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SURVEY OF RECENT DEVELOPMENTS

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SUMMARY

Monthly inflation fell to around zero in October 1998, while the rupiah strengthened considerably. Some recovery of share prices and significant declines in interest rates have given cause for optimism, and early estimates of increases in both poverty and unemployment now appear unjustifiably pessimistic. Although non-oil exports have been growing reasonably well, the plunge in imports reflects the severely depressed

POLITICAL AND SOCIAL DEVELOPMENTS

After the optimism about '*reformasi*' and democratisation that prevailed in the early months of the Habibie government, the political atmosphere became tense towards the end of 1998. There were violent clashes between the military and student demonstrators during the November meeting of the MPR (People's Consultative Assembly), summoned to decide on new 'broad guidelines of state policy'. Political uncertainty and party rivalry are bound to continue until the national elections in early June 1999 and a further MPR meeting to elect a President in November. It is probably too much to hope that a strong and capable government with decisive economic policies will emerge before then—or even afterwards, perhaps. On the other hand, a surprising feature of the last four months is that eco about the lack of strong leaders in any part of the Indonesian elite. Since the newly emerging political parties will soon be competing vigorously to build up mass support across the nation in the lead-up to the elections—and sometimes clashing, despite official orders to [illegible]

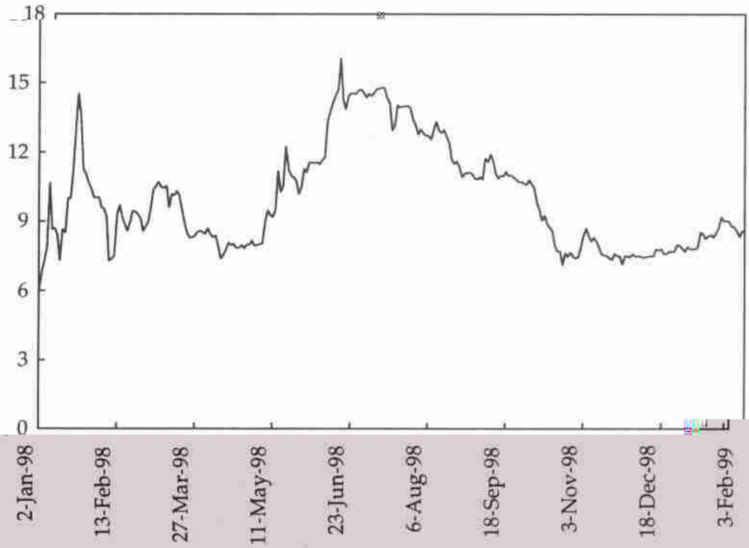
[illegible]

vote and seats, with Golkar, PDI (the Indonesian Democracy Party) and possibly PPP (the essentially Muslim United Development Party) likely to be the largest. The political situation will be very fluid until the election (and after)—although perhaps more stable than recently because so much energy will be directed at it.

ECONOMIC DEVELOPMENTS

Against the volatile socio-political backdrop some short-term economic indicators have been surprisingly stable and positive. The rupiah has strengthened and the value of

FIGURE 1 *Exchange Rate, January 1998 – February 1999*
(Rp '000/$)



Source: Pacific Exchange Rate Services.

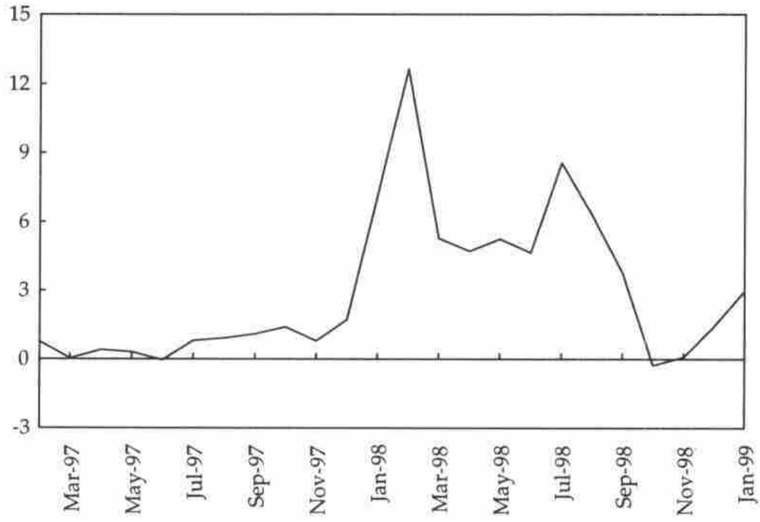
the year when IMF disbursements decrease and foreign debt repayments resume.

In contrast with Malaysia, speculation about moving to a fixed exchange rate or currency board has died down in Indonesia, and the floating regime is generally accepted. However, Amien Rais, leader of the opposition party PAN (Partai Amanat Nasional, the National Mandate Party), has stated that he does not oppose a currency board system.

The Stock Exchange

The Jakarta Stock Exchange (JSX) Composite Index rose from 276 at the end of September 1998 to steady at around 400 in mid February. Unlike the rupiah, it did not weaken during the parliamentary debate on electoral reform, although it became more volatile than earlier in the year. The volume of trade has fluctuated markedly, and is much lower on average than in early 1998. Traders report that there is little in the way of overseas interest in the market.[2]

FIGURE 2 *Monthly Changes in the CPI, February 1997 – January 1999*
(%)



Source: BI, *Weekly Report*.

Inflation and Monetary Policy

Figures released in the IMF's 13 November Supplementary Memorandum of Economic and Financial Policies show that in contrast with the period immediately following the onset of the crisis, Bank Indonesia (BI) met its monetary targets from mid 1998 through to September 1998. In the absence of IMF confirmation it is difficult to say whether the November and December targets were met, because BI's published figures are not easily reconcilable with those the IMF uses for targeting.[3] The IMF target was for a 4.4% increase in base money between September and November; since BI figures show a rise of 9.7% (BI, *Indonesian Financial Statistics*, December 1998), it appears the November target may have been missed. This could help explain the return to significantly positive inflation in December and January after –0.27% was recorded in October and 0.08% in November (figure 2). December base money contracted to only 3.8% above its September level, however, suggesting that monetary policy may be back on track.

The annual increase in the consumer price index for 1998 was 78%. The failure to meet the targets earlier in 1998 and the lack of long-term targeting had caused uncertainty about the direction of monetary policy, and are consistent with this inflation outcome (Fane 1998). The achievement of recent targets generated greater confidence in monetary policy, and inflation fell sharply. The 13 November Supplementary Memorandum did not set monetary targets beyond February 1999, however.

The introduction of a new central bank law, which, among other things, would ensure Bank Indonesia's autonomy, was initially scheduled for 30 September 1998 as part of the IMF package of reforms, but was still being debated by parliament in early February. The law in its current form may increase BI's independence, even though its board of directors (the governor and five to seven deputy governors) is still to be appointed by the President, because it stipulates that the President cannot dismiss a member of the board unless he or she resigns or is found guilty of a criminal act. At the time of writing parliament was demanding a greater role in deciding the central bank's key management team: specifically, members of Golkar were proposing that while the President could appoint the board, the candidates should be selected by the parliament. A further aim of the bill is to transfer BI's supervisory role to another agency. All factions of parliament reject this proposition, on the grounds that BI has the required expertise and that introducing a new supervisory authority would spread that expertise too thinly.

Interest Rates

Interest rates had been set high to support the rupiah. The recent decline in inflation and the strengthening and stabilisation of the rupiah allowed BI to reduce nominal interest rates (figure 3) and so lessen the burden on the corporate sector. In response to the late January weakening of the rupiah, BI increased interest rates slightly, but they are not expected to rise further. BI director Miranda Goeltom suggested that interest rates could fall below 30% before the end of March (*JP*, 25/1/99).

The most important issue is not the absolute level of interest rates but the [illegible]

FIGURE 3 *Interest Rates on One-Month SBIs,[a] January 1997 – January 1999* *(% per annum)*

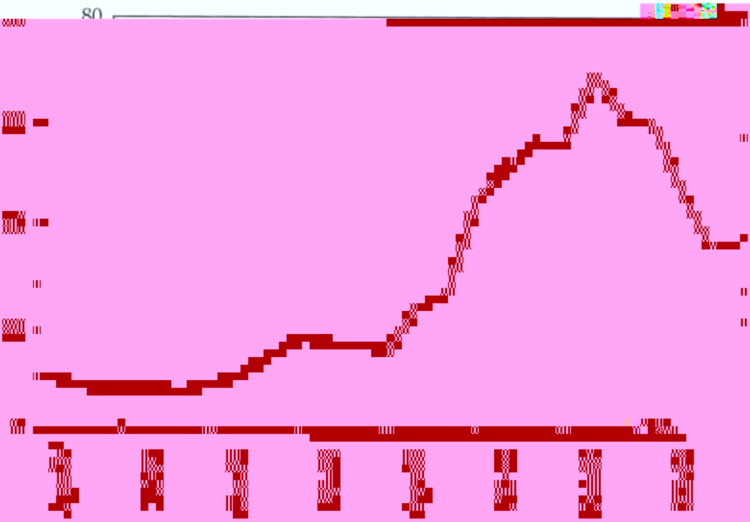
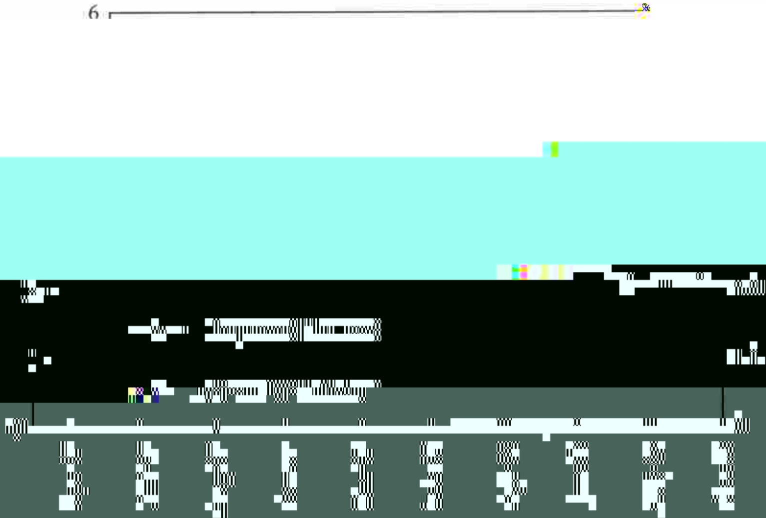


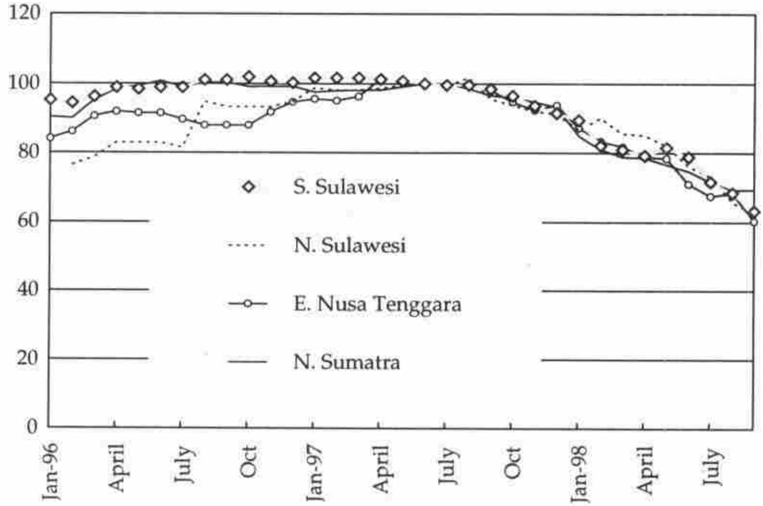
FIGURE 4 *Non-Oil Exports and Imports, March 1997 – October 1998*



bleaker than two years ago, and this may affect their labour market opportunities for years to come.

Estimates of Poverty from Pre-Crisis Data. One of the more pessimistic poverty estimates is that of the ILO, which predicted that 100 million Indonesians (49% of the population—39% in urban and 53% in rural areas) would be living in poverty by the end of 1998, and that this would increase to 140 million in 1999 (66% of the population—57% in urban and 72% in rural areas). These calculations assumed that nominal household income would not increase and that inflation in 1998 would lead to an 80% rise in prices of basic staples, with a further 25% increase in 1999.[6] We now know that although the inflation rate was close to what was assumed, the assumption that nominal incomes would not rise did not hold. Central [illegible]

FIGURE 5b *Real Wage Trends in Agriculture in Selected Outer Provinces, 1996–98 (Base June 1997 = 100)*



Source: As for figure 5a.

Coping Mechanisms

Evidence on the strategies people are using to cope with the crisis is still largely anecdotal. The *kecamatan* survey shows that people are selling assets and cutting back their participation in *arisan* (rotating savings and credit associations). There have been reports of large-scale migration back to rural areas and a return to agriculture; this is consistent with agriculture being among the few sectors experiencing positive growth. One possible reason for the weaker impact of the crisis in rural areas is that informal coping mechanisms are still intact in the villages—for example, the sharing of resources across households. Similarly, small and medium enterprises are reported to be weathering the crisis better than larger companies, because they are less reliant on formal markets, and less reliant on now far more costly borrowed funds.

Food Security

Although the main rice harvest was the worst in six years, Indonesia experienced no real rice shortage in 1998; the shortfall between domestic demand and supply was met by increased imports of rice. Rice production was low because of drought and dramatic rises in the cost of fertiliser and pesticides. The rice harvest is expected to return to normal in 1999 thanks to good wet-season rains.

ECONOMIC POLICY PROGRESS

IMF Update

The government's economic agenda is still largely driven by the requirements of its agreements with the IMF, consisting of four main Memoranda of Economic and Financial Policies (table 1). The latest (IMF IV) was signed on 29 July 1998 and has been followed by three supplementary memoranda.[8] The IMF was satisfied with Indonesia's performance at the time of writing, and the disbursement of funds has run according to the schedule set out in IMF IV. Table 2 shows the schedule of disbursements under the Extended Fund Facility, which replaces the three-year standby credit of 5 November 1997. The IMF has also committed itself to providing extra funds for the June elections and to strengthening Indonesia's foreign exchange reserves.

IMF IV is broadly consistent with IMF III (Johnson 1998: 32). It establishes performance criteria and monetary, fiscal and external targets to end March 1999, and strengthens the bank and corporate restructuring programs by providing more detailed frameworks. It also addresses the need to reduce the budget deficit in the next three years by better targeting subsidies to the needy, improving revenue performance, and streamlining public expenditure management.

TABLE 1 *IMF Letters of Intent*

Indonesian Bank Restructuring Agency) had been audited. There is considerable opposition to the program. On the one hand, the banks' owners fear loss of control. On the other, there are concerns that recapitalisation may transfer wealth from the general public to the wealthy elite who are the principal shareholders of the private banks. The current schedule has the program being completed by March 1999 (three months after the previously announced deadline), but at the time of writing there was little hope of the revised target being met.

The restructuring program rests with IBRA, which is politically weak in relation to its difficult task; its slow progress is a cause for concern. IBRA's lack of authority was evident previously in its dealings with Soeharto crony Bob Hasan: he repeatedly postponed meeting with the Agency, and IBRA later failed to act against him when he breached the deadline for repayment of his bank's debt to BI. In a positive move in November 1998, President Habibie agreed to extend IBRA's life by four years, and handed responsibility for ratifying the agency's decisions to the respected Finance Minister, Bambang Subianto. Habibie also committed the government to allowing IBRA a free hand to seize and liquidate banks' assets, and to prosecute owners who failed to ensure repayment of their banks' debts to the government, but commentators remain sceptical.

Audits of most of the larger banks have been completed, and the latter have been classified into one of three categories according to their capital adequacy ratio (CAR; i.e. the ratio of equity capital to risk-weighted assets):

- Category A: CAR over 4%;
- Category B: CAR between –25% and 4%;
- Category C: CAR below –25%.

Category A banks are not included in the recapitalisation program, since a 4% CAR is regarded by the government as acceptable for the time being—although this is only half the internationally accepted standard, and one-third of the level Indonesia had set as a target before the crisis. Category B banks will be eligible to participate in the program, but Category C banks face the threat of being excluded and required to close or merge with other banks if they are unable to raise their CARs above –25%. Surviving banks will be required to submit plans showing how they intend to raise their CARs to 8% in three years' time (*Financial Times*, 12/12/98). It is not clear how many banks will survive the restructuring program. President Habibie has said that he would like to see about 50, but the Governor of Bank Indonesia stated subsequently that the government had no target for the number of banks (*Wall Street Journal Interactive Edition*, 10/1/99). The Governor also signalled that the government would exercise its discretion as to whether individual Category C banks would actually be closed.

Of the 150 banks that had been audited by early 1999, 40 fell in Category C, 56 in Category B and 54 in Category A (*Indonesian Business*, January 1999). Despite all but one of the state banks falling into Category C, all are to be recapitalised. Four of them (Bank Ekspor Impor Indonesia, Bank Bumi Daya, Bank Dagang Negara and Bapindo) are being merged to form Bank Mandiri, a process expected to be completed by May or June 1999 (*Kompas Online*, 4/1/99). No explanation has been given for the different treatment of state and private banks.

The government will provide up to 80% of the funds necessary for recapitalising Category B banks; the remaining 20% are to be supplied by the banks' current owners. Rather than paying for newly issued shares with cash, which would have an undesirable expansionary impact on the money supply, the government will inject its equity contribution in the form of government bonds; these will take the place of non-revenue-generating bad loans, providing a risk-free source of earnings for the banks. Although this approach has been under discussion for some time, there is still considerable confusion about the interest rate to be paid on the bonds. Most recently, the Coordinating Minister for Economics, Ginandjar Kartasasmita, has stated that they may be indexed to inflation, paying a real interest rate of 3% p.a., but that the government was still also considering the possibility of using more familiar nominal, market-determined, fixed or floating bond interest rates (*Bisnis Indonesia*, 8/1/99). There is much to be said for inflation indexing of loans and other interest bearing securities in Indonesia's present circumstances, given recent wild fluctuations in the inflation rate. If the government used this approach it might act as a catalyst to encourage the banks to consider using it themselves in their deposit-taking and lending activities.[10]

Interest payments on the bonds are expected to amount to Rp 34 trillion in the 1999/2000 fiscal year, of which Rp 18 trillion will be a charge on the budget, and Rp 16 trillion is expected to be covered by off-budget sales of assets of troubled banks (*Bisnis Indonesia*, 8/1/99). At 20.5% interest (3% real adjusted for 17% inflation), this estimate implies a total bond issue of Rp 166 trillion. If the bonds are inflation indexed, the actual interest payments will be far smaller than Rp 34 trillion, at just 3% of Rp 166 trillion, or Rp 5 trillion. The remainder will take the form of an increase in the nominal value of bonds outstanding. A benefit of combining indexation with inflation-corrected accounting is that it would show that the true budget deficit is much smaller than it appears to be when no account is taken of inflation.

The government appears to lack a clear and coherent program for bank recapitalisation. Finance Minister Bambang Subianto had previously announced that the majority state-owned Bank BNI was likely to be among the first to be recapitalised 'because it was already publicly listed'. The wholly state-owned Bank Rakyat Indonesia was also said to be a priority because of its role in providing services to small businesses and farmers (*Antara*, 15/12/98). Neither bank has yet been recapitalised. Trade and Industry Minister Rahardi Ramelan is reported to have said that Bank PDFCI was to be restructured to become a trade-financing agency, but this was contradicted by the Finance Minister (*Wall Street Journal Interactive Edition*, 4/2/99). The planned acquisition by Bank BNI of the state-owned savings bank, Bank Tabungan Negara, was cancelled at the beginning of February (*Wall Street Journal Interactive Edition*, 4/2/99).

In late January 1999, it was announced that the first banks to be recapitalised would be Bank Lippo, Bank Sembada Artanugroho, and 10 state-owned provincial banks.[11] This would involve government outlays of Rp 4.3 trillion, of which Bank Lippo was to receive the lion's share of Rp 3.75 trillion (*Reuters*, 29/1/99). The choice of Lippo Bank—controlled by the ethnic Chinese Riady family, which is said to have close ties to President Habibie—and the high proportion of the funds going to it generated a strong negative reaction because it appeared to be yet another case of Soeharto-style cronyism.

Whether this reaction was justified is unclear, but the government has been justifiably criticised for its failure to supply adequate information about the transaction (*JP*, 5/2/99). In the absence of details as to the outside auditor's estimate of the value of equity and the price at which the new shares were issued, it is impossible to know whether there was an element of subsidy of the bank's owners by the government. Nevertheless this seems highly likely: it is hard to imagine why the owners would sell shares in the bank to the government unless the price received was above what they thought to be their true value. Banks' owners have an enormous informational advantage over the government in estimating the true value of assets and equity—not least because many bank loans are to companies that are part of the same conglomerate.

An alternative approach to recapitalisation that would address concern about its being a means of subsidising the rich would be for the government to take a much more hard-nosed, market-driven approach than it has until now. Banks that cannot—or will not—boost their CARs to 4% could be taken over by the government and offered for sale to foreign or domestic buyers—including the current owners—willing to bring equity up to this level. Given that equity is often likely to be negative, bidders would have to be given the option of specifying the minimum value of bonds the government would ne rather than an audit firm to put a value on the banks' assets; that it could avoid the disruption and waste of investment in physical and human capital implicit in closing banks down; and that it would prevent the government from becoming even more heavily involved as a bank proprietor (at a time when it is planning to divest ownership of the existing state banks). The original owners could be expected to offer a price at least as high as that which they would offer in the direct negotiations that now form the basis of the government's approach, and other bidders may offer something even better.

According to the government, the provincial banks were included in the first recapitalisation group because of their potential for accelerating economic development in the regions. An alternative explanation is that the element of opposition to recapitalisation that arises in the private sector banks, because of their owners' desire to avoid loss of control, was absent in these cases, as it was with the four national state banks that are being merged. The fact that only two private banks were included, one

will do nothing to convince observers that it has the will to tackle bank sector reform seriously.

Debt Restructuring

Indonesia's private foreign debt is estimated at around $80 billion. Restructuring this debt is imperative in re-establishing a functioning business environment and as a spur to economic growth. The government's approach to debt restructuring relies upon the Indonesian Debt Restructuring Agency (INDRA), bankruptcy law reform, and the Jakarta Initiative.

INDRA. The Indonesian Debt Restructuring Agency (McLeod 1998; Johnson 1998: 52; Evans 1998: 9–11) was established in July 1998 to aid in

rice to families adversely affected by El Niño, and provided 10 kg per month to poor families at Rp 1,000 per kg (about one-third of the market price). The program was said to be reaching six million families by end October (somewhat less than the 7.5 million specified in IMF IV), but is now being rather ambitiously extended to 17 million poor families (*Reuters*, [illegible]

process, the task may be allocated to 'quasi-NGOs' formed for opportunistic reasons only.[13]

Micro-Credit. The government aims to meet some of the objectives of the safety net programs by introducing new micro-credit schemes. It was announced in November that 16 subsidised loan programs would be established and allocated Rp 10 trillion ($1.3 billion). Most of the schemes will be targeted at SMEs or at poor families.[14] They will offer subsidised credit at an annual rate of 6–16% (the rate for normal commercial loans has been about 50% in recent months). Some schemes will not require collateral. Working capital loans are limited to Rp 5 million and require repayment within a year. Investment loans may be up to Rp 25 million, with repayment within 25 years.

The success of micro credit schemes in other countries has hinged on the provision of credit at market rates to individuals who would not otherwise have access to it (owing to lack of collateral, for instance), or on strictly controlled access to credit if it is subsidised. An institutional structure that discourages cheating and default, such as group-based lending, is important. Like previous Indonesian subsidised credit schemes, the present ones lack these characteristics. They appear to be little more than subsidised credit programs, with the funds to be disbursed via commercial banks. Critics claim that the schemes lack the controls necessary to prevent significant 'leakages', and that institutions that were not cooperatives have been able to acquire cooperative status and gain access to the subsidised funds (*JP*, 14/12/98). There have also been reports that the implementation of the credit schemes has corresponded to a large increase in time deposits, the inference being that people are earning handsome financial returns by depositing funds from the subsidised credit schemes at far higher commercial rates.

The targeted rice program has been more successful than the other social safety net programs: the labour-intensive programs, in particular, are likely to benefit far fewer Indonesians. The tragedy is that, at this time of perhaps greatest need, not all the available funds have been used. This is to some extent understandable given the difficulty of mobilising such an extensive program in such a short time.

'*EKONOMI KERAKYATAN*' AND CHINESE INDONESIANS

The establishment of a 'people's economy', one of the four areas to which social safety net expenditure will be directed, involves the dispersion of economic decision-making power to large numbers of Indonesians. Discussion of the 'people's economy' at the November Special Session of

significance of his exploitation of *ekonomi kerakyatan* as a popular slogan is harder to assess.

President Habibie has himself urged that the significance of MPR Decree No. XVI not be misunderstood. 'You should not imagine that the decree would serve as an impediment to

TABLE 3 *Government Budget*
(Rp trillion)

TABLE 4 *Development Budget*
(Rp trillion)

Expenditure	1998/1999 Total	1998/1999 %	1999/2000 Total	1999/2000 %	% change

Kabupaten/Kotamadya Development Funds. The budget allows for increases in the salaries of civil servants, members of the armed forces and retirees, but these are not sufficient even to offset last year's high inflation, let alone address the problems of accountability and transparency that arise from having such a poorly paid public service. The amount allocated for interest payments is also lower, in part because of the increase in the value of the rupiah and the suspension of principal repayments as agreed wi

NOTES

* This Survey has been compiled with the generous assistance of Professor Jamie Mackie, who is mainly responsible for the sections on social and political developments and the people's economy. I also thank Chris Manning for providing the real wage graphs, Peter Gardiner for his comments on the section on the social impact of the crisis and all others who provided information and comments.

1 'Gus Dur' is the popular name of Abdurrahman Wahid, the widely revered head of the rural-based Muslim organisation Nahdlatul Ulama, and head of the new PKB party (Partai Kebangkitan Bangsa).

2 The JSX Composite Index is plotted over the last year at http://indobiz.com/news/jsx.htm.

3 BI publishes base money figures for the end of the month, while the IMF uses a 10-day average centred on the last day of the month to assess whether its targets have been met.

4 The government assumes an oil price of only $10 per barrel for the coming financial year budget. This may be compared with a price of $23 per barrel at the end of 1996.

5 The poverty line in Indonesia is defined as the level of expenditure associated with a daily consumption of 2,100 calories. This is lower than the poverty line set in most comparable countries.

6 Information in this section borrows heavily from Booth (1998).

7 The Indonesian Family Life Survey is a random household survey conducted by the RAND Corporation and the Demographic Institute (Lembaga Demografi) at the University of Indonesia. It was first conducted in 1993 (IFLS1). The same 7,200 households (on the islands of Java, Sumatra, Bali, West Nusa Tenggara, Kalimantan and Sulawesi) were interviewed again in 1997 (IFLS2) and then a sub-sample of 2,000 across 13 provinces were re-interviewed in August–November 1998 (IFLS2+).

Two further data sets will eventually provide information on the social impact of the crisis. They are the '100 villages survey' conducted by BPS and funded by UNICEF, and a survey of schools conducted by the World Bank and the Ministry of Education and Culture. Both are said to be rich sources of data.

8 The interim report analyses expenditure, not income, data. Expenditure data are likely to be more closely related to household welfare than income data, but because we expect to see expenditure smoothing, changes in expenditure are likely to be smaller than income changes.

9 A fourth supplementary memorandum had been negotiated at the time of writing but had not yet received Washington approval and so was not publicly available. It was reported to focus on firm monetary policy, expansionary fiscal policy, bank recapitalisation and private company offshore debt restructuring. It also includes policies aimed at helping small and medium enterprises.

10 Inflation indexing made its original appearance on the policy making scene in the INDRA arrangements discussed by Evans (1998: 11–12) in the previous Survey.

11 Further batches were scheduled to be announced on 15 February, 7 March and 31 March (*Wall Street Journal Interactive Edition*, 1/2/99).

12 A scandal erupted over the distribution of 500,000 tons of rice sent by Japan as food aid. The rice is of a very high quality, and the government has stockpiled it rather than distributing it because it is said to be concerned about 'disrupting the country's rice market' (*JIJI Press Newswire*, 11/1/99).

13 The NGO sector already runs a form of safety net program, the Community Recovery Program (CRP), funded by the World Bank, Japanese and British ODA, the ADB and a number of other international organisations. Funds are managed by the UNDP office in Jakarta, and the program is being coordinated by a group of individuals from a consortium of NGOs. The CRP shares many of the objectives of the government scheme, with the exception of the labour-intensive projects (Abimanyu 1998b).

14 Subsidised credit has also been made available to public transport companies in major cities.

15 Press reports have linked his name with the emergence in January of a new party, Partai Daulat Rakyat (PDR, the People's Sovereignty Party), although he is not yet formally associated with it and officially remains a member of Golkar. PDR is described as a 'political machine' based on poor farmers, fishermen and *kaki-lima* (urban food vendors), a constituency that various other parties presumably will also be bidding for.

16 The circumstances that made possible the relatively smooth redistribution of corporate assets towards Malay business under the NEP are utterly inapplicable in Indonesia, so the likelihood that a similar policy could succeed is very low. The growth in the Malay share of total corporate wealth occurred at the expense of British companies, most of which were leaving Malaysia in any case between 1971 and 1990, and not at the expense of Chinese Malaysians, whose share of the cake actually increased in those years. The Malaysian economy was growing rapidly through that period, but Indonesia's is stagnant. Malaysia's financial system and bureaucracy were far more advanced, more efficient, better paid and less corrupt than Indonesia's (Mackie 1999).

17 These calculations deflate the 1999/2000 figures using the 1998 inflation rate of 77.63%.

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