



## Indonesia

**T**he Indonesian economy continued to grow strongly in 1995 and, driven by strong private consumption and investment demand, can be expected to maintain that momentum over the next two years. As the economy is operating at a very high level of capacity, macroeconomic policy is critical to the maintenance of stable growth and to the avoidance of overheating. Although inflation shows signs of moderating, it remains high; and the current account deficit, which deteriorated in 1995, must be addressed in a timely manner.

It will be important to continue deregulation measures in 1996 and 1997 to increase competition and improve economic efficiency. A trade deregulation package, including tariff reductions and a schedule for further liberalization, was introduced in May 1995 and another in January 1996. However, less progress has been made in removing non-tariff barriers in agriculture and in deregulation of domestic distribution. The drive for increased productivity and competitiveness requires improvements in the technological capabilities of the country's human resources as well as further reform of the present regulatory framework that imposes large, unnecessary costs on business.

### **Recent Trends and Prospects**

*Growth, Investment, and Employment.* Economic growth in 1995 at 7.6 percent was slightly higher than in 1994. The agriculture sector recovered from the 1994 drought and grew at 2.5 percent. The industry sector, including infrastructure-related activities

such as electricity and gas, continued to expand strongly at 10.6 percent, slightly lower than that experienced in 1994. Construction activity grew at a slower pace than in the previous two years because of an oversupply of apartments and commercial properties and rising interest rates. The services sector has usually grown in tandem with the overall economy; however, in 1995, the sector grew by only 6.7 percent because of a slowdown in the growth of banking services. Private sector consumption and investment expanded strongly in 1995; government consumption increased only modestly. Gross domestic investment in 1995 remained high at over 38 percent of GDP, while domestic saving increased to 36 percent of GDP.

Rapid economic growth over the past few years has contributed to growth in employment. Nevertheless, there is still considerable slack in the labor market. While the official unemployment rate is a modest 4.4 percent, the rate of underemployment remains high; nearly 45 million people work less than 35 hours per week. Progress in achieving full employment has also been slow because jobs for 2.7 million new entrants into the labor force must be created each year. Considerable progress has been made, however, in reducing poverty. The proportion of the population living below the poverty line in 1993 was 14 percent and the number of poor people has been reduced to about 26 million, from 70 million in 1970.

Minimum wage legislation has been strengthened in recent years. Mandated wage levels have been raised and coverage has been extended to most of the non-oil manufacturing

sectors and to some service industries. While this legislation has helped to raise living standards for those employed, care must be taken to ensure that the competitiveness of the dynamic labor-intensive manufacturing sector is not adversely affected.

Growth of the Indonesian economy in 1996 and 1997 is projected to be almost as strong as in 1995. Continued robust consumer demand and a high level of investment spending, especially for infrastructure development and export-oriented manufacturing, will help to sustain high growth. The investment boom is projected to add appreciably to productive capacity over the next two years. Net exports will make a modest contribution to GDP growth; import growth is expected to moderate and non-oil export growth will strengthen. The industry sector is projected to expand at 10 percent with a continued strong performance from manufacturing, telecommunications, and power generation. Oversupply of commercial real estate is likely to

continue to restrain the construction sector. The services sector will experience growth in line with that of the economy, averaging at 7.5 percent for 1996 and 1997, with new services, especially in the financial and business sectors, making a large contribution.

*Budget, Money, and Prices.* The 1995 budget provided for a modest increase in expenditure of 2 percent in real terms. The budget reflected a commitment to decentralization, with increases in regional development expenditure and a larger share of land taxes being retained by underdeveloped regions such as those in Northeast Indonesia (Box 2.2). Continued emphasis on improving tax collection was reflected in a 26 percent rise in revenue from the value-added tax (VAT). The Government also continued to give priority to infrastructure development, which saw increasing involvement of the private sector. In terms of its effect on the economy, the budget was estimated to be slightly contractionary with a negative

### **Box 2.2 Northeast Indonesia: Development Through Regional Cooperation**

Northeast (NE) Indonesia – comprising East Kalimantan, West Kalimantan, and North Sulawesi – is perhaps the most underdeveloped area of the country. More than half of the sparsely populated territory is covered by rain forest. Most of its residents are poor and are engaged in farming, forestry, or fisheries.

The marginalized socioeconomic conditions prevailing in NE Indonesia are in large part because recent development plans have directed proportionately greater resources to the development of the island of Java. To redress this deficiency and promote regional equity, the Indonesian Government in its latest national plan, *Repelita VI*, has accorded priority status to NE Indonesia in its economic and investment policies. A major strategy in this regard is the Government's promotion of economic cooperation with neighboring economies.

Indonesia is currently participating in regional economic cooperation ventures, such as the Indonesia-Malaysia-Singapore (IMS) and Indonesia-Malaysia-Thailand (IMT) growth triangles. These ventures exploit economic complementarities among geographically contiguous areas of the participating countries to gain a competitive edge in export production. Objectives are achieved through a combination

of public sector policy interventions and incentives and private sector investments.

Drawing on these experiences with the objective of developing its remote northeastern provinces, the Indonesian Government agreed to participate in an initiative to explore potential areas of cooperation within the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA). A distinguishing feature of the BIMP-EAGA is that, with the exception of Brunei Darussalam, the state of development of the component subregions lags significantly behind that of the "heartlands" of their respective countries. Thus, in a sense, BIMP-EAGA may be one of the last "frontiers" of Southeast Asia, an unexplored periphery with vast potential still waiting to be tapped.

The development of NE Indonesia, however, largely depends on overcoming the constraints associated with the past neglect toward the subregion. These constraints include centralized development planning and control; limited local autonomy; weak infrastructure; tariff barriers and other protection measures leading to uncompetitive products; and rigid regulations and complex procedures in investment, banking, and even immigration.

domestic impact estimated at Indonesian rupiah (Rp) 5.4 trillion or 1.8 percent of GDP.

The monetary authorities have focused on managing monetary aggregates with a view to dealing with inflationary pressure and the effects of large inflows of international capital. Using open market operations in Bank Indonesia Certificates (SBIs) and money market securities (SBPUs), the authorities adopted an expansionary stance in response to capital outflows in the first two months of 1995 in the wake of the Mexican financial crisis. In contrast, a contractionary stance was adopted in June and July to offset large capital inflows resulting from widened spreads between domestic and international rates of interest. In September, monetary policy was again eased in response to devaluation rumors caused by nervousness associated with worsening of the current account deficit and falling interest rates. In response to increased capital flows, the Central Bank also adopted more flexible interest rate and exchange rate policies

to enhance the effectiveness of money supply control. Interest rate targeting was abandoned in favor of auctioning a specified quantity of SBIs. This change in policy aimed to make the SBI rate, which is closely related to other domestic rates, adjust more quickly to changes in rates abroad. The exchange rate has also been used to stem speculative capital flows by gradually broadening the daily rupiah-dollar trading band to increase the cost of currency speculation. Further, to encourage the development of a domestic market for swaps and to insulate the foreign reserves held by Bank Indonesia from speculative pressures, the swap facility provided by Bank Indonesia was suspended.

The growth of narrow money (M1) slowed in 1995 to an estimated 14 percent compared with 23 percent in 1994, while broad money (M2) grew by about 24 percent. M1 growth was lower than targeted by the Government while M2 growth was higher than the Government's target of 19 percent and also higher than the rate of increase in the last four years. Despite the substantial slowdown in reserve money growth, M2 continues to expand as high interest rates still make it attractive for both domestic and international investors to place funds in interest-bearing instruments.

Although there was a slowdown in credit for property development, overall credit growth in 1995 rose by 23 percent as consumer demand remained buoyant. Credit by private domestic banks continued to rise but at a slower rate than in 1994. State banks also experienced an increased rate of credit expansion after sluggish growth in earlier years.

Inflation was relatively high in the early part of 1995 because of higher prices of rice and cement, and an increase in minimum wages. Thereafter, the growth in the CPI moderated; for 1995 as a whole inflation was 9.4 percent compared with 8.5 percent in 1994.

The draft budget for 1996 allows for a nominal rise in expenditure of 16 percent compared with budgeted expenditure in 1995. This increase is higher than in 1994 and 1995 when the nominal increases were 13 percent. Civil servants' salaries are to be increased by 19 percent and VAT revenues are projected to rise by 31 percent. It is expected that the recurrent budget will run at a surplus which could be spent on retiring government debt, especially high interest rate

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To address these development issues and constraints, three major programs under the BIMP-EAGA scheme are being proposed by an ADB regional technical assistance study: (i) human resource development (HRD); (ii) infrastructure development; and (iii) development of productive sectors.

The proposed HRD initiatives focus on facilitating labor mobility, establishing and improving training centers, and improving working conditions. The short-run objective is to create a skill base that will support directly productive activities and will allow the private sector to realize the significant market opportunities to be generated in the BIMP-EAGA.

Initiatives for infrastructure development center on improving the existing system rather than on providing new facilities. The projects seek the deregulation of existing policies and the establishment of common sea and air transportation laws to enhance cross-border movements of goods, people, and information.

Finally, the initiative emphasizes the need to promote the development of productive sectors, specifically agriculture, fishing, forestry, and tourism.

**Table 2.8 Major Economic Indicators: Indonesia**

		1993	1994	1995	1996	1997
Gross Domestic Product	% change	7.3	7.5	7.6	7.8	7.7
Agriculture	% change	1.7	0.6	2.5	2.4	2.5
Industry	% change	9.8	11.2	10.6	10.0	10.1
Services	% change	7.4	7.0	6.7	7.7	7.2
Gross Domestic Investment	% of GDP	33.2	34.0	38.3	39.0	39.0
Gross Domestic Saving	% of GDP	35.3	35.3	36.0	37.4	38.5
Inflation Rate	% change in CPI	9.6	8.5	9.4	7.5	8.0
Money Supply Growth	% change	22.0	20.2	24.1	22.0	20.0
Merchandise Exports	\$ billion	36.6	40.2	44.7	51.2	59.4
	% change	8.3	9.9	11.1	14.5	16.0
Merchandise Imports	\$ billion	28.4	32.3	39.8	45.7	51.7
	% change	6.0	13.9	23.1	14.8	13.1
Current Account Balance	\$ billion	-2.1	-2.8	-8.0	-9.2	-7.9
	% of GDP	-1.3	-1.6	-4.0	-3.8	-2.8
External Debt Outstanding	\$ billion	89.5	96.5	104.0	108.0	111.0
Debt-Service Ratio	% of exports	33.8	30.0	33.7	33.0	32.0

Sources: Data provided by the Central Bureau of Statistics (Biro Pusat Statistik) of Indonesia and Center for Strategic and International Studies; International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

loans. Development expenditure is to be increased by a modest 12 percent in nominal terms. The overall impact of the budget on the economy is again expected to be slightly contractionary, about the same order of magnitude as in 1995; this does not provide a strong signal about the Government's commitment to cooling down the economy.

The overall inflation rate is projected to moderate somewhat to 7.5 percent in 1996 and 8 percent in 1997. With the prospect of a better harvest in 1996, food price increases are unlikely to have as strong an influence on the CPI as they had in 1995. However, other sources of inflationary pressure will be present. These include wage increases, such as the scheduled increase in minimum wages by 10 percent from April 1996 and the increase in civil servants' salaries, which could in turn put upward pressure on private sector wage rates. Also, increases in administered prices, such as for fuel and energy, are likely. In 1997, there will be continued pressures from strong private sector demand and, because of the election in that year, from a more expansionary fiscal stance by the Government.

The challenge faced by the Government to manage stable growth remains. Since fiscal policy cannot be expected to play a major role, monetary authorities will continue to develop instruments to ameliorate the impact of these on the money supply and economic activity in general. Credit growth is targeted to slow down to 16 percent, and narrow money (M1) supply to 15 percent. However, since interest rates can be expected to remain relatively high and given expectations of large capital inflows, the growth rate of broad money (M2) is likely to be higher at 22 percent in 1996 and 20 percent in 1997.

*External Trade and Payments.* The external balance deteriorated sharply in 1995, primarily as a result of an increase in imports of over 23 percent and a rise of close to 13 percent in the services deficit. As a result, the current account deficit was more than double that of 1994, up from about \$3 billion to an estimated \$8 billion, an increase from 1.6 percent of GDP to 4 percent. Export performance was strong, as both non-oil and oil exports increased at double-digit rates. Robust growth in exports of minerals, rubber, metals, and

electronic products helped to offset declines in plywood and coffee exports and the slow growth in the export of textiles and apparel. However, the increase in exports was more than outweighed by import growth. Although capital goods imports rose, consumer and intermediate goods accounted for most of the increase in imports. Imports of rice and other cereals accelerated as stocks were rebuilt; while imports of intermediate goods, which account for the bulk of total imports, surged to meet increasing domestic demand, particularly in the automobile industry. The widening of the services account deficit from \$11.3 billion to \$13 billion was due mainly to an increase in debt-servicing costs and appreciation of the yen.

Foreign investment approvals reached an all-time high in 1995, rising from \$23.7 billion in 1994 to \$39.9 billion, a 68 percent increase. However, almost half of this was in the petrochemical sector. The UK was the leading source of investment, surpassing Japan. Net foreign investment flows in 1995 were substantial at close to \$6 billion, reflecting the high levels of investment approvals in 1994 (Figure 2.10). Other short-term borrowing and capital flows were close to \$5 billion in 1995 compared with around \$2 billion in the early years of the decade. Total official and non-official capital flows resulted in an estimated net capital inflow of \$10 billion in 1995, sufficient to offset the current account deficit and add around \$2 billion to reserves, which at the end of the year reached \$15 billion, equivalent to four-and-a-half months of imports.

The current account deficit in 1996 is likely to lower somewhat to 3.8 percent of GDP before falling further to 2.8 percent in 1997. Owing to the lag between investment and its effect on increasing production and export capacity, continued growth of capital goods imports will persist even as new exports are realized. Non-oil exports are expected to increase by around 19 percent over the next two years, while oil exports are not projected to increase much in view of rising domestic consumption and stable prices in the international markets. Import growth is expected to moderate to about 15 percent in 1996 and further to 13 percent in 1997. While the trade surplus will increase somewhat as export growth accelerates and import growth decreases, the services balance will continue to deteriorate. In sum, this will result in a

current account deficit in 1996 of \$9.2 billion or 3.8 percent of GDP, slightly lower than in 1995. In 1997, further improvement in the trade balance will bring about a modest decline in the current account deficit to \$7.9 billion or 2.8 percent of GDP. The debt-service ratio is expected to remain at about 33 percent in both years.

### **Policy and Development Issues**

The main challenge for macroeconomic policy in the next two years is to ensure growth with reasonable price stability and manageable fiscal and current account deficits.

Ensuring that productive and export-generating investments are made is a key component in reducing external imbalances. A transparent and competitive investment climate is needed so that investments and resources can be allocated efficiently and productively. This will entail, among other things, further deregulation and removal of impediments to private decision-making and resource use, streamlining of bureaucratic procedures, and ensuring more transparency in decision-making generally, but especially about large projects. Attention to the prioritization and phasing of large-scale infrastructure projects will be an important element of macroeconomic management. Such projects can have a significant impact on domestic demand and, as they are import intensive and do not lead to increased exports in the short run, they contribute to external imbalances.

Serious attention should also be focused on ensuring that export competitiveness is maintained and developed. This is important not only to preserve the country's growth momentum and competitive advantage but also to avoid a burgeoning of the current account deficit. Exports of new products, such as audio-visual equipment, electrical appliances, and footwear, are growing, although not as robustly as in previous years. Indonesia faces challenges in increasing its sources of competitiveness in the face of rising labor costs and lower labor productivity compared with other Asian economies. Maintaining a significant flow of FDI oriented toward export development is important in this context.

Management of large flows of capital is another critical issue which the monetary authorities will continue to face. Running a tight monetary policy with high interest rates



contractionary fiscal policy to assist in macroeconomic management. However, the Government has indicated that it intends to reevaluate and prioritize government projects, streamline government procedures, and rationalize the civil service. Other than that, the potential for increasing tax collection by expanding the tax base and reducing leakages remains great. The ratio of tax revenue/GDP for Indonesia in 1994 was only 14.7 percent compared with Malaysia at 33 percent and Thailand and Singapore at over 17 percent each.

Over the next two years, increased tax revenues and proceeds of initial public offerings of shares of state-owned enterprises should be earmarked for funding long-term liabilities such as debt prepayments and civil servants' pension funds. At the same time, efforts to rationalize and improve the management of state-owned enterprises should also be undertaken to enhance their profitability and reduce their burden on the budget.

Since 1994, much progress has been made in trade and investment deregulation. Restrictions on foreign investment have been virtually eliminated and a major trade deregulation package announced in May 1995 included not only some immediate tariff reductions, but also set out a schedule for further tariff reductions over the next few years. Progress on the removal of existing nontariff barriers, however, has been disappointing. Although import licensing procedures for some products have been eased, major items such as soybean meal, automotive products, wheat, sugar, and rice are still closely regulated. Furthermore, there has been an increasing number of complaints over the last two years about lengthy customs clearance procedures and other inefficiencies which impede imports and raise business costs.

The main medium- and long-term challenge facing the Indonesian economy in the context of an increasingly competitive and open world economy is how to ensure efficient and productive investment, whether for the domestic or export market. Other than providing a consistent and transparent investment climate, a fair competitive environment also needs to be created, crucial physical infrastructure bottlenecks need to be alleviated, and human resource development to increase productivity needs to be emphasized.

is the appropriate action when inflationary pressures are present. However, given that international rates are steady or falling, such a policy invites capital inflows which, in turn, need to be sterilized. Experience in 1995 indicates that these flows are very susceptible to external events such as the Mexican financial crisis and appreciation of the yen, and unfavorable perceptions of domestic policy changes.

Given that elections will be a preoccupation for the next two years, it may be more difficult for the Government to enact a