

7. POLITICAL AND ECONOMIC ENVIRONMENT

Overview

- Over the last five years Indonesia has undertaken major changes to its structure of governance—moving from a highly autocratic model under President Soeharto to a democratic and decentralised system under President Megawati Sukarnoputri. While support for personalities and parties will continue to fluctuate, analysts consider the fundamental contours of the national political landscape unlikely to change dramatically over the next five years.
- Indonesia's macroeconomic indicators are positive, with growth forecast at 4.5% for 2004, rising foreign exchange reserves and inflation coming under control. The banking sector is functioning and the corporate sector is well into recovery mode.
- In the medium-term, growth of around 6% will be necessary to employ the available workforce and underpin economic and political stability. The Indonesian Government and World Bank believe this is achievable. Some other commentators believe the Government has more to do to secure the stronger foreign investment flows needed to achieve this growth objective.
- Although serious for the immediate participants and localities, regional disturbances have had limited impact upon the nation and its economy as a whole. The Bali and Marriott Hotel bombings were the work of extremists with very little support from ordinary Indonesians—most are proud the terrorists have been captured and brought to justice quickly.
- There are on-going concerns about Indonesia's weak judicial system, certain aspects of decentralisation—especially regional levies which increase business costs—some labour militancy and low levels of productivity compared to important competitors such as China.
- In all, however, Indonesia has made an impressive transition during the past 5 years. While it still faces many challenges, it is a neighbour Australia should respect and build strong ties with, an economy that should not be underestimated, and a food market that serious exporters should not ignore.

The Indonesian market in context

Developments in Indonesia during the Asian economic crisis of 1997–98 impacted heavily on the market for Australia, and for food exports in particular. Whilst the Indonesian economy and the political situation since then have improved, they will continue to influence the 'comfort level' of Australians doing business in Indonesia. Accordingly, the background to Indonesia's emergence from its political and economic crises, including a brief historical overview is discussed below.

The Soeharto era

During over 30 years of strong but increasingly authoritarian rule by President Soeharto, Indonesia achieved rapid economic development, with average GDP growth of over 6.5% per annum, and economic wellbeing at all levels of society improved.

On the other hand, this period also saw the increasing centralisation of power in Jakarta in the person of the President and through the military.

In the Soeharto era, the Dewan Perwakilan Rakyat (DPR, lower house) comprised 425 elected members and 75 appointed by the military. The Majelis Permusyawaratan Rakyat (MPR, upper house) comprised the members of the DPR and a number of appointed persons representing regions and certain social groups. The MPR normally met every five years to elect the President and the Vice President and to set broad policy guidelines for the government. The President was not accountable to the DPR.

Political parties were regulated. The President endorsed the dominant political party, Golkar, which all civil servants were required to join.

The power of the central government in Jakarta was transmitted effectively through five levels of administration (national, provincial, district, sub-district and village) so that programs—such as, for example, education and health care—could be implemented across the archipelago in a relatively uniform way.

While there were many good results from such programs, this autocratic system stifled local initiative. Village heads looked to higher levels of government for direction rather than to the people of their communities. Provincial governors were appointed by the President. The Dwifungsi (Dual Role) policy placed a representative of the military in every village, enabling direct army influence on local affairs. President Soeharto made key military and provincial governor appointments.

Pressures for change

Centralised control of governmental decision-making, combined with patronage of certain commercial interests, resulted in domination of industries, regional enterprises and major projects by the Jakarta elites. Large corporate conglomerates—such as Indofood—emerged, many under Presidential patronage.

Some industries—notably timber and cloves—had licensing arrangements that delivered control and benefits to interests associated with the Soeharto family. This fed resentment and demands for regional autonomy.

More generally, a highly educated and articulate middle class was emerging. It sought more participatory government and had concerns about issues such as human rights and the environment. The Government's discouragement of political activism was successful with President Soeharto's own generation, but the next was increasingly sceptical, particularly those that did not benefit from patronage.

While Indonesia had prospered over thirty years, there were serious weaknesses in key institutions of government and poor corporate governance. Weak national institutions did not deal effectively with the burgeoning private banking sector (with 240 private banks at one point), some of which were owned or controlled by entrepreneurs linked to the Soeharto family. Large publicly owned banks were also weak and subject to political direction in regard to loans to favoured parties—which were often not repaid.

A further element in this volatile mix in the late 1990s was the rapid growth in short-term debt, in many cases, with scant due diligence. Indonesian entrepreneurs eagerly accepted the cash and many became highly geared.

The Asian economic crisis and the fall of Soeharto (1997–98)

In 1997, economic crisis unfolded across East Asia and Indonesia was particularly badly hit. The rupiah plummeted and business confidence collapsed, with foreign debts virtually unrepayable at the lower exchange rates. Indonesia sought and received international assistance, principally through the IMF in the form of US\$43 billion in standby loans.

President Soeharto and his advisors struggled with these issues and came into conflict with the IMF's recommendations for structural adjustment. Although he had been re-elected unopposed by the MPR early in 1998, there was considerable, but largely unarticulated opposition to his continued tenure. The economic crisis caused the collapse of his legitimacy,

which had been built upon delivering growth. After extensive student demonstrations and riots in Jakarta he agreed to step down in favour of his Vice-President, BJ Habibie.

The Habibie Presidency: Transition and decentralisation (1998–99)

President Habibie, an aeronautical engineer, had served as Minister for Technology under Soeharto and, in his final term, as Vice President. He led the development of the commuter aircraft manufacturing industry in Indonesia. He was an energetic President but was not popular. President Habibie held office until elections were held under new rules in June 1999. As President, Habibie introduced a number of reforms including liberalisation of the press and deregulation of political parties.

As part of a program agreed with the IMF, many market distorting regulations and monopolies were abolished. More significantly, he oversaw legislation to devolve substantial powers from the central government to the regions. His government also agreed to a plebiscite in East Timor that led to independence for that territory. Civil unrest in various forms continued however, and there was a damaging financial scandal.

Of particular significance for business, regional autonomy laws introduced by Habibie provided for all government functions to become the responsibility of district/city governments from 2001, other than defence, foreign affairs, the judiciary, religious affairs and trade. These reforms by-passed provincial governments, which retained a coordinating role but with much less authority than previously.

New financial arrangements were introduced to move a significant part of the national budget to the regions and enable the sharing of the resource rents (e.g. from oil and gas, forestry, coal and other minerals) that previously went to the central government.

There have been two major criticisms of these reforms. The first is that they were broadly drafted and are subject to interpretation, including by subsequent decrees and/or regulations. The second is that their introduction was rushed and implementation has proved messy and complicated.

In late 2003, the Government began considering measures to re-centralise some powers and strengthen the provincial level of government. Most analysts believe that these adjustments may help foster a more predictable and stable business environment, but that a wholesale reversal of decentralisation would be unhelpful.

The Wahid Presidency (1999–2001)

In 1999, Abdurrahman Wahid was elected President, a noted Islamic scholar and former leader of a 40 million-strong rural based Islamic body and leader of the People's Awakening Party (PKB). Megawati Soekarnoputri, leader of the Democratic Party for Struggle (PDI-P) and daughter of Indonesia's first president, became his deputy. President Wahid was a professed democrat and pluralist of long standing, committed to secular government. During his presidency he lifted restrictions on the public use of the Chinese language and religious and cultural practices. President Wahid personally took part in Chinese New Year celebrations.

But President Wahid's presidency was brief and widely regarded as chaotic. During this period, security problems arose in four provinces (Maluku, Kalimantan, Aceh and Papua). Some of these troubles were widely believed to have been orchestrated by anti-reform elements in Jakarta. Others were probably the natural outcome of the weakening of state authority and consequent release of latent inter-communal tensions. Still others were the work of criminal elements.

President Wahid had appointed new commanders to the armed services who were committed to reform and democratic principles, but he was unable to effectively deal with inter-communal conflict, particularly in Maluku. The IMF curtailed assistance because of Indonesia's failure to comply with its loan conditions and relations between the President and the parliament deteriorated.

Eventually the parliament exercised its prerogative of impeachment and President Wahid was removed from office to be replaced by Vice President Megawati Sukarnoputri. Hamzah Haz, the leader of the small Muslim-based United Development Party (PPP), was elected Vice President.

President Megawati stabilises reforms (2001–04)

While President Megawati has not overseen radical change, her tenure has brought a new measure of stability. She is supported by some well-qualified and competent ministers and advisers.

One of the most important achievements of this transitional period, and of President Megawati's presidency, has been the drafting and enactment of constitutional changes to entrench the democracy reforms and make government more workable. The President and Vice-President are now to be popularly elected. There will be, from 2004, two chambers of the parliament, a representative chamber elected by popular vote and a chamber comprising representatives of democratically elected regional parliaments.

At the regional government levels, more participatory and democratic governance structures are in place and appear to be operating tolerably well despite fuzzy boundaries between the functions of the different levels of government. One major issue is that regional governments, especially at the district level, have implemented a plethora of regulations, some of which increase costs and may make investment in those areas less attractive.

Ongoing political unrest at the regional level, particularly in Papua and Aceh where there are significant movements opposing the Indonesian Government and seeking secession, remains a concern. Troubles in other areas including Maluku have been inter-communal in nature, not secessionist, and have largely settled down. However, such troubles have less impact upon the country as a whole than might be imagined, as they are at relatively remote ends of a sprawling archipelago of 17 000 islands populated by more than two hundred million people.

Similarly, the existence of radical Islamic movements—principally Jemaah Islamiyah—has been dramatised by the Bali and Marriott bombings. But they only represent a small minority of Indonesian Muslims. The great majority of Indonesian Muslims are moderate and do not support an Islamic State or the introduction of Sharia (traditional Islamic) law. The quick and effective action by police to arrest the Bali bombers and bring them to justice has been a source of pride to most Indonesians.

No one would dare to predict that terrorism is at an end in Indonesia but it can be said that it has not noticeably affected the reform process and its impact on the macro economy has so far been manageable.

Economic recovery – how much is enough?

Economic recovery, which started in 1999, was initially weak and the limited availability of credit from the finance sector impeded activity. Nevertheless non-oil export volumes did begin to grow strongly on the back of a low rupiah exchange rate.

GDP growth reached 4.8% in calendar 2000. It then dipped and rose again to 3.5% in 2002 and an estimated 3.8% in 2003.

Overall, the economy has performed reasonably well in recent times, despite the further setbacks of two serious terrorist attacks, SARS and slow world growth. One particularly positive development has been the emergence of a strong small and medium-sized enterprise (SME) sector alongside the large and longer-established business conglomerates, many of which are still working off the effects of the crisis. Well managed SMEs are leading the recovery to a significant extent, particularly in the food processing sector.

A renewed sense of political stability is reflected in strong consumer demand: consumption spending has risen to 20% above pre-crisis levels, although growth is now slowing. It is also reflected in a strengthening currency and a rising stock market. These trends are amply apparent in the new residential complexes, shopping malls and other modern retail and food service outlets that are multiplying in various parts of Jakarta and other major cities.

On the other hand, investment has been much slower to recover. Gross inflows of Foreign Direct Investment (FDI) and portfolio investment in 2003 were US\$1.6 billion and US\$1.4 billion respectively, but were outweighed by private sector outflows of US\$8.4 billion.⁵⁰ A rise of 35% in the total value of new FDI projects approved in 2003, to US\$13.2 billion, was a more positive sign.⁵¹ This should be a leading indicator for stronger FDI flows in future years although a significant part of this growth is apparently accounted for by a change of status of some companies from domestic to foreign.⁵²

Refloating business

Whilst much remains to be done in the banking sector it is performing much better in recent years. Non-performing loans are now closer to acceptable parameters and credit is flowing again. An important ingredient of the present consumer spending boom is availability of consumer credit both from Indonesian and international sources.

Agencies were set up from 1999 (principally the Bank Restructuring Agency or IBRA) by the Indonesian Government to deal with, respectively, rescue by recapitalisation or closure of insolvent banks and management of corporate indebtedness. A new bankruptcy law was enacted to help deal with the latter as many technically bankrupt companies continued to trade. Also, a system of negotiated settlement, known as the Jakarta Initiative, was established. These mechanisms have had some success.

However, relatively few companies have been brought before the Bankruptcy Court and of those, few have been closed down. In the celebrated case of Canadian-owned Manulife Insurance, the Court attempted to prosecute a perfectly viable international company that was in dispute with its former Indonesian partners. This drew international attention to weaknesses in Indonesia's legal system although the case was eventually resolved.

Source: INSTATE research.

An important factor in the slow recovery of FDI in Indonesia is China's pre-eminence as a competitor destination for inward investment, which should encourage Indonesia to adopt measures to improve the investment environment. In particular, investors are looking for more consistency and fairness in the regulatory and legal systems. One structural challenge is Indonesia's slipping competitiveness in labour-intensive export industries—garments, textiles, footwear and toys. These accounted for 43% of exports in 1995 but only 34% by 2002. Again, China is a formidable competitor for these industries.

The rupiah has been appreciating and inflation has dropped from over 10% in 2002 to 6–7% for calendar 2003.⁵³ Foreign exchange reserves, at around US\$36.6 billion, are healthy and Indonesia is paying off debts incurred through the crisis. Public sector debt is high, at 72% of GDP at the end of 2002, but the World Bank has calculated that this ratio can be reduced to below 50% by 2008 and pre-crisis levels by 2016. By comparison, Thailand's debt ratio rose to around 60% in 2002 and the Philippines debt is estimated to be around the same level.

Despite the resumption of economic growth, Indonesia will need to do more to adequately employ its growing workforce:

Among policy makers and local commentators, the general rule of thumb is that Indonesia needs approximately 6% growth to accommodate the expanding workforce, and to make headway in re-integrating displaced workers within the formal economy. According to Bank Indonesia, growth of 3.5% in 2002 was only sufficient to absorb 1.2 million workers out of the 2.5 million expansion of the workforce.⁵⁴

The Indonesian Government believes that growth can be accelerated and has estimated that growth in 2005 and 2006 may reach as high as 6%. The World Bank has commented that its 'best picture' medium growth target is also 6%. McIntyre and Resosudarmo comment:

There is a rough consensus on many of the policy ingredients that would be needed to re-ignite rapid economic growth: continued macroeconomic stability, accelerated reform of the financial sector and specific measures to improve the investment climate, especially in the labour-intensive

⁵⁰ International Monetary Fund, 2004.

⁵¹ Badan Koordinasi Penanaman Modal, *Investment Board Casts Doubt About Prospect in 2004*, 2004, viewed 12 February 2004, <http://www.bkpm.go.id/en/board.php?mode=baca&message_id=210>.

⁵² DJ Ray, 'Survey of Recent Developments', *Bulletin of Indonesian Economic Studies*, no. 3, Australian National University, Canberra, December 2003.

⁵³ Ray, 2003.

⁵⁴ A McIntyre and B Resosudarmo 2003, 'Survey of Recent Developments', *Bulletin of Indonesian Economic Studies*, August 2003, Australian National University, Canberra.

export sector. The problem, of course, is forging agreement within and between the executive and legislative branches of government on enacting such reforms.⁵⁵

2004 and beyond

Much will depend upon the style and quality of leadership following the parliamentary elections held in April 2004. The presidential election will have its first round in July 2004 and, if necessary, the second round will be in September 2004 with inauguration in October 2004.

As noted above, analysts believe further policy adjustment and reform is needed to address outstanding economic and structural issues, but there is much evidence of vigour in the private sector amongst the better managed big companies and many SMEs. The overall impression is one of stability and progress, albeit patchy and uneven in pace.

In all, Indonesia has made an impressive transition during the past 5 years. While it still faces many challenges, it is a neighbour Australia should respect and build strong ties with, an economy that should not be underestimated, and a market that serious exporters should not ignore.

⁵⁵ A McIntyre and B Resosudarmo, 'Survey of Recent Developments'.