

Indonesia

Economic Assessment

The economy grew by 4.7% in the first half of 2004, with private consumption boosted by election-related spending accounting for 3.3 percentage points of the expansion. Government consumption contributed 0.6 percentage points, while investment added 1.6 percentage points. Weak growth in exports, at a time of surging imports, trimmed the GDP expansion. Communications, retail, and transportation activity picked up, and the sectors that matter most for jobs—agriculture and manufacturing—grew modestly. GDP growth in the second quarter was 4.3%, easing from 5.0% in the first.¹

The rupiah, which had been in a range around Rp8,600/\$1 since mid-2003, depreciated by about 12% over the first 6 months of the year to around Rp9,600. Government subsidies insulate consumers from the direct impact of rising oil prices, but higher prices for imported food and other items put upward pressure on consumer prices.

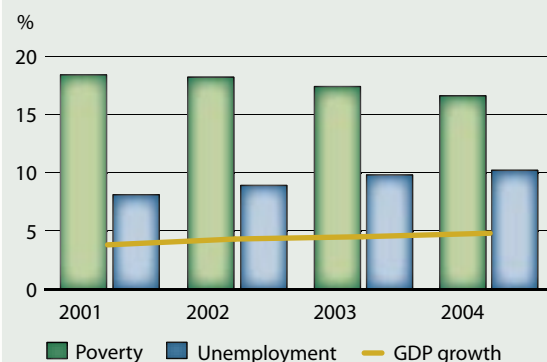
Consumer price inflation, which fell to a 3-year low in February 2004 of just below 5%, rose to 7.2% in July. Bank Indonesia intends to keep inflation at 6–7%, a target that might require higher interest rates in the near future. The central bank's reference interest rate has declined from above 11% in December 2003 to 7.4%. An increase in rates would damp private consumption at some stage, although election-related spending continued through September and holiday-related consumption spending will pick up in October and November.

Rising inflation raises concerns about further progress in poverty reduction. Indonesia reduced the poverty incidence from 27% in 1999 to 15% in 2003 but higher food prices, in particular, might slow or even reverse this process. Moreover, the nonincome aspects of poverty—poor health and

education delivery—remain. Regional disparities in the social indicators affect the country's efforts to achieve the Millennium Development Goals in a timely fashion. Steadily increasing unemployment also hurts poverty reduction. The unemployment rate rose to 10.2% in February 2004 from 9.8% in February 2003, partly because of the slow growth of manufacturing. Figure 2.6 reflects a gradually expanding economy that has been unable to contain unemployment.

Indonesia, traditionally an exporter of oil and gas, did not benefit from the rise in global oil prices over the first half of the year. The Government's subsidies on domestic fuel are projected to cost \$2.4 billion this year, constituting a major drain on the budget. Adding to this, net exports of oil and gas declined by 26% in January–June because the industry could not maintain production levels due to a weak regulatory environment and lack of investment. Crude oil production has declined from 1.4 million barrels a day (b/d) in 2000 to 900,000 b/d in 2004, even though its Organization of the Petroleum Exporting Countries (OPEC) quota has stayed at 1.4 million b/d, and the country became a net oil

Figure 2.6 Poverty, Unemployment, and GDP Growth, Indonesia, 2001–2004



Source: www.bps.go.id.

Table 2.6 Selected Economic Indicators, Indonesia, 2004–2005, %

Item	2004		2005	
	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>	<i>ADO 2004 Update</i>
GDP growth	4.5	4.8	4.5	5.2
Inflation (CPI)	6.5	6.5	6.5	7.0
Current account/GDP	3.4	3.4	3.1	3.1

Source: Staff estimates.

importer for a brief period in the first half. The 2004 budget assumes crude oil exports of just over 23,000 b/d, a substantial reduction from levels close to 700,000 b/d in 1998.

Overall exports grew only by 3.2% in the first half, but imports jumped by over 27%, pushed up by consumer spending. Non-oil and gas imports rose by over 24% while non-oil exports increased by just 2.2%, suggesting that Indonesia's export competitiveness is falling behind other countries'.

FDI has played a major role in boosting exports in the past, but foreign investment approvals fell by 34% to \$3.0 billion in the first half of 2004 from a year earlier. Domestic investment approvals picked up by 52% to \$1.8 billion from the year-earlier period, but actual investments lag approvals and many approved projects never proceed. In 2003, for instance, actual foreign and domestic investments were 30–40% of the level of approvals. Further, the quality of investments has become a concern, with more funds headed into property, which does not create as many long-term jobs as investments in manufacturing.

On the fiscal front, the deficit is likely to increase to 1.3% of GDP, against a target of 1.2%, due to the higher cost of fuel subsidies. In terms of financing, the Government has generated Rp3.3 trillion through privatization and anticipates raising most of the remaining funding through domestic bonds. It might ask SOEs to prepay debt, which would be a temporary cushion. The Government's external financing requirement still stands at \$2.8 billion for 2004, while the public debt-to-GDP ratio at end-2004 is projected at 60%, down from 66% a year earlier. External reserves, at \$35 billion as of July, are forecast to be around this level by year-end.

Policy Developments

The Government's policy reform agenda has been guided by its policy package, or White Paper, adopted in September 2003, to prioritize reforms in the post-International Monetary Fund (IMF) program era. As of July 2004, the Government had completed about 76% of the 160 measures intended for the September 2003–July 2004 period. Many of these actions were interim steps or relatively minor developments, though some major accomplishments were made, particularly in the first two planks (out of three) of the White Paper, namely Maintaining Macroeconomic Stability and Restructuring of the Financial Sector. The third plank, Increasing Investments, Exports and Employment, has fallen behind in implementation.

In the area of macroeconomic stability, most significant policy developments in 2004 have been on fiscal matters. Parliament enacted the State Treasury Law in January and the State Audit Law in June. These laws focus on enhancing the fiscal responsibility of the national and local governments. A new functional budget classification system unifies the development and recurrent budgets. To support the implementation of these measures, the President approved a reorganization of the Ministry of Finance that will include the establishment of a modern treasury management system. The Government has drafted amendments to the Tax Law, aimed at simplifying individual and company income tax rates and raising the income level at which income tax starts for individuals. The Tax Code is being amended to improve the governance of tax administration, and the authorities hope to increase tax revenues through improved administration, clearer procedures, and a broadening of the taxpayer base.

Uncertainty over the roles and responsibilities of different levels of government has affected the delivery of public services, such as education and health, and has been one reason for the deterioration of the investment climate. The Government has proposed amendments to the Law on Regional Autonomy and the Law on Fiscal Balances to provide for direct elections of regional representatives, enhance the role of provincial governors, and streamline local revenues. However, it is unclear when the amendments will be enacted.

Moreover, they do not appear to resolve issues of roles and responsibilities among the various tiers of government.

In the financial sector, good progress has been made on the sale of commercial banks that were put in the hands of the Indonesian Bank Restructuring Agency after the 1997–98 financial crisis, with the sale now under way of Bank Permata, the last of these banks. However, governance in state-owned banks remains a concern, especially as some of them plan to merge with other large state-owned or private banks. Given the potential scope for systemic risks stemming from one or two large banks that could account for a substantial part of total banking assets, it will be important that the Government and Parliament evaluate mergers between large institutions. Thus far, the authorities have not issued a clear policy statement on the issue.

The third plank of the White Paper—Increasing Investment, Exports and Employment—is more problematic. While the Government has established a National Investment and Export Promotion Team, Anticorruption Commission, Electricity Market Supervision Agency, and a one-stop investment licensing system, these institutions are yet to have an impact. The national team, chaired by the President, has taken some initial steps to reduce customs and inspection-related impediments to investments. However, a lack of implementing regulations is a problem in many areas. In other cases, a lack of progress in amending laws has been a major constraint. For instance, the Government and Parliament were expected to work together to amend the Bankruptcy Law in the second quarter, in order to allay investors' concerns following a damaging episode where the Jakarta Commercial Court declared the profitable and solvent Indonesian subsidiary of Prudential PLC to be bankrupt, before that bankruptcy verdict was overturned by the Supreme Court. But the amendments to the law have still not been adopted.

As part of efforts to improve the business environment, the Government has proposed a comprehensive national social security system. The draft law aims at integrating health, workplace, and other social safety-net provisions with basic pensions, and to expand social security coverage to workers in the informal

sector. However, the draft law is vague and its fiscal implications are unclear. It has also added to the prevailing uncertainties as to labor costs. Sound implementing regulations will be required to guide a gradual implementation of the law, if Parliament enacts it.

Outlook for 2004–2005

Growth in 2004 is forecast at 4.8%, with the revision from *ADO 2004* caused entirely by the official change in base year prices from 1993 to 2000. Growth could be up to 0.2 percentage points higher if the oil price is sustained at over \$40 a barrel for at least 3 months. However, if growth continues to slow in the third quarter as it did in the second, the full-year outturn could be slightly below the forecast. The proposed 2005 budget, which might be amended after a new Government takes office in October, projects GDP growth of 5.5% in 2005, and forecasts an overall budget deficit of 0.8% of GDP (against a 1.2% target in 2004). It also assumes a 5.5% inflation rate and a 6.5% reference interest rate (compared with 8.5% in 2004). Growth in the forecast period will depend to a large extent on investment and the export performance. The forecast for 2005 is revised up to 5.2%, partly because of the pickup in domestic investment. Inflation is projected to average 6.5% in 2004, similar to 2003, and to edge higher to 7.0% in 2005. Growth may exceed the forecasts if Indonesia's new President, elected directly by the people for the first time, shows early signs of policy clarity on key issues and forms a balanced and focused cabinet.

Downside risks are also apparent. On the political side, the President's party will almost certainly not have a clear majority in Parliament. The weather is a potential problem, too. Parts of Indonesia could suffer from drought caused by a predicted El Niño weather pattern, which would reduce agricultural production.

Several major issues face the new Government in October. One is promoting job creation. More than 10 million people are classified as unemployed and around 40 million are reported to be working fewer than 40 hours a week. About 2.5 million people enter the labor force annually and, based on past performance, the economy needs to grow consistently at 5–6% a year to absorb these new

entrants into the formal sector. However, only 1 million new jobs have been created in each of the past 2 years.

Another dimension is that unemployment among young people has been rising rapidly: almost two thirds of the unemployed are now in the 15–24 age group. New jobs are mainly in the informal sector, where labor productivity is significantly lower. Employment in the formal sector has been discouraged by a rise of more than 60% in labor costs in the past decade. Labor markets in the formal sector have also become more rigid, influenced by increases in minimum wage rates and by uncertainty over labor regulations. Some new jobs were being created in labor-intensive industries such as footwear, but there is evidence that jobs in these industries are shifting to the PRC and Viet Nam.

With regard to export competitiveness, Indonesia's export growth rates have lagged those of other countries in the region, due partly to declining FDI and partly to greater competition from those countries. For instance, over 2000–2003, Indonesian exports to the PRC increased by 30% to \$5.8 billion, while over that period Malaysia almost tripled its exports to the PRC (to \$14 billion), and Singapore and Thailand doubled their exports (to \$10.5 billion and \$8.8 billion, respectively). Besides the rising wage costs and weak growth in labor productivity, problems such as corruption and weak coordination within the Government have reduced the country's industrial and trade competitiveness. Indonesia needs to revive its competitiveness by, among other steps, attracting investment and revamping its import licensing system.

Another challenge for the new administration is reducing nonincome poverty. The Government has issued its first Progress Report on the Millennium Development Goals, which highlights the difficulties in attaining them, including resource constraints and the complexity in coordinating development policies in a decentralized environment. The United Nations Development Programme's *Human Development Report 2004* places Indonesia at 111 out of 177 countries surveyed, with the country's human development index below that of the Philippines and Thailand.

Strengthening the Indonesian civil service should receive priority attention as well. The public widely believes that the civil service is neither professional nor performance-oriented. Recruitment is based on merit, but mobility within the system is not. The pay system is complex and incentives are not geared to promote productivity, but are linked to seniority and other factors. It is critical that the new Government undertake a functional and organizational review at the central and local levels, and formulate a system for determining skill requirements and relative compensation levels for skill categories. The adoption of a State Finances Law has paved the way for integrating planning and budgeting processes. It also provides for performance-based budgeting. However, the challenge lies not only in formulating regulations, but also in implementing them effectively.

1 The National Statistics Agency has recalibrated GDP data using a base of 2000 prices, which has changed reported growth rates.