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INDONESIA

2001 PERFORMANCE

Indonesia's recovery has been sluggish. GDP growth in 2001 dropped to 3.3 per cent from last year's 4.8 per cent.

The arrival of the Megawati government improved expectations. The rupiah strengthened to less than 10,000 to the US dollar, even before the cabinet was announced, and then strengthened further to 8,425 per dollar. The composition of the cabinet eased fears of a return to the nationalist rhetoric of Megawati's father during the 1960s.

But the honeymoon period was short. By early October, the rupiah tumbled to below 10,000 again, and did not recover in 2001. Most macro indicators also began to weaken in Q3, even before September 11. GDP growth continuously dropped from 4.8 per cent in Q1 to reach only 1.6 per cent in Q4.

Ongoing problems in the banking sector blocked its proper intermediation function. Credit in commercial banks did not grow sufficiently, remaining practically stagnant in real terms. Persistent outflows and modest inflows of private capital meant that there were net negative flows overall. Consequently, real investment dropped sharply, reversing growth from a positive double-digit rate during the first half of 2001, to a 7 per cent fall in the second half. This pattern is also consistent with the trend of imports.

Ongoing legal and judicial reforms failed to provide more certainty to the business community. Amendments to the implementation procedure of the bankruptcy law were deferred, and the privatisation/divestment of some state-owned companies was delayed.

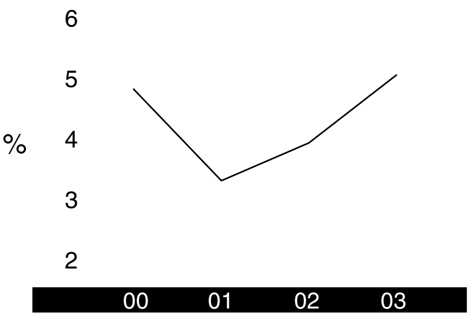
The Indonesian Bank Restructuring Agency (IBRA) is taking the central role in asset sales. Amid great controversy the agency put forward a plan to give 6 more years to the main shareholders of indebted banks to repay their debts (amounting to US$13 billion). According to the original agreement signed in 1998 (Master of Settlement and Acquisition Agreements, or MSAA), debt repayment should have been made within 4 years. The MSAA also stipulated, however, that the owners would not have to provide additional assets even if they were not sufficient to cover the debts. This agreement was widely scorned, particularly when it was shown that the value of the assets transferred was far from sufficient.

The unprecedented size of Indonesian debts put severe constraints on the effectiveness of most policies. Rescheduling of public debts has been more promising than that of private debts, although it is growing more difficult (the next Paris Club III meeting in April 2002 basically agreed to grant Jakarta's request to reschedule public debts maturing through the end of 2003. On private debts, during 2001 the Jakarta Initiative (JITF) has completed the mediation of 69 cases involving US$14.2 billion roughly 64 per cent of total registered cases in JITF. But actual restructuring only covered half that amount.

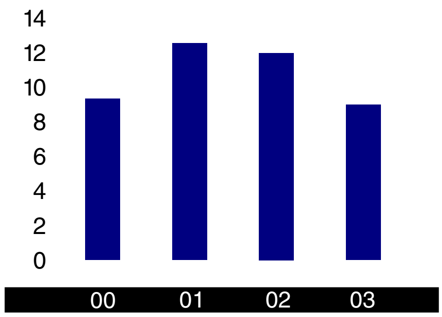
THE FORECAST

There have been some signs that the government is increasingly under pressure to mix prudent macroeconomics with populist policies. No significant changes are expected in the macroeconomic policy environment.

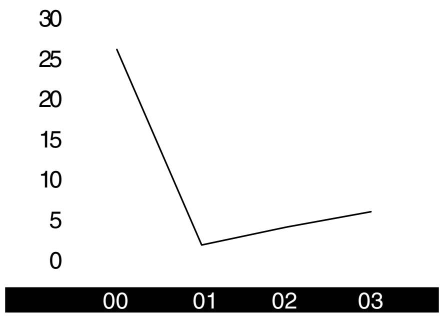
GDP growth



CPI inflation



Export growth



Market confidence has dwindled, with most people doubting the government's ability to pull Indonesia out of its current mess even though overall security conditions (non economic factors are often blamed as the source of investors' lack of interest) have actually improved.

Early 2002 was notable for the rise in fuel prices, rates of electricity, and tariffs for telephone as subsidies on these items were slashed. A rise in the minimum wage and a major flood in February put further pressure on price levels. Recorded inflation during the first 2 months was 3.5 per cent, while a 0.02 per cent deflation occurred in March. We forecast that inflation in 2002 will be higher than in 2001, suggesting that the target of a single-digit rate cannot be met. Only in 2003 will one-digit inflation be achieved.

In March 2001, the rupiah strengthened and broke the 10,000 barrier following a series of positive developments. But as the political environment deteriorated in relation to the arrest of Akbar Tanjung, the Speaker of the House, the rupiah moved back to 10,000. The market also seems to be anticipating an increase in the demand for dollars as major debtors to IBRA seeks dollars to repay their debts within the next three months, as the MSAA-based repayment period was not extended. However, the agreed debt rescheduling in the Paris Club III, along with the sales of BCA, formerly the country's largest private bank, helped improve the market confidence, strengthening the rupiah to reach 9,390 per dollar in late April. In our forecast, the average rate for the whole year is 9,950 to the US dollar, still weaker than the government had assumed in the current budget (9,000 per dollar). As long as the huge private debts cannot be successfully rescheduled, like the public debts, pressures on the exchange rate are expected to continue into 2003.

The growth of real exports is forecast to be modest, increasing from 1.9 per cent in 2001 to 6 per cent in 2003. There have been signs of rising non-oil exports early in 2002, offsetting a 6 per cent decline in oil. With improved oil prices, both categories of exports are expected to increase. Imports, on the other hand, are expected to grow faster, consistent with accelerating investment growth. The scheduled reduction of import tariffs under existing regional agreements (for example AFTA) is also likely to support the trend. The current account surplus will consequently fall to less than US$2 billion, 1 per cent of GDP, by 2003.

A recent DRI survey points to a record fall of consumers' confidence. Consumers' expectation of improved economic conditions during Q1 2002 fell by more than 20 per cent. With such a sentiment, the relatively high growth of private consumption in 2001 (5.9 per cent) is unlikely to hold in 2002. We forecast that the growth rate will decline gradually to 4 per cent and 3.6 per cent in 2002 and 2003, respectively.

The resulting GDP growth for 2002 will be less than the rate targeted by the government—3.9 per cent versus 4–5 per cent. This will have broad ramifications on other indicators as well. The unemployment rate and the poverty incidence will be higher.

Tax revenues will be lower, suggesting that the targeted budget deficit for 2002 (2.5 per cent of GDP) will be difficult to meet, and private capital inflows may not be as robust as expected. In 2003, overall conditions are expected to improve, at which point GDP growth may exceed 5 per cent.

Hence, our forecast points to a trend in which a more robust recovery will not occur in 2002, but may occur in 2003. The forecast also suggests that there will be a marked change in the composition of growth sources. While growth in 2001 was clearly consumption led, the contribution of investment and the external sector to GDP growth is expected to rise in 2002.

RISKS TO THE FORECAST

The external environment is always an important determinant for investment and trade. Since September 11, the growth of non-oil exports to the United States—one of the largest market destination of Indonesian non-oil exports—has, surprisingly, been unaffected. If the early signs of strengthening in the US economy lead to a more robust recovery, accelerated growth of real exports in our forecast is likely to hold. On the other hand, downward adjustments have to be made if the US recovery turns out to be more sluggish than expected.

Domestic risks are equally if not more important. The resolution of uncertainty surrounding the sales of IBRA assets could have important repercussions on the economy. Poor outcomes could easily cause the economy to slip into another round of sluggish recovery. But there are also upside risks. One of the risk factors pointed out in the forecast for 2001 was the possibility of a deteriorating relationship between the government and the IMF. Such a risk seems to have disappeared. There is no imminent threat of delays to IMF loan disbursements. While the legal system has yet to be improved enough to raise investors' confidence, political stability and domestic security have been enhanced. If the trend in political, security and economic conditions can be maintained, the rupiah, capital flows and investment can strengthen, augmenting the forecast growth.

Consumption grows but exports are down

Only the consumption component grew faster in 2001 than in 2000. The external sector performed the worst, with less than 2 per cent growth of real exports. In nominal terms, total exports dropped by 9.8 per cent. Inflation hit double-digit levels, as the exchange rate depreciated by more than 20 per cent.