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INDONESIA ECONOMIC QUARTERLY

Clearing Skies

September 2009

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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. Contributions came from Ian Amalo (international economy), Andrew Blackman with Fitria Fitriani and Sjamsu Rahardja (trade flows and balance of payments), Andrew Carter (government revenues), Andrew Ceber and Preya Sharma (national accounts and activity indicators), Faya Hayati (prices), Ahya Ihsan and Dhanie Nugroho (government expenditure), Diva Singh (financial markets and banking sector indicators), and Matt Wei-Poi (poverty and labor market analysis). Magda Adriani and Fitria Fitriani provided data support to the team. Tim Bulman coordinated and edited. The team is supervised by Shubham Chaudhuri, Senior Economist, under the leadership of Lead Economist William E. Wallace.

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: Clearing skies

Indonesia's economic recovery has gained steam following the turbulence of the start of the year

In the first half of 2009, Indonesia's economy has established a solid recovery from late last year. Quarterly growth has accelerated since the start of 2009, after stalling in the final quarter of 2008, although the year-on-year growth rate has continued to slow, recording 4.0 per cent in the year to Q2. This trend of a gradual recovery is projected to continue into 2011.

Indonesia's recovery coincides with an improved external environment. Q2 GDP outcomes across its major export destinations were better than expected, and most trading partners exited recession by mid-year. International prices of many of Indonesia's exports have recovered much of their late 2008 falls. These developments have supported Indonesia's economy, with exports recovering faster than imports.

Domestic consumption has remained robust

Domestic consumption continued to contribute strongly to growth in the second quarter. In the first quarter, large amounts of spending by campaign teams for the parliamentary election lifted private consumption. On the other hand, spending for the presidential election campaign in the second quarter appears to have been much smaller, and private consumption in Q2 was little changed from Q1. Higher government consumption has been a key driver of growth in Q2, as the government accelerated disbursement of its 2009 budget. Ongoing resilience in domestic consumption has supported the services sector, with output accelerating compared with Q1. Most other indicators of domestic economic conditions have also strengthened from the start of the year, with consumer confidence at historical highs and rising, retail and vehicle sales improving, and industrial activity recovering from its downturn in late 2008.

...although investors have become very cautious

Despite this resilience in the overall economy and the improving business environment, investors have remained cautious into mid-2009. Purchases of capital equipment continue to be cut, although investment growth in new buildings has remained buoyant. The slowdown in overall investment coincides with flat lending to firms for investment and working capital from late 2008, in contrast to the rapid lending growth earlier that year.

The banking sector has proved far sturdier than many commentators expected, although new loan approvals have remained constrained

Indonesia's banking sector has remained in good health overall. Non-performing loan ratios are stable, despite expectations at the turn of the year that they would rise as borrowers affected by the weaker economy would be unable to meet their commitments. In September, Bank Indonesia left its policy interest rate unchanged, following an easing of 300 basis points over the previous 9 months. Only a limited proportion of these cuts in the policy rate have been passed onto commercial banks, leading BI in late August to ask the 14 largest banks in the country to progressively lower their savings deposit rates to no more than 150 bps above the BI policy rate. BI hopes that this will reduce the cost of funds for banks, allowing them to lend more and at lower interest rates.

Financial markets have continued strengthening through mid-2009

Indonesia's financial markets have continued to strengthen through Q2, generally by more than markets elsewhere in the region. The rupiah has continued to appreciate against the weakening USD, although at a slowing rate, and stabilized around 10,000 per USD by early September. The stock market also performed strongly in Q2, rising over 20 per cent from late May to early September. By mid-June, yields on sovereign rupiah bonds had returned to early 2008 levels, while the spread on Indonesian government USD bonds had fallen below the global emerging market average. From late June to September, local currency bond yields have remained broadly stable, while spreads on USD bonds have fallen another percentage point. These improved market conditions have allowed the government to continue financing its budget through the bond market, accessing funds for longer terms and at lower yields.

...and portfolio investors have returned to Indonesian markets. Roll-over rates on debt have been high, leaving the balance of payments in a small surplus in Q2

Improved financial market conditions have coincided with somewhat less volatile flows on Indonesia's capital accounts, rendering Indonesia's external position in September 2009 more robust than at the start of the year. The overall balance of payments remained in surplus in the second quarter, although by less than in Q1. The current account surplus increased slightly, as the improved external environment lifted exports more than imports. While non-resident investors returned as net purchasers of Indonesian financial assets, overall the capital account switched to deficit, largely due to slower net foreign direct investment following several quarters of record inflows. Indonesia's scheduled external

debt was largely rolled over through the first half of 2009, countering concerns early in the year that roll-over rates may be low and that the amount of debt due may be greater than officially reported. Foreign reserves were stable through mid-2009, near USD 58 bn.

Inflation, after being more subdued than expected earlier in the year, has started to rise since August

After remaining subdued for longer than expected, inflation started to pick up in July and August. Headline inflation rose slightly to 2.8 per cent y-o-y while the poverty basket inflation rate rose to 3.8 per cent. Core inflation, which excludes the effects of the cuts in regulated fuel prices around the turn of the year and stable food prices through the first semester, remained much higher than the headline, at 4.8 per cent. Indonesia's inflation has fallen at a faster rate than seen in most of its trading partners, but still remains at a higher level.

Employment has grown at a faster rate than the working age population, although few of the new jobs are formal

Employment grew faster than the working age population in the year to February, allowing the unemployment rate to fall even with a larger share of the working age population entering the labor force. However, most new jobs are in the informal sector, especially for women. Higher employment, stabilizing prices, the final tranches of the government's unconditional cash transfer program (BLT), and a limited slowdown in growth led to a 1.2 percentage point fall in the poverty rate in the year to March 2009, to 14.2 per cent.

Public finances in the first half of 2009 have been more stimulatory than in recent years

Public finances in 2009 have been more stimulatory than in recent years. Through to July, the government budget overall was in deficit, whereas normally it records sizeable surpluses in the first semester. Revenues were down, due to cuts in tax rates scheduled in the government's stimulus package, and to weaker profits as a result of lower commodity prices and external demand, although the July data showed signs of recovery. During this time, the government spent more on its core programs compared with the same period in 2008, but significantly less on energy subsidies, lowering government spending overall. After a very slow start, disbursement of the government's stimulus package accelerated from mid-July.

...and there is scope for more ambitious spending in 2010 than the government's proposed budget envisages

The realized fiscal deficit in 2009 is likely to be a little smaller than originally budgeted, near 2.2 per cent of GDP. The government's proposed 2010 budget projects a deficit of 1.6 per cent of GDP, but the government's conservative nominal GDP growth and oil price assumptions suggest that the realized deficit may be much smaller under its proposed spending plan, creating scope for more ambitious spending.

The trend of a gradually recovering economy should continue into 2011, with accelerating output, and prices, and the end of the government's cash transfers slowing the gains in poverty

The mid-2009 trend of gradual recovery is expected to continue over the coming year and a half. Quarterly growth is expected to rise slowly from its Q2 rate, and year-on-year growth should start picking up by the end of the year and rising gradually towards its potential of a little over 6 per cent by 2011. (Table 1)

Domestic demand is likely to continue as the main driver of growth, as the government continues to disburse its stimulus and, in 2010, investors regain confidence. Net exports are unlikely to continue making their recent contribution to growth into 2010 since the Indonesian economy is expected to continue growing faster than its trading partners. Net exports should be more supportive in 2011 as the global economy slowly returns to trend growth. With a weakening trade surplus and recovery in commodity prices, the current

account is likely to move closer to balance or even to a small deficit by 2011. But the balance of payments should remain in surplus, and reserves are likely to slowly accumulate, as Indonesia's scheduled financing needs remain sustainable and global financial market conditions become more supportive of emerging markets.

Table 1: Growth is projected to gradually return to more typical rates in the coming years (annual percentage change)

	2008	2009	2010	2011
Gross domestic product	6.1	4.3	5.4	6.0
Consumer price index	9.8	4.7	5.6	6.5
Major trading partner growth	2.1	-1.8	3.3	3.4
Poverty rate	15.4	14.2	13.6	11.5

Sources: MoF, BPS via CEIC and World Bank

Rising domestic demand and global commodity prices will lift both headline and poverty basket inflation through the forecast horizon unless BI shifts policy more aggressively to limit inflation and inflation expectations than it has done historically. These developments, together with the conclusion of the BLT program, are projected to slow the decline in poverty over the coming 18 months.

A. ECONOMIC UPDATE

1. Growth in Indonesia, and globally, recovered in the second quarter

Growth picked up around the world, including Indonesia, in Q2

Indonesia's economy has accelerated since the start of this year after stalling in Q4 2008. (Figure 1) This pick-up has coincided with a return to growth in most major economies. (Figure 2) Q2 outcomes for Indonesia's major trading partners exceeded expectations, and virtually all of Indonesia's major trading partners have now exited recession. The US remains one of the major dampeners on global growth, however the rate of decline has fallen and there is mounting evidence that the longest post-war recession may have come to an end.¹

Seasonally adjusted estimates indicate the trough in Indonesia's growth has passed

Indonesia's economy appears to have passed the trough in growth. In Q2, output grew by 1.2 per cent quarter-on-quarter (seasonally adjusted), marginally below the average growth rate of recent years. Quarterly growth picked up from Q1, following a flat Q4 2008 when economic and financial turbulence was at its peak. In contrast, year-on-year (y-o-y) growth rates have continued to fall. In Q2, growth was 4.0 per cent y-o-y, down from the recent peak of 6.4 per cent in Q3 2008. The ongoing fall in y-o-y growth rates is partly due to the strong economy of early 2008. (Box 1 describes the seasonal adjustment of higher frequency data.)

Figure 1: Indonesia's economy troughed in the final quarter of 2008, and has since resumed growth at close to its recent average (per cent growth)

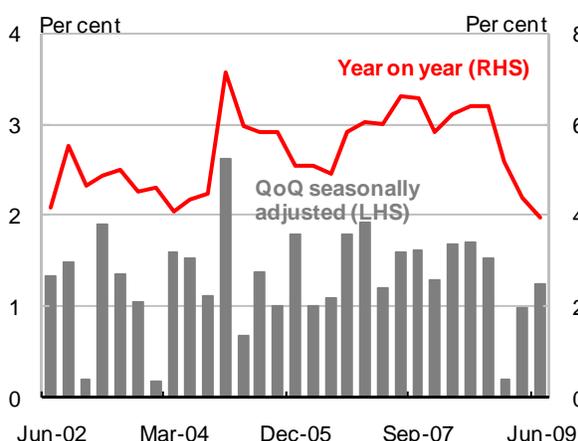
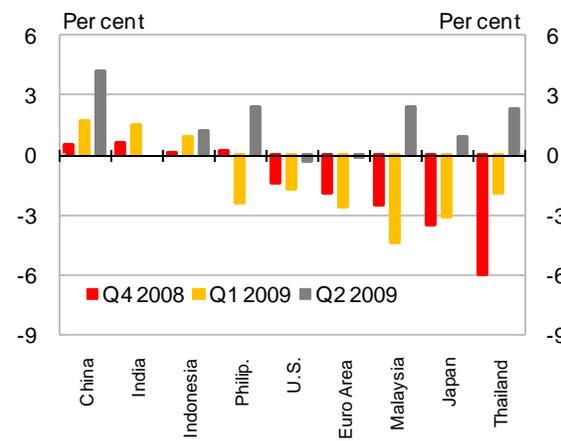


Figure 2: ...and the global economy stabilized and started to recover in the second quarter (quarterly per cent growth seasonally adjusted)



Sources: BPS via CEIC. World Bank seasonal adjustment.

Sources: National statistical agencies via CEIC and World Bank seasonal adjustment where data are published non-seasonally adjusted

Indonesia's Q2 growth was driven by a recovery in exports and government consumption, while private consumption stabilized

The main driver of growth in the second quarter came from a faster recovery in export volumes than in imports. (Figure 3). Government consumption continued its recent strong growth, rising 2.7 per cent q-o-q to be 17.0 per cent higher y-o-y, well above its 5-year average. Private consumption grew by only 0.1 per cent q-o-q, following strong (2.4 per cent) growth in Q1, associated with high levels of spending on parliamentary election campaigns and the strong harvest. Non-food household consumption, supported mostly by the election-related spending in Q1, fell slightly in Q2, while food consumption rose by 0.4 per cent. This suggests that the pause in private consumption growth in Q2 is likely to be temporary.

¹ For more on the global and regional economy, see the World Bank's forthcoming East Asia and Pacific Economic Update, to be launched in the first week of November at www.worldbank.org/eap.

...and investment remained a drag on growth

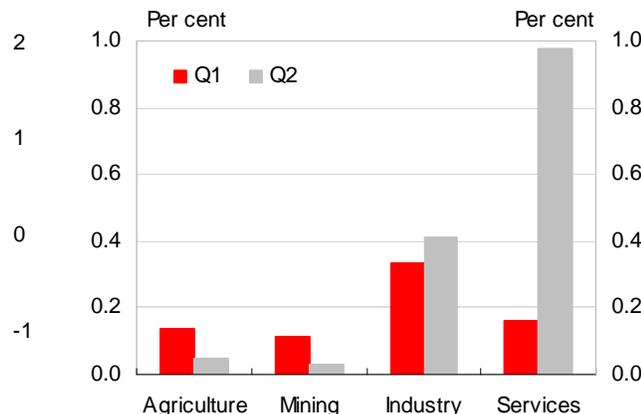
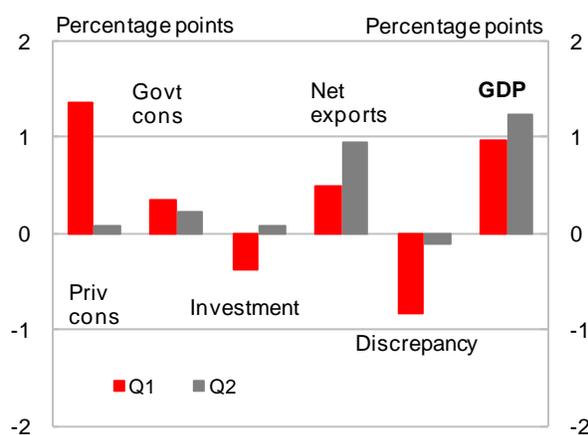
Investment expenditure grew by far less than its five-year average, growing by 0.3 per cent from Q1 to Q2 to be 2.7 per cent higher than a year earlier. This is a turn-around from the first quarter, when total investment fell. In the second quarter, spending on machinery & equipment and transportation items was cut further. The imported component of machinery & equipment for the second consecutive quarter, recording the largest falls since late 2005 (down 7.7 per cent from Q1 to Q2). Building investment growth has not slowed as dramatically, and quarterly growth lifted somewhat in Q2 relative to the previous three quarters. The continued slowdown in overall investment in the second quarter is consistent with lower investment borrowing by businesses since the start of the year (discussed below).

Strengthening in service sector activity supported the pickup in growth in Q2

During Q2, accelerating service sector activity supported the pickup in aggregate GDP growth. This is a turn-around of the steady deceleration which began in mid-2008. The acceleration is mostly attributable to the retail sector which constitutes the largest share of the service sector, and is corroborated by the gradual rise in the monthly retail sales index. Growth in the industrial sector has remained stable despite expectations of a slowdown, growing very close to its five-year average growth rate in the quarter. Most industrial sectors experienced stronger growth, but this was offset by mining which continued its secular decline in activity. Following robust growth in Q1, total agricultural production slowed as food and non-food farming output contracted (Figure 4).

Figure 3: Q2 growth was driven by the recovery in exports relative to imports, and further supported by ongoing solid growth in government consumption
(quarter-on-quarter percentage point contributions to aggregate GDP growth, seasonally adjusted)

Figure 4: ...while services activity made a much larger contribution to GDP growth in Q2 than in Q1
(quarter-on-quarter percentage point contributions to aggregate GDP growth, seasonally adjusted)



Notes and sources: Seasonally adjusted percentage point contributions may not sum to aggregate GDP growth. BPS via CEIC and World Bank

Other economic indicators also suggest an improvement in conditions since the start of the year

The recent strength in private consumption is supported by indicators of consumer spending and consumer confidence (Figure 6). BI's survey of consumer sentiment has performed strongly this year—the July reading was the second highest in the series' history—while BI's retail sales index has returned to mid-2008 levels after falling at the beginning of the year. Motor vehicle and motorcycle sales remain weak compared with the highs of mid-2008, but have been gradually recovering since the start of the year and are now back to the levels of early 2008. (Figure 7)

Production indicators also show an economy that is recovering well from the slowdown of late 2008. The industrial production index suggests that the depth of the contraction in industry at the end of 2008 was transitory, and the index reports rising activity among the medium- and large firms surveyed since the start of the year. Cement consumption, which correlates well with industrial production, also continued the upwards trend which began earlier this year. Production is now higher than the levels of a year earlier. One partial indicator that remains weak is bank credit (see section 5d below).

Box 1: Seasonal adjustment and enhanced economic monitoring

Macroeconomic time series data, such as gross domestic product or price indices, tend to move with three key processes: a trend-cycle component, a seasonal component and an irregular component. The trend-cycle component incorporates the long-term and medium term movements of the series—in the case of real GDP, it includes both the average growth rate and business cycle fluctuations. The seasonal component includes the within-year fluctuations that reoccur in a similar way in the same month or quarter from year to year, for example due to the agricultural harvest season creating a short-term increase in farm output, regular holiday periods reducing industrial activity, or the adjustment in many prices at the start of a new school or calendar year. The irregular component is what remains after the seasonal and trend-cycle components are removed. It may be due to sampling fluctuations in the data collection process or fluctuations in activity due to one-off events.

When analyzing developments in the economy, the trend-cyclical components of a series can provide useful information for policy makers. For example, whether an economy is slowing or accelerating, if current growth rates are above or below a sustainable trend, or if inflationary pressures are building. Identifying such movements in quarter-on-quarter or month-on-month growth rates in non-seasonally adjusted data can be difficult. (Figure 5) Seasonal adjustment aids this task by removing the seasonal component from economic time series data, leaving the trend-cyclical components and the random variation in the data.

The simplest approach to accounting for seasonality is to examine year-on-year growth rates. Year-on-year (y-o-y) growth accounts for regular seasonality by comparing the level in a particular period of one year (eg, the March quarter 2009, when there is the main agricultural harvest) with the same period in the previous year. Doing this will incorporate the cumulative movements in the current March, plus preceding December, September and June quarters. This smoothes out some of the quarter-to-quarter volatility. But y-o-y growth rates can also hide turning points in the underlying series. This is apparent in recent aggregate GDP series. (Figure 5) The y-o-y growth rates suggest that the Indonesian economy slowed continuously from 6.4 per cent in Q3 2008 to 4.0 per cent in the most recent quarter, Q2 2009. This decline is partly due to the high quarterly growth rates of late 2007 and early 2008 'dropping out' of the y-o-y calculation, and to the ongoing presence in the y-o-y calculation of near-zero growth in late 2008. This interpretation can be contrasted with the seasonally adjusted q-o-q growth rate, which shows stable, relatively strong growth through to Q3 2008, near-zero growth in Q4 during the peak of the financial and economic turbulence, and then a progressive recovery in growth in the first and second quarters of 2009. This also occurred over the first half of 2009 for other major Indonesian economic indicators. (Table 2) For example, both exports and imports showed signs of recovery in Q2 data but continue to be strongly lower in y-o-y terms. In sum, seasonal adjustment allows for enhanced monitoring of Indonesia's economy, especially around turning points in the economic cycle.

Figure 5: Three versions of Indonesian GDP growth (per cent growth)

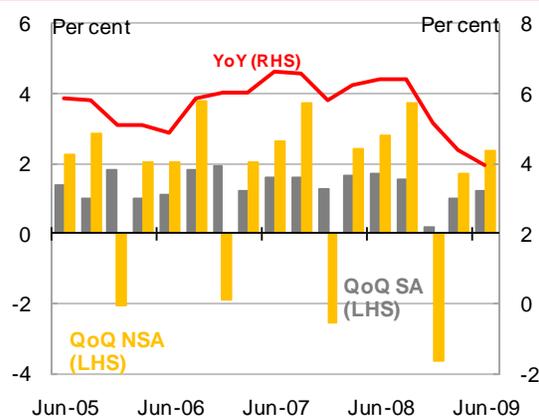


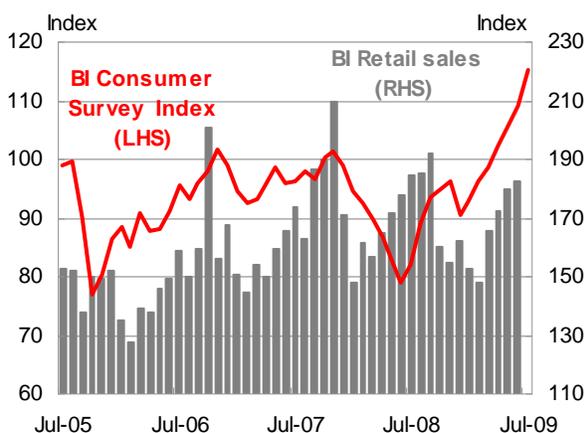
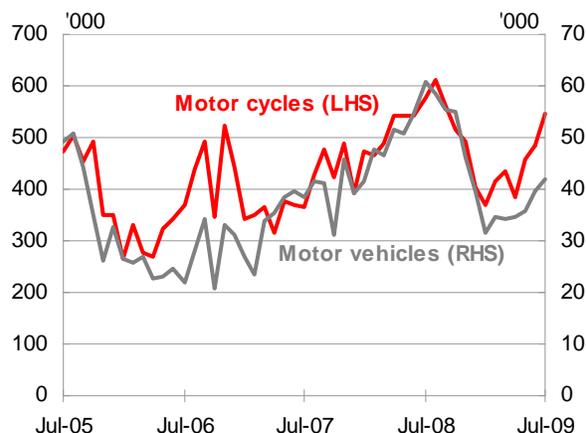
Table 2: Seasonally adjusted quarterly growth rates give a very different perspective on the Indonesian economy than y-o-y growth (per cent growth)

	2008			2009		
	Q4	Q1	Q2	Q4	Q1	Q2
	QoQ growth			YoY growth		
GDP	0.2	1.0	1.2	5.2	4.4	4.0
Domestic						
Private consumption	1.1	2.4	0.1	4.8	6.0	4.8
Gov Consumption	4.1	2.7	-1.2	16.4	19.2	17.0
Investment	1.3	-1.6	0.3	9.1	3.4	2.7
External						
Exports	-5.2	-14.4	4.8	1.8	-18.7	-15.7
Imports	-6.7	-19.5	9.9	-3.5	-26.0	-23.9

Sources: BPS via CEIC and World Bank

Indonesia's statistical agency, Badan Pusat Statistik (BPS), does not currently publish seasonally adjusted estimates of many macroeconomic series. There are several approaches to estimate and remove the seasonal component in an economic series. The simplest is to regress a dummy for each regular period on the original series. This approach assumes that the seasonal movement in a particular period does not change significantly over time. Other, more sophisticated approaches relax this assumption by allowing the seasonal factor to gradually change. One freely available and commonly used approach is the X12-ARIMA package. This was used to calculate the seasonally adjusted Indonesian data reported in this *Quarterly*.

Adjusting Indonesian data for seasonality has the additional complication of accounting for Muslim holidays. These follow a lunar calendar, which advances about 11 days each year relative to the Gregorian calendar. Ramadan and Idul Fitri have a significant impact on economic behavior, with food consumption rising, working hours often shortening and holidays taken. For quarterly data, the impact of Ramadan on seasonal patterns does not appear to be significant, particularly if seasonal factors are allowed to slowly adjust, for example through the X12-ARIMA technique. For monthly data, when Muslim holidays have a significant impact, they can be accounted for by regressing the seasonally adjusted series on dummy variables for the various holidays.

Figure 6: Consumer sentiment indicators are very strong (indices)**Figure 7: ...and this is translating into actual purchases (monthly purchases)**

Notes and source: BI consumer confidence index is at 100 when the net balance of respondents with a positive outlook equals the number with a negative outlook. BI via CEIC.

Sources: GAI and Astra via CEIC

2. Inflation is at a turning point

The headline inflation rate has risen for the first time in 10 months

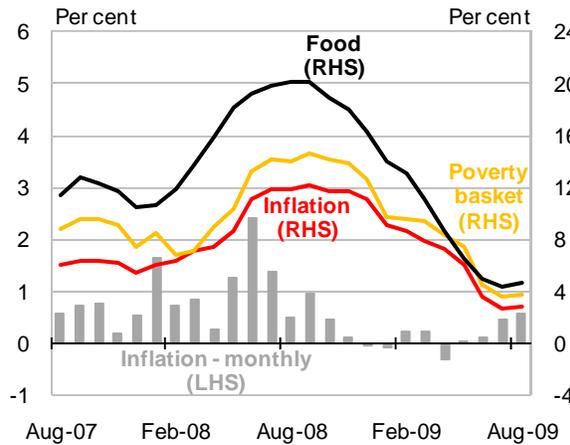
Consumer prices remained subdued into the middle of 2009, before recording moderate rises in July and August. (Figure 8) Year-on-year inflation now appears to be at its trough, reaching a low of 2.7 per cent in July (y-o-y) and picking up to 2.8 per cent in August, the first increase in 10 months. An increase in food prices, partly associated with Ramadan,² drove this increase. This particularly affected poor households, which continued to face faster price growth than the average. The cost of their consumption basket rose by 3.8 per cent in the year to August, slightly more than in July. Excluding volatile food prices, and the cuts in regulated fuel prices around the turn of the year, gives much higher inflation of 4.8 per cent in the year to August. This 'core' measure of inflation, like the headline number, had been falling quickly from early 2009 to July, but now seems to be near its low point.

Lower fuel and food prices explain the fall in headline inflation

The main factors reducing headline y-o-y inflation in the past quarter are excluded from the core measure. Year-on-year headline inflation recorded large falls in June and July, as the increase in regulated fuel prices in late May 2008 and the associated general price resetting dropped out of the calculation. With lower global prices, fuel prices were cut around the turn of the year, and fresh food prices fell each month in Q2. From the start of the year to August, the CPI has risen by just 1.2 per cent, much less than in the first 8 months of previous years. (Figure 9) The falls in food prices in the first half of 2009 have particularly benefited poorer households, given the higher weight of food in their consumption baskets. In fact, World Bank estimates suggest the inflation rate for the poor more than halved between March and August. (Figure 8)

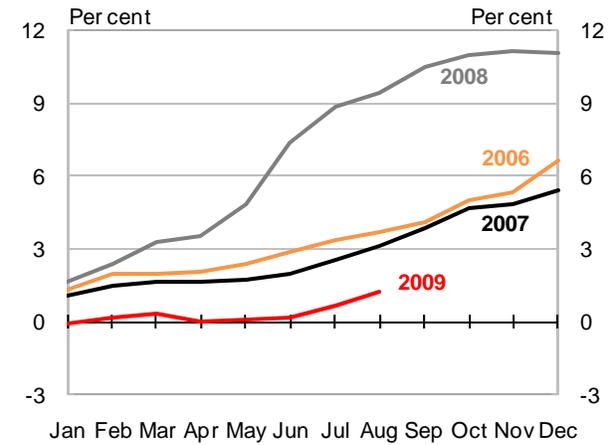
² The timing of Ramadan is based on the lunar calendar, which advances by about 11 days each year relative to the Gregorian calendar.

Figure 8: Moderate rises in prices in recent months suggest a turning point in the headline inflation rate
(year-on-year and month-on-month consumer price inflation)



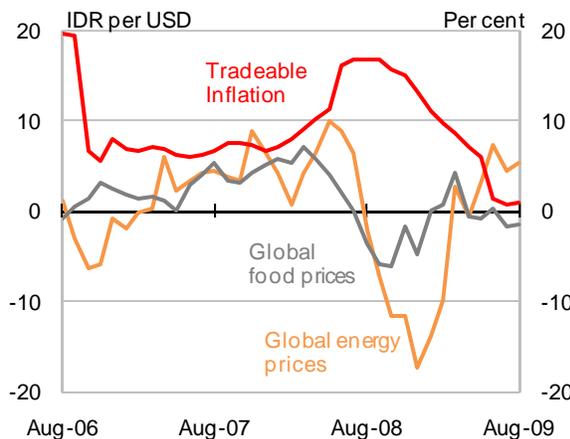
Sources: Bank Indonesia, BPS and World Bank

Figure 9: Average consumer prices barely moved in the first half of 2009
(cumulative growth in headline inflation)



Sources: BPS and World Bank

Figure 10: The appreciating Rupiah has offset the recent rise in commodity prices
(quarter-on-quarter per cent change in commodity prices converted into rupiah; year-on-year inflation rate)



Sources: BPS via CEIC and World Bank

Global commodity prices have been rising since the start of the year. The appreciation in the IDR has more than offset this increase in the case of most food commodities—with sugar being an important exception—leading to a fall in food prices in IDR terms. (Figure 10) Global energy prices have, however, risen more than the IDR has appreciated. While the government's fuel price subsidy system has, for the time being, insulated household energy costs from the direct impact of this increase, energy costs for industry have gone up. And as a result, prices of tradeable items, which are most sensitive to movements in global prices and exchange rates, have now started to rise. (Figure 10)

Indonesia's inflation rate is still relatively high

Indonesia's inflation rate continues to be higher than its trading partners—most of which are now experiencing deflation—much as has been the case in the past. (Figure 11) However, since late 2008, Indonesia's inflation rate has fallen by more than most of its major trading partners. (Figure 12) This is despite concerns that the depreciation of the rupiah in late 2008, and the rise of inflation expectations to high levels earlier that year as inflation became broadly-based, may have shifted Indonesia's structural inflation rate to an even higher level.

Upstream prices have been stable since February

Wholesale prices overall have changed little in the first quarter of 2009. Prices of most subcomponents were flat, including mining & quarrying prices, despite the rise in global commodity prices in this period. A 5 per cent increase in agricultural prices was offset by a small fall in reported export prices. Upstream prices remain much weaker compared with mid-2008, 7.7 per cent lower overall, largely due to lower trade and industrial prices.

Figure 11: Indonesia's inflation rate remains higher than most of its trading partners and neighbors... (year-on-year consumer price inflation)

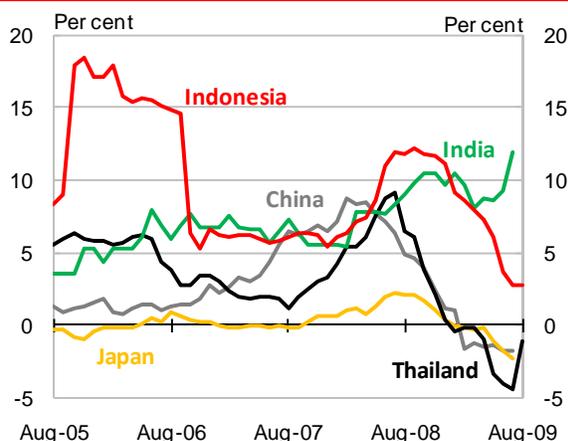
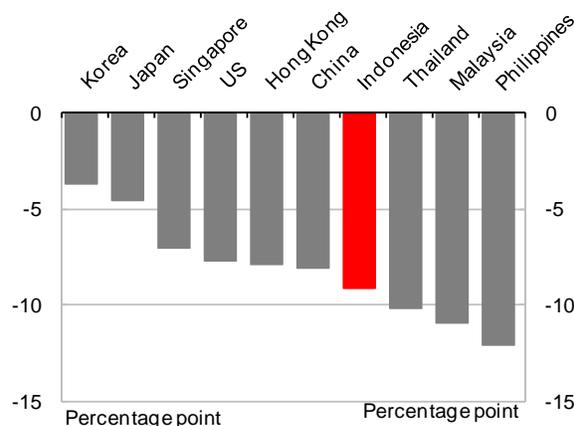


Figure 12: ...although the fall in its inflation rate has been in line with other economies (percentage point change in year-on-year consumer price inflation, 2008 peak to most recent observation)



Sources: National statistical agencies via CEIC and World Bank

...while prices across the entire economy continue to grow relatively strongly

Slower consumer price inflation over the past year has driven down economy-wide price growth, as measured by the GDP deflator, to 6.8 per cent in the year to Q2—the lowest growth rate in 5 years. But the GDP deflator remains significantly higher than the CPI, as it includes the prices of investment goods and government services (eg, civil servant salaries) that have continued to grow relatively fast.

3. Indonesia's trade flows have started to recover

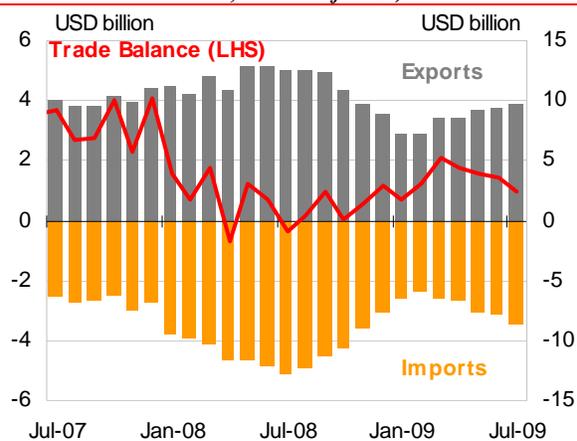
Trade flows started recovering in the second quarter, supported by gains in commodity prices and improving external demand

Indonesia's merchandise trade flows have gradually risen month-on-month into mid 2009, although they still remain well below their 2008 peaks. (Figure 13) Since February, trade flows have been supported by a partial recovery in commodity prices and modest gains in external demand. (Figure 13 and Figure 14)

By July, export values were over 35 per cent above their February levels, but were still one-quarter below the levels of a year earlier. While all export categories have posted positive growth since February, the recovery has been primarily driven by gains in mining and minerals exports (almost 80 per cent higher), and oil and gas exports (up 44 per cent).

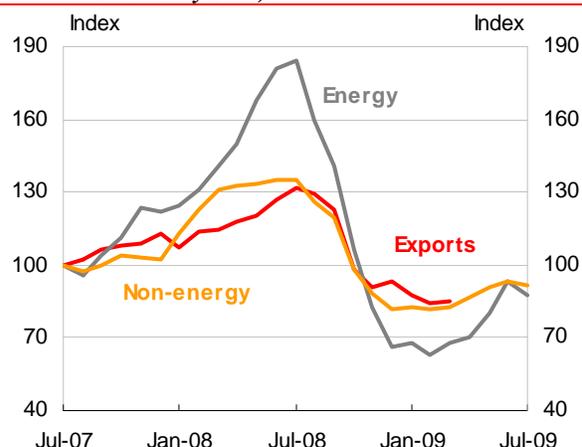
Higher global commodity prices plus resilient domestic demand lifted merchandise import values by almost 50 per cent from their February lows. Imports have posted gains across all categories. The largest increases have been in oil & gas products (up over 90 per cent), intermediate goods (semi-processed inputs into manufacturing—up 40 per cent) and consumption goods (up 47 per cent). Lower investment in plant & equipment was evident in compressed capital goods imports in Q2. But this too appears to be staging a mid-year recovery, with imports rising by nearly 20 per cent in July.

Figure 13: Trade flows are recovering...
(trade values and balance, billions of USD)



Sources: BPS and World Bank

Figure 14: along with commodity prices, which have driven Indonesia's merchandise exports prices
(indexed to 100 in July 2007)



Sources: World Bank global commodity prices. Indonesian export prices calculated by World Bank from BPS trade data.

Services trade also began to recover

Services trade flows also started to recover in the second quarter from the severe contractions around the turn of the year. The recovery in service imports has been far stronger than in exports, in contrast to merchandise trade. After contracting almost 16 per cent in Q1, services exports rose a modest 3.3 per cent in Q2, predominantly due to an increase in the number and spending of tourists. Service imports rose strongly in Q2 (up 11.8 per cent)—primarily due to higher spending on freight with the increase in Indonesia's oil & gas trade, and by more Indonesians travelling overseas.

4. ...and external financial flows have returned to more normal patterns

The BoP surplus narrowed in Q2

Flows on Indonesia's external accounts normalized in the second quarter, after the volatile flows around the turn of the year. A turnaround to deficit on the financial account narrowed Indonesia's balance of payments (BoP) surplus to USD 1.1 bn in Q2, from USD 4.0 bn in Q1. (Table 3) The turnaround relative to Q1 was due to Indonesians purchasing more liquid foreign assets (equities, and deposits in bank accounts for example), lower net investment in Indonesia by foreigners, and regular quarterly flows such as the scheduled repayment of offshore loans.

The larger trade surplus expanded the current account surplus

The stronger recovery in exports in Q2 relative to imports expanded Indonesia's trade surplus and overall current account surplus. Higher commodity prices, while supporting the trade surplus, led to a larger net income deficit as the profits from foreign investors' operations increased. By Q2, remittances from Indonesian workers abroad were near their average of recent years, recovering from the moderate contraction in Q1.

Volatile flows in the capital account have shifted towards their more typical patterns

Flows in the financial accounts have returned to more normal patterns after a half-year of turbulence, especially for the more volatile items. Non-resident portfolio investors returned as net purchasers on the equity and local government bond markets after reducing their holdings in the previous half-year. Meanwhile, Indonesian residents shifted deposits offshore at a rate only somewhat faster than their usual pace. Trade credits doubled from Q1—consistent with increased trade activity—but remain a fraction of the level of recent years. There are also anecdotal reports that corporations are beginning to raise debt offshore again, after a prolonged period of absence from the debt market.

The greatest exception to this general 'normalization' of Indonesia's financial flows was a large drop in inwards foreign direct investment, due to lower investment in sectors other than oil & gas. This follows the highest direct investment into Indonesia on record over the previous two quarters. Regardless, the stream of announcements of new direct investment plans, which seemed to pick up in May, did not abate in the months to September.

Reserves are back to pre-crisis levels

Indonesia's foreign reserves rose to USD 60.3 bn in early September, near the pre-crisis peaks of July 2008. The balance of payments surplus contributed to this gradual rise, as did the allocation to Indonesia of an additional 1.74 billion of special draw rights (worth USD 2.7 bn) by the IMF on August 21.

Table 3: The current account surplus offset a small net capital outflow in Q2, giving a small balance of payments surplus and slightly higher reserves
(billions of USD unless otherwise stated)

	2005	2006	2007	2008	2008				2009	
					Q1	Q2	Q3	Q4	Q1	Q2
Balance of payments	0.6	13.9	14.1	-1.8	1.0	1.3	-0.1	-4.2	4.0	1.1
% GDP	0.2%	3.8%	3.3%	-0.4%	0.8%	1.0%	-0.1%	-3.8%	3.5%	0.8%
Current account	0.3	10.9	10.5	0.3	2.8	-1.0	-0.9	-0.7	2.9	3.1
% GDP	0.1%	3.0%	2.4%	0.1%	2.3%	-0.7%	-0.6%	-0.6%	2.6%	2.4%
Goods balance	17.5	29.7	32.8	22.9	7.5	5.4	5.8	4.2	7.0	8.7
Services balance	-9.1	-9.9	-11.8	-12.7	-3.0	-3.3	-3.2	-3.3	-2.5	-3.1
Net income & transfers	-8.1	-8.9	-10.4	-9.9	-1.7	-3.1	-3.5	-1.6	-1.5	-2.5
Capital & financial account	0.3	3.0	3.6	-2.1	-1.4	2.5	0.9	-3.3	1.7	-2.4
% GDP	0.1%	0.8%	0.8%	-0.4%	-1.2%	1.9%	0.6%	-3.0%	1.6%	-1.8%
Direct investment (net)	5.3	2.2	2.3	2.0	-0.3	0.6	0.4	2.1	1.7	0.0
Inflows	8.3	4.9	6.9	7.9	1.5	2.0	1.9	3.3	2.5	1.0
Outflows	-3.1	-2.7	-4.7	-5.9	-1.7	-1.4	-1.5	-1.2	-0.8	-1.0
Portfolio investment (net)	4.2	4.3	5.6	1.7	2.0	4.2	-0.1	-4.4	1.9	2.0
Inflows	21.7	22.0	43.7	47.9	12.5	13.7	13.1	8.6	11.9	9.3
Outflows	-11.6	-15.3	-36.2	-41.8	-10.2	-9.2	-13.0	-9.4	-7.4	-7.5
Other investment (net)	-9.4	-3.8	-4.8	-6.2	-3.2	-2.3	0.4	-1.1	-1.8	-4.5
Government	-0.8	-2.5	-2.4	-1.4	-0.4	-1.5	-0.1	0.5	0.0	-2.0
Private	-8.6	-1.3	-2.4	-4.7	-0.6	0.3	0.2	-1.5	-1.0	0.2
Reserves	34.7	42.6	56.9	51.6	59.0	59.5	57.1	51.6	54.8	57.6

Sources: BI, BPS via CEIC and World Bank

5. In line with the real economy, Indonesia's financial markets have performed well and gained solid ground in Q2.

a. The stock market and Indonesian rupiah have recovered convincingly since March

The IDX composite saw sharper gains than other Asian indices from July to August

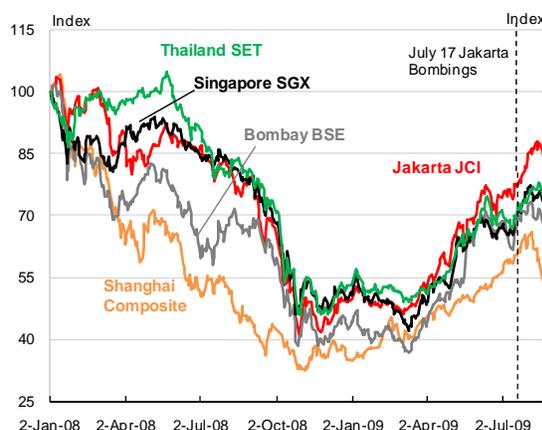
Indonesian financial markets continued their strengthening trend that started in March into the third quarter of 2009. By early September, Indonesian equities had gained 89 per cent over March lows. The July 17 bombings at the Ritz-Carlton and Marriott hotels in Jakarta did not shake investor confidence and the JCI strengthened more than any other Asian index from mid-April to August (Figure 15). Notwithstanding this optimism, it is important to note that the quantity of shares traded and total market capitalization of the JCI remain relatively small, so linking positive equity movements to developments in the real economy must be done with caution.

The rupiah has appreciated significantly since March, and has settled around the 10,000 level after strengthening to 9850 per USD in early August

Similar to equities, the IDR has also strengthened steadily against the USD since April. After weakening to above 12,000 IDR per USD in March, the rupiah recovered to trade in the 10,100-10,300 range for most of June and July. Strong trade balance numbers helped boost the currency further to just under 10,000 IDR per USD in August. Going forward, movements in the US market post-labour day will serve as an important indicator of the strength of the US recovery and whether it is bound to continue positively or experience a second slump. A strong US resurgence and rebounding of the USD against a basket of currencies could put renewed pressure on the IDR/USD exchange rate, which has been following the broader strengthening and weakening of the USD very closely since the onset of the crisis (Figure 16). Notably, gold prices, which have historically had an inverse relationship with the USD, have shot to unprecedented levels recently, and could be a useful indicator to watch for future direction in the currency markets, as well as a broad gauge for global investor sentiment and risk appetite.

In addition, since the rupiah's recent strength has been somewhat supported by Indonesia's positive trade balance, a decline in Indonesia's trade surplus as the domestic economy recovers further relative to Indonesia's trading partners could also put the currency under some strain (Figure 17).

Figure 15: The IDX has gained more than most regional indices since mid April (indexed to 100 on 2 January 2008)



Sources: CEIC and World Bank

Figure 16: As the FRB's broad USD index weakened from early March, the IDR appreciated rapidly against the USD (IDR per USD; Federal Reserve Board index of the USD against a broad basket of currencies, indexed to 100 on 21 Jan 1997)



Sources: FRB and BI via CEIC and World Bank

The appointment of a new cabinet in November could impact the IDR and Indonesian financial markets

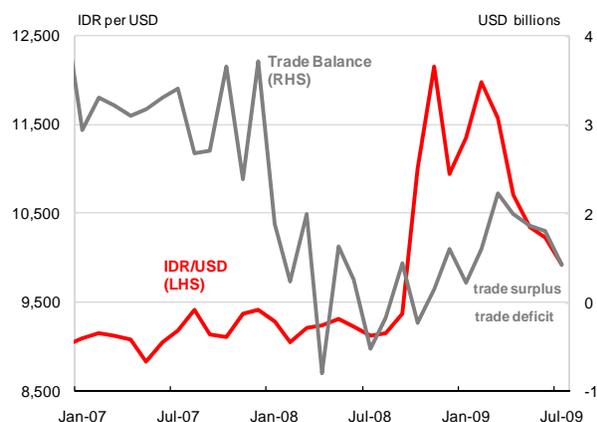
The appointment of a new cabinet by early November may also have an impact on Indonesian currency and equity markets. At this point, there is a degree of uncertainty surrounding the composition of key ministries such as agriculture, health, trade and public enterprise, all of which have a role to play in managing the real economy. Unexpected inclusions in the coalition and appointments to these ministries could lead to financial market fluctuations.

Yields on Indonesian local currency and USD denominated sovereign bonds have recovered to early 2008 levels

b. Yields on Indonesian government bonds have fallen at both the short and long end of the curve, though they remain high relative to elsewhere in the region

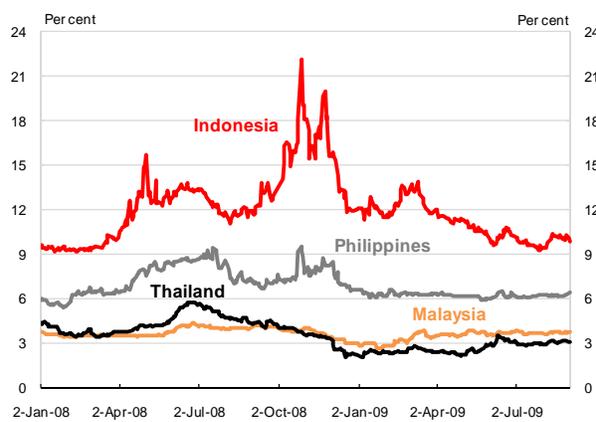
As in the case of equities and foreign exchange, Indonesian fixed income markets also continued to recover lost ground into mid-2009. Yields on 5 year rupiah denominated sovereign bonds dropped from almost 14 per cent in March to just under 10 per cent in August—levels last seen in March 2008. (Figure 18) Moreover, both short- and long-term bond yields have fallen steadily since March, and the yield curve has continued to steepen after being abnormally flat (and high) in December-January (Figure 19). Spreads on Indonesian sovereign USD bonds have also receded, and in July fell below the global emerging market average for the first time since August 2007 (Figure 20). While this is a positive development, average global EMBI spreads have yet to recover to pre-crisis levels.

Figure 17: The trade surplus has helped buoy the rupiah's recent strength (IDR per USD; trade balance in millions of USD)



Sources: BPS and BI via CEIC and World Bank

Figure 18: Indonesian 5 year bond yields have dropped since March but still remain higher and more volatile than sovereign yields in other Asian countries (5 year local currency sovereign bond yields in per cent)

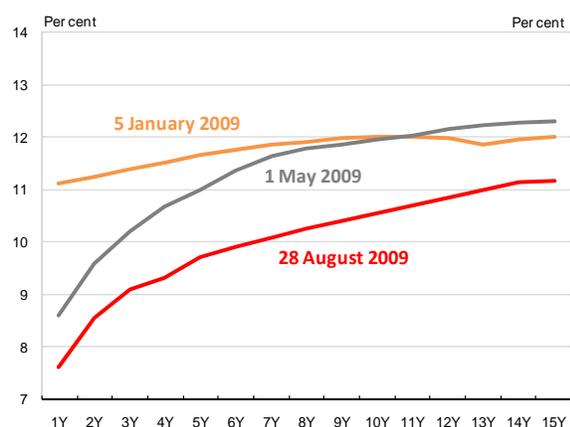


Sources: National exchanges via CEIC

...but remain higher and more volatile than those in neighboring economies

Despite the strengthening of rupiah-denominated bond prices in recent months, yields on Indonesian debt are still higher and more volatile than sovereign bonds elsewhere in the region. (Figure 18) This added risk and volatility premium, especially on long end yields, stems from several factors, particularly inflation and foreign investors' risk appetite.³ Inflation in Indonesia tends to be higher than in most countries (Figure 11), and also holds an added volatility risk due to the large adjustments of fuel prices under the current fuel subsidy system. The timing of these adjustments is uncertain, and this uncertainty adds a premium to long-end yields. Foreign investors' fund flows and risk appetite also impact the long end of the curve, but these are usually less tied to domestic fundamentals in Indonesia and more to global economic trends and events.

Figure 19: The yield curve has steepened after starting the year abnormally flat due to very high short-term yields (yields on 1 year to 15 year IDR sovereign bonds, per cent)



Sources: FRB, CEIC and World Bank

Figure 20: Indonesian USD bond spreads have been falling since February and are now lower than the global emerging market average (Indonesian EMBI spreads to US Treasuries and difference between Indonesian spreads and global emerging market average, both in basis points)



Sources: JP Morgan, Datastream and World Bank

³ R Goyal and M Ruiz-Arranz, 'Explaining Indonesia's Sovereign Spreads', [IMF Indonesia Selected Issues Paper](#), June 30 2009.

Fuel subsidy reform, if implemented, could lead to lower inflation volatility and uncertainty and thus bring down yields in the medium-long term

If the government takes steps to enact fuel subsidy reform, as mentioned in the President's annual budget speech, this could remove a key source of uncertainty and inflation volatility that drives up bond yields. Also impacting bond prices is the expected fiscal deficit for 2009 and 2010, and hence the government's financing needs for the remainder of this year and next. A smaller than expected deficit in 2009 would lower bond issuance needs in 2010 and thereby buttress bond prices.

c. This cycle of BI's policy rate cuts has come to an end, but banks' lending rates remain relatively high

With the policy interest rate now 300 bps below its peak and inflation beginning to rise, BI has signaled an end to its rate cuts

With falling inflation and weaker economic conditions, Bank Indonesia cut its policy interest rate by a cumulative 300 bps between December 2008 and August 2009, including 25 bps cuts at its Board meetings in June through August. However, as signs of a recovery in economic conditions have become more entrenched and global prices recover from late 2008 lows, BI has signaled that the 2009 rate cut cycle has come to an end, and left rates unchanged at 6.50 per cent in September. In the minutes of the September board meeting, BI expressed caution regarding the inflation outlook for 2010. Market commentators are now speculating about when rates will rise, with the expectation that this will pull up short-term yields on government IDR bonds and could lead to a flattening of the yield curve.

...but lending and deposit rates are lagging the fall in the policy rate

Only a small proportion of BI's rate cuts since December have been passed onto banks' lending and deposit rates, which remain relatively high. (Figure 21) Towards accelerating this process, the central bank signed an agreement with the 14 largest commercial banks in August to cap their deposit rates at 150 bps above the BI rate by November. Together these banks hold about four-fifths of Indonesia's savings deposits. The motivation for this policy move was likely two-fold: to reduce interbank competition for deposits which has raised the cost of funds for banks considerably; and, by bringing down the cost of funds, to allow banks to lower lending rates. The agreement has prompted concerns from some commentators that deposits may flee the larger banks for higher yields elsewhere. However, given the diverse nature of individual and institutional deposit holders, whether this movement of funds happens will remain to be seen.

d. The banking sector has stayed relatively robust through the crisis, despite the rising cost of funds

Various aggregate indicators such as CAR, ROA and NPL rates suggest the overall health of the banking sector is intact

Overall the banking sector appears to be in good health, as measured by a variety of official aggregate indicators, such as capital adequacy and return on assets (Figure 22). The percentage of non-performing loans held by commercial banks has remained fairly stable in light of the crisis. After climbing to just over 4 per cent in April and May, the June NPL number fell back to 3.94 per cent. While this is slightly higher than the average NPL ratio in 2008, it is still well below levels in 2006-2007 and even early 2008. (Figure 23) Interbank liquidity was also fairly robust in June and July. From tenuous territory in December 2008, it appears that Indonesia's banking sector has managed to weather the worst of this crisis without any major shocks.

In early August, Moody's downgraded the outlook for Indonesia's banking sector from stable to negative. Moody's attributed the downgrade to, among other factors, rapid loan growth in recent years, increasing cost of funds, and excess capacity in the banking system. Nevertheless, Moody's maintained the bank financial strength ratings (BFSR) of the 10 Indonesian banks it rates at a weighted average of D. Moreover, the downgrade came amidst a series of Moody's downgrades for various countries, and may have had more to do with internal adjustments to the agency's ratings model than with Indonesia-specific factors. Later in the month, Fitch affirmed its stable ratings outlook for the country's banking sector.

Figure 21: Little of BI's cuts in policy rates have been passed into banks' lending rates

(commercial banks weighted average interest rate on loans for working capital and BI policy rate)

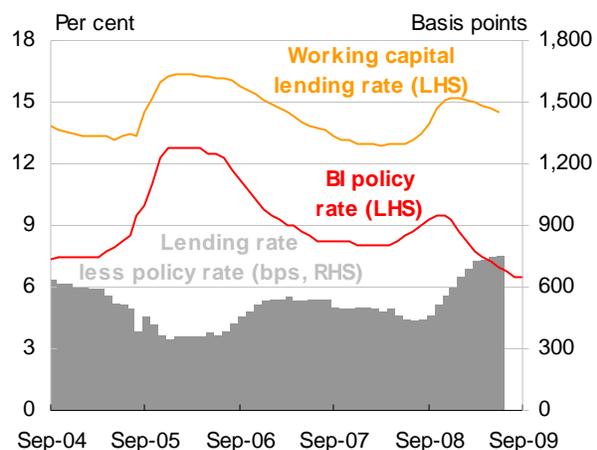
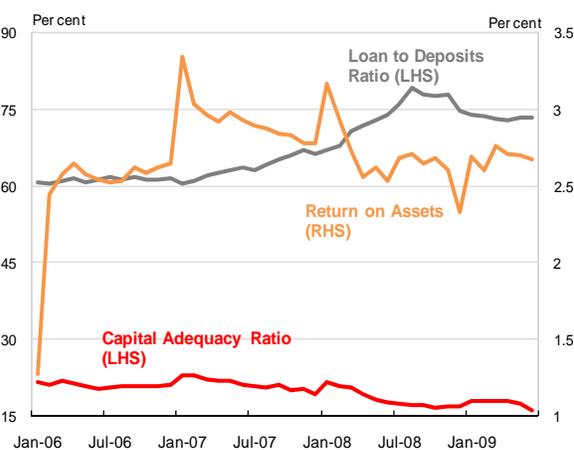


Figure 22: Average CAR, ROA and LDR numbers indicate a relatively robust banking sector

(average Capital Adequacy Ratio, Loan to Deposits Ratio and Return on Assets for all commercial banks, in per cent)



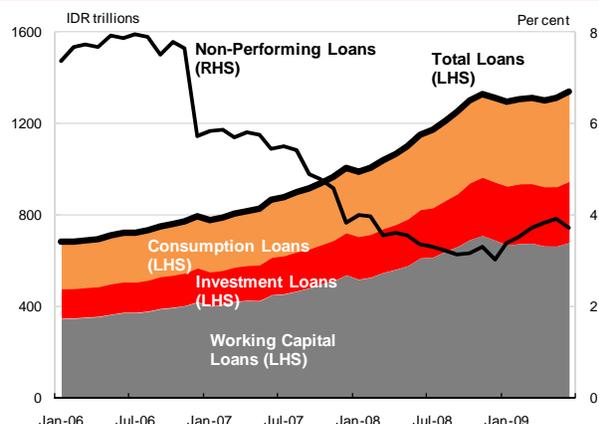
Notes and sources: Policy rate is the one-month SBI rate to Sources: BI and World Bank Q2 2008, and then the overnight rate. BI via CEIC and World Bank

Indonesian banks issued few new loans in the first half of 2009, quite a contrast to earlier very rapid lending growth

Commercial bank credit is one of the few indicators that has not picked up much in recent months. The total stock of outstanding credit was approximately Rupiah 1.3 trillion in June. This is 3 per cent higher than at the start of the year, following the sharp contraction in banks' approvals of new loans to businesses in late 2008, the slowest semester of lending growth this decade. Q2 brought some indication of more normal conditions, with loans growing by 2.3 per cent relative to Q1. (Figure 23) While new lending has stalled in most economies in the region since the start of 2009 (with the exception of India), Indonesia's credit slowdown particularly stands out because of how fast lending grew in the country relative to others prior to the crisis. (Figure 24)

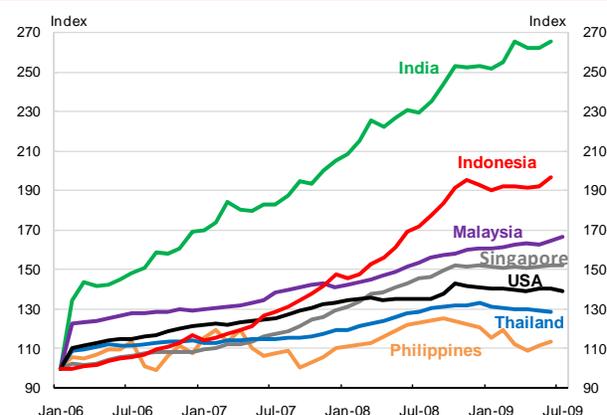
The halt in credit growth in Indonesia is attributable to both demand and supply factors, and it can be difficult to disentangle which is dominant. On the supply side, a tightening of credit standards as banks try to secure their capital against expectations of weaker economic conditions, plus the higher cost of accessing secondary funds, may restrict the quantity of new loans available. Demand has also been reduced by heightened risk aversion of firms and households reducing their willingness to take-up new loans, and the need for less working capital with lower prices and weaker turnover, as well as the limited fall in the cost of borrowing (Figure 21).

Figure 23: The ratio of non-performing loans fell in June and remains well below 2006-2007 levels, while the slowdown in overall lending since late 2008 has stabilized (total loans and their composition in trillions of IDR; total percentage of non-performing loans)



Sources: BI and World Bank

Figure 24: Credit growth has slowed more in Indonesia than elsewhere, relative to Indonesia's very rapid lending growth since 2006 (commercial bank lending, indexed to 100 at January 2006)



Sources: National central banks via CEIC, and World Bank

There are some concerns that a mismatch between deposits and loans could lead to tighter liquidity in the banking system going forward

Going forward, there is some concern that the cap on deposit rates could reduce the level of bank deposits at the same time as loans pick up pace (due to lower lending rates and ongoing economic recovery), thereby causing a liquidity mismatch. These pressures would probably not mount until early next year, particularly given the increased disbursement of the government's budget and lower bond sales through the rest of this year.

6. Government spending and revenue in the first half have supported growth

a. The fiscal stimulus and automatic stabilizers have contributed to the resilience of the Indonesian economy

The government's fiscal position in 2009 is aiding the economic recovery

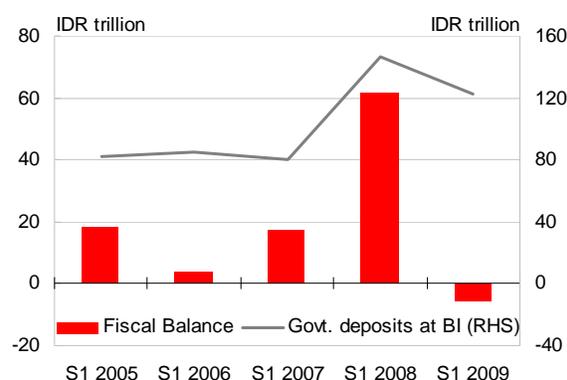
In contrast to the first half of recent years, automatic stabilizers of progressive tax rates applied to profits plus the policy decision to cut various taxes, plus faster than usual disbursement (discussed below), have cushioned the impact of the economic slowdown. In the first semester of 2009, the softening of revenues and limited fall in overall spending have put the fiscal balance into deficit, relative to surplus in previous years (Figure 25). In addition, while the government has continued its practice of front-loading of its considerable financing needs, the balance in government deposits has fallen in the first semester of 2009 relative to last year, consistent with the government taking a more expansionary stance.

b. Tax cuts and the weaker economy have lowered revenues, but there are early signs that revenue growth is beginning to recover

Government revenues have fallen with the government's tax cuts and lower commodity prices and profits

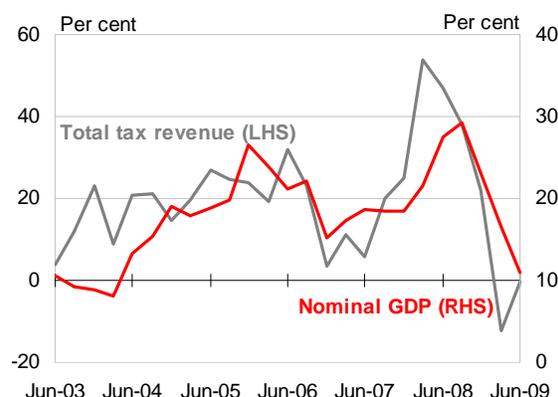
Government revenues to the end of July 2009 were 15 per cent below the equivalent period in 2008. This follows both the government's program of scheduled and stimulatory tax cuts and the weaker economic environment. Together these factors led to a sharper fall in tax revenues than nominal GDP. In line with the signs of recovery in economic growth, there are also early indications that tax revenues may have reached a turning point mid-year. (Figure 26)

Figure 25: A more stimulatory fiscal balance and lower government deposits at BI are working to lessen the slowdown
(levels in trillions of rupiah)



Notes and sources: MoF.

Figure 26: Tax revenues have fallen faster than nominal GDP has slowed
(year-on-year percentage change)



Source: BPS and MoF

Lower commodity prices and weaker external and, for some sectors, domestic demand have reduced turnover and profits and likely also cut formal sector employment and wages. This has been reflected in a sharp slowing in reported nominal GDP from its recent peak of 29 per cent growth in Q3 2008 to 11 percent in Q2 2009. Such a slowdown normally generates an even greater reduction in tax revenues, as tax revenues typically vary by a larger degree than changes in economic growth because of the greater volatility in profits and progressivity in tax rates, both as the economy slows and recovers. Oil & gas revenues give the clearest example of this: in the first semester of 2009, the government received less than half of its 2008 first semester collection, with Indonesian crude oil prices on average 47 per cent lower and little change in production levels.

The government's program of tax cuts has further reduced tax revenues. Some of these cuts were programmed in 2008 towards expanding the base of registered tax-payers. The notional value of these cuts was IDR 43.0 tr or 17 per cent of 2008's non-oil & gas income tax receipts. Others were introduced to support spending and employment in sectors particularly vulnerable to the fall in commodity prices and global economic downturn, with an estimated value of IDR 13.3 tr.

c. Disbursement on core government programs improved in the first half of 2009, although only about 10 per cent of the stimulus package has been spent

Spending on government programs has gone up compared with 2008, while lower subsidy spending lowered total outlays

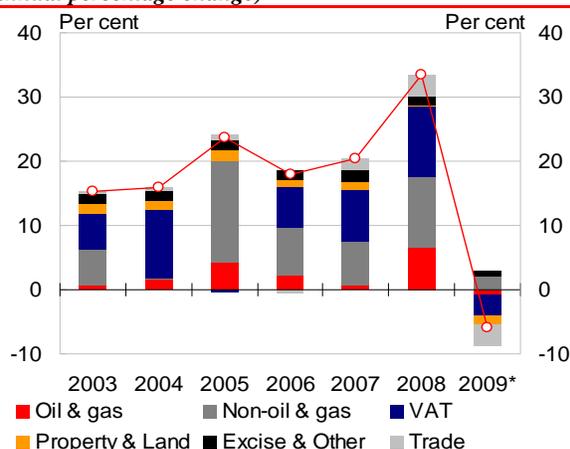
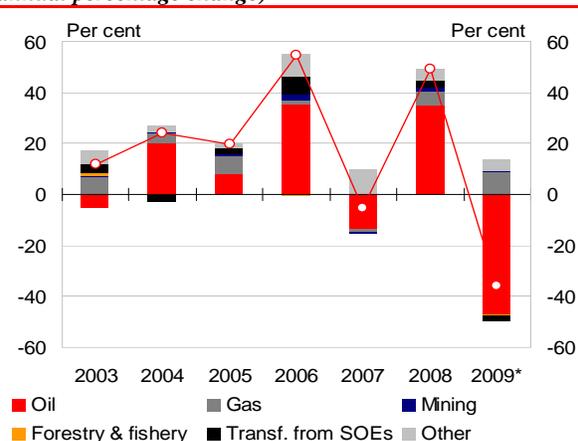
Almost two-thirds lower spending on energy subsidies reduced overall central government expenditure by around 7 per cent in the seven months to July 2009 relative to the same period in 2008. Lower international energy prices, tariff adjustments and the government's ongoing kerosene-to-LPG conversion program explain this fall.

In contrast, spending on core government programs was higher than 2008. (Figure 29) Higher spending on salaries, for example as the government streamlined its 'thirteenth month' payment program, made the largest positive contribution to central government spending. Capital spending was up by almost one-fifth and purchases of goods and services by a half, which was supported by the October 2008 introduction of processes that allow procurement processes to begin before the start of the fiscal year. Realizations of the cash transfer (BLT) program and election spending boosted the social assistance and 'other' expenditure categories by almost two-thirds.

Table 4: Developments in revenue and spending
(central government revenue and spending)

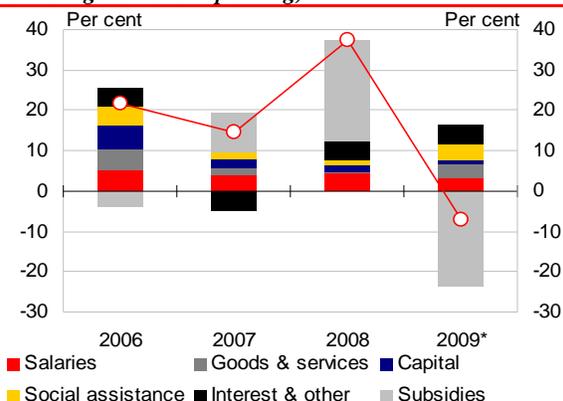
	2006	2007	2008	To July 2009*	Explanation
	Annual percent change and percentage point contributions			YoY percentage point contrib's	
Tax revenue	17.9	20.4	33.4	-5.9	Cuts in tax rates, lower profits and formal wages with lower commodity prices and slower activity growth
Non-oil and gas	7.3	7.1	11.0	-0.9	Lower profits with lower commodity prices & demand; cuts in tax rates
Oil & Gas	2.3	0.5	6.4	2.0	Around a 50% fall in the international oil price; slightly lower production
VAT	6.3	7.8	11.1	-3.2	Less discretionary spending, partic. for goods subject to luxury tax rates
Land and building tax	1.3	0.7	0.4	-1.4	Slower investment
Duties on land and building transfer	-0.1	0.7	-0.1	0.0	Reduced economic activity
Excise	1.3	1.7	1.3	0.9	Slowing in consumption, offsetting the increase in cigarette excise rate
Other taxes	0.1	0.1	0.1	0.0	Slowing of economic activity
Import duties	-0.8	1.1	1.2	-0.6	Reduced import values with lower commodity prices and destocking
Export duties	0.2	0.8	1.9	-2.7	Lower commodity prices and weak export volumes
Non-tax	54.5	-5.2	49.1	-35.9	Significant falls in oil prices
Oil	35.6	-13.9	35.0	-47.4	Around a 50 per cent fall in international oil prices
Gas	1.4	-0.8	5.3	8.9	Gas production remains steady
Mining	2.4	-0.4	1.4	0.4	Lower prices and some weakening in volume demand reducing profits
Forestry	-0.6	-0.1	0.2	-0.2	Slowing demand for woods and related products
Fishery	0.0	0.0	0.0	0.0	A small item where contributions to growth remain low
SOE transfer	6.9	0.1	2.7	-2.2	Reduced domestic demand reducing activity
Other	8.8	9.9	4.6	4.5	Lower fee collection through the slowing of domestic activity
Central gov't expenditure	21.8	14.7	37.3	-7.2	Growth in programmatic spending offset by a sharp decline in subsidies
Salaries	5.3	3.9	4.4	3.3	Growth in line with previous years' and streamlined 13th month salary
Goods and services	5.0	1.7	0.5	3.3	Increase in government consumption and early procurement
Capital	6.1	2.1	1.6	1.2	Planned government investment being spent earlier in the year
Social assistance	4.4	2.1	1.4	3.7	Growth in social expenditure and the BLT program
Others	1.0	-5.0	2.9	2.8	Election spending and increased 'planned expenditure'
Interest payments	3.8	0.2	1.7	2.0	In line with projections, with appreciation in IDR offsetting higher interest costs on new debt
Subsidies	-3.7	9.7	24.8	-23.6	Refined fuel prices have halved and the government continues to encourage less consumption of higher cost-energy

Notes and sources: * 2009 contributions to growth show growth to July 2009 relative the same period in 2008. MoF, World Bank

Figure 27: Tax receipts are generally weaker, reflecting lower commodity prices, weaker demand plus the government's cut in tax rates
(annual percentage change)**Figure 28: The collapse in oil prices in late 2008 and early 2009 have contributed significantly to the cut in non-tax revenues**
(annual percentage change)

Notes and sources: * 2009 contributions relate to first 7 months of the year. MoF, World Bank

Figure 29: The fall in subsidy spending more than offsets higher central government programmed spending (annual per cent change and percentage point contributions in central government spending)



Notes and sources: * 2009 contributions to growth relate to data to July 2009 relative to July 2008. MoF and World Bank.

Around one-third of the Indonesian's central government budgeted spending for 2009 was disbursed in the first half of the year, a figure similar to 2008's disbursement rate. But there are important compositional differences between the two years. In 2008 unexpectedly large energy subsidies dominated spending and lifted the overall disbursement rate. So far this year about 27 per cent of the subsidy, capital and social assistance budgets have been spent, and about half the salary and interest allocations. While 9.7 per cent of the IDR 12 tr stimulus spending had been disbursed by the end of July, this spending was accelerating with about 5 per cent being spent in July.

7. Employment increased despite the slowdown, while poverty continued to fall

The labor market was stronger this February than a year earlier

Employment does not appear to have been significantly affected by the slowdown in the economy around the turn of the year. (Indonesia's labor force survey is conducted each February and August.) Anecdotes of layoffs never became large scale and have been rare since the second quarter, although there are undoubtedly regions and sectors that have been hit harder than the national average. Employment rose by 2.4 per cent or 2.44 million workers in the year to February to 104.5 million, faster than the 1.6 per cent growth in the population aged 15 and over. (Figure 30) Female employment increased by 3.3 per cent, almost twice as fast as male employment, and the labor force participation rate increased for both genders to an average 68.5 per cent over all. Trade made the largest contribution to the increase in employment, with 21.8 million Indonesians working in the sector in February 2009. 43.0 million work in agriculture, 0.8 per cent more than a year earlier. Together these increases were more than enough to absorb the growing workforce and higher participation, leading unemployment to fall 0.3 percentage points to 8.14 per cent. (Figure 32)

Only a small portion of this employment growth comprised those classifying themselves as an 'employee' or 'employer'. (Figure 31) The casual non-agricultural workforce increased by 7.3 per cent, and the unpaid labor force increased by 4.0 per cent to 18.7 million; the number of 'employers' barely changed. Casual employment particularly affects female workers: only 39 per cent of female workers report being an 'employer' or 'employee', while almost 60 per cent of male workers are in these categories, and this trend became stronger in the year to February.

Figure 30: Employment continued rising, despite the global downturn, with the number of workers in trade and other service industries recording the largest increases (millions of workers, February)

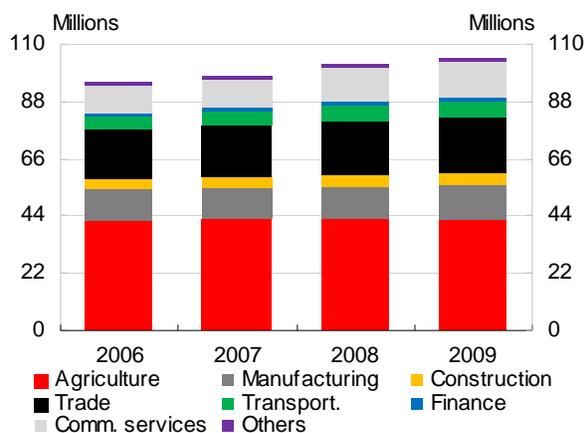
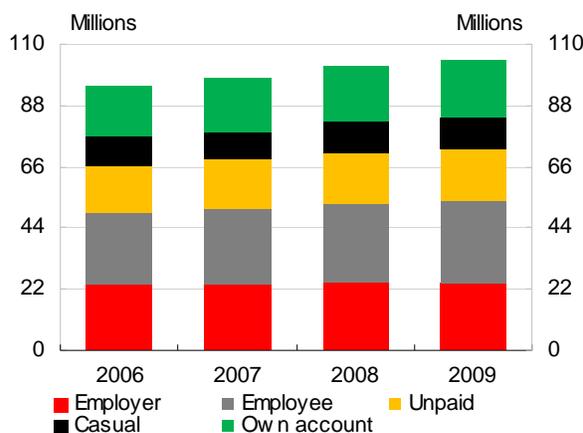


Figure 31: ...but most of this growth has been in less formal types of employment (millions of workers, February)

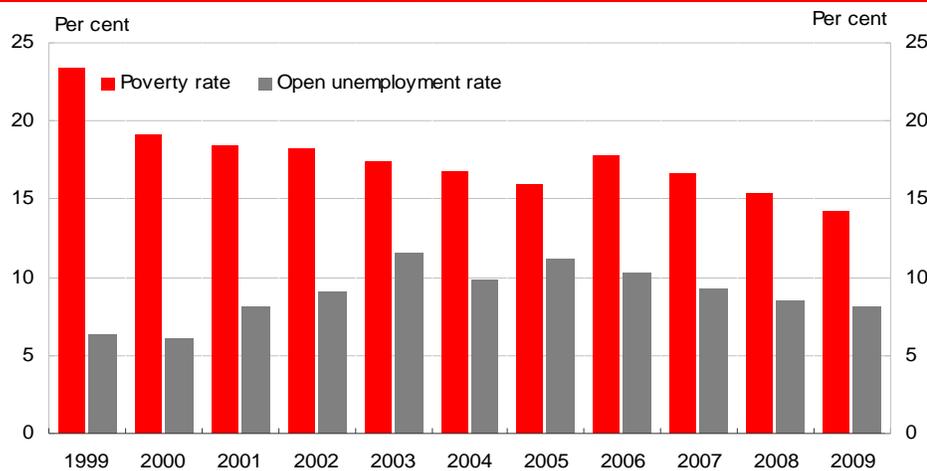


Sources: BPS and World Bank

...and poverty fell

The proportion of Indonesians living in poverty also fell in the year to March, from 15.4 per cent to 14.2 per cent. (Figure 32) This fall is despite the rapid increase in the cost of living, especially for poorer households, through to the third quarter of 2008, and the decline in incomes and employment that is likely to have occurred around the turn of 2009 as commodity prices slumped and economic activity stalled. Modeling suggests that much of the fall in the poverty rate is attributable to the boost in poorer households' income from the unconditional cash transfer program (BLT). February saw the last transfer under this program, and a survey conducted later in the second quarter 2009 is likely to have reported a higher poverty rate.

Figure 32: Poverty and the open unemployment rate fell from early 2008 to early 2009, despite the weaker economy around the turn of the year (per cent of the overall and working age population respectively)



Source: BPS

B. LOOKING AHEAD: A GRADUAL RECOVERY

1. The outlook for Indonesia's economy has improved

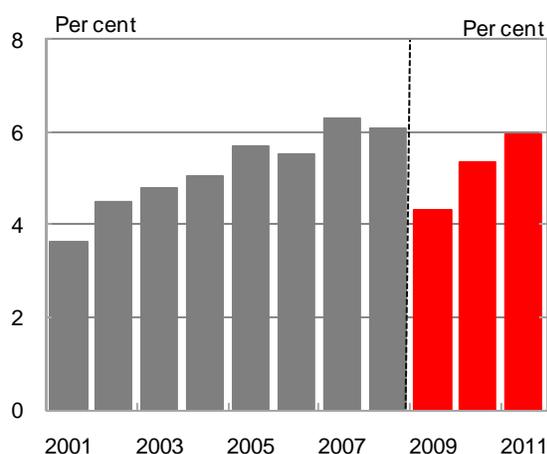
The outlook for the Indonesian economy has improved

The outlook for Indonesia's economy has improved over the last three months. The economy is expected to grow by 4.3 per cent in 2009, higher than the previous forecast of 3.5 per cent. In 2010 growth is expected to rise to 5.4 per cent, before returning towards Indonesia's current potential growth rate of 6 to 6.5 per cent from 2011. (Figure 33, Table 5)

Forecast growth across Indonesia's export destinations is also stronger

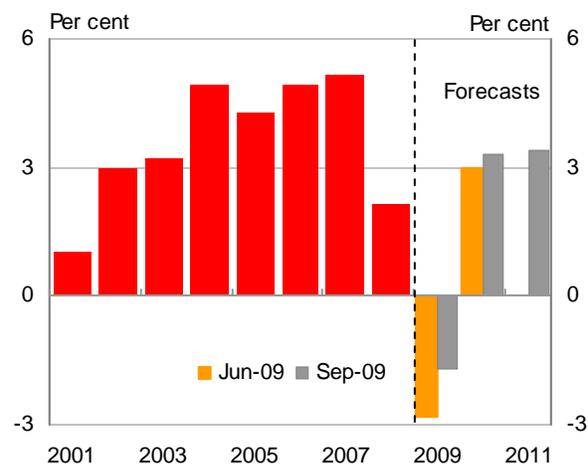
Coinciding with the stronger growth in Indonesia is the earlier-than-expected global recovery, with an improved outlook for Indonesia's major trading partners (MTP). Economic growth across Indonesia's MTPs is projected to contract by 1.7 per cent overall in 2009, considerably less than the almost 3 per cent contraction projected in June (Figure 34). While inventory restocking and fiscal stimulus appear to have supported the gradual recovery thus far, private spending will need to replace public spending to ensure that the recovery is sustained. The 2010 MTP economic growth forecast, while modestly revised upwards, is still much weaker than in previous years, although downside risks have eased considerably.

Figure 33: Indonesia's growth should rise towards its potential by 2011 (annual percentage change)



Source: BPS, CEIC and World Bank

Figure 34: Indonesia's major trading partners are projected to continue recovering, gradually, over the coming two years (annual percentage change)



Notes and sources: No 2011 MTP GDP growth forecast was published in the June Economic Quarterly. CEIC and World Bank

Growth in 2009 is expected to be supported by strong domestic consumption

The major drivers of Indonesia's growth in 2009 are expected to continue to come from domestic demand, supported by a recovery in the external sector (Table 5). Private consumption expenditure is expected to remain solid, growing by around 4.5 per cent in 2009 with election related spending in the first part of the year being complemented by the fiscal stimulus in the second half. Investment growth is expected to remain weak in 2009, consistent with weaker commodity prices, external demand, and credit growth than in the last two years. Government consumption is expected to continue growing as the fiscal stimulus continues to be spent and disbursement improves. Across production sectors, the contraction in the industrial sector in the Q4 2008 was recouped in the following quarter and industrial activity is expected to perform more strongly than previously expected through 2009.

...with investment recovering in 2010

In 2010, growth is expected to accelerate on the back of stronger investment, aided by more readily available credit and improved confidence among investors as global growth and commodity prices recover. Services production is expected to grow above trend following the slowing in 2009, as private consumption remains strong and consumer credit

expands. Growth in the agricultural sector may suffer a small impact from the weak El Nino weather pattern meteorologists are currently projecting. (Box 4)

2011 should see a return to potential growth

As the world economy starts to approach more typical levels of growth in 2011, Indonesia's economy is expected to approach its potential of around 6 to 6.5 per cent annual growth.

Table 5: Indonesia's macroeconomic and fiscal indicators
Per cent change unless otherwise indicated

	Annual				Year to December quarter			
	2008	2009	2010	2011	2008	2009	2010	2011
1. Main economic indicators								
Total Consumption expenditure	5.9	5.2	5.0	4.9	6.4	3.2	5.4	5.2
Private consumption expenditure	5.3	4.5	4.7	5.0	4.8	3.4	5.1	5.1
Government consumption	10.4	10.8	6.2	4.7	16.4	3.8	7.5	5.8
Gross fixed capital formation	11.7	2.7	8.1	6.8	9.1	2.8	8.7	5.7
Exports of goods and services	9.5	-12.2	9.6	11.4	1.8	-4.0	7.7	13.6
Imports of goods and services	10.0	-18.4	13.2	11.7	-3.5	-7.0	9.3	12.9
Gross Domestic Product	6.1	4.3	5.4	6.0	5.2	5.2	5.0	6.1
Agriculture	4.8	3.0	2.8	4.3	4.7	2.3	4.4	3.5
Industry	3.7	2.8	3.4	3.8	2.6	3.5	3.9	4.0
Services	8.9	6.2	8.0	8.7	7.8	5.8	8.0	10.3
2. External indicators								
Trade balance (USD bn)	10.2	16.9	11.9	11.2	n/a	n/a	n/a	n/a
Merchandise export (values)	26.8	-11.4	10.4	19.8	14.9	-8.1	14.3	23.0
Merchandise imports (values)	41.3	-18.6	13.6	22.8	26.6	-15.5	16.0	26.5
Balance of payments (USD bn)	-1.9	12.0	8.0	2.2	n/a	n/a	n/a	n/a
Financial account balance (USD bn)	-1.6	3.5	5.5	3.1	n/a	n/a	n/a	n/a
3. Other economic measures								
Consumer price index	9.8	4.7	5.6	6.5	11.5	2.4	6.8	6.0
Poverty basket Index	11.6	5.7	5.7	6.3	13.5	2.9	6.4	6.2
GDP Deflator	18.2	9.0	11.3	10.0	17.1	9.2	12.9	7.2
Nominal GDP	25.4	13.8	17.2	16.5	23.1	14.8	18.5	13.7
4. Economic assumptions								
Exchange rate (IDR/USD)	9,757	10,516	10,000	10,000	11,365	10,000	10,000	10,000
Interest rate (SBI, 1 month)	8.7	7.4	7.0	7.0	9.4	7.0	7.0	7.0
Oil price (Indonesian crude price) (USD/bl)	97.0	60.2	74.1	75.6	52.8	70.4	75.6	75.6
Major trading partner growth	2.1	-1.8	3.3	3.4	-1.6	1.7	3.0	3.6

Notes: Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices. The national accounts reported that the Rupiah value of exports fell by 15 per cent in the year to mid-2009—consistent with the balance of payments data—while the volume of exports fell by almost 16 per cent, imply that Indonesia's export prices, in rupiah terms, rose by 1.3 per cent, notwithstanding the collapse in commodity prices over this period and 12 per cent depreciation of the rupiah.

Alternative scenarios for the environment around the Indonesian economy show the range of potential growth paths, especially in 2010

Given the significant uncertainty surrounding the outlook for the Indonesian and global economies, alternative growth scenarios have been considered. (Table 6 and Figure 35) The 'high scenario' assumes the recovery in the global economy is greater than currently anticipated. In this scenario export prices and domestic credit are expected to accelerate. The high scenario also sees the Rupiah appreciating toward a level that was reached prior to the outbreak of risk aversion in October last year. The high scenario could add up to 1 percentage point to GDP growth from 2009 to 2011 relative to the reference scenario.

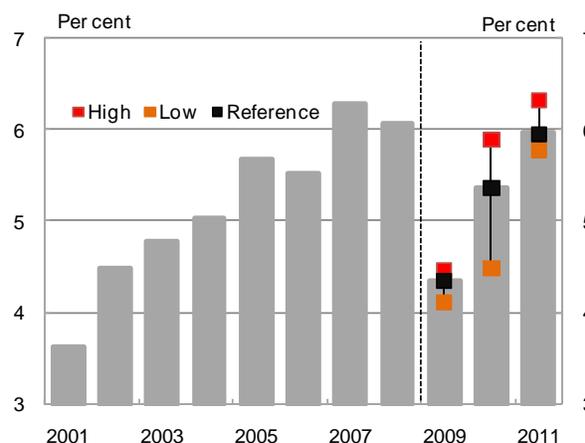
In the 'low' scenario it is assumed that the world recovery is far more protracted than currently expected. In addition, it is assumed that there is another episode of risk aversion toward the end of this year and early next year, which though not as severe as that experienced in October 2008, still leads to stagnation in global economic growth.

Domestic credit is assumed to stay weak, consistent with the weak growth in 2009. Indonesia's export prices are also assumed to fall considerably as global commodity prices fall. The Rupiah is assumed to depreciate toward levels experienced late last year. The low scenario could subtract up to 1¼ percentage points from GDP growth from 2009 to 2011 relative to the reference scenario.

Table 6: A wide distribution of potential growth environments can be envisaged for 2010...
(Per cent change)

	MTP*	Credit	Export prices	Rupiah (IDR/USD)
2009 Reference	-1.8	12	0.9	10476
High	-1.5	14	2.8	10426
Low	-2.4	12	-1.2	10724
2010 Reference	3.3	14	0.5	9920
High	4.2	17	5.7	9245
Low	1.4	12	-4.0	12039
2011 Reference	3.4	22	7.5	9920
High	5.2	26	10.9	8967
Low	2.4	18	1.5	11385

Figure 35: ...and these generate a wider distribution of potential paths for the Indonesian economy
(Per cent change)



Note and sources: * weighted average of major export destinations. BPS via CEIC and World Bank.

Sources: BPS via CEIC and World Bank

2. Indonesia's balance of payments is projected to remain near balance, with external financing needs remaining sustainable

a. Recovering growth among Indonesia's export destinations plus higher commodity prices are expected to lift Indonesia's trade flows

The outlook for Indonesia's trade flows in 2009 has improved

The fall in Indonesia's trade flows in 2009 compared with 2008 is likely to be less than expected earlier in the year. Indonesia's external environment started to recover sooner than expected, and the outlook for the rest of the year has improved. (Table 5) Over the full year, imports are projected to have fallen by more than exports. This is due to the much larger retrenchment in imports around the turn of the year, offsetting a faster recovery in imports in the second half driven with the firmer outlook for domestic demand and import prices.

...and they should rebound strongly in 2010 and 2011

The gradual recovery in the world economy is expected to continue supporting firm growth in Indonesia's exports volumes and prices over the forecast horizon. (Table 5) By the end of 2010, volumes should be above pre-crisis levels. Values should rise even faster, accelerating into 2011, due to the projection of higher commodity prices. Imports are expected to continue to recover faster than exports, as the domestic economy grows more quickly than Indonesia's export destinations, and recovering production of export items demands more imported inputs.

...with stronger growth in imports narrowing the trade surplus

The trade balance in 2009 is expected to be USD 17 bn, around two-thirds more than 2008. (Table 7) The greater fall in imports relative to exports around the turn of 2009 drove the expansion in the trade surplus. The stronger flows in both imports and exports from mid-2009 have increased the nominal value of the projected trade balance for the full year. This surplus should decline over the coming years as imports continue to recover slightly faster than exports.

b. External financing needs appears to be sustainable, and the risk of sudden, large capital outflows has declined

The overall balance of payments is likely to be in surplus in 2009...

The balance of payments (BoP) is expected to register surpluses in Q3 and Q4 2009, as non-residents continue to invest in liquid domestic asset markets, and the government's official borrowing program is disbursed. This will be partially offset by a narrowing in the current account, driven by a narrowing in the trade balance as imports values recover slightly more strongly than exports values. Combined with the surpluses registered in Q1 and Q2, the BoP is expected to register a surplus of above USD 10 billion in 2009.

...before narrowing in 2010 and 2011, as the recovery in commodity prices and imports bring the current account to near balance by late in 2010

Looking ahead, the BoP is expected to move towards balance in 2010 and 2011, as the current account approaches balance. This is expected to be partially offset by surpluses on the financial account, with a surplus of around USD 6 billion expected in 2010, before narrowing slightly further in 2011. (Table 7).

The narrowing in the current account is due to the fall in the trade surplus through the forecast window, combined with a widening in the income deficit. The net income deficit is expected to widen as the repatriation of profits to foreign equity holders in oil & gas production increases with higher global energy prices. Transfers are expected to be stable.

The outlook for the financial account is underpinned by an expectation that capital flows in Indonesia are relatively moderate—reflecting a gradual recovery in global credit markets and investor confidence (both foreign and domestic)—combined with a positive outlook for foreign direct investment (FDI) inflows. The outlook for net FDI follows anecdotal reports of considerable FDI projects, ranging from oil fields, paper and woodchip operations, Indian investments in textiles factories and aluminum smelters, and expanded investment in motorcycle manufacturing. Trade credits are expected to increase with higher trade volumes.

Table 7: The BoP surplus is expected to narrow through the forecast window, as the current account moves into deficit (billions of USD)

	2007	2008	2009	2010	2011
Balance of Payments	12.7	-1.9	12	8	2
Current Account	10.5	0.3	9	2	-1
Trade Balance	20.9	10.2	17	12	11
Income Balance	-15.5	-15.3	-13	-15	-18
Current Transfers Balance	5.1	5.4	5	6	6
Capital and Financial Accounts	3.6	-1.4	4	6	4
Capital Account	0.5	0.3	0	0	0
Financial Account	3.0	-1.6	3	6	3
Direct Investment	2.3	2.8	3	4	5
Portfolio Investment	5.6	1.7	5	6	5
Other Investment	-4.8	-6.2	-5	-4	-6
Foreign Reserves (a)	56.9	51.6	60.3		

Notes and sources: (a) 2009 foreign reserves at early September value. BI and World Bank

Over the 12 months to mid-2010, Indonesia's currently scheduled external financing obligations total USD 22 bn, based on BI reporting of the current stock of outstanding debt (Table 8). Projections of unscheduled financing needs (eg, historically typical sales of liquid financial assets), plus projected capital inflows based on moderately conservative assumptions, generates a projection of net inflows of around USD 32 bn in the 12 months to mid-2010. Combined, this gives a BOP surplus of around USD 10 billion, consistent with the projections presented in Table 7.

The assumptions underlying this projection are in line with recent trends. The 95 per cent roll-over rate on SBIs is lower than the realized rate through the first half of 2009. The 90 per cent roll-over rate on private short-term debt reflects still-fragile global credit conditions, plus the scaling back of some projects in line with lower investment following the global downturn and lower commodity prices. These roll-over rates compare to the implied roll-over rates on total external debt, which has been over 100 per cent for the first half of 2009, indicating that both the public and private sectors have been able to maintain access to external debt, even during the recent volatile financial market conditions (Figure 36).

Table 8: Indonesia's currently scheduled external financing needs over the coming 12 months total USD 22 bn (billions of USD)

EXTERNAL FINANCING NEEDS	22.3
Maturing short-term FCU private debt	8.5
Amortization of medium and long-term FCU debt	9.7
Public	6.5
Private (a)	3.1
Short-term IDR liabilities to non-residents	3.4
Amortization of medium and long-term IDR debt to non-residents	.7

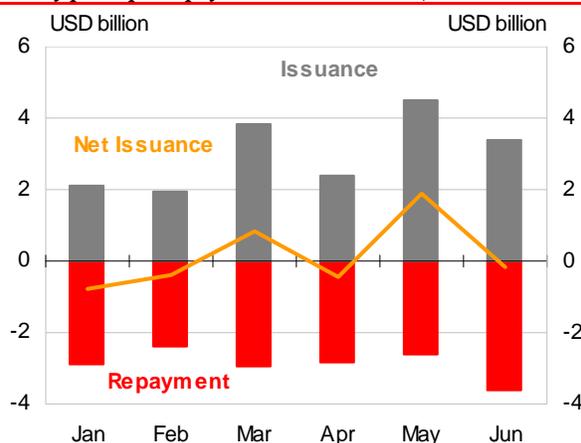
Notes and source: (a) Excludes standstill debt of USD 6.5 bn. BI and World Bank.

Table 9: Projected financing sources give a BOP surplus of around USD 10 bn (billions of USD)

PROJECTED EXTERNAL FINANCING SOURCES	32.3
Current account balance	3.8
Trade balance	12.6
Net income and transfers balance	-8.8
Net FDI Inflows (a)	2.8
Official Foreign Financing	-1.4
Drawings	5.0
Repayments	-6.3
New Debt Issuances	20.7
Short-Term Debt Instruments	9.9
Public (SBlS) (b)	2.5
Private (notes)	7.4
IDR debt (c)	.7
FCU debt	6.8
o/w loans	8.6
o/w trade credits (d)	-2.3
Medium and Long-Term Bonds	10.8
Public (SUN)	4.8
Foreign investment in IDR bonds (e)	1.8
FCU bonds	3.0
Private (bonds)	6.0
Non-residents' net purchases of debt and equity on secondary markets (f)	6.9
Public (SUN and SBlS)	3.0
Private (debt and equity)	3.9
Net investment offshore by residents (g)	-5
o/w outflows on currency and deposits (g,h)	.9

Notes and source: (a) reflecting increasing FDI inflows; (b) assuming 95 per cent roll-over rate; (c) assuming 90 per cent roll-over rate; (d) expected to rise with increasing trade flows; (e) assuming 16 per cent foreign ownership of new SUN (government IDR bonds); (f) reflecting increasing net purchases of domestic assets by foreigners; (g) negative reflects outflow; and (h) reflecting residents shifting assets back from foreign bank accounts. World Bank.

Figure 36: While roll-over rates on Indonesia's external debt have also been high in the first half of 2009 (monthly principal repayments and issuances)



Sources: BI and World Bank

Notwithstanding recent positive developments, Indonesia remains susceptible to sudden capital outflows, although the risk has declined in the past half year

In mid-2009, there did not appear to be a significant domestic trigger for large and sudden capital account outflows. Nonetheless, Indonesia's open capital accounts, thin financial markets, modest deposit base and historical experience suggest that there remains an ongoing, small, but marked risk of such outflows. 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 continued to decline in recent months. A second wave of heightened global financial market volatility would also pressure Indonesia's capital account. Such an event could again see a large drawback of foreign investors from liquid domestic assets, and could induce an outflow of capital by residents as described above.

3. Inflation is likely to drift higher with stronger demand and rising global commodity prices

Inflation in 2009 is likely to be weaker than earlier expected, at 4.7 per cent

The weaker-than-expected second quarter inflation rates and appreciation in the Rupiah suggest that inflation over 2009 may be a little more subdued than earlier expected. The annual inflation rate for 2009 is likely to be near 4.7 per cent, around the middle of BI's inflation target of 4.5 per cent (± 1 per cent). Monthly inflation rates are expected to lift later in the year as the dampening effect of lower energy prices wane and as the pick-up in global commodity prices is passed to consumers. Given projections of economic growth only returning to its potential rate later in 2011, price pressures due to supply bottlenecks are unlikely to emerge over the immediate horizon.

Relatively low inflation expectations are also likely to limit near-term inflation. Consumer inflation expectations for the coming 6 months remain near their lowest levels since 2005 when actual inflation was running close to 5 per cent in July, although they had risen from their February lows. Businesses have also lowered their inflation expectations, although they continue to expect inflation higher than the prevailing rate. Almost one-third of respondents to BI's second quarter survey expected inflation to be less than 7 per cent in the coming semester, compared with one-eighth with this expectation when BI conducted its survey Q3 2008.

...with poverty basket inflation 1 percentage point higher

Inflation experienced by poor households is likely to remain above the headline rate for the rest of the year, to average around 5.7 per cent for 2009. With rising food prices likely to drive Indonesian consumer prices in the coming quarters, and this will effect poverty basket inflation more than the headline rate. Agricultural wholesale prices rose in Q2 and this may be one of the factors increasing retail food prices in July and August, while further pass-through from higher global sugar prices is likely.

Stronger commodity prices and demand growth in 2010 are expected to lift inflation to between 5 and 6 per cent

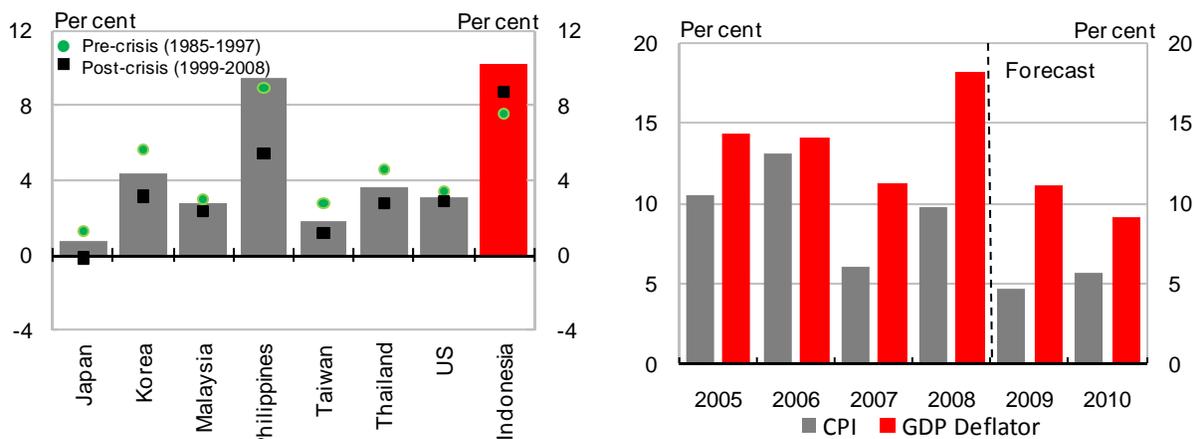
In 2010, ongoing rises in commodity prices and incomes and the lagged stimulatory impact of BI's cuts in interest rates are likely to raise inflation to between 5 and 6 per cent. As the effects of lower transport costs fall out of the headline inflation rate and energy and non-energy commodity prices begin to increase in Rupiah terms in early 2010, it is very likely that the headline inflation rate will move above the core rate.

Poverty basket inflation is expected to converge with headline inflation by the end of 2010 as food prices are assumed to stabilize while the increase in energy prices, which form a higher share of the aggregate CPI basket, drive the headline inflation rate higher relatively faster. In 2011, inflation is expected to stabilize around 6.5 per cent consistent with the continuation of a global recovery.

BI may be able to reduce Indonesia's structural inflation rate in the medium-term

The extent to which BI works to maintain inflation expectations at their current low levels and to reduce Indonesia's high structural rate of inflation will be a key determinant of the medium-term inflation outlook. If BI maintains a strong commitment to maintaining inflation near its published targets, the shorter-term output costs of doing so are likely to decline and Indonesia can secure the longer-term benefits of more stable growth and financial markets associated with low and stable inflation. Unlike its regional trading partners, Indonesia was not able to permanently reduce its inflation rate following the Asian Financial Crisis, indeed it is the only major economy in the region to have recorded a higher average inflation rate since then. (Figure 37)

Figure 37: Indonesia is the only major economy in the region to experience higher average inflation after the 1997/98 Asian crisis than before **Figure 38: The GDP deflator has grown faster than consumer prices, and this divergence is projected to continue**
(average annual consumer price inflation) *(year average consumer price inflation and percentage change in the implicit GDP deflator)*



Sources: National statistical authorities via CEIC and World Bank

Source: BPS via CEIC and World Bank

There are upside risks to the outlook for consumer prices...

The uncertainty about the strength of the global recovery in 2010 and 2011 places risk on the inflation forecasts. A stronger than expected recovery in world demand, or a significant re-alignment of exchange rates, are likely to drive up commodity prices and raise inflation. On the domestic side, if capital markets continue to increase in liquidity and credit growth returns to its early 2008 rates, there could be significant pressure on consumer prices. The impact of a moderate to severe El Niño event (worse than the mild event meteorologists are currently forecasting) on agricultural production could lead to higher food prices in late 2009 and early 2010. (Box 3) With planting already delayed by two months for many rice producers the risk of higher prices, particularly for those in more remote (and generally poorer) areas, is reasonably high. Finally, the government has indicated that it plans to increase several administered prices, including electricity in 2010 and LNG prices after Ramadan, and is considering a more targeted subsidy program that will ultimately lead to higher average prices.

...and economy-wide prices are likely to continue rising faster than the CPI

For some years, prices across the entire economy, as measured by the implicit aggregate GDP deflator, have been rising faster than costs for those items bought by consumers. (Figure 38) This overall trend is likely to continue, despite the current weakness in trade prices. The GDP deflator in 2009 is projected to grow by around 11 per cent, compared with 18.2 per cent in 2008, as fast growth in investment and government service prices drives a wedge with the CPI. In 2010, the GDP deflator is expected to moderate to a little below 10 per cent, based on the outlook of moderate ongoing growth in commodity prices and a moderation in other costs, particularly the growth in nominal wages following the slower growth in consumer prices.

4. These factors suggest that the government's deficit is likely to be less than budgeted

The government's 2009 outlook for slightly weaker revenues and some under-spending suggests a slightly-below-budget deficit

In its mid-year proposed revised budget, the government projects revenues in 2009 to be near the original budget, despite weaker forecasts for growth in the real economy and of prices. The government is expecting realized spending to be slightly less than it had originally budgeted, although the difference is likely to be smaller than in recent years. The higher crude oil price assumption (averaging USD 61 per barrel, against an original projection of USD 45) will lift projected oil & gas revenues, but this is likely to be more-than-offset by higher energy subsidy costs and larger transfers to subnational governments. Together these factors suggest that the budget deficit for 2009 may be slightly smaller than projected in the February APBN-P as a percentage of GDP, and almost IDR 20 tr smaller in nominal terms, given that the latest government forecast of nominal 2009 GDP is below that assumed in the budget. (Table 10)

The government is proposing a much smaller deficit in 2010

The government's proposed 2010 budget presented to parliament in early August projects that the budget deficit will contract to 1.6 per cent of GDP. (Box 2) This follows the expectation of a modest recovery in nominal GDP growth to 11.5 per cent, translating to a bounce-back in total revenues of only 4.5 per cent. This relatively low growth in projected revenues is being driven by the government's expectations that non-tax revenues will be even weaker than in 2009, particularly from oil & gas, with a fall of 17.6 per cent from 2009 to 2010. Tax revenues, which map more closely with nominal GDP, are expected to grow at around 12 per cent with the recovery in both the real economy and in price growth. On the expenditure side, the government is proposing to grow spending by only 0.4 per cent. This low growth is achieved through a cut in aggregate subsidies (-9.8 per cent), social assistance (-11.2 per cent) and 'other' expenditure (-40.3 per cent), offset by strong growth in spending on government wages (21.0 per cent).

If the nominal economy grows faster than the government projects, budget deficits are likely to be lower this year and next

The projections for the growth in the real economy, the GDP deflator, and crude oil prices presented in Table 5 differ from the government's projections. They suggest that the nominal economy will grow more quickly than the government is projecting in its proposed revised budget for 2009 (RAPBN-P) and proposed budget (RAPBN) for 2010. Underpinning the projected stronger nominal GDP growth is the use of a different price measure. The projections in Table 5 base nominal GDP growth on the sum of the projected growth in real GDP plus the growth in the GDP deflator. In contrast, the government forecasts growth in nominal GDP as the sum of projected growth in the real plus the increase in consumer price inflation. While better recognized and more commonly

understood, the CPI is a narrower indicator of prices than the GDP deflator. The GDP deflator reports changes not only in consumer prices, but also trade prices, the cost of investment, and even the cost of providing government services. Growth in government revenue depends on the nominal growth of these items. In recent years, the GDP deflator has grown faster than the CPI, and this divergence seems likely to continue (Figure 38).

Table 10: Projections for the government's budget deficits in 2009 and 2010 are sensitive to the rate of nominal economic growth that is assumed, with faster price growth implying a smaller deficit

	2007	2008	2009	2009	2010	2010
	Actual	Actual	Proposed revised	WB estimate	Proposed (RAPBN)	WB estimate
A. State revenues and grants	707,808	981,609	872,632	854,609	911,476	974,698
1. Tax revenues	490,989	658,701	652,122	642,827	729,165	753,695
a. Domestic tax	470,053	622,359	632,099	622,915	702,034	726,432
i. Income tax	238,431	327,498	340,376	332,885	340,322	377,852
- Oil and gas	44,000	77,019	49,500	52,627	39,883	56,073
- Non oil and gas	194,431	250,479	290,876	280,257	300,439	321,779
ii. Other domestic tax	231,622	294,861	291,723	290,030	361,712	348,580
b. International trade tax	20,936	36,342	20,023	19,912	27,131	27,263
i. Import duties	16,699	22,764	18,624	18,612	19,498	20,692
ii. Export tax	4,237	13,578	1,400	1,300	7,634	6,571
2. Non Tax Receipts	215,121	320,605	219,518	210,789	180,889	219,581
<i>o/w natural resources</i>	132,893	224,463	139,997	125,979	111,454	141,094
i. Oil and gas	124,784	211,617	129,088	115,498	101,259	129,443
ii. Non Oil and gas	8,109	12,846	10,909	10,481	10,195	11,651
B. Expenditures	757,651	985,731	1,005,674	979,827	1,009,486	1,020,437
1. Central government	504,625	693,356	696,101	670,254	699,688	710,640
- Personnel	90,425	112,830	133,709	127,113	161,736	153,757
- Material expenditure	54,511	55,964	87,004	75,903	100,170	87,389
- Capital expenditure	64,289	72,773	74,281	72,366	76,893	74,911
- Interest payments	79,808	88,430	110,051	110,051	115,595	115,595
- Subsidies	150,215	275,292	159,951	156,924	144,355	179,964
- Grants expenditure	0	0	32	32	34	34
- Social expenditure	49,756	57,741	77,765	77,765	69,078	69,078
- Other expenditures	15,621	30,328	53,309	50,101	31,827	29,912
2. Transfers to the regions	253,026	292,434	309,572	309,572	309,798	309,798
C. Primary Balance	29,965	84,309	(22,991)	(15,167)	17,585	69,856
D. SURPLUS / DEFICIT	(49,843)	(4,122)	(133,042)	(125,218)	(98,010)	(45,739)
Deficit (% of GDP)	(1.3)	(0.1)	(2.5)	(2.2)	(1.6)	(0.7)
Economic assumptions/outcomes						
Gross domestic product	3,957,404	4,954,029	5,425,405	5,635,502	6,050,055	6,604,772
Economic growth (%)	6.3	6.1	4.3	4.3	5.0	5.4
Inflation (%)	6.6	11.1	5.0	9.0	5.0	11.3
Exchange rate (Rp/US\$)	9,419	9,691	10,600	10,516	10,000	10,000
Crude-oil price (US\$/Barrel)	78.0	97.0	61.0	60.2	60.0	74.1
Oil production (barrel per day)	0.9	0.9	1.0	1.0	1.0	1.0
% of civil service wages increase	15.0	20.0	15.0	15.0	5.0	5.0
Interest rate of SBI (average %)	8.0	9.3	7.5	7.4	6.5	7.0

Notes and sources: The government's projections for 2009 and 2010 are the official budget submissions to parliament. These submissions were being revised in consultation with parliament at the time of publication. The final revised 2009 and 2010 budget are likely to differ from the numbers presented above. Ministry of Finance, and World Bank projections.

This different approach to forecasting nominal GDP growth suggests that revenue is likely to grow more strongly than the government is currently projecting in both 2009 and 2010. In 2009, assuming that spending is close to the government's announced plans, with the exception of energy subsidies which are likely to be slightly less than announced given the assumed lower world oil price, faster revenue growth reduces the budget deficit in 2009 to 2.2 per cent of GDP. This projection accounts for the realized revenue and spending

through to July 2009, with projections only made for the remaining five months of the year. In these months, allowance is made for the expected pick-up in the nominal economy.

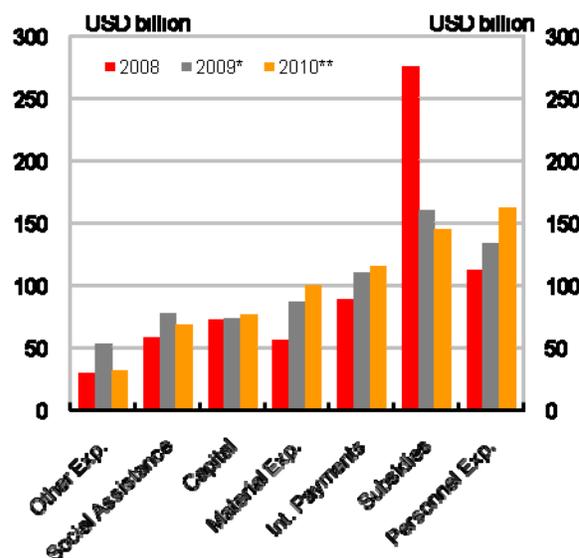
The stronger nominal GDP growth and higher oil prices projected for 2010 (Table 5), generate projections of an even smaller deficit that year, of around 0.7 per cent of GDP. The projection of nominal GDP is faster than the government's projection, and that suggests that revenue will also grow more quickly than the government's projection. The higher oil price assumption is also likely to lift revenues. This smaller projected deficit assumes that realized spending in 2010 is close to the government's announced plans, with the exception of energy subsidies which are adjusted to account for the higher crude oil price assumption.

Box 2: The government's proposed 2010 budget

The government announced its 2010 budget proposal in the presidential speech to parliament on August 3. The total budget amounts to IDR 1,009 tr in nominal terms (or 16.7 per cent of GDP), 0.5 per cent higher than the 2009 revised budget. The projected fiscal deficit is a modest 1.6 per cent of GDP. Two third of the budget will be carried out by central government and the remaining one third will be implemented by sub-national government. Some of the key features of the 2010 proposed budget include:

- Salary and material expenditures are anticipated to grow by 21 per cent and 15 per cent compared to 2009's levels, reflecting on-going bureaucracy reform and across-the-board salary increases of 5 per cent. These two budget items will increase government consumption to 4.3 per cent of GDP from 4.1 per cent of last year.
- Capital expenditure to only increase by 3.5 per cent, to be 1.3 per cent of GDP.
- Subsidies remain large and will consume about 20 per cent of central government budget, though the budgeted amount (notoriously poorly projected in the draft budgets under the current energy subsidy system) is projected to fall by 10 per cent compared with 2009.
- The sectoral composition of spending has not changed. Government administration remains the largest item, consuming 15 per cent of the central government budget, followed by education (11 per cent), and infrastructure (6.3 per cent). Defense will receive a 44 per cent budget increase while health only receives an additional 7.4 per cent, compared to the 2009 revised budget.

Figure 39: Central government budget shifts resources from subsidies to personnel, interest payments and material costs (trillions of IDR)



Notes and source: * proposed mid-year revised budget. ** proposed budget. Ministry of Finance

Sources: Ministry of Finance and World Bank

5. Further modest gains in poverty are likely

Poverty is likely to continue to fall

The forecasts for GDP growth and inflation presented in Table 5, plus the proposed government budget for 2010, suggest that the poverty rate is likely to continue to fall albeit at a slower pace than occurred in the last year. (

Table 11: The poverty rate is projected to continue to fall

	2008	2009	2010	2011
Reference projection	15.4	14.2	13.6	11.5
High scenario	15.4	14.2	13.9	11.8
Low scenario	15.4	14.2	13.4	11.3

Table 11) The slowdown in the fall in poverty is largely attributable to the withdrawal of the BLT program being offset by projected continued real income and employment growth. Under the alternative growth scenarios presented in Table 6 and Figure 35, the poverty rate is still likely to continue to fall, but at a respectively slower and faster pace in the weaker and stronger cases.

Source: BPS and World Bank estimates and forecasts

Box 3: Estimating the impact of El Niño on poverty

El Niño is a sustained and significant increase in the surface temperature of the eastern Pacific Ocean which leads to extreme weather patterns that disrupt agricultural production and prices. This poses a significant risk particularly to those living in poverty, many of whom are particularly vulnerable to shocks in the agricultural sector. Current assessments from the Australian Bureau of Meteorology indicate that 2009 will be an El Niño year. However, the September value of the Southern Oscillation Index, which measures the relative sea level pressures between Tahiti and Darwin, indicates that the development of El Niño in early September 2009 is less acute than in July.

While extreme El Niño years, such as the 1997/98 episode and to a lesser extent 2006, can have a severe impact on the agricultural sector, 2009/10 is currently not considered to fall in that category. Expectations are that 2009/10 will be a mild El Niño with a limited impact on economic and social outcomes. Nevertheless, it is worth considering the price and poverty impact in the unanticipated event that this El Niño episode is worse than currently expected.

Amongst other impacts, El Niño tends to cause drier weather in Indonesia, delaying the planting season for rice. The dry season harvest, following the rainy season harvest, tends to be better than normal. However, even a temporary reduction in rice production can lead to short-term price increases. This will reduce the purchasing power of consumers particularly those with a larger share of food in their consumption basket – those under or near the poverty line. (Naylor, Falcon, Rochberg, and Wada)

Other crops requiring irrigation sensitive to lower rainfall will also be affected, such as immature palm oil trees. The Ministry of Agricultural has estimated crude palm oil production could be 15 to 20 per cent below its target in the case of a moderate to severe El Niño, although total production is still expected to continue to rise over the year due to an increase in the area of plantations.

Simulating the impact of a repeat of the 1998 and 2006 El Niño weather conditions on rice prices in 2009/10, it is estimated that the 2010 poverty rate will increase to 16.3 and 15.5 per cent respectively from the base forecast. (Table 12) In anticipation of El Niño the Indonesian Government has doubled its emergency reserves of rice in an attempt to smooth prices. The cost to offset the El-Niño effect on poverty, before accounting for any price smoothing from emergency reserves, using the BLT program would be 91,000 Rupiah per household/per month in the 1998 El Niño scenario and 62,000 Rupiah per household/per month under the 2006 El Niño scenario. In both scenarios the costs to remedy the impacts would be less than the original BLT of 100,000 Rupiah per household/per month.

Table 12: El Niño events significantly worse than currently being projected for 2009/10 would bring some reverse recent gains in poverty reduction

	Scenarios		
	Base 2010 forecast given current EL Niño projection	El Niño (1998)	El Niño (2006)
<i>Southern Oscillation Index(a)</i>	-0.5	-5.4	-2.7
<i>Poverty Basket Inflation(b)</i>	4.8	10.1	8.5
<i>Poverty rate</i>	13.6	16.3	15.5
<i>BLT per household per month that would be needed to maintain poverty at base levels (IDR)</i>	-	91,000	62,000

a) Peak SOI reading during the El-Niño. b) March 2010 year on year rate.

Notes and sources: The scenarios assume the same weather conditions as measured by the Southern Oscillation Index during the 1998 and 2006 El Niño. The modeling measures the impact of a change in the SOI and the corresponding impact on low-quality rice prices in Indonesia and the subsequent impact on poverty basket inflation and the poverty rate. World Bank.

Source: 'Using El Niño/Southern Oscillation Climate Data to predict rice production in Indonesia'. R Naylor, W Falcon, D, Rochberg, N Wada, N. *Climatic Change* 50: 255–265, 2001

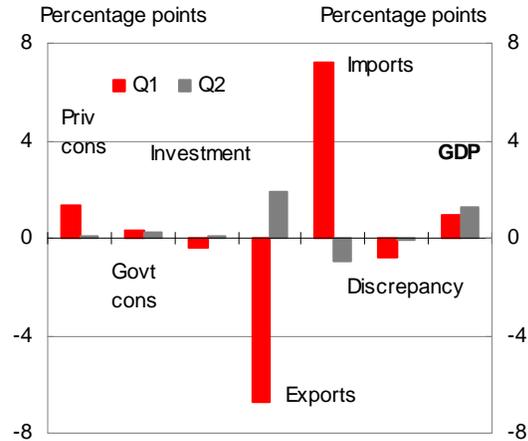
APPENDIX: A SNAPSHOT OF THE INDONESIAN ECONOMY

A1: GDP growth has picked up (QoQ sa & YoY growth)



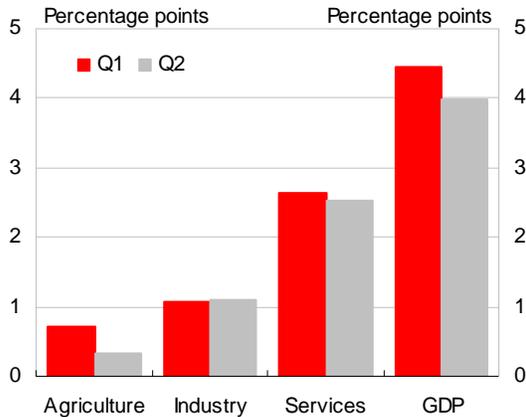
Source: BPS via CEIC and World Bank

A2: Consumption and NX contributed to growth (Contributions to QoQ growth, sa)



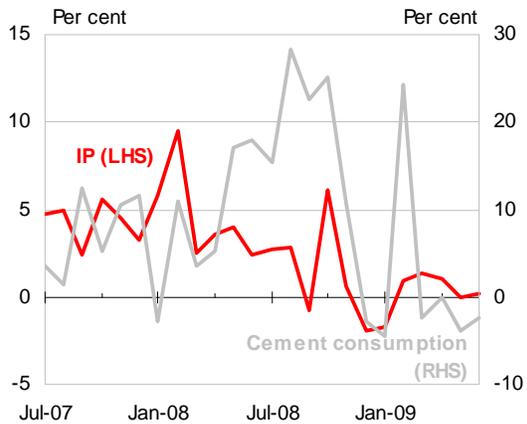
Source: BPS via CEIC and World Bank

A3: Services is the largest contributor (Contributions to YoY growth)



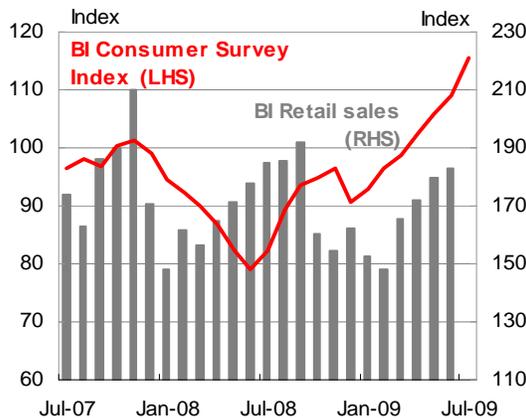
Source: BPS via CEIC

A4: IP growth is recovering (YoY growth)



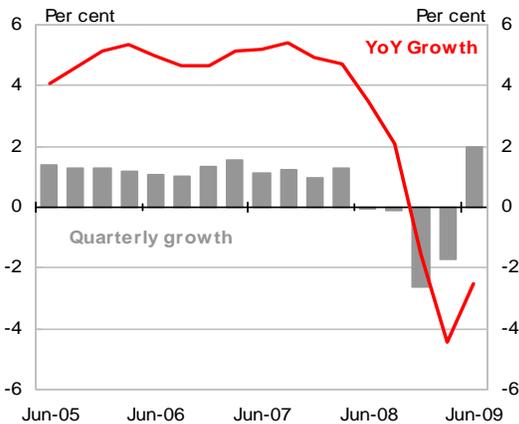
Source: CEIC

A5: Consumer indicators are picking up (Index)



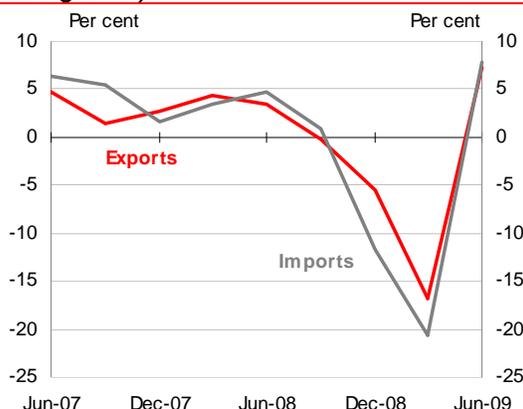
Source: BI via CEIC

A6: MTP growth recovered in Q2 (QoQ sa & YoY)



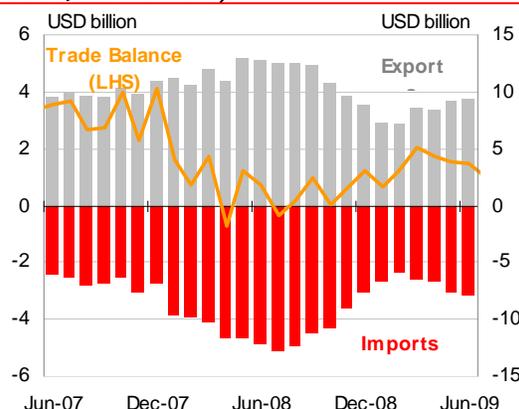
Source: National statistics agencies via CEIC

A7: Real trade flows have rebounded (QoQ growth)



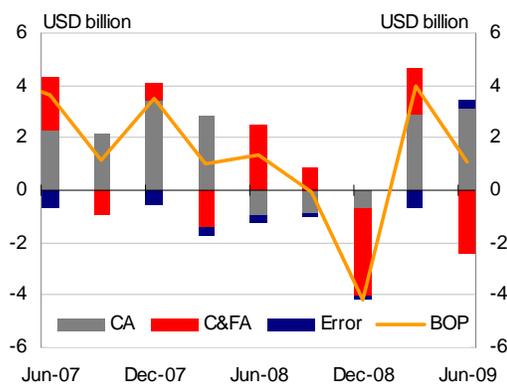
Source: BPS and World Bank

A8: Trade balance remains positive (Values, USD billions)



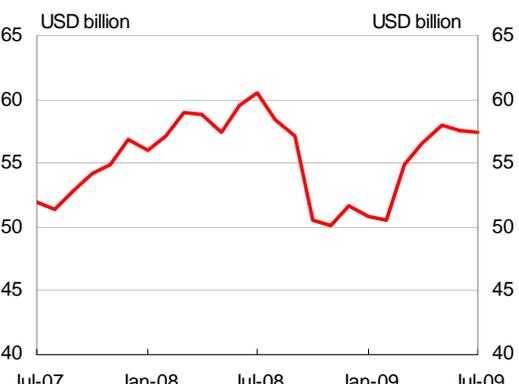
Source: BPS and World Bank

A9: Net inflow on the BOP in Q2 (USD billions)



Source: BPS and World Bank

A10: FX accumulation has stabilized (USD billions)



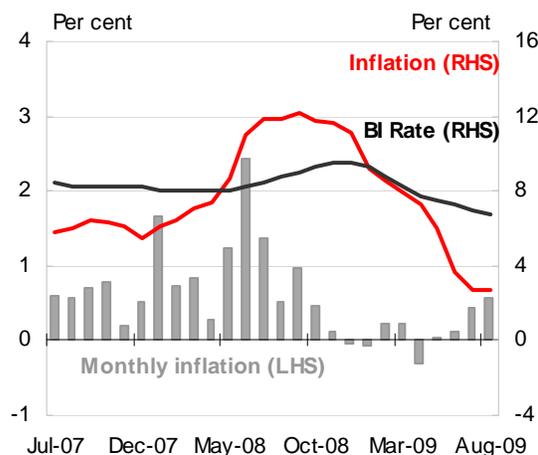
Source: BPS and World Bank

A11: Current account surplus offsets net capital outflow in Q2

USD billions	2005	2006	2007	2008	2008				2009	
					Q1	Q2	Q3	Q4	Q1	Q2
Balance of Payments	.4	14.5	12.7	-1.9	1.0	1.3	-.1	-4.2	4.0	1.1
% GDP	0.2	5.1	3.5	-0.5	0.8	1.0	-0.1	-3.8	3.5	0.8
Current Account	.3	10.9	10.5	.3	2.8	-1.0	-.9	-.7	2.9	3.1
% GDP	0.1	3.8	2.9	0.1	2.3	-0.7	-0.6	-0.6	2.6	2.4
Trade Balance	8.4	19.8	20.9	10.2	4.6	2.2	2.6	.9	4.4	5.6
Net Inome & Current Transfers	-8.1	-8.9	-10.4	-9.9	-1.7	-3.1	-3.5	-1.6	-1.6	-2.5
Capital & Financial Accounts	.3	3.0	3.6	-1.4	-1.4	2.5	.9	-3.3	1.8	-2.4
% GDP	0.1	1.1	1.0	-0.3	-1.2	1.9	0.6	-3.0	1.6	-1.8
Direct Investment	5.3	2.2	2.3	2.8	-.3	.6	.4	2.1	1.7	.0
Portfolio Investment	4.2	4.3	5.6	1.7	2.0	4.2	-.1	-4.4	1.9	2.0
Other Investment	-9.4	-3.8	-4.8	-6.2	-3.2	-2.3	.4	-1.1	-1.8	-4.5
Errors & Omissions	-.2	.6	-1.4	-.9	-.4	-.2	-.1	-.2	-.7	.4
Foreign Reserves	34.7	42.6	56.9	51.6	59.0	59.5	57.1	51.6	54.8	57.6

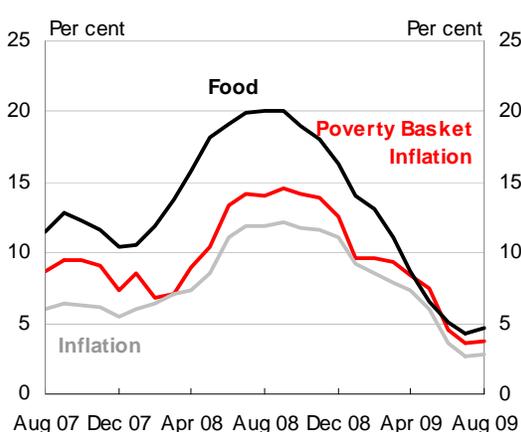
Source: BI, BPS via CEIC and World Bank

A12: Inflation may have reached a turning point (MoM & YoY)



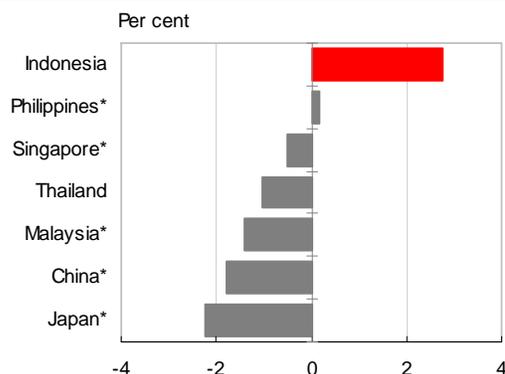
Source: BI, BPS and World Bank

A13: Inflation for the poor slowed most (YoY)



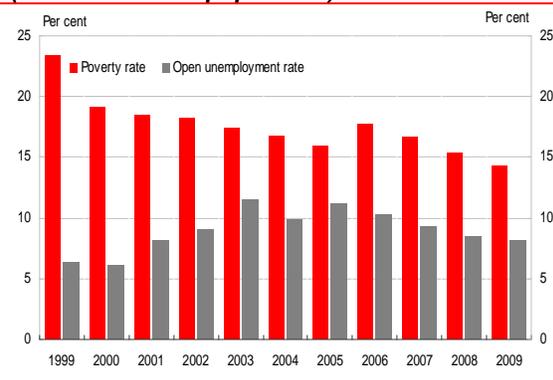
Source: BPS and World Bank

A14: Inflation remains high in the region (August inflation, YoY)



Source: CEIC and World Bank. *July data.

A15: Poverty fell in 2009 (Per cent of total population)



Source: BPS

A16: Fiscal deficit is likely to be smaller than originally budgeted

	2008	2009	2009 (f)	2010	2010 (p)
	Actual	Revised*	WB estimate	Proposed	WB estimate
A. State revenues and grants	981,609	872,632	854,609	911,476	974,698
1. Tax revenues	658,701	652,122	642,827	729,165	753,695
<i>o/w natural resources</i>	327,498	340,376	332,885	340,322	377,852
- Oil and gas	77,019	49,500	52,627	39,883	56,073
- Non oil and gas	250,479	290,876	280,257	300,439	321,779
2. Non Tax Receipts	320,605	219,518	210,789	180,889	219,581
<i>o/w natural resources</i>	224,463	139,997	125,979	111,454	141,094
i. Oil and gas	211,617	129,088	115,498	101,259	129,443
ii. Non oil and gas	12,846	10,909	10,481	10,195	11,651
B. Expenditures	985,731	1,005,674	979,827	1,009,486	1,020,437
1. Central government	693,356	696,101	670,254	699,688	710,640
2. Transfers to the regions	292,434	309,572	309,572	309,798	309,798
C. Primary Balance	84,309	(22,991)	(15,167)	17,585	69,856
D. SURPLUS / DEFICIT	(4,122)	(133,042)	(125,218)	(98,010)	(45,739)
Deficit (% of GDP)	(0.1)	(2.5)	(2.2)	(1.6)	(0.7)

Source and notes: MoF and World Bank. *Proposed.

A17: IDX performed well in the region
(Index, 2 Jan 2009=100)



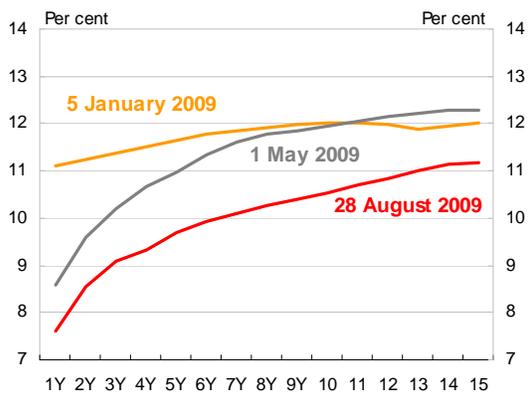
Source: CEIC and World Bank

A18: IDR appreciated rapidly against USD
(IDR/USD level & Index)



Source: FRB and BI via CEIC and World Bank

A19: Yield curve has steepened
(Yield, 1 to 15 year IDR sovereign bonds)



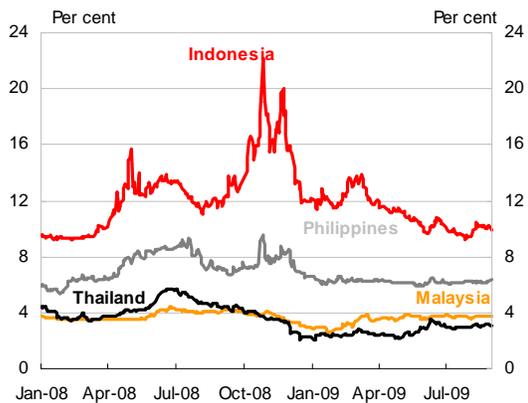
Source: IDX via CEIC

A20: Indonesian spread below EM average
(Basis point difference with UST)



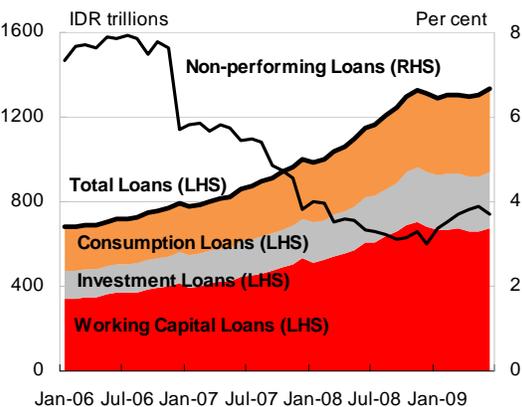
Source: JP Morgan, Datastream and World Bank

A21: 5 year yield remains high in the region
(5 year local currency sovereign bond yield)



Source: National exchanges via CEIC

A22: NPLs remain low despite recent increases
(IDR trillions and per cent of total loans)



Source: BI and World Bank



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