INDONESIA

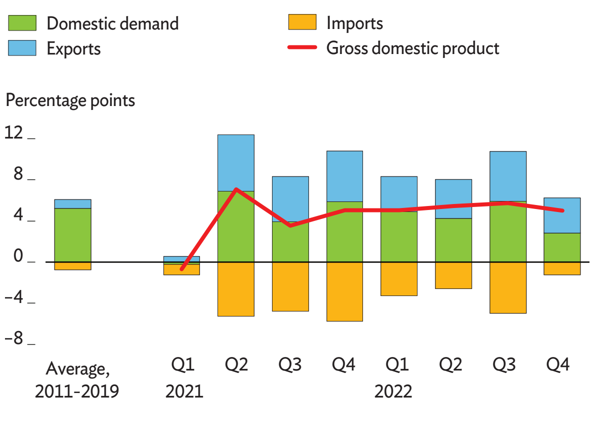
Growth rose in 2022. Exports boomed, supporting growth and generating windfall fiscal revenues. Higher commodity prices raised inflation—not as much as expected but enough to dampen consumption and investment and spur monetary tightening. External debt inflows decreased, foreign reserves fell, and the rupiah weakened. For 2023, slower global growth will contain exports and growth. For the medium term, repairing the impact of the recession will be challenging.

Economic Performance

Commodity exports boomed in 2022, making up for modest domestic demand. In national account terms, exports of goods grew by 14.4%. Exports of coal, palm oil, nickel, and copper were especially robust. As restrictions were reduced, tourism picked up, albeit from a very low base, and services exports grew by 56.1%. In contrast, domestic demand grew by 3.8%, below its pre-pandemic trend of 5.2%. Total imports grew by 14.8% (Figure 2.24.1).

Figure 2.24.1 Demand-Side Contributions to Growth

Exports rivaled domestic demand as the driver of growth.



Q = quarter

Notes: The statistical discrepancy is distributed proportionately to the components of GDP. Domestic demand is the sum of private consumption, government consumption, and gross capital formation.

Source: Statistics Indonesia.

Increased mobility spurred consumption, but rising inflation and uncertainty derailed "revenge spending." Pent-up demand (especially for services) drove private consumption growth to about 5.5% during the second quarter (Q2) and Q3. But rising prices of basic goods such as fuels, cooking oil, and noodles cut purchasing power, eventually trimmed consumption growth to 4.5% in Q4, and kept it to 4.9% for the full year, lower than the pre-pandemic trend (Figures 2.24.2 and 2.24.3). Meanwhile, government consumption fell each quarter and by 4.5% for the full year.

Businesses held back fixed investment, unsure about the duration of the export boom. Gross capital formation (fixed investment and inventories) grew by 4.0% (Figure 2.24.4). Despite favorable conditions (the export boom and recovering activity, ample liquidity, and investment-friendly policy reforms), producers adopted a "wait-and-see" attitude. The government, pursuing fiscal consolidation, kept capital expenditures unchanged from 2021 in nominal terms, a cut in real terms. Construction, 74% of total fixed investment, stagnated. Other indicators of business activity dipped in Q4 (Figure 2.24.5).

Inflation jumped in September after fuel price increases. Headline inflation had been rising through August but stayed below 5% (Figure 2.24.6). On 3 September, to contain swelling subsidies for fuel and electricity, the government raised key fuel prices by

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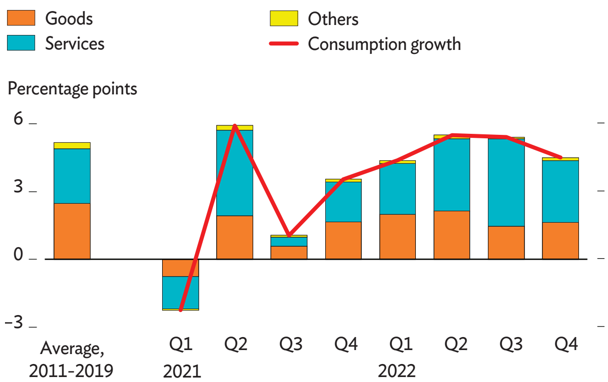
30%. Inflation rose to almost 6% in September, way above the 4.0% inflation ceiling of Bank Indonesia, the central bank.

Subsequently, inflation did not rise as much as expected. Some forecasters expected inflation to be above 6% in December and to average 4.7% for all of 2022. In the event, inflation averaged 4.2% in 2022, and the consensus forecast for 2023 fell to 4.1%. The persistent output gap helped contain inflation. Although the economy is now 3% larger than in 2019, it is about 7% below its full potential. Inflation expectations from surveys were broadly steady, likely

Figure 2.24.2 Contributions of Consumption Components to Growth

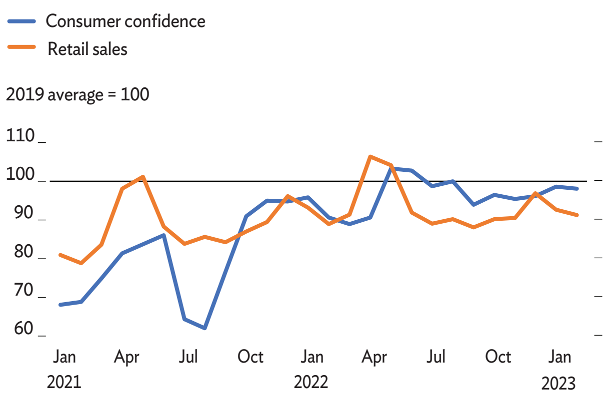
As restrictions eased, spending started strong, especially on services ...



Q = quarter.
Source: Statistics Indonesia.

Figure 2.24.3 Consumer Spending Indicators

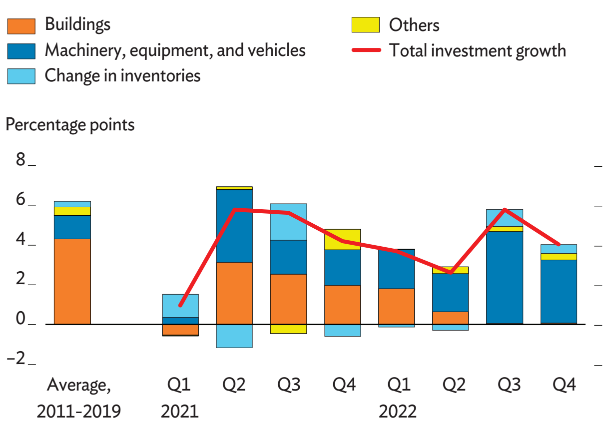
... but eventually there was no "revenge spending."



Sources: Bank Indonesia; CEIC Data Company.

Figure 2.24.4 Contributions of Investment Components to Growth

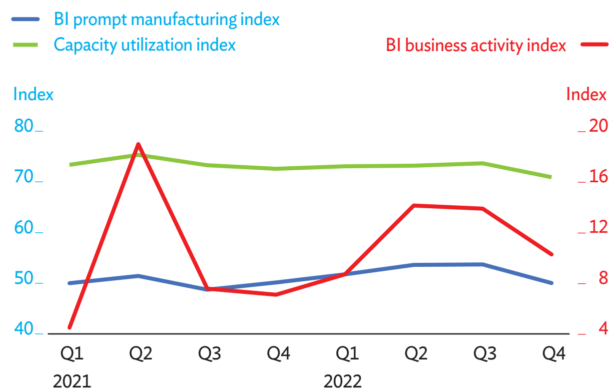
"Wait and see" held down investment, especially in construction.



Q = quarter.
Source: Statistics Indonesia.

Figure 2.24.5 Business Activity Indicators

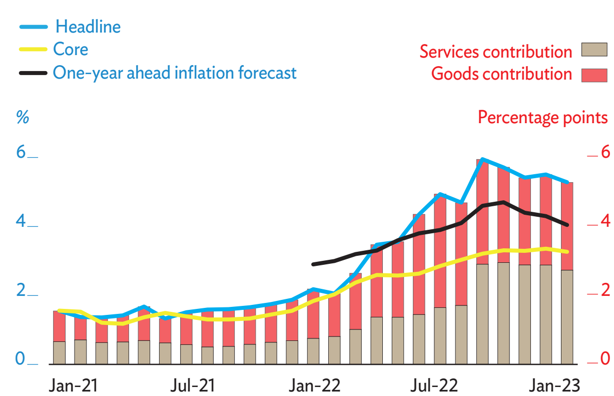
Business surveys bear out the Q4 slowdown.



BI = Bank Indonesia, Q = quarter.
Notes: For BI Prompt manufacturing index, a value greater than 50 indicates expansion.
Source: Bank Indonesia.

Figure 2.24.6 Inflation

Inflation jumped after the fuel price hike but then eased faster than expected.



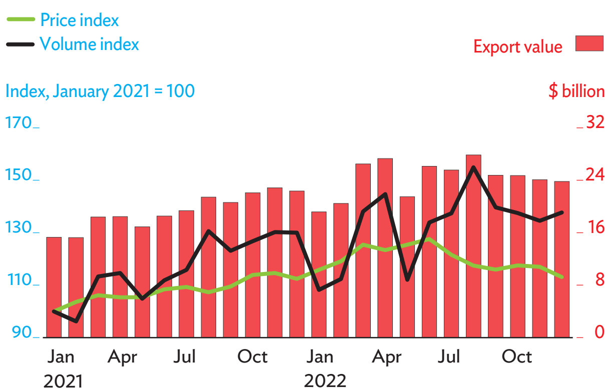
Q = quarter.
Source: Statistics Indonesia.

reflecting public acceptance of the low inflation regime set since 2015. It also helped that regional governments subsidized basic items, such as bus fares, and that infrastructure has improved since 2015, helping contain domestic logistics costs.

Indonesia achieved record trade and current account surpluses. The trade surplus in 2022 was $63 billion, compared to $44 billion in 2021, the previous record. Export and import growth both slowed in the second half, mainly due to a base year effect but also because of weaker prices for coal and palm oil exports. In US dollar terms, exports grew by 26% for the full year; imports, by 21% (Figures 2.24.7 and 2.24.8). Imports of intermediate goods were especially robust. After subtracting the usual deficits in services and incomes, the current account surplus was $13.2 billion (1% of GDP) in 2022, compared to 0.3% in 2021. Pre-pandemic current account balances averaged –2.5% of GDP.

Figure 2.24.7 Merchandise Exports

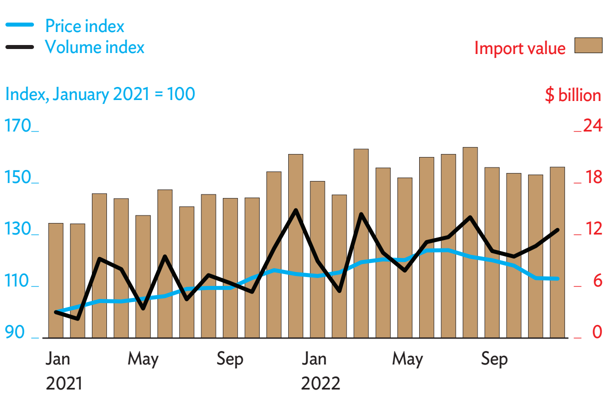
Strong demand kept export prices and volumes high all year.



Source: Statistics Indonesia.

Figure 2.24.8 Merchandise Imports

Like exports, imports remained robust, despite high import prices.



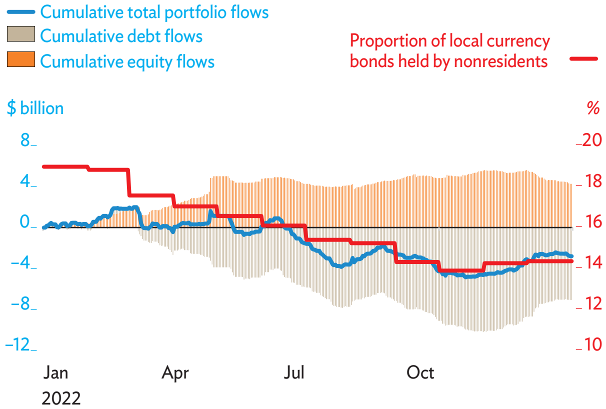
Source: Statistics Indonesia.

However, shrinking portfolio debt turned the financial account into a deficit, pushing down reserves and the rupiah. Portfolio debt financing suffered net outflows through August on rising yields in advanced economies (Figure 2.24.9). Debt inflows recovered in November on central bank policy rate increases, growing expectations of US Federal Reserve moderation, and a general rebalancing toward emerging market and developing economy assets by bond investors. Positive net flows have continued in 2023 so far, and equity capital and foreign direct investment have remained healthy. International reserves troughed at $130.2 billion in October and rose to $137 billion in December (Figure 2.24.10). In January, reserves rose to $139 billion, after a heavily oversubscribed global bond issue of $3 billion and further to $140 billion in February, about 6 months of imports and debt service and more than twice the amount of external debt due in 1 year. To boost domestic dollar availability, the central bank now offers a special term deposit facility for exporters' dollar proceeds. The rupiah bottomed out at Rp15,743 = $1 in November (9% lower than at end-2021) and was Rp15,235 = $1 at the end of February (Figure 2.24.11). The external debt was $397 billion at the end of 2022, equivalent to 30% of GDP, from 35% in 2021. Sovereign credit ratings are stable. Nonresident investors now hold about 14% of Indonesian bonds, down from 30% in 2020.

The fiscal deficit was much smaller than targeted. The revised budget in June targeted a deficit of Rp840 billion, or 4.50% of GDP. The actual deficit was Rp464 billion, or 2.37% of GDP in 2022, 1 year ahead of the scheduled return to the 3% deficit ceiling (Figure 2.24.12). The waning of COVID-19 and the economic recovery allowed lower spending on health and economic stimulus. However, higher fuel and food prices swelled subsidies for gasoline and electricity and cash transfers to vulnerable households. Total spending turned out 13% larger than budgeted. Revenues, however, were 42% larger than expected due to the export windfall, the recovery of economic activity, and new tax measures (including an increase in the value-added tax rate to 11% in April). Based on International Monetary Fund estimates, the deficit overperformance produced a contractionary fiscal impulse of about 1.8% of GDP, contributing to the tepid domestic demand. The public debt was Rp7,734 trillion (39% of GDP) in December, from Rp6,984 trillion (41% of GDP) in 2021.

Figure 2.24.9 Portfolio Flows

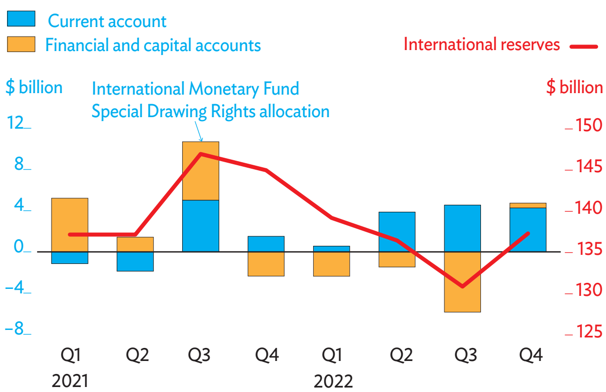
Large debt outflows eased starting November …



Sources: Institute of International Finance; Haver Analytics.

Figure 2.24.10 Balance of Payments

… but not soon enough and reserves fell for much of 2022 …

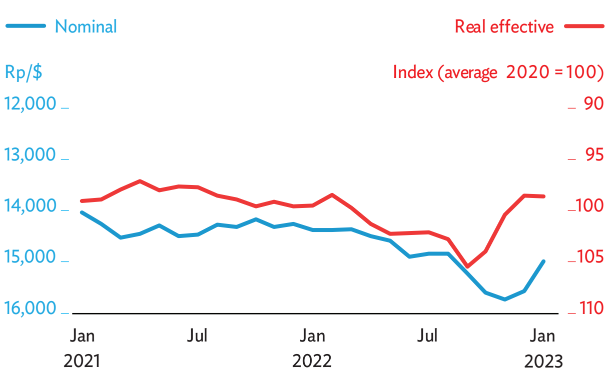


Notes: Net errors and omissions are included in the financial and capital accounts.

Source: Bank Indonesia.

Figure 2.24.11 Exchange Rate

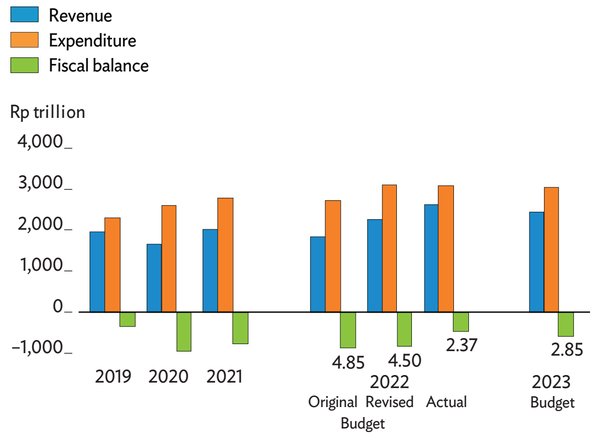
… as did the rupiah, in both nominal and real terms.



Sources: Haver Analytics; Bank for International Settlements.

Figure 2.24.12 Fiscal Indicators

Windfall revenues from commodity exports led to a smaller-than-expected fiscal deficit.



Note: Numbers in below the green bars are fiscal balances as percentage of gross domestic product.

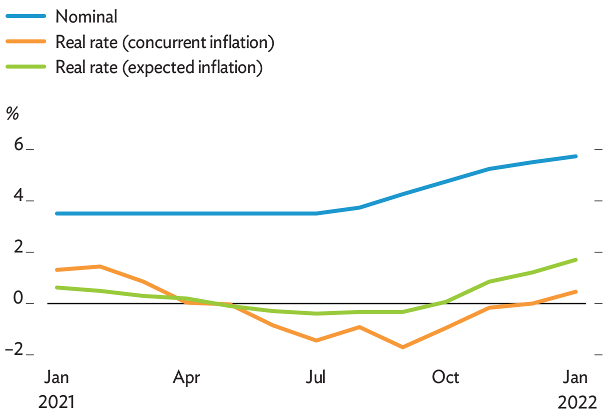
Source: Ministry of Finance.

Monetary policy tightening sped up in late 2022 but ended in early 2023. The central bank, after initially raising the reserve requirement to 9.50% and the policy rate to 3.75% in August, brought the policy rate to 5.75% by December and has kept it at that level. The real policy rate is now significantly positive, but the central bank has tried to keep the longer-term rates about the same (Figure 2.24.13). Because inflation is easing, the central bank kept the policy rate unchanged in February and will likely not raise it further. As agreed with the Ministry of Finance, the central bank's direct purchases of government bonds ("burden sharing") ended in December (Figure 2.24.14). These purchases totaled Rp831 trillion in 2020–2021 and Rp144 trillion in 2022.

Lending volumes and quality continued to improve. Lending to businesses grew by 11.6%; to households, by 9.1% (Figure 2.24.15). During previous export booms, lending increased by about 20%. The nonperforming loan ratio was 2.4% and the capital adequacy ratio 25%, both comfortably meeting regulatory requirements. Restructured loans peaked at Rp800 trillion in Q2 2020 and were Rp469 trillion in Q4 2022. Given improving conditions, the financial regulator ended banks' breathing room, which had allowed them not to classify as nonperforming the loans restructured during the pandemic. The remaining exceptions through March 2024 are loans to textile and footwear manufacturers, hotels and restaurants, and micro, small, and medium-sized enterprises.

Figure 2.24.13 Bank Indonesia Policy Rate

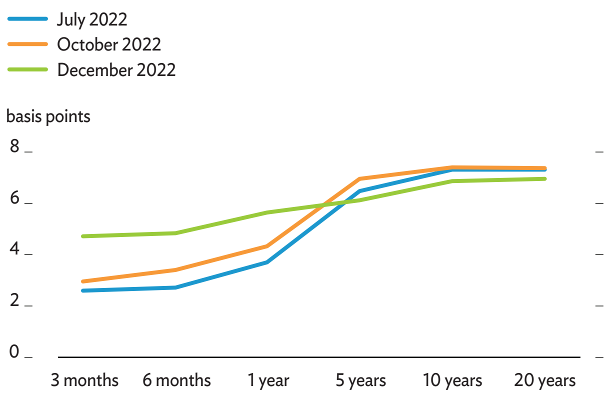
The central bank in August-December restored a positive real policy rate ...



Sources: Bank Indonesia; Haver Analytics.

Figure 2.24.14 Bond Yields by Maturity Dates

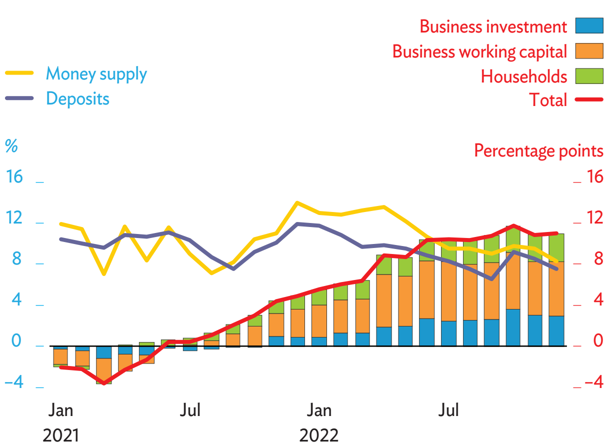
... while "twisting" the yield curve.



Source: Haver Analytics.

Figure 2.24.15 Monetary and Financial Indicators

Deposit growth slowed on rising spending; lending growth was steady.



Source: Haver Analytics.

Structural reforms continued in investment and finance. In 2022, the Constitutional Court, citing procedural shortcomings, halted the implementation of the Omnibus Job Creation Law, which aims to encourage trade and investment and improve business operations. In January 2023, the president issued a revised version of the law and submitted it to the legislature for an expedited vote, citing urgency. Also in January, the legislature approved the Omnibus Financial Law. The law beefs up consumer rights, recognizes crypto trading and places it under regulatory supervision, establishes a framework for carbon trading and for a "bullion bank," and gives the deposit insurance company's head a vote in the Financial Stability Committee. It charges the central bank with promoting sustainable growth, in addition to its mandate of price stability, and allows future direct purchases of government bonds by the central bank should the President declare an economic emergency.

Trade restrictions were stepped up to promote "downstream industrialization" and regulate domestic supplies of basic goods. The government banned exports of raw nickel in 2020, spurring domestic processing of nickel into ferronickel, pig iron, and matte. The government aims to use processed nickel to promote the production of batteries for electric vehicles. Despite a ruling against the nickel export ban at the World Trade Organization, the government will ban exports of bauxite and copper starting in June 2023 and is considering a similar ban for tin. It now also requires palm oil exporters to allocate 20% of their export volume to the domestic market at a set price and diesel producers to raise the palm oil content of their products. It is piloting the Commodity Balance mechanism, an integrated national database envisaged to eventually govern import permits and export licenses for thousands of goods.

Social indicators continued to improve, but most have not fully recovered. The poverty rate fell to 9.6% of the population in September 2022 from 9.7% in September 2021. The unemployment rate fell to 5.9% from 6.5% in the same period. The poverty and unemployment rates in 2019 were 9.2% and 5.2%, respectively. The stunting rate for children under 5 fell to 21.6% in 2022, the fifth successive annual decline.

Economic Prospects

Growth in 2023 is forecast at 4.8% and is expected to settle at about 5.0% in 2024, below the pre-pandemic trend of 5.3% (Table 2.24.1). This projection assumes persistent economic scarring from the pandemic and no additional major structural reforms (Figure 2.24.16). The budget deficit is expected to remain below the statutory ceiling of 3% of GDP. Inflation is forecast to ease further to 3% by 2024, comfortably within the central bank's target of 2%–4%. Export and import growth will be about 6%, with tourism recovering to its pre-pandemic level. The current account is projected to be in surplus during 2023 and 2024. Over time, measures like the European Union's anti-deforestation rules and carbon border adjustment mechanism could crimp Indonesia's export prospects.

Table 2.24.1 Selected Economic Indicators, %

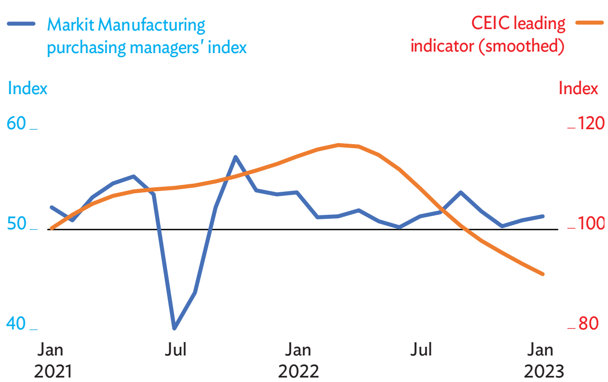
Growth is projected to settle slightly below its pre-pandemic trend.

	2021	2022	2023	2024
GDP growth	3.7	5.3	4.8	5.0
Inflation	1.6	4.2	4.2	3.0

GDP = gross domestic product.
Sources: Statistics Indonesia; Asian Development Bank estimates.

Figure 2.24.16 Leading Indicators

Leading indicators point to slower growth in 2023.



Note: Purchasing managers' index values above 50 indicate expansion, while observations above 100 for the CEIC leading indicator can be interpreted as periods above the long-term trend.
Source: CEIC Data Company; Haver Analytics.

Consumption is projected to pick up, but not that much. Consumption should be healthy on mobility restrictions disappearing, inflation moderating, monetary tightening ceasing, and fiscal policy somewhat easing. Pre-election campaign spending in Q4 in the run-up to the February–June general elections will also stimulate consumption. But the "revenge spending" that faded in 2022 is not likely to happen in 2023 because of a smaller trickle-down from export earnings and increased uncertainty. Private consumption should therefore grow by about 5% in 2023.

"Wait and see" by businesses will continue to restrain investment. Investment in machinery and buildings is projected to grow by about 5% in 2023, and changes in stocks to contribute about zero to growth. This projection is based on the fading of the export boom and investors' behavior during previous pre-election years. But the full implementation of the Omnibus Job Creation Law should provide a floor to investment.

Monetary and fiscal policies in 2023 are programmed to be slightly supportive of growth. The central bank is unlikely to tighten more as inflation is abating. The programmed fiscal deficit of 2.85% of GDP, larger than in 2022, would impart a small positive fiscal impulse. But because the government's projections tend to be cautious, revenue could turn out significantly larger than projected in the budget, and the deficit smaller. Government consumption is forecast to grow by 4.5%. The government may frontload spending in Q1 to help spur private demand. The government will also reform screening under the cash transfer mechanism to reduce the likelihood of needy households not getting aid.

Slower global growth is projected to sharply cut export growth, holding back incomes, jobs, and confidence. Export growth is projected to drop to 8% in national income account terms in 2023. There is some upside risk to exports and growth if recovery in the People's Republic of China turns out stronger. Still, the downside external threats are substantial, including the Russian invasion of Ukraine worsening, inflation and monetary tightening in advanced economies persisting, financial market volatility increasing, and asset prices sliding. And the baseline scenario assumes no shocks like an outbreak of war or a deadly new COVID-19 variant.

Inflation is projected to moderate to 4.2% on average in 2023. Global commodity prices are projected to ease further, reducing supply-side pressures on domestic prices. The policy rate increases in 2022 will have a lagged effect in 2023.

Lower commodity prices and lower export volume growth will cut the current account surplus to about 0.2% of GDP by 2024. Slower global growth and restrictions on exports of goods like coconut oil are near-term reasons to expect export growth to slow. Earnings from tourism will increase as arrivals return to pre-pandemic levels but only partly offset the sharp fall in exports of goods. Imports in US dollar terms will increase by less than 10% as weaker import prices will offset continuing growth in demand.

The financial account is projected to be modestly positive, enabling a small increase in reserves. The healthy financial inflows in 2023 so far point to a recovery of foreign portfolio investors' appetite for Indonesian debt instruments. Net inflows of portfolio equity finance and foreign direct investment should be about the same as in 2022, at $4 billion and $15 billion, respectively, producing a reserve buildup of about $5 billion.

For 2023, the risks are on the downside; for 2024, they are about evenly balanced. For 2023, the risks arise mainly from potential external shocks. For 2024, the benefits of normalization and the fruition of reforms enacted in 2021 and 2022 could be offset by the setbacks to workers' earnings potential and businesses' investment capacity.

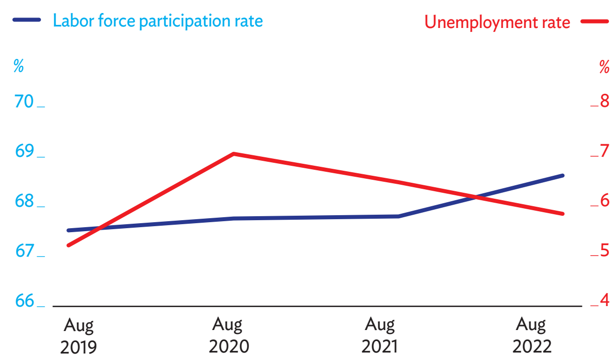
Policy Challenge—Repairing the Impact of the Recession

Most key labor indicators have not returned to their pre-pandemic levels. For the near term, continuing weakness in jobs and incomes (and their pass-through to confidence) could impede a full demand recovery. The working-age population's scarring could reduce potential growth in the medium to long term. This long-term concern is in addition to the learning losses experienced by children, which could affect their lifetime incomes.

Labor force participation has recovered, but unemployment is stubbornly high. In contrast to some advanced economies, Indonesia's labor force participation rate in 2022, at about 69%, was higher than its pre-pandemic level. But job creation has not kept pace. Hence, while the number of unemployed in August 2022 was 8.4 million, an improvement compared to 9.8 million in August 2020, it was much higher compared to around 7 million during 2016–2019. The unemployment rate in August was 5.9%, compared to 5.0% during 2016–2019 (Figure 2.24.17).

Figure 2.24.17 Labor Market Indicators

The labor market has not fully recovered.



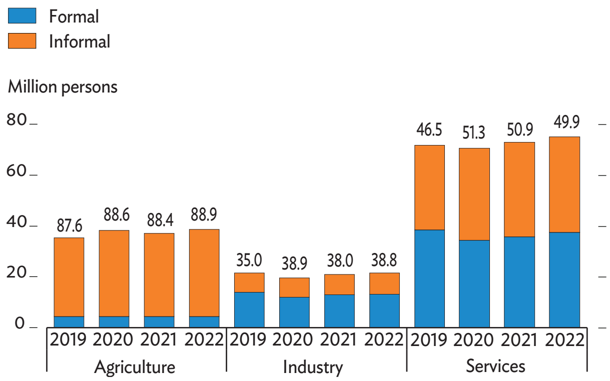
Source: Statistics Indonesia. 2019 to 2022. National Labor Force Survey Reports.

Informality has increased. Informality averaged 56% pre-pandemic and is now about 60%. This is concerning because informal workers tend to have low productivity, income, and social protection (Figure 2.24.18).

Gender gaps narrowed during the pandemic, but perhaps not in a good way. Pre-pandemic, females had a lower unemployment rate than males but also a lower employment rate, labor force participation rate, real wages, and higher informality. During the pandemic, females' relative positions improved. For instance, the female unemployment rate rose, but not as fast as for males. A study concludes that Indonesian women became more likely to be employed not because labor demand shifted toward females but because households suffering from income losses were compelled to send their female members to take up any jobs.

Figure 2.24.18 Formal and Informal Employment by Sector

Informality has increased in all of the main sectors.

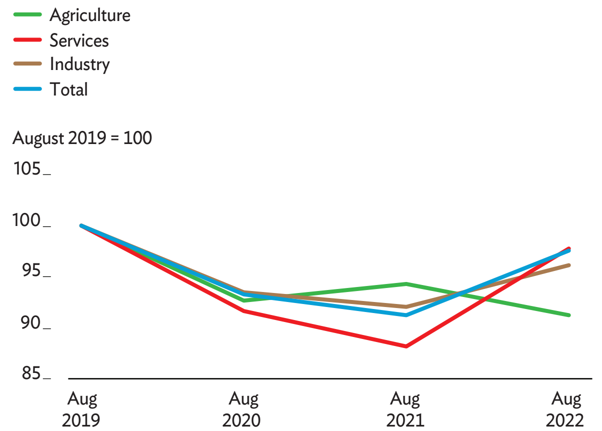


Note: Numbers above the bars refer to the share of informal sector to total employment in the sector.

Source: Statistics Indonesia. 2019 to 2022. *National Labor Force Survey* reports.

Figure 2.24.19 Monthly Real Wages

Real wages are still below pre-pandemic levels.



Source: Asian Development Bank calculations using Statistics Indonesia. 2019 to 2022. *National Labor Force Survey* reports.

Real wages have not recovered. The average real wage in 2022 was about 2.5% below its 2019 level, but this comparison conceals an important recent change. In Q3 2022, the real wage rose by 7.2% compared to Q3 2021, perhaps indicating that workers' bargaining power has improved somewhat as the economy recovered (Figure 2.24.19).

Young workers have suffered significantly. The proportion of youth not in employment, education, or training rose from 21.8% in 2019 to 24.3% in 2020 and was 23.2% in 2022. Studies have found that the negative consequences for youths entering working age during downturns can be large and long-lasting.

The Pre-Employment Card Program, launched in 2020, is one measure already in place to mitigate labor market scarring. To date, it has helped 16.4 million displaced workers reintegrate into the workforce. The program imparts technical and vocational skills through digital learning, training to start businesses, and scholarships.

Several additional measures could help. These include promoting local labor market exchanges, investing in job information, and piloting a fund that provides workers with training credits.

Sustaining the recovery is critical in returning key labor indicators to their pre-pandemic levels. Macroeconomic policy should stand ready to prop up demand should the global slowdown turn out worse than currently projected. For the long term, ongoing structural reforms can increase potential growth and soak up labor, raise skills and productivity, and increase incomes.