

Executive Summary

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Significance of the Birth of the New Government

In October 1999, Abdurrahman Wahid, chairman of Nahdlatul Ulama (NU), the country's largest Islam organization, was elected Indonesia's fourth president, and Megawati Soekarnoputri, leader of the Indonesian Democratic Party of Struggle (PDI-P) and the eldest daughter of the country's first president, Soekarno, was elected vice-president. The establishment of the Abdurrahman Wahid-Megawati government helped wipe out the people's deep distrust of government and quell the political instability that had continued since the last years of President Soeharto's government. With President B. J. Habibie, who succeeded Soeharto, failing in his bid for reelection, many Indonesians felt that the country at last could break with the Soeharto regime and take a step toward a new era of "civil society." This development furthermore provided the political stability that is the prerequisite for an economic recovery in Indonesia.

After Soeharto stepped down in May 1998, a general election was held under a new law, and the People's Consultative Assembly (MPR), formed chiefly by newly-elected members, chose the president and vice-president by majority vote for the first time since the country's independence. Indonesia, which had long been regarded by the international community as a "developmental dictatorship", deserves high praise for the fact that it accomplished the undertaking of electing national leaders following the legitimate democratic process in such a short period of time, namely, one and a half years. The presidential election marked the first step to construct a democratic regime in Indonesia, departing from the authoritarian rule which had long thwarted the people's will.

Characteristics of the New Government

The new government can firstly be characterized by legitimacy due to its democratic process of birth. Secondly, it can be regarded as a product of compromise owing to the successful way in which it reconciled conflicting forces, such as Islamization versus nationalism, and reformists versus the old guard, thus incorporating rival camps within its support base. It was Abdurrahman Wahid alias Gus Dur who, as a leader of the tolerant and moderate NU, was able to act as the adhesive for these opposing forces. This course of action was the best possible choice in terms of national reconciliation and social stability.

The newly-launched "national unity cabinet" sought to strike a balance of power between diversified forces including political parties, civilians and the military, and the various regions of the country, while at the same time reshuffling personnel to bring in new blood. This attempt at amelioration, however, could turn sour if a lack of expertise and teamwork is perceived, while the risk of conflicts of interest coming into the open at any time is ever present.

Of particularly importance is the fact that the Gus Dur government did not promote a single economic technocrat to the cabinet, who had been in charge of Indonesia's macroeconomic management throughout the Soeharto years and that it downgraded the National Development Planning Agency (Bappenas), the erstwhile bastion of development policy planning and fund allocation. This change suggests that the new government is trying to transform basic development strategy by shuffling policy planners, organizations and flows of funds; from central-government-led big-projects-driven development to participatory development revitalizing small capital on the basis of resources found in each region.

Reform of Political Institutions

Reform of Indonesia's political institutions had actually begun with the resignation of President Soeharto. Soeharto's authoritarian regime found its legitimacy in the country's "development", but lost credibility with the people because of structural corruption and the economic crisis. New legitimacy was derived from "Reform" (*Reformasi*), and that was why President Habibie hoisted the banner of *Reformasi* upon his assumption of power and announced a string of political reform steps in rapid succession.

While in office, Habibie first allowed freedom of speech and freedom of association (political liberalization). He then revised three political laws to lay the legal groundwork for holding free and open general elections (institutionalization of political competition and participation). Furthermore, the 1945 constitution was revised for the first time to restrict presidential powers (institutionalization of power and authority).

Habibie himself was forced to abandon his reelection bid as the people concluded that he had failed to deliver on *Reformasi* as promised. Yet it is true that major changes in Indonesia's political institutions were set in motion in the period of the Habibie government. What is expected of the new Gus Dur government is to bring the political reform process to the next stage and tackle such problems as legally safeguarding human rights, reform of the judiciary, a review of structure of the legislature particularly of appointed members of the House of Representatives (DPR) and MPR, and consideration of the method of presidential elections.

Reform of Indonesia's Military

The Indonesian military took the brunt of the people's demands for *Reformasi* in the last years of the Soeharto government. The military became the target of severe public criticism for the oppression by force of anti-government activists and violations of human rights as well as its involvement in politics justified on the pretext of "the dual function" of the military. The then-Military Commander Gen. Wiranto, using reform-minded officers as front men, tried to restore the military's prestige by putting forward his own proposals for reform of the military, including the scaling back of its socio-political function.

In the process from the general elections to the presidential race, Wiranto intentionally distanced himself from the Habibie camp to underline the military's political neutrality and instead sidled up to reform champions Megawati and Gus Dur. The strategy worked. The military headed by Wiranto was wooed by both Habibie backers and reformist groups and played a role in giving birth to the new government by discarding Habibie at the last moment in favor of Gus Dur. Thereby Wiranto managed to retain his influence within the new government being the only new cabinet minister with a past as a Soeharto aide.

Through this political process Wiranto actually reinforced his grip on intra-military politics by balancing himself on the power structure he created by having different factions within the military compete with each other. Against reformist officers who supported radical plans for reforming the military, he played status quo officers who regained power by asserting their logic that "the importance of the military increases as social crisis mounts in the transition period to the full establishment of a democratic regime." Thus, it seems premature to assume that a smooth reform of the military will be possible even under the new government. President Gus Dur started his push toward military reform from his third month in office, after which time investigations on human rights violations by Wiranto and other key officers began. However, Gus Dur will have to tread carefully along the path of gradual reform of the military toward the modern defense forces, taking into account the risk that the status quo officers' logic could make them play the security crisis card to shake the government.

Avoidance of Disintegration and the Path to Decentralization

Decentralization emerged as an important issue during the tenure of the Habibie government. Decentralization not only means reform of the Soeharto-dictated centralized system but also has the political implication that Habibie, who hails from a non-Java outer-island, would challenge Soeharto's Java-first policy and consolidate the support of political forces representing the outer islands.

The Habibie government enacted legislation that provided the legal groundwork for decentralization. The new law replaced the vertical relationship of responsibility running down from the central government to provinces, districts/cities, sub-districts and villages, which formed the basis of the centralized political regime, with the horizontal relationship of responsibility with the heads of all levels of regional governments being accountable to local assemblies. The review of the allocation of fiscal resources between the central and regional governments allowed regions to partially benefit from revenues derived from natural resources. Full implementation of decentralization, however, must deal with a myriad of problems, including the low administrative capabilities of regional governments, the shrinking fiscal bases of regions endowed with few natural resources, and the widening disparities among regions.

The Habibie government let East Timor hold a referendum on its future and allowed the territory to leave Indonesia in line with the result of the vote. This outcome, however, sparked separatist movements in Aceh and other regions. The first crucial test for the Gus Dur government is how to respond to the demand for secession from Aceh, which, unlike East Timor which was a Portuguese colony, shared a joint past with the rest of Indonesia as a part of the Netherlands East Indies. President Gus Dur is likely to follow a cautious approach toward wide-ranging autonomy, by enhancing the awareness of problem-solving capabilities of the people themselves. The case of communal turmoil in Maluku, with its complex background of religious, political and economic conflicts of interest among local residents, also highlights the inherent difficulties entailed in the introduction of regional autonomy. Indeed, the major political challenge facing President Gus Dur is how to proceed with decentralization while averting the danger of national disintegration.

Reconstruction of the Financial Sector

Upon his assumption of office, President Gus Dur declared the new government's top priority as economic recovery, and immediately resumed loan negotiations with the IMF and set out on a tour of foreign countries in a bid to restore international confidence in the Indonesian economy. He did so because it is essential to call back official foreign assistance as well as private capital to prime-pump the country's economic recovery. Over the medium term, however, Indonesia has to reconstruct a healthy financial sector to restore economic credibility. The problems in this regard are non-performing loans in the banking sector and debts in the corporate sector.

Major banks designated for reconstruction had their irrecoverable loans removed to public management and received an infusion of public capital. But continued monitoring is required to ensure that those banks restore financial health without further deteriorating the quality of remaining loans and resume normal lending activities at an early date. As for corporate debts, some business groups worked out arrangements on external debts, but there is still a long way to go before small and medium-sized companies can settle their domestic debts.

The degradation of bank loan claims and corporate debts exposed by the currency crisis can be traced to a host of structural problems, such as the lack of corporate credit appraisal capabilities at individual banks, rampant intra-group lending, dysfunction of supervision over the financial sector, the absence of due information disclosure and transparent accounting systems on the part of corporations, and failure of corporate gover-

nance systems. What should be noted in this regard is that the new government has to overcome these structural weaknesses with medium- and long-term institutional reforms, even after the economic activities get on the recovery track.

Developments in the Real Economy

After the initial phase of the economic crisis that came with the fall of the rupiah (the third and fourth quarters of 1997), manufacturing production tumbled due mainly to rises in the costs of imported intermediate goods and a contraction of the domestic market in the period of the deepening crisis (the first through third quarters of 1998). In the transition period to an economic recovery that was accompanied by a recovery in the rupiah's value (the fourth quarter of 1998 up to October 1999), production reached its bottom for consumer goods, semi-durable consumer goods and durable consumer goods in that order, with the overall economy bottoming out.

But exports are making little contribution to getting Indonesia out of the economic crisis. Though the rupiah's effective exchange rates in the transition-to-recovery period stayed lower than the pre-crisis levels, exports declined in terms of quantity from pre-crisis levels. To cite a few reasons for this, companies with debt problems found it difficult to raise necessary funds, banks saddled with bad loans cut back on credit extension, and Indonesia's higher country risk scared away orders from overseas. In addition, the real sector itself had causes of its weak export drive such as hurdles in marketing and quality for export shifting.

In the deepening-crisis period, the drop in the rupiah's value led to a short-lived boom in exports of primary products with less processing, but production fell back in tandem with the rupiah's recovery. Conversely, it was resource-based industries with higher processing that could increase output in the transition-to-recovery period from pre-crisis levels. The new government places an emphasis on agribusiness. However, as the developments described above indicate, depending on exports of primary products with a low degree of processing input entails the big risk of destabilizing production and farmers' income. It is of vital importance to secure stable industrial development by putting more processing into natural resources and deepening industrial linkages between upstream and downstream sectors.

Medium- to Long-Term Development Issues and Indonesia-Japan Ties

As major problems confronting President Abdurrahman Wahid's new government, we cited economic recovery and the disintegration issue for the short term, and reform of political institutions, reform of the military, decentralization and reconstruction of economic institutions including the financial sector for the medium to long term. Furthermore, the new government is also expected to address the following issues.

The Gus Dur government needs to eliminate a plethora of strains brought about by the growth-first policy of the Soeharto regime. It will require rectifying income gaps and central-regional disparities. The former calls for tax reform and an investment strategy targeted at small and medium businesses, while an effective way of achieving the latter is to pursue wide-area regional development linking neighboring regions. In order to correct the structural abuse of collusion, corruption and nepotism (KKN), another negative vestige of the Soeharto regime, steady institutional reform will be required, including an enhancement of morale and discipline accompanied by pay raises for public employees, the establishment of penalty systems and its enforcement, and the creation of workable monitoring mechanisms. Furthermore, in order to avoid a recurrence of economic confusion, the stabilization of the rupiah and the building of a safety net will be needed.

For Indonesia, it is essential for the time being to obtain assistance from the IMF and

the World Bank-coordinated Consultative Group for Indonesia (CGI). Prolonged policy support by the IMF and World Bank, however, are now being questioned by economic policy makers in the new government. The role foreign aid donors can play is to advise the new government against pursuing a populist handout economic policy or introverted nationalistic policy. The new government expects Japan, its largest aid donor, to take the leadership toward a prosperous and stable Asia, somewhat different from the policy line advocated by the Washington consensus. Indonesia, which is now led by Abdurrahman Wahid, a leader of great originality, is also about to rebuild its economic diplomacy focusing on Asia. For its part, Japan also needs to devise its own response to foster a new relationship with Indonesia at varied levels including that of government, the private sector and non-governmental organizations.

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