Indonesia

At its best pace since the Asian financial crisis, economic growth in 2007 was spurred by private consumption and investment. Domestic demand is forecast to drive moderate growth in 2008–2009. Rising prices for food and fuel have increased the risk that government subsidies on these basic needs will crowd out much-needed development expenditures. Inflation accelerated above 7% in early 2008. A longer-term challenge is to reduce the vulnerability of the many Indonesians who live near the poverty line.

Economic performance

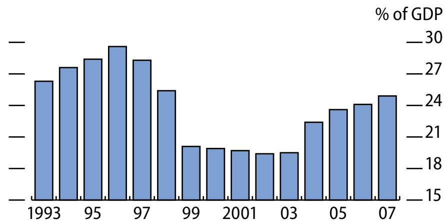
Economic growth accelerated to 6.3% in 2007, above its 5-year average of 5.5% and the best growth rate since 1996. The main drivers of growth were private consumption, supported by private investment, and an expansion of net exports. Growth in fixed capital formation increased to 9.2% in 2007, although most went to buildings (76% in real terms) and only 14% to machinery and equipment. The fixed capital investment-to-GDP ratio increased to 24.9% in 2007, up 5.4 percentage points over 4 years (Figure 3.23.1). The improvement in investment was underpinned by an increase in domestic credit, and by falling inflation and interest rates. The lower inflation and interest rates also helped push up consumer spending, with private consumption increasing by 5.0% in 2007 and making the biggest contribution to GDP growth (Figure 3.23.2). The contribution to GDP growth from net exports partly reflected a rise in exports owing to the boom in world commodity prices.

From the supply side, higher GDP growth was accounted for mainly by the services sector (Figure 3.23.3), with transportation and communications, and electricity, gas, and water supply recording double-digit growth. The rapid expansion of telecommunications services owes much to growing demand for mobile telephone and Internet services, which have been expanding by 40–50% a year. The expansion of utilities was due mainly to a 30% rise in gas usage as the state-owned electricity company switched to gas from more expensive fuels, and to a government drive to get consumers to shift from subsidized kerosene to nonsubsidized liquefied petroleum gas.

Manufacturing output growth of 4.7% reflected higher growth in machinery, food, rubber, and paper products, offset in part by declining output for textiles, refined petroleum products, and liquefied petroleum gas. The increase in food, rubber, and paper products was stimulated by higher world prices. Reduced output for textiles is a sign of declining competitiveness in this labor-intensive industry.

Agricultural output growth at 3.5% was driven by a 4.8% increase in rice production and higher world prices for plantation crops such as

3.23.1 Gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company Ltd.; Statistics Indonesia, available: http://www.bps.go.id, downloaded 29 February 2008.

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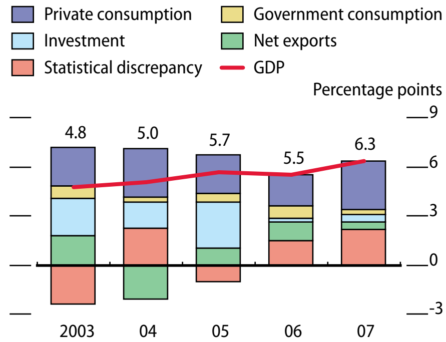
3.23.2 Contributions to growth (demand)



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 29 February 2008.

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This chapter was written by Purnima Rajapakse of the Indonesia Resident Mission, ADB, Jakarta.

palm oil and rubber. Mining and quarrying grew by just 2.0%, despite considerably higher prices for oil and gas (which account for 55% of this subsector's output). This weakness was largely due to a 1.2% decline in oil and gas extraction caused by years of underinvestment in the sector. Reflecting an easing in the global economy late last year, year-on-year GDP growth stepped down to 6.3% in the fourth quarter from 6.5% in the third.

Year-on-year inflation declined from a peak of 18.4% in late 2005 to 6.6% at end-2007 (Figure 3.23.4), as the impact of a 126% rise in fuel prices in October 2005 faded. Amid some volatility, inflation remained within Bank Indonesia's target range of 5–7% during the year, averaging 6.4%. While movements in food prices and seasonal factors contributed much to the volatility, a combination of factors ranging from higher global nonfood commodity prices, a depreciating rupiah, and a steady increase in domestic demand kept inflation from declining further.

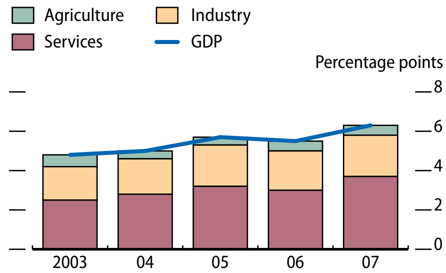
Broad money (M2) growth accelerated to 18.9% last year, largely because of a sharp rise in net foreign assets of the banking system owing to an increase in external reserves. Private sector credit growth also quickened (Figure 3.23.5), reflecting a reduction in interest rates. With the easing of inflation pressures, Bank Indonesia cut its policy rate from 12.75% in April 2006 to 8.0% in December 2007 (Figure 3.23.6). This led to a corresponding reduction in commercial bank rates and a recovery in bank credit, which increased by 25.5% year on year in December 2007. The stronger growth in lending helped lift bank profits. Banks' nonperforming loans fell to 1.9% (net) by December, from 3.6% at end-2006. The pickup in bank lending raised some concern about credit quality, as evidenced by growth in credit card nonperforming loans from 9% in 2006 to 12% in 2007.

The strengthened economic fundamentals and yield differentials attracted significant foreign portfolio inflows during the first half of 2007, before international investors turned more risk averse after the subprime credit problems in the United States (US). Having experienced a sharp downturn during July–August, the Jakarta Stock Exchange (JSX) nevertheless rebounded and more than regained lost ground in the rest of the year. By end-2007, the JSX composite index was 52% higher than a year earlier (Figure 3.23.7). The rupiah depreciated by 4.4% against the US dollar in 2007 (Figure 3.23.8), despite strong growth in international reserves. This growth was partly attributed to reserve management arrangements, whereby inflows of foreign exchange from oil revenues and royalties automatically accumulate as reserves of Bank Indonesia, while Pertamina (the state-owned oil company) buys dollars in the market to purchase oil imports.

The relatively moderate impact of the US subprime crisis on domestic financial markets, together with an improved policy environment, led to Standard & Poor's as well as Moody's rating agencies to raise the country's sovereign foreign currency debt rating to BB- and Ba3, respectively, in 2007.

The overall budget deficit has gradually widened in recent years from 0.5% of GDP in 2005 to 1.2% in 2007 (versus a revised budget target of 1.5% for that year). The actual outturn was assisted by increased revenues from petroleum royalties as the Government's share of oil revenues rose

3.23.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 29 February 2008.

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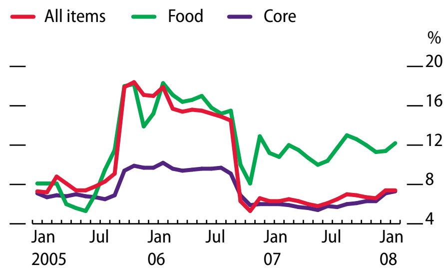
3.23.4 Monthly Inflation



Source: CEIC Data Company Ltd., downloaded 14 March 2008.

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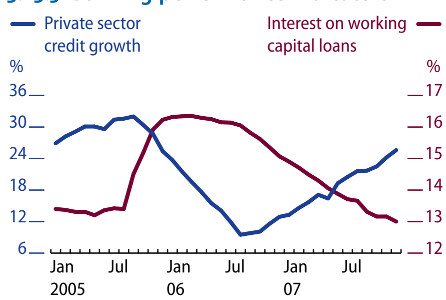
3.23.5 Banking performance indicators



Sources: Bank Indonesia, available: http://www.bi.go.id; International Monetary Fund, *International Financial Statistics* online database, downloaded 14 March 2008.

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along with higher oil prices. On the expenditure side, higher spending on food, fuel, and electricity subsidies was more than offset by reduced outlays on all other expenditure categories. Although there was some improvement in budget execution in 2007, capital expenditures were again subject to considerable back-loading, reflecting difficulties in the management of public expenditures. Capital spending fell short of the budgeted amount by an estimated 10%.

The authorities funded the widening fiscal deficit by issuing government securities and increased borrowing from development partners. Still, the ratio of total central government debt to GDP declined by 3.4 percentage points to 35.7% in 2007 (Figure 3.23.9), reflecting the concessionary nature of the borrowing and higher economic growth.

Merchandise exports rose by about 14%, to $118.0 billion last year. Non-oil and gas exports were up by 18.2%, driven mainly by agricultural produce, which was boosted by higher global commodity prices and by manufactured goods. Exports of oil and gas increased by only 8.4% in value terms, even though prices rose sharply, owing to production problems. Imports climbed by about 15% to $84.9 billion as a result of strong demand for imported consumption and capital goods.

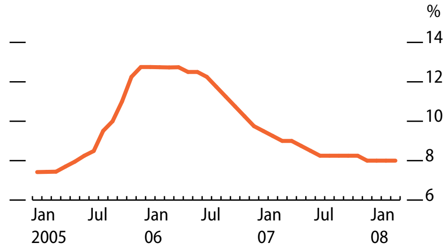
Despite faster import growth, the higher base of exports than imports meant that the trade surplus rose to $33.1 billion (Figure 3.23.10). The transfers account recorded a marginally higher surplus, owing to growing remittances from migrant workers. These were partly offset by widening deficits in the services and income accounts stemming mainly from a rise in imports of freight and business services, and the repatriation of profits and dividends by foreign companies operating in Indonesia. The upshot is that the current account surplus moderated to 2.5% of GDP from 2.9% in 2006.

On the capital and financial account, higher inflows of foreign direct and portfolio investments and loan disbursements to the private sector were offset to some extent by a significant increase in overseas asset placements by domestic investors. As a result, the overall balance of payments surplus fell slightly to $12.5 billion. International reserves increased by about $14 billion to $56.9 billion (Figure 3.23.11) (providing 5.7 months of import cover). Total external debt is estimated to have declined to about 31% of GDP at end-2007 from 35% at end-2006, and the debt service ratio was reduced to an estimated 19.2% from 24.8%.

The Government pursued its reform agenda in 2007 aimed at improving the investment climate and public service delivery. Parliament passed a landmark investment law, which stated the principle of equal treatment for all investors regardless of national origin, as well as a tax administration law that strengthened the rights of taxpayers and limited arbitrary decision making by tax officials. Other significant changes included reducing the time for refunds of value-added tax, streamlining business licensing procedures, and implementing good corporate governance and risk management standards for state-owned banks.

An economic policy package unveiled in July integrates and builds on separate policies covering investment, infrastructure, the financial sector, and small and medium enterprises. It involves 165 reforms to be achieved by July 2008. As of end-February 2008, 105 of these reforms had been completed. These gains have, however, taken place from a low

3.23.6 Bank Indonesia rate



Sources: International Monetary Fund, *International Financial Statistics* online database; Bank Indonesia, available: http://www.bi.go.id, downloaded 14 March 2008.

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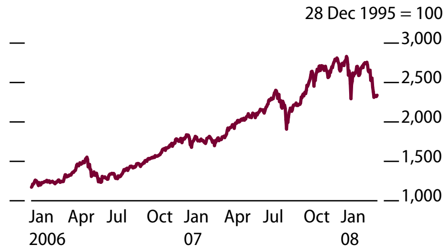
3.23.7 Jakarta composite index



Source: CEIC Data Company Ltd., downloaded 14 March 2008.

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3.23.8 Change in rupiah against the US dollar

Note: A point below zero indicates a depreciation in the rupiah from the end-2006 rate.

Source: Bank Indonesia, available: http://www.bi.go.id, downloaded 25 March 2008.

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base, and the investment climate continues to rank poorly. Transparency International's 2007 Corruption Perceptions Index ranked Indonesia 143 out of 180 economies, while the World Bank's *Doing Business 2008* put the country 123 out of 178 on ease of doing business. Firms still face a difficult legal and regulatory environment.

Strict labor regulations create a disincentive to employment expansion. The existing labor law is criticized by business groups for, among other things, mandating severance payments that are much higher than comparable economies, and limiting the ability of employers to outsource work. These have been identified as impediments to hiring new workers on a permanent basis, particularly in labor-intensive industries. Revisions to the labor law were proposed as part of an investment policy package in 2006 but were not implemented because of opposition from labor unions. The proposed changes would have addressed these issues and brought labor regulations into line with those of countries such as Malaysia and Thailand.

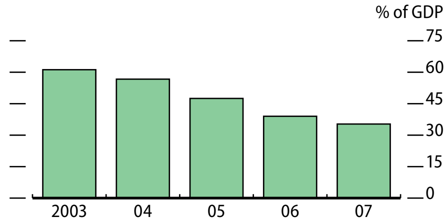
The Government launched a national community empowerment program in 2007 to improve local governance and service delivery at the subdistrict and village level by encouraging participatory planning and providing block grants for rural infrastructure, education, and health related projects. The program, which was rolled out to half the country's subdistricts in 2007, will be further expanded to cover the entire country by 2009.

The 2008 budget approved by Parliament last year proposed a substantial reallocation of spending to priority areas, including infrastructure and social sectors, with a scaling up of spending on poverty reduction through the community empowerment program. This reflects recognition of the need to ramp up development expenditures (comprising capital and social assistance spending). Before the 1997–98 Asian financial crisis, development expenditures were generally 7–8% of GDP. They dropped during the crisis and have been fairly stagnant at 2–3% of GDP since.

Higher development expenditures were made possible by the fiscal space of about $10 billion a year generated by a reduction in the fuel subsidy in 2005, declining debt service payments, and increased revenues from more effective tax administration. However, a recent decision by the Government to absorb the increase in global prices for oil and food and substantially increase the subsidies that it provides for fuel, electricity, and staple food items is likely to undermine the gains made by the 2005 fuel subsidy reduction.

The authorities were revising the budget in March 2008 to take account of the global economic slowdown and higher commodity prices. They raised the oil price assumption in the budget from an original $60 per barrel to $95 per barrel. As a result, the subsidy envisaged for fuel and electricity increased from Rp45.8 trillion and Rp29.8 trillion, respectively, in the original budget to Rp130 trillion and Rp61 trillion in the revised budget. The authorities also increased subsidies for food to Rp19.8 trillion from Rp7.2 trillion as part of a package of measures to bring down the price of food. The energy subsidies together currently exceed the total budgetary allocation for capital and social expenditures by 18%. Moreover,

3.23.9 Central government debt



Source: Indonesia Debt Management Office, available: http://www.dmo.or.id, downloaded 17 March 2008.

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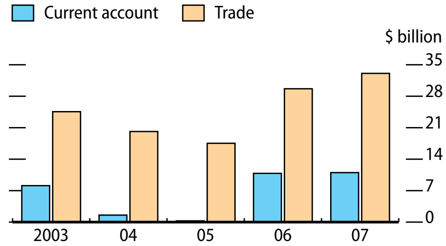
3.23.10 External balances



Sources: Asian Development Outlook database; Bank Indonesia, available: http://www.bi.go.id, downloaded 14 March 2008.

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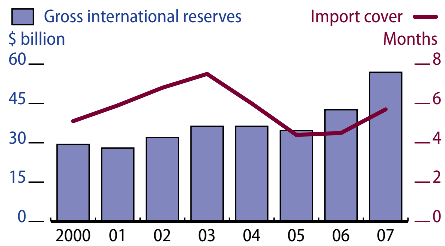
3.23.11 External liquidity



Note: Import cover is in months of imports and official debt repayment.

Sources: Asian Development Outlook database; Bank Indonesia, available: http://www.bi.go.id, downloaded 14 March 2008.

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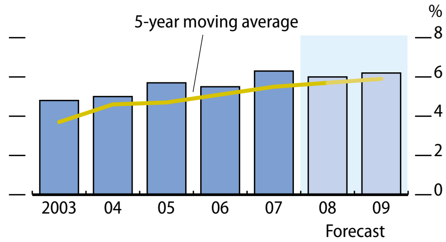
evidence suggests that the fuel and electricity subsidies have been poorly targeted, with minimal benefit to the poor.

To offset these increases, the Government intends to raise revenues through the application of so-called safeguard measures aimed at advancing tax and dividend payments of state-owned enterprises, restricting access to subsidized kerosene, and applying an across-the-board 10% cut in expenditures. Hoping to maintain development spending at original budgeted levels, the Government envisages the fiscal deficit for the year to widen to 2.1% of GDP. As in 2007, this deficit will be financed by the issuance of government securities and by increased borrowing from development partners.

3.23.12 GDP growth



Sources: Asian Development Outlook database; Statistics Indonesia, available: http://www.bps.go.id, downloaded 29 February 2008; staff estimates.

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Economic prospects

The forecasts are predicated on the Government maintaining efforts to improve the investment climate and public financial management, especially in relation to budget execution. It also assumes that the authorities will endeavor to maintain social assistance spending, but expenditures on infrastructure will to some extent be compromised if, as seems likely, the Government continues to absorb price increases for oil and staple foods. It is further assumed that Bank Indonesia will ensure that the high rate of growth in domestic credit does not give rise to balance sheet problems at banks that could undermine financial system stability. Finally, the forecast presupposes normal weather conditions and no major natural disasters.

On these assumptions, GDP growth is projected to ease to 6.0% in 2008, before picking up to 6.2% in 2009 (Figure 3.23.12). Growth will be driven mainly by private consumption, helped by the lagged effect of lower interest rates. Private investment is also likely to expand in response to the lower interest rates and an improving investment climate. However, public sector investment may not rise at the planned rate because of the cost of subsidies on the budget.

GDP growth will be supported by higher rates of credit expansion to the private sector, provided that bank and corporate balance sheets do not deteriorate due to high rates of credit growth and uncertainties in financial markets. Higher domestic demand will, however, be partly offset by softer export growth owing to the slowdown in industrial economies, and by a pickup in imports due to growth in consumption and investment. In 2009, private sector demand is expected to remain strong and might be supported by a cut in interest rates, if inflation moderates. This will be reinforced by some increase in export growth if, as expected, industrial nations stage a modest recovery and world trade picks up. Public sector investment growth will, however, continue to be constrained by heavy outlays on subsidies.

The higher domestic demand in 2008 is expected to underpin robust growth in services, while agriculture will benefit from high world prices for plantation crops and favorable weather prospects. In 2009, manufacturing activity is expected to rise owing to a modest recovery in external demand.

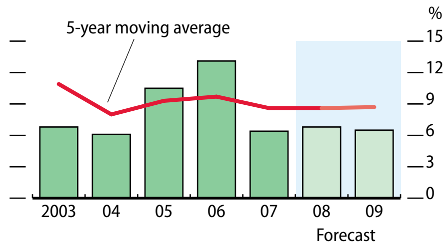
Continued turmoil in global financial markets into 2008 saw the JSX fall by 15.8% from the beginning of 2008 to mid-March.

3.23.1 Selected economic indicators

	2008	2009
GDP growth	6.0	6.2
Inflation	6.8	6.5
Current account balance (% of GDP)	1.9	1.6

Source: Staff estimates.

3.23.13 Inflation



Sources: CEIC Data Company Ltd., downloaded 26 February 2007; staff estimates.

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The rupiah/dollar exchange rate remained broadly stable, in part due to central bank intervention in the market to stabilize the rupiah and contain imported inflation.

Inflation accelerated in January and February 2008 to 7.4% year on year in both months, due mainly to increased prices of staple foods. In February, the Government announced measures to stabilize food prices, including increased outlays on food subsidies and the removal of import duties on soybeans and the value-added taxes on wheat floor and cooking oil. Food prices are seen moderating somewhat with the start of the harvest season. However, given the likely increase in domestic demand and high global food prices, inflation is set to average 6.8% in 2008 before moderating to 6.5% in 2009 on an easing of world food prices (Figure 3.23.13).

Preliminary data for January 2008 indicate that exports grew by a faster than expected 33.2% as a result of buoyant commodity prices, while imports grew by 43.9%, providing a larger than forecast trade surplus. During the remainder of the year, slower growth in exports combined with strong import growth will pull down the trade surplus. Although around 50% of Indonesia's non-oil and gas exports are destined for markets in Asia other than Japan, the slowdown in industrial countries will also indirectly hurt these exports since most are intermediate products that feed into final products that are then shipped to industrial markets.

In 2009, a modest increase in export volume growth due to a recovery in external demand will likely be offset somewhat by weaker export commodity prices, while import growth will remain buoyant owing to stronger domestic demand. Consequently, the trade surplus is forecast to moderate further. This will be accompanied by larger deficits in the services and income accounts, due to the repatriation of profits and dividends, and private debt interest payments. As a result of these developments, the current account surplus will decline to 1.9% of GDP in 2008, and to 1.6% in 2009.

Notwithstanding lower current account surpluses, the overall balance of payments is projected to remain in surplus during the forecast period as a consequence of growth in foreign direct investment and, to a lesser extent, portfolio inflows. International reserves are projected to increase to $68 billion at end-2008, and to $77 billion in 2009.

The main domestic risk to the forecast involves subsidies. Higher than expected prices for food and oil would mean even larger government subsidies that could crowd out development expenditures. Moreover, if food prices continue to exert pressure on inflation, interest rates could well rise, damping domestic demand. There is also a risk that planned reforms could meet intensified public opposition. Tariff changes and some aspects of investment climate reform, such as those relating to the labor market, are generally opposed by the public and special interest groups. In this context, reform efforts could slow in the lead-up to parliamentary and presidential elections scheduled for 2009.

3.23.1 Development challenges

While the share of the population in extreme poverty (living on less than $1 a day) has declined over recent years to 8.5%, nearly half the population still live on less than $2 a day. This suggests that there is a large group of people clustered around the poverty line who are highly vulnerable to shocks, such as natural disasters or price rises of food staples.

One factor contributing to this vulnerability is the lack of adequately paid jobs, which underlines the importance of improving the environment for employment generation. The gradual pickup in economic growth in recent years has led to some increase in employment, though at 9.1% in August 2007 the unemployment rate remains high compared with many East and Southeast Asian countries. Moreover, underemployment is also high at 27.6% of the labor force.

While it could be argued that postcrisis Indonesia has not experienced economic growth rates necessary to significantly bring down unemployment and poverty, the growth that has been achieved has not been accompanied by a commensurate increase in employment. The labor force absorption into the formal sector has dropped from 81% prior to the financial crisis to around 11%, which suggests a loss of competitiveness in labor-intensive manufacturing sectors such as textiles and clothing, as well as a mismatch between skills required and the skills possessed by workers.

Reforming the education system and ensuring that the labor force has access to affordable and quality training should be a priority in this regard.