

Indonesia: Economic and Social Update

April 2007



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Summary Introduction

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

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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. The PNPM initiative is designed to create employment, stimulate the local economy and build community participation. The conditional cash transfer program is a vehicle to address lagging human development outcomes in addition to providing income support for the poorest families. However, poverty rates are very sensitive to rice prices and recent increases in these prices, as well as the termination of the unconditional cash transfer program may lead to an increase in poverty in 2007 despite higher growth. The government's ad hoc decision to allow rice imports should stabilize prices in the near term but is not a solution to volatile domestic rice prices better addressed through a tariff. Unemployment remains high but 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, critically 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.

Pendahuluan Rangkuman

Indikator ekonomi menunjukkan pertumbuhan yang cukup kuat di akhir tahun 2006 dan awal 2007, meskipun sedikit terhambat oleh beberapa kejadian bencana alam yang terjadi baru-baru ini. Banjir di Jakarta pada bulan Februari telah memaksa lebih dari 300.000 jiwa mengungsi dan menyebabkan gangguan perekonomian yang cukup luas. Pemerintah memperkirakan kerugian sebesar 0,1-0,2 persen dari PDB. Insiden lain yang cukup relevan diantaranya adalah banjir di Flores, beberapa kejadian gempa di Sumatra, serta serangkaian kecelakaan transportasi laut dan udara.

Pemulihan mulai terjadi setelah perlambatan di akhir kuartal 2005 dan paruh pertama 2006 yang disebabkan oleh penghentian subsidi BBM serta kenaikan dalam harga BBM (dengan rata-rata 114 persen) dan suku bunga (sampai dengan 400 basis point). Pertumbuhan turun ke 5 persen di pertengahan 2006, tapi kemudian pulih kembali ke 5,9 persen dan 6,1 persen secara berurutan di kuartal ketiga dan keempat 2006. Di tahun 2006, pertumbuhan secara keseluruhan menjadi 5,5 persen. Pertumbuhan di paruh kedua 2006 didorong oleh kenaikan investasi dan konsumsi swasta, sementara ekspor masih tumbuh dengan kuat. Impor naik cepat seiring dengan pulihnya permintaan di dalam negeri. Penjualan mobil dan motor menunjukkan kegairahan, sementara impor barang modal dan tingkat kepercayaan konsumen mempertunjukkan percepatan dalam pertumbuhannya.

Untuk pertama kalinya, ekspor mencapai angka melebihi 100 miliar dollar AS di tahun 2006, atau tumbuh 18 persen dari tahun 2005. Ekspor non-migas tumbuh 20 persen, sementara ekspor migas tumbuh 10 persen. Tingginya harga komoditas primer di pasar internasional juga sangat berperan dalam memacu pertumbuhan ekspor komoditas primer non-migas (seperti karet, minyak sawit dan batu bara). Surplus *current account* naik menjadi 9,6 miliar dollar AS di tahun 2006, jauh lebih tinggi daripada tahun 2004 (1,6 miliar dollar AS) dan 2005 (0,3 miliar dollar AS). Cadangan devisa naik dari 35 miliar dollar AS di tahun 2005 menjadi 43 miliar dollar AS di tahun 2006.

Kepercayaan terhadap pasar semakin meningkat. Hal ini dibuktikan dengan nilai tukar rupiah yang stabil diperdagangkan di kisaran Rp 9.000-9.200 terhadap dollar AS selama beberapa waktu. *Yield* obligasi pemerintah yang jatuh tempo di awal 2007 terus menurun, mencerminkan sinyal positif terhadap inflasi dan terus berlanjutnya pemotongan tingkat suku bunga. Di Bursa Efek Jakarta, saham-saham juga terus mencatatkan harga yang cukup tinggi sepanjang sejarah. Inflasi mencapai angka 6,6 persen di akhir tahun 2006, atau lebih rendah dari apa yang ditargetkan BI sebesar 7-9 persen. Walau demikian, inflasi dianggap cukup tinggi dari apa yang diharapkan. Hal ini disebabkan oleh adanya kenaikan harga pangan, terutama beras. Tekanan ini terjadi di bulan Januari dan Februari ketika inflasi berada 1,2 dan 0,6 persen lebih tinggi dibandingkan bulan sebelumnya. Bank Indonesia juga telah menurunkan kebijakan suku bunganya sebesar 375 basis point, dari 12,75 persen menjadi 9,0 persen di bulan Maret 2006 setelah mempertimbangkan bahwa dampak utama inflasi *year on year* yang tinggi yang disebabkan kenaikan harga BBM tahun 2005 telah keluar dari perhitungan, Namun demikian, naik – turunnya tingkat suku bunga SBI tidak terlalu berpengaruh dalam perubahan tingkat suku bunga pinjaman.

Pengeluaran pemerintah tetap berjalan di bawah apa yang dianggarkan dan rasio utang terhadap PDB turun secara dramatis. Hasil awal 2006 menunjukkan defisit anggaran sebesar 1,1 persen dari PDB, lebih rendah daripada perkiraan awal sebesar 1,3 persen dari PDB. Rasio utang terhadap PDB pemerintah turun menjadi 41 persen dari 45 persen di tahun 2005. Defisit yang lebih rendah memberikan sinyal positif kepada pasar; tapi sayangnya hal ini juga mencerminkan pengeluaran modal pemerintah yang di bawah anggaran. Walaupun pengeluaran modal pemerintah pusat naik menjadi 1,9 persen dari PDB, jauh lebih tinggi daripada tahun 2005

sebesar 1,2 persen tapi lebih kecil dari target sebesar 0,3 persen dari PDB. Pengeluaran pemerintah daerah pun kemungkinan di bawah anggaran dengan jumlah yang jauh lebih besar.

Pada bulan Agustus, Presiden mengumumkan prakarsa penanggulangan kemiskinan yang baru, yaitu program penyediaan hibah untuk setiap desa di Indonesia sampai 2009 (PNPM) dan program percobaan bantuan tunai bersyarat. Inisiatif PNPM dirancang untuk mengupayakan penciptaan lapangan kerja, merangsang perekonomian di daerah dan membangun partisipasi dalam masyarakat. Program bantuan tunai bersyarat merupakan kendaraan untuk mengatasi kelambatan hasil pengembangan SDM, sekaligus memberikan bantuan dari sisi pendapatan kepada keluarga-keluarga termiskin. Sementara itu, kewaspadaan juga harus ditingkatkan mengingat pekanya tingkat kemiskinan terhadap naiknya harga beras yang terjadi akhir-akhir ini serta penghentian program bantuan tunai tanpa syarat. Bila tidak, yang akan terjadi adalah peningkatan angka kemiskinan di tahun 2007 – selain harapan pertumbuhan yang lebih tinggi. Keputusan *ad hoc* pemerintah untuk mengizinkan impor beras seharusnya dapat menstabilkan harga dalam waktu dekat tapi bukan solusi terhadap harga beras domestik yang tidak stabil, yang lebih baik diatasi dengan penentuan tarif. Tingkat pengangguran masih cukup tinggi meskipun mulai stabil di level sedikit di atas 10 persen (10,4 persen di bulan Februari 2006 dan 10,3 persen di bulan Agustus 2006).

Pemerintah terus mengedepankan paket kebijakan perekonomiannya. Setelah perdebatan berkepanjangan, akhirnya DPR meloloskan Undang-Undang Investasi terbaru yang antara lain memuat pasal-pasal yang berkaitan dengan perlakuan yang seimbang antara investor dalam negeri dan asing, arbitrase internasional yang bersifat mengikat, menghilangkan kemungkinan divestasi secara paksa, perpanjangan hak penggunaan tanah selama 95 tahun (sebelumnya 35 tahun), dan perpanjangan izin tinggal kepada para investor asing. Akan tetapi, beberapa isu penting yang berkaitan dengan undang-undang perpajakan masih dibahas di parlemen. Kebijakan terbaru di sektor keuangan berupa keputusan yang memperbolehkan bank negara menghapus pinjaman bermasalah, diharapkan dapat mempercepat proses penyaluran pinjaman dari sumber ini. Prestasi di bidang infrastruktur mencakup terbentuknya Unit Manajemen Risiko di Departemen Keuangan. Unit ini bertugas melakukan penilaian atas proyek-proyek dengan jaminan publik terbatas dan menjalin kesepatakan untuk membangun 10 proyek percontohan dalam bentuk kemitraan swasta-publik. Selain itu, masih ada beberapa proyek infrastruktur yang cukup besar yang saat ini sedang berjalan.

Pertumbuhan ekonomi diperkirakan naik menjadi 6,3 persen di tahun 2007. Walaupun secara eksternal diperkirakan terdapat perlambatan dalam pertumbuhan ekonomi dunia, efeknya terhadap Indonesia akan cukup kecil. Perekonomian Indonesia dianggap tidak terlalu tergantung pada ekspor dibandingkan dengan perekonomian negara-negara di Asia Tenggara lainnya. Di dalam negeri, masih ada ruang untuk penurunan suku bunga, terutama suku bunga pinjaman yang sampai saat ini masih tetap tinggi. Kebijakan fiskal pemerintah pusat dan daerah seharusnya lebih mendukung, bersamaan dengan naiknya pengeluaran ke tingkat yang dianggarkan.

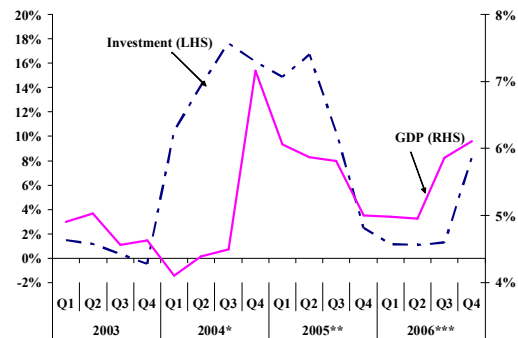
1. Growth and Investment

Higher investment drove accelerated growth in Q4 2006 (Figure 1). Year-on-year growth rates accelerated to 6.1 percent in Q4 2006, up slightly from the upwardly revised 5.9 percent in Q3 2006. This represented a substantial increase from economic growth rates that were stagnant in the 5.0 percent range from Q4 2005 to Q2 2006. In the expenditure account, investment growth accelerated to 8.2 percent in Q4 from 1 percent for the previous three quarters representing the highest rate since Q3 2005. Private consumption also rose to 3.8 percent from an average of 3 percent earlier in the year. Annual GDP growth rates were 5.5 percent, close to the in 2005 growth that was revised from 5.6 to 5.7 percent.

The source of growth shifts at the end of 2006. From late 2005 into the first half of 2006, economic growth was driven by external demand (i.e. high net exports). By Q4 2006, domestic demand had become the main driver of growth, though large ‘statistical discrepancies and change in stocks’ confused the picture (Figure 2).² As noted among domestic demand elements, investment (i.e. gross fixed capital formation) was the most striking growing by 8.2 percent (yoy), from a low base a year earlier. In investment, construction, which accounts for more than 80 percent, grew by 10.4 percent in the Q4, the highest growth in 10 years. In addition, a significant turnaround occurred in domestic capital goods production which rose from -2.5 percent in Q3 to 13.9 percent in Q4. The precipitous decline in foreign capital goods imports (a component of investment) improved from -22.2 percent in Q3 to -3.0 percent in Q4 (Figure 3).³

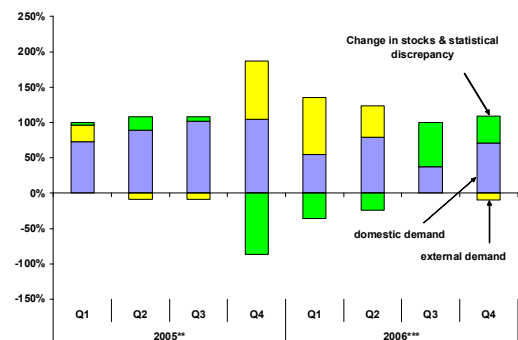
In 2006 for the year as a whole, investment grew by only 2.9 percent over 2005, reflecting

Figure 1: Growth and Investment
(year-on-year growth rates, percent)



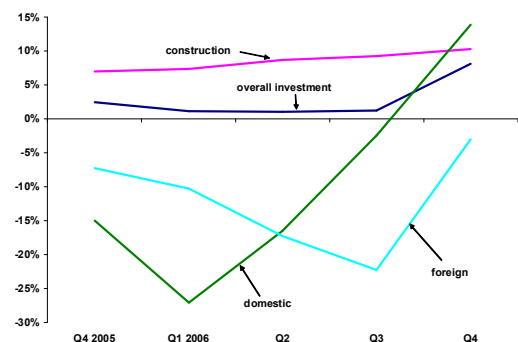
Source: BPS

Figure 2: Shifted growth source
(percent)



Source: BPS, World Bank staff

Figure 3: investment recovered in all categories
(year-on-year growth, percent)



Source: BPS, World Bank staff

² These items are derived from the difference between the level of GDP in the production account and the sum of consumption, investment and net exports in the expenditure account. A positive level of either (especially statistical discrepancy) implies that some other expenditure items is underestimated.

³ To calculate investment made up of foreign capital goods in the national account, BPS uses ‘capital goods imports’ in trade statistics as a proxy.

the very low growth early in the year and the lowest growth since 2003. The significant increase in construction (9.0 percent) was offset by the decrease in domestic investment (-9.1 percent) and foreign investment (-14.0 percent).

Manufacturing began to recover, though non-tradable sectors dominated (Table 1). In Q4 non-tradable sectors grew by 8.4 percent, while tradable sectors grew by 3.9 percent. Among tradable sectors, manufacturing grew by 5.9 percent (same as Q3 2006) up considerably from 3-4 percent in the first half of 2006. The recovery in manufacturing is consistent with the increase in investment on the expenditure side. By contrast, agriculture growth 1.8 percent and mining 0.7 percent were relatively stagnant. The change in the 2005 harvest and adverse weather conditions likely contributed to this. All the non-tradable sectors were strong, especially transportation and communication growing 15.9 percent and construction growing 10.4 percent.

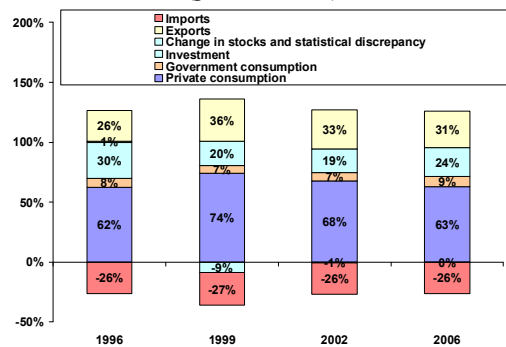
Structural change The structure of the expenditure accounts continues to evolve (Figure 4). In 1996, private consumption accounted for 62 percent of the economy followed by investment (30 percent) and government consumption (8 percent). Net exports were slightly negative (-1 percent). After the crisis private consumption increased, investment fell and net exports became larger. In 2006 private consumption has returned to pre-crisis levels, and investment has increased substantially, while net-exports remain strong.

Table 1: GDP- Production Account
(Year-on-year growth rates, percent)

	Q3 06	Q4 06	2006
Total GDP	5.9	6.1	5.5
Tradable	4.1	3.9	3.7
Agriculture	2.2	1.8	3.0
Mining	1.6	0.7	2.2
Manufacturing	5.9	5.9	4.6
Non-Tradable	7.8	8.4	7.4
Construction	9.3	10.4	9.0
Finance	4.7	6.8	5.6
Transport & Commu.	13.6	15.9	13.6
Utility	5.8	8.1	5.9
Trade, Hotel & Rest.	7.5	7.0	6.1
Services	6.8	6.0	6.2
Non-oil and gas	6.6	6.6	6.1
Oil and gas	-2.2	0.4	-1.3
Natural resource */	-0.1	0.6	0.6
Non-Natural resource	7.1	7.3	6.5

*/ including mining and, oil and gas manufacturing
Source: BPS, World Bank

Figure 4: Structural Change*
(percent share)



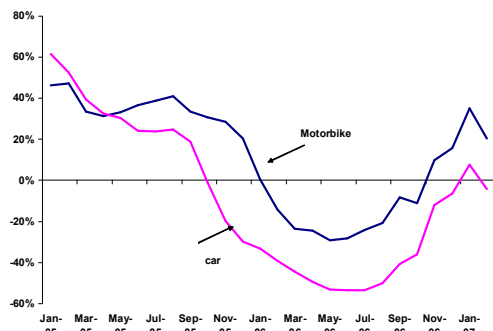
*/ 1996, 1999 are 1993 base GDP
Source: BPS, World Bank staff

Box 1: Nominal Investment Revised Upward

Indonesia's investment as a share of GDP remains far below pre-crisis levels. However, the latest GDP accounts represent a significant upward revision in nominal investment and therefore investment as a share of GDP. BPS revised up 2004-2006 nominal investment value up based on revisions to investment deflators. As a result, investment as a share of GDP was revised up by 0.7 percent to 22.4 percent in 2004, by 1.6 percent to 23.6 percent in 2005 and to 24.0 percent in 2006.

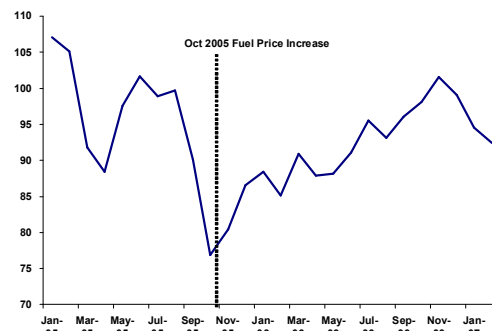
Other economic indicators suggest that the economic situation continued to improve in the fourth quarter. Motorbike and automobile sales (year-on-year growth rate at 3 month moving average) turned positive in January (Figure 5), as consumer confidence recovered (Figure 6). Bank Indonesia's consumer confidence index in November reached the highest level since February 2005, as monetary policy eased (see section 4) expected to support a continuing recovery in durable goods sales.

Figure 5: Motorbike and Car Sales
(year-on-year growth rates, 3 month moving average, percent)



Source: CEIC, World Bank

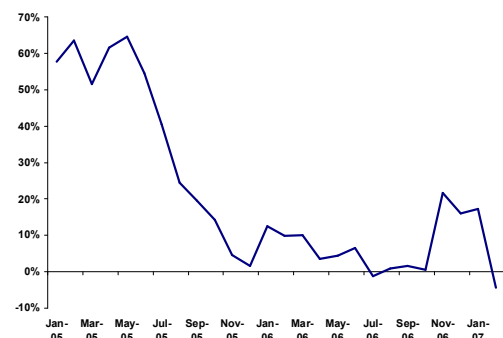
Figure 6: Confidence Recovering
(consumer confidence index, 2000=100)



Source: CEIC, World Bank

Capital goods imports suggest a continuing investment recovery in coming periods. Capital goods imports, a key source of investment in gross fixed capital formation, increased sharply in the fourth quarter (see section 3). As the decline in foreign investment was the main factor in low investment 2005 the increase of capital goods imports (yoy, 3 month moving average) of 16.0 percent in December 2006 and 17.2 percent in January 2007, though growth rates fell to -4.5 percent in February (Figure 7).

Figure 7: Capital goods imports jumped
(year-on-year, 3 month moving average, percent)



Source: BPS, World Bank

Box 2: Economic Impact of the Flood

The flooding in early February in Jakarta claimed about 80 lives and forced the evacuation of more than 300,000 people. The damage this year was estimated to have been more severe than 2002 in terms of number of people impacted, total area affected, and economic impact.

According to anecdotal evidence, some industries (e.g. automobile) had to stop production for a week due to the disruption of supply networks. However, in practice, lost production can, sometimes, be compensated by post-flood reconstruction activities. In this regard, the net impact on the economy is likely to be negligible.

The impact on prices in Jakarta was small. Rice prices increased by 1.8 percent during the week of February 5th, but the prices of 25 other basic commodities did not change. The recently released February CPI (section 5) shows an overall inflation of 0.6 percent (food prices increased by 0.8 percent), much lower than the increase in 2002.

The Planning Ministry/Bappenas released its own assessment of the flooding in mid-February. Bappenas estimates total damage and loss to be Rp.5.2 trillion, of which, Rp.1.8 trillion (34 percent of total) is considered damage and Rp.3.4 trillion (66 percent) is loss. The private sector bears most of the damage and loss, estimated at Rp.4.5 trillion, or 87 percent of the total. The government estimates the total negative impact of the flood on 2007 GDP (constant) to be about Rp.3.8 trillion, equivalent to 0.2 percent of GDP.

2. Markets

Rupiah, stock prices, and yield curve continue to improve. Despite recent instability, the trend since mid-2006 has been toward increasing confidence in financial markets due to Indonesia's improving macroeconomic and political stability. The Rupiah exchange rate has been trading between Rp. 9,000-9,500 against the US dollar. Stock prices have hit new highs (Figure 8). The bond yield curve fell in March 2007 (Figure 9).

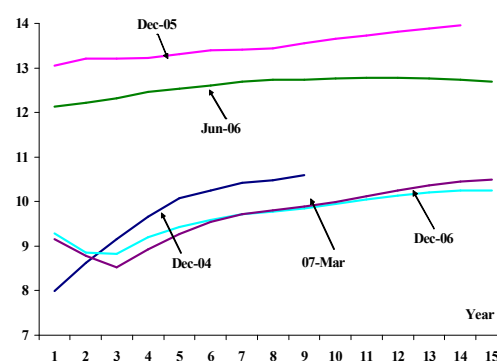
Rating prospects upgraded. Two international rating agencies (Fitch and Moody's) recently upgraded their rating prospects from stable to positive. The upgrades reflect recent developments in macroeconomic stability; some progress on structural reforms, as well as government and external debt positions. However, Fitch's rating (BB-) and Moody's rating (B1) are still three

Figure 8: Markets reflect confidence
(Rupiah exchange rates and stock index)



Source: CEIC, World Bank

Figure 9: Declining Yield Curve
(domestic bond yield curve, percent)

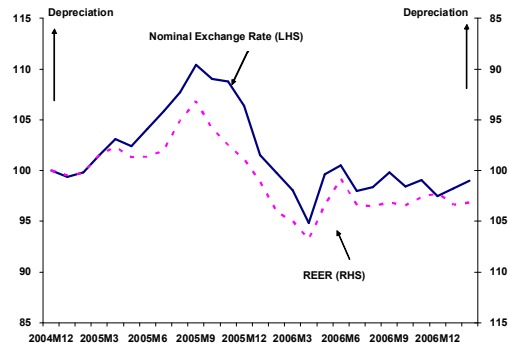


Source: CEIC, World Bank

and four notches below investment grade, respectively.

Real effective exchange rate⁴ was stable. Both nominal and real effective exchange rates (REER) appreciated in mid-2006 from late-2005 levels when Indonesia experienced a sudden and sharp exchange rate depreciation. However, both nominal and REER exchange rates were stable in the latter half of 2006 (Figure 10). A relatively stable nominal exchange rate and REER should provide improved certainty to exporters.

Figure 10: REER Stabilized
(nominal and real exchange rates, Dec 00=100)

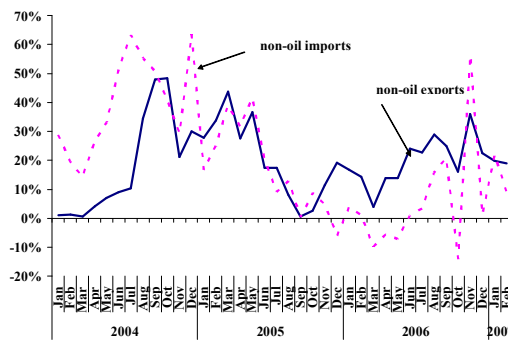


Source: World Bank

3. External Sector

Record high exports. Non-oil and gas trade has been picking up since early-2006, although there have been fluctuations due to the Idul Fitri holidays (Figure 11). In 2006, total exports exceeded US\$100 billion for the first time, surpassing 2005 exports by 17.5 percent. Non-oil and gas exports reached US\$79.5 billion, an increase of 19.7 percent, while oil and gas export increased by 10 percent. In light of higher prices, commodities (e.g. rubber, mining and mineral) exports significantly increased. Imports, on the other hand, increased only 5.9 percent as non-oil and gas imports increased by 4.6 percent and oil and gas imports increased by 8.7 percent.

Figure 11: Increasing Non-Oil Trade
(year-on-year growth rates, percent)



Source: BPS, World Bank

Among non-oil and gas imports, capital goods increased by 7.5 percent and followed by raw material (5.4 percent) and consumer goods (3.8 percent).

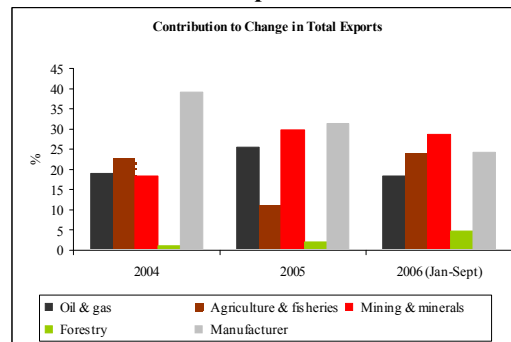
The oil and gas balance continues to fluctuate. After the fuel price increase of 114 percent in October 2005, the oil and gas balance moved to a positive US\$300-600 million a month and continued to fluctuate in the latter half of 2006, remaining mostly positive. However, preliminary data suggests Indonesia's oil production declined by another 4 percent in 2006 to 0.96 million barrel a day. This decline in oil production is a factor behind the declining trend in the oil and gas balance.

Manufacturing is contributing less to Indonesian exports. Weaker performance has reduced the role of the manufacturing sector in Indonesian export growth. The latest detailed data (January-September, year to date) show that manufactured exports grew 9.9 percent in 2006, lower than in 2005. The slower growth of manufactured exports occurred despite surprisingly strong growth in garments and footwear exports. The fall in manufactured exports was largely

⁴ The real effective exchange rate (REER) adjusts for the currency composition and relative rates of inflation between trading partners and is thus a better measure of competitiveness than the nominal exchange rate against the US dollar.

caused by a sharp 6.4 percent drop in exports of electronics and computer parts, representing 11.7 percent of total exports or 27 percent of total manufactured exports in 2005. As a result, the contribution of manufactured export growth to total export growth declined from 31.4 percent in 2005 to 24.3 percent in 2006. Conversely high export growth in primary commodities (rubber, palm oil, and coal) significantly increased their contribution to total export growth. The share of export growth in 2006 attributable to agriculture and fisheries was 23.9 percent while that for mining and minerals was 28.8 percent (Figure 12).

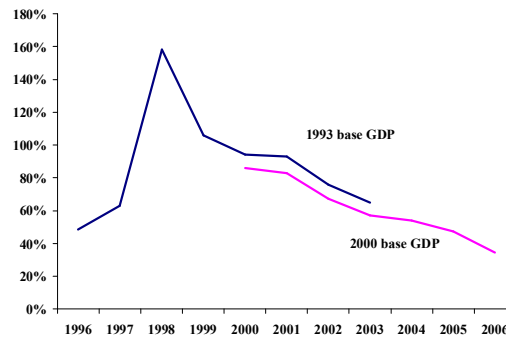
Figure 12: Contribution to Change in Total Exports



Source: World Bank

Balance of payments improves. In 2006, the current account surplus reached US\$9.6 billion, much higher than in 2004 (US\$1.6 billion) and 2005 (US\$0.3 billion). The balance of trade in goods reached US\$29.7 billion nearly double 2005's US\$17.5 billion, though this was partially offset by deficits on service and income accounts. The capital account also improved to US\$2.5 billion, from US\$1.9 billion in 2004 and US\$0.3 billion in 2005. In the capital account, gross foreign direct investment (US\$7.3 billion) fell from 2005's US\$8.5 billion but the 2005 figure reflects the very large inflow after the sale of Sampoerna.

Figure 13: External Debt Burden Eased (percent of GDP)



Source: World Bank

External risk indicators also improve. Gross international reserves increased to US\$42.6 billion in December 2006 even after prepayment of approximately US\$8 billion to the IMF in October. In addition to the increase in international reserves, the external debt to GDP ratio improved from 47.5 percent at the end of 2005 to 34.3 percent in September 2006 (Figure 13).

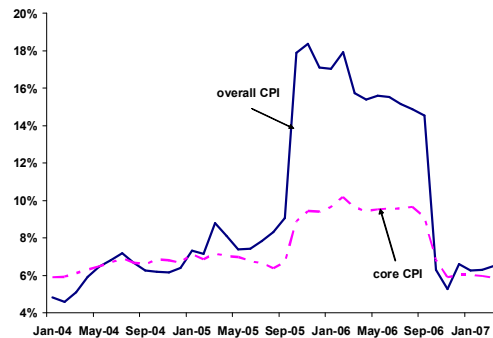
4. Inflation, Money and Monetary Policy

Inflation decelerated. The inflation rate (CPI) fell to 6.6 percent (yoy) in December 2006, its lowest yoy rate since 2004 and below the Bank Indonesia's inflation target range of 7-9 percent (Figure 14). By contrast, monthly inflation in December 2006 and January 2007 was stubbornly high at 1.2 percent, and 1.0 percent. Food prices (which account for 25 percent of CPI) increased by 3.1 percent in December in 2006 and 2.7 percent in January 2007, mainly due to high rice prices. In February and March, the monthly inflation rate decelerated to 0.6 percent and 0.2 percent, respectively. The impact of the floods in Jakarta and its surrounding areas proved to be limited.

Easing monetary policy. In light of declining inflationary pressure, Bank Indonesia continuously lowered policy interest rates (SBI 1 month) since May 2006. SBI 1 month policy interest rate fell from 12.8 percent in May to 9.0 percent in March 2007. During the previous easing phase (January 2002-April 2004), Bank Indonesia reduced the SBI 1 month rate from 17.6 percent to 7.3 percent. During the first eight months, interest rates fell by 3.3 percent, around the same pace as currently (Figure 15). Although Bank Indonesia was not following inflation targeting in 2002, over the same period inflation fell by 3.8 percent. Similarly between May and December 2006 the core inflation rate fell by 3.5 percent.⁵

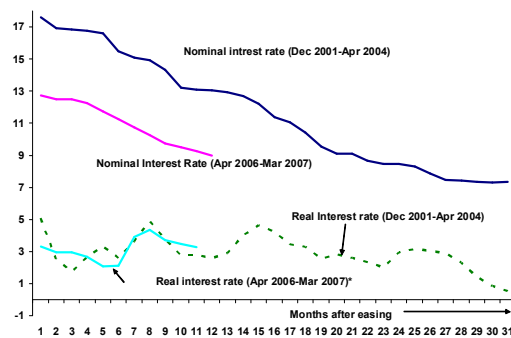
The pace and extent of interest rate cuts will slow. The real interest rate (SBI 1 month minus core inflation rate) fell to 3.0 percent in February 2007. The current real interest rate is about average in 2005-06 but 1-2 percent higher than 2004 levels. The gap between Indonesian and US interest rates (Federal Fund rate) has also fallen to 4.3 percent, the lowest since 1996 (Figure 16). Further reductions should take the following issues into account:

Figure 14: Inflationary Pressure Subsid
(year-on-year growth rates, percent)



Source: BPS, World Bank

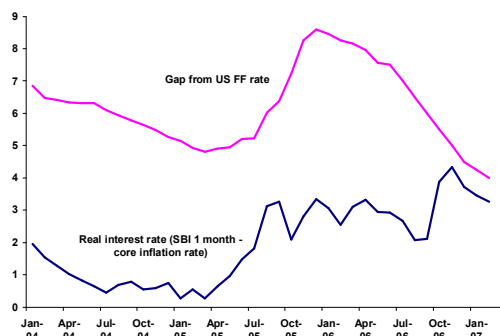
Figure 15: Comparison from the previous easing phase in 2002-2004



*/ adjusted by core inflation rate

Source: BPS, World Bank

Figure 16: Real interest rate and policy interest rate differential from US



Source: BPS, World Bank

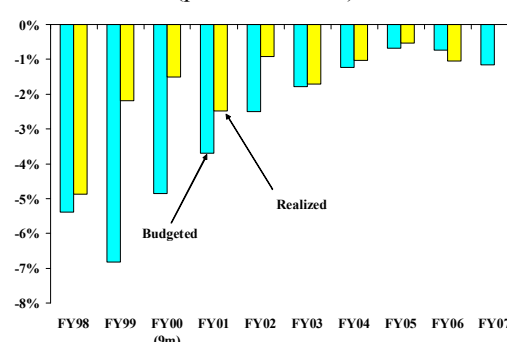
⁵ The core inflation rate excludes the direct impact of the fuel price increase.

- *Impact on inflation:* Bank Indonesia set inflation targeting in the 5-7 percent range for 2007, and average inflation rates in early 2007 suggest a full year figure outside the range.
- *The premium to the US Federal Funds (US FF) rate:* the Indonesian premium over the US FF rate is at a historically low level, (something true for a number of other countries). Further increases in US interest rates remain a possibility narrowing this premium further. Although Indonesia remains attractive for portfolio investors, a smaller premium to the US FF increases the risk of rapid capital outflows if emerging market premiums erode generally, an impact that might be felt disproportionately in Indonesia.

5. Fiscal Policy (Table 2)

Lower budget deficit in 2006. Preliminary results show the budget deficit as a share of GDP at 1.1 percent in 2006 (Figure 17). The budget deficit ended lower than projected in the revised budget (1.3 percent) approved in September 2006. Both revenues and expenditures were lower. While expenditures were lower by 0.6 percent of GDP, revenues were lower by 0.4 narrowing the deficit. Smaller budget deficits contribute to fiscal sustainability, but when achieved through low expenditures on key items (e.g. capital and social expenditures) they reduce the economy's growth potential.

Figure 17: Budget Balance
(percent of GDP)



Source: MOF, World Bank

Table 2: State Budget (Percent of GDP)

	2005	2006		2007	
	Actual	Pre. Actual	Dif from Revised Budget	Budget	Dif from 2006 Actual
Revenues	18.1%	20.7%	-0.4%	20.5%	-0.2%
Non-oil domestic tax	10.9%	11.5%	-0.5%	12.8%	1.4%
Oil and gas	5.1%	6.5%	0.2%	5.1%	-1.4%
Others	2.2%	2.7%	-0.1%	2.5%	-0.2%
Expenditures	18.6%	21.8%	-0.6%	21.6%	-0.1%
Central government	13.1%	14.4%	-0.9%	14.3%	-0.1%
Personnel	2.1%	2.4%	-0.3%	2.9%	0.5%
Material	1.1%	1.5%	-0.3%	2.0%	0.5%
Capital	1.2%	1.9%	-0.3%	2.1%	0.1%
Interest payments	2.1%	2.6%	-0.1%	2.4%	-0.2%
Subsidy	4.4%	3.5%	0.0%	2.9%	-0.6%
Social Assistance	1.0%	1.4%	0.1%	1.5%	0.1%
Others	1.1%	1.1%	-0.2%	0.5%	-0.6%
Transfers to Region	5.6%	7.4%	0.3%	7.3%	0.0%
Primary balance	1.6%	1.5%	0.2%	1.3%	-0.3%
Budget balance	-0.5%	-1.1%	0.2%	-1.1%	-0.1%
Net Financing	0.4%	1.1%	-0.2%	1.1%	0.1%
Domestic	0.7%	1.7%	-0.1%	1.6%	-0.1%
Foreign	-0.3%	-0.6%	-0.1%	-0.4%	0.2%

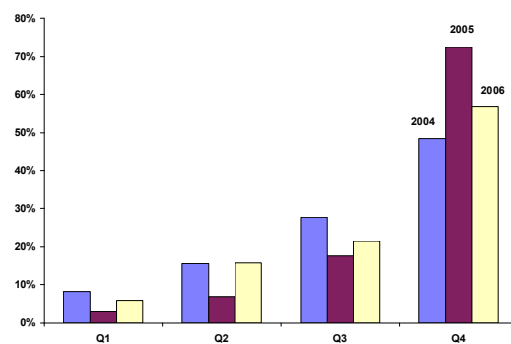
Source: Ministry of Finance, World Bank

Non-oil and gas tax revenues do not hit target. Non-oil and gas domestic tax revenues (11.5 percent) were lower than projected in the revised budget (12.0 percent). Income taxes ended at 5.4 percent, 0.2 percent lower and VAT at 4.0 percent, or 0.3 percent lower were the key items. Lower realization in 2006 negatively affects non-oil and gas domestic revenues in 2007 as estimates in the 2007 budget were based on the assumption that the 2006 target would be achieved. In 2007 the government plans to raise 12.8 percent of GDP from non-oil and gas domestic taxes, 1.4 percent higher than the 2006 realization. This increase would be far higher than achieved in recent years. Between 2001 and 2006, non-oil and gas domestic tax revenues increased from 9.0 percent to 11.5 percent, representing a 0.5 percent increase per year.⁶

Oil and gas revenues strong. Oil and gas revenues (tax and non-tax) were 6.5 percent of GDP (Rp.201 trillion), their highest level since FY2000 (8.0 percent) accounting for 32 percent of total revenues. Average oil prices (ICP, or Indonesia crude oil) increased from US\$52/bbl in 2005 to US\$64/bbl in 2006 and the exchange rate appreciated by 1 percent. But oil production also fell by 4 percent.

Low capital spending with most of it late in the year. Capital expenditure as a share of GDP was 1.9 percent. Although this was much higher than that in 2005 (1.2 percent), the government did not reach the targeted 2.2 percent in the revised budget. In addition to lower foreign financing (i.e. project loan and grants), public financial management problems including adjustments to new systems and stricter procurement standards resulted in lower capital spending. In 2006, more than half of total capital spending occurred in Q4 (Figure 18). Disbursement in 2006 was better than 2005 when a new government, a reorganization of the MOF and new budget systems combined to create very low disbursement. By 2006 the disbursement pattern was close to the 2004 one.

Figure 18: Disbursement Pattern
(Capital expenditures, % of realization*)



* / 2004- development expenditures

Source: World Bank

Despite the dramatic fuel price increases at the end of 2005 subsidies remain high. Subsidies reached Rp. 107 trillion or 3.5 percent of GDP in 2006. Fuel subsidies were still Rp. 64.2 trillion or 2.1 percent of GDP, a significant drop from 3.5 percent in 2005 but still high. Non-fuel subsidies (including larger subsidies for electricity) in the meantime reached Rp.43 trillion (1.4 percent of GDP). Total subsidies were close to estimates in the revised budget.

Fiscal policy more expansionary in 2006. Fiscal impulse analysis indicates that fiscal policy was contractionary during the second half of 2004 and even more contractionary in the first semester of 2005 before becoming expansionary in the second half of 2005 and more expansionary in 2006 (Figure 19).⁷ Spending on key items such as regional transfers and capital

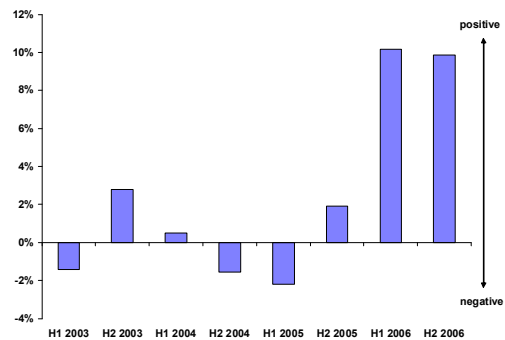
⁶ The Ministry of Finance has also indicated its desire to repay VAT arrears that have accumulated, which would further reduce tax revenues in 2007.

⁷ Fiscal Impulse is an analytical tool to quantify the extent to which fiscal policy has a contractionary or expansionary impact on the economy. It is calculated in two steps. The first step is to measure the fiscal balance excluding revenues and spending that does not have a direct impact on the local economy (e.g. external interest payments). The second step is to calculate changes in the balance from one year to the

expenditure increased significantly relative to a year earlier. For example, by the second semester of 2006 capital expenditures were 40 percent higher than the first half of 2005.

However, actual expenditures remain lower than budgeted levels implying that fiscal policy could have been even more expansionary. In addition, regional governments continue to have trouble spending. Deposits outstanding by regional governments (district/city and province) reached Rp. 85 trillion (more than US\$9 billion) and grew by 47 percent (yoy) as of January 2007 (Figure 20).

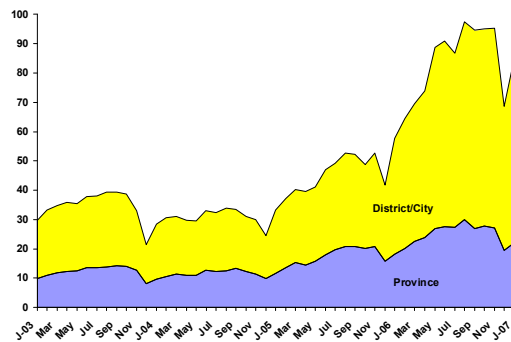
Figure 19: Fiscal Stimulus
(percent of GDP)



Source: World Bank

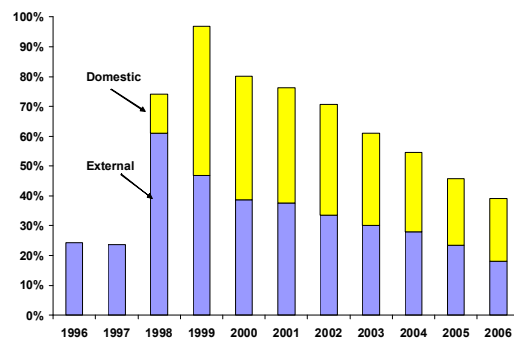
The government debt to GDP ratio continued to fall dramatically. The government debt as a share of GDP improved to 41 percent in 2006 from 45 percent in 2005 (Figure 21). Between 2005 and 2006, the level of debt outstanding increased by 11 percent but nominal GDP grew by 30 percent.

Figure 20: Unspent Financial Resources
(regional governments deposits, Rp.trillion)



Source: Bank Indonesia, World Bank

Figure 21: Government debt improved
(gov't debt % of GDP)



Source: World Bank

next (relative to GDP). This change provides estimates of the 'fiscal impulse'. A positive fiscal impulse is contractionary, whereas a negative one is expansionary.

6. Financial Sector Development

Banking indicators improved in 2006 (Table 3).

In 2006, the Capital Adequacy Ratio (CAR) rose to over 20 percent with Net Interest Margins (NIM) remaining about 6 percent. However, the return on Equity (ROE) deteriorated reflecting charges to cover an increase in non-performing loans (NPLs). However, in late 2006, NPL

Table 3: Financial Performance of Banking Sector
(Percent)

	2003 Dec	2004 Dec	2005 Dec	2006 Dec
CAR	19.4	19.4	19.3	21.3
NIM	4.6	5.9	5.6	5.8
NPL(Gross)	6.8	4.5	7.6	6.1
ROA	2.6	3.5	2.6	2.6
ROE	21.4	23.0	18.0	17.1
Op.Ex/Op.Inc	88.1	76.0	89.5	87.0
LDR	43.5	50.0	59.7	61.6

Source: Bank Indonesia, World Bank

ratio fell and total loans outstanding increased as intermediation picked up. The sharp decline in NPLs in December 2006 reflects the regulatory change by which state-owned banks could write-down NPLs according to the same procedures as private banks.⁸ The loan to deposit ratios (LDR) increased by 1.9 percent from 2005 to 2006. During this period, loans and deposits increased by a relatively limited 7.3 percent and 3.4 percent, respectively.

Bank Mandiri accounts for about 15 percent of total assets in the banking system. The 2006 financial performance for Bank Mandiri (Table 4) show loans outstanding grew by 10.3 percent from 2005 slightly lower than the average rate of the banking sector. Based on the regulatory change indicated NPLs improved to 16.3 percent in 2006 from 25.3 percent in 2005 with principal payments from major debtors, upgraded collectibility among the top 30 obligors, and agreements to restructure the loans of the two largest obligors contributing. However, Mandiri's NPL ratio remains far higher than the banking sector average.

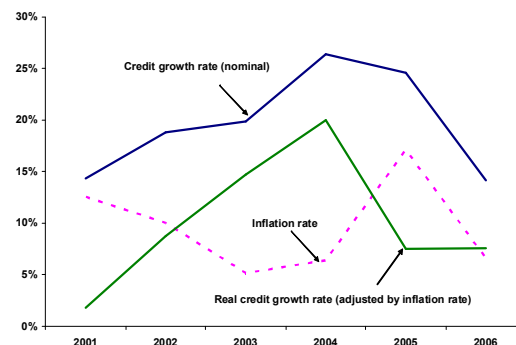
Table 4: Bank Mandiri's Financial Performance
(Percent)

	2005	2006
CAR	23.6	25.3
NIM	4.1	4.7
NPL(Gross)	25.2	16.3
ROA	0.5	1.1
ROE	2.5	10.0
Op.Ex/Op.Inc	55.6	48.9
LDR	51.7	57.2

Source: Bank Mandiri

But lending growth slowed with loans outstanding increasing by only 14.1 percent (yoy). This growth in loans outstanding is much lower than previous years. In 2004 and 2005, growth rates were 26.4 percent and 24.6 percent, respectively. However, if loans outstanding are adjusted by inflation, real the growth is 7.5 percent in 2006, the same as 7.5 percent in 2005 but again far lower than 2003 and 2004 (Figure 22). Although overall loans outstanding were stagnant, there were significant disparities by types of loan (consumption, investment, and working

Figure 22: Low lending growth rates
(year-on-year growth rate)



Source: Bank Indonesia, World Bank staff

⁸ This resulted in the NPLs of State-Owned Banks improving from 15.4 percent in September to 10.7 percent in December.

capital), economic sectors, borrower and region.

Loans to SME's are growing far faster than non-SMEs and are now over 50 percent of loans outstanding. (Table 5): Among three types of loans investment capital grew by only 10.8 percent, slightly higher than consumption loans (9.2 percent) but much lower than working capital loans (16.3 percent). The growth rate in investment capital loans reflects the lack of recovery in investment. Reflecting the higher interest rates and slowing durable sales consumer credit growth slowed dramatically from 36.8 percent in 2005 to 9.2 percent in 2006.

Table 5: Loan Outstanding by Types and Scales
(Year-on-year growth rates, percent)

1. Total				
	2003	2004	2005	2006
Total	18.7	27.0	24.3	13.2
SMEs	28.6	30.9	30.9	15.6
Non-SMEs	11.1	23.5	18.2	10.6
2. Working Capital				
Total	13.0	24.0	22.4	16.3
SMEs	23.7	22.5	27.8	20.0
Non-SMEs	7.1	25.0	19.0	13.9
3. Investment Capital				
Total	13.4	24.0	13.2	10.8
SMEs	31.1	25.0	16.1	12.4
Non-SMEs	8.9	23.6	12.3	10.2
4. Consumption Credit				
Total	39.0	35.8	36.8	9.2
SMEs	33.3	40.6	36.8	12.8
Non-SMEs	79.4	11.5	36.8	-14.1

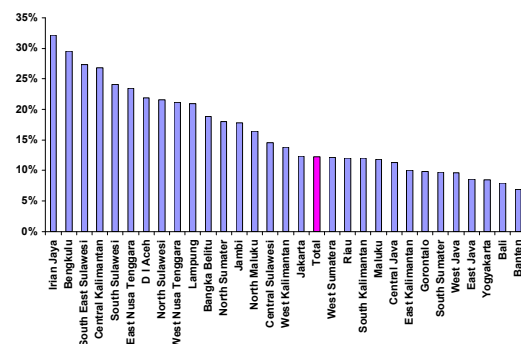
Source: Bank Indonesia

Perhaps surprisingly given the general discussion of capital constraints to smaller businesses loan growth has been significantly higher for SMEs than non-SMEs in recent years. In 2006, loan growth for SMEs (15.6 percent) was far higher than for non-SMEs (10.6 percent). Commercial banks and regional development banks are active in SME lending, while state-owned banks less so. Due to higher SME lending in recent years, SME loans as a share of total loans outstanding have increased from 43.4 percent to 52.1 percent in November 2006. Higher loan outstanding rates for SMEs suggest a significant contribution by SMEs to growth recovery in recent years.

There are large differences in lending between sectors ranging from loans to the transportation sector which saw loans outstanding grow by 33.4 percent and to utilities which saw loans outstanding contract by -2.7 percent. Lending growth rates by economic sectors reflects economic performance. For example, the transportation and communication sectors grew by 12.8 percent (yoy) in the first three quarters in 2006, much higher than the overall growth rate of 5.1 percent.

Regional diversity is increasing: Jakarta accounts for more than a third of total loans outstanding (36 percent) followed by West Java (13 percent) and East Java (10.6 percent). However, as of November 2006 the credit outstanding in these three provinces was growing by less than average (12.1 percent yoy). By contrast, loan growth far exceeded the national average in Irian Jaya (33 percent) and Bengkulu (32 percent) (Figure 23).

Figure 23: Loan growth by regions
(year-on-year growth rate, as of Dec 2006)



Source: Bank Indonesia, World Bank staff

Non-Bank Financial Institutions⁹

The Jakarta Composite Index (JCI) had another strong rally in 2006. The main index for shares trading on the Jakarta Stock Exchange closed at a new record high of 1,837 in early January. For 2006 as a whole, the JCI index has risen 55 percent and has outperformed main equity indices in neighboring countries. And the market appears to be gradually deepening with share trading also more active in 2006 than in 2005. The average daily trading volume on the Jakarta Stock Exchange rose to 1.8 billion shares (compared to 1.6 billion in 2005), with an average value of Rp1.8 trillion (compared to Rp1.7 trillion in 2005). Foreign investors were active and continued to be net buyers. New listings and secondary offers also continued to grow slowly. In the primary equity market, 12 companies had IPOs and raising Rp 3.0 trillion in new capital. The largest IPO was Bank Bukopin raising Rp.295 billion in June 2006. Rp.9.9 trillion in new capital was also raised through secondary offerings from 17 listed companies. The market capitalization of all shares on JSX rose to Rp.1,249 trillion from Rp.801 trillion in 2005.

There was also increased activity in the Bond Market. Fifteen corporations issued new bonds amounting to Rp.11.4 trillion led by infrastructure companies such as PLN and Jasa Marga. Government bonds are dominant with a total issuance of fixed coupon bonds amounting to Rp.53.4 trillion, including new well received retail bonds worth Rp.3.2 trillion.

The mutual fund industry begins to recovery. (Table 6): Total Net Asset Value (NAV) reached Rp.51.4 trillion by end-2006, a 76 percent (Rp.22 trillion) increase over 2005. From March 2006, there were more subscriptions than redemptions, marking a reversal of the net redemption trend starting in mid-2005. Among mutual funds, fixed income funds comprised the largest share, though declining from 46 percent of the total in 2005 to 38 percent in 2006. More investors are moving to buy equity funds, mixed funds and (principal) protected funds.

Table 6: Mutual Fund Growth in 2005 and 2006

	Net Asset Value 2005		Net Asset Value 2006		No. of Unit	
	Value (Rp Billion)	Share (%)	Value (Rp Billion)	Share (%)	2005 (millions)	2006 (millions)
Fixed Income	12,970.9	45.7	19,542.32	38.0	11,287.2	16,649.1
Equity	4,934.2	17.4	8,249.02	16.0	1,878.3	2,126.4
Mixed	5,391.9	19.0	8,483.82	16.5	2,681.9	5,233.6
Money Market	2,080.0	7.3	3,799.57	7.4	2,080.0	3,799.6
Protected	3,008.5	10.6	11,327.86	22.0	2,868.4	10,584.7
Index	-	0.0	29.64	0.1	-	22.2
Total	28,385.4	100.0	51,432.2	100.0	20,795.8	38,415.7

Source: Ministry of Finance, Bappenas

⁹ See the World Bank (2007) publication “Unlocking Indonesia’s Domestic financial Resources: The role of non-Bank financial institutions” for a comprehensive look at the situation and issues in these markets.

7. Social Sector¹⁰

Higher rice prices risk leading to higher poverty. Rice prices increased dramatically after September 2006. In part, this was because a moderate El Nino delayed the planting season by over a month, but the situation was exacerbated by the rice import ban introduced in January 2004, which contributed to an environment of low domestic stocks. By December 2006 the wholesale price was more than a third higher than a year earlier (which itself was over 40 percent above December 2004) and the price of rice continued to rise in January and February 2007. The government's decision to import additional rice and BULOG's implementation of Operasi Pasar is helping to stabilize prices but prices are only likely to move towards the level of a year ago when the delayed main harvest arrives in March/April.

The price of rice is a key determinant of poverty. The poor spend almost a quarter of their expenditure on rice and three-quarters of the poor consume more rice than they produce. Hence, increases in the price of rice drive up the poverty rate. Moreover, the unconditional cash transfer (UCT) put in place to compensate the poor for the fuel price increases in late-2005 ended in late-2006. On the other hand growth in late 2006 has picked up to the 6 percent range but whether it is enough to compensate for the removal of the UCT and the increases in the rice price remains unclear. Therefore, unless rice prices are brought down, there is a risk that poverty will rise again in March 2007 when the annual poverty measurement is done. As noted in the November East Asia Update, poverty rose in 2006 due, in large part, to the rise in rice prices last year.

The Government plans to scale up spending on poverty through a national program entitled National Community Empowerment Program (PNPM). In 2007, the Government will expand the PNPM to some 2,800 rural and urban sub-districts, with full national coverage of 5,360 sub-districts by 2009. The program builds upon the two World Bank-supported Kecamatan Development Program (KDP) and Urban Poverty Program (UPP). Both programs focus on improving local governance and service delivery to communities at the sub-district and village levels through participatory planning and community block grants. Funds are generally used for productive assets, such as rural infrastructure, education, and health. Previous evaluations of these community-driven development (CDD) programs reveal positive results. They have proven successful in the targeting of poor Kecamatan and have had a demonstrable impact on poverty. Investments produce high economic internal rates of return ranging from 39 to 68 percent, and the costs for infrastructure projects were estimated to be 20 to 25 percent less than other government-sponsored public works of the same quality. The programs also provide much needed

¹⁰ World Bank tabled the findings of two flagship reports on the nature, distribution, challenges and policy implications for poverty reduction and improved services for the poor in Indonesia. Making the New Indonesia Work for the Poor" and "Making Services Work for the Poor".

"**Making the New Indonesia Work for the Poor**" identifies three salient features of poverty problems in Indonesia.: (1) almost 42 percent of households are clustered around the national income poverty line, making even many of the non-poor vulnerable to poverty; (2) there are several human development indicators which are seriously lagging and require special attention, and (3) regional disparities remain wide. The report provides concrete actions to make growth work for the poor, make services work for the poor, and make expenditures work for the poor.

"**Making Services Work for the Poor**", accompanied by Voices of the Poor, makes four key recommendations: (1) improve the performance of public service providers by implementing service agreements with clear rewards and sanctions; (2) give communities a larger role in ensuring the poor receive basic services and maintaining local infrastructure; (3) reform the regulatory framework and incentive structure in the civil service; and (4) introduce measures to facilitate cross district learning on successful models of service delivery.

employment to the poor, especially during the agricultural off-season, or when there is drought, flood, and other natural or economic catastrophes.

Indonesia’s unconditional cash transfer has been phased out and a conditional cash transfer program will be introduced to address longer term development objectives. Two different approaches, cash to households and block grants to communities, will be piloted in seven provinces starting in 2007. Both will use the same conditions designed to address Indonesia’s relatively high maternal and child mortality rates, and low progression to junior secondary school among children of poor families. Based on the experience of about 40 other countries with household CCT programs, cash transfers will be given to mothers of 500,000 very poor and poor households on the condition that the family fulfills the relevant health and education conditions. Impact evaluations of CCTs in other countries show impressive results in terms of reduced poverty, increased school enrolment and attendance, usage of preventive health services, and improved nutritional status. The CCT will be rigorously evaluated two years after implementation to: (i) assess the effectiveness of program targeting; (ii) to determine the effect on utilization of basic health and education services; (iii) to gauge the impact on education attainment and health and nutrition status; and, (iv) to identify conditions under which the different approaches work best.

Unemployment stabilizes. The latest labor force survey in August 2006 indicates that the unemployment rate declined from 10.4 percent in February 2006 to 10.3 percent, the same level as February 2005. Youth unemployment remains stubbornly high at 30.6 percent. The improvement in the unemployment

Table 7: Change in Labor Force
(Comparison between Aug 04 and Aug 06, thousands)

	Employed	Unemployed	Total
High school degree or higher	2,901	549	3,451
Less than high school degree	-1,166	131	-1,035
Total	1,735	681	2,416

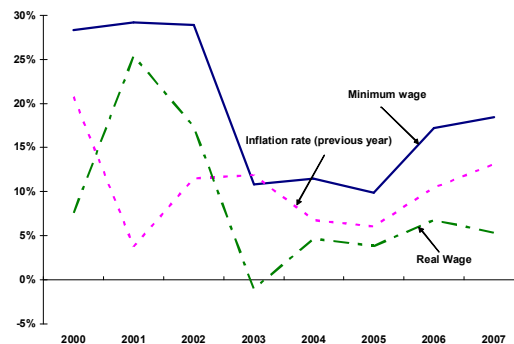
Source: BPS, World Bank staff calculation

rate suggests that the labor market may be recovering in the aftermath of the fuel price increase in October 2005. Between August 2004 and August 2006¹¹ the labor force grew by 2.4 million people and employment by only 1.7 million meaning that an additional 0.7 million people were unemployed moving the unemployment rate from 9.9 percent to 10.3 percent. The most striking changes are in labor force and employment outcomes of those with a High School degree and higher versus those without (Table 7). Between 2000 and 2003 about 75 percent of the labor force had less than a High School degree. Starting in 2004 the share of the labor force with less than a high school degree started to fall quickly reaching 72 percent by the August 2006 survey. In absolute amounts those with the degree or more increased by 3.4 million in the labor force while those with less than the degree declined by 1 million. These workers with high school degree and above (while only 28 percent of the work force) drive the employment and unemployment statistics as 2.9 million of them obtained jobs, but 0.6 million did not.

¹¹ The Annual Labor Force Survey is normally carried out in August each year. However, in 2005, due to the Statistics agency involvement in the Unconditional Cash Transfer the survey was delayed to November. As there is a great deal of seasonality perhaps the best comparison for technical reasons is between August 2004 and August 2006.

Minimum Wage: The average minimum wage in 2007 increased by 18.5 percent over the level in 2006.¹² While the minimum wage in Jakarta increased by 9.9 percent, far below the 15.1 percent increase in 2006, other provinces (e.g. Central Java, East Java and Papua) had minimum wage increases exceeding 20 percent. Real minimum wage (minimum wage minus the inflation rate of the previous year) increased by 5.4 percent, slightly lower than the 6.8 percent increase in 2006 (Figure 24).

Figure 24: Minimum Wage
(year-on-year growth rate)



Source: World Bank staff

8. Policy Direction

The government issued three policy reform packages in 2006: an investment climate policy package in February, an infrastructure package in March, and the financial sector reform package in July. The broad content of these packages is shown in Table 5.

The investment climate policy package covers five policy areas: (i) general investment policies; (ii) customs and excises; (iii) taxes; (iv) labor; and (v) SMEs. It lists 85 individual action items and assigns a minister to be responsible for each one. Fifty-four of these items specified a target date for completion, ranging from March to December 2006, of which 42 (or 78 percent) were completed by the end of 2006. The most important development is the approval of the investment law in March 2007 (Box 3).

Other key achievements include:

- Submission to parliament of revisions to the draft tax laws by the Ministry of Finance incorporating proposals from the business community (June 2006),
- Creation of new tax incentives for investments in certain sectors and regions. Government Regulation No. 1/2007 specifies three types of tax incentive: loss carry forward, accelerated depreciation, and investment tax credits. For example, corporate income tax can be reduced by 30 percent of realized investment spread over a six year period (i.e., 5 percent per year).

¹² 2007 minimum wage data is available in 24 provinces. Growth rates are a simple average.

- Establishment of a team to evaluate draft regional regulations (March 2006). As of December the team had recommended the cancellation of 130 non-business friendly regional regulations, of which 70 had already been cancelled by the Ministry of Home Affairs.
- Improvement of the electronic data interchange system at Customs to reduce customs clearance time to 30 minutes in the green lane and 3 days in the red lane (August 2006).
- Cancellation of regional regulations imposing taxes and fees on the movement of goods, telecommunication towers, and roadside weigh stations (October 2006)
- Elimination of VAT on certain primary agricultural commodities to increase competitiveness (Government Regulation No. 7/2007)

Unfortunately some of the most important reforms in the investment package have been held up in parliament. These include the three draft tax laws. The government also failed to submit revisions to the 2003 labor law to parliament following opposition from labor unions. The lack of progress on investment, tax and labor legislation has contributed to a perception that the

Box 4: Indonesia's New Investment Law

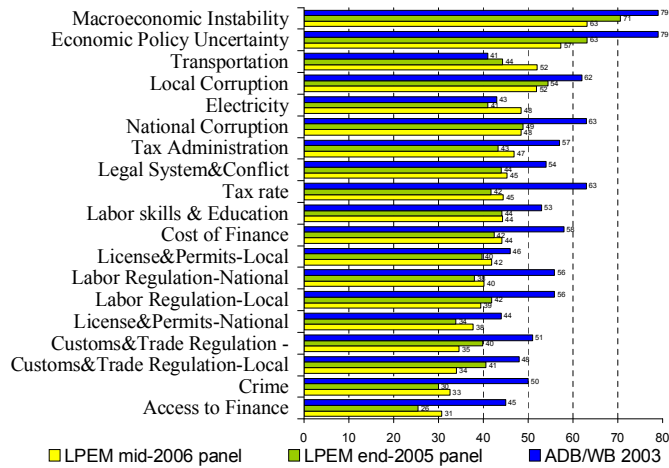
Parliament approved a long-awaited investment law on March 29th, one year after the government submitted the draft law to Parliament. The new investment law retains the spirit of the draft law and is expected to have a significant positive impact on the investment climate. The key items of the new law are:

- **Equal legal status:** Gives equal legal status and treatment to both domestic and foreign investors.
- **Investors' protection:** (i) Provides protection against nationalization and states that any expropriation must be based on law and compensated at market prices, (ii) guarantees the right to repatriate earnings in foreign currency, and (iii) omits the forced divestiture and limited duration of foreign investment under the old law (1967 Foreign Investment Law).
- **Dispute resolution:** Mandates binding international arbitration in the event of disputes between the government and foreign investors.
- **Negative list:** Makes all business activities open to investment unless explicitly closed or restricted and provides for a transparent investment negative list based on standard industrial classifications to be issued as a single Presidential Regulation
- **Property rights:** Provides stronger property rights (e.g. land use rights for investors of up to 95 years);
- **Immigration procedures:** Allows expatriate workers to be granted two year residence permits and two year multiple entry visas, and allows the two year residence permit to be turned into a permanent residence permit for expatriates living in Indonesia continuously for more than two years;
- **Tax incentives:** Provides for special tax incentives for certain types of investment under certain conditions, including tax holidays for pioneer industries, income tax reductions, exemption or reduction of import duty and value added tax for capital goods and raw materials, accelerated depreciation and reduced property tax;
- **Reporting requirement:** Requires all investors to submit periodic investment activity reports to the Investment Board (BKPM).

The new investment law creates the legal framework for better investment regulations. Success or failure of the law depends on its implementing regulations, currently being drafted, and on enforcement (i.e., whether the relevant line ministries and government agencies adjust their operating procedures in accordance with these new regulations).

investment package accomplished little, despite 78 percent of the targeted items having been finished in 2006. The success of many measures, such as the investment incentives decree, the VAT decree, numerous customs and tax measures, and the elimination of harmful regional regulations, has been overshadowed by parliamentary debates and coordination problems. The latter includes the failure of the Ministry of Home Affairs to issue a promised decree on the division of authority between the central and regional governments, and the failure of Customs to meet physical inspection targets.¹³

Figure 25: Investment Climate Monitoring
(% of respondent reporting obstacles to be moderate, severe or very severe)



Source: LPEM University of Indonesia

Investment Climate Monitoring Survey¹⁴. The results of the latest survey in mid-2006 (Figure 25) show that business perceptions of the investment climate improved between 2003 and end-2005, but there was little perceived improvement between end-2005 and mid-2006. Other findings are as follows.

- **The ranking of perceived obstacles remained similar:** Macroeconomic instability, economic policy uncertainty, and corruption remained the biggest obstacles.
- **Perceptions of infrastructure deteriorated:** Perceptions of electricity and transportation worsened, most likely in response to the doubling of fuel prices in October 2005.
- **Taxes and labor are viewed as greater problems:** Perceptions of labor issues (labor skills and education, and national labor regulations) and tax issues (tax administration and tax rate) deteriorated. These are core parts in the investment climate package. The delay in passing the three draft tax laws by parliament and the failure of the government to submit changes to the labor law to parliament may have contributed to deteriorating perceptions.

The infrastructure policy package covers four general areas: (i) strategic policy framework; (ii) sector policy frameworks; (iii) local government related policy; and (iv) implementation of infrastructure projects. According to the government, as of end- 2006, 92 out of 114 policy actions have been completed.¹⁵

¹³ The public report of the internal monitoring team for the investment package indicates that the stipulated revision of PP 25/2000 has been delayed due to lack of agreement between the Ministry of Trade and the Investment Board. It also indicates that the target for Customs to cut red lane physical inspections to 10 percent by December 2006 was not meet. As of November the rate of physical inspection was still 23 percent.

¹⁴ University of Indonesia conducts investment climate monitoring survey with about 500 manufacturing firms in greater metropolitan areas twice a year. The results are comparable to World Bank-ADB investment climate assessment, as questions are same.

¹⁵ In the original package, there are 156 policy actions. However, the number was revised to 114,

Key achievements include:

- Draft laws complete on transportation, state owned enterprises, electricity, postal service, energy,
- establishment and operation of a Risk Management Unit in the Ministry of Finance and a public service company for Land Acquisition in Ministry of Public Works,
- an infrastructure summit in 2006, and
- The establishment of 10 model projects for PPP (public private partnership).

Table 8: Progress of Financial Sector Policy Package (as of November 2006)

Subjects	Program	
	Plan	Completed
1. Financial System Stability	3	2
2. Banking Institutions	13	10
3. NBFI	10	8
4. Capital Market	15	14
5. Others	2	1
Total	43	35

Source: Coordinating Ministry for economic affairs, World Bank

In 2006, government disbursed Rp.2 trillion for an infrastructure fund with an additional Rp.2 trillion is earmarked in the 2007 budget. However, the specific allocation of the fund has not yet been specified, i.e., for guarantees, land acquisition, infrastructure financing facility. In the meantime, the Rp.2 trillion from the 2006 state budget has been put in an escrow account.

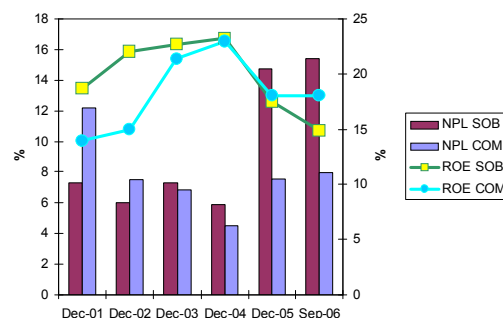
The financial sector policy package covers five areas: (i) financial system stability; (ii) banking institutions; (iii) non-bank financial institution; (iv) capital market; and (v) privatization and export financing. According to the government, until November 2006, the government completed 35 of the 40 targeted policy actions (Table 8).

In the banking sector, some of major accomplishments include the amendment to the regulation on write off for state banks, provision of incentives for mergers, and establishment of a mediation body. In the capital market and NBFI, major progress includes: changes in tax treatment on life insurance; issuance of a pension road map; approval of the stock exchange merger; requirement for bond transaction reporting; and regulations that allow broader access to bonds.

Following the financial sector policy package, Bank Indonesia announced eight initiatives in January 2007 (Box 4). Key among these is the development of banking intermediation, not only for large firms but also for small, medium, and even micro enterprises (UMKM).

State-owned banks have generally not performed well in recent years (Figure 26). As of September 2006, the NPL ratio of state-owned banks exceeded 15 percent before improving to 11 percent in December, but still worse than the NPL ratio of commercial banks dating back to December 2001. Similarly, state-owned banks had a lower ROE than commercial banks. The Ministry of Finance implemented amendments to regulations and decrees on state-owned banks.¹⁶ But operational actions (e.g., special supervision to

Figure 26: Performance of commercial banks and state-owned banks



Source: Bank Indonesia, World Bank

¹⁶ Government Regulation No. 33/2006 is the amendment of Government Regulation No. 14/2005 on the procedure for writing off the State/Regional Government's receivables; MOF decree No. 87/PMK.07/2006 issued in Oct 06 is the amendment of MOF decree No. 31/PMK.07/2005 on the procedure of proposal submission, evaluation and determination of write-off of Government's receivables

Box 4: Eight New Regulatory Initiatives in Banking

Bank Indonesia will

1. Play a more active role as a catalyst in motivating the banking intermediation process,
2. Endeavor to improve cooperation and coordination with the government to reshape the banking industry, particularly in revitalize the role of state-owned banks,
3. Endeavor to facilitate the merger process,
4. Facilitate the banking intermediation,
5. Issue guidelines for foreign banks to foster intermediation,
6. Develop market and financial instruments, e.g. universal banking,
7. Accelerate development of Indonesian syariah banking, and
8. Review the arrangement of the Rural Banks (BPR) to increase and expand its roles and contributions to the Small and Medium Enterprises (UMKM).

Source: Bank Indonesia

improve corporate governance) have not yet completed.

The issue of syariah banks, BPR, and UMKM are in the package though the same issues were picked up in 2006 implying that the development of syariah banks and BPR is not yet satisfactory.

Employment policies: The government is discussing changes to the existing severance pay system. Currently, severance payments are provided by employers to dismissed workers. The rates are determined by formula, based on the length of service within the firm. These severance payment rates are the highest in the region and employers see them as the main contributor to high labor costs.¹⁷ The objective of the new scheme is to find a compromise between the needs of employers to reduce the cost severance and the demand by unions to maintain some income security for dismissed workers.

Although detailed proposals have not been widely disseminated, several elements of the new system have been publicly discussed. First, the proposed new system would transfer the obligation to pay severance benefits from the employer to an agency. The existing national social insurance provider Jamsostek –formally a state-owned enterprise– is the prime candidate to manage this future severance fund. However, the government is also discussing the possibility of privatizing the scheme, making room for multiple providers. Second, there is a plan to divide the severance benefits into two categories: workers earning salaries below Rp.2 million a month would be entitled to severance pay benefits while workers with higher incomes would get less or no benefits.¹⁸

While these proposals are not yet final, the direction points to some potential problems. First, the transition to a new severance system will face the immediate challenge of how to settle and finance large accumulated severance liabilities. The introduction of a capped benefits system – excluding workers above a certain income threshold –might create a dual labor market with employers substituting toward skilled workers, not subject to the cap. Finally, the low returns to workers' contributions¹⁹ and low coverage under Jamsostek schemes make the issue of good governance a priority issue. Finally, unions complain of many cases where employers do not pay any severance benefits to laid-off workers as firms find it easier to walk away from the large

¹⁷ See for instance Doing Business 2007.

¹⁸ Jakarta Post, January 29 2007, "Labor Scheme to focus on low-paid." See also Jakarta Post, January 23 2007, "Government severance pay scheme moving forward."

¹⁹ See World Bank (2007). "Unlocking Indonesia's Domestic financial Resources: The role of non-Bank financial institutions." World Bank Office Jakarta, p.129-131.

liabilities. Workers would have to accept that a reduction in severance pay would be compensated for by an improved guarantee of benefits.

9. 2007-2008 Outlook (Table 9)

Growth is expected to be 6.3 percent in 2007 led by sharply higher investment as fiscal spending and lower interest rates add stimulus. The economy bottomed out in the first half of 2006 and 2006 growth rates managed to reach 5.5 percent for the year as a whole, close to 5.7 percent in 2005. Public investment was lower than expected due to continuing lower disbursements by central and regional governments but this already shows signs of changing in 2007. By contrast, net exports contributed significantly to GDP growth in 2006, partly due to high international commodity prices and are likely to play a smaller role in 2007. In 2007, the current cyclical growth recovery is likely to continue in the first half. In addition to the implementation of the economic policy packages mentioned above, the following factors would affect growth in 2007-2008

Opportunities:

- **Lower energy prices:** Industries in Indonesia now pay for fuel products at international prices (MOPs plus 15 percent) and lower international fuel prices in 2007 should feed through into lower energy costs for the economy as a whole and especially industries whose relative energy consumption is large (e.g. transportation and textile).
- **Decline in interest rates:** Since May 2005 policy interest rates (SBI 1 month) fell by 3.8 percentage points to 9.0 percent. Though lending rates have not yet fallen proportionally they have fallen and should continue to decline providing a boost to investment with a lag.

Risks:

- **Accumulation of short-term capital:** In balance of payments, gross portfolio investment inflows in 2006 reached US\$9.2 billion, 12 percent higher than the same period in 2005. The stock market's recent performance suggests that portfolio investment is likely to continue into 2007. Though Indonesia's foreign reserves have reached US\$43 billion (end December), a shock (domestic or external) affecting either Indonesia's or all emerging markets could trigger capital flows and a weakening of the rupiah. On the positive side, Indonesia has a floating exchange rate which, is relatively less integrated with the world in terms of trade mitigates some of the transmission of an external shock with a growing part of its trade commodities to China, and finally relatively larger shares of debt are denominated in rupiah.
- **Lower commodity prices:** Commodity prices have declined recently. High commodity prices contributed to the economy exports mainly, and a reversal would have a negative impact.

Table 9: Macroeconomic Projection 2007-2008

	2006	2007	2008
	Pre. Actual	Projection	Projection
GDP Growth Rates (percent)	5.5	6.3	6.5
o/w investment growth rates	2.9	11.7	9.3
Investment (% of GDP)	24.0	25.1	25.8
Current account balance (% of GDP)	2.6	2.1	1.2
Central government balance (% of GDP)	-1.1	-1.7	-1.5
Government debt (% of GDP)	41	37	36

Source: World Bank