Indonesia

Despite headwinds, the economy maintained its recovery and expanded by 5.6% in 2005. During the year, the Government cut fuel subsidies and redirected budget savings at spending on the poor. However, the rise in fuel prices pushed up already-high inflation and prompted interest-rate rises, which curtailed consumer spending and investment later in the year. Growth will slow in 2006 before picking up in 2007. Crucially, the investment climate is improving, but much remains to be done if the Government is to achieve its medium-term growth target of 6.6%.

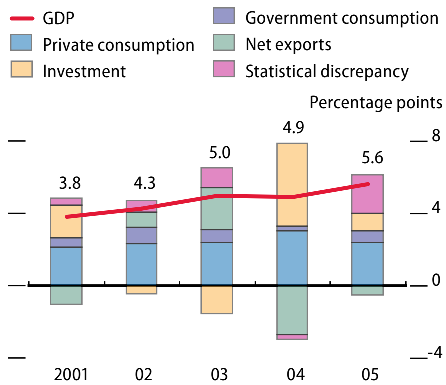
Economic performance

Gross domestic product (GDP) growth has picked up in recent years, from 3.8% in 2001 to 5.6% in 2005. Other indicators have improved commensurately: the fiscal deficit has narrowed to below 1% of GDP and public debt has declined to 52% of GDP, down nearly 30 percentage points over 4 years. The continuing recovery in 2005 was noteworthy because it was achieved in the face of several major difficulties, including the aftermath of the December 2004 earthquake and tsunami, which severely damaged Aceh province and Nias islands; changes in budgetary procedures, which led to a slowdown in the release of development funding; a slump in the rupiah; a sharp increase in domestic fuel prices; and a surge in inflation and interest rates.

Higher inflation and interest rates impeded both private consumption and investment spending as the year progressed. Growth of private consumption slowed by 1 percentage point to 4.0%, while growth in fixed investment, after showing encouraging signs of recovery, slowed by about 4 percentage points to 9.9%. Year-on-year GDP expansion stepped down from 6.3% in the first quarter to 5.6% in the second and third, and to 4.9% in the final quarter. Indeed, the economy contracted by 2.2% in the fourth quarter from the third. An 8% rise in government consumption spending in the later part of the year contributed to the full-year GDP performance of 5.6%, up 0.7 of a percentage point from 2004. Overall, private consumption and fixed investment contributed about 4.5 percentage points, while net exports continued to subtract from growth (Figure 2.22.1). The savings rate, too, makes it evident that personal consumption has been a driver of growth in recent years, having steadily declined between 2001 and 2004 (though it recovered a little in 2005) (Figure 2.22.2).

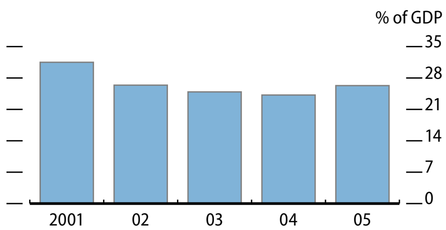
On the supply side, growth of agriculture slowed to 2.5% on account of a smaller harvest caused by changes in the crop mix and a shift in land use. Growth of manufacturing decelerated to 4.6%, reflecting higher production costs. Mining recovered from a slump to register a modest 1.6% upturn, supported by higher global prices for oil, metals, and minerals. Construction (included under industry) and services, together

2.22.1 Contributions to growth (demand)



Source: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=99&lang=eng&stat=io, downloaded 1 February 2006.

2.22.2 Gross domestic savings



Source: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=99&lang=eng&stat=io, downloaded 1 March 2006.

accounting for about half of the economy, expanded by 8.0% and were largely responsible for GDP growth (Figure 2.22.3).

An encouraging development in 2005 was an acceleration in private investment. Actual foreign direct investment (FDI) in sectors other than oil, gas, and finance nearly doubled to $8.9 billion from $4.6 billion in 2004, according to the Investment Coordination Board. While this is far from the FDI peak of $39.7 billion in 1995 (also excluding oil, gas, and finance), the slow recovery is a positive sign for the medium term. Realized domestic investment more than doubled to $3.2 billion. However, a slowdown in public investment outweighed the recovery in private investment, leading to decelerating fixed capital formation.

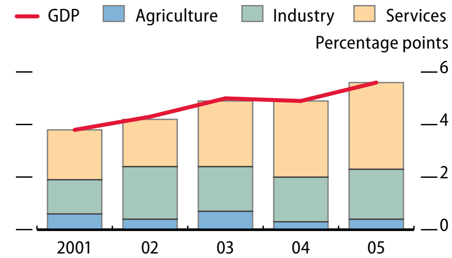
Total merchandise exports rose by about 20%, with non-oil and gas exports up at about the same rate. However, in volume terms, exports moved little, even after currency depreciation in mid-2005. Ministry of Trade data show that Indonesia has lost market share in some major exports since 1998 (Box 2.22.1). On the payments side, imports climbed by about 26% (Figure 2.22.4). With a widening deficit in services trade, the overall current account surplus fell to $3.0 billion, or 1.1% of GDP (which compares with a surplus of 4.8% of GDP in 2000.)

Fuel subsidies became a critical issue in 2005 as global oil prices climbed, placing an increasingly heavy burden on the budget. (The subsidies cost nearly $10 billion that year, or 3.5% of GDP). They also encouraged inefficient use of petroleum products. In March, the Government raised administered prices of these products by 29%, but in the absence of a strong signal on future policy direction, strong demand and soaring prices propelled oil imports higher, sending the current account into deficit in the second quarter. Financial markets reacted sharply: the rupiah slumped in August to its lowest point since 2002, the stock market weakened, and private capital outflows accelerated. Foreign exchange reserves dropped by more than $5 billion in the 5 months to September (Figure 2.22.5) as the authorities drew down reserves to fund the growing oil-related import bill and to defend the rupiah.

In October, the Government took the bold step of more than doubling fuel prices to slash the cost of the subsidies. Bank Indonesia also raised its 1-month policy interest rate by 4 percentage points to 12.75% between September and December to support the rupiah and damp inflation (Figure 2.22.6). These moves restored investor confidence, but they also ramped up inflation and slowed consumer spending. Between March and October, inflation doubled to 18% and stayed around that level in November–December—the highest in 6 years. To deal with the adverse impacts of inflation on the poor, the Government announced an unconditional cash transfer program to provide subsistence support of roughly $10 a month for 1 year to about 15.5 million poor households, at a cost of about $480 million in 2005. The fiscal resources conserved by the cut in subsidies enabled the Government to prepare a $1.4 billion spending program to upgrade education and health facilities and village infrastructure in 2005–2006. The rate rises helped strengthen the rupiah (Figure 2.22.7), and foreign reserves recovered to about $35 billion at end-December, from about $30 billion in September. The rupiah strengthened further through mid-March 2006 and reserves continued to recover.

Rising interest rates hurt the banking sector, particularly in the

2.22.3 Contributions to growth (supply)



Note: Construction is one of the subsectors in the industry sector.
Source: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=97&lang=eng&stat=io, downloaded 1 March 2006.

2.22.4 Export and import growth

Source: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=63&lang=eng&stat=io, downloaded 22 March 2006.

2.22.5 Gross international reserves

Source: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=67&lang=eng&stat=io, downloaded 21 March 2006.

2.22.1 Export performance in need of a revamp

Indonesia has experienced a significant slowdown in the growth of exports in sectors where it traditionally has had a comparative advantage, including furniture, palm oil, rubber, textiles, and footwear. In some cases, exports have seen an absolute decline. The average growth rate for non-oil and gas exports has slowed to about 13% in recent years, from 17% before the Asian financial crisis.

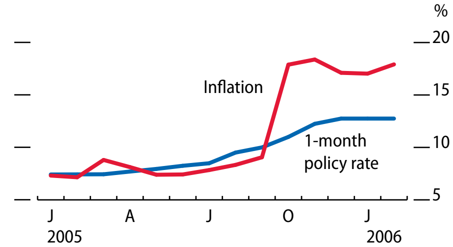
Rising labor costs, high inflation, and a relatively stronger currency have eroded the economy's ability to compete in export markets. The International Monetary Fund estimated in 2004 that unit labor costs were about 35% higher in dollar terms than before 1997. At the same time, the People's Republic of China (PRC) and Viet Nam have become keen competitors for Indonesia's traditional export markets. In 2005, Indonesia's exports of textiles and clothing to its principal markets produced a mixed performance. There was some erosion of market share to the European Union (EU) once quotas ended on 31 December 2004. However, the country increased its market share in the United States, with particularly strong export growth in cotton clothing (up 17%) in 2005. Looking ahead, competition will be stiff from Bangladesh and India. The PRC and Viet Nam, also strong competitors, remain quota constrained in the US market and, in the case of the PRC, also in the EU as both the US and EU used special textile safeguards allowed under the World Trade Organization accession agreement. Viet Nam may emerge as the main competitive threat when it becomes a member, unless it is saddled with safeguards.

Generally weak investment in recent years has hampered Indonesia's competitiveness. This applies not only to a lack of investment in manufacturing, but also in transportation, ports, and other infrastructure that affects exporters' costs. Raising the investment rate would likely benefit export industries, as would further liberalization of trade. After going through various rounds of trade liberalization, Indonesia has one of the most liberal trade regimes in Southeast Asia. Its average tariffs have declined from about 27% in the 1980s to 7–8% (although higher tariffs protect certain industries such as automobiles). Still, results from a 2005 UNCTAD simulation indicate that the economy could gain $2.3 billion in net export earnings annually from a completely liberalized ASEAN+3 regional trade agreement. It could capture about half of these benefits by liberalizing unilaterally, and in motor vehicle trade this would triple Indonesian automobile exports, while a regional arrangement would increase automobile exports by 1.5 times. Leather, textiles, and clothing would also gain with further trade liberalization.

second half of 2005. Loan growth decelerated and the net nonperforming loan ratio rose from 1.9% to 5.0% during the year. Banks' capital-adequacy ratio declined from 21.7% to 19.6%. State-owned commercial banks posted nonperforming loan ratios of around 15%, generating concern about their governance and risk management.

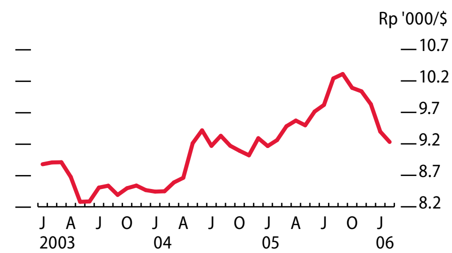
Fiscal consolidation has been a hallmark of economic policy in Indonesia since 1997. The overall budget deficit narrowed from 2.4% in 2001 to 0.5% in 2005, with the outcome last year helped by the cuts in fuel subsidies and delays in spending caused by changes to budgetary procedures (Figure 2.22.8). The ratio of external public debt to GDP

2.22.6 Indonesia 1-month policy rate and inflation



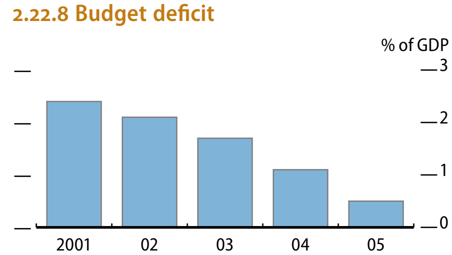
Sources: Badan Pusat Statistik, available: http://www.bps.go.id/sector/cpi/table3.shtml, downloaded 20 March 2006; Bank Indonesia, *Indonesian Financial Statistics*, various issues.

2.22.7 Nominal exchange rate



Source: CEIC Data Company Ltd., downloaded 21 March 2006.

2.22.8 Budget deficit



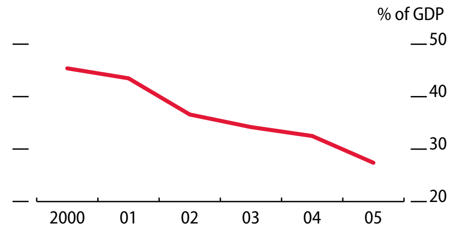
Sources: Ministry of Finance Press Release. *2005 Budget Release, Launching of 2006 Budget, and Government Salaries and Benefits in 2006*, 2 January 2006; *Asian Development Outlook* database.

has steadily declined in recent years, from about 45% in 2000 to 27% in 2005 (Figure 2.22.9), with overall public debt also falling. Paris Club debt rescheduling in 2005, granted to help the country deal with the tsunami devastation, allowed the Government to defer $2.5 billion in debt repayment until this year.

Indonesia's economy has been unable to generate enough jobs to employ 2.5 million annual entrants to the labor force. Labor market data compiled before the economy slowed later in the year put the 2005 unemployment rate at 10.3%, higher than a year earlier (Figure 2.22.10). While household survey data show that poverty incidence has fallen from 23% in 1999 to 16% in 2005, 53% of the population live on less than $2 a day. The increase in the price of cooking fuel made the poor more vulnerable in 2005, though the reduction in the regressive fuel subsidy and a reorientation of fiscal resources to programs that directly benefit the poor could have highly beneficial impacts on poverty reduction in the future.

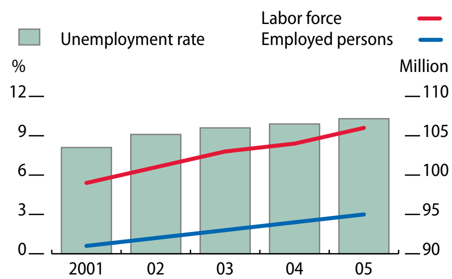
Some progress in fighting corruption was made during the year. The convictions of a former provincial governor and members and staff of the General Election Commission were successes for the Anti-Corruption Commission. This agency also launched investigations into the alleged payment of bribes to judges and court officials. The Government pursued scandals in Bank Mandiri and Bank Negara Indonesia. A cabinet reshuffle in December—particularly the appointment of a new economics team—helped improve market and investor confidence.

2.22.9 External public debt



Source: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=82&lang=eng&stat=io, downloaded 1 February 2006.

2.22.10 Labor indicators



Source: Badan Pusat Statistik, available: http://www.bps.go.id/sector/employ/table1.shtml, downloaded 1 February 2006.

Economic outlook

Prospects for 2006 and 2007

The fuel subsidy reduction in October set in motion a series of changes that have yet to work themselves out. The Government is expected to raise other administered prices. The following forecasts assume that inflation will stay high in the first half of 2006 and ease in the second. They also assume that the rupiah will average 9,600 to the dollar and that the central bank will lower interest rates a little in the second half of the year. The Government is expected to increase development spending and government employees' salaries.

Growth in the first half of 2006 is constrained by soft private consumption demand owing to the interest rate increases, high inflation, and a likely rise in unemployment. Fiscal policy will start to counteract this weakness through increased public spending (the fiscal deficit is likely to widen to 1% of GDP in 2006 from 0.5% in 2005), a shift in spending to the regions (the allocation for transfers to the regions is up to 7.2% of GDP from 5.8% in 2005), and the move away from fuel subsidies to better-targeted public spending. General-purpose grants to the regions are up by a net 1.5 times and special-purpose grants are up by two thirds from last year's allocations. The increased fiscal spending allowed by reduced fuel subsidies will have both direct and multiplier effects on growth. The size of the latter depends on the availability and condition of infrastructure in the regions, and the effectiveness of local governments in implementing projects.

The main generator of growth in 2006 and 2007 will be domestic

2.22.1 Selected economic indicators

	2006	2007
GDP growth	5.4	6.0
Inflation	14.0	7.5
Current account balance (% of GDP)	1.0	0.9

Source: Staff estimates.

demand, stimulated primarily by fiscal measures. The Government adopted a package in March 2006 to strengthen the investment climate through tax, customs and excise, and labor market reforms. It has taken initial steps to prepare policies and regulations for greater investment in infrastructure. The principal themes include: promotion of private sector participation, efforts to boost competition, and the adoption of market-based tariff structures where feasible. In an effort to ensure effective implementation of these measures, given that past performance has been less than impressive, the Government has strengthened its national committee charged with accelerating infrastructure development. The onus on this committee will be to ensure that adequately prepared and commercially viable infrastructure projects are offered to private investors, and that contracts are awarded transparently. This should be seen against a backdrop where, in early 2005, 91 infrastructure projects were announced but only a handful have since started construction.

For all of 2006, GDP growth is forecast at 5.4% (the Government's budget is based on a more optimistic prediction of 6.2%), picking up to 6.0% in 2007 (Figure 2.22.11). Inflation in the first half of 2006 will stay high (it was 17% in the first 2 months) because of implemented or planned increases in administered prices, minimum wages, and wages of government employees. By the end of 2006 inflation is expected to moderate to about 8%, giving a 2006 average rate of about 14.0%. Inflation is projected to slow in 2007 (Figure 2.22.12), on the assumption that administered prices are henceforth raised gradually. The current account surplus is expected to stay at around 1.0% of GDP.

Of the outstanding foreign debt, $9.4 billion in principal and interest is due in 2006, representing about 14% of export earnings and one third greater than debt repayments in 2005. The Government plans to meet these financing needs by issuing new bonds (about $5.7 billion) and seeking concessional project and program lending assistance ($3.6 billion).

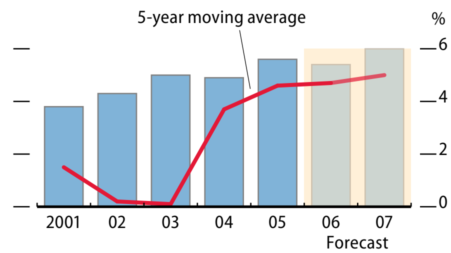
On policy issues, the primary focus will be on the reorientation of public expenditure to reduce poverty. The authorities are formulating a medium-term expenditure framework with poverty reduction as its principal goal. Its aims are to move away from unconditional cash transfers and toward targeted investments in selected sectors, and to scale up spending by regional governments.

Medium-term outlook

The Government's Medium-Term Development Plan for 2005–2009 envisages annual average GDP growth of 6.6%. It targets halving both the poverty incidence (to 8.2%) and the unemployment rate (to 5.1%) by 2009. A key priority is to spur investment in manufacturing and infrastructure to generate jobs. Over the past quarter century, Indonesia has increased its share of manufacturing in GDP from about 13% to about 28%, and manufacturing's share of exports rose by almost five times to 64% in this period. However, the medium-term plan's target to expand manufacturing by 8.6% annually will be difficult, given that growth in 2005 was only half this level. Overall, these medium-term targets appear ambitious. Growth of about 6% looks more achievable, provided that the investment climate continues to improve.

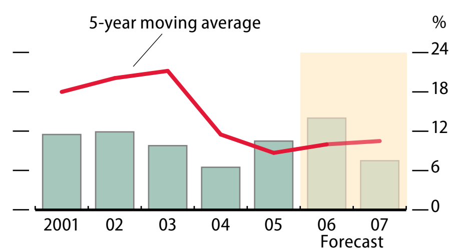
Gross domestic investment has been flat at about 21% of GDP since

2.22.11 GDP growth



Sources: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=99&lang=eng&stat=io, downloaded 1 February 2006; staff estimates.

2.22.12 Inflation



Sources: Badan Pusat Statistik, available: http://www.bps.go.id/sector/cpi/table3.shtml, downloaded 1 February 2006; staff estimates.

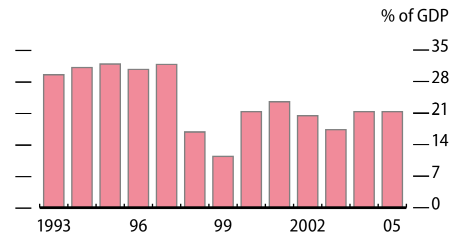
2000, down from 32% in 1997, just before the Asian financial crisis (Figure 2.22.13). In addition, much of the public and private investment has focused on maintenance rather than expansion of production. For example, as a result of underinvestment in the oil and gas sector since 1997, production of oil declined about 20% over a decade to around 1 million barrels a day in 2005 (Figure 2.22.14). Domestic consumption of oil, encouraged by the fuel subsidies, rose to above 1.2 million barrels a day. (Since the subsidies were cut, demand has declined by more than 20%.) Consequently, the country became a net oil importer, just as global oil prices started to climb, though it remains a net energy exporter because it supplies about a quarter of the world's liquefied natural gas from fields in Aceh and Kalimantan. An agreement reached in March 2006 between state-owned oil company Pertamina and Exxon Mobil to develop the large Cepu oil field, after years of negotiations, should improve the investment climate and boost the country's oil production (by 2009).

Even with natural gas becoming a major export, lack of clarity regarding the legal and regulatory environment and poor returns on investment in production and distribution have in the past hindered its use as a domestic energy source. Three recent developments have set the stage for gas to play a more important role: the removal of fuel subsidies has made gas competitive as a domestic fuel, the legal and regulatory framework for gas has been strengthened, and the Government has recently decided to prioritize domestic consumption over exports. Perusahaan Listrik Negara, the state-owned power utility, now wants to increase substantially the share of gas in its generation mix. However, major investment in infrastructure will be required to pipe gas to the large population centers in Java.

The near-term outlook faces several risks. Inflation could remain in double digits for longer than expected, keeping interest rates high and discouraging consumption and investment. The banking sector is vulnerable to currently rising rates of nonperforming loans. And Indonesia has had a high mortality rate of 69% of the 26 people tested positive for the avian flu virus between mid-2005 and February 2006. The 2006 budget allocates just $14 million to combat the disease, although the Government's own estimate is that at least 30 times that amount would be prudent.

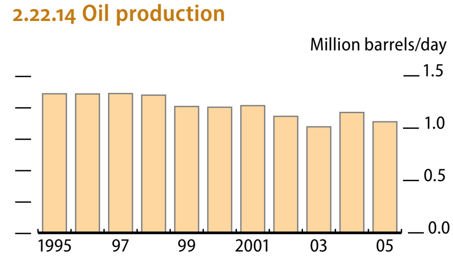
Over the medium term, the Government's ability to achieve its growth targets will be affected by its progress in overcoming several critical hurdles. The first is the investment climate, which is improving but still deficient. The March 2006 policy package is promising, but the actual implementation of such packages has been a source of concern in the past. Priority should be assigned to finalizing the legal framework for investment, tax, customs, and labor issues. A continuing debate on whether the Government should adopt an approval-oriented system or a simple registration system for investment has shaken investor confidence. The second constraint is poor delivery of public services, especially at regional level. Specific problems include lack of clarity in the roles and responsibilities of the national and regional levels of government, poor coordination at national and local levels, inconsistencies between laws and regulations at the various levels of government, and inadequate capacity among local governments to carry out projects. Third is a lack of performance in the civil service at national and local levels.

2.22.13 Gross domestic investment



Sources: Bank Indonesia, available: http://www.bi.go.id/web/en/Data+Statistik/statcat.htm?head=99&lang=eng&stat=io, downloaded 1 February 2006; CEIC Data Company Ltd., downloaded 10 March 2006.

2.22.14 Oil production



Source: Organization of the Petroleum Exporting Countries, *Statistical Bulletin 2004*, available: http://www.opec.org/library/Annual%20Statistical%20Bulletin/asb2004.htm, downloaded 9 March 2006.