CHAPTER 2, ECONOMIC TRENDS AND OUTLOOK

The Megawati Administration made significant progress in stabilizing Indonesia's economy during its first year in office. It rejuvenated Indonesia's economic reform program and restored Indonesia's relationship with the IMF, which had deteriorated during the Presidency of former President Abdurrahman Wahid. From September 2001 to April 2002, the GOI pushed through several important economic reforms, including reducing fuel subsidies and selling a majority stake in Bank Central Asia, Indonesia's largest formerly private bank. In April 2002, the Paris Club of official creditors recognized the GOI's renewed commitment to economic reforms by agreeing to reschedule USD 5.5 billion in principal and interest payments falling due from April 1, 2002 to December 31, 2003.

The markets responded positively to the GOI's improved policy performance. Indonesia maintained positive GDP growth through the world economic slowdown in 2001, with year-on-year (YoY) GDP growth bottoming out in the fourth quarter of 2001 at 1.6 percent. Growth picked up slowly in the first three quarters of 2002. The GDP grew 3.92 percent YoY in Q3 2002, improving on first half YoY growth of 2.87 percent. During the first three quarters of 2002, higher spending by government and consumers, up 10.8 and 5.8 percent YoY respectively, drove growth.

Despite the uncertain international environment, Indonesia's export performance began recovering in the first half of 2002 from its Q4 2001 low. Non-oil and gas exports increased in three consecutive quarters from Q1 to Q3 2002, with exports in the latter quarter 22.9 percent above their levels in Q4 2001. Increased political stability and more decisive monetary policy performance by Bank Indonesia (BI) led the rupiah to appreciate over 14 percent through the end of November 2002, stabilizing near the Rp 8,800/USD level. YOY CPI inflation rates fell from a two-and-a-half year high of 15.1 percent in February 2002 to 10.3 percent in October 2002.

The Government's FY 2002 budget implementation was on track through the first half of the year, with the full year deficit projected to fall slightly below the GOI's Rp 42.1 trillion target (equivalent to 2.5 percent of GDP.) In December 2002, Parliament passed a conservative Rp 365.8 trillion (USD 41.5 billion) FY 2003 budget that forecasts a Rp 36.6 trillion deficit, equivalent to 1.9 percent of projected 2003 GDP. The final budget includes an expanded fiscal stimulus designed to boost domestic demand in the wake of the October 12, 2002 Bali bombings. In recognition of the GOI's improving fiscal position, several international rating agencies upgraded Indonesia's sovereign ratings in August and September 2002.

GDP Growth: Future Prospects Uncertain

Despite the Megawati Administration's success in stabilizing the economy, concerns mounted in 2002 about Indonesia's short and medium-term GDP growth prospects. Indonesia's YoY GDP growth rates have remained in the 3-4 percent range since the beginning of 2001, with few signs of take-off to the 7.2 percent average GDP growth Indonesia experienced from 1990-96. A sustained period of strong economic growth and low inflation would give the GOI much needed room to consolidate its recovery from the 1997-98 financial crisis, reach a balanced budget, further reduce the country's debt/GDP ratio, and continue corporate restructuring.

With household consumption already growing almost six percent a year and the outlook for robust export growth clouded by an uncertain world economy, reviving business investment is the key to restoring GDP growth to pre-crisis levels. However, investment statistics through the first eight months of 2002 were very weak. Foreign investment approvals declined 39 percent from the same period in 2001 to USD 3.55 billion. The 39-percent decline came on the back of a 42 percent decrease in foreign investment approvals in 2001. Provisional balance of payments (BOP) statistics for 2001 indicate that while Indonesia's private capital deficit narrowed from its 2000 level, net foreign investment remained strongly negative during the year at USD -5.9 billion.

The October 12, 2002 terrorist bombings in Bali complicated the GOI’s economic challenge. An estimated 4.3 million foreign tourists visited Bali in 2001, and tourism-related activities account for more than half of Bali’s economy. Occupancy rates at most Bali hotels fell precipitously after the attacks, and at the end of 2002 were only slowly recovering. The World Bank estimates that tourist arrivals in Bali could fall by 20 percent in 2003 at a cost of approximately 350,000 jobs. The impact of the bombings on Indonesia’s economy should be more manageable, since Bali’s economy represents only 1.3 percent of GDP. Tourism and related industries nationwide contribute a modest 3.5 – 4.5 percent of GDP. Most economists expect GDP growth to fall by about one full percentage point in 2003 to approximately three percent.

Analysts cite a number of factors contributing to Indonesia's prolonged business investment slump. These include slowing structural reforms, rapidly rising labor costs, the lack of an efficient and transparent legal system, widespread official corruption, signs of impending infrastructure shortages, uncertainties stemming from Indonesia's decentralization program, and competition from other labor-intensive economies in Asia, especially China and Vietnam. Although the GOI has held dialogues on doing business issues with domestic and international business groups, through the end of 2002 it made little progress in formulating and implementing a meaningful reform program that would encourage potential investors. Focusing on improving Indonesia's investment climate has emerged as the GOI's top short-term policy challenge.

Implications for U.S. Business

Despite the many challenges facing the GOI, Indonesia retains most of the advantages that fueled rapid economic growth during the 1980s and early 1990s. These include generally adequate infrastructure, ample natural resources, an adequately trained work force, a strategic geographical location in the heart of South East Asia, and a large and expanding internal market of approximately 220 million people. These factors will remain attractive for many U.S. firms, particularly if the GOI makes significant headway on the policy issues described above.

GDP Growth: A Tentative Expansion

Although economic growth picked up moderately in the first three quarters of 2002, the post-Bali bombing outlook for Q4 is much less favorable. According to Central Bureau of Statistics (BPS) figures, GDP grew 3.92 percent YoY in the third quarter of 2002 after expanding 3.51 percent in Q2. Growth in the quarter was broad based, with government consumption, household consumption, investment and net exports all showing modest increases. Consumer spending continued its post-1999 pattern of strong growth, expanding 5.8 percent in the first three quarters of the year over 2001 levels. On the production side, growth was fairly evenly spread in the first three quarters, with manufacturing, transportation and communications, utilities, and retail, hotels, and restaurants showing the most consistent growth.

Indonesia's quarterly YoY GDP growth rate has increased in three consecutive quarters since Q4 2001, when growth bottomed out at 1.6 percent. Table 1 outlines Indonesia's Q2 2002 real GDP performance by production and expenditure category:

Table 1: Indonesian Real GDP, Q2 2002 vs. Q2 2001

A. By Production Category

Production Category	Percent Change Q3 2002 vs. Q3 2001	Share of GDP
Manufacturing	3.0	28.7
Agriculture	6.7	18.4
Retail, Hotel, Restaurant	4.3	17.7
Mining	0.8	9.5
Services	1.2	9.9
Finance and Leasing	3.4	7.3
Construction	5.7	6.4
Transportation and Comm.	6.1	8.4
Electricity, Gas, Water	5.0	1.9
Total (categories weighted)	3.9	100.0

B. By Expenditure Category

Expenditure Category	Percent Change Q3 2002 vs. Q3 2001	Share of GDP
Household Consumption	4.9	69.6
Government Expenditure	15.6	7.9
Investment	2.1	18.5
Exports	1.6	34.1
Change in Stock	---	-3.9
Imports	0.2	-26.1
Total (categories weighted)	3.9	100.0

Source: Central Bureau of Statistics (BPS).

Exports: Slow Recovery

When measured in dollar terms, Indonesia's exports in the first ten months of 2002 fell 0.9 percent to USD 47.6 billion compared to the same period in 2001. Non-oil and gas exports rose 2.0 percent to USD 37.7 billion during that period, while oil and gas exports fell 10.6 percent to USD 9.9 billion. Third quarter 2002 non-oil and gas exports remain 7.5 percent below their post-crisis peak in Q3 2000. However, YoY growth figures disguise a modest export recovery since the final quarter of 2001, when total exports fell to their lowest level in more than three years. Non-oil and gas exports rose from Q1 through Q3, with exports in the latter quarter 22.9 percent above their levels in Q4 2001. Total monthly exports topped the USD 5 billion level in four of the five months between June and October 2002.

Table 2 outlines Indonesia's post-crisis quarterly export performance.

Table 2. Indonesia: Post-Crisis Export Performance

Quarter	Oil/ Gas(1)	Non- Oil/Gas(1)	Total(1)	YoY Change(2) (Non-Oil/Gas)
97-Q3	2.7	11.3	14.0	16.5%
-Q4	2.9	11.0	13.9	12.2%
98-Q1	2.3	10.0	12.3	17.6%
-Q2	1.8	10.3	12.1	-12.7%
-Q3	1.9	10.8	12.7	-4.4%
-Q4	1.9	9.7	11.6	-11.8%
99-Q1	1.9	8.3	10.1	-17.0%
-Q2	1.9	9.6	11.5	-6.8%
-Q3	2.8	10.5	13.3	-2.8%
-Q4	3.2	10.3	13.5	6.2%
00-Q1	3.3	10.8	13.9	30.1%
-Q2	2.1	12.0	14.1	25.0%
-Q3	2.3	12.9	15.2	22.9%
-Q4	4.7	12.0	16.7	16.5%
01-Q1	3.9	10.9	14.8	0.9%
-Q2	3.2	11.2	14.4	-6.7%
-Q3	3.0	11.3	14.3	-12.4%
-Q4	2.6	9.7	12.3	-19.2%
02-Q1	2.7	10.0	12.7	-8.3%
-Q2	3.0	11.5	14.5	2.7%
Q3	3.1	12.0	15.0	6.2%

(1) USD billions. Source: BPS.
(2) YoY percentage change of non-oil and gas exports, an indicator of manufacturing performance.

Indonesia's export mix remains predominantly low technology manufactured goods and commodities. Manufactured goods represent approximately two-thirds of total exports. Given continuing economic uncertainty in Indonesia's export markets, many analysts forecast flat full-year export performance in 2002.

Uncertain Prospects for 2003

Given recent growth trends and the impact of the Bali bombings, most economists are forecasting full year 2002 GDP growth rates of 3.0 - 3.5 percent. The GOI forecast 2003 GDP growth of 4.0 percent in its final FY 2003 budget, but most economist believe this forecast is too optimistic. With household consumption already growing more than six percent a year, the outlook for more robust export growth clouded by an uncertain world economy, and the fallout from the Bali bombings, reaching the 2003 target will require a significant revival in business investment.

Indonesia needs a sustained period of strong economic growth and low inflation in order to consolidate its recovery from the 1997-98 financial crisis. A period of robust economic growth would give Indonesia's troubled corporate and banking sectors room to recover and restructure their operations along more efficient lines. Equally importantly, a period of sustained GDP growth would provide employment opportunities to Indonesia's millions of unemployed and under-employed workers.

Economists calculate that Indonesia's labor force is increasing by 2.2 - 2.7 percent a year, a growth rate equivalent to 2 - 2.5 million new job seekers each year. The National Development Planning Agency (BAPPENAS) in turn estimates that 4 percent GDP growth translates into an increase in the demand for labor of 2.4 percent, or 2.2 million new job opportunities per year. These figures make it clear that in order to re-employ large numbers of workers who lost their jobs during the 1997-98 crisis and absorb new labor market entrants, Indonesia needs a sustained period of GDP growth well above 4 percent.

Monetary Indicators: Significant Improvement

Increased political stability after President Megawati assumed office coupled with more decisive monetary policy by BI led to significant improvements in Indonesia's monetary indicators during the first eight months of 2002. YoY base money growth declined rapidly from its September 2001 peak of 24.6 percent, reaching single digits by May 2002, and Indonesia has consistently met its IMF base money targets in 2002. At the same time, the rupiah appreciated almost 15 percent through November 2002 from its year-end 2001 level, stabilizing near or above Rp 9,000/USD for much of the second and third quarters.

CPI inflation edged downward from its February 2002 YoY peak of 15.03 percent, declining to 10.33 percent YoY in October. The appreciating rupiah played a key role in bringing down CPI inflation: approximately one-quarter to one-third of changes in the CPI index can be traced to the "pass through" effect from changes in the value of the rupiah.

Improving monetary indicators gave Bank Indonesia scope to begin reducing interest rates in January 2002, after raising interest rates on Bank Indonesia Certificates (SBIs) more than 500 basis points since June 2000 in an effort to control inflation and defend the value of the rupiah. BI's effort to drive down interest rates gathered steam after March 2002, and by the end of August, SBI rates had fallen over 320 basis points from their year-end levels, to 14.35 percent. Table 3 presents more detailed information on Indonesia's recent monetary indicators.

Table 3: Indonesia: Recent Financial and Monetary Indicators (Source: BI)

Month	Base Money(1)	CPI(2) Inflation	Rupiah/USD XR(3)	SBI(4) Int. Rate
Jan. 2001	17.7%	8.28%	9,450	14.74
February	18.0%	9.14%	9,835	14.79
March	16.1%	10.62%	10,400	15.58
April	20.6%	10.51%	11,675	16.09
May	18.3%	10.82%	11,058	16.33
June	17.0%	12.11%	11,440	16.65
July	17.3%	13.04%	9,525	17.17
August	20.9%	12.23%	8,865	17.67
September	24.6%	13.01%	9,675	17.57
October	19.0%	12.47%	10,435	17.58
November	19.1%	12.91%	10,430	17.60
December	11.9%	12.55%	10,400	17.62
Jan. 2002	11.8%	14.42%	10,320	16.93
February	13.7%	15.13%	10,189	16.86
March	12.7%	14.08%	9,655	16.76
April	10.8%	13.30%	9,316	16.61
May	9.0%	12.93%	8,698	15.51
June	8.6%	11.48%	8,730	15.11
July	6.7%	10.05%	8,716	14.93
August	5.3%	10.60%	8,890	14.35
September	6.1%	10.48%		13.22
October	6.7%	10.33%		13.10

(1) Source: BI. YoY growth rate of base money.
(2) Source: BI. YoY growth rate in CPI inflation.
(3) Source: BI. End-month BI middle exchange rates.
(4) Source: BI. End-month interest rate for one-month Bank Indonesia Certificates (SBIs).

No Turnaround in Private Capital Flows

Preliminary balance of payments data for 2001 show a continuation of Indonesia's post-crisis pattern of large current account surpluses coupled with continuing capital account deficits. In the four years preceding the crisis (1993-96), net private capital inflows averaged USD 7.7 billion per year (see Table 4), or an average of over 4 percent of GDP. In 1997 this pattern reversed as imports and foreign investment (portfolio and direct) collapsed, resulting in average net capital flows of a negative USD 6.05 billion per year from 1998-2001.

Indonesia's exports fell 25 percent in 2001 from their record highs a year earlier. Coupled with a smaller reduction in imports, the decline in exports led to deterioration in the current account surplus from USD 8.0 billion in 2000 to an estimated 5.0 billion in

2001. The capital account deficit increased over the same period from USD -6.8 to -8.9 billion. According to BI, two factors led to the deterioration in the capital account: a large decrease in net official capital inflows (largely the result of a slowdown in drawings of program loans offered by the Asian Development Bank, World Bank, and Japan), and continued negative net foreign investment flows.

Table 4. Indonesia: Summary Balance of Payments Information (USD Billions, Source: BI.)

Year	94	95	96	97	98	99	00	01(2)
Current Account	–3.0	-6.8	-7.8	-5.0	4.1	5.8	8.0	5.0
Trade Balance	7.9	6.5	5.9	10.1	18.3	20.6	25.0	21.6
Capital Account	4.0	10.6	11.0	2.5	-3.9	-4.6	-6.8	-8.9
Private	3.7	10.3	11.5	-0.4	-13.8	-9.9	-10.0	-8.6
FDI(1)	2.1	4.3	6.2	4.7	-0.4	-2.7	-4.6	-5.9
Other	1.6	5.9	5.3	-5.0	-13.5	-7.2	-5.4	-2.7
Official	0.3	0.3	-0.5	2.9	10.0	5.4	3.2	-0.3
Errors/ Omiss.	–0.2	-2.3	1.3	–1.7	2.1	2.1	3.8	2.6
Monetary Mvmt(3)	–0.8	-1.5	-4.5	4.1	-2.3	-3.3	-5.0	1.4

(1) Foreign direct investment.
(2) Preliminary data.
(3) Monetary movement, minus (-) equals a surplus.

Indonesia's Official Debt: Modest Progress

Indonesia's official debt burden increased from 27 percent of GDP prior to the financial crisis to approximately 100 percent of GDP at the end of 2000 (Table 5). Virtually all of the increase came in the form of the Rp 658 trillion (USD 74.8 billion) in bonds the GOI issued to domestic banks and BI to cover the costs of Indonesia's banking sector bailout. The budgetary burden of Indonesia's debt service payments is very heavy: the GOI forecasts that total interest payments will account for almost 35 percent of central government expenditures in 2002-03. Indonesia's debt burden has become politically controversial, with some commentators urging the GOI to repudiate the country's foreign debt or limit repayments to an arbitrary percentage of GOI revenues. The GOI has made reducing Indonesia's official debt a national priority.

A combination of continued GDP growth, the appreciation of the rupiah/USD exchange rate, and the depreciation of the Japanese yen vis-à-vis the U.S. dollar (one-third of the Indonesia's official debt is yen-denominated) resulted in a decrease in Indonesia's debt/GDP ratio in 2001 for the first time since the financial crisis. The IMF and other analysts have predicted that Indonesia's debt/GDP ratio will fall further in 2002 to an estimated 75 percent of GDP. The IMF estimates that if the GOI can maintain a balanced budget and achieve 5-percent GDP growth in 2004 and 6-percent GDP growth in 2005-7, Indonesia's debt/GDP ratio could fall below 50 percent by 2007. Key to achieving this result will be maintaining budget discipline. Also important will be finalizing an agreement in principle between the Government and Bank Indonesia to restructure the Rp 228 trillion of GOI bonds held by BI in compensation for losses on BI liquidity credits.

Table 5: GOI Foreign and Domestic Debt, 1995-2001
(USD Billions)

Year	Foreign	Domestic	Total	Debt/GDP Ratio
1995	63.5	0.0	63.5	31%
1996	56.3	0.0	56.3	25%
1997	57.9	0.0	57.9	27%
1998	67.3	0.0	71.5	72%
1999(1)	75.8	68.7	144.5	102%
2000(2)	74.8	78.0	152.8	100%
2001(2)	71.4	64.2	135.6	93%

(1) 1999 domestic debt figure based on Rp 312 trillion in bank recapitalization bonds issued, plus Rp 228 trillion in bonds issued to BI, converted at the 1999 average exchange rate of Rp 7855/USD.
(2) 2000-01 domestic debt figures based on Rp 430 trillion in bank recapitalization bonds plus Rp 228 trillion in bonds issued to BI, converted at the exchange rate of Rp 8430/USD for 2000 and Rp 10,255/USD for 2001.
Source: Bank Indonesia.

In recognition of the GOI's continued budget discipline and the country's improving debt situation, several international rating agencies upgraded Indonesia in 2002. In August, Fitch Ratings upgraded Indonesia's long-term and short-term foreign currency ratings to B from B-. Fitch also upgraded Indonesia's long-term local currency rating to B. In September, Standard & Poor's upgraded Indonesia's long-term and short-term foreign currency ratings to CCC+ and C respectively.

In order to reduce the short-term budget burden of debt service costs, Indonesia has concluded three consecutive debt-rescheduling agreements with the Paris Club group of official bilateral creditors. In September 1998, the GOI and Paris Club agreed to reschedule USD 4.6 billion in principal payments falling due from August 1998 to March 2000. In April 2000, they concluded a similar agreement rescheduling USD 5.8 billion in principal payments falling due from April 2000 to March 2002. In April 2002, the GOI and Paris Club agreed to reschedule USD 5.5 billion in principal and interest payments falling due between April 1, 2002 and December 31, 2003.

Short-Term Policy Challenges: Fostering Investment

The key challenge facing GOI policymakers in mid-2002 is taking advantage of Indonesia's hard-won macroeconomic stability to enact effective policies to boost business investment. Indonesia's investment performance has been poor in 2002: in the first eight months of the year, foreign investment approvals declined 39 percent to USD 3.55 billion from the same period in 2001. Realized foreign investment in 2001 reached only USD 70 million, indicating that approved investment--if it is ever realized--is spread out over a long time horizon, or may be exaggerated. Many Indonesian commentators have criticized the lack of dynamism in the "real economy," but the GOI's response to lagging business investment has been tentative.

Analysts generally agree that GOI progress in the following core areas would greatly increase the prospects for sustained and robust business investment in Indonesia:

-- Legal and Judicial Reform: Foreign observers cite Indonesia's inefficient and opaque legal system as a major obstacle to attracting foreign investment. In a serious abuse of the bankruptcy law, in June 2002 the Jakarta Commercial Court declared bankrupt a local subsidiary of the Canadian insurance firm Manulife Financial, even though the Ministry of Finance declared it was solvent. Although Manulife's Supreme Court appeal was successful, few observers rule out the occurrence of similar cases in the future. Although the GOI has repeatedly recognized the importance of legal and judicial reform, it has moved very slowly and progress to date has been minimal.

-- Resolving Labor Problems: Back-to-back annual minimum wage hikes of 30 and 39 percent in Jakarta in 2001 and 2002, coupled with similar rises in other major cities, have reduced Indonesia's competitiveness for labor-intensive manufacturing. Extremely generous severance pay provisions have further boosted labor costs. Labor activism has also increased significantly as Indonesia's labor unions adjust to a more democratic political environment. The GOI attempted to enact a new labor law in July 2002 to deal with these problems, but the draft law effort collapsed under opposition from both labor and business groups. The increase in Jakarta's monthly minimum wage for 2003 was a more modest 7 percent to Rp 631,000 (USD 72).

-- Reducing the Uncertainty from Fiscal Decentralization: Indonesia's ambitious fiscal decentralization program, implemented in January 2001, continues to create uncertainty for foreign investors, particularly in the mining and petroleum sectors. Many local governments have enacted taxes that discriminate against foreign investors and restrict internal trade. The Ministry of Home and Regional Affairs (MOHRA) and the Ministry of Finance (MOF) have been reluctant to nullify taxes that violate Indonesian laws or overly burden business or commerce. In addition, local governments now have the authority to approve investments in all areas except in the financial and petroleum sectors, which remain the preserve of the central government. Despite the transfer of investment approval authority, investment rules and procedures approval criteria for new investments, licensing arrangements, etc. remain unclear.

-- Reforming the Banking Sector: The GOI completed its Rp 430 trillion bank recapitalization program in October 2000, but the banking sector remains fragile. Reports of solvency problems at a number of banks continued in 2002, including at six of the eleven banks owned by the Indonesian Bank Restructuring Agency (IBRA). Despite continuing management problems at state and IBRA-owned banks, the GOI's bank privatization program moved slowly after the April 2002 sale of Bank Central Asia. IBRA postponed the sale of Bank Niaga several times, finally completing the deal in October 2002. Re-privatizing the bulk of Indonesia's banks and ending the blanket GOI guarantee on bank liabilities is crucial for resuming commercial lending to the real economy and reducing the risk to the GOI's finances from potential bank failures.

-- Infrastructure bottlenecks: Indonesia has seen very little investment in infrastructure since foreign financing dried up in the wake of the 1997-98 financial crisis. Four years later, there are signs that the country's ports, roads, and other infrastructure are becoming overloaded. The problem is most acute in the area of electric power generation, and some experts predict power shortages in the Java-Bali grid by 2004. Although the GOI has announced the resumption of some projects suspended during the crisis, it has not developed a strategy for boosting infrastructure investment to pre-crisis levels.