IWAN J. AZIS
Cornell University

INDONESIA

2002: TEPID GROWTH

Indonesia's growth remained tepid in 2002. GDP grew by 3.7 per cent, only slightly higher than in 2001. Contrary to the speculations of many analysts, neither the weak global economy nor the tragic bombing in Bali were the major influence on this outcome.

The lowest growth occurred during the first quarter of 2002, primarily due to widespread floods. Great uncertainty in local government regulations and laws under the current policy of decentralisation affected the mining sector badly. The overall investment climate did not improve, despite increased political stability. There was also a decline in non-oil exports.

Consumption expenditure is the only component of GDP that continued to grow strongly, supported by a rapid increase in consumer credit (estimated to grow at 40 per cent). By contrast, investment credit fell, hurting the business sector and small and medium-scale businesses in particular. This sector has shown persistent strength since the crisis in 1997, and continued strength suggests that its growth was largely self-financed. With limited growth the sector cannot absorb the rising number of unemployed workers and the ongoing increase in the labour force. The number of unemployed and underemployed workers has been on the rise, and is estimated around 9 million and 25 million people respectively.

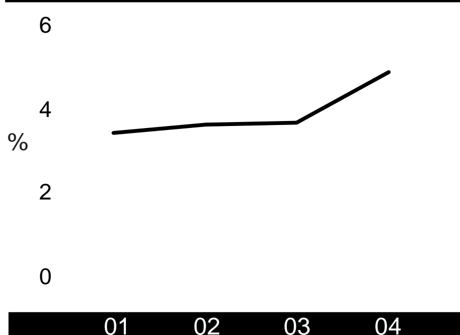
Another positive development was macroeconomic stability. The budget deficit has declined, reaching less than the targeted 2.5 per cent of GDP in 2002, even after taking into account the stimulus package following the Bali bombing (over 1 per cent of GDP). Despite strong popular protest, the government managed to reduce fuel subsidies. The exchange rate strengthened, averaging 9,333 rupiah per dollar in 2002, compared to 10,145 in 2001. The government debt–GDP ratio declined from 87 to 70 per cent. The trend was further supported by a successful debt resolution through the Paris and London clubs, in which US$5.4 billion debt was rescheduled. Progress in private debt resolution remains slow (corporate debt is around US$128 billion, half of which, if not more, is probably non-performing).

Budget deficit finance comes from domestic sources and foreign loans (CGI and non-CGI). The domestic sources rely heavily on IBRA asset recovery and privatisation. Throughout 2002, the achievement of targeted revenues from these two sources was relatively good, amid popular protests and some mismanagement of the asset sales.

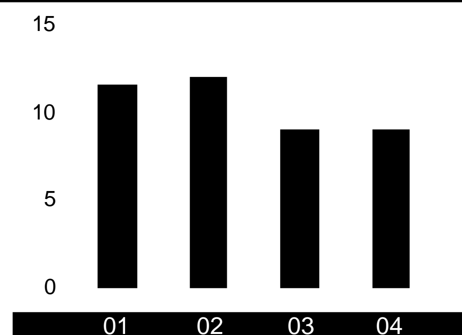
ASSUMPTIONS

September 11, 2001 had little direct impact, but rising tension over terrorism, especially with the US attack on Iraq, could have a more significant impact in Indonesia. which is both democratic and home to the world's largest Muslim population. Islamic fundamentalist groups are very few but could experience a surge of popularity among the more disaffected sectors of the Indonesian Muslim community. On the other hand, those demonstrating were organised

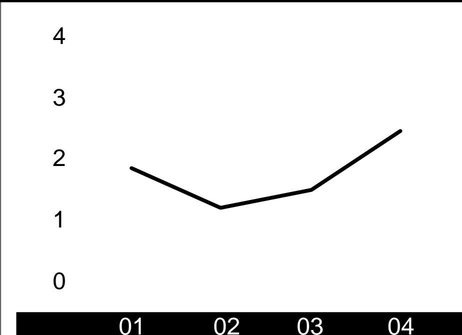
GDP growth



CPI inflation



Export growth



primarily by students or political parties not connected to terrorist networks and there is also increasing external support for the police and other law enforcement institutions, as in the Bali tragedy.

The net effects of the increase in oil prices was positive for the economy. These price effects, however, were shortlived. The assumption of a relatively low oil price in the current budget (US$22 per barrel) is now plausible.

Another important assumption concerns the emergence of China and its impact on trade and foreign direct investment. The overall net impact of this development will be positive for Indonesia. Drying up of FDI in Indonesia has been a consequence more of domestic conditions and policies (security, tax, labour) than of competition from China. Irrespective of China, Indonesia remains low on the list of FDI destinations.

Some Indonesian exports have suffered from increasing competition with Chinese exports in third markets and into domestic Indonesian markets. Open China also contributed to the recent surge of Indonesian exports to China—exports to China increased by more than 30 per cent in 2002 alone, making it the fourth largest destination for Indonesian exports. The rise of exports to China will contribute to the increasing (albeit slow) growth of real exports in 2003 and 2004. The subdued outlook for FDI is mitigated partly by increased FDI from China.

There has been a major shift in the country's political development reflected in amendments to the constitution, for example, regarding direct election of the President and Vice President. The successful and relatively calm sessions of the MPR (People's Assembly) in 2001 and 2002 provide good lessons for the 2004 election. The exchange rate will strengthen slightly but, more importantly, it will be relatively stable at around 8750–8900 rupiah per dollar, and the interest rate will fall further.

2003–04: GROWTH PICKS UP

The estimated 3.7 per cent growth of GDP in 2003 is the same as that in 2002. The growth rate is likely to pick up in 2004, rising to 4.9 per cent (still below the government's original target). Consumption expenditures will continue to be the main source of growth. The contribution of the trade sector is unlikely to change. The contribution of exports will increase slightly in 2004.

But the growth of consumption will decelerate in 2003. Declining consumer confidence in 2003 will be reflected in a fall in the growth rate of private consumption in 2003 (down to 3.2 per cent from 4.7 per cent in 2002) before picking up in 2004 (4.2 per cent). Lower interest rates, policy adjustments, privatisation, and continued selling of IBRA assets, are all expected to contribute to the ongoing growth of investment. Yet, the ratio of investment to GDP will still fall, and GDP growth will remain insufficient to absorb the increasing number of people entering the labour force. As a consequence, unemployment will rise.

Continued macroeconomic stability will keep inflation fairly steady in 2003–04 (although still high at around 9 per cent). This is consistent with the expected decline in the budget deficit, the assumed growth of reserve money, and the gradual removal of subsidies. While the largest repayment on government domestic borrowing (bonds) will have to be made in early 2004 (around 13 per cent of over 170 trillion rupiah bonds held by the state banks needs to be paid), recent efforts to re-profile these bonds and to auction off some bonds following the passage of the Sovereign Bonds Law are expected to result in the budget contributing less to credit expansion.

Oil will dominate the small increase in exports in 2003. In 2004, assuming that the price of oil is lower than in early 2003, non-oil exports should re-emerge as the main contributor to the export increase. The volume of exports is expected rise by 1.5 per cent in 2003 and 2.5 per cent in 2004. Import growth will also lift from 3.3 per cent in 2002 to 4 and 7 per cent in 2003 and 2004 respectively, consistent with the trend in investment.

Along with the slowing down of tourism activities, this will cause the current account surplus to decline more rapidly from US$3 billion (1.7 per cent of GDP) in 2002 to US$0.9 billion (0.4 per cent GDP) in 2004.

RISKS IN THE FORECAST

Even though the Iraq war was short, the highest risk remains a backlash from it. Megawati's government could face a challenge from Muslim groups. This would cause investment to drop further, consumer confidence to fall, and the country's risk premium to deteriorate.

The coincidence of the termination of IMF contracts and the election in 2004 could jeopardise macroeconomic stability. Unless there is a strong commitment from the government and the parliament to maintain such stability, a grimmer picture is not unlikely.

Gross fixed capital formation

2003 has officially been declared the 'Investment Year', and the growth of rate of gross capital formation continues to rise from 2002. The investment–GDP ratio, however, continues to fall.