Indonesia must break with past
Stephen Grenville
Australian Financial Review
27 September 2004

Indonesians can feel proud of their presidential election. It was calm, clean and clear: Susilo Bambang Yudhoyono, or SBY as he is popularly known, has an indisputable mandate, and it is a mandate for change.

But as Winston Churchill said, democracy is the worst system, except for all the others: winning the election was a triumph, but only a beginning. SBY's fledgling party received fewer than 8 per cent of the votes in the parliamentary election and he faces difficult issues on all sides.

The economic challenges are formidable. Many commentators speak as if the economy is back to normal after the 1997-98 crisis. It certainly is moving forward again with growth of about 4 per cent in recent years.

While this looks respectable enough compared with countries like Australia, gross domestic product has returned only recently to its pre-crisis level and remains lower in per capita terms. This pace of growth is modest compared with Indonesia's successful Asian neighbours and far too slow to provide productive jobs for the increasing workforce. This is the central economic message to emerge from the campaign.

There is general recognition that "muddling through" will not provide the wherewithal to respond to community expectations. Neither presidential candidate said much about what they would do. If there is a policy message from the campaign, it is that more interventionist economic measures may find favour and populist panaceas will be hard to resist.

This is perhaps understandable. The austerity of the post-crisis period may have been necessary, but has resulted in an economy operating with a tourniquet: life-saving perhaps, but unsustainable in the longer term.

One illustration: Indonesia, which should be a significant capital importer, is still running a current account surplus equal to 4 per cent of GDP. Fiscal restraint has been achieved at the cost of skimping on infrastructure and basic services such as education.

But simply easing the budget and monetary austerity is not the answer, particularly if it means subsidies for worthy but unprofitable projects and loans for borrowers who will not repay. Business confidence, already fragile, would be damaged by simple-minded belt-loosening. What else might get the economy moving forward at a good pace?

The early Soeharto years had an answer to this: a credible commitment to fiscal and monetary rectitude; a competitive exchange rate; encouragement to foreign investment; and a large reliance on the dynamism of markets to do the job. This worked well enough. Three decades of consistent 6 to 7 per cent annual growth, beginning in the late 1960s, took Indonesia from being a basket case, to playing in the same league as the South-East Asian tiger economies Thailand and Malaysia.

But a simple return to these policy elements will be neither easy nor sufficient. Not only are these policies (unfairly) tainted with "guilt by association" from the Soeharto years, but the circumstances now are far more constrained. The Indonesian budget now needs to service a heavy debt burden, a legacy of the 1998 crisis when the cost of bank rescue equalled 50 per cent of GDP. More than 10 per cent of revenue goes to an uneconomic but politically sensitive subsidy on petroleum. And at the same time parts of the best revenue sources have been reallocated to district governments under a decentralisation process.

Indonesia used to be a significant oil exporter, but is now barely self-sufficient. Aid flows used to amount to $3 billion annually, but the net inflow now is tiny. As world interest rates rise, the burden of servicing foreign debt will increase.

There will be a strong temptation to ease monetary policy to encourage domestic investment through easy credit. But there are few indications that bank lending processes have been substantially reformed and state banks (with unresolved governance problems) still make up nearly half the sector.

In any case, most corporations of any size went broke in 1998, leaving few bankable customers in the corporate sector. Small and medium enterprises may offer profitable lending opportunities whose expansion could provide productive jobs but banks have trouble doing effective credit and security checks on small businesses.

On top of this, the legal system, and in particular the bankruptcy courts, show few signs of having reformed their erratic ways. Lending will remain a risky business and artificial stimulation opens the possibility of a repeat of the 1997 bank collapse.

Perhaps the most serious deficiency, and the key to growth, is investment. Domestic investment is down one-third on the pre-crisis levels. Foreign investment showed substantial net outflow until recently and is now barely positive.

To some extent this is a chicken-and-egg dilemma: if growth were faster, the incentive to invest would be greater. But what can end this impasse? Foreign investment is a critical component: foreigners not only supplied investment funds, they also brought technical know-how and often provided access to export markets.

International competition for such investment is now much keener than 20 years ago with China and Vietnam both providing attractive alternatives to Indonesia. The main wave of de-industrialisation in Japan, which drove the foreign investment of the 1970s and 1980s, is slower now. Perceived security concerns add to the reasons for foreigners to invest elsewhere.

In the earlier era - for all its governance deficiencies - most businesses had worked out a modus vivendi that gave them the certainty and security they needed to pursue their investment plans. They did not rely on well-functioning courts and legal infrastructure to provide this certainty: it was achieved through relationships that ultimately centred on Soeharto.

Now that central point has been removed and businesses are subject to demands from various levels of government, it is much more important to establish a legal system that can adjudicate disputes and provide investors with clear property rights and some certainty about their operating environment. If the banks are to avoid a repeat of the collapse of 1997-98, the courts must back up their claims against borrowers and enforce loan security when necessary.

To change all this is a big ask. Successive presidents since Soeharto have mouthed anti-corruption rhetoric and new institutions and laws have been put in place. What has not happened is a clearly articulated "in principle" break with the old ways of doing things.

No doubt this is difficult (SBY himself is a product of the former system) but there is a precedent, set in 1967, when the New Order government of Soeharto put the future of the then-moribund economy in the hands of the so-called technocrats - the team of professional economists led by Widjojo Nitisastro.

Much more is needed now because it is not just the technical economic policies that need to be set on the right track. A democratic environment requires a much more comprehensive infrastructure of laws, rules and practices (particularly in the bureaucracy).

But the first element is a high-level commitment to break with the past. The people voted for change: it is up to the new president to deliver. A well-articulated, credible commitment to far-reaching reform might be just the catalyst needed to invigorate business and break the vicious circle of low investment and low growth.

With a good pace of growth restored, other constraints (notably the fiscal tourniquet) can be safely relieved. Momentum will keep the bicycle upright and moving forward.

Australia has a big stake in Indonesia's success. Clearly, the main job has to be done by Indonesia itself, harnessing the energy, administrative capacity and community goodwill shown in the election. That said, can we do anything to help the new government in its economic task?

While there are Australian companies that have and will invest profitably in Indonesia, the main funding of investment will come from elsewhere - mainly Japan, with Singapore playing a role above its size, because of the close economic ties and the special knowledge and relationships these bring, especially with Indonesia's ethnic Chinese business community.

We already have a model for the modest but important role Australia might play - the Australian Federal Police's assistance to its Indonesian counterparts after the Bali bombings. This kind of low-key, operational, on-the-ground assistance, carried out with sensitivity, could help to raise the standards of the overall administrative apparatus so that there is some chance that the political developments will be backed up by a more effective, innovative and dynamic bureaucracy and legal system.

This cannot be done unless the Indonesians themselves request it but maybe SBY will be more open to accepting the proffered hand. It is patently in our interests to provide such support wholeheartedly and with sensitivity.

Stephen Grenville is visiting fellow at the Lowy Institute for International Policy and former deputy governor of the Reserve Bank of Australia.