Indonesia's Economic Prospects and Challenges[1]
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Democratic Indonesia is politically stable and is weathering the global economic crisis better than most other developing countries. Indonesia suffered more than any other country in the Asian economic crisis of 1997-98 as political instability coincided with capital flight and other economic reversals. Thanks to good economic management in the interim and a timely response to the global crisis, however, the current world recession has seen Indonesia emerge as one of the most resilient emerging economies. Meanwhile, the parliamentary and presidential elections successfully conducted earlier this year have solidified the country's status as a solid democracy. As *The Economist* commented recently, "foreigners may not realize that the world's third largest democracy and fourth most populous country with more Muslims than any other is actually doing rather well."

Yet many problems remain. Corruption, unemployment, poverty, restrictive business practices, rickety infrastructure, environmental degradation, and the resolution of past political and military abuses are just some of the massive problems that need to be tackled. The reelection of President Susilo Bambang Yudhoyono in July provides a mandate for reforms in these and other areas.

Economic growth continued in 2009. In the early 2000s, the Indonesian economy grew at about 5.5% a year. Six percent growth was achieved in 2008. This year, the world recession is expected to cut the growth rate to around 4.4%, but that is still a remarkably good figure in the current unfavorable international economic environment. The fact that Indonesia is less dependent on exports to currently depressed developed country markets than many of its neighbors has lessened the damage it suffered from the global economic downturn. The country also benefited from its record of sound macroeconomic policy implementation, including prudent debt management and development of a stronger financial sector.

Consumption spending is leading the way right now. Private consumption expenditure, which is growing at about 4% per annum with some assistance from the government's fiscal stimulus program (which includes cash transfers and higher salaries for civil servants), as well as from election-related spending in the first half of 2009, is currently the main driver of economic growth. Moreover, Bank Indonesia's survey of consumer confidence is recording the highest levels since January 2005.

Investment is too low and has yet to recover. Prior to the global recession, private investment in Indonesia was reasonably robust while public investment was low. Total investment was sufficient to support a solid growth performance but fell sort of what would have been needed to replicate the growth and productivity-increasing achievements of China and India. Direct foreign investment was directed largely toward the extractive industries. Weak external demand and difficulty in obtaining credit growth have dampened private investment so far in 2009 and growth of only 0.5% in total investment over the 2008 level is predicted. Domestic non-financial

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corporations have obtained about 50% of their financing from abroad in the past and are unable to get such financing at present while weak overseas demand is reducing investment in export-oriented industries. Many investment plans have been postponed or canceled.

Higher growth is anticipated in 2010 and 2011. The IMF and World Bank expect the rate of economic growth to recover to around 6% per annum by next year or 2011 at the latest. They stress, however, that such a favorable outcome will be possible only if the currently nascent recovery of the world economy is maintained. The downside risk is that there could be another round of global risk aversion. In that case, Indonesia's export markets and access to external funding would be affected, potentially leading to a reversal of capital inflows and further declines in external and domestic demand.

Inflation is well contained at present but could speed up in the future. Inflationary pressures that led to an 11% rise in the cost of living index in 2008 have eased substantially as world food and fuel prices have declined. The current rate of inflation may be within the central bank's target range of 3.5-5.5% per year. However, the prices paid by the poor, whose consumption basket is heavily weighted toward food expenditures, tend to rise more rapidly and inflation is expected to accelerate in 2010 as domestic demand strengthens and international commodity prices rise.

Employment has been growing but most of the new jobs have been in the informal sector. Indonesia is going through a phase of the demographic transition in which youth dependency rates are falling and the labor force is rising faster than the total population. Faster job creation and skill development would enable this young and growing labor force to function as a major driver of economic growth. Meanwhile, large gender disparities in labor force participation show that the economy is not taking full advantage of women's productive potential, despite relative gender equality in education and health. The legal requirement that high severance payments must be made when workers are fired inhibits hiring. On the other hand, firms have so far not laid off workers in large numbers in the current unfavorable economic environment, perhaps for the same reason. Nevertheless, the unemployment rate (currently about 8%) is expected to rise in the next year or so.

Poverty is declining but near-poverty remains high. Indonesia's excellent long-term record in reducing the incidence of poverty was interrupted by the Asian economic crisis of the late 1990s. After rising to 23% in 1999, the percentage of households living below the official poverty line was reduced to 16% by 2005. There was some reversal in 2007 and 2008 as food price increases hurt the poor. Despite reductions in officially-measured poverty, however, nearly one-half of the Indonesian population still lives in poverty or near-poverty, earning less than $2/person/day and remaining highly vulnerable to shocks such as rising food and fuel prices, natural disasters, and economic downturns. There are also large regional disparities in the poverty profile. These conditions underscore the need for policies that will stimulate greater investment and faster, broad-based growth. Sustainable poverty reduction remains one of Indonesia's most pressing issues.

Infrastructure remains weak. Roads, port facilities, and electricity in particular require concerted attention. As a result of the aggressive and laudable government decentralization program that began in 1999, responsibility for maintaining four-fifths of the road network has devolved to the regional governments, many of which lack the capacity to deal effectively with maintenance tasks. Several indicators show that Indonesia lags behind other countries in the region in information and communication technology, which is just as important in a modern economy as traditional forms of infrastructure. Public investment in infrastructure is particularly critical. The weakness of basic infrastructure, such as roads, port facilities, and electricity, retards private investment, creates bottlenecks in various value chains, and restrains economic growth.

Indonesia's historically poor business environment is improving but still has a long way to go before it is truly friendly to investors and entrepreneurs. Indonesia has long been regarded as having a weak business environment. In particular, the restrictions, red tape and corruption entailed in starting a business, hiring and firing labor, acquiring business sites, and enforcing contracts have prevented the country from using its abundant labor resource to develop export-oriented, labor-intensive manufacturing on a large scale. There are some recent signs of improvement, however. Just this month, however, the World Bank lauded Indonesia as East Asia's leading reformer of business regulations in 2008/2009, reflected in the country's improved ranking on the Bank's Ease of Doing Business Index (from 129th worldwide in *Doing Business 2009* to 122nd in the recently published *Doing Business 2010*). Yet it still takes nine procedures, 60 days, and payments equivalent to 26% of per capita income to start a business in Indonesia, according to the World Bank, while hiring and firing workers is impeded by required redundancy payments equivalent to 108 weeks of salary. Enforcing a contract involves 39 procedures, takes 570 days, and costs 123% of the claim. These figures suggest that contracts are essentially unenforceable.

The draft budget for 2010 anticipates rising revenue, stable expenditure, and a smaller deficit. Based on an assumption of 5% growth in 2010, the government expects the budget deficit to fall to 1.8% of GDP next year. Small salary and pension increases for civil servants are planned and subsidies on food, fuel, and electricity will continue. These subsidies account for about one-fourth of all government expenditure. Cash transfers to low-income households will be maintained.

Economic growth in Indonesia must become less reliant on natural resource exploitation and environmental damage needs to be reduced. Past economic growth has relied heavily on exploitation of natural resources such as petroleum, natural gas, timber, coal, and metal ores. Exhaustion of these resources and growing recognition of their environmental costs will require Indonesia to shift its patterns of investment and economic growth in the future. Currently, as another *El Nino* weather pattern seems to be taking hold, smog caused by forest fires in Sumatra is choking parts of the Southeast Asian region, again calling attention to Indonesia's status as (surprisingly) the world's third-largest emitter of carbon after the United States and China.

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