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IN THIS ISSUE
Notes from the editor

Our new 'Survey of recent developments', contributed by **Mudrajad Kuncoro, Tri Widodo** and **Ross McLeod**, reveals that earlier fears about the likely impact of the global financial crisis (GFC) on Indonesia have so far proved unfounded. Although the economic growth rate has declined somewhat, Indonesia's economy has recently been performing quite well – and much better than most others in the region. The main concern is reluctance on the part of businesses to undertake new investment, but the recent recovery in listed companies' share prices suggests that initial fears of a dramatic downturn have by now dissipated. Careful management of monetary policy has resulted in declining inflation and nominal interest rates along with recovery of the exchange rate, and without the severe disruption of the banking system that has characterised many other economies. The central bank's deft response to the GFC raises the question whether it would be better to opt for a much more genuinely floating exchange rate, rather than persisting with building up international reserves in order to try to keep the exchange rate under control.

With a presidential election imminent, it is timely to evaluate Indonesia's economic performance under Susilo Bambang Yudhoyono (SBY) relative both to his 2004 election campaign promises and to economic performance under his predecessor, Megawati Soekarnoputri. On the former comparison, outcomes have been disappointing – mainly because the campaign promises were, to a large extent, unrealistic. But on the latter there is little to choose between the two regimes, other than somewhat higher levels and rates of growth of investment; the fact is that there has been considerable continuity of economic policies from one presidency to the next. To the extent that there has been any heat in the presidential election campaign it has largely been generated by the introduction of the pejorative term 'neo-liberalism'. The authors argue that this term should be taken to mean a belief in the efficacy of markets – rather than government intervention – in generating favourable economic outcomes for the population in general, whereas the critics of neo-liberalism often wrongly imply that a free market orientation reflects a lack of concern for the poor. The survey concludes with a discussion of attempts to improve governance through the reform of public sector accounting practices.

This issue of *BIES* includes the latest in our series of papers on recent economic legislation. **Simon Butt** focuses on the Corruption Eradication Law of 2001, within the context of the 100% conviction rate in cases brought before the Anti-Corruption Court since its establishment in 2003. The Constitutional Court has found that the law is too vague in one aspect of its crucially important definition of corruption to provide reasonable grounds for a conviction, but Butt argues that the Supreme Court has deliberately and explicitly circumvented this decision. Thus, while governance reformers applaud the Anti-Corruption Commission's success in putting corrupt individuals behind bars, Butt is concerned that this has been achieved at

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the expense of the rule of law. The Constitutional Court has also found that the Anti-Corruption Court itself is unconstitutional, and it is by no means certain that new legislation will be enacted before the end-2009 deadline in order to ensure its continued existence. If the Anti-Corruption Court closes down, it is feared that those guilty of corruption will enjoy effective legal immunity because they will be able to bribe their way out of trouble.

Christian von Luebke's paper discusses the progress of Indonesia's transition from centralised–authoritarian to decentralised–democratic rule. He observes that Indonesia's transformation into one of the largest and most decentralised democracies in the world has been accompanied by a pronounced variation in the quality of governance across local governments, which continues to constrain domestic and international investment. He presents the results of eight district government case studies intended to explain variations in administrative, taxation, licensing and corruption practices, and argues that government leadership is an important and often under-estimated policy determinant that outweighs demand-side pressures from local firms, associations and district councils.

Mark Turner, **Amir Imbaruddin** and **Wahyu Sutiyono** have also contributed a paper concerned with decentralisation. They focus on human resource management (HRM) in sub-national governments, arguing that this dimension has largely been forgotten – and that neglect of HRM is hampering realisation of the potential benefits of decentralisation. On the basis of nine case studies they find that HRM remains centralised and bureaucratic, with many practices carried over from the pre-decentralisation era. HRM continues to be about the administration of laws and regulations that have been centrally determined and that encourage conformity rather than innovation and concern with efficiency and effectiveness. In their view reforms are essential, but they recommend an incremental approach that creates incentives for reform by making local governments more accountable for personnel costs and performance.

Members of the Indonesia Project were greatly saddened by the passing of **Dr Robert (Bob) Rice** in February 2009. Bob served on the international advisory board of this journal from 1990 to 2007. Our colleague **Thee Kian Wie** has contributed an obituary to mark our appreciation of Bob's work on Indonesia over several decades, in which he describes him as 'a big man with an even bigger heart', who was 'a natural bridge between Australia and Asia in general, and between Australia and Indonesia in particular'.

We also present here a new set of four **abstracts of recently completed PhD dissertations on the Indonesian economy** (three of which happen to be written by former students of the Arndt–Corden Division of Economics at the Australian National University – the home of the Indonesia Project and this journal).

The **book review** section in this issue deals with a wide range of topics: the economic decolonisation of Indonesia; environmental policy relating to mining in Indonesia by comparison with the US; changing rural development challenges in Asia; production networks and economic integration in Southeast Asia; and the role of Indonesia's parliament in the process of democratisation.

Don't forget, you can comment on any of the articles we publish by entering the ***BIES* Interactive Forum** at <www.BIES-forum.com>.

Selamat membaca!

Ross H. McLeod

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SURVEY OF RECENT DEVELOPMENTS

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SUMMARY

In the recent legislative elections the Democrat Party of President Susilo Bambang Yudhoyono (SBY) was by far the most successful. Support for other major secular-nationalist parties fell significantly, as did that for the Islamic parties as a group. Two new parties led by former generals also performed relatively poorly. At the time of writing SBY seemed the likely winner of the forthcoming presidential election, supported by running mate Boediono, the former governor of Bank Indonesia.

Indonesia's performance during the global financial crisis has been vastly better than during the Asian financial crisis, and superior to that of most other countries in the region. Output growth remained positive through Q1 2009, although there were signs of heightened caution within the business community. Deft monetary policy saw inflation decline significantly, with little negative impact on output growth or the banking sector. Much of the earlier declines in the financial markets had been reversed by mid-June. Successful management of exchange rate policy in late 2008 and early 2009 raises the question whether Indonesia would fare better with a more genuinely floating exchange rate and a much lower level of international reserves. Economic outcomes during the SBY administration fell well short of the president's 2004 election campaign promises, but were comparable with those under former president Megawati, reflecting the great policy similarities of the two regimes.

A key feature of the presidential election campaign has been the use of the term 'neo-liberal' to attack one's opponents. It has been implied that those following 'neo-liberal' policies favour the business sector and foreigners over the people, whereas the real issue is what types of policies are more likely to benefit the Indonesian people as a whole. The debate provides the opportunity potentially to resolve long-standing disagreements as to the relative efficacy of free market- and interventionist-type policies.

Public sector accounting reform is an important aspect of efforts to improve governance. Newly introduced accounting standards require a shift to double-entry accounting, and away from the single-entry system inherited long ago from the Dutch. This requires the listing of government entities' assets and liabilities in a balance sheet, and should lead to far greater accuracy in government financial reporting. In turn, this has the potential to be a powerful anti-corruption instrument. But progress is significantly limited by a severe shortage of accountants in the public sector, and by dysfunctional personnel management practices.

* We are grateful to Greg Fealy for contributing material on the 2009 elections.

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POLITICAL DEVELOPMENTS

Indonesia's third national legislative elections of the post-Soeharto period were held on 7 April 2009. Despite some procedural problems and isolated cases of apparent electoral fraud, the poll was largely free and fair, cementing Indonesia's reputation as the most democratic of Southeast Asia's 10 nations. Of the 171 million registered voters, 71% cast votes in the election. This was 13 percentage points lower than in the previous election in 2004, but still a healthy participation rate compared with many other Asian and Western democracies. Thirty-eight parties competed for seats in national, provincial and district legislatures. Another six parties contested local elections in Aceh only, under a special arrangement agreed to as part of the peace accords. Of the national parties, only nine reached the 2.5% threshold that allowed them representation in the 560-seat parliament (DPR) (table 1). According to Law 42/2008, a presidential candidate can be nominated only by a political party or coalition that has won at least 20% of the seats in the DPR, or 25% of the valid votes in the election. The Democrat Party of the incumbent, Susilo Bambang Yudhoyono (SBY), was the only party to surpass one of the two thresholds; other parties wanting to field presidential candidates were obliged to join forces in coalitions. Box 1 contains an analysis of the election outcome and the implications for the presidential election.

TABLE 1 *Results of 2009 Elections for the National Parliament (DPR)*

	Votes		DPR Seats	
	Million	%	No.	%
Parties gaining seats in the DPR				
Established secular nationalist parties				
Democrat Party (PD)	21.7	20.9	150	26.8
Golkar Party	15.0	14.5	107	19.1
Indonesian Democratic Party of Struggle (PDI-P)	14.6	14.0	95	17.0
Islamic parties				
Prosperous Justice Party (PKS)	8.2	7.9	57	10.2
National Mandate Party (PAN)	6.3	6.0	43	7.7
United Development Party (PPP)	5.5	5.3	37	6.6
National Awakening Party (PKB)	5.1	4.9	27	4.8
New secular nationalist parties				
Greater Indonesia Movement Party (Partai Gerindra)	4.6	4.5	26	4.6
People's Conscience Party (Partai Hanura)	3.9	3.8	18	3.2
Totals for parties gaining seats in the DPR	**85.1**	**81.7**	**560**	**100.0**
Parties not gaining seats in the DPR	**19.0**	**18.3**		
Total valid votes	**104.1**	**100.0**		

[a] At the time of writing the numbers in this table were expected to change slightly as a consequence of challenges to outcomes in several regions. Discrepancies are due to rounding.

Source: KPU (2009).

BOX 1 THE 2009 ELECTIONS

The most successful contestant was the Democrat Party (PD) of President Susilo Bambang Yudhoyono (SBY), which increased its vote from 7.8% in 2004 to 20.9% in 2009 – an extraordinary result given the party was formed only in 2003. PD's victory was attributable largely to the personal popularity of SBY who, according to most respected survey organisations, enjoyed far higher approval ratings than any other politician in early 2009. The president's public standing rests primarily on two bases. First, he is seen to have managed the economy well, and has won support particularly for his program of direct cash payments to lower income families (Mietzner 2009). Second, he is credited with allowing a sweeping crackdown on corruption, which has snared many senior politicians and officials.

Most other major parties suffered a drop in their votes. Support for Vice President Jusuf Kalla's Golkar Party and former president Megawati Soekarnoputri's Indonesian Democratic Party of Struggle (PDI-P) fell by about a quarter, from 21.6% and 18.5% respectively in 2004 to 14.5% and 14.0% (table 1). Both parties, like PD, are predominantly secular nationalist in orientation, though all three sought to mobilise Islamic support by incorporating Islamic appeals in their campaigning. The decline in the Golkar and PDI-P votes is due partly to the 'SBY factor' – that is, the president enjoys such high standing that he attracts votes away from other middle-of-the-road parties. By comparison, Golkar and PDI-P lack leaders with broad appeal. Although Kalla is widely commended as an energetic and effective vice president, less than 10% of poll respondents back him for the presidency. Megawati enjoys solid support among her party's cadre, but has failed to make the most of PDI-P's standing as the only real opposition party.

Islamic parties also fared poorly. Only four of the 10 Islamic parties contesting the election cleared the parliamentary threshold, and the overall 'Islamic' vote slid from 38% in 2004 to 29% this year. Support for the two Islamic parties that performed best at the previous two elections – the National Awakening Party (PKB) and the United Development Party (PPP) – fell from 10.6% and 8.1% respectively five years ago to 4.9% and 5.3% this year. The National Mandate Party (PAN) recorded only a slight drop from 6.4% to 6.0% over the five–year period. The only Islamic party to increase its vote, albeit modestly, was the Prosperous Justice Party (PKS), whose support rose from 7.3% to 7.9%. Even this result was a disappointment, as PKS had confidently predicted a vote of 15% or more in this election.

The reasons for the poor performance of Islamic parties are various. First, opinion surveys showed that Islamic parties ranked low on those issues most important to voters: economic and professional competence. This is not surprising given that the 10 cabinet ministers representing Islamic parties have not performed well in their portfolios. Second, in recent years most Islamic parties have experienced serious internal divisions, which have had a negative impact on their electoral support. Finally, few Islamic parties have strong or inspiring leadership. Numerous party leaders and board members are elected because of their wealth or access to government or corporate patronage, rather than because of political or intellectual ability.

PKS is a somewhat different case. Its vote rose six-fold between 1999 and 2004, mainly because of the party's clean and reformist image. In 2009 it had a much larger membership than in 2004 and more political experience and money, leading its strategists to predict another big rise in support. PKS's electoral stagnation is a symptom of mounting external and internal problems for the party. Major Islamic organisations such as Nahdlatul Ulama and Muhammadiyah are antipathetic to PKS, accusing it of predatory tactics towards their members and assets. The party's previous reputation for

BOX 1 (CONTINUED) THE 2009 ELECTIONS

probity and distinctiveness has been tarnished by corruption accusations surrounding some senior leaders, and a growing perception that PKS is now immersed in the same sort of political manoeuvring as 'normal' parties. The 2009 election result casts doubt on whether PKS can, in the short term, become a pivotal player in Indonesian politics, as many commentators once predicted.

Two newly established parties, both led by former generals, deserve mention: Prabowo Subianto's Greater Indonesia Party (Gerindra), which gained 4.5%, and Wiranto's People's Conscience Party (Hanura), with 3.8%. Gerindra ran a sophisticated and expensive campaign, with well-produced prime-time television advertisements and extensive mobilisation of 'supporters' for mass rallies. Prabowo was the centrepiece of the party's campaign, and he proved a capable performer on the hustings. Hanura and Wiranto ran a lacklustre campaign by comparison, failing to generate much enthusiasm either in the media or at grassroots events. Prabowo and Wiranto were disappointed with their parties' results, and neither secured the electoral springboard necessary to realise his presidential aspirations despite their multi-million dollar outlays.

Aside from the changes in party votes, the election had several other notable features. A record number of women – 102 (18.2% of the total) – will hold seats in the DPR. This still fell well short of the legislated (but ultimately unenforceable) 30% minimum, however. The group of 12 new MPs of Chinese descent is also the largest for 50 years, evidence that parliamentary composition is slowly becoming more reflective of Indonesia's social complexity. One cause for concern is that 67% of MPs will be first-timers, following on from a 71% turnover in 2004. Although the average educational level of MPs will be higher than in any previous DPR, the lack of legislative experience will almost certainly mean a further decline over the next few years in the already poor parliamentary performance.

In the month after the election, parties and aspiring electoral candidates engaged in fevered manoeuvring to form political alliances for the presidential elections, the first round of which will be held on 8 July. Eventually coalitions formed around three presidential tickets. The largest grouping coalesced around SBY and his running mate, former Bank Indonesia governor, Boediono, and contains PD, PKS, PKB, PPP and PAN. Megawati and Prabowo led an alliance of small parties built around PDI-P and Gerindra, and Golkar and Hanura nominated Kalla and Wiranto. At the time of writing, three of the most credible survey organisations had SBY winning more than 50% of the vote, suggesting the possibility of a first-round victory.

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ANU

MACROECONOMICS

A tale of two crises

The global financial crisis (GFC) had not fully run its course at the time of writing, so it is possible that its impact on Indonesia will eventually be worse than has been observed so far. With that qualification, the differences between Indonesia's experience of the GFC and the Asian financial crisis (AFC) in 1997–98 are remarkable. Table 2 compares a number of the key economic variables during the two crises.

The indicator of most fundamental importance is the GDP growth rate, which plummeted below –18% in the earlier crisis, but has remained positive (4.4%) so far during the GFC. On most of the other measures the differences are equally striking. The depreciation of the currency from its strongest point just before each crisis to its weakest point was more than three times higher in the case of the AFC; the peak rate of year-on-year consumer price inflation was almost seven times higher; the peak interest rate on BI's open market operations instrument, the 30-day SBI (Sertifikat Bank Indonesia, Bank Indonesia Certificate), was more than six times higher; and the peak inter-bank seven-day borrowing rate was more than eight times higher. The loss of international reserves was only a little higher in absolute terms during the AFC, but well over twice as high in percentage terms. Only in relation to the rupiah market value of shares listed on the stock exchange have the two crises been comparable in their impact, with declines of a little over 50% in both cases. If we focus on the percentage decline in the dollar value of shares, however, the impact of the AFC was again considerably more severe. As we shall argue below, these much more favourable outcomes reflect, to a considerable extent, the far greater skill with which the shocks to Indonesia's economy have been handled by policy makers the second time around.

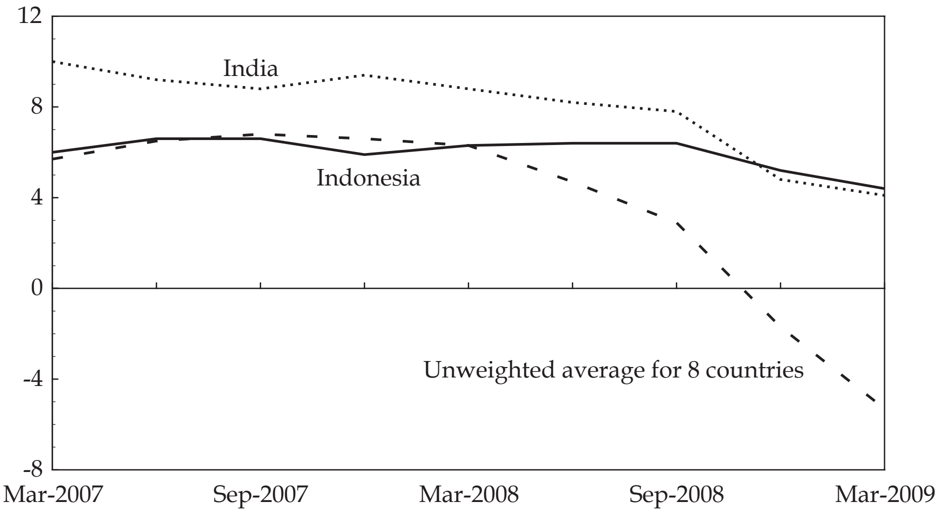
TABLE 2 *Crisis Comparisons*[a]

	Asian Financial Crisis (1997–98)	Global Financial Crisis (2008–09)
Lowest GDP growth rate (year-on-year % p.a.)	–18.3	4.4
(quarter)	*Dec-98*	*Mar-09*
Peak rupiah depreciation (%)	83.6	25.5
(period)	*Jun-97 – Jun-98*	*Feb-08 – Nov-08*
Peak CPI inflation		
(year-on-year % p.a.)	82.6	12.1
(month)	*Sep-98*	*Sep-08*
Peak SBI 30-day rate (% p.a.)	70.4	11.2
(month)	*Aug-98*	*Nov-08*
Peak inter-bank borrowing 7-day rate (% p.a.)	95.0	10.8
(month)	*Jul-98*	*Dec-08*
Decline in foreign reserves		
($ billion)	12.3	10.4
(%)	42.7	17.1
(period)	*Jun-97 – Feb-98*	*Jul-08–Nov-08*
Decline in stock market capitalisation (%)		
(rupiah value)	52.2	55.1
(period)	*Mar-98 – Sep-98*	*Jul-08 – Nov-08*
($ value)	88.1	56.3
(period)	*Jun-97 – Jun-98*	*Jul-08 – Feb-09*

[a] The table is based on end-of-month data, except for GDP growth, which is based on quarterly data. SBI = Bank Indonesia Certificate; CPI = consumer price index.

Source: CEIC Asia Database.

FIGURE 1 *Indonesia's GDP Growth in Regional Perspective*[a] *(% p.a.)*



[a] The eight comparator economies are: South Korea, Taiwan, Hong Kong, Vietnam, the Philippines, Thailand, Malaysia and Singapore.

Source: CEIC Asia Database.

Growth

As the GFC began to worsen in the second half of 2008, it was very easy to imagine Indonesia returning to conditions of economic upheaval similar to those experienced a decade earlier – a devastating contraction in output, a dramatic surge in inflation, and an even more dramatic reduction in the external value of the rupiah. The AFC created so much turmoil that it resulted in the downfall of the governing regime, just like the financial crisis of the mid-1960s. As it has turned out, however, Indonesia has been weathering the GFC remarkably well. Indeed, it, along with China and India, has been one of very few stand-out performers within the region.

Through the first quarter of 2008, Indonesia's GDP growth rate was less than that of India, but very similar to the (unweighted) average for the eight other comparator economies shown in figure 1.[1] India's growth slowed throughout 2008 – especially in the fourth quarter – to draw level with Indonesia's, while growth in the other countries fell away dramatically, especially in Q4 2008 and Q1 2009. The deceleration of Indonesia's growth in these two quarters was almost insignificant by comparison. Singapore and Taiwan registered year-on-year declines of over 10% in the year to Q1 2009, while Thailand, Malaysia and Hong Kong did little better, contracting by 6–8%. To some extent Indonesia's superior performance – in stark contrast to 1998 – reflects its much smaller exposure to international trade (Gunawan and Siregar 2009: 11), but there is little doubt that the monetary and fiscal authorities learned a great deal from that earlier, bitter experience. Nor have they had to contend with ill-considered advice from the international financial institutions which, it will be recalled, argued vociferously at that time for fiscal

1 China is not included in figure 1, because comparable data for it were not available.

TABLE 3a *Components of GDP Growth*
(2000 prices; % year on year)

	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
Gross domestic product	**5.8**	**6.2**	**6.4**	**6.4**	**5.2**	**4.4**
GDP excl. petroleum & gas	6.5	6.7	6.9	6.9	5.6	4.8
By expenditure						
Private consumption	5.5	5.7	5.5	5.3	4.8	5.8
Government consumption	2.0	3.6	5.3	14.1	16.4	19.2
Investment	12.4	13.7	12.0	12.2	9.1	3.5
Of which:						
Building	9.9	8.0	8.1	7.6	5.7	6.3
Machinery & equipment	30.5	39.6	24.3	24.5	15.7	–8.6
Transport	2.4	23.4	27.8	40.6	37.0	10.1
Exports	7.9	13.6	12.4	10.6	1.8	–19.1
Imports	13.9	18.0	16.1	11.0	–3.5	–24.1
By sector						
Tradables	*2.3*	*3.8*	*3.6*	*3.7*	*2.6*	*2.6*
Agriculture, livestock, forestry & fisheries	2.0	6.3	4.8	3.4	4.7	4.8
Mining & quarrying	–2.0	–1.7	–0.5	2.1	2.1	2.2
Manufacturing industries	3.8	4.3	4.2	4.3	1.8	1.6
Excl. petroleum & gas	4.6	4.6	4.6	4.9	2.1	1.9
Non-tradables	*9.4*	*8.8*	*9.3*	*9.2*	*7.6*	*6.1*
Electricity, gas & water supply	11.6	12.3	11.8	10.4	9.3	11.4
Construction	9.9	8.0	8.1	7.6	5.7	6.3
Trade, hotels & restaurants	8.6	6.9	8.1	8.4	5.6	0.6
Transport	5.4	10.0	3.9	–1.1	–1.0	1.0
Communications	25.5	27.1	31.4	33.3	32.9	30.9
Financial, rental & business services	8.6	8.3	8.7	8.6	7.4	6.3
Services	7.2	5.9	6.7	7.2	6.0	6.8

austerity rather than stimulus, and virtually ignored the importance of monetary policy.

Nevertheless, there is no room for complacency. The year-on-year (y-o-y) GDP growth rate declined from 6.4% to 4.4% over the two quarters to Q1 2009 (table 3a), despite household consumption accelerating slightly to 5.8%. The GDP deceleration was almost entirely attributable to a much more severe decline in investment spending, reflecting the sudden emergence of heightened caution on the part of the business community. The year-on-year growth rate of investment fell dramatically from 12.2% to only 3.5% during the same period, and if we focus on the change in seasonally adjusted investment spending in each quarter, the decline is considerably more alarming, from 2.0% to –0.8% (table 3b). Within

TABLE 3b *Components of GDP Growth*
(2000 prices; seasonally adjusted; % quarter on quarter)

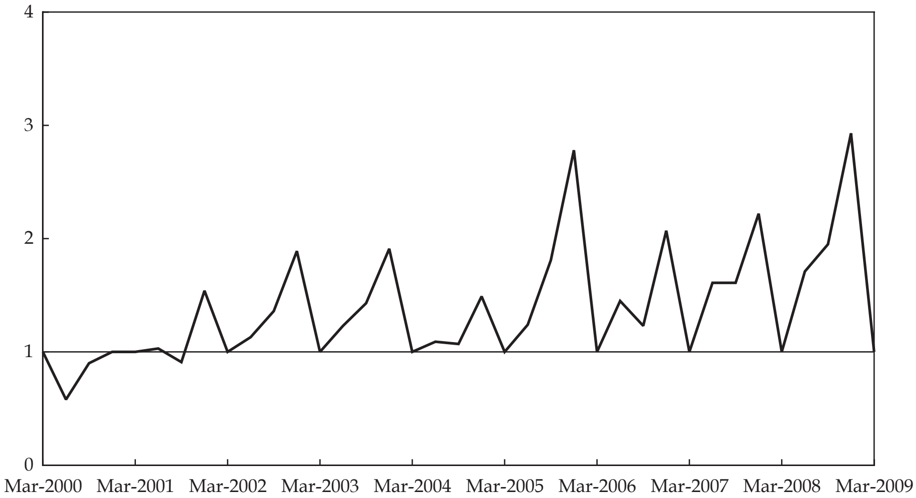
	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
Gross domestic product	**1.6**	**1.7**	**1.3**	**1.3**	**1.0**	**1.0**
GDP excl. petroleum & gas	1.7	1.7	1.4	1.4	1.1	1.1
By expenditure						
Private consumption	1.6	1.1	1.1	1.4	1.2	2.0
Government consumption	0.7	2.3	3.4	5.1	4.3	4.7
Not seasonally adjusted	*23.2*	*–30.5*	*26.1*	*5.6*	*25.6*	*–28.7*
Investment	2.0	4.1	2.0	2.0	0.7	–0.8
Of which:						
Building	3.4	0.5	1.8	1.6	1.6	1.4
Machinery & equipment	–1.0	12.7	1.8	9.6	–8.0	–10.9
Transport	8.7	4.3	10.4	9.9	5.7	–16.6
Exports	4.6	5.4	1.0	–0.7	–3.8	–16.3
Imports	5.6	7.0	1.4	–4.2	–8.3	–13.9
By sector						
Tradables	*0.7*	*1.0*	*0.7*	*0.8*	*0.7*	*0.8*
Agriculture, livestock, forestry & fisheries	0.7	0.9	1.6	1.1	1.0	1.3
Mining & quarrying	–0.3	0.0	0.6	1.0	–0.1	–0.1
Manufacturing industries	1.1	1.1	0.8	1.0	–0.9	0.8
Excl. petroleum & gas	1.1	1.2	1.2	1.3	–1.8	1.2
Non-tradables	*2.7*	*2.0*	*2.2*	*1.8*	*1.2*	*0.8*
Electricity, gas & water supply	2.9	2.6	2.5	2.4	2.4	2.4
Construction	3.4	0.5	1.8	1.6	1.6	1.4
Trade, hotels & restaurants	2.1	0.9	2.4	2.7	–0.5	–3.8
Transport	1.3	0.4	0.0	–0.2	0.3	0.3
Communications	7.4	7.0	9.0	6.5	7.0	5.4
Financial, rental & business services	3.1	1.9	1.5	1.8	2.0	0.8
Services	2.9	0.7	2.2	1.2	1.8	1.5

Source: CEIC Asia Database.

the investment category, the quarter-on-quarter (q-o-q) declines in spending on machinery and equipment (10.9%) and on transport (16.6%) in Q1 2009 have been especially severe. Reflecting the world-wide contraction in international trade, there has been a dramatic decline in the growth of exports over the last four quarters, particularly in Q1 2009, which saw a reduction (q-o-q) of over 16%. But the impact of this on Indonesia's output has been offset by even larger reductions in imports – of particular significance given the high import content of many of Indonesia's manufactured exports.

At first glance, the year-on-year data suggest that fiscal policy has been an important contributor to the maintenance of reasonably high economic growth, with a steady increase in the growth rate of government non-investment spending

FIGURE 2 *Volatility of Government Expenditures on Goods and Services (ratio of the current quarter to the March quarter in the same fiscal year)*



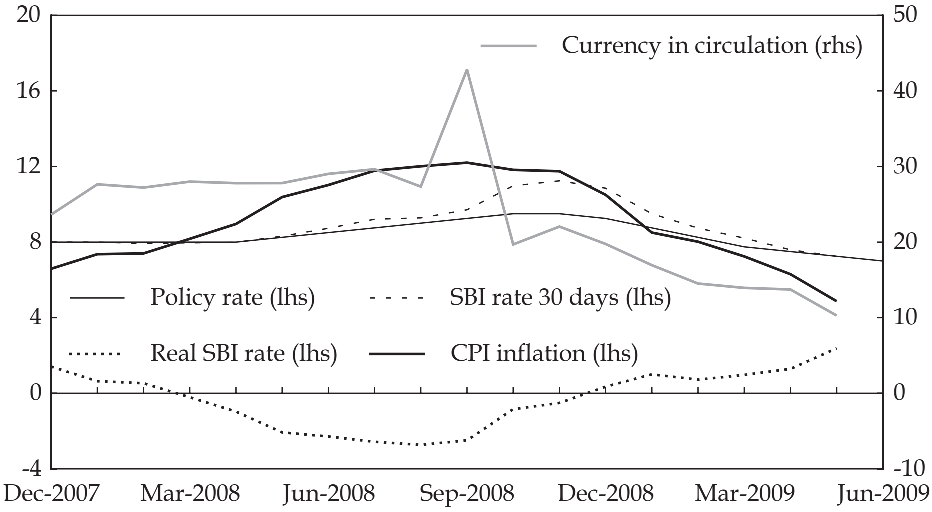
Source: CEIC Asia Database.

over the last three quarters, to over 19% (table 3a). But the quarter-on-quarter data show that a much better outcome could have been achieved if only the budgetary process had been improved so as to spread annual spending much more evenly over the fiscal year. There is extraordinary volatility of government expenditure on goods and services, such that spending in the early part of each year is far smaller than that in the latter part. For each year of the last decade, figure 2 shows the ratio of such spending in each quarter relative to the first quarter; for the last few years, first-quarter spending has been as low as one-third to one-half of that in the fourth quarter. Continuation of this pattern into 2009 resulted in a decline of almost 29% in such spending in Q1 2009, at precisely the time when continued fiscal stimulus would have been very valuable. Looking on the bright side, however, it can be expected that government spending will indeed provide a stimulus for the rest of 2009.

It may be noted in passing that the fiscal stimulus package reported by Gunawan and Siregar (2009: 31–2) has been slightly strengthened, by increasing proposed additional expenditure on infrastructure from Rp 10.2 trillion to Rp 12.2 trillion. This is expected to result in a budget deficit of Rp 139.5 trillion, or 2.5% of GDP (MOF 2009). By implementing this package the government is hoping to keep GDP growth within the range 4.0–4.5% in 2009. The increase in the deficit resulting from this package is to be financed by unspent funds from the 2008 budget and additional loans, including stand-by loans, from bilateral and multilateral sources.

Turning to sectoral performance, we note that growth of the tradables sectors in aggregate has slowed only slightly in year-on-year terms by comparison with that of non-tradables, although the latter continued to grow more than twice as fast (table 3a). The picture is quite different, however, if we focus on the quarter-on-quarter growth rates of seasonally adjusted output: by Q1 2009, non-tradables growth had fallen back to be equal to that of tradables (table 3b). Three main explanations suggest themselves. First, despite the dramatic reduction in

FIGURE 3 *Monetary Policy Indicators and Inflation (% p.a.)*



[a] The real SBI (Bank Indonesia Certificate) rate is the nominal rate less the contemporaneous rate of CPI (consumer price index) inflation.

Source: CEIC Asia Database.

exports, manufacturing output growth remained positive except in Q4 2008, suggesting that there has been a switch in domestic demand toward import substitutes and away from imports. Second, the agriculture, livestock, forestry and fisheries sector has proven resilient to the GFC – much more so than manufacturing – and this has helped to maintain tradables sector growth overall. Third, there has been a noticeable decline in the output of the trade, hotels and restaurants sector – especially severe in Q1 2009. Moreover, although the communications sub-sector continues to grow very rapidly, its quarterly growth rate has declined significantly, from 9.0% to 5.4%, over the three most recent quarters.

Inflation and monetary policy

The downward trend in consumer price inflation that first became evident at the end of 2008 continued through May 2009, by which time it was just below 5% p.a. – less than half the peak rate recorded in Q4 2008 (figure 3). Evidently the implementation of monetary policy has been considerably more successful in 2009 than it was in 2008. Bank Indonesia (BI) had been slow to respond to increasing inflation during 2008, and when it finally did begin to respond from May, the modest increases in interest rates it introduced were insufficient to slow the rate of growth of base money from an average of around 28% per annum, which is far too high to be consistent with sustained low inflation.[2] Inflation continued to accelerate. It

2 Figure 3 focuses on the growth of currency in circulation (by far the most important component of base money), since this measure is not distorted by changes in the banks' reserve requirements introduced in October 2008.

was not until the fourth quarter of 2008 that BI moved more aggressively to slow the growth of its monetary liabilities.

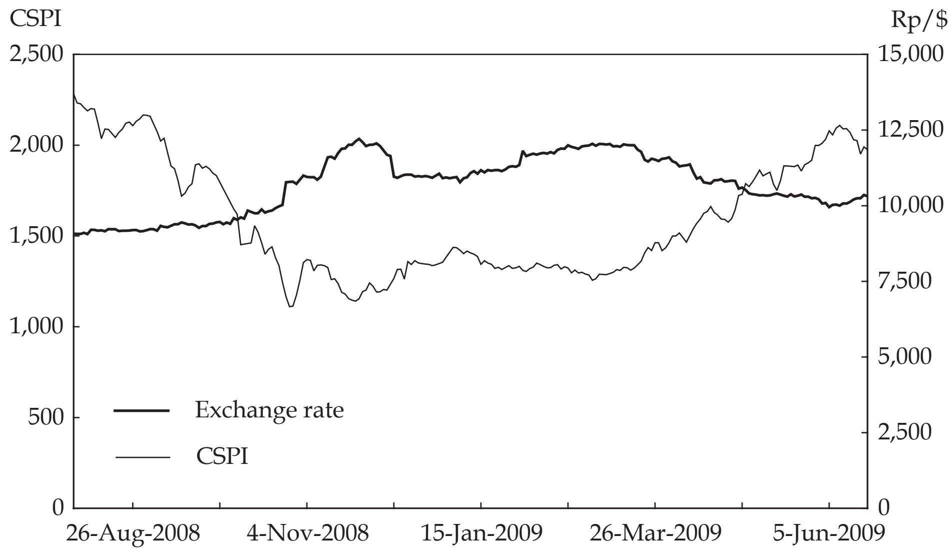
To achieve this end it would be necessary for BI to increase more significantly the rate offered on its certificates (SBIs), but this created a political problem. Central banks are almost inevitably criticised when interest rates are on the rise. In this case, the economy was already slowing down because of the GFC, and this resulted in widespread calls for rate reductions. BI's solution to this problem was to turn its 'policy rate' into a fiction. Whereas in the past the policy rate had been the market yield on its one-month SBIs, from February 2008 the announced policy rate was de-coupled from the SBI rate (and, indeed, from any interest rate observable in the market) – without any announcement or explanation, so far as we are aware. At first the gap between the policy rate and the one-month SBI rate was very small, but in October 2008 it widened to almost 1.5%, increasing to about 1.75% in November. By making SBIs a more attractive investment, BI was able to reduce the rate of monetary expansion to only about 20% by October, without having to announce any significant tightening of monetary policy. Indeed, it sought to create the opposite impression, purporting to adopt a more expansionary policy by reducing the commercial banks' minimum reserve requirements in October, and by bringing an end in November to the series of small increases in its (fictitious) policy rate (25 basis points per month for the six months from May).

By tightening monetary conditions while purporting to move in the opposite direction, BI was able to put an end to the acceleration in inflation without generating significant protest. And once inflation began to decline significantly, nominal interest rates could be reduced without reducing the attractiveness of SBIs to investors. The real rates of return on SBIs recorded in the middle of 2008 were negative, but they turned positive in 2009, and have continued to increase, because inflation has declined more rapidly than the nominal SBI rate. The political imperative to maintain a fictional policy rate has disappeared, so that the policy rate is now once again identical with the one-month SBI rate. The experience of the last nine months or so has demonstrated – as was the case in 1998, when Indonesia began its recovery from the AFC – that it is perfectly feasible to bring high inflation to an end by tightening monetary policy, without having any significant negative impact on GDP growth (although of course it is possible that growth might have been higher still under a more expansionary monetary stance).

Financial markets

Since Indonesia's stock market and foreign exchange market are integrated with the global financial system, it is not surprising that the GFC has had a noticeable impact on the financial sector. It has come as a pleasant surprise, however, that this impact has been quite restrained – especially by comparison with the previous crisis in 1997–98. After severe declines in the fourth quarter of 2008, both stock prices and the currency held relatively steady through Q1 2009 (figure 4). In the next two months, however, previous losses in both markets began to be reversed. Stock prices increased by about 50% from mid-March through mid-June, while the rupiah appreciated by about 17%. The rapid increase in stock prices would appear to reflect a strong upswing in investor confidence, and this provides some grounds for optimism in relation to Indonesia's near-term economic outlook. We may speculate that investors decided that the surge of

FIGURE 4 *Composite Stock Price Index (CSPI) and Exchange Rate (Rp/$)*

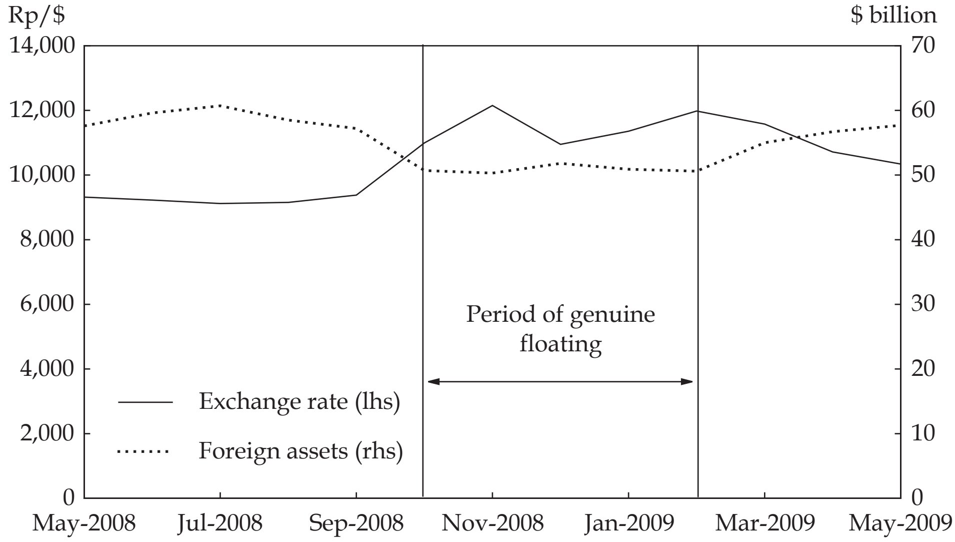


Sources: Indonesia Stock Exchange; Pacific Exchange Rate Service.

pessimism that overcame the markets toward the end of 2008 had been excessive; alternatively, they may have been surprised by the confidence and competence with which Indonesia's monetary and fiscal authorities responded to the impact of the GFC. The strengthening of the currency is further evidence of the willingness of investors to increase or restore their exposure to Indonesian assets, not least because of the firmness of monetary policy and the corresponding decline in the inflation rate.

These heartening outcomes in the financial markets provide useful background on the conduct of exchange rate policy and on the appropriate level for Indonesia's international reserves. Although the central bank 'floated' the rupiah at the outset of the Asian financial crisis in 1997, it has never been able to bring itself to allow a genuine float in which the value of the currency is determined solely by market forces. This can be seen by observing the level of BI's foreign exchange reserves, approximated by the level of foreign assets in figure 5. In June and July 2008 BI's intervention in the foreign exchange market involved adding to its reserves so as to lean against the tendency for rupiah appreciation. In the next three months, however, with the GFC looming, it began selling off its reserves in an attempt to limit depreciation; during this period its foreign assets fell from almost $61 billion to below $51 billion, but even this was not enough to prevent the price of dollars rising by over 20%. Rather than continue to fight market forces, BI then changed its policy to something approximating a genuine free float. It largely withdrew from the market, allowing the currency to depreciate further to a little over Rp 12,000/$. With BI sitting on the sidelines for the next three months, the exchange rate oscillated for the most part within the range Rp 11,000–12,000/$. Subsequently, however, the urge to intervene again took over, with BI returning to the market as a buyer in order to restrain – although not prevent – appreciation of the currency back toward the Rp 10,000/$ level.

FIGURE 5 *Exchange Rate Policy*



Source: CEIC Asia Database.

Undoubtedly there is strong political pressure on the central bank to manage the exchange rate. The president himself 'ordered' the governor of BI to guard against further depreciation early in February 2009 after the exchange rate hit Rp 11,813/$, although conceding that 'the rupiah is the domain of [the legally independent] Bank Indonesia, and not the government' (Maulia 2009). In the event, conditions in the foreign exchange market began to improve, so the governor was not forced to make a choice between his policy instincts and following the president's advice.

At other times, however, BI itself makes clear its preparedness to intervene in the market when circumstances dictate. It often draws attention to its success in building up its international reserves – the only purpose of which, of course, is to sell into the market to prevent depreciation (or to persuade potential speculators that it could do so on a scale so large as to defeat them); its withdrawal from the market in November 2008 was precisely to avoid a continuing loss of reserves. Even though reserves still amounted to over $50 billion at the time, this suggests that it feared it would quickly run out of reserves otherwise. This raises an interesting question as to how much would be adequate for such intervention. BI itself does not regard $60 billion as adequate; a figure of $80 billion has been suggested by unnamed analysts (Suharmoko 2009), but the basis for this seems arbitrary. By contrast, very few seem to argue that current reserves are sufficient – much less that they should be reduced to a low level.

Such a view is worth considering, however. Moving to a low level of reserves implies moving to a much more genuinely floating exchange rate. The experience of the three months through February 2009 shows how this would work in practice. At times when there is a loss of confidence in the rupiah and a corresponding outflow of capital, the rupiah depreciates in the absence of sales of foreign exchange by the central bank. The process is not open-ended, however. The more the price of dollars rises, the less reason there is to speculate: after all, speculation is the attempt to arbitrage between the low rate of the present and the higher rate of the future, and once the spot (current) rate moves close to the expected future rate, the basis for further speculation no longer exists. Thus, with BI's withdrawal from the market in November 2008 the momentum of depreciation quickly dissipated. The reality is that what usually drives currency speculation is central bank intervention – and the belief on the part of market participants that ultimately this intervention will be unsuccessful.

In opposition to this view it might be argued that the experience of 1997–98 after BI 'floated' the rupiah was quite the opposite. At that time, withdrawal of BI from the foreign exchange market saw the exchange rate leap from less than Rp 2,500/$ to over Rp 15,000/$. The explanation for this is quite straightforward, however. On that earlier occasion, monetary policy was out of control. BI was lending massively to the banking system in its capacity as lender of last resort, and thus inadvertently financing the speculation against its own currency. By contrast, in late 2008 and early 2009, the rate of growth of BI's monetary liabilities was relatively low and declining, not high and accelerating. In short, the perils of floating the exchange rate appear to be greatly exaggerated, provided the float is accompanied by sound monetary policy.

There is another argument against accumulating a high level of international reserves. Purchasing dollars involves BI in injecting additional rupiah into circulation; if not offset, this is inflationary. To offset this effect it is necessary to issue an equivalent quantity of SBIs; BI's investment in higher international reserves is thus financed by borrowing from the public in this form. The implication is that in aggregate, entities outside BI must be 'going long' in rupiah – in effect, substituting rupiah-denominated liabilities of BI in their balance sheets for dollar-denominated liabilities of the US government. This means, roughly speaking, that the private sector becomes heavily exposed to the rupiah as a result of BI building up its reserves. Paradoxically, in building up its war chest to fight future speculation against the rupiah, the central bank causes private sector entities in aggregate to take on an exchange rate risk that is likely to precipitate precisely that speculation at any time there is some adverse shock to the economy. By March 2009, BI had issued $34 billion of SBIs in order to finance its heavy investment in foreign exchange assets – implying that the private sector collectively was exposed to the same extent to the danger of rupiah depreciation.

Banking

Several indicators continue to suggest that Indonesia's banking sector has been far less affected by the GFC than those of many other countries, and that the dangers noted by Gunawan and Siregar (2009: 24–5) have yet to materialise. There has been little indication of bank customers – either borrowers or depositors – shifting between rupiah- and dollar-denominated instruments. This suggests a reasonably high degree of confidence that the exchange rate is unlikely to change greatly in the near future. The average level of non-performing loans increased modestly from the post-AFC low of 3.8% recorded in December 2008 to 4.5% in March 2009, but despite this the average capital adequacy ratio increased from 16.8% to 18.0% – over twice the regulatory minimum of 8% – during the same period.[3]

3 All data in this section are from CEIC Asia Database.

Bank interest rates peaked at the end of 2008, and then began to follow declining inflation and SBI rates. The average commercial bank rate for working capital loans declined slightly (by 22 basis points) through March 2009, while the average one-month time-deposit rate fell much more rapidly (by 133 basis points), such that the gap between them increased from about 4.5% to 5.6%. As an indicator of the gross margin on rupiah lending, this augurs well for banks' profitability (and thus their ability to strengthen their capital base). Lending growth rates continued to decline from the unsustainably high peak of almost 40% per annum recorded in October 2008 to about 26% in March, as banks applied much more conservative lending practices in order to strengthen their balance sheets (World Bank 2009). On the other hand, deposit growth continued to accelerate from a low of only 10% in August 2008 to over 21% in March. As a result, the loans-to-deposits ratio continued to decline from the peak of 79% recorded in August 2008 to 73% in March.

EVALUATION OF ECONOMIC PROGRESS UNDER SBY–KALLA

Of the three presidential candidates for election in July 2009, one (Megawati) is a former president, another (SBY) the incumbent president and the third (Jusuf Kalla) the incumbent vice president. Since this survey is to be published just as SBY nears the completion of his first term in office, we take this opportunity to undertake a brief evaluation of Indonesia's economic progress under his leadership, relative both to his own election campaign promises in 2004 and to what his predecessor was able to achieve, albeit during a shorter period in office. We begin by comparing SBY's achievements with his campaign promises, as summarised in table 4.

The SBY regime managed to increase the growth rate of the economy somewhat. However, it is unlikely that SBY's 2009 target of 7.6% – a little higher than the average recorded during Soeharto's period in office – would have been achieved even in the absence of the emerging GFC. As it was, output growth decelerated during SBY's last two years in office. Performance in relation to promises concerning

TABLE 4 *SBY's Achievements Relative to Key Economic Targets*

Target	Achievement	Comment
GDP growth to rise from 5.0% in 2004 to 7.6% by 2009	Growth peaked at 6.3% in 2007 before falling to 6.1% in calendar 2008, and then to 4.4% year-on-year in Q1 2009	GDP growth rate rose steadily for three years but was then adversely affected by the global financial crisis
Open unemployment rate to fall by about half, from 9.9% in 2004 to 5.1% by 2009	Unemployment rate rose to 11.2% in 2005 and then fell steadily to 8.4% in 2008	Unemployment rate was still well above the target by 2008, and seemed likely to rise in 2009
Poverty rate to fall by about half, from 16.7% in 2004 to 8.2% by 2009	Poverty rate increased to 17.8% in 2006 and then fell back to 15.4% in 2008	Poverty rate had declined a little by 2008, but remained far above the 2009 target

Source: GOI (2005); Bappenas (2008); Kuncoro (2009b); CEIC Asia Database.

TABLE 5 *Key Economic and Social Indicators under Successive Administrations*

	Megawati–Haz				SBY–Kalla				
	2002	2003	2004	2002–04[a]	2005	2006	2007	2008	2005–08[a]
Growth									
GDP (% p.a.)	4.5	4.8	5.0	4.8	5.7	5.5	6.3	6.1	5.9
Investment (% p.a.)	4.7	0.6	14.7	6.7	10.9	2.6	9.4	11.7	8.6
Investment : GDP (%)	20.4	19.6	21.4	20.5	22.5	21.9	22.5	23.7	22.7
Poverty (%)	18.2	17.4	16.7	17.4	16.0	17.8	16.6	15.4	16.5
(overall change %)				*–1.5*					*–0.6*
Unemployment (%)	9.1	9.5	9.9	9.5	11.2	10.3	9.1	8.4	9.8
(overall change %)				*0.8*					*–2.9*

[a] Annual averages.

Source: Coordinating Ministry for Economic Affairs (2009); CEIC Asia Database.

the unemployment and poverty rates is still less encouraging. SBY's campaign promises to cut both rates by about half by the end of his first term in office have proven quite unrealistic – as any knowledgeable observer would have predicted. Both rates have declined a little relative to their starting points, but by nowhere near 50%.

It is worth noting that poverty has fallen only slightly despite huge increases in the government budget overall, and even larger increases in spending on poverty alleviation. Between 2005 and 2008, total budget spending rose by 215% in nominal terms, while the budget for poverty alleviation increased by 283% (Kuncoro 2009a). That said, much of this poverty-oriented expenditure has been in the form of subsidies designed to offset the impact of huge increases in world oil prices; in the absence of this, poverty may well have increased.

Table 5 compares economic performance under the SBY–Kalla administration with the more realistic benchmark of performance under the previous regime, led by Megawati Soekarnoputri and her vice president, Hamzah Haz. For the most part the picture is one of continuity rather than significant change. Most fundamentally, both administrations managed to increase the rate of economic growth moderately – by about half a percentage point – during their first three years in office, and the slight decline in growth during SBY's fourth year can reasonably be attributed to external circumstances. The data on the growth of fixed investment expenditure are more difficult to interpret because they are far more volatile. Nevertheless there is a significant difference in the average rates of growth under the two regimes, with the rate under SBY almost two percentage points higher. Thus although the ratio of investment to GDP rose somewhat during both administrations, it was more than 2 percentage points higher by 2008 than in the last year of Megawati's presidency. To some extent, investment in the earlier period was still recovering from the trauma of the AFC, however, and to some extent also the SBY regime benefited from improvements in the business climate for which the foundation was laid during the Megawati period.

TABLE 6 *Measures of Income Inequality Under Successive Administrations*[a]

	Megawati–Haz			SBY–Kalla		
	2002	2003	2004	2005	2006	2007
Share of national income (%)						
Cohort						
Lowest 40%	20.9	20.6	20.8	18.8	19.8	19.1
Middle 40%	36.9	37.1	37.1	36.4	38.1	36.1
Highest 20%	42.2	42.3	42.1	44.8	42.2	44.8
Gini ratio	0.33	0.32	0.32	0.36	0.33	0.37

[a] Data in the table are based on consumption, as a proxy for income.

Source: BPS-Statistics Indonesia, 'Selected indicators [of] consumption, Indonesia 1999, 2002–2006', available at <http://www.bps.go.id/sector/consumpexp/table8.shtml>); BI (2008: 42).

So far as poverty is concerned, the long-term trend is downward, so it is not surprising that the average figure during the SBY period is somewhat lower. A better indicator of relative performance is the *reduction* in the incidence of poverty, and on this measure, the Megawati regime performed better, with poverty declining by about 1.5 percentage points over three years, while during the four years of the SBY presidency poverty fell by only 0.6 percentage points. The same cannot be said for unemployment. Whereas average levels were much the same under both regimes, unemployment had declined by about 2.9 percentage points by 2008 from the level SBY inherited from Megawati, whereas it had *increased* by 0.8 percentage points by 2004 from the levels Megawati had inherited from her predecessor.

All in all, however, these differences are not particularly great, so it is not possible to say on the basis of these data that one regime was clearly more successful than the other. This is perhaps not surprising, because there has not been any dramatic difference in the economic policies followed by the two administrations. In turn, this consistency of economic policy making reflects continuity in the key economic ministry, the Department of Finance. Megawati's Minister of Finance was Dr Boediono, who was to take up the position of Coordinating Minister for Economic Affairs in SBY's first cabinet. His comrade-in-arms, Dr Sri Mulyani Indrawati, has also been a key economic policy maker under SBY, first in the planning agency, then in the finance ministry, and subsequently also as Coordinating Minister for Economic Affairs.

Income inequality and social justice remain hot issues, and are an important element of widespread criticism (discussed in some detail below) of the so-called 'neo-liberal' policies of the SBY administration. Table 6 presents two measures of change in income inequality in the period 2002–07 (the period encompassing the Megawati regime and the first three years of the SBY regime). The top panel of the table shows changes in the share of national income of the poorest 40%, the middle 40%, and the richest 20% of the population. The share of the poorest cohort remained fairly steady during Megawati's period in office, but declined a little in the next three years. Mirroring this, the share of the richest cohort also remained steady during the first three years but then increased a little in the latter period. The middle group's share remained much the same in 2007 as it had been in 2002. On this evidence, the distribution of income has become somewhat more skewed. This seems to be confirmed by estimates of the Gini ratio (the most common indicator of income inequality), the average value of which has been a little higher over this period.

The extent to which policy makers should concern themselves with income inequality is mainly a matter for political judgment. There are certainly numerous individuals and groups who find increasing inequality objectionable, but it needs to be remembered that the incidence of absolute poverty has been declining, albeit gradually. In other words, the poorest 10–20% of the population have been sharing in the fruits of Indonesia's economic growth, notwithstanding the modest increase in inequality. It is by no means clear that the poor themselves are particularly concerned about the incomes of the wealthy, provided their own incomes are increasing. Countless poor people choose to migrate from rural areas to big cities – where the distribution of income is presumably much more unequal – in search of higher incomes for themselves. This would seem to suggest that their primary focus is their absolute, not relative, income.

ELECTION DEBATES ON ECONOMIC POLICY

A feature of the 2009 presidential election campaign has been the emergence of 'neo-liberalism' as an issue for debate, not only among academics and politicians, but also among the public at large. Attaching the pejorative label 'neo-liberal' to one's opponent has become an important tactic in the campaign. To a considerable extent this is disappointing because, in the absence of a widespread and common understanding of what is meant by the term, its use in this manner serves merely as a hindrance to reasoned consideration of important policy issues (Hartwich 2009). Nevertheless, the debate is interesting and important in so far as it reflects a fundamental issue over which Indonesians have struggled since independence.

There is no universally accepted definition of neo-liberal economics, and so there is no single set of policy approaches that is unambiguously 'neo-liberal'. It would appear, however, that the debate is fundamentally about the extent to which market mechanisms should be permitted to determine economic outcomes free of government intervention. Thus in Indonesia (as in most, if not all, other economies) we can observe a variety of preferred approaches to economic policy, ranging from a preference for free markets in most circumstances to a preference for high levels of government intervention in markets in most circumstances. The key phrase here is 'in most circumstances'. So far as we are aware, nobody advocates no role at all for government, nor does anybody advocate no role at all for markets. In the practical world of policy making, the need is to choose a position somewhere along the spectrum between these two extremes.

For the sake of brevity, however, let us refer here to those located toward the free-market end of the spectrum as 'neo-liberals', and to those located toward the opposite end as 'interventionists'. Whereas much of the debate has suggested a difference of *objectives* between these two groups, in fact the differences are really about *how to achieve* those objectives. Both groups, we believe, are fundamentally concerned to improve the material well-being of Indonesian citizens, with an especial emphasis on the poor. Neo-liberals argue that this objective can best be furthered not by policies that are 'pro-business', as their opponents often assert, but rather by policies that aim to maximise growth of the economy. Many neo-liberals are also in favour of supplementing such policies with at least a few others that will redistribute income in favour of the poor, such as heavy subsidies to education and health services, and direct cash transfers. In particular, they argue that growth is likely to be maximised by policies that limit the extent of – but most definitely do not preclude – government intervention. Interventionists, on the other hand, put much less emphasis on growth, and correspondingly more on direct interventions of a kind they believe will be beneficial to the poor – such as increases in minimum wages, cheap loans for farmers and small businesses, restrictions on rice imports to assist rice farmers, and subsidies to the consumption of fuel and electricity.

A key philosophical aspect of neo-liberalism is the concept of consumer sovereignty: the notion that most adults know best what they want, and that they should be left to pursue their own objectives rather than be encouraged to rely too heavily on governments to act on their behalf. Specifically, they should be free to participate in markets where they can sell their labour, seek a return on their capital and use their incomes to purchase the goods and services they desire. One aspect of reliance on markets is freedom to carry out transactions across international borders, and neo-liberals tend to favour low barriers to international trade and capital flows, arguing that in Indonesia such policies lead to faster growth and reductions in poverty. Participation in free markets necessarily involves competition with other buyers and sellers, and neo-liberals generally argue that such markets are very effective in enabling individuals to pursue their own self-interest. On the other hand, they are also well aware that free markets are not capable of generating socially optimal outcomes in the absence of government intervention.

But in the neo-liberal view such intervention is limited to only a few major areas of activity. Most obviously, governments need to provide public goods, such as protection from external threats (military and other) and protection against internal threats to individuals' personal safety and to the security of private property. Free markets do not work unless people can enjoy the fruits of their labour, which requires protection against theft and fraud, for example. Likewise, neo-liberals argue, governments have an important role to play in implementing policies to deal with externalities (such as pollution) and natural monopolies (industries in which the largest firm can drive out all competitors by virtue of achieving superior economies of scale); they also have a role in designing policies for the exploitation of natural resources that maximise the benefit to the general public. It is often in these areas – where *both* groups see the need for intervention – that important differences of opinion arise as to the most appropriate policies.

The interventionist solution to the natural monopoly problem, for example, is to set up a state-owned enterprise (SOE). But neo-liberals point to the record of state enterprises in Indonesia, arguing that it is one of inefficiency and corruption – so much so that this cure is typically worse than the disease. For this reason they are keen to explore alternative, more market-oriented, solutions to the problem, relying on appropriately regulated private firms instead of SOEs. In other cases where there is no natural monopoly rationale for state ownership of an enterprise, neo-liberals tend to argue in favour of privatisation of SOEs. This is a policy that meets with widespread opposition in Indonesia (and in many other countries), especially if the buyer is foreign, but it often seems to be misconstrued as giving away state assets rather than converting them to cash that can be put to other uses. Neo-liberals argue that SOEs are generally more poorly managed than privately owned enterprises, and therefore the Indonesian people could achieve a return on cash generated by the sale of such enterprises that is better than the low returns – and, very frequently, considerable losses – those enterprises have typically generated in the past.

From a historical perspective, the broad thrust of economic policy in Indonesia has swung toward one or other of these extremes at different times. The Old Order (Soekarno) regime in its parliamentary democracy period (1950–57) could be described as a democratic liberal system that relied relatively more on the free market mechanism, whereas its later years (1958–66) saw the introduction of a command system in which government intervention in markets proliferated. Neither approach was particularly successful, so the New Order (Soeharto) regime (1966–98) purported to follow a middle way, termed Pancasila economics – Pancasila being the five basic principles on which the Indonesian state is founded.[4] Especially in relation to macroeconomic policy making, Pancasila economics was to some extent inspired by Keynesianism, which presented an optimistic view of the extent to which governments could stabilise and fine-tune the markets.

At the microeconomic level, however, it is not possible to classify the policy approach of the Soeharto era as either neo-liberal or interventionist. On the one hand, there was increasing reliance on private rather than state-owned enterprise, which fits the neo-liberal approach. But on the other there was heavy intervention in the markets, very often designed to create special privileges for the president's cronies and family members. This was anathema to neo-liberals and also to those interventionists who wanted to see interventions in favour of the poor rather than the elite.

Just as the relative weights given to the market mechanism and government intervention changed over time during the Old Order, so economic policy during the New Order also fluctuated. It has often been argued that more market-oriented policies were followed when external circumstances were tough, and more interventionist policies when conditions were more favourable, as summarised in the aphorism 'good times mean bad policies and bad times mean good policies' (where 'good' is equated with market-oriented) (Fane 1996; Widodo 2008). Thus the large increases in government revenue during the oil booms between 1973 and 1982 were accompanied by an increasing policy orientation to anti-competitive, protectionist policies, characterised by state-directed or import-substituting industrialisation (Hill 1997). In contrast, rapid declines in government revenue following the collapse of oil prices between 1982 and 1986, and the shock of the AFC in 1997–98, resulted in the implementation of more liberal policies.

In order to obtain financial support from the IMF during the AFC, the government had to agree to various reforms, most of which reflected neo-liberal thinking.

4 Similarly, SBY claims to favour a 'middle way' between neo-liberalism and the interventionist *ekonomi kerakyatan* (people's economy) (Yudhoyono 2009).

These reforms included reduction in energy (fuel and electricity) subsidies, greater openness to international trade and foreign direct investment, and far-reaching privatisation of SOEs. Thus, as Indonesia emerged from the AFC in the late 1990s, it entered the post-Soeharto reform era strongly committed – at least on paper – to a neo-liberal policy agenda. But with the restoration of moderately rapid economic growth, the IMF program soon came to an end, without most of these policies having been fully implemented. In particular, very little has been achieved by way of privatisation or further deregulation of the trade regime or foreign investment. Likewise, during the SBY presidency fuel subsidies have been cut but by no means eliminated, and in recent weeks they have been increasing again along with increases in world oil prices.

Indonesia suffered greatly as a result of the AFC, and its suffering was amplified by poor policy advice from the IMF and other international financial institutions. There is a tendency to equate this advice with neo-liberalism, but many economists who favour free-market policies are also critical of that policy advice. It was undoubtedly a mistake to call for fiscal austerity at precisely the time the private sector was losing its nerve. Moreover, it was extremely short-sighted to push for the effective dismantling of the whole system of cronyism presided over by Soeharto – however desirable that objective was of itself when viewed in the abstract – in the midst of a crisis. But it is not reasonable to jump from these observations to a general recommendation against free-market policies in more normal conditions.

PUBLIC SECTOR ACCOUNTING REFORM

A previous survey reported on three areas of public sector reform in Indonesia: specifically the Ministry of Finance, two local governments in Central Java, and a group of SOEs (McLeod 2008: 196–207). In similar vein, we report here on a different aspect of reform that is also intended to improve the quality of governance over time: namely, the reform of public sector accounting.[5] This reform began in earnest in 2003 with the enactment of a law on state finances (Ginting 2003); that was soon followed by a complementary law on the state treasury (management of state assets and liabilities) and yet another on the auditing of state finances.[6] The essence of these laws was that much greater attention than hitherto was to be paid to transparency and accountability in relation to the use of resources entrusted to the state by the people. They were backed up by the formulation in 2005 of a new set of standards for public sector accounting (SAP, Standar Akuntansi Pemerintahan), the key feature of which was the introduction of accrual accounting, or double-entry accounting, in place of the single-entry accounting system inherited from the Dutch.[7] All governments, at central, provincial and local level, and all of their component parts (other than business enterprises), are now required to

5 This section draws heavily on McLeod and Harun (2009).

6 Laws 17/2003, 1/2004 and 15/2004, respectively.

7 Prior to the reforms, 'the entire financial information and accountability reports were … based on the single-entry recording method and administered in fragmented cash-based bookkeeping systems' (Manao 2008).

prepare financial statements in line with these new standards, and according to fairly tight deadlines.

The key difference between accrual accounting and the cash-based accounting systems traditionally used by governments is the addition of a balance sheet, where the attempt is made to list – and estimate the value of – all assets and liabilities. This approach is far more accurate and reliable. Double-entry book-keeping means that figures can and must be checked for internal consistency. Total credits must equal total debits; if they do not, a mistake has been made and, in principle, can be found and corrected. In a single-entry system, if a particular transaction has not been entered in the accounts for some reason, there will be no indication of this. Moving to a system based on double-entry book-keeping, therefore, is bound to result in a huge improvement in accuracy.

It is often the case that corruption takes the form of diverting funds away from the purchase of fixed assets intended to be used to deliver services to the public. Alternatively, it involves the surreptitious transfer of such assets to the ownership – or at least the control – of particular individuals, without proper compensation to the government. If the financial report on the budget realisation shows the purchase or sale of such assets, this will show up in the balance sheet, but if there is no balance sheet it will be very difficult for anybody reading the budget statement to check whether any funds have been misappropriated. Thus the importance of having a balance sheet, from an anti-corruption perspective, lies in having accurate lists of all of a government entity's individual assets and liabilities.

The view from local government level

To gain an understanding of progress with public sector accounting reform, McLeod and Harun (2009) undertook case studies of public sector accounting reform in early 2009, based on three local governments: the municipalities of Tangerang and Palu and the district of Bima, in the provinces of Banten, Central Sulawesi and Nusa Tenggara Barat, respectively. The case studies relied heavily on interviews with individuals involved in some way with the accounting reforms of the last few years. Three key sets of problems were identified: lack of suitable human resources; conflicting and changing directives from the centre; and responsibility without autonomy.

Lack of suitable human resources

Former president Soeharto built a monopoly on the leadership of Indonesia that was able to keep him in office for three decades, always ensuring his own re-election unopposed. In such a context, public sector accounting as a means of keeping the public informed about the actions of government was of very low priority, and so the bureaucracy – especially at local government level – emerged from this period with desperately few qualified accountants relative to the scale of the task of recording and reporting the financial aspects of government operations. The accounting reforms implicitly call for tens of thousands of reports to be produced each semester, whereas the number of qualified accountants available to all levels of the bureaucracy combined seems to be of the order of hundreds, or possibly even less. Many local governments have responded to this by devoting significant budgetary resources to hiring outside accounting consultants to design new accounting systems for them and to prepare their financial reports.

Ironically, the so-called 'mark-up' practices that accounting reform is intended to help eliminate (marking up the price of a good or service artificially and bribing the procurement committee to accept it) appear to have become a feature of procurement of these accounting consultancy services in at least some local governments.

Conflicting, changing and wasteful directives from the centre

The second major problem is the lack of consistency of demands from the centre. This has two dimensions: conflicting requirements of different ministries – specifically the Ministry of Finance (MOF) and the Ministry of Home Affairs (MOHA) – and requirements that change frequently over time. To a large extent the centre has imposed new rules and regulations without bothering to consult with the lower levels of government directly affected by them, and with little concern for the budgetary and human resource implications.

From the outset the MOF (as the main source of funding for local governments) attempted to minimise the burden of accounting reform on reporting entities, mindful of the problems that were bound to arise if Indonesia tried to move to a far more sophisticated accounting system within a very short time. However, MOHA insisted that it has authority over local government affairs – including over the accounting function – and imposed on local governments a chart of accounts (the system for classifying transactions) that is much more highly disaggregated than that required by MOF of central government departments, even though the scale and complexity of local government operations is generally much smaller and simpler. The lack of standardisation between the two sets of requirements results in considerable wastage because of each government entity's need to convert accounts prepared on the basis acceptable to MOHA to the different format required by MOF and the national audit agency (BPK).

At the same time, MOHA has obliged each local government to develop its own accounting system. Local governments for the most part undertake the same kind of service delivery to their constituents, however, so an accounting system designed for one should be just as suitable for all the others, provided there is enough flexibility to cope with local idiosyncrasies in service provision. This MOHA requirement therefore results in enormous waste of resources owing to failure to take advantage of economies of scale.

Responsibility without autonomy in human resource management

The third major problem arises from the manner in which decentralisation has been implemented. The rationale for decentralisation was to bring government closer to the people, since locally elected leaders and parliamentary representatives within these much smaller lower-level jurisdictions were likely to be more responsive to citizens than were those at the national level. In reality, the transfer of functions has been much more limited than appears at first glance, not least because these transfers imply a considerable loss of power for central government ministries. Many ministries have devoted considerable energy to clawing back lost territory – or simply asserting that the devolution of authority does not apply to them.

One such is the Ministry of State for Administrative Reform (MenPAN), which thus far has declined to relinquish control over human resource management at local government level. This is of crucial importance in the current context. As noted above, accountancy skills are extremely scarce, but under long-established MenPAN rules, recruits into the bureaucracy may enter only at the level of new graduates (from high school, technical college, university and other tertiary institutions), and then slowly make their way to higher levels primarily on the basis of seniority. This precludes an adequate response to sudden new human resource requirements.[8] Moreover, salary scales and promotion prospects are not at all comparable with those in the private sector, so even if there were freedom to recruit individuals to fill high-level positions, this would be almost impossible. In the face of the great need for qualified and experienced accountants, public sector entities can do little more than outsource accounting tasks, or alternatively require the work to be undertaken by individuals who lack the necessary skills – with the predictable consequences of inefficient accounting processes and poor quality accounting reports.

Local governments are well aware of the dysfunctionality of the current human resource management practices dictated by MenPAN, but most seem to accept that they do not have the authority to introduce their own systems of personnel management. That said, some local governments seem to have been able to negotiate special arrangements allowing more flexibility than is enjoyed by most of their peers. This has enabled them to recruit at least some individuals with specialised accounting skills and experience – albeit from elsewhere in the bureaucracy rather than from the private sector – and thus to prepare far superior sets of financial accounts. It would be a much more satisfactory outcome if there could be a general devolution of authority in relation to personnel management to all local governments rather than just a select few. It makes little sense to hand over responsibility for many government functions to local governments, and to require them to be accountable to their constituents for their performance, if they are not also given autonomy to manage their own human resources.

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