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# Survey of recent developments

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# SURVEY OF RECENT DEVELOPMENTS

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## SUMMARY

By June 2006, the government had largely completed the difficult tasks of stabilising macroeconomic conditions following the October 2005 fuel price increases, and of drawing up a blueprint to improve infrastructure and the investment climate. On the macroeconomic front, the main issues related to how, and how quickly, the economy could return to the growth rates of late 2004 and early 2005, given still low levels of private and public investment. Sound macroeconomic policies had delivered a stronger rupiah and reduced inflationary pressures, albeit with continued decelerating rates of growth. Private consumption and investment having slowed, government spending had become the key driver of growth, but major delays in public spending continued in the first four months of the year.

The reform agenda includes an impressive raft of new laws, or revisions to old ones, in investment, taxation, customs and labour, all of which were covered under a special Presidential Instruction. However, actual reform was slowed by substantial political obstacles. There was growing concern about divisions within the cabinet on the reform package, and about the capacity of the ministerial team to guide reforms quickly through the bureaucracy and the parliament. This included doubts about the resoluteness of President Susilo Bambang Yudhoyono (SBY) on reform initiatives in the face of vocal opposition (as in the case of labour reform), and about Vice President Jusuf Kalla's commitment when political or business interests close to him were opposed to change (as in the case of divestment of shares in Indonesia by the giant cement multinational, Cemex).

Given likely delays in the reform package's impact on output and employment, uncertainty persists about the level of support the 'duumvirate' is prepared to offer reformist ministers, and about the political clout of the reformers themselves, as the government moves into the middle period of the electoral cycle. Examples of weak policy making include watered-down investment reforms, the seemingly 'quick-fix' approach underlying a proposal to set up special economic zones, and unsatisfactory handling of continuing disputes in the mining sector. A backdown on labour market reforms, at least for the present, has probably been the biggest setback to date in the SBY–Kalla team's attempt to promote investment: a poorly managed reform effort in terms of both substance and political strategy.

Two other events shook Indonesia during the Survey period. A massive earthquake hit the Yogyakarta region on 27 May, killing nearly 6,000 people and leaving thousands homeless. And on the political front, the attorney general controversially dropped corruption charges against the ailing former president, Soeharto.

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## THE POLITICAL ENVIRONMENT FOR REFORM

Some of the high hopes for a reinvigorated reform agenda under the new economics team led by coordinating minister Boediono had been realised by mid-2006. Yet at the same time, signs of a less than strong commitment to economic reform within the government and the cabinet had become more apparent.[1] There was also growing concern that while the president and vice president supported improvement in the investment climate in principle, they were not necessarily prepared to back reform initiatives in the face of strident opposition, or when interest groups were (ostensibly) pitted against a more open, market-oriented and internationalist agenda.

At the time of writing the new team had been in office for six months, and had devised a new program of reform focused on improving the investment climate. Under Presidential Instruction 3/2006, new laws, or revisions of old laws, on investment, taxation, customs and labour were in various stages of preparation to go before the parliament (DPR)—starting with the investment law later in the year—and a long list of infrastructure projects had been drawn up. The Minister of Finance replaced the directors general of taxation and customs in late April, signalling that the government was serious about implementing its new reform program.

Despite these achievements, which were underpinned by a strong rupiah and relatively stable macroeconomic conditions, even many supporters of SBY question the capacity of the government to deliver on its economic promises. Unemployment remains stubbornly high (at just over 10% in February 2006), and poverty has levelled out after falling quite sharply in the early years after the crisis of the late 1990s. Few commentators believe the government is on track to meet its objective of a near halving of both rates by 2009.

A major problem appears to lie in the political management and implementation of the reform program. The economics members of the cabinet clearly differ in their commitment to more market-oriented reforms, with the ministers of agriculture, state enterprises and industry seeming to have less liberal approaches to key issues such as rice imports, privatisation and industrial development. The president and vice president have both given mixed signals in the past six months about the extent of their commitment to the reform package. In the case of amendments to the labour law, the president seemed to give in to opposition too easily; not for the first time, this provided a sign that he was vulnerable to pressure from interest groups. The failure of the government to wind up the unhappy Cemex saga quickly and cleanly, by approving the sale to local investors in May of Cemex's 25% stake in the cement producer Semen Gresik, provides another example of the mixed signals to investors. In this case the vice president chose publicly to support Sugiharto, the Minister of State Enterprises, in seeking to block this sale.[2]

Observers are divided in their assessment of the president's commitment to economic reform. Some see him as an internationalist committed to a transparent and market-oriented investment climate. Others question whether he places sufficiently high priority on more market-oriented approaches to be willing to risk his

[1] Early signs of divisions within the cabinet on economic policy were noted in the previous Survey (Kuncoro and Resosudarmo 2006: 9)

[2] The cases of labour reform and Cemex are discussed in more detail below.

popularity in the short term. They note that he is often reluctant to make difficult decisions on implementation, and is more comfortable with broad assertions of principle in favour of private enterprise. Recent examples include his seeming failure to provide sufficient support to his more reform-minded ministers on critical issues such as the Cemex sale and the investment law.

The president's commitment to reform is likely to be tested in coming months, at a time when opinion polls suggest that his popularity has fallen significantly.[3] Even under the most optimistic assumptions, it seems unlikely that the economic growth rate this year will increase much above the current level of less than 5% per annum. Most predictions range from 5% to 6%, and while such rates are impressive by Third World standards (though not by those of China or India in the past several years), they are not sufficient to make a major impression on the related and pressing problems of slow modern sector employment growth, high unemployment and poverty.

The concern is that the impact of planned changes, especially in basic laws and infrastructure investment, will not be felt for another 18–24 months, by which time—with the 2009 elections looming—the president may be even more vulnerable than at present to criticism of the government's economic reform agenda. The test will be whether he and his deputy can provide strong political support to their reformist ministers in the interim, or whether they will give in to pressures to favour the more populist and nationalistic tendencies of several other cabinet members and political leaders.

Another major natural disaster shook the nation during the period of the Survey. A massive earthquake hit Central Java and the province of Yogyakarta on 27 May, killing nearly 6,000 people and leaving an estimated 200,000 homeless. The impact of the earthquake on the national economy is likely to be limited, since Yogyakarta contributes only about 1% of Indonesia's GDP. The cost of rehabilitation will nevertheless weigh heavily on both provincial and district budgets. The districts worst hit, Bantul (Yogyakarta) and Klaten (Central Java), are two of the most densely populated regions in Indonesia, which means that the cost per household of accessing those affected is relatively low. But it also means that losses have been great over a relatively small land area. For example, some 50,000 houses are estimated to have collapsed entirely in Yogyakarta province alone (with a population of slightly over three million), and another 70,000 are reported to be seriously damaged (*Kompas*, 7/6/2006). But apart from the human toll, the sight of widespread destruction in one of Indonesia's principal cultural and tourist centres has dealt a blow to the national psyche, especially as the country is still recovering from the tsunami and earthquakes in Aceh and Nias in late 2004 and early 2005.

On the political front, two important events occurred in the first five months of 2006. First, the president reaffirmed the government's commitment to *pancasila*—the five guiding principles for the Indonesian state—in what was seen as an effort to allay fears among religious minorities, and many moderate Muslims, of a per-

[3] Although SBY remained much more popular than any alternative candidate, the Indonesian Survey Institute (Lembaga Survei Indonesia, LSI) reported in December 2005 that public confidence in the SBY–Kalla team had fallen considerably between November 2004 and December 2005, from close to 80% satisfaction to just above 50%. Other less highly reputed surveys conducted in early 2006 showed similar trends.

ceived rise in Islamic fundamentalism. Second, the attorney general dropped corruption charges against former president Soeharto, which may bring attempts to prosecute him to an end. Soeharto has not appeared in court since being declared unfit to stand trial following several strokes and other health complications. President Yudhoyono has stated that the government would consider taking control of some of the Soeharto family's wealth, accumulated in several foundations (*JP*, 14/5/2006), but he has not objected to the attorney general's ruling, which is unlikely to be overturned. The decision by the attorney general has split the public, and could undermine confidence in SBY's anti-corruption campaign, which has been one of the stronger aspects of his presidency.

## GROWTH AND MACROECONOMIC TRENDS

Sounder macroeconomic policies have stabilised the economy, bringing about a stronger rupiah and reduced inflationary pressure in the first five months of 2006. Output growth has continued to decelerate since the third quarter of 2005 under the influence of higher fuel prices and higher interest rates. While government spending became the key driver of growth in early 2006, delays in disbursements from the 2006 budget caused concern. There was also some nervousness about macroeconomic settings against a backdrop of some heightened uncertainty internationally.

### Economic growth

The economy slowed further in the first quarter of 2006, continuing its adjustment in the aftermath of the fuel price hike and the interest rate increases that followed it. Overall growth has declined to 4.6% year on year, down from 4.9% in the last quarter of 2005, and from 7.1% in the December quarter of 2004 (table 1). On the expenditure side, household consumption took a further significant dip from 4.2% to 3.2% growth year on year in the first quarter, as consumer purchasing power deteriorated with higher prices. Lower consumer demand can also be tracked by looking at the declining sales of motorcycles and cars. Car sales fell from just over 45,000 per month in July–September 2005 to less than 20,000 in February and March, while motorcycle sales showed a similar though less steep decline, from 480,000 per month in July–September to just under 300,000 in April. In both cases the trend was downwards each month for the first quarter of 2006, and was especially marked for cars.

Investment growth was slightly higher than in the December quarter, but remained far below the double-digit growth that spanned the five quarters preceding the third quarter of 2005. Firms have cut down massively on investment in machinery and equipment and other capital expenditures, providing a clear sign of how badly confidence has been affected by increased fuel prices and interest rates; for instance, growth of investment in machinery fell to –16.2% in the first quarter of 2006. Surprisingly, investment in construction managed to hold up quite well, increasing its growth rate a little. Overall, however, investment as a proportion of GDP remained stagnant, declining marginally from 21.8% to 21.5% in Q1 2006. The pre-crisis average of around 30% remains a distant target after almost eight years of *reformasi*. These dismal figures make the case all the more urgent for a renewed push to improve the investment climate.

TABLE 1 *Components of GDP Growth*
*(2000 prices; % p.a. year on year)*

| | Dec-04 | Mar-05 | Jun-05 | Sep-05 | Dec-05 | Mar-06 |
|---|---|---|---|---|---|---|
| **Gross domestic product** | **7.1** | **6.3** | **5.6** | **5.6** | **4.9** | **4.6** |
| Non-oil & gas GDP | 8.3 | 7.2 | 6.6 | 6.5 | *5.7* | *5.2* |
| **By expenditure** | | | | | | |
| Household consumption | 3.9 | 3.4 | 3.8 | 4.4 | 4.2 | 3.2 |
| Government consumption | 0.4 | –9.6 | –6.7 | 14.7 | 30.0 | 14.2 |
| Investment | 16.1 | 14.1 | 15.6 | 9.4 | 1.8 | 2.9 |
| Building construction | 7.6 | 6.3 | 7.1 | 5.7 | 5.7 | 7.2 |
| Machinery & equipment | 46.4 | 47.1 | 48.8 | 23.2 | –11.3 | –16.2 |
| Transport | 49.8 | 45.3 | 43.2 | 17.9 | –4.4 | 12.4 |
| Other | 39.2 | 15.5 | 16.8 | 3.3 | –2.6 | –6.7 |
| Exports | 22.2 | 11.8 | 11.2 | 4.8 | 7.4 | 10.8 |
| Imports | 31.2 | 18.8 | 17.9 | 10.6 | 3.7 | 5.0 |
| **By sector** | | | | | | |
| *Tradables* | *5.8* | *4.4* | *2.8* | *3.4* | *3.3* | *3.4* |
| Agriculture, livestock, forestry & fisheries | 1.3 | 1.1 | 0.9 | 2.9 | 5.5 | 3.9 |
| Mining & quarrying | 6.9 | 4.1 | –0.5 | 1.0 | 1.9 | 7.0 |
| Manufacturing | 7.4 | 6.3 | 4.9 | 4.5 | 2.9 | 2.0 |
| Excluding oil & gas | 8.7 | 7.5 | 6.2 | 5.7 | 4.1 | 2.8 |
| *Non-tradables* | *8.6* | *8.4* | *8.9* | *8.2* | *6.6* | *5.9* |
| Electricity, gas & water supply | 6.8 | 6.4 | 6.9 | 6.6 | 6.1 | 5.2 |
| Construction | 7.6 | 7.4 | 8.2 | 6.9 | 6.9 | 7.2 |
| Trade, hotels & restaurants | 9.2 | 9.9 | 10.0 | 8.6 | 6.0 | 4.2 |
| Transport | 8.5 | 10.3 | 7.7 | 5.2 | 2.6 | 3.8 |
| Communications | 20.0 | 21.6 | 25.7 | 27.4 | 25.4 | 22.9 |
| Financial, rental & business services | 9.8 | 6.7 | 8.9 | 7.9 | 5.2 | 5.1 |
| Other services | 5.0 | 4.6 | 4.4 | 5.6 | 6.0 | 5.4 |

*Source:* CEIC Asia Database.

Exports recovered slightly and are now close to the growth rate recorded in the second quarter of 2005. Nevertheless, both total and non-oil export growth slowed in the first four months of 2006, compared with the same period in 2005.[4] Import growth also recovered somewhat, from 3.7% to 5.0% year on year in the first quarter of 2006.

[4] Manufacturing export growth in particular grew slowly, at only 9% per annum in the first four months of 2006, while both agricultural and mining exports held up at rates of growth above 20% in the same period (BPS-Statistics Indonesia, Press Release, May 2006).

On the production side of the national income accounts, communications continued to be the leading sector, with a growth rate well above 20% year on year. Communications is a prime example of how a deregulated and competitive sub-sector—in this case the mobile phone industry—can prosper despite negative economic shocks. Thanks to record high prices for basic metals and gold, the mining sector recorded a jump in its growth rate to 7% in the first quarter of 2006, compared with less than 2% in Q4 of 2005. The trade, hotels and restaurants sector—one of the leading sectors until mid-2005—lost momentum, recording its third consecutive quarter of declining growth. Such a trend bodes ill for job creation, as this sector has created a great deal of formal sector employment in recent years. For instance, between 2001 and 2005 the domestic trade sub-sector created a significant share of new jobs—close to 25%, or almost 1.7 million, of which around 600,000 were regular wage jobs.[5] The story is even worse for the manufacturing sector. Total manufacturing output growth has now declined for the fifth consecutive quarter, and has not come close to the peak of 7.4% year on year achieved in the last quarter of 2004. Non-oil and gas manufacturing growth also peaked at the end of 2004 and has declined similarly since then.

The economy has shifted activity towards the non-tradables industries, as demonstrated by the consistently higher growth rates of this sector. In part this may be attributed to change in the relative prices of tradables and non-tradables: it is estimated that the real exchange rate appreciated by approximately 18% between October 2005 and March 2006.[6] This real appreciation partly reflects rising domestic production costs, including labour costs,[7] suggesting that revision of the labour law, together with other wide-ranging investment policy reforms, is necessary to improve the competitiveness of Indonesia's labour-intensive manufacturing industries.

### Inflation, monetary and exchange rate trends

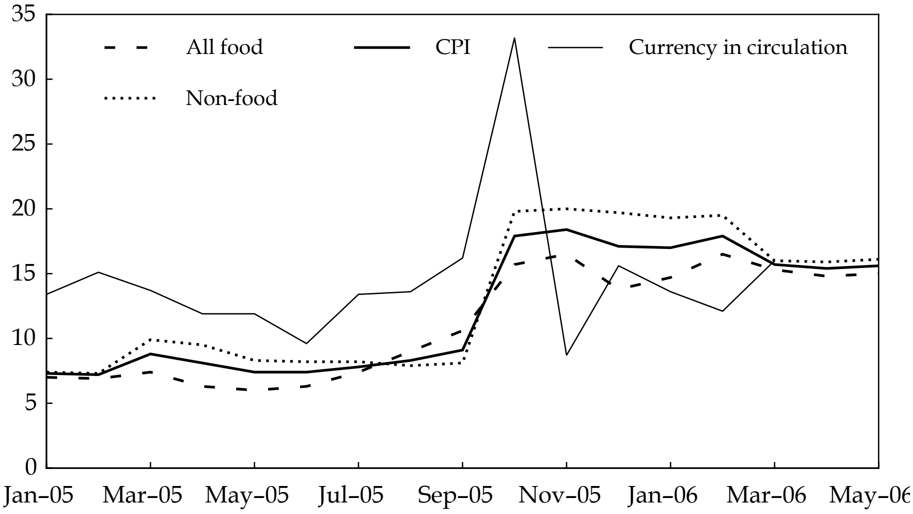
Thanks to Bank Indonesia's relatively conservative monetary policy stance, inflation had stabilised by the end of 2005. Increased confidence in the rupiah was reflected in capital inflow, which contributed to a substantial nominal appreciation of the currency from October 2005 through early May 2006. However, a degree of nervousness remained with regard to capital movements and the value of the rupiah, as short-term capital flows and the exchange rate fluctuated significantly on two occasions in May, mainly in response to anticipated movements in US interest rates and an uncertain international environment.

[5] However, recent plans to introduce new—and more restrictive—regulations for modern retailing could further dampen growth in this vital sector (Bird 2006).

[6] This estimate is based on calculations kindly provided by Kelly Bird (consultant to the World Bank, Jakarta). The real exchange rate is taken from the IMF Real Effective Exchange Rate dataset.

[7] There are some indications that real wage growth has outpaced productivity growth in recent years, and this could certainly be a factor in explaining sluggish investment growth in manufacturing (Roesad and Fitriani 2006).

FIGURE 1 *Inflation and Money Growth*
*(year on year; %)*



*Source:* CEIC Asia Database.

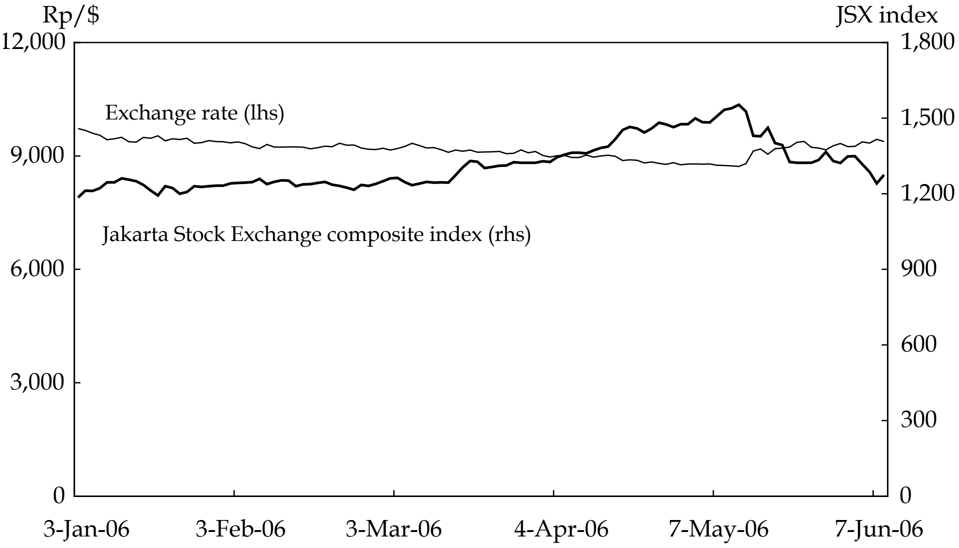
*Inflation*

Consumer price index (CPI) inflation has broadly been on a downward trend since November 2005, with virtually no increase in the CPI from January through May (figure 1); by this time inflation had declined to 15.6% year on year, helped by declining food prices in March and April (when increased output during the harvest season began to have an impact). The food and non-food sub-indices are now increasing at much the same rate, after a period of some months in which the transport sub-index dominated the inflation story following the jump in fuel prices in October 2005. The central bank target of 8% inflation for 2006—which is surprisingly unambitious by the standards of the region—is quite achievable, given that the annualised rate for the six months to May was already below 5%.

*Monetary policy, the capital account and exchange rate trends*

The slow decline in inflation has been helped by the central bank's moderately tight monetary stance. Mindful of the criticism it faced as a result of last year's exchange rate instability, and also the surprise of the big jump in inflation following the fuel price increases in October 2005, Bank Indonesia (BI) had increased the key indicator interest rate on its 1-month certificates (SBIs) by 275 basis points (cumulatively) from September 2005, to reach 12.75% by the end of the year (Kuncoro and Resosudarmo 2006). The rate was then held at that level through Q1 2006. As a result, the interest rate differential against the global market was kept quite wide, helping to attract large inflows of portfolio investment from the third quarter of 2005; these reached $4.1 billion by the end of the fourth quarter. The short-term flows continued during most of the first quarter of 2006, and the rupiah continued to strengthen accordingly. The value of the domestic currency increased to Rp 9,118/$ during Q1 2006, making it the world's second best performing currency

FIGURE 2 *Exchange Rate and Share Prices*



*Sources:* Pacific Exchange Rate Service; Datastream.

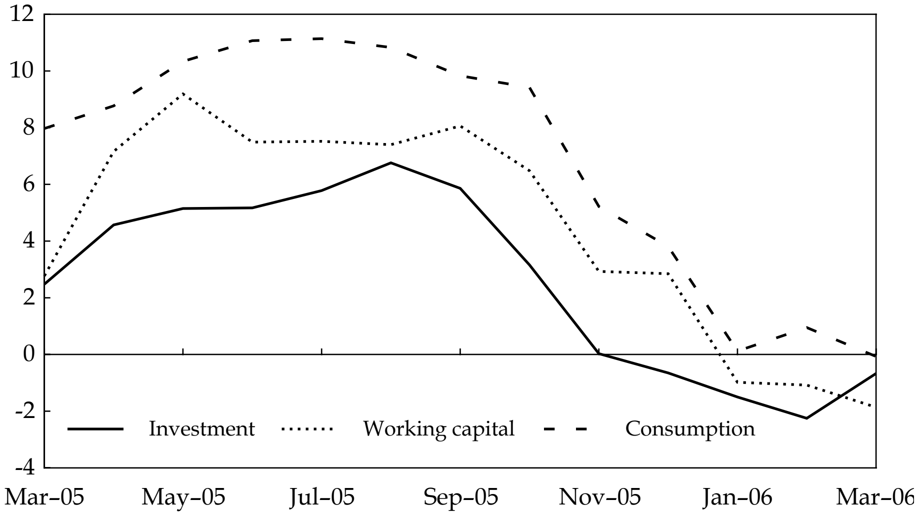
since the beginning of the year. Long-term foreign direct investment (FDI) inflows had also risen substantially in 2005, to $5.1 billion, compared with just $1.9 billion in 2004. But this masked a sharp decline in the last quarter of 2005, when FDI inflows fell to only $94 million, down from $1.1 billion in the previous quarter.

A steadily increasing inflow of FDI would reduce the economy's vulnerability to the sudden changes in market perceptions that drive portfolio investment and other short-term flows. Such vulnerability became evident again in the latter part of May, when speculation on an imminent increase in US interest rates moved investors to re-allocate their funds away from emerging market economies after a period of sustained investment in Indonesian shares. As a result, the value of the currency fell by more than 6% in mid-May. The JSX declined even more drastically at much the same time: by early June most of the gains of the first quarter had been erased (figure 2).

Jitters in the financial markets provide a reminder that trying to use a single monetary policy instrument to balance inflation and growth objectives is a delicate task. In the first week of May, BI reduced the 1-month SBI rate to 12.5%. This decision seemed warranted at the time, particularly in light of declining inflation and the strength of the rupiah. Pressures from the current account had been reduced in the fourth quarter of 2005, primarily as a result of reduced import growth. International reserves had also reached a record high of $42.8 billion by the end of April, up from $34.7 billion at the end of 2005, indicating that BI had purchased a significant amount of foreign exchange in the market to prevent further rupiah appreciation.

However, the key to stability remains BI's credibility in fighting inflation. The challenge is to withstand political pressure to lower interest rates too quickly. In this regard, money supply growth should continue to be restrained, as excessive growth is a significant factor underlying persistent high inflation in Indonesia (Palomba 2006). Growth of currency in circulation—the most useful indicator of money sup-

FIGURE 3 *Growth of Bank Lending*
*(quarter on quarter, %)*



*Source:* CEIC Asia Database.

ply trends—shows a somewhat erratic pattern (figure 1): setting aside the big fluctuations associated with the fasting month (ending in November), the growth rate has been of the order of 15% per annum since about September last year, rising to 16% in March. Despite the widespread belief that monetary policy has been quite tight—and therefore that interest rates should be brought down as soon as possible—the rate of money growth recently has in fact been somewhat faster than it should be if inflation is to be held to a low level. From this point of view, the recent small interest rate reduction may be premature, as is also suggested by the sudden reversal of short-term capital inflows very soon afterwards. Nevertheless, some risk indicators, such as Moody's debt ratings (upgraded from B2 to B1 in the third week of May) suggest improved risk perceptions, at least for the medium term.

### *Banking*

Bank lending growth, which had been running at high levels in 2005, slowed so drastically as to become negative on a quarter-on-quarter basis in March (figure 3). Presumably the higher interest rate environment that emerged in the second half of 2005 partly explains the slowdown, although this factor should not be over-emphasised: while the 30-day SBI rate almost doubled between March and December 2005, average bank lending rates for working capital rose much more modestly, from 13.3% to 16.2% per annum. Perceived credit risk may have increased somewhat with this rise in interest rates, but the disappearance of lending growth in the first quarter of 2006 is no doubt also a reflection of decelerating output growth.

With lack-lustre output growth and higher interest rates, the proportion of non-performing loans (NPLs) increased from 5.8% to 8.3% during 2005, and further to 9.3% in February. This is mainly a problem for the state banks, which have an NPL ratio of 15.9%—almost double the 8.1% ratio for the private banks. The state banks complain that they are at a disadvantage *vis-à-vis* their private competitors, in that they are not allowed to apply normal banking procedures in dealing with NPLs, such as writing off debt as part of restructuring deals, or selling NPLs at a discount. The government is considering issuing new legislation, as part of a financial sector reform package, that would authorise state banks to apply these procedures. While the problem is real, the danger is that this mechanism has the potential to allow bank borrowers to escape the responsibility of repaying their loans in full, thus imposing a cost on the economy and the general public.[8]

### Fiscal policy

The reduction of fuel subsidies was intended to put the budget on a stronger footing, providing an opportunity for the government to increase spending on important development programs and to boost transfers to regional governments. However, delays in spending early in the fiscal year, both at the centre and in the regions, have meant that the fuel price increases have had an unnecessary and avoidable contractionary impact on aggregate demand.

As already noted, government consumption has now become the main driver of growth, with a 14.2% year-on-year increase in the first quarter of 2006. But this figure needs to be interpreted with caution, since there was a large decline in the corresponding quarter of 2005 (table 1).[9] Low government spending in the first quarter of the fiscal year is still a cause for concern, and there is a need to offset the contractionary effect of reducing the fuel subsidies by boosting government spending quickly elsewhere in the economy.

The assumptions underlying the approved 2006 budget are little changed from those of the second revision of the 2005 budget (table 2). The assumed growth rate is a little higher, at 6.2% (compared with 6.0%), which seems excessively optimistic given the observed continuing decline in GDP growth. The expected inflation rate is higher, at 8% (compared with 6.0%), although much lower than the actual figure of 17.1% recorded last year. The assumed international oil price ($57/barrel) seems unrealistic, and will be severely tested in coming months as continued political uncertainty in the Middle East keeps the price of oil above $70/barrel. Preliminary calculations by the Ministry of Finance suggest that a higher than assumed oil price will not significantly harm Indonesia's fiscal position now that fuel subsidies have been substantially reduced. According to these estimates, the budget deficit will be around 1% of GDP if the international oil price stays at $70/barrel (Gunawan 2006). Note that the failure of the government to tie domestic fuel prices to global prices means that subsidies to consumption of fuel are still extremely costly: even at the unrealistically low assumed world oil price these are expected to amount to some 1.8% of GDP (table 2)—enough to cover roughly 70% of the government's total personnel expenses.

[8] Another option being discussed is to set up a special purpose vehicle (SPV) that would take the bad loans off the state banks' balance sheets, but this has met with limited enthusiasm among policy makers. As past experience with the Indonesian Bank Restructuring Agency (IBRA) shows, problems of moral hazard are almost certain to occur under these kinds of arrangements.

[9] The same need for caution applies to the astonishing 30% rise in the December quarter of 2005.

TABLE 2 *Revised Budget 2005 and Approved Budget 2006*

| | 2005 | | 2006 | |
|---|---|---|---|---|
| | 2nd Revision (Rp trillion) | % of GDP | Approved (Rp trillion) | % of GDP |
| **REVENUE AND GRANTS** | **540.1** | **20.5** | **625.2** | **20.6** |
| **Domestic revenues** | 532.7 | 20.2 | 621.6 | 20.4 |
| Tax revenues | 352.0 | 13.3 | 416.3 | 13.7 |
| Domestic taxes | 334.4 | 12.7 | 399.3 | 13.1 |
| Income tax | 180.3 | 6.8 | 210.7 | 6.9 |
| Value added tax | 102.7 | 3.9 | 128.3 | 4.2 |
| Land & building tax | 13.4 | 0.5 | 15.7 | 0.5 |
| Duties on land & building transfers | 3.7 | 0.1 | 5.3 | 0.2 |
| Excise | 32.2 | 1.2 | 36.5 | 1.2 |
| Other taxes | 2.2 | 0.1 | 2.8 | 0.1 |
| International trade taxes | 17.6 | 0.7 | 17.0 | 0.6 |
| Non-tax revenues | 180.7 | 6.9 | 205.3 | 6.8 |
| Natural resources revenues | 144.4 | 5.5 | 151.6 | 5.0 |
| Profit transfers from SOEs | 12.0 | 0.5 | 23.3 | 0.8 |
| Other | 24.3 | 0.9 | 30.4 | 1.0 |
| **Grants** | 7.5 | 0.3 | 3.6 | 0.1 |
| **EXPENDITURE** | **565.1** | **21.4** | **647.7** | **21.3** |
| **Central government** | 411.7 | 15.6 | 427.6 | 14.1 |
| Personnel | 61.2 | 2.3 | 78.0 | 2.6 |
| Goods & services | 42.3 | 1.6 | 48.1 | 1.6 |
| Capital | 54.7 | 2.1 | 45.0 | 1.5 |
| Interest payments | 61.0 | 2.3 | 76.6 | 2.5 |
| Subsidies | 119.1 | 4.5 | 79.5 | 2.6 |
| Fuel | 89.2 | 3.4 | 54.3 | 1.8 |
| Non-fuel | 29.9 | 1.1 | 25.2 | 0.8 |
| Social assistance | 30.0 | 1.1 | 27.3 | 0.9 |
| Other | 43.4 | 1.6 | 73.1 | 2.4 |
| **Transfers to regional governments** | 153.4 | 5.8 | 220.1 | 7.2 |
| **DEFICIT** | **–24.9** | **–0.9** | **–22.4** | **–0.7** |
| **FINANCING** | **24.9** | **0.9** | **22.4** | **0.7** |
| Domestic financing | 29.8 | 1.1 | 50.9 | 1.7 |
| External financing (net) | –4.8 | –0.2 | –28.5 | –0.9 |
| **ASSUMPTIONS** | | | | |
| Nominal GDP (Rp trillion) | 2,651 | | 3,041 | |
| Real GDP growth rate (%) | 6.0 | | 6.2 | |
| Inflation (% p.a.) | 6.0 | | 8.0 | |
| Average exchange rate (Rp/$) | 9,800 | | 9,900 | |
| SBI 90-day average (% p.a.) | 8.6 | | 9.5 | |
| Crude oil price ($/barrel) | 54 | | 57 | |
| Oil production (million barrels/day) | 1,075 | | 1,050 | |

*Source:* Ministry of Finance, <http://www.djapk.depkeu.go.id>.

Under the approved 2006 budget, revenues are projected to increase to Rp 625 trillion, from Rp 540 trillion under the second revised 2005 budget. This revenue increase is expected to be driven by tax collections targeted at 13.7% of GDP, an increase of 0.4 percentage points. This seems reasonable, as improved tax administration systems have indeed increased revenues in recent years. Expenditures are projected to increase from Rp 565 trillion to Rp 648 trillion. Central government expenditures are expected to decline from 15.6% to 14.1% of GDP, owing largely to reduced spending on fuel subsidies. But transfers to regions are projected to increase by 44% this year. The overall fiscal deficit is set at 0.7% of GDP, smaller than the 0.9% targeted under the second revised 2005 budget.

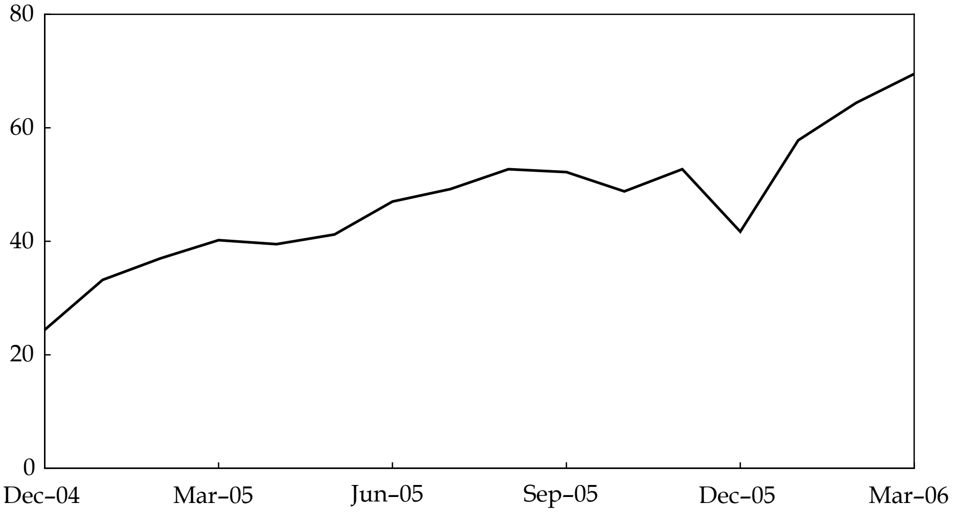
Effective government spending can be expected to be an important determinant of the growth outcome in 2006, given the limited capacity for monetary policy to be used to stimulate private consumption and investment spending. The government is expected to provide some stimulus to regional and rural Indonesia through two channels. First, the program of cash transfers to poor households as compensation for the fuel price rise will bolster the purchasing power of such households by approximately $2 billion.[10] Second, transfers to regions are also expected to play a role in supporting growth. The amount to be transferred is budgeted at 7.2% of GDP in 2006, up from 5.8% under the second revised budget for 2005. However, there is unlikely to be an expansionary effect overall. Total expenditure remains constant as a share of GDP, with a decline in spending by the central government offsetting the increase in transfers to regions (table 2).

There are several potential constraints on government spending. Traditionally, a great deal of it—particularly expenditures on capital items and goods and services—occurs in the fourth quarter of the budget year. On average, 50% of both goods and services and capital expenditures are realised during this quarter. Such a pattern makes no sense from an efficiency point of view, and raises major governance concerns about the use of public financial resources (Prasetya and Sheppard 2006).

Regional governments also seem to find it hard to absorb increased revenues transferred from the centre, as indicated by the more than doubling of unspent funds held as bank deposits from the end of 2004 through the end of March 2006 (figure 4*)*. One explanation for this build-up in bank balances is that the introduction of a new budget authorisation process (under Law 32/2004 on Regional Government) has significantly delayed spending (Lewis 2006). Tighter anti-corruption measures aimed at making tendering processes more transparent are reported also to have contributed to delays at the project implementation level. In addition, local governments frequently lack the capacity to implement projects. A further explanation is that, since interest earnings from deposits can be declared as own-source revenue in regional budgets, local governments have an incentive to deposit transfers from the centre rather than spend them, and to use the interest

[10] See Sen and Steer (2005) for a detailed discussion of the design and early implementation of the program. A preliminary evaluation has shown that district targeting was relatively good, in that sub-districts (*kecamatan*) with relatively more poor people had received relatively more fuel price compensation cards. However, targeting at the household level proved more difficult, showing significant leakage of cash compensation to non-poor households. Nevertheless, the targeting of poor households was assessed as relatively good by international standards (SMERU Research Institute 2006).

FIGURE 4 *Regional Governments' Deposits with Commercial Banks (Rp trillion)*



*Source:* Bank Indonesia, <http://www.bi.go.id/web/id/Data+Statistik/>.

earnings for discretionary spending on various perks such as travel and entertainment, rather than on more regular items of expenditure.

The impact of constraints on spending can be seen from realised budget figures as at the end of April 2006. Realised central government expenditures for the first one-third of the fiscal year stood at just 21.2% of total budgeted expenditures—even lower than the 24.9% recorded for the same period in 2005. Expenditure on capital items, personnel, and goods and services was reported at 17.4% (compared to 22.6% in April 2005), while realised outlays on subsidies stood at only 3.8% (Ministry of Finance website, 29 May 2006, <http://www.fiskal.depkeu.go.id>). These low realised figures are surprising, as the government was allowed by parliament to carry over capital spending from 2005 amounting to Rp 10–15 trillion through April 2006. All this suggests that the impact of government spending for this year can again be expected to be delayed. It is reported that the Minister of Finance is considering tax reductions as an instrument to stimulate spending if that turns out to be the case, but this can hardly be considered a satisfactory solution to the problem.

## INVESTMENT AND INFRASTRUCTURE

As so often seems to be the case in Indonesia, the greater macroeconomic stability achieved in the first half of 2006 went hand in hand with doubts about the government's capacity to push ahead quickly with the microeconomic reforms needed to improve the investment climate. A greater sense of urgency seems to have galvanised the SBY government into action on a number of fronts, but actual progress has been slow. New initiatives have been counter-balanced by conflicting policy substance and signals from the line ministries, and by relative inexperience in putting a strong case for economic reform to a potentially sympathetic public.

### A new package for improving the investment climate

In February the government announced a new package to improve the investment climate. It covered five major areas: general provisions (including the new investment law), customs, taxation, labour, and small and medium enterprises and cooperatives. The package was significant in a number of respects. It was issued through a Presidential Instruction (No. 3/2006), and hence had the direct support of the palace, unlike several other decisions from the Coordinating Ministry for Economic Affairs. It contained not only a long list of regulatory and administrative reforms, but also a list of deliverables, a time-line for action, and specification of the ministry responsible for each item (table 3). Moreover, the government has followed up with reports on implementation; two such reports had been issued by the coordinating ministry by mid-May 2006. Although not yet formally announced, a team with members from outside the government has been appointed to monitor progress and report back to it; the respected University of Indonesia economist, Faisal Basri, is rumoured to head the monitoring team.

The government has also set up a new inter-departmental committee under the Ministry of Finance to review local regulations (*peraturan daerah* or *perda*). However, a positive list specifying which taxes and charges are allowed to be levied is also included in amendments to Law 18/1997 on regional taxation and levies,[11] thus reducing the discretionary authority of the new committee, and perhaps also helping to overcome the problem of slow progress in similar review processes in the past.

The reform package signalled an increased sense of urgency about the government's reform agenda, and a new, more systematic approach to reform by Boediono, the new Coordinating Minister for Economic Affairs—in contrast to the 'deal making' or 'CEO' approach taken by his predecessor, Aburizal Bakrie. Several informed observers interviewed for this Survey were optimistic that the new approach would be more successful, even if it does take longer to achieve tangible results. This was especially because of the inter-dependencies among the various elements: players were aware of the direction of policy overall and of how their responsibilities complemented those of other ministries, and policy makers in the coordinating ministry were more likely to be aware of binding constraints that might affect the entire program.

The progress reports suggest that the majority of targets had been achieved by the end of April. These included the submission of draft laws to parliament; the issue of ministerial decrees in a range of areas, such as trade and manpower; changes to special policy and monitoring teams (such as the National Team for Increasing Exports and Investment); and announcements of improvements in licensing arrangements.[12] Nevertheless, real progress on a number of items—such as the claimed reduction in processing time by 50% or more on a number of business permits—will be able to be verified only after more time has passed.

[11] See Law No. 34, 20 December 2000, on Amendments to Law 18/1997 on Regional Taxes and Regional Levies.

[12] In the case of trade, the main reforms were a reduction in the number of licences required and in the time to process them (although some reports suggest these changes in the draft regulations were contested by officials in the Ministry of Trade). In the case of manpower, they related to simplification of the regulations for employing foreign personnel.

TABLE 3 *Summary of Actions to Be Taken under the Investment Climate Policy Reform Package*

| Area of Reform | Key Areas of Policy | Items for Action | Status of Major Legislation |
|---|---|---|---|
| General | Strengthen investment service institutions | 9 | Draft investment law ready for debate in parliament |
| | Synchronise central and regional regulations | 1 | |
| | Clarify environmental impact study obligations | 1 | |
| Customs & excise | Speed up the flow of goods | 13 | Amendments to customs and excise law submitted to parliament |
| | Extend the role of bonded warehouses | 4 | |
| | Wipe out smuggling | 2 | |
| | 'De-bureaucratise' customs | 1 | |
| Tax | Provide tax incentives for investment | 7 | New tax law with amendments submitted to parliament |
| | Implement consistent 'self-assessment' systems | 5 | |
| | Revise the value added tax for export promotion | 3 | |
| | Protect the rights of taxpayers | 2 | |
| | Promote transparency and disclosure | 3 | |
| Manpower | Create an industrial environment for job creation | 13 | Revisions to Manpower Law No. 13/2006 to be drafted |
| | Improve policy on placement and protection of overseas workers | 1 | |
| | Resolve labour disputes quickly, cheaply and justly | 2 | |
| | Speed up the issue of permits for foreign workers | 6 | |
| | Create a flexible and productive labour market | 1 | |
| | Make progress in the transmigration development paradigm to support job creation | 1 | |
| Small/ medium industry & cooperatives | Develop policies to 'empower' small and medium industry and cooperatives | 10 | |
| **Total** | | **85** | |

*Source:* Coordinating Ministry for Economic Affairs, Investment Climate Policy Reform Package, February 2006.

### The new investment law: some progress but also some backsliding[13]

The new investment law was sent to parliament on 21 March 2006. Several aspects of the law, if accepted by parliament without major amendment, will create a more favourable environment, for foreign investment in particular. The draft law establishes the principle of equal treatment for domestic and foreign investors, and calls for a transparent negative list of activities closed to foreign firms, based on standard industrial classifications. It also removes restrictions on the duration of foreign investment licences (currently 30 years).[14] Foreign investors will also welcome the apparent removal of the previous mandatory divestiture requirements (except for certain mining concessions).

However, the draft law does not address several key concerns of business. Originally, an important objective of the revised law was to move from an investment approval regime to a simple registration and promotion regime, requiring 'the Board of Investment [to act] as the principal promoter and facilitator of investment', as outlined by the president in late 2005.[15] This would have significantly reduced the authority of the Investment Coordinating Board (BKPM), taking away its power to issue investment approvals and permanent business licences. The final version of the draft law has been significantly watered down, providing a stark example of the ability of interested political and bureaucratic groups to subvert the reform agenda. The revised wording of the law ensures the continued existence of BKPM and the continuation of its regulatory role. Specifically, the draft law makes BKPM responsible for 'arranging norms, standards and procedures for investment activity', thus assigning it a clear regulatory function.[16] Another negative, and almost certainly costly, aspect of the draft law is the requirement that all businesses, including sole proprietorships, submit periodic reports to BKPM (details of which are to be specified by the Ministry of Trade in implementing regulations). Finally, as is common in Indonesia, most decisions on matters of substance have been left to be dealt with in the implementing regulations. The Chamber of Commerce and Industry (Kadin) has repeatedly pointed out that the main problems have been not so much with the existing investment law, but with the implementing regulations, procedures, and execution of the regulations.

Overall, the draft law appears to be a good example of the government backing away from an initial more market-oriented stance and conceding political compromises. The factionalised nature of the government and the parliament's ability to block legislation allows many entry points for interest groups, including vocal

[13] The authors wish to thank Peter Rosner for assistance with information on this subject.

[14] In the past, the time period could be extended despite the restrictions (Pangestu and Azis 1994: 21–3).

[15] See the president's 15 September 2005 speech at the Global Investment Forum in New York, p. 3.

[16] The devil is in the detail. It is reported that after the Minister of Trade had signed off on the draft law and the submission of the bill to parliament, the wording of the important article 16 of the draft, dealing with the investment board, was altered. The original draft left open the decision on whether to form a new investment authority, noting that it 'can be formed' (*dapat dibentuk*) to administer aspects of the law. This was changed to 'which [will] be established' (*yang dibentuk*) to perform the functions mentioned.

nationalist ones. In addition, reformers sometimes face strong resistance from sections of the bureaucracy opposed to a reduction in their influence.

**Special economic zones: how viable?**

On 16 March, the vice president announced that Indonesia would create eight new special economic zones (SEZs) within 12 months. Likely locations included the provinces of Banten (at Bojonegara), West Java, Central Java, East Java, East Kalimantan, North Sumatra, South Sulawesi and Aceh (at Sabang).[17] Just three days later, the vice president led a high-level ministerial team to begin talks with George Yong-Boon Yeo, the foreign minister of Singapore, on the possibility of Singapore managing one of the SEZs on Bintan Island in Riau Islands province, only 20 minutes by ferry from Singapore (*JP*, 19/3/2006).

Of course, like many other aspects of the investment climate, the key to progress lies in the details of design and implementation. Here there are several concerns, especially with regard to ensuring a clear division of functions between central and regional government authorities (bearing in mind the ongoing tensions that have emerged between the Batam Special Authority and the Riau Islands provincial government in recent years).[18] Hopes of fast-tracking the creation of a better environment for investment may be realised only to a limited extent, given that a basic regulatory framework has still to be introduced for establishment of the zones; issues still to be resolved include many difficult infrastructure problems (especially access to efficient ports), and the introduction of implementing regulations on taxation, duty arrangements and land acquisition procedures. Eight zones seems excessive given the lack of administrative capacity at the centre and current problems in infrastructure development. Special locational advantage for international investment and trade seems to lie only with Sabang in Aceh and with several of the Riau islands close to Singapore, such as Bintan.

Although it is one means of fast-tracking improvements in the investment climate, the SEZ initiative also has some of the hallmarks of a 'quick fix', seeking to sidestep, rather than confront, a host of physical and institutional constraints.

**Mixed outcomes in investment**

The actual record with regard to investment over the past several months has been mixed at best, reflecting the gap between the ambitious plans for improvement and actual outcomes. There were some positive signs. Both foreign and domestic investment approvals and realisations were up significantly in 2005 (including a near doubling of realisations), albeit from a low base (*Kompas*, 25/3/2006). The resolution in March of the dispute over allocation of the high-profile Cepu oil exploitation blocks in Central and East Java in favour of ExxonMobil as the operating agent was a signal that the SBY government could deliver on major deals for

[17] Subsequently the Coordinating Ministry for Economic Affairs established a national inter-departmental team led by the head of BKPM, Muhammad Lutfi, to evaluate potential strategies, study specific locations in consultation with regional governments, and set up bodies to monitor progress in the formation of the zones.

[18] See, for example, the views expressed on the deteriorating investment climate in Batam by the Minister of Trade and the head of BKPM at parliamentary hearings held in February (*JP*, 22/2/2006).

foreign investors, even if the process was long and sometimes tortuous. The final arrangement, giving the government 93.25% of profits at oil prices above $45 per barrel, appears to have been a very good deal for the government, although it was still criticised by some groups within the parliament (*Kompas*, 21/3/2006).[19] It is predicted that the new fields could increase Indonesia's oil production by some 20% within 10 years.

Some investors in labour-intensive activities have begun to show renewed interest in Indonesia as wage costs rise in neighbouring economies, or as countries such as China are constrained by quota restrictions in the US market. Investment in oil palm, much of it from neighbouring Malaysia, has been booming over the past 12 months. In May it was announced that some 50 Chinese footwear companies had plans to invest in Indonesia, bringing in around $150 million to various locations in West and East Java (*Bisnis Indonesia*, 19/5/2006). Some commentators regarded the February addition of Indonesia to its list of permissible emerging equity markets by CalPERS, the high-profile Californian pension fund, as a sign that international investors were beginning to take Indonesia seriously again. In addition, industrial estates and real estate developments were reported to have shown signs of recovery in the latter half of 2005 and early 2006 (*JP*, 15/5/2006; 24/5/2006). Although US, British and French business spokespersons all reported that recent unrest in mining areas in particular had damaged Indonesia's image as a destination for foreign investment (*JP*, 24/3/2006), there are plausible arguments to suggest that unfavourable developments in this industry should not be generalised.[20]

But there was some bad news as well. Investment approvals and realisations were both down in the first three months of this year compared with the same period in 2005. The mining industry continued to be plagued by high-profile disputes, and has been the prime target of nationalist criticism of FDI, at a time of record high prices of most commodities, especially copper and gold.[21] Judging by recent reports on the mining industry, a review by PriceWaterhouseCoopers through to the end of 2004 was probably still an accurate reflection of conditions in the industry in early 2006. While Indonesia continued to score highly in terms of prospects for the industry (ranking sixth out of 64 regions according to the annual Fraser Survey of mining corporations, 2004–05), it was rated third last in terms of investment conditions (ranked by a policy potential index), only just ahead of the Democratic Republic of the Congo and Zimbabwe (PriceWaterhouseCoopers 2006: 6).

Key figures in the mining industry were pessimistic about whether the new mining law, still bogged down in parliament, would deliver favourable outcomes for investors. They were especially concerned about moves to incorporate

[19] See the article by Rizal Mallarangeng, political analyst and government adviser, extolling the potential national revenue gains: 'how many schools, hospitals and public facilities could be built [with the estimated Rp 25 trillion annual increase in revenues]?' (*Tempo*, 2/4/2006: 46–7). Some commentators suggested that pressure from the US had clinched the deal for ExxonMobil (e.g. Dradjat Wibowo, *Tempo*, 2/4/2006: 46–7).

[20] For example, James Castle, a well-known commentator and businessman, has argued that much of the nationalist criticism of the mainly foreign interests in mining involves issues (such as land disputes and local political conflicts) specific to that sector (*JP*, 28/3/2006).

[21] See Aswicahyono and Hill (2004) for a survey of developments through to 2004.

a clause allowing for renegotiation of existing contracts with the government. Conflicts with local administrations and populations—in some cases believed to be linked to anti-mining NGO groups and outside interests—continued to affect the operations of several mining projects, such as Newmont in Sumbawa. Criticism of foreign interests in the highly profitable Freeport mine at Timika in Papua was widely publicised in February and March as a result of conflicts both at the mine site and in Abepura, near Jayapura, as well as orchestrated demonstrations in Jakarta, Semarang and other cities calling for the mine to be closed.[22]

While this has been a unique and controversial project from its earliest years, the issue is more about political conflict between Papuan elites and the central government than about the investment climate.[23] In the words of the recent International Crisis Group report 'Freeport is the mine that everybody loves to hate' (ICG 2006: 15). Three policy issues have received special attention in recent months. First, government review teams have raised the possibility of compensation payments for the substantial environmental damage caused by the discharge of mine tailings into the river system. Second, the Minister of Mining, Purnomo Yusgiantoro, announced that the government was in the process of reviewing the Freeport contract (starting with a series of open discussions of the company's performance in Jakarta) and was also seeking to increase its share of ownership in the mine from 10% to 20% (*JP*, 20/5/2006). And third, the government has been firm in rejecting calls for the closure of the mine—perhaps not surprisingly given that it contributed approximately $1.2 billion, or around 2%, of government revenue in 2005.

Probably more damaging for the investment climate has been government interference in the attempt to bring to a close one of the most regrettable episodes in relation to foreign investment since the fall of Soeharto. In May 2006, the giant cement multinational, Cemex, announced that it was seeking government approval to sell its 25% share of the publicly listed company PT Semen Gresik to the Rajawali Group (a diversified conglomerate with interests in activities including hotels, plantations, tobacco and charter airlines).[24] The value of the planned sale was over $300 million.

Inexplicably, from the standpoint of the need to be sending positive signals to private investors (both foreign and domestic), the Minister for State Enterprises, Sugiharto, supported publicly by Vice President Jusuf Kalla, sought to block the

[22] A clash between Papuans and Freeport security guards over access to mine tailings for gold panning in February–March was followed on 15 March by even more violent demonstrations in Abepura calling for the closure of the Freeport mine (ICG 2006: 16–17).

[23] As news of conflict at Freeport filtered through, high-profile politicians in Jakarta, most notably Amien Rais, called—not for the first time—for the mine to be closed. An earlier, thoroughly researched report by New York Times journalists on pollution, payoffs to the military, and human rights abuses has put Freeport back in the international public spotlight (Perlez and Bonnor 2005).

[24] Earlier, Cemex had been frustrated in its attempt to gain majority ownership of the cement company (through the exercise of an option to purchase additional shares from the government) as a result of opposition from politicians in West Sumatra (Pangestu and Goeltom 2001: 164; Siregar 2001: 295; see Prasetiantono 2005: ch. 5 for a detailed discussion).

sale. The vice president announced on 12 May that the government was searching for ways to give local governments a share in Semen Gresik. Subsequently it was announced that the minister had turned down the Cemex application and was seeking funds from other public sector sources (reported to include the pension and social security funds PT Taspen and PT Jamsostek, and the state-owned investment bank PT Danareksa) to enable the government to buy the shares in the first instance, before arrangements could be made for their purchase by regional governments (*JP*, 6/5/2006; 15/5/2006; 17/5/2006; 24/5/2006; *Bisnis Indonesia* 19/5/2006). Embarrassingly for the government, Cemex retaliated by rejecting this proposal, adding fuel to an already apparent dispute within cabinet ranks over the issue.[25]

The public statements by the vice president in favour of blocking the sale are especially surprising given that he has been at the forefront of efforts to promote the package of reforms designed to improve the investment climate. The case also illustrates that politicians in Jakarta are mindful of potential support in the regions—in this case especially from West Sumatra.[26] From a public interest point of view, the blocking of the sale to Rajawali is doubly perplexing, given that the government already owns a majority (51%) share of Semen Gresik.

The blocking of Cemex's proposed sale was roundly criticised by several well-known commentators, including Hadi Soesastro of the Centre for Strategic and International Studies, who is reported as saying: 'The debacle has only served to create more uncertainty among investors' (*JP*, 17/5/2006). In its editorial on 10 May, the *Jakarta Post* drew attention to the irony of the decision by Cemex, one of the three largest cement industry multinationals, to pull out of Indonesia at a time of potentially soaring demand for building materials as new infrastructure projects come on line. The newspaper's economics commentator, Vincent Lingga, saw regional interests as being at the heart of the matter:

> The only plausible reason behind Sugiharto's move could then be an inordinate fear that the Cemex–Rajawali deal would again set off protests, notably in West Sumatra, where vested interests, narrow-minded nationalists and various groups of rent seekers have tried since 2001 to spin off SP [subsidiary cement producer Semen Padang]. … What a great move to scare off potential foreign investment, as well as a resounding sullying of the pledged reform of state companies.[27]

[25] It was reported that the Minister of Finance, who has authority to sign off on the deal, was not prepared to provide written approval, although she did not veto the sale directly. Rather, she indicated that any purchase using non-budget sources would need to follow the regulations governing stock market purchases, and that the use of state enterprise funds would need approval from shareholder meetings of the companies involved (*Kompas*, 19/5/2006).

[26] It was reported that the governor of West Sumatra had put forward a proposal to Minister Sugiharto for local financing of the purchase of shares in the company by the provincial government.

[27] Lingga also referred to a forensic audit of Semen Padang conducted in 2005, which found a range of 'bad corporate governance practices'.

### Putting infrastructure development firmly back on the table

Following the disappointing response to the infrastructure summit in January 2005, the government issued a new package for infrastructure development in February 2006, and subsequently announced that Rp 300 trillion would be allocated in the 2006 budget to complement private sector initiatives. During 2005 there were a number of regulatory initiatives, such as the formation of a Committee on Policy for Accelerating the Provision of Infrastructure (KKPPI, Komite Kebijakan Percepatan Penyediaan Infrastruktur), and the issue of government regulations on investment in electricity, water supply, toll roads and land acquisition (Coordinating Ministry for Economic Affairs 2006). It is envisaged that the government will provide about 15% of total financing needs for infrastructure development (some $48 billion for the period 2005–09), including direct financing of some projects, a guarantee fund, insurance for several projects, and a revolving fund to facilitate land acquisition. Some 24 projects, worth $6 billion—17 of them involving toll roads—were put out to tender in 2005, and a further 25 are planned for 2006.

The Coordinating Minister for Economic Affairs announced that the government would encourage pension funds and the insurance industry to play a major role in infrastructure investment (*JP*, 22/2/2006). A new approach to the difficult problem of land acquisition, which has bogged down projects in the past, envisages government purchase in the public interest prior to tender, thus avoiding spiralling prices and protracted processes of land acquisition (McLeod 2005: 146–7).

While it will take some years for many of the planned projects to go to tender, Vice President Kalla has been trying to broker a number of deals in visits to China with large teams of Indonesian businesspeople. There have been a few reports of positive results, for example, the announcement of Chinese interest in developing a mass transit system in Jakarta, as well as in coal-powered electricity generation.[28] The government is under no illusions about the immensity of the task, given Indonesia's poor performance in the past several years compared with neighbouring countries. Recent reports of the parlous condition of the nation's roads, including the key Jakarta–Surabaya highway and others in outer island regions such as Central Kalimantan, confirm the extent of the challenge (see, for example, *Kompas*, 11/2/2006; 27/3/2006).

## LABOUR

The period from March to May 2006 saw increasing industrial unrest across the country over proposed revisions to Manpower Act No. 13/2003. A series of demonstrations and strikes throughout March and April in most of the major industrial centres was followed by a peaceful rally by an estimated 100,000 workers on

[28] In May 2006 the state electricity company, PLN, announced a memorandum of understanding with four Chinese consortia to establish coal-powered plants with a combined capacity of 10,000 MW, involving an estimated investment of $7 billion, and to be operational by 2009 (*Antara News*, 19/5/2006).

International Labour Day (1 May) in Jakarta, and then a smaller but more violent demonstration two days later (*JP*, 2/5/2006; 4/5/2006).[29]

The scale and ferocity of labour opposition to the proposed changes to the act appear to have taken the government by surprise. If reformers had studied international experience, they should not have been caught unawares. The case of labour reform exemplifies the difficulty of translating sound principles embodied in policy reforms into practical, workable regulations, gaining acceptance for the package among interest groups and the general public, and managing the process politically.

Why the need for labour reform? The protests should be viewed against the backdrop of rising government apprehension over continued stagnation in modern sector jobs growth, and stubbornly high and seemingly increasing rates of unemployment. Both the president and the vice president have made repeated strong statements highlighting employment growth as one of the government's main challenges, a position echoed by key figures within the Coordinating Ministry for Economic Affairs.

Manufacturing employment had recovered somewhat after the 1997–98 crisis. However, table 4 shows that it declined from 2000–01, as did modern sector employment, proxied by formal sector jobs outside agriculture. Most new jobs have been created in the informal sector, especially since 2000–01. Unemployment, which had risen after the crisis, continued to increase through to 2004–05.[30] Both agricultural and non-agricultural wages began to level out from around June–September 2004, after recovering somewhat following the crisis; but they then fell in real terms after the increase in fuel prices in October 2005 (figure 5). Nominal minimum wage increases of around 20% in 2006 have probably compensated most modern sector workers for the fuel price rise.[31] However, the majority of workers outside the modern sector were not protected from the impact of the fuel price adjustments on real wages, and anecdotal evidence suggests that the price rises also affected employment adversely.

Compositional effects within the modern sector to some extent explain the disappointing record of job creation in manufacturing. The relatively labour-intensive textiles, clothing and footwear sub-sector, which was the main source of all new manufacturing jobs in the large and medium sector in the decade before the crisis, appears to have shed jobs at an alarming rate over the period 2000–03.[32] To a considerable extent, this can be attributed to Indonesia's relatively poor per-

[29] Strikes in protest against the law led by KSPI (the Confederation of Indonesian Workers Unions, Konfederasi Serikat Pekerja Indonesia) began in late March, especially in the Bandung region, and became widespread in follow-up actions in early April 2006 (*Pikiran Rakyat*, 24/5/2006; *JP*, 6/5/2006).

[30] Most of the data on unemployment in table 4 conform to the definition applied before 2001. According to the new definition (expanded to include discouraged workers), on which the government has based its unemployment targets, the rates were 8.1% in August 2001, rising to 9.9% in August 2004, 10.3% in February 2005 and 10.4% in February 2006.

[31] Data on large and medium enterprise wages are only available to the last quarter of 2005; at the time of writing no adjustments had yet been made in response to the minimum wage increases introduced in January 2006.

[32] Roesad and Fitriani (2006) report that the share of textiles, clothing and footwear in large and medium manufacturing employment climbed from around 22% to 33% in the 15

TABLE 4 *Key Employment and Labour Force Indicators*[a]

| | 1996–97 | 2000–01 | 2004–05 | Average Growth Rates (% p.a.) | |
|---|---|---|---|---|---|
| | | | | 1996–97<br>to<br>2000–01 | 2000–01<br>to<br>2004–05 |
| **Working-age population** (million) | 133 | 143 | 155 | 1.7 | 2.0 |
| **Labour force** | | | | 1.4 | 1.3 |
| **Employment by sector** (% share) | | | | | |
| Agriculture | 43 | 44 | 44 | 2.2 | 0.7 |
| Manufacturing | 13 | 13 | 12 | 1.9 | –1.1 |
| Other | 45 | 42 | 44 | –0.2 | 2.2 |
| Total | 100 | 100 | 100 | 1.1 | 1.1 |
| **Non-agricultural employment** (% share) | | | | | |
| Formal | 52 | 51 | 48 | –0.2 | –0.1 |
| Informal | 48 | 49 | 52 | 0.8 | 3.0 |
| Total | 100 | 100 | 100 | 0.3 | 1.4 |
| **Rates** (%) | | | | | |
| Participation | 68.0 | 67.2 | 65.2 | | |
| Employment[b] | 64.7 | 63.3 | 61.0 | 1.1 | 1.1 |
| Unemployment | | | | | |
| on pre-2001 definition | 4.8 | 5.8 | 6.5 | 6.4 | 4.1 |
| on 2001 definition[c] | | 8.1 | 10.1 | | |

[a] Two-year averages.

[b] Employment divided by the working-age population.

[c] The new definition introduced in 2001 includes discouraged workers among the unemployed; the 2000–01 rate is the figure for August 2001.

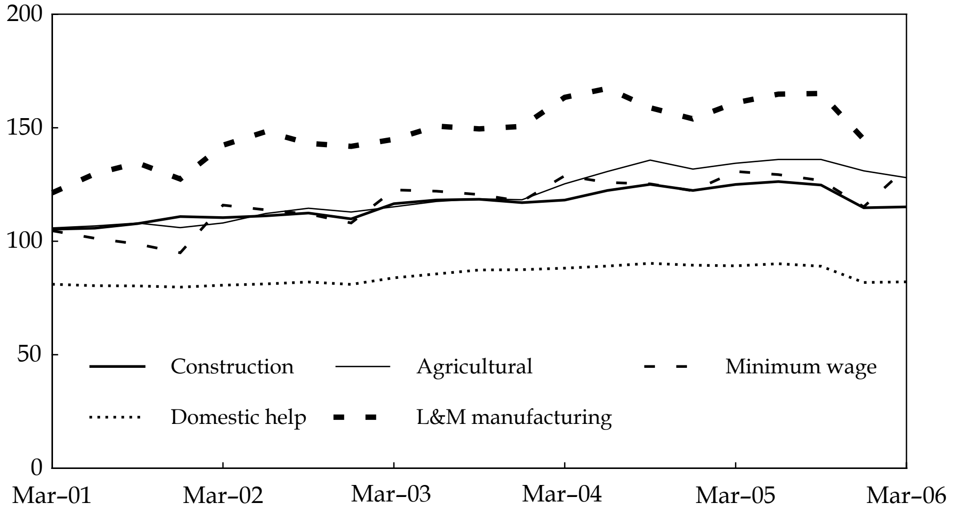
*Source:* BPS, National Labour Force Survey (Sakernas), various years (based on survey data collected in August for all years except 2005; survey data for 2005 were collected in February 2005 as part of a new bi-annual labour force survey).

formance in labour-intensive exports after the crisis (see Athukorala 2006, in this issue of *BIES*). Why formal sector jobs have expanded so slowly in the service sectors is less clear. Possibly the freeze on appointments to the civil service during 2001–05 helps account for the trend; under-investment in education and health may also have contributed.

From the government's standpoint, it is primarily these concerns about employment that have driven the fast-tracking of the proposed reforms of the Manpower Act. But they have also been viewed as a key to improving the investment climate.

years from 1985 to 2000, but that total employment in the sub-sector then declined absolutely by 2% per annum in the following three years.

FIGURE 5 *Real Wage Indices*[a]
*(March 1996 = 100)*



[a] Data for construction workers and domestic helpers are components of the CPI collected on a monthly basis; agricultural wages are rice sector wages taken from monthly data on the farmers' terms of trade index; and 'L&M manufacturing' refers to wages of employees below the level of supervisor (*mandor*) collected in the quarterly wages survey of large and medium industrial enterprises. Wages for construction workers, domestic helpers and agricultural workers are for the months of March, June, September and December; L&M manufacturing wages reported for March, June, September and December refer to data collected in these four quarters. The minimum wage is an unweighted average of 31 provincial minimum wages set in January in each year. All series except the agricultural series are based on nominal wages deflated by the CPI. The agricultural wage series is deflated by the cost of living index in the farmers' terms of trade series.

*Source:* BPS, Wage Statistics Section, unpublished data.

The main proposed changes related to generous provisions (at least by the standards of many East Asian competitors) on minimum wages and severance pay, and to restrictions on short-term contracts and outsourcing (Ministry of Manpower and Transmigration 2006). The proposed changes sought to reduce the degree of protection offered to workers and to remove many of these kinds of restrictions. Thus, for example, minimum wages were no longer to be tied to the newly introduced welfare standard (*kebutuhan hidup layak*, fitting living needs); severance rates and long-service entitlements were to be reduced—and, surprisingly, to be eliminated for all employees with wages and salaries above the tax threshold of approximately Rp 1.1 million or $120 per month; the maximum duration of contract work was to be extended to five years; and outsourcing was no longer to be restricted to non-core activities. While hardliners were opposed to any negotiation that might lead to reduced labour benefits, more moderate labour leaders of much larger organisations such as KSBSI (Konfederasi Serikat Buruh Sejahtera Indonesia, the Confederation of Indonesian Prosperity Labour Unions) reportedly recognised the need for reform. However, they too have argued strongly against the proposed changes to severance pay arrangements (especially the tax threshold provision) and the loos-

TABLE 5 *Indices of Employment Flexibility and Hiring and Firing Costs, Selected Developing and East Asian Countries, 2005*[a]

| | Hiring | | Firing | | Rigidity of Hours Index (0–100) | Average Index[b] (0–100) |
|---|---|---|---|---|---|---|
| | Difficulty of Hiring Index (0–100) | Cost of Hiring (% of salary) | Difficulty of Firing Index (0–100) | Cost of Firing (weeks of wages) | | |
| **More restrictive** (rigidity of employment index > 50) | | | | | | |
| India | 56 | 12 | 90 | 79 | 40 | 62 |
| Cambodia | 67 | 0 | 30 | 39 | 80 | 59 |
| **Indonesia** | **61** | **10** | **70** | **145** | **40** | **57** |
| Brazil | 67 | 27 | 20 | 165 | 80 | 56 |
| Vietnam | 44 | 17 | 70 | 98 | 40 | 51 |
| **Less restrictive** (rigidity of employment index < 50) | | | | | | |
| Korea | 44 | 17 | 30 | 90 | 60 | 45 |
| Philippines | 56 | 9 | 40 | 90 | 40 | 45 |
| China | 11 | 30 | 40 | 90 | 40 | 30 |
| Chile | 33 | 3 | 20 | 51 | 20 | 24 |
| Thailand | 33 | 5 | 0 | 47 | 20 | 18 |
| Malaysia | 0 | 13 | 10 | 65 | 20 | 10 |
| Singapore | 0 | 13 | 0 | 4 | 0 | 0 |
| **Mean for all countries** | **39** | **40** | **35** | **38** | **13** | **80** |

[a] A higher index denotes greater difficulty.

[b] Termed the 'rigidity of employment index', this is the average of the three other indices.

*Source:* Adapted from World Bank/International Finance Corporation 2006, <http://www.doingbusiness.org>.

ening of restrictions on employment of workers on short-term contracts (*Kompas*, 22/5/2006; *JP*, 18/4/2006).

How stringent are these labour regulations? A recent World Bank/International Finance Corporation study of the difficulties of doing business in countries around the world presents an 'employment rigidity index'—an average of indices of restrictions on hiring and firing workers, and on hours worked—for all countries in the study. Twelve of these countries, mainly from Asia, are shown in table 5. Indonesia ranks third among this group in relation to the overall measure of rigidity in its labour market. India and Cambodia had somewhat higher scores, but Indonesia was well above China, Malaysia, Thailand and, surprisingly, even the Philippines and socialist Vietnam, all of which are heavily committed to exporting relatively labour-intensive manufactured products. Together with Brazil, Indonesia stood out from this group in terms of the level of payments for severance for economic reasons ('cost of firing' in table 5). This is perhaps the most telling statistic, since high costs of firing imply less willingness to hire new workers on a permanent basis. It has been the combination of high severance payments, relatively high minimum wages, and the bureaucratic and less than transparent regulation of layoffs by the regional labour dispute settlement councils (Panitya Penyelesaian Perselisihan Perburuhan Daerah, P4D) that have made the cost of employing labour high (and unpredictable) in Indonesia relative to most other countries in the region.[33]

However, union opposition appears to have been as much about the process as about changes to specific clauses in the act. The proposal for major revisions to the act only three years after its introduction was itself an extraordinary step, and one that the unions were bound to oppose strongly, given that all of the major revisions were aimed at reducing the level of protection afforded to wage workers.

Union leaders had two major complaints about the process. First, they perceived that labour was being asked to make sacrifices in the interests of employers and the investment climate, while reform bills related to investment regulations, taxes and customs were still at an early stage in the political process, and had yet to be debated in parliament. Second, the government's proposals were perceived broadly as coming from employers, with little input from the union movement. While some union leaders had ostensibly agreed as early as January 2005 to participate in examining possible reforms to the act, the government appears not to have gained the support of any key union leaders before its proposals were released for wider discussion at tripartite meetings held a year later.[34] For example, distinguishing between workers who are eligible to receive severance payments according to whether their wages are above or below the tax threshold seems politically naïve. It is certainly unusual by international standards in countries with no state-funded unemployment benefits.

In the government's defence, negotiation of changes to the regulatory environment is enormously more complicated when there is no single voice representing the union movement. The three major confederations representing most of the union movement could not agree on a common strategy in negotiations. After the 3 May demonstrations, the largest union confederation, KSPSI (Konfederasi Serikat Pekerja Seluruh Indonesia, the All-Indonesia Confederation of Workers Unions), headed by former manpower minister Jacob Nuwa Wea, was implacably opposed to any changes in the law.

For its part the government appeared to take the process of reform rather too lightly, leaving the matter almost entirely to an inexperienced new Minister of Manpower and, in contrast with the case of the fuel price increases, providing little 'all of government' support for the reforms by promoting them more widely to the general public.[35] As a consequence, the public perception has been that the government is trying to cut worker benefits in the interests of employers, rather

[33] According to the Industrial Relations Act of 2004, labour disputes are now to be resolved through new labour courts, but in many provinces these have yet to be established.

[34] See interview with the Minister of Manpower, Erman Suparno, *Tempo*, 16/4/2006: 94.

[35] Two major meetings with union groups at the Ministry of Manpower in February and March 2006 to discuss proposed changes to the law did not arrive at any consensus.

than in the interests of labour in general—that is, reducing labour costs in order to create more jobs and reduce unemployment.

The perception of a poorly prepared reform agenda was further strengthened when the president backed down in the face of union unrest following a large demonstration in early April. He suggested that the government, unions and employers should meet again to discuss the proposed revisions to the law, and signalled the appointment of a team of researchers drawn from five prominent universities, under the direction of the Coordinating Minister for Economic Affairs, to examine the issues and report back within several months (*JP*, 9/4/2006). For their part, the major union confederations subsequently rejected any further discussion of revisions to the act, although they did agree to further bipartite meetings with the employer organisation, Asosiasi Pengusaha Indonesia (Apindo), in mid-May. There appears to be broad agreement among most groups that severance pay reforms could be dealt with in a broader package of social insurance arrangements, although details of the proposed reforms have not yet been worked out (*JP*, 18/4/2006).[36]

The entire episode has been costly for employers, although they too must bear some of the responsibility for a poorly prepared reform agenda and strategy. Apart from the many work days lost due to labour unrest over several months, new hopes for labour-intensive industries have received a setback, as potential investors and buyers reassess whether Indonesia is indeed likely to be a profitable business environment and a reliable source of supply.[37]

Nevertheless, despite optimism from some spokespersons for employers, it seems likely there will be a major delay to one of the key areas of reform covered in Presidential Instruction No. 3/2006. Reform of labour law is typically a long and difficult process, especially in democratic environments. A decade of reform efforts in Latin America has provided some spectacular successes (e.g. in Chile), but also some major failures (e.g. in Peru). Sometimes violent opposition to relatively benign labour market reforms (in France in recent times, for example) indicates the extreme sensitivity of reform in this area; the risk of polarising the community makes any dialogue on reform even more difficult. The World Bank notes that reforms in this area 'have come hard', taking some 11 years in Germany and nine years in the Netherlands (World Bank/International Finance Corporation 2006: 21–2). If the government is serious about creating better jobs, a new strategy for reform would seem imperative. Given the crisis in modern sector job creation, Indonesia surely cannot afford the luxury of waiting as long as some of these more developed countries have done.

[36] It has been proposed, for example, that Indonesia follow the example of Singapore and Malaysia by providing for employers to put a share of workers' salaries (perhaps as much as 10%) into a provident fund that could be used for unemployment insurance.

[37] Thus, for example, the Indonesian Footwear Association reported that European buyers had postponed placing repeat orders, partly as a result of the violent demonstration in Jakarta on 3 May 2006 (*JP*, 10/5/2006).

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In the April 1999 issue the Indonesia Project announced the introduction of a special prize intended to encourage Indonesian scholars to publish their work in the *Bulletin of Indonesian Economic Studies*.

The H.W. Arndt Prize, named in honour of the founding Editor of *BIES*, is awarded for the best article by one or more Indonesian authors published by *BIES* in each calendar year.

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Winners are invited to visit the Indonesia Project for a period of four weeks, during which time they have the opportunity to further their research and to present at least one seminar in the Economics Division of the Research School of Pacific and Asian Studies (RSPAS) at the Australian National University's College of Asia and the Pacific. The prize includes a round-trip economy air fare between Jakarta and Canberra, plus a living allowance for the duration of the visit.

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## H.W. ARNDT
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