

INDONESIA UPDATE

For the Asia-Pacific Roundtable

Presented by

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It is a pleasure to be here in such pleasant surroundings and among such an august gathering to talk about the current political and economic situation in Indonesia. Looking back over the difficult times of the past three years in my country, I am struck by the amazing resilience of the real sector of our economy. As I will discuss later, despite extreme exchange rate volatility and the utter collapse of the banking system, the real economy continues to function and is starting to lead the economy out of the current depression. I believe a fair reading of the economic history of the past three years will show that the fate of our economy has depended more on political and social issues than on more purely economic matters.

In preparing the materials for this meeting, I spent a fair amount of time reviewing the current economic situation and realized that one's view on the current situation depends heavily on the perspective that is brought to the analysis. For those of us who struggled with Indonesia's problems through 1998, the situation at the end of 1999 does not seem so bad. But someone who does not bring this perspective to his or her analysis might come to a less favorable conclusion.

Where does Indonesia stand today? Let me begin by looking at the macroeconomic situation. The most significant achievement of economic policy over the past year has been the stabilization of the rupiah. During most of 1998, the rupiah exchange rate against the dollar was highly volatile, starting the year at around 5000 rupiah per dollar and depreciating as far as 17,000 rupiah per dollar. At its nadir, the rupiah had lost approximately 85% of its value. While it did not stay at such very low levels for long, the currency did remain weaker than 10,000 rupiah per dollar for more than four months of 1998. Fortunately, by October 1998 the change to the Habibie government and the improved credibility of economic policy that that entailed allowed the rupiah to strengthen to around 8000 rupiah per dollar and the currency has stayed in a range of around 7000 to 9000 rupiah per dollar for the past fifteen months. More importantly, you can see on this graph that since the election of the government of President Abdurrahim Wahid at the end of October, the rupiah has traded in an even more narrow band between 6800 and 7200 rupiah per dollar.

Looking at these data from a longer-term perspective, I think that it is safe to say that the rupiah may have found its level at around 7000 rupiah per dollar. This is consistent with calculations of our real exchange rate. Since before the crisis, the rupiah's real exchange rate against a market basket of major world currencies has depreciated by around 50%. While part of this was needed to offset a fairly significant real appreciation in the mid-1990s, the devaluation has made our industries quite competitive again in world markets. Any substantial further appreciation of the nominal exchange rate would likely put us at a comparative disadvantage, particularly in light of the changes in perceptions regarding Indonesia over the past three years and the depreciation of other regional currencies. This latter point is born out by the fact that our real exchange rate against our major ASEAN competitors has depreciated by five to ten percent during the crisis.

Another major accomplishment of the past year has been the taming of inflation. In September of 1998, twelve-month inflation peaked at 82%, in great part due to very rapid increases in the price of food items over the preceding six months. Of particular importance among the food commodities were rice, our staple grain, and the price of which rose by more than 120%

from the end of May to the end of September. Fortunately, in response to the tight monetary policy that the government was able to implement early in the Habibie Government and the return of confidence in the rupiah that the new government ultimately engendered, inflation began to come under control in October of 1998 and by the end of 1999, inflation for the calendar year had been reduced to 2%.

Another positive indicator in 1999 has been real GDP. For most of 1997, GDP grew rapidly, even after the onset of the crisis. It was not until the first two quarters of 1998 that the crisis had a significant impact on real GDP, when real GDP for the second quarter of 1998, which included the period of significant social unrest in May, fell by 15% compared to the same quarter in 1997. However, as you can see in the chart, real GDP has now been rising for three straight quarters. Our best estimates are that real GDP increased slightly in 1999. During the year 2000, we expect growth to be more rapid, likely around 4%. It is important to note, though, that even if we achieve five-percent annual growth, it will take until at least 2003 for GDP per capita to recover to its pre-crisis level in real rupiah terms.

Non-oil exports, which had continued to grow during 1997 and even early 1998, collapsed sharply after mid-1998. While some attribute this to a lack of trade finance, I believe that the timing is more consistent with a decision by buyers to avoid purchasing from Indonesian sources after the unrest of May 1998 combined with a subsequent decision to await the outcome of our elections last year before restarting purchases. For these reasons, non-oil exports fell by 13% over the first six months of 1999 compared to the same period in 1998. Since August of 1999, we have seen a recovery in exports, with exports from August through November of 1999 being 6% higher than the same period in 1998, though still 5% lower than the same period in 1997. This has been in part due to a stabilization of export prices, but it has also been due to an increase in export volumes.

Of particular importance has been the improvement in the level of exports of manufactured goods. Since July of last year, manufactured goods exports have recovered to or exceeded their pre-crisis levels. This occurred despite a decline in prices for many of these goods until late this year.

Other more specific indicators also point to the beginnings of a recovery. For instance, automobile sales, which collapsed with the onset of the crisis have showed impressive gains in 1999 and should continue to grow into this year. However, even if the more optimistic projections come true, car sales this year will be less than half their annual level prior to the crisis. A similar story can be told for motorcycle sales.

This has given you some idea of what has been happening in the macroeconomy over the past year.

That's the good news. I believe that it points to an economy that are growing and that can continue to grow for some time to come, if the social and political situation remain stable. However, there are some problem areas in the economy. The most troubling item in our macroeconomic data is the level of imports. As you can see from this graph, imports just collapsed after the beginning of the crisis. The fact that imports collapsed is not surprising. In fact, that is exactly what economics would predict should happen, as the rupiah is devalued. However, the size of the collapse is very troubling for an economy that has become so integrated into the global economy. For the eleven months ending in November 1999, non-oil imports have averaged approximately \$1.7 billion per month. One has to go back to 1990 to find a year with average imports below this level.

This collapse in imports has come from both intermediate and capital goods. The decline in intermediate goods imports actually began well before the crisis. This is a subject that has not been commented upon much. In part it may simply reflect a statistical anomaly created by our statistical office in its treatment of imports into export processing areas. I will not dwell upon this point, but it is the case that the statistical office does not include imports into those

special zones in the import statistics, though it includes exports from those zones in our export data. As these special zones rapidly grew in importance beginning in the mid-1990s, part of the decline in intermediate good imports may be attributable to movement of export oriented business into those zones. Whatever the cause of the initial decline in intermediate imports, we experienced a precipitous decline in such imports at the end of 1997. Thus intermediate imports in 1998 were 36% lower than in 1997. Fortunately, though, once they fell in 1998, intermediate imports stabilized rapidly.

Unfortunately, the story behind capital good imports is more troubling. As you can see from this graph, those imports also fell sharply at the end of 1997. For much of 1998, we thought that these imports had stabilized at about 36% below their level for 1997. Then the data for 1999 began to become available and we realized that capital goods imports were continuing to fall. Over the last five months for which we have data, capital goods imports are 69% below the level that prevailed in 1997. It is hard to imagine that any sort of long-run recovery can be sustained if these imports do not recover substantially.

Driving this decline in capital good imports has been a complete collapse of investment. This is partly due to the problems in our banking system, which have still not been resolved and to the bankruptcy of much of corporate Indonesia. Bank restructuring and corporate refinancing are two critical issues that the current government must resolve. Until that happens there is little likelihood that domestic investment will recover.

However the investment problem in Indonesia is not simply a domestic one. It is also a problem of foreign investment, which utterly collapsed during the crisis. Prior to 1994, foreign investment approvals in Indonesia averaged somewhat more than \$8 billion a year. From 1995 through 1997, investment approvals, exclusive of petroleum refineries, which were never constructed, averaged nearly \$28 billion a year. In 1998, approvals fell back to \$8.5 billion and in the first six months of 1999 approvals were only \$1.9 billion. Clearly, Indonesia is no longer receiving significant amounts of foreign investment. This is not news, but it illustrates the need to revitalize this part of the formula that had led to Indonesia's impressive long-term growth record.

Related to the problem of investment is the weakness of our legal system. One of the problems that we have faced as we have tried to resolve our banking and corporate debt problems has been the weakness of our judicial system in enforcing our laws. For instance, early in the crisis we adopted a new bankruptcy law that was designed to speed the restructuring process. As we began to try to use the new law, it became clear that the judiciary was not able to implement the new law effectively. We recognize this weakness and are committed to taking the steps needed to reform the judiciary as quickly as possible. Unfortunately, this is a slow process that may very well take years.

Up until now, I have focused on the state of the Indonesian economy. However, the state of the economy has been and will continue to be dependent on the resolution of the political and social instability that has ravaged Indonesia over much of the past three years. I will now turn to a discussion of these factors.

In the many articles written about the economic crisis that has afflicted many countries in Asia over the past two and a half years, one often reads that the crisis has been most severe in Indonesia. That is almost certainly true. Sitting here today, we know that the rupiah has lost more value than other currencies in the region and the Indonesian economy has fallen further and suffered more from inflation as well. However, as late as the end of 1997, few would have guessed that this would have been the case. I still remember the very early days of the trouble in Thailand when IMF and World Bank officials would meet with the press and say that Indonesia's "fundamentals" were sound. Well we know now that they weren't, but it seems to me that they weren't that much worse than those of the other countries of the region.

I believe that what has distinguished Indonesia from the rest of the countries in the region has been the social and political turmoil that accompanied the crisis and that continues to this day. For over thirty years, the government of President Soeharto had held tightly to the reigns of power. While concerns were often expressed over the means by which control was maintained, the prosperity that the New Order Government was able to bring to the country made many people willing to ignore the excesses in some areas. With the beginning of the economic crisis it became clear to many that the compact between the government and the citizens had been broken. This led to calls for a greater level of participation in political life by people all over the country. Students took to the streets to demand greater democracy.

At the same time, the weakness of the economy strengthened the voices of those who had objected to the many excesses of the previous government in the field of economics. The rampant collusion, corruption, and nepotism that reigned during the boom years of the mid-1990s became unacceptable and unsustainable. This led to further calls for a new and clean government.

All of these feelings opened the door for the *reformasi* movement in Indonesia and which ultimately led to the downfall of President Soeharto. Unfortunately, the process that led to his resignation was violent and involved significant loss of life and property as well as unspeakable acts against some of our citizens. Even more unfortunately, neither of the two governments that have taken power since then seems to know how to channel the new found activism entirely to positive goals.

Today the most serious threats to the recovery of Indonesia as a country are political and social. The people of Aceh are calling for a referendum on independence for their province. Some of the people of Irian Jaya are also seeking to separate from the rest of the country. In many ways, these movements are merely the expression of desires for greater autonomy long suppressed by the government of President Soeharto. We are now seeking to address these concerns through a process of decentralization of authority and by returning to local government more of the value of their natural resources.

The even more serious threat to the integrity of the country comes from the violence that has plagued many areas of the country, but that has been particularly serious in Ambon, Ternate, and Halmahera, an area that we refer to as the Maluku Islands. This communal violence challenges the government's ability to maintain order and, given its religious overtones, threatens to spread beyond these areas, as demonstrated by the recent outbreak of violence on the island of Lombok as well as scattered evidence of religious-based violence on Java. The government is working hard to work with the people of the regions to address these problems, but given that the violence is not focused on specific issues, it presents more difficult problems than in other areas.

These are the problems that separated the crisis in Indonesia from the crisis in other countries. To illustrate this, I would like to show you a graph that plots total exports from Thailand and Indonesian non-oil exports on the same axis. Since Thailand does not export any significant quantity of oil or oil products, these are the two most comparable sets of export data. Export growth in Thailand was much higher than in Indonesia, on average, through 1995. But starting in 1996, Indonesia's exports continued to rise while Thailand's exports were stagnant, if not falling. It was not until late 1998 that the trends change. While it is difficult to see in this graph, Indonesia's exports fall more heavily than those of Thailand beginning in late 1998. This relates back to the increased level of social unrest in Indonesia during mid-1998. Thailand did not face similar problems. Thus, it is now exporting more than before the crisis while Indonesian non-oil exports are still below the levels attained in late 1997, early 1998.

What is the future prospects for Indonesia? I believe that they are very good, as long as we can resolve our own internal political differences. The unrest in Aceh and Maluku are creating political and social uncertainty that weigh heavily on the economy. We recognize that only when those issues are resolved we will be able to return to a path of sustainable growth.