

SURVEY OF RECENT DEVELOPMENTS

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SUMMARY

In the second half of 2005 the government was reminded how difficult it is to govern this vast and complex country. The most significant challenge came from the rise in world oil prices, which sharply increased fuel subsidies and generated considerable pressure to raise domestic fuel prices further. While the rising world oil price did not greatly threaten Indonesia's budget deficit, negative perceptions (even though misguided) of its impact on the balance of payments and the budget, and a perceived lack of government resolve to deal with the issue, led to considerable investor unease. This, combined with Bank Indonesia's delay in raising interest rates, resulted in a minor currency upheaval in late August. The government's appearance of dithering has thus created doubts about its ability to manage the economy in times of crisis. Fuel prices were finally raised on 1 October, accompanied by the introduction of a cash transfer program (the largest in the developing world) to cushion the impact on the poor.

Economic growth was sustained during the second quarter, though there is concern that this may falter in the aftermath of the fuel price shock. There has been a renewed sense of confidence in the economy (although the macroeconomic missteps in August and September somewhat dampened this new optimism). Recent surveys confirm that investors still consider the investment climate to be poorer than elsewhere in the region; macroeconomic instability, regulatory constraints and corruption are core concerns. In the past few months the government has worked on a number of laws to mitigate some of these constraints. The keystone legislation is the new investment law, the current draft of which reflects a shift from an approval to a registration approach to major investments, and aims to simplify registration procedures. The government is also working to make taxation laws more business friendly. It has not yet been as successful as it would have liked in attracting private investment in key infrastructure projects, however.

Reconstruction in Aceh has been much slower than hoped, but there have been some promising signs of progress recently. Indonesia has differentiated itself from other tsunami-affected countries in designing a set of principles to guide the reconstruction process that emphasise locally led and community-driven approaches, and in establishing a special Rehabilitation and Reconstruction Agency, albeit at some cost in terms of significant delays. The government has also used the unique opportunity afforded by the disaster to negotiate a peace accord with the Free Aceh Movement, raising hopes for an end to 30 years of violence in the province.