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Remarks to USINDO and US-Asean Business Council
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Introduction

It is a pleasure to be here today. A trip to the US is not complete with out a discussion among our friends at USINDO and the US-Asean Business Council. I believe I speak on behalf of all of us when I say that Indonesia is fortunate to have had your positive engagement and support over the years. I have spent the last few days in New York attending some fascinating meetings of the Growth Commission chaired by Micheal Spence. I am not sure that I have completely absorbed the insights from the meetings, but it has been a joy to have heard from many of the most creative minds currently thinking about how economic development works.

However, one of the issues of special relevance to Indonesia is how to recover the growth rates and reduced poverty we were experiencing before the crisis. I do not have time to address this issue in detail today, but let me just say that I think, or hope, that after ten years of economic and political challenges, we are on the threshold of once again achieving growth in the 7% range. We have all been taught the painful lesson that macroeconomic stability can never be taken for granted. However, it is increasingly clear that the challenge of fiscal stabilization is behind us.

The challenge now is to increase the amount of government resources used to push growth and reduce poverty while simultaneously addressing the policy and institutional challenges we still face. You may know that I recently gave a presentation to the University of Gajah Mada where I outlined some of the links that I believe exist between economic growth and political development. While I am confident of growth prospects in the near term, one has to recognize that democracy is a fragile flower. A failure on our part to sustain growth at rates that move Indonesia solidly into middle income status risks not only the economist's concern of lower welfare but more broadly the vibrant democratic experiment that is underway. I would be happy to share a copy of the presentation with those who are interested.

Let me now turn to discuss the two main topics: our view of Indonesia's macroeconomic picture, and a quick synopsis of the main reforms currently under way.

Macroeconomic picture

In 2006, growth declined slightly to 5.5% from 5.7% in 2005, but this is certainly a case where the annual figures do not begin to tell the tale and a bit more history is needed. Indonesia was growing in the 6% range for the first three quarters in 2005 but domestic interest rates were too low to prevent exchange rate volatility, and high international oil prices and domestic subsidies put the country's fiscal picture at risk. Thus the Government and the Central Bank moved to put their fiscal and monetary policy on solid footing with policy adjustments that included fuel price increases of well over 100% (on top of earlier increases that totaled around 150% for the year) and a 400 basis point increase in interest rates. This inevitably resulted in lower growth and the fourth quarter of 2005 and the first two quarters of 2006 slowed to 5%. However, by the second half of last year, the economy began to recover and growth again averaged 6%.

In retrospect, we were a bit too optimistic about our ability to recycle the subsidies into government spending and the regional governments in particular were not able to increase spending to compensate for the reductions in consumption. On the other hand, we were very fortunate that our trade picture brightened significantly with exports driving growth and turning in a 17% growth rate for the year as a whole. Investment turned sharply downward early but recovered to over 8% by the fourth quarter.

As you may know, this encouraging macroeconomic picture has not gone unnoticed. There have been some wobbles in the last few years as perceptions about emerging market risks have changed, but, generally, Indonesian markets have dealt well with recent global shocks. The exchange has weakened, but then reverted. Stock prices have fallen then recovered. In fact, this last week has once again seen Indonesian markets hitting all time highs. In addition, we continue to make steady progress improving our overall credit ratings and we are quite sure they will improve further soon.

One of the major concerns after the fuel price increases in 2005 was that the high inflation would work its way into wages, fueling an inflationary spiral. Fortunately, this does not seem to have occurred. Inflation rose to over 19% before the end of 2005 but Bank Indonesia was successful in reining it in at 6.3% by year's end—better than their inflation target range of 7 to 9%. Over this period, BI has brought interest rates down from a high of 12.5% to 9% today. Lending rates have not fallen quite as far, but there are signs that lending, especially investment lending, has begun to pick up in recent months. However, this year has seen a bit of a pickup in monthly inflation numbers and despite relatively benign inflation in March, Bank Indonesia paused its interest rate reductions (at 9 %). We would all like to see lower interest rates, and in all probability they will continue to decline, but the Central Bank's primary responsibility is to keep inflation under control, thus safeguarding the hard-won macro-stability I mentioned earlier.

As I indicated earlier, our budget picture has begun to change. Last year, 2006, saw a budget deficit in the 1% range, slightly lower than budgeted due to persistent spending problems. Nevertheless, low deficits and strengthening growth brought the debt to GDP ratio to the 40% range. Recall that just a few years ago it was close to 100%. This year's budget deficit was planned for 1.1% but we now expect that this will be exceeded. In part, this is occurring because of unanticipated expenditures—the flooding in Jakarta, for example—and the need to repay some substantial arrears that have built up around VAT payments. But it also reflects the fact that we are now more confident about our fiscal picture, allowing us to run somewhat larger deficits this year and next. The combination of increased fiscal space due to the reallocation of the fuel subsidies and higher deficits will allow us to expand spending on the national poverty program (more on this in a moment), on increasing agricultural production and most importantly infrastructure. Despite this increase in spending, the government's debt to GDP ratio should continue to decline, further reducing risk perceptions and improving ratings.

Let me finish this brief discussion on the macroeconomic picture with our outlook for this year and next. We take as a starting point the belief that world economic and trade growth will be a bit slower this year, as will commodity prices. This will likely play out in lower exports. However, this should be offset by the increasing momentum of domestic demand. As I noted earlier, we expect to see growth at 6.3% this year. This is a fairly substantial pickup from last year's 5.5% but only a bit higher than the 6% range we have seen in the last couple of quarters. This pick up should be driven by a combination of factors. First: adjustment. Both producers and consumers have largely adjusted to higher energy prices and we have seen significant changes in demand patterns and energy efficiency. Second: government spending will provide a larger fiscal stimulus. Finally: lower interest rates should trigger more investment and a recover in consumer spending on durables. All in all we expect the economy to grow in the 6 to 6.5% range this year. Next year should continue to see a pick up in government spending, the continued playing out of lower interest rates and a turn around in investment perception as increasing reform momentum sets in. Also, we expect to see even higher private investment driving growth to 6.8% with the possibility that it could go higher, i.e. return to the 7% range.

2

Reform accomplishments and agenda

The improving macroeconomic picture and the increased political and institutional stability allow us to turn with more focus and energy to the reform agenda. We appreciate that public opinion, including international public opinion, is impatient. Expectations were high that significant reforms would be forthcoming faster than has proven to be the case, but we have to accept that we are operating in a new reality. The situation is such that policy is now made in an environment where many more stakeholders, including Parliament, are engaged. This inevitably slows things down, but at the same time adds legitimacy. For example, last week Parliament passed a new Investment Law that we believe represents a clear improvement with the existing situation. Among other things, it includes equal treatment for domestic and foreign firms. In the areas that are not explicitly listed in a forthcoming negative list, it provides for land tenure close to 100 years and the right of foreign firms to seek redress through binding foreign arbitration if there are disputes with government.

But we have no intention to rest here. The investment law will only be as good as the regulations that support it and the Minister of Trade is already working to conclude the regulations laying out the procedures for the negative list and investment approval procedures. The set of tax laws has now moved to the forefront of our discussions with Parliament and, while we may not agree on every point, the business community is playing a constructive role that should result in a better tax system in the near future. Another area where we expect progress is trade facilitation, and especially the establishment of a national single window that will allow importers and exporters to deal on line with customs and all related government agencies cutting time and transaction costs. Pilots will be getting underway for the single window this year.

Probably the most contentious area is labor. Last year saw an attempt to increase labor market flexibility that was not well received. We accept that it is important to create more flexibility for companies, but it is also important that workers have a degree of income security. It is going to take time to move to a better balance, but this time we have to get it right.

The areas I have touched on will be part of forthcoming reform packages to improve the investment climate, the financial sector and the climate for small and medium enterprises. Let me briefly touch on some of the reforms in the financial area. Last year's package included a breakthrough by which state owned banks were allowed to write down non-performing assets in the same manner as private banks, which we believe will allow them to spur lending this year. Most recently, we have seen Bank Indonesia relax some of the regulations that have prevented banks from extending credit, including allowing banks more independence to assess borrower risk for projects and allowing them to lend to small enterprises on the basis of business plans rather than audited accounts which they may not have had time to develop. We also intend to push forward with improvements to the operations of capital markets, including the regulatory framework for insurance and pensions. Deeper and more diversified capital markets are critical to increased corporate borrowing and long term infrastructure finance.

Perhaps the key challenge to accelerating growth is infrastructure. We understand the concerns of the private sector, especially around power and transportation, but in other areas as well. Much effort in the last couple of years has been focused on improving the framework for public-private partnerships. There has been progress: we have changed policy about government partial risk guarantees, established a unit at the Ministry of Finance to assess projects and contingent risks and we have explicitly put aside funds in last year's and this year's budget to provide for land acquisition, guarantees and an infrastructure fund. Further, there is progress on model projects that will be put to international tender. However, the situation in many areas is critical and we are also pushing ahead with accelerated tendering of power plants as we attempt to find the right mix between a longer term framework and short term needs.

3

One of the areas where I am most pleased is our ability to increase our attention to employment generation and poverty reduction. As part of last year's fuel price increase, we put in place a program of unconditional cash transfers. Given time pressures, there were inevitably some problems of targeting, but overall our assessment is that the program protected the poor from the severity of the price shock that the fuel price increase generated. However, we never felt that this was a long term solution to poverty and we are now moving to attack the root of the problem on two fronts. First, we are expanding existing Community Driven Development (CDD) programs nationwide. Thus, by 2009, every district in Indonesia will be given a grant to support community development. Most of these funds will go to local level infrastructure, generating immediate employment impacts and longer term returns through improved access and services. We are also expanding the direct provision of basic health and education services for the poor, as well as attacking poverty outcomes from the demand side. To do this, we are piloting conditional cash transfer programs that will transfer funds to poor families for improved education and health outcomes. The evidence from Latin America is that these programs can be a powerful force for reducing the intergenerational transmission of poverty.

Finally, I hope that we can now also begin to attack one of the most fundamental reform agendas—civil service reform. It is no secret that one of the reasons we have had difficulty moving quickly on reforms has been an inability to deliver quickly on regulations needed to cut transactions costs. An even greater problem is our inability to make sure that policies once enacted are carried out as desired. This is not going to be a simple matter to fix. It will require difficult changes to incentives and institutions. We are not attacking the problem comprehensively as yet, but are rather allowing the Ministry of Finance *(among others)* to develop and implement new approaches, including assigning full time structural units to the reform process (in tax and treasury) and looking more carefully at job descriptions and compensation. As this effort progresses and we see the results, we will undoubtedly adopt them more widely.

Conclusion

In sum, we expect Indonesia to grow faster for the next couple of years and to deliver better employment and welfare outcomes as the new poverty programs take hold. We will continue to face problems with the investment climate and infrastructure reforms, but there is progress and it will continue.

Obviously there is much more happening than I have been able to touch on, and in each area we could go into more detail. But rather than listen to myself talk, I would prefer to hear your concerns and suggestions and I invite your questions.

4