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Indonesia After the Asian Crisis*

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Indonesia was deeply affected by the 1997–1998 crisis, more so than its East Asian neighbors. Its economic contraction was deeper and more prolonged. It was the only one to experience a (temporary) loss of macroeconomic control. It also suffered "twin crises," in the sense that its serious economic and financial problems were accompanied by regime collapse. Consequently, recovery was a slow and complex process, as new institutions had to be created, and old ones reformed under successive short-lived administrations. But this process is largely over. The directly elected president with a strong popular mandate is in power. The new institutional framework for economic policy-making is in place. Macroeconomic stability has been restored. Although growth has yet to return to pre-crisis levels, by 2004 per capita income and poverty incidence had recovered to levels prevailing in the mid-1990s, and in the circumstances economic recovery has arguably proceeded about as quickly as could reasonably have been expected.

Key words decentralization, democracy, economic crisis, economic recovery, Indonesia, Soeharto regime

1. Introduction

Eight years have passed since the collapse of Soeharto's New Order regime on the heels of the economic crisis of 1997–1998. During that time, Indonesia's economy contracted by over 13% in 1998 alone. This followed three decades of virtually uninterrupted rapid economic growth and led to deep social and political crises. Although countries such as South Korea and Thailand were able to overcome their economic crises in a few years, Indonesia's crisis resolution has been complicated by political instability, at least until 2004, and by a slower recovery trajectory.

The regime transition from centralized authoritarianism to decentralized democracy took place in these years. Major constitutional revisions were introduced. New laws governing government agencies and industrial sectors were enacted. Parliamentary elections were held in 1999 and 2004, and the first direct presidential election in 2004. Three presidents – B. J. Habibie, Abdurrahman Wahid, and Megawati Sukarnoputri – came and went in 6 years before the first directly elected president, Susilo Bambang Yudhoyono, came to power in 2004. The parliament as well as political parties emerged as key actors in politics alongside the government and the military. The Indonesian economy has gotten back on track in these years. Per capita income has recovered to pre-crisis levels as have

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most social indicators. But the country has in effect "lost" a decade of growth that, had it been sustained at pre-crisis rates, would have resulted in a much higher per capita income, closer to $US2 000 than $US1 000. Growth also remains more subdued, at around 5% rather than the 7% plus before 1997. The government now calls for a new politics of economic growth under the current and evolving decentralized democracy. The central questions key to its success are how and whether economic growth can be restored to pre-crisis levels.

This article is organized as follows. We first review the political transition from centralized authoritarianism to decentralized democracy. We then survey changes in institutions and players in the economic policy-making. And finally we provide a macroeconomic survey of the period since 1998 and examine trade policy, the commercial environment, and social policy and outcomes.

2. Post-Soeharto Politics

The fall of Soeharto clearly marked the end of an era of developmental authoritarianism that staked its regime stability on national economic development and the improvement of living standards (Shiraishi, 1997).

Soeharto fashioned his New Order regime with the state as his power base and the army as its backbone. The regime was centralized, militarized, and authoritarian. Army officers dominated the military and occupied strategic positions in the civilian arm of the state as district chiefs, provincial governors, directors-general, and ministers in the name of dual functions. State power was repeatedly impressed upon regime "enemies" – "communists," "separatists" in East Timor, Aceh, and Papua (Irian Jaya), criminals, labor activists, journalists, and Islamists (Crouch, 1988; Sukma, 2004; Tanter *et al.*, 2005; Davies, 2006). The government addressed the question of social divisions (along class, ethnic, and religious lines) through its politics of stability and economic development, which sought to transform political issues into problems of output, and to neutralize social conflict in favor of a consensus on growth, all of which were premised on the "virtue" of political stability that leads to economic development which leads to the rising living standard which in turn leads to further political stability. In effect, the state achieved the "low politics" deemed necessary to national development by barring oppositional groups (whether ethnic, religious, or political) from participation in the political processes.

This politics of stability and economic development, combined with the depoliticization and containment of religious, ethnic, and class divisions, served Soeharto's New Order regime well. Yet it became clear in the 1990s that cracks were appearing on the façade of the New Order state as the regime itself underwent significant transformation in those years. This change can best be summed up as a shift from a military regime to a personalistic/autocratic regime, because Soeharto, having outlived all other competitors of his generation, emerged as the unrivalled strongman. Army officers who had served as his personal confidants dominated the military (Shiraishi, 1999a). His family members, now grown up and each intent on building his or her own business empire, relied on presidential powers to obtain business opportunities and privileges. Soeharto's lieutenants – his ministers, commanders, governors, and district chiefs – followed their boss's example (Murai, 1999; Schwarz, 1999). Secret wars went on in East Timor, Aceh, and Irian Jaya, now called Papua (Schwarz, 1999; McGibbon, 2004). Jakarta's control of powers and resources as well as Javanese domination of the state (i.e. the domination of mainly Javanese army officers over the military and civilian state agencies) led to the rising demand for local autonomy and the appointment of *putra daerah* (literally, "local sons") in strategic positions of provincial governors, district chiefs, and mayors. Transmigration, forest exploitation, and the consequent disappearance of living space for local Dayaks in Kalimantan led to widespread ethnic violence against Madurese in East Kalimantan in 1996 (Morishita, 2005). Islamic and Islamist forces found more space for political action with the establishment of the Indonesian Muslim Intellectuals Association (Ikatan Cendekiawan Muslim Indonesia) in 1990 (Hefner, 2000; International Crisis Group, 2005).[1]

Indonesia was hit by the currency crisis shortly after Thailand in 1997. Soeharto's declining health deepened the economic crisis while also turning it into a political crisis in December 1997. By January 1998, most of the business empires, including those established and owned by Soeharto's relatives and cronies, were bankrupt because they were unable to repay loans in US dollars due to the sharp depreciation of the rupiah. The bankruptcy of the business empires had enormous consequences for the state, which had hitherto been funded only in part by the formal budget; its informal off-budget funding, sourced from state corporations and agencies such as Pertamina and the Logistics Agency (Badan Urusan Logistik Nasional, Bulog) as well as joint venture businesses with Sino-Indonesian business tycoons and elite family members, were tightly controlled by Soeharto and his lieutenants and had served as huge centrally controlled and directed patronage networks and the main prop of Soeharto's long-staying power. The crisis, by destroying business empires, also destroyed the informal funding mechanism of the state. Moreover, it deepened the social crisis, which manifested itself in increasing unemployment, lootings, disturbances, and rising criminality. Widespread anti-Chinese riots started in January and culminated in May. That same month, the desertion of his allies led to Soeharto's resignation in the wake of massive riots in Jakarta and elsewhere (Shiraishi, 1999b, 2005).

Although many had been aware that Soeharto's aging meant that the New Order was coming to a major crossroad, nobody expected the economic crisis to happen, let alone predicted the extent to which the crisis made it impossible for the New Order to survive intact. Soeharto's vice president, Habibie, who succeeded to the presidency according to constitutional stipulation, had only a weak presidential mandate and power base, and, therefore, chose to present himself as a reformer, initiating reform measures that eventually led to the transformation of the Indonesian political system from centralized authoritarianism into decentralized democracy (Shiraishi, 1999b; Habibie, 2006).

Although the post-Soeharto regime is still evolving, its basic shape is defined by the constitutional revisions and new laws introduced over the transitional period under Presidents Habibie (May 1998–October 1999), Wahid (October 1999–July 2002), and Megawati (July 2002–October 2004) (Sato, 2002, 2004; Matsui, 2004; Matsui & Kawamura, 2005). These constitutional revisions – which took place incrementally from 1998 to 2003 – reformulated the relationship among the three branches in terms of the division of powers. The president and the vice president, formerly elected by the People's Consultative Assembly (Majelis Permusyawaratan Rakyat [MPR]), are now to be elected directly; the legislature is to consist of the Dewan Perwakilan Rakyat, the Council of People's Representatives, and the newly created Dewan Perwakilan Daerah, the Council of Local Representatives. The MPR, the highest decision-making body under Soeharto, which saw the peak of its power in the transitional years under Habibie and Wahid, has lost much of its powers. Although Soeharto controlled the MPR through direct and indirect appointment of its majority members and by extension all the government organs, constitutional revisions in the post-Soeharto era have created a division of powers in which the presidency has to share power with a parliament whose members are directly elected and in which political parties dominate. Elections, both parliamentary and presidential, are to be held every 5 years and define the national political calendar. Although still powerful, the army no longer dominates politics. The military doctrine of dual functions was scrapped and military officers were withdrawn from the civilian arm of the state. New defense and police laws were enacted. The army domination over the military establishment came to an end. Navy and air force officers serve as a military chief in rotation with army officers. The police was separated from the military. Military intelligence no longer places civilian politics under surveillance.

The first free and fair parliamentary elections were held in 1999 and again in 2004. The first direct presidential election, which brought the current president Yudhoyono to power, took place in July and October 2004. Democratization has also gone hand in hand with decentralization. The new laws on local autonomy and local finance in 1999 have created local governments that are no longer accountable to the central government but answer to the local parliament. Although Soeharto could in effect appoint provincial governors, district chiefs, and mayors, the central government now has to share powers with local governments. More powers and resources have also been devolved to local governments, above all district and mayoralty governments at the expense of – and often in tension with – the central and the provincial government (Aspinall & Fealy, 2003).

In the new democratic politics, the Dewan Perwakilan Rakyat, the lower house of the parliament, has emerged as a new power center along with the presidency and the military, and electoral politics has assumed a crucial role in organizing the government. Yet no single party controls the parliament (see Table 1). Nor is this situation expected to change in the coming 2009 elections. A party or two may emerge or disappear in the next elections, but the multiparty system will remain with no single party controlling the parliament, as long as the current electoral system stays and deep social divisions along religious (pious Muslims versus statistical Muslims and non-Muslims, traditionalist versus modernist Muslims), ethnic, and class lines inform party divisions. It is not easy for any president to organize any cabinet to work as a team because any "team" composed of technocrats, professionals, military officers, career civilian officials, and politicians from different parties is cobbled together not only for the business of governing but also for achieving a majority in the parliament. In organizing his cabinet in 2004, the newly elected president Yudhoyono did his best to gather a stable parliamentary majority, enlisting most of the political parties except Megawati's Partai Demokrasi Indonesia Perjuangan while encouraging the

Table 1 2004 parliamentary elections

Party	Seats won
Golongan Karya Party (Golkar, chaired by Akbar Tanjung, former government party under Soeharto)*	128
Partai Demokrasi Indonesia-Perjuangan (PDI-P; Indonesian Democratic Party of Struggle, chaired by Megawati)	109
Partai Persatuan Pembangunan (PPP; Development Unity Party, Islamist)*	58
Partai Demokrat (PD; Democratic Party, S. B. Yudhoyono's party vehicle)*	57
Partai Kebangkitan Bangsa (PKB; National Awakening Party, Islamic)*	52
Partai Amanat Nasional (PAN; National Mandate Party, chaired by Amien Rais, Islamic)*	52
Partai Keadilan Sejahtera (PKS; Welfare Justice Party, Islamist)*	45
Others	49
Total Seats	550

*Indicates parties that join the governing coalition in the parliament.

vice president to take over the Golkar leadership and destroying the opposition coalition of Partai Demokrasi Indonesia Perjuangan and Akbar Tandjung-led Golkar. But the price he paid was high. He gave almost one-third of ministerial positions to party representatives in organizing his cabinet and allowed the vice president to have his way in appointing many of the economic team members, even though parties, including the Golkar, in the governing coalition do not hesitate exploiting opportunities to promote their own gains at the expense of the president and the government.

Given the new division of powers and the effects of decentralization on center–local relations, the president can no longer preside over political life in the way that Soeharto had done before. The government can take policy initiatives to address problems and policy issues only on the basis of an achieved national consensus. But achieving a national consensus under the new democratic dispensation is a big challenge precisely because the era of "low politics" is over, and various social forces are making themselves felt in political processes. For example, the government was forced to shelve the revision of labor laws (which will be discussed later in the article) owing to opposition from labor unions. Islamist forces have had notable success in imposing their agenda on local governments: in areas like South Sulawesi and West Java, the central government could not prevent local parliaments from adopting the Islamic law, a move that has alarmed nominal Muslims and non-Muslims, above all Sino-Indonesians.

But there are important commonalities among those who now dominate local and national politics: the great majority of national and local parliamentary members are predominantly men, born in the areas they represent (*putra daerah*), highly educated at least formally, with activist backgrounds in party, youth, and religious organizations (whether nationalist or Islamic), belong to Indonesia's small urban and rural middle classes, and are represented by business people, professionals, civil servants, school teachers, military and police officers, religious teachers, and journalists. There are hardly any parliamentary members with peasant, labor, and urban poor backgrounds.

The implications are clear. In national as well as local politics, local men with middle-class backgrounds dominate. In part a product of Soeharto's politics of stability and development, this emergent elite thrived under Soeharto, but now encompasses formerly marginalized (but nonetheless middle-class) groups composed of journalists, school teachers, and religious leaders. This elite shares in the belief that economic growth is the key to Indonesia's future, and is in a position to make its belief a part of the national agenda, even though its members disagree vehemently on how to achieve growth and they do not shy away from calling for populist and protectionist measures in the name of welfare whenever those measures suit their political and economic interests. In his election manifesto, Yudhoyono (2004) made the achievement of economic growth, along with maintaining national unity, central to his agenda. His government aims at achieving an economic growth rate of 6.6% on average in 2005–2009, and reducing the unemployment rate from 10.1% in 2003 to 5.1% in 2009, and the poverty rate from 17.4 to 8.2% from 2003 to 2009. Whether the government succeeds in achieving these aims will be decisive for the long-term health of the present decentralized democratic political system.

3. Economic Policy-making: Institutions and Players

Indonesia was formally under International Monetary Fund management from 1997 to the end of 2003, transitional years that saw drastic institutional changes such as the constitutional revisions, the expansion of local autonomy, and the promulgation of new laws governing the Bank of Indonesia (BI), state finance, and national planning. All of these institutional changes took place against the backdrop of an often chaotic economic policy-making process, at least under Habibie and Wahid.

The Central Bank Law, enacted in 1999 under Habibie, guaranteed the independence of the BI from the government; and prohibited the BI from purchasing government domestic bonds. BI's independence was tested in 2000 when President Wahid asked BI Governor Syahril Sabirin to resign while promising him other positions. Sabirin refused to resign and was arrested and put in jail, but was subsequently cleared of all charges by the High Court. To compound matters, during the Wahid years, cabinet members were constantly dismissed or else they resigned. It was a symptom of the technocrats' marginalization from economic policy-making that Wahid's first Coordinating Minister (Menko) for Economic Affairs, Kwik Kian Gie, went so far as to refer to his government as "they" and did not bother to coordinate. No state minister for national development planning was appointed, because the president wanted to undercut the power of BAPPENAS (National Development Planning Agency).

Under Megawati, who came to power in July 2001, restoring macroeconomic stability became the top priority. Megawati appointed "professionals" who were unbound by party politics to two strategic posts for this objective. Boediono was named Minister of Finance and Burhanuddin Abdullah replaced Sabirin as BI Governor. Both Boediono and Burhanuddin did their jobs well to achieve macroeconomic stability and banking sector reform to pave the way for Indonesia's graduation from the IMF program. But the economic ministers did not work as a team. Megawati confidant Kwik, appointed Minister of State for National Planning, had no intention of being a team player and openly attacked BAPPENAS as a nest of corruption.

Of particular significance was the enactment of Law Number 17 on State Finance in 2003. It introduced the European Union Maastricht Treaty-type rule to achieve economic and financial stability by legally requiring the government to keep the annual budget deficit below 3% of the gross domestic product (GDP) and the total government bonds issuance (both central government and local government bonds) below 60% of the GDP. In other words, the law holds the government politically accountable for maintaining a self-restraining fiscal policy.

This law led to the reorganization of the Ministry of Finance (MOF), expanding its powers and changing the relationship between the MOF and BAPPENAS, the National Development Planning Agency. The Agency for Economic, Fiscal, and International Cooperation Research was created out of the former Agency for Fiscal Analysis and was made responsible for budget making, whereas the budget planning function was assigned to the Directorate General for Budgetary and Fiscal Balance, which was created out of the former Directorate General of Budgeting. The power to make fiscal policy and macroeconomic framework, a power previously shared by BAPPENAS and MOF, came under MOF jurisdiction with the passing of the new law. Equally important, the budgets that had previously been classified as the routine budget and development budget and were respectively under the jurisdiction of the MOF and BAPPENAS came under MOF jurisdiction with the elimination of the routine and development budget distinction. By abolishing the distinction, the law stripped BAPPENAS of its control over the development budget. The Propenas (national development plan drafted by BAPPENAS under Wahid) was held to be incompatible with the new law; the MOF was made responsible for formulating a mid-term expenditure framework for the future fiscal planning system.

The diminution in BAPPENAS powers created the need for a law on national planning. Under Soeharto, BAPPENAS was in charge of national planning, drafting the development budget, coordinating with foreign governments and international organizations for international assistance, and monitoring functions in development project coordination and implementation. This in effect made BAPPENAS the high command for economic policy-making. In its heyday, Widjojo Nitisastro, Soeharto's most trusted economic adviser, simultaneously served as Coordinating Minister for Economic and Fiscal Affairs, State Minister for National Planning, and Chief of BAPPENAS. Under Soeharto, national development planning was implemented by presidential decree, not by law. The legal status of BAPPENAS was not clearly defined. Its effectiveness depended on its chief's ability to work with Soeharto and on his own commitment to prioritizing national development. BAPPENAS in the Soeharto years thus enjoyed his confidence and functioned as a super-ministry for directing Indonesia's national development, even though technocrats had to compete with economic nationalists for Soeharto's blessing and support.

In the post-Soeharto era, however, BAPPENAS came under attack. President Wahid viewed BAPPENAS as a major civilian pillar of Soeharto's New Order and openly talked about dismantling it. Under Megawati, BAPPENAS lost most of its powers to the MOF and to local governments whose powers expanded under the new local autonomy regime. In those years, achieving macroeconomic stability, not developmental planning, was the top priority of the government. But once Indonesia graduated from the IMF program in 2003 and the long-awaited macroeconomic stability was achieved, long-term national development planning became important once again. A new law on the national development planning system was enacted in 2004 in the final days of the Megawati presidency. It granted legal status to BAPPENAS and stipulated that the Chief of BAPPENAS support the president in formulating the presidential national development plan and assume responsibility for drafting the central government development plan. As a result, all the developmental planning – annual, mid-term, and long-term – now comes under BAPPENAS and the MOF is required to coordinate with BAPPENAS on the drafting of the mid-term development plan and mid-term expenditure framework as well as annual development plan and annual budget.

When Yudhoyono and Jusuf Kalla came to power in 2004, the policy orientation turned to accelerating economic growth, poverty reduction and job creation through proactive fiscal policies, government expenditures on national welfare such as education and health, and promotion of investment through infrastructural development. Kalla was the most active vice president since Mohammad Hatta served as the country's first vice president during the revolutionary years. Together with his ally and business politician Aburizal Bakri, Coordinating Minister for Economic Affairs, Kalla dominated the economic policy-making process. Confronted with the mini-crisis in August 2005, however, in which the government had to make a tough decision to cut the fuel subsidy and avoid the deterioration of its fiscal position in the face of high price oil, the president came to the conclusion that macroeconomic stability should be given the first policy priority, even though poverty reduction and job creation would become increasingly important in the coming years. He also wanted to have his own economic team, not his vice president's. To this effect, Boediono was appointed Menko and Sri Mulyani finance minister. But to placate the vice president and his party, Paskah Suzetta, a Golkar politician, was appointed as State Minister for Planning and Chief of BAPPENAS and Bakri was given a new post as Coordinating Minister for Welfare.

The Indonesian technocracy evolved under the New Order from 1966 to 1998 as a strategic component of its politics of stability and economic development. Technocrats were instrumental in persuading Soeharto to adopt reform measures in the 1980s that imposed market discipline on the government's developmental policies. Indonesian technocrats as a group were effective because they were cohesive in their adherence to the three principles of balanced budget, open capital account, and pegged exchange rate system, and also because they enjoyed Soeharto's confidence and could therefore function as his right arm in formulating and executing national development policies. In the 1990s, however, technocrats faced increasing challenges from economic nationalists entrenched in the government agencies such as the Ministry of Industry, the Investment Coordination Agency, and the BPPT/BPIS (Agency for State Strategic Industries) and from Soeharto's family and crony business interests. They tried to seize the opportunity offered by the 1997 currency crisis to persuade Soeharto to go to the IMF and to introduce reform measures, but the move backfired because technocrats could not gain access to an ailing Soeharto who was shielded by his family members.

The transitional governments led by Habibie, Wahid, and Megawati sought institutional and political alternatives to the discredited Soeharto-era economic policy-making process. These alternatives ranged from relying on technocrats while consulting key players in Indonesia's economy and politics such as businessmen, mass media, politicians, public intellectuals, and future technocrats, as well as foreign governments and international organization (as Ginandjar Kartasasmita did as Coordinating Minister under Habibie) to outright disregard for technocracy and its institutional bulwark BAPPENAS (under Wahid) to the empowerment of MOF for the sake of macroeconomic stability at the expense of BAPPENAS and long-term national planning (under Megawati). With the enactment of a series of laws governing the BI, government finance, and national development planning as well as constitutional revisions, however, a new institutional framework based on the interaction between the three preeminent agencies of BI, MOF, and BAPPENAS is now in place for economic policy-making. This might go a long way toward upholding the mid- and long-term economic rationality of the policy-making process. But technocrats are now more dependent on their ability to court public support for policy measures they are advocating and to secure the backing of the president and the vice president who may or may not agree on any policy issue and whose decisions on economic policy will be influenced by non-technical and highly political issues such as public reception, parliamentary approval, and personal chemistry. The era of "low politics" during which technocrats had a freer hand in formulating economic policies and could rely on the backing of the president alone is over. Although the institutional foundation is now in place for the independence of Central Bank, the fiscal prudence of the MOF and the planning function of the BAPPENAS, their performances ultimately depend on who runs these institutions and what political processes inform their operations.

4. The Economy

As noted above, after three decades of rapid economic growth, Indonesia was deeply affected by the economic crisis of 1997–1998. In 1998 the economy contracted by over 13%, the sharpest among all four crisis-affected East Asian economies. Income per capita has now recovered to pre-crisis levels. But the country has in effect "lost" a decade of growth that, had it been sustained at pre-crisis rates, would have resulted now in a much higher per capita income, closer to $US2 000 rather than $US1 000. In addition, growth remains more subdued, at around 5% rather than the 7% and more before 1997. In this section of the paper, we first provide a macroeconomic survey of the period since 1998. We then examine trade policy, the business environment, and social policy, and outcomes.

4.1 Macroeconomic survey[2]

Economic growth

The Indonesian economy began to decline precipitously in the fourth quarter of 1997, and recorded negative growth of over 13% (or 15% in per capita terms) in 1998 (Ito, 2007, figure 1). Growth was negligible in 1999, but recovered to nearly 5% in 2000. For the period 2000–2005, growth has averaged 4.5%, in contrast to the 7.3% recorded over the pre-crisis period 1990–1996. This suggests a V-shaped recovery. However, per capita growth has almost halved, from nearly 6% for the decade from 1986 to around 3% since 2000.

In the immediate aftermath of the crisis, the share of agriculture rose, as a survival strategy following the collapse of much urban-based modern sector activity, and as a result of the competitive boost to agricultural exports from the sharp exchange rate depreciation. The expenditure accounts since 1998 have been dominated by the sharp decline in investment, and the rising share of consumption. The latter, like the rising agriculture share, was an effective social cushion during the crisis.

The share of investment in GDP declined by over 10 percentage points between 1997 and 1999 (32% to 20%, see Ito, 2007, figure 2), before gradually recovering, albeit to levels well below those pre-crisis. In addition to the massive flight of short-term capital, which was the proximate trigger for the onset of the crisis, foreign direct investment turned sharply negative. Averaging $US2.7 billion per year 1990–1996, net outflows have been about $US1.4 billion since 2000.

Exchange rate and inflation

For much of this period, the exchange rate has been driven by the capital account. Before the crisis, the central bank ran a heavily managed regime, effectively targetting a fixed effective exchange rate against the US dollar. As the crisis hit, and conscious of the futile attempt in Thailand to hang on to a fixed rate, the government quickly allowed the rupiah to float. The rate then became a barometer of political conditions. By January 1998, the rupiah/dollar rate had fallen from 2 500 to 17 500, by far the largest depreciation among the crisis economies (Ito, 2007, figures 3 and 7). It then recovered following Soeharto's exit in May 1998, but with each bout of significant political instability it has deteriorated. With the apparent return of political stability since October 2004 under the Yudhoyono presidency, the rate has stabilized, generally within the 9 000–10 000 range. However, Indonesia's persistently high inflation rate continues to put pressure on the exchange rate.

Although Indonesia's nominal exchange rate has fallen far more than that of the other crisis-affected economies, the depreciation of the real effective rate has been comparable owing to its much higher inflation. This factor, combined with deteriorating physical infrastructure, increased administrative complexities affecting international trade, negative foreign investment (especially in key export-oriented industries such as electronics), and an inability to take advantage of high commodity prices, explain why export performance has been inferior to some other crisis-affected economies (Athukorala, 2006).

Unlike its crisis-affected neighbors, the monetary authorities temporarily lost control of monetary aggregates in the first half of 1998, as the government injected liquidity into the banking system. This attempt by BI to keep the banks operating was known as the BLBI scheme (Bank of Indonesia liquidity support). These injections were on a massive scale, at the time equivalent to more than half of GDP, and they explain the sudden increase in both domestic public debt and inflation in 1998.

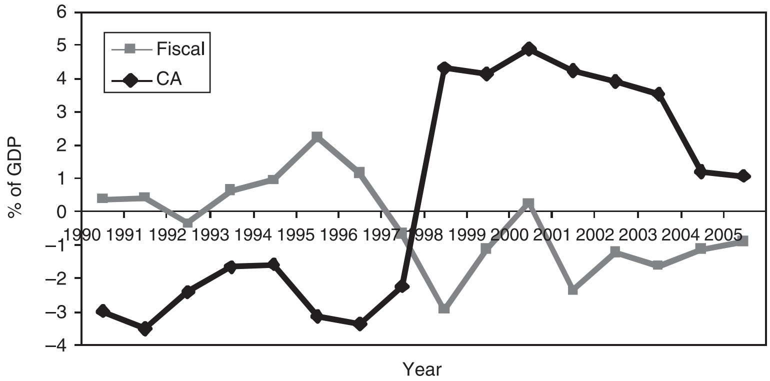

Figure 1 Fiscal and current account (CA) balances, 1990–2005.
Source: World development indicators.
Note: Fiscal balance and current account balance shown as a percentage of GDP.

Inflation on an annualized basis was running at 100% during the first half of 1998, but during the second half of the year it was quickly brought under control again, and was just 2% in 1999 (Ito, 2007, figure 5). Since 2000, inflation has averaged 10.1%, compared to the 1990–1996 figure of 8.4%. In this respect, Indonesia after the crisis resembles that of the Soeharto era: prices rarely get out of control, but it is a relatively high inflation economy.

In spite of these problems, there have been notable macroeconomic policy achievements. As discussed above, the central bank was granted independence after the crisis as part of the Letter of Intent (LOI) with the IMF. It has shifted towards a regime of inflation targetting and a managed float. Underpinned by fiscal prudence, the new arrangements have worked reasonably well in highly challenging circumstances. Indeed, the float has worked as a kind of economic policy discipline.

Macroeconomic balances

Fiscal and current account balances have moved in opposite directions since the crisis (Figure 1). The fiscal balance has swung from a small positive percentage of GDP to generally modest deficits. Meanwhile, the current account has shifted from a deficit of around 3% of GDP in the pre-crisis 1990s to a surplus of similar (but declining) magnitude. These trends are consistent with the experience of economies in crisis. The current account outcomes are explained by three main factors. There is expenditure switching (i.e. the exchange rate effects of boosting exports and inhibiting imports), declining absorption (i.e. declining imports in response to slower growth), and declining capital inflows. The latter occurs because, in effect, foreigners are much less willing to invest their savings in Indonesia. In the case of fiscal policy, the outcome is principally the effect of the "automatic stabilizers" at work. Lower growth means both reduced revenues and increased expenditures, the latter in the form of both social welfare spending and financial bailouts. It is important to emphasize that the magnitudes have been relatively small in all cases, and that the swing in fiscal balances has been surprisingly small in such calamitous circumstances.

Fiscal policy and public debt

As noted, in spite of the deep economic crisis, a weakened central government, an ambitious decentralization program, increased pressure to step up social expenditure, and widespread anti-IMF sentiment, the government brought fiscal deficits under control surprisingly quickly. The fiscal deficit had fallen to less than 2% of GDP by 2000, and it has remained there for most years since.

As a consequence, public debt as a proportion of GDP has fallen quickly, much more so than was expected immediately after the crisis. Government debt before the crisis was almost entirely foreign, owing to the "balanced budget rule" that the technocrats had persuaded Soeharto to sign on to early in his presidency. In the immediate aftermath of the crisis, both foreign and domestic debt rose alarmingly. The former occurred principally owing to exchange rate movements (i.e. the shrinking denominator measured in US dollars), whereas the latter was due to the newly floated recapitalization bonds to finance the bank and corporate debts much of which was transferred to the public sector. However, since 2001, these ratios have fallen quickly, in aggregate from 75 to 43%, and with both components trending downwards at similar rates. Three main factors explain this encouraging picture: very modest fiscal deficits, as noted; stronger economic growth, enabling the government to grow its way out of debt; and lower interest rates. The debt maturity profile has also been stretched significantly.

This is a major economic policy achievement, and much of the credit goes to the Minister of Finance in the Megawati administration (and the president herself for supporting him). It reaffirms a tradition in Indonesia of a relatively strong finance ministry, notwithstanding much corruption within the department (especially in customs and tax) and surrounding it (in "off-budget deals"). Essentially the minister was able to "sell" to the president the importance of adopting a formal fiscal policy framework, especially with the near-term prospect of exiting the IMF program. A *cordon sanitaire* was placed around fiscal deficits. As noted above, in Law 17/2003 the government adopted a similar principle to that of the European Union, under which fiscal deficits should not exceed 2% of GDP, and the debt/GDP ratio should be below 60%.

Of course, the aggregate fiscal balances are only part of the story, and the fiscal picture becomes more complex as it is unpackaged. First, fiscal deficits have been low in part because government officials are becoming increasingly apprehensive about the prospect of being caught up, however innocently, in corruption scandals. Ironically, the anti-corruption campaign is stymieing both "good" and "bad" projects. Second, the finance ministry has much less control over expenditure and revenue components than it does over the aggregates. This is clearly illustrated in the case of fuel subsidies. At their peak in 2004, subsidies totaled 74 trillion rupiah (almost $US8 billion), more than the central government's total development budget. In fact, in that year, and illustrative of the government's limited capacity to initiate development projects, 63% of its expenditure went on regional transfers, interest payments, and subsidies. Third, there is arguably a case for the government gradually relaxing its fiscal stringency, to the extent that it probably could borrow more on concessional rates for major projects with high social returns. This too is a complex issue, and it needs to be recognized that the cautionary arguments are powerful.

4.2 Trade policy and the commercial environment

Indonesia's trade and commercial environment has changed significantly since the crisis in some respects, but in other areas has proven resistant to reform.

On trade policy, Indonesia was a broadly open economy at the time of the crisis (Fane & Condon, 1995). There was further liberalization as part of the LOI with the IMF. Although the country has exited this program, there has been no major backtracking since then. This is an important policy achievement, and it partly explains the economy's underlying resilience during the post-crisis period.

Why was there no major backtracking, in spite of the crisis and the resultant resurgence in "nationalist" sentiment? At least six factors appear to be relevant (see Basri & Soesastro, 2005, for some discussion). First, in the immediate post-crisis period, the IMF LOI played a role, and some of the dismantled protection (e.g. Tommy Soeharto's national car project and clove monopolies) was popular. Second, the very large depreciation of the rupiah provided some exchange rate protection for tradables. Moreover, recovery has been dependent on the growth of the export sector, which is politically empowered, and opposed to protection. Third, finance ministries are typically central to the resolution of a crisis, and these now more powerful agencies are generally more likely to favor lower protection. Fourth, the major 1980s liberalizations were still a recent memory at the time of the crisis, and thus an unwinding of successful reforms was likely to be resisted. Fifth, the global trend toward liberalization now has strong intellectual appeal, particularly with the example of the increasingly open Asian giants, China and India, and in contrast to the earlier appeal of North-East-Asian-style guided, export-oriented, industry policy. Finally, at the margin, Indonesia was a signatory to various regional trade agreements – World Trade Organization and Association of South-East Asian Nations Free Trade Agreement in particular – that provided a mild barrier to increased protectionism.

Significant trade policy challenges do of course remain. Protectionist pressures have intensified in certain agricultural products. With democratization, rural votes matter, and politicians are able to exploit this factor along with appeal to sentimental notions of food self-sufficiency. Moreover, it is now easier to introduce protection for agriculture than manufactures owing to various loopholes (quarantine, etc.) and to the fact that the Organization for Economic Cooperation and Development north is extremely slow to liberalize its own agricultural protection. There are also a number of important "trade plus" issues, related to complex export–import procedures. In addition, domestic trade barriers have emerged as just as, if not more, important than international barriers.

In the case of competition and the corporate landscape, the crisis deeply affected much of Indonesia's modern sector. Before the crisis, Indonesia had high levels of corporate conglomeration and seller concentration (see Claessens *et al.*, 2000; Bird, 1999, respectively). There has not been any detailed empirical research on these issues since the late Soeharto period, but it is probable that the general findings from the mid-1990s still apply.

Nevertheless, competitive pressures have most likely increased somewhat since the crisis, for at least five reasons. First, this has been a period of corporate volatility and restructuring. The major Soeharto-linked business empires have collapsed, whereas many of the major private sector conglomerates have experienced significant changes, either related to financial workouts, or the loss of crony privileges, or both. Foreign ownership shares have increased in most major industries. Second, as noted above, levels of import protection are generally low and have very likely declined. Third, there has been some, though limited, additional deregulation in key, mainly state-owned-enterprise-dominated, sectors. Notable examples include domestic civil aviation and telecommunications. Moreover, the establishment of a Competition Commission in 1999 has probably increased competition (see Thee, 2006, for an early assessment). Fourth, although corruption is arguably as serious a problem now as in the Soeharto era, there is arguably less entrenched, systemic, and blatant "palace corruption" of the type that proliferated in the late Soeharto era. Finally, the decentralization initiative of 2001 has shifted power away from the center, and with it the concentration of regulatory authority and bureaucratic rents.

Much less has changed with regard to the regulatory regime. Indonesia's business regulatory environment remains complex, opaque, and costly. Most comparative business surveys now rank Indonesia quite poorly, by East Asian and international yardsticks. Corruption levels are high, and licensing procedures lengthy and unpredictable. For example, the World Bank (2006) ranks Indonesia 135th out of 175 countries in terms of ease of doing business; it also reports that it takes at least 80 days to register a business.

The key difference now is that this corruption occurs in the context of slower economic growth, and it is more unpredictable. Consequently, combined with labor and infrastructure problems, investment is a good deal lower than pre-crisis levels. Foreigners are less interested in the country. The state has less capacity to maintain its large state enterprise sector, although it continues to block privatization, especially when influential stakeholders are affected. But most important, it is domestic investors who are holding back. An additional effect is that the composition of investment has changed. Investors are now tending to eschew longer-term projects in favor of short-term investments that can be more easily liquidated. Thus, for example, the Jakarta Stock Exchange Composite index has increased much more quickly than foreign direct investment (evidence of foreigners' preference for portfolio investment), and real estate and shopping mall projects have boomed in recent years. Meanwhile, there has been much less interest in major sectors with longer-time horizons. Two notable examples are infrastructure and mining.

One major change since the crisis is the introduction of a "big bang" decentralization initiative in 2001 (see Brodjonegoro, 2004, for a summary overview). Center–regional relations during the Soeharto era were highly concentrated in Jakarta, but the government was always sensitive to its regional constituency, and a cautious decentralization program had been drawn up in the mid-1990s. The crisis accelerated the process, as democracy inevitably empowered the regions. The threat of territorial disintegration, with serious problems in Timor, Aceh, Papua, and elsewhere, was an additional consideration.

Although Indonesia remains a unitary state, major revenue, expenditure, and administrative authority has been devolved to the regions, principally to the now more than 450 second-tier districts, kota (cities), and kabupaten. Resource-rich regions have been the major beneficiaries, since they are now allowed to keep most of the locally generated revenue that formerly went to the center. Direct elections for leaders and parliaments at the regional level are being progressively introduced, thus changing the nation's political and institutional landscape profoundly.

This major reform is still in its infancy, and it is premature to attempt a definitive assessment of its achievements. In principle, the reforms make sense: it is virtually impossible to govern a hugely diverse nation like Indonesia in a centralized manner. If democracy is to be introduced in the center, then it obviously ought to be in the regions as well. It is also desirable to bring governance closer to the stakeholders, so that local accountability can be introduced, and in the hope that "voice and exit" mechanisms will over time lift the standard of local governance.

Thus far, the evidence is understandably mixed, and a number of clear lessons have emerged for managing the process. First, local-level economic progress still depends overwhelmingly on the national picture. Even the best-managed decentralized program is unlikely to stimulate growth at the regional level if national policies are not also conducive to growth. Second, it is probable that regional inequality will increase. The new financial allocation formulae favor the richer regions, and these are also better able to connect to the global economy. Third, and perhaps paradoxically, devolution requires a strong central government. The rules of the game have to be clearly specified and enforced. Indonesia decentralized at an extremely difficult time, when the central government was greatly weakened, administratively and financially. Fourth, the significant decline in infrastructure investment since the crisis further imperils the Soeharto-era trend toward national economic integration. Finally, decentralization might have taken some of the steam out of the demands for even regional autonomy, but its contribution to the resolution of the country's most serious cases of regional disaffection, such as Aceh and Papua, has been limited. The lesson here is that special presidential initiatives are the key factor, as has been successfully demonstrated in Aceh since the December 2004 tsunami.

The financial sector was at the heart of the deep economic crisis of 1997–1998. Many banks failed, perhaps inevitably given the nature of the stresses on a system, which had been suddenly liberalized a decade earlier, but in which the prudential supervisory framework to manage a competitive, resilient financial sector had not been put in place (Grenville, 2004). Since the crisis, the banking sector has been essentially cleaned up and is now functioning reasonably effectively. Non-performing loans in the commercial banking sector remain high, but they have declined significantly from the post-crisis peak of 33% in 1999 to about 8%. Firms that have an established record of operations do not appear to be significantly credit constrained. Most business surveys rank other problems more highly (labor, infrastructure, unpredictable corruption, etc.). This clean-up was hugely expensive, and the cost has been largely transferred to tax payers in the form of the steep increase in public debt.

The key actors have changed. Whereas before the crisis the domestic private sector was the largest single group, and expanding, since 1998 the banking sector has been effectively renationalized, returning it to something more nearly resembling the pre-liberalization

Table 2 Poverty in Indonesia, 1996–2004

	Population below the poverty line (million)			Population below the poverty line (%)		
Year	Urban	Rural	Urban + Rural	Urban	Rural	Urban + Rural
1996	9.6	24.9	34.5	13.6	19.9	17.7
1998	17.6	31.9	49.5	21.9	25.7	24.2
1999	15.7	32.7	48.4	19.5	26.1	23.5
2000	12.3	26.4	38.7	14.6	22.4	19.1
2001	8.6	29.3	37.9	9.8	24.8	18.4
2002	13.3	25.1	38.4	14.5	21.1	18.2
2003	12.2	25.1	37.3	13.6	20.2	17.4
2004	11.4	24.8	36.1	12.1	20.1	16.7

Source: Central Board of Statistics.

structure. The government has also found it difficult to divest itself of these newly acquired banks. These state banks remain a serious problem. Two of them still have high non-performing loans. They have been slower to complete the process of workouts, mainly because of extensive government interference. "Command lending" to politically favored clients continues to be a problem.

Meanwhile, the share of foreign banks has risen gradually, but they have been constrained from playing a larger role in the clean-up (and in lifting regulatory standards) owing to nationalist resistance to the sale of "distressed assets" to foreigners.

4.3 Social trends and policies

The crisis caused considerable social distress. As shown in Table 2, there was a marked increase in poverty in 1998, with the number of poor increasing by about 15 million people, equivalent to about a 50% increase in their number. The sharpest increase, both in absolute and percentage terms, was in urban areas, confirming the picture that this was primarily a crisis affecting the modern urban sector of the economy. Thereafter, poverty incidence has declined more or less continually, with inflation (particularly for food) being the main determinant of short-term departures from this trend. A series of terrible natural disasters and terrorist attacks had catastrophic local effects, but did not greatly affect the national numbers. The proportion of the population below the poverty line had returned to pre-crisis levels by 2003, in both urban and rural areas, reflecting the fact that per capita income levels had by then approximately returned to those of 1996.

Although the poverty picture has improved, labor market outcomes have deteriorated. Since 1998, there has been a welcome improvement in the freedom of labor to organize and negotiate. Moreover, initially, labor market flexibility enabled the labor market adjustment to the crisis to occur mainly on the price (i.e. real wages) rather than the quantity (i.e. employment), and thus there was not a major increase in open unemployment. But in other respects, labor market policies and outcomes have deteriorated. Labor market populism has resulted in mandated minimum wages rising sharply, while employment regulations have become among the most restrictive in East Asia. For example, the regulated minimum wage series increased by over 90% in the 3 years, 1999–2002. Severance pay entitlements have also been increased significantly (Manning & Roesad, 2006). The results have been largely predictable. Employment in the modern ("formal") sector has declined, whereas that in the informal sector, typically lower paid and less secure, has been rising. Moreover, Indonesia has become a less attractive location in intensively competitive, footloose labor-intensive industries.

5. Summing Up

Indonesia has learned some bitter lessons from the crisis of 1997–1998 (Boediono, 2005). A once impregnable regime was toppled. The global economy and its institutions, seemingly benign for the previous three decades, delivered some unpleasant medicine. There has been much personal hardship and corporate distress. A series of terrorist incidents, some nasty communal violence, and a string of natural disasters have compounded the problems.

But Indonesia is not in any sense a "failed state." It is now the world's third largest democracy, having navigated the transition from authoritarian rule with remarkable success.

Growth has returned. In these circumstances, of "twin crises," both economic and political/institutional, economic management has been surprisingly good once the immediate crisis passed. The key has been the quick return to prudent macroeconomic management and the maintenance of a broadly open economy.

A repeat of anything like the 1997–1998 crisis is unlikely. Indonesia remains highly indebted. Both its public debt and external debt to GDP ratios are high, but they have fallen substantially since the crisis. There have been current account surpluses almost continuously since 1998 and fiscal deficits are low. The floating rate regime should ensure that there is no serious currency misalignment. Banks and creditors have learned to be more cautious, although the problems in the state banking sector have yet to be overcome.

These achievements in macroeconomic and trade policy constitute a necessary but not sufficient condition for the restoration of high growth. Investors, both foreign but especially domestic, have to be persuaded that Indonesia offers a secure, profitable, and predictable business environment. This is now the Yudhoyono administration's key economic policy imperative. It is also the key to his political success and to the long-term health of a newly democratic Indonesia. The institutional foundations are in place for economic policy-making. But how these institutions perform ultimately depends on who runs them and what political processes inform their operations. Party politicians still need to learn to work with technocrats, whereas technocrats need to be savvier in courting the public than under Soeharto. Challenges also remain with the business environment, and with supply side constraints in infrastructure and education. Business confidence is returning, but slowly, and investors are still shunning projects with long-time horizons.

The country is missing out on a rare opportunity to convert record commodity prices into future growth and welfare improvements.

Notes

1 "Islamic" refers to pious Muslim groups that do not necessarily call for the establishment of an Islamic state, whereas "Islamists" advocate making the *Shariah* (Islamic law) the basis of the Indonesian state.

2 This section draws on a wide variety of source material, the most important being the 4-monthly "Survey of Recent Developments" in the *Bulletin of Indonesian Economic Studies*. Most of the economic data are drawn from the comparative figures and tables in Ito (2007).

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