Indonesia

A welcome increase in investment and expansion of private consumption contributed to a quickening in GDP growth in 2010, as external trade rebounded. Economic growth is forecast to step up this year and next. Near-term challenges are to curb inflation and manage surges in capital inflows, while reaching the government's medium-term growth target requires higher levels of investment in infrastructure.

Economic performance

A pickup in economic growth last year was driven by strong private consumption, buoyant investment, and robust recovery in export demand. GDP increased by 6.1%, recovering from a slowdown during the global recession in 2009 (Figure 3.24.1).

Private consumption, supported by a strengthening labor market and rising prices for agricultural commodities, increased by 4.6% and contributed 2.7 percentage points of GDP growth.

Fixed capital investment grew by 8.5% and contributed 2.0 percentage points to GDP growth. Investment in machinery and equipment rebounded by 17.1%, from a contraction in 2009, while that in buildings, including infrastructure, grew by 7.0% in 2011. Investment's healthy rise was underpinned by improvements in the domestic and global investment climate, an appreciation of the rupiah, and growth in credit. Gross fixed capital formation as a ratio to GDP rose to 32.2% (Figure 3.24.2).

Net exports also contributed to GDP growth, but government consumption did not, as the authorities unwound fiscal stimulus and lagged in disbursement of capital spending.

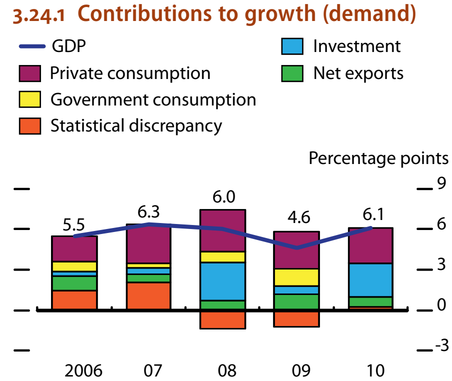
From the supply side, services again came in with the strongest expansion, at 8.4%, contributing 3.8 percentage points to GDP growth. Transport and communications recorded double-digit strengthening. Industry grew by 4.7%, reflecting a modest recovery in manufacturing, offset in part by slower growth in mining and quarrying. Manufacturing is still hindered by poor infrastructure and stringent labor regulations, while mining activity slowed during periods of unusually heavy rain last year.

Agriculture grew by 2.9%, the weakest increase in 5 years, as it, too, was set back by heavy rain.

Food supply disruptions caused by the bad weather and by infrastructure weaknesses drove inflation up from 2.8% in late 2009 to 7.0% in December 2010 (Figure 3.24.3). It exceeded the central bank's target of 4.0%–6.0% in some months (the year-average rate was 5.1%). Food price inflation was running at nearly 16% late in 2010.

Faced with rising inflation and a surge of capital from abroad, Bank

3.24.1 Contributions to growth (demand)



Source: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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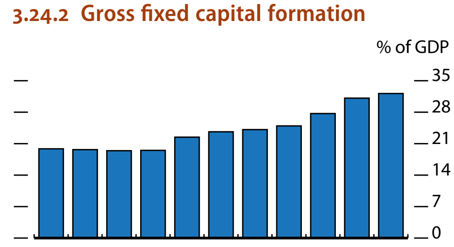
3.24.2 Gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

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This chapter was written by Edimon Ginting and Priasto Aji of the Indonesia Resident Mission, ADB, Jakarta.

Indonesia left its policy interest rate unchanged at 6.5% for 18 months (after cutting it by 300 basis points during October 2008–August 2009). Only in February 2011 did the central bank start to return the policy rate to more normal levels, edging it up by 25 basis points.

Bank Indonesia did, though, raise the reserve requirement for commercial banks, from 5.0% to 8.0% in November 2010. This measure absorbed an estimated Rp53 trillion of excess liquidity in the banking system (equal to about 3% of total bank lending). A 4.5% appreciation of the rupiah against the US dollar in 2010 provided some cushion against imported inflation.

Commercial banks passed on to borrowers only part of the central bank's policy rate cuts through August 2009. Credit growth was low until mid-2010, when it accelerated with economic activity, and was running at about 22% by year-end (Figure 3.24.4). That was still a little below Bank Indonesia's target, in part because lending rates remained relatively high. Banks' gross nonperforming loans fell by 1 percentage point in 2010, to 3.4% of total loans.

Recovery in world trade and higher commodity prices produced a 32% surge in merchandise exports to $158.2 billion in 2010 (Figure 3.24.5). Exports of natural rubber more than doubled, and exports of palm oil rebounded by about one-third. The value of metal ore and coal shipments jumped by 32%. Imports rose even faster than exports, by 42% to $127.1 billion, reflecting strong demand for intermediate and capital goods.

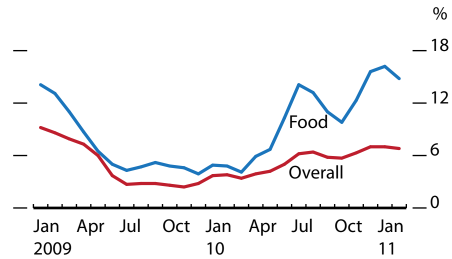
Nevertheless, the trade surplus rose to $31.1 billion in 2010 owing to a higher base for exports. The current account surplus moderated to $6.3 billion (0.9% of GDP). The transfers account recorded a marginally greater surplus, owing to growing remittances from migrant workers. However, the surplus was fully offset by widening deficits in the income and services accounts, due to higher interest payments and dividends to foreign investors and steeper freight costs attributable to a larger volume of exports.

The capital and financial account recorded a $26.2 billion surplus in 2010, up significantly from $5.0 billion in 2009, driven by higher inflows of portfolio and foreign direct investment. Portfolio inflows surged by 47.1% to $15.2 billion. Net foreign equity purchases estimated at $23 billion pushed the Jakarta Stock Exchange index of share prices up by 46% in 2010. Foreign holdings of government rupiah bonds increased by the equivalent of about $9.8 billion (81.3%—Figure 3.24.6) and their yields fell steeply.

Foreign direct investment more than doubled to $12.7 billion, reflecting the better domestic and international investment climate. Gross international reserves climbed by over $30 billion, to $96.2 billion at year-end, covering 7.1 months of imports and government debt payments.

More new jobs were generated in 2010 than new entrants to the labor market, helping to lower the unemployment rate to 7.1% in August 2010 from 7.9% a year earlier (Figure 3.24.7). This played a role in bringing back into the formal sector many of the workers who had been laid off from that sector during 2009's slowdown and had been working informally. Most new jobs created were in services. The employment share of the informal sector remains high, though, at around two-thirds.

3.24.3 Monthly inflation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2011).

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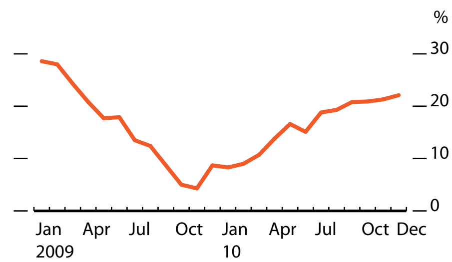
3.24.4 Credit growth



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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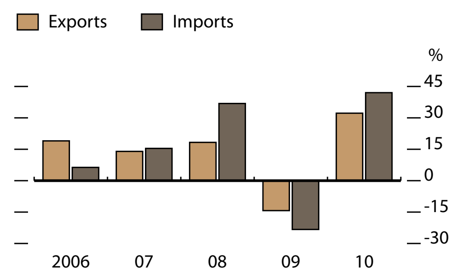
3.24.5 Merchandise trade



Sources: Asian Development Outlook database; CEIC Data Company (accessed 3 March 2011).

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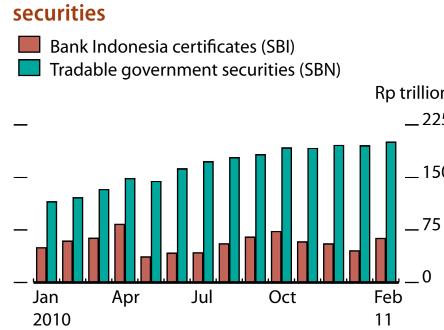
3.24.6 Foreign ownership of government securities



Source: Bank Indonesia. http://www.bi.go.id (accessed 14 March 2011).

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Household survey data show that poverty incidence fell to 13.3% in March 2010 from 14.1% in March 2009, and the number of poor in both rural and urban regions fell below 2004's levels for the first time.

Lower than budgeted spending, an increase in the tax-to-GDP ratio, and the impact of higher commodity prices on revenue tightened the budget deficit to an estimated 0.6% of GDP in 2010, well below the government's 2.1% of GDP projection. Central government revenue rose by 19.5% from the previous year. Government spending was 6.5% below projection, mainly because capital expenditure fell 20.6% short of budget.

Total spending on subsidies reached Rp214.1 trillion (3.4% of GDP), 6.4% more than projected, due to higher electricity subsidies and expansion of a program that provides rice to the poor. As a share of GDP, central government debt fell to about 26%, less than half its proportion in 2004 (Figure 3.24.8).

Efforts to improve the investment climate were illustrated by a reduction in the corporate income tax rate to 25% in 2010, the opening of a few more sectors to foreign investors, and new tax concessions for certain investments. The government launched a new system to reduce the time and costs of importing and exporting by allowing single submission, processing, and approval of import and export documents.

Recognizing such improvements (as well as the macroeconomic performance) the World Economic Forum's *Global Competitiveness Report* upgraded Indonesia's ranking by 10 places in 2010 to 44.

Standard & Poor's raised its long-term foreign currency credit rating on the country's debt from BB- to BB in March 2010, and Moody's upgraded its rating in January 2011 from Ba2 positive to Ba1 stable. Fitch raised its BB+ rating outlook from stable to positive in February 2011, which suggests an upgrade to investment grade within 12 months.

Economic prospects

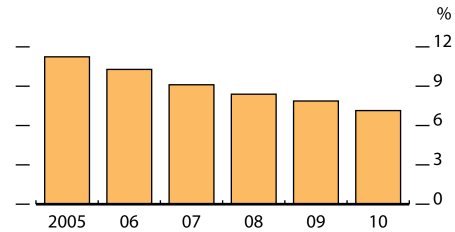
Forecasts assume that the government will continue to improve the investment environment, and that last year's bad weather (which hurt agriculture and mining) is not repeated in 2011.

Private consumption is forecast to expand on the back of increases in incomes brought about by the stronger labor market and high prices for agricultural commodities. Bank Indonesia's consumer confidence index rose sharply in January 2011 (Figure 3.24.9).

Private investment is expected to remain robust, given projected growth in domestic consumption and in external demand for agricultural products and minerals. Investment is supported by the growth in credit and higher levels of confidence in the country.

As for public investment, the government has budgeted for a near 30% rise in capital expenditure this year from the 2010 allocation, aimed at addressing infrastructure bottlenecks. Given chronic weakness in implementing capital works programs, the budgeted amount is unlikely to be fully drawn. To address this issue, the government is simplifying budget execution procedures and strengthening procurement capacity in spending agencies. It is also targeting higher overall spending and a wider budget deficit, equivalent to 1.8% of GDP, which should support GDP growth.

3.24.7 Unemployment rate



Source: CEIC Data Company (accessed 14 March 2011).
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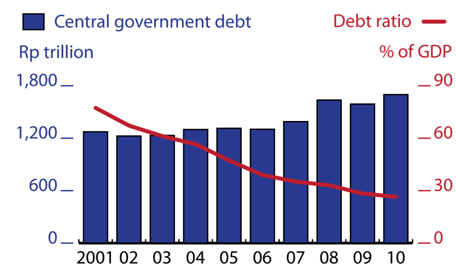
3.24.8 Government debt



Source: Directorate General of Debt Management. http://www.dmo.or.id (accessed 14 March 2011).
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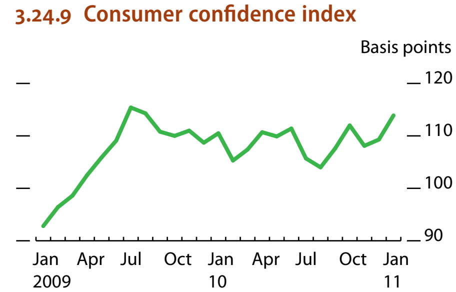
3.24.9 Consumer confidence index



Note: The index is constructed from a survey of Bank Indonesia among households. An index above 100 indicates optimism about the economy.
Source: CEIC Data Company (accessed 14 March 2011).
Click here for figure data

From the production perspective, signs point to manufacturers in several important subsectors preparing for higher levels of output: investment in machinery has increased in some industries, including paper and printing, rubber, plastics, food and beverages and, to a lesser extent, the labor-intensive industries of textiles, leather, and footwear.

A survey by the statistics office in March 2011 showed that business managers expect business conditions to continue to improve in the second quarter (Figure 3.24.10).

Growth in services will be underpinned by the forecast rise in domestic demand. Agriculture and mining are likely to put in better performances than last year on the basis of better weather and high global prices for agricultural commodities, energy, and metals.

On this basis, GDP is forecast to expand by 6.4% in 2011 and 6.7% in 2012 (Figure 3.24.11), stepping up from average growth of 5.6% over the past 7 years. The growth forecast for the next 2 years would be the best rates achieved since 1996.

Merchandise export growth is forecast to decelerate to about 15% this year, given the high base set by the rebound in 2010. The earthquake in Japan will likely have a brief and modest impact on exports (Japan accounts for about 12% of exports). Reconstruction there will stimulate demand for Indonesia's energy and raw materials. Imports are projected to increase by about 17%, attributable to robust investment and consumer demand.

The trade surplus is expected to rise modestly, but deficits in the services and income accounts will widen due to higher freight costs associated with larger trade flows and repatriation of profits and dividends. The current account surplus is seen declining to 0.5% of GDP in 2011 and 0.1% in 2012. The overall balance of payments is forecast to remain in surplus as a result of continued (but moderating) portfolio inflows and foreign direct investment.

Inflation was about 7% in the first 2 months of 2011 and is likely to remain relatively high through the first half of the year before moderating in the second half on base effects and an expected improvement in domestic food supplies. For the full year, inflation is forecast to average 6.3%. It will subside a little in 2012 if global food and commodity prices decelerate as projected (Figure 3.24.12).

Deviations in inflation from Bank Indonesia's 4.0%–6.0% target risk eroding the credibility of monetary policy, thus entrenching expectations of higher inflation. If the current inflation pressure persists, the central bank is expected to gradually raise its policy interest rate to more normal levels and is likely to allow the rupiah to appreciate further.

To address localized food shortages, the government has directed its rice procurement agency Bulog to intervene in the market to ensure adequate supplies. It has also expanded a program that distributes 15 kilograms of rice each month to 17.5 million poor households and has suspended import duties on some food items.

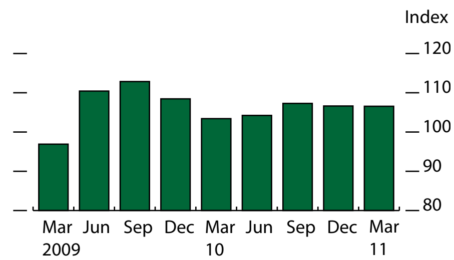
But inflation still poses a risk to the economic outlook. An unexpected sharp acceleration in prices could cloud the prospects for growth in private consumption, prompt a faster tightening of monetary policy, and raise fiscal outlays on subsidies, possibly at the expense of capital spending.

3.24.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.4	6.7
Inflation	6.3	5.8
Current account balance (share of GDP)	0.5	0.1

Source: ADB estimates.

3.24.10 Business tendency index



Note: An index higher than 100 means that business managers think that the current quarter will be better than the previous one.

Source: CEIC Data Company (accessed 14 March 2011).

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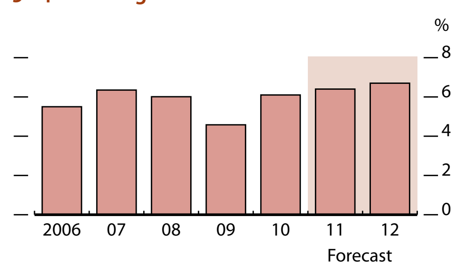
3.24.11 GDP growth



Source: Asian Development Outlook database.

Click here for figure data

When combating inflation, the authorities must also manage surging capital inflows that exacerbate inflation and make the economy vulnerable to swings in investor sentiment. The focus has been on macroprudential regulation to damp short-term inflows. Bank Indonesia last year imposed a minimum 30-day holding period for central bank certificates (SBIs), changed auctions of these securities to monthly from weekly, issued longer-maturity SBIs, and introduced a new term-deposit facility for commercial banks to reduce the need to issue SBIs. The central bank introduced higher reserve requirements for foreign currency deposits and stepped up its monitoring and reporting of foreign exchange transactions and capital inflows.

In the first quarter of 2011, Bank Indonesia limited banks' short-term foreign loans to a maximum of 30% of their capital and decided to rely more on 9-month SBIs, further discouraging short-term investments.

Concerns over the rise in inflation, coupled with international financial markets jitters in early 2011, resulted in some reversal of short-term capital inflows.

For its part, the government proposed measures to Parliament to cushion the local-currency government bond market from capital flight. Under them, funds from state-owned enterprises and the budget can be used to buy bonds in the event of a sudden capital reversal. In addition, Bank Indonesia can draw on the country's foreign exchange reserves and bond buyback funds allocated in the 2011 budget to support the bond market.

Development challenges

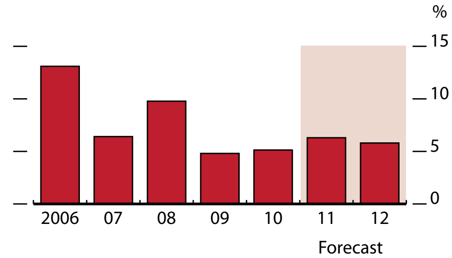
Although economic growth averaged 5.2% in the past decade, it remains below the 7%–8% rate recorded before the Asian financial crisis. This slowing of growth since the mid-1990s has been accompanied by lower growth in employment (Figure 3.24.13). The contribution of investment to growth has declined: the share of gross fixed investment in GDP fell from 26% in 1991–2000 to around 24% in 2001–2009 (although it has recently picked up to 32.2% in 2010). The contribution of private consumption has risen.

From the production side, growth has been driven by the nontradable sector (Figure 3.24.14), mainly services, while the performance of tradables, particularly manufacturing, has been lackluster. Employment generation in manufacturing has been stagnant, so that a large proportion of the labor force works in the informal sector, where wages and conditions are usually poor. Exports have become more dependent on volatile world commodity markets.

Significant gains in investment and exports are required if the government is to achieve its 2014 GDP growth target of 7%–8%. Investment is needed in infrastructure particularly, which would support growth of the more productive tradable sector. Government infrastructure spending as a share of GDP has fallen by nearly 50% from the first half of the 1990s and is well below that for faster-growing Asian economies. Logistics costs in Indonesia are estimated at about 14% of total production costs, compared with about 5% in, say, Japan.

Given that fiscal policy has focused on limiting budget deficits and

3.24.12 Inflation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 14 March 2011).

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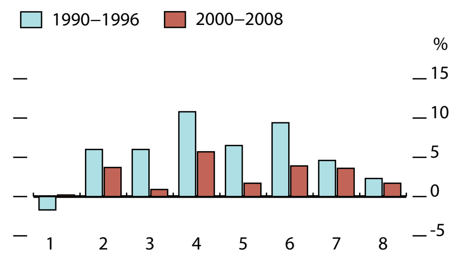
3.24.13 Employment growth by sector



1 = Agriculture; 2 = Mining and utilities; 3 = Manufacturing; 4 = Construction; 5 = Wholesale trade; 6 = Transport; 7 = Other activities; 8 = Total.

Source: ADB Statistical Database System.

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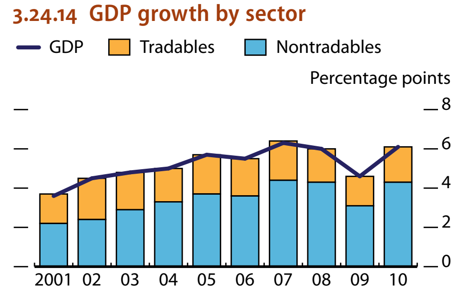
3.24.14 GDP growth by sector



Note: Tradables refer to agriculture, mining and quarrying, and manufacturing. Nontradables refer to utilities, construction, wholesale trade, transport, and other activities.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 21 February 2011).

Click here for figure data

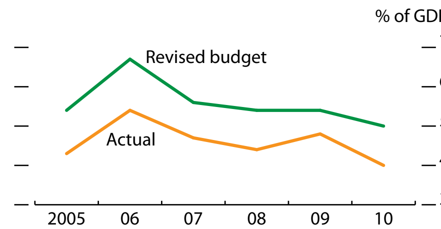
reducing public debt, at the same time as reorienting spending toward education and poverty reduction, the government needs to create greater budget resources (after accounting for essential spending) to lift infrastructure investment. Such space in the budget in the past 5 years has been low, at the equivalent of 4%–5% of GDP (Figure 3.24.15).

Pursuing reforms in tax administration would help generate such resources. The number of registered taxpayers increased by about 13 million in 2006–2010 and the tax-to-GDP ratio rose from 11.0% in 2009 to 11.7% in 2010. What is needed now are systems and procedures to increase compliance with tax laws, including a better tax database and modern information systems, risk-based compliance enforcement, and improvements in tax staff training and probity.

On the expenditure side, interest costs will fall if the government continues to bring down public debt as a ratio to GDP, and as a result of upgrades in the sovereign credit rating. Savings could also be made by better targeting of subsidies and avoidance of duplication across different levels of government.

Yet budget resources that were available were not always fully used. Indeed, the government has missed its budget deficit target by an average of 1% of GDP annually over the past 5 years, mainly because of an inability to complete spending programs. Moreover, a large proportion of budget spending is pushed through in the last quarter of each year. Efforts to improve budget execution by the public sector are getting greater attention from the authorities.

3.24.15 Discretionary expenditure



Sources: Ministry of Finance; ADB estimates.

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