

INDONESIA

Increasing macroeconomic stability in Indonesia did not translate into higher growth. After the Bali bombing, growth is likely to continue to slow, although macroeconomic stability is most likely to be maintained. Before the bombing, political stability and renewed structural reforms had supported market confidence, which allowed for a stronger Rupiah and lower interest rates. Together with tighter monetary policy, this started to reduce inflation. Growth remained modest and largely consumption driven as the fledgling global recovery failed to boost exports, and investment faltered in a cooling investment climate. In this low growth environment, the poor remain vulnerable, and despite higher wages and employment, poverty increased because of a spike in rice prices in the year up to February. The Bali shock is likely to reduce growth further this year and next.

MARKET SENTIMENT

Market sentiment had been supportive of macroeconomic stability in the first half of this year. Increased political stability, progress in reforms under the IMF supported program, and a successful Paris Club negotiation in April was welcomed by the markets. The Rupiah exchange rate against the US dollar appreciated from Rp.10,500 in December 2001 to Rp.8,800 in May 2002. The spread of the Yankee bond over US treasury bills narrowed from 480 bps to 400 bps, and the Jakarta Stock Exchange index rose from 390 to 530 over the same period, supported by renewed foreign interest. Since the middle of the year, amidst the global stock market malaise and slowing reforms, the Jakarta stock exchange index slipped back to a level below 400, and the Bali bombing knocked off 10 percent of its value in one day—although the loss in the week after Bali was only 5 percent.. The Rupiah exchange rate has been stable around Rp.9,000, although it lost some 3.5 percent in the wake of the Bali tragedy. S&P, the US rating agency, raised Indonesia's rating from selective default (SD) to CCC+ on September 5, as the London Club reschedule negotiation was completed. The CCC+ rating was lower than the B- achieved right after the second Paris Club in April 2000, and below the rating of other emerging economies,¹ and reflects S&P's doubts that

Indonesia could avoid the next rescheduling, although the authorities have expressed this to be their aim.²

THE REAL ECONOMY

Increasing macroeconomic stability in 2002 did not translate into higher growth. Real GDP growth reached 2.9 percent (yoy) in the first semester, after growing with 3.3 percent over 2001, and 4.8 percent in 2000. Growth accelerated in the second quarter, after being hit by the floods in January and February, but it remains modest by Indonesia's pre-crisis standards, and is still at the bottom of the league of former crisis countries. Growth in the second semester would have to be more than 5 percent to meet the budget assumption of 4 percent growth. After Bali, this seems highly unlikely, and the Bank's forecast for 2002 growth is now 3.2 percent, down from 3.5 percent before Bali.

Unusually robust consumption spending has been the engine of growth. Private consumption spending grew with a strong 6.4 percent (yoy) in the second quarter of 2002, although this was significantly lower than the almost 10 percent growth rates achieved in Q4 2001. Consumers reacted positively to the newly found economic and political stability. They also benefited from rapidly rising formal wages and strong growth in consumer credit, which expanded by 46 percent in the second quarter of 2002, despite stiff lending rates of around 19 percent. Vehicle sales in particular were boosted by this growth in credit, and by the reduction in import tariffs last year. More data that are recent suggest that the consumer boom may have run most of its course: growth rates in real VAT revenues, and motorbike sales have been declining, although they remain in positive territory. The events in Bali could accelerate the slowdown in consumer demand as they may affect consumer confidence, and could cause an increase in already high lending rates.

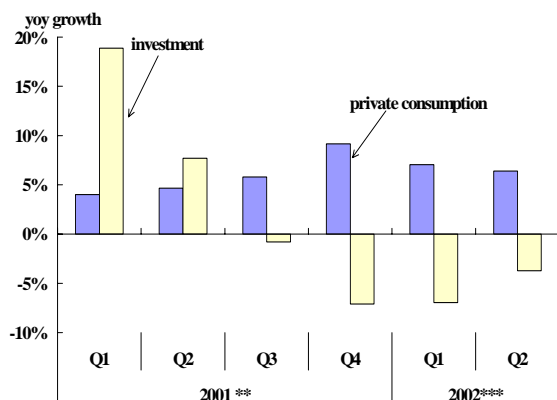
In contrast to booming consumption, growth in fixed capital investment has been dismal (Figure 1). Investment has now declined for 4 quarters in a row, and fell by 4 percent (yoy) in the second quarter of 2002, although this was slightly better than the 7 percent drop in the previous two quarters. Investors have started to feel the pinch of a deteriorating investment climate, and had to absorb a strong real

¹ For example, Thailand is BBB-, the Philippines are BB+, and Vietnam is BB-. Comparable countries are Turkey (B-) and Pakistan (B-).

² See the remarks of the Coordinating Minister for the Economy at the third quarterly review meeting of the CGI, August 2002.

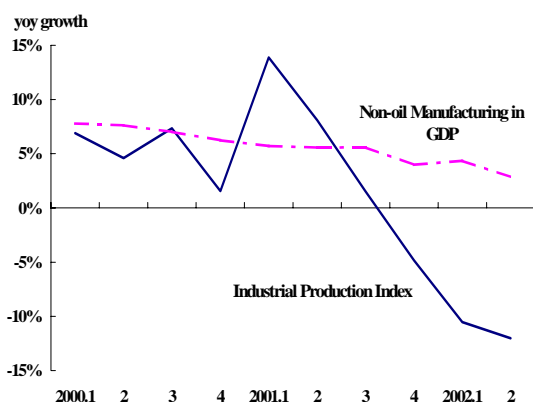
appreciation of the Rupiah. Investment approvals were also down,³ promising little recovery in investments down the line; although high growth in cement sales suggests that, some investment may not be captured by the statistics.⁴ Investor confidence is likely to suffer further in the aftermath of the Bali attack.

Figure 1: Strong consumption and weak investment



Source: BPS

Figure 2: Smaller enterprises are doing better



Source: BPS, staff estimates

Net export continued to contribute to growth, even though export growth, which was negative until mid-2002, only showed modest growth. However, imports continued to fall over the same period. Indonesia's terms of trade declined in the year up to the second quarter, but are likely to recover in the remainder of

the year in light of recent improvements in the price of oil and other commodities.

On the production side, Indonesia's economy showed a marked slowdown in manufacturing, while industry growth, after peaking in Q4 2001, slowed to 2.4 percent by the second quarter of 2002. Oil and gas, leather and textiles, and wood and wood products even saw a decline in output. A comparison of non-oil manufacturing in GDP with industrial production index suggest that smaller enterprises perform better than larger ones (Figure 2). Industrial productions, which only reflect the production of larger enterprises, have been declining for 3 quarters in a row, whereas output of non-oil manufacturing remained positive. The difference in trend suggests that small enterprises, which are captured in manufacturing statistics, are doing well. This is confirmed by information on credit, which suggests that—at least until the end of last year, credit to SMEs was thriving.

Agricultural growth bounced back after the modest growth of 2001. Last year, the sector grew only by 0.6 percent, but in the year until the second quarter of 2002, the statistics show an expansion by over 10 percent. This growth comes at the onset of a mild El Nino, which is expected to affect agricultural output in the months ahead.

The high growth rates in electricity supply have ebbed away in recent quarters. Electricity supply expanded by 8.4 percent in 2001, more than double GDP growth, but growth slowed to 3.5 percent by the second quarter of 2002. For many, the high growth in electricity supply reinforced the impression that statistics did not capture all growth in the economy. However, the expansion of the number of users and the relative price of electricity may well have been an underlying cause of growth. Nevertheless, without major new investment in transmission and generation, accommodating even a modest increase of 3 percent growth per year will prove to be difficult for PLN, the country's power distributor.

Poverty, wages and income.

Poverty reduction stalled in the current environment of modest growth. The headcount poverty index drifted up from 13.2 percent in February 2001 to 14.5 percent in February 2002, based on annual data from the SUSENAS core.⁵ This uptick comes after a strong

³ For the first five months of 2002, investment approvals amounted to a meager \$1.7 billion down almost 60 percent from the \$3.98 billion approved over the same period in 2001.

⁴ Cement sales, in particular retail sales in bags, has shown robust growth, while investment in buildings grows only slowly. One explanation is that part of consumption growth is actually construction of housing and small business venues, which should be recorded as investment.

⁵ BPS improved remarkably the timeliness of its household survey data. Whereas before the processing time for the SUSENAS

decline in poverty from 27 percent at the peak of the crisis in 1999, and was largely caused by a rapid increase in rice prices, offset by increases in informal sector wages and rising employment opportunities for the poor. The shift in growth from the larger, formal sector firms to SMEs and agriculture expanded the job opportunities for the poor.

Formal sector wages have been rising more rapidly than informal sector ones (Figure 3). By the first quarter of 2002, real wages in manufacturing were 40 percent higher than in the same quarter of 1996, and the yoy increase was 21 percent. The driving cause of this is the steep increase in minimum wages across the country, which is complied to by the formal sector, but not the informal sector. In 2002, average minimum wage increased by 30 percent.. Government wages also rose in July, 2001, by some 15-20 percent, as a result of consolidating several allowances with the base wage.⁶ Given these administrative increases, the informal sector wages probably reflects market developments better than the formal ones, and according to BPS almost two third of the labor force works in the informal sector. Considering the large parts of the workforce is in the informal sector most of them do not directly benefit from the minimum wage increases and therefore for the whole economy. Real wages in agriculture are still 12 percent below their 1996 levels, and the yoy growth was a mere 4 percent, if deflated by the CPI. The minimum wage hike is likely to have an impact on some labor-intensive industries sector such as textile or office electronics, since their employment, costs are higher than other industries.⁷

The Bali attack will affect poverty incidence. Beyond the localized effect, the Bali bombing will have a more widespread, national impact primarily through the slow-down in the GDP growth rate and the depreciation of the exchange rate (and therefore the price of foodstuff) that are projected as a consequence of the terrorist attack. Initial estimates indicate that

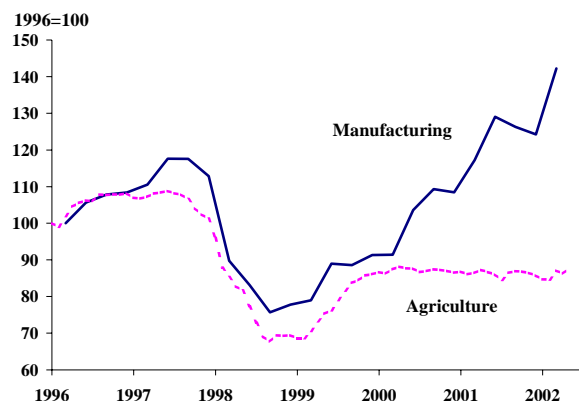
household data was well over a year, and sometimes more, the bureau managed to clean and process the data within six months. In addition, BPS' now regular surveys formal and informal wages, thereby enabling quarterly monitoring of income developments.

⁶ Civil servants had received 3 wage increases since the start of the crisis in the form of "cost of living increase" allowances. In 2001 these were consolidated with the base wage, which meant that family and child allowances, which are related to the base wage, went up as well.

⁷ Large and medium manufacturing statistics (2000) says the employment costs to total output ratios are higher in apparel, leather and office machinery industries.

the poverty rate will be 1.7 percentage points higher than without the Bali attack.

Figure 3: Manufacturing and agriculture wages diverge
(Index 1996=100)



Source: BPS

Money, interest and prices

Inflationary pressure subsided substantially in the course of 2002. CPI inflation rate peaked at 15 percent (yoy) in February 2002 in the wake of administrative hikes in electricity and transpiration, and the floods. Since then, inflation has been subsiding, reaching 10.6 percent in September, keeping the LOI target of 9.5 percent (eop) well in sight, although inflation for the year may overshoot the assumed 9 percent. The appreciating Rupiah contributed to lower headline inflation, as it lowered the prices of tradable goods that make up 60 percent of the CPI goods basket.⁸ [here something on rice prices—why did they rise?]

Tighter monetary policy contributed to declining inflation as well. Base money got back on track early this year, and by August stood at Rp. 116.5 trillion, some 11.5 trillion below the indicative target of the IMF supported program. Falling inflation, a lower risk premium, and higher real interest rates on deposits have reduced the share of currency in the public's portfolio [Kurnya: please check this], and the central bank could absorb the excess liquidity of the banking system through SBI auctions at increasingly lower price. The SBI rate fell from 17.6 percent at the end of 2001 to less than 14 percent in September 2002.

The banks have started lending since mid-2001. Overall credit outstanding rose from Rp. 306 Trillion in June 2001 to Rp. 313 trillion in June 2002, a modest

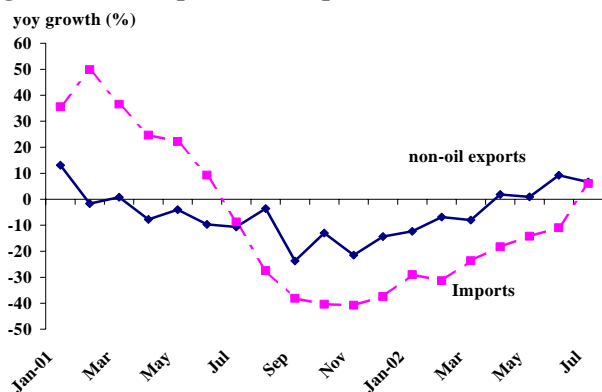
⁸ Ramakrishnan and Vamvakidids (2002) "Forecasting Inflation in Indonesia" (IMF Working Paper 02/111)

growth rate of 2 percent. Consumer credit and credit to SMEs benefited in particular. However, growth in the latter, which reached 10.5 percent in the year until end-2001 petered out as Government's plans to providing SMEs with a haircut of 25 percent were floated in early 2002. By June, 2002, loans outstanding to SMEs had declined from 63 billion Rupiah (June 2001) to 56 billion Rupiah in June 2002. Growth in consumer credit has slowed as well to 40 percent (yoy) by end-June 2002, down from almost 80 percent in early 2002. As household debt increases, consumer credit growth is likely to slow down, although the share of consumption financed by credit is still well below pre-crisis levels.

International Trade and Payments

Indonesia's international trade has started to recover from the sharp decline it experienced as a result of last year's global slowdown. Exports started to grow again in April 2002 (yo) after 13 straight month contractions, and imports growth also became positive in July 2002 for the first time since July 2001 (Figure 4). Machines and electrical products- contributed most to the recovery in exports. Two major export items- largely contributed to the positive export growth, in turn pulling along imports in electrical components, of which about 70 percent is imported. On the other hand, exports of textile products remains stagnant which is consistent with production figure in the national account. The stagnant textile exports reflects the relative increase in cost Indonesia experienced over the last year: apart from large wage increases, the real exchange rate of the Rupiah rose by almost 25 percent since mid-2001. While the trade balance remains for now in comfortable surplus, the rapid rise in imports suggest that the surplus could narrow in the period ahead—although more than 30 percent of imports gets exported again.

Figure 4: Both exports and imports started to recover



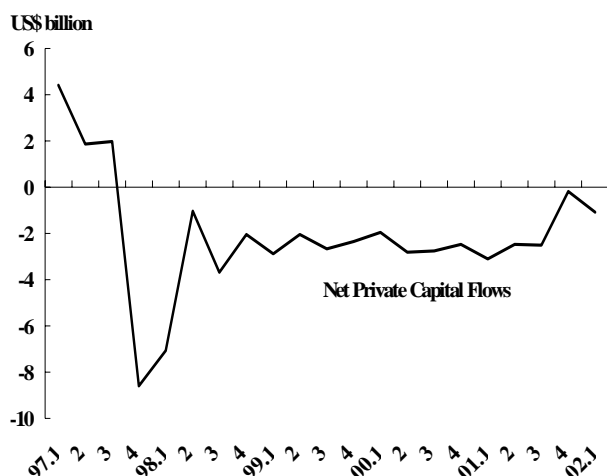
Source: BPS

Somewhat surprisingly, exports to China showed a rapid increase over the last year. Many feared a "China effect" from that country's entry into the WTO, but for now, this event seems to open more trade opportunities for Indonesia. However, the China effect is more likely to play a role on third-markets to which both countries export. Although China is, in contrast to Indonesia, rapidly upgrading from labor-intensive exports, the countries remain competitors on the world markets. And China is rapidly gaining market share. Although Indonesia's share is more or less stable, the competition from China could mean lower prices for Indonesia's exports.

The Bali attack is likely to have strong effects on the balance of payments. Tourism accounts for some \$5.4 billion in foreign exchange, and experience in Egypt after Luxor and Indonesia after the May 1998 riots suggest that a drop of visitors in the order of 20 percent can be expected in 2003. High spenders are also likely to be replaced by lower spending visitors, and thus a drop in exports of some \$1 billion is not inconceivable. However, lower growth and consumption growth is also likely to reduce imports, and thus the effect on the current account is likely to be smaller.

Indonesia's capital account has been improving. In 2001, despite a current account surplus of \$6.9 billion, international reserves still fell because of capital outflows amounting to \$9 billion. Most of this outflow (\$8.3 billion) was private, but for the first time since the start of the crisis, the official capital account ran into a deficit as well, largely because of slow disbursements on adjustment loans which ran into delays in the political turmoil of 2001. Private capital outflows account slowed substantially in the last quarter of 2001 and the first quarter of this year (Figure 5). In part, this reflects lower debt repayments on a declining stock of foreign debt owed by private firms. At the same time, portfolio investors showed renewed interest in Indonesia's stock market, and privatization (notably that of BCA). In contrast, foreign direct investment, as noted before, stayed way, and are unlikely to return droves in the current investment climate. Although BI's numbers exaggerate the gloom,⁹ FDI remains barely positive, in sharp contrast to the rapid inflows before the crisis.

⁹ Bank Indonesia includes repayments on foreign loans by foreign invested companies into foreign investment, whereas the international convention is to include those payments into other capital flows on the balance of payment.

Figure 6: Less private capital outflow.

Source: Bank Indonesia

EXTERNAL DEBT

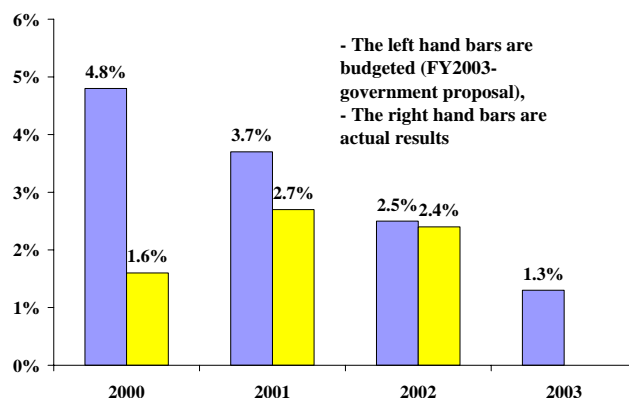
While external debt has been declining, Indonesia remains vulnerable on the external accounts because of the high share of short-term debt. External debt outstanding as of June 2002 was \$132 billion or \$20 billion less than at the peak in 1998 (\$151 billion). Government debt (incl. IMF) increased from \$67 billion to \$74 billion because of official aid, whereas private debt (incl. SOEs) declined from \$78 billion to \$56 billion. In the year until June, 2002 the external debt to GDP ratio dropped to 82 percent (Figure 6), largely because of an increase in dollar GDP, and an appreciation of the Japanese Yen against the dollar. Despite the decline, Indonesia's external position remains vulnerable because of short term debt. Debt due within a year accounted for \$19 billion, 70 percent of gross reserves, and about equal to net reserves¹⁰ While this ration declined by almost 10 percent over 2001, it was still much higher than other countries such as Thailand (39 percent), Korea (41 percent) and Malaysia (32 percent).

FISCAL CONSOLIDATION CONTINUES

Fiscal policy is continuing its consolidation path. The 2002 deficit of 2.7 percent of GDP in 2001 was well below the planned 3.7 percent of GDP, in part because foreign financing fell short of target because conditions on some adjustment loans were not met. For this year's a deficit of 2.5 percent of GDP is planned, and the Government is well on its way to

¹⁰ Data are derived from joint BIS-IMF-OECD-World Bank statistics on external debt, and therefore not compatible with debt outstanding data in the above paragraph.

achieve this. The proposed budget for 2003 aimed for a deficit of 1.3 percent of GDP at the time it was submitted to Parliament.

Figure 7 : Fiscal consolidation is on track
(budget deficit to GDP ratio, planned and actual)

Note: 2001 actual: preliminary result; 2002 actual: APBN-P (latest projection). Source: Ministry of Finance

This remarkable fiscal consolidation is largely due to reduction fuel subsidies, a decline in domestic interest rates, and to some extent to increases in tax revenues. Fuel subsidies were cut first by the June 2001 fuel price increase, and subsequently reduced further in January 2002, when the system of fuel pricing changed to one that tied domestic prices to international prices. This move not only reduced subsidies, but also made the budget less vulnerable to shocks in international oil prices, a feature that came in handy in 2002.

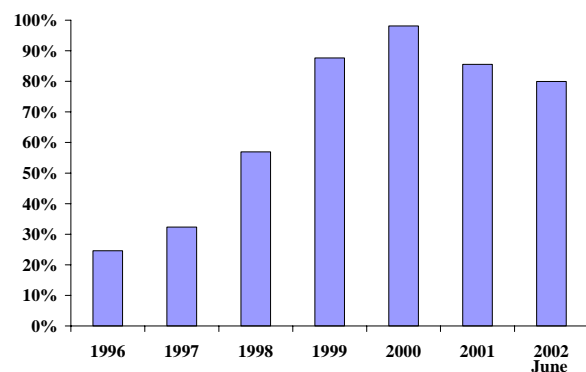
The Bali bomb may put fiscal consolidation on hold for now. The draft 2003 budget aimed for a deficit of 1.3 percent of GDP. Already before the bombing, this was ambitious, as the delayed recovery in the World economy had made the underlying 5 percent growth rate seem ambitious. Although the direct budgetary effect of the Bali bombing may remain small (a depreciated exchange rate is good for the budget, whereas lower growth is bad), the Government is likely to pursue a more expansionary stance to revamp growth, and the deficit could therefore become larger. At the time of writing, however, no revised budget proposal has been submitted to Parliament yet.

The government debt to GDP has been declining more rapidly than many had expected (Figure..).¹¹ The ratio dropped from its peak of 98 percent in 2000 to 86 percent at the end of 2001, and to 80 percent by June

¹¹ World Bank (2000) "Indonesia: Managing Government Debt and its Risks"

2002. The increase in nominal GDP and the appreciation of the Rupiah explain most of the decline.

Figure 8 Debt to GDP ratio is on the decline
(Percent of GDP)



Source: MOF, BI, BPS and staff estimates

STRUCTURAL REFORMS

Since the start of the Megawati Government, the IMF supported program has been on track. This is a stark contrast with the last year of the Gus Dur government, which went by without a regular review. As already noted, macroeconomic policies did particularly well, but structural reforms also accelerated, albeit some with considerable delay compared to the original timetable.

Privatization of bank BCA, IBRA asset sales, and measures in tax administration reform all were met on time, whereas the establishment of the anti-corruption commission (now more than a year overdue from the timetable in Law 28/99), the start of treasury bonds auctions, and the settlement of financial obligations on the liquidity credits between Bank, Indonesia and MOF experienced considerable delays. The initiation of the sale of stakes in Danamon, Niaga, and Mandiri. It is not just Government that is to blame for the delays: in each of the delayed measures, Parliament took its oversight responsibility rather serious. For instance, for each of the banks to be divested, Parliament has set up a special committee to oversee each step in the sale, and even formed its own opinion on the pricing of the sales.¹² In other cases, such as the anti-corruption commission, it was disagreement within government on the authorities of this commission what kept the government from meeting its target.

Delays also affected the World Bank's 'high case' scenario. To have access to higher lending and more IDA from the World Bank, the Government must meet certain high case conditions, including maintaining macroeconomic stability, improving fiduciary management in government, and increasing the poverty focus of Government policies.

¹² Some argue that reasons other than oversight are at play. For instance, the police is currently investigating allegations of two PDI-P parliamentarians who publicly stated that they refused payments from IBRA for the approval of the Bank Niaga sale—whereas their colleagues were happy to take the incentive.