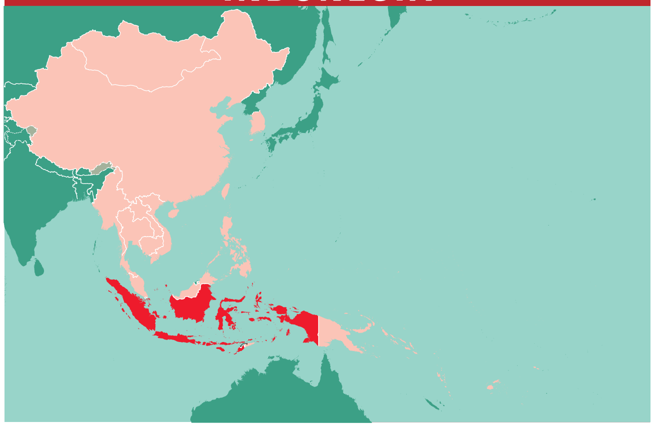
INDONESIA

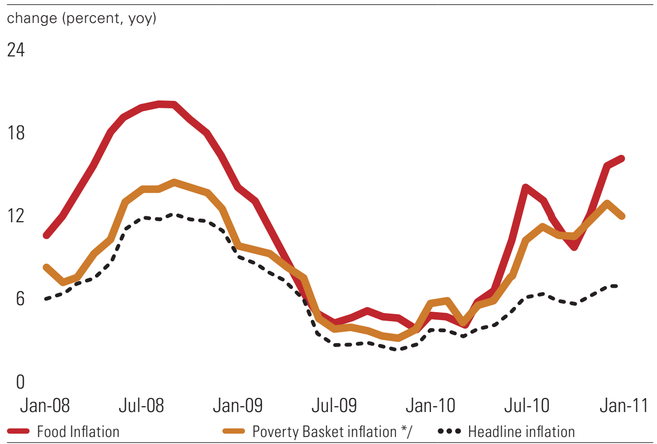


Population	228.2 million
Population growth	1.2 percent
Surface area	1,904,570 sq. km.
Capital	Jakarta

Source: World Development Indicators.

Since the middle of 2010, Indonesia has seen a marked rise in domestic inflation and continues to be affected by movements in international commodity prices and capital flows. The pick-up in inflation, driven by food prices, and concerns over the monetary policy response, have been accompanied with a recent downward correction in asset prices and in nonresident holdings of Indonesian local currency assets. Such holdings rose substantially during 2010. Nonetheless, growth remained robust, rising to 6.1 percent for 2010 as a whole. The trade balance was boosted by international commodity prices, with the overall balance of payment inflows reaching record highs for the year. Fiscal policy continues to be restrained, with the 2010 deficit well below the revised budget figure.

Rice price increases in Indonesia have contributed to higher headline and poverty basket inflation



Source: CEIC and World Bank.
Note: */ Poverty Basket Inflation calculated by World Bank.

Inflation started rising in mid 2010 as consumer prices largely due to food supply shocks and reflecting an accommodating policy stance (see Figure). Headline inflation reached 7 percent year-on-year in December, outside the central bank's target band of 4 to 6 percent. Supply-side disruptions were seen in key food items, such as rice and spices. Raw food prices grew 16 percent year on year (yoy) while grain prices were up 27 percent (dominated by the 30 percent rise for rice). Upward pressures on food prices are likely to continue at least until the harvest season at the end of the first quarter of 2011.

The rise in food price inflation risks a reversal of recent gains in poverty reduction. The wedge between the World Bank's poverty basket inflation and the overall CPI increased to its highest level since the series began in 2002. This reflects the fact that current food price increases particularly affect the poor and brings the risk of increased poverty numbers in 2011. The Government has responded to rising food prices with a number of measures. For example, the National Logistics Agency has been given the mandate to procure more rice on the international market (although actual imports remain considerably below the mandated level). Steps are also being taken to simplify import procedures for food commodities, including removing various import tariffs. The Government's rice for the poor program has also been extended through 2011 with a planned increased in the frequency of such transfers. The Government is also considering direct assistance to help farmers cope with extreme weather, for example, in the form of cash transfers.

The Bank of Indonesia (BI) adjusted its policy rate in February 2011 in response to rising inflation. The 25 basis point increase to 6.75 percent, which was the first change since August 2009, followed the sharp rise in local bond yields after the inflation numbers for December came through. Policymakers have indicated that further Rupiah appreciation may also be used to help curb inflationary pressures. These moves follow other earlier liquidity tightening measures including increases in reserve requirements. Credit growth has recovered to just over 20 percent, below the peaks of almost 40 percent in late 2008, and is increasingly for working capital loans.

The surge in capital inflows that Indonesia saw over 2010 has moderated recently. Portfolio flows (particularly purchases of domestic government bonds) accounted for the larger portion of such inflows. In December, BI announced further macro-prudential measures as part of its response to these inflows, including raising foreign currency reserve requirements. More recently, concerns over inflation, and BI's policy response, contributed to outflows of non-resident holdings of Indonesian assets (although to date these are limited compared with inflows over 2010). Profit-taking, along with push-side factors such as the recovery in the U.S., are also likely to have played a role. Domestic equity and bond prices have weakened in 2011 to date with local equities down 6 percent and local currency bond yields up 170 basis points to 8.2 percent (similar levels to those seen in May 2010).

The real economy continued to consolidate its recovery during the first three quarters of 2010. While growth in quarter three was slightly lower than expected at 5.8 percent year-on-year (yoy), growth in quarter four came in very strongly at 6.9 percent. Growth for 2010 as a whole reached 6.1 percent. Private consumption was supported earlier in the year by high consumer confidence and relatively low and stable inflation for most of the first half of the year. In the second half of the year, on a quarterly-growth basis, there was some weakening in private consumption's growth contribution. This was offset by substantial gains for investment spending, driven by machinery equipment investment, in part likely reflecting expectations of sustained demand for production going forward. Government consumption also played an important role in the second half of the year, after subtracting from growth in the first half of 2010 as a result of slow disbursements and the unwinding of the fiscal stimulus. Net exports also contributed strongly in the final quarters of 2010.

On the production side, domestically-focused sectors (such as communications and transport and retail trade) continue to make the most significant contributions to growth. Anecdotal reports suggest that some subsectors had reached capacity constraints by mid-2010 (although BI's third quarter 2010 survey of business indicated an average capacity utilization rate of 72 percent across a sample of firms in manufacturing, mining and quarrying, agriculture and electricity, gas and water). Manufacturing growth, which was lagging the rest of the economy, showed a strong quarterly growth performance in the fourth quarter. Agricultural output was affected by unusual weather patterns and, for some sectors, smaller crop area thus resulting in a modest contribution to growth.

Both the trade balance and financial account contributed to rising balance of payments inflows. Inflows on the capital and financial account in 2010 were $26 billion up from $5 billion in 2009. In addition to portfolio inflows, there has also been a recovery in foreign direct investment (for example attracted by the Government's electricity generation crash construction program). Financial inflows have more than offset the narrowing in the current account to $6.3 billion in 2010, down from $10.7 billion in 2009. The trade surplus improved toward end-2010, primarily reflecting strong commodity prices and agricultural exports. These inflows contributed to the rise in foreign reserves to $96 billion at end-2010, $36 billion above the pre-crisis peak of July 2008.

The budget deficit in 2010 was lower than expected, at 0.6 percent of GDP, significantly below the Revised Budget deficit of 2.1 percent. Revenue realization was 102 percent of the revised Budget level and expenditures a disappointing 93 percent, somewhat reversing the improving trend in budget realization of previous years. The Government approved a series of measures in August 2010 (new procurement regulation and new and more flexible guidelines on both virement procedures and budget authority appointments) to accelerate budget disbursements. However, their effect is likely to be seen more in 2011. They will be important in determining whether the rise in capital expenditures is achieved as set out in the Budget (which targets a 1.8 percent of GDP deficit). On subsidy reform, the Government has announced plans to exclude all private 4-wheel vehicles from purchasing subsidized fuel, starting in mid 2011 and in the Jakarta area, gradually extending to the whole of Indonesia in the next few years. Low fiscal deficits and strong nominal GDP growth have helped the downward trajectory for government debt-to-GDP (contributing to the January 2011 Moody's upgrade of Indonesia's sovereign rating to one notch below investment grade).

Despite the solid real sector performance, near-term risks to the outlook remain sizeable, for example, in terms of the risk of food inflation spilling over into inflation expectations and the headline rate. Indonesia still remains vulnerable to adverse shocks to international investor sentiment. These may come from both external and domestic sources, for example, related to perceptions of macro policy management. Further measures to shift inflows towards longer-term flows can help to mitigate this risk, particularly policies to enhance incentives for foreign direct investment. Looking to the medium-term outlook, the main uncertainty is whether the policies required to boost growth to 7 percent are adopted and implemented. This risk provides both upside and downside potential around the baseline outlook. Coordinated action will be required to address Indonesia's infrastructure needs, to address the investment climate-related constraints on growth, to enhance the creation of quality employment, and to ensure that the benefits of growth continue to be shared across the population.

Indonesia Key Economic Indicators

	2008	2009	2010	2011f	2012f	2010				2010			2011
	Year	Year	Year	Year	Year	Q1	Q2	Q3	Q4	Oct	Nov	Dec	Jan
Output, Employment and Prices													
Real GDP (% change y-y) 1/	6.0	4.6	6.1	6.4	6.7	5.6	6.1	5.8	6.9	..	..	..	..
Domestic demand (% change y-y)	7.5	5.4	5.2	6.5	7.2	4.0	4.6	6.2	5.9	..	..	..	..
Industrial production index (2000=100)	127.2	128.8	132.7	..	..	129.9	133.0	135.8	139.4	139.5	138.5	140.3	..
(% change y-y)	3.0	1.3	4.4	..	..	4.3	4.3	3.7	5.4	4.9	4.6	6.8	..
Unemployment (%)	8.4	7.9	7.1	..	..	..	..	..	..	..	..	..	..
Real wages (% change y-y) 2/	-1.9	0.2	..	..	..	-4.6	..	..	..	..	..	..	..
Consumer price index (% change y-y)	11.1	2.8	7.0	6.0	6.2	3.4	5.0	5.8	7.0	5.7	6.3	7.0	7.0
Public Sector													
Government revenues (% GDP)	19.8	15.5	16.0	15.4	15.1	..	..		..	..	..	..	..
Government expenditures (% GDP)	19.9	17.0	16.6	16.2	16.2	..	..	..	..	..	..	..	..
Government balance (% GDP)	-0.1	-1.6	-0.6	-0.9	-1.1	..	..	..	..	..	..	..	..
Domestic public sector debt (% GDP)	13.9	16.5	14.1	12.6	11.7	..	..	..	..	..	..	..	..
Government debt (% GDP)	29.2	31.1	26.2	23.8	22.1	..	..	..	..	..	..	..	..
Foreign Trade, BOP and External Debt													
Trade balance (billions US$)	22.9	30.1	31.1	46.3	50.3	7.0	7.0	7.8	9.3	2.3	2.6	3.7	2.0
Exports of goods (billions US$) 3/	139.6	119.6	158.2	180.8	197.5	35.1	37.4	39.7	46.0	14.4	15.6	16.8	14.5
(% change y-y)	18.3	-14.3	32.2	14.3	9.2	45.0	33.0	26.9	27.7	17.6	45.1	25.7	24.7
Key export (% change y-y) 4/	27.5	-35.5	..	..	..	..	..	..	..	..	..	..	..
Imports of goods (billions US$) 3/	116.7	89.5	127.1	134.5	147.2	28.0	30.5	31.9	36.7	12.1	13.0	13.1	12.5
(% change y-y)	36.9	-27.7	42.0	5.8	9.4	53.5	46.4	29.6	42.2	28.5	47.6	27.1	32.2
Current account balance (billions US$)	0.1	10.2	6.3	2.3	2.7	2.1	1.6	1.4	1.2	..	..	..	..
(% GDP)	0.0	1.9	0.9	0.3	0.3	1.3	0.9	0.7	0.7	..	..	..	..
Foreign direct investment (billions US$)	3.4	2.6	9.8	9.9	10.7	2.5	2.3	1.6	3.4	..	..	..	..
External debt (billions US$)	155.1	172.9	200.1	..	..	..	..	..	..	..	..	..	..
(% GDP)	30.4	32.1	28.1	..	..	..	..	..	..	..	..	..	..
Foreign exchange reserves, gross (billions US$)	51.6	66.1	96.2	..	..	71.8	76.3	86.6	96.2	91.8	92.8	96.2	95.3
(months of imports of g&s)	4.3	7.1	7.5	..	..	7.0	6.8	7.3	7.5	..	..	..	..
Financial Markets													
Domestic credit (% change y-y)	33.0	16.1	17.5	..	..	10.1	16.9	20.3	22.2	21.6	22.1	22.8	..
Short-term interest rate (% p.a.) 5/	8.7	7.1	6.5	..	..	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Exchange rate (Rupiah/US$, ave)	9,757	10,354	9,078	,,	,,	9,272	9,092	8,972	8,977	8,928	9,013	8,991	9,057
Real effective exchange rate (2000=100)	142.3	142.4	161.3	..	..	158.3	163.4	163.4	160.1	159.3	160.0	160.9	159.8
(% change y-y)	8.7	0.0	13.3	..	..	22.6	15.0	11.4	5.6	5.3	5.9	5.6	1.9
Stock market index (Aug. 1988=100) 6/	2,088	2,014	3,095	..	..	2,646	2,894	3,217	3,623	3,635	3,531	3,704	3,409
Memo: Nominal GDP (billions US$)	510.2	539.4	711.7	839.9	989.2	161.9	174.1	185.9	186.1	..	..	..	..

Source: National data sources.

f = forecast
1/ Using base-year 2000 national accounts
2/ Wages in manufacturing
3/ Annual and quarterly data are on a BOP basis while monthly data are on a customs basis
4/ Crude oil and gas
5/ Policy rate: one-month Bank Indonesia Certificates
6/ Jakarta Composite, period average