

Indonesia

The impact of sharp rises in fuel prices and interest rates in 2005 checked economic growth in the first half of 2006, but increased public spending in the second half is expected to take full-year growth back to 5.4%, as forecast in *Asian Development Outlook 2006 (ADO 2006)*. In 2007, growth is seen picking up to 6.0%, reflecting easing inflationary pressures and a lift to investment from likely lower interest rates and from policy reforms. However, growth is still not strong enough to boost employment. A run of natural disasters has heightened vulnerabilities, and Indonesia has suffered the most deaths from avian flu.

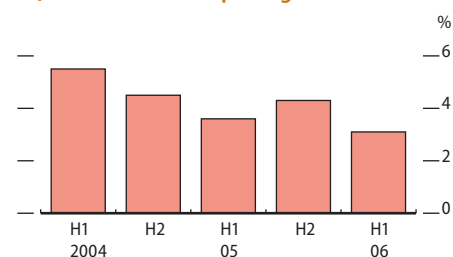
Updated assessment

In October 2005, the Government cut its expensive fuel subsidies and more than doubled the price of fuels. In addition, Bank Indonesia hiked its policy rate from 8.5% in July 2005 to 12.75% in December, in an attempt to damp rapid inflation sparked by the fuel price rises. These two sets of moves restored international investor confidence, as reflected in a return of capital inflows and a 7.2% appreciation of the rupiah in the first 7 months of 2006. But they also dented private consumption spending (Figure 2.4.1) and investment in the first half of 2006, which grew by only 3.1% and 0.9%, respectively, year on year. The effect was to lower GDP growth to 5.0% in the first half of 2006, from 5.9% in the year-earlier period.

Government spending, however, jumped by about 23%, both on improved budgetary execution and on increased fiscal transfers to the regions that were enabled by the fuel subsidy reduction. Net exports grew by 36%, supported by strong global demand for Indonesia's energy and commodities, and were the major contributor to aggregate growth from the demand side (Figure 2.4.2). Among industry groups, construction, transportation, and communication were the stronger-growth areas in the first half of 2006. All the major sectors expanded, and services were the biggest contributor to growth from the supply side (Figure 2.4.3).

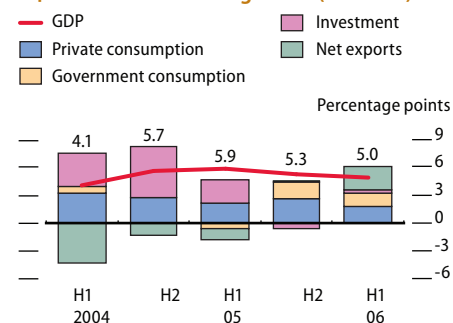
The combined impact of high interest rates (the policy rate was only eased back after May 2006, to 11.75% by late August) (Figure 2.4.4) and of long-standing problems of poor contract enforcement, inadequate infrastructure, and corruption has cut the growth of total investment to less than 3% year on year in the past 4 quarters, about one fifth of the rate of 2004 and early 2005. The investment-to-GDP ratio now stands at 22%, down from around 30% in the late 1980s and most of the 1990s. Despite this, a proposal for a simplified, one-stop approval process to spur foreign direct investment has been hampered by line ministries, which want to retain control over investments.

2.4.1 Private consumption growth



Source: Bank Indonesia, available: <http://www.bi.go.id/web/en>, downloaded 15 August 2006.

2.4.2 Contributions to growth (demand)



Source: Bank Indonesia, available: <http://www.bi.go.id/web/en>, downloaded 15 August 2006.

On the external front, the escalation of global prices for energy and metals pushed up the value of mining exports by just over 25% in US dollar terms during January–June 2006, year on year. Exports of oil and gas rose by about 15% to \$10.4 billion, outpacing their imports (which rose by 13% to \$9.0 billion), in part because demand for oil imports was moderated by the rise in domestic fuel prices. Total exports picked up by about 15%. The first-half 2006 trade surplus is estimated at around \$18 billion, 50% greater than in the year-earlier period. The current account surplus for all of 2006 is now projected at 1.2% of GDP, up from 1.0% forecast in *ADO 2006* in April. Foreign exchange reserves, supported by returning capital inflows, shot up from \$24.8 billion to \$40.1 billion in the first half (Figure 2.4.5).

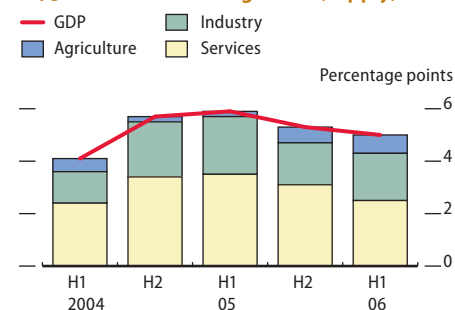
A noteworthy outcome in fiscal policy has been the increase in spending on development and social goals facilitated by the reduction in fuel subsidies. About \$6 billion, or the equivalent of 1.8% of GDP, is available in 2006 for additional spending on education, health, and rural infrastructure, as well as for a cash-compensation program to cushion the impact of fuel price increases on the poor. In the second half of the year, a continued acceleration in public expenditures in these categories is expected to lift the growth pace. The Government has also raised civil service wages and paid its employees an extra month's salary as a bonus in July, which should provide some support to consumption. Further, the monetary authorities are expected to guide policy interest rates lower. The result is projected to be full-year GDP growth in line with the 5.4% *ADO 2006* forecast.

Greater public spending, together with a decision to postpone increases in electricity tariffs (so maintaining subsidies for power users), will help push up the 2006 fiscal deficit to about 1.2% of GDP, from 0.5% in 2005. Driven by the boost in fuel prices, average year-on-year inflation in the first half of 2006 rose to 16.2%, more than double a year earlier. Partly because of the hike in interest rates last year, upward pressure on inflation has eased, and by December 2006 the year-on-year inflation rate is expected to be down to 8.0%, giving a full-year average of around 14%.

Effective debt-management measures lowered public debt to 42% of GDP at end-June 2006, heading it toward the Government's target of 30% by 2010. Indonesia prepaid in June half (\$3.7 billion) of its debt to the International Monetary Fund and plans to prepay the other half next year. There still are some near-term concerns on debt, including an increase in total public debt falling due this year to \$8.1 billion, from \$6.4 billion in 2005, and the fact that around 25% of all tax revenue is needed to pay interest on public debt. Standard & Poor's, citing an "improving fiscal and external performance," in July upgraded Indonesia's external debt rating to BB-minus (but still below investment grade).

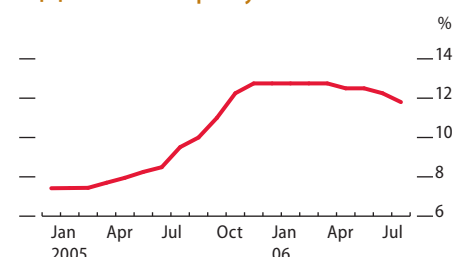
Despite progress in several policy areas, current rates of economic growth are insufficient to create jobs for all new entrants to the labor force. The economy has expanded at an annual rate of about 5% between 2004 and 2006, yet the unemployment rate in this period rose from 9.6% to 10.4% in the February 2006 labor force survey (Figure 2.4.6). Moreover, underemployment is high, with an estimated 30% of the labor force working fewer than 35 hours a week. Agriculture, which has traditionally provided jobs to those left out of the formal sector, is not growing fast

2.4.3 Contributions to growth (supply)



Source: Bank Indonesia, available: <http://www.bi.go.id/web/en>, downloaded 15 August 2006.

2.4.4 One-month policy rate



Source: CEIC Data Company Ltd., downloaded 14 August 2006.

2.4.5 Foreign exchange reserves



Source: Bank Indonesia, available: <http://www.bi.go.id/web/en>, downloaded 25 August 2006.

enough to absorb much of the increase in the labor force. Weakness in the labor market is also reflected in lower incomes: farmers' real wages fell by 2.3% in the 12 months to March 2006, and wages of industrial and construction workers came down by 10.4% and 2.2%, respectively, during 2005. Firms often cite lack of flexibility in the labor market as one factor discouraging investment, but planned revisions to labor laws are stalled as the Government tries to strike a balance between the interests of workers and employers.

Prospects

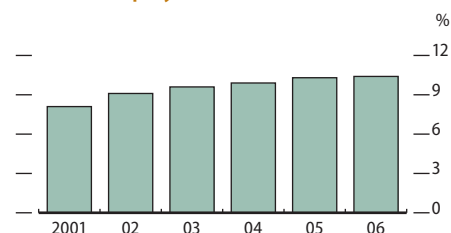
The authorities are pursuing a vigorous policy reform agenda aimed at reviving investment, which enhances prospects that economic growth will reach about 6.0% in 2007 (Figure 2.4.7), as predicted in April. Three policy packages have been unveiled in 2006: an Infrastructure Policy Package that sets out reform goals in nine infrastructure sectors, supplemented by measures to boost investment; an Investment Climate Policy Package that supports broad-ranging reforms on tax, customs, investment law, and labor; and a Financial Sector Reform Package that aims to strengthen both banking and nonbanking sectors and to diversify sources of financial intermediation. Furthermore, a small and medium enterprise reform package is in preparation. Growth could exceed 6% if the reform agenda is implemented well enough to revive investment, and if public spending stays at higher levels throughout 2007, which looks possible.

The president has outlined plans to boost health spending in 2007 by 11%, education spending by 19%, and infrastructure investment by 5% compared with 2006 levels. This scaling-up will help accelerate development, if the authorities are able to effectively use the additional allocations. In this context, one problem is the practice by many local authorities of investing transfers from the national Government into Bank Indonesia certificates of deposit, rather than spending them on development. It is estimated that the equivalent of at least \$4.5 billion, or 2.2% of GDP, is diverted this way. Causes include delays in disbursements and regulatory impediments related to decentralization, all of which slow spending. The Government has begun to focus on measures to unblock these funds to accelerate spending in the regions.

Private investment is projected to pick up in 2007, helped by proposed policy improvements, including legal amendments under deliberation in Parliament aimed at reducing the tax burden, strengthening governance of tax administration, and providing tax incentives for selected sectors. Some streamlining of the customs system should also help lift private investment. Private consumption is set to strengthen if inflation steps down as forecast to average 7.5% next year (Figure 2.4.8). Containing inflation will be assisted by a low political appetite for raising electricity prices now, though a power tariff revision will be needed or subsidies maintained to bolster the finances of the state electricity corporation. Externally, the current account surplus is projected to fall slightly to 0.9% of GDP (Figure 2.4.9) on a widening services deficit, stemming in part from higher international shipping and insurance costs.

Accelerating infrastructure investment will be important if growth is to get a lift. In turn, this requires the Government to translate good policy

2.4.6 Unemployment rate



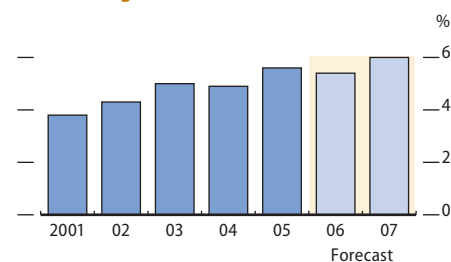
Source: Badan Pusat Statistik, available: <http://www.bps.go.id/index.shtml>, downloaded 28 August 2006.

2.4.1 Selected economic indicators, %

	2006		2007	
	ADO 2006	Update	ADO 2006	Update
GDP growth	5.4	5.4	6.0	6.0
Inflation	14.0	14.0	7.5	7.5
Current acct. bal. (share of GDP)	1.0	1.2	0.9	0.9

Source: Staff estimates.

2.4.7 GDP growth



Sources: Bank Indonesia, available: <http://www.bi.go.id/web/en>, downloaded 15 August 2006; staff estimates.

and regulatory measures adopted into viable public-private partnership projects. A list of 91 infrastructure projects was drawn up in early 2005 for such potential partnerships, but the only contracts awarded thus far are for three gas pipelines, one power plant, and three toll roads. This reflects a continuing incapacity to follow through on policies or regulations, rather than problems with the policy framework itself. The authorities are now focusing on a smaller and more realistic set of projects.

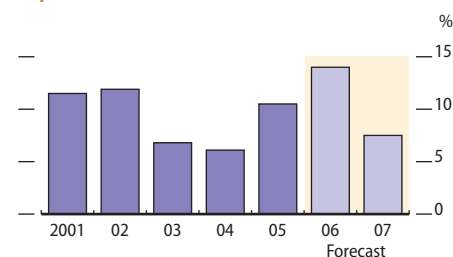
The challenge of improving the civil service is likely to be addressed in 2007. The Government appears to recognize that unless administrative capacity improves, policy or regulatory reforms may not be successful. For example, the president has established a high-level team on civil service reform, while a package of laws covering public administration and the ethics of state officials is being prepared. The draft budget provides for increasing civil service salaries again in 2007, and for similar reasons the Minister of Finance has set up a working group to review the civil service remuneration structure with a view to improving incentives to attract and retain able administrators, initially aimed at high-ranking officials. The recommendations of the group are expected to be implemented gradually from 2007 and replicated across the broader civil service. However, translating all these measures into action faces incentive constraints as well as political sensitivities.

Another policy area for strengthening is dealing with the aftermath of natural disasters, especially since recent events have highlighted the country's vulnerability to them. As Indonesia was recovering from the December 2004 earthquake and tsunami in Aceh, it was struck by an earthquake in May 2006 in Yogyakarta and Central Java, and again by an earthquake and tsunami on the southern Java coast in July, all of which require significant attention and funding from the Government. Social and economic structures come under heightened stress when disasters hit within a relatively short time. Disaster preparedness and management need to take a more central role in regular planning and fiscal management to enhance the economy's resilience.

Not a disaster, but a growing anxiety, avian flu poses an increasing risk. With 46 human deaths as of August 2006, Indonesia has become the country hardest hit by the disease. The Government has estimated that about \$900 million is needed over the next 3 years to combat the problem, but there are serious concerns about availability of resources and commitment by the authorities to containing the spread of the disease in the poultry stock.

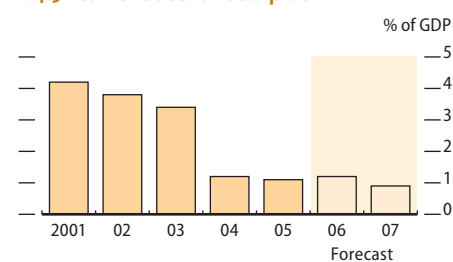
Finally, given a dependence on portfolio investment flows and weakness in foreign direct investment inflows in recent years, Indonesia is vulnerable to shifts in international investor sentiment and developments in global financial markets. This reinforces the need to accelerate reforms that would swing the composition of foreign investment toward greater direct, rather than portfolio, investment.

2.4.8 Inflation



Sources: CEIC Data Company Ltd., downloaded 14 August 2006; staff estimates.

2.4.9 Current account surplus



Sources: Bank Indonesia, available: <http://www.bi.go.id/web/en>, downloaded 26 July 2006; staff estimates.