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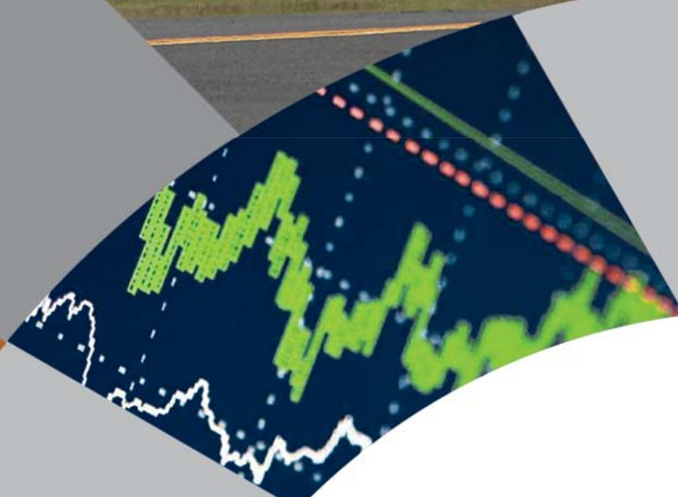
INDONESIA ECONOMIC QUARTERLY

Building momentum

March 2010



THE WORLD BANK | BANK DUNIA

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THE WORLD BANK | BANK DUNIA
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 the implications of these developments and other changes in policy for the outlook for Indonesia's economic and social welfare. Its coverage ranges from the macroeconomy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

This Indonesian Economic Quarterly was prepared and compiled by the macroeconomic analysis team at the World Bank's Jakarta office, under the guidance of Lead Economist Shubham Chaudhuri and Senior Country Economist Enrique Blanco Armas: Andrew Blackman (trade flows, balance of payments and the ACFTA), Andrew Carter (government revenues), Andrew Ceber (national accounts and domestic demand), Fitria Fitrani (trade flows and the ACFTA), Faya Hayati (prices), Ahya Ihsan (government expenditure and fiscal multipliers), Telisa Falianty (monetary conditions), Neni Lestari (banking sector), Peter McCawley (the PRJMN), Hassan Noura (education spending), Ririn Purnamasari and Matt Wai-Poi (recent developments in household welfare), Preya Sharma (fiscal multipliers), and Diva Singh (financial markets, banking sector and the costs of sterilization), and Djauhari Sitorus (banking sector). Enrique Blanco Armas, Tim Bulman and Andrew Ceber shared the editing. Ashley Taylor, Nathan Dal Bon and Jonas Fallov provided detailed comments on early drafts, and Diva Singh is grateful to comments from IMF Senior Resident Representative Milan Zavadjil on Part B-2.

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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.

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Executive Summary: Building momentum

Indonesia's economy built momentum through 2009, with government policies supporting growth, but maintaining this momentum will be a policy challenge

Indonesia's economy continued to build momentum through late 2009. The economy accelerated each quarter, to reach its pre-crisis peaks by Q4. The fiscal stimulus and Bank Indonesia's management of monetary policy have done much to support this momentum, while developments such as the ongoing implementation of the China-ASEAN Free Trade Agreement seem to have had little economic impact and offer medium-term opportunities to Indonesia. The government's deferral of energy price reform leaves public finances and the efficiency of government spending subject to the uncertain path of international oil prices and the exchange rate. Further building Indonesia's economic momentum into the medium-term requires investing more resources in public goods and social services, fostering a stronger investment climate and more effective bureaucracy, and ensuring the economy's growth leads to improving living standards for all Indonesians.

Growth returned to pre-crisis peaks in Q4 and other indicators were in sharp contrast to late 2008

In the last quarter of 2009, broadly-based growth accelerated to near the peaks achieved before the financial crisis of late 2008. The previous year's downturn appears to have had a limited impact on households' access to work and welfare, particularly their ability to purchase adequate food, and what impact there may have been appears to have waned by late 2009. In early 2010, partial indicators suggest that while domestic demand remains relatively high, the pace of growth may have moderated. The trade surplus widened on higher commodity prices and the continued recovery across Indonesia's major trading partners. Inflation remained subdued overall, although growth in some food prices was stronger than usual for the time of year, especially impacting poorer households, before some seasonal reversals in March.

The budget deficit was smaller than expected in 2009, with the stimulus supporting growth…

The Government's 2009 budget deficit of 1.6 per cent of GDP was 0.8 percentage points smaller than expected, as revenues surged in late December reflecting improvements in both economic conditions and the tax office's collections. The Government's fiscal stimulus and spending package, disbursed with a little less of a year-end rush than usual, is estimated to have provided as much as 1 percentage point of additional growth.

…but the government proposes to defer energy price adjustment in 2010, expanding this year's projected deficit

The Government also detailed its proposed revised 2010 budget. The key feature of this revised budget is a larger deficit, at 2.1 per cent of GDP, mostly due to deferred adjustment of regulated energy prices and a higher oil price assumption impacting the cost of energy subsidies and the Government's revenue transfer obligations to subnational governments. The revised package also contains some additional stimulus aimed at supporting the real economy while also improving tax compliance, featuring a cut in the corporate tax rate to 25 per cent from 28 per cent. The Government can easily finance the wider deficit from its 2009 financing surplus and from its improved access to commercial credit markets, where it has been able to issue bonds at sharply lower yields and for longer maturities than a year earlier; by the end of March the Government had filled about one-third of its bond issuance target. Ratings agencies have recognized the Government's sustainable public finances and Indonesia's larger economic robustness, raising their rating of Indonesia's sovereign debt.

Foreign investors continued to seek Indonesian financial assets, driving government bond yields to record lows…and challenging the central bank

Foreign investors continued to expand their exposure to Indonesian assets, making significant purchases of domestic bonds, short-term money market instruments and stocks, supporting the currency and pushing medium-term Government bond yields to record lows. These liquid capital inflows, with the expanding current account surplus, have supported further sizable balance of payments surpluses and allowed foreign exchange reserves to accumulate to almost USD 70 billion. These inflows have also challenged Bank Indonesia (BI, the central bank), as it seeks to moderate the rupiah's appreciation without sharply increasing the money supply or incurring significant costs of sterilization. So far it appears to have been successful at meeting these challenges.

The outlook has strengthened slightly since late 2009

The outlook for Indonesia's economy from March 2010 is a little stronger than three months previously, as improved global conditions offset the risk of slower and shallower reforms to improve the investment climate and the efficiency with which the government uses its resources and provides services to all Indonesians. The relative robustness of Indonesia's economy is likely to see imports grow more strongly than exports, while higher commodity prices and activity lead to greater repatriation of profits, reducing the current account surplus into 2011. Inflation is likely to gradually rise from recent historical lows as the disinflationary impact of the rupiah's appreciation wanes and higher global commodity prices and domestic demand feed into price pressures; BI's judicious control of the money supply and the slow growth in lending are likely to limit demand-pull inflationary pressures.

Table 1: The outlook remains for gradual recovery in growth

		2009	2010	2011
Gross domestic product	*(Annual per cent change)*	4.5	5.6	6.2
Consumer price index	*(Annual per cent change)*	4.8	5.3	6.1
Poverty rate	*(Per cent of population)*	14.2	13.5	11.4
Balance of payments	*(USD bn)*	12.5	6.2	4.7
Budget balance	*(Per cent of GDP)*	-1.6	-1.3	na
Budget balance, government projection	*(Per cent of GDP)*	-1.6	-2.1	na
Major trading partner growth	*(Annual per cent change)*	-1.0	4.3	4.0

Sources: MoF, BPS and other national statistical agencies via CEIC and World Bank

Maintaining this momentum into the medium-term will require supporting entrepreneurs' investments, both by investing in infrastructure and the quality of public services, and ensuring all Indonesians benefit from the economy's growth

Building Indonesia's economic momentum into sustained, stronger growth into the middle of this decade is a considerable challenge for policy makers. While the external environment has become more benign, domestic policy makers will continue to be challenged by the need to enable a more supportive investment climate for investors, an effective use of the government's scarce resources, and ensure that all Indonesians benefit from growth through improving incomes, better access to Government services and stronger welfare outcomes. The Government's medium term development plan (RPJMN) presents these issues and provides a broad-brush outline of the Government's approach to these issues, focusing a mix of existing and new programs on the priorities of i) bureaucracy and governance reform, ii) education, iii) health, iv) poverty reduction, v) food security, vi) infrastructure, vii) investment and business climate, viii) energy, ix) environment and disaster management, x) disadvantaged regions, and xi) culture, creativity, and technological innovation.

A. ECONOMIC UPDATE

1. Indonesia's economic momentum built through 2009

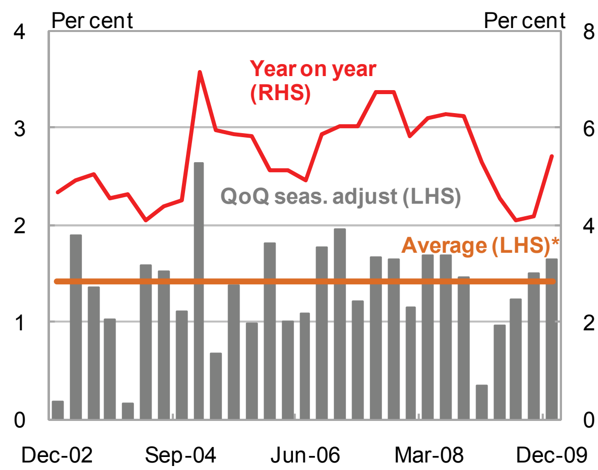
The momentum in Indonesia's economy continued to build in Q4, but may have moderated at the start of 2010

Into the end of 2009 Indonesia's economic momentum continued to build, with quarterly economic growth rising further to well outpace the past decade's average (Figure 1). Recent partial indicators of Indonesia's economy have now begun to moderate suggesting that growth in Q1 may have slow a little from Q4's pace. Quarter on quarter (QoQ) GDP increased by 1.7 per cent, seasonally adjusted, or around 6.8 per cent on an annualized basis (compared with 6.0 per cent in Q3). Year-on-year (YoY) growth increased strongly from 4.2 per cent to 5.4 per cent as the weak result recorded in Q4 2008 during the peak of the global downturn dropped out of the calculation. Real GDP growth for all of 2009 was 4.5 per cent – well above forecasters' projections at the start of the year. At the end of 2009 and the first months of 2010 domestic demand and indicators stabilized, albeit at relatively high levels, suggesting that Q1 growth may not be as strong in 2010,

Major trading partner growth continued to support growth in Indonesia in Q4, at a moderating pace

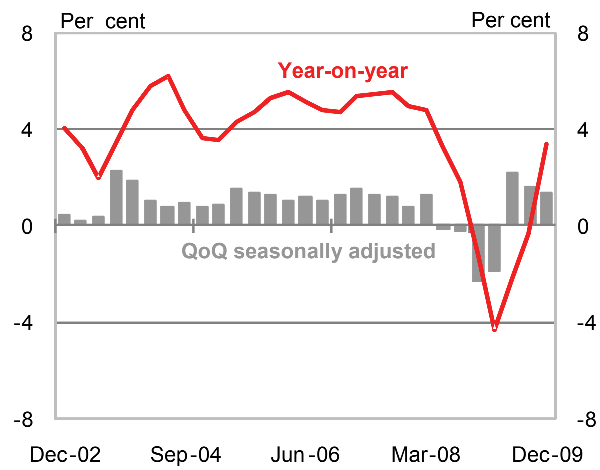
The acceleration in GDP growth over 2009 reflected improved international and domestic conditions. On the international side, many of Indonesia's major trading partners (MTPs) have reported robust growth in Q4 (Figure 2) as the global economy emerges from recession, fueled by inventory restocking and a recovery in global trade. . However, after the initial rebound in these growth drivers, MTP growth on a quarterly basis has moderated. Overall this moderation was less than expected earlier in 2009, with Q4 growth in China and the US stronger than had been expected.

Figure 1:GDP growth continues to accelerate
(per cent growth)



* average quarter-on-quarter growth between Q1 2000 and Q4 2009. Sources: BPS, World Bank seasonal adjustment

Figure 2: Growth across Indonesia's trading partners rebounded in the second half of 2009
(average GDP growth, weighted by Indonesia's export shares)



Sources: National statistical agencies via CEICand World Bank

a. Growth continues to be broadly based across both expenditure categories and production sectors

Growth in Q4 remained broadly based across all components of the production and expenditure measures

In Q4 contributions to growth were broadly based for the expenditure and production components of GDP (Figure 3 and Figure 4). Growth was driven by surging government consumption, while strong exports more than offset the recovery in imports. On the production side, the manufacturing, and retail trade sectors made prominent contributions after being hit hard during 2008, indicating that external and domestic conditions are also solid.

Consumption slowed in Q4 following solid growth in Q3

Private consumption growth slowed in Q4 compared with Q3, rising by 0.4 per cent (seasonally adjusted). This is below the historical average (around 1 per cent over the past 5 years). The slowdown in private consumption is consistent with the slight weakening of other consumer indicators, although they remain at high levels.

Figure 3: Contributions to GDP expenditure growth
(quarter-on-quarter percentage point contributions to aggregate GDP growth, seasonally adjusted)

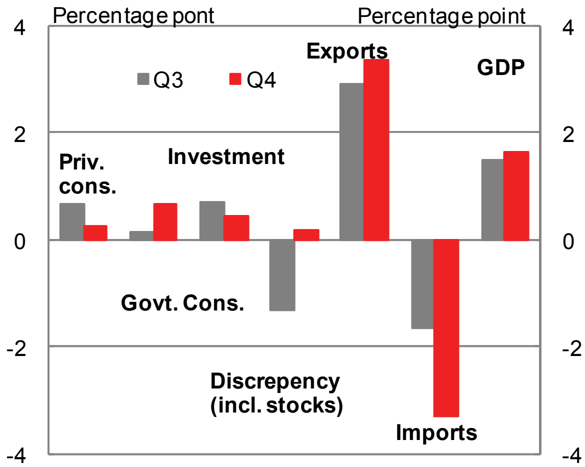
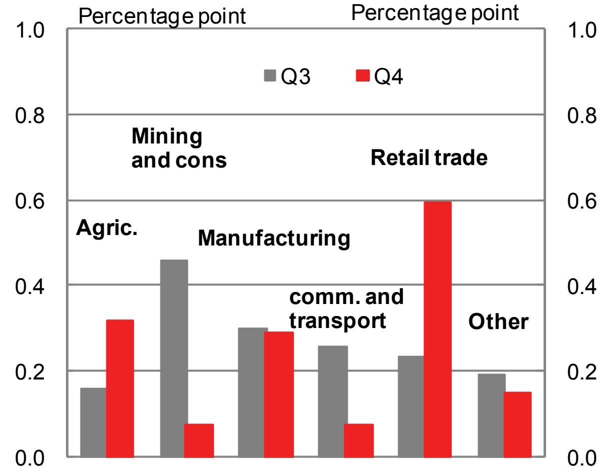


Figure 4: Production sectors' contribution to growth
(quarter-on-quarter percentage point contributions to aggregate GDP growth, seasonally adjusted)

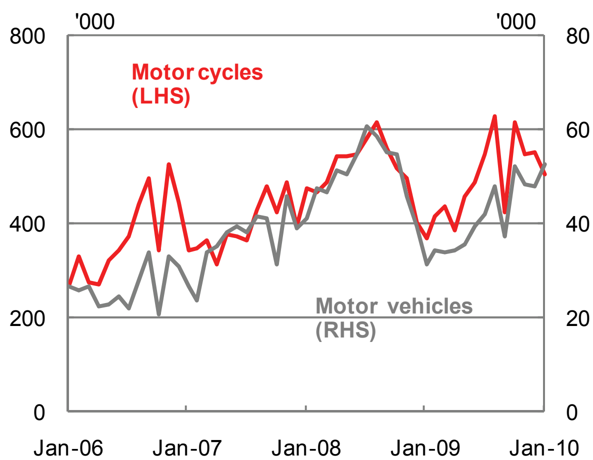


Seasonally adjusted percentage point contributions may not sum to total GDP growth. Sources: BPS and World Bank

Partial indicators for consumption and activity have stabilized since late 2009, at high levels

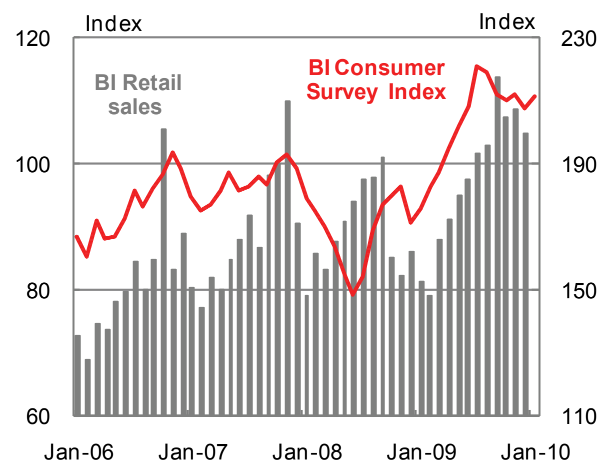
The various partial indicators of domestic demand and activity retreated around the start of 2010 but remained at high levels. Consumer confidence peaked in November 2009, but remained at relatively high highs into Q1 2010. Similarly Bank Indonesia's (BI) retail sales index retreated at the start of 2010 (as it generally does in January) but also remained at a high level. (Figure 6) Motor vehicle and motor cycle sales fluctuated around their 2008 peak in Q3 and Q4, but fell around the turn of the year; over 2009 as a whole, motor cycle sales are almost 6 per cent down on 2008 levels and motor vehicle sales fell by around 20 per cent. (Figure 5)

Figure 5: Motor vehicle and motorcycle sales
(monthly purchases)



Sources: GAI and Astra via CEIC

Figure 6: BI retail sales and consumer confidence
(indices)



BI consumer confidence index is at 100 when the number of respondents with a positive outlook equals the number with a negative outlook. Source: BI via CEIC

Government spending surged

Government consumption grew very strongly in Q4, up by 17.0 per cent YoY, which is well above the 5 year average growth of around 7 per cent, and follows stronger growth earlier in the year. This surge can in part be attributed to an increase in the disbursement of the stimulus in the December quarter.

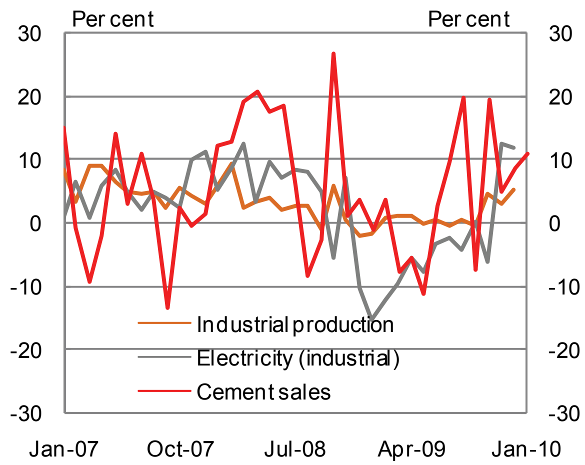
Investment continues to recover

Investment expenditure continues to recover following the sharp slowdown in late 2008 and early 2009. Investment grew by around 2 per cent between Q3 and Q4 to be 4.5 per cent higher YoY. This was driven by an acceleration in construction investment which is experiencing its fastest annual growth since early 2008. Machinery and equipment investment remains weak in YoY terms due to strong falls earlier in the year, but picked up in the fourth quarter, consistent with growth observed from the imports data. These low investment rates follow banks' limited new lending for investment purposes and weaker foreign direct investment over the past year.

Retail and wholesale trade contributed strongly to the production side of the economy in Q4

The retail and wholesale trade sectors made the strongest contribution to GDP growth on the production side of the economy in Q4. The strong trade contribution in recent quarters is consistent with BI's retail sales survey recovering in the second half 2009 and consumer sentiment being at high levels more generally (Figure 6).

Figure 7: Production indicators were stable around the start of 2010
(percentage change, year on year)



Source: CIEC

The manufacturing sector also continued to make a solid contribution in Q4 following weakness in the first half of 2009. Most manufacturing sub-sectors grew strongly in Q4, particularly those related to exports. Other indicators also suggest manufacturing activity is rising. For example cement sales and electricity production rose in Q4 in parallel with the solid YoY increases in the industrial production index (Figure 7).

Communications & transport continued to contribute significantly to growth, with ongoing very rapid growth in volume of communications (16 per cent higher YoY), and spending growing almost as fast. Air transport accelerated, growing by 21.6 per cent YoY, compared with negative growth in late 2008. This is consistent with significant airplane imports in recent months expanding the industry's capacity. Bank activity slowed slightly from Q3, but continues to grow in year-on-year terms. Output from other financial institutions and business service providers has generally been accelerating, growing around 10 per cent YoY.

b. Trade volumes accelerate in line with the domestic and international recovery

The recovery in trade volumes accelerated, contributing to growth and widening the trade surplus...

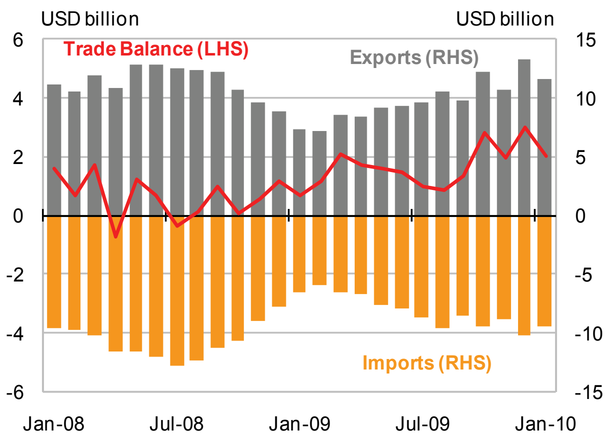
Seasonally-adjusted trade volumes continued to accelerate in Q4, with imports outpacing exports for the first time since the recovery began. Imports have been slower to rebound than exports, with oil, iron & steel and vehicle imports remaining well below pre-crisis levels. However net exports continued to support economic growth in Q4, although the contribution was smaller than in previous quarters. Monthly merchandise trade flows continued to recover from their early 2009 lows (Figure 8). Higher exports have been supported by increasing demand as the global economy emerges from recession, and continued gains in global commodity prices – leading Indonesia's exports prices higher.

The recovery in services trade also took hold in Q4, after stagnating in Q3. Service exports rose by 15 per cent in the quarter, driven by business services, while service imports rose by 30 per cent on Q3 (the highest QoQ growth on record), as strong growth in transportation and business services was complemented by increased personal travel by Indonesian residents.

…supporting an increase in the current account surplus.

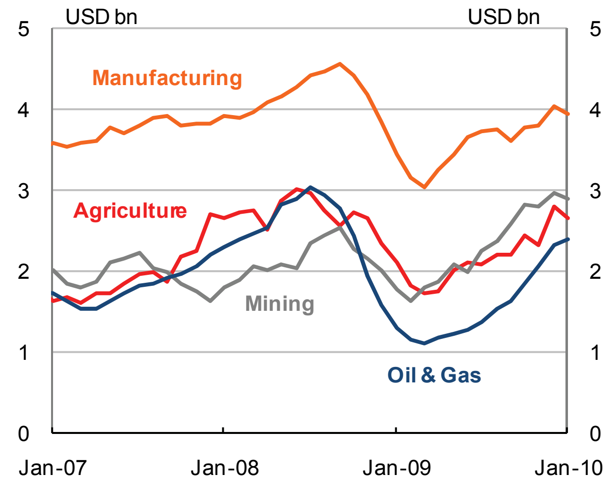
The current account surplus increased in Q4, as the widening in the trade balance more than offset an increase in the income deficit. The widening in the income deficit was driven by higher profit transfers by oil & gas companies, as higher commodity prices resulted in greater profit repatriation.

Figure 8: Trade flows continue to recover…
(trade values and balance, billions of USD)



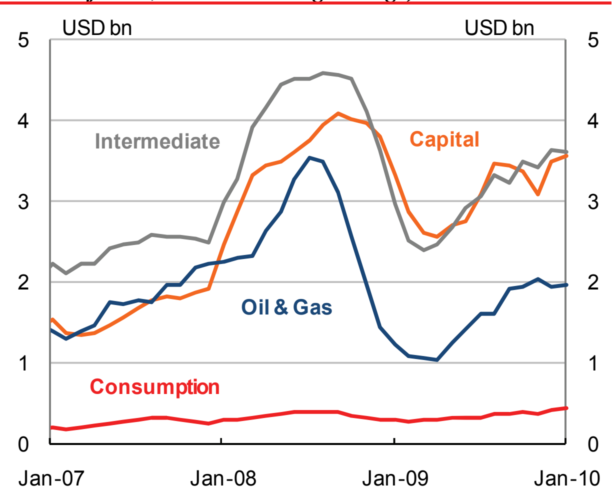
Sources: BPS

Figure 9: The recovery in exports values has been broadly based…
(billions of USD, 3 month moving average)



Sources: BPS and World Bank

Figure 10: …while imports values are still some way below pre-crisis levels
(billions of USD, 3 month moving average)



Sources: BPS and World Bank

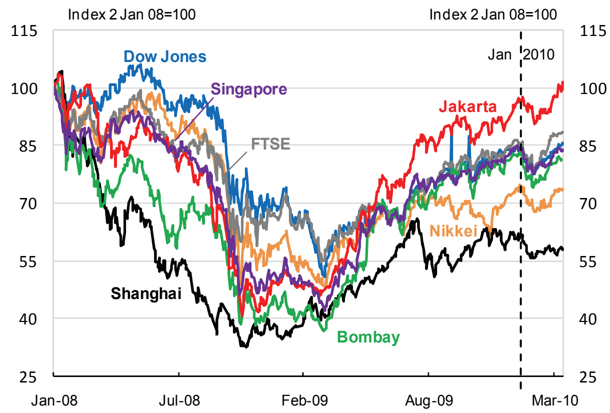
2. Indonesian financial markets have held up well against the increased volatility in global markets

a. Despite global turbulence, Indonesian equities have been relatively resilient and the rupiah and fixed income market continue to perform strongly

In spite of the global equity pullback, the JCI posted a positive return in January and seems set to achieve early 2008 levels

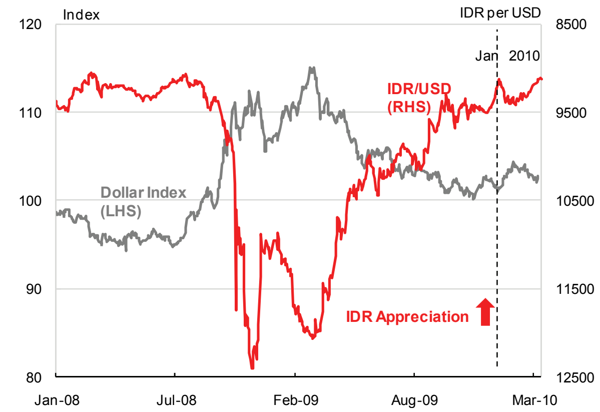
Despite a 5 to 6 per cent pullback in global equity markets at the start of the year (including an 8 percent and 6 per cent drop for China and India, respectively), the JCI was one of very few equity indices to rise in January (Figure 11). This is particularly interesting because Indonesia's financial markets usually move in line with global markets and exhibit high beta tendencies, ie, they over-perform in bull markets and underperform in downtrends. Although net selling of equities by foreigners throughout February caused a slight pullback, the JCI came back strong in March and is up 5.6 per cent year to date, making it a top global performer.

Figure 11: The IDX was one of few equity indices to rise in January and remains a top performer YTD in 2010
(equity indices indexed to 100 on 2 January 2008)



Sources: FRB, CEIC and World Bank

Figure 12:…and the rupiah has held its ground against the USD despite a broad strengthening of the latter with southern Europe's debt woes
(Broad Dollar Index, indexed to 100 on 21 Jan 1997)



Sources: CEIC and World Bank

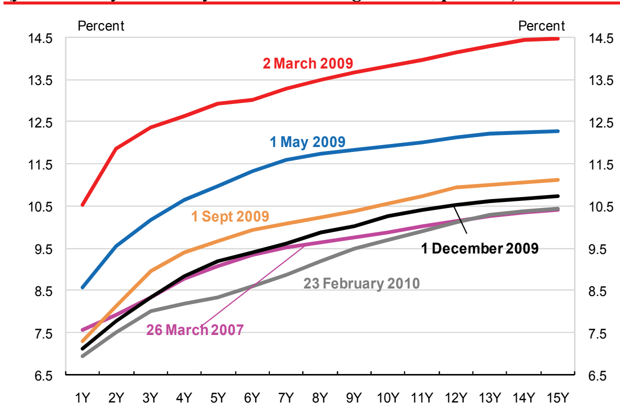
The rupiah has not lost ground against the USD despite broad USD strengthening in the wake of Europe's debt crisis

After appreciating by 22 per cent against the USD from March-December 2009, the rupiah depreciated slightly in January, but strengthened again in February to make it flat against the USD year-to-date (Figure 12). The slight weakening of the IDR in January was not isolated but part of a broad strengthening of the US dollar against major currencies (especially G7) triggered by concerns about the high and growing levels of public debt in several EU economies. The Federal Reserve Board's Broad Dollar Index (which includes 26 currencies representing America's major trading partners) was up 1.7 per cent in January, and then retreated slightly in February and early March. (Figure 12)

Foreign capital inflows and the trade surplus are two key factors that have helped buttress the rupiah

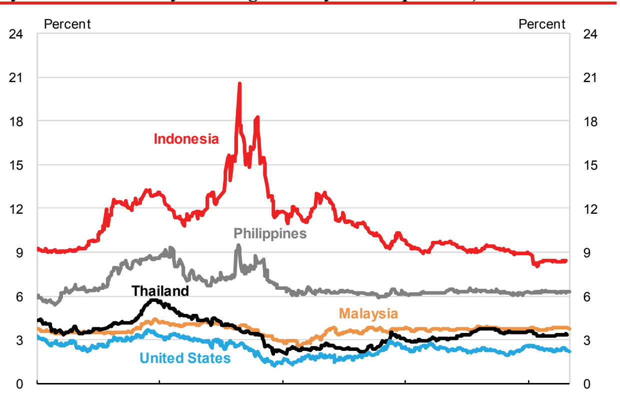
Two factors that have helped keep the rupiah strong are capital inflows and the trade surplus. Since June 2009, net foreign capital inflows into Indonesia have amounted to USD 6.6 billion, increasing non-residents' holdings of Indonesian equities, government bonds and short-term money market instruments by 36 per cent. These inflows, combined with the ongoing trade surplus (Figure 8), have supported the continued strength of the rupiah over this period, with the currency appreciating by 8.7 per cent against the USD since June.

Figure 13: The yield curve for local currency government bonds has continued downward, to record lows
(yields on 1 year to 15 year IDR sovereign bonds, per cent)



Sources: CEIC and World Bank

Figure 14: 5 year IDR sovereign bonds have reached their stronger point on record, although yields remain attractive compared to elsewhere in the region
(5 year local currency sovereign bond yields in per cent)



Sources: JP Morgan, Datastream and World Bank

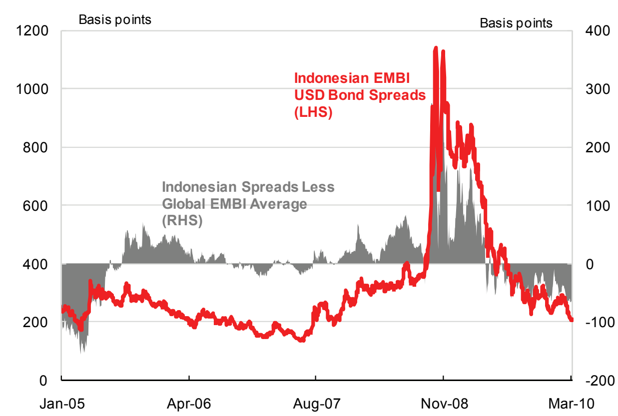
Local currency government bond yields are at their lowest levels ever…

The Indonesian fixed income market has also posted a solid performance so far this year, with both local currency and USD denominated sovereign bonds showing continued strength. Since December, the yield curve on local currency bonds has continued to move down to unprecedented levels across all tenors, but especially four- to ten-year bonds. (Figure 13) In January, yields on five year IDR sovereigns hit their lowest level (about 8.04 per cent) since these bonds were first issued in 2003. (Figure 14)

…and EMBI spreads on USD sovereigns also continue to narrow towards 2007 lows

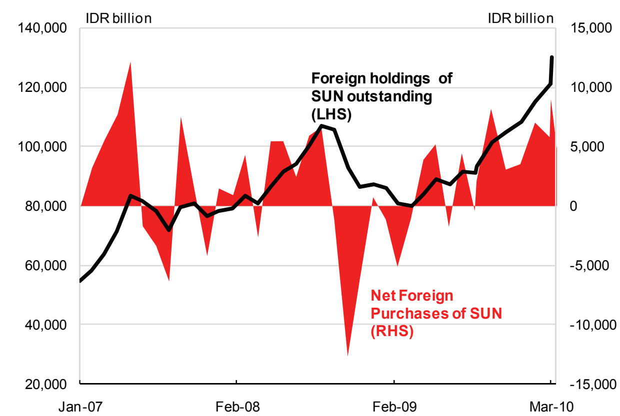
Indonesian EMBI USD bond spreads have also recovered to late 2007 levels, although are above the all-time lows of mid-2007. (Figure 15) Indonesian spreads have remained below the global average emerging market spread to US Treasuries since July 2009. To the extent that EMBI spreads are taken as a proxy for measuring "country risk," Indonesia's narrowing spreads may have served to indicate lower country risk and boost confidence in recent months. Together with ratings upgrades on foreign and local-currency sovereign debt by Moody's in September 2009 and by Fitch and Standard & Poor's in early 2010, narrowing EMBI spreads have therefore probably helped attract investment into Indonesia's financial markets.

Figure 15: Indonesian sovereign USD bond spreads to US Treasuries are yet to hit their mid-2007 lows, but have strengthened by more than most emerging market debt
(Indonesian EMBI spreads to US Treasuries and difference between Indonesian spreads and global emerging market average, in basis points)



Sources: CEIC and World Bank

Figure 16: Foreigners have invested heavily in local currency sovereign bonds since mid-2009, increasing their ownership to 20 per cent of outstanding bonds
(non-residents' holdings of conventional IDR government bonds and net purchases of the same, in billions of IDR)



Sources: JP Morgan, Datastream and World Bank

Foreign investment in local currency government bonds has been relentless since September, absorbing 90 per cent of net new issuance in Q4 2009 and over 50 per cent in the first months of 2010

Foreign investment in conventional IDR government bonds has been very strong in recent months and has helped bolster bond prices. (Figure 16) The last quarter of 2009 saw approximately USD 4.4 billion of net foreign capital inflows, over 40 per cent of which was invested in rupiah government bonds. In fact, over 90 per cent of the net increase in IDR government bonds in Q4 2009 was absorbed by foreigners. This trend has continued into 2010, with foreigners investing over USD 1 billion in rupiah sovereigns since January, absorbing about 50 per cent of new issuance. (Figure 16) Moreover, the share of total outstanding IDR government bonds owned by foreigners has risen to 20 per cent in February 2010, from 14 per cent in March 2009.

The government has already issued 28 per cent of its gross bond issuance target for 2010, and strong fundamentals and high yields should continue to attract foreign investment

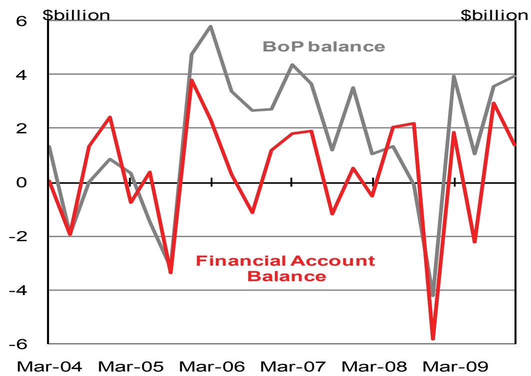
So far in 2010, the government has issued IDR 49 trillion of government bonds (IDR and non-IDR denominated), equivalent to 28 per cent of the year's gross bond issuance target of IDR 175 trillion. Although the Ministry of Finance has proposed a revised projected 2010 budget deficit of 2.2 per cent of GDP (IDR 129 trillion) from 1.6 per cent (IDR 98 trillion), the government's 2009 financing surplus of IDR 38 trillion (flowing from the below-target deficit) suggest that its original bond issuance target is unlikely to be increased.

Going forward, Indonesia's strong fiscal position and growth outlook, increasing reserves, moderate inflation outturns and its high yields relative to elsewhere in the region (among the more liquid, open markets), should support demand for Indonesian sovereign bonds.

Box 1: Identifying the regular fluctuations in Indonesia's Financial Account

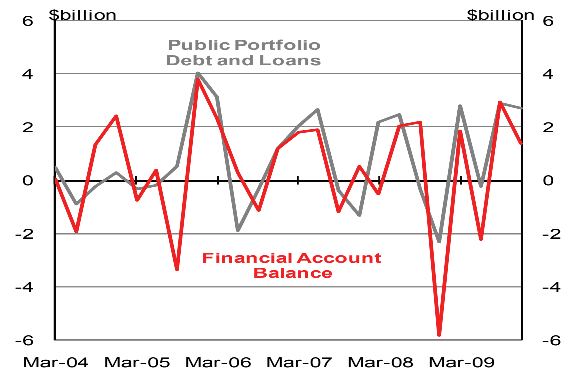
Analysts and commentators regularly identify the volatility of Indonesia's Balance of Payments (BoP) as a key concern for the country's macroeconomic stability. Large swings in the BoP are often attributed to a combination of the openness and underdevelopment in Indonesia's capital markets, as well as sensitive foreign investor sentiment – which can trigger large capital flows. While these are undoubtedly important factors contributing to the volatility in Indonesia's BoP, in addition there are regular fluctuations related to debt issuance strategies and repayment schedules. Recognizing these regular flows improves the analysis of changes in Indonesia's overall balance of payments position.

Figure 17: The fluctuations in the BoP are predominantly due to fluctuations in the financial account
(billions of USD)



Sources: BI

Figure 18: The fluctuations in the financial account are highly correlated with regular changes in public debt and loans…
(billions of USD)

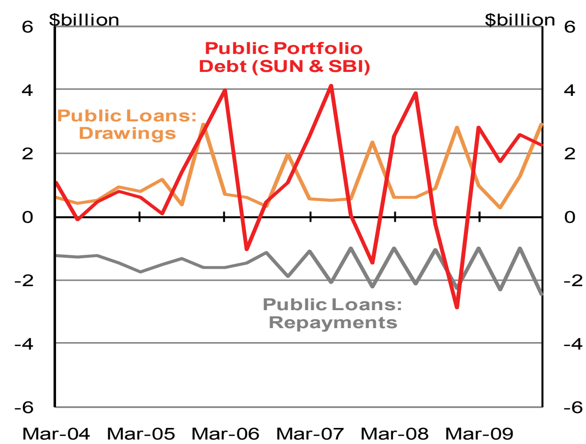


Sources: BI, World Bank calculations

Fluctuations in the BoP are predominantly driven by fluctuations in the financial account (the correlation between the overall BoP and the financial account balance is 75 per cent, and less than 60 per cent with the current account) (Figure 17) which in turn are predominantly due to regular increases and decreases in flows on public portfolio debt and loans (Figure 18). Understanding better the regular patterns of these flows can help to provide insights into the likely fluctuations in the financial account balance. In particular, it is important to understand why the flows may have been regular in the past, and why they may (or may not) be regular in the future.

The public portfolio debt consists of the net foreign purchases of SUNs and SBIs on both the primary and secondary markets. Given the size of new issuances, purchases on the primary market will usually dominate net purchases on the secondary market. If we assume that foreigners' holdings of SUN and SBI are stable, then the major determinant of fluctuations in foreign purchases is the government's issuance plan. Hence, the government's current practice of issuing the majority of new SUN in the first half of the year means that the majority of foreign purchases occur in Q1 and Q2, resulting in large net inflows. In Q3 and Q4 – when government issuance is less – net flows turn negative, as smaller inflows are dominated by repayments on maturing debt. (Figure 19) With the government's issuance practices likely to continue, it seems likely that this pattern of net foreign inflows on public debt will continue., leading the financial account to continue to fluctuate between surplus and deficit. However, the pattern of this fluctuation is likely to be somewhat regular (assuming the absence of significant shocks) – with larger surpluses in Q1 and Q4, and smaller surpluses, or deficits, in Q2 and Q3.

Figure 19: …while the major components of public debt and loans have regular patterns
(billions of USD)



Sources: BI, World Bank calculations

b. The balance of payments surplus increased slightly in Q4, supported by the surplus and capital inflows

The BoP surplus expanded in Q4, as a wider trade surplus more than offset a narrowing in the financial account surplus

The balance of payments (BoP) surplus increased slightly to USD 4.0 billion in Q4 as the widening of the trade surplus more than offset the expected narrowing in the financial account surplus. Abstracting from the SDRs allocation, the financial account surplus increased from Q3 to Q4, driven by the greater capital inflows into domestic government bonds, and into Indonesian private bonds, with net inflows on private debt totaling USD 1.2 billion in Q4, the highest level on record. The surplus on the BoP saw Indonesia's foreign reserves rise to USD 69.6 billion at the end of January, almost USD 10 billion higher than the pre-crisis peak of July 2008. (Table 2) Reserves then stabilized just below USD 70 billion through the first quarter.

Capital flows on the financial account continue to 'normalize'

While volatile by nature, Indonesia's external financial flows in Q4 continued to return to the patterns seen before the peak in global financial market turbulence. (Box 1) Residents have re-entered foreign equity markets, and the large net foreign inflows seen in Q4 have confirmed the strong return of foreign investors to Indonesia's liquid financial asset.

Table 2: Foreign reserves have expanded with an increase in the BoP surplus, predominantly due to the higher trade surplus
(billions of USD unless otherwise stated)

				2008				2009			
	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Balance of Payments	14.5	12.7	-1.9	1.0	1.3	-.1	-4.2	4.0	1.1	3.5	4.0
Per cent of GDP	*5.1*	*3.5*	*-0.5*	*0.8*	*1.0*	*-0.1*	*-3.8*	*3.5*	*0.8*	*2.4*	*2.6*
Current Account	10.9	10.5	.1	2.7	-1.0	-1.0	-.6	2.7	2.9	1.7	3.4
Per cent of GDP	*3.8*	*2.9*	*0.0*	*2.3*	*-0.8*	*-0.7*	*-0.6*	*2.4*	*2.2*	*1.2*	*2.2*
Trade Balance	19.8	20.9	9.9	4.5	2.1	2.5	.9	4.3	5.4	4.6	6.9
Net Inome & Current Transfers	-8.9	-10.4	-9.8	-1.7	-3.1	-3.4	-1.6	-1.6	-2.5	-2.9	-3.4
Capital & Financial Accounts	3.0	3.6	-1.9	-.5	2.1	2.4	-5.8	1.9	-2.2	3.0	1.4
Per cent of GDP	*1.1*	*1.0*	*-0.4*	*-0.4*	*1.6*	*1.6*	*-5.2*	*1.7*	*-1.7*	*2.0*	*0.9*
Direct Investment	2.2	2.3	3.4	.6	.2	1.9	.7	.8	.2	-.1	1.0
Portfolio Investment	4.3	5.6	1.7	2.0	4.2	-.1	-4.4	1.9	2.0	3.4	3.3
Other Investment	-3.8	-4.8	-7.3	-3.2	-2.3	.4	-2.2	-.8	-4.5	-.4	-2.9
Errors & Ommissions	.6	-1.4	-.2	-1.2	.2	-1.5	2.2	-.7	.4	-1.2	-.9
Foreign Reserves*	42.6	56.9	51.6	59.0	59.5	57.1	51.6	54.8	57.6	62.3	69.6

Sources: BI, BPS via CEIC and World Bank

c. Growth in the money supply has remained relatively contained, and BI has not changed its policy interest rate

Despite the BoP surplus and large increase in reserves, BI's policy mix of sterilization and appreciation appears to have been effective at limiting inflation so far

While the BoP surplus and associated increase in reserves may lead to an acceleration in the money supply, hence creating inflationary pressures, this has not materialized in the first quarter of 2010. This suggests that BI's policy of sterilizing the increase in the money supply by issuing more short-term money market instruments, and allowing some appreciation of the IDR, has been quite effective so far. (See Part B for a more detailed analysis of sterilization of capital inflows and related costs to the central bank.)

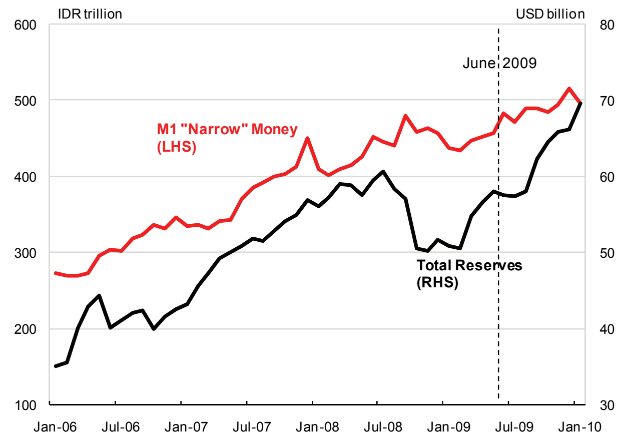
Growth in M2 and M1 has remained contained, especially compared to 2006-2008 levels

Taking a closer look at the money supply, the USD 12 billion increase in reserves since June represents 5.6 per cent of the M2 level in June, suggesting M2 may have accelerated near this rate in addition to its trend growth. However, since June, M2 has increased by USD 16 billion or 13 per cent annualized basis, lower than the average annual M2 growth of 18.3 per cent from 2006-2008. (Figure 21) Furthermore, M1 has only increased by USD 2.5 billion, or 4.8 per cent, since June. (Figure 20) This 8.1 per cent annualized rate is well below the 24 per cent average annual M1 growth 2006 to 2008.

Given muted inflationary pressures and the downward rigidity of lending rates, BI is generally expected to continue holding its policy rate at current levels

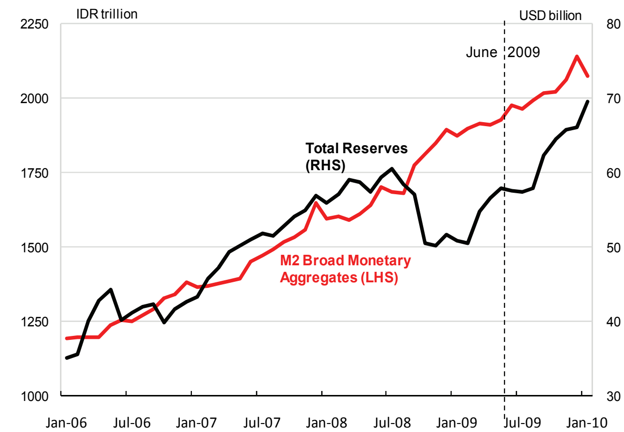
This contained money supply growth has coincided with recent mild inflation outcomes (core inflation was at its slowest pace in a decade in February). Given the lack of immediate inflationary pressures, and the fact that lending rates have remained relatively high (discussed below), financial market analysts generally believe that BI is unlikely to raise the policy interest rate from 6.50 per cent in the near future. Most market participants do not expect rate hikes before the second half of 2010, with some predicting the first hikes will only be in Q1 2011.

Figure 20: The sharp increase in reserves since June has not led to overly rapid growth of M1, the most liquid measure of money supply
(M1 in trillions of IDR; reserves in billions of USD)



Sources: BI, CEIC and World Bank

Figure 21: …and M2 broad money growth has also been within reason, suggesting BI's sterilization policy has been quite effective so far
(M2 in trillions of IDR; reserves in billions of USD)



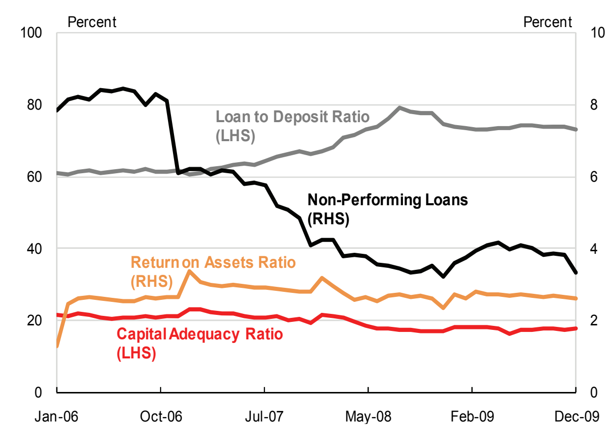
Sources: BI, CEIC and World Bank

d. The banking sector shows good health overall although the performance of certain subcategories is mixed

The banking sector appears in good health overall, according to financial ratios and earnings reports

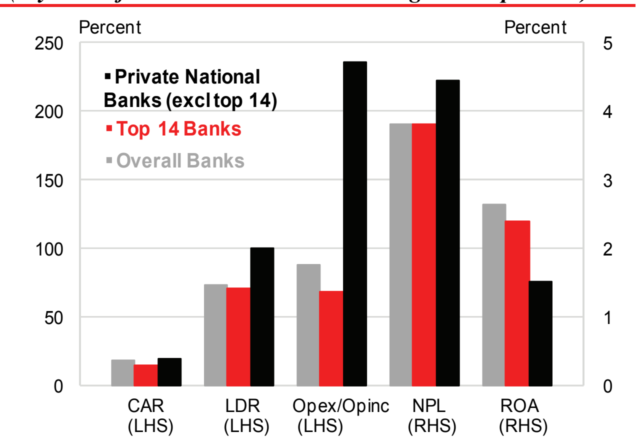
Earnings of major banks and various aggregate indicators such as capital adequacy and return on assets suggest the health of the overall banking sector remains robust. In December, commercial banks' non-performing loan ratios fell to 3.3 per cent, which is below the 2008 average of 3.6 per cent, and well below the 2007 and 2006 averages of 5.6 per cent and 8.0 per cent, respectively. (Figure 22)

Figure 22: Key financial indicators for the overall banking sector appear robust
(LDR, ROA, CAR and NPL ratios in per cent)



Sources: BI and World Bank

Figure 23: …but some groups of banks have less buoyant numbers, especially for NPL and operating efficiency
(key ratios for overall sector and subcategories in per cent)



Sources: BI and World Bank

…however, the health of Indonesia's middle tier banks, excluding the top 14, is more mixed

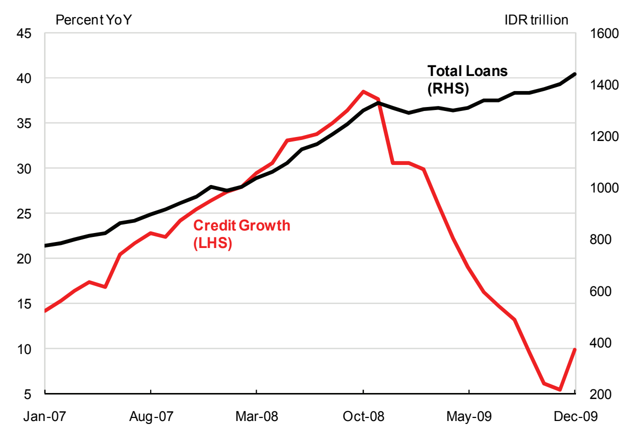
Although aggregate indicators for the overall banking sector appear strong, it is important to remember that the top 14 commercial banks in Indonesia account for 70 per cent of total assets of the banking sector and so dominate the aggregate ratios. After taking the top banks out of the picture, the indicators for other subcategories within the banking sector may not be quite as robust. This issue has been brought to the forefront by the recent troubles of Bank Eksekutif, a mid-tier bank which has a non-performing loan ratio of 15.5 per cent as well as inadequate capital, and has been given until the end of March to improve its financials or face stringent action from the central bank.

BI categorizes commercial banks in Indonesia into 6 subcategories: state owned banks, regional banks, foreign owned banks, joint venture banks, private national banks with foreign exchange, and private national banks without foreign exchange. Focusing on the last two subcategories (private national banks with and without foreign exchange), which contain many of Indonesia's middle tier banks such as Bank Eksekutif, the average non-performing loan ratio jumps to 4.43 per cent, 16 per cent higher than average NPL for the overall sector and top 14 banks. (Figure 23) Moreover, efficiency ratios such as return on assets (ROA) and operating expenditure to operating income are markedly worse for this segment. ROA for the top 14 banks is 60 per cent higher than for private national banks, and the operating expenditure to operating income ratio for top banks is 71 per cent lower. (Figure 23) Bank Eksekutif's crisis has shown the importance of not ignoring this subcategory of banks, and the low efficiency ratios of the subcategory suggest that consolidation among this tier of banks may improve the sector's overall performance.

Credit growth was sluggish for most of 2009 but higher approvals at the end of the year suggest it will pick up in 2010

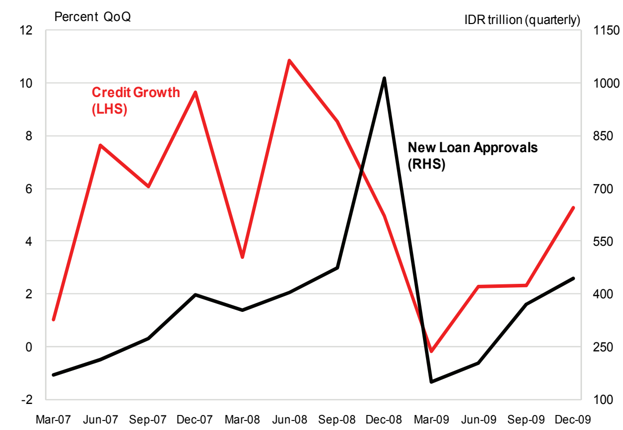
Credit growth remained weak through 2009, with overall lending growing by only 11.5 per cent in 2009, compared with 32 per cent in 2008. (Figure 24) However, lending growth did rise in the last three quarters (Figure 25) and with expectations of robust GDP growth and market participants not anticipating rate hikes in the near future, lending is expected to gain further steam over the next six months. Indeed, new loan approvals returned to their mid 2008 levels by Q3 2009. (Figure 26) Given the two- to three-month lag in the data on new loan approvals, further acceleration is likely in the first half of 2010.

Figure 24 : Credit growth in 2009 dropped sharply compared to 2008 levels but has recently turned the corner
(Total loans in IDR trillion; credit growth in percentage change year-on-year)



Sources: BI and World Bank

Figure 25: QoQ credit growth has been positive for the past three quarters and new loan approvals have been on the rise
(Quarterly new loan approvals in IDR trillion; credit growth in percentage change quarter-on quarter)

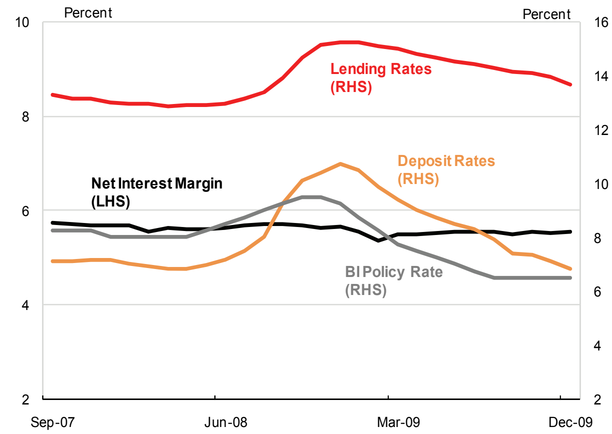


Sources: BI and World Bank

Lending rates have finally dipped below 14 per cent, but interest margins remain wide

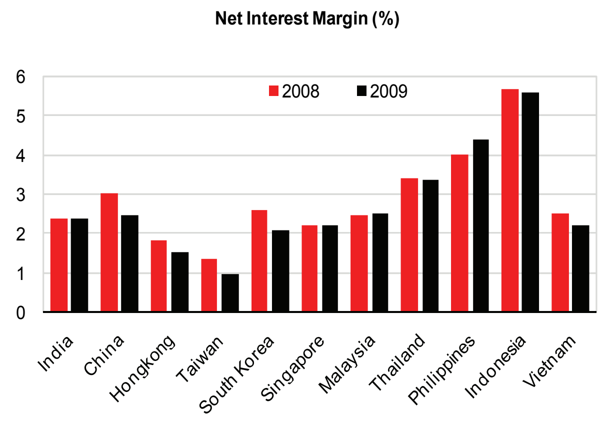
One of the most conspicuous elements surrounding last year's credit growth slowdown was the high cost of borrowing and the fact that lending rates did not budge despite BI's 300 basis point reduction of the policy rate from December 2008-August 2009. In November and December 2009, lending rates fell below 14 per cent for the first time in over a year, and have finally started to approach pre-September 2008 levels. (Figure 26) However, deposit rates have also continued to fall and this has kept net interest margins (NIMs) much wider than elsewhere in the region. At over 5.5 per cent, Indonesia has the highest NIMs of any country in the region by a wide margin, with the Philippines and Thailand being the only other countries to have NIMs above 3 per cent. (Figure 27) While such high NIMs may make Indonesian banks some of the most profitable in the region, the burgeoning spread between lending rates and deposit and savings rates increases the cost of investment and consumption smoothing, and so may limit economic growth.

Figure 26: Lending rates have finally dropped below 14 per cent and are beginning to approach pre-crisis levels
(net interest margin, lending and deposit rates, per cent)



Sources: BI and World Bank

Figure 27: Indonesia's average net interest margin is substantially higher than anywhere else in the region
(average net interest margins for 2008 and 2009, in per cent)



Sources: Fitch Ratings and World Bank

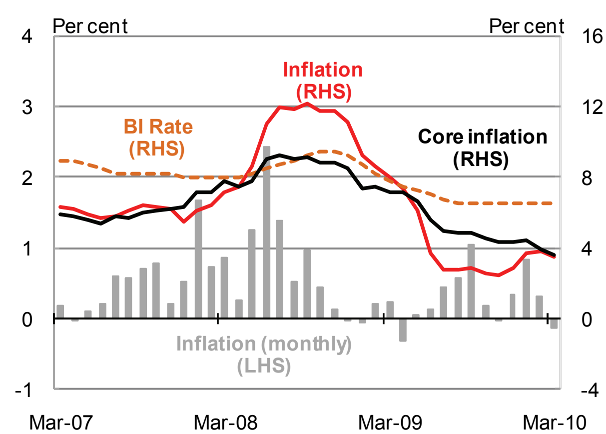
3. Food price rises dominated movements in inflation around the turn of 2010

The headline inflation rate moves away from 2009 lows

The inflation rate continued to rise out of its recent trough around the turn of 2010 and by March 2010 was at 3.4 per cent (YoY), down from 3.8 per cent in the year to February, its highest level in 9 months. Despite the increase in the headline rate it remains well below the pre-crisis levels. (Figure 28) Consumer prices rose in 2009 at the slowest pace in a decade. Inflation outcomes in the first quarter of 2010 were a little below market analysts' expectations overall.

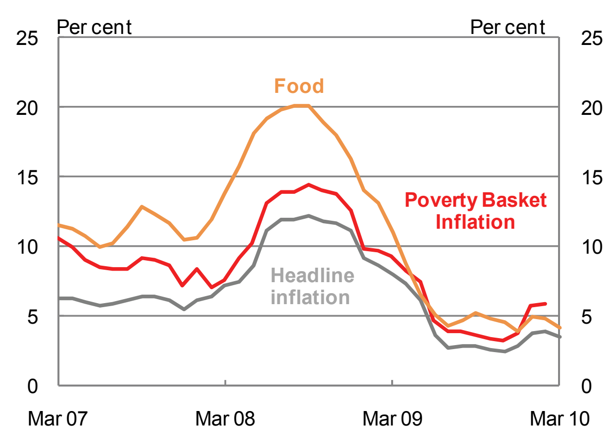
Indonesia's inflation rate in recent months has been stable relative to many of its regional trading partners, while remaining higher than most, due to the pass-through from the appreciating rupiah and from the government's system of regulated energy prices disconnecting households from the recovery in global energy prices. With the exception of Japan, all of Indonesia's major trading partners have positive inflation rates with the Philippines already above 4 per cent and Thailand at 3.7 per cent.

Figure 28: Headline inflation rate rose in early 2010 from the decade-lows of late 2009
(year-on-year and month-on-month consumer price inflation)



Sources: BI, BPS and World Bank

Figure 29: The increase in some food prices has had a larger impact on the poverty basket inflation rate than the headline
(year-on-year percentage change)



Sources: BPS and World Bank

Movements in both local and global food prices have disproportionately impacted the CPI recently

80 per cent of the growth in consumer prices in the first months of 2010 came from higher food, particularly grain prices. These prices typically rise around the turn of the year, as monsoonal weather disrupts supply and in the lead-up to the new harvest: between November and February, retail grains prices rose by 11 per cent on average between

2003 and 2009. But this year's increase has been stronger than usual, near 13 per cent, in part reflecting the increase in grain prices globally following poor growing conditions. Domestic retail rice prices, which are somewhat insulated from movements in global prices by the restrictions on rice trade, rose 14 per cent in the year to January. The doubling in global sugar prices in the year to February, following poor weather in India particularly and Brazil, has also fed into a 70 per cent increase in the domestic retail price (in the year to January), with the rupiah's appreciation partly offsetting the international price rise.

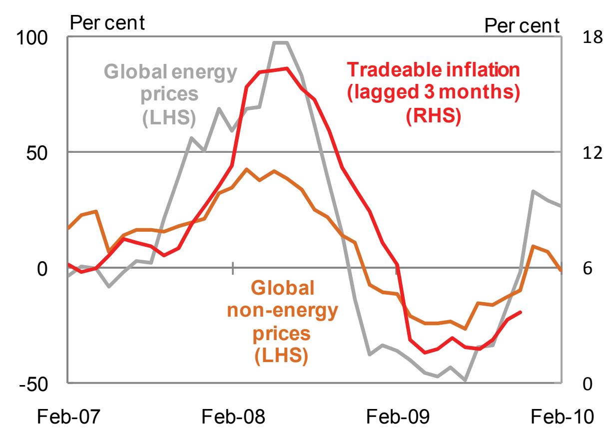
…affecting poorer households particularly

Increases in these basic food prices particularly affect poor households. Food items make up 63 per cent of these households' consumption basket on average, and the relatively strong growth in these food prices have contributed 85 per cent of the increase in the increase in their cost of living in 2010, lifting the poverty basket inflation rate 3 percentage points above the headline rate. (Figure 29)

Meanwhile core inflation slowed to decade lows

The core measure of inflation continued to ease from November, to 3.6 per cent in the year to March, the slowest since the early 2000s, as many of the volatile food prices increasing the headline inflation rate are excluded from the core measure. (Figure 28).

Figure 30: The recent rise in global commodity prices has driven up imported inflation
(global commodity prices indexed in rupiah at Jan 2007; tradeable inflation rate)



Sources: BPS via CEIC and World Bank

Agricultural prices dominated wholesale inflation; mining and construction price growth remained limited. Wholesale prices rose across the board in 2008 but most of the increases unwound in 2009. Trade prices continued to slowly trend higher into January, despite the stronger rupiah.

Slower consumer price inflation over the past year has also limited economy-wide price growth, as measured by the GDP deflator, to 6.6 per cent in the year to Q4. Relatively faster growth of investment good and government service prices continue to wedge the GDP deflator above consumer prices. For all of 2009, average GDP prices increased by around 8.5 per cent, the slowest growth rate since 2003.

4. The government's budget deficit in 2009 was somewhat smaller than expected

a. Stronger end-of-year revenues, partially offset by slightly stronger expenditure reduced the budget deficit to 1.6 per cent of GDP in 2009

The 2009 deficit was lower than expected …

While both government revenues and expenditure recorded significant declines in 2009, unexpected end-of-year strength in government revenues led to a smaller-than-expected deficit, at 1.6 per cent of GDP, in contrast to projections earlier in 2009 of a budget deficit between 2.3 and 2.4 per cent of GDP.

… however, despite end-of year-strength, total government revenues still remained weak in 2009, in line with the tax cuts, lower commodity prices and slower nominal GDP growth

Total government revenues in 2009 were 11.5 per cent weaker than in 2008. December brought a significant pick-up in government revenue collections which offset a large portion of the general weakness observed over most of 2009. (Figure 31) Total revenues to November 2009 were 17.9 per cent weaker compared to the same period in 2008 and by the end of the year they had picked up by nearly 6.5 percentage points. (Figure 32)

This additional strength in December occurred for two reasons. The first, which accounted for 60 per cent of the unexpected strength, was due to strong corporate installments made in December. This strength was driven by non-tax gas revenues, which have been the best performing revenue item in 2009, contributing around 15 percentage points to total non-tax revenues. The strength in non-tax gas revenues was due to robust extraction of gas. Income taxes also performed a little stronger than expected.

The second reason, which accounted for the remaining 40 per cent of the unexpected strength, was due to substantial revenue payments made in December for VAT arrears that had remained unsettled from previous years. These payments were part of the tax office's recent compliance crack-down to collect revenues from those taxpayers who had not met previous liabilities.

Figure 31: In comparison to 2008, total revenues remained weak for most of 2009 …
(monthly percentage splits of total realization)

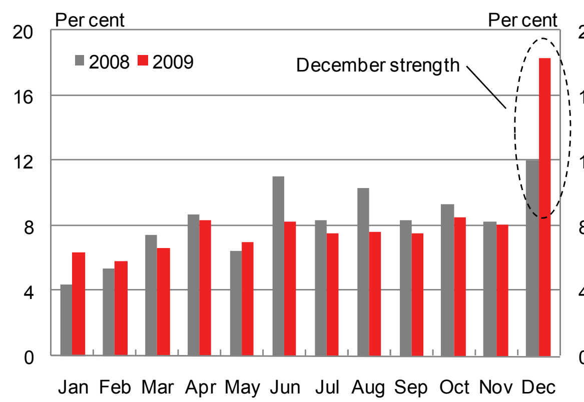
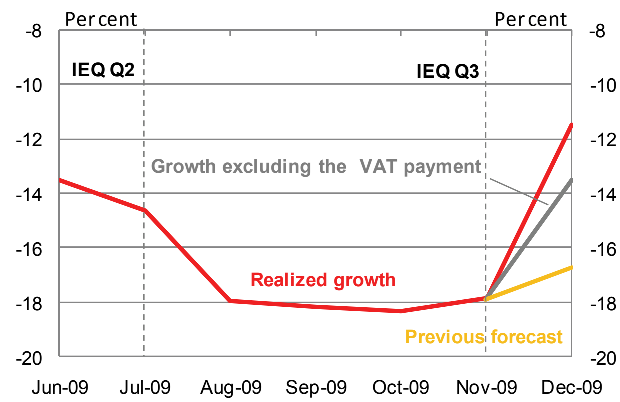


Figure 32: … with a surprisingly strong realization in December in part due to a one-off VAT arrears payments
(cumulative year-on-year percentage change)



Source: MoF

Tax revenues in 2009 were lower than in 2008, reflecting the cuts in tax rates, but higher than expected

Tax revenues ended 2009 2.5 percentage points weaker than in 2008 which is in line with the cuts in tax rates under the government's stimulus package and the slowing in nominal GDP growth. (Table 3) This was primarily driven by income tax revenues, which showed particular weakness in light of falls in the international oil prices and the reduction of the corporate tax rate from 30 per cent to 28 and 25 per cent. In addition, international trade taxes suffered from low external demand and the fall in the crude palm oil (CPO) price, affecting export duties. (See Box 2) Excises, which are levied on tobacco and alcohol products, remained relatively robust in 2009, recording just over 10 per cent growth.

Figure 33: Spending performance of line ministries improved in 2009…
(actual disbursement versus revised budget)

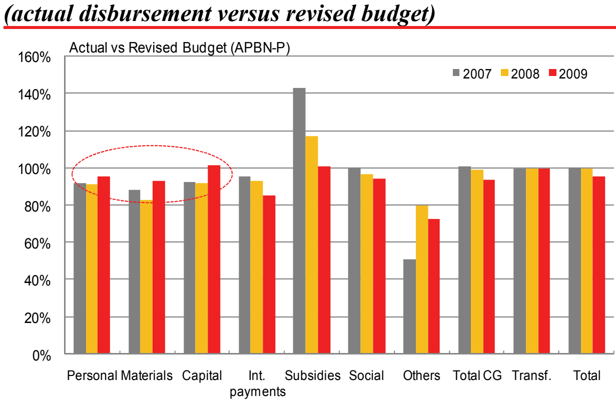
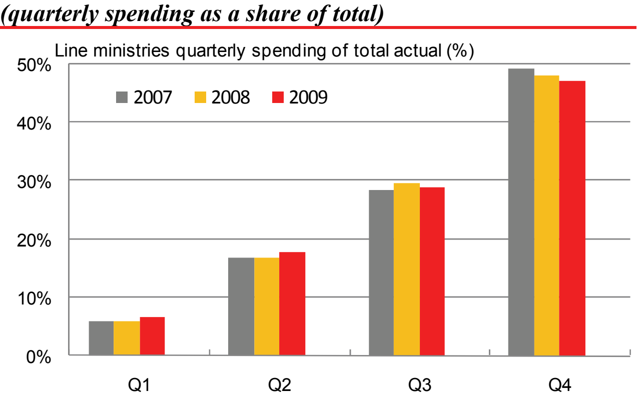


Figure 34: … but spending patterns were still skewed toward the end of fiscal year
(quarterly spending as a share of total)



Source: Ministry of Finance

Non-tax revenues also remained very weak in 2009, but ended the year slightly stronger than expected

Non-tax revenues ended the year 30.1 per cent weaker than in 2008. Non-tax revenues are much more volatile than tax revenues and typically do not correlate as well with movements in the economy. As with tax revenues, the fall in the international oil price was a big factor contributing to the general weakness. Oil non-tax revenues detracted 41.5 percentage points from total non-tax revenue growth which was partially offset by strength in gas revenues. The other non-tax revenue items ended 2009 broadly in line with expectations. (Table 3)

Spending performance of line ministries has improved, though overall 2009 disbursement rates are slightly below the 2008 levels

In total, the government spent 96 per cent of the revised budget (APBN-P) in 2009. Notable improvements are seen on capital and material spending where more than 100 per cent and 93 per cent of the allocated budget were disbursed. Lower-than-budgeted spending on energy subsidies and interest payments drove the overall disbursement rates lower than in 2008, reflecting moderate oil prices and the appreciating rupiah during the year. (Figure 33) The 2009 disbursement trends contrast with those of 2008. In 2008, the government spent almost 100 per cent of its revised budget as a result of high spending of subsidies (120 per cent) but lower performance of line ministries spending.

… but disbursement patterns are still skewed toward the end of fiscal year

Though total spending on core programs had improved, spending patterns are still skewed towards the end of fiscal year, with 47 per cent of line ministries' budget was spent in the last quarter of 2009. This included around 50 per cent of capital expenditure, 45 per cent of material expenditure and 49 per cent of social assistance expenditure. (Figure 34)

The fiscal stimulus was largely disbursed, supporting output growth in 2009

According to the Ministry of Finance, the 2009 stimulus package of IDR 73.3 trillion or 1.4 per cent of GDP contributed to an increase in GDP growth of 1.28 percentage points. On the expenditure side, the line ministries were able to quickly deliver the stimulus programs close to the amounts budgeted. In total, the government spent IDR 10.6 trillion, or 96.9 per cent of the IDR 11.6 trillion budgeted fiscal stimulus (Part B contains a more detailed discussion on the impact of public spending on growth).

Table 3: Developments in revenue and spending
(central government revenue and spending)

	2006	2007	2008	2009	Explanation for 2009
	Annual percent change and percentage point contributions				
Total cental gov't revenue	**28.8**	**11.3**	**38.2**	**-11.5**	Global economic slow dow n and falls in international oil prices
Tax revenue	**17.9**	**20.4**	**33.4**	**-2.5**	Cuts in tax rates, low er profits and formal w ages w ith low er commodity prices and slow er activity grow th
Non-oil and gas	7.3	7.1	11.0	2.8	Low er profits w ith low er commodity prices & demand; cuts in tax rates
Oil and gas	2.3	0.5	6.4	-4.1	Around a 50% fall in the international oil price; slightly low er production
VAT	6.3	7.8	11.1	0.7	Less discretionary spending, partic. for goods subject to luxury tax rates
Land and building tax	1.3	0.7	0.4	-0.2	Slow er investment
Duties on land and building transfer	-0.1	0.7	-0.1	0.1	Reduced economic activity
Excise	1.3	1.7	1.3	0.8	Slow ing in consumption, offsetting the increase in cigarette excise rate
Other taxes	0.1	0.1	0.1	0.0	Slow ing of economic activity
Import duties	-0.8	1.1	1.2	-0.7	Reduced import values w ith low er commodity prices and destocking
Export duties	0.2	0.8	1.9	-2.0	Low er CPO price
Non-tax revenue	**54.5**	**-5.2**	**49.1**	**-30.1**	Significant falls in oil prices
Oil	35.6	-13.9	35.0	-41.5	Around a 50 per cent fall in international oil prices
Gas	1.4	-0.8	5.3	14.8	Strength in production
Mining	2.4	-0.4	1.4	0.2	Low er prices and some w eakening in volume demand reducing profits
Forestry	-0.6	-0.1	0.2	-0.1	Slow ing demand for w oods and related products
Fishery	0.0	0.0	0.0	0.0	A small item w here contributions to grow th remain low
SOE transfer	6.9	0.1	2.7	-1.0	Reduced domestic demand reducing activity
Other	8.8	9.9	4.6	-4.4	Low er fee collection through the slow ing of domestic activity
Central gov't expenditure	**21.8**	**14.7**	**37.3**	**-7.5**	Grow th in programmatic spending offset by a sharp decline in subsidies
Salaries	5.3	3.9	4.4	2.2	Grow th in line w ith previous years' and streamlined 13th month salary payment
Goods and services	5.0	1.7	0.5	2.7	Increase in government consumption and early procurement
Capital	6.1	2.1	1.6	0.2	Planned government investment being spent earlier in the year
Social assistance	4.4	2.1	1.4	2.4	Grow th in social expenditure and the BLT program
Others	1.0	-5.0	2.9	1.2	Election spending and increased 'planned expenditure'
Interest payments	3.8	0.2	1.7	0.7	In line w ith projections, w ith appreciation in IDR offsetting higher interest costs on new debt
Subsidies	-3.7	9.7	24.8	-16.8	Refined fuel prices have halved and the government continues to encourage less consumption of higher cost-energy

Annual percentage point change in bold font, percentage point contributions not in bold. Sources: MoF and World Bank

Box 2: The rise and fall of the international crude palm oil price has had a dramatic impact on export duties

Export duties have historically been a very small, stable source of government revenue, averaging around 0.2 per cent of total revenues from 2001 to 2007. However, 2008 brought strong growth whereby export duties increased to 2.1 per cent as a share of total government revenues. Since this unprecedented peak, export duties fell dramatically to 0.1 per cent of total revenues in 2009, and are likely to remain weak in 2010.

Almost all exports duties revenues are sourced from tariffs on crude palm oil (CPO) and related products, some of Indonesia's key export commodities. A very small 'non-CPO' portion of duties are derived from exports of wood, sand and leather products, but these typically make up less than 2 per cent of export revenues.

The recent volatility in export revenues is created by a variable tariff structure that is imposed on exports of CPO commodities whereby the tariff rate depends on the international CPO price. (Table 4) This tariff structure explains most of 2008's windfall revenue gains at a time where the international CPO price soared. (Figure 35) For example, in 2008, when the CPO price was above USD1,250/MT, the maximum tariff rate of 25 per cent was imposed on CPO export revenues. Conversely, in 2009 the CPO price remained below USD700/MT for much of the year which corresponds with duty free exports.

Table 4: CPO export duty tariffs are based on developments in the international CPO price
(USD per metric ton, per cent)

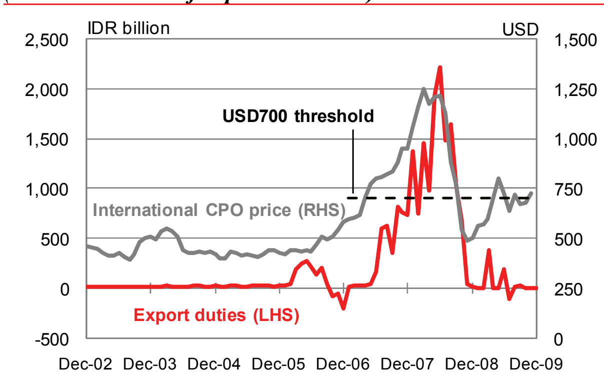
International CPO price (USD/MT)	CPO tariff (per cent)
< 700	0.0
701 - 750	1.5
751 - 800	3.0
801 - 850	4.5
851 - 900	6.0
901 - 950	7.5
951 - 1,000	10.0
1,001 - 1,050	12.5
1,051 - 1,100	15.0
1,101 - 1,150	17.5
1,151 - 1,200	20.0
1,201 - 1,250	22.5
> 1,250	25.0

Sources: Ministry of Finance

The objective of this tariff structure is to protect domestic consumers CPO commodities by ensuring supply at relatively stable prices to the domestic market, while generating revenue when the CPO price exceeds USD 700/MT and creating a wedge between the prices producers can receive on the international and domestic markets. However, the downside is that this pricing mechanism may create longer-term supply side disincentives to producers of palm oil if they are not able to fully retain the returns from international trade when there are significant increases in the CPO price. Over time, this could lead to reduced investment in CPO production or lead to some substitution from CPO production to the production of other commodities that do not attract export duties.

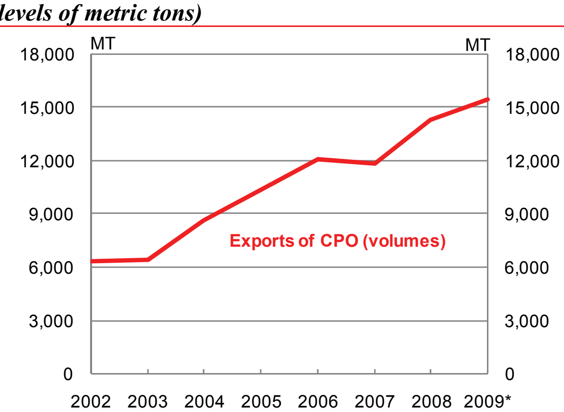
Over this recent period of booming export duties receipts, volume growth of CPO exports remained relatively stable, in part reflecting the lag in producers' ability to expand output in response to movements in the international market price. (Figure 36) While export duties are expected to recover in 2010, it is unlikely that they will hit the recent peaks of 2008 short of a new surge in international oil prices.

Figure 35: The recent export revenue windfall has ended as the CPO price falls …
(levels in billions of rupiah and USD)



Source: Ministry of Finance, BPS

Figure 36: … while growth in CPO exports remains relatively stable throughout the period
(levels of metric tons)



Sources BPS; * Association of Indonesian CPO producers for 2009

5. The economic outlook remains for an ongoing gradual recovery

a. Buoyant domestic demand is expected to offset a declining contribution from net exports, while the current account surplus is likely to narrow

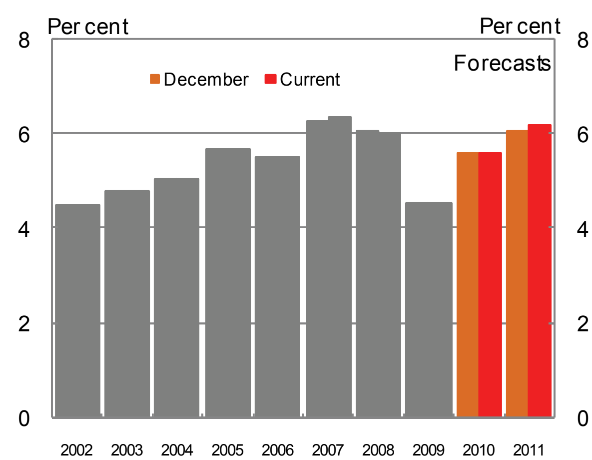
The outlook for Indonesia's economy has strengthened a little between December 2009 and March 2010

The outlook for Indonesia's economy has improved slightly between December 2009 and March 2010. (Figure 37) In 2010, Indonesia's economy is expected to grow by 5.6 per cent. While the outlook for some of Indonesia's growth drivers has improved, including major trading partner and domestic credit growth, there are still considerable risks facing the economy (see below). By 2011 growth is expected to have returned to trend of around 6.2 per cent or stronger.

Investment growth is expected to rebound while government spending is likely to remain strong

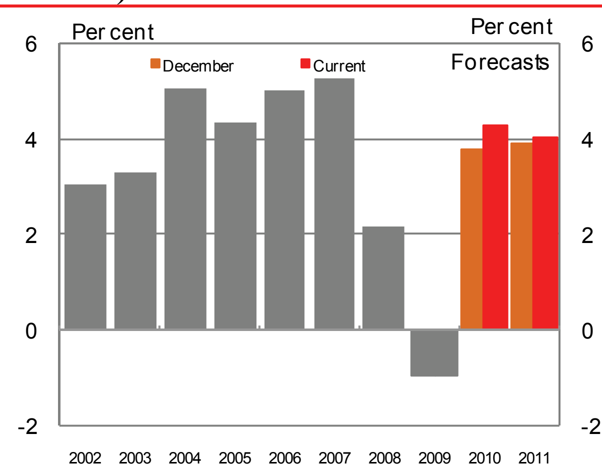
The major drivers of Indonesia's growth in 2010 are expected to continue to come from domestic demand, with the external sector contributing less than in 2009. (Table 5) Private consumption expenditure is expected to accelerate, growing by around 5.3 per cent in 2010, with price growth remaining moderate, lifting real purchasing power. Investment growth is also expected to accelerate in 2010, supported by increasing commodity prices and external demand. Government consumption is expected to continue growing with greater spending on core government programs and improved disbursement rates.

Figure 37: Indonesia's growth outlook improves
(annual average GDP growth, per cent)



Sources: BPS and World Bank forecasts

Figure 38: …along with the outlook for trading partners
(average annual GDP growth of Indonesia's export destinations)



Sources: CEIC, Consensus Forecasts Inc and World Bank

The outlook remains for further recovery in trade flows

The recovery in the world economy and commodity prices are expected to support continued firm growth in Indonesia's exports. (Table 5) Growth is expected to remain broad based, although increasing demand for raw materials from China and India may see commodity exports accelerate ahead of other items into 2011. Imports are expected to recover faster than exports, as the domestic economy grows more quickly than Indonesia's MTPs, and production to meet the sustained growth in non-commodity exports requires more imported inputs. This is expected to narrow the trade surplus from USD 21.2 billion in 2009 to around USD 14 billion in 2010. The surplus is expected to be stable in 2011, as nominal exports and imports both sustain solid growth.

Table 5: Projections for Indonesia's macroeconomy
(percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual	
	2009	2010	2011	2009	2010	2011	2010	2011
1. Main economic indicators								
Total Consumption expenditure	6.2	5.7	5.4	5.9	5.9	5.7	0.1	0.0
Private consumption expenditure	4.9	5.3	5.3	4.0	5.4	5.6	0.2	0.0
Government consumption	15.7	8.1	6.1	17.0	7.9	6.2	-0.7	0.3
Gross fixed capital formation	3.3	8.4	7.2	4.2	8.2	6.6	-0.6	-0.2
Exports of goods and services	-9.7	15.7	10.8	3.7	7.9	12.6	6.9	-0.1
Imports of goods and services	-15.0	18.5	12.1	1.6	10.4	13.6	5.9	0.0
Gross Domestic Product	**4.5**	**5.6**	**6.2**	**5.4**	**5.7**	**6.4**	**0.0**	**0.1**
2. External indicators								
Trade balance (USD bn)	21.2	14.0	13.7	n/a	n/a	n/a	4.0	2.8
Balance of payments (USD bn)	12.5	6.2	4.7	n/a	n/a	n/a	1.2	1.7
Financial account balance (USD bn)	4.0	3.2	3.5	n/a	n/a	n/a	-0.9	0.8
3. Other economic measures								
Consumer price index	4.8	5.3	6.1	2.6	5.9	6.5	-0.1	0.2
Poverty basket Index	5.8	6.0	6.3	2.9	6.0	6.5	0.6	0.4
GDP Deflator	8.5	10.2	12.0	6.6	11.5	12.3	1.0	1.1
Nominal GDP	13.4	16.3	18.9	12.4	17.8	19.5	1.1	1.4
4. Economic assumptions								
Exchange rate (IDR/USD)	10356	9400	9400	9475	9400	9400	-100.0	-100.0
Interest rate (SBI, 1 month)	7.1	6.5	6.5	6.5	6.5	6.5	0.0	0.0
Indonesian crude price (USD/bl)	61.6	78.3	81.3	75.1	79.6	82.0	-0.7	-2.3
Major trading partner grow th	-1.0	4.3	4.0	3.3	3.2	4.4	0.5	0.1

Note: Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices due to differences in price series.

The balance of payments surplus is expected to narrow in 2010 and 2011, as the recovery in commodity prices and imports bring the current account close to balance

The Balance of Payments surplus is expected to narrow through 2010 and 2011, while remaining in or near surplus, supporting further accumulation of reserves. (Table 6) The current account is expected to move towards balance through the forecast horizon, as the surplus on trade and current transfers is almost fully offset by the widening of the income deficit. The income deficit is expected to expand due to higher repatriation of profits to foreign equity holders, as the value of oil & gas, coal and CPO output increases with increasing production and relatively high global energy prices. Remittances from Indonesians working abroad are expected to be stable.

Net direct investment is likely to increase, underpinned by robust domestic growth and improved international financing conditions. Offsetting this is the projection of slightly smaller surpluses on portfolio investment, as domestic residents continue to reinvest in foreign equity and debt markets, and the Government faces higher amortization of SUNs. However, portfolio investment inflows in both short and long-term asset classes are expected to remain robust, assuming no reversal of recent carry trade activity. .

Table 6: The BoP surplus is expected to narrow through the forecast window, as the current surplus falls
(billions of USD)

	2007	2008	2009	2010	2011
Balance of Payments	**12.7**	**-1.9**	**12.5**	**6.2**	**4.7**
Current Account	10.5	0.1	10.8	2.7	0.9
Trade Balance	*20.9*	*9.9*	*21.2*	*14.0*	*13.7*
Income Balance	*-15.5*	*-15.2*	*-15.2*	*-16.4*	*-18.2*
Transfers Balance	*5.1*	*5.4*	*4.8*	*5.1*	*5.4*
Capital & Financial Accounts	3.6	-1.9	4.1	3.5	3.8
Capital Account	0.5	0.3	0.1	0.3	0.3
Financial Account	3.0	-2.2	4.0	3.2	3.5
Direct Investment	*2.3*	*3.4*	*2.0*	*2.5*	*2.7*
Portfolio Investment	*5.6*	*1.7*	*10.5*	*6.6*	*6.8*
Other Investment	*-4.8*	*-7.3*	*-8.5*	*-5.9*	*-6.0*
Foreign Reserves (a)	**56.9**	**51.6**	**66.1**	**69.6**	

(a) 2010 foreign reserves average value through Q1. Sources: BI and World Bank projections

Over 2010 Indonesia's scheduled external financing obligations total USD 29.3 billion. (
Table 7) Over the same period, projections of trade and investment-related capital flows, plus net purchases of liquid financial assets, generate a projection of net inflows of around USD 35.6 billion. Combined, this gives a BoP surplus of around USD 6.2 billion, consistent with the projections presented in Table 6.

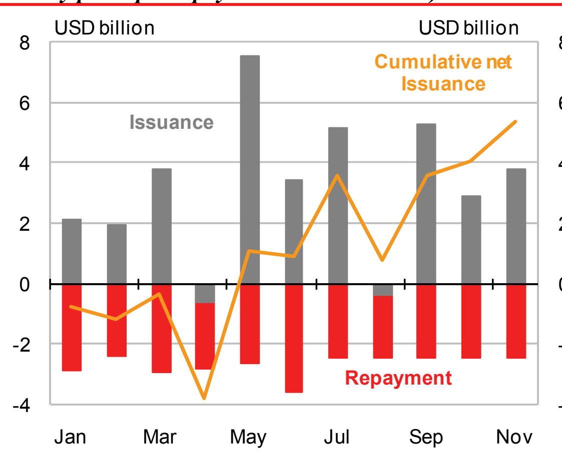
The assumptions underlying this projection are relatively conservative given recent trends. The 95 per cent roll-over rate on SBIs is lower than the realized rate through 2009, and allows for BI to reduce the stock of SBIs on issue. The 90 per cent roll-over rate on private short-term debt reflects still-recovering global credit conditions, plus the scaling back of some projects following the global downturn and lower commodity prices. These roll-over rates compare to the positive implicit roll-over rates on total external debt, with more debt being issued than has fallen due through 2009. (Figure 39)

Table 7: Indonesia's currently scheduled external financing needs over the coming 12 months total USD 29.3 billion
(billions of USD)

EXTERNAL FINANCING NEEDS	**29.3**
Maturing short-term FCU private debt	9.9
Amortization of medium and long-term FCU debt	**10.0**
Public	6.9
Private (a)	3.2
Short-term IDR liabilities to non-residents	**8.6**
Amortization of medium and long-term IDR debt to non-residents	**.8**

(a) Excludes standstill debt of USD 6.5 billion. Sources: BI and World Bank

Figure 39: Roll-over rates on Indonesia's external debt were high through 2009
(monthly principal repayments and issuances)



Sources: BI and World Bank

Table 8: Projected financing sources give a BOP surplus of around USD 6 billion
(billions of USD)

PROJECTED EXTERNAL FINANCING SOURCES	**35.6**
Current account balance	**2.7**
Trade balance	14.0
Net income and transfers balance	-11.3
Net FDI Inflows	**2.5**
Official Foreign Financing	**-2.1**
Drawings	4.4
Repayments	-6.5
New Debt Issuances	**30.8**
Short-Term Debt Instruments	18.8
Public (SBIs) (a)	7.1
Private (notes)	11.6
IDR debt (b)	*1.0*
FCU debt	*10.6*
o/w loans	*12.5*
o/w trade credits (c)	*-3.5*
Medium and Long-Term Bonds	12.0
Public (SUN)	5.5
Foreign investment in IDR bonds (d)	*2.0*
FCU bonds	*3.5*
Private (bonds)	6.5
Non-residents' net purchases of debt and equity on secondary markets (e)	**5.9**
Public (SUN and SBIs)	2.9
Private (debt and equity)	3.0
Net investment offshore by residents (f)	**-4.3**
o/w outflows on currency and deposits (f,g)	.0

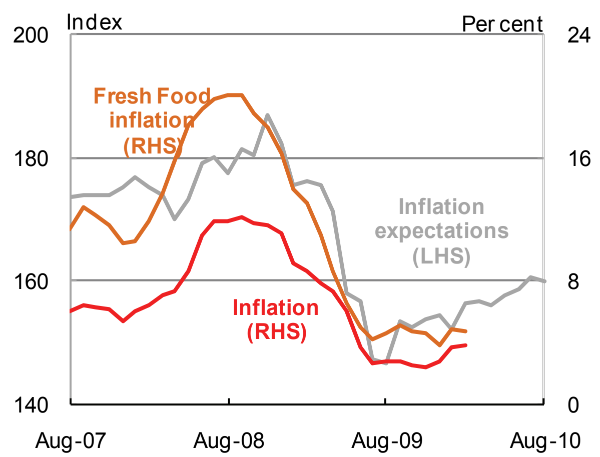
(a) assuming 95 per cent roll-over rate; (b) assuming 90 per cent roll-over rate; (c) expected to rise with increasing trade flows; (d) assuming 18 per cent foreign ownership of new SUN (government IDR bonds); (e) reflecting increasing net purchases of domestic assets by foreigners; (f) negative reflects outflow; and (g) reflecting residents shifting assets back from foreign bank accounts. World Bank projections.

b. Inflation is likely to remain moderate through the first half of 2010, rising later in the year

Inflation in 2010 is likely to remain slow in the first half of the year, before building into 2011

The annual inflation rate for 2010 is likely to be around 5.3 per cent, towards the upper end of BI's inflation target of 5.0 per cent (± 1 per cent). Monthly inflation rates are expected to be moderate into mid 2010 as the domestic harvest season in March and April relieves supply shortages and dampens food prices and improved growing conditions for global commodities unwinds some of the growth in global price of the turn of the year. Also limiting inflation will be ongoing pass through of the rupiah's appreciation in 2009 in to domestic retail prices. The second half of 2010 is likely to experience stronger inflation outcomes driven by an increase in core and administered prices (these projections allow for some increase in electricity tariffs. The forecast acceleration of GDP from mid 2010 is likely to increase capacity utilization, support price growth, while a more stable exchange rate should see more inflationary impetus from tradable prices.

Figure 40: Inflation expectations suggest rising inflation in mid 2010
(expectations of inflation in 6 months; year-on-year inflation)



Inflation expectations data are based on a survey by BI of consumers' expectations for price movements 6 months ahead. The line is advanced by 6 months, so the latest observation, for January, appears as July 2010. Sources: BI and BPS via CEIC

Inflation expectations continued to increase into early 2010, reaching their highest levels since October 2008. Higher expectations for food prices 6 months ahead, coinciding with higher actual food prices, drove this increase, with expectations of other prices, including housing, transport and clothing costs, falling. (Figure 40) If overall inflation expectations reflect contemporaneous movement in food prices, then the expected unwinding of recent rises in food prices should feed into lower reported inflation expectations, which may have implications for wage claims and upstream price pressures.

Inflation experienced by poor households is likely to remain above the headline rate for the duration of 2010, to average around 6.8 per cent, as these households benefit less from the appreciating exchange rate and are more exposed to the recent rise in some food prices. -

In 2011, the acceleration of domestic and world demand is expected to continue and, for some commodities and particularly in this region, place pressure on some prices. But the overhang of the 2008-09 global downturn on global capacity utilization should continue to limit price growth into 2011, limiting the rise in inflation to 6 per cent.

c. Domestic developments have generated downside risks to Indonesia's outlook, while the external environment may be more supportive than expected in late 2009

The risks to Indonesia's outlook appear balanced, with

Following a period of volatility during the global financial crisis, the outlook for Indonesia's external sector has become more positive in recent months. While risks remain – particularly to the global economy – these appear to be receding. Recent outcomes continue to be stronger than had been expected, some international imbalances are stabilizing, and international growth forecasts have generally been revised up.

Some uncertainty remains, however, particularly as major economies begin to withdraw fiscal and monetary stimulus in 2010. Sovereign-debt issues continue to pose a risk, but there appears to be little contagion from countries under stress to those with stronger fundamentals. Domestic financial market risks also seem to have receded in recent months, with SBI roll-over rates remaining high, the government continuing to meet its issuance targets at improving prices, and foreign capital continuing to enter domestic asset markets. Meanwhile debate over the implementation of capital controls on foreign ownership of short-term money market instruments seems to have dissipated somewhat since late 2009

The risk for inflation is on the upside

The uncertainty about the shape and strength of the global recovery in 2010 and 2011 translates into risk for the inflation forecasts. A stronger than expected recovery in world demand, or a significant re-alignment of exchange rates, may drive up commodity prices, impacting both import and export prices. On the domestic front, BI's ambition of credit growth increasing by 15-17 per cent (downgraded from a target of 20 per cent in December) may support domestic demand in a way that pressures consumer prices. Finally, the possibility of larger electricity tariff or other energy price adjustments presents the greatest risk of higher headline CPI inflation over the forecast horizon, although the significance of these increases may be limited to the extent that they lead to only a one-off increase in the price level, rather than a persistent rise in inflation expectations and the underlying inflation rate. On the downside, improved growing conditions and improved crops both domestically and internationally for food commodities may feed to a great extent than usual into weak food price inflation. Overall, the risks to the inflation outlook are titled somewhat to the upside.

Political developments could create uncertainty in financial markets and slow improvements in the investment climate

In addition, political developments since late 2009, in particular the parliamentary inquiry on the bailout of Bank Century, have begun to raise some questions about the timing and depth of future reforms and improvements in conditions for investors and firms, with potential downside risks to investment conditions and growth. To date, political developments do not seem to have had a significant impact on financial market investors' perceptions.

If all the upside risks eventuate GDP could be ¾ of a per cent higher

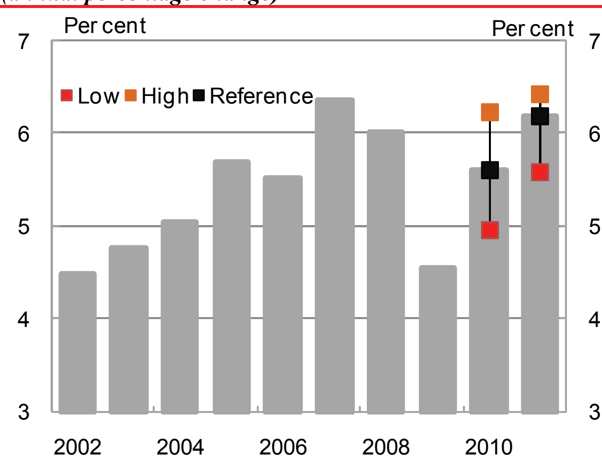
Scenario analysis indicates a possible range of Indonesian GDP outcomes if these up- or down-side risks are realized (Table 9 and Figure 41). The 'high growth scenario' provides for a faster recovery in the global economy, supporting accelerating export prices. This scenario also provides for stronger domestic conditions, with improved investor and consumer confidence accelerating credit, and capital inflows appreciating the rupiah. Under this scenario, GDP growth is around ¾ of one per cent above the reference scenario presented above (Table 9) over 2010 and 2011.

Table 9: Alternative outcomes for key variables
(annual percentage growth; exchange rate level)

	MTP*	Credit	Export prices	Rupiah (USD/IDR)	GDP
2010					
Reference	4.3	17	1.0	9400	5.6
Low	3.1	14	0.8	11000	5.0
High	4.7	18	7.2	8500	6.2
2011					
Reference	4.0	25	5.7	9400	6.2
Low	1.7	15	4.1	10000	5.6
High	4.9	31	14.8	9000	6.4

* weighted average of major export destinations. Sources: CEIC, Consensus Forecasts Inc. and World Bank.

Figure 41: …have their greatest impact on 2010 growth
(annual percentage change)



Sources: BPS via CEIC and World Bank

If all the downside risks eventuate GDP could be 1¼ per cent lower

The 'low growth' scenario' assumes the impact of the recent rebound in trading partner growth and commodity prices is temporary, and that a weaker domestic investment climate weakens credit growth. This scenario subtracts up to 1¼ percentage points from GDP growth from 2010 to 2011 relative to the reference scenario.

d. In 2010 revenue is expected to recovery in line with a recovering domestic economy

Revenues are expected to accelerate in 2010, in line with nominal GDP

Total revenues in 2010 are expected to increase significantly compared with 2009, increasing by around 16 per cent, a result of stronger nominal GDP expectations for 2010 and continued improvements in the capacity of the tax office to collect taxes. (**Table 10**)

Tax revenues, which typically map more closely with nominal GDP, are expected to grow at 18.1 per cent. Oil & gas income tax receipts are expected to remain relatively subdued, with the slight increase in the oil price assumption offset by changes to production expectations. Overall non-oil income tax, which maintained positive growth in 2009, is expected to show particular strength as corporate profits, wages and formal sector employment pick up with the economic recovery and higher commodity prices. However, income tax growth may be lower as a result of business and capital losses during 2009. VAT revenues are expected to bounce back by around 16 per cent following a recovery in consumer confidence and the expectation that spending on discretionary goods, which are generally subject to VAT, will return to pre-2008 levels. International trade taxes are expected to rebound strongly at 25 per cent, from a particularly weak 2008, as the international outlook improves and the CPO price increases.

Non-tax revenues are expected to be stronger than previously forecast due to higher than expected revenues from oil & gas natural resources. This is partly explained by the higher oil price assumption and the expectation that gas revenues will remain strong to meet demand, particularly externally. The government has allocated some additional funds to foster increased gas exploration in an effort to meet the growing demand. Growth in other non-tax revenues remains broadly in line with earlier expectations.

Fiscal policy will continue to stimulate the economy in 2010, but by less than in 2009

Fiscal policy will continue to stimulate the economy throughout 2010, but at a slower rate than observed in 2009 (IDR 42.7 trillion or 0.7 per cent of GDP in 2010 as opposed to IDR73.3 trillion or 1.4 per cent of GDP in 2009). Unlike last year, the entire stimulus package will be in form of tax incentives.

Tax policy reforms continue with their goal of both supporting real activity while achieving higher tax payer compliance. In 2010, the government legislated a decrease in corporate income tax rate to 25 per cent, from 28 per cent, that is expected to detract from income tax collections. In addition, for companies that list more than 40 per cent of their equity on the stock market, there is a larger 5 per cent reduction in the income tax rate. Other tax reforms include the eliminations of luxury tax for some high-end manufacturing industries. The government expects the revenues lost through these stimulus measures to be offset by the tax office's continued effort to collect more revenues through better administration and taxpayer compliance.

A stronger outlook for revenues and modest increase in spending have lowered the outlook for the budget deficit…

The change in the budget assumptions in the revised budget are likely to increase spending by 4 per cent compared to the 2010 budget approved in 2009. The major changes include a higher oil price assumption and deferred adjustment to regulated energy prices that increases the allocation to energy subsidy, and sharing of higher projected natural resource revenue with subnational governments. Subsidies have increased by 30 per cent in the revised proposed budget. Assuming that the recent years' broad trends of gradually improving budget execution by the line ministries continues in 2010, total expenditure is projected to increase by only 4 per cent. Above-budget revenues and below-budget spending may result in a budget deficit around 1.3 per cent of GDP, significantly less than the government's proposed revised budget deficit of 2.1 per cent of GDP and original projection of 1.6 per cent of GDP. Compared with December's outlook, revenues are expected to be stronger in 2010 given the strong outcome for revenues in December (even abstracting from one-off back-payments) and the outlook of faster nominal GDP growth. The outlook for expenditure has changed little.

… however the government has increased its projected deficit to 2.1 per cent of GDP, driven by deferred energy price reform and

The government's proposed revised 2010 budget projects a wider budget deficit, of 2.1 per cent of GDP. In line with the rise in global oil prices since Q3 2009 it assumes a higher average oil price, and slightly higher inflation. The revised budget raises spending by IDR 57 trillion, with subsidies consuming two-thirds of this increase following the government's deferral of energy price reform and the higher projected oil price, with

additional stimulus tax cuts

another 20 per cent to be transferred to subnational governments in line with the government's higher revenue projections (also associated with the higher oil price assumption). The remaining 13 per cent is to be allocated to program priorities identified in the Medium Term Development Plan (the RPJM 2010-2014) announced in February.

Table 10: The deficit in 2009 was smaller than previously expected, driven by the strength in government revenues. In 2010 the deficit is projected to reduce to 1.1 per cent of GDP
(central government revenue and spending)

	2007 Actual	2008 Actual	2009 Actual (prelim.)	2010 Budget	2010 Proposed Revised Budget	2010 (p) WB Estimate
A. State revenues and grants	**707.8**	**981.6**	**868.9**	**949.7**	**974.8**	**1,002.4**
1. Tax revenues	**491.0**	**658.7**	**641.4**	**742.7**	**733.2**	**757.4**
a. Domestic tax	**470.1**	**622.4**	**622.7**	**715.5**	**710.3**	**734.0**
i. Income tax	238.4	327.5	317.6	351.0	356.0	381.8
- Oil and gas	44.0	77.0	50.0	47.0	54.7	62.6
- Non oil and gas	194.4	250.5	267.6	303.9	301.4	319.2
ii. Other domestic taxes	231.6	294.9	305.1	364.6	354.3	352.2
b. International trade tax	**20.9**	**36.3**	**18.7**	**27.2**	**22.9**	**23.4**
i. Import duties	16.7	22.8	18.1	19.6	17.3	19.8
ii.Export tax	4.2	13.6	0.6	7.6	5.6	3.6
2. Non tax revenues	**215.1**	**320.6**	**226.4**	**205.4**	**239.9**	**245.1**
o/w natural resources	132.9	224.5	137.9	132.0	160.5	166.5
i. Oil and gas	124.8	211.6	125.7	120.5	149.0	153.5
ii. Non oil and gas	8.1	12.8	12.2	11.5	11.5	13.0
B. Expenditures	**757.9**	**985.7**	**956.4**	**1,047.7**	**1,104.6**	**1,085.5**
1. Central government	**504.6**	**693.4**	**647.8**	**725.2**	**770.4**	**752.3**
- Personnel	90.4	112.8	127.7	160.4	162.4	155.9
- Material expenditure	54.5	56.0	79.6	107.1	110.7	106.2
- Capital expenditure	64.3	72.8	74.5	82.2	88.1	88.1
- Interest payments	79.8	88.4	93.8	115.6	112.5	106.8
- Subsidies	150.2	275.3	159.5	157.8	199.3	204.4
- Grants expenditure	0.0	0.0	0.0	7.2	0.0	0.0
- Social expenditure	49.8	57.7	73.8	64.3	67.9	64.3
- Other expenditures	15.6	30.3	38.9	30.7	29.5	26.5
2. Transfers to the regions	**253.3**	**292.4**	**308.6**	**322.4**	**334.3**	**333.1**
C. Primary balance	29.7	84.3	6.4	-98.0	-17.4	23.8
D. SURPLUS / DEFICIT	(50.1)	(4.1)	(87.4)	(98.0)	(129.8)	(83.0)
Deficit (per cent of GDP)	(1.3)	(0.1)	(1.6)	(1.6)	(2.1)	(1.3)
Economic assumptions/outcomes						
Gross domestic product (GDP)	3,957.4	4,954.0	5,613.4	5,981.4	6,259.7	6,530.7
Economic growth (per cent)	6.3	6.1	4.5	5.5	5.5	5.6
Inflation (per cent)	6.6	11.1	2.8	6.5	7.0	5.7
Exchange rate (IDR/USD)	9,419	9,691	9,408	10,000.0	9,500.0	9,400
Interest rate of SBI (average %)	8.0	9.3	7.6	6.5	7.0	6.5
Crude oil price (USD/barrel)	78.0	97.0	61.6	65.0	77.0	78.3
Oil production ('000 barrels/day)	909	931	952	965	965	965

Sources: MoF and World Bank

The larger projected deficit for 2010 can be easily filled by the government's 2009 financing surplus

The government can use its 2009 financing surplus to finance its wider budget deficit. By early March it was already well advanced on filling its market-sourced financing plan, having sold IDR 27.3 tr of conventional rupiah bonds and IDR 10 tr of sharia rupiah bonds, and USD 2 billion of USD bonds. Prices achieved on these sales have significantly improved on a year earlier, with the change especially stark for the 5-year USD bond sale, which sold at a weighted average yield of 6 per cent, down 450 bps in a year. Recent sales have allowed the government to lower the average yield of its outstanding bond portfolio, although average maturity has also continued to fall This shorter maturity of new issuance and ongoing obligations for past issuances implying significant ongoing financing needs over the coming years. Through the remainder of 2010 the government plans a new sumarai offering on the JPY market, and a global sukuk offering. With the Indonesian government's access to commercial finance at falling yields and lengthening maturities, it has not had need to call on the public expenditure support facility beyond its issuance of samurai bonds. While the outlook in early 2010 suggests financial market conditions will remain supportive for Indonesia through the remainder of the year, the facility remains in place to support the government should need arise.

Table 11: Indonesia's wider 2010 financing needs be easily filled by 2009's financing surplus
(trillions of IDR unless otherwise indicated)

		2005	2006	2007	2008	2009	2010 (projections)		
							APBN	RAPBN-P	WB
Net financing needs:									
A	Primary deficit	-50.8	-49.9	-30.0	-84.3	-6.4	-17.6	17.4	-23.8
B	Total interest payments	65.2	79.1	79.8	97.0	93.8	115.6	112.5	106.8
	of which:[1]								
	Total commercial bonds:	45.9	58.0	55.9	66.8	63.7	77.4	74.1	77.4
	Variable interest rate	18.2	22.8	14.4	15.3	10.9	--	--	8.9
	USD-denominated	1.9	3.6	4.9	8.9	12.0	--	--	11.0
	Official external loans	-37.1	-52.7	-57.9	-63.4	30.1	38.2	38.3	37.9
A+B	**Overall deficit:**	**14.4**	**29.1**	**49.8**	**12.7**	**87.4**	**98.0**	**129.8**	**83.0**
Amortizations:									
C	Commercial bonds [2]	19.7	23.6	34.4	40.6	47.9	--	--	37.1
D	Official external loans	12.3	13.6	19.6	25.4	28.2	67.5	72.8	63.4
C+D	**Total amortization:**	**32.0**	**37.2**	**54.0**	**66.0**	**76.1**	**67.5**	**72.8**	**100.6**
Gross financing needs:									
A+B+C+D	**Total gross financing needs:**	**46.4**	**66.3**	**103.9**	**78.7**	**163.5**	**165.5**	**202.6**	**183.6**
	(in billions of USD)	**4.8**	**7.3**	**11.3**	**8.1**	**17.4**	**16.5**	**21.3**	**19.5**
Financing sources: [3]									
	Official borrowing	28.1	26.1	34.1	50.2	69.3	*57.6*	*72.3*	
	Total commercial bonds:	22.6	36.0	57.2	85.9	142.4	*67.3*	*69.2*	
	Domestic banking	-2.6	18.9	8.4	16.2	56.6	*7.1*	*45.5*	
	Other	6.6	3.1	2.7	2.9	3.1	*1.2*		
	Total gross financing sources:	**54.6**	**84.1**	**102.4**	**155.2**	**271.3**	**133.2**	**187.0**	
	(in billions of USD)	**5.6**	**9.2**	**11.2**	**15.9**	**28.8**	**13.3**	**19.7**	
Memo items:									
Variable interest rate (SBI-90 day rate)		9.16%	11.74%	8.04%	9.47%	7.60%	6.50%	7.00%	6.50%
Share of bonds at variable interest rate		31.9%	33.1%	28.6%	23.9%	20.5%			
IDR/USD exchange rate		9,751	9,141	9,164	9,757	9,408	10,000	9,500	9,400
Share USD bonds (prevailing exchange rate)		3.7%	6.9%	8.0%	11.8%	14.8%			

[1] Interest payments by component may not sum to totals due to different data sources, timing and rounding issues. [2] No USD bonds are due over this period.
[3] 2009 financing source projections in italics are taken from the APBN-P.
Sources: CEIC, Ministry of Finance, World Bank projections

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY

1. Estimating the impact of Indonesia's fiscal stimulus

Indonesian policy makers responded quickly to the global crisis across a broad front

From late 2008 through 2009 Indonesia rapidly moved to expansionary monetary and fiscal policy in order to support domestic activity in the face of adverse external price and demand shocks arising from the global financial crisis and economic downturn. Indonesia's central bank, Bank Indonesia (BI), started easing monetary policy from November 2008, with general easing including a cuts in its policy rate totaling 300 basis points. Meanwhile the Government of Indonesia was active in loosening fiscal policy, with a fiscal stimulus package passed by parliament in February 2009.

Indonesia's fiscal stimulus package was equivalent to 1.4 per cent of GDP

The fiscal stimulus was worth around IDR 73.3 trillion in 2009 or 1.4 per cent of Indonesia's GDP. It was designed to support consumers' purchasing power, protect the business sector from the global downturn, and generate employment to mitigate the impact of job losses in the private sector. While relatively modest; the size of the package is fairly typical of other regional economies.

..largely as tax cuts

However, Indonesia's stimulus package is unusual in the heavy share allocated to tax cuts – around IDR 61 trillion was allocated to income and corporate tax cuts compared with around Rp 12 trillion was delivered through increased infrastructure and other spending for 2009. Given the problems of slow and late disbursement of expenditures, this heavy weight afforded to tax cuts was intended to maximize the impact of the stimulus package on the economy. (For further details of the stimulus package see Box 1 in *Indonesia's Economic Quarterly* June 2009.).

a. How can the economic impact of fiscal stimulus packages be measured?

An estimate of the fiscal multiplier informs policy makers of how much support to the economy can come from expansionary policies

Fiscal multipliers are often used to assess the impact of fiscal policy on the economy. A fiscal multiplier is the ratio of the change in output to a change in fiscal policy either through tax cuts or government spending. These multipliers can be estimated at different time lags from the implementation of the policy change. Fiscal multipliers can inform policy makers how expansionary policies should be to support the economy. Too large an expansion could create inflationary risks and may raise concerns of fiscal sustainability which in turn could be detrimental to growth prospects; too small an expansion would fail to achieve policy makers' counter-cyclical goals.

There is much debate regarding the size of fiscal multipliers but some studies found that expenditure multipliers tend to be higher than tax multipliers, and overall multipliers tend to be smaller in lower income and smaller economies

There is much debate regarding the size of fiscal multipliers, even in developed economies, with size of the impact of expansionary policy even more uncertain during economic downturns. However, looking across the range of studies and country cases there are a few broad messages

1) Fiscal multipliers tend to be lower than one and as a general rule of thumb are somewhere between 1 and 0.5 for medium-sized countries and 0.5 or less for small, open countries.
2) Multipliers for lower income countries tend to be smaller, although these estimates are less robust as they are estimated with limited reliable data.
3) In general, expenditure multipliers tend to be higher than tax multipliers. This is consistent with the view that government spending has a more direct impact on output compared with tax changes which rely more upon on behavioral responses of consumers and businesses.
4) Capital expenditures tends to have higher multipliers than those for current expenditures. For example, during the current crisis, in March 2009 the IMF provided a range of multipliers to guide G20 Finance Minister discussions in which multipliers on spending, excluding capital, ranged from 0.3 to 1. Capital spending multipliers had a higher range of 0.5 to 1.8.
5) Country-specific differences in economic and budgetary institutions result in a wide range in the size of multipliers.

A recent study found that in Indonesia the multiplier for fiscal spending was higher than for taxes but the latter is more effective in smoothing out some of the effects of a large demand shock

A recent study[1] looked at the effectiveness of fiscal policy, both via discretionary policy and automatic stabilizers, for Bangladesh, China, Indonesia, and the Philippines using structural macro-econometric model simulations. The effectiveness of discretionary policy is evaluated based on the size of the short-term and medium term multipliers under three scenarios: i) an increase of untargeted government spending, ii) an increase of investment targeted spending, iii) and a tax reduction. Automatic stabilizers are also analyzed, with expenditure side and tax side multipliers distinguished. For Indonesia, the short-term (ie, the immediate impact and over the following three quarters) fiscal multiplier of an untargeted increase in government expenditure is estimated to be 0.22 (ie, a 10 per cent increase in spending is associated with a 2.2 per cent increase in GDP), smaller than the 0.76 estimated for increased capital spending but greater than the tax reduction multiplier estimate of 0.16. In terms of the automatic stabilizers, it was found that increased fiscal spending, while expansionary, is not particularly stabilizing but tax reduction, although a less effective expansionary tool, is found to be more stabilizing (i.e. more effective in smoothing out GDP variability, for example due to a large demand shock).

High frequency data, and a simple time series approach gives a smaller estimate of the impact of greater expenditure policy on GDP growth in Indonesia

Taking a new, unique quarterly dataset covering 1994-2009, simple time series analysis can give new estimates of the relationship between government expenditure and GDP growth.[2] The estimated model is:

$$\Delta\, GDP_t = c + a\, \Delta\, GE_{t,t-1,t-2,\, t-3,t-4} + b\;\; \Delta\, GDP_{t-1} + d\, \Delta\, GR_{t,\, t-1}$$

Where c is a constant, GE is the relevant government expenditure component with respected quarterly lag (e.g., t, t-1), and GR is government revenue. Taking this relatively straightforward approach will provide a guide to the correlation between expenditure and output rather than specifically identifying the casual impact. A control variable for government revenue is included in each specification to isolate a causal relationship, as the focus is on government expenditure rather than change in the fiscal stance.

The three specifications used are:

1) Several approaches to estimating the impact of expenditure on output indicators:
   a) Nominal expenditure growth on real output indicators seasonally adjusted
   b) Nominal expenditure growth on real output indicators not seasonally adjusted
   c) Real expenditure growth (deflated by the CPI) on real output indicators seasonally adjusted
   d) Nominal expenditures on nominal output indicators seasonally adjusted
2) Allowing for different coefficients if output is below its potential
3) Allow for the much higher disbursement each fourth quarter

Preliminary results indicate that an increase in government spending supports GDP growth in Indonesia

Under the base specification (1), it is found that a 10 percentage point increase in central government spending is associated with GDP growth increasing by 0.2 percentage points (seasonally adjusted) compared with no stimulus in that quarter. Over a longer horizon, the cumulative impact, which takes account the coefficients of the lagged effects is somewhat smaller at a little over 0.1 percentage points. There are no significant effects when nominal or real variables are used in the alternative specifications.

Under the second specification, using a dummy in the final quarter, suggests that the back-loaded spending in the fourth quarter gives an additional boost to GDP growth, of 0.026 (ie, 10 per cent additional spending increases GDP by 0.26 per cent). Over a full year, accounting for the fourth-quarter event, the cumulative impact of a 10 per cent increase in spending is a 0.15 per cent increase in GDP.

…especially when output is less than potential

The final specification tests whether government spending has a greater impact on output when the economy is running below its potential. A dummy variable is included and equal to 1 if there is a negative output gap. The ‘potential’ output series is estimated using a Hodrick-Prescott filter through the GDP data series – this statistical methods has its limitations, insofar as it incorporates no economic information about the stock of available

[1] Ducanes, Geoffrey, et al (2006). Macroeconomic Effects of Fiscal Policies: Empirical Evidence from Bangladesh, China, Indonesia and the Philippines

[2] This is ongoing analysis, the figures are preliminary result

resources for production, for example, beyond actual output, this is a common approach. The estimates suggest that additional spending indeed has a larger impact on GDP when the economy has spare capacity, with the dummy variable significant at the 5 per cent. Accounting for the output gap raises the estimated cumulative impact of a 10 per cent increase in spending to 0.18 per cent.

Personnel expenditure appears to have the largest impact on demand, supporting private consumption especially

Having estimated the impact of overall spending on aggregate GDP it is constructive to determine which parts of GDP are impacted most and which aspects of government spending have the largest impact on GDP. For example, personnel expenditure would be expected to have a direct impact on private consumption, and this is found to indeed be the case (with respect to consumption not seasonally adjusted, as may be expected given that personnel expenditure is a relatively stable series over time and may seasonal adjustment may smooth out the impact of higher government spending). Including seasonal dummies, personnel spending increases by 0.5 per cent following a 10 per cent increase in government spending.

The other components of government spending do not have an individual impact on GDP or the components of output. This may be because the size of these expenditure items is too small relative to overall government spending to have an identifiable impact on GDP. It may also be because the impact of spending operates across a range of components and is only discernable at the aggregate level.

The lags in the budget process may slow the impact of policy on the economy

These preliminary results reflect the budget process and execution challenges in Indonesia where disbursement of funds is concentrated in the final month of the year. This calls into question how quickly, under current institutional arrangements, fiscal policy can respond to short-term shocks to output, where the timing of support to the economy may be critical in limiting the impact on employment and households' welfare, particularly given the lags from the decision to increase expenditure policy through an extensive budgetary process before entering the real economy.

Table 12: Fiscal multipliers vary across countries

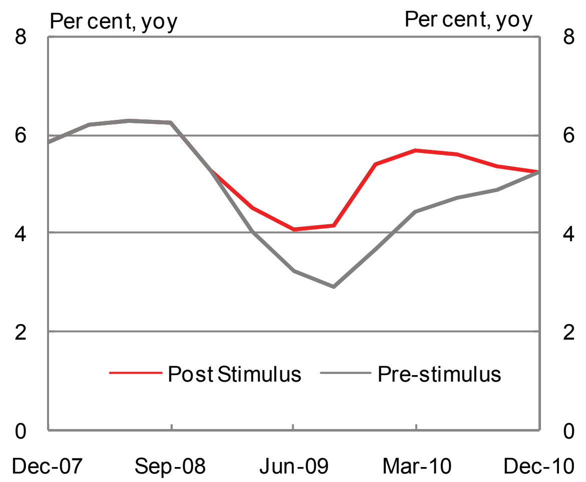
	Method	Countries	Fiscal shock	Impact multiplier: One quarter	Impact multiplier: One year
Blanchard and Perotti (2002)	Quarterly structural VAR	US	Gov spending	0.8	0.5
			Tax cut	0.7	0.7
Cogan et al (2009)	New Keynesian simulation	US	Gov spending	1.0	0.7
			Tax cut	1.0	0.9
Ilzetzki and Végh (2008)	Quarterly panel VAR	27 Emerging	Gov spending	0.6	0.4
		22 Advanced	Gov spending	0.4	0.7
Freedman, Laxton, and Kumhof (2008)	Global Integrated Monetary and Fiscal (GIMF) model simulations with Taylor rule	Emerging Asia	Gov investment and transfer		0.7
			Lump-sum transfer		0.4
IMF (2008)	Panel regression	Emerging	Gov spending		0.1-0.2
			Tax cut		0.1-0.2
Ducanes, et al. (2006)	Structural macro-econometric model	Indonesia	Gov spending 1 year		0.22
			Capital spending 3 years		0.76

b. Using fiscal multipliers to estimate Indonesia's 2009 fiscal stimulus impact

The relevant fiscal multiplier must be applied to each stimulus measure

The fiscal multipliers in Table 12 can be used to form a rough estimate of the impact of Indonesia's fiscal stimulus package on GDP growth over 2009. The methodology to calculate the real economic impact of the stimulus requires the application of the relevant fiscal multiplier to each individual stimulus measure. To estimate the impact on real GDP, the fiscal stimulus must be deflated by the relevant price index (e.g. CPI or GDP deflator) to covert it to the same price level as Indonesia's current real GDP series. For example, using a multiplier of 0.3 means that for every IDR 1 million Rupiah (real) spent by the Government on a particular measure, economic activity increases by IDR 300,000. The remainder is either saved by individuals and businesses, or leaks overseas through imports.

Figure 42: An estimate of the impact of the 2009 stimulus on GDP
(pear on year growth in aggregate GDP)



Source: BPS and World Bank

If it is assumed that all tax multipliers are around 0.3 and expenditure multipliers are around 0.5, then it is estimated that GDP in 2009 was around 1 per cent higher than it would have been without the stimulus measures. (Figure 42).

The chart shows, that while the stimulus policy was effective in limiting the severity of the downturn, Indonesia would have still have avoided a recession in the absence of the stimulus measures.

2. The ongoing implementation of the ASEAN-China free trade agreement

Another round of tariff cuts under the ACFTA prompted concern about the agreement's potential negative impact on Indonesian producers

Implementation of the ASEAN-China FTA started in July 2005, with the ASEAN economies progressively lowering their tariffs on imports from China and China reciprocally lowering its tariffs on imports from the ASEAN region. The agreement is aimed at boosting welfare in the participating economies, by reducing prices for consumers and producers, expanding access to markets and increasing the range of goods and services available.

Another round of scheduled tariff cuts was implemented on 1 January this year, and brought well-publicized expressions of concern of an imminent 'flood' of cheap Chinese imports and associated negative impacts on the Indonesian economy. These cuts were relatively small, and were in line with cuts made by other signatories of the agreement. Since the agreement was first implemented and tariffs started being cut, Indonesia's exports to and imports from China have increased significantly. Overall economic modeling work suggests that the agreement should benefit Indonesia, largely through lower prices, even if it reduces Indonesia's trade surplus and impacts the output of some sectors.

a. At the start of 2010 Indonesia made further, relatively small cuts in its tariffs on imports from China

Indonesia met its agreement under the ACFTA to eliminate tariffs on 90 per cent of goods by 2010

Under the ASEAN-China FTA (ACFTA), the ASEAN-6[3] and China agreed to eliminate tariffs on 90 per cent of goods by 2010, with the remaining four countries (Cambodia, Laos PDR, Myanmar and Vietnam) to achieve this objective by 2015. On 1 January 2010 this objective was met, with preferential tariff rates reduced to zero on the vast majority of goods traded between the ASEAN-6 and China. Indonesia also met this objective, reducing preferential tariff rates on 90 per cent of goods imported from China to zero,

[3] Comprises Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand.

across 99.11 per cent of tariff lines. (To qualify for the lower tariffs, goods must meet local content requirements – that a certain share of the value of the good was produced in China or Indonesia.).

These tariff reductions are in line with Indonesia's tariff rates under other FTAs…

Tariff reductions under the ACFTA – including for Indonesia – began in 2005, with gradual, annual cuts in tariff rates. The reductions implemented under the ACFTA are consistent with Indonesia's reductions to other major trading partners under the ASEAN FTA (AFTA), the ASEAN-Korea FTA (AKFTA), the Indonesia-Japan Economic Partnership Agreement (IJEPA), and unilateral reductions in Indonesia's Most Favored Nation (MFN) preferential tariff rates (Table 13).

Table 13: Indonesia's tariff rates on imported goods by trade agreement, simple average
(per cent)

	1995	2002	2003	2004	2005	2006	2007	2008	2009	2010
MFN	15.5%	7.3%	7.2%	9.9%	9.9%	9.5%	7.8%	7.6%	7.6%	7.5%
AFTA		4.32%	2.82%	3.42%	2.8%	2.8%	2.0%	2.0%	1.9%	0.0%
ACFTA					9.6%	9.5%	6.4%	6.4%	3.8%	2.9%
AKFTA							6.6%	6.0%	2.6%	2.6%
IJEPA								5.2%	4.5%	3.0%
Difference MFN - ACFTA					0.3%	0.0%	1.4%	1.3%	3.8%	4.6%

Source: Ministry of Finance

… and with other countries' tariff rates under the ACFTA

Indonesia's tariff reductions are also consistent with those implemented by other countries, including China, under the ACFTA. (Table 14) Indonesia cut tariff rates substantially in 2007 and 2009, in line with other economies under the ACFTA. However, Indonesia's average tariff reductions in 2010 were comparatively small.

Table 14: Goods imports tariff rates under ACFTA, simple average
(per cent)

	2005	2006	2007	2008	2009	2010
Indonesia	9.57%	9.50%	6.37%	6.38%	3.83%	2.92%
Thailand	12.36%	12.36%	8.38%	8.38%	5.10%	2.67%
Philippines					3.54%	4.64%
China*	8.30%	8.30%	6.55%	6.55%	3.02%	1.05%

* average tariff on goods imported from Indonesia. Source: Ministry of Finance

Indonesia's tariff reductions across all sectors in 2010 were small; high tariffs remain for some transport equipment and agriculture products

Under the ACFTA, Indonesia and China agreed to a series of 'Early Harvest' tariff cuts, which saw average tariff rates on a series of tariff lines fall quickly in early years (mainly on unprocessed agricultural products, such as fish), while cuts in other sectors were delayed until later years. As a result, average tariffs on most sectors either realized large cuts early in the agreement's implementation, or were cut incrementally over five years. For example, substantial reductions were seen in petroleum products and transport equipment in 2007, while most other sectors saw the largest one-off reduction in 2009 (Table 15).

However, tariffs on imports from China remain relatively high on some products, particularly in the transport equipment and agriculture sectors. These goods are commonly known as 'sensitive items' – and represent the final 0.89 per cent of tariff lines. Under the ACFTA, however, tariff rates on these goods are scheduled to be brought to zero by 2015. Indonesia's sensitive items include rice, sugar, alcohol, cigarettes, ceramic and china tableware, motorbikes, cars and trucks.

This discussion focuses on changes in tariffs, which are feasible on a bilateral basis, and does not account for reductions (or otherwise) in various non-tariff measures. These measures may be more significant barriers to trade than adjustments in ad valorem tariff rates.

… with most of these sensitive items to be subject to 0 to 5 per cent tariffs by 2018

Under the ACFTA, the ASEAN-6 and China have also agreed on the timeline for reducing tariff rates on 'sensitive items'. Of this list, not more than 40 per cent can be further classified as 'highly sensitive', with the remaining 'sensitive' items expected to have tariffs reduced to 20 per cent by 1 January 2012, and to 0 to 5 per cent by 1 January 2018.

Tariffs on 'highly sensitive' items are expected to be reduced to not more than 50 per cent by 1 January 2015.

Table 15: Indonesia's tariff rates under ACFTA fell to low levels by 2010, with the exception of many transport equipment and agricultural items
(tariff rate, per cent)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Agriculture	11.9	10.5	9.6	9.4	9.4	6.9	6.8	6.8	6.7
Chemicals	6.5	6.5	6.5	5.4	5.4	2.4	1.5	1.5	1.2
E. Machinery	6.8	6.8	6.8	4.6	4.6	2.1	0.5	0.5	0.4
Fish	4.7	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.0
Leather, Rubber, Footwear	8.7	8.7	8.7	7.3	7.3	4.3	3.5	3.5	3.0
Other Manufacturing	7.3	7.3	7.3	5.5	5.5	2.2	0.6	0.6	0.2
Metals	9.8	8.9	8.9	6.5	6.5	3.2	1.7	1.7	1.3
Minerals	5.1	6.0	6.0	5.0	5.0	1.9	1.2	1.2	1.1
NE Machinery	2.6	2.6	2.6	2.0	2.0	0.8	0.3	0.3	0.2
Petroleum	5.0	3.2	3.2	1.2	1.2	1.2	1.2	1.2	1.2
Textiles & Clothing	10.8	10.8	10.8	7.6	7.6	4.3	1.6	1.6	1.1
Transport Equipment	28.7	28.7	28.7	18.8	18.9	18.5	18.4	18.4	18.1
Wood, Pulp, Paper, Furniture	4.7	4.7	4.7	4.3	4.3	1.1	0.4	0.4	0.0
Average	9.9	9.6	9.5	6.4	6.4	3.8	2.9	2.9	2.6

Source: Ministry of Finance

Currently, few imports of goods from China use the ACFTA preferential rates, although with this may rise following the most recent tariff cuts

Yet, anecdotal evidence suggests that historically the majority of Chinese importers have not utilized the preferential tariff rates under the ACFTA, but instead have applied using the Most Favored Nation (MFN) tariff rates, which are – on average – marginally higher than the preferential rates. (Table 13) It has been suggested that the administrative costs associated with applying under the ACFTA mean the financial incentive to use the ACFTA rates can be diluted.

However, with the differential between MFN and ACFTA increasing in 2009 and 2010 (Table 13), there may now be sufficient incentive for Chinese importers to increasingly utilize ACFTA rates. Greater utilization of the preferential tariff rates by Chinese imports may lead to increased competition for some domestic industries, with potential negative impacts on domestic production. However, greater utilization should also realize benefits for Indonesian consumers, producers and exports, due to lower prices for final and intermediate products.

b. As bilateral tariff rates have fallen, trade between Indonesia and China has increased…

Indonesia's exports to China have increased significantly in recent years, especially of agricultural and mineral products

Since tariff reductions under ACFTA began in 2005, Indonesia's exports to China have increased by almost 70 per cent,[4] driven by a near tripling in mineral exports and a near doubling in agriculture products. (Figure 43) While some of this reflects higher prices, particularly for the commodities Indonesia exports to China, it also reflects greater volumes. Table 16 shows that since 2005 Indonesia has directed an increasing share of total commodities exports (agriculture, mining and metals) to China, and a general rise in the importance of commodities in Indonesia's exports since 2005 – as the values (the combination of the quantity exported and their prices) of these exports have grown much faster than values of other export sectors.

While Indonesia has also increased imports from China, particularly of capital equipment

Similarly, since tariff reductions began in 2005, the value of Indonesia's imports from China has grown by almost 70 per cent, led by growth in electronic machinery (over five-fold), non-electronic machinery (over three-fold), and transport equipment (over four-fold). (Figure 44) Most of this growth is due to greater volumes of imports, given that the prices for these manufactured goods have grown little over the past half-decade. Further, Table 17 again highlights that since 2005 Indonesia has sourced a significantly greater proportion of its capital goods imports from China – particularly for electronic machinery – where Chinese imports have increased from around one-eighth of all imports in the sector, to almost half.

[4] Values for the 10 months from January – October 2005 compared to January – October 2009.

Figure 43: While tariffs fell, the value of Indonesia's agriculture and minerals exports to China have increased…
(USD millions and simple average tariff rate across all goods)

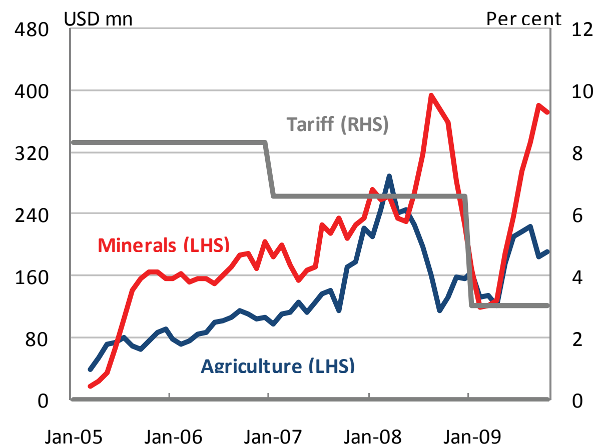


Table 16: …and a larger share of Indonesia's total agriculture and minerals exports now go to China.
(exports to China as a per cent of exports by sector, and proportion of total exports to China by sector)

	2005	2006	2007	2008	2009	Prop 05	Prop 09
AGRI (ex. FISH)	9	12	12	10	12	12	19
CHEMICAL	17	15	14	10	13	12	6
E MACHINERY	2	2	3	3	3	2	2
FISH	4	2	2	2	3	1	0
LEATHER, RUBBER	7	10	10	11	14	6	9
MANUFACTURE	2	2	3	2	2	0	0
METALS	6	6	7	7	9	8	11
MINERAL	7	11	12	12	12	17	28
NE MACHINERY	3	4	6	5	5	2	2
PETRO	16	10	11	9	15	24	11
TEXTILES	2	2	2	2	2	2	2
TRANSPORT	2	4	2	1	10	1	3
WOOD, PAPER, PULP	10	11	9	11	9	13	7
TOTAL	**8**	**8**	**8**	**9**	**10**	**100**	**100**

Sources: BPS, Ministry of Finance, and World Bank calculations

c. Studies suggest that Indonesia's economy, overall, gains from the ACFTA

The ACFTA is expected to increase overall welfare in Indonesia, and increase bilateral trade with China

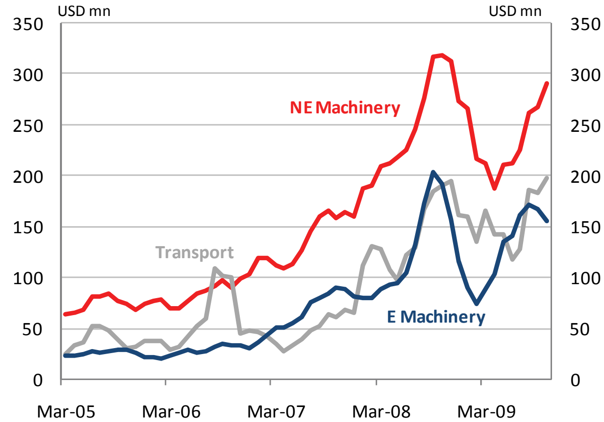
The Asian Development Bank (ADB) prepared the most comprehensive analysis of the impact of the ACFTA on Indonesia. The 2008 paper includes both quantitative and qualitative analysis of the impacts of the FTA by signatory, and across seven broad economic sectors. The quantitative analysis is based on a static Computable General Equilibrium (CGE) model using the Global Trade Analysis Project (GTAP) database to analyze the impacts of the ACFTA on each country by output, exports and imports for each of the seven sectors.[5] The paper finds that the ACFTA will provide welfare gains to Indonesia, partly by lowering prices and partly by expanding Indonesia's exports to China significantly.

The agreement offers access to larger markets for exporters, and lower costs for domestic consumers and producers

Qualitatively, Indonesia is expected to benefits from increased access to the third largest consumer market in the world; increased productivity and efficiency in the domestic resulting from greater competition, lower prices for domestic consumers and producers; and greater protection from adverse shocks to the global economy. The sheer size of the ACFTA offers potentially large trade creation benefits to Indonesia. ACFTA covers a population of almost 2 billion, who in 2008 produced over USD 6.6 trillion and traded around USD 4.3 trillion worth of goods with each other. This makes the ACFTA the third largest market in the world, behind only the North American FTA and the European Union. The agreement should result in reduced prices and greater choice for Indonesian consumer and producers, reducing costs, and supporting Indonesia's integration into regional production networks.

[5] These sectors comprise: Agriculture; Food; Extractive Industries; Light Manufacturing; Heavy Manufacturing; Technology-Intensive Manufacturing; and Services.

Figure 44: Indonesia's imports of capital goods have increased rapidly since 2005...
(USD millions and simple average tariff rate across all goods)



Sources: BPS, Ministry of Finance, World Bank calculations.

Table 17: … and now representing a far greater proportion of Indonesia's total capital goods imports.
(Imports from China as a per cent of world imports by sector, and proportion of total imports from China by sector)

Sector	2005	2006	2007	2008	2009	Prop 05	Prop 09
AGRI (ex. FISH)	8	10	11	10	13	5	7
CHEMICAL	9	10	11	13	14	11	11
E MACHINERY	15	18	31	45	45	5	14
FISH	2	3	2	2	6	0	1
LEATHER, RUBBER	12	15	15	15	16	1	2
MANUFACTURE	24	30	29	29	31	3	2
METALS	17	17	22	18	16	19	10
MINERAL	20	23	17	20	17	4	3
NE MACHINERY	11	14	17	22	25	15	25
PETRO	8	5	3	1	2	24	3
TEXTILES	14	15	17	19	23	4	4
TRANSPORT	8	11	8	15	16	8	17
WOOD, PAPER, PULP	7	9	10	11	12	2	2
TOTAL	**10**	**11**	**12**	**12**	**15**	**100**	**100**

Sources: BPS, Ministry of Finance, World Bank calculations.

…and greater insulation from global economic shocks

Another significant benefit of greater integration with China is the potential for such integration to shelter Indonesia from potential adverse shocks from elsewhere in the global economy, to the extent that an increased role for the Chinese market for Indonesia exporters offsets other major markets. This was evident following the recent global economic crisis, when Indonesia's exports recovered more quickly than trade in the rest of the world, driven by continued strong Chinese demand for Indonesia's commodity exports.[6] This has increased the diversity of Indonesia's export markets, increasing the importance of China and reducing the dominance of the Japanese and American markets. (Table 16) Further, Indonesia is much less exposed to the Chinese market than regional neighbors such as the Philippines, Malaysia and Thailand – where exports to China represent around 27 per cent of the Philippines' total exports, and around 15 per cent each for Thailand and Malaysia.

While it should support Indonesia's economic welfare and some sectors, modeling suggests it may lead to small falls in overall output and trade surplus

While the agreement is expected to improve Indonesia's overall economic welfare, the ADB's modeling suggests the agreement is likely to lead to a small contraction in total output and the trade balance. Output is expected to fall by 0.17 percentage points – compared to the agreement not having been implemented – with gains in agriculture and food production not enough to fully offset losses in the heavy manufacturing sector.

Further, while the ACFTA is expected to increase Indonesia's bilateral trade balance with China, it is expected to narrow Indonesia's overall trade balance. Total exports are estimated to increase by only around 1.5 per cent, while total imports are expected to increase by around 4.4 per cent. This projection is based on Indonesia's current exports to the US and Japan being diverted to China due to the lower tariffs applied on those goods under the agreement, with exports to those economies projected to fall by 10 to 15 per cent compared with the agreement not having been implemented. As these diverted exports are mostly agricultural and mineral, there is limited scope for producers to increase their supply.

By sector, total food exports are expected to increase the most, by around 20 per cent, partially offset by falls in other agricultural exports (around 8 per cent), services (6.5 per cent), and the heavy manufacturing equipment (around 4 per cent). Comparatively, imports are expected to increase across all sectors, with food products increasing the most, at over 16 per cent.

[6] Since the deepest period of the crisis in February 2009, Indonesia's exports have recovered by over 62 per cent, while exports for all developing countries are up only 26 per cent, and global exports only 13 per cent.

The ACFTA is likely to bring other longer-term benefits

This analysis only captures a few of the potential benefits that may accrue to Indonesia due to the ACFTA. Others range from greater technological transfer through greater specialization and investment within the region, to greater bargaining power in multilateral fora. Many of the benefits from the agreement are expected to accrue over the long-term – and as such are difficult to quantify, for example as Indonesian firms realize new market opportunities in China or improve their competitiveness relative to the expanded imports.

3. Capital inflows and central bank sterilization

a. BI has chosen to tackle capital inflows through a combination of allowing the rupiah to appreciate, and intervening in the foreign exchange market while sterilizing that intervention

BI has dealt with capital inflows since June through a combination of allowing rupiah appreciation and intervening in the foreign exchange market while sterilizing much of that intervention

Since June 2009, net foreign capital inflows into Indonesian financial assets (equities, government bonds and short-term money market instruments) have amounted to approximately USD 6.6 billion. (Figure 45) In the absence of any central bank intervention, these inflows could lead to a large appreciation of the rupiah, which in turn might cause a loss of export competitiveness and deterioration of the trade balance. Alternatively, if the central bank intervened to prevent a steep rise in the exchange rate, by buying foreign currency and selling rupiah, the resulting increase in the money supply could be inflationary. As a result, while inflows certainly provide a positive boost to the domestic economy, their impact on the monetary system and real economy also includes certain destabilizing elements. In order to mitigate the destabilizing impact of inflows on domestic capital markets, there are various options available to the central bank and treasury (Figure 50)—however each of these comes with its own cost.

In the case of Indonesia from mid 2009 to early 2010, we find that BI has chosen to deal with capital inflows by allowing the rupiah to appreciate to an extent, but also by allowing reserves to build towards preventing too sharp a rise of the currency, and then soaking out, or “sterilizing”, the extra liquidity through open market operations. This note discusses some of the pros and cons of central bank sterilization of reserve inflows, in an attempt to analyze the sustainability and effectiveness of this strategy in the recent Indonesian context.

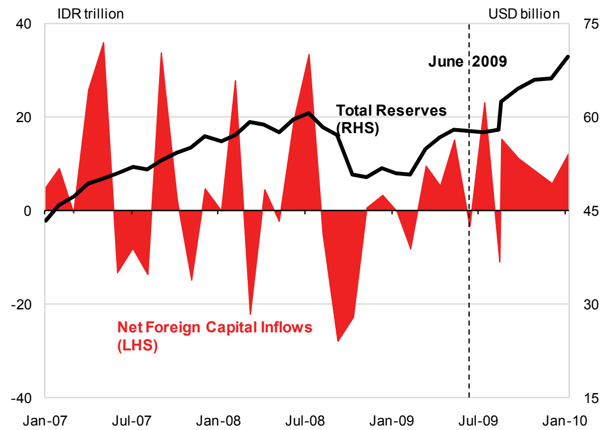
The rupiah has appreciated by nearly 9 per cent

We are able to discern BI’s policy mix because of trends exhibited by the exchange rate, total reserves and base money. The IDR/USD exchange rate has appreciated by 8.7 per cent since June—so allowing rupiah appreciation has clearly been one strategy. (Figure 46) However, given that net inflows of USD 6.6 billion accounted for a 36 per cent jump in the total stock of foreign capital invested in Indonesia, the appreciation would have likely been much stronger in the absence of any foreign exchange intervention by BI.

Reserves have increased by USD 12 billion but base money has only risen by half that amount, indicating BI has sterilized the rest…

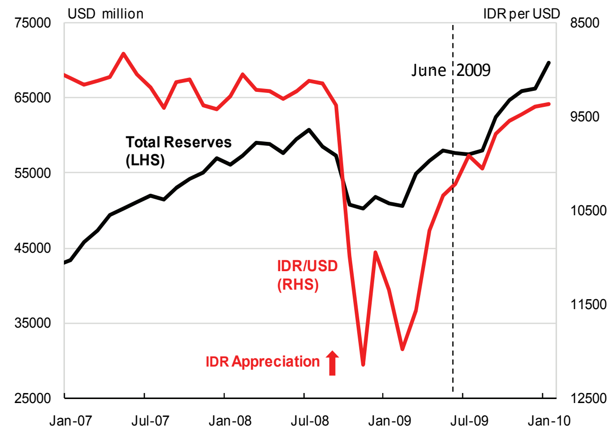
International reserves have increased by USD 12 billion or 21 per cent since June, on the back of capital inflows and the trade surplus. (Figure 45) Though part of this increase in reserves is due to direct export receivables paid into BI’s account, BI has not converted this into rupiah at the rate it may during periods of weaker inflows. At the same time it is believed to have actively intervened to buy foreign exchange in response to the capital inflows. To a certain extent therefore, the buildup in reserves indicates that BI has intervened in the foreign exchange market to prevent an overly rapid rise in the rupiah, by buying foreign currency from the private sector and selling back rupiah. Without sterilization, this extra liquidity would show up as a significant increase in base money (M0). However, we find that base money has only increased by about USD 6.5 billion (or half the increase in reserves) since June. (Figure 47) Thus, the central bank has sterilized part of the increase in reserves, by engaging in open market operations to drain out the extra liquidity.

Figure 45: Capital inflows together with the trade surplus have led to a sharp increase in reserves since June 2009
(net Purchases of equities, government IDR bonds and short-term money market instruments in IDR trillion; Reserves in USD billion)



Sources: Federal Reserve Board and BI via CEIC

Figure 46: …and to a 9 per cent appreciation of the rupiah
(IDR per USD spot exchange rate level; reserves in millions of USD)



Sources: JP Morgan and BI via CEIC

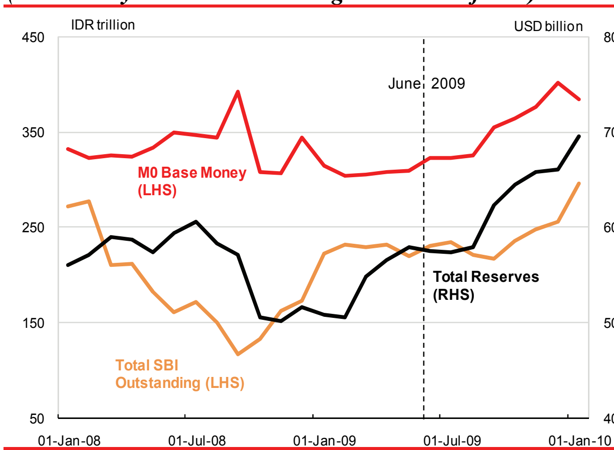
…through increased issuance of 1 month and 3 month SBIs

The short-term money market instruments used by the Indonesian central bank to conduct open market operations are SBI. Similar to US Treasury Bills, SBIs currently have month, 3 month and 6 month maturities (BI plans to phase out the 1 month SBIs). The net increase in total SBIs outstanding since June has been nearly USD 7 billion (a 29 per cent increase). 1 month and 3 month SBI issuance have been the drivers of this increase, as 6 month SBIs outstanding have actually reduced by 92 per cent over this period. (Figure 48)

The increase in SBIs outstanding and base money since June offsets the buildup in reserves

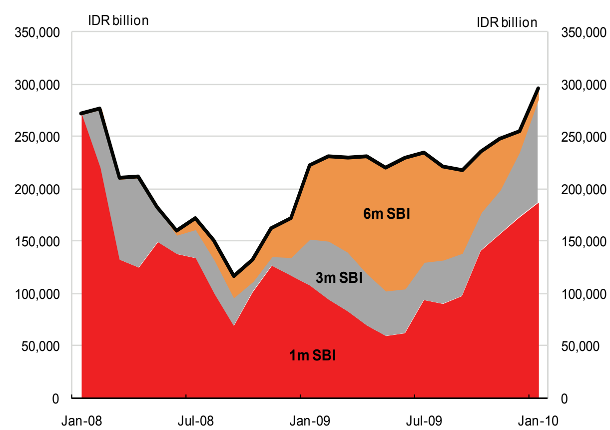
The increase in SBIs outstanding and base money should together offset the increase in reserves, assuming no fundamental change in the central bank's money management strategy. Since base money increased by USD 6.5 billion and SBIs by close to USD 7 billion, this does offset the USD 12 billion increase in reserves. (Note that slight discrepancies in the numbers could be due to exchange rate assumptions.)

Figure 47: BI has sterilized half of the increase in reserves through increased SBI issuance…
(base Money and SBI outstanding in trillions of IDR)



Sources: CEIC and World Bank

Figure 48:…largely through increased issuance of 1 month and 3 month SBIs
(1, 3 and 6 month SBI outstanding in trillions of IDR)



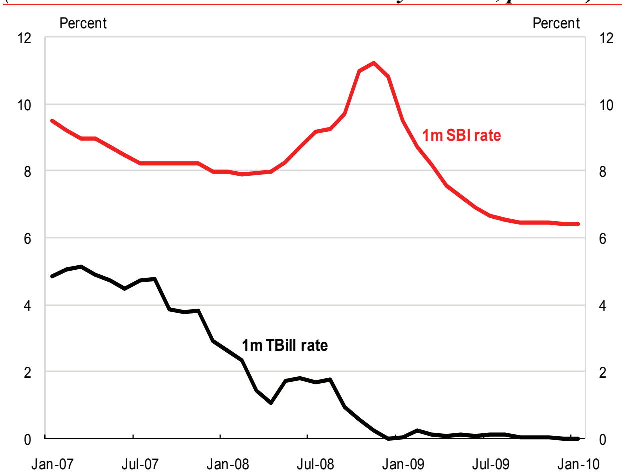
Source: CEIC

b. Despite the longstanding debate surrounding the potentially high costs of sterilization, the costs to Indonesia over the past six months have been limited

Sterilization can be costly for central banks due to the interest differential between what they earn on reserves and what they pay out on domestic money market instruments

The debate surrounding the potentially high costs of sterilization in emerging market countries is not new and arises for a few reasons. First, and often most compelling, is the quasi-fiscal cost incurred by the central bank as it earns relatively low interest on its (often USD) reserves, while paying out relatively high interest rates on the domestic money market instruments issued to soak out liquidity through open market operations. This argument would appear even more pertinent given the recent plunge of US Treasury Bill rates, since a high proportion of countries' international reserves are denominated in US Dollars. In the case of Indonesia, the central bank pays out about 6.5 per cent (annualized) on SBIs. Since the 1 month Treasury Bill rate[7] has gone down to 0.0075 per cent, the interest differential between what BI earns on reserves and pays out on SBIs is significant. (Figure 49)

Figure 49: Given near zero interest rates in the United States, the margin between BI's interest costs on SBI and interest earnings on USD reserves is high
(1 month SBI rate and 1 month Treasury Bill rate, per cent)



Sources: CEIC and World Bank

While the interest rate differential is high, the actual cost of sterilization for BI from June 2009-January 2010, given the change in BI's foreign exchange reserves and SBIs on its balance sheet and the interest rate differential, suggests that the actual cost may be moderate. This estimation suggests that the quasi-fiscal cost for the 6 months to early 2010 has been approximately USD 77.2 million, equivalent to 0.01 per cent of Indonesia's GDP.

Another widely stated argument against sterilization is that it causes domestic interest rates to rise (or remain high) due to the increased issuance of money market instruments, and might therefore prolong capital inflows leading to a vicious cycle of more sterilization and even higher rates. Although this argument has definitely shown some merit in previous sterilization episodes in other countries, it has not manifested in Indonesia over the past six months. Interest rates on 1 month, 3 month and 6 month SBIs have remained stable and actually *decreased* slightly since June.

The effectiveness of sterilization depends on the nature of the shock driving the capital inflows

The reason for this may lie in the argument that the effectiveness of sterilization depends on the nature of the shock that caused capital inflows in the first place (Frankel 2004). If inflows are "pushed" in due to external factors such as a fall in foreign interest rates, which make domestic financial assets more attractive relative to foreign ones, sterilization can be very effective and need not put an upward pressure on interest rates. On the other hand, if inflows are "pulled" in due to positive internal factors that increase the domestic demand for money, sterilization may not be the right answer as it is greater liquidity and credit that people are after—not high yielding money market instruments. In this situation, sterilization could lead to higher interest rates as the demand for money market tools such as SBI would not exist.

In Indonesia, inflows were largely "pushed" in from the second half of 2009 due to external factors, and therefore sterilization appears to have been relatively effective

In the case of Indonesia over the past six months, capital has flowed in because investors across the globe have been chasing higher yields and putting on carry trades to take advantage of historically low interest rates in the United States. The inflows therefore seem to have been "pushed" in rather than "pulled" in due to some change in domestic policy. If anything, BI's monetary policy was expansionary over the period, with rates falling by 300 basis points from December 2008 to August 2009, and then held flat from September 2009. In this environment, BI's policy of increasing the supply of high-yielding short-term paper has met with voracious demand and not led to higher SBI rates.

[7] Although BI diversifies its investment of reserves in terms of both currency and duration, here earnings on reserves are calculated based on the 1 month Treasury Bill rate as this provides a conservative estimate of earnings, giving an upper ceiling of the possible cost of sterilization.

Figure 50: Monetary and fiscal policy can limit the impact of capital inflows, but most options are costly

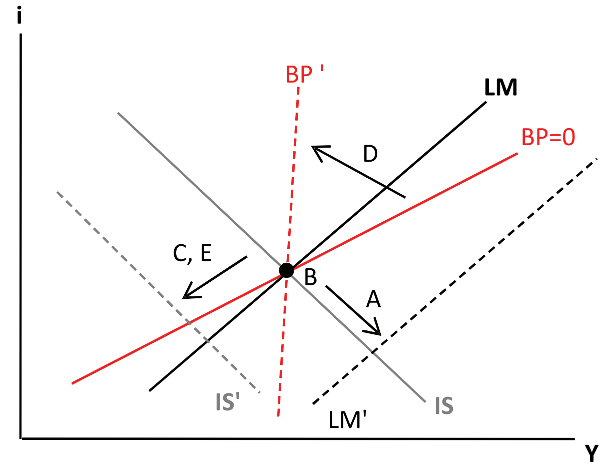
A : Allow inflow of money (*shifts LM right*) → Can be inflationary

B : Sterilize inflow by building reserves, OMO (*stay at B*) → Can prolong inflows by keeping interest rates high

C : Allow appreciation (*shifts IS and BP left*) → Exports lose competitiveness

D : Impose capital controls (*moves BP upward, steeper slope*) → Lose efficiency; have to finance investment through higher cost domestic funds rather than borrowing from abroad at lower cost

E : Fiscal contraction (*shifts IS left*) → Can be recessionary; politically difficult



The IS-LM model is a Keynesian framework that focuses on the interaction between the real and monetary elements of the economy. The IS (investment-savings) curve represents the relationship between output and interest rates that gives equilibrium in the goods market, while the LM (liquidity preferences and money supply) curve represents the relationship between income and interest rates that gives equilibrium in the money market.

Since Indonesia has an open capital account, sterilization is an important policy tool to retain monetary independence and greater economic stability

One positive argument that has been made for sterilization is that it allows emerging market countries to retain monetary independence. Given that the money base in a country is equal to the value of net domestic assets plus net foreign assets (reserves), without sterilization any increase or decrease in reserves would have a tangible impact on the amount of money in the economy. This would severely restrict the central bank's control over domestic liquidity, and leave the economy extremely vulnerable to capital inflows and outflows. Since Indonesia has a completely open capital account and money often flows out as quickly as it flows in, a policy of not sterilizing foreign exchange market interventions could be very destabilizing.

4. The impact of Indonesia's '20 per cent rule' on the level and quality of education spending

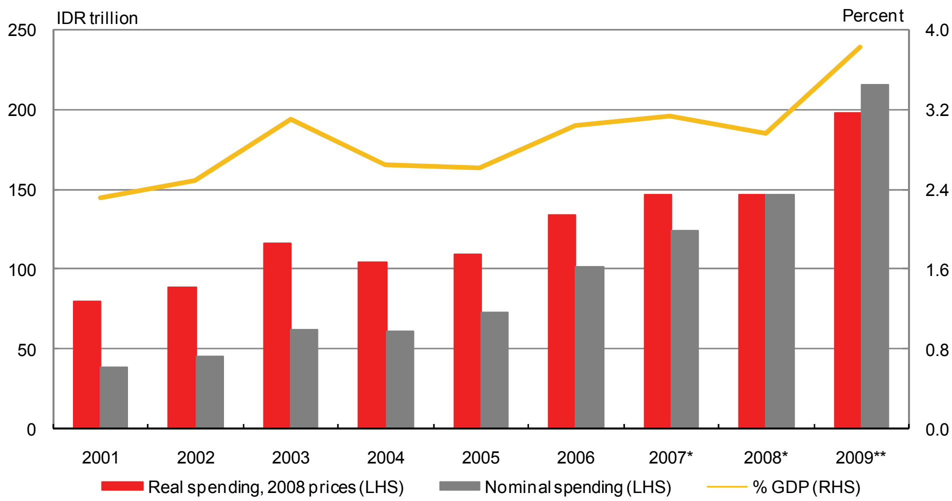
A 20 per cent earmark for education in the Indonesian budget guarantees a relatively high level of funding for a priority sector but also complicates budget management and raises some concerns about the quality of spending

A 2002 amendment to Indonesia's Constitution requires that at least 20 per cent of the State or Central Government budget be earmarked to education, the so-called "20 per cent rule".[8] While there was considerable debate for many years over how exactly to interpret this rule[9], from 2009 it is interpreted such that it: (1) applies to both the initial (APBN) and revised (APBN-P) state budgets; (2) includes all direct Central Government spending on education as well as estimates of sub-national spending on education funded from central transfers (such as teacher salaries); and (3) is calculated as a share of total state expenditures including subsidies, interest payments and transfers to the regions. The 20 per cent rule guarantees a high level of funding for a priority sector relative to other sectors and past spending, with spending reaching a new high in 2009 and expected to stay relatively high. However, the 20 per cent rule also has the potential to undermine the efficiency of public spending and, more immediately, is complicating budget management by generating additional budget allocations to the education sector at various stages of the budget cycle – often at short notice – which raises some concerns about the quality of spending.

[8] The rule also applies to regional government budgets.

[9] Debate first centered on whether teacher salaries should count towards the 20 per cent allocation and later on whether the 20 per cent should be calculated as a share of total expenditures, including subsidies, interest payments and transfers, or whether these items should be excluded from the denominator.

Figure 51: National public expenditure on education in Indonesia
(includes central, provincial and district spending)



***Sub-national data based on budgets. **Central Government data based on 2009 APBN-P budget, sub-national data are staff estimates. Sources: World Bank staff calculations based on MoF and SIKD sub national data.**

The 20 per cent earmark has helped galvanize additional public funding for education, with spending reaching a new high in 2009

Reflecting its status as a key national priority, spending on education by all levels of government (Central, Provincial and District) has grown strongly over the past decade (Figure 51). Since 2006, national education spending has averaged around 15 per cent of total national spending and 3.1 per cent of GDP, which is higher than for any other sector in the budget (with the exception of subsidies in some years). Moreover, spending on education increased sharply and reached a new high in 2009 after the Central Government implemented the latest interpretation of the 20 per cent rule. This is expected to have raised national education spending by around 35 per cent in 2009, in real terms, to IDR 216 trillion (USD 20.5 billion), equivalent to 3.8 per cent of GDP. 2010 and the coming years will see education spending stabilize at a relatively level high. Due to the recent increase in spending, Indonesian education expenditures now compare to other countries in the region, if not to other lower middle income countries, which spend an average of 16 per cent of their budgets and 5.4 per cent of GDP on education (Table 18).

Table 18: Education public expenditures in Indonesia's neighbors

	Malaysia	Thailand	Indonesia	Philippines	Lower-middle income countries*
Education expenditure as % of GDP	4.7	4.0	3.8	2.5	5.4
Education expenditure, % of gov spending	25	21	20	15	16
GDP per capita, PPP (constant 2005 int. $)	12,766	7,682	3,506	3,217	
Population (million)	27	65	237	91	

***Simple average of countries for which there is data available. Sources: World Bank staff calculations based on MoF and SIKD data for Indonesia and World Development Indicators (latest year available) for other countries.**

However, the earmark may also undermine the efficiency of spending and, more immediately, is complicating budget management by generating "windfalls" to education at short notice, which risks reducing the quality of spending

While the 20 per cent rule has contributed to an increased level of funding for this priority sector, it also has the potential to undermine the efficiency of public spending and is complicating budget management. In general, earmarking can be problematic as: (1) rigidities in the budget undermine allocative efficiency by preventing the government from moving resources to meet changing needs; (2) earmarked allocations reduce technical efficiency by undermining managerial incentives and planning capacity; and (3) there is a tendency for earmarks to proliferate, which increases overall budget rigidity. More immediately, because of the 20 per cent rule and the way it is currently interpreted, any decision to increase aggregate expenditures in the budget or the expenditure ceilings of a particular sector (e.g. health or infrastructure) at any stage of the budget cycle will require the Government to allocate additional funds or "windfalls" to the education sector unless its share of total state expenditures is already above 20 per cent. Since these windfalls can arise at short notice at late stages of the budget process (see below), they risk being poorly spent since short planning times can result in hastily implemented programs.

The windfall problem is exacerbated by a number of broader budgeting issues. First, Indonesia's Parliament plays an active role in the setting of budget assumptions such as GDP growth, inflation and crude oil prices. Changes to these assumptions following deliberations can lead to substantial changes in projections of revenues and expenditures (especially on subsidies), which in turn impacts on the size of the education allocation in the budget. Second, disbursing funds, both in the course of conventional government operations and through new spending programs and expanding existing programs, remains a serious challenge in Indonesia. Disbursement of budgeted funds has historically been slow and uneven. These challenges may limit the Government's ability to significantly expand spending on education, especially if additional funds are allocated to the sector at late stages of the budget process. Third, Indonesia's budget regulations do not normally allow the carryover of unspent funds from one year to the next. This limited end-year flexibility will increase incentives to hastily implement programs or, alternatively, could result in unspent education windfalls accruing back to the general government accounts at the end of the fiscal year.

The windfall problem is also exacerbated by energy price volatility, the Government's energy subsidy policies and, to a lesser extent, its resource revenue sharing policy. The GoI provides universal energy subsidies, primarily for fuel and electricity, to Indonesian consumers and businesses by fixing the price of these products below market prices. The GoI also shares revenues from oil and gas with the regions through a formula which transfers 15.5 and 30.5 per cent of realized oil and gas revenues respectively to regional governments on a quarterly basis. A consequence of these policies is that spikes in energy prices automatically increase total state expenditures by triggering both increased spending on subsidies and increased transfers to the regions, which in turn will automatically generate additional windfalls for the education sector whenever the state budget is revised.

Windfalls can arise at three different stages of the budget cycle, with potentially escalating consequences

Windfalls can arise at three different stages of the budget cycle:

- First, additional funds may be allocated to education following preliminary discussions with Parliament on the proposed state budget (RAPBN), normally between May and June of the budget preparation year (the year before the fiscal year). This occurs if changes are made to budget assumptions, projections or expenditure ceilings.

- Second, and more critically, windfalls can arise for similar reasons during final discussions with Parliament on the RAPBN, normally between mid-August and end-November of the budget preparation year. These windfalls can be substantial and, coming so late in the budget planning process, may require additional programs to be developed within a very tight timeframe. During discussions on the Government's proposed 2010 Budget, for example, changes to budget assumptions increased projected revenues and expenditures (largely due to increased spending on subsidies and transfers to the regions), resulting in an additional Rupiah 7.6 trillion (USD 0.8 billion) being allocated to the education sector. (Table 19) The majority of these funds (Rupiah 5.8 trillion) were allocated to Central Government line ministries with responsibilities in education, chiefly, the Ministry of National Education (MoNE) and the Ministry of religious Affairs (MoRA).

- Third, and most critically, potentially large windfalls can arise late in the actual fiscal year following discussions with Parliament on the Government's proposed revised state budget (RAPBN-P), which is normally submitted in the second half of each fiscal year following a mid-year performance evaluation in July. This can leave just months to plan and execute any additional education spending. Analysis of past budgets suggests that windfalls at this stage of the budget cycle are likely to be especially large in years where oil prices deviate substantially between the APBN and APBN-P. In 2008, for example, total expenditures in the APBN-P were Rupiah 135 trillion (or 16 per cent) higher than the APBN, almost entirely driven by increased spending on energy subsides in response to a spike in global energy prices. Had the current interpretation of the 20 per cent rule been applied in that year, a IDR 27 trillion (USD 3.0 billion) windfall would have accrued to education late in the fiscal year. With the current interpretation now firmly in place, the risk of such large windfalls occurring in the future is now a real possibility. Without proper planning, such a windfall may be poorly spent given the little time that will remain to plan and execute the additional allocation.

Table 19: Evolution of 2010 education allocation in the state budget
(IDR trillion unless otherwise stated)

	Proposed State Budget (RAPBN) Aug 2009	Approved State Budget (APBN) Sept 2009	Proposed Revised State Budget (RAPBN-P) Mar 2010
A. State revenues and grants	**911.5**	**949.7**	**974.8**
B. State expenditure	**1009.5**	**1047.7**	**1104.6**
Change		**38.2**	**57.0**
I. Central Government Expenditures	699.7	725.2	770.4
o/w Subsidies	144.4	157.8	199.3
II. Transfers to regions	309.8	322.4	334.3
C. Fiscal Deficit (% GDP)	**1.6**	**1.6**	**2.1**
Education allocation (20% of B. State expenditure)	**201.9**	**209.5**	**221.4**
Additional allocation/windfall		7.6	11.9
Cumulative windfall (relative to RAPBN)		7.6	19.5
Budget assumptions			
Real GDP Growth (%)	5.0	5.5	5.5
Inflation (%)	5.0	5.0	5.7
Crude-Oil Price (US$/Barrel)	60.0	65.0	77.0

Sources and notes: MoF and World Bank staff calculations.

The risk of a large windfall arising late in the 2010 fiscal year has been reduced by the Government's decision to make an early revision to the state budget

In January 2010, just one month into the fiscal year, the Government announced plans to make an early revision to the state budget in response to changing macroeconomic conditions - especially higher global oil prices - to help ensure the budget is implemented effectively. The proposed revised budget (RAPBN-P) released by the Government in March 2010 increases total state expenditures by IDR 57.0 trillion (5.4 per cent), largely due to increased outlays on subsidies, and allocates an additional Rupiah 11.9 trillion (USD 1.2 billion) to the education sector in order to maintain its 20 per cent allocation. (Table 19) This would take the cumulative education windfall in 2010 to Rupiah 19.5 trillion (USD 2.1 billion), 10 per cent higher than originally budgeted in the RAPBN. As in the past, the RAPBN-P proposes to allocate the majority of the windfall (Rupiah 9.4 trillion) to Central Government line ministries, chiefly MoNE (whose budget will expand by 11 per cent or IDR 6.2 trillion) and MoRA (9 per cent or IDR 2.1 trillion). These are relatively large additional allocations and may be a challenge to disburse for the reasons discussed above. Nonetheless, the decision to revise the budget early has reduced the risk of a large windfall arising even later in the 2010 fiscal year and, assuming the proposed budget is approved by Parliament sometime in April 2010, gives relatively more time (around eight months) for line ministries to plan and execute the extra spending.

The revised budget also includes a number of guidelines and establishes an education endowment fund to help ensure that windfalls are spent well

The RAPBN-P also includes a number of guidelines and specifies a number of priority spending areas to help ensure the additional allocations provided to line ministries are spent well. In particular, the allocations must be allocated to programs and activities which have already been designed, can be implemented by the end of the fiscal year and have clear outputs or outcomes. The new spending should also support priority programs announced by the Government in its recently released RPJMN 2010-14 (Medium Term Development Plan), such as the school operational assistance (BOS) program, scholarships, school feeding programs and school facility rehabilitation. Furthermore, the RAPBN-P also proposes to allocate the remaining IDR 2.4 trillion (around USD 250 million) of the windfall to establish an education endowment fund which aims to ensure the sustainability of education programs over the longer term and which can be used for education investments (e.g. scholarships). The fund will allow education windfalls to be disbursed smoothly over a longer time horizon, helping to address the issue of funds not being spent before the end of the fiscal year (and therefore accruing back to the government accounts) because of insufficient time.

Nonetheless, the windfall problem will be reoccurring and a number of policy options could help address the issue in the longer term

Windfalls will be a reoccurring issue in future years as the budget undergoes revisions and the strengthened criteria for how additional allocations can be spent and the establishment of an education fund should help to better manage the problem and mitigate the risk of poor spending when windfalls arise. Strengthening budget contingency planning in MoNE and MoRA could also help to better manage the problem. However, as noted above, education windfalls are part of a broader problem, namely, volatility in the budget caused by energy subsidies and fluctuations in resource revenues. Thus, longer-term policy options for addressing the windfall problem could include tackling this underlying issue directly by reforming energy subsidy policies and/or and establishing an "energy price stabilization fund" to manage fluctuations in resource revenues.

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

1. Indonesian households are recovering from the shock that occurred in the wake of the global financial crisis

Indonesia's economy weathered the global downturn but little is known about how the crisis affected Indonesian households

The effects of the global economic crisis on the Indonesian economy began in late 2008 with a sharp fall in exports in the fourth quarter. Consequently, growth in GDP slowed in the fourth quarter of 2008 and into the first quarter of 2009. As exports recovered through 2009, the economy made a steady recovery. Robust domestic consumption helped the Indonesian macro-economy to weather the storm. Financial markets were also affected but have since recovered strongly.

The effects of a crisis on households, however, may lag the recovery of the economy and only become evident months after the downturn in output. Also, groups and regions may experience the shocks differently and recover at different rates. Therefore, it is necessary to monitor key indicators at the household level to better understand how families are affected by shocks such as the global economic crisis and whether they are recovering. For these reasons, the Government of Indonesia established a Crisis Monitoring and Response System (CMRS) to understand how shocks are transmitted to households, how households are responding, and what their socio-outcomes are. The initiative was carried out by Bappenas and BPS in partnership with the World Bank, with financial support from AusAID.

The CMRS features a new household survey (CMRSS) that was conducted in August and November 2009. The first two rounds of the survey show that households, during mid-2009, experienced a drop in working hours that adversely affected household incomes. Families responded by consuming lower-quality or cheaper food. By late 2009, however, working hours had partially recovered and families no longer reported having difficulties in meeting their consumption costs. Regions experienced the shock differently, however, and may be recovering at different rates. These changes in households' spending and work patterns may be a consequence of the global economic crisis, but are difficult to disentangle from other possible causes (e.g., seasonality or events such as national elections). The third and final round of the survey began in February 2010 but the findings are not yet available.

Workers experienced a drop in working hours that eroded household income levels

The CMRS results show that there was little change in the unemployment or labor force participation rates for heads of households. Similarly, formal and informal wages remained steady for most workers. Workers, however, experienced a reduction in working hours. Weekly hours for heads of households dropped 1.3 hours on average between May and August 2009, across both poor and non-poor households. Rural areas experienced a greater drop than urban areas. The national average of weekly working hours of heads of household in CMRSS August 2009 is also 0.8 hours lower than the national average from the Sakernas surveys of August 2008. Sakernas data also show that working hours for heads of households were relatively the same between February and August 2009 (0.2 hours difference), whereas they were 0.8 hours increase between February and August 2008.

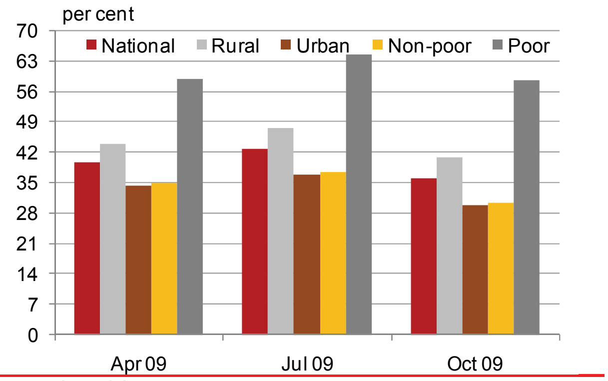
The drop in working hours corresponded to nearly a 5 per cent reduction in rural incomes, assuming constant wage rates. Consequently, households reported that they experienced a significant increase in the difficulty of meeting their consumption costs. The proportion of households that reported difficulty increased by 3 percentage points from April to July 2009, with the proportion amongst the poor increasing by 6 percentage points.

Figure 52: Working hours fell from May to August, then recovered later in the year
(change in head of households weekly working hours)

	May to August 2009	August to November 2009	May to November 2009
National	-1.3	0.6	-0.8
Rural	-1.5	1.1	-0.5
Urban	-1.1	0.0	-1.1
Non-poor	-1.3	0.3	-1.0
Poor	-1.5	1.8	0.3
Head of household:			
Male	-1.4	0.4	-1.0
Female	-1.1	2.4	1.2

Source: CMRSS

Figure 53: Reported difficulty in meeting consumption costs
(per cent of survey respondents)



Source: CMRSS

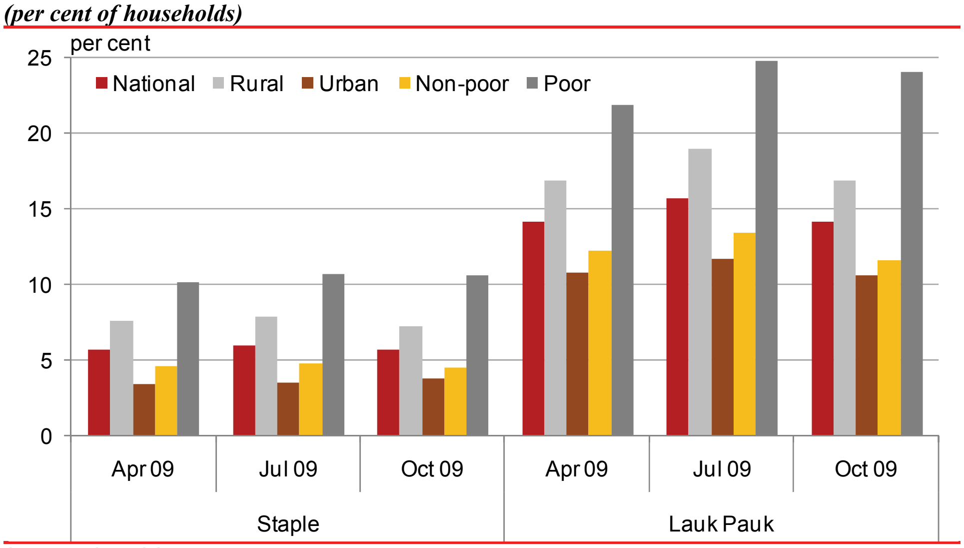
Families coped by buying food that was of lower cost or quality

Increasing prices for a number of food staples over the second half of 2009 put considerable pressure on households that were experiencing a drop in incomes. This stress was particularly acute for the poor, for whom food represents nearly three quarters of their consumption.

Households demonstrated their resilience when faced with these difficulties. They coped with falling household incomes and rising food costs by buying food that was of lower cost or quality. The proportion of households that substituted their *lauk-pauk* (main accompanying food) for food of lower cost or quality increased from 13 to 15 per cent. Households headed by females experienced more difficulties in meeting their consumption needs and were more likely to substitute staple food items and *lauk-pauk*.

Families, however, did not resort to extreme coping mechanisms. Household expenditures for healthcare and education remained constant. There is no evidence that families resorted to sending their children into the labor force to boost falling household incomes. 3.6 per cent of households had a child working in April 2009; this remained the same in July and October. Nor was there a change in the proportion of households with a female working, an increase in which might have been indicative of involuntary entry into the labor force to boost household income.

Figure 54: Coping by using lower quality staple or main accompanying food
(per cent of households)



Source: CMRSS

By the end of 2009, Indonesian households already started to recover

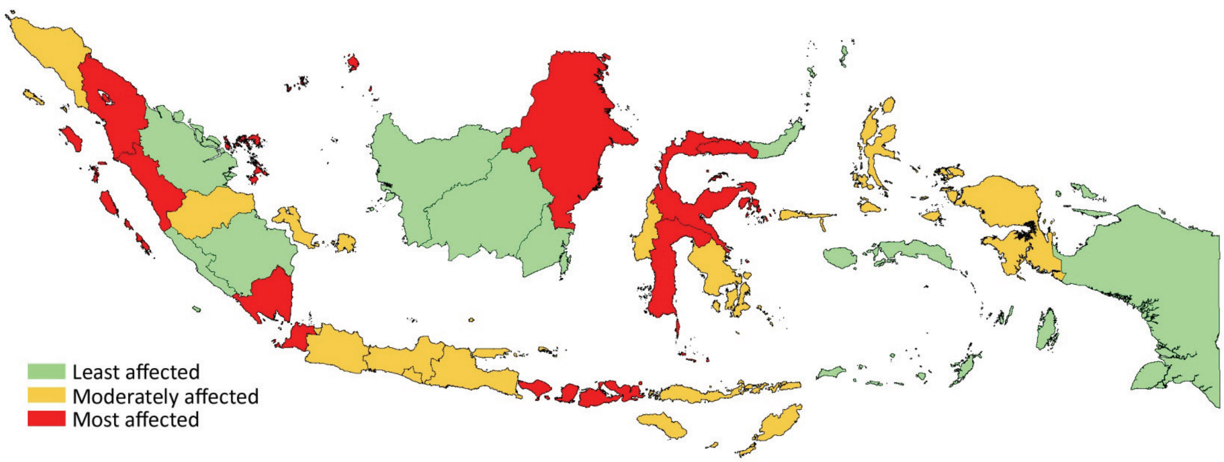
The results from the second round of the CMRS indicate that the situation for households has improved. Working hours increased by 0.6 hours between August and November 2009, partially compensating for the previous downward trend. Female headed households are recovering more quickly. Female heads regained more hours than male heads during this period, with weekly hours in excess of April levels. This appears to have improved household income levels. Household perceptions of difficulties in meeting their consumption costs returned to April quarter levels, as did food substitution trends.

Although not all provinces were equally affected

The CMRS showed substantial variations in results at the provincial level, both in labor market indicators (working hours and unemployment) and household hardship indicators (including perceived change in household income, difficulty in meeting consumption costs and reported food substitution). Some provinces were largely unaffected, some saw a deterioration in conditions from May to August but had recovered by November, while others saw continued or lagged deterioration. The most affected provinces over the May to November period were Lampung, West Nusa Tenggara and Gorontalo, followed by North and West Sumatra, Kepulauan Riau, Banten, Bali, East Kalimantan and Central and South Sulawesi. According to the survey, the least affected over the six months were South Sumatra and Bengkulu.

Figure 55: Provincial variations in household impact

(quarterly change in labor market conditions and household hardship by Province)



Source: CMRSS and World Bank analysis

Work remains to be done to understand the full impact of the crisis on households…

The CMRS survey results can provide more information about how Indonesian households experienced the downturn and how they coped, and to what extent these changes were caused by the global economic crisis. Further analysis will examine education outcomes and use of financing mechanisms. Any impact on school drop-out and absenteeism will be examined, along with nutrition and pre- and post-natal care. Financing mechanisms used by those experiencing difficulty meeting consumption needs will be presented in the context of average patterns of usage. The forthcoming CMRS report of the first and second round results will be available in the near future and will provide more details about the full survey findings.

… and better prepare for monitoring and protecting the vulnerable from shocks in the future

The suddenness of the global financial crisis highlighted the difficulties in detecting how shocks affect households. It has also emphasized the need to develop a national, standing monitoring and response system through which the government can quickly and appropriately support households that have been affected by serious shocks. The CMRS can serve as a prototype for a permanent system that monitors shock and vulnerability at the household level.

At the same time, much work remains to be done to establish an emergency response system with clear guidelines as to when to activate a response and which safety net programs should be used. The system should allow for tailored responses that are determined by an analysis of who is affected and how they are experiencing the shock. The response instruments may include programs that have proven to be effective, including (but not limited to) providing unconditional cash transfer (such as *Bantuan Tunai Langsung*, BLT) for vulnerable households or channeling additional block grants to crisis-affected regions through PNPM-Mandiri. In the future, a renewed public works (*Padat Karya*) framework could be established to generate temporary employment for the neediest during and in the wake of shocks. Public works could be implemented through a range of programs, most especially PNPM-Mandiri, which has been shown to decrease unemployment rates in rural areas.

2. Some key features of the Government of Indonesia's Medium Term Development Plan (RPJMN) 2010-2014

a. The recently unveiled RPJMN 2010-14 will be guiding sectoral and regional development plans as well as budgets for the next 5 years

The Government of Indonesia unveiled its Medium Term Development Plan (RPJMN) 2010-2014 on Feb 3, 2010

The RPJMN 2010-2014, which is stipulated through Presidential Decree No. 5/2010, provides policy direction and strategy and underlines national priorities to guide Indonesia's development for the next 5 years. It sets broad guidelines for line ministries in formulating their strategic plans (Renstra-KL) and for provincial and district governments in the formulation and revisions of their medium term development plans in support of national development targets. The current RPJM 2010-2014, the second phase of the Long Term Development Plan (RPJPN) 2005-2025, is a translation of the vision and mission of the President and is guided by the general policy directions of the overall RPJPN. Since both the sectoral plans and the annual budget for the next five years will be guided by the RPJMN, it is important to understand the priorities and policy directions outlined in the current RPJM.

The RPJMN consists of three books and sets out 11 national priorities

The RPJMN consists of three books. These outline national and sectoral priorities, and regional development strategies. In general, the plan is a comprehensive document which details program priorities for the 20010-2014 period along with the expected outputs/outcomes and indicative budgets for each priority and sector. The key features of the three books are:

- Book I outlines the strategy, general policy, and macroeconomic framework which reflect the vision, mission, and 11 national development priorities of the RPJM. These, in turn, reflect priorities set out by the President-Vice President team of Susilo Bambang Yudhoyono-Boediono. The overriding vision is "to realize an Indonesia that is prosperous, democratic, and just".
- Book II outlines sectoral development plans based on the RPJPN 2005-2025 with the theme "to strengthen the synergy across development sectors" in order to accomplish the national development vision in Book I.
- Book III outlines regional development plans by island: Sumatera, Java-Bali, Kalimantan, Sulawesi, Nusa Tenggara, Maluku, Papua with the theme "strengthen the synergy between central and regional and inter-regional governments" to accomplish national development vision in Book I.

The 11 national priorities spelled out in Book I are: i) Bureaucracy and governance reform, ii) Education, iii) Health, iv) Poverty reduction, v) Food security, vi) Infrastructure, vii) Investment and business climate, viii) Energy, ix) Environment and disaster management, x) Least developed, frontier, outer, and post conflict areas, xi) Culture, creativity, and technological innovation.

The priorities are a mix of existing and new development programs and reform initiatives

Most programs set out under the headings of poverty reduction, education, and health are a continuation or expansion of the existing development programs such as the integrated social assistance program including the national insurance system (Jamkesmas), scholarships for the poor, cash transfers (BLT), assistance for poor households (PKH), School Operational Assistance (BOS), and the expansion of rural community development programs (PNPM Mandiri). Some selected new program priorities include constructing about 20,000 km of highway across the five biggest islands, enhancing electricity generation capacity by 3,000 MW per annum, building a transportation infrastructure based on the National Transportation System and Transportation Blueprint, introducing a single identity number to be applied by 2011, reducing the number of least developed areas by 50 districts by 2014, developing a national logistic system and implementing an electronic investment license and information system. These new program priorities reflect the government's focus on infrastructure for the next 5 years.

The government aims to reduce poverty levels to 8-10 per cent by 2014

Through the above priorities, the poverty rate is expected to decline to 8 – 10 per cent from the current level of 14.15 per cent (2009). To achieve this, the government plans to improve the effectiveness of poverty reduction programs by integrating coordination of social/poverty reduction programs into the Vice President's office, expanding the coverage of current programs and developing rural infrastructure. The National Committee for Poverty Reduction is being revitalized to take on the coordination task. The government also aims to reduce the open unemployment rate to 5-6 per cent from 2009 levels of 7.9 per cent.

Table 20: Selected Key Development Targets of the RPJMN 2010-2014-2014

Selected Key Development Targets	2008/09	2014
Unemployment and poverty		
Unemployment rate (%)	**7.9**	**5.0 - 6.0**
Poverty rate (%)	**14.15**	**8.0 - 10.0**
Education		
Increasing GER* for senior secondary education (%)	64.28	85
Increasing GER for tertiary education (age 19 – 23, %)	21.26	30
Health		
Improving life expectancy (year)	70.7	72
Reducing malnutrition (<5 years infant, %)	18.4	<15
Reducing infant mortality per 1,000 deliveries	34	24
Infrastructure (inc. energy)		
Construct 19,370 km of highway: Trans Sumatera, Trans Java, Trans Kalimantan, Trans Sulawesi, Trans West Nusa Tenggara, Trans East Nusa Tenggara, and Trans Papua		Completed
Refine the transportation system and network in the 4 biggest cities (Jakarta, Bandung, Surabaya, Medan)		Completed
Increasing electrification ratio		80%
Electricity generation capacity		Addition 3,000 MW per annum

GER: Gross Enrollment Rate. Source: RPJMN 2010-2014, Ministry of Planning (Bappenas)

…and to significantly enhance key development outcomes

Improving access to and quality of education is the main priority in the education sector. This will be done in various ways including, among others, by providing scholarships for the poor, implementing teacher key performance indicators, balancing teacher-pupil ratios, and achieving a national education standard by 2013. The gross enrollment rates (GER) for senior secondary education and tertiary education are expected to reach 85 per cent and 30 per cent. Outcomes in the health sector are expected to improve: life expectancy is forecast to increase to 72 years and malnutrition to decline to below 15 per cent by 2014. To address long standing challenges in infrastructure, the government plans to construct more than 19,000 km of highways in the five biggest islands and to improve electricity supply by adding 3,000 MW per annum.

The government allocated IDR 1,287.6 trillion for the next 5 years to implement the 11 national priorities

Total resources allocated to implement the 11 national priorities are IDR 1,288 trillion (around IDR 200-300 trillion, or about USD 21-32 billion at current exchange rates, per year). Education, infrastructure, and poverty reduction receive the largest budget allocations, representing two-thirds of the total budget allocated to these 11 national priorities. Despite the comprehensive coverage and detailed programmatic plans, the RPJMN does not provide an estimate of the expected public resource envelope for the next 5 years, preventing further analysis on overall resource envelope and broader budget allocation.

The government targets economic growth averaging 6.3-6.8 per cent for 2010-2014, reaching 7 per cent growth before 2014

The government's aims to achieve an average 6.3-6.8 per cent growth per year for 2010-2014 period, with annual growth rising to 7 per cent GDP growth before 2014. Private consumption, the main source of growth, is projected to grow by 5.3-5.4 per cent per annum, while investment and exports are projected to rise by 9.1-10.8 per cent and 10.7-11.6 per cent annually. The government intends to maintain inflation at a level commensurate with the rate in neighboring countries or 3.5 – 5.5 per cent by 2014 to maintain exchange rate stability and low levels of domestic interest rates.

…while maintaining relatively conservative fiscal policy

On the fiscal front, the government maintains its conservative fiscal policy with relatively moderate budget deficit averaging 1.5 per cent of GDP. As a result total public debt to GDP ratio is expected to decline to 24 per cent of GDP in 2014. The tax to GDP ratio is projected to gradually increase from 12.4 per cent of GDP in 2010 to 14.2 per cent of GDP in 2014, with annual growth in tax receipts of 16.8 per cent.

Table 21: The RPJMN 2010-2014's macroeconomic framework

	Medium Term Projection				
	2010	2011	2012	2013	2014
Economic Growth and Stability					
Economic Growth	5.5 - 5.6	6.0 - 6.3	6.4 - 6.9	6.7 - 7.4	7.0 - 7.7
Inflation rate, CPI (%)	4.0 - 6.0	4.0 - 6.0	4.0 - 6.0	3.5 - 5.5	3.5 - 5.5
Nominal exchange rate (IDR/USD)	9,750 - 10,250	9,250 - 9,750	9,250 - 9,750	9,250 - 9,850	9,250 - 9,850
3 months SBI interest rate (%)	6.0 - 7.5	6.0 - 7.5	6.0 - 7.5	5.5 - 6.5	5.5 - 6.5
Balance of Payments					
Non oil and gas export growth (%)	7.0 - 8.0	11.0 - 12.0	12.5 - 13.5	13.5 - 14.5	14.5 - 16.5
Non oil and gas import growth (%)	8.0 - 9.0	14.0 - 15.6	16.0 - 17.5	17.0 - 18.3	18.0 - 19.0
Reserves (US$ billions)	74.7 - 75.6	82.4 - 84.1	89.6 - 92.0	96.1 - 99.2	101.4 - 105.5
State Budget					
Surplus/Deficit of APBN/GDP (%)	-1.6	-1.9	-1.6	-1.4	-1.2
Tax Revenues/GDP (%)	12.4	12.6	13	13.6	14.2
Government Debt/GDP (%)	29	28	27	25	24

Source: RPJMN 2010-2014, Ministry of Planning (Bappenas)

Transfers to the regions are expected to further increase

Transfers to the regions are expected to continue increasing due to the gradual increase of the DAU and DAK allocations as well as through the continued transfer of responsibilities for program implementation (and corresponding funds) to the regions. Some key policies with regards to transfers to region include the following:

- Gradually increasing the proportion of DAU allocation of total net domestic revenue
- Improving the DAU formula by eliminating the personnel expenditure variable and introducing incentive variables to reward well-performing regions
- Improving fiscal needs estimated to better align with the minimum service standard.
- Gradually increasing the DAK allocation so as to achieve national development priorities and transforming line ministry programs into DAK financial flows that finance decentralized functions such as the School Operational Assistance (BOS) program and the village infrastructure development fund.
- Improving the accuracy, transparency, and disbursement of revenue sharing

Some program priorities are expected to receive significant budget increases or have relatively ambitious development targets; this approach, however, raises concerns regarding implementation capacity and fiscal sustainability

Some priorities are expected to receive significant increases in resources and have relatively ambitious development targets. Accompanying such increases in resources should be a significant improvement of the implementation capacity of responsible agencies. Expansion of certain programs will also be building contingent liabilities that should be taken into account in the design of program expansion. For example the budget allocation for the national health insurance system which is envisaged to cover the whole population by 2014 would impose additional burdens on the national budget and increase forward liabilities. The fiscal costs of these policies may not have been felt so far because supply side constraints have meant that many people entitled to health services have not been able to get them. But as these constraints are addressed the costs of this program will increase significantly raising sustainability concerns. The line ministries implementing priority programs have received significant budget increases (such as agriculture or poverty reduction). They will also need to be properly staffed if the programs are to be managed effectively. Some priority programs will need close coordination with regional governments (such improving access of primary education and provision of clean water). Thus, clarifying the roles and functions of central and sub-national government is critical to ensure the effectiveness of the programs.

b. The RPJM puts renewed emphasis on the need to accelerate growth over the coming half-decade – while ensuring that this growth is inclusive and is shared among all segments of the population

The RPJM takes a strategic view of development policies over the next five years

At an overall strategic level, the RPJM 2010-2014 provides a comprehensive view of the development policies of the Government of Indonesia over the next five years. Many aspects of development are discussed. However looking ahead over the five year period to 2014, as the RPJM itself observes, the expectations of government are high and resources are limited. Indeed, the demands on government are almost unlimited. But the government cannot do everything. Effective government, therefore, will require that rigorous annual priorities are set out to sharpen the focus of the implementation of the overall broad plan.

The Indonesian Government's current development priorities are well-matched with those of the international community; the approach is consistent with Indonesia's expanding international role including in the G20

Indonesia has recently become a member of the G20. As the only G20 member from the ASEAN group of countries, Indonesia's stance towards the key issues on the current international development agenda is important. From this point of view, the economic diplomacy of the RPJM provides strong support for all of the main issues currently under discussion across the international development community in bodies such as the United Nations, international financial institutions, Asian regional organizations, and so on. For example, the RPJM contains considerable discussion of the following issues, amongst others:

- Economic growth, with a strong emphasis on equity
- Democracy and social inclusion
- Environmental issues and climate change
- Productivity, and improving the competitiveness of the economy
- Good governance
- Rule of law, including legal reform in key areas
- Fighting corruption
- Decentralization, to encourage more inclusive government
- Gender, children, related social issues
- Main sectors, with related economic and social issues, such as agriculture, education, health, infrastructure, employment, domestic and international trade
- Reform of the bureaucracy

A strong emphasis on sound economic policies is a central theme of the RPJM

As discussed earlier, the RPJM targets an acceleration of annual economic growth to over 7 per annum in real terms by the end of the five-year period. To this end, considerable attention is given to both the better mobilization of all main types of economic inputs as well as measures to improve productivity. The advantage of this approach is that it sends a strong signal to both public sector agencies as well as the private sector that the government gives high priority to creating the environment for a sound expansion of economic activity. However, the challenge for the government will be to implement the strategy as it is easier to formulate policies than to implement them.

Better mobilization of key inputs is seen as a priority to underpin accelerating economic growth

On the inputs side, it is recognized that for many reasons, economic inputs such as land, labor, capital, and entrepreneurship are often not mobilized effectively in Indonesia. The RPJM notes that numerous problems relating to the acquisition of and the efficient use of land are holding back much investment. Labor is seen to be underutilized as well. In recent years the bulk of new entrants to the labor force have been absorbed in low productivity activities in the informal sector in small and micro enterprises. Further, it is noted that large amounts of investment will be needed to underpin faster economic growth. Measures to improve the investment climate for both domestic and foreign investors are therefore listed as a priority. And the crucial role that entrepreneurs play in promoting, especially, private sector growth is acknowledged in the growth strategy set out in the RPJM.

… and increases in productivity are also crucial as part of the program to accelerate growth

Approaches to the promotion of improved technologies, both through improved training opportunities which focus on technology as well as support for the adoption of improved technologies across all sectors of the economy, are outlined in the RPJM. Measures suggested to promote international competitiveness with an eye to encouraging productivity improvements include steps to reduce underlying costs of operating in various sectors in Indonesia, and programs to promote exports.

The RPJM sets out a *pro growth, pro jobs* and *pro poor* strategy

A variety of themes and approaches to national priorities are set out in the RPJM but the emphasis on a strategy which is *pro growth, pro jobs* and *pro poor* is notable. The RPJM observes that *growth with equity* is needed, and that a range of cross-cutting policies should be designed to ensure that development is both sustainable and inclusive. Within this context, two of the strategies outlined in the RPJM need to receive particular attention. These are the strategies:

- to develop infrastructure, and
- to strengthen the pro poor agenda.

Investments in infrastructure – particularly infrastructure that is geared toward meeting the needs of the poor – are urgently needed to ensure that lack of infrastructure services are not the constraint on the poor's ability to benefit from national economic growth

A pro poor approach to infrastructure would reinforce the government's overall emphasis on *pro poor* growth

The RPJM sets out an agenda for the expansion of the infrastructure sector. A useful supplement to the current approach would be to place increasing emphasis on pro poor projects in the infrastructure sector. The key elements of such an approach are to design both infrastructure facilities and policies so that first, the poor have adequate physical access to infrastructure and that second, the prices charged for the services are affordable to the poor.

Different markets in the infrastructure sector need to be distinguished

The first step in designing pro poor infrastructure projects is to distinguish between the several distinct markets for many infrastructure services in Indonesia. These markets tend to be segmented with different suppliers providing different types of services to the different types of consumers. On one hand, there is demand from consumers in the modern, formal sector of the economy. These consumers tend to want large amounts of high quality infrastructure services. They are usually prepared to pay international prices, or more, provided the services provided are satisfactory. On the other hand, there is also a demand from small scale consumers, many of whom mainly live and work in the informal sector of the economy. Consumers in this sector can often only afford to purchase small (sometimes micro) amounts of infrastructure services.

Different arrangements for the supply of infrastructure to the different segments of infrastructure markets are needed

In designing infrastructure policy it is crucial to distinguish between these two markets. State owned utilities in Indonesia may not be able to reach all potential customers, in particular in the informal market. As a result, in many parts of the infrastructure sector – in road and water transport, in rail, in electricity, and in water supply and sanitation – a myriad of informal arrangements exist to provide services. This 'shadow' informal sector, which is largely unregulated, has sprung up and even flourished because it is able to carter to the needs of small scale consumers. The suppliers of infrastructure in the informal sector are usually prepared to supply small amounts of services for small payments. It is true that the quality of their services is usually below – sometimes well below – the quality of services provided in the formal sector, but the *total charges* for their services to consumers is often low (even though the *unit cost* of their services is frequently much higher than the unit costs of those provided in the formal sector).

Reforms are needed to ensure that the supply of infrastructure services meets the needs of the poor

In principle, the steps that need to be taken to provide improved infrastructure services to low-income consumers in Indonesia are clear. On one hand, reforms are needed to encourage government-owned utilities (including at the provincial and kabupaten/kotamadya level) and other suppliers in the formal sector to design and supply products which meet the simple needs of small scale consumers. As part of this approach, more effective ways of focusing government expenditure on small scale infrastructure projects in a cost-effective way, especially at the provincial and kabupaten/kotamadya level, should be designed. On the other hand, there needs to be a more positive approach towards reliance on private sector providers of infrastructure services. Small scale private sector providers should be seen as partners who can help fill important gaps in the market for infrastructure services rather than as unreliable entrepreneurs and middlemen who flout government regulations.

***Pro poor* infrastructure would help boost productivity in the informal sector and would support strong economic growth**

There are strong economic arguments in favor of designing infrastructure programs to supply better infrastructure services that also benefit lower-income groups. An increased supply of *pro poor* infrastructure would therefore reinforce the emphasis that the government has given to a *pro-growth* and *pro-jobs* approach in formulating the RPJM. At present, the loss of productivity in the informal sector resulting from lack of access to appropriate infrastructure is very large. Many millions of person-hours are wasted each year across Indonesia, for example, because of the large amounts of time that men, women and children must devote to hauling small amounts of water for personal use in both urban and rural areas. Similarly, small scale enterprises are often restricted in their use of electrical machinery because of the unreliable supply of electricity for small industry and other commercial users. And in rural areas, the isolation caused by the lack of simple feeder roads is a major barrier to development. The costs of inputs such as tools, fertilizers and insecticides are forced up at the farm level when communications are poor and access for farmers to markets to sell their produce is badly restricted. The construction of rural roads which link villages with nearby towns thus both improves the terms of trade for farmers and facilitates access for village communities to town-based social infrastructure such as schools and hospitals.

c. The RPJM also foresees a continuation of government efforts to combat poverty through targeted poverty programs, and identifies rising inequality as a main constraint for sustainable and balanced development

Tackling poverty and inequality

Themes of addressing both poverty and other forms of inequality are prominent through the RPJM. The importance of formulating a range of policies to tackle the following range of inequality issues in Indonesia is emphasized:

a) Poverty levels, as reflected in the national poverty line
b) Income inequalities, seen in the widening Gini coefficient
c) Rural and urban differences
d) Employment opportunities
e) Regional differences across Indonesia

This is a challenging set of issues. Each of the topics raises specific policy matters -- and each also adds to the extensive list of cross-cutting matters that Indonesian policy-makers are expected to bear in mind when preparing sectoral policies.

There are sound economic as well as social reasons for addressing the equity agenda

There are sound economic as well as social reasons for addressing these issues. For one thing, the inefficient use of resources which underpins these inequalities, especially labor which is widely underutilized across Indonesia, represents huge waste. A key challenge for policy-makers, therefore, is to design programs to utilize the human resources of the nation more effectively. For another thing, in the past, tensions arising from inequalities across Indonesia have led to open conflict. This conflict, in turn, has imposed high economic costs and has delayed development. Investment and growth in Aceh, for example, were held back in the 1990s during the period of conflict in the province. The processes of development in Aceh have been much more successful since the resolution of the regional conflict in 2005.

The reduction of measured poverty is given high priority in the RPJM

The government of Indonesia gives high priority to the aim of reducing the levels of measured poverty. One main theme of the RPJM is that poverty levels can be expected to fall as the economic growth rate accelerates towards the 7% per annum target level. However, accelerated economic growth may not be enough to reduce poverty levels in a significant way. Despite the emphasis that the government has given to the objective of reducing poverty, measured levels of poverty have not fallen as fast as desired in recent years. Renewed policy responses are needed to strengthen links between overall economic growth and levels of poverty. Policy measures which, in addition to the level of overall economic growth, might be given more support include programs to reduce underemployment in the informal sector and targeted interventions directed towards poverty reduction goals.

But a focus on income inequality is needed as well

Measures to deal with the levels of measured poverty alone are not enough because many Indonesians live just above the poverty line. There are many millions of Indonesians who could easily slip back into poverty, especially if the prices of basic commodities were to rise unexpectedly. Furthermore, as the RPJM notes, income inequalities across Indonesia (as measured by the Gini coefficient) can widen even while the level of measured poverty is falling. Broader approaches are needed to tackle overall issues of inequality to ensure that the benefits of development are widely shared: pro poor fiscal policy is important, on both the revenue and expenditure side of government budgets; increased provision of social infrastructure is needed to bridge social inequalities; and continued attention to job creation policies is part of an appropriate package to reduce inequalities.

Key development challenges are emerging as the rural-urban gap grows wider

Indonesia's urbanization rate has increased significantly in recent decades. The RPJM acknowledges that as a result of these trends new development challenges are emerging in both rural and urban areas. On one hand, the RPJM notes that problems resulting from the rapid growth of urban areas are becoming more acute. Demands on both economic and social infrastructure are becoming urgent in urban areas such as Jakarta and other large cities. But the changes are also leading to new strains in rural areas as young people move to the cities and as pressures on local resources are increasingly evident. Issues of land management and people movement therefore call for attention. In urban areas, large scale investment in infrastructure in such sectors as transport, flood control, and housing is called for. In rural areas, village communities give high priority to roads, local water supplies, and the supply of education and health facilities. New technologies in agriculture are also needed to help boost rural productivity.

Employment creation is seen as a priority in the context of a *pro jobs* approach

Policy-makers in various developing countries in Asia have been concerned that jobless growth has been a characteristic of economic expansion in a number of countries in the region in recent years. There are worrying aspects to the situation in Indonesia as well. For one thing, Indonesia has lagged behind prosperous neighboring countries in boosting productivity by creating higher value-added non-agricultural jobs. Further, employment growth in Indonesia has failed to match population growth since the regional economic crisis in 1997-98. Between 1999 and 2003, the share of workers employed in the formal sector fell markedly from 43 per cent to 35 per cent because there was a tendency for workers displaced in the formal sector to retreat to the informal sector for employment. There have been some significant improvements since then but the employment rate in the formal sector is still below what it was before the crisis. Indeed, the figures set out in the RPJM illustrate the challenge. On one hand, the rate of job creation during the period 2005-2009 was around 2.7 million per year, comfortably in excess of the increase in the labor force of about 2.0 million per year. As a result, the level of open unemployment fell from nearly 10 per cent in 2004 to 7.9 per cent in 2009. But disappointingly, out of the total number of almost 11 million new jobs, only 30 per cent (3.3 million) were created in the formal sector. The other 70 per cent of jobs were created in the low-productivity low-income informal sector. Recognizing the problem, the RPJM notes that '*Perpindahan "surplus tenaga kerja" keluar dari lapangan pekerjaan informal ke pekerjaan-pekerjaan formal yang lebih produkrif dan memberikan upah yang lebih tinggi merupakan tujuan utama dari siklus pembangun, pertumbuhan ekonomi dan pengurangan kemiskinan*'. ['The movement of surplus labor from the informal sector into formal work environments where productivity and wages are higher is a main objective expected to be achieved from the interlinked process of development, economic growth, and reductions in the level of poverty.']

Attention needs to focus on ways of improving both employment opportunities and working conditions in the informal sector as well as the formal sector

In responding to the employment challenge in Indonesia, it is useful to distinguish between unemployment and underemployment. Official attention to issues relating to employment policy in Indonesia often focuses on the unemployment rate in the formal sector. However, it is the phenomenon of mass underemployment in the informal sector which is of more relevance to the great majority of workers across the country. Thus while it is true that policies are needed, as the RPJM emphasizes, to facilitate the movement of labor from the informal to the formal sector, attention is also needed to working conditions in the informal sector. The prospects are that the majority of workers in Indonesia will continue to be employed in the informal sector for some decades to some. Policies are therefore needed to help improve both employment opportunities and the quality of jobs in the informal sector.

Accelerated growth may not be enough to create the types of decent jobs which are seen as needed

Within this context, the attention given in the RPJM to fostering economic growth that is *pro jobs* is therefore welcome. However there is no guarantee that accelerated economic growth will create the increasing number of *decent jobs* which the RPJM suggests are needed. In the 1980s and early 1990s, many jobs were created in labor-intensive manufacturing industries. However growth in manufacturing has slowed in recent years and is projected to grow at the relatively sluggish rate of around 6 per cent per annum during the RPJM period. A central challenge for policy-makers, therefore, will be to promote policies that will help create jobs in other sectors. However, many firms in the formal sector report that various aspects of the current labor laws are a barrier to the recruitment of permanent full-time staff. The current severance system in the formal sector is in need of reform, as are other aspects of current labor laws. But policies are also needed to create expanded job opportunities in the informal sector, especially in service industries such as construction, trade and transportation.

While in the long term job creation will need to come from increased productivity and competitiveness in labor-intensive sectors (such as manufacturing and certain services sectors), short-term measures which the government might consider to stimulate employment, especially in the informal sector, include greater reliance on labor-intensive public works schemes, particularly in rural areas, and expanded support for the small and medium-enterprise (SME) sector. Indeed, the RPJM places considerable emphasis on measures to promote SMEs. Policies of this kind have a long history in Indonesia but in practice, they have often proved ineffective. It has proved difficult for successive governments to find effective ways of fostering growth in the SME sector. Indeed, experience both in Indonesia and elsewhere suggests that the best way to help firms in the SME sector is, first, to promote strong, broadly-based economic growth, and second, to create a pro-business environment in all main sectors of the economy by implementing policies to tackle such constraints on business as excessive regulatory controls and infrastructure bottlenecks.

d. A decentralized Indonesia presents both challenges and opportunities in implementing development plans: reforms to the decentralization framework may be needed to increase the effectiveness of local governments in delivering key public goods and services

The relationship between the national government and regional governments has received much attention since the decentralization measures introduced during the past decade…

In recent years, democratization and decentralization have fundamentally changed accountability and decision-making processes at all levels of government across Indonesia. Partly as a result of the "big bang" decentralization measures introduced during the past decade, citizens and community groups are increasingly prepared to voice their opinions about government at both the provincial and district level. The relationship between the national government and regional governments is receiving increasing attention as well. Enhanced democracy and political participation at the regional level has encouraged local groups to be increasingly active in demanding more from Jakarta.

… so policies to respond to regional differences across Indonesia are outlined in the RPJM

Issues of regional development and equity, and the closely related subject of national unity, have been seen as matters of prime importance by national policy-makers ever since Indonesian Independence in 1945. The dilemma for policy-makers in Jakarta in balancing national and regional priorities is this: on one hand, in order to promote rapid overall national economic growth, there are good economic arguments for focusing efforts to promote investment and development on selected leading regions; to take advantage of agglomeration benefits. This focus on promoting growth in leading regions should be accompanied with continuing fiscal transfers to ensure the delivery of minimum services in lagging regions. Noting that issues of this kind need close attention, the RPJM outlines five main steps to help tackle the conflicting priorities of regional development policy:

1. Promote growth in regions seen as having good potential outside of Java-Bali and Sumatra while at the same time maintaining the momentum of growth in Java-Bali and Sumatra.

2. Strengthen interregional linkages by increasing interisland trade to support domestic economic activities.
3. Strengthen the competitiveness of regions by promoting leading sectors with specialized advantages in each region.
4. Promote the development of lagging regions, strategic areas, and regions with potential, as well as border and outlying regions, and areas facing high risks of disasters.
5. Support the development of regions and sectors oriented towards sea-faring and sea-related activities.

Choices will need to be made in this approach to regional development. Tradeoffs in policy will be needed…

The challenges implicit in this approach to regional development are daunting. The RPJM does not directly discuss the tradeoffs in policy which are likely to be necessary but they will need to be addressed. If, as the RPJM suggests, there is to be an emphasis on regional comparative advantage, this approach is likely to widen rather than reduce the present gaps between regions. It is easier, for example, to identify sectors with strong growth potential in provinces such as North Sumatra and South Sulawesi than in lagging regions such as some provinces in Eastern Indonesia. It is precisely in order to cope with the national implications of uneven regional growth patterns of this kind that many countries have created intergovernmental fiscal mechanisms which redistribute resources between states or provinces.

… and proposed capacity reforms in local government to support regional development may be slow in coming

In addition to the five steps outlined above, one of the main ways that the Indonesian government proposes to strengthen regional development is to support institutional strengthening of government at the district (kabupaten/kotamadya) level. However following the rapid expansion in the number of regional governments in recent years known as *pemekaran* [proliferation], there are now over 500 provincial and district governments across Indonesia. In many cases, the administrative capacity of these governments, especially at the district level, is currently badly stretched. Programs to strengthen government at these levels are to be welcomed. However a realistic assessment is that it will be some time before improvements in performance at the regional government level can be expected to become evident. In the short-term, programs to strengthen the capacity of governments at the regional level are unlikely to deliver the results that local communities are increasingly coming to expect.

e. The challenges ahead: priorities for improving government management and effectiveness

Challenges ahead: five main issues of government management will influence the way that the RPJM is implemented

The broad view that the RPJM presents of the development challenges over the period to 2014 is a comprehensive one. However, as the RPJM itself emphasizes, the effective implementation of the program will require a tighter focus on key priorities. And in setting priorities, the government's approach to five main issues of government management will play a major role in influencing the way that the RPJM is implemented. These issues are:

- The role that government sets for itself
- Civil service reform
- The stance of fiscal policy
- The effective use of public expenditures
- Management of decentralization

One risk is that governments will try to do too much…

A major challenge is that in implementing the RPJM, governments at all levels in Indonesia will try to do too much. The result would be that too many government programs would be spread too thinly across too many different activities, thus greatly complicating the task of efficient management of government. Indeed there is already a good deal of fragmentation of activity in many parts of government programs in Indonesia. Further dispersal of government resources across an increasing number of small, scattered programs would be quite wasteful.

… so a streamlining of government and the setting of strict priorities is called for

The solution is to place much greater emphasis on the streamlining of government and to set strict priorities. Governments at all levels in Indonesia need to consider what they will *not* do, as well as what they *will* do. This will not be easy, especially in the highly democratic environment which has emerged in Indonesia in recent years. There is a great deal of political competition for resources and influence in the hundreds of national and regional parliaments and assemblies that now exist. The RPJM clearly recognized the need to make choices in the following terms: '*Permasalahan dan tuntutan pembangunan yang dihadapi akan bertambah banyak, sedangkan kemampuan dan sumber daya pembangunan yang tersedia cenderung terbatas. Pemerintah harus mengoptimalkan pemanfaatan sumber daya yang tersedia untuk memenuhi tuntutan yang tidak terbatas dengan membuat pilihan dalam bentuk skala prioritas. Dalam menentukan pilihan tersebut, pemerintah bersikap realistis, dengan tidak membuat sasaran-sasaran yang sejak semula disadari tidak bisa dipenuhi*.' ['The problems and demands of development will continue to increase while the capacity and resources available to respond to these development challenges are quite restricted. Governments must aim to make optimum use of the available resources to meet these virtually unlimited demands by making choices in terms of development priorities. The government will be quite realistic about making these choices because from the beginning of the planning process, care has been taken to avoid setting unrealistic targets which cannot be met.']

Civil service reform is now an urgent priority to improve the capacity of government…

A closely related problem affecting the ability of government to implement the programs outlined in the RPJM is the limitations on the capacity of both the Indonesian civil service and of other implementing agencies such as the numerous national and regional state-owned enterprises. Government effectiveness in Indonesia has been limited by insufficient capacity and accountability of civil servants, both at the national and regional level.

...and a package of issues should be addressed to help improve the performance of the civil service

A range of issues need attention within the plans for civil service reform outlined in the RPJM. For one thing, salary arrangements, working conditions, and limited opportunities for career advancement often fail to provide effective incentives to civil servants to improve their performance. For another thing, bureaucratic accountability is limited by rigid civil service rules which apply at both national and regional levels. A third major problem arises from difficulties of both horizontal and vertical coordination of policy formulation and implementation between government agencies across Indonesia. This problem of coordination has been greatly compounded by a lack of clarity in Indonesia's decentralization framework. Other issues needing attention as well include transparency in government, accountability, and in-service training programs to ensure that civil servants at all levels have the skills they need to provide the services that the Indonesian community now expects.

There is also room for a careful expansion in fiscal policy...

A third area where reform would introduce more flexibility into the ability of government to implement the RPJM is fiscal policy. Fiscal policy in recent years in Indonesia has been quite cautious. Average budget deficits over the past decade have been less than 2 per cent of GDP, and in the last five years realized deficits have been around 1 per cent of GDP. On one hand, this careful approach has served Indonesia well because, importantly, it helped reduce Indonesia's public debt to GDP ratio from very high to relatively low levels, underpinning the resilience of the Indonesian economy during the 2008-09 global financial crisis. But on the other hand, there are significant opportunity costs involved in maintaining such low fiscal deficits as well. The room for even modest increases in spending in selected priority areas has been tightly constrained. Looking ahead to the need for pro-growth reforms during the RPJM period, a decision to adopt a more expansionary fiscal policy allowing for deficits which are, say perhaps 1 per cent of GDP higher than in recent years – still quite conservative when set against current international benchmarks -- would provide the government with much-needed additional resources to tackle some of the main bottlenecks constraining growth in Indonesia at present. An approach of this kind would be consistent with the government's policy of maintaining a low national debt level and thus protecting Indonesia's established reputation for the sound management of official international debts.

…which would allow for increases in spending across a number of priority areas

Additional financial resources made available from a more expansionary fiscal policy could be used effectively in at least three main areas. First, there is now an urgent need to increase spending on infrastructure. Indonesia has amongst the lowest levels of access to infrastructure in the region. Surveys of business firms regularly indicate that the poor quality of Indonesia's infrastructure is seen as a significant deterrent to job-creating investment and has hindered Indonesia's international competitiveness. Better infrastructure will therefore be critical to underpin the goal set out in the RPJM of accelerating growth. Second, government spending on the direct social assistance programs in Indonesia, less than 1 per cent of GDP, is still very low. Modest increases in spending on the main programs would support the *pro-poor* approach of the RPJM, and if well-presented would have the additional advantage of helping build community acceptance for a redirection of government spending in such areas as subsidies for fuel, power, and fertiliser. Third, although there is often popular resistance to proposals to increase salaries and other expenditures on the civil service in Indonesia, improved wages and working conditions are necessary preconditions to overall reform of government across the country. To be sure, increased spending on the civil service needs to be accompanied by a wider package of management reforms as well but it is difficult to see how government can become more effective in Indonesia unless increased resources are made available for key agencies of the civil service.

Improved efficiency in the management of public expenditures is also called for…

A fourth area calling for closer attention during the implementation of the RPJM is the efficiency of the management of public expenditures. It is true that that the resources available to governments in Indonesia are limited. Central government annual expenditure in Indonesia is around USD 450 per year per capita. In contrast, the equivalent figure in OECD countries is in the range of USD 8,000- USD 10,000 per year. It is important to acknowledge this constraint of limited resources because the challenge of managing programs within very tight budget constraints is a very real one for managers at all levels of government across Indonesia.

...because there is much that can be done to improve the effectiveness of government spending in Indonesia

Nevertheless, there is much that can be done in Indonesia to improve the effectiveness of government spending. For one thing, objectives for government spending programs need to be more clearly defined. At present, objectives for specific programs are often vague. It is difficult to know whether programs are achieving the desired objectives if the objectives themselves are unclear. For another thing, administrative arrangements both for expenditures of funds and for checks over spending need to be improved. Where the main form of disbursement of funds is cash such as in certain social assistance programs, careful checks over the management of the cash payments are needed. Where the main form of disbursement is through public procurement, civil service staff need to be well-trained in the management of contracts which govern the flow of funds. Third, better information is needed to improve the quality of public expenditure. Amongst other things, improved procedures for monitoring and evaluation of public expenditure should be introduced. The data required for the targeting of social spending, or for the management of public procurement, is often unsatisfactory. And because there are relatively few performance evaluations of government spending programs in Indonesia, the feedback loops that could provide government managers with the reliable information required to design better programs are often weak.

The management of decentralization is central to the overall governance of Indonesia…

The fifth policy priority concerns the management of decentralization. This, too, is a matter which is now central to the overall administration and governance of Indonesia. Following the 'big bang' decentralization introduced a decade ago, Indonesia has gone from having a highly centralized system of government to having a very decentralized one. Considering the complexity of the transformation, Indonesia has coped extremely well because the political, administrative, and fiscal changes have been dramatic. Nevertheless, as the RPJM notes, because the changes were introduced in a relatively short period of time, there is much in the legal and regulatory arrangements which relate to the decentralization reforms which is unclear.

… so a careful review of the numerous laws and regulations relating to decentralization is increasingly urgent to improve the effectiveness of government at all levels.

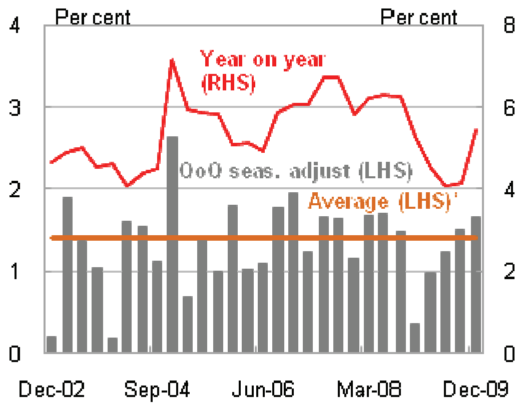
It is widely agreed that the numerous laws and regulations relating to decentralization should be reviewed with the aim of clarifying a range of important issues. There is, for example, considerable uncertainty surrounding the position and role of the governors of provinces: there are different views as to whether the main role of governors is to act as representatives of the Government of Indonesia at the provincial level (which would reflect a centralist view of their role) or to represent the interests of the province at the central level (which would reflect a decentralist view of their role). Similarly, there is a good deal which is uncertain in matters relating to the division of authority between provincial and district (*kabupaten/kota*) levels of government. Further, legal and administrative arrangements relating to budgetary procedures at the provincial and district level need more definition. Governments at both levels remain heavily dependent on fiscal transfers from the central government although, in principle, a wide range of functions has been transferred from the central government across to provincial and district governments. In order to improve the coordination and effectiveness of government at all levels in Indonesia, it is increasingly urgent that the uncertainty in these and other matters affecting the arrangements for decentralization in Indonesia be clarified.

These reforms would support accelerating growth raising the possibility that Indonesian might move towards a high-growth path in the 8-9 per cent range by the middle of the coming decade

Looking ahead, the prospects for accelerating growth in Indonesia during the RPJM period are promising. Indeed, the target set out in the RPJM of achieving a rate of growth in excess of 7 per cent per annum by the end of the plan period may even understate the potential for growth. For the first time since the economic crisis of 1997-98, it is time for policy-makers to begin considering whether a sustained growth rate in excess of 8 per cent per annum might be achievable in Indonesia. Certainly some of the main constraints on growth noted earlier in this brief would need to be addressed to allow Indonesia to raise growth to0020the 8-9 per cent range. But if the government can build on the successes of recent years, a high-growth path for Indonesia seems increasingly within reach.

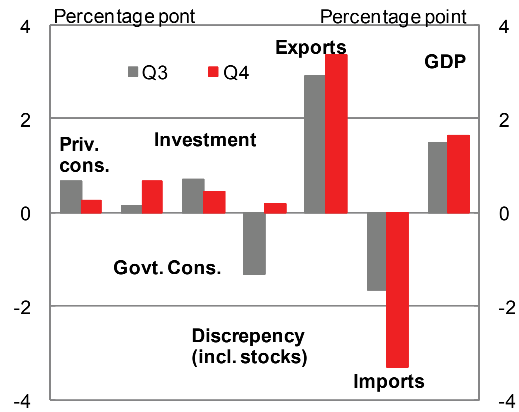
APPENDIX: SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Figure 1:GDP growth continues to accelerate
(per cent growth)



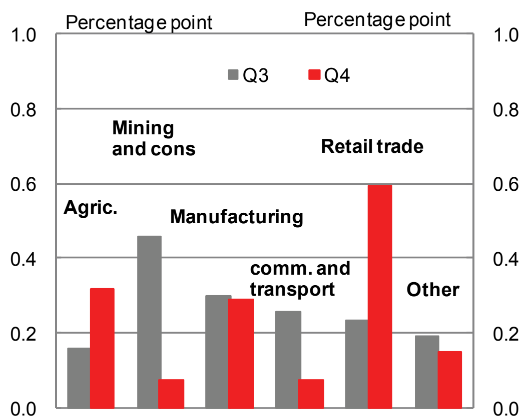
Sources: BPS, World Bank seasonal adjustment

Figure 2: Contributions to GDP (Expenditure)
(quarter-on-quarter seasonally adjusted)



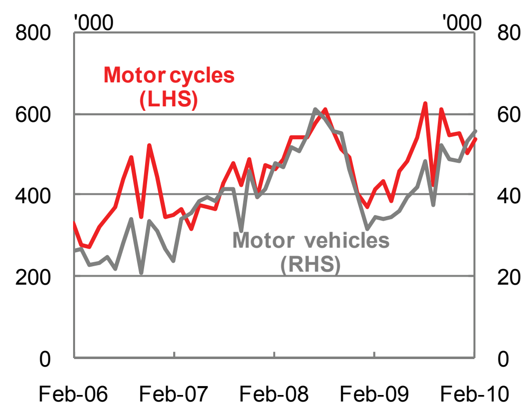
Source: BPS via CEIC, World Bank seasonal adjustment

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



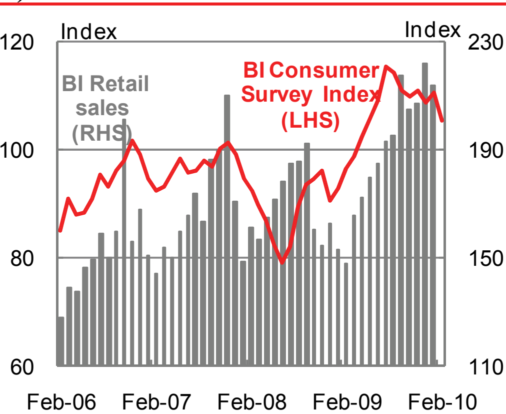
Source: BPS via CEIC World Bank seasonal adjustment

Figure 4: Motor cycle and motor vehicle sales
(levels)



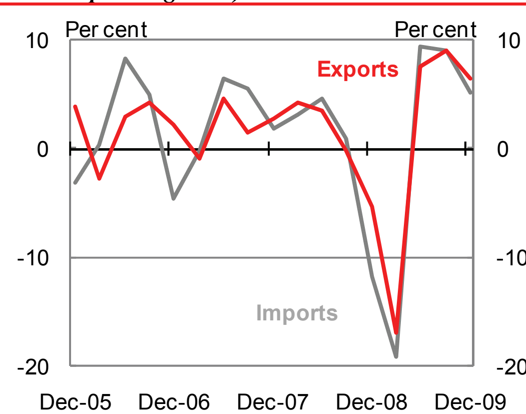
Source: CEIC

Figure 5: Consumer indicators
(indices)



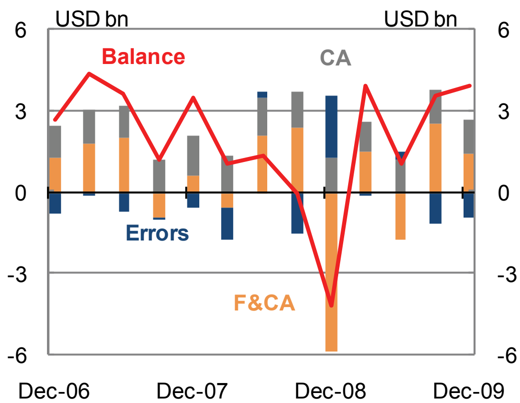
Source: BI via CEIC

Figure 6: Real trade flows
(quarter-on-quarter growth)



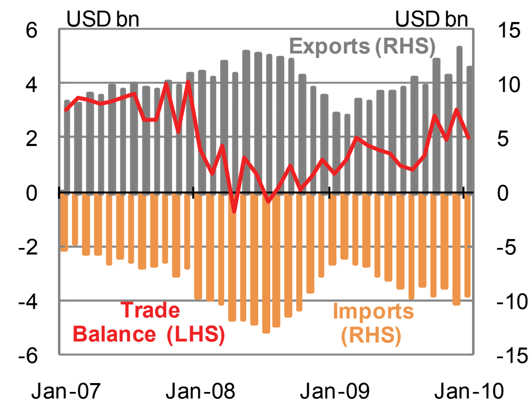
Source: BPS via CEIC

Figure 7:Balance of Payments
(billions of USD)



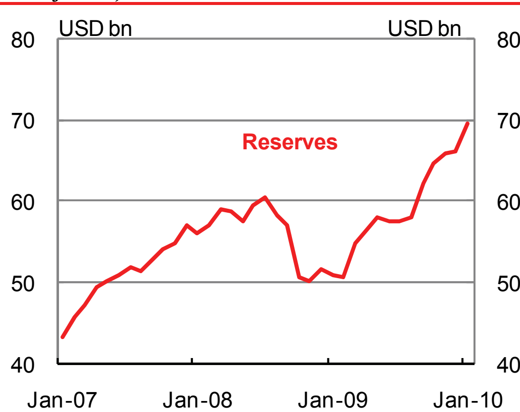
Source: BPS and World Bank

Figure 8: Trade balance
(billions of USD)



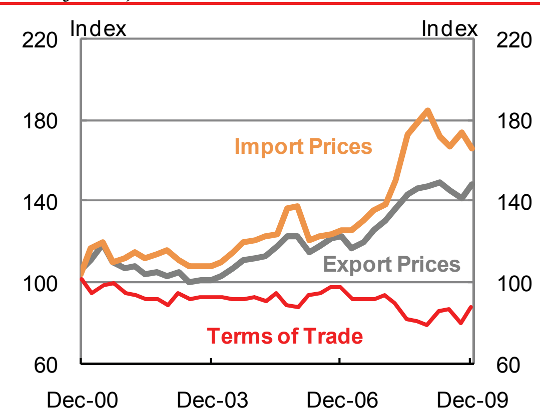
Source: BPS and World Bank

Figure 9: International reserves
(billions of USD)



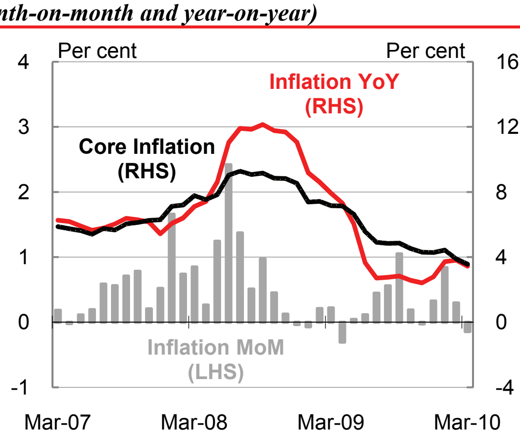
Source: BPS

Figure 10: Terms of trade and implicit export and imports prices, quarterly
(billions of USD)



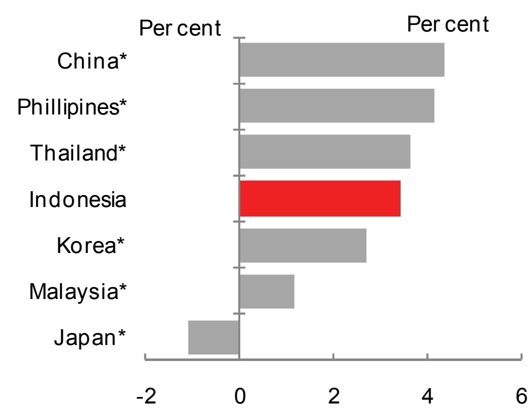
Source: BPS and World Bank

Figure 11: Inflation
(month-on-month and year-on-year)



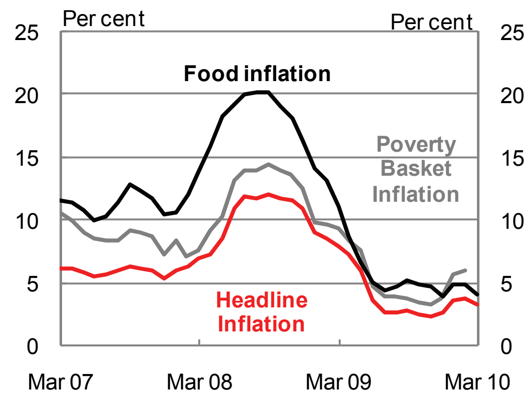
Source: BI and BPS

Figure 12: Inflation amongst neighboring countries
(year-on-year March 2010)



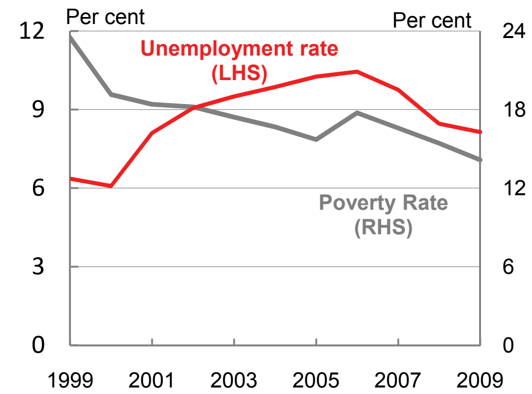
*February is latest data point
Sources: National statistical agencies via CEIC and BPS

Figure 13: Inflation, food prices and poverty basket inflation *(year-on-year)*



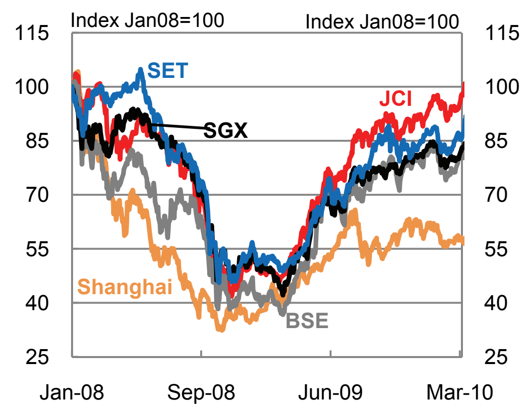
Sources: BPS, World Bank seasonal adjustment

Figure 14: Poverty and unemployment rate *(yearly data points)*



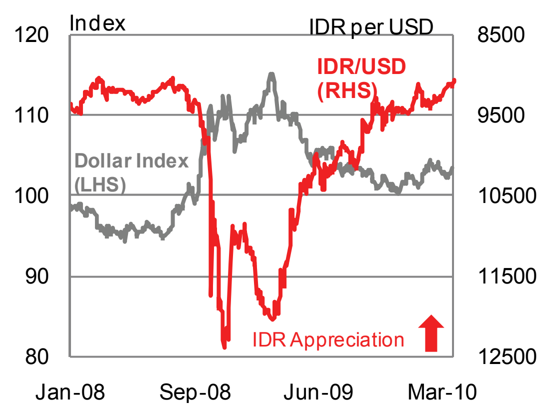
Source: BPS, Sakernas and World Bank

Figure 15: Regional equity indices *(daily, index)*



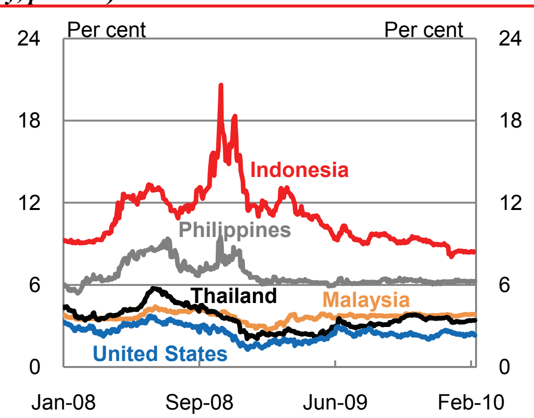
Sources: World Bank and CEIC

Figure 16: Broad Dollar Index and Rupiah spot *(daily, index and levels)*



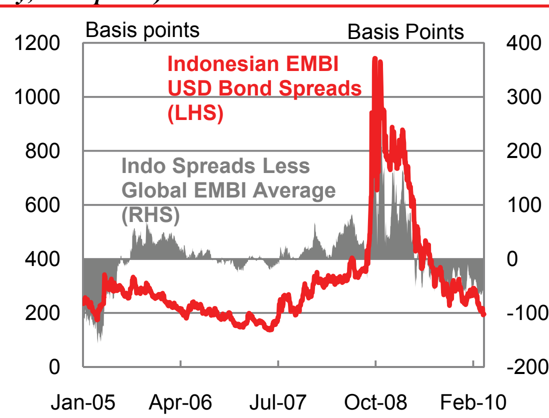
Sources: World Bank and CEIC

Figure 17: 5-year local currency bond yields *(daily, per cent)*



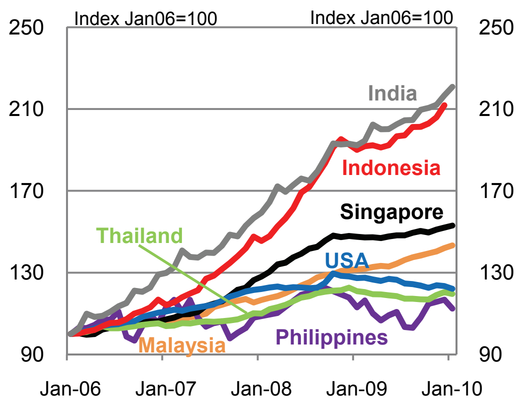
Sources: World Bank and CEIC

Figure 18: Sovereign USD Bond EMBI Spreads *(daily, basis points)*



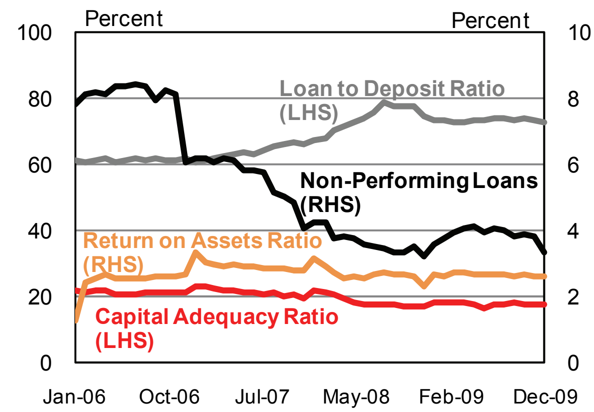
Sources: World Bank and CEIC

Figure 19: International commercial bank lending
(monthly, index)



Sources: World Bank and CEIC

Figure 20: Banking sector indicators
(monthly, per cent)



Sources: World Bank and BI

Figure 21: Budget outcomes and estimates
(trillions of IDR)

	2008 Actual	2009 Actual (prelim.)	2010 Budget	2010 Proposed revised Budget	2010 (p) WB estimate
A. State revenues and grants	981.6	868.9	949.7	974.8	1,002.4
1. Tax revenues	658.7	641.4	742.7	733.2	757.4
o/w natural resources	327.5	317.6	350.9	356.0	381.8
- Oil & gas	77.0	50.0	47.0	54.7	62.6
- Non oil & gas	250.5	267.6	303.9	301.4	319.2
2. Non tax receipts	320.6	226.4	205.4	239.9	245.1
o/w natural resources	224.5	137.9	132.0	160.5	166.5
i. Oil and gas	211.6	125.7	120.5	149.0	153.5
ii. Non oil and gas	12.8	12.2	11.5	11.5	13.0
B. Expenditures	985.7	956.4	1,047.7	1,104.6	1,085.5
1. Central government	693.4	647.8	725.2	770.4	752.3
2. Transfers to the regions	292.4	308.6	322.4	334.3	333.1
C. Primary Balance	84.3	6.4	(98.0)	(17.4)	23.8
D. SURPLUS / DEFICIT	(4.1)	(87.4)	(98.0)	(129.8)	(83.0)
Deficit (per cent of GDP)	(0.1)	(1.6)	(1.6)	(2.1)	(1.3)

Source: MoF and World Bank estimates

Figure 22: Balance of Payments
(trillions of IDR)

	2007	2008	2009	2009 Q1	2009 Q2	2009 Q3	2009 Q4
Balance of Payments	12.7	-1.9	12.5	4.0	1.1	3.5	4.0
Per cent of GDP	*2.9*	*-0.4*	*2.3*	*3.5*	*0.8*	*2.4*	*2.6*
Current Account	10.5	.1	10.6	2.5	2.5	2.2	3.4
Per cent of GDP	*2.4*	*0.0*	*1.9*	*2.2*	*1.9*	*1.5*	*2.2*
Trade Balance	20.9	9.9	21.0	4.1	5.1	5.0	6.9
Net Inome & Current Transfers	-10.4	-9.8	-10.5	-1.6	-2.6	-2.8	-3.4
Capital & Financial Accounts	3.6	-1.9	3.7	1.5	-1.8	2.5	1.4
Per cent of GDP	*0.8*	*-0.4*	*0.7*	*1.3*	*-1.3*	*1.7*	*0.9*
Direct Investment	2.3	3.4	2.3	.5	.4	.5	1.0
Portfolio Investment	5.6	1.7	10.1	1.9	2.0	3.0	3.3
Other Investment	-4.8	-7.3	-8.8	-.8	-4.1	-1.0	-2.9
Errors & Ommissions	-1.4	-.2	-1.7	-.1	.3	-1.1	-.9
Foreign Reserves*	56.9	51.6	66.1	54.8	57.6	62.3	66.1

Source: MoF and World Bank estimates

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