

Indonesia—Assessment Letter for the Asian Development Bank

August 1, 2017

Recent Developments and Outlook

Macroeconomic developments and outlook. Macroeconomic performance in 2017 has been satisfactory. On the back of the partial recovery of commodity prices, real GDP growth rose to 5 percent in 2017:Q1 (from 4.9 percent in 2016:Q4), led by net exports, even as private investment remained subdued. Growth for 2017 is expected to pick up slightly to 5.2 percent on account of higher net exports and fiscal spending. Supportive capital inflows and the recent S&P sovereign ratings upgrade to investment grade have buoyed financial markets, while the current account deficit has narrowed and international reserves have risen. Inflation has risen to 4.4 percent in June, mainly due to improved targeting of electricity subsidies.

Risks to the outlook. The balance of risks remains tilted to the downside. The main risks are external and include uncertainty about policies in advanced economies, including U.S. monetary policy normalization, heightened financial volatility, lower commodity prices, slowdown of growth in China, and higher geopolitical risk. Domestic risks include tax revenue shortfalls and lower fiscal space due to higher international and domestic interest rates.

Policy Framework and Settings

Fiscal policy. The revised budget for 2017 submitted to Parliament aims at a higher general government deficit (2.9 percent of GDP, compared to 2.4 percent in the original budget), reflecting lower projected revenues (0.3 percent of GDP) and somewhat higher expenditures on subsidies, public investment, and natural disaster contingency (0.2 percent). The authorities expect that the actual deficit will be near 2.7 percent of GDP due to the traditional underperformance of spending. The revised budget puts on hold the policy of rebuilding fiscal buffers and makes use of most of the available fiscal space, although there are no imminent risks to confidence or fiscal sustainability from the shift. Downside risks to tax revenues remain, including due to the reliance on commodity revenues, which will require careful monitoring of spending to continue to meet the statutory limit on the fiscal deficit (3 percent of GDP). At the same time, the authorities are aware of the essential need to put in place a comprehensive medium-term revenue strategy that includes both tax and additional tax administration reforms and are working towards the preparation of such a strategy. Further progress has been achieved with subsidy reforms, including better targeting of electricity subsidies and shifts from price subsidies to direct transfers for foodstuffs.

Monetary policy. Inflation has risen in recent months due to the adjustment of administered prices, although at 4.4 percent in June (y/y) it remains within the official target band (3–5 percent). Core inflation slowed to 3.1 percent (y/y) in June. Against this backdrop, the stance of monetary policy is appropriate, with BI interest rate policy on hold. Nonetheless, the authorities should stand ready to raise interest rates if inflationary or external pressures materialize. In addition, maintaining flexible exchange rates and market-determined government bond yields will be critical to help the economy

navigate through volatile external financial conditions. Monetary operations reforms have continued, including the move to place all BI securities through auctions and partial averaging of banks' reserve requirement.

External assessment. The external position of Indonesia in 2016 was assessed to be broadly consistent with medium-term fundamentals and desirable policies.

Financial sector. Financial sector indicators show a profitable and liquid financial sector and relatively low levels of systemic risk, although pockets of vulnerabilities remain among medium- and small-sized banks. Loan growth has started a weak recovery (9.2 percent (y/y) in 2017:Q1), while NPLs and restructured loans appear to have stabilized since 2016:Q4. Nonetheless, bank asset quality needs to be closely monitored. The authorities also need to watch corporate vulnerabilities carefully, even as they appear to have abated somewhat in recent months. The government promulgated several regulations related to the Financial System Crisis Prevention and Mitigation (FSCPM) Law.

Macrostructural issues. Promoting inclusive growth will require further efforts in structural reforms. There has been some progress in raising public investment in infrastructure as a result of an improved institutional framework. Continued infrastructure development, combined with an enhanced regulatory framework and a further opening of sectors to domestic and foreign investment will support the diversification of the economy and boost growth. The authorities should continue their efforts to strengthen human capital, including by improving the quality of education and reducing rigidities in the labor markets.

IMF Relations

The 2016 Article IV consultation was concluded by the IMF's Executive Board on January 25, 2017.

Table 1. Indonesia: Selected Economic Indicators, 2013–18

Nominal GDP (2016): Rp 12,407 trillion or US\$ 932 billion
 Population (2016): 258.7 million
 Main exports (percent of total, 2016): Coal (10.1), palm oil (9.9), oil and gas (9.1), textile & textile products (8.2)
 GDP per capita (2016): US\$3,604
 Unemployment rate (August 2016): 5.6 percent
 Poverty headcount ratio at national poverty line (2016): 10.9 percent of population

	2013	2014	2015 Est.	2016 Prel.	2017 Proj.	2017		2018 Proj.
						Latest outturn		
Real GDP (percent change)	5.6	5.0	4.9	5.0	5.2	5.0	Q1	5.3
Domestic demand	4.7	5.0	4.2	4.6	4.9	4.2	Q1	5.1
<i>Of which:</i>								
Private consumption 1/	5.5	5.3	4.8	5.0	5.0	5.0	Q1	5.2
Government consumption	6.7	1.2	5.3	-0.1	4.7	2.7	Q1	4.1
Gross fixed investment	5.0	4.4	5.0	4.5	5.2	4.8	Q1	5.4
Change in stocks 2/	-0.6	0.5	-0.6	0.3	-0.1	-0.4	Q1	0.0
Net exports 2/	0.6	-0.2	1.0	0.1	0.4	0.7	Q1	0.3
Saving and investment (in percent of GDP)								
Gross investment 3/	33.8	34.6	34.2	34.3	34.1	...	...	34.1
Gross national saving	30.7	31.5	32.1	32.5	32.5	...	...	32.3
Prices (12-month percent change)								
Consumer prices (end period)	8.1	8.4	3.4	3.0	4.5	4.4	Jun.	4.2
Consumer prices (period average)	6.4	6.4	6.4	3.5	4.4	4.0	Jan.-Jun.	4.3
Public finances (in percent of GDP)								
Central government revenue	15.1	14.7	13.1	12.5	12.4	4.3	Jan.-May	12.0
Central government expenditure	17.3	16.8	15.7	15.0	15.1	5.3	Jan.-May	14.8
<i>Of which: Energy subsidies</i>	3.2	3.2	1.0	0.9	0.8	0.2	Jan.-May	0.5
Central government balance	-2.2	-2.1	-2.6	-2.5	-2.7	-1.0	Jan.-May	-2.8
Primary balance	-1.0	-0.9	-1.2	-1.0	-1.1	-0.3	Jan.-May	-1.1
Central government debt	24.8	24.7	26.9	27.9	28.2	...	...	28.9
Money and credit (12-month percent change; end of period)								
Rupiah M2	9.4	13.5	9.0	11.7	12.0	...	...	...
Base money	16.7	11.6	3.0	4.6	9.8	7.8	Feb.	...
Private Sector Credit	20.0	11.8	10.3	7.7	9.5	...	...	...
One-month interbank rate (period average)	5.8	7.5	7.2	6.9	...	...	...	...
Balance of payments (in billions of U.S. dollars, unless otherwise indicated)								
Current account balance	-29.1	-27.5	-17.5	-16.9	-16.1	-2.4	Q1	-19.0
In percent of GDP	-3.2	-3.1	-2.0	-1.8	-1.6	-1.0	Q1	-1.7
Trade balance	5.8	7.0	14.0	15.4	17.2	5.6	Q1	16.8
<i>Of which: Oil and gas (net)</i>	-9.7	-11.8	-5.7	-4.8	-7.9	-2.2	Q1	-8.1
Inward direct investment	18.8	21.8	16.6	3.6	20.9	2.8	Q1	25.1
Overall balance	-7.3	15.2	-1.1	12.1	9.2	4.5	Q1	6.2
Terms of trade, percent change (excluding oil)	-2.8	-3.0	-12.6	0.6	1.6	...	...	-3.8
Gross reserves								
In billions of U.S. dollars (end period)	99.4	111.9	105.9	116.4	125.5	123.1	Jun.	131.8
In months of prospective imports of goods and services	5.9	8.1	8.0	8.1	8.3	8.1	Jun.	8.1
As a percent of short-term debt 4/	177	189	191	213	232	228	Jun.	246
Total external debt 5/								
In billions of U.S. dollars	266.1	293.3	310.7	317.1	330.8	...	...	345.3
In percent of GDP	29.0	32.9	36.1	34.0	32.5	...	...	31.3
Exchange rate								
Rupiah per U.S. dollar (period average)	10,414	11,862	13,391	13,306	...	13,342	Jan.-Jun.	...
Rupiah per U.S. dollar (end of period)	12,171	12,435	13,788	13,473	...	13,403	Jul. 7	...
Memorandum items:								
Jakarta Stock Exchange (12-month percentage change, composite index)	-1.0	22.3	-12.1	15.3	...	9.8	Jul.7 (ytd)	...
Oil production (thousands of barrels per day)	830	794	800	820	815	...	...	770
Nominal GDP (in trillions of rupiah)	9,546	10,570	11,532	12,407	13,625	...	...	14,977

Sources: Data provided by the Indonesian authorities; and IMF staff estimates and projections.

1/ Includes NPISH consumption.

2/ Contribution to GDP growth (percentage points).

3/ Includes changes in stocks.