INDONESIA ECONOMIC QUARTERLY

Turbulent times

October 2011

THE WORLD BANK | BANK DUNIA

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Investing in Indonesia's Institutions

for Inclusive and Sustainable Development

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 macroeconomic analysis team at the World Bank's Jakarta office, under the guidance of Lead Economist Shubham Chaudhuri and Senior Country Economist Enrique Blanco Armas: Magda Adriani (commodity prices), Andrew Blackman (international environment, external sector and international spillovers), Andrew Carter (government revenues), Fitria Fitrani (external sector), Faya Hayati (prices and labor), Ahya Ihsan (fiscal expenditures and PPPs), David Stephan (national accounts and international spillovers) and Ashley Taylor. Additional contributions were received from Anna I. Gueorguieva, Yuliya Makarova and Wahyoe Soedarmono (sub-national expenditures), Dwi Endah Abriningrum (PPPs), Cut Dian Agustina and Ahmad Zaki Fahmi (East Java inclusive growth) and Jon Jellema (poverty). Arsianti and Ashley Taylor shared the editing and production. Enrique Blanco Armas, Mustapha Benmaamar, Alex Drees-Gross, Franz Drees-Gross, Gregorius D.V. Pattinasarany, Djauhari Sitorus, P.S. Srinivas, William Wallace and Andri Wibisono provided detailed comments and input. 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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Table of contents

LIST OF FIGURES

LIST OF APPENDIX FIGURES

LIST OF TABLES

LIST OF APPENDIX TABLES

LIST OF BOXES

ABBREVIATIONS AND ACRONYMS

APBD	*Anggaran Pendapatan dan Belanja Daerah* (Sub-national budget)	MoF	Ministry of Finance
APBN	*Anggaran Pendapatan dan Belanja Negara* (State Budget)	MP3EI	*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia* (Masterplan for Acceleration and Expansion of Indonesia Economic Development)
APEC	Asia-Pacific Economic Cooperation	MSME	Micro, small, and medium enterprises
ASEAN	The Association of Southeast Asian Nations	MTP	Major trading partners
BAPPENAS	*Badan Perencanaan Pembangunan Nasional* (National Development Planning Agency)	LDR	Loan-to-deposit ratio
BI	Bank Indonesia	LHS	Left hand side
BOS	*Bantuan Operasional Sekolah* (School Operational Assistance)	NER	Net enrollment rate
BPS	*Badan Pusat Statistik* (Central Bureau of Statistics)	NPL	Non-performing loan
Bulog	*Badan Urusan Logistik* (National Logistics Agency)	OECD	Organization for Economic Co-operation and Development
CPI	Consumer price index	O&M	Operations and Maintenance
DAK	*Dana Alokasi Khusus* (Special Allocation Funds)	PDF	Project Development Facility
DAU	*Dana Alokasi Umum* (General Allocation Funds)	PISA	Program for International Student Assessment
DBH	*Dana Bagi Hasil* (Revenue Sharing Fund)	PPIAF	Public-Private Infrastructure Advisory Facility
DEKON/TP	*Dekonsenstrasi* (Deconcentration) and *Tugas Pembantuan* (Co-Administered Tasks)	PPI	Private Participation in Infrastructure
DID	*Dana Insentif Daerah* (Local Incentive Grants)	P3CU	Public Private Partnership Central Unit
DPRD	*Dewan Perwakilan Rakyat Daerah* (Regional House of Representative)	RHS	Right hand side
EFSF	European Financial Stability Facility	RMU	Risk Management Unit
EMBIG	Emerging Market Bond Index Global	SBI	*Sertifikat Bank Indonesia* (Bank of Indonesia Certificate)
EME	Emerging market economies	SD	*Sekolah Dasar* (Primary School)
EU	European Union	SIKD	*Sistem Informasi Keuangan Daerah* (Regional Financial Information System)
FDI	Foreign direct investment	SMP	*Sekolah Menengah Pertama* (Junior High School)
GDP	Gross domestic product	SMK	*Sekolah Menengah Kejuruan* (Vocational High School)
GoI	Government of Indonesia	SMU	*Sekolah Menengah Umum (*Senior High School)
HRV	Hausmann, Rodrik and Velasco	SUNs	*Surat Utang Negara* (government securities)
IDR	Indonesian Rupiah	Susenas	*Survey sosial ekonomi nasional* (National Household Socioeconomic Survey)
IEQ	Indonesia Economic Quarterly	TIMSS	Trends in International Mathematics and Science Study
IGF	Indonesia Guarantee Fund	UKP4	*Unit Kerja Presiden Bidang Pengawasan dan Pengendalian Pembangunan* (The Presidential Working Unit for Supervision and Management of Development)
IMF	International Monetary Fund	USAID	United States Agency for International Development
KKPPI	Committee for the Acceleration of Infrastructure Provision	US	United States
KPPOD	Regional Autonomy Watch Committee	USD	US dollar
LARF	Land Acquisition Revolving Fund	VAT	Value Added Tax
LDR	Loan-to-deposit ratio	WB	World Bank
MICI	Monitoring Investment Climate in Indonesia	yoy	year-on-year

Executive Summary: Turbulent times

How will the deterioration in the global economic and financial outlook impact Indonesia?

External events have dominated economic developments for Indonesia over the past quarter. The outlook for global growth has weakened and the Euro zone sovereign debt crisis has intensified. International risk aversion and market volatility have increased, although they remain well below levels seen in late 2008. Equity markets have fallen and emerging markets have seen capital outflows, putting downward pressure on their currencies. Indonesia's domestic economic performance has continued to be strong but, as in other countries in the region, its financial markets have not been immune from this turbulence. On 22 September Indonesian equities suffered their largest daily decline since October 2008, and non-resident investors' equity and bond holdings have been reduced. Looking forward, how will the deterioration, and increased uncertainty, in the global economic environment impact Indonesia over the near-term?

In the near-term it is expected that international financial market turbulence will continue but there are also risks of less likely, but more adverse scenarios

How events unfold in the US, the Euro area and China will be a primary determinant of the nature and extent of the external headwinds that Indonesia may face in the near-term. With the policy solution to the Euro zone debt crisis still evolving, ongoing financial turmoil and volatility, and moderation in commodity prices, would seem to be a reasonable baseline scenario. This turbulence could dissipate over time if there is supportive policy action, boosting confidence, investment and growth. However, there is a risk that a major negative event, such as a disorderly resolution to the situation in the Euro zone, triggers an international financial crisis, similar to that experienced in late 2008. With policy responses constrained in many countries, global growth, trade and commodity prices would likely take a further hit. In an extreme scenario this could lead to a severe global growth slowdown if major emerging economies such as China and India do not support global demand, as they did in 2009, but instead their growth also suffers a hard landing.

Indonesia enters this period of heightened uncertainty in a relatively strong position…

Indonesia's domestic drivers of growth, its solid fiscal position, accumulation of reserves, and strengthened financial sector performance make it relatively well-placed to deal with shocks arising from the above scenarios. This improved resilience to external shocks, and a strong policy response, was seen during the 2008-09 crisis.

…with robust recent growth performance and declining inflation,…

GDP growth in Q2 2011 was unchanged from Q1 at 6.5 percent year-on-year. Private consumption and investment remain robust. Non-tradable sectors continue to drive growth but manufacturing growth also moved above 6 percent in Q2 for the first time in six years. With food price inflation declining, headline inflation has moved down to 4.8 percent in August 2011. Notwithstanding the adverse impact of previous higher food prices on net food consumers, the strength of the domestic economy contributed to a decline in the national poverty rate to 12.5 percent in March 2011 from 13.3 percent a year earlier.

…a strong fiscal position,…

Indonesia's government debt to GDP ratio is low, at around 25 percent, and on a downward trajectory. This is in contrast with the worsening fiscal position of many countries since 2008. The deficit is projected to fall from 2.1 percent of GDP in the 2011 revised Budget to 1.5 percent in the Government's 2012 proposed Budget. Energy subsidy spending remains vulnerable to higher oil prices, as seen in the increase in the deficit in the 2011 revised Budget from the original Budget level of 1.8 percent of GDP. However, core expenditures, particularly infrastructure, are constrained by disbursement problems. The fiscal financing position also appears able to weather short-term market volatility, after over-financing in 2010 and pre-financing through 2011.

…the accumulation of reserves on the back of record balance of payment inflows over 2010 and the first half of 2011,…

Entering the market turbulence of September, Indonesia's reserves were USD 125 billion, over twice their level in August 2008. Total balance of payment inflows posted another high in the second quarter of 2011, on the back of record financial account inflows. In addition to portfolio inflows, FDI has been on an upward trend. The current account surplus has narrowed however, although mainly due to a widening of the income deficit.

..and strengthened financial sector performance

Indonesia's strengthened financial sector performance serves as a buffer against real spillovers from the recent market instability. This is in part due to efforts to implement and enforce improvements in the overall regulatory and supervisory framework. Banking sector capital adequacy is high and NPLs have come down. Liquidity for the system is also high but needs to be monitored as levels of liquidity are not even across banks.

International developments are however likely to affect Indonesia's near-term growth prospects through their impact on external demand, commodity prices and capital flows

International shocks can be transmitted to Indonesia through a variety of channels, including trade linkages. Indonesia's direct trade exposure to the US and EU is limited but indirect effects on Indonesia through other trading partners could be more significant. Falls in global commodity prices and lower demand from major emerging economies, particularly China, present another transmission channel which could affect Indonesia's exports and also its fiscal balances, domestic investment, consumption and inflation.

As highlighted above, financial market spillovers to Indonesia have already been seen. Indonesia's exposure to portfolio outflows has increased in parallel with the build-up of reserves over recent years. The volumes and direction of portfolio flows, and the cost of financing for the Government and Indonesian firms, are sensitive to international investor sentiment but also to the domestic economic situation and policy environment. Similarly for FDI, Indonesia's attractiveness as a destination will likely remain but a sustained weakening of corporate conditions in source countries could affect inflows.

The World Bank's baseline growth projection for 2012 has been lowered to 6.3 percent

In the baseline scenario of continued international financial market turbulence, the World Bank projects Indonesia's growth at 6.4 percent in 2011 before moderating to 6.3 percent in 2012 (Table 1). The 2012 growth projection has been downgraded from 6.7 percent in the June *IEQ* due to a weaker outlook for major trading partner growth and commodity prices, but is still at a solid level. Under a more pessimistic scenario including a major international financial crisis and further weakening of external demand, Indonesia's 2012 growth is projected to decline to around 5.5 percent. Finally, in an extreme scenario where such a crisis leads to a severe global growth downturn in which China and India also suffer a sharp decline in growth, Indonesia's growth in 2012 could drop markedly, although the projection remains just above 4 percent.

Table 1: In the baseline scenario growth is projected to moderate in 2012

		2009	2010	2011	2012
Gross domestic product	(Annual percent change)	4.6	6.1	6.4	6.3
Consumer price index*	(Annual percent change)	2.6	6.3	5.0	5.5
Budget balance**	(Percent of GDP)	-1.6	-0.6	-2.1	-1.5
Major trading partner growth	(Annual percent change)	-1.0	6.6	3.3	3.9

Note: * Q4 on Q4 inflation rate. ** 2011 figure is approved revised Budget and 2012 is the Government's proposed Budget
Source: Ministry of Finance, BPS via CEIC, Consensus Forecasts Inc., and World Bank

A strong and consistent domestic policy response can limit the spillovers of any external shocks and mitigate their impact

The Government and Bank Indonesia (BI) have already put in place a number of policies to deal with capital outflows, including purchasing domestic government bonds. Previous measures include lengthening maturities and extending the minimum holding period on BI certificates. BI has also been pursuing a range of other macro prudential policies. Room for fiscal stimulus is also there, if required, but, additional spending could be hampered by disbursement problems. However, Indonesia's solid macro fundamentals and existing policies are some of the strongest defenses to weather current and future turbulence. Further strengthening of the authorities' ability to address risks would be beneficial. Current volatility makes it even more important to avoid policy uncertainty, particularly relating to changes in restrictions on foreign investment and the regulatory and governance environment.

Maintaining progress on reforms to improve the investment climate, infrastructure and public service delivery can also help to boost investor confidence and enhance Indonesia's medium-term growth outlook

Indonesia's underlying economic fundamentals remain strong and the projection for medium-term growth of 6.5 percent or higher remains. Continued progress on signature structural reforms, such as energy subsidy reform, land acquisition and infrastructure financing, is key to moving these potential growth rates higher and can also play an important role in maintaining investor confidence in the near-term. This edition of the *IEQ* features a number of pieces on such medium-term issues. The first discusses how the framework for Public Private Partnerships in Indonesia and their implementation could be strengthened so as to help the Government meet its targets for private sector infrastructure investment. The second piece examines the central role of sub-national governments in public service delivery in areas such as infrastructure, health and education and the current constraints on the efficiency of sub-national spending. The final piece looks at the core development challenge of how to make growth more inclusive, as well as higher, focusing on an analysis of the province of East Java.

A. ECONOMIC AND FISCAL UPDATE

1. The return of global growth downgrades and increased market turbulence

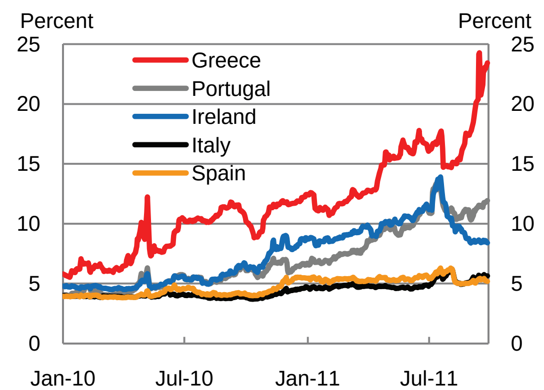
The global economic environment has weakened markedly over the past quarter and become more uncertain…

The past quarter has seen the intensification and widening of the Euro zone sovereign debt crisis and a weakening in the growth outlook for the US and EU, but also for some of the major emerging economies. The health of the European banking sector remains a major concern and its funding costs have risen. Policy uncertainty, particularly in relation to the response to the Euro zone debt crisis and on US fiscal policy (as seen in the federal debt ceiling negotiations), clouds the near-term outlook and weighs heavily on investor sentiment. Financial market volatility picked up sharply over the quarter. Large-scale sell-offs of equities were seen as rising risk aversion prompted a "flight to quality". Many commodity prices also declined, particularly of raw materials. The question of how this deterioration in the global outlook might impact Indonesia is a central theme of this *IEQ*. To set the scene, this section first provides a brief summary of major developments, focusing in on key areas of interest for Indonesia's economy, namely major trading partner growth, commodity prices and international portfolio flows.

…driven by heightened concerns over the uncertain resolution of the Euro zone debt crisis and its implications for the European banking sector…

Concerns over implementation of fiscal reforms and growth prospects have increased for Greece and for other Euro zone members (Figure 1). These fiscal sustainability worries have spilled over into the credit risk of banks with large holdings of Euro zone sovereign debt. Euro area bank funding costs have also risen. In response, Euro area member states agreed an additional bailout for Greece in late July and the resources and remit of the European Financial Stability Facility (EFSF) have been expanded. In late July it was agreed that, subject to national member state ratification or approval procedures, the EFSF would be able, if needed, to provide precautionary funding, to lend to non-program countries with the objective of recapitalizing financial institutions, and to intervene, subject to conditions, in secondary debt markets. However, there remains considerable market concern over the policy response to the debt crisis and the potential for a disorderly resolution.

Figure 1: Market concerns over Euro zone fiscal sustainability have risen
(10 year government bond yields, percent)



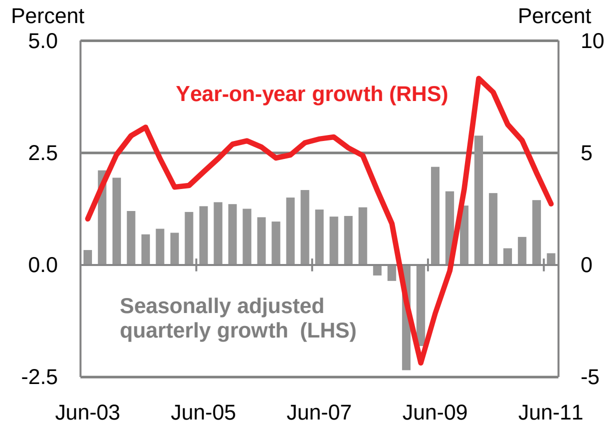
Source: Datastream

…along with a lowering of the growth outlook, particularly for high-income economies

The growth outlook for high income economies has been downgraded following weaker than expected outturns for the second quarter of 2011, along with downward revisions to previous growth outcomes. For example, in late June the official estimate of US growth in the first quarter of 2011 was revised down to an annualized 0.4 percent from the previous level of 1.9 percent. The impact of the earthquake and tsunami continued to pull down growth in Japan. Following very strong Q1 results there was also a moderation in growth across emerging East Asia. These factors contributed to the reduction in the overall growth rate of Indonesia's Major Trading Partners (MTP) (Figure 2).

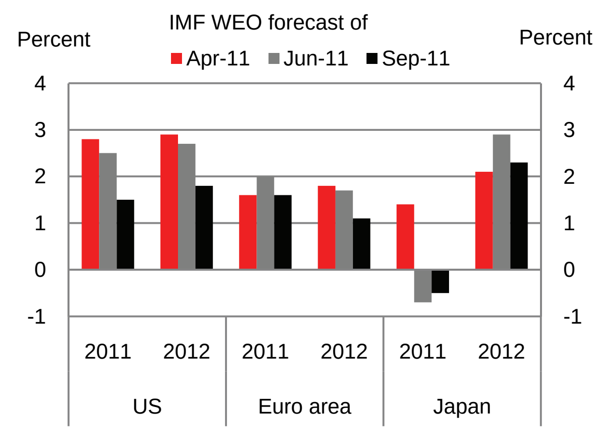
Forward and partial indicators point to weaker activity through the rest of 2011, as debt concerns and the real impact of fiscal austerity measures weigh on the European outlook, and US consumer confidence remains low. The OECD's leading indicators index suggests growth momentum is slowing across both developed and emerging markets. The IMF's September 2011 World Economic Outlook downgraded US growth forecasts for 2011 and 2012 by around one percentage point relative to the forecasts of June 2011. Forecasts for the Euro area were lowered by roughly one half of a percentage point (Figure 3). Growth for developing and emerging economies was also downgraded slightly but remains above 6 percent. With China's contribution so central to global growth and commodity demand, the signs of any weakening in Chinese manufacturing activity are being watched carefully.

Figure 2: Growth in Indonesia's major trading partners has weakened
(Indonesia's major trading partner GDP growth, percent)



Note: MTP series constructed from growth rates weighted by Indonesia's nominal export shares in 2010
Source: CEIC and World Bank

Figure 3: Driven by troubles in developed economies, the global growth outlook has been downgraded
(GDP growth, percent)



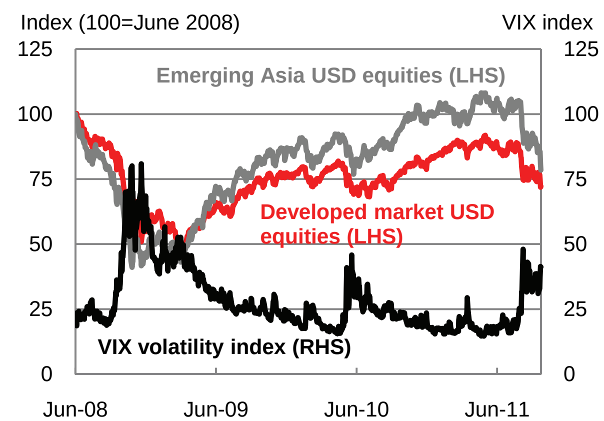
Source: IMF World Economic Outlook (WEO, various)

Global equity markets fell sharply with risk aversion rising

Financial markets have been buffeted over the past quarter by the above developments, although the level of financial market stress remains far from that seen in late 2008. The VIX index measure of equity market volatility roughly doubled from mid-June to mid-September (Figure 4). With risk aversion rising, investors moved into safer assets (Figure 5). From 15 June to 27 September developed market equities declined by 11.2 percent in US dollar terms. The yields on 10 year US Treasuries declined by around 1 percentage point to just under 2 percent.

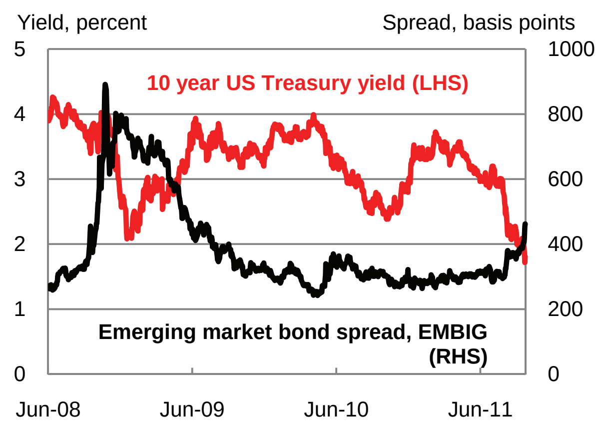
Emerging markets have not been immune from this turbulence. Emerging Asia equities were down by 21.3 percent in US dollar terms from 15 June to 27 September. Average spreads on emerging market bond increased by over 130 basis points to roughly 450 basis points and there has been an across the board increase in credit default swap rates. New capital issuance to developing countries fell off in July and August and significant investor outflows from emerging market positions were seen, including from Indonesia, as discussed below.

Figure 4: Equity markets have fallen sharply and volatility has increased…
(USD equity index; VIX equity volatility 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
Sources: Datastream and World Bank

Figure 5: …and investors have shifted towards safer assets such as US Treasuries
(yield, percent; spread over US Treasuries, basis points)



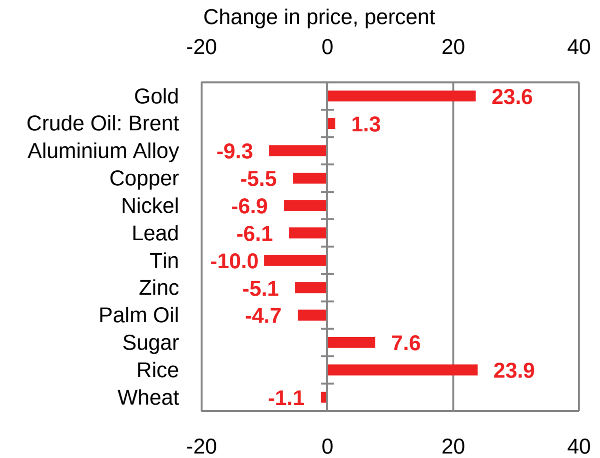
Note: EMBIG is JP Morgan Emerging Bond Index Global.
Source: Datastream

Many commodity prices have also seen falls, particularly those used as inputs to manufacturing or investment

Many commodity prices have fallen with the above developments. In August the World Bank's US dollar index of non-energy commodity prices fell by 1.6 percent while energy prices declined by 6.3 percent. Looking across a selection of commodities, the price declines from June to September were greater for metals (Figure 6), reflecting the fall in optimism on the outlook for manufacturing and investment. One notable exception has been the rise in gold prices as investors seek a "safe-haven" asset. International (Thai) rice prices have also increased due to domestic policy changes (see the prices section below for more details).

Figure 6: Global commodity price declines have focused on metals and raw materials

(change in average USD international price from June to September 2011, percent)



Note: September is average to 26 September
Source: CEIC and World Bank

Difficult economic challenges mean that the international financial market situation is likely to remain fluid over the near-term

The underlying economic challenges faced in many high income economies are medium-term - fiscal consolidation and the restoration of the health of bank and private sector balance sheets and structural reforms to improve trend growth prospects. For many highly-indebted economies the policy levers to respond to a further reduction in growth are limited and the policy responses may often be subject to complex political negotiations. Despite the still robust outlook for emerging economies, with no clear resolution of the Euro zone crisis yet in place, the international financial market situation is likely to remain fluid over the near-term. Dealing with the resultant volatility in capital flows will add to the challenges that developing economies face, including, for some, inflationary pressures but also addressing any real spillovers there might be from the growth downturn in the EU and US. In light of this uncertainty Part B of this *IEQ* explores a number of different scenarios for how the global economic situation may evolve and how this may impact Indonesia.

2. Uncertainty has risen around a baseline outlook of solid domestic growth

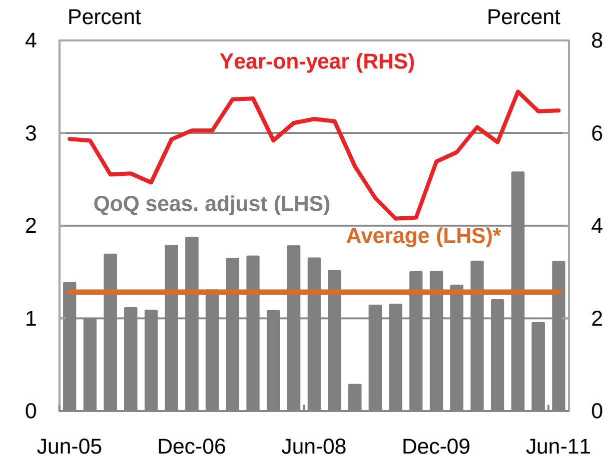
GDP growth remained strong in the second quarter of 2011 at 6.5 percent

Indonesia's economy continued to grow strongly in Q2 2011. Year-on-year growth was unchanged from Q1 at 6.5 percent (Figure 7). On a seasonally adjusted basis, quarterly growth increased by 1.6 percent, well above the 1.0 percent recorded in Q1 and the 10-year average growth rate. The growth recorded in the second quarter was in line with market expectations and the June *IEQ* forecasts. In light of this performance-to-date, and the continued strength of domestic drivers of growth, the growth forecast for 2011 of 6.4 percent is unchanged on the June *IEQ.* However, as highlighted above, the international outlook has deteriorated. As a result primarily of the projected slowdown in external demand, the 2012 growth forecast has therefore been reduced to 6.3 percent from 6.7 percent, and the uncertainty around this baseline has widened.

Private consumption and investment provide continued support to activity while net exports gave a strong boost in the second quarter of 2011

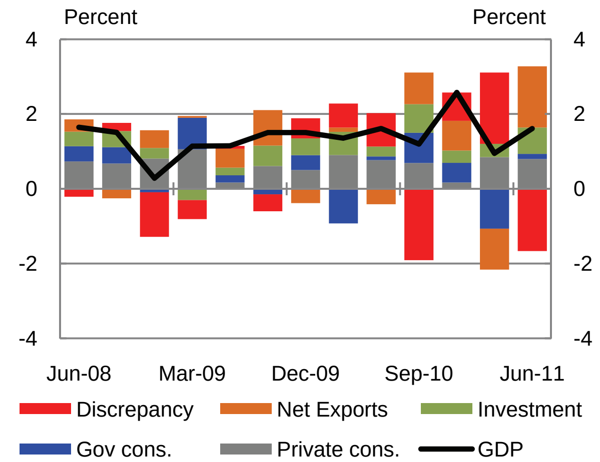
Private consumption continued to contribute strongly to quarterly GDP growth in the second quarter, while investment growth rebounded (Figure 8). The growth in private consumption has been supported by the continued high levels of consumer sentiment and the recent declines in inflation. The strength in investment was driven by building construction, consistent with recent strong cement sales. However, it was net exports which provided the major contribution to quarterly growth, after their negative contribution in Q1. Quarterly growth in real exports moved up to 5.4 percent; almost double that of real imports. The strength in Q2 exports was due to strong gains in commodity and agricultural exports particularly to Japan, China and India. Real government consumption made a minor contribution to quarterly growth, indicative of ongoing disbursement problems.

Figure 7: Quarterly GDP growth remained at 6.5 percent in the second quarter of 2011…
(growth in real GDP, percent)



Note: * Average QoQ growth since Q2 2001
Source: BPS and World Bank staff seasonal adjustment

Figure 8: …driven by net exports, private consumption and investment
(contribution to quarter-on-quarter seasonally adjusted growth, percent)



Note: Contributions may not sum to overall GDP growth due to seasonal adjustment of each individual series
Source: BPS and World Bank staff calculations

Manufacturing growth was notable, moving above 6 percent for the first time in six years

Growth on the production side of the national accounts in Q2 was driven by retail and wholesale trade, manufacturing, and transport and communications. Non-tradable sectors continued to contribute the majority of growth, although with some moderation of their growth rates. The manufacturing sector recorded a very strong result in Q2, rising by 6.1 percent year-on-year and 2.0 percent quarter-on-quarter seasonally adjusted, buoyed by exports and domestic demand. This was the first time for six years that year-on-year growth was above 6 percent. The broad-based growth in manufacturing came despite a slowdown in transport equipment and machinery production which resulted from supply disruptions associated with the devastating earthquake and tsunami in Japan in March.

The external environment has weakened but, with its strong economic fundamentals, Indonesia is projected to maintain growth of 6.4 percent in 2011 and, while the projection for 2012 has been downgraded, it remains a solid 6.3 percent

As highlighted above, events over the past quarter have increased the uncertainty over the global outlook and affected some of the key drivers of growth for Indonesia, in particular major trading partner growth and commodity prices. The extent of risk aversion of international investors, and the policy responses in Indonesia, will also feed through into the outlook for capital inflows.

Under a baseline scenario, the projection for major trading partner (MTP) growth is revised downwards relative to the June 2011 *IEQ* by around 1 percentage point in both 2011 and 2012. The oil price assumption remains at USD 105 per barrel, balancing the uncertain outlook with the strong outcomes in the first part of the year. Prices are expected to moderate slightly to USD 100 in 2012.

Under this baseline, the lower MTP growth is, however, offset by the near-term strength of domestic private consumption and investment, with the latter reflecting recent FDI inflows and rising capital expenditures under the Budget. Combined with the strong growth numbers seen already over the year, this leaves the 2011 growth projection unchanged from the June *IEQ* at 6.4 percent. For 2012 the growth projection has been revised down by 0.4 basis points to 6.3 percent. This reflects the downward revision to external demand and to the commodity price outlook which, along with the increased economic uncertainty, feeds into some moderation in the growth rates of consumption and investment over 2012 (Table 2).

This baseline is predicated on continued positive domestic fundamentals, including a coordinated policy response should there be any adverse spillovers from international market turbulence to the domestic financial sector, for example. How developments play out in the Euro zone, the US and China, and in international financial markets, could lead to different outlooks. The risks section below and Part B examine different potential scenarios in more detail.

Table 2: Baseline GDP growth projections for 2011 have been downgraded, risks around the outlook have risen further
(percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual	
	2010	2011	2012	2010	2011	2012	2011	2012
1. Main economic indicators								
Total Consumption expenditure	4.0	5.1	5.4	4.9	6.4	5.0	-0.1	-0.8
Private consumption expenditure	4.6	4.9	4.7	4.4	5.6	4.6	0.0	-0.3
Government consumption	0.3	6.6	10.1	7.3	10.6	6.9	0.0	-3.5
Gross fixed capital formation	8.5	9.2	9.3	8.7	10.3	9.0	0.0	-0.6
Exports of goods and services	14.9	14.1	8.9	16.1	9.1	7.7	1.2	-1.6
Imports of goods and services	17.3	15.4	10.0	16.9	10.4	9.1	-1.5	-2.6
Gross Domestic Product	**6.1**	**6.4**	**6.3**	**6.9**	**6.2**	**6.0**	**0.0**	**-0.4**
Agriculture	2.9	3.4	3.8	3.8	1.7	4.0	0.0	-0.1
Industry	4.7	5.1	5.0	5.3	5.3	4.5	0.2	-0.2
Services	8.4	8.5	8.1	9.2	8.8	7.8	-0.1	-0.7
2. External indicators								
Balance of payments (USD bn)	30.3	23.9	18.8	n/a	n/a	n/a	-0.9	-7.2
Current account balance (USD bn)	5.6	2.3	0.3	n/a	n/a	n/a	-0.5	-4.2
Trade balance (USD bn)	21.3	21.7	19.7	n/a	n/a	n/a	3.1	-1.3
Financial account balance (USD bn)	26.2	23.3	18.5	n/a	n/a	n/a	0.8	-3.0
3. Other economic measures								
Consumer price index	5.1	5.6	5.5	6.3	5.0	5.5	-0.3	-0.6
Poverty basket Index	8.4	8.1	6.7	11.1	5.8	6.4	0.3	-0.3
GDP Deflator	8.0	8.3	9.0	8.0	8.7	8.7	-0.9	-0.6
Nominal GDP	14.6	15.2	15.8	15	15.5	15.2	-1.0	-1.2
4. Economic assumptions								
Exchange rate (IDR/USD)	9074	8662	8650	8977	8650	8650	-50.9	0.0
Interest rate	6.4	6.8	6.8	6.5	6.8	6.8	0.0	-0.3
Indonesian crude price (USD/bl)	79.4	105.0	100.0	86.2	100.0	100.0	0.0	3.0
Major trading partner growth	6.6	3.3	3.9	5.6	3.9	4.1	-1.0	-0.8

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
Source: MoF, BPS, BI, CEIC and World Bank projections

3. Capital inflows remained strong in Q2 while the trade surplus narrowed

Overall balance of payment inflows in Q2 2011 posted another record inflow…

Overall balance of payment inflows posted another high in Q2 2011, reaching USD 11.9 billion on the back of record capital and financial account inflows of USD 12.5 billion (Figure 9). The current account surplus narrowed sharply to USD 0.2 billion while net errors contributed USD 0.8 billion in outflows. The strong Q2 overall inflows, plus further inflows in July and August, saw international reserves reach USD 124.6 billion at the end of August (equivalent to 7.1 months of imports and external government debt service).

…as FDI and portfolio flows continued to perform strongly, prior to the recent market turbulence

The eighth successive quarterly capital and financial account surplus was again driven by strong net portfolio inflows into government securities (both domestic and May's global bond) and corporate debt. Net repatriation of foreign currency and deposits and net loan drawings from overseas also contributed. FDI inflows continued to perform strongly, with USD 5.2 billion in gross inflows, while net FDI reached USD 2.7 billion. This adds to the favorable trend of rising longer-term investment, relative to portfolio flows.

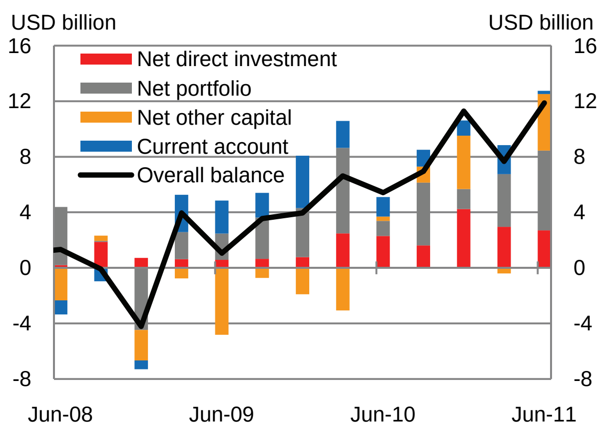
The current account continues to narrow, driven primarily by profit repatriation on the income balance

In Q2 2011 the current account approached a quarterly deficit for the first time since the global financial crisis in 2008. Indonesia's balance of trade in goods and services was broadly stable, although the oil and gas goods deficit continued to widen. Current transfers were also down slightly but it was the significant widening in the income deficit, to USD 6.9 billion from USD 5.3 billion in Q1, which was the major contributor to the decline in the current account surplus. This was mainly due to profit repatriation on direct investment which could be viewed as a signal of Indonesia's attractiveness as an FDI destination.

Rising oil and gas imports offset exports of other commodities in the second quarter

On the trade balance, a higher non-oil and gas trade surplus was offset by a wider oil and gas deficit, and an increase in the services deficit as expenditures on freight services rose in line with trade volumes. Particular increases in exports were seen for commodities, such as rubber, palm oil and coal, while imports of processed industrial goods and capital goods remained firm, in line with domestic investment. The oil and gas balance registered its first quarterly deficit, according to Bank Indonesia balance of payments data, as oil imports, particularly processed products, continued their upward trend. This is in line with higher domestic demand for subsidized fuel (see fiscal section below). Monthly data points to a continuation of the fall in goods trade surplus, which fell to USD 1.4 billion in July, but this was still USD 1.5 billion higher than the small net deficit recorded in July 2010.

Figure 9: Financial account inflows rose in the second quarter of 2011 but the current account surplus narrowed
(USD billion)



Note: Errors and omissions not shown
Source: BI

Table 3: Balance of payment inflows are set to moderate in 2011 and 2012 in the baseline scenario
(USD billion)

	2008	2009	2010	2011	2012
Overall Balance of Payments	**-1.9**	**12.5**	**30.3**	**23.9**	**18.8**
Current Account	0.1	10.6	5.6	2.3	0.3
Trade	*9.9*	*21.2*	*21.3*	*21.7*	*19.7*
Income	*-15.2*	*-15.1*	*-20.3*	*-23.9*	*-24.2*
Transfers	*5.4*	*4.6*	*4.6*	*4.5*	*4.8*
Capital & Financial Accounts	-1.8	4.9	26.2	23.3	18.5
FDI	*3.4*	*2.6*	*10.7*	*12.3*	*14.8*
Portfolio	*1.8*	*10.3*	*13.2*	*9.7*	*10.2*
Other	*-7.3*	*-8.1*	*2.2*	*1.3*	*-6.5*
Reserves[(a)]	51.6	66.1	96.2	122.0	

Note: Errors and omissions not shown. [(a)] 2011 reserves as of reported at 16 September
Source: BI and World Bank projections

The projections for the balance of payment inflows are highly sensitive to the path for future portfolio inflows but in the baseline scenario are expected to decline from 2010 highs

The recent declines in commodity prices and portfolio flows to emerging markets, along with the deterioration in external demand, point to a moderation of balance of payment inflows. However, with portfolio flows, in particular, sensitive to international investor sentiment the extent of this moderation is particularly uncertain. The baseline projection is for the current account to continue its downward path to just above balance in 2012 as the above trends of a declining trade balance and an expanding income deficit continue (Table 3). Portfolio inflows are expected to come down from their 2010 highs but remain solid in 2012 as a whole as fundamental drivers of inflows continue. Projecting such flows is a challenge even without the substantial market uncertainty currently seen. Similarly, for FDI while the baseline is for continued solid inflows this depends considerably on conditions in source countries, notwithstanding the strength of pull factors such as Indonesia's strong domestic market.

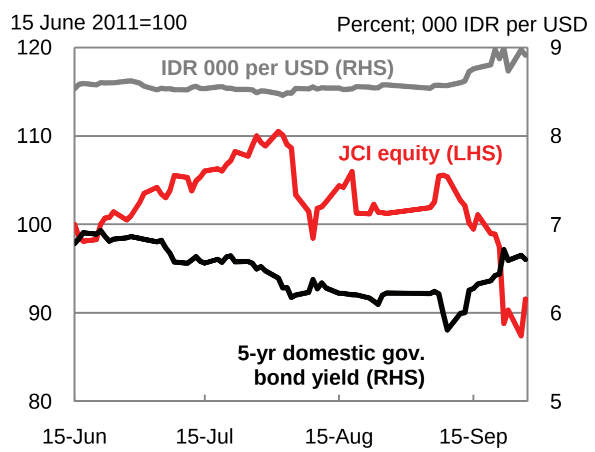
4. Recent international turbulence spilled over to Indonesia's financial markets

Indonesian equities have weakened sharply since the June 2011 *IEQ* due to increased global risk aversion that also put pressure on the Rupiah

Since August financial markets in Indonesia - and other countries in the region - have been adversely affected by the rise in uncertainty over the outlook for the Euro zone and the US. In early August the trigger was the downgrade by Standard and Poor's of the US sovereign rating. From early September there was a further deterioration in domestic equity markets, some upward movement in bond yields and depreciation of the exchange rate (Figure 10). Equities then fell sharply, by 8.9 percent, on 22 September 2011. This was the largest daily fall since October 2008 and followed the overnight announcement of "Operation Twist" by the Federal Reserve and its statement noting the significant downside risks to the global outlook. Tightening in international financing conditions for foreign investors with leveraged positions in Indonesia's domestic bond markets may have led to a reduction in their holdings, putting further downward pressure on the currency, resulting in lower sentiment towards equities.

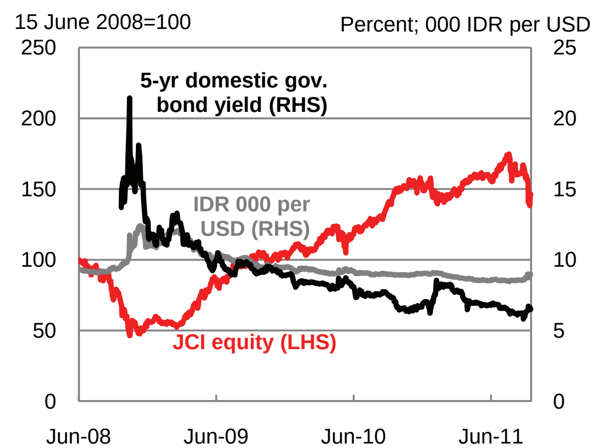
Overall, since the June 2011 *IEQ* (from 15 June to 27 September) Indonesian equities are down 8.4 percent while the Rupiah has depreciated by 4.3 percent against the US dollar. These falls are, however, coming off historical highs for domestic asset prices (Figure 11). Although rising in September, local currency government five-year bond yields actually narrowed by almost 20 basis points since mid-June to 6.6 percent. The average spread on Indonesia's external sovereign bonds has risen by 120 basis points to just over 320 basis points.

Figure 10: Asset prices weakened sharply in September…
(equity index, 15 June 2011=100; IDR per USD; yield, percent)



Sources: CEIC and World Bank

Figure 11: …falling from historically high levels
(equity index, 15 June 2008=100; IDR per USD; yield, percent)

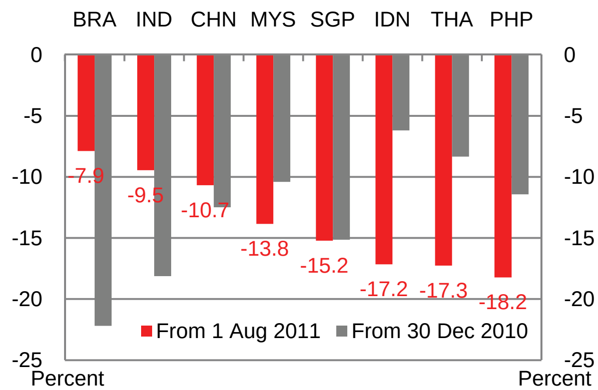


Sources: CEIC and World Bank

Similar movements were seen in other regional markets

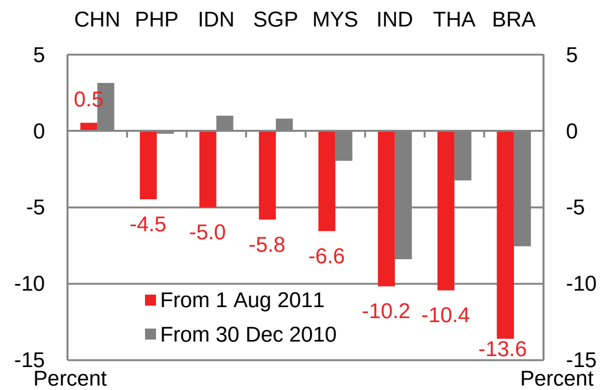
Capital inflows over 2010 and the first half of 2011 contributed to sizeable asset price gains in many emerging economies. The recent large scale shifts out of risky assets towards US Treasuries and other "safe" assets has hit emerging market equities and currencies hard. Since the intensification of market turbulence in early August, Indonesia's equity losses have been relatively large compared with regional peers (Figure 12). However, due to earlier gains, the fall for Indonesia relative to the end of 2010 is comparatively low. The Rupiah has been less affected than some other currencies due to intervention, with Bank Indonesia intervening, and it remains slightly appreciated on end-2010 levels (Figure 13).

Figure 12: The recent fall in Indonesian equities has been large but of a similar order to some regional peers…
(local equity market change to 27 Sep 2011, percent)



Note: BRA: Brazil; IND: India; CHN: China; MYS: Malaysia; SGP: Singapore; IDN: Indonesia; THA: Thailand; PHP: Philippines
Sources: CEIC and World Bank

Figure 13: …while the Rupiah's depreciation has been relatively limited compared with regional peers
(appreciation against US dollar to 27 Sep 2011, percent)

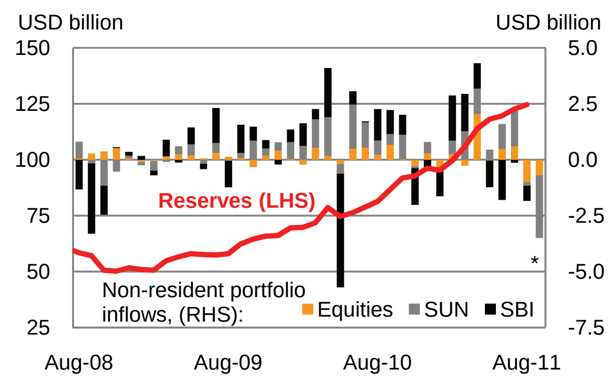


Note: See Figure 12
Sources: Datastream and World Bank

Indonesia has experienced large portfolio outflows by non-resident investors over August and September

In August Indonesia experienced portfolio outflows of USD 1.8 billion, of which just under USD 1 billion was in equities. From end-August to 26 September net equity sales by non-resident investors of around USD 690 million were seen but the pull back in their holdings of local currency government securities increased (Figure 14), reaching USD 2.8 billion versus a fall of USD 170 million in August. The ratio of non-resident investor holdings to the total outstanding stock of SUNs has fallen to 32 percent from 35 percent at end-August. Within month holdings of Bank Indonesia certificates (SBIs) are not available but August saw a decline in non-resident investor SBI holdings by USD 680 million. To put these figures in context, portfolio outflows reached USD 5.7 billion in May 2010, mainly in the form of SBIs. In September and October 2008 portfolio outflows reached USD 3 billion and USD 2 billion respectively. However, recent outflows are from a much higher base level of holdings.

Figure 14: Portfolio flows reversed sharply in August and September
(USD billion)



Note: "Flows" for SUN (local currency government securities) and SBI (BI certificates) indicate changes in holdings. * Data for September is to 26September, no data for SBI available
Sources: BI, CEIC and World Bank

The immediate policy response to the portfolio outflows has been intervention in the currency and bond markets

In response to the downward pressure on the Rupiah from non-resident portfolio outflows, Bank Indonesia has been intervening, selling foreign exchange reserves to support the currency. Reserves as of mid-September were reported at USD 122 billion, down from USD 124.6 billion at end-August. The past month has also seen Bank Indonesia purchasing government bonds directly through secondary market auctions. The Ministry of Finance has also repurchased debt. These actions follow the range of policies put in place over the past year by the Government and Bank Indonesia to deal with potential domestic bond outflows, included purchase mechanisms and macro-prudential measures such as lengthening the holding period on SBIs, etc. The international, and domestic, financial market volatility is likely to remain over the near-term. The authorities therefore need to strengthen further the mechanisms to deal with increased volatility, and its implications for the financial sector. The quality of policy is particularly important at this time given how sensitive investors are to policy missteps.

Strong overall banking sector performance has continued

Headline banking sector performance indicators are broadly unchanged from the June 2011 *IEQ.* Nominal loan growth was just over 24 percent year-on-year in August. The capital adequacy ratio has come down slightly since April but remained at 17.2 percent in July 2011. The gross non-performing loan ratio has remained stable at just above 3 percent. In terms of regulatory developments, there has however been some uncertainty over the report of proposals to potentially limit ownership shares in domestic banks.

Bank Indonesia has reduced the lower bound of its interest rate corridor to stimulate the domestic money market

In its September policy meeting, Bank Indonesia, while keeping the policy rate unchanged, reduced the lower band of the interest rate corridor for monetary operations from 100 to 150 basis points below the policy rate so as to stimulate transactions in the domestic money market. Interbank Rupiah overnight rates subsequently moved down in line with the new lower bound. While system-wide liquidity remains high, there may be individual banks which are facing tighter conditions, particularly for US dollar liquidity. In a more long-term measure which could affect dollar liquidity, Bank Indonesia has also indicated a potential new regulation requiring repatriation of foreign currency proceeds from exports to onshore commercial banks.

5. Headline inflation continued to fall as food price inflation shocks unwound

Headline inflation has returned to below 5 percent, continuing its downward path over 2011 due to the unwinding of the food price inflation shocks of late 2010

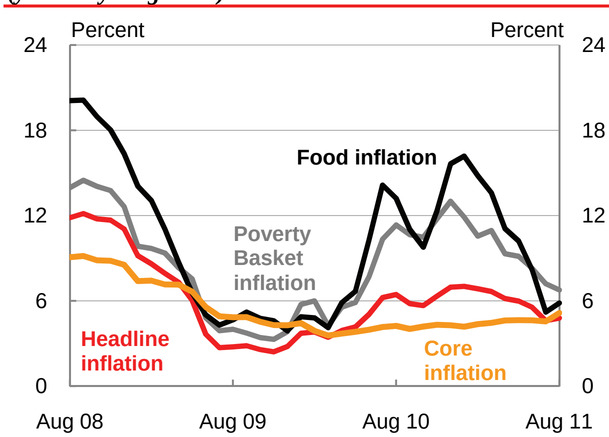
Over the past quarter, headline CPI inflation continued its downward trajectory. Inflation declined by just over one percentage point from its level in May 2011 to 4.8 percent year-on-year in August 2011, which was up slightly on 4.6 percent in July (Figure 15). This trend decline has been supported by the unwinding of the high levels of food price inflation seen in late-2010. Food price inflation has almost halved since May 2011 to be 5.8 percent in August 2011. This has contributed to the further retreat in the poverty basket inflation rate from its high of 13 percent in December 2010 to 6.8 percent in August 2011.

Month-to-month inflation picked up in July and August (Figure 16). In part this was due to familiar seasonal price pressures emerging in the run up to Ramadan and Idul-Fitri for several food items, including rice, meat, vegetables, as well as clothing costs. Much of these seasonal increases typically unwind in the month following Idul-Fitri.

Domestic rice prices have picked up since the end of the main harvest

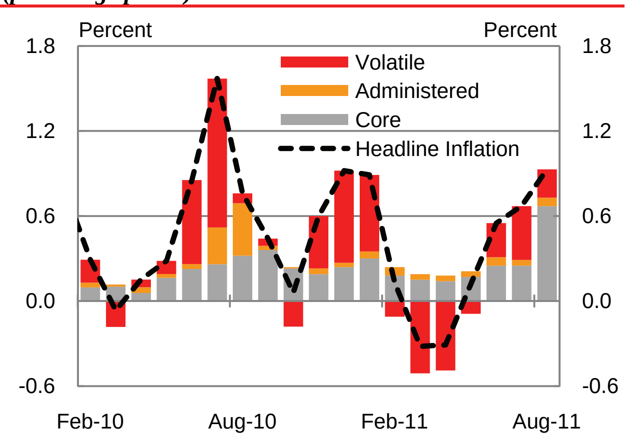
Domestic rice prices have followed their usual seasonal pattern, picking up since the end of the main rice harvest in April. From end-April to mid-September domestic wholesale prices (medium quality) and retail prices (average quality) increased by roughly 14 percent and 10 percent respectively. International wholesale prices have also increased. In particular, Thai rice prices rose by 5.3 percent over the month of August after the announcement by the new Thai government that it would increase prices paid to growers and millers who, in turn, began holding back on rice sales in expectation of the future higher prices. With both domestic and international wholesale prices rising, the gap between domestic and international rice prices remained around 35 percent in August.

Figure 15: Inflation has declined through 2011 but edged upwards in August…
(year-on-year growth)



Source: BPS and World Bank

Figure 16: …as monthly inflation picked up, in part due to rising core inflation
(percentage points)



Source: BPS

Core inflation, which has been rising gradually over 2011, moved up sharply in August to 5.1 percent driven by record high gold prices

Core inflation, which had remained at 4.6 percent year-on-year from April to July, picked up sharply to a two-year high of 5.1 percent in August. Around one-third of the rise in core prices over August was due to increased jewelry prices. This reflected higher domestic demand around Idul-Fitri but also the record international gold prices seen as a result of a "flight to safety" of investors amidst the global financial market turbulence. The rise in core prices in August contributed around two-thirds of the monthly increase in the CPI.

Consumer inflation expectations, as measured by BI, have also moved upwards, reaching a three year high. Some of this likely reflects the impact of the holiday season and respondents cited difficulty obtaining certain consumption goods. However, there are also concerns cited about the inflationary impact of any future government reforms to administered fuel and electricity prices.

Inflation is expected to rise gradually over the course of 2012 but the projection remains sensitive to progress on domestic energy subsidy reforms, the quality of the rice harvest in early 2012 and the strength of the exchange rate

The current uncertainty in the global outlook, and how it might impact Indonesia, also feeds through into the inflation forecasts. The path of the exchange rate is particularly important since a 10 percent depreciation in the Rupiah is estimated to be associated with a 0.5 percentage point increase in CPI inflation. However, under the baseline scenario of stability in the exchange rate and continued strong domestic real sector fundamentals, headline CPI inflation is projected to move gradually to 5.0 percent in the final quarter of 2011 as the large food-price spikes of late 2010 drop out of the base.

In 2012, the baseline of moderating but still robust economic expansion in Indonesia along with only a modest tightening in credit growth sees inflation continuing its gradual rise, reaching 5.5 percent by the final quarter of 2012. This scenario assumes no policy change on subsidy reforms. One key risk to the inflation outlook therefore comes from adjustments to administered fuel and electricity prices (with the latter planned to increase in April 2012 by 10 percent). Additionally, the quality of the harvest in early 2012 will determine rice price movements and so is a source of both downside and upside risk to the inflation forecasts. This is particularly so for poverty basket inflation which, under the baseline, is expected to ease in the final quarter of 2011 to 5.8 percent before rising to 6.4 percent in 2012. Finally, on the exchange rate, if resurgent capital inflows into Indonesia are indeed seen in 2012 this may put upward pressure on the exchange rate, dampening inflation.

Broader price growth in the economy also continues to moderate, with investment price inflation falling sharply

The broader level of prices in the economy has also come down. GDP deflator inflation was 7.4 percent year-on-year in Q2 2011, down from 8.8 percent in Q1. Prices rose by only 0.5 percent on a seasonally adjusted basis relative to Q1, the lowest quarterly growth in almost a decade. Tracking the movements of the CPI, the decline in private consumption price inflation to 5.6 percent played a role. In addition, investment price growth continues to decline, moving from 8.1 percent in Q1 to 5.3 percent in Q2 2011, its lowest level since 2002. Construction price inflation has fallen, as has that for imported machinery and equipment, in part due to the strength of the Rupiah in the first half of the year.

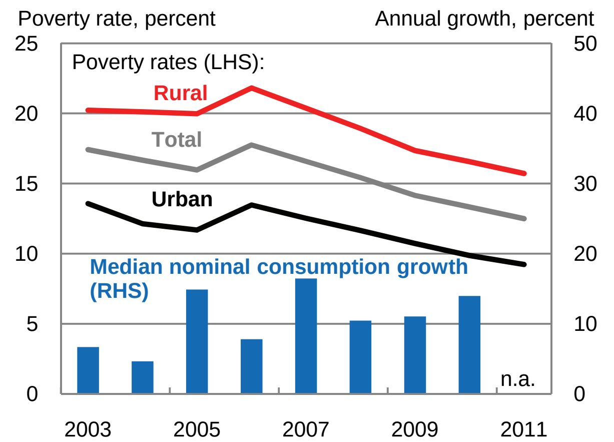
As for CPI inflation, GDP deflator inflation is expected to move up through Q4 2011, reaching 8.7 percent. However, the projection for the average deflator growth for 2011 has been revised down to 8.3 percent based on the outcomes seen to date. For 2012, GDP deflator inflation is expected to remain at a similar level, which remains below the pre-financial crisis average of 14.5 percent for 2005-2008.

6. Indonesia's national poverty rate fell in the year to March 2011

Indonesia's national poverty rate continues to decline, dropping to 12.5 percent in March 2011 from 13.3 percent in March 2010…

The latest figures released by BPS indicate that poverty continues to decline: the number of individuals living below the poverty line fell from approximately 31 million in March 2010 to 30 million in March 2011 (as established by the Susenas household survey). Year-on-year declines in urban and rural poverty rates of approximately 0.64 and 0.84 percentage points resulted in a drop in the national poverty headcount rate from 13.3 to 12.5 percent. Poverty reduction over 2010-2011 proceeded at roughly the same pace that was established from 2007 through 2010 (Figure 17).

Figure 17: Indonesia's national poverty rate fell in 2011
(share of individuals below the poverty line, percent; median nominal consumption growth, percent)



Note: Consumption growth is for individuals
Source: Susenas and World Bank

…and while poverty rates still vary across provinces, their dispersion has also fallen

As seen in the 2010 figures, there was regional variation in poverty reduction performance. The largest absolute declines in urban, rural, and overall poverty rates were found in Nusa Tenggara Barat, Gorontalo, and equally in Papua and Maluku (respectively). Relative to 2010 poverty rates, Gorontalo province again showed the best performance. Gorontalo recorded a 27.4 percent headcount poverty rate in 2007 but four years later has brought that number down to 18.8 percent. The lagging performers in Kalimantan, Sumatera, and Java saw reductions of less than one percentage point in poverty rates, but they generally began 2010 with headcount poverty rates of 10 percent or less. Overall dispersion in poverty rates (across provinces) has fallen by about 20 percent from 2007 to 2011, with a full 13 percentage points of that reduction occurring in 2011 alone, indicating increasingly good poverty reduction performance across all provinces.

Robust domestic growth has contributed to the decline in poverty rates, offsetting the impact of high food price inflation seen in late 2010 and early 2011

Robust domestic economic growth, rising household incomes and positive labor market outcomes have all contributed to the decline in poverty. These forces have offset the adverse impact on net food consumers of the food price shocks during the second half of 2010 (see the March 2011 *IEQ*). According to the Sakernas labor force survey, total employment grew by 3.6 percent (3.9 million people) in the year to February 2011 and the median nominal wage rose by 7.3 percent. This compares with the 6.1 percent growth in median nominal wages recorded in the year to February 2010. When deflated by the CPI, the growth in median real wages in 2011 was just below that of 2010. Looking across the sectors, the growth in median nominal wages in 2011 was driven by an increase of 27 percent in the agriculture, plantation, forestry, hunting, and fisheries sector, which is the largest employer, accounting for 40 percent of workers, and where most of the poor work. This may explain why there was a reduction in poverty in 2011 even with high food prices. Median wages in the mining sector were also strong, growing by 17 percent.

7. The 2011 deficit has been revised up on higher spending on energy subsidies

The revised 2011 Budget increased the deficit to 2.1 percent of GDP on the back of higher energy subsidy spending

The 2011 revised Budget, which was approved at the end of July, increased the deficit to IDR 151 trillion (2.1 percent of GDP) from IDR 125 trillion (1.8 percent of GDP) in the original Budget. This is mainly due to higher spending on energy subsidies, up by IDR 59 trillion to IDR 195 trillion. The rise in energy subsidy spending was due to an increase in the oil price assumption and in the volume of consumption after the postponement of planned restrictions on private cars using subsidized fuel which had been scheduled to start in April. The new oil price assumption for 2011 of USD 95 per barrel, up from USD 80, remains relatively conservative given the average prices seen in the year to date. There was also a slight reallocation within line ministry spending such as on pro-poor

program spending and to education, to maintain its mandated level at 20 percent of total expenditures. Transfers to the regions also increased in line with higher projections for oil and gas non-tax revenues. The increases in commodity-related revenues, along with export taxes (mainly crude palm oil export duties), explained much of the IDR 65 trillion upward revision to total revenues

After the first eight months of 2011 the Budget remained in surplus of IDR 41 trillion, reflecting the skewness of spending towards the year-end

Recent fiscal trends have been sustained over the past quarter. Higher oil prices have added to revenue collections but also led to increased spending on energy subsidies. Disbursement problems for core programs continue. As a result, total central government revenue in the first eight months of 2011 reached IDR 719 trillion, up 19 percent on the corresponding period of 2010, and in line with expectations at the June 2011 *IEQ*. Tax revenues were up 19.5 percent and non-tax revenues rose by 17.7 percent. Total expenditures reached IDR 678 trillion and as a result the surplus for the first eight months of 2011 was IDR 41 trillion.

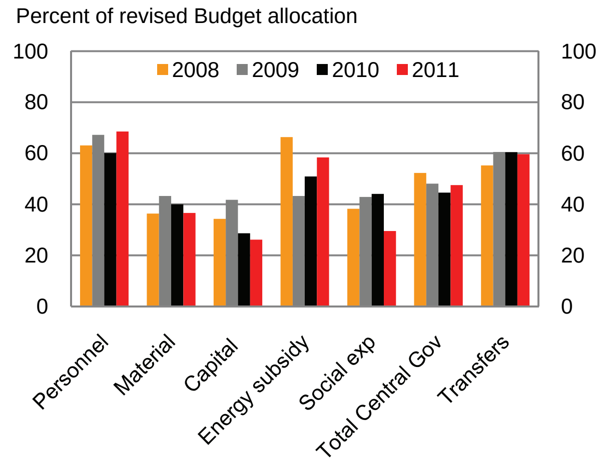
With the exception of energy subsidies and personnel spending, disbursement rates in the first eight months of the year remain weak relative to the revised Budget

Eight months into the fiscal year, total spending had reached one half of the revised Budget allocation. Excluding transfers to the regions, the disbursement rate relative to the revised Budget of 48 percent was up slightly on 2010 but down on 2008 and 2009 (Figure 18).

A high crude oil price and increased demand during the Idul-Fitri holiday contributed to the rise in energy subsidy spending to IDR 114 trillion by end-August. This represented just over a quarter of total central government spending and was equivalent to 83 percent of the initial Budget allocation to energy subsidies, or three-fifths of that in the revised Budget. Personnel disbursements were also boosted by the additional 13 month salary payment made in July.

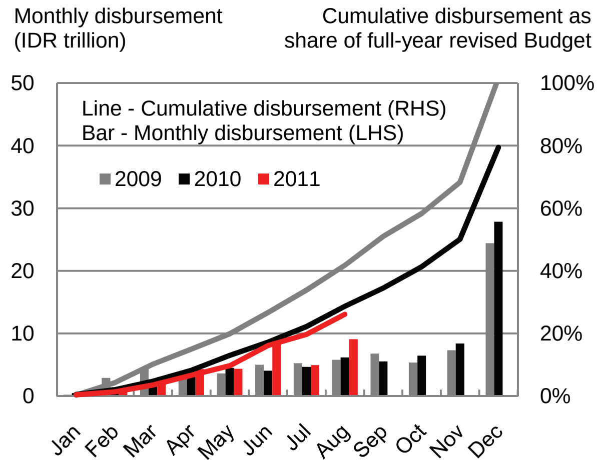
Cumulative spending on core programs (material, capital, and social) has picked up, more than doubling in nominal terms relative to the level spent as of end-May. However, the disbursement rate relative to the revised Budget of 31 percent lags that of previous years, with the rate for capital expenditures at only 26 percent (Figure 19).

Figure 18: Weak disbursement on core programs and higher energy subsidy spending continues
(spending in first eight months of year as share of revised Budget allocation, percent)



Source: MoF and World Bank staff

Figure 19: Capital expenditure disbursement improved in recent months, but its rate is still below previous years…
(monthly spending, IDR trillion; cumulative spending as share of revised Budget allocation, percent)

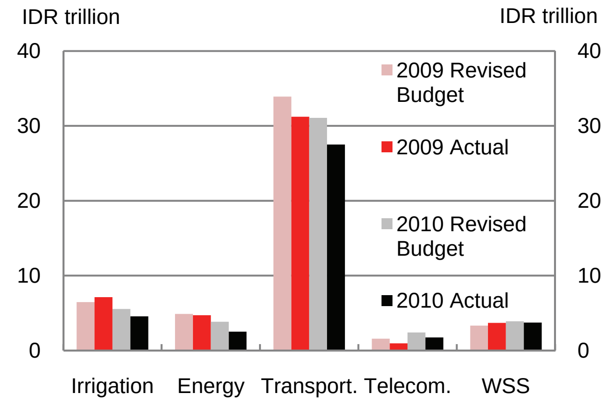


Source: MoF and World Bank staff

Budget execution for capital expenditure remains challenging and, as a result, infrastructure spending in key areas often comes in below Budget levels and nominal declines were even seen for spending in some infrastructure categories between 2009 and 2010

Infrastructure spending has received a higher priority in recent Budgets. However, execution problems constrain actual spending and in turn the achievement of development objectives for improving the supply and quality of infrastructure services. In 2010, central government infrastructure spending was only 86 percent of its revised Budget allocation. The value of spending actually fell by 16 percent relative to its 2009 level (Figure 20). Weak execution capacity was evident across all subsectors, but particularly for transport and energy.

Figure 20: Central government infrastructure spending on transportation, energy and irrigation declined in 2010
(IDR trillion)



Note: WSS is water supply and sanitation.
Source: MoF and World Bank staff

As discussed in the December 2010 IEQ, amongst the issues constraining disbursement progress are, for example, the lengthy process for budget revisions or transfer of funds across budget headings and the complex land acquisition process. There have also been difficulties with new systems designed to improve disbursement processes, such as with the newly introduced e-procurement system, which was expected to expedite the procurement process and improve transparency. The effectiveness of some policy reforms introduced to expedite budget execution has been hampered by a lack of socialization and inconsistencies with other regulations.

The World Bank's deficit projections has also been increased for 2011 to 1.5 percent of GDP

The World Bank has increased its baseline deficit projection for 2011 to 1.5 percent of GDP from 1.2 percent in the June *IEQ.* Revenues are broadly unchanged in aggregate. However, a lower oil lifting assumption (in line with the Government's latest assumption) and marginally weaker expectations for nominal GDP in 2011 see a reduction in the projection for taxes from oil and gas and a mild lowering for most revenue categories. However, offsetting this is the strength of export duties seen to date. On the expenditure side, although non-energy subsidy spending is revised down, higher fuel subsidy spending due to an upward revision of oil price assumption and a mild increase in assumed disbursement of core government spending lead to higher overall expenditure projections for 2011.

Looking towards 2012, the draft Budget released in August targets a deficit of IDR 126 trillion or 1.5 percent of GDP

In August the Government released its draft budget 2012. The Budget targets a reduction in the deficit to IDR 126 trillion or 1.5 percent of GDP (Table 4). The draft Budget assumption for GDP growth in 2012 is 6.7 percent. The oil price assumption is lowered relative to the 2011 revised Budget to USD 90 per barrel. In order to reduce the deficit relative to the 2011 revised Budget, revenue growth relative to 2011 of 10.5 percent is expected to outpace that of expenditure (7.4 percent).

In 2012 the Government plans to significantly boost capital expenditure and continue poverty and social programs

While total expenditures are planned to rise by 7.4 percent relative to the 2011 Budget, the allocation to capital expenditures is up by 19 percent. Personnel expenditures are up by a similar level, reflecting a 10 percent increase in salaries and a continuation of the bureaucracy reform process. On subsidies, the Government plans to increase electricity tariffs by 10 percent in April 2012, contributing to a reduction in electricity subsidy spending by one-third relative to 2011. However, the budget allocation on fuel subsidies, although below that in 2011 due to a lower assumed oil price, remains at IDR 124 trillion (13 percent of total central government spending). This reflects no policy change on fuel subsidy policy in 2012 although the President reaffirmed the Government's commitment to gradually limit fuel subsidy consumption in his draft budget speech to Parliament.

The tax ratio is projected to increase in 2012 and a taxpayer census is planned

Strong growth in income taxes, VAT and export duties, following the general forecasted strength in the economy, are the key drivers of expected revenue growth. Using the Government's nominal GDP forecasts (which use CPI inflation to inflate real GDP), the tax-to-GDP ratio is projected to increase from 12.2 percent in the 2011 revised Budget to 12.6 percent in 2012. In order to aid the current efforts to increase taxpayer compliance, the Finance Ministry is also planning to launch a national tax census to capture at least 1.5 million taxpayers, both individual and corporate, to better understand and direct future policy to increase taxpayer compliance.

To attract further foreign investment to Indonesia, the Government has announced plans for a tax holiday scheme

The Government has also announced plans for tax holiday and tax allowance schemes aimed at attracting foreign investment to Indonesia. The tax holiday scheme, effective from mid-August 2011, provides income tax breaks, for five to ten years, for companies meeting specific requirements. These include operating in one of five industrial sectors and making an investment in Indonesia of at least IDR 1 trillion. The proposed tax allowance scheme is expected to come in the form of a corporate income tax reduction of 5 percent for 6 years, again for firms meeting certain investment, employment, location and sector criteria.

Estimating the impact of these policy measures on corporate tax revenues is difficult given the absence of a clear counterfactual. However, it will be important to monitor them closely to evaluate their effectiveness in attracting investment and their potential impact on revenues.

The Government has already financed much of the 2011 revised Budget deficit

The Government's 2011 revised Budget deficit of IDR 151 trillion is planned to be financed primarily through net government securities issuance (IDR 127 trillion) and from accessing the Government's cash balances (IDR 40 trillion) which have accumulated through over-financing of previous years. These sources are planned to offset net financing drains from other sources.

Total net financing, i.e. also including financing from donors and other sources, had reached IDR 76 trillion at end-August. As of 12 September, net securities issuance of IDR 90 trillion had reached two-thirds of its 2011 target, with gross issuance of government securities at IDR 143 trillion. The level of net financing achieved for the year to date plus the accumulated cash balances from previous years, along with the low and declining levels of public debt, are supportive of Indonesia's near-term financing outlook despite potential continued market volatility.

Table 4: Deficit projections for 2011 have been revised upwards, primarily due to higher energy subsidy spending
(IDR trillion, unless otherwise indicated)

	2010 Outcome	2011 (p) Budget	2011 (p) Revised Budget	2011 (p) WB June estimates*	2011 (p) WB Sept estimates*	2012 (p) Proposed Budget
A. State revenue and grants	**1,014.0**	**1,104.9**	**1,169.8**	**1,189.4**	**1,185.8**	**1,292.9**
1. Tax revenue	744.1	850.3	878.6	858.6	857.1	1,019.3
a. Domestic tax	715.2	827.2	831.7	813.3	801.5	976.9
i. Income tax	356.6	420.5	431.9	432.3	419.7	512.8
- Oil and gas	58.9	55.6	65.2	77.0	65.4	58.7
- Non oil and gas	297.7	364.9	366.7	355.3	354.4	454.2
ii. Other domestic taxes	358.6	406.8	399.8	381.0	381.8	464.1
b. International trade tax	28.9	23.0	46.9	45.3	55.5	42.4
i. Import duties	20.0	17.9	21.5	24.5	25.4	23.5
ii.Export duties	8.9	5.1	25.4	20.7	30.1	18.9
2. Non-tax revenue	267.5	250.9	286.5	330.8	328.7	272.7
o/w natural resources	170.1	163.1	192.0	217.9	213.1	172.9
i. Oil and gas	152.7	149.3	173.2	197.5	192.8	156.0
ii. Non oil and gas	17.3	13.8	18.8	20.4	20.2	16.9
B. Expenditure	**1,053.5**	**1,229.6**	**1,320.8**	**1,280.3**	**1,296.7**	**1,418.5**
1. Central government	708.7	836.6	908.3	875.7	878.6	954.1
- Personnel	147.7	180.8	182.9	173.6	181.9	215.7
- Material expenditure	94.6	137.9	142.8	117.5	121.8	138.5
- Capital expenditure	75.5	135.9	141.0	116.1	122.6	168.1
- Interest payments	88.3	115.2	106.6	112.8	104.2	123.1
- Subsidies	214.1	187.6	237.2	262.2	256.8	208.9
- Grants expenditure	0.1	0.8	0.4	0.8	0.4	1.8
- Social expenditure	68.4	63.2	81.8	61.3	76.8	63.6
- Other expenditures	20.0	15.3	15.6	31.4	14.1	34.5
2. Transfers to the regions	344.7	393.0	412.5	404.6	418.1	464.4
C. Primary balance	48.9	-9.4	-44.4	21.9	-6.8	-2.5
D. SURPLUS / DEFICIT	(39.5)	(124.7)	(151.0)	(90.9)	(111.0)	(125.6)
(percent of GDP)	(0.6)	(1.8)	(2.1)	(1.2)	(1.5)	(1.5)
Economic assumptions/outcomes						
Gross domestic product (GDP)	6,423	7,020	7,227	7,462	7,399	8,120
Economic growth (percent)	6.1	6.4	6.5	6.4	6.4	6.7
CPI (percent)	5.1	5.3	5.7	5.9	5.6	5.3
Exchange rate (IDR/USD)	9,074	9,250	8,700	8,713	8,662	8,800
Interest rate** (average percent)	6.4	6.5	5.6	6.8	6.8	6.5
Crude oil price (USD/barrel)	79	80	95	105	105	90
Oil production ('000 barrels/day)	954	970	945	952	945	950

Note: * World Bank revenue forecasts are based on a different methodology to the Government to derive projections for nominal GDP (see Part C of the June 2010 *IEQ* for a full discussion). ** interest rate for 2010 and 2011 Budget is 3-month SBI and for 2011 revised Budget and 2012 proposed Budget is 3-month Treasury bill. World Bank is BI policy rate
Source: MoF and World Bank projections

8. As with the global economy, near-term risks to Indonesia's outlook have risen

The downside risks associated with the global economic and financial outlook loom large…

Some of the risks previously identified in the June 2011 *IEQ* of weaker global growth and portfolio outflows from Indonesia have materialized. The primary near-term risks to Indonesia remain external in origin and the question of how a further deterioration in the global economic and financial outlook might impact Indonesia is the focus of the following section. The direct impact of lower growth in the EU and US on Indonesia's economy is likely to be limited. However, if there is a more widespread severe growth downturn, particularly to major emerging economies, and sharp correction in commodity prices then the real impact for Indonesia would be more marked.

The real economy impact of continued international market turbulence should be relatively limited for Indonesia due to its strong recent economic performance and its available buffers to weather such shocks, such as its low government debt levels and increased reserves. While the strength and resilience of Indonesia's economy is generally accepted, international investors still have some concerns over the quality of policy. To address concerns of investors, the Government of Indonesia should continue implementing domestic policies that are well-coordinated and consistent so as to avoid amplifying future external financial shocks. As mentioned above, avoiding policy missteps will be important in an environment that will remain volatile.

…but risks associated with commodity prices remain…

Risks to the outlook relating to commodity price movements, as highlighted in the previous *IEQ,* remain*.* Lower commodity prices due to the weaker external environment could affect Indonesia's GDP growth via their impact not only on trade but through domestic consumption and investment. They would also lower fiscal revenues from the resource sector (see Part B of the June 2010 *IEQ*).

Indonesia's inflation outlook is also sensitive to commodity price movements, particularly domestic rice prices, and is vulnerable to an adverse shock to the harvest, as seen in 2010, or to the availability and price of rice on international markets. Notably, while most global commodity prices fell or stabilized in August and September, international rice prices increased.

Upward adjustment to administered energy prices are also a risk for the inflation outlook, the extent of which depends on the timing, nature and magnitude of any reforms. If international oil prices move down further the fiscal pressure for subsidy reform could be reduced. However, the magnitude of the price change needed to close the gap with market prices would also be lower and so the costs of reform, for example, in terms of the impact on inflation, could also be reduced.

…while medium-term risks are focused on the implementation of reforms and spending to boost trend levels of growth

While the focus is on the near-term risks from international developments, Indonesia's medium-term growth and development challenges remain. These include, in particular, addressing the country's infrastructure weaknesses and making further improvements to the investment climate. While the 2011 and 2012 Budgets involved a substantial rise in the allocation of spending to capital expenditures, budget execution difficulties lead to the risk that these funds are not fully disbursed or are not spent efficiently. Similarly, further progress on promoting greater private sector investment in infrastructure is needed which could take the form of public private partnerships (see Part B). Continued progress in these areas is required to ensure not only sustained growth and development outcomes in the medium-term but also to maintain investor confidence in the strong fundamentals of Indonesia's economy.

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY

1. The potential spillovers from the deteriorating global outlook to Indonesia

With the world economy in a "dangerous new phase" what could be the implications for Indonesia?

In the words of the Managing Director of the IMF the world economy is in a "dangerous new phase, with risks on the rise, but while the problems are largely economic, the solutions are mainly political." This political dimension and its interaction with financial markets, in particular relating to the resolution of the Euro zone debt crisis and its banking sector impact, adds considerable uncertainty to any near-term economic forecasts. This includes the outlook for Indonesia, notwithstanding its strong domestic fundamentals.

With its relatively low direct trade exposure to the EU and US, strong domestic drivers of growth and solid fiscal position, the Indonesian economy is comparatively well-placed to weather a real-economy external shock originating in high income economies. However, a relatively high exposure to foreign portfolio flows does pose risks to domestic financial markets and – if prolonged – to the real economy, in the event of a significant downturn in investor sentiment, notwithstanding the buildup in foreign exchange reserves. Ensuring that domestic policies are supportive of investor confidence is therefore key in the near-term along with policies to enhance monitoring and crisis preparedness and to further build up resilience to market volatility.

a. Thinking about potential scenarios for the global economy

A significant negative market shock could move the external outlook from the baseline of continued international market volatility to a financial crisis scenario, which could slip into a more severe global downturn if growth in the major emerging market economies were also to be affected

In light of the global uncertainty, this section attempts to put some structure around different near-term scenarios for the global economy over the next 12-18 months and considers their potential impact on Indonesia. The baseline scenario, as outlined in Part A, is for a continuation of ongoing international financial market volatility combined with a growth slowdown in the EU and US and a moderation of commodity prices. This is currently viewed as a relatively high probability, lower impact scenario for Indonesia (Figure 21).

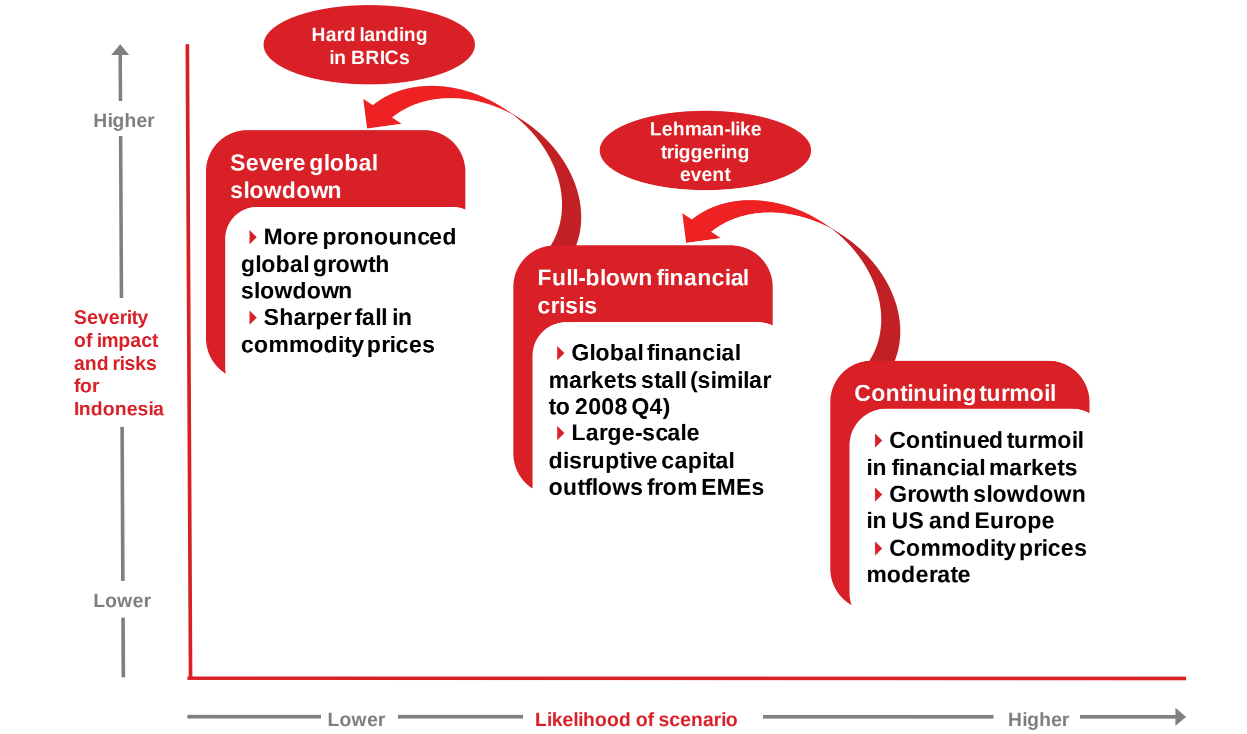
However, risks to the international outlook appear tilted to the downside. A second scenario sees a Lehman-like triggering event, most likely relating to a disorderly default in the Euro zone, which leads to a freezing up of global financial markets, as in the final quarter of 2008, constraining global growth further and amplifying capital outflows from emerging markets. A third scenario, which is viewed as having the lowest probability but clearly the highest impact, would occur if the slowdown in high income economies and the financial market crisis contributes to a hard landing for growth in the major emerging economies, precipitating a global growth slowdown and sharp falls in commodity prices. Clearly there may be other outcomes but these three scenarios capture a broad range of potential downside external risks.

Spillovers to Indonesia will depend on the nature of the external shock, the transmission channels, along with domestic vulnerabilities or buffers, and policy responses

To a large extent, the impact of these different scenarios on Indonesia will depend on the size and scope of these shocks to financial market instability and external demand. It will also depend on how they are transmitted to Indonesia, via trade, financial market or banking sector channels, on the level of domestic exposure or vulnerability to the shocks, and on the mitigating or offsetting policy responses taken by the Indonesian authorities. The short-term impacts may also be different from those seen over the medium-term.

Table 5 provides a summary mapping from the external shocks under the different scenarios to their impact on Indonesia. It is not exhaustive but aims to synthesize the likely major factors that will impact the Indonesian economy under these alternate scenarios. This assessment recognizes that the resilience of Indonesia's economy to shocks has increased in recent years, as seen in the 2008-09 crisis. Nevertheless, anticipatory policy measures can still play an important role in minimizing the impacts of future shocks.

Figure 21: Scenarios for the external outlook include continuing financial market turmoil through to a severe global slowdown



Source: World Bank staff

Table 5: Different scenarios for the global economy could have a range of spillovers to Indonesia

	SCENARIO 1: CONTINUING TURMOIL	SCENARIO 2: FULL-BLOWN FINANCIAL CRISIS	SCENARIO 3: SEVERE GLOBAL SLOWDOWN
EXTERNAL SHOCKS: DEVELOPED ECONOMY GROWTH	Slowdown in growth in Euro area and weak growth in US	Greater growth slowdown due to real impact of financial crisis and credit tightness	Additional slowdown relative to scenario 2
EME GROWTH	Little change – domestic demand and/or policy measures supportive	Moderate drag on growth from credit tightness	Lower global demand and financial market spillovers trigger hard landing for EME growth
COMMODITY PRICES	Weakening	Additional decline relative to scenario 1	…leading to a sharp drop in global commodity prices
INTERNATIONAL FINANCIAL MARKETS	Continued volatility, flight to quality and reduced demand for EME assets	Disorderly resolution of Euro zone debt crisis troubles triggers freezing up of international credit markets, sharp rise in risk aversion and EME sell-off	As in scenario 2
POTENTIAL IMPACT ON INDONESIA	Limited via trade channel - direct export linkages to EU and US limited but higher indirect linkages via regional trading partners. However, Indonesia's GDP is relatively less reliant on external demand Ongoing bouts of financial market turbulence (similar episodes as seen in May 2010). Indonesia's resilience to short-term financial shocks has increased	Trade and domestic confidence impact amplified plus negative impact if trade financing adversely affected Financial channel spillovers intensify - access to international finance restricted; sell off of non-resident equity and government bond holdings; downward pressure on exchange rate from outflows	Real sector impact as in scenario two with additional negative effects via trade channel due to exposure to EME and commodity demand Financial channel spillover from external shocks similar to Scenario 2 but additional impact via linkage of domestic financial markets with commodity prices

Source: World Bank staff

b. How might an international shock be transmitted to Indonesia?

An international shock could be transmitted to Indonesia through three main channels – trade, financial flows and the banking sector

There are three main channels through which an international shock can be propagated to another economy – trade and commodity prices, portfolio and FDI capital flows, and banking sector inter-linkages. The impact of these different transmission channels will interact as a shock propagates through the economy. There will also likely be feedback between them (for example, a tightening in the availability of bank trade finance from overseas would affect trade flows). As a starting point for mapping out the impact of the deteriorating global outlook, it is useful to consider how it might spillover to the Indonesian economy through each of these transmission channels.

Indonesia's direct trade exposure to the US and EU is limited, but indirect effects on Indonesia through other trading partners could be more significant

The global financial crisis of 2008-09 highlighted Indonesia's relatively low exposure to external demand shocks. Nevertheless, any slowdown of growth in the US and Euro zone will affect Indonesia through reduced direct trade with those markets and also indirectly through secondary markets (such as China). The direct trade impact to Indonesia is likely to be limited, with exports to the US and EU each only around 9 percent of Indonesia's total 2010 exports, compared with 16 percent for Japan and 23 percent for the other major ASEAN economies (Malaysia, Singapore, Thailand and the Philippines). However, weaker global demand would also reduce demand for exports from Indonesia's other major trading partners, as intermediate inputs for final products going to the EU and US markets, but also more generally if growth in those trading partners weakens. Taking China as an example, reduced external demand from the US and EU – which accounted for 18 percent and 16 percent of China's 2009 exports, respectively – could feed through indirectly into lower Chinese demand for exports from Indonesia (around 10 percent of Indonesia's total exports in 2010, Table 6).

Table 6: Indonesia's exposure to downturns in the US and EU is direct and via their importance as sources of external demand for Indonesia's other trading partners
(share of total 2010 exports, percent)

	Exports to:								
Exports from:	CHN	EU	IND	IDN	JPN	KOR	MYS	SGP	US
China (CHN)	–	16.4	2.6	1.4	7.7	4.4	1.5	2.1	18.0
EU	8.4	–	2.6	0.5	3.2	2.1	0.8	1.8	18.0
India* (IND)	5.9	20.4	–	1.7	1.8	2.1	2.0	3.8	10.8
Indonesia (IDN)	9.9	8.6	6.3	–	16.3	8.0	5.9	8.7	9.1
Japan (JPN)	19.4	12.2	1.2	2.1	–	8.1	2.3	3.3	15.6
Korea, Rep.* (KOR)	23.9	11.9	2.2	1.7	6.0	–	2.1	3.7	10.4
Malaysia (MYS)	12.6	10.5	3.3	2.8	10.4	0.0	–	13.4	9.5
Singapore* (SGP)	7.5	10.0	3.8	9.4	4.7	4.1	11.0	–	6.5
US	7.2	20.0	1.5	0.5	4.7	3.0	1.1	2.3	–
East Asia-5	14.2	11.4	2.8	4.5	7.5	1.7	5.3	4.9	9.3

Notes: * 2009 trade shares. EA-5 comprises Korea, Singapore, Malaysia, Thailand and the Philippines
Blue indicates export share from 5 to 10 percent and pink above 10 percent
Source: World Integrated Trade Solution (WITS)

By sector, manufactured exports would likely be the most affected by a slowdown in the EU and US

By component, Indonesia's manufactured exports are likely to be the most affected by a slowdown in the US and EU, as these remain the major markets for Indonesia's textiles, clothing, footwear and transport equipment exports. Manufactured exports could also be indirectly affected, as goods shipped to a third market (such as Singapore) may also be finally consumed in developed markets. Meanwhile commodity exports predominantly go to China, India, Japan and Korea, as inputs to infrastructure investments (Table 7). Underpinned by still-firm regional growth, these export volumes may be less affected by a slowdown in the US and EU. However, as discussed below, this exposure raises concerns over the third scenario in which there is a hard landing in these markets, and subsequent reduction in commodity demand and prices.

Table 7: Manufacturing is most directly exposed to the EU and US with commodities more reliant on regional demand
(major trading partners share of total exports, 12 months to May 2011, percent)

	Total	Oil & Gas	Non-O&G	Ag & For.	Mine. & Min.	Manu.
CH	10.0	1.0	9.0	2.4	3.8	1.9
EU	7.5	0.0	7.5	2.8	0.8	3.8
IND	6.5	0.0	6.5	3.4	2.4	0.7
JPN	16.8	7.0	9.8	2.2	4.8	2.9
KOR	7.8	3.8	4.0	0.7	2.2	1.2
SGP	7.9	2.2	5.8	1.1	1.1	3.5
US	8.8	0.5	8.3	2.7	0.2	5.5

Note: Ag. & For. is agriculture and forestry; Mine. & Min. is mining and minerals; Manu. Is manufactured products
Source: BPS

Movements in global commodity prices present another spillover channel to Indonesia

The downward revision to global growth has already led to a moderation in international commodity prices (as described in Part A). If the trigger for the reduction in global commodity prices is demand from Indonesia's major regional export markets, in particular China, then the fall in price is likely to be associated with a reduction in the volumes of exports as well. As described below, declining global commodity prices have a broader impact on Indonesia than just trade and the external accounts and can feed through into the outlook for the fiscal position, domestic investment, consumption and inflation.

Direct FDI linkages to the US and EU appear comparatively low...

A US/EU-driven global slowdown would also impact global capital flows. According to Bank Indonesia data, FDI inflows to Indonesia from the US and EU have been trending down in recent years, averaging USD 1.4 billion annually from 2008 – 2010, or around 15 percent of total FDI. Over 60 percent of FDI to Indonesia is sourced from Asia, with Singapore and Japan accounting for two-thirds of these inflows. However, some of these flows may also represent FDI originating from US or EU parent affiliates.

Determining how weaker growth in the US and EU affects FDI to Indonesia is complicated by the multiple determinants of FDI decisions on both the push side and pull side. The former is concerned with conditions in a firm's home market, where evidence on cross country FDI flows suggests that a downturn in the source country economy, all things being equal, does tend to reduce FDI outflows. Set against this are the pull factors for FDI (discussed in the June 2011 *IEQ*) including Indonesia's resource wealth, relatively low labor costs and large and growing domestic market. With these fundamental drivers expected to continue in the medium-term, Indonesia's higher growth prospects relative to the EU and US would likely improve further, particularly in light of the relatively positive short-term domestic economic outlook outlined in Part A. It is also worth noting that FDI investments tend to be longer-term in nature, limiting the extent to which short-term developments might prompt a reassessment of positions.

…but the economy retains a relatively high exposure to portfolio capital flows

Attracted by high interest rates, a strong domestic economy and strengthened public and financial sector balance sheets, Indonesia recorded over USD 26 billion of foreign portfolio investment inflows between Q1 2010 and Q2 2011, according to the BI Balance of Payments data. Data from the IMF Coordinated Portfolio Investment Survey indicate that in 2008-09 over 60 percent of the stock of portfolio investment in Indonesia came from the US and EU. However, the outlooks of all foreign portfolio investors, irrespective of their domicile, are likely to be affected by the falls in global markets and growth prospects. As the global economy stalls, Indonesia – like other emerging markets – faces risks associated with any reversal of these flows sparked by heightened global risk aversion

and a flight to quality (as already seen to some extent over August and September in Indonesia and other developing economies). In this regard, those emerging markets that saw the largest gains in recent years (Indonesia among them) may also see some of the biggest corrections. Another related transmission mechanisms is the impact of financial turbulence in global markets on the cost or ability to access international financing sources, such as global bonds, by Indonesian corporates or the Government.

Foreign bank loans represent only a small proportion of the assets of the Indonesian banking system

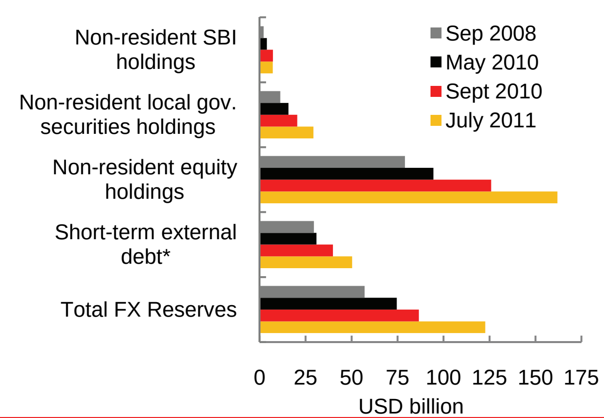
While there is limited public data on the direct exposure of Indonesian banks to Euro zone sovereign debt, Indonesia's direct exposure is expected to be relatively small. However, if global developments adversely affected the balance sheets of large international banks, they may decide to withdraw funds from emerging markets, such as Indonesia, to replenish damaged balance sheets in home-markets (although working against this is the motivation to maintain, or expand, presence in potential higher growth markets going forward). While the majority of Indonesia's leading banks and companies could likely withstand a pullback in foreign bank funds, there remains a possibility that the impact on smaller banks or corporates could be more pronounced. Finally, an intensification of global financial market uncertainty could lead to spillovers on domestic interbank market liquidity – as was seen in late 2008. To this end, BI recently announced greater flexibility around the lower band in the policy rate, a policy designed to encourage short-term funds to remain in the interbank market, rather than be deposited with the central bank.

c. Potential near-term impacts to the Indonesian economy

Indonesia's exposure to foreign investor outflows has risen since 2008, but so has the scope for policy response…

How might the transmission of these shocks affect Indonesia in the near term? This will depend on the nature of the shock, the resources available to Indonesia to mitigate potential vulnerabilities, the performance of the domestic economy and banking sector, and the Government's policy framework.

Figure 22: Indonesia's exposure to capital outflows increased as reserves were accumulated
(USD billion)



Note: * short-term external debt by remaining maturity
Sources: BI, KSEI, CEIC and World Bank

As outlined in Part A, Indonesia enters the current global situation from a position of macroeconomic strength, with considerable buffers to absorb financial sector shocks. Reserves have more than doubled since 2008 to USD 122 billion at mid-September, and cover 40 percent of short-term external debt by residual maturity, and 7.1 months of imports and external debt services of the Government. Nevertheless, Indonesia's exposure to non-resident capital outflows has also risen since 2008, necessitating continued policy prudence (Figure 22). The Government has put in place a mechanism to support domestic bond markets if needed through using some of its cash surplus, subject to Parliamentary approval, and BI has also announced a mechanism for it to make direct bond purchases. If a negative shock is propagated more intensely through real channels – such as lower demand for Indonesia's exports – then fiscal measures to stimulate the domestic economy could also be necessary. Having run a relatively conservative fiscal policy for several years, Indonesia has the fiscal space for large fiscal stimulus packages if it feels the need to do so.

…and domestic financial sector performance has also strengthened over the past decade

Indonesia's strengthened financial sector performance also serves as a buffer to the recent financial market instability. This is in part due to the effort over the past decade of financial sector authorities to implement and enforce improvements in the overall regulatory and supervisory framework. Banking sector performance since 2008 has been strong, with banks demonstrating high capital adequacy and steadily falling NPLs. Commercial banks assets have been growing steadily due to strong loan growth. While

the banking sector is characterized by high levels of liquidity, these levels need to be monitored as levels of liquidity are not even across banks. Second tier banks tend to have lower liquidity than top tier banks overall. The insurance and pensions industries have also grown, although continued expansion of the non-bank financial sector will also be required to meet the government's longer term efficiency in financial sector intermediation and stability goals.

There are also risks to the Indonesian economy emanating from commodity prices and the exchange rate

As previously outlined, a global slowdown would impact the real economy through direct and indirect trade channels. However the economy's relatively low exposure to external demand provides some insulation. For example, Indonesia's exports to GDP were less than 25 percent in 2010, compared with almost 100 percent in Malaysia and over 70 percent in Thailand.

Fluctuations in international commodity demand and prices do however present a continued source of vulnerability for Indonesia, given the country's export mix and the sensitivity of the budget to oil prices. A sharp fall in commodity prices could adversely impact Indonesia's external trade balance. It would also reduce subsidy expenditure but at the same time reduce fiscal revenues from the resource sector (previous analysis suggests that the fiscal deficit falls with higher overall commodity prices but increases with higher oil prices). Lower commodity prices could also lead to reduced profits in the commodity sector and related industries, potentially restraining foreign and domestic investment, and subduing domestic consumption. Movements in international commodity prices would also feed through into domestic inflation whose path would also depend crucially on the future path of the exchange rate.

Under more pessimistic scenarios for the global economy, domestic GDP growth would come down and BoP pressures would increase

Taking these vulnerabilities and defenses into account, and notwithstanding the inherent difficulties in forecasting during the current uncertainty, assessing the potential impacts on the Indonesian economy under the three scenarios for the global economy outlined earlier can provide valuable information to policymakers.

The baseline World Bank projections outlined in Part A are based on scenario 1. Under these conditions growth is expected to reach 6.4 percent in 2011, and moderate to 6.3 percent in 2012. The BoP is expected to register a healthy, although moderating, surplus over the two years. Under Scenario 2, with an international financial crisis, GDP growth is cut by 0.8 percentage point in 2012, reflecting lower investment and exports (Table 8). The BoP surplus is also expected to be significantly lower, due to a narrowing of the trade surplus and lower net capital inflows. In Scenario 3, the most pessimistic, with a severe global growth slowdown, Indonesia's growth is projected to slow even further in 2012, down to 4.1 percent. A combination of tighter financial markets and lower commodity prices would likely narrow the BoP further, potentially leading to a deficit, similar to the experience during the 2008 crisis. It is important to note that these GDP projections combine the external scenarios with moderations in the underlying domestic drivers of growth, i.e. private consumption and investment. In the unlikely event that there were was a major dislocation to these drivers then the projections could of course be very different.

Table 8: A severe global downturn would likely lead to a sizeable decline for domestic economic growth

Scenarios:	Scenario 1			Scenario 2			Scenario 3			Memo:	
	Continuing turmoil			Major financial crisis			Severe global slowdown			Outcomes	
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2008	2009
Indonesian GDP growth (percent)	6.1	6.4	6.3	6.1	6.3	5.5	6.1	6.3	4.1	6.0	4.6
Scenario assumptions:											
Investment/GDP ratio (percent)	23.9	24.6	25.3	23.9	24.6	24.6	23.9	24.6	23.6	23.7	23.4
Major trading partner GDP growth (percent)	6.8	3.3	3.9	6.8	3.2	2.0	6.8	3.0	-1.8	2.0	-1.4
Terms of trade growth (percent)	5.3	10.0	0.0	5.3	8.0	-15.0	5.3	7.0	-30.0	-18.1	-4.2

Note: 2011 and 2012 are projections. Real ratio of investment to GDP. Terms of trade series is constructed by World Bank from monthly trade data
Source: CEIC and World Bank staff projections

d. The role for policy support and the importance of avoiding policy missteps

Recent global events are a reminder of the importance of continued reforms to increase the economy's resilience to external shocks and the preparation of policies to mitigate their impact…

The recent market volatility serves as a reminder of the importance of maintaining progress on reforms to reinforce the economy's resilience to external shocks, for example, further strengthening financial sector regulation and supervision. As mentioned in *Part A*, the Government and BI have already put in place a number of recent policies aimed at supporting domestic bond markets in the event of sudden reversals, which supplement previous measures to reduce roll-over risk by lengthening average maturities and raising the holding period on SBIs. BI is also pursuing further macro prudential policies, such as committing exporters to repatriate export earnings.

Given the rapidly deteriorating international environment, Indonesia may benefit from additional policies to boost confidence and its preparedness, while avoiding actions which could adversely impact investor sentiment. Progress on signature policy reforms, such as on subsidy reform, land acquisition and infrastructure financing, could boost investor confidence, both domestic and foreign. Also, as recently indicated in the press, the Government could prepare anticipatory budget measures to stimulate domestic demand in the event of greater adverse spillovers. As mentioned previously, the Government currently retains the fiscal space to finance such stimulus, if needed. For example, this could accelerate the implementation of government infrastructure spending plans which could support demand, enhance long-term growth prospects, support investor confidence and take advantage of potentially lower global input costs.

…while avoiding measures which might exacerbate market concerns

Notwithstanding these additional anticipatory policy measures, Indonesia's strong macroeconomic fundamentals and existing policies are some of the strongest defenses to weather current and future turbulence. Current turbulence in financial markets makes it even more important to avoid policy uncertainty, particularly relating to changes in restrictions on foreign investment and the regulatory and governance environment.

e. Returning capital inflows in the medium-term give further incentive for continued progress on key structural reforms

Over the medium-term, the return of capital inflows is likely to continue to pose a policy challenge for Indonesia, and other emerging market economies

Over the medium-term, capital inflows to EMEs are likely to be resurgent (as in late 2009 and 2010 following the first wave of the global financial crisis). Once again relatively high yields, higher growth prospects and improved relative creditworthiness are likely to attract liquidity from developed markets. Indonesia is therefore likely to face the continued challenges of how to manage further exchange rate appreciation pressures associated with these inflows, how to continue to shift flows towards more stable FDI inflows, and how to ensure these inflows contribute to productive investment, job-creation and growth going forward.

Sustained progress on structural reforms can boost the economy's resilience and promote further strong, sustainable, inclusive growth

Although the impacts will be seen over the medium-term, continued efforts to progress the structural reform agenda (for example, relating to the investment climate and infrastructure constraints) are at the heart of addressing these challenges. Such reforms can help shift the balance of inflows further towards FDI from portfolio and can enhance the competitiveness of domestic firms in the face of a strengthening currency. More broadly they can help to promote more resilient, inclusive and higher economic growth. For example, progress on fuel subsidy reform can free up fiscal spending for other development needs or for a policy response to future adverse shocks. Banking and financial sector reforms – including strengthening the resolution framework for problem banks, implementing Basel II and examining the implications of Basel III, capital markets development, and corporate governance of the financial sector – can support investment, real sector development and job creation, as well as promoting greater stability of the financial sector.

2. Using PPPs to address Indonesia's infrastructure challenges

a. PPPs are at the core of Indonesia's development agenda

The infrastructure targets set out by the Government of Indonesia envisage a significant contribution from the private sector

As highlighted in the June 2011 *IEQ*, the Government of Indonesia has pledged its commitment to address infrastructure challenges as one of its main priorities to accelerate economic growth. This is seen in both the infrastructure development targets of the current medium term development plan (*RPJMN*) for 2010-2014 and the focus on infrastructure and connectivity within the Master Plan for the Acceleration and Expansion of Indonesia's Economic Development 2011-2015 (*MP3EI*).

Both the *RPJMN* and the *MP3EI* foresee private sector investment as a key driver in accelerating infrastructure service provision. The private sector was targeted to contribute more than 70 percent of USD 150 billion investment needs identified in the RPJMN and 51 percent of the Master Plan's investment plan of USD 468 billion between 2011 and 2025. One main way to mobilize this private financing for infrastructure investment is through Public-Private Partnerships (PPPs), i.e. contractual arrangements between public and private parties under which rights and responsibilities are shared during the duration of the contract. These contracts can potentially bring various benefits not just in terms of access to financing but also for the efficiency, performance risk management and quality assurance and monitoring (Box 1). Indeed, strengthening the framework and implementation for the PPP agenda, was highlighted as one policy priority in the proposed state budget (R-APBN) 2012.

Given the importance of PPPs for Indonesia's development agenda, this section aims to take stock of the progress made to date, highlight the remaining challenges ahead and offer suggestions to move forward in implementing PPPs in Indonesia.[1]

Box 1: Potential benefits of PPPs for delivery of infrastructure services

To meet ambitious development targets in infrastructure investment, governments commonly seek to mobilize financing from the private sector, including in the form of PPP, since public resources alone are limited. In addition to closing the financing gap for investment needs, private sector participation can also help to lower costs and improve efficiency. In general, PPPs, particularly those with long-term contracts, can, if well implemented, offer significant benefits in the delivery of public services, such as the following:

Greater efficiency in the use of resources. PPPs can allow risks to be managed optimally between public and private sectors, thus enabling a more efficient use of resources. Long-term contracts can also provide greater certainty in the price of service delivery.

Capital at performance risk. The explicit exposure of its capital to long term performance risk gives the private party an incentive to design and build the asset on time and within budget, and to take into account the costs of longer-term maintenance and renewal.

Quality assurance and scrutiny. The PPP process usually involves a much greater level of quality assurance than standard public procurement processes. The public authority will face scrutiny by private parties, outside government, whose capital will be at risk over the long term.

Source: Edward Farquharson, Clemencia Torres de Mastle, and E.R Yescombe with Javier Encinas (2010). How to Engage with the Private Sector in Public Private Partnerships in Emerging Markets. PPIAF- World Bank

b. Progress has been made in establishing the regulatory and institutional framework for PPPs, but actual implementation is the main remaining challenge

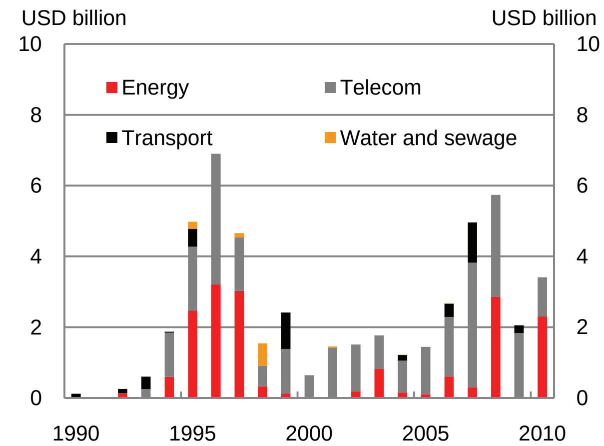
Private sector infrastructure investment in Indonesia is still limited and has not recovered to pre-1997 crisis

Indonesia's private sector investment in infrastructure has only partially recovered after the sharp falls seen after the 1997-98 financial crisis, from its 1996 peak of USD 6.9 billion. Private sector investment dropped from USD 5.5 billion on average between 1995-1997, to less than USD 1.6 billion between 1998 and 2006, before recovering to slightly above USD 4 billion between 2007 and 2010 (Figure 23). In 2010, Indonesia attracted private investment of USD 3.4 billion, focusing mainly in the telecom and energy sectors. Private investment in the transport sector has been relatively small and mainly for toll road development (e.g., the Trans-Java highway), while water and sewage sectors attract very little interest from private sector.

[1] This section draws heavily on recent World Bank analysis by Andri Wibisono, Jeff Delmon, and Hongjoo Hahm (2011), *Unlocking the Public-Private Partnerships Deadlock in Indonesia*.

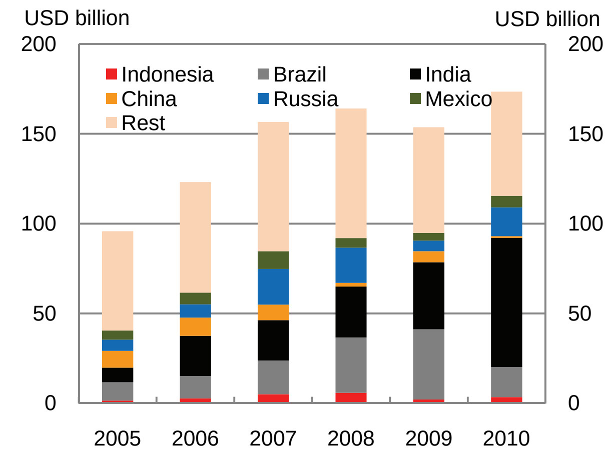
Other countries in the East Asia region such as Malaysia and Thailand also saw declines following the 1997-98 crisis, albeit to a lesser extent than Indonesia. In addition, looking at other countries such as India, Brazil, and Russia, private sector participation in Indonesia is still relatively limited (Figure 24). India and Brazil in particular seem to be quite successful in mobilizing private sector investment, attracting more than half of all private infrastructure investment to developing countries in 2010.

Figure 23: Indonesia's private infrastructure investment has only partially recovered since the 1997-98 crisis…
(USD billion)



Source: World Bank and Public-Private Infrastructure Advisory Facility (PPIAF), Private Participation in Infrastructure (PPI) Project database

Figure 24: …and remains relatively low compared with other emerging economies, particularly Brazil and India
(USD billion)



Source: World Bank and PPIAF, PPI Project database

In the past few years, the Government of Indonesia has made progress in legislative developments supporting the PPP framework which establish the foundation for PPP implementation…

In an effort to attract private sector participation in infrastructure, the Government has revisited and revised many sectoral regulations and laws related to infrastructure service provision (including transport, electricity, telecommunication, and water and sanitation) and established regulatory and institutional framework for PPP implementation. Under the new legal framework, the infrastructure sector and market are opened to the private sector. The private sector can invest in the development and operation of financially viable infrastructure projects, without being obliged to enter into joint ventures with SOEs. A revised Presidential Regulation (Perpres 13/2010, a revision of Perpres 67/2005) concerning public-private sector cooperation is a positive development as it provides better clarity and support for PPP framework and the provision of government support and guarantees. A draft Land Acquisition Law, which is currently in parliamentary consultation and expected to be finalized in 2011, is intended to address some of the land acquisition challenges by making the process "faster" and "fairer".

…and has set up various institutions and financing facilities to support PPP transactions

The establishment of these institutions and financing facilities further strengthen the institutional and modalities framework necessary for PPP implementation. In Indonesia a range of institutional and financing facilities have been developed. In particular, the KKPPI (Committee for the Acceleration of Infrastructure Provision) was established in 2001 and is an inter-ministerial coordinating committee to assist with high level coordination of PPP issues. It is chaired by the Coordinating Ministry for Economic Affairs and co-chaired by the National Ministry of Development Planning (Bappenas).

Various other bodies have also been set up to assist with a range of issues, such as project preparation, selection, financing and public sector risk management. For example, the Project Development Facility (PDF) was created to fund project preparation (e.g., feasibility studies), while the Public Private Partnership Central Unit (P3CU) was established to support selection of well-developed PPP projects. In terms of facilitating financing, PT Sarana Multi Infrastruktur (PT SMI) is a non-banking financial institution dedicated specifically to infrastructure financing and PT Indonesia Infrastructure Financing Facility (PT IIF), a privately-owned subsidiary of PT. SMI, aims to mobilize long-term, local currency financing for PPP projects. The PT. Penjaminan Infrastruktur Indonesia (PT. PII Persero) or the Indonesia Guarantee Fund, (IGF) has been set up to support the provision

of guarantees for PPP projects. A Land Acquisition Revolving Fund (LARF) has been set up, combined with a cost-capping scheme in which the LARF would pay any land costs that exceed by more than 110% those agreed in the concession agreement. A Land Fund was also created to finance private companies acquiring land for 2010 and 2011. In addition, the Risk Management Unit (RMU) of the Ministry of Finance was also created in 2005 to manage government contingent liabilities associated with PPP projects.

Some progress has been made on project preparation…

The Bappenas 2011 PPP Book indicates that there are only 13 projects which are "ready for offer" out of 79 identified PPP projects worth a total of USD 53 billion (Table 9). Few projects are in the advanced preparation stage. For example, the contract for Central Java Power Plant has recently been awarded and the contract for the Puruk Cahu – Bangkuang Coal Railway project is expected to be awarded this year (2011). The contract for Umbulan Water Supply in East Java is expected to be awarded in 2012. Meanwhile very little progress has been made on the Soekarno Hatta Airport railway development with the Ministry of Transport reformulating the Pre Feasibility Study of due to revisions to the route, project structure and design. Furthermore, though a few selected projects are in the advanced preparation stage as mentioned above, this is still a long way from reaching financial close.

Table 9: Ready-for-offer projects account for half the value of Indonesia's 2011 PPP projects plan
(number and value of projects, USD million)

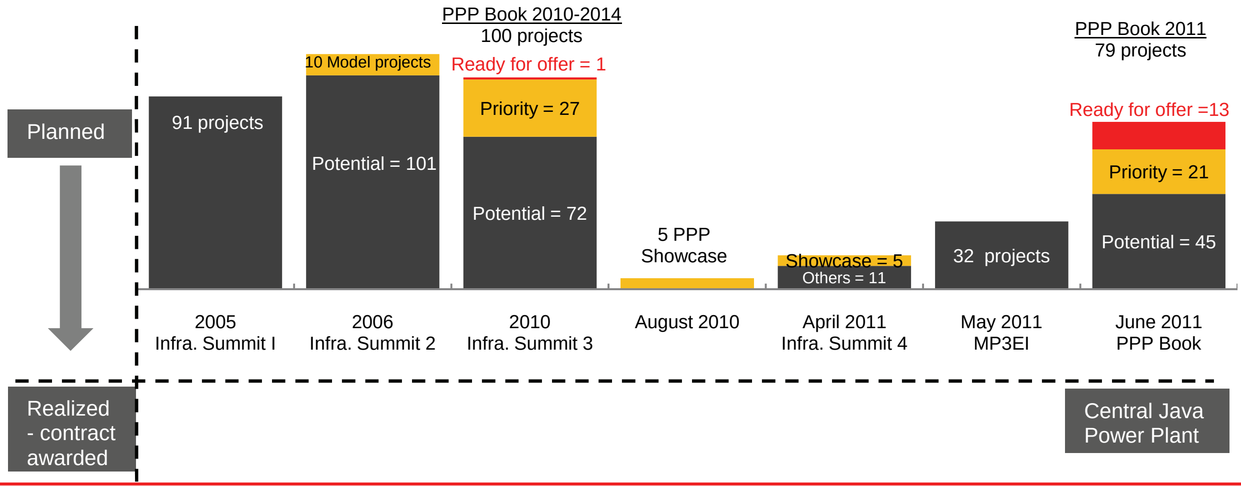
Sector/Sub-sector	I. Ready for offer projects		II. Priority projects		III. Potential projects		Total	
	No.	USD million	No.	USD million	No.	USD million	No.	USD million
Air transportation	1	214			7	1,973	8	2,186
Land transportation					2	274	2	274
Marine transportation	2	1,199			4	2,860	6	4,059
Railways					3	4,385	3	4,385
Toll road	2	25,670	17	8,221	3	1,811	22	35,702
Water resources								
Water supply	6	311			18	1,364	24	1,675
Solid waste and sanitation	2	130	2	120	4	50	8	300
Telecommunication								
Power			2	2,040	4	2,786	6	4,826
Oil and gas								
Total	**13**	**27,524**	**21**	**10,381**	**45**	**15,503**	**79**	**53,408**

Source: Bappenas, PPP Book 2011
Note: Potential project: conformity with the national/regional mid-term and sector plan and preliminary study stage; Priority project: pre-feasibility study stage and government support has been identified; Ready for offer projects: bidding document completed and government support has been approved (if required)

…however, little has been achieved on actual project transactions

The above institutional and legislative developments have laid the foundation for a PPP framework. But very little progress has been achieved on actual implementation under the official PPP framework. Since 2005, the Government has convened four Infrastructure Summits to promote potential PPP projects and attract private sector participation in the PPP scheme. In the first infrastructure summit (2005) the Government introduced 91 potential projects for the private sector under PPP scheme. The second infrastructure summit was conducted in 2006 and introduced 10 model projects and 101 potential projects. The third infrastructure summit was held in 2010 and introduced about 100 projects of which only 1 project held "ready for offer" status (complete bidding documents). The fourth infrastructure summit was convened in April 2011, where the government released the PPP Book 2011 (Figure 25). In conjunction with the launch of *MP3EI*, the government also announced 32 ready-for-offer PPP projects. It is important to note that these PPP projects lists are not always similar from one event to another. As discussed further below, rather than a long list of projects, a key success factor identified in other countries has been the ability of the government to prioritize a short list of well developed projects which are clearly financially viable.

Figure 25: The realization of PPP projects in Indonesia has lagged behind announced plans



Note: Model project: Feasibility assessment stage; Potential project: conformity with the national/regional mid term and sector plan and preliminary study stage; Priority project: pre-feasibility study stage and government support has been identified; Ready for offer projects: bidding document completed and government support has been approved (if required)

Source: Adapted from Sinthya Roesly, 2011. Challenges in Developing a Robust Project Pipeline – Indonesia Case. Presentation at APEC Finance Ministers' Process Conference: The Framework and Options for Public and Private Financing of Infrastructure and Praptono Djunedi, http://www.fiskal.depkeu.go.id/webbkf/kajian%5Cartikel_PPP_prap.pdf

…reflecting ongoing institutional and coordination challenges

There are two main challenges that slow the progress in advancing offered PPP projects to implementation stage: poor project preparation and poor project selection process. This leads to too many less viable and difficult-to-implement projects being offered. For example, there are 33 projects dropped from the PPP Book 2010-2014 due to lack of progress made by the Contracting Agency. Projects need to be better developed, which may call for an increase in resources devoted to project preparation. Given the complexity of designing projects and contractual arrangements, capacity at the agency levels may be inadequate and in need of significant improvement. Contracting agencies need assistance from experts experienced in PPP to understand best practice and to structure projects in a manner that will attract investors.

In addition, lack of coordination during the selection process among involved agencies has resulted in multiple lists of projects which create confusion for potential investors. Coordination on PPPs at the central government level is complicated, with the KKPPI having a dual chairmanship (Coordinating Ministry for Economic Affairs and Bappenas). As discussed below, in countries with a successful PPP framework, strong coordination and leadership support is provided by the top government leadership (such as at the Presidential or Prime Ministerial level).

c. International experience can offer lessons for successful PPP implementation

Attributes of successful PPP frameworks in other countries include firm policy foundations, long-term political commitment and a sound and predictable legal and regulatory environment

Experiences of countries which have successfully attracted private sector investment through PPP schemes suggest that PPPs need to be based on firm policy foundations, a long-term political commitment, and a sound and predictable legal and regulatory environment. In particular, the following factors have been found to be useful:

Strong political and leadership support. High level executive leadership support is essential to achieve effective coordination. In many countries, such as the Netherlands, Australia, and the United Kingdom, decisions on major PPP projects, as well as the overall PPP program, are made by the cabinet which is chaired by the Prime Minister or President. In India, the Cabinet Committee on Infrastructure, headed by the Prime Minister, decides on infrastructure sector projects and monitors their performance.

Strong lead agency and clear assignment of responsibilities. Countries with a strong PPP tradition have a single and strong agency that coordinates PPP decisions, ensuring consistency in policy and development of PPP projects. In the Netherlands and South

Africa, as well as the UK and Australia, the lead agency is housed within the Ministry of Finance. In Colombia, South Korea and the Philippines, PPP policy and decision-making is coordinated by the national planning agency.

Direct fiscal support to attract private sector investment and make projects commercially viable. In India, the Government provides direct fiscal support of up to 40 percent of the cost or the amount needed to make them commercially viable (whichever is less), provided the project is cost-benefit justified.

Clear and consistent rules, policies and detailed guidelines and regulations for PPP. The United Kingdom, Australia, and Colombia have gone through ongoing enhancement of their regulations and procedures through issuance or revision of detailed implementing rules and procedures as they gain experience in implementing PPP projects.

Integrated and structured project selection process. In countries with successful PPP implementation, a project must be shown to be both technically and economically feasible before being considered as a PPP candidate. The selection process of PPP projects is well coordinated. For example, in the Philippines, the planning agency runs a process which brings together the Department of Finance and the sector agency, and presents all relevant information to a committee of ministers, who decide simultaneously on whether a project should go ahead, whether it should be a PPP, and what fiscal support it should be given.

Enhanced capacity of implementing agencies to structure, procure, and manage PPP projects. Flexible, multi-agency, multi-disciplinary teams are the best way to develop and implement PPP projects. In Colombia and the Philippines, the planning agency officials work closely with their Ministry of Finance colleagues on multi-agency teams. Both also utilize sector specialists during the project development phase. The Netherlands and South Africa form similar working groups, but seem to rely more on the implementing agencies for the needed sector specialists. The UK arranges for secondments from commercial banks and law firms of staff with expertise in project finance. South Africa and Egypt initially hired long-term consultants to work in their PPP units to improve access to global best practices.

Box 2: PPP experience in India

India's successful experience in developing and implementing PPPs presents a good case study for Indonesia. India and Indonesia share a lot of similarities in their development challenges. Both are growing economies trying to maintain and enhance historically high growth rates and have very large domestic markets. India and Indonesia have been quite successful in establishing democratic leadership with significant decentralized functioning at the State/Provincial level. To maintain high economic growth, both countries need large scale infrastructure investment, with significant opportunities for private sector to contribute.

India is running a USD 500 billion infrastructure development program. Despite being a "developing country" India is at the center stage of the global infrastructure investment sector. Domestic investors and developers are leading the infrastructure initiative, with specific sectors (such as ports and airports) witnessing higher FDI. Investment commitments to infrastructure projects with private participation in India have increased remarkably in the past five years from USD 20 billion in 2006 to almost USD 40 billion in 2010. With its unique approach, India has been able to address many of the complexities inherent in developing a successful PPP institutional framework.

To attract private sector participation, in the initial stages India focused on the preparation of a small number of viable projects, providing strong support until they were fully implemented and operational to showcase to the private sector. The Government of India developed integrated and comprehensive policies and guidelines to ensure private sector participation. Investors' confidence over policies is strengthened by transparent selection procedures and guidelines, standardized contract documents, and streamlined clearance procedures. Some measured actions to enhance project viability were applied using financing vehicles and additional revenue streams and mechanisms.

One important feature of successful PPP implementation in India is the establishment of independent quasi-judicial bodies for tariff determination across sectors such as the Telecom Regulatory Authority of India, the Tariff Authority for major Ports, the Central Water Commission, etc. Through this set up, user charges were determined independently by the bodies based on technical consideration (and outside the political arena) ensuring the sustainability of the services. Subsidies are provided for deserving consumers subject to approval by the respective commissions during the tariff determination process. Government intervention in developing institutional and capacity building and providing structured human resource development has also been successful in sustaining the development momentum.

Source: Feedback Ventures, 2010: Learning from PPP Experience in Indian Infrastructure

d. The way forward

Focusing on the most strategic and viable PPP projects, and getting them tendered and transacted can be a powerful approach to demonstrate government commitment to PPP implementation

As discussed above, the real challenge for Indonesia in advancing its PPP agenda is on the implementation. Although every country may have different institutional and regulatory set up and business environment to support successful PPP implementation, learning from India's experience could be a starting point. For example, while convening international forums and gatherings can be a useful facility to promote PPP projects, focusing on the most strategic and viable projects and getting them implemented could send a powerful signal to private investors on the Government's commitment to implement PPPs. India's experience of demonstrating the successful implementation of few viable PPP projects has proven successful in attracting private sector interests in the PPP scheme rather than promotion through international forums or gatherings.

To ensure the selected projects are viable and implementable, project identification and preparation needs to be improved by involving the Ministry of Finance and key related institutions from the beginning and throughout the process

As highlighted above, one of the factors slowing PPP implementation progress in Indonesia is that many PPP projects are being offered with inadequate background analysis undertaken prior to tendering. The complexity of designing PPP projects and their contractual arrangements requires improving the capacity of the contracting agencies (line ministries, state-owned enterprises, and provincial and local governments) to help them prepare PPP projects better, faster and at less expense and requires involving the Ministry of Finance and related agencies early and throughout the process. A range of options could be adopted to institutionalize an improved project preparation process. For example, a Project Task Team could be set up for each individual PPP project, led by the contracting agency and made up of specialists from different Government bodies to develop the project. A team of PPP experts could be established, comprised by and large of investment bankers and lawyers, to help the contracting agencies and the Project Task Team to develop the PPP projects using international best practice. Other suggestions are to allocate necessary resource to support project preparation as well as viability gap funding and to resolve land issues before commencing project procurement. Also, given its complexity, PPP land acquisition should be supported by government

The project selection process needs to be enhanced to ensure the selected projects received high level leadership support

The focus on the most strategic and viable PPP projects could be achieved by establishing an integrated and coordinated PPP selection process within government. This process needs to be properly funded and staffed with experts familiar with PPP implementation. This would identify projects that need to be brought up to higher level decision making, for example at a limited cabinet meeting chaired by the President, to ensure high level leadership support in a coordinated manner. Announcing a new list of PPP projects (outside of the prior mentioned process) should be avoided as it may create confusion among investors and risk government credibility.

Last but not least, to ensure strong preparation and implementation, the Government could identify a "project champion" for each selected project

Since implementing a PPP scheme will involve many parties and line ministries, lack of coordination and lengthy bureaucracy process are two risks for success. To ensure strong preparation and implementation and continued high level leadership support, the Government could identify a "project champion" for each priority PPP project equipped with convening power to move the project forward through the bureaucracy. In addition, the Government could also establish a credible monitoring body which could be tasked to UKP4 (a presidential supervisory and monitoring for development working unit) to closely monitor project preparation and implementation.

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

1. Sub-national spending is not delivering

Sub-national governments have a critical role to play in Indonesia's development as a middle-income economy, particularly in the areas of infrastructure and education[2]

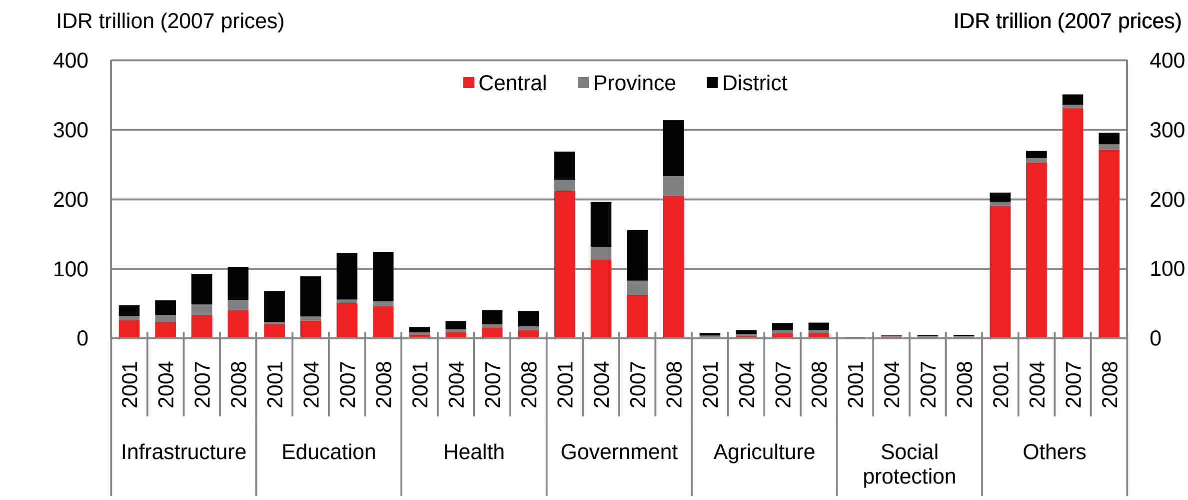
Indonesia has undergone a major transition both economically and politically over the past decade. Output growth has been strong and consistent and, following a decade of relatively successful political and institutional reforms, Indonesia in 2011 is a competitive, decentralized electoral democracy. However, many challenges remain, including those posed by a growing urban population, the need to enhance skills development and create quality jobs, and by Indonesia's connectivity weaknesses. The growth challenges in infrastructure and education are some of the most important ones and the areas where sub-national governments in particular play a critical role.[3] With one-half of core public spending under sub-national government control, and with most service delivery functions, including education and infrastructure, having been delegated to these sub-national entities, there is considerable scope to improve the lives of Indonesians through efficient spending at the sub-national level in the coming years. This section discusses some of the current impediments to reaching this goal after first reviewing recent trends in sub-national public spending and their service delivery outcomes.

a. Sub-national spending has increased dramatically over the past decade

With increased responsibilities of sub-national governments for service delivery, their spending grew to 7.2 percent of GDP in 2007

The big bang process of decentralization in Indonesia in 2001 was accompanied by a shift of substantial funds and responsibilities to sub-national governments. Sub-national governments took over primary responsibility for managing public services and, a decade later, manage half of total core public spending (excluding subsidies and interest payments) in key public sectors (Figure 26). Their new functions were accompanied by an increase of over 150 percent in spending in terms of share of GDP – sub-national spending grew from 2.7 percent in 2000 to 7.2 percent of GDP in 2007 (Figure 27).

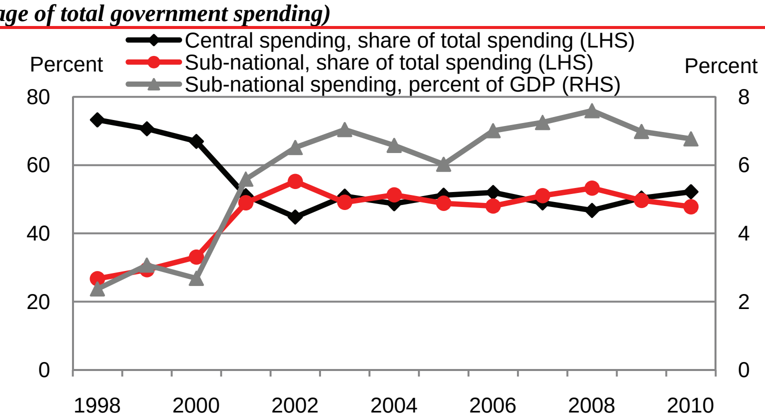
Figure 26: Sub-national governments manage half of total public spending in key sectors
(IDR trillion, 2007 prices)



Note: 2008 is planned budget.
Sources: World Bank staff estimates based on Regional Financial Information System (Sistem Informasi Keuangan Daerah, SIKD) data, Ministry of Finance (MoF)

[2] This section draws upon Indonesia Sub-National Public Expenditure Review (World Bank, forthcoming).
[3] The health sector is another area that presents development and economic growth challenges for Indonesia in the long term. Although examined in the forthcoming Indonesia Sub-national Public Expenditure Review, the analysis of the health sector is not included in this IEQ publication.

Figure 27: Sub-national spending is equal to core central spending
(percentage of total government spending)

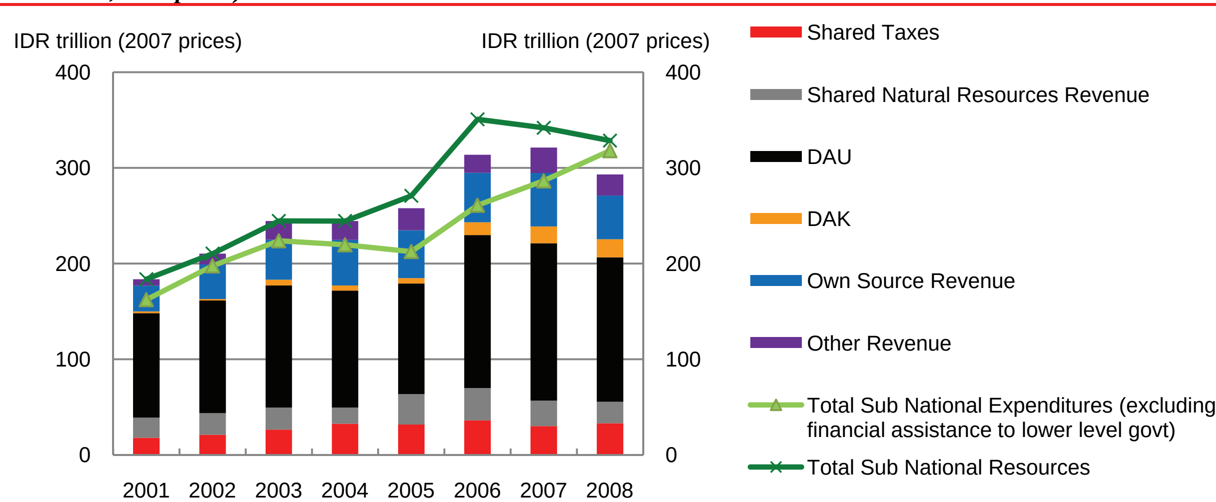


Note: Central spending excludes transfers, subsidies and interest payments. Sub-national 2001-2007 data are realization, 2008 is Budget, 2009 and 2010 are projections
Sources: WB staff estimates based on SIKD data and Central Government Financial Report (Laporan Keuangan Pemerintah Pusat, LKPP), Ministry of Finance and Ministry of Home Affairs

The increase in spending at the sub-national level is financed by transfers from the central government

Transfers to local government have almost doubled in real terms since decentralization. There are multiple types of regional transfers of which the three main ones are General Allocation Fund (*Dana Alokasi Umum*, DAU), Specific Allocation Fund (*Dana Alokasi Khusus*, DAK), and Revenue Sharing Fund (*Dana Bagi Hasil*, DBH) (see Box 1 regarding other types of transfers). Most of the increase in spending at the sub-national level has been driven by the DAU (Figure 28). The DAU has two portions – the Basic Allocation (which covers a share of sub-national spending on staff) and the Fiscal Gap Allocation, which aims to address the problem of imbalances among sub-national governments due to differences in regional ability to raise revenues (see Box 3). In 2010, DAU, DBH (tax and natural resources) and DAK constituted 63 percent, 18 percent and 3 percent respectively of total sub-national revenues.[4]

Figure 28: Central government transfers, in particular the DAU, finance the majority of sub-national revenues
(IDR trillion, 2007 prices)



Note: Total sub national financing resources also include deconcentration funds (DEKON), co-administered tasks (TP), and the central government program PNPM, which are not recorded in sub-national governments' budget (APBD)
Sources: World Bank calculations based on SIKD data, MoF

[4] While revenue data is available with a 1 year lag, the sub-national expenditure realization data (the SIKD dataset) usually has a 4 year lag. At the time of the writing, the revenue data available was for 2010 and the sub-national expenditure data available is for 2007 realized, 2008 planned and 2009 and 2010 projected.

Box 3: An overview of current transfer mechanisms in Indonesia from the central to sub-national governments

This box provides a brief description of the objectives and determination of the various transfer mechanisms from the central government to sub-national governments within Indonesia. These transfers represent the major source of financing for sub-national governments and thus, to a large extent, explain the level and composition of their spending.

General Allocation Fund (*Dana Alokasi Umum*, DAU)

DAU, according to Law 33/2004 Article 1 (21), is a fund sourced from the Central Budget (APBN) allocated to bring equality in the financial capacity among the regions to finance the need of the regions in implementation of decentralization. It is a discretionary block grant designed to equalize the fiscal capacities of sub-national governments. It is transferred monthly and directly from central to sub-national governments. DAU is allocated based on a national formula and is the sum of a basic allocation (which is a portion of the sub-national budget spending on public servant salaries) and the "fiscal gap" of the sub-national government. The basic allocation accounts for about 53 percent of the DAU in 2010. The "fiscal gap" is the difference between the estimated fiscal needs and fiscal capacity of each region. Fiscal needs are based on regional variables such as population, area, GDP per capita, and human development index. Fiscal capacity is measured by a region's own-source revenue and a fraction of total revenue-sharing. Based on Government Regulation 55/2005, provinces only receive 10 percent of the total DAU, while districts receive 90 percent.

Specific Allocation Fund (*Dana Alokasi Khusus*, DAK)

DAK, according to Law 33/2004 Article 1 (23), means a fund sourced from revenue in APBN allocated to a certain region with the aim of funding special activities of the region in accordance with national priorities. The DAK allocation policy involves the Parliament (DPR) Budget Committee and central government bodies, such as the Ministry of Finance, the Planning Agency Bappenas, the Ministry of Home Affairs, and line ministries associated with sectors receiving DAK. The final decision concerning the total amount of DAK allocation per sector and sub-national government depends on MoF after consultations with DPR. The DAK allocation has a formula component that takes into account the fiscal gap and has a 10 percent matching requirement. The DAK cannot be used for research, training, administration, or official travel. In 2011, 19 economic sectors received DAK allocations including, for example, education, health, agriculture, forestry, trade and various infrastructure sectors (road, irrigation, water, sanitation, rural electricity, housing and local government and remote areas infrastructure). DAK is transferred in three tranches, which depend on the depletion of the previous tranche. Although DAK is earmarked to fund capital spending, the government has shown some flexibility in defining capital spending.

Revenue Sharing Fund (*Dana Bagi Hasil,* DBH)

Unlike DAU, which is a horizontal equalization grant, DBH is a vertical equalization grant, which shares tax and natural resource revenues with all districts with a larger proportion of revenues going to resource-rich districts where the revenues originated. DBH consists of revenue sharing from natural resources and taxes. In 2007, most DBH natural resource revenues came from fuel (48 percent), natural gas and geothermal (36 percent), mining (10 percent), forestry (6 percent) and fisheries (0.7 percent). In the same year, the DBH tax revenue sharing came mainly from property tax (59 percent), acquisition tax of land and buildings (17 percent) and income tax (24 percent).

Special Autonomy and Adjustment Funds

Special Autonomy Funds include specific grants for Papua, Papua Barat and Aceh and additional funds for infrastructure development in Papua and Papua Barat. Special Adjustment Funds (*Dana Penyesuaian*) include additional allowances for teachers, professional benefits for teachers, School Operational Assistance program (*Bantuan Operasional Sekolah*, or BOS), and local incentive grants (*Dana Insentif Daerah*, or DID).

Grants (*Hibah*)

Hibah is a source of sub-national government financing that can originate from foreign partners, central government, or domestic partners. It can be in the form of money (e.g. for the Water Hibah) or in goods and services, for example, training and assistance.

Central Government spending at the sub-national level not recorded in sub-national budgets (APBD)

De-concentration (*Dekonsentrasi*) and Co-Administered Tasks (*Tugas Pembantuan*, TP)

De-concentration funds originate from the central government's budget (APBN), are administered by the Provincial Governor and are to finance non-physical activities. This includes, among others, synchronization and planning coordination, facilitation, technical assistance, training, counseling, supervision, guidance, and control. Co-administered tasks (TP) are similar to de-concentration funds, but can be allocated to both provinces and districts, to finance spending on physical activities, such as for procuring goods, land, buildings, equipment and machinery, roads and irrigation.

Sources: MoF and various laws

b. Service delivery outcomes present a mixed picture

Returns from the increase in sub-national resources present a rather mixed picture when it comes to service delivery outcomes

The expectation inherent in the decentralization process was that local governments would be able to better identify development needs in their constituencies, and their increased authority and resources would enable them to significantly improve the quality of public service delivery. However, after a decade since decentralization, improvements in the outcomes in important public sectors, such as education and infrastructure, present a mixed picture. This section will show that, nationwide, some progress has been made

on most indicators but it is far from enough to catch up with regional peers. Furthermore, at the district level, progress has not been uniform. The relationship between increases in spending on education and infrastructure and improvements in service delivery outcomes is statistically insignificant, and a large share of districts have seen no improvement or even deterioration in their outcome indicators, despite increased spending in these districts.

Although Indonesia has made progress in most service delivery outcomes at the national level, it still lags behind its regional peers, particularly when it comes to infrastructure quality

With significant increases in sub-national governments' funding and responsibilities in providing services in education and infrastructure, progress has been made in several key service delivery outcomes in these sectors. Slight progress has been seen, for example, in several infrastructure service delivery indicators, including access to clean water source rising from 77 percent to 80 percent and access to improved sanitation facilities from 44 percent to 52 percent from 2000 to 2008 (according to SUSENAS data). However, improvements have not been sufficient for Indonesia to catch up with its regional neighbors. The country still ranks among the lowest in the region on surveys of the overall quality of infrastructure and on indicators of infrastructure condition, such as for roads (see Part C of the June 2011 *IEQ).* Indonesia is also lagging behind neighboring middle-income countries in enrollment rates beyond basic education. For example, in 2008, gross tertiary enrollment in Indonesia was 21 percent versus 23 percent in China, 29 percent in Philippines and 36 percent in Malaysia (World Development Indicators data). Insufficient improvement in access to secondary and higher education is slowing progress toward creating a high-skilled labor force and improving Indonesia's international competitiveness.

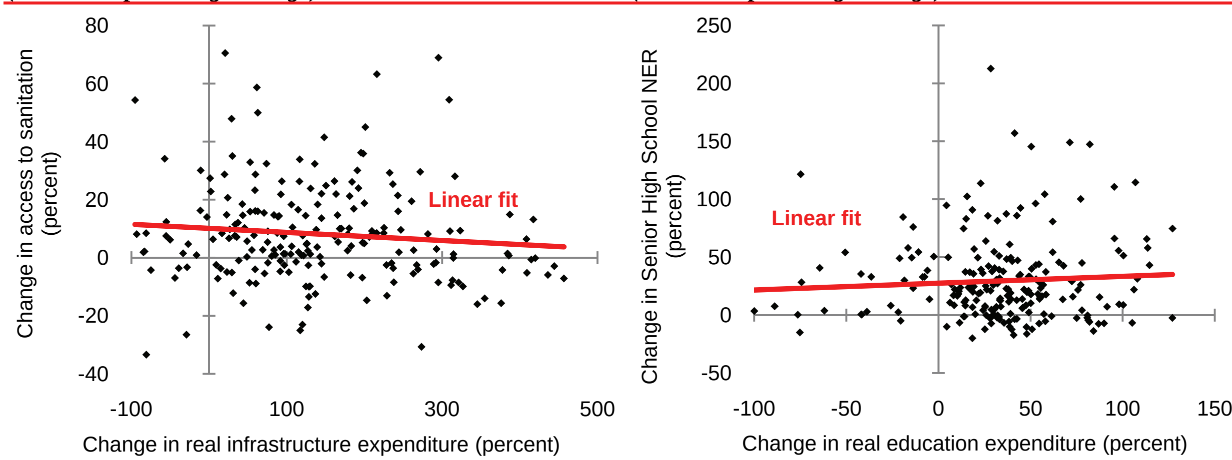
A significant share of districts have seen no improvements in their service delivery outcomes despite increases in spending

Within these aggregate trends, not all districts achieved improvements in service delivery outcomes with increases in their spending. Looking at 200 districts for which spending and outcome data are available over 2002 to 2007, the statistical link between increased spending and the corresponding sector outcomes for infrastructure and education is not significant. The majority of districts in the sample increased their spending on education and infrastructure by up to 50 percent, albeit with significant variations. However, higher spending is not correlated with greater improvements in outcomes, and similar increases in spending can be associated with very different changes in outcomes across different districts (Figure 29). More worryingly, a significant share of districts has not improved or has experienced deterioration in outcomes despite an increase in expenditure – roughly 30 percent of districts in the sample (see notes to Figure 29).

Figure 29: The correlation between increases in spending and increases in service delivery outcomes is not statistically significant

a) Access to sanitation *(2002-2007 percentage change)*

b) Senior High School net enrollment rate *(2002-2007 percentage change)*



Sources: SUSENAS, SIKD

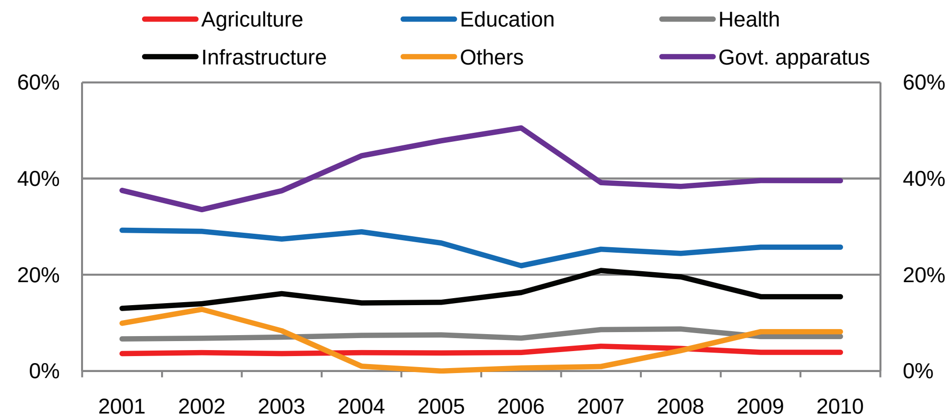
Notes: NER is net enrollment rate. Additional indicators tested include paved roads, access to clean water, enrollment rates for primary, junior, and senior high school education, as well as years of schooling and literacy rates. When tests were conducted taking into account split districts, the results were similar to not separating split districts

c. Service delivery would be improved by better prioritization and efficiency.

Although sub-national spending on key sectors has increased significantly since decentralization, the biggest share of sub-national expenditure has been allocated to government administration rather than direct service provision

The allocation of sub-national budgets is not aligned with key sectoral development needs. The largest share of sub-national spending goes to the government apparatus sector (i.e. administration) rather than to direct services. Increase in spending on government apparatus can be partially explained by the growing number of districts and hired civil servants since decentralization. At the start of decentralization, Indonesia had 30 provinces and 342 districts and grew to 490 districts and 33 provinces in 2008. Many studies (for review see USAID, 2009)[5] indicate that financial incentives encourage district splitting – central government assistance is obtained to establish new administration and per capita flows are higher in the separated regions than in the original region.[6] Although the level of sub-national spending on infrastructure and education has seen a significant increase over the past decade (up 64 percent for education and 195 percent for infrastructure from 2001 to 2008), the biggest share of the resources has been spent on government administration. This has ranged from 30 to just over 40 percent of total sub-national spending over this period (Figure 30). Spending on education represents the second largest share in total sub-national spending (25 percent in 2007), followed by infrastructure (21 percent) and health (9 percent).

Figure 30: Although infrastructure's share has risen, government administration still accounts for the largest share of sub-national spending by sector
(share of total sub-national spending, percent)



Note: 2001-2007 data are realization, 2008 is budget, 2009 and 2010 are projections
Sources: World Bank staff calculation based on SIKD data, MoF

Increased spending alone is not sufficient to improve outcomes and districts could greatly improve their performance with the funds available by increasing their efficiency

The level of funding available within each sector is not the only factor affecting service delivery performance. There is evidence that some districts achieve lower results in outcomes with similar spending inputs as the best performers, indicating differences in capacity and spending efficiency across districts. Ongoing analysis by the World Bank of the education and infrastructure sectors provide valuable insights into the variations in output attainment across districts with similar spending inputs. These studies use "Best Practice Efficiency Analysis" to estimate a frontier production function, or the maximum observed output for all available input levels. "Outputs" and "inputs" are represented by respective indexes which combine several indicators into a single composite index.

In both the education and infrastructure sectors, there are wide variations in district level service delivery performance although most have similar inputs (Figure 31). The fact that for a given level of measurable inputs, districts are achieving very different level of outputs suggests varying degrees of efficiency in service delivery. For example, a comparison of

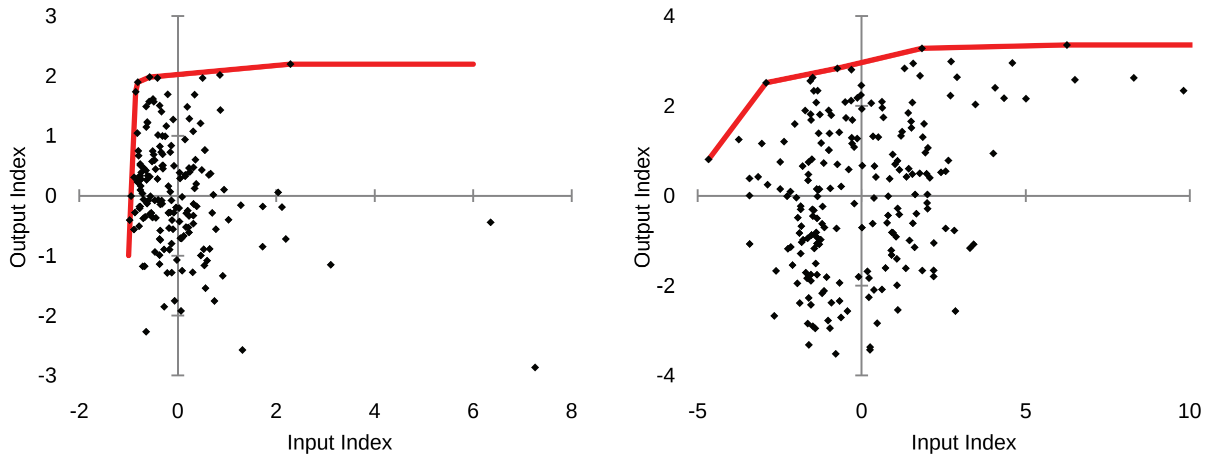
[5] USAID, 2009. Decentralization 2009. Stock Taking on Indonesia's Recent Decentralization Reforms Update.
[6] Other reasons for local government proliferation include administrative dispersion due to large size of jurisdictions, a preference for homogeneity with respect to ethnicity, religion, language, urban-rural character, etc., bureaucratic and political rent seeking (Kaiser et al. 2005).

an average district and a best performer (achieving maximum observed output for the available input level) in the infrastructure analysis, suggests that the average district could improve its access to sanitation outcome by 43 percent and reduce costs associated with staff expenditure by 15 percent. This analysis does not take into account various important inputs that may affect the results of the tests but that are difficult to measure, such as the capacity of government staff, governance issues, as well as the starting point in districts' levels of inputs and outputs. The challenge for the average-performing local governments is to move to the frontier through improving their spending efficiency at current resource levels.

Figure 31: Some districts could deliver much higher outcomes with the same level of inputs

a) Infrastructure *(Efficiency score of Best Practice Efficiency Analysis)*

b) Education *(Efficiency score of Best Practice Efficiency Analysis)*



Source: SIKD, Susenas, Podes

Note: Infrastructure inputs: Dinas Public Work spending, number of civil servant per 1000 population. Infrastructure outcomes: quality of roads, access to road network, water and sanitation. Education inputs: realized education expenditure; average service area of schools (primary, junior high, and secondary, in sq. km); number of teachers per level of school; and the number of schools per 1,000 students at each age group. Education outputs: net enrollment rate, adult literacy, means years of schooling

d. What is driving spending inefficiency and poor service delivery?

The challenges to enhancing the level and quality of sub-national spending and improving service delivery lie in the areas of incentives, financing and systems

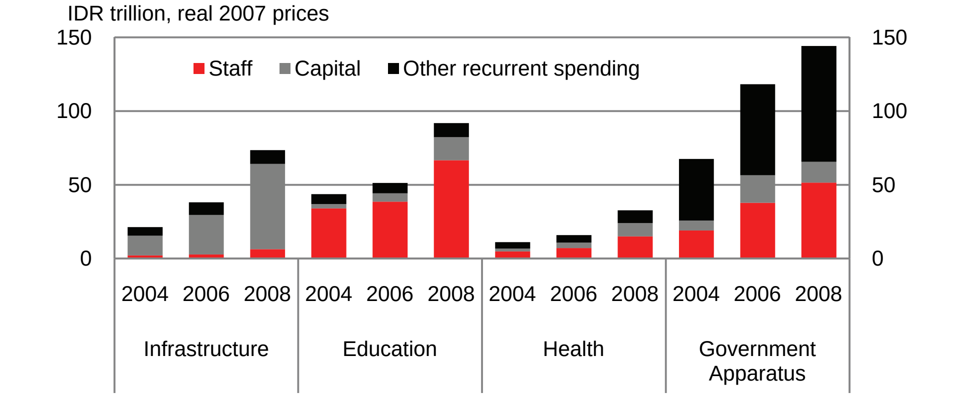
Based on examination of different sectors, evidence suggests that a combination of incentive, financing and systems constraints are affecting the level and efficiency of local government spending and may explain why increased spending has not produced corresponding improvements in public service delivery outcomes. First, incentive constraints reflect perverse incentives that have arisen from the overall institutional set-up. Second, the financing constraints refer to two issues: first, financing for capital investment and, second, the total resource envelop available for programs. These constraints might be due to a combination of a lack of an appropriate funding mechanism to realize capital investments, and of high earmarking of the transfers, which might limit the total resource envelop of some districts to fund new programs. Lastly, systems constraints refer to the complex system and institutions of intergovernmental transfers, budgeting and execution processes. Addressing these three constraints could greatly improve sub-national spending quality and service delivery.

The main fiscal transfer can introduce unintended incentives, such as to increase staffing and reduce effort in increasing own-source revenues

Several of the main fiscal transfers and spending mechanisms, such as the DAU and the de-concentration and co-administered tasks, are associated with unintended effects on staffing, revenue-raising efforts and capital investment and operations and maintenance (O&M). The formula for the largest transfer, the DAU, has a positive relationship with the number of staff at the sub-national level. This contributes to the high level of staff expenditures at the sub-national level, around 52 percent of recurrent expenditures in 2007, almost double the level of the central government. This is primarily driven by the education and the government administration (or apparatus) sectors (Figure 32) which accounted for 43 percent and 32 percent, respectively, of sub-national staff spending in 2008. Furthermore, the coefficient linked to own-source revenue in the DAU formula

exhibits a negative sign, creating perverse incentives at the sub-national level because local governments will receive less DAU funding when their own-source revenues increase (about 60 cents less of DAU for each dollar of own-source revenue raised). Consequently, revenue decentralization policies intended to strengthen own-source revenue at the sub-national level - such as the property tax devolution - will not deliver.

Figure 32: High staff expenditures at the sub-national level are driven by the government apparatus and education sectors
(IDR trillion, real 2007 prices)



Note: 2001-2007 is realization, 2008 is budget. Deflated using GDP deflator
Sources: World Bank staff calculation based on SIKD, MoF

Line ministries' spending on sub-national functions through DEKON/TP funds can disrupt local governments' own development plans for similar activities

As detailed in Box 3, de-concentration (DEKON) and co-administered tasks (TP) are spending by the central government through its line ministries on sub-national functions for non-capital investment and capital investment activities respectively. They enter the national budget (APBN), but not the sub-national budgets (APBDs). In 2010, DEKON and TP constituted 12 percent of sub-national revenues. These funding mechanisms can result in distortions to spending, planning and rent-seeking at both the local and central levels.[7] First, local governments may postpone their funds' disbursement until the end of fiscal year in order to obtain interest by putting the funds in local commercial bank deposits. Second, local governments may anticipate that the central government will take over some sub-national projects through DEKON/TP spending if such projects are under the central government's priorities. In addition, at the central level, unlike the DAK scheme, the distribution of DEKON/TP is not revealed formally via Ministerial decree and so the transparency and accountability of DEKON/TP remains a challenge.

Since the central government funds capital investment through various channels, local authorities await rehabilitation funds rather than spend on O&M. The irrigation system is one such example

The irrigation sector provides an insight into how the central government's funding of capital investment plays out. There are three different types of irrigation networks, depending on the network size, each managed by a different level of government. The underfunding of O&M at the sub-national level is most evident in the lower quality of the sub-nationally-managed irrigation networks. With each government level responsible for O&M of those systems under its authority, the irrigation networks under the district and provincial authorities were found to be in a worse state of deterioration than those under central authority in 2009 (World Bank, 2010). Lack of ownership and incentives to locally fund O&M for irrigation networks were the main problem, as local governments anticipated rehabilitation funds (capital investment) from higher levels of government to "bailout" the deterioration of the system.

[7] Lewis, B.D., Chakeri, J., 2004. Central Development Spending in the Regions Post-Decentralization. Bulletin of Indonesian Economic Studies Vol. 40 (3), 379-394.

With a heavily earmarked budget, some sub-national governments have little flexibility to fund new programs

Turning to the resource constraints, with the DAU mainly allocated for salary spending and the DAK being quite small (constituting only about 3 percent of their revenues), some local governments might have limited funds for new programs. Moreover, earmarked funds often do not match with local needs. For instance, in a field visit to the Pasuruan district, East Java province, the World Bank team found that a large transfer of tobacco shared tax revenue that was earmarked for projects involving tobacco plantations, could not be utilized because Pasuruan district has no tobacco industry. Lastly sub-national governments have limited short-term options to release their resource constraints or to raise funds for investment projects. The immediate potential of own-source revenues is limited, mainly to large metropolitan areas.[8] In the medium term, there is potential for debt to serve as a financing instrument for sub-national governments, but again mainly for larger urban centers with greater investment needs and better capacities.

The system of intergovernmental transfers is very complex and carries a high transaction and coordination burden

Coordination conflicts occur vertically (between the central and sub-national levels of government), horizontally (between agencies and departments at the sub-national level, for instance) and inter-regionally (between several district governments in a metropolitan area, for example). The multiple agencies and budgets involved in sub-national spending can introduce high transaction costs and coordination burdens. As an illustrative example of the potential coordination difficulties in education, schools, the primary point of service delivery management, receive seven different transfers originating from four different budgets, sometimes for overlapping functions.

e. Concluding remarks

There is a range of policy reforms which could promote improved efficiency of sub-national spending, including fixing the perverse incentives of the current transfer system and taking steps towards performance-based mechanisms

To summarize, spending efficiency and service delivery at the sub-national level are constrained by perverse incentives, inappropriate funding mechanisms and an over-engineered intergovernmental transfer system. With the ongoing revision of Law 32/2004 on regional administration and Law 33/2004 on regional fiscal balance, it is a very opportune time to address some of these constraints. The above discussion provides some insights into policy options which could be considered. For example, first steps towards addressing systems and financing limitations could include fixing some of the perverse incentives in the current transfer mechanisms. Revisions to the DAU formula could be used to address the problem of disincentives to right-size staff levels and to raise own-source revenues. In the medium term, spending efficiency could also be promoted by introducing the right incentives for sub-national governments to improve their service delivery through performance-based transfers. International experience suggests that intergovernmental transfer systems evolve from input to performance-based instruments, resulting in much more efficient systems. Indonesia could start by putting in place some of the elements needed, such as a fiscal and a non-financial outcome database, and further pilot and expand on a sectoral basis some of its current results-based transfers in the medium term. Finally, the over-engineered system will need to be refocused and made simpler and more transparent in the long run.

[8] World Bank Sub-National Public Expenditure Review (forthcoming).

2. Identifying constraints to inclusive growth in East Java

Making growth inclusive, as well as higher, is at the core of Indonesia's development challenges at the national and provincial level

The development challenge for many developing countries such as Indonesia is not just to raise their level of growth but to ensure that is also inclusive, with the benefits shared across the population. This section aims to look at the factors constraining inclusive growth in East Java, one of the most dynamic and economically important regions in Indonesia.[9] Looking at this issue at the regional level can provide a better understanding of the different type of problems that inhibit inclusive growth within Indonesia. The framework of inclusive growth that is applied in this analysis focuses on the ways to raise the pace of growth by increasing the level of private investment and utilizing more fully those parts of the labor force that are trapped in low-productivity activities or completely excluded from the growth process. Using a "growth diagnostics framework", this piece will analyze this issue through an assessment of the constraints on the ability of the poor and the labor force to contribute and benefit from growth (Box 4).

a. The economic performance of East Java

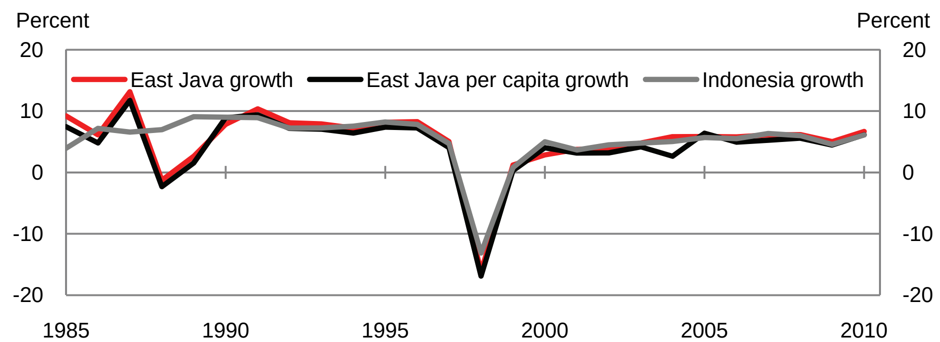
East Java is one of the largest and highest income provinces of Indonesia…

East Java is the second largest province in Indonesia by population, accounting for 16 percent of the national population, with almost 50 percent of its population living in urban areas, slightly higher than the national level of 44 percent in 2010. On average, the economy grew by 5.4 percent per annum between 2001 and 2010, similar to the national average growth rate. The province's GDP per capita was the second highest in Java at IDR 20.8 million in 2010 and within the top ten highest of provinces in Indonesia. Within East Java province, there was a substantial variation in GDP per capita across districts, ranging from IDR 2.2 million to IDR 79.9 million.

…however, recent growth rates are still below the pre-1997/1998 crisis levels and its contribution to Indonesia economy has slightly declined

Although growth in East Java has been steady over 2003 to 2010, within the range of 5.8 to 6.7 percent, the figures are still below the levels of the early 1990s, similar with the national pattern (Figure 33). Before the crisis of the late 1990s, growth averaged 8.3 percent over 1990-1996. Furthermore, East Java's share of Indonesia's overall GDP has declined. Between 1976 and 1983, East Java's proportion of the total national GDP was higher than any other province in Indonesia, with an average share of 16.1 percent. Jakarta and West Java, the other economic centers in Indonesia, in comparison only represented around 14.0 and 14.8 percent of the national GDP, respectively. By the mid-1980s, however, both Jakarta and West Java surpassed East Java. During the period between 1992 and 1999, East Java's share of total GDP remained at 16.1 percent, but West Java had increased to 17.4 percent and Jakarta's share increased to 18.2 percent. The splitting of West Java into two provinces (West Java and Banten) in 2000 nevertheless has moved East Java back to the second highest share, albeit with a declining share compared to the 1990s. In 2010, East Java represented 14.7 percent of Indonesia's GDP, with the majority of the provincial economy accounted for by manufacturing, trade, and agriculture (73 percent in 2010).

Figure 33: Economic growth in East Java has tracked the national rate in recent years
(real growth per annum, percent)



Source: BPS and World Bank

[9] This section is based on World Bank (2011), *East Java Growth Diagnostic*, http://go.worldbank.org/BA4F5OCZB0.

The trends in poverty and employment in East Java suggest that the benefits from economic growth need to further reach the poor

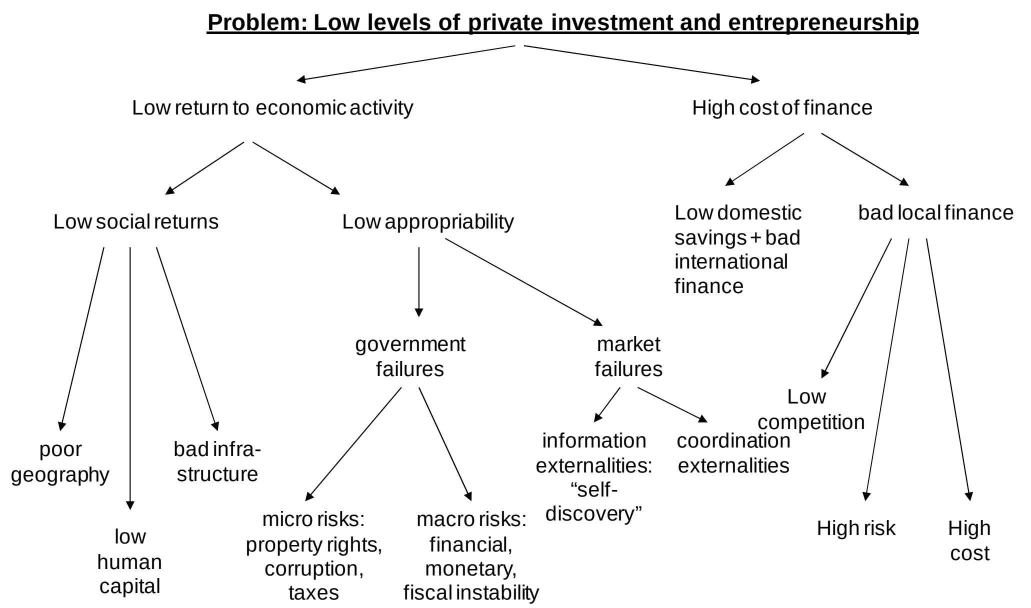
Although declining, in 2010 East Java's poverty rate of 15.3 percent remained above the national rate of 13.3 percent and significantly higher than the poverty rate in Jakarta (3.5 percent) or Banten (7.2 percent). In terms of unemployment, East Java experienced a rapid increase in unemployment during the Asian economic crisis in 1997; however, the unemployment rate was almost back to the pre-1997 level at 4.3 percent in 2010. Nevertheless, within the working population, there remained a high share of underemployment and a large proportion of employment was within the agricultural sector, which is regarded as the least productive sector in the province.

Box 4: A brief introduction to inclusive growth diagnostics

Inclusive growth analysis focuses on ways to raise the pace of growth by utilizing more fully parts of the labor force trapped in low-productivity activities or completely excluded from the growth process. The concept emphasizes productive employment that covers 'employment growth' to generate new jobs and income for the individual as well as 'productivity growth' that could lift the wages of those employed and the returns to the self-employed. This involves looking into an individual's employability, as well as the opportunities for them to be employed. Thus studying inclusive growth implies looking at the ability of individuals to be productively employed (the labor supply side) and the opportunities to make full use of available resources as the economy evolves over time.

The inclusive growth analysis of East Java follows the growth diagnostic framework developed by Hausmann, Rodrik and Velasco (HRV, 2005). The approach is based on the idea that there may be many reasons why an economy does not grow, but each reason generates a distinctive set of symptoms (Figure 34). This approach acknowledges the importance of the private sector for growth. It provides a strategy that is aimed at identifying the most binding constraint(s) on economic activity and hence the set of policies that, once targeted on these constraints at any point in time, is likely to provide the biggest impact of reforms. There is no quantitative method for scoring all potential constraints according to how binding they are, but a combination of economic analysis and knowledge of the economic situation in the province can be used to identify the most binding constraint.

Figure 34: An example of the HRV growth diagnostics framework



Source: Hausmann, Rodrik and Velasco (2005), "Growth Diagnostics", Inter-American Development Bank, mimeo

The HRV analysis follows a systematic approach to identify what could be constraining growth and investment using the growth diagnostic tree (Figure 34). The analysis starts from the top of the tree and then proceeds downwards, trying at each stage to identify what is constraining private sector investment. Each branch represents a potential symptom or 'disease' of the economy that may explain low levels of private investment and entrepreneurship. It asks whether the binding constraint is low returns to economic activity or high cost of finance. If the binding constraint is low returns, are social returns the problem (because of the lack of complementary factors such as good geography, human capital or infrastructure) or is it the difficulty of private agents to appropriate these returns (because of government or market failures)? If the issue is the high cost of credit, is the problem low savings or problems with the domestic financial system where intermediation is inefficient? To identify the most binding constraint(s), one has to go through an iterative process: the growth diagnostic itself.

Note: For more details on inclusive growth see the World Ban's related website http://go.worldbank.org/KMA8I1PV60

b. Exploring the constraints to inclusive growth in East Java

East Java accounts for a relatively small proportion of national private investment, and has a low investment rate, which prevents the province from achieving higher rates of growth

Low private investment in East Java is the main factor that inhibits the province from achieving a higher growth rate. The level of private investment in East Java, according to BKPM data, has for long been behind Jakarta and West Java, and has been behind Banten as well in recent years. This has also been reflected in the proportion of total national private investment located in East Java. In 2010, East Java accounted for only 12 percent of total national investment, which is lower than Jakarta (30 percent) and West Java (15 percent).[10] The pattern is similar when looking at the ratio of investment to GDP where East Java has consistently lagged behind Jakarta, Banten, and the national rate. In 2009 the investment to GDP ratio in East Java was 18 percent versus 35 percent in Jakarta and 28 percent in Banten. The proximity of Banten and West Java to the nation's capital (Jakarta) may help in attracting more private investment.

Table 10: East Java's share of private investment has remained relatively low
(share of total national private investment, percent)

	2001	2003	2005	2007	2010
Jakarta	27	48	29	36	30
West Java	16	20	24	18	15
Central Java	3	1	1	1	1
East Java	**6**	**4**	**9**	**13**	**12**
Banten	16	8	9	6	10
Others	32	18	28	26	33

Source: World Bank calculations based on BKPM data

There are several factors that inhibit greater private investment in East Java, but the biggest constraints are infrastructure and the investment climate

East Java offers many economic advantages for investors such as its strategic geographical location, adequate credit facilities, an abundant and competitively priced workforce, conducive security, and an overall sound macroeconomic condition. Nevertheless, the growth diagnostic analysis found some binding constraints to private investment and growth, particularly relating to infrastructure and the investment climate, which resulted in lower returns to economic activity. The relatively lower productivity of human capital is also a concern for inclusive growth, particularly if lower income groups are to improve their productivity and returns.

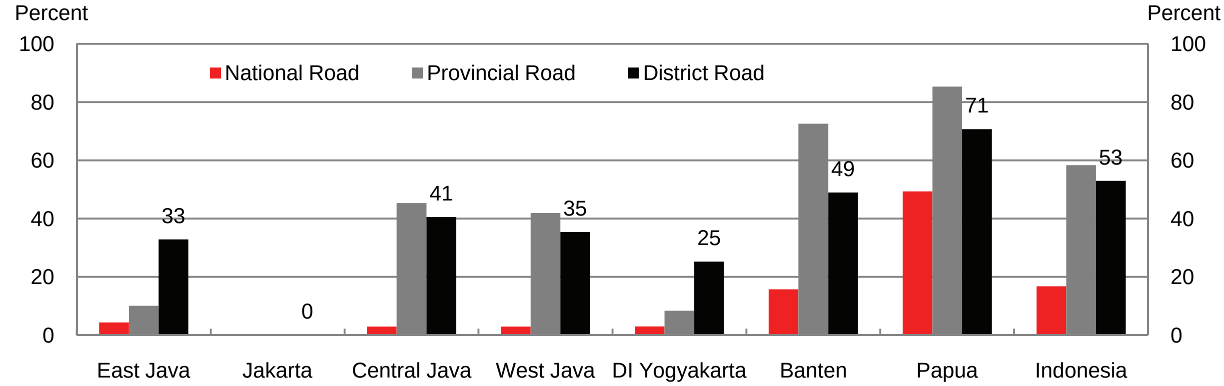
The types of infrastructure that constrain business operations are district roads, sea ports, and reliable electricity supply

As in other parts of the country (see the June 2011 *IEQ*), infrastructure weaknesses that constrain business operations in East Java include the poor quality of district roads, inefficient port operation, and the reliability of electricity to businesses. The poor state of district roads compared to provincial and national road network as well as possible congestion at the main economic centers are the two main drivers of high transportation costs, which in turn lower returns to investment. In 2008, although conditions of the road network in East Java were better than other provinces of Indonesia, around 33 percent of all district roads remained in a poor or very poor condition followed by 10 percent of provincial roads and 4 per cent of the national road network (Figure 35). The poor condition of district roads may increase transportation costs as the majority of small businesses in the manufacturing and agriculture sector use these roads to transport their products to the main markets in big cities. These roads are often used to carry inputs and intermediate goods for further processing in major industrial centers. A LPEM study (2005) found that the main contributor to high logistics costs in Indonesia are the input logistics costs (from vendor to manufacturer), which contribute around 7 percent of the production costs (or about 50 percent of the logistics costs). The bad quality of some district roads could become a key driver to the higher overall logistic costs and are particularly a concern for East Java as it attempts to become an economic center in Indonesia.

[10] The total realized private investment in East Java has, however, increased significantly by more than doubling between 2009 and 2010. In terms of the share of total private investment nationally, East Java increased from 5 percent in 2009 to 12 percent in 2010.

The main port facility in East Java is also operating at almost full capacity and capacity problems are compounded by operational inefficiencies. The reliability of electricity supply, rather than the power supply itself, is also a problem for the private sector in East Java, particularly due to the low transmission capacity and distribution network. Most of these constraints have been acknowledged by the provincial and local governments in East Java, and some remedial actions have been undertaken such as widening the channel for the port gateway as well as investments in the electricity network and equipment.

Figure 35: In 2008 one third of East Java's district roads were in poor or very poor condition
(share of total roads in province in poor or very poor condition, percent)



Source: Ministry of Public Works 2008

Cumbersome business registration processes and perceived corruption in the main economic center in East Java are other potential main constraints

According to a "Doing Business" survey in 2010, business registration in Surabaya (taken here to be a proxy for East Java province) involved more procedures and was more costly than many other cities in Indonesia. For example, Surabaya's business registration process had 10 procedures, versus 9 in Jakarta and 8 for the average city in the East Asia and the Pacific region. The time used to complete the 10 procedures (50 days) is also behind national best practice cities, that is, Bandung and Yogyakarta (43 days), but is faster than Jakarta (60 days). The cost of registering a company in Surabaya is equivalent to 32 percent of per capita income and amongst the highest in Indonesia. The number of days needed to obtain a construction permit in Surabaya is 230 days. The province also suffers from a high perception of corruption in its main economic center of Surabaya which can also increase the effective costs and uncertainty of doing business.

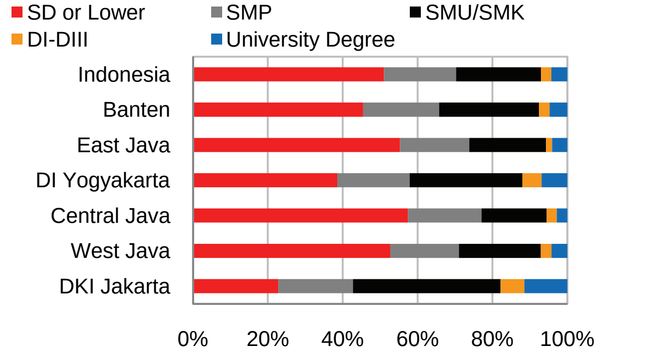
Labor supply and its cost do not appear to be a binding constraint to higher investment in East Java, particularly in labor-intensive industries

East Java has the largest provincial labor force in Indonesia, and can still be viewed as a "labor surplus" province, particularly for low-skill labor-intensive industries. Labor intensive investment can utilize the high pool of workers with some intermediate level of skills, i.e. those with at least high school education. The unemployment rate for people with a minimum of high school education currently stands at 11.3 percent, indicating the labor market is still far from saturated. East Java has one of the lowest minimum wage and average monthly wage of all of Indonesia's provinces. The wage premium of employing a skilled worker was also found to be lower than many other regions in Indonesia, indicating that there is relatively no shortage of skilled labor.

….however, the high proportion of unskilled workers within the labor force may limit the inclusiveness of growth

In 2009, more than half (55 percent) of the labor force in East Java had only primary school education or lower, including about 21 percent of the labor force who had never been to school or did not finish elementary school (Figure 36). Only about 6 percent of the labor force enjoyed post-high school education. The majority of the unskilled labor was employed in the lower productive agricultural sector. Workers in this sector earn the lowest wages. About 52 percent of agriculture employment are in the older age group (over 40 years old) and has the maximum education level of primary school.

Figure 36: In East Java a relatively high share of the labor force only has primary school education or lower
(share of total 2009 labor force, percent)



Notes: SD is primary school; SMP is junior high school; SMU is senior high school and SMK vocational high school; DI-DIII is diploma
Source: World Bank calculations based on Sakernas

The high proportion of unskilled labor may be caused by the low access to secondary education in many districts

The main constraint to having a more skilled workforce is the low access to secondary education, resulting in low education attainment in the province. There is a wide gap between the rich and the poor as well as between rural and urban residents in accessing secondary education. This unequal access may be due to the limited number of secondary schools, an unequal distribution of schools and the relatively higher cost of secondary education. In 2009, the net enrollment rate in East Java was 95 percent for primary level, 70 percent for junior secondary, and 48 percent for senior secondary level. This trend is similar to the Indonesia enrolment rate, where junior and senior secondary level enrolment is still far from universal. At the district level, most districts have primary enrollment rates above 90 percent. Larger variation in enrolment rates, however, exists at the junior secondary level. For example, the average junior secondary enrolment rate in Kab. Magetan is 85 percent, while in Kab. Sampang, it is only 45 percent. The variation is even more significant at the senior secondary level - Kota Madiun has the highest average enrolment rate in East Java with 80 percent; while Kab. Sampang's average senior secondary enrolment rate is only 18 percent, the worst in the province.

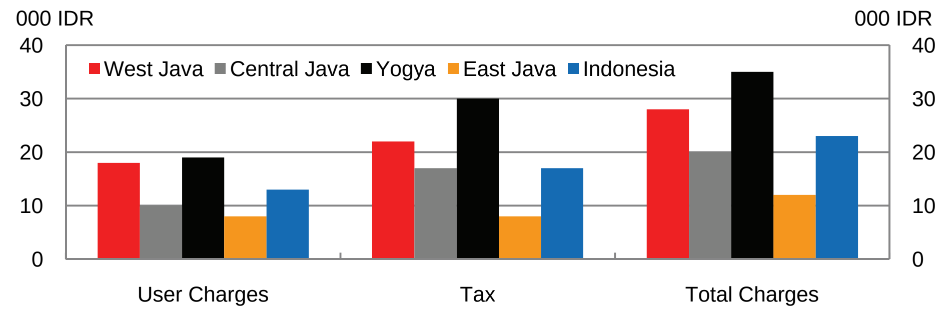
On the other hand, several factors appear to be favorable to support growth and private investment in East Java, such as, supply, cost, and access to finance

The ratio of credit to GDP in East Java is slightly lower than the national figure, but this is more likely due to the lack of demand rather than lack of access. Of the allocated credit, the majority goes to investment and working capital. There is no correlation between change in lending rates and growth rates in East Java, suggesting that growth is not responsive to changes in the interest rate and so the price of credit is probably not a constraint on growth. The lending rate in East Java is also similar to the national average rate, suggesting that banks do not charge a premium to cost for any perceived business risk. Furthermore, the high loan to deposit ratio (LDR), low non-performing loan (NPL) and the availability of banks in East Java suggests that banks are adequately performing their financial intermediation role. Micro, small and medium-sized enterprises (MSME), nevertheless, seem to face challenges in accessing credit as in the rest of Indonesia. This may be due to their inability to fulfill key requirements such as having formal legal status and collateral, before a loan is granted and they can also encounter greater interest rates due to higher costs of managing micro-credit (such as greater overheads and default risk). Overall, access to finance for MSMEs may still be problematic, requiring support from the Government and financial institutions. Several initiatives have been implemented to address this issue including through a special credit scheme called Kredit Usaha Rakyat (KUR) and a provincial government credit guarantee scheme.

The level of local taxation and charges in East Java is also not considered as particularly burdensome

The level of local charges and taxation in East Java is relatively low compared to other regions (Figure 37). Local taxes and charges, such as, for building license retribution and motor vehicle retribution, are amongst the lowest in Java and below the national average. Furthermore, only a small proportion of enterprises surveyed in several investment climate surveys, such as Regional Autonomy Watch Committee (KPPOD, 2007) and Monitoring Investment Climate in Indonesia (MICI, 2006), found that the amount of tax and user charges paid were burdensome.

Figure 37: User charges and local taxes are relatively low in East Java
(Median user charges and local tax paid by enterprises per year per employee, 2007, 000 IDR)



Source: World Bank staff calculations based on KPPOD and Asia Foundation Survey

c. Policy options to promote further inclusive growth in East Java

Improving the availability and quality of infrastructure and creating a favorable investment climate is crucial to promoting investment and growth in East Java

The diagnostic study outlined above identified three main infrastructure areas that need to be prioritized by the government, namely district roads, port, and the electricity network, if East Java is to achieve higher economic growth. Several efforts are currently ongoing to improve the condition of these infrastructures, such as the plan to enhance the port capacity and the expansion of power supply capacity. Implementation of these plans could be expedited, and the government could do more to further improve infrastructure, such as improving the quality of district roads by allocating adequate budget for road maintenance or by providing incentives to districts for maintaining the road network. As for creating a more favorable investment climate, this will require, among other things, simplification of business registration procedures, monitoring and evaluating the performance of one stop licensing services in provinces and districts, and improving business orientation and professionalism of relevant government agencies.

Improving the inclusiveness of growth will require enhancement of human resources capacity and revitalization of the agriculture sector

Providing greater access to secondary education could increase the number of skilled workers in the province. This can be achieved by increasing the allocation for secondary education as well as expanding and optimizing the vocational schools and non-formal education institutions.

The agriculture sector, which has the lowest labor productivity, and absorbs the largest share of unskilled labors in the province, is also at the heart of moving towards inclusive growth. In order to reduce poverty in East Java, the province needs not only a strategy to facilitate the transition to higher productivity sectors for the younger labor force, but also to put in place polices to increase the agriculture sector's productivity, enhance agriculture value-added, and promote rural non-farm employment, such as in agro industries and rural small scale industries to accommodate those that have fewer possibilities (i.e. older and lower educated members of the labor force) to move into non-agriculture sectors.

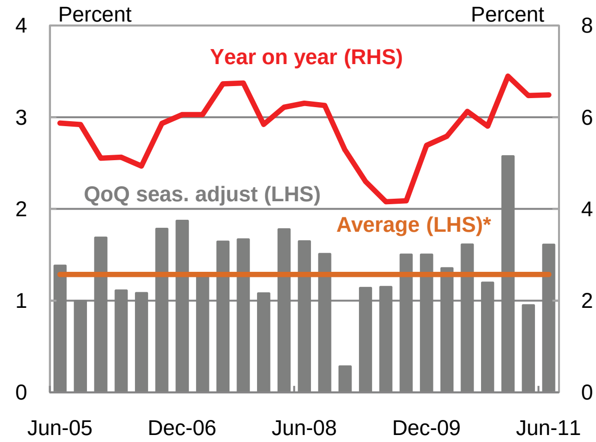
Connecting leading and lagging regions can also help to promote inclusive growth in East Java

Promoting the integration of leading and lagging regions within the province may help in opening access for people to move toward better economic opportunities. The spatial pattern of growth in East Java shows the existence of leading and lagging regions. The leading regions consist of districts located in the central area of East Java including the industrial districts such as Gresik, Kediri, Sidoarjo, and Surabaya. Meanwhile, the lagging regions that are characterized by consistently low GDP per capita over time are located in the southern part of the province and in Madura Island such as Pacitan, Trenggalek, Pamekasan, and Sampang.

Connecting rural areas to local markets and cities will not just provide households with greater access to goods and services at lower and more stable prices, but will also provide access to larger markets and job opportunities. It can facilitate economies of agglomeration and scale. An unbalanced pattern of growth does not call for specific intervention to move economic activities to the lagging regions. Instead, the government should apply a spatially blind or universal development program such as providing better access to health and education to enable people to move toward opportunities and develop spatially connective infrastructure to increase the flow of goods, people, and information to the economic centers. On the whole, there are only a few impediments to the mobility of labor and capital within the province but the construction of Suramadu bridge is a good start as an example of improving the connectivity between lagging regions in Madura Island with the economic center of Surabaya and its surrounding region.

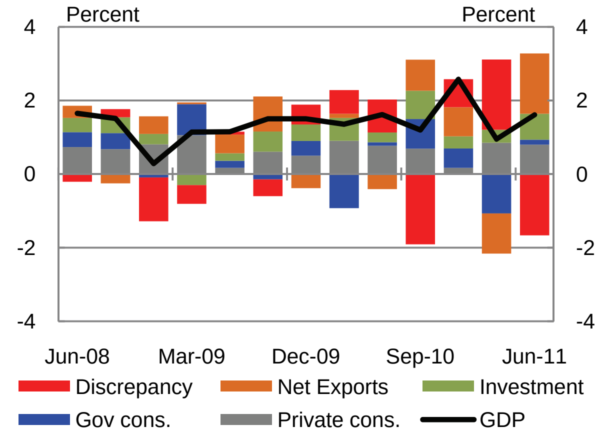
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

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



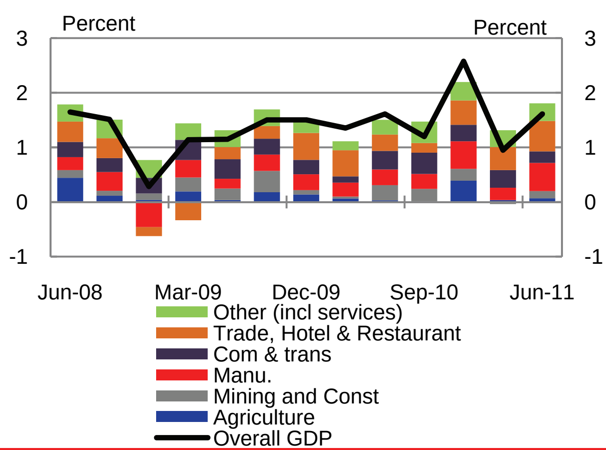
*Average QoQ growth between Q2 2001 – Q2 2011
Sources: BPS, World Bank seasonal adjustment

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



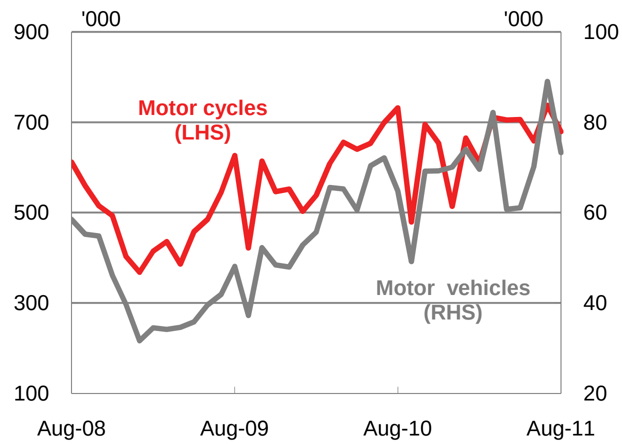
Source: BPS via CEIC and World Bank

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



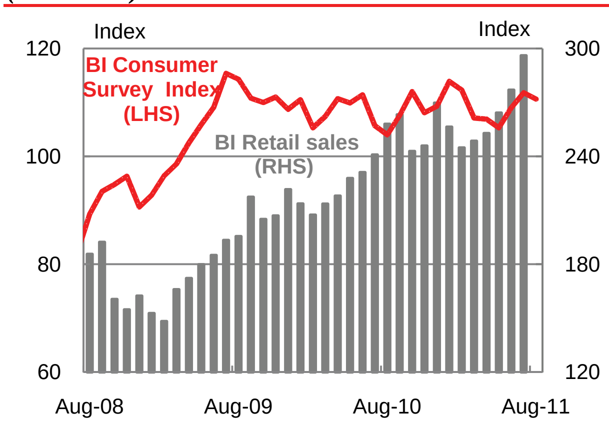
Source: BPS via CEIC

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



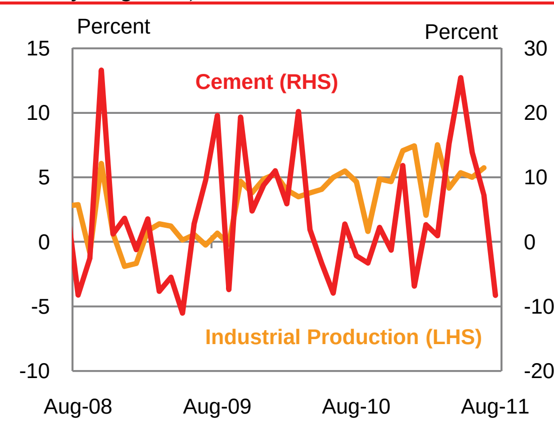
Source: CEIC

Appendix Figure 5: Consumer indicators
(index levels)



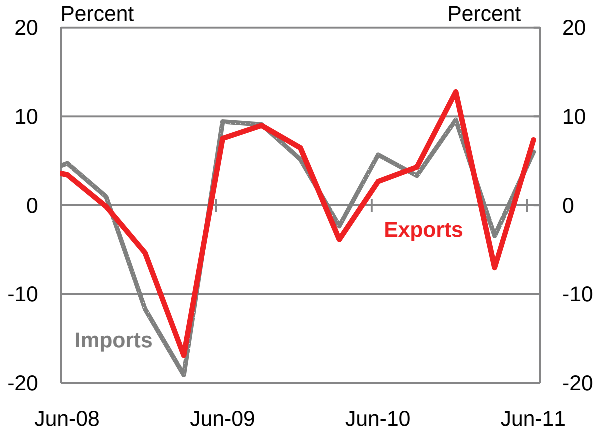
Source: BI via CEIC

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



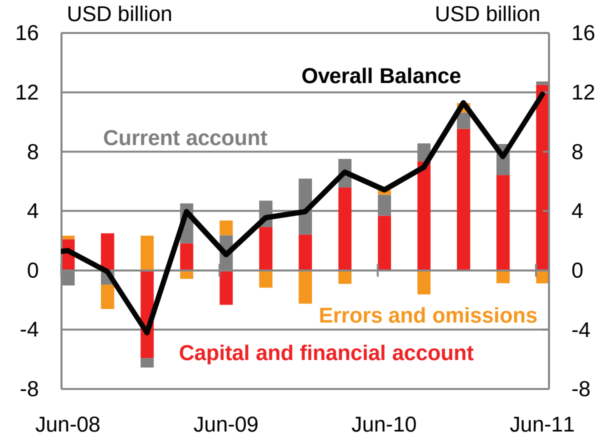
Source: CEIC

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



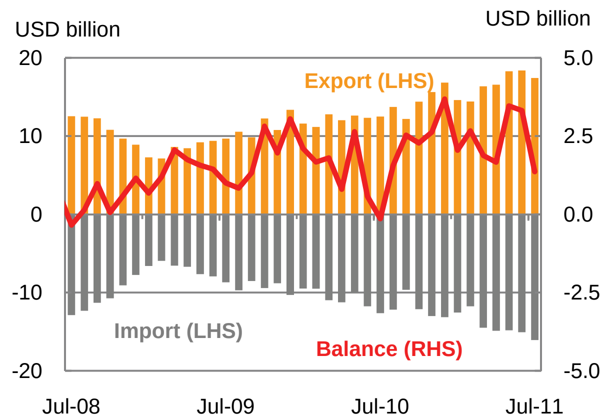
Source: CEIC

Appendix Figure 8: Balance of Payments
(USD billion)



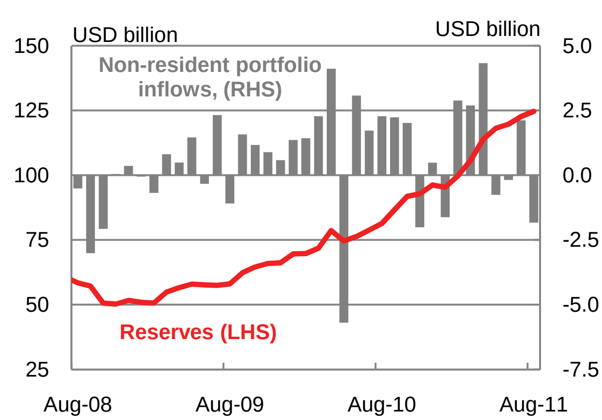
Source: BI and World Bank

Appendix Figure 9: Trade balance
(USD billion)



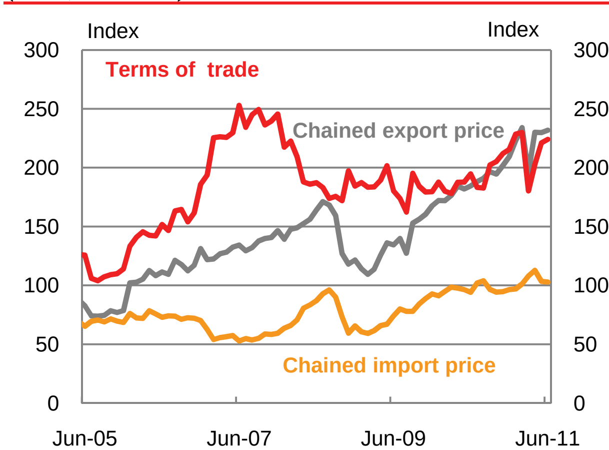
Source: BPS and World Bank

Appendix Figure 10: International reserves and capital inflows
(USD billion)



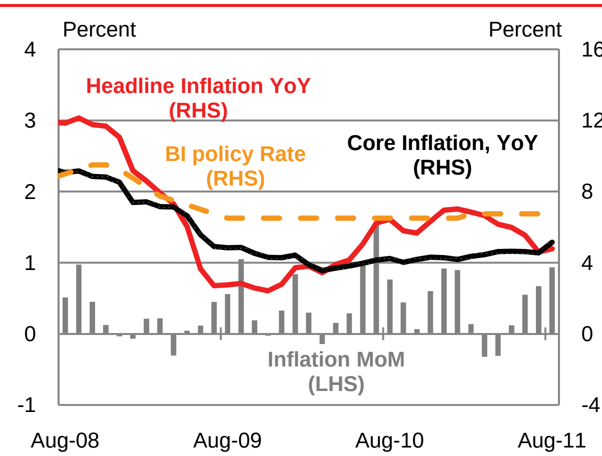
Source: BI and World Bank

Appendix Figure 11: Monthly terms of trade and chained Fisher price indices
(index, 2000=100)



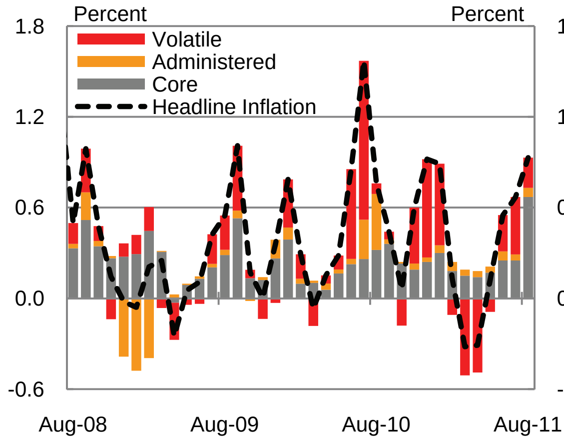
Source: BPS and World Bank

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



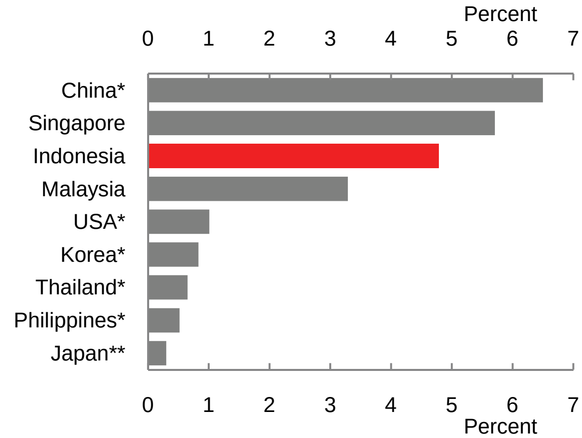
Source: BPS and World Bank

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



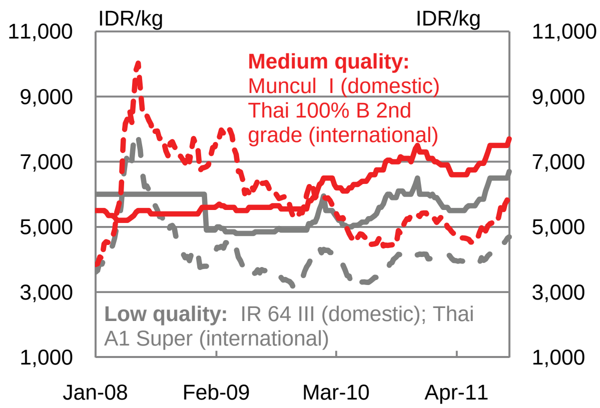
Sources: BPS and World Bank

Appendix Figure 14: Inflation among neighboring countries
(year-on-year, August 2011)



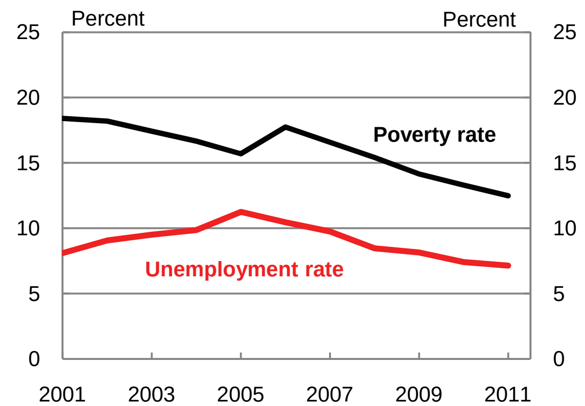
Note: *July, and ** June are the latest data points
Sources: National statistical agencies via CEIC, and BPS

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



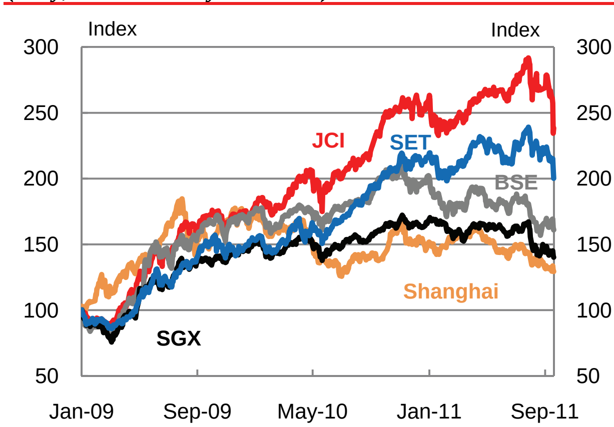
Note: *Dashed: international Thai rice (cif) prices.* Solid: domestic wholesale rice
Sources: PIBC, FAO and World Bank

Appendix Figure 16: Poverty and unemployment rate
(percent)



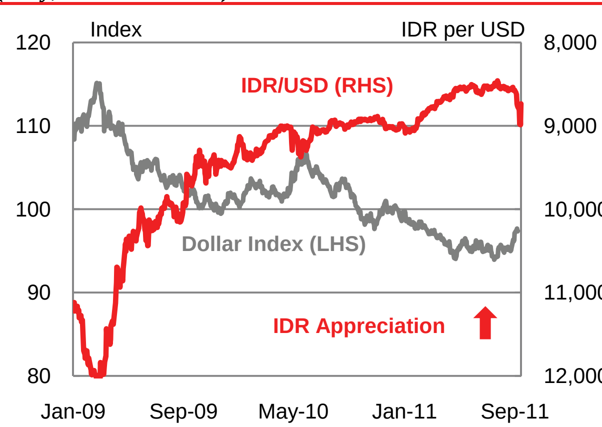
Note: Labor data from February Sakernas
Sources: BPS, and World Bank

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



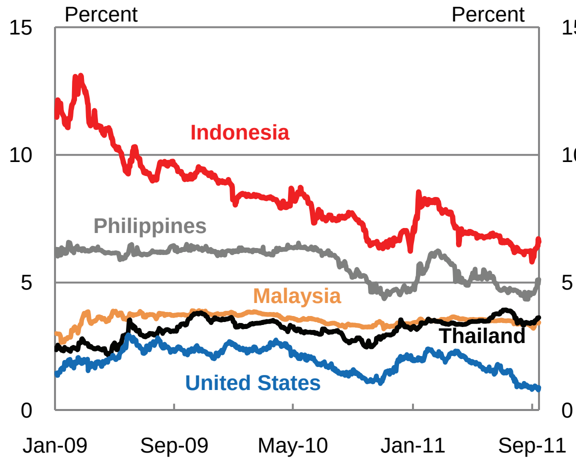
Sources: World Bank and CEIC

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



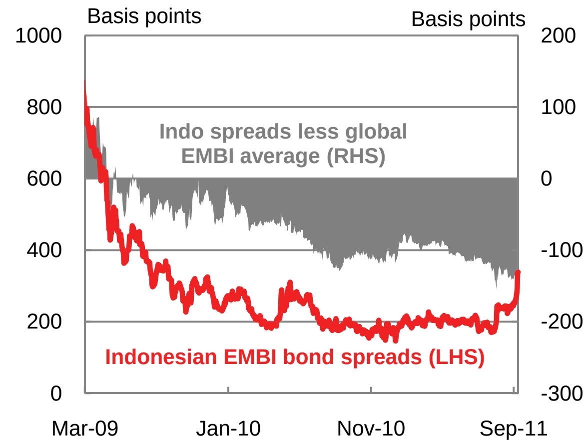
Sources: World Bank and CEIC

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



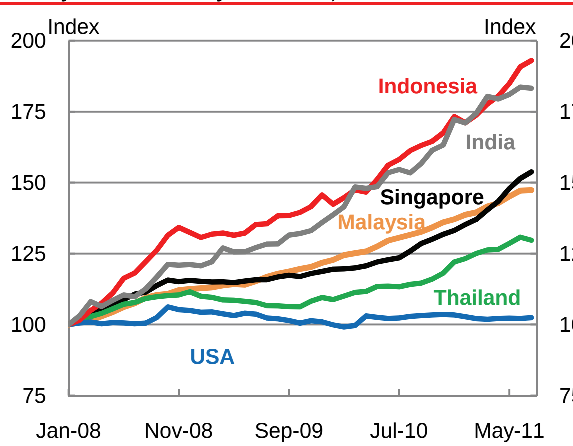
Sources: World Bank

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



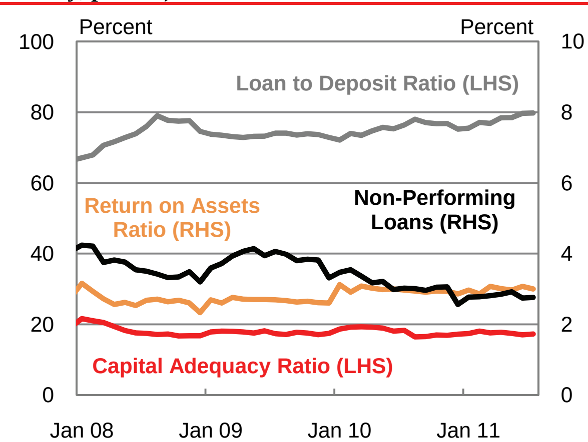
Sources: World Bank and CEIC

Appendix Figure 21: International commercial bank lending
(monthly, index January 2008=100)



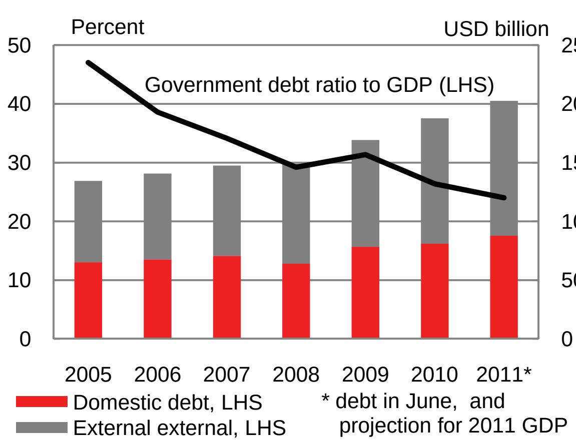
Sources: CEIC and World Bank

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



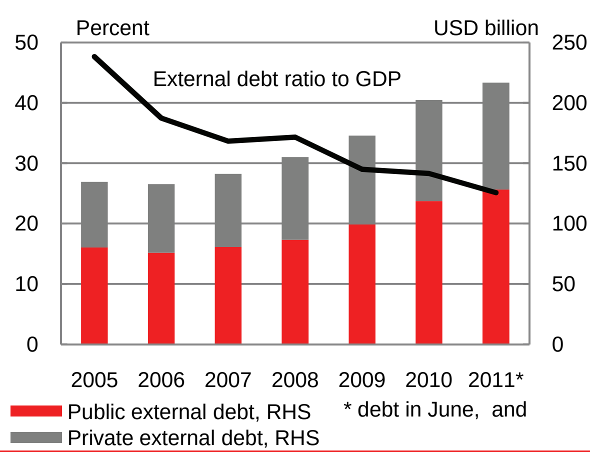
Sources: BI and World Bank

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



Sources: BI and World Bank

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



Sources: BI and World Bank

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

	2008 Outcome	2009 Outcome	2010 Outcome	2011 (p) Budget	2011 (p) Revised Budget	2011 (p) WB June estimates*	2011 (p) WB Sept estimates*	2012 (p) Proposed Budget
A. State revenue and grants	**981.6**	**848.8**	**1,014.0**	**1,104.9**	**1,169.8**	**1,189.4**	**1,185.8**	**1,292.9**
1. Tax revenue	658.7	619.9	744.1	850.3	878.6	858.6	857.1	1,019.3
a. Domestic tax	622.4	601.3	715.2	827.2	831.7	813.3	801.5	976.9
i. Income tax	327.5	317.6	356.6	420.5	431.9	432.3	419.7	512.8
- Oil and gas	77.0	50.0	58.9	55.6	65.2	77.0	65.4	58.7
- Non oil and gas	250.5	267.5	297.7	364.9	366.7	355.3	354.4	454.2
2. Non-tax revenue	320.6	227.2	267.5	250.9	286.5	330.8	328.7	272.7
o/w natural resources	224.5	139.0	170.1	163.1	192.0	217.9	213.1	172.9
i. Oil and gas	211.6	125.8	152.7	149.3	173.2	197.5	192.8	156.0
ii. Non oil and gas	12.8	12.8	17.3	13.8	18.8	20.4	20.2	16.9
B. Expenditure	**985.7**	**937.4**	**1,053.5**	**1,229.6**	**1,320.8**	**1,280.3**	**1,296.7**	**1,418.5**
1. Central government	693.4	628.8	708.7	836.6	908.3	875.7	878.6	954.1
2. Transfers to the regions	292.4	308.6	344.7	393.0	412.5	404.6	418.1	464.4
C. Primary balance	84.3	5.2	48.9	-9.4	-44.4	21.9	-6.8	-2.5
D. SURPLUS / DEFICIT	(4.1)	(88.6)	(39.5)	(124.7)	(151.0)	(90.9)	(111.0)	(125.6)
(percent of GDP)	(0.1)	(1.6)	(0.6)	(1.8)	(2.1)	(1.2)	(1.5)	(1.5)

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 September 2011 IEQ for a full discussion)
Source: MoF and World Bank estimates

Appendix Table 2: Balance of Payments
(USD billion)

	2008	2009	2010	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2
Balance of Payments	-1.9	12.5	30.3	3.5	4.0	6.6	5.4	7.0	11.3	7.7	11.9
Percent of GDP	-0.4	2.3	4.3	2.4	2.6	4.1	3.1	3.7	6.1	3.9	5.6
Current Account	0.1	10.6	5.6	1.8	3.8	1.9	1.4	1.2	1.1	2.1	0.2
Percent of GDP	0.0	2.0	0.8	1.2	2.5	1.2	0.8	0.6	0.6	1.1	0.1
Trade Balance	9.9	21.2	21.3	4.7	7.1	4.8	4.6	5.4	6.4	6.4	6.1
Net Income & Current Transfers	-9.8	-10.6	-15.7	-2.9	-3.3	-2.9	-3.2	-4.2	-5.4	-4.3	-5.9
Capital & Financial Accounts	-1.8	4.9	26.2	2.9	2.4	5.6	3.7	7.4	9.5	6.4	12.5
Percent of GDP	-0.4	0.9	3.7	2.0	1.6	3.5	2.1	4.0	5.1	3.3	5.9
Direct Investment	3.4	2.6	10.7	0.6	0.8	2.5	2.3	1.7	4.2	3.0	2.7
Portfolio Investment	1.8	10.3	13.2	3.0	3.5	6.2	1.1	4.5	1.4	3.8	5.7
Other Investment	-7.3	-8.2	2.2	-0.7	-1.9	-3.1	0.3	1.2	3.8	-0.4	4.1
Errors & Omissions	-0.2	-3.0	-1.6	-1.2	-2.2	-0.9	0.3	-1.6	0.6	-0.9	-0.9
Foreign Reserves*	51.6	66.1	96.2	62.3	66.1	71.8	76.3	86.6	96.2	105.7	119.7

Note: * Reserves at end-period
Source: BI and BPS

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