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INDONESIA ECONOMIC QUARTERLY

Weathering the storm

June 2009

THE WORLD BANK | BANK DUNIA

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Investing in Indonesia's Institutions

for Inclusive and Sustainable Development

Preface

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

This Indonesian Economic Quarterly was prepared and compiled by the macroeconomic analysis team at the World Bank's Jakarta office: Tim Bulman, Economist, supervised by Shubham Chaudhuri, Senior Economist, under the leadership of Lead Economist William E. Wallace. Other teams in the World Bank's Poverty Reduction and Economic Management group, Jakarta office, plus analysis produced by the World Bank's Development Economics Prospects Group based in Washington DC, also contributed to this update:

- Matt Wai-Poi prepared the analysis of the impact of the slowdown on Indonesia's employment outlook and the welfare of its poorest citizens, working with Vivi Alatas and Edgar Janz. More on Indonesia's labor markets can be found in the forthcoming Indonesia Jobs Report.

- Sjamsu Rahardja with Fitria Fitrani contributed the sections focusing on the impact on trade of the global crisis, and prepared the analysis of Indonesia's trade prices and the forecast of Indonesia's nominal trade flows.

- Sarah Horrignan contributed the analysis of the Indonesian government's budget disbursement, drawing on work with Hari Purnomo and Vijay Ramachandran; analysis by Dhaine Nugroho also contributed to this focus section.

For more World Bank analysis of Indonesia's economy…

The World Bank's Indonesia macroeconomic team has started blogging. Read Nalar Ekonomi Indonesia's latest comments on Indonesian economic developments, and contribute to the discussion by following the links from http://eapblog.worldbank.org/

To be included on an email distribution list for this Quarterly series and related publications, please contact madriani@worldbank.org. For questions and comments relating to this publication, please contact tbulman@worldbank.org. For information about the World Bank and its activities in Indonesia, please visit www.worldbank.org/id

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Executive Summary: Weathering the storm

The global economic downturn has impacted Indonesia's growth, but later and by less than elsewhere

Indonesia's slowdown has come relatively later and been more moderate than for many countries but the adverse effects of the global economic slowdown are now playing out. GDP growth slowed in the fourth quarter of 2008 and into the first quarter of 2009, to 4.4 percent y-o-y, from 6.4 percent in the year to the third quarter. For 2008 as a whole the Indonesian economy expanded by 6.1 percent, only slightly below 2007's 6.3 percent pace. Nevertheless, all sectors of the economy were impacted during the period of peak turbulence in global financial markets in late 2008. Into the first quarter of 2009 externally-focused sectors continued to be especially impacted by the global slowdown, while domestic demand rebounded on buoyant consumer confidence, stable retail prices and renewed investor confidence. Agriculture was a notably strong sector, with agricultural production increasing by 4.8 percent in 2008, the fastest growth since 1992. While agriculture now accounts for 14.4% of total output it continues to provide most or all of the support for 42% of households.

Indonesia's financial markets were affected by the global financial turmoil, but have lately staged a strong recovery

Indonesian financial markets have followed the ups and downs of recent global trends, albeit with greater amplitude. After being severely affected in October and early November, they strengthened with renewed global confidence from late November, before weakening again in mid-January as market participants' perceptions of the global situation deteriorated. Most recently Indonesian markets have strengthened again in response to policy shifts in the major economies, and Indonesian moves to shore up financing including the contingent financing from development partners, and swap agreements with Japan and China. After settling around 11,000 per USD in December, the rupiah depreciated gradually to well over 12,000, before recovering again recently to stabilize below 10,500. By the end of the year Indonesian government bonds had recovered much of their October and November losses (when, for example, the five year bond yield rose to over 20%), but then retreated in line with renewed global risk aversion. They have been recovering again recently and five year yields now stand at 10.2 percent. Front loading its financing needs, Indonesia issued USD 2 bn in 10 year bonds and USD 1 bn in 5 year bonds in February at 11.75 percent and 10.5 percent yields, and since then it has been able to sell longer-tenored bonds at gradually lower yields.

The banking sector remains in good health, but new lending has been cut

Although Indonesia's direct exposure to troubled American- and European-domiciled banks is limited, Indonesian bankers became more conservative in line with tightening global financial conditions. Far fewer new loans are being approved, and anecdotal reports suggest that some new customers have had difficulty accessing credit. While interbank lending has been improving since November and there is sufficient overall rupiah liquidity in the system, it is not evenly distributed with larger banks typically liquid and smaller banks facing problems. Nevertheless banking sector indicators continue to be relatively robust, and the nation's largest banks reported higher net profits in the first quarter of 2009.

And lower global commodity prices and global demand compression have hit Indonesia's exports…and imports

After several years of strong and sustained growth, lifted by rising commodity prices, the global downturn hit Indonesia's trade flows in late 2008. Indonesia's total exports reached USD 136 billion in 2008, 20 percent above 2007's exports. But the fall in commodity prices and, to a lesser extent, the compression in global demand had the anticipated impact on exports in the last quarter of 2008. By January, export values had dropped by 36.1 percent (y-o-y), the largest monthly fall in a decade. The dramatic decline in oil prices and associated falls in other commodity prices drove much of this decline in value. Real exports volumes were almost one-fifth below the levels of a year earlier by the first quarter of 2009. Imports are closely linked to exports and have been falling even faster: values were down about 30 percent in the first quarter of 2009 compared to a year earlier and are almost one-quarter lower in GDP (volume) terms. The net effect of these falls was some compression of Indonesia's merchandise trade surplus which declined from USD 5.8 bn in Q3 2008 to USD 4.6 bn in Q4, but recovered somewhat in the first months of 2009.

..as well as firms' profitability, leading to cuts in investment, employment, and consumer demand

With lower global commodity prices cutting profits and weakening demand firms are reducing investment and laying off workers. As noted consumption and investment growth both slowed with investment up 3.5 percent y-o-y in the first quarter of 2009 as equipment & machinery investment fell; however construction activity rose 6.3 percent, ahead of aggregate demand. Demand for consumer durables, notably motorcycles and motor vehicles, dipped in the fourth quarter and continued to fall in January before rebounding slightly from February – by April car sales were down 23 percent and motorcycles down 29 percent from April 2008. Reduced profits and falling orders, especially in the export sector, are leading to layoffs. Employers in the formal sector have reported around 30,000 permanent redundancies out of a formal sector workforce of about 36 million by early 2009 (total labor force is 105 million), although newspaper reports suggest the number may be above 200,000, including contract workers. Despite these more recent layoffs, unemployment in February 2009 was 8.14 percent, down 0.3 percentage points on a year earlier.

Consumer prices have stabilized, allowing Bank Indonesia to loosen monetary policy

Inflation has slowed sharply with the fall in commodity prices. Reductions in international prices are passing into domestic and regulated prices (as fuel prices have been adjusted downward). Consumer prices have stabilized: they did not move from November 2008 to April, reducing the year-on-year inflation rate to 7.3 percent from a peak of over 12 percent in September. The inflation rate has fallen even more for poorer households whose consumption basket has a greater weight in food. Consumer inflation expectations are now at their lowest level since early 2005, when actual inflation was running close to 5 percent. Lower inflation and the deteriorating global economy have prompted BI to lower its policy rate by 225 basis points from December to May, after a proactive anti-inflationary stance through the third quarter of 2008.

Despite the global downturn, Indonesia's external position remains sound, the country's significant external financing obligations are being met, and reserves have risen slightly

Indonesia's external position remains sound, though weaker than in 2007. Developments in global commodity and financial markets buffeted Indonesia's balance of payments throughout 2008. While the current account ended the year in a small surplus of USD 0.6 bn (forth quarter), portfolio outflows at the end of the year moved the overall balance of payments to a deficit of USD 1.9 billion, the first since 2001. Both the current account and capital flows were in substantial surpluses in the first quarter of 2009, lifting the balance of payments surplus to USD 4.0 bn. After declining by close to USD 10 billion in September and October foreign reserves have subsequently been relatively stable rising slowly from USD 50 bn to USD 56.7 bn at the end of April, equivalent to over 4 months of imports and official debt repayments.

Indonesia's public finances are strong, allowing policy makers to quickly move to offset the global downturn's effects on Indonesia

Indonesia's government is well-positioned to respond to the downturn. In 2008 the budget deficit was just 0.1 percent of GDP, compared with 2.1 percent projected earlier in the year when international oil prices and Indonesia's energy subsidies peaked. Revenues were 9.6 percent above budgeted levels, due to high commodity prices and improvements in tax office administration, while underspending continued as it has in recent years. Despite the exchange rate depreciation the debt to GDP ratio continued its secular decline ending the year at 33 percent.

In anticipation of declining revenues and the need for fiscal stimulus, Parliament approved an accelerated revised 2009 budget, with a 2.5 percent deficit target and 1.5 percent stimulus package. The revised budget seeks to stimulate demand, expanding government spending on infrastructure, and lowering taxes for specific sectors, in addition to already-programmed reductions in tax revenues. This stimulus will add to the government's financing needs in 2009, which the government plans to meet by applying the surplus financing from 2008, and raising USD 12.5 bn from local and global markets. By late May the government had raised around over four-fifths of this amount; in addition to the international bond issue (above) they have issued USD 4.2 bn in domestic financing. In the event the Government is unable to access markets, the government can tap back up support from its development partners.

The global downturn will continue to slow Indonesia's growth

The global downturn, lower global commodity prices, and tighter global financing will continue to slow Indonesian growth in 2009 and 2010. The sharp downturn in the global economy combined with the fall in commodity prices imply lower external demand and reduced incomes in exposed sectors and regions than in recent years. Tightening domestic credit conditions and greater uncertainty about the global outlook are reducing

investment and consumer durable purchases. Together these factors are expected to slow growth to between 3 and 4 percent in 2009, before a gradually recovering global economy in 2010 pushes growth back into the 5 percent range.

… and limit gains on social indicators, particularly poverty reduction

The crisis is expected to put pressure on poverty but some protection is provided by lower food prices, strong growth in agriculture and government programs including cash transfers and a program of community block grants that reaches national scale in 2009. Continued employment and income losses risk reversing these gains in 2010, although the Government is to be commended for its efforts to put in place a crisis monitoring and response system.

A. ECONOMIC UPDATE

1. The global economic outlook has deteriorated rapidly...

Growth at the end of 2008 was uniformly bad, led by an unprecedented decline in industrial production

GDP outturns at the end of 2008 and early 2009 were uniformly bad. Global GDP barely grew in 2008, and is likely to have shrunk in the year to the first quarter 2009 (in purchasing power parity terms), an extreme deterioration from the 4 and 5 percent growth that had continued for several years to mid-2008. All developed economies now show large GDP compression, with the biggest hit taken by Japan with a 12.7 percent SAA falloff in the fourth quarter grounded in a virtual collapse in exports. Into the first quarter of 2009, the picture has been more mixed. The 6.1 percent SAA decline in U.S. first quarter GDP was even worse than expected; in the region, the 19.7 percent fall in Singapore's GDP and Thailand's 7.3 percent fall in GDP were also below expectations, on the other hand Korea's output stabilized.

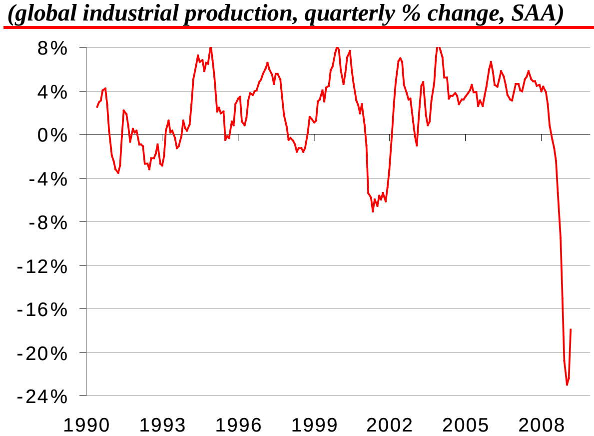
The cuts to industrial production have been global

The downturn in global GDP was led by a collapse in world industrial production. By March 2009, global industrial output was more than 13 percent below its peak in February 2008 (SA). (Figure 1) Sharp falls occurred in both high-income (-18.3 percent below a February 2008 peak) and developing (-4.5 percent below a June 2008 peak) economies. The collapse has been truly global, but producers of capital goods, Japan (-35 percent from 2008's peak to the most recent observation) Germany (-22 percent), and Korea (-22 percent), and the vulnerable Eastern Europe and Central Asia region have been hit especially hard. By late May, conditions had improved, with some economies' industrial output growing, and leading indicators, such as JPMorgan's Global All-Industry PMI, rising from rock-bottom levels, although they generally remain well within the 'declining output' range.

With the fall in global production, trade flows globally and especially in Asia are collapsing

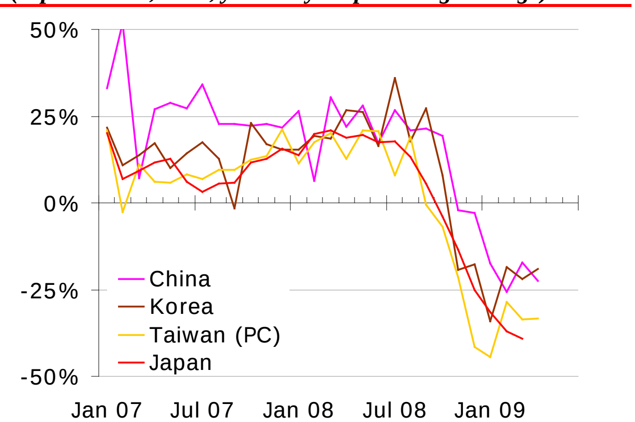
Contractions in international trade transmitted the downturn globally and have had an especially marked effect in East Asia. Initially a sharp falloff in U.S. import demand adversely affected exports and activity in partners Japan and Europe. OECD demand, retrenching in a synchronized fashion, affected exports from developing countries particularly in East Asia, in turn quickly limiting emerging economies' import demand, which then brought more pressure on high income economies' exports. And so on. OECD imports dropped abruptly in the final quarter of 2008, with U.S. import volumes compressing at an annual pace of 16.0 percent; those in France by 10 percent, while Japan's imports picked up with the strength of the yen. Trade across East Asia has fallen especially sharply, with the region's production networks exposing all its economies to the downturn in demand in high-income countries. Exports across the region's major economies fell by at least 50 percent in annualized terms by January 2009. Since then, trade flows have followed the stabilization and, in some cases, partial recovery in industrial production. (Figure 2)

Figure 1: Industrial production slumped globally at the end of 2008, with some recovery by March 2009
(global industrial production, quarterly % change, SAA)



Sources: Thomson/Datastream and World Bank

Figure 2: ...bringing even larger contractions in trade, especially in East Asia
(export values, USD, year-on-year percentage change)



Sources: National Statistical Agencies via Haver Analytics

International credit conditions remain tight and capital flows limited, though both have improved somewhat since late 2008, and sovereigns have been able to raise new finance

After very limited capital flows in the final quarter of 2008, some liquidity returned in the first months of 2009, supported by increased bond issuance. (Table 1) While total issuance of USD 23 billion in January is much lower than the average issuance over the past four Januarys of USD 30 billion, it is considerably higher than the fourth quarter's total issuance of USD 4.9 billion. Sovereigns continued to dominate in new issuance (USD 5.8 billion of sovereign-issuance against USD 2.8 billion of corporate issuance reported in January 2009, for example), as many took advantage of strong local demand and improving market conditions. Meanwhile, bank lending was weak at the start of 2009; and no activity was recorded for equity issuance for a third month in succession. Emerging credit ratings of sovereigns have generally been cut, especially in eastern Europe, raising the cost of borrowing and restricting market access.

After falling fast and far in the second half of 2008, commodity prices stabilized or even risen slightly in early 2009

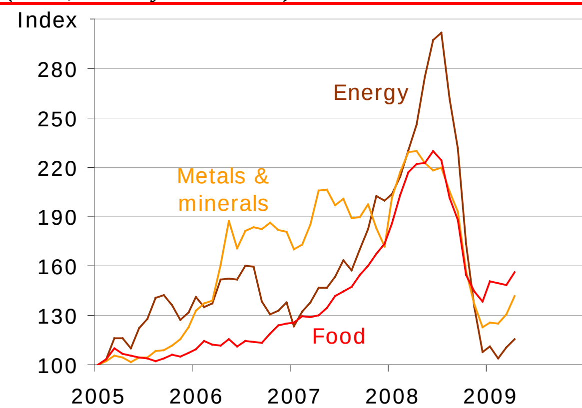
Commodity prices stabilized in early 2009 around 40 percent below their mid-2008 peaks, although from a longer-term perspective they remain relatively high at almost 60 percent above the lows of the late-1990s. (Figure 3) Energy prices were particularly volatile. Following their USD 100 per barrel fall from early July to the start of December 2008, crude oil prices have stabilized within a USD mid-30s to mid-40s range as OPEC's cuts in production largely offset falling demand, then rose to above USD 60 by late May.

Table 1: Capital flows, weak since late 2008, are yet to recover
(billions of USD)

	2007				2008					2009			
USD billion	**Total**	Q1	H1	H2	**Total**	Q1	H1	H2	Dec	Q1	Jan	Feb	Mar
Total	**652**	**156**	**349**	**302**	**389**	**103**	**251**	**119**	**17**	**40**	**23**	**8**	**9**
Bonds	**146**	**58**	**107**	**39**	**65**	**12**	**53**	**12**	**3**	**18**	**9**	**7**	**2**
Banks	**312**	**72**	**156**	**156**	**257**	**71**	**151**	**106**	**14**	**13**	**8**	**1**	**5**
Equity	**194**	**26**	**86**	**107**	**68**	**20**	**47**	**2**	**0**	**8**	**6**	**1**	**2**
Latin America	**156**	42	69	87	**90**	19	56	24	6	17	9	3	4
Bonds	**45**	20	31	14	**20**	5	17	3	2	10	5	3	2
Eastern Europe	**247**	79	156	91	**157**	36	98	56	5	5	5	1	0
Bonds	**64**	27	50	14	**35**	2	27	8	34	3	2	1	0
Asia	**188**	24	93	94	**98**	38	69	23	4	14	8	4	2
Bonds	**23**	8	18	6	**7**	3	7	0	0	5	2	3	0
Others	**61**	11	31	30	**44**	11	27	15	3	3	0	1	2

Source: World Bank

Figure 3: After the volatility of 2008, commodity prices stabilized in early 2009
(index, January 2005 = 100)



Source: World Bank

2. ...and the Indonesian economy is beginning to feel its adverse effects

a. GDP growth slowed at the end of 2008

Indonesia's GDP growth slowed sharply in Q4 2008

Indonesia's GDP growth stalled in the fourth quarter of 2008 and the little growth in the first quarter of 2009 appears to be largely due to temporary factors. The year-on-year growth rate fell to 4.4 percent by the first quarter 2009 from a revised 6.4 percent in the year to the third quarter 2008. Over 2008 the Indonesian economy expanded by 6.1 percent, only slightly below 2007's 6.3 percent pace.

The slowdown was faster than generally expected in the final quarter of 2008. This occurred during the peak period of turbulence in global financial markets. It was broadly-based across private spending categories, and both tradables and most non-tradables industries' output grew more slowly; some offset came from expanding government spending (Figure 4 and Table 2). By the first quarter of 2009, the most externally-oriented parts of Indonesia's economy continued to be impacted by the bleaker global conditions. But domestic demand had recovered somewhat, led by private and government consumption and the industries supplying that demand, although this in at least part appears to be due to spending related to the legislative elections. Arguably the most positive development was agricultural production growth in 2008 of 4.8 percent, the strongest annual growth since 1992.

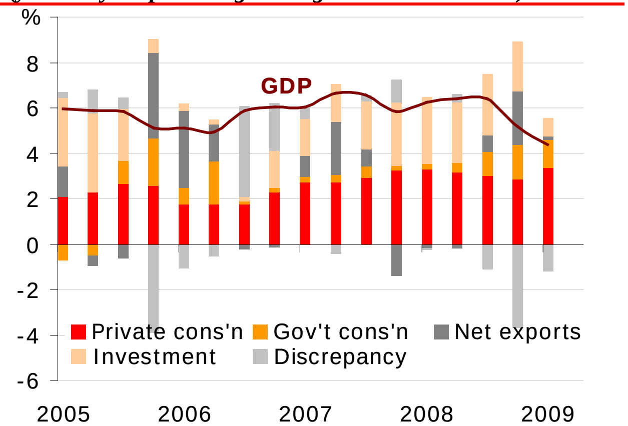
Domestic demand, from both consumers and the government, have supported the economy, while trade volumes have collapsed and investment has weakened

Table 2

	2007	2008	2008 Q2	2008 Q3	2008 Q4	2009 Q1
	Annual % change		*Year-on-year percentage change*			
Total GDP	**6.3**	**6.1**	**6.4**	**6.4**	**5.2**	**4.4**
Domestic	**6.0**	**7.4**	**7.1**	**7.9**	**7.1**	**6.2**
Private consumption	5.0	5.3	5.5	5.3	4.8	5.8
Government consumption	3.9	10.4	5.3	14.1	16.4	19.2
Investment	9.4	11.7	12.0	12.2	9.1	3.5
(Construction)	8.6	7.3	8.1	7.6	5.7	6.3
External	**6.8**	**7.3**	**-1.9**	**9.0**	**25.5**	**1.8**
Exports	8.5	9.5	12.4	10.6	1.8	-19.1
Imports	9.0	10.0	16.1	11.0	-3.5	-24.1

Figure 4

(year-on-year percentage change and contributions)



Sources: BPS and World Bank

Indonesia's slowdown has come later and, so far, been more moderate, than elsewhere in the region, in large part due to its relatively smaller export shares

Indonesia was one of few economies globally to maintain its growth momentum into the third quarter of 2008; growth in most other economies in the region started slowing in late 2007 (Figure 5). In recent years, Indonesia's growth has not been as reliant on increasing exports. The share of Indonesia's output that is exported is the smallest of the major economies in South East Asia, and the growth of this share has not been especially fast. (Figure 6) Similarly, Indonesia's tradables production industries (in contrast to the production that is not easily tradable, such as utilities or government services) contributed about one-third of the growth in Indonesia's output in the past five years, about the same as in Malaysia, but otherwise the smallest contribution among the South East Asian economies.

Figure 5: Indonesia's growth slowdown has come later, and been more moderate, than elsewhere in the region

(year-on-year growth)

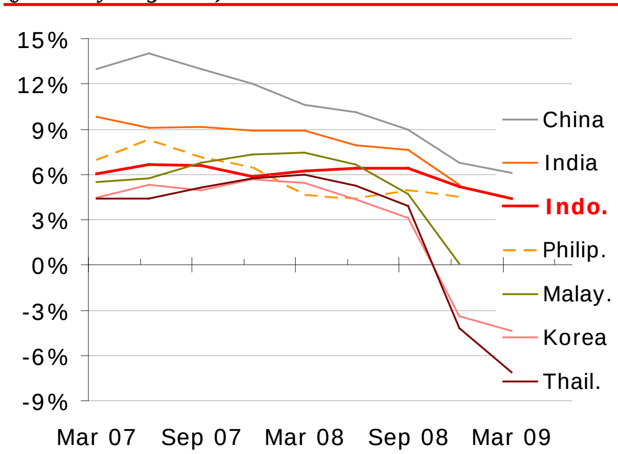
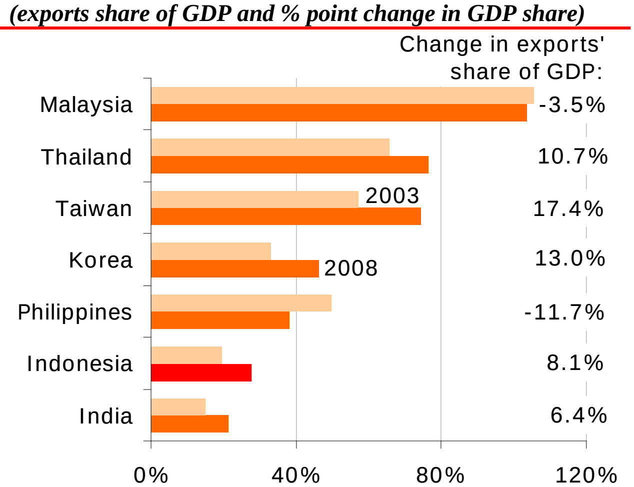


Figure 6: Indonesia's exports make up a relatively smaller share of the economy, and have not expanded as rapidly as in many other economies in the region

(exports share of GDP and % point change in GDP share)



Sources: National statistical authorities via CEIC, and World Bank

So while Indonesia did not enjoy the extent of the export-led growth of other economies, it was impacted by compression in global demand later and to a smaller extent than other economies in the region. Elsewhere in the region, the halt in external demand brought falling exports, so that net exports have switched from making significant contributions to significant subtractions from aggregate growth (with the exception of Korea, where the slowdown in domestic demand has been very significant, cutting import demand).

b. The global downturn has hit Indonesia's trade flows

Indonesia's exports achieved strong and sustained growth through to 2008, lifted by trading partner growth and rising commodity prices

Up to mid-2008, commodity prices boomed and Indonesia's emerging trading partners of China, Malaysia and India grew strongly. This lifted Indonesia's exports to new levels. Total exports reached USD 136 billion, 20 percent above 2007's exports, which in turn were 13 percent above 2006 levels. Agricultural and natural resource goods contributed most to export growth – notably, crude palm oil (CPO), rubber, ores, minerals, petroleum, and natural gas. Exports of certain manufactured products such clothing, footwear, and automotive parts also increased considerably, as Indonesia built a niche as a mid-market producer.

...and the collapse of commodity prices and global downturn are now hitting Indonesia's export values hard

Just as they were an earlier source of growth, the fall in commodity prices and compression in global demand had the anticipated impact on Indonesia's exports from the last quarter of 2008. Total export values in the fourth quarter fell by 6.2 percent y-o-y or by 22 percent relative to the third quarter, and export values only began to stabilize in March 2009. By January export values were 36.1 percent below the level of a year earlier, the largest monthly fall in a decade; even with some recovery in March, they were still down 29 percent on a year earlier (Figure 7). Export volumes – ie, controlling for the collapse in commodity prices – started falling in the third quarter of 2008, and by the first quarter of 2009 were almost one-fifth lower than a year earlier. However this may overstate the true fall in export volumes. These data are taken from the national accounts, which also report that the nominal value of exports has fallen by only 13 percent in the year to the first quarter, implying that Indonesia's export prices are 9.4 percent higher than a year ago, in contrast to the steep falls in commodity prices especially over this period.

The more-than two-thirds drop in oil prices to a low near USD 30 drove much of the decline in Indonesia's export values; the value of oil & gas exports contracted by 31 percent in the fourth quarter of 2008 y-o-y, with little change in export volumes. Lower commodity prices and the downturn across Indonesia's major trading partners are also causing severe falls in the value of agriculture, minerals and mining exports. And resources exports are not the only sector to be affected by global events. Declining global demand and compression in trade volumes also affected manufactured export values, which fell by 21 percent in the year to March.

…but not as hard as elsewhere in the region

While the retrenchment in Indonesia's exports has been sharp, it has been even more severe elsewhere in the region (Figure 2). Exports of Japan and the new industrialized economies (NIEs) of East Asia have been hit harder than Indonesia by the twin blows of the slowdown in demand for manufactures in European and North American markets, plus declining demand for machinery parts and components from China, Malaysia, and Thailand. As production chains fragmented across the region, these economies became major production bases assembling goods for high-income markets, and so the fall in demand outside of the region has cut intra-regional trade. Exports of Singapore and Malaysia have also been hit harder than Indonesian exports by falling demand for electronics and other manufactured goods in European and American markets.

Imports have fallen at least as sharply as exports, due to lower global prices…and less processing for export goods

Both the value and quantity of imports has been dropping too, at least as fast as the fall in exports. The pace of decline in imports may at first surprise, given Indonesia's ongoing relatively firm growth. In part it is because of lower commodity prices, especially for refined petroleum, cutting the value of the goods imported. At the same time, external demand for manufactures produced in Indonesia has fallen, and these manufactures generally use some imported inputs. World Bank estimates suggest that a 10 percent fall in Indonesia's total exports reduces total import demand by 4 percent and imports of capital goods by as much as 9 percent.

Total import values in the first quarter were down over one-third compared to a year earlier. In volume terms – ie, after controlling for price movements – imports fell by 28 percent. Sharp falls in imports of oil & gas, intermediate goods, and, to a much lesser extent, capital and transport goods into March contributed to the decline. Imports of consumer and other products, which constitute less than 5 percent of total imports, continued to grow into early 2009.

Declining fuel prices and lower imports have expanded Indonesia's trade surplus

In Balance of Payments terms (ie, not accounting for the cost of shipping and insuring imports to Indonesia, costs which fell sharply in the fourth quarter of 2008), merchandise imports and exports both dropped by about one-fifth between the third and fourth quarters of 2008. In early 2009, export values continued to fall at this pace, while import values fell even faster, by 31 percent. This had the effect of widening the trade surplus to USD 6.2 bn in the first quarter of 2009, the largest in a year. Over 2008, the run up in energy prices compressed the trade surplus (in customs terms, ie including the shipping and import cost for imports). While Indonesia is a net energy exporter, the prices of the types of energy products that it imports, especially refined fuels, increased faster than the prices for the crude oil and gasses that it exporters. Since the third quarter 2008, the opposite has happened, bringing the reverse effect of widening of Indonesia's total trade surplus (Figure 8).

Figure 7: Indonesia's export values fell in substantially in the first quarter after a flat fourth quarter
(year-on-year percentage change)

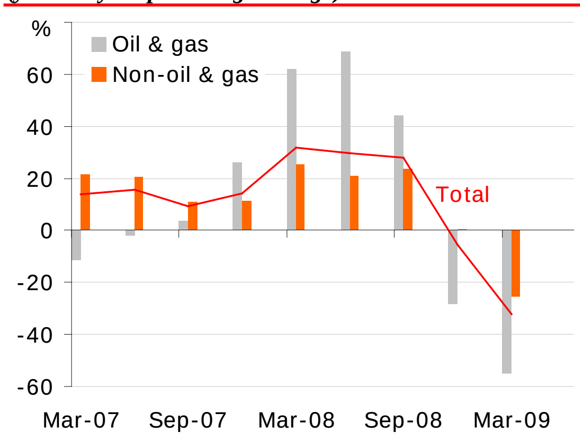
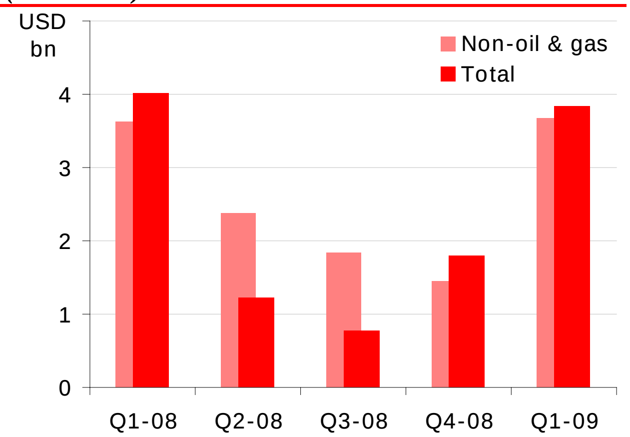


Figure 8: The fall in oil prices expanded the trade surplus
(USD billion)



Sources: BPS and World Bank

c. With weakening demand and activity, and lower commodity prices cutting profits, firms have reduced investment and laid off workers

Private demand was hit by the global financial turmoil in late 2008, but consumers have since regained some confidence

All categories of domestic private demand slowed during the period of peak turbulence on global financial markets in the fourth quarter of 2008. But households appeared to have recovered confidence in the first quarter, as prices stabilized and incomes were further supported by the final tranche of the unconditional cash transfer program, spending associated with the legislative elections, and, for rural households, a strong harvest. Private consumption rose to 5.8 percent in the year to the first quarter, the fastest pace this decade; non-food consumption rose by 7.0 percent.

In contrast, investment spending slowed further in the first quarter, to 3.5 percent y-o-y, as firms cut machinery and appliance purchases. Construction growth continued to slow from the pace of early 2008 according to the quarterly data, although the year-on-year data report stable growth. The cuts in investment spending appear to be concentrated in machinery & appliance investment, which was 8.6 percent lower than the first quarter 2008. Spending on transport equipment was cut even more substantially, although this is only about one-third the size of machinery investment.

While consumers have cut purchases of some big-ticket items, confidence remains very robust

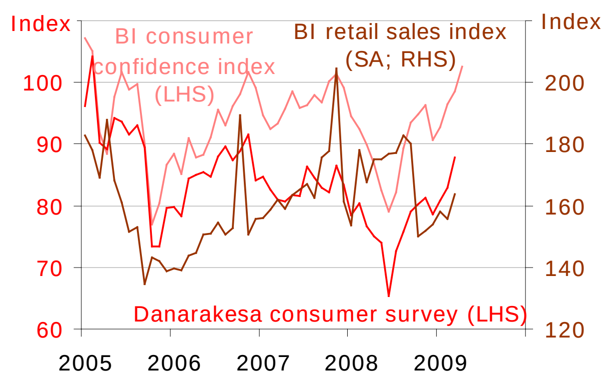
Consumption indicators filling out the national accounts presentation are mixed. On the one hand, consumers' purchasing power is being supported by the stabilization in retail prices since November, by spending by legislative election candidates, by the good harvest season especially for rice, and, for poorer households, the government's unconditional cash transfer program (BLT), and these factors have fed into more positive responses to confidence surveys. After falling with the inflation outbreak in the first half of 2008, surveyed consumer confidence recovered in the third quarter and by March 2009 the balance of respondents had a positive outlook, for the first time since late 2007 – despite the flow of negative economic news since October. Meanwhile BI's retail sales

index stabilized in early 2009 and remains well above the troughs of late 2005 after falling in the third quarter of 2008 (Figure 9)

The relatively modest slowing in non-food consumption growth contrasts with the sharp falls in motor cycle and motor vehicle sales at the end of 2008. Sales numbers fell dramatically in January, before recovery in February and March, but are still around 30 percent lower than a year earlier (Figure 10). Anecdotal reports suggest this slump in demand has been greatest off-Java, in areas most affected by the commodities downturn. Others attribute the drop to financing companies tightening their lending since credit conditions became more restricted in September.

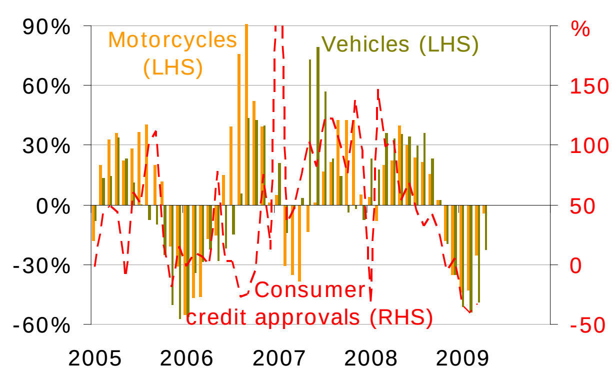
Somewhat offsetting the relatively robust Indonesian consumer, the number of overseas visitors was unchanged in the year to March 2009, in contrast to the double-digit growth rates of the previous 2 years. Further, anecdotal reports suggest that the average international tourist visiting Indonesia in early 2009 was more frugal than their mid-2008 counterpart.

Figure 9: Retail sales indicators have stabilized since late-2008, and consumer confidence is near historical highs
(indices)



Notes and sources: * World Bank experimental seasonal factors. BI via CEIC and Danarakesa

Figure 10: Motor vehicle sales fell sharply at the end of 2008, but have since stabilized
(quarter-on-quarter growth, annualized)



Sources: Astra and BI via CEIC, World Bank

...but businesses are cutting investment spending

Businesses are cutting back on spending. Real investment dropped in the first quarter of 2009, in contrast to the 12-to-14 percent annualized growth rates of much of 2007 and early 2008. Spending was lower on machinery, appliances and transport equipment, which together constitute about 20 percent of total investment reported in the national accounts. This slowdown is corroborated by the fall in capital goods imports (broadly defined), 5.4 percent lower in March than a year earlier and about two-thirds below December's levels, although aircraft purchases inflated the October and November imports. Investment's share of nominal GDP rose to 27.6 percent in 2008 from 25.0 percent in 2007, a post-1997/98 crisis high.

Growth in construction activity has been slowing since mid-2008, according to seasonally adjusted quarterly data, but the slowdown has not been great and spending was still 6.3 percent higher in the first quarter of 2009 on a year earlier. Activity may be stabilizing in the second quarter, with cement sales, an indicator of investment in new buildings, factories, and large-scale infrastructure, down 5.5 percent by April on a year earlier, although this fall may be due to lower export demand.

…and borrowing less

Businesses are also borrowing less for investment, although it is unclear whether this reflects lower demand for credit as businesses cut spending plans rather than banks tightening their lending. Lending by commercial banks to enterprises was cut by January from the peaks of 2008, but recovered somewhat in February and March. Lending to mining, construction and manufacturing was cut especially immediately after the period of peak turmoil on financial markets, although in March miners were expanding their borrowing again. Lending is likely to continue to fall, with approvals for new loans for investment and for working capital down a massive 50 to 60 percent in March y-o-y.

Expanded government spending is supporting private demand

Public sector spending is offsetting some of the weakness in investment demand. Real consumption spending by all levels of government accelerated to 19.2 percent in the year to the fourth quarter, contributing 1.2 percentage points to Indonesia's overall growth. In annual terms, real government consumption rose by 10.4 percent in 2008, compared with 3.9 percent in 2007, the fastest growth since 2002. Higher spending on goods rather than on officials drove the overall increase. This momentum is likely to have continued into the second quarter of 2009, with more spending on goods and a faster disbursement than in earlier years.

d. Production growth slowed across both tradables and non-tradables industries

Most industries recorded slower output growth, although non-tradable sectors continue to outpace tradables

Output fell or grew much less rapidly across both tradables and non-tradables industries in the final quarter of 2008, before production showed some recovery in many more domestically focused industries in the first quarter of 2009. The notable exception is agricultural production, which has maintained above-average growth. (Figure 11, Table 3) Output of tradables decelerated to 2.6 percent y-o-y in Q4 2008 and Q1 2009, from 3.7 percent y-o-y in the first three quarters of the year. Manufacturing output slowed considerably, to 1.6 percent in the year to the Q1 2009 from the 4¼ percent growth rates recorded in the first part of the year. This more than offset stable mining output growth and accelerating agricultural production. While non-tradables industries' output continued to grow much faster than the tradables sector around the turn of the year, here too growth slowed – to 6.1 percent in the year to the first quarter of 2009 from 9.2 percent in Q3 2008.

Figure 11: Both tradables and non-tradables output growth slowed, but the gap difference in growth remains wide

(year-on-year growth)

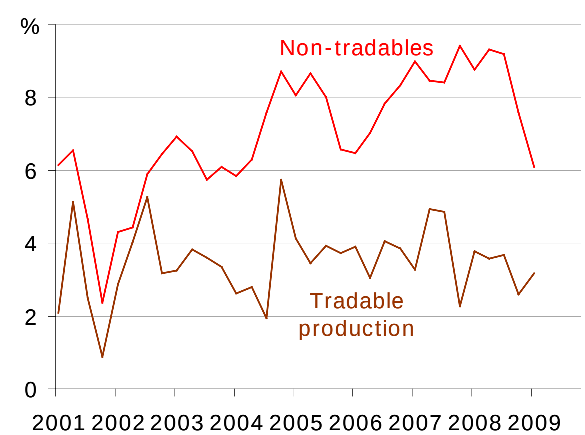


Table 3: The slowdown in manufacturing and construction output was particularly significant

	Share of GDP	2007	2008	2008 Q2	2008 Q3	2008 Q4	2009 Q1
	(%, 2008)	*Annual % change*		*Year-on-year percentage change*			
Tradable	**53.2**	**3.9**	**3.4**	**3.6**	**3.7**	**2.6**	**2.6**
Agriculture	14.4	3.4	4.8	4.8	3.4	4.7	4.8
Mining	11.0	2.0	0.5	-0.5	2.1	2.1	2.2
Manufacturing	27.9	4.7	3.7	4.2	4.3	1.8	1.6
Non-Tradable	**46.8**	**8.8**	**8.7**	**9.3**	**9.2**	**7.6**	**6.1**
Construction	8.5	8.6	7.3	8.1	7.6	5.7	6.3
Finance	7.4	8.0	8.2	8.7	8.6	7.4	6.3
Transport & comm's	6.3	14.0	16.7	17.3	15.5	15.8	16.7
Utilities	0.8	10.3	10.9	11.8	10.4	9.3	11.4
Trade & hospitality	14.0	8.4	7.2	8.1	8.4	5.6	0.6
Services	9.8	6.6	6.4	6.7	7.2	6.0	6.8
Oil	10.7	-0.8	0.2	0.8	-0.1	-0.2	-0.7
Non-oil	89.3	6.9	6.5	6.9	6.9	5.6	4.8
Natural resources	25.4	2.9	3.1	2.8	3.0	3.6	3.8
Non-natural resource	74.6	7.3	6.9	7.5	7.5	5.6	4.5
Total GDP	**100.0**	**6.3**	**6.1**	**6.4**	**6.4**	**5.2**	**4.4**

Sources and notes: BPS via CEIC and World Bank. Shares are of nominal GDP, growth rates are calculated with real data.

Output of many manufacturing industries fell in the December quarter

Output fell across most manufacturing industries in Q4 relative to Q3 (seasonally adjusted), but then recovered in some industries the first quarter of 2009. Overall, this cut y-o-y growth to 1.6 percent from 4.3 percent in the year to the third quarter 2008. Transport equipment production fell particularly sharply in the December and March quarters, with output contracting by 6 percent y-o-y, the weakest this decade for what has been a driver of Indonesian manufacturing growth. Iron & steel production has been falling since mid-2008, to be down almost 10 percent in the year to the March quarter. Textile, leather products & footwear production has also been falling, although the quarterly data show a recovery in the first quarter of 2009. Food, beverage & tobacco production was the only subsector to record significant output growth, almost 14 percent higher y-o-y. Paper & printing production was boosted in the first quarter, most likely by election-related spending.

Agriculture output grew at its fastest pace since the Asian crisis

Agricultural production accelerated to 4.8 percent y-o-y in Q1 with crop production increasing especially. The annual growth rate in 2008 of 4.8 percent is the fastest since 1992. Food crop production growth increased to 5.6 percent in the March quarter on a year earlier. The national accounts reported growth in the real volume of non-food crop production, which includes crops especially affected by the fall in commodity prices, of almost one-quarter y-o-y, but this is likely to be biased upwards by price movements.

Weakening oil & gas extraction continued to weigh on mining

As commodity prices slumped, mining output continued to grow weakly year-on-year (2.2 percent in the year to Q1), and was unchanged in the quarter (seasonally adjusted), weighed by a small fall in crude oil & gas production.

Non-tradables production, while still outpacing the overall economy, decelerated by 1 to 2 percentage points across most industries

Activity slowed across most domestically-oriented industries at the end of 2008, before many recovered in early 2009. The trade, hotels & restaurants industry recorded one of the largest slow-downs with output now barely changed on a year earlier, led by lower activity in wholesale & retail trade. Growth in financial, ownership & business services output slowed, on a drop in growth in building rental and business services activity. Services activity growth also slowed with the small acceleration in government services not enough to offset slower growth in private services. The most significant exception to this general weakening was communications, where activity continued to grow by about one-third year on year in real terms (and by about one-fifth before taking into account the fall in prices). Transportation activity fell slightly in real terms although spending continued to grow by about 16 percent y-o-y. Air transport activity, which had fallen in the first half of 2008, grew firmly in the fourth quarter and first quarter of 2009.

Together these factors are likely to be lowering profits, and have already lead to layoffs

Firms' profitability is likely to have been cut by lower external demand reducing production quantities, lower commodity prices reducing revenue, and the flow-on impacts on domestic demand. While we lack leading indicators of profits, firms were cutting employment at the start of 2009. Formal sector employers have reported around 50,000 redundancies out of a workforce of about 30 million. But the growth of contract labor firms in the past 5 years, supplying workers to, for example, labor intensive firms such as garment manufacturers, suggest that the actual number of workers that have lost or are soon to lose their job in early 2009 may be much higher. Nonetheless, despite these cuts in employment around the turn of the year, Indonesia's unemployment rate fell to 8.14 percent in February, down 0.3 percentage points from a year earlier.

3. After being buffeted by the global market turbulence, Indonesia's financial markets have improved by more than most since March

a. Financial markets have gained renewed confidence in the rupiah

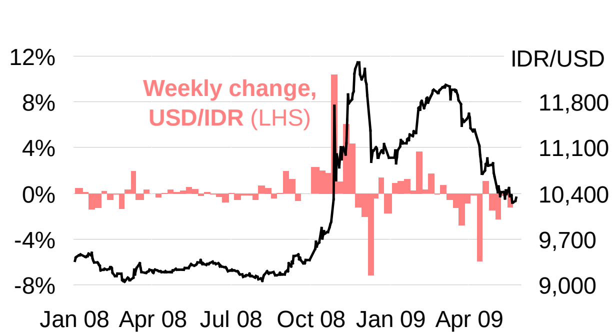
After the extreme volatility of October and November, and then again in February, the rupiah has settled below 10,500 per USD in the second half of mid-May

The rupiah/USD exchange rate has reversed its depreciation since December, as markets gain confidence in the economy's ability to meet its external financing needs and in the robustness of its foreign reserves, and as global investors become a little less risk averse.
.

After the volatility of October and November 2008, the rupiah traded near 11,000 per USD from early December to mid-January. In the following weeks, the rupiah progressively weakened, losing about 8 percent of its value against the USD by early March. (Figure 12) In part this reflected the strength of the USD against most currencies, as actors on global financial markets became more pessimistic about the global economic outlook – the Federal Reserve Board's broad dollar index appreciated 4.2 percent over this period. But during that episode, the rupiah was somewhat weaker than most East Asian currencies, apart from the Korean won (Figure 13). Market participants attributed the rupiah's relative weakness to Indonesian companies paying back foreign currency loans, and to non-residents gradually selling their holdings of government bonds.

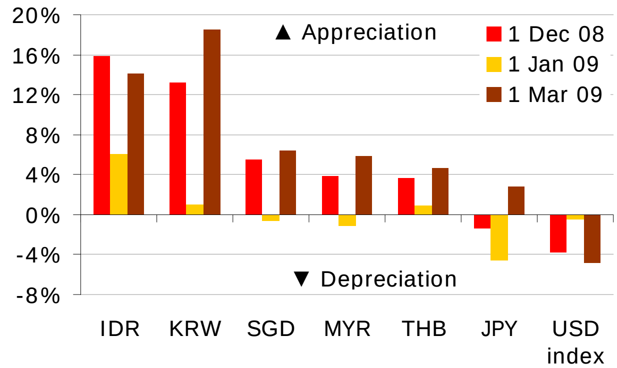
These factors reversed from early March, and the rupiah staged one of the stronger rallies in the region. This coincided with weakness in the USD as global investors gained confidence in the global economic outlook and the effectiveness of policy makers' response to the global downturn, and grew less risk averse. At the same time, confidence in Indonesian assets improved especially, as the economy gained access to more currency swap facilities, raised its foreign exchange reserves, achieved a balance of payments surplus, and staged orderly parliamentary elections.

Figure 12: After being buffeted by renewed global risk aversion in February, the rupiah returned to levels below 10,500 per USD in mid-May
(IDR per USD and weekly percentage change)



Sources: BI via CEIC, World Bank

Figure 13: ...this has been one of the strongest rallies in the region
(percentage change to late May 2009, inverted scale)



Sources: National central banks, via CEIC, and World Bank

b. The stock market has been among the region's strongest

The IDX composite index has generally moved with global markets, although with somewhat greater amplitude

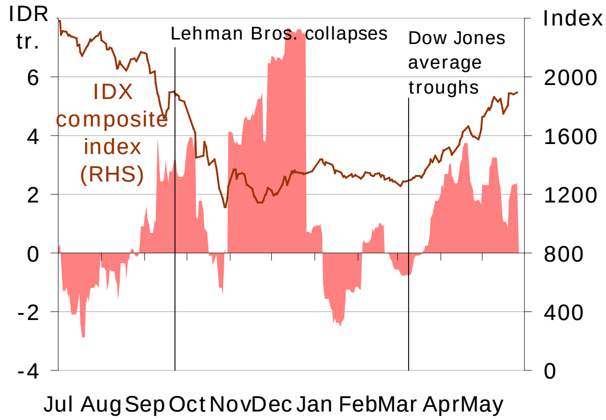
Like the currency markets, equities on Indonesia's stock markets recovered some of their October and early November losses in the final week of November and through December. By the first day of trade of 2009, the composite index had risen over a quarter from its November 24 low. But by early March the market had given up about half of those gains, as market participants became gloomier about the global economic outlook and non-resident investors became net sellers. Trading also became thinner.

These factors reversed from early March through to late May. The Indonesian market rose by one-half, as global market sentiment shifted. Mining stocks benefited especially, almost doubling in value on average. Market turnover also picked up, as non-residents moved back into making net purchases in the market – from its trough in early March to late May, non-residents purchased IDR 6.1 tr (about USD 0.6 bn) more than they sold on Indonesian markets – a return to the trend of most of 2008 (Figure 14).

While most regional and global markets have achieved significant rises since the start of March, the strength of Indonesia's stands out. (Figure 15) Compared with the start of December and the start of March, Indonesia's stock market has risen by more than any other regional market, apart from India's.

Figure 14: After buying into the Indonesian stock market during the peak market turmoil, non-residents became net sellers in early 2009, then returned as global risk aversion waned from late March

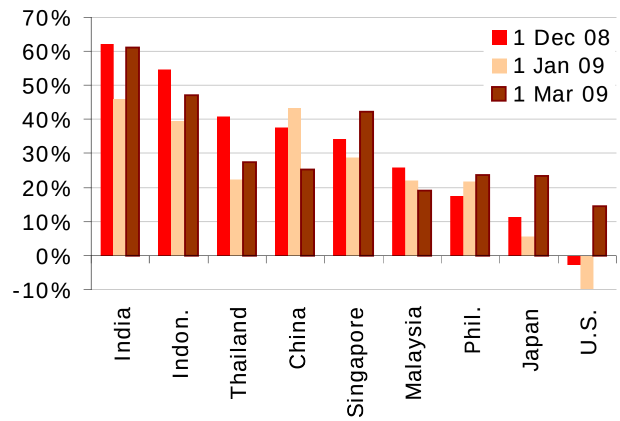
(net purchases by non-residents over the previous 30 days, IDR tr, and Indonesian Stock Exchange Composite Index)



Sources: IDX via CEIC, and World Bank

Figure 15: Indonesia's stock market outperformed all but India in the region and has been among the strongest in the world since December 1

(percentage change to late May)



Sources: Principal national stock market aggregate indices, via CEIC, and World Bank

c. Domestic bond yields have recovered from much of the recent volatility

Since December, Indonesian government bond yields recovered not only their much of their October and November losses

Like Indonesia's stock and currency markets, Indonesian government bonds recovered much of their October and November losses by early January, then suffered a second decline in confidence and rise in yields as global economic pessimism and risk aversion rose through February and March, but more than recovered these losses from the second half of March to late May.

The fall in IDR government bond yields has been significant and unmatched in other major south east Asian economies. (Figure 16) By late May shorter and medium tenor bonds (bonds due to mature in 1 to about 7 years) were at their lowest level in a year, before concern peaked in late April 2008 about the mounting cost of the government's fuel subsidies and the fiscal and inflation implications of price adjustment. This follows the

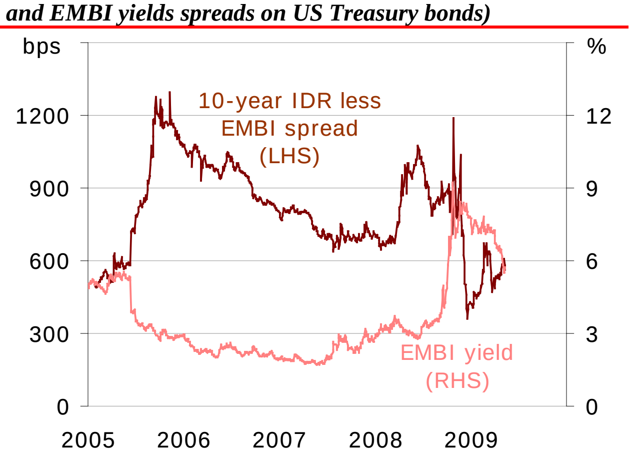
Figure 16: Although they have recovered since March, Indonesian sovereign bond yields remain far higher and volatile than those elsewhere in the region

(5 year local currency sovereign bond yields)

Source: National exchanges, via CEIC

Figure 17: While the wedge between Indonesian sovereign USD and IDR bonds has fallen from December's troughs, Indonesia's USD bond yields remain high

(basis point difference between Indonesian 10-year IDR bond and EMBI average of Indonesian USD bond yield spreads, and EMBI yields spreads on US Treasury bonds)



Sources: IDX via CEIC, JP Morgan, and World Bank

recent trend of Indonesian bond yields being particularly sensitive to movements in global risk aversion. As global risk aversion rose in February when the credit ratings on a number of sovereigns were downgraded and the depth of the challenges facing the economies of Central and Eastern Europe became clearer, non-residents reduced their holdings and yields rose. Non-residents' holdings of SUNs (Indonesian government conventional IDR bonds) fell by IDR 9.8 tr (USD 0.8 bn) from early December to the end of February. As risk aversion receded, so did bond yields and non-residents became net purchasers, buying IDR 7.2 tr between early March and late May.

The fall in shorter-tenor yields especially has brought a return to a more normal yield curve. At one point in mid-December, as BI was just starting to loosen monetary policy, the difference between the yields on 10-year and 1-year bonds was less than 50 bps. By mid April it was back above 300 bps, near its recent average. This is generally interpreted as a positive signal, in terms of the health of the bond market and the broader economic outlook (Figure 18).

Spreads on Indonesian USD bonds have fallen too, and in May fell below the global average for emerging economies

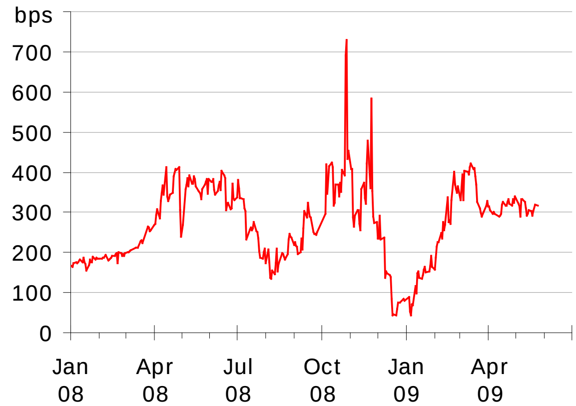
Yields on Indonesian government USD-denominated bonds have not recovered from the late-2008 peak in market turbulence to the same extent as its IDR-denominated bonds. But spreads on Indonesian debt have fallen significantly, and fell below the global average emerging market spread at the start of May, the first extended period at this level since 2007. The difference between the yield investors require for holding IDR-denominated Indonesian government bonds relative to holding USD-denominated bonds remains at relatively low levels, although it is now above the lows of the start of 2009. (Figure 17)

Internationally traded Indonesian corporate bond yields did not experience the transitory recovery of government bonds in December, but rose further in the first quarter of 2009, with the JP Morgan Index of Indonesian corporate spreads peaking at 4858 bps in mid-March, then falling 600 bps in the following 6 weeks. This compares with an emerging market CEMBI average of 780 bps in late April. Illiquidity in this market potentially makes this data difficult to interpret.

Indonesian yields continue to be more volatile, and have a higher risk premium, than those of neighboring economies

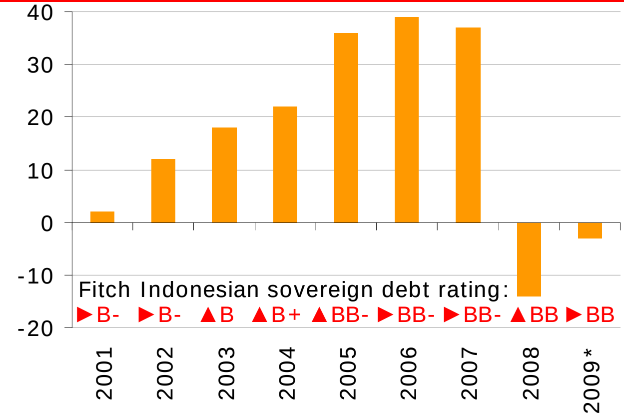
Yields on Indonesian debt continue to be higher and to rise faster and further when global risk averseness increases, than yields on sovereign debt elsewhere in the region and globally. This applies to both local currency and USD government bonds, and on sovereign and internationally traded corporate bonds. Indonesia's mid-February USD sovereign bond sale was priced 300 bps above a slightly smaller sale by Turkey of similar maturity sovereign bonds several weeks earlier. This volatility and higher yield contrasts with Indonesia's sovereign credit rating – its status has been maintained, for example by Fitch Ratings in January, while that of some other economies with debt trading at similar yields have been downgraded. (Figure 19)

Figure 18: The yield curve became unusually flat in December, but has since returned to a more normal slope
(basis point difference between 10-year and 1-year government IDR bond yields)



Source: IDX via CEIC, and World Bank

Figure 19: While many sovereign debt ratings are downgraded, Indonesia's rating has been maintained
(number of upgrades less downgrades)



Notes and sources: 2009 data to mid-February. Fitch long-term local currency rating reported for Indonesia. Bloomberg, EMTA and World Bank data.

d. Overall, the banking sector remains in good health

Official aggregate indicators suggest that the banking sector remains in good health and is becoming more conservative in the face of rising financial stress

Various aggregate indicators suggest that Indonesia's banking sector remains in good health. Non-performing loans averaged 4.5 percent in March, only a little higher than the post-Asia crisis low of 3.8 percent recorded in December 2008; capital adequacy ratios at commercial banks rose to 18.0 percent, lower than several years ago but much higher than in banking systems in developed economies elsewhere. But these ratios tend to be lagging indicators. For example, a loan is classified as non-performing when interest payments are missed for three or more months, and the data on those loans are reported with a 2 month lag. This means that a business with repayment difficulties from January 2009 would only appear in the official statistics in May.

Nonetheless, other indicators suggest most banks remain healthy. There were no signs of widespread withdrawal of deposits from the banking systems during the peak of the turmoil on global financial markets. While rupiah deposit growth slowed in November 2008, as did deposits in foreign currency, there is little evidence of a wide-spread switch to foreign currency accounts. Indeed, most of the growth in deposits in 2008 was in relatively illiquid time deposits.

In the last 4 or 5 months of 2008, especially following the extreme financial market instability that started in late September, banks switched from the fast growth in loans in the first part of 2008 to much more conservative lending practices, and sought to strengthen their balance sheets. Loan approvals have been cut, especially to businesses (discussed above), and anecdotal reports suggest that new customers are having difficulty obtaining loans, while banks are becoming less willing to roll over loans to existing customers in some sectors. The result is a falling ratio of loans to deposits (from a peak of 79 in August 2008 to 72 in March for commercial banks), and a return in the level of excess deposits to their 5-year average. Banks have built their excess deposit levels back up to longer-term average levels, and have started increased their holdings of short-term monetary authority instruments (SBIs) after running them down in the first semester of 2008.

While some foreign banks are likely to reduce their exposure to the Indonesian market, their market share is small

The difficulties facing western Europe and United States domiciled banks mean that banks headquartered offshore are a potential source of financial sector stress in many economies. This is most apparent in Eastern Europe where they can make up as much as 80 percent of the banking sector. But 'foreign banks' (as defined by BI) in Indonesia hold a small market share: about 4.5 percent of outstanding loans and 3.6 percent of outstanding deposits in March, little changed from their market share 5 years earlier. In addition, some non-Indonesian banks hold large shares of Indonesian banks, but these tend to be banks

headquartered elsewhere in the region and have little direct exposure to the 'toxic' financial assets polluting American and European banks' balance sheets.

The other major recent source of concern in the Indonesian financial market is the impact of losses incurred by purchasers of complex foreign exchange derivative instruments on the purchasers themselves and on the financial institution that sold the products should the purchasers not meet their repayment commitments. These instruments are significantly more complex than traditional currency hedges. The latter allow traders, for example, to enter contracts to buy USD with IDR at a prescribed rate on a future date. This allows them to lock in the IDR cost of the goods they plan to import and pay for several months in the future at today's exchange rate.

In contrast, the complex foreign exchange derivative instruments pay a rate of return, or generate a liability, that is a function of the difference between the actual exchange rate at some future rate and the one agreed to in the contract (the 'strike' rate). This rate of return, or repayment cost, can increase exponentially depending on the difference between the actual and the strike exchange rate. These contracts were often entered by parties not seeking to protect an underlying transaction, but trying to exploit what many believed to be an implicit guarantee by BI to keep the IDR/USD exchange rate at less than 9500. As the IDR passed first 9500 and then 10,000 per USD, the purchasers of these contacts incurred increasing losses, which some were not able or not willing to cover. Anecdotal reports suggest that most of these derivative contracts have generally now been renegotiated or rescinded, and one private domestic bank that was heavily involved in retailing these products has made a significant allowance for the associated losses. BI has also introduced stricter regulations relating to whom these instruments can be sold and the extent of information that must be disclosed.

Figure 20: Depositors have been switching into less liquid (but more costly for the bank) time deposits
(commercial banks, seasonally adjusted, trillions of IDR)

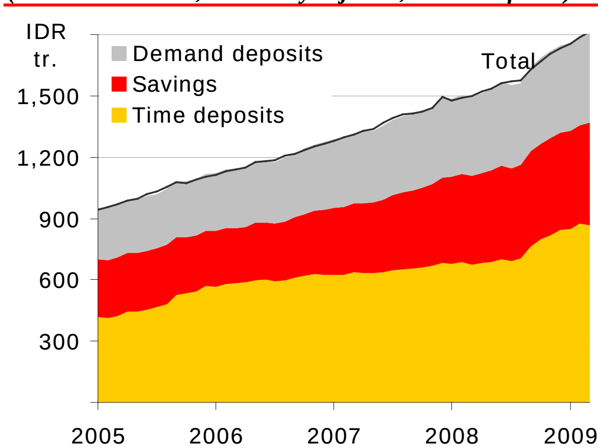
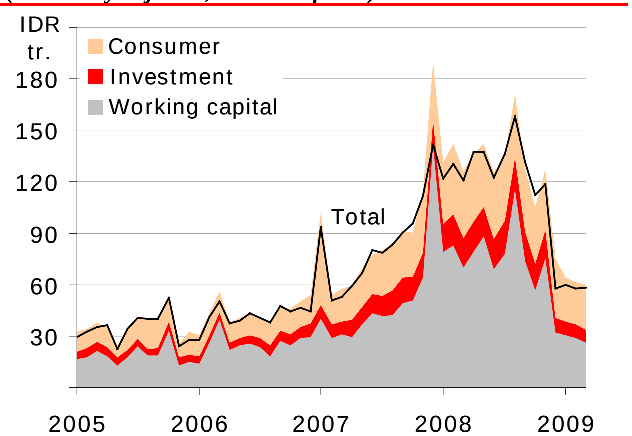


Figure 21: Commercial banks' approvals of loans to businesses were cut sharply in the final quarter of 2008
(seasonally adjusted, trillions of IDR)

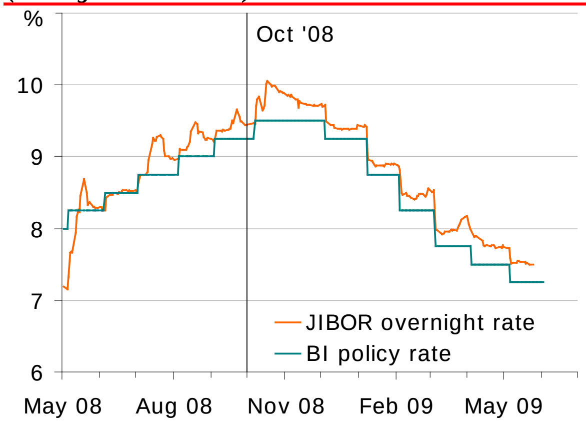


Source: BI via CEIC and World Bank

Interbank lending conditions have improved and there appears to be a great deal of liquidity

Conditions on the interbank money market appear to be significantly improved from October and November. On the one hand, the wedge between the overnight rate at which banks lend to each other (JIBOR) and the rate they would receive from BI has returned to pre-September levels, and BI's net instrument maturity has almost returned to the levels prior to the collapse of Lehman brothers. Yet, in practice, banks appear to be reluctant to lend directly to each other, and larger banks reportedly are especially reluctant to lend to medium-sized and smaller banks. Anecdotal reports suggest that banks have instead used BI to provide inter-bank intermediation. Commercial and rural banks cut their liabilities to other financial institutions by 15 percent between April and December 2008,

Figure 22: One indicator of interbank IDR lending returned to normal levels at the start of 2009
(overnight interest rates)



Source: BI via CEIC, and World Bank

although this shift occurred relatively gradually. On the other hand their use of BI's overnight facilities jumped with the peak in financial market turmoil in October, to double the average of the first 9 months of 2008. Commercial banks' liabilities to BI also spiked in September, and then in November to levels double the average of the first part of 2008.

Consistent with a global USD liquidity shortage, conditions on the local USD interbank market, however, remain very tight, despite BI's injection of USD liquidity and lowering of USD reserve ratios. Banks report a general lack of liquidity, and this is evidenced in interbank rates, which through the first 3 months of 2009 have tracked 20 to 40 bps above the levels on equivalent instruments in the Singapore and London markets on overnight and one-month instruments.

4. and **lower global commodity price**s are slowing inflation

a. Lower prices, including administered fuel prices…

Lower commodity prices, especially fuel, have cut Indonesia's import prices

The fall in global commodity prices has lowered Indonesia's import prices, by about 20 percent from the peak of August 2008 to February 2009, according to World Bank estimates. Along with the fall in global energy prices – at the end of April regional refinery prices for gasoline prices were less than one-half of their June 2008 peak – prices on other important internationally traded items have also recorded significant price decreases. In particular, international rice prices are down about 60 percent from their May peak. But these price falls are all expressed in USD terms, so the rupiah's 30 percent depreciation has an offsetting effect once the prices are expressed in rupiah. World Bank estimates suggest that these international price falls have their full effect on domestic prices within a couple of months.

… and these are passing quickly into upstream, and regulated prices

The Government of Indonesia has allowed lower global prices to pass into regulated prices. It cut the price of regulated premium and gasoline three times (Figure 23) between December and mid-January, and has also reduced some commercial electricity tariffs. This is in line with its goal of allowing regulated prices to move with market prices, below a threshold of IDR 6000 per liter for premium gasoline and IDR 5500 for transportation diesel. Household kerosene prices, far below the market cost, were not changed, as the government continues to roll out the kerosene-to-LPG conversion program.

Lower import prices and the cuts in regulated fuel prices have sent wholesale prices falling. These fell by 12 percent between July and December 2008, and were flat over this period after accounting for the direct impact of oil & gas prices on trade prices.

b. …have meant much lower inflation

Consumer prices increased just 0.2 percent from November to February, lowering the year-on-year inflation rate to 8.6 percent

Consumer prices barely moved on average between November and April. The cuts in fuel prices and then a very good harvest season subtracted from the CPI. Food price inflation fell sharply. Meanwhile, the inflationary impact of the depreciating rupiah has only been evident in clothing costs, which increased by 2.6 percent in February m-o-m, mostly due to the increasing cost of gold jewellery according to market analysts. While falling transportation costs subtracted most from the CPI, the disinflation appears to be broadly based. Core inflation declined in February and in April, lowering the y-o-y rate to 7.1 percent, and most other items recorded moderating price growth over the first four months of 2009.

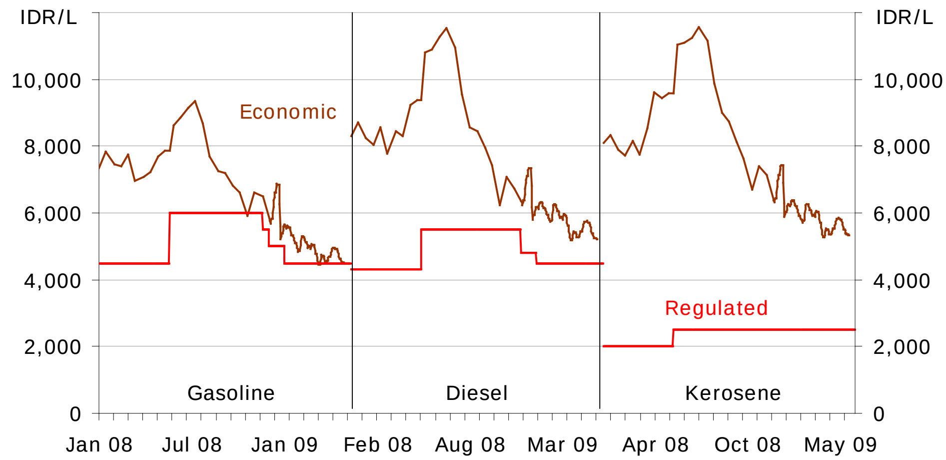
Consumers inflation expectations have fallen

Slower growth in prices at the market and high-profile news of cuts to fuel prices have seen consumer's expectations of future inflation plunge to the lowest levels since the 2005

with the inflation rate

fuel price rises (based on a World Bank composite index). Consumers' lower inflation expectations are likely to become self-filling, as they feed into reduced second-round inflationary pressures, for example through lower demands for wage rises.

Figure 23: Gasoline prices are near the economic cost of the fuel; regulated diesel and kerosene prices remain below their economic costs
(rupiah per liter)



Sources: Ministry of Mining and Energy; World Bank estimates of 2009 economic prices

c. … especially for poorer households

Food inflation has fallen particularly sharply, benefiting poor households especially

The fall in commodity prices has lowered the growth in the cost of living. In particular, poorer households, which spend a far larger proportion of their budget on food than the average household, have benefited from the stabilization in food prices. Food inflation between December 2008 and April 2009 was the weakest since mid 2005 – indeed, after accounting for the effects of the rainy season, food prices fell in January, and they fell again in April with the good harvest, by 1.3 percent. World Bank estimates of a poverty-consumption-bundle weighted consumer price index show the prices faced by poor households rose by 8.4 percent on average in the year to April, 6.2 percentage points below the September 2008 peak.

Figure 24: Inflation has slowed sharply in the past 8 months, especially for poor households
(year-on-year % change)

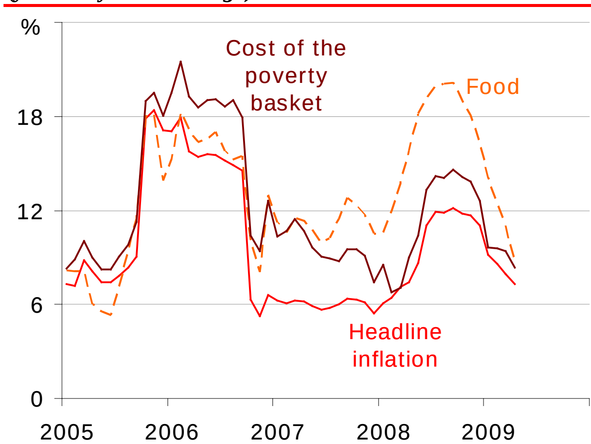
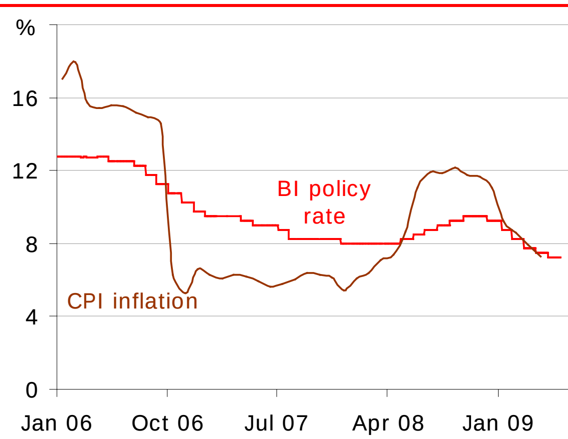


Figure 25: The gap between interest and inflation rates has narrowed, despite BI's swift easing of monetary policy since December 2008



Sources: BPS and BI via CEIC. World Bank estimates of poverty consumption basket

d. ...and prompted BI to lower its policy rate by 225 basis points from December to May

After being the region's perhaps most proactively anti-inflationary central bank in mid-2008, waning inflation and the deteriorating global outlook have prompted BI to ease monetary policy

Citing the need to limit emergent demand-pull inflationary pressures, BI raised its policy rate by 25 bps in each of 6 successive months from May 2008, and took various other measures to reduce growth in the money supply. In the process, among market participants, it earned a reputation as one of the region's most aggressive anti-inflationary monetary policy authorities. As inflationary pressures waned with the collapse in commodity prices, and the global economic outlook grew bleaker in the final months of 2008, BI responded with an abrupt shift in the direction of policy. It cut interest rates first by 25 bps in December, then by 50 at each of its January, February and March board meetings, and then by a 25 bps in April and May. This took the overnight policy rates from a peak of 9.5 percent in November to 7.25 percent in May. While this about-turn has been swift and strong, the sharp decline in inflation has outpaced BI's rate cuts, implying that the real interest rate has increased from around -2½ percent mid-2008 to around 7 percent by late May, depending on the measure of inflation (Figure 25).

5. Indonesia's external position remains sound though weaker than in 2007

a. Indonesia's balance of payments recorded a small deficit in 2008, moving back to surplus in early 2009

The balance of payments fell into deficit in 2008, largely due to portfolio outflows from Indonesia; this turned around in the first quarter of 2009

Developments in global commodity and financial markets buffeted Indonesia's balance of payments through 2008. The balance of payments fell into a deficit of USD 4.2 billion in the fourth quarter, creating a deficit for 2008 overall of USD 1.9 bn, the first annual BoP deficit since 2001. This turned around in the first quarter of 2009, with a balance of payment surplus of USD 4.0 bn and a current account surplus of USD 1.8 bn.

Table 4: Portfolio investment outflows moved Indonesia's balance of payments into deficit in late 2008; the current account approached balance
(billions of USD unless otherwise stated)

					2008				2009
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1
Balance of payments	**0.6**	**13.9**	**14.1**	**-1.8**	**1.0**	**1.3**	**-0.1**	**-4.2**	**4.0**
% GDP	*0.2%*	*3.8%*	*3.3%*	*-0.4%*	*0.8%*	*1.0%*	*-0.1%*	*-3.8%*	*3.5%*
Current account	**0.3**	**10.9**	**10.5**	**0.3**	**2.8**	**-1.0**	**-0.9**	**-0.7**	**1.8**
% GDP	*0.1%*	*3.0%*	*2.4%*	*0.1%*	*2.3%*	*-0.7%*	*-0.6%*	*-0.6%*	*1.6%*
Goods balance	17.5	29.7	32.8	22.9	7.5	5.4	5.8	4.2	6.2
Services balance	-9.1	-9.9	-11.8	-12.7	-3.0	-3.3	-3.2	-3.3	-2.5
Net income & transfers	-8.1	-8.9	-10.4	-9.9	-1.7	-3.1	-3.5	-1.6	-1.9
Capital & financial account	**0.3**	**3.0**	**3.6**	**-2.1**	**-1.4**	**2.5**	**0.9**	**-4.1**	**2.4**
% GDP	*0.1%*	*0.8%*	*0.8%*	*-0.4%*	*-1.2%*	*1.9%*	*0.6%*	*-3.7%*	*2.1%*
Direct investment (net)	5.3	2.2	2.3	2.0	-0.3	0.6	0.4	1.3	2.7
Inflows	8.3	4.9	6.9	7.9	1.5	2.0	1.9	2.5	3.5
Outflows	-3.1	-2.7	-4.7	-5.9	-1.7	-1.4	-1.5	-1.2	-0.8
Portfolio investment (net)	4.2	4.3	5.6	1.7	2.0	4.2	-0.1	-4.4	1.9
Inflows	21.7	22.0	43.7	47.2	12.5	13.7	13.1	7.8	12.2
Outflows	-11.6	-15.3	-36.2	-41.8	-10.2	-9.2	-13.0	-9.4	-6.7
Other investment (net)	-9.4	-3.8	-4.8	-6.2	-3.2	-2.3	0.4	-1.1	-2.3
Government	-0.8	-2.5	-2.4	-1.4	-0.4	-1.5	-0.1	0.5	-0.1
Private	-8.6	-1.3	-2.4	-4.7	-0.6	0.3	0.2	-1.5	-0.9
Reserves	**34.7**	**42.6**	**56.9**	**51.6**	**59.0**	**59.5**	**57.1**	**51.6**	**54.8**

Sources: BI, BPS via CEIC, MoF, and World Bank

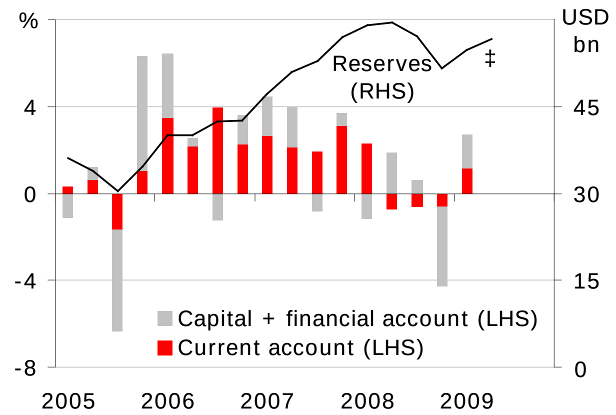
The current account recorded a small surplus over 2008, although it was in deficit from the second quarter; this too turned around in early 2009

The current account recorded a small surplus over 2008 (USD 0.6 bn), as a large surplus in the first quarter (USD 2.8 bn) turned into a moderate deficit from the second, before moving back to a surplus in the first quarter of 2009. The bubble in oil prices explained much of these movements. The cost of fuel oil imports ballooned in the second quarter as oil prices peaked and refinery margins widened, while Indonesia's regime of regulated, fixed fuel prices disconnected consumers from these movements in the economic price,

meaning demand continued to grow. In addition, high prices of oil and other commodities made foreign-owned mining operations highly profitable, and the repatriation of these profits expanded the net income deficit. As oil prices collapsed these flows unwound, albeit with a lag: while private oil & gas companies repatriated USD 2.4 bn of profits in Q3 (the most ever), this amount halved in Q4. Overall Indonesia's net income deficit shrank by USD 1.9 bn between the September and December quarters to the lowest since the start of 2006, before expanding slightly in the first quarter of 2009 (to USD 3.0 bn).

Figure 26: Capital outflows pulled the balance of payments into deficit in the fourth quarter 2008, before returning to surplus in early 2009

(balance of payments as % of GDP; reserves in USD bn)



Notes and sources: ‡ Q2 reserves data to April 30. BI, BPS via CEIC, MoF, and World Bank

This strengthening in Indonesia's net income position has partially offset the smaller surplus on goods & services trade. Indonesia's trade surplus fell from USD 4.6 billion in the first quarter of 2008 to Q3 to USD 0.9 bn by Q4, before expanding again to USD 3.7 bn in the first quarter of 2009. This was not due to a mismatch between domestic and external demand. Rather, as discussed above, the collapse in global commodity prices and the global downturn has led to collapses in the value of both imports and exports (in the first quarter 2009, total goods & service exports and imports are down about 30 percent on the corresponding period in 2008), reducing the absolute USD value of the surplus of exports over imports.

Portfolio outflows at the end of the year led to a balance of payments deficit in 2008

Portfolio outflows generated a financial account deficit in Q4-2008, before returning in the first quarter of 2009. Residents shifted USD 2.7 bn into offshore bank accounts in Q4, while non-residents sold down their holdings of debt securities (net outflow of USD 3.8 bn from both corporate and government securities). More was paid back than issued in new trade credits and bank loans, although the difference was not great.

After further withdrawals in the first quarter of 2009, non-residents returned as net investors in liquid Indonesian financial assets such as stocks and bonds into late May. Residents also slowed their transfers to offshore bank accounts. Most support came through the government's USD bond sales, which generated a net USD 2.8 bn flow of funds into Indonesia.

Despite tight global financial conditions, Indonesia is receiving large inflows of foreign direct investment

Other areas of the capital accounts appear untouched by the financial market turbulence and tighter global credit conditions. This is most notable in flows of foreign direct investment (FDI), which recorded the largest quarterly surplus in 3½ years in both Q4-2008 and Q1-2009. Over these two quarters, non-residents invested a net USD 6.0 bn in Indonesia, in both oil & gas and the non oil & gas sector; residents invested USD 2.0 bn offshore over this period. The flow of new FDI announcements continued into the second quarter, including announced investments in Indonesia's banking and mining sectors, and in textiles, clothing and motor vehicle manufacturing.

Foreign reserves have been stable since November

Indonesia's foreign reserves stabilized from the end of October 2008, moving in a range between USD 50.2 bn and USD 52.6 bn, then rising to USD 56.7 bn by the end of April, equivalent to over 4 months of imports and official debt repayments. This stabilization and growth contrasts with the speculation in foreign exchange markets of intervention by BI.

In addition to its own official reserve holdings, Indonesia has gained the ability to call on more foreign reserves under various bilateral and multilateral swap arrangements. It has access to the USD 12 bn facility pooled among the ASEAN+3 countries under the Chiang Mai Initiative, plus a total of USD 18 bn in bilateral swap agreements with Japan, China and Korea under that initiative. Twenty percent of these swaps can be exercised without entering an IMF surveillance program. In addition, Indonesia has access to a USD 14.6 bn swap facility with China, which operates outside of the Initiative and so does not require an IMF program. To date, none of these swap facilities have been called on, so their effectiveness in the case of a crisis remains unknown.

b. External debt exposure, while significant, appears to be sustainable

One-sixth of Indonesia's external debt, over USD 25 bn, is due in 2009

The depreciated exchange rate has increased the rupiah cost of repaying Indonesia's external obligations. Indonesia's stock of external debt grew by 9 percent in 2008, to total USD 149 bn. At September's exchange rate, this was equivalent to 27.7 percent of GDP; when the rupiah depreciated to 12,000 per USD this rose to 36 percent of GDP. BI data suggest that at least one-sixth, or USD 23.9 bn, is due in 2009; including estimates of the value of some other types of debt raises this to USD 30.5 bn, or just over 4 months of exports at the unusually low levels of the first quarter of 2009 (Table 5). This amount includes trade credits, which are securitized by the value of the goods being traded. In addition, non-residents are able at any point to withdraw their USD 3.9 bn holdings of currency & deposits in Indonesian banks. Indonesia's short-term debt obligations as a share of GDP are not large relative to other economies in the region, despite Indonesia having one of the more open capital accounts (Figure 27).

An alternative estimate is that USD 32.4 bn was owed externally by Indonesian private entities in 2009 at the end of December. This estimate is based on reports from mostly OECD-domiciled banks to the Bank for International Settlements. This amount is not directly comparable to the USD 15.9 bn estimate in Table 5 below. It includes the money lent by the parents of foreign banks to their local subsidiaries. Another difference is that it includes the consolidated debt owed to local branches of foreign banks operating in Indonesia, and so includes, for example, the debt owed on consumer credit cards. Foreign banks had IDR 113 tr. (USD 9.4 bn) of outstanding loans of all maturities in December 2008.

Most private sector debt is owed by foreign or joint venture companies, and was largely rolled over in the first quarter of 2009

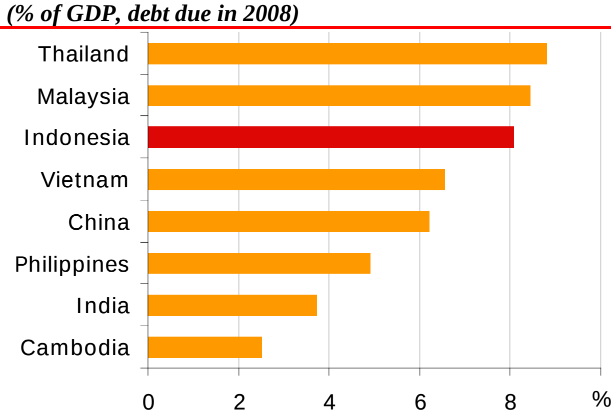
The private sector owes 40 percent (USD 60.7 bn) of Indonesia's external debt, according to BI data. Indonesian private and state-owned enterprises owe less than half of this amount; 30 percent of it is owed by foreign and joint venture companies to their parent or an affiliated companies. These ratios would suggest that there is a high likelihood of these debts being rolled over, at least in normal economic times, and first quarter data show that this was indeed the case, with Indonesian banks and corporate entities repaying USD 1.9 bn in loans, and borrowing USD 2.4 bn. But the uncertainty of current economic conditions and the precarious financial state of many companies headquartered in developed economies increases the risk that some of these debts may not be rolled over.

Table 5: Indonesia's short-term external debt
(billions of USD)

Public sector	**9.4**
Foreign currency, official debt	6.9
Amortization of gov't IDR bonds [e]	0.5
BI certificates [e]	2.0
Private sector	**21.1**
Short term debt	6.9
Amortization of medium- & long-term debt	8.5
Trade finance	5.2
Amortizing securities	0.5
TOTAL	**30.5**
Other items:	
Currency & deposits held by non-residents	3.9
'Standstill debt', from the 1997/98 financial crisis, under renegotiation	6.4

Sources and notes: BI and World Bank. [e] indicates World Bank estimate.

Figure 27: Indonesia's short-term external obligations are in line with other regional economies
(% of GDP, debt due in 2008)



Sources and notes: BI, Joint External Debt Reporting Hub, World Bank. Short-term obligations at the end of 2007 are used to abstract from the impact of the financial markets events of late 2008

6. Indonesia's government budget is well-positioned to respond to the downturn

a. Preliminary realization numbers indicate near budget balance in 2008, much lower than projected…

2008's budget was near balance, reflecting strong revenues and spending slightly less than budgeted for some categories

Indonesia's central government budget was near balance in 2008, with the Ministry of Finance's preliminary realization figures showing a deficit of just 0.1 percent of GDP. This compares with a deficit of 1.7 percent of GDP projected in the initial budget, and 2.1 percent projected in the revised budget passed as international oil prices, and Indonesia's energy subsidies, neared their peak. (Table 6) This near-balanced budget represents a significant contraction from fiscal policy relative to 2007's 1.3 percent deficit and 2006's 0.9 percent deficit, synchronizing with the peak in Indonesia's current economic cycle (Figure 28).

Both stronger-than projected revenues and below-budget spending explain the difference between the government's budgeted and realized deficits. Much of both is explained by the boom in commodity prices that continued into the first half of 2008 and then their collapse from July.

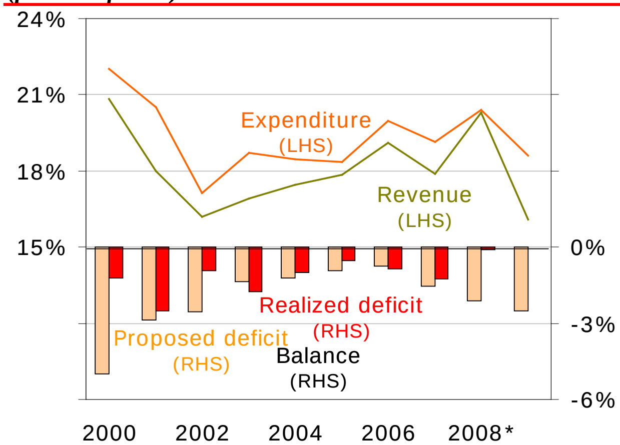
Revenues were far above budget, mostly due to oil prices far above the level assumed in the budget

Government revenues were almost one-third higher than budgeted in November 2007, and 10 percent higher than the revised budget (based on unaudited estimates of realized revenues). High oil prices explain most of the difference. Realized oil & gas revenues were 80 percent (or IDR 133 tr) higher than budgeted in November 2007. The budget had assumed Indonesian crude oil prices averaging USD 60 per barrel, far below the realized average oil price of USD 97. The government collected more than budgeted on most other revenues items too, including VAT (IDR 23 tr more), revenues from mining, and land & building tax. The most significant exception was non-oil & gas income tax, which was 95 percent of the initially budgeted amount and very near the revised budget projection. These revenues were growing strongly in the first half of 2008, partly due to significant improvements in the tax office's ability to collect taxes, so this may already reflect the initial impact of the fall in profitability associated with the downturn in the final months of 2008.

…which also drove energy subsidies far above budgeted amounts; the government underspent on most other items

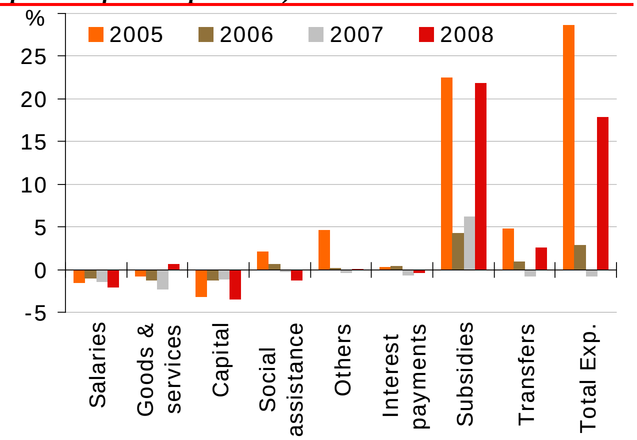
At the same time, the disbursements for a number of budget items fell short of the government's initial budget targets, and total disbursements were less than projected in the revised budget. The largest underspends were on capital (IDR -29 tr or 30 percent below budget), salaries and social assistance. Subsidies, particularly energy subsidies, more than made up the difference, again reflecting the gap between the budgeted oil price and the realized oil prices of 2008. But these trends are consistent with recent years, especially 2005, the last year when the increase in the market cost of fuel prompted an adjustment to regulated fuel prices (Figure 29). Disbursement of materials and capital spending also remains bunched in the final months of the year (discussed in Part B below).

Figure 28: After the sustainable budget deficits of recent years, 2008's near-balanced budget is a contraction
(percent of GDP)



Sources and notes: MoF, BPS via CEIC, and World Bank. *2008 data are preliminary.

Figure 29: In 2008, like 2005, the government underspent on most budget items – apart from energy subsidies
(difference between budgeted and realized expenditure, percent of total expenditure)



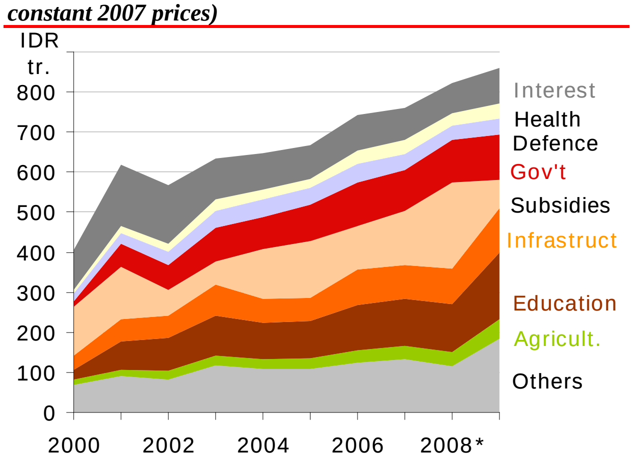
Sources: MoF, and World Bank

b. In anticipation of declining revenues and the need for fiscal stimulus, Parliament approved a revised budget with a 2.5 percent deficit target

The government and parliament have responded to the worsening outlook with a revised 2009 budget

As the economic outlook rapidly deteriorated in the last quarter of 2008 and early 2009, the government of Indonesian revised its revenue projections and formulated a fiscal stimulus plan (see Box 1). Slower growth and lower commodity prices will cut revenues, as will the government's targeted tax breaks, while the government has also increased its budgeted infrastructure spending. Together these developments increase the budgeted 2009 deficit to 2.5 percent of GDP, from 1.0 percent in the budget approved in November.

Figure 30: Public spending on subsidies ballooned in 2008; this is budgeted to be transferred to education, agriculture, infrastructure and 'other' spending in 2009
(total central and subnational spending, trillions of IDR, constant 2007 prices)



Sources: MoF and World Bank

Parliament approved the revised budget in the final weeks of February, in record time and with minimal adjustment to the government's proposals. In an important improvement to the efficiency of the budget review process, which in some previous sessions had taken weeks, the larger house delegated the authority to approve the budget to the financial affairs committee, which spent 2 days evaluating the government's proposals.

Consistent with the goal of protecting social investment from the economic slowdown, the government is budgeting to significantly increase spending on education, agricultural support and 'other' categories, as well as infrastructure (Figure 30). National spending on education and on agriculture in 2009 is projected to increase by around 40 percent in real terms from 2008; spending on infrastructure by all levels of government is projected to increase by about one-quarter. These are largely funds freed by the decline in the cost of the government's energy subsidies.

Table 6: Government's share of GDP is budgeted to shrink in 2009, even with more spending on government activity

(% of GDP unless otherwise indicated)

	2006	2007		2008			2009	
	Actual	Budget	Realizat'n	Original budget	Revised budget	Prelim. Realiz'n	Initial budget	Revised budget
Revenues	**19.1%**	**19.1%**	**17.9%**	**17.7%**	**20.0%**	**20.7%**	**18.5%**	**15.5%**
Non-oil domestic tax	10.6%	12.0%	10.8%	12.2%	11.7%	20.4%	12.0%	11.0%
o/w Non-oil & gas income tax	5.0%	5.8%	4.9%	6.1%	5.6%	10.4%	5.6%	5.1%
o/w VAT	3.7%	4.3%	3.9%	4.3%	4.4%	5.3%	4.7%	4.3%
Oil & gas	6.0%	4.8%	4.3%	3.6%	5.3%	6.3%	4.1%	2.4%
Other	2.5%	2.3%	2.9%	1.9%	2.9%	-3.6%	1.8%	1.7%
Expenditures	**20.0%**	**20.2%**	**19.1%**	**19.4%**	**22.1%**	**19.9%**	**19.5%**	**18.0%**
Central Govt.	13.2%	13.4%	12.8%	13.1%	15.5%	14.0%	13.4%	12.5%
Personnel	2.2%	2.7%	2.3%	3.0%	2.8%	2.3%	2.6%	2.6%
Materials	1.4%	1.9%	1.4%	1.2%	1.5%	1.2%	1.7%	1.7%
Interest Payments	2.4%	2.3%	2.0%	2.1%	2.1%	1.8%	1.9%	2.0%
Subsidies	3.2%	2.7%	3.8%	2.2%	5.2%	4.5%	3.1%	2.3%
Social Assistance	1.2%	1.4%	1.3%	1.6%	1.3%	1.1%	1.5%	1.4%
Other Current	1.1%	0.5%	0.4%	0.7%	0.8%	0.6%	1.2%	1.0%
Capital	1.6%	1.9%	1.6%	2.4%	1.8%	1.5%	1.4%	1.3%
Transfers to Regions	6.8%	6.8%	6.4%	6.3%	6.5%	5.9%	6.0%	5.5%
Primary Balance	**1.5%**	**1.2%**	**0.8%**	**0.4%**	**0.0%**	**1.7%**	**0.9%**	**-0.5%**
Overall Balance	**-0.9%**	**-1.1%**	**-1.3%**	**-1.7%**	**-2.1%**	**-0.1%**	**-1.0%**	**-2.5%**
Assumptions/realized outcomes:								
GDP (IDR tr.)	3,338,196	3,779,155	3,957,404	4,306,608	4,484,372	4,954,029	5,327,538	5,487,578
GDP growth (%)	5.5%	6.3%	6.3%	6.8%	6.4%	6.1%	6.0%	4.5%
Inflation (%)	8.0%	6.5%	6.6%	6.0%	6.5%	9.8%	6.2%	6.0%
Exchange rate (USD)	9,141	9,300	9,419	9,100	9,100	9,694	9,400	11,000
Oil Price (USD/bl)	$64.00	$63.00	$78.00	$60.00	$95.00	$96.80	$80.00	$45.00

Sources: MoF, BPS via CEIC, and World Bank

c. The Indonesian government's financing needs will rise in 2009

Indonesia's public financing needs for the next few years are considerable

The near-balanced budget in 2008 created a financing surplus of about 1 percent of GDP. The government follows international practice in front-loading its fund raising from financial markets each year, and embarked on a financing program predicated on the deficit outlook of the first half of the year. Fortuitously, this has created a pool of funds to finance its 2009 stimulus package while limits the government's need to call on now much-more-expensive and fragile financial markets.

Due to the maturity structure and servicing costs of its existing debt Indonesia's gross financing needs are high, despite the fact that Indonesia has successfully maintained its budget deficit at levels that are low by international standards – 1.3 percent of GDP in 2007, a preliminary estimate of 0.1 percent of GDP in 2008, and a planned 2.5 percent of GDP in 2009 (Table 7).

…and the government has already raised much of its 2009 needs

The GoI's financing strategy for 2009 assumes it will attempt to borrow the equivalent of about IDR 144 tr (USD 13.7 bn) from financial markets (including an amount that the budget documents do not attribute to any particular financing source). This is lower than the near-USD 13 billion it raised in both 2007 and 2008. The lower figure reflects the government's plan to draw down much of its financing surplus from 2008 and to increase financing from official sources.

By late May, the Indonesian government had raised IDR 82.1 tr of its financing target, filling the majority of its financing needs. In late February it sold USD 3 billion of 5- and 10-year dollar-denominated bonds. The sale was well-received with over USD 4.5 billion in offers, although the final yields were high at 10.5 percent and 11.75 percent respectively. In a series of smaller sales from mid-January the government also sold IDR 44.3 tr of IDR bonds. The rupiah bond sales include the nation's first retail Islamic (Sukuk) offering, with demand exceeding the government's expectations. Conventional bond sales on shorter tenors (less than 10 years) have also been near targets; 10 year bond offerings have

fared worse especially by late February when market conditions were turning tighter. From March, the government was able to sell more longer-dated bonds at improving yields. For example in late April it sold a USD 0.65 bn of a global 5-year sukuk with an average yield of 8.8 percent.

Table 7: After achieving a large financing surplus in 2008, the government's financing needs increase again in 2009

	IDR (trillions)			USD (billions)		
	2007 audited	2008 preliminary	2009 revised budget	2007 audited	2008 preliminary	2009 revised budget
Overall budget deficit	**49.8**	**4.2**	**132.1**	**5.5**	**0.4**	**12.0**
(as a % of GDP)	1.3	0.1	2.5	1.3	0.1	2.5
Primary budget deficit	**-30.0**	**-84.4**	**24.2**	**-3.3**	**-8.7**	**2.2**
Interest payments	**79.8**	**88.6**	**107.9**	**8.7**	**9.1**	**9.8**
Commercial debt	54.1	59.9	70.1	5.9	6.2	6.4
Official loans	25.7	28.7	37.8	2.8	3.0	3.4
Amortization	**117.6**	**103.5**	**117.0**	**12.9**	**10.7**	**10.6**
Commercial debt	**59.7**	**40.3**	**44.9**	**6.5**	**4.2**	**4.1**
Official loans	**57.9**	**63.2**	**72.1**	**6.3**	**6.5**	**6.6**
Other	**2.0**	**2.8**	**13.3**	**0.2**	**0.3**	**1.2**
Gross financing need	**169.5**	**110.6**	**262.4**	**18.5**	**11.4**	**23.9**
(as a % of GDP)	4.3	2.3	5.1	4.3	2.3	5.1
Gross financing plan	**169.5**	**110.6**	**262.4**	**18.5**	**11.4**	**23.9**
Domestic and commercial	**135.4**	**66.8**	**206.3**	**14.8**	**6.9**	**18.8**
Banking and other sources	**18.6**	**-60.1**	**68.9**	**2.0**	**-6.2**	**6.3**
Debt	**116.9**	**126.9**	**137.5**	**12.8**	**13.1**	**12.5**
IDR bonds	103.3	86.9	101.7	11.3	9.0	9.2
USD bonds	13.6	39.9	35.8	1.5	4.1	3.3
Official foreign financing	**34.1**	**44.1**	**56.5**	**3.7**	**4.5**	**5.1**
Program loans	**19.6**	**29.6**	**30.8**	**2.1**	**3.1**	**2.8**
Project loans	**14.5**	**14.5**	**25.7**	**1.6**	**1.5**	**2.3**
Memorandum items:						
Exchange rate: IDR per USD	9140	9691	11000			
Nominal GDP	3957.4	4732.6	5195.0	433.0	488.3	472.3

Sources: MoF, BPS via CEIC, and World Bank

In case access to markets becomes more restricted again, the government with its development partners has developed an innovative back-up

Nonetheless, there remains a considerable risk that liquidity conditions may tighten again, such that the government can only raise additional funds at prohibitively high interest rates. As a fall-back in such a case, and to send a strong positive signal to financial markets, the government proactively approached its development partners in late 2008 to create a public expenditure support facility fitted to these circumstances. Access to the facility is contingent firstly on the government not being able to access financial markets on reasonable terms. The government has drawn up a financing plan that specifies the market conditions in which it is not willing to access financial markets. Access is secondly contingent on Indonesia's macroeconomic policy framework remaining stable. The government, in cooperation with its development partners, will review whether both of these criteria have been satisfied on at least a quarterly basis through the 2-year life of the facility. The Board of the World Bank agreed at the end of February to contribute USD 2 billion to the facility. The governments of Australia and Japan are contributing USD 1 billion each, and the Board of the Asian Development Bank has agreed to provide an additional USD 1 billion.

B. THE IMPACT OF THE GLOBAL CRISIS ON INDONESIA: LOOKING AHEAD

1. Sharp downturn in the economies of Indonesia's major trading partners combined with lower commodity prices imply a sharp drop in exports

a. The global outlook has further worsened since December, impacting Indonesia's external sector

Indonesia's trade partners will record little economic growth in 2009, a grimmer outlook than in late 2008

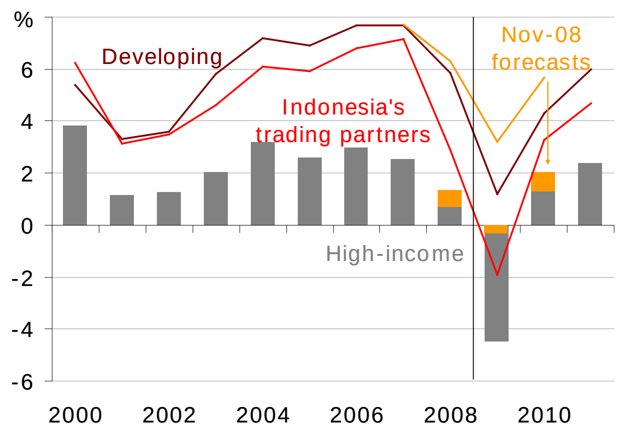
Developments in the global economy, and the responses of Indonesian consumers, investors and the government to these developments, will determine the evolution of Indonesia's economic outlook for the next 2 or 3 years.

The outlook for Indonesia's external environment is for a sharp slowing on 2008's growth, itself significantly slower than the pace of 2007. Even with the most recent recovery in financial asset prices and stabilization of global industrial production and commodity prices, the outlook has deteriorated considerably since November 2008 (Figure 31) – that this global downturn is the deepest since World War II has become cliché. Among the more extreme cases, Japanese output is projected to decline by 5.3 percent in 2009, compared with a projection of only a minimal contraction when the forecasts for the World Bank's 2008 Global Development Finance were prepared in late 2008. Also suffering from a sharp deterioration in outlook are the economies of developing Europe and Central Asia: growth projections have been revised down by 4.2 percentage points to -1.4 percent. Across Indonesia's other major export destinations the deterioration in outlook has also been more moderate. In particular, China is now projected to grow by between 6 and 7 percent in 2009, a comparatively mild downward adjustment of about 1 percentage point. Overall, Indonesia's export destinations are projected to grow by 0.7 percent in 2009, about 5 percentage points slower than in 2008, and well below the 7.2 percent growth in 2007 (economies are weighted by their importance as Indonesia's export destinations).

Global prices have stabilized, although lower projected growth means limited recovery is now projected

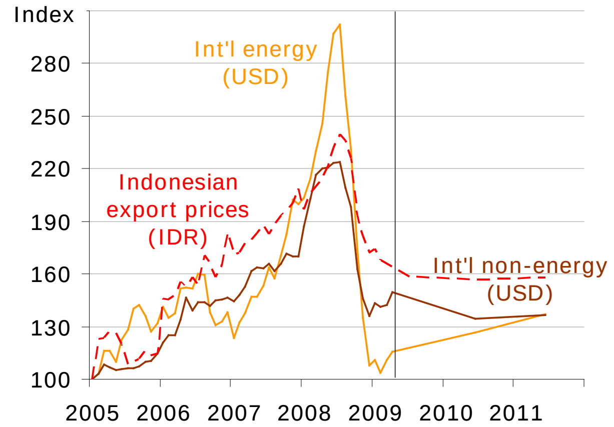
While commodity prices have stabilized since November, the weaker global growth outlook has led to a lowering in projected prices for the next few years. Indonesia's export prices will vary with these developments in global commodity prices, albeit with a lower amplitude given that the prices of Indonesia's manufactured exports are not subject to the sharp swings of commodity prices in global markets. Indonesia's average export prices for major agriculture and forestry products and for crude oil fell by about 40 percent in the fourth quarter of 2008 compared to the third quarter. However the depreciation of the rupiah against the USD (in which global trade prices are generally quoted) commensurately reduces the fall in prices once they are expressed in rupiah. World Bank estimates place Indonesia's export prices, expressed in rupiah, at around their average of 2006. Based on the rupiah's levels through May and the first quarter 2009 outlook for global commodity prices, Indonesia's export prices are projected to rise only modestly (around 14 percent) from these levels by 2011.

Figure 31: The global growth outlook has worsened considerably over recent months
(year average change in GDP by group of economies)



Source: World Bank

Figure 32: Only a small recovery is projected in global commodity prices, and in Indonesia's export prices
(index January 2005 = 100)



Sources: BPS via CEIC, and World Bank

Indonesia's terms of trade should remain around early 2006 levels as export prices fall by more than import prices

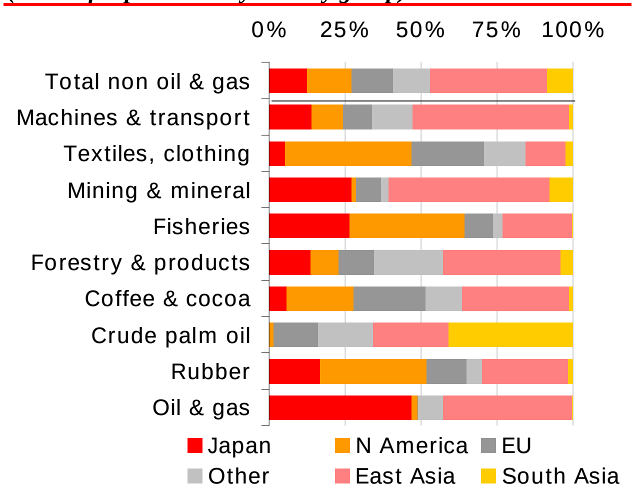
Indonesia's imports more manufactured items, particularly more transformed manufactures, and less energy products (oil, gas, coal, and crude palm oil), then it exports. This means that its terms of trade – the ratio of export prices to import prices, or the amount of imports Indonesia can purchase from its exports given their prices – have fallen around 40 percent from their September 2007 peak, to around the levels of early 2006, according to World Bank estimates. Over the next two years they are likely to increase by several percent a year with the gradual recovery in commodity prices.

b. Indonesia's exports are likely to stabilize

Export values and volumes have declined with lower prices and compressed demand, and are likely to now stabilize at these levels

Indonesia's trade flows have already recorded steep falls, like those of most other economies. As the economies of Indonesia's trading partners and commodity prices stabilize, Indonesia's exports are likely to do so too. Export volumes have been impacted especially by lower regional industrial production, although the impact is smaller than for neighboring economies given the relatively smaller share of industrial products in Indonesia's exports (manufactured products made up about one-third of the value of total exports in the first ten months of 2008). The collapse of output from East Asia's production networks implies deep cuts in intraregional trade, and weakening domestic demand across the region further reduces demand for Indonesia's exports. Over half of Indonesia's total exports and 70 percent of resource exports (rubber, pulp, palm oil) go to the region (Figure 33). To the extent that these goods enter the production chains at early stages or are relatively income inelastic (eg, Indonesia's energy exports to Japan), the impact of the global slowdown will be smaller than will be observed elsewhere. However, the relatively inelastic supply of these goods means that lower demand may limit the recovery in their prices.

Figure 33: Indonesia's textiles, fisheries, and rubber exports are especially dependent on high-income markets
(share of export items by country group)



Sources: BPS and World Bank

Export values are additionally being affected by the collapse in many commodity prices. The impact will be slowed by many commodities being pre-sold at set contracted prices, and these are renewed only once a year or even less frequently, thus delaying some of the impact of late 2008's falls in spot prices on Indonesia's export receipts. Total exports in 2009 are likely to also be about one-quarter less than the total for 2008, or a little above the total for 2006.

c. The fall in exports is hitting some sectors and some regions harder

Some sectors, and hence some regions, will be especially affected by the external slowdown, and the impacts goes beyond the sector immediately affected

Some sectors and some regions are more exposed to the downturn in external demand than others. Sectors that are more focused on supplying external markets will be more affected. These sectors make up a significant share of economic activity in some regions, usually regions that have a comparative advantage in producing that good because of their geography (eg, areas where minerals are concentrated or that best support certain types of agriculture) or their resource endowment (eg, a large and relatively skilled labor force). The projected falls in export revenues will hit employment, incomes, and even new investment in these regions especially.

Sectors that are more focused on supplying external markets will be more affected by the downturn in external demand. However, lower activity in major export-oriented industries can also have larger effects on a region's overall economy. Specialization in the export industry leads to the development of related industries that are dependent on the externally-oriented sector. For example, growth in mining or rubber plantations supports growth in transport and other extension services, even specialized financial services, or, among manufacturing industries, growth in clothing or footwear production that is relatively labor intensive leads to growth in housing, retailing, and telecommunications facilities in their immediate vicinity. Therefore, the cuts to export volumes and drop in prices are likely to echo through a region's entire economy, including the sectors not specifically focused on external markets.

Exposed manufacturing is in central and west Java; primary production at risk is mostly in Sulawesi and Kalimantan

Sectors where global prices have or are projected to fall most sharply, or where production is especially sensitive to global growth, are currently at the greatest risk. And the regions at greatest risk are those which produce a large share of the national output for these sectors, or where these sectors make up a large share of regional activity. Table 8 present World Bank projections for the relevant prices and for change in export values in 2009, and for the regions likely to be most affected by the slowdown.

Table 8: Regions especially exposed to the commodity sector will be hit harder by the slowdown

	Export value, 2008	Share of total exports [a]	Projected price change	Projected export growth	Regions at risk based on: Region's output as a share of national production	Regions at risk based on: Dependency on production of good [b]
Commodity or product group	*USD bn*	*2008, %*	*2008 to 2009, percent*			
Oil & gas	**29.0**	**21.2**	**-30**	**-45**	Riau, E. Kalimantan, S. Sumatra	Riau, E. Kalimantan, Aceh
Agriculture, fishery & forestry	**38.9**	**28.4**	**-31**	**-22**		
Rubber		4.7	-31		Riau, S. Sumatra, N. Sumatra	Jambi, Bengkulu, S. Sumatra, Central and West Kalimantan
Palm Oil (CPO)		9.0	-32		Riau, S. Sumatra, N. Sumatra	W. Sulawesi, E. Kalimantan, Bengkulu
Coffee		0.8	-20		Bengkulu, Lampung, S. Sumatra	Lampung, Bengkulu, W. Sulawesi
Cocoa		0.9	-22		Central, South, West, Southeast Sulawesi	SE. Sulawesi, W. Sulawesi, C. Sulawesi
Plywood		1.2	-14		Riau, E. Kalimantan, W. Kalimantan, N. Sumatra	W Kalimantan, C Kalimantan, Jambi
Pulp and Waste Paper		1.1	-19			
Fresh Fish and Shrimp		1.4	-11		E. Java, S. Sulawesi, and N. Sumatra	Maluku, Papua, SE. Sulawesi
Mining & mineral commodities	**22.9**	**16.7**	**-35**	**-26**	Papua, East & South Kalimantan	Papua, W. Nusa Tenggara, S.Kalimantan, Bangka-Belitung
Copper		3.9	-50			
Coal		7.3	-37			
Textiles, clothing & footwear	**12.0**	**11.9**	**~ 0**	**-9**	Banten, Jakarta, W. Java	Banten, W. Java, C. Java
Electronics, machinery & transport equipment	**17.2**	**12.6**	**~ 0**	**-3**	Banten, Jakarta, W. Java	Banten, W. Java, Jakarta
Other manufactures	**16.8**	**9.1**	**~ 0**	**-6**	Banten, W. Java, E. Java	Banten, W. Java, N. Sumatra
TOTAL	**136.8**	**100.0**	**-23**	**-23**		

Sources and notes: BPS and World Bank. [a] January-October 2008. [b] share of output of product in regional GDP relative to national average.

2. Domestic credit growth, having slowed, is also likely to stabilize

The uncertainty surrounding the outlook, heightened risk aversion among both firms and bankers, and lower price growth will see credit growth around half of 2008's pace

In addition to the deterioration in the external environment discussed above, the outlook for domestic financing has worsened. Conditions on both the supply and demand side are tighter than in 2008.

While Indonesia's banks, overall, are in good health and, on average, are neither over-extended nor under-capitalized, Indonesia's bankers quickly become more conservative with the financial market turmoil of September through November. Fearing growth in non-performing loans subtracting from their capital base, bankers became less willing to take on new clients, fearing that they may have already been rejected by other banks with greater knowledge of their risk profile.

Demand for credit will also grow less rapidly in 2009 than 2008. Firms are less willing to borrow because of stricter lending conditions, the uncertainty surrounding firms' financial positions as cash flows decline with the downturn in trade values and volumes, much slower growth in prices, cuts to investment plans, and heightened general uncertainty about the economic outlook.

Given these factors, BI has lowered its domestic credit growth target for 2009 to 14-16 percent, less than half the 33.2 percent year-average growth in 2008, based on a survey of banks' lending intentions. Anecdotal reports suggest that this may be optimistic.

3. Indonesia's balance of payments is likely to be weaker than in recent years

a. The outlook for the current account is near balance

An ongoing trade surplus, and lower net income deficit, means the current account is likely to remain near balance

Indonesia's current account is likely to remain near balance over the next 2 years. With the fall in import values at least matching declining export values (especially given the drop in shipping costs Indonesian importers have to pay), Indonesia will continue to report trade surpluses. However, the fall in the value of trade flows means the absolute USD value of the difference between exports and imports will be lower than in recent years.

The fourth quarter 2008's trend of a lower net income deficit is likely to continue into mid-2009, given the lagged impact of the fall in commodity prices and trade volumes on firms' profitability and repatriation of those profits.

Income transfers in the other direction, from Indonesians working abroad back to their families, are not likely to decline dramatically. Indonesian migrant remittances tend to be from residents working temporarily abroad, and not from members of a longer-term diaspora sending funds home as a means of supporting business connections. World Bank research finds that remittances of the former type are less sensitive to the global economic downturn, and this was borne out in the first quarter. There may, however, be a decline in employment opportunities for Indonesians abroad – for example due to the downturn in crude palm oil prices reducing output or profitability of plantations in Malaysia, and already there are anecdotal reports of tens of thousands of Indonesians returning earlier than originally intended. This surge in returning migrant workers may lead to an upwards blip in remittances as workers send saved funds ahead.

b. Considerable external financing requirements suggest there remains the possibility of further net capital outflows

Global market conditions make forecasts of capital and financial account movements more uncertain than usual

Conditions in global financial markets make forecasting how Indonesia's capital and financial accounts will evolve over the coming years even more fraught than usual. The extent to which the improvements in global risk appetite and liquidity since early March continue is likely to be the most important determinant of how much of Indonesia's existing debt is rolled over and new issues replacing amortizing bonds will be purchased – at a price feasible for the issuer. These factors plus Indonesia-specific conditions will affect the magnitude of non-residents withdrawal from their existing holdings of Indonesian financial assets, and of residents' transfers of capital offshore.

Table 9: Indonesia needs about USD 30 bn in external financing in 2009
(billions of USD)

EXTERNAL FINANCING NEEDS, 2009	**30.4**
Current account deficit (-ve if surplus)	**.1**
Trade (GNFS) deficit (-ve if surplus)	-10.0
Net income	5.1
Maturing short-term FCU debt	**12.1**
Debt instruments	6.9
Trade credits	5.2
Short-term IDR liabilities to non-residents	**2.7**
Maturing short-term LCU debt	2.0
Amortization of medium and long-term IDR debt	.7
Amortization of medium and long-term debt	**15.6**
Public	7.0
Private	8.6

Sources: BI and World Bank

Indonesia's basic financing needs in 2009 are approximately quantifiable, even if projections of the net flows to meet those needs, or of unscheduled withdrawals from other types of holdings, are more speculative. Scheduled debt repayments, bond amortizations, and projected current account movements in 2009 sum to a little over USD 30 bn (Table 9).

This does not include non-residents again reducing their holdings of ongoing Indonesian financial assets (eg, shares or bonds) or of drawing down bank accounts. Non-residents have been were gradually reducing their holdings of government IDR bonds during the periods of peak financial turbulence over the past 6 months, and also became net sellers of equities in the first months of 2009. Bank account holdings, however, have been less susceptible to changes in market confidence, but may be drawn down moderately as lower activity reduces foreign firms' IDR cash needs.

With very conservative assumptions, appropriate for a period of high global risk aversion and fragile financial markets rather than the more benign conditions prevailing by May, a scenario can be generated that fills the majority of these financing needs. On its own, the government's financing plan brings in to Indonesia at least USD 8.4 bn, or more than a quarter of the nation's total external requirements, even assuming that it can make extensive use of finance from domestic bond markets and not draw on contingent financing (Table 7). The government's use of official financing implies an 80 percent roll-over rate.

A conservative assessment would be that at least half of the private sector short-term debts will be rolled over, with the non-100 percent rollover reflecting tighter global credit conditions, plus the scaling back of some projects with the global downturn and drop in commodity prices. This roll-over draws in at least a further USD 6.5 bn. About one-third of the private sector's debt due in the next year has been borrowed from a parent or affiliated company, and almost 60 percent is owed by a foreign or joint-venture corporation, which may be associated with lower sovereign risk than a purely Indonesian firm.

Finally, while flows of net foreign direct investment (FDI) have been exceptionally strong recently, this may slow in coming quarters, as for example resource projects are decelerated. World Bank research suggests that the impact of the 1997/98 crisis on FDI was small, although in that crisis capital scarcity was regional. On balance, very conservative assumptions suggest net FDI may bring in another USD 1 bn or USD 2 bn.

Allowing for some net purchases by non-residents on the stock market and of government bonds, and allowing foreign lending lines to be created, brings the total financing past two-thirds of Indonesia's needs.

There exists a small risk of significant capital outflows

In general, there does not appear to be a significant domestic trigger for large and sudden capital account outflows. Nonetheless, as mentioned in the last *Quarterly*, this remains an ongoing, small, but important risk. Residents are the biggest source of outflow risk, given many higher net wealth residents already have offshore bank accounts and have historically shown a tendency to shift funds offshore. A large range of factors may trigger this remote event, although the risk of any of these has declined since the last *Quarterly* was produced. Nonetheless, the consequences of such an event remain a depreciation of the rupiah and reduction in reserves, increasing Indonesia's vulnerability to other shocks.

4. Inflation should fall further, particularly for the poor

Lower commodity prices, slower credit growth, and lower inflation expectations, will

For consumers, the weak outlook for commodity prices and for growth, described above, bring lower inflation. The depreciation of the rupiah partially offsets the fall in commodity prices, but overall, on balance, the net effect is negative. World Bank estimates suggest that the full effect on consumer prices of the exchange rate and commodity price

continue to pass into slower consumer price growth

movements of late 2008 should occur by the second quarter of 2009. Other disinflationary processes may take longer. For example the fall in construction materials costs will lower the cost of construction which will lower housing costs in due course, and the decline in consumers' inflation expectations is likely to limit wage demands. The growth in the money supply tends to be the other key determinant of movements in Indonesian consumer prices, and this is projected to slow in 2009 as lending growth slows. This will also be disinflationary.

Together, these factors are likely to slow consumer price inflation to 5 percent in 2009, with the year-on-year inflation rate likely to fall to this level by June. As workers' wage claims fall with the slowing growth in the cost of living, and with global growth and commodity prices weak, inflation may slow a little further in 2010, to average near 4 percent.

Inflation will slow most for poorer households

Price growth for the goods and services poor households consume is expected to converge to the average inflation rate, or even slightly below. This is due to the limited growth projected in food prices and ongoing pass-through of the recent falls in global goods prices to consumers. The good 2009 harvest should also limit growth in food prices for items insulated from global markets. (Food items make up a larger share of poor households' consumption baskets, as discussed above.)

5. The government is responding to the global slowdown

a. The government has responded with a fiscal stimulus package

Indonesia, like many economies, has enacted a fiscal package designed to quickly inject funds into the economy

Many countries around the world are implementing fiscal stimulus packages in order to counter the current global crisis. One of the key factors in making such fiscal stimulus proposals effective is to ensure that the appropriated funds move into the country's economy at a rapid pace. Indonesia is no different than other countries. The fiscal stimulus package that the Government has presented to the Parliament includes both tax cuts (to put more money into the hands of private individuals with the expectation that they will spend it) and additional government spending in critical areas (to move money for government projects into the hands of contractors and others). Box 1 describes some key features of Indonesia's fiscal stimulus.

Figure 34: The size of Indonesia's stimulus plan, while moderate, is typical of other economies in the region
(% GDP)

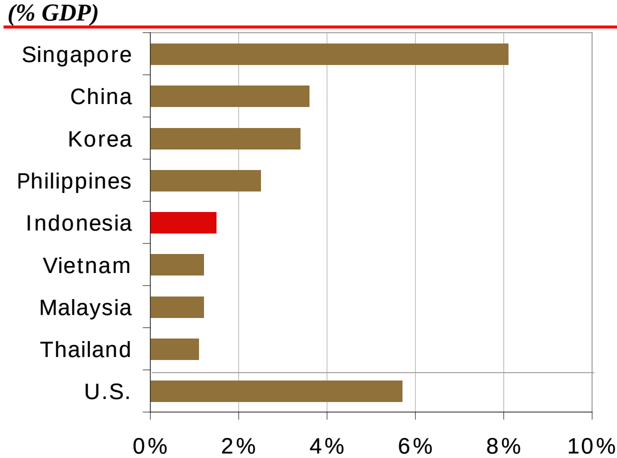
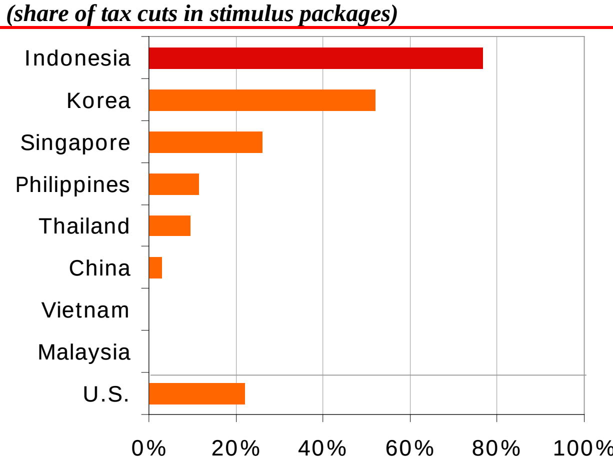


Figure 35: ... but tax cuts make up a much larger share of Indonesia's plan than in neighboring economies
(share of tax cuts in stimulus packages)



Sources: National authorities and World Bank

Box 1: The government's stimulus package

The revised budget seeks to stimulate demand, with an immediate impact. The government's goals are to support consumers' purchasing power, to protect the business sector from the global downturn, and to generate employment to mitigate the impact of job losses in the private sector. It does this via two mechanisms: expanding government spending especially on infrastructure; and lowering taxes for specific sectors. These tax cuts are in addition to the already programmed 2009 cuts in income tax rates that are a component of the government's drive to expand taxpayer registration, and to the automatic reduction in tax receipts due to the decline in profitability. Together these measures will cost the government about 1.5 percent of GDP, in line with the first round of stimulus packages that have been announced across the region (Figure 34).

By far the largest component of the government's stimulus plan is tax cuts, and in this respect Indonesia's stimulus package stands out from others in the region (Figure 26). In a policy move made before the depth of the downturn was apparent, the government lowered income and personal tax rates and raised the tax-free income threshold to IDR 15.8 million. These measures are budgeted to forego IDR 43 tr. in revenue in 2009, although they form part of a larger plan to increase tax payer registration and hence the tax base, strengthening the government's revenues in the long term.

Table 10: Marginal tax rates have been cut and income tax brackets raised

Rates from 1 Jan 2009		Previous rates	
Monthly income, millions of IDR	Marginal tax rate:	Monthly income, millions of IDR	Marginal tax rate:
Less than 50	5%	Less than 25	5%
		25 to 50	10%
50 to 250	15%	50 to 100	15%
250 to 500	25%	100 to 200	25%
Above 500	30%	Above 200	35%
Minimum taxable income:	IDR 15.84 m		IDR 13.2 m

Source: MoF

With the emerging global downturn, the government introduced more targeted tax cuts, including to VAT on oil & gas exploration and on low-cost household cooking oil. It also reduced import duties on imported raw materials and capital goods, and introduced payroll tax breaks for firms in labor-intensive industries. IDR 13.3 tr. is budgeted for these cuts. The government has also cut electricity tariffs for industrial users and reduced the price of automotive diesel.

Finally, slower economic growth and lower prices for oil and other commodities mean smaller profits and lower income growth, which in turn will cut government revenues. This acts as a stabilizer, with the amount of funds the government is removing from the economy automatically falling as the economy weakens. The deteriorating outlook for 2009 has cut about IDR 38.7 tr from tax revenues, almost half of which are due to the lower expected oil price (from USD 80 in the initial 2009 budget to USD 45 / barrel). Lower consumption also means lower VAT – down 6 percent from the budget passed in November. These projections are based on economic growth of 4.5 percent and inflation of 6.2 percent. As the government acknowledges, significant downside risks exist to both projections, and hence also to revenues.

In contrast to the experience of the 1997/98 crisis when spending on infrastructure and social support were cut, the government's revised budget further expands the budgeted increase in spending on infrastructure and social support. The stimulus package allocates IDR 12.2 tr to infrastructure – generally labor-intensive projects on which work can start quickly, such as road maintenance and rural irrigation. This brings capital spending to 16.5 percent above 2008's realized levels. This stimulus package also adds IDR 0.6 tr. to the community block grants program (PNPM).

Sources: MoF, World Bank staff

b. ...and is both working around while directly addressing the challenge of achieving full and fast disbursement

Indonesia's difficulty in quickly disbursing funds and enacting or expanding spending projects limits what the stimulus package can include

However, the efficacy of the proposed fiscal stimulus measures, particularly on the government spending side, will depend on the rate at which such funds are disbursed. If the appropriated funds sit in government accounts during a prolonged contract award process, for example, then the funds will not be acting as a stimulus. Some delay in spending the stimulus is inevitable, as, for example, spending plans are debated and selected, blueprints are generated and contracts are let. This leads to the empirical observation that in some instances, fiscal policy can be pro-cyclical as the stimulus funds allocated in the depths of a recession only enter the economy when the upswing is well underway. The projected depth and length of this downturn suggests that the risk of such pro-cyclicality is much smaller during this episode.

The pace of Indonesia's spending can be slow and uneven

Disbursing funds, both in the course of conventional government operations and through new spending programs and expanding existing programs, appears to be especially difficult in Indonesia. Historically disbursement has been slow and uneven. While disbursement was spread more consistently across 2008 than 2007, and has improved slightly further during the first few months of 2009, spending is still highly skewed towards the final months of the year, with 23.4 percent of the total goods budget and 32 percent of the capital works budget spent in December. (Figure 36 and Figure 37)

Figure 36: Indonesia's government spending is concentrated at the end of the year
(IDR trillions and percent of total ministerial spending)

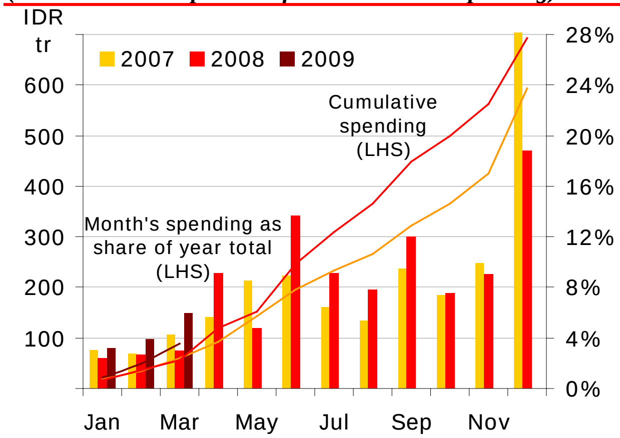
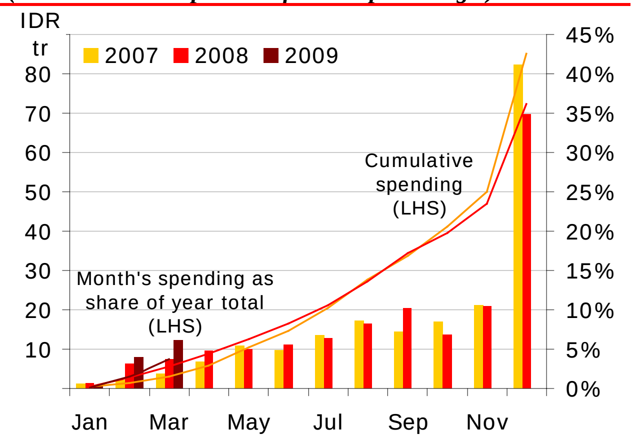


Figure 37: …especially infrastructure spending, although
(IDR trillions and percent of total capital budget)



Sources: Ministry of Finance and World Bank

…in part due to the budget process

Indonesia's slow and uneven disbursement is partly due to the complex, highly detailed budget execution process. The challenge in designing budget execution processes is to balance the goal of applying funds rapidly with the need for appropriate accounting, reporting, and auditing to ensure that the funds are spent effectively and as intended. In Indonesia, the State Treasury Law enacted in 2004 (Law 1/2004) outlines this process. It attributes line ministries (those that spend government funds) with greater responsibility for the management of their own finances. The delegation of financial responsibilities, including expenditure management, is balanced by the implementation of financial procedures to ensure better accountability for and transparency of the use of budgetary funds.

Line ministries, which spend government funds on education, health care, environmental services defence, etcetera, are allocated funds in the annual government budget issued by the Treasury Department. The allocation documents are called DIPAs. Budget allocations in the DIPAs are broken down by organization code, functions, sub-functions, activity, and two levels of economic classification of expenditure (Box 2 outlines the meaning of these terms). The DIPAs contain this level of detail to enable the Treasury, as the central agency, to track how government funds are spent.

Before any money can be spent in a given year, the DIPAs are prepared by the line ministries based on the Presidential Decree on the State Budget. The DIPAs must be ratified by the Minister of Finance (or the Directorate General of Treasury on her behalf), before they can become the basis of a payment. Before approving the DIPA, DG Treasury must verify that the material in the DIPA is consistent with the Presidential Decree.

There are several ways in which this process delays spending:

- The core staff (*Pejabat Perbendaharaan*) managing particular expenditure projects need to be reappointed to that project each fiscal year, and, in some cases, the entire unit implementing the expenditure project needs to be re-established each fiscal year.
- Single-year budgeting means that if the process of procuring a project is lengthy, and the project is only for a single year, the procurement cannot be rolled into the following budget year.

- The initial planned budget may lack credibility with spending agencies given the substantial and frequent revisions over recent years as the government tries to meet overall deficit targets in the face of the impact on revenues and energy subsidies of large swings in crude oil prices. This leads agencies to be conservative during the first part of the year, and then to rush to spend their allocation in the final months as their total allocation becomes clear.
- Parliament has traditionally applied strict oversight of budget allocation to each program, prohibiting ministries from re-allocation funds initially budgeted for one program to another program.

Box 2: Classifying expenditure types – what the terms mean

The **organization code** identifies the ministry responsible for spending the money, and the unit within that ministry. Indonesia has 6 superior agencies, 20 technical departments, 3 co-ordinating ministries, 10 state ministries, and 34 state ministries formed by Presidential Decree. This list includes organizations, such as the Ministry of National Education – responsible for schools and teachers – and the Ministry of Public Works – responsible for building and maintaining roads, among other activities.

The **function code** puts the expenditure into one of 11 different *functional* categories. These categories are different from the organizational structure, although they often overlap in practice. Functions include defense, education, health services, and the environment. It is common practice to track spending by functional area, as these are not affected by changes in the government's organizational structure.

Economic classifications, the third type, relate to the expenditure *type*: eg, spending on personnel including wages and salaries, for the acquisition of goods and services, for the acquisition of capital assets, for social expenditures, interest payments on loans, subsidies, and grants.

Sources: MoF, World Bank staff

The global economic downturn has hastened the Indonesian government's reforms to the budget process

Recognizing the need to ensure its fiscal stimulus is effective and timely, the Indonesian government has taken extraordinary measures to accelerate disbursement in 2009 and to improve its budget process.

The DIPA has been accelerated by making funds available sooner in the initial process, allowing for more streamlined changes to an existing DIPA while maintaining fiscal controls, and by simplifying the DIPA by allowing line ministries to reallocate funds across sub-activities without needing approval from the Budget Office. Treasury officers are appointed for multiple-year terms, and hence avoid the re-appointment process at the start of each year.

To monitor the speed of budget disbursement, the Government has established a DIPA 2009 Monitoring Committee, consisting of the Directors General of Treasury and Budget, the Head of the Fiscal Policy Office, and a representative from the Planning Ministry (Bappenas). This committee will follow the progress of the implemented reforms and their effect on the budget disbursement throughout the year.

The government is also working to improve the procurement process, so that funds for large infrastructure projects can be spent more efficiently. DIPAs are now issued at the beginning of the budget year. The government is expanding the use of advance procurement processing, whereby procurement processes can begin as soon as the State Budget is adopted in the October before the start of the relevant fiscal year. Also, the 2009 Budget Law rolls funds for infrastructure projects that cannot be completed in a single year into 2009 so that work on such projects can continued without impediments.

c. Access to trade finance has become a problem for exporters, and the government is providing support

The global financial crisis also challenges Indonesia's exporters indirectly, limiting their access to trade financing

In addition to declining prices and falling demand, exporters have experienced difficulties accessing trade finance (Box 3 outlines how trade finance works and why it is an important enabler of trade). World Bank research has found that as turbulence on global financial markets peaked, banks limited the amount of trade finance available and increased both its cost and its collateral requirements. The decline in access is particularly

severe for exporters relying on imported raw materials, such as exporters of clothing and footwear, as banks are also tightening access to credit for working capital.

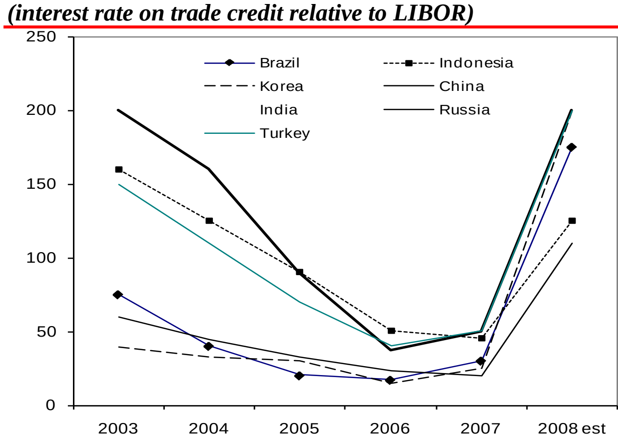
A lack of liquidity may explain the decline in trade financing more than higher perceived risk

The price of trade credit has increased. Although trade credits are still available, the interest rate charged has substantially increased as USDs became more scarce in the Indonesian (and global) interbank markets, due to global deleveraging and heightened risk aversion particularly affecting banks in emerging markets. Interest rates charged by Indonesia's four major trade financing banks rose by 200-300 bps relative to LIBOR in the last quarter of 2008 relative to a year earlier, according to a World Bank survey. This increase is in line with price adjustment elsewhere (Figure 38).

Also weighing on the market has been higher counter-party risk. As discussed above, banks have become more risk-averse as global financial and economic conditions deteriorate. In this environment of low certainty about the credit-worthiness of counter-parties, most foreign buyers prefer to use open account transactions (i.e., paying the cost of the goods to the exporter once trade documents have been accepted) as letters of credit have become more expensive. However, fearing that buyers may default on their purchase contract, Indonesian banks have become reluctant to provide financing for exporters without a confirmed letters of credit (L/C) from buyers. Aggravating the problem is the lack of capacity and limited role of Indonesia's export insurance agency (PT ASEI) to provide export credit insurance for banks and export insurance for exporters.

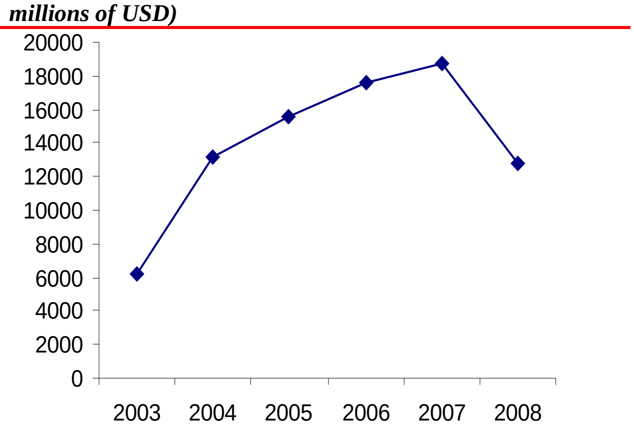
It is still hard to gauge the overall impact of the tightening in trade finance on trade flows. Various indirect indicators suggest that, with global demand, trade finance flows declined in the last quarter of 2008 – by about 40 percent on a year earlier, according to Dealogic (Figure 39), and the number of loans signed fell to the lowest level since 2004. Whether the contraction of trade finance contributed to the decline in world trade or was a consequence of this decline remains an open question. The latter appears to be dominant: overall demand for trade finance has decreased with global trade flows. At the same time, the price of trade finance and the need for securing transactions through guarantees and insurance has increased.

Figure 38: Spreads on trade credits rose in 2008
(interest rate on trade credit relative to LIBOR)



Sources: Standard Chartered and World Bank

Figure 39: ...and trade finance volumes have shrunk
(short-term trade finance (structured) in emerging markets; millions of USD)



Source and notes: Dealogic. The Dealogic data are not always good indicators of banks that handle the larger share of L/C-based trade finance as they represent only 'reported' and 'structured' trade transactions

Policy markers have responded, creating alternative sources of trade finance

Indonesian authorities have taken several steps to ease the bottleneck in trade finance. In November 2008 Bank Indonesia reactivated its re-discount facility for Indonesian banks to trade at a discount the L/Cs they hold that have been issued by foreign banks, in exchange for foreign currencies (BI regulation No.10/34/PBI/2008). The facility is intended as short-term measure to provide foreign exchange liquidity to banks so they in turn can provide trade credits. That is, the facility would act as a stand-by resort in case Indonesian banks have difficulties raising foreign exchange funds to finance trade.

In December 2008 Parliament approved the government's plan to turn its existing Ekspor Impor Bank into a trade financing agency. The credit agency supports banks in providing trade finance for exporters. Nevertheless, the success of the efforts by BI and GoI to ease access to trade finance and support exporters will become evident in the coming quarters.

Box 3: A primer on trade finance

Access to financial services is important for exporters. Exporting production can entail a considerable investment: the cost of importing raw materials, hiring workers, sourcing intermediate inputs to produce goods, identifying and applying the right technologies, and establishing new relationships with buyers in new markets. Even for a long-term exporter, exporting demands effective liquidity management, even just to cover the period between incurring the costs for producing the goods and payment. To meet those challenges, most exporters draw on external financing, additional to their own cash reserves. While many different financing products are available, the types of trade flows and their corresponding financing facilities can be grouped into three types:

- **Documentary trade**, using letters of credit (L/Cs). L/Cs are instruments issued by banks that provide for payment upon presentation of documents showing shipment. They provide the exporter with some protection against importer and country risk. These are usually short-term (up to six months) and are used extensively in intra-Asian trade. A L/C may allow the exporter to request earlier payment at a discount for goods that have been sent to the buyer. Banks issuing L/Cs can also offer importers short-term financing so that importers can pay after the goods are sold. In addition, L/Cs can be confirmed by a bank, guaranteeing payment of the draft where there is concern about the purchaser's credit worthiness.

- **Commodity lending**, including both export and import financing. Export financing can cover the full lifecycle of the commodity, from the purchase of seeds and fertilizer to coverage of the amount receivable after the good has been exported. Import financing covers the period between payment for the good and receipt of revenue for its sale. Commodity lending is usually secured by the commodity being traded. It also tends to be short-term, with terms of three to six months.

- **Open account trade** involves the shipment of goods by the seller to the buyer before the buyer has paid for those goods. The trading entities usually have an ongoing relationship, which has built such trust that they do not expect delays in payment. Open account financing can cover financing needs both pre-shipment (working capital) and post-shipment (pending accounts receivable). Financial institutions can provide receivables and factoring services that reduce the risk of the supplier not being paid, thus increasing the amount of finance that the supplier can access. Open account trade has been growing faster than documentary trade, and over 80 percent of global trade is financed this way, according to data compiled by Standard Chartered. It is becoming especially important for services trade. Like the other types of financing, open account financing tends to be for less than 6 months, and is self-liquidating when the accounts payable are closed.

These three broad groups of facilities are often built into larger systems of trade services provided by financial institutions to assist traders in managing the documentation and payment process. In practice, these facilities may see the financial institution managing all payment flows in the production process. Thus an offshore customer may send a purchase order to a supplier, the supplier then borrows working capital from their financial institution to cover the cost of raw materials and processing, then when the goods are processed and sent to the customer, the supplier may forward the shipping documents and invoice to their bank. The bank creates a post-shipment loan, which pays off the pre-shipment loan. When the customer receives the goods, they pay the invoice to the supplier's bank directly, thus making the loan self-liquidating and ensuring that the bank's commitments are not open-ended.

In many cases, trade finance only covers accounts receivable, with the financial institution purchasing the accounts due to the supplier, and collecting customers' payments when the accounts are due. This provides the supplier with liquidity, and helps them reduce their risks and to better manage their balance sheet.

There are considerable **risks** to trade finance loans, even through trade finance is supported by valuable collateral (the goods being traded) and is generally self-liquidating. Risks that increase the likelihood that trade financing is not repaid include:

- **Performance risk** that, eg, the producer's goods differ from the specifications in the supply contract
- **Buyer risk** – eg they refuse delivery or they or their financial institutions fail to pay
- **Disasters or political upheaval** preventing delivery of the goods.

The global financial crisis has impacted trade finance in two ways: it has increased the perceived

risk associated with trade financing, and it has increased the cost of the funds used in trade financing. The crisis raises questions about the ability of counter-party banks to fulfil their commitments (eg, to transmit promised funds) as many previously reputable global banks face liquidity shortages. The associated disruption to trade flows and sharp worsening in economic conditions creates uncertainty about whether buyers will accept the goods they have ordered, and, if they do, pay for them, at the contracted prices, and on the terms originally agreed. While there are only limited reports that these problems have grown recently, the perception that they risk occurring has increased.

Given this greater uncertainty, exporters now prefer to secure their sales with L/Cs, whereas in less disrupted times buyers preferred to use less costly open account transactions. L/Cs offer greater security, which allows exporters better access to trade credits from banks, and there are anecdotal reports that banks are limiting trade credits to export transactions secured by L/Cs.

Higher cost of finance for the originators of trade finance also affects its supply. The global financial crisis has increased cost of funds for banks, particularly funds in international trade currencies (the USD) and for financial institutions in emerging markets. Global deleveraging and lack of inter-bank liquidity make it more difficult for banks to raise money. Consequently, pricing of trade finance deals around the word has increased by 300-400 basis points over interbank refinance rates—two to three times more than the going rate in early 2008 (Figure 38). Higher rates also increase the cost of obtaining L/Cs, affecting importers.

Sources: Standard Chartered, Citi, and World Bank

d. The government has also taken actions to control smuggling and the dumping of goods

Higher illegal imports risk weakening domestic industries

Policy makers are concerned about the potential impact of illegal imports on domestic producers. Illegal imports gain better access to the Indonesian market by avoiding import tariffs either fully, by smuggling the goods into the country, or partially, by under-stating the value of the goods in their invoice. The concern is that as global demand slows, more of these products will flow to Indonesia, with its relatively robust domestic demand and relatively porous borders. This increased low-cost supply will occur just as Indonesia's domestic producers are being pressured by weaker demand and tighter cash flows.

Consumer products are particularly susceptible to illegal imports; intermediate goods less so. The size of illegal imports can be observed indirectly, as the difference between the value of imports recorded by Indonesian customs (excluding bonded zones) and the value all other countries report exporting to Indonesia (adjusted for shipping and insurance costs). For example in 2006, Indonesia's trading partners reported exporting about USD 4.1 bn of clothing to Indonesia, while Indonesian customs recorded imports of only USD 1.8 bn. Likewise, imports of electronics to Indonesia were recorded as USD 1.8 bn while trade partners reported exporting as much as USD 4.4 bn. (Table 11) Although errors in reporting imports are common, under-invoicing and smuggling could also explain the magnitude of discrepancies.

Table 11: Particularly for consumer items, there is evidence of a considerable amount of illegal imports

	Import value	
Products	Recorded by Indonesian customs	Reported by the rest of the world [a, b]
Food, food products & beverages [c]	0.90	0.99
Chemicals	8.10	8.17
Iron and steel [d]	4.13	4.99
footwear	1.79	4.12
Cameras, consumer & household electronics	1.76	4.36

Notes and sources: a/ Adjusted for 15 percent insurance & freight; b/ Assuming 80 percent of imports went to non-bounded zones; c/ Excluding alcoholic beverages; d/ Including base metals. BPS, UN ComTrade. and World Bank

…prompting the government to restrict how and where certain goods can be imported

To reduce the scope for under-invoicing and smuggling, the government has introduced measures regulating certain imports. Effective January 2009, only licensed importers may import five categories of consumer goods (toys, clothing, footwear, consumer electronics, and food & beverage products). The goods must be pre-inspected prior to their arrival in Indonesian ports, and they can only be cleared through five international sea ports in Indonesia (Ministry Regulation No 56, 2008).

Importers have raised concerns that the regulation lacks clarity, and that the requirement for pre-shipment inspection imposes considerable costs. Indonesia's trade partners have expressed concerns that the regulation may be a form of covert protectionism. Regardless, the regulation is expected to affect only about 3 percent of Indonesia's total imports.

6. GDP growth is projected to slow, due to the multiplier effects of slowing exports and declining commodity prices, plus tighter domestic credit

Lower growth among trading partners, weakened commodity prices, and slower credit growth will slow Indonesia's GDP growth, despite policy makers' proactive response

The deteriorating external environment discussed above, will impact Indonesia's externally-oriented firms' revenues and demand, hence the dividends they pay their owners, the wages they pay their employees and the size of their workforce. This in turn impacts domestic demand, as employees concerned about job security cut purchases of consumer durables especially. At the same time the tightening in credit restricts investment and reduces consumer financing, both affecting domestic demand.

Partially offsetting these negative external developments, Indonesian policy makers' response offers some succor. With BI easing monetary conditions at a measured pace, parliament speedily passing the government's revised budget and stimulus package, and the government seeking to ensure this package is fully implemented and leaving open the possibility of a further package, it is clear that policy makers are engaged in limiting the impact of the global downturn on Indonesia. The limited range of policy tools open dulls these efforts – in particular, the lack of capacity to disburse additional funds, and the lack of ready projects on which the stimulus package can be spent, but virtually all stimulus packages, including those of OECD economies, are confronting this problem.

On balance, these developments weaken Indonesia's economic outlook for 2009 through 2011. Given the developments outlined in this document, Indonesia's economic growth is expected to slow to around 3.4 percent in 2009 before lifting to 5.4 percent in 2010 (Table 12). These projections are about 1 percentage point lower for 2009 and one-half percentage points lower for 2010 than projections constructed in November 2008. They are consistent with the first quarter outcomes, which are likely to have been lifted by temporary factors, such as election-related spending, and growth in the second quarter is likely to have a similar momentum. These forecasts suggest that Indonesia's growth will slow by less than economic growth among other major emerging economies in the region. (Figure 40)

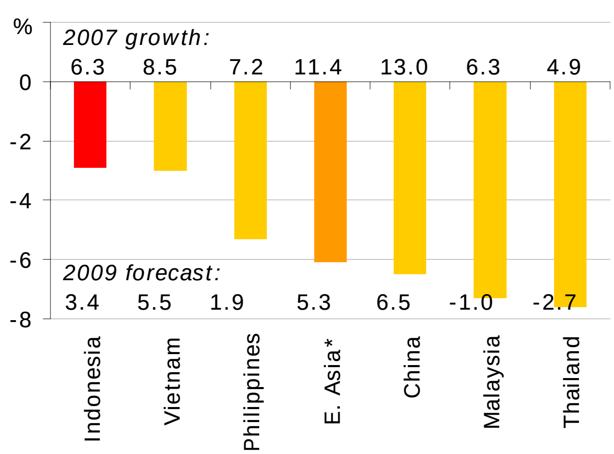
Table 12: Indonesia's GDP growth is projected to slow to 3.4 percent in 2009, recovering in 2010, under baseline forecasts for global growth and prices and domestic policy

		Actual		Projected		
		2007	2008	2009	2010	2011
Domestic economy:						
Real GDP growth	%	**6.3**	**6.1**	**3.4**	**5.4**	**6.3**
Investment	% change	9.2	11.7	4.1	8.4	10.2
Consumer prices	% change	6.5	9.8	5.0	4.0	4.0
Budget deficit	% GDP	-1.3	-0.1	-2.0	-1.4	-1.2
Poverty rate	% pop'n	16.6	15.4	13.2	11.7	--
External sector:						
Current account balance	USD bn	**10.4**	**0.5**	**-0.1**	**-1.1**	**-3.7**
Exports GNFS	USD bn	131	154	113	124	140
Imports GNFS	USD bn	110	144	104	112	124
Growth environment:						
Trading partner GDP	% change	1.9	3.0	-0.2	3.3	4.3
Real effective exchange rate	% change	5.7	9.4	-2.9	0.0	0.0
Export prices	% change	17.8	28.1	-39.8	-5.9	0.8
Credit growth	**%**	10.2	17.1	12.0	13.5	13.5
Gov't consump'n	% change	3.9	10.4	11.9	14.9	11.2

Sources: BPS and BI via CEIC, and World Bank

Figure 40: While the slowdown in Indonesian growth is considerable, it is among the smallest in the region

(difference between 2007 and forecast 2009 GDP growth)



Sources: national agencies and World Bank forecasts

Considerable uncertainty surrounds these forecasts – the external environment may be considerably worse, or measures to support domestic demand even more effective than expected

But considerable uncertainty surrounds the baseline outlook. Global economic conditions remain volatile. February and early March brought some further deterioration to the global economic outlook, both in terms of the depth of the downturn and its potential length, and first quarter profitability of many major corporations in developed economies was below analysts' expectations; on the other hand, the stabilization in the outlook for commodity prices has become more entrenched, and financial market conditions have improved significantly since early March. Uncertainty surrounds Indonesian banks' willingness to continue lending, and firms' willingness to accept the more stringent conditions and higher

real costs of borrowing given their more uncertain earnings outlook. This adds to the general uncertainty surrounding investment plans given the range of potential returns those plans may generate. On the upside, the government's policy stimulus package may have a larger effect on the economy than previously planned expansions in government spending. Thus a wide range of potential alternative outcomes surrounds the projections above. Analyzing the impact on projected growth of more extreme but plausible projections for these indicators throws light on the size of the risks to Indonesia's economic outlook.

Table 13: A deeper or longer global downturn would also extend Indonesia's slowdown, while an effective policy stimulus would boost domestic demand and lift growth

		Actual		Projected		
		2007	2008	2009	2010	2011
DEEPER GLOBAL DOWNTURN:						
Domestic economy:						
Real GDP growth	%	**6.3**	**6.1**	**3.0**	**4.9**	**6.2**
Investment	% change	9.2	11.7	2.9	8.2	10.2
Growth environment:						
Trading partner growth	%	1.9	3.0	-1.9	3.2	4.3
Real effective exchange rate	% change	5.7	9.4	-9.6	-0.3	0.0
Export prices	% change	17.8	28.1	-42.4	-1.6	0.8
SLOWER GLOBAL RECOVERY:						
Domestic economy:						
Real GDP growth	%	**6.3**	**6.1**	**3.4**	**4.7**	**5.8**
Investment	% change	9.2	11.7	3.5	7.3	10.1
Growth environment:						
Trading partner growth	%	1.9	3.0	-0.9	2.6	4.3
Real effective exchange rate	% change	5.7	9.4	-7.5	-0.7	0.0
Export prices	% change	17.8	28.1	-39.8	-5.9	0.8
STRONGER DOMESTIC STIMULUS:						
Domestic economy:						
Real GDP growth	%	**6.3**	**6.1**	**3.8**	**5.7**	**6.4**
Investment	% change	9.2	11.7	5.0	11.7	11.2
Growth environment:						
Credit growth	**%**	10.2	17.1	18.0	17.2	14.0
Gov't consump'n	% change	3.9	10.4	16.7	22.6	11.2

Sources: BPS and World Bank

Table 13 presents two scenarios for growth among Indonesia's export partners and of export prices, and one scenario with a larger fiscal stimulus. These generate alternative projections to the baseline presented in Table 12, and aid in evaluating the risks to the growth outlook.

A much deeper recession among Indonesia's trading partners, which would bring some further falls to commodity prices and slow their recovery, and further depreciation of the rupiah, would lower Indonesia's 2009 and 2010 growth by about one-half of one percent. Investment especially would be hit, with little growth in 2009.

A longer recession, with trading partner growth in 2010 one percentage point below the baseline, further falls in commodity prices, and some depreciation in the real exchange rate in 2010, is projected to slow 2010 growth by about three-quarters of one percentage point and also delay Indonesia returning to its potential growth rate.

As a final scenario, Indonesian policy makers may expand the size of the fiscal stimulus package and take other measures to support domestic demand, for example through encouraging bank lending and through rapid improvements in the investment climate. Without changing any other factor, several percentage points faster credit growth and government spending add about one-quarter of one percentage point to 2009 and 2010 GDP growth. This scenario particularly lifts investment growth from 2010.

7. Employment, especially in some regions and for some sectors, will be affected by the slowdown

Indonesia's employment experience during the 1997/98 crisis throws light on the potential impact of the current downturn

Indonesia's current growth slowdown is quite different from both the 1997/98 crisis especially and the 2001 downturn – this downturn is largely driven by external developments whereas the other two had considerable domestic drivers. The 1997/98 saw a far deeper fall in growth and worsening in social outcomes than is likely during this crisis, while the 2001 downturn, only 3 years later, occurred with growth still suppressed and domestic demand and policy-making institutions weak. Despite the substantial differences, both experiences throw valuable light on the likely impact of this downturn on jobs in Indonesia. (For a more extensive of Indonesia's labor market over the past decade, please see the *Indonesia Jobs Report*, forthcoming from the World Bank).

a. During the 1997-98 Asian crisis, Indonesian unemployment increased only modestly, with workers losing better paid formal jobs and shifting to the informal and agricultural sectors

Unemployment increased only modestly during previous downturns…

The Asian Crisis of 1997-98 and the economic slowdown in 2001 both saw modest increases in unemployment. Core unemployment increased by 1.7 percentage points in the two years to 1999, and by 0.5 percentage points in 2002. Open unemployment, including both those seeking work and those who are discouraged from the job search, increased by 1.0 percentage points in 2002.

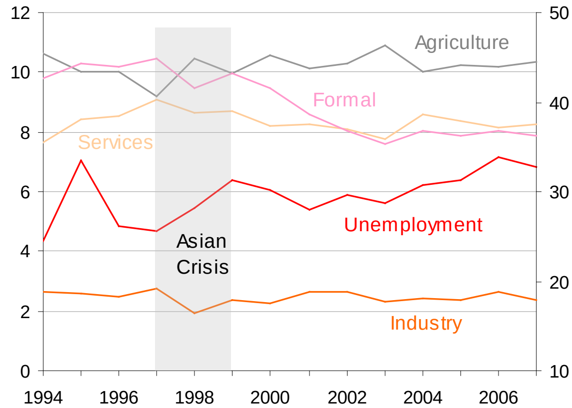
… as workers losing formal sector jobs moved into agriculture and informal work…

A flexible labor market saw laid-off workers shift into the agricultural sector and informal work. Agricultural employment increased by 4.3 million, or 13 percent in 1998, while the number of workers employed by the formal sector fell by 3.3 million. Industry and services share of the workforce dropped by 2.6 percentage points as over 3 out of every 10 male workers changed sectors between 1997 and 1998, and close to 4 out of every 10 females.

…but with real wages falling for all workers

Real median wages fell 31 percent between 1997 and 1998. No subgroup was immune, with male wages down 10.2 percent each year between 1997 and 1999, while female wages fell 10.4 percent each year; non-poor wages fell by 11.9 percent while poor wages fell 10.8 percent 1997-1999; urban wage loss was dramatic (12.9 percent) but rural wages also suffered (9.5 percent fall). Less-educated workers experienced a similar drop to more-educated workers (10.9 percent and 10.7 percent respectively), but younger worker wages fell 12.7 percent, 1.7 percentage points more than adult wages.

Figure 41: Unemployment increased modestly during Indonesia's 1997/98 economic crisis and 2001 downturn
(employment, percent, RHS, and unemployment, LHS)



Sources: BPS and World Bank

Table 14: … but real wages declined substantially
(wage growth)

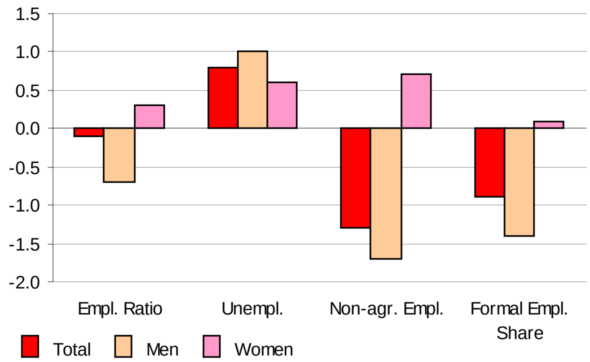
	1990-97		1997-99		1999-2003	
Median growth (%)	**7.1**		**-11.0**		**8.9**	
Men/Women	6.4	10.3	-10.2	-10.4	7.9	9.7
Poor/Non-poor	-0.2	11.1	-10.8	-11.9	6.1	9.3
Urban/Rural	5.9	7.4	-12.9	-9.5	9.6	5.6
Adult/Young	6.5	8.8	-11.0	-12.7	7.6	10.6
Less-educ./ More-educ.	7.1	4.4	-10.9	-10.7	7.0	7.0

Sources: BPS and World Bank

Large numbers of women entered the workforce

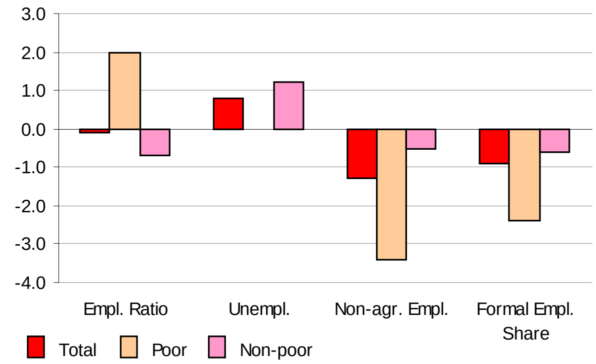
In both urban and rural areas, there were major increases in the share of women who entered the workforce. They worked mostly as unpaid workers in family businesses and farms (3.8 percentage point increase in the share) or become 'self-employed' (3.9 percentage point increase). It was mostly less educated women who made this transition; better educated women were mostly in the formal sector, which was hit particularly hard, and 4.2 percent of these women left employment. Generally more poor women entered the labor force over this period – their participation rate jumped from 52 to 59 percent between 1997 and 1999, playing a key role in supplementing family incomes that would otherwise have been severely eroded by falling wages of the principal earner.

Figure 42: Record numbers of women entered the workforce to compensate for falling household incomes …
(growth in employment indicators)



Sources: BPS and World Bank

Figure 43: … while the poor showed the highest movement out of non-agricultural and formal work
(growth in employment indicators)



Sources: BPS and World Bank

Poor households were more likely to move into agricultural or informal work

Low-income households moved out of non-agricultural and formal employment at a greater rate than the non-poor. Although they did not experience greater unemployment or real wage loss than other households, poor households were more likely to take up informal and agricultural work, with growth in non-agricultural employment falling by 3.4 percentage points, and the share of workers in formal employment fell by 2.4 percent, while for the non-poor, these falls were 0.5 percentage points and 0.6 percentage points respectively.

b. … but low-income households are more vulnerable to shocks generally…

The income of poor households is more at risk during shocks …

For poor and near-poor households, the ability to earn an income, and the income itself is generally more fragile and at risk than wealthier households'. Poorer households' incomes tend to be more at risk and more vulnerable to shocks because they generally are more often employed informally, or self-employed (and not as professionals), and/or are more likely to be underemployed. Less poor households are less often in this situation. (For more detail, see the World Bank's 2006 *Indonesia Poverty Report*.)

Table 15: Poor and near-poor households are more likely to suffer from economic shocks
(incidence of negative impact from losses due to economic risks, percent)

	Urban		Rural	
	Male Head of Household	Female Head of Household	Male Head of Household	Female Head of Household
Poor	12.8	4.9	27.9	25.5
Near-poor	9.2	4.6	24.0	17.5
Non-poor	6.5	2.6	24.7	17.9
Total	7.7	3.1	25.1	18.9

Sources: BPS and World Bank

… and their childhood experiences are more likely to threaten their future earnings ability

The infancy and childhood experience of poor- and near-poor households often creates an ongoing legacy of diminished earnings capacity. These risks – malnutrition, lack of immunizations and dropping out of school – at the earliest stage of the life-cycle can increase the likelihood of, and perpetuate, chronic disadvantage. This is especially the case among rural households which have higher rates of unattended birth, higher drop-out rates, and a higher incidence of child labor. These experiences have effects that persist into the later teens and early working life, and in adulthood manifest in higher rates of incomplete education, meaning lower human capital, plus underemployment, informal employment, non-professional self-employment and reported disability.

Table 16: Workers most at risk in the current crisis tend to be less educated and in more rural areas

(worker background by vulnerability)

Percent	Highly Vulnerable	All workers
Male	0.58	0.62
Age (years)	37	38
Urban	0.15	0.40
Primary educ.	0.44	0.36
Jun. high educ.	0.30	0.32
Sen. High educ.	0.04	0.06
University educ.	0.01	0.06

Sources: BPS and World Bank

Table 17: ...and are also more likely to be informal workers and earn less with poorer benefits

(worker employment characteristics by vulnerability)

Percent	Highly Vulnerable	All workers
Self-employed	0.17	0.20
Formal workers	0.16	0.28
Monthly income (Rp.000s)	297	508
Health insurance	0.01	0.05
Workers' insurance	0.05	0.05
Work pension	0.01	0.04
Other pension	0.04	0.04

Sources: BPS and World Bank

c. ... and are some of the most vulnerable to the current crisis

Some manufacturing and agriculture sectors are particularly exposed to the current crisis, and are concentrated in some regions

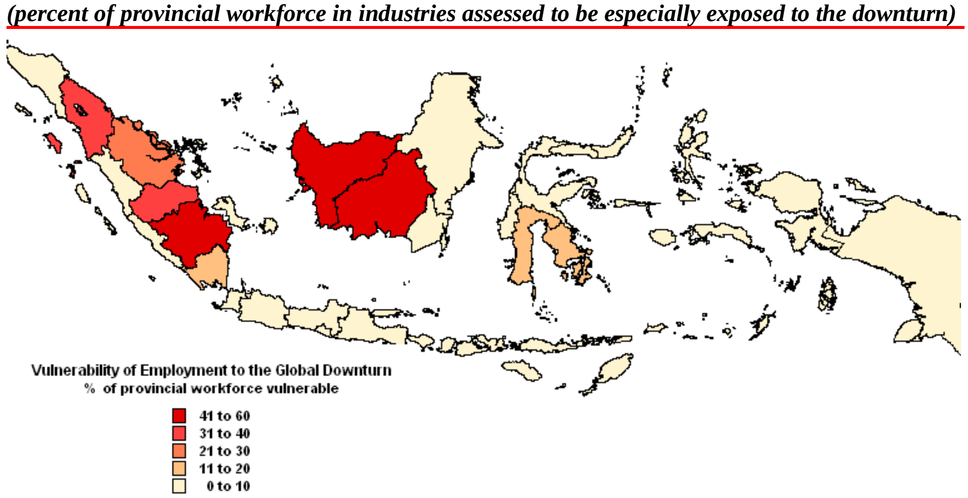
Much of the production in many manufacturing industries (12.4 million workers in 2008, out of Indonesia's workforce of a little over 100 million) and agriculture sectors (41.2 million workers) is exported. A quarter of manufacturing workers are in industries where exports are high relative to the industry's gross-value added, while 15 percent of the agricultural labor force work on estate crops and are judged to be vulnerable to the downturn in that sector (ie, they are in provinces where production of the estate crop is a high proportion of national output or is a large component of provincial GDP). These workers are a significant part of the work force in some regions – for example, nearly 20 percent of workers in Sumatra and Sulawesi work in industries which are particularly exposed to an export slowdown (Figure 44 and Figure 45).

Non-tradable sectors may also be affected

Indonesia's experience a decade ago, during the 1997-98 crisis, suggests that employment in some non-tradable sectors is also particularly vulnerable. During that episode employment fell in utilities by more than one-third, in construction by 16 percent and in finance and other business services by 6 percent. During this crisis, the trade & hospitality, and finance & business services sectors are likely to be relatively vulnerable, given their greater reliance on credit to fund working capital. In the longer term, utilities investment may be postponed.

Figure 44: Western Kalimantan and much of Sulawesi are likely to be especially affected by the global downturn

(percent of provincial workforce in industries assessed to be especially exposed to the downturn)

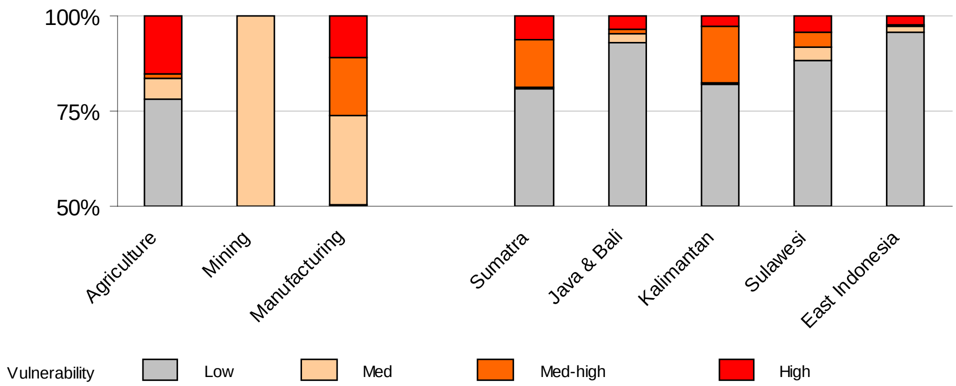


Sources: BPS and World Bank

The most exposed workers in the current crisis tend to be less educated with lower incomes

The industries most at risk tend to employ workers with less education and poorer remuneration. Workers in the most vulnerable industries live in more rural areas and are more likely to have only a primary school education. They are also more likely to be informal workers, with a monthly income that is only 60 percent of the average worker, and unlikely to have health insurance or retirement savings.

Figure 45: A considerable number of workers are employed in export-vulnerable sectors, representing a significant proportion in Sumatra and Kalimantan
(proportion of workers in export vulnerable sectors)



Sources: BPS and World Bank

d. The way poor households cope with shocks can be costly in the longer term

Poorer households are more likely to cut spending and have members enter the workforce

Poorer households are more likely to sell household goods and cut spending or to ask family members to enter the workforce. Poor and near-poor families are more likely to reduce consumption; 20 percent of poor rural households with female heads reported cutting back on consumption when their incomes were hit, while 23 percent of poor urban households with male heads did. Poorer households are also more likely to ask members not previously working to enter the workforce – 11 percent of poor households rely on 'bad coping' mechanisms, such as asking children to work.

These may be poor coping mechanisms

Reduced consumption and higher entry into the workforce raise concerns that poorer households are being forced into measures that have longer-term costs for their ability to earn an income. Cuts in spending or having more household members look for work are to be expected after a cut in income. The concern is that these cuts may be to investment in human capital, for example that those being sent into the labor market are children who would otherwise be in school. Moreover, productive assets sold during a crisis bring in a lower price and can no longer assist household production after the crisis has passed.

Table 18: Poorer households are more likely to reduce consumption and ask family members to enter the workforce when their income falls
(percent of households)

	Reported Recourse after an income shocks											
	Urban						Rural					
	Male Head of HH			Female Head of HH			Male Head of HH			Female Head of HH		
	Poor	Near-poor	Non poor	Poor	Near-poor	Non poor	Poor	Near-poor	Non poor	Poor	Near-poor	Non poor
Drawing on savings	8.2	7.9	13.9	8.9	3.2	11.1	3.5	5.6	8.1	1.3	4.4	7.6
Borrowing	26.4	23.1	16.0	24.2	14.7	11.1	21.2	24.7	20.7	11.6	18.9	19.8
Selling possessions	9.5	7.3	5.0	8.3	5.1	3.1	12.1	11.2	9.4	6.3	6.7	5.9
Cutting consumption	23.4	12.7	9.0	10.5	11.7	7.8	17.3	15.5	10.6	20.2	13.8	12.1
Entering workforce	9.9	8.5	6.2	5.3	5.2	4.3	11.3	8.7	8.4	10.8	5.5	8.0

Sources: BPS and World Bank

Similar patterns were seen in the Asian crisis

Falling incomes and dramatic increases in the price of daily goods during the 1997-98 crisis hit poorer households hardest. Rice, which accounts for up to one-quarter of poor

households' consumption, experienced a four-fold price rise in 1998. Other tradable goods also became more expensive, at the same time as incomes were falling. The coping strategies adopted by affected households during the crisis period resulted in many moving backwards along the pathways that had been taking them out of poverty. The downturn was concentrated in the urban, formal and modern sectors, leading many households to move back, from urban to rural, from formal to informal, and from non-farm to farm activities.

While a flexible labor market made this significant reshaping possible and meant a relatively small increase in unemployment, it also meant real wages and hence living standards fell dramatically. Household spending fell in real terms, impacting human wealth and household assets, including health, education and savings. These cuts in consumption may possibly have led to a significant increase in malnutrition, with levels of malnutrition among children under five years of age rising between 2000 and 2003.

Again, the impact of the current downturn is likely to be far more moderate than the severe economic and social disruption of the 1997-98 crisis. Thus the magnitude of the impact of that crisis on social outcomes does not reveal the likely impact of the current crisis. But it is helpful in identifying which Indonesians are likely to be most at risk both from the downturn itself, and from the long-term costs of their mechanisms to cope with that downturn.

8. After significant gains, poverty will continue to fall, but at a slower pace, and the government is responding

The crisis is expected to slow the pace of gains in poverty

The crisis is expected to put pressure on poverty. The poverty rate is expected to have declined slightly to 15.0 percent in early 2009 from 15.4 percent in early 2008. This reflects firm economic growth, especially for agriculture, and slower growth in food and fuel prices, and it especially reflects the impact of the government's 2008-09 unconditional cash transfer program to poor and near-poor households (BLT). With a continued slowing in growth, and the BLT having ceased in March 2009, poverty is unlikely to fall much further by early 2010 without a new program of public assistance.

The government has a range of instruments available to maintain employment and to protect the poor and vulnerable

Policy makers have two broad policy toolkits to offset the impact of the global downturn on Indonesia's more vulnerable citizens. The first focuses on protecting existing employment levels. The government is focusing its labor policy response on protecting existing jobs and creating new ones. A mix of regulatory and assistance policies is intended to help firms remain viable and workers retain employment, and new jobs will be created through public investment in more labor-intensive infrastructure projects and via the adjustment of regulations affecting the investment climate. Existing public spending programs, such as the PNPM rural program, can be focused more on labor-intensive employment-generating programs. Empirical analysis of the impact of the current PNPM rural programs finds that they reduce unemployment in the target areas by 1.3 percentage points.

The second toolkit is the government's cluster of poverty-mitigation programs. First, targeted social protection programs, such as the Jamkesmas health insurance program for poorer households, educational scholarships and unconditional cash transfers, can be extended to an additional 10-30 percent of poor and near-poor households. Secondly, poor communities will benefit from an anticipated extra IDR 5 bn in funding under the PNPM program. Finally, there will be an increased focus on supporting small and medium enterprises (SMEs), which tend to be the sorts of enterprises that workers revert to when they lose their formal-sector jobs.

To support these policy responses, the government is investing in an enhanced rapid-response system to monitor social outcomes in vulnerable areas

The government is implementing an enhanced, higher-frequency system to monitor the impact of the crisis on the poor and vulnerable, and to assess the effectiveness of government responses. Real-time data gathering will be conducted through a network involving local governments, and may be expanded to include media tracking and enterprise surveys. This will be supplemented with monthly village and household survey data, which may better reveal the effects of government support programs. Local research organizations and institutions will be used to assist in analyzing the data collected by the monitoring system.

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