

## ECONOMIC DEVELOPMENTS

### KEY POINTS

- The 1997 financial crisis interrupted two decades of impressive economic growth, which lifted Indonesia's per capita income from US\$310 in 1976 to US\$1 144 in 1996.
- After contracting sharply in 1998, Indonesia's economy returned to positive growth in 2000 led by stimulatory macroeconomic policy, a low exchange rate, stable prices, lower interest rates and stronger private consumption. Export-oriented and small and medium enterprises, SMEs, have grown well since the crisis.
- GDP should grow by about 5 per cent in 2000 and at least 4 per cent in 2001. Indonesia's short term recovery prospects therefore are relatively good.
- Strong growth beyond 2001 requires investment in new capacity. The Government's new Ten Point Recovery Program recognises the importance of repairing the banking sector and restructuring the large stock of debt major corporates currently owe, to ensure new investment can occur.
- The Government also is implementing a new framework of bank and corporate governance to reduce the economy's vulnerability to another financial crisis. Progress in these areas will determine medium to long term economic prospects.
- The Government's economic reform program is opening up new opportunities for Australian business through selling assets currently held by the Indonesian Bank Restructuring Agency, lowering barriers to investing in most sectors and liberalising trade.
- Investors should remain well informed about developments in key government reform areas, including corporate debt and bank restructuring, corporate governance, devolution and legal reform. These developments could guide decisions on when to best invest in Indonesia.

Throughout 1999, Indonesian authorities stabilised inflation and the exchange rate, enabling the economy to rebound from the deep recession of 1998. Slowly increasing consumption, relaxed monetary and fiscal policy, and a low exchange rate expanding exports are driving a modest expansion in gross domestic product, GDP. Lifted by strong growth in the September quarter, GDP should increase by close to 5 per cent in 2000, with an increase of at least 4 per cent likely in 2001. While this is less than growth in most other crisis affected economies in Asia, it is a marked improvement on 1998 economic performance when output fell 13 per cent, and 1999, when growth was negligible. These forecasts indicate the environment and prospects for Australian exporters and investors are improving.

Export-oriented and smaller firms less affected by the financial crisis increasingly drive much of the recovery, benefiting from the low exchange rate, their lower reliance on the banking system and recovering consumption. However, the Government recognises a recovery in investment is essential for Indonesia to regain pre-crisis growth (Coordinating Ministry for Economic Affairs, 2000). The Government is attempting to restructure bank and corporate sector balance sheets damaged during the crisis, improve corporate and banking sector governance, and strengthen legal and economic institutions. While economic recovery is still fragile, this reform process also should present major new opportunities to Australian business, especially through the sale of corporate and banking assets, which the Government recently took over. (See Chapter 3 - *Foreign Investment*.)

This chapter first analyses the nature of the current recovery, and the relatively favourable outlook for short term growth, focusing on its sustainability. It then considers medium to long term growth prospects. To do this, it examines the continuing legacy of the crisis, highlighting the impact of economic governance in the financial, corporate and public sectors, and briefly examines government efforts to sustain the recovery by addressing bank and corporate sector insolvency. Finally, the chapter assesses the implications of this outlook for Australian business and the new opportunities it provides.

## GOVERNMENT'S TEN POINT PLAN

In September 2000, the new Coordinating Minister for Economics, Dr Rizal Ramli, issued a ten point economic recovery plan, stressing the importance of repairing the financial sector, and accelerating banking and private sector restructuring. The plan emphasises the need for corporates to reduce debt and expand equity to avoid future crises. It also emphasises the importance of small and medium enterprises, SMEs, and agriculture in improving economic efficiency and equity outcomes. The recovery program indicates the Government's ten top priorities are to:

1. create stability in the financial sector
2. increase revenue levels from non-oil exports
3. increase agricultural productivity and the welfare of farmers
4. accelerate banking and private sector restructuring
5. emphasise equity based rather than loan based recovery
6. use a value-creation approach in privatising state owned assets
7. meet economic decentralisation targets through an orderly and phased transition
8. optimise the use of natural resources
9. expand the development of micro, small and medium scale enterprises
10. increase employment generation, particularly in rural areas.

Source: Coordinating Ministry for Economic Affairs, 2000.

## Key Economic Indicators

The financial crisis interrupted two decades of strong growth that produced major structural changes in the Indonesian economy, and made real gains in raising living standards and reducing poverty (Table 1.1). Per capita GDP rose from US\$310 in 1976 to US\$1 144 in 1996, but by 1999 had slipped back 40 per cent to US\$694 due to the 70 per cent depreciation of the rupiah since 1997 and falling GDP in 1998. Purchasing power parity, PPP, estimates of per capita GDP fell by a smaller but still substantial 24 per cent, from I\$3 700 to I\$2 800.<sup>1</sup>

<sup>1</sup> International dollars, I\$, measure average per capita income of a country in terms of its purchasing power in the US economy; that is, in 1999 the average Indonesian received income sufficient to buy US\$2 800 worth of goods and services at US prices. Because nominal exchange rates do not always reflect international differences in relative prices, PPP rates are used to allow a standard comparison of real price levels between countries and hence allow better comparisons of average income levels between economies.

Table 1.1

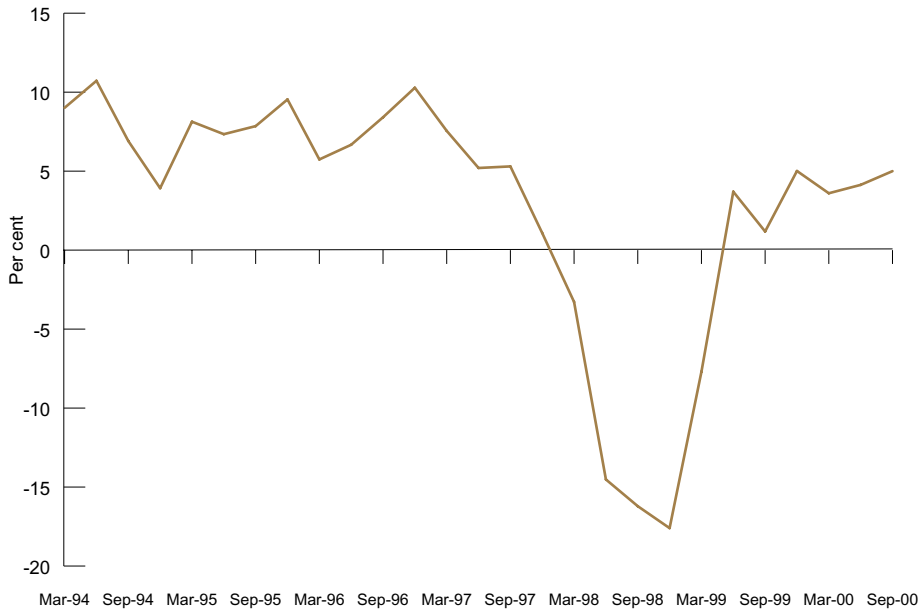
**Crisis Interrupts Two Decades of Growth**  
**Summary of Key Economic Indicators, 1980-1999**

	1980	1985	1990	1993	1995	1996	1997	1998	1999
GDP (US\$ billions)	52.5	87.2	114.4	157.8	201.8	226.9	212.7	100.2	143.4
GDP per capita (current prices US\$)	410	535	642	834	1 033	1 144	1 056	490	694
GNP per capita (PPP, in I\$)	na	na	na	3 140	3 800	3 310	3 390	2 790	2 439
<b>Key variables as ratio to GDP (per cent)</b>									
Private consumption	51	60	58	59	62	62	62	65	73
Government consumption	11	12	9	9	8	8	7	5	6
Investment	24	30	28	26	28	30	28	25	21
Exports of goods and services	34	23	26	27	26	26	28	51	35
Current account balance	-1.0	-2.2	-2.6	-1.5	-3.4	-3.4	-2.4	4.1	4.0
<b>Sectoral structure of GDP (per cent)</b>									
Agriculture	24	23	19	18	17	17	16	18	19
Mining	na	na	na	10	9	9	9	13	10
Manufacturing	13	16	21	22	24	26	27	24	25
Services and other	34	41	41	50	50	49	48	45	45
<b>Current account</b>									
Exports: goods and services (US\$ billion)	26.7	20.1	29.9	36.6	47.5	50.2	56.3	50.3	51.2
Imports: goods and services (US\$ billion)	15.8	17.9	27.2	28.4	40.9	44.2	46.2	31.9	30.6
Current account balance (US\$ billion)	-0.6	-1.9	-3.0	-2.3	-6.8	-7.8	-5.0	4.1	5.8
Foreign direct investment (US\$ billion)	na	na	1.1	2.0	4.3	6.2	4.7	-0.4	-2.7
External debt (US\$ billion)	20.9	36.7	69.9	89.2	124.4	128.9	136.1	150.9	136.2
External debt (per cent of GDP)	27	42	61	56	62	57	64	151	103
<b>Real growth rates (per cent)</b>									
Real GDP	8.7	3.5	9.0	7.3	8.2	7.8	4.7	-13.0	0.3
Exports	2.9	-9.2	17.9	9.1	7.7	7.6	7.8	-11.2	-31.6
Gross fixed capital formation	26.4	7.2	16.1	13.5	14.0	14.5	8.6	-33.0	-19.9

Note: PPP is purchasing power parity.  
 I\$ is international dollars.  
 na Means not available.

Source: GDP PPP statistics from *The World Bank Atlas*, 1995-1999 and the *World Development Report*, 2000-2001. Statistics from 1993 onward taken from CEIC, 2000, except external debt. External debt and all other statistics from World Bank World Tables, DXD Online Database, 2000.

Figure 1.1

**Economy Recovered in 1999, but at Lower Growth Level****Indonesian Real GDP Growth Year Ended, Per cent**

Note: Real GDP valued in 1993 prices.

Source: CEIC, 2000.

## MACROECONOMIC STABILITY RETURNS

After 1998, monetary authorities regained control of the money supply and inflation, and lowered interest rates, giving rise to a modest but broad based recovery in GDP starting in mid 1999 (Figure 1.1).

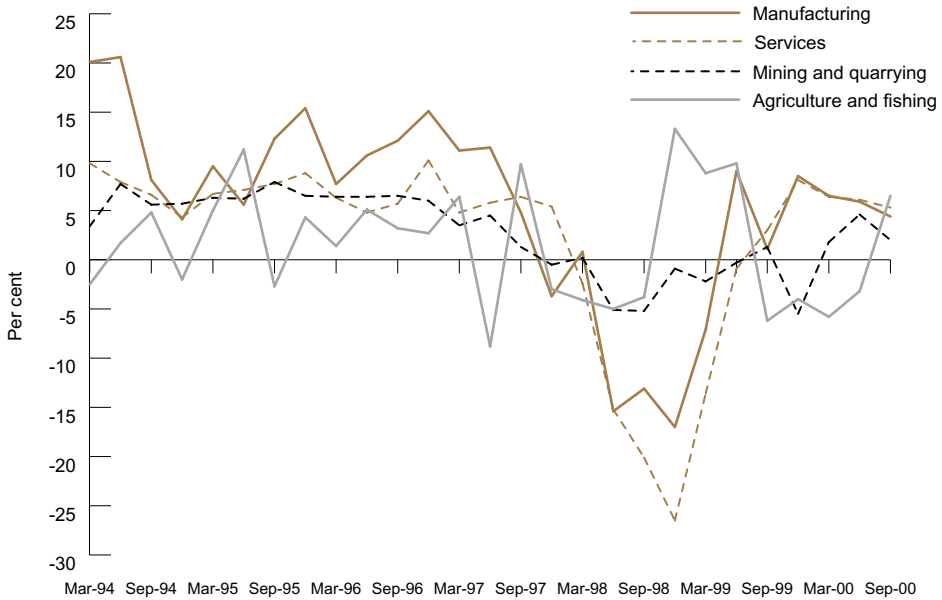
All sectors resumed positive growth in the year to September 2000 (Figure 1.2). Output growth in construction, transport and communications grew strongly, and output in some manufacturing areas is close to pre-crisis levels (World Bank, 2000).

The recovery mainly reflects the impact of the favourable exchange rate on exports, improved macroeconomic policy management and returning consumer confidence.

Figure 1.2

**All Sectors Show Growth in 2000, but Volatile**

**Real Sectoral Growth Rates, Year Ended, Per cent**



Source: CEIC, 2000.

**Exports Responding**

Exports now are recovering very strongly, growing 17 per cent in the third quarter of 2000 from a year earlier in constant price rupiah terms (Figure 1.3). In US dollar terms, exports in the year to September 2000 were 28 per cent higher than a year earlier and higher than pre-crisis peaks (Figure 1.4).

Throughout 1998, reduced trade finance and flight of skilled human capital caused exports to drop, but in 1999 and 2000, as more businesses accessed trade finance, the rupiah's earlier depreciation started to boost export growth. The central bank, Bank Indonesia, and selected private banks now guarantee letters of credit exporting firms issue.<sup>2</sup> Furthermore, subsidiaries of foreign firms form a large part of the export sector. These firms can access trade finance through their parent company, and are not constrained by the Indonesian banking sector. For example, a September 2000 survey of firms in an export-oriented industrial estate found output was 50 per cent higher than the pre-crisis peak (World Bank, 2000). As Indonesia is a net oil exporter, higher oil prices also boost the value of exports.

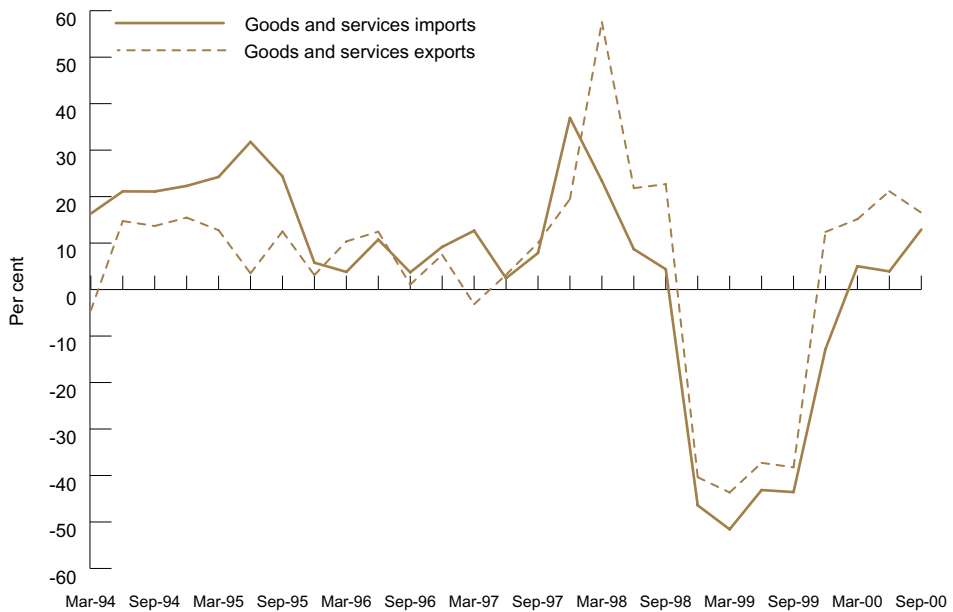
<sup>2</sup> However, some analysts express concern about the small number of firms accessing these schemes.

Reflecting the recovery in exports and domestic consumption, imports also are recovering from crisis driven lows, to be around 13 per cent higher in the September 2000 quarter than a year earlier, in real rupiah terms (Figure 1.3). In US dollar terms, imports rose over 15 per cent in the year to September 2000 over the level a year earlier, to reach US\$28.8 billion (Figure 1.4). Despite this increase, imports are still 34 per cent below the pre-crisis peaks of March 1997 in US dollar terms.<sup>3</sup> In the September quarter of 2000, Indonesia enjoyed a trade surplus equal to around 11 per cent of GDP.

Figure 1.3

**Exports and Imports Recovering Well**

**Growth of Indonesian Exports and Imports, Real Rupiah Terms, Year Ended, Per cent**



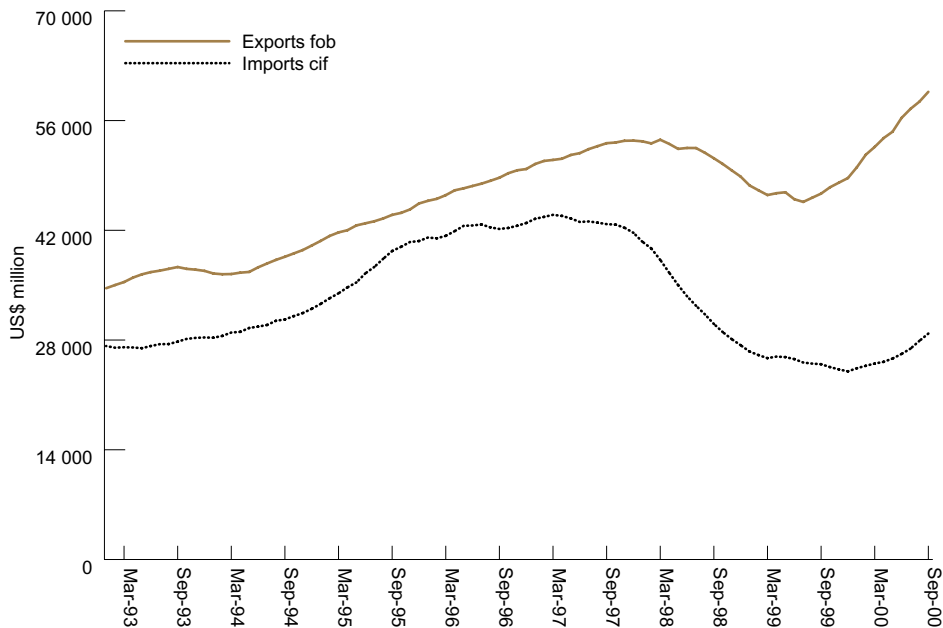
Source: CEIC, 2000.

<sup>3</sup> The World Bank's cited trading partner data on exports to Indonesia show even stronger growth in imports than Indonesian customs import data (Figure 4.5 and World Bank, 2000).

Figure 1.4

**Exports and Imports Recovering Well**

**Value of Indonesian Exports and Imports, US dollar Terms, Cumulative 12 months**



Note: Import data are from the Customs Department.  
 fob Means free-on-board.  
 cif Means cost-insurance-freight.

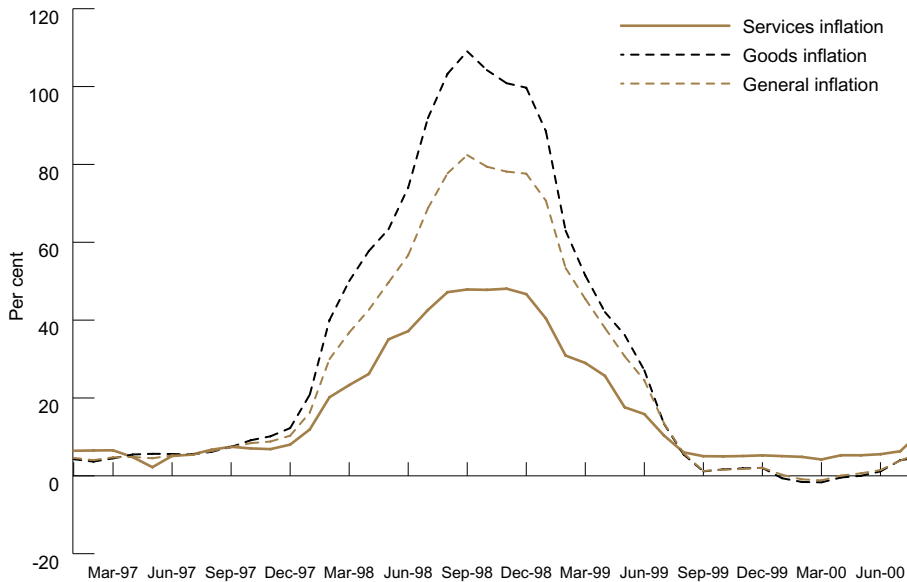
Source: CEIC, 2000.

**HIGH OIL PRICES BOOST GOVERNMENT REVENUE**

The Indonesian budget is highly sensitive to oil prices. Higher oil prices in 1999 and 2000 almost doubled the Government's non-tax oil and gas revenues between the 1999-2000 and 2000 fiscal years, and by late 2000, these revenues were 21 per cent of total revenues. Higher oil prices also increase fuel subsidy spending, but this is less than the rise in revenue. Expenditure on fuel subsidies in 2000 was almost twice that of the previous fiscal year, and now comprises around 11 per cent of total expenditure. Higher oil prices will reduce the 2000 fiscal year deficit below its targeted 4.8 per cent of GDP to between 2.5 and 3.9 per cent (World Bank, 2000).<sup>4</sup> Rising oil prices also will affect the 2001 budget outcome; the draft 2001 budget anticipates revenue will rise another 50 per cent. Although the Government has started reducing subsidy rates, expenditure on fuel subsidies still will increase by over 60 per cent in 2001.

<sup>4</sup> Indonesia is changing its fiscal year to the calendar year in 2000. Much of the deficit has reflected increased spending on interest payments to banks holding bonds issued under the bank restructuring program. While an increase in these outlays provides a net fiscal stimulus, the second round effects of these outlays is lower than from outlays in other areas, including public works and safety net projects.

Figure 1.5

**Inflation down from Crisis Peaks****Inflation Rate of Goods and Services, 1997-2000**

Source: CIEC 2000.

**Inflation Contained**

Despite rising towards 8 per cent by the end of 2000, inflation is well below levels reached during the crisis. After peaking at 78 per cent in October 1998, inflation fell dramatically through 1999-2000 in line with restrained growth in money supply (Figure 1.5). Lower inflation helped reduce downward pressure on the exchange rate, building consumer confidence and allowing Bank Indonesia to reduce interest rates. Falling inflation also supports social and political stability, enhancing the foreign investment environment.

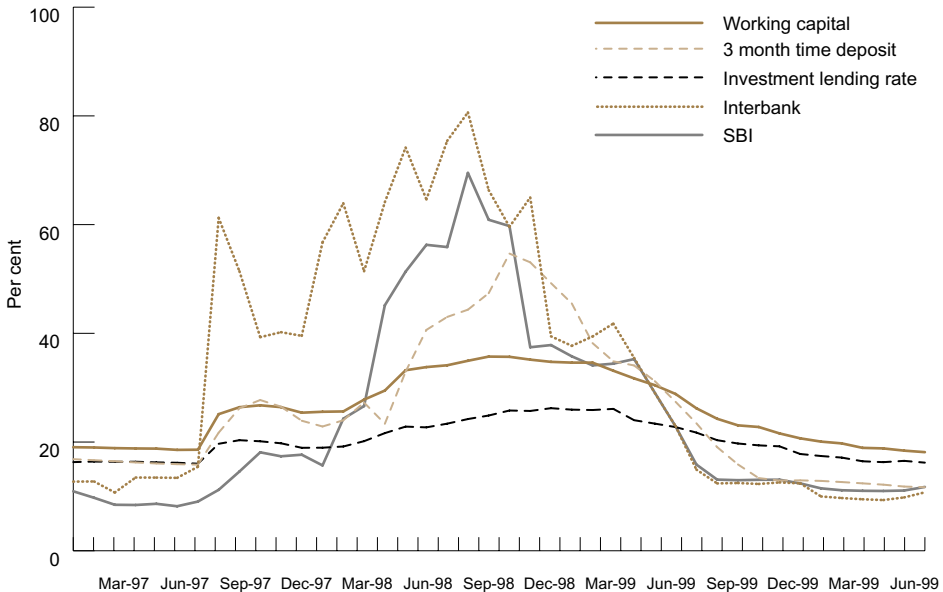
**Interest Rates Fall**

Throughout 1999, as the rupiah stabilised and inflation declined, Bank Indonesia lowered interest rates from 36 to 12 per cent, where they broadly remain; this supported a recovery in consumption and investment over 1999 and early 2000. The mild increase in inflation to 8 per cent has lowered further the level of real interest rates, assisting private sector activity.

Figure 1.6

**Interest Rates Fell Sharply**

**Various Short and Long Term Interest Rates, 1996-99**



Note: SBI is the Bank Indonesia Certificate.  
 Source: CEIC, 2000.

**Consumers Resume Spending**

The combination of stable prices, rising wages, falling unemployment, lower interest rates and the peaceful transition to a new government boosted consumer confidence in 1999. Real consumption grew by close to 3 per cent in 1999, leading the recovery in output in 2000. In the first six months of 2000, retail sales were 11 per cent higher than for the corresponding period a year earlier (Coordinating Ministry for Economic Affairs, 2000).

**SMALL FIRMS PROSPERING**

SMEs' impressive performance has underpinned the recovery. Following the crisis, many large firms remain burdened with excessive borrowing, often denominated in appreciated foreign currencies, but SMEs hold less than 2 per cent of non-performing loans (Coordinating Ministry for Economic Affairs, 2000). This is because they had limited access to bank credit before the crisis; of 320 SMEs surveyed recently, only around 2.5 per cent had access to bank loans (Asia Foundation, 2000). Hence, most SMEs are unencumbered by insolvency and bad debt problems.

Mostly, SMEs are supplying recovering domestic demand. Output from small domestically oriented firms recovered strongly in 2000 in response to the pick up in local consumption, and the low exchange rate helped small export-oriented firms during 1999 (Asia Foundation, 2000).<sup>5</sup>

However, constraints in accessing capital are likely to limit SME output growth. Internally generated funds finance most SME investment, and this limits scope for rapid expansion. A recent survey indicated almost 50 per cent of the garment manufacturers in Central Java and nearly 75 per cent of furniture producers in South Sulawesi interviewed, were constrained financially (Asia Foundation, 2000). To boost their output since the crisis, SMEs have cooperated to obtain finance, as well as access to raw materials, production processes and marketing (Asia Foundation, 2000). While the Government's ten point plan prioritises SME development, recognising the need for credit schemes and other facilities, it also acknowledges repairing the large corporate sector is central to restoring medium term economic growth (Coordinating Ministry for Economic Affairs, 2000).

## **RECOVERY SET TO CONTINUE IN SHORT TERM**

The relatively stable macroeconomic environment and weak rupiah should ensure the economy continues to expand in the short to medium term. The Indonesian Government and IMF forecast GDP will grow by between 4.5 and 5 per cent during 2000 (Table 1.2). Private sector economists currently forecast 3.8 per cent growth in real GDP in 2000 and 4.3 per cent in 2001 (Consensus Forecasts, 2000). GDP data for the September quarter suggest 2000 growth will be closer to 5 per cent, and 2001 growth could be more than 4 per cent.

As real GDP is still about 10 per cent below its pre-crisis level and unused capacity remains high, except in rapidly growing export sectors, modest short term GDP growth could occur in 2001 without much new investment, but will be constrained after that if investment does not recover. Forecast growth levels, while modest, should improve the environment for foreign investors and boost trade flows.

<sup>5</sup> These firms included Balinese furniture makers and garment producers in West Sumatra. However, as the exchange rate appreciated and stabilised in 1999, growth in these firms' output moderated.

Table 1.2

**Modest Recovery Forecast to Continue**
**Actual and Forecast Sectoral Real GDP Growth, Year Ended Percentage Change**

	1999 Q1	Q2	Q3	Q4	1999	2000 Q1	Q2	Q3	2000 <sup>b</sup>	2001 <sup>b</sup>
Gross domestic product <sup>a</sup>	-7.7	3.7	1.2	5.0	0.4	4.0	4.5	5.1	3.8	4.3
<b>GDP by sectors</b>										
Agriculture	8.8	9.8	-6.2	-4.0	-0.5	-5.8	-3.2	6.5	na	na
Mining and quarrying	-2.2	-0.3	1.3	-5.5	-1.3	1.8	4.6	2.0	na	na
Manufacturing	-7.1	9.0	1.1	8.5	2.8	6.5	5.9	4.4	na	na
Electricity, gas and clean water	4.3	9.5	10.1	8.8	8.1	9.8	5.6	5.4	na	na
Construction	-23.4	1.8	9.7	12.5	-0.4	12.2	10.5	8.3	na	na
Trade, hotels and restaurants	-15.3	1.0	4.4	11.6	0.2	5.9	5.6	5.4	na	na
Transport and communication	-17.8	-2.1	9.7	11.7	0.2	11.6	10.7	8.3	na	na
Finance, leasing and business services	-22.4	-7.1	-4.8	5.8	-6.2	5.7	5.6	5.4	na	na
Services	1.2	1.6	2.3	2.0	1.8	4.2	4.1	3.7	na	na
<b>GDP by expenditure</b>										
Household consumption	0.6	2.4	6.0	2.9	2.5	2.6	2.5	2.8	3.4	4.0
Government expenditure	-3.9	10.2	-0.4	-2.8	0.3	2.9	2.3	13.6	na	na
Total consumption expenditure	0.2	3.1	5.5	2.4	2.3	2.6	2.5	3.7	4.0	4.0
Gross fixed capital formation	-35.6	-21.6	-18.5	3.5	-16.5	10.1	16.2	13.9	8.2	6.2
Exports of goods and services <sup>c</sup>	-18.8	-4.4	-5.6	17.1	-0.4	39.1	32.1	24.8	14.1	7.4
Imports of goods and services <sup>c</sup>	-22.9	-2.0	-9.5	-12.7	-12.2	18.0	20.4	41.9	11.1	14.7

Note: a GDP and components data are 1993 constant prices.

b Forecasts based on Consensus Forecasts, 2000.

c Exports and imports in US\$ terms.

na Means not available.

Source: Centre for International and Strategic Studies, 2000; CEIC, 2000; and Consensus Forecasts, 2000.

Consumer spending should continue to support economic expansion in 2000 and 2001, boosting durable goods sales (Danareksa Research, 2000).<sup>6</sup> Private sector economists forecast private consumption should expand by close to 4 per cent in 2000 and 2001. This will continue to underpin modest GDP growth. Indonesian exports also should continue to expand with the lower rupiah and more accessible trade finance. Private sector economists forecast exports will increase by almost 15 per cent in 2000 and about 7 per cent in 2001 (Table 1.2 and Consensus Forecasts, 2000).

Macroeconomic policy, on balance, should support expanding demand, creating a more positive outlook for foreign investment and trade. Despite the impact of higher oil prices, fiscal policy should provide a small stimulus in 2000, although its flow on effects will be limited. The increase in inflation towards the end of 2000 may require Bank Indonesia to tighten monetary policy, raising interest rates to defend its inflation target of 5 to 7 per cent; this may dampen growth. A recent acceleration in wages and depreciation in the rupiah pose added risks to inflation in early 2001. Nevertheless, the economy's large excess capacity suggests additional rises in inflation should be limited, and any interest rate increases by Bank Indonesia should be too moderate to derail the recovery.<sup>7</sup>

By 2001, increasing demand probably will deplete stocks in the manufacturing sector, boosting production and absorbing excess capacity. Probably by late 2001 and 2002, higher production levels will require investment in new facilities across the economy. Economic performance then will depend on how successfully the government restructures corporate debt, so the banking system can resume lending.

## LEGACY OF THE CRISIS REMAINS

The financial crisis affected Indonesia's economy significantly more than other East Asian economies (International Monetary Fund, 2000a). Weak banking sector regulation and easy access to foreign credit at a fixed exchange rate led to a build up of foreign liabilities, making Indonesia vulnerable to deteriorating international investor sentiment. Implicit government guarantees of bank deposits, a fixed exchange rate, lack of bank supervision and poor incentives for sound corporate investment, all contributed to this exposure. When confidence in the economic structure of some Asian economies sharply deteriorated, the rupiah's value plunged in early 1998 (Figure 1.7). This vulnerability transformed a sharp exchange rate depreciation into a major financial crisis by mid 1998 (Feridhanusetyawan and Anas, 2000). In November 2000, the rupiah still remained over 70 per cent below its June 1997 level of Rp. 2 450 : US\$1 at approximately Rp. 9 200 : US\$1, making foreign loan repayments impossible for many highly leveraged debtors.

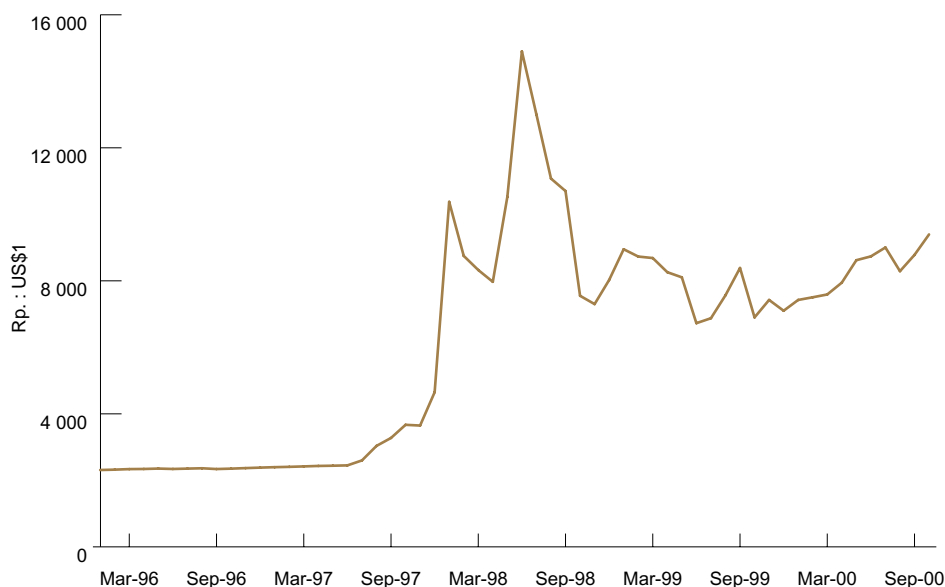
<sup>6</sup> Consumer confidence dropped from April to August 2000, but recovered in September. Throughout this period, however, the number of optimists consistently outnumbered pessimists.

<sup>7</sup> A renewed weakness in the rupiah may increase pressure for Bank Indonesia to increase interest rates, although in the past, this policy was largely ineffective; Bank Indonesia is more likely to actively purchase the rupiah in currency markets.

Figure 1.7

**Exchange Rate More Stable but at a Much Depreciated Level**

**Rupiah:US Dollar Exchange Rate, 1995-2000**



Source: CEIC, 2000.

**Rupiah Depreciation Still Hurts Borrowers**

The falling rupiah caused the value of foreign debt in rupiah terms to escalate sharply, reducing the solvency of corporations holding large foreign exposures and their capacity to repay debts to the domestic banking system. Deterioration in the quality of loan portfolios and the banking system’s unhedged exposure to foreign borrowing severely damaged banks’ capital adequacy levels. Several bank closures contributed to depositors’ loss of confidence; a series of bank runs sparked widespread investor panic (Radelet and Sachs, 1998).<sup>8</sup> While debtors accelerated rescheduling and repaying foreign debts in 2000, these were still worth US\$58 billion at the end of June 2000 (World Bank, 2000).

**Lower Output Hit the Corporate Sector**

The sharp drop in output following the crisis also damaged corporate balance sheets and affected turnover and profitability. After growing at around 7 per cent per year in the two decades preceding the crisis, Indonesian output contracted 15 per cent over the year to the June quarter of 1998.

<sup>8</sup> Many depositors believed the government would protect deposits if a crisis occurred, reducing their discernment in choosing banks, and undermining some banks’ commitment to risk management. The rupiah’s relatively stable value against the US dollar over the 1990s led domestic borrowers to underestimate foreign exchange risk when borrowing overseas. These factors deterred bank self-regulation and adequate enforcement of prudential controls.

Expenditure shrank, with contraction most marked in private investment, as undercapitalised banks virtually ceased extending credit to corporates. Falling investment and diminishing confidence reduced consumption, further damaging investment and employment prospects. As in most severely affected crisis economies, the lower exchange rate did not immediately benefit exports.<sup>9</sup> However, activities based on natural resources largely withstood the crisis.<sup>10</sup>

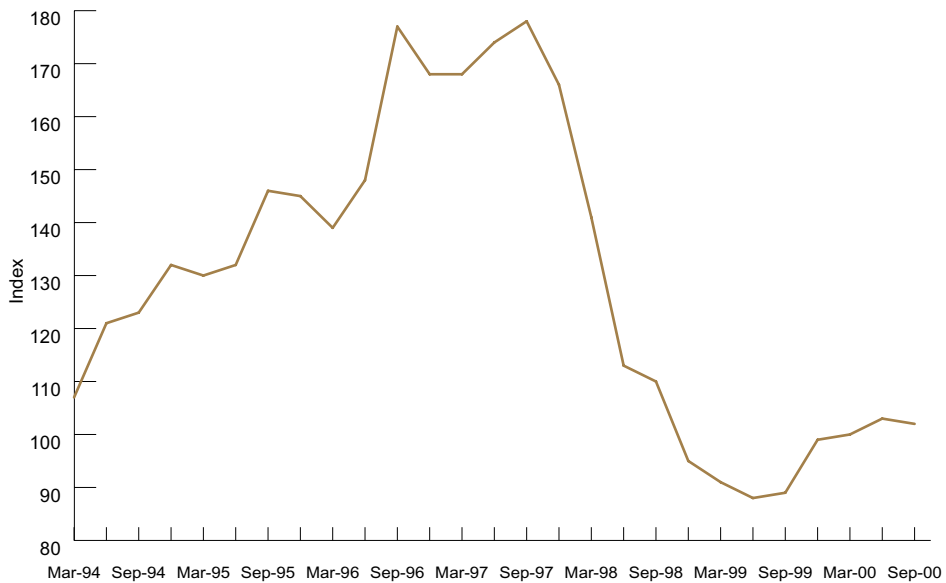
### Investment Remains Weak

Investment started to recover in late 1999 and early 2000, but fell again in the September quarter of 2000 (Figure 1.8). Spending on investment, adjusted for price movements, remains over 40 per cent below pre-crisis peaks. The drop in investment spending in September underscores the importance of improving the condition of the banking sector and repairing corporate balance sheets.

Figure 1.8

#### Investment Faltering at Low Levels

#### Index of Real Gross Investment, March 1993=100



Source: CEIC, 2000.

<sup>9</sup> Exports continued to decline well into 1998, due to an international rejection of Indonesian letters of credit; a lack of working capital and capacity to buy imports reduced some exporters' capacity to meet delivery deadlines and fill orders (Pardede, 1999). By 1999, as trade finance became more available, export-oriented sectors could capitalise on the low exchange rate and grew strongly.

<sup>10</sup> In particular, minerals and energy relied less on bank financing and external creditors, and their costs benefited from the lower exchange rate. In 1997 and early 1998, agriculture suffered from El Nino induced drought, but later recovered.

## REGAINING SUSTAINABLE GROWTH

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Having achieved macroeconomic stability by adopting appropriate monetary and fiscal policies, the Government realises sustaining this growth will require new investment in productive assets, and now is focusing on repairing the banking and corporate sectors, as its new ten point plan indicates (Coordinating Ministry for Economic Affairs, 2000). The Government purchased many non-performing loans from the banking system in return for bank equity; this effectively nationalised most of the banking sector. The Government has begun selling these banks to the private sector. The corporate sector remains heavily indebted to banks and foreigners, but government efforts to restructure these loans now are moving ahead.

The following sections briefly discuss progress on the main restructuring and reform priorities, as this directly affects Indonesia's macroeconomic prospects. (Details of bank and corporate restructuring are discussed in Chapter 7 - *Financial Sector Restructuring* and Chapter 8 - *Corporate Restructuring*.)

### Banking System Repair

The Indonesian Bank Restructuring Agency, IBRA, established in January 1998 to oversee banking sector rehabilitation, soon will have reviewed, closed, merged, recapitalised or taken over all private and state banks. The Government has announced that by 2004, it will have completed banking sector restructuring and returned nationalised banks to private owners, including foreign investors.<sup>11</sup> However, this timetable suffered some delays in 2000; the Government has indicated IBRA is waiting for market conditions to improve.

### Restructuring the Corporate Sector

Current estimates suggest around 70 per cent of Indonesia's corporate sector is insolvent. However, the Government has prioritised rescheduling outstanding debt, so the corporate sector can undertake new investment. As creditor to some Rp. 235 trillion (US\$37 billion) of corporate debt, IBRA plays a central role in this process. After delays in 1998 and 1999, the Government is addressing the obstacles to more rapid debt restructuring, including the weak legal system, and corporate restructuring is starting to accelerate.

## MEDIUM TERM FORECASTS

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Indonesia's growth prospects depend largely on the pace of corporate and financial restructuring. As the timing of restructuring is uncertain, considering alternative growth scenarios is useful (Figure 1.9). The baseline scenario reflects the situation if no crisis had occurred, and assumes GDP growth of 7 per cent per year from 1996 to 2010, roughly equal to Indonesia's potential long term growth rate. This provides a benchmark against which to estimate output lost due to the crisis. Under the baseline scenario, 2006 GDP is about double 1996 GDP and 2010 GDP is roughly two and a half times higher than 1996 GDP.

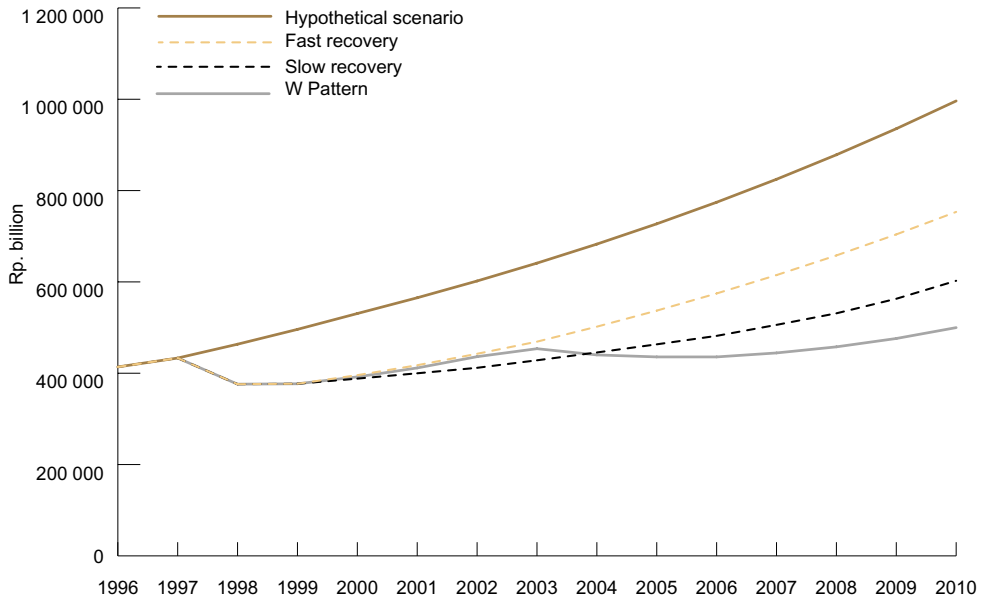
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<sup>11</sup> These sales could provide opportunities for Australian business seeking to enter the Indonesian financial sector.

Figure 1.9

### Rapid Restructuring Will Pay Big Growth Dividends

#### Real GDP under Alternative Growth Scenarios, Rp. billion



Source: Centre for Strategic and International Studies, 2000.

Provided the Government can resolve rapidly banking and corporate sector problems, rapidly sell IBRA and state enterprise assets, and maintain social stability in 2000 and 2001, the recovery in output evident in the first three quarters of 2000 should improve and be sustained. Analysts expect this 'V' shaped recovery would create growth of 5 per cent in 2000 and 2001, 5 to 6 per cent in 2002 to 2003, then 7 per cent per year in 2004 and beyond. Under this fast recovery scenario, GDP would return to pre-crisis levels in 2002 and output would be only 25 per cent lower in 2010 than under the baseline scenario (Figure 1.9). A 'V' shaped recovery generally describes the experience of the Republic of Korea and Malaysia, which quickly removed non-performing loans from bank balance sheets, refinanced banks and moved to restructure corporate debts (Centre for Strategic and International Studies, 2000).

If prolonged delays occur in corporate debt and bank restructuring and IBRA asset sales, growth is likely to be slower. Under such a slow recovery scenario, output may grow by only 2 to 3 per cent per year until 2003, then by 4 to 5 per cent until 2008, before regaining its potential rate of 6 to 7 per cent in 2009 and 2010. In 2010, real GDP would be about 45 per cent below that in the baseline scenario. The worst case scenario, a 'W' shaped recovery, implies serious problems implementing the reform program and a relapse into recession. Pre-crisis GDP would be surpassed only in 2007 (Figure 1.9).

### SOCIAL IMPACT OF THE CRISIS

Despite the generally negative impact of the crisis on employment and consumption, some parts of the community adapted to the crisis (known as *krismon*) better than others. Living standards fell sharply between 1996 and 1998, with the number of people living below the poverty line increasing by around 65 per cent, from around 11 to 18 per cent of the total population, depending on the survey. However, this was still well below the poverty rate of 40 per cent recorded in the 1970s.

The flexible labour market provided a buffer to shrinking output, employment and profits, with the agricultural sector absorbing a large share of workers dismissed from the urban economy. Rural employment growth increased from 0.6 per cent before the crisis to 2.3 per cent after it. Growth in urban employment, which had averaged around 5 per cent between 1990 and 1996, slowed dramatically (Feridhanusetyawan, 1999; and *Sakernas*, various issues). Many urban workers also moved into the informal sector, where employment grew by around 7 per cent during 1997-98, to 65.4 per cent of total employment (Feridhanusetyawan, 1999).

### REQUIREMENTS FOR LONG TERM GROWTH

To achieve rapid, longer term growth, Indonesia will require new investment in public infrastructure, education and institutional capital; required investment in public infrastructure alone is estimated to be around US\$100 billion over the next ten years (Younger, 2000). Indonesia also faces human capital constraints with international comparisons showing investments in public primary and secondary education are low. Government's new obligations to service the greatly expanded public debt are likely to constrain its investment in these areas. The IMF estimates the ratio of public debt to GDP is 93 per cent in 2000 (International Monetary Fund, 2000a, 2000b and 2000c).

### REFORM INDICATORS FOR BUSINESS

Business needs to remain informed of government reforms in key areas, including corporate debt and bank restructuring, asset sales, corporate governance and legal reform. These could guide when it is best to invest in Indonesia.

#### **Corporate Restructuring, Asset Sales and Bankruptcy Functioning**

A key indicator is the success of debt restructuring, as this is critical to restoring the economy's long term prospects. Business should interpret government success in prosecuting major debtors who refuse to participate in the debt restructuring process as a sign that the investment environment will improve. Investors also should interpret positively announcements of sales of major IBRA assets and a continuation of recent, more rapid progress in debt workouts, particularly if they generate viable long term restructuring.

## Successful Bank Restructuring and Corporate Governance

IBRA has nearly recapitalised the banking sector, and is readying banks for sale to the private sector. Timing of these sales and willingness to offer banks to capable private investors, including well qualified foreign banks, indicate important reform progress.

The Government has passed many new laws to improve corporates' reporting and accounting standards, directors' obligations and minority shareholders' rights. Success in enforcing new requirements, including by prosecuting non-compliers, will indicate a likely improvement in corporate governance standards and an enhanced investment environment.

## IMPLICATIONS

The Indonesian economy is experiencing a short term macroeconomic recovery from the crisis, but the Government clearly understands more work needs to be done to sustain it (Coordinating Ministry for Economic Affairs, 2000). Sustaining growth depends on successfully restructuring corporate balance sheets and the banking sector. Limiting risks to investors and achieving sustainable economic growth also requires an efficiently functioning legal system, political stability and maintenance of basic security.

Indonesia is trying to establish these foundations for sustainable growth. This is occurring in an environment of rapid political change, adding to this challenge, and at times reducing the pace of necessary economic and institutional reform. Hence, plausible scenarios indicate medium term economic growth could be slower than in other crisis affected economies.

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