun to revive in 2003 some of the large investment projects that it abandoned during the Asia Financial Crisis. These include a large power plant, toll roads and a flood control project. Indonesia badly needs renewed investment in public infrastructure, particularly in energy and roads. Lack of maintenance of existing infrastructure is also a growing problem. Focusing public investment more on low-income households could also improve its effectiveness.

The country's recent history suggests that public investment has "crowded-in" private investment, not "crowded it out". Over the years 1972-1997, for example, a one percentage point increase in government investment translated into a 0.66 percentage point increase in private investment. Given the current slack conditions in the economy, with significant under-utilized capacity, the "crowding-in" effect is likely to be stronger.

The Government has begun to issue bonds to finance an increase in public investment. This makes sense as long as current revenues cover current expenditures. Fortunately, this has remained the case. It also makes sense as long as gross domestic savings exceeds gross domestic investment, which has been the case since 1998. Failure to boost public investment will pose, however, a major roadblock to implementing a pro-poor development strategy, which depends on substantial investments in physical and human capital, particularly for the poorer half of the Indonesian population.

Generating Resources for Investment-led, Pro-Poor Growth

This report advocates an investment-led growth strategy that relies initially on increasing public investment in order to raise the Indonesian economy to a higher growth path that can provide adequate employment and substantially reduce poverty. The report assumes that the acceleration of growth prompted by public investment will not only serve to crowd in private investment but also begin to attract back external financing and flight capital. The rise in income will also serve to increase domestic savings, which will continue to be the main source for financing of increased private investment.

A key issue, however, is how to finance a rise in public investment. This report estimates that raising the growth rate from 4 per cent to 6 per cent would require an additional US$ 5 billion of public investment per year. Securing debt relief is a major way of financing the additional public investment. Monetizing the deficit is another option although it would run the risk of increasing inflation. Even without these two options, however, the Government of Indonesia could raise revenue to finance public investment.

Tax revenues in Indonesia have declined substantially over two decades, namely, from a level of 20 per cent of GDP in 1980 to 13 per cent in 2002. The income tax base is very small and tax evasion is widespread. Property taxes contribute a mere 3.4 per cent of all tax revenue: the rate is a mere 0.5 per cent of the assessable poverty value, which, in turn, is only one fifth of the market value. Trade tax revenues are also small, comprising three per cent of all revenue. The value added tax contributes about 30 per cent of all revenue but avoidance of this tax is prevalent and many luxury goods are exempt.

Tax Revenue
(as a Percentage of GDP)

1980	**20%**
2002	**13%**

This report advocates a number of measures to boost tax revenue back up to levels that Indonesia earlier achieved. The most controversial measure is to raise tariffs. Raising tariffs on all imports by ten per cent would, by itself, raise the additional US$ 5 billion needed to finance public investment. However, the report does not advocate such an option. Other measures that could be employed include reducing or removing exemptions granted to importers and exporters, raising the property tax, reducing VAT exemptions on luxury goods, as well as improving administration to more accurately identify the income of taxpayers, collect taxes more effectively and reduce corruption. Currently, for example, there are only 1.3 million registered taxpayers.

The Government should seek to reverse the current decline in income taxes from sources other than oil and gas. From 1998 to 2001, revenue from such sources dropped from 47 per cent of the total to 38 per cent.

The Large Taxpayers Office, started in mid 2002, could make a major contribution to revenue mobilization. It targets the 200 largest taxpayers in the country, who account for 40 per cent of all tax revenues. If this office is successful in having the rich pay their fair share of taxes, this effort could substantially boost public revenues.

Raising taxes on domestic income will not nullify the expansionary impact of an increase in public investment because the latter, as an autonomous factor, will have a powerful multiplier impact on the economy. However, this effect is likely to be eroded unless the process of decentralization is reformed. Development spending at the local level has not compensated for the loss of capital expenditures by the central government. Moreover, local objectives are not aligned with national development priorities.

Regional inequities are being exacerbated since resource-rich provinces are benefiting most from decentralization. Poorer provinces do not necessarily benefit since many local governments have imposed additional taxes and fees that impede the development of small and medium enterprises and restrict inter-regional trade.

Dealing with the External Debt

Policymakers in Indonesia have made great strides in recent years in reducing the external debt burden. The external debt, as a ratio to GDP, had dropped to below 70 per cent by mid 2003. However, Indonesia has paid a heavy price in terms of withholding financing necessary for accelerated economic growth. Substantially more debt relief could

mitigate the need for Indonesia to raise more domestic revenue in order to increase investment and accelerate pro-poor growth.

Currently, Indonesia has committed itself, in effect, to slowing growing out its debt burden. Meanwhile, unemployment and underemployment increase every year, and with such an increase, the income basis for consumption growth slows down. Without consumption fuelling a recovery, GDP growth is likely to slow down further.

Judging Indonesia's external debt by international standards, the country has been transformed into a seriously indebted low-income country (SILIC) as a result of its crisis in 1998-99. Recently, the Government has been paying 4.3 per cent of GDP to service the external debt. About half of the external debt is private. A major problem is that much of it is short term and non-guaranteed debt. While the Government had restricted external borrowing by banks, it had not placed similar restrictions on non-financial corporations.

As a result of the crisis, all capital accounts—net FDI and other capital flows, including official loans—turned negative. Part of the reason is that rich Indonesians resorted to capital flight on a massive scale. Estimates of such flight capital range from US$ 20 billion to US$ 40 billion. The outflow of foreign direct investment alone ballooned to 3.2 per cent of GNP in 2000. Total net outflows of capital in 2001 were 6.7 per cent of GNP. This adds another layer of problems on top of the debt burden itself.

The private capital that has flowed back into the economy has been used mainly to buy up cheap privatised corporations and banks. Because of the appreciated exchange rate, some short-term capital has also recently returned but if the economy continues to struggle, this capital could rapidly flee again, contributing to undermining the basis for sustained recovery.

How can the Government of Indonesia deal with its huge debt problem? With regard to its public external debt, which is about half of its total external debt, it should lobby strenuously for more favourable terms for debt reduction and rescheduling. This would imply lobbying for Naples terms, which provide a two-thirds reduction of the debt stock and a much longer period for interest payments.

Indonesia has made little progress in rescheduling its private commercial foreign debt. At the end of 2001, this amounted to US$ 7.5 billion owed by banks and US$ 55 billion owed by corporations. Three fifths of the corporate debt—most of which is owed by subsidiaries of foreign multinational firms—is not being repaid.

One option that Indonesia could pursue is to sue for international insolvency—in the same way that a company in a country can sue for bankruptcy under Chapter 11. International debt relief organizations, such as Jubilee Plus or Jubilee 2000, support such a mechanism, as do some IMF representatives. However, there is a powerful international lobby of creditors that has opposed any such solution. Indonesian policymakers have also been reluctant to pursue this option because they believe that it would undermine the confidence of foreign investors in the economy. But as long as the Indonesia economy is not growing, such confidence is not likely to revive.

The best approach to international insolvency is to have an independent arbitration body set up to mediate between Indonesia and its international creditors in order to find the solution to its debt problems that is most in line with protecting the well being of its citizens. Part of the advantage of such an arbitration arrangement is that it can impartially examine the issue of 'odious' debt, i.e., that part of the debt incurred through corrupt means and used for activities inimical to the interests of its people.

Dealing with the Domestic Debt

In dealing with its huge domestic debt, the Government of Indonesia is hamstrung by the poor performance of the economy, which discourages potential buyers of bank and corporate assets. This situation cannot be fundamentally altered until an investment-led economic strategy is able to spark an accelerated rate of growth. However, the Government can still take a tougher negotiating stance with the current owners of failing banks and corporations—for example, by requiring the debtor to pay his obligations within a certain period, undertaking bankruptcy proceedings or filing a criminal report with the police.

The Government would benefit greatly if the Parliament enacted a law to set up a special court to handle cases of domestic debt and the sale of corporate assets. Until now, the judicial system of Indonesia has ruled against the Government in most of its litigation cases against large debtors. It is no coincidence that such debtors are leading members of Indonesia's economic elite.

With regard to the large problem of recap bonds, the Government could take some immediate measures to have overcapitalised banks return the excess bonds that they received from the Government and could encourage stronger and larger banks to take over banks with significant shares of recap bonds. In any case, the Government should set an upper limit on the interest payments on recap bonds, in order to provide some debt relief that could

free up resources to be channelled to poverty reduction. Since the recap bonds were a free gift to the banks from the public, they should have been issued at below-market interest rates.

In order to raise badly needed revenue, the Government has resorted to the privatisation of state-owned enterprises (SOEs), both financial and non-financial. Until 2002, however, the pace of privatisation had been slow. There have been widespread criticisms in Indonesia that public assets are being sold too cheaply, sales are based on kickbacks and corruption, foreigner investors are being given monopoly control over strategic national interests and many workers in SOEs are bound to lose their jobs.

One of the underlying issues is whether Indonesia's privatisation plans will concentrate the power of the economic elite or dilute it. If SOEs are privatised, strong anti-monopoly laws and regulations need to be instituted to foster a competitive environment and protect the public interest. Moreover, more analysis is needed of the social consequences of privatisation. When a substantial proportion of the population remains vulnerable to poverty, significant rises in prices of public services, such as water, electricity and health, can have a clear adverse impact on people's welfare.

As the experience of the economic crisis demonstrates, structures of corporate governance inherited from the Suharto era are so weak and unreliable that mere changes in ownership structure, such as privatising SOEs, cannot resolve them. In fact, if privatisation cedes more power to the economic elite that grew powerful during the Suharto regime, it will only exacerbate the problem. If the path of privatisation is to be followed, it should be designed to contribute to greater democratisation of the ownership and control of economic assets, not greater monopoly and cronyism.

Outline of a Pro-Poor Development Strategy

1. Fostering More Rapid Growth

Assuming that Indonesia can secure adequate debt relief and/or raise additional domestic resources, national policymakers would have the latitude needed to begin implementing an investment-led, pro-poor economic strategy. They could make macroeconomic policies more growth-oriented and complement them with broad sectoral policies and redistributive measures that could give growth a more equitable impact. This report is based squarely on the assumption that "there *is* an alternative" to the Neo-Liberalism that helped plunge the Indonesia economy into crisis and the continuing legacy of that policy orientation, which still hamstrings the prospects for growth and development.

In order to pursue an alternative development strategy, which will stimulate more rapid growth with equity, policymakers need to further relax some of their Neo-Liberal assumptions, such as maintaining an open capital account and striving for balanced budgets. In an era of slow growth with continuing capital outflows and little prospect of foreign finance, combining a balanced budget with only modest efforts to mobilize domestic resources while allowing capital to freely flee the country is likely to continue undermining the basis for pro-poor development.

Striving to balance the budget puts unnecessary restrictions on fiscal policy and keeping an open capital account implies maintaining relatively high real rates of interest in order to retain capital in the country. Such rates continue to contribute to corporate distress and put pressure on government finances, furthering undercutting any prospects for accelerated growth. Indonesia's current policy orientation appears to lock it into a slow-growth debt trap, with dramatically narrowed policy options for an escape.

Fiscal and Monetary Policies

The growth accounting conducted by this report suggests that neither consumption nor exports will provide an engine of growth that can extricate Indonesia from its economic predicament. Also, under the bleak conditions in the banking sector and the economy-wide lack of aggregate demand, private investment is unlikely to revive itself autonomously. Policymakers must rely on more expansionary fiscal policies focused on augmenting public investment.

The danger of precipitating spiralling inflation with such expansionary policies is not high. The overall deficit has been brought down to about 2 per cent of GDP in 2002-2003 even without significant debt relief or a substantial increase in tax revenue. This report calls explicitly for raising additional tax revenue in order to finance increased public investment. Such a combination of policies will still have a significant "balanced-budget multiplier" impact on the economy.

Further easing of monetary policy would give an added boost to the fiscal stimulus. The interest rate was kept artificially high during the crisis in order to stabilize the exchange rate. This was an ill-advised and useless effort, as it turned out. While the Government has lowered policy rates of interest since the crisis, more efforts need to be focused on bringing down lending rates of interest. Applying the so-called "Golden Rule", namely, attempting to align the real interest rate with the sustainable rate of growth of per capita income, would imply bringing real interest rates down to 3-4 per cent. Although in decline overall, the real Central Bank rate has remained higher than this and has contributed to nullifying some of the stimulus for faster growth.

In Indonesia, the standard practice of 'targeting' inflation rates to be well below 10 per cent, and converging towards five per cent, has contributed to propping up real interest rates. But historically, inflation rates above 10 per cent have not been detrimental to rapid economic growth in Indonesia. Under current conditions of a dampening of aggregate demand, attempting to lower inflation further is likely to be counter-productive.

The Capital and Current Accounts

Easing monetary policy further will be difficult, however, as long as the capital account remains completely open. While an open capital account does little to attract foreign capital, it does provide a well-oiled swinging door for the massive exiting of capital, both foreign and domestic, when an economy falters. Policymakers should now consider partially closing the capital account, by providing some regulation through raising reserve requirements, lengthening minimum holding periods for capital or instituting exit taxes. During the Asia financial crisis, Malaysia demonstrated the feasibility of exit taxes and other countries such as China and Vietnam have shown the value of capital controls as insulation against financial contagion.

Regulating the capital account will help policymakers conduct a more autonomous monetary policy. It will also provide a basis for re-instituting a managed float for the rupiah—a policy that the Government abandoned during the financial crisis. A freely floating exchange rate is too likely to impart instability to the Indonesian economy, particularly when it is struggling to revive growth and investor confidence remains weak. A managed float could offer enough flexibility to promote the international competitiveness of Indonesian exports while guarding against unnecessary and destabilizing fluctuations in the exchange rate. In many countries, policymakers are now instituting more 'intermediate' exchange-rate regimes and avoiding the 'corner solutions' of either rigidly fixed or completely flexible systems.

Trade, Industry and Agriculture

Policymakers in Indonesia should take a similarly cautious approach towards trade liberalization. In the wake of the economic crisis in 1997, Indonesia's exports of labour-intensive manufactures have faced stiff competition from other developing countries, especially China. Despite lowering its wage costs through devaluation, Indonesia has not boosted its labour productivity high enough to compete with such low-cost competition. As a result, full-scale trade liberalization has contributed mainly to Indonesia's increased vulnerability.

The country needs a more pro-active industrial policy that can enhance the competitiveness of sectors producing manufactured exports. But because of the heavy reliance of its manufacturing sectors—even those engaged in exporting—on imports of raw materials, intermediate inputs and machinery, Indonesia should also seek to promote some forms of import substitution. Otherwise, its trade balance in manufacturing will remain in deficit, and likely worsen.

In order foster more pro-poor development, policymakers should target agriculture, and agro-industry in general, for greater support. Increases in employment and incomes for much of the population are still dependent on agricultural prosperity, particularly because of the slowdown in growth of labour-intensive exports.

In rice production, which is critical to the food security of the Indonesian people, raising productivity is essential—and the only long-term solution. In line with this priority, policymakers should re-institute the past practice of concentrating public investment on rural infrastructure and basic social services. Meanwhile, reforms in the country's current system of tariffs and quotas should be instituted to provide more effective medium-term protection to rice producers. Full liberalization in rice production under current conditions courts social disaster.

2. Making Growth More Equitable

This report argues that a more heterodox investment-led economic strategy would stimulate more rapid growth than the tepid rates attributable to the current conventional set of policies. However, a pro-poor development strategy requires more than faster economic growth. The impact of growth on poverty depends also on the character or pattern of growth.

For growth to have the biggest impact on poverty, policymakers need to complement macroeconomic and adjustment policies with equity-enhancing sectoral and redistributive measures. These include policies to foster more agricultural development and faster development of small and medium enterprises. Agricultural development is likely to have a powerful direct impact on poverty since the majority of poor households continue to live in rural areas and have livelihoods that are tied to agriculture. The development of small and medium enterprises (SMEs) will help break the stranglehold of the economic elite on public resources and services and help generate remunerative employment for a large share of the working population.

Agricultural Development

To foster agricultural development and the growth of agro-industry, national policymakers should follow a three-pronged strategy: 1) maintaining rice production in order to protect food security, 2) encouraging farmers to diversify into the production of commodities with a higher value added in order to boost incomes and 3) stimulating off-farm employment in order to absorb surplus agricultural labour.

For reducing poverty, it is critical to raise agricultural productivity. The surest long-term strategy is to invest in more efficient technology, as was done in Indonesia during the promotion of the Green Revolution. However, investment in agriculture has progressively declined over a thirty-year period. Also, land has become increasingly fragmented. About 80 per cent of farmers now own plots smaller than 0.5 hectares, compared to 70 per cent in 1993.

The most pronounced effect of these trends is the stagnation of the productivity of rice output on Java. Off Java, where land is more plentiful, the prospects for increasing rice production are better, provided that investment are made to complete large irrigation projects and finances are made available to improve agricultural extension services. Agricultural productivity can increase on Java if farmers are allowed to diversify into cash crops, such as coffee and coconut, which have higher value added.

In rural areas, public investment needs to be revived in physical infrastructure and basic social services. Indonesia's laudable record of growth with equity in the 1970s and 1980s was based, in part, on such investment. Such an approach implies more investment in upgrading rural roads, irrigation, electricity and communication. Indonesia's earlier advances in promoting basic human development should also be emulated. Investments in education, health and sanitation are critical for raising the productivity of rural labour.

SME Development

Such investment will help foster more off-farm employment. Stimulating agricultural prosperity will, in fact, promote the development of small and medium enterprises in rural areas. Such enterprises are most likely to be concentrated in agro-industry, either supplying inputs to agriculture or processing its commodities.

For SME development, the Government needs to develop a comprehensive and integrated programme, coordinated by one administrative unit, instead of the numerous ministries and departments that currently overlap in their authority. This is imperative if the monopoly of large corporations on government privileges is to be broken. There are myriad small enterprises in Indonesia, many in the informal sector, but few can obtain the access to

resources and services to graduate into medium-sized enterprises that can provide Indonesian workers with decent work, i.e., work based on skills and for which decent wages are paid.

Public policies can facilitate the development of SMEs, especially of medium-sized enterprises, through various means. Facilitating the start-up of enterprises through a "one-stop services" facility could contribute to this objective. Since SMEs are usually starved of capital, setting up a financial institution that could mobilize resources for SME development could also help. Since the business skills of workers and managers in SMEs are low, fostering the spread of business development services could also prove valuable. SMEs could also develop if the Government assisted them in developing overseas markets or encouraged them to produce goods that could substitute for imports.

When public resources are directed more to the development of agriculture and small and medium enterprises, instead of being cornered by large banks and corporations as part of a system of crony capitalism, then growth will accelerate and take on a more broad-based character that will benefit the majority of Indonesians, especially the substantial proportion of the population that is still subjected to poverty or remains vulnerable to it. Such policies are an integral part of a coherent investment-led development strategy that can lead to greater poverty reduction based on faster growth and a more equitable distribution of its benefits.

Chapter One

Slow Post-Crisis Recovery in Indonesia: The Historical Background[1]

1.1 Introduction

During the 1970s and 1980s, Indonesia was widely regarded as one of the "East Asian 'Miracle" economies. It achieved rapid economic growth along with equity in the distribution of the benefits of growth—at least among the non-elite portion of the population. Widespread state intervention in the economy was combined with a heavy dose of neo-liberal orthodoxy in macroeconomic policy, such as mandating a balanced budget and completely opening the capital account.

In the late 1980s, when the country embarked on a more ambitious programme of economic liberalization, few mainstream economists warned of the perils. Moreover, when the Asian Financial Crisis that first hit Thailand began to spread to other countries in 1997, few analysts expected Indonesia to succumb to the contagion. Also, when the IMF was invited by the Indonesian Government in October 1997 to recommend measures to contain the crisis that was gripping the country, few commentators predicted that the IMF recommendations would make matters worse. The policy measures that were adopted turned a short-term financial crisis into a full-blown economic recession.

In late 2003, almost six years after of the onset of the crisis, Indonesia is still struggling to disengage itself from the adverse effects. The financial crisis revealed some structural weaknesses in its model of development. But its IMF-supported policy responses only imposed additional obstacles—such as a debilitated banking sector and a huge domestic and external debt. More expansionary fiscal and monetary policies in recent years have not yet extricated the country from the doldrums of a long, slow post-crisis recovery.

In response to these currents problems, what can Indonesia do to chart a way forward? This report attempts to provide some answers, based on recommending an alternative development strategy and a new set of economic policies. In this chapter, the report briefly examines the historical background to the crisis, the responses of policymakers to the crisis and its after-effects, and the effect of these responses on the well being of the Indonesian population. The intent is not to rehash past problems but to help clarify how to move forward.

1.2 The Historical Background

During 1968-1996, the Indonesian economy had been expanding at an annual rate of 7.5 per cent. This translated into an annual increase of 5.5 per cent in per capita income. This growth had been accompanied by a remarkable change in the sectoral composition of national income. From being heavily reliant on agriculture and mining for growth, Indonesia had transformed itself in 1996 into a country with a large and diversified manufacturing base. The share of agriculture had

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[1] This chapter was written by Terry McKinley and Barsha Khattry

declined to only 15 per cent of GDP and that of mining to only nine per cent, while that of manufacturing had risen to account for a quarter of national income (Text Table 1.1 and Appendix Table 1.1).

Table 1.1. The Sectoral Composition of GDP in Indonesia

Sectoral Shares (%)	1985	1990	1996	2001	2002
Agriculture	22.7	20.2	15.4	16.2	15.9
Mining	18.2	10.1	9.1	9.4	9.3
Manufacturing	15.8	20.6	24.7	26.7	26.6
Construction	5.3	5.8	8.0	5.9	5.9
Trade	14.6	15.9	16.8	16.2	16.2
Transport/Communicaiton	5.3	7.0	7.2	7.7	7.9
Finance	6.4	8.2	8.8	6.9	7.0
Public Administration	7.6	7.9	5.6	5.5	5.4
Others	3.7	3.5	3.2	3.9	3.9

Sources: See Appendix Table 1.1.

Although there are differing estimates of the levels of poverty in Indonesia, there is no debate on the dramatic reduction in poverty that the country achieved from the 1970s until the crisis in 1997. From 1976 to 1996, for example, official statistics record that the proportion of the population in poverty declined from about 40 per cent to about 11 per cent.

This dramatic reduction was due to not only the pace of growth but also its character (Ikhsan 2002). In the 1970s and early 1980s, growth benefited the poor because of the Government's policy of promoting agriculture and rural development (Radelet 1999). Farmers were guaranteed stable prices for their commodities, were able to take advantage of green revolution technologies and had access to pesticides, fertilizers and cheap credit (Mishra 2001). As a result, output from rice and tree crops grew rapidly during this period and the effects were spread broadly among the rural population.

One reason for the widespread effect was the investment by Government in rural infrastructure, particularly in schools and health clinics and physical infrastructure such as roads and irrigation. Thus, the poor were able to benefit not only from the 'location' of growth—namely, in rural areas—but also from their enhanced ability to participate in growth through greater productivity or better access to resources and opportunities.

Revenues from Indonesia's oil boom and its earnings from other natural-resource exports, such as rubber, palm oil and tin, financed the investment in human capabilities and physical infrastructure. This approach contrasted to that of many other resource-rich developing countries, which squandered the initial advantages of substantial export earnings. Drawing lessons from the Sukarno era and popular demonstrations in the early 1970s, the Indonesian Government was concerned to distribute the benefits of growth widely among the population.

In the mid 1980s, the emphasis of Indonesia's development strategy shifted from growth generated by the export of primary products to labour-intensive, export-oriented industrialization. Building on agricultural prosperity, this shift in strategy generated widespread manufacturing employment among low-skilled workers, amplifying the reduction in poverty. Exports of manufactured items such as footwear, furniture, textiles and toys grew dramatically. In addition, the rapid growth in both agriculture and manufacturing stimulated growth of the service sector in both rural and urban areas, providing an additional layer of jobs.

1.3 The Crisis and its Economic Legacy

With such a development momentum, Indonesia appeared well positioned to weather the regional financial crisis triggered by the run on the Thai bhat in 1997. But when speculators bore down on the Indonesian rupiah in mid 1997, the speed and severity of the financial crisis that enveloped the country astonished practically everyone. The growth rate of GDP reversed by almost 18 percentage points, from a positive 4.7 per cent in 1997 to a negative 13.1 per cent in 1998—an incredibly large and precipitous turnaround (Table 1.2).

Unfortunately, the crisis was exacerbated by a severe drought, which drove up food prices and thus had a devastating impact on the real incomes of the poor. The inflation rate shot up to almost 60 percent in 1998. An additional shock was the drop in prices in 1997 for Indonesian exports, such as oil, which deprived the economy of badly needed aggregate demand.

Although at first the Government tried to expand the trading band for the rupiah, which rapidly depreciated under the speculative attack, it wisely refused to deplete its international reserves in defense of the currency. The rupiah quickly depreciated below the band as both domestic and foreign investors rushed to dispose of their rupiah denominated assets. The rupiah was trading, for instance, at about 10,000 to the U.S. dollar in 1998, well below its average of about 2,300 during the pre-crisis year of 1996. This rapid depreciation inflamed, in turn, the inflation rate. The collapse of the exchange rate and the associated skyrocketing of inflation in Indonesia were much more severe than in the other four debtor countries affected by the Asian Financial Crisis—The Republic of Korea, Malaysia, the Philippines and Thailand (Weeks 2001).

Table 1.2. GDP Growth Rate (%), 1980-2002

Year	Rate		Year	Rate
1980	9.9		1991	7.0
1981	7.9		1992	6.4
1982	2.2		1993	6.5
1983	4.2		1994	7.5
1984	7.0		1995	8.2
1985	2.5		1996	7.8
1986	5.9		1997	4.7
1987	4.9		1998	-13.1
1988	5.8		1999	0.9
1989	7.5		2000	4.8
1990	7.2		2001	3.4
			2002	3.7

Sources: See Appendix Table 1.1.

Because of skyrocketing input prices, corporations that had borrowed, particularly in foreign currency, began to default on loans. Faced with a rapid rise in non-performing loans, the banking system collapsed, choking off loans for investment and preventing access to foreign exchange for purchasing capital and intermediate imports. Between 1997 and 1998, imports declined by 31 percent and gross domestic investment, relative to GDP, fell by half.

Why did a crisis of such magnitude occur? There is consensus that external factors triggered the crisis. But such factors cannot explain the depth of the downturn. Domestic financial de-regulation of the late 1980s and early 1990s was one of the principal underlying causes of the fragility of the Indonesian economy. Secondly, this de-regulation went hand in hand with an upsurge of short-term capital inflows that intensified Indonesia's vulnerability. The third major factor was that policy mismanagement at the onset of the crisis exacerbated its impact. The Government of Indonesia responded to the financial crisis and economic downturn principally by implementing pro-cyclical fiscal and monetary policies when it should have been implementing counter-cyclical measures.

Indonesia has had an open capital account since the 1970s but such openness became an invitation to instability mainly in the late 1980s and early 1990s when large amounts of private capital began to flow into the country. Financial de-regulation, the large spread between domestic and international interest rates and the perception of low exchange rate risk attracted the large capital inflows. During 1990-1996, these amounted to about four per cent of GDP.

The magnitude of the flows appreciated the rupiah, making it vulnerable to speculative attack as the Government tried to maintain a managed float. The distinctive feature of this trend was that the resulting external debt was mostly private and held by non-bank firms. While the Government limited borrowing by commercial banks, it did not put limits on borrowing by private companies (Pincus and Ramli 1998).

By mid 1997, private corporations in Indonesia had accumulated about US$ 40 billion and banks about US$ 12 billion in foreign debt. The biggest immediate problem was that US$ 35 billion of this total debt was short-term and due to mature within the next year. At the start of the crisis, short-term debt represented 170 per cent of the country's foreign reserves (Aziz 2001). Moreover, this short-term debt was unhedged against exchange-rate risk.

Domestic financial liberalization had been allowed to gain momentum without any corresponding strengthening of the regulatory and supervisory capacity of the Government. By the early 1990s, Indonesia had one of the most liberal banking systems in the world. But financial liberalization had markedly weakened the ability of the State to avert a financial crisis or contain it when it intensified. The Government had little control over capital movements or credit creation, or even fiscal policy. The only macroeconomic instruments left were the interest rate on Bank Indonesia securities and the exchange rate. Since domestic and foreign investors closely monitored the use of these instruments, macroeconomic policies became chained to boosting "investor confidence."

Foreign banks lent generously to Indonesian firms assuming that because Suharto's family members and friends controlled many of them, the Government would bail them out in the event of any problems. Apparently, the firms operated on the same assumption when they took on so much short-term debt. Thus, liberalization went hand in hand with the rise of "crony capitalism", which was not weakened by liberalization, as the technocrats in the Indonesian Government had no doubt expected, but was strengthened (Pincus and Ramli 1998).

The technocrats in the Indonesian Government tried to implement "a self-imposed IMF programme" in September 1997 when the Bank Indonesia announced cancellation of $62 billion worth of large investment projects and threatened to close insolvent banks. As a consequence, capital flight accelerated. The open capital account was an open invitation to funnel speculative capital out of the economy. In desperation, the technocrats turned to the International Monetary Fund for help in October 1997. One of the Fund's first recommendations was to tighten fiscal policies: its target was to achieve a fiscal surplus of one per cent of GDP. Its initial programme

was based on the assumption that the Indonesian crisis was “a moderate case of cantagion” (IMF, 2003, p. 110). In the face of plunging private investment and output, in January 1998, the Government proposed to achieve a zero deficit for its 1998-1999 budget.

The ensuing tightening of fiscal policy served only to accelerate the contraction of the economy. The evaluation of the IMF Independent Evaluation Office notes that the IMF had failed to foresee the near-collapse of private investment in the face of the crisis (IMF 2003). But the evaluation blames the plummeting of private investment for the collapse in output, not tight fiscal policies. The Independent Evaluation notes that the Letter of Intent of April 1998 recognized the gravity of the situation when it allowed for a deficit reaching 4.7 per cent of GDP. However, the evaluation undercuts this argument when it states that in any case there was little real latitude for counter-cyclical measures, partly because of the lack of a government bond market.

Another major recommendation of the IMF, which was designed to reduce capital flight and stabilize the currency, was to tighten up monetary policy by raising the interest rate. The interbank interest rate lept from 20 per cent to 300 per cent during the third quarter of 1997 but this precipitated a liquidity crunch in the banking sector and increased the vulnerability of corporations, which were now badly in need of funds. Instead of strengthening in response, the rupiah weakened further.

It is arguable whether devaluation of the rupiah alone would have exacerbated the financial crisis in Indonesia since its major tradable sectors, such as manufacturing and agriculture, were net foreign exchange earners. Devaluation might well have increased revenues more than costs (Weeks 2001). The mistake was to expect that raising interest rates would have prevented or slowed devaluation. If anything, the rise in interest rates *followed* the depreciation of the exchange rate.

With skyrocketing interest rates, banks were unable to secure short-term credit to cover their immediate obligations. In response, the IMF insisted in November 1997 that 16 insolvent banks be closed down—as a signal to investors of the Government’s resolve in addressing the crisis. This was a grave miscalculation, compounding the error of ratcheting up interest rates. Investor confidence evaporated as people rushed to remove money from private banks and even more capital flooded out of the country, unimpeded by any capital controls. About US$ 5 billion is estimated to have left the country in the immediate aftermath of this policy, most of it flowing to Singapore (Ramli 2002). Predictably, the rupiah weakened even further.

In order to bolster plummeting investor confidence, the Government stepped in to salvage the banking system by injecting huge liquidity credits into it (through Bank Liquidity from Bank Indonesia (BLBI)). By some estimates, this plentiful liquidity support amounted to 14 per cent of GDP. However, much of its potential impact was quickly dissipated. According to the Supreme Audit Agency of Indonesia, well over half of these credits were misused.

The Government also supported the banking system by converting private debt into public debt through the use of recapitalization bonds. Prior to the crisis, the public sector had virtually no domestic debt but by 2001 it had acquired debt worth about US$ 63 billion dollars. At the same time, its foreign indebtedness had increased to about US$ 74 billion.

The injection of public funds into the banking system represented a massive short-term expansion of monetary policy. But it had little effect on expanding credit to the economy as banks grew increasingly reluctant to lend—instead opting to live off the interest payments on the recapitalization bonds that the Government had used to ‘nationalize’ banking assets. The IMF Independent Evaluation points to the injection of liquidity credits into the banking system as a

basis to argue that Government monetary policy was not, in fact, tightened in 1998 since higher interbank interest rates could have had little effect on reducing monetary aggregates (IMF 2003).

In any case, after providing costly blanket guarantees to insolvent banks—which ended up imparting a very weak stimulus to credit provision—the Government of Indonesia resumed in mid-1998 the implementation of tight inflation-targeting by continuing to maintain high interest rates. Inflation targeting succeeded in bringing down the inflation rate to a low point of below 4 per cent in 2000. But in the process, the policy not only slowed growth but also substantially increased the burden of debt servicing, jeopardizing essential social spending and investment in infrastructure.

In the name of honoring the debt, the IMF counseled the Government to continue exercising fiscal austerity, especially by reducing various subsidies. But the reduction of fuel subsidies catapulted the country into a political crisis by sparking violent protests throughout the country. The crisis eventually led to the downfall of the Suharto regime.

Without any stimulus from expansionary fiscal or monetary policies and shackled by a huge public debt, the Indonesian economy can achieve only slow growth of per capita incomes. Despite the substantial depreciation of the rupiah, export performance has been disappointing. As incomes have stagnated, domestic savings has dropped—from 30.7 per cent of GDP during 1995-1997 to 23.0 per cent during 2001-2202 (Table 1.3). Ironically, although domestic savings now exceed investment, domestic investors are starved of capital.

The banking sector lies in disarray and public investment has been slashed. Relative to GDP, gross domestic capital formation had been cut in half from 1995-1997 to 2001-2002. Foreign investors remain wary. Foreign direct investment has not been flowing back into the country. Public policies explicitly geared to boosting "investor confidence" have not yet succeeded in turning the economy around. However, in 2003, with the appreciation of the exchange rate, short-term portfolio investment, i.e., "hot money", has started to move back into the country, seeking quick profits. With slowing growth and weakening aggregate demand, such an inflow of potentially unstable capital only heightens the economy's vulnerability.

During 2000-2002, GDP grew by less than four per cent per year. The projected growth for 2003 is only 3.4 per cent—a rate that can supply jobs to about only half of the new entrants into the labour force. The main impetus for this growth remains consumption but, ominously, consumption growth began to slow in 2003. Neither net exports nor private investment provide an alternative source of growth.

Early in 2003, the Government began to provide a fiscal stimulus to the economy in the wake of the Bali bombing that occurred in late 2002, and it imparted an additional stimulus in mid 2003. However, since the stimulus in mid 2003 has been provided mainly by tax cuts to business, it is not having a strong multiplier impact on the economy. Moreover, the Government has announced its intention to reduce its budget deficit from the two per cent of GDP that is projected for 2003 to only 1.2 per cent for 2004. This will further restrict its ability to stimulate the economy.

As long as the Government gears all its economic policies to repaying its huge domestic and external debt—such as insisting on continually reducing its deficit—it will have few instruments at hand to stimulate the economy. Without a strategic change in policy, the Indonesian economy appears destined to remain mired in a slow-growth debt trap. Eventual exit from its heavy debt burden remains a distant prospect. Debt rescheduling only postpones the problem, especially as long as growth remains sluggish.

Table 1.3 Domestic Savings and Investment

	1980-1984	1985-1989	1990-1994	1995-1997	1998-2000	2001-2002
Gross Domestic Investment (% of GDP)	26.7	29.8	31.1	31.5	15.6	15.9
Gross Domestic Savings (% of GDP)	29.8	31.4	33.1	30.7	24.1	23.0
Difference between GDS and GDI (% of GDP)	3.1	1.6	2.0	-0.8	8.5	7.1

Sources: See Appendix Table 1.1.

1.4 Poverty Before and After the Crisis

Indonesia's history of growth with equity during the 1970s and 1980s led to a substantial reduction in poverty. From 1976 to 1987, for example, the proportion of the population in poverty (based on estimates of expenditures) dropped from 40.1 per cent to 17.4 per cent—a decrease of about 57 per cent (Table 1.4). From 1987 to 1996, during a major process of economic liberalization, the rate of decline in poverty slowed. The percentage of the population that was poor had dropped to 11.3 per cent by 1996—a decrease of 35 per cent compared to the level in1987.

A 2000 study by the United Nations Support Facility for Indonesian Recovery (UNSFIR), Dhanani and Islam 2000, gives higher estimates of poverty but confirms the general trend of poverty reduction leading up to the crisis. This study estimated a drop in poverty from slightly less than 69 per cent in 1976 to almost one third in 1996. The higher estimates of poverty derive from a methodology that includes a higher share for non-food expenditures and uses higher prices for rural areas.

The UNSFIR estimates seem more realistic judging by Indonesia's level of development. In addition, poverty estimates are likely to under-state the extent of the problem. A significant proportion of the Indonesian population is "near-poor," with expenditures only marginally above the poverty line. A 2001 study by the Social Monitoring and Early Response Unit (SMERU) estimated, for example, that half of the Indonesian population was either poor or vulnerable to falling into poverty in the wake of the crisis (Pritchett, Suryahadi and Sumarto 2001).

What happened to poverty during the crisis? Estimates based on mini-susenas surveys (surveys with smaller samples done during the three-year intervals between major surveys) suggest that at its highest point during the crisis, income poverty had roughly doubled compared to its level in 1996. In that year, the Central Bureau of Statistics (CBS) switched to a new methodology that gave a higher estimate of income poverty. The new estimate for 1996 was 17.7 per cent instead of 11.3 per cent (Table 1.4). By September of 1998, the new methodology registered that 37.2 per cent of the population had become poor. World Bank estimates for 1996 through 1999 reflect a similar pattern. The Dhanani and Islam estimates show that poverty did increase markedly during the crisis (by about 50 per cent) but not as dramatically as shown by the CBS and World Bank estimates.

According to all three methodologies (CBS, Dhanani and Islam, and the World Bank) income poverty had roughly subsided to its pre-crisis levels by late 1999 or 2000. The CBS and World Bank estimates emphasize that the rise in poverty was mainly due to an inflation shock,

which drove down real incomes. Once inflation was reduced, real incomes rose back to their pre-crisis levels. However, slow growth continues to make little dent in widespread unemployment, underemployment and poverty. Government mini-surveys in February 2001 and February 2002 suggest, in fact, that poverty increased from 13.2 per cent in 2001 to 14.5 per cent in 2002 (World Bank 2003). Rising unemployment statistics indicate that growth is too slow to provide enough jobs to new entrants into the labour force.

Table 1.4 Consumption Poverty (% of population)

	1976	1981	1984	1987	1990	1993	1996	1997	1998			1999		2000	2002
									Feb	Sept	Dec	Feb	Aug		
CBS-1	40.1	26.5	21.6	17.4	15.1	13.7	11.3								
CBS-2							17.7			37.2	24.2	23.4	18.2		
Dhanani & Islam	68.9	60.8	51.1	46.1	42.8	34.0	32.5	28.9	38.5	43.6	37.1	42.4	32.6	33.9	
World Bank							15.7	12.7	21.8			26.9			16.0

Source: BPS, Dhanani and Islam 2000 Table A.4, World Bank 2003, Dhanani Data Table 2002.

The Dhanani and Islam estimates suggest that income poverty is still a major problem, affecting about one third of the population in 2000. This implies that poverty is still a widespread structural feature of Indonesian society, not a residual problem that can be eliminated merely through growth with low inflation.

The Dhanani and Islam estimates also accord with various estimates of the magnitude of human poverty. For example, the percentage of people who have less than a primary school education was still 35 per cent in 1999 (Table 1.5). The percentage of the population without access to safe water remained persistently high in 1999, i.e., 52 per cent. And the percentage of children under age five who were underweight in 1999 was still 30 per cent, despite substantial improvements throughout the decade.

Table 1.5 Capability Poverty (% of population)

	1990	1993	1996	1999
Less than Primary School Education	-	45	40	35
Without Access to Safe Water	55	-	53	52
Underweight Children Under Age Five	45	36	35	30

Source: BPS, Islam 2002 Table 2.1, Dhanani and Islam 2000 Tables 2 and 3

1.4.1 Employment and Wages

What specifically were the effects of the crisis on employment and real wages? While unemployment and under-employment increased significantly, real wages appear to have undergone the most notable change. Open unemployment rose from 4.9 per cent of the labour force in 1996 to 6.4 per cent in 1999, before declining slightly in 2000 (Table 1.6). However, unemployment has been rising since then, reaching 8.1 per cent in 2001 and 9.1 per cent in 2002 (Bank Indonesia 2003). The rate of growth of the labour force has been outstripping the rate of growth of the economy.

The officially unemployed are not necessarily the poorest workers in the labour force. Among poorer workers, rising under-employment has been the principal problem aggravated by the crisis. This is shown in the rising percentages of workers employed in agriculture and the urban informal sector. While the share of the employed in agriculture had been dropping up through the early 1990s, it rose during the crisis and remained at about 45 per cent in 2000 (Islam 2002). A significant number of urban workers returned to agriculture during the crisis and have been slow to return to industry as the economy has grown at sub-optimal rates since the crisis. By 2002, 42.5 per cent of the employed still worked in agriculture.

The percentage of workers in the urban informal sector rose significantly during the crisis, to reach almost 46 per cent in 1998 and 1999, and then dropped in 2000 (Table 1.6). However, a broader measure of the informal sector, including both rural and urban workers, shows a rising trend since 1999. While the informal sector accounted for 64 per cent of the employed in 1999, this percentage had risen to over 68 per cent in 2002 (Bank Indonesia 2003).

Table 1.6. Labour Market Conditions

	1993	1996	1998	1999	2000
Urban Informal Sector Employment (%)	43.7	42.5	45.7	45.8	44.7
Unemployment Rate (%)	2.8	4.9	5.5	6.4	6.1
Percentage of Workforce in Agriculture	50	43.5	45	43.2	45.1

Source: Islam 2002, Tables 3.1 and 3.2

The shift in the composition of the labour force towards lower-paying sectors contributed to the marked decline in real wages. During the first year of the crisis, consumer prices rose by 100 per cent while nominal wages increased by only 20 per cent. This signified a 40 per cent plunge in real wages (Dhanani and Islam 2001). Principally because of rising rice prices, agricultural wages fell by 40-45 per cent in Java and 30 per cent in Sumatra (Papanek and Handoko1999).

By 2000, real wages had regained some of their ground as the consumer price index increased by less than 4 per cent compared to 1999. But real wages were still 12 per cent below their 1997 level (Table 1.7). If one assumes that real wages would have maintained their pre-crisis trend rate of growth of 5 per cent per year, then real wages were, in fact, almost one quarter below their expected level in 2000.

Real wages dropped more in urban areas than in rural. Whereas urban wages were 16 per cent below their 1997 level in 2000, rural wages were only 10 per cent below their 1997 level. However, wage inequality rose sharply in the initial stages of the crisis in both rural and urban areas. Compared to the level in 1997, urban wage inequality in 1998 was one third higher whereas rural wage inequality was about 7 per cent higher (Dhanani and Islam 2001). But rural wage inequality in 1998 still remained over 20 per cent higher than urban wage inequality. Wage inequality remained highest in agriculture, where most of the Indonesian poor were concentrated.

Rising inequality among poorer workers appeared to be a characteristic feature of the Indonesian crisis. One indication is the greater relative rise in the severity of poverty in rural areas compared to urban areas. Whereas the FGT Poverty Severity Index (P_2) rose from 0.71 to 0.74 in urban areas between February 1996 and August 1999, it jumped from 0.96 to 1.17 in rural areas (Dhanani and Islam 2002). Thus, while urban areas might have experienced a greater

average fall in wages and a more pronounced rise in wage inequality, the poverty consequences of the fall in wages and rising wage inequality in rural areas were likely to be more severe.

Table 1.7. Trends in Real Wages (Index, 1997=100)

Real Earnings	1989	1997	2000
Indonesia	61	100	88
Urban	63	100	84
Rural	63	100	90
Male	63	100	89
Female	53	100	88

Source: Dhanani and Islam 2001, Table 4.1

Such considerations belie the complacent standard explanation that the Indonesian crisis mainly affected the urban middle classes and formal-sector workers and that the poverty induced by the crisis was merely the transitory effect of an inflation shock, which was quickly resolved. Both income and human poverty remain widespread and deep-seated in Indonesia even after the crisis. Much more rapid growth along with greater equity will be necessary to uproot these forms of deprivation.

In 2002, formal-sector wages were rising. In manufacturing, for example, real wages were 10 per cent higher in 2002 than in 1996 (World Bank 2003, p. 5). Minimum wages in the formal sector were also rising. These increases helped to fuel consumption growth. However, wages in the informal sector were increasing relatively slowly. For example, real wages in agriculture were growing by only one per cent in 2002. Also, although provincial minimum wages were on the rise in 2002, their increase lagged behind the cost of basic needs (Bank Indonesia 2003). These trends help explain why, by some measures, poverty was still on the rise.

1.5 The Untold Story of Inequality

The real story of inequality in Indonesia in the 1990s remains largely untold. The Gini coefficient of the distribution of expenditures per person has remained fairly stable since the 1960s. In 1964 it was 0.35, in 1984 0.33 and in 1990 0.32. On the eve of the crisis, 1996, it had risen to 0.36 but in the wake of the crisis, in 1999, it was back down to 0.32 (World Bank 2003). By 2002, as growth had resumed, it had risen again to 0.34.

While the Gini coefficient was oscillating, it was evident that a massive regressive redistribution of income from the great majority of the population to a very small elite was occurring. The Gini coefficient was simply not capturing the incomes of very rich Indonesians—the richest 1-2 per cent of the population. It was, however, reflecting a relatively stable distribution of expenditures among the majority of the population.

There is no dispute that Indonesia experienced a dramatic reduction of poverty from the early 1970s until the eve of the crisis. This was due to a rapid rate of growth with relatively low and stable inequality in the distribution of expenditures. During the period of financial de-regulation, the determinants of the distribution of expenditures began to change. The rise of the Gini coefficient from 1990 to 1996—i.e., from 0.32 to 0.36—is partial evidence of this trend but a pale reflection of the more pronounced redistribution that was beginning to occur.

During the crisis, overall inequality dropped, as suggested by the Gini coefficients cited above—leading to the complacent conclusion that the crisis was mainly afflicting the middle classes and formal-sector workers. But within this general trend, inequality in Jakarta shot up from 0.36 in 1996 to 0.46 in 1999—a rise of about 28 per cent within the very short span of three

years. Vulnerability spread among a larger segment of the population as the income levels of the near-poor were being pushed down closer to poverty levels. Meanwhile, inequality was increasing among the poor, signifying that the extremely poor were becoming much more worse off than the more moderately poor.

But the real story was the intensive concentration of income among the richest Indonesians, who were mainly responsible for the crisis and were the biggest beneficiaries of the public bail-out of large banks and corporations. First of all, early during the crisis, they spirited huge sums of money out of the country—estimated roughly to be US$ 20-40 billion. The value of this money, in domestic terms, ballooned immediately after devaluation of the rupiah. Most of the liquidity credits used by Bank Indonesia to prop up the banking system no doubt ended up as flight capital safely harbored in Singaporean banks. The owners of the big banks were also recipients of the windfall interest payments due them because of the recap bonds that the Government used to salvage the capital of their banks.

Because of payments on the interest and principal of both domestic and foreign debt has consumed so much of the national budget, the Government has had little money left to invest in agriculture, physical infrastructure or human development. As poverty spread rapidly during the crisis, the Government had few resources that it could marshal to combat impoverishment. The debt burden has served to channel lavish sums of public money from the majority of Indonesians to the very rich, all in the name of bolstering "investor confidence" in the economy, even while private capital was continuing inexorably to flow out of the country. The main form of confidence that economic policies have promoted has been the profligate "luxury consumption confidence" of the rich.

Meanwhile, the Government has not chosen to raise more revenue by increasing taxation of wealthy Indonesians, who have benefited so handsomely from the "nationalization" of the domestic debt and have been protected from the consequences of their resort to so much short-term external corporate debt. These are the broad outlines of the untold story of the dramatic rise of inequality in Indonesia—a story that standard measures of inequality, such as the Gini coefficient, cannot reveal.

Appendix Table 1.1: Indonesia's Macroeconomic Performance

	1972	1975	1981	1985	1990	1995	1996	1997	1998	1999	2000	2001	2002
Real per capita GDP growth (%)			6.0	1.6	7.1	6.5	6.1	3.0	-14.5	-0.8	3.7	2.3	2.5
Real GDP growth (%)	9.4	5.0	7.9	2.5	7.2	8.2	7.8	4.7	-13.1	0.9	4.8	3.4	3.7
Sectoral shares (% of GDP)													
Agriculture				22.7	20.2	16.1	15.4	14.9	16.9	17.1	16.6	16.2	15.9
Mining				18.2	10.1	9.3	9.1	8.9	10.0	9.7	9.7	9.4	9.3
Manufacturing				15.8	20.6	23.9	24.7	24.8	25.3	26.1	26.4	26.7	26.6
Construction				5.3	5.8	7.6	8.0	8.2	6.0	5.8	5.8	5.9	5.9
Trade				14.6	15.9	16.7	16.8	17.0	16.0	15.8	15.9	16.2	16.2
Transport and communications				5.3	7.0	7.1	7.2	7.3	7.2	7.1	7.4	7.7	7.9
Finance				6.4	8.2	8.9	8.8	8.9	7.5	6.9	6.9	6.9	7.0
Public administration				7.6	7.9	6.0	5.6	5.5	5.8	5.9	5.7	5.5	5.4
Others				3.7	3.5	3.2	3.2	3.3	3.9	3.9	3.9	3.9	3.9
Gross Domestic Saving (% of GDP)	16.4	20.9	33.4	29.8	32.3	30.6	30.1	31.5	26.5	19.5	25.6	24.9	21.1
Gross Domestic Investment (% of GDP)	18.8	20.3	29.8	28.1	30.7	31.9	30.7	31.8	16.8	11.4	14.6	17.4	14.3
Exports f.o.b. (billion $)			23.3	18.5	26.8	47.5	50.2	56.3	50.4	51.2	65.4	57.3	58.0
Imports f.o.b. (billion $)			16.5	12.7	21.5	40.9	44.2	46.2	31.9	30.6	40.4	34.7	34.8
Current account balance (% of GDP)			-0.6	-2.2	-2.6	-3.2	-3.4	-2.3	4.3	4.1	5.3	4.9	4.2
Fiscal balance (% of GDP)			-2.9	-3.6	-0.9	1.9	1.8	-0.6	-2.2	-2.4	-3.0	-3.7	-1.7
Public domestic debt (bn $)					0.0	0.0	0.0	0.0	2.5	63.2	77.6	63.1	60.5
Public external debt (bn $)					48.2	64.4	59.1	57.9	71.5	80.7	80.0	73.6	74.7
Discount rate (%)					18.8	14.0	12.8	20.0	38.4	12.5	14.5	17.6	13.0
Money market rate (%)			16.3	10.3	14.0	13.6	14.0	27.8	62.8	23.6	10.3	15.0	13.5
Consumer Price Index	6.6	14.5	32.2	45.5	65.3	100.0	100.8	115.2	181.7	218.6	228.5	255.9	285.2
Inflation rate (%)	6.5	18.9	12.6	4.6	8.0	9.4	8.0	6.7	57.7	20.5	3.7	11.5	11.9
Exchange rate (Rp per $)	415	415	632	1,111	1,843	2,249	2,342	2,909	10,014	7,855	8,422	10,261	9311
Real Effective Exchange Rate			220.5	167.8	95.5	100.0	103.9	62.0	65.8	72.6	62.8	65.9	

Sources: Asian Development Bank, Bank Indonesia, International Monetary Fund, Ministry of Finance, World Bank.

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<u>**Chapter Two**</u>

Towards a Pro-Poor Development Strategy: The Macroeconomic Dimensions[2]

2.1 Introduction

Chapter One briefly reviewed the historical background of the crisis in Indonesia, the policy responses to it and the effects on the well being of the Indonesian people. This chapter begins by describing recent economic trends. Given this context, the chapter sketches out the broad outlines of a pro-poor development strategy for Indonesia based on both the legacy of the crisis and the country's current post-crisis trajectory. The chapter ends with recommendations on how to make macroeconomic policies more growth-oriented and equitable in their impact.

This chapter argues for a heterodox investment-led development strategy designed to achieve more rapid growth along with greater equity. It foreshadows many of the themes developed more fully in Chapter Three (equitable development and trade liberalization), Chapter Four (public expenditures and taxation), Chapter Five (financial liberalization) and Chapter Six (corporate governance and privatisation).

While this chapter concentrates on macroeconomic policies—fiscal, monetary and exchange-rate policies—Chapter Three complements this approach with an analysis of how sectoral policies, such as those for agricultural and SME development, can promote more equitable outcomes. Chapter Four deals in depth with fiscal policies—both taxation and the allocation of public expenditures—as means to foster pro-poor development. Chapters Three, Five and Six deal extensively with the poverty impact of adjustment policies, such as trade liberalization, financial liberalization and privatisation. The general objective of this report is to recommend economic policies that are an integral part of a coherent general development strategy that will lead to greater poverty reduction based on accelerated growth and a more equitable distribution of its benefits.

One of the fundamental premises of this report is that developing countries such as Indonesia should engage the world economy on their own terms. Having the space to do so requires, of course, reforms at the international level, especially with regard to the international financial architecture. This report concentrates, however, on what Indonesian policymakers can do to promote more pro-poor development. This involves, in part, changing policies, such as financial liberalization, which have left Indonesia more vulnerable to international instability.

The majority of national policymakers appear to assume that "there is no alternative" to the standard package of restrained fiscal and monetary measures and wide-ranging liberalization policies that primarily benefit the domestic economic elite and foreign investors (see Rao 2002 for a further elaboration of this point). Part of the explanation is the legacy of an onerous foreign and domestic debt that was bequeathed by financial de-regulation, the economic crisis and the ill-advised policy responses to it. This report extensively addresses these issues in Chapter Five.

Another part of the explanation is the fixation on bolstering "investor confidence," which implies primarily the confidence of external investors, whose capital fled Indonesia during the crisis and has been slow to return. But such an approach also applies to the confidence of the

[2] This chapter was written by John Weeks and Terry McKinley

country's economic elite, who spirited billions of dollars worth of their capital out of the country during the crisis and is keeping it in Singapore until "appropriate economic conditions" are created in Indonesia for its return. This chapter deals with the issue of "investor confidence" in Section 2.3D.

2.2 Recent Economic Trends

As 2003 draws to a close, the Indonesian Government prepares to terminate its IMF economic bailout programme, which started in 1997 at the height of the crisis. The Government still owes the IMF US$ 9 billion, which it could pay off from its accumulated international reserves of US$ 34 billion. Instead, it has decided to enter into a "post-programme monitoring" arrangement with the IMF.

The major difference is that beginning in 2004 the Indonesian Government will be able to formulate its own economic strategy, free of conditionalities. In September 2003, it unveiled a "White Paper" outlining the basis for such a strategy. Hopefully, economic policies will begin to depart significantly from those applied under the IMF bailout programme.

By a variety of standard measures, the Government has made significant progress in the last few years in achieving macroeconomic stability. The public deficit has been reduced, the current account has achieved a surplus, international reserves are rising, the external debt to GDP ratio has come down, real rates of interest have declined, the exchange rate has strengthened and inflation continues to drop. For example, government officials estimated that in September 2003 the debt to GDP ratio had fallen below 70 per cent and international reserves had risen to be equivalent of eight months of imports (Kuntjoro-Jakti 2003).

In 2002, CPI inflation was 10 per cent, down from 12.5 per cent in 2001. Despite a rise in government-administered prices and a reduction in fuel subsidies in 2003, annual inflation continued to subside, converging towards an average of six per cent late in the year. However, this may well be a sign of impending problems because of the recent slowdown in aggregate demand.

Moreover, given Indonesia's past experience, such low inflation targets—which are often recommended by the IMF—can be a drag on growth. In the 1970s, for example, average inflation rates were over 17 per cent while the average annual economic growth rate was 7.7 per cent, higher than the average in any period since then (Chowdhury 2002). Under current circumstances, the drop in the inflation rate is likely to be a consequence of slowing economic growth, rather than a basis for accelerating growth.

Since 2000, the pace of economic recovery in Indonesia has been slow. Its average annual rate of growth of GDP during 2000-2002 has been less than four per cent. This is a little over half its rate of growth during 1991-1996. In 2002, GDP growth was only 3.7 per cent. Such a slow pace can provide jobs to only about half of the new entrants into the labour force. As a result, unemployment and underemployment continue to spread despite growth.

Most of the recovery has been based on consumption growth—a fragile basis indeed. Consumer financing has supported much of this growth but this financing has benefited mostly rich consumers (Bank Indonesia 2003, p. 14). And with a continuing rise in unemployment and higher prices on fuel and electricity, the basis for broad consumption growth is sure to weaken. In 2003, in fact, consumption growth began to slow—an ominous sign.

Moreover, consumption is not an autonomous factor: it is ultimately dependent on other factors that drive the growth of income. But other components of aggregate demand that are autonomous are not likely to provide an alternative source of growth. In 2002, gross domestic fixed capital formation, a crucial autonomous factor, declined by 0.2 per cent and shows no signs of recovering in 2003.

Exports are another important autonomous factor. Net exports contributed more to growth in 2002 than in 2001 but only because imports contracted by over eight per cent, which was more than the decline of exports, i.e., 1.2 per cent. Thus, until exports begin to grow, net exports will provide only a weak impetus to growth.

Growth of household consumption is propping up GDP growth in the short run. In 2002, this component grew by 4.7 per cent, accounting for about 90 per cent of GDP growth. Although a much smaller component than household consumption, government consumption grew much

faster. However, much of this government spending has been allocated to the regions, as part of decentralization reforms, but it has not been focused on public investment.

Government began to explicitly stimulate the faltering economy in the wake of the Bali bombing, when it committed Rp. 10 million to public expenditures in early 2003. This has had a multiplier impact on the economy, prompting further growth in private consumption in 2003.

Table 2.1. Growth of GDP and Its Components (2000-2002)

Item	2000	2001	2002
GDP	**4.9**	**3.4**	**3.7**
Consumption	**3.9**	**4.8**	**5.5**
Household Consumption	**3.6**	**4.4**	**4.7**
Government Consumption	**6.5**	**9.0**	**12.8**
Investment	**13.8**	**7.7**	**-0.2**
Exports	**26.5**	**1.9**	**-1.2**
Imports	**21.1**	**8.1**	**-8.3**

Source: Bank Indonesia 2003.

Recognizing the fragility of the recovery, however, the Government has provided another fiscal stimulus in mid 2003, mainly in the form of tax cuts. For example, it waived 10 per cent of the Value Added Tax on the imports of certain capital goods and raw materials by several industrial sectors. It also eliminated luxury taxes on certain electronic products, attempting to boost consumption of these domestically produced items. But since such a stimulus was focused

on tax breaks instead of expenditures, it has had a weak multiplier impact on the economy. Current projections suggest that economic growth will slow to only 3.4 per cent in 2003, far too sluggish to boost employment or significantly reduce poverty.

Private investment remains weak. In fact, in the first eight months of 2003, domestic investment approvals dropped by about 14 per cent. All the policies geared to boosting “investor confidence” have apparently had little impact. Although monetary policy has been designed in recent years to lower interest rates, lending rates of interest have remained stubbornly high. While deposit rates of interest have declined, contributing to the growth of consumption (by dampening savings), banks have been reluctant to extend investment credits to the private sector. They are more inclined to lend for consumer durables, such as automobiles and motorcycles, or for working capital for businesses. In 2002, interest rates on consumer credit were on the rise, helping boost bank profits.

The costs to the real economy and the government of relatively high lending rates of interest can be substantial (Stiglitz 2002a). When corporations are heavily indebted, as they have been in Indonesia, high real interest rates intensify corporate stress. Even when firms do not face bankruptcy, they experience a loss in net worth, which lead to a contraction of production.

High real rates of interest can also serve to increase the public deficit. As a result, there is more pressure to raise prices on fuels, electricity and other subsidized items and to accelerate the sale of public assets, particularly those taken over during the financial crisis by the Indonesian Bank Restructuring Agency (IBRA). However, IBRA assets have commanded such low prices that they have barely covered one-year’s worth of interest on recap bonds (see Chapter Five for details on this issue). When such assets are sold, they are often recycled back, at fire-sale prices, to the domestic economic elite that originally controlled them.

Meanwhile, corporations that seek to increase their productive investment remain starved of long-term credit. The reason is not insufficient domestic savings. During 2001-2002, gross domestic savings was 23 per cent of GDP while gross domestic investment was only about 16 per cent. The problem is the widening spread between deposit and lending rates of interest and the build-up in banks of excess liquidity. Either lending rates should come down or the Government should sell bonds to tap the excess liquidity for financing public investment.

Public investment could be used to stimulate private investment but it is constrained by the Government effort to reduce budget deficits. Capital expenditures by the Government, both central and local, plummeted from 6.5 per cent of GDP in 1997 to 4.8 per cent in 2002—a drop of over one quarter. The transfer of one quarter of central government revenue to local government has contributed, unfortunately, to this overall decline. Much of the recent increase in government expenditures is accounted for by larger allocations to regions but these allocations are not leading to commensurate increases in public investment.

An additional factor has been the Government's policy stance of increasing fiscal restraint. The Government is concerned that its deficit will reach two per cent of GDP in 2003, exceeding its target of 1.8 per cent of GDP. Its goal for 2004 is to reduce the deficit to close to one per cent of GDP and eliminate it by 2005. However, given the slowdown in private consumption, more fiscal stimulus, not less, is badly needed.

Fortunately, the Government has begun to revive in 2003 some of the large investment projects that it abandoned during the Asia Financial Crisis. These include a large power plant, toll roads and a flood control project. Indonesia badly needs renewed investment in public infrastructure, particularly in energy and roads. Lack of maintenance of existing infrastructure is also a growing problem. Focusing public investment more on low-income households, instead of relying on large high-profile projects, could also improve its effectiveness.

The country's recent history suggests that public investment has "crowded-in" private investment, not "crowded it out"—a topic this report addresses later in this chapter. Given the current slack conditions in the economy, with significant under-utilized capacity, the "crowding-in" effect is likely to be strong.

The Government has begun to issue bonds to help reschedule its domestic debt and free resources for an increase in public investment. This makes sense as long as current revenues cover current expenditures. Fortunately, this is the current budget condition. It also makes sense as long as gross domestic savings exceeds gross domestic investment, which has been the case since 1998. The existence of excess savings weakens the standard neo-liberal argument that the public sector will compete with the private sector for scarce savings.

Failure to boost public investment will pose a major roadblock to implementing a pro-poor development strategy, which depends on substantial investments in physical and human capital, particularly for the poorer half of the Indonesian population. In the following section, the report lays out the broad outlines of a pro-poor development strategy. In ensuing chapters, this strategy is developed in more detail.

2.3 The Economic Dimensions of A Pro-Poor Development Strategy

2.3.1 The Policy Dilemmas of Neo-Liberalism

Accepting the constraints imposed by the country's debt and chaining policymaking to satisfying the elusive phantom of "investor confidence" imply that Indonesia will remain mired in a slow-growth scenario for the foreseeable future. Policymakers are banking on the assumption that Indonesia can eventually "grow out" of the debt burden. But this burden plus the accompanying bias towards fiscal and monetary restraint are standing in the way of generating more rapid growth.

Indonesian policymakers are shackled not only by the fall-out of the recent economic crisis but also by a legacy of adherence to neo-liberal policies dating back to the 1970s. An open capital account is one such tradition. This has implied that policymakers have been quick to resort to restrictive monetary policies in order to counteract the effects of external shocks due to exchange rate movements and/or capital flows.

While Indonesia was growing rapidly, attracting capital inflows and maintaining financial regulations, the open capital account did not pose an immediate problem. But when the country confronted financial crisis and the loss of "investor confidence" in 1997-98, in the afermath of domestic financial de-regulation, the open capital account facilitated a rapid and huge outflow of funds. Now policymakers are reluctant to institute any regulations of capital flows because they are fearful that this will dissuade investors from bringing their capital back.

Policymakers are still assuming that private investment will revive and conditions will improve sufficiently to attract more foreign investments. But substantial foreign investment is

unlikely to return without more rapid growth sparked by increased domestic private investment. But such domestic investment is unlikely to revive, in turn, without an initiating push from public investment.

Another long-standing neo-liberal tradition has been the “balanced budget law.” Although it does not strictly require that annual expenditures equal annual revenue, it has stipulated that a deficit be covered by foreign finance. This has established a consistent proclivity to fiscal restraint. Just when fiscal policy should be used to counter-act an economic downturn, it is required to operate pro-cyclically. Also, in order to maintain high real rates of interest as a basis to attract foreign finance, monetary policy must remain at least moderately tight. Building up a domestic government bond market to tap into excess liquidity in the banking system has relieved some of this burden, but not enough.

While Indonesia was generating income through rapid growth and earning foreign exchange through the export of oil and manufactures, fiscal conservatism did not impede its ability to invest in capital formation to sustain growth and in rural infrastructure, agriculture and basic social services to improve equity. Not only did growth of incomes boost tax revenue but also the tax system was buoyant. In addition, foreign capital was eager to enter the country to reap profits from a rapidly growing economy. But in a slow-growth era with little foreign finance, a balanced budget combined with only marginal efforts to mobilize domestic resources hamper pro-poor development. For some time, policymakers appeared to believe—judging at least by their actions—that official inflows in concert with the fire sales of public assets could cover public deficits. This approach appears increasingly untenable.

Massive Regressive Redistribution

The public proceeds from the privatisation of state-owned enterprises and the sale of financial institutions held by the Indonesian Bank Restructuring Agency have been earmarked to pay off Indonesia’s substantial domestic debt instead of helping to finance development expenditures, which would generate growth and reduce poverty. This is regressive redistribution on a grand scale since the interest payments and principal repayments on the domestic debt go to rich Indonesians while poorer Indonesians are deprived of badly needed social services, infrastructure and social assistance.

In addition, Indonesia faces an onerous external debt burden (see Chapter Five for details). Compared to other countries affected by the Asia Financial Crisis, such as Malaysia, the Philippines and Thailand, Indonesia has been burdened with the heaviest external debt burden. Making matters worse, the composition of its external debt has been more short-term and of a private non-guaranteed character. A major reason for the increase of such debt was that prior to the crisis, the Government had placed few restrictions on external borrowing by corporations.

As a consequence of this external debt burden, a sizeable proportion of the national budget goes to servicing it, i.e., a significant share of public income is leaving the country. Another large chunk goes to keeping domestic banks and corporations afloat. Because the Government chose to ‘nationalize’ the domestic debt, in part by injecting recap bonds into the banking sector in order to bolster capital adequacy ratios, the public is now saddled with interest payments to these banks to service these bonds. Even when the banks are sold to private business interests, the Government is still required to make interest payments on the recap bonds. The capitalization of this obligation often exceeds the proceeds from the sale. Thus, the Government and the public are net losers from the combined transactions.

These payments represent a huge transfer of income, within Indonesia, from the poorer households to the richer. This calculation does not take into account the huge liquidity credits

that the Bank of Indonesia injected into the banking system, almost all of which will probably never be reimbursed. Also, the calculation does not take into account the draining of capital out of the country by the Indonesian economic elite. In domestic terms, this wealth has increased handsomely as a result of devaluation of the Indonesian rupiah. As the rupiah has appreciated recently, some of this "hot money" has seeped back into the domestic economy, but has been targeted mainly at reaping quick profits.

While such massive redistribution of income and wealth from the poor to the rich continues, few policymakers focus on raising more government revenue, especially through taxes on wealthier Indonesians. But such revenue is essential for an investment-led strategy of development. Raising more revenue will not lower the current rate of consumption-based growth if the additional revenue is used to finance more public investment. Besides, relying on consumption to spark growth will soon run out of steam because it does not increase the economy's productive capacity.

Given Indonesia's low ratio of taxes to GDP, i.e., only about 13 per cent, there is considerable leeway for raising more revenue. In the 1980s, this ratio was about 20 per cent. Chapter Four explores various options for raising revenue. It argues, for instance, for a modest rise in import tariffs, raising tax rates on wealth, such as urban real estate, and closing loopholes and exemptions (which mostly benefit the rich).

A pro-poor development strategy does not assume, as neo-liberalism does, that public investment necessarily crowds out private investment. In fact, the history of Indonesia's growth from the 1970s until the eve of the financial crisis in 1996 supports the contention that public investment can be a stimulus to private investment and an instrument for redistribution. However, public investment is now threatened from various directions. This problem is at the root of Indonesia's painfully protracted recovery from crisis.

2.3.2 Is There an Alternative?

Fortunately, there are viable alternatives to neo-liberalism. This section sketches out the broad elements of one such alternative. It is based on reviving some of the elements of Indonesia's development strategy prior to the crisis, particularly prior to financial de-regulation. It is based on a more pro-active, developmental state, which takes responsibility for mobilizing public resources adequate to finance essential public investment and services.

The strategy also advocates for a state that is actively concerned with the equitable distribution of the fruits of growth. In many countries, a strategy of growth with equity is likely to be less costly (in terms of the opportunity cost of foregone consumption) than a pure growth strategy (see Box 2.1).

This is likely to be the case for Indonesia as well. Such a strategy would imply a greater emphasis on rural development and public investment in agriculture. It would also involve breaking the monopoly of the economic elite that controls Indonesia's large corporations and providing small and medium enterprises, the engine of employment creation, with greater access to economic opportunities.

This alternative strategy starts with a more aggressive stance towards reducing Indonesia's unsustainable foreign and domestic debt. It advocates a tougher stance with regard to big domestic debtors, who have been massively bailed out at the public's expense. This involves setting up a special court to expeditiously settle any disputes on debts. It also involves the Government's reclaiming of excess recap bonds issued to overcapitalised banks and the consolidation of weaker banks into larger and more viable banks.

With regard to Indonesia's large external debt, the alternative approach advocates that the Government press for eligibility under the Naples terms for debt reduction. This would imply a two-thirds reduction in the stock of debt and favourable rescheduling of interest payments. The strategy also argues that Indonesia should sue for international insolvency and request debt arbitration by an independent international body. Such special bankruptcy provisions would be a key element of Indonesia's corporate restructuring. In this regard, some well-known economists have called for a "super-Chapter 11" (Stiglitz 2002b) and IMF representatives have advanced a similar proposal, although it lobbies for its own role as the arbiter of settlements. Despite opposition from some rich creditor countries, Indonesian policymakers should press ahead with lobbying for such an arrangement.

Without a significant measure of debt relief, national policymakers face formidable barriers to accelerating growth to the rates needed for employment generation and poverty reduction. Early debt relief would free up resources to help finance the investment needed by a pro-poor development strategy. However, the debt burden should not be used as an excuse by policymakers not to undertake pro-poor economic reforms. They still have meaningful policy choices even within the current constraints—choices that can produce faster and more broad-based growth than that offered by neo-liberalism.

This report's alternative approach takes a more assertive stance with regard to mobilizing domestic revenue, which should be used to finance additional public investment, not to pay off the debt. Mobilizing more revenue is preferable to more external borrowing (which can increase the debt burden and the imposition of attendant external conditionalities) or monetization of the deficit (possibly raising the inflation rate). The public investment financed by more revenue can be used, in turn, to stimulate more private investment.

The alternative strategy starts from the analysis that the current lack of private investment is due not so much to a lack of enterprise-level opportunities to garner profits (based on potential revenues and costs) as on the lack of economy-wide aggregate demand. Consumption cannot provide a sustainable boost to demand. Neither are exports likely to do so, at least in the short run. Positive net exports are being achieved mainly at lower overall levels of trade (with imports declining faster than exports). The main lever to jumpstart increases in aggregate demand is public investment, which can have a powerful multiplier impact on the whole economy. This would relieve not only the current demand constraints on the economy but also the more long-term supply constraints that hamper sustainable economic growth.

While the lack of public investment is a central reason for the stagnation of private investment, it is not the only reason. Other factors are capital flight, the lack of foreign finance in general, the lack of credit because of the disorganization of the domestic financial system and the delays in restructuring banks and corporations. Some of these issues are taken up in Chapter Five. But a major point that needs to be underlined here is that domestic investment will have to lead foreign investment and motivate the return of flight capital. The reverse is very unlikely to happen. Foreign investors (and the domestic economic elite with funds abroad) will not invest in a stagnant economy—especially one in which political conditions remain uncertain.

Public investment can help create a coordinated rise in investment (positively affecting both aggregate demand and profit expectations), which can trigger further private investment. Without such a stimulus, private domestic investors are faced with a coordination failure, in which each one is reluctant to invest because others are also reluctant (Rao 2002). The same coordination failure applies to banks, which are reluctant to lend to corporations when general profit expectations are low. The growth sparked by public investment can overcome this

coordination failure, help foster greater investor confidence and eventually provide a "bandwagon" to attract foreign finance.

Keeping the capital account completely open is not a decisive inducement to foreign capital, certainly not to foreign direct investment. Such openness does not, in itself, attract more capital, especially if domestic economic conditions are depressed or stagnant. This is evident from Indonesia's recent economic history. But an open capital account does pose an ever-present danger of a stampede of portfolio investment out of the economy. This is a rising danger because portfolio investment has recently been on the rise.

Indonesian policymakers should consider partially closing the capital account despite the fact that complete openness has long been enshrined as a neo-liberal prerequisite of macroeconomic stability and growth. Other countries, such as Chile, China, Malaysia and Vietnam, have done well without open capital accounts. And international consensus has recently shifted in favour of some limited controls in view of the negative experience of many countries during recent financial crises.

Partially closing the capital account will provide greater autonomy for domestic monetary policy. Regulating the capital account can be done through higher reserve requirements, minimum holding periods or exit taxes. Some economists argue that exit taxes are preferable to direct controls because they have fewer adverse side effects and can be modified as the crisis subsides (Stiglitz 2002b). This is the option that Malaysia chose in the heat of the Asian financial crisis and helped enable it to weather the difficulties.

With a more regulated account, the Government could have greater success in lowering interest rates, which, as a means of easing monetary policy, could help generate more growth. Real interest rates have come down in Indonesia, but should come down further, particularly for lending. The present system of inflation targeting, which seeks to achieve inflation rates in low single digits, is too restrictive to generate the demand necessary for higher rates of growth. Continued monetary easing is desirable. Already, the CPI inflation rate is dropping towards a yearly average of 6-7 per cent in late 2003, and could well drop further as consumption demand declines. If inflation increased, it would not likely be harmful to growth. Historically, inflation rates above 10 per cent have not been detrimental in Indonesia.

The evidence from Indonesia's experience points paradoxically to a generally positive, not a negative, relationship between inflation and economic growth (Chowdhury 2002). There appears to be no evidence that an inflation rate in the range of 8-15 per cent would dampen economic growth. Only when the rate is over 40 per cent has there been a negative impact of inflation on growth. Thus, attempting to drive inflation rates well below 10 per cent (and preferably below 5 per cent) is unnecessarily restrictive.

In order to lower inflation rates, monetary policy is often kept relatively tight, thus maintaining relatively high real rates of interest. But such rates are an impediment to growth in circumstances where the corporate sector is heavily indebted, which is the case for Indonesia. Few corporations in developing countries can rely on equity financing for their investment. If debt is too expensive or risky, they will lower their borrowing and will have to turn to retained earnings. But high profit margins are unlikely in a slow-growth scenario (Stiglitz 2002b). Hence, under such conditions, a policy of relatively high interest rates leads, in fact, to a less efficient allocation of resources.

It is difficult to achieve some consistency between fiscal and monetary policies when a central bank, such as Bank Indonesia (BI), remains largely autonomous—and appears committed to low-inflation targeting, for the sake of "investor confidence". While BI should have autonomy

in determining its policy instruments, its objectives should be subject to public discussion and oversight. Moderating Bank Indonesia's complete autonomy need not open the floodgates to profligate "populism," as neo-liberal economists often fear. By setting inflation targets that are too low, BI can, in fact, compromise the achievement of other objectives, such as growth of income and employment generation, which most people value highly, in addition to price stability.

A partial closing of the capital account could allow national policymakers not only to further ease monetary policy but also to re-institute a managed float for the rupiah. A freely floating exchange rate (especially in conjunction with unregulated capital flows) exacerbates short-term volatility in an economy, raises risk premia on investment and invites more speculation on the exchange rate. With some regulations on capital flows, a managed float for the rupiah could allow for enough flexibility to enhance the international competitiveness of Indonesian exports without subjecting the economy to sudden and unnecessary exchange-rate fluctuations.

2.4 Macroeconomic Policies for Poverty Reduction

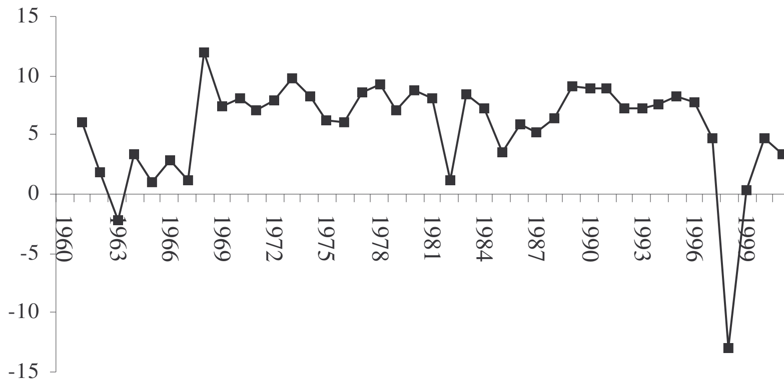
This section examines more closely the character of macroeconomic policies in Indonesia. This examination involves an evaluation of the impact of fiscal policies, monetary policies and exchange-rate policies on growth and poverty. The section begins with an examination of the sources of growth in the economy and the implications for policymaking.

2.4.1 Sources of Growth in the Indonesian Economy

For about 30 years, from 1968 to 1996, the Indonesian economy grew at a phenomenal rate of 7.5 per cent per annum. Over this period, growth was fairly balanced, with exports, private investment and government expenditures all making major contributions to the growth dynamic. Then in 1997, the Asia financial crisis struck the country, leading to a catastrophic decline in national income of twenty per cent from the last quarter of 1997 to the last quarter of 1998.

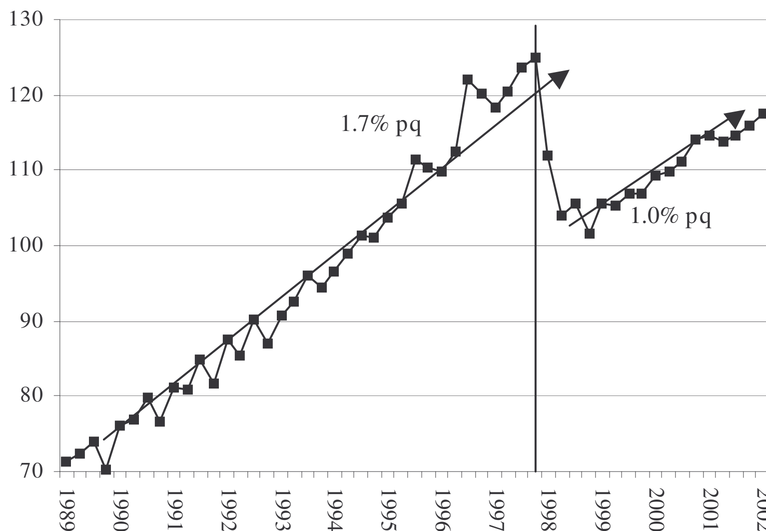
The dramatic fall in national income is shown in Figure 2.1, which gives the annual growth of gross national product in constant prices from 1960 to 2001. From 1968 through 1996, the annual growth rate fell below seven per cent in only seven of the 29 years, and below six percent in only three years. By contrast, during the five-year period 1997-2001, the growth rate failed to reach even five per cent. The impact of the crisis is revealed even more dramatically by quarterly data, as shown in Figure 2.2. From the first quarter of 1989 through the second quarter of 1997, GDP grew at a quarterly rate of 1.7 per cent (seven per cent per annum). Recovery from the crisis began in the first quarter of 1999, after which the economy grew at a quarterly rate of only one per cent (4.1 per cent per annum).

Figure 1: Indonesia Annual GDP Growth, 1960-2002



Understanding why Indonesia's recovery has proved so slow is essential to formulating a pro-poor development strategy. As a first step, this section investigates the determinants of growth on the demand side over the period 1972-1999. The initial year is chosen because of the availability of statistics that allow disaggregation between public and private investment. The terminal year is selected in order to contrast the period of rapid growth to the years of crisis.[3]

Figure 2: Indonesia, Quarterly Index of GDP, 1989-2002



Our calculations derive from the basic national income identity:

$$Y = C + I + G + (X - M)$$

[3] Our calculations are analogous to those used by the IMF in its 2001 report on Indonesia (IMF 2001).

Consumption (C) and investment (I) are separated into private and government. Private consumption and imports (M) are assumed to be functions of national income (Y), as is standard procedure. The autonomous components are private investment (Ip), government consumption (Cg), government investment (Ig), and exports (X). Keeping with standard presentation, the expanded identity is as follows:

$$Y = Cp + Ip + [Cg + Ig] + [X - M]$$

The equation becomes an identity by including inventory change in private investment. If α is the marginal propensity to consume out of GDP, β is the marginal propensity to import out of GDP, t is the marginal generation of government revenue, S_j is each component's share in GDP, and lower case letters indicate growth rates, then the growth rate of GDP is:

$$y = \{S_{cp}c_p + S_{ip}i_p + S_{cg}c_g + S_{ig}i_g + S_x x\}/\{1 - \alpha[1 - t] + \beta\}$$

The sources of demand calculations are based on Table 2.1 (growth rates). The numbers in bold are the standard textbook categories: household expenditure, private expenditure, government expenditure, and exports and imports, divided into four time periods, 1972-1980, 1980-1990, 1990-1996 and 1996-1999.[4] Marginal values for shares are given for each time period in Table 2.2.

Table 2.1. Indonesia: Growth Rates of National Income Categories, 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999
Private consumption	**4.2**	**7.8**	**8.9**	**-3.2**
Investment	9.3	9.0	7.8	-11.0
Private	**7.1**	**11.7**	**9.0**	**-10.0**
Gov't	13.9	3.0	3.2	-16.0
Total gov't expenditure	**12.5**	**3.9**	**4.3**	**-11.0**
Gov't consumption	11.3	4.5	5.1	-7.8
Exports	**17.4**	**3.2**	**8.2**	**7.3**
Imports	**11.1**	**8.1**	**9.8**	**-2.4**
GDP	8.0	6.4	7.8	-3.0

Source: World Bank, *World Development Indicators 2001* (CD-rom)

Some analysts have argued that the downturn in Indonesia was moderated by the behaviour of households, which maintained their expenditures in the face of income falls. This allegation has been extended to conclude that the recovery is 'consumption-led' (World Bank

2003, p. 1-3)—a presumptuous conclusions since consumption is not autonomous of income. A glance at Table 2.2 indicates that the former is not correct, for the marginal propensity to consume out of GDP (less government revenue as an approximation of disposable income) was the same during the downturn as in the previous time period. The only category of demand that did not fall, as one would predict, was exports—which rose as GDP declined. While export growth declined, net exports were boosted by the negative growth of imports.

Overall, the behaviour of the private and external components of GDP are what a simple Keynesian model would predict: private consumption had an elasticity with respect to GDP not significantly different from unity; import demand showed an elasticity of greater than one; private investment was highly volatile; and producers turned to the export market when the home market collapsed. With regard to policy components, government investment was strongly pro-cyclical (e.g., declining along with the economy), and government consumption expenditure slightly pro-cyclical. Thus, policy magnified the downturn.

It is striking to note that the economy became much more volatile during the downturn, with the autonomous expenditure multiplier more than doubling, from 1.56 to over 3.20. In other words, automatic stabilisers, which had moderated the volatility of the economy during 1970-1996, virtually disappeared. The biggest contributors to increased volatility were private investment and public investment, both of which plunged dramatically during the crisis, and dragged down much of the economy with them.

Hopes that future growth might be based on 'consumer confidence' have little support from past behaviour, before or during the crisis. The recent upturn in growth of consumer expenditures in 2001-2002 does not contradict this underlying dynamic. Consumer financing has

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[4] There is no overlap in the calculations. Shares are calculated for the periods 1972-1979, 1980-1989, etc; while growth rates are compounded for the periods 1972-1980, 1980-1990, etc.

propped up most of the consumption expenditures. And in 2003 these have begun to decline, as the underlying factors driving growth, such as exports and private investment, have weakened.

Table 2.2. Indonesia: Marginal Shares in GDP of National Income Categories, 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999
Private consumption	.31	.68	.68	.75
Investment	.27	.38	.31	1.05
Private	.13	.35	.28	.80
Gov't	.13	.04	.02	.25
Total gov't expenditure	.26	.11	.08	.44
Gov't consumption	.13	.07	.05	.19
Exports	.54	.15	.27	-.70
Imports	.25	.28	.31	.21
Marginal propensities				
To consume (Yd)	.48	.80	.78	.78
To generate revenue	.31	.16	.14	.03
Multiplier	1.03	1.66	1.56	3.20

Note: For 1996-1999, all categories were negative except exports.
Source: World Bank, *World Development Indicators 2001* (CD-rom)

Table 2.3 uses the previous calculations to decompose the growth in aggregate demand into the percentage points contributed by major components, and Table 2.4 shows these as percentages of the aggregate growth rate. Growth in the 1970s—which was the fastest compared to any subsequent period--can be described as primarily 'export-led' since external demand represented almost 60 per cent of total demand (column one, Table 2.4). However, government expenditures accounted for 27 per cent of total demand, with government investment, in particular, responsible for over 13 per cent. Since the 1970s, both these percentages have declined.

By contrast, the 1980s were 'investment-led', largely by the private sector,[5] since private investment rose to account for a little over 60 per cent of total demand. There was also still a

notable contribution of government investment to total demand, i.e., 6.9 per cent. However, during 1990-1996, before the crisis, private investment (domestic plus foreign) had dropped to become virtually equal to export demand. Public investment had also declined, namely, to 5.6 per cent (down from 6.9 per cent in the 1980s and 13.2 per cent in the 1970s). The economy had become more vulnerable to an exchange-rate shock as the domestic drivers of growth diminished.

During 1996-1999, virtually all drivers of growth collapsed, except for exports. While GDP growth averaged a minus three per cent, private investment plummeted on average by about eight per cent and government expenditures dropped by almost three per cent. At the same time, exports grew on average by eight per cent.

Table 2.3. Indonesia: Percentage Point Contributions to Aggregate Demand, 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999
Investment	2.2	4.3	3.8	-9.9
private	**1.1**	**3.9**	**3.3**	**-8.1**
Gov't	1.1	.4	.4	-1.7
Total gov't expenditure	**2.2**	**1.2**	**1.2**	**-2.9**
Gov't consumption	1.1	.7	.8	-1.1
Exports	**4.7**	**1.4**	**3.4**	**8.0**
GDP growth	8.0	6.4	7.8	-3.0

Source: World Bank, *World Development Indicators 2001* (CD-rom)

Table 2.4. Indonesia: Relative Contributions to Aggregate Demand (percentages), 1972-1999

Category	1972-1980	1980-1990	1990-1996	1996-1999	1972-96
Investment	27.5	67.2	47.2	-327.6	49.9
private	**14.3**	**60.3**	**41.6**	**-270.7**	**41.4**
gov't	13.2	6.9	5.6	-56.9	8.5

[5] Very little of the private investment was from abroad. In no period could it have accounted for more than a tenth of a percentage point of aggregate demand. Precise calculations are not possible because the FDI data are a balance of payments category, indicating capital inflows, not actual investment.

Total gov't expenditure	**27.0**	**18.7**	**15.4**	**-95.6**	**20.4**
gov't consumption	13.8	11.7	9.8	-38.8	11.9
Exports	**58.7**	**21.0**	**42.9**	**366.3**	**38.2**
GDP growth	100.0	100.0	100.0	100.0	100.0

Source: World Bank, *World Development Indicators 2001* (CD-rom)

This analysis of trends in the drivers of demand growth, especially since 1999, suggests that regaining a strong growth rate will be based on resuscitating investment, both public and private, rather than exports. In recent years, exports have been in dramatic decline. Also, in the medium term the world economy is unlikely to generate a rate of growth of trade that would allow Indonesia to achieve the export expansion that it did in the 1970s.

Thus, while a robust export performance is necessary to relieve the foreign exchange constraint, pro-poor growth in Indonesia will be based in practice on growth of investment. But the revival of private investment—as well as of exports—will depend to a significant degree on expanding public investment.

The country's past economic performance suggests that public investment has "crowded-in" private investment, not "crowded it out" (see Box 2.2). During the period 1972-1997, for example, every one percentage point increase in public investment corresponded to a 0.66 percentage point increase in private investment.

2.4.2 Fiscal Policy and Effective Demand for Pro-Poor Growth

In light of the present state of the world economy, it is unlikely that Indonesia in the near future will achieve the 7.5 per cent rate of growth that it enjoyed during 1968 to 1996. A more realistic target would be 5-6 per cent, which would imply per capita growth of 3.5 to 4.5 per cent per annum. A central question is: what will be the source of the aggregate demand necessary to achieve this growth target?

As shown in the previous section, the growth of the economy before the crisis was relatively balanced in terms of the distribution of aggregate demand. Over the years 1972-1996, total investment contributed slightly less

than half of the increment in demand, with private investment representing 41.4 per cent and government investment 8.5 percent (with foreign investment accounting for only about 1.5 per cent). The contribution of exports was 38 per cent, and that of current public expenditure 12 per cent.

As already suggested, it would be optimistic to assume that export growth in the medium term could achieve the average contribution that it made for the entire period of rapid growth. Only in the 1970s did exports grow at a pace that led the economy to a boom, and world market conditions are now considerably less favourable than during that period.

Doubts must also be cast upon the likelihood that growth could be led by private-sector investment. For example, the Asian Development Bank's country review for 2002 comments, "low investment has raised concerns that future growth prospects will be limited" (ADB 2002, p. i). The report goes on to note that "the current share of GDP allocated to private investment is low by recent historical standards" (ADB 2002, p. 5) and cites the Indonesian Coordinating Board for Investment (BKPM), which reported a fall in investment projects by both foreign and domestic firms.

As mentioned before, private investment is not constrained by savings: on the contrary, in recent years the private-sector balance (investment minus saving) has been negative (ADB 2002, p. 6), implying a contractionary effect on aggregate demand. If neither exports nor private investments are likely to be engines of expansion in the near future, a strong growth performance will require expansionary fiscal policy, as basis for both revising private investment and strengthening exports.

There is scope for increasing government expenditure since the overall deficit was 2.3 per cent of GDP for 2000-2003.1. Until recently, none of these deficits has been financed through domestic borrowing; instead, they have been covered by asset sales and foreign assistance inflows. In terms of fiscal policy, only the foreign assistance component was expansionary. A legal change to allow for domestic borrowing for a further fiscal stimulus was justified in light of the economy's slow growth rate. Fortunately, Parliament made this change in 2003, allowing a government bond market to open up.

The consensus of the IFIs is that "the biggest constraint on fiscal policy is the need to meet debt service obligations," (ADB 2002, p. 7), which primarily arise from bank recapitalisation. What is frequently omitted from the discussion of domestic debt service, which averaged 3.5 per cent of GDP for 2000-2002, is that it represents a political decision rather than a technical imperative. More specifically, it represents a political decision about who will pay for the financial crisis. Interest payments on the domestic debt represent a substantial redistribution from the majority of the population, via public revenue and asset sales, to the commercial banking system. In the case of private-sector banks, the redistribution is regressive since the owners of banks are the wealthiest Indonesians. For state banks, the redistribution is also regressive, since public expenditure is switched from social services to support for institutions that lend primarily to the wealthy.

Thus, the interest payments imply that most of the Indonesian population bears the cost of recapitalizing a banking system that in part was responsible for provoking the crisis through its imprudent lending practices. This is unwise public policy for several reasons. First, for practical purposes, it institutionalises 'moral hazard'. Recapitalizing the banks, with full coverage of their lost assets, carries the lesson that banks will be rescued from the consequences of reckless financial practices. Second, it is profoundly regressive in its effect on the distribution of national income. As a direct consequence, any given rate of economic growth will be less poverty reducing. Third, it shifts the cost of the crisis to households that suffered most during the crisis, and away from those who suffered least.

It goes without saying that Indonesia requires a sound banking system to finance the investment needed for economic growth. However, this fact should not be treated as a blank check for the banking system. It is encouraging that the Government recently decided to end its policy of recapitalizing banks to the full amount of their lost assets. Had this approach been taken from the outset, the interest burden would be considerably lower than it is now.

Further steps can be taken. A moderate one, which would have a substantial impact, is to recapitalize to the minimum capital adequacy ratio that is nationally acceptable, rather than raising it to international 'best practice'. Second, since the recapitalisation bonds are, in effect, a free gift to the banks from the public, it would be justified to issue them at below-market interest

rates. Third, and complementary to the second, a bold step could be taken to set an upper annual limit to the interest payments on recapitalisation bonds. Such a step would not meet with the approval of the financial sector, but would be consistent with an international consensus on advocating debt relief for poverty reduction.

Just as the HIPC initiative has reduced international debt to official lenders on the condition that the savings be used for poverty reduction, so could the service on Indonesia's domestic debt be relieved in order to support the Government's commitment to poverty reduction. This would establish the principle that during the economic recovery, the remaining costs of the financial crisis will be shared and made contingent on achieving a recovery that benefits the whole population. While the policy is bold, the principle upon which it is based represents fairness in its simplest form.

2.4.3 More Expansionary Monetary Policy

During the crisis of mid-1997 through 1999, the Indonesian Government tried to use the central bank rate to maintain the exchange rate but it totally failed to achieve this objective (See Chapter One). Indeed, many analysts have argued that the interest rate policy applied during the crisis was a major factor that turned what could have been a severe downturn (as in other countries of the region) into an unprecedented catastrophe.

The conversion of the Indonesian currency crisis of mid-1997 into a collapse of the real economy was the direct result of attempting to support the Rupiah by use of the central bank rate. From July to August 1997, the central bank rate doubled, from 11 to 22 per cent. Over the same period, the nominal exchange rate rose (depreciated) from about 2500 to 3000 to the US dollar. During the next 8 months, the bank rate more than trebled, to 71 per cent, and the exchange rate ballooned to 14,000.

The interest rate increases had no strengthening effect on the exchange rate. Indeed, during 1996-2000, the relationship between the central bank rate and the exchange rate was *positive* (i.e., higher interest rates were associated with depreciation of the exchange rate). While this would appear to defy all theory, there was a simple explanation. Due to conjunctural factors, the collapse of the exchange rate could not be stopped. Operating as if the interest rate could do so, Bank Indonesia was, in effect, letting the interest rate be led upwards by the exchange rate. If one lags the exchange rate one month, for instance, it explains almost 40 per cent of the variation in the interest rate.

As chasing the exchange rate sent the interest rate upwards, domestic debt service costs helped drive the private economy to collapse (with the negative correlation coefficient between the nominal interest rate and real GDP being about two-thirds). This correlation need not imply causality, but in this case the mechanism by which the nominal interest rate devastated the growth rate can be identified specifically. In 1996, with an exchange rate of 2342 Rupiah to the dollar and a central bank rate of 11 per cent, the operating surplus of the manufacturing sector was 19 per cent of total revenue. For 1997, the Rupiah averaged 3550 to the dollar and the interest rate 14.5 per cent, a combination that resulted in a surplus of about 15 per cent of revenue. When in 1998 the exchange collapsed to an annual value of almost 10,000 and the interest rate averaged almost 50 per cent, the operating surplus turned negative, to minus 10 per cent of revenue.[6] The response of the private sector to the collapse of profitability was widespread bankruptcy and a massive drop in real output.

The sharp decline in aggregate output caused by the high interest rates also explains the run-away inflation in 1998. So rapid was the fall in output that it left an excess demand for goods, which pushed prices up. Of course, devaluation itself was fuelling inflation, but contractionary high-interest rate policy also played an important role.

The inflation story was as follows: the fall in output and the runaway inflation were both the result of the futile attempt to arrest the collapse of the exchange rate by means of the central bank rate. The devaluation generated inflation at the expected 'pass-through rate'—that is, it was transmitted in proportion to the share of imports in GDP. At the same time, given the growth of the money supply, falling output produced an inflationary effect, with an elasticity of unity (as the Quantity Theory would predict).

Misuse of the interest rate during the crisis to support the currency should not be revisited in the name of 'targeting' inflation. Given the severity of the Indonesian crisis, which resulted in the collapse of the country's financial infrastructure and productive investment, it is not surprising that inflation rose initially and has remained relatively high—until very recently.

Indeed, what is striking is that recent inflation has been roughly in line with historical experience—until 2003, when it began to drop due to dangerously flagging aggregate demand. During the 1970s, when the economy grew at eight per cent per year, the consumer price index showed an annual rate of increase of 17 per cent. In the following decade, a lower rate of economic growth was accompanied by a lower, but substantial, rate of inflation of 10 per cent. During 1990-1996, the growth rate returned to eight per cent and inflation continued close to double figures, at nine per cent. Thus, for almost three decades of rapid growth, the economy averaged double-digit inflation, with a relatively low standard deviation. This historical experience casts doubt on allegations that recovery in Indonesia requires a very low inflation rate.

In fact, the inflation rate is continuing to drop well below 10 per cent, indicating that fiscal and monetary policies are not yet sufficiently expansionary in order to forestall a marked slowdown in growth. In Indonesia's current circumstances of weak aggregate demand, an inflation rate that is dropping towards six per cent per annum is a worrying sign.

Furthering moderating real interest rates would contribute to pro-poor growth since they would be associated with monetary expansion, which would stimulate money demand and lower the costs of investment. An appropriate guideline for policy would be the so-called Golden Rule—namely, that the real interest rate for investors and savers should approximate the sustainable rate of growth of per capita income. Assuming that a growth rate of 5-6 per cent could be sustained, and population growth in the medium term would be between 1.5 and 2 per cent, the growth-accommodating real interest rate should be 3-4 per cent.

From the second half of 1999 through mid-2000, the real central bank rate averaged almost 10 per cent, then 5 per cent from mid-2000 to the end of 2001. Briefly in early 2002, the real interest rate approached the Golden Rule level (i.e., equal to the long term growth rate), before rising again. Bank Indonesia has continued, since then, to lower policy interest rates (such as on the SBI) but real lending rates in the market have remained stubbornly high. While deposit rates have declined, the spread between them and lending rates has widened. By end 2002, for example, the real lending rate of interest for working capital was still over eight per cent (with a nominal rate of about 18 per cent versus an inflation rate of about 10 per cent).

While monetary policy can be geared to bring such rates down further—particularly for investment credits—in order to stimulate more rapid growth, part of the solution lies in overhauling the banking sector and putting it back on its feet. Another part of the solution is to utilize more expansionary fiscal policy to step up growth and revive banking sector confidence in the economy. Since aggregate demand is already perilously slowing down, such a fiscal expansion is unlikely to accelerate inflation to unmanageable levels.

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[6] This discussion is based on calculations in a technical paper prepared for this report by John Weeks and available from the author.

2.4.4 Exchange Rate Policies and the Capital Account

If ever there were a country in which market-based controls on the external capital account represented rational policy, it is Indonesia at the beginning of the twenty-first century. This is all the more the case because expert opinion has shifted towards greater acceptance of such controls. The rationale for capital-account regulations derives from basic factors constraining the recovery of the economy: the severity of the crisis from which it has emerged, lack of investor confidence and international capital market volatility.

A legacy of the collapse of the Indonesian economy is an exceptional degree of pessimism about economic institutions and the capacity of the country to regain its historically strong growth performance. The collapse of the economy has destroyed or severely damaged many key economic institutions, with the banking system being the most obvious.

Investor confidence remains highly volatile and is currently ruled by pessimism. Circumstances call for interim capital controls, which would be maintained until the economy recovers to a strong growth performance, which would re-establish, in turn, expectations of long-term profitability.

Given this domestic situation, the Government of Indonesia is not well equipped to deal with the expected volatility of international capital markets. Prudential controls, weak before the crisis, have yet to be adequately established. International volatility combined with domestic vulnerability to external shocks make a strong case for capital controls.

The precise form these take will depend on the goals of the Government with respect to exchange rate stability, the type of foreign investment that it seeks to attract and the capacity of the Government to implement controls. These constraints can be incorporated into an effective package of regulations, as has been done in other countries, most notably Indonesia's neighbour, Malaysia.

With some controls on the capital account, policymakers could revert to a managed float for the exchange rate—a policy that they abandoned during the panic of the financial crisis. A managed float could contribute to the kind of economic stability that entrepreneurs need in order to make investment plans. With volatile exchange rates, which can be associated with a free-floating currency, banks are reluctant to lend and corporations are reluctant to invest because of the risks involved.

2.4.5 Investor Confidence

The need to boost investor confidence provides much of the rationale for the current choice of economic policies. According to conventional wisdom, the cause of the Indonesian crisis is explained by the following superficial argument, which turns on the concept of 'investor confidence': 'investors' had established limits for major economic indicators, which, if they had not been exceeded, would have maintained their 'confidence'. The explanation goes on to state that the crisis was so severe and the recovery so slow because the Indonesian Government failed to maintain the indicators within that range.

This simple story has several problems, each of which is potentially fatal. First, there may be no consensus among 'investors'. The lack of a consensus can result from 1) different investors having different degrees of access to information 2) investors having the same information, but different economic interests[7] and 3) investors having different analytical frameworks to process economic information. If there is no consensus, then the 'sustainable' range into which outcomes must fall to maintain confidence may be so wide as to be irrelevant for practical policy. A problem is that in the absence of a consensus, there may be no range that all major market agents judge as sustainable. Second, the control that governments have over outcomes is limited by the effectiveness of policy instruments, the capacity and experience of policymakers and the non-deterministic nature of economic and social behaviour.

Even if one assumes that economic processes are deterministic, so that outcomes are strictly stochastic in the sense that precise probabilities can be assigned to all possibilities, the 'investor confidence' argument can still breakdown logically and practically. Consider, for example, a 'confidence range' so narrow that purely random effects on policy would result in outcomes falling beyond the boundaries of this range during a high proportion of the time (see Box 2.3). That is, by a Rational Expectations argument (which holds that the expectations of market agents are fulfilled on average), one could predict that instruments would produce outcomes in the centre of the range *on average*, but the actual outcomes, even with 'best practice' policies of the international financial institutions (IFIs), would fall outside the range, say 20 per cent of the time. In such a situation, the loss of 'investor confidence' is the result of neither bad policy nor unstable international markets, but the consequence of a mismatch between investor rules of thumb and the inherently stochastic nature of economic phenomena.

If, as is likely, there is no consensus among investors, and instruments have limited and occasionally unpredictable effects in Indonesia, then the 'investor confidence' argument completely breaks down. To quote the head of the United Nations Support Facility for Indonesian Recovery,

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[7] For an insightful discussion of this point, see Mishra (2000). He points out, 'In fact the investor community in Indonesia today is divided into a wide range of categories: large and small, debtors and creditors, foreign and domestic, Chinese and Pribumi, portfolio and direct (p. 22)'. With this in mind, he goes on to warn,

> Singing the mantra of some generic 'investor confidence' or using such a term as short hand for 'foreign' investor confidence will actually serve to diminish rather than enhance the confidence of long-term investors. (p. 2)

There is a consensus that countries in the midst of a crisis need to restore confidence. How can this be done?...Confidence is an elusive concept. One is tempted to define it as a successful outcome, but then we are left with the unhelpful tautology that successful policies lead to successful outcomes. (Mishra 2000, p. 30)

Box 2.1: Redistribution Matters in Indonesia

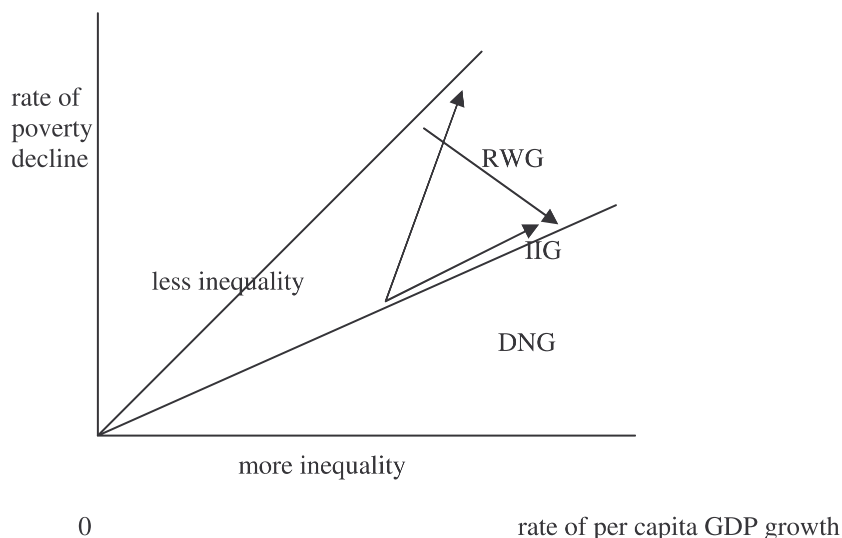
Contrary to what the prevailing orthodoxy might suggest, income redistribution can have a major impact on poverty. The validity of this general principle is demonstrated in the diagram below. The relationship between economic growth and poverty reduction is determined by the overall distribution of income and the distribution near the poverty line. The economy-wide distribution sets the potential for redistribution, while the distribution near the poverty line determines the impact of redistribution on the poor. If the poor are clustered just below the poverty line, then a given distribution will reduce poverty more than if most of the poor are well below that line.

The diagram treats the distribution near the poverty line as an extension of the distribution function for the entire population. The steeper line reflects a more equal distribution of income. Three possible growth paths are shown. On the basis of recent empirical work (Cornia 2001), it would appear that a common outcome in the 1990s was Growth with Increased Inequality (line GII). In this case, the poverty- reducing effect of growth declines. Alternatively, growth can be Distribution Neutral Growth (argued by Dollar & Kraay 2000), and the rate of poverty reduction is constant as the economy expands (line DNG). Most favorable for the poor is Redistribution With Growth (line RWG), in which any growth rate is associated with more poverty reduction.

The practical importance of these logical possibilities is substantial for Indonesia. Using the distribution of income for 1996 (Gini coefficient of 36.5), a rate of growth of one per cent per capita that was distribution neutral would reduce poverty by 0.5 percentage points. That same rate of growth, distributed in equal absolute amounts across all households, would reduce poverty by 1.27 percentage points. In other words, with regard to poverty reduction, a one per cent per capita redistributive growth is equivalent to a distribution neutral growth rate of 2.5 per cent. Such a one-year redistribution rule would have reduced the Gini coefficient only to 35.7. This change is quite small compared to actual changes in distribution in the country. In 1970, Indonesia's Gini coefficient was a modest 30.7. For Indonesia and a large number of other developing countries, Lübker has shown that regaining historic levels of income equality would have a dramatic impact on poverty reduction.

The difference between poverty reduction with distribution-neutral growth (DNG) and redistributive growth has important resource implications. To achieve the same poverty reduction as a one per cent increase in redistributive growth, DNG must rise by an additional one percentage point. Assuming the aggregate capital-output ratio in Indonesia is 3.0, this increase would require a rise in net investment of 3 percentage points. By any reasonable estimate of the administrative costs of redistribution, the opportunity cost of reducing poverty through redistribution should be less than for generating growth alone.

Alternative Growth Paths and Poverty Reduction



For further discussion, see Dagdeviren, van der Hoeven & Weeks (2002) and Lübker (2002).

Box 2.2: Crowding-In in Indonesia

In the orthodox analysis the relationship between government expenditure and private expenditure is viewed as negative: increases in government expenditure tend to 'crowd-out' private expenditure. A special case of this is investment, in which government capital expenditure reduces private capital formation. In the abstract, this can occur under two general circumstances. First, if the economy is at full employment, an increase in any category of expenditure must reduce another category. At less than full employment, crowding out might occur if the government and private sector compete over the same investment opportunities.

Also possible is 'crowding in', in which government investment stimulates private investment. At less than full employment, government investment can stimulate private investment if 1) the former stimulates the overall level of demand, thus increasing the rate of capacity utilisation in the private sector, and inducing private investment to expand capacity; and 2) if the public investments are specifically chosen to reduce private sector costs, through construction of roads, communication facilities, and other public goods. During 1968-1997, the Indonesian Government implemented many investments to achieve the latter effect. Using national income data from the World Bank's World Development Indicators, it is possible to test for 'crowding-out' and 'crowding-in'.

One can specify the **capital stock** to be equal to

$K = vY$, where K is the capital stock, Y is potential output, and v is the marginal capital-output ratio.

the change in the capital stock, net investment, is

$\Delta K = I = v\Delta Y$, and $\Delta Y = Y_t - Y_{t-1}$

To test for 'crowding' effects, one includes the level of government investment, GI, and estimates:

$I_t = \alpha_0 + \alpha_1[\Delta Y_t] + \alpha_2[GI_{t-1}] + \varepsilon$

The theory predicts that α_0 should not be significantly different from zero, and that α_1 should be considerably less than one. When this is estimated empirically in logarithmic form for 1972-1997, the years for which there are data up to the economic crisis, the result provides strong support for the 'crowding-in' hypothesis (the numbers in parenthesis show the levels of statistical significance).

$I_t = .381 + .333[\Delta Y_t] + .736[GI_{t-1}]$

(nsgn) (.01) (.00)

Adj. $R^2 = .79$; F-stat = 45.0

Durbin-Watson stat = 1.61

Degrees of Freedom = 22

As predicted, the constant term can be taken as zero, and the implied capital-output ratio for the economy as a whole is three (low, but in the expected range). The coefficient α_2 indicates a strong 'crowding-in' effect. The average values of I and GI for the period can be used, along with α_2 , to calculate the elasticity of private investment with respect to government investment. This yields a statistic of 0.66. In other words, over the years 1972-1997, a one percentage point increase in government investment was associated with an increase in private investment of 0.66 percentage points.

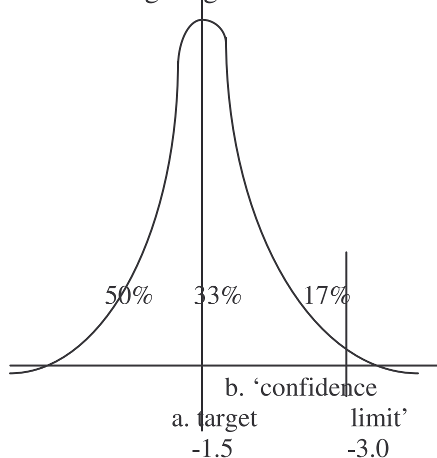
A more complete model of private investment would include other explanatory variables, such as relative costs and capacity utilisation. However, the simple model above sustains the hypothesis that government investment crowded-in, instead of crowding-out, private investment. If one tests the hypothesis using total government expenditure instead of public investment, crowding in is also sustained, with a higher crowding-in elasticity of slightly less than one, with the constant term not significantly different from zero.

Box 2.3: Sound Policy Results in 'Loss of Confidence'

Governments do not determine economic outcomes by their policies; rather, those policies affect outcomes subject to random (stochastic) changes that affect economic agents. Consider the case in which 'investors' have a consensus that a budget deficit of over 3 per cent of GDP would result in the loss of their confidence in the economy. To be safe, the government sets fiscal and monetary policies to achieve a deficit of 1.5 per cent of GDP. If these policies could be repeatedly applied in exactly the same circumstances, the mean of the outcomes would be the government's planned deficit level. However, the actual outcome will be somewhere on a normal distribution around the intended policy-generated outcome. In the diagram below, there is one chance in six that the 'sound' policies will be associated with a confidence-breaking outcome. If the standard deviation of the normal distribution is higher than that assumed in the diagram, then the probability of loss of confidence from 'sound' policies is greater. Thus, the larger the expected variation around the policy outcome, the more cautious the policy-designated outcome must be (i.e., point *a* must be further to the left of point *b*). Since the policy package cannot be applied under the same conditions more than once, investors cannot tell whether the unacceptably high deficit is the result of random shocks or 'bad' policy.

Also assume that the deficit chosen by the government was that which would be associated with the desired rate of economic growth, and smaller deficits (or surpluses) would reduce the rate of growth by suppressing aggregate demand. In such a case, an attempt by the government to reduce the probability of destroying investor confidence would result in lower growth. To avoid trading growth for investor confidence, the government might introduce exchange rate controls in various forms, hoping to reduce the consequences of the most devastating manifestation of loss of confidence, i.e., capital flight.

Fiscal Deficit Targeting Can Fail Due to Random Factors:



In Indonesia during the Asian financial crisis it appears that investors were so risk-shy that the distribution of values around the mean was extremely wide, and not even extremely high interest rates and fiscal tightening could regain private-sector confidence. Thus, there was a strong technical case for capital controls.

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Chapter Three

Equitable Development and Trade Liberalization[8]

3.1 A Pro-Poor Development Strategy: The Equity Dimensions

Although the investment-led path that this report recommends should lead to more rapid growth than the modest rates achieved so far, a pro-poor development strategy requires more than economic growth. The impact on poverty also depends on the pattern of growth. Is growth, for example, having a more equitable impact on people's livelihoods or is it mainly benefiting an economic elite with only second-round trickle-down effects on the poor? So far, the available evidence suggests that the economic elite has been the main beneficiary of economic policies in Indonesia.

For growth in Indonesia to be both more rapid and more pro-poor, policymakers need to adopt a set of sectoral and redistributive policies that complement the kind of macroeconomic and restructuring policies that this report recommends. This is the topic of the first half of this chapter.

Chapter Two has already covered macroeconomic policies—namely, fiscal, monetary and exchange-rate polices. Restructuring policies are covered in the rest of this report, starting with the second half of this chapter, which covers trade liberalization. Following that, Chapters Five and Six cover financial liberalization and privatisation.

The first half of this chapter concentrates on economic policies that can foster 1) more agricultural development, since the majority of the poor have livelihoods tied to this sector; and 2) faster development of small and medium enterprises (SMEs), since they are more likely than large corporations to generate employment among a broad majority of the working population.

Much of the growth in Indonesia in the medium term will still rely heavily on agriculture. Agricultural growth will also be the main engine for poverty reduction. Urban manufacturing is unlikely to recover soon the dynamism it enjoyed in the pre-crisis period. This puts a premium on increasing public investment in agriculture and rural development in general. The priorities are the re-allocation of resources to investments in rural infrastructure and social services.

Encouraging greater agricultural diversification will also help raise rural incomes, principally on the island of Java, where rice production predominates. Since land is in short supply and becoming increasingly fragmented on Java, raising productivity is an essential focus. One approach is to re-allocate land and labour to more productive uses. Another is to apply more efficient technology. Diversification on Java should be complemented, however, by increases in rice production off Java since this will help safeguard food security by holding down rice prices. Since rice is the most important wage good, keeping its price low will help speed industrialization.

More pro-active public policies to spur the growth of small and medium enterprises will also contribute to a more equitable pattern of economic growth. SMEs are the main source of employment, but most of their employment is concentrated in low-wage jobs in small enterprises. The monopoly of large corporations over government resources and services needs

[8] This chapter was written by Terry McKinley,Rina Oktaviani, Hendri Saparini, Anwar Shaikh and Umar Juoro.

to be broken, especially in order to foster the growth of medium-sized enterprises, which have the most potential to provide widespread employment at decent wages.

Government could do a lot to improve SME access to the capital market, provide a broader range of business services tailored to their needs and undertake a more active industrial policy to foster cluster development of SMEs or enhance their access to export markets. In many cases this would involve not the allocation of new resources, but the re-direction of some of the resources directed primarily to benefiting large corporations. SME development and the incomes and employment that they could generate are still being sacrificed to the large-scale bail-out by the Government of large banks and corporations from the consequences of the crisis.

3.1A Agricultural Development

The agricultural sector is still by far the largest employer in Indonesia, accounting for more than 40 per cent of all jobs. Also, the majority of the poor—landless labourers and small farmers—live in rural areas, with livelihoods directly or indirectly tied to agriculture. This is especially the case in the less developed outer islands. Also, expanding rice production is still the centrepiece of food security and a vital contributor to maintaining trade balances through reducing food imports. In addition, agricultural exports and manufactured exports based on natural resources will be the source of much of Indonesia's export growth in the foreseeable future.

For these reasons among others, a strategy of pro-poor development hinges on agricultural development. This in turn depends on maintaining rice production for food security, allowing farmers to diversify into higher value added commodities and stimulating off-farm employment. In all these areas, more pro-poor public policies and investment can make a critical difference. Through various forms of support to rice production, including maintaining tariffs, the Government can continue safeguarding food security. It can also facilitate the shift of farm production to other crops by helping minimize the risks involved. And it can provide the public goods and services that are essential to sparking the growth of non-farm economic activities.

Agro-industry is the key to generating off-farm employment, both in upstream industries producing inputs for agriculture and downstream industries processing its commodities (Banerjee

and Siregar 2002). When agro-business is added to primary agriculture, they account together for about 70 per cent of all employment. Agro-industry is certainly critical for increasing agricultural prosperity. But agricultural development remains the essential foundation for the rise of agro-industry itself. Increasing agricultural output is tremendously important because it has strong multiplier effects throughout the economy.

SME development, which is essential for employment creation, is closely tied to agricultural development since many inputs into SME production are based on agricultural and forestry products. With such strong backward linkages to the agricultural sector, SME manufactures are much less import-intensive than those of large enterprises. But agricultural prosperity will not only stimulate SME development through such supply channels; its income effect will also generate increased demand by the rural population for SME products.

A strategy of agriculture-driven growth depends on reviving public investment in the sector. In earlier periods, the Indonesian Government invested heavily in rural infrastructure development, for example. Indonesia's remarkable advances in rural development in the 1970s and 1980s were linked to public investments in green revolution technologies and irrigation. But investment in agriculture has been in marked decline for many years.

The two key areas of public investment are rural infrastructure and basic social services. For infrastructure, upgrading is badly needed in rural roads, irrigation, electricity and communications. Greater efforts are also needed to maintain the earlier advantage in basic human development that Indonesia had achieved by providing basic services in health, sanitation and education. In the recent period, the Government has consistently under-invested in health and education. This has lowered the productivity of rural workers. About three-quarters of them have only a primary school education or less.

Public Investment in Agriculture

Development expenditures fell across the board during the 1990s. As a ratio to total government expenditures, development expenditures fell from 44.5 per cent in 1992-93 to 31.9 per cent in 1999-2000 (Table 3.1). Development expenditures by local government jumped after 1998-99 with the advent of decentralization, but it is not yet completely clear how these expenditures are being allocated (see Chapter Four). Development expenditures on such items as rural roads, sanitation and public health had been falling progressively until 1998-99, when local governments began to take over responsibility for these expenditures. What is clear, however, is that overall development expenditures have continued to decline, despite decentralization.

Table 3.1. Government Current and Development Expenditures (%)

Category	1992/1993	1993/1994	1994/1995	1995/1996	1996/1997	1997/1998	1998/1999	1999/2000
Current Expenditures	55.5	58.6	59.0	63.7	63.5	70.0	68.5	68.1
Development Expenditures	44.5	41.4	41.1	36.3	36.5	30.0	31.5	31.9

Source: Central Bureau of Statistics Home Page, http://www.bps.go.id, July 17th, 2002

While general development expenditures have been in decline in the 1990s, public investment in agriculture, in particular, has been steadily declining since 1970. During the first national development plan (PELITA I, 1969-1974), the share of total government development expenditure going to agriculture-related activities as a whole was 23.4 per cent (Table 3.2). By the sixth development plan (PELITA VI, 1994-1999), this share had been more than halved, dropping to 11.1 per cent. The shares of all three major components—direct expenditure on agriculture, expenditures on irrigation and fertilizer subsidies—dropped substantially. The sharpest drop was evident in direct expenditures on agriculture, which declined from 10.5 per cent to 3.9 per cent. Since the mid 1980s, the most dramatic reductions have been in subsidies for fertilizers.

Investment in agriculture remains essential to the development of Eastern Java and all non-Java islands. While Jakarta and West Java are the most industrialized areas of the country, agricultural development will be decisively important in the rest of the country. A greater focus on agricultural development, particularly outside Java, has the advantage of helping to mitigate regional inequalities and making direct contributions to poverty reduction. The move towards greater decentralization can help tailor investment to local needs but the central government has to retain a major responsibility for ensuring the equitable distribution of public resources across provinces.

Table 3.2. Changes in the Allocation of Government Development Expenditures on Agriculture-related Activities
(Over Five-Year National Development Plans, PELITA)

Period	Agriculture (%)	Irrigation (%)	Fertilizer Subsidies (%)	Total Agriculture-Related Expenditures (%)
PELITA I (1969-1974)	10.5	9.9	3.1	23.4
PELITA II (1974-1979	7.0	5.6	6.7	19.3
PELITA III (1979-1984)	3.7	5.5	4.8	14.1
PELITA IV (1984-1989)	3.0	4.8	5.7	13.5
PELITA V (1989-1994)	6.3	5.4	1.3	13.0
PELITA VI (1994-1999)	3.9	6.2	1.0	11.1

Source: Central Bureau of Statistics (1980, 1985, 1990, 1995, and 1998)

Diversification and Off-Farm Employment

Diversification within agriculture is essential to raising rural incomes and combating poverty. While rice production is critical to food security, a rise in rural incomes depends on developing production in other commodities, such as vegetables, fruits, fish and tree crops (Tabor 2001).

Since these commodities have higher value-added, shifting land and labour to their production will augment agricultural productivity.

Increasing production of other crops in Java and Bali, the two main rice-producing areas that enjoy the advantages of fertile lands and past investments in infrastructure, could significantly boost rural incomes in the near term. The majority of the poor reside in Java even though the incidence of poverty is higher in many other islands.

This strategy assumes, however, that rice production can be increased enough to meet rising domestic demand through greater investment in the non-Java islands. In the 1990s, most of the increase in rice production occurred off Java, mainly through an increase in the cultivated area. Through providing more agricultural extension and completing existing irrigation projects, the Government could substantially enhance rice productivity off Java and compensate for the loss of paddy land and slowing productivity growth on Java.

Although land is still relatively equitably distributed, the evidence on general trends suggests that polarization is rising, especially if landlessness is taken into account. However, the fragmentation of land into increasingly smaller plots has emerged as the major constraint on raising farm productivity. There is a limit to what land consolidation can achieve on Java, where land is scarce. There are now a large number of landless or near-landless farmers, particularly in Java and other parts of western Indonesia. Since rice yields are facing diminishing marginal returns as land plots become smaller and more fragmented, farmers have been forced to find other sources of income.

In Java, farmers earn only 13 per cent of their total income from paddy production. The picture is similar off Java, where farmers earn only 21 per cent. Farmers off Java earn 35 per cent of their income from other crops and 36 per cent from off-farm employment (Tabor 2001, p. 9).

On Java, almost half of farmers' total income comes from off-farm employment. This trend highlights the need to promote crop diversification and non-farm industry and services. These are the major avenues for raising rural incomes and reducing poverty.

While in the past, the growth of manufacturing in urban areas could provide jobs for low-skilled rural workers, this is not likely in the near future. The financial crisis interrupted the growth of manufacturing, and in its aftermath Indonesia's manufactured exports have been subjected to more intense competition from other Asian economies, especially from more productive low-wage labour in China. In the wake of the crisis and the ensuing slow growth, there is a surplus of poor urban workers waiting for better employment opportunities.

The Distribution of Land

Formally, the 1960 Agrarian Law still governs the distribution of land in Indonesia. However, the reality of land distribution has changed appreciably since the 1960s. Land holdings have become more fragmented and their distribution more polarized. Also, many hectares of agricultural land have been transferred to non-agricultural uses.

The 1960 Agrarian Law was designed to eliminate the landlord system, restrict the use of land for exploiting the labour of farm workers, ensure security of use-rights and maintain some equality in land distribution. For example, maximum and minimum limits were set on landholdings. In regions of high population density, for instance, the maximum holding on wet land was 5 hectares and on dry land 6 hectares; and in regions of low population density the corresponding limits were 15 hectares and 20 hectares respectively. Absentee landownership was discouraged and priority in the distribution of land was given to farmers and labourers who worked the land. Moreover, the rights and interests of sharecroppers were protected vis-à-vis landowners.

The distribution of land is critical for poverty reduction in Indonesia since, as stated earlier in this report, over 40 per cent of the employed still work in agriculture. As a result of the economic crisis and the loss of jobs in the urban sector, this share reversed its historical decline, edging up from 44 per cent in 1995 to 45 per cent in 1998, with the most dramatic increase occurring on Java.

Up-to-date information on the distribution of land is difficult to obtain since the last agricultural census was carried out in 1993. However, the general trend seems clear. From 1983 to 1993, for instance, the share of farm households producing food crops that had less than one tenth of a hectare of land increased from 1.3 per cent to 6 per cent (Table 3.3). Similarly, the share of farm households with land holdings between one tenth and one half of a hectare rose from 39.6 to 42.5 per cent.

In 1993, 71.5 per cent of all farm households growing food crops held less than one hectare of land—up from 65.8 per cent 10 years earlier. These farm households accounted for only 31.4 per cent of all land. By contrast, the other 28.5 per cent of farmers with more than one hectare held 68.6 per cent of all farmland. The 11.8 per cent of farmers with over two hectares accounted, by themselves, for 43.6 per cent. The average holding for farmers with more than two hectares was 3.16 hectares per household. But this represented a decline from 1983, when the average holding was 3.65 hectares per household. If land had become more concentrated, it would have had to be at levels of holding much larger than two hectares.

Table 3.3. Land Ownership for Food Crops in Indonesia in 1983 and 1993

Land Ownership (ha)	1 9 8 3		1 9 9 3		Percentage Change
	Household	Per cent	Household	Percent	
< 0.10	199 747	1.3	1 081 006	6.0	441.2
0.10 – 0.49	6 315 092	39.6	7 645 428	42.5	21.1
0.50 – 0.99	3 986 876	25.0	4 130 271	23.0	3.6
1.00 – 1.99	3 166 465	19.9	2 991 747	16.6	- 5.5
> 2.00	2 279 034	14.3	2 129 975	11.8	- 6.5
Total	15 947 214	100.0	17 978 427	100.0	12.7

Source: Central Bureau of Statistics, 1985 and 1995

Examining trends in land ownership underscores the problem of land fragmentation, which is consigning increasing numbers of farmers to pitifully small, uneconomic plots or outright landlessness. The total land for food crops decreased during 1983-1993 from about 16.7 million hectares to 15.4 million hectares (Table 3.4). Within this overall decline, the biggest increase, i.e., about 340 per cent, was in holdings of less than one tenth of a hectare. In fact, there was an across-the-board increase in total holdings of land by farmers holding less than one hectare.

Calculations based on a Social Accounting Matrix for 1995 and 1999 suggest a continuing trend towards land fragmentation as well as landlessness. The share of landless farm labourers in the total agricultural workforce increased from 27.6 per cent to 31.6 per cent; and the share of farm households holding less than half of a hectare edged up from 43.7 to 44.9 per cent (Table 3.5). The biggest decline was in households holding 0.5-1.0 hectares. Meanwhile, the absolute number of households holding more than one hectare increased by almost nine per cent.

With continuing land fragmentation, agricultural productivity will be difficult to increase in Indonesia. One option is to raise the level of efficiency through greater application of technology. This will require greater public and private investment. Another option is to consolidate land holdings, at least through common contracting among farm households. This could ease some of the problems associated with fragmentation in areas of high population density such as Java. But the evidence for efficiency gains through consolidation is not convincing. The scope for consolidation is much greater off Java. In general, some consolidation of land could be beneficial if it is achieved through the formation of cooperatives or other forms of organization, such as water use associations.

A general problem is that some of the most fertile land in Indonesia is being transferred to non-agricultural uses. One estimate suggests, for example, that 30,000-50,000 hectares of irrigated rice fields are being converted to non-agricultural uses each year. In Java, agricultural land decreased from 6.2 million hectares in 1983 to 5.1 million hectares in 1993 and this trend has continued thereafter. Other regions such as Sumatra have increased the hectares of agricultural land but their land is less productive. In the outer islands, substantial public investment would be required in irrigation for rice production, for example, to raise productivity to levels comparable to that of Java.

Table 3.4. Changes in Land Holdings for Food Crops in Indonesia, 1983-1993

Land Category (ha)	1 9 8 3		1 9 9 3		Percentage Change
	Land Ownership (ha)	Per cent	Land Ownership (ha)	Per cent	
< 0.10	14 967	0.1	66 327	0.4	343.1
0.10- 0.49	1 695 383	10.1	2 033 093	13.2	19.9
0.50 – 0.99	2 646 813	15.9	2 744 943	17.8	3.9
1.00 – 1.99	4 070 805	24.4	3 859 119	25.0	- 5.2
> 2.00	8 261 484	49.5	6 732 139	43.6	-18.5
Total	16 689 542	100.0	15 440 621	100.0	- 7.5

Source: Central Bureau of Statistics, 1985 and 1995

Table 3.5. Land Ownership Patterns in Indonesia in 1995 and 1999

	1995		1999		Percentage Change
	Households ('000)	%	Households ('000)	%	
Farm Labourers	5064.7	27.6	7099.1	31.6	40.2
Land Ownership:					
< 0.5 ha	8024.2	43.7	10097.9	44.9	25.8
0.501-1.0 ha	3076.4	16.8	2915.9	13.0	-5.2
> 1.0 ha	2190.7	11.9	2379.9	10.6	8.6
Total	18356.0	100.0	22492.8	100.0	22.5

Source: Calculated from the Indonesian Social Accounting Matrix 1995 and 1999,

Central Bureau of Statistics, Jakarta

The encroachment of non-agricultural interests onto farmland has led to numerous conflicts. Many communities that have occupied the same land for generations have found themselves displaced by larger, better-connected corporate interests. A major problem is that only about one third of privately held land is registered and titled. This puts smallholders at a disadvantage since they cannot use land for collateral and they have little protection when efforts are made to appropriate the land for other uses. Continuing the effort to register and title land could provide some protection in these circumstances. But the priority is for communities or co-operatives to organize themselves to protect their interests.

3.1B. Empowering SMEs for Poverty Reduction

The role of Small and Medium Enterprises in generating growth, employment and poverty reduction is strategically important in Indonesia. SMEs in Indonesia employ over 73 million workers. However, although SMEs accounted in 2001 for over 99 per cent of all

enterprises and over 99 per cent of all employment, they accounted for much smaller shares of exports and GDP.[9]

For example, SMEs accounted for 63 per cent of GDP in 2001. Large enterprises (only about 2,000 in number) contributed the other 37 per cent of GDP. However, large enterprises contributed about 81 per cent of all exports (Table 3.6). The SME contribution of 19 per cent was little changed from their 15 per cent contribution in 1992. By comparison, SMEs in the Republic of Korea accounted for 40 per cent of exports in 2001.

The productivity differential in Indonesia between large enterprises and SMEs is sizeable. In 2001, output per worker in large enterprises was over 40 times higher than in medium enterprises and 130 times higher than in small enterprises. The contrast is most telling in small enterprises because they employ 88.5 per cent of all workers.

Table 3.6. Economic Performance by Size of Enterprise

Category	**Share of Employment (%)**	**Output Per Worker (Million Rp.)**	**Share of Exports (%)**
Large Enterprises	0.5	1,153	81.3
Medium Enterprises	11.0	289	14.3
Small Enterprises	88.5	9	4.4

Source: SME Statistics 2002, Ministry of Cooperatives and SMEs (processed)

These summary statistics underscore the importance of more pro-active public policies to promote SME development. The focus needs to be on raising productivity and wages. If successful, such policies could make a substantial contribution to reducing poverty.

Recommendations

A first step would be for the Government to establish an administrative unit that could coordinate all support to SMEs. In Japan, for example, such an institution is the Japan Small Business Corporation and in the Republic of Korea the Small and Medium Business

[9] According to BPS, small firms hire less than 20 employees, medium firms between 20 and 100 and large firms more than 100.

Administration. In Indonesia, by contrast, there are at least six ministries (and the National Family Planning Board) that have some responsibility for SME development. But there is little coordination among them and considerable overlap in their programmes. Moreover, the programmes are poorly matched to the needs of entrepreneurs, many of whom are not even aware of them.

An SME Administration in Indonesia could develop a comprehensive and integrated programme to address many of the problems confronting SMEs. This would help economize on scarce budget resources and focus them on priority projects.

Such a programme is needed in part because large enterprises continue to receive most government privileges, including access to credit at low interest rates, licenses to monopolize certain markets and low tax rates. As a result, small enterprises have little chance to grow into medium-sized enterprises. One indication of the under-development of medium-sized enterprises is that they provide only 11 per cent of all employment. It should be a priority of public policy to accelerate the development of medium-sized enterprises, which have more potential than small enterprises to generate remunerative employment.

The proliferation of small enterprises in Indonesia is not a healthy sign. In the short term—in order to have an immediate impact on poverty—resources should be targeted to small enterprises and the self-employed but over the long term medium-sized enterprises will be main source of employment at wages high enough to make a substantial dent in poverty.

The registration process for SMEs could be considerably simplified and expedited and the registration fees lowered. This is especially important because decentralization has subjected them to another layer of local taxes and charges that can hinder their development. One policy recommendation that could be particularly helpful is to establish a “one-stop

services" facility to make the registration process more efficient. Overall, the taxes and charges to which SMEs are subjected should be lowered.

On paper, SMEs receive 30 per cent of all credit from banks but most of the loans classified as going to SMEs are allocated, in fact, to finance the purchase of real estate or the use of credit cards for consumption. SMEs have few financing options available to them so much of their investment has to be self-financed out of their own profits. Hence, it would be helpful for the government to set up a development institution that could focus on mobilizing SME funds, such as grants, soft loans and commercial credit. In this regard, public policies could support the registration of land and document the ownership of other assets that could be used as collateral for loans.

The business skills of the owners and managers of SMEs are low. The great majority of them, for example, have only a junior high school level of education or lower. Hence, a welcome initiative would be government encouragement of business development services for SMEs, which should be run by private entrepreneurs in order to make them as demand-driven as possible.

With the advent of decentralization, greater opportunities exist for regional governments to promote the cluster development of SMEs that are located in one area, such as through the identification and marketing of products in which particular regions have a comparative advantage.

A major constraint on SME development is their lack of ability to develop overseas markets on their own. This is a major reason that their share of exports is less than 20 per cent. Another part of the explanation is the privileges enjoyed by the economic elite that controls the large corporations in the country. Government could boost the growth of SMEs through more

active export promotion of their products. It could also encourage import substitution of products in which they are competitive.

3.2 International Trade and Pro-Poor Development

SME development and agricultural development have derived little direct benefit from trade liberalization. In fact, Indonesia’s food security relies on tariff protection, and the development of small and medium enterprises depends on implementing an active industrial policy that opens up broader access to trade opportunities. This section examines more closely the overall impact on growth and poverty of trade liberalization in Indonesia.

3.2A Introduction

Until the devastating economic crisis of 1997, Indonesia was widely considered to be a prime example of successful economic liberalization, especially trade liberalization. During 1989-1994, it had launched numerous trade and investment reform packages designed to make itself more open to foreign competition and investment. Restrictions on trade, including tariff and non-tariff barriers, were gradually eliminated, as were regulations on foreign direct investment. It was widely claimed that Indonesia’s program of trade liberalization would dramatically improve its efficiency and spur further growth in its output, investment and exports.

The conventional view is that liberalization had little to do with the onset of the crisis. Indeed, this view holds that trade liberalization has set the stage for a recovery. This section will offer a different analysis of Indonesia's path, and the policy conclusions it will derive will be equally distinct. It will argue that the pressing need for pro-poor development requires the state to take a more active role in trade policies. Neither the restoration of rapid growth nor the further integration of Indonesia into the world market can be left entirely to the vagaries of market forces.

3.2B The Historical Background of Trade liberalization in Indonesia

Prior to the crisis, Indonesian economic policy went through four distinct phases: protectionism (1945-1966), outward orientation (1967-1973), oil export-led industrialization (1974-81) and full-blown financial and economic liberalization (1982-1997). Over the latter period, Indonesia was regarded as a prime example of the soundness of trade liberalization theory. This section examines Indonesian trade policy prior to the 1997 crisis. The next section analyzes the post-crisis period.

After Indonesian independence in 1945, government policy was inward-oriented and interventionist. The focus was primarily political rather than economic (GATT, 1991): the emphasis was on unification of a very diverse group of people—in terms of culture, religion, and social and economic development—which was dispersed over thousands of islands. From 1948 to 1966, government policy was characterized by nationalism and guided development (World Bank, 1993). High tariff and non-tariff barriers reinforced the country's isolation from the world economy.

During 1965 and 1966, the economy suffered an annual inflation rate of almost 1200 per cent, and from 1960 to 1966 average GDP growth slowed to 2 per cent (Fane, 1999). The rupiah was held at a fixed exchange rate relative to the US dollar during this period in order to support the inward looking strategy. But because of high inflation, this led to a real over-valuation of the rupiah, which seriously reduced the competitiveness of Indonesian exportables.

The next stage of economic policy, from 1967 to 1973, was an outwardly oriented "new order", associated with the Soeharto regime (World Bank, 1993). When Soeharto came to power, Indonesia's economy was "debt-ridden and chaotic" (Dhanani, 2000, p. 27). It was characterized by a large and inefficient public sector, high external debt, spiraling inflation and falling levels of private investment (GATT, 1991).

The first steps of the new government were directed towards restoring monetary and fiscal stability and encouraging external and domestic private investment. The stabilization program, sponsored by the IMF, helped Indonesia to reduce the inflation rate to an annual average of 8 per cent (Rodgers, 1996). The government promoted foreign investment laws in 1967 to encourage foreign direct investment and offered accelerated depreciation allowances and income tax holidays for approved investment projects (Fane, 1999). Backed by government guarantees, foreign investment surged, as did short-term credits to finance imports and long-term loans to finance infrastructure development (Dhanani, 2000, p. 27, citing Robison 1986, p. 138).

The third stage of economic policy, implemented from 1974 to 1981, was characterized by an oil and commodity boom, state-directed industrialization, trade protection, subsidies and targeted finance. Rising oil prices dramatically increased export revenues. The state took an active role in creating industries in steel, aluminum, natural gas, petroleum refining, petrochemicals, fertilizers and cement. The state also subsidized rice and sugar farmers and indigenous small-scale businesses (Dhanani, 2000, p. 27; Fane, 1999). In order to support the exports of oil and gas and other commodities, the rupiah was devalued by about 31 per cent in November 1978. But because the Government changed the exchange rate system from a fixed to a managed float (Bank Indonesia, 1993), the rupiah returned almost to its pre-devaluation levels by 1981.

All in all, this was a period that initiated a structural shift in Indonesia's economy from agricultural production to manufacturing. Between 1975 and 1981, manufacturing production grew at about eight per cent per annum while manufacturing exports grew at 34 per cent. Nonetheless, this was a period of persistent trade deficits in manufactured goods, as imports of capital goods and chemicals outweighed all manufacturing exports (Dhanani, 2000, Table 2.1, p. 28).

A stead drop in oil prices initiated the fourth distinct period of economic policy, which lasted from 1982 to the onset of the crisis of 1997. This immediately worsened the current account, which had already been in deficit since the late 1970s (Rodgers, 1996). But the Government responded by devaluing the rupiah in 1983 by 27.5 per cent relative to the US dollar and by cutting back sharply on its expenditures on import-intensive capital projects (Rodgers, 1996).

Pressures from international financial institutions led to the deregulation of investment controls and banking and finance, the removal of credit ceilings and preferences, and the reform of customs, taxes and import duty drawbacks for exporters. An export-oriented industrialization strategy was announced, with credit at low interest rates for exports. However, foreign investors were still required to have local partners (Dhanani, 2000, pp. 28-29).

A chief policy objective in this period was to achieve food self-sufficiency, which was attained in 1985 through the introduction of high-yielding rice varieties. As part of this strategy, domestic agricultural production was protected by restrictive import licensing arrangements (Fane, 1996). BULOG (the Food Logistics Agency) controlled the price and quantity of imports, exports and domestic marketing of major crops such as rice, sugar, soybeans, wheat and flour.

BULOG monopolized these markets in order to stabilize the domestic price by protecting it from the fluctuations in the world price. However, in terms of fulfilling domestic demand at a relatively low price, the effectiveness of the monopoly on products other than rice has been questionable. Tomich (1992) found that the domestic prices of sugar and soybeans were 35-45 per cent and 50 per cent above the world prices, respectively. Furthermore, companies acting on behalf of BULOG, such as PT Bogasari Flour Mills (which monopolized flour milling) and PT Sarpindo Soybean Industry (which monopolized soybean crushing) earned extraordinary profits.

Import restrictions and taxes were applied to forestry exports in order to fulfill domestic demand and slow deforestation. Bans on log exports were introduced in 1980 and extended to raw rattan in 1986 and semi-processed rattan in 1988 (Fane, 1999). License requirements were also introduced for rubber, cocoa, tea, rattan, plywood and coffee (Fane, 1999). The export tax on crude palm oil was constantly adjusted to satisfy the demand for cooking oil at an affordable domestic price.

In the meantime, the 1985 Plaza currency accord led to a swift re-valuation of the currencies of many industrialized countries, which greatly benefited Thailand, Malaysia and Indonesia. In 1986, the rupiah was devalued again by 30 per cent, and a year thereafter by a further six per cent. These events served to attract foreign investment into Indonesia by labor-intensive garment and footwear firms from South Korea, Taiwan, Hong Kong and Singapore in the late 1980s, followed by Japanese investments in the 1990s. Domestic investments were also substantial in this period. The net effect was to raise Indonesian manufacturing growth to 13 per cent per annum during 1985-88 and to 20 per cent during 1989-93 (Dhanani, 2000, p. 29). Of course, the rapid inflow of foreign investment was attended by a rise in Indonesia's foreign debt, which was to become later a critical problem.

Between 1989 and 1994, numerous trade and investment reform packages were launched in order to make Indonesia even more open to foreign competition and foreign investment. After 1989, restrictions on trade, including tariff and non-tariff barriers, were gradually eliminated, as were regulations on foreign direct investment. When unrestricted foreign direct investment was permitted for the first time in all sectors in 1994, it surged thereafter until 1997.

The assumption, strongly supported by international financial institutions, was that all of the trade liberalization measures undertaken in the 1980s and 1990s would improve Indonesia's economic efficiency and further enhance the growth in its output, investment and exports. But, despite these reforms, Indonesia's competitiveness in manufactured exports had already begun to decline, relative to its Asian neighbors, three to four years *before* the crisis. Growth in manufacturing production and exports reached a plateau by 1993 and declined thereafter. During 1989-93, manufacturing value added grew at an average annual growth rate of 20 per cent and manufacturing exports by 27 per cent (Table 3.7). But during 1994-1997, these rates slowed down to averages of 12 per cent and 8 per cent, respectively.

Exports of resource- and labor-intensive manufactures, such as plywood, textiles, garments and footwear, declined more drastically than total manufactured exports, i.e., to only a 2 per cent growth rate during 1994-97. In effect, trade liberalization had exposed Indonesia to low-cost competition in its traditional labor-intensive exports, without giving it sufficient time to adapt (Dhanani, 2000, pp. v, 2, 3, 13, 26, and Table 2.1, p. 28).

Table 3.7. Manufacturing Value Added and Exports 1975-1999

Average Annual Growth Rates	**1975-81**	**1982-84**	**1985-88**	**1989-93**	**1994-97**	**1998-99**
Manufacturing Value Added	8	5	13	20	12	-7
Manufactured Exports	34	29	27	27	8	2
Exports of plywood, textiles, garments and footwear	94	64	32	28	2	-7

Source: Dhanani 2000, Table 2.1.

3.2C. Indonesia in the aftermath of the East Asian Crisis: 1997-2002

As a condition for receiving international aid to help with its economic crisis, Indonesia reached an agreement with the IMF to extend the scope of its trade and financial liberalization (Soesastro and Basri, 1998). The agreement included provisions for the dissolution of internal monopolies and cartels, such as BULOG's monopoly over the import and distribution of sugar and wheat flour and the control exercised by cartels in cement, paper and plywood. Domestic trade in all agricultural products was completely deregulated, and the Clove Marketing Board was eliminated. Special taxes, customs and credit privileges (such as had been granted to the National Car Project) were discontinued, as were any budgetary and extra-budgetary support and credit privileges (such as had been accorded to the state-owned aircraft industry).

Further steps included the gradual reduction of import tariffs to 5-10 per cent by the year 2003, including those on chemical products, iron and steel, fishery products, soybeans and garlic. Wheat and wheat flour, soybeans

and garlic have been imported freely under a General Importer license since January 1998 but the Government is permitted to provide a temporary subsidy for wheat flour to protect consumers. The administrative retail price of cement is to be eliminated in the near future. Also to be abolished are any local content rules on dairy products, as well as import restriction on all new and used ships.

On the side of exports, taxes on a wide range of products, such as leather, cork, ores and waste aluminum, were abolished in February 1998 while those on sawn timber, rattan and minerals were reduced to a maximum of 10 per cent. Export restrictions on palm oil, which were put in place to ensure adequate domestic supplies, were eliminated in March 1998. And export quotas were eliminated by the end of 2001.

Formal and informal barriers to foreign investment in palm oil plantations were removed in February 1998 and all restrictions on investment in wholesale and retail trade were lifted in March 1998.

As a result of these conditions, Indonesia is by now almost entirely open to foreign competition and foreign capital flows. Tariffs have been mostly eliminated, with the exceptions of food and some other critical goods (e.g., cars above a size of 1500cc.) Subsidies are also largely gone. And, of course, capital flows are relatively unrestricted.

But liberalization has opened the floodgates to cheap imports from countries such as China (electronics, motorcycles) and the United States (chicken, rice). Further liberalization in the food sector, particularly in rice, is likely to create a social upheaval. All in all, the combined effects of tariff reductions and the disappearance of guaranteed export quota markets threaten to de-industrialize Indonesia and drive it back into natural resource-based goods such as palm products and furniture, unless the Government undertakes a more pro-active industrial policy that seeks to build up the country's comparative advantage in higher-valued-added products (Dhanani 2000, pp. v-vi, 3, 26).

Competitiveness depends heavily on unit costs, of which unit labor costs are particularly important. But the problem for Indonesia is one of productivity, not unit wages. While in 1997 Indonesia's wage rates were higher than those in China and India, the subsequent devastating economic crisis reversed this gap by sharply reducing wages, at the cost of great social misery. Currently, it is estimated that the average wage in Indonesia is 50 US dollars per month compared to 71 US dollars per month in China. *But Indonesia's productivity relative to China's is lower still,* so that its unit labor costs are higher than those in China (Dhanani and Scholtes 2002, pp. 24-28). Footloose industries such as shoes (Reebok being a recent example) and textiles are already leaving Indonesia for countries where labor is cheaper. Thus even after a substantial wage reduction, Indonesia is still not competitive, and faces further erosion in its export markets (Dhanani 2000, p. v).

With regard to external demand, competitive sectors such as plywood are still viable, but have been hurt by the prolonged stagnation in the large Japanese market. The demand for plywood has also declined because China and Malaysia, using smuggled Indonesian logs, produce plywood more cheaply than Indonesia. To add insult to injury, some of this plywood is imported back into Indonesia.

While China's remarkable growth implies an increase in demand for some Indonesian exports, its low cost production will have a negative impact on other Indonesian exports. Thus it is not difficult to foresee that in the absence of pro-active support by the Government, Indonesia's exports will no longer likely be an engine of its growth.

3.2D Recommendations for improving Indonesia's international competitiveness

Indonesia's access to the world market is essential to its further development. But blanket trade liberalization will not bring this about. If Indonesia is to move away from its dependence on resource-based exports, what is needed is a strategy of industrial and agricultural development geared to fostering its international competitiveness over a wider range of products. Critical is the lowering of the costs of production and sales by improving the productivity of existing export industries. It is also necessary to diversify the export base, particularly with regard to natural resource-based sectors. A greater focus on intra-Asian trade appears to hold out the most promise. Of course, these efforts must be undertaken within a more general policy of developing and diversifying the industrial base itself. This involves upgrading the training and skills of the workforce.

The large employment base provided by small and medium enterprises (SMEs) implies that a greater emphasis should be placed on providing them with economic opportunities. They could develop rapidly if they were better integrated, in terms of forward and backward linkages, with large industrial enterprises (Pincus and Ramli 1998, p. 732; Dhanani 2000, pp. v-vi, 3-3, 13-14, 182-185).

Without complementary policies, export promotion is not sufficient to improve trade patterns since there are strong linkages between domestic production, export production and imports. Indonesia's balance of trade in all goods has been positive since the 1980s. Despite this, Indonesia has run a persistent deficit on its current account since then, and has suffered persistent deficits in its balance on manufactured goods (except after the crisis of 1997 because of the collapse of growth) (Table 3.8).

Prior to the crisis, Indonesia ran a trade surplus in labor-intensive goods, such as foods, beverages and tobacco, raw materials, fuel, oils and fats, textiles, garments, footwear, furniture, toys and sports goods. But this surplus was outweighed by deficits in higher technology goods, such as chemicals, machinery, machine components and transport equipment (Table 3.8).

Table 3.8. Balance of Trade
(By SITC Category, 1993-1997, US$ billion, average)

	Standard Industrial Trade Category	Exports	Imports	Balance
0	Food & live animals	3.48	2.64	0.84
1	Beverages & tobacco	0.20	0.18	0.02
2	Raw materials, inedible	4.05	3.05	1.00
3	Fuels & lubricants	11.73	3.06	8.67
4	Oils & fats	1.49	0.11	1.39
5	Chemicals	1.39	5.42	-4.02
6	Manufactured goods	10.02	5.97	4.04
7	Machinery & transport equipment	3.74	15.39	-11.65
8	Miscellaneous manufactured goods	7.63	1.28	6.35
9	Others	1.41	0.01	1.39
	Total	45.13	37.11	8.02
	Manufactured goods (SITC 5-8)	23.52	28.06	-4.55

Source: Foreign Trade Statistics, Monthly Statistical Bulletin, CBS (see Dhanani 2000, figure 6.9, page 178)

In addition, the manufacturing sector has always been heavily dependent on imported raw materials and intermediate inputs. For example, two-thirds of the foreign exchange generated by oil and gas exports are absorbed in the financing of corresponding imports of oil products and related services. Thus, any effective policy of industrialization must foster some degree of import substitution, in both goods and services (Dhanani 2000, pp. 14, 177-184).

Finally, since the agricultural sector accounts for about 43 per cent of Indonesian employment, compared to a mere 13 per cent accounted for by manufacturing, any attempt to foster pro-poor development in Indonesia must focus on substantially improving conditions in agriculture (Banerjee and Siregar 2002, pp. 5, 10). Moreover, small and medium enterprises, in which the bulk of Indonesian employment is concentrated, depend heavily on forestry and agriculture. While the issues of SME development are discussed earlier in this chapter (Section 3.1B), this section focuses on the relations between trade, agriculture and pro-poor development.

Recent events have highlighted the importance of agriculture as a potential growth sector for the Indonesian economy. This sector was less severely damaged by the economic crisis of 1997 than industry because it depended less on imported inputs (whose prices rose sharply as the rupiah depreciated), and less on bank credit (which collapsed during the crisis). Because agriculture was less dependent on imports, the benefits it derived from exports as a result of depreciation were not canceled out by the higher price of imports.

Agro-industry as a whole (agriculture, forestry and fisheries, as well as the upstream industries that produce agricultural inputs and the downstream ones that process the sector's output) is vitally important to pro-poor development in Indonesia. It provides 70 per cent of Indonesia's employment and encompasses 90 per cent of its

small and medium enterprises. Agro-industry's high labor-intensity implies that its growth will have strong multiplier impacts on employment. While it accounted for 35 per cent of total non-oil exports in 1999, there still exists great scope for export expansion in fisheries, fruits and horticultural products, which will be associated with only a modest reliance on imports (Banerjee and Siregar 2002, pp. 6-9).

Thus, through policies of both export promotion and import substitution, Indonesia's dynamic comparative advantage is likely to lie in a range of exports, spanning "agricultural, resource-based and labour-intensive products" (op. cit., p. 6). The realization of this competitive advantage, across a range of products, would require strategic and pro-active intervention by the state.

Indonesian agriculture is presently underdeveloped compared to the sector in other neighboring countries such as Malaysia and Thailand. Infrastructure development, which played a critical role in Indonesia's earlier stages of development, would have to become central once again. This implies substantial improvements in transportation, communications and irrigation, as well as in social sectors such as health and sanitation.

Cost-efficiency would have to be improved in the state-run sectors, and technical information would have to be widely disseminated to boost productivity in the smallholder sector. The widespread provision of finance, particularly non-bureaucratic access to credit in rural areas, would be crucial. So too would be the facilitation of upstream linkages to industries providing relevant inputs and equipment, and to downstream industries providing processing and marketing. Many such policies have been effectively carried out in Malaysia, Thailand and Chile, with concomitant jumps in exports. It is possible, moreover, to accomplish this through environmentally low-impact development (Banerjee and Siregar 2002, pp. 11, 16-22).

At the same time, Indonesia's long-run success depends on the opening up of agricultural markets in industrialized countries. So far, as many commentators have noted, the commitment of the industrialized nations to liberalized agricultural trade is more a promise than a reality. Under the Uruguay Round, the EU and the US bound their tariffs 67-75 per cent higher than their tariff equivalents for 1989-93. These bindings have enabled the industrialized countries to set their tariffs at levels that protect their domestic markets. Also, the EU and the US have provided farm subsidies that average about US$ 19,000 per farmer (Tabor, Sawit and Dillon, 2002, pp. 4-6).

Regaining Industrialization Momentum[10]

To provide employment and raise living standards of the entire population, Indonesia needs to regain its momentum of industrialization of the early 1990s and overcome past weaknesses. The above discussion suggests that a strategic realignment in industrial policy is required to maintain the country's market share in world trade and compete successfully against increasingly cheaper foreign manufactures, both in the country's own import market and its potential export markets.

Indonesia cannot continue indefinitely to rely on a narrow range of labour-intensive and resource-based products, such as wood products, textiles, garments and footwear, to spearhead manufacturing development. Just as its import-substitution strategy of the 1960s and 1970s gave way to an export-oriented strategy in the 1980s and 1990s, its present post-crisis strategy will have to give way to a more pro-active, creative and innovative industrial strategy that can adapt to a rapidly changing international environment.

The role of government in industrial development, while necessary, should change from that in the past. Even in the context of liberalized investment and trade flows, public policy can go a long way towards influencing the nature and direction of industrialization, without resorting to distortions in pricing policies or firm-specific incentives.

In order to raise industrial competitiveness, public policies can encourage the following: 1) the efficient domestic production of components and intermediate inputs as a basis to lower the production costs of final products 2) diversification of export products and markets 3) promotion of the downstream processing of agricultural commodities 4) increased linkages between SMEs and large establishments and 5) the development of medium- and higher-technology industries. In general, these policies should be harnessed to foster Indonesia's competitiveness on the basis of product differentiation and innovation and moving up the value chain.

The absence of an effective support system for industrial technology or, more accurately, for manufacturing capability, is perhaps the single most important impediment to achieving many of the aims of industrial development outlined above. Competitiveness increasingly depends on technology development and its underlying foundation of knowledge, skills and organizational infrastructure. As in many other developing countries, however, Indonesia has focused its efforts on developing a structure of public and semi-public institutions to deliver technological services to firms, instead of undertaking the decisive task of strengthening technological capabilities *within* firms (Dhanani and Scholtes, 2002, p. 68).

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[10] This section draws on direct contributions to this report by Shafiq Dhanani.

Most of the industrial firms in Indonesia either do not recognize the urgent need for technological upgrading or, if they do, are not clear about how to achieve it. To stimulate investment by firms in new technology, the numerous existing public technology institutes should explicitly undertake a well-designed outreach programme, including the use of enterprise counselors and advisers. These institutes should seek to understand the existing capabilities of firms and their business strategies, and then directly engage and assist them in an open-ended process of technological learning.

In the new competitive global environment, industry associations also need to upgrade themselves to help their members compete more effectively abroad (Dhanani 2000, p. 39). The range of their support activities could include monitoring prices and other market developments, analyzing signals from international consumers and communicating these to local firms, facilitating technology transfer by maintaining databases of equipment and machinery suppliers, conducting trade missions, organizing trade fairs and distributing promotional materials and newsletters.

Since the process of developing manufacturing capabilities is necessarily a lengthy one, it is all the more urgent to adopt now a fundamentally new strategy for industrial technology. Without a more active and innovative industrial policy, Indonesia will have difficulty, in the face of fierce competition in global markets, in graduating to a higher level of industrial development that can provide widespread employment at decent wages.

3.2E. Food security, self-sufficiency, and trade liberalization

Within this international context, the liberalization of Indonesian rice imports and exports is a particularly contentious issue because this commodity is essential to food security. Food security refers to the availability, stability and accessibility of adequate supplies of food (FAO definition cited in Arifin, *et al*, 2001). Food availability requires food supplies that are sufficient to meet the population's consumption needs. Stability requires supplies sufficient to maintain adequate food consumption during difficult times. And accessibility requires some mechanism for people to obtain the food they need either through their own production or through private or public financial resources. Thus food security can be defined as a situation in which all households have both physical and economic access to adequate food for all members, and where households are not at risk of losing such access.

Obviously, such security implies both a sufficient real income and an adequate supply of food. But trade liberalization does not automatically generate either of these all-important conditions. When it generates growth, it can also impoverish many people who are excluded from the benefits of such growth. When it increases food supplies, it can also displace many small-scale agricultural producers in the process. And when it generates crises, as in 1997, it can reduce food security drastically. For all of these reasons, food security requires that the state strive to integrate its policies on growth, poverty reduction and stability of food supplies (Bappenas, DAI/USAID, PSP-IPB, 2000).

Although Indonesia's productivity in rice production grew substantially after the 1970s, it has been losing ground since it attained rice self-sufficiency in 1984. Its productivity level has fallen considerably because no new rice technology has been available to Indonesia since the Green Revolution. By 2001, its productivity level was only slightly higher than that of Asia as a whole, but lower than that of Vietnam and considerably lower than that of China (Table 3.9).

Not surprisingly, trade liberalization has led to a rapid increase in the import of rice into Indonesia. During 1990-2001, rice imports grew by an average of 26 per cent per year while production grew by only 1 per cent (Table 3.10).

Table 3.9. Rice Productivity and Productivity Growth in Asian Developing Countries, 1970 – 2001

Year	Productivity (Ton GKG/ha) and Productivity Growth (%)			
	Asia	Indonesia	China	Vietnam

1970	*2.27*	*2.43*	*3.29*	*2.06*
1975	*2.41*	*2.68*	*3.51*	*2.17*
1980	*2.74*	*3.26*	*4.24*	*2.12*
1985	*3.27*	*3.94*	*5.31*	*2.78*
1990	*3.56*	*4.30*	*5.61*	*3.17*
1995	*3.74*	*4.37*	*6.02*	*3.67*
1996	*3.87*	*4.39*	*6.33*	*3.98*
2000	*3.96*	*4.40*	*6.26*	*4.24*
2001	*3.97*	*4.25*	*6.35*	*4.56*
Productivity Growth (%)				
1970-1975	*1.9*	*2.0*	*1.7*	*1.3*
1975-1985	*3.1*	*3.9*	*4.2*	*2.5*
1985-1996	*1.3*	*1.1*	*1.4*	*2.8*
1996-2001	*0.5*	*-0.6*	*0.1*	*2.9*

Source: FAO Home page: http://www.fao.org, July 2nd 2002

Table 3.10. Production, Export, Import and Consumption of Rice in Indonesia and in the World, 1990 – 2002

Year	**World [1] (10^3 ton)**			**Indonesia [2] (10^3)**				
					Consumption			
	Production	**Export**	**Import**	**Production****	**Per capita (Kg/yr)**	**Total**	**Export**	**Import**
1990	521.703	12.482	12.305	25.698	150,06	26.873	3	30
1991	517.410	13.096	12.588	25.419	143,98	26.229	0	179
1992	527.913	16.078	14.831	27.439	148,36	27.484	73	634
1993	524.804	16.559	15.409	27.405	148,40	27.947	494	24
1994	537.338	17.990	17.655	26.503	150,99	28.898	233	876
1995	550.193	22.515	21.426	28.294	157,74	30.673	0	3.014
1996	569.236	20.353	21.710	29.067	154,49	30.505	0	1.090
1997	580.202	20.861	18.836	28.086	145,30	29.129	0	406
1998	563.188	28.605	25.533	28.006	147,33	29.980	0	5.783
1999	590.000	27.251	25.429	28.933	159,98	33.039	0	4.000
2000	592.956	28.956	26.953	28.479	160,76	33.687	0	1.512
2001*	601.094	30.661	28.477	28.793	161,56	34.383	0	1.384
Avg.	548.199	18.153	17.810	27.578	150,66	30.301		1.388

Growth (%/yr)	1.48	9.10	8.56	1.11	0.49	3.99		25.75

Source: 1) FAO Home page: http://www.fao.org, July 2nd 2002 2) BULOG, September 2000, Rice Trader Report.
Note: *Temporary Figure;**After depreciation and 10 % seed. Conversion from Paddy Rice to Rice is 63.2 %.

When combined with the large numbers of people who have become increasingly vulnerable to poverty since the crisis, Indonesia's high import dependence on its critical food staple poses a significant risk to food security. Conventional trade theory would insist that free trade is the best approach to every good, including rice. But this assumes a deep and competitive global market in this product. However, the international rice market is neither deep nor competitive. Rice exports account for just four per cent of world rice production because most rice is consumed in its country of origin. This limited exportable surplus makes for a thin market. Moreover, rice production has been highly protected even in the OECD countries, where domestic rice prices were five times higher, for example, than world market prices in 1998-2000 (Tabor, Sawit and Dillon, 2002, pp. 5, 10).

In Indonesia, domestic rice production has been stagnant since the crisis. Nominal tariffs of 30 per cent already exist on rice imports, but the effective tariff level is more like 11 per cent (Tabor, Sawit and Dillon 2002, p. vi). Due, in part, to Indonesia’s geography, tariffs are not effectively enforced. About half of rice imports apparently escape Custom's controls. The resulting lowered price of rice adversely affects the livelihoods of the vast majority of Indonesia's 14 million rice producers. It reduces any opportunities that they might have to generate the income necessary to finance changes in their methods of production.

Worse yet, more liberalized trade would expose them to devastating competition from large, capital-intensive *and highly subsidized* agricultural producers from industrialized countries. Moreover, even Indonesia’s Asian neighbors, such as India, Thailand and Vietnam, explicitly subsidize their rice production in order to enhance their international competitiveness.

Even though Indonesia has so far managed to substantially insulate its domestic rice price from the volatility of world prices, it may not be able to do so in the future. Indeed, in another crisis, it may not even be able to afford to import sufficient rice (Tabor, Sawit and Dillon, 2002, pp. 14-19).

Keenly aware of the social consequences, few national policymakers appear eager to lower the tariffs on rice imports. But some analysts have advocated that Indonesia adopt a “tariff-quota” in order to maintain food security while remaining consistent with WTO commitments (Tablor, Sawit and Dillon 2002, p. vi). This arrangement would set a modest tariff on an import quota and raise the tariff for any quantity imported above that limit. For the foreseeable future, it appears reasonable for Indonesia to maintain some such form of protection for its rice production.

Although some combination of tariffs and quotas could alleviate problems in the rice sector in the short run, longer run considerations of food security imply that Indonesia should focus on revitalizing domestic rice production and place it within the context of a general state-led programme of agricultural development. Only then will it be able to regain its competitive advantage in rice production, and develop the backward and forward linkages to agro-industry that will be so vital to achieving a pro-poor pattern of growth that benefits Indonesia’s large rural population.

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Chapter Four

Revenue Mobilization: Loosening the Fiscal Constraint[11]

4.1 The Fiscal Legacy of the Economic Crisis

The economic crisis of 1997-1998 has had grave consequences for the Indonesian budget. The country has experienced significant reductions in revenues as a result of the crisis. Between 1997 and 1998 alone, total revenues relative to national income declined by 11 percent. There was also an explosive increase in public debt due to the conversion of corporate debt into public debt. This has had the effect of substantially increasing the costs of debt servicing.

Another significant and recent change that has affected the Indonesian budget is the decentralization of one quarter of central government revenues to lower levels of government. This has adversely affected the composition of expenditures, lowering the share of developing spending in the total. Moreover, development spending has also been reduced because of declining revenues, the Government's effort to achieve a balanced budget and rising non-discretionary expenditures.[12]

Most analysts recognize that the fiscal problem is the central factor dampening the prospects for economic recovery. However, they also believe that "there is no alternative" (TINA) to the current dispensation. This raises fundamental questions about how to increase economic growth while making it more equitable and pro-poor. Ensuring fiscal sustainability while providing adequate resources to promote pro-poor growth in Indonesia has, therefore, become a crucial challenge for the Government.

Bank recapitalization bonds are the principal added fiscal burden arising from the crisis (see Chapter Five for more detailed discussion). The banking system was essentially nationalized as the Government assumed control and ownership of banks that had been previously privately controlled and owned. To finance these recapitalization bonds, the Indonesian Bank Restructuring Agency (IBRA) issued Rp 412 trillion of bonds (Ramstetter 2000). In addition, in 1998 and 1999, the Republic of Indonesia issued repayment bonds to Bank Indonesia (BI) of Rp 228 trillion (used to refund its liquidity support and its outlays for bank guarantees). Thus, IBRA's combined liabilities rose to Rp 640 trillion in government bonds.

With the government bailout, enterprise assets and outstanding loans were transferred to IBRA. Although IBRA has acquired assets with a book value of Rp 470 trillion, their market value is thought to be only 35-40 per cent of book value and actual realizations have been much lower. This has resulted in three major fiscal problems for the Republic:

- The Government has to finance interest on recapitalization bonds.
- Beginning in 2003,the Government has had to start paying down the principal on these bonds.
- IBRA has to dispose of assets with highly uncertain, and so far extremely low, realizations to help alleviate the fiscal burden of recapitalization bonds.

Table 4.1 indicates the magnitude of this added fiscal burden. In 2002, domestic interest payments constituted 3.9 percent of GDP, in contrast to zero domestic debt-servicing expenditure in the pre-crisis year of 1996. Domestic debt-servicing obligations can be expected to increase further since the redemption of bonds commenced in 2003. IBRA asset recovery is expected to

[11] This chapter was written by J. Mohan Rao and Barsha Kattry, with updating and editing by Terry McKinley.
[12] Indonesia's balanced budget rule does not require that revenues equal expenditures, but rather that deficits be covered by inflows of aid and overseas borrowing, coupled with privatization receipts and IBRA asset sales.

finance half or less of this increased burden and the privatization of state-owned enterprises (SOEs) is expected to contribute another 10-20 per cent. These expectations are, however, optimistic. According to Ramli (2002), the growing debt service burden will continue to force the Government to raise fuel prices, electricity rates and taxes, and to sell off state assets at fire-sale prices.

Subsidies comprised 6.1 per cent of GDP in 2000, a large increase from their level of 0.3 per cent in the pre-crisis year of 1996. They were intended to cushion the effect of the crisis on the welfare of the population. But there has been much debate about whether subsidies should be reduced and eventually phased out since they have been a major expenditure item and have not been well focused on the most needy. By 2002, in the continuing effort to reduce its deficit, the Government had reduced subsidies to only 2.4 per cent of GDP.

Another major source of fiscal strain on the budget stems from the current decentralization policy. Law No. 22/1999, formulated during the regime of President Habibie, came into effect on January 1, 2001. Under this law, the central government transfers one quarter of its revenue to local governments. This has translated to expenditures at local level equal to 5.9 per cent of GDP or 30 per cent of total expenditures (Table 4.1).

To be sure, the devolution of funds could increase efficiency in the delivery of net benefits (minus "leakages") and, in the long run, could be a powerful force for democracy and empowerment. However, in the short to medium term, there are serious problems stemming from the lack of clarity about the law and jurisdictional issues, and the lack of capabilities at the local level. Thus, there is an immediate potential for even greater leakages of funds than under central authority.

The large expenditure items such as debt servicing have had serious implications for development spending since they have diverted revenue away from productive expenditure. The primary fiscal surplus has risen steadily since 1998 because of the conditionalities imposed by the international financial institutions and the steep cutback in development expenditures. During 1996-2002, central government capital expenditure contracted by 61 per cent, from 6.2 per cent to 2.4 per cent of GDP.

The decline in development spending at the center has to some extent been alleviated by regional development spending since the implementation of the decentralization law. The fall in total capital expenditure (central and regional) has therefore been from 6.2 per cent of GDP in the pre-crisis year of 1996 to 4.4 per cent of GDP in 2001 (Table 4.1). Although development spending by the regions has to some extent compensated for the decline in such spending by the center, there has still been a net reduction in overall expenditures on development. Moreover, the regions will not be able to provide the critical infrastructure (such as national highways, ports and power plants) that can be provided by the center.

Fiscal policy in Indonesia is operating under tight constraints dictated by obligations to meet large debt service payments, transfer one quarter of total public revenue to local governments under the decentralization process and eliminate budget deficits. Reluctance to change revenue parameters by raising taxes and the imposition of the balanced budget rule have meant that development expenditures have borne a substantial part of the burden of adjustment. The key problem now is how to alleviate these constraints so that the Republic of Indonesia can pursue a pro-growth and pro-poor development strategy.

Table 4.1: Central Government Fiscal Aggregates (in billion rupiah)

	1995	1996	1997	1998	1999	2000	2001	2002
Domestic Revenue	70852	87630	107965	146872	204422	194146	300600	299887
	(15.6)	(16.5)	(17.2)	(15.4)	(18.4)	(19.7)	(20.2)	(18.0)
Tax Revenue	54258	64422	81752	118795	135533	111064	185541	210950
	(11.9)	(12.1)	(13.0)	(12.4)	(12.2)	(11.3)	(12.4)	(12.6)
Nontax Revenue	16595	23209	26213	28076	68889	82871	115059	88933
	(3.7)	(4.4)	(4.2)	(2.9)	(6.2)	(8.4)	(7.7)	(5.3)
Total Expenditure	62402	77900	111543	168096	231082	223907	341563	327863
	(13.7)	(14.6)	(17.8)	(17.6)	(20.8)	(22.7)	(22.9)	(19.7)
Capital Expenditure	27201	32928	36311	52824	57638	25926	41585	40271
	(6.0)	(6.2)	(5.8)	(5.5)	(5.2)	(2.6)	(2.8)	(2.4)
Current Expenditure	35201	44972	75232	115272	173444	164087	218923	189069
	(7.7)	(8.4)	(12.0)	(12.1)	(15.6)	(16.6)	(14.7)	(11.3)
Domestic Interest	0	0	0	8385	22230	34770	58197	64461
	(0.0)	(0.0)	(0.0)	(0.9)	(2.0)	(3.5)	(3.9)	(3.9)
Foreign Interest	6875	9902	16735	24189	20058	18559	28945	25406
	(1.5)	(1.9)	(2.7)	(2.5)	(1.8)	(1.9)	(1.9)	(1.5)
Subsidies	0	1416	20413	33872	65916	59725	77443	40006
	(0.0)	(0.3)	(3.3)	(3.5)	(5.9)	(6.1)	(5.2)	(2.4)
Regional Expenditure	0	0	0	0	0	33894	81054	98522
	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(3.4)	(5.4)	(5.9)
Regional Capital Expenditure	0	0	0	0	0	n.a.	23390	n.a.
	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	n.a.	(1.6)	n.a.
Overall Deficit/Surplus	8450	9730	-3578	-21224	-26660	-29761	-40480	-27680
	(1.9)	(1.8)	(-0.6)	(-2.2)	(-2.4)	(-3.0)	(-2.7)	(-1.7)
Primary Balance	15325	19632	13157	11349	15628	23568	46660	62190
	(3.4)	(3.7)	(2.1)	(1.2)	(1.4)	(2.4)	(3.1)	(3.7)
Memo Items								
Total Capital Expenditure (Rp Billion)	27201	32928	36311	52824	57638	n.a.	64975	n.a.
Total Capital Expenditure (% of GDP)	6.0	6.2	5.8	5.5	5.2	n.a.	4.4	n.a.

Source: World Bank (2001), Ministry of Finance and Bank Indonesia.
Notes: Variables are expressed as percentage of GDP in parentheses. Fiscal year beginning April 1 for 1995-99, April-December for 2000, and January-December for 2001. n.a.: not available.

4.2 Financing Public Investment-Led Growth

There has been a broad consensus among key decision makers that there is no viable alternative to adherence to orthodox, conservative macroeconomic prescriptions. However, in late 2002, an important grouping of national economists emerged to pose an alternative to orthodox policymaking.[13] The reason for the upsurge in debate and the rise of alternative strategies is that, as of late 2003, nearly six years after the crisis ignited, orthodox macroeconomic prescriptions have neither revived rapid growth nor fostered pro-poor development. The investment rebound has not materialized, export growth has not been sustained despite substantial real depreciation of the rupiah and GDP growth has remained far below what is required to absorb new entrants into the labour force, let alone clear the huge crisis-induced backlog of unemployment and under-employment.

The central premise of this report is that a higher rate of growth and more rapid poverty reduction can be achieved along with stability only if basic macroeconomic policies are substantially reconfigured. This reconfiguration reverses the causal sequence between finance and the real economy: a coordinated rise in investment and growth in the real sectors will create the conditions for monetary and financial stability rather than the other way around.

The key element in the proposed macroeconomic package is growth led by public investment, which will serve to crowd in "investor confidence" and provide a "bandwagon" to lure back foreign capital inflows, especially the US$ 20-40 billion that are widely believed to have fled Indonesia after the crisis began. Provided that financing for the boost in public investment is secured, the corresponding rise in private investment will be financed by a combination of rising domestic savings (stemming from the rise in incomes that the investment will generate) and the ensuing rise of capital inflows.

But can the fiscal stance be relaxed on the grounds that public investment (including human capital expenditures) will crowd in rather than crowd out private investment? Since fiscal conservatism (on the part of both the Government of Indonesia and the IMF) produced only a weak, delayed and unreliable economic stimulus in the immediate aftermath of the crisis, the depth of the recession and the loss in growth momentum have been greater than might have been expected (see, for example, Pincus and Ramli 1998). Since there are still few signs of a recovery in private investment, the case for a fiscal stimulus is compelling. The central economic issue is a failure of investment coordination: each will invest if all invest, but if one invests when others do not, expected profits cannot be realized. What public investment can provide is the investment coordination that can resolve this "prisoner's dilemma".

Contrary to the prevailing opinion among policy makers, it is domestic investors, rather than foreign investors, who are the key to investment recovery. Even at their peak in 1996, inward FDI flows amounted to only nine per cent of total fixed investment; it is domestic firms that undertake most fixed investment. If cumulated from 1983, FDI amounted to only four per cent of fixed investment through 1999. During this period, increases in FDI have followed or coincided with rises in domestic fixed investment. Thus, the key to stimulating capital inflow is a revival in domestic investment.

This report's proposed investment-led strategy is not dependent on exports to play the leading role in raising the rate of GDP growth. In particular, an investment-led approach is likely to be the most effective strategy to lure back foreign capital inflows and thereby help increase the foreign exchange earnings needed to finance both additional imports of capital goods and the servicing of the external debt without causing any major swing in the medium-term prospects for

[13] See the document by Indonesia Revitalized, "After the IMF: Indonesia Revitalized," Mimeograph, November 15, 2002, Jakarta.

the rupiah. Moreover, it is inadvisable to pin hopes on exports to pull the economy out of its current stagnation. One reason is that the crisis has dampened the prospects for many export sectors, including textiles, footwear and toys, while competition from China threatens to make further inroads in these labor-intensive sectors.

Despite a real depreciation of the rupiah, the trend in the ratio of non-oil exports to GDP has been disappointing. A related consideration is that Indonesia has suffered terms of trade losses in major export areas. Also, growth prospects for world income have weakened in the wake of the US corporate scandals and stock market slump. Under these circumstances, any sustained rise in GDP growth is not likely to be led by exports. Thus, the country must also rely on market expansion in the domestic import-substituting and nontradable sectors. By contrast, the current policy regime and the thrust of advice from international financial institutions are placing too much emphasis on export recovery.

Scenarios for Raising Public Investment

If public investment is crucial to economy recovery, how much would be needed to jumpstart the Indonesian economy? Following are estimates of the magnitude of additional public investment required to raise the rate of GDP growth under alternative scenarios (see the table below). For this purpose the report makes the following assumptions:

1. Real GDP growth during 1999-2002 has been around 4 per cent.
2. In Scenario 1, GDP growth rises by one percentage point to 5 per cent. In Scenario 2, GDP growth rises by two percentage points to 6 per cent.[14]
3. The Incremental Capital-Output Ratio (ICOR) is estimated to be 4.
4. Two crowding-in ratios are estimated by regressing current private investment on both current and lagged public investment.
   These ratios are:
   Scenario A: The crowding-in ratio is 2 for private investment relative to current public investment.
   Scenario B: The crowding-in ratio is 4 for private investment relative to lagged public investment.

	Scenario			
	1A	**1B**	**2A**	**2B**
Targeted real GDP growth (%)	5	5	6	6
Additional required GDP growth (% points)	1	1	2	2
Crowding-in ratio	2	4	2	4
ICOR	4	4	4	4
Change in total required investment (% points of GDP)	4	4	8	8
Change in required public investment (% points of GDP)	1.3	0.8	2.7	1.6

Notes: Change in total required investment = ICOR times additional required GDP growth.
Change in required public investment for scenarios 1A and 2A = 0.3 times change in total required investment.
Change in required public investment for scenarios 1B and 2B = 0.2 times change in total required investment.

[14] Based on current estimates of employment elasticity, a growth rate of at least five per cent in the short to medium term is required for mitigating the incidence of poverty in post-crisis Indonesia. The growth rate for 2003 is projected to be 3.4 per cent—well below that required to absorb new entrants into the labour force, much less provide jobs for those laid off by corporate restructuring.

The required additional public investment ranges between 0.8 percentage points to 2.7 percentage points of GDP. In Scenario 2A, for example, where the required additional real GDP growth rate is 2 percentage points and the private-public crowding in ratio is 2, the additional public investment required is approximately Rp 40 trillion or US$ 4.5 to US $5 billion (assuming an exchange rate of $1 = Rp 8000 to Rp 9000).

Financing Options for Public Investment

As discussed in the previous section, the key constraint for such a public investment-led growth strategy is fiscal, due to the rising costs of bank recapitalization bonds and the difficulties of achieving rapid sales of IBRA assets at reasonable prices. The various options that can alleviate this fiscal constraint are discussed below:

1. Raise Revenues: Successive governments in Indonesia and the IMF have not emphasized tax rate increases as an option to reduce fiscal deficits or, more importantly, to maintain public investment and development expenditures. Instead, the emphasis has been on strengthening tax collections. But, even allowing for the disincentives that higher tax rates might create, the drop in revenue has surely had adverse effects on current welfare and even more on future welfare. This fiscal stance has entailed large and certain macroeconomic costs in the name of achieving much-vaunted microeconomic gains that, in reality, are both negligible and uncertain. The usual objections to raising corporate income taxes are that these would serve to depress investment since corporations invest from their own financial sources and banks have not yet increased credit allocations significantly. It is worth noting, however, that in light of the severe fiscal constraint faced by the Republic, the IMF has recently proposed to increase corporate tax rates. There are also objections to increasing indirect taxes, such as the VAT, because, it is claimed, this could depress household consumption, which has of late been the prime stimulus to economic growth. The various options for revenue mobilization will be considered in greater depth in the next section. The basic stance of this report is to both raise certain tax rates and fortify effectiveness in tax collection. There need be no inherent trade-off between the two approaches.
2. Monetize the Deficit: The balanced budget rule, enforced since the crisis in Indonesia, does not call for revenues to equal expenditures, but rather requires that deficits be covered by inflows of aid and overseas borrowing, coupled with privatization receipts and IBRA asset sales. These sources of finance are governed by factors that are extraneous to those governing the growth process and, therefore, have no relation to the present imperative of increased pro-poor growth. Moreover, as the IMF itself has acknowledged, since concessional aid is volatile and cannot be predicted reliably, its disbursements often fall short of commitments. Therefore, the Government's version of the balanced budget rule, limiting fiscal deficits to these sources of finance, is not helpful. Domestic sources of financing are needed. However, it is generally believed that monetization of the deficit is usually one of the least desirable forms of financing although it can raise revenue through seignorage effects.

   The usual objection to deficit financing is that it causes inflation. Those who support the prevailing policy regime argue that inflation will be highly destabilizing for the external balance, the fiscal balance and poverty. But, in late 2003, inflation had dropped to 6-7 per cent and the demand side factors pushing up inflation had considerably weakened. The inflation argument against monetizing the deficit is not compelling in current circumstances since there is little danger of "crowding out" private investment when there is excess liquidity in the banking system. Instead, public investment can help crowd in private investment both from the supply-side effects of improved infrastructure and human capital and from the

demand-side benefits of a confidence-boosting or investment-coordinating effect. In fact, the current preoccupation with reining in inflation appears to have inhibited the resurgence of growth.

3. Domestic Borrowing: Instead of relying on Bank Indonesia to finance the deficit through additional money creation, another option is to borrow funds domestically instead of internationally. As long as such funds are used to finance productive public investment, this approach is sustainable. Fortunately, the Government has been able in recent years to lower the rate of interest that governs such borrowing. In 2003, Parliament legally approved the creation of a government bond market and the current administration has begun to avail itself of this option. However, the emphasis has been on rescheduling the debt rather than financing public investment.
4. Request Independent Assessment of External Debt: The World Bank and the Government of Indonesia have acknowledged that the country's external debt burden is directly affecting fiscal sustainability and investor confidence, and thereby, new capital inflows. Moreover, a part of the multilateral loans to the Soeharto regime was no doubt misused. This criminal or odious debt is estimated to be approximately US$10 billion (Winters 2000). The World Bank estimated that total debt service in 2002 was Rupiah 136 trillion or 45 per cent of projected revenues. To put this in perspective, debt service expenditures are equal to approximately forty times the budget for the Social Safety Net Program designed to help the poorest of the poor and are eight times the size of the education budget (Bahagijo 2002 and Ramli 2001).

Many non-governmental organizations have recently advocated that Indonesia's debt be re-evaluated by an Independent Debt Tribunal (see Chapter 5 of this report). In March 2002, the International NGO Forum on Indonesian Development (INFID) and Jubilee 2000 campaigners proposed such a tribunal. Its aim would be to provide a comprehensive, long-term solution to Indonesia's debt problems, based on the human development needs of her population, as set out in the Millennium Development Goals, and realistic assumptions on the future outlook for the Indonesian economy. This human development approach to debt sustainability estimates that only half of Indonesia's total debt should be repaid if the country is to devote sufficient resources to poverty reduction and human development. Moreover, such an approach would likely call for a cancellation of the roughly US$ 10 billion of criminal or odious debt acquired by Indonesia under Soeharto since the public has never received any benefits from it.

4.3 Options for Revenue Mobilization

Although the preceding section has outlined four different ways to finance a public investment-led strategy of growth, this section confines its attention to the revenue mobilization option because this report regards it as the most important. This is more under the control of the Government of Indonesia (in contrast to external debt), less likely to worsen inflation (in possible contrast to monetizing the deficit) and does not potentially add to the public debt (as can happen with domestic borrowing).

This chapter operates on the assumption that the additional required investment of approximately Rupiah 40 trillion (in scenario 2A) can be financed from additional revenues. It also recommends that the additional revenues be mobilized in ways that maximize pro-poor gains while holding down efficiency losses.

The following discussion considers in some detail the historic structure of taxation in Indonesia and the high prevalence of tax evasion that has plagued the tax system for a long time. Changes in the tax structure that have arisen as a result of the crisis are also discussed at some length. The discussion takes account of both the endemic features of Indonesia's tax system and the changes stemming from the crisis and suggests that both of these issues need to be addressed in order to ease the fiscal constraint and promote pro-poor growth.

Figures 4.1 and 4.2 summarize the trends in tax revenue (both relative to GDP and in terms of constant Rupiah) for the period 1980-2001. Tax revenues as a share of national income have declined substantially since the peak of approximately 20 per cent attained in the early 1980s. This extraordinary decline is contrary to the virtually universal finding that national tax effort rises as per capita GDP rises. In terms of constant rupiah, too, tax revenues in 2001 were well below the peak attained in 1994. Indonesia is also under-taxed relative to Asian neighbors that have similar economic conditions. Its tax revenue/GDP ratio of approximately 12 per cent is below even those of the Philippines and Sri Lanka, which have tax revenue/GDP ratios of 14 and 15 per cent respectively. Ratios of 12-15 per cent are all relatively low. In 2002, Indonesia's tax revenue/GDP ratio was 12.4 per cent while in 2003 it inched up to only 12.6 per cent.

Table 4.2 summarizes the structure of central government revenue for recent years (1995-2001). While tax revenue as a proportion of gross domestic product has declined since the crisis, reaching the low of 11.3 per cent in 2000, overall domestic revenues as a share of GDP have risen due to a rising share of nontax revenues. That latter have increased due to a sharp increase in the share of natural resource revenues. The decline in tax revenue can be attributed to a fall in income tax revenue. Income taxes on oil and natural gas have, in fact, risen since the pre-crisis year of 1996—from 1.3 per cent in 1996 to 1.6 per cent in 2001 (relative to GDP). The contrary situation characterizes income tax revenue from sources other than oil and gas. These taxes have declined to 4.7 per cent of GDP in 2001 from 5.5 per cent in 1997.

One of the main contributors has been the recent economic crisis, which has afforded new opportunities for income tax evasion. The massive flight of Indonesian capital that occurred in the immediate aftermath of the crisis could explain, in part, the observed decline in income tax revenue. In Chapter Two, growth accounting exercises revealed that the marginal propensity to tax had fallen by almost 80 per cent, from 0.14 to 0.03 (see Table 2.2). Tax buoyancy needs to be raised either by changing the composition of taxes, raising rates on certain taxes or improving tax collection.

Under-reporting of income is a major problem that also plagues income tax revenue. The income tax base is very small compared to that in other countries of comparable income levels because a relatively higher proportion of tax payers under-report their income and a similarly higher proportion do not even file tax returns. Uppal (2000) estimates that the ratio of income tax payers to total population is only 0.5 per cent in Indonesia compared to two per cent in other Asian countries with comparable income. During 2000, of the 20 million people that should have paid taxes, only 1.3 million were registered tax payers and less than half of these were dutiful tax payers. Moreover, at least half of Indonesia's government officials did not pay taxes in 2001 (Swire 2001).

The World Bank (2003) claims that even a 50 per cent increase in uncollected taxes would have nearly eliminated the public deficit in 2002. It confirms the general impression that the vast majority of tax returns claim no income even though many of the tax payers receive corporate or personal income. Thus, it stresses the importance of the collection of taxes and the expansion of the tax base. However, in some instances, it also favours increasing tax rates, such

as raising the 10 per cent VAT rate by one or two percentage points or increasing excise tax rates on alcohol and tobacco.

The Large Taxpayers Office, started in mid 2002, could make a major contribution to revenue mobilization. It targets the 200 largest taxpayers in the country, who account for 40 per cent of all tax revenues. If this office is successful in compelling the rich to pay their fair share of taxes, this effort could substantially boost public revenues.

Tax evasion is flourishing because of difficulties in identifying and locating potential income tax payers, verifying tax returns and recovering unpaid arrears. These problems are also compounded by the lack of computerization and the culture of corruption that encourages negotiations between tax payer and collector on the agreed amount to pay.

While income taxes constitute the lion's share of tax revenue, property taxes contribute a paltry 3.4 per cent of GDP. The tax rate on property is a low 0.5 per cent of the assessable value; and the latter is 20 per cent of the market value of the property, except for residences with a market value in excess of Rp 1 billion. It is imperative, for the sake of equity in Indonesia's tax system, to increase taxation of the wealthy. Since the rich tend to hide or under-value their income, it is important to identify their forms of wealth, such as real estate holdings, which can be more easily taxed.

Indonesia's trade tax revenues are also low compared to those in other countries with similar levels of per capita income. In 2001, revenues from international trade taxes were 0.7 per cent of GDP and approximately 5.7 per cent of tax revenue. Their share has remained roughly the same since the mid-1990s. By contrast, the trade tax revenue/GDP ratios in the Philippines and Sri Lanka are much higher, at 2.9 per cent and 2.5 per cent respectively.

Trade revenues in Indonesia are expected to decline substantially in the near future since the country endorses reducing custom barriers and promoting free trade under regional trade agreements. Tariff rates are low since most goods subject to import tariffs are in the zero to five per cent duty category. The Government has agreed, however, to sharply increase import tariffs on sugar and such other farm commodities as rice, soybean and corn in order to protect local farmers from unfair competition caused by cheap foreign farm produce dumped on the local market (Jakarta Post, June 27).

Trade tax revenues are also low because of the numerous exemptions granted to both domestic and foreign importers, which enable them to import duty-free capital and intermediate goods and raw materials provided that the imports will be employed in producing exports. This system has allegedly been abused by falsely claiming tax credits for imported intermediate goods even though these goods are not utilized for manufacturing exports. Export taxes have also declined and are expected to decline further as exporters are pressing for tax reductions because Indonesian non-oil exports are facing problems of heightened competition from other Asian countries (particularly China) and the growth in Indonesia's main export markets has slowed.

About one-third of the country's tax revenues are raised from the Value Added Tax (VAT). This source yielded almost four per cent of GDP both before the crisis (1996) and after it (2001), although its level fluctuated considerably during this period. According to Uppal (2000), considerable scope exists to raise additional revenues from the VAT since a large number of goods and services are currently exempt from this tax. These range from agricultural and forestry products to public telephones and religious activities.

Figure 4.1: Trends in Fiscal Aggregates (in constant rupiah)

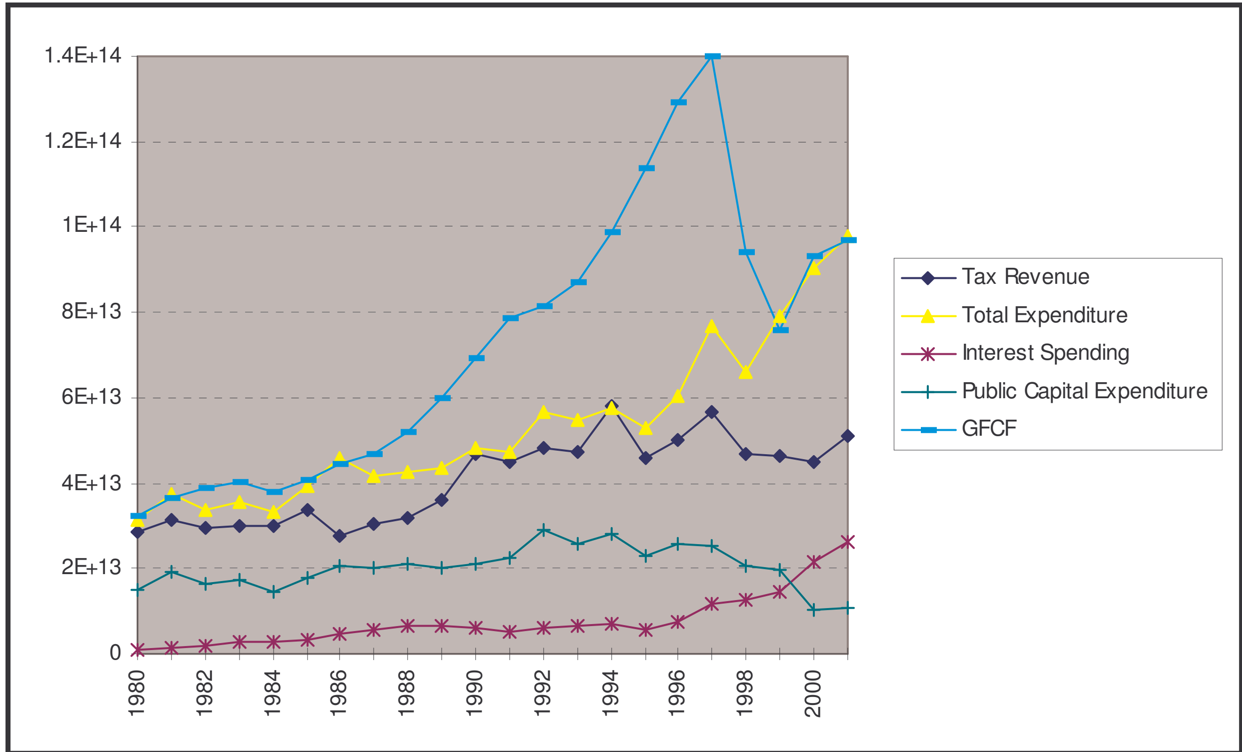
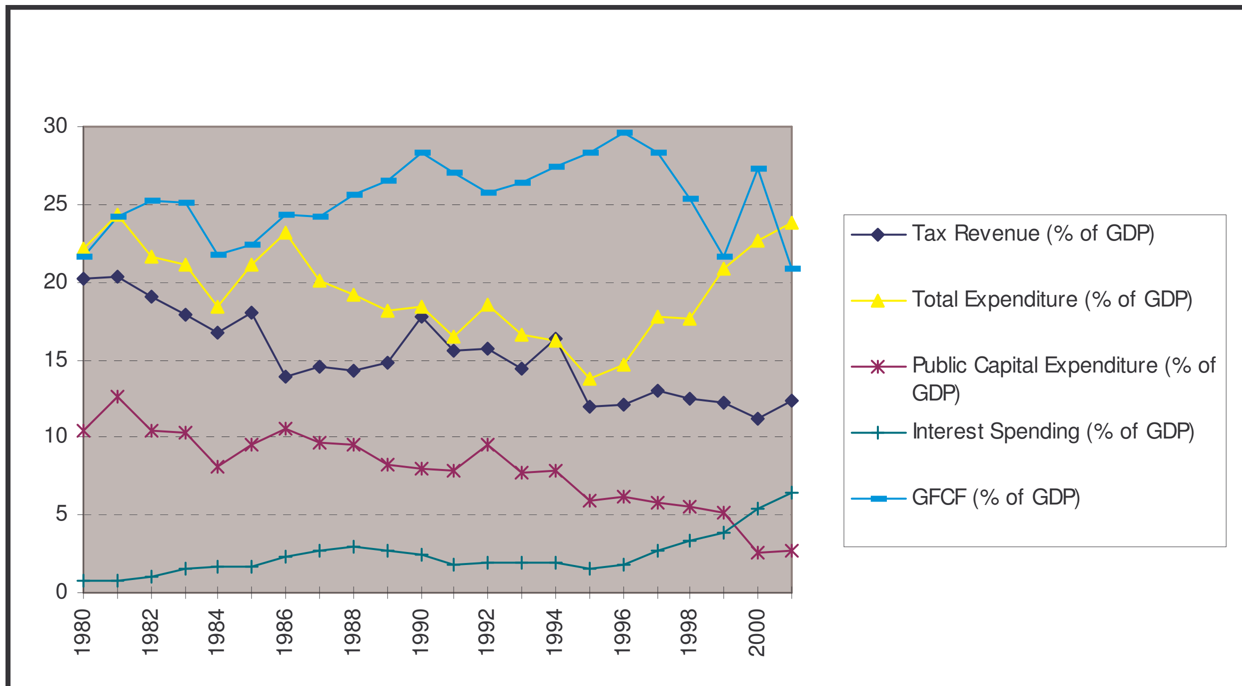


Figure 4.2: Trends in Fiscal Aggregates (% of GDP)



Sources for both figures: IFS (various issues) and World Bank (2001).

Table 4.2: Central Government Revenues

	1995	1996	1997	1998	1999	2000	2001
Domestic Revenue (% GDP)	**15.6**	**16.5**	**17.2**	**15.4**	**18.4**	**19.7**	**20.1**
Tax Revenue (% GDP)	**11.9**	**12.1**	**13.0**	**12.4**	**12.2**	**11.3**	**12.4**
(% Domestic Revenue)	76.6	73.5	75.7	80.9	66.3	57.3	61.6
Trade Taxes (Rp Billion)	**3216**	**2660**	**3127**	**6936**	**5036**	**6454**	**10548**
(% GDP)	0.7	0.5	0.5	0.7	0.5	0.7	0.7
(% Tax Revenue)	5.9	4.1	3.8	5.8	3.7	5.8	5.7
Import Duties (Rp Billion)	3029	2579	2999	2306	4177	6116	9828
(% GDP)	0.7	0.5	0.5	0.2	0.4	0.6	0.7
(% Tax Revenue)	5.6	4.0	3.7	1.9	3.1	5.5	5.3
Export Duties (Rp Billion)	186	81	129	4630	859	338	720
(% GDP)	0.0	0.0	0.0	0.5	0.1	0.0	0.1
(% Tax Revenue)	0.3	0.1	0.2	3.9	0.6	0.3	0.4
Income Taxes (Rp Billion)	**26583**	**34144**	**45206**	**72345**	**82311**	**57615**	**92767**
(% GDP)	5.9	6.4	7.2	7.6	7.4	5.8	6.2
(% Tax Revenue)	49.0	53.0	55.3	60.9	60.7	51.9	50.2
Oil & Gas (Rp Billion)	5571	7082	10818	16401	22628	17472	23071
(% GDP)	1.2	1.3	1.7	1.7	2.0	1.8	1.6
(% Tax Revenue)	10.3	11.0	13.2	13.8	16.7	15.7	12.5
Non-oil & gas (Rp Billion)	21012	27062	34388	55944	59683	40144	69696
(% GDP)	4.6	5.1	5.5	5.9	5.4	4.1	4.7
(% Tax Revenue)	38.7	42.0	42.1	47.1	44.0	36.1	37.7
VAT (Rp Billion)	**18519**	**20351**	**25199**	**27803**	**33087**	**31525**	**55841**
(% GDP)	4.1	3.8	4.0	2.9	3.0	3.2	3.8
(% Tax Revenue)	34.1	31.6	30.8	23.4	24.4	28.4	30.2
Excise Duties (Rp Billion)	**3593**	**4263**	**5101**	**7733**	**10381**	**10632**	**17622**
(% GDP)	0.8	0.8	0.8	0.8	0.9	1.1	1.2
(% Tax Revenue)	6.6	6.6	6.2	6.5	7.7	9.6	9.5
Property Taxes (Rp Billion)	**1894**	**2413**	**2641**	**3565**	**4107**	**3824**	**6289**
(% GDP)	0.4	0.5	0.4	0.4	0.4	0.4	0.4
(% Tax Revenue)	3.5	3.8	3.2	3.0	3.0	3.4	3.4
Other Taxes (Rp Billion)	**453**	**591**	**478**	**413**	**611**	**1014**	**1670**
(% GDP)	0.1	0.1	0.1	0.0	0.1	0.1	0.1
(% Tax Revenue)	0.8	0.9	0.6	0.4	0.5	0.9	0.9
Nontax Revenue (% GDP)	**3.7**	**4.4**	**4.2**	**2.9**	**6.2**	**8.4**	**7.7**
(% Domestic Revenue)	23.4	26.5	24.3	19.1	33.7	42.7	38.4
Natural Resource Revenue (Rp Billion)	**10483**	**13055**	**15431**	**15431**	**35854**	**70186**	**86658**
(% GDP)	2.3	2.5	2.5	1.6	3.2	7.1	5.8
Profits of Public Enterprises (Rp Billion)	**1604**	**2650**	**2341**	**3428**	**5430**	**5281**	**10440**
(% GDP)	0.4	0.5	0.4	0.4	0.5	0.5	0.7
Other Nontax Revenues (Rp Billion)	**4508**	**7503**	**8442**	**9217**	**27605**	**7403**	**18007**
(% GDP)	1.0	1.4	1.3	1.0	2.5	0.8	1.2

Source: World Bank (2001)

Notes: Fiscal year beginning April 1 for 1995-99, April-December for 2000, and January-December for 2001.

While some basic goods, such as rice and salt, are exempt from the VAT (which is desirable from an equity point of view), many luxury goods are also exempt. Exempting goods and services that are consumed mainly by high-income consumers renders this tax regressive. In 2003, the Government eliminated luxury taxes on certain domestically produced electronic products, ostensibly in order to benefit local firms. Along the same lines, it also waived in May 2003 10 per cent of the VAT on the import of certain capital goods and raw materials by several industrial sectors. In contrast, this report would recommend raising consumption taxes on such luxury items as high-priced vehicles and brand-name consumer goods (see Chapter Six).

Tax avoidance is prevalent among potential VAT payers. A recent survey in Jakarta found that about 30-40 per cent of tax obligators avoid paying the VAT. Uppal (2000) estimates that Indonesia's tax revenue to GDP ratio would triple if all taxes were fully collected according to legal provisions!

Based on the situation sketched out above, various options to mobilize revenues are considered below:

1. Imposing a tariff of ten per cent on all imports could raise the additional $5 billion required to finance the desired public investment-led strategy of growth.[15]
2. Reducing and removing exemptions granted to importers and exporters would not only raise additional revenue but also mitigate the widespread abuse of these exemptions.
3. Raising the property tax rate from the current low rate of 0.5 per cent of assessable value would contribute valuable revenues to the exchequer while making the tax system more progressive**.** Undertaking more extensive registration of properties, particularly in urban areas, would be very helpful.
4. Identifying potential income tax payers by relying on indirect evidence on income. India has employed such a strategy, widening the tax base by identifying non tax payers, for example, who possess automobiles, telephones, have traveled abroad or stayed in expensive hotels.
5. Reducing VAT exemptions granted to numerous goods and services as long as equity considerations are taken into account.
6. Reforming the tax administration to bolster revenue receipts through improved tax collection techniques. This could be achieved by computerizing records (leading to better verification and identification of tax payers) and training tax administrators.
7. Reducing corruption amongst tax collectors (and hence, improving revenue collection) by providing them with greater incentives for effectiveness. As constrained fiscal resources will not permit salary increases for collectors, a bonus scheme financed by additional revenues that are collected should help in alleviating corruption.

A judicious combination of the above seven proposals is the general recommendation of this report in order to boost the revenue base of the Government enough to finance essential public services and increase badly needed public investment. The combination of proposals emphasizes increased taxation of the rich, such as through eliminating exemptions on taxation of luxury consumption and boosting property taxes, and improvements in the collection of taxes, especially for corporate and income taxes. In some cases, such as taxes on luxury consumption

[15] The import tariff rate is obtained by applying the US$ 5 billion of additional public investment required to achieve a real GDP growth of 6 percent to expected imports in 2002 ($49.3 billion) assuming a similar growth rate of real GDP.

goods or real estate, tax rates should be raised, not lowered. Through such means, equity can be promoted with little projected loss of efficiency.

Ramli (2003) reports that in the future nontax revenues might well contribute substantially more funds since Indonesia is likely to enjoy a boom in gas revenue. This is a promising development but such revenues should not be allowed to substitute for increased vigor in collecting tax revenues. In this regard, Ramli places emphasis on increasing the number of Indonesians on the tax rolls in order to augment income tax revenues. Instead of raising tax rates on corporate and personal incomes, he favours reducing nominal tax rates while boosting the effectiveness of tax collection. He also advocates providing a tax amnesty to corporations and individuals that have failed to pay taxes as long as they pay back taxes and penalties.

4.4 Pro-poor Allocation of Current and Capital Expenditures

Policy makers have been hesitant to implement tax hikes as a means of raising revenues for fear of the disincentive effects that might accompany them. They have also espoused fiscal conservatism by seeking to achieve a balanced budget. Consequently, the increased fiscal burdens of debt servicing and decentralization have had to be accommodated at the expense of other expenditures—mainly by a drastic reduction in development expenditures. Several crucial infrastructure projects have been canceled and spending on schools, healthcare and other social expenditures have also been severely cut. This section outlines how a judicious re-allocation of resources between current and capital spending could provide a sound foundation for renewed pro-poor growth. Attention is confined to interest spending, subsidies and development spending.

Total real expenditures have increased substantially since the onset of the crisis. As Figures 4.1 and 4.2 show, this has transpired as a result of a sharp increase in interest spending. By contrast, central government capital spending, both in constant rupiah and as a share of GDP, is well below the pre-crisis (1996) level and even below the levels attained during the early 1980s. Tables 4.3 and 4.4 demonstrate that there is a substantial imbalance in the shares of total expenditure allocated to current and capital spending. Moreover, this disparity has been increasing during the last few years. During 2001, development spending comprised just 11 per cent of total central government spending (compared to 42 per cent just prior to the crisis), while the share of spending allocated to routine expenditures was approximately 66 per cent.

Debt Servicing

The main culprit for the rising share of routine expenditures is the rising interest burden. As a poor and populous country undergoing multiple transitions, Indonesia has allowed itself to become mired in a debt trap, in part because of the advice it has received from international financial institutions. Debt reduction is vital if the Republic is to focus on the imperatives of physical and human capital formation and poverty reduction.

Many solutions have been suggested for reducing the debt-burden. As discussed in the preceding section, some analysts have argued for debt relief. Others have suggested that the amount and type of debt rescheduling be increased significantly in order to manage the large stock of external debt. However, Indonesia needs substantial debt reduction, not just rescheduling. Lemoine (2002) suggests, for instance, that Indonesia needs a reduction of the stock of debt in accordance with the Naples terms, i.e., a reduction in debt by 67 per cent. This would reduce the interest burden and free resources that could be channeled into more productive development spending (see Chapter Five).

Table 4.3: Central Government Current Expenditures (in billion rupiah)

	1995	1996	1997	1998	1999	2000	2001
Total Expenditure	**62402**	**77900**	**111543**	**168096**	**231082**	**223907**	**354578**
(% GDP)	13.7	14.6	17.8	17.6	20.8	22.7	23.8
Current Expenditure	**35201**	**44972**	**75232**	**115272**	**173444**	**164087**	**232796**
(% GDP)	7.7	8.4	12.0	12.1	15.6	16.6	15.6
(% Total Expenditure)	56.4	57.7	67.4	68.6	75.1	73.3	65.7
Personnel Expenditure	**13001**	**14455**	**17269**	**23216**	**32719**	**29990**	**39544**
(% GDP)	2.9	2.7	2.8	2.4	2.9	3.0	2.7
(% Total Expenditure)	20.8	18.6	15.5	13.8	14.2	13.4	11.2
Interest Payments	**6875**	**9902**	**16735**	**32574**	**42288**	**53329**	**95527**
(% GDP)	1.5	1.9	2.7	3.4	3.8	5.4	6.4
(% Total Expenditure)	11.0	12.7	15.0	19.4	18.3	23.8	26.9
Subsidies	**0**	**1416**	**20413**	**33872**	**65916**	**59725**	**81575**
(% GDP)	0.0	0.3	3.3	3.5	5.9	6.1	5.5
(% Total Expenditure)	0.0	1.8	18.3	20.2	28.5	26.7	23.0
Oil Subsidies	0.0	1416	9814	28607	40923	51135	68381
(% GDP)	0.0	0.3	1.6	3.0	3.7	5.2	4.6
(% Total Expenditure)	0.0	1.8	8.8	17.0	17.7	22.8	19.3
Non-oil Subsidies	0.0	0.0	10599	5265	24993	8590	13194
(% GDP)	0.0	0.0	1.7	0.6	2.3	0.9	0.9
(% Total Expenditure)	0.0	0.0	9.5	3.1	10.8	3.8	3.7

Source: World Bank (2001)
Notes: Fiscal year beginning April 1 for 1995-99, April-December for 2000, and January-December for 2001.

Subsidies

The second largest component of routine spending has been government subsidies. Both oil and non-oil subsidies had increased in the aftermath of the crisis, but have since been on the decline. Fuel subsidies declined to 4.6 per cent of GDP in 2001 compared to their peak of 5.2 per cent in the previous year. Non-fuel subsidies, as a share of GDP, comprised only 0.9 per cent in 2001, far lower than their peak level of 2.3 per cent in 1999.

In 2002, subsidies as a whole had fallen to account for only 2.4 per cent of GDP—a precipitous drop from their high of 6.1 per cent in 2000. The removal of subsidies has generated considerable controversy and political upheaval in the Republic. Several studies have been carried out to examine the incidence of the various subsidies. Ikhsan (2001) has demonstrated that fuel subsidies mainly benefit rich urban households. Recent SUSENAS data show that the ratio of kerosene consumption between the poorest 20 per cent and richest 20 per cent is about 1 to 3 in rural areas and about 1 to 4 in urban areas. This inequality is higher still for diesel oil, for which the ratio of consumption between the poorest 20 per cent and the richest 20 per cent of the population is 1 to 5 in rural and about 1 to 8 in urban areas. Thus, a general fuel subsidy has been benefiting the rich more than the poor.

Table 4.4: Central Government Capital Expenditures (in billion rupiah)

	1995	1996	1997	1998	1999	2000	2001
Capital Expenditure	27201	32928	36311	52824	57638	25926	39382
(% GDP)	6.0	6.2	5.8	5.5	5.2	2.6	2.6
(% Total Expenditure)	43.6	42.3	32.6	31.4	24.9	11.6	11.1
Development subsidy to villages	426	458	467	477	806	n.a.	n.a.
(% GDP)	0.1	0.1	0.1	0.0	0.1	n.a.	n.a.
(% Total Expenditure)	0.7	0.6	0.4	0.3	0.3	n.a.	n.a.
Development subsidy to regencies	2474	2941	3440	3730	5756	n.a.	n.a.
(% GDP)	0.5	0.6	0.5	0.4	0.5	n.a.	n.a.
(% Total Expenditure)	4.0	3.8	3.1	2.2	2.5	n.a.	n.a.
Development subsidies to provinces	1257	1394	1608	1741	3039	n.a.	n.a.
(% GDP)	0.3	0.3	0.3	0.2	0.3	n.a.	n.a.
(% Total Expenditure)	2.0	1.8	1.4	1.0	1.3	n.a.	n.a.
Government capital participation	380	830	379	1962	0	n.a.	n.a.
(% GDP)	0.1	0.2	0.1	0.2	0.0	n.a.	n.a.
(% Total Expenditure)	0.6	1.1	0.3	1.2	0.0	n.a.	n.a.
Fertilizer Subsidy	143	186	708	2125	0	n.a.	n.a.
(% GDP)	0.0	0.0	0.1	0.2	0.0	n.a.	n.a.
(% Total Expenditure)	0.2	0.2	0.6	1.3	0.0	n.a.	n.a.
Construction of Primary Schools	494	592	658	586	0	n.a.	n.a.
(% GDP)	0.1	0.1	0.1	0.1	0.0	n.a.	n.a.
(% Total Expenditure)	0.8	0.8	0.6	0.3	0.0	n.a.	n.a.
Retribution for regional development	1724	2396	2352	2847	3263	n.a.	n.a.
(% GDP)	0.4	0.4	0.4	0.3	0.3	n.a.	n.a.
(% Total Expenditure)	2.8	3.1	2.1	1.7	1.4	n.a.	n.a.
Sanitary facilities/public health centers	339	564	592	827	0	n.a.	n.a.
(% GDP)	0.1	0.1	0.1	0.1	0.0	n.a.	n.a.
(% Total Expenditure)	0.5	0.7	0.5	0.5	0.0	n.a.	n.a.
Road facilities	0	0	263	414	0	n.a.	n.a.
(% GDP)	0.0	0.0	0.0	0.0	0.0	n.a.	n.a.
(% Total Expenditure)	0.0	0.0	0.2	0.3	0.0	n.a.	n.a.

Source: BPS home page, www.bps.go.id, July 17, 2002.
Notes: Fiscal year beginning April 1 for 1995-99, April-December for 2000, and January-December for 2001. n.a.: data not available.

The government has also passed a bill to end the monopoly by the state-owned electricity company, PLN, of the country's power sector. All power producers, including PLN, will sell power to the public through a bidding system and the cheapest power will be allowed to enter the power grid first. It is estimated that the country must raise its installed capacity from 22,732 MW

to 58,800 MW by 2010 in order to avoid shortages. New investment to the tune of US$ 37 billion is required to achieve this. This implies an annual investment of over 2.5 per cent of present GDP for the next eight years. The passage of the bill into law is a condition set by the Asian Development Bank for the disbursement of the remaining part of its US$ 380 million loan. But, what effect will liberalization of the power industry have on consumers?

According to Kurtubi, a leading expert on energy, prices will rise significantly without guaranteeing better services to the public (interview by report team, August 2002). The model of deregulation being pursued follows similar models in the state of California and in Sweden and the Netherlands, where prices have risen steeply in the wake of such deregulation. Thus, the Government should carefully study the equity effects of liberalizing the power sector before proceeding with deregulation.

Better focusing of subsidies to social services would help improve the well being of lower-income households. Although subsidies to education are in the process of being phased out, studies have found that public spending on elementary education has had a major influence in raising the income of the poorest 20 per cent of the population. Subsidies to middle school have also had a positive effect. However, subsidies for higher education are not effective in reaching the poor (Ikhsan 2001). Although the incidence of education subsidies is unequal, the Government should continue to subsidize higher education while shifting the emphasis of subsidies to primary and secondary education. Given that approximately 63 per cent of the labour force has only a primary level of education, the need to develop a skilled labour force capable of competing in the competitive global economy is becoming increasingly urgent.

Ikhsan (2001) finds that with the exception of subsidized primary health care, most other subsidies to health tend to be regressive. Hence, to more effectively improve human development, the Government should target expenditures on preventive health for poorer people and poorer regions.

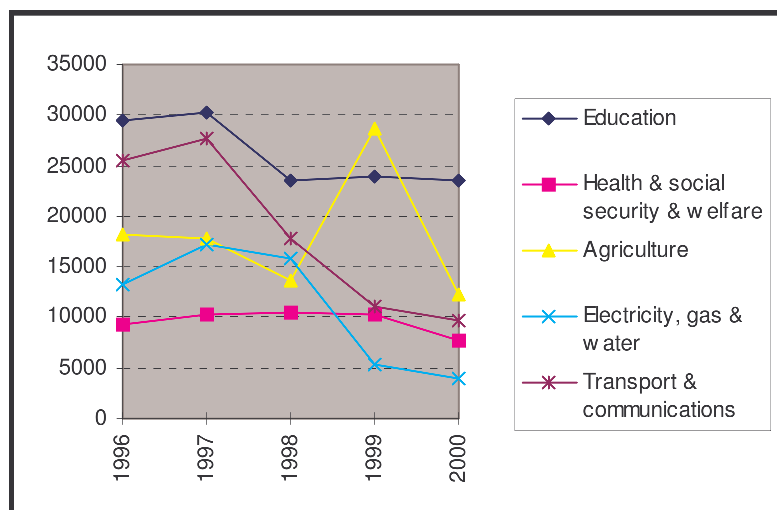
The key problem, however, with targeting subsidies, rather than providing universal subsidies, is that the quality of services tends to decline in the absence of rich and politically vocal beneficiaries. In the case of Indonesia, where up to 50 per cent of the population is estimated to be vulnerable to poverty, targeting can make the error of omitting the deserving poor and those vulnerable to poverty while tending to reduce the error of including the undeserving rich. From a human development perspective, erroneously omitting the deserving poor and the vulnerable from social safety nets is unacceptable. Moreover, since the Indonesian bureaucracy is not free of corruption, targeting subsidies will increase the potential for substantial leakages.

Development Spending

Since the crisis hit Indonesia in 1997, central government development spending has declined consistently. In 2001 it was a meagre 2.6 per cent of GDP and 11 per cent of total expenditure. In 2002, development spending had dropped to 2.4 per cent of GDP. Development spending by the center has been cut by 50 per cent since the implementation of decentralization. In fact, some components of development spending have been completely eliminated. The central government no longer expends resources on the fertilizer subsidy and on the construction of primary schools, sanitary facilities, public health centers and roads. As demonstrated by Figure 4.3, per capita real spending on health, social security and welfare, education, transportation, electricity and agriculture were all lower than their levels during the pre-crisis year of 1996. It is crucial that the State augment the resource base of the economy by investing

substantially more in the development of physical and human capital, otherwise the bottlenecks caused by the lack of such infrastructure will pose major impediments for growth.

Figure 4.3: Trends in Per Capita Government Spending



Source: ADB (2001).

The State can stimulate the private inducement to invest and promote pro-poor growth through various measures. First, the public sector could adopt labour intensive production techniques in public investment. Although the Indonesian government has always been the major provider of infrastructure, its role in promoting infrastructure investment has assumed increased importance in the post-crisis era. Adopting labour-based production techniques in infrastructure investment can substantially enhance the direct and indirect employment impact of public investment.

Second, pro-poor growth can be promoted by improving access of the informal sector to economic opportunities. This can be achieved by channeling information to entrepreneurs about potential business opportunities, providing support for the creation of new enterprises through increased and easier access to credit and upgrading the informal sector labour force through the provision of training facilities for both workers and entrepreneurs.

Third, the Government could invest directly in developing human capabilities by substantially increasing investment in education and health, sanitation, drinking water and housing facilities.

Finally, increased investment in irrigation and agricultural research could also provide the basis for renewed pro-poor growth. During the 1990s, government expenditure in the agricultural sector declined substantially because the national development strategy had shifted its focus from agricultural development to manufacturing. This resulted in stagnation of agricultural technology and productivity, rendering Indonesian agricultural commodities less competitive than those of neighboring countries where agriculture is highly subsidized. Since a majority of the poor work in the agricultural sector, the public sector could better accomplish its goal of reducing poverty by devoting substantially more resources to this sector (see Chapter Three).

4.5 The Fiscal Dilemmas of Decentralization

The ongoing decentralization program in Indonesia has transferred approximately one quarter of central government revenues to local governments. At the same time, it has given responsibility to local governments to manage and organize development programs in the areas of agriculture, capital investment, culture, education, environment, health, industry, infrastructure, labor, land, trade and transportation. As a result, central government development spending in these areas has either ceased completely or declined substantially.

Due to the lack of data, this report could not carry out a complete analysis of the effects of decentralized development expenditures on poverty in the regions. Nonetheless, the results of our preliminary analysis are presented in Table 4.5. No systematic correlation is found across provinces between the share of capital spending in total expenditure and the level of poverty (as measured indirectly by real provincial per capita GDP or directly by the percentage of the population below the poverty line).

An initial analysis of the available data suggests that development spending is, to some extent, related to the initial level of infrastructure—namely, those provinces with more infrastructure than other provinces tend to continue investing more. This implies that the burden of development expenditures is higher for provinces with low levels of development compared with relatively developed provinces. Hence, the Government should consider modifying the formula for fiscal decentralization to take account of this extra burden of the less developed provinces.

Although the devolution of responsibilities to the local levels can be a powerful avenue of promoting democracy and empowerment in the medium to long term, there are several problems associated with the Indonesian decentralization process in its current form.

First, development spending at the local levels has not offset the decline in central government development spending. Aggregate development spending for the 30 provinces was only 1.6 per cent of GDP in 2001. In sum, during 2001, the central government still implemented 62 per cent of development spending and the regions only 38 per cent.

Second, local development objectives are not necessarily in harmony with national objectives, as clear guidelines concerning expenditure responsibilities have not been established. Thus, it is unclear how decentralizing expenditure responsibilities will promote the Government's mission of reducing poverty, improving infrastructure and increasing growth. In this context, it should be emphasized that the central government has completely ceased its spending on such basic items as primary schools, sanitary facilities, public health centers and roads—all of which are essential to reducing poverty. Provinces must, therefore, be required to invest substantially in these crucial areas in order to make up for the shortfall.

Third, of the 2.3 million former central government staff transferred to the regions, few are equipped and trained to identify local development needs and implement programs to achieve national objectives. The imperatives of promoting high levels of professionalism, skills, and expertise among personnel have never been stronger than in the present context of decentralization.

Fourth, anecdotal evidence suggests that due to the lack of sufficient accountability and transparency in the decentralization process, corruption could have, in fact, increased.

Fifth, in the move to augment revenue, many local governments have arbitrarily imposed local taxes and fees that are dampening local business development and inter-regional trade.

Table 4.5: Selected Development and Poverty Indicators across Provinces

Province	2001	2000	2000	2001
	Development expenditure (% of total expenditure)	Real per capita GDP (million rupiah)	% people below poverty line	% people below poverty line
Sumatra Selatan	34.8	1.9	17.4	16.1
Sumatra Barat	24.5	1.9	11.4	15.2
Sumatra Utara	25.4	2.1	13.1	11.7
Nanggroe Aceh Darussalam	46.7	2.5		
Kalimantan Selatan	29.7	2.1	13.0	11.9
Kalimantan Tengah	41.4	2.3	12.0	11.7
Kalimantan Timur	46.6	1.2	16.3	14.0
Kalimantan Barat	30.1	1.9	29.4	19.2
Jawa Timur	30.2	1.7	22.8	21.6
Yogyakarta	20.1	1.6	33.4	24.5
Jawa Tengah	21.5	1.3	21.2	22.1
Jawa Barat	25.8	1.4	15.4	15.3
DKI Jakarta	32.3	7.1	5.0	3.1
Lampung	23.6	1.1	30.4	24.9
Bengkulu	22.6	1.2	17.8	21.7
Jambi	27.6	1.4	21.2	19.7
Riau	55.2	4.6	10.4	10.1
Sulawesi Utara	18.8	1.5	19.7	10.7
Sulawesi Tengah	32.3	1.2	24.5	25.3
Sulawesi Selatan	23.1	1.3	15.4	16.5
Sulawesi Tenggara	18.6	0.9	23.9	25.2
Bali	32.8	2.3	5.7	7.9
Nusa Tenggara Barat	29.8	1.2	28.1	30.4
Nusa Tenggara Timur	32.0	0.8	36.5	33.0
Maluku	5.4	1.0		14.0
Maluku Utara	47.4			14.0
Papua	40.1	4.0	46.4	41.8
Banten	30.0			17.2
Bangka Balitung	18.6			13.3
Gorontalo	33.6			29.7

Source: BPS home page, www.bps.go.id.

Finally, regional inequities are also being exacerbated because resource-rich provinces are permitted to keep a significant share of the revenues obtained from natural resources.[16]

It is vital that the Government work rapidly to establish more effective local institutions and provide systematic information on local progress in development, especially on pro-poor aspects, so as to make local governments more accountable to the public. Moreover, guidelines that clearly outline expenditure responsibilities in line with national objectives must be established and trained government personnel that can help regions attain national goals should be deployed to the local levels. If the shortcomings discussed above are not remedied, a

[16] Under the new laws, provinces are allowed to retain 15 per cent, 30 per cent, and 80 per cent of revenue obtained from oil, gas, and forestry and fisheries, respectively.

potentially effective avenue of promoting local participation will become captive to local special interests and impede overall growth and development in Indonesia.

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Chapter Five

Revitalizing Monetary and Financial Institutions

Joseph Lim, Umar Juoro and Bagus Santoso

5.1. Factors Leading to the Financial Crisis that Persist

The critical factors that made Indonesia the worst hit country during the Asian financial crisis are still operative and should be squarely faced in order to resolve the current problems of debt overhang and financial rehabilitation. The mishandling of the crisis, which had resulted in additional gargantuan problems, also merits close examination in order to help clarify the best policy direction that Indonesia can take now in order to accelerate growth and magnify the impact on poverty. The following section gives a brief review of the factors behind the current financial situation, including the crisis itself and the policy responses to it.

5.1.1. Undue Dependence on External Financing and Private, Short-Term External Debts

In comparison with its Southeast Asian neighbors, Indonesia's gap between total investments and total savings (as a percentage of GNP) was low in the 1990s, before the Asian financial crisis (Table 5.l). There was a small increase in this gap, from about 2 per cent in the early 1990s to 3.9 per cent in 1995-1996, but this was much smaller than the high investment-savings gaps in Malaysia, the Philippines and Thailand, which ranged from 5 to 7 per cent in the pre-crisis period. However, Indonesia's external debt in absolute magnitude has become the largest among the four countries (Table 5.2a). Of course, Indonesia's economy is also larger. But other indicators demonstrate that, based on capacity to pay, Indonesia's external debt was, and still is, very large.

Table 5.1: Investment and Savings Rates As Percentage of GNP

	Average 1990-1994	Average 1995-1996	1997	Average 1998-2000	2001	2002
Indonesia						
Gross domestic capital formation, % of GNP	32.43	32.22	32.71	15.82	18.18	14.99
Gross national saving, % of GNP	30.38	28.32	29.41	18.22	21.72	17.11
Investment-savings gap, % of GNP	2.05	3.90	3.30	-2.40	-3.54	-2.12
Malaysia						
Gross domestic capital formation, % of GNP	39.08	44.64	45.41	27.12	26.00	
Gross national saving, % of GNP	33.57	38.42	40.71	43.66	37.59	
Investment-savings gap, % of GNP	5.51	6.22	4.69	-16.55	-11.59	
Philippines						
Gross domestic capital formation, % of GNP	22.48	22.46	23.78	18.17	16.61	
Gross national saving, % of GNP	16.79	17.40	17.66	18.67	21.38	
Investment-savings gap, % of GNP	5.69	5.05	6.13	-0.50	-4.77	

Thailand					
Gross domestic capital formation, % of GNP	41.54	42.78	34.56	21.78	24.30
Gross national saving, % of GNP	34.87	35.64	33.93	31.76	30.59
Investment-savings gap, % of GNP	6.67	7.14	0.63	-9.98	-6.30

Source: ADB Key Indicators for Asia-Pacific Countries, 2001; Bank Indonesia.

As a percentage of GNP (Table 5.2a), Indonesia's external debt has also been much higher than that of the other countries (except for the Philippines during the 1980s and early 1990s). By the mid-1990s, right before the crisis, this ratio remained high, surpassing the Philippines'. In 1996, Indonesia's high external debt, as a ratio to GNP, was matched only by that of Thailand—the source country of the East Asian crisis.

Table 5.2a: External Indebtedness
Indonesia, Malaysia, Philippines, Thailand, Selected Years

	1990	1995	1996	1997	1998	1999	2000	2001	2002
EXTERNAL INDEBTEDNESS bn US dollars; as of end of year									
Indonesia	69.9	124.4	128.9	136.2	151.2	150.8	144.1	135.7	131.3
Malaysia	15.3	34.3	39.7	47.2	42.4	41.9	41.8	43.4	
Philippines	30.6	37.8	40.1	45.7	48.3	53.0	50.4	52.4	
Thailand	28.1	100.0	107.7	109.7	104.9	96.8	79.7	67.4	
EXTERNAL INDEBTEDNESS as % of GNP									
Indonesia	64.0	63.4	58.3	65.0	167.5	114.5	101.8	98.1	79.8
Malaysia	36.4	40.6	41.3	49.8	62.1	56.9	50.7	53.4	
Philippines	69.4	49.7	46.5	53.2	70.4	66.1	63.7	69.3	
Thailand	33.3	60.5	60.5	74.6	97.2	81.2	66.2	59.4	
EXTERNAL INDEBTEDNESS as % international reserves									
Indonesia	936.7	907.5	706.5	820.4	664.3	560.0	497.1	488.4	424.1
Malaysia	157.1	144.5	146.9	227.2	165.9	137.0	141.6	142.4	
Philippines	3308.3	593.6	400.3	628.7	523.2	400.8	386.2	389.5	
Thailand	211.2	278.0	285.5	419.0	364.0	284.1	248.9	208.3	

Source: derived from ADB Key Indicators of Asia Pacific, 2002, WB Global Development Finance 2003, IMF International Financial Statistics, June 2003; Bank Indonesia data.

As a percentage of international reserves, Indonesia's debt is also the worst, starting from the mid 1990s onwards. This poor relative performance was most prominent during 1995-1997, the period immediately prior to the financial crisis.

In terms of debt service ratio (debt payments as a percentage of merchandise exports), Indonesia is also the worst performer since 1995 (see Table 5.2b). Indonesia's very precarious position in the pre-crisis year of 1996 is reflected in the 43 per cent of merchandise export earnings that were going to debt payments compared to around 25 per cent for the Philippines, 17 per cent for Thailand and 10 per cent for Malaysia.

Table 5.2b: Debt Service, as % of Merchandise Exports
Indonesia, Malaysia, Philippines, Thailand, Selected Years

	1985	1990	1996	1997	1998	2000	2001
DEBT SERVICE during the year, as % of merchandise exports*							

Indonesia*	29.2	36.3	42.9	35.1	36.0	27.9	39.5
Malaysia	34.5	15.1	11.0	9.2	8.5	6.1	6.0
Philippines	49.2	38.4	24.5	17.0	15.6	17.8	19.7
Thailand	7.7	5.9	5.4	8.0	11.7	11.3	n.a.

*Debt Service does not include principal repayment of short-term debt. Debt service of Indonesia for 2001 Also does not include short-term interest payments

Source: ADB Key Indicators of Asia Pacific, 2001

To make matters worse, Indonesia's external debt portfolio was, to a large extent, in short-term debt and private non-guaranteed debt (Table 5.2c). As a percentage of GNP, Indonesia's private non-guaranteed debt became the highest in the wake of the financial crisis.

As a percentage of international reserves, its short-term foreign debt was the highest starting in 1995 and extremely high before the crisis—hitting close to 200 per cent in 1997. Indonesia's ratio of private non-guaranteed to international reserves far above 200 per cent in the mid-1990s while Thailand's was much less than 200 per cent. Short-term debt as a percentage of international reserves also soared to close to 200 per cent in 1997.

Table 5.2c: Private Non-Guaranteed Debt, Short-Term Debt; as % of GNP and International Reserves: Indonesia, Malaysia, Philippines, Thailand

	1985	**1990**	**1996**	**1997**	**1998**	**2000**
PRIVATE NON-GUARANTEED, as % of GNP						
Indonesia	4.6	9.4	16.6	21.2	60.8	27.7
Malaysia	10.2	4.3	13.4	16.3	23.1	22.0
Philippines	8.8	2.7	5.7	8.0	15.9	10.9
Thailand	8.8	8.7	27.1	32.1	40.7	26.8
PRIVATE NON-GUARANTEED, as % of international reserves						
Indonesia	77.1	137.6	201.1	268.1	240.9	137.4
Malaysia	60.3	18.8	47.8	74.5	61.8	61.2
Philippines	422.8	129.9	48.9	94.0	117.9	66.3
Thailand	153.9	54.9	127.8	180.1	152.4	100.9
SHORT-TERM DEBT, as % of GNP						
Indonesia	7.2	10.2	14.6	15.7	22.3	16.0
Malaysia	9.3	4.5	11.5	15.8	12.4	5.6
Philippines	30.9	10.0	9.2	13.7	10.5	7.5
Thailand	8.4	9.9	23.9	25.7	27.5	12.4
SHORT-TERM DEBT, as % of international reserves						
Indonesia	121.6	149.3	176.6	198.1	88.5	79.4
Malaysia	54.7	19.5	41.0	71.9	33.1	15.7
Philippines	1489.2	479.0	79.5	162.3	77.9	45.6
Thailand	146.1	62.5	112.9	144.5	102.9	46.5

Source: ADB Key Indicators of Asia Pacific, 2001

All the indicators showed that Indonesia would have had extreme difficulty in servicing its debts once a crisis such as the one in 1997-1999 occurred. The crisis included, of course, the worst possible scenario for Indonesia—a stoppage of commercial credits and massive devaluation of its currency.

There were large net capital outflows from Indonesia and all the other crisis countries from 1998 onwards (Table 5.3). For Indonesia alone, the capital outflows included outflows from direct foreign investments. The massive foreign capital outflows from Indonesia no doubt contributed to the economic and financial collapse of the country in 1998.

Table 5.3: Balance of Payments Items for Indonesia, Malaysia, Philippines and Thailand: 1990-2002, as % of GNP

	1990	1995	1996	1997	1998	1999	2000	2001	2002
CURRENT ACCOUNT BALANCE, as % of GNP									
Indonesia	-2.7	-3.3	-3.5	-2.3	4.5	4.5	5.7	5.1	4.4
Malaysia	-2.2	-10.3	-4.6	-6.3	14.0	17.1	10.2	9.0	
Philippines	-5.8	-4.3	-4.6	-5.1	2.3	9.2	10.7	6.0	
Thailand	-8.5	-8.0	-8.1	-2.1	13.2	10.5	7.7	9.0	
FOREIGN DIRECT INVESTMENTS, as % of GNP									
Indonesia	1.0	1.9	2.5	2.1	-0.4	-2.1	-3.3	-2.4	-1.4
Malaysia	5.5	7.8	5.6	7.2	4.0	3.4	2.1	0.4	
Philippines	1.2	1.8	1.6	1.3	2.3	0.8	1.7	2.6	
Thailand	2.9	0.7	0.8	2.2	6.8	4.8	2.8	0.4	
Other Capital Account (incl. Errors & omissions)									
Indonesia	3.8	2.2	3.0	-3.7	-8.3	-0.8	0.2	-2.7	-0.3
Malaysia	1.3	0.4	1.6	-5.0	-2.9	-14.1	-13.6	-8.2	
Philippines	4.4	3.4	7.8	-0.1	-2.6	-5.5	-13.0	-8.8	
Thailand	10.1	11.7	8.5	-7.4	-18.4	-11.4	-11.9	-8.2	
BALANCE OF PAYMENTS, as % of GNP									
Indonesia	2.1	0.8	2.0	-3.9	-4.1	1.5	2.7	0.0	2.7
Malaysia	4.7	-2.0	2.6	-4.1	15.0	6.4	-1.2	1.2	
Philippines	-0.2	0.8	4.8	-3.9	2.0	4.5	-0.6	-0.3	
Thailand	4.5	4.4	1.2	-7.2	1.6	3.8	-1.3	1.2	

*includes net errors and omissions

Source: ADB Key Indicators for Asia-Pacific, 2002; IMF, International Financial Statistics, various years, Bank Indonesia

5.1.2. Financial Liberalization without Sufficient Supervision, Monitoring and Controls

A key factor behind Indonesia's crisis was that it carried out domestic financial liberalization, in conjunction with an open capital account, without sufficient supervisory and monitoring mechanisms. This triggered rapid and massive flows of capital that led to systemic risks, and to the country's vulnerability to external, uncontrollable events such as the shocks from Thailand, Republic of Korea and Japan in the 1997-98 period.

Table 5.3 gives the balance of payments picture for Indonesia, Malaysia, the Philippines and Thailand from 1990 to 2001. In terms of percentage of GNP, Indonesia did not experience massive capital inflows (either foreign direct investments or other capital inflows) into the country during the 1990s—unlike Thailand and Malaysia, and even the Philippines. There was a spurt of foreign direct investments and other capital inflows in 1995-96, totaling annually around 5 per cent of GNP. This was low compared to the total capital inflows of 10-13 per cent annually during the same period for both Thailand and Malaysia.

The seeming inconsistency between, on the one hand, Indonesia's low investment-savings (and current account) gaps and relatively small capital inflows, compared to those of its Southeast Asian neighbors prior to the crisis, and its large external indebtedness, on the other hand, underscores a complication arising from capital account and financial liberalization. Indonesia had put capital and financial restrictions, in fact, on bank borrowings from foreign banks. Completely liberalized, however, were the direct corporate borrowings from offshore banks and other foreign financial institutions.

Thus, by 1996-1997 (immediately prior to the crisis), a high share of the external debt of Indonesia was owed by corporations (45 per cent of total debt in March 1997, and amounting to 24 per cent of GNP and 307 per cent of international reserves (see Appendix Table A for more details)). Indonesian banks owed only 8.5 per cent of the external debt in 1996-1997 because of restrictions and controls on their borrowings. But the financial liberalization of offshore lending to large corporate entities relied on private market forces without any substantial monitoring and supervision.

It is likely that the official data on investment-savings gaps and balance of payments significantly underestimated these private offshore borrowings. This exacerbated the effects of the crisis on Indonesia once the information on the size and amount of corporate offshore, unhedged and unguaranteed borrowings trickled in. The information was a negative shock that revealed the extreme dangers faced by the corporate sector as currency depreciation and deterioration of loan portfolios ensued. Foreign creditors immediately stopped all credits and demanded short-term debts to be paid back. Unhedged dollar borrowers, liquid banks and other institutions faced enormous incentives to speculate on the dollar against the rupiah. This triggered a downwardly spiraling cycle based on self-fulfilling projections and intensifying systemic risk.

In the financial sector, financial liberalization consisted partly of allowing many banks to operate without much supervision. Even Bank Indonesia (BI) (Bank Indonesia (2001) criticized its own past policy of allowing as many as 240 banks to operate freely right before and during the crisis, making supervision difficult and cut-throat competition more harmful.

Market transactions are only as sound as the institutions and governance structures within which they have to operate. Without proper supervision and monitoring, many banking and offshore borrowings were plagued with corrupt, illegal and improper transactions. These transactions were tied to affiliated industries and enterprises, as well as rich individuals, whose ability to receive the loans was linked to personal connections and bribes, rather than the merit and viability of the business venture. Many foreign and domestic creditors and banks were involved in such transactions.

5.1.3. Faulty Responses to the Crisis: IMF and Government Roles

Initially, during the months of July to September 1997, the crisis seemed to hit Indonesia the least. Bank Indonesia (BI) immediately widened the band on the exchange rate and did not attempt to spend precious foreign reserves as much as the central banks of Thailand and South Korea did to defend the domestic currency. Compared to the other countries involved in the crisis, Indonesia's economic fundamentals were strong (economic growth rates were high, fiscal balances were in surplus, inflation was manageable and international reserves were historically large before the speculative attacks on the currencies). The initial crisis was primarily a crisis of liquidity and confidence. The response should have been confidence-building mechanisms as well as reasonable workout arrangements between debtors and creditors (brokered by the governments and multilateral institutions), which would have kept the credit lines open and prevented the illiquid situation from deteriorating into an insolvency problem.

The events that unfolded were very different. Because they are widely known, they will only be summarized here. When the IMF entered the picture in Thailand, Indonesia and Thailand, what were implemented as confidence-building policies turned out to undermine the economic fundamentals and aggravate the lack of confidence. The liquidity problem and the urgent need to keep credit lines open were ignored. Some of the policies that were implemented exacerbated the situation and became the catalyst for deepening the crisis. These are enumerated below:

a. Restrictive Fiscal and Monetary Policies

The main problem was that the IMF initially saw the crisis as an overspending problem. Thus fiscal tightness, monetary restraint and high interest rates were imposed.[17] These measures undermined the countries' strong fundamentals and plunged their economies into recession. Confidence deteriorated even more.

The high interest rates, partly implemented to stem the currency depreciation, never achieved the intended result since the systemic risk aspects of the problem were never well understood. Instead, the high-interest policy worsened the loan portfolio even more as borrowers could not afford to pay back the extremely high interest payments (not to mention paying with a seriously depreciated currency). The high interest rates also led to a credit crunch, which ensured that the economies undertaking these programs would experience serious downturns. Their financial systems collapsed, investments stopped and deep economic recessions ensued.

b. Overemphasis on Punishment and Closing Down of Banks

Another wrong interpretation of the crisis was that market forces were not the problem and only government and corporate (corrupt) mismanagement and moral hazard were to blame.

[17] The Independent Evaluation Office (IMF 2003) claims that the IMF did not consistently advocate restrictive fiscal policies, that its restrictive monetary recommendations were not, in fact, followed by the Government and that the liquidity credits provided to the banking system were exceedingly expansionary.

The insistence on punishing domestic banks (which were not the heavy external borrowers) and closing down 16 of them (after a longer list was initially drawn up) were indications that the first rule of forebearance[18] during financial crisis was forgotten. The potential for a negative impact on previously sound banks was ignored.

Most unfortunate was that the closure of the banks was done without any system of deposit insurance and without any consideration of the systemic risk of potential bank runs and panic. The result was, of course, the collapse of the Indonesian private banking sector as depositors panicked and transferred all their funds either abroad or into state banks (which they thought were less prone to be closed).

The result was a paradox. Whereas the IMF blamed implicit bank guarantees by the state as the culprit behind the financial disaster, and therefore aimed to rectify this by punishing the errant banks, the resulting bank run and panic forced the central bank (Bank Indonesia or BI) to provide a 100 per cent blanket guarantee to all deposits and debts to foreign and domestic creditors in order to stop the hemorrhage of funds from the financial sector.

c. Pouring Unsupervised Liquidity Credits into the Banks

Another even bigger paradox occurred. Stunned by the extent of bank runs and bank collapses, BI dispensed 144,536 billion rupiahs (around US$13-$16 billion, depending on the exchange rate used) of liquidity credits or assistance (called BLBI) to domestic banks between November 1997 and January 1999. This was done without a clear set of criteria (except that a negative daily balance was sufficient to qualify a bank for the liquidity credits). It was also done without restricting and supervising the funds' use (and without any pre- and post-audit mechanisms).

The intention was obviously to keep the banking system afloat amidst the deepening crisis, but the result was a clear bailout of many banks by giving them free money. The IMF criticized this move by the central bank and blamed part of the inflation on these monetary injections, but offered no solution of its own to stave off the bank runs, panic and collapse resulting from its own policy of bank closures.

An investigative audit done by the Supreme Audit Agency (BPK) in 2000 revealed that as much as 138.6 trillion rupiahs (96 per cent of the total) might have been lost to the

[18] This simply means that previously sound and lawful banks that became weak because of uncontrollable circumstances, such as the currency depreciation, high interest rates and loss of confidence, should be given every

Government due to the issuance of the liquidity credits and that around 84.8 trillion rupiahs (59 per cent) had been misallocated and misused. The general perception was that much of the money had been used to bail out banks associated with relatives or allies of ex-President Suharto. The liquidity assistance funds—which were intended to keep the banks liquid and able to handle massive withdrawals—were used improperly, such as to speculate on the dollar or pay bank obligations, instead of being used as a liquidity buffer to deal with bank runs and massive withdrawals.

d. Lack of Political Stability and Reforms

Obviously, the depth of the economic and financial collapse of Indonesia in 1998 had a lot to do with the political instability, chaos and riots bred by the economic dislocation, the repressive responses of ex-President Suharto to increasing dissent, the perceived corrupt practices he used to protect his relatives and allies, the food shortages (largely caused by an El Nino drought during the same year) and food and fuel price increases in 1998. President Suharto also did not help the economic situation by opposing the IMF on the wrong issues, such as his attempt to save his son's bank and his insistence on creating a currency board system.

The crisis was also deepened because the corrupt practices, revealed by the crisis and its aftermath, had not been confronted by reforms in the judicial, executive and legislative branches of government.

5.1.4. The Need to Address the Underlying Factors

Many of the critical factors that led Indonesia to financial and economic collapse in late 1997 to early 1999 have not been adequately addressed. The ratio of external indebtedness to international reserves was still at a very high level of over 400 per cent in 2000 to 2002 (Table 5.2a and Appendix Table A). The ratios of short-term and private non-guaranteed debt to international reserves were still at very high levels (much higher than those of its neighbors) at the end of 2000 (Table 5.2c), and total corporate external debt still exceeded 200 per cent of international reserves in December 2001 (Appendix Table A). Debt service as a ratio to merchandise exports in 2001 was close to 40 per cent, as high as during the crisis (Table 5.2b).

Obviously, Indonesia had failed to obtain adequate foreign debt relief from both its official and private creditors. The negotiated restructuring agreements on the principal and interest payments for private and official debts are not adequate for the country to shift its foreign reserves from debt payments to economic development. Unfortunately, this is occurring as talks abound that Indonesia should be concerned more with its domestic debt than its external debt, due to the problem of servicing the recapitalization bonds (a topic covered later in this chapter).

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opportunity to continue operations under more conducive terms and conditions.

Secondly, capital account liberalization still rules the day, especially for corporate offshore borrowings. As prudential regulations are further imposed on the banks, one of the main causes of the crisis—the unsupervised and unmonitored freedom of conglomerates to borrow offshore—remains. Although this might not pose an immediate, major threat since confidence is still low, and foreign lending to corporations remains low, policies for future prevention of a similar crisis are definitely not in place. Such safeguards have become increasingly important in 2003 as ‘hot money’, speculative short-term portfolio investment, has begun to return to Indonesia.

Furthermore, there is a fatalistic attitude nowadays that conservative fiscal and monetary policies should rule the day because of problems specific to Indonesia. This issue is discussed extensively elsewhere in this report, such as in Chapters Two and Four. But it is important to note here that giving up on reviving the economy—either through fiscal or monetary stimulus or both—would be tantamount to relegating the country to continuing low confidence and low growth.

IMF responses to developing country crises have not substantially changed. Crises in Turkey, Argentina and Brazil are still being managed by monetary and fiscal austerity, and have been characterized by blanket punishment of local economic actors during the worst period of confidence. Foreign creditors are still not forced to share the burden of the adjustments despite their own roles and responsibilities in the lending transactions. The Independent Evaluation Office of the IMF (IMF 2003) has noted that the IMF did not adequately warn of the impending financial crisis facing Indonesia in 1997 and under-estimated the severity of the crisis once it hit the country.

In Indonesia, political and legal reforms needed to prosecute corporate and banking abuses are lacking, as well as the political resolve to retrieve the assets and extract the necessary payments from conglomerates and previous bank owners for their non-performing loans and foreclosed bank liabilities (such as the BLBI liquidity credits). Also, the lack of political stability is impeding the return of economic confidence.

All in all, the factors that led to the crisis still remain and are impeding the economy from recovering its growth potential.

Indonesia is still in a critical condition. Ever since 1998, all capital accounts—net foreign direct investments, and other net capital flows have continued to be negative (see Table 5.3). This is important since official loan inflows to the government are included in the 'capital account' category. What is even more worrisome is that net foreign direct investment outflows have been continuing, reaching more than 2 per cent of GNP in 1999 and 2001 and 3.2 per cent in 2000, although dropping to 1.4 per cent of GNP in 2002. The capital outflows from Indonesia are signs of low confidence in the economy, both in the short and long terms, from both foreign and domestic investors. As indicated elsewhere in this report, the answer is a public investment-led strategy of growth, using public investment to stimulate private investment and attract foreign investment back.

5.2. The Current Financial Sector and the Banking System

5.2.1. Banks and Bank Assets Falling into the Government's Lap

Because of the deep economic decline and deteriorated loan portfolios (aggravated by sharp currency depreciation, initially high interest rates and bank runs), most major banks became

saddled with non-performing loans (NPLs), which, reaching 60 per cent to 75 per cent of total loans, became unviable (see Radelet (1999)). Even many state banks (which originally benefited from the bank runs) became distressed due to the large number of non-performing loans.

In September 1998, the Government closed banks with a capital adequacy ratio (CAR) of less than -25 per cent and started a recapitalization process for banks with a CAR of between -25 per cent and four per cent. Those with a CAR of four per cent or above were allowed to operate normally, with the stipulation that this ratio be increased to eight per cent over two years. In 1998-1999, around 100 banks were closed. Those that met the four per cent CAR minimum in mid-1999 accounted for only five per cent of total bank deposits (Radelet (1999)).

The result was that the Government took over many of the failed banks and their assets. This move, together with the recapitalization process, effectively nationalized the banking sector, with the state owning the biggest banks and owning the equities of many other banks.

5.2.2. The Issuance of Recapitalization Bonds and the Rise of Domestic Debt

For the recapitalization process with private banks, the Government injected 80 per cent of the funds needed to bring the banks to a CAR of 4 per cent, while the bank owners were required to provide the remaining 20 per cent. For state-owned banks and banks taken over by the central bank, the capital injected was almost exclusively that of the Government. The recapitalization process consisted of the injections of government bonds (called recapitalization or recap bonds). The banks were also allowed to swap their non-performing loans for recap bonds in order to clean up and strengthen their asset positions. As of December 31, 2001, there were 435 trillion rupiahs (around US$42 to $47 billion, depending on the exchange rate) in the financial system, 60.6 per cent of which was in state-owned banks, 23.7 per cent in taken-over banks and the rest in recapitalized banks, regional development banks and other items (Table 5.4).

Table 5.4: Government Bonds for Recapitalization Program and Government Bank Guarantee
(as of Dec. 31, 2001)

Recapitalization Bonds

Group of Banks	No. of Banks	Bond (Trllns of Rp)			Total (trllns of Rp)	Share of Total
		Fixed Rate	Variable Rate	Hedge Bond		
State-owned banks	4	123.2	112.2	28.5	263.9	60.6
Taken over banks	4	28.9	74.3		103.2	23.7
Recapitalized banks	7	4.0	12.5	11.9	28.4	6.5
Other banks	n.a.	7.1	18.8		25.9	5.9
Total recap bonds for banks		163.2	217.8	40.4	421.4	96.8
Sub-registry		11.3	1.7		13.0	3.0
Ministry of Finance		0.9			0.9	0.2
Grand Total recap bonds*		175.4	219.5	40.4	435.3	100.0
Inflation-Indexed Bonds for Guarantee of Bank Liabilities (includes BLBI)			267.7		267.7	
Total Govt Bonds		**175.4**	**487.2**	**40.4**	**703.0**	

Source: Bank Indonesia, Annual Report 2001, Bonds for bank guarantee figure from "Indonesia: Selected Issues," IMF Country Report No. 02/154, July 2002

Apart from this, the Government had also issued Rp 267 trillion to Bank Indonesia (BI) to fund the government guarantee scheme for bank liabilities. All in all, shoring up the financial system had increased government debt by Rp 703 trillion.

Unlike BLBI, the Government has to pay interest on the recap bonds, thereby enhancing the profits of troubled banks even if they do not undertake any intermediate role of bank lending. About 52 per cent of the bonds are at variable rates (using the discount rates on Bank Indonesia certificates (SBIs), which was 17.6 per cent for one-month certificates in the beginning of 2002 and around 15 per cent in early August of 2002) (Table 5.4). The fixed rates are mainly 13 per cent.

Thus in the post Asian crisis situation where confidence is low, pressure to maintain CARs of eight per cent is strong and non-performing loans have to be limited to five per cent of total loan assets, most banks with recap bonds simply are not undertaking the risk of lending. Financial intermediation is not happening and the continuing credit crunch is contributing to the slow economic growth in 2001-2003.

Table 5.5: Balance Sheets of Banking System (Deposit Money Banks) and Shares of Each Item

	1996	1997	1998	1999	2000	2001	2002
Total Assets / Liabilities (billions rupiah)	362668	485657	751125	765690	950267	996857	1029406
% of total assets / total liabilities							
Assets							
Reserves	3.3	3.6	4.8	5.8	6.0	5.6	6.2
Claims on Mon Author Securities	3.9	2.7	7.8	11.3	7.2	9.3	10.5
Foreign Assets	5.7	9.6	15.4	15.7	10.8	11.0	8.8
Claims on Government	1.7	1.8	1.4	35.9	46.3	42.6	38.2
Claims on Private Sector & financial instns & public ent.	85.4	82.3	70.5	31.2	29.8	31.5	36.3
Total Assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Liabilities							
Demand Deposits	8.8	9.0	6.5	7.5	8.7	9.8	10.4
Time, Savings & Fgn. Currency Dep.	62.3	57.5	64.1	68.6	61.8	67.2	67.5
Money Market Instruments	0.9	0.9	0.4	0.4	0.2	0.2	0.2
Restricted Deposits	0.6	0.3	0.3	0.2	0.5	0.8	0.5
Foreign Liabilities	8.2	14.5	13.0	13.1	9.8	6.9	5.0
Central Government Deposits	3.0	2.7	2.6	2.7	4.5	4.0	3.5
Central Govt. Lending Funds	1.4	0.3	0.2	0.6	1.0	0.9	0.0
Credit from Monetary Authorities	3.2	4.7	15.0	4.4	1.7	1.5	1.2
Liab to Nonbank Financial Insts	0.7	1.6	5.2	1.9	1.5	0.3	0.5
Capital Accounts	11.7	11.0	-12.6	-2.3	5.5	6.7	9.1
Other Items (Net)	-0.8	-2.5	5.1	2.8	4.7	1.7	2.0
Total Liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: IMF, International Financial Statistics, June 2003

There was a sharp shift in 1999-2000 in bank assets from claims on the private sector (or bank loans to the private sector) to government bonds (claims on government, i.e., the recap bonds (see Table 5.5). Bank loans (claims on the private sector, financial institutions and public enterprises) comprised only 36.3 per cent of bank assets at the end of 2002, while claims on government and monetary authorities made up 48.7 per cent. Bank loans used to make up 70 per cent—and sometimes more than 80 per cent—of bank assets during the pre-crisis period. The behavior of the banks is understandable given the low confidence in the system and the heavy pressure to maintain capital adequacy ratios and low rates of non-performing loans. But this picture also reveals financial dis-intermediation, wherein banks collect deposits (and saved funds) from the public but do not channel them to productive activities and investments. This is a clear indication that the financial system remains in trouble and a credit crunch continues. Although bank loans improved slightly from 2001 to 2002, the increase is not adequate to make the banks viable without government support through the recap bonds. Table 5.5 shows that from negative bank capital accounts (signifying large losses, closures and decapitalization in the financial sector) during 1998-99, the capital accounts regained some ground in 2000-2002; but the increased capital and profits are mostly due to the recap bonds and the interest earnings provided by the bonds.

Bank Indonesia estimates that total government debt, which ranged between 50 and 60 billion in US dollars before 1998 (see Table 5.6), suddenly doubled from 1998 to 2000. This increase was due primarily to the large injections of recap bonds in 1999 and bonds for government guarantee of bank liabilities. By the end of 2002, the domestic debt was 44.7 per cent of total public debt and 36.7 per cent of GNP. The sharp rise in domestic debt had increased tremendously the national debt from 26.4 per cent of GNP in 1997 to 100 per cent of GNP at the end of 2001. This ratio improved to about 82 per cent by the end of 2002. By late 2003, the Government expected to reduce this ratio to below 70 per cent, but with slow growth and little prospects for debt relief or restructuring, it will be difficult to continue this progress.

Table 5.6: Government Debt (in billions US $)

	Domestic Debt	External Debt	Total
1994	0.4	58.6	59.0
1995	1.4	59.6	61.0
1996	0.0	55.3	55.3
1997	1.4	53.9	55.3
1998	1.3	67.3	68.6
1999	49.0	75.9	124.9
2000	62.8	74.9	137.7
2001	63.4	71.4	134.8
2002	60.5	74.7	135.1

% of Total

	Domestic Debt	External Debt	Total
1994	0.7	99.3	100.0
1995	2.4	97.6	100.0
1996	0.1	99.9	100.0
1997	2.5	97.5	100.0

1998	2.0	98.0	100.0
1999	39.2	60.8	100.0
2000	45.6	54.4	100.0
2001	47.0	53.0	100.0
2002	44.7	55.3	100.0

% of GNP

	Domestic Debt	External Debt	Total
1994	0.3	34.0	34.3
1995	0.7	30.4	31.1
1996	0.0	25.0	25.0
1997	0.7	25.7	26.4
1998	1.5	74.7	76.2
1999	37.9	58.7	96.6
2000	45.1	53.8	98.9
2001	46.8	52.6	99.4
2002	36.7	45.4	82.1

Source: Bank Indonesia (BI), Domestic Debt from 1994 to 1998 calculated from International Financial Statistics, IMF, 2001, Bank Indonesia.

The biggest impact of the domestic debt burden is felt in debt servicing since the recap bonds have to make current interest payments annually. From zero in 1997, government debt service for domestic interest payments shot up to 11.8 per cent of government revenue and 2.2 per cent of GNP in 1999 (Table 5.7). This increased further to 21.5 per cent of government revenue and 4.2 per cent of GNP in 2002, with the absolute amount almost tripling. Domestic interest payments since 1999 have been larger than foreign interest payments in the Government's current expenditure.[19]

Table 5.7: Domestic and Foreign Interest Payments, as % of Government Revenue, and as % of GNP

	1994	1995	1996	1997	1998	1999	2000	2001	200
Bns rupiah									
Government revenue	66418	80412	87630	112276	156409	187819	205334	301078	30018
GNP (Nominal)	382220	454514	518296	609340	901860	1015967	1172757	1391319	153219
As Percentage of Govt Revenue									
Domestic Interest Payments	0.00	0.00	0.00	0.00	5.36	11.84	15.21	19.33	21.4
Foreign Interest Payments	9.74	8.55	11.30	14.91	15.47	10.68	9.17	9.61	8.4
As Percentage of GNP									
Domestic Interest Payments	0.00	0.00	0.00	0.00	0.93	2.19	2.66	4.18	4.2
Foreign Interest Payments	1.69	1.51	1.91	2.75	2.68	1.97	1.61	2.08	1.6

[19] But from the beginning to at least 2002, there have been much more substantial amortization payments for foreign debt compared to amortization of domestic debt.

Source: ADB Key Indicators for Asia-Pacific, 2001. 1999 and 2001-2 data from BI Annual Report 2001, 2002

Table 5.8 shows that there was no budget deficit in the pre-crisis period (negative or near-zero net financing), but that budget deficits zoomed up in the post-1998 period (positive net financing). This increase in budget deficits (reaching 4.3 per cent and 2.9 per cent of GNP in 1999 and 2001, respectively) parallels the rise in domestic interest payments (shown in Table 5.7) during the post-1998 period. That the budget deficit had been kept at 1.8 per cent of GNP in 2002 reflects the sale of assets of IBRA (which is winding down), privatization efforts and austerity measures by the Government. The projected deficit for 2003 is expected to rise to two per cent of GDP, prompting greater government efforts to reduce spending. The domestic debt payments are a major hindrance to public investments and public spending to revitalize the economy.

5.2.4 How to Deal with the Recap Bonds

The experience of IBRA in the last four years (see Chapter Six) suggests that there may be limits to reducing the recap bonds or using IBRA sales to finance the domestic debt payments. The recommendations of this report for jumpstarting the economy and taking a stronger stance in dealing with the debtors/ bank owners would bring in, if successful, more proceeds for IBRA. But a feasible recovery strategy cannot bank everything on IBRA success in getting enough proceeds from its sales. There have to be other means to retire the recap bonds so that domestic debt and its servicing will be reduced and government revenues will be channeled to more productive expenditures, such as on social and economic services.

Some measures that can directly reduce the recap bonds or ease the resulting debt burden are:

1. The return of excess recap bonds in overcapitalized banks. Overcapitalization might have been due to:
   a) An over-estimation of loan assets by the previous bank owners, and
   b) CARs of some state-owned and taken-over banks that are way above the required eight per cent (some as high as 20 per cent). These banks can be required to return the excess recap bonds and reduce correspondingly the government's equity share (down to a level so that their CAR will be around 10 per cent).

   The government should move aggressively to reduce the capital base and equity of banks where capital injections had been excessive, especially due to duplicity of the previous owners.
2. The absorption of banks with a high share of recap bonds by stronger and larger banks. The mergers would allow some recap bonds to be reduced. However, one caveat is that as banks are consolidated and become bigger, an oligopoly system (possibly linked to affiliated industries) might arise once the banks are privatized. The regulatory and supervisory powers of BI against monopoly, interlocking directorates and cartel actions should therefore be strengthened.
3. The Government, at the end of 2002, re-profiled a significant amount of recap bonds of the four biggest state-owned banks, by exchanging the recap bonds with new bonds of equal value but of longer maturities. This was designed to avoid the bunching up of principal payments on recap debt in the period 2004-9, and at the

same time, spread out the recap payments over a longer period in the future. Such a measure, if extended more broadly, could reduce the short and medium term strain on fiscal resources.

Table 5.8: Financing of Budget Deficit (as % of GNP)

	1995	1996	1997	1998	1999	2000	2001	2002
As % of GNP								
Domestic Financing				-0.5	1.4	0.5	2.2	1.3
Domestic Banks				-0.7	-0.2	-1.1	-0.1	-0.3
Non-Bank Financing				0.2	1.6	1.6	2.3	1.6
Privatization				0.2	0.4	0.0	0.2	0.5
Asset recovery					1.3	1.6	2.0	1.3
Domestic Bonds, net								-0.1
Government bonds								0.1
Domestic debt/bond								
Amortization								-0.3
Foreign Financing	-2.5	-0.2	0.3	2.3	2.9	0.9	0.7	0.5
Gross Drawing	2.0	2.3	2.4	5.7	4.9	1.5	1.9	1.3
Program loan				2.8	2.5	0.1	0.5	0.5
Project loan	2.0	2.3	2.4	2.9	2.4	1.4	1.4	0.8
Amortization	-4.5	-2.5	-2.1	-3.3	-2.0	-0.7	-1.1	-0.8
Net financing	-2.5	-0.2	0.3	1.8	4.3	1.4	2.9	1.8

Source: Bank Indonesia

Recent legislation on government bonds has created a secondary market for recap bonds, wherein banks can sell these bonds for cash or other assets. There are pros and cons to this option. Those who oppose it point to the institutionalization of government interest payments for recap bonds, since to ensure their marketability, the Government cannot terminate the bonds (and their interest payments) arbitrarily (which it can do more easily if the recap bonds remain with the state banks). Those who favor sales on the secondary market predict that economic recovery will lead banks to sell their recap bonds for better assets, thus making the banks healthier. But as long as economic confidence does not revive, and a credit crunch continues (with banks unwilling to lend), most banks will decide to hold onto their recap bonds, since these are the main income generating assets they own.

Recently, the Government has decided to buy back some of these bonds in order to avoid future interest payments. In early August 2003, the Government repurchased 3.21 trillion rupiahs (around $392 million) worth of bonds. This is small compared to the 13.5 trillion rupiahs (around $1.5 billion) allocated for the buyback, and miniscule compared to the more than 400 trillion rupiahs worth of recap bonds that were issued.

In short, the main means of reducing recap bonds and easing their interest payments would be: 1) financial recovery based on accelerated economic growth, with bank profits (and retained earnings) used to retire some of the recap bonds, 2) the ability of IBRA to generate revenues to pay for the interest payments on the recap bonds, 3) merger of strong banks with weak banks heavily dependent on recap bonds, 4) reduction of recap bonds for over-capitalized banks, 5) re-

profiling of the maturities of recap bonds and 6) Government's repurchase of bonds although this would strain fiscal resources in the short run. All would get a big boost if economic recovery is speeded up.

5.2.5 On Financial and Capital Account Liberalization

The East Asian crisis and its aftermath has led to a reversal of the unbridled financial liberalization that occurred before the crisis. Strong financial regulations and supervision on capital adequacy ratios, non-performing loans and unhedged and speculative borrowings were undertaken as a result of the financial turmoil and financial collapse. Since these regulations are now in place, this report will not delve into details. Suffice it to say that:

1) There is still a need to link the new financial reforms and regulations to a strong and just legal and judicial process so that the previous experience of lack of punishment of errant bank owners and big borrowers will not be repeated;
2) To avoid future crises, the Government should closely monitor and provide some regulation of the capital account, especially the offshore borrowings of the Indonesian corporate sector, which contributed significantly to the crisis. Unbridled capital flows, particularly in the form of short-term portfolio investment, should also be regulated to avoid the extreme volatilities that occurred during the crisis.

5.3. The External Debt Problem of Indonesia

This chapter has already mentioned (in section 5.1) the high external debt dependence of Indonesia, which was a major factor precipitating the country's financial crisis. Its domestic debt and recapitalization bond problem should not overshadow the fact that Indonesia still has a serious and sizeable external debt problem. Table 5.7 (which shows domestic interest payments far outweighing foreign interest payments) might support the contention that the domestic debt problem is bigger than the external debt problem. But this is not valid.

There are good reasons to focus on external debt: 1) apart from the Government, the private sector is also paying for foreign debt interest and principal payments since half of the external debt is owed by the private sector and 2) due to accounting practices, principal payment for foreign debt is not included in government expenditures but is included under the financing of the budget deficit. Thus Table 5.7 underestimates the payments for foreign debt.

Principal (amortization) payments by the Government on foreign debt had been very high before the crisis (more than 4 per cent of GDP in 1994-1995) (Table 5.8). Although this percentage has gone down since then, such principal amortization still amounted to 1.1 per cent of GNP in 2001 (Table 5.8). In 2002, this was projected to reach 2.6 per cent, but was reduced to less than one per cent of GNP due to the rescheduling of Paris Club debts falling due in 2002 and 2003. This has temporarily postponed payment of foreign debts, but the debts still due will

bunch up in the future and may cause a liquidity (or worse, unsustainable debt) crisis, unless there is some significant amount of debt relief and debt reduction.

As discussed before (related to Table 5.2a), the external debt burden of Indonesia is high compared to those of Malaysia, the Philippines and Thailand. Comparisons with other countries throughout the world by *Global Development Finance 2003* highlight Indonesia as one of the seriously indebted low-income countries (SILIC), alongside Lao PDR, Myanmar, Angola, Ethiopia and many other countries that have qualified for special treatment under the HIPC (Heavily Indebted Poor Countries) Initiative.

As shown in Table 5.9, the status of countries in terms of indebtedness is determined by: 1) taking the ratio of the present value of total debt service in 2001 to gross national income (GNI) in 1999, 2000 and 2001 and 2) taking the ratio of the present value of total debt service in 2001 to average exports (of goods and services, including worker remittances) in 1999, 2000 and 2001. If the first ratio exceeds 80 per cent and/or the second ratio exceeds 220 per cent, then the country is classified as severely indebted.[20] Low-income countries are those whose 2000 GNI per capita was $755 or less.[21]

It is clear from the available indicators (Table 5.9) that Indonesia is severely indebted, especially in its capacity to undertake debt service. Note that, together with Yugoslavia, its ratio of external debt (or the present value of total debt service) to Gross National Income is the highest for the countries listed. The high debt stock relative to exports and GNI as well as moderately high debt service (and interest payments) to export ratios point to potential unsustainable debt and default problems once rescheduled debts become due.

Given these facts, plus the problem of domestic debt and the capital outflows currently occurring (both discussed in this chapter), it is of utmost urgency that Indonesia obtain the fiscal and external funds necessary to finance its economic and social development.

Since Indonesia is the fifth most populous country in the world, the largest Muslim country and a country of great geo-political importance, official and commercial debt restructuring should have favored more debt reduction and longer rescheduling periods. But Indonesia has, so far, not received any debt reduction and obtained only inadequate debt rescheduling.

5.3.1. The Official Debt

Public foreign debt makes up more than half of the total foreign debt of Indonesia (Appendix Table A). Appendix Table B gives a detailed breakdown of the external public and publicly guaranteed long-term debt of Indonesia as of Dec. 31, 2001. The biggest components of public and publicly guaranteed debt are bilateral loans and multilateral loans, making up 82 per

[20] If the ratio of debt to GNI is between 48 per cent and 80 per cent or if the ratio of debt to exports is between 132 per cent and 220 per cent, then the country is classified as moderately indebted. Countries falling below the critical levels for both ratios are classified as less indebted.

[21] Middle income countries are those whose GNI per capita in 2000 was between US$ 755 and US$ 9,265.

cent of the total. Of these, bilateral loans make up around 44 per cent while multilateral loans make up around 38 per cent (using the figures of total loans disbursed).

As of December 2001, the biggest bilateral lender by far was Japan with US$ 22.5 billion (more than 28 per cent of total external debt disbursed) while the US had loans of only US$ 2.5 billion (3 per cent of total external debt disbursed). Among the multilateral agencies, the World Bank had US$ 11.7 billion outstanding credits, the IMF US$10.2 billion and the Asian Development Bank US$ 6.4 billion.

The Paris Club has rescheduled Indonesia's bilateral and official development assistance loans three times, as of end of December 2002. But, as Table 5.10 shows, the terms that Indonesia obtained were not very favorable. Most of the restructuring has been rescheduling of payments due only for several years and does not include a comprehensive debt restructuring. The restructuring has also included no debt reduction and involved only very minor debt swaps.

Table 5.10 also shows that three other countries, Pakistan, Poland and Yugoslavia, were able to get substantial debt reduction. Poland got a 50 per cent reduction of debt stock from a US$ 30 billion total. Pakistan got around a 30 per cent reduction on the present value of debt payments for debt stock worth about US$ 12.5 billion while Yugoslavia got a two-thirds reduction from the present value of debt payments on debt stock worth US$ 4.5 billion. The rescheduling that Pakistan and Yugoslavia received was also over 38-39 years with 15-16 years of grace period while Indonesia got, in 1998 and 2000, rescheduling based on Paris Club's Houston terms, which included a rescheduling over 11 to 14 years with a grace period of 3 years.

Table 5.9: Key External Indebtedness Ratios of Selected Countries, 1999-2001

Country	Ext. Debt/ Exports	PV of Debt/ Exports	Ext. Debt/ GNI	PV of Debt/ GNI	Debt Service/ Exports	Interest Payment/ Exports	Status
Argentina	375	409	50	55	67	30	SIMIC
Ethiopia	598	306	91	46	19	6	SILIC
Indonesia	205	198	99	96	23	9	SILIC
Mexico	89	97	29	32	27	7	LIMIC
Pakistan	299	238	55	43	28	8	SILIC
Philippines	114	120	67	71	17	7	MIMIC
Poland	129	123	39	37	32	5	LIMIC
Thailand	84	83	58	57	25	4	MIMIC
Yugoslavia*	379	378	123	122	4	2	LIMIC

Ext. Debt=Total External Debt
Exports=Exports of Goods and Services, incl. worker remittances
PV of Debt=Present value of total debt service
GNI=Gross National Income
Debt Service=Total Debt Service
Interest Payment=Foreign Interest Payments
SIMIC=Severely Indebted Middle-Income Country
SILIC=Severely Indebted Low-Income Country
LIMIC=Less Indebted Middle-Income Country
MIMIC=Moderately Indebted Middle-Income Country

*It is not clear why Yugoslavia was classified as a LIMIC when its PV/GNI ratio exceeds 80%. Most likely, it is because a substantial portion of its debt was cancelled in Nov. 2001.

Source: Global Development Finance 2003, World Bank, Appendix 1.

It was only in the latest rescheduling (April 2002) that Indonesia received the full Houston terms with rescheduling over 20 years and a grace period of 10 years for Official Development Assistance (ODA) debts. Note that Indonesia's indicators in Table 5.9 suggest a condition just as difficult as that in the other three countries. Obviously, the three countries got better deals because of geo-political considerations. But Indonesia is as important as these countries, if not more so.

The Paris Club members have decided, despite Indonesia's strong compliance with IMF conditionalities since 1997, that it is eligible only for Houston terms because of overoptimistic growth projections and a belief that it has access to private commercial loans. But the figures on net capital outflows from Indonesia, including large negative flows in foreign direct investments (very rare even among developing countries), belie this assumption. Even if one or two large Indonesian firms are able to borrow abroad, the majority of firms are in distress (see subsequent discussion).

Table 5.11 gives the Paris Club terms of eligibility. *Clearly, Indonesia should qualify for at least the Naples terms since it is low-income and is listed as severely indebted.* This has been the lobbying position of the European Debt and Development (EURODAD) network and the International NGO Forum on Indonesian Development (INFID). *Such terms would allow Indonesia's debt to be reduced by 67 per cent, with optional add-ons by creditor countries on a bilateral basis, and a rescheduling of interest rate payments over 40 years with a 16-grace period and progressive repayment.* Note that Yugoslavia was able to get Naples terms (see Tables 5.10 and 5.11) without satisfying the Naples' condition of being low-income (less than US$ 775 per capita GNI) and without being an IDA-only borrower. Indonesia should be given the Naples terms and restructuring arrangements that are at least as good as Pakistan's and Yugoslavia's (see Table 5.11). This is especially appropriate now since the growth assumptions for Indonesia for 2003 will definitely not be realized. Its exports and FDI have been down sharply and these declines are seriously impairing its capacity to pay its debt service. The Indonesian Government and civil society organizations should lobby strongly with the IMF, the Paris Club members and the Consultative Group of Indonesia (CGI) to gain the Naples terms. This is particularly true now that Indonesia is exiting the IMF program after abiding by it for more than five years.

The other alternative is to lobby that Indonesia be a member of the Heavily Indebted Poor Countries (HIPC) to avail of the Cologne terms, listed in Table 5.11, with even bigger potential debt reduction than the Naples terms. But this is not likely since part of the HIPC Initiative would require Indonesia to be under heavy IMF and World Bank supervision to avail of the debt relief. Since it was the consensus to get an exit from the IMF program and its supervision, the HIPC option is difficult for Indonesia to entertain.

Also, Indonesia has had very few debt-for-environment swaps or debt-for-poverty swaps, which creditor countries have given more extensively to other poor countries. So far, only Germany has provided such swaps, amounting to a mere DM 50 million. Some creditor countries (Canada, France, Finland, Italy, New Zealand, Sweden and Spain) are interested in providing debt swaps and the Indonesian Government is currently seriously lobbying for debt-for-nature and debt-for-poverty swaps. But the experience of other countries shows that the amount of debt swaps will, most likely, not exceed two or three per cent of total external debt. Costa Rica, the country with the biggest amount of debt swaps in comparison with its external debt, only managed to reduce five per cent of its external debt through such means. Furthermore, the biggest bilateral creditor of Indonesia, Japan, is not enthusiastic arranging debt swaps.

Table 5.10
Previous Paris Club treatments

Ad hoc terms	Eligibility	Debt treatment (1)		Other	
Pakistan - Dec. 2001 **Islamabad terms**		**ODA**	**Non-ODA**	**Debt swaps**	**Multilatera debt treatment**
	Ad hoc	More than 30% reduction in NPV terms of total debt stock (no cutoff date) and rescheduling for $12.5 billion of principal payments		- On all ODA loans; - Up to 20% of non-ODA outstanding credits as of December 31, 1998 or up to an amount of 30 million SDR, whichever is higher.	No
		Rescheduled over 38 years with grace period of 15 years.	Rescheduled over 23 years with grace period of 5 years. Cash flow relief: Maturities of post cut-off date debts and interest payments due on the restructured amounts deferred up to June 30, 2002. 20% of interest payments are also deferred.		
Yugoslavia – Nov. 2001	Ad hoc	66.7% reduction on NPV of total debt stock (cutoff date set at Dec. 2000) and rescheduling of principal payments of $4.5 billion		Up to 10% of the Relevant Principal, or up to an amount of 20 million US dollars, whichever is higher.	No
		Rescheduled over 39 years with 16 years of grace at interest rates at least as favourable as original rates (following first phase deferral - see next square) Three phases: 1/ 100% of debt deferred 2/ After an IMF 3 year is agreed, 51% of NPV stock cancelled. The rest is rescheduled at market interest rates over 22 years with 6 years of grace. 3/ After completion of IMF programme, additional 15% of NPV debt cancelled.			
Poland – 1991	Ad hoc	50% stock of debt reduction (no cut off debt) for principal payments of $29.871 billion		Yes	No
Indonesia:					
Apr-02	Houston terms	Rescheduling of principal payments for $5.4 billion falling due from April 1, 2002 to Dec. 31, 2003.		Yes	No
		Rescheduling over 20 years with 10 years grace period.	Rescheduling over 18 years with 5 years of grace period and progressive repayment		
Apr-00	Houstrn terms	Rescheduling over 14 years of principal payments for $5.4 billion maturities falling due from April 2000 to March 2002 with 3 years grace period.		Yes	No
Sep-98	Ad hoc	Rescheduling over 11 years of principal payments for $4.176 billion maturities falling due from August 1998 to March 2000 with 3-5 years grace period.		Yes	No

(1) Only pre-cutoff date debt is eligible to debt treatment, except for Pakistan and Poland.
Source: European Network on Debt and Development, “Towards a Sustainable Debt Workout for Indonesia,” April 2002.

5.3.2. The Private Commercial Debt

In March 1998 (at the beginning of the crisis), private commercial foreign debt totaled US$ 12.8 billion for Indonesian banks and US$ 64.6 billion for the corporate sector (Appendix Table A). This made up around 59 per cent of total foreign debt. As of end-2001, Indonesian banks still owed US$ 7.5 billion and corporations still owed a gargantuan US$ 55 billion, amounting to almost half of the total foreign debt.

During the crisis, foreign banks immediately cut foreign credits to Indonesian banks and corporations and demanded immediate repayments of obligations despite the massive devaluation of the rupiah. Indonesia was able to strike an agreement with its creditors in 1998 (for US$ 2.7 billion total) and in 1999 (for US$ 3.5 billion total) on the obligations of its banks. For inter-bank debts of Indonesian banks, the creditors allowed eligible debt to be converted to new loans with maturity of one to four years, plus market interest rates (with premiums) only if the new loans had sovereign guarantees. Only then did creditors allow for debt rollovers. For trade financing, foreign creditors agreed to keep aggregate trade credit exposure to Indonesian banks at the levels of end-April 1998, again with full guarantees from Bank Indonesia .

But it is in the much bigger corporate foreign debt that debt restructuring has been most stingy. An agreement on a framework for voluntary restructuring of outstanding obligations was made between Indonesia and its foreign creditors in June 1998. After the failed attempt of establishing the Indonesian Debt Restructuring Agency (INDRA) to facilitate corporate debt payments, the Jakarta Initiative Task Force (JITF) was set up in September 1998 to provide technical support for debt restructuring, administer an out-of-court debt workout framework and serve as mediator and facilitator of specific restructuring cases.

Out of a total corporate foreign debt of $55 billion at the end of December 2001, $18.9 billion of corporate foreign debt, comprising 65.2 per cent of delinquent debts of around $30 billion, had been restructured by the end of 2002 (based on a Bank Indonesia estimate (Bank Indonesia (2003)). It is also reported that some corporations had informally restructured their debts or had undertaken debt buybacks. The IMF (IMF 2002) states that most of the restructured (and previously delinquent) debts are owed by foreign subsidiaries of multinational firms. Again without debt reduction, the restructuring of these debts will only lead to bunching up of external debts at some future date.

5.3.3. A Total View: Debt Arbitration and International Insolvency Procedures

Dealing with Indonesia's huge burden of public and private external debt will require bold new initiatives. Recourse to conventional mechanisms of debt relief will not be adequate. Appendix Table C shows the external debt and debt service payments by Indonesia from 1980 to 2000 and projections from 2001 to 2014. Obviously, the projections are too optimistic since they are based on high growth scenarios for GNP, exports and capital inflows. Already, the projection for the end-period external debt for 2002 was underestimated by around US$15.7 billion.

There are now serious discussions among international debt relief organizations, such as Jubilee Plus or Jubilee 2000 (see Pettifor (2002)), and recommendations from Anne Kreuger and Kenneth Rogoff of the IMF,[22] about mechanisms to allow nations as entities to sue for bankruptcy proceedings and protect themselves from creditors. Such a recourse would ensure that budgets could be redirected towards developmental and poverty reduction needs, rather than debt service.

Both Jubilee Plus and Jubilee 2000 prefer to follow Chapter 9 of the US Legal Code, which allows municipalities to sue for bankruptcy, rather than Chapter 11, which allows corporations to sue for bankruptcy. Chapter 9 allows citizens of municipalities, taxpayers and others affected by the debt payments to be heard in the bankruptcy proceedings.

The above procedures would entail the creation of an independent body to arbitrate the debt standstill arrangements and negotiations between creditors and debtor country.

It is important to distinguish the international insolvency recommendations made by Jubilee Plus, Jubilee 2000 and Kunibert Raffer (Raffer 2001), on one hand, and those of the IMF, on the other. The IMF initiative, which is called the Sovereign Debt Restructuring Mechanism (SDRM), gives the IMF tremendous powers in choosing the members of the arbitration panel, and limits the powers of the panel members to mere referees. The main power in the process still resides in the creditors and their chosen representative committee.

As Rogoff and Zellelmeyer (2002) claim, the IMF aim in debt arbitration is to protect all creditors from rogue creditors that demand too much payment from the debtor country, to the detriment of the collective interest of all creditors. The view of Jubilee Plus or Jubilee 2000, as well as this report, is that a country and its citizens should be protected, in order to reserve funds for its developmental and poverty eradication needs.

[22] Kenneth Rogoff has since left the IMF to return to academia.

Table 5.11

Previous Paris Club treatments

<table>
<tr><th rowspan="2">Classic terms</th><th rowspan="2">Eligibility</th><th colspan="2">Debt treatment</th><th colspan="2">Other</th></tr>
<tr><th>ODA</th><th>Non-ODA (1)</th><th>Debt swaps</th><th>Multilateral Debt Treatment</th></tr>
<tr><td>Houston</td><td>(i) low level of income (GDP/cap/ lower than $2995).
(ii) Reaching at least two of the following three criteria:
- debt to GDP higher than 50%,
- debt to exports higher than 275%,
- scheduled debt service over exports higher than 30%
(iii) have a stock of official bilateral debt of at least 150% of private debt.</td><td>Rescheduling interest rate at least as favourable as the original concessional interest rate over 20 years with 10-year grace and progressive payments.</td><td>Rescheduling at market rate over 15 years with 2-3 years grace and progressive payments raising year by year</td><td>Possibility to conduct debt-swaps (up to 20% of the outsanding amount or 15-30 million SDR for non-ODA credits)</td><td>No</td></tr>
<tr><td rowspan="2">Naples</td><td rowspan="2">Assessed on a case-by case basis. Takes into account:
- IDA-only country
- Low GDP-per-capita (755 $ or less).
- Past track record with IMF and WB</td><td colspan="2">67% stock of bilateral debt reduction, with possible topping-up on bilateral basis</td><td rowspan="2">Without limit on ODA, and up to 20% of the outstanding amount or 15 up to 30 million SDR for non-ODA credits.</td><td rowspan="2">No</td></tr>
<tr><td colspan="2">Rescheduling interest rate at least as favourable as the original concessional interest rate over 40 years with 16-year grace and progressive repayment).</td></tr>
<tr><td>Cologne (HIPC)</td><td>Be eligible tot he HIPC Initiative:
- Be an IDA-only country
- Be on track with current IMF programme; PRSP or interim PRSP
- Have a NPV debt-to export ratio of more than 150% or a NPV debt-to-revenue ratio of more than 250%</td><td colspan="2">90% to 100% stock of bilateral debt reduction if necessary to reach HIPC II Thresholds; debt reduction from multilateral creditors</td><td></td><td>Yes</td></tr>
</table>

Source: European Network on Debt and Development, “Towards a Sustainable Debt Workout for Indonesia,” April 2002.

But since part of the IMF’s approach is a step in the right direction, the international debt arbitration and insolvency procedures should be supported, but modified to be more in line with the Jubilee Plus or Jubilee 2000 recommendations. These two NGOs (see Pettifor (2002)) even suggest that the IMF can act as 'a portal, a gateway’ between the sovereign debtor and international creditors. But for this arrangement to work, the IMF should agree to two requirements:

1. A sovereign country need not ask for IMF permission to sue for international insolvency and ask for debt arbitration.

2. A truly independent arbitration body should be set up to act as a 'court' and arbiter. The IMF and its board members should be excluded from representation in this independent body since they are part of the foreign creditor community and therefore cannot be impartial and unbiased.

The debt arbitration procedure has an additional advantage of letting an independent court decide whether to force the citizens of a country to pay for 'odious' debts—i.e., debts that were incurred through corrupt or non-transparent means and/or were used for activities inimical to the interests of the nation.

Obviously, for this entire scheme to succeed, multilateral institutions (such as the IMF) and the foreign creditor community, as well as sovereign countries and bilateral donors, should agree to the principles and guidelines of the international insolvency and debt arbitration arrangements.

There are short-term risks in such an approach. For example, credit rating agencies can downgrade a country's ratings due to its request for international insolvency. Something similar happened after the April 2002 Paris Club rescheduling of Indonesia's external debt, when Standard and Poor downgraded Indonesia's sovereign debt rating, due to the technicality that it was in default until the commercial creditors approved of the rescheduling.

The move caused short-term havoc and a plummeting of investors' confidence in the country. However, such dangers are very short-term. More astute investors will know that a sovereign country that has the political will and acumen to stop its bleeding from huge debt service payments will eventually end up stronger and more revitalized than if it continued unsustainable debt payments.

The United States and commercial creditors rejected the IMF's SDRM initiative during the 2003 Spring Meeting of the Bretton Woods Institutions (BWIs). The mainstream initiative now centers on including Collective Action Clauses (CACs) as part of sovereign bonds. CACs bind rogue creditors to the majority creditors' wishes in debt restructuring. This gets rid of the independent arbitration panel and gives the negotiating power to the majority of the creditors and the committee they set up.

Thus the pragmatic position now of Indonesia should be to lobby to achieve Naples terms of debt relief for official and bilateral debts. For commercial debts, it can demand CACs in its sovereign bonds, with aggregation features. Aggregation means that past sovereign bonds should be re-contracted to include CACs, so that all of Indonesian debt can be restructured in one comprehensive deal. But, at the same time, Indonesia should be in the forefront of the developing world in demanding a debt arbitration and insolvency mechanism to allow developing countries to stop debt payments and win debt relief and debt reduction during liquidity and financial crises. This initiative should naturally shift from the IMF (especially after the US rejection of SDRM) to the Third World countries and the United Nations.

5.4. Dealing With the Credit Crunch

From the start of the crisis in 1997, Indonesia has been experiencing a credit crunch. This arose as a consequence of the initial massive devaluation, capital outflows, high interest rate

policy, financial collapse and deep economic recession. This condition continues up to the present due to the persistent financial and debt problems, the lack of economic stimulation and the continued poor performance of exports and foreign direct investments.

Recent monetary policies that have been carried out to overcome the decline in credit, such as lowering interest rates, have so far not significantly increased bank loans to the real sector. Financial distress among banks and corporations has made the transmission mechanism from the financial to the real sector—operating through interest rates, credit and balance sheet channels—less effective. The difficulties of corporations in accessing funds from banks have seriously slowed down Indonesia's economic recovery.

5.4.1 Demand and Supply Factors for Credit Decline

The decline of credit during and after the crisis can be attributed to supply and demand factors. From the supply side, the principal factor was the reduction of banks' supply of credits at the prevailing interest rates. Other internal factors, such as the high ratio of non-performing loans, the low quality of loan applications and the sudden decrease in the real value of bank assets as a consequence of depreciation and negative interest margins, have also played a significant role in reducing the ability of Indonesian banks to provide loans. Closures of commercial banks, partly a consequence of IMF policies, have led banks to become much more risk-averse. Banks have also been forced by Bank Indonesia to achieve higher capital adequacy ratio and institute better loan loss provisions by either increasing their capital base (to overcome the reliance on recap bonds) or reducing loans.

Before the crisis, companies were highly leveraged. Massive exchange rate depreciation and high interest rates at the early stage of the crisis weakened the ability of companies to repay loans. The resulting rise in the number of non-performing loans (NPLs) weakened bank balance sheets. Also, the imposition of high interest rates, combined with the increased risk of defaults if lending rates were raised, forced many banks to pay a higher interest rate on deposits than they received on loans.

The twin effects of deteriorating loan portfolios and decreasing bank capital (or equity) forced Bank Indonesia (BI) to increase the required capital adequacy ratio to eight per cent and reduce the required ratio of NPLs to total loans to five per cent in 2001. BI also imposed maximum credit limits. All of these policies resulted in further declines in credit.

Another financial factor, the decrease in the creditworthiness of debtors, has also played a significant role in reducing loans. Banks have difficulty in differentiating sound borrowers from

risky borrowers. And if they raise interest rates, this only encourages riskier projects. Thus, banks become more cautious, relying on non-price factors to ration credit. They lend to borrowers based on collateral, established personal ties or other information on the credit applicant. As a result, many potentially profitable projects cannot secure credit, even if they were able to pay back loans based on a 'market' rate of interest. As banks have been merged or restructured under new management, they have become even more cautious.

Demand factors also help explain the decline of bank lending. First, the quality of borrowers has become lower as a consequence of the financial crisis. Highly leveraged before the crisis, corporate borrowers have faced higher debt servicing costs because of currency depreciation and relatively high interest rates. Second, corporate borrowers have been hit with lowered real asset values and cash flows. Hence, instead of investing and expanding their businesses, these companies have concentrated on retrenching and solving internal problems. Their lower demand for investment funds has contributed to the decline in loans. Also, the prevailing risk and uncertainty in the economy have also lowered their demand for financing of working capital.

5.4.2 Policy Issues and Options

Following are summaries of the key issues related to the credit crunch and the presentation of policy options to deal with it:

a. Stabilizing the Rupiah

Stabilizing the rupiah may help ease the credit crunch by reducing uncertainty in business sectors. Greater certainty will give companies more confidence to plan for future activities and increase their demand for credit. From the banks' point of view, more certainty will reduce their lending risks.

The present system of a freely floating exchange rate could exacerbate instability. But the contrasting policy of maintaining a tight band around the exchange rate will also probably not succeed in stabilizing the rupiah under the present weak economic conditions. Protecting such a system could quickly deplete international reserves. Under current conditions, a policy of a managed float (or a wider band) is more likely to succeed. This has the added benefit of helping provide the latitude for more accommodating monetary policy. Fortunately, the rupiah has been stable in recent months and appreciating. Ultimately it is a strong growth performance that will provide the main foundation for exchange rate stability. But the economic and political situation is still quite fragile as the bombing in 2003 of the Marriott Hotel clearly demonstrated.

b. Improving Information and Its Dissemination

Policies that can contribute to the quality of information in the credit market will help to reduce risk-averse behavior. These could include: (1) the regular release by Bank Indonesia of reliable information on creditworthy borrowers in key economic sectors (2) the improvement of BI's general information system to help banks access higher quality information on potential

borrowers, market prices and credit ratings and (3) the development by BI of an information retrieval system to monitor the behavior of banks in providing credits.

c. Credit and Deposit Guarantee

Bank Indonesia provides a 100 per cent guarantee on bank liabilities (as of September 2002). This is mainly for third-party deposits and bank debts and letters of credit. This was a result of the trauma of the bank run in 1998-1999. Though such a blanket guarantee had been crucial to stave off bank runs and panics, it is costly for the Government and, more importantly, causes moral hazard problems as well as give undue protection to deposits of the wealthy. Based on such protection, banks are encouraged to undertake overly risky borrowings and investments. There is now a strong movement in the executive and legislative branches to devise a more normal system of limited deposit and credit guarantee. The scheme calls for:

1) A first phase wherein debt notes issued by banks, direct loans, letter of credits, standby loans and derivative transactions will no longer be guaranteed.

2) A second phase wherein third-party funds worth more than Rp 5 billion (around $550,000) and inter-bank loans will no longer be guaranteed.

3) A third phase wherein third party funds above Rp 100 million (around $11,000) will no longer be guaranteed (supposed to start February, 2004).

The plan calls for the establishment of a deposit insurance facility and company that will manage and disburse the guarantee funds. However, this laudable plan entails several risks:

1) There might be another ‘panic’ as large depositors, especially insurance companies, move their money out of Indonesian banks and into foreign or offshore banks or into the stock or bond markets, since their deposit funds will no longer be safe if the Indonesian banks fold.

2) Overseas banks may reduce transactions with local banks because their credit will no longer be guaranteed. This will mostly affect local importers who usually have letters of credit in local banks. This will be a problem since the economic recovery will, to a large extent, require imported capital and intermediate goods.

The above discussion emphasizes the underlying importance of re-invigorating business confidence through more pro-growth economic policies. If the current blanket guarantee system is converted into a more limited guarantee system, the economic and business climate must indeed be conducive to such a change.

d. Selective Credit Facilities

The monetary authority can offer selective liquidity support to re-install the effective functioning of the credit market. Carefully selective credits for exporters or importers or for small and medium enterprises are examples of such a policy. But such an approach would call for the use of performance criteria to monitor these firms and sectors to ensure that the liquidity credits are being productively used.

Once the Government is able to put in place a transparent system of supervision and monitoring, it could facilitate syndicated loans among the banks to increase domestic investment. Under present circumstances of high risk and low confidence, government encouragement of productive investment would be beneficial. Lacking this, banks are most likely to focus their loans on consumption and commercial activities. Stimulated by public investment and support, the growth in domestic private investment could trigger a multiplier effect that would encourage an increased inflow of foreign direct investments.

e. Policies on Bank Closures

Closure of banks should take place only after thorough investigation and preparation. Premature and rash policies would just make matters worse, leading to bank runs and domino-like bankruptcies. This is one of the lessons of the bitter experience of 1998-99.

f. Improve Financial Supervision and Corporate Governance

There is a clear and critical need to enhance the practice of good corporate governance and increase bank transparency in order to reduce moral hazard in lending and borrowing transactions and enable stakeholders to assess the financial conditions of banks. As the first part of this chapter showed, poor corporate governance and lack of financial monitoring and supervision were decisive factors contributing to the corporate and banking crisis in Indonesia.

g. Overall Monetary and Interest Rate Policy

Since capital markets, such as those dealing with commercial papers and corporate bonds, are not well developed in Indonesia, a credit crunch leaves companies with few alternatives to finance their needs for investment and working capital.

Tight monetary policy worsens companies' balance sheets and thus tends to aggravate a credit crunch. However, expansionary monetary policy, on its own, cannot lead to the increased supply of credit.

Indonesia's monetary policy has not been consistently effective, for instance, in influencing the target rate of interest. In the period of tight monetary policy (which was reflected in high SBI rates), deposit rates did not necessarily follow suit (Bank Indonesia 2001b).

Also, during the current period of more accommodative monetary policy, loan interest rates remain rigidly high. This rigidity is a normal consequence of the high risks, non-performing loans and overhead costs in Indonesia's banking system. However, if growth is going to be accelerated, the preferred option is the current one, namely, more expansionary monetary policy and lower interest rates. But if fiscal policies are not also expansionary, monetary policies will be inadequate to overcome the credit crunch and speed economic recovery.

h. More Emphasis on Fiscal Stimulation of Economic Activity

Now is the appropriate time for more expansionary fiscal policies. The Government was obliged by the IMF in the initial Letters of Intent to conduct tight fiscal policy in reaction to the crisis. But this had made matters worse at that time.

Although the current Government could undertake more expansionary fiscal policies to help the economy overcome the credit crunch, it confronts serious constraints, due to low revenue generation and rising debt payments. Other chapters of this report have dealt with the problem of low revenue generation and the balanced budget rule.

This chapter emphasizes the importance of resolving Indonesia's debt burden. Thus it is vital to convince the international development community to provide more debt relief and additional financing to Indonesia. It is also vital for the Government to tackle its domestic debt problem so as to release funds for stimulating the economy and attacking poverty. Lightening Indonesia's heavy debt burden goes hand in hand with opening greater latitude for expansionary fiscal policy.

5.5. Credit Policies for Small and Medium Enterprises (SMEs)

Since the credit crunch reduces economic activity and threatens the employment of a growing labor force, the Government is looking at directed credit policies for small and medium enterprises (SMEs), especially since these firms have high labor-absorbing capacities.

5.5.1. Directed Lending to SMEs

The Central Bank defines SME credit as loan transactions allocated to investment and working capital with nominal value of no more than Rp 5 billion (US$ 555,000). Before the crisis, the Government required banks to allocate one fifth of their credit to SMEs. However, this policy was not considered successful in promoting and developing SMEs. Many banks allocated this stipulated share of credit to SMEs of their own creation. During the crisis, SMEs also faced serious problems of paying back their loans, even though in absolute amount, their loans were much smaller than those of large enterprises.

During the crisis, the Government extended sizeable amounts of credit to SMEs and farmers in order to a) restore the distribution system for basic goods, which was destroyed during

the unrest and riots b) increase rice production and c) create employment. One of the resultant problems was the rise of non-performing loans among SMEs. Also, in order to encourage productive lending for micro-enterprises and cooperatives, the Government and parliament have given incentives to recapitalized banks to allocate credit to SMEs.

In 2002, about 43 per cent of new credit allocated by banks was earmarked for SMEs. But the definition of SME credit includes consumer loans, such as for credit card bills, mortgages and automobile loans—as long as they are less than Rp 5 billion. Moreover, Bank Indonesia reports that the current capability of SMEs to absorb credit from banks remains low, at only about 70 per cent of its potential. Reasons include the concentration of SMEs in retail sales and services and the fierce competition among firms.

In order to assist SMEs that face problem of paying back their bank loans, the Government recently issued a policy for a 25 per cent 'haircut' (namely, discounting their principal debt by 25 per cent), especially on debts owed to state-owned and state-controlled banks. The detailed implementation of this policy was left up to the individual banks. However, banks openly complain that such a 'haircut' only encourages irresponsible borrowing.

5.5.2. People's Credit Banks (BPR) and Syariah Banking

As an additional measure to promote SMEs, Bank of Indonesia supports the development of rural banks called BPRs (People's Credit Banks). BPRs are allowed to take savings and time deposits and undertake inter-bank borrowing. BPRs are also allowed to allocate credit to one another. Some BPRs practice Islamic (*Syariah*) banking, which lends money based on cooperative risk-sharing among borrowers. As of end-August 2002, there were 2,144 BPRs and 82 BPR Syariah banks operating in Indonesia. About 85 per cent of the BPRs are located in Java and Bali, where business activities and population are concentrated.

BPRs have developed relatively well, significantly increasing their numbers and accumulation of funds. However, their aggregate size remains very small compared to that of the overall banking system. The total assets of BPRs in 2002 amounted to about Rp 7 trillion, which represented only 0.7 per cent of total banking assets. These banks perform relatively well in the secondary town, especially in supporting the trading activities and consumption of lower-income households. However, these banks have not been functioning well yet in rural areas. Furthermore, their interest rates remain very high, reaching 30-50 per cent annually. Nevertheless, small traders and low-income households are willing to accept loans with such high rates.

In rural areas, the role of micro-credit provided by the informal financial system is still very important. The formal banking system in rural areas is dominated by the state bank BRI, which adminsters program of Simpedes (saving) and Kupedes (lending). It disposes of funds totaling about Rp 3 trillion while other formal micro-financing institutions have accumulated funds of only about Rp 800 billion.

5.5.3. Strengthening Banks' Role in SME Development

Since economic growth for several years to come may not be high enough to absorb the growing labor force, the development of labor-intensive SMEs is very important to generate sufficient employment. Banks have been reluctant to allocate significant new credits to the corporate sector

(usually defined as credits above Rp 50 billion or US$ 5 million), but they have channeled more resources to reliable SMEs. However, in the medium run, if NPLs are brought under control and corporate debt restructuring is successfully carried out, the large banks will resume lending to the corporate sector, which will support investments that create higher-wage jobs.

Certainly, a balanced portfolio between corporate and SME loan transactions would be a generally healthy development. Moreover, credit to SMEs should support their expansion into productive sectors, where they can generate remunerative work for a large segment of the Indonesian workforce. Most SMEs are very small in scale and concentrated in trade and services. In order to support the growth of larger and more production-oriented SMEs, government facilities and the support services provided by banks and other financial institutions could play a crucial role.

In this regard, a new system of networking between large and small banks is promising. Many large banks have limited experience with SMEs. In order to overcome this problem, these large banks have begun channeling SME credits through smaller banks, such as BPRs (People's Credit Banks) and BPR S*yariah* banks, which have more direct links and more experience, especially with small enterprises. This scheme will not only reduce the lending risk of the large banks but also support the development of small banks with specialized expertise in credit allocation to SMEs.

In summary, the growth of BPR and Islamic banking is likely to have a positive impact on SME development and help generate widespread employment. Government support is crucial to their success. Supervision by Bank Indonesia will help these small-scale banks function better as financial institutions. The small-scale credits being allocated by BRI, the specialized state bank for SMEs, is also an encouraging development, even though its coverage needs to be expanded.

5.6. An Assessment of Tasks and Responsibilities

Despite a moderate increase in bank loans in 2002 (see Table 5.5 under claims to private sector) and talk of stronger financial and macroeconomic conditions in 2002 and 2003, the Indonesian economy remains in a weak condition. This is reflected in Table 5.1, which shows that the investment and savings rates had deteriorated in 2002, dropping to rates lower than the average of the worst years of 1998-2000. The rise in bank loans in 2002 was mostly concentrated in consumer loans while investment loans registered negative growth. This does not bode well for the long-run development prospects of the country as an increasingly smaller share of real and financial resources are being allocated to capital formation.

Many policy recommendations have been offered to the Indonesian Government on how to revitalize credit and the financial sector. It would help if interest rates continue to decline so as to decrease the difficulties that firms have in obtaining loans and moderate banks' risks of default and deterioration of loan portfolios.

Furthermore, initiatives are under way to increase lending to SMEs and lower-income households. These include increased credit to SMEs and enhanced support to small-scale banks, such as BPRs and *Syariah* (Islamic) banks.

However, these reforms in monetary and credit policies will be insufficient if the underlying problems of the financial sector detailed in this chapter are not addressed. The main policy recommendations that this chapter has advanced to deal with these problems are:

a. Boost investor confidence by stimulating the economy through increased public investments and employment generating programmes (a point elaborated in other chapters of this report, such as Chapters Two and Four) and carry out more thorough-going reforms in corporate governance (a point elaborated in Chapter Six).

b. Aggressively pursue external debt relief from bilateral, multilateral and commercial creditors and examine the possibility of achieving debt relief on official debts based on the Naples terms and lobby in the forefront of the struggle to allow insolvency and sovereign debt restructuring for developing countries, such as Indonesia, facing financial crises and severe indebtedness.

c. Reduce the government's domestic debt stock and interest payments on recap bonds by reducing the bond-holdings of over-capitalized banks, merging banks

and implementing confidence building policies to motivate banks to increase lending to the private sector.

It is clear from the discussion in this chapter that the tasks involved in extricating Indonesia from its financial dilemma and credit crunch will fall on many shoulders.

First, the Government has a number of very important tasks: 1) undertaking public investments and employment generating programmes 2) carrying out structural, judicial and political reforms to foster the return of economic confidence (see the next chapter for more details), 2) demanding a renegotiation of its external debts with official and private creditors and ensuring that this results in benefits to the Indonesian people and 3) improving economic governance so as to assure appropriate regulation and supervision of the financial sector and corporate sector. This latter task would include better financial supervision of banks' loan portfolios and the external inflows and outflows of financial capital.

External public and private lenders have the responsibility to provide debt relief to Indonesia so that the country's foreign exchange can be used to revive its economy, reduce poverty and enhance the human development of its people. They also can supplement such relief with the provision of more concessional financing facilities.

Indonesia's Government is exiting the IMF programme this year, although there has been a delay in coming up with an exit programme. The IMF, based on its latest document (Boorman and Hume (2003)) released in July of this year, has rejected major responsibility for the economic and financial collapse in the last Asian crisis. This is an opportune time for the Government to push for bolder policies to promote investment and employment generation and more radical, but badly needed, external and domestic debt relief. It should negotiate more concertedly with its external creditors, especially the Consultative Group and Paris Club, inclusive of the IMF, World Bank and ADB, while at the same time eliminating unnecessary

domestic debts in the form of excessive recap bonds. The well-being of the Indonesia people is directly tied to freeing up additional resources to finance a faster rate of economic growth and a more rapid reduction in poverty.

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Appendix Table A: External Debt, Indonesia: March 1996 - December 2001

(US $ billions)	Mar. 1996	Mar. 1997	Mar. 1998	Mar. 1999	Mar. 2000	Dec. 2000	Dec. 2001
Public Sector	58.6	52.6	54.2	68.4	74.7	74.9	73.8
Central government	58.6	52.6	51.2	59.2	64.2	61.7	62.4
Bank Indonesia	0.0	0.0	3.0	9.2	10.5	13.2	11.4
Banks	8.9	9.6	12.8	11.8	10.5	7.8	7.5
Public	2.9	3.0	5.0	4.9	4.7	4.2	3.8
Private	6.0	6.6	7.8	6.9	5.8	3.6	3.7
Corporates	38.9	50.9	64.6	68.0	57.7	58.5	55.0
Private companies	34.0	47.2	60.8	62.8	51.9	52.8	51.2
State-owned enterprises	4.9	3.7	3.8	5.2	5.8	5.7	3.8
Total	106.4	113.1	131.6	148.2	142.9	141.2	136.3
As a percent of GDP	52.4	48.1	88.6	143.2	95.8	92.8	93.7
External Debt: March 1996 - December 2001 (% of Total)							
Public Sector	55.1	46.5	41.2	46.2	52.3	53.0	54.1
Central government	55.1	46.5	38.9	39.9	44.9	43.7	45.8
Bank Indonesia	0.0	0.0	2.3	6.2	7.3	9.3	8.4
Banks	8.4	8.5	9.7	8.0	7.3	5.5	5.5
Public	2.7	2.7	3.8	3.3	3.3	3.0	2.8
Private	5.6	5.8	5.9	4.7	4.1	2.5	2.7
Corporates	36.6	45.0	49.1	45.9	40.4	41.4	40.4
Private companies	32.0	41.7	46.2	42.4	36.3	37.4	37.6
State-owned enterprises	4.6	3.3	2.9	3.5	4.1	4.0	2.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
% of Annual GNP							
Public Sector	26.5	25.1	60.2	52.9	52.9	53.0	52.8
Central government	26.5	25.1	56.8	45.8	45.4	43.7	44.7
Bank Indonesia	0.0	0.0	3.3	7.1	7.4	9.3	8.2
Banks	4.0	4.6	14.2	9.1	7.4	5.5	5.4
Public	1.3	1.4	5.6	3.8	3.3	3.0	2.7
Private	2.7	3.2	8.7	5.3	4.1	2.5	2.6
Corporates	17.6	24.3	71.7	52.6	40.8	41.4	39.4
Private companies	15.4	22.5	67.5	48.6	36.7	37.4	36.7
State-owned enterprises	2.2	1.8	4.2	4.0	4.1	4.0	2.7
Total	48.1	54.0	146.1	114.6	101.1	99.9	97.6
% of International Res.							
Public Sector	321.1	317.1	238.6	258.7	262.1	262.8	270.9
Central government	321.1	317.1	225.4	223.9	225.2	216.5	229.0
Bank Indonesia	0.0	0.0	13.2	34.8	36.8	46.3	41.8
Banks	48.8	57.9	56.4	44.6	36.8	27.4	27.5
Public	15.9	18.1	22.0	18.5	16.5	14.7	13.9
Private	32.9	39.8	34.3	26.1	20.3	12.6	13.6
Corporates	213.1	306.9	284.4	257.1	202.4	205.2	201.9
Private companies	186.3	284.6	267.7	237.5	182.1	185.3	187.9
State-owned enterprises	26.8	22.3	16.7	19.7	20.3	20.0	13.9

Total	583.0	681.9	579.4	560.4	501.4	495.4	500.3

Source: IMF (2002), 'Indonesia: Selected Issues', IMF Country Report No. 02/154, July 2002, p.53

Appendix Table B. External Public Debt Outstanding including Undisbursed as of December 31, 2000

Type of creditor/creditor country	Debt outstanding			Present Value	% of Total Disbursed
	Disbursed	Undisbursed	Total		
PUBLIC AND PUBLICLY GUARANTEED DEBT					
Bilateral Loans					
Australia	739,793	28,730	768,523	507,206	0.9
Austria	243,622	59,495	303,117	187,556	0.3
Belgium	129,211	2,548	131,759	100,808	0.2
Brunei	82,262	0	82,262	40,874	0.1
Canada	423,558	24,259	447,817	273,997	0.5
China	18,846	4,444	23,290	14,409	0.0
Denmark	39,944	0	39,944	30,599	0.1
Finland	12,510	4,116	16,626	10,649	0.0
France	698,203	37,037	735,240	460,839	0.9
Germany	2,650,653	196,566	2,847,219	2,008,262	3.3
Italy	176,367	0	176,367	123,074	0.2
Japan	22,517,675	5,606,320	28,123,995	21,755,874	28.3
Korea, Republic of	80,476	4,771	85,247	65,787	0.1
Kuwait	51,369	15,546	66,915	40,377	0.1
Multiple Lenders	3,632,714	0	3,632,714	3,049,266	4.6
Netherlands	599,335	14,239	613,574	416,504	0.8
New Zealand	4	0	4	0	0.0
Norway	30,060	0	30,060	22,170	0.0
Other	20,366	0	20,366	14,985	0.0
Saudi Arabia	23,823	0	23,823	13,306	0.0
Singapore	1,194	0	1,194	1,146	0.0
Slovak Republic	3,421	0	3,421	3,362	0.0
Spain	339,554	61,694	401,248	224,122	0.4
Sweden	11,606	0	11,606	10,704	0.0
Switzerland	151,083	0	151,083	132,769	0.2
United Kingdom	24,794	395	25,189	25,570	0.0
United States	2,495,755	107,106	2,602,861	1,874,179	3.1
Total Bilateral Loans	35,198,198	6,167,266	41,365,464	31,408,394	44.2
Bonds					
Multiple Lenders	545,000	0	545,000	541,317	0.7
United States	426,000	0	426,000	435,507	0.5
Total Bonds	971,000	0	971,000	976,824	1.2
Export Credits					
Austria	660,963	14,543	675,506	559,774	0.8
Belgium	136,572	266	136,838	107,222	0.2
Denmark	37,569	0	37,569	28,191	0.0
Finland	42,026	0	42,026	32,450	0.1
France	665,608	20,873	686,481	483,804	0.8
Germany	14,734	0	14,734	8,053	0.0
Japan	38,977	0	38,977	36,796	0.0
Netherlands	227,140	0	227,140	180,979	0.3
Norway	44,005	0	44,005	30,333	0.1
Spain	50,806	0	50,806	36,621	0.1
Sweden	22,213	0	22,213	11,634	0.0
Switzerland	266,396	0	266,396	198,062	0.3
United Kingdom	549,336	62,467	611,803	397,168	0.7

United States	245,220	0	245,220	178,812	0.3
Total Export Credits	3,001,565	98,149	3,099,714	2,289,899	3.8

Appendix Table B (cont.) External Public Debt Outstanding including Undisbursed as of December 31, 2000
(US$ thousand)

Type of creditor/creditor country	Debt outstanding			Present Value	% of Total Disbursed
	Disbursed	Undisbursed	Total		
Financial Institutions					
Australia	2,243	0	2,243	674	0.0
Austria	147,493	15,585	163,078	120,982	0.2
Belgium	2,228	461	2,689	1,946	0.0
France	176,095	39,071	215,166	148,535	0.2
Germany	2,020	79	2,099	1,780	0.0
Hong Kong	461,518	133,457	594,975	457,413	0.6
Japan	147,272	1,270	148,542	145,847	0.2
Multiple Lenders	6,885,475	0	6,885,475	6,843,055	8.7
Netherlands	59,966	8,076	68,042	50,744	0.1
Norway	40,595	8,544	49,139	27,526	0.1
Singapore	1,162,292	466,976	1,629,268	1,011,527	1.5
Spain	4,199	0	4,199	2,741	0.0
Switzerland	2,139	0	2,139	1,601	0.0
United Kingdom	389,484	37,862	427,346	269,024	0.5
Total Financial Institutions	9,483,019	711,381	10,194,400	9,083,395	11.9
Multilateral Loans					
ASDB "soft window"	648,714	150,525	799,239	353,831	0.8
Asian Dev. Bank	6,355,420	2,552,275	8,907,695	6,173,208	8.0
EEC	3,647	0	3,647	2,135	0.0
European Dev. Fund	1,236	393	1,629	971	0.0
IBRD	11,714,727	1,866,538	13,581,265	12,709,832	14.7
IDA	713,566	178,938	892,504	399,751	0.9
International Monetary Fund	10,248,000				12.9
Int'l Fund. Agr. (IFAD)	101,538	14,397	115,935	84,212	0.1
Islamic Dev. Bank	83,680	13,948	97,628	85,356	0.1
Nordic Invest. Bank	170,604	8,370	178,974	160,042	0.2
Nordic Investment Fund	11,301	0	11,301	10,237	0.0
Total Multilateral Loans (excl. IMF)	19,804,433	4,785,384	24,589,817	19,979,575	24.9
Total Multilateral Loans (incl. IMF)	30,052,433				37.8
Nationalization					
Netherlands	15,876	0	15,876	14,723	0.0
Total Nationalization	15,876	0	15,876	14,723	0.0
Supplier Credits					
France	0	2,624	2,624	0	0.0
Japan	834,985	1,431	836,416	742,295	1.0
Singapore	0	6,246	6,246	1	0.0
Slovak Republic	0	10,413	10,413	0	0.0
United States	0	18,465	18,465	19	0.0
Total Supplier Credits	834,985	39,179	874,164	742,315	1.0
Creditor Types					
Bilateral Loans	35,198,198	6,167,267	41,365,465	31,408,393	44.2
Bonds	971,000	0	971,000	976,824	1.2
Export Credits	3,001,564	98,149	3,099,713	2,289,898	3.8
Financial Institutions	9,483,019	711,379	10,194,398	9,083,395	11.9
Multilateral Loans (incl. IMF)	19,804,432	4,785,383	24,589,815	19,979,576	37.8
Nationalization	15,876	0	15,876	14,723	0.0

Supplier Credits	834,985	39,179	874,164	742,315	1.0
Total (excl. IMF)	69,309,074	11,801,357	81,110,431	64,495,124	
Total (incl. IMF)	79,557,074				100.0

Notes:
(1) Only debts with an original or exteded maturity of over one year are included in this table.
(2) Debt outstanding includes principal in arrears but excludes interest in arrears.
Source: World Bank (2001), "Indonesia: The Imperative for Reform," Brief for the Consultative Group on Indonesia (Nov. 2, 2001)

Appendix Table C. Service Payments, Commitments, Disbursements and Outstanding Amounts of Total External Debt, 1980-2013/a
(US$ thousand)

	Debt outstanding at end of period		Transactions during period				
					Service Payments		
	Disbursed only	Including Undisbursed	Commitments	Disbursements	Principal	Interest	Total
Actual							
1980	20,937,697	30,420,359	4,277,373	3,245,505	1,632,494	1,451,811	3,084,305
1981	22,761,139	33,805,826	5,008,002	3,845,429	1,784,995	1,707,127	3,492,122
1982	25,133,280	38,847,056	7,067,267	4,410,336	1,942,084	1,914,070	3,856,154
1983	30,229,384	44,069,191	5,686,879	6,392,696	1,798,027	1,943,231	3,741,258
1984	32,025,604	46,152,969	4,816,038	4,840,324	2,270,173	2,575,904	4,846,077
1985	36,715,241	52,664,318	4,583,947	4,170,204	3,421,579	2,401,135	5,822,714
1986	42,916,426	60,291,414	4,104,406	4,829,475	3,285,237	2,698,511	5,983,748
1987	52,535,204	71,997,352	5,994,820	7,489,770	4,059,579	2,941,855	7,001,434
1988	54,078,473	72,944,387	6,087,327	8,179,570	5,296,940	3,345,242	8,642,182
1989	59,401,728	78,040,191	7,643,407	9,008,916	5,993,871	3,839,209	9,833,080
1990	69,871,535	90,281,275	6,691,047	10,024,229	5,968,647	3,977,615	9,946,262
1991	79,547,725	100,178,646	8,811,427	11,758,429	6,857,771	4,617,488	11,475,259
1992	88,002,159	107,367,183	7,878,074	13,532,913	7,943,980	4,512,662	12,456,642
1993	89,171,879	109,869,371	8,136,637	8,084,176	9,137,539	4,951,220	14,088,759
1994	107,823,935	129,207,339	7,711,610	12,546,541	8,951,065	5,316,014	14,267,079
1995	124,398,325	149,421,280	10,954,145	13,628,469	10,196,992	6,219,010	16,416,002
1996	128,936	152,638,402	7,795,728	20,973,217	14,895,938	6,647,014	21,542,952
1997	136,160,846	155,516,175	3,424,551	22,453,960	13,010,479	6,726,343	19,736,822
1998	151,235,672	167,630,856	7,375,001	16,391,639	11,202,473	7,107,267	18,309,740
1999	150,990,499	166,504,501	5,233,619	9,460,136	11,710,701	5,953,972	17,664,673
2000	141,951,256	153,752,614	1,903,316	7,059,446	11,295,880	7,378,724	18,674,604
Projected							
2001	128,240,716	134858643	0	5,049,558	15,941,595	6,312,278	22,253,873
2002	116,118,867	119379584	0	3,357,211	15,581,834	5,458,507	21,040,341
2003	104,850,709	106526585	0	1,584,856	12,853,014	4,582,148	17,435,162
2004	95,348,794	96,148,939	0	875,742	10,377,657	3,934,340	14,311,997
2005	85,347,163	85,703,515	0	443,824	10,445,455	3,398,276	13,843,731
2006	76,690,045	76,816,838	0	229,584	8,886,830	2,777,136	11,663,966
2007	67,298,729	67,305,816	0	119,762	9,511,143	2,302,520	11,813,663
2008	58,482,417	58,484,981	0	4,526	8,820,837	1,772,500	10,593,337
2009	53,705,441	53,706,198	0	1,807	4,778,783	1,402,660	6,181,443
2010	49,072,238	49,072,478	0	516	4,633,719	1,152,291	5,786,010
2011	45,728,848	45,729,070	0	0	3,343,388	936,104	4,279,492
2012	42,262,734	42,262,956	0	0	3,466,114	786,709	4,252,823
2013	39,395,567	39,395,789	0	0	2,867,167	617,422	3,484,589
2014	36,837,464	36,837,685	0	0	2,558,104	499,316	3,057,420

a/ Total external debt includes total amount of public, private, short term and IMF credit only debt.
b/ This column shows the amount of arithmetic imbalances in the amount outstanding, including undesbursed, from one year to the next. The most common caused of imbalance are changes in exchange rates and transfers of debts from one category to another in

Source: World Bank (2001), "Indonesia: The Imperative for Reform," Brief for the Consultative Group on Indonesia (Nov. 2, 2001)

Chapter Six

CORPORATE GOVERNANCE AND PRIVATIZATION[23]

The reform of corporate governance and the restructuring and privatization of state-owned banks and non-financial firms are central to the economic health of Indonesia. The overthrow of Suharto and the setting up of a more democratic government had generated high expectations that the corporate-military complex that had thrived under the previous regime would be weakened, and that a more equitable and democratic economic system would be established, based on reforming corporate ownership and management and building up effective judicial and legal structures.

What has happened since 1998 shows strikingly that such transformations are not easily achieved, and that Indonesia still has to go through a difficult process of economic, political and structural reforms.

The key processes and issues in corporate governance and privatization facing Indonesia are the following:

1. The attempts of the Indonesian Bank Restructuring Agency (IBRA) to deal with the non-performing loans and assets that it inherited, and dispose of and sell the restructured and unrestructured debts; and the impact of these efforts on ownership patterns;

2. The attempts of IBRA to punish previous bank owners and have them pay the debts that they assumed when they misused liquidity funds and went beyond legal limits in lending to relatives and affiliate companies; and the legal and judicial processes involved;

3. The sale (and privatization) of state-owned banks that IBRA has had to take over;

4. The sale and privatization of non-financial state-owned enterprises by the Ministry of State Enterprises.

6.1 The Problems Faced by IBRA[24]

In January 1998, the Indonesian Bank Restructuring Agency (IBRA) was established for the following purposes:

1. To take over, manage and dispose of (at reasonable prices) the non-performing loans and bank assets of which the Government had assumed responsibility;
2. To restructure and enhance these loan assets in order to ensure repayment of both principal and interest and improve their quality and sale price;
3. To restructure state-owned and taken-over banks and sell them to private owners;
4. To manage shareholder settlements with former bank owners; and
5. To administer the Government's blanket guarantee programs for all bank liabilities before the establishment of a deposit insurance company, which would take over the management of a limited deposit insurance scheme.

IBRA offered the main hope of the Government and the banking sector for speeding up a financial recovery through deriving reasonably adequate proceeds from the sale of assets. These proceeds could offset, it was hoped, the big rise in domestic debt brought about by the issuance of recap bonds and the regular interest payments on them.

Table 6.1 gives IBRA's targeted revenues versus its contributions to the Government's coffers. Though the targeted revenues were achieved, the total amount for the four years (around Rp 127 trillion) is small compared to

[23] This chapter was written by Joseph Anthony Lim.
[24] This section relies heavily on the data and figures provided by the IMF study, "Indonesia: Selected Issues," IMF Country Report No. 02/154, July 2002. These data and figures, however, originate from IBRA.

the estimated Rp 700 trillion in public debt that the Government had incurred in order to rescue the financial sector, plus its interest payments on the recap bonds. Still, IBRA's revenues have been crucial in reducing budget deficits, and, more importantly, in providing some financing for the short-run stimulation of the economy.

Table 6.1. IBRA Revenues

	1999	2000	2001	2002	Total
IBRA Target Revenue	17,000	18,900	37,000	42,800	115,700
IBRA Contribution to Government Budget					
Cash	12,886	18,900	27,626	35,300	94,712
Bonds	4,262	-	20,540	7,500	32,302
Total	17,148	18,900	48,166	42,800	127,014

Source: IBRA, Annual Report 2001 and 2002.

Following is a more detailed description and analysis of the problems faced in disposing of loan assets and recovering debts owed to IBRA. There are three main operations of IBRA: 1) disposal of non-performing loan assets; 2) recovering debts of previous bank owners through shareholders' agreements; and 3) sale of banks that had fallen into IBRA's lap.

6.1.1 The Sale and Disposal of Non-Performing Loan Assets

IBRA's Asset Management Credit (AMC) has been given the responsibility to restructure and sell loan (core) assets and other (non-core) assets of state-owned, taken-over or recapitalized banks. Its biggest holdings are corporate loans, which are defined as loans whose principal amounts are Rp 50 billion or above. Commercial loans are loans with a principal of Rp 5 to 50 billion. Small and medium enterprise (SME)[25] and retail loans are those with a principal of under Rp 5 billion. See Table 6.2 for the shares of these components in the total assets transferred to IBRA.

Table 6.2: Total Loan Assets Transferred to IBRA

Asset Type	Face Value (Rp trillions)	% of Total
Loan Assets	**328.1**	**100.0**
Core Assets	**310.7**	**94.7**
Corporate	269.2	82.0
-- Top 50 Obligor	100.0	30.5
-- Top 21 Obligor	90.5	27.6
Commercial	30.5	9.3
SME/ Retail	10.9	3.3
Non-core Assets	**17.4**	**5.3**

[25] Although these loans are called SME / retail loans, many are not loans to SMEs. For example, many of them are credit card dues, automobile loans and housing mortgages.

Source: IBRA, Annual Report 2001 and 2002.

The strategy of AMC for corporate loans up to the end of 2001 was to separately categorize the top 21 'obligors' and the top 50 ‘obligors’. The 'obligor' concept puts debtor companies belonging to the same conglomerate ('obligor') together and tackles their loans accordingly. In debt restructuring, the 'sustainable' portion of the debt would be sold while the 'unsustainable' portion would be converted to government equity, which would be sold eventually. Direct sale of corporate loans has been allowed as long as a buyer has been willing to pay 70 per cent of the face value of the loan. IBRA has also allowed recap bonds to be used as payment for loan purchases (in the form of an asset-bond swap) when these are corporate loans that are not in the top 21 'obligor' category.

Debt servicing for around half of commercial loan assets was outsourced to four banks until the end of 2001. The four banks were paid management fees. The other half of the loans was to be dealt with on the basis of outright sale or restructuring.

Retail and SME loans have been given more leeway and special treatment, namely, qualifying for 'crash' programs granting interest and penalty write-offs and in some cases a 25 per cent principal reduction (i.e., the 'super crash' program). Loan auctions have been used to sell the remaining portion.

SME/retail loans have had the highest rate of disposal, with around 72 per cent being disposed of by the end of 2001. This means that the larger corporate and commercial loans now account for most of those remaining. Commercial loans remain the ones with minimal restructuring. The Rp 14.1 trillion of commercial loans outsourced to the banks yielded only a measly Rp 1.47 trillion (10 per cent of the face value).

As of June 30, 2003, around five years after the establishment of IBRA, only 67.4 per cent of loan assets (Rp 221.12 trillion) had been sold while Rp 107 trillion (32.6 per cent) still remain with IBRA. Furthermore, IBRA reported that the average recovery rate of the loan assets disposed of was around 29 per cent as of end of 2002. This means that only around Rp 60 trillion of the Rp 221.12 trillion loan assets sold had been retrieved. The Institute for Development of Economics and Finance (INDEF) estimated in a survey of the banking sector in 2002 that IBRA had managed to retrieve only around 16-17 per cent of the book value of its assets (including non-loan assets). (Laksamana.net, July 4, 2003).

The first set of reasons for the slow pace of loan asset disposal by AMC has included delays in processing, lack of adequate documentation and resistance and delays from the conglomerate debtors. The use of legal mechanisms and courts to stop IBRA from forcing debtors to pay or stop it from appropriating their assets has been successful.

According to an IMF study (IMF (2002b)), many of the debt restructuring deals have been too lenient and biased towards the large debtors. Some companies are artificially being kept alive by these restructuring deals, which tend to make IBRA either vulnerable to risks of asset stripping or burdened with unpaid liabilities.

Other restructuring agreements have used below-market interest rates and unduly long maturities. Some have involved undue conversion of IBRA debt into equity, thus undermining IBRA's position as creditor. These have been partly detected by IBRA's Oversight Committee (OC), which reviews debt restructuring for large debtors, and have been admitted by the Financial Sector Policy Committee (FSPC), the oversight body for IBRA.

AMC's difficulties in selling loan assets and low recovery rates have also been due to a second set of factors. First has been the overvaluing of loan assets by the originating bank. Second has been the low quality of the loans because the economic position of those servicing the debt has not been sustainable. This highlights the limited success in credibly restructuring the loans, due, in no small part, to the absence of confidence in an economic recovery. Connected to this problem has been the depreciation in value of non-core assets such as real property and

stock shares. But perhaps more basic is the imbalance in bargaining strength between the Government, on one hand, and the powerful conglomerate debtors, on the other.

The Political Economy of Debt Restructuring and Loan Assets Disposal

IBRA's original intent with regard to many of the conglomerate debts was to restructure them into healthier and more credible debts, with debt schedules set commensurate with the companies' ability to pay. The banks could then choose to swap their recap bonds with the restructured loan assets, or IBRA could proceed to sell the restructured debts in the secondary markets in order generate income. In fact, most conglomerate debts have not been restructured, but sold outright in the secondary markets at high discounts. This may have been due partly to the inevitably long period needed to restructure the debts while the IMF and donors, as well as the general public, were pushing for quick sales by IBRA. Also, paradoxically, some restructured debts have been fetching market values lower than those for unrestructured debts.

But many people believe that this process has unfairly favored the large, rich debtors. The conglomerate debts have been owed by once-powerful business groups, such as Chandra Asi, Texmaco, Sinar Mas, Djajanti, Dharmala, PSP, Gunung Sewu, Humpuss, Bimantara and APAC (see Jakarta Post, Dec. 27, 2002). The public and media have protested against the lenient treatment of these powerful interests, believing that the lack of restructuring or very favorable terms of restructuring have let these conglomerates off the hook.

Many people also believe that the high discounts and low recovery rates of the non-performing loans (a logical offshoot of the lack of restructuring of the debts) have allowed the same powerful interests to buy back their debts at a huge discount. The charge is that 'brokers' or proxies reap huge commissions by undertaking the buy-backs for the original debtors.

The most controversial case involves Indonesia's wealthiest businessman, Salim, an alleged associate of Suharto who owns both banks and non-bank conglomerates. He was supposed to have owed state funds amounting to Rp 52.7 trillion (around $5.8 billion). Salim avoided criminal charges when IBRA announced that he had settled his debts. But he is suspected to have regained control of a number of his companies taken over by IBRA by buying them cheaply in IBRA sales via proxy representatives. Among the companies suspected to have reverted back to him are car manufacturer PT Astra International (Rp 2.1 trillion), cellphone company Pt Indomotil Sukses International (sold for Rp 625 billion despite a book value of Rp 2.14 trillion), television company PT Indosiar Visual Mandiri (Rp 775 billion) and palm oil firms under Salim Palm Plantation ($365 million). (Jakarta Post (Nov. 27, 2002)).

If this is true, then there is a serious 'moral hazard' problem. The logical conclusion is that if you owe debt to the Government but do not repay it or keep prolonging its repayment, you will benefit by getting large discounts on what you owe. When your assets are sold, you may even buy them back at incredibly cheap prices.

The perception that conglomerates are getting back their assets at fire sale prices has ignited a great deal of public anger and eroded confidence in the Government and corporate governance.

6.1.2 Problems with Punishing Errant Bank Owners and Recovering Their Debts

IBRA also has an Asset Management and Investment (AMI) division that is in charge of shareholder settlement agreements. Shareholder settlements have been the main mechanisms by which former owners of closed and taken-over banks have settled claims related to their liabilities to the Government. These have been mainly debts based on the misuse of the liquidity funds (BLBI) and penalties for their violation of legal lending limits and other financial regulations. AMI also has the task of managing and disposing of assets transferred to IBRA from bank shareholders and the bank equity acquired by IBRA in the process of bank recapitalization.

The performance in this area has been below expectations because of bank owners' resistance and their reneging on previous settlements. The total amount for settlement agreements has been Rp 141.4 trillion. As of end-2001, only Rp 18.2 trillion of bank shareholders' pledged assets had been recovered, mainly from one bank (Bank of Central Asia (BCA) of the Salim group).

The main arrangements with shareholders have been of three types. Two of them, MSAA (Master Shareholder Acquisition Agreement) and MRNIA (Master Refinancing and Note Issuance Agreement), are based on the shareholders' establishment of holding companies to dispose of their pledged (collateral) assets. The holding companies have issued promissory notes to IBRA with values equal to the shareholders' obligations minus their cash payments. The main difference between the two agreements is that MSAA has been intended as a final settlement since the pledged collateral was appraised to be sufficient to cover the banks' liabilities. For MRNIA cases, since the

pledged assets were insufficient, the agreement included a personal guarantee of the bank owners' debts and a refinancing of the liability over four years (without any repayment schedule).

The third arrangement has been APU (Deed of Debt Acknowledgment). It was concluded with owners of around 30 banks whose operations were frozen by the Government who provided personal guarantees and promises to abide by a regular debt service schedule, entailing the payment of interest rates set at the SBI (Bank Indonesia certificates) rate plus 3 per cent.

Table 6.3 shows the amount covered by the arrangements and the proceeds from asset sales:

Table 6.3
Amount Covered and Proceeds from Asset Sale of Shareholders' Agreements
(as of Dec. 31, 2001)

	Amount Covered (Rp trillion)	Proceeds from Asset Sale (Rp. Trillion)
MSAA	87.7	17.1
MRNIA	23.8	1.1
APU	12.7	--

Source: IBRA, Annual Report 2001 and 2002.

The main reason for the lack of successful settlement of shareholders' agreements has been the resistance and refusal by the former bank owners to put pledged assets into holding companies.

Political Economy of Dealing With the Errant Bank Owners

Errant bank owners had allegedly misused the BLBI liquidity funds—which were given by Bank Indonesia in 1998 and 1999 to stave off bank runs—by diverting them to company affiliates. Many of the previous bank owners have also been accused of going beyond legal lending limits to obtain loans for relatives, friends and company affiliates.

Difficulties in prosecuting and punishing the previous bank owners stem from the nature of corporate law borrowed from industrial countries (which provides for limited liability) and a corruption-ridden judicial system. Under the current corporate law in Indonesia, company misdeeds are the responsibility of the board of directors, not the owners of the company (in this case, the bank owners). Thus, the courts usually decide in favor of the bank owners. Controversial cases that IBRA has lost include the acquittal of Kaharudin Ongko, former co-owner of the erstwhile Bank Umum Nasional (BUN), and Samadikun Hartono, the former owner of the defunct Modern Bank. Both cases were thrown out by the courts because of limited-liability corporate law.

In early February, 2003, Fadel Muhammad, the previous Bank Intan owner, won his suit against Bank Indonesia (BI) and IBRA over the closure of his bank during the financial crisis. His argument, which the court accepted, was that BI had broken an agreement made in 1996, which gave the bank 15 years (up to 2011) to restructure. Thus, he claimed that its closure during the financial crisis (notwithstanding the deterioration of its loan assets and portfolio) was a breach of this agreement. This defeat of BI and IBRA might inspire other ex-bank owners who owe IBRA large debts or are being sued by IBRA to launch their own lawsuits against it in order to avoid debt payments or sidestep prosecution.

Despite this setback, IBRA has brought legal suits against five previous bank owners who have been uncooperative in resolving shareholders' settlements. IBRA wants this to be a showcase to bring other previous bank owners into line. In pursuing the case, IBRA is attempting to prove that the previous bank owners had used their influence on the board of directors to sue the entire management of the bank – including its directors, commissioners

and shareholders. IBRA has also sought to obtain support from the Supreme Court and the Ministry of Justice and Human Rights to pursue these legal cases.

But even these suits have drawn criticism because they have deflected attention from other large debtors. The five previous owners being charged owe Rp 2.18 trillion (around US$ 240 million) compared to a total of 35 ex-bank owners who owe Rp 144.5 trillion (around US $16 billion).

This criticism has turned into an outcry with regard to the big ex-bank owners who were exonerated by the Government in November 2002 for allegedly being cooperative in settling their debts. Among the exonerated are two of the biggest debtors: the Salim family (which owes Rp 52 trillion, or close to US$6 billion) and Sjamsul Nursalim. The huge size of their misused funds contrasts sharply with the soft treatment accorded to them.

Given these circumstances, it seems to pay for ex-bank owners either 1) to be uncooperative and expect to win the legal suits or 2) to be cooperative, win large discounts on debts owed and be exonerated from criminal suits. In any case, State institutions are not united and strong enough to punish criminal deeds and thereby to motivate debtors to make large concessions to avoid prosecution and punishment.

6.1.3 Selling the State-Owned Banks

The Bank Restructuring Unit (BRU) of IBRA, which has been charged with the task of restructuring the banking system, has the following tasks: 1) closing non-viable banks b) consolidating banks to make them stronger c) managing financial transactions for closed, frozen, taken-over and recapitalized banks d) selling the banks and their equities and divesting government shares in order to recoup some of the value of the recap bonds and BLBI liquidity credits and e) administering the government guarantee program for bank libailities.

Many state-owned, taken-over and recapitalized banks in active operation are being kept alive by the recap bonds (and the transfer of bad assets to IBRA). However, the sale of bank equities and the divesting of the Government's shares in the banking sector have yielded only two sales so far.

Political Economy of the Sale and Privatization of State-Owned Banks

The first bank sold, in September 2002, was the Bank of Central Asia (BCA) (owned by the Salim family), which was sold to a strategic foreign investor for Rp 5.6 trillion (around US$610 million). Earlier, the Government had already sold Rp 1.4 trillion (around US$150 million) in stock shares of BCA to the public.

But the sale caused a furor when the head of the Economic Planning Agency (Bappenas), Minister Kwik Kian Gie, criticized the IMF for its insistence on the sale even when the results were inimical to the Government's interest (Kwik Kian Gie 2002). BCA has recap bonds totaling around Rp 60 trillion, which reap around Rp 10 trillion (about US$1.1 billion) of interest payments to the bank annually. Minister Kwik therefore concluded that the sale price of Rp 5.6 trillion was too small. His general position was that banks should be made stronger before they are sold so that the Government would benefit from higher bids.

There have also been numerous rumors, unsubstantiated so far, that during this first sale the strategic foreign investor, the American company Farallon, was a 'broker' for the Salim family, which, as a result, got its bank back at a big discount. Even if this were not true, the perception that old, powerful cronies of Suharto are getting back their properties at very cheap prices is putting any sustained financial recovery at risk.

In November 2002, IBRA also sold 51 per cent of the shares of Bank Niaga to Malaysia's Commerce Asset Holding Berhad (CAHB) for around Rp 1.05 trillion (about US$116 million).

In early 2003, IBRA was planning to sell Bank Danamon to a strategic partner and sell shares of Bank Mandiri, the largest state-owned bank, in the equities market. But these actions were postponed because of a scandal affecting Bank Lippo. IBRA suspects that the management of the bank is colluding with its old owners (the Riyadi family) to bring the bank share prices down in order to enable the old owners to regain majority ownership by purchasing new low-priced issues in the stock market. The management of the bank reduced the estimated capital of the bank by drastically reducing the value of property assets seized from debtors. The management then claimed that the new issuance of stock was offered to compensate for the lack of capital in the bank. IBRA has ordered an independent audit of the bank's assets before any rights issues are to be launched.

IBRA finally sold 51 per cent stake in Bank Danamon in May 2003 to a consortium comprising Singapore's Temasek Holdings and Germany's Deutsche Bank AG for about US$ 347 million. IBRA also announced that it will start preparations for the sale of 52 per cent of Bank Lippo to a strategic investor.

In July 2003, the Government also finally sold, through initial public offering (IPO), its 20 per cent stake in the country's largest bank (which is state-owned), Bank Mandiri. The sale raised around Rp 2.7 trillion (about $328.3 million) and was widely publicized to have restored some confidence in the financial system of Indonesia.

All in all, however, the sale of state-owned banks—particularly those to strategic investors—is tainted by charges that subsidies and fire sale deals are being given to foreign investors and/or (hidden) previous owners of the banks. This situation is exacerbated by the credit crunch, which has led to the reliance of banks mainly on interest payments from the recap bonds for their income. The buyers of the bank (so far, mostly foreign entities) are getting cheap prices for banks with ensured profitability—through interest payments from recap bonds. At the same time, the sales have been providing windfall fiscal revenues to help offset the burden of domestic and foreign debt payments.

6.1.4 Working Towards a Solution to IBRA's Problems of Corporate Restructuring and Governance

Through the announcement of its chairman, Syafruddin Temenggung, IBRA is closing shop earlier than planned -- by early 2004. One explanation is that IBRA has been overshooting its revenue targets. But these targets are set arbitrarily with the IMF. And the latest recovery rates of the assets that IBRA has been selling are around 20 per cent. Furthermore, the previous bank owners are generally not complying with the shareholders' agreements. It is projected that IBRA will still have around Rp 100 trillion of assets, and that it will be able to dispose of all of these by the end of its term. It is planned that holding companies would be formed to manage the remaining bank and property assets while small-scale credit/property assets would be handed over to other government institutions.

IBRA's problems stem from two main factors. First, under current conditions, the sale of loans, related assets and bank equities and the implementation of shareholders' agreements will not yield the best prices for the Government. Economic and financial conditions militate against obtaining reasonable sales prices. This is, of course, a chicken-and-egg problem. The IMF and Government are hoping that fast and reasonably effective sales of IBRA assets would revitalize the financial sector and thereby stimulate the economy. However, current prospects are not promising.

Postponing the asset sales to better times might work to the advantage of large debtors and previous bank owners, who definitely want to delay the payment of their obligations. It also risks further depreciation of IBRA's assets if conditions deteriorate.

IBRA has plans to set up holding companies to manage its assets better, improve the asset quality and undertake profitable investments, especially after it closes shop. While this approach might marginally improve the current situation, it is unlikely to qualitatively alter the current dynamics unless the underlying economic constraints limiting IBRA's performance are decisively addressed.

Two inter-related policies need to be implemented to address IBRA's problem of corporate restructuring and reformed governance. One policy, which is part of the strategic thrust of this report, is to concentrate on boosting public investment in order to accelerate economic growth. Improved economic conditions will appreciate the market value of the assets being held by IBRA. The other policy is to take a tougher stance in negotiations with conglomerate debtors and previous bank owners.

Dealing With Conglomerate and Corporate Debtors

In dealing with conglomerate and corporate debtors, the same principle should be applied that governed the Government's bank recapitalization program. When enterprises fail and debts are unsustainable, the creditor—in this instance the Government through IBRA—should assume the majority equity position. The owners' equity share should be reduced correspondingly as the Government's unsustainable debt claims are exchanged for a majority equity position through the issuance of new shares.

While the former owners would retain their previous shares, their proportion of equity holdings would be sharply reduced to compensate the creditors for foregoing their claims on the enterprise. This is a fundamental principle of best practice, in which former owners lose a proportion of their equity interest on the basis of a reduction in their enterprise's unsustainable debt and the creditors assume a corresponding equity interest in exchange for foregoing their debt claims.

In the interests of consistency, the Government should not treat owners of 'real sector' enterprises any more favorably than owners of financial institutions. This 'level playing field' principle would strengthen the Government's case vis-à-vis Parliament and the business community.

Some commentators have argued that if the Government assumes majority equity ownership of these enterprises, this would be tantamount to 'nationalization'. Technically, this would be correct. But the same could be said of the Government's ownership of about 90 per cent of the banking sector (including the state banks). Moreover, the former owners of enterprises should be held accountable for incurring such a level of debt, which has,

in turn, cost the public considerable losses because the Government's policy of injecting recap bonds into the banking sector to replace the bad loans. There will likely be further public losses when these enterprises and their restructured loans are sold eventually at a discount.

The Legal and Judicial Framework

IBRA has been given quasi-judicial rights, in fact, to deal strongly with the big debtors and bank owners by Government Regulation 17 (PP17). The means at the Government's disposal include: 1) the right to issue a writ to the debtor to pay his obligations within a certain time 2) expropriation rights over certain assets 3) the ability to undertake bankruptcy proceedings 4) the ability to undertake a civil lawsuit and petition for debtor's imprisonment and 5) the ability to instigate with the police a criminal report against the debtor or company/bank directors (such as in cases of embezzlement and corruption) (see IMF 2002b).

One of the biggest problems is that the judicial system of the country has allowed debtors to reverse IBRA's orders in courts. An IMF study (IMF 2002b) revealed that by end-2001, IBRA had processed 2,400 litigation cases, of which 2,125 cases had been through the civil courts and 68 through bankruptcy courts. At that time, only 230 were settled, most of which IBRA had lost. The study also reports that as of February 2002, out of 25 cases brought in the bankruptcy courts against the top 21 'obligors', IBRA had won only seven. It had won none of its four cases in the civil court.

IBRA had also brought litigation cases against a number of uncooperative previous bank owners. A re-assessment of the nominal value of IBRA's loan assets by outside experts revealed that the value was grossly over-stated by the troubled banks. In other words, the Government over-capitalized the banks (i.e., poured in excessive recap bonds) because the NPLs were overvalued. If the judicial system worked better, this situation could be easily rectified. Legal settlements would allow IBRA to collect more from the debtors and from the previous bank owners.

For IBRA to effectively use its legal clout, the Parliament should enact the establishment of special courts, led by respected judges, to handle IBRA cases. These special courts should be independent from intervention from other courts in the judicial system. This would make it imperative that the judges and prosecutors in this system be respected individuals with impeccable credentials.

IBRA should also be more assertive with the big debtors and previous bank owners by pressing for stiffer penalties, or even prison terms. If the debtors and bank owners recognize that the justice system is working effectively, a significant amount of money would surge into IBRA's coffers. The Government could also negotiate the return of capital flight money as part of the negotiated settlement with the debtors and previous bank owners. This would inject new life into the economy and partly reverse the massive capital outflows from the country.

In summary, this report is lobbying for a twin approach of 1) firm and resolute settlement with conglomerate debtors and previous bank owners and 2) the injection of public investment into the economy to revive Indonesia's growth momentum. This approach could substantially boost the prospects for viably disposing of the massive non-performing assets now held by the Government, reducing the domestic debt stock and drastically lowering the annual drain of interest payments on recap bonds.

Reversing the Inequities

It cannot be emphasized that in of Indonesia since the Asian financial crisis, wealthy but errant bank owners, large corporate debtors as well as foreign creditors have been bailed out by the Government and the Indonesian people have had to pay for this bailout with large domestic and foreign debt payments. Not has the economic elite been bailed out but also, according to the public's perception, they have been allowed to regain their previous assets and corporations at

fire-sale prices. The large domestic and foreign debt resulting from this bailout is obstructing the financing of the fiscal stimulus needed to revive the economy.

If government actions and judicial processes of the country fail to redress this grossly inequitable situation, other indirect means to do so should be undertaken. One option is to increase the taxation of the very wealthy (who are likely to coincide to a large extent with those bailed out by the government). Since much of the income of the wealthy is hidden or undervalued, it would be more efficient to tax their real estate holdings (based on location and land size) and place luxury taxes on such items as expensive jewelry, high-priced vehicles, first and business class travel, luxury appliances and costly brand-named consumer items. Such taxation on luxury consumption items would have to be accompanied, of course, by strong measures against smuggling. These taxes directed to the wealth and consumption of the rich could hit two birds with one stone. They could both provide the increased revenues needed to finance productive public investment and reverse the inequitable subsidies and bail-outs that they rich have enjoyed during the crisis and in its aftermath.

6.2 The Sale and Privatization of Non-Financial State Enterprises

Post-Suharto Governments in Indonesia have been seriously committed to selling state-owned (financial and non-financial) enterprises to the private sector. The main justification has been the generation of windfall revenue to deal with the increase in budget deficits, which have resulted from the additional expenditures for resuscitating the economy and paying interest on the huge stock of recap bonds.

Privatization of state-owned enterprises (including state-owned banks) can take various forms:

1. The sale of shares of the enterprises in the stock market – through either initial public offerings (IPOs), secondary offerings (SOs) or block sale of shares.

2. The sale of a significant amount of shares to a strategic investor through a competitive bidding process, or strategic sale (SS).

Of course, the two options can lead to the same result: if one buyer purchases the majority of shares, he will gain control of the company. But strategic sales usually determine that one buyer that will end up with majority control of the enterprise.

Table 6.4 shows the list of shares of non-financial companies privatized between 1998 and 2002. Note that the big items sold after the Asian financial crisis are the subsidiaries of PT Pelindo II and III, sold in 1999, and the telecommunications firm PT Indosat, sold in late 2002 for the largest amount of any sale. A real property firm Wisma Nusantara Internasional was also sold in 2002 to a strategic investor. Planned future privatization efforts include the selling of majority shares of the mining firm Aneka Tambang and the pharmaceutical firms Kimia Farma and Indofarma.

Table 6.4: Privatization of State-Owned Enterprises 1998-2002

State Owned Enterprise	Product or Service	Year	Amount (billion Rp)	Amount (million $)	Method
PT Semen Gresik Tbk	Cement	1998	1.317	0.13	Block Sale
PT Indosat Tbk	Telecommunications	1994	2537	1174	IPO
		2002	967	105	IPO
		2002	5600	610	Strategic Sale
PT Telkom Tbk	Telecommunications	1999	3.188	0.41	IPO

		2001	3.1	0.3	IPO
		2002	1.1	0.12	IPO
PT JICT (subsidiary of PT Pelindo II)	Port Services	1999		190	Strategic Sale
PT TPS (subsidiary of PT Pelindo III)	Port Services	1999		157	Strategic Sale
PT Kimia Farma Tbk	Pharmaceutical products	2001	110	10.7	IPO
PT Indofarma Tbk	Pharmaceutical products	2001	150	14.6	IPO
PT Tambang Batubara Bukit Asam	Coal Mining	2002	175	19	IPO
PT Wisma Nusantara Internasional	Hotels and Offices	2002	250	27.2	Strategic Sale

Source: Arief Arryman and Adam Wirahadi, "Post-Crisis Restructuring and Performance in Indonesia" (2003).

The pace of privatization has been slower than that desired by the IMF and other advocates of privatization. Table 6.5 gives the targeted and realized proceeds of the privatization program since 1998. The realized proceeds have fallen significantly below those targeted year after year, except in 2002 when Indosat was sold.

Table 6.5: Target and Realization of Privatization Program (in trillion rupiah)

APBN (State Budget)	Target	Realization
APBN 1998/1999	15	1.634
APBN 1999/2000	17	3.727
APBN 2000	6.5	0
APBN 2001	6.5	3.25
APBN 2002	6.5	8.025

Source: IBRA, Annual Report 2001 and 2002.

6.2.1 The Political Economy of Privatization

The controversies resulting from the recent sale of PT Indonesia Satellite Corporation (Indosat) point to some inherent problems in the privatization processes. Singapore Technologies Telemedia (STT) won a 41.9 per cent stake in Indosat on December 15, 2002 with a bid amounting to Rp 5.62 trillion (around US$620 million). The Government had previously privatized 43 per cent of the state company through the sale of shares in the stock market (see Table 6.7 for some of the sales through IPOs).

The pros and cons of the sale reveal the typical issues that are raised in the privatization process:

Arguments of the pros:

a. The privatization of Indosat has raised considerable revenues for the Government, allowing it for the first time to meet, and overshoot, the target for privatization proceeds (Rp 8 trillion instead of the target of Rp 6.5 trillion) and thus helping it to plug its budget deficit.

b. The price bid of STT was a 50.6 per cent premium on Indosat's share price in the Jakarta Stock Exchange, and therefore favored the Government. The sale used a price of Rp 12,950 per share while Indosat's closing share price on the last working day before the deal was Rp 8,600.

c. Ownership by STT will lead to the modernization of Indosat since STT has a lot of experience in the international telecommunications industry. This take-over will also allow Indosat to compete

effectively with PT Telkom, the leading (state-owned) phone operator in the country.[26] The competition between Telkom and Indosat will be a good start for the deregulation of the telecommunication industry.

d. STT can raise capital for the debt-strapped Indosat and turn it into a financially strong firm.

e. The credible sale of Indosat to STT initially strengthened the rupiah, raised stock market prices and increased foreign and domestic confidence in the economy. (However, this confidence was eroded by the legislative investigation into the deal and the threat of rescinding it).

<u>Arguments of the cons</u>:

a. Critics charge that the deal was undervalued by Rp 1.8 trillion (around US$200 million) since the share price should have been that of the recently acquired subsidiary of Indosat, the cellular phone company PT Satelindo, which provides 70 per cent of Indosat's revenues. Indosat acquired PT Satelindo on June 2002 for $1.3 billion and injected $75 million more capital into it after the purchase. At the time of the Indosat strategic sale, the share price of Satelindo was Rp 14,000, higher than the Rp 12,950 used for the sale. (This is the basis for calculating the Rp 1.8 trillion shortfall).

b. Based on the discount given to STT for the sale, critics, including many in the Parliament, claim that the Government is subsidizing foreign investors. They argue that that foreigners should not be allowed to own monopolies in strategic industries and public utilities such as telecommunications.

c. The deal may lead to the monopoly of one Singaporean firm over the cellular phone industry in Indonesia. The Singaporean state-owned Temasek Holding Company controls both STT and SingTel. The latter owns 35 per cent of PT Telkomsel (Satelindo's rival firm owned by Telkom). Since STT controls Satelindo and SingTel controls Telkomsel, the cellular phone business is effectively under the control of Temasek Holding Company, which controls both STT and SingTel.

d. The allegations that the sale was at a discounted price and that there may be monopoly control of a vital public utility have triggered speculations that the deal involved payoffs and corruption. This suspicion was intensified by the involvement of a special purpose vehicle (SPV), a paper company named Indonesian Communication Limited (ICL) based in the tax haven country of Mauritius. STT used this company (which it claims it wholly owns) to do the bidding. The use of ICL was supposed to allow STT to obtain some tax exemptions and reductions. But it still is not clear whether the Government had explicitly agreed to the use of an SPV in the bidding process. It is also now not clear which legal entity—ICL or STT—was registered to represent Temasek Holding. Some lawmakers suspect that ICL was used as a conduit for payoffs and kickbacks on the deal.

e. The whole process has been complicated by the opposition of the 1,500 workers of Indosat, who have threatened strikes and boycotts if the sale is not reversed. The workers fear that Indosat's plan, under STT management, to build fixed lines for telecommunications might result in job cuts.

6.2.2 Towards a Solution to the Privatization Problems of Indonesia

The problems of Indosat's privatization are a microcosm of the general privatization process in Indonesia. Following are the general problems and their possible solutions:

1. Current pressures for privatization of state-owned enterprises (financial or non-financial) are due mainly to the overriding goal of revenue generation in order to finance government deficits. There is a lack of analysis, vision and explanation offered to the public on the long-term benefits (if any) of privatization. The problem is aggravated by the approach of some international financial institutions of pushing privatization by

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[26] The competition between Telkom and Indosat begins in 2003, based on a deal struck in May 2001 between the two state-owned companies to end their cross-ownerships in several subsidiaries. The two also have profitable cellular phone subsidiaries.

emphasizing the short-term advantages of revenue generation. There is an absence of recommendations going beyond the short term to address the medium-term and long-term problem of the lack of regulation, institutions and policies needed to ensure that public utilities and public services, whether managed and controlled by the state sector or the private sector, will deliver quality products and services at reasonable prices, especially to poor and low-income groups.

There is also a lack of understanding on the need to regulate industries that enjoy natural monopolies due to increasing returns to scale. The case of the aforementioned telecommunications sector is illustrative. Before the current privatization efforts, Telkom monopolized local and long-distance calls in Indonesia, while Indosat had a monopoly over international calls. In order to promote increased competition, the Government planned a two-phase liberalization of the two aforementioned branches of telecommunications. In the first phase in 2002, the Government granted Indosat a license to engage in local calls. The second phase was scheduled to start 1 August 2003, when the Government was to grant a long-distance call license to Indosat and an international call license to Telkom. Meanwhile, without the granting of an international call license, Telkom was able to go into the international call business by using the voice-over Internet protocol (VOIP) technology, which remains unregulated (callers can call 017 and make an international call). The second phase licensing was delayed due to stalled negotiations about compensation to the two telecommunication giants (especially Indosat) for the loss of their monopolies. This experience shows the power of the monopolies to circumvent rules and force the State to accord them unnecessary compensations. To counter this strong economic and political power of the monopolies, the State should be autonomous and impartial, and possess the capacity to deal with unforeseen circumstances (such as corporate circumventing of the rules by resorting to unregulated technologies and activities) and implement adequate anti-trust regulation.

2. The possible negative impact of privatization is not faced squarely. The general public is fearful (and with good basis) that privatization of water, electricity, health and pharmaceutical products and services will lead to the increase of prices, which are currently subsidized. It is a basic economic principle that the private sector, on its own, will not provide public services (which generate positive externalities) to the poor because they lack purchasing power. There is a critical need for competent, comprehensive analyses to determine how the Government will provide these public services and how the private sector will play a role in the Government's overall scheme of providing essential public services and goods (including essential medicines) to the population—especially to the poor and needy—at affordable prices. For instance, cross-subsidy programmes will have to be developed to ensure the poor's access to essential goods and services.

3. If privatization merely entailed private ownership of a minority share of state-owned enterprises, there would be less need to debate the issue. But if privatization entails the private take-over of control and management of enterprises in public utilities and public services, then it is important to demonstrate that such a change would benefit the public. Even traditional neoclassical economics holds that strong state interventions and regulation are required: a) if there is a natural monopoly of an industry b) if there are increasing returns to scale, or economies of scale in an industry, c) if there are important information asymmetries, wherein the producers know more than the public and the consumers about their products and services. All these conditions apply, in one way or another, to enterprises targeted for privatization. Thus, the state must continue to exercise strong regulation of public utilities and public-service providers even if they are privatized. There can be no presumption that transferring these enterprises to the private sector will necessarily result in positive benefits to the public.

4. Thus, any serious effort to analyze the pros and cons of privatization would necessitate an emphasis on the regulatory framework and regulatory capacity of the State over the industries that will be privatized, especially if they are public-service providers, public utilities and/or enterprises enjoying a natural monopoly. These would require: a) strong anti-trust or anti-monopoly regulatory powers exercised by the executive branch and a strong legal framework guiding the judicial branch, b) an effective regulatory body to monitor and evaluate the pricing, quality of public service and operations (including critical inventory levels) of each natural monopoly, public utility or public-service sector to be privatized. In the case of the telecommunications industry (in which Indosat operates), the Ministry of Transportation and Communications has so far resisted the set-up of a wholly Independent Regulatory Body (IRB). The Ministry still wants to be the sole regulator of the industry and wants IRB to be merely its advisor. But the Ministry has to regulate many other transportation and communications sectors apart from telecommunications. This

highlights the need to set up strong, responsible and independent regulatory bodies for the crucial public utilities, public services and natural monopoly sectors in the economy.

5. In sectors where foreign investors are invited, the Government should not only ensure a strong regulatory environment but also pursue an industrial strategy to derive positive benefits, such as an injection of new capital or technology transfer. A great deal can be learned from China, which has enjoyed massive amounts of foreign investment but has still sought to control and manage it. In economic sectors in which the State believes strategic foreign investors can make a significant positive contribution, it enters into joint ventures or strategic partnerships with foreign firms, but with strong oversight exercised by state regulatory bodies. Like China, Indonesia is a huge country, with a sizeable domestic market. So foreign investors are likely to be attracted to owning and managing its public utilities and public services. It is the State's duty and responsibility to ensure that the Indonesian people benefit substantially from such investments.

6. The Government needs to be prepared, in advance of privatization, with programs to offer separation pay, temporary unemployment insurance, and/or assistance in finding new employment for state-owned enterprise employees who might lose their jobs as a result of retrenchment or company restructuring.

6.3. Summary and Conclusion

The policy recommendations in this chapter hinge critically on the political commitment to reduce the concentration of corporate power and democratize the ownership of economic assets and resources. This includes addressing the institutional bottlenecks in the Indonesian executive, legislative and judicial systems that obstruct the processes of democratization of economic ownership. This includes weakening the control of the conglomerates and powerful individuals who have abused, and are continuing to abuse, their elite economic power and refuse to pay back to the Government the huge debts that they have incurred. This report's recommendations call for the legislation and enforcement of effective anti-monopoly laws and regulations and for the establishment of efficient and responsible regulatory authorities and bodies. Currently, there is a vacuum of institutions for such purposes.

It must be emphasized that IBRA is the single and most important regulatory body in Indonesia today. Strengthening it and replacing it with a stronger set of institutions when it ends its term in 2003 are a crucial item of any economic reform agenda.

Although there is a long and arduous road toward achieving the economic and structural reforms mentioned in this chapter, there is already one obvious bright spot. Indonesia's progress towards democracy has opened up an arena for an array of public voices in civil society and the media that have exposed wrongdoing and put pressure on Government to carry out critical reforms in economic governance. This widespread public pressure and mobilization are essential to continuing success in reforming corporate governance and restructuring state-owned enterprises for the public benefit.

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Chapter Seven

Summary of Analysis and Policy Recommendations[27]

The Build-up to Crisis

From 1968 to 1996, the eve of the Asia financial crisis, Indonesia grew by 7.5 per cent a year. Between 1976 and 1996, it reduced poverty incidence from about 70 per cent to about one third of the population. The character of its growth was a big factor in its success in reducing poverty. The Government channelled considerable resources into agriculture and rural development and helped build up labour-intensive export-oriented industries that generated widespread employment.

When the financial crisis buffeted Indonesia in 1997, few analysts expected the country to be shaken to its roots. But the exchange rate plummeted as a result of a speculative attack, inflation soared and the banking sector collapsed. The financial de-regulation of the late 1980s and early 1990s was the chief reason for the economy's vulnerability. Left unregulated, private corporations had gone on a borrowing spree, accumulating a mountain of short-term external debt. Rich Indonesians quickly funnelled billions of dollars worth of capital out of the country, and reaped a handsome profit from the ensuing devaluation of the rupiah.

The contractionary fiscal and monetary policies that the Government implemented—due largely to external advice from international financial institutions—only exacerbated the recession. As the economy stumbled towards a free fall, the Government stepped in to bail out the large banks and their elite corporate clients. As a huge domestic debt piled up along with a large external debt, the Government had to assume the chief responsibility for paying them off.

[27] This summary chapter was written by Terry McKinley.

During the crisis, poverty shot up by 50 per cent. The incomes of the near poor, i.e., those only moderately above the poverty line, slumped badly and vulnerability spread to about half of the population. As inflation shot up, real wages nose-dived by 40 per cent and a large share of the workforce was pushed into low-paid under-employment in agriculture and the urban informal sector.

Meanwhile, the rich were big beneficiaries of the colossal liquidity credits and the hefty interest payments on recap bonds injected into their banks to keep them afloat. The Government 'nationalized', in effect, their debt and paid them for the privilege. Having benefited from capital flight, the rich have been reluctant to return their money until "investor confidence" is restored—namely, the speculative rate of return on their money is much higher and their continued control over large corporate assets is assured.

When their banks or corporations end up on the selling block, they are the same circle of people who buy them back at fire sale prices. And the capitalization of the Government obligation to continue paying them interest when it sells off a bank usually exceeds the proceeds that the Government receives from the sale.

Slow Post-Crisis Recovery

Since 2000, Indonesia has been on the road to recovery, albeit at a slow pace. Its average annual rate of growth of GDP during 2000-2002 has been less than four per cent—a little over half its rate of growth during 1991-1996, the period prior to the crisis. In 2002, GDP growth was 3.7 per cent—a rate that could provide jobs to only about half of the new entrants into the labour force. As a result, unemployment continues to rise, as does the number of informal-sector jobs.

The recovery remains fragile since the main impetus for growth has been consumption. And the rich and upper middle classes have been the main ones consuming. This is not uncommon for a post-crisis recovery period in a liberalized economy. A troubling sign is that consumption growth has begun to slow in 2003. At the same time, other components of aggregate demand do not provide an alternative source of growth. In 2002, gross domestic fixed capital formation declined by 0.2 per cent and shows no signs of recovering in 2003 (Table 7.1). Net exports contributed more to growth in 2002 than in 2001 but only because imports contracted by over eight per cent while exports declined by only 1.2 per cent.

Table 7.1

Growth of GDP and Its Components (2000-2002)

Item	2000	2001	2002
GDP	**4.9**	**3.4**	**3.7**
Consumption	**3.9**	**4.8**	**5.5**
Investment	**13.8**	**7.7**	**-0.2**
Exports	**26.5**	**1.9**	**-1.2**
Imports	**21.1**	**8.1**	**-8.3**

Source: Bank Indonesia 2003.

Growth of household consumption in 2002 was 4.7 per cent, accounting for about 90 per cent of GDP growth. Government consumption grew much faster than private consumption, especially in the wake of the Bali bombing, but made a much smaller contribution to overall growth. Recognizing the fragility of the recovery, the Government has provided another fiscal stimulus in mid 2003, mainly in the form of tax cuts. Yet, current projections suggest that

economic growth will reach only 3.4 per cent in 2003, far too slow to boost employment or significantly reduce poverty.

According to World Bank estimates, the proportion of the population in poverty dropped from a high of 27 per cent in 1999, in the wake of the crisis, back down to 16 per cent in 2002—about the same level as that for 1996.Yet, estimates based on annual (smaller) surveys suggest that poverty rose from 2001 to 2002, i.e., from 13.2 per cent to 14.5 per cent. Rising inequality was part of the explanation, as the Gini coefficient rose from 0.32 in 1999 to 0.34 in 2002. With growth slowing in 2003, poverty is likely to rise further, as unemployment and underemployment spread.

Every year, Indonesia suffers an employment deficit. Workers openly unemployed rose from 8.0 million in 2001 to 9.1 million in 2002. The unemployment rate had risen to 9.1 per cent by 2002. Underemployment has also been on the rise. Workers employed in the informal sector continued to rise in 2002, reaching 62.4 million compared to 53.7 million in 1997. Relative to the formal sector, the informal sector has been progressively increasing, accounting for 68.1 per cent of all jobs in 2002 compared to 62.8 per cent in 1997.

Although the Government has not been successful in fully reviving growth, it has made significant progress in the last few years in achieving macroeconomic stability. The public deficit has been reduced, the current account has achieved a surplus, international reserves are rising, the external debt to GDP ratio has come down, real rates of interest have declined, the exchange rate has strengthened and inflation continues to drop.

In 2002, CPI inflation was 10 per cent, down from 12.5 per cent in 2001. Despite a rise in government-administered prices and a reduction in fuel subsidies, annual inflation continued to

subside in 2003, converging towards an average of six per cent late in the year. However, this is not necessarily a positive sign because it is largely due to the slowdown in aggregate demand.

Private investment remains weak. In fact, in the first eight months of 2003, domestic investment approvals dropped by about 14 per cent. Although monetary policy has been geared in recent years to lower interest rates, lending rates of interest have remained stubbornly high. While deposit rates of interest have declined, contributing to the growth of consumption, banks have been reluctant to extend investment credits to the private sector. They are more inclined to lend short-term—for consumer durables, such as automobiles and motorcycles, or for working capital for businesses.

As a result, corporations remain starved of long-term credit for productive investment. The reason is not a lack of domestic savings. During 2001-2002, gross domestic savings was 23 per cent of GDP while gross domestic investment was only about 16 per cent (Table 7.2). Just before the crisis, investment was close to one third of GDP, with savings near the same level.

Table 7.2

Gross Domestic Investment and Savings (as a Percentage of GDP)

	1995-1997	**1998-2000**	**2001-2002**
Gross Domestic Investment	**31.5**	**15.6**	**15.9**
Gross Domestic Savings	**30.7**	**24.1**	**23.0**

Source: See Appendix Table 1.1.

Public investment is down substantially, constrained by the effort to reduce budget deficits. Capital expenditures by the Government, both central and local, plummeted from 6.5 per cent of GDP in 1997 to 4.8 per cent in 2002—a drop of over one quarter (Table 7.3). The

transfer of one quarter of central government revenue to local government has contributed, unfortunately, to this overall decline. An additional factor has been the Government's policy stance of increasing fiscal restraint, despite the availability of domestic savings.

The Government is concerned that its deficit will reach two per cent of GDP in 2003. Its goal for 2004 is to reduce the deficit to close to one per cent of GDP and eliminate it by 2005. However, given the slowdown in private consumption, more fiscal stimulus, not less, is badly needed. In 2003, the Government has resorted mainly to tax breaks for private businesses as a way of stimulating the economy, but this kind of stimulus is likely to be weak—generating certainly a much weaker multiplier impact on the economy than an increase in public investment.

Fortunately, the Government has begun to revive in 2003 some of the large investment projects that it abandoned during the Asia Financial Crisis. These include a large power plant, toll roads and a flood control project. Indonesia badly needs renewed investment in public infrastructure, particularly in energy and roads. Lack of maintenance of existing infrastructure is also a growing problem. Focusing public investment more on low-income households could also improve its effectiveness and promote pro-poor growth.

Table 7.3

Public Capital Expenditures

(as a Percentage of GDP)

1997	**6.5%**
2002	**4.8%**

Source: Ministry of Finance and Bank Indonesia

The country's recent history suggests that public investment has "crowded-in" private investment, not "crowded it out". Over the years 1972-1997, for example, a one percentage point increase in government investment translated into a 0.66 percentage point increase in private investment. Given the current slack conditions in the economy, with significant under-utilized capacity, the "crowding-in" effect is likely to be stronger.

The Government has begun to issue bonds to finance an increase in public investment although much of the financing is targeted to rescheduling its domestic debt. This makes sense as long as current revenues cover current expenditures. Fortunately, this has remained the case. It also makes sense as long as gross domestic savings exceeds gross domestic investment, which has been the case since 1998. Failure to boost public investment will pose, however, a major roadblock to implementing a pro-poor development strategy, which depends on substantial investments in physical and human capital, particularly for the poorer half of the Indonesian population.

Generating Resources for Investment-led, Pro-Poor Growth

As 2003 draws to a close, the Indonesian Government prepares to terminate its IMF economic bailout programme, which began in 1997, at the height of its economic crisis. Although at the start of 2004 the Government will enter into a "post-programme monitoring" arrangement with the IMF, it will maintain autonomy to formulate its own economic strategy. As early as September 2003, the Government unveiled a "White Paper" sketching the outlines of its proposed strategy for the post-IMF era.

Hopefully, future economic policies will diverge substantially from those applied under the IMF bailout programme. Outside the IMF, those policies have been widely regarded as a failure. This report lays out an alternative set of economic policies. But a range of other feasible policy options is also available to national policymakers. It would be a shame to see IMF policies implemented even without IMF conditionalities.

The policy recommendations of this report constitute an alternative framework that advocates an investment-led growth strategy that relies initially on increasing public investment.

Such a strategy would raise the Indonesian economy to a higher growth path that can provide adequate employment and substantially reduce poverty.

The report assumes that the acceleration of growth prompted by public investment will not only serve to crowd in private investment but also begin to attract back external financing and flight capital. The rise in income will also serve to increase domestic savings, which will continue to be the main source of financing for increasing private investment.

A key issue, however, is how to finance a rise in public investment. This report estimates that raising the growth rate from 4 per cent to 6 per cent would require an additional US$ 5 billion of public investment per year. Securing debt relief is a major way of financing the additional public investment. Monetizing the deficit is another option although it would run some risk of increasing inflation. A third option, already mentioned, is to borrow domestically, such as through a bond market. Even without these three options, however, the Government of Indonesia could raise substantially more revenue to finance public investment.

Tax revenues in Indonesia have declined significantly over two decades, namely, from a level of 20 per cent of GDP in 1980 to 13.6 per cent in 2003 (Table 7.4). The income tax base is very small and tax evasion is widespread. Property taxes contribute a meagre 3.4 per cent of all tax revenue: the rate is a mere 0.5 per cent of the assessable poverty value, which, in turn, is only one fifth of the market value. Trade tax revenues are also small, comprising only three per cent of all revenue. The value added tax contributes about 30 per cent of all revenue but avoidance of this tax is prevalent and many luxury goods are exempt.

Table 7.4

Tax Revenue
(as a Percentage of GDP)

1980	**20%**
2003	**13.6%**

Source: Ministry of Finance and Bank Indonesia

This report advocates a number of measures to boost tax revenue back up to levels that Indonesia earlier achieved. The most controversial measure is to raise tariffs. Raising tariffs on all imports by ten per cent would, by itself, raise the additional US$ 5 billion needed to finance public investment. However, the report does not advocate such an option. It favours a combination of measures, which could include reducing or removing exemptions granted to importers and exporters, raising the property tax and reducing VAT exemptions on luxury goods.

Also helpful would be improvements in administration that can help identify the income of taxpayers more accurately, collect taxes more effectively and reduce corruption. Indonesia faces a major problem of uncollected taxes and unregistered taxpayers. Currently, there are only 1.3 million registered taxpayers, out of a potential total of 20 million, and, worse still, less than half of the 1.3 million pay taxes.

The Government should seek to reverse the current decline in income taxes from sources other than oil and gas. From 1998 to 2001, revenue from such sources dropped from 47 per cent of the total to 38 per cent. Oil and gas revenues cannot substitute indefinitely for more standard income taxes even though Indonesia can expect to benefit from an impending boom in gas production.

The Large Taxpayers Office, started in mid 2002, could make a major contribution to revenue mobilization. It targets the 200 largest taxpayers in the country, who account for 40 per cent of all tax revenues. If this office is successful in compelling the rich to pay their fair share of taxes, this effort could substantially boost public revenues.

Raising taxes on domestic income will not nullify the expansionary impact of an increase in public investment because the latter, as an autonomous factor, will have a powerful multiplier impact on the economy. However, this effect is likely to be eroded unless the process of decentralization is reformed. Development spending at the local level has not compensated for the loss of capital expenditures by the central government. Moreover, local objectives are not aligned with national development priorities.

Decentralization has exacerbated regional inequities since resource-rich provinces are benefiting most from the retention of resource-based revenues. Poorer provinces do not necessarily benefit since many local governments have imposed additional taxes and fees that impede the development of small and medium enterprises and restrict inter-regional trade.

Dealing with the External Debt

Policymakers in Indonesia have made great strides in recent years in reducing the external debt burden. The external debt, as a ratio to GDP, had dropped to below 70 per cent by mid 2003. However, Indonesia has paid a heavy price by withholding financing necessary for accelerated economic growth. Substantially more debt relief could mitigate the need for Indonesia to raise more domestic revenue in order to increase investment and accelerate pro-poor growth.

Currently, Indonesia has committed itself, in effect, to slowly growing out its debt burden. Meanwhile, unemployment and underemployment increase every year, and as they increase, the income basis for consumption growth grows more slowly. Without consumption fuelling a recovery, GDP growth is likely to slow further.

Judging Indonesia's external debt by international standards, the country has been transformed into a seriously indebted low-income country (SILIC) as a result of its crisis. Recently, the Government has been paying 4.3 per cent of GDP to service the external debt. About half of this debt is private and much of it is short term and non-guaranteed. While the Government had restricted external borrowing by banks, it had not placed similar restrictions on non-financial corporations.

As a result of the crisis, all capital accounts—net FDI and other capital flows, including official loans—turned negative. Part of the reason is that rich Indonesians resorted to capital flight on a massive scale. Estimates of such flight capital range from US$ 20 billion to US$ 40 billion. The outflow of foreign direct investment alone ballooned to 3.2 per cent of GNP in 2000. Total net outflows of capital in 2001 were 6.7 per cent of GNP. This adds another layer of problems on top of the debt burden itself.

The private 'investment' capital that has flowed back into the economy has been used mainly to buy cheap privatised corporations and banks. Because of the appreciated exchange rate, some short-term portfolio capital has also recently returned. But if the economy continues to struggle, this capital could rapidly flee again, contributing to undermining the basis for sustained recovery.

How can the Government of Indonesia deal with its huge debt problem? With regard to public external debt, it should lobby strenuously for more favourable terms for debt reduction and rescheduling. This would imply lobbying for Naples terms, which provide a two-thirds reduction of the debt stock and a much longer period for interest payments.

Indonesia has made little progress in rescheduling its private commercial external debt. At the end of 2001, this amounted to US$ 7.5 billion owed by banks and US$ 55 billion owed by corporations. Three fifths of the corporate debt—most of which is owed by subsidiaries of foreign multinational firms—has not been repaid.

One option that Indonesia could pursue is to sue for international insolvency—in the same way that a company in a country can sue for bankruptcy under Chapter 11. International debt relief organizations, such as Jubilee Plus or Jubilee 2000, support such a mechanism, as do some IMF representatives. However, there is a powerful international lobby of creditors that has opposed any such solution. Indonesian policymakers have also been reluctant to pursue this option because they believe that it would undermine the confidence of foreign investors in the economy. But as long as the Indonesia economy is not growing, such confidence is not likely to revive in any case.

The best approach to international insolvency is to have an independent arbitration body set up to mediate between Indonesia and its international creditors in order to find the solution to its debt problems that best protects the well being of its citizens. Part of the advantage of such an arbitration arrangement is that it can impartially examine the issue of 'odious' debt, i.e., that part of the debt incurred through corrupt means and used for activities inimical to the interests of the Indonesian people.

Dealing with the Domestic Debt

In dealing with its huge domestic debt, the Government of Indonesia is hamstrung by the poor performance of the economy, which discourages potential buyers of bank and corporate assets. This situation cannot be fundamentally altered until an investment-led economic strategy is able to spark an accelerated rate of growth. However, the Government can still take a tougher negotiating stance with the current owners of failing banks and corporations—

for example, by requiring the debtor to pay his obligations within a certain period or undertaking bankruptcy proceedings.

The Government would benefit greatly if the Parliament enacted a law to set up a special court to handle cases of domestic debt and the sale of corporate assets. Until now, the judicial system of Indonesia has ruled against the Government in most of its litigation cases against large debtors. It is no coincidence that such debtors are leading members of the country's economic elite.

With regard to the large problem of recap bonds, the Government could take some immediate measures to have overcapitalised banks return the excess bonds that they received from the Government and it could encourage stronger and larger banks to take over banks with significant holdings of recap bonds. In any case, the Government should set an upper limit on the interest payments on recap bonds, in order to provide some debt relief that could free up resources to channel to poverty reduction. Since the recap bonds were a 'free gift' to the banks from the public, they should have been issued, at least, at below-market interest rates.

In order to raise badly needed revenue, the Government has resorted to the privatisation of state-owned enterprises (SOEs), both financial and non-financial. Until 2002, however, the pace of privatisation had been slow. There have been widespread criticisms in Indonesia that public assets are being sold too cheaply, sales are based on kickbacks and corruption, foreigner investors are being given monopoly control over strategic national interests and many workers in SOEs are losing their jobs.

One of the underlying issues is whether Indonesia's privatisation plans will concentrate the power of the economic elite or dilute it. If SOEs are privatised, strong anti-monopoly laws and regulations need to be instituted to foster a competitive environment and protect the public interest. Moreover, more analysis is needed of the social consequences of privatisation. When a substantial proportion of the population remains vulnerable to poverty, significant increases in prices of public services, such as water, electricity and health, can have an unequivocally adverse impact on people's welfare.

As the experience of the economic crisis demonstrates, structures of corporate governance inherited from the Suharto era are so weak and unreliable that mere changes in ownership structure, such as privatising SOEs, cannot resolve them. In fact, if privatisation cedes more power to the economic elite that grew powerful during the Suharto regime, it will only exacerbate the problem. If the path of privatisation is to be followed, it should be designed to contribute to greater democratisation of the ownership and control of economic assets, not greater monopoly and cronyism.

Outline of a Pro-Poor Development Strategy

1. Fostering More Rapid Growth

If Indonesia can secure adequate debt relief and/or raise additional domestic resources, national policymakers would have the latitude needed to begin implementing an investment-led, pro-poor economic strategy. They could make macroeconomic policies more growth-oriented and complement them with broad sectoral policies and redistributive measures that could give growth a more equitable impact. This report is based squarely on the assumption that "there *is* an alternative" to the Neo-Liberalism that helped plunge the Indonesia economy into crisis and the continuing legacy of that policy orientation, which still hamstrings the prospects for growth and development.

In order to pursue an alternative development strategy, which will stimulate more rapid growth with equity, policymakers need to abandon some of their Neo-Liberal assumptions, such as maintaining an open capital account

and striving for balanced budgets. In an era of slow growth with continuing capital outflows and little prospect of foreign finance, combining a balanced budget with only modest efforts to mobilize domestic resources, while allowing capital to freely flee the country, is likely to continue undermining the basis for pro-poor development.

Striving to balance the budget puts unnecessary restrictions on fiscal policy and keeping an open capital account implies keeping real rates of interest unnecessarily high in order to retain capital in the country. Such rates continue to contribute to corporate distress and put pressure on government finances, furthering undercutting prospects for accelerated growth. Indonesia's current policy orientation consigns it to a slow-growth debt trap, with dramatically narrowed policy options for an escape.

Fiscal and Monetary Policies

The growth accounting conducted by this report suggests that neither consumption nor exports will provide an engine of growth that can extricate Indonesia from its economic predicament. Also, under the bleak conditions in the banking sector and the economy-wide lack of aggregate demand, private investment is unlikely to revive itself autonomously. Policymakers must rely on more expansionary fiscal policies focused on augmenting public investment as the stimulus to faster recovery.

The danger of precipitating spiralling inflation with such expansionary policies is not high. The overall deficit has been brought down to about 2 per cent of GDP in 2002-2003 even without significant debt relief or a substantial increase in tax revenue. This report calls explicitly for raising additional tax revenue in order to finance increased public investment. Despite the 'leakage' of taxes, such a combination of policies will still have a significant "balanced-budget multiplier" impact on the economy.

Further easing of monetary policy would give an added boost to the fiscal stimulus. The interest rate was kept artificially high during the crisis in order to stabilize the exchange rate. This was an ill-advised effort. While the Government has lowered policy rates of interest since the crisis, more efforts need to be focused on bringing down lending rates of interest. Applying the so-called "Golden Rule", namely, attempting to align the real interest rate with the sustainable rate of growth of per capita income, would imply real interest rates of 3-4 per cent. Although in decline overall, the real Central Bank rate has remained higher than this, partly nullifying some of the stimulus for faster growth.

In Indonesia, the standard practice of 'targeting' inflation rates to be well below 10 per cent, and converging towards five per cent, has contributed to propping up real interest rates. But historically, inflation rates above 10 per cent have not been detrimental to rapid economic growth in Indonesia. Under current conditions of a dampening of aggregate demand, attempting to lower inflation further is counter-productive.

The Capital and Current Accounts

Easing monetary policy further will be difficult, however, as long as the capital account remains completely open. While an open capital account does little to attract foreign capital, it does provide a well-oiled swinging door for the massive exiting of capital, both foreign and domestic, when the economy falters. Policymakers should now consider partially closing the capital account, by providing some regulation through raising reserve requirements, lengthening minimum holding periods for capital or instituting exit taxes. During the Asia financial crisis, Malaysia demonstrated the feasibility of exit taxes and other countries such as China and Vietnam have shown the value of capital controls as insulation against financial contagion.

Regulating the capital account will help policymakers conduct a more autonomous monetary policy. It will also provide a basis for re-instituting a managed float for the rupiah—a policy that the Government abandoned during the financial crisis. A freely floating exchange rate is too likely to impart instability to the Indonesian economy, particularly when it is struggling to fully recover and investor confidence remains weak. A managed float could offer enough flexibility to promote the international competitiveness of Indonesian exports while guarding against destabilizing fluctuations in the exchange rate. In many countries, policymakers are now instituting more 'intermediate' exchange-rate regimes and avoiding the 'corner solutions' of either rigidly fixed or completely flexible systems.

Trade, Industry and Agriculture

As with financial liberalization, policymakers in Indonesia should take a cautious approach towards trade liberalization. In the wake of the economic crisis in 1997, Indonesia's exports of labour-intensive manufactures have

faced stiff competition from other developing countries, especially China. Despite lowering its wage costs through devaluation, Indonesia has not boosted its labour productivity high enough to compete with such low-cost competition. As a result, full-scale trade liberalization has contributed mainly to Indonesia's increased vulnerability.

The country needs a more pro-active industrial policy that can enhance the competitiveness of sectors producing manufactured exports. But because of the heavy reliance of its manufacturing sectors—even those engaged in exporting—on imports of raw materials, intermediate inputs and machinery, Indonesia should also seek to promote some forms of import substitution. Otherwise, its trade balance in manufacturing will remain in deficit, and likely worsen.

Indonesia cannot continue to rely on a narrow range of labour-intensive and resource-based manufactures. An industrial strategy should help it achieve greater product differentiation, more innovation and a larger share of products with higher value added. One of government's most important contributions should be to help build an effective support system for industrial technology, focusing on strengthening technological capabilities within firms themselves.

In order foster more pro-poor development, policymakers should target agriculture, and agro-industry in general, for greater support. Increases in employment and incomes for much of the population are still dependent on agricultural prosperity, particularly because of the slowdown in growth of labour-intensive exports.

In rice production, which is critical to the food security of the Indonesian people, raising productivity is essential—and the only long-term solution. In line with this priority, policymakers should re-institute the past practice of concentrating public investment on rural infrastructure and basic social services. Meanwhile, reforms in the country's current system of tariffs and quotas should be instituted to provide more effective medium-term protection to rice producers. Full liberalization in rice production under current conditions courts social disaster.

2. Making Growth More Equitable

This report argues that a more heterodox investment-led economic strategy would stimulate more rapid growth than the tepid rates attributable to the current conventional set of policies. However, a pro-poor development strategy requires more than faster economic growth. The impact of growth on poverty depends also on the character or pattern of growth.

For growth to have a more decisive impact on poverty, policymakers need to complement macroeconomic and adjustment policies with broad equity-enhancing sectoral and redistributive measures. These include policies to foster more agricultural development and faster development of small and medium enterprises. Agricultural development is likely to have a powerful direct impact on poverty since the majority of poor households continue to live in rural areas and have livelihoods that are tied to agriculture. The development of small and medium enterprises (SMEs) will help break the stranglehold of the economic elite on public resources and services and help generate remunerative employment for a large share of the working population.

Agricultural Development

To foster agricultural development and the growth of agro-industry, national policymakers should follow a three-pronged strategy: 1) maintaining rice production in order to protect food security, 2) encouraging farmers to diversify into the production of commodities with a higher value added in order to boost incomes and 3) stimulating off-farm employment in order to absorb surplus agricultural labour.

For reducing poverty, it is critical to raise agricultural productivity. The surest long-term strategy is to invest in more efficient technology, as was done during the promotion of the Green Revolution in Indonesia. However, investment in agriculture has progressively declined over a thirty-year period. Also, land has become increasingly fragmented. About 80 per cent of farmers now own plots smaller than 0.5 hectares, compared to 70 per cent in 1993.

The most pronounced effect of these trends is the stagnation of the productivity of rice output on Java. Off Java, where land is more plentiful, the prospects for increasing rice production are better, provided that investment are made to complete large irrigation projects and finances are made available to improve agricultural extension services. Agricultural productivity can increase on Java if farmers are allowed to diversify into cash crops, such as coffee and coconut, which have higher value added.

In rural areas, public investment should be revived in physical infrastructure and basic social services. Indonesia's laudable record of growth with equity in the 1970s and 1980s was based, in part, on such investment. Such an approach implies more investment in upgrading rural roads, irrigation, electricity and communication.

Indonesia's earlier advances in promoting basic human development should also be emulated. Investments in education, health and sanitation are critical for raising the productivity of rural labour.

SME Development

Such investment will help foster more off-farm employment. Stimulating agricultural prosperity will, in fact, promote the development of small and medium enterprises in rural areas. Such enterprises are most likely to be concentrated in agro-industry, either supplying inputs to agriculture or processing its commodities.

For SME development, the Government needs to develop a comprehensive and integrated programme, coordinated by one administrative unit, instead of the numerous ministries and departments that currently overlap in their authority. This is imperative if the monopoly of large corporations on government privileges is to be broken. There are myriad small enterprises in Indonesia, many in the informal sector, but few can obtain the access to resources and services to graduate into medium-sized enterprises that can provide Indonesian workers with decent work, i.e., work based on skills and paying decent wages.

Public policies can facilitate the development of SMEs, especially of medium-sized enterprises, through various means. Facilitating the start-up of enterprises through a "one-stop services" facility could contribute to this objective. Since SMEs are usually starved of capital, setting up a financial institution that could explicitly mobilize resources for SME development could also help. Since the business skills of workers and managers in SMEs are underdeveloped, fostering the spread of business development services could also prove valuable. SMEs could also expand if the Government assisted them in securing overseas markets or encouraged them to produce goods that could substitute for imports.

When public resources are directed more to the development of agriculture and small and medium enterprises, instead of being cornered by large banks and corporations as part of a system of crony capitalism, then growth will accelerate and take on a more broad-based character that will benefit the majority of Indonesians, especially the substantial proportion of the population that is still subjected to poverty or remains vulnerable to it. Such policies are an integral part of an investment-led development strategy that can lead to greater poverty reduction based on faster growth and a more equitable distribution of its benefits.