Indonesia

Southeast Asia’s biggest economy achieved another year of 6%-plus growth in 2012, despite falling exports. Sluggish external demand combined with stronger domestic demand to shift the current account into deficit. Inflation fell to a 12-year low. GDP growth is forecast to quicken in the next 2 years. Near-term challenges are to manage risks associated with the current account deficit and keep inflation moderate.

Economic performance

GDP growth at 6.2% in 2012 was based on robust private consumption and a better performance in fixed capital investment (Figure 3.24.1). Net exports fell, acting as a drag on GDP growth. Private consumption picked up to increase by 5.3%, the strongest pace in 4 years, and it contributed almost half of total GDP growth on the expenditure side. Consumption got a lift from increases in employment and wages as well as lower inflation. Sales of automobiles rose by nearly 25%, even though Bank Indonesia, the central bank, raised minimum downpayments on loans to buy cars and motorcycles.

Fixed investment accelerated to 9.8% in 2012, building on the previous year’s increase of 8.8%, and was the source of 2.4 percentage points of GDP growth. Driving factors included an improved investment climate, a record of solid economic growth over recent years, and the expansion of credit. Outlays on buildings and infrastructure rose by 7.5%, and investment in machinery and equipment increased by a strong 12.7%. Renewed efforts to improve public infrastructure saw the central government’s capital spending rise by 18.9%. As a result, the ratio of fixed capital formation to GDP rose to 33.2%, the highest in at least 20 years (Figure 3.24.2).

Realized foreign direct investment (FDI) surged by 26.1% to $23.6 billion, nearly half into manufacturing and 17% into mining (the data exclude investment in oil and gas). Investment in inventories also rose sharply.

The service and manufacturing sectors were key drivers from the supply side. Services expanded by 7.7%, contributing more than half of total growth (Figure 3.24.3). Telecommunications continued to record double-digit expansion owing to buoyant demand for mobile telephone and internet services.

Growth in manufacturing decelerated to 5.7%, reflecting weaker export markets. Mining output was lackluster, showing growth of just 1.5%, largely a result of declining crude oil extraction. Oil production fell by 42,000 barrels a day to 860,000 barrels a day last year, the outcome...
of aging oil fields and low investment over many years. (A decade ago production was more than 1.1 million barrels a day.) Construction recorded solid expansion of 7.5% in 2012. A good harvest of food crops lifted growth in agriculture to 4.0%. Paddy production rose by 5.5% to 68.9 million tons, which generated rice surpluses estimated at 5.7 million tons.

Merchandise exports fell by 6.3% in US dollar terms (Figure 3.24.4), weighed down by sagging demand in major markets and lower prices for export commodities. Exports of manufactured goods declined by 6.7%. Shipments of commodities including coal and palm oil fell when measured by value despite higher export volumes. Merchandise imports, in contrast, rose by 8.3%, reflecting buoyant fixed investment, which requires imported capital goods, and growth in imported inputs for the expanding manufacturing industries. Imports of consumption goods were virtually flat, discouraged by a depreciating rupiah.

These developments—lower exports and higher imports—narrowed the trade surplus by 76% to $8.4 billion. The current account shifted into deficit, equivalent to 2.8% of GDP, the first deficit since 1997. This put downward pressure on the rupiah, which depreciated by 8.0% against the US dollar in 2012.

Strong inflows of portfolio investment and FDI produced a substantial surplus in the capital and financial account. Portfolio investment nearly tripled to $9.2 billion last year, and net FDI inflows were a record at $19.9 billion. Foreign holdings of government bonds jumped by $3.4 billion to $28.0 billion (Figure 3.24.5). The balance of payments recorded a small surplus, and gross international reserves had increased by year-end to $112.8 billion, which is cover for 6.1 months of imports and government payments on foreign debt.

The good harvest, lower global food prices, and the postponement of increases in government-controlled fuel prices brought down inflation to an average of 4.3% in 2012, the lowest in 12 years. Inflation generally has trended down over recent years, reflecting the adoption of inflation targeting in 2005 and improved management of supply-side price pressures through an official inflation task force. Food prices started to edge up late in 2012 (Figure 3.24.6).

New jobs generated last year exceeded the number of entrants into the labor market. The unemployment rate fell from 6.6% to 6.1% in the 12 months to August 2012, though the rate of underemployment was barely changed at 29%. In a positive development, employment in the formal sector rose by 6.4%, or 2.7 million jobs, in this period, mostly in manufacturing and construction. Informal-sector employment fell by 2.3%, or 1.5 million jobs, as workers left agriculture. Poverty declined by 0.7 percentage points to 11.7% in the 12 months to September 2012 (Figure 3.24.7). Contributing factors were lower food price inflation, higher wages for agricultural and construction workers, and better incomes for farmers.

In the context of subdued inflation and a sagging global economy, Bank Indonesia lowered its policy interest rate by 25 basis points to 5.75% in February 2012 and reduced its overnight deposit facility rate by 25 basis points to 3.75%. Although the central bank later reversed the cut in the overnight deposit rate to drain excess liquidity, it maintained the policy
A requirement since March 2011 that banks disclose base lending rates to the public helped to bring down lending interest rates in 2012 (Figure 3.24.8). Growth in credit remained high at 23.1%, with loans for investment up by just over 27% (Figure 3.24.9).

Fiscal policy was also set to counter the impact of the global slowdown on the domestic economy. The government raised spending and widened the budget deficit target to 2.2% of GDP in 2012, double the actual deficit in 2011 of 1.1%. As it turned out, shortfalls in government spending held the budget deficit to 1.8% of GDP. Central government debt fell to 24.0% of GDP, maintaining a downward trend (Figure 3.24.10).

Reflecting the country’s better performance over recent years, Moody’s raised Indonesia’s rating to investment grade Baa3 in January 2012, and Fitch reaffirmed its investment grade rating BBB– in November 2012.

Economic prospects

Economic growth is forecast to pick up to 6.4% this year and 6.6% in 2014 (Figure 3.24.11), underpinned by robust private consumption, the improving investment performance, and a gradual pickup in world trade. Growth of 6.6%, projected for 2014, would be the highest in 15 years.

Private consumption is expected to quicken in 2013, fueled by rising employment, a 30% increase in average minimum wages, a 7% rise in public service wages, and a tax break from January 2013, when the government raised the income threshold at which income tax is payable. With parliamentary elections scheduled for April 2014 and a presidential election in July 2014, election-related spending is likely to contribute to consumption from the second half of 2013. A consumer survey conducted by Bank Indonesia in February 2013 showed an upturn in consumer confidence from a dip late last year (Figure 3.24.12).

Investment, both private and public, looks likely to maintain healthy expansion. Support for this projection comes from the upgrades in sovereign credit ratings, lower interest rates, increased budget allocations for infrastructure, and a lengthening record of good GDP growth. A $2.7 billion expansion by the auto maker Toyota over the next 4 years is one of several large FDI-funded investments. Businesses planned significant increases in investment in the first half of 2013, according to a survey late last year.

Public investment will benefit from a 55% increase in the 2013 budget allocation for infrastructure, even though the outcome will likely fall short of that target because of chronic delays in the execution of budget projects. With this in mind, the government is directing state-owned enterprises to become more involved in building infrastructure and is making concerted efforts to accelerate budget execution.

The government took two other steps last year to overcome obstacles to infrastructure development: First, it issued implementing regulations for the new land-acquisition law passed by Parliament in December 2011, which provides more certainty in the resolution of land acquisition for infrastructure. Second, it established a viability gap fund to support public–private partnership. This year, officials are reviewing investment regulations, including the list of industries currently closed or only partly open to foreign investment.
Exports are projected to improve in light of stronger growth in the People’s Republic of China and some other markets in 2013. Next year, the export recovery should gather pace as prospects brighten for growth in major industrial economies. The drag on GDP growth from net exports is expected to moderate. Monthly data indicate that the decline in exports bottomed out in August 2012 (Figure 3.24.13). Prices for export commodities have firmed. Merchandise exports are forecast to rise by 7% in 2013. Robust investment will keep imports of capital goods relatively high, though imports of consumption goods will likely be curtailed by the rupiah’s depreciation.

The trade surplus is projected to rise and the current account deficit to narrow (Figure 3.24.14). Inflows of direct and portfolio investment are seen keeping the balance of payments in surplus. Downward pressure on the rupiah is expected to abate as the current account deficit shrinks.

Inflation is forecast to average 5.2% in 2013, rising since last year because of a 15% increase in electricity tariffs, the depreciation of the rupiah, and a boost in minimum wages. Higher food prices lifted inflation to 5.3% in the first 3 months of this year. Upward pressure from this source should ease as the harvest season gets under way in April. Inflation in 2014 is expected to average 4.7%, taking into account base effects from the pickup this year. These forecasts assume the government does not raise fuel prices in 2013 or 2014. Inflation would be higher if fuel prices were increased to ease the high cost to the budget of fuel subsidies or if food supplies are disrupted by bad weather.

The government targets a budget deficit this year equivalent to 1.6% of GDP, narrowing slightly from last year’s outcome of 1.8%. The budget contains incentives for oil and gas exploration, the production of low-emission motor vehicles, and manufacturing with higher value added, plus the boost in infrastructure spending.

Inflation within Bank Indonesia’s target range of 3.5%–5.5% suggests that monetary policy will be accommodative to economic growth. If the government were to increase fuel prices, the central bank might need to quickly lift the policy rate to dampen inflationary expectations and bolster market confidence. Nevertheless, bank lending interest rates will likely stay relatively low this year and stimulate credit growth.

External risks to this outlook involve the global economy and capital inflows. Slower-than-projected growth in major export markets would delay the recovery in exports and hold down GDP growth. The shift of the current account into deficit has made the country more dependent on capital inflows. A sharp slowdown in inflows, or a reversal to outflows, would put pressure on the balance of payments and could disrupt the financing of the budget. The government has taken steps to manage this risk by establishing a bond stabilization fund and arranging for a $5 billion standby loan from development partners, among other precautionary measures.

Domestic risks involve investment and inflation. It will be important to maintain efforts to improve the investment climate to safeguard the uptrend in fixed investment. An unexpected spike in inflation, perhaps caused by tight food supplies or a large increase in fuel prices, would hurt consumption, investor sentiment, and capital inflows.
Policy challenge—building infrastructure for inclusive growth

Economic growth averaging about 6% over the past 6 years has helped to lift 8.6 million people out of poverty. Yet 29 million Indonesians continue to live below the government’s poverty line, and another 30 million would join them in the event of even a small reduction in their incomes. Of those employed, 60% work in the informal sector, where incomes are low. Further, income inequality as measured by the Gini coefficient has worsened from 0.35 in 2008 to 0.41 in 2011 (Figure 3.24.15).

Improved public infrastructure would make a significant contribution to reducing poverty and closing gaps in income inequality.

Toward reducing poverty, better infrastructure, particularly for transportation and generating electricity, would support growth in manufacturing, which generates jobs in the formal sector. The performance of manufacturing has been lackluster since the late 1990s and started to improve only in the past 2 years.

Congested ports and rising logistic costs are major constraints on the expansion of manufacturing. The average time cargo containers spend at Tanjung Priok, the country’s main port, stretched to 6.7 days in January 2012 from 4.9 days in 2010. This compares with 1–2 days at Asia’s most efficient ports (Figure 3.24.16). It costs $750 to transport a container 56 kilometers from the Cikarang industrial zone to Tanjung Priok port, almost 70% more than moving a container a similar distance in Malaysia. The difference is primarily caused by road congestion in Indonesia.

Toward closing income gaps, investment in infrastructure is needed to address high poverty rates in rural areas, which average 14.7% compared with 8.6% in urban areas. Surveys suggest that 41% of district roads and 24% of provincial roads throughout Indonesia are in bad condition. Development prospects are poor for rural areas that lack good connections with towns and markets. Finally, poverty in some eastern provinces is even higher—at 24.1% in Maluku and Papua. Weak infrastructure there hinders economic activity, the growth of employment, and access to services such as education and health care.

The government’s master plan to accelerate economic development, known by its Indonesian abbreviation MP3EI, has three main pillars: developing six economic corridors, improving connectivity both within the country and internationally, and strengthening human resource capacity and technology. Acting to support these goals, the government has increased its budget for infrastructure, with a large share allocated to eastern provinces. Substantial additional funding could become available if the government redirected huge budget allocations for fuel subsidies, equivalent to 2.6% of GDP in 2012, toward infrastructure and social development. The fuel subsidies benefit mainly higher-income households.

Progress on infrastructure is being achieved. Work started last year on 182 infrastructure projects valued at $65 billion under the MP3EI program. Funding came from private companies (44%), state-owned enterprises (20%), governments (19%), and public–private partnerships (17%). Nearly 40% of this amount was allocated to eastern provinces. More projects are scheduled for this year.