RECONSTRUCTION OF THE INDONESIAN ECONOMY: ROLES FOR DEVELOPMENT COOPERATION

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1. Long-term Impacts of the Crisis

Crisis as a change at an ultra-high speed usually leaves a number of lasting damages. The output shock in form of a deep contraction of GDP by an expected 13 percent in 1998 and another 2% in 1999 is very likely to bring Indonesia away from the pre-crisis trends to the one with a lower level over a long period of time. Even if one assumes that starting in 2000 Indonesia returns to a positive growth in such a away as to enjoy an average growth of 7 percent a year in the first two decades of the third millenium, forgone output for the period of 2000-2007 would still be a massive Rp 390 trillion or 60 percent of the GDP in 1997 and Rp 775 trillion or 117 percent of the GDP in 1997 for the period of 2000-2017. The severity of this output shock will differ from one sector to another. It is likely to be worst in financial services, real estate and a range of industries with high import dependence. These industries may never return to their respective pre-crisis trends, to put it mildly.

Given the negative relation between output growth and unemployment rate, the Indonesian labor market is also bound to suffer from a lasting effect Duration of unemployment is bound to lengthen. It will take a longer time for the currently unemployed Indonesians to exit the pool of unemployment even when the economy has returned to a high growth path. A similar problem will arise in poverty alleviation. Among the ones who are thrown back to the group of subsistent income a large number may find it difficult to climb beyond the threshold level of income even under a major change in the social policy.

The reputation of policy making has also been eroded seriously. The erosion is not new. In fact, the last full term of Soeharto's presidency can also be seen as a period of worsening dissociation from the norms and rules of good economi policy making Indonesia was adhering to in the early days of the New Order. The dismantling of the economic technocracy was unmistakeable in the last five years before Soeharto was replaced by B.J. Habibie. The recrafting of good reputation has turned out to be very difficult under the new president. The key personnels in the current government were simply too good as Soeharto's loyalists to be credible as champions for a new beginning.

Indeed, Indonesia is currently still grappling with the "future costs" of the sub-standard governance of the past and is likely to remain so until a truly new government is formed. Too little attention is paid to a more rapid stabilization and the design for the period of reconstruction.

2. The Quest for Stabilization

The representative of the IMF and government officials, including President Habibie, are quick to remark on the strengthening of the rupiah in the third week of October as a reflection of improving conditions in the economy. The evidence is sparse. Inflation rate in the first two weeks of October 1998 is reported to be negative, reflecting perhaps a very weak domestic demand. But even on this score one still has to caution. Some problems of price adjustment are still kept under the carpet lest allowing it to occur would end up in an inflation rate which is so high that people take it as a sign of a hyperinflation in the making. What is more, the attempt to get the crisis under control is hampered by a number unsolved issues.

First of all, solution to the external debt is yet to be found. This applies to both government debt and the private debt. As regards the government debt, the current debt stock does not seem to allow anymore a large increase. A far-reaching reform is needed in government finance. Equally urgent is a solution to the private external debt. Within the context of the Frankfurt Agreement, debtors, creditors, the Indonesian Debt Restructuring Agency (INDRA) and the *Jakarta Initiatives* will have to work together to come to a realistic solution which essentially implies a sizeable debt reduction. The latter can result as a combination of a *hair cut*, debt-equity conversion, and conversion into bonds with a collateralized interest payments subject to a certain level of minimum debt reduction.

Second, stabilization is unthinkable without a success in bank restructruing. As a group Indonesian banks are currently operating at a negative capital. Twenty six banks have been closed. The ones which survive are crucially dependent on the blanket guarantee by Bank Indonesia, a scheme which is meant as temporary measure. Some of the survival banks are yet to recover from the deposit exodus that took place in the period between August 1997 and June 1998. Two of the largest private banks have been brought under government control in exchange for the huge emergency loan extended during the time of deposit exodus. Furthermore, bad debt is estimated to have reached a level of 50 percent. Given the negative spread under the current high-interest rate policy, internally generated resources are a no-option for

recapitalization. The situation is highly dilemmatic. Relocating sub-standard assets to the Asset Management Unit (AMU) of the Indonesian Banking Restructuring Agency (IBRA) would mean a substantial shrinkage of banking. Allowing banks to convert problem loans into equity would relieve corporate borrowers of interest and repayment obligations, but may only mean postphoning the collapse of banking.

Third, adjustment to the new exchange rate has not been completed. This is particualrly true of some important prices which are controlled by the government. They include prices of fuel, public transportation and electricity. A strong reflation can occur in the wake of an increase in these prices. Wage increase is another important issue. On the one hand, the very high inflation has eaten up a large proportion of real wages, especially lowest wages whose receivers are hit the hardest by the more than proportional increase in the prices of basic food products. On the other hand, a major increase in wages is hard to imagine under the circumstances of high inflation, a strong increase in the rate of unemployment and a collapsing profitability. It will also weaken the competitiveness of export.

A credible commitment to the reestablishment of good governance is another important ingredients of stabilization. On this issue the signals of what the current government has done are mixed. Political freedom have been rediscovered in Indonesia. Basic direction of economic policy making is not clear, however. On the one hand a market-friendly policy is sought under the banner of the IMF program. On the other hand some members of the government seem to favor a different direction as reflected in the attempt to replace certain private distributors by cooperatives and in the failure to push privatization forward. The way the government handles the issues of corruption is also highly dubious. The government fails to appreciate the importance attached by the public at large to a successful campaign against corruption as a necessary ingredient of a credible government. Not a single case of corruption has been investigated thoroughly so far.

3. Policy on Reconstruction

In an open economy a government enjoys only a very limited room for being different in respect of economic policy making. Indonesia is no exception. Following the deregulation of the 1980s and early 1990s Indonesia has established a basically free flows of goods, services, and capital, though the principles of non-discrimination are oftentime violated in favor of politically well-connected bisiness people. Given the high level of openness, policy

making should also converge towards world best practices. In other words, Indonesians are perhaps well adivised not to improvise too much while laying the foundations for economic reconstruction. The roadmap to be followed is more or less clear. It centres around a credible macroeconomic prudence, a basically neutral incentive system, a reformed corporate internal governance and a progressive accumulation of human capital. In this process of change external support is bound to play a major role.

To restore a credible macroeconomic prudence the following issues are critical. Government finance will have to undergo a number of important changes. A shift in government expenditures away from econmic type of expenditures in favor of social type of expenditures is badly needed. This restructuring requires a fresh look at state enterprises and marketization in some areas of infrastructure, however. Assuming such a restructuring a new agreement on the division of labor between the central government and lower levels of government is needed. Under the current high level of centralization a spatial element of competition is hardly existent in Indonesia. Under the principles of subsidiarity the contribution of government to economic development may increase a great deal, if local governments are given a clear areas of responsibility. Given such a responsibility local governments will need to be equipped with adequate resources which can come from a pre-specified shares in revenues from income tax, value added tax, land rights, fishery rights, mining rights. Furthermore, the current level of tax to GDP ratio in Indonesia is simply too low. Tax efforts will have to be strengthened. A pre-specified shares of local governments in tax revenues may can be expected to boost such efforts.

Of equal importance is a credible commitment to a prudent monetary policy. Judged from the rises in Consumer Price Index, the frequency and depth of devaluation in the course of the last 30 years the lack of monetary stability in Indonesia is unmistakeable when compared for instance to Malaysia. This is not to deny the toughness of the government in certain circumstances such as the cleaning up of Pertamina finance in mid-1970s, the monetary and banking reform in the 1980s, and the tifht money policy in 1991. By and large, this toughness has been very sporadic in nature, however. Classic problmes include the lack of independence of the central bank, the extreme flexibilixty in which the central bank excercises its discretionary policy, the conflicts of interest that oftentime arise from the extensive mandate of the central bank and the lack of a clear monetary policy targeting. Given the poor record, Indonesia's monetary policy may need to be locked-in. Assuming the crisis has subsided, adoption of an inflation targeting as it is currently pursued in a

number of countries may help discipline monetary policy making. To allow the central bank to concentrate attention on monetary policy the various functions of the central bank may also need to be unpackaged.

Poor corporate internal governance is part of the reasons behind the vulnerability of Indonesian companies to an external shock such as the exchange rate contagion of 1997. Large businesses in Indonesia are organized as conglomerate with overarching networks under a single dominant owner. Transparency is very low. Internally generated funds are invested in new businesses rather than the existing ones. Businesses which remain outside the reach of conglomerate are also dominated by a single owner. Even state enterprises are dominated by their single owner, the government. Competition between owners is hardly existant.

The second issue of governance relates to corruption, collusion and nepotism(CCN). These practices were reduced in the course of the reform of the 1980s. However, they resurfaced with greater seriousness in the 1990s when children of high officials entered business in a big way. Rent seeking was rampant again in this period. Profitability of large projects of which nearly all are catered to local market, was inflated artificially, causing a large scale misallocation of resources away from export-oriented activities.

Allowing domestic competition to strengthen is, therefore, an important part of the policy fundamentals which are needed for reconstruction. While eradication of CCN sounds utopian, a credible commitment to its minimization is badly needed. Furthermore, abuses of market power should be penalized severely.

For a while relying on domestic market as an engine of recovery does not seem to be realistic. Real income of average Indonesian has shrunk. Allowing domestic demand to recover too soon may backfire in terms of imbalance in the external sector. Indonesia is doomed to live with a huge stock of debt in the years to come even without the new loans that Indonesian creditors agrree to extend in exchanage for the reform committment. Therefore, a progressive export expansion is needed. For this purpose a strong shift in the reorientation of business is imperative. The stagnant investment in exportables in the pre-crisis part of the 1990s will have to be replaced by a strong investment. While seeking such a strong expansion of export the government does not have a wide range of options. Nevertheless, it can at least abolish any bias against export. It can also engage in an active search for foreign investors rather wait for them to come. Where possible, it should negotiate with official creditors on a scheme of export promotion where official capital is involved as a major part.

Finally, the serious gap of competencies will ave to be narrowed. The crisis might have turned out to be less severe, had Indonesian officials, business owners and professionals, educators and trainers were richly endowed with the knowledge and skills which are needed to minimize the probability of occurance of a crisis and to manage crisis more effectively. The global financial market has chanaged in many fundamental ways. However, financial institutions of Indonesia were slow to adjust to the new world of finance.

4. The Global Setting

The 1990s started off as a decade of thousand promises. The cold war was over. The world was hoping to reap the dividend of peace. The WTO was agreed upon. World prosperity was expected to experience a booster from the positive impacts of the promised freer flows of information, goods, services, capital and even, to a lesser extent, people. Up until 1996 trade and investment were expanding at a rapid rate. In the ten years to 1996 merchandise trade was nearly doubling. Services trade increased even more strongly, led by a more than trippling size of trade in other private services and a nearly trippling size of travel. Transborder flow of investment income was also rising at a more rapid pace than services did. In 1996 it rose to 23 percent of merchandise export compared to 20 percent in 1985 The flow of direct investment (FDI) is even more impressive. Its annual value more than quintuppled to $ 331 billion in 1996. A similarly strong increase is observable in portfolio investment. The speed of expansion is strongest in capital, followed by investment income, services and merchandise.
From the perspectives of developing countries the 1990s were also a promising decade. Their combined shares in world export and FDI inflow rose respectively from 28 percent in 1990 to 35 percent in 1996 and from 16 percent to 41 percent. Even the emerging markets were being discovered by investors from North America, West Europe and Japan. Within this spatial change the developing Asia is of central importance. Its share in world merchandise export rose from 13 percent in 1985 to 18.5 percent in 1996. It also turned into a major destination of FDI with a share of 24,5 percent in 1996 compared to 9 percent in 1990. A kind of "Asianization" was occuring in world trade and investment in the first six years of the 1990s. Even for the United States, the European Union and Japan developing Asia is no longer a trade and investment dwarf. Interestingly, intra-Asia trade was gaining ground in the course of the 1990s.

The promises of the 1990s were dimmed as the Mexican crisis erupted in late 1994, in spite of the quick response of the United States to come to rescue with the help of a massive financial commitment. When the Asian crisis also occured in 1997, the rescue process was slow. The former growth champions are faced with a contraction. The world is deprived of its most vital growth area with no other area being likely to emerge in the immediate future as a substitute. In the wake of the Asian crisis world output and trade are expected to decelerate. Capital flows are also likely to experience a similar slowdown. Worsening risk profile is chasing portfolio investment and bank loans away from the crisis-hit economies. FDI, too, is bound to weaken due to eroded profitability in host and home economies. However, the current crisis is not the end to globalization.

Integration of the Asian economies with each other and between them and the rest of the world on the other is rooted in more fundamental forces. It is pushed on the one hand by advances in a wide range of technologies, notably infromation, telecommunication and transportation technologies. These advances make various barriers to the flows of ideas, goods, services and capital more and more porous. They also keep redefining the structure of competitiveness between economies and firms. On the other hand, liberalization works as a pull factor for deeper integration. It can be unilateral, regional or global. It is these two groups of forces that allow in the past a progressive growth of intra-Asia trade and investment even in the absence of a formalized regional scheme. The current crisis alone is not going to reverse permanently this trends of economic integration in Asia. Within Asia there has developed a regional production and distribution system with a dynamic of its own.

For Indonesia the decade of the 1990s is one of a mixed performance Growth-wise it had been an impressive period before the crisis erupted. From the point of view of global competition, however, the last 5 years were a period of disappointment. From 1993 onward Indonesia turned inwardly. Trade and investment deregulation was losing momentum. Export of non-oil products was decelerating, and merchandise surplus declined from a peak of $ 8 billion in 1993 to only $ 5 billion in 1996. On this score Indonesia was an outlier within Asia. The Asian trade boom was not observable in Indonesia. On the other hand merchandise import, services import and income payment rose dramatically. Ironically, investors remained bullish. FDI, portfolio investment and short-term debt capital flooded Indonesia. These flows were concentrated in non-tradeables and import substitution, aided by a very high level of distortion in favor of domestic orientation. The very high growth had

blinded market participants, policy makers and researchers. What Indonesia is currently doing is, in a way, paying the bill associated with the domestic-oriented boom of the last fiver years.

5. Reinvented Development Cooperation

In the fifteen months since the eruption of the crisis Indonesia has been offered the opportunity to bring the crisis under control with the IMF-led consortium. This package contains first of all the badly needed cash. Its second element consists of policy prescriptions. The fact that the package has not worked as quickly as expected is now a subject of controvercy.

In its original design the IMF program was very similar to the standard package put together by the IMF for any member who is faced with a balance of payments crisis. It prescribes a fiscal and monetary conservatism. This approach was also favored by Indonesian economists. However, the government was highly ambiguous about the policy prescriptions in spite of its formal endorsement. Precious time was wasted to explore alternative measures such as the ill-fated currency board system. The IMF on its side insisted on its basic formula. The disbursement of loans was delayed. In this connection a major question arises as to the appropriateness of the IMF's standard model of adjustment. At a time when quick actions are needed this standard model does not seem to be the appropriate way of handling a major crisis.

Apart from the problem of timing, a redesign is needed in balance of payment adjustment. The Indonesian crisis is not primarily a current account crisis one can hope to reverse with a contractionary measures. It is largely a crisis of a sudden termination of capital inflows, be they long-term or short-term. The ease at which capital can come and go is perhaps the crux of the matter Undoubtedly, Indonesia and the rest of Asia do subscribe to some practices which turned out to be a liability rather than a strength in the current global financial markets. They centre on the Asian pragmatism in contrast to transparency and accountability. Under pragmatism the level of risk is hard to assess. However, they cannot explain the entirety of the problems. Reducing volatility in a globalized financial market requires the adherence to a set of principles and rules which currently are lacking in respect of certain financial transactions. Expecting Asia in general and Indonesia in particular to address these issues of financial regime separately is not realistic. The greater the importance of capital flows is to the health of the global economy the more urgent it is to address capital flows in a global context. This brings us to the

current discussion of the new architecture of global finance. While conceiving such an architecture experiences of Mexico and the crisis-hit countries of Asia provide valuable lessons. Globalization of the financial market is much more than just the removal of barriers. It also has to give adequate attention to reducing systemic sources of extreme volatility. This an area where Indonesia can only expect to play the role of a follower. The key players in this search for a new architecture are going to be the mulatilateral lending institutions, the G7 or G3 and perhaps also the United Nations. Making the global financial environment more friendly to developing coountries is perhaps even more important than offering financial assistance in times of crisis.

Fresh inflows of capital are certainly needed in any attempt to bring a crisis under control. In times when private flows are halted, official flows are the only option. In this connection, the huge financial package put together by Indonesian creditors is a necessary part of the plan to enable Indonesia to stabilize its economy and to embark upon a reconstruction program later on. However, another loan cannot be a solution to an economic crisis that hit at a time when an economy is already highly indebted. A successful reconstruction requires a strong recovery in non-debt flows of resources. Given its current risk profile, Indonesia cannot expect much in terms of the attraction of greenfield FDI in the near future. Indirect equity inflows may also take time to return in sizeable amount. Therefore, the foreign exchange need of reconstruction will have to be covered with export earnings. Openness of markets in the major economies becomes crucial. Yet, an economic slowdown may awake a new sentiment of protectionism in some markets. In fact, some alarmists have started to complain about the strong import to the United States in the post-crisis period.

Mention was made eralier of the competence gap as part of the causes of the Asian crisis. Even before the crisis many economists had pointed out to the small contribution of productivity improvement to the Asian growth "miracle". This gap of competencies is particularly strong in the financial services industry. The current crisis in Indonesia, Thailand and South Korea and the protracted crisis in Japan point out to the truth in this argument. Asia in general and Indonesia in particular do have a lot to catch up as far as the stock of knowledge capital is concerned. Narrowing the gap should be made an important item in a reinvented development cooperation. It implies that development cooperation should shift its focus from the accumulation of physical capital to that of human capital.