

Indonesia

Summary

A revival in investment following the smooth transition to a new administration in late 2004 has improved the outlook for the economy. GDP grew by 5.9% in the first half of 2005 and is expected to expand by 5.7% over the full year, an estimate revised up slightly from *ADO 2005*. In 2006, growth is projected to edge higher, to 5.9%.

Inflation, averaging 7.7% in the first 7 months of 2005, is well above expectations. Higher food prices, an increase in administered prices of fuel, and a weakening of the rupiah are the main causes. For the whole year, inflation is expected to average 7.5%.

The policy to subsidize domestic fuel prices through the budget has put the fiscal position under pressure as global oil prices have climbed. Although the Government took the politically difficult decision to raise domestic fuel prices in March, a substantial element of subsidy remains and it still had to raise the full-year allocation for subsidies to \$7.9 billion. Despite major resources of oil, natural gas, and coal, the economy is vulnerable to rising oil prices due to underinvestment in production and fast demand growth underwritten by expansive subsidies.

Updated assessment

Supported by continued strong growth in fixed capital investment, GDP grew by 5.9% in the first half of 2005 on a year-on-year basis, an improvement from 4.4% in the first half of 2004 and 5.1% for all of that year. This performance largely reflects improving investor confidence in the economy. Fixed investment expanded by 13.6%

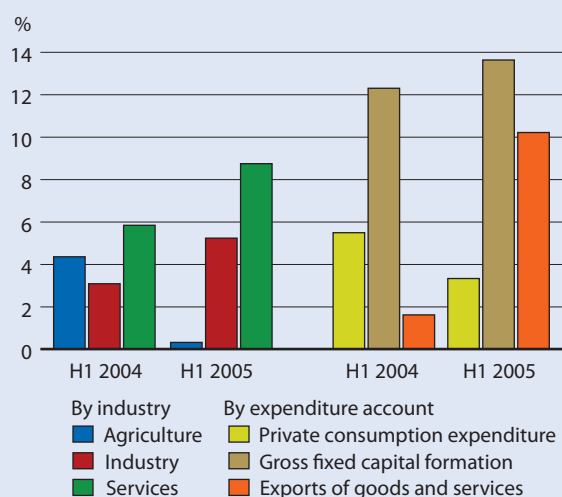
in the first half. The investment pickup, from a low base, follows the relatively seamless transition to a new Government after elections in 2004, and expectations of greater regulatory certainty and a recovery in infrastructure spending. Private consumption growth was 3.3% in the first half as consumer spending was pinched by rising fuel prices.

By industry, first-half growth was fairly robust in manufacturing, construction, and services, but agricultural production grew by just 0.3% (Figure 2.4) while mining output (including oil and natural gas) shrank by 0.9%. With the pickup in investment, GDP for the whole year is likely to expand by about 5.7%, revised up from 5.5% in *ADO 2005*. Although the December 2004 tsunami has devastated communities in Aceh and North Sumatra, it has not had a significant impact on national economic growth.

Inflation has been higher than earlier projected, averaging 7.7% in the first 7 months of 2005, largely on the back of increases in food prices, a boost in administered fuel prices from March, and a declining rupiah. Prices of fuel and electricity might be raised again. For the full year, inflation is now estimated at about 7.5%, revised up from 5.9% in *ADO 2005*.

The increase in investment—together with the associated requirement for more capital equipment and production materials—was a major reason that imports grew by a rapid 35.4% in the first half of 2005. Exports also grew strongly, at 27.5%, partly as a result of higher prices for shipments of oil and natural gas. The trade surplus rose by 12.3% to \$12.2 billion. Tsunami-related emergency relief boosted net transfer receipts in the first quarter. The forecast for the full-year current account surplus is revised up to 2.3% of GDP from 2.1%.

Figure 2.4 Growth of selected GDP components, Indonesia, H1 2004 and H1 2005



Sources: Badan Pusat Statistik.

The rising global oil price has put the budget under pressure as the cost of subsidies has increased with a widening gap between domestic fuel and international oil prices. In June, the Government increased the budget allocation for fuel subsidies to Rp76.5 trillion (\$7.9 billion) from Rp19 trillion in the October 2004 budget. It has subsequently estimated the subsidy in the 2006 draft budget at Rp101 trillion. Although a \$2.7 billion Paris Club moratorium to support tsunami relief provides some fiscal flexibility, the authorities must weigh the costs of keeping domestic fuel prices low relative to world prices. While the Government revised the budget deficit target from 0.8% to 1.0% of GDP, Bank Indonesia has predicted that the gap will be 1.1–1.5%, compared with 1.4% in 2004. The budget target could also be undermined by delays in approving the privatization program, including the sale of part of the Government's stake in Bank Negara Indonesia, the third-biggest lender in terms of assets. The 2005 budget anticipates that Rp3.5 trillion will be raised through privatization, but the prospects for this are increasingly uncertain.

Reflecting a combination of higher inflation, the need to finance dollar-denominated oil imports, and some speculative selling, the rupiah depreciated by about 10% between end-2004 and

end-August 2005. In nominal terms, the value of the rupiah was lower than at any point in the last 4 years. Foreign exchange reserves fell by 10.5% to \$32.5 billion by mid-August, mainly a result of higher oil import costs, short-term capital outflows, and central bank support for the rupiah.

To lean against the higher demand for dollars and higher inflation, Bank Indonesia has raised domestic interest rates: the 1-month Bank Indonesia Certificate rate has been increased by 2.07 percentage points so far this year, to 9.50% in August. (The surge in inflation had pushed real interest rates into negative territory.) However, the banking system is potentially vulnerable to rising rates: its nonperforming loans increased to 7.9% in June 2005 from 5.8% at end-2004, and the capital-adequacy ratio for commercial banks declined.

The economy is not creating enough jobs to absorb new entrants into the labor market. About 1.2 million jobs were generated in the period August 2004 to February 2005, but the National Labor Force Survey indicates that the number of unemployed rose to 10.9 million, or 9.9% of the workforce, as of February 2005. Among the employed, construction workers are enjoying rising real wages due to increased building activity, but for those working in the urban informal sector, real wages are still lower than before the 1997 crisis.

Prospects

The upturn in investment is a positive development that holds out the hope of increased economic growth, greater employment, and higher wages. To sustain the investment expansion, the Government needs to follow through on its agenda to, among other things, reduce corruption, improve the legal and regulatory environment for investment, and support the development of infrastructure. On the expectation that more resolute action will be taken on these fronts, GDP growth is forecast to edge higher next year.

Supported by a weaker rupiah, export growth is expected to rise in the near term and the trade surplus may edge higher. With investment picking up, however, import growth is likely to continue to outpace both the growth of exports and of GDP. Trade and current account surpluses are

Table 2.4 Selected economic indicators, Indonesia, 2005–2006, %

Item	2005		2006	
	<i>ADO 2005</i>	<i>Update</i>	<i>ADO 2005</i>	<i>Update</i>
GDP growth	5.5	5.7	6.0	5.9
Inflation (CPI)	5.9	7.5	5.4	7.5
Current account/GDP	2.1	2.3	1.5	1.6

Source: Staff estimates.

forecast to decline in the medium term. The rise in oil prices and weakening of the rupiah also are likely to result in inflation staying in the 7–8% range in 2006, revised up from *ADO 2005*.

Budgetary prospects in 2006 depend on the Government's willingness to address the current gap between the prices of domestic subsidized oil products and world oil. Although domestic prices have already been raised, they are still well below world levels. In late August, the Government stated that it plans to raise fuel prices again sometime after October. Its fiscal maneuverability and debt position may deteriorate if the rupiah weakens further and interest rates and the cost of oil continue moving up. In the event of still higher oil prices, budget deficits may be larger than expected, risking an end to several years of determined fiscal consolidation.

Indonesia has large resources of oil, natural

gas, and coal. Its vulnerability to the current rise in global oil prices stems from low investment in oil production and from rising oil demand that has been underwritten by subsidies. Failure to provide adequate incentives to the private sector and to improve the business investment climate has led to stagnating domestic oil production, while the maintenance of administered fuel prices at below international market levels has encouraged rapid consumption growth and fed back into unsustainable budget subsidies. The revised budget assumes crude oil production of 1.1 million barrels a day, but the current output is 940,000 barrels. Major investments are needed to prevent a further decline, though some hope may be seen in recent progress in drawn-out negotiations with ExxonMobil to develop the large Cepu oil field. This could boost production from 2007 or 2008.

Headway is being made in the rehabilitation and reconstruction of tsunami-affected Aceh and North Sumatra, after a slow start. A recent budget revision provides clearance for the start of large-scale public spending, and the creation of a coordinating body to oversee the process is another positive development. The peace agreement signed between the Free Aceh Movement and the Government on 15 August holds out significant hopes for continued political progress in Aceh.