

INDONESIA

MACROECONOMIC UPDATE

Current Developments, Policy Implementation and Assessment

Macroeconomy stable but fragile

Latest events in Indonesia bear out the key message of our most recent economic report¹ – that the country's newfound economic stability remains highly fragile. The sudden upsurge in violence in East Timor and the disturbing implications of the Bank Bali affair have shaken market confidence. These developments have interrupted, and may even derail, an otherwise steady march toward economic stabilization and even turnaround in key economic indicators. The last three months had seen further consolidation of this incipient recovery, and only time will tell if this has been undone.

Stabilization has progressed. Three key stability indicators in the economy—the exchange rate, inflation, and interest rates—have continued to respond well in the last three months to the government's sustained commitment to conservative monetary policies² (Figure 1).

The exchange rate remained broadly stable until two weeks ago. This was principally the result of market forces, not government interventions in the market for foreign exchange.³ Tight domestic liquidity conditions, and a gradual return of capital from abroad undoubtedly helped.

The appreciation of the rupiah, together with adequate food availability in local markets, maintained steady downward pressure on the price level. Growth in the consumer price index (CPI) peaked in September 1998, reaching 82%

(120% for food);⁴ by end August 1999, this had declined to 5.8% (5.1% for food). The CPI in the last seven months (February-August 1999) declined by 3.4%, and the decline in the last three months was 2.3%. Clothing and food prices led the way, although the deceleration was across the board from transport to education. In this context, real estate rental prices in rupiah also continued to fall, although they appear to have stabilized in US dollars.

The deceleration in inflation has continued to bring in its wake a steady decline in interest rates. The one-month SBI rate has declined from a peak of 70% in late August 1998 to less than 13% today, halving in the last three months alone. Deposit rates have followed suit, helping improve banks' lending margins considerably.⁵

A factor helping Indonesia's stabilization program has been an improving international economic environment. Regional demand, in particular, is growing again. Japan's recent improved economic performance is contributing to higher Indonesian exports; Indonesia is the largest source of Japanese imports within the region (20%). Renewed growth in Korea this year and even more rapid import growth is also assisting Indonesian exporters. Finally, tighter OPEC quotas has helped oil prices recover from a low of \$10 a barrel in early 1999 to about \$22 by August 1999, raising Indonesia's export and budgetary revenues.

But the economy is fragile. National accounts estimates show modest GDP growth in the second quarter of 1999 (Figure 2). Growth has come largely from agriculture, although output in construction, manufacturing, and utilities also appear to be stabilizing. There is some glimmer of stabilization in services, even if this continues to be the weakest part of the economy, wracked

¹ World Bank. 1999. *Indonesia: From Crisis to Opportunity*. (Washington D.C.: World Bank)

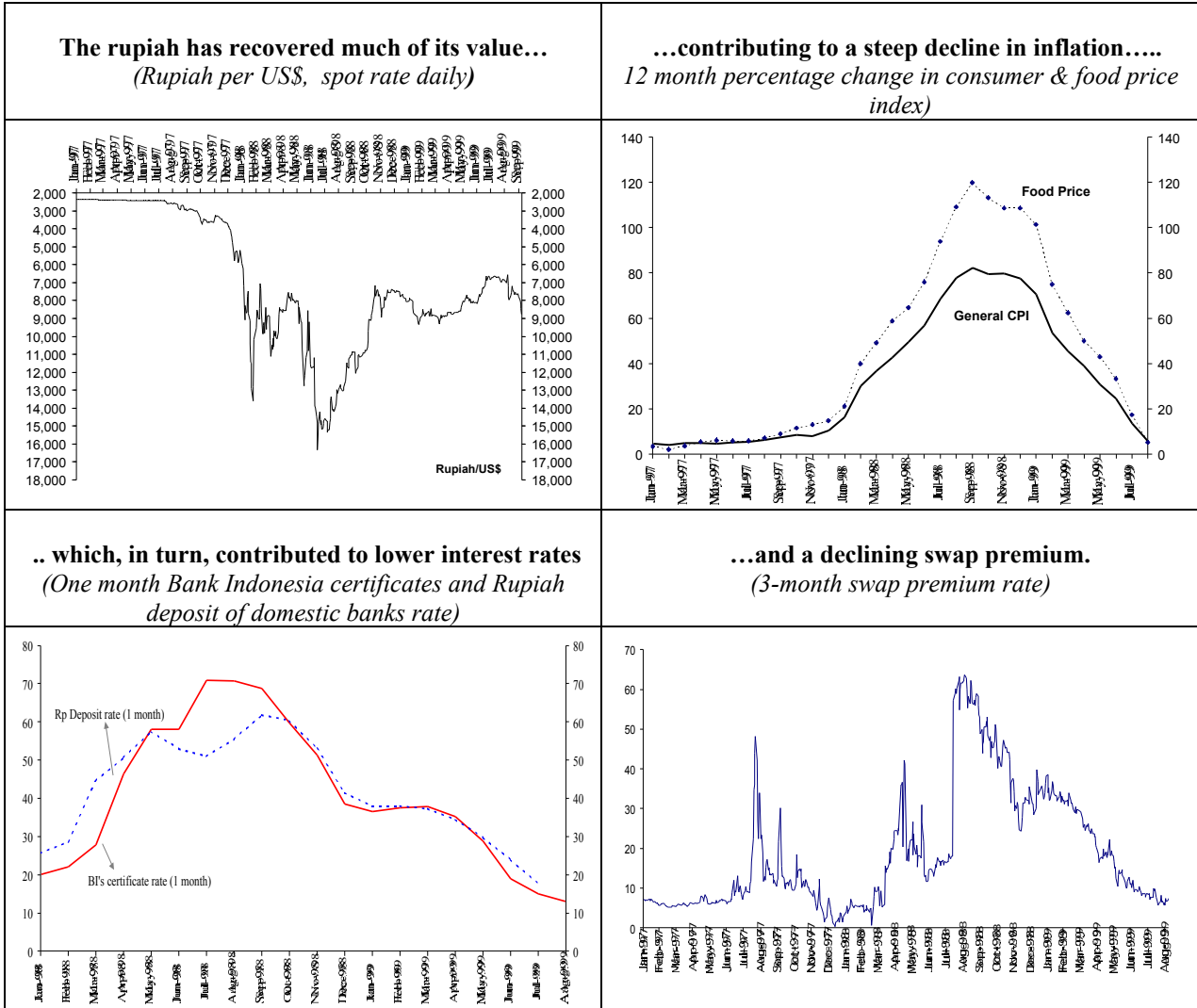
² Since September 1998, base money has tracked IMF program targets very closely (except for some deviation in the first quarter of 1999).

³ Central Bank sales of foreign exchange have been largely for conduct of monetary policy.

⁴ Using end-period data.

⁵ The one-month deposit rate has more than halved, falling from over 60 percent in September 1998 to less than 15 percent today. The lending rate remains sluggish, dipping below 30 percent only recently.

Figure 1
The virtuous circle of stability



Source: Bank Indonesia; Central Bureau of Statistics (BPS).

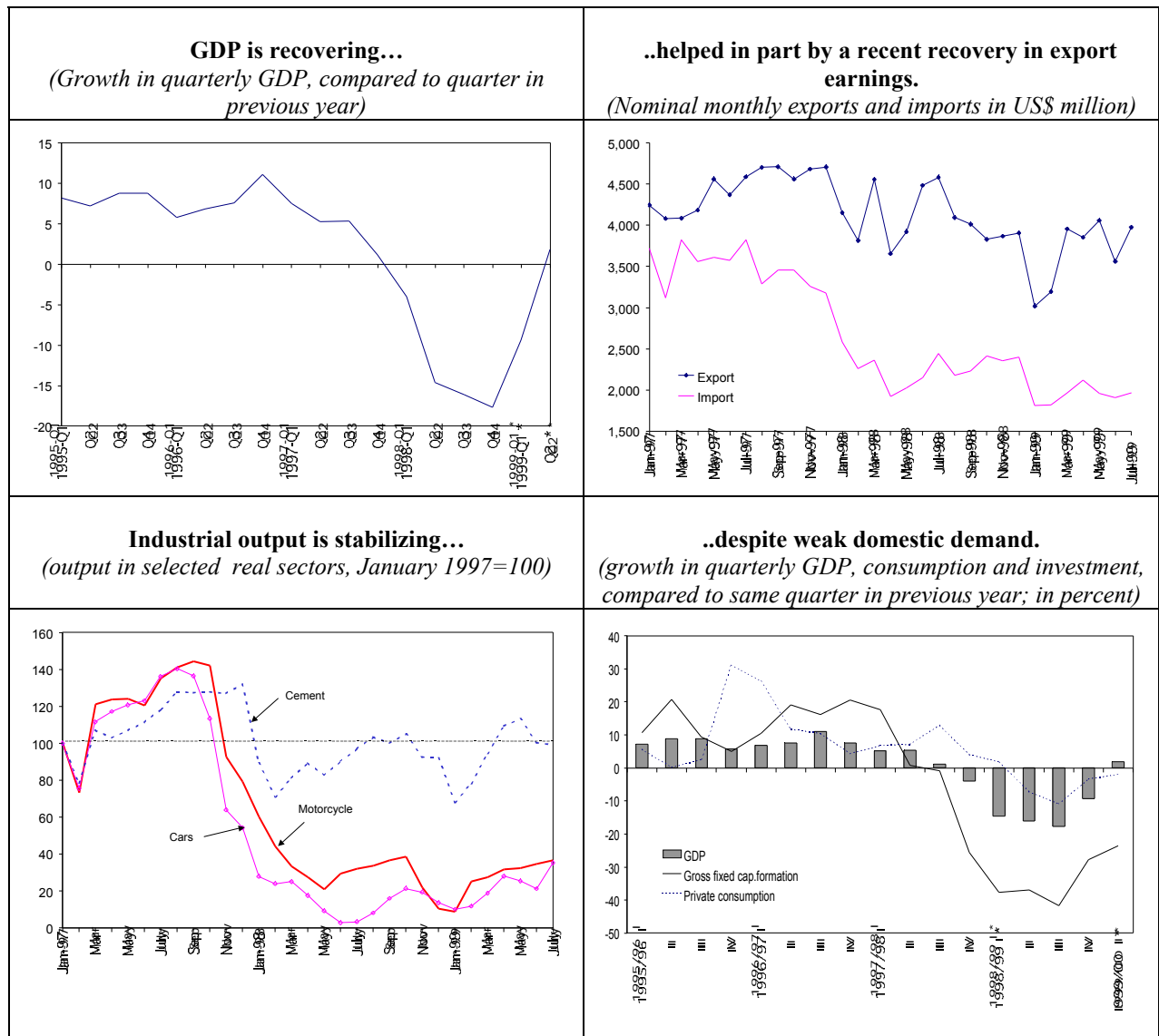
by problems in banking and the dependence of transport on revival in domestic demand. From the perspective of demand, two factors have contributed to recent growth: consumption, especially government consumption, has been key, helped by increases in civil service salaries; and recent expansion in the trade surplus. Unfortunately, investment continues to decline in real terms, a stark symptom of the depressed state of domestic demand and stagnation in the banking system.

Indonesia's export earnings have risen from their lows of January and February, 1999. Some of

this is a seasonal upswing, normal for the first quarter. Improved market conditions appear to be helping natural resource exports, especially oil. But seasonally adjusted exports of commodities and manufactures remain sluggish due to lower international prices.⁶ Export volumes in contrast show healthy growth, especially since May 1999.

⁶ Export statistics need to be treated with more-than-usual care, partly because of the effects of political events in April and May, 1998.

Figure 2
Signs of some increase in output



Source: World Bank staff estimates, based on official statistics.

Imports appear to have bottomed out in the first half of 1999 but have not matched the recent rise in export earnings. This is unsurprising given the slump in domestic investment and overall production. As a result, the trade surplus widened, notably in the last two months.

The increase in the trade surplus reflects the depths of the recession in the economy. Output and incomes remain at unacceptably low levels. The economy is still operating at 15-20% below capacity. The consequences for employment and

incomes is not distributed equally across the nation. Urban households, for example, appear to have suffered a larger income decline than rural households. The outer islands and regions producing export commodities (such as rural Sulawesi and Sumatra) seem to have experienced fewer adverse effects.

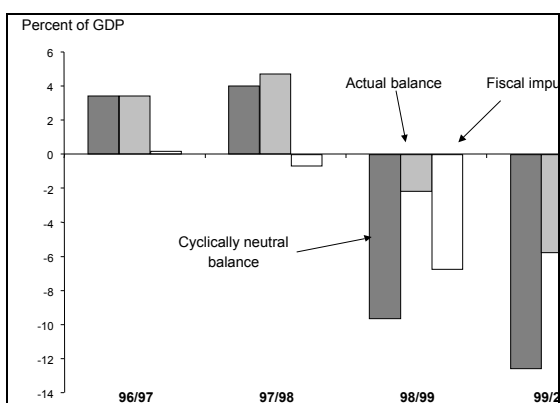
This is not surprising, since the epicenter of the crisis was in banks and corporates. Layoffs in these two sectors continue, adding to the ranks of those seeking employment in informal activities,

Table 1
The crisis has led to lower wages and more informal employment
(in percent)

Indicator	1993-1997 (annual growth rate)	1997-98 (year on year change)
Employment in:		
Agriculture	-2.5	13.3
Manufacturing	6.5	-9.8
Employment of wage earners	7.9	-5.1
<u>Memo item:</u>		
Real wages	4.0	-35.0

Source: Sakernas; Ministry of Manpower, *The Human Resource Profile In Indonesia* 1999

Figure 3
Indonesia's 1999/00 budget is designed to provide a small fiscal stimulus



Note: all 1998/99 numbers are preliminary; all 1999/2000 numbers are budgeted.

Source: Staff estimates based on data from Ministry of Finance and IMF.

especially in agriculture (Table 1). As a result, employment of wage earners has declined and with it, real wages have fallen sharply.

Latest estimates show that the number of poor as a share of the population has increased from 11% in 1996 to 16.7% in end-1998. This means about 35 million Indonesians are living in poverty. But there are still many “near poor”, as a relatively small upward adjustment of the poverty line

increases the poverty rate to 24%, or some 50 million Indonesians.⁷

The poverty rate in rural areas was probably worse in the depths of the crisis. Recent data from the “100 villages” survey tentatively suggests that consumption in rural areas rebounded by about 5 percentage points between August and December, 1998. Such a rebound, if true, would have erased about half the initial rise in poverty, although further data is needed to confirm this finding.

In the depths of the crisis, a key concern was whether economic hardship would force parents to withdraw their children from school. Data from the Indonesian Family Life Survey indicated a drop of 5-6% in high school enrolments from 1997 to 1998. Since then, however, this decline has been arrested, thanks largely to the back-to-school scholarship program implemented by the government with international assistance.⁸

Fiscal policy still contractionary. For the current fiscal year, the planned deficit of 5.8% of GDP would result in a modest stimulus of a bit less than 1 percentage point of GDP (see Figure 3). Output is now far below potential, and a cyclically neutral fiscal stance would mean a larger deficit. But to even achieve the planned deficit will require considerable effort on the part of government to implement the budgeted development expenditure program.

Estimates for the first five months of the fiscal year (April-August 1999) show that the budget continues to exert contractionary pressure on economic activity. Revenues have been better than expected, thanks largely to higher oil prices as well as surprisingly robust income taxes thought to be the result of high interest income (owing to unusually high interest rates earlier this year). Expenditures this year are broadly on track, reflecting significantly improved performance on the part of line ministries in project implementation. In this context, it should be noted that virtually no budgetary disbursements have been made for key social safety net programs, especially public works projects and community fund programs. As the

⁷ This is based on the reported results from a household survey in December 1998 conducted by the Central Bureau of Statistics in cooperation with UNDP and the United Nations Support Facility for Indonesian Recovery (UNSFIR).

⁸ The international agencies involved are the Asian Development Bank, the World Bank, UNICEF, and AUSAID.

year progresses, not only will expenditures accelerate for these programs, they will also rise significantly to meet the interest costs of bank restructuring.

One of the expected, but nevertheless unfortunate, outcomes of large planned deficits has been a sharp increase in government foreign borrowing. As a result, public debt has jumped from 24% of GDP in end-June 1997 to 60% in end-1998, and is expected to reach 102% by end-1999.⁹ Even though the incremental borrowing has been from concessional official sources, it will mean higher debt servicing costs for the budget and the balance of payments in future years, adding additional constraints to a rapid recovery and to the level of sustained growth the economy can achieve.

East Timor

Violence erupted in East Timor after the announcement of the ballot results in which the overwhelming majority of the population voted for independence. Destruction is reported to have been extensive and the death toll large. The World Bank publicly called on the Indonesian Government to restore peace in East Timor, and, together with the IMF, has indicated that failure to do so could undermine international support for financial assistance to Jakarta.

An international force has arrived in East Timor and peace appears to have been restored. Serious humanitarian issues, including repatriation and caring for displaced people, must be dealt with before reconstruction can begin.

Aceh, at the opposite end of Indonesia from East Timor, has also experienced rising conflict in recent weeks. The Indonesian military estimates that 450 people have been killed in the past year, and many press reports put the figure much higher. The conflict has apparently resulted in the displacement of 300,000-400,000 people. There have also been further outbreaks of local conflict in Ambon and the Riau island of Batam.

Bank Bali

It has been disclosed that Bank Bali made an illicit transfer to a firm connected with the ruling Golkar party. The World Bank and the other

IFIs have strongly encouraged the Government to undertake an independent investigation of the incident and to fully disclose all findings. The inquiry by the international auditors Price Waterhouse Coopers into the Bank Bali affair has been completed but is yet to be made public. A summary has been handed to the Indonesian parliament. The report apparently points to irregularities, bribery, corruption, and mismanagement by key individuals involved. Those implicated involve ministers, political personalities, and senior officials. So far, no legal actions have been initiated.

From the beginning the World Bank has strongly encouraged the Government to take strong actions to investigate the facts surrounding the Bank Bali incident, to fully disclose its findings to the public, and to make a firm commitment to fully prosecute any wrongdoers—irrespective of their position. The Bank has urged the Government to fully use the Independent Review Committee (IRC) to add credibility to its response to the Bank Bali incident and to oversee any follow-up actions required in the operations of the Indonesian Bank Restructuring Agency (IBRA).

The violence in East Timor and the disturbing implications of the Bank Bali affair have affected market confidence. The exchange rate slipped by 10% in the space of a week and the stock exchange slid by an almost equivalent proportion.

Pending resolution of the Bank Bali issue, all fast-disbursing budget support, including the Social Safety Net Adjustment Loan is on hold. This includes \$850m in approved funds and \$900m in new funds to be approved during the first half of CY2000.

In the mean time, the World Bank is continuing to fund all other already approved projects and programs in Indonesia, responding to the crisis by focusing on assistance in such areas as health and education. Much of this lending focuses directly on the poorest and most vulnerable. The World Bank is also continuing preparation of investment projects in the pipeline.

⁹ Public debt is defined here as the sum of external debt of government, state enterprises, and state banks, and the outstanding stock of restructuring bonds issued by the government.