

INDONESIA ECONOMIC QUARTERLY

Current challenges, future potential

June 2011



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THE WORLD BANK | BANK DUNIA

Investing in Indonesia's Institutions

for Inclusive and Sustainable Development

Preface

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

This Indonesia Economic Quarterly was prepared and compiled by the macroeconomic analysis team at the World Bank's Jakarta office, under the guidance of Lead Economist Shubham Chaudhuri and Senior Country Economist Enrique Blanco Armas: Magda Adriani (commodity prices), Andrew Blackman (external sector, ASEAN and FDI trends), Andrew Carter (government revenues), Andrew Ceber (executive summary, international environment, national accounts and risks), Fitria Fitriani (FDI trends), Faya Hayati (prices and risks), Ahya Ihsan (fiscal expenditures and infrastructure challenges), Kiyoshi Taniguchi (international environment) and Ashley Taylor. Additional contributions were received from Henry Sandee and Natalia Cubillos Salcedo (Master Plan and connectivity) and Neni Lestari and Djauhauri Sitorus (banking). Arsianti and Ashley Taylor shared the editing and production. Enrique Blanco Armas, Mustapha Benmaamar, Anna Gueorguieva, Stephen Magiera, Sjamsu Rahardja, Della Temenggung and Soekarno Wirokartono provided detailed comments and input. Farhana Asnap, Indra Irnawan, Jerry Kurniawan, Nugroho, Marcellinus Winata and Randy Salim organized the dissemination and Titi Ananto, Sylvia Njotomihardjo and Nina Herawati provided valuable administrative support.

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ABBREVIATIONS AND ACRONYMS

APBN	<i>Anggaran Pendapatan dan Belanja Negara</i> (State Budget)	LDR	Loan-to-deposit ratio
BAPPENAS	<i>Badan Perencanaan Pembangunan Nasional</i> (National Development Planning Agency)	LPG	Liquefied Petroleum Gas
BI	Bank Indonesia	MoF	Ministry of Finance
BKPM	<i>Badan Koordinasi Penanaman Modal</i> (Indonesia Investment Coordinating Board)	mom	month-on-month
BLT	<i>Bantuan Langsung Tunai</i> (cash transfer)	NPL	Non-performing loan
BoP	Balance of Payments	OECD	Organization for Economic Co-operation and Development
BPS	<i>Badan Pusat Statistik</i> (Central Bureau of Statistics)	OMOs	Open market operations
Bulog	National Logistics Agency	PKH	<i>Program Keluarga Harapan</i> (Conditional Cash Transfer)
CDS	Credit default swap	PLN	<i>Perusahaan Listrik Negara</i> (State Electricity Company)
CPI	Consumer price index	PPP	Purchasing Power Parity
CPO	Crude palm oil	qoq	quarter-on-quarter
DIPA	<i>Daftar Isian Pelaksana Anggaran</i> (Program Budget Authorization Document)	RPJM	<i>Rencana Pembangunan Jangka Menengah</i> (Medium-Term Development Plan)
EMBI	Emerging Market Bond Index	RPJMN	<i>Rencana Pembangunan Jangka Menengah Nasional</i> (National Medium Term Development Plan)
EME	Emerging Market Economies	SBI	<i>Sertifikat Bank Indonesia</i> (Bank of Indonesia Certificate)
FDI	Foreign Direct Investment	SSN	Social safety net
FY	Fiscal Year	SUNs	<i>Surat Utang Negara</i> (government securities)
GDP	Gross Domestic Product	SUSENAS	<i>Survei Sosial Ekonomi Nasional</i> (National Household Socioeconomic Survey)
Gol	Government of Indonesia	USD	US dollar
IDR	Indonesian Rupiah	WB	World Bank
IEQ	Indonesia Economic Quarterly	yoy	year-on-year

Executive Summary: Current challenges, future potential

Indonesia's economic performance remains positive, and future potential is high, but recent developments have highlighted ongoing challenges and risks around the outlook

Indonesia's economic performance through mid-2011 has been positive. Solid growth has been accompanied by further portfolio capital and foreign direct investment inflows. Public and financial sector balance sheets remain strong. However, events over the past quarter serve as a reminder of a number of Indonesia's ongoing policy challenges. At the same time, the launch of the Government's *Master Plan* 2011-2025 has focused attention on the investments and policy reforms which can help Indonesia reach its future growth potential.

In the March 2011 *IEQ* increases in domestic food and international commodity prices prompted comparisons with the experience of 2008. The rise in fuel subsidy expenditures seen in 2011 to date has deepened this comparison, re-emphasizing the related fiscal risks, opportunity costs and economic distortions. Weak disbursement rates on core government programs illustrate the challenges of improving public service delivery and infrastructure provision. In addition, despite the recent falls in the price of rice, poor households remain vulnerable to further domestic production shocks. Finally, heightened international risk aversion originating from the Greek debt crisis, and the potential market implications of any haircut, were it to occur, are a reminder of the external shocks which could prompt reversals of short-term capital flows to Indonesia.

Growth moderated slightly in the first quarter of 2011 but still came in at a robust 6.5 percent year-on-year

The underlying macro outcomes over the last three months have been robust. GDP growth in Q1 2011 was in line with expectations at 6.5 percent year-on-year, down from an unusually strong 6.9 percent in Q4 2010. Investment and private consumption growth held up well. In contrast, net exports and government consumption were a drag on quarterly growth. Indeed, due to the skewness of fiscal disbursements towards the year-end, the performance of government consumption was one of the lowest on record. Service sectors such as retail and wholesale trade, transport and communications and finance, continue to be among the main growth drivers, reflecting the strength of domestic demand. Agriculture growth weakened along with that of mining and construction.

The baseline projections for Indonesia's growth are unchanged although uncertainty has risen

Headline GDP growth projections for 2011 and 2012 remain the same as in the March 2011 *IEQ* at 6.4 percent and 6.7 percent respectively. Key drivers of domestic growth are largely unchanged despite the rise in uncertainty mentioned above. For example, notwithstanding the weakness in the US recovery and the impact of the earthquake and tsunami on Japan, underlying global growth for 2011 and 2012 remains relatively strong, with only a slight downward revision to the projected growth of Indonesia's major trading partners. There is the downside risk to this global outlook from any spillovers to the real sector if major financial sector losses were realized due to the problems in the Euro zone.

Table 1: Growth is projected to rise gradually through 2011 and 2012

		2009	2010	2011	2012
Gross domestic product	(Annual percent change)	4.6	6.1	6.4	6.7
Consumer price index*	(Annual percent change)	2.6	6.3	5.7	5.9
Budget balance**	(Percent of GDP)	-1.6	-0.6	-1.8	n.a.
Major trading partner growth	(Annual percent change)	-1.0	6.6	4.3	4.7

Note: * Q4 on Q4 inflation rate. ** 2011 figure is approved Budget

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

High oil prices are highlighting the fiscal burden of Indonesia's energy subsidies

Despite a downward correction in May, oil prices remain elevated. The price of Indonesian crude oil averaged USD 113 per barrel over the first five months of 2011, versus the Budget assumption of USD 80 per barrel. Energy subsidy spending has risen, accounting for one quarter of total central government expenditures excluding regional transfers in the first five months of 2011. The Government is considering a range of subsidy reform options but the exact nature and timing of implementation of any new policies remains uncertain. While higher oil prices also boost related revenues, these gains have been partially offset by lower oil production. Overall, higher oil prices are likely to increase the deficit. Notwithstanding low spending rates on capital and social expenditures, the World Bank 2011 budget deficit projection has been revised up to 1.2 percent of GDP (versus 0.9 percent in the March 2011 *IEQ* and 1.8 percent in the original Government Budget).

Headline inflation has come down but a range of risks remain...

Headline inflation has fallen gradually from 7 percent in January 2011 to just below 6 percent in May 2011. Just as in its run-up in the second half of 2010, this fall has been driven by food prices, particularly the declines in rice and chili prices. Nevertheless, core inflation is ticking up gradually and, while inflation expectations of international investors have fallen, there has been a move up in domestic price expectations. With inflation now just within its target range Bank Indonesia (BI) has left the policy rate unchanged since February. Looking forward, absent policy changes, such as on energy subsidies, headline CPI inflation is projected to reach 5.7 percent in Q4 2011 and move up slightly over 2012. Poverty basket inflation is projected to fall to 5.8 percent in Q4 2011. However, there remain many uncertainties, especially related to future rice and energy prices.

...while previous rises in rice prices are likely to weigh against the positive impact of higher growth and job creation on poverty reduction

Although there has been some unwinding of the rice price rises seen in the second half of 2010, the preceding increases are likely to weigh negatively on the progress in reducing poverty. Countering this are the positive impact of the strong GDP growth and rising rates of employment growth. However, the creation of quality jobs remains an issue, particularly for the youth of Indonesia, necessitating measures to, for example, enhance education and training and facilitate the matching of workers with employment opportunities.

Capital inflows into Indonesia have continued to be strong...

Following record financial account inflows in 2010, the first quarter continued in a similar vein. Portfolio inflows recovered after outflows in January, although subsequently weakened in May. FDI inflows are moving upwards. Managing the impact of these capital inflows remains a policy challenge. BI has continued to allow managed appreciation, in line with regional currency movements, and to employ additional macroprudential policies, such as the extension on the minimum holding period on BI certificates. While reserves have increased, so has the exposure to potential outflows. Indonesia has shown greater resilience to turbulence in international financial markets in the past few years, but any disorderly resolution of the Greek debt crisis could significantly raise the risk aversion of international investors, testing this improved resilience.

...and the upward movement in FDI has the potential to provide a range of benefits to the economy

Although still relatively low as a share of GDP compared with prior to the 1997/1998 financial crisis and relative to regional peers, FDI inflows are increasingly attracted by Indonesia's natural resources, large domestic market and relatively low labor costs. Further increases in FDI could help balance the risks associated with portfolio capital inflows and also have the potential, if accompanied by supporting policies in areas such as education, skills and infrastructure, to boost Indonesia's growth through financing investment and through other channels such as technology transfer and linkages with global supply networks.

Improvements to connectivity and regulatory reforms can enhance the medium-term growth outlook and are central elements of the Government's *Master Plan 2011-2025*...

The Government's recently released *Master Plan* for the Acceleration and Expansion of Indonesia's Economic Development 2011-2025 aims to move Indonesia into one of the largest global economies by 2025. The first pillar of the plan is the development of six regional economic corridors through investments in sectors with high growth prospects and in which a region has comparative advantages. This requires support from the second and third pillars, namely improving connectivity and strengthening human resources and science and technology. The *Master Plan* has the potential to be a transformative tool but successful implementation will require the identification of policy reform and investment priorities along with the political commitment and coordination to address them.

The *Master Plan* targets investments of USD 468 billion over 2011-2025 of which 45 percent are in infrastructure. One-fifth of the total investment is expected to come from the Government. As recent experience has shown, further improvements in procurement and budget processes and absorptive capacity will be needed to make effective a greater fiscal allocation to capital expenditures. The ambitious target for private sector participation, at one half of the total investment, will also require supporting policies, such as on public private partnerships and deepening domestic financial markets.

...but there remain many challenges if Indonesia is to meet its potential as a leading global growth driver of the next few decades

Indonesia is a dynamic emerging economy, playing an increasing role on the international stage through, for example, its G20 membership and current Chairmanship of ASEAN. However, events over the past quarter are a reminder of the current challenges which are faced and the need to put in place, and implement, the policies and investments necessary for Indonesia to reach its potential as a leading global growth driver of the next few decades.

A. ECONOMIC AND FISCAL UPDATE

1. Multiple sources of uncertainty in the external environment

Developments over the past quarter highlight ongoing uncertainty in the international economic environment, although underlying global growth dynamics appear relatively robust

The international environment over the last three months has been characterized by ongoing uncertainty. In addition to volatility in international energy and wider commodity prices, financial markets have shown increased concern over the recent intensification in the public debt crisis in Greece (Figure 1), and potential spillovers to other Euro zone members, and banking sectors. As a result there has been a pick up in risk aversion which could feed through into the appetite for emerging market assets. However, to date there has been little upward movement in their sovereign spreads as investors continue to search for yield in an environment of low interest rates in high income economies.

In terms of the global growth outlook, the US recovery has shown some weakness, for example, in labor market and property price data, prompting downward revisions to its growth projections for 2011. In addition, the devastating earthquake and tsunami has hit near-term activity in Japan. While the level of global uncertainty may have risen, underlying real global growth, driven by the strong performance of emerging economies, is projected to remain relatively robust at 3.2 percent in 2011, rising to 3.6 percent in 2012 (World Bank, Global Economic Prospects, June 2011). Of course, there is the downside risk to this global outlook from any spillovers to the real sector if major financial sector losses were realized due to haircuts on Euro zone debt.

Figure 1: Rising market concerns over sovereign debt risk in Greece

(sovereign external bond spreads, basis points; VIX index)

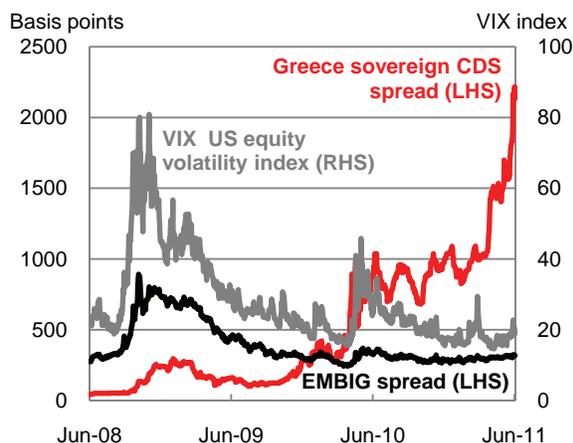
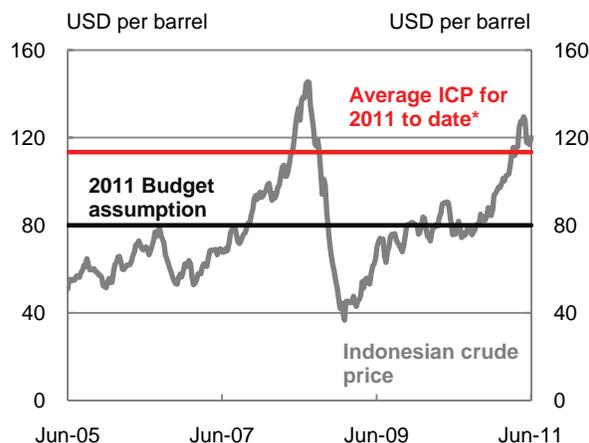


Figure 2: The average price of Indonesian crude oil in 2011 to date has exceeded the Budget assumption

(USD per barrel)



Note: VIX measures 30-day implied volatility of the S&P 500, CDS is credit default swap, EMBIG is JP Morgan Emerging Market Bond Index
Source: Thomson Financial Datastream

Note: * average for first five months of 2011
Sources: Ministry of Finance, US Energy Information Agency and World Bank

Global commodity prices remain elevated despite the downward correction in May

These international developments are transmitted to Indonesia via their impact on external demand, terms of trade and capital flows. The commodity price impact is particularly important given Indonesia's export mix and fiscal sensitivity to oil prices. Global commodity prices corrected in May amidst the above concerns over the outlook. Energy prices declined by 6.5 percent and non-energy prices by 4.7 percent on the month, in part due to US dollar appreciation. However, energy prices remain up 9.1 percent and non-energy prices up 7.2 percent over the three months since February. In addition, reflecting supply-side factors, along with the uncertain demand outlook, the correction has not to date prompted a trend decline in prices. Over the near-term, commodity prices are expected to remain elevated. The World Bank's June 2011 forecasts are for the strong price rises of 2011 to be followed by declines in 2012. However, 2012 prices in real terms for both energy and non-energy indices are expected to be still just above 2008 levels.

The high level of international oil and food prices continue to be a concern for many countries, including Indonesia

After their sharp drop in May, oil prices received further support from concerns over the implications of events in Libya, Syria and Yemen, falling inventories, the inability of OPEC in early June to reach agreement on increasing production quotas and expectations of rising demand in the second half of the year. In late June, oil prices did however fall sharply following the agreement of the International Energy Agency to release additional supplies from their stocks.

The price of Indonesian crude has tracked international market movements, falling from a high of almost USD 130 per barrel at end-April to USD 120 in early June, bringing the average price in the first five months of 2011 to USD 113 per barrel (Figure 2). As discussed in more detail below, the stronger oil prices put greater pressure on Indonesia's fiscal position through higher spending on energy subsidies.

Turning to international food prices, overall they are down around 6 percent from their recent peak in February. Grain prices are, however, up by 1 percent over this period as the falls in March have been offset by recent rises. For example, in May, international wheat prices rose by 5.7 percent on the back of concerns over drought in parts of Europe, although international rice prices have been falling gradually.

2. While growth moderated in Q1 2011, the near-term outlook remains positive

GDP growth moderated in Q1 2011...

After an extremely strong quarter in Q4 2010, GDP unsurprisingly moderated in Q1 2011 (Figure 3). Year-on-year growth was 6.5 percent, down from 6.9 percent in Q4 2010. On a seasonally-adjusted basis, quarterly growth also fell, after the record levels of the fourth quarter of 2010, down to 1.0 percent, below its 10-year average. The first quarter outcome was roughly consistent with what was expected in the March 2011 *IEQ* projection, leaving the outlook for 2011 and 2012 unchanged at 6.4 percent and 6.7 percent respectively. However, given developments over the quarter the uncertainty around this baseline projection has risen (see the risks section below).

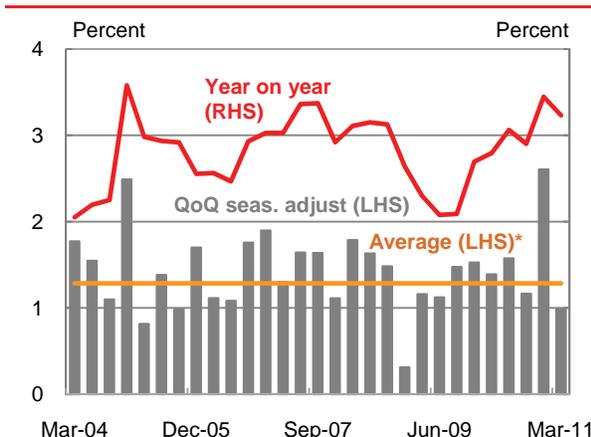
...reflecting the weakness in net exports and government consumption

On a seasonally-adjusted quarterly basis both net exports and government consumption subtracted significantly from GDP growth, by a combined 2 percentage points (Figure 4). Real government spending was particularly weak in Q1, with spending falling by 11.4 percent seasonally adjusted, the weakest quarterly outcome in over a decade. Fiscal data indicates that around 15 percent of the full-year budget allocation of personal and material spending (the two categories that impact GDP statistics) had been disbursed in Q1. This is roughly consistent with first quarter disbursement rates over the last two years.

Private consumption and investment held up relatively well although construction spending was also weak, again perhaps reflecting public sector disbursement issues. Consumer confidence has been improving on the Danareksa index, which includes lower income consumers and hence reflects the impact of falling food prices, but has shown the opposite movement on the BI index. The BI index fell due to lower employment expectations and worries about future price increases.

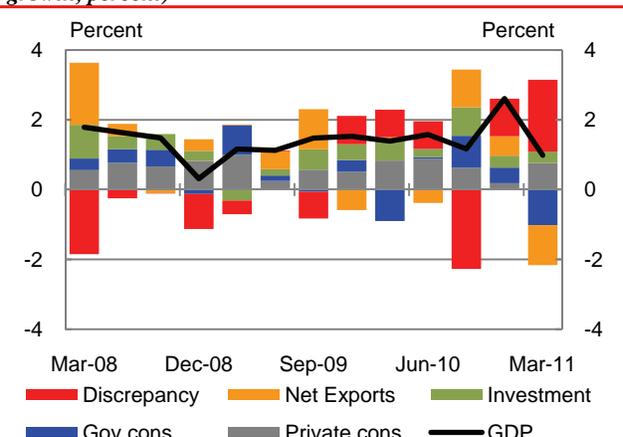
The drag on growth from net exports reflected continued surging real imports against flat real exports. Exports fell by 0.3 percent, while imports grew 2.6 percent. The relative growth in imports is consistent with domestic demand continuing to outpace that of Indonesia's major trading partners.

Figure 3: Quarterly growth moderated in Q1 2011, coming down off the highs of Q4 2010...
(percentage change in real GDP)



Note: * Average QoQ growth since Q1 2000
Sources: BPS and World Bank staff seasonal adjustment

Figure 4: ...with government consumption and net exports particularly weak
(contribution to quarter-on-quarter seasonally adjusted growth, percent)



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

Retail and wholesale trade and other service sectors led the way on the production-side

Retail and wholesale trade continues to be one of the main drivers of growth on the production-side, reflecting the strength of domestic consumption. Agriculture growth weakened while that of mining and construction fell. The construction sector recorded very low growth in Q1, growing at its weakest rate in almost 10 years, perhaps reflecting the problems with government capital expenditure disbursements. Cement sales, which can be seen as a proxy for construction activity actually grew quite strongly in the quarter, rising by over 15 percent over the year in March 2011. The contribution of manufacturing to quarterly growth dipped after the strength of the fourth quarter but on a year-on-year basis growth has been above 5 percent for the last 2 quarters, the first time since 2007. Textiles, iron and steel, and transport equipment have been the primary contributors.

Spillovers from the Japan earthquake and tsunami to Indonesia's GDP are likely limited in aggregate, although sectors such as automobiles have been affected

A number of Indonesian manufacturers of cars and motorcycles have been affected by the shortage of inputs from Japan as plants there were affected by the impact of the tsunami and earthquake. Indonesia's largest automobile distributor, Astra, expects that production at its vehicle assembly plant will drop by 15 percent in the second quarter. Japan's trade data indicate that in April Japanese exports to Asia fell by 6.6 percent, with exports to Indonesia down by 12.9 percent. Much of these exports were components headed to Indonesia for assembly. However, any impact on Indonesia in Q2 is likely to be limited given the relatively diversified nature of Indonesia's manufacturing sector.

The outlook for Indonesia's growth over 2011 remains strong, albeit with changes in the composition relative to the March 2011 IEQ

Headline GDP projections for 2011 and 2012 are unchanged from the March 2011 IEQ at 6.4 percent and 6.7 percent respectively (Table 2). The movement in real GDP recorded in the first three months of 2011 was largely as expected in the March IEQ. In addition, despite the international uncertainty mentioned above, the main drivers of growth are relatively stable in terms of global growth and domestic economic conditions. There have however been changes in the composition of projected growth. For example, growth in private consumption has been revised upwards offsetting downgrades for government spending and investment.

The underlying assumptions for the macro outlook for 2011 and 2012 have however been revised slightly to reflect developments in the year-to-date such as the appreciation of the exchange rate against the US dollar, the rise in oil prices and falling inflation (and hence lower likelihood of policy rate increases). In particular, the oil price assumption has been moved up to a relatively conservative average of USD 105 per barrel given the average in 2011 to date of USD 113. This assumption implies a gradual decline in oil prices from their early June level of around USD 120 such that the average for the rest of 2011 is just below USD 100. These has also been a slight reduction in major trading partner growth, reflecting the impact of the earthquake and tsunami in Japan, the weakness in the US and revisions to Singapore's GDP growth.

Table 2: Aggregate GDP projections for 2010 and 2011 remain unchanged
(percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual	
	2010	2011	2012	2010	2011	2012	2011	2012
1. Main economic indicators								
Total consumption expenditure	4.0	5.2	6.2	4.9	5.4	6.3	-0.1	0.1
Private consumption expenditure	4.6	4.9	5.0	4.4	5.3	5.7	0.2	0.1
Government consumption	0.3	6.6	13.6	7.3	5.5	9.6	-2.2	0.1
Gross fixed capital formation	8.5	9.2	9.9	8.7	9.8	10.5	-0.8	-0.2
Exports of goods and services	14.9	12.9	10.5	16.1	8.0	10.3	1.2	-1.9
Imports of goods and services	17.3	16.9	12.6	16.9	12.3	12.8	4.7	-0.5
Gross Domestic Product	6.1	6.4	6.7	6.9	6.5	6.8	0.0	0.0
Agriculture	2.9	3.4	3.9	4.1	3.8	2.5	-0.2	-0.6
Industry	4.7	4.9	5.2	5.3	5.3	5.1	-0.2	-0.1
Services	8.4	8.6	8.8	5.8	9.2	8.6	0.3	0.1
2. External indicators								
Balance of payments (USD bn)	30.3	24.8	26.0	n/a	n/a	n/a	8.1	11.2
Current account balance (USD bn)	5.7	2.8	4.5	n/a	n/a	n/a	0.5	1.8
Trade balance (USD bn)	21.3	18.6	21.0	n/a	n/a	n/a	1.4	2.7
Financial account balance (USD bn)	26.1	22.5	21.5	n/a	n/a	n/a	8.3	9.5
3. Other economic measures								
Consumer price index	5.1	5.9	6.1	6.3	5.7	5.9	-0.4	-0.1
Poverty basket Index	8.4	7.8	7.0	11.1	5.8	6.9	-0.5	0.0
GDP Deflator	8.0	9.2	9.6	8.0	9.9	9.5	-0.2	-0.7
Nominal GDP	14.6	16.2	17.0	15.0	17.0	16.9	-0.2	-0.8
4. Economic assumptions								
Exchange rate (IDR/USD)	9074	8713	8650	8977	8650	8650	-187.5	-250.0
Interest rate	6.4	6.8	7.0	6.5	7.0	7.0	-0.2	-0.5
Indonesian crude price (USD/bl)	79.4	105.1	97.0	86.2	97.0	97.0	15.1	7.0
Major trading partner growth	6.6	4.3	4.7	5.5	4.9	4.7	-0.1	-0.1

Notes: 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. Revision is relative to March 2011 IEQ projection
Sources: MoF, BPS, BI, CEIC and World Bank staff projections

3. Strong portfolio and FDI inflows continue

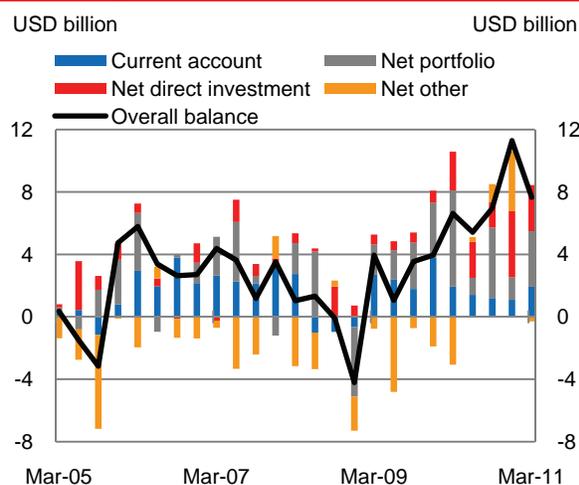
Overall balance of payment inflows in Q1 2011 were second only to the record of Q4 2010

The overall balance of payment inflows in Q1 reached USD 7.7 billion, the second highest on record. The current account surplus was USD 1.9 billion, while total inflows on the capital and financial account reached USD 6.2 billion (Figure 5). International reserves reached USD 118 billion at the end of May, or equivalent to 6.9 months of imports and external debt service of the Government.

Portfolio flows were resurgent and FDI continued to perform strongly

Financial account inflows in Q1 2011 – while down on Q3 and Q4 2010 – were the third highest on record, sustaining a run of seven consecutive quarters of inflows, the longest in the post 1997-1998 crisis period. Portfolio flows showed a strong return, despite weakness earlier in the year, FDI strength continued (see Part B) with USD 4.5 billion in gross inflows while net direct investment reached USD 3 billion. The strength of the FDI flows continues the favorable trend toward rising longer-term investment, relative to portfolio flows.

Figure 5: Capital inflows have driven record overall balance of payment inflows
(USD billion)



Note: Errors and omissions not shown
Source: BI

Table 3: Capital inflows are projected to remain strong through 2011 and 2012
(USD billion)

	2008	2009	2010	2011	2012
Overall Balance of Payments	-1.9	12.5	30.3	24.8	26.0
Current Account	0.1	10.6	5.7	2.8	4.5
Trade	9.9	21.2	21.3	18.6	21.0
Income	-15.2	-15.1	-20.3	-20.9	-21.8
Transfers	5.4	4.6	4.6	5.1	5.3
Capital & Financial Accounts	-1.8	4.9	26.1	22.5	21.5
Capital Account	0.3	0.1	0.0	0.2	0.2
Financial Account	-2.1	4.8	26.1	22.3	21.3
Direct investment	3.4	2.6	10.6	12.4	14.5
Portfolio	1.8	10.3	13.2	13.5	13.1
Other	-7.3	-8.2	2.2	-3.6	-6.3
Reserves ^(a)	51.6	66.1	96.2	118.1	

Notes: Errors and omissions not shown. ^(a) 2011 reserves as of end-May 2011
Sources: BI and World Bank staff projections

The trade balance continues to narrow reflecting the relative strength of domestic demand

Indonesia's trade balance narrowed in the Q1 2011 relative to Q4 2010 moving to USD 6.2 billion, reflecting a USD 8.4 billion surplus for goods and USD 2.2 billion deficit for services. Import growth outpaced that of exports. On a quarterly basis export growth generally remained sluggish. On the import side, intermediate inputs performed strongly, particularly from electronics, machinery and iron and steel. The oil and gas balance continues to deteriorate as domestic consumption continues to grow strongly. Monthly data points to an improvement in manufacturing sector exports offset by falls in agriculture and mining sectors. However, rising imports have contributed to the fall in the goods trade balance to USD 1.6 billion in April, but this is still double the surplus of April 2010.

Looking forward, balance of payment inflows are expected to remain strong, although down on 2010 levels as the current account surplus narrows and capital inflows come off their highs

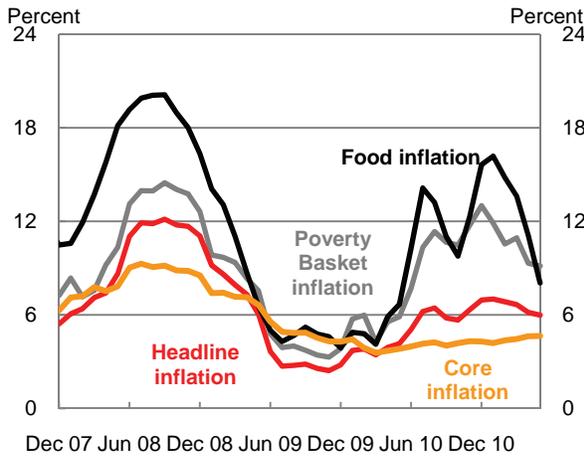
The trade balance is projected to narrow further over 2011 reflecting the strength of domestic activity (affecting not just goods imports but also payments for professional, business and transportation services). In addition the income deficit is expected to continue its expansionary trend (driven by profit repatriation) and current transfers to remain steady. As a result the current account surplus is projected to fall in 2011 and recover slightly in 2012. Offsetting this will be sustained, albeit moderating, capital inflows. The net result is that 2011 and 2012 are expected to see overall balance of payment inflows of around USD 25 billion per year (Table 3).

4. Headline inflation has fallen but inflationary risks remain

On the back of declines in food prices, headline CPI inflation fell from 7 percent in December 2010 to just below 6 percent in May 2011

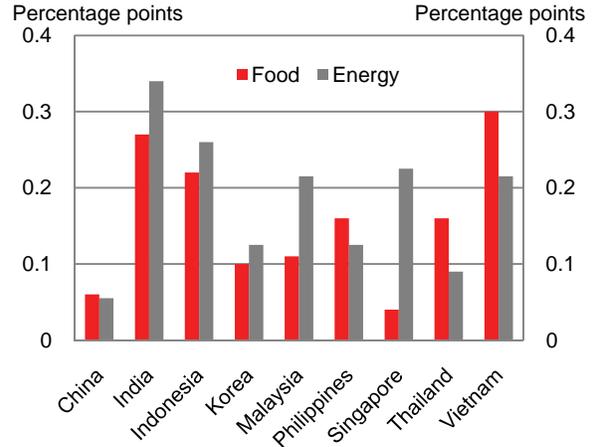
Headline CPI inflation has fallen gradually from 7 percent in December 2010 and January 2011 to just below 6 percent in May 2011 (Figure 6). Just as in the run-up in inflation in the second half of 2010, volatile food prices have driven the recent fall in headline inflation. Food price inflation fell from 16.2 percent in January to 10.2 percent in May (although for almost all food items the average rate of inflation remains above that of the overall basket). The level of the CPI food price index declined by 4.4 percent over this period as the supply responses from the harvest took effect. For example, chili prices are down 77 percent over this period and domestic retail rice prices are down 7.6 percent from their early 2011 peaks.

Figure 6: Headline and poverty basket inflation have fallen with food price inflation but core inflation has moved up (year-on-year growth)



Source: BPS and World Bank staff

Figure 7: The pass-through from domestic food and energy prices to core inflation in Indonesia is relatively high (percentage points)



Notes: Figure indicates the estimated impact on core inflation of a 1 percent increase in domestic food and energy prices. Wholesale prices used for India.
Source: IMF Asia and Pacific Regional Economic Outlook, April 2011

Core inflation has been rising steadily although inflationary expectations have tracked down with movements in headline inflation

Core inflation has risen gradually to a 20-month high of 4.6 percent as services and clothing costs start to pick up. The level of core prices has risen by 1.6 percent on a non-seasonally adjusted basis from December 2010 to May 2011 (versus a rise of 1.2 percent in the corresponding period to May 2010). The gradual rise in core inflation could reflect the pass-through of international and domestic commodity prices or the potential emergence of capacity constraints. IMF estimates suggest that the pass-through to core inflation of domestic food and energy price inflation is relatively high in Indonesia (Figure 7). As discussed in the April 2011 IMF Asia and Pacific Regional Economic Outlook high rates of pass-through may reflect not only expenditure weights (for example, food items, including prepared food, account for 25 percent of the weight of Indonesia’s core prices basket) but also monetary policy frameworks and ability to control inflationary expectations.

Inflation expectations in Indonesia have come down with headline inflation in the Consensus survey of professional forecasters. However, the BI consumer survey indicated rising price expectations for six-months ahead, owing to concern over potential adjustments to government subsidies for fuels and electricity, and rising food prices following the Ramadan period.

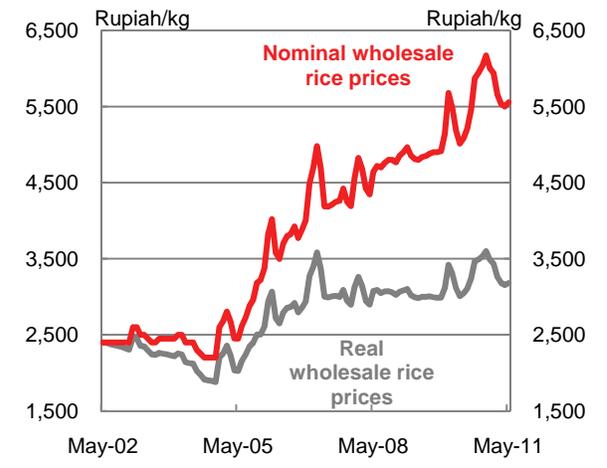
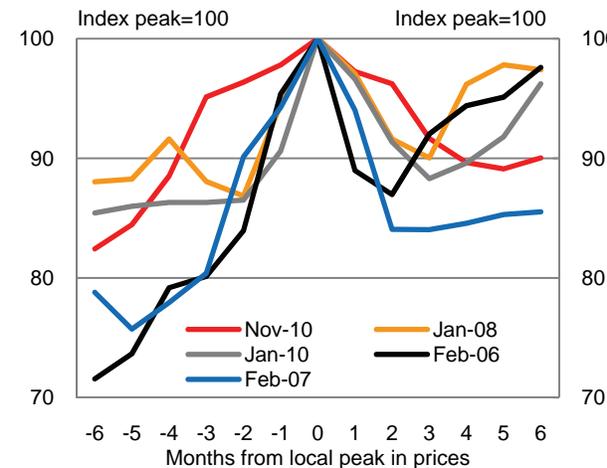
Box 1: Recent rice price developments in Indonesia

Weather-related disruptions throughout 2010 reduced rice supply in several regions across Indonesia. The shortfall in domestic rice production led to large increases in the domestic price of rice. Figure 8 compares the most recent experience to previous paths of wholesale rice prices since 2005. Examining the path to the yearly peak in prices over the past five years reveals the most recent peak in late 2010 was different to previous ones. Prices peaked relatively early before the harvest, in November, following a relatively steady increase over six months. Some of those increases were gradually unwound in the months that followed. Previous annual price highs have occurred in either January or February immediately prior to the harvest and the acceleration of prices was much faster and usually over a shorter period. Similarly the fall in prices in the immediate three months after the peaks of previous years were more rapid than the declines seen following the November 2010 peak, largely owing to the closer proximity of the harvest to these previous peaks. Since November 2010, wholesale rice prices have partially unwound, falling 15 percent, due to the harvest and the import of rice by Bulog. In previous years prices resumed their upward trajectory within the first 3-6 months from the local peak (the only exception is the 2007 shock which was followed by relatively muted rice price growth and in that year Bulog imported rice to help boost supplies).

In 2011, rice prices have started increasing since the first week of May through to June and the upcoming months traditionally experience large seasonal increases in rice prices associated with the month of Ramadan, raising concerns about renewed price pressures in the months ahead. The path of rice prices for the remainder of the year will depend largely on the quality of the harvest season and Government decisions on the import of additional rice. Given the difficulties associated with forecasting rice production and weather patterns the risk section below examines four different scenarios of rice price growth and their impact on inflation measures.

Figure 8: The late 2010 price rise has unwound more slowly in wholesale markets than following other recent peaks
(Nominal index of wholesale rice prices with each series indexed at 100 at the local peak)

Figure 9: The wholesale price of rice remains elevated in nominal and real terms
(Nominal wholesale prices, real prices are deflated by core inflation and in 2002 prices)



Note: Based on low quality wholesale price IR-64 III
 Sources: BPS and World Bank

Note: Based on low quality wholesale price IR-64 III
 Sources: BPS and World Bank

Looking at long-run trends, the nominal price of wholesale rice has risen on average 9.7 percent a year since 2002. In real terms, wholesale rice prices have risen on average 3.1 percent a year since 2002. The November 2010 peak in wholesale prices was the highest in nominal and real terms and prices in real terms remain above the averages of previous years (Figure 9).

The outlook for CPI inflation depends crucially on the future path of domestic rice prices and administered energy prices

Notwithstanding the downward trend in headline inflation, there are large uncertainties around the inflation outlook, particularly relating to food and energy prices. Further upward movements in global grain and energy prices remain a concern. The direct pass-through of the rise in global grain and energy prices since the start of 2011 is muted by the restrictions on import of rice and Indonesia's fuel subsidies. However, even without policy adjustment there may be indirect effects. For example, refined oil products are used as intermediate inputs, indicating the scope for higher oil prices to feed through into consumer prices. In terms of rice prices, as mentioned, the future path for domestic prices is hard to predict given the difficulty in assessing the strength of the harvest and the uncertain prospects for weather for the rest of the year. Other factors influencing the inflation outlook include domestic credit conditions, which appear accommodative, and continued exchange rate appreciation (although as discussed below, the appreciation of the real effective exchange rate has been less marked than against the US dollar).

Weighing these factors together, and assuming no policy change, headline CPI inflation is projected to reach 5.7 percent for the final quarter of 2011 before steadily picking up to end at 5.9 percent for the final quarter of 2012 driven by higher economic growth and credit expansion. Poverty basket inflation is projected to fall to 5.8 percent by the final quarter of 2011 based on the assumption of no further shocks to food prices and the influence of the high base levels from the 2010 food price increases. For 2012, as GDP growth increases, inflation is projected to move up to 6.1 percent on average over the year with poverty basket inflation rising to 7 percent.

Economy-wide prices continued to rise gradually through Q1 2011 and are expected to grow by 9.2 percent in 2011

GDP deflator inflation rose to 8.4 percent in Q1 2011, continuing its gradual rise from the low of 5.3 percent in Q3 2009. Investment price inflation was just under 8 percent while private consumption prices fell in line with the falling CPI and, as is usual in the first quarter of the year, government consumption inflation rose sharply to above 10 percent.

Looking forward, the trend rise in GDP deflator inflation is expected to continue towards end-2011 (with Q4 deflator inflation of 9.9 percent) before dropping over 2012. The outlook for 2011 was dampened by benign construction activity and prices in Q1 2011 which was the lowest outcome in seasonally adjusted terms in 10 years.

5. Earlier rises in food prices are likely to affect measured poverty in March 2011

Rice prices have come down from their peaks of late 2010 but their increase through the year to March 2011 is likely to weigh against the benefits of higher growth for the progress in reducing poverty

Following the reduction in the poverty rate in 2010 to 13.3 percent, the March 2011 Susenas household survey will provide the latest national poverty update for Indonesia. Over the year to March 2011, real GDP growth reached 6.5 percent, providing a boost to real incomes, the extent of which is dependent upon the degree of pass-through into employment creation and wage growth. However, offsetting this positive effect is the fact that due to the rises in food prices, poverty basket inflation in March 2011, i.e. the increase in the average basket of goods consumed by the poor, reached 10.9 percent year-on-year. As highlighted in Part B of the March 2011 *IEQ*, sufficiently large food price shocks can lead to increases in the poverty rate, even when GDP growth is strong, such as in 2005-06. Looking forward to 2012, the baseline path for falling poverty basket inflation, along with robust growth, is projected to contribute to falling poverty rates (abstracting from the impact of any policy changes, for example, in relation to social protection programs or food or fuel prices).

Employment growth has moved steadily upwards...

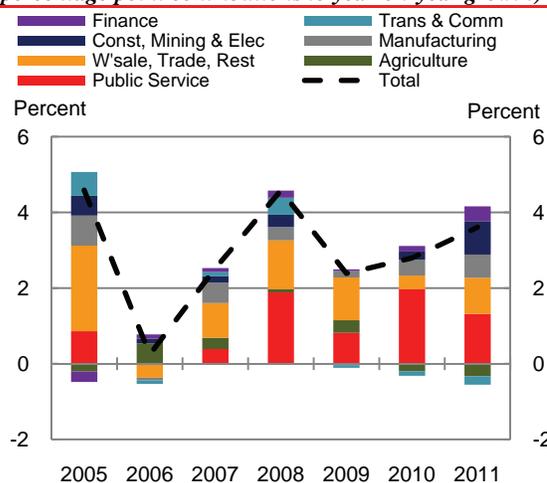
In the year to February 2011, employment growth in Indonesia continued to move upwards. Total employment rose by 3.6 percent (3.9 million people) compared with a 2.9 percent rise in the labor force (3.4 million people). As a result, Indonesia's official unemployment rate fell to 6.8 percent in February 2011 from 7.4 percent a year earlier.

Across the sectors, employment in finance grew by a record 26 percent over the year and construction employment grew by 15 percent (the fastest since before 1997/1998). Agricultural employment fell for the second straight year, down 1 percent, but remains the largest employer, accounting for 40 percent of all workers. Public service

employment grew by 9 percent over the year and contributed over one-third of the growth in overall employment since February 2010. The high employment growth in the finance sector meant that despite an employment share of only 1.5 percent it still contributed 11 percent of all new workers since February 2010.

Figure 10: Employment growth has been rising steadily

(percentage point contributions to year-on-year growth)



Note: Data points are for February
Sources: Sakernas and World Bank

...but productive job creation remains a priority, particularly for young workers

Unemployment rates for young workers (i.e. those between 15 and 24 years old) tend to be higher than those for the overall workforce. Data from the August 2010 Sakernas labor force survey indicates that half of all youth in Indonesia were in the workforce and of these 18 percent were unemployed versus 3 percent for the rest of the work force. The six times higher unemployment rate for young workers compares to a projected world average figure from the International Labour Organization of 2.7 times higher.

There can be a number of reasons for this higher unemployment rate. On the one hand, younger workers may prefer to wait for a better job. On the other hand, it may reflect a lack of work-relevant skills and access to information about the jobs market. Labor regulations may also hamper job creation and entrepreneurship. To maximize the demographic dividend Indonesia could reap over the next decade as the dependency ratio continues to fall, the right policy choices will need to be made to support the acceleration of job creation and improve employment outcomes. To support growth that is job-creating, the Government can enhance entrepreneurial training and access to quality education and provide better services to match employers and job seekers, and accelerate the creation of entry-level jobs for youth by improving the flexibility of current labor regulations.

6. Portfolio capital inflows came back strongly but have recently softened

Indonesian asset prices recovered the losses of late 2010 and early 2011 but have recently been affected by the rise in global market uncertainty

Over the past quarter Indonesian financial asset prices have recovered the losses experienced in the beginning of 2011. In the period since the March 2011 *IEQ*, i.e. from 15 March to 20 June, Indonesian equities are up 5.8 percent (7.7 percent for the US dollar MSCI equity index), local currency government five-year bond yields are down almost 1 percentage point to 6.9 percent and the Rupiah has appreciated by 2.3 percent against the US dollar. The spread of external sovereign bonds has fallen slightly to just over 200 basis points.

However, since the beginning of June, concern over the resolution of Greece’s fiscal crisis, and potential spillovers to other Euro zone members, has contributed to a rise in market uncertainty and decline in global equities (Figure 11). The spillovers to Indonesian asset prices have been relatively limited. Sovereign external bond spreads have risen only slightly although equities have fallen. The MSCI Indonesia US dollar index is down 3.8 percent since 1 June, although this fall is less than in emerging Asia as a whole or for developed economy equity markets.

Figure 11: After recovering from early year losses, Indonesian equity prices have declined in recent weeks (equity index, 30 Dec 2010=100; VIX volatility index)

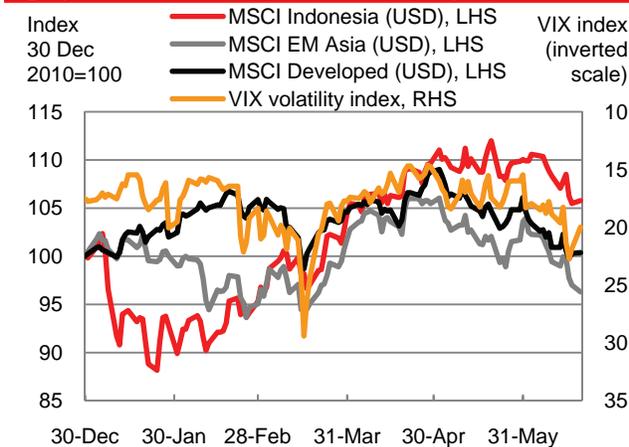
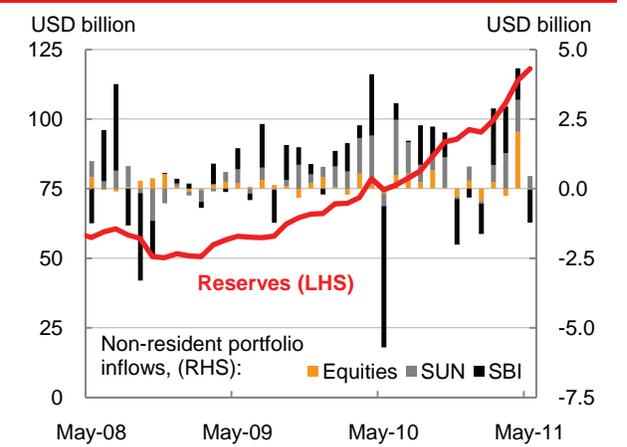


Figure 12: Portfolio capital inflows recovered strongly through April but then softened in May (USD billion)



Note: VIX index measures the 30-day implied volatility of the S&P 500 index as implied by option contract prices
 Note: “Flows” for SUN (government securities certificates) indicate changes in holdings
 Sources: Thomson Financial Datastream, CEIC and World Bank
 Sources: BI, CEIC and World Bank

Portfolio capital inflows recovered from February through April 2011 but net outflows were seen in May

The recovery in Indonesian asset prices from February through April reflected the return of portfolio capital inflows, particularly into SBIs and SUNs (Figure 12). Non-resident investor holdings of SBIs rose from USD 7.1 billion at end-February to USD 10.2 billion at end-April. These holdings then fell over May as the overall stock of SBIs also declined (the share of non-resident holdings rose slightly to 39 percent) and the extension of the minimum holding period from one to six months becoming effective. After strong inflows in the preceding three months, non-resident inflows into local government securities, SUNs, also moderated in May. However, non-resident investor holdings of SUNs rose strongly in the first few weeks of June (up USD 1.2 billion from end-May to USD 27.6 billion on 16 June), perhaps reflecting the new restrictions on SBI holdings. Net purchases of equities continue to account for a lower share of the portfolio inflows (with the strong inflows in April due primarily to significant net purchases on one day).

The drivers of the recovery of portfolio inflows through April are in part the reverse of those behind the outflows in late 2010 and early 2011

The drivers of the return of strong portfolio capital inflows, mainly to SBIs and SUNs, from February to April, can be viewed as the flipside of the determinants of the earlier outflows. In terms of domestic pull factors, headline inflation has come down and with it inflation expectations. Similarly, after relative optimism earlier in the year there has been rising uncertainty over high income economy growth, serving again to highlight the higher relative growth of Indonesia. Other factors supporting inflows to Indonesia are more stable. This includes, for example, Indonesia's continued improvement in relative credit-worthiness as seen in the sovereign ratings upgrade by S&P in early April 2011 to one notch below investment grade. Indeed, since 2009 Indonesia's external sovereign spreads have moved down to trade almost in line with the JP Morgan Emerging Market Bond Index Global investment grade sub-index.

Managing Indonesia's capital inflows is an ongoing policy challenge while the Euro zone debt crisis is a reminder of the potential vulnerabilities of capital flows to Indonesia to external shocks

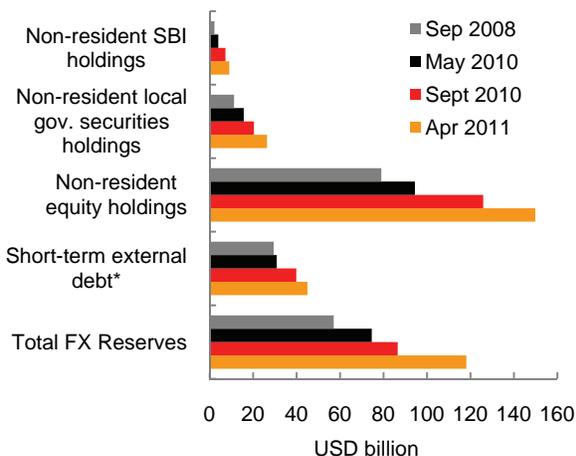
BI's policy response to the capital inflows continues to combine managed appreciation with a range of macro-prudential policies. The Rupiah has appreciated by 4.7 percent against the US dollar since the end of 2010. However, this movement against a weakening dollar has been broadly in parallel with that of other regional currencies and Indonesia's real effective exchange rate has been stable over the year (but as of May 2011, remains up by 6.2 percent from December 2009). International reserve accumulation continues apace, reaching USD 118 billion at end-May 2011, up USD 20 billion since end-February, and almost double the level at end-2009. These reserves cover roughly 7 months of imports and official debt repayments (or around 2.5 times the value of short-term external debt by remaining maturity at end-April). However, exposure to other possible foreign currency outflows has also risen in line with the buildup in reserves (Figure 13). As such, developments in the Euro zone are a reminder of the potential for shocks to expose Indonesia's ongoing vulnerability to a reversal in portfolio flows.

With inflation coming down to just within BI's target range, the monetary policy rate is unchanged since the March IEQ

The monetary policy interest rate has remained unchanged since the 25 basis point rise in February to 6.75 percent. As inflation has come down to just within BI's target band for the year of 5 +/-1 percent so market expectations of further rate hikes have been pushed out towards the end of the year. Bank Indonesia's latest policy announcements have indicated that Rupiah appreciation, "in line with exchange rate appreciation in the Asian region", will continue to be part of a policy mix including monetary and macroprudential measures aimed at managing capital inflows and domestic liquidity. This has been interpreted by some market participants as a signal of potential further reserve requirement adjustments.

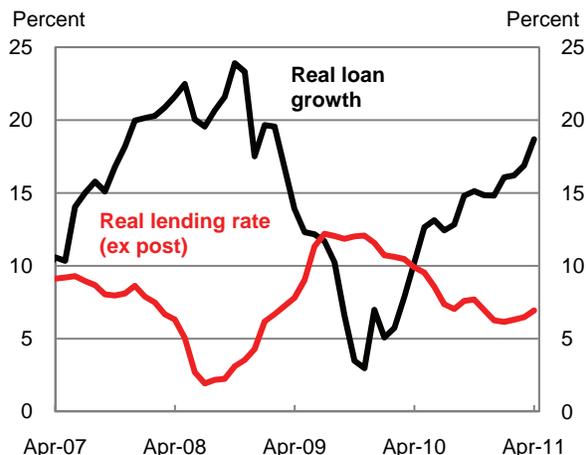
Turning to monetary indicators, the rise in BI's net foreign assets has been primarily matched by higher liabilities to the central government (reflecting start of year low disbursements). Open market operation sterilization has played a lesser role (with a continued rise in the relative use of term deposit facilities rather than the falling stock of SBIs). Since rising in late 2010 related to the hike in reserve requirements, narrow money aggregates have remained relatively stable while broad money growth through end-April 2011 was around 15 percent.

Figure 13: Reserve accumulation has been accompanied by rising non-resident holdings of Indonesian assets (USD billion)



Note: * short-term external debt by remaining maturity (value denoted April 2011 is as of end-March 2011)
Sources: BI, KSEI, CEIC and World Bank

Figure 14: Real loan growth continues to rise while real lending rates ticked up slightly with the fall in inflation (real interest rate, percent; year-on-year loan growth, percent)



Note: Ex post real rate deflated by year-on-year CPI inflation
Sources: BI, CEIC and World Bank

Quantity and price indicators suggest credit conditions are supportive of the real sector outlook

The past quarter has seen a continuation of recent trends in credit conditions. Nominal loan growth reached 26 percent year-on-year in April. With inflation declining, the ex post real rate of growth has risen to 18.7 percent, up from 14.8 percent at end-December but below the highs of 2008 (Figure 14). Working capital loans still account for the majority of year-on-year growth through April, followed by investment and then consumer loans.

In relation to the price of credit, nominal lending rates have been stable, at roughly 13 percent, and so ex post real rates have ticked up slightly with the downward movement in inflation. The effectiveness of BI's policy of requiring banks to display their prime lending rate in promoting intermediation is difficult to judge. For example, it may not make final loan rates clearly comparable since while the prime rate includes the basic cost of funds, overhead, and profit margin it does not include the risk premium of debtor.

Macroprudential banking indicators remain robust...

Headline banking sector prudential indicators have been stable and remain robust. The system wide capital adequacy ratio was 17.8 percent in April 2011 and gross non-performing loans are at 3.2 percent. Recent publicized fraud cases at two banks highlight the importance of strong internal risk control systems and supervision mechanisms to protect against such operational risks and any adverse impact on reputational risk. With loan growth outpacing deposit growth of 18 percent, the system-wide loan-to-deposit ratio (LDR) has risen to 80 percent in April. Some of the major commercial banks' LDRs fall outside BI's target range of 78 to 100 percent, which became effective in March, as they have traded off the penalty of the higher statutory reserve requirements against the benefits of maintaining their current ratios and corporate strategies.

7. Rising fuel subsidy expenditures and ongoing disbursement challenges

The fiscal performance in 2011 to date has been driven by the impact of rising oil prices and ongoing disbursement problems

With relatively strong revenue realization and weak spending on core government programs, recent fiscal trends have continued in the first five months of 2011. Rising oil prices have boosted related revenues but also led to increased spending on fuel subsidies. Total central government revenues in the first five months of the year reached IDR 421 trillion, up 18.3 percent on the corresponding period in 2010. Expenditures reached IDR 364 trillion, up 23.5 percent on 2010, as stronger energy subsidy spending has offset weaker outcomes for core spending. As a result the fiscal surplus in the first five months of 2011 was IDR 57 trillion as of end-May.

Commodity price developments have aided revenue growth in the first five months of the year...

Tax and non-tax revenues experienced similar growth in the year-to-May, up by 18.6 percent and 17.5 percent respectively on the comparable period in 2010. The influence of commodity price rises can clearly be seen. For example, oil and gas non-tax revenues, in which gas is accounting for a rising share, contributed 4 percentage points to the overall revenue growth of 18.3 percent. Export taxes, although only 3 percent of total revenues over this period, contributed just under one-fifth of the growth in revenues due to the rise in crude palm oil prices (CPO).

...and are a key determinant of the revenue projection for 2011...

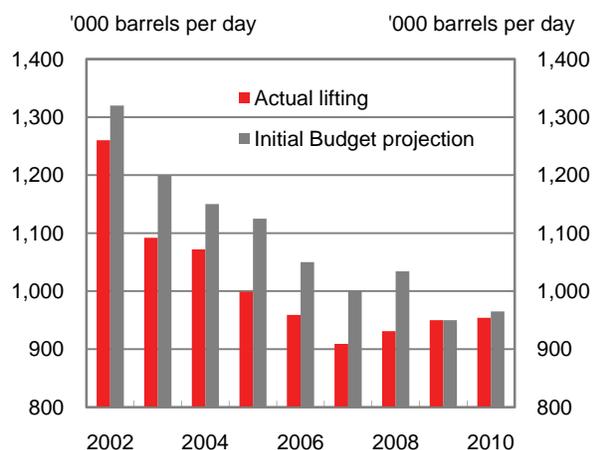
Total revenue in 2011 is projected by the World Bank to reach IDR 1,189 trillion, up IDR 41 trillion on the projections in the March 2011 *IEQ*. With no new revenue policy announcements for 2011, this upward revision primarily reflects the increase in the World Bank assumption for the average crude oil price in 2011, from USD 90 to USD 105 per barrel. There is also a smaller upward revision to non-oil & gas related revenues, mostly due to a more optimistic outlook for imports; increasing import duties.

...as are assumptions on oil lifting volumes

Offsetting some of the strength in oil prices is the expectation that lifting of oil will fall below the initial budget assumptions of an average of over 970,000 barrels per day over 2011. Ministry of Finance figures indicate that the average lifting rate in January to March was 872,000 barrels per day. The lower lifting rate was attributed to a variety of factors including unplanned shutdowns, limited investment in the sector, technology and equipment limitations, bad weather and the impact of the implementation of cabotage restrictions.¹ The weakness in the oil lifting figures in 2011 is consistent with the broad decline over the last decade (Figure 15).

The Government's proposed revised lifting projection for 2011 is 945,000 to 970,000 barrels to day. The World Bank 2011 lifting assumption has therefore been adjusted down to within this range, set at 952,000 barrels per day which is the amount submitted by holders of profit sharing contracts in their work program and budgets for the year (Jakarta Post, 3 June 2011). Given the uncertainty over this level, Table 4 provides some sensitivity analysis. A 5 percent fall in lifting from this assumption is projected to result in an approximately 2 percent fall in revenues. This analysis assumes no change in the oil price and is based on a rule-of-thumb simplification given the complex cost sharing arrangements within the sector.

Figure 15: Indonesia's oil lifting is trending downwards and tends to undershoot initial budget assumptions
(oil lifting, '000 barrels per day)



Source: MoF

Table 4: Lower lifting would offset the benefits to revenues of higher oil prices
(IDR trillion)

	WB June IEQ baseline	Deviation in lifting from baseline (percent in brackets)	
		5% lower	5% higher
Total revenue	1189.4	-23.5 (-2.0%)	24.2 (2.0%)
1. Oil & gas tax revenue	77.0	-3.7 (-4.8%)	3.7 (4.8%)
2. Oil & gas non-tax revenue	197.5	-19.8 (-10.0%)	20.5 (10.4%)
Assumptions			
Oil production ('000 barrels/day)	952.0	904.4	999.6
Crude oil price (USD/barrel)	105.0	105.0	105.0

Source: World Bank staff

¹ "Kerangka Ekonomi Makro dan Pokok-Pokok Kebijakan Fiskal Tahun 2012", Ministry of Finance, Indonesia.

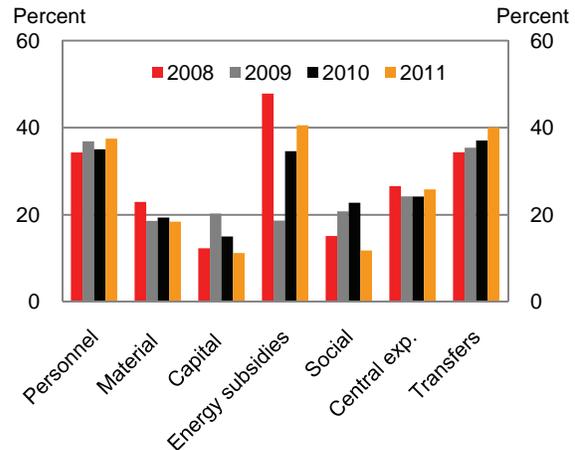
Spending on core programs has continued to be weak in the first five months of 2011...

In the first five months of 2011 total expenditures reached only 30 percent of the budget level. Within this figure, higher oil prices pushed energy subsidy expenditures up but line ministries' disbursement rates were weak. Excluding energy subsidies and transfers to regions, central government spending was only 23 percent of its full-year budget, similar to the level in the period of 2010 (Figure 16).

...with low levels of capital expenditures, as in previous years, but also of social expenditures

Despite previous reforms introduced to speed up budget execution (see December 2010 *IEQ* for a review), the realization of 2011 core program spending has continued to be weak. Disbursement of capital expenditures, which received an increase of around two-fifths quarter in their budget allocation relative to the revised Budget of 2010, continues to be a concern at only just over 10 percent of the full-year figure in the first five months of 2011. This was the weakest performance in the last five years, as was the case for social expenditures which came in at a similar level. The complexity of land acquisition, long procurement and budget virement processes, and the limited capacity of contractors on the ground are contributing factors to the low rates of capital spending. The weak disbursement of social expenditures reflected factors including the complexity in identifying and verifying beneficiaries, and the payment methods based on actual claims which normally accumulate at the end of the year for programs such as Jamkesmas. Expenditure performance to date highlights again that increasing budget allocations alone will not achieve the desired development outcomes if absorptive and implementation capacity has not improved.

Figure 16: Subsidy spending has been strong but capital expenditure disbursement weak...
(actual spending as share of Budget in first five months of the year, percent)



Source: MoF and World Bank staff

However, spending on energy subsidies is on the rise again

The rise in global oil prices over 2011 has increased spending on energy subsidies in the first five months of 2011. As mentioned above, the price of Indonesian crude in the year-to-date has averaged USD 113 per barrel, far exceeding the government budget assumption of USD 80 per barrel. By end of May, energy subsidies had reached 40 percent of their full year Budget allocation and accounted for 26 percent of total central government spending excluding transfers in 2011 to date. By way of comparison, energy subsidies accounted for 20 percent of expenditures excluding transfers in 2010 and 32 percent in 2008.

The direct impact of the higher oil price increases the cost of the fuel subsidy per liter with the current retail price of subsidized Premium fuel of IDR 4,500 per liter almost half that of non-subsidized Pertamina at IDR 8,365 per liter. However, the higher spending is also due to the demand response to rising non-subsidized prices as consumers switch back to subsidized fuel. In addition, PLN used more fuel for electricity generation in the first quarter due to a gas supply shortage. By the end of May, consumption of subsidized fuel reached 16.4 million kilo liters or 42 percent of the quota for the year. If the current trends continue, the Government projects subsidized fuel consumption to reach 41.3 million kilo liters or 7 percent more than the annual quota². This will create additional fiscal costs to the Government and further increase the opportunity cost of the poorly-targeted fuel subsidy spending.

² <http://www.bisnis.com/infrastruktur/energi/27090-bph-migas-ajukan-tambahan-kuota-bbm-bersubsidi>

The Government has again postponed the plan to implement fuel subsidy reform

The pressures for fuel subsidy reform are mounting although whether there will be policy adjustment, and over what period, remains uncertain. The Government has again postponed the plan to restrict subsidized fuel consumption for private cars which was planned to take effect in April 2011. Following the second postponement and discussion with parliament in January 2011, the Ministry of Energy and Mineral Resources established a team from three leading universities (University of Indonesia, Gajah Mada University, and Institute Technology Bandung) to assess options and potential social and economic impacts, as inputs for the implementation in April 2011. The three options proposed by the team were a combination of price and quantity adjustments, with all including price differences by users. The Government, concerned with high international oil prices and relatively high inflation, decided to indefinitely postpone the reform.

World Bank projections of 2011 government spending have been revised upwards with the fuel subsidy spending...

The upward revision to the World Bank assumption for the average crude oil price over 2011 contributes to a rise in projected energy subsidy (fuel and electricity) spending to IDR 211.1 trillion (up IDR 47.9 trillion on the March 2011 *IEQ* projection and above the Budget level of IDR 136.6 trillion). Rising oil and gas prices also contribute to a rise in related revenue-sharing transfers to the region and the education spending (which must equal 20 percent of total national fiscal spending). The performance of core spending is expected to accelerate in the second half of the year but is assumed to come in below full budget levels. Overall, total spending, including transfers, is projected at IDR 1,280 trillion (around IDR 50 trillion above the Budget level).

...and the World Bank deficit projection for 2011 has increased

The World Bank projection for the budget deficit in 2011 has been revised up to IDR 90.9 trillion or 1.2 percent of GDP (Table 5). The rise in projected expenditures more than offsets that of revenues leading to the upward revision in the deficit by IDR 27.2 trillion or 0.4 percent of GDP on the March 2011 *IEQ* projections. Nevertheless, the World Bank projected deficit is still below the Government's original budget level of IDR 124.7 trillion or 1.8 percent of GDP. Due to the rising energy subsidies, the Minister of Finance was also reported in the press as indicating that the Government will propose an increase in the deficit to above 2 percent of GDP in the budget revision (APBN-P) which is expected to be discussed in July.

The fiscal financing position remains solid

The 2011 Budget's estimate of the Government's gross financing needs was IDR 258 trillion. Total tradable bond issuance in the year to 7 June had already reached IDR 98.7 trillion or 49 percent of the target issuance of IDR 200.6 trillion for 2011. In addition, according to BI data, the Government's accumulated cash surplus is IDR 96 trillion, although parliamentary approval is required prior to its usage.

The Government's bond issuance over the quarter has included a USD 2.5 billion USD-denominated 10-year conventional global bond at a yield of 5.1 percent (versus a 6.1 percent yield for the previous such issue in January 2010). The Government has postponed its samurai debt issuance for 2011 due to current economic conditions in Japan. The Ministry of Finance has also begun the issuance of 3-month Treasury bills. These will provide the reference rate for the Government's variable-rate bond series, replacing the 3-month Bank Indonesia Certificate (SBI), whose issuance was suspended by BI in November 2010. The Government also indicated that it may issue 6- and 9-month Treasury bills.

The Government has outlined the 2012 macro and fiscal framework and is currently discussing the budget assumptions with Parliament

The Government has announced its proposed macro and fiscal framework for 2012. The proposed budget deficit is 1.4 to 1.6 percent of GDP (down on the 2011 Budget level of 1.8 percent). The Government is currently discussing the 2012 budget assumptions with Parliament but it is reported in the press that the economic growth assumption is likely to be between 6.6 and 7 percent, the exchange rate at IDR 8,600-9,100 per USD and inflation between 4 and 5.3 percent.³ The spending priorities for 2012 include social programs and infrastructure spending to support domestic connectivity and the development of the economic corridors as outlined in the recently released *Master Plan* (see Part C). The Government proposals also put forward the objective of improving subsidy targeting such as implementing the closed distribution of subsidized fuel, reducing the electricity subsidy and better targeting agriculture subsidies.

³ <http://economy.okezone.com/read/2011/06/14/20/467996/inilah-asumsi-makro-apbn-2011>

Table 5: Rising fuel subsidies have contributed to the upward revision to the World Bank 2011 budget deficit projection (IDR trillion, unless otherwise indicated)

	2009	2010	2011 (p)	2011 (p)	2011 (p)
	Outcome	Outcome	Budget	WB June estimates*	Revision from Mar 2011 estimates*
A. State revenue and grants	848.8	1,014.0	1,104.9	1,189.4	40.6
1. Tax revenue	619.9	744.1	850.3	858.6	11.8
a. Domestic tax	601.3	715.2	827.2	813.3	9.3
i. Income tax	317.6	356.6	420.5	432.3	9.0
- Oil and gas	50.0	58.9	55.6	77.0	8.7
- Non oil and gas	267.5	297.7	364.9	355.3	0.2
ii. Other domestic taxes	283.6	358.6	406.8	381.0	0.3
b. International trade tax	18.7	28.9	23.0	45.3	2.5
i. Import duties	18.1	20.0	17.9	24.5	1.6
ii. Export duties	0.6	8.9	5.1	20.7	1.0
2. Non-tax revenue	227.2	267.5	250.9	330.8	28.7
<i>o/w natural resources</i>	139.0	170.1	163.1	217.9	26.8
i. Oil and gas	125.8	152.7	149.3	197.5	26.6
ii. Non oil and gas	12.8	17.3	13.8	20.4	0.2
B. Expenditure	937.4	1,053.5	1,229.6	1,280.3	67.7
1. Central government	628.8	708.7	836.6	875.7	57.3
- Personnel	127.7	147.7	180.8	173.6	1.8
- Material expenditure	80.7	94.6	137.9	117.5	-6.6
- Capital expenditure	75.9	75.5	135.9	116.1	-6.1
- Interest payments	93.8	88.3	115.2	112.8	-0.8
- Subsidies	138.1	214.1	187.6	262.2	48.0
a. Energy	94.6	140.0	136.6	211.1	47.9
b. Non Energy	43.5	74.2	51.0	51.1	0.1
- Grants expenditure	0.0	0.1	0.8	0.8	0.5
- Social expenditure	73.8	68.4	63.2	61.3	0.6
- Other expenditures	38.9	20.0	15.3	31.4	20.0
2. Transfers to the regions	308.6	344.7	393.0	404.6	10.4
C. Primary balance	5.2	48.9	-9.4	21.9	-28.0
D. SURPLUS / DEFICIT	(88.6)	(39.5)	(124.7)	(90.9)	(27.2)
Deficit (percent of GDP)	(1.6)	(0.6)	(1.8)	(1.2)	(0.4)
Economic assumptions/outcomes					
Gross domestic product (GDP)	5,604	6,423	7,020	7,462	-13
Economic growth (per cent)	4.6	6.1	6.4	6.4	0.0
CPI (per cent)	4.8	5.1	5.3	5.9	-0.5
Exchange rate (IDR/USD)	10,356	9,074	9,250	8,713	-188
Interest rate of SBI (average %)	7.3	6.4	6.5	6.8	-0.2
Crude oil price (USD/barrel)	61.6	79.4	80.0	105	14.9
Oil production ('000 barrels/day)	950	954	970	952	-18

Note: * World Bank revenue forecasts are based on a different methodology to the Government to derive projections for nominal GDP (see Part C of the June 2010 IEQ for a full discussion)
Sources: MoF and World Bank projections

8. Risks around the outlook have risen

A range of downside risks surround the global economic and financial outlook but Indonesia appears relatively well-placed to absorb those external shocks

As highlighted in the discussion of the external environment, the period since the March 2011 *IEQ* has seen renewed uncertainty in the international outlook around a relatively strong global growth outlook. Some external shocks may have limited transmission channels through to Indonesia. For example, Indonesia's direct trade exposure to a weakening in growth in the US and EU is relatively limited compared with other countries in south east Asia that are more linked with global production chains of manufactured goods. Other shocks are likely to have a larger impact. For example, an adverse shock to construction investment in China and India would feed through to demand for Indonesia's commodity exports. Alternatively, upward shocks to global commodity prices, as discussed in previous *IEQs*, could benefit Indonesia's terms of trade but, with the current systems of energy subsidies, Indonesia remains at risk from the fiscal impact of higher oil prices. Higher international food prices, or reforms to administered fuel prices, could also spill over to the domestic inflationary outlook. Finally, the scope for shocks in international financial markets to prompt capital outflows remains clear, particularly originating from the Euro zone debt crisis. These could arise through increases in risk aversion or, in the event of any restructuring, the impact of losses on bank balance sheets could prompt further deleveraging, affecting cross-border flows to emerging markets.

On the one hand, strong domestic growth drivers and public and financial sector balance sheets put Indonesia in a relatively good position to manage any such shocks. On the other hand, recent developments have highlighted certain structural characteristics, such as the system of fuel subsidies, relatively high share of short-term portfolio flows and shallow domestic financial markets, which present a vulnerability to such shocks. Short- and medium-term policy reforms to address such areas could enhance the robustness of the Indonesian economy to these shocks going forward.

Domestically, near-term risks surround the outlook for inflation...

Risks around the inflation outlook include the path for future rice prices. In relation to energy prices, the pass-through of higher international energy prices into domestic consumer prices depends crucially on the magnitude, and profiling, of any adjustments to administrative fuel prices. Although the pick-up in core inflation has been moderate to date, and mainly driven by gold prices, vigilance over potential signs of over-heating are also required.

...particularly for rice prices which have a large impact on poverty basket inflation forecasts and to a lesser extent, the CPI inflation forecasts

Rice prices are a critical determinant of CPI and poverty basket inflation and are one key source of uncertainty around the baseline forecasts. Given the difficulties in forecasting rice prices due to uncertainties over the quality of the domestic harvest, weather conditions and import volumes, it is useful to evaluate a range of scenarios for rice price growth.

Table 6: The impact of retail rice price scenarios on inflation in Q4 2011

	Retail rice price growth scenario				
	Very low	Low	Baseline	Modest	High
CPI Inflation	5.2	5.5	5.7	5.9	6.2
<i>Change from baseline</i>	-0.5	-0.2	-	0.2	0.4
Poverty basket Inflation	2.6	4.2	5.8	7.3	8.8
<i>Change from baseline</i>	-3.1	-1.5	-	1.5	3.0
<i>Memo:</i> Retail rice price growth in Q4 2011	-8.2	-1.5	5.4	12.5	19.9

Note: Inflation is year-on-year inflation in Q4 2011. Baseline assumes retail rice price growth in Q3 and Q4 in line with average of past decade (up 5 percent yoy). Modest and low scenarios have growth rates at +/- 1 standard deviation from this mean and high and very low are at +/- 2 standard deviations

Source: World Bank projections

Table 6 presents the headline inflation and poverty basket inflation in the fourth quarter of 2011 under a number of scenarios for retail rice

price growth over the rest of the year, based on historical rice price growth in the third and fourth quarters. Roughly put, two-thirds of the time, retail rice price growth would normally lie between the low and modest scenarios with the extreme scenarios likely only 5 percent

of the time. The path of such a high scenario would be a similar occurrence to what occurred in 2006 with the rise in 2010 slightly lower. The simulation results clearly illustrate the sensitivity of the inflation outlook to rice price variability. The adverse impacts of higher rice prices are seen particularly for poverty basket inflation as rice is around one-fifth of the total basket whereas it only accounts for four percent of the CPI basket.

High and variable oil prices also pose a fiscal risk and opportunity cost

The underlying fiscal position is strong with low debt levels and conservative Budget deficits. However, around this baseline there are also risks to expenditures and revenues. The rising fiscal expenditures, and opportunity cost, of the status quo subsidy policies may be offset by ongoing disbursement problems (both on capital expenditures and on other programs such as BOS). The declining profile for oil lifting over the rest of the year adds downside risk to the revenue side, set against the revenue gains if oil prices rise further.

The primary medium-term risks continue to concern the implementation of policies and investments needed to boost growth going forward

The medium-term risks in reaching the growth targets of the RPJMN and of the *Master Plan* concern the prioritization, coordination and implementation of the policies and public infrastructure investments necessary to catalyze the private investments needed to reach these goals. Key “debottlenecking” policy reforms, such as the land acquisition law, are required both in themselves and as signaling measures. Given the cross-cutting nature of many of the constraints on growth, no one measure is a panacea and progress in a wide array of area will support achieving the ambitious growth targets. Meeting the Government’s objectives for broad and sustainable growth will also require accompanying investments in social protection, education and health along with a sustainable usage of Indonesia’s natural resources. If these challenges are met then Indonesia has the potential to become one of the major growth drivers of the next few decades (Box 2).

Box 2: Indonesia’s potential in the multi-polar world

How will the world economy and financial system evolve over the years until 2025? These are the questions addressed by a recent World Bank report entitled *Global Development Horizons 2011, Multipolarity: The New Global Economy*. The analysis finds that a new global economic order is unfolding with the balance of global growth shifting from developed countries to emerging economies such as Indonesia. In this new multipolar world there is the concurrent existence of more than two global growth poles, i.e. countries that drive global growth by virtue of their size, dynamism and linkages with the rest of the world. The report predicts that the United States, the Euro Area and China will constitute the three major growth poles by 2025, providing stimulus to other countries, including Indonesia, through trade, finance and technology channels. Other emerging markets will also develop as major growth poles, reflecting their relatively strong growth. Between 2011 and 2025 emerging economies are projected to expand by an average of 4.7 percent a year, while developed economies by only 2.3 percent a year.

The results of the analysis highlight the potential for Indonesia to join the ranks of the main global growth poles, although reaching this position is not automatic. It depends on the success of policies and investments to support sustained growth over this period. If this is achieved then by 2025, Indonesia could be one of six major emerging economies that will account for half the world’s output, including Brazil, China, India, Korea and Russia. Under this scenario in 2025, Indonesia’s share of global growth is projected to be around 2.8 percent (Figure 17), ahead of Brazil and Russia. This could see Indonesia’s economy grow to USD 4.1 trillion in nominal terms by 2025 (Figure 18) and its GDP per capita double in real terms from today.

Figure 17: Indonesia could join the ranks of global growth drivers by 2025...
(share of global growth contribution, 2021–25)

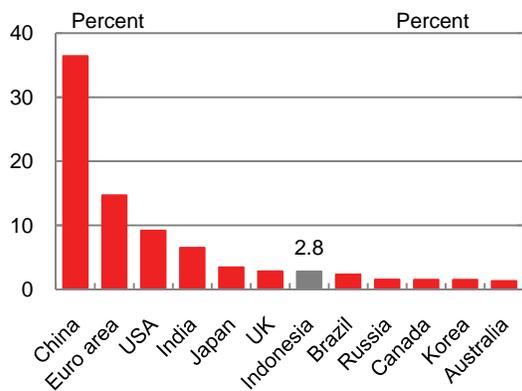
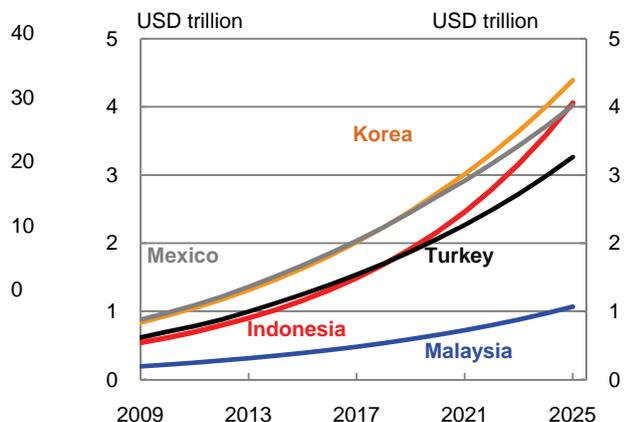


Figure 18: ...and has the potential to become one of the larger emerging economies
(nominal GDP paths, 2009–25)



Source: World Bank (2011), *Global Development Horizons* Source: World Bank (2011), *Global Development Horizons*

Note: This box draws on World Bank (2011), *Global Development Horizons*

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY

1. ASEAN 2011: Indonesia's Chairmanship

Indonesia can play an important role in shaping ASEAN's forward agenda in its role as Chairman for 2011

As the ASEAN Chairman for 2011, Indonesia currently has a key role in framing the future work program of this group of ten south-east Asian countries.⁴ What are the economic objectives of ASEAN, how large is its economy and what are Indonesia's ambitions for its Chairmanship year? Following the first ASEAN Leaders' meeting of the year hosted by Indonesia in Jakarta in early May, this section provides a brief overview of these issues.

a. Indonesia and ASEAN

ASEAN is a diverse grouping...

After its inception with the Bangkok Declaration of 1967, the past four decades of regional cooperation within ASEAN have not always been smooth. ASEAN is a region of significant economic, political, social and cultural diversity. Diversity which has resulted in a form of ASEAN diplomacy and cooperation which – according to a recent ADB study by Hill & Memon – has been characterized by caution, pragmatism and consensus-based decision-making.⁵ This “ASEAN Way” can limit speed and decisiveness but can also be a strength for building inclusive policies. Nevertheless, in recent years the rise of major emerging economies, such as China and India, has provided added impetus for ASEAN to create a stronger, more united and cohesive regional grouping to act as both a partner and as a counterbalance to these two neighboring economic powers.

...within which Indonesia retains a unique role

As the largest economy and population within ASEAN, Indonesia is uniquely placed to provide leadership within the group and represent ASEAN in international fora. For example, as the only ASEAN economy that is also a member of the G20, Indonesia can play an important role as a global voice for the region, in cooperation with the ASEAN Chair and Secretary-General. Indonesia can also use ASEAN as a vehicle to progress its own international economic interests. Where these interests align with the interests of the wider ASEAN groupings, Indonesia can leverage their influence for more effective partnerships with other major economies, such as China, India, the US, and Europe. This can be through ASEAN or the other “concentric circles” of East Asian regionalism such as ASEAN+3 which includes Japan, China and South Korea or the East Asia Summit (EAS) which includes India, the US and Russia, among others.⁶

b. ASEAN and East Asian regional economic integration

Moves towards ASEAN economic integration are set out in a series of formal declarations

The last decade has seen considerable moves to strengthen ASEAN's institutional structures, including the signing of the ASEAN Charter, the Roadmap for the ASEAN Community 2009-2015, and the associated ASEAN Community Blueprints. The ASEAN Community comprises three pillars: political-security, economic and socio-cultural. The ASEAN Economic Community (AEC) includes an ambitious commitment by ASEAN members to establish a single market and production base, with free flow of goods, services, investment, capital and skilled labor by 2015. It also includes further pillars on Equitable Economic Development and on small- and medium-sized enterprises. In turn, the AEC incorporates three ASEAN Integration Schemes: on trade, investment and on services. While these developments have strengthened ASEAN's institutions, Hill & Memon (2010) note that ASEAN has made relatively less progress in becoming a formal economic entity and comment that it remains a region of preferential trade arrangements, while members still maintain their own, very different, trade and economic structures.

ASEAN regional economic integration has focused on trade, crisis financing and financial market development

Through the combination of ASEAN, ASEAN+3 and the EAS, East Asian economic integration has developed along three broad categories: trade, crisis financing, and financial market development. Trade and investment integration has been progressed through a series of related – but sometimes fragmented – free trade agreements (FTAs).

⁴ The Association of South-East Asian Nations (ASEAN) comprises: Brunei Darussalam; Cambodia; Indonesia; Laos PDR; Malaysia; Myanmar; the Philippines; Singapore; Thailand; and Vietnam. More details on the history and current work program of ASEAN can be found at <http://www.aseansec.org/>.

⁵ Hill, H. & Memon, J. (2010) “ASEAN Economic Integration: Features, Fulfillments, Failures and the Future”. ADB Working Paper Series on Regional Economic *Integration*. No. 69.

⁶ ASEAN+3 was established in 1998. The EAS originally comprised the ASEAN+3 plus Australia, India and New Zealand. In 2011, the EAS was expanded to 18 countries, with the US and Russia joining.

With the ASEAN FTA (AFTA) as the base, ASEAN has pursued trade liberalization with a series of major trading partners through 'ASEAN+1' FTAs. These agreements allow the ASEAN members to negotiate as a bloc, increasing their bargaining power. Broader East Asian FTAs are also under study, including an FTA for the ASEAN+3 grouping and one for the East Asia Summit group. These broader FTAs could yield considerable strategic benefits and could be used to help rationalize the existing web of FTAs.

The Chiang Mai Initiative emerged to provide regional crisis financing following the experience of the Asian financial crisis

Perhaps the issue that has most strongly galvanized East Asian regionalism is crisis surveillance and mitigation. Following the establishment of the ASEAN+3 grouping in the wake of the Asian financial crisis, in May 2000 the grouping established the Chiang Mai Initiative (CMI). Originally a series of bilateral currency-swap arrangements between the ASEAN+3 economies totaling USD 24.5 billion, over the past 11 years the CMI has evolved into a multilateral pool of crisis financing, valued at over USD 120 billion in 2010.⁷ It has however yet to be tested and thus its effectiveness and decisiveness in the face of economic or financial crisis remain unknown. In response, it was agreed in 2011 to establish the ASEAN+3 Macroeconomic Regional Surveillance Office (AMRO) to provide economic analysis and stress testing for the ASEAN+3 economies with the aim of contributing to the early detection of risks, the swift implementation of remedial actions, and effective decision-making on disbursement of the CMI in the event of a crisis.

A range of initiatives have been put forward to develop local bond markets

In order to provide more diversified funding sources for firms, the development of regional bond markets within East Asia has received considerable attention. On the demand-side, the Asian Bond Fund, an initiative of the East Asia and Pacific Central Banks, is designed to invest a portfolio of pooled reserves into US dollar and local-currency sovereign and quasi-sovereign bonds. The ASEAN+3 Asian Bond Market Initiative and ASEAN+3 Bond Market Forum focus on a range of supply-side issues relating to, for example, new debt instruments, settlement processes, standardization of market practices and harmonization of regulations for cross-border bond transactions, etc. Nevertheless, the size of regional bond markets relative to GDP is not much larger than a decade ago. However, according to a recent IMF paper, institutional development of the market, and strong foreign investor interest, means that markets are in a position to expand rapidly over the next decade.⁸

c. The economic rise of ASEAN

ASEAN represents a large and rapidly developing economic region...

The dynamic economies within the ASEAN group have the potential to sit alongside China and India as drivers of the global economy over coming decades. By population, ASEAN is around half the size of both China and India. Its combined economic size, measured by US dollar GDP in 2009, was about a third of China and one-fifth larger than India. By comparison, ASEAN is double the size of the US by population, and about 20 percent larger than the EU-27 – but is only a tenth of the size of both economies.

...which is expected to increase in size relative to other major economies over the next 15 years

Looking forward, ASEAN's relative market size is set to grow. According to UN figures, ASEAN's population is expected to increase over 16 percent between 2009 and 2025. In comparison, the total populations in developed economies and in China are expected to grow by less than 5 percent over the period. Regarding economic size, the combined economies of Indonesia, Malaysia, Singapore and Thailand will more than double in real terms between 2009 and 2025 (World Bank, Global Development Horizons, 2011). This is reaching towards the trebling for China and growth by two and a half times for India, and much higher than the increases of one third and one half in the US and Euro zone, respectively. The dynamic domestic markets of ASEAN could also represent a significant opportunity for ASEAN to seek greater influence and recognition on the global stage.

There has also been a gradual rise in intra-regional trade flows within ASEAN but a considerable rise for FDI

The last decade has seen a gradual strengthening of ASEAN's intra-regional integration across a range of metrics. Total ASEAN trade reached USD 1.5 trillion in 2009, with intra-ASEAN trade accounting for 25 percent. This is up from 22 percent in 2000 but, as a comparison, is relatively low compared with the levels inside the much bigger market of the economic union of the EU, where around 70 percent of trade is intra-regional. Meanwhile, intra-regional FDI inflows have increased dramatically since 2000, up from 3 percent of total FDI inflows to 20 percent by 2008.

⁷ See www.adb.org/Documents/ERD/Working_Papers/wp006.pdf and www.asean.org/24433.htm.

⁸ Feldman, J. et al. (2011) "ASEAN5 Bond Market Development: Where Does it Stand? Where is it Going?" *IMF Working Paper*.

d. Indonesia's priorities for ASEAN

Indonesia wants to begin discussion on the shape of ASEAN after 2015 and has also prioritized progress on connectivity, food security and energy security

A key platform for Indonesia's 2011 Chairmanship has been a desire to commence discussion of an ASEAN vision beyond 2015. Following their May meeting, the ASEAN leaders indicated that by 2022, ASEAN will endeavor to have a "more coordinated, cohesive and coherent ASEAN position on global issues". Such a framework could prove valuable as ASEAN seeks to increase its influence in regional and global issues. Indonesia has also focused ASEAN discussions on making progress on connectivity, food security and energy security. These priority areas are consistent with Indonesia's domestic policy priorities, as seen in the recently released Government *Master Plan* (see Part C). As is the case for Indonesia, improving connectivity remains a vital issue to improve the competitiveness of ASEAN as a whole given it is a diverse island region. Meanwhile, the rapid rise in global food and energy prices since mid-2010 has once again put pressure on poorer households across East Asia, and represents a significant risk to fiscal space for many ASEAN governments. If delivered, cooperation in these issues could provide significant benefit to ASEAN. However, implementation of these agreements will require considerable time, effort, and political will from each of ASEAN's members.

Leaders' agreed to expedite the implementation of the Masterplan on ASEAN Connectivity...

On connectivity, the leaders of ASEAN in Jakarta called on the recently established ASEAN Connectivity Coordinating Committee and the ASEAN Connectivity National Coordinators to expedite the implementation of the Master Plan on ASEAN Connectivity. Signed in October 2010, the Master Plan provides a comprehensive framework for advancing regional connectivity through enhanced trade, investment, tourism and people-to-people exchange, and encompasses both physical and institutional connectivity factors.

...to establish an Integrated Food Security Framework...

The issue of food security in ASEAN dates back to the signing of the ASEAN Food Security Reserve in 1979. Progress on the issue has historically been slow, but recent agreements could re-energize regional cooperation. At the Jakarta meeting, the ASEAN leaders agreed to establish an Integrated Food Security Framework, which comprises the ASEAN Strategic Plan of Action on Food Security (2009-2013) and the ASEAN+3 Emergency Rice Reserve (APTERR), which is scheduled to be signed by the end of 2011. The Strategic Plan of Action on Food Security is a multi-faceted framework covering issues such as strengthening national food security programs and promoting non-discriminatory trade. It includes supply-side measures such as promoting greater R&D, investments in food and agro-based industry, facilitating technology transfer and investing in agricultural infrastructure. It also aims to promote monitoring of food security and to assist in targeting assistance should a food shock hit. Meanwhile, the APTERR is expected to provide rice reserves – mainly from Japan, China and Korea – to help ensure the stability of food supply to ASEAN, in the event of a food shortage or crisis.

...and have provided renewed focus for a regional solution to energy security

On energy security, the ASEAN leaders agreed that further efforts are required to accelerate the implementation of the ASEAN Plan of Action on Energy Cooperation 2010-2015 (APEAC). Although there have already been a range of positive achievements under previous APEACs – such as establishing the ASEAN Power Grid and Trans-ASEAN Gas Pipeline – it was stressed that there was a need to accelerate cooperation to ensure greater security and sustainability of energy, for example through enhanced technology transfer. It was also underlined that cooperation should be intensified on the development of renewable and alternative energy, including hydropower, geothermal and bio-fuels.

What will it take for ASEAN to make a difference in these areas?

Making progress on these issues, and in putting forward ASEAN's views in global fora, will require ongoing commitment and coordination from ASEAN members. In particular, the grouping will need to work hard to maintain progress through the annual rotation of the Chair, which is to be passed to Cambodia for 2012. On economic integration, one clear tool for members to demonstrate their commitment is by addressing outstanding integration issues identified under the ASEAN Economic Scorecard, which measures the progress of each member in achieving jointly agreed integration priorities. Finally, to ensure consistency between national, regional and global mechanisms, ASEAN can continue to develop a coordinated voice. This is particularly important to ensure that weight is given to ASEAN members' interests during the ongoing changes in the global economic and financial architecture.

2. The revival of foreign direct investment (FDI) into Indonesia?

Indonesia has experienced record FDI inflows in recent quarters...

Recent financial inflows into Indonesia have been driven not only by portfolio flows but also by a rise in FDI inflows. Net FDI flows into Indonesia reached USD 4.5 billion in the first quarter of 2011 (Figure 19), the highest quarter since the series began in 2004, following cumulative inflows of USD 13.3 billion over 2010 as a whole, which was another high. These recent data, along with the spread of FDI across sectors, raise hopes of a resurgent trend of FDI inflows, which have been relatively weak for Indonesia over the past decade, which could provide a further driver of growth and economic development.

...which have the potential to boost Indonesia's growth through financing investment and through other channels such as technology transfer and linkages with global supply networks

FDI can potentially provide significant economic benefits through a range of economic channels. For example, FDI can help meet Indonesia's needs for greater investment to achieve its goals for economic development and poverty alleviation. The Government's recently released *Master Plan 2011-2025* (see following section) and Medium-Term Development Plan (RPJM) recognize these needs, with the latter targeting an increase in annual real investment growth to a level of 11.7-12.1 percent by 2014. Indonesia's relatively low savings rate and thin financial markets mean that these higher investment needs are unlikely to be met by domestic sources alone (see, for example, the op-ed by Silmy Karim, Paramadina University, in the Jakarta Post, "Assessing Benefits of FDI to the Nation", November 2010).

FDI can also bring a series of other benefits, which can outweigh the direct benefits of additional financing for investment. Depending on host country characteristics and the extent of linkages with the rest of the economy, FDI can also potentially increase the productivity and growth of the economy by introducing new technologies, business processes, systems, and management practices and can provide links to export markets and international supply chains. It can also bring jobs in production and management. While the non-financial benefits of FDI are by no means automatic, there are many examples of how investments by foreign firms have spearheaded the growth of domestic industries, such as textiles and clothing in Bangladesh, software in Costa Rica or the electronics sector in China's coastal areas.

There may also be risks associated with FDI. At the macro level there may be policy challenges in dealing with greater capital inflows and the pressure these may put on the exchange rate. If the linkages with domestic companies or suppliers are limited then the scope for technology spillovers can be reduced. Similarly, limited employment and training of domestic workers could hamper any human capital benefits. In addition, particularly for natural resource-based FDI, the environmental sustainability of the investment must be taken into account, as for the operations of domestic companies.

This section provides an overview of recent FDI trends into Indonesia and outlines some of the main drivers. It also highlights that domestic policy measures, for example, to improve connectivity, the investment climate and skills, can not only enhance growth prospects directly but can attract further FDI and the ability of host countries to benefit from it, creating a potentially virtuous relationship between FDI and domestic incomes.

a. The patterns of FDI into Indonesia have changed in recent years

The upward trend in FDI is seen across different data series...

The upward trend of FDI into Indonesia is seen across the two main data series, namely the Balance of Payments data of BI and the data from the Investment Coordinating Board, *Badan Koordinasi Penanaman Modal* (BKPM) (Box 3). Unless otherwise stated, the discussion below focuses on trends in net FDI flows into Indonesia, i.e. inflows of FDI into Indonesia from foreign investors net of the repatriation of capital by these investors, as measured by the BI Balance of Payments data.

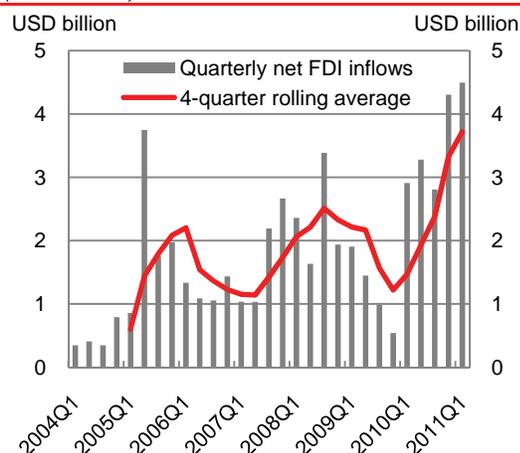
...which also highlight the shifts in the composition of FDI across a number of dimensions

While the level of FDI has moved upwards, the composition has also shifted across a number of dimensions such as the type of inflows, their source, sector and regional destination. For example, although direct equity capital accounted for around three quarters of total FDI in the past four years, 2010 saw an increasing contribution from reinvested earnings and debt inflows most likely reflecting Indonesia's strong domestic growth and the recovery in global economic and financial conditions.

FDI inflows are now dominated by inflows from Japan and Singapore...

BI data suggest that FDI inflows by source country are now dominated by inflows from Japan and Singapore, while inflows from the US and Europe have trended down recently (Table 7). However, the rise in regionally-sourced FDI, particularly from Singapore, may in part reflect changes in business practices as multinationals choose to invest in Indonesia through regionally-based affiliates, rather than directly from parent organizations, motivated by tax and regulatory arrangements or evolving corporate strategies. Empirical studies also suggest that common service agreements, such as the ASEAN Framework Agreement on Services to which Indonesia and Singapore are members, can stimulate cross-border FDI.⁹ In addition, although it is difficult to quantify, there is the potential that some of these inflows from Singapore may also represent “round-tripping” of capital which actually originates in Indonesia.

Figure 19: FDI flows into Indonesia are trending up (USD billion)



Sources: BI and World Bank staff

Table 7: Intra-regional FDI inflows have become more important (share of total FDI inflows by source country, percent)

	2004	2005	2006	2007	2008	2009	2010
Japan	-1.6	18.5	21.5	16.3	12.3	18.4	28.0
US	-27.6	41.3	-11.2	15.8	11.2	3.3	4.3
Europe	82.5	19.0	41.0	37.8	21.1	13.8	2.1
China	15.5	3.6	2.5	1.7	5.7	7.3	2.7
Korea	12.1	2.9	6.5	3.6	2.0	1.6	2.6
ASEAN, of which:	10.8	10.6	27.5	16.0	36.5	28.3	44.4
Malaysia	6.4	1.7	5.6	3.3	10.9	6.4	2.6
Singapore	4.4	8.9	21.9	12.1	24.7	20.8	41.2
Other	8.3	4.2	12.1	8.8	11.3	27.3	16.0
Total	100	100	100	100	100	100	100

Sources: BI and World Bank staff

Manufacturing remains a key sector for FDI inflows, while services are also growing in importance

Looking at the sectoral composition using the BI data, FDI inflows go into four major sectors (Table 8). Manufacturing continues to account for the largest share of FDI inflows, relatively stable at over one-third of the total. Just as for total FDI inflows, the source of FDI to the manufacturing sector has shifted in recent years. Inflows have recently been driven by investment from Japan and ASEAN while in earlier years, strong FDI into manufacturing was driven mainly by investment from the EU.

Inflows into the mining & quarrying sector rose considerably prior to the 2008/09 global downturn, with the majority coming from the US. Having fallen more than other sectors during the crisis, inflows have returned to pre-crisis levels but are now sourced roughly evenly between the US, EU, Korea and China. Wholesale & retail trade and other service sectors, such as transport and telecommunications, have also realized increasing shares of total FDI. In contrast, FDI to the financial sector suffered severely during the global crisis and has yet to recover.

⁹ Di Giovanni (2005), “What drives capital flows? The case of cross-border M&A activity and financial deepening”, *Journal of International Economics*.

Box 3: Different sources of data on FDI inflows into Indonesia

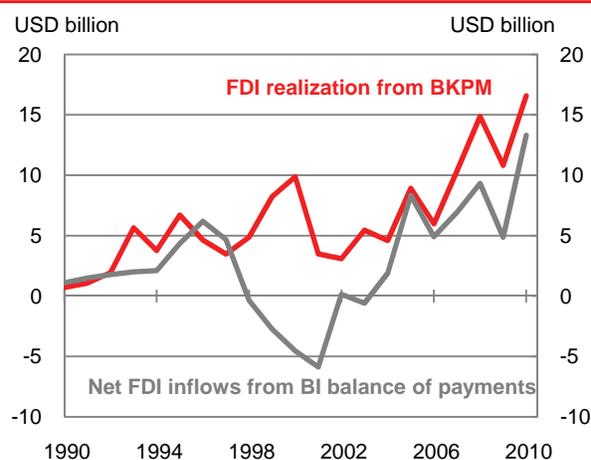
There are two sources of data commonly used to analyze trends in FDI into Indonesia. The first is BI's Balance of Payments data. The second is the data on FDI realizations from Indonesia's Investment Coordinating Board (BKPM). While both data sources display broadly similar trends, methodological differences can result in some divergences between the two series (Figure 20).

The primary reason for the difference lies in the classification of FDI. Since the BI data follows guidelines for balance of payments statistics it considers that "direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy". Thus, an investment in an Indonesian company by a foreign investor is recorded as FDI if the investment gives rise to control or influence, either through equity (of greater than 10 percent of total equity), reinvested earnings, debt or reverse investment. Under the BKPM data an investment project is counted as FDI if any of the financing for that project originates from a foreign resident, regardless of the size of that investment. Furthermore, for any joint venture project which involves both domestic and foreign investment, the entire value of the project is recorded as FDI. In addition, the BKPM data does not record divestments by foreign investors (which contributed to the negative FDI inflows on the Balance of Payments series following the 1997/1998 crisis).

There are also differences in sectoral coverage across the two sources. The BI data includes FDI flows for all sectors while the BKPM data excludes certain sectors such as oil and gas, and banking and financial institutions. Despite these differences the two data sets are useful complements to analyze trends in foreign investment flows. For example, while both provide a breakdown of FDI by industry and by source country, only the BKPM data provides a breakdown of FDI by host region within Indonesia.

Sources: OECD Investment Policy Review, Indonesia, 2010

Figure 20: BKPM and Balance of Payments FDI series follow similar trends but with some differences (USD billion)



Sources: Bank Indonesia and BKPM

Table 8: Manufacturing continues to attract the largest share of FDI inflows into Indonesia (share of total net FDI inflows by sector, percent)

	2004	2005	2006	2007	2008	2009	2010	Average
Agriculture, Hunting, and Forestry	6.7	0.0	4.6	4.1	2.1	-1.1	2.1	2.7
Fishing	0.0	0.1	0.1	0.3	-0.3	0.2	0.4	0.1
Mining & Quarrying	5.9	14.7	6.5	27.5	38.7	26.7	13.5	19.1
Manufacturing	39.3	63.1	34.4	34.8	24.9	32.3	36.2	37.9
Electricity, Gas and Water	0.0	1.9	0.0	-0.9	-0.6	1.1	1.6	0.4
Construction	-0.8	1.6	1.7	2.8	0.3	0.1	-0.4	0.8
Wholesale & Retail	-10.1	0.7	7.6	3.1	12.4	1.5	19.4	4.9
Hotel & Restaurant	0.0	0.0	0.1	-0.1	0.2	0.0	0.0	0.0
Transport, Storage & Communication	10.7	4.6	12.1	8.6	1.4	36.9	18.7	13.3
Financial Intermediation	20.5	9.4	20.9	19.3	20.7	3.1	3.2	13.9
Real Estate and Business Activity	-0.8	0.2	-0.3	-0.1	-2.2	-0.5	0.2	-0.5
Others	28.6	3.6	12.2	0.5	2.3	-0.3	5.1	7.4
Total	100	100	100	100	100	100	100	100

Sources: Bank Indonesia and World Bank staff

FDI inflows are still concentrated in Java but recently a rising share is going to other islands, particularly Kalimantan

BKPM data shows that FDI inflows, by their location of investment, are heavily concentrated in Java, with 70–90 percent of FDI flows each year being directed to the most populous island of the archipelago (Table 9). On Java FDI is further concentrated around the capital, Jakarta. This investment likely constitutes the majority of investment into the manufacturing, wholesale & retail, and other services sectors. There has been a

rise in FDI to other regions with particular increases over the last couple of years seen for Kalimantan. The region's rich deposits of natural resources have attracted increased FDI inflows associated with mining, oil, and gas projects, predominantly in the east of the territory. Meanwhile Sumatera has experienced a sizeable decline in its share of FDI inflows over the past three years, driven by a fall in FDI going to Riau.

Table 9: FDI inflows are still concentrated in Java, especially in the capital
(share of total FDI by location of investment, percent)

	2004	2005	2006	2007	2008	2009	2010	Average
Java, of which:	70.6	81.3	73.8	82.3	91.2	86.7	70.9	79.5
<i>Jakarta Capital Territory</i>	32.1	36.7	24.6	45.2	66.8	51.0	39.9	42.3
<i>West Java</i>	24.7	28.8	27.1	12.8	17.2	17.9	10.3	19.8
<i>East Java</i>	4.2	7.9	6.4	16.4	3.1	3.9	10.5	7.5
<i>Banten</i>	7.3	7.5	8.6	6.9	3.2	13.1	9.8	8.0
Kalimantan, of which:	8.0	2.0	9.0	3.0	0.8	2.6	12.5	5.4
<i>East Kalimantan</i>	8.0	0.4	6.8	1.6	0.1	0.7	6.9	3.5
Sumatera, of which:	18.5	13.7	14.8	13.4	6.8	7.2	4.8	11.3
<i>Riau</i>	11.2	8.9	9.8	7.0	3.1	2.3	0.9	6.2
Sulawesi	0.6	1.6	0.2	0.8	0.4	1.3	5.1	1.4
Nusa Tenggara, of which:	2.3	1.2	1.8	0.5	0.6	2.2	2.2	1.6
<i>Bali</i>	2.3	1.1	1.7	0.5	0.5	2.1	1.7	1.4
Maluku	0.0	0.1	0.3	0.0	0.0	0.1	2.3	0.4
Papua	0.0	0.0	0.0	0.0	0.1	0.0	2.4	0.4
Total	100.0							

Sources: BKPM and World Bank staff

b. Despite the rising value of inflows, FDI relative to GDP remains relatively weak

FDI inflows across East Asia were severely affected during the Asian financial crisis

From 1993 to 1997, FDI inflows into Indonesia averaged almost 2 percent of GDP (Figure 21). This was higher as a share of GDP than, for example, the levels in India and Thailand. However, the impact of the Asian financial crisis was severe, prompting foreign investors to repatriate their capital and as a result there was a net outflow of capital by foreign direct investors from Indonesia over 1998 to 2001 (i.e. net FDI was negative).

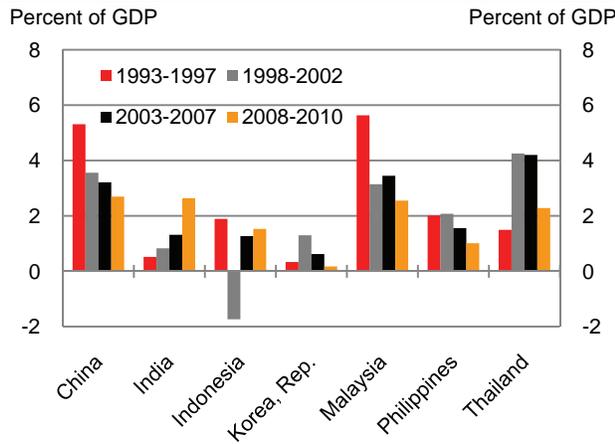
Despite their recovery, FDI inflows to GDP for Indonesia remain relatively weak compared with regional peers...

While nominal domestic investment rates in Indonesia have returned to pre-crisis levels (as detailed in Box 2 in the March 2011 *IEQ*), FDI as a share of GDP has not followed such a strong recovery. But for a one-off spike in 2005, FDI remained less than one percent of GDP over 2002 to 2009 before rising to just under two percent in 2010. The relative weakness in FDI inflows following the 1997/1998 crisis has been seen in other countries in the region, such as Malaysia and the Philippines. However, Indonesia's FDI to GDP remains relatively low compared with many regional peers, particularly China and also India which has experienced a strong rise in FDI inflows over the past decade.

...and relative to other resource-rich economies

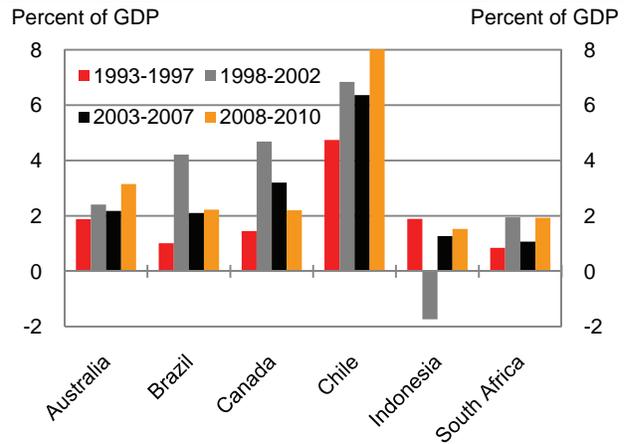
It is also instructive to compare Indonesia's FDI levels to that of other resource rich economies. Once again, FDI inflows to Indonesia remain relatively low by comparison (Figure 22). For example, FDI to GDP for Indonesia in 2010 of 1.9 percent of GDP compares with 2.3 percent in Brazil and over 7 percent for Chile. There are of course many factors that affect the level of FDI inflows into a country, such as the size of the local population, its geography, natural resources, labor costs and skills. These regional and resource-based economy comparisons are therefore mostly useful to illustrate trends and to provide a context with which to view the recent pick up in Indonesian FDI inflows.

Figure 21: Indonesia's FDI inflows to GDP remain relatively low versus regional peers... (average annual FDI net inflows to GDP, percent)



Note: Indonesia FDI data from BI
Sources: BI, CEIC, World Development Indicators, and World Bank staff

Figure 22: ...and compared with inflows to other middle- and high-income resource rich economies (average annual FDI net inflows to GDP, percent)



Note: Indonesia FDI data from BI
Sources: BI, CEIC, World Development Indicators, and World Bank staff

c. The FDI outlook for Indonesia appears positive...

Expectations for future FDI inflows into Indonesia are positive...

Recent announcements of intentions to invest by multinationals point to a continuation of the positive outlook for FDI inflows into Indonesia. BKPM, for example, targets a rise in FDI by 22 percent over 2011. The Government has also been active in promoting Indonesia as an investment destination signing deals with Japan (USD 24 billion), India (USD 15 billion) and Singapore (USD 10 billion). The cooperation with Japan is through an infrastructure plan, signed in December 2010, to promote the development of Jakarta's Metropolitan Priority Area (MPA).

...reflecting a range of underlying drivers – natural resources, a growing domestic market and relatively low labor costs

As seen in the sectoral composition of flows, the drivers of FDI into Indonesia are broad-based. One attraction is, of course, Indonesia's endowment of natural resources. A second is Indonesia's large and growing domestic consumption base. A third driver is Indonesia's relatively low labor costs which can be used in production for export markets, particularly for manufactured goods. Furthermore, the same company may have a number of these motivations for making an investment in Indonesia (as indicated in surveys of foreign-affiliates, Box 4), and the mix may vary over time. For example, companies such as Korea's Hyundai and Hankook Tire have stated their motivations for investment in Indonesia as both an attempt to expand domestic market share, as well as to take advantage of lower production costs to service export markets.

The strong global demand for commodities is likely to support FDI going forward...

Expectations for continued strong growth in China and India, along with other developing economies, suggest commodity demand and prices will remain elevated in coming years. As such, Indonesia's natural resources, and strategic location to service the Chinese and Indian markets, are likely to see further FDI inflows into the commodity sectors. The Indonesian Mining Association forecasts that FDI into the industry will reach USD 8 billion over the year. BKPM has also announced that they have received private sector applications for investment in a range of mineral sectors, including aluminum and nickel plant projects in West Kalimantan, Southeast Sulawesi and North Maluku.

...as will the rising domestic incomes and the emergence of Indonesia's middle class

Indonesia's emerging middle-class, along with expectations of rising incomes and consumption spending, continue to provide an incentive for FDI looking to serve the domestic market. As outlined in the March 2011 IEQ, over the next decade Indonesia's middle class is likely to continue growing and, most importantly for producers of consumer durables, for example, more people will move upwards within the middle class. This expansion of the middle-class – along with the positive outlook for economic growth – continues to provide an incentive for foreign firms to seek market presence in Indonesia, potentially through FDI in local production, as seen in the recent examples of L'Oreal and Honda establishing production bases in Indonesia.

Indonesia also has the potential to benefit from the relocation of manufacturing-for-export FDI from China as labor costs rise

The rise in labor costs that has been seen in the coastal regions of China has raised the scope for Indonesia to attract an increasing amount of export-processing manufacturing. There is of course strong competition from other countries, and regions within China, but Indonesia's relatively low production and labor costs may prove attractive. India and the Philippines have also shown that there is the potential for using low labor costs to build up FDI for service exports, such as in business processing, if combined with strong infrastructure, skills and training.

Box 4: Optimistic outlook, but challenges remain: the views of Japanese-affiliate companies in Indonesia

Surveys of the attitudes of foreign companies operating in Indonesia can provide some valuable insights into the relative importance of the various drivers of FDI inflows and of the factors which may be constraining activity, and so potentially deterring additional inflows. One such survey of Japanese-affiliate firms is conducted by the Japanese External Trade Organisation (JETRO). The most recently released survey, conducted in August and September 2010, covered almost 3,500 Japanese-affiliate firms located in 18 countries across Asia and Oceania, including around 130 respondents from Indonesia, predominantly in the manufacturing sector.

Looking at the question of whether the affiliates focus on domestic or export markets, the survey found that for the region as a whole 45 percent of the companies gave a higher priority to developing their position in the local market than to exporting. Around 30 percent gave an equal weight to the two, 11 percent gave a higher priority to exporting and 7 percent were only focused on exporting. As expected, local market development comes up as a great priority in markets with larger populations or higher average incomes. For example, in Indonesia 51 percent of firms were focused on the local market, just below the level for China and Australia but considerably below the 74 percent response for India.

Business confidence and expectations of future growth appeared upbeat across the region. The majority of survey respondents expected to record a profit in 2010, with projections of even better sales in 2011. This reflected both local market and export sales, as regional growth and export demand normalized following the downturn of 2008 and 2009. As a result, over 60 percent of firms reported plans to expand their business in the next 1-2 years, mainly to develop new markets. The outlook in Indonesia was one of the strongest across the region, reflecting the relative strength of domestic demand in recent years. 80 percent of the firms expected they would realize a profit in 2010 – one of the highest percentages for any market – while 65 percent of firms expected their profits would be higher still in 2011. Over two-thirds of businesses expected to expand activities in Indonesia over the next 1-2 years.

The survey also documented the major issues faced by the affiliates in their operations. Such information can provide valuable inputs to policymakers to identify, to develop and to prioritize policies to improve the domestic investment climate. For Indonesia, respondents identified the following main issues as constraining business activity: lack of capacity of local workers and management staff; restrictions on staff dismissals; lack of information on trade rules and regulations; complicated and time-consuming customs procedures; lack of adequate electricity supply (black-outs); and the exchange rate volatility of the Rupiah against the US dollar.

Across the region, survey respondents also identified rising labor costs as the most significant challenge to business activities, with firms in six of the 18 countries reporting double-digit increases in annual average salaries. Wage pressures were particularly strong in China and Vietnam and in the electronics, transport and textiles sectors. While the results reflect only this survey, and a relatively small number of firms, they indicated that labor costs in Indonesia remained lower than the regional average – and in particular, lower than China – across both manufacturing and non-manufacturing sectors, and for both workers and management.

According to the respondents, at the time of the survey average US dollar monthly salaries for workers in the manufacturing sector were said to be around 40 percent lower in Indonesia than in China (around 45 percent lower when allowances, bonuses, overtime and social insurance were included). Engineers in manufacturing also received monthly base salaries around one fifth lower than in China. For non-manufacturing staff the difference was greater. Base wages for non-manufacturing staff in Indonesia were less than half the level of their Chinese counterparts, while the total pay burden was roughly one quarter. Again, these results are only illustrative, and do not reflect the business conditions for all foreign firms, nor are they adjusted for the relative productivity of labor across countries, but these relative low labor costs may prove attractive for additional foreign firms to relocate to Indonesia. As mentioned earlier there is a sizeable literature debating the impact such FDI has on the welfare of domestic workers and the wider economy but, when accompanied by supportive policies on education and training for example, it may facilitate knowledge transfer to domestic workers and build up their human capital, contributing to higher productivity and wages.

Source: JETRO (2010). "Survey of Japanese-Affiliate Firms in Asia and Oceania", FY 2010 Survey, <http://www.jetro.go.jp/en/reports/survey/biz/>

d. ...but could be even stronger with improvements in investment climate, infrastructure and skills

The attractiveness of Indonesia for FDI inflows could be further enhanced by addressing infrastructure and skills weaknesses and by improvements in the business environment...

While the above structural drivers provide strong incentives for FDI into Indonesia, foreign companies may be deterred by concerns over the regulatory environment, infrastructure weaknesses or mismatches between their demand for skills and those available in the domestic labor force. For example, as outlined in Box 4, Japanese-affiliate firms based in Indonesia identified a number of such factors, such as complicated customs clearance procedures or difficulties in meeting labor demands, as factors hampering their business activities. Put another way, improving the regulatory investment climate, addressing infrastructure 'bottlenecks' in domestic transport, electricity, communication and information networks, and strengthening the education and skills of the labor force could therefore provide added incentives for foreign firms to establish a domestic production base, or to shift export production, to Indonesia.

...which are also necessary if the full benefits of the FDI are to be gained

The implementation of such policy reforms and investments could increase the attractiveness of Indonesia for FDI by lowering the costs and improving the productivity of operations. As emphasized in the Government's recently released *Master Plan*, such investments and reforms are also crucial to raising Indonesia's growth rate over the next few decades. Rising domestic incomes are likely to stimulate more inflows attracted by Indonesia's growing consumer base. These different dimensions raise the prospect that such pro-growth policy reforms and investments could create a virtuous relationship with improved growth prospects and FDI inflows. If realized, this could provide benefits for incomes and employment prospects of the population, helping to further progress on poverty reduction. However, such an outcome is not guaranteed. Empirical evidence suggests that the benefits of FDI for growth and investment can be dependent upon a range of country-specific factors, including institutional quality (such as legal certainty) or levels of human capital. Thus, to achieve the potential benefits of FDI will require the prioritization, coordination and sustained implementation of the supporting reforms and investments. For example, this includes focusing education and skills training to match with the needs of companies so as to promote quality job creation from the FDI flows.

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

1. Addressing Indonesia's infrastructure challenges to enhance competitiveness and growth

Indonesia's infrastructure weaknesses are one of the main constraints on lifting its growth to a higher trajectory

Poor levels of infrastructure development are holding back Indonesia's growth potential and poverty reduction progress. The symptoms of more than a decade of low infrastructure investment include the increasing congestion in urban areas, high levels of inter-island cargo transport costs, electricity blackouts, and low access to improved sanitation. Indonesia ranks low among other countries with regards to the quality of infrastructure and the inadequate supply of infrastructure is consistently identified by firms as a constraint on their operations and investment. Poor infrastructure can also adversely affect the well-being of the population through a variety of other channels. It can adversely impact health directly, for example, in the case of poor water and sanitation facilities. In addition, high transport costs also impede access to health and education facilities. Weak infrastructure linkages between regions can also exacerbate the impact of shocks, such as weather-related events, due to the rising transportation costs and difficulties in moving products across regions.

The Government of Indonesia recognizes the importance of addressing Indonesia's infrastructure challenges in its longer-term plans...

Recognizing these issues, the Government has pledged its commitment to address infrastructure challenges as one of its main priorities. This is emphasized in the current medium-term development plan (RPJMN) for 2010-2014 which sets a range of infrastructure development targets to be achieved by 2014. These include, for example, building 2,800 km of toll roads, adding 3,000 MW of generating capacity per year and improving access to water and sanitation to meet Millennium Development Goal (MDG) targets. As discussed in the following section, improving infrastructure is also at the heart of the *Master Plan* for the Acceleration and Expansion of Indonesia's Economic Development 2011-2025.

... and more immediate policy measures

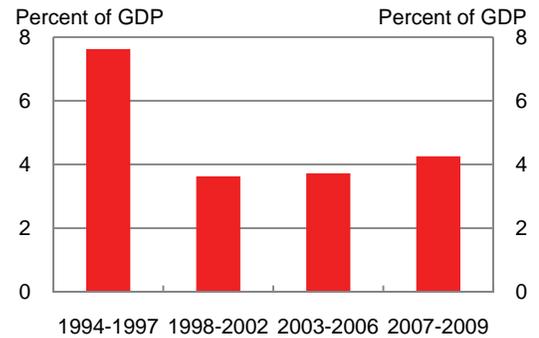
The prioritization of infrastructure spending is also seen in recent budget allocations and policy measures. For example, in 2011 the Budget allocation to capital expenditure was increased by two-fifths relative to the 2010 revised Budget. However, as discussed in Part A, ongoing disbursement challenges remain, and have to be addressed if these allocations are to be realized.

There have also been some supportive legislative developments as well as the allocation of additional funds. These include, for example, the creation of the Risk Management Unit in the Ministry of Finance and the enactment of a Presidential Regulation (Perpres 67/2005) which sets out the criteria that apply to Public Private Partnership (PPP) projects requiring Government financial support. The law on Land Acquisition has also been submitted to Parliament. Many issues remain to be addressed, not least improving coordination of related policies across different levels and institutions within Government. This section provides a brief overview of recent infrastructure investment trends and performance in Indonesia.

Indonesia's investment in infrastructure fell sharply after the Asian financial crisis in the late 1990s and has only partially recovered

Though it has recovered partially, Indonesia's recent investment in infrastructure still lags below its pre-1997/1998 crisis levels (Figure 23). Infrastructure investment fell from over 8 percent of GDP in 1995 and 1996 to around 3 percent in 2000 as the Government focused on fiscal consolidation and cutting public debt. Spending by the private sector and state-owned enterprises on infrastructure investment also declined. As a result, Indonesia faced major challenges in meeting the demand for infrastructure investment during the late nineties.

Figure 23: Indonesia's infrastructure investment fell sharply after the Asian crisis (percent of GDP)



Sources: MoF, annual reports for state-owned enterprises, World Bank's Public-Private Infrastructure database for private investment

Since then, the level of investment has recovered moderately, but only to around 4 percent of GDP in 2008-09 (Figure 24). While cross-country data is difficult to obtain, these figures seem low compared to some countries in the region. For example, a 2005 report on "Connecting East Asia: A New Framework for Infrastructure" estimated infrastructure investment to GDP in China, Thailand and Vietnam at over 7 percent. Although the appropriate or optimal ratio of infrastructure investment to GDP for a country will clearly depend on country-specific factors such as the stock of infrastructure, its quality, geography and development objectives, the impact of recent investment levels can be seen in the poor performance of Indonesia on infrastructure quality measures.

Figure 24: Indonesia ranks relatively low on quality of infrastructure indices... (Overall quality of infrastructure index, 2010-2011)

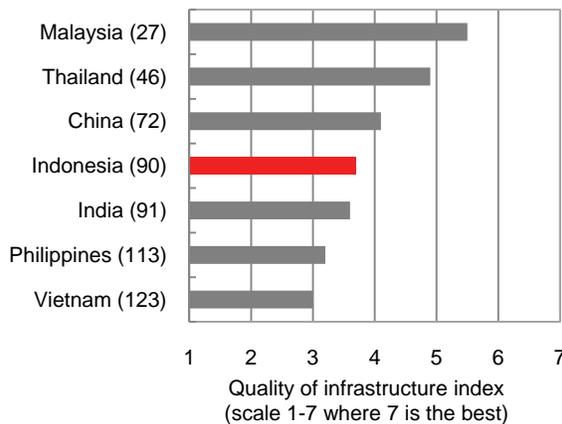
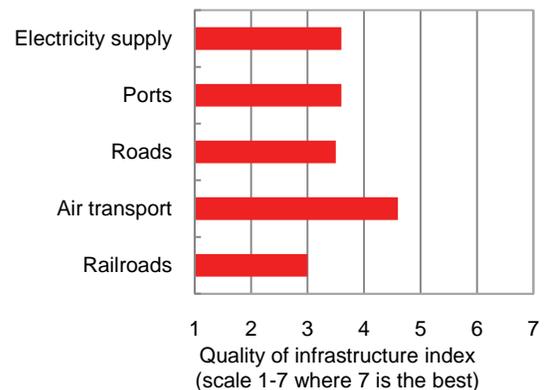


Figure 25: ...with weak performance across most types of infrastructure (Quality of infrastructure indices, 2010-2011)



Note: The Global Competitiveness Index infrastructure measure is based on executive survey responses on the responses quality of roads, railroads, ports, air transport and electricity supply plus data on fixed phone lines and mobile phone subscriptions and scheduled airline seat kilometers Source: World Economic Forum Global Competitiveness Report 2010-2011

As a result the quality of Indonesia's infrastructure is relatively poor...

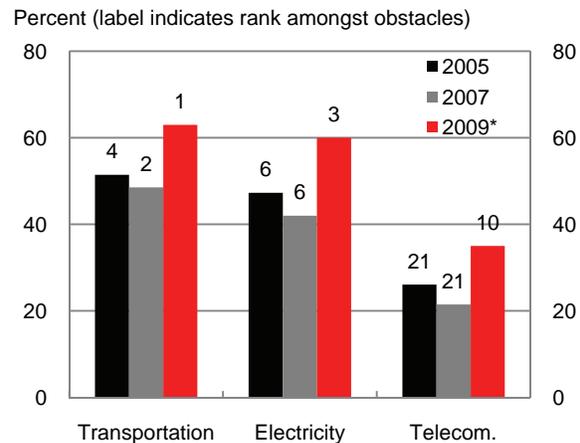
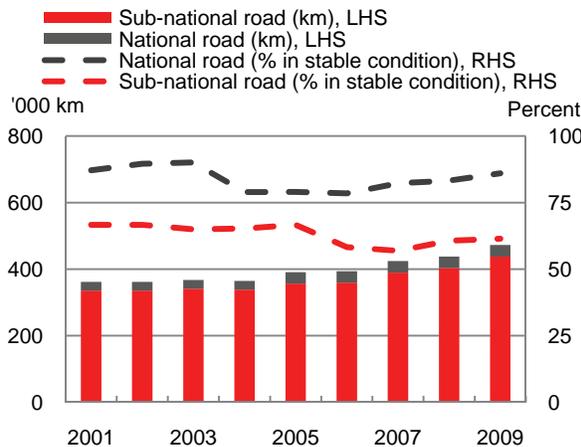
The limited investment in new infrastructure and maintenance has led to Indonesia's relatively weak ratings for the quality of its infrastructure (Figure 24), although the scores are broadly in line with trends based on levels of income per capita. The rankings are relatively similar across transportation and energy supply (Figure 25). Indeed, the recent World Economic Forum's "Indonesia Competitiveness Report 2011" highlights that the quality of infrastructure is one factor holding back further improvements in Indonesia's competitiveness ranking.

...and poses an increasing obstacle to firms' operations and investment

These ratings reflect the worsening condition of roads, increasing traffic congestion in urban areas, limited port capacity, and the need for modernization of railways. Available data on the condition of roads provides some quantification of these trends. Since 2005 the share of sub-national roads in stable condition (i.e. rated as in good or fair condition) has declined gradually (Figure 26). As these roads account for the majority of the total road network, this trend more than offsets the improvement for national roads when looking at the stable condition share for overall roads. In 2009 63 percent of the total road network was in stable condition, 22 percent in poor condition and 15 percent damaged compared with 68 percent, 19 percent and 13 percent respectively in 2001.

These infrastructure weaknesses have clearly become a growing concern for firms operating in Indonesia. This can be seen in the results of surveys which ask firms what are the major constraints on their operations and investments. From 2005 to 2009 infrastructure issues have moved up the ranking in terms of the share of firms mentioning them as major obstacles (Figure 27). In 2009 transportation and energy supply were the first and third highest mentioned, with roughly 60 percent of respondents viewing them as major constraints. Telecommunication constraints were less frequently mentioned but also moved up into mid-table ranking from 2005 to 2009.

Figure 26: The quality of Indonesia's sub-national roads has gradually deteriorated (length of road, km; share of roads in stable condition, (share of firms citing issue as major obstacle to operating and investing, percent)



Note: Stable condition indicates roads in good or fair condition (the remainder are in poor or damaged condition)
 Source: National road data are obtained from DG-Highway – MPW, and sub-national data are available from BPS

Note: * Most recent survey conducted in 2010 but question concerned the situation in 2009. Rank amongst 22 surveyed obstacles
 Sources: World Bank – LPEM-UI firm level investment climate surveys

...with likely impacts on aggregate macroeconomic growth and productivity...

The obstacles posed by weak infrastructure at the firm-level are likely to manifest themselves in aggregate investment, productivity and growth. For example, a recent study by the IMF (Regional Economic Outlook: Asia and Pacific, October 2010) found that improvements in infrastructure are strongly associated with private investment in the region. This study is part of a large literature that has developed to analyze and quantify such links (see Box 5 for a brief overview). Differences in data, sample and methodological approaches make it difficult to compare the various studies but there is broad consensus on the positive effects of infrastructure on growth, particularly when physical measures of infrastructure are used.

... motivating the sizeable investments in infrastructure targeted in the Government's *Master Plan 2011-2025*

As mentioned, the Government has recognized that its investments in infrastructure have lagged behind and the current medium-term development plan focuses on more public investments throughout the country. The Government's new *Master Plan 2011-2025*, discussed in the following section, takes the need for more infrastructure investments to boost growth even further. It targets more than IDR 1,786 trillion additional infrastructure investments out of a total investment figure of IDR 4,012 trillion in six economic corridors over the period from 2011 until 2025. These infrastructure investments cover virtually all areas of current weakness, with a particular focus on transportation and energy. However, it is not yet clear what will be done in terms of incentives and improvements in the investment climate to sequence and promote the necessary investments by the private sector and state-owned enterprises.

Box 5: The literature on infrastructure and growth - a very brief overview

There has been a long debate over the linkages between infrastructure and growth in both high-income and developing economies. Three main transmission channels are usually emphasized. The first is the productivity-enhancing effects of infrastructure, for example, via reduced transportation costs and improved communications. The second channel is improvements in human capital, such as better health and education outcomes as more clinics and schools are built or are better connected to the population. The third channel is through the promotion of economies of scale and scope in production, for example, by facilitating concentration of activity in clusters or allowing firms to serve larger markets. Set against these benefits there may also be concerns over crowding out of other investment in the short-run, despite the potential longer-term gains from the infrastructure investment. Also, if new investment comes at the expense of maintenance spending on existing infrastructure then there may be issues in terms of its cost effectiveness. From a political economy perspective, depending on the institutional setting, a sharp rise in infrastructure spending could widen the scope for rent-seeking behavior, again affecting cost-effectiveness.

Turning to the empirics, a survey by Straub (2008) highlights the variations across studies in their country samples and time periods, econometric techniques, usage of infrastructure investment amounts or physical measures of infrastructure and their focus on growth, output or productivity and between long-term and transitory effects. Looking across 80 different specifications, roughly half found that infrastructure had a positive and significant effect, two-fifths found no effect and the remainder a negative and significant effect. Finding a positive effect on output or growth was more likely in those studies which used physical indicators of infrastructure rather than investment spending data (which may not always map well to actual physical investment levels).

A recently released paper by Calderon et al (2011) is one such study finding a positive relationship between output and the level of physical infrastructure. In particular, an infrastructure index is constructed as a weighted sum of a country's endowments in transport, power, and telecommunications. This is then used as the explanatory variable in an empirical analysis of 88 countries over 1960–2000. As an illustration of the economic significance of their results, if a country's level of infrastructure provision were to increase from the sample median in the year 2000 to the 75th percentile this would be associated with an increase in output per worker of just under 8 percent. Alternatively, moving from the median level of infrastructure provision of lower-middle income countries up to the median of upper-middle income countries would increase output per worker by 5.2 percent. Interestingly, this study finds little evidence of variation across countries in the estimated elasticity between infrastructure and growth. However, they do find that the marginal benefit to growth of improving infrastructure is higher for those countries starting from a low base level of infrastructure and that countries with higher populations may get lower marginal benefits due to congestion effects.

Note: See also the recent World Bank Policy Research Papers by Straub (2008), "Infrastructure and Development: A Critical Appraisal of the Macro Level Literature" and Calderon et al (2011) "Is Infrastructure Capital Productive? A Dynamic Heterogeneous Approach" available at <http://go.worldbank.org/GVSDC9EPB0>

2. Connectivity and the *Master Plan* 2011-2025

The Government of Indonesia recently released its *Master Plan* aimed at increasing economic growth rates and moving Indonesia into a top ten economic power by 2025

Despite achieving rapid growth recently, Indonesia has the potential to achieve even higher growth rates given the wealth of its natural and human resources and strategic location within the Asian engine of global economic growth. To help to meet this potential, the President of Indonesia recently announced a new *Master Plan* for the “Acceleration and Expansion of Indonesia’s Economic Development 2011-2025” (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI). This longer-term strategy, which goes beyond, but is designed to be integrated, and coordinated, with the five-year development plans, aims to move Indonesia into the top ten global economies by 2025. Growth rates in the range of 7 to 9 percent are targeted and the *Master Plan* recognizes the need for Indonesia to structurally transform its economy and change ‘business as usual’ practices in order to meet these goals.

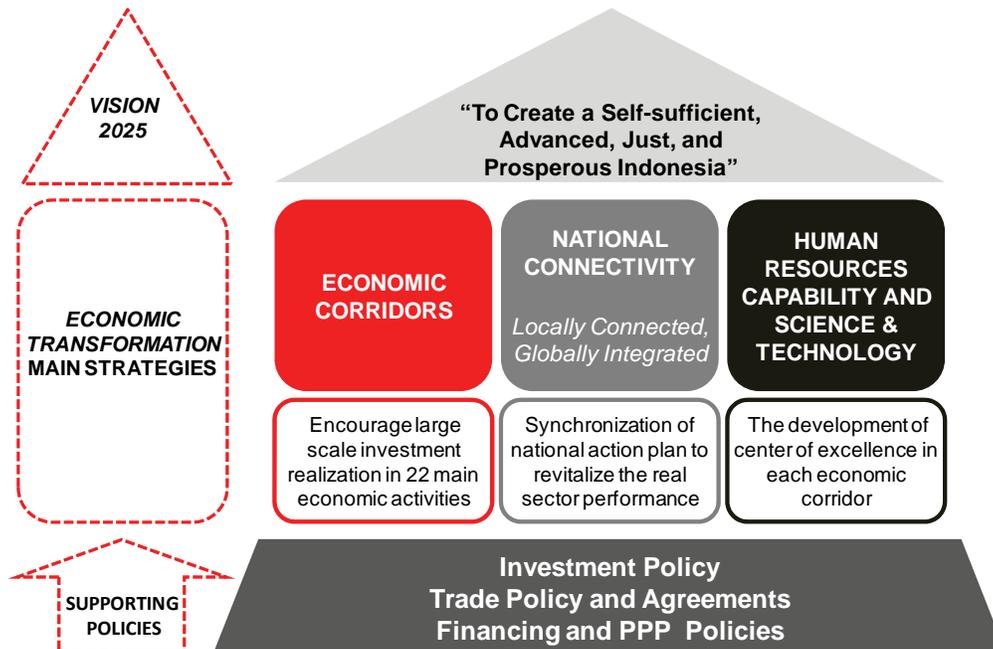
In light of its potential importance as a framework for Indonesia’s development strategy going forward, this section provides a brief initial overview of the *Master Plan* and then discusses in more depth the issue of connectivity which is a central pillar of the plan.

a. Combining sectoral and regional approaches to development

The three pillars of the *Master Plan* are developing economic corridors, improving connectivity and strengthening human resources and science and technology

The new plan is based on three strategies: (i) the development of six economic corridors, (ii) the strengthening of national connectivity, and (iii) the acceleration of technological and R&D capacity (Figure 28). The first strategy aims to build centers of growth in each corridor by developing leading sectoral clusters, matched to the economic potential of the corridor. The successful development of these sectors is reliant on the implementation of the second strategy on improving connectivity since this allows synergies to be built between the centers of growth and links them domestically and internationally to facilitate trade and tourism. Successful development of the clusters is also dependent on industries having access to skills and technology and so the third strategy aims to improve human resources capabilities and to increase investments in research and development. At the same time, the new plan also highlights that the benefits of these strategies will only be realized if they are supported by the development of new trade and investment policies, including trade agreements, as well as new financing policies, including public private partnership (PPP) ventures.

Figure 28: Achieving economic transformation through the strategies of the *Master Plan*



Sources: World Bank based on Coordinating Ministry for Economic Affairs “Grand Design of Economic Transformation” 2011 and “Acceleration and Expansion of Indonesia’s Economic Development Master Plan 2011-2025”.

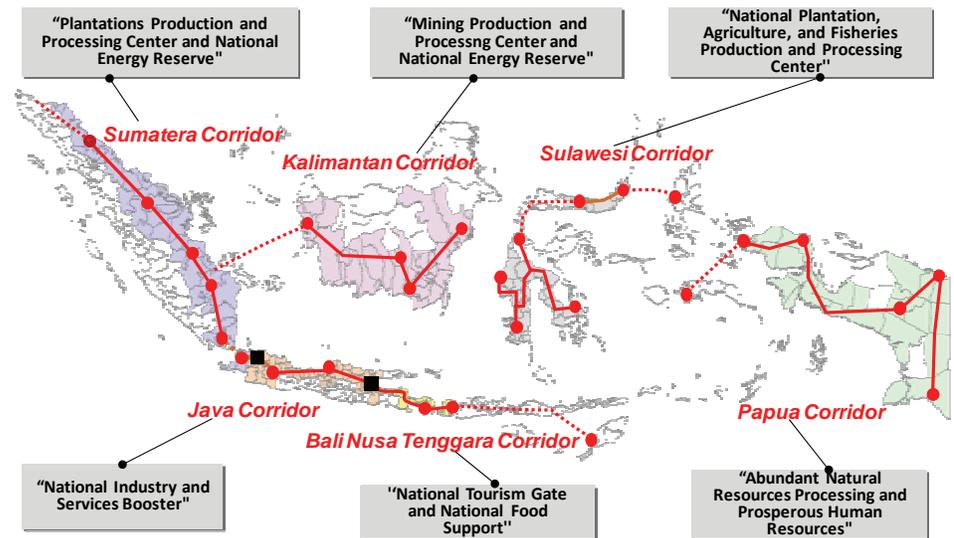
The *Master Plan* combines sectoral and regional approaches to development within each economic corridor

The thrust of the *Master Plan* is to combine sectoral and regional approaches to development within the identified economic corridors. The sectoral approach focuses on identification of leading sectors within each corridor which have high growth prospects, and where Indonesia has the potential and ability to increase its competitiveness. The regional component complements the sectoral approach and identifies, for each corridor, what regional or national regulations need to be changed, what investments in infrastructure are needed in the region, and what type of human resource development (HRD) and science and technology upgrading will be beneficial to growth in those sectors. This regional emphasis intends to bridge West and East Indonesia, helping to close the development gaps between islands.

The *Master Plan* identifies 22 sectors for investment and two large-scale infrastructure projects...

The *Master Plan* considers the Government as a regulator and facilitator for new investments, inviting the private sector, state-owned enterprises and foreign capital to increase investments in key sectors, particularly for further processing. The Master Plan identifies investment opportunities in 22 sectors, including palm oil, rubber, coal, nickel, copper, oil and gas, tourism, fisheries, food estates, food and beverages industry, textiles, machines/ transportation, ship building, steel, aluminum and information and communication technology (ICT). These nation-wide investment opportunities are subsequently grouped into six regional corridors: Sumatra, Java, Kalimantan, Sulawesi, Bali-Nusa Tenggara Timur (NTT), and Papua and Maluku (Figure 29).

Figure 29: Each of the six economic corridors has different development themes



Sources: Coordinating Ministry for Economic Affairs "Grand Design of Economic Transformation" 2011.

... and estimates the infrastructure investments needed in each corridor

The *Master Plan* also identifies for each corridor which additional investments, mainly in infrastructure, will be needed to ensure that the sector-specific investments will have maximum economic impact. Construction of roads, ports, railways, and power plants are given high priority. For example, further development of the coal industry in Sumatra and Kalimantan requires investments in rail links and in ports to ensure efficient transport of coal to others parts of the archipelago and for export.

Total investments under the *Master Plan* are estimated to be IDR 4,012 trillion (USD 468 billion) driven by the private sector

Over the next 15 years, the Master Plan targets investments of IDR 4,012 trillion (USD 468 billion at current exchange rates) in these six regions of which 55 percent will be in the productive sectors and 45 percent in infrastructure. Private sector investment is targeted as the key driver and is envisaged to cover 51 percent of this total. State-owned enterprises are targeted to contribute 18 percent. Central and provincial governments are to contribute 10 percent in the form of basic infrastructure provision, such as roads, seaports, airports, railways, and power generation. The remaining 21 percent will be provided from a mix of funds, including foreign investment and PPPs.

In addition to these investments, the *Master Plan* also highlights some cross-cutting reforms

Along with the investment targets, the new *Master Plan* also highlights the need to implement some cross-cutting reforms. These include synchronizing national and regional laws and regulations, developing a regulatory framework that supports increased domestic processing of commodities, and putting in place incentive systems to promote investments and streamlining investment permits procedures throughout the country.

b. Improving Indonesia's connectivity

Improving Indonesia's connectivity covers intra-island, inter-island and international connections

Achieving the goals of the *Master Plan* is not possible without improving Indonesia's connectivity, i.e. the supply chain linking producers to consumers. This involves both intra-island, inter-island and international connections. While the *Master Plan* focuses primarily on intra-island connectivity, a supply chain is only as strong as its weakest link and so improvements should be conducted simultaneously at all three levels. Improving connectivity between domestic producers and domestic consumers in dispersed locations within Indonesia will require strong intra and inter-islands links. Linking domestic and foreign producers and consumers requires efficient and reliable international gateways such as ports and airports.

Enhancing intra-island connectivity can link urban growth poles to each other and to rural areas

The key objectives for intra-island connectivity are to link rural areas to urban areas, to link urban areas to growth poles on the island and to link growth poles to each other. Stronger links within islands can provide synergies between growth poles and spread the benefits of growth to less developed areas by providing them with better access to urban centers and larger regional markets. Consequently, the benefits of the investments in corridors will not be limited to the growth centers.

Approaches to improve intra-island connectivity vary with the population density of a region...

Different approaches are required to improve intra-island connectivity depending on the density of population of a region. A *fishbone strategy* connects high-traffic urban areas through a backbone consisting of broad roads, highways or railways and connects these urban areas with the hinterlands through feeder roads connected to the backbone. This strategy is most appropriate in the more densely populated islands of Indonesia, given that the high usage by the population justifies the high construction cost.

... and may involve fishbone or ink-spot strategies

In contrast, an *ink-spot strategy* which links peripheral areas with a center using smaller and less costly transport systems is more appropriate in more remote and less densely populated areas, like the regions of eastern Indonesia. As the ink-spots expand, they become connected, evolving gradually to more closely resemble the *fishbone strategy*.

...supplemented by specific infrastructure to support resource sectors

In resource abundant regions, the fishbone or ink-spot strategies will need to be complemented with specific infrastructure for the transport of commodities from the resource areas to the ports (e.g. rail transport of coal in Kalimantan or development of port hubs for particular commodities). Figure 30 below illustrates a possible mapping of the fishbone and ink-spot approaches to the different regions of Indonesia.

Using fishbone and ink-spot strategies as appropriate can help to improve intra-island connectivity in a cost effective manner

The *Master Plan* sets out in each corridor a fishbone approach to connect high-growth cities. In less-developed regions, with smaller and dispersed growth poles, the strengthening of transport systems around these centers through targeted investments can facilitate the linking of those centers into the economic corridors of the *Master Plan*. Such a combination of ink-spot and fishbone strategies can be used to improve intra-island connectivity and spread the growth benefits of the sectoral clusters of the corridors.

Figure 30: Applying a fishbone and ink-spot approach to intra-island connectivity

Source: World Bank staff

Improved inter-island connectivity is needed to achieve economic integration within an archipelago...

Turning to inter-island connectivity, this is crucial to achieving economic integration within an archipelago. Although the *Master Plan* contains several large and expensive infrastructure projects to improve inter-island connectivity (such as the Sunda Bridge between Java and Sumatra), there is a need for clearer policy directions and strategies to address the most pressing and important constraints in this area.

...and requires reductions in cargo transportation costs and improved reliability

In order to improve inter-island connectivity, the key objective should be to reduce the costs of inter-island cargo transportation and make it more reliable, especially for the transportation of consumer goods to remote and often poor islands. At present, these costs are very high, with the cost of domestic sea transportation being significantly higher than the cost of maritime transport to foreign countries over comparable distances (Box 6). These high costs are an important contributing factor to the generally higher prices for consumer goods in remote provinces. They are also a constraint to bringing commodities to processing facilities and products to markets (usually on Java and overseas).

There is also a case for government support for inter-island transportation to improve connectivity in the islands of Eastern Indonesia

There is a case for government support for inter-island sea transportation services to improve the level of connectivity between remote and less densely populated areas in eastern Indonesia with key urban centers. These areas suffer from low demand and large trade imbalances, which constrain the provision of transport services at an affordable price. However, it is critical that the government support is implemented in a way that guarantees efficient and high quality services, and that does not distort the rest of the market.

Finally, improving inter-island connectivity in an efficient manner requires a well-planned and coordinated multi-modal approach

Improvements in inter-island connectivity go beyond just shipping transportation costs. As mentioned in the *Master Plan*, it also involves a multimodal transportation system, in which road, sea, river, and air transportation facilities are all components. This must be carefully planned in order to avoid expensive overlaps and inefficiencies. It is important that switching points between the various transportation modes facilitate ease-of-use. For example, a multimodal system could incorporate roll on, roll off facilities to achieve a greater integration between ferry transportation services and connecting roads. The placement of multimodal transportation hubs also needs careful planning, with the location being based on accurate identification of regional growth centers to ensure the connectivity of the entire archipelago.

Strong international connectivity can enhance the export competitiveness of Indonesian firms and allow access for domestic producers and consumers to new and cheaper products and services

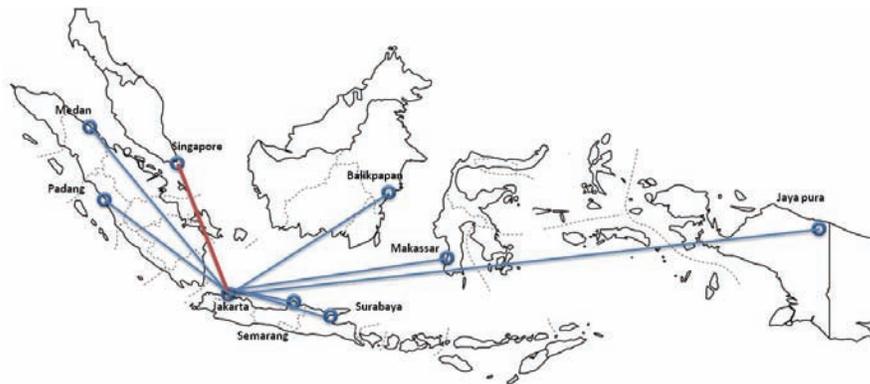
The ability to move goods and services across borders rapidly, cheaply, and with a high degree of predictability is a critical determinant of a country's competitiveness. Improved international connectivity can enhance the export competitiveness of Indonesian producers by enabling their products to reach foreign markets at competitive prices. It can also allow domestic manufacturers and consumers to access imported inputs and consumer products which may be at lower prices or of different varieties than those produced domestically. High transaction costs due to port inefficiencies, congestion and border transactions are one of the largest obstacles that prevent Indonesian firms and consumers reaping the full advantage of growing global international trade linkages. The *Master Plan* rightly acknowledges that having the necessary regulatory environment and institutions to facilitate trade is key to addressing some of these constraints.

Box 6: Geographical distance versus economic distance in Indonesia

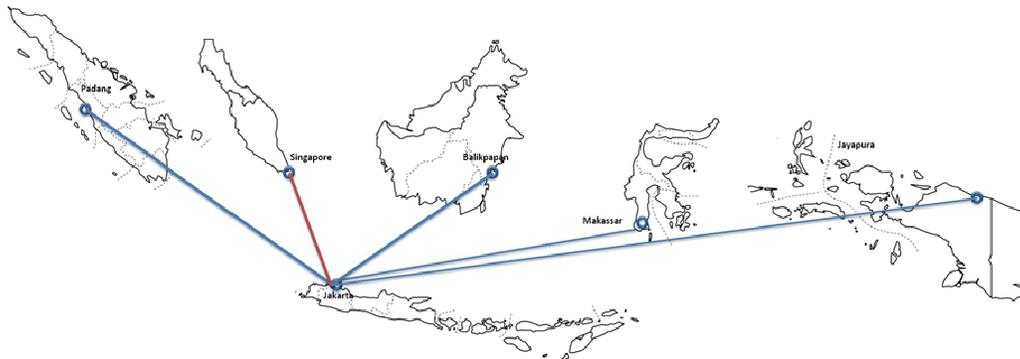
The high level of inter-island cargo transport costs increases the economic distance between Indonesia's regions. Figure 31 shows transportation costs from Jakarta to domestic destinations and to Singapore. The first map shows geographical distances. The second map shows the relative cost of transporting a 20-foot container by sea which to Padang, for example, is 2.7 times more expensive than shipping the same container to Singapore. As a result of these high costs, economic distances within the archipelago are magnified relative to geography. The third map shows that for air passengers the opposite pattern holds: it is relatively much cheaper to fly from Jakarta to domestic destinations than to Singapore. This reflects the fall in air transport costs following liberalization of the sector and the higher level of domestic competition. However, at first glance, lack of competition does not seem to be the main factor pushing up domestic sea transportation costs. Major factors include a low density of demand and regional freight imbalance which contributes to a backhaul problem. Most ships returning to Java are more than half empty. There is also a need for stronger integration between modes of transport and a sound regulatory framework.

Figure 31: Variations in transport costs – moving cities in Indonesia apart and bringing them closer

a) Geographical distances



b) Economic distances based on sea transport costs (unit cost=1.00 distance to Singapore)



c) Economic distances based on air passenger ticket costs (unit cost=1.00 distance to Singapore)



Notes: Economic distances are based on the cost per mile from Jakarta to Singapore as the base unit: for sea transport for a 20-foot container USD 0.23 per mile=1.00 and for passenger air transport IDR 936 per mile=1.00. Sources: World Bank staff calculations based on Maersk, Lion Air and Garuda 2009 data

Addressing the imminent capacity limits at Jakarta's Tanjung Priok port requires urgent action...

The imminent clogging of Jakarta's Tanjung Priok port compromises Indonesia's international and inter-island connectivity. Tanjung Priok, through which 70 percent of Indonesia's container exports and imports pass, is the main international gateway and a major gateway for domestic trade. Inefficient bureaucracy, limited capacities, congestion, and a low level of productivity at the port hamper exports and the domestic distribution of products. A substantial proportion of goods exported through this port do not reach ships according to schedule. As a result, they often miss connections in Singapore or Malaysia. With the forecast growth in container traffic, Tanjung Priok will reach its maximum capacity in less than four years. Urgent government action is needed to improve and expand the Tanjung Priok facilities and to develop a new port for Jakarta to facilitate trade.

... and is included in the new Master Plan

The new *Master Plan* includes explicitly the urgent need for upgrading of Jakarta's main port. However, decisions on the expansion of the port capacity have been postponed several times and there is a danger that additional capacity will not be available when needed. Consequently, the exports and imports logistics will become slower and more costly, which may undermine the implementation of other major projects in the plan.

A mix of hard and soft infrastructure improvements in other ports throughout the country can also improve international connectivity

Increasing the efficiency and expanding the capacity of other international ports throughout the country could further improve Indonesia's international connectivity. In order to achieve this, a rehabilitation of infrastructure and a reduction of red tape in these facilities will be vital. In addition to expanding capacities of existing international ports, the Government could assess the possibility of opening up to external trade a number of land borders and increasing the number of international ports.

c. Implementing the *Master Plan*

The *Master Plan* envisages three sequential stages of implementation

Returning to the *Master Plan*, the key to meeting its ambitious objectives is in the implementation. The document sets out three sequential phases. The first phase from 2011 to 2015 will focus on "quick wins" and on preparing action plans for the "debottlenecking" of various pending regulations, licenses, incentives, as well as preparing the ground for major investments. It is envisaged that these action plans will ensure that strategies are well implemented in the next phases. The second phase from 2016 to 2020 will focus on the acceleration of long-term infrastructure development, enhancing innovation to improve competitiveness and promoting the creation of higher value-added industries. The third and final phase from 2021 to 2025 assumes that the foundation will be in place for Indonesian industries to compete globally while applying high-level technologies.

The first phase aims to integrate different government national, regional and sectoral plans into a single roadmap for action

In the first phase, different existing government national, regional and sectoral plans are being integrated into a single roadmap for action. For example, to strengthen national connectivity, components from four different government plans will be integrated: (a) National Logistics System (SISLOGNAS), (b) National Transportation Systems (SISTRANAS), (c) Regional Development (RPJMN and RTRWN); (d) Information and Communication Technology (ICT). In order to ensure the implementation of the various strategies, the plan mentions a new dedicated committee chaired by the President of the Republic of Indonesia in order to enhance efficiency in coordinating, monitoring, evaluating, and strategic decision-making.

d. Way Forward

The *Master Plan* provides strategic direction for investors on where the Government's industrial emphasis will be in the next 15 years

The new *Master Plan* clearly aims to support domestic business and investment opportunities and constitutes a bold attempt by the administration to bring provincial and local government, business leaders and state-owned enterprises into one, integrated national development framework. The *Master Plan* is governed by presidential decree, which will likely provide a better legal umbrella for frontline ministries and regional governments while, at the same time, putting more pressure on them to support industrial and infrastructure development. More broadly, the *Master Plan* provides strategic direction for investors on where the government's economic development emphasis will be in the next 15 years. The Government is also aware that improvement of the investment climate and regulatory reform are needed to promote investments set out in the *Master Plan*, especially by the private sector. But, the key to successful implementation of such reforms will always be in their execution and enforcement.

The <i>Master Plan</i> is to be a working document which will be updated and refined	The <i>Master Plan</i> is an integral part of the national development planning system, and as such, it is a working document that will probably have to be updated and refined progressively. The following points suggest a way forward that may facilitate the implementation of the main strategies, and more specifically, of the connectivity pillar.
Identification of the policy and investment priorities and the political commitment to address them will be needed for successful implementation	The first phase of the implementation reveals a very ambitious short-term agenda for reform on cross-cutting policies. The identification of priorities can be very helpful to identify a first batch of reforms to unlock some of the most important investment barriers. Identifying the appropriate priority activities to improve connectivity at the intra-island, inter-island and international levels would also help to facilitate a higher level of integration between the different blueprints and plans. Political commitment will be required to address specific regulatory bottlenecks that have been blocking investment for several years, such as land acquisition, pricing mechanisms such as in energy, competing regulatory jurisdictions, the slow disbursement of public funds, and cost recovery issues, among others. There is also a need to place more attention on the importance of regional government planning in fostering an enabling business climate. Few of the quickwin projects envisioned in the first few years actually represent new investment initiatives. Indeed, most appear to be projects already in the pipeline over the past several years but where these cross-sector regulatory constraints are still present (e.g. the Trans-Java Highway).
Inter-island connectivity will be important to develop synergies within and between corridors	As mentioned, much of the connectivity discussion in the <i>Master Plan</i> focuses on intra-island connectivity. Improving inter-island connectivity is also crucial, building synergies within and between corridors. For example, inputs for the development of specific corridors are likely to come from other islands and it is essential that they become available at affordable prices. Inter-island connectivity also facilitates the movement of products to markets. For example, the <i>Master Plan</i> highlights the area around Merauke (Papua) for development of food estates, but high transport costs from Papua will need to be addressed to ensure products are competitive in domestic markets.
Further elaboration on the third pillar on human resources and research and development would be useful within a comprehensive approach to economic competitiveness	In-depth analysis of the third pillar on human resources capability and research and development support will be important to allow it to play its fundamental role in improving competitiveness and accelerating growth. For example, this includes analysis of the type of labor and innovative capacities that are required by the different sectors along with the identification of the reforms that can help to meet these needs. In addition, other elements of a comprehensive view of economic competitiveness could be expanded upon. This includes the role of logistics in linking activities within and between economic corridors. Relatedly, promoting the development of competitive services sectors could also further improve the productivity of economic corridors both in terms of transportation services but also business and other services which serve as inputs to production. The in-depth participation of providers of soft infrastructure, such as public services, skills and education for workers, in the economic corridors will complement the hard infrastructure of the <i>Master Plan</i> .
Other useful next steps include identifying the mechanisms to mobilize private financing...	The <i>Master Plan</i> does not yet lay out how the targets for the large amounts of private sector investment will be generated. The target of 50 percent private participation is ambitious. For example, on infrastructure investment, according to a 2005 study the share of the private sector in infrastructure investment in developing economies in total reached only 20 to 25 percent even during its mid-1990s peak. ¹⁰ The Indonesian private sector is interested to participate in some of the large investment opportunities but some remain skeptical. Some long-standing issues persist, for example in the relation to the availability of long-term financing schemes, mechanisms and regulations, and so significant challenges to attracting private sector investment remain.

¹⁰ Asian Development Bank, Japan Bank for International Cooperation and World Bank (2005), *Connecting East Asia: A New Framework for Infrastructure*.

...and the institutional arrangements for high-level coordination, monitoring and evaluation

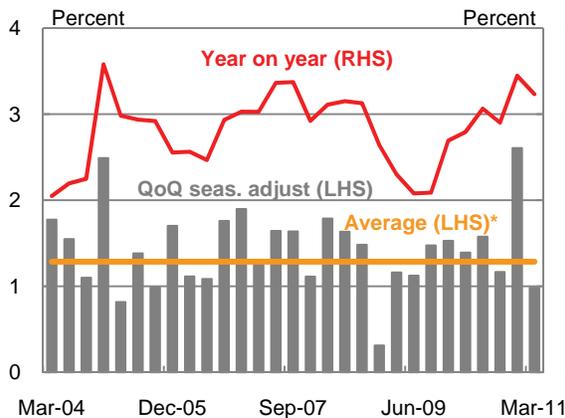
An important additional next step is the elaboration of the institutional arrangements required for high-level coordination between the different ministries and agencies involved in the design and implementation of the *Master Plan*. The plan is an enormous undertaking that will also require in-depth monitoring by a team that has also the mandate to make adjustments if deemed necessary. Based on the performance of other inter-departmental working groups, current monitoring arrangements appear to need strengthening.

In summary, while recognizing the implementation challenges, the *Master Plan* has the potential as a transformative tool

There is a risk that this new *Master Plan* suffers from implementation delays and bottlenecks and that it may seem like many other blueprints and plans produced by the Government. However, for cautious optimists, the plan has the potential to become a transformative tool enabling the nation to pursue pro-business and investment policies that are essential to long-term, sustainable and inclusive economic growth.

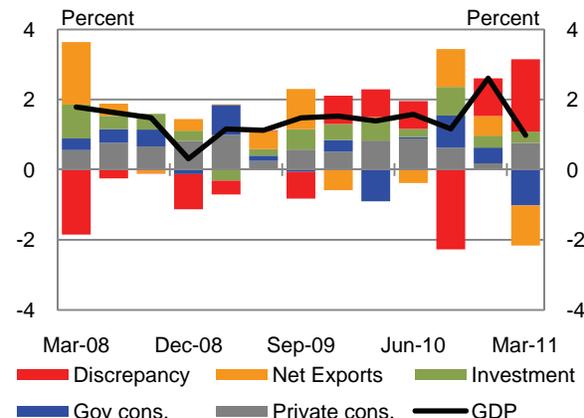
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

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



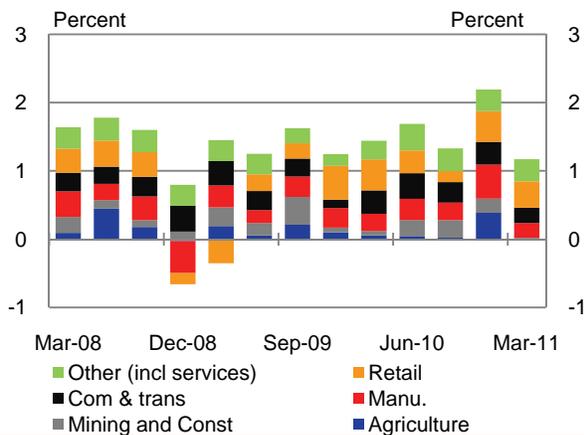
*Average QoQ growth between Q1 2000 – Q3 2010. Sources: BPS, World Bank seasonal adjustment

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



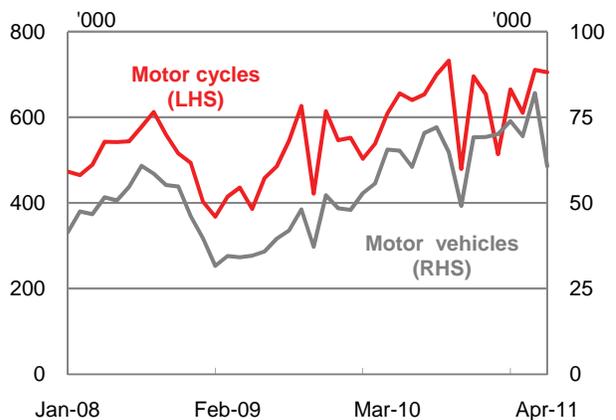
Source: BPS via CEIC and World Bank

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



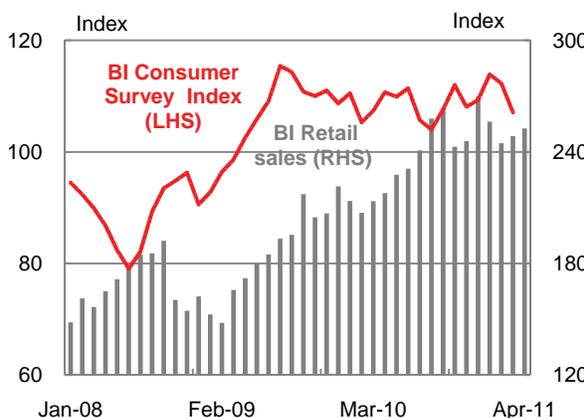
Source: BPS via CEIC

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



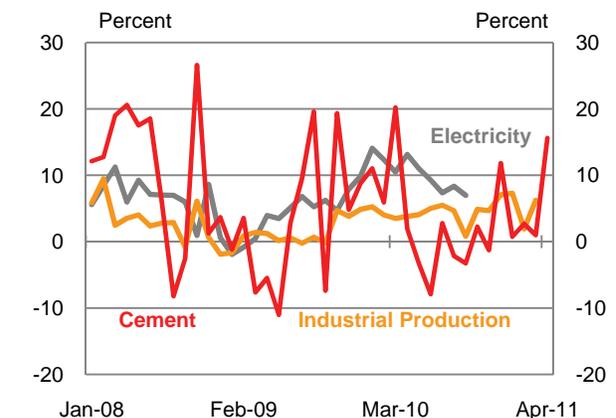
Source: CEIC

Appendix Figure 5: Consumer indicators (index levels)



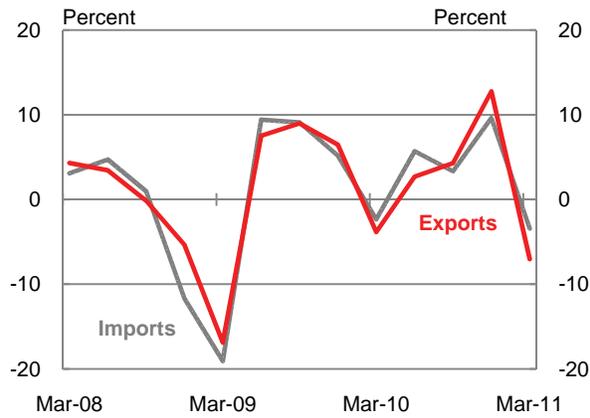
Source: BI via CEIC

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



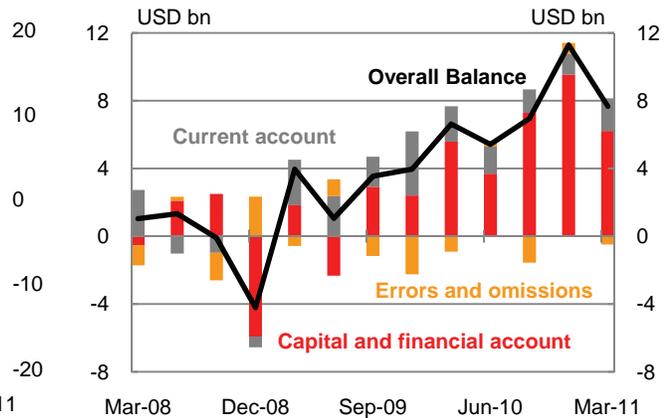
Source: CEIC

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



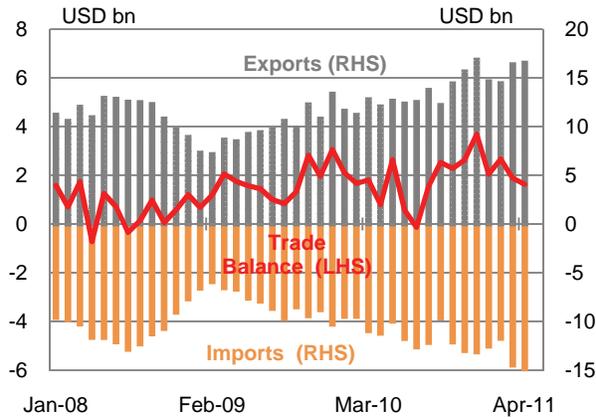
Source: CEIC

Appendix Figure 8: Balance of Payments
(USD billion)



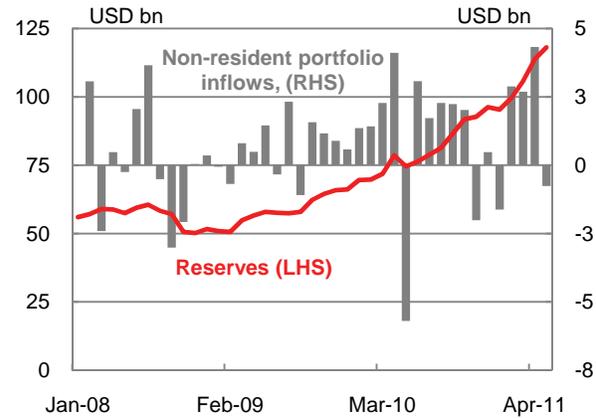
Source: BI and World Bank

Appendix Figure 9: Trade balance
(USD billion)



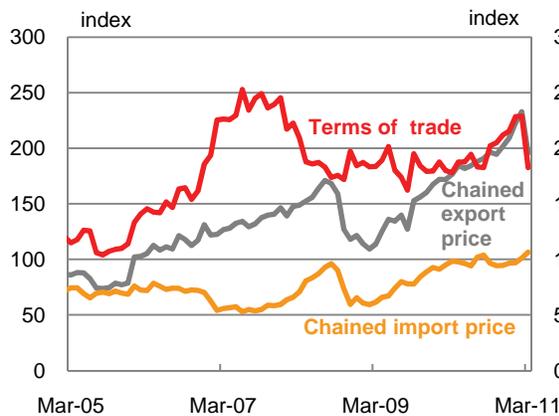
Source: BPS and World Bank

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



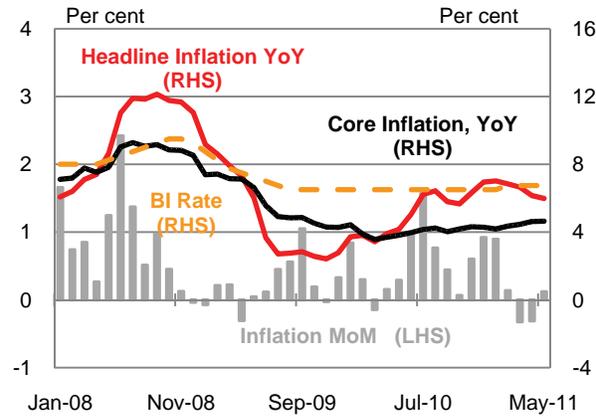
Source: BI and World Bank

Appendix Figure 11: Terms of trade, export and import chained Fisher-Price indices
(index 2000=100)



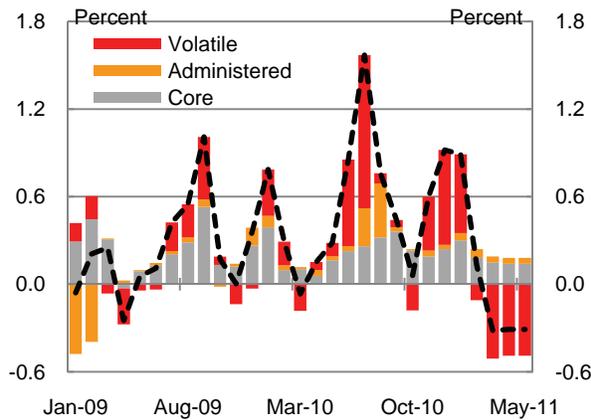
Source: BPS and World Bank

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



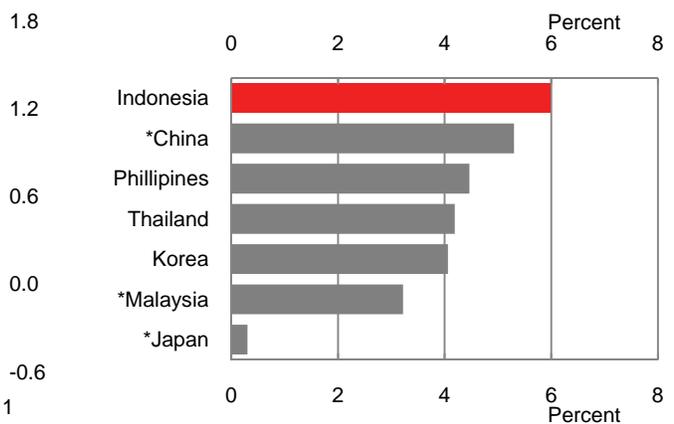
Source: BPS and World Bank

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



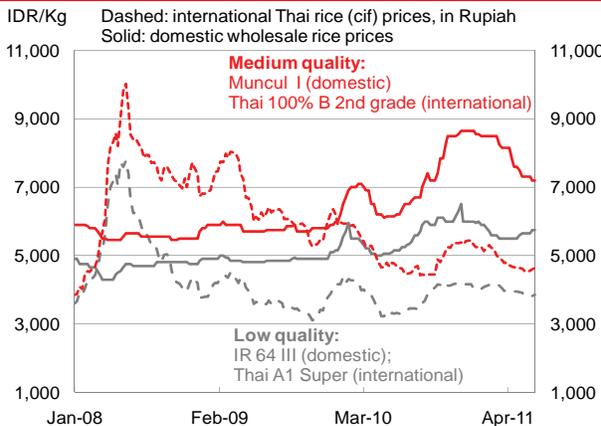
Sources: BPS and World Bank

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



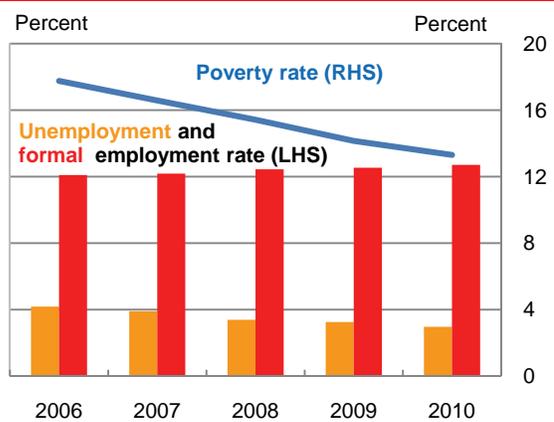
*April is the latest data point
Sources: National statistical agencies via CEIC, and BPS

Appendix Figure 15: Domestic and international rice price comparison
(IDR per kg)



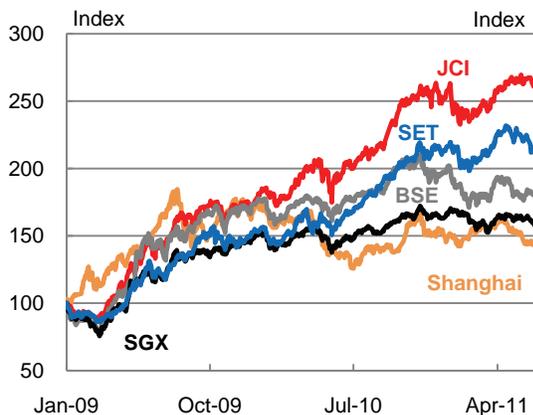
Sources: PIBC, FAO and World Bank

Appendix Figure 16: Poverty, employment, and unemployment rate
(percent)



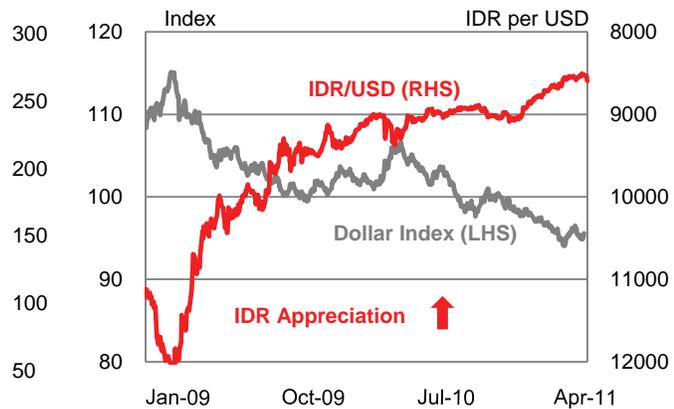
Labor data from February Sakernas
Source: BPS, and World Bank

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



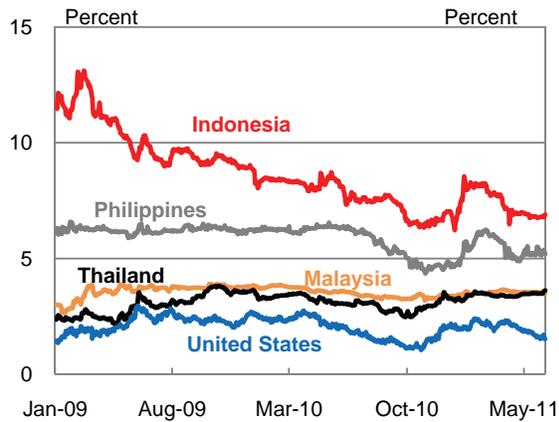
Sources: World Bank and CEIC

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



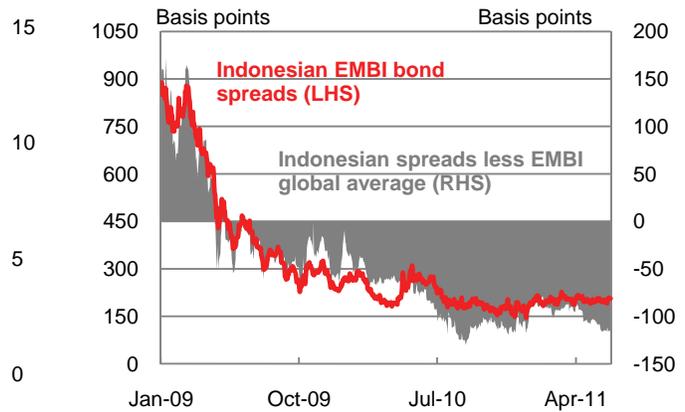
Sources: World Bank and CEIC

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



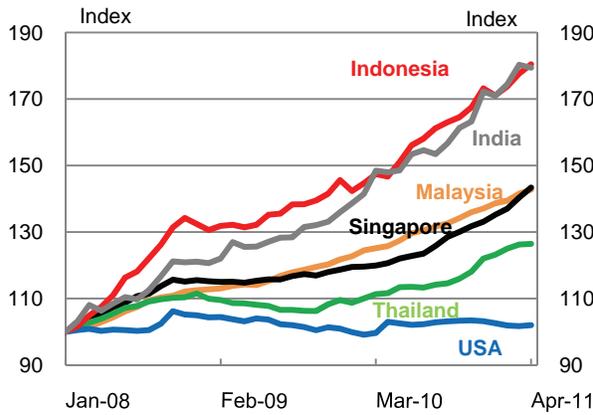
Sources: World Bank

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



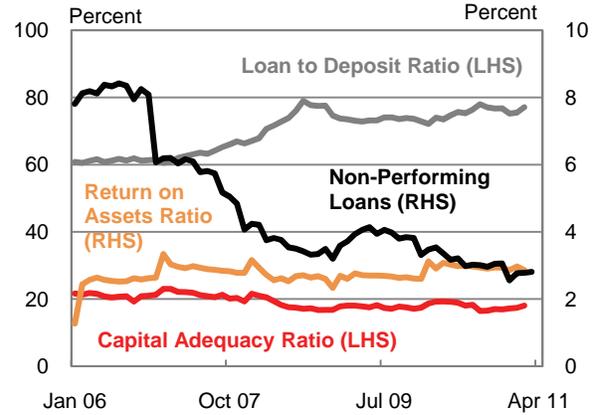
Sources: World Bank and CEIC

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



Sources: CEIC and World Bank

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



Sources: BI and World Bank

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

	2008	2009	2010	2011 (p)	2011 (p)
	Actual	Outcome	Outcome	Budget	WB June estimates*
A. State revenue and grants	981.6	848.8	1,014.0	1,104.9	1,189.4
1. Tax revenue	658.7	619.9	744.1	850.3	858.6
<i>o/w income tax</i>	327.5	317.6	356.6	420.5	432.3
- Oil and gas	77.0	50.0	58.9	55.6	77.0
- Non oil and gas	250.5	267.5	297.7	364.9	355.3
2. Non-tax revenue	320.6	227.2	267.5	250.9	330.8
<i>o/w natural resources</i>	224.5	139.0	170.1	163.1	217.9
i. Oil and gas	211.6	125.8	152.7	149.3	198
ii. Non oil and gas	12.8	12.8	17.3	13.8	20
B. Expenditure	985.7	937.4	1,053.5	1,229.6	1,280.3
1. Central government	693.4	628.8	708.7	836.6	875.7
2. Transfers to the regions	292.4	308.6	344.7	393.0	404.6
C. Primary balance	84.3	5.2	48.9	-9.4	21.9
D. SURPLUS / DEFICIT	(4.1)	(88.6)	(39.5)	(124.7)	(90.9)
Deficit (percent of GDP)	(0.1)	(1.6)	(0.6)	(1.8)	(1.2)

Note: *World Bank revenue estimates are based on a different methodology than the Government to derive projections for nominal GDP (see Part C of the June 2010 IEQ for a full discussion)
Sources: MoF and World Bank estimates

Appendix Table 2: Balance of Payments
(USD billion)

	2008	2009	2010	2009		2010		2011		
				Q3	Q4	Q1	Q2	Q3	Q4	Q1
Balance of Payments	-1.9	12.5	30.3	3.5	4.0	6.6	5.4	7.0	11.3	7.7
<i>Percent of GDP</i>	-0.4	2.3	4.3	2.4	2.6	4.1	3.1	3.7	6.1	3.9
Current Account	0.1	10.6	5.7	1.8	3.8	1.9	1.4	1.2	1.1	1.9
<i>Percent of GDP</i>	0.0	2.0	0.8	1.2	2.5	1.2	0.8	0.6	0.6	1.0
Trade Balance	9.9	21.2	21.3	4.7	7.1	4.8	4.6	5.4	6.4	6.2
Net Income & Current Transfers	-9.8	-10.6	-15.7	-2.9	-3.3	-2.9	-3.2	-4.2	-5.3	-4.3
Capital & Financial Accounts	-1.8	4.9	26.1	2.9	2.4	5.6	3.7	7.3	9.6	6.2
<i>Percent of GDP</i>	-0.4	0.9	3.7	2.0	1.6	3.5	2.1	3.9	5.1	3.2
Direct Investment	3.4	2.6	10.6	0.6	0.8	2.5	2.3	1.6	4.2	3.0
Portfolio Investment	1.8	10.3	13.2	3.0	3.5	6.2	1.1	4.5	1.4	3.6
Other Investment	-7.3	-8.2	2.2	-0.7	-1.9	-3.1	0.3	1.2	3.8	0.0
Errors & Omissions	-0.2	-3.0	-1.5	-1.2	-2.2	-0.9	0.3	-1.6	0.6	-0.5
Foreign Reserves*	51.6	66.1	96.2	62.3	66.1	71.8	76.3	86.6	96.2	105.7

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



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