Indonesia

Southeast Asia's biggest economy in 2011 grew at its fastest rate since before the 1997–1998 Asian financial crisis. The pace will likely ease in 2012 on weaker external demand, before accelerating again in 2013 on the expected recovery in trade. Inflation, which receded in 2011, is forecast to quicken when the government raises administered fuel prices. The external current account is projected to slip into deficit this year as exports soften while robust investment keeps capital-equipment imports high. Addressing a major challenge to development, the government is stepping up efforts to improve infrastructure.

Economic performance

Growth of 6.5% in 2011, the highest in 15 years, was based on sustained private consumption, stronger investment, and expansion of net exports (Figure 3.24.1).

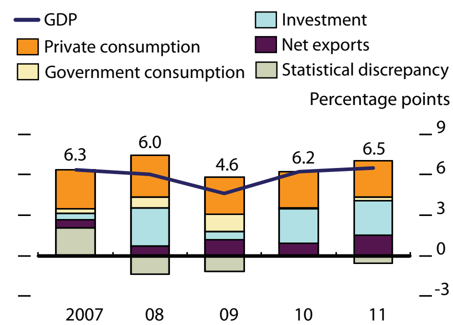
Private consumption grew by 4.7%, contributing 2.7 percentage points of total growth. It was driven by rising incomes and employment and by easing inflation. In a notably positive development, fixed investment grew by 8.8% and contributed 2.1 percentage points of GDP growth. Public investment was constrained by weakness in implementing capital works, although private investment in construction and machinery was robust, supported by increases in foreign direct investment (FDI) and in bank lending. The ratio of nominal fixed capital investment to GDP rose to 32.0% in 2011, up by 7.1 percentage points over 5 years (Figure 3.24.2). Net exports contributed 1.5 percentage points of growth.

From the supply side, economic growth was led by services and manufacturing. Services grew by 8.5% to account for more than half the total GDP increase. Retail and wholesale trading, as well as transport and communications, showed double-digit expansions, while financial services benefited from a stronger performance in banking.

Manufacturing registered its best performance in 7 years: expanding by 6.2% and contributing 1.6 percentage points of overall growth, this outturn was based on the country's large and growing domestic market, alongside a better performance from exports. Subsectors to report significant production gains in 2011 included iron and basic steel, food processing, textiles and footwear, and transport equipment (Figure 3.24.3). By contrast, mining and quarrying recorded weak growth of 1.4%, reflecting years of underinvestment and production problems in crude oil and natural gas.

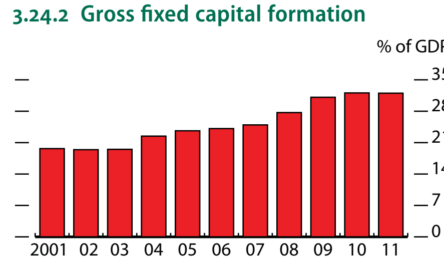
Agricultural output rose by a modest 3.0%. An increase in production of estate crops, such as palm oil and rubber, was partly offset by a decline in food crops. Paddy rice output fell by 1.6% during the year, owing to dry weather in the second half.

3.24.1 Contributions to growth (demand)



Source: Asian Development Outlook database; CEIC Data Company (accessed 1 March 2012).

3.24.2 Gross fixed capital formation



Sources: Asian Development Outlook database; CEIC Data Company (accessed 1 March 2012).

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

About 1.5 million new jobs were generated in 2011, easily exceeding the number of new entrants to the labor force (843,000). The quality of employment also improved: in the 12 months through August 2011 formal employment climbed by 16.0%, or 5.7 million positions. Most jobs were in construction, manufacturing, and services. Employment in the informal sector fell by 5.9%, or 4.2 million, as workers left the agricultural labor force. But 62% of the employed labor force (about 68.2 million people) still work in the informal sector, where wages and job security are low.

Poverty incidence fell to 12.4% in September 2011, from 13.3% in March 2010. (It was 17.6% just before the Asian financial crisis.)

Inflation slowed from 7.0% year on year at the start of 2011 to 3.8% at year-end as food price rises moderated (Figure 3.24.4). A good harvest in the first half was followed by government moves to suspend import duties on some food items and to improve food distribution. Year-average inflation was 5.4%, up slightly from 2010.

Bank Indonesia raised its policy interest rate in February 2011 by 25 basis points to 6.75% to damp inflation expectations. During October 2011–February 2012, after inflation trended down and the global economic outlook dimmed, the central bank lowered this rate by 100 basis points. Broad money (M2) growth accelerated to 16.4% and commercial banks' credit expanded by 24.6% in 2011, slightly above Bank Indonesia's target of 23%. Credit for investment jumped by 33.2%, reflecting the improving economic conditions and declining interest rates.

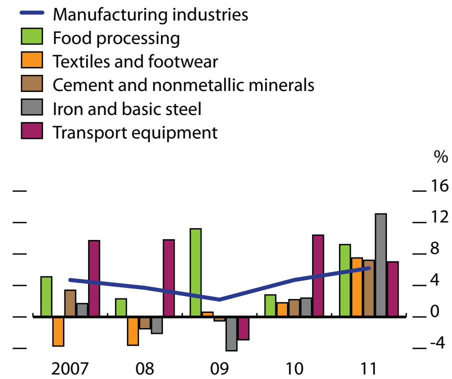
Merchandise exports rose by 27.5% to $201.5 billion in 2011 (Figure 3.24.5), although the pace eased in the fourth quarter. Exports of hydrocarbons rose by nearly 34%—declining oil exports were more than offset by rapid expansion in gas exports, reflecting rising gas prices and output. Non-oil and gas exports increased by 26.1%, with large gains for coal, palm oil, and rubber. In the other direction, strong demand for raw materials, machinery, and consumption goods pushed up merchandise imports by 30.3% to $166.1 billion.

Despite the larger trade surplus (which rose because of a higher export base), the surplus on the current account fell to the equivalent of 0.2% of GDP. That was attributable to a smaller surplus in transfers (remittances from workers abroad declined) and wider deficits in services (higher outlays on freight and business services) and in the income balance (a result of repatriation of investment income by foreign companies).

The capital and financial account turned into deficit in the second half, reflecting increased portfolio capital outflows caused by global financial market anxieties. Net portfolio investment of $4.2 billion in 2011 was down sharply from 2010 (Figure 3.24.6). FDI inflows, though, shot up by 31.9% to a record $18.2 billion, reflecting improvements in the domestic investment environment. The overall balance of payments maintained a healthy surplus and gross international reserves rose to $110.1 billion, equal to 6.4 months of imports and government debt payments combined.

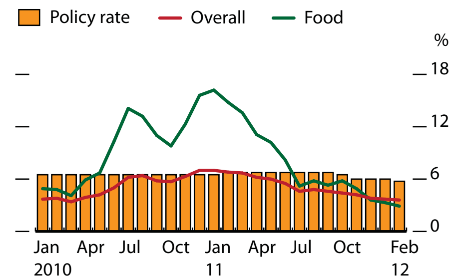
In the first 8 months of 2011, the rupiah appreciated by about 5% against the US dollar, but it turned weaker when global economic concerns heightened, ending the year little changed.

3.24.3 Growth of selected manufacturing subsectors



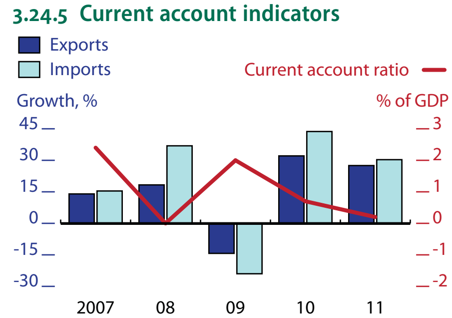
Sources: Asian Development Outlook database; CEIC Data Company (accessed 1 March 2012).

3.24.4 Inflation and policy rate



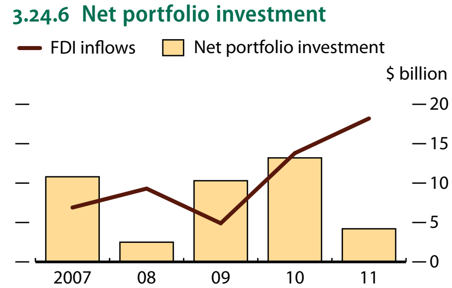
Sources: Asian Development Outlook database; CEIC Data Company (accessed 13 March 2012).

3.24.5 Current account indicators



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2012).

3.24.6 Net portfolio investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 12 March 2012).

A strengthening bond market saw the yield on 5-year rupiah government bonds fall by 139 basis points to 5.4% during 2011. The government stepped in to stabilize the market by buying bonds when foreign investors cut their holdings in August–November's market turbulence. Over the year, the stock market edged up 3.2%.

The government aimed for a budget deficit equal to 2.1% of GDP, but the outcome was around half that, at 1.1%. One reason was that public capital spending fell short of target because of chronic weakness in implementing capital projects. Another was buoyant revenue: tax receipts increased to 11.8% of GDP (from 11.2% in 2010) owing to a widening tax net, improving tax administration, strong economic activity, and high commodity prices.

Subsidies for fuel and electricity, however, remained a heavy burden on the budget, at 3.4% of GDP, and their cost exceeded the amount invested in public capital works. Still, the ratio of national government debt to GDP fell to 24.3% in 2011, maintaining a declining trend (Figure 3.24.7).

Reflecting the country's improved macroeconomic performance, two major rating agencies raised Indonesia sovereign ratings to investment grade: Fitch to BBB minus in December 2011 and Moody's to Baa3 in January 2012.

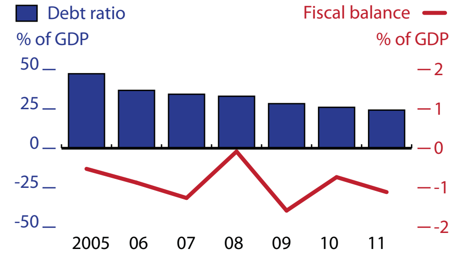
Economic prospects

Forecasts assume the government will maintain its efforts to improve both the investment climate and public financial management, especially for budget execution. The forecasts also assume that the authorities will pursue major policies outlined in the master plan for economic development 2011–2025 (known by its Indonesian acronym MP3EI), published last year. The plan calls for raising public investment in infrastructure, reducing bottlenecks, and closing the development gap between eastern and western regions of the country.

Private consumption is forecast to remain strong this year and next. Surveys of households conducted by Bank Indonesia show high consumer confidence (Figure 3.24.8), driven mainly by optimism about growth in jobs and incomes. Consumption is underpinned by an expanding middle class (those with incomes of $2–20 a day in 2005 purchasing power parity terms, a group increasing by about 7 million a year) and rising labor force participation.

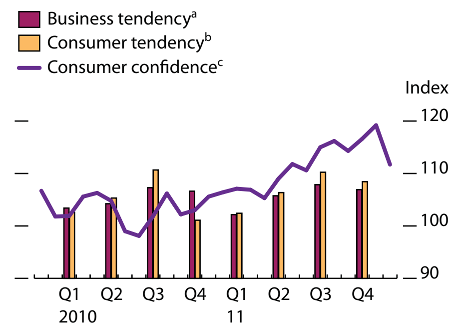
Private investment is expected to maintain its upward trend, given the country's solid record of economic growth over recent years (averaging 5.7% since 2004), upgrades in sovereign ratings, and an improved investment environment. Indonesia's ranking as an investment destination rose two places to seventh in the 2011 *World Investment Report* by the United Nations Commission of Trade and Development. A Bank Indonesia Business Survey conducted in the fourth quarter of 2011 indicated a steady rise in planned business activity and investment in the first half of 2012, and the Business Tendency Survey conducted in that quarter by the statistics office also suggested optimism over the near-term outlook (Figure 3.24.8).

3.24.7 Fiscal indicators



Sources: Directorate General of Debt Management. http://www.dmo.or.id; Republic of Indonesia Ministry of Finance. http://www.fiskal.depkeu.go.id (both accessed 13 March 2012).

3.24.8 Business and consumer confidence indexes

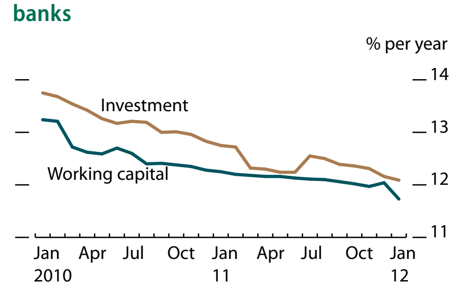


[a] From a quarterly Statistics Indonesia survey among business executives. [b] From a quarterly Statistics Indonesia survey among middle- and upper-income households. [c] From a monthly Bank Indonesia survey among households.

Note: A score above 100 means that respondents are optimistic and vice versa.

Source: CEIC Data Company (accessed 13 March 2012).

3.24.9 Average lending rates of commercial banks



Note: Refers to rupiah credit.

Sources: Asian Development Outlook database; CEIC Data Company (accessed 13 March 2012).

The fiscal stance will be accommodative to mitigate the impact on economic growth of the global slowdown. In late March 2012, Parliament passed a revision to the 2012 budget, widening the fiscal deficit to 2.2% of GDP from an originally planned 1.5%. The revised budget contains three key components: a provision to increase administered domestic fuel prices if the average Indonesian crude oil price exceeds $120.80 over a 6-month period; an additional $2.8 billion of social spending if fuel prices are raised; and a further $1.9 billion in capital spending. Public infrastructure investment is expected to surge by 48.6% in 2012 from that spent in 2011. A budget deficit recorded in January 2012, unlike recent years' surpluses for this month, indicates improved budget execution.

Investment in infrastructure by the private sector and state-owned firms could start to increase, as outlined in the MP3EI. A Land Law for Public Use (approved by Parliament in December 2011) should help in acquiring land for public infrastructure, easing a serious constraint. Domestic commercial banks, which have excess liquidity, have expressed interest in financing infrastructure development, and the sovereign investment-grade ratings are expected to facilitate a greater volume of long-term financing.

Lending interest rates have come down (Figure 3.24.9, above) since Bank Indonesia lowered its policy rate. Credit to the private sector is projected to grow by at least 25% this year, financing increases in investment and consumption.

Manufacturing output looks set to increase further during the forecast period, based on announcements by companies of planned new facilities. The expansion has spread to industries such as metal products and machinery, which are more export oriented than transport, storage, and communications, sectors that previously attracted most investment. This diversification of manufactured products contributed to the solid increase in output last year (Figure 3.24.10).

Exports, though, face headwinds this year as global trade slows. GDP growth is therefore forecast to ease to 6.4%, before stepping up in 2013 (Figure 3.24.11) as world trade and economic growth pick up and infrastructure investment gathers momentum.

Inflation during the forecast period depends in part on the timing and size of increases in fuel prices. The year-average rate for 2012 is projected at 5.5%, on the assumption that fuel prices will be lifted later this year (Figure 3.24.12). If fuel prices are increased later than anticipated, inflation would likely be lower than forecast this year and higher than projected in 2013.

Slower growth in exports will likely produce a small current account deficit in 2012. Merchandise exports are projected to increase by about 13.5% and imports by 18.5% (strong investment will spur imports of capital equipment). The income deficit will widen, consistent with strengthening FDI flows and related repatriation of corporate earnings. In 2013, the current account is seen returning to a small surplus as external demand recovers (Figure 3.24.13).

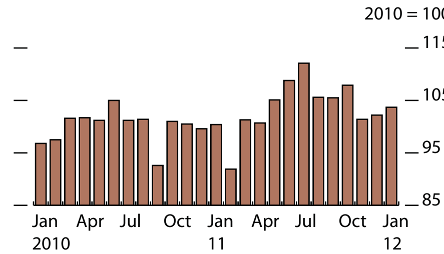
Inflows of foreign direct and portfolio investment are expected to keep the overall balance of payments in surplus through the forecast period. The rupiah could soften this year against the US dollar in light of the current account deficit and higher inflation.

3.24.1 Selected economic indicators (%)

	2012	2013
GDP growth	6.4	6.7
Inflation	5.5	5.0
Current account balance (share of GDP)	-0.1	0.2

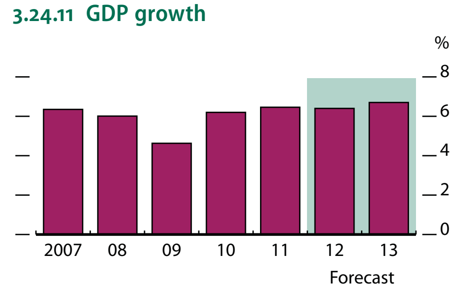
Source: ADB estimates.

3.24.10 Manufacturing production index



Source: CEIC Data Company (accessed 13 March 2012).

3.24.11 GDP growth



Source: Asian Development Outlook database.

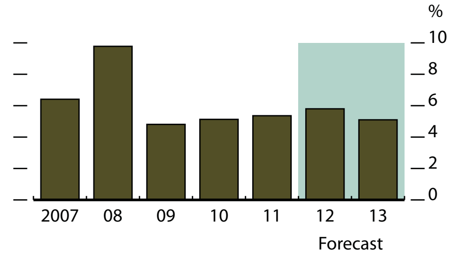
Uncertainties in the global economic outlook mean that risks to the forecasts are tilted to the downside. A sharper deterioration than anticipated in major export markets would translate into even lower export growth. Further, Indonesia is vulnerable to financial-market volatility because of its relatively open capital account and heavy foreign presence in its stock and bond markets (about two-thirds of equities and one-third of sovereign bonds are foreign held).

The government's gross financing needs remain high, despite its low budget deficit and declining debt-to-GDP ratio. The share of financing from market sources is expected to increase to about 85% this year, from 60% in 2009, in line with official policies to develop the capital market. This suggests the financing of the budget could be disrupted in the event of large capital outflows.

Anticipating such risks, the government included provisions in its 2012 budget that enable it, in an economic emergency, to get approval from Parliament within 24 hours to raise spending above the budgeted level and to switch spending priorities. That is in addition to the additional capital and social spending added to the budget in March that should provide a buffer to weaker external demand. Contingency plans also include the bond stabilization program that provides for the government to tap funds from its current budget, accumulated budget surpluses, and state-owned enterprises to steady a volatile market.

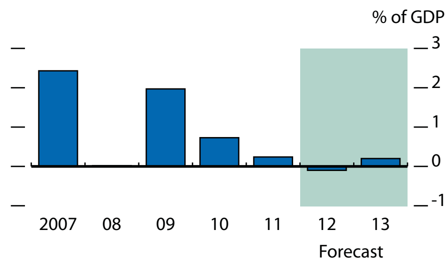
Moreover, the central bank has upgraded macroprudential measures to reduce short-term and speculative capital inflows and mitigate the risks of sudden outflows. These include gradually replacing short-term Bank Indonesia certificates with government bonds for liquidity management, reinstating limits on short-term offshore borrowing by banks to a maximum of 30% of their capital, increasing banks' foreign currency reserve requirements, and requiring an underlying economic exchange for any foreign currency transaction above $100,000.

3.24.12 Inflation



Source: CEIC Data Company (accessed 13 March 2012).

3.24.13 Current account



Source: CEIC Data Company (accessed 13 March 2012).

Policy challenge—strengthening infrastructure

Lagging development of infrastructure—transport and telecommunications networks, electricity, and water supply—is a prime constraint on economic growth. The quality of infrastructure is ranked below that of, for example, Malaysia and Thailand (Table 3.24.2). Indonesia's logistics costs (including transportation, warehousing, and distribution) are about 14% of total production costs, much higher than Japan's roughly 5%.

The government has made infrastructure development a key priority in both its Medium-Term Development Plan 2010–2014 and the longer-term MP3EI. Several transport projects financed through the budget are scheduled to get under way this year, including expansion of Jakarta's main airport, construction of highways and ports, and the building of transport infrastructure in eastern provinces.

Indeed, budget allocations for infrastructure have been raised significantly since 2010, but the execution of capital projects has lagged (Figure 3.24.14) because of capacity and other constraints. In efforts to address this issue, officials are simplifying procedures and strengthening procurement capacity in the spending agencies: the Ministry of Public

3.24.2 Rank in Global Competitiveness Index

	2010–2011 (out of 139)	2011–2012 (out of 142)
Overall ranking		
Singapore	3	2
Malaysia	26	21
Thailand	38	39
Indonesia	44	46
Philippines	85	75
Infrastructure		
Singapore	5	3
Malaysia	30	26
Thailand	35	42
Indonesia	82	76
Philippines	104	105

Source: World Economic Forum. 2011. *The Global Competitiveness Report 2011–2012*. http://www.weforum.org/reports/global-competitiveness-report-2011-2012 (accessed 22 March 2012).

Works, for example, is introducing electronic bidding and procurement systems. Further, a new task force to accelerate budget execution reports directly to the President. Coordination between the central and local governments will also need to improve and local governments' weak capacity to implement infrastructure projects has to be addressed.

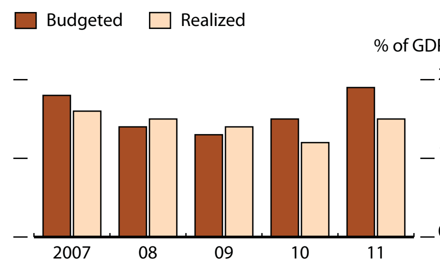
As for private participation in infrastructure development, the Land Law for Public Use will provide greater certainty on land acquisition for infrastructure projects. Moves to refine regulations and institutions to support public–private partnerships are starting to produce results. Agreements were signed in October 2011 for private investors to build a $3 billion power plant in Central Java, guaranteed by the government. The Rajabasa and Muaralaboh geothermal projects, involving total investment of $1.4 billion, were approved under a similar arrangement in March 2012.

Also in March, the government issued a blueprint for the development of a national logistics system that aims to attract considerable private sector participation.

However, to ensure sustained private investment in infrastructure, further efforts are needed to improve governance, develop a more consistent legal and regulatory framework, and address government capacity constraints in preparing projects for private participation.

The subdued external economic environment in 2012 should provide an incentive for a stronger push on infrastructure development to support growth in the near term, as well as raise the country's potential in the medium term.

3.24.14 Government capital expenditure



Source: Republic of Indonesia Ministry of Finance. http://www.fiskal.depkeu.go.id (accessed 13 March 2012).