Indonesia

First-half private consumption and investment showed greater strength than expected in *Asian Development Outlook 2007* (*ADO 2007*), and this is likely to be maintained in the second half, leading to an upward revision in the full-year GDP growth forecast to 6.2%. Net exports are also contributing to aggregate growth. The inflation forecast for 2007 is nudged up to 6.3%. In 2008, GDP growth is projected to edge higher, driven mainly by domestic demand. The Government has addressed several impediments to investment, but further reforms, and implementation of those already approved, are necessary.

Updated assessment

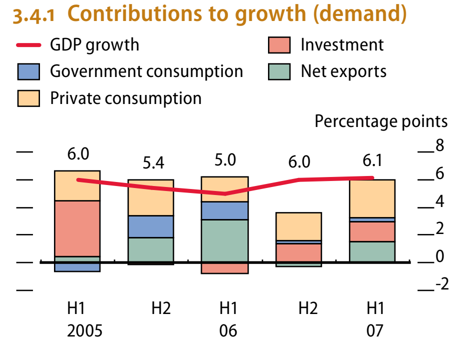
GDP growth accelerated to 6.3% in the second quarter of 2007 from 6.0% in the first, putting first-half expansion at 6.1%. The main drivers of growth were private consumption (Figure 3.4.1), a recovery in private investment, and a solid expansion of net exports. Growth in fixed capital investment increased to 7.3% in the January–June period, the strongest rate in this key indicator for 2 years (Figure 3.4.2). In 2006, investment sentiment had been hurt by high inflation that resulted from a sharp lift in administered fuel prices in late 2005, and a subsequent hike in interest rates. According to data from the state investment agency, actual foreign direct investment (FDI) nearly doubled to $7.3 billion during the first 7 months of 2007 relative to the year-earlier period (the data exclude FDI in oil, natural gas, and banking). Indicators for construction-related investment, such as demand for cement and steel, suggest a recovery in this area, too. A pickup in investment credit also is evident.

Lower inflation and interest rates have helped push up consumer spending, with private consumption increasing by 4.7% in the first half, up by 1.3 percentage points from the second half of 2006. Consumption indicators such as retail sales have picked up during 2007. On the supply side, services again made the biggest contribution to aggregate GDP growth. Industry also expanded, but agricultural output was little changed.

Overall, private consumption and investment are stronger than was anticipated in *ADO 2007*, and the full-year GDP growth forecast is revised up to 6.2% from 6.0%.

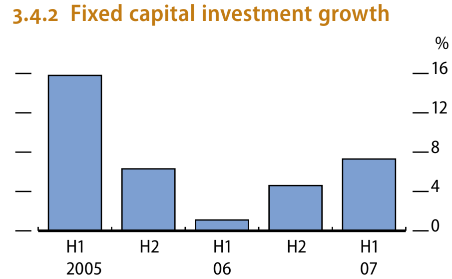
Inflation slowed to average 6.2% in the first 6 months of 2007, within this year's 5–7% target range set by Bank Indonesia, the central bank. Year-on-year inflation stepped down from 6.6% at end-2006 to 5.8% in June 2007, then quickened to 6.5% in August (Figure 3.4.3). The initial drop was mainly a result of moderating food prices, reflecting both a government decision to resume rice imports in response to drought in early 2007, and the start of a delayed rice harvest. The recent increase was attributed to a combination of pressures: higher food prices when the harvest ended, other seasonal factors, and a depreciating rupiah. The stronger domestic demand and higher food prices have led to a marginal upward revision in the 2007 inflation forecast to 6.3% from 6.2% in *ADO 2007*.

3.4.1 Contributions to growth (demand)



Note: Excluding statistical discrepancy.
Source: CEIC Data Company Ltd., downloaded 16 August 2007.
Click here for figure data

3.4.2 Fixed capital investment growth



Source: CEIC Data Company Ltd., downloaded 16 August 2007.
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Fiscal policy in 2007 has focused on accelerating development spending, while reducing public debt. Cuts in fuel subsidies 2 years ago and increased revenues from more effective tax administration have permitted higher development outlays. Government forecasts for the budget deficit put it at 1.6% of GDP in 2007, compared with an original target of 1.1%. This variance is due to greater than expected spending (particularly on disaster management, infrastructure, electricity subsidies, and fiscal transfers to regions) and lower revenues (following a shortfall in oil and gas income caused by lower production, and lower privatization receipts relative to budgeted levels).

Higher volumes of concessional borrowings from development banks will provide most of the additional financing for the deficit. The wider fiscal gap is still consistent with a further reduction in the ratio of total central government debt to GDP to around 36% at end-2007, from 39% at end-2006.

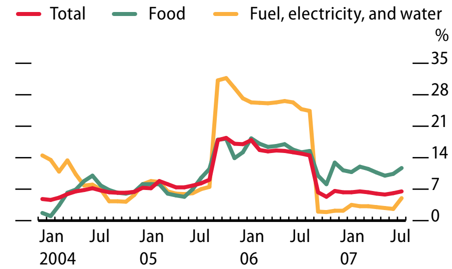
Preliminary trade data for the first 6 months of 2007 show that merchandise exports increased by 14.5% to $53.7 billion (Figure 3.4.4). Exports of manufactures and minerals rose by 18.9% and 35.4%, respectively, although sales of oil and gas to overseas markets fell by 7.0% due to lower production. Imports increased 1.7 percentage points faster than exports, by 16.2% to $33.6 billion, on strong growth in demand for imported consumption goods, raw materials, and (to a lesser extent) intermediate goods, refined oil products, and capital goods. Despite this faster import growth, the trade surplus rose to $20.0 billion from $18.0 billion a year earlier, as a consequence of a higher export base.

Even though a surplus on the transfers account was bolstered by growing remittances from migrant workers, the trade surplus was offset to some extent by widening deficits in the services and income accounts. This reflected primarily a rise in imports of construction and financial services, and the repatriation of profits and dividends by foreign companies operating in Indonesia. The upshot is that the current account surplus is estimated to have moderated during the first 6 months of 2007 from the corresponding period of 2006. However, due to continued strong inflows of both foreign portfolio capital and FDI, the overall balance of payments for the first half is estimated at a surplus of $3.7 billion. This helped lift international reserves to $51.9 billion at end-July 2007, from $42.6 billion at end-2006 (Figure 3.4.5).

These broad patterns are expected to continue for the rest of the year, and the surplus in the current account is now projected to decline to 1.4% of GDP in 2007 from 2.7% in 2006. This still represents an increase over the *ADO 2007* forecast (of 1.0%), due to the higher than expected growth in exports. External reserves, fueled by a likely rise in FDI in the second half of 2007, are seen increasing further to about $55 billion at the end of the year, providing 7.7 months of import cover. Total external debt is projected to decline to about 31% of GDP at end-2007 from 37% the previous year, reflecting net repayments of loans by banks and companies.

Slowing inflation enabled Bank Indonesia to lower its policy interest rate by 450 basis points to 8.25% between early May 2006 and late July 2007. The flow-on to lower commercial bank lending rates contributed to a recovery in credit, which rose by 20.4% in June 2007 from a year earlier. Credit to business is now growing at a faster rate than credit to

3.4.3 Monthly inflation



Source: CEIC Data Company Ltd., downloaded 7 September 2007.

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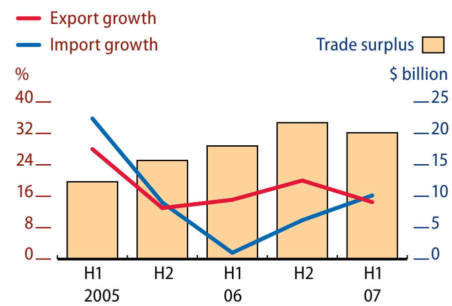
3.4.4 Trade indicators



Sources: Badan Pusat Statistik, available: http://www.bps.go.id; CEIC Data Company Ltd.; both downloaded 7 September 2007.

Click here for figure data

3.4.5 Gross international reserves

Source: Bank Indonesia, available: http://www.bi.go.id/web/en, downloaded 31 August 2007.

Click here for figure data

consumers, reversing a trend seen in recent years (Figure 3.4.6). Slightly faster growth in credit than deposits raised the loan-to-deposit ratio to 65.8% in April 2007, the highest level in 6 years. With commercial banks' loan rates declining at a more gradual pace than deposit rates, their profitability has improved.

A range of factors, including improved macroeconomic fundamentals, relatively high interest rates on debt securities and deposits, and expectation of currency appreciation attracted significant foreign portfolio inflows and helped propel the Jakarta Composite Index of share prices up by 30% in the first 7 months of this year (Figure 3.4.7). The portfolio inflows, in turn, helped support the rupiah. However, the reassessment in financial markets of global risks early in the second half prompted a weakening of the rupiah, and by end-August the currency had depreciated by 4.1% from the start of 2007 (Figure 3.4.8). The stock market index fell from its July peak, but at end-August was still up by 21.5% from the beginning of the year.

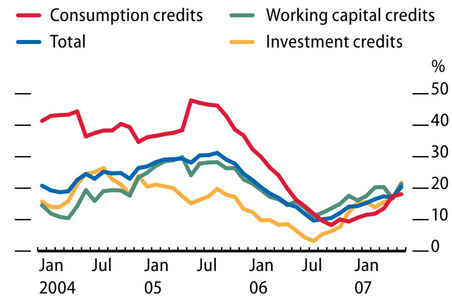
Recent data suggest that the pickup in economic growth has helped lower the poverty incidence to around 16.7% in March this year from 17.8% in March 2006. These levels of poverty, however, translate to almost 40 million poor people and remain far from the Millennium Development Goal target of 7.6% by 2015, and the Government's own target of 8.2% by 2009. Deeper structural reforms and pushing through with already-approved changes are necessary to make significant inroads into poverty and unemployment.

Indeed, some progress has been made over the past 2 years in reallocating fiscal expenditures toward programs that favor the poor and away from inefficient fuel subsidies. But Indonesia is still underspending in key sectors, including infrastructure, where the level of spending has fallen from a high of around 6% of GDP before the Asian financial crisis in 1997–98 to 2–3% of GDP recently. (Spending on infrastructure in Viet Nam, for example, in 2006 exceeded 9% of GDP.)

In surveys, businesses continue to identify this lack of investment in infrastructure—along with a weak legal system, labor-market rigidities, excessive bureaucracy, and corruption—as major impediments to business activity and investment. But reforms are slowly being made. Parliament finally passed a new investment law in March 2007, having earlier prevaricated. Among other changes, the law provides for equal treatment of local and foreign investors and for the resolution of contract disputes between the Government and investors (a major source of disputes in the past) through international arbitration. As part of the implementing regulations of the new law, the authorities have clarified which business sectors are open to foreign investors.

Steps in the appropriate direction include an investment climate policy package (adopted in February 2006), which includes proposals to reduce the time required to set up a company, and measures to boost smaller enterprises (adopted June 2007), which aim to improve access to finance. But against these potentially useful measures, labor unions have blocked amendments to the Labor Law intended to increase flexibility of labor regulations. Businesses criticize the current law for, among other things, mandating layoff payments that are much higher than in comparable countries, and limiting the ability of employers to outsource work.

3.4.6 Growth of commercial banks' loans



Source: Bank Indonesia, available: http://www.bi.go.id/web/en, downloaded 31 August 2007.

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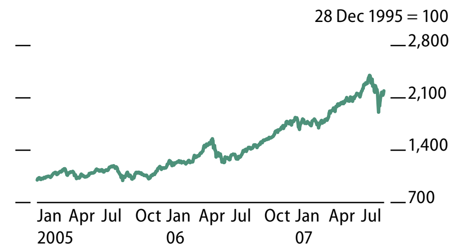
3.4.7 Jakarta Composite Index



Source: CEIC Data Company Ltd., downloaded 7 September 2007.

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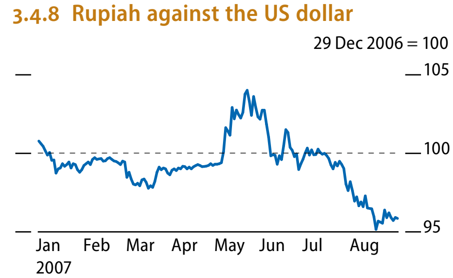
3.4.8 Rupiah against the US dollar



Note: An index below 100 signifies a depreciation of the rupiah.

Source: Bank Indonesia, available: http://www.bi.go.id/web/en, downloaded 31 August 2007.

Click here for figure data

Companies see these requirements as stifling employment generation, particularly in labor-intensive sectors such as textiles and footwear.

Prospects

Growth in 2008 is likely to be driven by domestic demand. The reductions in domestic interest rates since May 2006 and an improving investment climate are set to push investment growth next year, while a recovery in consumer confidence will lead to an acceleration in private consumption expenditure. GDP growth will be supported by higher rates of credit expansion to the private sector as bank and corporate balance sheets strengthen. Moreover, government infrastructure outlays are expected to increase.

These positive developments are likely to be partly offset by a smaller surplus in net exports as imports rise in response to stronger investment and consumption demand, and as exports moderate in line with a projected decline in global nonfuel commodity prices. Overall, GDP growth in 2008 is forecast to edge up to 6.4% (Figure 3.4.9), a marginal upward revision from that in *ADO 2007*.

The 2008 budget predicts a wider deficit of 1.7% of GDP, reflecting a near 50% increase in capital spending from the revised 2007 budget; a 16.2% reduction in state spending on consumption; and increased allocations for education and health, and for transfers to the regions. The authorities aim to meet the additional financing needs through the issuance of government securities, the recovery of state bank assets as part of banks' restructuring efforts, increased privatization receipts, and external loans. But even with these higher budget financing requirements, the central Government's total debt-to-GDP ratio is projected to decline further to around 33% in 2008 from 36% this year.

On the external side, the current account surplus is projected to fall to 0.7% of GDP in 2008 (the same as forecast in *ADO 2007*; Figure 3.4.10), as export growth eases while stronger domestic investment and consumption demand lifts imports. In addition to a smaller trade surplus, wider deficits are likely in the services and income accounts. However, the overall external balance will remain in surplus owing to growth in FDI and portfolio investment flows, which will contribute to the further accumulation of foreign exchange reserves. Total international reserves should be about $62 billion at the end of next year, or 7.4 months of import cover.

Food prices are expected to be more stable than this year (assuming normal weather and food production) paving the way for inflation to ease to an average 6.0% in 2008, against 6.1% forecast in *ADO 2007*.

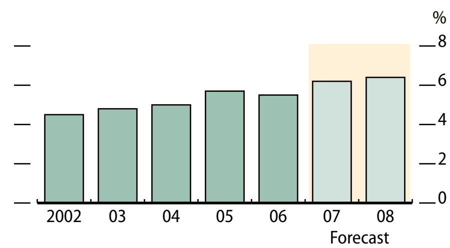
Domestic risks to this outlook are headed by inadequate effective action on structural reforms, insufficient investment in infrastructure (which could lead to supply bottlenecks), and regional governments' inability to implement projects. Despite budgeted increases in national public infrastructure expenditure in 2008, actual disbursement might come in below target. In the regions, too, despite their now larger role in spending, earlier this year they were holding cash deposits equal to an estimated 2.5% of GDP, reflecting their weak capacity to carry out projects (thereby hindering GDP growth).

3.4.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	6.0	6.2	6.3	6.4
Inflation	6.2	6.3	6.1	6.0
Current acct. bal. (share of GDP)	1.0	1.4	0.7	0.7

Source: Staff estimates.

3.4.9 GDP growth



Sources: CEIC Data Company Ltd., downloaded 16 August 2007; staff estimates.

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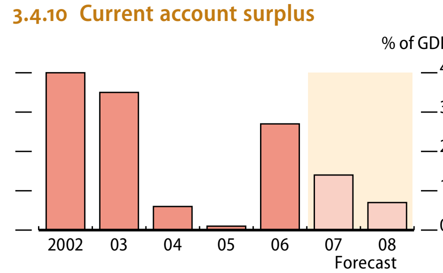
3.4.10 Current account surplus



Sources: CEIC Data Company Ltd., downloaded 16 August 2007; staff estimates.

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