OPEN FORUM
USINDO Brief
A PUBLICATION OF THE UNITED STATES–INDONESIA SOCIETY

"Indonesia's Prospects in the Midst of Global Financial Turmoil: Reflections on the Latest IMF Assessment"

An Open Forum With

Tom Rumbaugh
Assistant Director in the Asia and Pacific Department of the IMF

Bruce Bolnick
Nathan Associates

James Castle
CastleAsia

Joseph Stern
Harvard University

Co-sponsored by the International Monetary Fund (IMF)

September 23, 2009

Indonesia has emerged relatively well from the global financial turmoil and its economic performance so far this year is behind only that of China and India among the G-20 countries. On September 23rd, Tom Rumbaugh, Assistant Director in the Asia and Pacific Department of the IMF, presented on the recent IMF Staff Assessment of Indonesia. Following his presentation, three distinguished panelists, Bruce Bolnick of Nathan Associates, James Castle of CastleAsia, and Joseph Stern of Harvard University, commented on the assessment.

Tom Rumbaugh began his presentation by outlining Indonesia's strong performance overall, describing the country as one of the brightest spots in a gloomy global environment. Virtually every economy is facing negative economic growth; in the G20, only three countries have positive economic growth: China, India, and Indonesia. Indonesia's strong growth has been a surprise to many casual observers, but several factors are responsible for its success.

First, Indonesia entered the financial crisis from a strong position, with a strong current account balance, as well as sound macroeconomic policy decisions that have resulted in a more than halving of public and external and a doubling of foreign exchange reserves. Moreover, over the past decade the banking system has worked to decrease nonperforming loans and increase capitalization, while corporations remain profitable and had significant reserves heading into the crisis.

In comparison to other ASEAN countries, Indonesia has strong domestic demand and diversified exports, which also helped the country to weather the crisis. For example, the domestic demand growth strategy has allowed 20 to 25 percent of GDP to be based on domestic consumption. The export sector, meanwhile, was not overly reliant on a specific product or location. For this reason, Indonesia could still rely on exports to China when the United States went into a recession and import demand dropped.

Several of Indonesia's export commodities appear to be performing well, due primarily to exports to China, particularly coal and copper. Garment exports have done very well, with exports increasing sharply in May and June. However, despite the strength of domestic demand, Indonesia's outlook still depends on the strength of the global recovery. When global exports fell, Indonesia's exports fell, albeit not as dramatically.

Indonesia needs to continue work on fiscal stimulus. Indonesia, like most of the world, passed a stimulus bill in the beginning of 2009, but at least a partial retention of the stimulus plan into 2010 is necessary to maintain recovery. It is also important to maintain infrastructure spending, with a concrete plan for implementation. Election spending helped to boost the economy in 2009, providing its own stimulus, which in fact had a greater impact on boosting demand than the central government's stimulus package. While Indonesia is planning to reduce the current fiscal deficit from 2.5 percent of GDP to 1.75 percent in 2010, this may be too steep of a drop given that the money could be used for infrastructure and spending on much needed social programs.

Despite its success, there are several risks facing Indonesia's ability to maintain economic growth. On a macroeconomic level, if there is a return of global risk aversion, if the recovery is not sustained, or if a double-dip recession occurs in developed economies, Indonesia could be negatively affected by inherently volatile capital flows.

There are also inflationary risks – the country has trended towards an 8 to 10 percent inflation rate, which, says Mr. Rumbaugh, carries a cost. For example, bond spreads in Indonesia are generally higher than comparable countries such as the Philippines, due in large part to the legacy of the 1997 crisis, but also because the country has always had higher and more volatile bond premiums.

Is Indonesia's economy ready to join the ranks of BRIC countries (Brazil-Russia-India-China) ? Mr. Rumbaugh explained that this will depend on Indonesia's ability to maintain high growth. Sustaining high growth can be achieved by strengthening the credibility of monetary and fiscal institutions, which will help lower bond spreads; sustained infrastructure investment, as well as structural reforms, including energy subsidy reforms, are also important.

Following the presentation by the IMF, **Bruce Bolnick of Nathan Associates** discussed Indonesia's vulnerabilities, the role of the IMF in Indonesia, and results of the IMF Staff Assessment.

Nathan Associates worked with USAID to ascertain which countries appeared to be most vulnerable to economic crises; Indonesia was not on the list of 30 countries identified. It was not included for many reasons: Indonesia's banks are sound, it has low exposure to toxic assets, the government is in a strong fiscal position, the central bank has adequate foreign exchange reserves and strong access to additional reserves and the country has a stable political outlook, even in the lead up to an election. However, this does not mean that Indonesia will completely avoid any adverse effects. The exchange rate remains sensitive to large capital outflows, and commodities are sensitive to declines in demand and prices, as is the manufacturing sector, which both have potential feedbacks into the banking sector.

According to Mr. Bolnick, the IMF analysis is very useful, both from a technical and policy perspective, for the host governments. He notes that the analysis in the Staff Assessment is perhaps too conservative. In the past, the IMF focused almost exclusively on Balance of Payment (BOP) issues, but since 1998 has paid more attention to the impact of its recommendations on economic growth and poverty reduction, countercyclical policy implications, in addition to recommendations for responding to crises.

Mr. Bolnick noted that the IMF identifies in its Assessment three main policy challenges faced by Indonesia: macroeconomic monetary and fiscal policy, the safety and stability of the financial sector, and the potential stresses to BOP and FX reserves. However, the report goes on to say that these are not the major issues Indonesia needs to be focusing on for sustained growth. The main issues, according to Nathan Associates analysis of the country, are: rule of law and corruption issues, lack of infrastructure spending, and the ongoing challenges of decentralization that have led to a complex and disparate regulatory system for investors, lack of investment in education, and job creation.

Professor **Joseph Stern of Harvard University** began his comment by noting that Indonesia's recovery is an astounding development. He focused his comments on what may have allowed such recovery in a country so devastated during the 1997 crisis.

First, there has been a remarkable transformation of political system. Amendments to the Indonesian constitution provide a distinction in legislative and executive branches, in addition to the establishment of a separate judicial branch with several new courts to monitor constitutional issues. Amendments also include strong statements on human rights, protection for women, freedom of speech; many other countries still lack such provisions. While enforcement is still lacking, the amended constitution is a major improvement, and provides a framework for the institutions that are an important part of Indonesia's current economic success.

There are still a number of issues with which the country must deal, in addition to the improvements already made. Court cases drag on, which creates disincentives for progress in attracting investment and business. In addition, the country needs to focus more on social issues, especially on education. Education remains a major weakness – Indonesia does not produce enough graduates who can manage a modern state, and will face significant issues when the current generation of leaders begins to retire. Corruption is a longstanding, and remains a major, issue. While measuring corruption is difficult, and Indonesia has improved some in the Transparency International rankings, it is still considered to be very corrupt. For example, while decentralization has been in many ways a step forward in Indonesia's reform, it has also served to decentralize corruption, which makes it more expensive to do business, and can lead to evenmore corruption.

Ultimately, Professor Stern is very optimistic about Indonesia's progress in the short term. His main concern is what will happen when the current president, Susdilo Bambang Yudhoyono, reaches his constitutionally prescribed term limit, and whether he will exit the political arena and leave room for a new political leader to emerge peacefully. In addition, while the economic growth rate has certainly been impressive, the economy is not yet performing at the level it needs to be at to continue to reduce poverty and promote job creation.

Jim Castle of CastleAsia began his remarks by noting that Indonesia disappoints both the optimists and the pessimists – while the economy it is performing very well, the performance is still sub-optimal. For example, Indonesia has a reputation for being a poor manufacturing country, yet the garment manufacturing sector held up well during the current crisis. While few foreign manufacturing companies left Indoensia during the 1998-1999 crisis, they did not add capacity. And, although the sector is productive, it looses its competitive advantage because of poor infrastructure.

Mr. Castle believes that there will be some small breakthroughs in infrastructure investment over the next five years, but the government has thus far been unable to develop a politically acceptable means to raise the capital needed for major infrastructure projects. The state-owned enterprises are currently in charge of all major infrastructure projects, a situation which presents a major obstacle to private sector financial investments in infrastructure. However, a new law was recently passed that allows regional governments to build power plants and sell to an independent distributor, rather than the state distributor, PLN.

According to Mr. Castle, this may be the first step in ending the domination of the state-owned enterprises in Indonesia. It may also lead to the development of a municipal bond market, allowing municipal and regional governments to raise capital independently for their own projects. While there is not enough local currency available to finance large-scale infrastructure projects, this model can work for small to medium sized projects.

Decentralization has also allowed for the development of regional elites. Through the year 2000, 60 to 65 percent of all deposits were made in Jakarta, which had only 10 percent of the population

Mr. Castle does not think that Indonesia will benefit much from its natural resources in the next five years, due primarily to issues related to exploration rights. Thus, expect to see little in the way of investment in exploration for oil, gas and minerals, despite anticipated high commodity prices.

Because Indonesia has weathered the crisis so well, there is a real danger of complacency. Mr. Castle noted that Indonesia may have recovered too quickly, and was not forced to make any hard choices that would have led to the necessary reforms. If the country does not invest in infrastructure, promote job creation, and reform rule of law, the next 10 years could see a swift reversal of fortune.

Following the presentations, the panelists took several questions from the audience.

Q: What do the panelists advise Indonesia to do to avoid the "middle income trap", where rising developing countries face stalled growth?

A: Tom Rumbaugh: As Jim Castle noted, Indonesia has always been a resource and potential rich country, but always suboptimal in resource and potential. Thus, it needs to continue to advance in terms of strengthening institutions. From an economic policy, everyone lauds Indonesia's macroeconomic monetary and fiscal policies, which are extremely important, but if you look deeper into efficiency of fiscal policy, you see very low infrastructure spending, poor implementation capacity, and problems with civil service reform. These are the issues that need to be addressed now to avoid the middle income trap.

A: Jim Castle: Indonesia can work right away on improving investment in infrastructure. It also has to figure out a way to shift the social safety net away from subsidies – target them toward poor and low income, and not the rich. A new policy substituted an energy subsidy for direct payments to the poor worked well, and should be continued. He recommended picking a few key projects and working to solve everything that needed to be fixed on those issues, instead of waiting for an official government reform program. By solving the case rather than the underlying issues, the underlying issues will resolve themselves.

A: Bruce Bolnick: Investment in infrastructure is key, as is investment in science/technology/management education to develop the human capital necessary to avoid the middle income trap.

Q: There is a difference between honest graft and dishonest graft. Dishonest graft is when you pay money and do not get anything for it. Honest graft is where you pay money, but you get something for it. In contrast to other countries, in Indonesia you get something for the corruption, thus you can have economic growth and corruption. But the other aspect is that people began to see that this was the only way to do business, and it becomes difficult to change the mindset when you do see benefits of corruption.

A: Joseph Stern: Some corruption probably speeds up the process, thus being totally honest can lead to delays. The issue is where do you stop - is it okay for building of a hospital, or the building of a toll road to get to hospital? Where do you stop?
A: Bruce Bolnick: Regulatory reform is critical – for example, reducing degree of discretion rather than trying to get people to report irregularities and corruption.

Q: Indonesians are committed to development, even with corruption. Why do they not change the incentive system, for example, modeling after Singapore where government workers are paid a livable salary, or making the local budgets public so that politicians would be more accountable to citizens?

A: Joseph Stern: While civil servants probably deserve more money, no amount of a raise will stop corruption. There is no evidence of declining marginal utility of pay versus corruption. Singapore is unique - a city state with a relatively uniform population that is a bad model for Indonesia. Thus, while a better salary would help the workers, it would not do much to wipe out corruption.

A: Tom Rumbaugh: While civil servants probably need to be paid more, Indonesia probably also needs to reduce the number of civil servants, thus it is a tricky reform to undertake.