Financial Deepening for Stronger Growth and Sustainable Recovery
Table of Contents

Table of Contents ii
Preface v
Abbreviations vii
Executive Summary 1

A. Economic Fiscal Update 10
1. A Diagnostic of the Recovery 10
2. The Policy Response 21
3. The Outlook 30
4. Structural Reform Priorities 33

B. Strengthening the Financial Sector to Support an Inclusive and Sustainable Recovery 44
1. Introduction 44
2. Deepening the Indonesian Financial Sector 48
  2.1. Financial Sector Context 48
  2.2. Opportunities for deepening the financial sector 51
3. Policy Recommendations 62
  3.1. Increasing demand and supply of finance 62
  3.2. Improving the allocation resources through the financial sector 65
  3.3. Strengthening the capacity of the financial system to withstand financial and non-financial shocks 68

References 72

NOTE: CLICK THE SIDE BUTTONS TO GO TO THE SECTION YOU WANT TO READ OR GO TO THE TABLE OF CONTENTS (TOC). CLICK HOME BUTTON TO GO BACK TO TOC PAGE
### FIGURES

<table>
<thead>
<tr>
<th>Figure A.1: The recovery continues...</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure A.2: Leading indicators on investment also point to continued recovery...</td>
<td>12</td>
</tr>
<tr>
<td>Figure A.3: Narrowing output gap and increase in input cost led to increase in inflation, including core inflation</td>
<td>17</td>
</tr>
<tr>
<td>Figure A.4: Inflation is picking up but remains below peer countries</td>
<td>17</td>
</tr>
<tr>
<td>Figure A.5: Global oil prices shocks raises significantly short-term impact on inflation in Indonesia</td>
<td>17</td>
</tr>
<tr>
<td>Figure A.6: But higher commodity prices also contribute to an appreciation in the Rupiah</td>
<td>17</td>
</tr>
<tr>
<td>Figure A.7: This helps contain inflation through cheaper imports (in addition to energy subsidies)</td>
<td>18</td>
</tr>
<tr>
<td>Figure A.8: The 2022 commodity price shock has contributed to a slight increase in inflation expectations, which nevertheless seem anchored for now</td>
<td>18</td>
</tr>
<tr>
<td>Figure A.9: Operating status of firms and changes in sales, June 2020 – August 2021</td>
<td>19</td>
</tr>
<tr>
<td>Figure A.10: Digital adoption during the COVID-19 pandemic</td>
<td>19</td>
</tr>
<tr>
<td>Figure A.11: Sales change</td>
<td>20</td>
</tr>
<tr>
<td>Figure A.12: Favorable 2021 fiscal outcomes as consolidation takes hold</td>
<td>23</td>
</tr>
<tr>
<td>Figure A.13: The government is phasing out the COVID-19 fiscal package in 2022 ...</td>
<td>23</td>
</tr>
<tr>
<td>Figure A.14: Rising commodity prices and economic recovery supported solid revenue growth in Q12022</td>
<td>23</td>
</tr>
<tr>
<td>Figure A.15: Gross Financing Needs Have Increased During the Pandemic</td>
<td>23</td>
</tr>
<tr>
<td>Figure A.16: Public debt has increased but is relatively low compared to peers and the official debt limit</td>
<td>24</td>
</tr>
<tr>
<td>Figure A.17: The Real policy rate is now closer to zero</td>
<td>25</td>
</tr>
<tr>
<td>Figure A.18: External financing needs and non-resident holdings of Rupiah assets have been relatively low and stable</td>
<td>25</td>
</tr>
<tr>
<td>Figure A.19: The real interest rate differential with the US is positive and one of the highest among peers</td>
<td>25</td>
</tr>
<tr>
<td>Figure A.20: Money growth accelerated in the third quarter last year pointing to moderating lending to central government and uptick in credit to the private sector</td>
<td>25</td>
</tr>
<tr>
<td>Figure A.21: Financial sector support for recovery has accelerated</td>
<td>27</td>
</tr>
<tr>
<td>Figure A.22: NPLs are low whilst provisioning is high</td>
<td>27</td>
</tr>
<tr>
<td>Figure A.23: But loans at risk remained higher than pre-pandemic level</td>
<td>27</td>
</tr>
<tr>
<td>Figure A.24: Cross-sectoral output multipliers in Indonesia</td>
<td>41</td>
</tr>
<tr>
<td>Figure A.25: Export restrictions in place by year</td>
<td>41</td>
</tr>
<tr>
<td>Figure A.26: Diversification opportunities for metal products</td>
<td>41</td>
</tr>
<tr>
<td>Figure A.27: Tariff equivalents of non-tariff measures (NTMs) affecting imports of green goods</td>
<td>41</td>
</tr>
<tr>
<td>Figure A.1.1: Soaring global commodities prices have benefitted the trade balance thus far</td>
<td>13</td>
</tr>
<tr>
<td>Figure A.1.2: International credit risks rose slightly but remained low overall</td>
<td>13</td>
</tr>
<tr>
<td>Figure A.1.3: Higher commodity prices helped attract foreign equity inflows, ... contributing to a stock market rally</td>
<td>13</td>
</tr>
<tr>
<td>Figure A.1.5: Price shocks could lead to increased poverty rate up to 0.2 percentage points</td>
<td>14</td>
</tr>
</tbody>
</table>
The Indonesia Economic Prospects (IEP) is a bi-annual World Bank report that assesses recent macroeconomic developments, outlook and risks, as well as specific development challenges for the Indonesian economy. In doing so, the IEP aims to inform the public policy debate and is geared towards a wide audience, including the general public, the government, the private sector, civil society organizations, and other domestic and international stakeholders.

The IEP has two main parts. Part A highlights key developments in the Indonesian economy over recent months, and places these in a longer-term context. The IEP also regularly updates the outlook for Indonesia’s economy. The resumption of economic activity from the pandemic highlights the continued need for sound macroeconomic monitoring to ensure strong growth and sustainable recovery. Part B provides an in-depth examination of selected economic and policy issues, and an analysis of the country’s medium-term development challenges. Part B of this edition is on the financial sector deepening to support stronger growth and sustainable recovery.

The IEP is a product of the World Bank Jakarta office and receives strategic guidance from an editorial board chaired by Satu Kahkonen, Country Director for Indonesia and Timor-Leste. The report is prepared by the Macroeconomics, Trade and Investment (MTI) Global Practice team, under the guidance of Lars Christian Moller (Practice Manager) and Habib Rab (Lead Economist). The report is led by Wael Mansour (Senior Economist) and prepared by a core team composed of Angella Faith Montfaucon, Anthony Obeyesekere, Assyifa Szami Ilman, Bayu Agnimaruto, Csilla Lakatos, Dwi Endah Abriningrum, Francesco Strobbe, Indira Maulani Hapsari, Innes Clara Shinta, Kathleen Victoria Tedi, Mochamad Pasha, Neni Lestari, Ou Nie, Ralph van Doorn, Ratih Dwi Rahmadanti, Ketut Kusuma and Salman Alibhai. Deviana Djailil provided administrative support and coordinated the organization of the report launch event. The dissemination is organized by Jerry Kurniawan, Gb Surya Ningnagara, Maulyati N. Slamet, and Kyaw Soe Lynn under the guidance of Lestari Boediono Qureshi. The report was typeset by Arsianti and edited by Yuen Yee Tam.

Part A of this edition of the IEP was prepared by Wael Mansour and Indira Maulani Hapsari (report lead), Indira Maulani Hapsari (real sector), Ahya Ihsan (fiscal sector), Dwi Endah Abriningrum (external sector), Csilla Lakatos and Angella Faith Montfaucon (trade sector), Francesco Strobbe, Salman Alibhai, Ou Nie and Neni Lestari (financial sector), Alexandre Laure, Alvaro Gonzalez, Aufa Doarest (private sector), Rabia Ali, Bambang Suharnoko Sjahir and Anissa Rahmainati (poverty), Somil Nagpal (health sector). It benefited from inputs and comments from Angella Faith Montfaucon, Anthony Obeyesekere, Francesco Strobbe, Habib Rab, and Ralph van Doorn. Box A.1 was prepared by Innes Clara Shinta, Box A.2 was prepared by Ahya Ihsan, Box A.3 was prepared by Csilla Lakatos, Box A.4 was prepared by Ralph van Doorn and Dwi Endah Abriningrum, and Box A.5 was prepared by Ratih Rahmadanti. The report also benefited from comments from Cecile T. Niang (Practice Manager), as well as Ekaterine T. Vashakmadze, Ergys Islamaj and Agustin Samano Penaloza on behalf of the World Bank Chief Economist Office for East Asia and Pacific.

Part B was prepared by Francesco Strobbe, Dara Lengkong, Fernando Dancausa, Neni Lestari, Ou Nie, Ketut Kusuma, I Gede Putra Arsana, Salman Alibhai, Cynthia Clarita Kusharto, Fajar Pane, Katia D’Hulster, Tatiana Didier, Calvin Koenig, Putri Sari and Michael Fuchs. Box B.1 was prepared by Calvin Koenig, Dara Lengkong and Neni Lestari. Box B.2 was prepared by Salman Alibhai and Clarita Kusharto. The analysis benefitted from comments from Cecile T. Niang, Habib Rab and Erik Feyen.
This report is a product of the staff of the International Bank for Reconstruction and Development/the World Bank and is supported by funding from the Australian Government under the Australia-World Bank Indonesia Partnership (ABIP) program.

The findings, interpretations, and conclusions expressed in this report do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent, or the Australian government. The World Bank does not guarantee the accuracy of the data included in this work. The data cut-off date was May 31, 2022. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of the World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

The Photographs are by PanuShot/shutterstock.com, Andrzej Rostek/shutterstock.com, and WHYFRAME/shutterstock.com. All rights reserved.

This report is available for download in English and Indonesian via: worldbank.org/iep
Previous report editions:
- December 2021: A Green Horizon: Toward a High Growth and Low Carbon Economy
- June 2021: Boosting the Recovery
- December 2020: Towards a Secure and Fast Recovery

To receive the IEP and related publications by email, please email ddjalil@worldbank.org. For questions and comments, please email ihapsari@worldbank.org and wmansour@worldbank.org.

For information about the World Bank and its activities in Indonesia, please visit:

- www.worldbank.org/id
- @BankDunia #IEPBankDunia
- BankDunia
- https://instagram.com/worldbank
- www.linkedin.com/company/the-world-bank
### Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADR</td>
<td>Alternative Dispute Resolution</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
</tr>
<tr>
<td>AVE</td>
<td>Ad-Valorem Tariff Equipment</td>
</tr>
<tr>
<td>BI</td>
<td>Bank Indonesia</td>
</tr>
<tr>
<td>BPJS</td>
<td>Badan Penyelenggara Jaminan Sosial</td>
</tr>
<tr>
<td>BPS</td>
<td>Badan Pusat Statistik</td>
</tr>
<tr>
<td>BRI</td>
<td>Bank Rakyat Indonesia</td>
</tr>
<tr>
<td>CDD</td>
<td>Customer Due Diligence</td>
</tr>
<tr>
<td>CEQ</td>
<td>Commitment to Equity</td>
</tr>
<tr>
<td>CICO</td>
<td>Cash In Cash Out</td>
</tr>
<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
</tr>
<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>CPO</td>
<td>Crude Palm Oil</td>
</tr>
<tr>
<td>DAK</td>
<td>Dana Alokasi Khusus</td>
</tr>
<tr>
<td>DAU</td>
<td>Dana Alokasi Umum</td>
</tr>
<tr>
<td>DFS</td>
<td>Digital Financial Services</td>
</tr>
<tr>
<td>EA</td>
<td>East Asia</td>
</tr>
<tr>
<td>EAP</td>
<td>East Asia Pacific</td>
</tr>
<tr>
<td>FCS</td>
<td>Financial Conglomerates</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>EFI</td>
<td>Equitable growth, Finance, and Institution</td>
</tr>
<tr>
<td>EMDE</td>
<td>Emerging Markets and Developing Economies</td>
</tr>
<tr>
<td>Fintech</td>
<td>Financial Technology</td>
</tr>
<tr>
<td>FMCG</td>
<td>Fast Moving Customer Goods</td>
</tr>
<tr>
<td>FSOL</td>
<td>Financial Sector Omnibus Law</td>
</tr>
<tr>
<td>PSP</td>
<td>Financial Service Providers</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GOI</td>
<td>Government of Indonesia</td>
</tr>
<tr>
<td>IA</td>
<td>Import Approvals</td>
</tr>
<tr>
<td>ICP</td>
<td>Oil Import Price</td>
</tr>
<tr>
<td>IEP</td>
<td>Indonesia Economic Prospects</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IP</td>
<td>Insolvency Practitioners</td>
</tr>
<tr>
<td>JHT</td>
<td>Jaminan Hari Tua</td>
</tr>
<tr>
<td>KUR</td>
<td>Kredit Usaha Rakyat</td>
</tr>
<tr>
<td>LAPS SJK</td>
<td>Lembaga Alternatif Penyelesaian Sengketa Sector Jasa Keuangan</td>
</tr>
<tr>
<td>LAR</td>
<td>Loan at Risk</td>
</tr>
<tr>
<td>LHS</td>
<td>Left Hand Side</td>
</tr>
<tr>
<td>LKD</td>
<td>Lembaga Kemasyarakatan Desa</td>
</tr>
<tr>
<td>LPG</td>
<td>Liquefied Petroleum Gas</td>
</tr>
<tr>
<td>MCS</td>
<td>Market Conduct Supervision</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MoPWH</td>
<td>Ministry of Public Works and Housing</td>
</tr>
<tr>
<td>MSME</td>
<td>Micro, Small Medium Enterprise</td>
</tr>
<tr>
<td>MT</td>
<td>Medium Term</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non-Bank Financial Institutions</td>
</tr>
<tr>
<td>NFIS</td>
<td>National Financial Inclusion Strategy</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-Performing Loan</td>
</tr>
<tr>
<td>NTM</td>
<td>Non-tariff measures</td>
</tr>
<tr>
<td>OJK</td>
<td>Otoritas Jasa Keuangan</td>
</tr>
<tr>
<td>PCB</td>
<td>Private Credit Bureau</td>
</tr>
<tr>
<td>PEN</td>
<td>Economic Recovery Program</td>
</tr>
<tr>
<td>PKH</td>
<td>Program Keluarga Harapan</td>
</tr>
<tr>
<td>PLN</td>
<td>Perusahaan Listrik Negara</td>
</tr>
<tr>
<td>POE</td>
<td>Port of Entry Restrictions</td>
</tr>
<tr>
<td>P2G</td>
<td>Persons to Government</td>
</tr>
<tr>
<td>P2P</td>
<td>Peer to Peer</td>
</tr>
<tr>
<td>PP</td>
<td>Percentage Points</td>
</tr>
<tr>
<td>PSI</td>
<td>Pre-Shipment Inspection</td>
</tr>
<tr>
<td>PSO</td>
<td>Public Service Obligation</td>
</tr>
<tr>
<td>QRIS</td>
<td>QR Indonesian Standard</td>
</tr>
<tr>
<td>RHS</td>
<td>Right Hand Side</td>
</tr>
<tr>
<td>RNA</td>
<td>Ribonucleic acid</td>
</tr>
<tr>
<td>SDG</td>
<td>Sustainable Development Goals</td>
</tr>
<tr>
<td>SJSN</td>
<td>National Social Security System</td>
</tr>
<tr>
<td>SOB</td>
<td>State-Owned Banks</td>
</tr>
<tr>
<td>SOE</td>
<td>State owned Enterprise</td>
</tr>
<tr>
<td>SME</td>
<td>Small Medium Enterprise</td>
</tr>
<tr>
<td>SNI</td>
<td>National Standard Certification</td>
</tr>
<tr>
<td>SN-PPPK</td>
<td>Strategi Nasional Pengembangan dan Pendasalaman Pasar Keuangan</td>
</tr>
<tr>
<td>SNGs</td>
<td>Sub National Government</td>
</tr>
<tr>
<td>ST</td>
<td>Short term</td>
</tr>
<tr>
<td>SUSenas</td>
<td>Survei Sosial Ekonomi Nasional Indonesia</td>
</tr>
<tr>
<td>THL</td>
<td>Tax Harmonization Law</td>
</tr>
<tr>
<td>VAT</td>
<td>Value Added Tax</td>
</tr>
<tr>
<td>WDR</td>
<td>World Development Report</td>
</tr>
<tr>
<td>WHO</td>
<td>World Health Organization</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
<tr>
<td>Yoy</td>
<td>year-on-year</td>
</tr>
</tbody>
</table>
Executive Summary
Indonesia’s economic recovery from the COVID-19 pandemic comes amidst an increasingly challenging global environment.

Domestic Recovery from Pandemic Amidst a More Difficult Global Economic Environment

Indonesia’s growth accelerated at the end of 2021 as the country stepped off from a devastating Delta wave in July-August, ending the year with 3.7 percent growth. The momentum carried into the first quarter of 2022 with the economy growing at 5 percent (yoy) and absorbing a short and sharp increase in Omicron-related COVID cases. Growth drivers since end of 2021 have rebalanced gradually from exports and public consumption towards private consumption and investment. Since February, the war in Ukraine has disrupted the global economic environment with rising commodity prices and de-risking in global financial markets. The positive terms-of-trade effect has benefited Indonesia in the near term through higher export and fiscal earnings. But the country is feeling the pressures of rising prices and tightening external finance.

Global oil prices, which have risen from an average of $70 per barrel in 2021 to over $100 since end-February, have a positive impact on Indonesia’s inflation rate. Higher energy prices raise food prices through agricultural input costs. Energy prices in Indonesia, however, have been partially contained by fuel subsidies. There has only been some passthrough for non-subsidized and premium fuels. Cooking oil and other food prices have also shot up due to global supply shortages and rising demand during the month of Ramadan. As a result, headline consumer price inflation (CPI) jumped from a 1.6 percent average in 2021 to 3.5 percent (yoy) in April 2022. Proxy indicators suggest that short-term inflation expectations may have risen slightly though seem to be anchored within Bank Indonesia’s inflation target.

The current account recorded a surplus in 2021 (0.3 percent of GDP) and in Q1-2022 (0.1 percent of GDP) owing to increased commodity earnings. Indonesia like other emerging market economies is facing tighter external financing conditions. Sovereign spreads saw increases between March and May, though remained below levels reached during the height of the pandemic in 2020. Non-resident sales of Rupiah debt accelerated between February and May (0.4 percent of GDP) but this was offset by equity inflows over the same period (0.4 percent of GDP). The Rupiah has remained stable though there has been a steady nominal depreciation (1.9 percent cumulative since February 2022) and real depreciation (1.3 percent cumulative since January 2022). This was in part associated with a general appreciation of the US dollar. Foreign currency reserves have also declined but remain adequate (equivalent to 6.9 months of imports and short-term government debt).

Inflation in Indonesia has picked up, though the passthrough from international commodity prices has been contained for now by subsidies.

External vulnerabilities have been low despite a moderate increase in external market pressures since the start of the war in Ukraine.
Multiple surveys between June 2020 and August 2021 show that most firms have resumed operations since closures during the early phase of the pandemic in June 2020, but that many in August 2021 were still operating below capacity. Over this period, MSMEs experienced a sustained contraction in sales. Most of them coped by lowering working hours or wages of employees (intensive margin), as opposed to through layoffs (extensive margin). Recovery of firms between June 2020 and August 2021 was uneven. Large firms and those in high value-added service recovered more quickly than MSMEs. Export-oriented firms fared much better than domestically oriented firms. Tourism and other contact-intensive services suffered disproportionately, whilst firms that were able to adopt digital technologies were also more resilient.

The budget deficit narrowed in 2021 (from 6.1 percent of GDP in 2020 to 4.6 percent in 2021) thanks to a recovery in revenue and slowing expenditure. Government debt levels rose slightly from 38.6 percent of GDP to 40.7 percent in 2020-2021. The 2022 budget saw a reduction in extraordinary COVID support as the authorities refocus efforts on healthcare and dealing with the effects of the war in Ukraine. Monetary policy remained accommodative with low nominal rates. Rising prices and tightening external finances created headwinds for monetary policy, though the stance has been appropriate under existing conditions. On the domestic front, Indonesia still has a negative output gap, inflation expectations seem anchored, and the financial sector has started to support the real sector. On the external front, financing needs are not significant, the real interest rate differential with the US remains positive, and foreign exchange reserves are adequate.

Private credit growth began to pick up and turned positive in mid-2021. In February 2022, private credit expanded by 6.3 percent (yoy) after 5 consecutive months of relatively strong growth. The banking sector has a strong capital position: the capital adequacy ratio has edged up slightly to 25.8 percent as of February 2022, which is well above the regulatory minimum. Bank asset quality is generally high, with adequate bank capital and provisioning levels. Non-performing loan (NPL) ratio has barely increased since mid-2020 and stands at 3.1 percent as of February 2022. At the same time, however, forbearance measures mask the true extent of balance sheet risks. Though NPLs are low, the system-wide loans at risk (LAR) ratio, defined as the sum of NPLs, restructured loans and special mention loans, stood at 19.5 percent as of December 2021. Asset quality therefore warrants close monitoring as loan forbearance measures have been extended until March 2023.

---

1 Included restructured loans in collectability 1 (performing loans), restructured & non restructured special mention loans, and NPL in the LAR calculation as of December 2020 based on Bank Indonesia definition.
Global growth is now expected to slow from 5.7 percent in 2021 to 2.9 percent in 2022. As a result of the war in Ukraine, prices for most commodities are expected to be significantly higher in 2022 than in 2021; whilst commodity prices are expected to peak in 2022, they are projected to remain high over the medium-term. This exacerbates concerns over food insecurity and poverty and rising inflation, contributing to tighter financial conditions, magnifying financial vulnerability. Growth in emerging market and developing economies (EMDEs) this year has been downgraded to 3.4 percent, as negative spillovers from the invasion of Ukraine more than offset any near-term boost to some commodity exporters from higher energy prices. There is no rebound projected next year: global growth is forecast to edge up only slightly to a still-subdued 3 percent in 2023, as many headwinds—in particular, high commodity prices and continued monetary tightening—are expected to persist.

In the baseline, GDP growth is projected at 5.1 percent in 2022, rising to 5.3 percent in 2023. This assumes the release of pent-up demand, improved consumer confidence, and improved terms of trade. Inflation is projected to rise to 3.6 percent (annual average) with the pick-up in domestic demand and higher commodity prices. External financing conditions are expected to tighten though commodity exports are projected to contribute to a current account surplus. But the global economic environment could create important downward pressures on growth. This could fuel a downside scenario with higher inflation pressures forcing fiscal reallocations from pro-growth spending to untargeted subsidies, falling demand for commodity exports, and tight external financing impacting borrowing costs and appetite for private investment. In such a scenario, Indonesia's growth could be lower than anticipated and reach 4.6 percent in 2022 and 4.7 percent in 2023.

A fiscal adjustment of around 1.6 percent of GDP will be needed to reach the government's deficit target. This is expected to be achieved through an even split of expenditure cuts and revenue-generating reforms. Fiscal revenues are projected to increase due to tax reforms and stronger commodity prices. The Tax Harmonization Law is expected to boost government revenues by 0.9 percentage points of GDP, on average, over 2022-2025. Public spending is projected to gradually decline with the phasing out of the COVID-19 support package, but remain above pre-pandemic levels, due in part to subsidy and social assistance pressures. Spending on fuel and electricity subsidies is
expected to rise temporarily in 2022, as the government implements a partial passthrough of higher global energy prices to retail prices before gradually increasing the administered retail prices.

Explicit energy subsidies are projected to increase from 0.8 to 1.1 percent of GDP in 2021-2022. The implicit subsidy, however, paid to PLN and Pertamina to compensate them for selling electricity and fuel at below market prices, is projected to increase from 0.7 percent of GDP in 2021 to 1.5 percent of GDP in 2022. These subsidies largely benefit middle and upper-class households. These households consume between 42 and 73 percent subsidized diesel and 29 percent of subsidized LPG. If these two subsidies are eliminated (saving 1.0 percent of GDP at 2022 prices) and replaced by targeted social transfers for the poor, vulnerable, and aspiring middle class (costing 0.5 percent of GDP), the net fiscal gain would be 0.6 percent of GDP. Moreover, whilst energy subsidies could contain cost-push inflation in the short-term, given commodity prices are expected to remain sticky, subsidies will not be sustainable. As such, there is a strong case to be made on the need to prepare an exit plan from high energy subsidies with gradual passthrough of prices and shift towards targeted subsidies to protect the poor and the vulnerable.

Rising inflation expectations create headwinds for monetary policy. The real policy rate has gradually declined to near zero. But at the same time, output remains below its potential and firms need financing to meet growing demand. Bank Indonesia has therefore rightly signaled that it is closely monitoring core inflation to inform policy rate adjustments. It is also using macroprudential tools and payment system reforms to support the real sector. Core inflation has started to gradually pick up as the negative output gap begins to close. A gradual adjustment to the policy rate would be warranted when inflation is more broad-based, as it is expected to become with demand continuing to recover over the course of the year. Indonesia’s stable macroeconomic fundamentals provide the basis for a gradual and predictable adjustment to policy rates.

As macroeconomic policy space shrinks, structural reforms that help remove constraints to allocative efficiency will need to play a bigger role to drive growth going forward. Indonesia has taken important steps already through for example lifting of investment restrictions in the Omnibus Law on Job Creation. There are other overarching agendas that could play a bigger role in stimulating the economy and boosting the country’s potential growth. The report identifies four structural reform areas, many of which the authorities have started tackling but would need to accelerate:

i) Creating fiscal space through tax reforms to enlarge the spending envelope on pro-growth and pro-poor programs and ensure public investment to plug critical infrastructure gaps

---

5 Between 42 and 73 percent according to World Bank estimates. [www.worldbank.org/gep](http://www.worldbank.org/gep)
i) Prioritizing business environment reforms to support Micro and Small and Medium Enterprises in access to credit, formalization, as well as digital and green transition to overturn scarring effects from COVID and boost their productivity.

ii) Replacing trade restrictions with a mix of fiscal, trade, business environment, land management and infrastructure policies to develop greener downstream industries.

iii) Deepening of the financial system to help channel more savings to productive investments. This topic is discussed in more detail in Part B of the report.

Part B: Financial Sector Deepening

A stable and smooth-functioning financial sector is important to ensure that governments and financial institutions can support both the recovery from the COVID-19 crisis and longer-term economic growth. A deeper financial sector, as measured by the size of banks and non-bank financial intermediaries, is often accompanied by (i) greater financial access for both households and firms, (ii) increased financial efficiency due to a more competitive environment which lowers intermediation costs and (iii) improved financial resilience as household and firms profit from a diverse set of financial instruments that protect them against unforeseen events (job loss, natural disasters etc.)

Although there has been substantial progress in the Indonesian financial sector, whose macro-financial fundamentals have proved to be strong during the recent COVID crisis, the sector is suffering from structural shortcomings which hold back financial development and, ultimately, inclusive and sustainable economic growth. To date, the financial sector is too small, too costly and exposed to global risks to adequately fund Indonesia’s development needs and sustainability objectives (e.g., SDG goals and Net Zero aspirations).

Although households’ access to the formal financial sector has increased in recent years, the country still has the fourth largest unbanked population in the world. Bank intermediation efficiency is relatively low with net-interest margins, a commonly used measure of intermediation efficiency, being structurally higher in Indonesia than in peer countries with a potentially negative impact on domestic savings, investments and bank lending. Many factors, including lack of competition, weaknesses in the institutional environment, and operational inefficiencies can contribute to the observed weak intermediation.

Non-bank financial institutions have not kept pace with economic growth: pension funds and insurance companies remain relatively small and their contribution to the provision of finance is still modest. As the domestic investor base is unable to provide sufficient longer-term financing for Indonesia’s economic development, foreign funding tends to play an important role, which exposes the country to external vulnerabilities.
The institutional architecture of financial supervision and regulation has been a focus area for policy makers in recent years and COVID-19 has underscored the need to strengthen it.

The Government of Indonesia (GoI) is committed to promoting a deep and inclusive financial sector.

**Deepening the Indonesian financial sector requires a concerted set of actions.**

Growing the institutional investor base and ensuring access to digital financial services (DFS) can expand the sources of funding available.

Expanding the lending/usage of financial services through new products and services provides access to finance and facilitates the transition towards a more sustainable economy.

While the financial sector is overall stable, the supervisory architecture suffers from limited and fragmented supervision mandates and limited legal protections for supervisory staff. The increased footprint of financial conglomerates (FCs), with activities across financial sub-sectors, requires enhanced capacity and better supervisory cooperation to achieve fully-fledged integrated supervision.

Before COVID-19, the GoI issued key national strategies focused on core elements of the financial sector development agenda that are still relevant in the pandemic recovery context. The main government approach to financial deepening is elaborated in the National Strategy for Financial Market Deepening (SN-PPPK) 2018-2024. Moreover, a new National Financial Inclusion Strategy (NFIS) underpinning the GoI’s efforts in further expanding access to financial services was issued in December 2020. Further, the Financial Sector Omnibus Law (FSOL), which is currently under preparation aims to comprehensively address long-standing legal and regulatory issues in the Indonesian financial sector while supporting economic recovery from the pandemic.

Given the scarcity of resources vis-à-vis the development needs and the potential of Indonesia, increasing the sources of funding for the financial sector is necessary to better position it to support the economic recovery by expanding lending and increasing usage of financial services. An efficient allocation of the resources within the financial sector will enhance its support to the real economy by channelling savings into the most productive investment opportunities in a less costly, faster, safer, and more transparent way. A stable financial sector with a conducive financial sector architecture represents a key enabling factor.

Expanding the size of institutional investors will bring about opportunities to reduce reliance on foreign investors, reduce dependency on bank financing, and expand access to long-term financing through the capital markets. In addition, DFS can lower costs, increase speed, transparency, security, and availability of more tailored financial services serving the poor at scale. Digital credit is one form of DFS that has already begun to make substantial inroads in expanding access to finance in Indonesia with volumes of digital lending growing significantly over the past two years.

Next to encouraging the usage of transaction accounts for individuals and households, the promotion of digital financial services is poised to unlock critical constraints for MSMEs. Digital loans can reach previously underserved segments, new technologies are transforming business services, and e-commerce platforms enable firms to expand their access to markets. The introduction of new sustainable finance market instruments presents great potential in facilitating investments in the short-run and a transition towards a more sustainable economy in the long-run.
Digital finance can improve efficiency by fostering financing at scale and greater risk diversification through innovative product design or by integrating new technologies or improved data models for financial services. Competition in the financial sector constrains market power for individual institutions, improves the efficiency of risk pricing, and encourages innovation. A sound financial infrastructure provides the enabling environment for an efficient financial sector.

The strength of financial regulation and supervision, including an integrated supervision framework and legal protection for supervisors, as well as comprehensive crisis preparedness, resolution arrangements and safety nets are important elements to ensure the stability of the financial sector. Climate-related risks, to which Indonesia is particularly prone, may also pose risks to the stability of the sector.

This package can be divided into three pillars: (i) increasing demand and supply of finance; (ii) improving the allocation of resources through the financial sector; (iii) strengthening the resilience of the financial system to withstand financial and non-financial shocks. Some policy recommendations can be achieved within a short-term (ST) horizon (i.e., up to one year), while others might require a medium-term (MT) horizon (i.e., from 1 to 3 years) as summarized in the following table.

### Table ES.1. Summary of Key Policy Recommendations for Financial Sector

<table>
<thead>
<tr>
<th>Key Recommendations</th>
<th>How to implement them:</th>
<th>Priority (ST/MT)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Increasing demand and supply of finance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Increasing access to and usage of financial services</td>
<td>a) Establishing a well-functioning (fully interoperable) payment system and developing credit infrastructure that can use alternative data.</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Establishing government data platforms and creating digital ID.</td>
<td>ST</td>
</tr>
<tr>
<td></td>
<td>c) Promoting open banking services and policies that create demand for digital financial services (such as digitizing G2P and P2G payments).</td>
<td>ST</td>
</tr>
<tr>
<td>2. Broadening and improving the quality of financial market products</td>
<td>a) Continuing to introduce new financial market products (e.g. green bonds; covered bonds; infrastructure project bonds; municipal bonds).</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Developing a market for risk hedging to attract international investors by establishing central counterparty for clearing and close-out netting</td>
<td>ST</td>
</tr>
<tr>
<td>3. Mobilizing long-term savings</td>
<td>a) Accumulating savings through institutional investors, by expanding coverage, increasing contributions and reducing withdrawals.</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Promoting professional management and appropriate long-term investments of pension fund assets.</td>
<td>ST</td>
</tr>
</tbody>
</table>
### II. Improving the allocation of resources through the financial sector

#### 1. Promoting competition in the banking sector
- a) Strengthening the capacity of lenders to adopt risk-based pricing.  
  - MT
- b) Opening the servicing of government business to the most capable service provider, regardless of ownership type.  
  - ST
- c) Expanding partial credit guarantees for MSMEs and supporting effective graduation policies from the KUR program  
  - ST

#### 2. Strengthening the insolvency framework
- a) Strengthening insolvency proceedings such as out-of-court workouts, without resorting to the court system to address financial distress.  
  - MT
- b) Ensuring adequate protection of creditors’ interests through key amendments to the Bankruptcy Law  
  - ST

#### 3. Protecting consumers
- a) Implementing financial consumer protection laws and regulations monitored and enforced through market conduct supervision (MCS)  
  - ST
- b) Finalizing the personal data protection law, currently pending since 2019.  
  - ST

### III. Strengthening the capacity to withstand financial and non-financial shocks

#### 1. Strengthening the effectiveness of fin. sector oversight
- a) Addressing gaps and limitations in the supervision of financial conglomerates.  
  - ST
- b) Strengthening legal protection for financial supervisors.  
  - MT

#### 2. Strengthening crisis preparedness and resolution framework
- a) Enhancing legal framework to establish effective bank resolution regime and inter-agency coordination.  
  - ST
- b) Providing clear arrangements for resolution funding, including provisions for extraordinary funding when required.  
  - MT

#### 3. Promoting climate and natural disaster related risk management
- a) Developing policies (including assessment, disclosure and reporting) for managing climate related risks for the financial sector.  
  - ST
- b) Deepening catastrophe insurance markets to provide financial risk management services to government, businesses and households.  
  - MT

Note: ST: Short Term up to 1 Year; MT: Medium Term up to 1 – 3 years.
Indonesia Economic Prospects
June 2022

A. Economic Fiscal Update

1. A Diagnostic of the Recovery

Indonesia’s ongoing recovery from the pandemic comes amidst an increasingly challenging global environment.

Global growth projections in January this year already pointed to a significant slowdown given persistent supply chain bottlenecks and global monetary policy tightening. Since then, the war in Ukraine has led to increasing commodity prices and de-risking in global financial markets. These have exacerbated global inflation pressures and emerging market concerns over tightening external finance. Attention has now turned to renewed risks of global recession. This comes as the US looks to engineer a soft landing from record inflation amid tight labor markets, China clamps down on mobility as part of a zero-COVID policy, and Europe reels under inflation and energy supply pressures. Indonesia so far has benefited from the commodity price rally and rising consumer confidence but is also feeling the pressures of inflation and external finance.

After a 2.1 percent contraction in 2020, the economy rebounded by 3.7 percent in 2021 on the back of strong exports and public consumption (Figure A.1). The rebound was stronger than most peers in East Asia and the Pacific (EAP), with output surpassing pre-pandemic levels (World Bank EAP Update, April 2022). GDP per capita picked up from USD 3,757 from 2020 to USD 3,856 in 2021 but remains below the pre-pandemic level.

Rising prices of key commodities, such as coal and palm oil, coupled with recovering global demand, have kept Indonesia’s exports solid at 35.9 percent yoy in 2022 Q1. Exports made the largest contribution to GDP growth (4.7 percentage points in 2021). Public consumption has also played a supporting role, owing to fiscal expansion in response to the pandemic. The government increased the allocation for the Economic Recovery Program (PEN) to IDR 658.6 trillion (3.9 percent of GDP) in 2021. Authorities prioritized healthcare spending (up from 0.4 in 2020 to 1.2 percent of GDP in 2021) and scaled back social assistance spending (down from 1.3 to 1.0 percent of GDP). The fiscal package has had notable welfare implications. Estimates suggest that social assistance spending in 2021 prevented a 0.8pp rise in poverty⁶. Even with the increased fiscal response, the fiscal deficit remained manageable and government debt level (40.7 percent of GDP) remained below the legal threshold of 60 percent.

---

⁶ World Bank (2022c)
On the supply side, almost all sectors have returned to pre-pandemic levels except for some contact-intensive sectors like transportation and accommodation. Meanwhile, manufacturing, construction, wholesale and retail trade and telecom contributed to more than 60 percent of GDP growth, reflecting recovering demand. Mining and health were the fastest growing sectors in 2021 (contributing 9.0 and 1.3 percent to total GDP respectively). Mining benefitted from strong commodity prices and related expansion in production, and the health sector from government spending on vaccination and hospital services.

The latest GDP data highlight a sustained recovery, with the economy expanding by 5.0 percent in Q1-2022 (yoy). Growth is underpinned by a strong boost in private consumption (up 4.4 percent yoy) and private investment (up 4.1 percent yoy). Bank Indonesia’s Consumer Confidence Index and Consumer Expectations Index have picked up sharply between Q4-2021 and May 2022. Retail sales also continued to expand through April (up 8.6 percent yoy). The strong growth in capital imports, cement sales, and commercial vehicle sales, as well as a pickup in investment credit, point to recovering private investment (Figure A.2).

Services (trade, tourism, transport, and telecom) combined contributed to 40 percent of GDP growth, while manufacturing contributed to 20 percent of growth. The recovery comes amidst emerging global economic risks, including from the fallout of the war in Ukraine (Box A.1).

Indonesia experienced a short-lived spike in Omicron cases in January-February 2022 with daily cases peaking at about 65,000 on February 16, 2022. Cases and deaths since then have been declining, averaging below 300 and 10 respectively by late May. Indonesia has flattened the curve earlier than peers and loosened mobility restrictions, partly thanks to vaccination efforts. Over 60 percent of the population is now fully vaccinated. However, the vaccination rate is lagging that of some peer countries as large provincial gaps persist. Indonesia has also made strides to strengthen its health system and infrastructure to face the risks associated with the resurgence of potential new variants. This includes improving testing and tracing systems, including genomic sequencing ability, and increasing both isolation beds and critical care beds, including in locations outside Jakarta.

---

7 Particularly consumer income expectation in the next 6 months.
8 Litbang.kemkes.go.id
The war in Ukraine is casting its shadow over the global recovery from the pandemic. On February 24, Russian forces invaded Ukraine, sending commodity prices soaring and increasing volatility in global financial markets. Western countries and several of Russia’s trading partners have imposed sanctions on Russia. These include a ban on new investments, restrictions on state-owned companies, increased tariffs on Russian imports, bans on exports of certain commodities, and disconnection from the SWIFT cross-border payments system. The direct impacts on Indonesia from the war remain limited. The country is exposed though to the impacts on the global commodity and financial markets.

Limited direct impact on FDI and trade

Ukraine and Russia are not among Indonesia’s major trading and investment partners. The share of total trade between the two countries and Indonesia falls short of 1 percent of Indonesian trade, while the share of direct investment is below 0.1 percent (Figure A.1.1). Moreover, there are no reported external liabilities to either country.

Exposure to global commodity prices

At a time when global commodity prices are rising due to recovering demand, the crisis has intensified the impact particularly for food and energy prices. Natural gas prices rose more than 30 percent while Brent crude oil surpassed the US$ 100 per barrel mark just after the invasion. High global commodity prices can be transmitted within Indonesia to domestic prices and aggravate the inflation outlook despite being partly cushioned through government subsidies. At the same time, as a net commodity exporter, the high commodity prices particularly for Indonesia’s main export products like palm oil and coal, will benefit the country. It will boost its trade surplus despite a potential slowdown in the regional trading partners due to the war, as well as provide fiscal revenues. High commodity prices will also likely increase incomes of households working in those sectors, which in turn could boost consumption and investment, as well as inter-sectoral linkages with potential positive spillovers.

Exposure to global financial markets

Indonesia’s credit risk rose by slightly more than other regional peers at the onset of the war but tracked lower after (Figure A.1.2). Escalating global tensions have affected international market sentiments, weakened confidence, and led to tighter financing conditions for emerging markets, including for Indonesia. It also raised uncertainty, putting a toll on investment and trade. Despite those risks, Indonesia saw acceleration in equity inflows (Figure A.1.3), which were also reflected through a stock market rally since February (Figure A.1.4). However, there has also been an acceleration in debt portfolio outflows since February. The exchange rate has remained broadly stable compared to other emerging markets, but there has been some downward pressure with a general appreciation of the dollar.
Impact on Poverty

Surging food and energy prices could negatively affect purchasing power and poverty. World Bank simulations on the impact of energy, food and transportation shocks found that a simultaneous increase in prices could increase the poverty rate by 0.2 percentage points in an extreme scenario\(^9\) (Figure A.1.5). This is equivalent to putting 435,000 people into poverty. The price shock could also reduce purchasing power by up to 0.6 percent of initial consumption level. The poorest 40 percent would experience five times greater loss in purchasing power compared to the richest 10 percent, mainly due to food prices. Food accounts for about a third of total consumption for the poorest 4 deciles (Figure A.1.6).

\(^9\) Estimate assumes no behavioral responses in the economy in the short term (e.g., substitution in consumption toward cheaper food items), and thus does not use a cross-price elasticity or adjust the poverty line. Source: World Bank staff calculations using Susenas March 2021, and Input-Output Table 2016, following the CEQ methodology.
Higher commodity prices support external balances, but tightening financial conditions add to external market pressures

The current account recorded a surplus in 2021 (0.3 percent of GDP) and in Q1-2022 (0.1 percent of GDP) owing to a trade surplus and narrowing income deficit. High commodity prices, particularly for coal and palm oil, have helped Indonesia’s terms of trade with exports rising by 35 percent respectively in Q1-2022 (yoy). In line with recovering domestic demand and investments, imports also grew steadily, particularly imports of capital goods.

This is driven by the rapid tightening of U.S. monetary policy and global risk aversion towards emerging markets following the start of the war in Ukraine. Both the 5-year Credit Default Swap rate and the Emerging Market Bond Index sovereign spreads saw sustained increases between March and May, though remained below levels reached during the height of the pandemic in 2020. Non-resident sales of Rupiah debt accelerated between February and May (reaching 0.4 percent of GDP) and pressures are likely to remain as inflation erodes yields. Moreover, Indonesia’s borrowing cost has increased as surpassed some peers. Medium-term (3-year) government bond yields picked up between January and April (4.4 – 5.3 percent), while 10-yr government bond yields were at 6.3 percent, a higher rate compared to Thailand, Malaysia, or China. On the other hand, equity inflows between February and May have remained strong thanks to higher expected corporate earnings linked to commodity windfalls (also around 0.4 percent of GDP).
Tighter financing conditions have been offset by declining financing needs thanks to the current account surplus and relatively low external financing rollover needs. But whilst the Rupiah has remained stable relative to other emerging market economies, there has been a steady nominal depreciation (1.9 percent cumulative since February 2022). This is in part associated with a general appreciation of the U.S. dollar. The REER has also depreciated over the same period by (1.3 percent cumulative since February 2022). Foreign currency reserves have also declined slightly (down to US$ 135.6 billion in May, equivalent to 6.6 months of imports and short-term government debt) due to government repayment of foreign currency debt.

Although NTMs are used to achieve legitimate non-trade objectives, such as protection of consumer health and safety, they can also unnecessarily distort trade by having a protectionist impact. Governments today have less room to raise import tariffs due to multilateral and regional trade agreements. But they have more discretion over the use of NTMs, which can worsen the impact of other shocks stemming from the domestic and global economy, such as the COVID-19 pandemic.

Non-Tariff Measures (NTM) are increasingly used as a trade policy tool, and can worsen trade performance, especially in the presence of other shocks. NTMs have worsened the negative impact of COVID-19 on trade in Indonesia.

Lockdown measures have reduced the survival rate\(^{10}\) of both exports and imports in Indonesia (Montfaucon and Majune (2022)). The closure of workplaces was responsible for the collapse of exports while the ban on international travel had a larger effect on the decline of imports. Hence, production chokepoints had a bigger effect on exports during the pandemic, while distribution bottlenecks\(^{11}\) were behind the impact on imports. However, the implementation of NTMs has exacerbated the situation especially for imports. The effect of domestic lockdowns was the largest on products exposed to import approval measures (a form of NTMs). The negative effect lasted throughout the entire period of the lockdown reducing import values by 25 percent per month\(^{12}\). This might not be the case though for intermediate import products given high compliance costs of these measures in Indonesia relative to peers. Indeed, the ad-valorem tariff equivalents (AVE) to the NTMs imposed by Indonesia, for example on the requirement to pass through specific ports, are on average 8.9 percent higher for intermediate goods compared to East Asia\(^{13}\).  

---

\(^{10}\) Trade survival is the likelihood that a trade relationship stays active for a specific period.

\(^{11}\) Production chokepoints and distribution bottlenecks are blockages at both production and distribution chains that slowdowns imports.

\(^{12}\) Arenas, Majune and Montfaucon (2022).

\(^{13}\) Montfaucon, A.F, Khan, S. Y. and Agnimaruto, B (forthcoming).

\(^{14}\) World Bank (2022d)
Inflation has started picking up due to a mix of demand and supply side pressures, with global food and fuel prices passthrough partially contained by subsidies

In the past year, global median headline CPI inflation surged from 2 to 7.8 percent (by April 2022 yoy) reaching the highest level since the global financial crisis in 2008. Energy prices have been the main driver with natural gas prices rising by more than 30 percent and Brent crude oil surpassing the US$100 mark. Other factors such as supply disruptions, clogged ports, and food supply shortages (due to war in Ukraine) have also contributed particularly in Europe and many EMDEs. This has prompted central banks globally to tighten monetary policy, in some instances faster than warranted by real sector conditions.

Headline consumer price inflation (CPI) jumped from a 1.6 percent average in 2021 to 3.6 percent (yoy) in May 2022. This was in part driven by increased food demand in the run up to the start of Ramadan (Islamic month of fasting) as well as food distribution challenges. Private consumption tends to spike during Ramadan. This has fed into core inflation which is rising as domestic demand improves and the output gap narrows (Figure A.3). There has also been some passthrough from global food and fuel prices to input costs. However, these effects remain limited due to energy subsidies, enabling inflation to track lower compared to peers (Figure A.4) and remain within Bank Indonesia’s (BI) inflation target of 2–4 percent.

For example, with rice, the increase in global prices do feed into a small increase in the domestic rice prices in the short term. However, the impact is limited due to government policies that manage rice imports; this tends to keep rice supply and rice domestic price stable despite changes in the international rice price (Hermawan, et.al., 2017). The domestic rice price is mainly influenced by factors that affect supply and demand, such as the period of rice harvest, climate, government actions to manage supply, and seasonal consumer preferences for example rising demand for food during the holy month of Ramadan.

In Indonesia, estimates show that an increase in global oil prices has a small but statistically significant impact on inflation. There are, however, two offsetting factors. The first is that rising commodity prices contribute to short-term Rupiah appreciation (Figure A.6). The second are fuel subsidies, where retail prices are fixed. Both factors cushion the effect of an oil price shock on domestic CPI in the short term, but the impact diminishes with time (Figure A.5, Figure A.7).

---

15 For detailed analysis on the impact to energy subsidies, please see section 2 on Policy Responses.
16 However, in April and partly May, the Rupiah has been depreciating mainly due to capital outflows.
17 Pertamina (the state oil and gas enterprise) has increased the price of high-octane (RON92/Pertamax) gasoline by almost 40 percent on April 1. Pertamax accounted for around 13 percent of the fuel consumption in Indonesia. Meanwhile, the price of lower-octane gasoline such as Peralite and Premium (RON90 and RON88), which made up 85 percent of fuel consumption in the transportation sector are kept fixed.
Global oil prices not only affect domestic energy prices but also affect agricultural commodity prices in two different ways.

First, crude oil is included in the aggregate production of primary commodities with various energy intensive inputs such as fertilizer. Second, some agriculture commodities are used as alternatives of conventional fossil fuels, raising as such its prices. Eventually, the second-round effect to headline CPI will come from almost all components of CPI.

Figure A.3: Narrowing output gap and increase in input cost led to increase in inflation, including core inflation

(contribution to headline inflation, percentage points (LHS); consumption growth, percent yoy (RHS))

Figure A.4: Inflation is picking up but remains below peer countries

(change in consumer price index, percent yoy)

Figure A.5: Global oil prices shocks raises significantly short-term impact on inflation in Indonesia

(Response of monthly changes in CPI to changes in global crude oil prices)

Figure A.6: But higher commodity prices also contribute to an appreciation in the Rupiah

(Response of monthly changes in Exchange Rate to changes in global crude oil prices)
Indonesia Economic Prospects | June 2022

Proxy indicators suggest that short-term inflation expectations may have risen slightly though seem to be anchored within Bank Indonesia’s inflation target. They have risen for 2022 from around 2.9 percent in January to 3.8 percent in June. Analysis of past global crude oil and palm oil price shocks have not significantly alternated inflation consensus forecasts, and not increased by more than 0.3 pp (Figure A.8). For example, during the December 2019 – January 2020 CPO price shock, inflation forecasts even declined by 0.1 pp. In October 2021, inflation forecasts declined by 0.1 pp despite oil prices increasing by almost twofold and the CPO price rising more than 70 percent. Though this rough proxy for expectations has risen by more in the most recent commodity price shock, short-term forecasts seem anchored within BI’s inflation target for now.

Recent acceleration in demand should have supported recovery of firms, particularly MSMEs that were disproportionately impacted by the pandemic.

During initial mobility restrictions (in June 2020), more than 85 percent of firms reported a drop in sales relative to before the pandemic. On average, sales declined by 56 percent yoy (Figure A.9). By March 2021, as the economy was recovering, nearly all firms (92 percent) had resumed operations. Despite this, 47 percent of firms still reported a yoy sales drop. On average, sales in March 2021 were 16 percent lower than in October 2020. The mid-2021 Delta surge interrupted the recovery process; by August 2021, sales were down a further 22 percent compared to March 2021.

18 Inflation expectations are proxied by monthly consensus inflation forecasts produced by Consensus Economics Inc. given the limited frequency of survey-based data.
19 Based on Consensus Forecasts publications from Consensus Economics, Inc.
The share of primary breadwinners in waged work who were not working declined from a peak of 25 percent in June 2020 but stagnated through 2021 at around 10 percent (World Bank, 2022 – forthcoming). Survey data shows that firms coped with reduced sales by lowering working hours or wages of employees (intensive margin), as opposed to through layoffs (extensive margin). The share of breadwinners working with reduced incomes was 56 percent in May 2020, falling to 40 percent by March 2021, then rising moderately to 44 percent after the Delta wave. While both employment and income indicators registered a slight deterioration after the Delta wave, the change was small relative to the initial shock in 2020.

Despite an incipient economic recovery in the first half of 2021, adverse impacts on employment and income of workers persisted throughout the first three quarters of the year.
Limited mobility and lockdowns in many regions reduced sales for many firms relying on traditional point of sales models (e.g., brick and mortar stores). Around 41 percent of surveyed firms (in the June 2020 survey) adapted to the pandemic-induced crisis by starting to or increasing their use of the internet, social media, and other digital methods to carry out business. This adjustment was implemented by firms of all sizes, but not evenly—8 in 10 large firms surveyed in June 2020 adopted digital approaches, compared to 3 in 10 micro firms (Figure A.10). In August 2021, 30 percent more firms adjusted by adopting digital tools compared to June 2020. Furthermore, more MSMEs started to catch up and adopt digital platforms but at a lower rate than large firms.

Despite the common shock in the early stage of the pandemic, multiple Business Pulse Surveys (BPS) revealed a different pace of recovery across sectors. Large firms and firms in high value-added services tended to recover more quickly. On the other hand, micro firms in the creative and tourism economy continued to experience sharp declines in sales (Figure A.11). The tourism sector has been a particular area of concern. Despite partial reopening of borders in 2022, international tourist arrivals remain very low. This has affected major tourism hubs such as Bali, where businesses continue to reel from the impacts of the pandemic.

The recent BPS analysis revealed a positive association between early investment in digital equipment and sales trajectory. Firms that invested in digital equipment in the previous wave had higher sales (5.8 percentage points higher) than those that did not invest.

Data from the fourth wave of the BPS indicate that export-oriented firms had significantly higher sales (11 percentage points higher) than those restricted to the domestic market. This is consistent with the sharp acceleration in exports in 2021.
2. The Policy Response

The fiscal policy stance is tightening as the government reverts to the 3 percent fiscal deficit target and refocuses the pandemic support

Following an expansionary policy to manage the fallout from the pandemic, Indonesia’s fiscal stance is gradually tightening.

The government is gradually phasing out the COVID-19 fiscal package and refocusing the support to public health and vulnerable households.

High commodity prices and the pick-up in domestic demand are boosting fiscal revenues and supporting the government’s consolidation efforts.

The authorities have embarked on reforms to increase tax revenues and boost collection.

The fiscal deficit narrowed in 2021 due to a broad-based rebound in public revenues and moderation in public spending. Fiscal revenues rose from 10.7 percent of GDP in 2020 to 11.8 percent of GDP in 2021 on the back of strengthening commodity prices and domestic demand. Spending moderated from 16.8 percent of GDP in 2020 to 16.4 percent of GDP in 2021, reflecting a scaling back of the pandemic relief package as well as a drop in personnel spending and transfers to subnational governments (Figure A.12). Increased commodity prices however have started to increase fiscal pressures through subsidies and social assistance spending and the gaps between market and administered prices of LPG, electricity and fuel have widened. The government also noted that fiscal space is currently limited due to large mandatory spending despite increased in revenues (KEM PPKF 2023, Kementerian Keuangan, 2022).

While the reduction is broad based (Figure A.13), support to firms and businesses has experienced the largest decline of around 0.6 percent of GDP, followed by a reduction of the COVID-19 health package of around 0.4 percent of GDP. The 2022 PEN remained focused on strengthening healthcare services, core social assistance programs and priority programs such as cash for work, infrastructure connectivity, and food security. The government has also introduced fiscal reforms to improve expenditure efficiency most notably the recently passed Law on Intergovernmental Finance. This law is expected to improve horizontal equalization of fiscal capacity across subnational governments, improve the quality of transfer-financed spending, better integrate national and subnational spending in the medium term (Box A.2).

Consumption based taxation has been a key driver of revenues in 2021 and early 2022. In Q1 2022, total revenues grew by 32 percent (yoy), reaching 27 percent of the full year target (Figure A.14). Tax collections remain below the pre-pandemic levels of 12.4 percent of GDP in 2019. This is because of lower corporate and personal income tax revenues, as well as the tax relief provided by the government as part of the stimulus package in 2021 estimated at about IDR 68 trillion (0.4 percent of GDP).

The Tax Harmonization Law (THL), which was approved in October 2021, represents a crucial step to help address Indonesia’s low tax revenue collection. The THL expands the tax base, increases tax rates, and improves the equity of the tax system. Implementation of the law is well underway. Several measures have

---

21 Support to firms includes tax relief, interest subsidy for MSMEs, and capital injections to selected SOES. COVID-19 health package includes the vaccination program, incentives for health workers, and COVID-19 related medical treatments.
The government has reformed the framework for intergovernmental finance to make it more equitable and effective. Indonesia’s transfer system does not adequately target fiscal resources to the subnational governments (SNGs) that need them the most. This contributes to disparities in service delivery outcomes. The landmark reform in the Law Concerning Financial Relationship Between the Central Government and Subnational Governments (No. 1/2022) aims to address these challenges. The law is expected to improve horizontal equalization of fiscal capacity across subnational governments, improve the quality of transfer-financed spending, better integrate national and subnational spending in the medium term. The General Allocation Grant (Dana Alokasi Umum or DAU) will be allocated based on a “per client” fiscal needs measure which will take effect in 2023. This reform is projected to significantly equalize total revenues per capita across SNGs in the medium term, increasing allocations to SNGs of the most populous areas. In addition, the Specific Allocation Grants (Dana Alokasi Khusus or DAK) will be allocated in view of reducing “service disparities”. DAK allocations are expected to help close service gaps in less populous SNGs that may receive lower funding due to the DAU reform. The new Law also encourages SNGs to collect more own-source revenues. Local government’s own-source revenue remains very low, at only 13 percent of total district revenues in 2018 despite large spending and service delivery responsibilities. The new Law strengthens fiscal incentives for districts to exert more own-source revenue efforts, by no longer compensating the underperforming districts through larger transfers. Subnational tax reforms in the law will also further ease tax administration and assign additional revenue bases to SNGs. Increased revenue autonomy is expected to improve accountability and service delivery.

The fiscal deficit reached 4.6 percent of GDP in 2021, down from the 6.1 percent of GDP in 2020. This outcome is better than the target set in the 2021 budget law (5.7 percent of GDP). Moreover, gross financing needs declined slightly to 7.8 percent of GDP after peaking at 10.9 percent of GDP in 2020 (Figure A.15). As a result, central government debt has started to stabilize reaching 40.7 percent of GDP in 2021, up by only 2.1 percent of GDP from 2020. This level is relatively low compared to peers and well below the fiscal rule debt ceiling of 60 percent of GDP (Figure A.16). The government resorted primarily to the domestic markets for financing. As a result, BI’s share of local currency debt rose to 26.1 percent at end-2021, up from 9.9 percent at end-2019. Likewise, commercial bank holdings of government debt have increased from 22.6 percent to 34.0 over the same period, while the share of non-resident holdings declined from 38.6 percent to 19.0. BI’s primary market purchases of government bonds also fell from 3.0 percent of GDP in 2020 to 2.2 percent of GDP in 2021, in line with its policy of phasing out monetary financing by end-2022.

Public debt has started to stabilize as the fiscal deficit is narrowing amid the recovery, relieving pressure from the bond markets in a context of increased domestic financing.

BOX A.2
Improving the effectiveness of Indonesia’s intergovernmental finance

The government has reformed the framework for intergovernmental finance to make it more equitable and effective. Indonesia’s transfer system does not adequately target fiscal resources to the subnational governments (SNGs) that need them the most. This contributes to disparities in service delivery outcomes. The landmark reform in the Law Concerning Financial Relationship Between the Central Government and Subnational Governments (No. 1/2022) aims to address these challenges. The law is expected to improve horizontal equalization of fiscal capacity across subnational governments, improve the quality of transfer-financed spending, better integrate national and subnational spending in the medium term. The General Allocation Grant (Dana Alokasi Umum or DAU) will be allocated based on a “per client” fiscal needs measure which will take effect in 2023. This reform is projected to significantly equalize total revenues per capita across SNGs in the medium term, increasing allocations to SNGs of the most populous areas. In addition, the Specific Allocation Grants (Dana Alokasi Khusus or DAK) will be allocated in view of reducing “service disparities”. DAK allocations are expected to help close service gaps in less populous SNGs that may receive lower funding due to the DAU reform.

The new Law also encourages SNGs to collect more own-source revenues. Local government’s own-source revenue remains very low, at only 13 percent of total district revenues in 2018 despite large spending and service delivery responsibilities. The new Law strengthens fiscal incentives for districts to exert more own-source revenue efforts, by no longer compensating the underperforming districts through larger transfers. Subnational tax reforms in the law will also further ease tax administration and assign additional revenue bases to SNGs. Increased revenue autonomy is expected to improve accountability and service delivery.

been introduced: i) a VAT rate increase from 10 to 11 percent effective on April 1, 2022, ii) a new PIT tax bracket with a 35 percent tax rate is imposed on taxable income above IDR 5 billion, iii) a CIT rate of 22 percent is maintained, iv) an asset declaration program (‘tax amnesty’) is underway between January-June 2022.23

The fiscal deficit reached 4.6 percent of GDP in 2021, down from the 6.1 percent of GDP in 2020. This outcome is better than the target set in the 2021 budget law (5.7 percent of GDP). Moreover, gross financing needs declined slightly to 7.8 percent of GDP after peaking at 10.9 percent of GDP in 2020 (Figure A.15). As a result, central government debt has started to stabilize reaching 40.7 percent of GDP in 2021, up by only 2.1 percent of GDP from 2020. This level is relatively low compared to peers and well below the fiscal rule debt ceiling of 60 percent of GDP (Figure A.16). The government resorted primarily to the domestic markets for financing. As a result, BI’s share of local currency debt rose to 26.1 percent at end-2021, up from 9.9 percent at end-2019. Likewise, commercial bank holdings of government debt have increased from 22.6 percent to 34.0 over the same period, while the share of non-resident holdings declined from 38.6 percent to 19.0. BI’s primary market purchases of government bonds also fell from 3.0 percent of GDP in 2020 to 2.2 percent of GDP in 2021, in line with its policy of phasing out monetary financing by end-2022.

Support to firms includes tax relief, interest sus22

MoF reported that more than 37 thousand taxpayers have participated in the voluntary asset declaration program by mid-April. Tax collected from this program amounted to IDR 6.65 trillion or about 10 per cent of total net assets.

22 Support to firms includes tax relief, interest s

23 MoF reported that more than 37 thousand taxpayers have participated in the voluntary asset declaration program by mid-April. Tax collected from this program amounted to IDR 6.65 trillion or about 10 per cent of total net assets.
Figure A.12: Favorable 2021 fiscal outcomes as consolidation takes hold.  
(annual fiscal balance, percent of GDP)

Figure A.13: The government is phasing out the COVID-19 fiscal package in 2022 ...  
(percent of GDP)

Source: Ministry of Finance and World Bank staff calculation

Source: World Bank staff calculation based on Ministry of Finance data. Note: In 2022, the COVID fiscal package is reclassified into three programs: health, social assistance, and economic recovery. The above classification is World Bank staff’s estimates. 2022 is budgeted amounts and expressed in percent of 2021 GDP, while 2020-2021 are actual expenditures. A = Actual and B = Budget.

Figure A.14: Rising commodity prices and economic recovery supported solid revenue growth in Q1 2022  
(quarterly revenue outcomes, percent of GDP)

Figure A.15: Gross Financing Needs Have Increased During the Pandemic  
(increase in gross financing needs between 2019-2021 and 2019-2020, percent of GDP)

Source: Ministry of Finance and World Bank staff calculation

Source: IMF Fiscal Monitor April-October 2021
Monetary policy has remained appropriately accommodative even with rising domestic demand and tightening external conditions.

BI maintained its benchmark policy rate at 3.5 percent since January 2021 following a cumulative 150 basis points cut during the pandemic. This is with the backdrop of a negative output gap, rising but low inflation, and stable external conditions despite rising pressures more recently. The real policy rate has moved closer to zero between January and March, averaging 0.2 percent compared to -7.2 percent among peers during the same period (Figure A.17).

BI loosened monetary policy during the pandemic through cuts to the nominal policy rate, open market operations, cuts to reserve requirements, and government bond purchases. This increased liquidity in the economy, with M2 growth doubling from 8.2 to 16.0 percent yoy between September and December last year. Further, M2 growth continued at 13.3 percent yoy in March 2022. Claims on the central government and private sector have accelerated, with the latter sluggishly picking up from 1.7 percent yoy in 2021 Q3 to 5.8 percent yoy in 2022 Q1 (Figure A.20). More recently, in a move to tighten monetary policy, BI raised reserve requirements for commercial banks from 3.5 percent to 5 percent in March. In May, BI announced an accelerated pace in reserve requirement ratio hikes to 7.5 percent from July and 9 percent from September considering rising price pressures.

On the external front, firstly financing needs dropped from 10 to 9.3 percent of GDP in 2020-2021, reducing vulnerabilities to sudden stops or pauses in capital inflows (Figure A.18; IEP December 2021). Secondly, the stock of non-resident holdings of Rupiah assets as a share of official reserves also declined during the pandemic, reducing vulnerabilities to capital outflows. Thirdly, the real interest rate differential between BI’s policy rate and the US Federal Reserve’s rate has...
been positive and widening (Figure A.19). Fourthly, foreign exchange reserves have remained adequate at 7 months of imports and short-term financing requirements.

**Figure A.17:** The Real policy rate is now closer to zero (nominal policy rate minus inflation forecast, in percentage points)

**Figure A.18:** External financing needs and non-resident holdings of Rupiah assets have been relatively low and stable (external financing needs as a share of FX reserves, LHS; stock of assets held by non-residents as a share of FX reserves, RHS)

**Figure A.19:** The real interest rate differential with the US is positive and one of the highest among peers (real interest rate differential with the US, in percent)

**Figure A.20:** Money growth accelerated in the third quarter last year pointing to moderating lending to central government and uptick in credit to the private sector (M2 growth and contribution to growth from components, in percent)
The financial sector’s support to the real economy has picked up (Figure A.21) amid strong bank capital positions.

Bank asset quality is generally high, with adequate bank capital and provisioning levels.

Preliminary results from a reverse stress test suggests that Indonesia’s banking system is resilient to a significant credit shock.

At the same time, however, forbearance measures mask the true extent of balance sheet risks.

---

**Financial Sector Support to Economic Recovery is Starting to Pick Up amid Low Banking Sector Vulnerabilities**

Monetary expansion did not immediately translate into credit growth, signaling weak monetary transmission mostly related to the lack of financial depth, a longstanding structural issue in Indonesia (see part B). Growth of commercial bank lending to the private sector turned negative in October 2020 and registered a lackluster -3.7 percent as of March 2021, its lowest pace in over a decade. However, private credit growth began to pick up and turned positive in mid-2021. In February 2022, private credit expanded by 6.3 percent (yoy) after 5 consecutive months of relatively strong growth. The banking sector has a strong capital position: the capital adequacy ratio has edged up slightly to 25.8 percent as of February 2022 and remains well above the regulatory minimum. Survey data also point to stable household demand for credit.

The system-wide non-performing loan (NPL) ratio has barely increased since mid-2020 and stands at 3.1 percent as of February 2022 (Figure A.22). Indonesia’s NPL level has been on par with East Asia and Pacific (EAP) peers such as China and other ASEAN-5 countries, but the provisioning level is higher. Hence, NPL net of provision to capital remains on the lower end of the EAP distribution. Provisioning levels relative to NPLs continued to increase, reaching 198 percent in January 2022 compared to 182 percent a year ago.

The exercise was performed by the World Bank across several countries to identify the rise in NPLs necessary to trigger a bank’s undercapitalization. Using bank level balance-sheet data as of Q4 2021, the results show that the NPL ratio should reach around 19.4 percent before at least 20 percent of the banking system would breach the minimum capital adequacy ratio due to depleted capital buffers.

Though NPLs are low, the system-wide loans at risk (LAR) ratio, defined as the sum of NPLs, restructured loans, and special mention loans, stood at 19.5 percent as of December 2021. This is lower than the 23.5 percent a year ago but still much higher than its pre-pandemic level (Figure A.23). Asset quality therefore warrants close monitoring as loan forbearance measures have been extended until March 2023 and makes it hard to interpret increasingly opaque bank balance sheets. This opacity should be countered by strong bank governance, robust regulatory definitions of NPLs, and careful bank supervision.

---

24 EFI Macro-financial review, Spring 2022. Results should be interpreted with caution as: 1) the available data do not allow for the consideration of collateral in determining the appropriate level of provisions; 2) NPL data are backward-looking and come with a lag; 3) policy support such as forbearance measures and government guarantees are not accounted for. World Bank (2022b)

25 Included restructured loans in collectability 1 (performing loans), restructured & non restructured special mention loans, and NPL in the LAR calculation as of December 2020 based on Bank Indonesia definition.

26 World Bank (2022h)
Trade barriers have detrimental economic effects both globally and on the domestic market

Indonesia is the world’s top exporter of crude palm oil and a global price setter. The government used several policy measures to restrict exports of crude palm oil and its derivatives to help stabilize domestic prices and address domestic supply shortages. This ultimately resulted in a ban on exports on April 28, 2022, which was subsequently withdrawn on May 23. The export restrictions had negative impacts on both the global and domestic markets. Global supply and price pressures went up significantly, whilst in Indonesia the frequent changes to palm oil export policies created uncertainty in the domestic market for producers and consumers. Effects of uncertainty included restricting quantities of palm oil sold at retailer shops and/or consumer hoarding of palm oil products. The export

Policy restrictions on Indonesia’s palm oil exports in a bid to contain inflation have contributed to global food price pressures and caused confusion in the domestic market.
Soaring global crude palm oil prices have affected many countries including Indonesia, the largest producer (and exporter) of crude palm oil. Between May 2020 and March 2022, the world price of palm oil tripled from $576/mt to $1777/mt due to rising production and processing costs as well as adverse weather conditions. Indonesia and Malaysia, which together account for more than 84 percent of global crude palm oil production, have also been affected. Therefore, policies affecting production and exports in these countries will have far reaching consequences not only domestically but also for the rest of the world.

In the event of large swings in world food prices, governments are confronted with difficult policy choices. One option is using trade policies to insulate the domestic markets from the rise in global prices. Usually, net importing countries intervene by lowering food import tariffs, losing valuable fiscal resources, while net exporters impose export restrictions or bans. Alternatively, governments could allow domestic prices to adjust in line with global food price changes. While such policies do not create price distortions nor a negative fiscal response, they can have political repercussions due to inflationary pressures. To mitigate against this and ensure that the most vulnerable are not exposed, policies are often complemented with social safety net programs. This includes programs such as cash transfers or school feeding programs, that help cushion the effects of food price increase without distorting domestic prices.

Between April 28 and May 23, 2022, Indonesia imposed an export ban on palm oil products aimed to stabilize domestic prices and tackle supply shortages. The ban covered exports of crude palm oil and many of its derivatives and was meant to stay in place until the price of cooking oil stabilized. The export ban followed a series of policy reversals affecting exports of palm oil and its derivates starting with a requirement for export approvals in January 2022, replaced by the obligation of domestic producers to sell 20-30 percent of their output on domestic markets in February and March 2022. The latter was then replaced with an export levy. These policy reversals contributed to additional uncertainties and confusion in domestic and world markets. More generally, since the start of the war in Ukraine, there were a total of 26 other countries that imposed export restrictions on food products covering an estimated 16 percent of global calorie consumption (Figure A.3.1).

Although export restrictions could help insulate domestic markets, they come at the cost of adding significant distortions that can have wide ranging unintended consequences. Through the diversion of supplies to domestic markets, export restrictions suppress prices for domestic producers, while at the same time contributing to world price volatility. If imposed by large exporters (such as in the case of palm oil in Indonesia), export restrictions could contribute to further increases in world prices and in turn adversely affect net importers and low-income countries that rely heavily on food imports. Palm oil is a common ingredient in the production of a wide variety of food products, cosmetics, and household items. Export bans can also contribute to balance of payments pressures and exchange rate fluctuations domestically and externally. Conversely, speculative pressures, hoarding of inventories as well as cuts in output by domestic suppliers can limit the effectiveness of export restrictions to contribute to a decline in domestic prices for consumers.

**BOX A.3**

The unintended consequences of export restrictions during food price shocks

Soaring global crude palm oil prices have affected many countries including Indonesia, the largest producer (and exporter) of crude palm oil. Between May 2020 and March 2022, the world price of palm oil tripled from $576/mt to $1777/mt due to rising production and processing costs as well as adverse weather conditions. Indonesia and Malaysia, which together account for more than 84 percent of global crude palm oil production, have also been affected. Therefore, policies affecting production and exports in these countries will have far reaching consequences not only domestically but also for the rest of the world.

In the event of large swings in world food prices, governments are confronted with difficult policy choices. One option is using trade policies to insulate the domestic markets from the rise in global prices. Usually, net importing countries intervene by lowering food import tariffs, losing valuable fiscal resources, while net exporters impose export restrictions or bans. Alternatively, governments could allow domestic prices to adjust in line with global food price changes. While such policies do not create price distortions nor a negative fiscal response, they can have political repercussions due to inflationary pressures. To mitigate against this and ensure that the most vulnerable are not exposed, policies are often complemented with social safety net programs. This includes programs such as cash transfers or school feeding programs, that help cushion the effects of food price increase without distorting domestic prices.

Between April 28 and May 23, 2022, Indonesia imposed an export ban on palm oil products aimed to stabilize domestic prices and tackle supply shortages. The ban covered exports of crude palm oil and many of its derivatives and was meant to stay in place until the price of cooking oil stabilized. The export ban followed a series of policy reversals affecting exports of palm oil and its derivates starting with a requirement for export approvals in January 2022, replaced by the obligation of domestic producers to sell 20-30 percent of their output on domestic markets in February and March 2022. The latter was then replaced with an export levy. These policy reversals contributed to additional uncertainties and confusion in domestic and world markets. More generally, since the start of the war in Ukraine, there were a total of 26 other countries that imposed export restrictions on food products covering an estimated 16 percent of global calorie consumption (Figure A.3.1).

Although export restrictions could help insulate domestic markets, they come at the cost of adding significant distortions that can have wide ranging unintended consequences. Through the diversion of supplies to domestic markets, export restrictions suppress prices for domestic producers, while at the same time contributing to world price volatility. If imposed by large exporters (such as in the case of palm oil in Indonesia), export restrictions could contribute to further increases in world prices and in turn adversely affect net importers and low-income countries that rely heavily on food imports. Palm oil is a common ingredient in the production of a wide variety of food products, cosmetics, and household items. Export bans can also contribute to balance of payments pressures and exchange rate fluctuations domestically and externally. Conversely, speculative pressures, hoarding of inventories as well as cuts in output by domestic suppliers can limit the effectiveness of export restrictions to contribute to a decline in domestic prices for consumers.
While some countries can succeed at insulating their domestic markets from short-term fluctuations in global food prices, the collective action of many countries exacerbate the prices volatility in a “race to the bottom”. Only countries that insulate themselves to a large degree can reduce price volatility in their domestic market. Doing so leads to a potential “race to the bottom” during a food crisis.\textsuperscript{27} Insulating policies introduced during the 2010–11 food price spike are estimated to have accounted for 60 percent of the increase in the world price of wheat and one-quarter of the increase in the world price of maize (Figure A.3.2). Combined with government policy responses, the 2010–11 food price spike tipped 8.3 million people (nearly 1 percent of the world’s poor) into extreme poverty.\textsuperscript{28}

Instead of distortive trade policies, targeted measures to protect the most vulnerable are recommended, along with structural food system reforms. Targeted safety net interventions such as cash, food and in-kind transfers can mitigate the negative impact of food price shocks. Additional sector policy measures, such as crop and weather insurance, warehouse receipt systems, commodity exchanges, and futures markets, could also be used as risk management instruments. More generally, policy reforms to advance the development of more productive and diverse food production systems can contribute to achieving long-term food and nutrition security in the face of food prices shocks.\textsuperscript{29}

\textbf{Figure A.3.1: Export restrictions on food products since the start of the war in Ukraine}  
\textbf{Figure A.3.2: The contribution of insulating policies to food price increases during 2010-11}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure_a3_1.png}
\includegraphics[width=\textwidth]{figure_a3_2.png}

Source: International Food Policy Research Institute Food & Fertilizer Export Restrictions Tracker; Laborde, Lakatos, and Martin 2019
\end{figure}

\textsuperscript{27} Anderson, Martin, and Ivanic (2017)  
\textsuperscript{28} Laborde, Lakatos, and Martin (2019).  
\textsuperscript{29} Pangestu (2022).
3. The Outlook

The global economic outlook is heavily weighed down by concerns over rising inflation and a renewed global recession.

Global conditions deteriorated with rising price pressures and external financing constraints warrant monetary tightening.

Indonesia will not be immune to these global developments, so whilst growth is projected to continue recovering, downside risks are significant.

A downside scenario could see some of the risks materialize, significantly impacting the growth prospects for Indonesia.

The global growth projection has been downgraded from 4.1 percent in 2022 to 2.9 percent. This includes a significant slowdown in the US as the authorities tighten monetary policy. It also accounts for a slowdown in Europe and further downgrades to growth in China. Most commodity prices are expected to be significantly higher in 2022 than in 2021 and to remain high in the medium term. The price of Brent crude oil is projected to average $100/bbl in 2022, a 45 percent increase from 2021 and its highest level since 2013. Oil prices are expected to gradually decline over the medium-term as global demand softens and as OPEC+ countries expand production. However, it will remain at a relatively high price as it is projected to reach $80/bbl by 2025. Non-energy prices are expected to rise by about 20 percent in 2022 and would also be impacted global shipping and global supply chains bottleneck. As a result, inflationary pressures are expected to persist over the outlook period.

In Emerging Market and Developing Economies (EMDEs), consumer price inflation has been broad based across countries and components (including food, energy, and core inflation). Inflation expectations have also risen (Global Economic Prospects 2022). But tighter monetary policy poses risks in an environment of slowing growth and record levels of public and private debt. Price pressures call for fiscal support to poor households but fiscal space for most countries has shrunk after two years of extraordinary support to fight the pandemic. EMDEs government debt rose by 9 percentage points to 63 percent of GDP in 2020, the fastest one-year increase in the past three decades. With high debt on the one hand, and risks to growth on the other, it becomes increasingly difficult to generate positive fiscal dynamics because higher interest payments require higher levels of growth to reduce the debt burden.

In the baseline, GDP growth is projected at 5.1 percent in 2022, rising to 5.3 percent in 2023 (Table A.1). Three factors underpin the recovery: domestic, with the release of pent-up demand as well as improved consumer confidence; and, external, with improved terms of trade. Despite accelerating growth, the output level would remain below pre-COVID trend, reflecting the scarring effects of the pandemic on the economy. This projected growth is not immune through to growing global risks, which could materialize and weigh negatively on the recovery.

This includes sustained price pressures that would force authorities to expand subsidies and re-allocate fiscal resources away from pro-growth programs. It could also see tightening of global monetary policy triggering capital outflows from emerging markets like Indonesia and leading to tighter and more expensive

---

30 World Bank (2022d)
31 World Bank (2022a)
32 Ibid
external and domestic financing conditions. Moreover, a deeper global economy deterioration and a deeper regional deterioration especially in Indonesia’s main trade partners could lead to lower exports and less appetite for private investment. The materialization of these risks could weigh significantly on growth which could reach 4.6 and 4.7 percent in 2022 and 2023, respectively.

Price pressures are expected to be sustained in the medium term\(^3\). Headline inflation is projected to rise to 3.6 percent in 2022 and stay elevated up to 2025, as the output gap closes. This will be exacerbated by global energy and global food prices. High oil prices have been partially passed on to consumers as the cap on fuel prices was adjusted. Moreover, the authorities have put in place a plan to increase the electricity tariff in Q3-2022. High inflation could prompt a reconsideration of the monetary stance towards more tightening. However, growth and employment trade-offs would also need to be considered given tighter fiscal policy.

Strong commodity windfalls are expected to maintain the current account in surplus at 0.2 percent of GDP in 2022. However, the pick-up in private consumption and investments are projected to bolster imports. This is projected to turn the current account into a small deficit in 2023, which will gradually deepen to 1.3 percent of GDP by 2025. External financing conditions are expected to worsen as global monetary policy tightens, including in the U.S. Moreover, pressures on portfolio debt will mount as climbing inflation will erode yields. However, low external financing needs, sound fiscal and public debt positions, a positive interest rate differential with the US, ongoing structural reforms, and a higher commodity price rally, provide Indonesia with some buffer against tighter global financial conditions. Portfolio equity inflows and FDI are projected to pick-up as the country remains so far one of the stable countries in emerging market and the region (Table A.1). Official reserves are projected to remain adequate at an average of 7.5 months of imports over the medium-term.

A fiscal adjustment of around 1.6 percent of GDP will be needed to reach the government’s deficit target. This is expected to be achieved through an even split of expenditure cuts and revenue-generating reforms. Gross fiscal financing needs are projected to gradually decline but remain sizeable at an average of 7.0 percent of GDP in 2022-2025. With FX-denominated debt issuances and loans expected to finance a larger share of the deficit, monetary financing is expected to subside. The eventual withdrawal of monetary financing is a positive development as it potentially limits moral hazard and the risks of financial repression. However, it also has risks given the uncertainty surrounding the current recovery. The government plans to utilize a cash balance of around IDR 100 trillion for deficit financing in 2022, which will help reduce pressure on bond issuance\(^34\). It also prepared a strategy to mitigate the impact of the tighter

---

\(^3\) Consensus Economics (2022).
\(^34\) For more information see Kontan (24 February 2021)
Public spending is projected to gradually decline with the phasing out of the COVID-19 support package, but remains above pre-pandemic levels, due in part to subsidy and social assistance pressures.

Fiscal revenues are projected to increase due to tax reforms and stronger commodity prices.

Allowing fiscal policy to absorb some of the short-term shocks of the global crisis provides space for a gradual normalization of monetary policy.

global financing through a Bonds Stabilization Framework (BSF) and a Crisis Management Protocol (CMP). The debt-to-GDP ratio is projected to increase to 42.9 percent in 2022, but it will remain well below the fiscal rule threshold of 60 percent.

The COVID-19 fiscal package is expected to be phased out as the pandemic comes under control and the economic recovery strengthens. Overall, fiscal consolidation efforts will also markedly reduce capital spending in the outlook, returning them to pre-pandemic levels. Social assistance spending will be maintained above pre-COVID levels to protect the poor and vulnerable (at 0.9 percent of GDP), including from the impacts of rising food prices, and to accommodate the planned roll out of unemployment insurance and social insurance schemes. Spending on fuel and electricity subsidies is expected to rise temporarily in 2022 (up to 1.1 percent of GDP), as the government implements a partial passthrough of higher global energy prices to retail prices before gradually increasing the administered retail prices. Interest payments will also increase due to the build-up in public debt (+0.7 percent of GDP in 2023 compared to 2019).

The THL is expected to boost government revenues by 0.9 percentage point of GDP, on average, over 2022-2025. This will be complemented by near-term temporary revenue gains from a tax amnesty measure, as well as a modest permanent uptick in 2024 as ongoing tax administration reforms begin to bear fruit. In addition, the strength in global commodity prices, combined with the recent war-driven surge, is expected to boost income taxes and non-tax receipts from the resource sector in 2022-2023. The combination of these factors will result in the tax ratio rising above its pre-pandemic (2019) share of GDP of 9.8 percent, throughout most of 2022-2024 (Table A.1).

Rising inflation expectations create headwinds for monetary policy. The real policy rate has gradually declined to near zero. But at the same time, output remains below its potential and firms need financing to meet growing demand. Bank Indonesia has therefore rightly signaled that it is closely monitoring core inflation to inform policy rate adjustments. It is also using macroprudential tools and payment system reforms to support the real sector. Core inflation has started to gradually pick up as the negative output gap begins to close. A gradual adjustment to the policy rate would be warranted when inflation is more broad-based, as it is expected to become with demand continuing to recover over the course of the year. Indonesia’s stable macroeconomic fundamentals provide the basis for a gradual and predictable adjustment to policy rates.

35 Republic of Indonesia, Ministry of Finance (2022)
36 World Bank (2022c)
4. Structural Reform Priorities

Creating fiscal space through tax reforms and improving quality of spending to sustain medium-term growth, while managing rising pressure for subsidies

In the short-term, priority has shifted from managing COVID-19 to managing the effects of high energy and food prices. In the medium term, expanding fiscal space for growth-supporting spending would require a mixed reform package of deepening tax reforms and improving the quality of public spending including further rationalizing energy subsidies and improving efficiency of public investment. The ministry of finance has also been active in managing its public debt to reduce repayment risks. Indeed, it has gradually turned to smoothen its borrowing portfolio and avoid loan repayment accumulation. (KEM PPKF 2023, Kementerian Keuangan 2022).

As the government embarks on implementation of tax reforms, it is critical to ensure effective implementation and consider complementary measures like conditional cash transfers to minimize potential adverse impact of the reforms on the poor and vulnerable households. The World Bank's analysis suggests that VAT reforms are likely to affect the poor disproportionately, leading to an increase in the poverty rate of 0.27 percentage point (or about 0.7 million people). A direct cash transfer to 23 million poor households and food vendors to deal with the increased cost of living implemented in April is expected to offset the impact to some extent. Continued efforts are also needed to support the preparation and monitoring of implementing regulations.

Surging commodity prices are likely to increase subsidy expenditures and put pressure on the budget. Between January-March 2022 Indonesia’s oil import price (ICP) was averaging USD 98.4 per barrel compared to USD 63 per barrel in the Budget law assumption. While the government has made some price and volume adjustments in early April, most of fuel and electricity prices remain unchanged. The World Bank projects energy subsidies (e.g., fuel, LPG and electricity) to increase by 0.3 percent of GDP relative to the budget allocation, reaching 1.0 percent of GDP in 2022. The fiscal cost will be higher if the implicit subsidies borne by the two state companies (Pertamina and PLN) were also considered (projected at 1.5 percent of GDP in 2022).

On the one hand, they face increasing fiscal costs if domestic prices are not increased, and this could derail the fiscal consolidation process. On the other hand, inflationary risk (if domestic prices are increased) can slow the recovery and hurt poor and vulnerable households. Fiscal support should be designed to preserve the appropriate market incentives and contain costs by providing targeted and direct support to vulnerable household while allowing gradual passthrough of higher international prices to domestic prices (IMF Fiscal Monitor...
April 2022). Without price adjustment and targeting, increasing energy subsidies will disproportionately benefit higher income households and contribute to a higher fiscal deficit and pose risks to the fiscal consolidation target. For Indonesia, preparing an exit plan from high energy subsidies and shifting to targeted support to protect the poor and vulnerable is needed. As such, reallocating untargeted energy subsidies toward more targeted social protection programs such as Program Keluarga Harapan (Family Hope Program/PKH) while addressing gaps in the social protection system would achieve the above objectives (Box A.4).

**BOX A.4**

**Indonesia’s Energy Subsidy Reform Options**

While explicit (on-budget) energy subsidies are projected to remain below 1 percent of GDP in 2022, implicit (off-budget) subsidy spending is estimated to increase sharply because of rising energy commodity prices. The explicit energy subsidy is projected to increase from 0.8 to 1.1 percent of GDP in 2021-2022 (Figure A.4.1). This is driven largely by the LPG price subsidy and the electricity tariff subsidy. However, the actual subsidy is larger because subsidized diesel, gasoline, and electricity are sold at fixed retail prices. This becomes a burden for Pertamina and PLN, the fuel and electricity SOEs respectively, as the economic price (the price before subsidy including taxes and transport costs) is above the fixed retail price (Figure A.4.3). This implicit subsidy is projected to increase from 0.7 percent of GDP in 2021 to 1.5 percent of GDP in 2022 (Figure A.4.2). The MoF compensates the energy SOEs for part of the implicit subsidies in subsequent years through the budget. In response, parliament approved an increase in the energy subsidy by IDR 74 trillion (0.4 percent of GDP) and compensation for the energy SOEs by IDR 216 trillion (1.2 percent of GDP).

The recent change to subsidized fuels is projected to lower the implicit fuel subsidy slightly. Implicit subsidy is expected to decline by a marginal 0.1 percent of GDP. This comes as the subsidized Premium (RON 88) is entirely removed from the market, the Pertalite (RON 90) is designated as subsidized, and the retail price of Pertamax (RON 92) is increased. The government announced plans to increase fuel prices and electricity tariffs in the second half of 2022, which is expected to reduce the implicit subsidy further.

The case for eliminating or better targeting the subsidies remains strong. The explicit and implicit fuel subsidies are largely benefitting the middle and upper class in Indonesia. For example, these two groups consume between 42 and 73 percent of subsidized diesel and 29 percent of subsidized LPG (Figure A.4.4). If these two subsidies are eliminated (saving 1.0 percent of GDP at 2022 prices) and replaced by perfectly targeted social transfers for the poor, vulnerable, and aspiring middle class (costing 0.5 percent of GDP), the net fiscal gain would be 0.6 percent of GDP.

Such reforms can focus on the pricing and quantity of subsidized fuel available. Various analyses show promoting a more targeted diesel and LPG subsidy will increase value for money of the subsidy. Spending on untargeted subsidies is far less efficient than targeted spending on social assistance programs and induces overconsumption behavior, which further increases their fiscal costs (WB PER 2020). Increasing electricity tariffs by 10 percent will reduce the total subsidy bill by IDR 30 trillion; implicit subsidy falls by 25 trillion and explicit subsidy by 5 trillion. Potential subsidy reforms could include:

- Cap the volume of subsidized diesel to support public transport services, small fishermen, and poor farmers only. Subsidized diesel reportedly disappears from the market due to the large price disparity between subsidized and non-subsidized diesel and unclear selection based on eligibility.

---

37 See Channel News Asia (19 May 2022)
38 Based on MoF calculation, the targeting of diesel and LPG improved in 2017 but still far from well-targeted. LPG subsidy was mostly received by middle-income group. Bottom 40 percent of households received only 39 percent from the total of LPG subsidy. The diesel subsidy is regressive to the Gini Coefficient, meaning richer income group received more. The top 10 percent households received 45 percent the diesel subsidy.
39 See CNBC Indonesia (24 March 2022) and Bnis (5 April 2022)
- Cap the number of 3-kg LPG canister available to households. Subsidized 3-kg LPG cylinders are currently available to all citizens with fiscal costs rising from 0.2 percent of GDP to 0.4 percent in 2020-2022. The cap should be set at a level that would be sufficient to meet annual fuel consumption needs of the eligible households, family fishers and farmers, and micro-businesses.

- Electricity: Gradual tariff adjustments to reflect the actual input costs will encourage more efficient energy consumption, investment in efficient equipment, and allow the carbon tax to function as intended. Replacing the subsidy through PLN by direct cash transfers to households will strengthen PLN’s financial position so that it can support the energy transition.

Figure A.4.1: Energy subsidies and natural resources revenues (percent of GDP, LHS; USD/barrel, RHS)

Figure A.4.2: Total fuel subsidy before and after price changes (percent)

Figure A.4.3: Weighted average of tariff and production cost plus margin, subsidized and non-subsidized (IDR)

Figure A.4.4: Distribution of electricity subsidy by subscriber group (IDR trillion)

Source: MoF, MoEMR, Pertamina WB Commodity Price, WB Staff estimates.
Increasing the level and improving the efficiency of public investment at the central and subnational levels is critical to support recovery and medium-term growth.

Indonesia faces two main challenges in managing public investment. First, the inadequate level for infrastructure investment due to a low tax-to-GDP ratio. Second, the inefficiency of public investment due to institutional challenges with public financial management and infrastructure governance. Addressing these challenges is a policy priority as Indonesia shifts the focus from the emergency response to supporting medium-term economic recovery. To achieve this objective, the government will have to create the needed fiscal space and improve the effectiveness of public investment management (Box A.5).

**BOX A.5**
Enhancing public investment efficiency in Indonesia to support recovery and medium-term growth

Years of underinvestment in the infrastructure sector has left Indonesia with a significant infrastructure deficit. Indonesia's general government investment hovered between 2 and 3 percent of GDP for more than a decade (Figure A.5.1). General government investment started to pick up in 2011 and reached 3.6 percent of GDP in 2019, but it is still below the emerging market average of 5.8 percent of GDP (Figure A.5.2). This is partly driven by limited fiscal space given the low tax-to-GDP ratio. Subnational governments, which are responsible for managing half of total capital expenditure (Figure A.5.4), have insufficient resources given limited own-source revenue and restrictions on subnational borrowing. Consequently, Indonesia faces a substantial infrastructure gap that constrains the country's productivity and competitiveness. In 2019, Indonesia's infrastructure stock per capita was estimated at USD 4,254, or about 41 percent of the emerging market average, equivalent to a USD 1.7 trillion gap (Figure A.5.3).

Indonesia also suffers from low efficiency in public investment management. This is reflected by the statistically insignificant short-term multiplier effect of public capital spending in Indonesia (World Bank IEP, June 2021). This could be due to several reasons including high propensity to import, informality, and public expenditure and revenue administration inefficiencies, all of which dampen the multiplier. The 2019 IMF Public Investment Management Assessment (PIMA) highlighted key shortcomings stem from a lack of focus on the appropriate project-level information when planning, budgeting, and monitoring public investment. Multiyear contracts are also not commonly used for infrastructure investment (World Bank, 2020). This is mostly due to absence of information on the medium-term spending envelopes, ongoing and new projects, and the total cost of projects. At the subnational level, the challenge of multiyear budgeting and lack of medium-term perspective in capital investment planning is exacerbated by uncertainty and the annual approach of intergovernmental fiscal transfers. The effectiveness of public investment is also undermined by fragmentation of contracts for capital projects across line ministries (World Bank, 2020).

State-owned enterprises (SOEs) play a prominent role in infrastructure in Indonesia. In recent years, the government relied heavily on SOEs to deliver its infrastructure agenda, including actively assigning key projects to SOEs, often accompanied by government capital injections or guarantees. Equity injections to SOEs have significantly increased, from IDR 54.0 trillion (USD 3.8 billion) in 2016 to IDR 71.3 trillion (USD 5.0 billion) in 2021, of which half was for infrastructure SOEs. In addition to state equity injections, SOEs may receive direct subsidies through Public Service Obligation (PSO) payments and soft loans. SOEs also benefit from soft budget constraints, including preferential access to financing and guarantees, foregone dividend payments, and presumed protection from insolvency (World Bank- InfraSAP, 2019).

The COVID-19 pandemic has exacerbated the urgency to close infrastructure gaps. During the pandemic, public investment was postponed or cut to create space for COVID-19 fiscal packages. For example, the central government budget for Ministry of Public Works and Housing (MoPWH) in 2020 was cut by 10 percent. Similarly, the DAK Fisik transfer—primarily a capital grant from the central government to subnational governments (SNGs) — was also reduced by 5 percent. Authorities also relaxed the mandatory use of transfers for subnational infrastructure spending to allow SNGs' policy response to COVID-19.
Increasing fiscal space and enhancing public investment effectiveness through improved infrastructure governance can help support the recovery while achieving fiscal consolidation. To address longstanding challenges of low and inefficient public investment in Indonesia, the authorities can focus on two policy priorities. First, effectively implement tax reforms (Tax Harmonization Law) to sustainably increasing revenue collection to increase fiscal space for public investment. Second, enhance public investment management and infrastructure governance. The 2019 PIMA assessment recommends six high-priority actions: 1) enhance the focus on capital project-level information; 2) identify major capital projects in the medium-term development plans; 3) strengthen multiyear budgeting framework for capital expenditure; 4) improve the quality of project preparation and selection; 5) modernize capital portfolio oversight and monitoring; and 6) strengthen capital project management.

**Figure A.5.1: General government investment (percent of GDP)**

**Figure A.5.2: General government investment in 2019 (percent of GDP)**

![Graph showing general government investment over time.](image)

Source: MoF, MoEMR, Pertamina WB Commodity Price, WB Staff estimates.

**Figure A.5.3: Public capital stock per capita in 2019 (constant 2017 USD)**

**Figure A.5.4: General government capital expenditure (percent of GDP)**

![Graph showing public capital stock per capita.](image)

Source: World Bank staff calculations using IMF (2021) and Indonesia's Ministry of Finance data.
Prioritizing policies for targeted MSME access to credit, formalization, and digital and green transition for businesses is essential for economic recovery

MSMEs still lack access to credit despite the overall credit recovery. MSMEs account for only 21.3 percent of all bank lending as of January 2022, with micro and small firms receiving only 7 percent and 7.9 percent of total bank lending, respectively, even though 99 percent of all firms in Indonesia are MSMEs. Moreover, 54 percent of MSMEs reported difficulty in accessing finance and 20 percent of MSMEs reported difficulties in repaying loans. The lingering impact of COVID-19 on business performance could inhibit new lending due to increased risks.

These include:

i. the creation of an enabling environment to leverage new sources of data,
ii. promoting innovations in product design,
iii. provide well-targeted and tuned guarantee programs,
iv. advancing the regulatory framework and financial infrastructure to support innovation, enforce consumer and market protection, and facilitate digitalization.

While multiple types of support were necessary to help firms survive the pandemic, this support might also result in “zombification”. The authorities might provide support to ‘zombie’ firms, which would have downsized or exited in the absence of the pandemic. This would take away potential resources from firms who could potentially grow and create value added. For example, the deferrals and restructurings of outstanding loans through the Credit Subsidy program (Kredit Usaha Rakyat – KUR) worked effectively by providing relief to borrowers who were in good standing before the crisis.

The existing GoI’s assistance was not targeted to the most adversely impacted firms. A better targeting mechanism may improve the effectiveness of the support and reduce the allocated budget for these programs. Furthermore, the GoI may prioritize the support to viable MSMEs. On the other hand, financing schemes for large firms could come from the financial sector (World Bank, 2021). This would help reduce short-term fiscal needs, improve the effectiveness of the fiscal response, and stimulate private credit.

Ninety-three (93) percent of the private sector enterprises in Indonesia do not have legal entity status (Economic Census, 2016). The significant proportion of informality reduced the ability of the GoI to quickly respond during the early stages of the pandemic. The readily implemented and expanded programs (e.g.,

---

41 World Bank (2022a)
42 Chapter 4, World Bank (2022h)
Capacity building on digital and greener technology and access to green financing schemes in Indonesia are essential for digital and green transitions.

The interconnectedness of the mining sector with the rest of the Indonesian economy has been limited.

Indonesia is among the few countries using bans on exports of raw mining products with the objective of developing higher value-added mining activities downstream.

Fiscal and credit support) were only available for formal and registered firms. Due to the non-existent dataset on informal firms, other supports aimed to help micro and small firms required a complex and lengthy mechanism for self-registration. Delays in implementation and a complicated registration process potentially reduced the effectiveness and accuracy of the support programs.

Digitalization and green should be the future path of the recovery programs in Indonesia to help firms transition and be more resilient to short- and longer-term shocks. The BPS shows that knowledge and equipment were the main obstacles in doing the digital transition. A recent Green Manufacturing Survey\(^43\) also revealed similar constraints in adopting greener technology. Skills and access to green finance are the two most needed interventions for adopting the digital and greener production process.

**Prioritizing trade policies in support for sectors with potential for growth and job creation; the case of incentivizing down-streaming and the development of higher value-added mining activities**

Output multipliers indicate that a $1 increase in the output of the mining sector leads to a $1.6 increase in total domestic output. This is in contrast with other comparable exporters such as China, South Africa and Brazil that have mining output multipliers close to twice as high. Among specific mining products there is variation in output multipliers, on the lower end being natural gas, bauxite, crude petroleum and iron ore, and on the higher end, coal and lignite, nickel, silver and gold. Compared to other sectors in the Indonesian economy, the potential of mining to generate value added in other sectors has been lagging with mining placed towards the lower end of the distribution together with agriculture, real estate and whole/retail trade (Figure A.24). In terms of existing linkages, the mining industry is relatively better connected with the processing industry, transportation and warehousing, and business services.

Among comparable exporters of mining raw materials, about a third of countries use no restrictions at all, close to half use less restrictive policies such as export taxes or quotas, and non-automatic licensing – while Indonesia is among the remaining 20 percent of countries imposing export bans (Figure A.25). In terms of products, export restrictions in Indonesia are notably imposed on bauxite and tin. For both, Indonesia accounts for more than a quarter of world exports. Export bans are also imposed on nickel where Indonesia’s share of world production adds up to more than a third of the total\(^44\). This significant share in world exports and production puts Indonesia in the position of a price maker. As such, policies affecting exports of these products will have implications not only domestically but also for the rest of the world economy.

---

\(^43\) Conducted by the World Bank as part of World Bank (2022e)

\(^44\) Restrictions cover exports of other raw materials such as aluminum, cobalt, copper, gold, metal waste, nickel and zirconium.
Global evidence suggest that export restrictions are distortive and not effective to incentivize the development of downstream industries.

With the right combination of targeted policies, Indonesia could replace distortive export restrictions to promote the development of greener and higher value-added mining activities.

In the context of the global transition to a low-carbon and green economy, Indonesia could benefit by adapting to new sources of international demand.

Not only that, but export restrictions often have unintended adverse consequences and negatively affect the competitiveness of downstream mining industries and that of the unprocessed products themselves. Examples from countries that have successfully developed their industrial raw materials sectors (e.g., Australia, Chile) show that reforms that incentivize the development of value-added creating clusters around mining sectors, especially in services (engineering, mapping, geological analysis, specialized equipment and technologies for extraction and processing) and reforms that boost regulatory stability to attract investment are much more successful in achieving such policy objectives. Nevertheless, even with successful diversification into higher value-added mining industries, countries relying heavily on commodities for economic growth remain highly vulnerable to commodity price and production cycle.

Indonesia has untapped comparative advantages for exports of mining products such as semi-finished products of iron and non-alloy steel, copper mattes and zinc powders. It also has untapped comparative advantages for exports of mining products such as springs of iron and steel, flat-rolled products of stainless steel, wires of stainless steel or articles of nickel slightly farther from current production capabilities (Figure A.27). A mix of tax, fiscal, trade, business environment, land management and infrastructure policies could create the enabling environment for the development of greener downstream industries (World Bank 2021). Among specific reforms identified were i) amending local content requirements to lower the target for solar to a level achievable for current industry conditions (from 60 to 40 percent); ii) allow accelerated depreciation together with the extension of a ‘tax-loss carry-forward’ incentive; iii) review the existing tax allowance/tax holiday for CIT deduction up to 100 percent in order to assess costs and benefits relative to investment in downstream industries; iv) ease the process for ore sample export permits for technological research purposes; and v) create an intersectoral land conflict resolution mechanism by improving the current one map policy.

The transition will involve adjusting existing productive capabilities and cultivating new green industries. The green transition will boost demand for metals such as bauxite, nickel, cobalt, iron ore and steel, for which Indonesia has important comparative advantages. However, there are important policy constraints to Indonesia’s own climate adaptation and mitigation efforts in the form of NTMs, which are affecting imports of green goods and technologies (World Bank, forthcoming). NTMs come in many different forms such as certification, packaging and marking requirements but some are found to impose significant costs and administrative burden on firms trying to access lower cost and higher quality greener inputs and technologies from abroad (Figure A.26). Similarly, Indonesia has untapped potential in exports of green goods and technologies. Therefore, access to lower cost environmentally friendly goods and technologies through imports would be crucial to enable Indonesia’s own climate transition.
Indonesia’s post-COVID recovery sustainability hinges on the authorities’ ability to implement structural reform priorities. The report has identified the small fiscal space, the scarring effects of COVID-19 on firms, and distortive trade practices as structural bottlenecks for growth. As such three structural reform areas are recommended. First create fiscal space through tax reforms to enlarge the spending envelope and improve quality spending on pro-growth and pro-poor programs. Second, prioritize policies for MSME support, including for access to credit, formalization, and digital and green transition, to overturn COVID-19 scarring effects and propel them toward higher productivity. Third, address trade policy distortions including those linked to NTMs and incentivize through trade the down-streaming and the development of high value-added mining activities. The report has also been vocal on the need for deepening the financial sector as a pre-condition for longer-term sustainable growth. A topic that is thoroughly discussed in Part B.

Figure A.24: Cross-sectoral output multipliers in Indonesia (output multipliers)

Figure A.25: Export restrictions in place by year (share of exports restrictions to total exports)

Source: BPS. 2016 Input-Output table; OECD.

Figure A.26: Diversification opportunities for metal products (distance from current production possibilities)

Figure A.27: Tariff equivalents of non-tariff measures (NTMs) affecting imports of green goods (number of NTMs)

Note: Figure A.27: SPS refer to sanitary and phytosanitary, while TBT is technical barriers to trade. Source: World Bank, The Role of Trade Policies in Indonesia’s Green Transition, forthcoming.
### Table A.1: Selected Macroeconomic Indicators.

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
<th>2021 actual</th>
<th>2022 WB projection</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real GDP Growth and Inflation, percent change</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP</td>
<td>5.0</td>
<td>-2.1</td>
<td>3.7</td>
<td>5.1</td>
<td>5.3</td>
<td>5.3</td>
<td>5.3</td>
</tr>
<tr>
<td>Consumer Price Inflation (CPI) (average, %)</td>
<td>2.8</td>
<td>2.0</td>
<td>1.6</td>
<td>3.6</td>
<td>3.5</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>Private Consumption</td>
<td>5.2</td>
<td>-2.7</td>
<td>2.0</td>
<td>4.7</td>
<td>5.0</td>
<td>5.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Government Consumption</td>
<td>3.3</td>
<td>2.0</td>
<td>4.2</td>
<td>1.4</td>
<td>1.5</td>
<td>4.4</td>
<td>3.9</td>
</tr>
<tr>
<td>Gross Fixed Investment</td>
<td>4.5</td>
<td>-5.0</td>
<td>3.8</td>
<td>5.6</td>
<td>6.4</td>
<td>6.5</td>
<td>6.7</td>
</tr>
<tr>
<td>Exports</td>
<td>-0.5</td>
<td>-8.1</td>
<td>24.0</td>
<td>14.7</td>
<td>10.3</td>
<td>8.3</td>
<td>8.0</td>
</tr>
<tr>
<td>Imports</td>
<td>-7.1</td>
<td>-16.7</td>
<td>23.3</td>
<td>14.9</td>
<td>11.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td><strong>Fiscal Accounts, Central Government, percent of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues</td>
<td>12.4</td>
<td>10.7</td>
<td>11.8</td>
<td>12.5</td>
<td>12.2</td>
<td>12.2</td>
<td>12.4</td>
</tr>
<tr>
<td>of which Tax Revenue</td>
<td>9.8</td>
<td>8.3</td>
<td>9.1</td>
<td>9.9</td>
<td>9.8</td>
<td>10.0</td>
<td>10.4</td>
</tr>
<tr>
<td>Expenditures</td>
<td>14.6</td>
<td>16.8</td>
<td>16.4</td>
<td>16.2</td>
<td>15.2</td>
<td>15.1</td>
<td>15.4</td>
</tr>
<tr>
<td>Primary Balance</td>
<td>-0.5</td>
<td>-4.1</td>
<td>-2.6</td>
<td>-1.5</td>
<td>-0.6</td>
<td>-0.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>Fiscal Balance</td>
<td>-2.2</td>
<td>-6.1</td>
<td>-4.6</td>
<td>-3.7</td>
<td>-3.0</td>
<td>-2.9</td>
<td>-2.9</td>
</tr>
<tr>
<td>Central Government Debt</td>
<td>30.2</td>
<td>39.3</td>
<td>40.7</td>
<td>42.9</td>
<td>43.1</td>
<td>43.3</td>
<td>43.7</td>
</tr>
<tr>
<td><strong>Balance of Payments, percent of GDP unless indicated otherwise</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>-2.7</td>
<td>-0.4</td>
<td>0.3</td>
<td>0.2</td>
<td>-0.6</td>
<td>-1.3</td>
<td></td>
</tr>
<tr>
<td>Exports, Goods and Services</td>
<td>17.9</td>
<td>16.8</td>
<td>20.8</td>
<td>23.5</td>
<td>23.0</td>
<td>22.9</td>
<td>22.1</td>
</tr>
<tr>
<td>Net Foreign Direct Investment</td>
<td>1.8</td>
<td>1.3</td>
<td>1.4</td>
<td>1.6</td>
<td>1.7</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Gross Reserves (months of imports of goods and services)</td>
<td>9.7</td>
<td>7.5</td>
<td>7.0</td>
<td>7.5</td>
<td>7.6</td>
<td>7.8</td>
<td>7.3</td>
</tr>
<tr>
<td>Terms of Trade (2019=100)</td>
<td>100.0</td>
<td>111.5</td>
<td>190.0</td>
<td>303.2</td>
<td>226.6</td>
<td>219.2</td>
<td>147.9</td>
</tr>
<tr>
<td><strong>Memorandum Items</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nominal GDP (IDR trillion)</td>
<td>15,833</td>
<td>15,438</td>
<td>16,971</td>
<td>17,883</td>
<td>19,234</td>
<td>20,736</td>
<td>22329</td>
</tr>
<tr>
<td>Per Capita GDP (US$)</td>
<td>3,877</td>
<td>3,757</td>
<td>3,856</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Nominal GDP (US$ billion)</td>
<td>1,119</td>
<td>1,059</td>
<td>1,186</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
</tbody>
</table>
B. Strengthening The Financial Sector to Support an Inclusive and Sustainable Recovery
B. Strengthening the Financial-Sector to Support an Inclusive and Sustainable Recovery

1. Introduction

Finance plays a central role in the recovery from the COVID-19 crisis. The financial sector facilitates allocation of resources across space and time to support the real economy and serves many crucial functions such as 1) value exchange/payment: provides means of transaction in an economy, 2) Intermediation/credit provision: channels credit from savers to borrowers, 3) Liquidity provision: helps meet unexpected needs of economic agents, and 4) Risk management: facilitates pricing and allocation of risks. Due to the important roles and functions it plays, a stable and smooth-functioning financial sector is important to ensure that governments and financial institutions can support both the recovery from the COVID-19 crisis and longer-term economic growth, including through investments in public services such as health care and education.

Financial institutions are connected with households, firms, and the government through numerous mutually reinforcing channels. For instance, when households and firms are under stress, the financial sector may be impacted by bad loans and corporate insolvencies, and hence less able and willing to provide credit to households and firms. In addition, a weakened financial sector may also require public sector support, reducing the government’s fiscal policy space. Monetary policy such as policy rate changes, liquidity injections, and provisioning requirements can influence the financial sector’s ability to support the real economy.

A deeper financial sector, as measured by the size of banks and non-bank financial intermediaries, is often accompanied by greater financial access as more resources are available for allocation to households and firms, including those traditionally underserved. A larger financial sector could be associated with greater financial efficiency if greater competition in the sector lowers the cost of financial intermediation. Financial deepening also permits households and firms to choose from a diverse set of financial instruments to increase financial resilience, i.e., ability to recover from adverse economic shocks such as job losses, unanticipated expenses, or natural disasters.
Although there has been substantial progress, the financial sector is not yet sufficiently developed to be able to fund the country’s development needs or boost inclusive economic growth. The financial sector remains shallow compared to peers (Figure B.1), both in terms of its size and credit relative to GDP, and dominated by banks. Bank intermediation efficiency and financial inclusion of both households and SMEs lags peer countries. Capital markets do not intermediate sufficient funding for the economy and do not represent a competitive alternative to banks. As the domestic investor base is unable to provide sufficient longer-term financing for Indonesia’s economic development, foreign funding tends to play an important role, which exposes the country to external vulnerabilities.

Before COVID-19, the GoI issued key national strategies focused on core elements of the financial sector development agenda that are still relevant in the pandemic recovery context. The main government approach to financial deepening is elaborated in the National Strategy for Financial Market Deepening (SN-PPPK) 2018-2024. This strategy contains a detailed and comprehensive plan of action for developing six financial markets; good but uneven progress is observed in those markets. Moreover, a new National Financial Inclusion Strategy (NFIS) underpinning the GoI’s efforts in further expanding access to financial services was issued in December 2020. Further, the Financial Sector Omnibus Law (FSOL), which is currently being drafted, aims to comprehensively address long-standing legal and regulatory issues in the Indonesian financial sector while supporting economic recovery from the pandemic.

The Government of Indonesia (GoI) is committed to promoting a deep and inclusive financial sector. The effectiveness and success of these strategies depend on their execution and implementation, and the role of the financial sector in supporting the country’s economic recovery, especially in the context of the COVID-19 pandemic.
### TABLE B.1. Total Assets of Financial Institutions in Indonesia

<table>
<thead>
<tr>
<th>Total Assets of Financial Institutions as of 2021</th>
<th>IDR Trillion</th>
<th>% of Total Assets of Financial Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>10,297.81</td>
<td>78.77%</td>
</tr>
<tr>
<td>Commercial Bank</td>
<td>10,112.30</td>
<td>77.35%</td>
</tr>
<tr>
<td>- SOB</td>
<td>4,251.75</td>
<td>32.52%</td>
</tr>
<tr>
<td>- Regional Development Bank</td>
<td>861.33</td>
<td>6.59%</td>
</tr>
<tr>
<td>- Domestic Private Bank</td>
<td>4,562.82</td>
<td>34.90%</td>
</tr>
<tr>
<td>- Branch Offices of Foreign Bank</td>
<td>436.41</td>
<td>3.34%</td>
</tr>
<tr>
<td>Rural Bank</td>
<td>185.50</td>
<td>1.42%</td>
</tr>
<tr>
<td>Insurance</td>
<td>1,590.72</td>
<td>12.17%</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>327.40</td>
<td>2.50%</td>
</tr>
<tr>
<td>Finance Companies</td>
<td>433.11</td>
<td>3.31%</td>
</tr>
<tr>
<td>MFI</td>
<td>1.28</td>
<td>0.01%</td>
</tr>
<tr>
<td>Infrastructure Finance Companies</td>
<td>129.13</td>
<td>0.99%</td>
</tr>
<tr>
<td>Pawnshop</td>
<td>67.02</td>
<td>0.51%</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>21.27</td>
<td>0.16%</td>
</tr>
<tr>
<td>Fintech</td>
<td>4.06</td>
<td>0.03%</td>
</tr>
<tr>
<td>Other Financial Institutions</td>
<td>201.60</td>
<td>1.54%</td>
</tr>
</tbody>
</table>

Source: OJK

Figure B.1: Financial depth in Indonesia

The GoI, over the past four years, has issued various national strategies related to financial oversight, capital markets, financial inclusion, payment systems, and disaster risk finance aimed at further promoting financial sector development by increasing (i) financial deepening, (ii) financial efficiency, and (iii) financial resilience.

(i) Financial Deepening: The GoI’s main approach to financial deepening is outlined in the National Strategy for Financial Market Deepening 2018-2024, which contains a detailed and comprehensive plan to develop financial markets in terms of their accessibility, instruments, financial market infrastructure, benchmark rates, and the regulatory framework. The strategy is complemented by the National Strategy for Financial Inclusion, which was issued in December 2020 and underpins GoI’s efforts in further expanding access to financial services for both households and firms. Building on a similar initiative from November 2016, it identifies three key areas of engagement, namely providing appropriate services, providing appropriate products as well as responsible finance through financial education and consumer protection.

(ii) Financial Efficiency: Following the launch of the 2018 Bali Fintech agenda, the GoI has launched a national payment gateway, an ecosystem that connects various electronic payment or cashless transaction instruments to facilitate the interconnection and interoperability of the country’s retail payment system. In addition, to better harness the benefits and opportunities of rapid advances in digital finance, while at the same time managing emerging risks, the government introduced the Indonesia Payment Systems Blueprint 2025 in 2019 – a major step towards the establishment of a modern payment system.

(iii) Financial Resilience: To address the various challenges from global and domestic economic uncertainties and align with the main national development agenda as stated in the 2020-2024 Medium Term National Development Plan (RPJMN), OJK has formulated the 2021-2025 Indonesian Financial Services Sector Master Plan (MPSJKI). The Master Plan is intended to serve as a basic framework for the strategic direction of the financial services sector, with the overall objective to promote economic recovery and enhance resilience and competitiveness. The structure of the MPSJKI focuses on three areas, namely: (1) strengthening resilience and competitiveness; (2) development of financial services ecosystem; and (3) digital transformation acceleration. Furthermore, to better manage fiscal and financial risks from climate-related shocks and natural disasters, to which Indonesia is particularly prone, the GoI launched the National Disaster Risk Financing and Insurance Strategy during the WB-IMF Annual Meetings in October 2018. On a supra-regional level, Indonesia, together with other ASEAN countries, has established the Southeast Asia Disaster Risk Insurance Facility (SEADRIF), a regional platform to provide ASEAN countries with financial solutions and technical advice to increase their financial resilience to climate and disaster risks.

BOX B.1
Key elements of GoI’s Financial Sector Development Agenda

The GoI, over the past four years, has issued various national strategies related to financial oversight, capital markets, financial inclusion, payment systems, and disaster risk finance aimed at further promoting financial sector development by increasing (i) financial deepening, (ii) financial efficiency, and (iii) financial resilience.
2. Deepening the Indonesian Financial Sector

2.1. Financial Sector Context

This has allowed the banking system to remain well-capitalized and resilient despite the economic and financial disruptions caused by the COVID-19 pandemic and to play an important countercyclical role by continuing to support the economy during the downturn. Banking sector profitability is increasing (albeit remaining below pre-pandemic levels) and the banking industry maintained a solid capital base as a buffer to absorb the potential risk of deteriorating loan quality (although loan forbearance measures may continue to mask the true extent of bank balance-sheet health). However, long-term structural challenges remain against this backdrop.

As of end 2021, commercial banks’ assets represented 61 percent of GDP and accounted for 79 percent of total financial sector assets. This dominance has remained relatively stable in recent years. Institutional investors, such as mutual funds, insurance companies and pension funds, are comparatively small (14.7 percent of GDP in 2021), relative to their potential as exhibited in Malaysia or Thailand.

The financial system is bank-centric and highly fragmented, with many banks, microfinance institutions, cooperatives, and non-bank financial institutions (NBFIs) spread across a very large and diverse geographical area.

Figure B.2: Institutional Investors Assets as % of GDP

Figure B.3: Cost of Financial Intermediation

Note: 2020 data. Source: OJK, FinStats
Bank intermediation efficiency is relatively low, marked by high intermediation costs (Figure B.2), which holds back financial development and, ultimately, inclusive and sustainable economic growth.

Stemming from weak financial intermediation, a related longstanding challenge is access to credit for micro, small, and medium enterprises (MSMEs) in Indonesia.

Capital markets are also shallow, and liquidity is relatively low.

Capital markets do not provide an alternative source of funding, nor do they represent a competitive alternative to banks.

Net-interest margins, a commonly used measure of intermediation efficiency, have been structurally higher in Indonesia than in peer countries. High interest spreads impact domestic savings and investment negatively and may inhibit bank lending. Many factors, including lack of competition, weaknesses in the institutional environment, and operational inefficiencies can contribute to the observed weak intermediation efficiency.

The “People’s Business Loan” (Kredit Usaha Rakyat, KUR) program is the GoI’s flagship public program to enhance access to finance for MSMEs. Since 2015, KUR has provided subsidized loans for millions of MSMEs, often enabling them to access finance for the first time. Under the KUR scheme, the Government provides interest subsidies directly to participating financial institutions, allowing them to lend to MSMEs at lower interest rates. The interest rate subsidy also covers a guarantee fee which banks can choose to pay to selected credit guarantee companies, but the loan capital comes from the banks themselves. Annual fiscal expenditures on KUR total approximately 13 trillion IDR (US$ 900 million, or around 0.07 percent of GDP). Through the pandemic period, the KUR program served as the central platform for the government to direct assistance to MSMEs, with millions of KUR borrowers receiving support in the form of deferred payments, repayment grace periods, and interest-free loans. The KUR program plays an important role in helping MSMEs to access finance for the first time. At the same time, since the program allows borrowers to take repeat loans, only a small proportion of borrowers’ transition from the subsidized KUR loans to commercial loans. Exploring new options for graduation from KUR loans and strengthening the credit guarantee portion of the program could widen its impact and outreach.

As of end 2021, stock market capitalization was 48.6 percent of GDP and domestic private debt securities outstanding were about 4.4 percent of GDP, both smaller than G-20 and ASEAN peers. Despite recent growth in the number of listed companies, the overall size of the Indonesian equity market remains relatively small by international comparison. The market for fixed-income securities is also relatively shallow. Except for the government bond market, other segments of the capital market (the stock market and corporate bond market) in Indonesia are somewhat illiquid. For the capital markets to provide access to finance for the public and private sector broadly, they need to be sufficiently deep; while for the markets to provide price signalling effect that help make capital allocation in the economy more efficient, they need to be liquid.

This is due to, among others, the absence of a well-developed domestic investor base, especially one that can provide longer-term financing, which entails reliance on foreign funding and associated risks. Corporate bond markets are particularly shallow and bank loans are still the dominant and typically the only funding option for companies, especially SMEs. Like bank loans, corporate bonds are a source of debt financing for firms. While banks are the typical lenders in the loan market in Indonesia, creditors in the corporate bond market are financial investors, primarily

---

49 Defined as banks total interest income minus total interest expenses divided by total assets.
institutional investors. In this context, the role of foreign funding is important, with around 70 percent of corporate debt securities issued offshore (as of Sept 2021). Reliance on foreign investors exposes the economy to risks associated with the volatility of capital flows, a feature more salient in the uncertain external environment today. Non-financial corporate debt in foreign currencies represents about 36 percent of total corporate borrowing; though overall corporate external debt is less than 15 percent of GDP. These features expose corporates with external debt to risks related to global financial tightening and currency mismatch. These risks are important given the absence of deep and liquid derivative markets to protect investors and firms from interest rate and foreign exchange fluctuations.

There has been an improvement in financial inclusion, but many challenges remain.

Many Indonesian firms, especially MSMEs, lack access to a line of credit and suffered from financial difficulties during the pandemic.

Low financial inclusion in Indonesia is a multidimensional problem, involving lack of physical access to financial providers, high transaction costs, low levels of education, lack of identification documents, and other socio-economic factors. These challenges are further compounded by low levels of financial awareness and literacy. Financial products offered to firms and households are often limited to traditional banking products and basic capital market products such as mutual funds. Although household access to the formal financial sector has increased in recent years, the country still has the fourth largest unbanked population in the world: 95 million adults (and two thirds of the poorest adults) as of 2017.

MSMEs account for only 18.5 percent of all bank lending, with micro and small firms receiving only 3.7 percent and 7.2 percent of total bank lending, respectively, even though 99 percent of all firms in Indonesia are MSMEs. In the latest round of the World Bank Business Pulse Surveys (August 2021), 54 percent of MSMEs reported difficulty in accessing finance and 20 percent of MSMEs reported difficulties in repaying loans as tighter lockdowns and mobility restrictions impacted firm revenues. However, MSMEs are generally faring better with debt servicing compared to the height of the pandemic in June 2020, when 28 percent of MSMEs had reported difficulties repaying loans. Firms with more female managers experienced more problems in accessing finance and in loan restructuring.

---

50 These figures are based on the 2017 Global Findex database. New figures, collected in 2021, are expected to be released by end-June 2022.
2.2. Opportunities for deepening the financial sector

This section looks at opportunities for deepening the financial sector, following the conceptual framework outlined in Figure B.5. Given the scarcity of resources vis-à-vis the development needs and the potential of Indonesia, it is necessary to increase the sources of funding for the financial sector (I), to support the economic recovery by expanding lending and increasing usage of financial services (II). An efficient allocation of the resources within the financial sector (III) will enhance its support to the real economy by channeling savings into the most productive investment opportunities in a cheaper, faster, safer and more transparent way. A stable financial sector (IV) with a conducive financial sector architecture represents a key enabling factor.

Figure B.5: Conceptual Framework

I. Expanding the sources of funding

Access to financial services, such as payments systems, basic savings accounts, credit, and insurance products, can facilitate investments in education, health, housing, and businesses. It can smooth consumption and bolster resilience to shocks such as disease, job loss, or a weak harvest. Digital financial services (DFS) encompass financial services that rely on digital technologies for their delivery and use by consumers. Facial recognition in account opening, biometric verification to confirm customer identification or authenticate transactions, and automated creditworthiness assessments in credit applications are some notable examples. DFS are often characterized by low marginal costs per account or transaction, bringing efficiencies of scale and reducing operational costs. DFS also enhances
transparency, since every transaction generates a data trail that can be utilized by financial service providers to formally develop a credit-scoring mechanisms even for informal market participants, which makes it easier for lenders to extend credit to these market participants in an otherwise opaque information environment. DFS can thus lower costs, increase speed, transparency, security, and availability of more tailored financial services, catering to all households, and at scale.

Digital credit is one form of DFS that has already begun to make inroads in expanding access to finance in Indonesia. Volumes of digital lending have increased significantly over the past two years with digital loans reaching a total of 76 million borrowers. Many of Indonesia’s banks have moved to the digital frontier and have begun to develop and roll-out digital products. The number of fintech firms in the country has also increased significantly over the past two years, largely driven by domestic and regional fintech lenders popularly known as ‘Peer to Peer (P2P)’ lenders.

The pilot program worked with Amartha, one of Indonesia’s leading P2P lenders, and three private banks. The three banks studied in the pilot partnered with Amartha to disburse a total of IDR 1.2 trillion (approx. USD 85 million) in loans to women entrepreneurs. Amartha utilized their alternative data credit scoring technology and digital platform to help the banks reach new women entrepreneur borrowers. The results of the pilot speak to the value of digital technologies in supporting financial inclusion. Women entrepreneurs receiving the new digital loan product increased their incomes by 14 percent. At the same time, defaults were similar to the banks’ broader MSME portfolios, demonstrating the viability of the new digital product line and business model in serving women entrepreneurs.

Non-bank financial institutions have not kept pace with economic growth and remain small and underdeveloped. Asset holdings by institutional investors remains low, with outstanding assets under management of private pension funds at just 1.9 percent of GDP, 3.4 percent of GDP for mutual funds, and 9.4 percent of GDP for insurance companies as of December 2021. The share of insurance assets to total financial assets has grown, but insurance penetration rate (contribution of gross premium to GDP) is low at 3.2 percent compared to ASEAN peers. Expanding the size of institutional investors will bring about opportunities to reduce reliance on foreign investors in both equity and government bond markets, reduce the dependency on bank financing, and expand access to long-term financing through the capital markets. To address this issue, policymakers should provide strong incentives for long-term savings, particularly in the form of pension and old-age savings under occupational pension scheme and the National Social Security System and expand pension and social insurance coverage. Not only do these efforts improve financial security against adverse events and during unproductive years, but they also accumulate funds that can be used for financing development.

---

51 Total assets of insurance companies including life, general, reinsurance, and mandatory insurance to GDP is 5.53 percent while total assets of social insurance (BPJS Employment and BPJS Health) is 3.84 percent as of December 2021.
II. Expanding lending/usage of financial services

As noted above, there are long-standing demand and supply side constraints to delivering affordable and suitable financial services to the poor. Transaction accounts (either a bank account or e-money account) are essential since they allow individuals or business to (i) make and receive payments, (ii) safely store value, and (iii) serve as gateway to other financial services (credit, insurance, or investment products). Basic savings account options (e.g., TabunganKu, Simpel) have been introduced to reach a broad range of the target population at little or no cost (no admin fee, low opening and maintaining balance). Agent network services (Laku Pandai, Layanan Keuangan Digital/LKD) have also been introduced to increase the outreach of financial services by facilitating account opening, cash-in/cash out transactions (CICO), fund transfer, and bill payments. Large-volume and recurrent payment streams such as government payment programs, government and utility bill payments, transit fare payments, employer payrolls, and remittances, are good opportunities to expand access while also functioning as a source of income to payment service providers.

In addition to transaction accounts for individuals and households, digital financial services are also poised to unlock other critical constraints that could yield gains in firm-level growth. Both credit and business services are being transformed by the digital revolution. Indonesia is relatively advanced on the digital spectrum, with Global Findex data showing that 35 percent of Indonesian adults have made or received digital payments in 2017, compared to an average of 29 percent in comparator middle income countries. On the credit side, digital loans can reach previously unbanked firms, reduce or eliminate reliance on fixed assets as collateral, and can reach those without formal credit histories. Business services, too, are undergoing dramatic transformations, with digital players providing everything from cloud accounting services to electronic platforms for business-to-business trade and communication, to apps for business training. E-commerce platforms, meanwhile, enable firms to expand their access to markets and increase their sales. Firm-level evidence in Indonesia finds that firms of all sizes were less likely to experience a decline of revenue during the pandemic if they used digital services.

The development of green financial markets can play a central role in facilitating investments in the short-run and a transition toward more sustainable economies in the longer run. In Indonesia, $6.4 billion, or about 0.6 percent of GDP, was raised through green bonds and syndicated loans since 2018, when the first issuances took place. The country ranked 42nd in the world in terms of amount raised to GDP over the 2017-2021 period. Bonds accounted for the bulk of green debt markets, representing 92 percent of the amount raised in Indonesia. While

---

52 Since 2017, the government has been utilizing basic savings accounts and agents to enable access to formal financial services for social assistance beneficiaries.
53 Defined as financial flows to sustainable development priorities.
the depth of green debt markets in Indonesia is notably smaller than that of China, it compares favorably to most of its other structural benchmark countries, when depth is measured both in absolute dollar amounts and as a share of GDP (Figure B.6). However, sustainable financial markets in Indonesia do not have yet the scale required to meet the funding needs for the country’s sustainability objectives (e.g., SDG goals and Net Zero aspirations) and funding for the private sector remains very limited. Among well-known market failures that arguably lead to under-investment in green projects, informational ones appear to be among the most binding constraints in Indonesia. This suggests an active role for government intervention in implementing reforms to foster the development of sustainable financial markets, especially aimed at mobilizing capital toward sustainable growth objectives, including by tackling the informational challenges in the market.

### III. Allocating resources efficiently

Digital finance can improve efficiency by fostering financing at scale and greater risk diversification through innovative product design or by integrating new technologies or improved data models for financial services. Competition in the financial sector constrains market power for individual institutions and can improve the efficiency of risk pricing while encouraging innovation. A sound financial infrastructure provides the enabling environment for an efficient financial sector.

Banks are moving to expand their digital banking services while simultaneously reducing their physical presence. At one end of the spectrum are virtual banks or neo banks which often have no physical presence at all. More importantly, Indonesia’s largest banks are beginning to roll out digital financial services, either through partnerships with fintechs or through increased in-house digital capacity. Although smartphone penetration rates are increasing, mobile data infrastructure

---

54 Based on a World Bank survey of local financial institutions on the drivers and constraints behind sustainable financial markets in Indonesia.
55 See the Bali Fintech Agenda (2018) and Fintech and the Future of Finance (2022) for more information.
is not keeping pace and data packages can be considered too expensive for underserved and unserved customers, particularly in rural areas. With fewer options available to access cash, consumers are expected to increasingly use digital payment services. However, without convenient access to and acceptance of cash, there is a risk that some segments will be left behind such as senior citizens, disabled individuals, undocumented migrants, people within extreme poverty levels, inhabitants of rural and remote areas, and those with limited financial literacy.

As such, they become an important component to facilitate the consumer transition from a cash-based to a digital economy while maintaining the cash liquidity service to the cash-based loyalists. Unfortunately, current agent business models, which heavily rely on the commission from CICO activities, are facing a big challenge due to the new digital payment methods. More and more people are accustomed to using mobile money, mobile wallets, or mobile banking applications to carry out their payments via QR channel. Transaction volumes also tend to be low in rural areas. Thus, new agent business models which aggregate different types of transactions at the agent level (e.g., e-commerce, ride hailing, investment etc.) can generate more revenue streams and provide stronger incentives for agents to become active.

This should help to expand access to credit beyond the small proportion of borrowers who reside close to bank branches and have the needed documentation and credit history to access loans. While potentially transformative, structural challenges currently hinder the still struggle with high costs of funding due to their inability to mobilize deposits and foreign investment restrictions. Lack of credit information on prospective borrowers keeps the cost of lending elevated. As a result, digital lending rates are often high, with lenders charging daily or weekly interest rates that can mount quickly for borrowers who struggle with repayment. The presence of illegal and unregistered digital lenders remains another ongoing challenge, with some charging exorbitant daily interest rates up to 10 percent. Fostering competition, consumer protection, and sound regulation in the digital lending sector has become critical, allowing Indonesia to capture the benefits while minimizing the risks of scaling digital credit, and hence, should be an emerging priority for regulators.
**Box B.2**

**Bank Fintech Partnerships**

A large financing gap in the MSME sector has contributed to low productivity and competitiveness in Indonesia’s private sector. Finance constraints are amplified for women-owned businesses, which make up a large proportion of Indonesian MSMEs and tend to have less access to credit than their male counterparts due to inequalities in ownership of fixed assets (e.g., land, house etc.), which can serve as collateral to secure loans. Without needed credit, these women-owned enterprises, are starved of opportunities to grow.

In recent years, Indonesia has undergone a dramatic expansion in financial technology prevalence, particularly around P2P lending. Volumes of P2P loans have increased 1800 percent over the past two years and the number of fintech firms in the country has tripled over the same period, in parts propelled by the COVID-19 pandemic which has led to a rapidly growing digitization of the financial services sector. The leading P2P players have developed data-driven technologies to identify and predict potential borrowers’ creditworthiness, reducing the need for asset collateral and offering the opportunity to reach previously unbanked but credit-worthy borrowers.

Against this backdrop, a pilot program supported by OJK and the World Bank paired banks with fintech P2P lenders to deliver digital credit to women entrepreneurs, using data-driven credit scoring to replace fixed asset collateral. The pilot program worked with Amartha, one of Indonesia’s leading P2P lenders, and three private banks. The three banks studied in the pilot partnered with Amartha to disburse a total of IDR 1.2 trillion (approx. USD 85 million) in loans to women entrepreneurs. Amartha utilized their alternative data credit scoring technology and digital platform to help the banks reach new women entrepreneur borrowers.

Evidence from the study yielded three important findings and insights on the potential of bank-fintech partnerships to increase access to finance for women-owned firms in Indonesia. First, the study found that despite initial concerns from banks over the risks of digital lending, digital portfolios disbursed through bank-fintech partnerships performed as well or in some cases better than the banks’ existing analog MSME loan portfolios. From the USD 85 million of digital loans disbursed, NPLs were just under 2 percent, a figure comparable to banks’ NPLs on their traditional MSME portfolios. Second, the study found that firms benefited from the access to digital credit: women entrepreneurs receiving the new digital loan product increased their incomes by 14 percent. Finally, the study found that not all loans are equal, and that larger ticket-size digital loans tended to have more impact on borrower incomes and were more suited to market demand, but were typically less attractive for digital lenders, suggesting a need for incentives for digital lenders to enter this market segment.

Competition/pricing risks.

The banking system is dominated by four state-owned banks (SOBs) and large private banks. Together these banks have considerable market power. They benefit from their established presence and trust as reflected by their dominance of distribution channels (branches, ATMs and agents). This enables them to pay lower interest rates on retail deposits than smaller private banks. In addition, SOBs play an important role in servicing government businesses as well as micro and small enterprises (e.g., due to their role in the administration of the KUR program). They therefore dominate important segments of the market, while at the same time promoting financial inclusion. SOBs also benefit from the development and operation of certain infrastructure services. This allows them to deploy common services (e.g., points of sale and automated teller machines) using common systems. This creates economies of scale and scope as well as network effects.

---

59 The KUR program has allowed BRI, the dominant distributor, to build knowledge on servicing the MSE sector and to assemble data (credit information) on its MSE clients.
A recent World Bank analysis suggests that SOBs may have adopted a universal pricing policy in lending.

They seem to be charging similar rates irrespective of location across the country, with limited price differentiation to reflect the riskiness of different categories of borrowers and the costs of servicing clients in various geographical locations. This universal pricing policy may in turn discourage the pricing of risks by all other banks, thereby affecting the efficient allocation of resources within the Indonesian financial sector.

Making wider use of data analytics, including scoring models, or referring to alternative data sources could strengthen their ability to serve riskier and underserved segments. The credit information system in Indonesia is still in its nascent stage and, if adequately exploited, has the potential to strengthen the pricing of risk and support the efficient allocation of resources to the real sector. The limited competition among banks in the upper tier of the market seems to determine a lack of incentives for risk-pricing: large private banks are not willing to significantly lower their lending rates for their low-risk clients to levels below those charged by SOBs, since this would lower profitability and not necessarily increase market shares. Large banks also have limited incentives to reach out to riskier clients (at higher rates) if credit risks are not reflected in the prices of products and services. Indeed, larger banks seem to exclude the riskier clients, which are likely being served by smaller banks or excluded altogether.

Gaps in financial infrastructure

Financial institutions assess creditworthiness of loan applications based on the ability and willingness of the borrower to repay the loan. However, not all necessary information to assess creditworthiness is available, which discourages risk-pricing. Sound, efficient, and effective credit information systems help to address this problem. The main source of data for lenders is the credit registry (OJK’s SLIK system) which consolidates credit data from banks, finance companies, venture capital funds, and investment companies. To date, private credit bureau (PCB) coverage of data in addition to the data from the credit registry is severely limited. Hence FIs tend to rely on their own database of clients and the credit registry, with very few utilizing services provided by PCBs. PCBs are struggling to access data from other sources such as public sector data, utility companies, business registries, the courts, tax authorities, social security offices and credit guarantee companies. Lack of shared access to such data severely hampers the ability of financial institutions to assess credit risks.

Financial institutions in Indonesia generally require borrowers to put up immovable assets as collateral. Gaps in the legal, regulatory, and institutional frameworks for secured transactions limit the appetite of financial institutions to extend credit backed by movable assets (movables). The legal provisions for financing against
movables are based on the civil code, the fiduciary security act and the companies act. A web-based collateral registry is also functional. However, these acts do not constitute a unified legal framework for secured transactions. Compared to modern provisions, there are major gaps such as incomplete priority rules and little enforcement provisions. Moreover, functionally equivalent transactions are not included and protection for secured creditors under the insolvency framework is limited. There have been no movables finance market development efforts either. The current share of commercial finance involving movables assets is tiny, concentrating on motorbikes, vehicles and heavy equipment only. The development of a substantive movables finance market will have positive implications for SME finance, agriculture finance, infrastructure finance, and trade and supply chain finance.

The legal framework of Indonesia's insolvency system is largely adequate, but its implementation remains a challenge. Limited uptake by firms and lack of access by smaller firms have been identified as the most salient shortcomings of the insolvency system\textsuperscript{57}. This is explained by the costs associated with insolvency proceedings which are excessively high, with remuneration of insolvency practitioners (IP) as the largest contributor. Excessively high costs prevent smaller firms from accessing the system, as they cannot afford the fees associated with the procedure. Additionally, the system also allows IPs to prioritize the treatment of some creditors at the expense of others, a practice that can adversely affect international creditors.

According to OJK, over 60 percent of Indonesians lack awareness of financial services, as well as the skills to understand and responsibly use them as of 2019. Consumer protection benefits all consumers by ensuring that they have the right to access reliable and secure financial products, and adequate information which would enable them to make informed choices according to their needs, and to make effective complaints. Consumer protection also contributes to creating a level playing field so that all financial service providers need to apply a common set of standards which promotes competition. In 2020, BI updated its fundamental principles of consumer protection in payment system services which now encompass data protection as well as a more proactive enforcement approach through market conduct supervision. OJK also just updated its consumer protection regulation in May 2022, which now includes market conduct supervision elements to strengthen the enforcement practice.

\textsuperscript{57} Indonesia features around 30 million firms but insolvency filings amount to only 500 cases a year, mostly large corporates.
IV. Ensuring overall stability of the financial sector

Financial stability is a crucial enabling factor for the financial sector to perform its key functions of efficiently allocating resources, assessing and managing risks, and supporting the real economy. The strength of financial regulation and supervision, including an integrated supervisory framework and legal protection for supervisors, as well as crisis preparedness, resolution arrangements and safety nets are important elements to ensure the continued stability of the financial sector. Climate-related risks, to which Indonesia is particularly prone, may also pose risks to the stability of the sector.

The institutional architecture of financial supervision and regulation in Indonesia presents some areas of improvement to strengthen the stability of the sector and hence promote a more efficient allocation of resources. One of these areas is the capacity to supervise Financial Conglomerates (FCs) in an integrated manner. The Indonesian financial sector is dominated by FCs, accounting for over 80 percent of banking sector assets and almost 60 percent of financial system assets. Most FCs have a horizontal structure with a non-regulated holding company controlling the group. The legal framework (OJK Law and the Banking Act) does not define what constitutes a financial conglomerate and a holding company and does not provide OJK with the legal authority to supervise the holding company and the non-financial institutions that are part of a FC, especially those with a diversified set of activities. Supervision of FCs will require the establishment of an enhanced integrated supervision approach to allow for a comprehensive view of the risks in the financial system.

Strengthening legal protection for supervisory staff is a key element of supervisory and resolution frameworks since the threat of litigation to officials for undertaking their supervisory and resolution responsibilities will undermine their willingness to act even in situations where they have the powers and instruments to do so. It also risks resulting in excessive reliance on quantitative indicators over judgment in situations where the speed of decisions is critical. While an existing law on mitigating the threats to financial stability caused by the COVID-19 pandemic introduced a provision on the legal protection of the authorities and officials exercising their duties in good faith, there is a need to strengthen the legal framework to protect the financial authorities against any potential legal challenge unless in cases of bad faith, misconduct, or negligence.

Indonesia has made some progress towards establishing institutional arrangements for crisis management, but the legal and institutional set-up remains fragmented and in need of further clarity and harmonization. While the current regime allows for separation of the different authorities’ mandates and objectives, possibly minimizing potential conflicts of interests among themselves, the segregation

---

58 Most of the FC (39) have banking as their main activity, while insurance is the main activity of 8 FC and securities of 2 FCs. 12 FC are so diversified that they need fully-fledged conglomerate supervision.
of responsibilities results in significant challenges for inter-agency coordination and collaboration. Significant progress remains to be made, especially to clarify the statutory objectives of each agency with respect to crisis management and ensure robust accountability for the performance of these functions.

As the deposit insurance and resolution authority, LPS plays a critical role in ensuring effective resolution and depositors’ payouts in the event of bank failures. Certain legal changes need to be implemented in order for LPS to properly carry out its function, including strengthening its status as the Indonesian resolution authority, conferring resolution planning powers to LPS to instruct banks to take measures that would remove obstacles to resolution, amending the current regime of resolution triggers to make sure resolution action is based on non-viability and action can be taken at a sufficiently early stage and increasing the legal protection of LPS’ staff. In addition, there is a need to enable the operationalization of the banking resolution regime, especially during financial crisis situations.

Climate-related risks are also increasingly relevant to preserving financial stability. Indonesia is highly exposed and vulnerable to climate-related natural disasters, such as different types of floods, tropical cyclones, landslides, and extreme heat, which have made up almost 70 percent of major disaster events since 2000. The country is projected to experience a consistent trend of warming, which will increase both the frequency and severity of these disasters.

Physical risks and transition risks are the two primary sources of climate-related risks that are considered important for the financial sector. Climate-related physical risks can lead to economic costs and financial losses as they threaten the profitability and solvency of banks and the overall stability of the financial system. Preliminary estimates indicate that Indonesian banks’ exposure to physical risks is equivalent to around 65.8 percent of their total credit portfolio.

Transition risks are related to adjustment costs during the transition towards a greener, carbon-neutral economy. These risks could be related to climate policies, technological change or shifts in investor and consumer sentiment with respect to climate change and the preservation of the environment. The Indonesian banking sector is exposed to potential climate transition risks, as it currently has the fourth highest carbon intensity of its loan portfolio around the world. Financial risks could specifically emerge from sudden implementation of climate policies as carbon-intensive sectors could face difficulties in reducing their emissions as green technologies are currently expensive or not available, creating stranded assets and decreasing asset quality of banks.

---

59 These are 7 out of the 18 sectors OJK identified: (i) the processing industry (16.3 percent), (ii) wholesale and retail trade (17.2 percent), (iii) Construction (7 percent), (iv) provision of accommodation and the provision of eating and drinking (2.1 percent), and (v) Agricultures, Hunting and Forestry (9.8 percent), (vi) Fishery (0.3 percent), and (vii) Real Estate, Business, Ownership, and Business Services (4.7 percent).

60 For instance, the processing industry, with carbon intensive cement and steel production make up 24 percent of Indonesian banks loan portfolio. Agriculture, specifically sensitive to non-carbon related GHG emission regulation (such as methane from rice and beef production) makes up 11 percent, followed by construction (10 percent), transportation (8 percent), and real estate (7 percent).
3. Policy Recommendations

Following the overview of opportunities for deepening the financial sector, policy recommendations can be organized into a three-pillar reform strategy: (i) increasing demand and supply of finance; (ii) improving the allocation of resources through the financial sector; (iii) strengthening the capacity of the financial system to withstand financial and non-financial shocks. Some policy recommendations can be achieved within a short-term (ST) horizon (i.e. up to one year), while others might require a medium-term (MT) horizon (i.e. from 1 to 3 years).

3.1. Increasing demand and supply of finance

Increasing demand and supply of finance

a) As part of their operations, financial service providers (FSPs) are required to conduct verification for customer due diligence (CDD) or validating customer information and their assets. In the process, FSPs need to access each record from public authorities such as ID, land records, demographic information, income, tax records, education records, or employment history. In Indonesia, every FSP will require to create a legal agreement and infrastructure arrangement with each public record authority, resulting in inefficiencies in terms of cost and time. Availability of these data in an efficient manner using automated interface would allow FSPs to reduce their costs and improve customer convenience. Moreover, Indonesia does not yet have an official digital identification system or framework and has become the only middle- or high-income country in ASEAN to have not launched official digital identification to allow citizens and residents to prove their identity online. When interlinked with data ecosystems, digital ID systems can provide people with greater control over their personal data and records (e.g., consent to its sharing and use) which can then be used to promote DFS innovation further such as in the area of open banking.

b) Much has been achieved by Indonesia in terms of digital infrastructure such as QR Indonesia Standard that enables interoperable payment transactions at merchants, the BI FAST infrastructure initiative that enables 24/7 real-time retail payments, and a dual credit reporting system to facilitate credit applications. Despite the development much can still be done to promote DFS adoption further. First, it can start with ensuring good penetration of mobile phones and connectivity. Second, promote competition in the provision of payment services and enhance efficiency by enabling interoperability further. Interoperability improves convenience for users, enhances efficiency by enabling sharing of

---

Establishing government data platforms and creating digital ID (MT).

Establishing a well-functioning (fully interoperable) payment system and developing a credit infrastructure that can use alternative data (ST).

---

61 Digital ID typically comes in the form of smartphone applications or a marketplace of licensed digital identification providers, governed by a trust framework. There is currently no national-scale biometric verification service for institutional users either, which would provide more security for higher value transactions such as electronic know-your-customers (e-KYC).
different transaction channels like ATMs, merchant point of sale (POS) terminals, and agents. Third, further optimize the performance of credit infrastructure (credit registry, private credit bureaus, collateral registry) to lower the cost of lending, improve the speed of service delivery, and enable responsible lending. Focus should be given to enhancing coverage of credit relevant data from different sources. Lack of credit data is often the major obstacle for MSME financing, especially for those operating with some level of informality. Using alternative data to enhance credit reporting represents a tangible opportunity to expand access to finance to MSMEs.

c) Development and adoption of financial services requires concerted legal and regulatory reforms. The first of such reforms is to enable new players and new approaches, for example allowing non-bank mobile money providers to leverage individual agents based on their risk management capabilities or a third party - such as airtime distributors, fast-moving consumer goods (FMCG) distribution agencies, transport companies, or dedicated agent management companies - to become agent network manager to promote viable and active agent network services. The second potential reform relates to enabling competition and establishing a level playing field, for example through open banking services that would allow third parties, acting on behalf of customers, to directly access account information by incumbent institutions and initiate transactions (e.g., customers can directly initiate payments on their existing bank accounts in third-party apps, upon customer consent). Finally, promoting policies that create demand for DFS and incentivize switching away from cash to digital payments is also advised. These policies may come in the form of encouraging more social benefit transfer programs to shift from cash disbursements to direct deposits into transactions accounts.

Broadening and improving the quality of financial market products

a) To optimize the use of financial markets to finance development needs, the products in the market should meet the needs of the users (e.g., enterprises in need of financing) and the financing providers (i.e., investors). Over the past several years, the authorities and market participants have spent significant efforts to innovate, introduce and adopt new types of financial products in the Indonesian capital markets. Among these new products are green bonds and green sukuk, various types of securitizations (including those backed by mortgage and infrastructure assets/revenues), collective investment funds (including

---

62 Currently, customers can transact in any ATM, in some merchants through QR Indonesia Standard (QRIS) but cannot transact seamlessly across all agents as there is not yet a uniform standard for agents.

63 Lenders may leverage alternative data such as information from utilities, retail lending, behavioral data, online platforms, and mobile applications. This approach also brings forth additional risks (e.g., inconsistency, incompleteness), and hence authorities should balance this effort by ensuring that such inherent risks are mitigated.

64 Leveraging the same payment mechanism and infrastructures across different programs as well as promoting the inclusion of more service providers into the programs as envisioned in the government’s Government to Person (G2P) 4.0 initiative would help further increasing efficiency. Government collections of Persons to Government (P2G) payments such as payments for public transport, payment of bills to public utilities and payments for government services can also be leveraged to facilitate adoption.
Developing a market for risk hedging to attract international investors by establishing central counterparty for clearing and close-out netting (ST).

Accumulating savings through institutional investors, by expanding coverage, increasing contributions and reducing withdrawals (MT).

Mobilizing long-term savings

a) Policies to mobilize long-term savings are important to improve the demand-side of the capital market for it to meet its critical role in supporting economic growth and recovery. Over the past couple of years, new regulations have provided additional instruments for pension funds’ and insurance companies’ (both conventional and Islamic-focused) long-term investments. However, irrespective of the financial market products developed, they will not be effective in providing financing if the amount of pooled financing available to invest in them is insufficient. Therefore, deepening the domestic financial markets should begin with efforts to accumulate savings through institutional investors like pension, social security, insurance, and mutual funds. Particularly with pension and social security funds (especially the old-age savings under the National Social Security System/SJSN), there is room for improvement in terms of expanding participation (coverage), increasing contribution rates, and reducing withdrawal rates. The authorities should consider significant tax and administrative incentives to increase participation, primarily non-salaried professional and informal workers, and increase contributions by existing participants. Reducing early withdrawals is important to keep the savings in the system and could be achieved by revising eligibility for early retirement, limiting the purpose and number of withdrawals other than when reaching the retirement age or non-productive stage. The design of pension schemes should be done in alignment with the overall architecture of the social security system.

b) The need for infrastructure financing, for example, is way beyond what the domestic financial institutions can provide. Thus, significant financing by foreign investors is needed. To this end, the development of a market for risk hedging is critical, especially to hedge interest rate and currency risks. Mitigating risks arising from currency and interest rate volatility through derivatives instruments (e.g., interest rate swaps and futures, currency swap) is important so that investors are more able to invest long-term and in Rupiah. While such instruments exist, the market is not efficient enough and transaction costs are high. To increase efficiency, while minimizing potential risks to financial stability, several measures are important including the establishment of a central counter party for clearing (which reduces counterparty risk) and the introduction of a close-out netting process (which increases certainty of settlement and minimizes contagion in the event of default).

The policy that allows, or even encourages, automatic enrolment has proven to be an effective way to increase pension participation. The recent effort to limit early withdrawal of old-age savings account (known as JHT), through Ministry of Labor Regulation No. 2/2022, which was later rescinded, was met with strong pushback by the workers due to such preference, coupled with other factors including (i) lack of alternative program to cover unemployment, (ii) low trust toward the social security administrator (BPJS), and (iii) lack of early communication on the objectives of the policy. Any measure in the future to limit pension or JHT withdrawals should be accompanied with measures which address the above factors.

---

65 The policy that allows, or even encourages, automatic enrolment has proven to be an effective way to increase pension participation. The recent effort to limit early withdrawal of old-age savings account (known as JHT), through Ministry of Labor Regulation No. 2/2022, which was later rescinded, was met with strong pushback by the workers due to such preference, coupled with other factors including (i) lack of alternative program to cover unemployment, (ii) low trust toward the social security administrator (BPJS), and (iii) lack of early communication on the objectives of the policy. Any measure in the future to limit pension or JHT withdrawals should be accompanied with measures which address the above factors.
b) Pension fund assets should be managed professionally and invested appropriately according to the objective of the savings. Investments of pension funds should have a long-term horizon because the funds are not needed before retirement. Therefore, the investment could tolerate short-term volatility (or short-term risk) to achieve a higher long-term return. Instruments with such a profile include stocks, bonds, private equity or venture capital funds, infrastructure funds, and other long-term instruments—in contrast with short-term investments like bank deposits. Policies should be directed toward motivating funds to invest appropriately in such long-term instruments. As long-term investments might suffer from occasional short-term losses, fund managers should be protected from prosecution against investment losses, given that investment decisions are made with good intention and within an accepted strategy and appropriate risk management framework.

3.2. Improving the allocation resources through the financial sector

Promoting competition in the banking sector

a) Reducing intermediation costs and achieving greater efficiency in the banking system will depend on concerted implementation of a wide-ranging set of policy actions. The adoption of risk-based pricing is fundamental to move banks away from their current pricing practice of charging very similar interest rates on loans across geographical locations and irrespective of client creditworthiness. The authorities could strengthen the capacity of lenders to price and manage their credit risks by providing professional training to build necessary skills and expertise, especially in the areas of financial product development, pricing, and in the assessment and modeling of risk, and by supporting the development of the credit information system.

b) Redefining the role of SOBs to foster a leveled playing field between SOBs and private banks when servicing government business, increase contestability, add pressures for cost reduction, and encourage reallocation of service provision to the most efficient financial service providers, thereby leading to efficiency gains. A key lesson from international experience is that rather than competing with private banks, SOBs should transition to sharing risk-burdens with private banks, particularly in those areas where market failures exist. That is, SOBs would function as a “helping hand” or catalyst in deepening the provision of financial services through the private sector.
Expanding partial credit guarantees for MSMEs and supporting effective graduation policies from the KUR program (ST).

Incentivizing informal restructurings, such as out-of-court workouts, that do not resort to the court system to address financial distress (MT).

Ensuring adequate protection of creditors’ interests through key amendments to the Bankruptcy Law (ST).

c) The KUR program plays an important role in helping MSMEs to access finance for the first time. At the same time, since the program allows borrowers to take repeat loans, only a small proportion of borrowers’ transition from the subsidized KUR loans to commercial loans. Exploring new options for graduation from KUR loans and strengthening partial credit guarantees for MSME lending – either within or beyond KUR - could improve the landscape for MSME lending.

Strengthening the insolvency framework

a) Improving the capacity to manage insolvency cases is critical for the economic recovery from the crisis. A stronger insolvency framework can facilitate more rapid reduction of debt burdens and a quicker economic recovery through greater access to credit, faster creditor recovery, job preservation, and lower failure rates for small businesses. Households and firms may be struggling with unsustainable debts as a result of the pandemic. To prepare for an increase in corporate bankruptcies, Indonesia could benefit from strengthening its insolvency proceedings. Insolvency proceedings can be an effective way to help reduce excessive private debt, but a sudden increase in loan defaults and bankruptcies may pose a significant challenge for the capacity of the insolvency system to resolve bankruptcies in a timely manner, in part due to the complexity of court-led insolvency processes. Out-of-court workouts allow parties to address financial distress without resorting to the court system and can be particularly useful in the current environment. They may include (i) privately negotiated and purely informal restructurings between the debtor and all or some of its creditors, and (ii) enhanced workouts, that is, restructurings in which participants are bound by law, regulation or contract, to follow restructuring-specific standards similar to those introduced in Indonesia under the “Jakarta Initiative” in 1998.

b) The legal framework of Indonesia’s insolvency system is largely adequate, but its implementation remains a challenge. Limited uptake by firms and lack of access by smaller firms have been identified as the most salient shortcomings of the insolvency system. The high complexity of the Bankruptcy Law, which was designed to address the needs of the largest firms during the 1997 Asian Financial Crisis, is one of the reasons explaining these shortcomings. Key amendments to the Bankruptcy Law should be introduced to ensure protection of creditors’ interests. These improvements should focus on the system of appointment of the curator/administrator, the protections received by creditors upon confirmation of a restructuring plan and the conditions applicable for individual entrepreneurs to obtain a debt discharge. This reform would complement the recently introduced reforms on the regulatory and supervisory framework for insolvency administrators and curators, which focused on the implementation aspects of the insolvency system.

---

66 Chapter 3, World Bank (2022h).
67 IMF (2021)
68 This is a potential concern for Indonesia: with Loans at Risk (LAR) ratio at 21.6 percent as of late 2021, corporate stress and loan default may come to the surface once the government stimulus and forbearance measures end in March 2023.
Protecting consumers

a) Market conduct supervision (MCS) implementation is still at its nascent stage in Indonesia. More adjustments are needed along the way to ensure its effectiveness. An independently established, well-governed, adequately resourced, alternative dispute resolution (ADR) authority with sufficient powers (to issue binding decisions to financial service providers) is needed for consumers to seek redress when they are not satisfied with the result of financial service providers’ internal handling of complaints. LAPS SJK started operating in 2021 to fulfill such role. Raising consumer awareness will be needed at early stage so that they can fully utilize the service of LAPS SJK.

b) Indonesia is currently one of the remaining countries without a personal data protection law. The law has been pending in parliament since its submission by government in December 2019. While there are provisions in existing laws and regulations, these do not create a comprehensive and adequate regime to govern the collection, storage, use, and re-use of personal data, as well as accountability and oversight, with implications for all databases in the country.

3.3. Strengthening the capacity of the financial system to withstand financial and non-financial shocks

Strengthening the effectiveness of financial sector oversight

a) Gaps and limitations in the supervision of FCs can be addressed through a series of well-considered and carefully paced interventions. The first area involves harmonizing the regulatory and supervisory framework across sectors under the current organizational structure, which can be done through: (i) proper identification of the most diversified conglomerates; (ii) assignment of a dedicated team to supervise conglomeration risks only of the most diversified FCs with centralized supervisory support functions; and (iii) harmonization of the regulatory and supervisory framework to eliminate gaps and overlaps between sectors. The second area relates to amending the OJK Act by: (i) establishing financial sector safety and soundness as OJK’s primary goal; (ii) removing sector-specific supervisory responsibilities of individual commissioners; and (iii) introducing the definition of FC and assigning responsibility for the prudential oversight of non-operating holding companies to the OJK supervisory authority.

b) Risk-based supervision, proportionality, and principles-based regulation have gained prominence recently, particularly in international standards. These trends require stronger legal protection for supervisors than compliance-based supervision as supervision relies more on supervisory judgment. Resolution actions are generally even more intrusive than supervisory actions and may involve larger sums of money which further increases the legal risk for officials, heightening public scrutiny of bank supervisors. Legal provisions generally exclude actions performed in bad faith, misconduct, or negligence. Also, it is
generally recommended to compensate officials for defense costs and ensure that the legal protection extends to supervisory or resolution decisions made by officials that have since left the supervisory or resolution authority.

**Strengthening crisis preparedness and resolution framework**

a) Indonesia has reasonably well-established institutional arrangements for crisis management, largely underpinned by the 2016 Law on the Prevention and Handling of Financial System Crisis and the more recent 2020 Law on Financial System Stability Policies for Managing the COVID-19 Pandemic. As the resolution authority, LPS plays a critical role in ensuring effective resolution. Yet the existing legal framework, despite the significant progress to date, does not yet clearly assign LPS with the roles and responsibility of a resolution authority in line with the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. Further, there is still a need to clarify the statutory objectives with respect to crisis management of each agency to avoid gaps or overlaps between agencies’ mandates and ensure robust accountability for the performance of their functions.

b) Existing laws and regulations do not specify whether recapitalization or liquidity provision by the government to a financial institution is restricted to cover insured deposits or funds for resolution. Enabling public funding to be provided in the resolution of systemic banks, possibly through establishment of a resolution fund subject to robust safeguards, is also recommended. Further, the availability of liquidity funding and clear arrangements prior to resolution is important. Effective implementation of resolution requires that a bank has access to sufficient liquidity to maintain its operations both before and after the point of resolution action, until it is able to access market funding again. In the absence of any such mechanism, the bank may suffer a disorderly failure due to its inability to settle payment obligations, increasing risks to financial stability.

**Promoting climate and natural disaster related risk management**

Broadly speaking, reforms to strengthen climate and natural disaster risk management can fall into two areas: (i) activities to strengthen the resilience of the financial sector itself to climate and disaster shocks; and (ii) activities by the financial sector to strengthen the financial resilience of the real economy.

a) Financial sector authorities (OJK and BI) in Indonesia could use a combination of different policies to promote the understanding and management of climate-related risks for the financial sector. The authorities could consider conducting a more advanced assessment of climate-related financial risks in Indonesia, including by stress testing of such risks for the banking sector; developing a climate risk strategy, including clear objectives, measurable actions, metrics to track progress and specific timelines; providing more specific supervisory guidance on climate risks and developing more detailed climate disclosure and reporting requirements for financial institutions.
Efficient and sustainable insurance markets can help the government, businesses, and homeowners to transfer risk of disasters and climate shocks to dedicated risk carriers, protecting public services, business continuity, and physical assets. To deepen catastrophe insurance markets in Indonesia, the government could assess bottlenecks and explore both supply side and demand side reforms. This should aim to increase catastrophe insurance penetration for government assets, SMEs, households, as well as the agriculture and aquaculture. Other financial sector interventions could promote new approaches to financial risk management, including for example the use of crisis response windows for partial credit guarantees, linked to natural disaster and climate risks.

Table B.2: Summary of Key Policy Recommendations for Financial Sector

<table>
<thead>
<tr>
<th>Key Recommendations</th>
<th>How to implement them:</th>
<th>Priority (ST/MT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Increasing demand and supply of finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Increasing access to and usage of financial services</td>
<td>a) Establishing a well-functioning (fully interoperable) payment system and developing credit infrastructure that can use alternative data.</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Establishing government data platforms and creating digital ID.</td>
<td>ST</td>
</tr>
<tr>
<td></td>
<td>c) Promoting open banking services and policies that create demand for digital financial services (such as digitizing G2P and P2G payments).</td>
<td>ST</td>
</tr>
<tr>
<td>2. Broadening and improving the quality of financial market products</td>
<td>a) Continuing to introduce new financial market products (e.g. green bonds; covered bonds; infrastructure project bonds; municipal bonds).</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Developing a market for risk hedging to attract international investors by establishing central counterparty for clearing and close-out netting</td>
<td>ST</td>
</tr>
<tr>
<td>3. Mobilizing long-term savings</td>
<td>a) Accumulating savings through institutional investors, by expanding coverage, increasing contributions and reducing withdrawals.</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Promoting professional management and appropriate long-term investments of pension fund assets.</td>
<td>ST</td>
</tr>
<tr>
<td>II. Improving the allocation of resources through the financial sector</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Promoting competition in the banking sector</td>
<td>a) Strengthening the capacity of lenders to adopt risk-based pricing.</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Opening the servicing of government business to the most capable service provider, regardless of ownership type.</td>
<td>ST</td>
</tr>
<tr>
<td></td>
<td>c) Expanding partial credit guarantees for MSMEs and supporting effective graduation policies from the KUR program</td>
<td>ST</td>
</tr>
<tr>
<td>2. Strengthening the insolvency framework</td>
<td>a) Strengthening insolvency proceedings such as out-of-court workouts, without resorting to the court system to address financial distress.</td>
<td>MT</td>
</tr>
<tr>
<td></td>
<td>b) Ensuring adequate protection of creditors’ interests through key amendments to the Bankruptcy Law</td>
<td>ST</td>
</tr>
<tr>
<td>3. Protecting consumers</td>
<td>a) Implementing financial consumer protection laws and regulations monitored and enforced through market conduct supervision (MCS)</td>
<td>ST</td>
</tr>
<tr>
<td></td>
<td>b) Finalizing the personal data protection law, currently pending since 2019.</td>
<td>ST</td>
</tr>
</tbody>
</table>
### III. Strengthening the capacity to withstand financial and non-financial shocks

<table>
<thead>
<tr>
<th>1. Strengthening the effectiveness of fin. sector oversight</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Addressing gaps and limitations in the supervision of financial conglomerates.</td>
<td>ST</td>
<td></td>
</tr>
<tr>
<td>b) Strengthening legal protection for financial supervisors.</td>
<td>MT</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Strengthening crisis preparedness and resolution framework</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Enhancing legal framework to establish effective bank resolution regime and inter-agency coordination.</td>
<td>ST</td>
<td></td>
</tr>
<tr>
<td>b) Providing clear arrangements for resolution funding, including provisions for extraordinary funding when required.</td>
<td>MT</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. Promoting climate and natural disaster related risk management</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Developing policies (including assessment, disclosure and reporting) for managing climate related risks for the financial sector.</td>
<td>ST</td>
<td></td>
</tr>
<tr>
<td>b) Deepening catastrophe insurance markets to provide financial risk management services to government, businesses and households.</td>
<td>MT</td>
<td></td>
</tr>
</tbody>
</table>

Note: ST: Short Term up to 1 Year; MT: Medium Term up to 1 – 3 years.
References


Supported by funding from the Australian Government under the Australia-World Bank Indonesia Partnership (ABIP) program.