Indonesia

Stronger than anticipated economic recovery in the first half of 2010 was driven by growth in private consumption and private investment, gains that more than offset reduced government spending. GDP forecasts for this year and next are revised up from those made in *Asian Development Outlook 2010* in April. Inflation has been more subdued than expected, but there is a risk of price pressures building. The current account is projected to remain in surplus through the forecast period.

Updated assessment

GDP growth accelerated to 6.2% year on year in the second quarter of 2010 from 5.7% in the first (Figure 3.5.1.), putting the first-half expansion at 5.9%. The main drivers of growth on the demand side were private consumption and a welcome boost in investment.

Private consumption, supported by a firmer labor market, rising wages, and relatively high prices for agricultural commodities, grew by 4.5% in the first 6 months from the prior-year period and contributed nearly half the total GDP growth. By contrast, government consumption spending, which had expanded at double-digit rates from late 2008 through late 2009, fell by 8.9% in the first half of 2010 as the government unwound its fiscal stimulus and as budget disbursement lagged behind schedule.

A 7.9% increase in fixed capital investment (Figure 3.5.2) was a particularly beneficial development, contributing to the economy's productive capacity and adding 1.8 percentage points to first-half GDP growth. Investment in machinery and transportation equipment rebounded (it had contracted in the year-earlier period), while investment in buildings (including infrastructure) was maintained at a solid pace.

Investment was supported by a 4% appreciation of the rupiah against the US dollar in the first 8 months of 2010 and by a pickup in credit to the private sector. Net foreign direct investment inflows rose by about 45% to $4.9 billion in the first half, suggesting consolidating international confidence in the economy.

The contribution of net exports to GDP growth was just under 1 percentage point in January–June, similar to the same period of the previous year.

Among production sectors, services grew by 8.3% (Figure 3.5.3). Double-digit expansion was recorded in telecommunications services as well as wholesale and retail trading. Services contributed more than half of total GDP growth (3.7 percentage points) on the supply side. Industry expanded by 4.4%, with a moderate recovery in manufacturing (output up by 4.0%), in part reflecting the recovery in export demand. The

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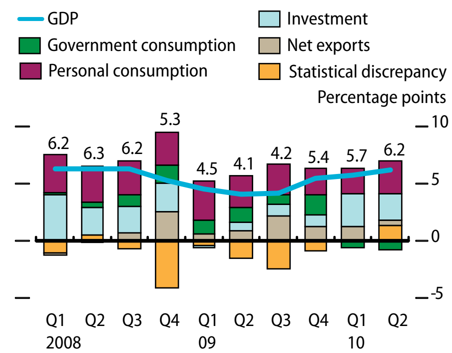
3.5.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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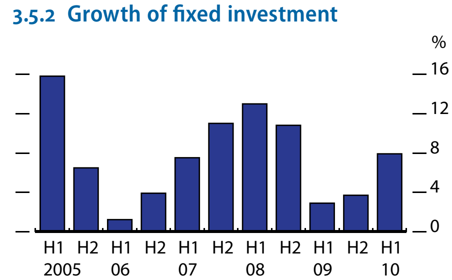
3.5.2 Growth of fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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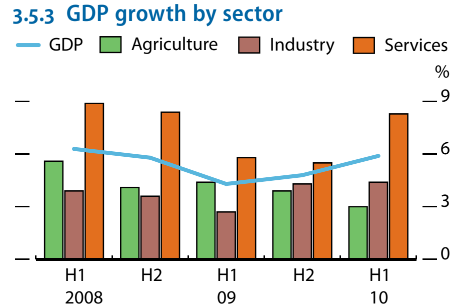
3.5.3 GDP growth by sector



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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manufacturing production index edged higher during the first 6 months (Figure 3.5.4). Growth in mining was slightly ahead of the year-earlier period, at 3.4%. Industry as a whole contributed 1.8 percentage points to GDP growth.

Agriculture, however, recorded its weakest performance for 3 years due to bad weather. Production in this sector rose by 3.0%, and made only a small contribution to GDP growth.

The rebound in world trade propelled merchandise exports by 39% in nominal US dollar terms during the first half, with notably strong gains in exports of oil and gas as well as rubber. Imports surged even faster than exports (Figure 3.5.5), at nearly 50%, in large part reflecting the need for imported inputs for manufactured exports and increases in capital equipment imports. The half-year trade surplus rose by just over 14% to $17.4 billion. After taking into account deficits in services trade and the income account, the outcome for the current account was a surplus of $3.9 billion (equivalent to 1.2% of GDP).

At $12 billion, the surplus in the overall balance of payments was more than double that of a year earlier (Figure 3.5.6), driven by increasing foreign investment in Indonesian bonds and short-term debt securities, coupled with the increase in foreign direct investment. Significant volumes of capital flowed out of the country in May, triggered by a rise in global risk aversion during the Greek sovereign debt crisis, though inflows resumed in June. International reserves in the first 8 months of 2010 rose to $81.3 billion, equivalent to 6.1 months of imports and government foreign debt payments. This strong external position contributed to the rupiah's appreciation against the dollar.

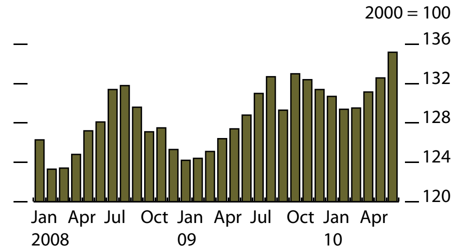
Higher levels of short-term capital inflows over the past 18 months have increased the country's exposure to the risk of a sudden reversal in these sometimes volatile capital movements. To temper that risk, the authorities have built additional foreign reserves and adjusted policies to check short-term flows. For example, Bank Indonesia has imposed a minimum 30-day holding period for central bank certificates, has issued longer-dated certificates, and has introduced a new term-deposit facility for commercial banks.

Robust economic growth helped to trim the rate of unemployment, to 7.4% in February 2010 from 8.1% in February 2009. About 2.9 million jobs were generated in that 12-month period, mainly in industry, domestic trade, and construction. Poverty incidence, as measured by the national poverty line, was 13.3% in March, down about 2 percentage points over 2 years.

Inflation, subdued at below 4% year on year since mid-2009, accelerated to just over 6% in July and August 2010 (Figure 3.5.7). That increase was fueled by a surge in the price of rice and some other food, in part a result of the bad weather, and higher electricity tariffs. For the first 8 months of this year, inflation averaged 4.6%. (Bank Indonesia's inflation target is 4%–6% for 2010–2011.)

The central bank left its policy interest rate unchanged at 6.5% through September 2010 to stimulate growth in credit and in the context of modest core inflation (4.2% in August) and an appreciating exchange rate. (The monetary authorities had cut the policy rate by 300 basis points to 6.5% between October 2008 and August 2009 to support growth during

3.5.4 Manufacturing production index



Source: CEIC Data Company (accessed 15 September 2010).

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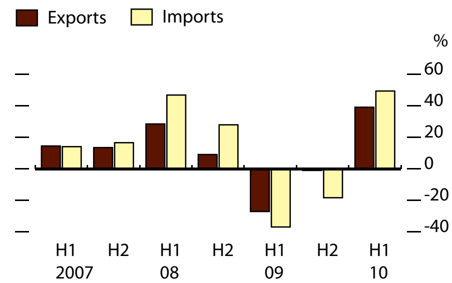
3.5.5 Merchandise trade growth



Note: Based on balance-of-payments data.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 6 September 2010).

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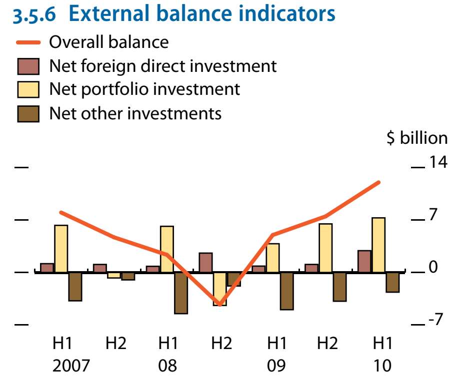
3.5.6 External balance indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 September 2010).

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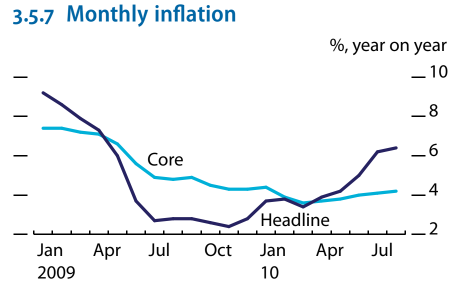
3.5.7 Monthly inflation



Sources: CEIC Data Company (accessed 3 September 2010); *Asian Development Outlook* database.

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the global recession.) Bank Indonesia, did, however, opt to raise the primary reserve requirement ratio for banks, effective 1 November 2010, to drain some of the considerable excess liquidity in the banking system. The central bank also took steps to encourage banks to spur sluggish lending, with the result that credit to the private sector started to pick up in the second quarter and was running at about 19% in July.

Domestic financial markets were generally buoyant. The Jakarta Composite Index of share prices climbed by nearly 22% in the first 8 months of 2010 (Figure 3.5.8). Yields on 5-year government local-currency bonds fell by 132 basis points to 7.7% during that period.

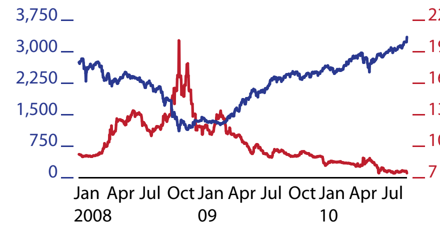
Revisions to the 2010 budget approved by Parliament in May widened the budget deficit target to 2.1% of GDP. These changes take into account higher international oil prices than originally expected, so that the amount allocated for energy subsidies in 2010 was increased to the equivalent of $15.7 billion. The revised budget includes a provision to raise retail fuel prices if international prices exceed the projected price in the budget ($80 per barrel) by 10%. Electricity tariffs were raised by an average of 10% from July.

The revised budget also allocated additional spending for physical infrastructure, poverty reduction, education, and reconstruction of earthquake damage. However, the budget outturn in the January–June period showed a surplus of Rp46 trillion, or 0.7% of GDP, instead of the budgeted deficit. Only about 35% of the 2010 budget spending was disbursed in the first half, mainly owing to delays in executing budget projects, a perennial problem (the equivalent spending figure a year earlier was 37%).

On the receipts side, higher domestic oil prices and production, an improved performance by state-owned enterprises, and the higher levels of business activity underpinned growth in government revenue.

Indonesia's debt-to-GDP ratio fell to 26% in August 2010 (preliminary data for national government debt), maintaining a decline that has seen the ratio fall by more than half over the past 6 years.

3.5.8 Financial market performance



Source: Bloomberg (accessed 15 September 2010).
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Prospects

The basis for the projections assumes that the government will implement the major policies formulated in the National Medium-Term Development Plan, which targets raising average annual GDP growth to 6.3%–6.8% in 2010–2014, and lowering the poverty incidence to 8%–10%.

Fiscal deficits are projected through the forecast period. Government spending will accelerate in the second half of this year, following the slow start to budget disbursement, although the targeted budget deficit of 2.1% of GDP for this year seems unlikely to be achieved (a deficit of about 1.5% seems in prospect, close to the 2009 deficit). Next year, the government is projecting a fiscal deficit of 1.7% of GDP. Deficit spending, together with some improvement in budget execution and increasing allocations for infrastructure, will support economic growth.

Monetary policy is assumed to be generally accommodative. The monetary authorities have indicated that they are inclined to adjust bank reserve requirements before they start to return the policy interest rate to more normal levels.

3.5.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth	5.5	6.1	6.0	6.3
Inflation	5.6	5.2	6.2	5.7
Current acct. bal. (share of GDP)	1.4	1.2	0.6	0.7

Source: ADB estimates.

Investment is forecast to gain momentum through the second half of 2010 and in 2011, underpinned by prospects for growth in exports, improved credit availability, and efforts by the government to accelerate disbursement on capital works. A survey by Bank Indonesia in the second quarter of this year showed that 81% of respondents believe 2010 to be a good time to invest. International investor sentiment toward Indonesia, too, is improving. Standard & Poor's raised its long-term foreign currency credit rating on the country's debt from BB- to BB in March 2010, and Moody's revised its rating outlook in June from Ba2 stable to Ba2 positive.

Private consumption is expected to be robust, backed by rising real incomes, a public wage increase, and growth in employment. The index of consumer confidence dipped in July and August when inflation accelerated (Figure 3.5.9), but it still suggested growth in consumption.

The pace of growth in exports will likely moderate in the second half of 2010, given the base effects from an upturn in exports late last year.

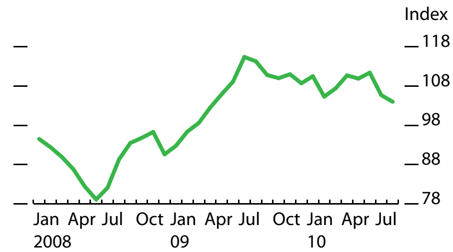
Taking these factors into consideration, GDP growth in the second half is projected to remain around the 6.2% rate recorded in the April–June quarter. The full-year 2010 forecast is revised up to 6.1% (Figure 3.5.10), in light of the upgrading of the projection for growth in world trade, and the stronger than expected, broad-based expansion of the Indonesian economy in the first half. GDP growth next year is seen at 6.3%, slightly higher than in 2010 owing to projections of continued growth in private consumption and in both private and public investment.

The surge in imports spurred by the stronger than expected domestic demand will trim the current account surplus from the level anticipated in April. Current account surpluses now are forecast at the equivalent of 1.2% of GDP this year and 0.7% in 2011.

Some of the upward pressures on prices in July–August were one-time and seasonal factors that are expected to subside. For the full year, inflation is forecast to average 5.2%, accelerating to 5.7% in 2011 (Figure 3.5.11) as domestic demand continues to strengthen. These forecasts are trimmed from April's on the basis of lower than expected inflation in the first half of 2010 and the pickup in investment, which will help to ease capacity constraints.

Still, there is a risk that inflation could exceed the forecasts, given the outlook for quickening economic growth and still low interest rates. Further bouts of bad weather would be reflected in higher prices for rice and vegetables, and global wheat prices have been under upward pressure. A return to high levels of inflation would dent private consumption and reduce room for accommodative monetary policy, hurting investment.

3.5.9 Consumer confidence index



Source: CEIC Data Company (accessed 15 September 2010).

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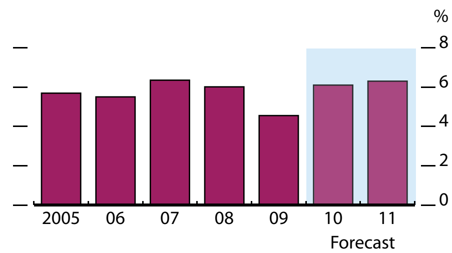
3.5.10 GDP growth



Source: Asian Development Outlook database.

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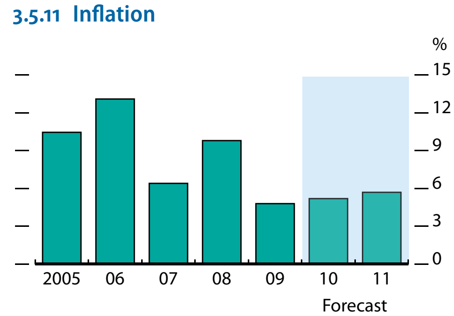
3.5.11 Inflation



Note: 2005–2007 base year = 2002; 2008 onwards base year = 2005.

Source: Asian Development Outlook database.

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