Indonesia

The last six months have witnessed a pick-up in the momentum of growth. After a moderate slowdown in 2005, economic growth in Indonesia has increased appreciably. By 2Q 2007, year-on-year growth was up to 6.3 percent compared with 5 percent in early *2*006. Most monthly indicators signal a further rise in the third quarter of 2007, despite recent turbulence in international financial and oil markets.

The main drivers of recent growth have been investment and net exports. Investment growth has been running around 7-8 percent *per annum* since 2Q 2006 with indications of a further pick-up in the near-term. For their part, net exports were neutral or a slight drag on growth in the second half of 2006. In the first half of 2007, they added more than 1 percent to growth in GDP. In nominal terms, exports have surged to record levels, owing only in part to the world commodity price boom. Exports of agricultural and mining and mineral commodities (accounting for about 1/3 of merchandise exports) increased by 18 and 42 percent in US$ terms respectively earlier this year. Exports of manufactured products (which account for almost half of the total) also increased at a robust rate of 15 percent; with forestry products up by 24 percent.

Reflecting the strength in exports, the current account surplus is projected to widen further to US$10.8 billion in 2007 (some 2 1/2 percent of GDP) versus virtual balance in 2005. Some of these recent gains have been offset by the capital account, which is currently projected to record a narrower surplus in 2007 than the year before. Net international reserves have climbed steadily during this period, to almost US$53 billion in late September, compared with US$42.6 billion at end-2006.

Financial markets quickly absorbed the recent turbulence in international markets with what appears to be minimal disruption of overall economic performance to date. As examples, the Jakarta Stock Exchange, after plunging by 20 percent in the 3 weeks between late July and mid-August, rebounded quickly and was back at record highs by mid-October. The rupiah exchange rate, which was around 9000/US$ in the months prior to the turmoil, slid to 9500, before recovering to 9100 by early October. Medium- and long-term interest rates rose by some 200 basis points across the yield spectrum during the crisis. As of early September, the yield curve had reversed about half of the rise, and there was a further moderate improvement (especially at the shorter end of the spectrum) through early October.

Inflation has been a growing concern recently. It fell dramatically in the wake of the major 2005 fuel price increases from a high of 18.4 percent (y-o-y) to 5.3 percent in November 2006. However since then inflation has been creeping higher, reaching 6.9 percent by October, very near the upper end of Bank Indonesia's target band of 5-7 percent by end-2007. Foodstuffs, which account for almost 25 percent of the CPI in Indonesia, have been the main source of inflation in the past several months; they have outpaced general inflation since early 2006, often by several percentage points. By contrast, administered prices (fuel, transportation and electricity among others) have been holding down inflation during the past year, running at less than 2 percent (measured on a 12-month basis).

Reflecting concerns about inflation, Bank Indonesia held its key policy rate steady at 8.25 percent since early July. This shift in stance followed a series of cuts in steps of 25-50 basis points from a peak of 12.75 percent in April 2006. Reflecting the stronger economy, including investment, credit growth has accelerated in 2007, reaching 22 ½ percent (y-o-y) by August.

Fiscal deficits have narrowed significantly in recent years, from above 4 percent of GDP in 1998 to 0.5 percent in 2005. However, the deficit widened a little to 0.9 percent of GDP in 2006, and it looks likely to widen further in 2007, to 1.5 percent of GDP. This wider deficit stems, in part, from temporary factors (e.g., large, once-only settlements of arrears in payment of

VAT refunds and spending for disaster relief). But it also reflects more lasting factors, e.g., increased spending on priorities, including health, education and infrastructure. Notwithstanding these wider deficits, the ratio of government debt to GDP is projected to continue to decline, from 39 percent at end-2006 to less than 35 percent by end-2007, owing to continued strong growth.

The incidence of poverty dropped in 2007, to 16.6 percent from 17.8 percent in 2006. This reverses about 75 percent of the deterioration in 2006. Analysis of this latest data is underway but it appears that strong economic growth, falling inflation and targeted cash transfers contributed to the decline in 2007. Nevertheless, a large proportion of the population remains vulnerable with many households tightly clustered around the poverty line. Viewed in relation to the eight Millennium Development Goals (MDGs), poverty alleviation (as measured by the percentage of the population living on US$1/day) is one of Indonesia's successes. Other MDG successes include: enrollment in primary schools; child mortality; and access to improved water facilities. Other indicators are less positive, but overall the majority of Indonesia's indicators are on-track to achieve the MDGs

Reform momentum continues, especially in budgeting and investment climate reforms. The Government is using increased fiscal space to scale up spending on poverty alleviation through a large National Community Empowerment Program and two conditional cash transfer pilots, one directed at households and the other at communities. The 2008 budget proposes a substantial reallocation of spending to priority areas, including infrastructure, education and social assistance. In July 2007 the Government issued an integrated economic policy package aimed at improving the investment climate and building upon a series of individual policy packages issued in 2006 covering investment policy, infrastructure, financial sector reform and SME policy. The Government has established teams to monitor progress on each part of the package and has designated a minister responsible for each item. There have been a number of specific reform initiatives as well, including passage of an investment law and associated regulations on the negative list designed to improve transparency. There was also a new tax administration law that addresses business concerns about arbitrary treatment and a Government Regulation in lieu of Law that clarifies the status of Batam (Indonesia's largest and most active free trade zone).

Looking ahead, growth is expected to reach 6.3 percent for 2007 as a whole and to rise a bit further, to 6.4 percent in 2008. Investment is expected to remain strong, but exports are expected to slow modestly, due to the projected slowdown in the world economy. A mild fiscal stimulus will help growth prospects with the slight widening of the budget deficit to 1.8 percent of GDP. Spending on pro-poor programs and key priority areas such as infrastructure and social programs (poverty reduction) while increase (in part through a reallocation from fuel subsidies), while achieving reductions in government debt (measured as share of GDP).