

INDONESIA ECONOMIC QUARTERLY

October 2017

Closing the gap



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Preface

The Indonesia Economic Quarterly (IEQ) has two main aims. First, it reports on the key developments over the past three months in Indonesia's economy, and places these in a longer-term and global context. Based on these developments, and on policy changes over the period, the IEQ regularly updates the outlook for Indonesia's economy and social welfare. Second, the IEQ provides a more in-depth examination of selected economic and policy issues, and analysis of Indonesia's medium-term development challenges. 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.

The IEQ is a product of the World Bank's Jakarta office and receives editorial and strategic guidance from an editorial board chaired by Rodrigo A. Chaves, Country Director for Indonesia. The report is compiled by the Macroeconomics and Fiscal Management Global Practice team, under the guidance of Ndiame Diop (Practice Manager), and Frederico Gil Sander (Lead Economist). Led by Derek H. C. Chen (Senior Economist and lead author), the core project team comprises Magda Adriani, Arsianti, Dwi Endah Abriningrum, Indira Maulani Hapsari, Ahya Ihsan, Taufik Ramadhan Indrakesuma, Jonathan William Lain, Alief Aulia Rezza, Jaffar Al Rikabi, Dhruv Sharma, and Pui Shen Yoong. Administrative support is provided by Sylvia Njotomihardjo. Dissemination is organized by Nugroho Sunjoyo, Jerry Kurniawan, and GB Surya Ningnagara. Thanks to Edgar Janz, Jonathan William Lain, Juul Pinxten and Nathaniel P. Adams for proof-reading the report.

This edition of the IEQ also includes contributions from Indira Maulani Hapsari (Part A.1 and A.2) Magda Adriani and Dwi Endah Abriningrum (Part A.3 and Box 1), Dhruv Sharma (Part A.4 and A.5), Alief Aulia Rezza (Part A.5 and Box 2), Jaffar Al Rikabi (Part A.6, Box 3 and 4), Jonathan William Lain and Hamidah Alatas (Part A.7 and Box 5), Taufik Ramadhan Indrakesuma (Part A.8), Derek H. C. Chen (Part A.9); Jenny Jing Chao, Jeffrey John Delmon, Ian Halvdan Ross Hawkesworth, Sunita Kikeri, Ketut Ariadi Kusuma, Ratih Dwi Rahmadanti, Alexander Weber, Andri Wibisono, and Pui Shen Yoong, under the guidance of Taimur Samad and Cledan Mandri-Perrott (Part B: Mobilizing the private sector for infrastructure development); Hamidah Alatas, Ratih Dwi Rahmadanti, Daim Syukriyah, Bagus Arya Wirapati for their data contribution (Appendix: social indicators). The report also benefited from discussions with, and in-depth comments from Sudhir Shetty (Chief Economist, World Bank), Yongmei Zhou (Program Leader), Ekaterine T. Vashakmadze (Senior Country Economist, World Bank), and Congyan Tan (Senior Economist, World Bank).

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Acronyms

ADB	Asian Development Bank
AIPEG	Australia Indonesia Partnership for Economic Governance
ANRPC	Association of Natural Rubber Producing Countries
AP	Availability Payments
APBD	Anggaran Pendapatan dan Belanja Daerah
APBN	Anggaran Pendapatan dan Belanja Negara
ASEAN	Association of South East Asia Nations
Bappenas	Badan Perencanaan Pembangunan Nasional
BCA	Bank Central Asia
BI	Bank Indonesia
BKPM	Indonesia's Investment Promotion Agency
BNI	Bank Negara Indonesia
BOP	Balance of Payments
BPJT	Badan Pengatur Jalan Tol
BPS	Badan Pusat Statistik
BRI	Bank Rakyat Indonesia
CAGR	Compound Annual Growth Rate
CEIC	Census and Economic Information Center
CPI	Consumer Price Index
CPO	Crude Palm Oil
DJPPR	Direktorat Jenderal Pengelolaan Pembiayaan dan Risiko
EBRD	European Bank For Reconstruction and Development
ECB	European Central Bank
EMCI	Emerging Market Currency Index
EMDE	Emerging Markets and Developing Economies
EPC	Engineering, Procurement, and Construction
FDI	Foreign Direct Investment
GCA	Government Contracting Authorities
GDP	Gross Domestic Product
GOI	Government of Indonesia
GR	Government Regulation
HET	Harga Eceran Tertinggi
IIF	The Institute of International Finance
IIGF	Indonesia Infrastructure Guarantee Fund
ICP	Indonesia Crude Prices
IMF	International Monetary Fund
LFPR	Labor Force Participation Rate
LHS	Left Hand Side
JCI	The Jakarta Composite Index
KPPIP	Komite Percepatan Penyediaan Infrastruktur Prioritas
KPPU	Komisi Pengawas Persaingan Usaha (Anti-Monopoly Supervisory Commission)
LGST	Luxury Goods Sales Tax
LNG	Liquefied Natural Gas
MOF	Ministry of Finance
MOHA	Ministry of Home Affairs
MPPD	Million Barrels Per Day
MSOE	Ministry of State-Owned Enterprises
NPL	Non-Performing Loans

NTI	Net Trade-Weighted Index
OBC	Outline Business Cases
OECD	Organization for Economic Cooperation and Development
O&G	Oil and Gas
O&M	Operation and Maintenance
OPEC	Organization of The Petroleum Exporting Countries
PDF	Project Development Facility
Pelindo	Pelabuhan Indonesia (Indonesian Ports)
PINA	Pembiayaan Investasi Non Anggaran (Non-Budgetary Financing of Infrastructure)
PLN	Perusahaan Listrik Negara
PMI	Purchasing Managers' Index
PMK	Peraturan Menteri Keuangan
PNBP	Penerimaan Nasional Bukan Pajak (Other Non-Tax Revenues)
PPP	Public-Private Partnership
PRC	People's Republic of China
PSC	Public Sector Comparator
PSN	National Strategic Project
PSO	Public Service Obligation
RHS	Right Hand Side
RPJMN	Rencana Pembangunan Jangka Panjang Menengah Nasional
SAKERNAS	Survei Angkatan Kerja Nasional (National Labor Force Survey)
SBI	Sertifikat Bank Indonesia
SBL	Single Borrower Limit
SMI	Sarana Multi Infrastruktur
SOE	State-Owned Enterprises
S&P	Standard and Poor
SPV	Special Purpose Vehicle
SSL	Sector Specific Laws
SUN	Surat Utang Negara (Conventional Government Securities)
SUSENAS	Survei Sosial Ekonomi Nasional
TASPEN	Tabungan dan Asuransi Pensiun
UNCITRAL	United Nations Commission International Trade Law
VAT	Value Added Tax
VGf	Viability Gap Funding
VIX	Volatility Index
YOY	Year-on-Year

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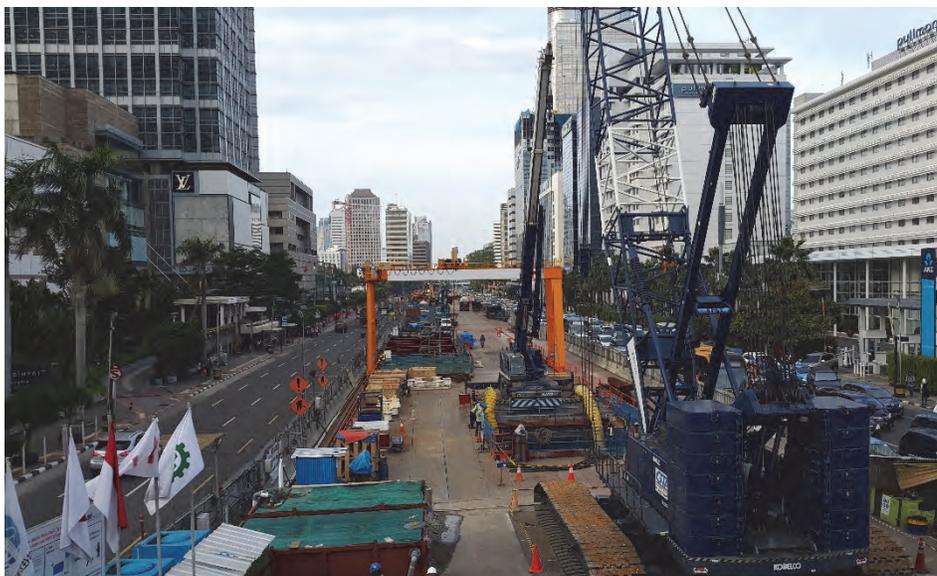
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Executive summary: Closing the gap



Indonesia's GDP growth rate remained steady at 5.0 percent...

Indonesia's real GDP expanded by 5.0 percent yoy in Q2 2017, unchanged from Q1. Growth rates have been steady at around 5 percent since Q1 2014, lower than those recorded at the beginning of the decade. While this growth rate places Indonesia among the fastest-growing large economies in the world, the lack of an acceleration is a matter of concern, considering the favorable external environment and domestic policy reform momentum.

...notwithstanding a continued pickup in the global economy and strong momentum in policy reforms

Global growth improved, international trade picked up, and monetary conditions in advanced economies remained accommodative over the past quarter. Commodity prices, while easing during the second quarter, remain higher compared to 2016. More importantly, Indonesia's macroeconomic fundamentals are sound and have been strengthening, as the Government continues to implement critical structural reforms. The recent upgrade by Standard & Poor's of Indonesia's sovereign credit rating and the country's leap in the World Bank's Doing Business rankings reflect those continuously improving fundamentals.

Investment was a bright spot

Investment growth rose to the highest levels since Q4 2015, driven largely by investments in Buildings and Structures. Strong growth in construction-related investment partly reflects enhanced public infrastructure investment in the first half of the year, a result of the improved composition of expenditures – one key example of structural reforms undertaken in the recent past. Lower lending rates, in line with the 150-basis point reduction in the policy rate in 2016, and strong foreign direct investment also contributed to higher investment growth.

Private consumption growth failed to pick up amid favorable conditions

Private consumption growth unexpectedly remained unchanged in Q2. The steady momentum in private consumption, which accounts for over half of Indonesia's GDP, stands in contrast to several favorable drivers: strong job growth (four million jobs created in the year to February), double-digit wage increases, buoyant consumer

confidence, declining food price inflation, a stable Rupiah, and the shifting of the Idul Fitri festive season to Q2 this year, which typically leads to a bump in consumption. Meanwhile, Government consumption contracted from the previous year, partly reflecting base effects of a large increase in material spending in Q2 last year, combined with fewer working days in Q2 this year.

Export growth weakened, contributing to a widening of the current account deficit

After surging in Q1, export and import growth both slowed significantly, in part reflecting easing commodity prices in Q2 and fewer working days due to the Idul Fitri holidays. The current account deficit doubled to 2.0 percent of GDP in Q2. A seasonal rise in the primary income deficit and a widening of the services trade deficit, as transport and travel imports jumped during Idul Fitri, also contributed to the larger current account deficit.

Short-term pain for long-term gains?

The absence of pickup in growth in Q2, particularly in private consumption, is a puzzle that requires further data and analysis. One possibility is that the economy is adjusting to recent reforms, while growth dividends come with a lag. For example, the ongoing subsidy reform implied a transitory pickup in inflation that dampened the purchasing power of many middle- and upper-income households. However, the tangible benefits of this reform – enlarged fiscal space for additional capital expenditures – will only accrue in the medium term. Other, and possibly complementary, explanations for the modest growth momentum include the economy's continued sensitivity to commodity prices, which declined in Q2 relative to Q1, and simple statistical noise given the shift of the Idul Fitri festive season and base effects, which likely played a role in the performance of public consumption and exports.

The 2017 Revised Budget and BI's recent rate cuts provides some stimulus

Fiscal and monetary policies responded to growth concerns with prudent stimuli. The 2017 Revised Budget recently approved by Parliament sets out a higher fiscal deficit of 2.9 percent of GDP, up from 2.4 percent in the original 2017 Budget, mainly due to an increase in expenditure, including subsidies, as the Government postponed the removal of electricity subsidies. Revenues were also revised downward. The deficit will remain within the legal limit of 3.0 percent, while enhanced revenue collection will prevent disruptive cuts towards the end of the fiscal year, reflecting continued strong fiscal management. Recently, BI embarked on a new easing cycle, cutting interest rates by 25 basis points in both August and September to support GDP growth, noting lower than expected inflation and sluggish credit growth.

Real GDP growth is expected to accelerate to 5.3 percent in 2018 from 5.1 percent in 2017 as reforms continue and start paying dividends, while soft commodity prices provide a drag

Real GDP growth is expected to reach 5.1 percent in 2017, climbing to 5.3 percent in 2018, on a supportive global economy and stronger domestic demand as reforms continue and gradually start paying dividends (Table 1).

Private consumption is projected to strengthen in line with gains in real wages and employment, while private investment will benefit from BI's recent interest rate cut

Table 1: Real GDP growth is expected to rise to 5.3 percent in 2018

		2016	2017f	2018f
Real GDP	(Annual percent change)	5.0	5.1	5.3
Consumer price index	(Annual percent change)	3.5	4.0	3.5
Current account balance	(Percent of GDP)	-1.8	-1.7	-1.8
Budget balance	(Percent of GDP)	-2.5	-2.7	-2.2

Source: Bank Indonesia; Central Bureau of Statistics (BPS); Ministry of Finance; World Bank staff calculations

Note: 2016 actual outcome; f stands for World Bank forecast

and resulting further reductions in borrowing costs, improvements in the business environment, and increased public investment in infrastructure. The external sector is expected to contribute positively given the stronger global economy, although this contribution will be partially offset by projected deteriorating terms-of-trade due to a decline in coal prices. The current account deficit is forecast to widen from 1.7 percent in 2017 to 1.8 percent in 2018.

The 2018 budget reaffirms the Government's commitment to fiscal responsibility and realism

Government consumption is expected to increase in 2018, but deficits will remain contained due to enhanced revenue performance linked to economic growth and tax reforms. In a signal of its commitment to fiscal discipline, the Government's proposed 2018 budget implies a deficit of 2.2 percent of GDP, a clear signal that it places a high value on fiscal prudence. Revenue forecasts are conservative, and the reduction in the deficit relies on significant expenditure restraint, especially in material spending. Continued strong fiscal management lays a strong foundation for future growth.

Risks to the outlook include external headwinds...

External risks to the outlook include a pickup in global uncertainty if the Fed deviates from its expected path of very gradual monetary policy and balance sheet normalization, a further weakening of commodity prices, and broader implementation of protectionist measures by advanced economies that would have a negative impact on global growth. Indonesia depends on external funding of both the public deficit and large corporates, and therefore remains sensitive to volatility in global capital flows.

... and a loss of reform momentum

It is critical to maintain reform momentum as gaps in physical and human capital, as well as institutional quality, are still significant. Part B of this report highlights the case of the gap in infrastructure capital, but alleviating other shortfalls is equally vital and require steadfast commitment to reforms and ensuring their implementation on the ground. As the legislative and presidential elections draw closer, opportunities for advancing critical and perhaps unpopular structural reforms, necessary for higher rates of economic growth, may be narrowing. Should these structural reforms be overlooked, potential growth could slow and weigh on the outlook.

This edition includes a focus topic that discusses boosting private sector participation in infrastructure development

Increased participation from the private sector in infrastructure development is necessary for closing Indonesia's infrastructure gap

The infrastructure needs in Indonesia's fast-growing, rapidly urbanizing economy are vast. However, years of underinvestment have led to a large infrastructure deficit, constraining Indonesia's growth and limiting the pace of poverty reduction. Indonesia's per capita public capital stock is only a third of other emerging economies, implying an estimated gap in infrastructure assets of around USD 1.5 trillion. The Government of Indonesia recognizes the importance of infrastructure and, as a starting point, has targeted additional investments in transport, water, energy and other key sectors amounting to over USD 400 billion from 2015-2019. Leveraging private sector investment can help Indonesia meet its large infrastructure needs more efficiently and effectively. Boosting the participation of the private sector in infrastructure development will require improvements in (i) the complex legal and regulatory environment for public-private partnerships, (ii) project planning, appraisal and selection processes, (iii) transparency and efficiency of state-owned enterprises that dominate the infrastructure sector, and (iv) the depth of local banking and capital markets. The Government has begun to take measures to

address these concerns, but accelerating the pace of private sector investments to close the infrastructure gap with emerging economies will require further efforts.

A. Economic and fiscal update



1. Generally favorable global economic environment

Global growth pickup continued during the first half of 2017

The pickup in the global growth momentum was sustained throughout the first half of 2017. This was due to stronger growth in both major advanced and emerging economies in Q2, a continued robust growth in international trade, and accommodative global monetary conditions, despite the gradual normalization of U.S. monetary policy and the measured unwinding of quantitative easing by the European Central Bank (ECB). While prices of key commodities have been declining since the beginning of this year, they are still above their average values for the same period last year, providing major commodity exporting countries a positive terms-of-trade boost.

Major economies recorded stronger growth in Q2

Growth in Q2 for major economies such as the United States, the Euro Area and Japan and China rose, relative to Q1¹ (Table 2). In the United States, growth strengthened on the back of recovery in the job markets, while in the Euro Area, robust growth was partly due to positive political developments, particularly with the French election result. In Japan and China, growth rebounded due to firming domestic demand and exports². Partly reflecting the recovery in commodity

Table 2: Growth in major economies strengthened in Q2

(growth yoy, percent)

	Q1-2017	Q2-2017
United States	2.0	2.1
Euro Area	1.9	2.2
United Kingdom	2.0	1.7
Japan	1.4	2.1
China	6.9	6.9

Source: OECD Stats; CEIC; Haver Analytics; World Bank staff calculations

Note: Growth rate compared to the same quarter of previous year, seasonally adjusted

¹ Based on the actual yoy growth rate in Q2, seasonally adjusted by the OECD data.

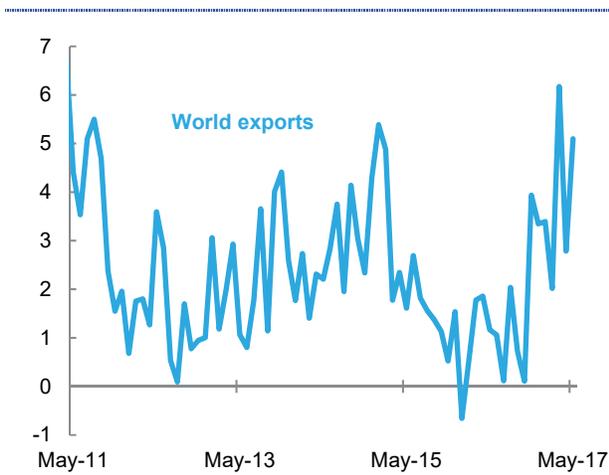
² World Bank (2017c).

exporting countries, emerging markets and developing economies (EMDEs) growth also gained momentum, supported by robust global demand and relatively stable financial markets.

Global trade volumes grew the fastest in six years in Q2

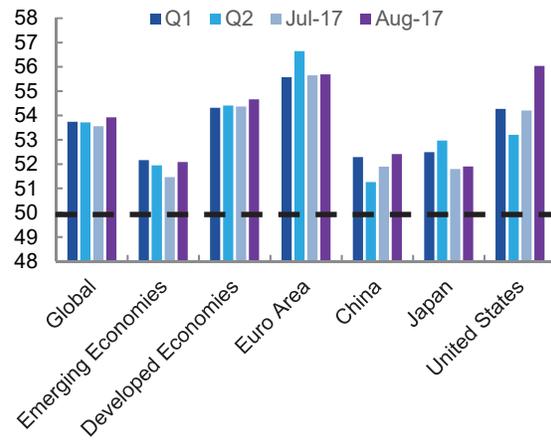
Global trade volume also recorded robust growth in Q2 of 4.4 percent yoy, up from 3.2 percent in Q1 (Figure 1). Growth of global exports and imports strengthened, as stronger trade growth of advanced economies outweighed weaker trade growth of emerging economies. The steady growth in global trade was largely investment driven, partly reflecting that the slump in global investment was bottoming out. Stronger investment-led trade is in line with a sustained pickup in global business confidence, indicated by strong readings in the Purchasing Managers' Index (PMI) in Q2, particularly for the Euro Area and Japan (Figure 2).

Figure 1: Global trade volume is firming...
(growth yoy, percent)



Source: CBP World Trade Monitor, World Bank staff calculations

Figure 2: ...and positive readings in Composite Purchasing Managers' Indexes continue to signal upbeat business sentiment
(index)



Source: Markit Economics, Haver Analytics; World Bank staff calculation

Note: Outcome above 50 represents an expansion and an outcome below represents a contraction.

Financial markets remained calm despite monetary policy tightening in the United States

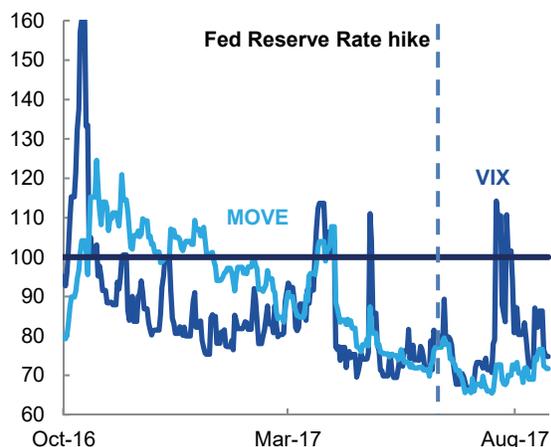
Global financial markets were relatively calm throughout the first half of 2017. Largely because markets had already priced in the rate hike, the recent increase in the U.S. federal funds rate in June did not disrupt global financial markets, as signaled by both the VIX and MOVE³ indexes remaining relatively low after the hike (Figure 3). Domestically, Indonesian bond yields across all tenors have been stable since the hike⁴. Despite the gradual monetary policy normalization in the United States, global monetary conditions have remained accommodative. The ECB continues to hold its benchmark refinancing rate at the record low of zero percent, and has confirmed the net asset purchases are intended to run at the current monthly pace of €60 billion until the end of December 2017, or beyond, if necessary. Similarly, the Bank of Japan continues to hold its key short-term interest

³ The VIX index measures volatility in the equity markets, while the MOVE index is a gauge of bond market volatility.

⁴ See detailed discussion in Section 4 on the macro financial sector.

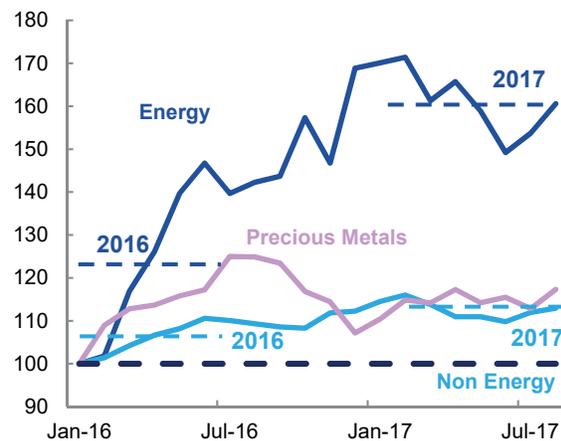
rate unchanged at -0.1 percent and its asset purchase program at annual pace of 80 trillion yen⁵.

Figure 3: Monetary policy normalization in the U.S. has had limited impact on the global financial market
(index, 1 January 2017 = 100)



Source: Bloomberg; World Bank staff calculations

Figure 4: Commodity prices are still higher than their last year values despite softening this year
(index, January 2016 = 100)



Source: World Bank Pink Sheet; World Bank staff calculations
Note: Horizontal dash lines indicate average January – August price index for each commodity category.

Despite weakening in Q2, commodity prices are still higher than last year, providing a positive terms-of-trade boost to major commodity exporting countries

After surging in the second half of 2016, global commodity prices have been easing from their peaks earlier in 2017, but still above their average values over the same period last year (Figure 4). Non-energy prices weakened, mostly due to easing prices of metals and minerals. Energy prices reached their peak in February and have declined substantially since then. While most of commodity prices eased in Q2, they are still higher than last year, and therefore providing a positive terms-of-trade boost to major commodity exporting countries⁶.

Risks to the global outlook, while diminished are still tilted to the downside

While diminished, risks to the global outlook are still tilted to the downside. The ongoing tension with North Korea has already rattled equity markets, as shown by the recent spike in the VIX index. An unexpected escalation in tension would weigh on market sentiment, leading to capital flight towards safe haven assets, such as the Japanese Yen and U.S. treasury bills⁷. Unexpected shifts in U.S. monetary policy, including the intention to reduce the size of the Federal Reserve balance sheet, could spark global market volatility. Likewise, changes in U.S. trade policy could dampen global trade activity. Lastly, unexpected declines in commodity prices, would exert downward pressures on commodity exporters' terms-of-trade, weighing on external balances and economic growth.

2. Consumption disappointed, but gains in investment kept growth steady

Indonesia's real GDP grew at 5 percent for the second consecutive

Indonesia's real GDP grew 5.0 percent yoy in Q2 2017, unchanged from Q1, and slightly below market expectations of 5.1 percent. Growth rates (yoy) have been hovering around 5 percent since Q1 2014, significantly lower than those recorded at the beginning of the decade. Investment growth strengthened to a six-quarter high,

⁵ Bank of Japan (2017).

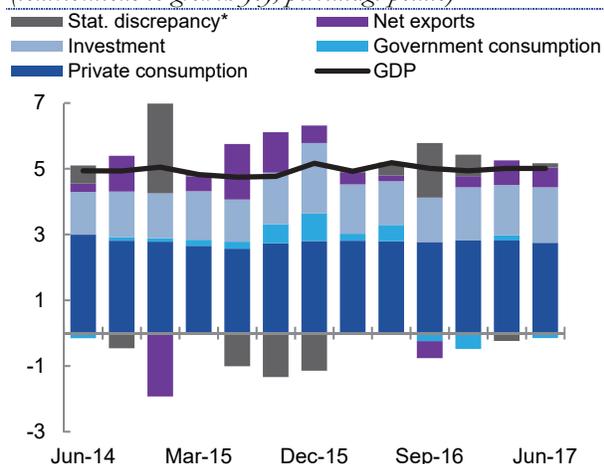
⁶ See detailed discussion in Section 5 on commodity prices.

⁷ The Guardian (2017).

quarter supported by strengthening investment growth

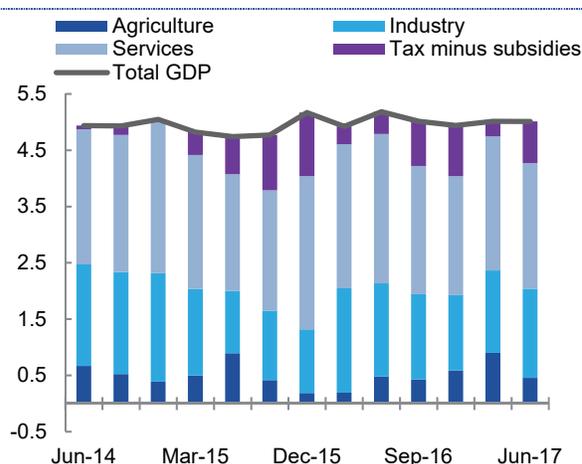
but was offset by contracting Government consumption, flat private consumption growth and a slowdown in net exports growth. Despite significant easing, both export and import growth remained positive for the third consecutive quarter, after contracting for two years (Figure 5). On the production side, growth was driven by the industry sector, but weighed down by a significant slowdown in the growth of the agriculture sector (Figure 6).

Figure 5: GDP growth remained unchanged in Q2 2017 as stronger investment was offset by contracting government consumption and slowing net exports
(contributions to growth yoy, percentage points)



Source: BPS; World Bank staff calculations
Note: * Stat. discrepancy includes changes in inventories.

Figure 6: The industry sector drove economic growth while the agriculture sector growth eased substantially
(contributions to growth yoy, percentage points)



Source: BPS; World Bank staff calculations
Note: Industry sector consists of mining and quarrying, manufacturing, utilities and construction; Service sector consists of trade, hotel and restaurant, transportation and communication, finance and services

Private consumption growth remained unchanged despite the festive season in June

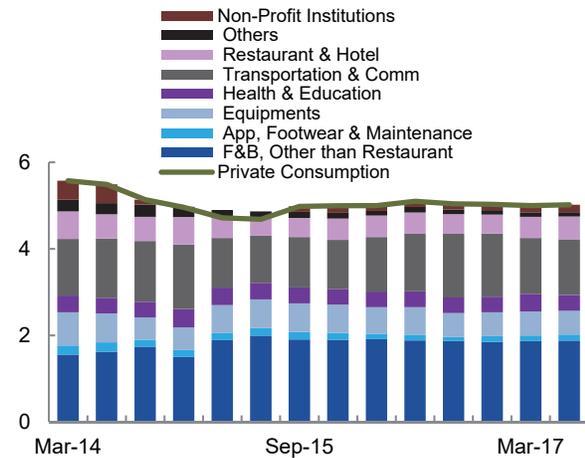
Despite the shifting of the Idul Fitri festive season to Q2 this year, which typically leads to a bump in consumption, private consumption growth was flat at 5.0 percent yoy for the fourth consecutive quarter. Household consumption growth slowed slightly, with growth largely driven by expenditures at restaurants and hotels⁸ (Figure 7). Monthly indicators also hint at weakening household consumption. Except for stronger consumer confidence index, retail, passenger car, and motorcycle sales all slowed during the quarter compared to Q1 (Figure 8). The flat growth in private consumption therefore could suggest an underlying weakness, as the boost from the festive season, falling unemployment and a jump in real wages⁹ were offset by higher inflation, partly due to electricity subsidy cuts, higher non-subsidized fuel, and a rise in cigarette taxes, which weighed on consumer purchasing power¹⁰. Moreover, stepped-up efforts to increase tax collections may have led to higher precautionary savings on the part of higher income households, evidenced by an increase in bank deposits as households effectively cut back on consumption.

⁸ Non-profit institution consumption growth accelerated from 8.0 percent in Q1 to 8.5 percent in Q2, although its contributions remains small at 0.2 percentage points to total private consumption growth.

⁹ See detailed discussion in Section 7 on the labor market.

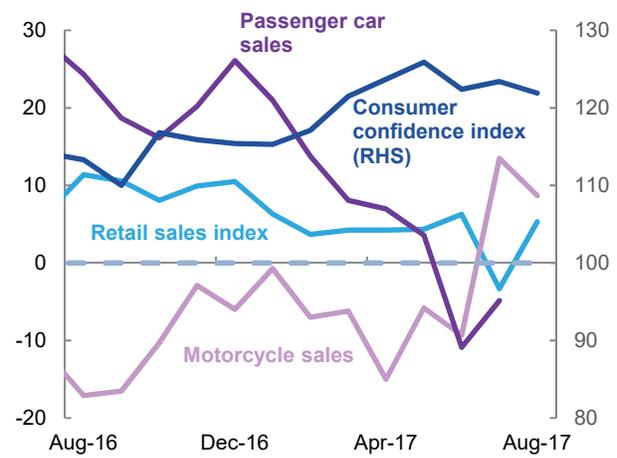
¹⁰ Indonesia Investment (2017).

Figure 7: Private consumption recorded stable growth; expenditures on food and beverage, and transport and communication were the largest contributors
(contributions to growth yoy, percentage points)



Source: BI; World Bank staff calculations

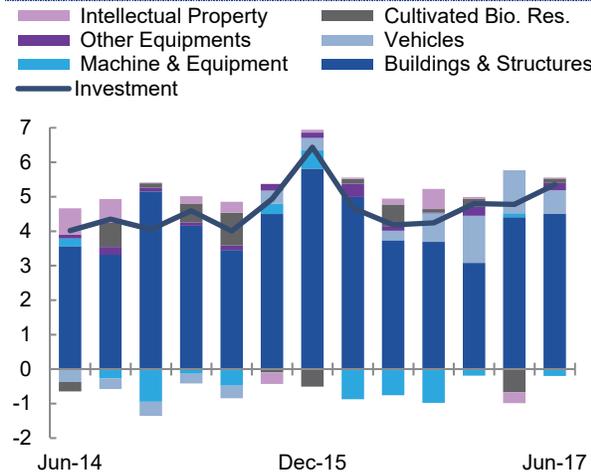
Figure 8: Monthly indicators for consumption weakened in Q2
(3mma growth yoy, percent, LHS; index; RHS)



Source: BI; World Bank staff calculations

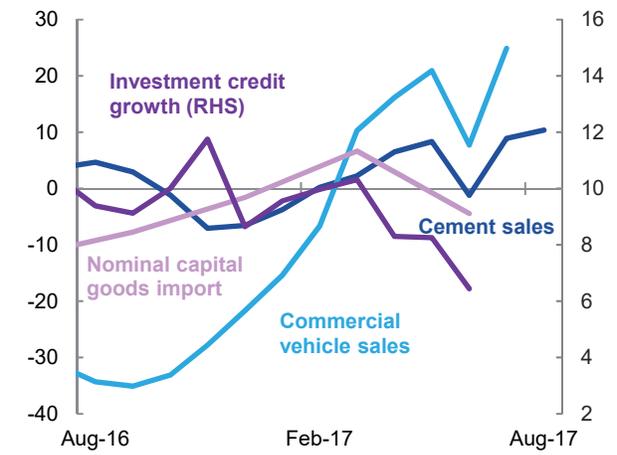
Note: The retail sales index is measured in yoy terms. All other LHS variables are measured in 3-month moving average (mma) percent yoy terms

Figure 9: Investment in Buildings and Structures continued to drive investment growth
(contributions to growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Figure 10: Monthly indicators signal moderation in investment growth
(3mma growth yoy, percent, LHS; growth yoy, percent, RHS)



Source: BI; BPS; World Bank staff calculations

Note: The nominal capital goods imports is measured in yoy terms. All other LHS variables are measured in 3-month moving average (mma) percent yoy terms

Investment growth picked up to a six-quarter high...

Gross fixed capital formation growth accelerated to a six-quarter high of 5.4 percent from 4.8 percent Q1 2017, overwhelmingly driven by growth in investment in buildings and structures (Figure 9), which is in line with stronger cement sales and commercial vehicle sales in Q2 (Figure 10). The Government’s (and SOE’s) higher infrastructure investment appear to have gained traction despite a slowdown in growth of public capital expenditure disbursements from the budget, while lower interest rates also contributed positively. Investment in vehicles and ‘Other Equipment’ (a category that includes office equipment and electronics) also grew

strongly. Cultivated Biological Resource and Intellectual Property Products rebounded after contracting in Q1 and provided an additional boost to total investment. In contrast, investment in machine and equipment contracted, consistent with a weakening of capital goods imports. Net foreign direct investment rose to its highest level since Q3 2016¹¹.

...but offset by a contraction in Government consumption...

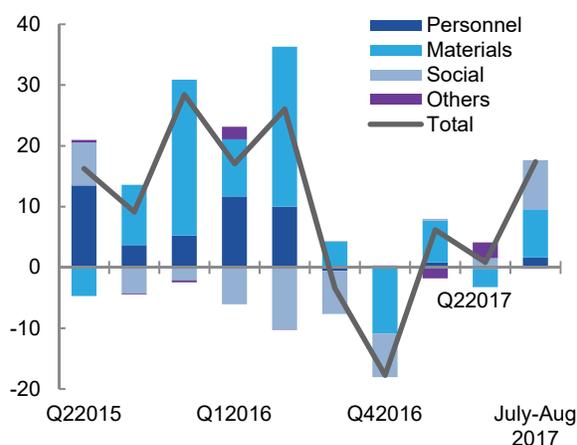
Government consumption, making up of 8.6 percent of GDP, contracted 1.9 percent yoy in real terms (0.8 percent growth in nominal terms), down from 2.7 percent in Q1 (6.2 percent in nominal terms). The slowdown was partly due a decline in material spending (7.0 percent yoy in nominal terms), likely reflecting a base effect of a large increase in material spending over the same period last year (Figure 11). Personnel spending also slipped partly because of the delay in payment of bonuses to civil servants.

Social spending advanced 18.6 percent (in nominal terms) from a 3.4 percent increase in Q1, after contracting for the previous six consecutive quarters. However, monthly budget realization data in July and August showed that government consumption growth picked up significantly at 17.4 percent yoy in nominal terms. The recovery in July and August was mostly driven by jumps in materials and social spending.

...and muted growth in net exports partly due to the sluggish manufacturing sector

Export and import growth plunged to 3.4 percent and 0.5 percent, respectively, after surging in Q1. Net exports contributed 0.6 percentage points to GDP growth – down from 0.7 percentage points in Q1 2017. This could potentially be due to an expanded number of public holidays, leading to significantly fewer working days in Q2 this year, dampening economic activity. The slowdown in the total export growth was mostly due to significant moderation in goods export growth, in particular non-oil and gas (non O&G) export growth (Figure 12), while the softening import growth was mostly due to contraction in oil and gas (O&G) goods imports (Figure 13). Non-O&G exports growth softened on the back of contracting manufacturing exports¹², while the decline in oil imports was potentially attributed to the increase in domestic crude oil lifting, as several refineries resumed its production after shutting down in Q1 due to generator breakdowns and regular maintenance.

Figure 11: Contracting government consumption was partly due to a steep drop in material spending
(contributions to nominal growth yoy, percentage points)

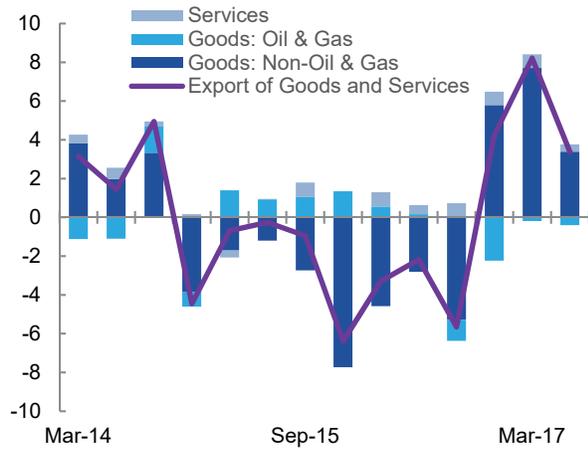


Source: Monthly budget realization data, Ministry of Finance; World Bank staff calculations
Note: Government consumption realization includes central government spending on personnel, materials, social and other expenditure.

¹¹ See detailed discussion in Section 5 on the external sector.

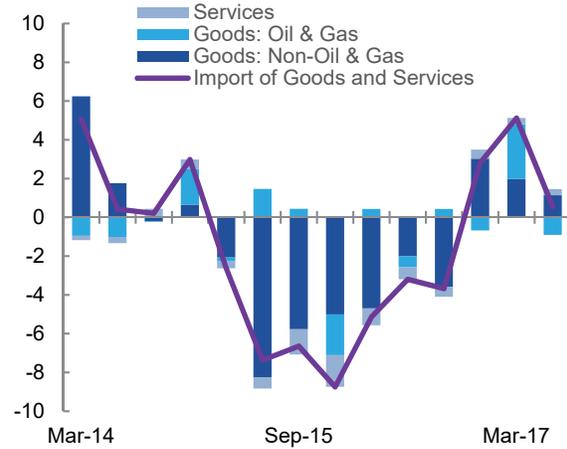
¹² See detailed discussion in Section 5 on the external sector.

Figure 12: Total exports growth plunged as non O&G exports softened and O&G exports contracted
(contributions to real growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Figure 13: Total imports growth also slowed with a contraction in O&G imports
(contributions to real growth yoy, percentage points)

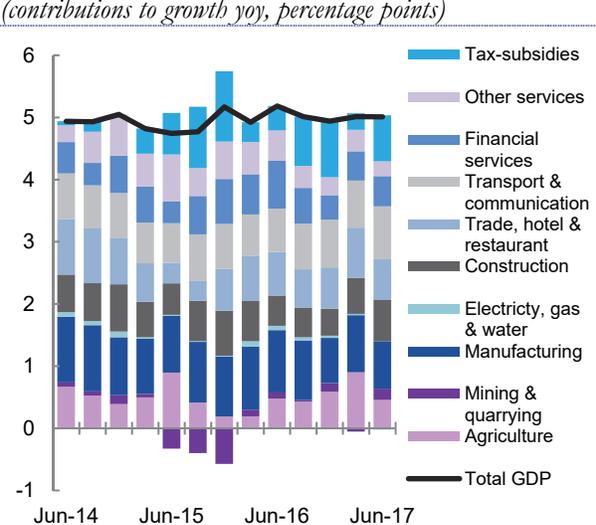


Source: BPS; World Bank staff calculations

On the production side, a pickup in the construction and transport sectors was offset by significant moderation in agriculture

On the production side, growth was driven by the industry sector, particularly construction where growth advanced from 5.9 percent in Q1 to 7.0 percent this quarter (Figure 14), in line with the large contribution of Buildings and Structures investment to total investment growth. The stronger growth was partially counterweighed by a significant moderation in the agriculture sector, whose growth fell from 7.1 percent to 3.3 percent in Q2. Service sector growth also moderated, mainly due to a slowdown in growth of Other Services (which include public services, education services, health services and social work activities).

Figure 14: Construction sector advanced the most, in line with strong investment growth in buildings and structures
(contributions to growth yoy, percentage points)



Source: BI; World Bank staff calculations

Tax minus subsidies, often known as net indirect tax¹³, grew strongly by 23.3 percent in Q2. This category has been generally growing rapidly over the past five years.

¹³ Net Indirect Tax is indirect taxes minus subsidies. Indirect taxes include sales taxes, export and import duties, excise and other taxes, except for income tax and personal tax while subsidies consist of any subsidy given by the Government to the production units.

3. Headline inflation accelerated in Q2 due to administered price increases, but food, transport and core inflation eased

Inflationary pressures picked up in Q2 compared to Q1 and Q4 2016 on the back of electricity tariff hikes...

Headline inflation reached a 15-month high in June and rose to an average of 4.3 percent yoy in Q2 2017 from an average of 3.6 percent in Q1 and 3.3 percent in Q4 2016. The spike in inflation, which started to come down in July and August, was due to the combined effects of electricity tariff hikes in the first half of the year and the Muslim festival of Ramadan and Idul Fitri in June (Figure 15).

Electricity prices were raised for household customers with 900-VA subscriptions (18.7 million households)¹⁴ in January, March and May of this year to curtail energy spending through better targeting¹⁵. Core inflation averaged 3.2 percent in Q2, lower than the 3.4 percent average in Q1.

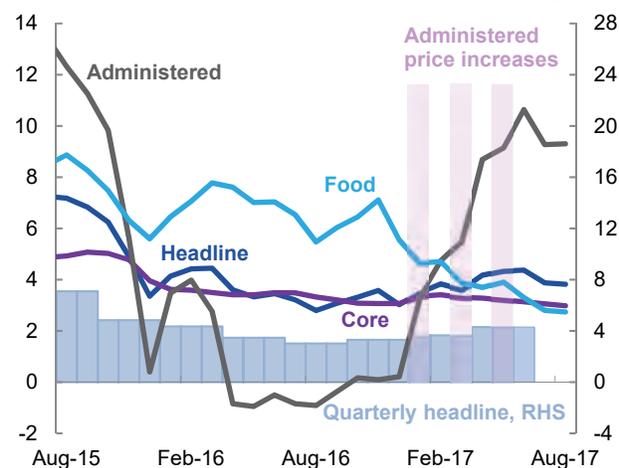
...but upward price pressures are subdued and inflation has declined in July and August

At the same time, despite the relatively sharp climb in administered prices, upward price pressures were partially offset by falling food inflation throughout the first half of 2017. Increases in raw food prices averaged 2.9 percent in Q2, the lowest in 13 years, largely due to favorable weather conditions and government programs to stabilize food prices (Box 1). Similarly, prepared food inflation eased to an average of 4.6 percent in Q2, the lowest since Q1 2012.

Headline inflation, eased in July and August to 3.9 and 3.8 percent yoy, respectively, from 4.4 percent in June, as the transitory upward pressures in H1 dissipated and food inflation continued to fall. Indeed, foodstuff inflation fell to a 17-year low of 1.5 percent in August, while prices of prepared food only rose to 4.2 percent, the lowest since October 2004¹⁶. Core inflation stood at a monthly record low of 3.0 percent in August, a slight ease from June and Q4 2016. Stable prices amid steady economic growth suggests that inflationary expectations have largely been contained, with the stable exchange rate, subdued commodity prices, and easing food inflation offsetting the upward pressures from the increase of household electricity prices.

Figure 15: Headline inflation rose in Q2 due to electricity tariff hikes

(change yoy, percent; last observation August 2017)



Source: BPS; World Bank staff calculations

Note: Food prices are a weighted average of the raw and processed food price components of CPI

¹⁴ See World Bank (2017a).

¹⁵ See World Bank (2017d).

¹⁶ The current CPI weight is constructed based on household expenditure data in the Living Cost Survey or *Survei Biaya Hidup*, of Central Bureau of Statistics. The survey is conducted every 5 year with the last survey conducted in 2012. The weight for 'prepared food' based on the 2012 Survey was 16.2 percent.

Box 1: Food price inflation during Ramadan and Idul Fitri eased this year, partly due to Government efforts

The recent Ramadan and Idul Fitri period in May–June, which typically observes significant upward pressure on prices, saw muted price level increases (similar to what was observed in 2014 due to favorable weather and a rice import policy¹), mainly due to an easing of food inflation, particularly from raw food. Low prices of key domestic food items such as rice, sugar, chicken, and cooking oil, contributed to the unusually low food inflation during this Ramadan period (Figure 16).

Apart from favorable weather conditions, low food inflation has been attributed to Government efforts to stabilize domestic food prices that involved line ministries, institutions such as Bulog (the state-run logistics agency), and trading associations. Prior to Ramadan, the Government allowed garlic, beef, and sugar to be imported to increase domestic food stockpiles. For example, in anticipation of a spike in domestic demand for beef and to ease upside

pressures on prices, the Ministry of Trade allowed the import of 10,000 tons of beef, in addition to the 45,000 ton stockpile in Bulog warehouses². As for rice, local warehouses were required to increase stockpiles, while there were crackdowns against hoarding by local operators, which has historically pushed up prices, particularly in the run-up to Ramadan³. In addition, the Sea Toll Road launched in 2015 and recently improved digital infrastructure technology also contributed to relieving bottlenecks in food distribution systems⁴. A central bank-sponsored web portal, hargapangan.id, shows average food prices and scarcity throughout the country, a useful guide for the government in directing much-needed food deliveries.

In early 2017, the Government signed MoU with a number of retail associations and food distributors to agree on ceiling prices (Harga Eceran Tertinggi or HET) of key food commodities. To further support the effectiveness of the policy, the Finance Ministry and the Anti-Monopoly Supervisory Commission (KPPU) signed another MoU in May 2017, agreeing to exchange information to prevent import cartels from setting large increases in prices of basic food items.

In addition, also earlier this year, the Government announced six policy measures to tame inflation this year which include improving infrastructure for food logistics, developing a database that monitors food and goods traffic, providing fiscal instruments to incentivize sub-national governments to maintain food stability, and improving staple food cropping patterns⁵.

¹ See World Bank (2014).

²

http://www.salaamgateway.com/en/story/indonesia_pushing_early_beef_imports_ahead_of_ramadan_will_review_process_for_india_buffalo_meat_-_salaam02042017164159/

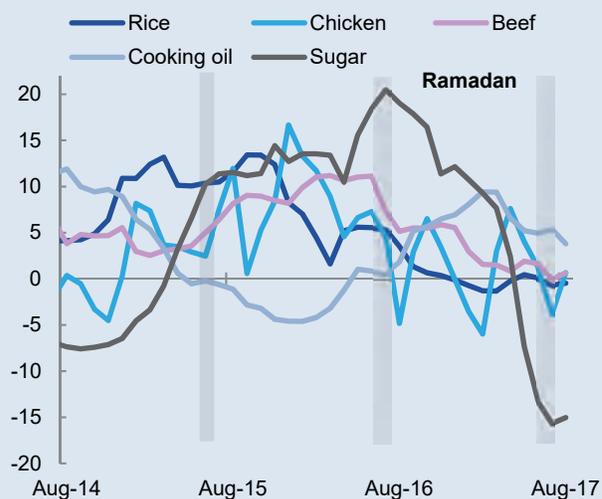
³ EIU (2017).

⁴ Bank of Indonesia press release, “Penguatan Infrastruktur dan Pemanfaatan Teknologi Digital untuk Mendukung Pengendalian Inflasi”, http://www.bi.go.id/id/ruang-media/siaran-pers/Pages/sp_195517.aspx, July 27, 2017.

⁵ <https://www.kemenkeu.go.id/Berita/ini-enam-langkah-strategis-pemerintah-dan-bi-untuk-jaga-inflasi-2017>

Figure 16: Main domestic food prices continued to moderate during Ramadan 2017

(change yoy, percent)



Source: BPS; World Bank staff calculations

4. Financial markets performed well, reflecting confidence in Indonesia's macroeconomic fundamentals

Investor appetite for Indonesian assets continued to be strong in Q2

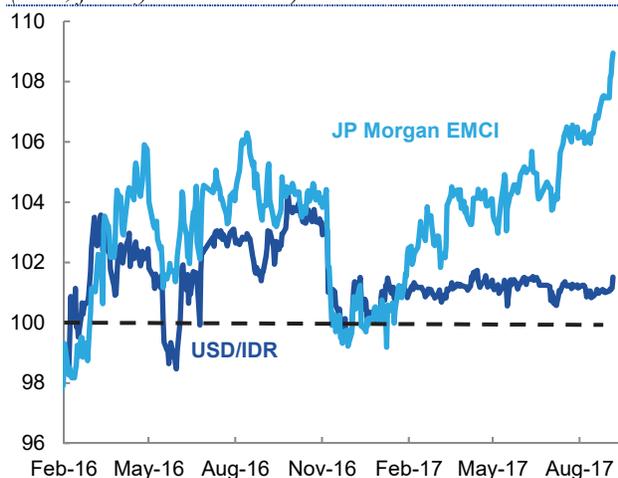
In Q2, Indonesian assets continued the pattern seen in Q1 with the Jakarta Composite Index (JCI) once again growing strongly by almost 5 percent (outperforming some regional peers except India, Vietnam and Philippines), bond yields falling and the Rupiah appreciating a little against the U.S. dollar.

The Rupiah remained stable while currencies of emerging market peers appreciated

While several other emerging market economies continued to see appreciation of their currencies, the stability of the Rupiah (Figure 17) persisted for much of Q2 with the currency remaining flat and leading to an effective depreciation (Figure 18). Foreign reserve accumulations seen in the first half of the year (to near record level highs) contributed to the (nominal) stability of the Rupiah, offsetting the upward pressure that arose from strong portfolio and capital inflows. In recent months, however, these trends have reversed slightly.

Figure 17: A stable rupiah amid appreciating EM currencies...

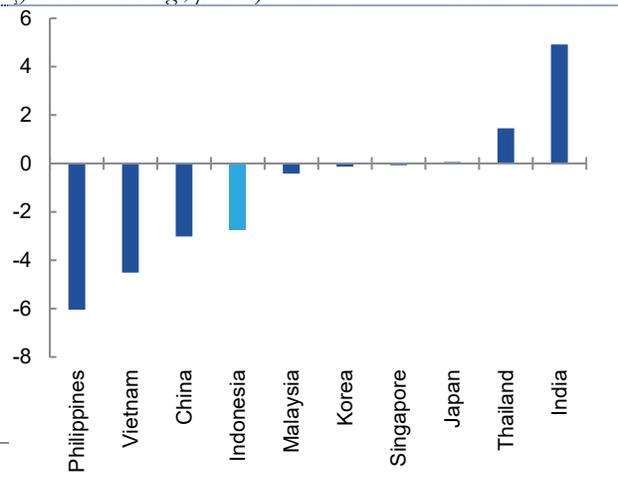
(index, January 3 2017 = 100)



Source: CEIC, JP Morgan; World Bank staff calculations
Note: Downward movement represents a depreciation

Figure 18: ... implied depreciation in real effective terms

(year-to-date change, percent)



Source: JP Morgan Real Broad Effective Exchange Rate Index, CPI Based (2010=100); World Bank staff calculations
Note: Downward movement represents a depreciation

Investors continued to be attracted to Indonesian equities in Q2...

Infrastructure, finance and consumer goods sectors led the way with strong gains in Q2 (Figure 19). The strong momentum in Q1 and Q2 was tempered by more moderate gains into Q3, despite the JCI reaching a record high in early July. Notably, the manufacturing and trade sub-index fell. However, in what may bode well for overall economic activity and potential growth, the mining, infrastructure and finance sub-indices picked up in Q3.

...as well as bonds whose yields continued to fall

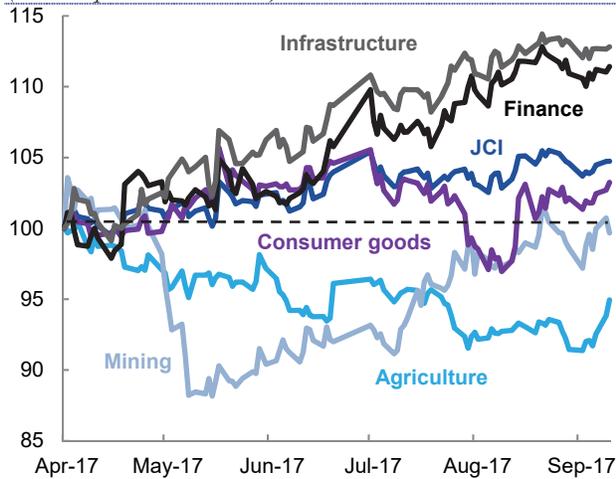
As with equities, investors also sought Indonesian bonds in Q2 with bond yields across all tenors falling, but at a slower pace than that seen in Q1. Following the trend in Q1 2017, bond issuance remained oversubscribed in Q2 as investors searched for yields¹⁷. The spread between Indonesian and U.S. bond yields continued to narrow in Q2 (Figure 20). The downward trend in yields was also present in Q3. U.S. 10 year bond yields have fallen 11 basis points as geopolitical

¹⁷ Directorate General of Budget Financing and Risk Management (August 22, 2017).

tensions in the Korean Peninsula has seen an increase in safe haven demand. In year-to-date terms, Indonesian bond yields across all tenors have fallen around 130 basis points on average.

Figure 19: Infrastructure, finance and consumer goods sectors led the way in Q2

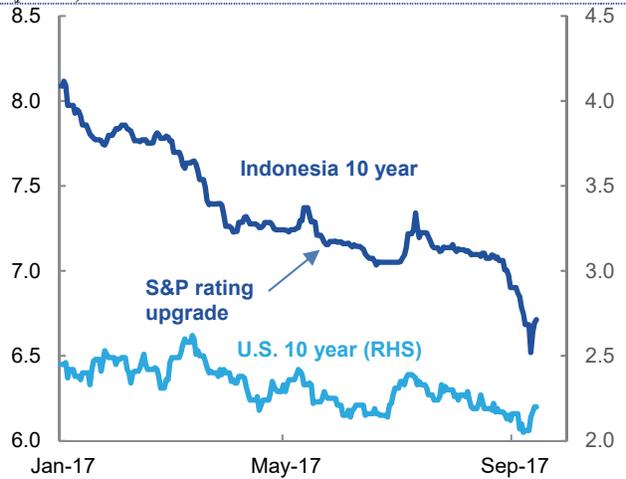
(index, April 3 2017 = 100)



Source: CEIC; World Bank staff calculation

Figure 20: Bond yields fell and the spread between Indonesia and the U.S. narrowed

(percent)



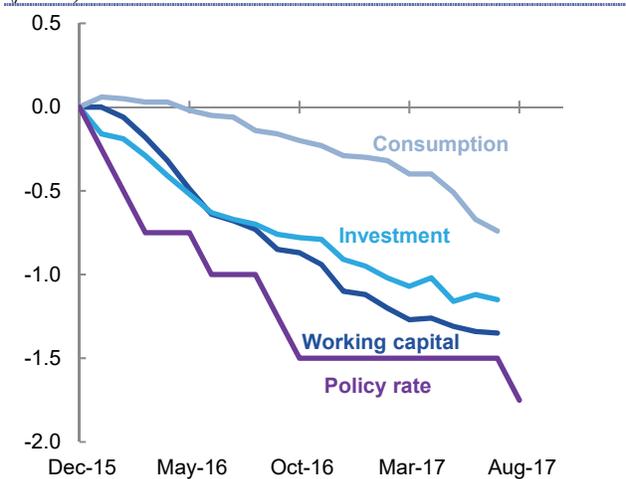
Source: CEIC; World Bank staff calculations

Bank Indonesia cut its benchmark rate on the back of weaker than expected economic growth in Q2 and low inflation

After holding rates steady 4.75 percent since October 2016, Bank Indonesia (BI) began a new easing cycle by cutting its benchmark policy rate, the 7-day reverse repo, by 25 basis points in both August and September. Low inflation and a manageable current account deficit were cited by BI as the main reasons for the renewed easing. The central bank also noted that external risks stemming from the pace of U.S. monetary policy normalization and the U.S. Federal Reserve's stated

Figure 21: Working capital and investment lending rates have fallen significantly

(percent)



Source: CEIC; World Bank staff calculations

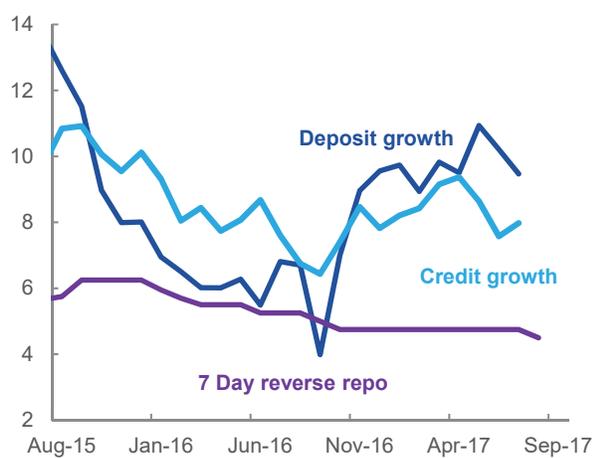
intentions to reduce the size of its balance sheet has decreased, and therefore had added room for monetary policy to be eased. The rate cuts come on the back of weaker than expected Q2 GDP growth and some signs that the interest rate cuts made in 2016 have begun to impact on the real economy, as working capital and investment lending rates have been falling and contributed to stronger investment growth in Q2. Additionally, given moderate price pressures and the fact that the 2018 budget signals continued commitment to fiscal responsibility, there could potentially be room for further easing if required.

While lending rates for working capital and investment have fallen by at least 100 basis points since the January 2016, lending rates for consumption have fallen only by around 70 basis points (Figure 21). Disappointingly, credit growth has also reversed the upward trajectory seen late last year and earlier this year. Deposit growth continues to outpace credit growth. Growth in deposits reached double digits, in May and June, for the first time since September 2015 and has eased only marginally since then. This is despite key deposit rates, such as the 3-month time deposit rates, having fallen by an average of 130 basis point since January 2016 (Figure 22).

Non-performing loans (NPLs) have now remained largely flat since mid-last year while the capital adequacy ratio has done the same, and remains well above the Basel III threshold (Figure 23). While NPLs are not a significant concern at the moment, there is some evidence that the amount of restructured loans (which exclude NPLs) is elevated but given the ample buffers in the banking system this is not something to be concerned about at this stage¹⁸.

Figure 22: Deposit growth rates continue to accelerate in Q2

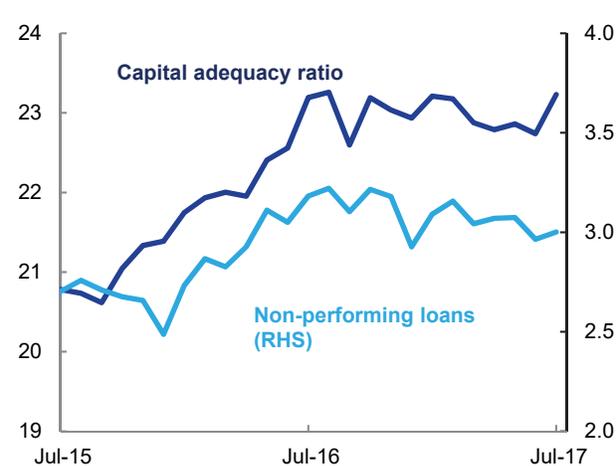
(growth, yoy percent)



Source: CEIC; World Bank staff calculations

Figure 23: Banking system remains sound

(percent)



Source: CEIC

5. Commodity prices ease while the current account deficit double

Prices for most of Indonesia's key commodities have either been flat or declined in Q2

Indonesia's six key commodities, which include crude oil, crude palm oil (CPO), rubber, coal, base metals, and liquefied natural gas (LNG), and their related processed products account for nearly 45 percent of total exports in June 2017¹⁹. Prices for most of these key export commodities have either been stable or in decline in Q2. The notable exception is the price of LNG, which has been rising.

After reaching near five-year highs in late 2016, coal prices started to decline at the beginning of Q2, partly because the Chinese government decided to relax their domestic production limit. Further downward movements were later halted by supply disruptions caused by Tropical Cyclone Debbie. The downward oil price movements in Q2 were also supply driven. The significant increase in U.S. oil production

¹⁸ Moody's Investor Service (August 24, 2017).

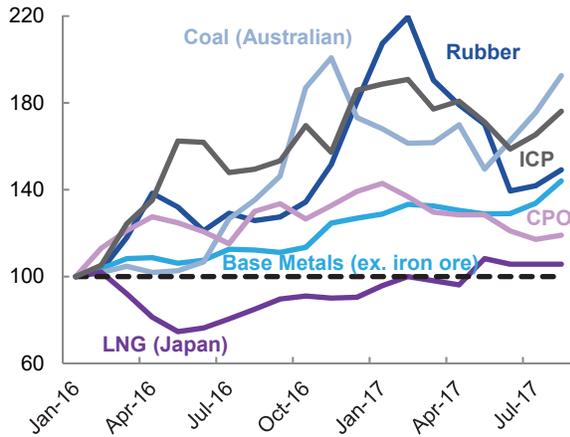
¹⁹ The mining sector alone contributes to 23 percent of total export while additional 22 percent comes from processed rubber, palm oil, base metals, LNG and oil products.

encouraged crude oil markets to ignore geopolitical risks and, instead, focus on OPEC’s and Russia’s inability to cut back production to rebalance the market. LNG prices steadily improved in Q2 as markets anticipated higher demand for electricity generation during the summer. Prices of rubber and CPO, on the other hand, have been in easing in Q2 due to strong production and weak demand (See Box 2 for a more detailed discussion on movements of commodity prices in recent months).

The most recent data readings in July and August show an upturn in prices for all commodities. For coal, CPO, rubber, and crude oil, stronger prices in July and August represent recoveries as prices have been declining after peaking either late last year or early this year. LNG and base metal prices, on the other hand, have been consistently strengthening since the second half of 2016 (Figure 24).

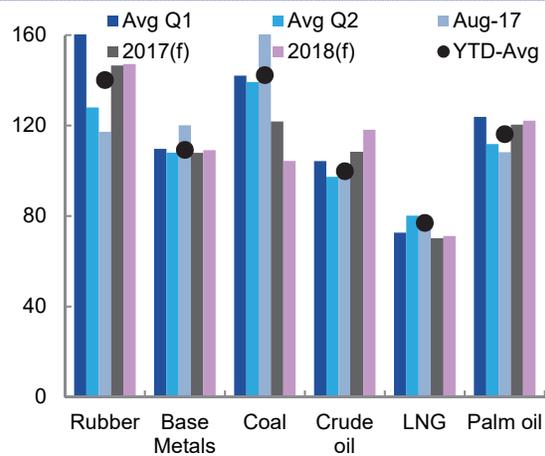
Figure 24: Global prices for Indonesia’s six key export commodities diverged in Q2, with most of the commodity prices either being relatively stable or in decline

(index January 2016 = 100)



Source: World Bank Pink Sheet; CEIC; World Bank staff calculations. Note: Liquefied Natural Gas (LNG)

Figure 25: Crude oil prices are forecast to rise in the medium term, while coal prices are expected to fall (index 2015=100)



Source: World Bank (2017); World Bank staff calculations. Note: f stands for forecast

Indonesia’s key commodities’ ToT is expected to end 2017 broadly at the same level as 2016, before declining in 2018

World Bank (2017b) projections suggest that the prices for rubber, base metals, LNG and palm oil will be relatively flat in 2017 compared to 2016 (Figure 25). Crude oil prices are expected to climb 28.5 percent in 2017 and 9.1 percent in 2018²⁰. In contrast, coal prices averaged USD 87.5 per metric ton in July, but are forecast to be USD 70/mt in 2017, and decline further to USD 60/mt 2018. As Indonesia is a net exporter of coal and a net importer of oil, the expected movement of coal and oil prices implies a deterioration in the country’s terms-of-trade (ToT)²¹. The Net Trade Commodity Price Index²² for 2017 is therefore expected to be slightly higher than the

²⁰ The average prices of crude oil were USD 42.8 per barrel (bbl) in 2016. These are forecast to raise to USD 55/bbl and USD 60/bbl in 2017 and 2018 respectively,

²¹ Terms of trade (ToT) refers to the relative price of imports in terms of exports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods

²² The Net Trade-Commodity Price Index (NTI) is defined as: $NTI_t = \frac{Weight_{i,p} \times Price_{i,t}}{Price_{i,t}}$ where

$Weight_{i,p} = \frac{(E_{i,t}) - (I_{i,t})}{\sum (E_{N,t}) - \sum (I_{N,t})}$ and i= commodity type; t= month; p=period cycle (ex. 5 year average); N = number of commodities; T= base year; E=value of export; I=value of import

level it was at in 2016. The Index in 2018 is projected to be lower than the 2016 level (Figure 26).

Box 2: Prices for most of Indonesia's key commodities improved in recent months

After weakening from a peak in December last year, crude oil prices rose in July following the fourth consecutive week of declines in the U.S. crude oil inventories and a sharp drawdown of gasoline inventory. Prices were also boosted by renewed commitment from the members of the Organization of the Petroleum Exporting Countries (OPEC) members to reduce oil supply¹, the potential for the U.S. to impose sanctions against Venezuela and talks by several oil majors to reduce their capital expenditures². LNG prices have risen 5.7 percent since the beginning of the year, due to warmer-than-normal summer weather outlook in Asia. LNG prices in July were positively driven by lower rain fall that decreased hydro power generation in China and the surge in demand for cooling, but weighed down by high gas inventories in South Korea, Taiwan and Japan, as well as overproduction from certain gas fields in Indonesia.

After plunging more than 30 percent between February and June, rubber prices edged up in July and August. The uptick was in part due to the strong upward movement of oil prices³ and the possibility of the Thai government intervening to bolster rubber prices by absorbing excess supply of Thai produced rubber⁴.

The prices of coal have gained some further momentum over the past months with multiple factors in play. Chinese producers have been producing less because of government policies that limit their production. After being hit by Tropical Cyclone Debbie in March, coal supply from Australia has been disrupted by a miners' strike. On the demand side, a surge in demand for electricity for cooling during the hot summer months in China, and weather disruptions that reduced the capacity of hydropower stations have considerably lifted the need to ramp up electricity output from coal-generated power plants. As a result, Indonesia's coal reference price, as a result, has been set at a seven-month high of USD 83.97/mt, up 44 percent yoy and 6.4 percent higher than June 2017.

Palm oil prices extended their downward trajectory in July, leading them to be 18 percent lower than the peak in January. July prices were weighed down by forecasts of rising output in Malaysia and Indonesia as workers came back from their Muslim festivals at the end of the fasting month. Output is also expected to rise gradually, in line with seasonal patterns, with the peak typically occurring in October.

The price of base metals has been steadily rising since early last year, on the back of strong demand, particularly from China's property, infrastructure, and manufacturing sectors. The supply side has also been an important driver, in particular, because of the strikes among mining workers in Chile, regulatory uncertainty around Southeast Asian nickel and copper pits as well as the decision of some miners to operate below capacity.

¹ In November 2016, OPEC members agreed to reduce its combined oil output by 1.2 million bpd in order to shrink global stockpiles and balance an oversupplied market.

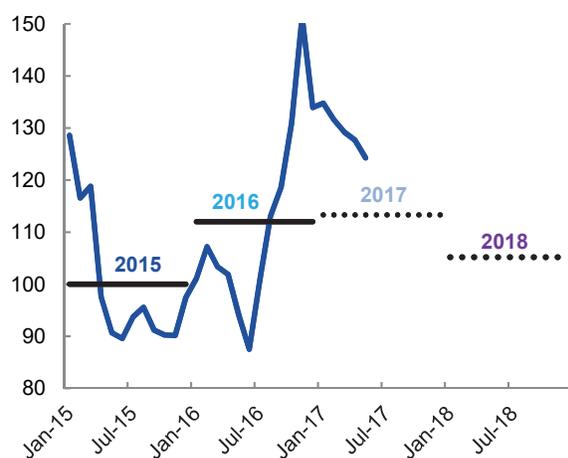
² <https://www.cnbc.com/2017/07/27/big-oil-reports-could-put-the-brakes-on-the-earnings-fueled-rally.html>

³ Synthetic rubber, a substitute for natural rubber, is an artificial elastomer made from petrochemical feedstocks. The price of rubber therefore generally follows the price of oil and its feedstocks.

⁴ http://news.xinhuanet.com/english/2017-07/17/c_136450651.htm

Figure 26: The net trade-weighted price index indicates a positive commodities terms-of-trade shock for Indonesia since July 2016

(index 2015=100)

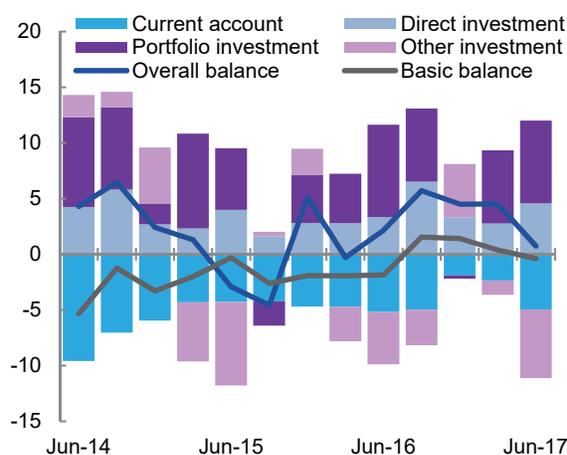


Source: BPS; World Bank; World Bank staff calculations

Note: Net trade-weighted price index is constructed over Indonesia's six major export commodities (rubber, base metals, coal, oil, gas, and palm oil)

Figure 27: The BOP remained in surplus in Q2 2017, despite the doubling of the current account deficit

(USD billion)



Source: CEIC and BI; World Bank staff calculations

The BOP posted a narrower surplus in Q2 2017, as the current account deficit doubled and the financial account surplus narrowed

Indonesia's balance of payments (BOP) posted a surplus of USD 0.7 billion (0.3 percent of GDP) in Q2 2017, a surplus for the fifth straight quarter, but down from USD 4.5 billion (1.9 percent of GDP) and from USD 2.2 billion (0.9 percent of GDP) recorded in Q1 2017 and Q2 2016, respectively (Table 3). Underlying the BOP surplus was a wider current account deficit that doubled to 2.0 percent from 1.0 percent of GDP in Q1. At the same time, the financial account surplus shrank to 2.3 percent but still exceeded the current account deficit (Figure 27). Accordingly, international reserves reached USD 123.1 billion at the end of Q2, up USD 1.3 billion from the end of Q1, and are sufficient to finance government external debt repayments and imports for 8.6 months.

Table 3: Indonesia's Balance of Payments (BOP)

(USD billion unless otherwise indicated)

	Q2-2016	Q3-2016	Q4-2016	Q1-2017	Q2-2017
Overall Balance of Payments	2.2	5.7	4.5	4.5	0.7
As percent of GDP	0.9	2.3	1.9	1.9	0.3
Current Account	(5.2)	(5.0)	(1.9)	(2.4)	(5.0)
As percent of GDP	(2.2)	(2.0)	(0.8)	(1.0)	(2.0)
Goods trade balance	3.8	3.9	5.1	5.6	4.8
Services trade balance	(2.4)	(1.5)	(2.0)	(1.3)	(2.3)
Income	(7.8)	(8.4)	(6.2)	(7.8)	(8.5)
Capital and Financial Accounts	6.8	9.78	7.6	7.9	5.9
As percent of GDP	2.9	4.0	3.2	3.3	2.3
Direct Investment	3.3	6.6	3.3	2.8	4.6
Portfolio Investment	8.3	6.5	(0.3)	6.6	7.4
Other Investment	(4.7)	(3.2)	4.8	(1.3)	(6.2)

Source: BI; World Bank staff calculations

The current account deficit widened on a lower trade surplus

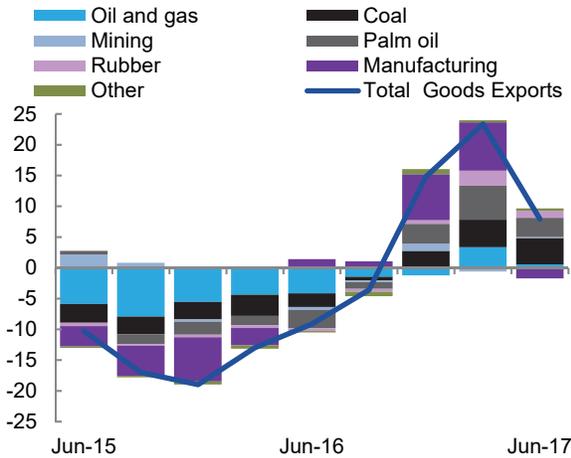
The current account deficit widened in Q2 2017, as the larger deficits for services trade and primary income contributed to a narrower trade surplus. Since 2012, the Q2 current account deficit as a share of GDP in Indonesia has always been highest among the four quarters of the year, mainly due to seasonally higher deficits in

and larger primary income deficits

primary income accounts²³. This seasonality is in line with the surge in dividend payments that occur at the end of second quarter annually. Q2 2017 in particular, saw a rising share of dividends being paid to foreign investors, following the large net foreign equity portfolio investment inflows during the first half of 2017. Additionally, the deficit in the services account in the current reporting period was largely driven by the surge in overseas travel by Indonesians during the festive holidays at the end of June.

Figure 28: Goods exports growth slowed down on the back of unusually long Idul Fitri festivities

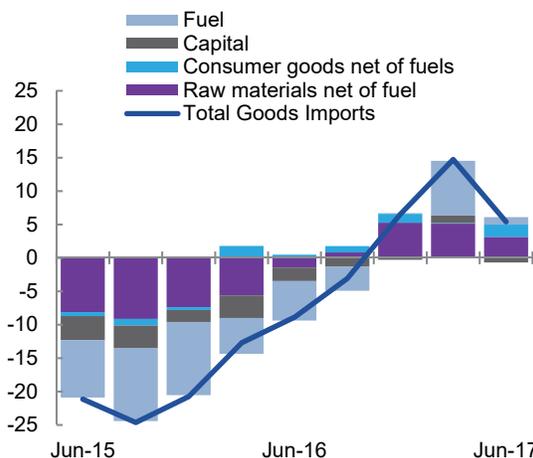
(yoy growth, percent)



Source: CEIC and BI; World Bank staff calculations

Figure 29: Slower growth in O&G imports contributed to a slowdown in total goods imports

(yoy growth, percent)



Source: CEIC and BI; World Bank staff calculations

Goods trade remained in surplus, but narrowed when compared to Q1

Partly on the back of there being fewer working days due to the unusually long Idul Fitri holidays and the fact that Idul Fitri shifted to Q2 this year from Q3 last year, goods exports grew 7.9 percent yoy, significantly slower than the 23.4 percent increase witnessed in Q1 (Figure 28). Growth of goods imports also slowed to 5.6 percent (Q1: +15.5 percent) as imported oil and gas (O&G) fell due to better domestic O&G lifting that provided more supply for domestic consumption (Figure 29)²⁴. Overall, the rise in the import of raw materials and consumption goods to meet the demand for Idul Fitri festivities, was not enough to offset the decline in O&G imports. The goods trade surplus accordingly narrowed to USD 4.8 billion, down from USD 5.6 billion recorded in Q1, but still higher than the USD 3.8 billion surplus registered in Q2 2016.

Non-O&G exports grew 8.1 percent yoy, slower than the growth recorded in Q1 2017

Non-O&G goods export values grew 8.1 percent yoy, significantly slower than the 21.9 percent growth recorded in Q1. In addition to the fewer working days available during the quarter, the sluggish growth of non-O&G goods exports was due to a contraction of manufacturing exports, in contrast to the sector's strong positive contributions to export growth recorded in the previous two quarters. At the same time, prices of Indonesia's main export goods, especially primary products such as agricultural and food products, were also weaker. In particular, the continued decline in the CPO prices has adversely influenced the growth values of Indonesia's exports to China, the United States, Singapore, Malaysia, and Netherlands²⁵.

²³ The only exception to this was in 2015.

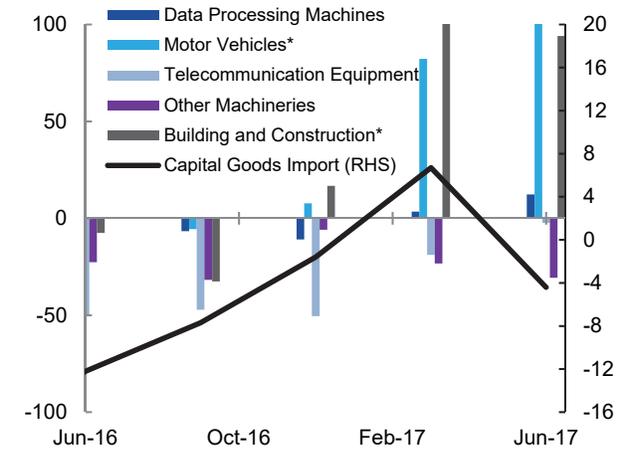
²⁴ Oil lifting rate in Q1 2017 was recorded at 0.79 million barrels per day (mbpd) while that of Q2 2017 was registered at 0.82 mbpd.

²⁵ Bank Indonesia (2017).

Imports of capital goods fell in Q2

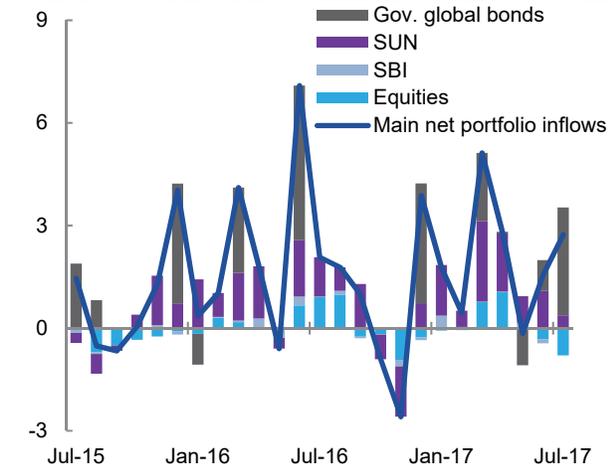
Non-O&G goods import values grew 5.6 percent yoy, much slower than the growth of 15.5 percent in Q1. Imports in Q2 were driven by an uptick in the import of consumption goods (especially fresh fruits and vegetables, including marine transportation) both in nominal and real terms, as well as import for raw materials (mainly for telecommunication equipment, vehicle spare parts, and livestock feed)²⁶. Imports of capital goods shrank 4.4 percent, despite a surge in imports of capital goods for motor vehicles and building and construction (Figure 30)²⁷.

Figure 30: Capital import growth fell despite surging motor vehicle and building and construction imports (yoy growth, percent)



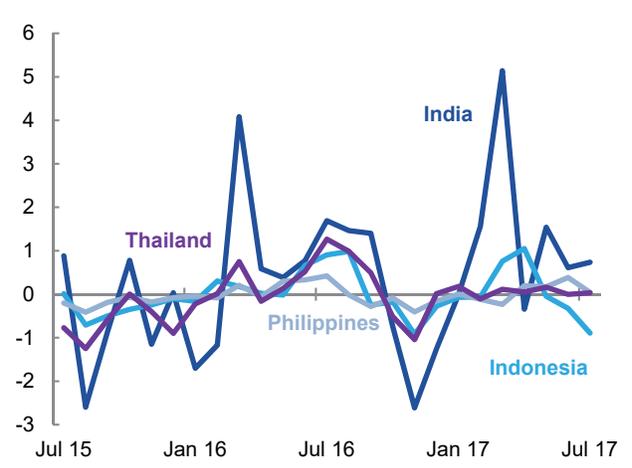
Source: CEIC and BI; World Bank staff calculations
 Note: * LHS axis truncated at 100. In Q1 2017 building and construction machinery imports grew 128 percent. In Q2 2017, motor vehicle imports increased 208 percent.

Figure 31: Total portfolio inflows picked up on the back of a surge in government global bond purchases (USD billion)



Source: The Institute of International Finance (IIF) database, World Bank Staff calculations
 Note: Sertifikat Bank Indonesia (SBI), Surat Utang Negara (SUN)

Figure 32: Portfolio equity inflows turned negative and Indonesia was outperformed by regional peers (USD billion)



Source: The Institute of International Finance (IIF) database, World Bank Staff calculations

The financial account surplus

The financial account surplus narrowed in Q2 to 2.3 percent of GDP, from 3.3 percent in Q1. The sovereign credit rating upgrade by Standard and Poor's at the

²⁶ Bank Indonesia (2017).

²⁷ The customs processing has been exceptionally slower at the end of the Q2 partly due to the government ramping up its efforts to combat illegal imports and a strike of port workers. The effects impact both exports and imports, but nevertheless, would most likely be one off.

narrowed on outflows from other investments

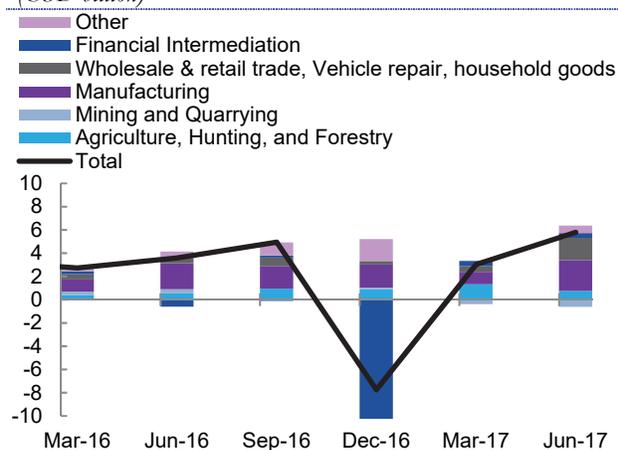
end of May partly contributed to higher foreign inflows with foreign direct investment (FDI) inflows reaching the highest since Q3 2016 and the second highest since Q3 2014. Portfolio flows also recorded higher inflows in Q2 compared to Q1 due mainly to net foreign purchases of government global bonds (Figure 31). Foreign ownership of government bonds remains stable at around 40 percent. Other investment saw more outflows than any period since Q2 2015 partly due to a buildup in foreign currency deposits by domestic banks during the Idul Fitri festive period²⁸.

Net foreign purchases of equities moved into negative territory as foreign investors continued to pull out of Indonesian equities, with net foreign inflows into the Jakarta Composite Index (JCI) contracting in July on a scale that was last seen at the end of 2016²⁹. In this regard, Indonesia was outperformed by regional peers (Figure 32).

Net foreign direct investment flows surged in Q2

Net foreign direct investment (FDI) continued the momentum seen in Q1 and recorded the largest net inflow since Q3 2016. The manufacturing sector saw the largest positive inflows, with FDI inflows totaling around USD 2.6 billion, around 57 percent of total FDI in Q2 (Figure 33). The wholesale and retail motor vehicle repair and personal and household goods sector also saw strong inflows. The mining sector saw a second consecutive quarter of net outflows.

Figure 33: Net FDI inflows surged in Q2 2017
(USD billion)



Source: CEIC and BI; World Bank staff calculations

6. 2017 has seen improved fiscal management, but significant risks remain

Improved fiscal management, but risks remain

Fiscal policy management in 2017 has improved notably against 2016, with improved revenue collection and higher quality of expenditure. Continuing the trend from the first half of the year, oil and gas (O&G) related revenues and the value-added tax (VAT) have been the drivers for higher total revenue collection in August. On the expenditure side, budget execution thus far continues to improve, although incrementally yoy as it did in 2016. By end of August, year-to-date capital and material spending grew yoy continuing last year's trend, social spending saw a rebound, and subsidy spending continued to decline. Importantly, whereas 2016 saw budget cuts, the 2017 Revised Budget increased total spending by 2.5 percent compared to the original 2017 Budget³⁰. Government financing tracks well against its targets. By July 2017, the Government had raised IDR 484 trillion, equivalent to 70.7 percent of its gross financing needs (IDR 685 trillion).

²⁸ Bank Indonesia (2017).

²⁹ Typically portfolio equity inflows are a relatively small share of total portfolio inflows. However, given that they can be quite volatile, they can play important role in influencing total portfolio inflows.

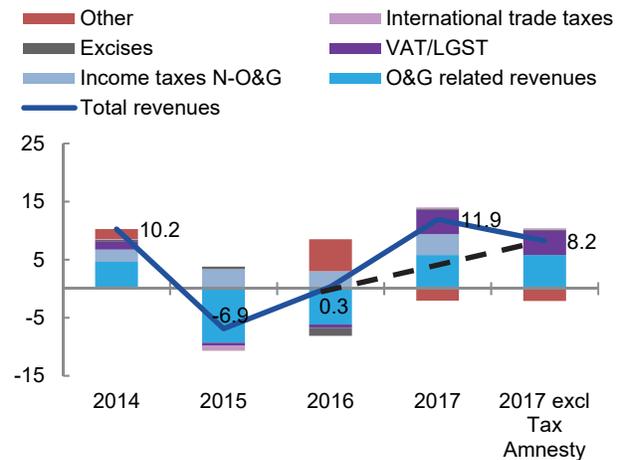
³⁰ Please see Box 4 for discussion of planned expenditure in the 2018 Proposed Budget.

Oil and gas-related revenues and VAT are driving strong revenue collections

Total revenue collection by end of August 2017 grew by 11.9 percent yoy in nominal terms, or by 8.2 percent if revenues collected from the tax amnesty program are excluded (Figure 34). As in previous quarters this year, non-tax amnesty program tax revenue is being driven mainly by O&G income tax revenues and by the VAT, with the two growing 62.8 percent and 15.6 percent yoy, respectively (Figure 34). The strong growth of VAT is particularly noteworthy given flat private consumption growth in the first half of the year. Higher collection rates, facilitated by the introduction of VAT e-invoicing as part of the Government’s administrative reform efforts, appear to be yielding results. Revenue from excises, which fell in 2016, is now growing at 3.2 percent yoy, but in level terms, it is still nevertheless lower than 2015, 2014 or 2013.

Figure 34: O&G related revenues and VAT are driving strong revenue collection growth to-date

(January-August revenue realizations nominal growth yoy, percent)



Source: Ministry of Finance; World Bank staff calculations
 Note: O&G stands for oil and gas, Non-O&G stands for non-oil and gas; LGST stands for luxury goods sales tax; “Other” includes: property taxes, other tax revenues; non-oil and gas non-tax revenues; other non-tax revenues (profits of public enterprises, revenues from Public Service Agency (BLU), and other non-tax revenues (PNBP). R-Budget stands for Revised Budget.

Expenditure realizations reflect improved quality of spending, with higher capital expenditure, and a rebound in social spending

Capital expenditure drove growth in spending this year with a 10.6 percent increase yoy in January-August realizations. This reflects the Government’s determination to expand investments in infrastructure and improve the quality of spending allocations overall (Figure 35). Total expenditure realization by end of August 2017 saw 6.1 percent growth yoy in nominal terms. The Government’s rate of budget execution rate continues to improve incrementally yoy as it did in 2016 (Figure 36). Year-to-date social spending saw a rebound, jumping 38.4 percent yoy, after the 51.2 percent plunge in 2016. In level terms, social spending is still lower than its levels during the years 2012-15. A significant decline in 2017 spending came on subsidies, with energy subsidies experiencing a 12.6 percent fall over the same period. This contraction is mainly due to the Government’s energy subsidy reform and associated electricity tariff hikes.

Figure 35: Budget execution rates show incremental improvements yoy from 2015

(January-August expenditure realizations as a share of budget target, percent)

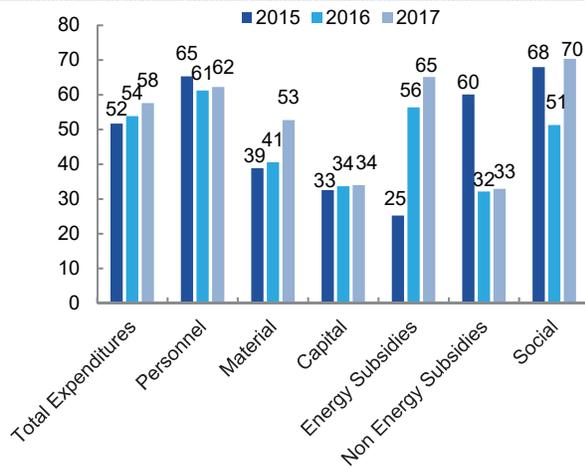
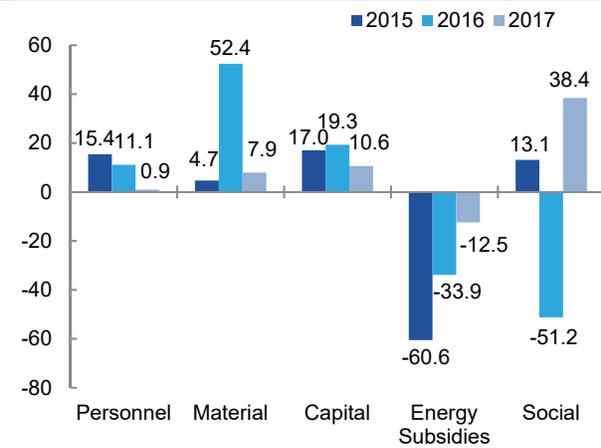


Figure 36: A shift in spending is ongoing from personnel and subsidies to material, capital and social

(January-August expenditure realizations nominal growth yoy, percent)



Source: Ministry of Finance; World Bank staff calculations

Note: Figure 35 illustrates spending as a share of targets in the Budget in percent while Figure 36 shows nominal expenditure realization yoy growth. The 2017 Budget had a 9.4 percent higher target for capital compared to 2016, which is why increases in realized capital spending from Figure 36 are not captured as an equally-large increase in the capital share of budget execution in Figure 35.

Revenue targets in the 2017 Revised Budget are slightly down, but still represent strong growth

The 2017 Revised Budget was approved by Parliament on July 26, 2017. Within it, the nominal total revenue target set is slightly down at IDR 1,736 trillion, 0.8 percent lower than the original total revenues target of IDR 1,750 trillion in the 2017 Budget. Nevertheless, the new target represents an 11.6 percent increase against 2016 actual realizations, in-line with the Government’s objective to improve its revenue-to-GDP ratio. Moreover, a key feature of the Revised Budget is realistic revenue targets when compared against targets set in previous Revised Budgets (Figure 37). Thus, the growth rate required to meet 2017 revenue targets from 2016 actuals is lower than the growth that the 2016 Revised Budget required from 2015 actuals.

Expenditure targets went up, driven by higher spending on materials, subsidies and social expenditures.

On the expenditure side, the 2017 Revised Budget set a nominal total expenditure target of IDR 2,133 trillion, an increase of 2.5 percent relative to the 2017 Budget target of IDR 2,081 trillion (Figure 38). Against the 2017 Budget, the Revised Budget increases the allocations on material (18.2 percent), subsidies (5.5 percent) and social spending (4.2 percent), and reduces the allocation on capital (6.6 percent). Despite these revisions, the allocations in the Revised Budget still represent an improvement in the quality of spending relative to the previous year. As seen in Figure 38 against 2016 actuals, capital allocation, for instance, represents a 21.7 percent increase, social allocation represents a 17.1 percent increase, and subsidy represents a 3.1 percent decrease.

Figure 37: Revenue targets set in 2017 Revised Budget are more realistic than those set in previous years
(revised budget as a ratio of actuals in previous year, percent)

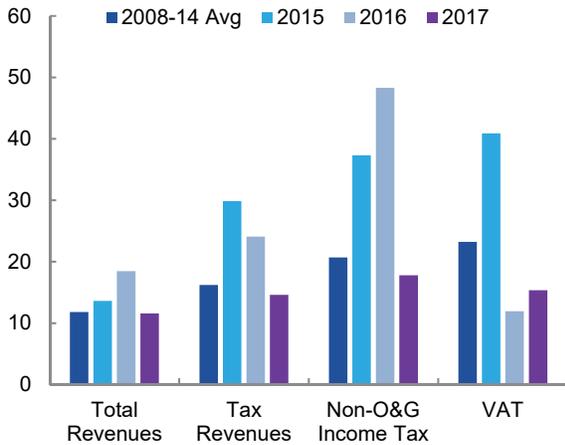
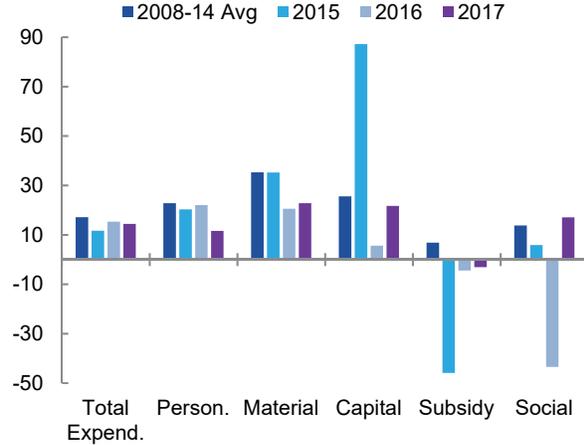


Figure 38: Expenditure allocations in 2017 Revised Budget reflect higher quality of spending
(revised budget as a ratio of actuals in previous year, percent)



Source: Ministry of Finance; World Bank staff calculations

Note: In Figure 37, Total Revenues includes tax revenues (shown) and non-tax revenues (not shown). Tax Revenues includes other tax components (including excises and international taxes) that are not shown. In Figure 38, Total Expenditures includes other expenditure allocations that are not shown, including transfers to subnational governments and interest payments.

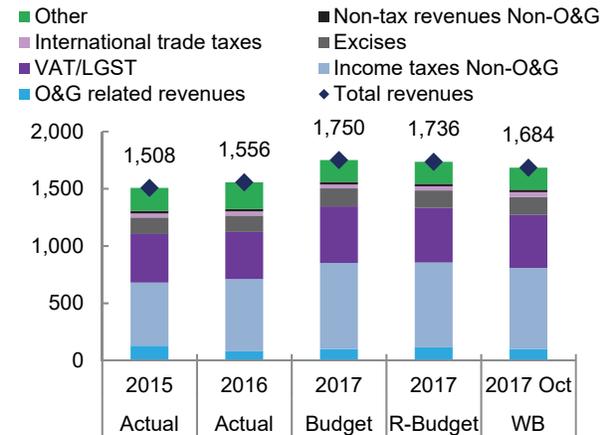
The World Bank fiscal deficit projection is increased to 2.7 percent of GDP in 2017

Total revenues are projected to reach IDR 1,684 trillion in 2017 (Figure 39), an 8.2 percent yoy increase in nominal revenues, in part reflecting stronger economic growth. The growth in revenues is expected to be broad based, with projected increases in revenue collection across tax and non-tax revenues. Against the Revised Budget target of IDR 1,736 trillion, this projection implies a shortfall of IDR 52.1 trillion, or 3.1 percent of total revenues.

Total expenditure is projected to reach IDR 2,052 trillion in 2017, a nominal increase of 10.1

percent year-on-year. Thus, the fiscal deficit is projected to widen slightly, reaching 2.7 percent of GDP, but lower than the 2017 Revised Budget estimate of 2.9 percent of GDP (Table 4). The Bank’s lower deficit projection is driven by a 96.2 percent budget disbursement rate as compared to the Revised Budget assumption of 100 percent.

Figure 39: The World Bank projects revenue collections to fall just short of Budget 2017 targets
(IDR trillion)



Source: Ministry of Finance; World Bank staff calculations

Note: O&G stands for oil and gas, Non-O&G stands for non-oil and gas; LGST stands for luxury goods sales tax; “Other” includes: property taxes, other tax revenues; non-oil and gas non-tax revenues; other non-tax revenues (profits of public enterprises, revenues from Public Service Agency (BLU), and other non-tax revenues (PNBP). R-Budget stands for Revised Budget.

Risks to revenue and expenditure come from a slowdown in tax reforms, exposure to weaker commodity prices, and broader macroeconomic trends

Risks to revenue and expenditure from a slowdown in tax administration and policy reforms and from exposure to oil prices remain salient, and are set to be particularly significant over the medium term³¹. Another source of risks is associated with the broader macroeconomy. A slowdown in the growth of private consumption, and/or a slowdown in manufacturing output would both hurt revenue collection, with VAT a major driver of Indonesian tax revenues, and the manufacturing sector a major contributor to corporate income tax collections³². Structural tax reforms that broaden the base and improve the efficiency of tax collections are needed to mitigate such risks. Reforms would enable the Government to grow its expenditure envelope so it can increase spending on priorities including infrastructure, education and health, without compromising the 3 percent fiscal deficit rule.

³¹ See World Bank (2017b).

³² As discussed in Section 2, there are signs hinting that private consumption could be weakening. At the same time, manufacturing sector growth slowed in Q2, relative to Q1, and could continue to slow as manufacturing business sentiment is weak.

Table 4: The World Bank projects lower revenue and expenditure than in the 2017 Budget
(IDR trillion, unless otherwise indicated)

	2015 Actual audited	2016 Actual Audited	2017 Budget	2017 Revised Budget	2017 MoF Outlook	2017 World Bank	2018 Proposed Budget
A. Revenues	1,508	1,556	1,750	1,736	1,736	1,684	1,878
(% of GDP)	13.1	12.5	12.5	12.8	12.8	12.4	12.6
1. Tax revenues	1,240	1,285	1,499	1,473	1,473	1,432	1,609
(% of GDP)	10.7	10.4	10.9	10.8	10.8	10.6	10.8
Income taxes	602	666	788	784	784	745	853
Oil & Gas	50	36	36	42	42	36	35
Non-Oil & Gas	553	630	752	742	742	709	817
VAT/LGST	424	412	494	475	475	462	535
Property taxes	29	19	17	15	15	17	17
Excises	145	144	157	153	153	157	155
International trade taxes	35	35	34	36	36	41	39
Import duties	31	32	34	33	33	38	36
Export duties	4	3	0	3	3	3	3
Other taxes	6	8	9	9	9	9	10
2. Non-tax revenues	256	262	250	260	260	249	268
(% of GDP)	2.2	2.1	1.8	1.9	1.9	1.8	1.8
Natural resources revenues	101	65	87	96	96	87	99
Oil & Gas	78	44	64	72	72	64	77
Non-Oil & Gas	23	21	23	23	23	23	22
Other non-tax revenues	155	197	163	165	165	162	169
3. Grants	12	9	1	3	3	3	1
B. Expenditures	1,806	1,860	2,080	2,133	2,099	2,052	2,204
(% of GDP)	15.6	15	15.2	15.7	15.4	15.1	14.8
1. Central government	1,183	1,149	1,316	1,367	1,343	1,302	1,443
(% of GDP)	10.3	9.3	9.6	10.0	9.9	9.6	9.7
Personnel	281	305	345	340	331	328	369
Material	233	260	270	319	302	301	281
Capital	215	169	221	206	203	204	231
Interest payments	156	183	221	219	219	220	248
Subsidies	186	174	160	169	169	165	172
Energy	119	107	77	90	90	93	103
Fuel	61	44	32	44	44	30	51
Electricity	58	63	45	45	45	64	52
Non-energy	67	67	83	79	79	71	69
Grants	4	7	2	6	6	8	1
Social	97	50	56	58	58	54	76
Other	10	6	41	50	56	22	64
2. Transfers to regions	623	710	710	766	756	751	761
(% of GDP)	5.4	5.7	5.5	5.6	5.6	5.5	5.1
Overall Balance	-298	-308	-308	-397	-363	-368	-326
(% of GDP)	-2.6	-2.5	-2.4	-2.9	-2.7	-2.7	-2.2
<i>Assumptions</i>							
Real GDP growth rate (%)	4.9	5.0	5.1	5.2	5.2	5.2	5.4
CPI (%)	6.4	3.5	4.0	4.3	4.3	4.3	3.5
Exchange rate (IDR/USD)	13,389	13,300	13,300	13,400	13,400	13,359	13,500
Crude-oil price (USD/barrel)	36	51	45	48	48	55	48

Source: Ministry of Finance

Box 3: Analyzing revenue targets in the 2018 Budget

On 16 August 2017, President Joko Widodo proposed the 2018 state budget to Parliament. The key macroeconomic assumptions are a higher GDP growth rate of 5.4 percent (compared to 5.2 percent in the 2017 Revised Budget) and inflation of 3.5 percent (compared to 4.3 percent for 2017). The crude oil price is set at USD 48 per barrel, unchanged from the 2017 Revised Budget, but lower production of oil and gas are assumed.

Revenue targets are relatively conservative

The 2018 Proposed Budget sets relatively conservative nominal revenue targets, a notable change from previous years. Total revenues and tax revenues are projected to increase 11.2 percent and 11.7 percent respectively, compared to the 2017 Revised Budget target excluding collections from the Tax Amnesty program. In contrast, nominal total revenues and tax revenues in 2017 are set to grow 13.7 percent and 18.5 percent yoy respectively, though this is from a lower base.¹ Non-oil and gas income tax and value added taxes (VAT) are expected to drive 2018 tax collection, with the two projected to grow by 15.0 percent and 12.6 percent respectively (Figure 40).

Implementation of tax reform could provide upside risk

2018 is set to be a critical year for tax revenue reforms with the Government setting out an ambitious tax reform agenda. Revenue reforms currently being discussed include several pieces of legislation that aim to improve the efficiency and equity of tax collection and broaden the tax base, resulting in an improved tax-to-GDP ratio.² These reforms are being coordinated by *Tim Reformasi* under the Ministry of Finance. Proposals include:

- Tax administration reform that provides increased autonomy for the Directorate General of Taxes (DGT), facilitates DGT's organizational and HR reform, and makes a significant investment in DGT's IT systems
- VAT reform that rationalizes exemptions, and sets a new VAT registration threshold that reflects Indonesia's level of economic development and is comparable to other countries in the region
- Income tax reform, including to strengthen efforts to tackle base-erosion and profit shifting, and to restructure the tax regime on micro, small and medium enterprises (MSMEs)
- Reform of excises, including new proposed excises on sugar-sweetened beverages

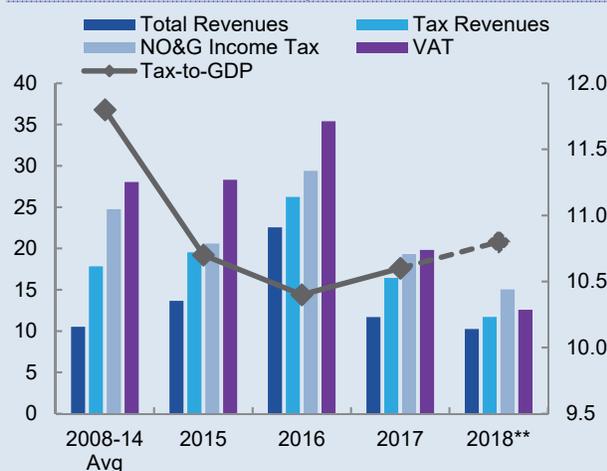
The extent of the Government's success on passing such legislation through Parliament and effectively implementing it will shape Indonesia's efforts to collect more revenues over the medium term. Moreover, implementation of 'quick win reforms' may also yield gains in 2018 itself, with upside risk for the 2018 revenue budget targets.

¹ 2017 yoy growth is calculated excluding revenues from the Tax Amnesty program. 2016 was a particularly poor year for revenue collections, with total tax revenues declining yoy in nominal terms excluding revenues from the Tax Amnesty program. Nevertheless, the base effect is insufficient to explain the conservative revenue targets in 2018. Additional evidence can be found when analyzing the 2017 Proposed Budget. This assumed tax revenue growth of 16.4 percent against 2016 actuals despite assuming lower GDP growth at 5.2 percent, lower crude oil prices at 45 USD/thousand barrel, and lower oil and gas production targets.

² Indonesia is amongst the countries in the region with one of the lowest tax-to-GDP ratios. For more discussion of this, see World Bank (2017a), pp. 25

Figure 40: The tax-to-GDP ratio is growing again after several years of decline

(proposed budget targets as a ratio of actuals from previous year, LHS; tax-to-GDP ratio, RHS)



Source: Ministry of Finance; World Bank staff calculations

Note: For 2018 Proposed Budget comparison, we use 2017 Revised Budget revenue targets less revenues collected in the third phase of the Tax Amnesty program as end-of-year Actuals are yet to be achieved and revenues collected from the Tax Amnesty program are treated as a one-off positive shock.

Box 4: Analyzing planned expenditures in the 2018 Budget

Planned expenditures in the Proposed 2018 Budget have provoked much public interest. Compared to previous years, total spending targets are modest, but comparing the budget composition against last year reflects a continued prioritization of capital expenditure as well social spending. Material spending is set to decline, while subsidies are up.

Modest spending targets and a low deficit

Total nominal spending in the Proposed Budget is planned to grow at a modest 3.3 percent relative to the target set in the 2017 Revised Budget. In contrast, the 2017 Proposed Budget assumed total expenditure growth of 11.1 percent against 2016 actuals (Figure 41). Relatively low spending growth enables the Government to lower its fiscal deficit, which is expected to be 2.2 percent of GDP compared to 2.7 percent for 2017 (Ministry of Finance Outlook projection, see Table 4).

Figure 41: The 2018 Proposed Budget prioritizes capital and social expenditures, and cuts material spending. Energy subsidies are increased
(proposed budget targets as a ratio of actuals from previous year)

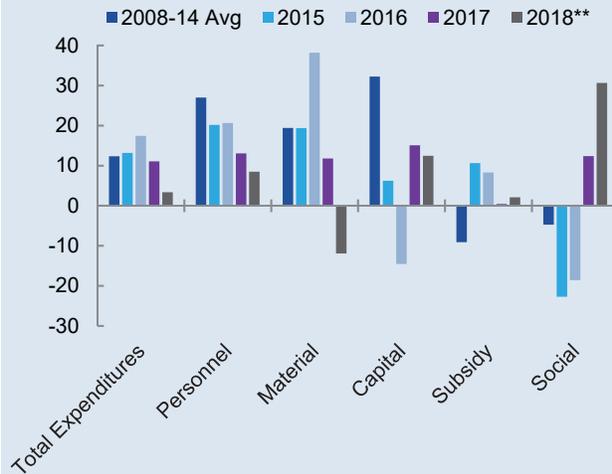
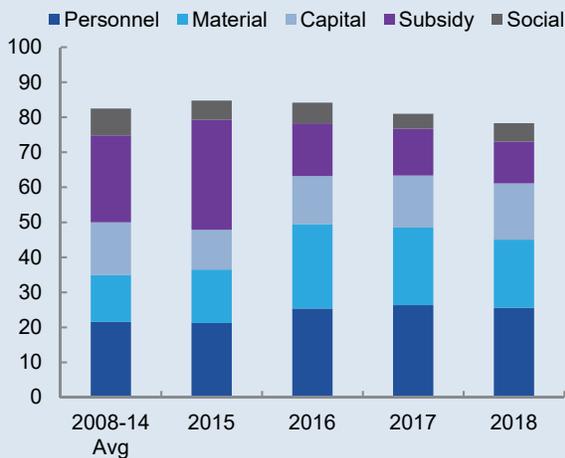


Figure 42: While nominal subsidy spending is planned to increase in 2017, it occupies a smaller share of Central Government spending than in 2017
(spending components as shares of Central Government spending)



Source: Ministry of Finance; World Bank staff calculations
Note: 2018 Proposed Budget comparison uses 2017 Revised Budget expenditure targets as end-of-year actuals are yet to be achieved.

Source: Ministry of Finance; World Bank staff calculations
Note: Other categories of central government spending not presented here include interest payments and grants.

Higher levels of infrastructure investment maintained, but subsidies creep up

The 2018 Proposed Budget reflects the Government’s continued commitment to invest in infrastructure, with nominal capital expenditure experiencing a 12.4 percent increase relative to the 2017 Revised Budget. Starting from a high base, this capital spending target represents more than a third of the contribution to total expenditure growth. Social spending also makes a strong contribution, growing by 30.6 percent relative to 2017 Revised Budget (representing a quarter of the contribution to total expenditure growth). Material spending, however, sees a cut, by 11.9 percent. Depending on which subcomponents of material spending will be cut, this may be interpreted as a further improvement in the quality of spending allocations overall.

One surprise, however, came with the increase in nominal energy subsidies, reversing a policy of year-on-year cuts since 2015. The numbers indicate a suspension of the Government’s policy to raise electricity tariffs. Nevertheless, higher spending on energy subsidies should be tempered by the fact that they are lower than 2010-16 in nominal level terms (Figure 42).

7. The labor market continues to tighten as employment growth outpaced growth in the labor force and working-age population

The Indonesian economy created nearly 4 million jobs in the year to February 2017

The number of employed individuals grew by 3.2 percent (4 million in absolute terms) in the year to February 2017, reaching 124.5 million workers.³³

Employment growth therefore outpaced growth in the broad labor force – which grew by 3.0 percent to 131.5 million – and growth in the working-age population – which grew by 1.6 percent to 190.6 million (Figure 43).³⁴ This leaves the employment rate at 65.3 percent, up from 64.3 percent in February 2016.³⁵

Additionally over the same period, broad unemployment³⁶ fell from

5.5 percent to 5.3 percent, the lowest since it was first recorded in 2000, indicating that the labor market has continued to tighten.

Large gender differences in labor force participation and employment rates remain

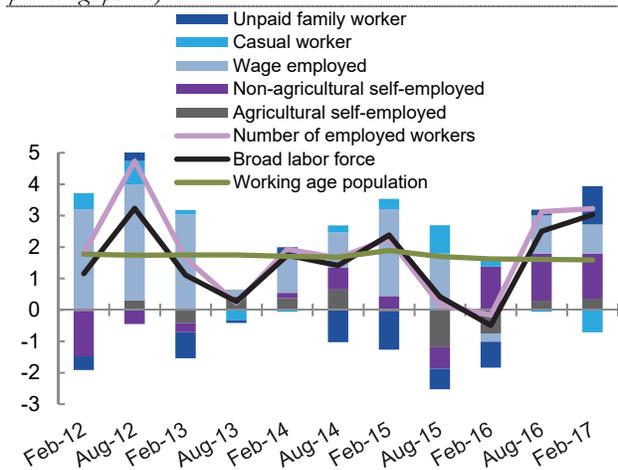
The total labor force participation rate (LFPR) was 69.0 percent in February 2017, but the broad LFPRs of women and men were 55.0 percent and 83.0 percent, respectively. The gender gap narrowed slightly from February 2016 when women's broad LFPR was 52.7 percent and men's broad LFPR was 83.5 percent. Despite this slight reduction in the LFPR gender gap, the employment rates of women and men were still vastly different in February 2017, at 52.1 percent and 78.6 percent, respectively.

Non-agricultural self-employment and unpaid family workers contributed more to employment

Wage work remained the largest component of employment, comprising 38.1 percent of all jobs in February 2017, with wage jobs growing by 2.4 percent over the preceding year. However, over the same period, non-agricultural self-employment grew 6.5 percent, with the proportion of such workers rising from 22.1 percent to 22.8 percent. As such, non-agricultural self-employment contributed more to employment growth than wage-employment. Additionally, the number of unpaid family workers grew 8.8

Figure 43: Employment growth outpaced growth in the labor force and working age population, driven by rising wage-employment, non-agricultural self-employment, and unpaid family work

(growth in employment, labor force, and working age population, percentage points)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

³³ According to latest data from Statistics Indonesia (*Badan Pusat Statistik*, BPS).

³⁴ In accordance with BPS convention, 'working age' is defined as anyone aged 15 years or more.

³⁵ The employment rate is the number of employed workers divided by the total working-age population.

³⁶ Under the 'core' definition, the unemployed are those individuals who do not work, but who are actively looking for work. The 'broad' definition includes the core unemployed, as well as discouraged workers, those who are establishing a new business, and those who have a future job arranged. Data on broad unemployment have only been available since the year 2000, but core unemployment can be calculated as far back as 1986. While broad unemployment is currently at its lowest recorded rate, core unemployment – which was at 3.3 percent in February 2017 – was actually lower in the late 1980s and early 1990s, dipping as low as 2.6 percent in 1991.

growth than wage-employment

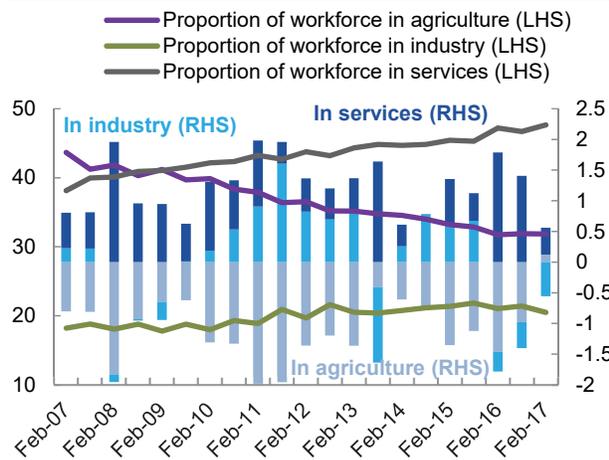
percent, and the proportion of such workers reached 14.6 percent, its highest level since February 2015. Job creation is therefore starting to tilt away from wage-employment, overturning the trend witnessed between 2010 and 2015.

The structural transition of the workforce from agriculture to services slowed

The rise of the service sector as a provider of jobs to the Indonesian workforce has continued into the start of 2017, albeit at a slower pace (Figure 44). In February 2017, 47.6 percent of workers were employed in the service sector, while 31.8 percent were in agricultural jobs.^{37, 38} This reflects the fact that, over the last 10 years, the workforce has shifted towards services, mainly at the expense of agriculture. Between February 2007 and February 2017, the proportion of workers in the service sector rose by an average of 0.9 percentage points per year, while the proportion of workers in agriculture fell by just over 1.1 percentage points per year on average. However, in the year to February 2017, the proportion of workers in services grew by just 0.4 percentage point while the proportion of workers in agriculture increased slightly, by 0.1 percentage point.

Figure 44: Workers' shift from agriculture to services has slowed, and the proportion of workers with industrial jobs has started to decline

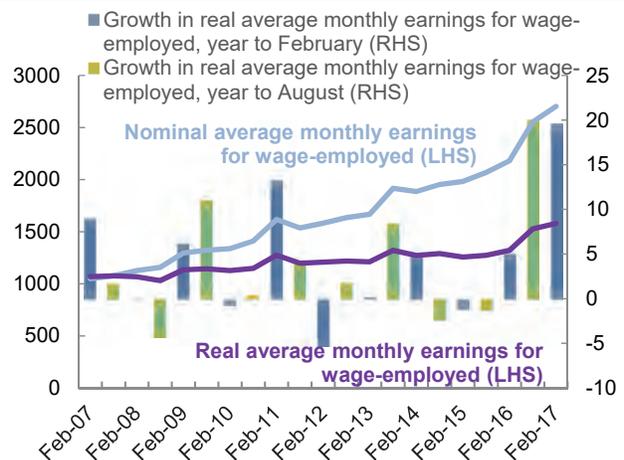
(proportion of employed workers, percent, LHS; yoy percentage point change in the proportion of employed workers, percent, RHS)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Figure 45: Mean real earnings saw double-digit growth in the year to February 2017

(earnings, thousand IDR, LHS; yoy percentage growth in mean monthly earnings, percent, RHS)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

The latest data provide further evidence of a sharp rise in real wage growth

Mean earnings for the wage-employed surged 19.5 percent in real terms and 23.9 percent in nominal terms in the year to February 2017³⁹, further indicating that the labor market is tightening (Figure 45). Median earnings for the wage-employed also

³⁷ This means that in February 2017, 59.3 million workers were engaged in service sector jobs and 39.7 million workers were employed in agriculture.

³⁸ 'Agriculture' covers workers engaged in agriculture, hunting, forestry, and fishing. 'Industry' covers workers engaged in (1) mining and quarrying; (2) manufacturing; (3) electricity, gas, and water supply; and (4) construction. 'Services' covers works engaged in (1) wholesale and retail trade, and hotels and restaurants; (2) transport, storage, and communication; (3) financing, insurance, real estate, and business services; and (4) community, social, and personal services.

³⁹ According to the latest National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas).

rose by 8.2 percent and 14.3 percent in real and nominal terms, respectively.⁴⁰ These differences between growth at the mean and the median reflect the fact that wage growth over this period was not pro-poor, as higher income groups saw faster wage growth than lower income groups. The latest results are consistent with the staggering wage growth recorded in the year to August 2016, when mean earnings for the wage-employed grew by 20.0 percent in real terms and 23.4 percent in nominal terms.⁴¹ Earnings are therefore undergoing steep upward adjustments, partially compensating for the drop in real earnings witnessed in 2014 and 2015. However, given the methodological changes to the measurement of earnings applied in the February 2017 Sakernas, some caution should be exercised when making comparisons in wages across time (Box 5).

Box 5: The effects of methodological changes in Sakernas

BPS occasionally makes adjustments to the methodology for collecting the Sakernas. Many of these adjustments should have little effect on calculating historical trends in key labor market metrics. For example, the sample for the August 2016 Sakernas was around a quarter of the size of the sample for the August 2015 Sakernas, but since the sample was reduced approximately evenly across each kabupaten/kota, the sample weights can still be applied to recover national-level estimates that are consistent with previous rounds of the survey. Similarly, the 2015 adjustments to the sampling strategy – when BPS began stratifying the sample by sector as well as by the wealth index and location (rural-urban) – have had no discernable impact on the calculation of national- or sector-specific statistics.

However, in the February 2017 Sakernas, the questions asked to certain respondents about their incomes were changed in a way that may potentially have a more profound effect on the measurement of earnings over time. In particular, wage-employed respondents were no longer simply asked to estimate their *total* salary or wages received during the previous month (in terms of both cash and goods), but instead they were asked to explicitly separate out salary and allowances, overtime pay, and special transportation and food wages. This is, to some extent, analogous to increasing the number of consumption categories in a household socio-economic survey, which – based on the experience of other countries – generally results in higher measured total consumption. As such, it is possible that the estimates of wages recovered from the February 2017 Sakernas are exaggerated, which would make them not directly comparable with previous rounds. It is important, therefore, to exercise caution when interpreting the most recent earnings data and looking at earnings trends over time.

Recent trends in real earnings growth are yet to translate into changes in household consumption

The recent growth in real earnings does not appear to have translated into any changes in household consumption, presenting an empirical puzzle. In the year to March 2016⁴², mean real per capita consumption only grew 4.0 percent, according to the National Socio-Economic Survey (*Survei Sosial Ekonomi Nasional*, Susenas), just as real earnings growth had started to pick up.^{43, 44} The apparent disparity between the earnings and the consumption trends may partly be because the latest Sakernas data were published more recently than the latest Susenas data, so the latter have

⁴⁰ If the earnings of own account workers and casual workers – the only other workers whose earnings are captured by the Sakernas – are included, the growth in mean earnings was 16.2 percent in real terms and 20.6 percent in nominal terms. Growth in median earnings for this expanded sample was 5.0 percent in both real and nominal terms. The difference between real growth in median earnings and nominal growth in median earnings does not necessarily correspond to average Consumer Price Index (CPI) inflation because the earnings data are deflated using city/province CPIs, which can reorder observations within the same year.

⁴¹ Given that the February 2017 Sakernas survey was collected using a fresh sample targeting the same population and the years to August 2016 and February 2017 partly overlap, the latest survey results help to validate the figures for earnings growth observed between August 2015 and August 2016.

⁴² Latest year of available microdata.

⁴³ In these calculations, per capita consumption was deflated using city/province CPIs rather than the provincial/urban-rural poverty line in order to best match the methodology used to deflate earnings.

⁴⁴ Median real per capita consumption grew by 7.0 percent in the year to March 2016.

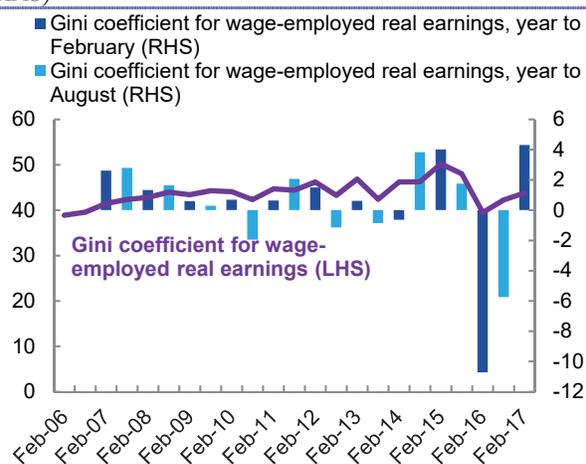
not yet captured any possible surge in real consumption. Additionally, increases in earnings are likely to have an attenuated effect on per capita consumption, insofar as extra income is shared around among all household members, including dependents. It is also possible that households perceive that the increase in real earnings growth is transitory and are therefore saving to smooth their consumption accordingly. However, the relative importance of these factors can only be unpacked when new data become available.

Earnings inequality is rising again

The Gini coefficient for the real earnings of the wage-employed was 43.8 in February 2017, having risen by 4.3 points over the preceding year (Figure 46).⁴⁵ This follows an apparent drop of 10.7 points in the year to February 2016. As such, the gradual increase in earnings inequality that took place between the mid-2000s and 2014, which appeared to dissipate in 2015 and 2016, has been somewhat recouped. Additionally, the Gini coefficient for consumption – discussed in Section A.8 – has typically remained lower than the Gini coefficient for earnings throughout recent years. Low-income workers are therefore at risk of missing out on average gains in real wages.

Figure 46: Although the Gini coefficient for real earnings dropped from the high levels observed in 2014 and 2015, earnings inequality has begun to rise again

(Gini coefficient, index, LHS; yoy point change in Gini coefficient, RHS)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

8. Poverty reduction remains slow, but inequality continues to fall

Poverty declined slightly, continuing a trend of slower poverty reduction since 2011

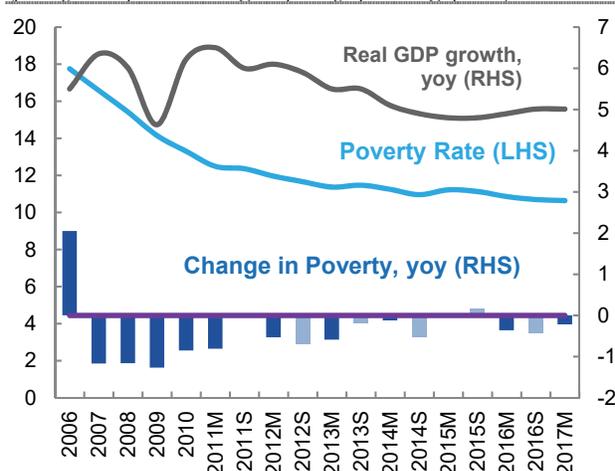
The official poverty rate was 10.6 percent in March 2017, 0.2 percentage points lower than March 2016. (Figure 47). The poverty headcount also fell from 28 million people to 27.8 million people over the same period. These developments indicate a continued decline in the pace of poverty reduction, which averaged 1.1 percentage points annually from 2007-2011, and partly reflects the trend of slower economic growth since 2011⁴⁶. In addition, as the poverty rate decreases, the remaining poor are further below the poverty line, requiring higher consumption growth to maintain the rate of poverty reduction.

⁴⁵ If own account workers and casual workers are included, the earnings Gini coefficient reached 45.8 in February 2017, having increased 4.1 points from February 2016.

⁴⁶ Indonesia's average real GDP growth has fallen to an average of 5.3 percent for the period 2012-16 from average 6.2 percent during 2007-11, excluding the global financial crisis year of 2009.

Figure 47: Poverty reduction from March 2016 to March 2017 continued a trend of slower poverty reduction since 2011

(poverty rate, percent; change in poverty, percentage points)



Source: National Socio-Economic Survey (Survei Sosial Ekonomi Nasional, Susenas)

Note: M for March and S for September. March and September poverty rates are not directly comparable, as seasonality of poverty is not yet well-understood.

Table 5: Rural poverty reduction was higher over the past year, partly due to urbanization of the poor
(population and poverty headcount, millions; poverty rate, percent)

	Mar-16	Mar-17	Δ16-17
Urban population	132.7	138.2	+5.5
Rural population	125.2	122.8	2.
Urban poverty headcount	10.3	10.7	0.3
Rural poverty headcount	17.7	17.1	- .6
Urban poverty rate	7.8	7.7	-0.1
Rural poverty rate	14.1	13.9	-0.2

Source: Susenas

Poverty reduction is slow despite a smaller increase in poverty lines

The national poverty line⁴⁷ increased by 5.7 percent between March 2016 and March 2017 to a level of IDR 374,478 per person per month. This is lower than the 2015-2016 increase of 7.1 percent, and the 2014-2015 increase of 9.3 percent. This indicates a low rate of inflation for the basket of goods consumed by the poor. However, this lower rate of poverty basket inflation has not been enough to accelerate poverty reduction.

Poverty reduction was higher in rural areas, partly driven by urbanization

Rural poverty, at 14.1 percent, remains higher than urban poverty (7.8 percent). However, over the past year, the poverty rate in rural areas fell more than twice as fast as the decline in urban poverty (Table 5). The rural poverty headcount dropped by 570,000 people, while the urban poverty headcount increased by 330,000 people. Increasing urbanization may be a reason: as indicated by the growing urban population and the shrinking rural population, more people (including the poor) are moving to urban areas. Some of these population shifts, however, may be caused by districts splitting and/or being reclassified as urban. Going forward, government policies to reduce poverty will need to consider the implications of an increasingly urban profile of poverty in Indonesia⁴⁸.

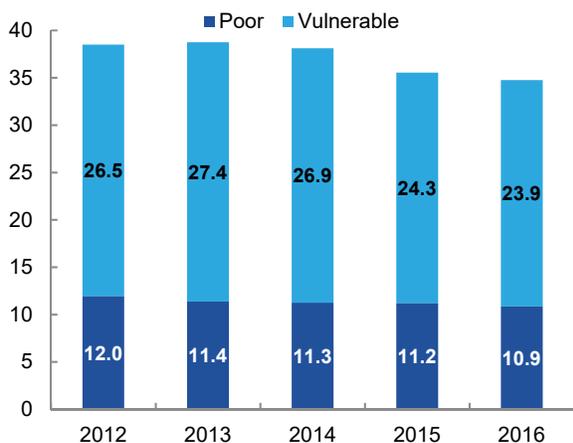
Over one in five Indonesians remains vulnerable to poverty

Though poverty has fallen, a large percentage of the population remains just above the poverty line. (Figure 48). This “vulnerable” population, defined as those with consumption levels below 1.5 times the poverty line, is at risk of falling back into poverty with the smallest shock. In March 2016, nearly 24 percent of the population, or 61.6 million people, fell into this category. The vulnerability rate has dropped consistently between 2013 and 2016, but remains high.

⁴⁷ The “national poverty line” is only a weighted average of the 67 poverty lines (1 for DKI Jakarta and 1 urban + 1 rural for all other provinces) actually used in the calculation of poverty rates.

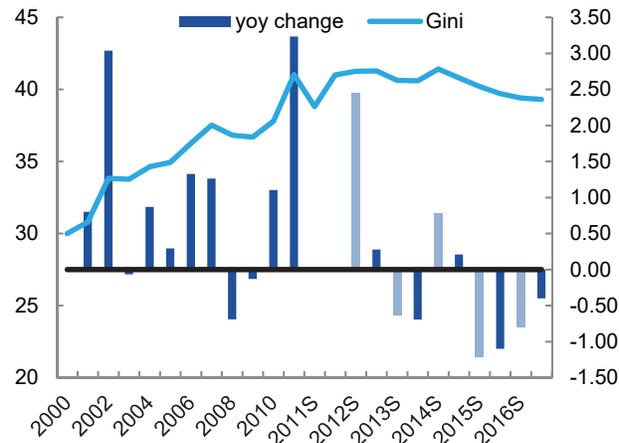
⁴⁸ The World Bank has initiated further analytical work to better understand the “urbanization of poverty in Indonesia”.

Figure 48: Over 20 percent of Indonesians are vulnerable to falling into poverty
(poverty rate and vulnerability rate, percent of total population)



Source: Susenas (March surveys)
Note: “Vulnerable” is defined as consuming above the Poverty Line but below 1.5 * the Poverty Line.

Figure 49: After several years of near-stagnation, the Gini coefficient has fallen yoy four consecutive times.
(Gini coefficient, points; change in Gini coefficient, points)



Source: Susenas
Note: M for March and S for September. March and September Gini coefficients are not directly comparable, as seasonality of poverty and inequality are not yet well-understood.

The Gini coefficient continues to fall, as the consumption of the Bottom 40 and Middle 40 catch up to the Top 20

Inequality - as measured by the Gini coefficient for consumption – continued to decline. The Gini coefficient for March 2017 was 39.3, falling by 0.4 points from 39.7 in March 2016 (Figure 49).

Table 6: Inequality continues to fall, due to increasing consumption shares of the Bottom 40 and Middle 40
(share of national consumption, percent)

Period	Bottom 40	Middle 40	Top 20
Mar 2016	17.0	36.1	46.9
Mar 2017	17.1	36.5	46.4
Δ 2016-2017	+0.1	+0.4	-0.5

Source: Susenas

This continues the trend that began in September 2015 when the Gini started to fall after rising sharply from 2000-2011 and remaining relatively flat between 2011-2015. Over the past year, both the Bottom 40 (quintiles 1 and 2) and the Middle 40 (quintiles 3 and 4) increased their share of total national consumption relative to the Top 20 (quintile 5) (Table 6). However, the consumption growth of the Bottom 40 has still been weak, relative to the Middle 40. Providing equal opportunities for all Indonesians, enabling access to more and better jobs for all, building resilience to shocks and making fiscal policy more inclusive will help Indonesia achieve its objective of reducing the Gini coefficient to 36 by 2019.

9. A positive outlook but with significant uncertainties

Indonesia’s economic outlook is moderately positive with a growth-conducive global economy and continued macroeconomic stability

The economic outlook for the Indonesia continues to be moderately positive, on the back of a favorable external environment, sustained macroeconomic stability and a strong commitment to reforms on the part of the government. The global economy continues to be supportive with strengthening economic growth and international trade flows, as well as relatively accommodative monetary conditions. Commodity prices have been easing from their peaks earlier this year, but remain higher than the same period last year. Despite signs of softness, the domestic economy continues to enjoy robust economic growth with low inflation. The current account deficit has doubled, but is still relatively benign. The 2017 Revised Budget and BI’s recent rate cut provides a modest stimulus.

Lower-than-expected food prices and the absence of energy subsidy reform in Q4 should reduce inflationary pressures, lowering the inflation forecast for this year

In light of the lower-than-expected price level increases observed in the first eight months of this year and the absence of energy subsidy reforms in Q4, consumer price inflation is projected to be at an average of 4.0 percent this year and easing to 3.5 percent in 2018 (Figure 50). The government has announced that they will maintain current electricity tariffs until the end of 2017⁴⁹ and postpone subsidized fuel adjustments, hence keeping energy price inflation steady in the short run. In addition, the current favorable weather

conditions and government programs to avoid food supply shortages are expected to persist, contributing to low food price inflation.

The baseline inflation projection assumes a small rise in crude oil prices and accounts for the inflationary effects of regional government elections in 2018 and legislative and presidential elections in 2019⁵⁰. Risks to the inflation outlook are on the upside and includes the Government proceeding with fuel subsidy reforms earlier than expected and reducing subsidies, thereby leading to fuel price increases. Extreme weather conditions could also lead to poor harvests, reduced food supplies and surging food costs.

Real GDP growth is estimated to rise to 5.1 percent this year, strengthening to 5.3 percent in 2018

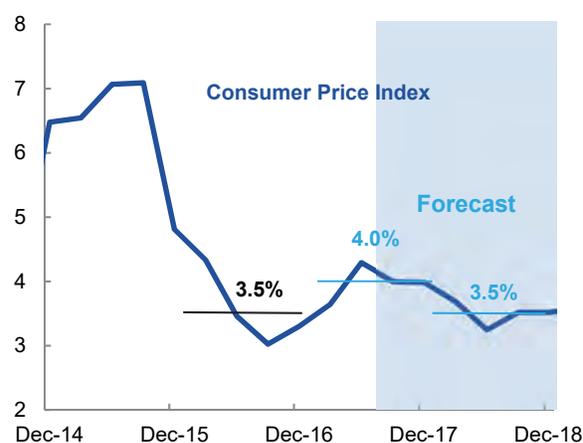
Real GDP growth is estimated to inch up to 5.1 percent this year and further rise to 5.3 percent in 2018 (Table 7). Private consumption growth is projected remain steady this year, largely due to the dampening effects of the transitory higher rates of inflation. However, the record low unemployment rate, double-digit real wage increases, higher consumer credit growth and easing inflation are expected to lift private consumption growth next year.

Government consumption is expected to rebound in 2017 and surge in 2018

Meanwhile, government consumption will surge in 2018, supported by enhanced revenue performance linked to stronger economic growth and tax reforms. The fiscal deficit is projected to remain below the Government's 3.0 percent ceiling in 2017. In a signal of its commitment to fiscal discipline, the Government's proposed 2018 budget implies a deficit at 2.2 percent of GDP.

Figure 50: Continued low food price inflation is expected to weigh on headline inflation in 2017 and 2018

(annual average change yoy, percent)



Source: BPS; World Bank staff calculations

Note: Food prices are a weighted average of the raw and processed food price components of CPI.

⁴⁹ The Ministry of Energy and Mineral Resources announced in June that the government will maintain current electricity prices including for the 900 VA subscribers group due to the expected decrease in gas and coal prices.

⁵⁰ Indonesia will undergo a series of elections in 2018 and 2019, which includes regional, legislative and presidential elections. The regional elections (pilkada) will be conducted in 171 sub-national governments, which include 17 provinces, 39 cities, and 115 districts, with the campaigning period lasting February 15 - June 23, 2018. Legislative and presidential elections will be held in April 17, 2019, and the campaigning period will be October 13, 2018 – April 13, 2019.

Investments are projected to pick up, while exports will stay robust, lifting GDP growth

On back of the accommodative global monetary conditions, the substantial monetary loosening last year and the recent decrease in the policy rate this year, financing costs are expected to remain low, supporting investment growth in 2017 and 2018. Stronger public capital expenditures and strong FDI will also supplement private domestic investment expenditures. Stronger global economic growth and the continued strengthening of global trade is forecast to lift Indonesian exports, despite easing commodity prices.

Table 7: Key economic indicators
(*growth yoy, percent, unless otherwise indicated*)

	Annual			Revision from previous IEQ
	2016	2017f	2018f	2017
1. Main economic indicators				
Gross Domestic Product (GDP)	5.0	5.1	5.3	-0.1
Private consumption expenditure	5.0	5.0	5.2	-0.1
Government consumption	-0.1	3.5	5.0	0.7
Gross fixed capital formation	4.5	5.0	5.1	-0.1
Exports of goods and services	-1.7	5.0	4.8	-2.9
Imports of goods and services	-2.3	3.2	3.8	-3.1
2. Other economic indicators				
Consumer price index	3.5	4.0	3.5	-0.3
GDP Deflator	2.5	3.9	3.2	0.2
3. Economic Assumptions				
Exchange rate (IDR/USD)	13300	13333	13500	-26
Indonesian crude price (USD/bl)	51	50	52	-3

Source: BPS; BI; CEIC; World Bank staff projections

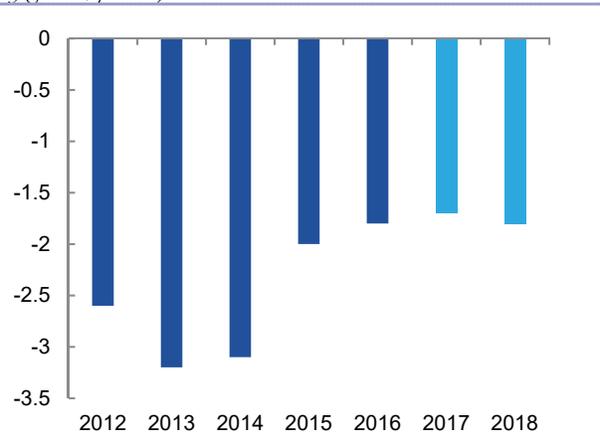
Note: 2016 figures are actual outcomes. F stands for forecast. Statistical discrepancies and change in inventories are not presented in this table. All GDP components are based on the latest GDP data. Exchange rate and crude oil price assumptions are average annual data. Revisions are relative to projections in the March 2017 IEQ.

The current account deficit is expected to widen modestly in 2018

With the global economy continuing to be supportive and the commodities terms-of-trade expected to be higher than 2016, Indonesia's current account deficit is expected to narrow 1.7 percent of GDP in 2017. Owing to the projected deterioration in the ToT, strong domestic demand, and slightly weaker projected growth for Indonesia's major trading partners, the current account deficit is expected to widen modestly to 1.8 percent of GDP in 2018 (Figure 51).

Figure 51: The current account is expected to widen modestly in 2018

(*yoy growth, percent*)



Source: CEIC and BI; World Bank staff calculations

Global policy uncertainty and geopolitical risks are substantial external risks	External risks to the outlook include a pickup in global uncertainty if the Fed deviates from its very gradual expected path of monetary policy and balance sheet normalization, a further weakening of commodity prices, and a wider implementation of protectionist measures among advanced economies. Indonesia depends on external funding of both the public deficit and large corporations, and therefore remains particularly sensitive to volatility in global capital flows.
Key domestic risks include a slowdown in private consumption and investment expenditures...	The baseline forecast assumes that private consumption and investment growth will pick up in 2018. However, there are signs of weakness in the retail sector and among firms, as signaled by weak retail sale outturns, contracting capital goods imports, as well as the weak business sentiment. Weakening private consumption and/or investment would weigh on overall economic growth.
...higher-than-expected inflation ...	With the recent cuts in the policy rate, Bank Indonesia has embarked on a new monetary easing cycle to support economic growth. At the same time, the Government has announced its intention to increase fiscal expenditures and widen the fiscal deficit. These expansionary policies together with the tight labor market could lead to a bout of elevated inflationary pressures, which would have a dampening effect on private consumption growth, and hence GDP growth.
...and adverse political economy effects	As the legislative and presidential elections draw closer, opportunities for implementing critical and perhaps unpopular structural reforms for enhancing higher rates of economic growth may be narrowing. Should these structural reforms be overlooked, potential growth could slow and weigh on the outlook.
Continued progress on structural reforms is critical to raise potential growth	While the outlook for Indonesia's economic growth remains positive, the growth rate in recent years have been lackluster, hovering around 5 percent since Q1 2014, and significantly less than those recorded at the beginning of the decade. While the drivers of this lack of acceleration are currently unclear, two plausible hypotheses underline the importance of continued progress in structural reforms. The first is that the current flat growth is temporary and the result of the economy adjusting to reforms, such as subsidy cuts and increased tax collections, that have a short-term cost but long-term benefits. The second is that the implementation of reforms has not trickled down to individual experiences on the ground, and that continued policy uncertainty in certain areas has dampened the impact of positive reforms. The combined effect being that reforms have not been able to lift potential GDP growth from current levels. Therefore, while the government remains committed to implementing structural reforms and indeed has made significant progress in recent years, renewed efforts at implementing key structural reforms, and especially ensuring their application on the ground, are necessary to further expand the economy's potential growth and to attain higher sustained rates of economic growth.

B. Focus Topic



Mobilizing the private sector for infrastructure development⁵¹

The demand for infrastructure in Indonesia's fast-growing, rapidly urbanizing population is vast. However, years of underinvestment have led to a large infrastructure deficit, constraining Indonesia's growth and limiting the pace of poverty reduction. With public capital stocks per person at only a third of the average of major emerging economies, Indonesia faces an estimated gap in infrastructure assets of USD 1.5 trillion. The Government of Indonesia recognizes the importance of infrastructure for growth and, as a starting point, has targeted additional investments in transport, water, energy and other key sectors amounting to over USD400 billion from 2015-2019. Leveraging private sector investment can help Indonesia meet its large infrastructure needs more efficiently and effectively. Mobilizing the private sector for infrastructure development will require improvements in (i) the complex legal and regulatory environment for public-private partnerships, (ii) project planning, appraisal and selection processes, (iii) transparency and efficiency of state-owned enterprises that dominate the infrastructure sector, and (iv) the depth of local banking and capital markets.

a. Years of underinvestment have led to a large infrastructure deficit in Indonesia

Investments in infrastructure tend to boost growth and shared prosperity

Adequate, well-planned infrastructure promotes economic growth and development. Infrastructure can increase productivity by lowering transport and telecommunications costs, generate economies of scale and scope in production, and promote improvements in human capital. Although the responsiveness of growth to infrastructure differs across countries⁵², the relationship is strongly positive (Figure 52). On average, increasing infrastructure stocks by 1 standard deviation is expected to raise an economy's growth rate by 3 percentage points.⁵³ Infrastructure may also

⁵¹ This article draws heavily from the ongoing Infrastructure Sector Assessment Program (InfraSAP), co-led by the World Bank's Indonesia Country Management Unit and the Infrastructure, PPPs and Guarantees Group, with inputs from the Transport, Water, Energy, Finance & Markets, and Governance Global Practices and IFC and MIGA. World Bank (2017f).

⁵² See World Bank (2013) for a fuller discussion.

⁵³ Calderon and Servén, 2017.

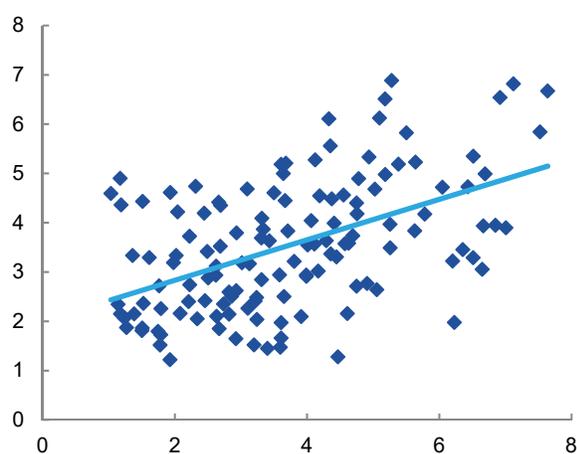
help to reduce income inequality by enabling the poor to access productive opportunities.⁵⁴

Indonesia’s infrastructure assets lag emerging market peers by about USD1.5 trillion

A comparison of public capital stocks⁵⁵ across countries illustrates Indonesia’s large infrastructure deficit. In per capita terms, Indonesia’s public capital stock is estimated at USD 3,811 – about a third of the average for other emerging markets and developing economies (EMDEs) and about an eighth of the corresponding average for advanced countries (Figure 53). In absolute terms, the gap in infrastructure assets between Indonesia and other major EMDEs stood at about USD 1.5 trillion in 2015.⁵⁶ This figure would be even higher if it accounted for additional infrastructure investments that Indonesia will need for climate adaptation and mitigation.⁵⁷

Figure 52: Boosting public capital stocks is expected to have a positive impact on economic growth

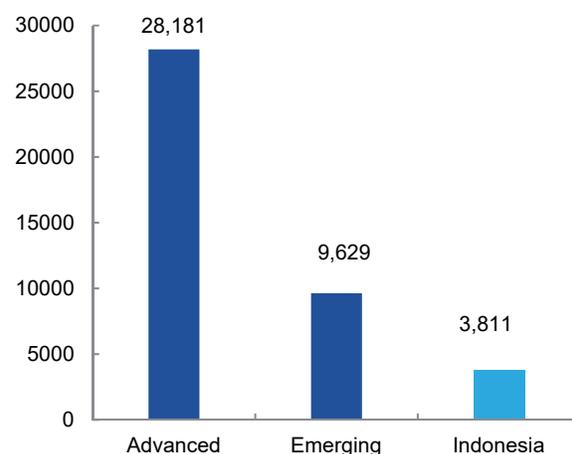
(y-axis: average real GDP growth, 1980-2015; x-axis: average growth in public capital stocks in real terms, 1980-2015)



Source: World Bank staff calculations using IMF Investment and Capital Stock Dataset (2017)

Figure 53: Indonesia’s public capital stock per person is low vis-à-vis other emerging markets and advanced economies

(constant 2010 USD)



Source: World Bank staff calculations using IMF (2017) data
Note: 2015 estimates. Unweighted averages were computed for 14 advanced economies and 21 emerging economies⁵⁸.

Underinvestment in infrastructure has led to a deterioration of existing assets

Yet Indonesia has underinvested in public infrastructure, leading to a growing infrastructure deficit. Indonesia’s rate of growth in public capital stock per capita has generally fallen behind that of Vietnam, China, India and Malaysia, even accounting for initial differences (Figure 54). Public investments have also not kept pace with economic growth: despite robust GDP growth of 5.6 percent on average from 2005-2015, Indonesia’s public capital stock grew 2.8 percent annually on average over the decade. As such, not only is the quantity of infrastructure in Indonesia among the

⁵⁴ Seneviratne and Sun (2013) show that improvements in infrastructure would lead to decreases in the Gini index by 1-2 percentage points in ASEAN-5 countries.

⁵⁵ Calculated from the IMF Investment and Capital Stock dataset (January 2017). Infrastructure capital is a significant component of public capital in most countries. Public capital stocks also include non-infrastructure components (e.g. machinery and equipment, inventories, valuables and land), but this data is used as a proxy in the absence of comparable cross-country estimates.

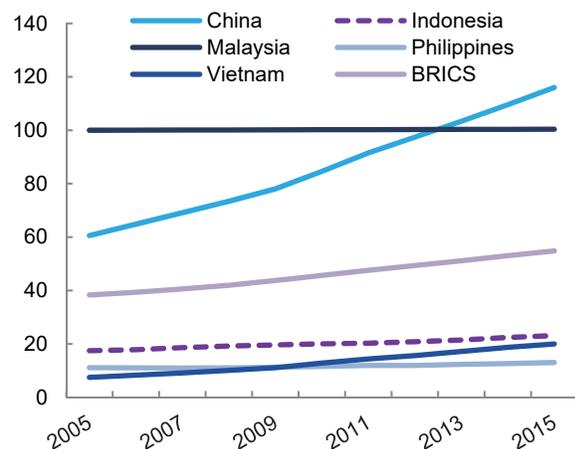
⁵⁶ This figure is obtained by multiplying the difference in public stocks per capita between Indonesia and EMDEs (USD 5818) by the size of Indonesia’s population (261 million) in 2015.

⁵⁷ The ADB (2017) estimates Indonesia’s infrastructure investment needs at USD 1.1 trillion from 2016-2030. Accounting for climate adaptation, this figure would increase to USD 1.3 trillion.

⁵⁸ These are middle-income countries using the IMF World Economic Outlook classification: Argentina, Botswana, Brazil, Bulgaria, Chile, China, Colombia, Egypt, India, Jordan, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Vietnam

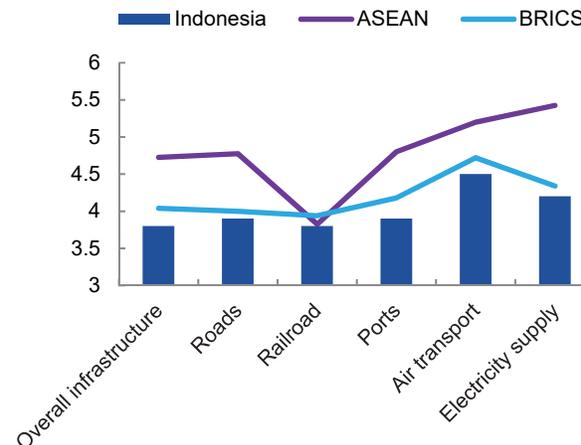
lowest in the region⁵⁹ – the quality of infrastructure also lags ASEAN and other emerging market peers (Figure 55).

Figure 54: Public capital stock per capita has grown more slowly over time relative to most peers...
(year-on-year growth in index of public stocks per capita)



Source: World Bank staff calculations using IMF (2017) data.
Note: Malaysia's public capital stock per capita in 2005 is used as the base year of the index as it is the highest among EMDEs. BRICS is the unweighted average of Brazil, Russia, India, China, South Africa

Figure 55: ...leading to perceptions that Indonesia's infrastructure is of comparatively poorer quality
(indices of infrastructure quality; 1 (worst) to 7 (best) points)



Source: World Bank staff calculations using World Economic Forum Global Competitiveness Report (2016-2017) data
Note: ASEAN is the unweighted average of Malaysia, Singapore, Thailand and Philippines; BRICS is the unweighted average of Brazil, Russia, India, China, South Africa

Fully addressing the infrastructure deficit is a long-term endeavor that needs to start immediately

The Government of Indonesia (GoI) recognizes the need to address the infrastructure deficit as a national priority. As a starting point, the National Medium Term Development Plan (RPJMN) estimates that IDR 5.4 trillion⁶⁰ (USD 415 billion, or about half of Indonesia's GDP) of additional investments in infrastructure are needed from 2015-2019. This implies spending an average of USD 83 billion per year. Most of this spending is expected to occur in the transport sector, followed by electricity and water resources (see Box 6 for more details on these expected investment needs). However, even if the RPJMN target is met, closing Indonesia's large infrastructure gap will require far more effort. To illustrate, if public investment flows increase every year consistent with the RPJMN target⁶¹ and some additional assumptions⁶² are made on depreciation rates and population growth, it would take 20 years for Indonesia to reach the current stock of public capital in the average EMDE. To be on par with the average advanced economy, it would take about 44 years.

⁵⁹ Seneviratne and Sun, 2013.

⁶⁰ Bappenas presentation, "Prioritas Kedaulatan Energi dan Infrastruktur, RPJMN 2015-19," December 2014.

⁶¹ These projections are done by keeping public investment as a share of capital stock constant at 8 percent (USD 83 billion divided by USD 984 billion, the 2015 level of public capital stock in Indonesia).

⁶² The average depreciation rate of public capital stocks for middle-income countries is used (3.5 percent per annum). Population growth is assumed to be 0.8 percent every four years.

Box 6: Indonesia needs significant infrastructure investment in transport, energy and water

Transport: Massive infrastructure gaps exist in the national road network, airports, ports and urban transport. The current backlog of network capacity is estimated at about 20 percent or 16,000 lane km of road space. To cater to an estimated growth of 5 percent per annum in traffic demand, an estimated 3,000-4,000 lane km of road space needs to be added annually. The Expressway Development Program, targeting over 6,220 km of expressways by 2025, is estimated to cost IDR 720 trillion (USD 54 billion). In the ports sector, an estimated USD 47 billion is needed up to 2030 for port development. A further USD 7-13 billion is needed for mass transit investments, as RPJMN aims to increase the percentage of trips occurring on public transport in large cities from 5-20 percent to at least 32 percent.

Electricity: Demand has grown at 7.1 percent annually on average since late 2000s. GoI estimates that electricity demand will grow about 8.8 percent per annum on average between 2015-24, i.e. an increase in power production from 219.1 to 464.2 terawatt hours (TWh) is required to meet the expected demand. GoI estimates that investment expenditures for power infrastructure (generation, transmission and distribution) will total USD 95 billion between now and 2025.

Water and sanitation: The RPJMN calls for an investment of around IDR 253 trillion (USD 20 billion) over five years. The Ministry of Public Works projects that the largest share (47 percent) of the investment will come from local governments, and the remainder from private sector and bank financing.

Source: World Bank (2017f)

b. Closing the infrastructure gap will require increased private sector involvement

The Government has devoted public resources to infrastructure...

Recognizing the need to address the large infrastructure deficit, Central and Subnational Governments have increased capital expenditures in recent years. In 2016, the Central Government spent IDR 169 trillion (USD 12.7 billion) on capital expenditures, a tenth of total expenditures. Capital expenditures have been increasing in nominal terms (Figure 56), notwithstanding substantial capital injections to state-owned enterprises (SOEs) mostly to undertake priority infrastructure projects (Figure 57). In 2016, such injections amounted to IDR 50.5 trillion (USD 3.8 billion). Subnational capital expenditures have also increased, amounting to an allocated IDR 250.6 trillion (USD 18.8 billion) in the same year.⁶³

...but even if revenues increase, public resources alone cannot meet the large infrastructure needs

Collecting more revenues would help the Government spend more on infrastructure, but even then, public resources would not be sufficient to meet infrastructure needs. The Government aims to raise the tax ratio by 1 percentage point of GDP per year until 2020⁶⁴, and part of these additional revenues could be allocated to infrastructure projects. However, even in the hypothetical scenario where all new Government receipts in 2018-19 are allocated to infrastructure,⁶⁵ total capital expenditures⁶⁶ over 2015-19 would only amount to IDR 5,180 trillion (USD 389.5 billion). This is far from the USD 1.5 trillion needed to catch up with other emerging market peers. In a more realistic, but still optimistic scenario where a fifth of all new revenues in 2018-19 are spent on infrastructure, total capital expenditures from 2015-2019 would only amount to IDR 1,497 trillion (USD 112.6 billion), far from the RPJMN target and even further from the aim of narrowing the infrastructure disparity of USD 1.5 trillion with other EMDEs.

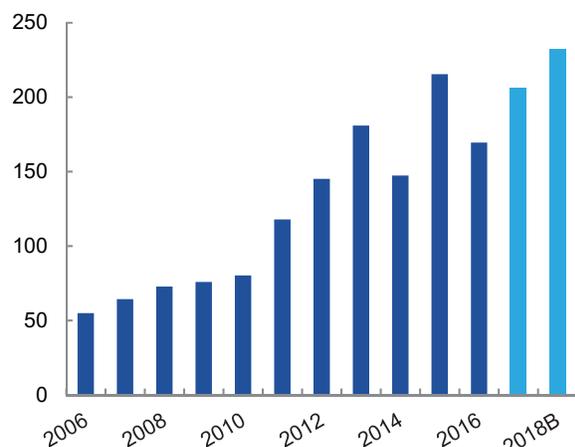
⁶³ 2016 data on actual capital expenditures by the Subnational government is not yet available.

⁶⁴ The GoI plans to improve its tax ratio through a series of reforms coordinated by Tim Reformasi under the Ministry of Finance. In its kick-off launch meeting on 20 December 2016, Tim Reformasi set itself an objective of raising the tax ratio by approximately 1 percent year-on-year until 2020.

⁶⁵ This would not be realistic because some areas of spending are earmarked and augment almost automatically with revenues (e.g. education, social security). It is also not desirable since infrastructure is not the only area with spending gaps that have social impacts (e.g. health).

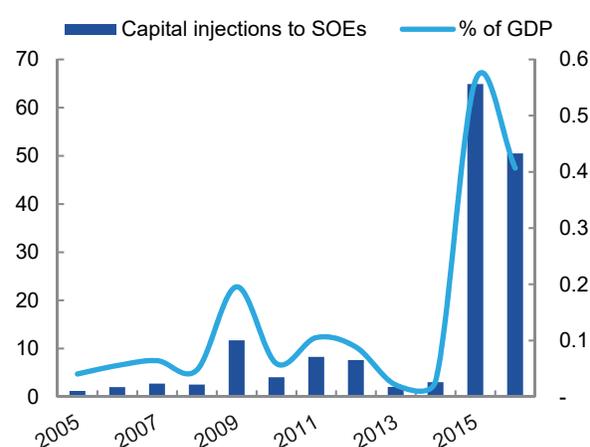
⁶⁶ This assumes that subnational government capital expenditures remain at 2014 levels of IDR 92.4 trillion (USD 7 billion). It does not include capital injections to SOEs.

Figure 56: Capital expenditures by the Central Government have increased...
(capital expenditure in IDR trillions)



Source: Ministry of Finance, World Bank staff calculations
Note: 2017 estimates from revised budget, 2018 projections from approved budget. All other years refer to actual audited spending.

Figure 57: ...and substantial capital injections have been given to SOEs, especially in 2015-2016
(IDR trillions, LHS; Percent of GDP, RHS)



Source: Balance sheets from various SOEs, World Bank staff calculations

Addressing Indonesia's infrastructure needs will require more private sector investment...

Closing Indonesia's infrastructure gap with other EMDEs will thus require increased private sector investment. This is not only due to limited public resources, but due to the efficiency gains that the private sector can bring. Efficiently allocating risks between the public and private sectors can significantly enlarge the size of the pie of infrastructure that can be built for a given level of fiscal commitments and risks, potentially leading to a faster expansion of infrastructure services. In addition, the private sector can help to deliver infrastructure services at better value for money than traditional government procurements. In Australia and other OECD countries, infrastructure projects involving public-private partnerships (PPPs)⁶⁷ are more likely to conclude on budget and on time.⁶⁸ Studies from developing countries also show that private sector participation in telecommunications, electricity and water distribution tend to elevate labor productivity and operational efficiency.⁶⁹

...but private sector appetite for infrastructure investments has weakened over the years

The GoI envisions that the private sector will finance nearly two-thirds of the USD415 billion in additional infrastructure investments over 2015-2019 (Figure 58). However, the share of 'core' infrastructure investment⁷⁰ financed by the private sector has steadily declined from an average of 19 percent in 2006-2010 (0.8 percent of GDP) to 9 percent in 2011-2015, or 0.2 percent of GDP (Figure 59). Data for 2016 appear to indicate a pick-up in private sector investment, but in reality reflects lagged progress on previously tendered projects.⁷¹ Meaningful increases in private infrastructure spending will require lifting key constraints that inhibit private sector involvement in infrastructure.

⁶⁷ Defined as a long-term contract between a private party and a government entity for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance.

⁶⁸ See, for example, Allen Consulting Group (2007) and Burger and Hawkesworth (2011).

⁶⁹ Andres, Foster and Guasch (2006); Gassner and Pushak (2008).

⁷⁰ Transportation, energy, telecommunications, water and sewage, and irrigation infrastructure.

⁷¹ The Central Java Coal-Fired Power Plant and the Umbulan Springs Bulk water project reached financial close in 2016, but were tendered in 2009 and 2011 respectively.

Figure 58: Private investment will need to ramp up significantly to achieve the Government’s target...
(share of total investment in core infrastructure, percent)

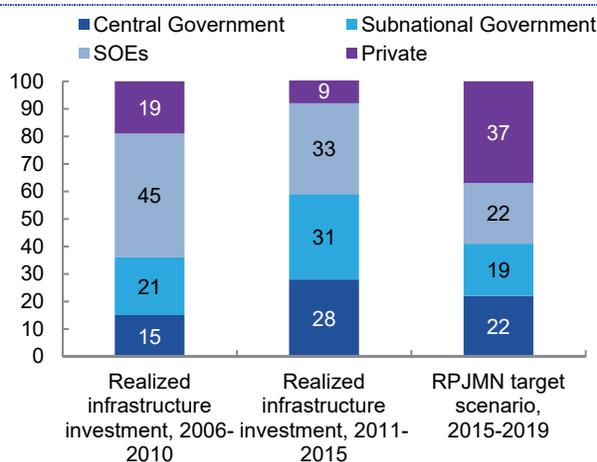
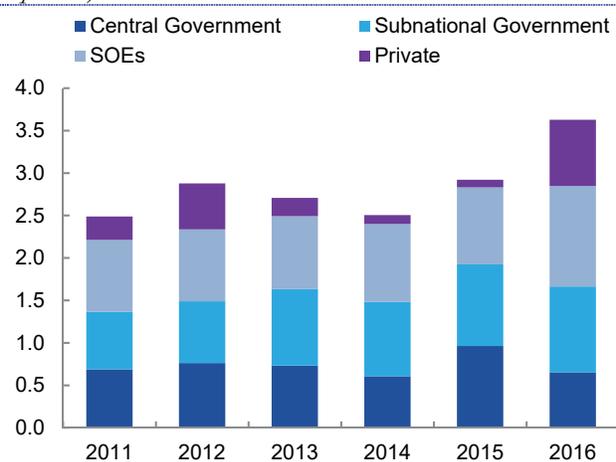


Figure 59: ...but private investment in core infrastructure declined steadily until recently
(total investment in core infrastructure as a share of GDP, percent)



Source: Audited accounts of Central and Subnational Governments, SOE balance sheets, World Bank Private Participation in Infrastructure (PPI) database.

Notes: Uses methodology from World Bank (2015) and AIPEG (2017) for 2013-2016 SOE estimates. For subnational government, 2015-2016 data refers to budgeted amounts.

c. Several constraints need to be addressed to leverage private sector financing for infrastructure

In Indonesia, the private sector faces four key challenges when looking to invest in infrastructure. First, the complex legal landscape for PPPs has resulted in project delays and cancellations, acting as a disincentive to new investments. Second, the multitude of different actors and a lack of standardized processes at the project identification, planning and preparation stage has resulted in few attractive projects being put to the market. Third, the dominance of SOEs in infrastructure provision risks crowding out the private sector. Fourth, local debt and equity market limitations make it difficult for private sector players to access long term local currency financing. This section discusses each of the constraints in detail.

i. Legal and regulatory uncertainty dampen private sector interest

Overlapping, inconsistent and conflicting PPP regulations result in project delays or cancellations

Indonesia has many laws, regulations and decrees relating to PPPs, resulting in a complex legal framework that creates confusion among investors and contracting agencies. There is no overarching law that governs PPPs; rather, various regulations legislate on particular aspects of the project preparation and procurement cycle. The PPP legal framework comprises: (1) main PPP regulations, (2) sector specific laws (SSL) and (3) other PPP Laws. In the first category alone, it is estimated that there are 158 national laws and regulations that are relevant to PPPs.⁷² Some of these laws overlap or are inconsistent, and the interplay between more general PPP laws and SSL is often unclear. Compounding this issue is that main PPP regulations generally have a lower position in the legislative hierarchy compared to most SSL. When these regulations conflict, PPP projects are thus delayed until the relevant SSL is amended or special rulings are issued, or eventually cancelled (see Box 7 for examples).

⁷² World Bank (2017f).

Amending Sector-Specific Laws is time-consuming and unpredictable

Ensuring the consistency of SSL with main PPP regulations has been a topic of discussion amongst relevant stakeholders for quite some time, but little progress has been made in this area. Amending SSL involves a variety of Indonesia's ministries, and thus requires inter-ministerial coordination, which makes the process time-consuming and unpredictable.⁷³ The sheer complexity of the legal framework is daunting for all those involved in the development of PPPs, and has led to a lack of coordination and confusion along the project cycle.

Box 7: Some PPP projects have encountered difficulties due to legal and regulatory constraints

Restrictions on private sector participation. In February 2015, the Constitutional Court invalidated Law No. 7/2004 on Water Resources due to a broad reading of Article 33 of the Constitution which states that the “land, the waters and the natural resources within shall be under the powers of the State and shall be used to the greatest benefit of the people.” Following this decision, PPP projects of PT PAM Lyonnaise Jaya (Palyja) and PT Aetra Air Jakarta were cancelled. Under the new set of regulations⁷⁴, the private sector is not permitted to operate distribution networks in water projects. The Constitutional Court has also invoked Article 33 several times to prevent establishing an independent regulator, liberalizing electricity markets, or privatizing state owned enterprises involved in energy production (IEA, 2015).

- **Implication:** Since private sector participation is governed by sector-specific laws, investors may fear that the Constitutional Court may also invalidate private sector participation in other public goods, creating long-term uncertainty.

Overlapping laws on local parliament approval: By law (GR No. 50/2007), any regional government that plans to enter into a PPP agreement with a private sector entity and requires regional budget funding/support must seek local parliament approval prior to entering into any such agreement. As part of this process, a draft PPP agreement must be submitted to the local parliament for review. However, MOHA 96/2016 requires regional governments to obtain local parliament approval of the project's availability payment mechanism in the relevant fiscal year of payment. It is thus unclear whether local parliament approval before entry into a PPP Agreement includes a long term regional budget commitment throughout the life of the PPP agreement, or whether such budgetary approval needs to be obtained each fiscal year of payment.

- **Implication:** Securing local parliament approval after the completion of construction work is a considerable risk for PPP projects (e.g. the Bandung Waste-to-Energy Project was suspended due to failure to obtain such approval). Private sector bidders will be wary of entering a bid which might subsequently never receive approval on its proposed payment mechanism.

Separate requirements for the outline business case (OBC). Indonesia's Ministry of National Development Planning (Bappenas) and the Ministry of Finance (MoF) have separate requirements for the preparation of the OBC, i.e. preliminary feasibility study. This is cumbersome as all government contracting agencies (GCAs) need to prepare the OBC for a PPP project in accordance with the requirements set out by Bappenas, but must also submit the OBC to MoF in accordance with their requirements if viability gap funding (VGF) is needed. Although the requirements appear to overlap substantially, complying with MoF requirements can require significant additional effort, e.g. social cost and benefit analysis, financial model, and analysis indicating that VGF is the last resort.

- **Implication:** Complying with two separate requirements is time-consuming for GCAs, and could slow down the project preparation process.

Mispricing of tariffs in core infrastructure sectors may deter private sector interest

Poorly-designed tariff regulations in certain sectors may also dampen private sector interest. In the water sector, average tariffs paid by consumers to water utilities is USD 0.28 per m³, which is seemingly low and partly explains the insufficient interest of private sector financiers/operators⁷⁵. In the power sector, the current methodology for determining electricity tariffs does not incentivize the national power utility (PLN) to improve efficiency, hampering its credibility as a partner for independent power

⁷³ From interviews for the World Bank InfraSAP.

⁷⁴ Government Regulation No. 122 of 2015 on the Drinking Water Supply System (“GR No. 122/2015”) and its implementing regulations

⁷⁵ World Bank (2017f).

producers (IPPs). Under the current cost plus 7 percent margin formula, PLN is compensated irrespective of whether the costs are efficiently incurred, which promotes cost inflation. Moreover, uncertainty regarding tariff setting and frequent revisions can also discourage private investment. In January 2017, the Ministry of Energy and Mineral Resources (MEMR) reduced feed-in tariffs for renewable energy sources, following complaints from central and local governments that feed-in tariffs enacted in 2014 were too high.

Despite improvements, obtaining permits and approvals for PPP projects is still cumbersome

More general constraints in Indonesia's investment climate also deter private investment in infrastructure. Despite efforts by the Investment Coordinating Board (BKPM) to develop a one-stop integrated services center and a fast-track online permits system⁷⁶, interviews with investors indicate that the permits regime is still cumbersome. Permits and approvals are often delayed due to technical issues, unclear procedures or slow responses from government agencies in reviewing and approving applications.

ii. Lack of incentives and capacity to identify well-prepared, commercially viable projects throughout the project cycle

Public sector weaknesses in project planning, appraisal and quality assurance result in a lack of bankable projects

Identifying, selecting and preparing viable PPP projects for the market involves multiple actors at both the regional and central levels (Figure 60). By regulation, new infrastructure project proposals must originate from Government Contracting Authorities (GCA)⁷⁷ in the sector or region where the project is located. GCAs are responsible for all aspects of project preparation, from preliminary studies through to the completion of outline business cases (OBCs),⁷⁸ procurement and implementation. Projects that GCAs identify as potential PPPs are forwarded to Bappenas, the national central planning agency, which is responsible for screening these proposals and assisting GCAs in the development of OBCs. Based on the project proposal documents received, Bappenas identifies a selection of projects for publication in the annual PPP Book. After MoF approves the OBC, GCAs may apply for project development funding from MoF's Project Development Facility. MoF also decides which projects will receive Viability Gap Funding (VGF) and endorses the use of Availability Payments (APs) where relevant (see Box 8 for a description of these financing instruments). MoF can also assign other infrastructure financing vehicles – e.g. the Infrastructure Financing Facility (IFF),⁷⁹ PT. SMI⁸⁰ and the Indonesia Infrastructure Guarantee Fund (IIGF) – to provide technical advice and other assistance on project preparation, procurement and transaction.

⁷⁶ In late 2015, BKPM issued a licensing policy that allows investors with investments worth a minimum of IDR 100 billion (USD 7 million) or plan to employ at least 1,000 workers to process their principal permits in three hours. In 2016, BKPM added more permits to the fast-track program and extended its implementation to several infrastructure sectors.

⁷⁷ Encompasses all government entities with the authority to implement infrastructure projects, from central government ministries, departments and agencies, to local governments and their agencies.

⁷⁸ In this context, OBCs set forth a preliminary analysis of the feasibility of a proposed PPP project, including legal, technical, economic, financial, risk allocation, environmental and social aspects, in order to inform subsequent decision-making regarding the project.

⁷⁹ PT. Infrastructure Financing Facility is a privately-owned subsidiary of PT. SMI that provides local currency project financing in the form of loans, equity and nonpolitical risk guarantees.

⁸⁰ PT. Sarana Multi Infrastruktur is a nonbanking financial institution dedicated to infrastructure financing. It was established as a state-owned enterprise in February 2009.

Figure 60: Identifying, selecting and preparing infrastructure PPP projects involve multiple actors



Box 8: The GoI has developed several financing instruments to support PPP implementation

The GoI has developed a series of fiscal and contracting tools to facilitate the participation of the private sector and enhance the viability of potential PPP projects. Specifically, the GoI introduced:

- (i) Project Development Fund at MoF to support the hiring of professional transaction advisors for the early-stage development of infrastructure projects identified to be developed as PPPs;
- (ii) Viability Gap Funding (VGF) – this is the Government’s contribution for part of the cost of constructing a PPP project that is economically but not commercially viable.⁸¹ In effect, it provides a capital subsidy to buy down the cost of projects;
- (iii) Government Guarantees to cover political and government performance risks; and
- (iv) Availability Payment (AP) scheme – this is a periodic payment by the Minister/Chairman/Head of the Region to a private entity for providing infrastructure services that conform to the quality and/or criteria specified in the PPP agreement.

The VGF and AP instruments are starting to be implemented by GoI on specific projects (e.g. VGF on the Umbulan Water Project; AP for the Palapa Ring national fibre optic backbone network project), but are not yet widely applied. Part of the issue is that they are relatively new instruments (VGF was introduced in 2012-13 and AP in 2015), so their uptake may be a matter of time. However, the regulations and accounting standards for these instruments are perceived as overly complex by GCAs, exacerbated by the fact that both tools are regulated and administered by different directorate generals within MoF. It is also not possible to blend both instruments, i.e. utilize VGF to subsidize a portion of APs to make a PPP viable.

GCAs’ capacity to identify and prepare PPPs is limited...

From project identification to planning and preparation, there is no clear process for allocating projects between the public and private sectors. GCAs have limited ability to effectively analyze the viability of projects, and rarely prepare robust preliminary studies on implementation of potential PPPs⁸² (e.g. financial viability, overarching need, demonstration of value for money). Only a handful of projects that GCAs pass on to Bappenas have underlying data (e.g. estimated cost, revenue forecasts) and demonstrable commitment from the GCA project owner. Moreover, procurement regulations and remuneration caps prevent GCAs from hiring qualified international advisors to prepare projects to an adequate standard that can attract private financing. Since project preparation costs are considered part of GCAs’ capital expenditures, there is little incentive for GCAs to fund seemingly high-cost studies that do not immediately achieve physical targets (e.g. an increase in the project size or scope). GCAs are thus reluctant to incur expenses upfront to make projects commercially viable and allow for internationally competitive tenders that would attract sufficient competition and quality investors.

...resulting in few PPP proposals being implemented

Due to staffing and budget constraints, Bappenas’ PPP Unit does not have the capacity to actively screen each proposal before it is inserted into the PPP Book. This has resulted in few projects in the PPP Book going to implementation as a PPP.

⁸¹ A project is considered commercially viable if it is expected to earn sufficient revenue to cover its costs and yield an acceptable financial rate of return. Economic viability takes social and environmental costs/benefits into account as well.

⁸² Based on InfraSAP team discussions with Bappenas PPP Directorate.

Moreover, the proliferation of different but often overlapping PPP project lists is causing the market to lose confidence in the PPP Book.⁸³ While Bappenas does have a limited budget to support the GCAs in completing OBCs, it lacks sufficient resources to make up for the relative lack of project preparation on the part of GCAs.

Uncoordinated support may result in commercially inviable projects being submitted as PPPs...

Indonesia has made strides in developing the institutional framework to fund and finance infrastructure, but bureaucracy and the lack of appropriate implementation mechanisms to create robust project pipelines (regardless of whether they are funded by the public or private sector) have marred the implementation process. Although different Government support instruments (VGF, AP, etc) have been developed, different functions in MoF assign projects to each fund without a coordinated assessment. Since this array of Government support is available only through a centralized process, there is some concern that the availability of Government support is what is incentivizing GCAs to submit for projects for PPPs, with the result that only those projects that need Government support to make them commercially viable are being designated as PPPs.

...while commercially viable projects may be allocated to SOEs, rather than being brought to market

These weaknesses in project planning, appraisal and quality assurance have led to the most commercially viable projects being implemented through public procurement or being directly assigned to SOEs. However, to maximize aggregate financing for infrastructure development, private financing should be sought first and foremost for thoroughly prepared, bankable projects, with instruments such as VGF, AP and government guarantees reserved for judicious use to improve the attractiveness of projects that involve inherent risks.

iii. SOE dominance may hinder private sector interest

SOEs have played an important role in boosting Indonesia's infrastructure stock...

Driven by the aim of accelerating infrastructure development, the Government has mainly relied on state-owned enterprises to execute Indonesia's ambitious infrastructure plans.⁸⁴ An important contributor to Indonesia's economy, SOEs are estimated to account for a third of total infrastructure spending and are expected to contribute a fifth of additional investments in 2015-19 (see Figure 58). This approach is largely a pragmatic response to the urgent need for new capacity, as well as a means of circumventing existing inefficiencies in the project cycle. SOEs' procurement process is faster, and they are more willing and able to take on more risks than a typical private sector concessionaire. They are also willing to take on non-commercial projects as part of their mandate as 'agents of development.'

...but they do not always have the capacity to deliver infrastructure efficiently...

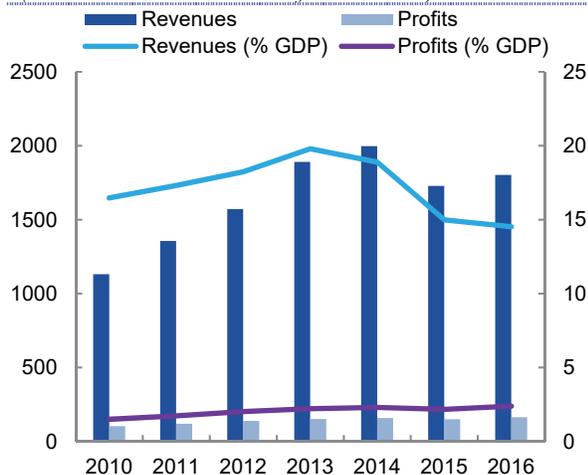
Despite their prominence, not all SOEs have delivered infrastructure efficiently. While SOE assets and equity have increased in recent years, revenues have declined and profits have remained flat as a share of GDP (Figure 61). Listed private companies also generally outperform listed SOEs on return in terms of equity/return on assets in several key infrastructure sectors (Figure 62). These indicators suggest that SOEs are not always well-managed from a financial perspective, and therefore are not driven to achieve the same governance and efficiency standards on infrastructure projects. In the transport sector, for example, ports solely run by SOEs

⁸³ Based on InfraSAP team interviews with private sector investors.

⁸⁴ In the power sector, PLN accounts for 70 percent of total installed generation capacity and remains dominant in transmission and distribution. IN toll roads, Jasa Marga is the largest toll operator, owning about 70 percent of all operating toll roads. The commercial ports are managed by four SOEs (Pelindo I to IV) which operate under extended concessions (30-50 years), and the two state-owned airports (Angkasa Pura I and II) operate most airports in Indonesia. Water supply and sanitation services are provided mainly by local government-owned water utilities.

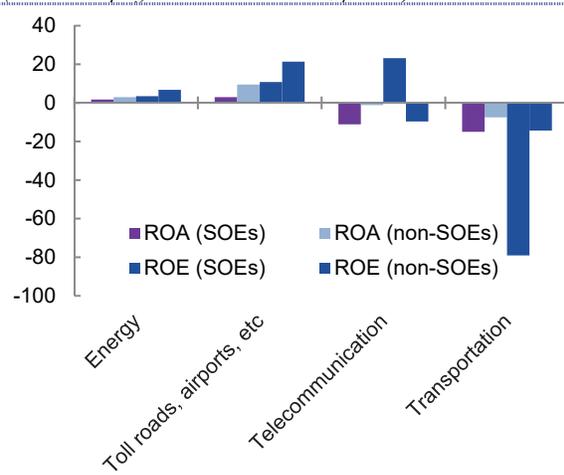
show weak operational performance compared to the few joint ventures between international operators and the Pelindos.⁸⁵ In the water sector, 73 percent of local government-owned water utilities (PDAMs) run at a loss, with average tariffs lower than unit costs, and just under 50 percent of PDAMs are classified by the Government as financially unhealthy.

Figure 61: SOE revenues have declined and profits have remained flat as a share of GDP
(IDR trillions, LHS; Percent of GDP, RHS)



Source: Ministry of SOEs and press reports, World Bank staff calculations.

Figure 62: ...and listed SOEs have lower returns than private companies in most infrastructure sectors.
(return on equity and return on assets, percent)



Source: Indonesia Stock Exchange (August 2017), World Bank staff calculations.

...and may increase fiscal risks if not closely monitored.

Since SOEs rely heavily on public finances and need to adhere to single borrower limits⁸⁶ of local banks, SOEs face limits on how much they can ramp up infrastructure spending. SOEs have access to a variety of explicit Government subsidies (e.g. to carry out public service obligations) and implicit subsidies (e.g. Government guarantees and equity injections). However, the Government has limited the use of capital injections in 2017 and needs to ensure that the fiscal deficit does not exceed 3 percent. Although SOEs' guaranteed debt is currently less than 1.0 percent of GDP, close monitoring of contingent liabilities and SOEs' financial performance is needed to ensure that fiscal risks remain moderate. These constraints further strengthen the case that greater private investment in infrastructure is needed.

There are signs that SOE dominance may have crowded out the private sector in delivering core infrastructure...

Preferential access to finance and direct assignment of projects to SOEs have crowded out the private sector. As previously noted, the private sector only accounted for 9 percent of core infrastructure spending in 2015. Crowding out is also evident at the sector level. In electricity, as of 2015, PLN accounted for 70 percent of total installed generation capacity while independent power producers (IPPs) accounted for 21 percent and the balance by private power utilities and captive generation.⁸⁷ PLN also remains the dominant force in transmission and distribution, even though

⁸⁵ Pelindos are SOEs. Source: Transport sector assessment for InfraSAP. World Bank (2007f).

⁸⁶ Bank Indonesia (BI) places restrictions on commercial bank lending to a single entity or borrower group. For a single name, the single borrower limit (SBL)⁸⁶ is 20 percent of the banks' capital; for a single borrower group, it is 25 percent; and for related parties it is 10 percent. In practical terms, however, borrower limits are determined internally and may be actively managed for experienced borrowers who are key clients.

⁸⁷ The Oxford Institute for Energy Studies: "Indonesia's Electricity Demand and the Coal Sector: Export or meet domestic demand?" Cited from Energy Sector Assessment for InfraSAP. World Bank (2017f).

the 2009 Electricity Law permits private power utilities outside PLN's service areas to generate and sell electricity.⁸⁸ In transport, most toll road concessions are owned/controlled by SOEs while the private sector accounts for only 33 percent in the total length of completed roads and less than 15 percent in terms of roads under construction or awarded/assigned road projects.⁸⁹ The operational dominance of the four SOE ports has led to limited equity participation of private investors beyond the few joint ventures between international operators and the ports.⁹⁰

...due to easy access to finance...

The crowding out effect is partly because SOEs, by their nature, have easier access to Government sources of funding. As such, SOEs and their lenders/guarantors may pay less attention to the commercial viability of projects because of the expectation that any corporate loss will be covered by the state budget. In toll road tendering, for example, the acceptable internal rate of return for SOEs can be as low as 13 percent, whereas private sector competitors aim at 16 percent.⁹¹ In addition, there is no established dividend policy for SOEs, with dividend payments determined on a case-by-case basis. Below-market required rate of equity returns may also give SOEs an unfair advantage over their competitors.

...and the usage of direct assignments

Directly assigning infrastructure projects to SOEs may also have deterred the private sector from infrastructure investment. In the interest of accelerating infrastructure delivery, the Government has made seven direct assignments of projects or wholesale programs (which include multiple projects) through Presidential Regulations to SOEs in light rail transit, high speed train, toll roads, seaport, and electricity. However, these direct assignments create the market perception that the more viable projects are assigned to SOEs, further deterring private sector interest. In the case of ports, for example, many new developments of key commercial ports have been directly assigned to the Pelindos in recent years.⁹²

iv. Long-term instruments for local currency financing of infrastructure projects are limited

Long-term local currency financing for infrastructure is not widely available in Indonesia

Given that revenues for many infrastructure projects in Indonesia are IDR-denominated, long-term local currency financing instruments are critical to attract private sector players. This is not only to avoid the volatility associated with international financial markets, but also to mitigate foreign exchange risks and the high cost of international finance due to high country risk premiums and foreign exchange hedging. However, Indonesian debt and capital markets are still relatively nascent, limiting the availability of long-term IDR financing. The remainder of this section focuses on a selected number of challenges in banking and capital markets that hamper the entry of private investment into infrastructure.

The small, highly concentrated banking sector does not facilitate the development of

The Indonesian banking sector is relatively small at around half of GDP, less than many neighboring countries and other large emerging markets (Figure 63). Attaining a banking system of a broadly comparable size (relative to GDP) by 2019-2020 would require banking assets to grow by 20-25 percent each year;⁹³ however, they only grew 6 percent from 2015-16 and 9 percent the previous year. Banking assets are thus

⁸⁸ Energy Sector Assessment for InfraSAP. World Bank (2017f).

⁸⁹ Transport Sector Assessment for InfraSAP. World Bank (2017f).

⁹⁰ In ports, for example, the Pelindos already own much of the land that could be used for port development, which makes it difficult for the private sector to compete for market share.

⁹¹ Transport Sector Assessment for InfraSAP. World Bank (2017f).

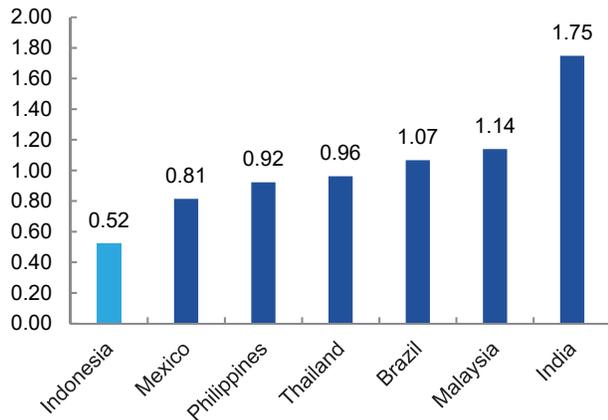
⁹² Transport Sector Assessment for InfraSAP. World Bank (2017f).

⁹³ Assuming 5 percent GDP growth per annum for the next four years.

suitable instruments for infrastructure finance...

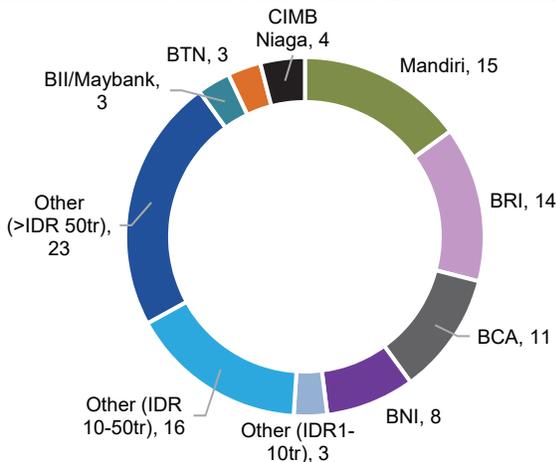
growing too slowly to effectively support and supply credit for Indonesia’s infrastructure needs. Moreover, local lending is also highly concentrated: four banks (Mandiri, BRI, BNI and BCA⁹⁴) account for half of total banking assets (Figure 64) and dominate the supply of IDR financing to the infrastructure sector. These banks benefit from comparably high net interest margins⁹⁵, which may provide little incentive for them to innovate, expand product offerings or deepen credit analysis so that they can implement more complex credits in local currency (e.g. limited recourse infrastructure financing⁹⁶).

Figure 63: Indonesia’s banking sector is relatively small compared to peers...
(ratio of banking assets to GDP)



Source: World Bank, IMF

Figure 64: ...and banking assets are fairly concentrated.
(share of total banking assets, percent)



Source: Bank Indonesia, World Bank staff calculations

...and there is limited liquidity for infrastructure lending

The banking sector is also substantially segmented, which limits the liquidity available for infrastructure lending. The state-owned banks (Mandiri, BRI and BNI) are more focused on supporting SOEs and strong corporate names.⁹⁷ Less well established private sector sponsors are unlikely to get funding from state-owned banks, and larger private local banks (in particular BCA) and foreign banks are highly selective. Much of the debt financing to infrastructure projects is done through corporate lending, based on the strength of borrowers’ balance sheets and often on a relationship basis. This means that: a) the amount that can be borrowed by private sponsors is limited by their balance sheets, and b) SOEs often have an advantage, as banks are more willing to lend to them due to perceived lower risk (given state ownership).

⁹⁴ Mandiri, BRI and BNI are state-owned, whereas BCA is a private bank.

⁹⁵ 5.6-6.1 percent in 2016, compared to 2.5-3.0 percent for other countries in the region

⁹⁶ Recourse financing gives lenders full recourse to the assets or cash flow of the shareholders for repayment of the loan in the case of non-performance by the SPV. If the project or SPV fails to provide the lenders with the repayments required or to achieve a certain performance as specified in the contract, then lenders will have recourse to the assets and revenue of the shareholders without limitation. In the case of “limited” or “non-recourse” financing, the project company is a limited liability SPV, so lenders’ recourse is limited primarily or entirely to the project assets in the case of default. Limited recourse finance, i.e. a true project finance, can relieve the burden of the project sponsor’s balance sheet.

⁹⁷ For example, about 64 percent (IDR 65.5 trillion or USD 4.9 billion) of total lending to PLN comes from local banks. Loans from Mandiri, BRI and BNI together make up 49 percent (IDR 51 trillion or USD 3.8 billion) on both fast track and non-fast track projects, while BCA contributes 8 percent and smaller local banks a further 6 percent.

Short corporate loan tenors and the absence of limited recourse financing make it difficult to invest in infrastructure

Due to a lack of credit assessment and financial structuring, all major IDR lenders rely on senior corporate-style loans that do not facilitate infrastructure lending. However, corporate loans tenors are short (3-7 years), with possible extension to 10 years in exceptional cases. The duration mismatch between loan tenors and the infrastructure project life cycle creates the additional risk of refinancing the debt to spread repayment over the life of the asset. Moreover, even loans for specific projects generally have recourse to the ultimate sponsor, rather than being done on a limited recourse basis. This is partially because the poor preparation of projects, as discussed above, creates risks that banks are not willing to shoulder. Also, the technical skills, experience and corporate motivation to manage limited recourse financing credit has not developed to a meaningful extent in the local bank market.

The bond market is an underutilized source of infrastructure finance

Although the infrastructure sector is the second largest source of corporate bond issuance with 16 percent of total bonds outstanding (Figure 65), the bond market is mostly accessible only to large, well-known entities. New infrastructure projects have so far been unable to raise funding from this source unless the fundraising is done by companies that already have sizeable operating assets. This is because stand-alone projects, especially greenfield ones, typically carry too much risk for bond investors, who tend to be more receptive to SOEs and well-known corporations. Additionally, a significant structuring of the bond would be necessary for a standalone project to mitigate most of the credit risk before it can borrow in the capital markets. However, these structured bonds are not common in Indonesia because the credit culture is not prevalent⁹⁸. The use of structured bonds is also hampered by the absence of a Special Purpose Vehicle (SPV)⁹⁹ structure that can be used to issue project bonds¹⁰⁰.

Domestic institutional investors are mostly focused on short-term gains...

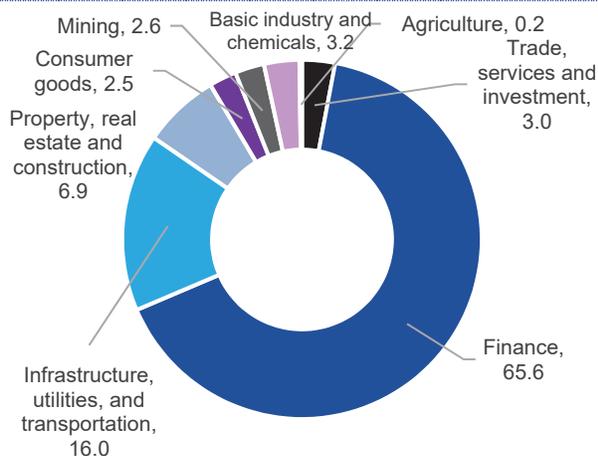
Institutional investors (pension funds, social security, and life insurance companies) with longer-term liabilities are well-positioned to make infrastructure investments. However, the domestic institutional base in Indonesia is also small compared to neighbouring countries and to the size of domestic funding needs. Together, social security funds, private pension funds, insurance industry, and collective investments amount to IDR 1,394 trillion (12.3 percent of GDP), or USD110 billion. Pension fund assets (public and private combined) are 5 percent of GDP, well below the Philippines (10 percent of GDP) and Malaysia (40 percent of GDP). Moreover, most assets of institutional investors are invested conservatively with a relatively short-term perspective. For example, nearly 30 percent of pension fund assets are invested in bank deposits (Figure 66).

⁹⁸ Most Indonesian investors are familiar only with plain-vanilla corporate bonds without any structure that would enhance the bonds' credit quality beyond the corporate's own credit rating. In recent history, there has been only one corporate bond issuance that carries a credit enhancement in the form of a partial credit guarantee.

⁹⁹ An SPV would allow ring-fencing of a specific operation – a single asset or project – with high administrative efficiency (especially tax efficiency), which is clearly separated from other operations (assets and liabilities) of the project owner/sponsor. Since this SPV structure doesn't exist in Indonesia, a project must be contained within a corporate entity, which is subject to the same requirements as those applied to a typical corporation.

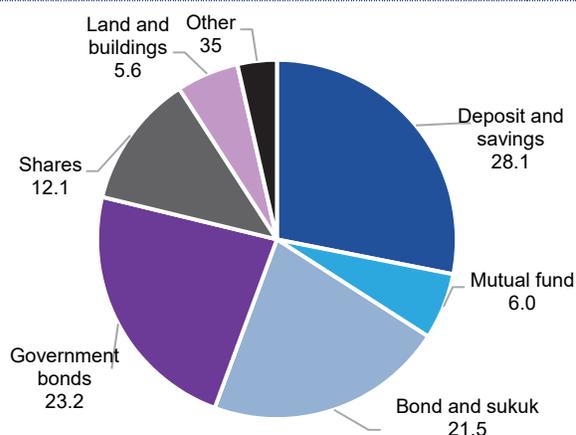
¹⁰⁰ These are bonds tied to a specific project and whose payment is dependent primarily on the project's revenue streams.

Figure 65: The infrastructure sector is the second largest source of corporate bond issuance
(share of corporate bonds outstanding, percent)



Source: Indonesia Stock Exchange (August 2017)

Figure 66: A third of pension fund assets are invested in bank deposits with relatively short-term gains
(share of pension fund investments, percent)



Source: OJK (July 2017), World Bank staff calculations

...and infrastructure funds have not gained ground, partly due to regulatory challenges

Investing in infrastructure through a fund could alleviate direct risks to investors, but the Indonesian fund industry is underdeveloped, aside from mutual funds. Instead of investing directly in the company that undertakes new infrastructure projects, investors could invest indirectly through a professionally managed fund, which will in turn invest in new or existing projects. The private nature of these individual transactions (which may take the form of debt, equity or quasi-equity) enables the fund manager to negotiate and structure the deal to better manage the risks. However, although private sector players have attempted to establish domestic infrastructure funds in Indonesia, they have not been successful¹⁰¹, judging from the lack of uptake in the form of new or follow-up funds or growth of existing funds. This is mostly due to regulatory weaknesses such as the structure of these funds, which does not uphold internationally recognized standards, and different regulatory treatments (taxation, investment types, and limits) for different types of institutional investors. The authority (*Otoritas Jasa Keuangan*, OJK) has attempted to address these weaknesses by introducing a new type of recognized fund (i.e. infrastructure fund), but no fund has been created under the new framework thus far.

Securitization is being promoted as an avenue for asset recycling

Securitization¹⁰² may be an effective means of mobilizing private investment in infrastructure, but has only started to gain ground in Indonesia recently. Although a regulatory framework for domestic securitization was established in 2008, only one type of securitization (mortgage-backed securities) had been issued up until recently. Securitization backed by other types of assets or by other entities had not materialized, partly due to a lack of economic motivation to securitize, but also due to the lack of a supportive enabling environment (i.e. issues around taxation, accounting and legal ownership). However, as many SOEs have started to feel the pressure on their balance

¹⁰¹ For example, in 2015, out of IDR 20 trillion of total outstanding value of supposedly private funds, less than 5 percent was invested in true private equity portfolios. Others were either invested in public equities or established as proxies for single debt securities investment

¹⁰² Securitization refers to issuance of debt securities whose payment is backed by revenues of a project or a pool of project, without recourse to the project owner or sponsor. In the infrastructure context, examples in emerging markets include a securitization of future cash flows received from user fees for water services in Colombia and a securitization of future cash flows received from India's National Highway Authority upon completion of certain sections of highways in North India.

sheets, securitization is now being actively pursued. In August 2017, an infrastructure-based securitization of IDR 2 trillion was issued, backed by future revenues of the Jagorawi toll road operated by Jasa Marga, an SOE.¹⁰³ It is unclear, however, whether the challenges in the enabling environment have been adequately and comprehensively addressed. Also, the investor base has yet to be diversified, as it largely targets the same pool of domestic investors.

d. Efforts to mitigate constraints to private investment are underway

Recent Government initiatives seek to improve the process of identifying and preparing projects

The Government of Indonesia (GoI) recognizes that there are constraints to private sector involvement in infrastructure and has taken some steps to resolve them. From 2014-2016, GoI made several institutional changes to improve the coordination and capacity of government agencies to support the PPP project pipeline. These include the establishment of the PPP Unit in the Ministry of Finance (the Directorate for Government Support and Infrastructure Financing Management), the preparation of standard operating procedures for the operations of the PPP Unit, the approval and funding of a Project Development Facility (PDF) in the MoF and a revitalized Committee for Accelerated Infrastructure Delivery (KPPIP). KPPIP has undertaken an impressive workload in terms of issuing guidance, regulations and assisted in developing projects and moving them forward. As of July 2017, KPPIP notes that 20 projects with a value of IDR 33.5 trillion (USD 2.5 billion) have been removed from the National Strategic Project as they have been completed or nearing completion.

Efforts to improve the legal and regulatory environment for PPPs are underway

The GoI is also taking steps to clarify and streamline the legal regime. In March 2015, President Joko Widodo signed Perpres No. 38/2015 to introduce key changes to PPP implementation rules in Indonesia, e.g. expanding the types of infrastructure that can be developed through PPP schemes, introducing a direct appointment mechanism and expanding the types of investment return schemes that can be adopted in infrastructure projects. Discussions about elevating Perpres 38/2015 are underway, which could add clarity to the PPP legal regime if enacted. It will be important for any new regulation to set out a comprehensive system of project identification at the GCA level, where the projects most attractive to the private sector (or those that would most benefit from private sector involvement) are put through a detailed PPP process. International guidelines such as the UNCITRAL Guidance on Public-Private Partnership/ Concession Laws, EBRD Core Principles for a Modern Concession Law and OECD Principles for Public Governance of Public Private-Partnerships, should also be considered when preparing the draft of the Infrastructure Law.

Clear criteria on allocating projects between the public and private sector are needed

Despite significant progress, Indonesia still struggles with establishing a process that will effectively screen projects on an integrated basis so that the optimal mode of delivery is chosen based on the characteristics of the project as well as the GoI's objectives. To that end, certain adjustments along the project cycle of project identification and project preparation could be made to enhance GoI's ability to bring suitable PPP projects to market. To start, GCAs will need to be trained on project screening, OBC preparation, and initial appraisal, so that the project pipeline develops stronger projects. Bappenas and the MoF PPP Unit are the best-positioned central government institutions to assist the GCAs in this respect. In particular, MoF should focus on the application of value for money assessments (see Box 9) at both the GCA and central government levels. Further steps include having clear criteria for GCAs on which projects are most appropriate to be procured as PPPs, socializing that

¹⁰³ In addition, at the time of writing, a securitization backed by receivables in the electricity sector amounting to an estimated IDR 4 trillion was under preparation and is expected to be launched soon.

criteria to build capacity for PPPs at the line ministry or local government level, and implementing systematic processes for hiring professional advisors to ensure that the project is structured to be attractive to the private sector.

Box 9: Assessing the ‘value for money’ of PPP projects

The term ‘value for money’ is used in the UK in relation to several different tests under the strategic, economic, commercial and financial case assessments. It refers to the general concept of delivering a good level of service for the money spent, and sometimes to specific technical comparisons of alternative financing/contractual options.

A prominent tool when assessing value for money of a PPP project involves comparing the PPP option with a public sector reference project, i.e. the ‘public sector comparator’ (PSC). A PSC spreadsheet tool was developed by HM Treasury and has been widely copied throughout the world. A PSC compares the net present cost of bids for the PPP project against the most efficient form of delivery according to a traditionally procured public-sector reference project. The PSC thus serves as a hypothetical risk-adjusted cost of public delivery of the project. However, ensuring the robustness of a PSC is difficult, and may be open to manipulation to either strengthen or weaken the case for PPPs (e.g. depending on the chosen discount rate or the value attributed to a transferred risk).

In addition to the quantitative aspects usually included in a ‘hard’ public sector comparator, value for money includes qualitative aspects and usually involves an element of judgement on the part of the government.

Applying value for money assessments would improve the quality of the PPP pipeline

However, mobilizing significant amounts of private investment will still require further reforms to ensure a pipeline of well-planned, well-prepared projects that attract the private sector. While GoI has many elements of a successful PPP program, certain adjustments along the project cycle of project identification and project preparation could be made to enhance GoI’s ability to bring suitable PPP projects to market. It would be important to develop an integrated approach to infrastructure that agnostically integrates a traditional public works track, an SOE track, and a PPP track, and mitigate the weaknesses of each track. Projects that represent the most value for money for society at large should be developed, and relative value for money should determine what procurement track is chosen. Box 10 illustrates an example of a checklist that could be used to identify the most relevant delivery mode for infrastructure projects.

Box 10: Checklist for identifying the most relevant delivery mode for infrastructure projects

Project size and profile:

- Is there a large initial capital outlay and long payback period?
- Does project size justify the legal, technical, and financial costs of the delivery mode?
- Can quality enhancements in the design and construction phase generate savings during the operating phase of the project?
- Do these savings justify the additional transaction costs involved in bundling construction, operation, and maintenance in a single contract?

Revenue and usage:

- Can user fees be charged, are they affordable for the majority of users, and are they politically acceptable?
- Are user fees sufficient to cover the majority of capital and operating costs?
- Can usage be monitored?

Quality:

- Can the quantity and quality of project outputs or outcomes be specified and measured efficiently?
- Will design innovation be required to achieve improvements in efficiency and value for money?

Uncertainty and risk:

- What is the level of uncertainty related to future technological conditions?
- What risks is each sector (public vs private) most capable of influencing and managing?
- Is demand relatively predictable over the lifetime of the project?
- Who is best placed to influence demand for the infrastructure-based service?
- Is the private sector willing to and capable of bearing some or all of the demand risk?
- Are there particular integrity risks in terms of corruption and undue influence that merit attention?

Competition:

- Will there be a sufficient number of qualified bidders in the case of a PPP/concession project to ensure a competitive bidding process?

The Government has made efforts to attract private capital

In recent years, the Government has attempted to make progress in seeking to attract private capital. These efforts have included (i) permitting greater foreign ownership in certain sectors, and in some cases allowing full private sector participation, e.g. in toll roads; (ii) implementing regulations on expediting land acquisition¹⁰⁴; (iii) allowing PPPs to use availability payments¹⁰⁵; and (iv) seeking to address the overall coordination of national infrastructure development by establishing centralized coordinating bodies for licensing, PPP development and delivery of strategic and priority projects. Further, MoF (through the Directorate General of Budget Financing and Risk Management, DJPPR) has established various financing instruments such as the Viability Gap Fund, Project Development Facility and the Infrastructure Guarantee (see Box 8 earlier). The Government has also launched a scheme to mobilizing financing from domestic institutional investors (Box 11).

¹⁰⁴ Land Acquisition Law No.2/2012, PR No.71/2012 on Land Acquisition for Public Interest (operational in 2015)

¹⁰⁵ MoF decree PMK no. 190/ PMK. 08/2015

Box 11: The GoI has made attempts to mobilize financing from domestic institutional investors

In early 2017 GoI launched a scheme called *Pembiayaan Investasi Non-anggaran Pemerintah* (non-budgetary financing of infrastructure – or PINA) to use, amongst others, managed pension and insurance funds to support the development of strategic infrastructure projects, particularly through equity financing of these projects. To attract PINA funding, projects need to support the national development priority targets, have social and economic benefits, be commercially viable, and meet readiness criteria.

Under the scheme, PT Sarana Multi Infrastruktur (PT SMI, a state-owned infrastructure financing company) and PT TASPEN, a local state-owned pension fund, have co-invested equity into the early stages of a portfolio toll road company. In February 2017, Waskita Toll Road received IDR 3.5 trillion (USD 264 million) in equity under the PINA scheme. A further IDR 1.5 trillion worth of equity is being finalized for Kertajati Airport in West Java, bringing the total realized investment under the PINA scheme to IDR 5 trillion.

Further development of banking and local capital markets is needed to mobilize private sector investment in infrastructure

To mobilize more financing from capital markets for infrastructure, further efforts are needed to (i) increase savings into long-term investments, (ii) address weaknesses in capital market products available to channel funding into infrastructure, and (iii) encourage foreign investor participation. These could be done through increasing incentives into long-term savings, such as imposing tax penalties for early withdrawal, easing the process of transferring pension savings in case of job changes, and introducing an age-based “default investment choice” for those who do not wish to make their own investment choices to encourage a more appropriate investment duration for the savings. Additionally, policies should be amended to encourage proper long-term investment by institutional investors. These should include a review of regulations on liability management, performance measurement, and risk management of institutional investors. Proper reporting frameworks and performance measurement should be introduced using a long-term portfolio benchmark suitable to the liability structure of pension or social security funds, rather than a short-term performance target. In the meantime, given the current small size of domestic source of financing, efforts should be made to make IDR issuances attractive and investible by foreign investors. Impediments for foreign investor participation in the domestic market and for issuance of IDR-linked bonds globally should be addressed. Furthermore, there may be ways to introduce Indonesia-focused infrastructure funds where international and domestic investors can co-invest.

A balanced approach between SOEs and the private sector will help ensure that resources are maximized most efficiently

While SOEs will remain a core part of Indonesia’s infrastructure development landscape for the foreseeable future, the GoI will need to consider measures that improve competitiveness, transparency and efficiency in sectors where SOEs are prominent to leverage private investment for infrastructure development. The current model of using SOEs as the primary vehicle for infrastructure development must therefore be assessed to ensure that resources are being maximized in the most efficient manner possible. For example, if SOEs develop projects that are commercially viable for the private sector, they are effectively replacing a source of external financing for infrastructure. If SOEs are benefiting from public support of various forms, limited public resources are being deployed where the private sector could have financed the projects.

Greater transparency and efficiency in sectors with SOE dominance would

Given the huge infrastructure investment needs, a pragmatic approach calls for SOEs and the private sector to fill the financing gap and provide higher efficiency in delivery and operations. This requires reducing SOE dominance through opening up sectors to competition, abandoning or reforming the process of direct assignment to allow a

create room for private sector involvement

more rigorous and transparent screening process based on clearly defined criteria, and, where possible, demonopolizing sectors and allowing private sector players to compete with SOE monopolies to create competition for the market. A hardening of budget constraints is also needed to instill greater financial discipline in SOEs and level the playing field with the private sector. This involves ensuring that the public service obligation (PSO) system minimizes the likelihood of over- and under-compensation for the delivery of services, encouraging SOEs to seek equity capital at market terms from the capital market, phasing out the use of implicit subsidies, and developing a formal dividend policy.

GoI has started a program to attract investment into SOE assets

One concrete and promising development is the Ministry of SOEs' (MSOE) ambitious program to enhance private sector involvement in its infrastructure projects. The MSOE has identified over 80 projects with expected investments of around USD 70 billion through direct investment, IPOs, bonds, and securitizations to mobilize more commercial financing for infrastructure. For this program to be successful, the SOEs must be well-prepared to partner with private entities. Besides ensuring the careful structuring of each project, SOEs must adopt good governance practices. Investors will be conducting due diligence on the SOEs, and will have certain basic corporate governance standards and requirements aimed at higher levels of efficiency, transparency, and accountability. To understand the requirements of potential private partners, the MSOE should engage early and often with the private sector, through open and transparent market soundings. Besides financing, the private sector can provide skills, know-how, and operational experience, raising efficiencies and giving greater comfort to financiers. The success of some of these structures will go hand in hand with bringing in private sector operations, for example through an equity investor or under a performance-based engineering, procurement and construction (EPC) and/or operation and maintenance (O&M) contract.

This note details some of the constraints to achieving maximum financing for infrastructure development by mobilizing private sector investment. While well-coordinated project planning and procurement processes, balanced SOE participation, an enabling legal and regulatory framework and well-functioning local capital markets are key, there are numerous other issues beyond the scope of the current note that should also be addressed. These include environmental and social safeguards, and sector-specific challenges. The World Bank Group is currently advising the Government of Indonesia on an infrastructure sector assessment with a focus on mobilizing private sector financing. A roadmap will be presented to the GoI detailing key solutions to these and other constraints in the short, medium and long term.

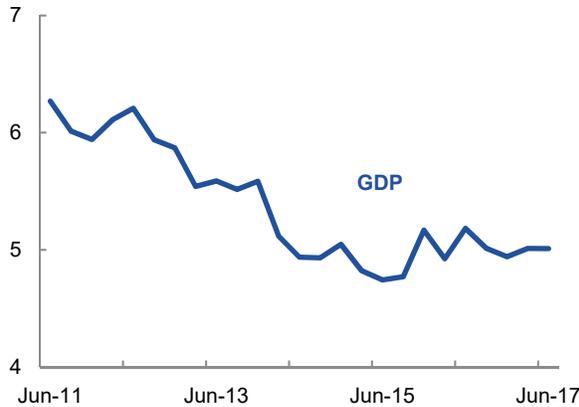
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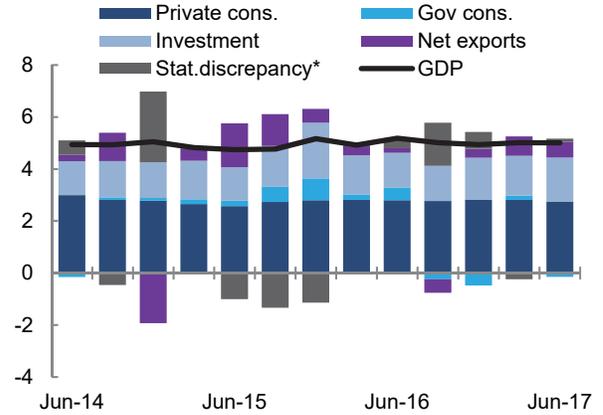
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Real GDP growth
(growth quarterly yoy, percent)



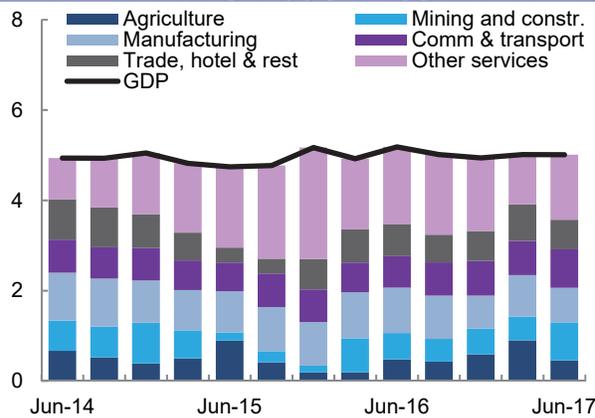
Source: BPS; World Bank staff calculations

Appendix Figure 2: Contribution to GDP growth (expenditure)
(contribution to real GDP growth yoy, percentage points)



Source: BPS; World Bank staff calculations
Note: * includes changes in stocks.

Appendix Figure 3: Contribution to GDP growth (production)
(contribution to real GDP growth yoy, percentage points)



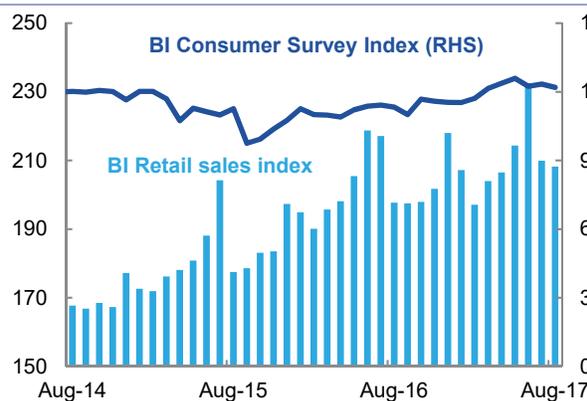
Source: BPS; World Bank staff calculations

Appendix Figure 4: Motorcycle and motor vehicle sales
(growth yoy, percent)



Source: CEIC; World Bank staff calculations

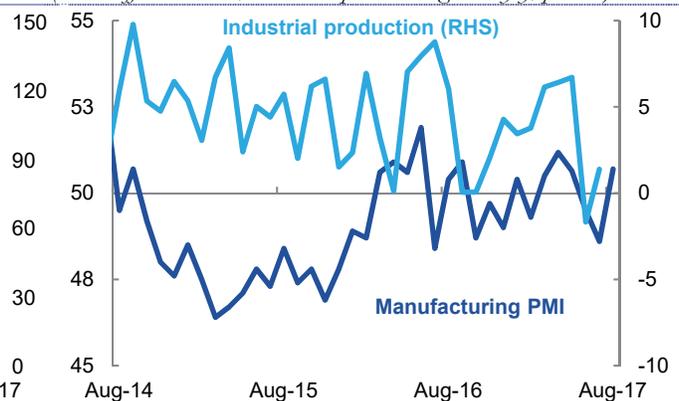
Appendix Figure 5: Consumer indicators
(retail sales index: 2010=100)



Source: BI

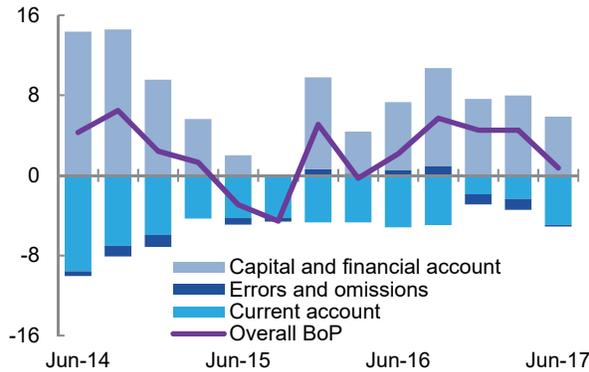
Appendix Figure 6: Industrial production and manufacturing PMI

(PMI diffusion index; industrial production growth yoy, percent)



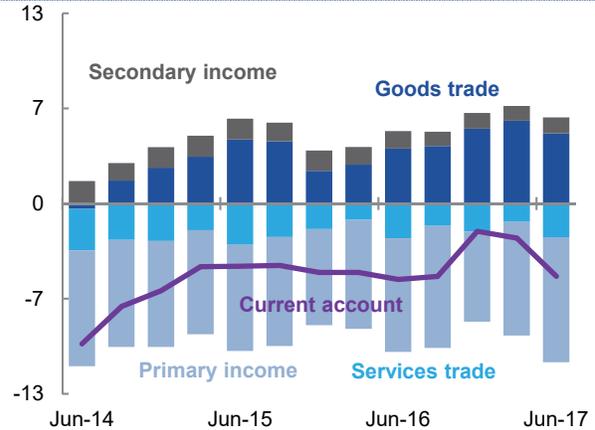
Source: BPS; Nikkei/Markit; World Bank staff calculations

Appendix Figure 7: Balance of payments
(USD billion)



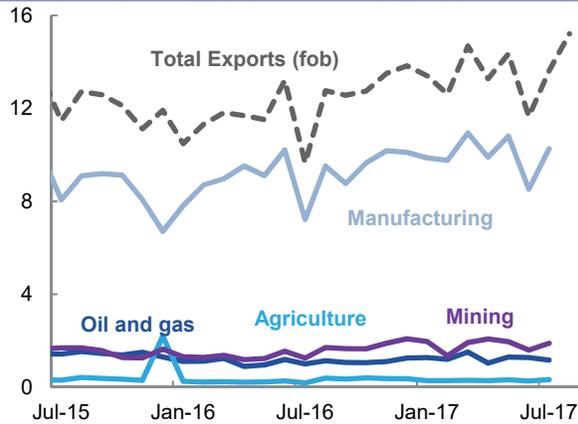
Source: BI

Appendix Figure 8: Current account components
(USD billion)



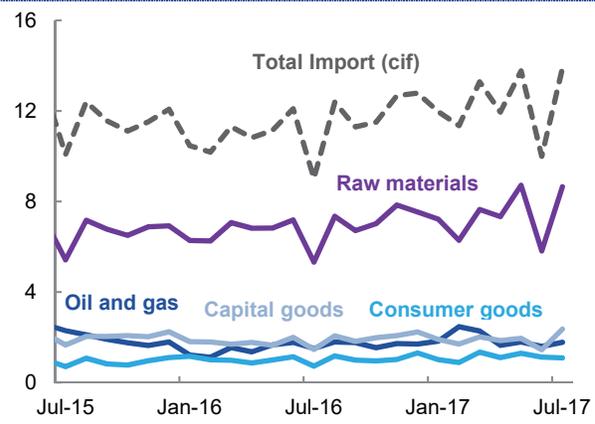
Source: BI

Appendix Figure 9: Exports of goods
(USD billion)



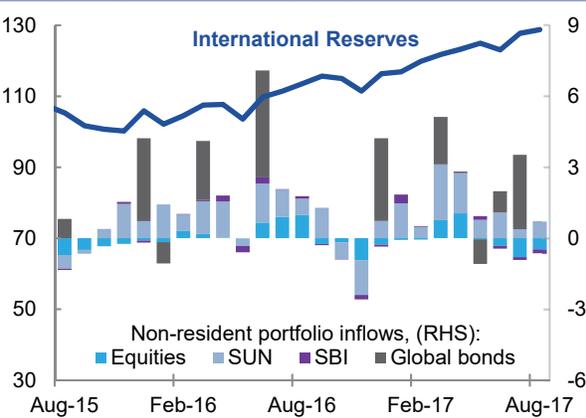
Source: BPS

Appendix Figure 10: Imports of goods
(USD billion)



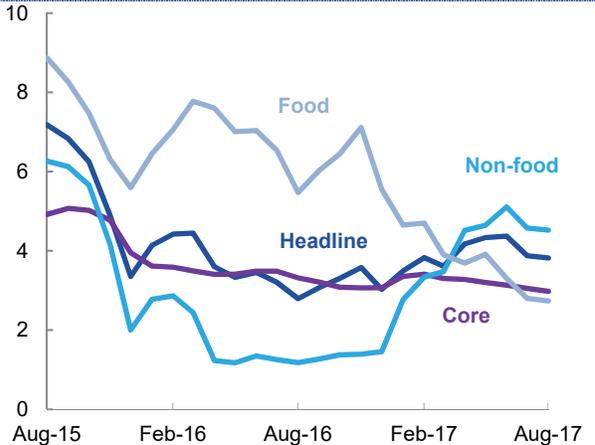
Source: BPS

Appendix Figure 11: Reserves and capital flows
(USD billion)



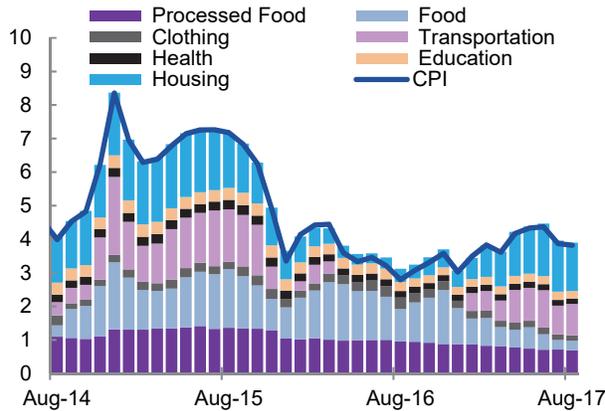
Source: BI; Ministry of Finance (MoF)
Note: SUN is government securities, SBI is BI certificates

Appendix Figure 12: Inflation
(growth yoy, percent)



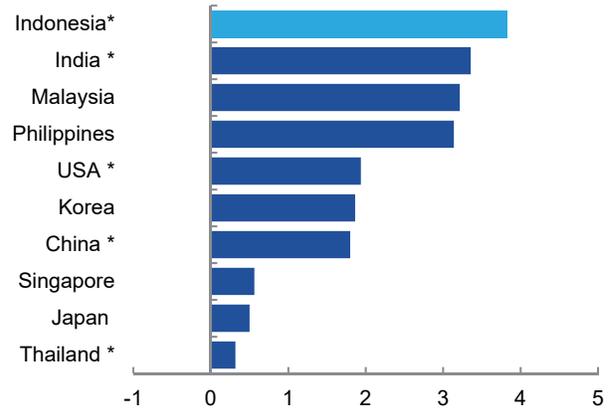
Source: BPS; World Bank staff calculations

Appendix Figure 13: Monthly breakdown of CPI
(contribution to growth yoy, percentage points)



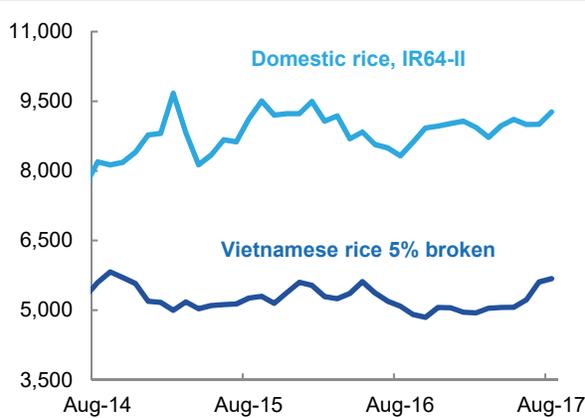
Source: BPS; World Bank staff calculations

Appendix Figure 14: Inflation comparison across countries
(growth yoy, percent)



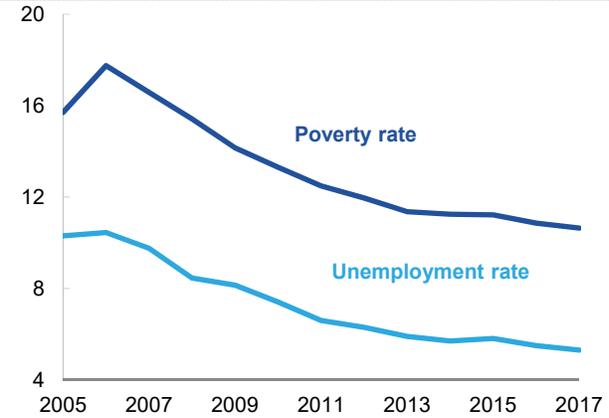
Source: BPS; CEIC; World Bank staff calculations
Note: *August 2017 data; others July.

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



Source: Cipinang wholesale rice market; FAO
Note: "5% broken" refers to the quality of milled rice. 5 percent being the proportion of grains broken during the processing stage.

Appendix Figure 16: Poverty and unemployment rate
(percent)



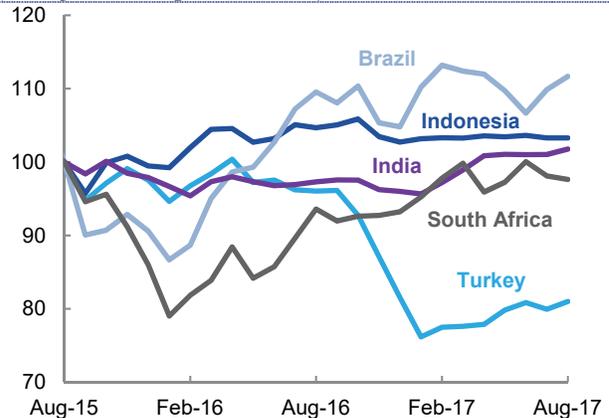
Source: BPS
Note: Poverty line based on national poverty line

Appendix Figure 17: Regional equity indices
(daily index, September 1, 2015=100)



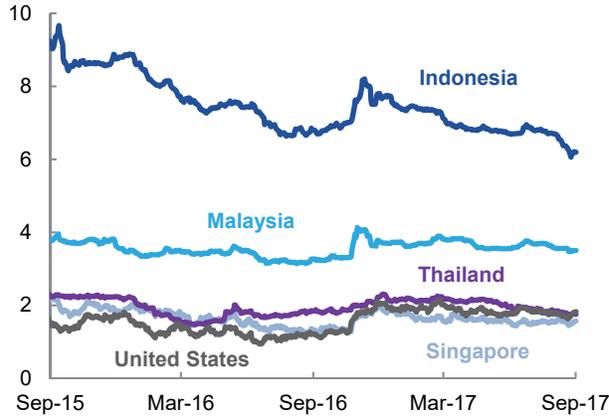
Source: CEIC; World Bank staff calculations

Appendix Figure 18: Selected currencies against USD
(monthly index, August 2015=100)



Source: CEIC; World Bank staff calculations

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



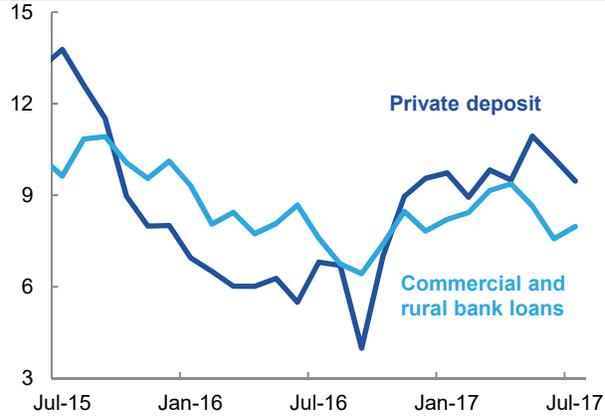
Source: CEIC

Appendix Figure 20: Sovereign USD bond EMBIG spread
(basis points)



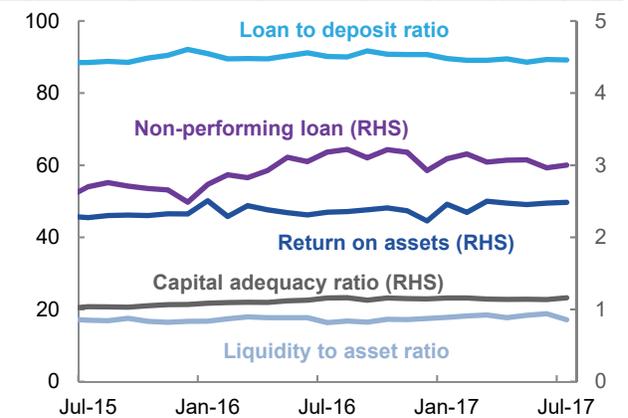
Source: JP Morgan

Appendix Figure 21: Commercial and rural credit and deposit growth
(growth yoy, percent)



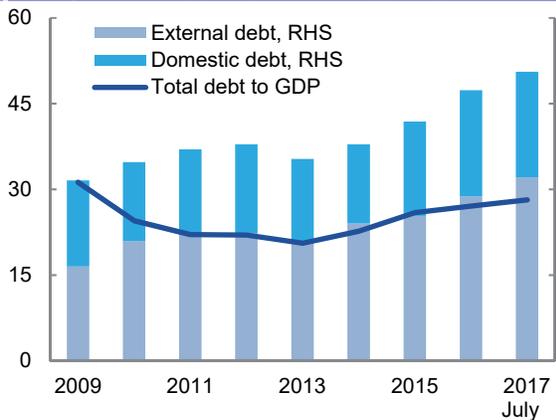
Source: BI; World Bank staff calculations

Appendix Figure 22: Banking sector indicators
(percent)



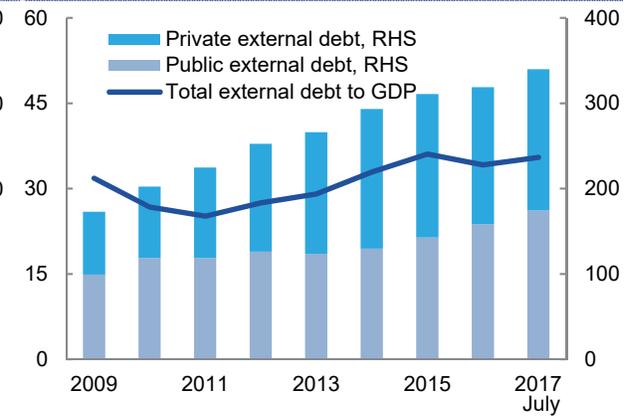
Source: BI; World Bank staff calculations

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



Source: BI; MoF; World Bank staff calculations

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



Source: BI; World Bank staff calculations

Appendix Table 1: Budget outcomes and projections

(IDR trillion)

	2011	2012	2013	2014	2015	2016	2017
	Actual	Actual	Actual	Actual	Actual	Actual	Revised Budget
A. State revenue and grants	1,211	1,338	1,439	1,550	1,508	1,556	1,736
1. Tax revenue	874	981	1,077	1,147	1,240	1,285	1,473
2. Non-tax revenue	331	352	355	399	256	262	260
B. Expenditure	1,295	1,491	1,651	1,777	1,807	1,864	2,133
1. Central government	884	1,011	1,137	1,204	1,183	1,154	1,367
2. Transfers to the regions	411	481	513	574	623	710	766
C. Primary balance	9	-53	-99	-93	-142	-126	-178
D. SURPLUS / DEFICIT	-84	-153	-212	-227	-298	-308	-397
(percent of GDP)	-1.1	-1.8	-2.2	-2.1	-2.6	-1.6	-2.9

Source: MoF; World Bank staff calculations

Note: Budget balance as percentage of GDP uses the revised and rebased GDP

Appendix Table 2: Balance of payments

(USD billion)

	2014	2015	2016	2015	2016				2017	
				Q4	Q1	Q2	Q3	Q4	Q1	Q2
Balance of payments	15.2	-1.1	12.1	5.1	-0.3	2.2	5.7	4.5	4.5	0.7
<i>Percent of GDP</i>	1.7	-0.1	1.3	2.4	-0.1	0.9	2.3	1.9	1.9	0.3
Current account	-27.5	-17.5	-16.9	-4.7	-4.7	-5.2	-5.0	-1.9	-2.4	-5.0
<i>Percent of GDP</i>	-3.1	-2.0	-1.8	-2.2	-2.2	-2.2	-2.0	-0.8	-1.0	-2.0
Trade balance	-3.0	5.4	8.5	0.5	1.5	1.4	2.4	3.2	4.4	2.5
Net income & current transfers	-24.5	-22.9	-25.2	-5.2	-6.2	-6.6	-7.4	-5.1	-6.8	-7.4
Capital & Financial Account	44.9	16.9	28.8	9.2	4.2	6.8	9.8	7.6	8.0	5.9
<i>Percent of GDP</i>	5.0	2.0	3.1	4.3	1.9	2.9	4.0	3.2	3.3	2.3
Direct investment	14.7	10.7	15.9	2.8	2.8	3.3	6.5	3.3	2.8	4.6
Portfolio investment	26.1	16.2	19.0	4.3	4.4	8.3	6.6	-0.3	6.6	7.4
Other investment	4.3	-10.1	-6.2	2.3	-3.1	-4.7	-3.2	4.8	-1.3	-6.2
Errors & omissions	-2.2	-0.4	0.1	0.6	0.2	0.5	0.9	-1.0	-1.1	-0.2
Foreign reserves*	111.9	105.9	116.4	105.9	107.5	109.8	115.7	116.4	121.8	123.1

Source: BI; BPS; World Bank staff calculations

Note: * Reserves at end-period

Appendix Table 3: Indonesia's historical macroeconomic indicators at a glance

	2000	2010	2011	2012	2013	2014	2015	2016
National Accounts (% change)¹								
Real GDP	4.9	6.2	6.2	6.0	5.6	5.0	4.9	5.0
Real investment	11.4	8.5	8.9	9.1	5.0	4.4	5.0	4.5
Real consumption	4.6	4.1	5.1	5.4	5.7	4.7	4.9	4.3
Private	3.7	4.8	5.1	5.5	5.5	5.3	4.8	5.0
Government	14.2	0.3	5.5	4.5	6.7	1.2	5.3	-0.1
Real exports, GNFS	30.6	15.3	14.8	1.6	4.2	1.1	-2.1	-1.7
Real imports, GNFS	26.6	17.3	15.0	8.0	1.9	2.1	-6.4	-2.3
Investment (% GDP)	20	31	31	33	5.0	4.4	5.0	4.5
Nominal GDP (USD billion)	165	755	893	918	915	891	861	933
GDP per capita (USD)	857	3,167	3,688	3,741	3,668	3,532	3,371	3,603
Central Government Budget (% GDP)²								
Revenue and grants	20.8	14.5	15.5	15.5	15.1	14.7	13.1	12.5
Non-tax revenue	9.0	3.9	4.2	4.1	3.7	3.8	2.2	2.1
Tax revenue	11.7	10.5	11.2	11.4	11.3	10.9	10.8	10.4
Expenditure	22.4	15.2	16.5	17.3	17.3	16.8	15.7	15.0
Consumption	4.0	3.6	3.8	3.9	4.1	4.0	4.5	4.6
Capital	2.6	1.2	1.5	1.7	1.9	1.4	1.9	1.4
Interest	5.1	1.3	1.2	1.2	1.2	1.3	1.4	1.5
Subsidies	6.3	2.8	3.8	4.0	3.7	3.7	1.6	1.4
Budget balance	-1.6	-0.7	-1.1	-1.8	-2.2	-2.1	-2.6	-2.5
Government debt	97.9	24.5	23.1	23.0	24.9	24.7	27.4	28.3
o/w external government debt	51.4	11.1	10.2	9.9	11.2	10.2	11.9	11.3
Total external debt (including private sector)	87.1	26.8	25.2	27.5	29.1	32.9	36.1	34.2
Balance of Payments (% GDP)³								
Overall balance of payments	..	4.0	1.3	0.0	-0.8	1.7	-0.1	1.3
Current account balance	4.8	0.7	0.2	-2.7	-3.2	-3.1	-2.0	-1.8
Exports GNFS	42.8	22.0	23.8	23.0	22.5	22.3	19.9	18.0
Imports GNFS	33.9	19.2	21.2	23.2	23.2	22.7	19.3	17.1
Trade balance	8.9	2.8	2.7	-0.2	-0.7	-0.3	0.6	0.9
Financial account balance	..	3.5	1.5	2.7	2.4	5.0	2.0	3.0
Direct investment	-2.8	1.5	1.3	1.5	1.3	1.7	1.2	1.7
Gross official reserves (USD billion)	29.4	96	110	113	99	112	106	116
Monetary (% change)³								
GDP deflator ¹	20.4	8.3	7.5	3.8	5.0	5.4	4.0	2.5
Bank Indonesia benchmark policy rate (%)	..	..	..	..	..	..	6.3	4.8
Domestic credit (eop)	..	22.8	24.6	23.1	21.6	11.6	10.4	7.9
Nominal exchange rate (average, IDR/USD)	8,392	9,087	8,776	9,384	10,460	11,869	13,389	13,309
Prices (% change)¹								
Consumer price Index (eop)	9.4	7.0	3.8	3.7	8.1	8.4	3.4	3.0
Consumer price Index (average)	3.7	5.1	5.3	4.0	6.4	6.4	6.4	3.5
Indonesia crude oil price (USD per barrel, eop) ⁴	28	79	112	113	107	60	36	51

Source: ¹ BPS and World Bank staff calculations, using revised and 2010 rebased figures. ² MoF and World Bank staff calculations, ³ BI, ⁴ CEIC

Appendix Table 4: Indonesia's development indicators at a glance

	2000	2010	2011	2012	2013	2014	2015	2016
Demographics¹								
Population (million)	213	242	245	248	251	254	258	261
Population growth rate (%)	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.1
Urban population (% of total)	42	50	51	51	52	53	53.7	55
Dependency ratio (% of working-age population)	55	51	51	50	50	49	49.0	49
Labor Force²								
Labor force, total (million)	98	117	117	120	120	122	122	125
Male	60	72	73	75	75	76	77	77
Female	38	45	44	46	45	46	46	48
Agriculture share of employment (%)	45	38	36	35	35	34	33	32
Industry share of employment (%)	17	19	21	22	20	21	22	21
Services share of employment (%)	37	42	43	43	45	45	45	47
Unemployment, total (% of labor force)	8.1	7.1	7.4	6.1	6.2	5.9	6.2	5.6
Poverty and Income Distribution³								
Median household consumption (IDR 000 per month)	104	374	421	446	487	548	623	697
National poverty line (IDR 000 per month)	73	212	234	249	272	303	331	354
Population below national poverty line (million)	38	31	30	29	28	28	29	28
Poverty (% of population below national poverty line)	19.1	13.3	12.5	12.0	11.4	11.3	11.2	10.9
Urban (% of population below urban poverty line)	14.6	9.9	9.2	8.8	8.4	8.3	8.3	7.8
Rural (% of population below rural poverty line)	22.4	16.6	15.7	15.1	14.3	14.2	14.2	14.1
Male-headed households	15.5	11.0	10.2	9.5	9.2	9.0	9.3	9.0
Female-headed households	12.6	9.5	9.7	8.8	8.6	8.6	11.1	9.8
Gini index	0.30	0.38	0.41	0.41	0.41	0.41	0.41	0.40
Percentage share of consumption: lowest 20%	9.6	7.9	7.4	7.5	7.4	7.5	7.2	7.1
Percentage share of consumption: highest 20%	38.6	40.6	46.5	46.7	47.3	46.8	47.3	46.2
Public expenditure on social security & welfare (% of GDP) ⁴	..	0.40	0.40	0.39	0.59	0.53	0.59	0.60
Health and Nutrition¹								
Physicians (per 1,000 people)	0.16	0.29	..	0.20	..	..	..	..
Under five mortality rate (per 1000 children under 5 years)	52	33	32	30	29	28	27	..
Neonatal mortality rate (per 1000 live births)	22	16	16	15	15	14	14	..
Infant mortality (per 1000 live births)	41	27	26	25	24	24	23	..
Maternal mortality ratio (modeled est., per 100,000 live births)	265	165	156	148	140	133	126	..
Measles vaccination (% of children under 2 years)	76	78	80	82	81	75	75	76
Total health expenditure (% of GDP)	2.0	2.9	2.7	2.9	2.9	2.8	..	..
Public health expenditure (% of GDP)	0.7	1.1	1.1	1.2	1.2	1.1	1.2	1.4
Education³								
Primary net enrollment rate (%)	..	92	92	93	92	93	97	97
Female (% of total net enrollment)	..	48	49	49	50	48	49	49
Secondary net enrollment rate (%)	..	61	60	60	61	65	66	66
Female (% of total net enrollment)	..	50	50	49	50	50	51	51
Tertiary net enrollment rate (%)	..	16	14	15	16	18	20	21
Female (% of total net enrollment)	..	53	50	54	54	55	56	55
Adult literacy rate (%)	..	91	91	92	93	93	95	95
Public spending on education (% of GDP) ⁵	..	3.5	3.6	3.8	3.8	3.6	3.5	3.0
Public spending on education (% of spending) ⁵	..	20.0	20.2	20.1	20.0	19.9	20.6	20.0
Water and Sanitation¹								
Access to an improved water source (% of population)	78	85	85	86	86	87	87	..
Urban (% of urban population)	91	93	93	94	94	94	94	..
Rural (% of rural population)	68	76	77	77	78	79	80	..
Access to improved sanitation facilities (% of population)	44	57	58	59	60	61	61	..
Urban (% of urban population)	64	70	71	71	72	72	72	..
Rural (% of rural population)	30	44	45	46	47	48	48	..
Others¹								
Disaster risk reduction progress score (1-5 scale; 5=best)	..	..	3.3	..	..	..	..	..
Proportion of seats held by women in national parliament (%) ⁶	8	18	18	19	19	17	17	17

Source: ¹ World Development Indicators; ² BPS (Sakernas); ³ BPS (Susenas) and World Bank; ⁴ MoF, Bappenas, and World Bank staff calculations, only includes spending on rice distribution for the poor (Raskin), health insurance for the poor, scholarships for the poor, and Family Hope Program (PKH) and actuals; ⁵ MoF; ⁶ Inter-Parliamentary Union



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