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Indonesian Growth Dynamics*

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October 2010

Abstract:

This paper provides an analytical narrative of Indonesian economic growth over the past two decades. Particular attention is paid to the key economic crisis events of 1997-98 and 2008-09, and how and why Indonesia's response to them was completely different. We emphasize and illustrate how the years 1997-98 were a watershed in the country's economic history and political economy. We underline the country's generally good economic performance, especially the rapid recovery over the past decade, while also highlighting the fact that its economic growth has never quite matched that of the very high growth East Asian economies. The final section analyzes some key policy challenges, including embedding reforms in a highly fluid political environment, maintaining a broadly open commercial policy regime, the regional and international architecture, macroeconomic management, and 'connectivity' and regional (sub-national) development.

Key words: Indonesia, growth dynamics, economic crises, policy reform.

JEL codes: G01, O53.

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(1) Introduction

How countries respond to and manage economic crises is an important indicator of the quality and resilience of the country's institutions, the government's economic management credentials, the adaptability of the business and household sectors. In this respect, Indonesia – a country that has been variously labeled both a 'chronic economic dropout' and an 'East Asian miracle' – is an excellent case study. It has experienced two severe crises, in the mid 1960s and 1997-98, while it has successfully avoided two threatening episodes, the mid 1980s collapse in energy prices and the 2008-09 global financial crisis. This paper examines Indonesia's growth dynamics over the past two decades, in the context of its management of the two major crisis events since the mid 1990s. In particular, we examine why and how the country was deeply affected on the first occasion, while its growth momentum was little interrupted in 2008-09. We undertake this analysis with reference to modern theories of growth and crises, and in light of the country's dramatically altered political economy settings after 1998. We also consider some of the broader lessons learned from these events, in particular how to achieve reform in complex, newly democratic nations. We also ask whether large developing countries like Indonesia are likely to remain open economies with a commitment to the current global architecture and institutions.

The events of 1997-98 are crucial in understanding the country's long-term growth dynamics. The crisis and the associated reshaping of institutions and commercial rules of the game had three main effects. First, it led to the sudden end of the 32-year Soeharto era of rapid economic growth and authoritarian rule. Second, it appears to have set the country on a new growth trajectory, both somewhat slower in aggregate and with different drivers. Third, the commercial policy environment was altered profoundly, with a weakened presidency, an assertive if unpredictable legislature and substantial devolution of authority and resources to the regions.

Our organization is as follows. We first provide an overview of the country's growth dynamics and macroeconomic performance since 1990. Here we underline the country's generally good economic performance, albeit a record that does not quite equal that of the really high-performance Asian economies (eg, China and earlier the NIEs), and the significant discontinuity introduced by the Asian financial crisis (AFC) of 1997-98. We also provide a sketch of the new institutional and policy landscape. In section 3 we examine the two crisis episodes, focusing on the differences: a deep economic and political crisis on the one hand, in contrast to a virtual non-crisis in 2008-09. We survey the various explanations for these vastly different outcomes, principally focusing on the combination of 'good policy' and 'good luck' factors. In section 4 we review the broader lessons and implications. Here we focus on five sets of factors: the complexities of policy reform in a newly emerging democracy in which an influential constituency is skeptical of the case for reform; the importance of good macroeconomic management, including the need for high-quality financial regulation; the challenge of maintaining a broadly open economy; the links between reform at home and regional and international architecture; and 'connectivity' and regional development.

(2) An Economic Overview

We focus in this paper on the period since 1990, but it is important to understand the historical context. By the mid 1960s, Indonesia was an economic basket case. Inflation was out of control, and the left-leaning government had withdrawn from most international organizations, preferring instead to be part of the Beijing-Pyongyang-Hanoi axis of 'new economic forces'. Rudimentary national accounts estimates suggest that the country's per capita income was about three-quarters of that one-half a century earlier (van der Eng, 2002). The standard development economics textbook of the time, authored by one of the leading foreign authorities on the country, portrayed Indonesia as a 'chronic economic dropout' (Higgins, 1968). Then, in one of the most remarkable reversals of fortune in recent economic history, the regime change in 1966 ushered in a period of rapid economic growth, with per capita income approximately quadrupling over the next three decades.

Since 1990, economic growth has been moderately strong apart from the crisis years 1997-99 (Figure 1). At least five sub-periods are discernible. First, there were the last few years of the long Soeharto-era boom, with growth through to 1996 in the range 7-8%. The AFC began to affect Indonesia in the third quarter of 1997, but growth for the whole year remained positive. Then there was the catastrophic contraction of 13.4% in 1998, followed by negligible growth in 1999. A third phase, of precarious growth in the context of continuing political stability, occurred 2000-03. Growth accelerated from 2004 as political normalization took root. A final phase saw a moderate growth slowdown from 2008 as the global financial crisis began to take effect. But the impact on Indonesia was relatively mild, and in 2009 it was the third fastest growing economy in the G20 group, behind only China and India.

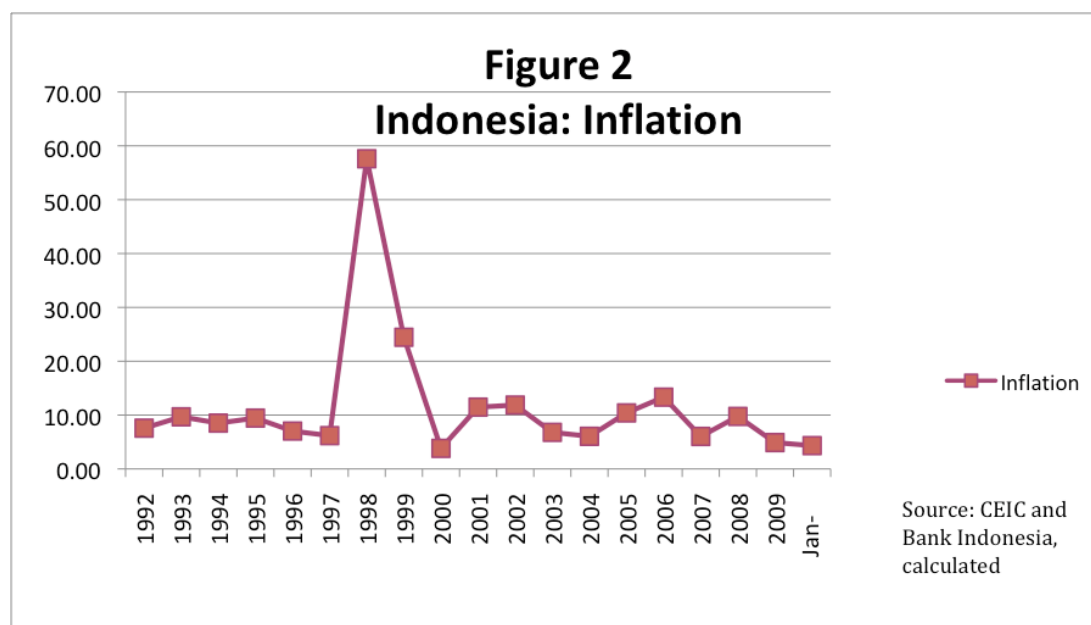


As will be discussed further below, the years 1997-98 were a watershed in the country's history, with deep 'twin crises', both economic and political. In this respect, Indonesia was quite unlike the other crisis-affected economies, Korea, Malaysia and Thailand, which suffered no major political complications. Indonesia's experience in having to suddenly develop new institutions and processes while grappling with economic crisis management more closely resembles that of the Philippines after similarly deep twin crises in 1985-86. If Indonesia has not quite matched the recovery trajectory of its neighbours after

1998, its record – both in economics and politics – compares very favourably with its archipelagic neighbour. Nevertheless, with a lag owing to the political complexities, perhaps surprisingly Indonesia mirrored the region's V-shaped recovery out of the crisis.

At least four factors explain such an outcome. First, macroeconomic stability was quickly restored, and the alarmingly high debt levels brought down. Second, the economy remained largely open to trade, and to a lesser extent foreign investment. Third, from around 2004, especially following the election of the first Yudhoyono administration, the political system stabilized, and the commercial rules of the game became more predictable, albeit with continuing high levels of corruption and a weak legal system. Fourth, there was a beneficial neighbourhood effect, both in the sense of rapid growth and the pressure to keep up with productive, reforming economies in the region.

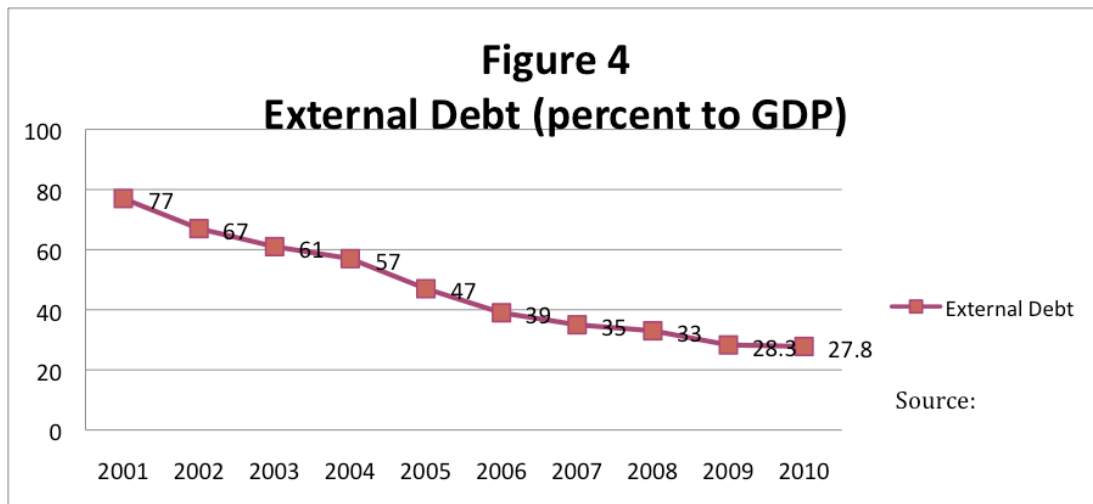
Over this period, macroeconomic management has generally been good. Three key features have been evident. First, apart from a brief period of hyperinflation in 1998, the result of fiscal expansions in support of an open-ended bank recapitalization program being monetized, inflation has been moderate (Figure 2). However, in spite of its formal independence, the central bank, Bank Indonesia (BI), has struggled to keep inflation in check, to about on par with its neighbours and major trading partners. There has therefore been a tendency for the real exchange rate to appreciate which, combined with mostly buoyant commodity prices over the past decade, has put continuous pressure on the tradables good sectors. This inflation record has been a continuous feature of Indonesian economic policy since the late 1960s (McLeod, 1997), and must be counted as a significant ongoing policy challenge.

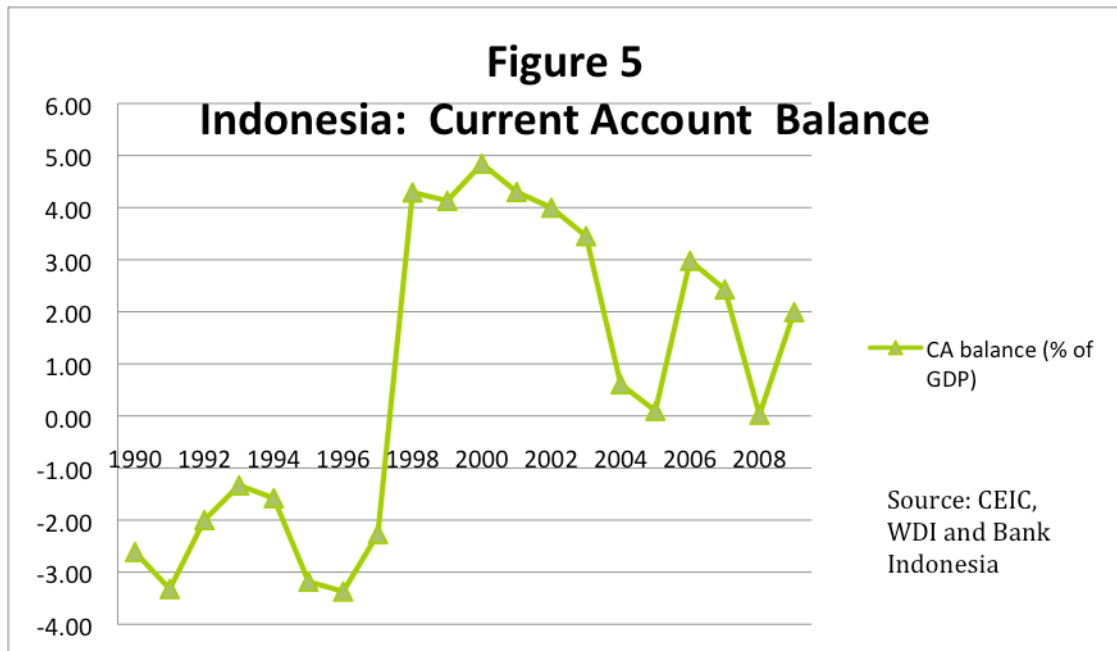


The second feature has been the challenge of cleaning up after the 1997-98 crisis. Much of the banking and corporate collapse was 'socialized', in the sense of being transferred to the government. As a result, government debt rose dramatically, to over 100% of GDP in the immediate aftermath of the crisis. Most of the increase was in domestic public debt, which had hitherto been negligible. The macro situation therefore looked extremely perilous in the late 1990s. But one of the great achievements of the recovery period was how quickly the debt

problem was managed, in spite of the fluid politics and weak governments. Successive governments quickly returned to the pre-crisis tradition of fiscal prudence (Figure 3). From 2000, fiscal deficits were rarely greater than 2% of GDP. These outcomes were reinforced by the government's fiscal policy law of 2003, essentially modeled on the Maastricht principles of deficits not exceeding 3% of GDP and public debt of less than 60% of GDP.¹ Combined with modest sales from the nationalized distressed assets, public debt fell sharply over the decade 2000-10, from about 100% to less than 30% (Figure 4). In comparative perspective, Indonesia is now grouped among the low debt economies. At the same time, the current account balance has switched from deficit to surplus, reflecting the fact that, like its neighbours, investment rates have not recovered to their pre-crisis levels, while the savings rate has held up (Figure 5).

¹ Moreover, unlike the EU, Indonesia has stayed well within these limits!

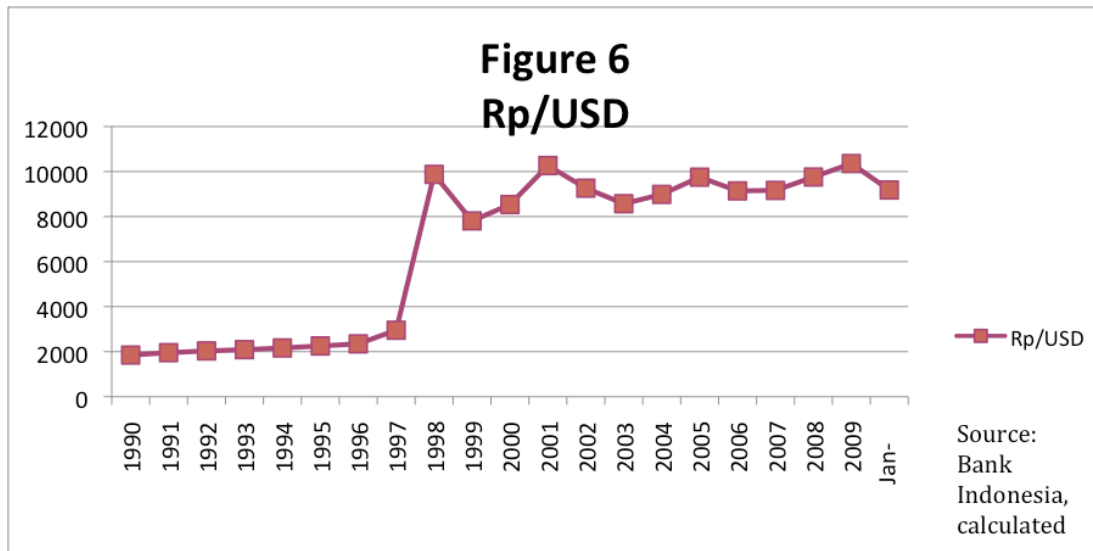




Although inflation outcomes are broadly similar to the pre-crisis period, the conduct of monetary policy has changed. As mentioned, BI has been granted formal independence, and has gradually evolved towards a regime of inflation targetting with a flexible exchange rate. Both these developments accord with modern monetary policy practice, and in Indonesia's case they were hastened by the IMF conditionality associated with the 1997-98 crisis.² Although BI has struggled with inflation outcomes, the new exchange rate regime has generally worked well. The Rupiah has generally moved in the desired direction, appreciating in times of strong commodity exports and large capital inflows, and weakening in response to negative external shocks or capital outflows occasioned by domestic policy uncertainty (Figure 6). This is of course still work in progress. Indonesia does not yet possess the breadth of financial instruments, the depth in its capital markets, and the confidence in its policy institutions to conduct sophisticated monetary policy effectively. Moreover, the memories of the spectacular exchange rate collapse of 1997-98 are still recent enough for the foreign exchange market to become quickly jittery.³ Nevertheless, the broad story should be recognized as a significant policy achievement in a challenging domestic political economy and international environment.

² Not surprisingly in such circumstances, and given also the continuing unpopularity of the IMF in Indonesia, the path to monetary policy reform has been a rocky one. Since 1997, all but one of the BI governors has faced legal action, and either house arrest or imprisonment. The one exception is Dr Boediono, the current vice president.

³ For example, in late 2008/early 2009, BI was reluctant to let the exchange rate go, for fear that an orderly decline might degenerate into a capital market panic. (The Rp actually appreciated against the Australian dollar, another major regional 'commodity currency'.) In early 2009, President Yudhoyono took the unusual step of publicly instructing the BI governor not to allow the rate to go below Rp12,500.



After the crisis, Indonesia's growth dynamics have changed in two respects. The first, as noted above, is slower but still moderately fast growth. The second is that the growth drivers have changed. The latter outcome may be illustrated with reference to two inter-related indicators.

First, the slower output growth was not uniform across sectors (Table 1).⁴ In fact, comparing the periods 1990-96 and 2000-09, two sectors actually grew faster: agriculture, reflecting generally buoyant commodity prices, and transport and telecommunications, driven by technological changes and substantial deregulations. By contrast, there was a major slowdown in three sectors, mining and utilities, manufacturing, and construction, with growth rates in the second period less than half those of the first. The explanations for these outcomes are both sector specific and economy-wide. Construction growth pre-crisis was at unsustainable levels, and it was hard hit by the crisis. Growth since then has been subdued, owing in part to financing constraints and reduced public sector investments. The latter factors also explain slower utilities growth, while mining growth has been slow, notwithstanding historically high commodity prices, as a result of the uncertain exploration and taxation environment.

⁴ We are grateful to Haryo Aswicahyono of the Centre for Strategic and International Studies for providing this table.

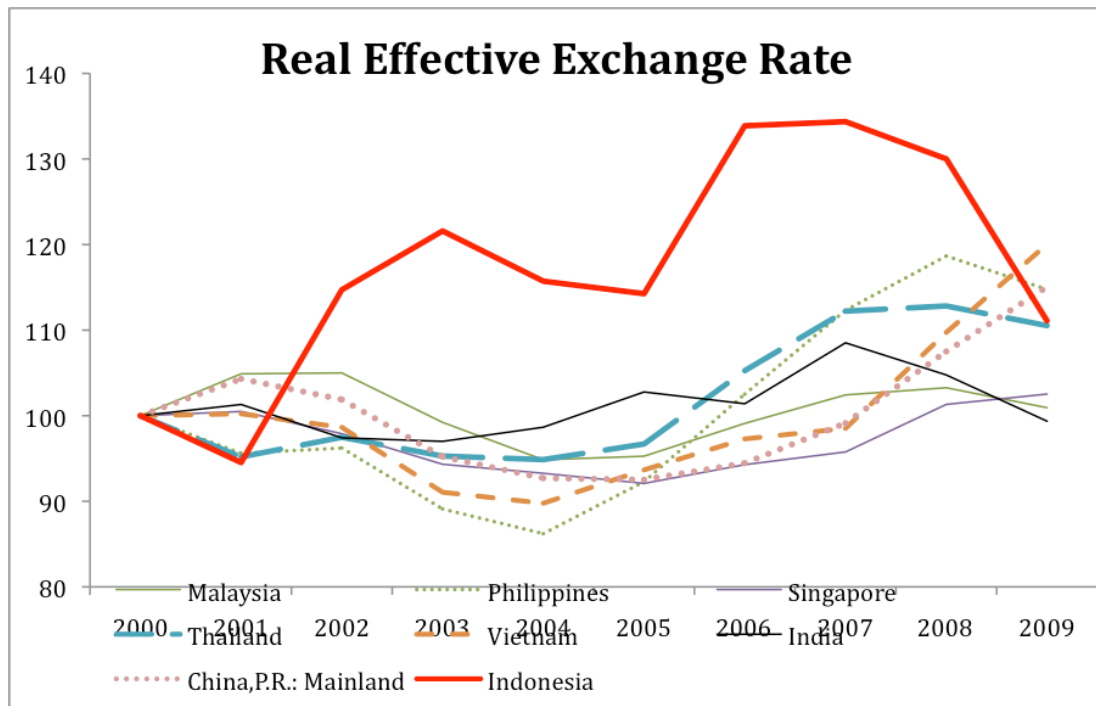
Table 1: Sectoral Output and Employment Growth, 1990-2008

	1990-1996	2000-2008
GDP Growth (%)		
Agriculture	3.1	3.9
Mining and Utilities	5.3	1.5
Manufacturing	11.2	5.2
Construction	13.7	6.5
Wholesale Trade	8.9	5.8
Transport	8.2	10.1
Other Activities	6.4	5.8
Total	7.9	5.3
Employment Growth (%)		
Agriculture	-1.7	0.2
Mining and Utilities	6.0	3.7
Manufacturing	6.0	0.9
Construction	10.8	5.7
Wholesale Trade	6.5	1.7
Transport	9.4	3.9
Other Activities	4.6	3.6
Total	2.3	1.7

Source: ADB Statistical Database System
(<https://sdfs.adb.org/sdfs/index.jsp>)

The slowdown in manufacturing growth, from well above the economy-wide average to just below it, is the most puzzling result. As a tradable goods sector, like agriculture it initially benefited from the competitive boost of a depreciating exchange rate in the wake of the crisis. Moreover, the sector faced no significant demand-side constraints until the recent global financial crisis: global manufacturing growth was rapid, and relocating to developing economies, while

there were no major external trade barriers. However, manufacturing has been adversely affected by the steadily appreciating exchange rate over the past few years, without the compensating benefit of the high commodity prices enjoyed by agriculture and mining. As Figure 7 shows, Indonesia's real effective exchange rate appreciated significantly against all other major Asian currencies over the period 2001-08. It fell back to closer to regional norms in late 2008, but since late 2009 the real rate has again appreciated faster than neighbouring economies. In addition, manufacturers have been squeezed by high infrastructure costs and a rigid labour market, in addition to intensified competition from efficient neighbouring exporters.



Second, export growth has been indifferent for most of the post-crisis period (Athukorala, 2006b). To understand the patterns during an era of high and volatile commodity prices, Indonesian export data need to be disaggregated into commodity and non-commodity groupings (Figure 8). In the case of mining, the response to historically high prices has been variable, with most of the increased exports coming purely from price effects in cases where long-term investments have been deterred by the uncertain investment climate (such as oil and gas), whereas in some sectors (eg coal) both price and quantity effects have been positive. Agricultural exports have grown strongly, particularly in sectors with high prices such as palm oil. The weakest performance has been in manufactures (Aswicahyono et al, 2010). Some of the reasons have already been noted: a less competitive exchange rate, and the relatively high cost of logistics and labour. The traditional labour-intensive sectors of textiles, clothing and footwear have been particularly hard hit by the latter factor. Indonesia has also missed out on the rapidly growing 'fragmentation trade' opportunities in parts and components, for these reasons and also due to the uncertain FDI environment and inefficient export-import procedures.



Two additional dimensions of the manufacturing export story warrant mention. One is that export performance in the 2000's has been markedly weaker than that of the reform period from the mid 1980s. Table 2 provides the relevant comparison, for total exports as well as major categories. Real export growth since the AFC has been considerably slower than that of the previous decade. Practically all the decline has occurred in the labour-intensive sector, which was central to transforming the country's fortunes and providing rapid employment growth prior to the AFC. Apart from the special case of 2008-09, supply-side competitiveness considerations explain these outcomes, since Indonesia is a price-taker in international markets, even arguably for its leading export commodities such as coal and palm oil. Second, drawing on the recent literature on the links between export composition, innovation and competitiveness, Basri and Rahardja (2010b) argue that over the period 1990-2008 Indonesian exports were characterized by a lack of 'discovery', in the sense that about 71% of the increase in exports was due to the growth in same set of products sold to the same markets. Clearly this important finding requires further research: does it indicate a lack of export dynamism, and is therefore symptomatic of deeper problems, or is Indonesia currently in the fortunate position of specializing in the production of traditional commodity exports that are in high demand in its traditional markets, that is the dynamic Asia-Pacific region, most of all China?

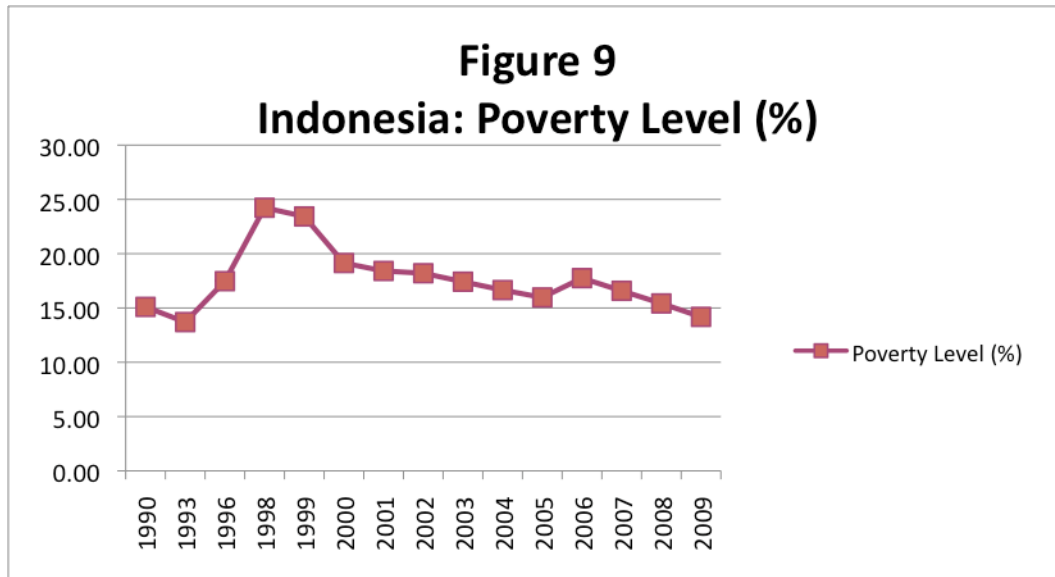
Table 2. EXPORTS AT CURRENT AND CONSTANT PRICES 1975 TO QUARTER I 2009, BY MAJOR COMMODITIES in US \$ billion and percent

	Current price						Constant prices						
	Annual % change						Annual % change						
							At 1980-2008 average prices or unit values						At 08-09 Prices
	75-85	85-90	90-96	96-08	04-08	l'08-l'09	75-85	85-90	90-96	96-08	04-08	l'08-l'09	l'08-l'09
TOTAL EXPORTS	10.1	6.4	11.8	8.9	17.8	-31.8	0.7	7.3	9.1	5.1	5.4	-19.5	-16.2
Non-oil/gas total	12.6	19.4	17.6	9.2	18.0	-25.3	0.8	11.7	13.9	7.6	7.2	-20.5	-17.3
Labor-intensive manufactures*	61.8	44.6	17.1	3.2	7.1	-13.8	49.5	31.9	17.1	3.9	3.1	-13.6	-13.2
Commodity-based exports	9.6	2.6	7.5	9.9	21.7	-38.3	0.2	4.5	5.0	3.4	5.5	-22.8	-16.0

	Increase in \$ billion in current prices						Increase in \$ billion at Constant Prices = change in quantity weighted by price/ unit value						
							At 1980 - 2008 average prices or unit values						At 08-09 Prices
	75-85	85-90	90-96	96-08	04-08	l'08-l'09	75-85	85-90	90-96	96-08	04-08	l'08-l'09	l'08-l'09
TOTAL EXPORTS	11.5	6.8	24.1	87.6	65.8	-10.7	1.6	9.7	22.4	45.4	19.1	-5.0	-5.0
Non-oil/gas total	4.1	8.4	23.4	70.2	52.3	-6.7	.7	7.3	20.5	52.7	21.8	-4.7	-4.4
Labor-intensive manufactures	0.6	3.2	6.0	4.5	3.4	-0.5	.8	2.4	4.9	4.7	1.5	-.4	-.5
Commodity-based exports	10.6	2.4	10.9	64.8	52.2	-9.2	.5	5.3	9.3	18.0	10.4	-3.4	-3.4

*Includes: Textiles, garments, footwear + furniture

The growth record has been largely translated into improved social indicators. As is clear from Figure 9, changes in poverty incidence closely follow economic growth rates, except in periods of rising inflation or food price volatility (Manning and Sudarno eds, 2011). Thus, the proportion of the population in poverty returned to pre-crisis levels at about the same time as per capita GDP caught up, that is around 2004. The government also continued with the rudimentary social protection measures introduced in the wake of the 1997-98 crisis, particularly when it sought to reduce the costly and poorly targeted energy subsidies. We return to this issue below.



(3) Two Crisis Episodes: the best and worst of times

Indonesia has experienced two major economic crises in the past decade and a half. In the 1997-98 Asian financial crisis, it was the most seriously affected Southeast Asian economy, whereas it was the least affected by the 2008-09 global financial crisis (GFC) among the original ASEAN 5. These crisis episodes tell us something about the Indonesian economy and its management, and more broadly the Indonesian experience sheds light on the origins and impacts of crises.⁵

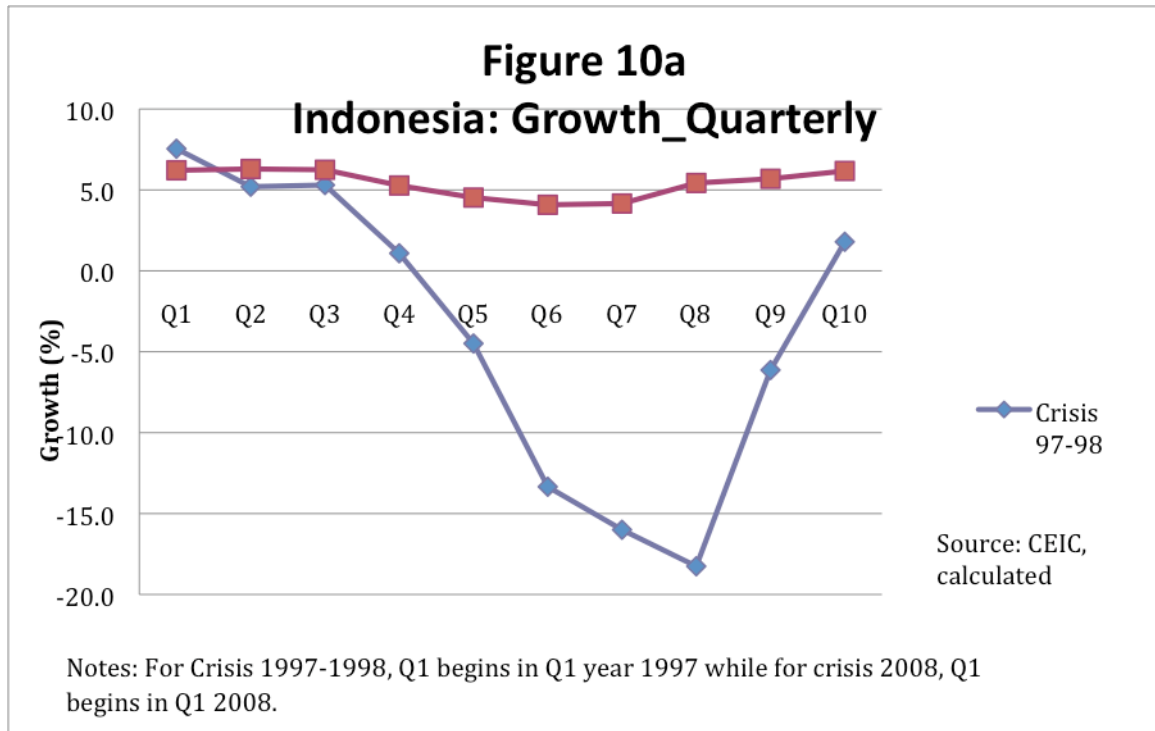
The two events are summarized with reference to quarterly data in Figures 10 abc. The series commence just prior to the onset of the crisis, which for convenience we take as the first quarters of 1997 and 2008.⁶ That is, Q1 corresponds to these two quarters. In both cases, Indonesia entered the crises growing strongly, in 1997 with a decade of historically high growth, and three decades of strong performance. In 2008, there had been almost a decade of moderately strong, and increasing, growth.

⁵ On the subject of Indonesia and crises, two other events, both outside our time frame, should be noted to complete the picture. In the mid 1960s, the economy contracted owing to political instability and a loss of macroeconomic control. In the mid 1980s, Indonesia looked like succumbing to the developing economies' debt crisis, but it managed to avoid the crisis owing to swift and effective reforms. The four episodes and their origins could be characterized as follows:

- a) mid 1960s: entirely home-grown, mild contraction, swift recovery;
- b) mid 1980s: mixture of external and domestic factors, substantial growth slowdown, swift recovery.
- c) 1997-98: mixture of external and domestic factors, deep crisis, moderately quick recovery.

- d) 2008-09: entirely external, slight growth deceleration, quick recovery (thus far).

⁶ The AFC is generally dated from July 2, 1997 following the collapse of the Thai Baht. The formal date of commencement of the GFC is a matter of debate, but the impacts were not felt in Indonesia until Q3 2008.



But the outcomes diverged almost immediately. Growth collapsed from Q4 1997, and continued to be sharply negative for the first two quarters of 1998, after which there was an anaemic and erratic recovery for several quarters (Figure 10a). The key to this crisis was the capital flight, which commenced in Q3 1997, and accelerated in the next three quarters. This put pressure on the exchange rate where Bank Indonesia, learning from the experience of the Bank of Thailand, quickly let the formerly heavily managed rate float. From a pre-crisis rate of Rp 2,500, the collapse was truly spectacular, bottoming out at Rp 17,500 in early 1998 (Figure 10b). Neither the banking sector, which had been liberalized in 'big bang' fashion a decade earlier, nor the corporate sector could withstand this magnitude of collapse. Practically all overseas borrowings were unhedged, premised on the assumption that BI could maintain its quasi-fixed rate. The formal banking sector therefore imploded, and much of the modern economy – especially construction and import-substituting manufacturing – came to a halt. This collapse occurred against the backdrop of, and partly caused, rapidly accelerating inflation, which for a brief period verged on hyperinflation (Figure 10c).



The crisis was also mismanaged both domestically and internationally. The IMF 'over-managed' the crisis, by demanding fiscal austerity and excessive policy conditionality, in addition to displaying a lack of political sensitivity at key periods. Then President Soeharto, who dominated all aspects of Indonesian government and the military, had already weakened the authority of his gifted team of technocrats and undermined popular support for the regime through egregious

family-based corruption. He was subsequently forced to step down from office in May 1998 in the face of widespread street protests.⁷

In every respect, the events of 2008-09 were different, as the growth, exchange rate and inflation series in Figure 10 clearly demonstrate. The crisis originated from outside the region, in western financial capitals. While there was some nervousness in the Indonesian financial market, the resulting capital flight was modest and the banking sector remained intact. The only really threatening period was late 2008 and early 2009. The Jakarta Stock Exchange was down by about 50% at the end of the year, and was closed for a period. The growth in bank lending fell sharply, from about 32% before the crisis to 10%. Banking confidence also fell sharply, as illustrated by the fact that outstanding inter-bank borrowing fell from Rp206 trillion in December 2007 to Rp84 trillion in December 2008. Banks therefore sought to repair their balance sheets by pushing up interest rates (Basri and Siregar, 2009).

Inflation was kept under control, and the exchange rate was allowed to drift downwards. In the most difficult period, Q4 of 2008, the economy continued to grow. The now democratic political system managed these shocks effectively. National parliamentary and presidential elections were conducted in 2009, and the Yudhoyono administration was decisively returned to office.

Why were these outcomes so different, and in particular why did Indonesia navigate the 2008-09 crisis with little difficulty? This is a large and complex issue, but the key in a latter period was a fortuitous combination of 'good luck' and 'good management' factors. We briefly consider each in turn. It is also important to emphasize that the two crisis episodes were of course inter-related. As is well documented (eg see Rogers, 2010), crises force governments, policy makers and business to review their strategies. Governments attempt to pinpoint and correct policy gaps, such as a loosely regulated banking system or an under-performing central bank. Businesses, banks and households become more risk-averse.

There are several aspects to Indonesia's good management story over the past decade that moderated the crisis impacts (Basri and Rahardja, 2010a). The most important is overall good macroeconomic management. As noted, fiscal policy has been remarkably prudent since 2000, with successive administrations able to resist demands for greater spending. This gave the government credibility in managing its public debt, and some room to move in its fiscal stimulus packages in late 2008 and early 2009.⁸ Monetary policy was also better managed, with an independent central bank and a more flexible exchange rate. Both these factors were positive elements, although their importance should not be overstated. As noted, BI had constant political problems, and it struggled to keep inflation on a par with Indonesia's trading partners. Exchange rate flexibility also had its limits,

⁷ For a more detailed account of these developments, see the four-monthly 'Survey of Recent Developments' in the [Bulletin of Indonesian Economic Studies](#) over this period, especially Soesastro and Basri, April 1998; see also Hill (2000).

⁸ In fact, the government's discretionary stimulus was quite modest, about 1% of GDP in 2009, considerably smaller than could have been justified by 'fiscal fundamentals'. The two main constraints were an ability to quickly increase spending, particularly on infrastructure projects, and a reluctance on the part of the parliament to authorize significant increases in expenditure during an election year.

with the central bank understandably reluctant to let the rate drift down too far in view of recent history.

A second factor was that the financial sector remained intact. This is a key difference compared to 1997-98. Banks and the corporate sector were not highly leveraged, there was no generalized decline in asset prices, and Indonesian banks had virtually no connection to the troubled assets and financial markets of the US and UK. Although there was some nervousness in Indonesian financial markets, the government quickly extended the deposit guarantee facility, and it had to rescue only one minor bank, Bank Century,⁹ and its deposit guarantee scheme was hardly deployed. The government can claim a substantial part of the credit for this favourable outcome, as financial regulation had improved in the wake of the disastrous collapse a decade earlier. But the general increase in private sector caution, aided by relative small speculative capital inflows, rendered a boom and bust scenario much more unlikely.

Third, the political underpinnings were favourable in 2008-09. The government was seen as legitimate, and it had the authority to act, even if its general response was rather timid. There was a general public understanding that, as in the mid 1980s, the principal causes of the crisis were external. And although there were constant allegations of corruption, unlike in the late Soeharto era they were not primarily directed at the president and his inner circle. Moreover, the economics team was regarded as credible.

So much for the good management story. We have already drawn attention to the fact that the above outcomes also contained elements of good luck. In addition there were other fortuitous factors at work. At least four deserve mention. First, Indonesia was much less affected than its neighbours by the implosion in world trade that commenced in late 2008. In spite of the major liberalizations since the mid 1980s, Indonesia is not as globally connected as its neighbours. Its exports of goods and services are equivalent to about 30% of GDP, much less than Malaysia (114%), Thailand (73%) and even the Philippines (45%). It is of course true that, in the years leading up to the GFC, Indonesia enjoyed rapid export growth on the back of high commodity prices. Over the period 2004-08, real export growth averaged 11%, more than double the rate for 2000-04, and one of the highest in East Asia. In fact, gross export growth accounted for 83% of the expansion in GDP from 2004 to 2008. Nevertheless, imports also grew very rapidly, with the result that the contribution of net export growth was more modest.¹⁰

Second, moreover, Indonesia is a much smaller participant in that part of global trade that contracted the most. This is the so-called 'fragmentation trade' in electronics and automotive parts and components, much of it under MNC auspices. This trade declined the most rapidly as consumers deferred purchases of non-essential consumer goods. As a share of Indonesia's total exports, parts

⁹ While the bank was a minor one, its rescue had massive political repercussions, resulting in the 'departure' – many regarded it as the 'removal' – from office in May 2010 of the country's highly regarded Minister of Finance, Dr Sri Mulyani Indrawati (see Hill, 2010).

¹⁰ According to unpublished ADB estimates, over the period 2000-09 net exports accounted for 7.7% of Indonesia's GDP growth, compared to the median for nine major Asian economies of 10.8% (and 15.2% excluding China).

and components account for about 9%, less than half the share for Thailand and one-quarter that of Malaysia (Athukorala, 2006b).

A third good luck factor was the continued strong growth of the Chinese economy. This has not only become East Asia's principal economic locomotive over the past decade but, as a major commodity importer, its economy is highly complementary with Indonesia's. In turn, this relates to a fourth positive factor over this period, the continuing high commodity prices over this period, apart from a brief and short dip in late 2008. Thus Indonesia's terms of trade remained at historically high levels throughout.¹¹ Together with good rainfall, the agricultural sector, which still employs almost 40% of Indonesia's workforce, remained buoyant in 2008-09, here also in contrast to the experience in 1998.¹² The lagged effects of strong commodity prices from the previous three years also contributed to consumption holding up well in 2009 (Basri and Rahardja, 2010a).

On balance, therefore, the explanations for these highly divergent outcomes are manifold, economic and political, domestic and international, with no one-size-fits-all explanation. If 'everything went wrong' in 1997-98, the opposite could be said of 2008-09, with good luck just as important – indeed some would argue more important – than good management.

4) Lessons Learnt and Future Challenges

Looking back over these past two, turbulent decades, what are some of the general lessons from the Indonesian experience? These are matters of some international consequence, both because of Indonesia's size, as the largest economy in Southeast Asia (not to mention the country with the largest number of adherents to Islam) and because other developing countries have had to navigate the complex transition from authoritarian to democratic rule against a sometimes volatile economic backdrop. We focus here on five issues, in each case emphasizing the interplay between economic and political factors.

(4.1) Domestic political economy

Indonesia swung from deeply entrenched authoritarian rule centred on Soeharto to a vibrant, sometimes unpredictable democracy in the space of just two years, and against the backdrop of deep economic crisis. The events were spontaneous, unscripted and for a period appeared to threaten territorial integrity and ethnic harmony. With little history of democratic rule, and in view that of the fact that institutional development is a long-term process, the remarkable achievement over the past decade is how quickly the economy recovered from the AFC, how little the macroeconomic policy settings have changed, and how smoothly the democratic processes have operated. Nevertheless, much has changed in the new democratic Indonesia, including especially the commercial rules of the game and how economic policy-making is conducted.

¹¹ Although commodity prices dipped over this period, coal export volumes continued to increase in 2009. CPO (palm oil) export volumes declined in 2009, but they were still 50% higher than that of 2007. Copper exports also rebounded quickly in 2009.

¹² In 1998, oil prices were at historically low levels, at just over \$10 per barrel, while food crop production was hard hit by a severe El Nino drought.

Indonesia now has a political system resembling that of the US. Its president and vice-president are elected for a maximum of two (five-year) terms. It has a bi-cameral national parliament (with the houses known by their Indonesian acronyms DPR and DPD), which operates independently of the executive. The political parties dominate both houses, and the president's party has thus far not enjoyed a majority. Party discipline is anyway not strong. The president appoints the cabinet, and in order to establish a working majority in the houses, cabinet is a 'rainbow coalition' of sometimes competing political forces. A small group of non-political ministers is also chosen, typically (but not always) in key portfolios such as Finance, Defence and Foreign Affairs. Parliamentary approval is required for key government appointments, such as the governor of BI, ambassadors and the heads of various commissions and statutory authorities. Alongside these changes at the national level, a 'big bang' decentralization was hastily introduced in January 2001. Significant administrative and financial authority was devolved to the sub-national authorities, mainly the more than 450 (and rapidly proliferating) sub-provincial districts and municipalities. Transfers to the regions now account for 30% of total public sector expenditure, although all but a few of the rich ones remain heavily dependent on the central government.

In addition to changes in the executive and the legislature, the third arm of government, the judiciary, has also changed significantly. In the Soeharto era, like the parliament it effectively operated as a rubber stamp for the government on all major decisions. The courts now have considerable autonomy. Many corruption cases that have resulted in legislators and senior officials being fined and imprisoned as a result of action initiated by the Anti-Corruption Commission (KPK). This is arguably the area of institutional reform where progress has been the slowest. The quality of judicial appointments is highly variable. Bribery and the 'purchase' of court decisions is evidently quite common. Commercial cases have unpredictable results, with foreign firms in particular remaining distrustful (Butt, 2009). These outcomes are perhaps understandable. Building up a high quality judiciary is a complex, lengthy and expensive process.

Policy making is now a much more contested process, as befits a democracy. The 'low politics' memorably characterized by Soesastro (1989) – where the key was the technocrats persuading Soeharto of the merits of reform, essentially behind closed doors – has been replaced by a noisy, often populist polity. Without an automatic majority in parliament, horse-trading and vote-buying have become the order of the day. It is widely believed that large sums of money are a pre-requisite for the successful passage of major bills, especially the budget. Losers have to be compensated. Cabinet solidarity is shaky, especially when powerful vested interests are challenged.¹³ Bureaucrats are risk-averse on any major expenditure program for fear of retribution on alleged corruption grounds. Thus democracy has certainly brought greater accountability and transparency. But it does not appear to have resulted in lower corruption. By all available (and admittedly imperfect) evidence, the levels of corruption have remained largely unchanged. But it has certainly been 'democratized' and decentralized. Moreover, the link between payment and 'reward' is weaker, thus discouraging investments in projects with long time horizons such as infrastructure.

Reformers now have to resort to other means to make progress. The first and most important is to insulate key economic policy areas from political

¹³ This was revealed most dramatically in May 2010 in the Sri Mulyani case, referred to above in footnote 9.

interference, or at least to expose vested interests seeking preferential treatment to some sort of public scrutiny process. Here there have as noted been some important achievements, in some cases formalizing pre-AFC informal guidelines. The most notable have been central bank independence and formal restrictions on fiscal deficits and public debt. The floating exchange rate tends to put a check on policy mistakes. The agencies designed to constitute a check on executive authority or independently scrutinize claims for assistance have also had a mixed record. The Anti-Corruption Commission (KPK) has had some notable victories, but has itself become embroiled in controversy. The Competition Commission (KPPU) performed effectively in its early years, but more recently appears to have become somewhat politicized through the appointment of its commissioners. The Audit Office (BPK) has assumed greater importance, albeit with limited resources. Special export zones have enabled exporters to partly circumvent the administrative complexities involved in international trading, although they are of course a second-best alternative to systemic trade policy reform.

It might also be argued that decentralization has contributed to improved governance, since footloose production factors may migrate to better-governed jurisdictions. However, the system is still work in progress. The political market is not yet able to weed out poorly performing sub-national governments owing to local capture. There are gains from lobbying strategies (mainly directed at the national government), and competitive advantages of location, market size and labour supplies have so far tended to outweigh any governance quality advantage. There is also a principal-agent problem present, in the sense that the agents (local governments) no longer feel compelled to 'obey' the principal, that is the central government. This arises because the agents are now directly elected by their own constituencies and the central government is therefore unable to enforce a carrot-and-stick system of rewards and incentives. Even though the flows from the central government are large, most are formula driven and hence, unlike in the Soeharto era, Jakarta can no longer effectively coordinate spending programs.

The second route is to engage in and win the public policy debates, thereby pressuring members of parliament to adopt the preferred policies. Such a strategy has to confront the classic political economy dilemma that benefits of reform are widely diffused, while those from interventionist strategies (tariff protection, barriers to entry, etc) are highly concentrated. Moreover, the benefits of reform typically bear fruit over the medium term, while the costs are immediate. For example, deregulation reduces the rents available to bureaucrats, and therefore ideally should be accompanied by civil service reform. But there has been little progress in this field thus far. A further complication in Indonesia is that both the supply of and demand for high quality analytical work in the public domain are very limited. Much of the press is populist in orientation. The country has very few rigorous think tanks of any quality. Independent university research hardly exists. And the parliamentary research and analytical support services are practically non-existent.

(4.2) Macroeconomic management and crises

Macroeconomic management – fiscal policy, inflation, and exchange rate policy – has as noted been the major post-AFC success story. As in the Soeharto era, Indonesian policy makers since 1999 have continued to be adept at avoiding

serious crises. The debt problems inherited as a result of the AFC have been brought down to manageable proportions remarkably quickly. The major policy challenges are now principally in the realm of 'fine-tuning', and continuing the progress towards higher quality performance benchmarks.

In the case of fiscal policy, these challenges include the following.¹⁴ First, government expenditures are usually heavily concentrated in the second half, and particularly the last quarter, of the financial year. In 2009 for example, fourth quarter expenditures accounted for more than 40% of the total. Second, as discussed below, the government has encountered major problems with its infrastructure projects. Even the modest projected expenditure targets are not met, pricing restrictions deter private investors, and the powerful state-owned instrumentalities found in most utilities sectors are inefficient. Third, as noted civil service reform is proceeding very slowly: salaries for middle and upper echelons are uncompetitive, merit-based promotions and incentive systems are under-developed, and there is little mobility. This was a key priority reform area of the recently departed Finance Minister, and some progress had been achieved. Fourth, in spite of long-running, large-scale scholarships programs, analytical capacity within the Ministry is weak below the top echelons. One result is that, notwithstanding the government's more distant relations with the IFIs and donors, it is forced to call on them for much of the requisite analytical work. Fifth, given the now comfortable fiscal position, the government is in a position to develop longer-term debt mechanisms to fund the urgently required infrastructure, but little progress has yet been made in this area.

The GFC also illustrated the difficulties of implementing emergency, quick-acting fiscal policy measures. The conventional wisdom suggests that increased expenditure is likely to provide a larger first-round stimulus than tax cuts, given that in times of great uncertainty a high proportion of the latter would be saved. This is particularly so since the tax cuts generally favoured higher-income groups, and many lower-income people do not have tax file numbers. However, most of Indonesia's fiscal stimulus in 2008-09 took the form of tax cuts. The reasoning was that it would be difficult to identify and implement quick-spend projects. Moreover, owing to the less developed financial sector, and the country's stage of development and still relatively youthful population, the marginal propensity to consume tax cuts is probably higher than in more advanced economies. A practical consideration was also that parliamentary approval for corporate and income tax reductions had already been granted.

One interesting feature of newly democratic, post-crisis Indonesia is the beginnings of a rudimentary but reasonably broad-based system of social welfare and compensation. In 2005, the government was grappling with a mounting fuel subsidy problem, that arose because domestic petroleum prices were fixed, while international prices soared. The problem became untenable and threatened macroeconomic management when the subsidy rose to unsustainable levels.¹⁵ The government was in a difficult position, wanting to wind back the subsidy, that made no sense on efficiency, equity or environmental grounds, but it had become a populist, emotional issue in public discussions. In response, the government devised a direct cash transfer (BLT, Bantuan Langsung Tunai) scheme to ensure that the poor were protected from the direct and indirect price rises as the

¹⁴ See Baird and Wihardja (2010), on which this paragraph draws.

¹⁵ At its peak in early 2005, the subsidy amounted to about Rp 200 trillion, equivalent to 4% of GDP and 20% of total government expenditure.

subsidy was wound back. Identifying households as 'poorest', 'poor' and 'near-poor' on the basis of a special enumeration of the Central Board of Statistics (BPS), for a period of one year the targeted households received Rp100,000 (about \$11) per month, paid quarterly.

The 2005 program, reintroduced in 2008 in response to further petroleum price increases, was reportedly the largest cash transfer program in a developing country (World Bank, 2008). It had three positive features. First, it took the macroeconomic pressure of the government, and provided it with some fiscal policy space to move. About Rp33 trillion of government expenditure was saved, equivalent to about 3.3% of the budget. Second, there were positive distributional effects. Estimates from the (Susen) household expenditure data showed that 70% of the benefits of the subsidy were enjoyed by the top 40% of households. Third, there were efficiency and environmental gains, of particular importance given that Indonesia is the fourth or fifth largest CO2 emitter in the world.

Two additional features of the BLT deserve emphasis. First, targeting to the intended recipients was quite effective. The international literature suggests that anything over 50% is considered successful, even in advanced economies. As Table 3 shows, 50% of the BLT funds are estimated to have gone to poor and 'near-poor' households. This compares favourably with the government's other social compensation schemes, heavily subsidized rice (Raskin), health insurance for the poor (known as Askeskin), a health card (Kartu Sehat) scheme for the poor, and a school assistance program (known as BOS). Second, it appears that the levels of abuse and leakage were relatively contained. The funds were transferred directly to the poor, rather than through the bureaucracy.¹⁶ In addition, community pressure and the local media played a role.

Table 3 BLT targeting is better than other poverty alleviation programs

	% Poor Households	% Near Poor Households	% Non Poor Households	Total
BLT	26.0	24.1	49.9	100
Raskin	21.0	22.3	56.7	100
Askeskin	24.4	24.0	51.6	100
Kartu Sehat	21.6	21.2	57.2	100
BOS*	16.7	20.8	62.5	100

Source: World Bank (2008)

In monetary and exchange rate policy, as noted, the principal challenges lie in keeping inflation broadly at the levels in major trading partners, and ensuring that BI's de jure independence is fully operationalized. In addition, monetary policy has had to manage considerable balance of payments volatility, in both the current and capital accounts. The former arises from buoyant and fluctuating commodity prices in a resource-rich economy, while the latter reflects the swings in investor sentiments among foreign and domestic investors that are common among emerging markets and developing democracies.

¹⁶ The cash was paid through post offices and branches throughout the country. The households identified as poor by BPS were given 'BLT cards', which they could redeem for cash at these offices.

In this context, and given also the country's very open capital account, the adoption of a floating rate regime has been of inestimable importance in facilitating Indonesia's macroeconomic management. But this is still, understandably, work in progress. As the balance of payments has strengthened over the past decade, except briefly during the capital flight in the early months of the GFC, policy makers have been faced with a familiar 'Dutch disease' challenge, further complicated by the tightly regulated labour market and other structural rigidities. How might the authorities respond? At least five options present themselves (see also World Bank (2010) on this issue).

First, there is the status quo, of letting the rate appreciate, recognizing the inevitability that these developments necessitate structural change, perhaps in the process with some smoothing interventions. The main drawback is that the tradables goods industry will suffer and exports will lose competitiveness.

A second option is to allow the funds to enter the economy but attempt to hold a fixed nominal rate to protect exporters. Such a strategy is likely to be counter-productive: the resulting increase in inflation will anyway lead to a real appreciation, and BI would be in danger of losing credibility in the market place.

Third, BI could sterilize the inflows by building up international reserves through open market operations. This preserves exchange rate competitiveness. But it forces BI into uneconomic transactions, for example by currently paying investors 6.5% (and often more in the past) on its certificates (known as SBI's) while investing the funds in very low yield securities, probably denominated in declining exchange rates, such as US T Bills earning as little as 0.3% currently. Hence the spread (that is, loss) in the transaction is 6-7%. Moreover, it risks international reaction if trading partners believe that the government is deliberately depressing the exchange rate or building up very large international reserves.¹⁷

A fourth option is the imposition of some sort of capital controls, particularly on short-term, 'speculative' flows. While intuitively attractive, this is a risky option for a country like Indonesia. As an emerging market, investors by definition regard it as a somewhat risky proposition, and this would increase the risk premium relative to competitors. Indonesia has had an open capital account since the early 1970s, on the premise that investors will be more likely attracted to the country if they are secure in the knowledge that they can repatriate their funds. Moreover, the decision to open the capital account was taken in recognition of the endemic corruption that capital controls had spawned.

Fifth, the government could implement compensatory fiscal contraction policies to maintain macroeconomic balance, that is (G-T) could be reduced in response to the rising (X-M). Public debt would also thereby be further reduced. This might be an attractive medium term response. But fiscal policy is not a quick-response policy lever in Indonesia, especially with the executive-legislature divide. And there are political pressures to spend the proceeds of the boom, especially given the infrastructure deficiencies and the need to appease local communities in the resource-boom regions.

Elements of these various options have at times formed part of the government's response in recent years. The real rate has appreciated, and reserves have

¹⁷ Neither of these factors is a serious concern for Indonesia currently, it should be added.

increased. Fiscal policy has been prudent and debt reduced. The most effective long-term strategy – where to date the government has had the most difficulty – is to accelerate the reform agenda and invest in supply-side gaps, notably infrastructure and education, to raise productivity. We return to this issue below.

In addition, effective monetary policy relies on a viable financial sector. Indonesia continues to make progress here (Turner, 2007). The sector had been dramatically liberalized in 1988, but the technocrats were subsequently disempowered, and not able to put in place the prudential safeguards required for the operation of a globally integrated banking system. The sector was not able to manage the large build up of mobile, short-term capital flows through to 1996, followed by the sudden exodus and exchange rate collapse. Much of the banking sector was then renationalized and recapitalized in 1998-99, at great cost. Since 2000, there has been a gradual improvement in regulatory standards, and foreign banks have returned, all in the context of much less corporate leverage. Although NPL's remain quite high for some banks, the system as a whole survived the GFC.

(4.3) Staying open¹⁸

Indonesian public opinion has always been somewhat reluctant to embrace liberalism and globalization. And yet it is frequently observed that, with its 17,000 islands, 'Indonesian was made by God for free trade'. The pendulum has swung from the global disengagement of the early 1960s, through to a very open regime from the late 1960s, growing state intervention during the 1970s oil boom, and then a major deregulation (incidentally never referred to as 'liberalization' in government pronouncements) from the mid 1980s. It might have been expected that these reforms would have been reversed over the past decade, given the deep unpopularity of the IMF rescue package in 1997-98, the perceived lack of support from the international donor community more generally, and the shock of the GFC of 2008-09.

Nevertheless, the Indonesian economy has remained broadly open over this period, at least in relation to comparators. Average tariffs are moderate at about 6%, and continuing to trend down slightly. Non-tariff barriers remain a challenge for economic reformers, but have generally been contained to some agricultural products (including a prohibition on rice imports for several years) and heavy industry. Total exports and imports are equivalent to about 55% of GDP, the lowest in ASEAN apart from (probably) Myanmar, but this in part reflects the country's size. The country remains moderately open to foreign investment, with the stock of realized FDI equivalent to about 14% of GDP, the lowest in ASEAN alongside the Philippines. This comparatively low figure also partly reflects the country's size, as well as the commercial uncertainty in recent times, from 1997 to 2003. The uncertain environment over the past decade in the mining sector, traditionally a major recipient of FDI, is also a factor. The country's economic freedom ranking, at 131, is the lowest among the ASEAN 5 but above the group's fastest growing economy, Vietnam (at 145).

This outcome might appear 'precariously open' as we have elsewhere termed it, but the current situation is arguably Indonesia's new normal. There are both pro

¹⁸ This sub-section draws on Basri and Hill (2008) and Bird, Hill and Cuthbertson (2008).

and anti-reform currents, and in large measure they balance each other out. The former includes the continuing – though perhaps waning – influence of a partly insulated technocracy in the cabinet, able to resist special pleading pressures. Reformers can also point to past successes, especially in the 1980s, that built up coalitions in support of reform. They are also able to point to the general rule of thumb in Indonesia, that once tariffs are much above 25%, especially for high value to weight products, smugglers are in business. This is particularly a factor in view of the fact that the customs service is not known for its probity, and that in an increasingly decentralized governance structure, some regional governments in coastal regions facing Malaysia and Singapore have in effect sanctioned their own customs arrangements. There are also two important external factors, arguably now the major factors in keeping Indonesia open. One is the country's international trade commitments, which prevent any radical departure from the status quo. These include the WTO provisions and most important the ASEAN Free Trade Area. The second is what the country's distinguished trade minister has referred to in the past as 'competitive liberalizations', that is keeping up with the region's fast reforming lower middle-income countries, notably China, India and Vietnam. The President's 2010 Independence day speech emphasizing the government's goal of 7.7% growth towards the end of his current tenure adds impetus to this objective.

But there are also powerful forces opposed to further reform, and these are able to exploit sentimental notions of food self-sufficiency or fears of globalization. The two major line ministries of Agriculture and Industry are in this camp. Their views are embedded in their bureaucracies, they have been run by ministers from political party rivals to the president that were subsequently induced to join his government's 'rainbow coalition', and their parties have attracted funding from a range of protectionist interests. An additional factor complicating the reformers' agenda is that, as noted, the country's real exchange rate has tended to appreciate in recent years, thus putting pressure on these tradables sectors.

(4.4) International and regional architecture

In spite of its size, G20 membership, dominant position within ASEAN and strategic importance, in some respects Indonesia has found itself friendless over the past decade. The sentiment, dating back to the colonial era, became a powerful factor after the AFC. The twin Washington bete noirs, the IMF and the US administrations, the latter a proxy for the west more generally, were regarded as particularly unhelpful in 1997-98, the former through its excessive conditionality in the successive rescue packages, the latter for its unwillingness to redirect IMF programs and its general propensity to lecture. This mood was further enhanced by a range of factors, including Indonesia's bitter experience in East Timor, western intervention in Iraq, and international media attention directed to domestic challenges ranging from terrorism to high-level corruption cases and complex corporate workouts after the crisis.

Indonesian governments and legislators therefore do not have high levels of trust and confidence in the current international institutions and architecture. The most serious breakdown has occurred in its relationship with the IMF, which is still officially non-functioning.¹⁹ The government is not willing to be part of any formal

¹⁹ Even to the extent that for several years there was no signage on the Jakarta IMF office!

IMF program. The once very close relationship with the World Bank has also cooled, in part owing to the anti-borrowing sentiment that surfaced in Indonesia after the AFC. The net Bank program has been negative for the past decade. The long established donors group, the Consultative Group on Indonesia (formerly known by the acronym IGGI), has been dismantled.

As a result, Indonesia's international commercial diplomacy has changed over this period. Although consumed by domestic political considerations for much of the period since the AFC, and hence unable to play a major leadership role in ASEAN, it has been a strong supporter of various proposals to redesign regional and international institutions, including the stillborn Asian Monetary Fund and the Chiang Mai Initiative (CMI). The government has sought to increase international reserves that, while far below those of some countries, are now at historically high levels of over \$70 billion. In late 2008, when the economic environment appeared particularly threatening, the government avoided the IMF option, opting instead for a series of bilateral emergency fiscal standby and balance of payments swap arrangements.²⁰ In spite of its able Trade Minister, Indonesia has not been a major player in international and regional trade negotiations, including resolution of the stalled Doha Round.

In the recent years, the level of Indonesia's regional and global engagement has been rising, and this is likely to continue under the current (2009-14) Yudhoyono administration. ASEAN and its various extra-regional initiatives with ASEAN as a hub require an active Indonesia, especially as the major economic powers of East Asia, China and Japan, do not have a common view of future directions (Soesastro, 2008).

(4.5) Connectivity and infrastructure

Indonesia is the world's largest archipelagic state, with huge spatial differences in resource endowments, per capita incomes, social progress, ethnicity and degree of 'connectedness' to the global economy. Its government therefore has to worry about regional (sub-national) development dynamics more than most. In particular, the issue has received much attention over the past decade for three interrelated reasons. The first is the renewed global interest in economic geography, including the location of economic activity and the rise of really large urban concentrations, most of all in developing Asia (on which see World Bank, 2009). The second reason is that as noted Indonesia, while still formally a unitary state, embarked on a major decentralization program in 2001. Third, infrastructure has emerged as a major constraint to Indonesian development. Its infrastructure expenditure as a percentage of GDP is about half that of both the Soeharto era and the current East Asian average. Both the second and third factors have arisen directly or indirectly as a result of the AFC.

Although sub-national diversity is very great, with per capita GDP in the richest province more than 12 times that of the poorest, Indonesia's regional

²⁰ These involved the ADB, Australia, China, Japan, and the World Bank. In the event, no funds were accessed. Notably also, the CMI facility was not able to function. One explanation for the latter is that IMF scrutiny is still required for withdrawals beyond designated thresholds. These thresholds were relaxed in 2009 as part of the 'enhanced' CMI, but by then the immediate crisis threats had abated.

development record is reasonably impressive. Since the early 1970s, when regional accounts first became available, there has been little change in inter-provincial inequality, unlike the other developing giants Brazil, China and India (Hill, Resosudarmo, Vidyattama, 2008). This is in spite of several powerful centrifugal forces: the many region-specific booms, the highly uneven distribution of natural resource endowments, highly variable access to the global economy, and the partial retreat from equality at the centre since the decentralization program commenced. Three factors explain the stability of regional equality outcomes over this period: the strong commitment to national development during the Soeharto regime, the comparatively high levels of labour mobility that have enabled populations to migrate out of poverty (see Manning and Meng eds, 2010), and the reasonably broad geographic spread of economic opportunities throughout the country, with the exception of the lagging Eastern region.

Connecting the regions to each other, and to the outside world, through transport, power and communications networks, or 'connectivity' in current parlance, is therefore a major challenge. Indonesia has some serious problems, which have been well documented.²¹ For example, as a result of poor distribution systems, the price of basic commodities such as sugar, flour and cement are up to three times higher than Java in some regions (eg, Nabire) of Eastern Indonesia. Logistics costs in Indonesia are estimated to constitute about 14% of production costs, compared to 5% in Japan. The productivity and efficiency of Indonesia's harbours are well below the standards of regional best practice. Various point-to-point transport cost studies have demonstrated that Indonesia is expensive. In the World Bank's 2010 Logistics Performance Index, Indonesia ranked 75th, well below not only Malaysia (29th) and Thailand (35th), but also the Philippines (44th) and Vietnam (53rd).

The problems revolve around funding, coordination and regulation (McCawley, 2010). The government's development expenditures were severely curtailed in the wake of the crisis. As noted above, a strong post-AFC aversion to foreign borrowings has meant that the Indonesian government does not avail of much of the long-term concessional finance potentially available to it, while large subsidies have further squeezed development programs. Decentralization to inexperienced local governments introduced additional problems of coordination and assignment of responsibility. Land acquisition has emerged as a serious constraint in newly democratic local communities intent on redressing past grievances. Private sector infrastructure suppliers are hesitant to invest owing to the resistance to setting prices at levels that would make such investments economic. The bitter experience of many foreign infrastructure providers during the AFC has also deterred investors (Wells and Ahmad, 2007). There is also considerable resistance to infrastructure deregulation, principally from bureaucrats and state-owned utility providers who would lose their rents in a more deregulated market. This is in spite of the popularity of two successful deregulations over the past decade, in domestic civil aviation and telecommunications. There is also a temptation for the government to be seen to be solving the problem by investing in high-profile mega infrastructure projects, such as the proposed Java-Sumatra bridge (which has recently received presidential blessing), in spite of their extremely high cost and doubtful feasibility.

²¹ See for example Baird and Wihardja (2010), Basri and Rahardja (2010), Patunru et al (2009) and LPEM-Asia Foundation, 2009.

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