

INDONESIA

Despite a slowing global economy, in 2007 Indonesia's economic growth accelerated to a 10-year high of 6.3 percent. This growth rate reduced poverty from 17.8 percent to 16.6 percent based on the government's poverty line. This growth rate also reversed the recent trend toward jobless growth by causing unemployment to fall from 10.3 percent to 9.1 percent. The drivers of growth shifted over the course of the year. During the first half, the economy drew strength from external demand; in the second half, the driving force was investment and consumer demand. High commodity prices continued to play an important role, with coal and palm oil exports growing rapidly. Inflation ended the year at the upper end of the government's inflation target—6.6 percent—but since has risen further to 7.4 percent due to rising food prices. The government budget deficit was 1.3 percent of GDP. Meanwhile, the debt-to-GDP ratio continued to decline rapidly, falling to below 35 percent by the end of 2007, down from 80 percent in 2000. The nominal exchange rate weakened in 2007, but the rupiah remained within the Rp 9,000–Rp 9,500 range and strengthened again in early 2008.

Global financial turmoil is beginning to have an effect. The commodity-heavy Indonesian stock market enjoyed one of the world's best performances in 2007, during which it grew by 52 percent. It continued to perform well until March 2008, when—along with global financial markets—it saw a significant correction. Similarly, despite an upgrade in Fitch's sovereign long-term foreign debt rating for Indonesia to BB (speculative grade) in February 2008, the financial turmoil raised international risk premiums (up from a low of 130 bps mid-year 2007 to over 300 in 2008), and increased domestic interest rates for government borrowing (from well under 9 percent mid-year to well over 10 percent in 2008 for a 10-year bond).

High commodity prices make the state of the economy in early 2008 difficult to read. On the one hand, high prices in energy, mining, and agriculture are positive for the Indonesian economy as a whole. For example, net oil and gas exports were estimated to be US\$6.6 billion in 2007, while exports of coal, copper, and CPO were US\$6.7, US\$7.3, and US\$7.4 billion, respectively. All are growing at double-digit rates. These commodities contributed to a current account surplus of 2.6 percent in 2007. On the other hand, high commodity prices also have downsides. Most immediately, high agricultural commodity prices are feeding through into domestic food prices with food inflation year-on-year in February 2008 running at 10.4 percent, far higher than overall inflation at 7.4 percent. These higher food prices affect the poor. Fortunately, the domestic rice price, the largest single item in the consumption basket of the poor, was virtually constant over the past year.

Another important area of growing concern is the central government budget. Fixed domestic prices for gasoline, transportation diesel, and kerosene account for over two-thirds of fuel sales. However, their subsidies have grown rapidly and, based on the government's estimate of US\$95 a barrel, will reach Rp 130 trillion (US\$14.3 billion) in 2008. At this level, total energy subsidies (to electricity as well as fuel) will equal total central government capital and social spending. Driven by the increase in subsidies, measures have been proposed to cut spending in line ministries, reduce subsidies to electricity, and ration kerosene to ensure that it goes only to the poor. With these measures, the government expects the budget deficit to rise from 1.7 percent to just over 2 percent of GDP.

Investment picked up substantially in 2007, reaching 24.8 percent of GDP. In addition, there was progress on reforms, and business perceptions showed improvement. In fact, in its upgrade, Fitch attributed this pick-up in investment to the government's efforts to improve the investment climate. Hopefully, the upturn also reflects the beginning of a turnaround in perceptions of Japanese global investors, who returned Indonesia to the 8th most desirable investment location from 9th in 2006, still down substantially from 4th in 2002.

On the downside, discussions among the government, employers, and workers on labor regulations on severance provisions have not been concluded, and formal sector employment growth continues to lag. Indonesia's inability to maximize its tremendous potential in mining is another area of weakness (especially given current prices). No Contract of Work (CoW) for a major mining company has been signed in the past 10 years, and an amended mining law continues to languish in parliament.

Looking ahead, the slowdown in the world economy and increasing risks make projecting outcomes for 2008 and 2009 more difficult than usual. Indonesia is expected to weather the global slowdown reasonably well, with growth slowing to 6.0 percent in 2008 before returning to 6.4 percent in 2009. These projections see export growth slowing from 8 percent in 2007 to 7.0 percent in 2008. Domestic demand, especially investment and consumption, should also remain robust as the economy's momentum carries into 2008. With higher international fuel prices and subsidies, the budget deficit is projected to widen to over 2 percent of GDP with the debt-to-GDP ratio falling further to 31 percent by the end of 2008.