

INDONESIA

Indonesia's economic recovery remains fragile. While 2001 GDP growth held up better than in most neighboring countries, the economy slowed markedly throughout the year, and investment and exports were falling rapidly by the end of the year. The markets have stabilized on the back of a more stable political situation, but there are few signs of recovery in capital inflows and investors' confidence remains weak. Recent progress in the structural reform agenda needs to be sustained for Indonesia to benefit from the global economic upturn.

Market sentiment. Markets have started to show renewed strength on the back of growing political stability. After the inauguration of the Megawati government the Rupiah and the Stock Market showed a remarkable, but short-lived recovery. The Rupiah exchange rates against the US dollar strengthened from over 12,000 in July 2001 to 8,500 in August 2000, only to drift back to the 10,000-11,000 level afterwards. Similarly, the JSX composite index rose from less than 350 in May to over 460 in August, but then fell back to less than 380 in November. Since then, a new Letter of Intent, and some concrete action on the policy front—including some last-minute privatization in 2001 and completion of the divestment of BCA—has reinforced market confidence. As a result, and despite rising inflation and stable interest rates, the currency strengthened to below Rp.10,000/\$. The stock market also rallied almost a hundred points to 490.

The real economy. Indonesia's recovery in the real sector remains fragile. In 2001, GDP grew by 3.3 percent, the third year in a row of positive growth, and higher than most countries in the region. However, growth was 1.6 percentage points lower than in 2000, and fell significantly short of the 5 percent originally

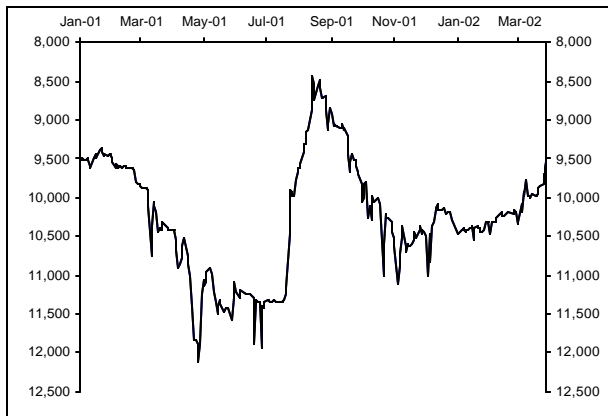
projected in the State budget.ⁱ Private consumption remains the key driver of growth, while gross fixed capital formation was weaker than expected. This trend of strong private consumption and weak gross fixed capital formation became more pronounced in the second half of 2001, and in the last two quarters of 2001 investment actually fell (Table 1). A sharp increase in the minimum wage and civil service wagesⁱⁱ and stronger consumer confidence after the July 2001 change in government may have boosted consumption, especially of durable goods. The growth in the number of motorbikes sales (over 50 percent in 2001), and higher automobile sales seem to confirm the strong consumption numbers, although they also reflect lower real prices for vehicles resulting from lower tariffs and more import competition.

The decline in gross fixed capital formation came as a surprise. Six months ago, investment started to show strong growth for 2001, but this has now turned out to be a statistical artifact.ⁱⁱⁱ The latest data show sharp downward revisions of the numbers for the first half of 2001, and decline for the second half of the year. The decline in the construction activity in the production account confirms weaker investment. Falling imports of machinery and equipment equally suggests that the decline in investment is for real.

The foregoing discussion highlights that expenditure-based national accounts data remain weak. Private consumption is particularly prone to errors as it is not based on surveys but based on estimates that rely on a consumption function, and GDP estimates from the production side. Large swings in changes in stocks, which includes statistical errors, raises a concern in the accuracy of growth estimates for the components of GDP.

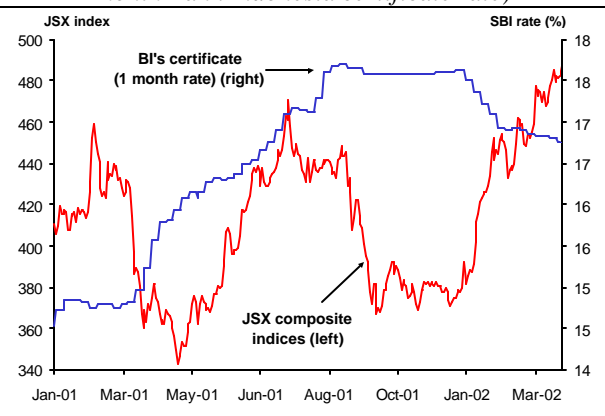
Figure 1: A macroeconomic snapshot

The Rupiah appreciated slightly ...
(Rupiah per US\$, spot rate daily)



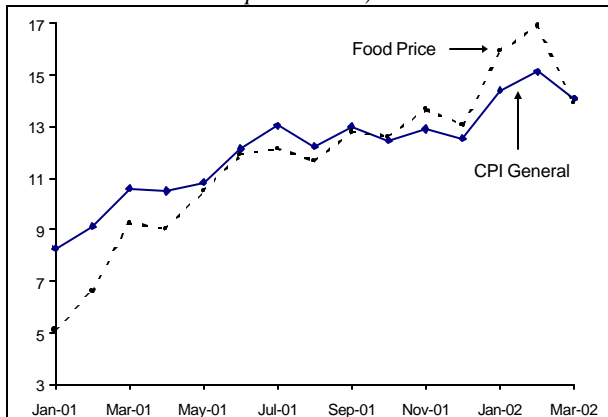
Source: Bank Indonesia

...a movement mirrored by the stock market.
(Jakarta stock exchange composite index and one month Bank Indonesia certificate rate)



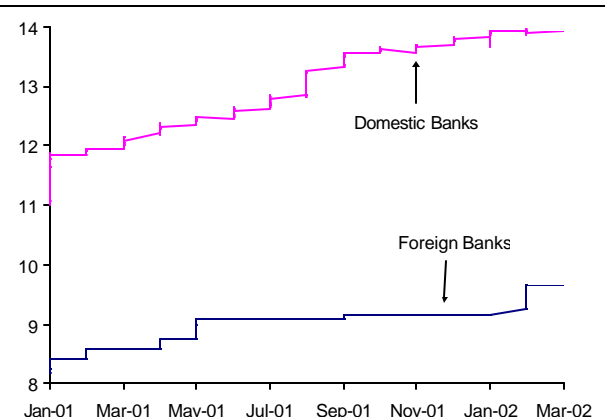
Source: CEIC

Inflation is rising....
(12 month percentage change in consumer & food price index)



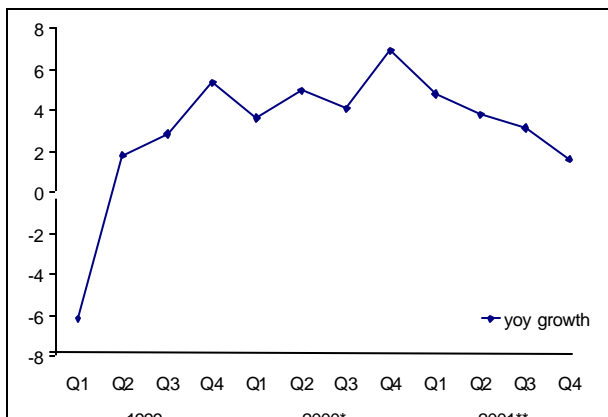
Source: CBS

...and nominal interest rates remain high.
(One month Rupiah deposit rate in Indonesia)



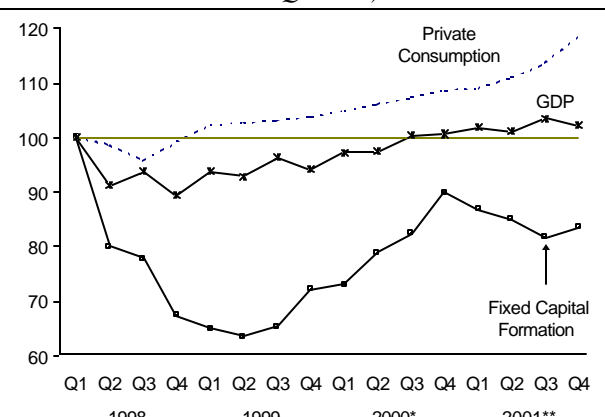
Source: CEIC

GDP growth remained positive....
(% Y on year and quarterly growth)



Source: CBS

...but recovery in investment stalled
(GDP, consumption and investment index, 1998Q1=100)



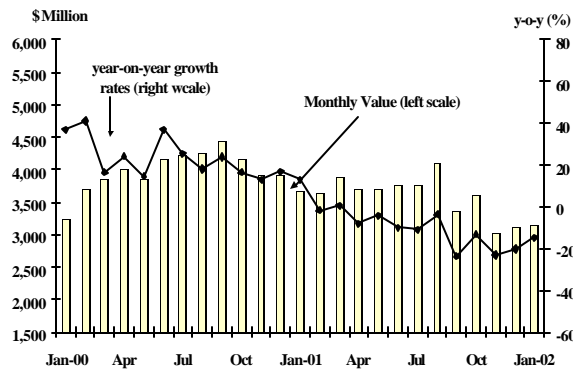
Source: CBS

Table 1: Real GDP growth rates (Expenditure Account)

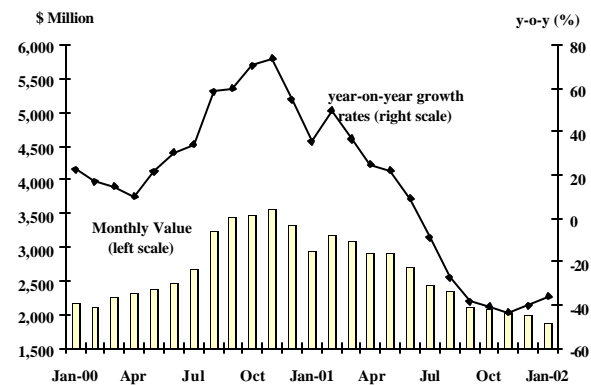
year-on-year growth rates	2001				1999	2000	2001
	Q1	Q2	Q3	Q4			
Consumption	4.2%	4.6%	6.3%	9.3%	4.3%	3.9%	6.2%
Household consumption	4.0%	4.7%	5.8%	9.2%	4.6%	3.6%	5.9%
Government consumption	6.0%	4.2%	11.9%	11.0%	0.7%	6.5%	8.2%
Gross fixed capital formation	18.9%	7.7%	-0.8%	-7.1%	-18.2%	21.9%	4.0%
Export of goods and services	18.4%	8.0%	-2.6%	-12.9%	-31.8%	26.5%	1.9%
Less import of goods and services	50.7%	37.2%	-3.7%	-29.8%	-40.7%	21.1%	8.1%
Gross Domestic Product	4.8%	3.8%	3.1%	1.6%	0.8%	4.9%	3.3%

Source: BPS

Figure 2. A slowdown of international trade continued...
Sluggish non-oil exports... ..and plummeting imports



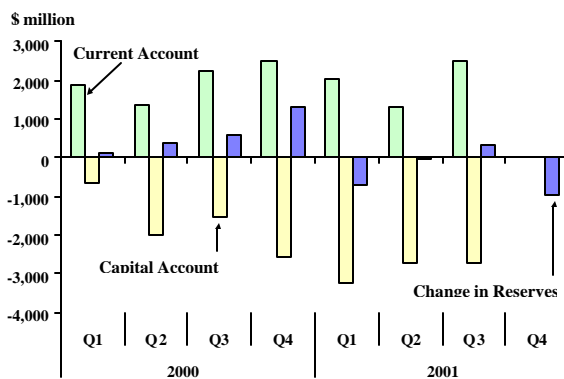
Source: BPS based on Customs data



Source: BPS

Figure 3: Balance of Payments 2000-2001

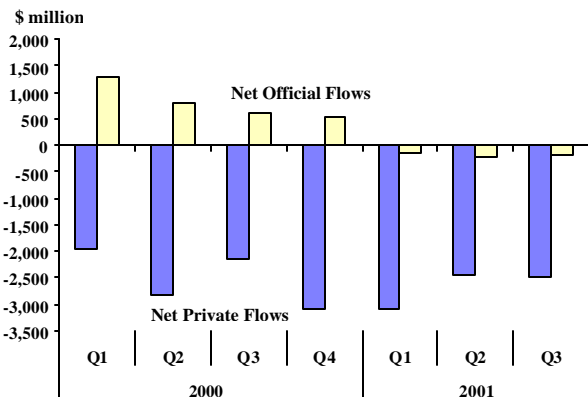
The capital account was a drain on reserves...



Source: BI

Note: current and capital account data are not available for 4Q01

...in part because net official capital account turned negative



Source: BI

Indonesia's production-based national account data can be considered more reliable. They show that slower growth was largely due to a slowdown in the tradables sectors, while the non-tradables sectors performed relatively well. This trend became more pronounced during the second half of 2001 when growth in agriculture and mining and quarrying turned negative and growth in manufacturing fell significantly. The global slowdown in the second half of 2001 also affected mining of oil and gas, and manufacturing industries such as textile and electric products. In addition, incidental factors played a role in lower 2001 growth, including fewer business days compared to 2000. Moreover, a return to normal weather patterns compared to the exceptionally good weather in the year 2000 suppressed 2001 agricultural growth. And finally, liquefied natural gas (LNG) production suffered a major setback because of the security situation in Aceh.

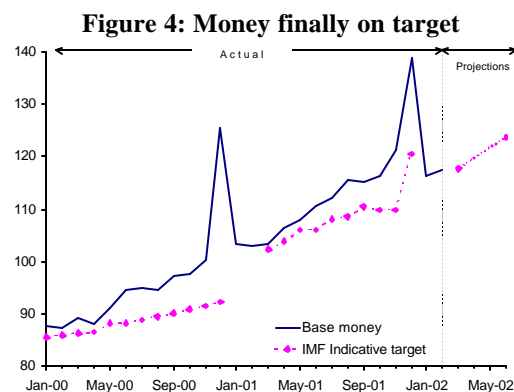
International trade. There are few signs of recovery in trade so far. The global economic slowdown, the decline in world oil demand and subsequent decline in oil prices hurt Indonesia's exports. Exports for 2001 were \$56 billion or 9 percent below the level of the year 2000. Manufacturing exports—mainly electrical products and transportation equipment—contributed around half of the decline. Indonesia's exports, unlike the rest of the region's, rely less on high-tech products, and the slump in exports set in later than in other countries. But when the slump came, it hit hard (Figure 2) and the decline in exports became the highest among the region once the decline spread into non high-tech products: year-on-year growth rates were negative for eleven straight months since April 2001, and there are few signs of recovery.

Growth in imports still outpaced that in exports until the first quarter of 2001, but then fell as a result of falling exports and falling investment demand. For the year as a whole, import amounted to \$31 billion, some 8 percent below that of 2000. Year-on-year growth rates were negative for eight straight months since July 2001. The decline in imports of raw materials and intermediate goods—which account for 80 percent of total imports—was mainly due to the decline in exports. Surprisingly, consumption goods imports fell by 18 percent in 2001, and the decline accelerated in the second half of 2001. This seems to be inconsistent with glowing private consumption in the national account, and reconfirms concerns about the quality of consumption data in the national accounts. One possible explanation for the sharp reduction in imports is rampant smuggling. However, statistics from

exporters on exports to Indonesia show even steeper declines than the numbers reported by Indonesia's customs, suggesting smuggling was not on the increase.

External payments and reserves. Private capital outflows continue unabated, and for the first time since the start of the crisis, official capital flows turned negative. Despite Paris Club rescheduling, official capital flows turned negative in 2001 because policy slippage delayed disbursements of program loans and IMF support. Private capital outflow continued in 2001, in part because exporters were unwilling to repatriate export earnings, and despite arrears and rescheduling of overdue private debt. As a result, foreign reserves went down from \$29.4 billion in end-2000 to \$28.0 billion in end-2001. This level still prevailed at end end-February 2002, the latest data available.

Inflation, money and interest rates. Inflation has been on the rise since mid-2000. CPI inflation reached 12.5 percent in December 2001 (yoy), slightly higher than the government target range of 11-12 percent. Inflation has accelerated since then, and reached 14.1 percent (yoy) in March. Partly to blame were hikes in administrative prices in January, and the impact of the floods in the first two months of 2002. But monetary policy added to inflationary pressures as well (Figure 4): base money has been overshooting its program targets for the last two years, and only this February did BI actually meet the targets agreed with the IMF.



Source: BI, IMF

The high inflation of recent months raises concerns on the government's target of 9-10 percent for the year. Even without further increase in prices until December, CPI inflation in 2002 (year average) would reach 9.9 percent. In light of these inflationary developments, monetary policy seems far from tight. Bank Indonesia's key policy interest rate—the 1-month SBI

rate—has been lagging behind inflation, and real interest rates have been around 4-5 percent. In March 2002, the SBI rate even fell from about 17.5 percent to under 17 percent, less than 2 percent above inflation. In part this reflected a lower country risk premium due to growing political stability, but it may also reflect lower inflationary expectations following BI's success in meeting monetary targets.

Fiscal Policy

The 2001 budget. Government met the 2001 budget deficit target of 3.7 percent. To achieve this, the Government had to resort to some extraordinary measures. These included counting as revenues the elimination of some Rp. 10 trillion, or 0.7 percent of GDP in escrow accounts held for the payments of subsidies to PLN and Pertamina. In addition, privatization and program financing fell short of target, and the Government took the extraordinary measure not to pay the Rp. 7.5 trillion interest due to the central bank.^{iv} A further extraordinary measure that was taken during the year was to freeze the transfers to the regions to the budgeted amount, even though the law states that revenue sharing and DAU (the general grant) should be based on actual revenues. This saved the central government some Rp.11 trillion in transfers. Finally, the deficit was also limited by squeezing foreign-financed development projects by some Rp.4 trillion.

The 2002 budget. Parliament gave the green light to the 2002 state budget in October. The state budget projects a deficit of 2.5 percent of GDP, thereby continuing the trend towards fiscal consolidation. The main economic assumptions underlying the budget are:

- A real GDP growth rate of 4 percent (1 percent lower than the draft budget);
- An inflation rate of 9 percent;
- A Rupiah exchange rate of Rp.9,000 per dollar (revised from the draft budget figure of Rp.8,500);
- An oil price of \$22 /bbl
- Oil production of 1,320 MBCD (revised from the draft budget figure of 1,232 MBCD)

During the Parliamentary budget debate, Government changed the underlying economic assumptions because of the expected impact of September 11. Both revenues and expenditures were revised upwards by 0.8 percent of GDP from the draft budget, in part reflecting the new economic assumptions, but also Parliament's desire to increase the tax to GDP ratio. The increased revenues were allocated to more

development spending, in particular on primary education. This arrested a further decline in central government's development budget as a percent of GDP (3.1 percent) from the previous year.

Foreign aid. The CGI (Consultative Group Indonesia) meeting in November 2001 was successful. Donors pledged to disburse \$3.1 billion in 2002, including \$1.8 billion in project loans. The \$1.3 billion in program loans would, as before, be disbursed only when the Government meets key policy conditionalities. If the past is any guide, this is far from assured. For example, at the Tokyo CGI in 2000, donors pledged \$2.6 billion of program loans, but the actual disbursement was only \$0.5 billion. A successful completion of the Paris Club III meeting scheduled in April is also essential for fiscal sustainability. The government is likely to request \$5.5 billion of rescheduling, including both interest and principal due between April 2002 and December 2003. A successful Paris Club would bring debt service as a share of government revenue down from 45 percent to 36 percent.

Government debt. Government debt in dollars and as a share of GDP is in decline. Total debt outstanding (excluding the IMF loans) declined from \$133 billion at end-2000 to \$122 billion at end-2001, a drop of some 8 percent. External debt declined from \$64 billion to \$60 billion and domestic debt from \$69 billion to \$62 billion. Exchange rate changes explain most of these declines. For domestic debt, 90 percent can be explained by the depreciation of the rupiah against the dollar between end-2000 and end-2001. The decline in Rupiah terms explains just 10 percent. For external debt, the depreciation of the Japanese yen against the US dollar lowered the dollar value of the 30 percent of debt denominated in Japanese Yen.^v Government debt to GDP ratio declined to 83 percent in end-2001 from 92 percent in end-2000 thanks to the increase in nominal GDP.

Policy Progress. The Megawati Government has begun to show slow, but steady progress in policy reforms. After being off track for more than a year, the new Government concluded a new LOI in August, 2001, and a further one on December 13, 2001. The 4th review of the EFF program was successfully completed in January, 2002, and the program was extended until the end of 2003. The fifth review—important for a successful Paris Club in early April—is currently pending. Outstanding issues include amendments to the BI law, , and the conversion of fixed into floating rate recapitalization bonds, which should page the way

for privatizing Bank Niaga. The controversial plans of Government to extend the so-called MSAA agreements with former bank owners were shelved in early March, removing one obstacle for successful completion of the IMF review.

The CGI concluded in its quarterly review in February 2002, that the Government has made good progress in macroeconomic policies, and has started some of the processes necessary to achieve structural reforms. Progress in key policy areas such as fiscal sustainability, small-medium enterprise (SME) development, governance, justice sector, forest management, education policy, poverty agenda, and aid effectiveness were discussed.

The macroeconomic outlook. In the short-run, the floods in January and February are likely to affect economic activity, especially in agriculture,

transportation and manufacturing. But reconstruction activities as well as public sector expenditures could have positive impacts on the economy subsequently. A declining consumer confidence index suggests that the brisk growth in household consumption is likely to wane, and further fiscal consolidation will temper government consumption growth. On the other hand, an earlier and sharper than expected recovery in the world economy is likely to turn around Indonesia's dismal export performance. Continued political stability and progress in the IMF-supported program could start to pay off in modestly higher, especially foreign financed investment, although we continue to believe that there will be delays in implementation of the program from time to time. The fragile political situation will probably preclude any dramatic or profound policy changes. On balance, therefore, we see little reason to revise our projections of the November CGI brief.

INDONESIA: Key Economic Indicators - Base Case

	CY2002	CY2003	CY2004
	<----- projections ----->		
NATIONAL ACCOUNTS			
Growth rates:			
Real GDP	3.5%	4.0%	4.0%
Consumption	3.8%	4.3%	4.2%
Fixed Investment	8.4%	9.2%	8.9%
Real GDP per capita	2.0%	2.5%	2.5%
Consumption per capita	2.3%	1.3%	2.7%
GDP Deflator	8.5%	5.0%	5.0%
Share of GDP:			
Fixed Investment	19.9%	20.9%	21.8%
Gross National Savings	21.6%	22.8%	23.9%
Nominal GDP (Rp. Tr.)	1,646.5	1,798.0	1,963.4
CENTRAL GOV'T. OFFICIAL BUDGET			
Share of GDP:			
Revenues [excl. privatization & asset recovery]	19.6%	18.5%	18.3%
Oil and gas revenues	4.0%	3.9%	3.6%
Total expenditures	22.1%	20.3%	20.2%
Subsidies	2.7%	2.2%	2.1%
Government Official Budget Deficit(-) (incl. arrears)	-2.5%	-1.8%	-1.8%
Foreign financing of deficit	0.8%	0.4%	0.5%
Total government debt [excl. IMF]	75.8%	71.6%	67.3%
Domestic debt (Rp. Tr.)	657.6	675.6	681.0
Government Debt [a] (including IMF)	81.2%	76.2%	71.2%
Government debt service/Revenue, %	35.0%	38.7%	55.4%
BALANCE OF PAYMENTS			
Export volume growth rate (Merch. FOB)	2.1%	3.0%	3.4%
Import volume growth rate (Merch. CIF)	7.0%	8.1%	8.4%
Exports (Merch. FOB) (US\$Billion)	63.7	66.7	70.4
Imports (Merch. CIF) (US\$Billion)	48.3	52.8	57.7
Non-oil merch. export growth rate in US\$ (%)	5.9%	6.0%	7.0%
Export growth rate (FOB, % p.a. US\$)	2.6%	4.7%	5.6%
Import growth rate (CIF, % p.a. US\$)	8.0%	9.3%	9.2%
Current Account Balance (US\$Billion)	1.7	-0.5	-1.2
Current Account Balance percent of GDP	0.9%	-0.3%	-0.6%
Gross Reserves (months imports GFS)	6.0	6.0	6.0
EXTERNAL DEBT			
Total DOD (US\$Billion)	136.1	132.9	131.1
M<+IMF DOD (US\$Billion)	117.0	114.3	112.7
Public & Publicly Guaranteed Debt (US\$Billion) [a]	75.4	74.8	74.0
Total External Debt/GDP (%)	75.5%	69.5%	64.7%
Debt Service (M<, US\$Billion)	22.2	22.0	23.5
Amortization (incl. IMF Repurchases, US\$Billion)	14.1	13.9	15.3
Interest Burden (M<, US\$Billion)	8.1	8.1	8.2
Total Debt Service/Exports(G&S) after rescheduling	29.9%	28.1%	28.2%
IBRD and IDA Exposure (US\$Billion):			
IBRD Debt Service	1,741	1,917	1,999
IBRD Total DOD	10,724	9,705	8,821
IDA Debt Service	32.1	31.4	31.9
IDA Total DOD	732.0	772.8	830.9

Note: Scenario includes impact of Paris Club III Rescheduling of eligible principal and interest in 2002 and 2003.

ⁱ The original state budget approved in December 2000 assumed real GDP growth rate of 5 percent. The revised budget agreed in June reduced the growth rate to 3.5 percent.

ⁱⁱ For example, minimum wage was raised by 38 percent in Jakarta in 2002, and with similar amounts in other regions. In addition, an adjustment in the civil service salary system led to an effective nominal wage increase of some 16 percent. The increase was made effective in June, but made retroactively starting January 1. Thus, civil servants received a windfall in their income in the middle of the year.

ⁱⁱⁱ When 3Q01 GDP was released in November last year, the growth rates of gross fixed capital formation in 1Q and 2Q01 were revised downward from 17.5 percent and 17.9 percent to 12.9 percent and 7.1 percent, respectively. Small-scale maintenance activities were excluded from the original figures.

^{iv} This interest is to be paid in 2002 upon settlement of the outstanding issue of responsibility for the liquidity support BI gave to commercial banks during the crisis.

^v The Japanese yen depreciated by 14 percent over the period 4Q 2000 to 4Q 2001. The Indonesian rupiah depreciated by 10 percent against the dollar during the same period.