Executive Summary

In the past year, Indonesia experienced fundamental political changes that were a first stage in reforms necessary to provide a sustainable foundation for future growth. In June 1999, the country held parliamentary elections in which multiple parties competed and which were widely received as free and fair. In October 1999, the People's Consultative Assembly chose Abdurrahman Wahid as President and Megawati Sukarnoputri as Vice President in a process regarded as producing a legitimate government. President Wahid appointed a cabinet drawn from several political parties.

The new government faced immense challenges -- consolidating internally, establishing the rule of law, addressing human rights cases and corruption, putting civil-military relations on a new footing, establishing new patterns for relations between the central, provincial, and district governments, and improving the economy's health. On economic issues, members of the economic cabinet moved quickly to re-establish active relationships with the International Monetary Fund (IMF) and the World Bank and, in January 2000, signed a new Memorandum of Economic and Financial Policies (MEFP) to the IMF. Implementation of some of the commitments contained in the MEFP, especially involving corporate debt and bank restructuring, was confusing and fragmentary over the opening months of the program.

An overarching challenge facing both the government and business community was that Indonesia's economy had not yet shaken off the effects of the 1997-98 financial and economic crisis. Instead, the most serious problems -- companies saddled with bad loans, and crippled banks -- had not been dealt with decisively. Indonesia's recovery was being delayed as a result. In the interim, even as Indonesia labored to emerge from the crisis, new economic realities had emerged that together painted a sobering before-and-after picture:

- Private capital inflows crimped: Few expected the massive net inflows of the early 1990s--which fueled real GDP growth averaging 7.2 percent per year from 1990-96--to resume anytime soon, especially because foreign creditors were still licking their wounds.

- Banking sector deep freeze: Banking sector growth was a hallmark pre-crisis; its collapse was a central feature of the crisis. The collapse required a massive GOI rescue effort, coordinated by the Indonesian Bank Restructuring Agency (IBRA), that will take several more years to complete and over a decade to pay for. In the meantime, the banking system remained in a deep freeze. In early 2000, few banks, including recapitalized banks, were lending except to consumers, though some banks were eager to resume limited corporate lending provided that credit-worthy companies could be found. With banking activity at a low ebb as of mid-2000, companies were seeking alternative financing: using cash flow, issuing domestic bonds if they qualified, or in a few cases borrowing abroad.

- Exchange rate volatile: Stability was the watchword pre-crisis, part of the lure for foreign investors seeking to lock in high returns on rupiah assets. Volatility was a fact of life afterward. Hedging mechanisms were incomplete. Even so, a return to an effectively fixed-rate system was unlikely.

- Government debt large: Pre-crisis, the GOI borrowed abroad each year to help finance its budget and some years it prepaid higher-cost debt. It had a comfortable debt-to-GDP ratio and virtually no domestic debt. Neither was true afterward. Government debt exceeded GDP, and debt servicing was a major constraint on government expenditure.

- Legal uncertainty: There was no legal certainty in the pre-crisis days, but there was predictability, based on a tacit understanding that contracts would be honored and debts paid. President Soeharto's fall left a vacuum that was unlikely to be filled for several years as Indonesia moved from a personality-based to a rule-based system. In the interim, the problem was that the economic crisis left a host of unresolved legal issues--including major ownership questions--in its wake.

- Regional decentralization: As the economy was undergoing upheaval, Indonesia's far-reaching transition to a decentralized political and fiscal system--under laws passed in 1999 that take effect May 2001--added another layer of uncertainty that was especially relevant for foreign investors.

What did these shifts mean for Indonesia? First, financial austerity: businesses were hard-pressed to get capital and government was constrained by its debt overhang. Second, uncertain future growth prospects: in the second half of 1999, GDP began recovering from its 1998 low point, and forecasts were for reasonable growth in 2000. But investment remained depressed, with long-dormant construction sites as visible reminders. In light of large uncertainties and unresolved regional issues, potential domestic as well as foreign investors were sitting on their hands while existing investors faced new difficulties. Compared to other countries in the region, Indonesia appeared to be in the slow lane toward recovery.

Some Rays of Hope, Some Fundamentals Unchanged

Before looking at the factors weighing on Indonesia's economy as it emerged from the worst of the crisis, it is worth noting the brighter side. After a real GDP decline of 13 percent in 1998, and negligible growth in 1999, GDP was expected to increase 3-4 percent in 2000, according to Bank Indonesia, the IMF, and private economists (see Table 1). The macroeconomic picture was more stable than at the peak of the crisis because of low inflation (the CPI rose only 2 percent in 1999, and inflation was forecast to reach only 7 percent in 2000) and relatively low interest rates (down from 40 percent in March 1999 to below 11 percent at end-April 2000). The agricultural sector, which

Table 1. Indonesian Real GDP, 1999 vs. 1998.

A. By Production Category

Production Category	Percent Change 1999 vs. 1998	Share of GDP
Manufacturing	+2.19	26%
Agriculture, Forestry	+0.67	21%
Retail, Hotel, Rest.	-1.10	16%
Mining	-0.11	10%
Services	+2.82	9%
Finance and Leasing	-8.67	6%
Construction	+1.15	6%
Transpo. and Comm.	-0.72	5%
Electricity, Gas, Water	+7.25	1%
Total (categories weighted)	+0.23	100%

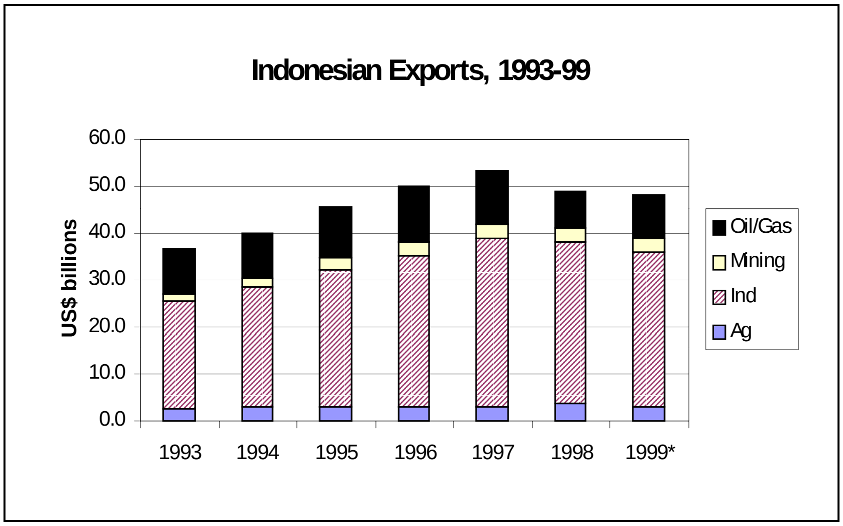
B. By Expenditure Category

	Percent Change 1999 vs. 1998
Household Consumption	+1.48
Government Expenditure	+0.69
Investment	-20.78
Exports of Goods/Services	-32.06
Imports of Goods/Services	-40.90

Note: Real GDP declined 13 percent in 1998.
Source: Central Bureau of Statistics (BPS).

employed close to half the workforce, was producing as before (better than under 1997-98 drought conditions), though there were structural stresses affecting the sector.

Consumers' domestic spending picked up in early 2000, reflecting improved consumer confidence after President Abdurrahman Wahid's election in October 1999, as well as the



"switching" effect of a weakened currency that made imported goods more expensive in local currency terms and domestic goods more attractive. The surprise results were early 2000 waiting lists to buy the most popular cars, new restaurants and stores opening in Jakarta and other cities, and even a mild resurgence in home building. The boomlet was said to be fueled in part by flight capital returning from overseas, though there were no reliable data to confirm the anecdotes.

More generally, many observers were surprised by the resiliency of the Indonesian economy even during the worst of the economic crisis. The 1998 GDP decline of 13 percent did not send armies of unemployed into the streets. Though many manufacturing firms closed their doors or cut back production (many remained at reduced output levels in early 2000), the shock absorbers were Indonesia's vast informal economy, close family networks, and increased agricultural export earnings, especially off Java. In short, Indonesia limped through the worst of the crisis, but did not fall. That image is relevant for the near term, as the same open-market economics that had produced such impressive growth in the three decades before the crisis remained intact. At the same time, the resiliency of the economy in the face of the crisis ultimately lessened the pressure to fundamentally reform Indonesia's financial and legal infrastructure.

Table 3. Import Values, by quarter, 1997-2000

Quarter	Imports: Total US$ billions	Imports: change*
III-97	9.5	
IV- 97	8.9	-5.8%
I- 98	6.2	-30.3%
II- 98	5.6	-9.3%
III-98	6.2	10.4%
IV- 98	6.5	5.1%
I- 99	4.8	-26.2%
II- 99	5.4	11.7%
III-99	4.9	-9.0%
IV- 99	5.1	4.9%
I- 00	5.7	10.6%

* quarter-on-quarter change.
Source: Central Bureau of Statistics

Though the crisis left several major changes in its wake, other fundamental features of Indonesia's economy were unlikely to change in the near term:

- **Robust trade sector**

A hallmark of the pre-crisis economy was rapid expansion of exports as well as imports. Exports increased by an average of 11 percent per year during 1993-96. During 1998-99, imports collapsed and exports sagged, largely because of disarray in the financial sector. A significant piece of good news in 2000 was the apparent resumption of export growth. First quarter 2000 figures showed that non-oil exports had recovered to 93 percent of their pre-crisis (third-quarter 1997) levels, while total exports—boosted by higher world oil prices--were at almost 100 percent of the pre-crisis level (see Table 2).

While a return to export growth, if sustained, would be welcome, the export mix was likely to remain low-tech and natural-resource-based: low-tech manufactured goods (sport shoes, textiles, basic electronics, with many inputs imported); natural resources (plywood, furniture, paper); and agricultural products (palm oil, spices). There was no evidence that exporters had taken advantage of the changed exchange rate picture to improve productivity. Instead, many claimed that the exchange needed to remain weak (having depreciated about 30 percent in real terms since before the crisis, see Table 7) for their products to remain competitive.

Table 2. Export Values, by quarter, 1997-2000

Quarter	Exports Oil/gas	Exports Non-oil	Exports change*	Exports Total
	US$ billions			
III-97	2.7	11.3		14.0
IV- 97	2.9	11.0	-3.0%	13.9
I- 98	2.3	10.0	-8.9%	12.3
II- 98	1.8	10.3	2.5%	12.1
III-98	1.9	10.8	5.2%	12.7
IV- 98	1.9	9.7	-10.3%	11.6
I- 99	1.9	8.3	-14.8%	10.1
II- 99	1.9	9.6	16.3%	11.5
III-99	2.8	10.5	9.8%	13.3
IV- 99	3.2	10.3	-2.2%	13.5
I- 00	3.3	10.6	2.8%	13.9

* quarter-on-quarter change of non-oil export values, an indicator of manufacturing performance.
Source: Central Bureau of Statistics

Export growth was accompanied by an uptick in imports (see Table 3), including capital goods. Even so, imports stood at 60 percent of pre-crisis levels. Imports of capital goods, primarily machinery and other equipment vital for manufacturing, declined to 30 percent of their 1997 level in 1999, according to preliminary estimates. The decline was not critical given the deep recession that left much manufacturing capacity underutilized, but it would be important once growth resumed and it meant that modernization plans had been postponed.

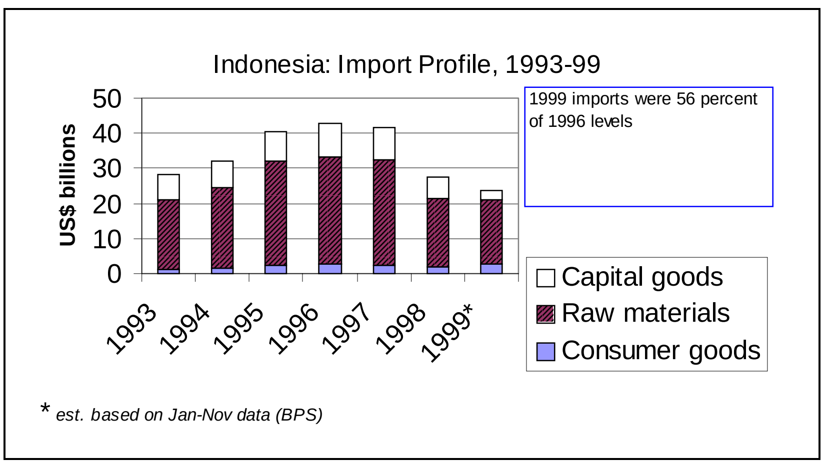
- Business ownership patterns unchanged

The Indonesian Bank Restructuring Agency (IBRA) technically owned most of the manufacturing sector and much real estate as of mid-2000. But since it had not foreclosed much of anything, there was little everyday evidence of changed ownership. Moreover, even as IBRA sells assets and settles debts, ownership is likely to remain concentrated in the hands of the pre-crisis ownership group. Supporting this impression is anecdotal evidence that business groups are buying back and retiring their non-IBRA debt at reduced rates offshore through proxies. Politicians' proposals to shift ownership on a grand scale to ethnic Indonesian ("pribumi") owners got little traction. Harsh corporate debt settlements could lead to some prominent owners losing their companies, or divesting segments of their empires, but that had not occurred as of mid-2000. Small and medium business, less affected by the levels, should continue to be a dynamic part of the economy whose prospects would be improved by reform to remove obstacles to doing business. At the same time, large state-owned companies would still play an important role in the economy, barring an unexpected acceleration of privatization. Work force skilled in basics

Indonesia's manufacturing work force was generally regarded as skilled-in-the-basics but undereducated. The limitations that made high-tech manufacturers reluctant to set up shop in Indonesia pre-crisis were sure to persist beyond the next several years. Improving human resources was Indonesia's fundamental long-term challenge. Alarmingly, competitors in China, Vietnam, and India were capturing many of the low-tech markets in which Indonesia had recently excelled.

- Internal market attractive

A population of 210 million would remain an interesting market by any measure. But it remained to be seen when the rapid growth of the middle class -- an exciting feature of Indonesia's pre-crisis economy -- would resume.



Several Fundamentals are Challenging

Against this background -- a large, low-tech, agricultural, regionally diverse, trading economy -- what had changed? Mainly the financial environment, both externally and internally. In essence, Indonesia's private sector lost its line of credit with the outside world in 1997-98. Foreign creditors stopped being paid as the rupiah exchange rate collapsed. Domestic banks collapsed because their loans were not repaid either. In response, the GOI pledged to prop up the banks (and their depositors) and took on a huge load of foreign and domestic debt. The consequences of this sequence of events were likely to continue looming over the economy for several years:

- Private capital flows

During the five years preceding the crisis, 1992-1996, net private capital inflows averaged US$ 7.2 billion per year (see Table 4), or an average of 4 percent of GDP per year. In 1997, the tide reversed. Net capital inflows, even taking into account heavy government borrowing, remained negative in 1998 and 1999.

Analysts regarded a resumption of private capital inflows as essential for placing Indonesia back on a growth path. Even so, few expected substantial inflows to resume for several years. A May 2000 macroeconomic forecast prepared by the National Development Planning Agency (Bappenas), with a best-case scenario assuming that Indonesia successfully reformed many aspects of its economy, foresaw net negative private capital flows through 2001, followed by resumption of net inflows: US$ 2.4 billion in 2002, US$ 5.4 billion in 2003, and US$ 6.7 billion in 2004.

Table 4. Indonesia: Net Capital Inflows

	1992	93	94	95	96	97	98	99*
				US$ billions				
Private	5.4	5.2	3.7	10.3	11.5	-0.4	-13.8	-7.4
FDI	1.8	2.0	2.1	4.3	6.2	4.7	-0.4	-1.5
Other	3.6	3.2	1.6	5.9	5.3	-5.0	-13.5	-6.0
Government	12.8	12.8	0.3	0.3	-0.5	2.9	10.0	5.2
Total	18.1	18.0	4.0	10.6	11.0	2.5	-3.9	-2.3

note: FDI is foreign direct investment
* preliminary data for January-September
Source: Bank Indonesia

- Bank trauma; bad loans unresolved

Banks were at ground zero of the financial crisis that hit Indonesia in 1997-98. Normal banking ground to a halt. Upwards of 70 percent of bank loans were estimated to be non-performing. The banking system's total credit fell by almost 50 percent during 1999, from Rp 545 trillion at end-1998 to Rp 278 trillion at end-1999. The total number of banks had declined from 238 pre-crisis to 162 (5 state-owned national banks, 27 state-owned regional development banks, 120 private banks, and 10 foreign branches, not counting joint-venture banks and foreign banks' representative offices). The crisis left Indonesian banks in parlous condition, on par with American banks at the height of the Great Depression.

Table 5. Bank Assets and Bank Recapitalization Bonds as of April 2000 (all figures in Rp trillions)

Bank	Status	Recap. Bonds Received	Recap. Bonds Expected	Assets
State Banks				
Mandiri	Recapd. 10/99 and 12/99	178	(not clear)	205
BNI	Partial recap. 4/00	30	30	98
BRI	Delayed	0	29	31
BTN	Delayed	0	11	11*
Subtotal		208	70	345
Category "B" Banks				
BII	Recap. 5/99	8.7	-	44*
Lippo	Recap. 5/99	7.7	-	24
Universal	Recap. 5/99	4.6	-	10*
Prima Exp.	Recap. 5/99	0.6	-	2*
Bukopin	Recap. 5/99	0.4	-	8*
Arta Media	Recap. 5/99	0.1	-	1*
Patriot	Recap. 5/99	0.1	-	0*
Bali	Delayed	0	5	9*
Niaga	Delayed	0	9	17*
Subtotal		22	13	115
Taken-Over Banks				
BCA	Recap. 5/99	65	-	96
Danamon	Recap. 5/99	17	(see below)	26
PDFCI	merged with Danamon 12/99	-	-	2*
Tiara	see note 1		30	4*
Nusa	"	-		4*
RSI	"	-		3*
Duta	"	-		1*
Tamara	"	-		1*
Jaya	"	-		0.5*
Rama	"	-		0.4*
Pos	"	-		0.2*
Subtotal		82	30	138
Total		312	114	598

note 1: These 8 banks are to be merged with Danamon. The combined bank will receive additional recapitalization projected to total Rp 30 trillion.
Source: Recapitalization figures from IBRA and press reports. Assets are December 1999 (* are September 1999) estimates by Infobank magazine. Total assets of the banking system were estimated at Rp 812 trillion.

The GOI embarked on a massive bank recapitalization program in 1999, guided by the IMF and other international financial institutions, that it planned to complete by mid-

2000. There were five categories of domestic banks involved in the ambitious restructuring process:

-- State-owned banks: With their credit portfolios abused for years, the state-owned banks had the biggest bad loan portfolios. In several cases they still had much the same management as before the crisis. Four of the banks were merged into Mandiri, now Indonesia's largest bank. State-owned banks had been partially recapitalized; their collective capital adequacy ratio (CAR) was negative 9.4 percent as of the end of January 2000.

-- Taken-over banks: The largest private banks, BCA and Danamon, as well as other banks, were taken-over by the Indonesian Bank Restructuring Agency (IBRA). They had been partially recapitalized, and in some cases were being merged, with the aim of re-privatization.

-- Category "A" banks: With capital adequacy ratios (CAR) of 4 percent or better, these mostly small private banks did not require recapitalization. The GOI pledged to reassess their condition and close them if their financial condition deteriorated, but there had been scant attention to this issue.

-- Category "B" recapitalized banks: The GOI selected nine banks for GOI-assisted recapitalization in March 1999. Seven of the nine made it through the process and were apparently relatively healthy, but two of the larger ones, Bank Niaga and Bank Bali, remained in limbo.

-- Category "C" closed banks: 38 private banks with CAR worse than negative 25 percent were closed in March 1999; 10 other banks had been closed in 1998. Settlements of the owners' liquidity credit loans from Bank Indonesia remained pending.

Recapitalization: As of April 2000, the GOI had issued Rp 312 trillion in recapitalization bonds (the bonds replaced bad loans, and the GOI in turn took majority ownership of the banks). Estimates were that at least an additional Rp 114 trillion in bonds would be needed to complete the program, bringing the total to Rp 426 trillion (US$ 54 billion, see Table 5). The Finance Ministry in 1999 issued an additional Rp 228 trillion (US$ 28.5 billion) in bonds to Bank Indonesia to repay Bank Indonesia for liquidity credits. Even so, Bank Indonesia announced at the end of January 2000 that the overall capital adequacy ratio of the banking system was still negative 7.15 percent.

Challenges: As of mid-2000, the banking sector was no longer in a state of collapse, but neither had it recovered substantially. Several state-owned banks continued to lose money. The challenges for the GOI and bankers were to (1) restore the solvency of the banking system (banks were to raise capital adequacy ratios to 8 percent by end-2001); (2) re-privatize much of the banking sector and introduce professional standards in the state-owned banks; (3) pay the tremendous costs associated with the bail-out; (4) restore a climate of normal corporate lending that would promote economic growth; and (5) establish supervisory and legal standards that would prevent future banking crises.

Restructuring would be a multi-year process requiring difficult political commitments from a fragile coalition government. This meant that Indonesia's economy would have to cope with a wounded banking sector in the interim. A number of coping mechanisms had already emerged. Companies were said to be using internally generated cash flow to finance inputs (68 percent of companies said that was how they would finance capital spending, in a March 2000 survey) and, in rare cases, expansions. Relatively creditworthy companies were borrowing offshore from Singapore or Hong Kong. Other companies were issuing domestic bonds. One conglomerate, Sinar Mas (known internationally under its holding company name, Asia Pulp and Paper, APP) continued to issue USD-denominated bonds because its paper and palm oil businesses were still seen as strong. Meanwhile, domestic banks incrementally increased lending, but continued to focus on the consumer sector rather than on capital-starved corporates. Corporates remained for the most part in suspended animation, having neither paid nor restructured their pre-crisis debts.

- IBRA's role

The Indonesian Bank Restructuring Agency (IBRA), created in January 1998, was charged with the heavy lifting associated with bank and corporate restructuring. In addition, it was the GOI's primary means of recovering some of the costs associated with the massive restructuring program. IBRA reported that it had about US$ 52 billion in assets as of April 2000 (see Table 6). Its three main tasks were to: (1) restructure banks in preparation for their re-privatization, then sell them; (2) restructure and collect on bad loans taken over from banks, with assistance from the Jakarta Initiative Task Force (JITF) and Attorney General; and (3) sell assets pledged by bank owners as settlement of the emergency Bank Indonesia Liquidity Credits issued in 1997-98. These tasks were difficult enough on their face, but IBRA's more significant obstacle was lack of resolute political support under President Soeharto (January-May 1998), President Habibie (May 1998-October 1999) and President Abdurrahman Wahid (elected in October 1999). The jury was still out on this issue as of mid-2000.

- Exchange rate volatile

Pre-crisis, the stable rupiah was a linchpin of both Indonesian borrowers' and foreign lenders' calculations. From 1990-1996, for example, the rupiah depreciated an average of 3.9 percent per year with relatively little variation (ranging from 2.7 percent to 5.5 percent per year). Bank Indonesia managed the exchange rate on a gradual weakening path to keep Indonesia's exports competitive. The business community believed the exchange rate would remain both stable and predictable. Meanwhile, deposit interest rates over that period were in the teens or higher (ranging from 13 to 23 percent, according to IMF figures), and lending rates were higher (ranging from 18 to 26 percent or more). The numbers meant that Indonesian borrowers were motivated to borrow at lower interest

Table 6. IBRA Assets as of April 2000

Category	Rp trillions	US$ billions
Loans transferred from frozen, recapitalized, state-owned, and taken-over	217.5	28
GOI investment in recapitalized and taken-over banks	86.8	11
Assets from Shareholder Loan Settlements for Bank Indonesia Liquidity Credits 1	93.8	12
Non-core assets (property, etc.)	3.6	0.5
Total	401.7	52

Note: Rp 402 trillion was equivalent to about 36 percent of Indonesia's 1999 GDP, Rp 1,107 trillion.
Source: IBRA monthly report, April 2000

rates abroad. They did so in droves. On the other hand, some foreign investors placed funds on deposit in Indonesia or loaned out funds there, because the rates were favorable even when the rupiah depreciation was taken into account. The result was that Indonesia's corporate world and financial system became very internationally integrated -- and, it turned out, vulnerable to an exchange-rate shock. When the crisis hit in 1997, Indonesian corporates had an estimated US$ 80 billion in foreign debt, equivalent to over a third of Indonesia's GDP that year. Little of that debt had been paid as of mid-2000; most remained to be restructured.

The pre-crisis exchange rate calculations changed in August 1997 when the GOI announced an end to the managed float. Under the managed float, the GOI had pledged to intervene when the exchange rate threatened to go outside a several-percentage-point band. But having watched neighboring countries expend large amounts of foreign exchange reserves in fruitless efforts to stabilize their currencies in mid-1997, GOI authorities opted out of that system. The rupiah weakened somewhat over the rest of 1997 (see Table 7). The rupiah then lost its moorings entirely in 1998, driven mainly by mounting political uncertainty. The exchange rate strengthened somewhat in 1999 but volatility remained a fact of life. The standard deviation of the exchange rate averaged 5 percent per week in 1999, according to a bank analyst, and in early May 2000 the rupiah's value against the USD was still fluctuating by as much as 5 percent per day.

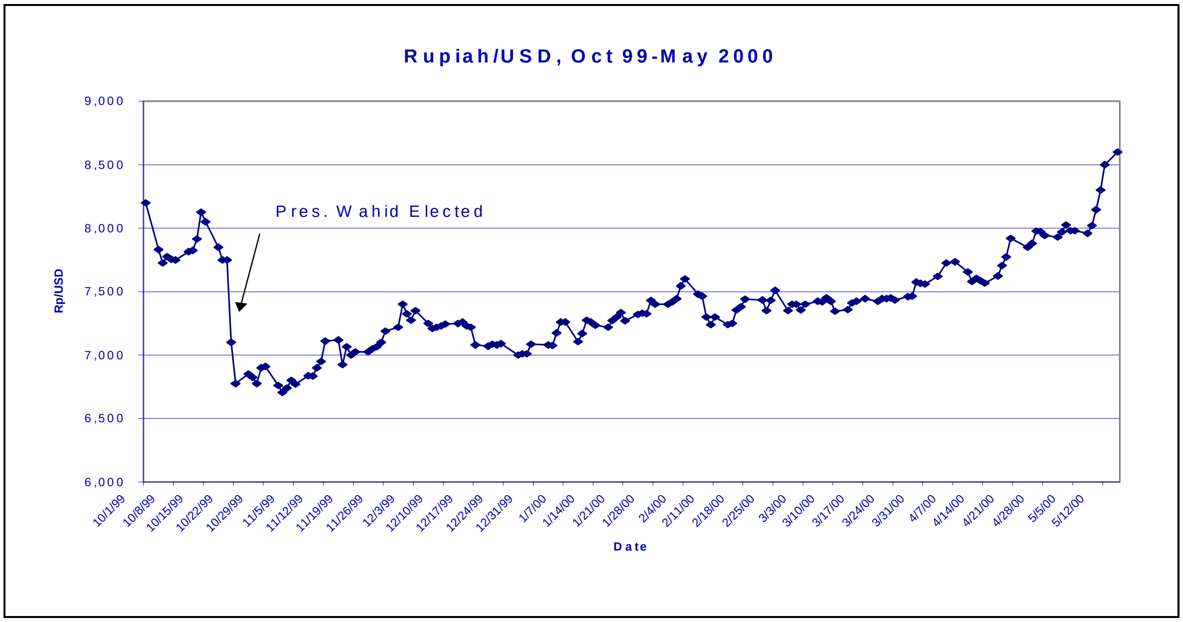


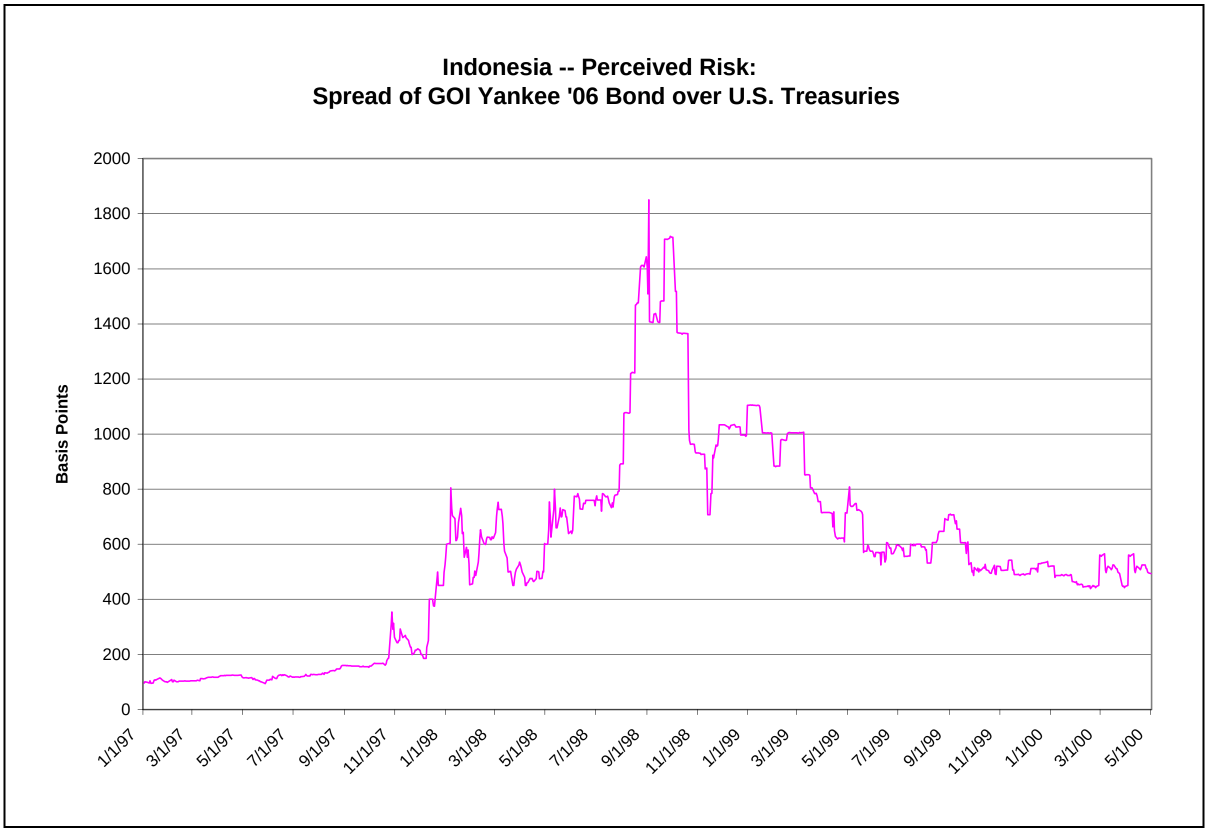
Table 7. Rupiah/USD Exchange Rate Indices by quarter, 1997-2000 (June 1997=100)

	Nominal	Real
Jun-97	100	100
Sep-97	75	77
Dec-97	53	58
Mar-98	29	40
Jun-98	16	26
Sep-98	23	44
Dec-98	31	59
Mar-99	28	57
Jun-99	36	72
Sep-99	29	57
Dec-99	35	68
Mar-00	33	65
Apr-00	31	61

Note: This table indicates that as of April 2000, the rupiah retained 31 percent of its pre-crisis value against the USD in nominal terms, but 61 percent in real terms, taking into account Indonesian consumer price inflation (and assuming U.S. inflation to be negligible).

The FY 2000 GOI budget introduced in January 2000 posited an average exchange rate of Rp 7,000/USD for April-December, but the exchange rate weakened to Rp 8,700/USD as of mid-May suggesting that parts of the budget might have to be recalculated. For businesses, the variable and varying exchange rate became another element of uncertainty that they had to take into account. The hedging mechanisms available in more developed economies were not always at hand: a bank analyst said in March 2000 that in practical terms there was no forward rupiah market beyond one month.

Business people and officials were disturbed that variations in the exchange rate, in a foreign exchange market that was said to have decreased from US$ 2 billion/day pre-crisis to only US$ 100-200 million/day in early 2000, appeared to be driven more by political than economic issues. Hence, improvements in economic factors were no guarantee of a stronger or more stable exchange rate. (As the Perceived Risk chart indicates, political uncertainty resulted in a steep premium on the GOI's USD-denominated "Yankee" bonds, where the exchange rate is not at issue, during the crisis. In early 2000 the premium was still a significant five percentage points above U.S. treasuries, compared to about one percent pre-crisis.)



- Government Debt large

As Table 8 indicates, the GOI had a relatively comfortable debt situation pre-crisis. The GOI borrowed abroad each year, primarily from a group of donor countries grouped in

the Consultative Group on Indonesia (CGI), as well as from multilateral institutions such as the World Bank and Asian Development Bank. The proceeds were used to fund the development budget. By long-established convention, the GOI avoided domestic borrowing, because economists feared it could lead to inflationary financing. The resulting debt-to-GDP ratio was sustainable -- part of what was widely seen as Indonesia's prudent macroeconomic management strategy.

As a result of its shouldering the cost of the 1997-1998 banking crisis and borrowing from the IMF, the GOI's debt burden increased sharply in 1998-99. Officials were unnerved by the fact that the debt load exceeded GDP in 1999 -- a fourfold increase over 1996. (High debt-to-GDP ratios are not unprecedented for Indonesia, economist Anne Booth recently wrote. In the late 1980s, Indonesia's ratio was about 80 percent, reduced over the next decade because of strong economic growth.) The immediate concern, however, was not so much the debt burden as the servicing costs. To create some breathing room, the GOI went to the Paris Club to reschedule principal due to sovereign creditors on two occasions, in September 1998 (rescheduling loans falling due August 1998-March 2000) and in April 2000 (rescheduling loans falling due April 2000-March 2002).

Table 8. GOI Foreign and Domestic Debt, 1995-2000

	Foreign	Domestic	Total	Debt/GDP
	US$ billions			
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	71.5	0.0	71.5	72%
1999	78.9	68.7	147.6	105%
2000 proj.	78.9	93.4	172.3	99%

Note: 1999's Domestic Debt figure is based on Rp 312 trillion in bank recapitalization bonds issued, plus Rp 228 trillion in bonds issued to repay Bank Indonesia for liquidity credits (converted at the 1999 average exchange rate of Rp 7855.2/USD). The 2000 projection assumes no net additional foreign debt, and an additional Rp 114 trillion in recapitalization bonds issued (converted at the GOI-budget exchange rate of Rp 7,000/US$).
Source: Data from Bank Indonesia, Business News

Even so, debt servicing was sure to be a major issue going forward. In the FY 2000 GOI budget, for example, debt service (which already assumed that bilateral sovereign debt would be rescheduled) accounted for 27 percent of expenditures, eclipsing the entire development budget at 21 percent. Pre-crisis, development expenditures had helped reduce Indonesia's poverty rate and develop its infrastructure. Looking forward, there was pressure to keep restraining expenditures (by cutting fuel subsidies and moderating civil service salary increases, for example) and raising revenues (through higher taxes and better collection) because crisis-era debt servicing bills would keep rolling in for the foreseeable future. Despite demands that the government "do something" to improve economic conditions and create jobs, the debt overhang would make it difficult for the GOI to adopt expansionist fiscal policy. A May 2000 Bappenas study projected that given solid GDP growth, low interest rates, and other favorable developments in the economy, the debt-to-GDP ratio could be reduced to 53 percent by end-2005. Analysts considered that projection very optimistic.

- Legal uncertainty

It was well known before the crisis that Indonesia's economic system was rife with corruption. However, the Soeharto-era patronage system amounted to an informal but often predictable substitute for a properly functioning justice system. Courts could not be relied on to issue impartial verdicts, but contracts were honored, for the most part, and debts paid. With Soeharto's abrupt resignation in May 1998, the former system broke down. At the same time, a host of thorny legal issues arose in connection with the mountain of unpaid domestic and foreign debts and contracts concluded during Soeharto's rule. The result was gridlock. A revised bankruptcy law was introduced in September 1998, but the Commercial Court proved disappointing to creditors. Thirty bankruptcy cases were filed in 1998 and 100 were filed in 1999. Creditors won about one-fifth of cases. IBRA remained winless in bankruptcy court after several attempts in early 2000.

The lack of legal certitude was not the only problem. Outside of the courts, flagrant political interference kept IBRA from doing its job of going after well connected debtors. In the most notorious case, mid-1999's Bank Bali scandal, GOI officials allegedly conspired to arrange an IBRA payment to the bank, siphoning off over half the amount for then-ruling party Golkar.

The justice system was not the only corrupt institution by any means, but the extent of corruption there was disturbing because it stood in the way of erecting the professional legal infrastructure that Indonesia needed to effect reform. Before the GOI could use the justice system to clean up corruption, it had to clean up corruption in the justice system.

As of mid-2000, thoroughgoing judicial reform was not yet underway, but there were steps being taken that, if they were not reversed, could lead to progress on corporate debt restructurings. In line with the IMF program, ad hoc judges were to be appointed to the Commercial Courts, and would hear cases at IBRA's request. An early-2000 effort to appoint ad hoc judges failed, but a renewed effort was said to be nearing success as of mid-2000. This effort to place new judges in the courts was seen as a stopgap measure until the entire court system could be overhauled, starting with the Supreme Court. Systems were being put in place to shunt non-cooperative debtors to the Attorney General for legal action. The Jakarta Initiative Task Force had beefed-up authority to offer "sticks and carrots." However, these measures remained untested as of May 2000. The upshot was that legal uncertainty was an additional factor that foreign and domestic businesses had to take into account before investing here. Some foreign investors had doubts about likely progress on the judicial front in the near term, opting instead to deal only with Indonesian businesses that had proven reputations for integrity.

- Regional decentralization

In May 1999, in an effort to satisfy restive regions clamoring for more local authority and revenues, the GOI passed Law 22 on Regional Autonomy and Law 25 on Fiscal Balance Between the Center and the Regions. Both laws are to take effect in May 2001. Law 22 devolves most functions away from the center to provincial and sub-provincial regency ("kabupaten," or county equivalent) levels, though the central government retains responsibility for foreign affairs, defense, justice, monetary and fiscal affairs (though regions can borrow on their own), and religious affairs. Law 22 calls for local legislative bodies to elect provincial governors and other officials.

Law 25 is best known for its revenue sharing formulas: 15 percent of net oil revenues, 30 percent of net gas revenues, and 80 percent of forestry, mining, and fishing revenues will go to the provinces and regencies, mainly to the latter. However, other aspects of revenue sharing that would determine the net benefit or loss to a given region were left to regulations. The implementing regulations for Law 25 had not been published as of early May 2000, prompting analysts to speculate about which areas would gain and which would lose under the new system. The law contained a vague formula to protect non-resource-endowed areas from suffering declines in financial flows from the central government, but the details were unclear and sure to be controversial.

For Indonesians as well as foreign investors and others, the far-reaching laws were fraught with great uncertainty. In the context of Indonesia's highly centralized system, a wholesale shift of authority and revenues to the sub-provincial level was potentially--if implemented in full--revolutionary, and potentially--in light of untested regional capacities, and the central government's budget constraints-- problematic.

The impression in mid-2000 was that regions had taken hold of Law 22 and were essentially implementing it in advance of the official schedule. Local authorities were dividing up forests for logging (in one case handing out concessions for what was ostensibly a national park), counting local mining revenues as already theirs, causing concern among U.S. and other foreign investors whose regional operations some local governments regarded as additional revenue sources. An additional concern was that regions seemed eager to take on the "profit centers" such as mines and forests, but reluctant to handle "cost centers" such as hospitals and schools. With only one year to go before the laws took effect (but longer to work out the uncertainties), decentralization was an area that merited close attention.

Implications for U.S. Business

- Trade

For U.S. exporters to Indonesia, the 1997-98 crisis was a major setback. Prior to the crisis, when the Commerce Department identified Indonesia as one of several "big emerging markets," U.S. merchandise exports to Indonesia were growing by 10 percent per year, from US$ 2.8 billion in 1992 to US$ 4.5 billion in 1997. When the crisis hit, U.S. exports plunged, totaling only US$ 1.9 billion in 1999. Early 2000 (January-February, see Appendix A) data suggested that U.S. exports to Indonesia were on the increase again. But it was likely be several years before U.S. exports, along with other nations' exports to Indonesia, recovered to pre-crisis levels. Meanwhile, Indonesian exports to the United States remained strong. Having doubled from US$ 4.5 billion in 1992 to US$ 9.2 billion in 1997, they increased further to US$ 9.5 billion in 1999.

Was there was a silver lining to the collapse of Indonesia's import market? For U.S. companies that had not yet established robust relationships in Indonesia, maybe so. The crisis-induced dislocations in Indonesia's economy meant that many of the old importer-exporter relationships had broken down. U.S. companies willing to aggressively build trade relationships during the recovery period (including being willing to provide creative financing, such as letters of credit via an offshore bank, for example) could see substantial benefits once strong growth resumes.

In addition, there were bright spots for U.S. exports as selected Indonesian sectors recovered. U.S. export figures in early 2000 showed good Indonesian demand for raw materials for pulp and paper, forestry and woodworking equipment, agricultural sector equipment, and building products. Indonesian business people showed renewed interest in U.S. trade shows in 1999 and 2000. Expansion of Indonesia's nascent internet businesses meant opportunities for U.S. firms, and upgrading of bank and telecommunications information systems provided other opportunities. Education and training remained a significant U.S. export to Indonesia, with an estimated 12,000 students studying at U.S. colleges and universities.

- Investment

United States companies were among Indonesia's leading investors pre-crisis. Cumulative investment approvals from U.S. companies totaled US$ 5.1 billion dollars during 1995-99, not counting the important oil and gas sector where U.S. firms were leaders. Not surprisingly, overall investment figures fell sharply as a result of the crisis, and U.S. figures declined apace. In 1998, U.S. investment approvals (fewer than half of approved foreign investments are usually realized) totaled only US$ 568 million; in 1999, the figure was only US$ 136 million, excluding oil and gas and financial sector investments. U.S. investors' concerns went beyond the general economic slowdown. U.S. electricity infrastructure companies faced contract renegotiations with the Indonesian government; U.S. mining companies endured local authorities' efforts to garner a growing share of company revenue, emboldened by the movement toward regional autonomy; and some U.S. oil companies struggled with regional unrest. Potential new investors were understandably hesitant. That said, most U.S. companies with a presence in Indonesia opted to ride out the difficulties, seeing a return to growth in the future.

Appendix A: Country Data

Population in 1999:	210 million (projection based on 1990 census)
Population growth rate:	1.7 %/year (avg. 1990-97)
Religions:	Islam, Hinduism, Buddhism, Christianity, Animism
Government System:	Emerging Democracy
Languages:	Indonesian, English, and Regional Languages
Work-week:	Monday-Friday

Appendix B. Domestic Economy

	1997	1998	1999	2000 (forecast)
GDP (USD billions)	215	99	138	174
Real GDP growth rate (%)	5.0	-13.4	0.2	3.0
GDP per capita (USD)	1,070	492	688	829
Government spending as percent of GDP	21	27	20	22
Consumer Price Infl. (%)	11.1	77.6	2.0	7.0
Unemployment (percent)*	5	5	5	5
Foreign Exchange Reserves (USD billions)	21.4	24.1	27.2	27.2
Average exchange rate for USD 1.00**	2,909	10,014	7,855	7,000
Debt service ratio (Debt service/exports, %)	38	37	41	40
U.S. economic aid (USD millions)	47	250	270	273999

Appendix C: Trade (USD billions)

Total exports (1)	53.4	48.8	48.7	13.9
non-oil/gas (1)	41.8	41.0	38.9	10.6
oil/gas (1)	11.6	7.8	9.8	3.3
Total imports (1)	41.7	27.3	9.7	5.7
U.S. exp. to Indonesia (2)	5.0	3.5	1.9	0.5
U.S. imp. from Indonesia (2)	7.1	7.0	9.5	1.5

Notes:
* Indonesia does not have reliable unemployment data, because of the large informal workforce.
** 2000 figure is GOI budget assumption for Apr-Dec budget year.
note 1: 2000 figure is January-March.
note 2: 2000 figure is January-February.
Sources: Indonesian Central Bureau of Statistics, Bank Indonesia, Ministry of Finance, World Bank, U.S. Department of Commerce.