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INDONESIA ECONOMIC QUARTERLY

Maintaining resilience

October 2012



THE WORLD BANK

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Preface

The Indonesia Economic Quarterly reports on and synthesizes the past three months' key developments in Indonesia's economy. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy for the outlook for Indonesia's economic and social welfare. Its coverage ranges from the macroeconomy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

This Indonesia Economic Quarterly was prepared and compiled by the macro and fiscal policy cluster of the World Bank's Jakarta office, under the guidance of Sector Manager and Lead Economist, Jim Brumby, Economic Advisor and Lead Economist, Ndiame Diop and Country Economist, Ashley Taylor. The team included Magda Adriani (commodity prices), Alex Sienaert (international environment, external sector, financial markets and executive summary), Fitria Fitriani (manufactured exports and external sector), Faya Hayati (prices and real sector) and Ahya Ihsan (fiscal and 2013 Budget). Additional contributions were received from Dwi Endah Abriningrum (fiscal and 2013 Budget), Neni Lestari (banking), The Fei Ming (corporate sector), Christopher Smith and Siwage Dharma Negara (Higher Education Law), Staffan Synnerstrom, Erwin Ariadharma and Enda Ginting (government personnel spending), and Matthew Wai-Poi (poverty). Alex Sienaert, Arsianti, Faya Hayati, and Ashley Taylor shared the editing and production. Mark Ahern, Jim Brumby, Ndiame Diop, Alex Drees-Gross, Yue Man Lee, Samer Al-Samarrai, Theo Thomas and Soekarno Wirokartono provided detailed comments and input. Dini Sari Djalal, Farhana Asnap, Indra Irnawan, Jerry Kurniawan, Nugroho, Marcellinus Winata and Randy Salim organized the dissemination and Titi Ananto, Sylvia Njotomihardjo, and Nina Herawati provided valuable administrative support.

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Executive summary: Maintaining resilience



The challenge of maintaining resilience...

Indonesia's economic growth has so far remained resilient to the weakness in the global economy. Amidst a still uncertain outlook, Indonesia will need to prepare itself for the potential consequences of China's slowdown and additional falls in commodity prices, and for the possibility of renewed turbulence in financial and commodity markets. Continuing to strengthen the policy framework to deal with shocks and building economic resilience through improvements in the quality of spending and in the regulatory environment will be key to maintaining, and improving further, Indonesia's strong recent growth performance. Progress towards these goals could be tested as the 2014 election year approaches.

...in the face of a global economy which has slowed, prompting renewed monetary expansion

The ongoing recession in the Euro Area, the weak US recovery, and slowdowns in major emerging economies, especially China, have contributed to subdued global growth. In September, the US Federal Reserve and the Bank of Japan responded by announcing fresh monetary stimulus, while the European Central Bank confirmed its willingness to support Euro Area sovereign bond markets. These measures, which were widely anticipated, helped to stabilize international financial markets, and fueled significant rallies in higher risk asset markets, including in Indonesian equities. Commodity prices have also risen, with oil prices also affected by supply concerns. The price movements of Indonesia's other major commodity exports have been mixed after the large falls of the three months to June 2012, with copper and coal rising since June but rubber and palm oil seeing further falls.

Amidst weak external demand and commodity prices, Indonesia's growth performance in the first half of 2012 was strong...

Indonesia's economy maintained its robust pace of growth in the second quarter of 2012, expanding by 6.4 percent year-on-year, up slightly from 6.3 percent in the first quarter (Figure 1). Buoyant private consumption continued to lift domestic demand, and investment spending also increased strongly. Despite the rapid pace of economic activity, consumer price inflation has remained moderate to date. Headline CPI inflation fell back to 4.3 percent year-on-year in September after edging up to 4.6 percent in August, when it was pulled higher temporarily by the Idul Fitri holidays. Core inflation has remained stable, just above 4 percent.

**Figure 1: Indonesia's recent growth has been resilient
amidst weaker external demand
(real GDP growth, percent year-on-year)**



Note: Major trading partner growth is weighted by Indonesia's export values
Source: BPS, CEIC, World Bank staff calculations

...but the impact of weakening global demand and commodity prices has been seen and recent high frequency indicators show some signs of a moderation in domestic demand

The trend of a declining current account balance reflects Indonesia's relative growth and investment needs...

...but does highlight the importance of continuing to attract solid FDI inflows

The budget deficit remains modest but high energy subsidy costs have caused some fiscal slippage

The resilience of Indonesia's growth performance, to date, despite the external headwinds has been notable. However, this is no grounds for complacency. On the one hand, real credit growth remains high; on the other hand, some high frequency indicators, such as car, motor cycle and cement sales have dropped off recently. However, it is too soon to know for certain if the latter is an early sign of a slow-down in domestic demand growth, or whether this reflects the effects of the Idul Fitri period. In contrast, the significant downward pressure exerted by weaker global growth on Indonesia's commodity-intensive exports has been clear. In the second quarter, net exports were a significant drag on GDP growth, and recent trade data suggest that export earnings continued to decline in the third quarter of 2012.

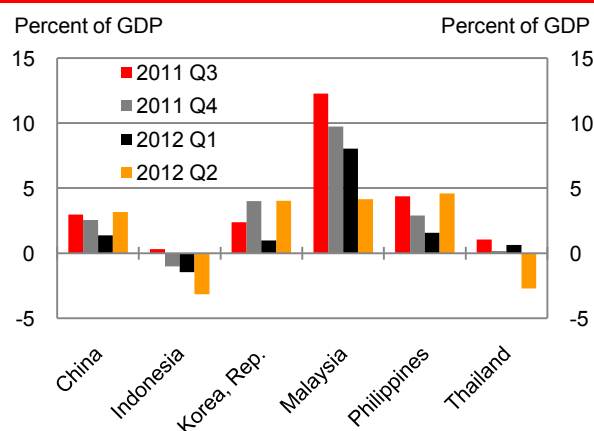
Indonesia's current account moved further into deficit in the second quarter of 2012. Structurally, the trend towards current account deficits reflects consistently strong domestic investment relative to the level of domestic savings. The slowdown in exports over 2012, alongside generally strong import demand, has seen the large goods trade balance surpluses of recent years narrow and this, coupled with consistent net outflows in the income and services sub-accounts, moved the overall current account into a deficit of 3.1 percent of GDP in the second quarter of 2012. A

similar narrowing in current account balances has also been seen in regional neighbors, particularly Malaysia and Thailand which are similarly exposed to falls in commodity prices and demand (Figure 2). It is also important to note that some of the recent pressure on the trade balance is cyclical in nature and should be partly self-correcting as import demand related to export production declines – the sharp fall in imports seen in August may be due in part to this effect, as well as possible holiday effects.

While renewed current account deficits to support domestic investment levels can be seen as a natural part of Indonesia's economic development path, the need to fund these deficits does highlight the importance of maintaining strong foreign direct investment inflows, in order to limit reliance on potentially volatile portfolio investment flows. Maintaining progress towards structural reforms to lift the competitiveness of domestic production should also be prioritized, supporting not only the trade balance but also domestic investment and job creation. Shorter-term measures aimed at import-substitution may have limited effectiveness and could, in fact, have counter-productive consequences, by introducing distortions over the medium term or if they adversely affect near-term investor confidence, thereby actually putting more pressure on external balances. Allowing for a gradual weakening of the exchange rate, as has been seen recently, can also facilitate an improvement in the trade balance.

Higher than expected spending on energy subsidies and a moderation in public revenue growth move the World Bank's deficit projection for 2012 to 2.4 percent of GDP, slightly above 2.2 percent in the Government's revised Budget. Deficit financing, however, is comfortably on track. High cash balances and the Government's proactive approach to preparing contingent financing for use in the event of market dislocations should stand Indonesia in good stead in the event of any further international market turbulence. The Government's proposed Budget for 2013, currently under discussion with Parliament, sees the deficit decline to 1.6 percent of GDP, with the Medium-Term Budget Framework targeting a gradual move to a surplus of 0.3 percent of GDP by 2016.

Figure 2: A deterioration in current account balances has been seen in regional peers, as well as in Indonesia (current account balance, percent of GDP)



Source: Haver Analytics, BI and World Bank staff calculations

The baseline case is for continued solid growth through 2013

As in recent *IEQs*, the baseline scenario remains one in which international market volatility persists and global growth remains weak but there is no major financial crisis or pronounced global slowdown. Indeed, renewed global monetary expansion, potential positive feedback effects to investment from higher financial asset prices, and increased public spending in China, should contribute to some pick-up in global activity entering 2013. Yet the pace of any cyclical upswing will likely be limited by generally high inventory levels and the negative effects of ongoing uncertainties on private sector consumption and investment. In addition, the long-standing headwinds of deleveraging and the required fiscal adjustments in many high-income economies remain.

In this baseline scenario, Indonesia's growth is projected at 6.1 percent for 2012 as a whole (Table 1), up marginally from 6.0 percent projected in the July 2012 *IEQ*, reflecting above-expectation growth already seen in the first half of the year. The growth forecast for 2013 is adjusted to 6.3 percent from 6.4 percent previously, reflecting a slight downward revision to the forecast for major trading partner growth next year to 3.6 percent from 3.7 percent in the July *IEQ*.

Table 1: Under the baseline scenario Indonesia's growth is projected at 6.3 percent in 2013

		2010	2011	2012	2013
Gross domestic product	(Annual percent change)	6.2	6.5	6.1	6.3
Consumer price index*	(Annual percent change)	6.3	4.1	4.9	5.1
Budget balance**	(Percent of GDP)	-0.7	-1.1	-2.2	-1.6
Major trading partner growth	(Annual percent change)	6.8	3.1	3.3	3.6

Note: * Q4 on Q4 inflation rate. ** Government figures for Budget deficit - 2012 is revised Budget and 2013 is proposed Budget

Source: Ministry of Finance, BPS via CEIC, Consensus Forecasts Inc., and World Bank staff

Risks to Indonesia's near-term growth outlook remain to the downside, driven by potential spillovers from global developments...

International risks to the 2013 forecast are skewed significantly to the downside. Recent policy action has helped contain the situation in the Euro Area but not eliminated the possibility of a renewed intensification of the crisis. Should the US economy be hit by a fiscal contraction on the scale of that implied by current and expiring legislation, the impact on global growth would likely be large. Another key uncertainty is the impact on international portfolio capital flows and commodity prices of renewed monetary easing by major central banks. A repeat of the large inflows to emerging market assets, including to Indonesia, that were seen in 2010 is possible and would raise significant monetary and fiscal policy challenges. However, such a repeat is by no means guaranteed given the current policy uncertainties weighing on investor sentiment, and developments in the international economy since the more immediate post-global financial crisis period.

...and, in particular, from the slowdown in China and its impact on commodity prices and demand

One of the biggest differences, and perhaps the biggest near-term external risk for Indonesia, is the slowing down in China's economy. This risk is also important for many other economies, especially commodity exporters. However, it is particularly significant for Indonesia given direct and indirect trade links, along with the support to growth that commodity prices and production have provided through positive income effects on private demand. For example, estimates in the September 2012 IMF Article IV report on Indonesia, incorporating direct and indirect trade effects and global commodity price impacts, suggest that a one percentage point reduction in China's growth could lower Indonesia's GDP by up to half a percentage point. In addition, there would also be spillovers to Indonesia through the commodity channel from a shift in the composition of China's growth from investment to consumption.

Of particular interest, given its role as a major engine of Indonesia's domestic demand growth, is how any spillovers from developments in China affect domestic investment in Indonesia. This has tended to be closely positively correlated with global commodity prices and the pace of investment growth may yet prove susceptible to external headwinds. Even if growth as a whole proves relatively robust to softening commodity prices, significant localized impacts could be felt by households and businesses in regions highly dependent on commodities for livelihoods and income.

The uncertain outlook places a premium on making continued progress to build Indonesia's economic resilience...

...through improvements in policy consistency, clarity and certainty...

...and improving further the quality and efficiency of government spending to support Indonesia's development objectives

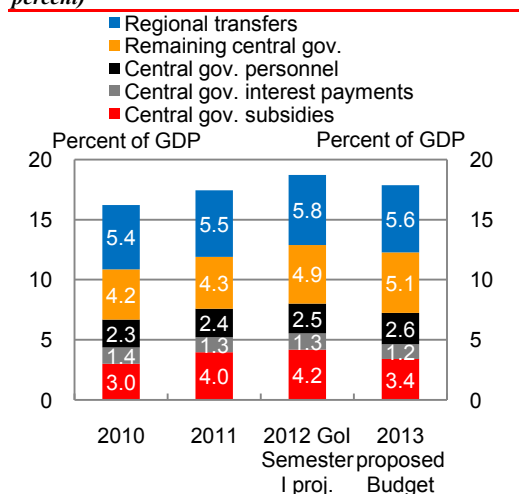
The ongoing uncertainties of the international environment raise the importance of Indonesia continuing to build on the progress it has already made in making its economy more resilient. This will equip the country to benefit fully from the gradual improvement in global growth expected in the baseline outlook, as well as to weather any further deterioration in external conditions should this occur. As emphasized in the July *IEQ*, the policy challenge for Indonesia, as well as across developing economies, is therefore to maintain a twin focus on short-term crisis preparedness, and on longer-term structural measures, such as to support the development of infrastructure, skills and education, aimed at boosting the sustainable growth rate.

Maintaining policy consistency and clarity, particularly in the area of business and investment regulation, furthers both of these objectives. It will be important to avoid policy missteps, such as policies which, while aiming to address a near-term issue, may carry longer-term risks and costs. In addition, maintaining a clear and consistently reform-oriented policy framework will be particularly important given the likely rise in political uncertainty in the lead-up to national elections in 2014 and the continued fragility of investor confidence around the globe.

The draft 2013 Budget under discussion with Parliament proposes the continuation of the crisis mitigation and response measures included in the 2012 Budget. Spending is also directed to key development priorities such as addressing the infrastructure backlog and improving and expanding social assistance programs.

However, flexibility to respond to a downturn in growth is limited by the disbursement challenges in infrastructure and the efficiency of spending is limited by the continued burden of energy subsidies (accounting for one quarter of central government spending, excluding regional transfers, in the 2013 proposed Budget, Figure 3). The significant allocation of spending to energy subsidies imposes high opportunity costs, adds uncertainty to the fiscal outlook, disproportionately benefits rich households rather than targeting the poor, and impedes the efficient usage of energy. It also runs the risk of crowding out vital public investment should the domestic fuel bill rise further, with similar concerns raised by the rise in personnel spending. Therefore, there is a need to improve further the quality of both the allocation and the efficiency of spending. Failure to make such improvements in the medium-term could lower the growth outlook going forward and the ability of the Government to meet its development objectives.

Figure 3: Subsidies and personnel costs continue to account for a large share of spending
(central government spending as a share of GDP, percent)



Note: Proj. is projection

Source: Ministry of Finance and World Bank staff calculations

A. ECONOMIC AND FISCAL UPDATE



1. The global economy has weakened and the outlook remains cloudy

The global economic recovery has lost momentum

Indonesia, as other emerging market economies, continues to face a challenging external environment. The global economy appears to have slowed markedly in the third quarter of 2012, weighed down by the Euro Area crisis and softening activity in several major emerging economies. Near-term, global economic conditions are likely to remain soft through the end of 2012. Risks to this baseline view are tilted to the downside and the possibility of severe financial market dislocations and a further deterioration in global economic momentum cannot be ruled out.

Major central banks have reacted to growing stability and growth risks with fresh monetary stimulus...

The Euro Area's fiscal and banking sector challenges were the key focus for global investors at the time of the last *IEQ* in July. Subsequently, expectations that the European Central Bank would take further measures to contain the crisis helped the euro gain ground and drove down Euro Area yields. Global asset prices were further supported by the ECB's announcement on 6 September that it was prepared to purchase the shorter-term debt of qualifying sovereigns under a new — "Outright Monetary Transactions" program. This was followed by the additional asset purchase programs announced by the US Federal Reserve, so-called "QE3", and the Bank of Japan.

...which has helped boost international financial markets

These expansionary monetary policy measures have boosted sentiment by increasing liquidity and reducing the expected probability of worst case scenarios occurring in the Euro Area. This has fueled significant rallies in key financial asset markets, including emerging market debt and equities. For example, emerging market equities as of the end of September were up 13.6 percent in US dollar terms from their 2012 lows in June, yielding a gain of 9.4 percent for the year to date (Figure 4). The spreads of dollar-denominated emerging market sovereign bond yields over US Treasuries, as measured by the EMBIG index, tightened to 310 basis points, having widened to as much as 440 basis points in early June (Figure 5).

Yet economic conditions appear set to remain challenging in the near term...

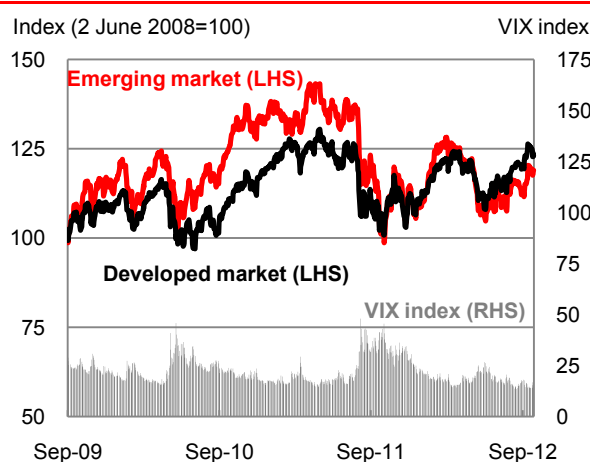
This easing in monetary and financial market conditions occurred against the backdrop of generally weak leading and high frequency economic activity indicators, prompting global growth projections to be revised down. The World Bank has trimmed its projection for global economic growth in 2012 to 2.3 percent, down from 2.5 percent in June.¹ This reflects the expectation that growth continued to slow in the third quarter as well as the likelihood that, while the slowdown in global industrial production and trade may have bottomed in July or August, the pace of economic activity in the final quarter is unlikely to pick up strongly. In general, inventory levels are high, across the major high income economies business and consumer sentiment readings remain weak, and there are persistent headwinds from private sector deleveraging and limited fiscal space.

¹ See the World Bank's October 2012 East Asia and Pacific Economic Data Monitor <http://www.worldbank.org/en/news/2012/10/08/east-asia-and-pacific-economic-data-monitor>.

...not only due to the Euro Area recession, but also due to US risks and the slowdown of major developing economies like China

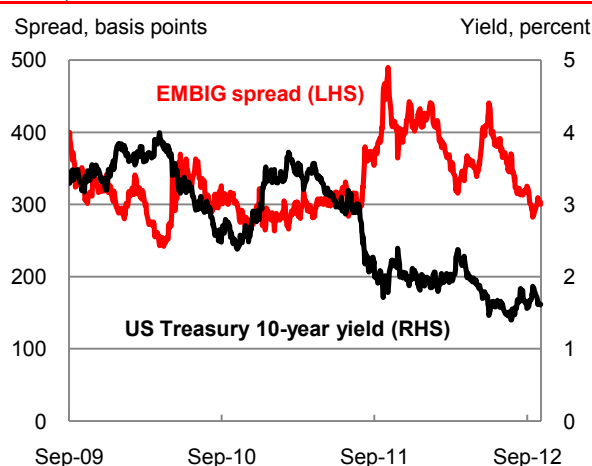
While the Euro Area has remained in focus, tepid economic growth conditions and downside risks are not confined to that region. In the United States, growth has slowed through 2012 and the potential “fiscal cliff” at the end of the year could pull down growth further in 2013, unless policymakers succeed in renewing and amending relevant budget legislation. China’s economy, a key driver of Indonesia’s exports and global commodity prices, has also slowed, posting growth of 7.6 percent year-on-year in the second quarter, its slowest pace since mid-2009 and down sharply from 9.2 percent in 2011. The World Bank is projecting China’s GDP to expand by 7.7 percent over 2012 as a whole, still relatively robust but down from the June 2012 forecast of 8.2 percent. Downside risks to this projection remain and a harder landing for the Chinese economy would further dampen global demand, in particular for commodity exports.

Figure 4: Equity markets staged a strong recovery in the third quarter and US equity volatility declined...
(USD equity indices, 1 September 2009=100; VIX index)



Note: VIX index measures the 30-day expected volatility of the S&P 500 index as implied by option contract prices. Equities are MSCI indices
Source: MSCI, Chicago Board Options Exchange, World Bank staff calculations

Figure 5: ...while emerging market sovereign dollar funding costs fell as risk spreads came down
(EMBIG spread, basis points; US Treasury 10-year yield, percent)



Note: EMBIG is Emerging Market Bond Index Global
Source: JP Morgan

Energy and metals prices rose over the quarter but the prices of some of Indonesia’s key export products continued to drop

International commodity markets have been buffeted by the opposing forces of slackening economic activity on the one hand, and renewed monetary stimulus, geopolitical concerns and supply-side shocks, on the other. The prices of most commodities bottomed out mid-year and ended the third quarter higher. For example, oil prices showed strong gains over Q3, with Brent crude rising by 18.6 percent. However, the price movements of some of Indonesia’s other key commodity exports lagged the rises seen for other commodity markets. International coal prices edged higher by a few percentage points over the third quarter but remain well down on their 2011 levels. Rubber prices were down around 5 percent, and palm oil slid 3 percent (Table 2).

Table 2: Commodity prices remain historically high in nominal terms but recent performance was mixed
(percentage)

	Change to September 2012			Export share*
	Jan-05	Dec-11	Jun-12	
Coal	69.7	-17.9	5.1	14.0
Natural gas	38.9	-2.9	0.6	11.6
Palm oil	142.0	-5.3	-2.6	9.0
Crude oil	156.0	5.1	18.6	6.5
Rubber	156.8	-10.2	-5.0	4.5
Copper	155.1	6.9	9.0	2.5

Note: Australian coal, World Bank global natural gas index, Brent crude, SGP/MYS rubber; Export share is for January-July 2012

Source: BPS, DECPG-World Bank and World Bank staff calculations

Overall, the baseline growth outlook for Indonesia's major trading partners remains relatively weak

Indonesia enters the final quarter of 2012 facing international financial and commodity market conditions that have stabilized somewhat compared to the situation in the middle of the year, thanks in large measure to renewed policy stimulus around the globe. Yet it is too early to know for sure whether the pace of global economic expansion has indeed begun to pick up again. Much depends on the Euro Area's ability to emerge from its shallow recession and the bottoming-out of China's slowdown, both of which are subject to uncertainties. The World Bank's baseline projection is that Indonesia's major trading partners (MTP) will grow at a relatively weak pace of 3.3 percent in 2012, accelerating modestly to 3.6 percent in 2013. However, this projection of mildly improving external conditions for the Indonesian economy is subject to significant downside risks, which are detailed further at the end of this section.

2. Despite external weakness, Indonesia's economy has so far grown robustly

Growth of the Indonesian economy picked up slightly to 6.4 percent in the second quarter of 2012

Indonesia's GDP rose by 6.4 percent year-on-year in the second quarter of 2012. This was slightly higher than the 6.3 percent growth seen in the first quarter of 2012 and the seventh consecutive quarter of above 6 percent growth (Figure 6). On a seasonally-adjusted quarter-on-quarter basis the economy grew by 1.6 percent in Q2, up from 1.0 percent in Q1, reflecting the strength of a resilient domestic demand base that offset the effects of weak external demand (Figure 7).

Growth was supported by the strong performance of investment...

Private consumption growth continued to provide solid support for growth in the second quarter of 2012. For the second quarter in a row, government consumption growth also came in stronger than expected, at 7 percent year-on-year. Investment growth was even stronger, contributing 1.6 percentage points to seasonally-adjusted quarterly growth, as its year-on-year growth reached 12.3 percent, the highest since the start of the global financial crisis in late 2008. The rise in investment also pushed the nominal investment ratio to GDP to a record high of 33 percent. This compares well to regional peers such as Thailand (28 percent) and Malaysia (26 percent).

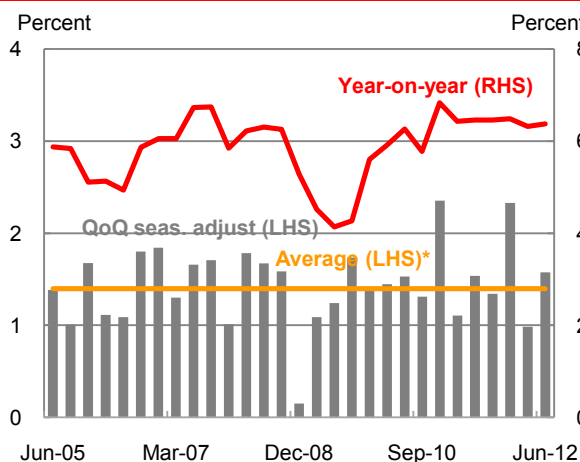
Within investment, construction (which accounts for 70 percent of total investment) saw steady growth of 7.2 percent, but the increase in investment spending was mainly driven by import-intensive investments in foreign machinery and equipment (up by 23 percent year-on-year) and foreign transportation (up by 60 percent year-on-year). These high growth rates are consistent with strong investment lending and capital goods imports data discussed further below.

...while weak external demand subtracted from growth for the third successive quarter

After showing no growth in the first quarter of 2012, real exports fell by 0.7 percent in seasonally adjusted terms in the second quarter. However, imports were stronger than expected, with seasonally-adjusted quarter-on-quarter growth of 4.9 percent, reflecting strong investment demand for intermediate inputs from overseas. As a result, net exports were a drag on quarterly GDP growth for the third successive quarter, subtracting a sizable 2.2 percentage points on a seasonally-adjusted quarter-on-quarter basis. This was larger than the drag on GDP from net exports in Q1 2012 and Q4 2011 of 0.3 and 1.5 percentage points, respectively. Import growth is, however, likely to drop off in the second half of the year, as weaker exports reduce the need to import capital and intermediate inputs.

Figure 6: GDP growth increased to 6.4 percent in the second quarter of 2012...

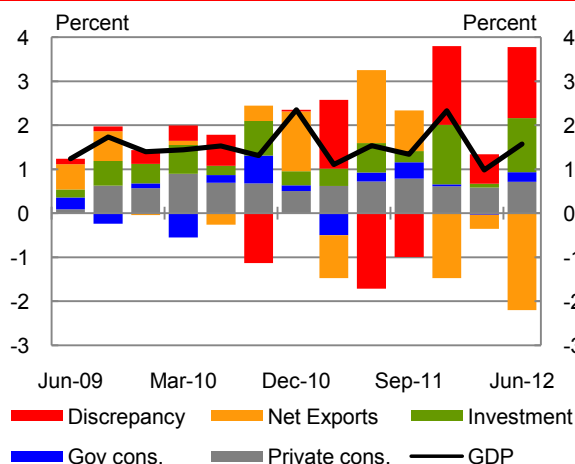
(real GDP growth, percent)



Note: * Average quarter-on-quarter growth since Q2 2002
Source: BPS and World Bank staff seasonal adjustment

Figure 7: ...driven by an acceleration in investment growth while net exports were a large drag on growth

(real QoQ sa GDP growth, percent)



Source: BPS and World Bank staff seasonal adjustment

Growth on the production side was driven by the service sectors, offsetting weakness in the manufacturing, mining and agricultural sectors

On the production side, the major drivers of growth were the service sectors, while the contribution to growth from the manufacturing, mining and agricultural sectors weakened. Services growth rose by 2.1 percent in seasonally adjusted terms in the second quarter to be 8.1 percent year-on-year in Q2, led by wholesale and retail trade whose growth moved up to 9.8 percent in Q2. This performance was partially offset by the deceleration of almost all types of manufacturing activity, with growth in the sector edging lower to 5.4 percent year-on-year from 5.7 percent year-on-year in Q1. However, transport equipment and machinery, the largest of the manufacturing subsectors, resisted the pressures of a softening global environment to record the largest quarterly growth in five years, at 11.7 percent year-on-year.

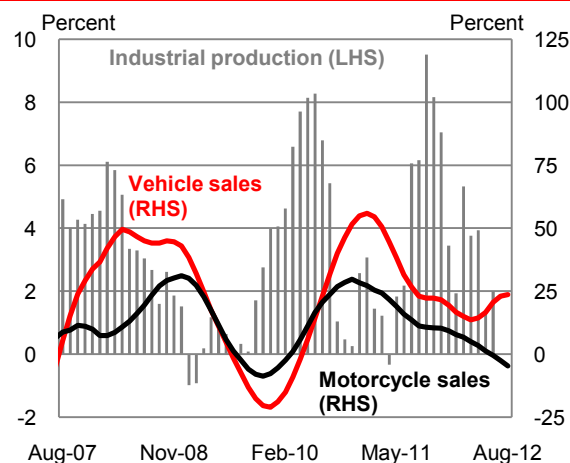
In the baseline scenario Indonesia's GDP growth is projected at 6.1 percent in 2012 and 6.3 percent in 2013...

A number of partial indicators have fallen significantly recently, suggesting that there may be some moderation in economic activity (Figure 8), but it is too early to tell how much of the decline was due to the usually large seasonal impact of Ramadan.

The stronger than expected performance of the domestic economy in the first half of 2012, which saw average growth of 6.3 percent year-on-year, more than offsets the recent weakness in the external sector outlook, leading to a slight improvement in the baseline 2012 growth projection. As a result, GDP growth in 2012 is forecast at 6.1 percent (an upward adjustment by 0.1 of a percentage point from the projection in the July IEQ). The outlook for 2013 remains for a slight rise in growth to 6.3 percent as the external environment improves somewhat. This represents a slightly lower projection than in the July IEQ due to the small downward revision in Indonesia's major trading partner growth, following cuts in the outlook for China, the US and the Euro Area.

Figure 8: Some high frequency activity indicators show signs of moderating

(year-on-year change in 3-month moving average of industrial production, car and motorcycle sales)



Source: CEIC and World Bank staff calculations

...with risks to the outlook remaining heavily skewed to the downside

As discussed in the final section of Part A below, the risks to the outlook remain heavily skewed to the downside and in the event of more severe adverse shocks to international financial markets, commodity prices or external demand, domestic growth could come in considerably below these baseline projections. Already, anecdotes have surfaced on the spillovers into some corporate production and profits from lower commodity prices and if this were to become pervasive this would have a negative impact on the domestic consumption and investment projections.

Table 3: Under the baseline scenario GDP growth of 6.1 percent is projected for 2012, rising to 6.3 percent in 2013 (percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual	
	2011	2012	2013	2011	2012	2013	2012	2013
1. Main economic indicators								
Total Consumption expenditure	4.5	5.4	5.3	4.6	5.8	5.0	0.6	0.3
Private consumption expenditure	4.7	5.0	5.1	4.9	5.1	4.9	0.5	0.3
Government consumption	3.2	8.2	6.5	2.8	9.8	5.9	1.4	0.5
Gross fixed capital formation	8.8	12.3	11.2	11.5	13.4	10.1	2.7	1.2
Exports of goods and services	13.6	2.8	5.7	7.9	0.8	7.6	-3.6	-2.0
Imports of goods and services	13.3	7.1	4.7	10.1	2.5	8.2	-0.5	-3.3
Gross Domestic Product	6.5	6.1	6.3	6.5	5.7	6.6	0.1	-0.1
Agriculture	3.0	3.9	3.5	4.1	3.4	3.6	0.4	0.2
Industry	5.3	5.0	5.0	5.3	4.4	5.4	0.0	-0.3
Services	8.5	7.8	8.1	9.0	7.9	7.6	0.0	-0.1
2. External indicators								
Balance of payments (USD bn)	11.9	-7.0	3.3	n/a	n/a	n/a	-10.0	-7.5
Current account balance (USD bn)	1.7	-21.2	-16.4	n/a	n/a	n/a	-13.3	-11.8
Trade balance (USD bn)	24.2	0.2	6.8	n/a	n/a	n/a	-11.1	-8.9
Financial account balance (USD bn)	13.4	15.9	19.7	n/a	n/a	n/a	4.6	4.3
3. Other economic measures								
Consumer price index	5.4	4.4	5.1	4.1	4.9	5.1	0.0	0.0
Poverty basket Index	8.2	6.8	7.1	6.3	6.5	7.4	0.2	-0.4
GDP Deflator	8.4	6.5	7.9	7.5	7.4	8.0	-0.7	-0.2
Nominal GDP	15.4	13.0	14.8	14.5	13.5	15.1	-0.7	-0.3
4. Economic assumptions								
Exchange rate (IDR/USD)	8773	9350	9400	9024	9400	9400	50	300
Indonesian crude price (USD/bl)	112	115	100	111	113	105	5.0	0.0
Major trading partner growth	3.6	3.3	3.6	2.6	3.8	3.9	0.0	-0.1

Note: Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices due to differences in price series. Revisions are relative to projections in July 2012 IEQ
Source: MoF, BPS, BI, CEIC and World Bank projections

3. The current account deficit widened markedly in the second quarter of 2012

A rising current account deficit in the second quarter of 2012 more than offset improved financial account inflows to result in overall balance of payment outflows for the fourth consecutive quarter

Overall balance of payment outflows of USD 2.8 billion in the second quarter of 2012 were at a similar level to the average seen in the previous three quarters. However, divergent trends were seen in the current and financial accounts. The current account deficit of USD 6.9 billion was more than twice the level seen in Q1 2012, while financial account inflows also doubled, reaching USD 5.5 billion (Figure 9).

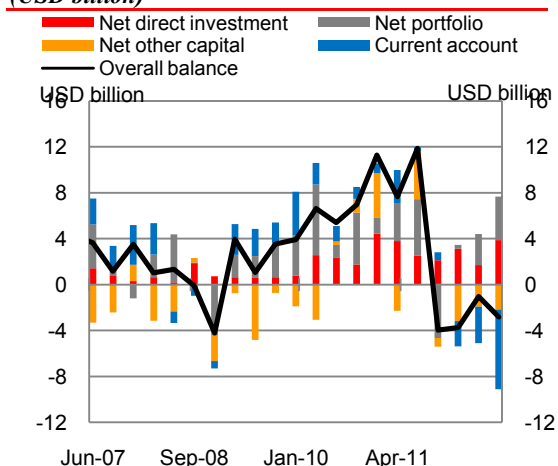
Within the financial account, net portfolio investment flows improved to USD 3.8 billion, in part due to the Government's USD 2.5 billion global bond issue in April but also due to inflows to private sector portfolio assets. Although there were outflows from local equity holdings, large inflows to private debt securities were seen (USD 2.8 billion, just below the level seen in the whole of 2011). Other investment outflows rose slightly to USD 2.2 billion while net direct investment flows also picked up to USD 3.9 billion. This was mainly due to a fall in direct investment abroad, while FDI inflows dropped relative to the previous quarter, as discussed below.

The trend weakening of the trade and current account balances was amplified by falling commodity prices and weaker external demand

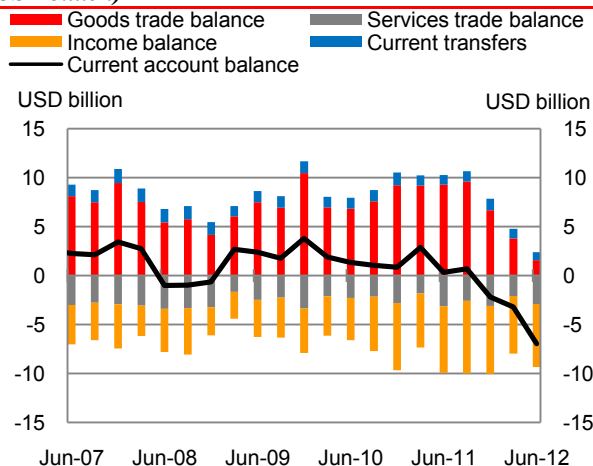
The recent rise in the current account deficit, reaching 3.1 percent of GDP in the second quarter of 2012, has been due to the decline in the goods trade surplus (Figure 10). With the oil deficit offsetting the surplus for gas, this is driven by the deterioration of the non-oil and gas trade balance. As highlighted in Part B of the July 2012 *IEQ*, the trend decline in the trade surplus reflects the support for domestic imports from strong domestic demand set against relatively weaker external demand. In addition, the drop off in commodity prices in the second quarter of 2012 further pulled down exports. Other regional economies have seen similar falls in their current account balances, particularly in Malaysia and Thailand which are also relatively dependent on commodity exports, although pick-ups were seen in the second quarter for China, Korea and Malaysia (Figure 11).

The picture across other current account flows was similar to the preceding quarter. The deficit on the services account remained relatively large, primarily due to transportation services (supported by imports). Income outflows, which have tracked the rise in FDI inflows in recent years, picked up slightly while current transfers were broadly unchanged.

Figure 9: Balance of payment outflows were again dominated by a rise in the current account deficit (USD billion)



Source: BI

Figure 10: The narrowing in the trade surplus contributed to the rise in the current account deficit...**(USD billion)**

Source: BI

Goods exports have stayed weak, keeping the cumulative trade balance close to flat so far in 2012

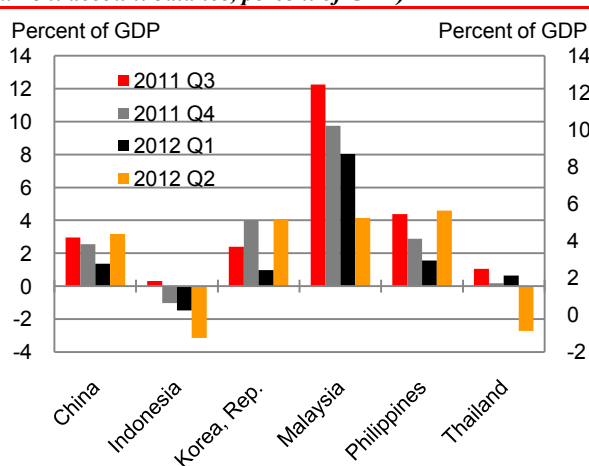
The monthly goods trade deficit widened sharply in June to USD 1.3 billion as exports declined almost 9 percent on the month. Commodity price declines played a role but also volumes, reflecting weaker external demand which, as detailed in Part B, has also led to a drop in non-resource-related manufacturing exports. The imposition of the new regulations on mineral exports also contributed to marked falls in mineral exports in June. Since then the trade balance has improved, with a deficit of USD 264 million in July and a small surplus of USD 249 million in August. This has reflected the recovery in some commodity prices but also softening in imports, in part because of the share of imports (capital and intermediate goods) related to exports. Holiday-related effects may have also played a role in August. Overall, the trade balance in the first eight months of 2012 reached USD 497 million versus USD 19.8 billion in the corresponding period of 2011.

Closer inspection of the available detailed monthly trade statistics shows that the decline in exports in recent months has been broad-based but led by gas, copper, rubber and coal. The continued strength in imports through July was attributable mainly to intermediate and capital goods, notably including machinery and components for automotive production. The growth of the domestic automotive industry has been reflected in the pattern of imports by countries so far in 2012. Imports were dominated by Japan, comprising mostly machinery and automotive parts. Automotive and parts imports from Thailand were also a significant source of total import growth. More broadly, China continues to be an important supplier of capital and intermediate products to Indonesia, second only to Japan.

The rise in the current account adds to the importance of supporting FDI inflows, which, although still relatively strong, have come down somewhat in recent quarters

As discussed in Part B of the July 2012 *IEQ*, the weakening in the trade balance and movement to a current account deficit places greater pressure on securing stable external financing sources, in particular FDI. The sum of the current account and direct investment balances (the “basic balance”) turned negative in first two quarters of 2012, indicating the importance of policy measures to promote further FDI inflows and support portfolio investor confidence.

FDI inflows on the balance of payments in the second quarter of 2012, although a solid USD 3.7 billion, continued their gradual fall from a high of USD 5.4 billion in Q4 2011. The higher levels of FDI seen in H1 2012 compared to the same period in 2011 were sustained by non-mining investments, while mining-related foreign investment was flat on H1 2011 levels, likely reflecting the more cautious global outlook for commodities but also possibly the impact of new mining sector regulations in Indonesia. Foreign direct investment remains well diversified, with mining, manufacturing and utilities accounting for most of the second quarter’s inflows.

Figure 11: ...with current account deteriorations also seen in a number of regional peers**(current account balance, percent of GDP)**

Source: Haver Analytics, BI and World Bank staff calculations

The deterioration in the current account has prompted some proposed policy measures...

In response to the deterioration in the current account deficit in the second quarter figures, Bank Indonesia and the Government announced a number of policy responses to adjust the current account deficit to “a sustainable level to support the momentum of the national economy”. For example, Bank Indonesia indicated it would focus on stabilizing the Rupiah “in accordance with its fundamental conditions” and will take measures to manage credit growth and deepen the foreign exchange market. The measures announced by the Government include support for boosting exports but also steps aimed at limiting dependence on imports and supporting domestic production, such as a proposal for a tax holiday policy aimed at encouraging investment to produce capital goods and regulations to reduce “dependence on imports for finished goods”.

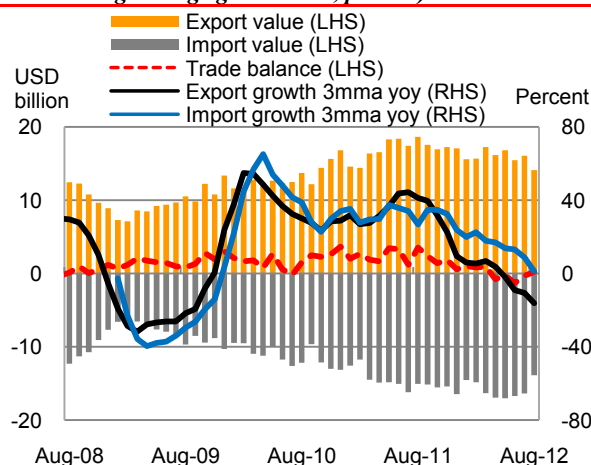
...but it will be important to ensure that policies remain supportive of continued domestic and foreign investment

It will be important that any policy response is appropriate. For example, when looking at the near-term outlook for the current account, it is important to take into account the natural falls in imports mentioned above as exports weaken. Measures aimed at import substitution, for example, on capital goods, would likely only have any impact with a lag, may not be effective and could actually limit the benefits that domestic firms gain from using imported intermediates, such as accessing a wide range of technology or benefiting from cheaper costs or better quality (see Part C in the July 2012 IEQ).

Furthermore, any new policies should not introduce additional uncertainty into the direction of trade and investment policy-making and thereby put more pressure on external balances. Allowing for a gradual weakening of the exchange rate, as has been seen recently, could facilitate an improvement in the trade balance through promoting a relative price adjustment which supports export performance and makes imports more expensive. In addition, continued progress on key structural reforms, such as upgrading infrastructure and the regulatory environment, can both support domestic competitiveness – lifting the economy’s export potential while also limiting imports’ competitiveness against local firms – and investor confidence.

Figure 12: Falls in export growth have been followed by declines for imports

(value of goods trade, USD billion; year-on-year growth of 3-month moving average goods value, percent)



Note: 3mma is three month moving average. Data on growth of imports, including imports to Special Economic Zones, only available from January 2009

Source: BPS and World Bank staff calculations

A full year balance of payments deficit is projected for 2012 but a return to surplus is forecast for 2013

A full-year current account deficit of around USD 21bn is projected for 2012, equivalent to approximately 2.3 percent of GDP. In 2013 we project the current account deficit to narrow to 1.6 percent of GDP on the back of a recovery in the trade surplus, reflecting a pick-up in major trading partner economic growth and the impact of the depreciation of the Rupiah to date. The outlook for the overall balance of payments hinges on potentially volatile net portfolio inflows. In the base case, where FDI holds up and contributes to strong total financial inflows, the overall balance of payments deficit seen this year is projected to close in 2013.

Table 4: A narrowing in the trade surplus will move the current account into deficit for 2012 as a whole
(USD billion)

	2009	2010	2011	2012	2013
Overall Balance of Payments	12.5	30.3	11.9	-7.0	3.3
Current Account	10.6	5.1	1.7	-21.2	-16.4
Trade	21.2	21.3	24.2	0.2	6.8
Income	-15.1	-20.8	-26.6	-24.9	-27.3
Transfers	4.6	4.6	4.2	3.5	4.0
Capital & Financial Accounts	4.9	26.6	13.4	15.9	19.7
Direct Inv.	2.6	11.1	11.5	10.1	10.0
Portfolio	10.3	13.2	3.9	10.5	10.0
Other	-8.2	2.3	-2.1	-4.7	-0.3
Reserves^(a)	66.1	96.2	110.1	110.2	n.a.

Note: Errors and omissions not shown. ^(a) 2012 reserves as of end-September

Source: BI and World Bank staff projections

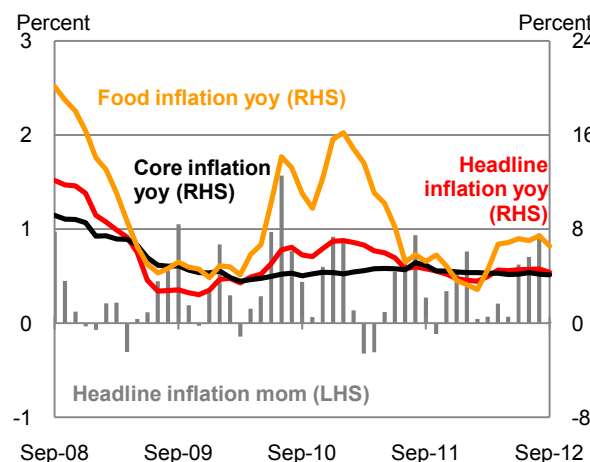
4. Inflationary outcomes have remained moderate

Headline year-on-year inflation moved down to 4.3 percent in September 2012 while core inflation remained stable at just above 4 percent

Headline CPI inflation eased to 4.3 percent year-on-year in September 2012, down 0.3 percentage points from its level in July and August (Figure 13). Core inflation, a better measure of underlying consumer price pressures, remains relatively low and stable, moving down slightly to 4.1 percent in September. The stability of headline inflation, amidst still robust economic growth, suggests that inflation expectations have, to date, been contained in the absence of large administered price shocks and subdued commodity price shocks, offsetting any pass-through from the nominal currency depreciation over the year. However, it will be important to watch for signs of future inflationary pressures in the general economy and in particular sectors, for example, certain property markets which have seen strong recent increases.

Figure 13: Headline and core inflation remain at historically low levels

(price inflation, percent)



Note: yoy is year-on-year and mom is month-on-month
Source: BPS and World Bank staff calculations

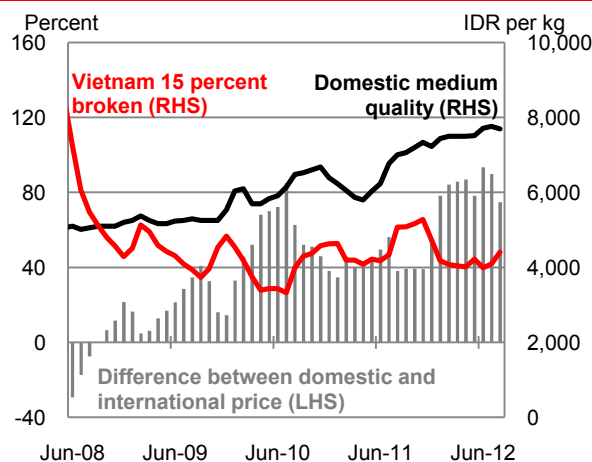
Food price inflation was lower than usual over the festive season

The gap between Indonesian and international rice prices, has fallen from the record highs in June

Near-term price expectations fell sharply, falling well below the levels seen before the run-up to Ramadan

Figure 14: The gap between Indonesian and international rice prices has come down from record levels earlier in 2012

(price difference, percent; wholesale rice price, IDR per kg)



Source: Cipinang Wholesale Rice Principal Market, Food and Agriculture Organization and World Bank

The year-on-year fall in headline inflation was mainly due to the fall in food price inflation to 6.6 percent in September. Stable domestic rice prices were the major factor that kept food inflation growth lower than usual during Ramadan. Rice price growth over the first nine months of 2012 was 3.1 percent, the lowest (along with 2009) of any calendar year since 2004. The fall in food price pressures led the poverty basket inflation rate down from 7.7 percent in June to 5.9 percent in September. Although rice price growth has been subdued throughout 2012, the price level remains at a record high and is 50 percent higher than the beginning of 2010 following large price shocks at the end of the year. The commencement of a new school year saw education costs increase by 2.9 percent over the month in August, while, with no changes in subsidized energy prices in more than a year, transport and household energy cost inflation remain moderate.

The gap between domestic and international prices of rice eased from their peaks in June (Figure 14). In September 2012, domestic wholesale rice prices were 65-76 percent higher (depending on quality) than comparable rice from international markets (from Thailand and Vietnam respectively), down from the record gap of 73-101 percent in February 2012. The reduction in the price gap was driven by three factors: a large increase in international rice prices (15 percent increase for low quality rice from Vietnam); the continuing depreciation of the Rupiah against the US dollar; and very low domestic rice price growth due to improved production.

As in previous years, after the Ramadan period, consumer price expectations came down sharply in August to levels significantly lower than what was seen in the months leading up to the holiday period. According to BI's survey, more respondents compared to last month believe prices in three and six months will fall as certain foods enter the harvest period and the distribution of goods throughout the country improves. The balance of respondents expecting higher prices eased most for food, followed by clothing.

CPI inflation is projected to rise to 4.9 percent year-on-year in the final quarter of 2012, towards the upper end of BI's target range of 4.5 ± 1 percent, and to move slightly higher in 2013

Under the baseline outlook, CPI inflation is projected to rise to 4.9 percent year-on-year in the final quarter of 2012 reflecting continued high levels of credit growth, still solid domestic demand and some pass-through to higher import prices of the depreciation of the Rupiah against the US dollar. It is estimated that a 10 percent depreciation in the Rupiah against the USD is associated with roughly a 0.5-1 percentage point rise in headline inflation over the quarter. The forecast is moving towards the upper end of Bank Indonesia's target range of 4.5 ± 1 percent. Annual CPI inflation for 2012 as a whole is projected to be 4.4 percent.

In 2013, inflation is projected to move up to 5.1 percent for the year as a whole, on the back of stronger consumer demand, strengthening consumer credit growth and the depreciation of the exchange rate. There are downside risks to this forecast should the external environment deteriorate further (although the effects could be offset by higher import prices if it is accompanied by a weakening in the exchange rate). The path for administered prices is also key to the outlook, with the baseline forecasts assuming no energy price rises. However, the draft 2013 Budget currently under discussion in Parliament does incorporate a proposed 15 percent increase in electricity prices, in quarterly steps, although there is no proposal on fuel price reform. The results of a good harvest earlier in the year have driven the poverty basket inflation forecasts lower to 6.5 percent in Q4 2012 and to 7.4 percent in the final quarter of 2013.

GDP deflator growth has fallen to the lows seen during the global financial crisis as investment price growth eased

The broad level of prices in the economy, as measured by the GDP deflator, rose by 5.7 percent year-on-year in Q2 2012, the lowest rate since 2009. This was due to investment prices growing by only 0.1 percent in Q2, the lowest seasonally-adjusted quarterly growth in over a decade. GDP deflator inflation is projected to rise through the rest of 2012 to reach 6.5 percent for the year as a whole (with the low first half outcomes contributing to the downward revision in the forecast). In 2013, annual GDP deflator growth is expected to continue rising, reaching 7.9 percent on the back of faster economic growth and continued strong credit conditions, but remaining well below the 14.5 percent average seen in the 4 years prior to the global financial crisis.

5. Equities rallied in the third quarter and rapid credit growth continues

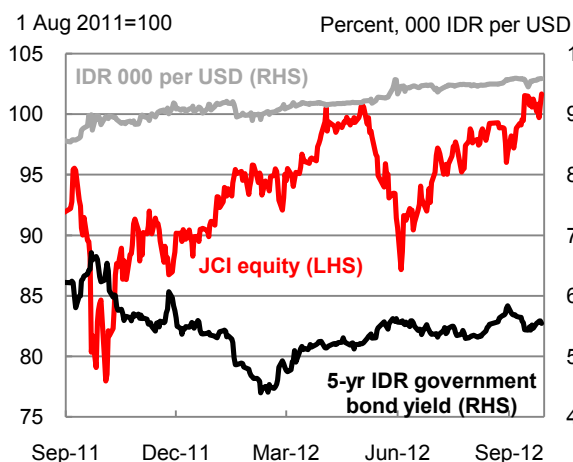
Indonesian equities had a strong quarter while the performance of the bond market was more mixed

Indonesia participated fully in the global equities markets rally of the third quarter. The JCI equity index rose close to 8 percent on the quarter, compared with 7.3 percent for the US S&P 500 index (in Rupiah terms), more than recouping its second quarter losses. This rally was fueled by strong net equity purchases of IDR 14.4 trillion by non-resident investors, after net sales in the previous quarter. Domestic sovereign bond yields trended higher and were up on the order of 50 basis points in late August along with a weaker Rupiah but, with the rise in international risk appetite, bond prices subsequently recovered. The 5 year benchmark yield ended the quarter at 5.5 percent (Figure 15).

The Rupiah continued to depreciate modestly against the US dollar

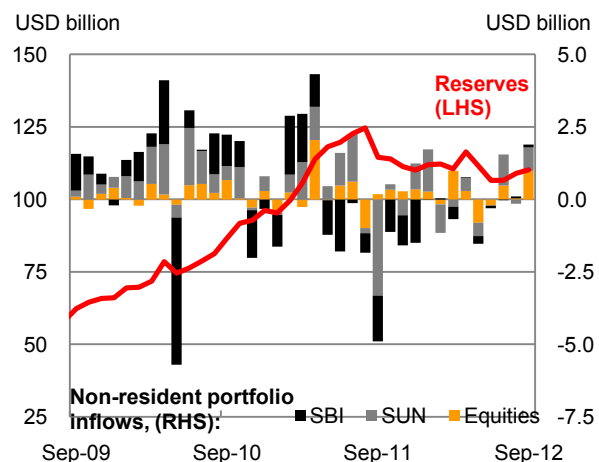
The Rupiah continued its recent depreciation against the US dollar, weakening by 1.5 percent over the quarter, for a year-to-October depreciation of 5.7 percent. While the Rupiah had tended to underperform other Asian currencies so far in 2012, the recent weakening was similar to that seen in some other major commodity exporters, such as Brazil and South Africa. The depreciation, which as mentioned above should facilitate the adjustment of Indonesia's trade balance, reflects a policy choice by Bank Indonesia to intervene only on a selective basis to smooth currency market fluctuations. Indeed, BI appears to have used the strong recovery in portfolio inflows in September to rebuild its foreign reserves, which rose by USD 3.7 billion in the third quarter (Figure 16). Taking into account Indonesia's somewhat higher inflation rate than its major trading partners, the depreciation of the currency remains modest in real terms. The (CPI-weighted) real effective exchange rate at the end of August was 5.7 percent lower than its post-financial crisis peak in August 2010.

Figure 15: Indonesian equities showed strong gains in the third quarter but the weakness in the Rupiah persisted... (equity index, 1 August 2011=100; IDR per USD; yield, percent)



Source: CEIC World Bank staff calculations

Figure 16: ...although net foreign purchases of equities and bonds picked up strongly in September (USD billion)



Note: "Flows" for SUN (IDR government securities) and SBI (BI certificates) indicate changes in holdings
Source: BI, CEIC and World Bank staff calculations

With stable inflation, BI is focused on supporting growth while managing currency volatility and limiting inflation expectations

With inflation returning back below the midpoint of its 4.5 percent +/- 1 percent target for 2012 in September, Bank Indonesia indicated in its September monetary policy statement that it had space to focus on continuing to —...tain external balance in a gradual manner". The challenge for BI will be to balance the need to continue to support growth in the face of global economic conditions which are expected to remain soft in the near-term, while capping any short-term inflation pressures due to a pass-through from the weaker Rupiah. In its recent 2012 Article IV report on Indonesia, the IMF encouraged BI in particular to act to normalize liquidity conditions to reign in any nascent inflation pressures and financial sector risks. In respect of both such liquidity management and for monetary policy more broadly, a key uncertainty is the impact of renewed monetary expansion by major global central banks. Should this activity result in more portfolio investment inflows, BI may need to guard against an excessive rise in onshore dollar liquidity and asset price inflation. However, this outcome is far from certain given the still fragile global economic backdrop.

Overall banking sector performance continues to be robust

The banking sector's system-wide performance continues to be solid and key financial soundness indicators remain robust. As of June 2012, the Capital Adequacy Ratio (CAR) was maintained at above 17 percent, the aggregate loans-to-deposits ratio was 83 percent, while the level of non-performing loans (NPLs) remained low, at 2.2 percent. Banking industry profitability as measured by the return on assets and the return on equity stood at 3.2 percent and 18.2 percent, respectively.

Loan growth remains strong and is near recent highs in real terms...

Loan growth in July was a rapid 26.6 percent year-on-year (12.3 percent year to date). Investment loans, up 30 percent year-on-year in July, have led this growth with working capital loan growth close behind, at 27 percent and consumption loan growth lower but still 18.9 percent (Figure 17). There has also been a sizeable rise in the level of private external debt recorded by BI, reaching USD 123.7 billion (up 30 percent on the level of USD 96.5 billion at the end of July 2011). The increase is attributable in part to better compliance with external debt reporting obligations following increased enforcement by BI since mid-2011, but also to robust external corporate bond issuance, as well as the provision of subsidiary financing by offshore holding companies.

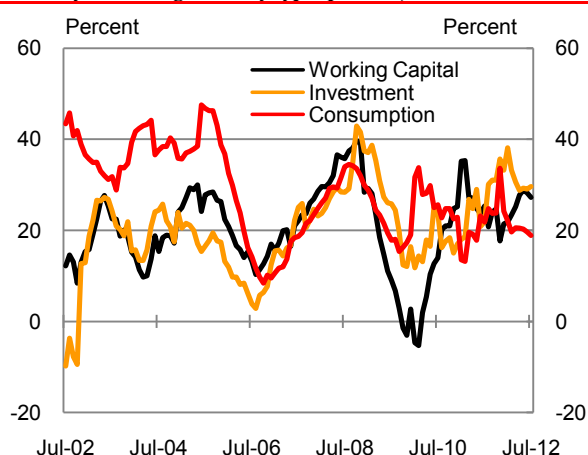
...which will be important to monitor going forward, as well as potential financial sector spillovers from the downturn in exports and commodity demand

The fact that the fastest credit growth has been for investment and working capital, rather than for consumption, has tended to allay concerns about the sustainability of the current robust pace of credit growth, even for an under-banked economy such as Indonesia's. To the extent that this credit is effectively utilized to raise the domestic capital stock and lift potential growth, the rapid pace of lending is good for long-term economic growth. However, it does appear that real credit growth (adjusting for contemporaneous inflation)

is back to the peaks last seen in 2004 (Figure 18), and the pace of lending, and credit quality controls, merit careful monitoring. The same is true for private external dynamics, since while the private external debt stock remains low and external debt vulnerability metrics are benign, private external borrowing has been increasing and now exceeds public external debt.

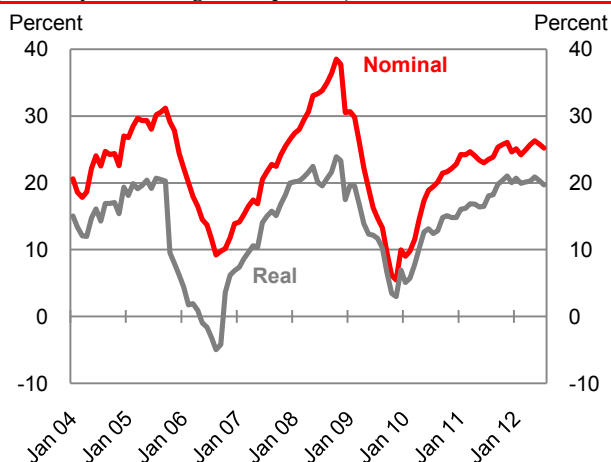
It will also be important to watch for any further signs of spillovers from the downturn in exports to the strength of the cashflows and balance sheets of Indonesian financial institutions and corporates. For example, media reports indicate that some large coal producers and shipping companies, both of which have been affected by weaker external demand and commodity prices, have recently come under financial pressure, for example, undertaking restructuring plans with their banks. In the non-bank financial sector, leasing companies which provide capital for expenditures such as heavy equipment for the mining sector may also be impacted by the reduction in demand.

Figure 17: Credit growth remains rapid, led by investment and working capital loans...
(year-on-year loan growth by type, percent)



Source: BI and World Bank staff calculations

Figure 18: ...with estimated real credit growth around previous highs
(year-on-year credit growth, percent)



Note: Real is ex post deflated by CPI

Source: BI, CEIC and World Bank staff projections

The transition process to the new financial regulator, the OJK, continues

The above developments take place within the transition period to the new Indonesia Financial Services Authority (*Otoritas Jasa Keuangan*, or OJK). As outlined in the October 2011 *IEQ*, the OJK will integrate the capital markets and non-bank supervision functions, currently carried out by Bapepam-LK, with the bank supervision and regulation functions currently performed by Bank Indonesia. The capital markets and non-bank financial institution supervision will transfer to OJK in January 2013, and banking supervision responsibilities in January 2014.

In preparation, the Government of Indonesia has taken a number of steps to facilitate the successful establishment of OJK, including supporting efforts to maintain current supervisory capacity during the transition process and drawing on international experiences in regulatory reform. In addition, in July 2012 the OJK Board of Commissioners was appointed in accordance with the timeline set forth in the OJK law and the Board members have taken up their responsibilities. The Board also has adopted an initial organizational structure plan for the OJK. Priority next steps for the establishment of OJK will include completing the adoption of HR policies and appointment of key positions and finalizing internal management systems. Concurrently, the OJK and other financial sector authorities continue to work on implementing Indonesia's medium-term financial sector reform agenda, including prioritizing the implementation of revised crisis management protocols, supporting financial sector diversification, and promoting financial inclusion for the underserved.

6. The fiscal position remains solid but risks have risen

Though Indonesia's fiscal position continued to be solid in Q3 2012, downside fiscal risks have risen with energy subsidy costs rising and a moderation in revenue collection

The overall budget balance recorded a deficit of IDR 35 trillion in the first eight months of 2012. This is well below the full-year revised Budget deficit target of IDR 190 trillion or 2.2 percent of GDP (Table 5) but expenditure and hence the budget deficit tend to rise towards the end of the year. Indeed, in 2010 and 2011, when small full-year budget deficits were recorded, the central government balance was in surplus from February to November. The cumulative deficit registered so far in 2012 reflects higher energy subsidy disbursements and a slight moderation in revenue collection. On the positive side, the Government's financing plans are on track, with 76 percent of gross issuance needs for the year having been met by mid September.

Table 5: The deficit is set to rise, though government financing plans are well on track
(budget deficit, primary deficit, net financing, percent of GDP)

	2010			2011			2012		
	Revised Budget	Actual	Realization end-August	Revised Budget	Actual	Realization end-August	Revised Budget	MoF SI Projection	Realization end-August
Overall balance	-2.1	-0.7	0.7	-2.1	-1.1	0.6	-2.2	-2.3	-0.4
Primary balance	-0.4	0.6	1.6	-0.6	0.1	1.4	-0.8	-0.9	0.4
Net financing	2.1	1.4	1.2	2.1	1.7	1.0	2.2	2.3	1.3

Note: SI is MoF Semester I projection

Source: MoF and World Bank staff calculations

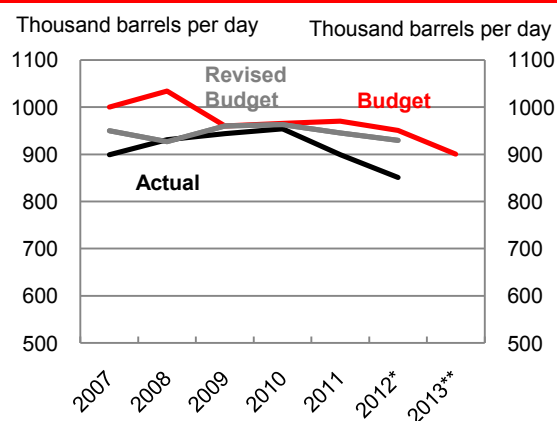
Revenue collection moderated, driven by lower receipts related to exports and commodities

In the year to end-August, revenues reached 59 percent of the full-year revised Budget target (IDR 798 trillion), up 11 percent on the same period last year. However, this level of nominal growth was lower than previous years, reflecting weaker external demand and lower receipts related to export and commodities. Non-oil and gas income tax revenues grew by only 10 percent, compared to 18 percent in the same period last year, reflecting moderation in export and commodity related business activity. Export duties through August dropped by 30 percent compared to 2011, as weaker global demand depressed prices of such as crude palm oil. However, value added taxes performed relatively strongly, supported by solid consumption growth in H1 (Table 6). Non-tax revenues, which made up a quarter of total revenues and largely comprise resource revenues, also moderated on the back of lower than expected oil production (Figure 19).

Rising energy subsidy spending adds pressure to the near term fiscal outlook

Overall the rate of expenditure disbursement has increased, largely driven by higher energy subsidy spending. Total expenditure in the first eight months of 2012 was IDR 833 trillion, up by 23 percent compared with the same period in 2011, while more than two-thirds of the full-year allocation to energy subsidies had been realized (Table 6). The revised 2012 Budget allowed the scope for a hike in subsidized fuel prices if the six month average of the Indonesian Crude Oil Price (ICP) reached USD 121 per barrel (15 percent above the ICP budget assumption). This condition is highly unlikely to be met, even with the ICP rising from USD 99 per barrel in June to USD 112 in August. In addition, the proposed electricity tariff increase in 2012 was also not approved by Parliament earlier in the year. The absence of energy subsidy reform is likely to lead to an overspending on energy subsidies and a continuation of their considerable opportunity cost (see April 2012 IEQ for further discussion). The Government has projected that energy subsidy spending

Figure 19: Lower than projected oil production has contributed to lower non-tax revenue
(Oil production, thousand barrel per day)



Source: MoF (Financial Note and Semester I report)

Note: * Data are up to August. ** proposed Budget

will reach IDR 306 trillion in 2012, exceeding the allocation in the revised Budget by IDR 94 trillion (or 44 percent). The Government's policies to restrict subsidized fuel consumption appear to have had little overall impact so far. The volume of subsidized fuel is expected to exceed the quota of 40 million KL allocated in the revised Budget on the back of rapid growth of vehicles and the significant price differential between the market and the subsidized gasoline prices; the Parliament recently approved an additional 4 million KL of subsidized fuel for the year.²

Table 6: Budget disbursement rates through the end of August have improved
(Budget realization by end-August)

	Nominal value by end August (IDR trillion)			As share of full year revised Budget levels (percent)			Nominal growth relative to Jan - Aug in previous year (percent)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
State revenue and grants	603	719	798	60.8	61.4	58.7	21.0	19.2	11.0
Tax Revenues, of which	448	535	615	60.3	60.9	60.5	15.6	19.5	14.9
Non oil & gas income tax	197	232	256	64.1	63.4	57.4	13.7	18.1	10.1
Value added tax	137	157	204	51.9	52.7	60.8	20.9	15.2	29.9
Export tax	3	21	15	52.7	82.7	63.9	461.3	632.7	-29.6
Non Tax Receipts	155	182	181	62.5	63.5	53.1	39.7	17.7	-0.4
Expenditure	557	678	833	49.4	51.3	53.8	7.1	21.8	22.9
Central Government, o/w	348	432	533	44.6	47.5	49.8	4.7	23.9	23.4
Personnel	98	125	137	60.1	68.5	64.7	8.8	28.2	9.6
Material	45	52	63	40.0	36.6	33.7	21.8	16.1	20.4
Capital	27	37	51	28.7	26.1	30.4	-11.1	35.3	39.3
Energy subsidy	73	114	155	50.9	58.3	76.4	69.4	55.5	35.8
Social assistance	31	24	42	44.0	29.5	76.2	-6.2	-22.9	74.6
Transfers to Regions	208	246	300	60.4	59.7	62.7	11.2	18.2	21.9

Source: MoF and World Bank staff calculations

Budget disbursement of core spending programs has improved, but under-spending remains a challenge

Disbursements for capital spending have increased but remain below the targets. Capital spending reached IDR 51 trillion in the year through August, 40 percent higher than over the same period last year. Material expenditure reached IDR 63 trillion, up by 20 percent from last year. Social expenditures also improved, as more than two-thirds of the allocation has been disbursed. These improvements reflect efforts being made by line ministries and the Budget Execution Task Force (*Tim Evaluasi dan Percepatan Penyerapan Anggaran, TEPPA*), to monitor and accelerate budget execution in 2012. Despite these improvements, both capital and material disbursement levels are still well below the 50 percent H1 target set by TEPPA, reflecting ongoing, long-standing challenges in budget execution. These include administrative delays prior to project implementation such as delays in the appointment of implementing unit (*Satker*) personnel, the complex budget revision process, and lengthy procurement processes. TEPPA indicated that procurement had not been completed for 47 percent of projects (53,000 out of 115,000 identified packages/projects) six months into the fiscal year.

Progress has been made on preparing for any potential crises in the government securities market

Meanwhile, as part of its effort to enhance crisis preparedness, the Government has revealed a Crisis Management Protocol (CMP), to enhance responsiveness in the case of a crisis in the local currency bond market. The indicators to be monitored to determine the level of any crisis include: the benchmark yield on Government securities, the exchange rate, the Jakarta Composite Index (JCI), and the share of foreign ownership in Government securities. The policies proposed to address a crisis include re-purchasing Government securities in the secondary market and postponing or stopping the issuance of Government securities.³

² <http://www.bphmigas.go.id/>

³ <http://www.dmo.or.id/dmodata/6Publikasi/4Presentasi/2012/Investor%20Presentation%20-%207%20September%202012.pdf>

Table 7: Higher energy subsidy spending and moderation in revenue collection is likely to push up the deficit in 2012
(IDR trillion, unless otherwise indicated)

	2011	2012	2012 (p)	2012 (p)	WB October 2012 forecast Difference relative to:		
	Outcome	Revised Budget	MoF Semester I report projection	WB October 2012*	Revised Budget	MoF Semester I report	WB June 2012
Assumption on subsidized fuel price	No Change	Potential for IDR 1,500 hike if oil price high enough**	No Change	No Change			
A. State revenue and grants	1,211	1,358	1,362	1,340	-18.6	-22.7	4.8
1. Tax revenue	874	1,016	1,017	1,001	-14.8	-15.6	-2.0
2. Non-tax revenue	331	341	345	337	-3.6	-7.1	6.1
B. Expenditure	1,295	1,548	1,553	1,541	-6.9	-11.7	29.8
1. Central government, o/w	884	1,070	1,071	1,062	-7.8	-9.1	29.7
Personnel	176	212	206	204	-8.3	-2.2	0.0
Materials	125	187	170	160	-26.4	-9.8	-1.8
Capital	118	169	153	146	-22.8	-7.4	0.9
Subsidies, o/w	295	245	347	345	99.7	-2.1	16.8
Fuel subsidy	165	137	217	214	77.1	-2.3	16.5
Social	71	55	48	54	-1.7	5.8	0.7
2. Transfers to the regions	411	479	482	480	0.9	-2.6	-0.3
C. Primary balance	9	-72	-79	-84	-11.7	-5.1	-24.9
D. SURPLUS / DEFICIT	-84	-190	-191	-202	-11.6	-11.0	-24.9
As percent of GDP	-1.1	-2.2	-2.3	-2.4	-0.2	-0.1	-0.3
Economic growth (percent)	6.5	6.5	6.3-6.5	6.1	-0.4	N.A	0.1
CPI (percent)	5.4	6.8	4.8	4.4	-2.4	-0.4	0.0
Exchange rate (IDR/USD)	8,742	9,000	9250	9,350	350.0	100.0	50.0
Crude oil price (USD/barrel)	111	105	110	115	10.0	5.0	5.0
Oil production ('000 barrels/day)	898	930	900	900	-30.0	0.0	0.0

Note: *World Bank revenue estimates are based on a different methodology than the Government to derive projections for nominal GDP (see Part C of the June 2010 IEQ for a full discussion). ** the revised Budget includes the option of a IDR 1,500 fuel price increase provided the ICP price is on average, over a six month period, 15 percent above the revised Budget assumption of USD 105 per barrel

Source: MoF and World Bank staff calculations

The World Bank's projection for the budget deficit in 2012 is 2.4 percent of GDP, slightly higher than the revised Budget target of 2.2 percent

Revenue collection over 2012 is likely to be lower than targeted due to a projected moderation in income tax revenues and receipts from commodity-related activities, although value added tax should remain strong on the back of robust private demand. Expenditure is likely to exceed the level in the revised Budget, driven by significantly higher spending on energy subsidies due to an upward adjustment to the World Bank's ICP forecast (from USD 110 per barrel in the July IEQ to USD 115 per barrel).

As a result, the World Bank projection of the full-year 2012 deficit moves to IDR 202 trillion or 2.4 percent of GDP (Table 7). This is IDR 11 trillion higher than the Government's IDR 190 trillion target (2.2 percent of GDP) in the revised Budget. The Government has allocated contingency funds of around IDR 48.6 trillion for energy subsidy risks and compensation programs if the subsidized fuel price were to increase, and these can be used to meet the additional spending needs. This projection provides a clear indication of the fiscal risks associated with delaying subsidy reform, given current levels of oil prices, and the potentially rising opportunity cost of what is a regressive form of spending. In addition, should the international oil price trend higher, the risk of getting close to Indonesia's three percent of GDP deficit limit may prompt a tightening in spending in key development areas.

The Government submitted its proposed Budget for 2013 in mid-August

The Government and Parliament are currently discussing the proposed 2013 Budget and this is expected to be finalized by end-October. Amidst on-going global uncertainty, the proposed Budget foresees robust GDP growth in 2013 of 6.8 percent. Inflation is projected to stabilize at 4.9 percent. A fiscal deficit of 1.6 percent of GDP is targeted, lower than the 2012 revised Budget target of 2.2 percent. The proposed 2013 Budget foresees an increase in infrastructure and social spending (Box 1 outlines progress in creating a Unified Database to enhance targeting across social assistance programs). However, spending on energy subsidies will remain substantial as the proposals only incorporate a 15 percent electricity tariff hike. See Part B for a detailed discussion of the 2013 budget.

Box 1: The Unified Database—towards better targeted social assistance programs

As the poverty rate in Indonesia continues to fall, the remaining poor are farther and farther below the poverty line, making poverty reduction more difficult. The Government of Indonesia spends around 0.5 percent of GDP on household-targeted social assistance programs, which is low by regional and developing country standards. One way of strengthening poverty reduction efforts is to increase the amount of spending targeted at the poor. Another is to improve how many poor households benefit from these programs—that is, to improve the targeting of the programs. Until recently, the major social assistance programs, targeting the poorest 30 percent of Indonesian households, identified beneficiaries separately, with half of all target households being excluded from any one program. Since 2010, the Government of Indonesia has been planning and developing a new national targeting system which includes a unified registry of potential beneficiaries to be used to target all household social assistance. Using household data collected by Statistics Indonesia in 2011, *TNP2K*, or the National Team on Accelerating Poverty Alleviation, is now managing the new targeting system, *Basis Data Terpadu*, or Unified Database, which includes 25 million households, or just over 40 percent of Indonesians.

The Unified Database is now operational and has already been used to select 400,000 new beneficiaries for the 2012 expansion of *PKH*, Indonesia's pilot conditional cash transfer program. In addition, 76.4 million names have been sent to the Ministry of Health for the new distribution of *Jamkesmas* (health insurance for the poor) cards, and around 17.5 million households to local governments for targeting *Raskin* (subsidized rice for the poor). The Ministry of Education has agreed to use the Unified Database for the selection of *BSM* scholarship beneficiaries. In addition, the *TNP2K* team managing the registry has been working closely with various regional governments at both provincial and district level who have requested the data for local government social assistance and poverty alleviation programs. A number of such programs are currently active, financed by regional budgets. For some of these programs, such as *Jamkesda*, the local supplement to *Jamkesmas*, using the Unified Database to select beneficiaries provides the necessary coordination in targeting to avoid overlapping beneficiaries.

With previous targeting lists of the poor having been developed either with urgency (the list of the BLT cash transfer, last updated in 2005), or varying in implementation by district (*Jamkesmas* and *Raskin*), the use of the Unified Database is expected to significantly reduce the number of poor and vulnerable households which are excluded from social assistance programs, thus helping make current poverty reduction programs more effective. An important agenda item for the new targeting system being currently explored is developing an effective updating mechanism, to keep the database current over time.

Notes: This box draws on <http://documents.worldbank.org/curated/en/2012/02/15879721/protecting-poor-vulnerable-households-indonesia>. For more information on recent changes in the distribution of poverty, see the July 2012 *IEQ*.

7. External risks abound, bringing domestic policy responses into focus

Downside external risks to the outlook remain predominant...

While the recent policy support announced by the ECB has significantly reduced fears of a full-blown financial crisis in the Euro Area, the Euro Area economy remains in recession. The ultimate resolution of the crisis remains unclear, creating ongoing risks to global financial markets and the global economy. Meanwhile, near-term risks from the possibility of a further slowdown in China and other major emerging economies, including India, remain. Moving towards 2013, fiscal policy developments in the US will likely come into focus. Current legislation, unless modified, would impose a drag of around 5 percent of US GDP (although World Bank baseline forecasts assume a smaller cut of around 1 percent of GDP).⁴ Should any of these scenarios unfold in the near-term, their impact would likely stretch into 2013, keeping external uncertainty elevated, and hampering Indonesia's growth by undercutting the country's strong domestic demand dynamics through trade, commodity price and financial market channels.

...which, if realized, could push growth in 2013 significantly below the baseline projection

With risks remaining high into 2013 it remains important to evaluate the potential impact on Indonesia of such downside scenarios and to continue to make further efforts to improve crisis preparedness and resilience. The estimated impacts of more adverse global economic scenarios on Indonesia's growth remain similar to those elaborated in the July 2012 *IEQ*. In the event of a major freezing up of international financial markets, World Bank projections are that the spillovers to Indonesia from the consequent fall in global commodities, drop in trading partner growth and reduced domestic investor confidence could move Indonesia's growth in 2013 down to just below 5 percent in 2013. In a

⁴ World Bank October 2012 East Asia and Pacific Economic Data Monitor.

scenario in which such a crisis was accompanied, or indeed precipitated, a severe, prolonged global downturn encompassing the major emerging economies, it is projected that growth in Indonesia could drop to just below 4 percent.

Developments in China are of particular interest with concerns remaining over a further slowdown...

Should the particular risk of a further slowdown of China's economy occur, the impact on Indonesia, and the rest of the region, could be substantial. In particular, further declines in commodity prices and demand could spill over to the domestic investment which has been so supportive of Indonesia's growth in recent quarters. For example, the IMF's 2012 Article IV report finds that, incorporating direct and indirect trade effects and global commodity price impacts, a one percentage point reduction in China's growth could lower Indonesia's GDP by up to half a percentage point. However, as detailed in the World Bank's recent East Asia and Pacific Data Monitor, the risk of a hard-landing remains relatively small. This view reflects, for example, some recent improvements in activity and the scope for government investment spending to support activity.

...and a key uncertainty is the impact on capital flows to emerging economies, including Indonesia, of more global monetary stimulus

Another, more ambiguous, risk is posed by major central banks' renewed monetary policy response to the slowing in global economic activity in the second half of 2012. In 2010, monetary stimulus contributed to strong inflows to emerging market assets (including USD 13 billion in net portfolio investment to Indonesia alone) and helped lift global commodity prices. The impact of more quantitative easing by the US Federal Reserve and the Bank of Japan, and likely easing by other central banks, on global asset and commodity markets this time around remains uncertain at this stage. Weak fundamentals, notably slower growth in developing economies like China, and ongoing policy uncertainties, could temper inflows and the response of commodity prices.

Should inflows indeed pick up, they will bring new policy challenges for Indonesia. In particular, stronger inflows and a recovery in global growth in 2013, which would add further support to domestic asset prices and domestic demand, would tilt the balance of risks more towards overheating concerns. To date, although there are some areas which have seen pricing pressures rising, for example, in some property sectors, recent aggregate data are less definitive and near-term risks to growth are to the downside.

Domestically, the 2013 budget outlook is in focus, with disbursement challenges and subsidy spending remaining the key fiscal risks...

Following the missed opportunity to lift subsidized fuel prices in 2012, energy subsidy spending is projected by the Government to come in 44 percent higher than anticipated in the revised budget. The proposed 2013 Budget projects a further rise in fuel subsidy spending, and there are ongoing risks that costs will be pressured higher still by continued high domestic demand, any weakening in the currency or a rise in global oil prices. If subsidy spending were to increase further it could move the fiscal deficit higher or, for a given deficit level, crowd out other expenditures. Rising fuel subsidy spending, in terms of its opportunity costs for spending on more progressive transfer programs and public investment, for example, and its incentives for inefficient fuel usage also pose a medium-term risk to achieving Indonesia's sustainable and inclusive development objectives.

...and increased spillovers from the commodity sector slowdown are a key private sector risk factor...

The negative economy-wide effects of weaker demand for some of Indonesia's major commodity export products appear contained thus far. However, domestic investment has tended to be closely correlated with global commodity prices and the pace of investment growth may yet prove susceptible to external headwinds. Even if overall growth proves relatively robust to softer commodity prices, significant localized impacts could be felt by households and firms in regions highly dependent on commodities.

...while the overall policy environment will be in focus ahead of 2014 elections

Indonesia has made remarkable progress over the past decade in terms of macroeconomic and political stability. Improvements in the policy-making framework played an important role in supporting the sustained growth of recent years, despite international economic and financial turmoil. However, over the course of the past year, a number of policy announcements, for example, involving changes in the trade and investment regulations, have raised some concerns over the business and investment policy environment. There is a risk that these concerns intensify in the lead-up to national elections in 2014, and as investor risk appetite globally remains volatile. Maintaining progress on key structural reform issues and investments, making further improvements in the quality of policies and, importantly, an emphasis on policy certainty and clarity of communication, could help mitigate such risks.

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY



1. Indonesia's manufactured exports: near-term dynamics and longer-term trends

With Indonesia's overall exports weakening, how have manufactured exports performed, what are the implications for the trade balance and how can the long-term performance of the sector be enhanced going forward?

The impact of the weakness in global demand has been clearly seen in the sluggish performance of Indonesia's exports over 2012. While Indonesia has a high dependence on commodity-based exports, there has also been a weakening in manufactured exports. As highlighted in Part A, the global backdrop remains challenging, with particular recent concerns over the outlook for China and consequently for commodity prices and demand. This section provides an overview of these near-term developments, examining the recent dynamics in manufactured exports and their linkages with demand for intermediate and capital goods imports. It then places recent developments within the longer-term shifts in the composition of Indonesia's exports and concludes with a brief discussion of the potential for the manufacturing sector, including export-based manufacturing, to revive its role as an engine of Indonesian growth and supplier of quality jobs to the workforce.

a. Recent dynamics in Indonesia's manufactured exports

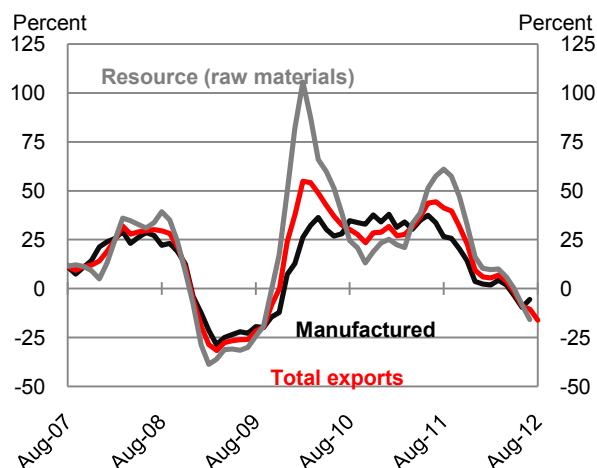
While commodity-based exports have seen particular falls over the past six months, the growth rate of manufactured exports has also dropped

The growth rate of Indonesia's total exports began falling in the second half of 2011 as metal, mineral and other non-energy commodity prices came down from their highs. As a result, resource-based export growth has slumped. The downturn in manufactured export growth started somewhat later and has been more gradual, especially relative to the sharp contractions seen in late 2008 and early 2009 (Figure 20). For example, in August 2012, total exports, on a three-month moving average basis, fell by 16.2 percent year-on-year, versus 10.6 percent in July. Disaggregated data, available through July, indicates that resource exports fell even further, down by 15.9 percent, while the decline in manufactured exports was more moderate at 5.5 percent. Within the region, a similar trend of slowing manufactured export growth has emerged, with Thailand's decline and recovery reflecting the impact of the floods, although Indonesia's drop in growth has been relatively large (Figure 21).

A number of processing-based export sectors have stronger growth as they have become more integrated in regional supply chains

Within this overall trend, the moderation of manufactured exports to Europe and USA has been partly offset by the relatively strong performance of exports to regional markets (i.e. Malaysia and Japan) as regional supply chains become more integrated. This is reflected by positive export growth for products such as footwear (up 8.9 percent year-on-year in the first seven months of 2012), electronics and parts (up 5.8 percent), machinery (7.8 percent), and transport equipment and parts (14.8 percent). Together these products account for 13.4 percent of total exports, and 25.3 percent of manufactured exports. The emergence of significant markets in Latin America, Russia, and the United Arab Emirates (together accounting for 14.1 percent of total footwear in 2012) and the relocation to Indonesia of plants from China likely explain the positive growth of footwear. The floods in Thailand and the rising income levels and size of the market in Indonesia, have helped promote Indonesia as one of the main regional players in automotive production.

Figure 20: Resource-based exports have fallen sharply, but Indonesia's manufactured exports have also weakened...
(year-on-year growth of 3 month moving average value of exports, percent)



Note: Resource exports are raw commodity exports, including oil and gas, coal, copper, and other agricultural commodities

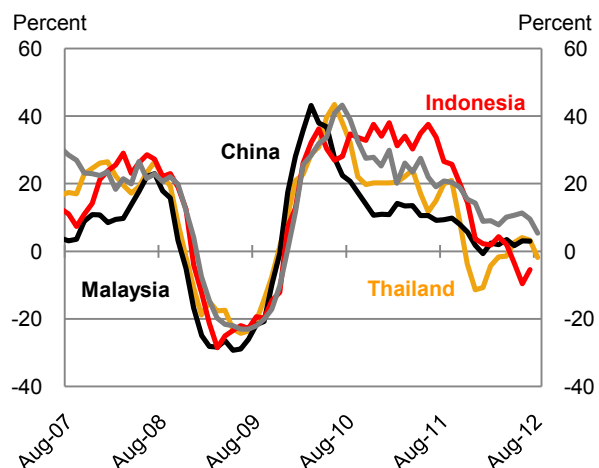
Source: BPS and World Bank staff calculations

The performance of resource-based manufactured exports has been affected by the declines in price in 2012

A key driver of the overall decline in Indonesia's manufactured exports is therefore the combination of a relatively large share of resource-based manufactured products (36.9 percent of total manufactured exports) with the commodity price declines seen in the first seven months of 2012.

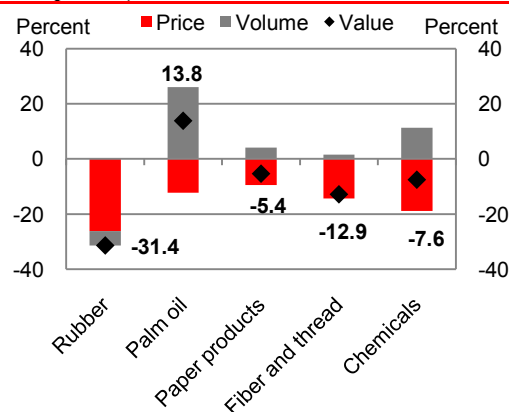
Rubber and palm oil – together accounting for 13.5 percent of total exports – are two examples of resource-based manufactured exports. In the case of palm oil, rising volumes have offset price declines but for rubber, both price and volumes have fallen (Figure 22). Similar price drops contributed to the falls in value for exports of paper and fiber and thread products (together accounting for 3.6 percent of total exports). Price falls for chemicals (5.8 percent of total exports) also drove their 8.7 percent fall in export values.

Figure 21: ...and a similar deceleration in manufactured export values has been seen for regional peers
(year-on-year growth of 3 month moving average value of manufactured exports, percent)



Source: BPS, CEIC and World Bank staff calculations

Figure 22: Price falls have pulled down some of Indonesia's resource-based manufactured exports
(contribution of price and volume changes to year-on-year growth in export values for January to July 2012, percent)



Note: Price and volume indicate respective contributions to change in value. In the first seven months of 2012, rubber accounted for 4.5 percent of total exports, palm oil 9 percent, paper products 2.1 percent, fiber and thread 1.5 percent and chemicals 5.8 percent

Source: BPS and World Bank staff calculations

Box 2: Medium-term trends in Indonesia's manufactured exports

In recent years, Indonesia's exports have increasingly tilted towards agricultural resource-based manufactures and raw-commodity exports, at the expense of the share of non-resource based manufactured exports. The importance of exports of raw commodities, such as coal and copper, has increased significantly as a result of the global commodity price boom that took place between 2003 and 2008. Similar factors have driven the rising share in exports of agriculture resource-based manufacture exports, e.g. rubber and palm oil.

Looking over the past decade, Indonesia's exports of raw commodities have expanded from 15 percent of total non-oil and gas exports in 2001 to 34 percent in 2011 (non-oil and gas exports accounted for 80 percent of total exports in 2011). Meanwhile agriculture-based manufactured exports saw a rise from 18 percent to 22 percent (Figure 23). In contrast, the share of non-resource based manufactured exports (including textiles, clothing and footwear, electronics, machineries, and other processed products, except transport parts), and low technology products (such as steel and base metal) in non-oil and gas exports declined from 61 percent in 2001 to only 36 percent in 2011.

As Table 8 illustrates, much of the rise in Indonesia's raw material exports was as a result of rising demand from China, and other countries such as India. This has contributed to the overall relative shift in Indonesia's manufactured export dependence away from developed markets, such as the US, EU and Japan, and towards China and other emerging markets. For example, in 2011, China's share of Indonesia's total non-oil and gas exports was 6.7 percent, up by almost two percentage points on the level of 2005. Over this period the Chinese economy has become Indonesia's largest market for resource-based manufactures, mainly for agriculture and mining and mineral-based products. Meanwhile, its share of non-resource based manufacture remained similar to that in 2005.

These shifting patterns of trade highlight the risks, and opportunities, for Indonesia's export patterns going forward – both from commodity prices and trading partner growth. In particular, a slowdown in China's growth rate could have significant direct implications for the demand for Indonesia exports. For example, a recent IMF report estimates that a 1 percent increase in Chinese domestic demand translates into a 0.7 percent increase in Indonesia's exports.⁵

Table 8: Rising dependence on China and a higher share of resource based exports

a. The pattern of Indonesia's manufactured exports by destination in 2011

(exports as a share of Indonesia's total non-oil and gas exports, percent)

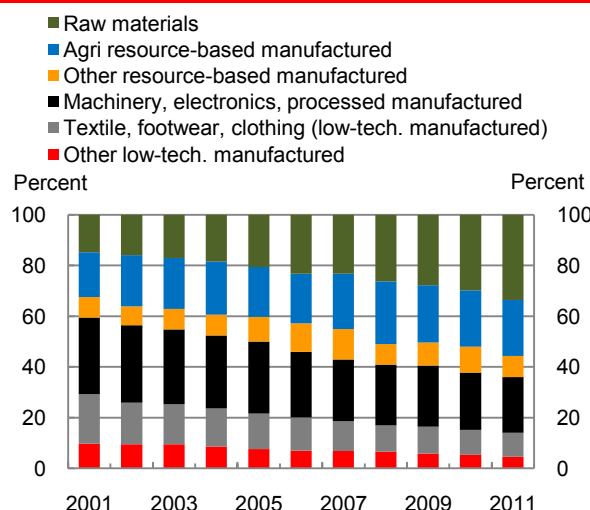
Exports to:

Export product:	China	ASEAN3	NIEs	Japan	EU25	USA	RoW	World
Raw materials	6.6	4.0	4.6	5.1	2.8	2.8	7.7	33.7
Agri res-based manuf.	2.8	2.6	1.5	1.3	2.9	1.0	10.0	22.1
Other res-based manuf.	2.5	0.6	1.1	1.7	0.7	0.2	1.6	8.3
Textile, footwear, clothing	0.2	0.2	0.5	0.6	2.5	3.4	2.0	9.4
Other low-tech manuf.	0.1	0.5	0.6	0.6	0.8	0.8	1.2	4.6
Mach, elec., proc. manuf.	1.1	3.3	5.3	2.0	2.9	1.5	6.0	22.0
Total non-oil and gas exports	13.3	11.2	13.5	11.3	12.5	9.7	28.4	100.0

Memo:

Manufactured exports	6.7	7.2	8.9	6.2	9.8	6.9	20.7	66.3
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Figure 23: Indonesia's exports have shifted towards raw commodities and resource-based products
(share of Indonesia's non-oil and gas exports, percent)



Sources: COMTRADE via WITS and World Bank staff calculations

⁵ IMF (2012), *Regional Economic Outlook Asia and Pacific: Managing Spillovers and Advancing Economic Rebalancing*, April http://www.imf.org/external/pubs/ft/reo/2012/APD/eng/c4_0412.pdf.

b. Comparing the pattern of Indonesia's exports by destinations in 2005 and in 2011
(percentage point change in share of Indonesia's total non-oil and gas exports from 2005 to 2011)

Exports to:

Export product:	China	ASEAN3	NIEs	Japan	EU25	USA	RoW	World
Raw materials	↑ 5.5 ↗	1.3 →	0.9 ↗	1.4 →	0.4 →	0.1 ↑	3.5 ↑	13.1
Agri res-based manuf.	↗ 0.4 ↗	1.1 →	-0.4 →	-1.0 →	-0.4 →	-0.3 ↗	3.0 ↗	2.4
Other res-based manuf.	↗ 1.9 →	-0.5 →	-0.2 ↘	-1.4 →	-0.8 →	-0.1 →	-0.4 ↘	-1.5
Textile, footwear, clothing	↗ 0.1 →	-0.2 →	-0.4 ↘	-0.2 ↘	-1.0 ↘	-1.9 ↘	-1.0 ↘	-4.7
Other low-tech manuf.	↗ -0.1 →	0.0 →	-0.1 →	-0.4 ↘	-1.1 →	-0.9 →	-0.4 ↘	-2.9
Mach, elec., proc. manuf.	↗ -0.5 →	-0.5 ↘	-3.0 ↘	-1.5 ↘	0.0 ↘	-1.5 ↘	0.7 ↘	-6.4
Total non-oil and gas exports	↑ 7.4 ↗	1.2 ↘	-3.2 ↘	-3.1 ↘	-3.0 ↘	-4.6 ↑	5.3	

Memo:

Manufactured exports ↗ 1.9 → -0.1 ↘ -4.1 ↘ -4.4 ↘ -3.4 ↘ -4.7 ↗ 1.8 ↘ -13.1

Note: Panel a: darker color indicates larger share. Panel b: figures represent percentage point change in non-oil and gas exports from 2005 to 2011. For example, the share of raw materials to China by 5.5 percentage points from 1.1 percent in 2005 to 6.6 percent in 2011. Up or down arrows indicate a change greater than 3 percentage points, angled arrows are for changes between 1 and 3 percentage points and flat arrows indicate changes less than 1 percentage points

Source: COMTRADE via WITS and World Bank staff calculations

b. Manufactured exports and imports of intermediate and capital goods

Declines in exports and robust intermediate and capital goods imports contributed to the deteriorating trade balance in the first half of 2012

As detailed in Part A, Indonesia's current account deficit widened to USD 6.9 billion (3.1 percent of GDP) in the second quarter of 2012 as the goods trade surplus halved to USD 1.6 billion from USD 3.6 billion in the first quarter. This decline in the trade surplus was primarily driven by weaker export performance relative to buoyant imports, predominantly of intermediate and capital goods, in line with strong domestic investment and FDI.

But global production networks suggest that intermediate imports also decline with falling manufactured exports, cushioning the impact on the trade balance...

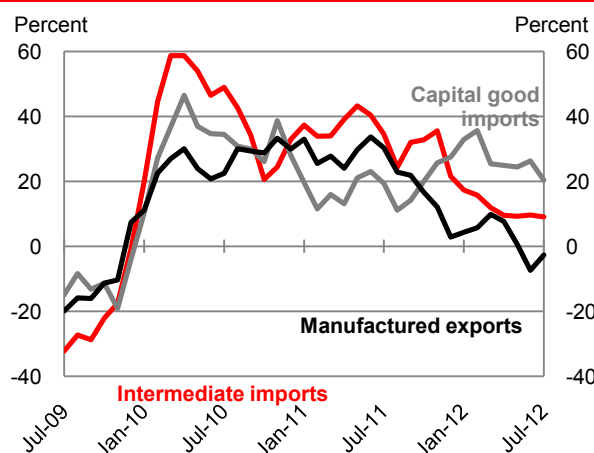
The rising influence of global production networks is one explanation behind the rising trend of intermediate and capital goods imports seen not only in Indonesia but in many countries globally, as discussed in the July 2012 *IEQ*. This creates a positive relationship between the growth of imported intermediate goods and that of the manufactured exports for which they are an input (Figure 24). As seen in Indonesia's trade data of recent months, the decline in manufacturing exports therefore tends to be followed by drops in intermediate imports, cushioning the impact of declining export demand on the trade balance (Figure 24). In addition, although not evident in the relative strength of capital good import growth to date, a reduction in primary resource production and exports may also reduce demand for capital goods such as heavy machinery.

...and price effects may also play a role

A relatively stable trend in the relative price of manufactured imports over the last three and half years has accompanied the increasing price of Indonesia's commodity exports. As a result, Indonesia's terms of trade have been increasing steadily, boosting the ability of Indonesia to import a range of products with new varieties, and potentially lower costs than products available in the domestic market. This relative price trend can be seen by comparing a Manufactured Unit Value Index as a proxy for intermediate and capital good import prices with an export-weighted index of the prices of Indonesia's main commodity exports (Figure 25).⁶

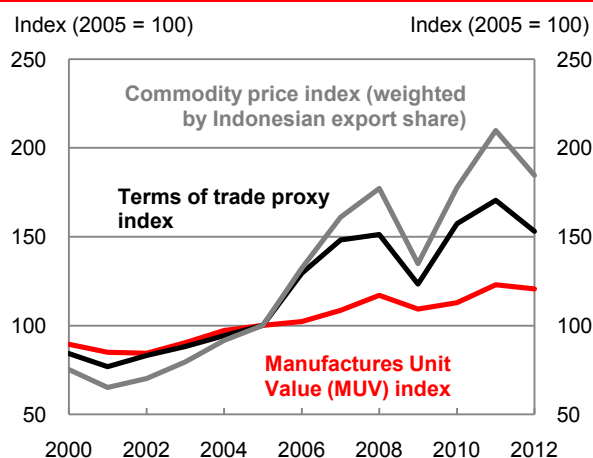
⁶ The Manufactured Unit Value Index (MUV) is a composite index of unit value for manufactured exports from the fifteen major developed and emerging economies to low- and middle-income economies, including Brazil, Canada, China, France, Germany, India, Italy, Japan, Mexico, South Africa, South Korea, Spain, UK., USA, and Thailand. This index can be used to approximate the price in US dollar terms of imports of manufactured goods by developing economies.

Figure 24: Intermediate import growth has come down with the declines for manufactured exports
(year-on-year growth of 3 month moving average of trade goods value, percent)



Source: BPS and World Bank staff calculations

Figure 25: Import prices have cheapened relative to exports
(US dollar international commodity price, manufacturing unit value, and terms of trade proxy, index 2005 = 100)



Note: Terms of trade proxy index is calculated by dividing commodity price index with the MUV index; 2012 is a forecasted indices

Source: DECPG World Bank and World Bank Staff calculations

c. Reviving the growth in Indonesia's manufacturing sector and exports

Looking at the medium-term outlook, there is the potential for reviving the growth of Indonesia's manufacturing sector and its export performance...

The recent downturn in manufactured exports should be seen in the perspective of an improvement in the performance of manufacturing output growth in recent years, after the experience of its "lost decade" in the aftermath of the Asian financial crisis.⁷ However, the real appreciation of the Rupiah over the past five years, rising unit labor costs, a shift to commodities and resource-intensive sectors, strong international competition and a tightening of profit margins have all made Indonesia's manufacturing sector less competitive than its regional neighbors. Set against this, given Indonesia's still relatively low labor costs, the rapidly growing domestic market, and the opportunities of integrating into value chains facilitated by new regional growth poles, there is the scope for a "second chance" for export manufacturing. Rising wage costs in China, for example, are prompting firms in labor intensive industries (such as textiles, clothing and footwear) to relocate to countries such as Indonesia and Cambodia. Indonesia's large domestic market, and the scope to strengthen linkages with regional markets, can enhance the opportunities to reach production scale economies.

...but to improve overall competitiveness and sustain growth, the Government and private sector need to overcome a range of challenges

Indonesia therefore has the potential to boost its global market share in manufacturing, create millions of new jobs and facilitate structural transformation. To achieve these goals the opportunity must be taken now to make an aggressive effort to improve manufacturing sector competitiveness, including addressing traditional investment climate issues, such as improving the transparency and certainty in regulations, but most importantly, weaknesses in the quality and innovation environment. It is through this that the Indonesian manufacturing sector will begin to move up the value chain, build deep and competitive domestic value chains, and deliver quality and sustainable job opportunities. Export performance can be further enhanced by making it easier for non-exporting firms to become exporters and for exporters to expand their market share abroad, especially by resolving transportation and logistics issues and reducing non-tariff barriers to market access abroad (for example, by promoting international standards and improving the standards regime).

⁷ World Bank (2012), *Picking up the Pace: Reviving Growth in Indonesia's Manufacturing Sector*, <http://www.worldbank.org/en/news/2012/10/10/picking-up-the-pace-reviving-growth-in-indonesia-manufacturing-sector>. This discussion draws on Policy Note 2 Export Competitiveness in Indonesia's Manufacturing Sector.

2. The 2013 proposed Budget and the allocation of spending

The Government of Indonesia submitted the 2013 proposed Budget to the Parliament in mid August, 2012

The Government and the Parliament are currently discussing the proposed 2013 Budget - the fourth-year Budget of the government's current five year term (2010-2014). The proposed Budget, which is expected to be passed by the end of October, seeks to improve the resilience of the domestic economy and to further enhance crisis preparedness measures in the face of continued global uncertainties. The theme is "strengthening the domestic economy to improve and expand the welfare of the Indonesian people". The proposed Budget reflects a continuation of the Government's prioritization of key development areas, such as addressing the infrastructure backlog, improving and expanding social assistance programs, and continuing bureaucracy reforms. However, it also highlights the continued fiscal burden of the current energy subsidy policies. This section provides a brief overview of the proposed Budget, outlining some high-level policy objectives and policy areas of particular interest.

a. Strengthening the domestic economy while advancing crisis preparedness

The 2013 proposed Budget continues to support policies and priorities outlined in the existing medium- and long-term development plans

The 2013 proposed Budget continues supporting initiatives and priorities outlined in the National Medium-Term Development Plan (*RPJMN* 2010-2014), the Master Plan for Acceleration and Expansion of Indonesia's Economic Development 2011-2025 (*MP3EI*), and the Master Plan for Acceleration and Expansion of Indonesia's Poverty Reduction (*MP3KI*). The Budget contains a four pillar development strategy of policies, which are pro-growth, pro-job, pro-poor, and pro-environment. The pro-growth strategy aims at improving the competitiveness and resilience of the economy by accelerating infrastructure development to improve domestic connectivity. The pro-job strategy includes efforts to promote labor intensive industries and targets providing 450,000 job opportunities for every additional 1 percent of economic growth. The pro-poor policy includes a continuation of social programs and new initiatives included in the *MP3KI*. Lastly, the pro-environment policy will be implemented by enhancing mitigation and the adaptive capacity to respond to climate change and promoting the use of alternative energy.

GDP growth is projected at a robust 6.8 percent in 2013 amidst ongoing uncertainty over the global outlook

The pro-growth strategy is expected to support a robust GDP growth target of 6.8 percent, on the back of improved investment and consumption. This is higher than the 2012 revised Budget growth target of 6.5 percent. Supporting this target, an inflation rate of 4.9 percent is projected, notwithstanding the plan for a 15 percent electricity tariff hike in 2013. The exchange rate is expected to average IDR 9,300 per US dollar. The Indonesia

Crude Oil Price (ICP) is assumed at USD 100 per barrel, which appears relatively conservative against its recent level (USD 111.7 per barrel as in August 2012) and Brent futures market prices for 2013. Oil lifting, an important variable affecting revenues, is targeted at 900 thousand barrels per day (kbpd), lower than the 2012 revised Budget assumption of 930 kbpd, although lifting outcomes have been below target in recent years. Finally, the

inclusion for the first time of a gas lifting variable in the budget assumption can be seen as a positive step in improving the transparency of revenue projections, as gas production has become increasingly important for Indonesia (Table 9). At the time of writing this report, the proposed Budget assumptions had been agreed at Parliament's Budget Commission discussion stage.

Table 9: 2013 Budget assumptions include robust GDP growth of 6.8 percent
(Budget assumptions)

	2011 Actual	2012 Revised Budget	2013 Proposed Budget
GDP Growth (percent)	6.5	6.5	6.8
Inflation (percent)	3.8	6.8	4.9
Exchange Rate (IDR/USD)	8,742	9,000	9,300
3-month Treasury Bill (SPN) rate (percent)	6.6	5.0	5.0
Oil Price (US\$/barrel)	111.5	105	100
Oil lifting (000 barrel per day)	898	930	900
Gas lifting (000 bpd oil equivalent)	n.a	n.a	1,360

Source: Ministry of Finance

This solid growth is projected to facilitate meeting development targets such as reducing poverty and unemployment rates

In line with the projected economic growth and policy priorities, the Government has set out measurable development targets to be achieved by the end of 2013. The national poverty rate and unemployment rate are projected to continue to decline to 9.5-10.5 percent and 5.8-6.1 percent respectively. These would be in line with the targets set in the RPJMN to achieve by the end of 2014 a poverty rate of 8.0-10.0 percent and an unemployment rate of 5.0-6.0 percent. The Government also pledges to improve the business and investment climate (ease of doing business) through simplification of business procedures. For example, the time needed to start a business is targeted to fall to 20 days in 2013 from 36 days in 2012. On the infrastructure front, the Government aims to improve the share of national roads in a stable condition to 92.5 percent to support the domestic connectivity agenda, and to connect more households to the power grid through increasing the electrification ratio to 77.6 percent. The corruption perceptions index is targeted to improve to 4.0, reflecting efforts to improve bureaucracy performance through full implementation of bureaucracy reforms in all line ministries (Table 10).

Social indicators such as poverty and unemployment reduction are generally tracking well against the targets set in the RPJMN, while infrastructure indicators are progressing below expectations. Selected development targets in the transport sector have seen slow progress due to implementation challenges. For example, integrated urban transport development in four big cities, railway development, and new toll roads development have seen little progress on the ground.

Table 10: Poverty and unemployment rates are projected to decline in 2013
(selected development targets in the 2013 proposed Budget)

Selected indicators	2011 Actual	2012 Revised Budget	2013 Proposed Budget
Poverty rate	12.5	10.5 – 11.5	9.5 – 10.5
Unemployment rate	6.6	6.4 – 6.6	5.8 – 6.1
Improving competitiveness (ease of doing business)			
Time to start business (day)	45	36	20
License to start construction (day)	158	145	137
Infrastructure development			
National road in stable (good and fair) condition (percent)	88.5	90.5	92.5
Electrification ratio (percent)	73.0	75.9	77.6
Power generation capacity (MW)	37,353	43,653	48,555
Corruption perceptions index (bureaucratic improvement)*	3.0	3.2	4

Note: * The Corruption Perceptions Index is published annually by Transparency International and ranks countries on a scale from 10 (very clean) to 0 (highly corrupt) by their perceived levels of corruption as determined by expert assessments and opinion surveys

Source: Ministry of Finance

In view of ongoing uncertainty in the global outlook, the 2013 proposed Budget retains a number of measures to enhance crisis preparedness

The Government proposes to maintain a number of measures included in the 2012 revised Budget that give the Government flexibility to better manage and mitigate the risks that may arise from ongoing uncertainty and volatility in the international economic environment (see Part B of the December 2011 *IEQ*). The Government has taken a number of precautionary initiatives, including: developing a Crisis Management Protocol (CMP) and Bond Stabilization Framework (BSF); the signing of a Memorandum of Understanding between the Ministry of Finance, Bank Indonesia, and the Financial Service Authority (OJK) on a Coordination Forum for Financial System Stabilization (FKSSK), to improve policy coordination in responding to a crisis,⁸ and continuing into 2013 the USD 5 billion contingent financing support arranged with the World Bank, the Asian Development Bank, Australia, and Japan. In addition to the above policy measures, the 2013 proposed Budget also allocates a contingency fund of IDR 6.5 trillion to mitigate fiscal risks that may arise in 2013 due to deviations in macroeconomic variables from their assumptions or commodity price shocks.

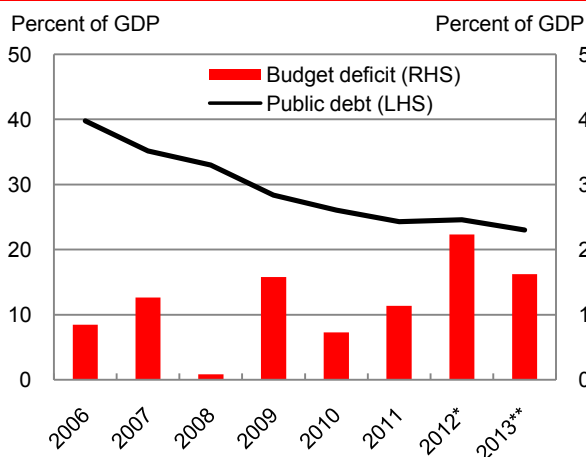
⁸ http://www.depkeu.go.id/ind/Read/?type=ixNews&id=24810&thn=2012&name=br_011012_11.htm

b. Despite a solid aggregate fiscal position, effective space for key development expenditures is constrained by rising energy subsidy spending

A fiscal deficit of 1.6 percent of GDP is targeted for 2013, 0.6 percentage points lower than the target in the 2012 revised Budget

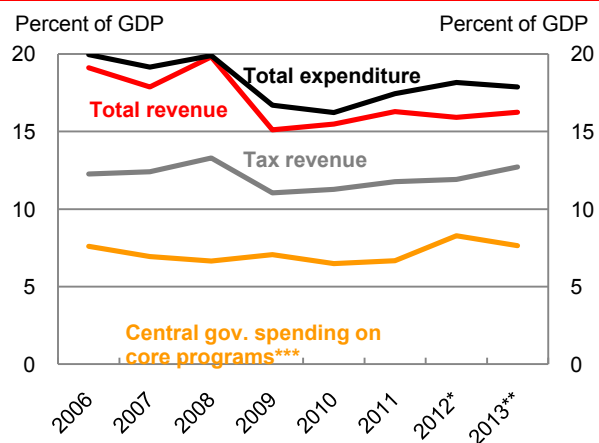
The 2013 proposed Budget targets a deficit of IDR 150.2 trillion (1.6 percent of GDP), lower than the IDR 190.1 trillion (2.2 percent of GDP) in the revised Budget 2012, as nominal spending rises less than GDP while projected revenues increase faster. Indonesia's gross financing needs are projected to remain significant in 2013 (for example, the 2012 IMF Article IV projects gross financing needs of 4.2 percent of GDP based on a deficit projection of 1.8 percent of GDP). Financing will mostly be met through government bond issuance. However, with relatively low net financing needs and strong nominal GDP growth, government debt-to-GDP is projected to continue to decline, reaching 23 percent of GDP by the end of 2013 (Figure 26).

Figure 26: The 2013 proposed Budget maintains a solid overall fiscal position...
(percent of GDP)



Note: * revised Budget; ** proposed Budget
Source: Ministry of Finance

Figure 27: ...but effective spending on core development programs has stagnated as a share of GDP
(percent of GDP)



Note: * revised Budget, ** proposed Budget, *** central government spending excluding subsidies and interest payments
Source: Ministry of Finance and World Bank staff

Overall revenues as a share of GDP are projected to rise, driven by improved tax revenue collection

Total revenues are targeted at IDR 1,508 trillion in 2013, up 11 percent relative to the 2012 revised Budget. Nominal tax revenue is targeted to grow by 16 percent, moving the tax-to-GDP ratio up by 0.8 percentage points to 12.7 percent of GDP (Figure 27). This increase is supported by strong economic growth and continued improvement in tax revenue collection and administration through efforts to broaden the tax base (especially for income tax), improve tax potential through the tax census, and improve quality assurance through regulation, especially in the oil and gas, and mining, sectors. Tax revenues, which represent 78 percent of total revenues in 2013, play an increasingly important role as non-tax revenues start to decline.

Non-tax revenues are projected to weaken in 2013, due to low oil production and oil price assumption

The 2013 Budget projects that non-tax revenues will actually decline in nominal terms by 4.9 percent (IDR 20.3 trillion) relative to the 2012 revised Budget level. This fall is driven by lower receipts from oil revenues due to lower oil price and lifting assumptions. In contrast, non-tax revenues from non-oil and gas are targeted to increase by 12.8 percent relative to the 2012 revised Budget, supported by strong revenue collection from the mining sector.

Overall budget expenditures, while up in nominal terms, are projected to fall slightly relative to GDP in 2013

Total expenditures are proposed at IDR 1,658 trillion, up 7.1 percent relative to the 2012 revised Budget, but slightly down as a share of GDP to 17.9 percent from 18.2 percent in 2012. Of total spending, 69 percent will be implemented by the central government while 31 percent will be transferred to provincial and local governments. Within central government spending, the allocation to energy subsidies, at 24 percent, is the largest share, followed by personnel expenditure (21 percent), capital expenditure (17 percent), material expenditure (14 percent), and social expenditure (6 percent). Despite the solid overall fiscal position, effective space for spending on key development expenditure is restrained with subsidies and interest payments take up nearly half of central government expenditure (Figure 27).

Table 11: The 2013 proposed Budget projects a deficit of 1.6 of GDP
(IDR trillion unless indicated)

	IDR trillion				Percent of GDP			
	2010 Actual	2011 Actual	2012 Revised Budget	2013 Proposed Budget	2010 Actual	2011 Actual	2012 Revised Budget	2013 Proposed Budget
A. State revenue and grants	995	1,211	1,358	1,508	15.5	16.3	15.9	16.3
1. Tax revenue	723	874	1,016	1,179	11.3	11.8	11.9	12.7
2. Non-tax revenue	269	331	341	324	4.2	4.5	4.0	3.5
B. Expenditure	1,042	1,295	1,548	1,658	16.2	17.4	18.2	17.9
1. Central government, o/w	697	884	1,070	1,139	10.9	11.9	12.5	12.3
Personnel	148	176	212	241	2.3	2.4	2.5	2.6
Materials	98	125	187	159	1.5	1.7	2.2	1.7
Capital	80	118	169	194	1.3	1.6	2.0	2.1
Interest payments	88	93	118	113	1.4	1.3	1.4	1.2
Subsidies, o/w	193	295	245	316	3.0	4.0	2.9	3.4
Energy subsidies	140	256	202	275	2.2	3.4	2.4	3.0
Social	69	71	55	59	1.1	1.0	0.6	0.6
Other expenditures	22	5	82	53	0.3	0.1	1.0	0.6
2. Transfers to regions	345	411	479	519	5.4	5.5	5.6	5.6
C. Primary balance	42	9	-72	-37	0.6	0.1	-0.8	-0.4
D. SURPLUS / DEFICIT	-47	-84	-190	-150	-0.7	-1.1	-2.2	-1.6
E. Net financing	92	131	190	150	1.4	1.8	2.2	1.6
1. Domestic financing	96	149	195	170	1.5	2.0	2.3	1.8
2. Foreign financing	-5	-18	-4	-20	-0.1	-0.2	-0.1	-0.2

Source: Ministry of Finance and World Bank staff calculations

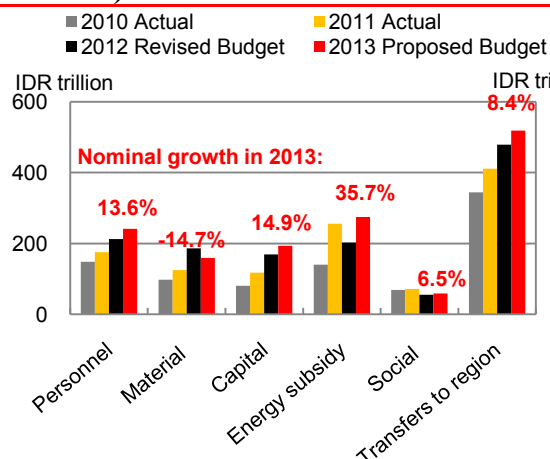
Spending on energy subsidies remains substantial, notwithstanding a proposed 15 percent hike in electricity tariffs...

Spending on energy subsidies is set to remain substantial in 2013 at 3 percent of GDP (IDR 275 trillion), up over one-third in nominal terms on the 2012 revised Budget allocation (Figure 28).⁹ This allocation remains higher than combined central government spending on capital and social programs. The fuel subsidy allocation, which makes up 70 percent of the total energy subsidy cost, is IDR 194 trillion, up 41 percent from the 2012 revised Budget. The Government has allocated a subsidized fuel volume of 46 million kilo liters (KL), 6 million KL higher than the allocation in the 2012 revised Budget. This reflects increasing consumption due to the rapid rise in the number of vehicles, as well as the substantial gap between subsidized and market prices, that leads to potential leakages. The Government's recent policy to restrict subsidized fuel consumption is unlikely to be effective due to enforcement and monitoring challenges, as well as a lack of supporting infrastructure. Meanwhile, the electricity subsidy is allocated IDR 80.9 trillion, up 25 percent from 2012. The Government is proposing a 15 percent gradual electricity tariff

⁹ For further analysis on the budget cost Indonesia's fuel subsidies see the April 2011 IEQ.

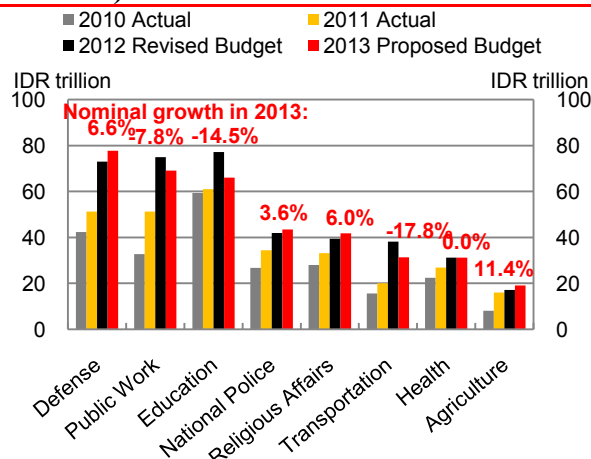
increase in 2013 for customers with connections above 900 Volt-ampere (VA). Although this proposal has been agreed at the Commission discussion level, the implementation is still subject to Parliament's formal Budget approval.

Figure 28: Rising energy subsidy relative to spending on capital and social programs (IDR trillion)



Note: nominal growth in 2013 is proposed Budget relative to 2012 revised Budget
Source: Ministry of Finance

Figure 29: After strong rises in 2012, in 2013 key ministries implementing infrastructure programs see lower allocations (IDR trillion)



Note: nominal growth in 2013 is proposed Budget relative to 2012 revised Budget
Source: Ministry of Finance

...limiting the room, within a given aggregate spending level, to target more aggressive expenditures to address the infrastructure backlog...

Capital expenditure, mostly to finance infrastructure development, is budgeted at IDR 194 trillion in 2013, up 15 percent relative to 2012. Relative to GDP this level of spending only increases slightly, to 2.1 percent in 2013 from 2.0 percent in 2012, but this still represents a significant increase in the amount that the Government was able to deliver in 2011 (0.5 percent of GDP). While the nominal increase in the budget for capital spending is relatively modest, compared to the pressing infrastructure development needs to support *MP3EI*, implementation issues may continue to be the binding constraint on execution rates. Material expenditures see a 14.7 percent fall in nominal spending relative to the 2012 revised Budget to IDR 159 trillion in 2013 reflecting the Government's efficiency measures to reduce government operational and travel expenses in 2013.

...and expansion of social protection programs to protect the vulnerable

Spending on social assistance sees a modest nominal increase of 7 percent relative to the 2012 revised Budget, despite a growing need to integrate and expand the current social protection programs. Social assistance spending is budgeted at IDR 59 trillion to support programs that are implemented by line ministries such as school operational assistance (*BOS*) managed by the Ministry of Religious Affairs, scholarships for poor students (*BSM*), health insurance for the poor (*Jamkesmas*), conditional transfers for poor households (*PKH*), and the community based development program (*PNPM*). In addition other core social programs, which are not included above and which are channeled through subsidy spending, such as rice for the poor (*Raskin*), and through transfers to the regions (*BOS* programs supporting elementary education) also receive a lower or flat allocation in 2013 relative to the 2012 revised Budget.

Personnel expenditures are projected to increase relative to total spending, to support the rolling out of bureaucratic reform to all line ministries

Personnel expenditures in 2013 are projected at IDR 241.1 trillion (2.6 percent of GDP), up 13.6 percent from the 2012 revised Budget. Of this spending, 46 percent is for civil servant salaries and allowances, 32 percent for pensions, and 21 percent for honoraria and overtime. The increase in personnel spending reflects the Government's policy of 7 percent annual increases in civil servant salaries and retiree pensions, continuation of bureaucracy reforms, and a reserve to anticipate additional salaries for new employees in government institutions in 2013. The longer-term drivers behind the rise in personnel spending at both the central and local government level are outlined in Part C.

Key line ministries that carry infrastructure

Total line ministry spending remains flat in nominal terms relative to the 2012 revised Budget. Despite the stated priority on infrastructure, and after strong increases in the 2012

development (public work and transport) receive a lower budget allocation than in 2012, but remain in the top 10 spenders

revised Budget, the budget allocations for the Ministry of Public Works and the Ministry of Transportation see 8 percent and 18 percent nominal declines in 2013, although both line ministries remain among the top ten biggest spenders (Figure 29). To support infrastructure investment, the Government also allocates funding for Viability Gap Funding (VGF) in the proposed 2013 Budget. VGF aims to increase private sector participation in infrastructure projects, which are not financially feasible without such funding but economically viable, improve the certainty of infrastructure projects provision, and increase the availability of infrastructure services under the Public Private Partnership (PPP) scheme. However, how VGF support will be implemented remains to be seen.

Though the Ministry of Education foresees a 14 percent budget decline in the 2013 proposed Budget, the Government still maintains a 20 percent of total expenditure on education as mandated by the Constitution. Allocations on other education spending such as the spending directed to the education endowment fund and teacher allowances channeled through transfers are increasing.

Budget execution is expected to improve in 2013

As described in Part A, although under-spending for core programs, such as on infrastructure, remains a challenge in 2012, budget execution is expected to improve in 2013. The Government has recently issued two critical regulations; the revised procurement regulation and the new land clearing regulation (a derivative regulation of Law No. 2/2012 on Land Procurement for Development Purposes in the Interest of the Public), that should accelerate the implementation of big infrastructure projects.

Financing needs for 2013 are largely to be met by government securities issuance

The net financing need in 2013 is targeted at IDR 150.2 trillion which is mainly to be funded by net government securities issuance of IDR 177.3 trillion. The planned use of financing from the Government's accumulated cash balance (SAL) has fallen to IDR 10.0 trillion from IDR 56.2 trillion in the 2012 revised Budget. Net financing from official foreign loans is again projected to be negative (minus IDR 19.5 trillion) as project and program loan disbursements are offset by IDR 58.4 trillion in amortizations. The modest fall in foreign loan disbursements to IDR 45.9 trillion in the 2013 proposed Budget from IDR 53.7 trillion in the 2012 revised Budget is due primarily to a reduction in program loans.

c. The Medium-Term Budget Framework projects a surplus by 2016

Looking ahead, the budget balance is projected to move to surplus in 2016...

The Government also updated its Medium-Term Budget Framework (MTBF) in the 2013 proposed Budget to incorporate recent policy and economic developments. Over the period from 2014 to 2016, the fiscal balance is projected to move gradually to a surplus of 0.3 percent of GDP (Table 13). Along with strong growth, this will contribute to a further decline in government debt-to-GDP to 18 percent by 2016. The government expects to deepen domestic financing for the deficit and to continue with the net negative flow of financing from foreign official loans.

...supported by an ambitious target for growth to reach 7.4 to 7.9 percent by 2016

The MTBF is based on a macro outlook which sees growth rising to an ambitious 7.4-7.9 percent by 2016 (Table 12). The GDP growth projections have been revised up compared with the previously released MTBF, reflecting a more positive outlook for global recovery and the strength of Indonesia's economy. The ambitious growth target is expected to be supported by low and stable inflation at around 3.0-5.0 percent and an exchange rate in the range of IDR 8,700-9,300 per US dollar. To optimize revenue from the oil and gas sector, oil and gas production is projected to increase gradually in the near future with projected new investments and operations coming online.

Revenues are expected to grow by an annual average of 13 percent in nominal terms between 2014-2016

Tax revenues are projected to grow by an average of 16 percent per year, moving the tax-to-GDP ratio up by 1.2 percentage points from 12.7 percent in 2013 to 13.9 percent of GDP in 2016, although this remains relatively low by international standards. Both income tax and value added tax are projected to grow strongly at annual averages of 17.3 percent and 18.7 percent, respectively. Revenue from import duties is projected to decline due to implementation of free trade agreements. Export tax revenue is expected to moderate as mineral exports are projected to decline by 2014 due to the full implementation of the mineral ore export ban. Oil and gas revenue is projected to increase, supported by new exploration, investment and technology.

Table 12: GDP growth is projected by the Government to be above 7 percent in 2014
(Medium-Term Budget Framework assumptions)

Assumptions	2012 Revised Budget	2013 Proposed Budget	2014 Projection	2015 Projection	2016 Projection
Growth (percent)	6.5	6.8	7.0 - 7.6	7.3 - 7.8	7.4 - 7.9
Inflation (percent)	6.8	4.9	3.5 - 5.5	3.0 - 5.0	3.0 - 5.0
Exchange Rate (ID/USD)	9,000	9,300	8,700 - 9,300	8,700 - 9,300	8,700 - 9,300
3-month SPN rate (percent)	5.0	5.0	4.5 - 5.5	4.5 - 5.0	4.5 - 5.0
Oil Price (USD/barrel)	105	100	100 - 120	100 - 120	100 - 120
Oil lifting (000 barrel per day)	930	900	940 - 1,010	1,010 - 1,025	1,010 - 1,030
Gas lifting (000 bpd oil equivalent)	n.a	1,360	1,360 - 1,390	1,440 - 1,475	1,490 - 1,520

Sources: Ministry of Finance

Expenditure as a share of GDP is projected to moderate in the medium term, while achieving the planned expansion of capital and social program spending may prove difficult without bolder expenditure reforms

Expenditure to GDP is expected to fall gradually from 17.9 percent in 2013 to 16.3 percent in 2016. Line ministries' expenditures, which comprise core programs, are projected to grow by only 8 percent per year in nominal terms. Personnel expenditure is projected to rise, reflecting the Government's policy to maintain the real income of civil servants (6 percent average increases), and rolling out of the bureaucracy reform process to all line ministries. The Government will continue to implement efficiency measures on material expenditures, with a flat budget policy for operational expenses and spending efficiency for official travel and workshop activities.

Capital spending is projected to increase to support infrastructure development and MP3EI implementation and continuation of the national security minimum essential force target. Subsidy spending is, however, projected to remain significant. The Government indicates a strategy to improve the targeting of the subsidy program, controlling the quantity of subsidized fuel and promoting the use of alternative energies, as well as electricity tariff adjustment. Social expenditures are expected to grow significantly in the near future with the projected expansion of the current social programs such as BOS, PKH, and PNPM, and Jamkesmas, and integration of the national social security scheme (SJSN) in 2014. Financing these, and other, key development needs is likely to require significant resources and bold policy and expenditure-composition reforms, including improvements in the allocation of spending beyond that outlined in the proposed MTBF.

Table 13: The Medium-Term Budget Framework targets a fiscal surplus by 2016
(IDR trillion unless indicated)

	IDR trillion					Percent of GDP				
	2012 Revised Budget	2013 Proposed Budget	2014 Projection	2015 Projection	2016 Projection	2012 Revised Budget	2013 Proposed Budget	2014 Projection	2015 Projection	2016 Projection
A. Revenues and grants	1,358	1,508	1,715	1,941	2,186	15.9	16.3	16.6	16.7	16.6
1. Tax revenues	1,016	1,179	1,358	1,580	1,830	11.9	12.7	13.1	13.6	13.9
2. Non tax revenues	341	324	353	358	356	4.0	3.5	3.4	3.1	2.7
B. Expenditures	1,548	1,658	1,864	1,994	2,145	18.2	17.9	18.0	17.1	16.3
1. Central Government, o/w	1,070	1,139	1,278	1,328	1,401	12.5	12.3	12.3	11.4	10.6
Line Ministry	548	547	602	645	687	6.4	5.9	5.8	5.5	5.2
Non-Line Ministry	522	592	676	683	714	6.1	6.4	6.5	5.9	5.4
2. Regional transfers	479	519	586	666	744	5.6	5.6	5.7	5.7	5.6
C. Primary balance	-72	-37	-21	76	174	-0.8	-0.4	-0.2	0.7	1.3
D. Overall balance (A-B)	-190	-150	149	-54	42	-2.2	-1.6	1.4	-0.5	0.3
E. Net financing	190	150	149	54	-42	2.2	1.6	1.4	0.5	-0.3
1. Domestic financing	195	170	167	77	-18	2.3	1.8	1.6	0.7	-0.1
2. Foreign financing	-4	-20	-18	-24	-24	-0.1	-0.2	-0.2	-0.2	-0.2

Source: Ministry of Finance and World Bank staff calculations

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

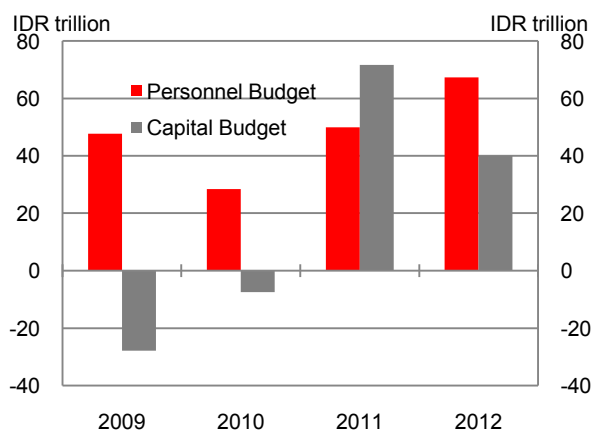


1. Drivers behind the rapid growth of government personnel expenditures

Government Budget allocations for spending on personnel have grown more rapidly than most other spending categories

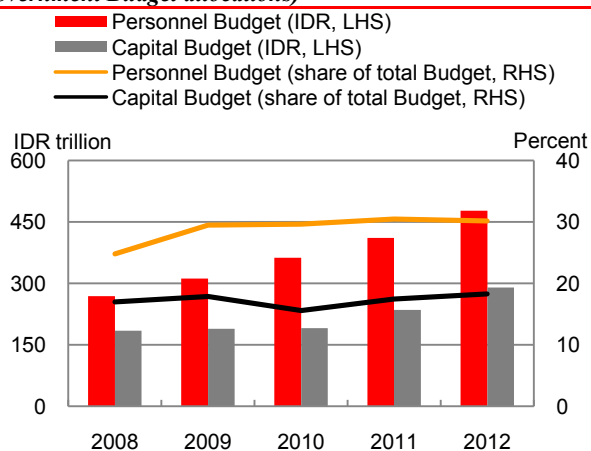
Indonesia's low debt-to-GDP and conservative fiscal deficits provide considerable scope for spending to be increased on key development priorities such as health, human capital development and much-needed capital spending on infrastructure. However, as discussed in the previous section, recent trends show notably higher increases for subsidy and personnel spending than for many other categories. For example, looking across national and sub-national governments, the planned budget allocations to personnel expenditure during the last five years have grown much faster than for capital spending (Figure 30), with average nominal growth rates of 14 percent and 8 percent per year respectively from 2008 to 2012. As a result, in absolute terms, the total government Budget allocation for personnel expenditure is around two-thirds higher than for capital expenditure, which is mainly infrastructure (Figure 31). Given the importance of personnel expenditures in both national and sub-national government budgets, this section provides a brief overview of the main drivers behind the recent rise in spending on personnel.

Figure 30: Increases in total Budget allocations to personnel spending have outpaced those to capital spending...
(annual nominal change in central and sub-national government Budget allocations, IDR trillion)



Source: MoF and World Bank staff calculations

Figure 31: ...and personnel accounts for a much higher share of national and sub-national Budget allocations
(IDR trillion; percent of total central and sub-national government Budget allocations)



Source: MoF and World Bank staff calculations

a. The main drivers of rising personnel spending in Indonesia

Budget management reforms designed to improve expenditure control and the quality of spending...

Many of the recent reforms to the budget system, which are aimed at improving the control over, efficiency, and quality of public spending, have been designed and implemented by the Ministry of Finance and the planning agency, *Bappenas*. Reforms include improved controls over debt and cash management; the unification of the development and capital budgets; the introduction of a medium-term expenditure framework; performance based budgeting (PBB); and accrual accounting.

...have not addressed the three main drivers of rising personnel expenditures

However, budget reforms have not yet fully addressed the three main drivers behind the escalating personnel expenditure, which all are largely outside the control of the central fiscal agencies. The first two drivers are a legacy from the New Order regime and its 'National System for Administration', introduced between 1968 and 1974 and codified through several laws, among them Law 8/1974 on the Civil Service. This system was characterized by opaque decision-making processes and fragmentation of decision-making powers, leading to weak accountability. In contrast to most Indonesian government sectors and cross-cutting functions, the National System for Administration has not been subject to any fundamental reform to adapt it to the new, democratic Indonesia where transparency, fiscal prudence and accountability have become more prominent. The third driver is largely a consequence of how central transfers to regional governments are determined, which has created incentives for expanding sub national staffing levels.

The first driver is the process for determining staff establishments and personnel budgets...

The first driver behind the current escalation of personnel expenditure is the policies and processes for how organizational structures and numbers of positions are determined in government institutions and consequently how personnel costs are budgeted and money spent. Staff numbers are determined in an administrative process in which the Ministry of Administrative and Bureaucracy Reform (*MenPAN-RB*) approves an institution's staff establishment (*formasi*). Decisions are reportedly made by benchmarking against pre-determined blueprints, which are more or less similar for all institutions – “one size fits all approach” - and not against operational needs.

...which results in a lack of accountability at the level at which personnel spending takes place

The process reduces the accountability for personnel spending at the level where the spending takes place, i.e. Budget managers are not perceived as being responsible for the personnel budget and so cannot be held accountable for managing it. This practice provides an incentive for central government institutions and budget managers to maximize staff numbers and personnel spending, rather than to manage these costs. The Ministry of Finance's role in this process is basically to provide the fiscal allocation for personnel expenditures, rather than reviewing them.

Furthermore, incentives for efficiency in personnel spending are low...

Since personnel budgets, based on the approved staff establishments, are guaranteed, the Directorate General of Budget in the Ministry of Finance deducts the budgeted personnel costs from the aggregate of available resources when allocating those for new operational and development initiatives. This practice means that personnel expenditure is not subject to the same review as other expenditures by the Ministry of Finance, despite representing more than 20 percent of central government spending and, in aggregate, more than 30 percent of total government spending. Trade-offs between personnel expenditure and other spending categories at the level of the institution (K/L), programs or activities are difficult and there are few incentives for rationalizing or for managing staff costs. In effect, this means that the level of spending on personnel in a government institution is determined by a third party, *MenPAN-RB*, through its approval of staff establishments, and not by the concerned K/L or the Ministry of Finance.

...due to a large extent to the fact that staff costs are not included in the budget for a program or activity

As mentioned, Indonesia has recently introduced performance-based budgeting, which is intended to shift the focus of budget management from inputs towards the purpose of expenditures and the outputs produced. With this reform, operational budgets should also be allocated to activities or sub-programs and spending is similarly managed. The intention is that managers would eventually have more flexibility in the choice of inputs to meet the desired outcomes and outputs. However, personnel expenditure, i.e. salaries and allowances, continue to be treated as an administrative overhead separated from the activity/program budgets. This practice also makes it difficult to properly attribute the true costs for a particular program or activity, since staff costs cannot be associated with any technical output or any policy outcome.

The second driver of the rise in personnel spending is the government's wage-bill management...

The second driver is the government's wage bill management, where annual basic pay increments have been given priority in resource allocation within available fiscal space, seemingly without reference to clear productivity or pay developments in the private sector or to any other clear, transparent benchmark. The fact that civil service pension levels are indexed to annual salary increases, and not to inflation, raises spending levels further. The outcome of this process is that over the years 2009-2012 civil servants received annual increases in their basic pay of 15 percent, 5 percent, 10 percent and 7 percent respectively, or 9.25 percent on average, and the almost two million retired civil servants received similar increases. Over these four years, CPI inflation averaged 4.9 percent (World Bank projections for 2012).¹⁰

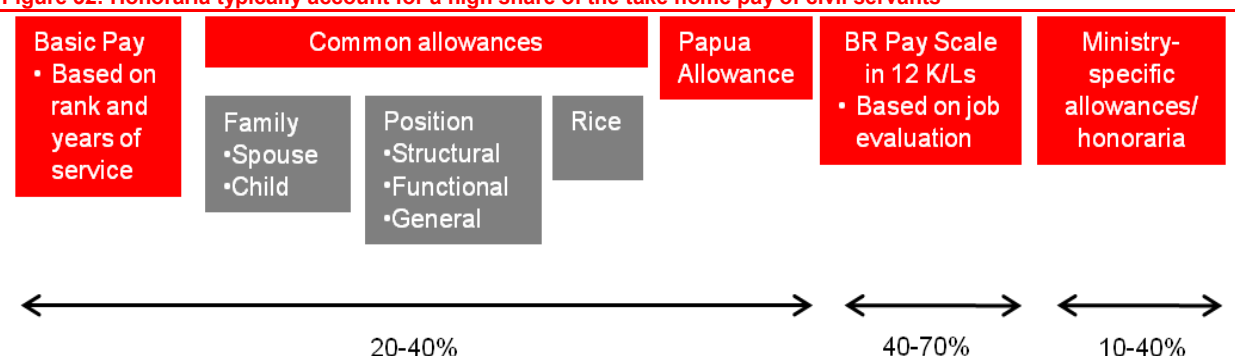
...along with the bureaucracy reform process at the central government level...

In addition, a Bureaucracy Reform (BR) allowance has been given to several K/Ls and by 2014, almost eighty central government institutions should have received this additional allowance. Bureaucracy Reform is a national government initiative intended to: (1) realize a clean and corruption-collusion-nepotism free government; (2) improve the quality of public services; and (3) improve the capacity and accountability of bureaucrats' performance through nine major programs covering, among other things, change management, business process improvement, HR improvement and laws and regulations alignment. The BR allowance levels in the Ministry of Finance, the first ministry to undertake BR, were determined by the Ministry itself, while the levels for the subsequent BR agencies, although lower, have also been determined without any transparent benchmarking process that would justify the levels or the differences between institutions.

...and the extent of other allowances

The Indonesian civil service remuneration system is fairly complicated and, in parts, opaque. It includes a range of elements, as detailed in Figure 32 (including the BR allowance), and consists of items like honoraria, which are paid to civil servants for tasks such as attending meetings and making speeches. Honoraria are not classified as Personnel Expenditures, but are budgeted under 'Goods and Services'. Budget managers have considerable discretion when it comes to allocating honoraria, although the Government is now introducing measures to try to limit the amount of honoraria and other ministry specific allowances in different K/Ls.

Figure 32: Honoraria typically account for a high share of the take home pay of civil servants



Note: K/L is line ministry Basic pay, common and Papua/hardship allowances count for 20-40% of total civil servants pay, with the BR allowance accounting for 40-70 percent of total pay in BR institutions, and specific allowances/honoraria for 10-40 percent of total pay

Source: Actual Government Pay, Directorate General of Budget, Ministry of Finance (2011). Data processed by World Bank Staff (2011)

¹⁰ Although not strictly comparable, according to the SAKERNAS labor force survey, the average hourly nominal wage for salaried employees in the private sector rose by 13 percent in the year to August 2009, 3 percent in the year to August 2010 and 12 percent in the year to August 2011. These data cover all nine employment sectors with the exception of the community services, social services, personal services, and other services sectors.

The third driver is the formula for determining the size of the DAU or general allocation funds

The third driver of rising personnel spending is the way the formula for determining the general block grant for regional governments (*Dana Alokasi Umum*, *DAU*, or General Allocation Funds) is designed, where the size of the regional civil servants wage bill is one of the parameters determining the size of the allocation. This creates a strong incentive for regional governments to maximize personnel numbers and increase the wage bill rather than managing or reducing such spending. In addition, since the process for determining staff establishments is not always clear and is based on benchmarking to blueprints rather than operational needs, regional governments have often been able to receive central government approval for an expansion of their workforce. The outcome of this arrangement has been a rapid growth of the number of civil servants at the regional level. Five years ago, there were around 2.8 million regional civil servants, today there are around 3.9 million. This expansion is, however, also partly due to a government policy to convert a huge number of temporary/honorarium staff into permanent civil servants in 2007 and 2008.

b. Offsetting policies or mechanisms are currently lacking

It is difficult to offset the fiscal impact of these drivers...

The Indonesian government currently lacks a set of policies and mechanisms which can be used to offset the fiscal impact of these three drivers. Importantly, budget managers have few opportunities to influence personnel spending and cannot therefore be held responsible for the spending. Further, government institutions and budget managers cannot retain any of the funds freed up by rationalization or other efficiency savings (that might be used, for example, to invest in improving staff capacity or rewarding high performers), providing a strong disincentive for rationalization or for more comprehensive budget management. Finally, there is a lack of mechanisms for right-sizing, both within institutions and units and for closing or merging of institutions to increase efficiency and to adapt the administration to the evolving national and international environment.

...while, increasing spending on personnel may crowd-out spending on political priorities

In aggregate, personnel expenditure represents more than 30 percent of all central and regional government expenditures. As noted above, aggregate personnel expenditure, however, excludes some allowances which represent a significant additional fiscal cost. The personnel spending ratio is growing each year due to the three drivers described above, coupled with the current lack of clear policies and mechanisms both to control and to off-set the rapidly increasing costs. One immediate challenge is to ensure that increasing personnel spending does not crowd-out spending on political priorities, such as infrastructure.

Going forward, improving the link between personnel costs and public sector performance is important

The way forward is to continue with the range of reforms focused on improving the performance orientation of the budget and the management of public employees. This includes performance based budgeting, under which personnel expenditures could be included in the activity budgets managed by the budget managers. Program managers could thereby be given responsibility, and held more accountable, for how resources are used to achieve results. This would also likely require a change of *MenPAN-RB*'s role from having the authority to approve detailed staff establishment ex-ante, into a role of providing policies and models for staffing, while the actual numbers would be determined within the performance based budget process and involve a discussion regarding how the concerned institution would better manage its total resources, including savings/efficiency objectives where appropriate. Mechanisms for rightsizing would also be required.

2. The Higher Education Law: a milestone achieved but still a difficult road ahead

Indonesia's new Law on Higher Education marks a significant milestone on the road towards greater autonomy and accountability of higher education institutions in Indonesia, but support is not universal

A new Law on Higher Education (UU12/2012) was approved by the Indonesian Parliament on July 13, 2012 and signed into law by the President on August 10, 2012. This Law marks what has the potential to be a significant milestone on the long road toward expanded autonomy and enhanced accountability for Indonesian higher education institutions (HEI), i.e. public and private universities, institutes, *Sekolah Tinggi* (colleges), academies, polytechnics, and the soon-to-be-created community colleges. The extent to which this potential will be realized will take time to assess; it depends firstly on development of the regulatory framework which will guide the operation of the law and later on the implementation and application of those regulatory principles. Also, support for the new law is not universal, with concerns raised by several groups in civil and academic society, among them the Association of Indonesian Private Universities (APTISI), with media reports suggesting that they are considering challenging aspects of the new law.¹¹

Expanded autonomy with increased accountability has the potential to modernized the higher education sector and feed through into better institutional performance, improved skills and sustained growth

When greater autonomy comes with greater accountability it can be an important factor in enhancing the performance of higher education institutions, improving educational attainment, skills and ultimately productivity growth. A recent World Bank report highlighted that "higher education is critical for sustained growth in low and middle income East Asia" and can "lift productivity and competitiveness by: providing the high level skills demanded by the labor market - including technical, behavioral, thinking, science, technology, engineering and math skills... [and] launching or expanding robust research needed for innovation and growth".¹² Although most of the available empirical studies are from OECD countries the common finding is that "In countries where more freedoms have been granted, institutions of higher education have begun to act in a more entrepreneurial fashion, align their programs to a greater degree with the demands of students and the labor market, and respond efficiently to government incentives."¹³

Given the intense interest that the debate on autonomy has generated, the following sections first provide an overview of evidence on institutional autonomy and accountability in other countries, as background and context to these developments in Indonesia. A brief summary of other key features, innovations and changes the new Law plans to introduce is then provided, followed by brief concluding comments on likely next steps, and issues.

a. The potential benefits of institutional autonomy and enhanced accountability

Empirical studies, mainly for the OECD, have found enhanced institutional autonomy to be linked to overall positive impacts on academic activity, increased graduate production and enhanced research productivity...

What evidence is there on the potential benefits of greater autonomy and accountability on the performance of higher education institutions? A number of studies have found that university research performance is positively correlated with institutional autonomy.¹⁴ Simulations have also shown that institutional reforms to enhance flexibility and accountability could lead to much greater numbers of graduates and studies have also found that institutional autonomy and leadership could improve HEI's ability to engage in regional development.¹⁵

¹¹ See, for example,

<http://edukasi.kompas.com/read/2012/09/25/19393329/Gugatan.UU.PT.Diajukan.ke.MK>.

¹² World Bank (2011), *Putting Higher Education to Work - Skills and Research for Growth in East Asia*, <http://go.worldbank.org/JTFOQZP670>.

¹³ Sondergaard, L. and M. Murthi with Abu-Ghaida, D., Bodewig, C. and J. Rutkowski (2012), *Skills, Not Just Diplomas: Managing Education for Results in Eastern Europe and Central Asia*, Directions in Development Series, World Bank, <http://go.worldbank.org/E3A4O3PD30>.

¹⁴ See, for example, Knott, J. H. and A. A. Payne (2004), "The impact of state governance structures on management and performance of public organizations: A study of higher education institutions." *Journal of Policy Analysis and Management* 23(1): 13-30 and Aghion, P., Dewatripont, M., Hoxby, C. Mas-Colell, A. and A. Sapir (2009), "The Governance and Performance of Research Universities: Evidence from Europe and the U.S." NBER Working Paper Series No. 14851.

¹⁵ See, respectively, Martins, J., Boarini, R., Strauss, H. de la Maisonneuve C., and C. Saadi (2007), "The Policy Determinants of Investment in Tertiary Education", OECD Economic Department Working Paper No. 576 and OECD (2008), *Tertiary Education for the Knowledge Society* Vol. 1.

Of particular interest is the massive legal reform launched in Japan in 2004, giving its 89 national universities a legal status separate from its Ministry of Education, moving also to financial autonomy and non-civil service status of staff, with a set of accountability arrangements such as external evaluation and internal governance structures. An interim review conducted in 2010 portrays generally positive impacts not only in their educational activities, but also in their ability to win competitive research funds, and in their ability to engage with society.¹⁶

....however, the benefits of increased autonomy are unlikely to be realized if over burdensome accountability measures are imposed and funding is inadequate

The potential benefits from increased autonomy are not, however, automatic. For example, a detailed review of higher education governance reforms launched in a number of countries in Europe since the 1990s, including in transition economies, concluded that institutional autonomy had a positive impact on all aspects of performance, and that European universities should be granted further institutional autonomy to develop their own strategies and structures, particularly their own internal governance structures, budgets and human resource policies.¹⁷ But, the report also provided two warnings. First, the impact of institutional autonomy can be easily lost by excessive accountability requirements. Second, autonomy without adequate funding investments is also unlikely to lead to desirable changes.

b. Enhanced autonomy during Indonesia's New Paradigm era and in the 2012 Law

Indonesia began a move to institutional autonomy in 1999 and for the following decade piloted autonomy measures under the *New Paradigm* era

As in other countries, achieving a balance between institutional autonomy and accountability has been a challenge in Indonesia's higher education system since the mid-1990s. As the higher education sector expanded and became more diverse and complex through the 1980s and 1990s, the Directorate General of Higher Education (DGHE) within the Ministry of Education sought to realign its position from central management to monitoring and supervision with a focus on holding HEI accountable for education outcomes. In response, Indonesian HEI called for greater autonomy, arguing that they could not be held accountable if they did not have the responsibility for their own management. As a result, in 1999, a Government Regulation (PP/61) provided Indonesia's four largest universities a degree of autonomy on a pilot basis by granting them status as Government-Owned Legal Entities (or *BHMN*), and so ushered in what was to be referred to over the next decade as the *New Paradigm* era.¹⁸

During this period Indonesia was a pioneer in enhancing autonomy through competitive funding, but the *New Paradigm* remained a pilot without foundation in law

This new paradigm focused on improving efficiency and effectiveness in HEI management and the quality and relevance of educational outcomes. In recognizing that efficiencies and enhanced "ownership" were to be derived from bottom-up planning and that end-users were best placed to determine their own needs, competitive funding grew from less than 5 percent of the DGHE development budget in the early 1990s to more than 30 percent by 2005. During this period, Indonesia was seen as a pioneer in enhancing HEI autonomy through peer-reviewed competitive grants and a source of lessons of experience to other developing higher education systems in Sri Lanka and later Tunisia and Mozambique. But, the *New Paradigm* era remained a pilot without foundation in law.

A decade passed after the *New Paradigm* began before its innovations were formalized in law, but this was short-lived

It is a mark of the complexity and difficulty in building consensus that it was not until ten years after the *New Paradigm* era began that the 2009 Higher Education Law (UU/9/2009) was ratified, providing a formal basis in law for the autonomy granted under the pilot begun with PP/61. However, just eleven months after its promulgation the 2009 Law was repealed by the Constitutional Court.

¹⁶ Japanese Ministry of Education, Culture, Sports, Science and Technology (2010), *Status and Issues Following Incorporation of National Universities: Interim Report* (report in Japanese).

¹⁷ Center for Higher Education Policy Studies, International Centre for Higher Education Research, (2008), *Progress in Higher Education Reform Across Europe: Governance Reform*.

¹⁸ The four universities were ITB (Bandung Institute of Technology), IPB (Bogor Agricultural Institute), UI (University of Indonesia) and UGM (Gadjah Mada University). In the following five years three further universities were granted BHMN status, namely USU (University of North Sumatera), UNAIR (Airlangga University) and UPI (Indonesian National Education University).

Within less than a year the 2009 Law was repealed, challenged on the basis that autonomy was equivalent to commercialization of higher education....

Fundamentally, the challenge to the 2009 Law was two-pronged; firstly, and most damagingly, was the proposition that institutional autonomy equated to the commercialization of higher education, that the BHMN experience suggested it would lead to higher tuition fees and thus make access to higher education for the poor more difficult. Tuition fees did rise at BHMN institutions after 1999 but from a very low base and a narrow view that the driving force was simply the emergence of commercialization overlooked the real cost of providing a quality higher education.¹⁹

...and that in setting a timetable for all institutions to move to autonomy the Law overlooked the wide diversity in capacity amongst Indonesia's HEI

Secondly, critics argued that, by setting a timetable for all HEI to move to institutional autonomy as financially independent entities, the 2009 Law failed to take account the huge disparities in the development and institutional capacity of Indonesian HEI and their readiness to assume greater autonomy. The movement toward enhanced institutional autonomy was dealt a double blow as in parallel the Ministry of Finance reaffirmed that, commencing in Fiscal Year 2009, the degree of financial management autonomy which had been afforded by the flexibility of competitive block grant funding was withdrawn, requiring public HEI funding to be through the strictly line item budget warrants or DIPA.

The 2012 Law does deliver on its central promise of opening the possibility of institutional autonomy...

The new law sets out the basis for HEI management and the transition to institutional autonomy, including a "grandfather" clause for universities with experience of autonomy under the *New Paradigm* era. Indeed, much of the focus of the debate over institutional autonomy in the new law has been on how to deal initially with addressing the status of those HEI with existing autonomy experience. These universities would move to a new status as a State-Owned Higher Education Legal Entity (*Perguruan Tinggi Negara Badan Hukum PTNBH*) within a period not to exceed two years. In the interim they are required to follow existing procedures for the financial management of State Service Units (*BLU*) until the relevant Government Regulation is produced²⁰ and revise their BHMN statutes to align with what will be their new status as PTNBH.

....but with important caveats

For those HEI not covered by the grandfather clause, the caveat comes in Article 62 where it states that autonomy must be exercised in alignment with the goals and capacity of the institution, that the goals and capacity of the HEI will be evaluated by an independent tertiary institution (yet to be determined) and that "further provisions" on the basis, goals and capacity to exercise autonomy will be detailed in a Ministerial Regulation. While the five principles identified as the basis for autonomy in Article 63 draw on current international best practice; accountability; transparency; non-profit; quality assurance; and effectiveness and efficiency; the devil will be in the detail of how institutions are evaluated against these principles and by whom and over what period of time.

c. Proposed innovations under the new Law

The 2012 Law proposes a number of important innovations

Although the major focus, the law has misleadingly been characterized as simply a law on institutional autonomy, whereas its scope is considerably broader, dealing with quality assurance, access and equity, opening up the possibility of the establishment of foreign universities, expanded higher education pathways, financing priorities and modalities, and the development of new institutions. The law covers both public and privately provided higher education, although private higher education (PTS) receives relatively scant attention in the text of the law. Private providers may however take solace in that those few references are favourable to the operation of PTS; extending the Government commitment to pay the certification allowance to PTS lecturing staff and including private institutions in the incentives program to stimulate research.

Under the new law higher education is delivered through three streams; academic, professional and vocational

The 1989 Law established a dual system of higher education pathways - *academic*, being the traditional, predominantly theory-based, university route and *professional*, envisaged as vocationally-oriented education delivered through Polytechnics. Under the new law, the definition and details of the academic pathway are unchanged, but it envisages the professional stream to be applied post-graduate education towards employment that requires a specific qualification, and introduces a *vocational* stream as diploma level practical education preparing students for employment in a specific field.

¹⁹ World Bank (2010), Indonesia: Higher Education Financing, Section 2.2, pages 22 – 26.

²⁰ DGHE has established working groups and expects to have final drafts for the financing Regulation available for approval in December 2012.

The vocational stream supports the creation of Community Colleges as a new type of HEI and a central task for Government will be to ensure that establishment is demand-driven, asking industry and the community what they need, rather than asking existing educational institutions what they can supply

The new vocational higher education stream aligns with the government proposal to create community colleges in districts, municipalities and remote areas. The Government has undertaken to commence immediately and intends to have approximately 550 by end-2015. Community Colleges are expected to emerge from six sources: in cooperation with existing HEI; in cooperation with the local community; in conjunction with local government; in cooperation with local and regional industry; through upgrading existing non-formal education certificate courses run by non-formal sector private training providers; and as standalone new institutions where an untapped demand is identified.

The budget implications of establishing community colleges could be substantial; with DGHE reportedly estimating the development cost of establishing a standalone Community College as IDR 50 billion (USD 5.3 million)²¹, at which rate just ten percent of the target, the development of fifty colleges, if standalone, would account for a fifth of the annual DGHE capital budget. The majority of Colleges are expected to be financed in cooperative ventures but, even so, with the “20 percent” rule for education as a share of total government spending already achieved, the costs of the targeted roll out will require a reallocation within the current frame of education spending rather than being “top”.²²

Throughout the Law reference is made to the essential “not for profit” nature of higher education...

The criticism levelled at the 2009 Higher Education Law that Indonesian higher education was becoming more commercialized has had a noticeable impact on the drafting of the new law. In several sections the law reinforces that a fundamental principle of Indonesian higher education, applied to both public and private providers, is that it must be “not for profit”.

...and operational support is introduced to compensate public HEI for lowered tuition fees, and lowered revenue from fees, significantly increasing government liability for higher education funding

Sensitivity to the cost of education to students is further apparent with the introduction of operational support to compensate public HEI for lowered tuition fee revenues. Public HEI in Indonesia receive funds primarily from two sources - fees paid by students on the one hand (approximately a third of income) and government allocation on the other (approximately 60 percent) with the balance coming from fee for service to the community and or industry. The Law states that the Government will determine and apply standard higher education operational unit costs for each study program in public HEI as a basis for future budget allocations. It will also set an operational standard for public HEI to use as a reference in determining the amount of tuition fees payable by students and the Government will then use this standard to have public HEI lower the amount of income raised from student fees; by IDR 1.5 trillion in 2013 and IDR 3.0 trillion in 2014 (USD 167 million or a 13.6 percent reduction in 2013, and USD 334 million or a 27 percent reduction in 2014). The Government will then compensate public HEI for the reduced income from tuition fees through an operational assistance fund (*Bantuan Operasional Pendidikan Tinggi Negeri*, BOPTN).

The Government faces the challenge of the need to balance expectations of subsidized higher education with budget constraints while ensuring a quality education

Even with the enhanced autonomy that may be permitted by the Law, both student fees and budget allocation are therefore to be determined by the government. Although this is not uncommon elsewhere, what is unusual in Indonesia is that the Government treats the student fees that HEI receive as public investment in higher education, and reduces the allocation that it pays accordingly.

The road ahead is likely to be challenging as the Government attempts to find its balance between three competing imperatives: community expectations of subsidized higher education with low and not increasing tuition fees, the availability of public funds to supply the subsidy, and both against a backdrop of ensuring HEI have the funding they need to provide a quality education.²³ Critical to achieving this balance will be the calculation of the unit cost of a graduate.

²¹ Kompas, <http://edukasi.kompas.com> 2012/09/09/14064172/Akademi.Komunitas.

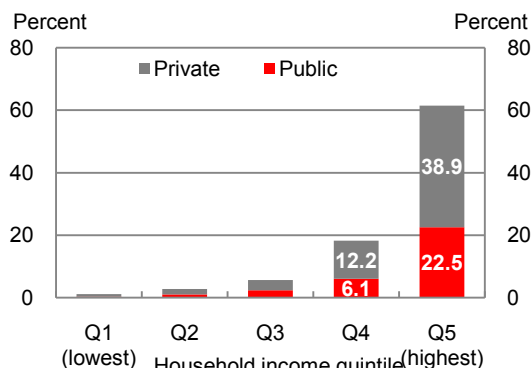
²² For further details and analysis on the “20 percent” rule see Part C of the April 2012 IEQ.

²³ Under one scenario where average public university fees are on the order of IDR 1 million annually and the estimated real need to provide a quality education is IDR 20 million annually, the BOPTN and Government would need to make available would be an annual figure approaching IDR 57 trillion (USD 620 million equivalent), a figure which exceeds by 78 percent the total 2012 DGHE spending on higher education. See World Bank, 2010, *ibid*, Box 2.2, page 36.

The new Law intends to be pro-poor but realizing the mandated enrolment targets will be problematic

In a further attempt to improve access to higher education, the new Law requires HEI to enrol 20 percent of students from poor economic backgrounds, and students from remote and disadvantaged areas. The Law does not provide a definition of “poor” - that will come with the development of the regulatory framework - but under almost any definition policy realisation will be problematic. In 2009 less than 10 percent of HEI public and private enrolment came from the bottom three income quintiles (Figure 33). Policies aiming to increase access through introduction of scholarship and fee support programs for HEI students must address the fact that the vast majority of prospective poor students have left the education system in junior or senior high school before the transition to tertiary education.

Figure 33: The share of students in higher education coming from poorer households remains very low (share of total enrolment in public and private higher education by income quintile in 2009)



Source: SUSENAS 2009

The Law also sets directives to increase HEI spending on research, a step in the right direction given the low level of research funding

The Government will allocate 30 percent of the new operational assistance fund to research funding applied to both public and private HEI and requires both public and private universities to allocate a further 30 percent of their operational budget for research. Given the historically low level of research funding in Indonesia, this new initiative is a move in the right direction, but it is a small step and the challenge ahead will be how to effectively utilize these new research funds within the framework of a line item public financing system.²⁴

The challenge will be to ensure that support to raise the income of private HEI staff flows on to improved teaching competencies or enhanced educational outcomes

The Government will contribute to the professional allowance of lecturers, honorary allowance of professors, and investment and development in private universities. This initiative opens a substantial on-going liability for the Government which in practice is likely to see the Government funding a significant portion of the private higher education sector human resource bill, as by 2014 all lecturing staff should meet certification criteria and hence become eligible for the professional allowance. Recent evidence from wide scale competency testing of primary and secondary teachers suggest no impact on teacher competencies or student outcomes attributable to certification, and the challenge will be to ensure that such a result is not replicated in higher education.²⁵

Foreign universities may open but the Government has reserved significant controls

The new law makes possible the establishment of foreign HEI provided they are accredited in their home country, obtain a license from the government, are based on the principle of non-profit, and are prepared to cooperate with Indonesian HEI —with the approval of Government” which appears to suggest the Government will exercise a veto over the right of association between foreign and Indonesian HEI. Foreign HEI must also give priority to engaging Indonesian teaching staff, and —support the national interest”. It is apparent the Government intends to exercise substantial control on this latter point determining the regions, and types of study programs foreign HEI are permitted to operate.

²⁴ Part C of the December 2011 IEQ provides a review of innovation and R&D in Indonesia, highlighting that Indonesia's R&D expenditure, at 0.08 percent of GDP in 2009, is significantly below regional peers such as China (1.44 percent in 2007), Malaysia (0.63 percent in 2006) and Thailand (0.26 percent in 2006).

²⁵ World Bank, October 2012, Policy Brief; Teacher Certification in Indonesia: A Doubling of Pay or a Way to Improve Learning?

d. Next steps and future challenges

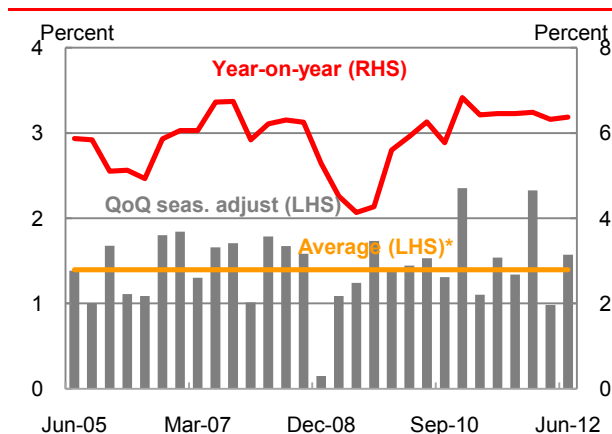
Frequent revisions to the Law in year before promulgation have resulted in misunderstandings and misconceptions which need to be addressed as a matter of urgency and consensus build in support of the required implementing regulations

Debate and the pursuit of agreement amongst stakeholders over the past year have led to many revised drafts of the Law. The immediate challenge the Government and DGHE now faces is how to broadly disseminate information about the actual content of the Law, to dispel any misconceptions and build support. The law itself identifies some 31 Ministerial Decrees (*Permen*) and 11 Government Regulations (PP) that will be needed and which must be developed within the frameworks provided by the 2003 State Finance Law, the 2004 State Treasury Law, the 1974 and 1999 Civil Servant Laws, among others. There are examples of past education laws and regulations²⁶ appearing at odds with the broader Government legislative framework, and so the Ministry of Education, and DGHE in particular, must build consensus across all relevant stakeholders to establish a sound foundation for the urgent next step of developing the requisite Decrees and Regulation.

²⁶ For example PP30/1990 allowed HEI to raise and retain income from fees and contracts for service with the community and industry, but it was subsequently reversed in the same year by a clarification from Ministry of Finance.

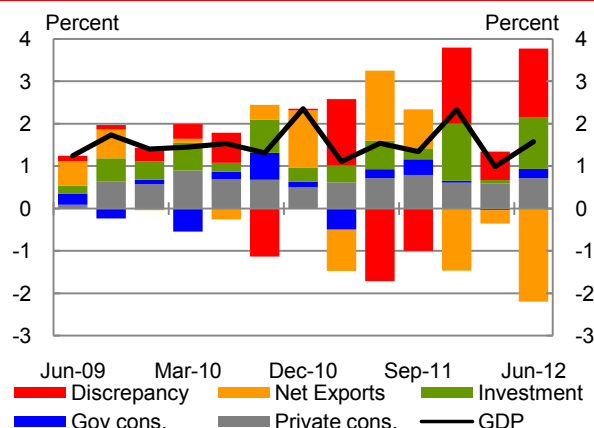
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Quarterly and annual GDP growth
(real GDP growth, percent)



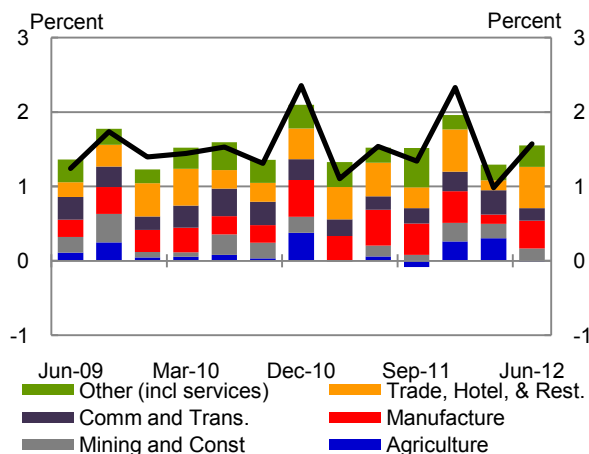
Note: *Average QoQ growth between Q2 2002 – Q2 2012
Source: BPS, World Bank seasonal adjustment

Appendix Figure 2: Contributions to GDP expenditures
(contribution to quarter-on-quarter seasonally-adjusted real GDP growth, percent)



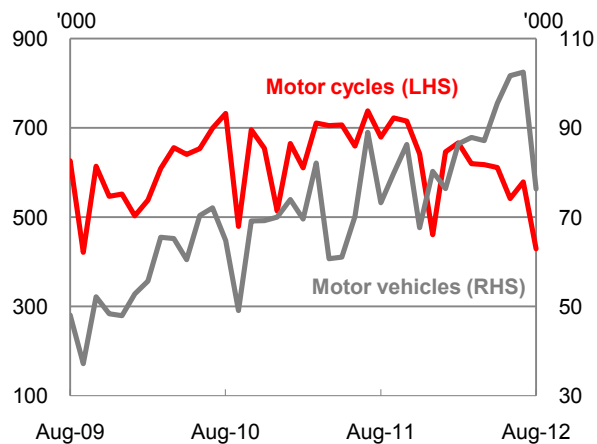
Source: BPS via CEIC and World Bank staff calculations

Appendix Figure 3: Contributions to GDP production
(contribution to quarter-on-quarter seasonally-adjusted real GDP growth, percent)



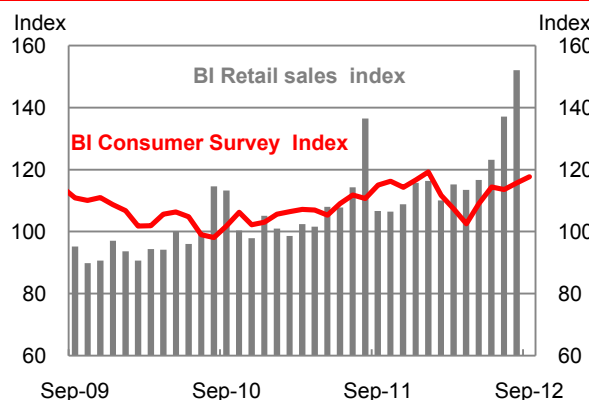
Source: BPS via CEIC and World Bank staff calculations

Appendix Figure 4: Motor cycle and motor vehicle sales
(monthly sales)



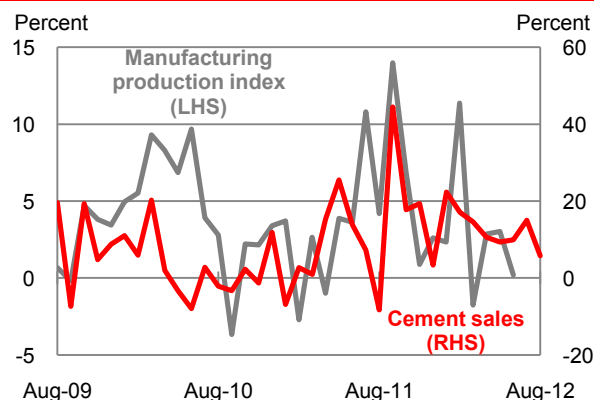
Source: CEIC

Appendix Figure 5: Consumer indicators
(index levels)



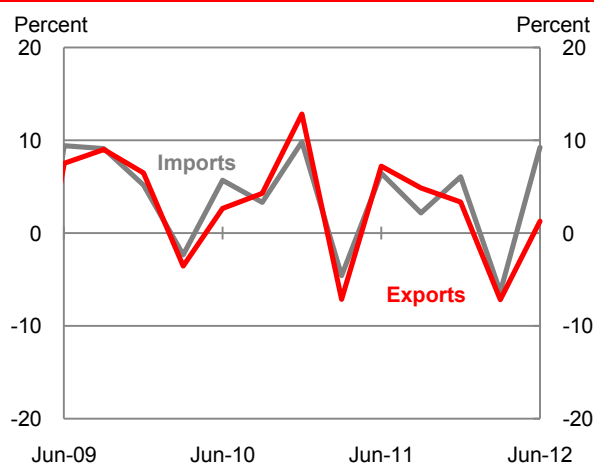
Source: BI via CEIC

Appendix Figure 6: Industrial production indicators
(year-on-year growth, percent)



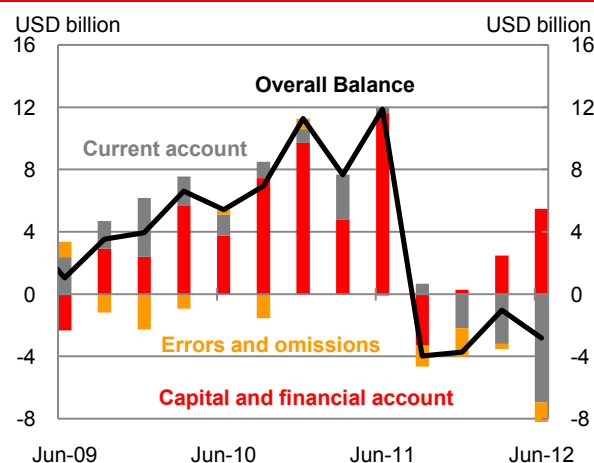
Source: CEIC

Appendix Figure 7: Real trade flows
(quarter-on-quarter real growth, percent)



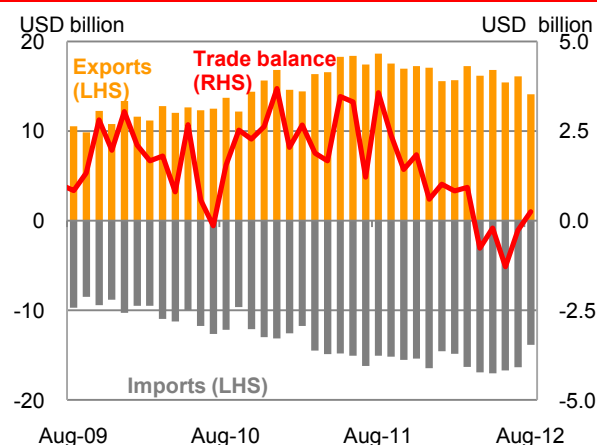
Source: BPS (National Accounts)

Appendix Figure 8: Balance of Payments
(USD billion)



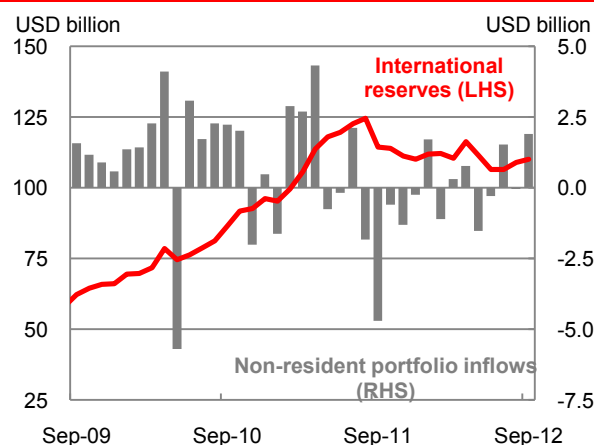
Source: BI

Appendix Figure 9: Goods trade balance
(USD billion)



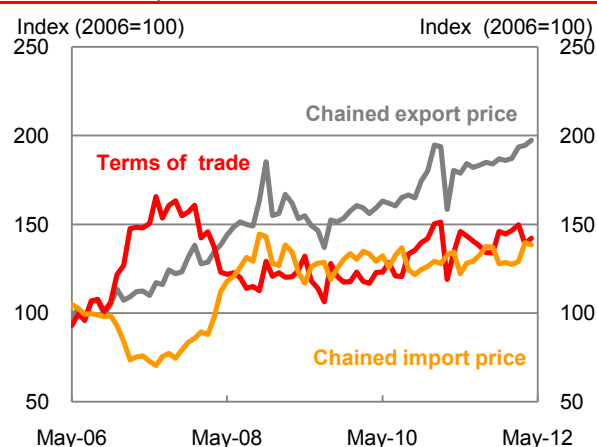
Source: BPS

Appendix Figure 10: Reserves and capital inflows
(USD billion)



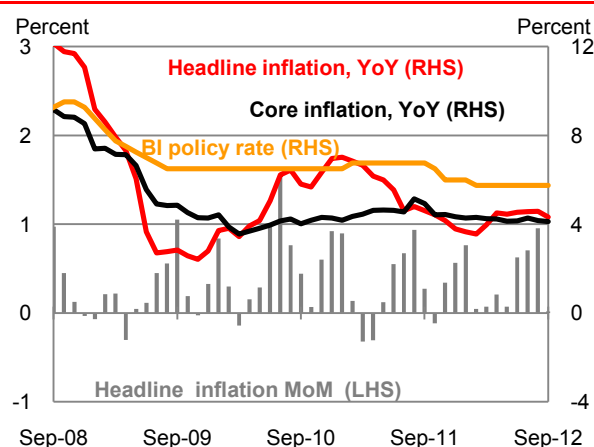
Source: BI, CEIC and World Bank staff calculations

Appendix Figure 11: Term of trade and export and import chained-Fisher price indices
(index 2006=100)

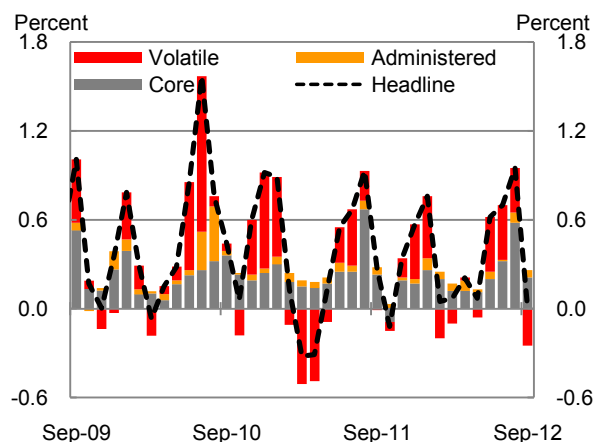


Source: BPS and World Bank staff calculations

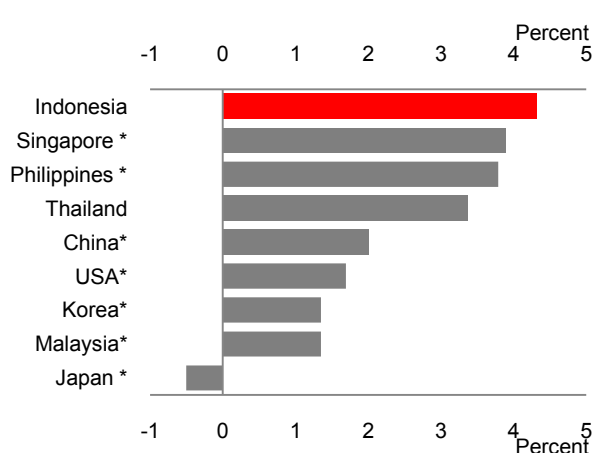
Appendix Figure 12: Inflation and monetary policy
(month-on-month and year-on-year growth, percent)



Source: BPS and World Bank staff calculations

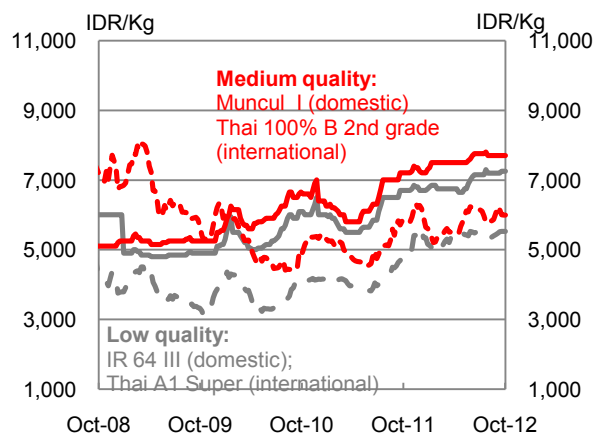
Appendix Figure 13: Monthly breakdown of CPI
(percentage point contributions to monthly growth)

Source: BPS and World Bank staff calculations

Appendix Figure 14: Inflation among neighboring countries
(year-on-year, September 2012)

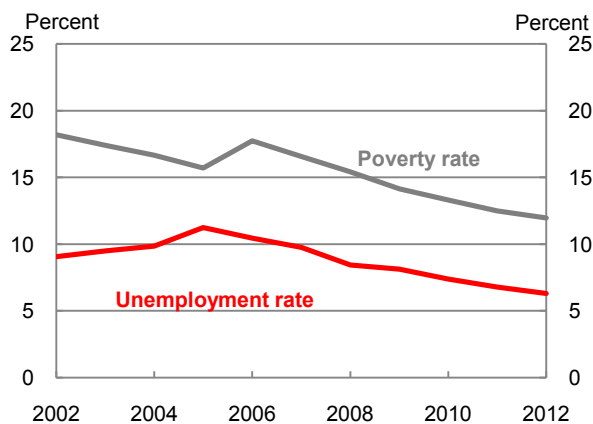
*August is latest available month

Source: National statistical agencies via CEIC, and BPS

Appendix Figure 15: Domestic and international rice prices
(Wholesale price, in IDR per kg)

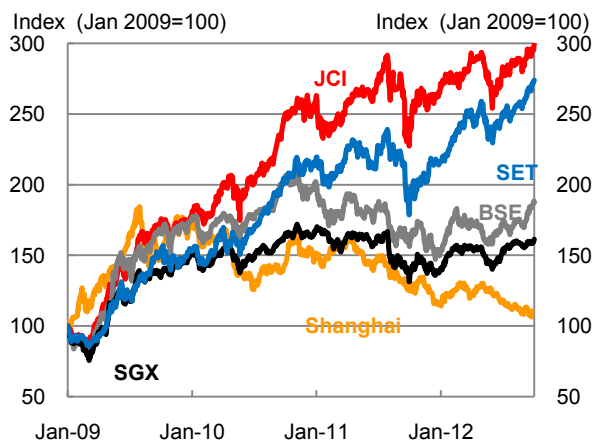
Note: Dashed: international Thai rice (cif) prices. Solid: domestic wholesale rice

Source: PIBC, FAO and World Bank

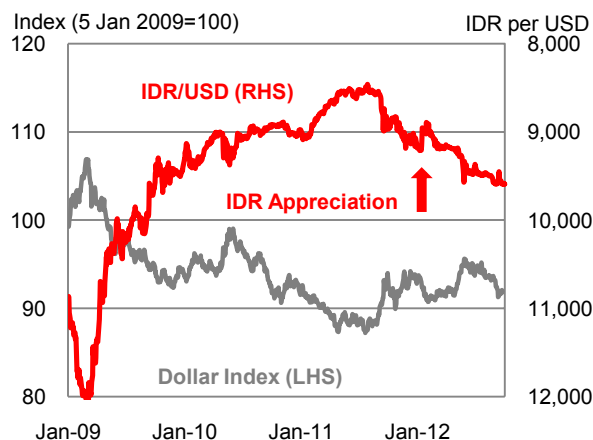
Appendix Figure 16: Poverty and unemployment rate
(percent)

Note: Labor data from February Sakernas

Source: BPS

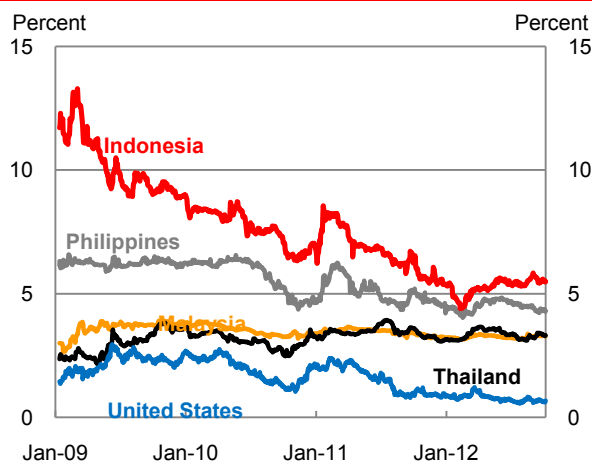
Appendix Figure 17: Regional equity indices
(daily, index January 2009=100)

Source: CEIC and World Bank staff calculations

Appendix Figure 18: Dollar index and Rupiah exchange rate
(daily, index and levels)

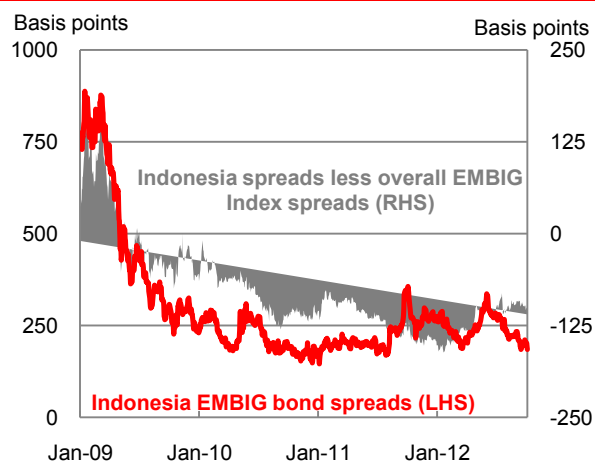
Source: CEIC and World Bank staff calculations

Appendix Figure 19: 5-year local currency government bond yields
(daily, percent)



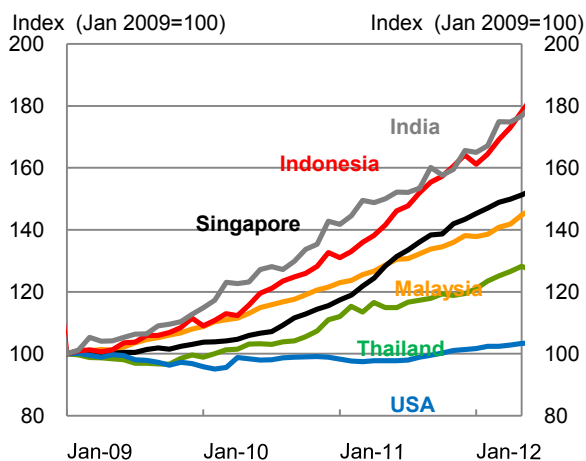
Source: CEIC and World Bank staff calculations

Appendix Figure 20: Sovereign USD Bond EMBI spreads
(daily, basis points)



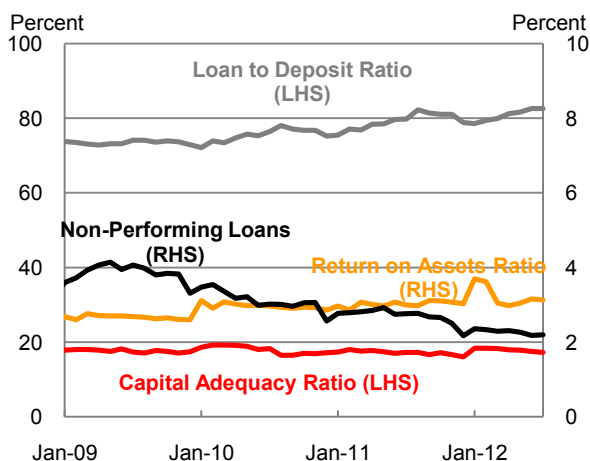
Source: JP Morgan and World Bank staff calculations

Appendix Figure 21: International commercial bank lending
(monthly, index January 2009=100)



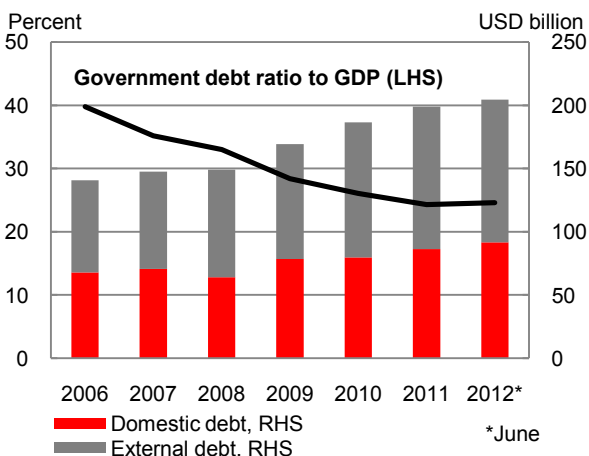
Source: CEIC and World Bank staff calculations

Appendix Figure 22: Banking sector indicators
(monthly, percent)



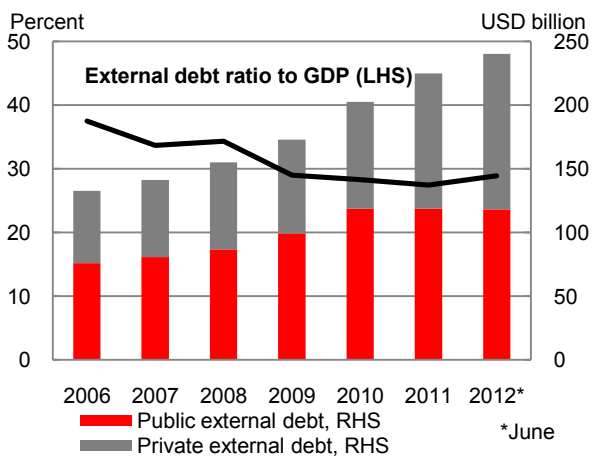
Source: BI

Appendix Figure 23: Government debt
(percent of GDP; USD billion)



Source: MoF, BI and World Bank staff calculations

Appendix Figure 24: External debt
(percent of GDP; USD billion)



Source: BI and World Bank staff calculations

Appendix Table 1: Budget outcomes and projections
(IDR trillion)

	2009	2010	2011	2012 (p)	2013
	Outcome	Outcome	Outcome	MoF Semester I projections	proposed Budget
A. State revenue and grants	848.8	995.3	1,210.6	1,362.4	1,507.7
1. Tax revenue	619.9	723.3	873.9	1,017.0	1,178.9
2. Non-tax revenue	227.2	268.9	331.5	344.6	324.3
B. Expenditure	937.4	1,042.1	1,295.0	1,553.1	1,657.9
1. Central government	628.8	697.4	883.7	1,070.8	1,139.0
2. Transfers to the regions	308.6	344.7	411.3	482.3	518.9
C. Primary balance	5.2	41.5	8.9	-78.9	-37.0
D. SURPLUS / DEFICIT	-88.6	-46.8	-84.4	-190.8	-150.2
(percent of GDP)	-1.6	-0.7	-1.1	-2.2	-1.6

Note: * MoF estimates based on MoF Semester I 2012 report

Source: MoF

Appendix Table 2: Balance of Payments
(USD billion)

	2009	2010	2011	2010		2011				2012	
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Balance of Payments	12.5	30.3	11.9	7.0	11.3	7.7	11.9	-4.0	-3.7	-1.0	-2.8
<i>percent of GDP</i>	2.3	4.3	1.4	3.7	6.0	3.9	5.6	-1.8	-1.7	-0.5	-1.3
Current Account	10.6	5.1	1.7	1.0	0.9	2.9	0.3	0.7	-2.2	-3.2	-6.9
<i>percent of GDP</i>	2.0	0.7	0.2	0.6	0.5	1.5	0.2	0.3	-1.0	-1.5	-3.2
Trade Balance	21.2	21.3	24.2	5.4	6.4	7.4	6.2	7.1	3.6	1.7	-1.3
Net Income & Current Transfers	-10.6	-16.2	-22.4	-4.4	-5.6	-4.5	-5.8	-6.4	-5.7	-4.9	-5.6
Capital & Financial Accounts	4.9	26.6	13.4	7.5	9.7	4.8	11.6	-3.3	0.3	2.5	5.5
<i>percent of GDP</i>	0.9	3.8	1.6	4.0	5.2	2.4	5.5	-1.5	0.1	1.1	2.5
Direct Investment	2.6	11.1	11.5	1.8	4.4	3.8	2.5	2.1	3.1	1.7	3.9
Portfolio Investment	10.3	13.2	3.9	4.5	1.4	3.3	4.9	-4.7	0.3	2.7	3.8
Other Investment	-8.2	2.3	-2.1	1.2	3.8	-2.3	4.2	-0.8	-3.2	-1.9	-2.2
Errors & Omissions	-3.0	-1.5	-3.3	-1.6	0.7	0.0	-0.1	-1.4	-1.8	-0.3	-1.4
Foreign Reserves*	66.1	96.2	110.1	86.6	96.2	105.7	119.7	114.5	110.1	110.5	106.5

Note: * Reserves at end-period

Source: BI and BPS

