

INDONESIA ECONOMIC QUARTERLY

Rising to present and future challenges

July 2012



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 macro and fiscal policy cluster of the World Bank's Jakarta office, under the guidance of Lead Economist Shubham Chaudhuri and Country Economist Ashley Taylor. The team included Magda Adriani (commodity prices), Andrew Blackman (international environment, external sector, financial markets and current account), Fitria Fitrani (labor market), Faya Hayati (prices and property market), Ahya Ihsan (fiscal, budget execution and roads) and David Stephan (real sector and risks). Additional contributions were received from Dwi Endah Abriningrum (fiscal and roads), Neni Lestari (banking), The Fei Ming (corporate sector), Gonzalo Varela and Victor Duggan (global linkages and economic performance) and Matthew Wai-Poi (poverty). Arsianti, Faya Hayati, Yus Medina Pakpahan and Ashley Taylor shared the editing and production. Enrique Blanco Armas, Mustapha Benmaamar, Shubham Chaudhuri, Dini Sari Djalal, Alex Drees-Gross, Anna Gueorguieva, Bert Hofman, Tehmina Khan, Sjamsu Rahardja and Samer Al-Samarrai provided detailed comments and input. Dini Sari Djalal, Farhana Asnap, Indra Imawan, Jerry Kurniawan, Nugroho, Marcellinus Winata and Randy Salim organized the dissemination and Titi Ananto, Nayu Ramadhaningsih and Nina Herawati provided valuable administrative support.

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Executive summary: Rising to present and future challenges



The global growth outlook remains weak and financial markets turbulent

The near-term global economic outlook is fragile and emerging economies, including Indonesia, again face the risk of a potential crisis that is not of their making. The growth outlook for Indonesia's major trading partners (MTP), at 3.3 percent in 2012, remains relatively weak as increased Euro zone uncertainty adds to the ongoing drags on global growth from budget cutting and deleveraging in developed economies, and capacity constraints in some developing economies. Recent international financial market turbulence looks set to continue in the near-term and, while this baseline scenario remains the most likely outcome, capital flows to emerging economies and sentiment are likely to remain volatile. Further enhancing crisis preparedness is therefore a policy priority for economies such as Indonesia but, at the same time, it is important to push ahead with reforms and investments which can support medium-term growth in what is likely to be a weaker global economic environment.

However, to date Indonesia's growth performance has remained solid

Indonesia's GDP growth remained a solid 6.3 percent year-on-year in the first quarter of 2012, down slightly from an average of 6.5 percent in 2011. Seasonally-adjusted growth overall came down off the highs of the final quarter of 2011 but consumption growth held up well. However, investment growth dipped and, reflecting the relative weakness of external demand, net exports again were a drag on growth. Inflation, although picking up somewhat, has remained relatively low and price expectations came down with the reduced likelihood of a subsidized fuel price increase in 2012, as oil prices declined.

Indonesia is not, however, immune to spillovers from international developments through both trade channels...

Non-oil commodity prices have also seen sizeable drops in recent months, including the prices of some of Indonesia's key commodity exports such as coal, rubber, palm oil and copper (Table 1). Falling international commodity prices, and weaker volumes, contributed to a sharp slowdown in export growth in recent months. With import growth still relatively strong, the trade balance moved into deficit in April and May. This trend has contributed to the current account balance turning into deficit which, while consistent with stronger domestic economic performance relative to the external environment, adds additional importance to the continuation of strong stable capital flows, such as FDI, to meet Indonesia's external financing needs.

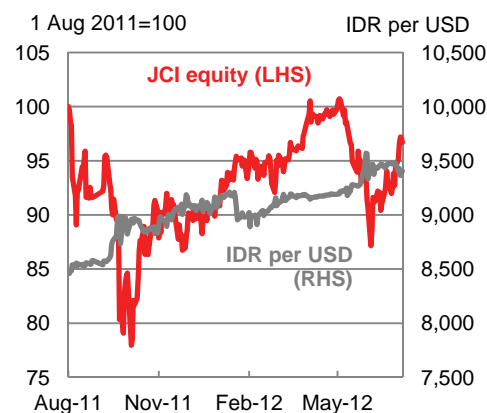
Table 1: Some of Indonesia's major export commodities have seen marked price falls in recent months

	Change in international commodity price		Share of Indonesia's total goods export value in 2011 (percent)
	Three months to June 2012	Year to June 2012	
Coal	-19.4	-29.0	13.4
Palm oil	-13.4	-11.9	8.5
Rubber	-18.6	-35.2	5.8
Copper	-12.4	-18.1	4.1

Note: International commodity prices in US dollar
Source: BPS and World Bank

...and financial channels, particularly given the sensitivity of portfolio capital flows to changes in investor sentiment

Figure 1: Amidst equity market volatility, the Rupiah has continued to gradually depreciate (Indonesian equity index 1 Aug 2011=100; Rupiah per US dollar)



Source: CEIC

Heightened international risk aversion in May was accompanied by outflows of domestic asset holdings by non-resident portfolio investors in Indonesia (although at USD 1.5 billion these were well below those seen during previous bouts of market turbulence in September 2011 and May 2010). As in other emerging economies, equity markets declined sharply before rebounding. The portfolio outflows, plus weaker trade balance, put pressure on the Rupiah which has continued to depreciate against the US dollar, down 9.8 percent since August 2011 (Figure 1). There was also a tightening of onshore US dollar liquidity, particularly in late May. With Bank Indonesia intervening, foreign exchange reserves fell by roughly USD 5 billion in both May and June to reach USD 106.5 billion at the end of June.

Reflecting the relatively robust domestic performance seen to date, the baseline outlook is for Indonesia's GDP to grow by 6.0 percent in 2012 and by 6.4 percent in 2013

Under the baseline outlook in which there continues to be turbulence in international financial markets, weak global growth and softening commodity prices, Indonesia's growth is expected to continue to be supported by domestic consumption and investment. These are, however, expected to soften somewhat over the year, in line with high frequency indicators and, for investment in particular, reflecting global economic uncertainty. Growth is expected to pick up in 2013 with some stabilization in the international situation, moving to 6.4 percent from 6.0 percent in 2012 (Table 2).

Table 2: Under the baseline scenario growth is projected at of 6.0 percent in 2012

		2010	2011	2012	2013
Gross domestic product	(Annual percent change)	6.2	6.5	6.0	6.4
Consumer price index*	(Annual percent change)	6.3	4.1	5.0	5.1
Budget balance**	(Percent of GDP)	-0.6	-1.2	-2.2	n.a.
Major trading partner growth	(Annual percent change)	7.2	3.6	3.3	3.7

Note: * Q4 on Q4 inflation rate. ** Government figures for Budget deficit - 2011 is preliminary figure and 2012 is revised Budget

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

Risks in the international environment remain high, are expected to persist...

With the resolution of the Euro zone crisis still unclear, and the ongoing potential for other downside shocks to hit the global outlook, such as from developments in China or other major emerging economies, there continues to be a risk of more adverse scenarios for Indonesia's near-term external environment. The real impact of such scenarios, even if they occur in the second half of 2012, would probably be felt most strongly in 2013, although the financial impacts would be seen more immediately. Indeed, risks during 2013 are set to remain high given the likely continuation of problems in the Euro zone plus the ongoing fiscal challenges faced in other economies such as the US.

...and, if realized in a severe global slowdown, could push Indonesia's growth in 2013 down to around 4 percent

In the event of a major freezing of international financial markets which contributes to a drop in trading partner growth, a fall in global commodity prices and reduced domestic investor confidence, similar to in 2009, it is projected that growth could slow to 4.7 percent in 2013 (Table 3). In a scenario in which such a crisis was accompanied, or indeed precipitated, a severe, prolonged global downturn encompassing the major emerging economies, growth in Indonesia could drop to 3.8 percent, with the impact of the slowdown felt more sharply in domestic activity as commodity price falls reduce incomes and investment. In the event of a severe crisis, it is possible that domestic consumer and business sentiment drops sharply which, combined with any potential stresses in the financial sector, could result in further downside to the growth scenarios.

Table 3: The impact of a severe global downturn on economic growth in 2013 would be significant

Scenarios:	Outcomes				Scenario 1		Scenario 2		Scenario 3	
					Continuing turmoil		2009 again		Severe global slowdown	
	2008	2009	2010	2011	2012	2013	2012	2013	2012	2013
Indonesian GDP growth (percent)	6.0	4.6	6.2	6.5	6.0	6.4	5.8	4.7	5.7	3.8
Scenario assumptions:										
Investment/GDP ratio (percent)	23.7	23.4	23.9	24.4	25.3	26.1	25.1	25.1	25.0	24.1
Major trading partner GDP growth (percent)	2.1	-0.7	7.2	3.6	3.3	3.7	2.3	0.1	1.9	-1.8
Terms of trade growth (percent)	-18.1	-4.2	5.7	10.2	2.0	9.0	0.0	-15.0	0.0	-30.0

Note: 2012 and 2013 are projections. Terms of trade series is constructed by World Bank from monthly trade data

Source: CEIC and World Bank staff projections

Policymakers face the twin challenges of improving both crisis preparedness and boosting medium-term growth

Emerging economies, including Indonesia, face the twin challenges of enhancing crisis preparedness to deal with near-term shocks while at the same time putting in place policies to support medium-term growth in a weaker global environment. These two challenges should not be viewed in isolation. Backtracking or stalling on medium-term reforms can adversely impact investor confidence now, increasing the susceptibility of the economy to changes in sentiment. Failing to adequately prepare for a near-term crisis can increase its impact, with long-term consequences for growth and welfare.

Indonesia has made good progress on its crisis preparation but further work is required...

Indonesia has made considerable recent progress in improving its crisis preparedness but further work is necessary and, as in other economies, there is no room for complacency in the current fragile market environment. The 2012 Budget Law provided flexibility for the government to adjust spending and financing in response to a crisis, subject to Parliamentary approval within 24 hours. Crisis Management Protocols have also been put in place to improve information-sharing, monitoring and crisis response mechanisms. However, there remain some gaps in the legal framework that need to be addressed, such as legal backing for decision-making and resolution of a failed bank or financial institution. In the long term, the authorities will need to design and put in place permanent arrangements for systemic monitoring and impact assessment, crisis preparedness, and crisis management (once the new Financial Services Authority, OJK, is fully operational).

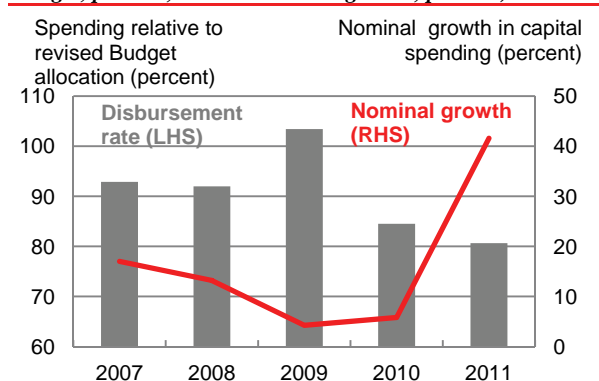
...such as to improve budget execution in order to support the effectiveness of any stimulus – should it be required...

After strong issuance in the year to date, the Government's near-term financing position looks relatively well placed to weather future market tightness. The Government has also arranged contingent financing of up to USD 5.5 billion from development partners including the World Bank, the Asian Development Bank, and Australia.

However, further work on preparing a fiscal stimulus plan is required, in case domestic conditions deteriorate sharply. Budget execution challenges remain, particularly for capital expenditures, limiting their

ability to be used to support near-term demand. Capital spending, although up in nominal terms, continues to come in well below budgeted levels (Figure 2). Disbursement rates in the first half of 2012, although still relatively low, were up slightly on 2011, perhaps reflecting efforts made by the newly established budget execution task force to monitor and speed up execution. However, some long-standing issues remain, such as land acquisition (where implementing regulations on the new law are still required), a complex budget revision process, and the need to improve the quality of project preparation.

Figure 2: Capital spending, although up in nominal terms, continues to come in well below Budget allocations (central government capital spending relative to revised Budget, percent; nominal annual growth, percent)



Source: Ministry of Finance and World Bank staff calculations

... to ensure that social programs can reach those in need of support during a crisis...

Although steps have been made to enhance the ability of the Government to target the poor and vulnerable, further improvement in the social safety net, expanding programs that work, and filling gaps in the existing coverage is required to protect the vulnerable from moving into poverty in the event of a crisis. In addition, social promotion programs are also required to help move out of poverty the remaining poor, many of whom are far below the poverty line (a feature which is likely to be one reason why, although poverty continues to decline, moving to 12.0 percent in March 2012, the rate of poverty reduction has fallen in recent years).

... and to reduce the opportunity costs and inefficiencies of fuel subsidies

With the Indonesian Crude Price moving down to USD 99 per barrel in June, it looks unlikely that its six month average will exceed the revised Budget threshold of USD 121 necessary to allow the Government to hike the subsidized fuel price. However, even with the fall in the oil price, in the absence of any price adjustment the fiscal burden, opportunity costs and inefficiencies of fuel subsidies will remain high. Recent Government forecasts project fuel subsidy spending in 2012 to come in almost 60 percent above their revised Budget allocation and to account for 20 percent of total central government spending excluding regional transfers. As highlighted in the April 2012 *IEQ*, the decision not to increase prices therefore represents a missed, or delayed, opportunity to redirect spending at a time when risks remain in the global environment.

There is also a need to focus in on policies and investments which can boost medium-term growth through improving productivity and addressing key infrastructure constraints

Indonesia, and other emerging economies, should prepare for a likely long period of global economic volatility and weaker demand by re-emphasizing medium-term development strategies. These include productivity-enhancing reforms and stimulating increased investment, from domestic and foreign investors, as a pre-requisite for moving growth in Indonesia up to 7 percent or higher and to produce quality jobs for the roughly two million workers joining the labor force each year. Coordination, clarity and consistency of regulatory policies are particularly important to support these investments, along with addressing Indonesia's infrastructure weaknesses.

To give a scale of the infrastructure challenges which are faced, while the total number of vehicles in Indonesia has increased threefold between 2001 and 2010, the national road network, that serves more than one third of vehicle traffic (in vehicle-km), only grew by a quarter. While the government has set ambitious targets for public private partnership (PPP) funding of infrastructure projects, much of the infrastructure investment will still need to come from the public sector given the limited performance on PPPs to date.

Greater access to domestic and international markets has the potential to play an important role in improving domestic economic performance...

Facilitating international and domestic trade also has an important role to play in enabling Indonesia to harness the strength of its domestic market and to tap into the rising importance of the East Asia region within global demand. With further improvements in skills and infrastructure, for example, access to international trade and investment networks can also help to promote improvements in productivity and in the competitiveness of domestic firms, as seen in the relative performance of those manufacturing firms more closely integrated with global markets. For example, in the same industry and province, those manufacturing firms which are exporters or that use imported materials are, on average, 19 percent more productive than non-integrated plants – while foreign-owned plants are 38 percent more productive than their domestic counterparts.

...but recent announcements in this area have raised some concerns both about the direction of policy-making and the difficulties in policy coordination and communication

Recent policy announcements have, however, raised some concerns on the direction of trade and investment policy making. These measures include, for example, restrictions on imported horticulture products and new divestment regulations and processing requirements in the mining sector. While the aims of these policies may originate in the development objectives of promoting domestic productivity, jobs and growth, their presentation, which has been often changing, highlights coordination and communication issues. As well as their uncertain effectiveness in meeting those development objectives and the risk of adverse long-term consequences, there is a concern that the expansion of such policies could weaken the confidence of investors in the domestic economic outlook at a time when it is needed most.

A. ECONOMIC AND FISCAL UPDATE



1. The global economic outlook remains weak and financial markets turbulent

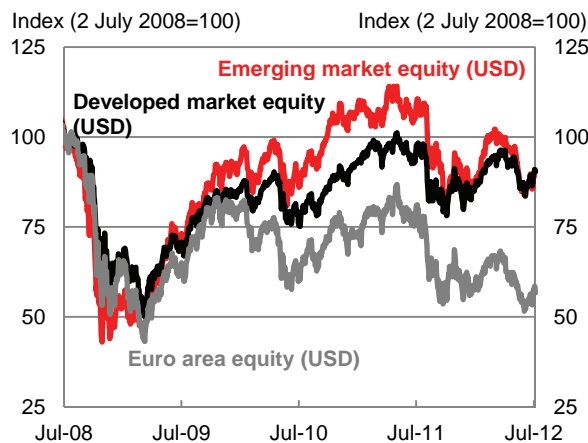
There has been renewed concerns that the global economic recovery is losing momentum

The outlook for Indonesia's external environment continues to be dominated by developments in the Euro zone, along with renewed fears that the global economy may weaken further. The baseline near-term outlook remains a scenario of ongoing international financial market turbulence, as outlined in the October 2011 *IEQ*. However, recent developments have again highlighted the risks of more adverse scenarios involving, for example, further tightening in global credit conditions and sharper declines in growth in developed and developing economies and in global commodity prices.

Economic and political developments in the Euro zone have again held center stage, contributing to sharp swings in international financial markets

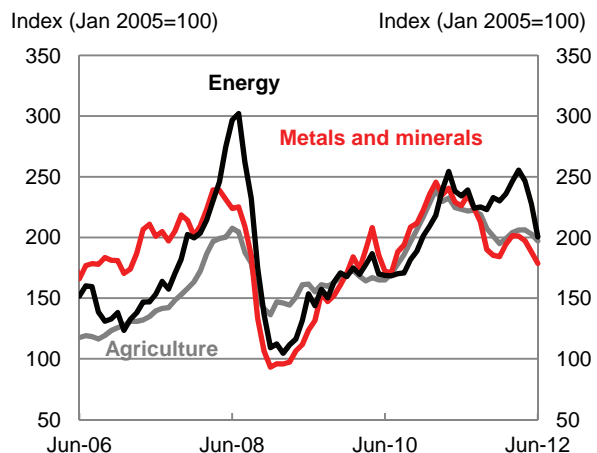
Concerns regarding the interlinked fiscal and banking problems of the Euro zone, and the policy responses, have again been at the center of investor attention, with government bond yields in Spain and Italy again rising, for example. Deleveraging by Euro area banks has continued, contributing to drops in cross-border lending to emerging economies. International financial markets have been buffeted by changes in sentiment on the back of developments in Europe, although most market stress indicators have been considerably lower than their peaks of late 2008 or in May 2010 and September 2011. Nevertheless, developed and emerging market equities have, on average, given up much of their gains from early 2012 (Figure 3). For example, as of 4 July emerging markets equities (in US dollars) were 11.6 percent below their peaks of early March, but up 4.2 percent on end-2011. Emerging market sovereign bond yields have also drifted higher as investors have retreated to safer assets, such as US, German and Japanese sovereign debt.

Figure 3: Equity market movements continue to be affected by developments in the Euro zone
(USD equity index, 2 July 2008=100)



Sources: MSCI and World Bank staff calculations

Figure 4: Global commodity prices have come down, but remain relatively high by historical levels
(USD international commodity price indices Jan 2005=100)



Source: World Bank

Leading indicators also point to a slowing in global activity...

Financial sector and policy developments in Europe have occurred against the backdrop of contracting or flat leading and partial indicators in the Euro area, the US, Japan and China, which point to a slowing down in global activity. Global trade is also expected to remain subdued, with the World Bank projecting global trade volumes to grow by 5.3 percent in 2012, down from 6.1 percent in 2011, before recovering to 7.0 percent in 2013.

... and international commodity prices – including oil – have come down

In line with the renewed concerns on the economic outlook, international commodity prices have retreated in recent months, but remain at relatively high levels by historical standards (Figure 4). Energy prices dropped 21.5 percent from March to June while non-energy prices fell by 6.3 percent. Average crude oil prices (Brent) in June (USD 96 per barrel) were 23.5 percent below their March average, due to slowing global demand and improving production prospects. Metal and mineral prices fell 11.2 percent over the same period, on softening demand from Europe and China. The falls affected prices of some of Indonesia's key commodity exports such as coal and rubber (down by almost 20 percent from March to June), palm oil (by 13 percent) and copper (by 12 percent).

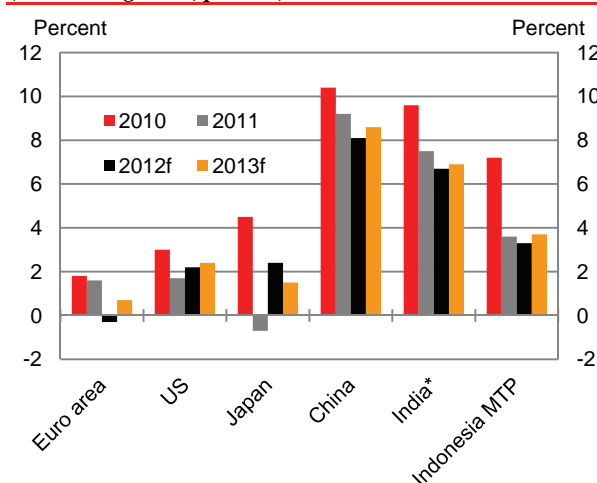
Although there have been moves to ease policy to support growth, this support is likely to be more constrained this time round

The risk of a further weakening in the global economy and renewed financial market strains have prompted further monetary easing by, for example, the central banks in the UK and Euro zone. Authorities in Asia, such as in China, have also cut rates or eased reserve requirements to support growth. However, as for developed economies, many emerging economies have become more constrained in their ability to loosen monetary and fiscal policy further in the event of another major economic shock. Some emerging economies are also running up against capacity constraints. Added to this, ongoing processes of fiscal consolidation and deleveraging in developed economies will continue to hold back growth over the near and medium term.

Overall, the baseline growth outlook in 2012 and 2013 for Indonesia's major trading partners remains relatively weak

Combining these factors, the growth outlook for Indonesia's major trading partners (MTP) remains weak, at 3.3 percent in 2012 (Figure 5). Following the devastating Thai floods in the Q4 2011, restocking of East Asian supply chains contributed to above-expected regional growth outturns in Q1 2012. However, renewed weakness in the US, Europe and China has depressed the baseline growth outlook for the remainder of 2012 to leave the MTP projection for 2012 as a whole unchanged. The baseline projection for MTP growth in 2013 is 3.7 percent although, as highlighted in the Risks section below, more adverse scenarios for the external environment would push this down significantly.

Figure 5: Indonesia's major trading partner growth is set to remain weak in 2012, before picking up slightly in 2013 (Real GDP growth, percent)



Note: * India on fiscal year basis

Source: World Bank Global Economic Prospects June 2012

2. Growth slowed in Q1 but remains solid against global headwinds

The Indonesian economy grew by a solid 6.3 percent in the first quarter of 2012, although there were more signs of weakness in external demand

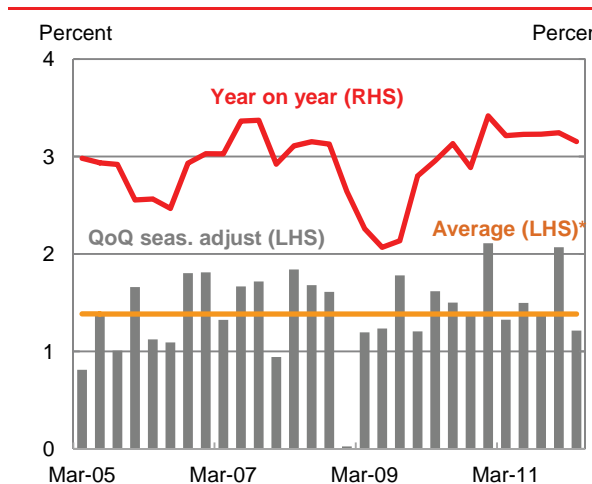
Indonesia's GDP increased by 6.3 percent year-on-year in the first quarter of 2012. Although slowing slightly from 6.5 percent growth in the fourth quarter of 2011, this was the sixth consecutive quarter of above 6 percent growth, (Figure 6). On a seasonally adjusted basis the economy grew by 1.2 percent in Q1, down from the very strong growth of 2.1 percent in Q4 2011, reflecting the effects of weaker external demand but the offsetting strength of still buoyant private consumption.

Growth was supported by strong consumption, both private and public, but trade volumes were weaker

Private consumption growth was unchanged from the previous quarter (at 4.9 percent year-on-year and 1 percent on quarterly seasonally adjusted basis). Government consumption growth also came in stronger than expected, at almost 6 percent year-on-year, perhaps reflecting improved disbursements. However, following a very strong performance in the final quarter of 2011, investment growth slowed, with seasonally adjusted quarterly growth of only 0.3 percent, the lowest rate since Q1 2009.

The weakness of real exports continued, registering zero growth in seasonally adjusted terms. However, imports were also weaker than expected, with seasonally adjusted growth dropping from 5.2 percent in Q4 2011 to 0.5 percent, likely reflecting the weak investment demand. As a result, net exports subtracted 0.2 percentage points from seasonally adjusted quarterly GDP growth, less than the 1.6 percentage points subtracted in the final quarter of 2011.

Figure 6: GDP growth slowed to 6.3 percent in the first quarter of 2012...
(real GDP growth, percent)



Note: * Average QoQ (quarter-on-quarter) growth since Q1 2002

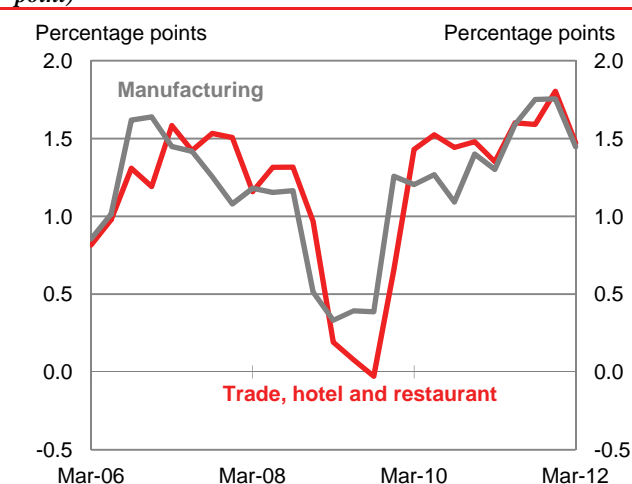
Source: BPS and World Bank staff seasonal adjustment

Production growth was driven by agriculture, mining, and transport and communications, offsetting weakness in the manufacturing and trade sectors

On the production side, the major drivers of growth were the primary sectors while the contribution to growth from the manufacturing and trade sectors weakened (Figure 7). Mining recorded its strongest quarterly growth since late 2006 while agriculture remained strong. Manufacturing growth continued to decline, moving down to 5.7 percent year-on-year in Q1 after peaking at 6.9 percent in Q3 2011. The first quarter performance was driven by the sharp deceleration in growth in the food, beverage and tobacco sector while trade-exposed sectors, such as textiles, clothing and footwear, also slowed. At the same time, service sector growth weakened, with the largest category, trade, hotels and restaurants, growing at less than 1 percent in quarterly seasonally adjusted terms for the first time since early 2009, although the transport and communication sector grew strongly.

Comparing the strength of the production sectors in mid-2012 with the situation in mid-2008, overall industry activity, particularly in manufacturing, remains relatively robust. In contrast, services sector year-on-year growth, which has been moderating after peaking at 9 percent in Q4 2010, is lower than in early 2008.

Figure 7: ...driven by a slowdown in the manufacturing and trade sectors
(contribution to real GDP growth year-on-year, percentage point)



Source: CEIC and World Bank staff calculations

Recent partial indicators have pointed to a slight moderation in economic activity

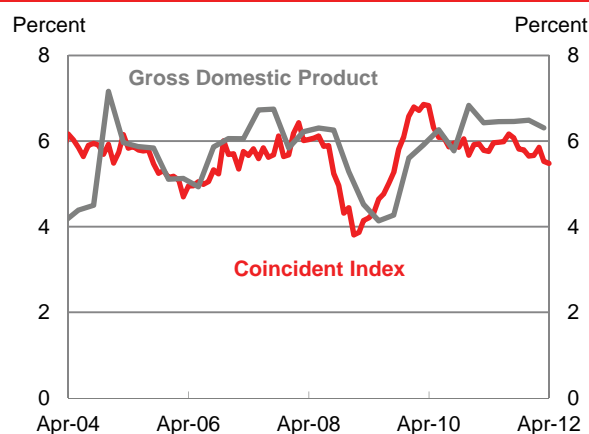
Recent data points to a slight slowing in domestic economic indicators (Figure 8). Cement sales and motorcycle sales have been trending down in recent months. Motorcycle sales were down 14 percent year-on-year in May, reflecting weak sales in rural areas as rural incomes declined with recent commodity price falls. However, sales of motor vehicles remained robust, although demand is expected to soften as new minimum down payment requirements came into effect on June 15. After declining in early 2012, reflecting uncertainty over fuel prices, consumer sentiment rebounded in May and June but remains around 4 percent below January levels.

In the baseline scenario Indonesia's GDP growth is projected at 6.0 percent in 2012 and 6.4 percent in 2013, although risks to the outlook remain heavily skewed to the downside

While domestic economic performance has been largely in line with the April 2012 *IEQ* forecasts, the recent weakness in trade data and other partial indicators, plus the slight downgrade to major trading partner growth for the remainder of 2012 (within an unchanged projection for growth in the year as a whole), point to a slight moderation in the baseline outlook for 2012. As a result, GDP growth in 2012 is now forecast at 6.0 percent.

The baseline outlook for 2013 remains for a rebound in growth to 6.4 percent as the external environment improves somewhat. However, as discussed further below, the risks to the outlook remain heavily skewed to the downside and, in the event of more severe adverse shocks to international financial markets, commodity prices or external demand, domestic growth could come in considerably below these baseline projections.

Figure 8: Higher frequency indicators are pointing to a slight moderation in activity (year on year growth, percent)



Note: The coincident index is a weighted average of production, trade, financial and international variables. The index is scaled to have the same mean and standard deviation as year-on-year GDP growth
Source: CEIC and World Bank staff calculations

Table 4: Under the baseline scenario GDP growth of 6.0 percent is projected for 2012, rising to 6.4 percent in 2013 (percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revisions to annual	
	2011	2012	2013	2011	2012	2013	2012	2013
1. Main economic indicators								
Total Consumption expenditure	4.5	4.8	5.0	4.6	4.8	5.0	-0.1	0.0
Private consumption expenditure	4.7	4.5	4.8	4.9	4.3	4.9	-0.1	0.0
Government consumption	3.2	6.8	6.0	2.8	6.9	5.9	0.0	0.0
Gross fixed capital formation	8.8	9.6	10.0	11.5	9.5	10.1	-0.1	0.0
Exports of goods and services	13.6	6.3	7.6	7.9	6.8	6.9	-1.1	-1.9
Imports of goods and services	13.3	7.7	8.1	10.1	6.1	8.2	-1.5	-1.5
Gross Domestic Product	6.5	6.0	6.4	6.5	5.8	6.5	-0.1	0.0
Agriculture	3.0	3.4	3.4	4.1	2.8	3.6	0.0	0.0
Industry	5.3	4.9	5.3	5.3	4.7	5.4	0.0	0.0
Services	8.5	7.8	8.2	9.0	7.9	7.7	-0.2	0.0
2. External indicators								
Balance of payments (USD bn)	11.9	3.0	10.8	n/a	n/a	n/a	-4.8	-1.8
Current account balance (USD bn)	1.7	-7.9	-4.6	n/a	n/a	n/a	-3.8	-2.9
Trade balance (USD bn)	23.3	11.3	15.7	n/a	n/a	n/a	-4.2	-2.9
Financial account balance (USD bn)	14.0	11.3	15.4	n/a	n/a	n/a	-0.7	1.1
3. Other economic measures								
Consumer price index	5.4	4.4	5.1	4.1	5.0	5.1	-0.3	-0.1
Poverty basket Index	8.2	7.0	7.5	6.3	7.0	7.6	-0.1	-0.5
GDP Deflator	8.4	7.2	8.1	7.5	8.1	8.1	-1.5	-1.5
Nominal GDP	15.4	13.7	15.1	14.5	14.4	15.1	-1.6	-1.6
4. Economic assumptions								
Exchange rate (IDR/USD)	8773	9300	9100	9024	9400	9100	300	100
Indonesian crude price (USD/bbl)	112	110	100	111	100	100	-10	-15
Major trading partner growth	3.6	3.3	3.7	2.5	3.5	3.9	0.0	-0.2

Note: Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices due to differences in price series. Revisions are relative to projections in April 2012 IEQ. The annual revisions under '3. Other economic measures' are based on the no-fuel subsidy reform projections of the

World Bank in April 2012 and not the published April 2012 IEQ projections which were based on fuel-subsidy reform
Source: MoF, BPS, BI, CEIC and World Bank projections

3. The balance of payments recorded a third consecutive deficit in Q1 2012

Indonesia's overall balance of payments recorded a third consecutive quarter of outflows in Q1 2012 as the current account widened

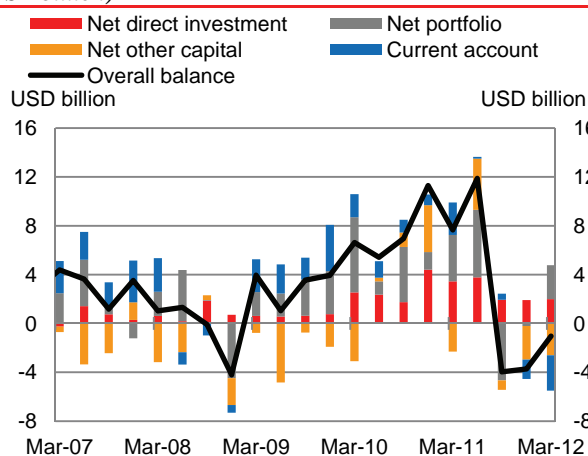
Indonesia experienced further overall balance of payment outflows in the first quarter of 2011, for the third consecutive quarter (Figure 9). However, at USD 1.0 billion the outflows were less than those seen in the third and fourth quarter of 2011 (USD 4.0 billion and USD 3.7 billion respectively). Furthermore, while capital outflows were the primary drivers of the deficits in the second half of 2011, the notable feature in the first quarter of 2012 was the widening in the current account deficit, as slowing external demand and continued strong domestic demand further narrowed the trade surplus (Figure 10). The recent trends in the current account balance and their implications are discussed in greater detail in Part B.

Modest capital inflows were seen and FDI remained firm

With global financial market strains having subsided somewhat in the first quarter of 2012, Indonesia recorded net inflows of USD 2.2 billion on the capital and financial accounts. Although “other” banking flows continued to be negative, net portfolio capital inflows resumed with the USD 2.8 billion of inflows supported by net purchases of government securities (including January’s USD 1.75 billion issuance of US dollar global bonds). These inflows were complemented by continued solid foreign direct investment (USD 4.6 billion, up slightly on the preceding quarter). According to the Investment Coordination Board (BKPM), FDI inflows in the first quarter were primarily directed towards the mining sector; transportation, storage and telecommunications, food crops and plantation; and metals, machinery and electronics. FDI inflows are also becoming more evenly distributed throughout Indonesia, with realized investment outside Java increasing to 47.2 percent of total investment, up from 44.2 percent in the same period in 2011.

Figure 9: A widening current account deficit contributed to overall balance of payments outflows in Q1 2012...

(USD billion)



Source: BI

More recently, however, further weakness in the global economy and commodity prices has seen export growth decline and the trade balance move into deficit

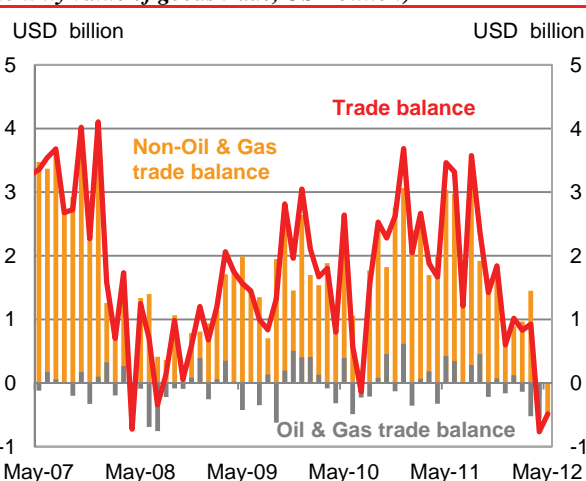
The past quarter has seen further announcements of proposed changes to domestic trade and investment policy

Export values have come down markedly in recent months, contracting by 8.5 percent year-on-year in May 2012. These falls have been driven primarily by lower bulk commodity exports as both prices and volumes have moved down due to the weaker global economic environment. Meanwhile imports growth has remained strong, at 16.1 percent year-on-year in May, with a pick-up in intermediate goods, particularly machinery, electrical appliances and transport goods. These trends have pushed the non-oil & gas goods balance into a deficit for only the second time in the past decade while oil and gas trade remains broadly in balance. As a result the trade surplus has narrowed and moved into a deficit in April and May (Figure 11).

Amidst this period of slowing external demand and heightened financial market volatility, there has been a number of announcements of changes to domestic trade and investment policy. For example, in May the Government issued a new regulation to restrict certain categories of imports, including finished goods, and the Government has moved to introduce a 20 percent export tax on raw commodities and base metals by holders of certain license types (see fiscal section below) and measures to promote domestic processing. On the investment-side, the Government has indicated that it is preparing to revise the negative-investment list to allow increased FDI into several key industries including pharmaceuticals, health care, telecommunication and education. However, there have also been recent announcements moving to limit foreign ownership and forced divestment in the banking and mining sectors. While many of these different policies are aimed at developing local industries and supporting domestic investors, they may also create uncertainty for businesses and investors, which could impact on future investment. In addition, for some of the proposed policies it is unclear whether their implementation will be able to meet the desired objectives.

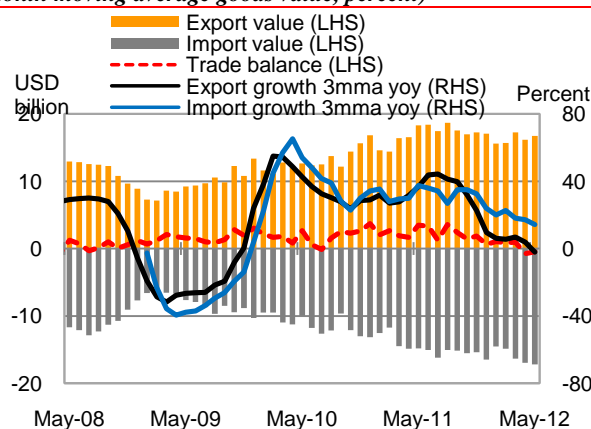
Figure 10: ...as the non-oil & gas trade surplus has narrowed sharply

(monthly value of goods trade, USD billion)



Source: BPS

Figure 11: The trade balance has moved into deficit as export growth has come down
(value of goods trade, USD billion; year-on-year growth of 3-month moving average goods value, percent)



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

Source: BPS and World Bank staff calculations

Table 5: The current account is projected to move into a small deficit in 2012 and financial inflows to come down
(USD billion)

	2009	2010	2011	2012	2013
Overall Balance					
of Payments	12.5	30.3	11.9	3.0	10.8
Current Account	10.6	5.1	1.7	-7.9	-4.6
Trade	21.2	21.3	23.3	11.1	15.6
Income	-15.1	-20.8	-25.8	-23.8	-25.2
Transfers	4.6	4.6	4.2	4.6	4.8
Capital & Financial					
Accounts	4.9	26.6	14.0	11.3	15.4
Direct Inv.	2.6	11.1	11.1	10.4	10.8
Portfolio	10.3	13.2	4.5	6.9	8.7
Other	-8.2	2.3	-1.6	-6.1	-4.1
Reserves^(a)	66.1	96.2	110.1	106.5	

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

Source: BI and World Bank staff projections

Table 6: The projections for Indonesia's external accounts are driven by a range of dynamics

	MTP growth	Commodity prices index**	Real export and import growth***	Trade Surplus	Current Account
2008	Low and moderating 2.1 percent	Peak mid-year, before falling rapidly Energy = 156.0 Non-Energy = 155.5	Solid growth X = 9.5 percent M = 10.0 percent	Moderate and narrowing USD 9.9 billion	Moderate quarterly surplus then deficits USD 0.1 billion
2009	Recession then rebound -0.7 percent	Gradual recovery Energy = 104.8 Non-Energy = 129.9	Big contractions. Imports fall more than exports X = -9.7 percent M = -15.0 percent	Expanding to large surplus USD 21.2 billion	Quarterly deficit then large surpluses USD 10.6 billion
2010	Strong rebound 7.2 percent	Continued gradual recovery Energy = 128.2 Non-Energy = 154.0	Strong recovery. Imports recover faster than exports X = 15.3 percent M = 17.3 percent	Stable large surplus USD 21.3 billion	Moderate but narrowing surplus USD 5.1 billion
2011	Moderate and stable 3.6 percent	Increasing followed by renewed moderation Energy = 153.0 Non-Energy = 170.8	Recovery continues X = 13.6 percent M = 13.3 percent	Stable large surplus USD 23.3 billion	Low and narrowing surplus USD 1.7 billion
2012*	Moderate but easing 3.3 percent	Relatively high but easing Energy = 152.7 Non-Energy = 162.2	Moderate but easing. Exports weaker than imports X = 6.3 percent M = 7.7 percent	Moderate and narrowing USD 11.1 billion	Moderate and widening deficit USD -8.1 billion
2013*	Slowly recovering 3.7 percent	Stable but slightly lower Energy = 149.3 Non-Energy = 155.5	Slowly recovering X = 7.6 percent M = 8.1 percent	Widening slightly USD 15.6 billion	Low and narrowing deficit USD -4.8 billion

Note: * forecasts under the baseline scenario. ** World Bank commodity price index in constant 2005 US dollars (2005=100). *** goods and services real trade growth.

Source: World Bank

Baseline projections for the overall balance of payments inflows have come down reflecting the weaker global outlook, while financial flows will continue to be sensitive to global market conditions

The near-term outlook for Indonesia's external accounts will depend critically on developments in Indonesia's export markets and international commodity prices, and on investor sentiment. In the baseline scenario the trade surplus is projected to narrow in 2012 to roughly half its 2011 value but to improve in 2013, in line with the international environment, reducing the current account deficit slightly (Table 5 and Table 6). On the financial account side, net direct investment is expected to remain firm. Portfolio and other capital flows for 2012 have been downgraded in light of the outflows in the year-to-date but should gradually improve through 2013 in the baseline scenario as volatility in international financial markets recedes. Should global conditions deteriorate further, the set of dynamics driving the balance of payment would clearly play out differently for both trade and, in particular, financial flows.

4. Spillovers from global financial market turbulence were seen again in May

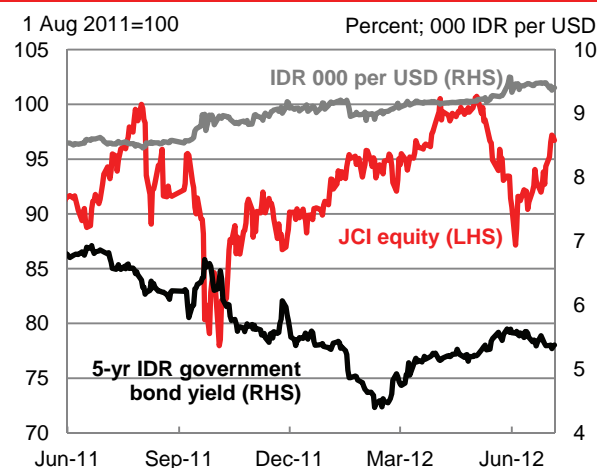
Indonesia's financial markets were again affected by a deterioration in international investor sentiment in the second quarter of 2012

The rise in global risk aversion and financial market turbulence in the second quarter of 2012 was transmitted to Indonesia's asset markets, with equities declining by 8.3 percent over May before rebounding strongly. Some domestic sectors, such as mining and banking stocks, were also affected by the trade and investment policy announcements mentioned above. Domestic currency government bond yields also widened, as non-resident investors reduced their positions over May, but have since come down (Figure 12).

Portfolio capital outflows, and the deteriorating trade surplus, put upward pressure on the Rupiah

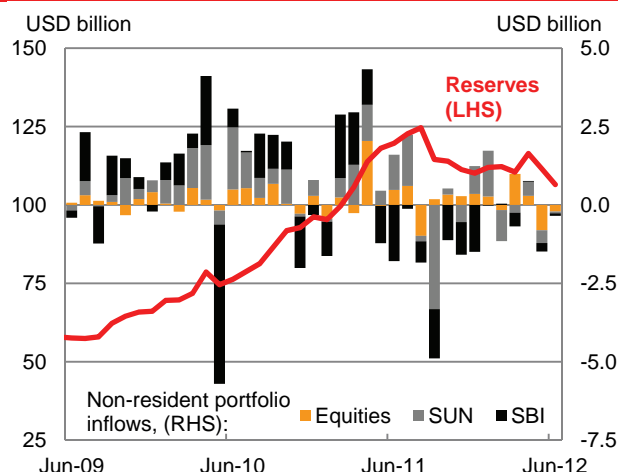
April saw modest capital inflows to domestic equity and debt markets, but the inflows reversed with the renewed intensity of the Euro zone crisis in early-May. Portfolio capital outflows of USD 1.5 billion in May were followed by much lower outflows in June (Figure 13). These outflows, plus the move to a goods trade deficit, put the Rupiah under pressure and resulted in a tightening in onshore US dollar liquidity, particularly in late May. With Bank Indonesia intervening, foreign exchange reserves fell by roughly USD 5 billion over May and June to reach USD 106.5 billion at the end of June. To support dollar availability and encourage foreign currency deposits to move onshore, in mid-June Bank Indonesia began offering short-term US dollar term deposits to local banks with flexible maturities and at favorable interest rates compared to offshore markets.

Figure 12: The latest bout of international financial market turmoil in May spilled over to Indonesian assets ...
(equity index, 1 August 2011=100; IDR per USD; yield, percent)



Source: CEIC World Bank staff calculations

Figure 13: ...as foreign investors reduced their domestic debt and equity holdings in May and reserves declined
(USD billion)



Note: "Flows" for SUN (IDR government securities) and SBI (BI certificates) indicate changes in holdings.

Source: BI, CEIC and World Bank staff calculations

With inflation concerns receding, Bank Indonesia is focusing on exchange rate stabilization and managing inflation expectations

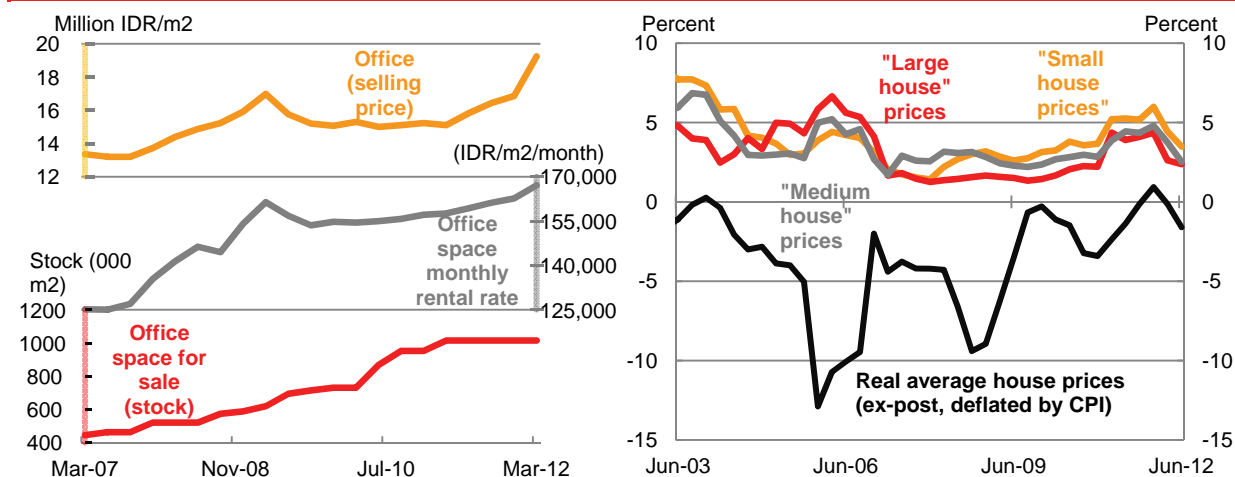
With inflation set to remain within its target of 4.5 percent +/- 1 percent for 2012, Bank Indonesia has turned its focus to providing "support for Rupiah stabilization" and managing inflation expectations through monetary operations and macro-prudential policies. The latter include the maximum loan-to-value regulations for housing and vehicle loans that were outlined in the April 2012 *IEQ*. The challenge for the central bank is to continue to utilize its various policy instruments to support growth during this next period of softening global conditions, whilst ensuring that short-term inflation pressures – such as the upcoming Ramadan price spikes – do not translate into sustained rises in inflation and inflation expectations.

Box 1: Commercial property prices have been increasing strongly, while residential price growth has come down

The property sector in Indonesia, particularly commercial property, has witnessed strong growth over the past year following the large declines in construction output and prices in the years following the global financial crisis. Amongst domestic equities, the property sector has seen the second highest increases, rising by 22 percent in the first quarter of 2012 and by 43 percent over the year, compared to gains of 8 percent and 12 percent, respectively, for the overall equity index over those periods. Commercial property sales and rental rates in Jakarta have also seen sizeable increases. According to the BI Commercial Property Survey of 706 property companies in Greater Jakarta, the selling price of offices in Jakarta rose by 27 percent over the year to Q1 2012, close to double the fastest pace seen in the previous four years (Figure 14). Demand for office space has increased, and with the stock of office space for sale or lease largely unchanged in Jakarta, the occupancy rate has risen to 96 percent. However, by the end of 2012 a further 429,220 m² is expected to come online (an increase of approximately 40 percent on current stock available for sale) which is likely to dampen the strong growth in prices witnessed over the past year. Higher rental demand has also led to a six percent increase over the year for the rental rate.

The rate of increases in nationwide residential property prices has been significantly lower, below the rate of inflation for most of the previous decade (Figure 15). Despite strong investment growth in the sector, residential prices growth has been subdued. According to BI's Residential Property Survey of 260 property developers across 14 major cities in Indonesia, residential property prices continue to ease from their recent peak of 5 percent year-on-year in December 2011 to a projected 2.8 percent year-on-year in June 2012. Some of the reasons for this trend include a surge in supply following a construction boom in 2007 and 2008. Respondents to BI's survey also pointed to the impact of higher prices of building materials, relatively high mortgage rates as well as bureaucratic red tape. Several respondents also cited the new regulations in Housing Law No. 1/2011 that came into effect in 2012 as affecting demand of new homeowners because it prevents developers from constructing properties smaller than 36m². In addition, the above-mentioned new higher minimum down-payments on larger properties may also affect the price outlook going forward. However, the medium-term outlook is supported by projections for rising incomes and the emergence of the middle class, along with the continued trends in urbanization and improved access to finance.

Figure 14: Jakarta's commercial property prices move up... (office stock available for sale, 000 m²; office space monthly rental rate, IDR per m² per month; office average selling price, million IDR per m²) **Figure 15: ...but, nationwide, residential house price growth has eased in 2012 (year-on-year growth in residential property price, percent)**



Note: Based on greater Jakarta area only
Source: BI Commercial Property Survey

Note: Small houses are less than 36m², medium houses are between 36m² and 70m², large houses are above 70m²
Source: BI residential property survey and World Bank staff calculations

Overall banking sector performance continues to be robust

As of April 2012, overall banking sector indicators remained solid. The capital adequacy ratio, while down slightly, remains at 18 percent. Non-performing loans were down half a percentage point over the year to 2.3 percent. With lending rates coming down close to 1 percentage point in the first quarter, net-interest margins also came down to 5.4 percent. Credit growth accelerated to 25.7 percent year-on-year in April 2012 led by investment credit (up by 28.8 percent), capital credit (up by 27.7 percent), and then consumer credit (up by 20.5 percent). The new regulations on housing and vehicle loans may dampen credit growth directed to these sectors. As discussed in Box 1 residential property prices has eased recently, although commercial property sales and rental prices have seen strong growth.

Loan growth has contributed to the gradual rise in the loan-to-deposit ratio to 81.6 percent at April 2012. There are, however, reports that banks are lending more cautiously to industries which are most sensitive to current global economic and commodity price volatility such as natural resources, minerals, plantations and shipping firms. At the same time, the US dollar liquidity tightness mentioned above is reportedly affecting the ability of some local corporates to obtain dollars and dollar credit facilities.

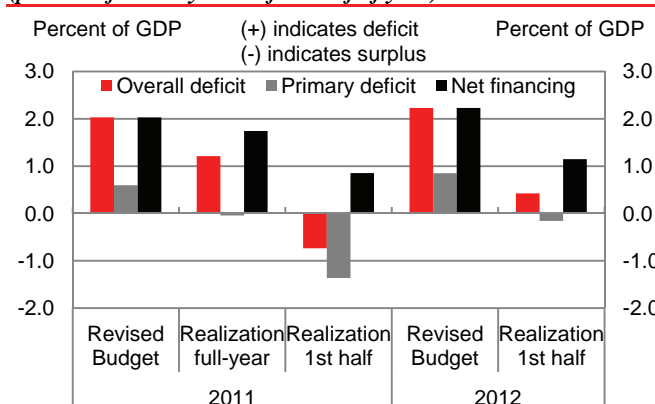
There has been progress on some important financial sector institutional developments

In a welcome development to enhance crisis preparedness, the Ministry of Finance, the Indonesian Deposit Insurance Corporation, and BI have signed a Memorandum of Understanding (MoU) to coordinate efforts in order to prevent and address issues of financial system stability. The MoU provides guidelines for coordination in the event of a financial crisis and identifies mechanisms for sharing data and information. It also supports the creation of an integrated crisis management protocol (CMP) based on the agencies' authority under existing laws and regulations. While the National CMP helps improve crisis prevention and the handling of a potential financial crisis in the short-term, it does not fully address the gaps in the current legal framework and, in the long term, the authorities will need to design and put in place permanent arrangements for systemic monitoring and impact assessment, crisis preparedness, and crisis management, once the Financial Services Authority (OJK) is fully operational. As discussed in the December 2011 *IEQ*, the OJK is due to take over supervision and regulation of non bank financial institutions and capital markets by January 1, 2013 and of the banking industry by January 1, 2014, while Commission XI of the House of Representatives recently voted to select seven Commissioners of the OJK. Finally, in another regulatory development, Bank Indonesia signed two MoUs on cross border banking supervision with the Australian Prudential Regulation Authority and the Financial Services Commission of Korea.

5. Fuel subsidy spending remains high but a price hike in 2012 is now unlikely**Indonesia's fiscal position in the first half of 2012 remained solid with revenue performance strong against relatively weak expenditures**

The central government budget balance recorded a deficit of IDR 36.1 trillion in the first half of the year, well below the full-year government target of IDR 190.1 trillion deficit or 2.1 percent of GDP (Figure 16). The primary balance was also in a surplus, reflecting strong revenue collection along with relatively weak expenditure performance, particularly for capital and material expenditures. However, it is worth noting that the deficit tends to be back loaded

Figure 16: The budget deficit in the first half of 2012 was less than a fifth of the full-year target under the revised Budget (percent of GDP by in the first half of year)



Source: MoF and World Bank staff calculations

with expenditures towards the end of the year – in both 2010 and 2011, despite full-year deficits, the central government balance was in surplus from February to November. The government's financing plans were well on-track. By end of June, 61.8 percent of the government's total gross securities issuance target of IDR 270.7 trillion had been realized.

Solid economic growth in has supported strong revenue collection in the first half of the year despite lower receipts relating to exports and commodities

Revenues in first half of 2012 reached 44 percent of the full-year revised Budget target and were up 19 percent on the first half of 2011 (Table 7). Non-oil and gas income taxes, sales taxes, as well as excise taxes performed well but revenues from export duties declined by 34 percent on the first half of 2011 as weaker global demand depressed commodity prices, such as crude palm oil. Non-tax revenues, which made up a quarter of total revenues, were boosted by the relative high crude oil price in the first half of the year and strong dividends from State-Owned Enterprises.

Table 7: Strong revenues outcome were seen in H1 2012 and disbursement rates, while improving overall, remain relatively low for capital expenditures
(value in the first half 2012, IDR trillion; share of revised Budget level, percent)

	Nominal value in the first half of the year (IDR trillion)			As share of full-year revised Budget level		
	2010	2011	2012	2010	2011	2012
Total revenue	444	497	593	44.7	42.5	43.7
Tax revenue, of which	338	388	457	45.4	44.1	44.9
Non-oil & gas income tax	148	174	199	48.2	47.3	44.6
Sales tax (VAT)	99	112	150	37.8	37.7	44.5
Non-tax revenues	106	109	136	42.8	38.2	39.8
Total expenditures	396	442	629	35.1	33.5	40.7
Central gov. expenditures, of which	234	260	394	30.0	28.6	36.8
Personnel	73	81	104	45.2	44.0	49.0
Material	29	35	42	26.0	24.4	22.4
Capital	16	23	31	17.3	16.2	18.2
Energy subsidy	52	54	124	35.9	27.8	61.5
Social	19	12	30	26.8	14.8	54.4
Transfers to regions	162	183	236	46.9	44.3	49.2

Source: MoF and World Bank staff calculations

The government recently issued a regulation imposing a 20 percent export tariff on a range of raw minerals and ores (excluding coal)

As mentioned above, the Government recently issued a new regulation (PMK No. 75/PMK.011/2012), effective mid-June 2012, imposing a 20 percent export tariff on unprocessed mining exports of a list of raw minerals and ores, such as gold, copper and iron ore, for holders of mining business licenses ("IUPs") and Special Business Mining Licenses ("IUPKs"). The stated objective was to increase domestic value added through promoting investment in the mineral processing sector, as well as to promote sustainable use of resources. There has been some lack of clarity on the details of the policy and its implementation, adding to policy uncertainty in the sector, with the potential to impact on future investment.

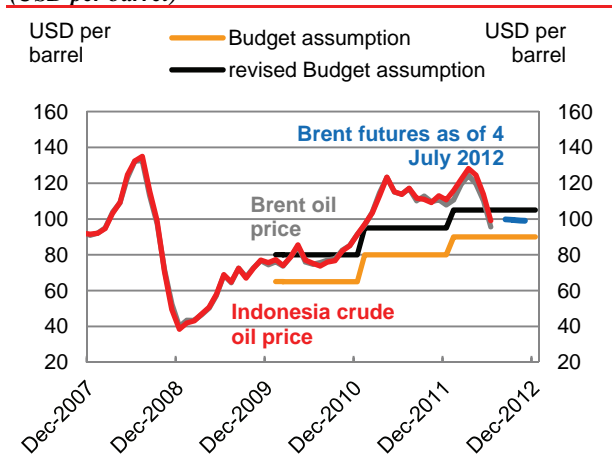
Expenditure disbursements are on track but this is to a large part driven by energy subsidies...

Expenditures in the first half of 2012 reached 41 percent of the full-year revised Budget allocation (Table 7) and were up by 42 percent compared to the first half of 2011. However, the improved disbursement was partly driven by strong fuel subsidy spending, led by the high oil price at the start of the year and the weakening Rupiah. By the end of June, 65 percent of the allocated fuel subsidy spending had been realized (IDR 89 trillion out of IDR 137 trillion). Fuel subsidies accounted for 23 percent of central government spending (excluding transfers), while the share for energy subsidies reached 32 percent.

...but the price adjustment for subsidized fuel is unlikely to occur in 2012...

The opportunity to adjust subsidized fuel prices in 2012 is unlikely to be realized. The six-month average ICP peaked in May at just under the USD 121 per barrel threshold required to allow the Government to hike the subsidized fuel price. With international oil prices moving down sharply from May to USD 99 per barrel in June (Figure 17), this threshold is unlikely to be breached. The absence of fuel subsidy reform is likely to lead to an overspending on fuel subsidies and a continuation of their considerable opportunity cost (see April 2012 *IEQ* for further discussion).

Figure 17: Crude prices have fallen sharply and with them the likelihood of any subsidized fuel price hike in 2012 (USD per barrel)



Source: EIA, ESDM, ICE, Ministry of Finance

..prompting the Government to announce policies to improve energy efficiency

In an effort to improve broader energy efficiency and to control subsidized fuel consumption, the President announced five policies, effective from June 2012, aimed at improving energy efficiency. These include, for example, banning official government and SOE vehicles, as well as vehicles of mining and plantation firms, from consuming subsidized fuel and encouraging conversion from gasoline to liquefied petroleum gas. However, the saving of these efforts for 2012 are projected by the Government to be relatively small at 0.568 million KL of the allocated volume of 40 million KL.¹

As discussed further in Part B, disbursement rates of capital expenditures, while improving remain relatively low

Disbursement of capital and material expenditures in the first half of the year, while showing strong nominal growth, remain relatively low compared to the full-year revised Budget allocations. The disbursement rate on capital expenditures reached 18 percent, up on the 2011 level of 16 percent, on the back of nominal growth in spending of 35 percent. Spending on materials rose by 20 percent in nominal terms although the first-half disbursement rate dipped slightly on the performance in 2011. The improvements seen in spending, such as for capital expenditures, may in part reflect the efforts being made by the Government's budget execution task force (TEPPA) in monitoring and speeding up budget execution.

The World Bank's projection for the budget deficit in 2012 is 2.1 percent of GDP

For 2012 as whole, expenditures are projected to be in line with the revised Budget, largely due to over-spending relative to budget on energy subsidies and under-spending on core programs than budgeted. On the other hand, revenues collection is likely to be lower than targeted with lower oil production, moderation in commodity prices, and weaknesses in the global outlook. Combined, these factor result in a World Bank deficit projection of IDR 177 trillion, or 2.1 percent of GDP, slightly lower than the Government's latest Semester I forecast.

¹<http://nasional.kompas.com/read/2012/05/30/2052179/Target.Penghematan.BBM.Bersubsidi.568.000.Kiloliter>

The Government has made solid progress on its financing position for 2012, despite continued uncertainty in the global outlook

The 2012 revised budget deficit will be financed largely by net government securities issuance of IDR 159.6 trillion and the Government's accumulated cash balance of IDR 56.2 trillion. In the first half 2012, Government net securities issuance had already 73.7 percent of its target (with gross securities issuance above 60 percent of its target). The Government's front loading of issuance included the placement of USD 2.5 billion in global bonds in April. However, with the international financial market outlook remaining uncertain, the Government has taken the precautionary step of arranging contingent financing of up to USD 5.5 billion from development partners, including the World Bank, the Asian Development Bank and Australia, so as to support critical spending in the event of a sharp rise in financing costs.

The Government has submitted to the Parliament the 2013 macro economic and fiscal framework

In mid-May, the Government submitted its macro and fiscal framework for 2013 to Parliament. The macro assumptions project a continuation of strong growth and improved oil lifting (Table 8). The framework also set out the Government's policies and strategies which are to aim at "strengthening the domestic economy to improve people's welfare". A number of specific policies on revenue and expenditure were also outlined. For example, the Government is proposing to increase the value

Table 8: The Government's macro framework for 2013 projects growth to move up to around 7 percent

	2011 Actual	2012 Revised Budget (APBN-P)	2013 Budget macro and fiscal framework
Real GDP growth (percent)	6.5	6.5	6.8–7.2
Inflation (percent)	5.4	6.8	4.5–5.5
Exchange rate (IDR per USD)	8,742	9,000	8,700–9,300
SPN interest rate (percent)	6.6	5.0	4.5–5.5
Indonesia Crude Price (USD/Barrel)	111	105	100–120
Oil lifting (000 bpd)	898	930	910–940
Gas lifting (000 boepd)	n.a.	n.a.	1,290–1,360

Note: mbpd is million barrels per day. mboepd is million barrel of oil equivalent per day
Source: MoF

added tax on luxury goods (non-vehicle) and the excise tax on cigarettes. The minimum annual income tax threshold is also to be increased from IDR 15 million to IDR 24 million.² Investments will continue in infrastructure projects related to the targets of the Master Plan (MP3EI) MP3EI), as well in social and poverty reduction programs, while salaries are proposed to be increased by 7 percent. The draft budget and financial note 2013 are expected to be officially submitted by the Government to Parliament in mid-August 2012.

² <http://www.pajak.go.id/content/news/ditjen-pajak-dukung-kenaikan-ptkp>

Table 9: Subsidy spending in 2012 is projected to significantly exceed the revised Budget allocation (IDR trillion, unless otherwise indicated)

	2011*	2012 Revised Budget	2012 (p) MoF Semester I report projection	2012 (p) WB July 2012**	WB July 2012 forecast Difference relative to:	
					Revised Budget	MoF Semester I report
Assumption on subsidized fuel price	No Change	Potential for IDR 1,500 hike if oil price high enough***	No Change	No Change		
A. State revenues and grants	1,200	1,358	1,362	1,334	-24.0	-28.2
1. Tax revenue	873	1,016	1,017	1,003	-12.9	-13.6
2. Non-tax revenue	324	341	345	331	-10.3	-13.8
B. Expenditure	1,290	1,548	1,553	1,512	-36.7	-41.5
1. Central government, o/w	878	1,070	1,071	1,032	-37.6	-38.8
Personnel	176	212	206	204	-8.5	-2.5
Materials	121	187	170	162	-24.8	-8.3
Capital	116	169	153	145	-23.2	-7.9
Subsidies, o/w	295	245	347	328	82.7	-19.1
Fuel subsidy	165	137	217	198	60.4	-19.0
Social	71	55	48	53	-2.8	4.8
2. Transfers to the regions	411	479	482	480	0.9	-2.6
C. Primary balance	3	-72	-79	-59	13.3	19.9
D. SURPLUS / DEFICIT	-90	-190	-191	-177	12.6	13.3
As percent of GDP	-1.2	-2.2	-2.3	-2.1	0.1	0.2
Key economic assumptions/outcomes						
Economic growth (percent)	6.5	6.5	6.3-6.5	6.0	-0.5	n.a.
CPI inflation (percent)	5.4	6.8	4.8	4.4	-2.4	-0.4
Exchange rate (IDR/USD)	8,742	9,000	9250	9,300	300.0	50.0
Crude oil price (USD/barrel)	111	105	110	110	5.0	0.0
Oil production ('000 barrels/day)	898	930	900	900	-30.0	0.0

Note: * 2011 is unaudited outcome. ** World Bank revenue estimates are based on a different methodology than the Government to derive projections for nominal GDP (see Part C of the June 2010 IEQ for a full discussion). *** the revised Budget includes the option of a IDR 1,500 fuel price increase provided the ICP price is on average, over a six month period, 15 percent above the revised Budget assumption of USD 105 per barrel

Source: MoF and World Bank staff calculations

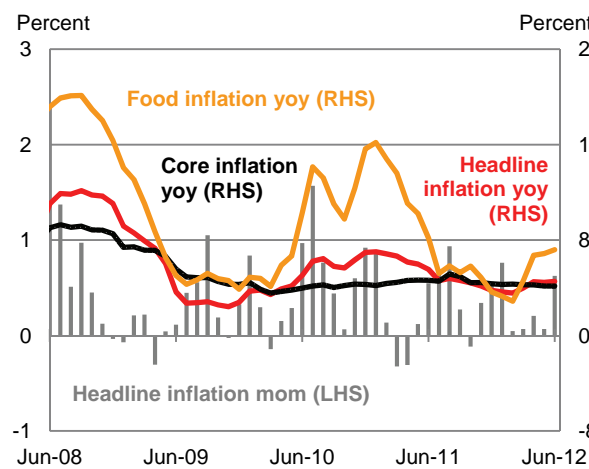
6. The lower risk of a hike in subsidized fuel prices subdues the inflation outlook

After reaching a two-year low in February 2012, headline year-on-year inflation has moved up by close to 1 percentage point to 4.5 percent in June 2012...

Headline CPI inflation was 4.5 percent year-on-year in June 2012, close to one percentage point up on the two-year low seen in February (Figure 18). However, inflation remains below five percent, close to half the average in the previous decade, despite above average growth. This reflects the absence of large administered price shocks, subdued commodity price shocks and improved macro-prudential policy management.

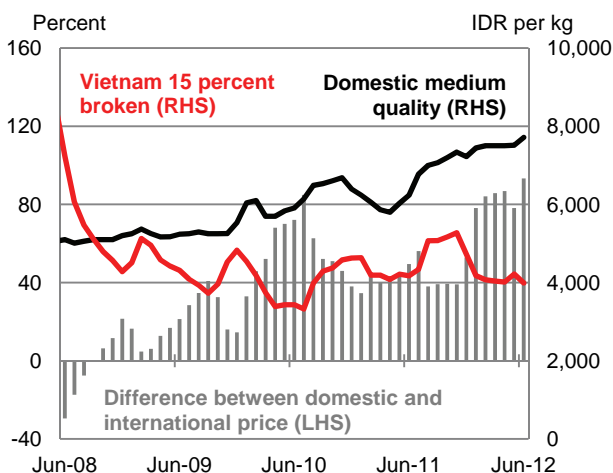
Monthly inflation outturns have also been relatively subdued as good harvests increased food supplies. Core inflation, a better measure of underlying consumer price pressures, edged down to a 21-month low in May of 4.1 percent, before ticking up slightly in June.

Figure 18: Headline inflation has eased up but core inflation remains relatively low
(price inflation, percent)



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

Figure 19: The gap between Indonesian and international rice prices once again moved towards record levels
(price difference, percent; wholesale rice price, IDR per kg)



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

...as food price inflation has picked up

The year-on-year rise in headline inflation was mainly due to an uptick in food price inflation to 7.2 percent in June. This followed the declines in food price inflation through 2011 and early 2012, as the food price highs of 2011 unwound, which resulted in an 8-year low of 2.9 percent in February 2012. The rise in food prices pushed the poverty basket inflation rate up from 6.3 percent in February to 7.7 percent in June.

Looking across the consumer price index, the rate of price increases has been relatively even, with the dispersion of inflation rates across sub-components the lowest in eight years. Retreating gold prices have pushed down inflation for personal effects, a subcomponent of clothing and, while, with no changes in subsidized energy prices in more than a year, transport and household energy cost inflation remain moderate.

The gap between Indonesian and international rice prices, which had fallen through to May, moved back towards record highs in June

The gap between domestic and international prices of rice eased during the harvest season before rising again in June (Figure 19). In June 2012, domestic wholesale rice prices were 86-95 percent higher (depending on quality) than comparable rice from international markets (from Thailand and Vietnam respectively), slightly down from the record gap of 72-100 percent in February 2012. The reduction in the price gap over the harvest period was driven by three factors: a small increase in international rice prices; the depreciation of the Rupiah against the US dollar; and falling domestic rice prices due to improved production. In June, however monthly international rice prices declined by 5 percent and, coupled with the pick-up in domestic prices following the end of the harvest season, the gap increased back towards record highs.

Near-term price expectations fell as a fuel price increase in 2012 became unlikely

The large near-term upside risks to the CPI inflation outlook from administered price reforms have largely subsided, with both electricity and fuel subsidized price hikes most likely off the agenda for 2012. As discussed further below, with oil prices falling, the threshold condition to allow for a rise in the subsidized fuel price is unlikely to be met in 2012. Consumer price expectations came down following their previous increases related to the initial plans to hike fuel prices but, with Ramadan and Idul Fitri in August, near-term price expectations, as they usually do at this point, have begun to increase.

CPI inflation is projected to rise to 5.0 percent year-on-year in the final quarter of 2012, towards the upper end of BI's target range of 4.5 percent \pm 1 percent

Under the baseline outlook, CPI inflation is projected to rise to 5.0 percent year-on-year in the final quarter of 2012 reflecting strong credit growth, still solid domestic demand and some pass-through to higher import prices of the depreciation of the Rupiah against the US dollar. This is towards the upper end of Bank Indonesia's target range of 4.5% \pm 1%. Annual CPI inflation for 2012 as a whole is projected to be 4.4 percent.

In 2013, inflation is projected to move up to 5.1 percent for the year as a whole, although downside risks persist should the external environment deteriorate further. The path for

administered prices is key to the outlook, with the baseline forecasts assuming no energy price rises. In terms of the likelihood of reform, electricity prices are more likely to be increased than any reforms to fuel prices. Domestic food price developments through Ramadan and Idul Fitri will also be particularly important for poverty basket inflation which, in the baseline scenario, is expected to ease to 7.0 percent in Q4 2012 and end 2013 at 7.6 percent.

GDP deflator growth is also expected to pick up from its current lows

The broad level of prices in the economy, as measured by the GDP deflator, rose by 6.0 percent year-on-year in Q1 2012, the lowest rate since 2009. GDP deflator inflation is projected to rise through the rest of 2012 to reach 7.2 percent for the year as a whole (with the low first quarter outcome contributing to the downward revision in the forecast). In 2013, annual GDP deflator growth is expected to continue rising, reaching 8.1 percent on the back of strengthening economic growth and credit conditions, but remaining well below the 14.5 percent average seen in the 4 years prior to the global financial crisis.

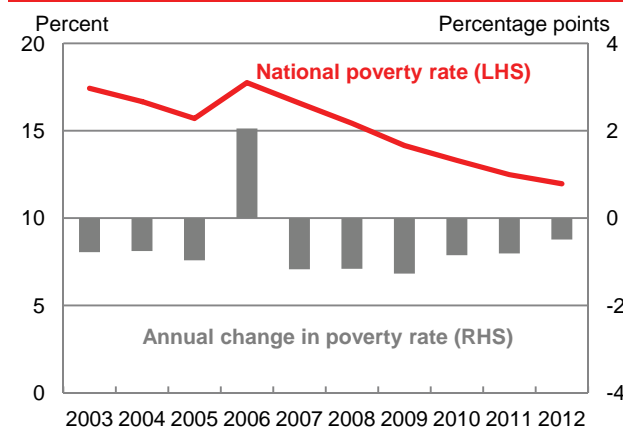
7. Poverty continues to fall, but at a slowing rate

The poverty rate continued to fall in the year to March 2012, but the rate of decline was the lowest in a decade

The official poverty rate fell from 12.5 percent in March 2011 to 12.0 percent in March 2012. Both urban and rural areas experienced a decline, with urban poverty falling from 9.2 to 8.8 percent, and rural poverty from 15.7 to 15.1 percent. The highest rates of poverty are in Eastern Indonesia, while the lowest are in Kalimantan (Figure 20). Poverty lines across the country increased on average by 6.4 percent to a consumption level of IDR 249,000 per person per month.

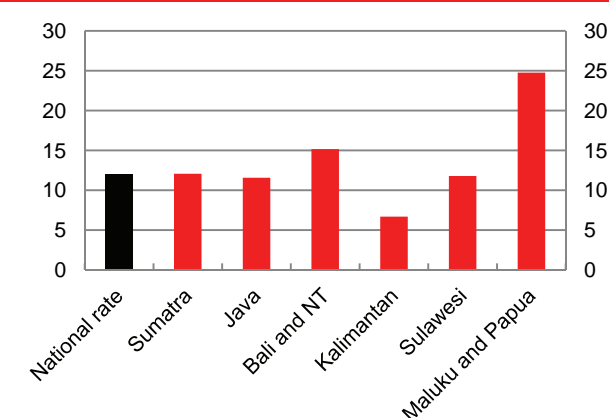
While the poverty rate continued to fall, the 0.5 percentage point decline is the lowest drop in ten years, excluding the 2 percentage point increase in 2006. This reflects the slowing rate of poverty reduction evident in the last four years (Figure 21).

Figure 20: The national poverty rate continued to decline in 2012 but the fall was the lowest in the last decade
(change in poverty rate, percentage points; poverty rate, percent)



Source: BPS and World Bank staff calculations

Figure 21: Poverty rates are relative high in Eastern Indonesia
(poverty rate, percent)



Note: NT is Nusa Tenggara
Source: BPS

There are a number of possibilities for the relatively small fall in poverty in 2012

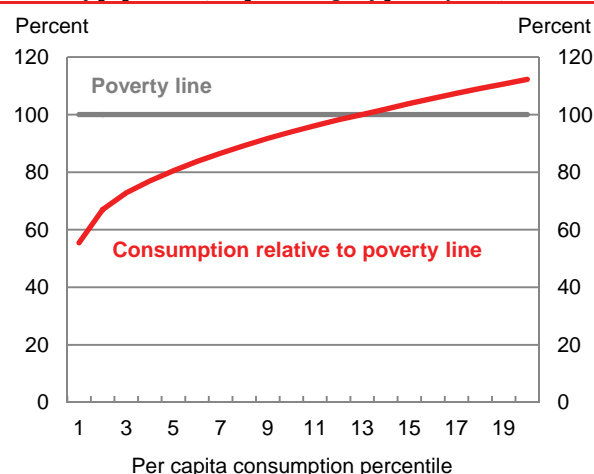
There are a number of possibilities for the relatively small fall in the poverty rate in 2012. One contributing factor apparent now is that the prices for the goods and services consumed by the poor have experienced a larger increase than those for the average household or the economy in general - the 6.4 percent increase in the poverty line in the year to March 2012 is higher than the corresponding increase in the GDP deflator (6.0 percent) or the rates of headline inflation (4.0 percent) and core inflation (4.3 percent). Evaluation of three other possibilities can also be conducted after the March 2012 Susenas household microdata become available. First, there could be a greater rate of new entry of individuals into poverty than in previous years. Second, the growth in nominal consumption for the poor could be less than that of the average household. Third, the year-on-year growth in GDP to March 2012 of 6.3 percent may be higher than the average growth in household consumption reported in the Susenas.

Slower poverty reduction may also reflect the entrenched nature of the remaining poor, as well as the large number of households vulnerable to falling into poverty

The changing nature of the poor is also a factor. As the poverty rate nears 10 percent, poverty reduction is becoming more difficult. When poverty was 20 or 30 percent of the population, there were many people living just under the poverty line, so moderate increases in income brought a large number out of poverty. However, in recent times, there are fewer people just below the poverty line, with many of the remaining poor being much further below (Figure 22). As a consequence, greater increases in their income are required to achieve the same rate of poverty reduction as in previous years.

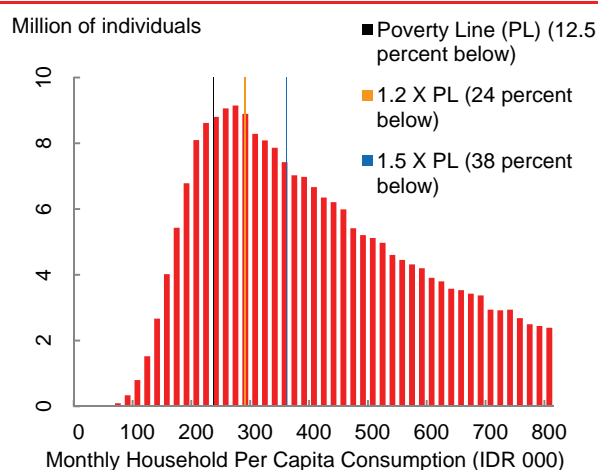
At the same time as the remaining poor are increasingly far below the poverty line, the many people who have moved out of poverty in the last three decades still live close to the poverty line and remain vulnerable to falling back into poverty (Figure 23); over half of the poor in each year were not poor the year before.

Figure 22: The remaining poor live increasingly far below the poverty line... (average per capita consumption by percentile for bottom 20 percent of population, as percentage of poverty line)



Source: Susenas 2011 and World Bank staff calculations

Figure 23: ...while a large number of Indonesians just above the poverty line remain vulnerable to falls back into poverty (2011 monthly per capita consumption, 000 Rupiah)



Source: Susenas 2011 and World Bank staff calculations

Addressing these problems of poverty and vulnerability requires more effective government programs

These two related phenomena of chronic poverty and widespread vulnerability mean poverty reduction policies in Indonesia should focus on two objectives. First, social *promotion* programs are required to help the remaining poor out of poverty through income support and investment in their human capital. This includes programs in Indonesia such as Scholarships for Poor Children (*Beasiswa Siswa Miskin*, or BSM) which allows poor families to meet the cost of education, and the conditional cash transfer program (*Program Keluarga Harapan*, or PKH) which provides cash transfers to the mothers of very poor households while promoting maternal and child health and school enrolment. However, coverage of these programs remains very low and needs to be increased to include the many poor who currently miss out.

Second, social *protection* programs are required to protect the many more vulnerable households in Indonesia from falling into poverty.³ Some such programs exist, such as Rice for the Poor (*Raskin*) and Health Insurance for the Poor (*Jamkesmas*), but they experience problems of implementation and do not reach all of the poor and vulnerable. These programs need to be improved and expanded to cover all vulnerable households. At the same time, new programs are needed protect especially vulnerable groups, such as the destitute elderly and the disabled, or to provide work for the temporary unemployed.

³ For more details see the Part C of the April 2012 *IEQ* and the recently released World Bank (2012) report on *Protecting Poor and Vulnerable Households in Indonesia*, available at <http://go.worldbank.org/5BWH4ZCQM0>.

Employment growth in the year to February 2012 was led by the industrial and services sectors...

Turning to labor market developments, total employment in February 2012 rose by 1.4 percent year-on-year, pushing the open unemployment rate down by 0.5 percentage points to 6.3 percent (Figure 24). Based on GDP data for Q1 2012, each 1 percentage point of GDP growth was associated with an increase in employment of around 216,000, somewhat lower than the average of around 400,000 in the past six years (although further analysis is required to look into these trends in more detail).

The services and industrial sectors were broadly equal drivers of this employment growth with the former increasing by 3 percent, boosted by the financial sector. Employment in industry increased by 6.4 percent and had the highest elasticity to GDP growth amongst the various sectors.

...as jobs continue to move away from agriculture and towards more formal employment

The decline in agricultural employment in the year to February 2012 is consistent with the longer-term trends. Over the past six years the share of total employees in non-agricultural sectors increased from 56 percent to 63 percent. This transition to the non-agriculture sector is one major factor why formal employment has picked up in recent years, although even within the formal sector the vast majority of workers do not have a contract. Interestingly, in line with increased demand for skilled labor, it was higher educated employees who contributed the most to employment growth over the past year and who also achieved the largest falls in unemployment rates.

8. External uncertainty remains the greatest near-term risk to the economy

Risks in the international environment remain high and are expected to persist...

With the resolution of the Euro zone crisis still unclear, and the ongoing potential for other downside shocks to hit the global outlook, such as from developments in China or other major emerging economies, there continues to be a risk of more adverse scenarios for Indonesia's near-term external environment. The domestic real impact of such scenarios, even if they occur in the second half of 2012, would probably be felt most strongly in 2013 (although the financial market impacts would be more immediate). Indeed, it is likely that risks during 2013 will remain high given the likely continuation of problems in the Euro zone plus the ongoing fiscal challenges also faced in economies such as the US.

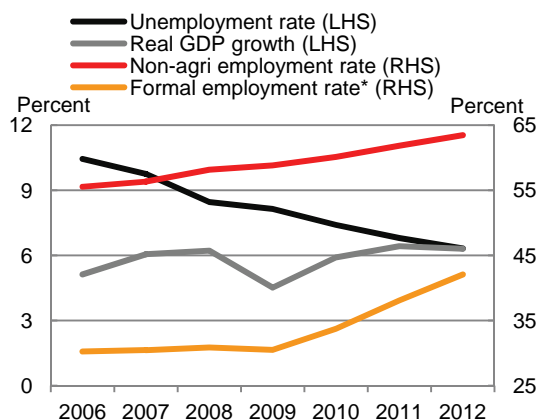
...and, if realized in a severe global slowdown, could push Indonesia's growth in 2013 below 4 percent

The October 2011 *IEQ* outlined a number of alternative scenarios for the international environment. Assumptions were made for the likely path of trading partner growth, terms of trade (primarily commodity prices) and domestic investment in each scenario which then flow through to projected growth to provide some guide to the downside risks that the Indonesian economy might face.

In the baseline scenario of continued financial market turbulence, as outlined above, growth is expected to moderate to 6.0 percent in 2012 before recovering slightly to 6.4 percent in 2013. In the event of a major freezing of international financial markets which contributes to a drop in trading partner growth, a fall in global commodity prices and reduced domestic investor confidence leading to a scenario similar to in 2009, it is projected that growth could slow to 4.7 percent in 2013 (Scenario 2 in Table 10). In a third scenario in which such a crisis was accompanied by, or indeed precipitated, a severe, prolonged global downturn encompassing the major emerging economies, growth in Indonesia could drop to 3.8 percent, with the impact of the slowdown felt more sharply in domestic activity as commodity price falls reduce incomes and investment. Developments

Figure 24: Unemployment continued decline in year to February 2012...

(year-on-year growth, percent; unemployment rate, percent)



Note: Data for February. BPS changed the labor force survey weighting in February 2011. *Formal employment includes employers with, permanent workers and salaried workers

Source: BPS and World Bank staff calculation

in China, for example, are of particular interest not just for commodity demand but also for the outlook for global commodity prices (see Box 4). It is also possible that if consumer and business sentiment drop particularly sharply, perhaps in conjunction with stresses in the domestic financial sector, this could push growth down further, below these scenario projections.

Table 10: The impact of a global downturn on economic growth would be significant

Scenarios:	Outcomes				Scenario 1 Continuing turmoil		Scenario 2 Return to 2009		Scenario 3 Severe global slowdown	
	2008	2009	2010	2011	2012	2013	2012	2013	2012	2013
Indonesian GDP growth (percent)	6.0	4.6	6.2	6.5	6.0	6.4	5.8	4.7	5.7	3.8
Scenario assumptions:										
Investment/GDP ratio (percent)	23.7	23.4	23.9	24.4	25.3	26.1	25.1	25.1	25.0	24.1
Major trading partner GDP growth (percent)	2.1	-0.7	7.2	3.6	3.3	3.7	2.3	0.1	1.9	-1.8
Terms of trade growth (percent)	-18.1	-4.2	5.7	10.2	2.0	9.0	0.0	-15.0	0.0	-30.0

Note: 2012 and 2013 are projections. Terms of trade series is constructed by World Bank from monthly trade data
Source: CEIC and World Bank staff projections

The balance of payment outlook also remains uncertain and more adverse global scenarios would put pressure on trade and capital flows

Under the baseline scenario, Indonesia's overall balance of payment is expected to register a small surplus in 2012, expanding slightly in 2013. Should the international environment move into either of the more negative scenarios, there could be significant implications for Indonesia's balance of payments inflows, particularly in the third scenario. Lower external demand and commodity prices would bring down the trade surplus and widen the current account further. Increased international market turbulence, and investor flight to quality, would likely lead to capital outflows, putting pressure on the Rupiah and domestic asset prices.

Risks to the inflation outlook, while reduced, remain sizeable...

The reduced likelihood of a fuel price increase in 2012 has reduced the near-term inflation risks. However, inflation risks to the upside and downside remain sizeable. If growth continues to be robust then inflation could surprise on the upside as capacity constraints tighten. Further the depreciation of the exchange rate could also feed into higher domestic prices (a 10 percent depreciation in the Rupiah against the USD is associated with roughly a 0.5-1 percentage point rise in headline inflation). However, greater-than-expected falls in external demand and global commodity prices would tend to dampen domestic inflation, both directly through import prices, and through their impact on income and demand in the economy. Finally, any changes in policy on administered prices, such as for electricity and fuel, would result in a significantly different outlook.

...while subsidy spending and disbursement challenges pose risks to the Budget outlook

Recent falls in crude oil prices have dampened the cost per liter of fuel subsidies. However, spending in the first half of the year indicates the high risks of overspending relative to the revised Budget allocation (with the Government projecting total subsidy spending IDR 100 trillion above the revised Budget level of IDR 245 trillion). The reforms measures to limit consumption are unlikely to have a sizeable impact on the level of spending, which continues to present a significant cost in terms of spending which could be better used on other development objectives and to more effectively support poor households. Set against this is lower spending due to the execution challenges mentioned above and discussed further in Part B. These two factors, along with the path of commodity prices, and hence revenues, are some of the main risks to the deficit outcome in 2012.

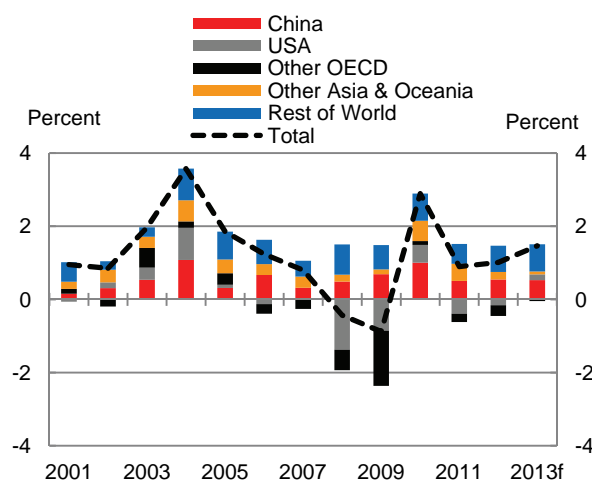
Box 2: The “China effect” on global commodity prices

Fluctuations in global commodity demand and prices are a key driver of the economic outlook for Indonesia, affecting the fiscal position, the trade balance and also domestic consumption and investment. Much of the recent rise in the volume of Indonesian commodity exports has been due to rising demand from China, but how important is Chinese demand as a driver of global commodity prices?

As a global center of production, China has become an increasingly important source of commodity demand. In 2000, most of its exports were consumption goods, yet by 2009 capital goods accounted for about half of its exports (IMF, 2011). These goods tend to require larger quantities of natural resources as production inputs, explaining part of the surge in its appetite for commodities. Another source of Chinese commodity demand is investment in infrastructure and housing as the country moves up the income ladder. Demand is particularly strong for energy and metals. Chinese consumption of liquid fuels is a major driver of global energy demand (Figure 25). While in the year 2000, China accounted for 6.4 percent of global demand, it almost doubled by 2011 to 11.2 percent. The IMF anticipates that Chinese energy consumption is going to double by 2017 and triple by 2025 from its 2008 level.

Figure 25: China's appetite for energy is a key driver of global consumption of liquid fuels

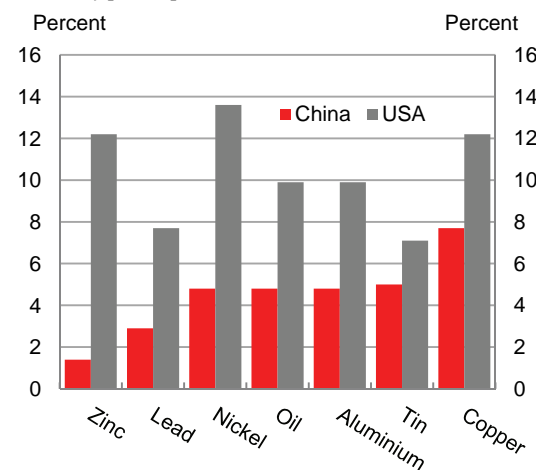
(contributions to year-on-year growth, percent)



Source: Energy Information Administration

Figure 26: China's effect on commodity prices is considerable – yet it still trails the US

(contribution of variation in China's demand to variation in commodity prices, percent)



Note: 4-quarter variance decomposition shock of one standard deviation in industrial output, showing the contribution of variation in China's demand to variation in commodity prices. Data for 2000-2010
Source: IMF

Given its weight as a major global consumer of raw materials, it is not surprising that China has a considerable effect on commodity prices. Jenkins (2011) estimates for the period 2002 to 2007 that China's growth in demand for oil at 42.1 percentage points above global demand growth translated into an increase in global oil prices in the range of 10.8 to 27.1 percent. Between 2001 and 2011, China's consumption of metals increased by 350 percent (World Metal Statistics). Its effect on global prices is particularly pronounced in copper, tin, aluminum, and nickel (Figure 26). However, although pressure on commodity prices from China has intensified significantly, it does not yet reach the same levels as pressures from the US (which remains the world's largest economy).

As China's growth outlook dims, global commodity prices will ease. The persistent fragility of the global economy still dampens demand for Chinese exports. Domestic investment is likely to slow as tighter credit conditions curb activity in residential real estate and manufacturing. Moreover, restocking in the aftermath of the financial crisis of 2009 is coming to an end as Chinese companies have rebuilt their inventories. Jointly, these factors are likely to reduce demand for many commodities – and indeed, as discussed earlier, recent months have seen declines in international commodity prices. It is however worth noting that a rebalancing in Chinese demand towards private consumption would add support to prices of products such as palm oil, vegetables, fish and meat, rubber for the production of tires, and other consumer-related commodities – many of which Indonesia also exports.

Notes: This box is reproduced from the World Bank East Asia and Pacific Economic Update (2012) and refers to Jenkins, R. (2011) “The ‘China effect’ on commodity prices and Latin American export earnings”, CEPAL Review 103, and IMF(2011), “China: 2011 Article IV Consultation”, IMF Country Report No. 11/192

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY



1. Drivers and implications of recent trends in Indonesia's current account

Indonesia's current account balance has been narrowing and is projected to move into an annual deficit in 2012 for the first time since the Asian financial crisis

Rapid domestic growth and weak external demand have seen Indonesia's current account surplus (CAS) narrow substantially in recent years. The World Bank projects that Indonesia will record an annual current account deficit (CAD) in 2012 for the first time since before the Asian financial crisis. While the recent weakening of the trade balance, as described in Part A, has accelerated the movement of the current account into deficit, this is also a medium-term trend. This section analyzes the drivers that underlie these recent dynamics in Indonesia's current account, and discusses related issues of the sustainability of the deficit and its implications for Indonesia's external financing position.

a. Recent dynamics in Indonesia's current account

After maintaining a current account deficit through the 1980s and 1990s, the fundamentals of Indonesia's external accounts changed during the Asian financial crisis

Prior to the Asian crisis, Indonesia experienced almost three decades of strong economic expansion, driven by industrialization, urbanization and the reduction of trade barriers, which saw the economy become more globally integrated.⁴ As in many other countries, this rapid 'catch-up' phase of economic development required a significant increase in the investment rate, with investment-to-GDP rising from 28.5 percent in 1980 to 37.2 percent in 1997. Given low domestic savings, this investment was financed by borrowing from overseas with the current account deficit averaging around 3 percent of GDP annually (see Box 3 for a description of the current account). Current account outflows were financed by short-term loans and portfolio capital inflows. The sudden withdrawal of external financing during the Asian financial crisis saw Indonesia's current account swing to a surplus as the currency depreciated heavily, followed by policy reforms aimed at reducing external debt and building domestic buffers against sudden stops in foreign capital flows.

In recent years, Indonesia has maintained a current account surplus, contributing to the build-up of foreign reserves

Since 1998 Indonesia's current account has generally remained in surplus, with export earnings more than offsetting imports and income payments to foreign investors. This reflects an increase in savings relative to investment compared to before the Asian financial crisis, reflecting more conservative investment practices and lending regulations. The persistent current account surplus has also helped to provide a source of external financing in recent years, lowering vulnerabilities to sudden capital stops, and has contributed to the four-fold increase in foreign reserves over the past decade.

Yet, the current account has been trending down since the 2008 global financial crisis...

However, since the 2008 global financial crisis, strong domestic conditions combined with ongoing weakness in the global economy have resulted in a narrowing of the current account surplus, as imports and income outflows related to increasing FDI (particularly in the mining & minerals sector) have grown faster than exports earnings.

⁴ Elias & Noone (2011), "The Growth and Development of the Indonesian Economy", Reserve Bank of Australia Bulletin, December.

Table 11: The current account surplus is projected to shift into a deficit in 2012
(USD billions, unless otherwise stated)

	20-year average	5-year average	2009	2010	2011	2012	2013	2014
Current Account	2.7	6.4	13.6	5.6	1.7	-7.9	-4.6	-7.4
<i>percent of GDP</i>	0.9	1.2	2.5	0.8	0.2	-0.9	-0.4	-0.6
Trade Balance	8.1	19.3	21.2	21.3	23.3	11.3	15.7	15.2
Goods	20.6	30.2	30.9	30.6	33.9			
Services	-12.5	-10.9	-9.7	-9.3	-10.6			
Income balance	-10.2	-18.5	-15.1	-20.8	-25.8	-23.8	-25.2	-27.4
Transfers balance	2.3	4.8	4.6	4.6	4.2	4.6	4.8	4.7

Source: BI and World Bank

Box 3: What is the current account balance?

A country's current account balance records all transactions with the rest of the world related to the exchange of goods and services (trade balance), an income balance, and current transfers. The income balance records net interest and dividend payments and earnings of domestically owned firms operating abroad, while the last component reflects net payments (that do not correspond to purchases of any good, service, or asset) received from the rest of the world.⁵

$$\text{Current Account} = \text{Trade Balance} + \text{Income Balance} + \text{Current Transfers Balance}$$

Taken another way, the current account reflects the difference between savings and investment in an economy. If an economy consumes and invests more than it produces or receives in income or transfers, i.e. it runs a current account deficit, it must be borrowing from foreigners to finance this deficit or equivalently its national savings are lower than investment. Thus a current account deficit allows a country to borrow now to fund investment which cannot be financed from national savings, and repay later out of higher national income.

There are also important economic linkages between the current account and a country's net international investment position (NIIP). A country's NIIP reflects the build-up – or stock – of an economy's financial transactions with the rest of the world. In the absence of valuation changes, the level of the current account, i.e. an economy's net saving, will equal the change in the NIIP in a period. This is, however, rarely the case: valuation changes reflecting asset price and currency movements also impact the stock of foreign assets and liabilities during a period. The sum of current account transactions and valuation changes therefore give the change in a country's NIIP.

A CAD also has implications for short-term financing, as it will add to a country's gross external financing needs. Although borrowing and investing now against future income can provide an effective means to accelerate economic development, a CAD also increases a nation's dependence on foreign capital inflows. An economy's external financing needs in a given year comprise all medium- and long-term debt which will amortize, plus any short-term debt falling due, plus any current deficit that needs financing. On the other hand a current account surplus would provide additional external financing sources.

...recording a deficit in the past two quarters, as imports growth has continued to outpace sluggish exports growth

Recent falls in commodity prices and weak external demand have accelerated the trend towards a CAD, with Indonesia recording a deficit in Q4 2011 and Q1 2012 (Figure 27). Q1 2012 saw the CAD widen to USD 2.9 billion (1.3 percent of GDP) from USD 1.6 billion (0.7 percent of GDP) in Q4 2011. As a ratio to GDP the current account deficit is only around half the average deficit prior to the Asian financial crisis. The widening in the CAD was driven by a sharp fall in the goods trade surplus to USD 3.5 billion, down from USD 6.4 billion in Q4 2011 and USD 9.4 billion in Q3 2011.

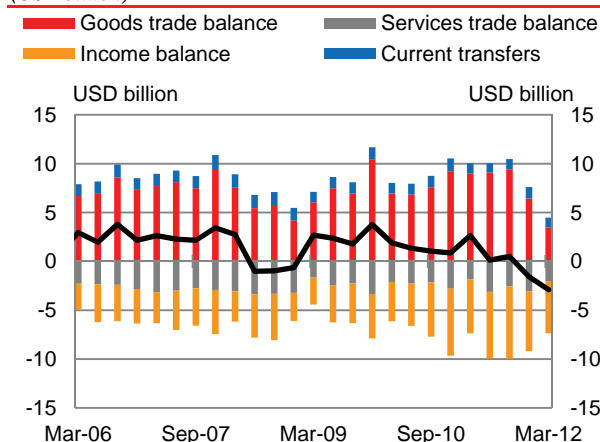
The narrowing has primarily been driven by weak non-oil and gas export volumes, consistent with slowing industrial production in major trading partners. By sector, mining and manufacturing exports have fallen, particularly to China. On the imports side, non-oil and gas imports have been rising due to increased demand for capital and intermediate goods as inputs to domestic investment. Imports of oil and gas have also been rising, reflecting strong consumption and industrial activity. Meanwhile the services deficit has been trending wider in recent years as demand for freight services has

⁵ Previously referred to as Workers' Remittances, this category was amended in the IMF Balance of Payments and International Investment Position Manual, 6th edition (2007) to reflect all transfers between residents and non-residents, regardless of the source of income or the relationship between the households.

increased with higher bulk commodity export volumes, combined with an increase in Indonesian residents travelling abroad. The income deficit has also increased, due to increased profit repatriation in line with rising FDI inflows in recent years.

Figure 27: The recent move into a current account deficit is part of a medium-term trend...

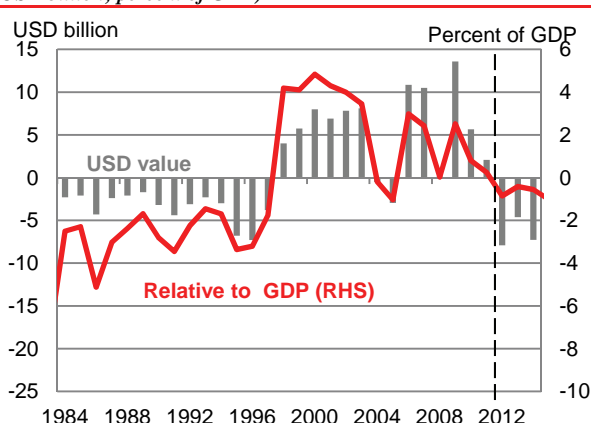
(USD billion)



Source: Bank Indonesia

Figure 28: ...and is projected to remain at around 1 percent of GDP over the medium-term

(USD billion; percent of GDP)



Sources: historical IMF data, World Bank projections

Robust domestic demand, combined with ongoing global economic weakness, is projected to push the current account into deficit

Looking ahead, the current account is expected to record an annual deficit for 2012, and continue to widen in dollar terms over the medium-term (although remaining below 1 percent of GDP, Figure 28). The move towards a CAD is not unexpected. Rather, it reflects the relative strength of the domestic economy and is consistent with Indonesia's growing demand for foreign savings to finance strong domestic investment and economic expansion.

Current account deficits and surpluses may arise for a variety of reasons

There is no strict causality between a current account deficit and poor economic performance. As mentioned, a CAD can allow an economy to front-load investment, supporting economic growth and improvements in social outcomes. As discussed in Part C, financing the deficit through increased FDI, and the imports of capital goods which may contribute to the current account position, can also have potential positive spillovers to productivity, wages, and the transfer of management skills and technology. A current account deficit can also reflect a relative abundance of investment opportunities, which can attract greater foreign capital inflows, particularly stable FDI funding. However, there may be concerns if a CAD reflects funding of speculative investment opportunities that do not increase the productive capacity of an economy and which are financed by short-term capital flows that are vulnerable to sudden stops.

Conversely, a CAS could imply there are insufficient domestic opportunities for high quality investment, leading residents to channel their savings overseas. This deprives the domestic economy of capital to finance infrastructure and private sector development. It is also worth noting that the world economy cannot operate with all countries running a CAS.

b. Long-term sustainability and near-term financing

Current account sustainability refers to the willingness and ability of an economy to repay current borrowings and foreign investors' willingness to lend to an economy

CAD sustainability – the ability of a country to run a CAD over an extended period of time – is linked to its capacity to repay the related accumulated stock of foreign debts through future trade surpluses, and whether foreign investors are both willing and able to lend to the country to finance the CAD in the short-term. Part and parcel of this are foreign investors' perceptions regarding the economy's willingness and ability to meet its debt obligations and ability to do so. This perception improves with the quality of investment projects and the macroeconomic policy environment of the country. Sustainability can also refer to an assessment of whether a continuation of the current stance is vulnerable to shifts in policy or external shocks which will require a sharp rebalancing of the economy, such as a tightening of monetary or fiscal policy to reduce imports. If the answer is yes, the imbalance is unsustainable.

Indonesia's external debt position is viewed as sustainable

As of end-2010 Indonesia's recorded net international investment position showed USD 422 billion in liabilities, of which USD 154 billion were the stock of FDI liabilities, set against USD 133 billion in assets. The move towards a CAD is expected to add to Indonesia's net liability position. Focusing on external debt liabilities (which were equivalent to 27 percent of GDP at end-2011), the sustainability assessment of the 2011 IMF Article IV report concluded that Indonesia's external debt position is sustainable over the medium-term. The relatively modest current account deficit is expected to be more than offset by relatively high growth, increasing non-debt creating (i.e., FDI and equity) flows and some further real appreciation. The IMF's shock analysis also suggests that external sustainability is robust to most shocks, with the external debt ratio expected to trend down and remain at manageable levels under all standardized shock scenarios.

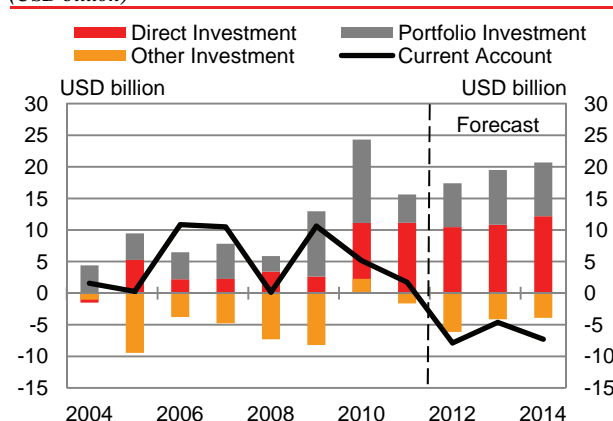
Yet it remains important to ensure the economy can meet its short-term financing needs, particularly during periods of acute financial market stress

As mentioned above, the move to a current account deficit will add to Indonesia's external financing needs. However, it is likely to remain a relatively low share of the overall financing requirements. For example, over the past two quarters in which Indonesia recorded a CAD, the country's servicing of the principle due on external debt was USD 32.9 billion and USD 39.8 billion, respectively. The CAD in each of these quarters (USD 1.6 billion and USD 2.9 billion, respectively) was only a small fraction of this value and were fully covered by net non-debt creating inflows (net direct investment and net equity inflows of USD 2.6 billion and USD 3.0 billion, respectively). In a baseline scenario of continued solid FDI performance this situation would be expected to continue, although a sharp weakening in external demand and commodity prices and rise in financial market volatility could clearly affect this outlook.

The composition of Indonesia's net capital inflows have changed in recent years, with direct investment now a larger share of net inflows

The changing composition of Indonesia's capital inflows is also important when looking at foreign investors' perceptions of the sustainability of the emerging CAD. Prior to the global financial crisis, FDI represented around 50 percent of gross financial account inflows. This ratio fell to around 25 percent in 2009. However, a strong recovery in FDI inflows in recent years saw the ratio rise to 65 percent in 2011. World Bank projections are for FDI to remain at around 60 percent of total financial account inflows over the forecast horizon.

Figure 29: FDI has become a larger proportion of total financial account inflows since 2008-09 (USD billion)



Source: BI historical data and World Bank projections

The outlook for FDI is key to current account sustainability and stability of financing

High long-term FDI flows, as opposed to short-term portfolio flows, are an important factor in reducing the external financing risks of an economy. For example, recent work by Levchenko and Mauro (2006) concludes that FDI helps protect countries from sudden stops in capital flows.⁶ As outlined in the June 2011 *IEQ*, the underlying drivers of FDI inflows to Indonesia appear positive, with average quarterly FDI during Q1 2010 – Q1 2012 more than three times higher than the five-year average before the 2008/09 global downturn. These FDI inflows are also broad based, and becoming more geographically disbursed across the archipelago, as foreign companies seek access to Indonesia's large consumer base, natural resources and to take advantage of lower production costs to service export markets. However, they are sensitive to the regulatory and investment climate.

⁶ Levchenko, A. and Mauro, P. (2006) "Do Some Forms of Financial Flows Help Protect from Sudden Stops?" Working paper WP/06/202. International Monetary Fund.

c. Recent policy measures to mitigate external vulnerabilities

The authorities in Indonesia have taken steps to reduce the economy's exposure to both foreign capital withdrawals and domestic capital flight

Aside from prudent macro policy management and building foreign reserves, authorities have undertaken a range of regulatory reforms to help mitigate Indonesia's external vulnerabilities and to reduce the potential for short-term capital flows to destabilize the domestic economy and financial markets. BI has gradually reduced the stock of central bank bills (SBI) on issuance, replaced short-term 1, 3 and 6 month bills with term deposit facilities, and introduced a 6-month holding period on SBI. These measures have seen the share of SBI owned by foreigners drop from 39 percent in May 2011 to less than 2 percent at the end of May 2012.

BI has also combined regulatory reform and incentives to encourage domestic firms and investors to hold capital onshore, to mitigate a possible sudden flight of domestic savings. These policies include requiring companies to repatriate all foreign-currency export earnings to domestic banks, capping the value of forex purchases by residents for savings purposes, and introducing a range of USD term deposit products. As mentioned in Part A, the Government has also advanced crisis preparedness through improved coordination of a Crisis Management Protocol, as well as adding significant fiscal buffers to the 2012 Budget, including: a framework to support domestic bonds prices; and contingency plans to support a rapid government response to crisis or emergency situations.⁷

Sustainable financing of the CAD requires stable long-term investment inflows, which can be supported by policies to improve the investment climate and competitiveness

Policies to reduce the economy's reliance on volatile capital flows and increase stable long-term foreign investment are vital to improving the nation's capacity to meet both its short and medium-term external financing needs. While Indonesian policymakers cannot control the international "push factors", such as a high-income economy interest rates or growth, behind foreign capital flows, the authorities can help to provide a conducive domestic environment for business and investment by putting in place policies to promote a stable and open investment climate and increased private-sector competitiveness.

Policy consistency and communication are also critical for attracting long-term investment and mitigating volatile short-term capital flows. Managing policy changes to avoid uncertainty or confusion in the policy environment, and to consider the long-term, as well as the short-term, implications of policy can help to support longer-term investments. In this regard, recent policy announcements regarding trade restrictions and ownership limits in the banking and mining sectors appear to have already increased investor uncertainty.

d. Concluding remarks

Indonesia's move towards a current account deficit reflects its relatively strong domestic economic conditions but, in the current fragile international environment, it will be important to monitor developments closely, particularly related to short-term external financing

Overall, as outlined in Part A, the baseline outlook for Indonesia's economy remains solid, although downside risks remain high. Strong domestic growth and a relatively weak external environment are gradually pushing Indonesia towards a CAD – a development which is common for a rapidly-growing emerging economy with high investment needs and low domestic savings. Baseline projections are for Indonesia to attract sufficient long-term non-interest bearing capital inflows, such as FDI, to service the CAD over the coming years.

However, investor sentiment remains sensitive to adverse commodity price shocks that could widen the current account deficit and to further global market volatility which could intensify financing pressures. In this regard, recent policy changes to reduce Indonesia's exposure to volatile capital outflows are welcome, as is the emphasis on improving areas such as infrastructure. A lack of clarity or consistency on trade and investment policies, however, could undermine foreign investor confidence with potential implications for both short-term portfolio and longer-term FDI flows. In the current fragile international environment monitoring the drivers of the CAD and the sources of Indonesia's short-term external financing can also play an important role in the early identification of dynamics which may give rise to any concerns over both long-term trends and near-term financing pressures.

⁷ For example, the Budget Law 2012 provides the legal basis for the Government to seek parliamentary approval, within 24 hours of submission, to respond to an emergency event, as outlined in the law.

2. Identifying the constraints to budget execution in the infrastructure sector

Timely budget execution and sound public financial management institutions are critical in delivering public services and achieving development outcomes

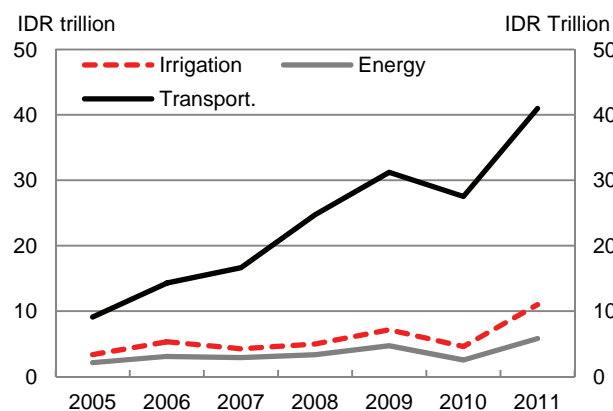
Timely budget execution and sound public financial and management (PFM) institutions are key to achieving development targets and outcomes. In Indonesia's case improving budget execution is all the more important given the recent steep increase in the budget allocation for key infrastructure sectors to address infrastructure shortfalls. Timely budget execution is even more critical during an economic slowdown as expenditure policy is a key countercyclical tool with can be used to inject demand into the economy. Indeed, understanding the challenges and constraints facing budget execution can help policy makers better prepare and respond to any potential shocks, for example emanating from a deteriorating external environment.

Drawing on recent analysis, this section discusses key issues in the execution of the central government budget and policy options to address those challenges.⁸ The study was conducted by analyzing 36 samples of DIPA (*Daftar Isian Pelaksanaan Anggaran*, Budget Warrant) in the infrastructure sector at each stage of budget execution (budget preparation, procurement, and implementation) and by identifying gaps between plans and actual implementation. It was carried out in four locations through data analysis, focus group discussions, and in-depth interviews with stakeholders including officials of the project implementing unit (Satker), officials at the local treasury offices (KPPN), and selected contractors. The objective of the study was to identify constraints in budget execution in 2010 and to assess the effectiveness of reforms that have since been introduced to address these constraints.

Budget execution in the infrastructure sector continues to be a challenge in Indonesia

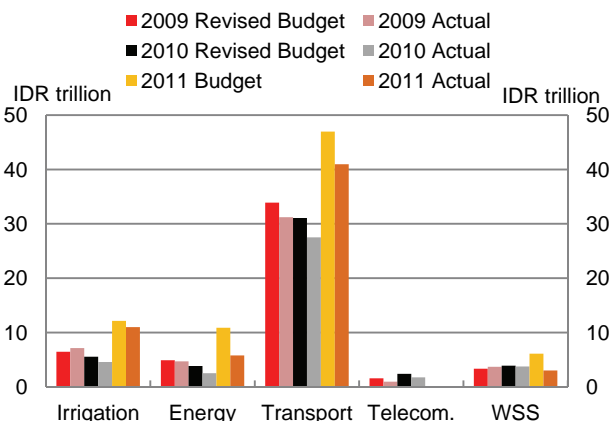
Weak disbursements of the budget in 2010 and 2011 highlight ongoing challenges with budget execution. In 2010, all key infrastructure sectors saw actual spending come in below the budgeted amount. In both 2010 and 2011, less than 85 percent of the revised capital expenditure budget was disbursed, notwithstanding an increase in nominal terms of 44 percent in actual capital expenditure between 2010 and 2011. Most budget increases were allocated to key infrastructure sectors (Figure 30 and Figure 31). In addition, more than 50 percent of total disbursements occurred in the last quarter of those two years. These slow and low disbursement patterns are likely to reoccur in 2012. In the first half 2012, disbursement of capital expenditure improved slightly but remained low at 18 percent of the full year budget allocation (see Part A). (For cross country analysis of government spending disbursement profiles please see Dec 2010 *IEQ*).

Figure 30: Key infrastructure sectors received significant budget increases in 2011 (IDR trillion, nominal)



Source: Ministry of Finance & World Bank staff calculations

Figure 31: But low 2010 and 2011 budget outcomes highlighted the ongoing challenges in budget execution (IDR trillion, nominal)



Note: WSS is water supply and sanitation

Source: Ministry of Finance & World Bank staff calculations

⁸ This section draws upon a recent joint publication, *DIPA Tracking Study: Identifying the constraints to budget execution in the infrastructure sector* (2012), between the Fiscal Policy Office of the Ministry of Finance, Lembaga Penyelidikan Ekonomi dan Masyarakat Universitas Indonesia (LPEM-UI), and the World Bank.

The Government has introduced a number of measures to accelerate budget execution performance

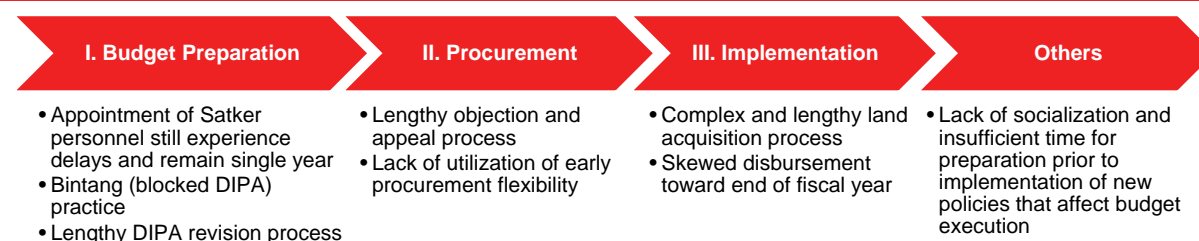
The Government has recently established a budget execution task force (TEPPA or *Tim Evaluasi dan Pengawasan Penyerapan Anggaran*) to closely monitor and to eliminate bottlenecks constraining budget execution. TEPPA is led by the Presidential Work Unit for Supervising and Controlling Development (UKP4 or *Unit Kerja Presiden Bidang Pengawasan dan Pengendalian Pembangunan*) and co-led by the Ministry of Finance and the State Development Audit Agency (BPKP). Other measures that have been introduced include: streamlining budget preparation and payment processes; implementation of a new regulation on procurement (*Perpres* No. 54/2010), and; the implementation of guidance on budget execution (*Perpres* No. 53/2010, a second revision of *Keppres* No. 42/2002), which provides flexibility on Satker (work unit) personnel appointments.

a. Delays during budget preparation present the main bottlenecks, with procurement and implementation also affecting disbursements

Critical constraints can be identified in each step of budget execution

The assessment of budget execution was divided into three stages: budget preparation, procurement, and implementation. The performance of budget execution is influenced by many factors such as the nature of the project (maintenance and operation, or construction), the length of a project, and the source of funding. The implementation is not only influenced by internal factors within Satker or the respective line ministry, but also by external factors such as other line ministries, lower-level governments, parliament, and other institutions. Thus, issues identified in budget implementation vary widely from technical, capacity, policy and regulation, and institutional. Nonetheless, some critical issues commonly emerge as constraints during budget execution (Figure 32).

Figure 32: Identified critical issues within each step of budget execution in 2010 and 2011



Source: *DIPA Tracking Study: Identifying the constraints to budget execution in the infrastructure sector (2012)*

Delays and complexities during budget preparation appear to be the most critical issue constraining budget execution

Although the procurement and implementation stages also face some challenges, delays during budget preparation are the most critical and significantly affect subsequent activities (Figure 32). Long-standing issues remain the primary reasons for delays during budget preparation. Those include: administrative delays in the Satker receiving the DIPA (although the DIPA are approved before the fiscal year) and delays in appointing Satker personnel; the lengthy process of DIPA revision and unblocking blocked (*bintang*) DIPA; poor planning and budgeting due to weak capacity of the Satker; and the budget details of the appropriation process (approval by Parliament) being at a highly disaggregated level - i.e. not only at the ministry or project level, but also at the activity level as well as by type of expenditure.

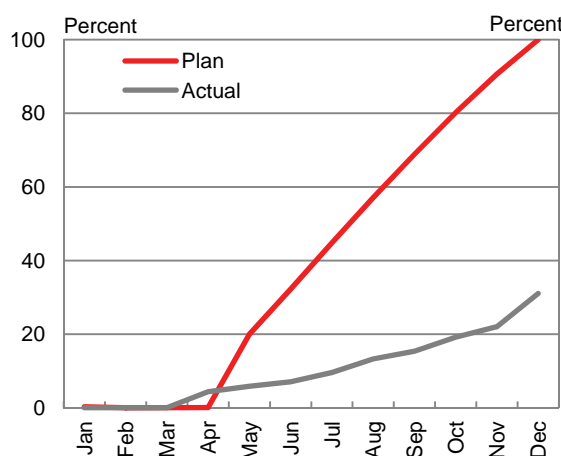
The procurement process also faces challenges and delays

The procurement process is regulated by a new procurement regulation (*Perpres* No. 54/2010, a revision of *Keppres* No. 80/2003) which became effective in 2011. This has brought with it some new challenges on account of a number of structural changes introduced by the new regulation. For instance a lack of familiarity with the new system has resulted in multiple interpretations and has caused procurement committees to adopt an overly cautious approach during the procurement process. The objection-and-appeal procedures, which aim to improve transparency, were introduced with no clear time limits, significantly affecting the procurement process. The lack of human resources (certified procurement specialists as required by the law) and inadequate infrastructure to support e-procurement (e.g., limited bandwidth) were also often identified as constraints by Satker personnel. A weak incentive structure for Satker personnel, coupled with growing concerns over the heightened level of fiduciary (audit) control, also discourages Satker personnel performance in project implementation. The flexibility to conduct early procurement before the fiscal year, to accelerate procurement process as allowed by the new regulation, has also not been effective.

The lengthy and complex land acquisition process is the main constraint during the implementation stage

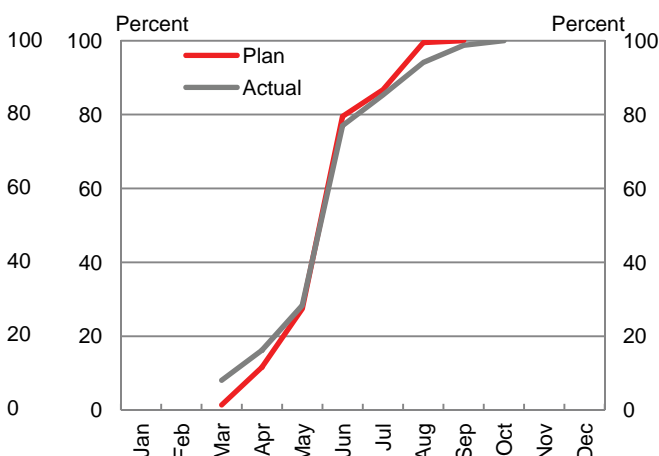
Although project implementation depends on the nature of the project, large-scale construction projects that have a land acquisition component often experienced delays due to the lengthy and complex processes, coupled with coordination issues. About two thirds of the Satker in the sample indicated that they faced problems in land acquisition. For example, Satker development of the Double Track Railway 2010 experienced significant gaps between the planned and actual implementation progress due to delays in land acquisition process (Figure 33). Meanwhile, non-construction projects (maintenance and operation) were mostly implemented as expected. For example, a road maintenance activity (carried out by Highway Construction and Maintenance West Java 2010) was implemented as planned as it did not require land acquisition (Figure 34).

Figure 33: Physical progress on the Double Track (2010) project experienced significant delays relative to plans (plan and actual cumulative physical progress, percent)



Source: Satkers and KPPN Office

Figure 34: Actual physical progress of the Highway Construction and Maintenance West Java (2010) project was in line with the plan (plan and actual cumulative physical progress, percent)



Source: Satkers and KPPN Office

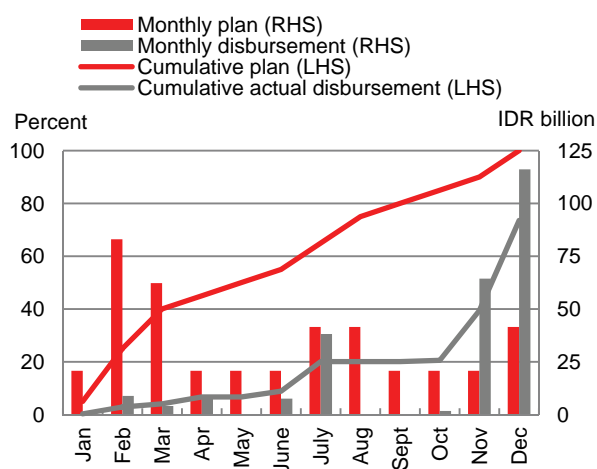
Financial disbursement is skewed towards the end of the fiscal year

The first disbursements of capital expenditure generally occur at the end of the first quarter and vary by the nature of the project. There are inconsistencies when comparing disbursement plans against actual spending caused by delays in starting implementation of projects, delays at the Satker in processing payments, and contractors' preference for submitting invoices for payment at the end of the fiscal year as many contractors feel that the payment procedures are cumbersome (see example in Figure 35). There is still no clear monitoring system and a lack of enforcement to monitor the process by which the Satker issue payment orders to local treasury offices (KPPNs). However, similar to project implementation, the financial disbursement of non-construction activity (maintenance and operational) remained in accordance with the plan (Figure 36).

The implementation of some policies in 2011 (e.g., budget efficiency and budget optimization) had an adverse impact on budget execution

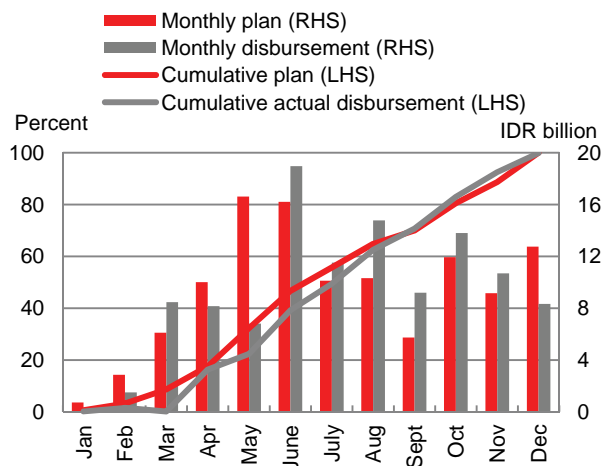
While new policies on budget efficiency and optimization are expected to enhance the quality of spending, insufficient experience and time for preparation prior to implementation has negatively affected budget execution (e.g., through multiple DIPA revisions). Presidential Instruction (*Inpres*) No. 7/2011 on Budget Efficiency required all line ministries to cut/reduce their budgets by a minimum of 10 percent. Ministry of Finance Regulation PMK No. 38/2011 regarding budget optimization aimed to provide rewards and punishments to line ministries based on efficiencies in procurement in 2010. Most Satker consequently had to revise their DIPA and budget details (POK). The utilization of budget optimization and reallocation of the 10 percent savings were decided in March, which slowed down Satker's performance and left insufficient time for proper planning. As a result, new initiatives/activities for budget optimization were blocked and were not fully spent.

Figure 35: Financial disbursements on the Power Plant and Transmission Sulawesi-Maluku-Papua (2010) project were skewed towards the year end...
(cumulative financial progress of plan and actual, percent of total; monthly financial disbursements, IDR billion)



Source: Satkers and KPPN Office

Figure 36: ...while disbursements for the Highway Agency of West Java Province (2010), a non-construction project, were more evenly spread through the year
(cumulative financial progress of plan and actual, percent of total; monthly financial disbursements, IDR billion)



Source: Satkers and KPPN Office

b. Addressing budget execution challenges is critical for Indonesia

Intensive monitoring and providing coordinated and targeted assistance to identified high-risk projects may be warranted to assist in the implementation of the 2012 budget

Budget implementation for 2012 is currently entering the second half of the fiscal year. Accordingly, efforts to accelerate budget execution can be focused on high-risk projects that are likely to experience delays - such as large capital and priority projects and those that have previously experienced problems during the preparation phase. This can be done through close monitoring and by providing targeted support to selected line ministries and Satkers. To this end, TEPPA has been very active in monitoring and coordinating with line ministries to accelerate budget execution. In addition, the introduction of any new policies should take into account potential adverse impacts on budget execution and allow enough time for understanding the new regulations and preparing accordingly prior to implementation. Otherwise this could exacerbate an already complex budget execution process and delay implementation.

Streamlining some procedures and regulation relating to budget preparation, procurement, and implementation can accelerate the implementation of the 2013 budget

Accelerating the issuance of the new government regulation (PP) on budget execution which is currently under preparation, can address some of the constraints and regulatory inconsistencies in budget preparation and execution in 2013 and in the medium term. The recurring administrative delays can be reduced by minimizing the application of conditional budget approval or blocked (*bintang*) DIPA and further streamlining budget revision procedures.

The procurement process can also be improved in 2013, particularly by optimizing the flexibility to conduct early procurement before the fiscal year, allocating the necessary resource for e-procurement implementation, and improving understanding of the regulation across line ministries and Satkers. Streamlining the objection-and-appeal procedure (e.g., increasing the deposit for submitting an objection and introducing clear limits on the number and duration of appeals and objections) can also help. Finally, linking performance of the procurement committee members to Key Performance Indicators (KPIs) can provide incentive for the committee to improve their performance.

In addition, expediting the finalization of government regulation on land acquisition in order for the newly approved law (Law 2/2012) to be effective is critical in enhancing land acquisition process which has been the main bottleneck in infrastructure project implementation.

In the medium term, efforts to accelerate budget execution should be part of broader Public Financial Management (PFM) reforms

In the medium term, efforts to improve budget execution should be closely aligned with the ongoing broader PFM reforms including the implementation of Performance Based Budget (PBB) and Medium Term Expenditure Framework (MTEF). To this end, one of the important elements is providing increasing authority to line ministries (Echelon 1 officials) to deal with DIPA revisions within the activity level. This can speed up budget preparation and implementation through strengthened ex-post control and audit. Therefore, current detailed input-based budget appropriation by Parliament is no longer in line with the current reforms towards performance-based budgeting, suggesting that budget appropriation (approval by parliament) should be at a more aggregated level. In addition, efforts should be made to gradually discontinue the practice of using blocked DIPA (*bintang*) or conditional budget approval.

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK



1. Investing in Indonesia's roads

Reliable and accessible road infrastructure are important for economic growth and poverty reduction, as the Government of Indonesia strongly recognizes

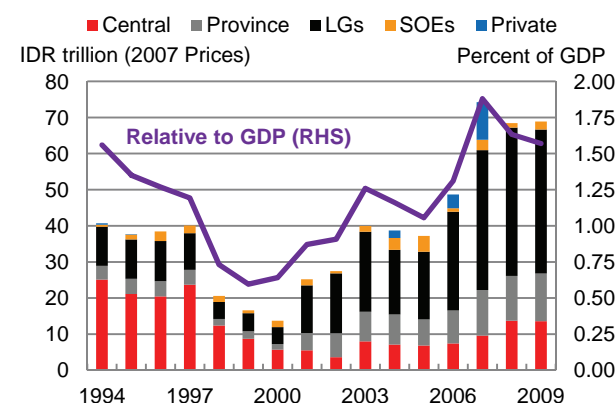
Road vehicles are the predominant mode of transport in Indonesia, accounting for 70 percent of freight ton-km and 82 percent of passenger-km. Roads play a critical role in facilitating inter-urban passenger movements, in linking communities and markets, and in sustaining the country's international competitiveness. Roads, and other transport modes, can also help poverty reduction progress and provide access to education and health services, particularly in rural areas. The Government recognizes this importance and improved road infrastructure is one of the focuses of the Master Plan for Acceleration and Expansion of Indonesia Economic Development (*MP3EI*), which provides the basis for supporting the connectivity agenda. This section outlines the current state of Indonesia's road network, the levels of investment and potential ways to support improved performance of the sector going forward.⁹

a. Under-investment, undersupply and deterioration in quality

Indonesia's investment in roads has returned to the pre-1997/1998 financial crisis level after a sharp decline in late 1990s...

After a steep decline in the late 1990s road investment returned to the pre-1997/1998 financial crisis level of 1.6 percent of GDP (Figure 37), although overall infrastructure investment has only partially returned to pre-crisis levels. The public sector has historically been the major player in road sector investment and the recovery in road investment has been largely dominated by district governments, following the implementation of decentralization in 2001. Private sector and state owned enterprises (SOEs) contributions have historically been small and only concentrated on a few toll road developments.

Figure 37: After a steep fall, Indonesia's investment in roads has only now returned to pre 1997/1998 crisis levels ... (IDR trillion 2007 prices; total as percent of GDP)



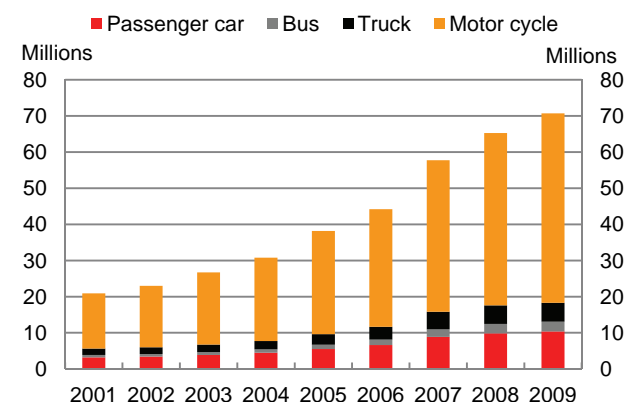
Note: SOE: state-owned enterprise; LG: local government
Source: Ministry of Finance (processed) for central and sub-national governments; annual reports for state-owned enterprises; World Bank PPIAF (Public-Private Infrastructure Advisory Facility) database for private investment

⁹ This section draws upon the forthcoming World Bank publication *Investing in Indonesia's Roads: Improving Efficiency and Closing the Financing Gaps*. For an overview of overall infrastructure investment in Indonesia, please see June 2011 *IEQ*.

....but this level of investment no longer keeps pace with increasing traffic demand and growth

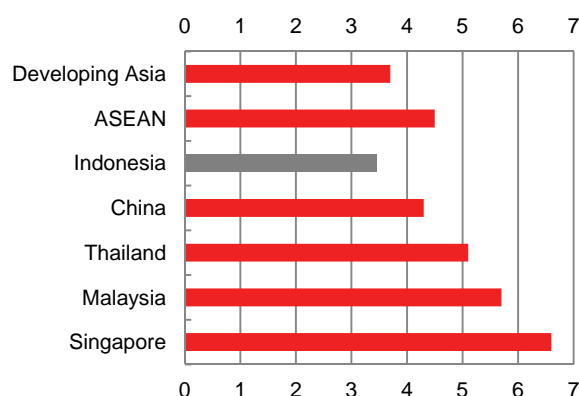
The current level of road investment no longer keeps pace with rapid increases in traffic demand and is inadequate to address a decade of maintenance backlogs. The total vehicle fleet has increased threefold between 2001 and 2010 and is projected to continue increasing for the foreseeable future. The number of passenger cars, buses, and trucks registered rapid growth of above 20 percent annually between 2005 and 2010 (Figure 38). However, the national road network that serves more than one third of vehicle traffic (in vehicle-km) only grew by a quarter during the same period. Furthermore, the availability and quality of Indonesia's road infrastructure lags those of some regional peers, and trip times are longer (Figure 39 and Figure 40). The demographic road density (2.0 km per 1,000 people) and spatial road density (200 km per 1,000 km²) are below average when compared with regional and international benchmarks.

Figure 38: ... but no longer keeps pace with increasing traffic demand and growth
(number of vehicles, million)



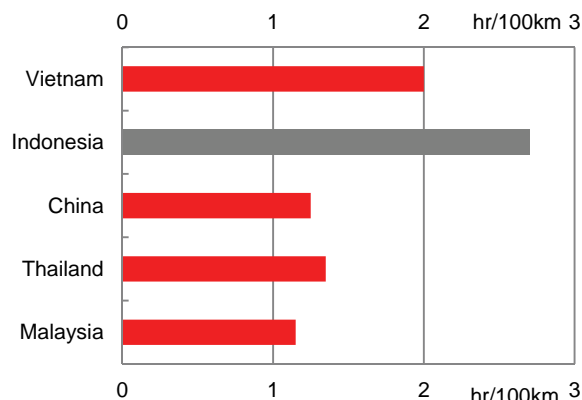
Source: BPS

Figure 39: ...which led to a deterioration in road infrastructure and services
(Quality of road infrastructure index, 2010-2011)



Source: World Economic Forum Global Competitiveness Report 2010-2011

Figure 40: ...and higher transport cost in term of trip time
(average trip time, hour per 100 km, 2010-2011)



Source: World Economic Forum Global Competitiveness Report 2010-2011

The condition of the road network is particularly poor at the district and city level and needs to be properly maintained and expanded

In 2009, the total length of the classified road network in Indonesia was reported to be 477,079 km (Table 12). This excludes non-engineered village roads (*jalan desa/lingkungan*) in the order of 244,000 km. It is important to note that national roads have the highest network utilization (vehicle-km/year) of 34 percent, although they represent only 8.8 percent of total road network. The utilization of district/city roads is at 33 percent even though they account for nearly 80 percent of the network. On quality, the national roads are classified as mostly in good condition, while sub-national roads are largely in bad and poor condition.

Table 12: The state of Indonesia's road network, 2009

	Length (km)	2 lane equivalent (percent of total)	Paved (percent of total)	Good & Fair Condition (percent of total)	Bad & Poor Condition (percent of total)	Asset value (percent of GDP)	Network Utilization (percent of total vehicle km per year)
National	38,570	8.8	91	86	14	2.8	34
Provincial	48,691	9.7	81	63	27	2.3	19
District/city	384,810	79.9	55	43	57	10.1	33
Jakarta	6,266	1.3	79	64	36	0.3	10
Toll	742	0.3	100	96	4	0.1	4
Total	477,079	100	61	54	46	15.6	100

Sources: DGH-Ministry of Public Work, BPS, and World Bank staff estimates using RNET

b. National roads are in good condition, but heavily congested

National roads, including tolled expressways, are mostly well maintained, but traffic congestion is prevalent

National road condition has improved in recent years. About 86 percent of national roads are currently in good condition, which is well above the developing country average of 70 percent. This improvement in national road condition reflects a recent emphasis on national road maintenance. However, there has been only a marginal increase in new road construction. As a result, there is a strong concentration of traffic in the urban centers and on the regional roads and road travel speeds are consequently relatively low, in the order of 40 to 45 km/hr on many national routes. Overloaded vehicles on regional main roads are prevalent due to the low level of enforcement, while the extent of damage is exacerbated by ineffectual vehicle inspections, and poor vehicle maintenance. Progress with expressway and toll road development has been exceedingly slow. By 2010, only 742 km of toll roads had been constructed and become operational even though the first toll road development was back in 1978. This is less than a third of the estimated needs of 2,400 km according to the Ministry of Public Works' Strategic Plan and lags well behind several countries in the region in terms of expressway density (km/1,000 population). The implementation of toll road development under PPP (Public Private Partnership) has continued to be constrained by a complex land acquisition process, weak project preparation and selection, as well as the absence of an efficient toll roads viability gap funding mechanism.

Central government spending on national roads has sharply increased recently

Central government spending on national roads has almost tripled in real terms between 2005 and 2011 (Figure 41). Spending on national roads represents about 60 percent of the central government's transport spending (on all modes). In 2009, the significant increase reflected the additional spending for fiscal stimulus in an effort to contain the impact of the 2008 global financial crisis. Further, a sharp decline in 2010 was partly due to ongoing budget execution challenges (see Part B for further discussions). In 2011, budget allocation increased significantly reflecting the Government's priority to address the infrastructure development gap which is in line with the RPJMN 2010-2014.

Despite the recent sharp increase, spending on new national road construction is still critically needed

Given the growth in traffic demand and medium term development targets, increased investment in new national road construction with appropriate standards is required. During the period 2005-11, the national road network was mostly extended through the re-classification of 8,000 km of main roads, especially through betterment¹⁰ (minor widening) interventions to improve sub-standard roads considered strategically important. On the other hand, the current level of spending on national road maintenance is sufficient if spent efficiently and close to the estimated needs of IDR 6.9 trillion.

Both new construction and maintenance could be done more efficiently. First, expanding the national current network through reclassifying roads as national or special roads and devoting most of the budget to limited betterment and incremental widening of existing

¹⁰ In Indonesia, "betterment" typically involves the base course strengthening, minor widening, providing a new asphalt wearing course, and improving drainage. In most cases, the road already has an asphalt pavement.

roads will not accomplish the development of a high standard arterial network that best meets the needs of the economy. Second, unit costs for national road maintenance in Indonesia are relatively high when benchmarked against international norms. While many countries have now contracted out most of their routine maintenance works, Indonesia still uses the force account (in-house) approach. The fragmented (small size) procurement packages also contribute to higher administrative costs and inefficiency, and create disincentive for the private sector to participate.

Figure 41: Central government spending on national roads almost tripled in real terms between 2005 and 2011 (IDR trillion 2007 prices)

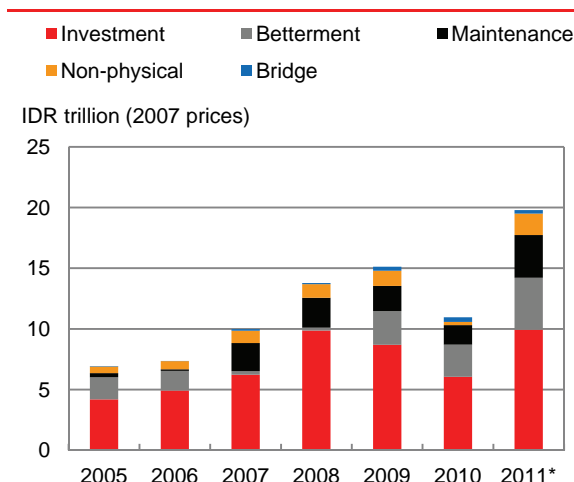
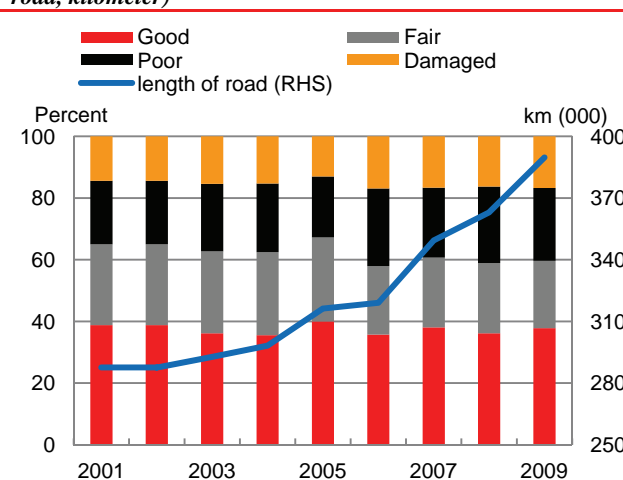


Figure 42: The share of district roads in good condition has been supported by new construction (district road condition, percent of total roads; total length of road, kilometer)



Source: Ministry of Finance, Ministry of Public Work, World Bank staff estimates

Bank staff estimates

Note: * 2011 figures are for budget allocations

c. Sub-national roads condition has deteriorated due to maintenance backlog

Lack of maintenance of sub-national roads is a serious concern as new development takes priority over maintenance

Following the transfer of responsibility to manage sub-national roads with decentralization in 2001, provincial and district/city spending on sub-national roads has more than tripled in real terms from IDR 18 trillion in 2001 to IDR 53 trillion in 2009. This rise in spending has mostly translated into significant increases in district road networks. However, district road conditions have deteriorated, with slightly declining percent of roads in good condition being supported by the new construction (Figure 42). These significant increases in the length of district/city roads are partly driven by local political preference for new construction over maintenance and a proliferation of new districts after decentralization, which has led to fragmented and weak institutions managing sub-national roads.

Closing the financing gaps to address sub-national road maintenance backlogs would require doubling the current spending levels

Provincial and district/city governments currently allocate about IDR 14.9 trillion, less than half of their estimated needs for road preservation of around IDR 32.5 trillion, hence the annual funding gap is IDR 17.6 trillion. To improve the percent of sub-national roads in fair and good condition from 63 percent to 86 percent would require doubling the current spending level which includes overall road network integrity, including rehabilitation works to bring damaged roads to a maintainable condition during the first five years.¹¹ Furthermore, the opportunity cost of neglecting road maintenance is high. It is estimated that for every IDR 10,000 spend on road maintenance, IDR 46,000 in road user cost savings are generated. Therefore it is important to close the funding gap that has opened up and to eliminate the backlog of sub-national road maintenance.

¹¹ These preservation needs are generated from the World Bank's Road Network Evaluation Tool (RONET), see *Investing in Indonesia's Roads: Improving Efficiency and Closing the Financing Gaps*.

d. Towards improved roads infrastructure performance

The capacity of the national road network should be expanded only by following appropriate road capacity standards

The current policy of expanding the national network through reclassifying provincial roads as national or special roads and devoting most of the budget to limited betterment and incremental widening of existing roads is not optimal and will not accomplish the development of a high standard arterial network that will best meet the needs of the economy. The long term need for national road development is road expansion to 4-lane divided standard and a separate integral expressway network where appropriate.

The efficiency of national road maintenance can be improved by phasing out force accounts and gradually moving towards performance based contracts, and increasing the average size of procurement packages,

Phasing out force account and moving towards performance-based contracts (PBC), could further improve efficiency through competition.¹² A successful approach in other countries has been to encourage force account units to become small contracting firms. Initially such firms are given special support and are guaranteed work for the first few years, but eventually they have to become fully competitive contractors. Some of these firms continue to expand and eventually can handle large-scale projects. Extending road preservation activities from annual to multi-year programs and increasing the average size of road maintenance procurement packages could reduce administrative cost and improve efficiency as well as create incentives for the private sector to participate.

Given the urgency to address congestion and the slow progress with Public Private Partnerships (PPPs) implementation, the Government may need to step up public investment while addressing constraints to PPPs

To accelerate highways development as outlined in the Ministry of Public Works' strategic plan, the Government may need to step in and increase public investment in highways, particularly in low traffic volume sections and outside Java routes. At the same time, addressing factors that constrain PPP implementation is also critical. Improving PPP project selection and preparation by involving key related institutions (such as the Ministry of Finance) and providing adequate fiscal support through a viability gap assessment is critical for successful implementation. Focusing on the most strategic and viable PPP projects and getting them transacted can be a powerful way to demonstrate government commitment to PPP implementation (for a further discussion on PPPs please see the October 2011 *IEQ*).

To address district/city road maintenance backlogs, a new institutional and funding mechanism is proposed

Higher priority should be given to resolving the district/city roads maintenance backlog and fragmented and weak institutional capacity. One possible option is to integrate district/city road planning and management at the provincial level to increase regional coordination and benefits from economies of scale, and to address the technical and managerial capacity issue without undermining local decision-making authority. Districts could delegate the management of all or part of their road networks using a contract management approach. The funding for this maintenance could potentially be secured through earmarking of the road-related user charges (RUCs), which include the annual vehicle license fees (PKB), vehicle transaction/transfer fees (BBNKB) and the fuel levy (PBBKB). Should these RUCs be allocated entirely to maintenance, it is estimated that about 90 percent of the maintenance needs can be met. Earmarking may have its own challenges such as reducing budget flexibility, but in this case, there is an argument to be made that the benefit incidence principle applies more and those who benefit from the roads should pay more for its maintenance.

¹² In a traditional contract, the contractors are paid for the amount of work completed. Under a performance-based contract, the contractor works on a lump sum basis, usually receiving annual payments for meeting contractually binding performance requirements. International experience shows that PBCs can deliver higher quality results, often for a lower price.

2. The role of the global marketplace in enhancing domestic competitiveness

How can the global marketplace for goods and investment play a role in enhancing the performance of Indonesia's private sector?

Indonesia has the potential to move to a higher level of growth through leveraging its natural resource endowments, growing domestic market size and enhancing the skills of its growing workforce. To turn potential into reality the Indonesian private sector needs to ramp up investment, to improve competitiveness, and to become more efficient. To what extent can global inter-linkages be harnessed to help achieve these objectives? Using firm- and sector-level data from the Indonesian manufacturing sector, this section analyzes the linkages between domestic economic performance and three aspects of international linkages - foreign direct investment, access to imports, and access to export markets.

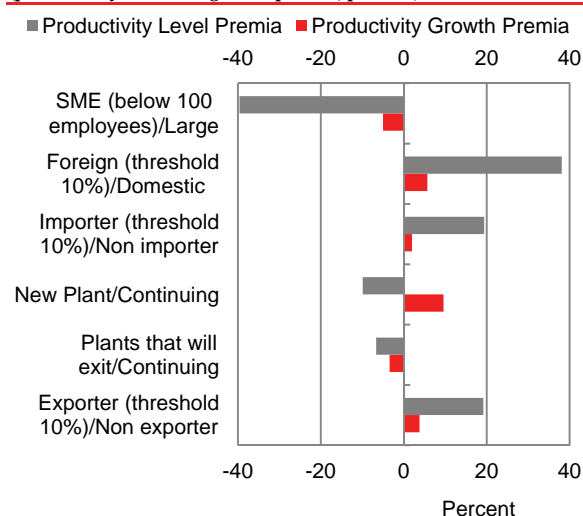
a. Some evidence on how greater integration can help improve productivity

Using firm-level data of Indonesian medium and large manufacturers, evidence suggests that greater integration is associated with better performance...

Given the diverse nature of firms, detailed information about their characteristics is crucial to identify how one particular element, such as, in this case, their degree of integration in the global marketplace, can affect their performance.¹³ The comparison of performance indicators between firms that are more globally integrated and those that are not, but operate in the same industry, and are located in the same province, can provide preliminary information on the potential benefits of integration. In this analysis the focus is on a firm's total factor productivity (TFP), a measure of the efficiency with which inputs are transformed into output, and its rate of growth.

In Indonesia, firms that are either exporters, users of imported inputs or foreign-owned tend to perform better than those firms which are less integrated. For example, exporters and firms that use imported materials are, on average, 19 percent more productive than non-integrated plants – while foreign-owned plants are 38 percent more productive than their domestic counterparts (Figure 43).

Figure 43: Indonesian firms that are integrated into the world economy have performed better (productivity level and growth premia, percent)



Note: The premia is the percentage difference between productivity levels and growth for plants with the listed characteristic relative to those without that characteristic, after controlling for a firm's industry and province and the year. Foreign plants are those that have at least 10 percent of foreign ownership; importer/exporter are plants that respectively import/export at least 10 percent of their output; exiting plants are those that will stop producing during the coming 2 years; and new plants are those that have been created in the past 3 years

¹³ The analysis in this section relies on data from the annual BPS Indonesian Census of Manufacturing conducted. The Census surveys all registered manufacturing plants with more than 20 employees, and contains detailed information on plants in the formal manufacturing sector including output, inputs, labor, capital, imports, exports, and foreign ownership. While the unit of analysis in the Census is the 'plant', in this piece, however, 'plant' and 'firm' are used interchangeably. The data available are for the period 1990–2009 and contain more than 420,000 plant observations.

...and improving performance over time

The relative out-performance of more integrated firms is also seen in their performance over time. For example, productivity growth for exporters has been on average 3 percentage points faster than for non-exporters over 1990 to 2009; for firms with foreign owners it has been about 6 percentage points higher than for domestic firms; and for users of imported inputs it has been 2 percentage points higher than for those that rely only on domestic inputs. These premia suggest an association between integration and performance, but they cannot determine the direction of causality. It is likely that firms that performed better in the first place were the ones that succeed in entering export markets, that ventured into using imported inputs, or that attracted foreign investors. However, as outlined below, there is substantial evidence pointing to greater integration as an important force affecting productivity in Indonesia (see Box 4 for some case study evidence).

Box 4: Do local manufacturing firms benefit from greater integration? Some case studies from Jakarta and Surabaya

Local firms can benefit from the presence of foreign-owned firms through business interactions which transfer knowledge, skills and practices. Indeed, anecdotal evidence provides examples of such interactions which have contributed to increased knowledge capacity, improvement in product quality, and increase in sales volume.

For example, a domestic producer of metal components for Japanese automotive firms highlighted the substantial benefits received from the interaction with its foreign-owned clients. The Japanese firms operating in Indonesia provided support during several free consultations, as well as auditing activities, which were conducive to improvements in product design and quality. More importantly, the producer claimed that the new knowledge acquired by the local firm improved the quality of inputs sold to other customers (both local and foreign). In addition, the new knowledge gained by the local firm helped it to gain market shares and enter new markets.

Other examples point to improvements in product quality and standards by some Indonesian manufacturing firms due to their interaction with foreign clients as well as with suppliers of imported inputs. For example, two resource-based manufacturers (one in the coffee processing sector, another in the fish industry) claim that their interactions with foreign clients involved in exporting helped them to introduce better quality and sanitary standards. The fish producers, for example, pushed by strict sanitary standards abroad, and encouraged by free training provided by their foreign clients improved the standards in all their production processes. For the coffee producer, suppliers provided training on how to operate a sophisticated imported coffee processor, which led to an improvement in the quality of the final product.

Meanwhile, increased competition from foreign products can also motivate local firms to innovate to produce better products for customers. For example, a large local household and electrical appliances producer based in Surabaya reported that competition with Chinese producers encouraged them to be more creative, which led to the development of a customer service unit, providing quality after-sales services. This proved to be effective in maintaining market share, by differentiating their product from competitors.

b. The importance of FDI for enhancing Indonesia's productive capacity**The importance of FDI in the Indonesian economy has increased over the past two decades,...**

Foreign-owned plants accounted for 41 percent of total output in 2005-9, up from 23 percent in 1990-94. Over the same period, their share of exports rose from just above 25 percent to 50 percent. In some industries it is even higher. For example, in 2009, plants with foreign equity accounted for over 75 percent of exports in 8 of 21 manufacturing industries and over 50 percent of exports in a further 5 industries.

...is likely continue to rise...

Recent BKPM data suggest that in the first quarter of 2012, foreign investment realization in manufacturing reached USD 5.7 billion, a 30 percent increase year on year. As outlined in the June 2011 *IEQ*, these increased FDI inflows have been driven by relatively low labor costs, the availability of key natural resources and a large and growing domestic market, reflecting favorable demographics, high GDP per capita growth, and a rapidly growing middle class. However, the attractiveness of Indonesia for FDI inflows could be further enhanced by addressing weaknesses in terms of infrastructure and skills, and by improvements in the business environment, which are also necessary, if the full benefits of the FDI are to be gained.

...and can potentially bring a number of important benefits to the domestic economy

FDI can play three crucial roles in supporting Indonesia's development in terms of financing of investment, facilitating the opening up of export markets, and boosting productivity, helping the country move up the value chain. Foreign sources of financing are likely to be crucial to help meet the targeted increases in physical capital investment that Indonesia needs. Although it is possible to design policies to stimulate higher saving rates domestically, these could have the unintended consequence of choking off domestic demand. Within foreign financing, FDI is regarded as the most attractive source of longer-term funding given its relative stability and the other potential benefits it may bring.

Foreign-owned plants tend to exhibit higher efficiency and can play an important role in improving domestic competitiveness

As mentioned above, foreign-owned plants in Indonesia's manufacturing sector tend to be more efficient than domestically-owned plants. On average, they have a 39 percent higher TFP, and 122 percent higher labor productivity, than domestic plants in the same industry. One reason for this is that, due to their larger size, they are better positioned to reap the benefits of scale economies. Their use of imported inputs and a more capital intensive production process also tends to make them more export-oriented than their domestic counterparts and they tend to have a larger volume of exports per product. Although they do not seem to employ a much higher proportion of skilled labor, they do spend more on training and R&D both in absolute and per worker terms – important factors for improving competitiveness. Moreover, foreign producers are less likely than Indonesian producers to report problems such as access to finance and raw materials and with marketing.

Foreign-ownership can help generate productivity gains within the firm...

Research also shows that foreign ownership leads to significant productivity improvements in the acquired plants. For Indonesia, a recent study of foreign acquisitions during 1985-99 established a causal effect of foreign ownership on productivity. The increases in productivity became visible in the acquisition year and continued in subsequent periods. After three years, the acquired plants had productivity levels 13.5 percent higher than a comparable "control" group of domestic firms. The rise in productivity was a result of restructuring, as acquired plants increased investment outlays, employment and wages.¹⁴

...and for other firms through technology spillovers

Furthermore FDI is a potentially important channel for international technology diffusion. In this way productivity gains are not restricted to the multinational itself, but may spillover to other firms that directly or indirectly interact with it. This may occur in a number of ways. For example, firm-specific technology is likely to be transferred from multinational parents to domestic subsidiaries and there is also likely to be beneficial technological knowledge transfer to domestic firms that interact with multinationals either by supplying or buying inputs (vertical spillovers), or by competing with them (horizontal spillovers).

Firms with skilled labor and R&D capacity benefit the most from these spillovers...

Indeed, in Indonesia, FDI has been found to improve the productivity of manufacturing establishments supplying inputs to multinationals (by over 2 percentage points in a number of industries) although the gains do not accrue to all suppliers equally. Firms that have the necessary learning capacities, such as a skilled labor force and active R&D programs, benefit the most. In addition, the productivity gains achieved by suppliers to multinationals can also lead to reduced input prices, which are of benefit to other uses of these inputs beyond the multinational firm.¹⁵

... and facilitating interactions between local and foreign-owned firms is key to achieving effective knowledge transfers

Furthermore, becoming a supplier to multinational can be a challenging process. For example, many foreign firms often require their prospective suppliers to improve their products or processes prior to signing contracts. This is why firms that become suppliers to multinationals are generally already high-performers. Facilitating the interactions between foreign-owned and locally-owned firms can therefore play an important role in helping to promote the beneficial knowledge transfers highlighted above.

¹⁴ The study established the causal link between foreign ownership and productivity by pairing up each Indonesian plant that was going to receive FDI in the subsequent period with a domestic plant with very similar observable characteristics operating in the same sector and year and then comparing their productivity performance. For more details, see Arnold and Javorcik (2009), "Gifted kids or pushy parents? Foreign direct investment and plant productivity in Indonesia", *Journal of International Economics*, 79(1), pp. 42-53.

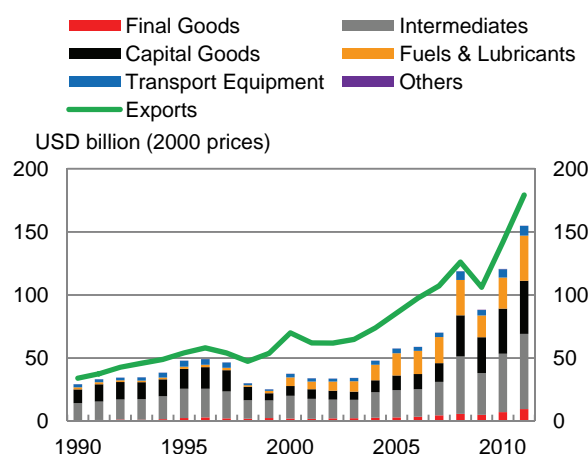
¹⁵ Blalock, G. and P. Gertler (2008), "Welfare gains from Foreign Direct Investment through technology transfers to local suppliers", *Journal of International Economics*, 74(2), pp. 402-421, and Blalock, G. and P. Gertler (2009), "How firm capabilities affect who benefits from foreign technology", *Journal of Development Economics*, 90 (2), pp. 192-199.

c. Imports as instruments to facilitate innovation and promote competition

Indonesia's imports of intermediates and capital goods, and exports, have accelerated in recent years

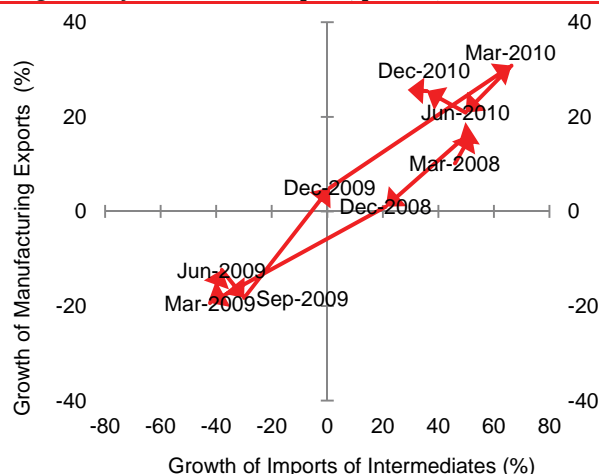
As with many other countries, Indonesia's imports, and exports, have seen strong growth over the past two decades. For the period 1990-2011, annual growth rates for imports (in constant US dollars) have averaged 11 percent, increasing to 19 percent over 2000-2011. A closer look at the composition of imports indicates that intermediates and capital goods, some of which will be used as inputs in the production of exports, account for the largest (and growing) share of Indonesia's imports (Figure 44). In 2010, for example, these two components amounted to 70 percent of total imports (and roughly explained the same proportion of its growth), compared with only 6 percent for consumer goods. The remaining 24 percent was accounted for by imports of transport equipment and other goods.

Figure 44: Imports have been on the rise, driven by expansions in intermediate and capital goods imports
(Indonesian imports of goods, broad economic classification, USD billion 2000 prices)



Sources: Comtrade, WITS

Figure 45: The relationship between intermediate imports growth and export growth is very strong
(year-on-year growth of USD value of manufacturing exports and growth of intermediates imports, percent)



Sources: Comtrade, WITS

The increasing importance of global production networks, combined with price, quality or variety advantages, partly explain why firms in Indonesia opt for foreign intermediates and capital goods

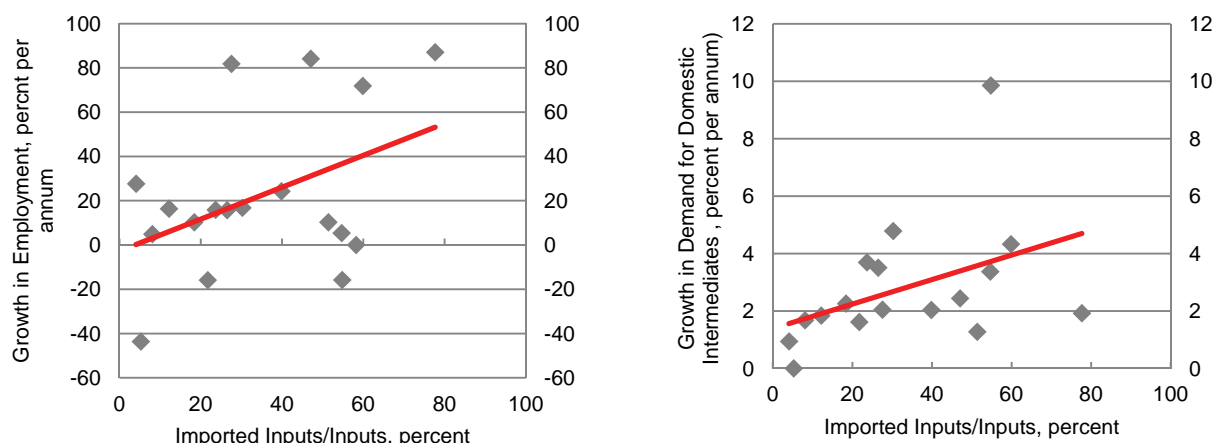
Firms may import intermediates or capital goods because they are cheaper, of better quality or simply because there are no domestically-produced versions of the same input available. However, global value chains, in which multinational firms "slice" production processes and carry out each part wherever the necessary skills and materials are available at competitive costs, also seem to play an important role in the rise of intermediate and capital imports. First, it is among multinational firms where the use of foreign inputs is the highest, with its share of total inputs reaching 37 percent, compared to only 6 percent among local firms (2009 data from BPS). Second, if global value chains do account for an important part of intermediate inputs, one would expect to see a strong link between the growth in imports of intermediates and export growth. This is indeed apparent (Figure 45 illustrates this relationship by focusing on 2008-2010, a period of sharp changes in trade flows). The sharp deceleration of imports of intermediates was accompanied by a sharp deceleration of export growth, reflecting the heavy reliance of many exporters on imported components. These linkages between exports and intermediate imports highlight the potential for restrictions on imports to affect export competitiveness, given that for each dollar exported by Indonesians, 20 cents correspond to imported components.

Sectors that use a larger portion of imported intermediate goods are also those in which demand for domestic intermediate goods increased the most

Figure 46 and Figure 47 look at the relationship between the relative intermediate imports of a sector against its growth in employment and in demand for domestic intermediate goods. While some firms or domestic sectors may face pressures from import competition, it is notable that these relationships suggest that sectors relatively reliant on imported intermediaries have been the ones providing greater employment growth and demand for domestic producers of intermediate goods.

Figure 46: Sectors that imported more of their inputs have generated more employment... **Figure 47: ...and have increased demand for domestic intermediates faster**

(employment growth across sectors in manufacturing, percent per annum; share of imported inputs in total input bill in manufacturing, percent) (growth of demand for domestic intermediates growth, percent per annum; share of imported inputs in total input bill in manufacturing, percent)



Note: Shares of imported inputs to total inputs are sectoral averages in 2005 for the manufacturing sector. Sectoral growth in employment is for the period 2000-2005

Source: BPS and World Bank staff calculations

Sources: BPS and staff calculation

Increased import competition can also encourage better performance of domestic producers

Increased competition from foreign products can also stimulate improvements in the allocation of resources, improvements in productivity levels and incentives to invest and innovate (Box 5 provides anecdotal evidence). For example, goods that were successfully produced and exported by Indonesian firms and at the same time faced import competition domestically were 15 percentage points more likely to survive in export markets than those that were not subject to import competition.

Box 5: The potential benefits of input quality and variety for manufacturing competitiveness

Research suggests that imported inputs have played a key role in improving performance in the Indonesian manufacturing sector. A study based on Indonesian manufacturing census data from 1990-2001 by Amiti and Konings (2007) found that a 10-percentage point fall in input tariffs led to a productivity gain of 12 percent via learning, quality and variety effects. This gain was at least twice as high as the gains from reducing output tariffs that may arise via tougher competition effects.

Affordable imported inputs can also raise productivity via quality and variety effects. For example, although a fall in a tariff on inputs such as compressors may force the domestic compressor industry to become more competitive, it has quite different effects on users of these inputs, such as producers of refrigerators. Their productivity can increase as they can access the latest foreign technology embodied in imported inputs. Higher quality compressors facilitate production of higher quality refrigerators. Moreover, access to a wider range of compressors may allow producers to lower their costs by choosing the most appropriate and potentially cheaper type of compressor, which was previously not available.

Recent research on India shows similar important roles for imported inputs. According to Goldberg, Khandelwal, Pavcnik and Topalova (2008), the expansion in the number of products produced by Indian manufacturing firms during the 1990s was in part a direct consequence of cheaper, more varied, and better quality imported inputs. Tariff reductions lowered prices and increased volumes of existing imports, but they also meant access to new types of intermediate inputs from the rest of the world. These new inputs, in turn, resulted in an increase in the number of products manufactured by firms, which explained nearly a quarter of manufacturing output growth. Firms then could use the input cost savings due to trade liberalization to cover the fixed costs of entering new product lines. In addition, access to higher quality intermediate inputs and capital goods relaxed technological constraints.

Note: See Amiti, M. and J. Konings (2007), "Trade liberalization, intermediate inputs, and productivity: evidence from Indonesia", *American Economic Review*, 97(5), pp 1611-1638, and Goldberg, P. Khandelwal, A. Pavcnik and P. Topalova (2008), "Imported Intermediate Inputs and Domestic Product Growth: Evidence from India", *NBER Working Paper* 14416, National Bureau of Economic Research

d. Exporting as a means to drive productivity and growth

Exporting allows Indonesian firms to learn and innovate

Export markets can generate dynamic gains associated with faster productivity growth and innovation capacity. For example, tougher competition in export markets increases the costs of not innovating. Local firms tend to find foreign customers more sophisticated and discriminating, and to satisfy them, exporters may need to improve production processes, upgrade capital and standards, as well as train their workers. In addition, export markets can be a powerful force for product diversification.

The more trade there is with a particular market, the more information is available for new exporters, and therefore the easier it is to enter that market

Firms in developing countries face considerable fixed costs in order to enter export markets.¹⁶ Firms need to search for market information, comply with foreign standards, and understand foreign clients. Recent research shows that the overall level of trade between two countries is important in allowing new entrants to enter and survive in the export market. The expansion of exports of existing products is therefore helpful for future export growth and diversification, including for new firms to enter the existing export market. This is because the higher the export flows with a particular destination, the larger the stock of available information there is about that market, lowering the information related costs a firm faces when entering a new export market.¹⁷

As well as the potential supply-side productivity benefits of exports, they can of course support demand for domestic production

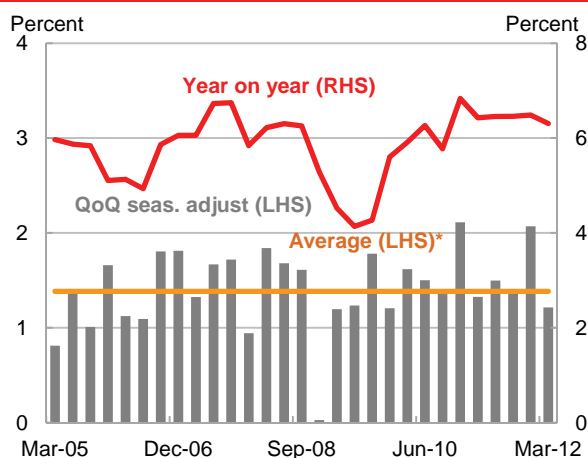
As well as providing an engine for learning and innovation, export markets have of course played a key role in increasing demand for the goods and services produced by Indonesian firms. For example, over the period 1990-2010, export growth was equivalent to 52 percent of the total growth in demand for Indonesia's goods and services (although import growth must subtracted from this to get the contribution of net external demand to growth).

As seen in the growth performance of many of Indonesia's regional peers during the global financial crisis of 2008 to 2009, greater trade openness can also bring with it the potential for growth volatility. However, recent work suggests that greater trade openness tends to reduce volatility in economies that show relatively high levels of export diversification, while the opposite happens in poorly diversified economies. In particular, it is product diversification that plays the most important role in shielding an economy from the detrimental impact of foreign shocks.¹⁸

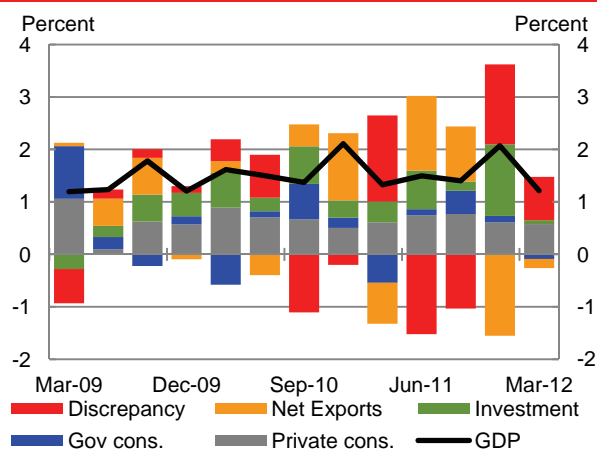
¹⁶ Brenton, P., Newfarmer, R. and P. Walkenhorst (2007), "Avenues for Export Diversification: Issues for Low-Income Countries", MPRA Paper 22758, University Library of Munich, Germany.

¹⁷ Ibid.

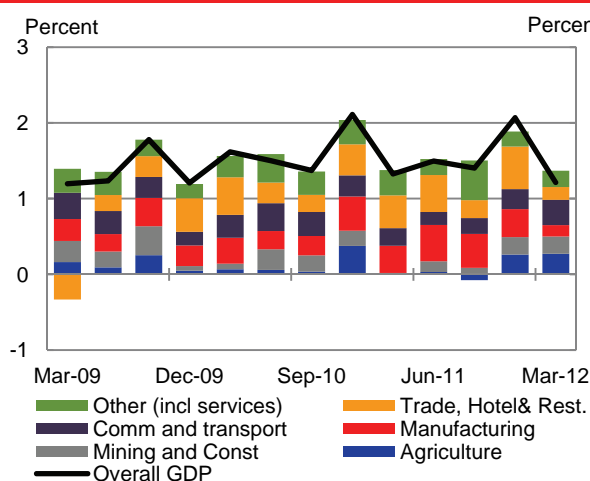
¹⁸ Haddad, M., Lim, J., Munro, L., Saborowski, C. and B. Shepherd (2011), "Volatility, Export Diversification and Policy", Chapter 11 in *Managing Openness*, Ed. Haddad, M. and B. Shepherd, The World Bank.

APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS**Appendix Figure 1: Quarterly and annual GDP growth (percent growth)**

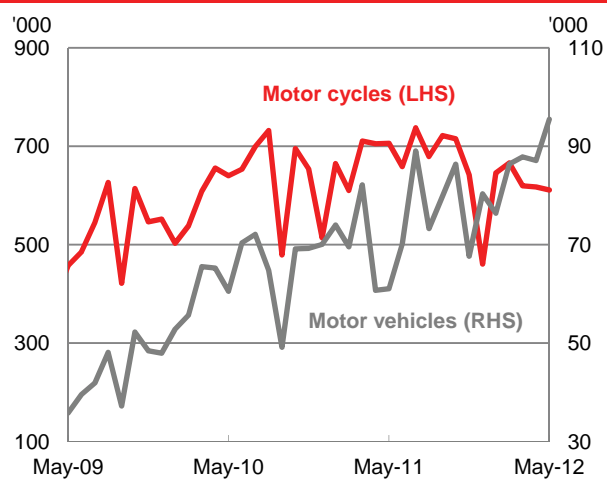
Note: *Average QoQ growth between Q4 2005 – Q1 2012
Sources: BPS, World Bank seasonal adjustment

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

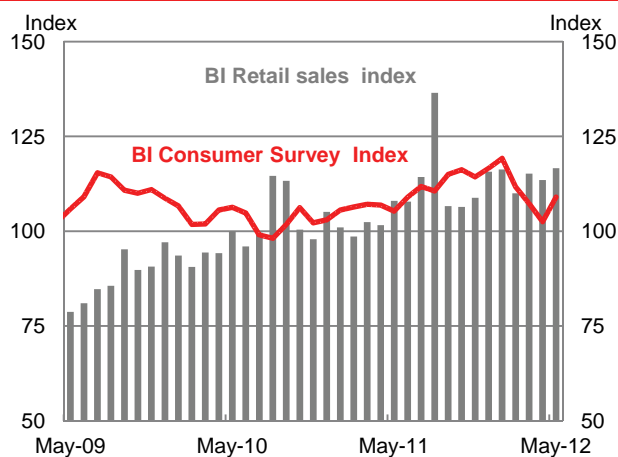
Source: BPS via CEIC and World Bank

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

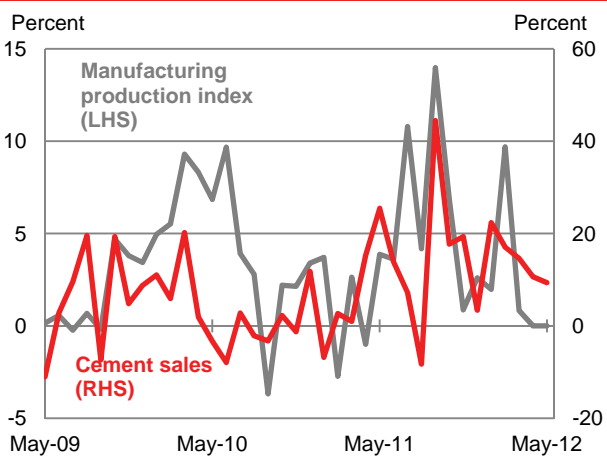
Source: BPS via CEIC

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

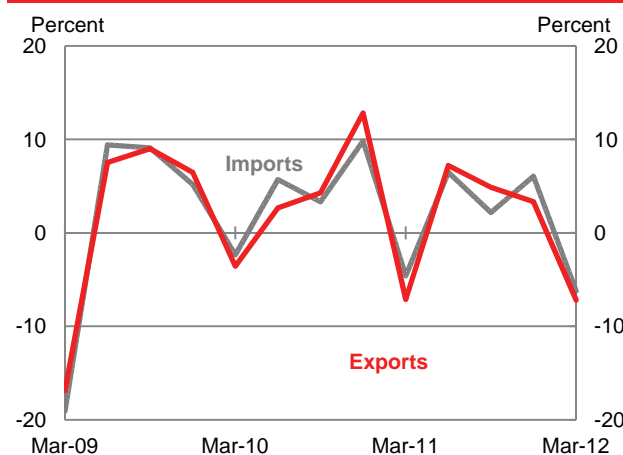
Source: CEIC

Appendix Figure 5: Consumer indicators (index levels)

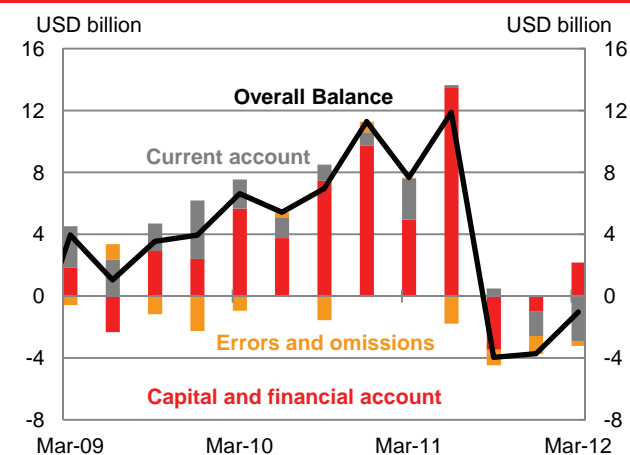
Source: BI via CEIC

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

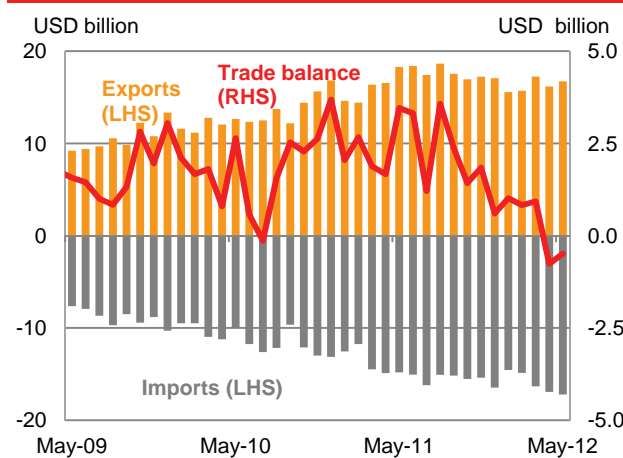
Source: CEIC

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

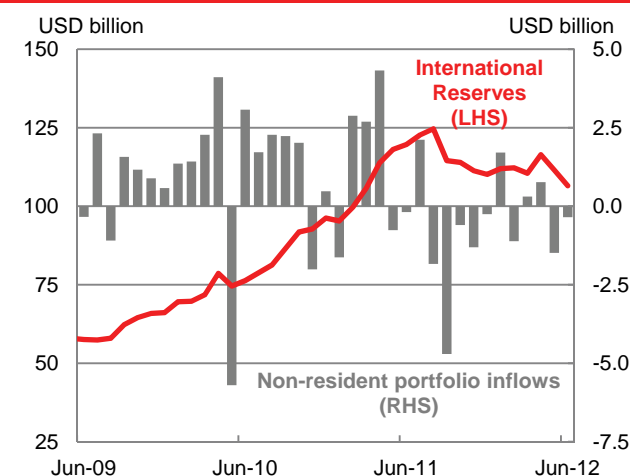
Source: BPS (National Accounts) and World Bank

Appendix Figure 8: Balance of Payments
(USD billion)

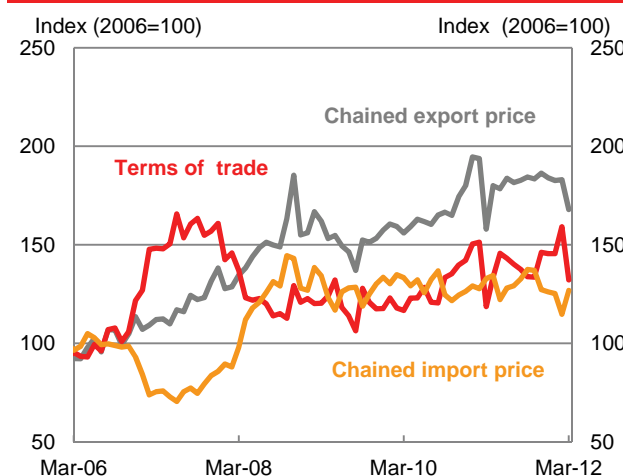
Source: BI and World Bank

Appendix Figure 9: Trade balance
(USD billion)

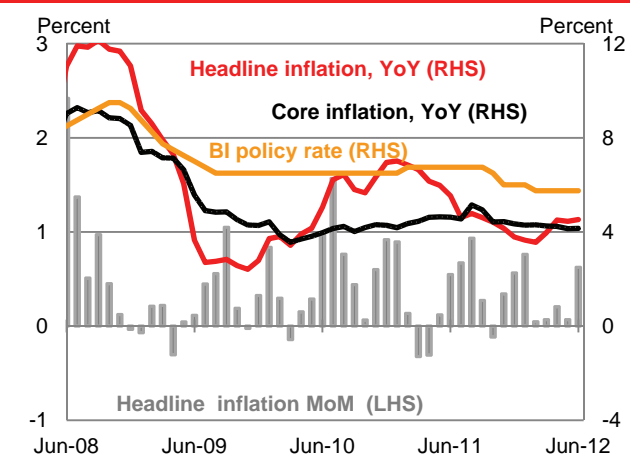
Source: BPS and World Bank

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

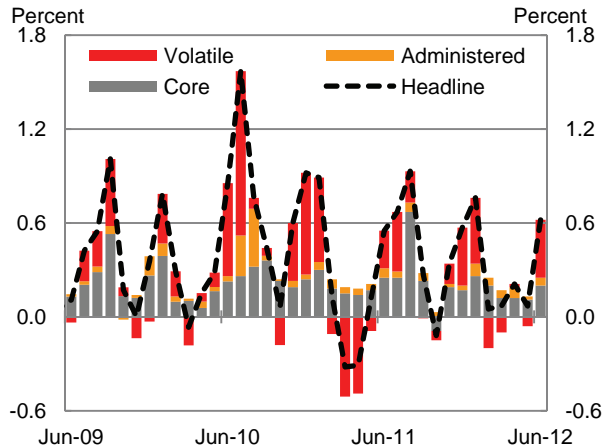
Source: BI and World Bank

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

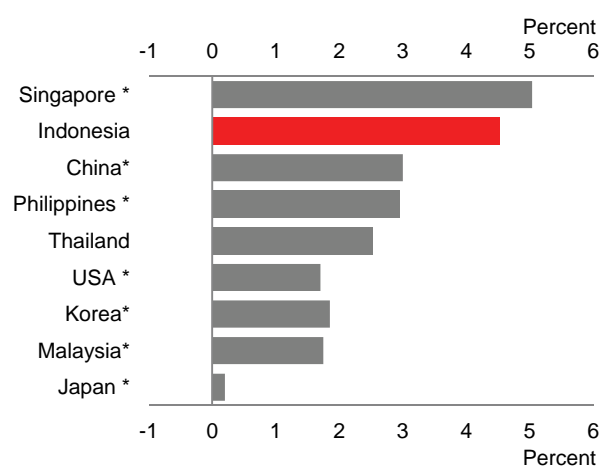
Source: BPS and World Bank

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

Source: BPS and World Bank

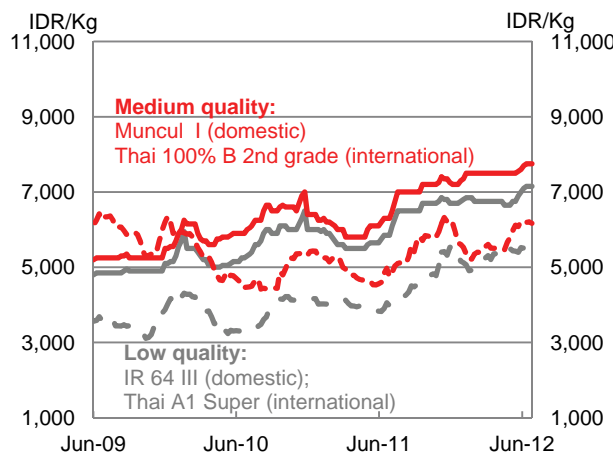
Appendix Figure 13: Monthly breakdown of CPI (percentage point contributions to monthly growth)

Sources: BPS and World Bank

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

*May is latest available month

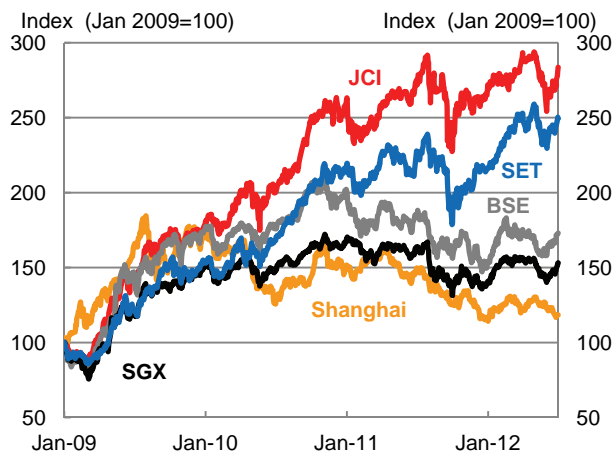
Sources: National statistical agencies via CEIC, and BPS

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

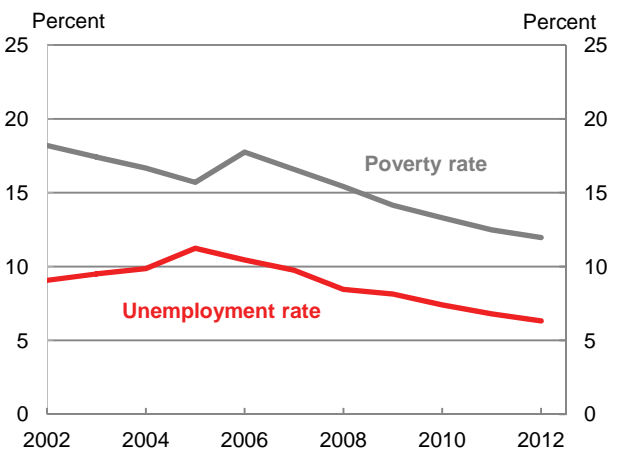
Note: Dashed: international Thai rice (cif) prices.

Solid: domestic wholesale rice

Sources: PIBC, FAO and World Bank

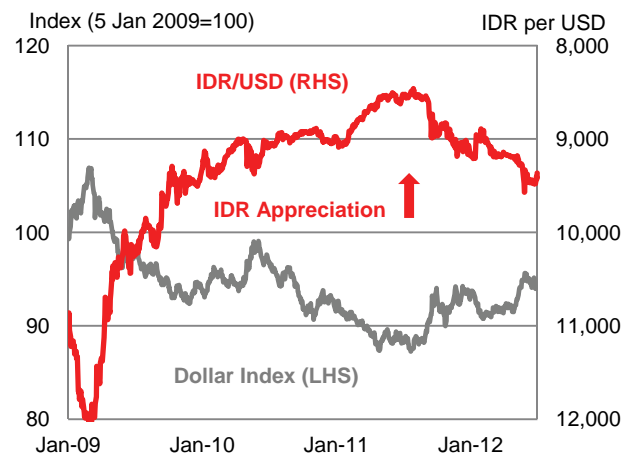
Appendix Figure 17: Regional equity indices (daily, index January 2009=100)

Sources: World Bank and CEIC

Appendix Figure 16: Poverty and unemployment rate (percent)

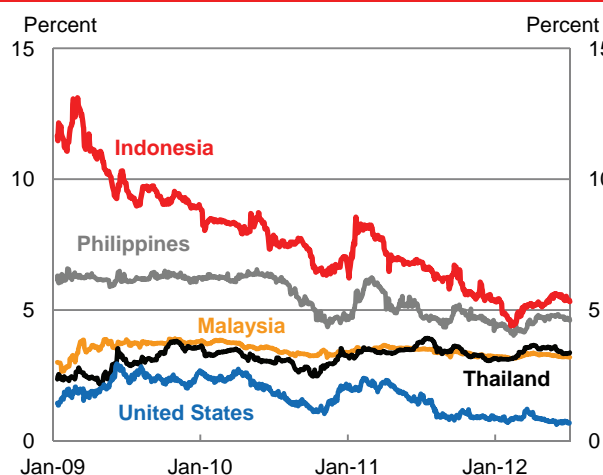
Note: Labor data from February Sakernas

Sources: BPS, and World Bank

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

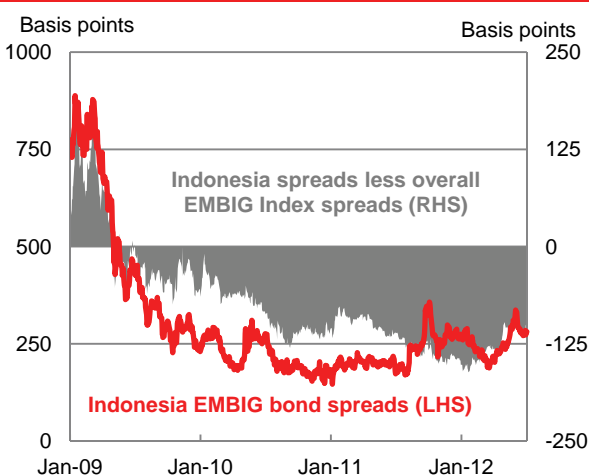
Sources: World Bank and CEIC

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



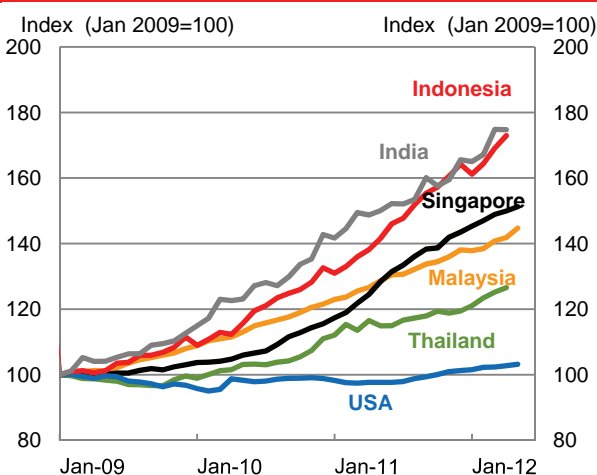
Sources: World Bank

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



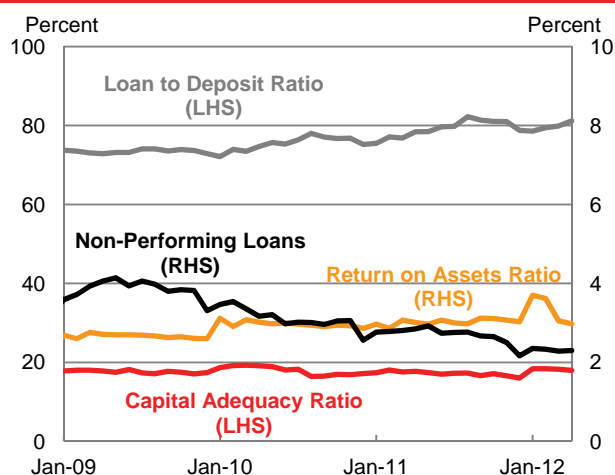
Sources: World Bank and CEIC

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



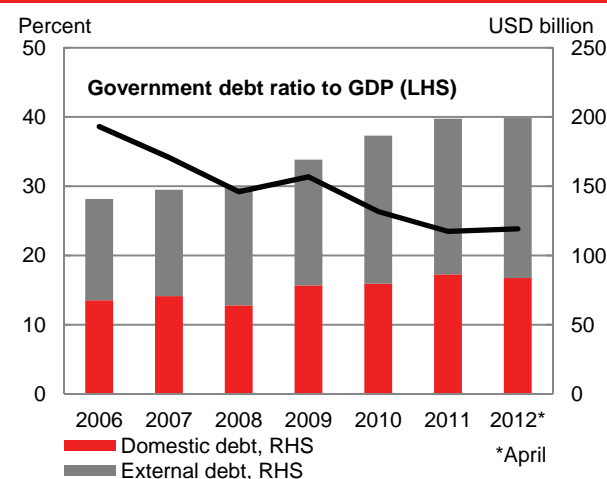
Sources: CEIC and World Bank

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



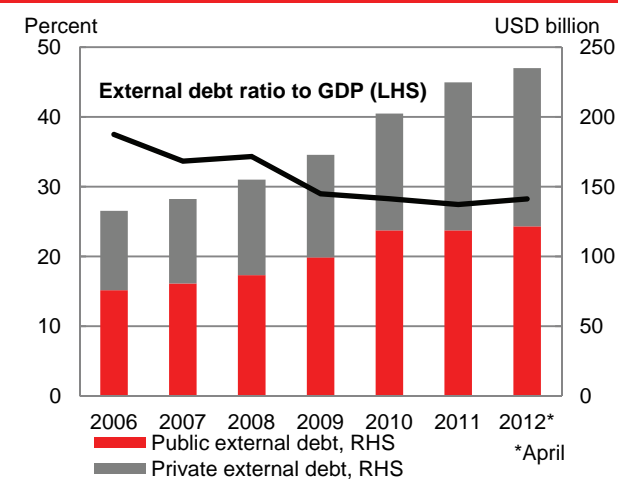
Sources: BI and World Bank

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)

	2009	2010	2011	2012	2012
	Outcome	Outcome	Outcome (Unaudited)	Revised Budget	MoF Semester I projections
A. State revenue and grants	848.8	995.3	1,199.5	1,358.2	1,362.4
1. Tax revenue	619.9	723.3	872.6	1,016.2	1,017.0
2. Non-tax revenue	227.2	268.9	324.3	341.1	344.6
B. Expenditure	937.4	1,042.1	1,289.7	1,548.3	1,553.1
1. Central government	628.8	697.4	878.3	1,069.5	1,070.8
2. Transfers to the regions	308.6	344.7	411.4	478.8	482.3
C. Primary balance	5.2	41.5	3.1	-72.3	-78.9
D. SURPLUS / DEFICIT	-88.6	-46.9	-90.2	-190.1	-190.8
(percent of GDP)	-1.6	-0.7	-1.2	-2.2	-2.3

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

Appendix Table 2: Balance of Payments
(USD billion)

	2009	2010	2011	2010		2011		2012	
				Q3	Q4	Q1	Q2	Q3	Q4
Overall Balance of Payments	12.5	30.3	11.9	7.0	11.3	7.7	11.9	-4.0	-3.7
As percent of GDP	2.3	4.3	1.4	3.7	6.0	3.9	5.6	-1.8	-1.7
Current Account	10.6	5.1	1.7	1.0	0.9	2.7	0.1	0.5	-1.6
As percent of GDP	2.0	0.7	0.2	0.6	0.5	1.3	0.1	0.2	-0.7
Trade balance	21.2	21.3	23.3	5.4	6.4	7.2	6.0	6.9	3.3
Net income & transfers	-10.6	-16.2	-21.6	-4.4	-5.6	-4.5	-5.8	-6.4	-4.9
Capital & Financial Account	4.9	26.6	14.0	7.5	9.7	5.0	13.5	-3.5	-1.0
As percent of GDP	0.9	3.8	1.7	4.0	5.2	2.5	6.4	-1.5	-0.5
Direct investment	2.6	11.1	11.1	1.8	4.4	3.5	3.8	2.0	1.9
Portfolio	10.3	13.2	4.5	4.5	1.4	3.8	5.5	-4.7	-0.2
Other	-8.2	2.3	-1.6	1.2	3.8	-2.3	4.2	-0.8	-2.8
Errors & omissions	-3.0	-1.5	-3.9	-1.6	0.7	0.0	-1.8	-1.0	-1.2
Reserves^(a)	66.1	96.2	110.1	86.6	96.2	105.7	119.7	114.5	110.1

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



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