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2003: GROWTH REMAINS MODEST

Indonesia's growth remains modest in 2003, but the economy has performed better than expected. 2003 was marked by various external and internal threats. Contrary to the speculations of many economic observers, neither the Iraq war and nor SARS has influenced economic growth. In addition, the war in Aceh has so far not had a significant impact on the Indonesian economy. The business sector has responded calmly to the decision of the government not to extend the IMF program after 2003. The exchange rate and the stockmarket remained stable, and the business sector as represented by the Indonesian Chamber of Commerce welcomed the move.

Inflation was low; interest rates fell; the rupiah appreciated; and stock prices surged. Year-on-year real GDP growth for the 2003 grew 4.1%, slightly higher than 2002 (3.7%).

Economic growth continues to depend heavily on private consumption (accounted for 72% of GDP) and government expenditure.

The rupiah has strengthened against the dollar from Rp9,375 (average of 2002) to Rp8,465 (average of 2003).The strengthening of the rupiah and Indonesia's stable macroeconomic conditions have given Bank Indonesia room to lower the interest rate (one-month Certificate Bank Indonesia Rate) from 12.99% (2002) to 8.31% (2003). Despite all this, lending rates remained high.

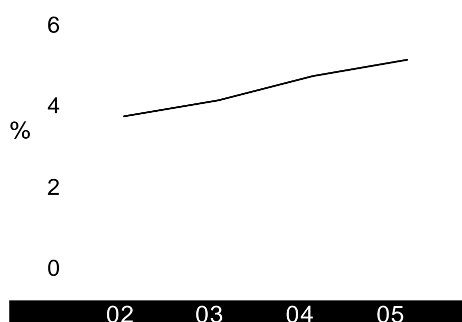
The government has been quite successful in keeping the fiscal policy in track. The budget deficit has declined, reaching below than 2% in 2002–03, although it slightly increased from 1.7% of GDP (2002) to 1.9% of GDP (2003). The government debt/ GDP ratio declined further from 81.2% in 2002 to 67.7% in 2003. Nevertheless, the investment performance remained bleak. In 2003 investment only grew by 1.4% slightly improved from 0.2% in 2002.

The growth of the non-oil manufacturing sector continued to slow from 5% (2001), 4.2% (2002) and only 2.2% (2003). Total exports grew by 6.8% in 2003, with the most important contribution coming from oil export and higher oil prices in 2003.

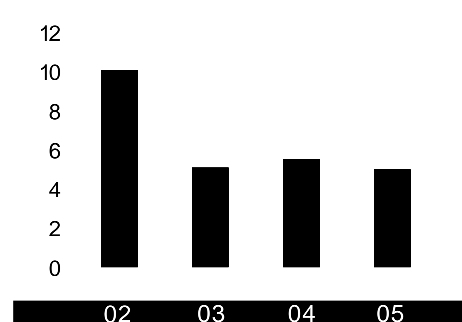
Indonesia's growth of non-oil export to China is the highest among other countries' destinations (22.9% in 2003). This is obviously higher than non-oil export to Japan (3.2%) and the US (–0.9%). Imports from China recorded 7.7% in 2003 and improved Indonesia's trade balance with China. Indonesia took advantage of booming trade with China, where China has rapidly emerged as the central regional production network and market for export and intermediate inputs in Asia.

Despite booming trade with China, serious problems persist and are systemic in the export sectors. The

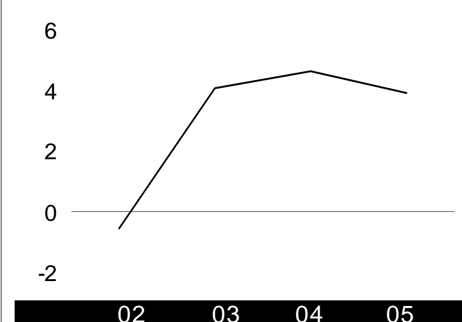
GDP growth



CPI inflation



Export growth



sluggish growth in exports can be attributed to supply-side problems, including the high cost of doing business, the government's weak industrial relations policy, increases in the minimum wage and poor infrastructure.

2004–05: SLIGHT GROWTH ACCELERATION FACING HEADWIND

Growth is likely to pick up in 2004, rising to 4.7% for two reasons. First, food consumption is expected to continue to increase due to the positive impact of 2004 election. Second, the possibility of economic recovery in both Japan and the United States will maintain Indonesia's export performance as in 2003. In 2005, the economic growth is predicted to reach 5.1%. In 2004 and 2005 economic growth continues to rely largely on consumption, while investment is still lagging and exports remain modest. The consumption-driven growth alone will not produce sustainable growth. The economy is expected to grow by 4–5% in 2004–05, not enough to reduce unemployment, poverty and social tensions significantly. Investment and exports remain sluggish, reflecting the serious problems that persist in the manufacturing sector. Slowness of investment and export growth reflects the serious problems that persist in the Indonesian manufacturing sector.

The general election that will take place in 2004 will delay new FDI to Indonesia. A new president and cabinet will be inaugurated in October 2004 and after that it will be more likely that foreign investors will wait to observe the performance of the new government before making any decision to invest in Indonesia. Without FDI it is difficult to expect strong economic growth.

Continued macroeconomic stability will keep inflation stable in 2004–05 (less than 6%). This is consistent with the exchange rate assumption of Rp 8,500 (2004) and Rp 8,400 (2005) and the growth of base money targeted by Bank Indonesia.

Oil exports are expected to increase slightly in 2004 and 2005 due to the high price of oil. As a result total exports will increase by 8% in 2004 but slightly decline to 7.5% in 2005 due to the impact of the MFA being removed on Indonesian textiles exports. A survey by the Indonesia Central Bureau of Statistics (BPS) reveals the poor condition of the manufacturing sector, particularly in textiles, clothing and footwear industries. In addition, Indonesian exports from 1995–2003 seem to be shifting into resource intensive products, whereas the competitiveness of manufacturing is in decline, except for a few products such as palm oil, printing, writing paper, and electronics. To make matters worse, the declining competitiveness of Indonesian exports is combined with creeping protectionism.

Import growth will also lift from 3.5% in 2003 to 4.6% in 2004 and 7.6% in 2005, consistent with the trend in investment. As a result, the current surplus is predicted to decline from 4.2% of GDP in 2003 to 4% in 2004.

Looking at the severity of the economic crisis and the shortcomings in institutional reform, immediate recovery is unexpected in the short-term. The investment climate remains bleak due to various labour and institutional problems.

RISKS

The government has called for further reduction in untargeted fuel subsidies. This is an important issue considering the government's target for maintaining fiscal sustainability. The prospect of privatisation remains bleak as it is a heavily politicised issue; nationalist sentiment is invoked as an argument for rejecting privatisation. There is a possibility that state-owned enterprises are regarded by some political parties as cash-cows and can be used as a source of funding.

Indonesian exports will be affected if the oil prices turn out to be lower than US$28 per barrel. This will affect GDP growth. However, as consumption is major of engine of growth, the impact will be limited. The exchange rate is a key variable in this forecast. If the rupiah depreciates against the US dollar it will affect inflation and subsequently raise interest rates.

It has been argued that the strengthening of the rupiah suggests an inflow of portfolio investment to Indonesia. However, the government should also be wary of the possibility of reverse capital flow, when short-term capital exits occur in response to an economic or political shock due to the general election. Nevertheless it would be fair to say that, thus far, the Indonesian government has succeeded in maintaining political stability.

The impact of the 1999 general election on consumption

Consumption growth was evident in the the 1999 election, when food consumption growth reached around 5.1%.