

## SURVEY OF RECENT DEVELOPMENTS

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### SUMMARY

Political and economic stability prevailed in Indonesia to early June 2007. President Yudhoyono made some badly needed changes to his cabinet, but left the core economic team unchanged. This inspired further confidence in the government's economic policies, yet it still fails to satisfy public expectations. The Lapindo mudflow disaster continues to weigh on the government, with no clear strategy apparent.

The economy shows stable macroeconomic fundamentals. Growth remained at around 6% p.a., driven mainly by investment and exports. The exchange rate strengthened and the stock market continued its rise. The central bank lowered the policy interest rate further, but this is likely to have little effect on growth, and brings some macroeconomic risks. Increasing or even maintaining current growth rates could be a challenge, given that export growth depends strongly on the global commodity boom, and improvements in the investment climate remain uncertain.

The parliament passed the long-awaited new investment law, which promises a more open and friendly investment regime. Doubts surround the implementation of the law, however. There are concerns that the new negative list could be overly protective and that the continued role of the Investment Coordinating Board may cause coordination problems among agencies and with sub-national governments. Boosting growth in manufacturing could be the key to higher overall growth. Structural change in the manufacturing sector over recent years has seen labour-intensive industry decline in terms of both output and exports, mainly because of rigid labour policies.

Efforts to boost private sector investment in infrastructure still show limited success. Implementation of regulatory and bureaucratic reforms is ineffective, and domestic financing remains in short supply. Public provision of infrastructure needs to increase, but suffers from shortcomings in fiscal management and a mismatch between the often cross-district nature of infrastructure projects and the now strongly district-based budgetary authority. Electricity supply exemplifies how the lack of well-designed investment strategies limits Indonesia's growth potential. Power sector investment has stagnated despite strong growth in electricity demand, and current plans for coal-based capacity expansion lack thorough planning.

An emerging long-term challenge for policy makers is climate change. Ahead of the December UN climate change conference in Bali, recent reports have highlighted Indonesia's vulnerability to climate change and its contribution to global greenhouse gas emissions, predominantly from deforestation. Slowing or halting of deforestation is unlikely to occur without large-scale international financial flows.