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Remarks by Richard Woolcott AC at the Asian Bankers Association (ABA) Conference in Melbourne, 17-19 November 2005.

<u>The Indonesian Economy and its Developing Market.</u>

NOTES FOR ASIAN BANKERS ASSOCIATION

Firstly, I want to thank the Asia Pacific Bankers Association for inviting me to participate in this timely conference on the *Globalisation of Markets*. I am familiar with the ABA and addressed its 10th General Meeting in Bali in 1990.

Secondly, I wish to make a modest disclaimer. Although I have been Australia's Alternate Governor at the IBRD and represented the then Treasurer, Paul Keating, at its initial meeting in London in 1991, and although I have been a member of the Board of Commissioners of Lippo Bank for two years, I am neither an economist by training nor a banker, judged by experience.

But I am, I hope, equipped to make some observations on the Indonesian economy and its developing market in a changed political context.

Let me start with some comments on the present political / economic situation in Indonesia under President Susilo Bambang Yudhoyono's (SBY) Government. After an uncertain first year in office, partly due to initial organisational problems, complicated by the need to respond to the tsunami in Ache and subsequent emergency situations, SBY and Vice President, Jusuf Kalla, have begun to address the country's major continuing and pending economic problems.

A measure of economic stability had, in fact, been established towards the end of Megawati Sukarnoputri's Presidency. Although Indonesia's real GDP and export volume growth had lagged behind China, South Korea, Thailand and Malaysia, Megawati did bed down the country's democratic reform process and did, with her capable Finance Minister, Boediono, oversee a modest recovery of the economy. Inflation fell from 16% in 2002 to 6.5% earlier this year, while interest rates dropped from 17% to 7%. Foreign reserves also increased under Megawati from $US 29 billion to US$ 36 billion.

Although Indonesia became a net importer of oil in late 2003 and has not benefited from rising oil prices (it is still a net exporter of oil and gas), economic growth picked up from 3.8 % in 2001 to 5.1% at the beginning of this year. The economy seemed to be gaining momentum and it did earlier this year look as though this progress would continue.

Prediction is always a hostage to fortune. Late last August the rupiah depreciated by about 8% against the US dollar. While this is unfortunate because the sustainability of Indonesia's macroeconomic stability is now being questioned again while the country's economic fundamentals are not in fact so bad. A music critic once said of Wagner's music that it is not as bad as it sounds. One could paraphrase this and make the point that Indonesia's economy is not as bad it sometimes seems.

In Indonesia's relatively new and somewhat fragile democracy, efforts to accelerate growth, to improve the business and investment climate, and to intensify the anticorruption drive will depend on the effectiveness of the government's economic team and the degree of cooperation between the President and the Vice President to sustain a coherent and credible economic strategy. It is therefore important to attempt some assessment of how the key players will perform.

The Cabinet represents a compromise aimed at strengthening political support in Indonesia's elected Parliament. The key economic Ministers are not as strong as they could be, or as they were in Megawati's Government, and the investment community was disappointed when the Cabinet was announced on 25 October last year.

The Finance Minister, Jusuf Anwar, who had worked at the Asian Development Bank in Manila, was a career public servant. He may yet perform well but he is not as highly regarded as his predecessor, Boediono. The Minister for Mines and Energy, which includes oil, is Purnomo Yusgiantoro, who is known to be close to SBY. The Trade Minister, whom I know well, is a highly regarded economist, Mari Pangestu. The Planning Minister (Bappenas), Sri Mulyani Indrawati, is also highly regarded and was considered for the Finance portfolio, which was given to Anwar. She has been an executive director for South East Asia at the IMF.

We should not expect too much too quickly from President Yudhoyono's Government. When the former American Secretary of State, Richard Armitage, visited Sydney recently he described Indonesia as a "fantastic success" because it had become a democracy, because President Yudhoyono has close connections with America and because of his opposition to Islamic extremism and terrorism. The reality is, however, that SBY is a cautious consensus builder. He calculates what he can do politically and what he thinks would be too disruptive to attempt.

Democracy is rarely associated with decisive decision-making and Indonesia is a fragile democracy. SBY's party holds only 55 seats in the Indonesian Parliament. His strength is derived from the size of his popular mandate, rather than his parliamentary support. He received 60.62% of the popular vote at the Presidental election but Golkar, led by Vice President Jusuf Kalla, and the PDI, still led by former President Megawati Soekarnoputri, could, if they combine, defeat legislation introduced by the President.

This is why SBY has chosen to move initially against issues such as acts as terrorism, in which Indonesians have died, gambling, drugs and corruption, which can command wide parliamentary support. As Prime Minister Howard said in a speech to the Asia Society in New York recently, countries like Australia sometimes overlook how long it can take to fashion a stable democracy.

The relationship between the SBY and Jusuf Kalla in the ruling duumvirate will be important. Kalla is more of an internationalist and is clearly pro-market forces. He accepts globalisation. SBY has a military background and is more nationalist in outlook and less knowledgeable about economic issues. So far they have worked well together and it is important for the effective management of the economy that they continue to do so.

The Government's main economic task will be to restore growth and maintain macro economic stability. Indonesia needs to lift its growth rate to 6 or 7%. It will also need to address promptly the four main impediments to foreign investment and higher growth rates, namely a weak banking system, an unreliable judiciary, widespread corruption and uncertainties relating to tax, investment and mining law.

The Government will also need to increase Indonesia's competitiveness in the face of growing Chinese and Indian competition and increase employment opportunities. The labour market is however now less flexible than it was. Minimum wages have risen faster than productivity. Megawati briefly sought to raise fuel prices in 2003 but backtracked after widespread anti-government demonstrations.

An overriding preoccupation of the present and previous Indonesian government, following the fall of Soeharto, has been to ensure that the four State Banks lend prudently and do not accumulate bad loans, as happened during the financial crisis of 1997 / 1998. Bank losses during the financial crisis reached $US 60 billion. It was the Government and not the borrowers, who covered this loss. The banking system still requires careful monitoring and management.

Three weeks ago the Indonesian Parliament voted to cap this year's fuel subsidy bill at 89 trillion rupiah ($A 11.5 billion). This is a positive example of the ability of SBY and Jusuf Kalla to gain legislative support for locally unpopular but very necessary economic reforms when they work together closely, especially following the 29% fuel price rise last March that SBY had said would be the only rise this year.

Conclusion

Indonesia offers a market of some 220 million consumers with a GDP expected to grow by 5.4% this year and, hopefully, reach 6% next year. Foreign investment, which depends on continuing political stability, progress in reforming the bureaucracy, reducing corruption, and improving the banking system and the legal framework, is picking up again. After falling to US$ 10.28 billion in 2004, direct foreign investment approvals for the first six months of this year are about $US 8.7 billion, a very substantial increase above 2004.

If the Indonesian economy continues to improve – and the country's economic fundamentals are in reality not so bad, there will be considerable opportunities for Australian food and beverages, in which sector there is already a strong complementarity between what Australia produces and what Indonesian consumers require. Other areas of potential growth for investment include dairy products education, beef, poultry, services and infrastructure development. Mining prospects are less clear at present pending the passage of revised regulations and laws.

Politically, the firm if cautious approach of President Yudhoyono and the present cooperation of Vice President Kalla are reassuring after several years of erratic and ineffective leadership. Although the Indonesian economy, including the banking system, still faces serious problems, which call for continuing management and ongoing reform, I believe we can expect that in the medium and longer term - and with stable government - Indonesia will offer considerable commercial and selective investment opportunities.

RW/bc
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