Indonesia

The global recession had only a moderate impact on this large economy: growth was maintained, mainly due to increases in private consumption and government expenditure. Inflation eased to low levels. Economic activity is forecast to quicken this year and return to prerecession levels in 2011, based on strengthening domestic demand and supportive macroeconomic policies. Despite economic achievements over recent years, raising investment in infrastructure and generating enough jobs remain major challenges.

Economic performance

Growth slowed during the global recession, but not precipitously, reflecting the economy's relatively low dependence on exports (equal to 30% of 2008 nominal GDP) and large domestic market. The slowdown bottomed in the second quarter of 2009, and the economy rebounded in the fourth, assisted by a pickup in exports and prices of export commodities, as well as by stimulatory fiscal and monetary policies. For the year, GDP increased by 4.5% (Figure 3.24.1), only about 1 percentage point below the average expansion in the previous 5 years.

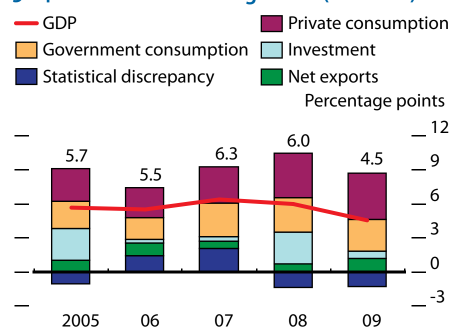
Private consumption grew by 4.9% in 2009, to contribute the majority of GDP growth (2.8 percentage points). It was driven by good harvests (which bolstered rural incomes), low inflation, government cash transfers to poor households early in 2009, election-related spending, and tax cuts (adopted as part of a fiscal stimulus package).

The government boosted its consumption spending by 15.7% (a second consecutive year of double-digit increases), which contributed 1.3 percentage points to GDP growth. Alongside efforts to raise the rate of budget disbursement to stimulate the economy, the fiscal stimulus package was an important factor in higher public spending. Election-related outlays in the first half and pay increases for civil servants also contributed.

Growth in investment slowed in the face of the world financial crisis and poor global outlook. Fixed investment rose by a modest 3.3%, due to increased outlays on buildings and infrastructure. Investment in machinery and equipment slumped by 9.2%, although the pace of its contraction moderated in the fourth quarter (Figure 3.24.2). As for international trade, imports of goods and services contracted faster than exports, generating positive net exports and contributing just over 1 percentage point of GDP growth.

On the supply side, growth of agriculture was solid at 4.1% (though slower than in 2008). Harvests were good, but demand softened for exports of natural rubber and palm oil. Growth in manufacturing production also eased from 2008, to 2.1%. After a drop in late 2008 and early 2009, the manufacturing production index started to edge up

3.24.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; Statistics Indonesia. http://www.bps.go.id (accessed 15 March 2010).

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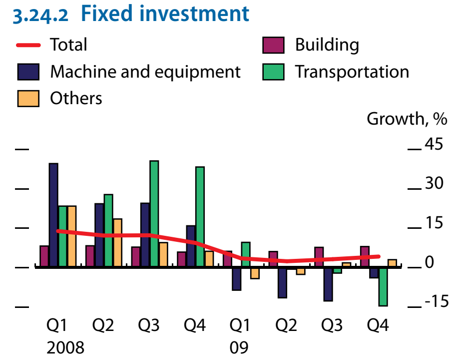
3.24.2 Fixed investment



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

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This chapter was written by Jörn Brömmelhörster and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

(Figure 3.24.3). Higher production of coal and copper lifted mining output by 4.4% (but crude oil output fell by about 3% to 301 million barrels in 2009). Construction expanded by 7.1%, bolstered by the investment in buildings and by government spending on infrastructure.

Growth in services moderated to 5.7%, but this sector (accounting for about 45% of GDP) still contributed more to total growth than industry and agriculture together. Transport and communications continued to outpace most other services subsectors, expanding at double-digit rates.

Lower prices for export commodities as well as softer demand drove down merchandise exports by 14.4% in United States (US) dollar terms last year. Merchandise imports fell at nearly double that rate, reflecting lower prices, weak investment in machinery and equipment, and a fall in exports of manufactures (which require imported inputs). Monthly data show exports and imports turning up in late 2009 as prices and demand recovered (Figure 3.24.4). The sharper slide in imports than exports generated a $35.2 billion trade surplus, and contributed to a current account surplus equivalent to 2.0% of GDP (the trade surplus outweighing a decline in current transfers and higher income and services deficits).

Net foreign direct investment inflows plunged by about 43% to $5.3 billion in 2009, but portfolio investment rose strongly in a sign of improved investor confidence. The overall balance of payments recorded a substantial surplus. International reserves, which had declined to $50.6 billion in October 2008, rebounded to $66.1 billion by end-2009, representing 6.5 months of imports and government foreign debt payments. The government entered into currency swap agreements totaling more than $30 billion that it could tap, if needed, to further bolster the external position.

The good harvests, an appreciating rupiah, and lower global food and fuel prices paved the way for inflation to abate to its lowest in almost a decade. Inflation decelerated from 12.1% year on year in September 2008 to 2.8% in December 2009, averaging 5.0% in 2009.

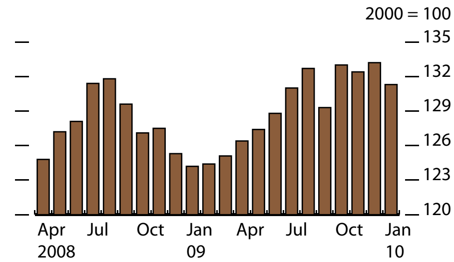
The unemployment rate declined slightly from 8.1% in February 2009 to 7.9% in August 2009, but employment in the formal sector increased by just 0.8%, or 260,000 jobs in this period. Lower (notably food) inflation and government cash payments for poor households in early 2009 contributed to a decline in poverty incidence by about 1 percentage point to 14.1% in the 12 months to March 2009.

As inflation and economic activity slowed, Bank Indonesia, the central bank, lowered its policy interest rate by 300 basis points from November 2008 to August 2009 to 6.5% (Figure 3.24.5). However, because commercial banks lagged in reducing their interest rates, these cuts had little impact on lending. Growth in credit slowed to about 10% in 2009, and growth in broad money supply eased to 12.4% by year-end.

Financial indicators strengthened as the year progressed. The rupiah appreciated against the US dollar by 18.2% in 2009, recovering from a depreciation in late 2008. Capital inflows picked up, along with the economy, from March. Yields on government bonds fell significantly, stock prices climbed, and credit default swaps returned to levels seen before the crisis (Figure 3.24.6).

To counter the impact of the global recession, the government rolled out a fiscal stimulus package costing Rp73.3 trillion, or about

3.24.3 Manufacturing production index



Source: CEIC Data Company (accessed 26 March 2010).

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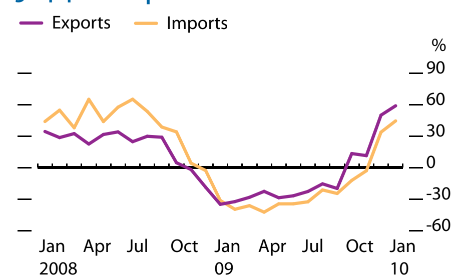
3.24.4 Trade performance



Note: Based on customs data.

Source: CEIC Data Company (accessed 5 March 2010).

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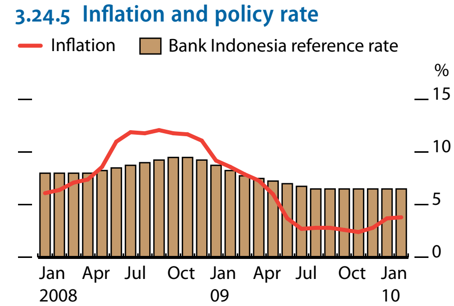
3.24.5 Inflation and policy rate



Sources: Bank Indonesia. http://www.bi.go.id; CEIC Data Company (both accessed 5 March 2010).

Click here for figure data

1.4% of GDP. It consisted of tax breaks and subsidies to support private consumption and businesses (84% of the total stimulus) and labor-intensive infrastructure works. Efforts to raise the budget disbursement rate succeeded in getting much of the package implemented.

At the same time, lower international fuel prices allowed for a reduction in spending on fuel subsidies, so that total spending was less than budgeted. Revenue fell by about 15%, trimmed by lower corporate profits and commodity prices. The budget outcome was a deficit of 1.6%, widening from 0.1% in 2008, but smaller than the budgeted deficit of 2.4%.

Funding for the stimulus package was augmented by unspent budget resources from 2008 and from bond issuance. The government insured itself against a worsening financial climate by securing access to $5.5 billion through 2010 in contingency financing from development partners, only a small part of which was used in 2009. The contingency agreements helped restore confidence in financial markets, and the government was able to raise about $13.7 billion from domestic and international debt markets in 2009.

Still, the debt-to-GDP ratio of the national government fell to 28% in 2009, maintaining a decline that has cut the ratio by half in 5 years (Figure 3.24.7). An expanding economy, fiscal consolidation, and lower interest rates have helped bring down the debt burden. Reflecting improvements in the country's public and external positions, Standard & Poor's raised its long-term foreign currency credit rating for Indonesia's sovereign debt to BB from BB- in March 2010. Fitch Ratings upgraded its rating to BB+ from BB (one notch below investment grade) in January this year.

Some progress was made in addressing constraints to growth. A regional tax law finalized last year clarifies and limits new taxes that can be levied by regional governments, and a new export finance agency was established to provide lower-cost export credit to small and medium-sized businesses.

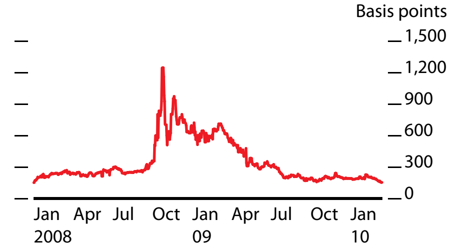
Efforts were stepped up to improve power supplies. Electricity demand is growing by at least 8% a year, and the state power company, which operates 85% of generating capacity and has a monopoly on transmission and sales, has struggled to meet it. A law introduced in 2009 allows private investors and local authorities to generate, transmit, and sell electricity without having to work with the state firm.

Economic prospects

Forecasts assume that the government will implement the major policies outlined during the 2009 national elections, including following through with the recently formulated National Medium-Term Development Plan 2010–2014. They also assume that monetary policy will be generally accommodative to growth, the rupiah will average about Rp9,400/$1, and that weather conditions will be normal.

The medium-term plan envisages average annual GDP growth of 6.3%–6.8% over 2010–2014, as well as, by 2014, a reduction in the unemployment rate to 5%–6% and a decline in poverty incidence to 8%–10%. The plan's focus is on ameliorating infrastructure, the bureaucracy, governance, and the investment climate. It calls for

3.24.6 Credit default swaps



Source: Bloomberg (accessed 16 March 2010).
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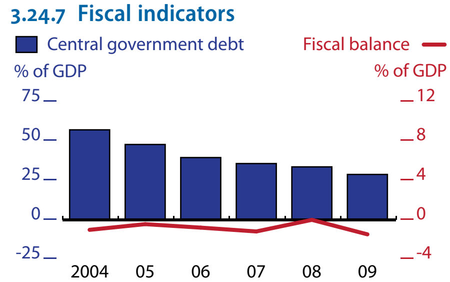
3.24.7 Fiscal indicators



Sources: Directorate General of Debt Management. http://www.dmo.or.id (accessed 1 March 2010); *Asian Development Outlook* database.
Click here for figure data

3.24.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.5	6.0
Inflation	5.6	6.2
Current account balance (share of GDP)	1.4	0.6

Source: ADB estimates.

a substantial increase in development expenditure, which implies ambitious targets for funding from the private sector and public–private partnerships.

The 2010 budget aims to support the economic recovery, increase outlays on infrastructure, and sustain social spending. In September 2009, Parliament adopted a budget with a deficit target of 1.6% of GDP. However, taking into account rising world oil prices that will lead to a higher allocation for energy subsidies, the government proposed a revised budget with a wider deficit of 2.1% of GDP. This revised budget assumes a 15% rise in electricity charges at midyear, but no increase in administered fuel prices at any point during the year.

Budget revenue will benefit from higher rates of economic activity this year. Offsetting this to some degree will be a reduction in the corporate tax rate from 28% to 25% and tax breaks to encourage companies to list on the stock exchange and to invest in priority sectors, such as oil and natural gas. Unspent funds from 2009 (totaling the equivalent of $4.1 billion) will contribute to financing this year's budget.

Monetary policy is expected to remain generally accommodative, with inflation projected to stay within Bank Indonesia's 4%–6% target band in 2010. In March 2010, the central bank left the policy rate at 6.5%, for the seventh month in a row. The monetary authorities are also adjusting regulations to spur lending and encourage banks to lower their lending rates, in an effort to stimulate sluggish growth in credit.

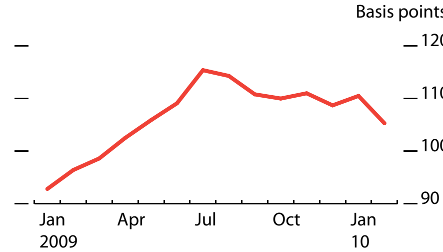
Against this policy background, private consumption is forecast to grow by at least 5.5% this year, benefiting from a stronger labor market, increases in real wages, and relatively high prices for agricultural commodities. Bank Indonesia's consumer confidence index showed a trend increase during 2009, though it subsequently dipped (Figure 3.24.8).

Investment will strengthen in light of improved global trade and financial conditions, the country's record of solid growth, and the upgrades in its credit rating. Foreign direct investment is expected to rebound and domestic investment will be encouraged by the quickening pace of economic activity, tax breaks, a better market for raising equity capital, and improved credit availability. Fixed capital investment is forecast to grow by at least 6% in 2010, accelerating to about 9% in 2011. Net exports are expected to make a relatively small contribution to GDP growth in the forecast period, given that higher exports of goods and services will be accompanied by higher imports.

Based on the above factors, GDP growth is forecast to rise to 5.5% in 2010 and about 6.0% in 2011 (Figure 3.24.9). Growth may exceed this if the government can accelerate its rollout of infrastructure investment.

In value terms, merchandise exports in January 2010 soared by 59%, and imports by 45%, from depressed levels in the prior-year month. For the full year, exports are forecast to rise by about 11%, based on the forecast increase in world trade and firm prices for commodity exports. Stronger domestic demand will propel imports by about 16%. Consequently, the trade surplus will narrow (Figure 3.24.10) and the current account surplus is forecast to contract to 1.4% of GDP in 2010 and 0.6% in 2011. Higher inflows of direct and portfolio investment should keep the overall balance of payments in surplus.

3.24.8 Consumer confidence index



Source: CEIC Data Company (accessed 26 March 2010).
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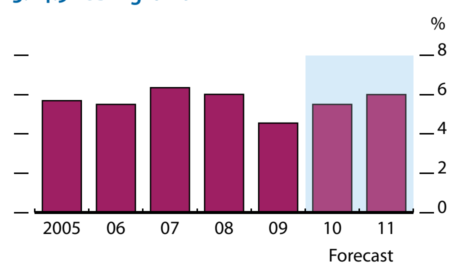
3.24.9 GDP growth



Source: Asian Development Outlook database.
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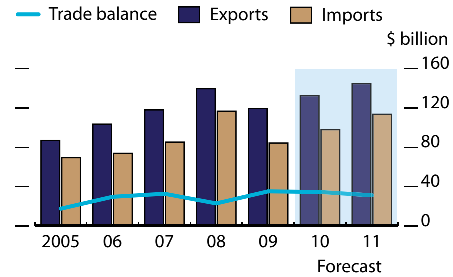
Rising domestic demand and higher global prices for oil and commodities this year will put upward pressure on inflation, countered somewhat by a projected appreciation of the rupiah. Food prices depend heavily on the weather, and in this regard earlier concerns about the impact of an El Niño weather pattern that could reduce food production have been alleviated, in part by increases in food stocks. Inflation in 2010 is forecast at 5.6% (it averaged 3.8% in the first 2 months), accelerating to 6.2% next year.

Domestic risks to the forecasts are headed by oil prices. A significantly higher global oil price than assumed, at a time that the authorities plan to keep fuel prices steady, would propel the cost of government subsidies. This would push out the budget deficit or lead to cuts in other spending, or a bit of both. Policy slippage and natural disasters are also a risk.

3.24.10 Merchandise trade



Source: Asian Development Outlook database.

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Development challenges

Since 2004, Indonesia has achieved 5.5% average growth, maintained a surplus in its current account, guarded a strong fiscal position, reduced external debt, and nearly doubled international reserves. Inflation, though, has averaged a high 8.5% since 2004, even if it has come down from the double-digit rates of 2005–2006 (Figure 3.24.11).

These solid fundamentals provided good underlying support in the face of the global recession. However, the moderate pace of growth over an extended period has not generated sufficient jobs to absorb the unemployed, underemployed, and new entrants to the labor market.

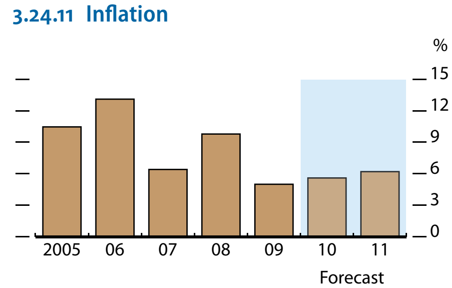
Furthermore, about 70% of those who are employed work in the informal sector, where wages and job security are low. The International Labour Organization estimates that in 2006 there were 52.1 million workers (about 55% of the total employed) earning no more than the equivalent of about $1 a day, and a further 7.9 million (8.2%) earning no more than $2 a day. Income inequality, as measured by the Gini coefficient, has increased from 0.32 in 2004 to 0.37 in 2009.

Insufficient job creation is a consequence of lackluster growth in the tradable sector, particularly labor-intensive manufacturing. That, in turn, is largely caused by weaknesses in the business environment (problems include legal and regulatory uncertainty and governance issues), and deficient infrastructure (such as roads, ports, and electricity supply).

Investment in infrastructure has dropped to the equivalent of about 3.5% of GDP in the past 3 years, from 7% before the Asian crisis, lagging such investment in faster-expanding economies. The government's investment coordinating agency estimates that $150 billion is needed to build and upgrade infrastructure in 2010–2014, of which the public sector could supply one-third.

Bridging that gap with private investment will require, among other things, faster progress in developing public–private partnerships, closer alignment of national and local regulations (which are sometimes in conflict), and overcoming hurdles related to acquisition of land for infrastructure projects.

3.24.11 Inflation



Note: 2005 = 100.

Sources: International Monetary Fund. International Financial Statistics online database (accessed 1 February 2010); ADB estimates.

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