**Indonesia**

Forecasts for economic growth are edged up from April’s *Asian Development Outlook 2011* reflecting a strong performance in the first half of 2011 and a positive outlook through this year and next. Increases in fixed investment, private consumption, and net exports boosted the first-half result. Rises in food prices have moderated during this year, allowing inflation to abate. Forecasts for inflation are trimmed for both 2011 and 2012. Managing the impact of potentially volatile capital inflows is likely to remain a challenge.

**Updated assessment**

Growth picked up to 6.5% in the first half of 2011 owing to stronger investment, private consumption, and robust exports (Figure 3.5.1). Rates of growth were similar in both the first and second quarters.

Fixed investment increased by 8.3% to support much-needed capacity expansion of the economy. Private consumption, underpinned by growing employment, easing inflation, and improving consumer confidence, rose by 4.5% and contributed 2.6 percentage points of the GDP growth. Net exports expanded, despite a surge in imports, and government spending made a small contribution to overall growth.

In terms of sectors, services contributed more than half the total growth. Strong gains were recorded in retail and wholesale trading and transport and communications. Manufacturing output, driven by textiles, iron and steel, as well as transport equipment, expanded by 5.6%, the best performance in 5 years. March’s earthquake in Japan caused some brief supply shortages for the automotive industry, however.

Mining output (including crude oil) grew by just 2.5%, largely owing to a decline of about 3% in oil production. Better weather than in 2010 enabled agriculture to lift production by 3.7% in the first half of 2011.

Merchandise exports continued to power ahead, by 34.1% in nominal terms to $97.3 billion in the first half, bolstered by higher global prices for commodities (Figure 3.5.2). Notable gains were made in shipments of manufactures, agricultural commodities, and oil. Imports also increased by about 34%, to $78.9 billion, reflecting strong demand for capital and intermediate goods, particularly from manufacturing industry. The surplus in goods trade rose in January–June, but the current account surplus declined to $2.3 billion (0.6% of GDP) on deficits in the services and income accounts.

The economy continued receiving large inflows of both portfolio investment and net foreign direct investment (FDI). During the first 7 months of this year, foreign holdings of government bonds and Bank Indonesia (central bank) certificates surged by 30.5% to $36.4 billion (Figure 3.5.3) and net foreign purchases of equities nearly doubled to...
$2.7 billion. FDI inflows of $10 billion were at the highest rate in 10 years, helping to balance risks associated with short-term capital flows.

Consequently, the overall balance-of-payments surplus rose by nearly two-thirds in the first half to $19.5 billion. International reserves of $122.7 billion at end-July 2011 were equivalent to 7 months of imports of goods and external debt service of the government (Figure 3.5.4).

As projected in April’s Asian Development Outlook 2011, inflation has eased, from 7.0% year on year in January 2011 to 4.8% in August (Figure 3.5.5), within Bank Indonesia’s target range of 4%—6%. Food price inflation slowed from 16.2% to 5.8% over the same period, reflecting a good harvest as well as government measures to suspend import duties on some food items and to expand a rice-distribution program for the poor. However, core inflation edged up to 5.1% in August, suggesting that strong domestic demand is pushing against capacity constraints.

With inflation slowly subsiding, the central bank kept its policy interest rate steady at 6.75% after it raised the rate by 25 basis points in February 2011. The rupiah appreciated by about 5% against the US dollar between end-2010 and August 2011, helping to limit imported inflation. The central bank used macroprudential measures to manage the impact of potentially volatile short-term capital inflows.

In domestic financial markets, the capital inflows pushed up stock prices, until a global market slide in August, and pushed down yields on government rupiah bonds.

Credit to private sector businesses and consumers expanded by about 23% year on year in June (Figure 3.5.6). The pickup in lending was attributable in part to a decision by the central bank to link banks’ statutory reserve requirements to their loan-to-deposit ratios from March 2011. Lending rates have been steady at about 13% owing to high levels of liquidity and stiffer competition in the financial system.

As for fiscal policy, Parliament approved revisions to the 2011 budget in July to widen the deficit target to 2.1% of GDP (from an original target of 1.8% and 2010’s actual deficit of 0.7%), a move that accommodates the rising cost of subsidies for fuel and electricity. (Global oil prices have been higher than originally projected in the budget.)

Spending on subsidies for electricity and fuel is projected to cost the budget $22.4 billion this year, about 15% of total government expenditure. Despite efforts to expedite government capital spending, only 16.8% of the budgeted capital outlay was disbursed in the first half of the year. Revenue collection in the period was better than expected, about 12% higher than revenue outturn in the first half of the previous year, driven by the rise in commodity prices and import duties.

Central government debt is projected to decline to 25.7% of GDP at end-2011, maintaining the downward trend over the past 7 years (Figure 3.5.7). Both Standard & Poor’s and Fitch ratings agencies raised Indonesia’s sovereign foreign currency debt rating to BB plus in the first half of 2011, one notch below investment grade. Moody’s upgraded its rating to Ba1 with a stable outlook.

Robust economic growth generated 3.9 million jobs in the 12 months through February 2011, mostly in the public service, wholesale and retail trading, hotels and restaurants, and construction. This was more than sufficient to accommodate 3.4 million new entrants to the labor market.
According to the twice-yearly unemployment survey, the rate fell to 6.8% in February from 7.4% a year earlier. Poverty incidence declined to 12.5% of the population in March 2011 (the date of the latest annual survey) from 13.3% a year earlier.

Nevertheless, employment creation, particularly for workers aged between 15 and 24, remains a challenge. About 18% of the young people who had joined the workforce by August 2010 were unemployed, or six times as high as the rest of the workforce.

The share of the population of working age is projected to rise and the dependency ratio to decline through 2025. To take advantage of this demographic dividend, productive jobs need to be generated faster. Necessary policies include fostering entry-level jobs for young people, improving access to high-quality education and training, providing better services to match job seekers and employers.

**Prospects**

In May this year, the government published a Master Plan for the Acceleration and Expansion of Economic Development 2011–2025, which recognizes that higher and sustainable economic expansion requires the country to diversify sources of growth, accelerate infrastructure development, close the development gap between eastern and western regions, improve the quality of human resources, manage rapid urbanization, and cope with climate change. Projections discussed below for 2011 and 2012 assume that the government will start implementing key policies in this plan.

Even though budget spending, particularly on capital items, is projected to accelerate in the second half of this year from low levels in the first 6 months, it will fall short of target. Coupled with buoyant revenue collection, the budget deficit is thus expected to be lower than the target of 2.1% of GDP. For 2012, the government has proposed a deficit of 1.5% of GDP. If approved by Parliament, the 2012 budget would support goals of the master plan to increase capital spending, expand social programs, and accelerate poverty reduction. The budget proposes to reduce the allocation for subsidies and improve their targeting. Overall, fiscal policy is likely to be supportive of economic growth.

Private consumption is expected to remain robust in the forecast period, underpinned by rising employment and consumer confidence, and easing inflation. A Bank Indonesia consumer survey in July showed consumer confidence at the highest level in 18 months. Both the business and consumer tendency indexes from surveys in the second quarter indicated optimism about the near-term outlook (Figure 3.5.8).

The outlook for private investment is also favorable, supported by global demand for Indonesia’s agricultural, energy, and mineral commodities; solid domestic economic growth (averaging 5.6% since 2004); and the country’s expanding middle class (increasing by about 7 million people a year). A central bank survey in the second quarter of medium and large businesses showed that 40% of respondents expected business prospects to improve in the second half of 2011 (from the first) and 58% expected them to stay the same. The pickup in credit to the private sector and stable lending rates this year suggest that credit conditions will buttress growth.
Private investment will benefit from accelerating government capital spending during the current half year and projects rolled out under the master plan in 2012. In August 2011, the government announced tax breaks for investments of at least $117 million in priority industries.

Efforts to simplify investment procedures are making some progress. Land acquisition, which businesses often cite as a steep hurdle for investing in infrastructure, is to be addressed in a new law scheduled to be passed by the end of this year.

From the production side, signs point to continued growth in manufacturing (Figure 3.5.9). Machinery investment by foreign companies increased by 23.3% in the first 6 months. Services will get continued support from domestic demand growth, and agriculture looks likely to recover further (at least through 2011) given the better weather this year.

Taking these factors into consideration, the forecasts for GDP growth are raised slightly from April to 6.6% this year, and to 6.8% for 2012 based on the improving outlook for investment next year (Figure 3.5.10).

The external position will remain healthy. Merchandise exports are projected to rise by about 30% this year and should benefit next year from the somewhat stronger growth in world trade. The goods trade surplus is forecast to narrow modestly, reflecting the strength of domestic demand, while the deficit in the income account will widen because of greater profit repatriation. The current account surplus is seen declining to around 0.4% of GDP in 2011 and to 0.1% in 2012. The overall balance-of-payments surplus is forecast to remain buoyant, supported by capital inflows including FDI.

Assuming better weather continues, food prices are expected to ease further in the second half of 2011. The Update trims the full-year average inflation forecast to 5.6% (Figure 3.5.11).

In 2012, the moderation in global food and oil prices will help to damp price pressures. Higher investment should improve the supply-side response to increasing demand. These factors will be offset a little by the inflationary impact of higher domestic economic growth and by government proposals to reduce the electricity subsidy next year. (Bank Indonesia’s inflation target range for 2012 is 3.5%–5.5%, down a half percentage point from 2011’s.)

The forecast for average inflation next year is edged down to 5.4%. The main risk to this forecast is bad weather that damages agriculture, given that food (both processed and raw) accounts for 36% of the consumer price index.

Bank Indonesia might decide to leave its policy interest rate steady through the rest of this year, particularly if the rupiah is firm. It is likely to continue to use bank reserve requirement ratios and macroprudential policies to manage domestic liquidity and capital inflows. In 2012, Bank Indonesia may need to step up interest rates if core inflation remains under upward pressure from stronger domestic demand.

The government has prepared plans to manage the impact of any sudden reversal of foreign capital. It would use funds from the budget, state-owned enterprises, and international reserves to stabilize the domestic bond market. In addition, the central bank has strengthened its tools for conducting open-market operations by allowing Treasury bills for managing foreign currency liquidity.