Indonesia

Moderate economic growth last year was based on private consumption and exports, while fixed investment growth dwindled. Inflation eased from high levels as the year progressed, enabling a reduction in interest rates. The economy is expected to pick up in 2007 and 2008, supported by greater development spending and some improvement in the investment climate. There is a window of opportunity to accelerate reforms, which would pave the way for a significant lift in investment, in turn making headway on job creation and poverty reduction.

Economic performance

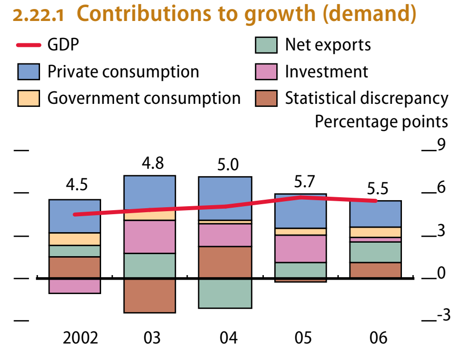
The economy grew by a modest 5.5% in 2006, slightly faster than average expansion over the previous 3 years. In line with recent trends, private consumption made the major contribution to overall GDP growth (Figure 2.22.1), even though spending slowed after the October 2005 reduction in fuel subsidies, which pushed up inflation and interest rates until well into 2006. Sales of motorcycles, a good barometer of confidence, fell by 12% in 2006, and auto sales collapsed by 40%. For all of 2006, growth in private consumption decelerated to 3.2%, from 4.0% a year earlier.

Net exports also made a significant contribution to overall growth. Exports surged by 9.2%, supported by buoyant world trade and high global prices for Indonesia's commodities such as crude oil, natural gas, minerals, and palm oil. Import growth slowed sharply to 7.6%, in part a result of weak investment for most of the year. Fixed investment grew by just 2.9% in 2006, far below rates achieved in 2004 and 2005, although it perked up in the fourth quarter when inflation and interest rates eased. As a result, investment made a relatively small contribution to GDP growth.

The weakness in investment stemmed not only from higher borrowing costs but also continuing deficiencies in the business environment. Planned reforms on tax, investment, and labor laws were bogged down in the parliament. Both realized foreign direct investment and domestic investment fell by a third in 2006, to $6.0 billion and $2.2 billion, respectively. Investment approvals, on the other hand, rose, which indicated that investment could turn up soon. As a share of GDP, gross fixed capital formation in Indonesia last year was 24%, up slightly from 2005 (Figure 2.22.2).

By sector, services continued to grow faster than agriculture and industry, and contributed 3.0 percentage points of the total 5.5% GDP growth (Figure 2.22.3). Transport, telecommunications, and domestic trade services performed strongly. Construction, part of the industry sector, grew by 9%, supported by a property market boom in many cities. Industry's contribution to GDP growth was 2.1 percentage points. Growth in manufacturing was moderate but mining growth was low, despite the country's wealth of mineral resources and high world prices for these

2.22.1 Contributions to growth (demand)



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id, downloaded 26 February 2007.

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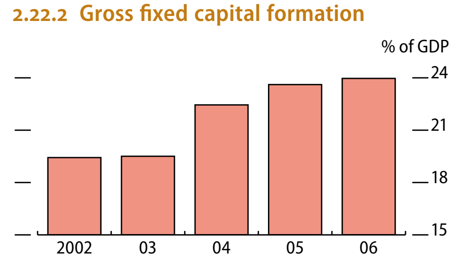
2.22.2 Gross fixed capital formation



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id, downloaded 26 February 2007.

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commodities. A manifestation of weakness in the natural resources sector is Indonesia's continuing status as a net oil importer: crude oil production fell by 8% to 860,000 barrels a day by end-2006, and is down nearly 31% from 2001. Agriculture was hurt by drought in many parts of the country, although it continued to expand and contributed nearly a half percentage point to GDP growth.

Inflation eased from the rapid pace of above 17% in January, to around 7% late in the year as the impact of the 2005 raising of fuel prices faded (Figure 2.22.4). Bank Indonesia, the central bank, lifted its policy interest rate in 2005 to counter the upward pressure on prices. By May 2006, it was able to start reducing the policy rate, and by year-end had cut it by 3.0 percentage points to 9.75%. High interest rates and low levels of investor confidence led to a slowing in credit growth to 12.5% in 2006 from 29% a year earlier. While the central bank lowered its policy rate from May, commercial banks did not cut their lending rate to the same extent owing to perceptions of risk. Indicative of this, gross nonperforming loans increased from 8.3% of total loans at end-2005 to 8.6% in November 2006.

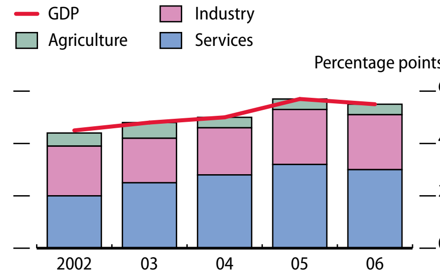
Much of the increase in nonperforming loans since 2004 has been due to operational and governance problems at state-owned banks. Consequently, the adoption in October 2006 of a regulation allowing state banks to restructure and dispose of such loans helped bring down the ratio to 7.0% by year-end. In early 2007, Bank Indonesia cut its policy rate in February and again in March, to 9.0%.

Citing improvements in the country's fiscal management and the Government's efforts to deal with corruption, international rating agencies Moody's and Fitch uprated Indonesia's outlook in early 2007 to positive from stable, though the sovereign rating remains below investment grade. Foreign portfolio investment inflows picked up last year. The Government issued $2.0 billion in international bonds in 2006 and $1.5 billion in February 2007. Stock prices soared, with the market index up by 55.3% in 2006, and market capitalization rose to the equivalent of about 40% of GDP from around 30% in 2005.

On the external front, the strength in merchandise exports (up 18.1% in nominal US dollars) and moderate rise in imports (up 5.1%) propelled the trade surplus 69.5% higher to $29.7 billion. Trade in services remained in deficit, to the extent of $11.2 billion, largely the result of rising imports of construction and financial services. The current account surplus rose to $9.6 billion (Figure 2.22.5), or 2.6% of GDP. Foreign reserves reached $42.6 billion, equivalent to about 7 months of import cover. These developments supported the rupiah, which appreciated by 9% over 2006 to end the year at Rp9,150/$1.

Overall, the economy's vulnerability to external shocks has been decreasing, reflecting sound debt management. The ratio of total external debt to GDP fell from 46.1% in 2005 to just under 34.0% in 2006. The debt service ratio rose to above 20% from 15.5%, primarily because of the early repayment of $7.8 billion owed to the International Monetary Fund and the end of a postponement on debt servicing that had been granted by the Paris Club to help the country handle its December 2004 earthquake and tsunami disaster. Public debt was reduced to 42.4% to GDP in 2006 (Figure 2.22.6).

2.22.3 Contributions to growth (supply)



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id, downloaded 26 February 2007.

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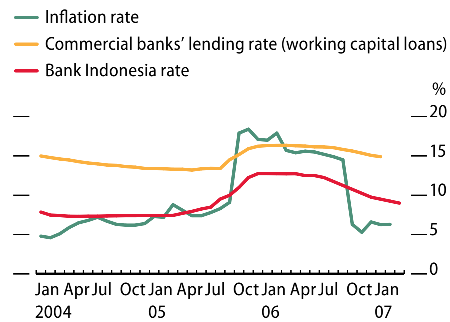
2.22.4 Interest and inflation rates



Sources: International Monetary Fund, *International Financial Statistics* online database, available: http://ifs.apdi.net, downloaded 26 February 2007; Bank Indonesia, available: http://www.bi.go.id, downloaded 14 March 2007.

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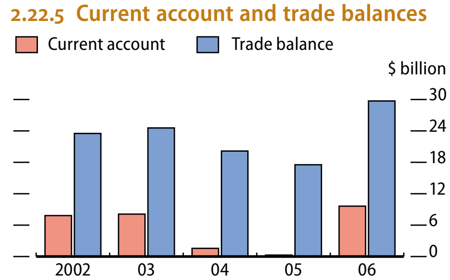
2.22.5 Current account and trade balances



Sources: Asian Development Outlook database; Bank Indonesia.

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The Government pressed ahead with its aim to contain the fiscal deficit and redirect public expenditures to development and social goals. The realized fiscal deficit in 2006 was 1.0% of GDP, against a planned level of 1.3% (Figure 2.22.7). Total national public expenditures—at all levels of government—have risen steadily over the past 8 years, and at an accelerated pace in 2004–2006.

As a proportion of GDP, national public expenditures rose from about 19% in the years 2003–2005 to about 20% in 2006. The cost of subsidies, mainly for fuel and electricity, increased to 4.4% of GDP in 2005, and then declined to 3.2% last year. The October 2005 hikes in fuel prices cut about $10 billion a year from subsidies. Fiscal space generated by these cuts has enabled the Government to increase fiscal transfers to the regions from 5.6% of GDP in 2005 to an estimated 7.4% in 2006. Overall development expenditures are estimated to have risen by 1 percentage point to 7% in 2006.

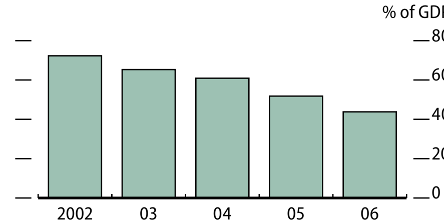
At the central government level, there is a clear effort to redirect spending. Education outlays rose by 34% in real terms last year. They accounted for 17.2% of total government spending and stood at 3.6% of GDP. However, health and infrastructure expenditures remain low, with health less than 1% of GDP in 2006 and new public infrastructure investment below 3%.

Although fiscal transfers to the regions have gone up substantially, the funds often are not spent because of severe capacity limitations. As of November 2006, the regions were estimated to hold the equivalent of almost $10 billion (3.1% of GDP) in cash deposits. The central Government is rolling out a community-designed development program that could become a vehicle for lifting spending by local governments. The program will provide resources to communities to undertake locally executed small-scale public works projects.

While macroeconomic stability has been restored, much remains to be done to combat unemployment and poverty. The moderate pickup in economic growth since 2001 has not been enough to reverse a persistent increase in unemployment from below 9% to an estimated 10.3% over this period (Figure 2.22.8). Underemployment, based on the Government's estimate, was about 21% in 2003. Consequently, about 42% of Indonesians live on $1–2 a day, leaving them particularly vulnerable to adversities such as ill health or natural disasters. National poverty incidence is estimated to have increased from 16% in 2005 to 17.8% in March 2006. The reduction in fuel subsidies certainly hurt many people, although it was cushioned by government cash payments that provided subsistence support for 19.2 million poor and near-poor households.

But what appears to have deepened poverty to a greater extent was a 33% rise in rice prices between early 2005 and early 2006, caused by lower output of the crop and the Government's reluctance to lift a ban on rice imports. After a prolonged debate in 2006 over the benefits to the poor of imports against possible damage to domestic growers, the Government imported rice from Viet Nam in the fourth quarter to shore up its buffer stock and stabilize prices. Late seasonal rains and drought in several parts of the country delayed rice planting and pushed up prices by a further 8% in December. The Government therefore imported more rice early this year.

2.22.6 Total government debt



Sources: Bank Indonesia, available: http://www.bi.go.id; Ministry of Finance, available: http://www.dmo.or.id, both downloaded 28 February 2007.

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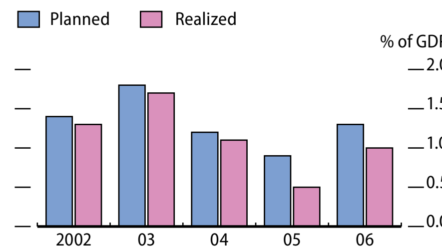
2.22.7 Fiscal deficit



Sources: Asian Development Outlook database; Ministry of Finance, available: http://www.fiskal.depkeu.go.id, downloaded 28 February 2007.

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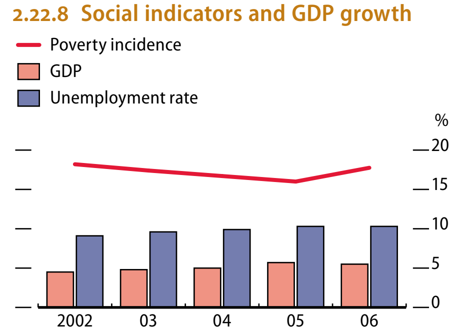
2.22.8 Social indicators and GDP growth



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id; CEIC Data Company Ltd., downloaded 26 February 2007.

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Some progress was achieved on policy matters in 2006, but several important issues were not resolved. Government financial management was strengthened with a focus on improving tax and customs administration and on treasury reforms. The parliament enacted amendments to the Law on Customs, enabling customs procedures to be simplified and imposing stiffer penalties on smuggling. This law, and one on warehouse receipts that enables their use as collateral for financial intermediation, were the only noteworthy economic laws approved by the parliament.

Legislators did not resolve their differences over the more important laws on investment, tax, and labor market issues. The proposed investment law would clarify which sectors are open for foreign investment and simplify investment procedures. Proposed amendments to the income tax system would, among other changes, establish a single corporate income tax rate, phase down the maximum income tax rate for individuals, and cut the tax on dividends. The law also would (once on the statue books) provide tax incentives to investment in mining, oil, gas, and geothermal energy and to small and medium enterprises.

Proposed changes to labor legislation also stalled, as discussion continued to resolve the three main weaknesses of the 2003 Labor Law: there is no role for negotiated wage settlements, instead allowing for ad hoc increases in minimum wages by regional administrations leading to unpredictable increases in labor costs; it mandates severance, or layoff, payments that are much larger than in comparable economies; and it limits the ability of employers to outsource tasks, even tasks that cannot be done locally.

The Government fell short of its 2006 privatization target, raising Rp2.5 trillion ($277.2 million), including Rp2.1 trillion through a 5.1% divestment in the state gas utility Perusahaan Gas Negara, against a budget target of Rp3.0 trillion. For 2007, the budget targets privatization receipts of Rp2.0 trillion.

Economic prospects

The Government is at the midpoint of its elected term, and the opportunity to implement reforms that could accelerate economic growth may be fairly brief because electioneering and positioning for 2009 parliamentary and presidential elections will probably start from about mid-2008. The following forecasts assume the administration will push harder in the next year or so to implement the policy measures already in place. They also assume that the Government will improve the legal and regulatory environment, and that regional governments will do a better job in spending transfers from Jakarta.

On this basis, economic expansion is projected to accelerate to 6.0% this year and 6.3% the next, rates of growth not seen since the mid-1990s (Figure 2.22.9). A gradual decline in interest rates will likely feed a recovery in bank lending to fuel growth in consumption and investment. The latter should also benefit from the recent strong export performance, as well as an anticipated pickup of manufacturing. A long list of planned infrastructure projects involving public-private partnerships was prepared by the Government in early 2005, but only a handful have been started.

2.22.1 Selected economic indicators

	2007	2008
GDP growth	6.0	6.3
Inflation	6.2	6.1
Current account balance (% of GDP)	1.0	0.7

Source: Staff estimates.

The focus now is on a shorter list of projects; some power, transport, and water supply projects are expected to get under way in 2007 or 2008. Gross fixed investment is forecast to climb to 25–27% of GDP over the forecast period. Spurred by investment growing at above 9% and consumption at 4.5%, GDP growth will likely be ratcheted up in 2008 by election-related spending.

In the external accounts, exports are forecast to decelerate to around 10% in nominal terms this year because of softer growth in major export markets. Imports, in contrast, will accelerate to meet the higher investment needs. The current account surplus is expected to decline to 1.0% of GDP in 2007 and 0.7% in 2008 (Figure 2.22.10).

Central government public expenditures are forecast to rise by 1.4 percentage points of GDP to 22.5% in 2007. In particular, development expenditures in nominal terms are budgeted to increase by 25%, or from 3.2% of GDP in 2006 to 3.6% in 2007. Spending looks likely to exceed budget projections for various reasons: January 2007 floods in Jakarta that killed over 80 people and caused extensive property damage; a hot mudflow from an East Java gas exploration site, which requires an estimated $833 million to clean; repairing earthquake damage in West Sumatra; and buying rice for buffer stocks. With these elements, the overall 2007 deficit is expected to be wider than the 1.1% of GDP forecast in the budget. Still, Government debt is projected to decline because of repayments and may yet reach the targeted 30–32% by 2009.

Inflation is projected to average just over 6% this year and next (Figure 2.22.11). However, these forecasts would need to be raised if the Government decided to reduce subsidies on electricity. A phased increase in power tariffs and a restructuring of the tariffs, so that each market segment paid the true cost of providing electricity, would be desirable, as it would free budget resources for more productive purposes. It would also encourage investment in power generation—the Government provided nearly $4 billion (1.4% of GDP) in subsidies to the state power generation utility in 2005 and an estimated $2.6 billion last year.

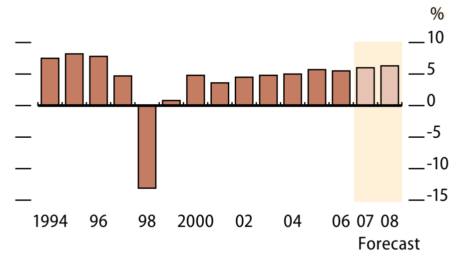
Two key domestic downside risks lurk: agricultural output and avian flu. Drought persists in parts of the country, while other areas have been flooded; and the El Niño weather phenomenon may return, which would cause drier than usual weather. Avian flu has already claimed more than 60 human lives in Indonesia, the largest death toll in the world, and agriculture has suffered from selective culling of poultry in many parts of the country and from bans on backyard poultry-keeping in urban areas.

An optimistic scenario for the next 5 years is that pending laws and regulations are enacted, encouraging private sector development and accelerating GDP growth to 7–8%. A gloomier scenario has the country faltering on implementation of policies and failing to unblock funding constraints at the regional level. In such an event, Indonesia would be locked into sub-6% growth.

Development challenges

The foremost challenge is to accelerate growth to a level that can create enough jobs to hold back the tide of unemployment and underemployment and reduce the vulnerability of the poor.

2.22.9 GDP growth



Sources: Asian Development Outlook database; Badan Pusat Statistik, available: http://www.bps.go.id; CEIC Data Company Ltd., downloaded 26 February 2007.

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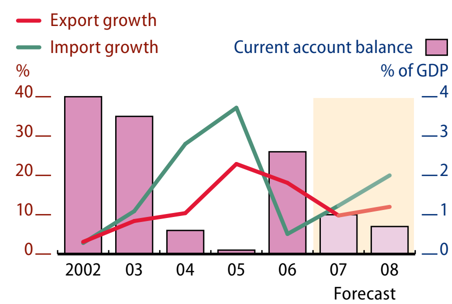
2.22.10 External indicators



Sources: Bank Indonesia; staff estimates.

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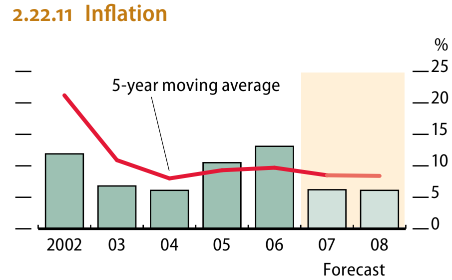
2.22.11 Inflation



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

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Macroeconomic stability and sustained modest growth rates have been achieved in recent years through generally sound policy management, but little in the way of major structural improvements. Portfolio investment has been strong, partly a result of the surge in global liquidity, but direct, long-term investment is tepid.

Rankings of national competitiveness (Table 2.22.2) put Indonesia below many comparable economies in factors such as government efficiency, the business environment, and infrastructure quality. The Government has done much to prepare its reform agenda over the period 2003–2006. Effective implementation, though, has lagged. Attention to some vital issues would boost the outlook.

Finalizing and adopting the proposed investment and tax reform packages is vital. While the investment climate-related laws still pending in the parliament are likely to be enacted this year, a long delay and a continuing lack of clarity on institutional arrangements for investment coordination within the Government have undermined credibility. On the labor front, the authorities need to bring labor and business to the negotiating table to achieve consensus on ways to make the labor market more flexible, particularly with regard to outsourcing and payment for layoffs. In this regard, a proposed insurance-based system to fund such payments holds promise.

A significant increase in private investment also requires greater legal and regulatory certainty. The executive branch of the Government can play a key role in two ways. First, it can improve credibility by speaking with one voice, and adopting a concerted approach to resolving contract disputes. Several disputes between the Government and private investors have been protracted, damaging Indonesia's credibility. Second, greater coordination between executive, parliamentary, and judicial institutions, and between central and regional authorities, would be most useful. The judiciary should be adequately resourced and be able to look at the costs imposed by its rulings on the investment climate. Private investment would be encouraged if small and medium enterprises had better access to funding.

The plan to improve physical infrastructure needs a solid push. High-quality projects have to be prepared, and then bid out in a transparent manner. An effort now under way to prepare model projects requires support by all the ministries concerned. Civil service reforms are also needed (Box 2.22.1.).

Given Indonesia's vulnerability to natural disasters, another challenge is to enhance disaster management capabilities and risk mitigation. Better coordination and planning can help to reduce the impact on the population and the economy of calamities such as floods and earthquakes. Regional governments in particular need to use their increasing resources to build better roads and flood protection systems and to plan for the perhaps inevitable disasters.

2.22.2 World competitiveness rankings

Country	2001	2003	2006
China, People's Rep. of	26	29	19
India	42	50	29
Malaysia	28	21	23
Philippines	39	49	49
Indonesia	46	57	60
Number of countries/ regions ranked	49	59	61

Source: World Competitiveness Yearbook, 2006, published by IMD, Switzerland.

2.22.1 Civil service reforms

Attracting capable people to the civil service will take better incentives, merit-based entry, and a more performance-oriented culture.

Public agencies sometimes perform similar functions with unclear mandates. For instance, there are numerous agencies with different responsibilities on civil service management.

In the audit area, the supreme audit institution has the legal mandate, but inadequate human resources, while an internal government agency with no clear mandate on audits has hundreds of well-qualified auditors. Local governments that are entrusted with severe public resources have huge capacity constraints.

Some ministries, such as finance, are moving to strengthen their organizational structure and improve capacity. This needs to be replicated across the whole government bureaucracy.

Civil service reforms would help the Government sustain its anticorruption efforts.