Restarting Growth: Indonesian Policy Reform in the aftermath of the Crisis.

Mohamad Ikhsan and William Wallace *

*) Lecture at University of Indonesia and Special Advisor to the Coordinating Minister for Economic Affairs and Lead Economist at the World Bank Jakarta
What are going to present today?

- An outline of a case study on Indonesia—focused on strategy and implementation of economic reform post crisis.
- progress so far
Why a case study on Indonesia?

- Indonesia is a big, diversified and heterogeneous country
- It has a remarkable growth episode for over 30 years but has struggled to restart high growth since the crisis in 1997
- There are also a number of transitions occurring
  - From a centralized to a decentralized regime
  - From an autocratic to a democratic system.
  - From lower income to middle income
Indonesia ten years later

Per capita growth

- Gradually growth has picked up and income has recovered to pre crisis levels
- But it growth rate is still well below pre-crisis levels.
Indonesia ten year later:
Sources of growth

- Growth (and recovery) have relied on consumption and, to a lesser extent, external demand.
- Investment is still quite low compared to pre crisis level.
- However Indonesia is not alone. Many crisis affected countries face are seeing the same thing.

<table>
<thead>
<tr>
<th>Year</th>
<th>HH Consumption</th>
<th>Gov Consumption</th>
<th>Investment</th>
<th>Export</th>
<th>Import</th>
<th>Aggregate Demand Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-96</td>
<td>8.8</td>
<td>2.9</td>
<td>10.9</td>
<td>10.4</td>
<td>12.8</td>
<td></td>
</tr>
<tr>
<td>2000-06</td>
<td>3.6</td>
<td>8.2</td>
<td>7.1</td>
<td>10.1</td>
<td>11.2</td>
<td></td>
</tr>
</tbody>
</table>

Table 3: Fixed Investment (as % of GDP)- Pre and Post Crisis Periods

<table>
<thead>
<tr>
<th>Country</th>
<th>Peak</th>
<th>Bottom</th>
<th>Latest in 2006*</th>
<th>Bottom-Peak (extent of decline)</th>
<th>Latest - Bottom (extent of recovery)</th>
<th>Latest - Peak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>29.6</td>
<td>19.4</td>
<td>21.5</td>
<td>-10.2</td>
<td>2.0</td>
<td>-8.2</td>
</tr>
<tr>
<td>Korea</td>
<td>37.5</td>
<td>28.0</td>
<td>28.0</td>
<td>-9.5</td>
<td>0.0</td>
<td>-9.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>43.6</td>
<td>20.0</td>
<td>20.4</td>
<td>-23.6</td>
<td>0.4</td>
<td>-23.2</td>
</tr>
<tr>
<td>Philippines</td>
<td>24.4</td>
<td>14.6</td>
<td>14.6</td>
<td>-9.8</td>
<td>0.0</td>
<td>-9.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>41.1</td>
<td>20.8</td>
<td>29.6</td>
<td>-20.2</td>
<td>8.7</td>
<td>-11.5</td>
</tr>
</tbody>
</table>

Source: World Bank, * until the second or third quarter depending on data availability.
Indonesia ten years later: old patterns and new problems

- Despite lower inflation worldwide Indonesia has struggled to reach regional norms in spite of the creation of an Independent Central Bank.

- Exchange rate volatility in Indonesia is the highest among the emerging market countries.
Indonesia ten years later: Macroeconomic stability still a key problem

- Growth (lower), exchange rate (more volatile) and inflation (again high, but more volatile), has resulted in investment climate surveys consistently putting macroeconomic instability as among the most important obstacles to an improved investment climate.
Indonesia ten years later: and poverty reduction has slowed and unemployment risen

Indonesia: Trend on Unemployment

Indonesia: Trend on Poverty Rate
Indonesia ten years later: Indonesia’s now less vulnerable

Source: IMF staff calculations.

Figure 2
Indonesia: Macroeconomic Risk Indicators -
Public Debt to GDP Ratio, 1996-2006

Sovereign Default Probability
(1-Year Risk-Neutral)

Credit Spreads
(Basis points)

Source: IMF staff calculations.

Table 1
Expected Banking Sector Losses 1/
(1 year horizon, in millions of US$)

Source: IMF staff calculations.
1/ Sample of 9 private and 3 public banks.
the case study is intend to look at

- Indonesia’s experience dealing with economic growth post crisis period from the political economy as well as economic perspectives
- Parallel reform efforts:
  - Reestablishing macroeconomic stability especially through fiscal consolidation,
  - Restarting growth and investment through investment climate reforms
- Policy Question: Why were macro/fiscal reforms more successful than investment climate reforms?
The Report

- **Structure**
  - The Indonesia’s economy: ten years after the crisis
  - Indonesia Policy Reform Post Crisis
  - An Assessment. Lesson Learned and the Way Forward.

- **Status**
  - The ten years after and policy reform sections are well underway, the assessment not yet
I. Indonesia - Ten Years after the Crisis

1. Background
2. The Reform Agenda, what has been achieved
3. Posing the Problem: why has been easier to reestablish macro stability and fiscal consolidation (including accompanying institutional reforms) than to improve the investment climate and get infrastructure untracked?
II. Indonesia Policy Reform Post Crisis


Linking government commitment (1) through political process and enabling environment (institution) to the process of reform (setting the priorities, marshaling support, getting endorsements, implementation and sustainability)
II. Indonesia Policy Reform Post Crisis
Some thoughts

- Reform processes take place in an environment where political economic factors critically shape and condition efforts
  - Political economy is the interrelationship between political and economic reform processes and institutions – policy decisions
- Reform involves politics because it requires collective action in an environment characterized by conflicting perceptions and interests.
- Policy reform takes place in institutions that condition the initiation, design and implementation of the program
- The role of politics and institutions is related and they move together through various stages of reform.
- The process is typically iterative rather than sequential
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Identifying the process

- Several steps:
  - Initiating reforms
    - How was the problem initially identified and put on the priority agenda
  - How was it subsequently managed
    - Presentation
    - Endorsement
    - Implementation
    - Sustainability (reducing reversals)
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The Political Economy Dimension

- The political situation post crisis has been characterized by numerous, splintered and weak parties, with limited ideological bases and few policy resources
  - Political expediency has led to having Minister’s in the cabinet from parties whose allegiance was divided at best, creating inherent coordination problems (a typical transition to democracy problem)
- The appointment of these political Ministers was a major break with the technocratic system and institutions established under Soeharto.
  - Ministers were typically unprepared, there was no shadow cabinet, and no position papers leading to additional coordination problems due to widely differing levels of substantive expertise, management skill and knowledge of how to work with the bureaucracy
  - This was compounded by relatively short tenures of each Presidency until recently (insufficient time to learn on the job).
- Big Bang decentralization (another story) led to a significant redistribution in the control of resources to regional governments (particularly at the regency level) – Again leading to inherent coordination problems (vertical this time)
- Resources were constrained: The crisis cost the government significantly and debt to GDP ratio reached 100 %, from around 20% pre-crisis.
  - most of the reform agenda was initiated when the central government had limited resources affecting priority setting.
- Distrust was high:
  - Within the executive branch and the executive and the legislative
  - Between the people and the government
II. Indonesia Policy Reform Post Crisis

The Institutional context

- Without strong leadership institutional inertia set in
  - Most of new institutions created post crisis have been ill adapted
    - Poor design (?)
    - Lack of capacity and poor incentives
    - Institutional and bureaucratic resistance
- The capacity of important ministries was degraded
  - Lack of new staff recruitment and effective training led to understaffing at a point when new areas of expertise were needed
- The mandate of the National Planning Agency (Bappenas), a traditional source of technocratic reform, was very uncertain
  - Downgraded in status during the Wahid Administration
  - Chemistry problems during the Megawati Administration.
  - Changed role under the state finance laws.
- The IMF (and letters of intent), the World Bank and the CGI.
  - A two edged sword: on the one hand they provide useful finance and associated policy guidance (including checks on populism), on the other hand they can create counterproductive resistance
II. Indonesia Policy Reform Post Crisis

The Institutional context

- Post crisis sustained government initiated reforms have largely derived from Bappenas White Papers, the IMF Exit Strategy, the SBY Government’s 100 days policy action and most recently the Medium Term Development Plan

- Setting the priorities: Fiscal Trilemma
  - Reestablishing macroeconomic stability and restoring confidence was the first priority as credible and sustained reductions to the debt overhang were needed to reduce the risk premium and crowd in private investment.
  - As fiscal consolidation improved investment climate reform packages were initiated
II. Indonesia Policy Reform Post Crisis

Establishing reforms

- **Reaching the Agreement on approach (within the government)**
  - On the broad priority setting-up: there was almost no debate that macroeconomic stability and restarting investment were critical
    - Propenas and the IMF letters of intent reinforced this
    - The economic team was generally cohesive
  - But the bureaucracy was able to enact budgets and revise institutions around the fiscal agenda but the detail of reforms requiring more coordination and challenging vested interests i.e. the investment climate were always more difficult to agree on

- **Getting it accepted and enacted (the parliament and the people)**
  - Using the crisis of a window of opportunity for reform
  - Essential fiscal conservatism and post crisis aversion to debt made it easy to convince audiences about the need for limited budget deficits, although there was always a strong minority that wanted a) more fiscal stimulus and/or b) debt repudiation
  - Outside the government there has been less clarity in thinking about improving the investment climate, especially for foreign investment around nationalism, rent seeking etc.
II. Indonesia Policy Reform Post Crisis

The Reform Process

○ Implementing it
- Relatively fewer actors are involved in macro/fiscal – even the more difficult institutional reforms at Finance are generally limited to within one ministry
- Improving the investment climate, including infrastructure and trade are areas spread across ministries, and many reforms trigger bureaucratic resistance due to capacity and interests
  - The role of leadership is essential even at the implementing level (comparing the reform process under B & SM leaderships and others)
  - The involvement and ownership of the bureaucracy is one important determinant of the reform outcomes
II. Indonesia Policy Reform Post Crisis

The Reform Process

○ *Sustaining it*

- At the policy level Macro/fiscal success leads to a relatively clear virtuous circle making it easier to maintain once the process is well underway.
  - However, while the framework for fiscal institutions reforms was set it has been more difficult to implement as a) structures do not reward reform as a process rather than a project and b) civil service structures are often antagonistic.
- Investment climate reforms even those agreed on have been characterized by continuing differences and difficulty in locking them in.
  - The current process of implementing investment climate reform is a good example. But the current Parliamentary process indicates that perceptions can change leading to improved economic outcomes rather than less effective investment outcomes driven by nationalist or populist sentiment.
  - Unbundling the investment climate reform is another solution and focusing on the workable action programs.
III. An Assessment. Lesson Learned and the Way Forward

- Were the priorities correctly identified and the strategy broadly correct given the constraints? How inclusive were the results, for example what do we know about why growth is less pro-poor and generating less employment for example?
- In retrospect what should have been done differently?
- Where does Indonesia go from here?
  - What is the potential growth rate?
  - Is there a trade-off with democracy?
  - What does the country need to do to get there?
  - How do we make it more pro-poor, more pro-job? – hope the commission will help with the answers.
The parameter conditions are also reflected on the economic outcomes.
Contrasting the result

Investment Climate

Fiscal Consolidation

Investment Climate Monitoring:
% respondent reporting obstacles to be moderate, severe and very severe

- Land Procurement
- Telecommunication
- Manpower Practice
- Financial Access
- Crime, Theft and Chaos
- Customs & Trade Regulations Local Government
- Customs & Trade Regulations Central Government
- License & Permits Local Government
- Labor Regulation Local Government
- Labor Regulation Central Government
- License & Permits Central Government
- Labor Data Collection
- Tax rate
- Legal System & Conflict Resolution
- Cost of Finance
- Tax Administration
- Electricity
- Corruption Central Government
- Transportation
- Corruption Local Government
- Economic Policy & Regulations Uncertainty
- Macroeconomic Instability

ADB (2003)  Phase 2 (Dec 05)  Phase 3 (Sep 06)

Figure 2
Indonesia: Macroeconomic Risk Indicators - Public Debt to GDP Ratio, 1996-2006

- Public Debt to GDP
- External Public Debt to GDP
- Public Debt to Revenue

Indonesia: Trend of Non Oil and Gas Tax Revenues (% of GDP)

Conclusion: Implementing the reform

- It must start with credible and feasible agenda
  - Taking to account political constraint is necessary
  - Consider all possible negative side effects
- Priority is essential
- Need to manage expectation
  - Reform should not be oversold
- Setting the pace and sequence of reform is really art.
  - Need to have as full as possible knowledge of constraints and opportunities
  - Crisis can increase opportunity.
- Need to have reform champions
  - Role of bureaucracy is important.