Paris club decision keeps Indonesian economy temporarily afloat

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Two decisions by international economic bodies last month provided a much-needed, temporary reprieve to the Indonesian government of President Megawati Sukarnoputri, but none of the underlying weaknesses of the debt-burdened economy have been resolved. In mid-April, the Paris Group of Indonesian creditors gave a $US5.4 billion extension for repayments on loans due to expire this fiscal year. Subsequently, the International Monetary Fund disbursed $347 million worth of loans.

While the announcements boosted the price of the rupiah, these amounts are a drop in the ocean compared to total government and private debt of more than $200 billion. At the start of the year, public debt amounted to $148.8 billion, of which nearly half was owed to foreign institutions. Corporate foreign debt stands at $64 billion.

The debt reached these dizzy heights in the course of the Asian economic crisis—jumping from just 34 percent of GDP in April 1997 to 98 percent by the 2000 financial year. Interest payments alone went from 26 percent of the government budget in April 1997 to 43 percent the following year and began to stabilise at about 31.5 percent over the following two years.

The sharp escalation of government debt resulted from the formation of the Indonesian Banking Restructuring Agency (IBRA). It took over the bad loans of banks and other institutions, which were threatening to drag down the country's financial system. Four years later, IBRA still has not sold most of its assets, as insisted by the IMF and international investors.

A large slice of the government budget—some $9.7 billion a year—goes to paying the interest, squeezing the amount left for other items such as the country's already limited education, health and welfare programs. Describing the impact of the debt, Vice-President Hamazah Haz commented earlier this year: "Had this country been a company, we would have gone bankrupt."

In February, *Businessweek* commented bleakly: "As Megawati becomes increasingly disengaged, Indonesia is slipping toward economic disaster. Costs are rising, exports are dropping, investment is plummetting, unemployment is soaring, and the rest of the world is starting to see the nation as a crucible of radical Islam... In a sign of how desperate it has become, Indonesia will request a two-year reprieve on $4.5 billion of the outstanding foreign debt at the Paris Club in April. While Jakarta seems sure to get a break, that might not ward off serious financial difficulties."

While it did grant Indonesia some temporary relief, the Paris Club insisted that Megawati's administration carry out the IMF's program of economic reforms, including privatisations, cutbacks to public spending and improved conditions for international investors.

A key demand is for legal changes. International investors want an end to a situation in which it is difficult to recover funds, institute compensation claims or pursue bankruptcy proceedings. Or conversely, where they are subject to legal proceedings by Indonesian companies that they would not normally have to face elsewhere.

The frustrations of foreign investors were underscored by a World Business Environment Survey provided to the World Bank this year. It found that Indonesia was considered by business observers to have the "least honest" legal system out of 81 countries surveyed.

US Ambassador-Designate Ralph Boyce recently urged reform of Indonesia's "ineffective and corrupt" legal system as a major priority to help attract foreign investment. He pointed to the sharp decline in investment in Indonesia: "In the first two months of this year the government approved 149 foreign direct investment projects worth $489.3 million against 189 projects worth $2.33 billion a year earlier."

One high profile court case involves Indonesia's state-owned oil and gas company Pertamina and Karaha Bodas, which is controlled by two US firms, Florida Power Energy and Caithness Energy. Karaha was working with Pertamina to build a geothermal power plant in West Java but the plans were suspended in 1998, in the midst of the Asian financial crisis.

Karaha, which claimed to have invested $100 million, went to the Swiss-based international arbitration panel and was awarded $261 million in compensation from Pertamina. When the Indonesian company refused to pay, Karaha filed another suit in a US court and succeeded in freezing $200 million in Pertamina assets in two US banks.

Pertamina hit back using the Indonesia courts, obtaining a local order to prevent Karaha from freezing the company's accounts overseas. The oil company also asked the Indonesian police to investigate Karaha for "overpricing" in its claim to have invested $100 million. International investors want such legal avenues in Indonesia shut off. As the *Far Eastern Economic Review* commented last month: "The protracted wrangling [over Karaha] only adds to Indonesia's reputation for legal uncertainty."

Megawati's administration is under pressure to speed up the sale of IBRA assets. The sale of Bank Central Asia (BCA), Indonesia's largest retail bank, was finalised in March when the US-based hedge fund Farallon paid $531 million for a 51 percent stake. But the process was marred by recriminations over government tampering in the bidding process and delays in announcing an outcome. The sale of BCA was necessary to help plug the hole in the state budget and to gain support at the Paris Club meeting.

Privatisation proceeds are meant to help cover the 2002 budget deficit. A senior official announced last week, however, that the privatisation target for the first six months would not be met. He pointed to several possible sales but none have so far been completed. There are 24 state-owned enterprises slated for sale this year—nine of them left over from last year's list.

Businessweek commented earlier in the year: "In 2001, the state sold its most marketable assets, including phone company PT Telekomunikasi Indonesia. Last month, the best of the leftovers—automobile assembler PT Indomobil Sukses Makmur and Bank Central Asia—went up for grabs. It's still not enough."

To try to reduce the budget deficit of $4.3 billion, the government has slashed subsidies on basic commodities including fuel—a measure that will particularly hit the poor. Last week, bus fares in Jakarta rose by 25 to 40 percent and intercity transport costs will increase between 14 and 24 percent over the next six months. The price hikes followed the fourth successive increase in fuel prices.

Prospects for economic growth are gloomy. The GDP grew by just 2.2 percent in the first three months of the year, according to official data released this week. The government estimate for the year is 3.5 percent as compared to an actual rate of 3.3 percent last year and 4.8 percent in 2000. Just as the recovery following the Asian economic crisis was driven largely by exports, the current slowdown reflects declining markets, particularly in the US and Japan.

The Indonesian Chamber of Commerce and Industry warned earlier this year that the country's unemployment figure could reach 50 million or over 50 percent of the workforce this year. The official rate is about 17 to 20 percent but the Manpower Ministry has indicated that the figure could be much higher if all the unemployed or very underemployed were counted.

For a large number of people, rising prices, lack of jobs and deteriorating social services are combining to create a social nightmare. While the Paris Club decision may have shored up the shaky Indonesian financial system, at least for now, the measures insisted upon by the IMF and other creditors will only worsen what for many is an already desperate situation.

According to a World Bank report in January, Indonesia is the only country directly affected by the Asian financial crisis in which current economic "activity remains significantly below pre-crisis levels. And, despite progress made since the height of the crisis, poverty levels remain very high. More than half of Indonesia's population is living on less than $US2 per day. Most of these people are poor or vulnerable to becoming poor if they lose their job, suffer a family illness, or have to pay more for basic commodities."

A recent UN World Food Program survey found that more than one million people had been forced to flee their homes as a result of various ethnic and communal conflicts. Of these, 54 percent were unemployed and 55 percent of households were living below the poverty line. In Aceh, 90 percent were in poverty. In half the districts surveyed, illnesses were a significant problem for 90 percent of households—the most common being debilitating diseases such as malaria, dengue fever and hepatitis.

Even before the Asian economic meltdown, Indonesia had high levels of infant and maternal mortality, which were respectively 41 deaths per 1,000 live births and 373 for every 100,000 live births in 1997. These figures were the poorest in ASEAN (Association of South East Asian Nations) and will have worsened significantly in the subsequent four years as budgets for health and welfare services have been squeezed.