

Japan - Indonesia Economic Policy Dialogue

By *Shiraishi Takashi*

IN late August, the Japan-Indonesia Economic Policy Dialogue organized the Tokyo Seminar on Indonesia, with support from the Japan International Cooperation Agency (JICA). Japan and Indonesia have held these discussions on economic policy since early 2002, based on an agreement between Prime Minister Koizumi Junichiro and President Megawati Sukarnoputri. The Japanese members of the team are Asanuma Shinji (professor at Hitotsubashi University), Ito Takatoshi (professor at the University of Tokyo), Urata Shujiro (professor at Waseda University), Kinoshita Toshihiko (professor at Waseda University), Komatsu Masaaki (professor at Hiroshima University), and Shiraishi Takashi (professor at Kyoto University). The Indonesian team consists of Laksamana Sukardi (Minister of State-Owned Enterprises), Djunaedi Hadisumarto (advisor to the Head of the Planning Board), Heri Akhmadi (member of parliament), Sri Mulyani Indrawati (professor at the University of Indonesia, IMF Executive Director for Southeast Asia), Sri Adiningsih (professor at Gadjah Mada University), Mochtar Buchori (member of parliament), Teddy Rahmat (business executive), and Oentoro Surya (business executive).

Indonesia is a very important country for Japan. This can be seen in Indonesia's share of Japan's Official Development Assistance (ODA), direct investment and trade. Indonesia's geopolitical position and its central role in ASEAN also attest to the country's importance for Japan. During the Suharto era informal political channels played an important role in bilateral relations alongside formal diplomatic ties, as evidenced by the relationships former Prime Minister Fukuda Takeo and the House of Representatives member Watanabe Michio (subsequently appointed Minister of Foreign Affairs) had with President Suharto. However,

Japan lost these high-level political channels when the Suharto regime collapsed, especially after Abdurrahman Wahid – who did not have any political contacts with Japanese – became president. The Policy Dialogue was devised as a solution to this problem.

The Japanese and Indonesian members of the Dialogue regularly exchange frank opinions on Indonesia's economic policy. The Japanese team encourages the Japanese government to provide ODA for the policies that both sides have agreed on, while their Indonesian counterparts convey the consensus to the president and work to have it reflected in government policy. These are the basic principles. The two main goals are to ensure fiscal sustainability and international competitiveness. The Policy Dialogue conducts joint research on macroeconomic policy, financial sector reform, improvement of the investment climate, policy on Small and Medium-sized Enterprises (SMEs) and reform of local autonomy. Based on this research, the Dialogue makes policy recommendations. The Indonesia Survey Institute was also established in support of greater democratization.

The Tokyo Seminar this August was intended to cap the Policy Dialogue's activities over the past two-and-a-half years. The Sept. 20 presidential election will result in the inauguration of either the incumbent Megawati or Susilo Bambang Yudhoyono, the former Coordinating Minister for Political and Security Affairs, on Oct. 20. The new administration marks the end of the Policy Dialogue's mandate in its current form. Accordingly, the seminar brought together more than 50 Indonesian participants – among them politicians, academics, bureaucrats and technocrats who are likely to play important roles in Indonesia's next administration – to discuss economic policy issues. It is worth noting that, as of this August, there was no way of knowing whether Megawati

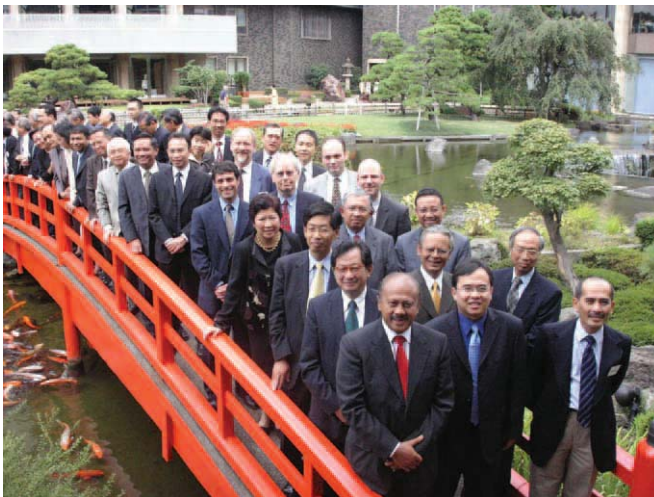
or Yudhoyono would be chosen as the next president. For this reason, people from both sides were invited, such as Heri Akhmadi (secretary-general of Megawati's election campaign), Arifin Panigoro (leader of Megawati's Indonesian Democratic Party-Struggle), Joyo Winoto (member of Yudhoyono's election campaign), and Marsilam Simanjuntak (former chief cabinet secretary).

What was discussed at the seminar, and what was agreed upon? First, the seminar stressed the importance of the president creating a stable, strong, and growth-oriented government run by able officials and capable of establishing good working relationships with the parliament. This is crucial to promoting the socio-economic and political conditions for implementing policies that adequately address specific problems in the investment climate, financial sector reform, decentralization, and poverty reduction.

The seminar also identified the specific problems of improving the investment climate, formulating viable macroeconomic policy, and reforming the financial sector and local government.

The Megawati government has successfully managed macroeconomic stability and fiscal sustainability, but it has not been able to achieve economic growth rates that are high enough to create jobs for those who enter the labor force each year. The long-term health of the Indonesian economy and politics depends on defusing the social crisis that might arise from mounting unemployment and underemployment. The key to generating employment is investment. The problem is that investment, both foreign and domestic, has been consistently low over the past six years. This is in part because of the unpredictability of political and economic conditions, the weakness of the legal and judicial framework, widespread corruption, and deteriorating infrastructure.

Photos: Japan International Cooperation Agency



The Tokyo Seminar on Indonesia 2004



What is needed, therefore, is a strong leadership that can formulate good policies to improve the investment climate. The government should set up a benchmark for the investment climate and international competitiveness and adopt strong measures that include improving law and order, reforming the judiciary, fighting corruption, passing a new Investment Law, rebuilding the deteriorating infrastructure, creating a stable labor market, and cutting bureaucratic red tape.

With regard to macroeconomic policy, it is important that the inflation rate does not become too high in order to secure medium-term macroeconomic stability. Any inflation rate higher than 5% would mean either gradual depreciation of the rupiah or loss of export competitiveness. The inflation target announced by the central bank should be based on careful analysis of achievability, and should become the de facto standard to anchor expectations.

On the issue of financial sector reforms, the Megawati administration has made important inroads on improving Indonesia's financial sector since 2001. Along with the restructuring of commercial banks, the reduction of banks' non-performing loans (NPLs), the raising of capital adequacy ratios above the international standard, the installation of the Bank for International Settlements (BIS)-based regulations and supervisory system, and the sale of IBRA (the World Bank) assets to the private

sector, Bank Indonesia now stands independently from political interventions and can properly concentrate on controlling inflation. But the financial sector remains vulnerable: bank lending is low and concentrated in consumer finance and funds are not yet being channeled for the purposes of investment and economic growth. The challenge for the new government is to improve the rules and regulations governing the financial sector in accordance with Indonesia's current social and economic conditions.

Indonesia has had five years' experience of decentralization. Recent public opinion surveys indicated the strong support among the people for this basic policy. There remain problems, however, relating to the abuse of devolved powers, confusion concerning the roles of the central and local governments, emerging inequalities in the access to and availability of fiscal resources among local governments, and the spread of corruption and money politics among local politicians and officials.

There is an urgent need then, to revise the basic laws of decentralization to include the clarification and redefinition of divisions of power, functions, and responsibilities among central, provincial and local governments. An efficient system of allocating fiscal resources from the central to provincial and local governments should be put in place. The seminar also recommended the establishment of provincial civil services that

provide, manage and develop human resources for local governments and the institutionalization of a viable framework for coordinating development policy and planning among central and local governments.

The participants understand very well that implementing these policies will take considerable time. However, managing expectations is also highly essential. It is crucial that the newly installed and popularly mandated government demonstrate its will and ability to meet the expectations of the Indonesian public and the international community by implementing institutional changes such as deregulation and customs reform.

In retrospect, the Japan-Indonesia Economic Policy Dialogue has played a reasonably important role in strengthening Indonesia-Japan relations over the past two-and-a-half years. It is not clear if this dialogue can be maintained with the next administration. However, creating a forum in which Japanese and Indonesians can share their honest opinions and are able to reach a consensus that can be reflected in government policy is always an important issue in the relations between Japan and Indonesia (as well as between Japan and other countries). **J.S**

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