

Indonesia

Economic indicators are signaling a strong pickup in economic growth at the end of 2006 and into 2007, although recent natural disasters may dampen the upturn in the near term. Flooding in the greater Jakarta area in February forced more than 300,000 people from their homes and caused widespread economic disruption. The government estimates losses of 0.1-0.2 percent of GDP. Other incidents included flooding in Flores, more earthquakes in Sumatra and a series of air and sea transport accidents.

Growth is recovering from a slowdown in the last quarter of 2005 and the first half of 2006 caused by the removal of fuel subsidies and the accompanying increase in fuel prices (an average of 114 percent) and interest rates (up 400 basis points). Growth dipped to 5 percent through mid 2006, but then recovered to 5.9 percent and 6.1 percent respectively in the third and fourth quarters of 2006, leaving growth for 2006 as a whole at 5.5 percent. Growth in the second half of 2006 was led by a pickup in private consumption and investment, while exports also remained strong. Imports picked up rapidly in response to reviving domestic demand. Rebounding automobile and motorbike sales, capital goods imports and consumer confidence all suggest that growth is continuing to accelerating.

Exports exceeded US\$100 billion in 2006 for the first time, growing 18 percent over 2005 in US dollar terms. Non-oil and gas exports grew 20 percent while oil and gas exports increased 10 percent. High international commodity prices contributed to strong growth in non-oil primary commodity exports (e.g. rubber, palm oil and coal). The current account surplus rose to US\$9.6 billion in 2006, much higher than 2004 (US\$1.6 billion) and 2005 (US\$0.3 billion). International reserves rose from US\$35 billion in 2005 to US\$43 billion in 2006.

Markets are increasingly confident. The rupiah exchange rate has traded in a stable range between Rp.9,000-9,200 against the US dollar for some time. Yields for government bonds continued to fall at all maturities in early 2007, reflecting a positive outlook for inflation and further cuts in interest rates. The Jakarta Stock exchange continues to trade near all time highs. Inflation fell to 6.6 percent at the end of 2006, lower than Bank Indonesia's target of 7-9 percent but higher than expected due to recent increases in food and especially rice prices. These pressures spilled into January and February when inflation remained at worryingly high 1.2 and 0.6 percent rates over the previous month. As the base effect of higher year on year inflation created by the fuel price in 2005 has worked its way out of comparisons, Bank Indonesia lowered policy rates by 375 basis points from a high of 12.75 percent to 9.0 percent by March 2006. However, the rise and fall in administered rates was not reflected in a proportional changes in lending rates.

Government spending continued to run below budget and the debt to GDP ratio fell dramatically. The preliminary 2006 results show a budget deficit at 1.1 percent of GDP, lower than the earlier estimates at 1.3 percent of GDP. The government debt to GDP ratio dropped to 41 percent from 45 percent in 2005. The lower deficit sent a positive signal to markets but unfortunately also reflects below-budget government capital spending. While central government capital spending rose to 1.9 percent of GDP, significantly higher than 2005's 1.2 percent, it was still below target by 0.3 percent of GDP. Regional government spending is also likely to undershoot budgets by an even greater amount.

In August the President announced major new poverty initiatives including: a program to provide block grants to every village in Indonesia by 2009 (PNPM); and a pilot conditional cash transfer program (PKH). The PNPM initiative is designed to create employment, stimulate the local economy and build community participation. The PKH pilot should support demand through conditional cash transfers designed to improve health and education outcomes. Research has shown that poverty outcomes are very sensitive to rice prices. Recent increases in rice prices, as well as the termination of the unconditional cash transfer program could slow poverty reduction or even lead to an increase in poverty in 2007 despite higher growth. However the government's decision to undertake some imports of rice appears to be stabilizing prices. Unemployment appears to have stabilized at a little over 10 percent (10.4 percent in February 2006 and 10.3 percent in August 2006).

The government continued to push forward on its economic policy packages. After much debate Parliament has passed a new investment law providing, among other things, equal treatment between domestic and foreign investors, binding international arbitration, the elimination of forced divestiture, land use rights up to 95 years (from 35 years previously), and extended residency permits for foreign investors.

However, important tax laws remain under discussion in Parliament. The latest package on the financial sector includes a decree to allow state-banks to write-off non-performing loans, which should accelerate lending from this source. Infrastructure achievements include a Risk Management Unit in the Ministry of Finance that is assessing limited public guarantees for projects and an agreement to develop 10 model projects for Public Private Partnerships. But there are still relatively few large infrastructure projects actually getting underway.

Growth is expected to pick up to 6.3 percent in 2007. Externally, while a slowdown in world growth is expected, consensus projections are for it to be relatively modest. Indonesia is also less export dependent than other East Asian economies. Domestically there may be some further room for interest rate declines, especially in lending rates which have remained high. Central and regional government fiscal policy should be more supportive as spending catches up to budgeted levels.