Indonesia

Economic growth remains robust, driven by private consumption and fixed capital investment. However, inflation has climbed to double-digit levels, prompting the monetary authorities to raise interest rates several times. Government subsidies on food, fuel, fertilizer, and electricity are squeezing the budget, leading to reduced spending for social services and capital works. GDP growth is forecast at 6.2% for both this year and next, little changed from April's forecasts. Inflation forecasts are revised up.

Updated assessment

GDP expanded by 6.0–6.5% for seven consecutive quarters through June 2008, and the 6.4% outcome for the first half of 2008 remained in this band. The main contributors to first-half growth were private consumption (Figure 3.5.1) and fixed investment. Private consumption growth picked up from 4.7% in the first half of 2007 to 5.5% in first half of 2008, despite rising food prices. Consumers were insulated from higher global fuel prices until May, when domestic fuel subsidies were cut. Encouragingly, the growth rate for fixed investment doubled to 14.1% in the first half from the prior-year period (Figure 3.5.2). Although more than two thirds of this investment was in buildings, spurred by strong demand for offices and apartments, investment in machinery and equipment needed to build productive capacity also grew rapidly. Net exports made a relatively small contribution to GDP growth.

From the production side, growth of the services sector accelerated to 9.4% in the first half of 2008, contributing 4 percentage points of total GDP growth. Growth picked up in transport, communications, and financial services but slowed in wholesale and retail trading, hotels, and restaurants. In contrast, the growth rate of industry decelerated to 3.7% and its contribution to total growth was just 1.6 percentage points.

Within the industry group, manufacturing growth slowed for a third consecutive 6-month period, to 4.1%. The poor performance is largely attributed to rising wages, inflexible labor laws, and low investment in manufacturing. Construction expanded by about 8.0%, consistent with its performance over recent years. Mining production contracted slightly, despite high global prices for oil, natural gas, coal, and metals. This largely reflects a lack of investment in oil extraction in recent years. Crude oil production fell to 899,000 barrels a day in 2007 from 1.4 million barrels in 2000 as existing fields moved toward depletion. Oil output this year has edged up to 927,000 barrels a day, but still not enough to make the country a net petroleum exporter, a status it lost in 2003.

Agricultural production rose by 5.3% in the first half of 2008, well above the rate of the year-earlier period, largely a result of rains in the

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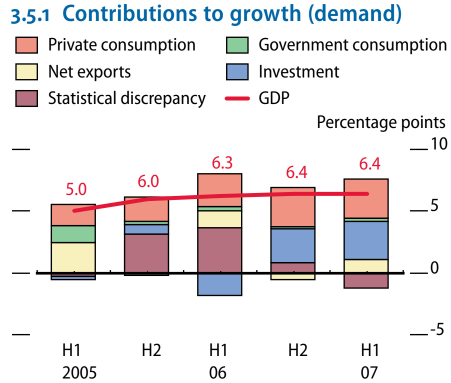
3.5.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 22 August 2008.

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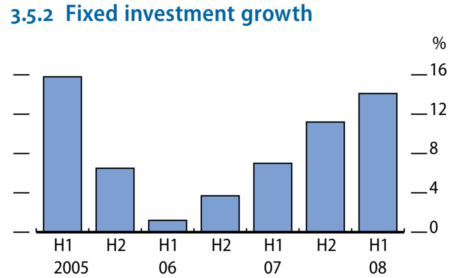
3.5.2 Fixed investment growth



Source: CEIC Data Company Ltd., downloaded 22 August 2008.

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dry season and an expansion of production from rubber and palm oil plantations attributable to higher global commodity prices. The rains and an increase in the area planted to rice are expected to lift rice production by 6% to 35 million metric tons in 2008. If this is achieved, net rice imports are unlikely this year. Agriculture's share of the economy is relatively small, so its rebound added just 0.8 percentage points to GDP growth. The increase in production and higher prices received for agricultural products supported growth in rural incomes and consumption.

Many of Indonesia's energy and commodity exports benefited from higher global prices in the first half, pushing up the value of total exports by about 28% to $71.7 billion. A diversification of export destinations toward expanding markets in Asia also helped. The value of agricultural exports surged by about a half and the value of manufactured exports rose by about a quarter.

Imports rose at an even faster pace than exports, by 47% to $58.8 billion, a result of higher prices for imported commodities and oil products, as well as continuing expansion of domestic demand. Consequently, the trade surplus fell by about 20% to $12.9 billion in the first half from a year earlier. The current account surplus dropped to $851 million, from $4.9 billion in the first half of 2007. (It was in deficit in the second quarter, the first deficit in nearly 3 years—Figure 3.5.3.) The overall balance-of-payments surplus fell to $2.4 billion from $8.0 billion a year earlier. International reserves rose by 16.7% to $59.5 billion over the 12 months to June 2008, providing 4.5 months of cover for imports and official debt repayments.

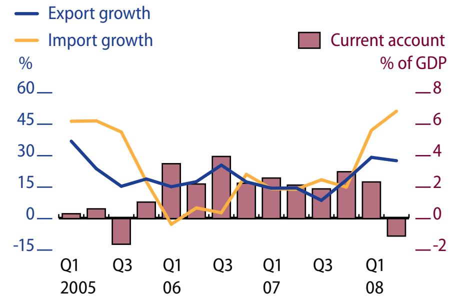
Inflation increased faster than expected. Rising prices for food (which makes up 37% of the consumer price index) were a major driver of inflation, with the solid overall domestic demand underpinning price pressures. Average inflation during the first 6 months of 2008 was 8.9%, and in July inflation accelerated to a 22-month high of 11.9% (Figure 3.5.4).

The Government raised administered fuel prices by nearly 29% in May, which propelled inflation in subsequent months. Producer price inflation shot up to 25.5% in April 2008, an 8-year high, and businesses are expected to pass through higher costs to consumers in the months ahead (operators of public transportation, for example, have yet to pass on all their higher fuel costs). The weights of the consumer price index were adjusted in June, reflecting changes in consumption patterns, to increase the weight of transportation and reduce the weighting for unprocessed food (Figure 3.5.5).

Credit growth remained high, adding to demand-side price pressures. Growth in consumption credit accelerated to 32% in June 2008, partly on account of strong sales of motorcycles and cars. Investment and working capital credit showed similar growth (Figure 3.5.6). Broad money growth (M2) slowed to 17% in June 2008 from 19% in December 2007, contained by Bank Indonesia's draining of excess liquidity from the banking system.

After inflation had remained well above Bank Indonesia's 4–6% target band for several months, the central bank raised its policy interest rate in May, and followed with monthly hikes that lifted the rate by 125 basis points to 9.25% through September (still below the inflation

3.5.3 External indicators



Source: CEIC Data Company, Ltd., downloaded 6 September 2008.

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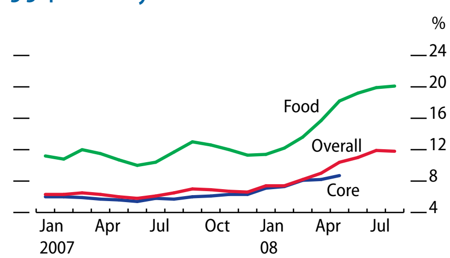
3.5.4 Monthly inflation



Note: Series break starting June 2008.

Sources: Asian Development Outlook database; CEIC Data Company Ltd., downloaded 1 September 2008.

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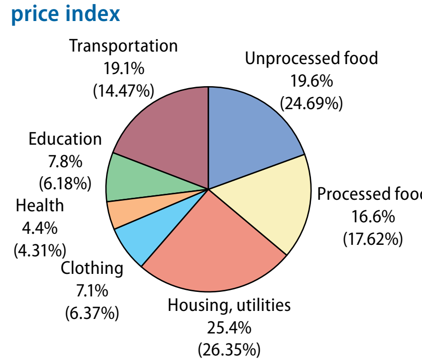
3.5.5 Adjusted weights for the consumer price index



Note: Figures in parentheses indicate old weights.

Source: Thomson Reuters, Details of Indonesia's New CPI Weighting, available: http://in.reuters.com/article/asiaCompanyAndMarkets/idINJAK32965020080701, downloaded 1 July 2008.

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rate—Figure 3.5.7). The rupiah appreciated by 2.7% against the US dollar from the start of 2008 to end-August.

Given the range of subsidies provided by the Government for food, fuel, fertilizer, and electricity, the high international oil and food prices put considerable pressure on the budget in the first half of 2008 (Box 3.5.1). The cost of all subsidies this year is projected to nearly double to the equivalent of 7.0% of GDP, from 3.8% in 2007 (Figure 3.5.8). The May hike in retail fuel prices trimmed growth in fuel subsidies. However, total subsidies this year will absorb about 30% of state expenditure (central government spending and transfers to the regions), based on a revised budget assumption that domestic crude oil will average $127 a barrel.

3.5.1 Fuel subsidies a heavy burden on the budget

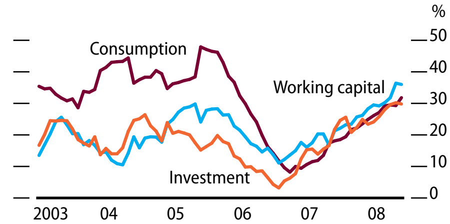
Fuel prices in Indonesia are determined by the Government, which provides subsidies to keep retail prices low by world standards (see the figure in Box 2.1.1, *Are high oil prices here to stay?*, in Part 2). The subsidies depend on global oil prices, exchange rate fluctuations, and the domestic fiscal position. In 2005, the cost of fuel subsidies ballooned to $12.0 billion, or 4.4% of GDP, as global oil prices climbed. The Government raised retail fuel prices by a weighted average of 160% in two adjustments that year. Even though domestic gasoline prices were brought close to international levels, providing an opportunity to link domestic gasoline prices with international ones, the subsidy system was maintained.

Retail prices were then left unchanged for nearly 3 years, even though global oil prices were rising. When they took off this year, the surging cost of subsidies pressed the Government to raise administered fuel prices by 28.7% in May, which brought the effective domestic price up to about $75 a barrel, still well short of global levels. On the basis of an assumption of domestic oil prices averaging $127 this year, the Government expects that subsidies for energy (fuel and electricity) will cost it Rp268.7 trillion ($28.2 billion), equivalent to about 5.7% of GDP, with fuel subsidies alone accounting for 22.4% of total central government expenditure or 16.4% of state spending (which includes transfers to the regions).

To mitigate the impact of the May fuel price increases, the Government provided cash compensation of Rp14.1 trillion ($1.5 billion) for 7 months to 19 million very poor households, which also received food assistance. These concessions muted public criticism of the price hike. However, the budget remains vulnerable to increases in oil prices. Further, the central Government pays all the fuel subsidies but does not get all oil and gas revenues, owing to an arrangement that gives regional governments a share of these revenues. In addition, the subsidies are regressive: the top 10% of income earners receive 45% of the fuel subsidies and the poorest 10% less than 1%.

There would be advantages in removing fuel-price setting from the political process by linking fuel prices to global market levels. Such linking would reduce pressures on the budget, allowing for greater spending on priority expenditures, and would provide more accurate price signals to household and industrial users of fuel, encouraging them to be more fuel efficient.

3.5.6 Credit growth



Source: CEIC Data Company Ltd., downloaded 22 August 2008.

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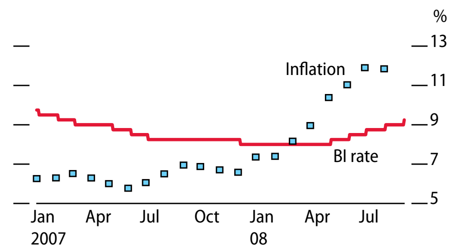
3.5.7 Prices and policy rate



BI = Bank Indonesia.

Source: Datastream, downloaded 4 September 2008.

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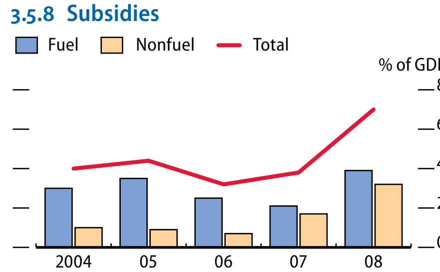
3.5.8 Subsidies



Sources: Bank Indonesia, *Economic Report on Indonesia*, various issues, available www.bi.go.id; Ministry of Finance, *Budget Statistics*, various issues, available: www.fiskal.depkeu.go.id.

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As a result, other spending, including social development and capital works, has been reduced from original budget targets. Planned expenditure on education, for example, has been cut by 9.5% from the original budget and health spending by 7.4%. Capital spending is lowered by 17% from the original budget. The Government aims to limit the budget deficit to 1.8% of GDP (widening from 1.2% last year). It will finance the deficit through loans from multilateral and bilateral development agencies and bond issues. Domestic and international bond issuance in the first half totaled $8.4 billion, 64% of the full-year target. The spread on Indonesian sovereign bonds has increased sharply, reflecting risk aversion in global markets and concerns over domestic inflation and the cost of subsidies (Figure 3.5.9).

Moderate economic growth is generating jobs, but not enough to significantly take down unemployment and underemployment. The Government targets unemployment of 5.1% in 2009 (it was 8.5% in February 2008), which would still be above the 4.7% seen just before the 1997–98 Asian financial crisis. The rate of underemployment (those working fewer than 35 hours a week) was 27.5% of the labor force in February. Furthermore, 70% of total employment is in the informal sector, where wages and benefits are generally very low. More than 40% of the population lives on less than $2 a day, leaving them vulnerable to increases in food and fuel prices.

Underinvestment in power facilities over many years is, since July, manifested in controlled power blackouts in metropolitan Jakarta and other cities. The Government required manufacturers to shift some work to weekends to spread the demand for electricity. Electricity tariffs are set by the Government and kept low, one reason for underinvestment in this industry.

Prospects

The forecasts assume that the central bank will continue to address inflation pressures, that the rupiah remains in its narrow band against the US dollar (Figure 3.5.10), and that the Government contains the growth of subsidies. They further assume that weather conditions will be normal for the rest of 2008 and during 2009, and that there will be no natural disasters.

Growth in private consumption eased in the April–June quarter and is expected to slow to 5.1% in the second half of 2008 alongside high inflation. The impact of inflation will be offset to some degree by additional spending during the Ramadan holiday period in September. Growth in investment is expected to moderate in the second half because of the weaker global economic and financial environment and the rise in domestic interest rates. Bank credit continues to expand robustly, though. Government capital and social spending should pick up, given that the decline in global oil prices at the start of the second half will tend to reduce the cost of fuel subsidies. Growth in export earnings is expected to ease because of likely weaker external demand and a decline in some commodity prices.

Taking these factors into account, GDP growth is forecast to decline to 6.0% in the second half. As growth in the first half was higher than

3.5.9 Sovereign risk spreads

Note: JPMorgan Emerging Markets Bond Index sovereign stripped spreads.

Source: Datastream, downloaded 4 September 2008.

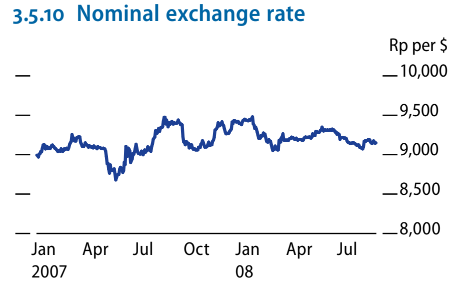
Click here for figure data

3.5.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	6.0	6.2	6.2	6.2
Inflation	6.8	10.2	6.5	7.5
Current acct. bal. (share of GDP)	1.9	1.1	1.6	1.7

Source: Staff estimates.

3.5.10 Nominal exchange rate



Source: Datastream, downloaded 1 September 2008.

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expected at 6.4%, the full-year forecast is now 6.2% (Figure 3.5.11), slightly above the 6.0% expected in *ADO 2008*.

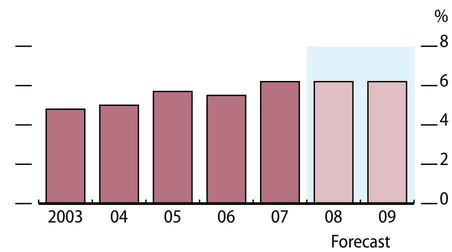
Parliamentary elections are scheduled for April 2009 and presidential elections for 3 months later, pointing to a pickup in budget disbursements in the first half of next year (the proposed 2009 budget raises spending by 12.3%). This is expected to support consumption, which will also be underpinned by a forecast easing in inflation. The weak global outlook and rising domestic interest rates will tend to damp investment, but capital outlays on public infrastructure are expected to increase in the second half of 2009 as the new administration turns its attention to deficiencies in ports, power generation, and many other areas. As fuel subsidy costs decline alongside the expected easing in world oil prices next year, budget resources should be freed for social and development spending. Export growth is expected to ease because of softening commodity prices and generally sluggish growth in world trade, while import growth could remain robust if domestic demand is as firm as expected. The GDP growth forecast for 2009 is unchanged from *ADO 2008* at 6.2%

The trade surplus this year looks set to decline to $22.0 billion, from $32.8 billion in 2007. The forecast for the current account surplus is revised down to 1.1% of GDP, from 1.9% in *ADO 2008* and an actual surplus of 2.4% in 2007. The overall balance of payments is projected to remain in surplus as a consequence of foreign direct investment and portfolio inflows. In 2009, the current account surplus is forecast at 1.7% of GDP, upgraded a little owing to the revised assumption of moderate growth in global nonfuel commodity prices.

Inflation is expected to remain high through the rest of 2008 and into 2009, although it may well peak in September 2008. A good domestic rice harvest has moderated rice prices, but other food items (especially imported ones) are pushing up inflation. The May increase in retail fuel prices will underpin high inflation for some time. Moreover, if the Government's assumption of domestic crude oil averaging $127 a barrel proves to be low, another increase in retail fuel prices might be required. Without any further fuel price increases, inflation is seen averaging 10.2% this year, revised up from 6.8% in *ADO 2008* because of higher than expected inflation in the first half. The tightening in monetary policy will have an impact on price pressures in 2009, when inflation is set to ease to 7.5% (revised up by 1 percentage point from *ADO 2008*) (Figure 3.5.12).

Risks to the forecasts are largely grounded in the costs of subsidies. Higher than expected prices of food and oil would require larger subsidies, which would further erode funds available for other public spending. If inflation does not decline as projected in 2009, thereby requiring a longer cycle of monetary policy tightening, consumption and investment would be weaker than forecast.

3.5.11 GDP growth



Sources: CEIC Data Company Ltd., downloaded 22 August 2008; staff estimates.

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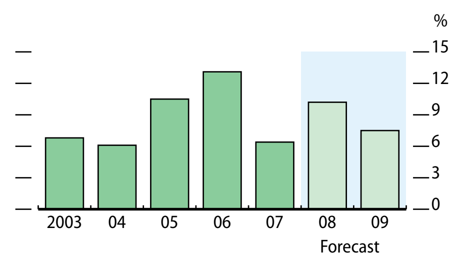
3.5.12 Inflation



Sources: CEIC Data Company Ltd., downloaded 22 August 2008; staff estimates.

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