

Indonesia: Economic and Social Update

October 2005



BANK DUNIA | THE WORLD BANK

Executive Summary¹

Financial markets welcome fuel price increases. The government moved to address ballooning fuel subsidies and exchange rate instability with a bold policy package on October 1st. The package included (i) a dramatic increase in domestic fuel prices, (ii) the launch of an unprecedented cash compensation program for the poor and (iii) a broad based incentive package. Administered fuel prices were raised by a weighted average of 114 percent and household kerosene prices by 186 percent.² Budgetary saving from the October fuel price hikes in 2005 alone are approximately Rp.25 trillion (equivalent to US\$2.5 billion), and could be more than US \$6-8 billion in 2006, depending on international oil prices. In order to mitigate the impact of the price increase on poor households the government is providing cash transfers of Rp.300,000 a quarter. The first quarterly tranche of payments target 15.5 million poor and near-poor households. Other measures are aimed at mitigating the impact on workers, businesses and especially transport costs. Despite a second Bali bombing, which claimed more than 20 lives the day of the hike, the rupiah exchange rate appreciated by 3 percentage points and stock index improved by more than 2 percent the first week of October.

The second Bali bombing is likely to have a limited impact given the restrained response thus far and the relatively small share of Bali in the national economy. In the immediate aftermath of the Bali bombing in 2002, occupancy fell to 10 percent in many hotels and tourist arrivals declined by 32 percent for the year as a whole. This was devastating as hotels and restaurants account for 30 percent of the Balinese economy. However, Bali's economy accounts for only 1.3 percent of the total Indonesian economy.³ The response to this year's attack has been more muted with departures relatively limited. However, the bombing does hurt Indonesia's image and enhancing security, to re-assure investors, was announced as an administration priority.

Underlying economic growth and key macroeconomic/financial indicators parted company in mid-2005. Overall GDP grew by 5.9 percent in the first half of 2005 and the non-oil economy was grew an even more robust 7.0 percent.⁴ Investment continued as the key driver with growth in Q2 at 13.2 percent, now above 10 percent for six quarters. Most indicators on the underlying economy remain strong. Exports were up 15 percent (yoy), consumer durables were growing 10 to 20 percent and motorcycles sales were 30 percent above last year's level.

In contrast, macroeconomic uncertainty accelerated in Q3 triggering a rapid depreciation in the rupiah, a substantial turn-around in interest rates and a

¹ A report "Rebuilding a Better Aceh and Nias – Stocktaking of the Reconstruction Efforts" produced for the Coordination Forum for Aceh and Nias (CFAN) on October 4th, 2005 is available. The CGI Brief focuses on the remaining critical issues for Indonesia. Further discussion of the impact of oil prices on the Indonesian economy is included in the appendix to this Brief.

² Fuel prices on sales to industry had already been increased so the weighted average increase as calculated by the government is 87 percent.

³ 2003 data.

⁴ Headline growth in GDP in Q2 was 5.5 percent, below market expectations and down from 6.2 percent in Q1. Underlying growth in non-oil and gas GDP at 6.7 percent was also down from Q1 at 7.3 percent, but still robust.

correction in the stock market. The rupiah had been under pressure throughout 2005, gradually depreciating while Bank Indonesia reserves declined. Overall imports, especially capital, grew rapidly, while the oil and gas balance declined and the current account moved into deficit by the second quarter. The rapid increase in imports was not supported by private capital inflows, perhaps due to lagging investment climate reforms, resulting in continuing pressure on the currency. Domestic interest rates were not raised sufficiently to offset hikes in global interest rates and oil prices rose into the high US\$60 dollar range causing concerns to mount. Market confidence fell in late August early September with players reacting strongly to the perception that higher oil prices would put further pressure on the exchange rate and Indonesia's fiscal position.

The President, in his Speech of September 2nd, laid out an initial 4 part agenda to deal with the incipient currency crisis. The measures included reduced subsidies and increased production to deal with the energy issue, monetary tightening, fiscal prudence and accelerating investment reforms. These measures, especially a hike in interest rates, partially stabilized the rupiah, but uncertainty around announced fuel price increases and further interest rate hikes kept uncertainty high through September, until addressed by the October 1st package.

Fiscal policy had become a key market concern. The government submitted a second revision to the 2005 budget and the original 2006 budget to Parliament in mid-August with neither signaling any change in fuel prices which added to general uncertainty. However, subsequently the Government and Parliament agreed on an explicit subsidy level of Rp. 89.2 trillion for 2005 which formed the basis for the fuel price increase on October 1. In addition to the average increase of 114 percent in subsidized fuel prices the government indicated that domestic fuel prices would be linked to economic or international levels, perhaps as was done in 2002. Revised macroeconomic assumptions for 2006 and a second revised budget for 2005 have now been agreed on with Parliament. In the 2005 second budget revision, the government projects a budget deficit of 0.9 percent of GDP at an average international oil price at US\$54/bbl, an average exchange rate at Rp.9,800, lower oil production and higher domestic fuel consumption. For 2006 the Government and Parliament have agreed on a crude oil prices (ICP) of US\$57/bbl, an exchange rate of Rp.9,900, an inflation rate 8.0 percent and interest rates (3 month SBI) at 9.5 percent. At this point just these assumptions are available.

Post fuel price hike, the government is going ahead with a nation-wide program to transfer cash to the poor. Approximately 15.5 million poor and near-poor households are being given a cash transfer of 100,000 rupiah per month, distributed quarterly, starting in October. Beneficiary households were designated by community heads and verified by the Statistics Agency through a questionnaire on household economic and welfare characteristics, expenditures and assets. PT Pos has been selected as the payment agency. The agency will draw funds from BRI (a state bank), consistent with the number of designated poor households in each area. Cards are distributed to each beneficiary household entitling them to receive the cash transfer at their nearest Post Office or designated cash post. Initial reports include mis-targeting and abuse by local government heads but while the extent is not clear the government indicates that it remains in the 5 percent range. However, the government will need to ensure continued proper delivery, monitoring and oversight

mechanisms to ensure transparency, credibility and control of fraud. It will also be important to quickly evaluate the effectiveness of this program while designing a road map toward a comprehensive social protection system.

After a year in office, there are frustrations about in-adequate progress on investment climate reforms. Despite on-going efforts and the widely regarded Infrastructure Summit, the government has little to show for its efforts on improving the investment climate. New laws on investment, taxes and regional taxes and charges are nearing completion, but few concrete measures have been taken and some issues within these laws, especially the tax law, remain controversial. On the plus side, the new investment law is meant to simplify procedures by moving from an approval to a registration regime (which will reduce time and uncertainty), and clarify the negative list. The tax law will cut corporate and individual marginal tax rates by 2 percent (from 30 and 35 percent respectively) in 2007 and reduce marginal rates further to 25 and 30 percent by 2010. The Law on Regional taxes and charges will move from a negative to a positive list and allow local governments more flexibility on property taxes. Nevertheless, concrete progress is limited. Most of these laws have not been presented to Parliament. There have been no initiatives to cut the amount of days, often quoted as 151, required to register a firm, many of which do not require a change in law. The business community remains concerned about a lack of progress on assessment, audit and payment procedures in the tax administration law, especially in the context of increased powers for tax officials. There is some progress on infrastructure, although the pace is also much slower than desired. A long-awaited committee to coordinate infrastructure is operational, the government is nearing completion of the government regulation on public private partnerships and there is a commitment to develop a risk-sharing framework at the Ministry of Finance. Nevertheless, of the 91 projects committed at the Summit only 6 toll-roads were tendered, and two of them did not receive bids. In conclusion, it is important for the government to accelerate policy reform to reduce costs and uncertainty for the business community in general, and infrastructure in particular.

The Highly Pathogenic Avian Influenza (HPAI) virus is an area of rising concern as Indonesia reported its fifth confirmed case from the virus, with increasing reports of infections in other regions. After a slow initial response and an over-dependence on poultry vaccination, the government announced a stronger focus on culling chickens (including at higher compensation per chicken), following increased human infections. Public health awareness campaigns are being carried out in infected areas, and in other areas throughout the country. International support is rising and the country is stock-piling anti-viral drugs. So far, the economic impact has been relatively limited with 10.3 million poultry deaths, 4.8 percent of Indonesia's stock of poultry, by end August. The costs of the vaccination program were largely born by the national government in 2005 but next year local governments are expected to play a bigger role. There are risks that such a decentralization strategy will undermine the efficiency of the response. It is also important that Indonesia phase out high-risk farming practices such as the integrated livestock system that is still being promoted.

Economic momentum is likely to slow in the aftermath of the macroeconomic uncertainty in August and September, the hike in domestic fuel prices and associated inflation. Growth for 2005 is now estimated to be 5.7 percent, and inflation could peak at 13 to 14 percent by the end of the year. Meanwhile the hike in fuel prices and slow budget

spending should keep the budget deficit below 1 percent of GDP. Growth prospects in 2006 depend crucially on the government's ability to recycle spending from subsidies to more productive uses. However, the adjustment process to higher domestic fuel prices and a slow transition to increased capital and social spending are likely to slow growth rates in early 2006 before accelerating later in the year to between 5.5 to 6.0 percent. Bank Indonesia should aim to rein in inflation to the 8 percent range by the end of 2006.

Longer term prospects are more bullish as concrete investment reforms impact decisions and subsidy spending is reallocated into infrastructure and social spending. Growth should rise to the 7 percent range in the medium term, still constrained by infrastructure shortfalls, while the debt to GDP ratio would fall below 30 percent by 2010. The President in his speech of September 15, 2004 to the Global Investment Forum outlined his commitment to achieve Indonesia's Millennium Development Goals. He indicated that it would involve "pro-growth", "pro-job creation" and "pro-poor" strategy. He focused especially on the need to create jobs and attract investment while acknowledging his understanding of the problems investors face. The key challenge facing Indonesia now is the positive but difficult challenge of reallocating US\$6-8 billion from fuel subsidies to "pro-growth", "pro-job creation" and "pro-poor" uses, and therefore delivering on Indonesia's MDG Goals.

In conclusion, it is the Bank's view that recent domestic and international market turbulence and the response to policy measures reinforce the importance of a good macroeconomic policy, investment climate reforms and effective expenditure management. Good macroeconomic management includes a continued focus on the reduction of the government debt burden (as measured by a trend decline in debt to GDP), depoliticizing domestic fuel prices by linking them to international prices and monetary policy designed to bring inflation into line with regional averages. Additionally, a clearer articulation and coordination of policy announcements should be a priority. Improvements to the investment climate would be led by reversing the slide in oil and gas exploration and production, concrete measures to address investor concerns including the time and expense to register a company and redressing cumbersome tax administration procedures. A quick clearance of an investment bill that dramatically reduced red tape would send out a strong, highly visible signal to investors. However, Indonesia's key challenge may lie in the allocation and management of public expenditures. The government's reduction of untargeted fuel subsidies and their reallocation to capital and social spending represent an unprecedented opportunity to improve the level and quality of growth in the medium term. The government will need to build on budget reforms to improve the link between government priorities (to accelerate infrastructure and reduce poverty for example), improve the efficiency of budget procedures, and reduce leakages.

Economic and Social Update

1. Markets

Rupiah exchange rate depreciates. The rupiah exchange rate depreciated below Rp.10,000 against the US dollar for the first time since March 2002. Since January, the exchange rate depreciated by 12 percent (Figure 1). Unfortunately, this loss of confidence in the Rupiah exchange rate spilled over to other markets. In July 2005 the Jakarta Stock Exchange (JSX) index reached an all time high of 1,192 (Figure 2), before declining by 16 percent in 17 working days. The spread of the Indonesian international bond market over US treasuries, an indicator of the international risk premium, improved till early August, but widened dramatically in recent weeks (Figure 3). The domestic bond yield curve, a measure of domestic risk, has also risen substantially (Figure 4).

The following are key factors responsible for the currency depreciation.

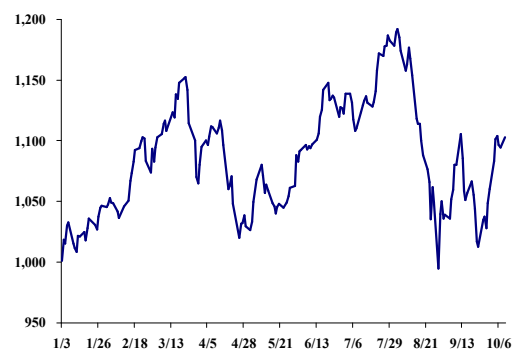
- **Macroeconomic management.** Uncertainty over macroeconomic management was the primary reason for the currency depreciation. Concern was focused on the speed and adequacy of the monetary measures, especially interest rate hikes. The markets also questioned macroeconomic assumptions used in the government 2006 budget proposal, especially the oil price assumption of US\$40/bbl (please see details in Fiscal Policy section).

Figure 1. Rupiah depreciates below Rp.10,000 for the first time since 2002



Source. Bank Indonesia, World Bank

Figure 2. Stock Index falls (JSX stock index, 1983=100)



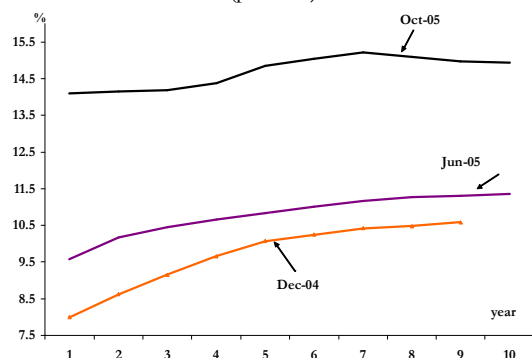
Source. CEIC, World Bank

Figure 3. Yield spread over US treasury (global bond, bps)



Source. Bank Indonesia, World Bank

Figure 4. Domestic yield curve (percent)



Source. CEIC, World Bank

- **Shrinking current account surplus and international reserves.** The current account surplus shrank from US\$ 8.1 billion in 2003 to US\$3.1 billion in 2004. The Q2 2005 quarterly current account balance turned negative at -US\$0.5 billion and is likely to deteriorate further in Q3 due to high oil prices and increasing imports. Anecdotal evidence and the increase in government bond yields suggest the capital account is under pressure as well. International reserves declined from a peak of US\$37 billion in late April to US\$30.2 billion in October. In fact, in the absence of forex intervention by the central bank), the depreciation of the rupiah would have been greater.
- **Increasing oil imports and worsening oil and gas balance.** Growing domestic fuel demands, higher oil prices, limited refinery capacity and a widening price gap between crude oil and fuel product prices led to higher oil imports and an increased demand for US dollars. International trade data shows that the oil and gas trade (excluding services) was almost in balance in Q2 2005.
- **Declining real interest rates.** With the inflation rate at 8.8 percent and the 3 month SBI rates at 7.5 percent, real interest rates turned negative in March-April 2005, leading to a portfolio reallocation. The situation was worsened as the gap between Indonesia SBI (90 days) and the US Treasury bill (3 month) fell from 7.3 percent in January 2004 to 4.6 percent in March before recovering to 5.7 percent in September 2005 and 7.5 percent in October.

Bank Indonesia regulation on foreign exchange transactions. In an effort to reduce speculative trading in the Rupiah, Bank Indonesia issued regulation No.7/14/PBI/2005 (June 2005) restricting some Rupiah transactions and foreign currency lending by banks. This new regulation limits the transfer of Rupiah to foreign parties and reduces bank limits on foreign exchange derivative transactions with foreign parties from US\$3 million to US\$1 million.⁵ An unforeseen effect was that investors were unable to hedge currency risks, which may have added to the volatility and the depreciation of the rupiah.

Limited impact on the Rupiah from the change in the Chinese and Malaysian exchange rate. On July 21, Chinese authorities adjusted the RMB exchange rate from 8.28 to 8.11 against the US dollar and allowed it to float within a daily ± 0.3 percent band. Malaysia also shifted from a pegged exchange rate of 3.8 against the US dollar to a managed float. Although the Indonesian rupiah appreciated slightly after the announcement, it quickly returned to its original level.

2. Growth and Investment

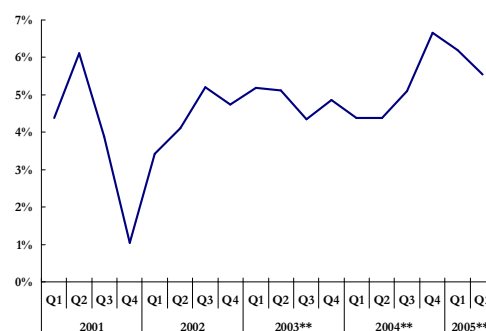
Growth has been steady, though decelerating. In Q2 2005, the year-on-year growth rate was 5.5 percent (Figure 5), compared to 6.2 percent and 6.4 percent in the previous two quarters. First half growth of 5.9 percent (yoy) is almost in line with the latest government projection

⁵ For example, Banks are prohibited from provision of credit in rupiah and/or foreign currencies with foreign parties (Article 3.a of Bank Indonesia regulation No.7/14/PBI/2005)

of 6.0 percent.⁶ Historically, a growth rate above 5 percent for 4 straight quarters should prevent unemployment from rising. However, in Q3 2005, the economy faces a number of risks among them that, Indonesia's oil and gas balance is now approximately neutral and higher oil prices no longer have a positive effect on the economy.

Non-tradable and non-oil and gas sectors contribute to growth (Table 1). The gap in growth between tradable and non tradable sectors has been widening (Figure 6). Non-tradable sectors grew by 8.8 percent (yoy), while tradable sectors grew by just 2.7 percent dragged down by negative growth in agriculture and mining.⁷ The recent currency depreciation will improve price competitiveness for tradable sectors and a potential turnaround for these sectors could be in the offing. Growth in the oil and gas sector

Figure 5. Steady Growth
(real GDP growth, year-on-year, percent)



Source: BPS, World Bank

Table 1. Sector Growth Rates

(2000 base year, year-on-year growth rates)

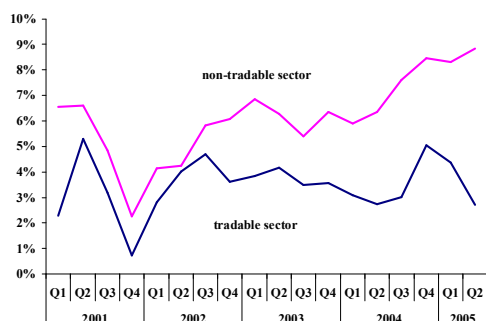
	2003	2004	H1 05	Q1 05	Q2 05
Tradable	3.8%	3.5%	3.5%	4.4%	2.7%
Agriculture,	4.3%	4.1%	0.3%	1.6%	-1.0%
Mining & Quarrying	-0.9%	-4.6%	-0.9%	1.0%	-2.9%
Manufacturing	5.3%	6.2%	6.8%	7.1%	6.7%
Non-Tradable	6.2%	7.1%	8.6%	8.3%	8.8%
Construction	6.7%	8.2%	7.4%	7.3%	7.4%
Financial	7.0%	7.7%	8.2%	6.5%	10.0%
Transport & Communication	11.6%	12.7%	13.5%	13.1%	13.9%
Electricity, Gas & Water Supply	5.9%	5.9%	7.7%	7.8%	7.6%
Trade, Hotel & Restaurant Services	5.3%	5.8%	9.7%	10.0%	9.5%
Services	3.9%	4.9%	4.6%	4.9%	4.4%
Non-oil and gas	5.8%	6.2%	7.0%	7.3%	6.7%
Oil and gas	-2.9%	-4.4%	-5.6%	-4.4%	-6.8%
GDP	4.9%	5.1%	5.9%	6.2%	5.5%

Sources: BPS, World Bank staff

continued its four-year decline in Q2 and fell by 6.8 percent (Figure 7). Consistently low investment in the oil and gas sector has impacted production, post crisis.

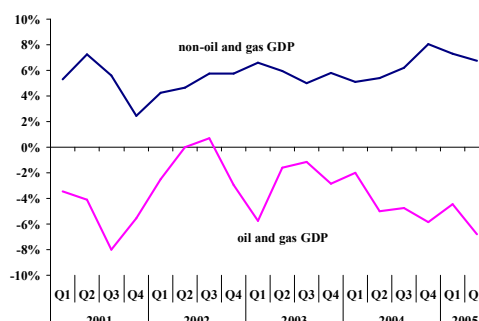
Continued strong investment growth. Investment (i.e. gross fixed capital formation) remains the main source of growth in Q2. It grew by 13.2 percent (yoy) in Q2 2005 (Figure

Figure 6. Non-tradables support growth
(year on year growth rate, percent)



Source: BPS, World Bank staff

Figure 7. Non-oil and gas growth strong
(year on year growth rate, percent)

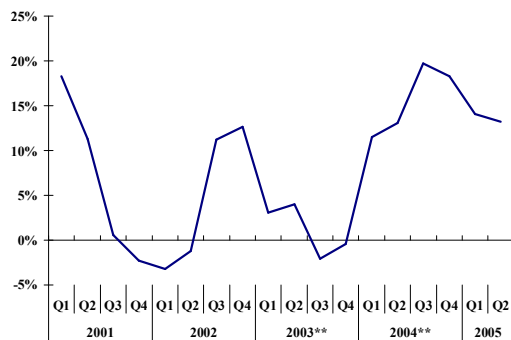


Source: BPS, World Bank staff

⁶ In the government's second budget revision for the 2005 budget they projected 6.0 percent growth.

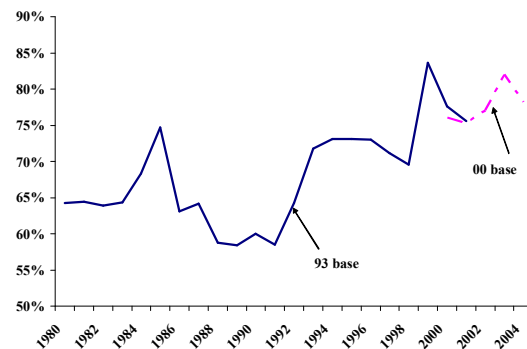
8). Investment has now grown by more than 10 percent for 6 straight quarters since Q1 2004, the longest period since the late 1980s.⁸ Strong investment growth was observed in all categories: construction 7.4 percent (yoy), domestic capital goods (machinery, transportation) 18.0 percent and capital imports 37.8 percent. There are signs of shifts in investment as well. For example, the share of construction investment (i.e. property like shopping malls, apartment and infrastructure) has been fallen as a share of total investment although it remains significantly higher than pre-crisis levels (Figure 9).

Figure 8. Continuing high investment growth
(year-on-year growth rate, percent)



Source. BPS, World Bank staff

Figure 9. Higher than the pre-crisis period
(property share in total investment, percent)



Source. BPS, World Bank staff

Investment indicators improve. In Q2 2005, net FDI inflows were US\$2.2 billion, well above the US \$1.0 billion in 2004.⁹ Foreign investment licenses¹⁰, the last stage in the investment approval process, and the best indicator for investment realization increased by 160 percent (yoy) in the first 8 months of 2005. Capital goods imports have grown an amazing 36 percent between January and August.¹¹ In fact the nominal value of capital goods imports in US dollars is now at 1995-1996 pre-crisis highs.

3. External Sector

Current account balance turns negative. The current account balance deteriorated, largely due to increasing imports of oil and gas. The current account balance in Q2 2005 was -US\$0.5 billion, while the previous quarter was revised down by US\$0.4 to US\$1.8 billion (Figure 10). In Q2 2005, the oil and gas balance shrank to US\$0.3 billion from a peak of US \$ 2.5 billion in late 2000– early 2001 (Table 11). In comparison, the non oil and gas trade balance increased by 35.9 percent (yoy). Strong export growth of 23.9 percent was countered by an even stronger import growth of 32.2 percent in January-August 2005.

⁷Manufacturing has been relatively strong although it would be weak compared to most non-tradable sectors.

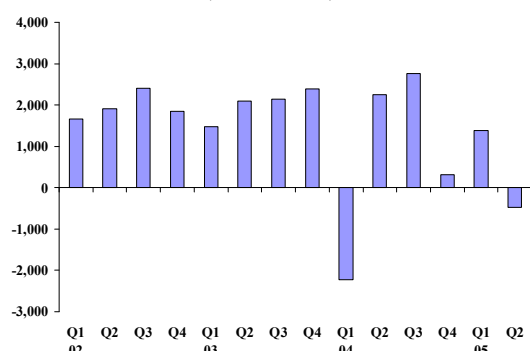
⁸ Investment growth rates were above 10 percent on a year-on-year basis between Q2 1988 and Q1 1990 for 8 straight quarters.

⁹ Sharp increase in net FDI in Q2 2005 was mainly due to Philip Morris's investment in PT Samperna.

¹⁰ Figures released by BKPM (the Investment Coordinating Board) do not include oil and gas, and financial sectors.

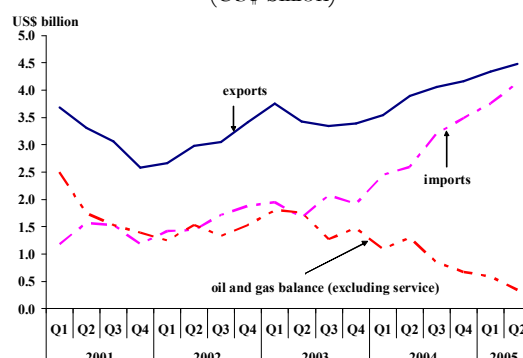
¹¹ The figure of 37.8 percent in the previous paragraph refers to the estimate of capital goods imports in the national accounts through the 2nd quarter. The figure of 36 percent here refers to trade data from the balance of payments through August.

Figure 10. Negative current account
(US\$ million)



Source: Bank Indonesia

Figure 11. While oil and gas balance deteriorates
(US\$ billion)



Source: CEIC, World Bank

Private capital outflows return. In Q2 2005, the overall private capital account was negative US\$1.1 billion the first time since Q2 2004. Net FDI was positive however portfolio investment and loan disbursements were negative.

International reserves fall. Gross international reserves declined from US\$36.1 billion in January 2005 to US\$30.2 billion in early October. International reserves were at 9.4 months of goods imports in 2004, but increasing imports and declining reserves pushed the level down to down to 7.5 months. This decline in reserves, accompanied by the depreciation of the rupiah suggests that the balance of payments in Q3 2005 will deteriorate. Though Q3 2005 data is yet to be released, given the international reserve trend, the private capital account will likely deteriorate significantly.

Trend decline in external debt to GDP ratio threatened. The debt situation continued to ease through Q2 and the external debt to GDP ratio fell from 53.2 percent in 2004 to 50.7 percent in June 2005. The main contributor to the decline in this ratio was the increase in nominal GDP (Table 2) although nominal external debt outstanding fell from US\$137 billion in 2004 to US\$136 billion in Q2 2005. Unfortunately the reversal in the current account and especially the recent depreciation in the rupiah is likely to slow or possibly reverse the rapid decline in external indebtedness.

Table 2. External debt to GDP ratio

		2004	2005 June	Change	Contribution
I. Total External Debt	US\$ billion	137.0	136.3	-0.73	11.3%
(1) US dollar denominated 1/	US\$ billion	103.7	106.9	3.20	-49.2%
(2) JPY denominated	US\$ billion	33.3	29.4	-3.94	60.5%
a. JPY denominated	JPY billion	3,471	3,246	-225.19	31.3%
b. JPY exchange rate 2/	Yen/US\$	104.12	110.40	6.28	29.1%
II. Nominal GDP	US\$ billion	257.7	268.6	10.9	88.7%
1. Nominal GDP	Rp. Billion	2,303,031	2,491,780	188,748	166.2%
(1) Real GDP	Rp. Billion	1,660,579	1,708,455	47,876	60.0%
(2) GDP deflator	2000=100	139	146	7	106.2%
2. Rp. Exchange rate 3/	Rp/US\$	8,936	9,277	341	-77.4%
Gov't Debt to GDP ratio		53.2%	50.7%	-2.42%	100.0%

1/ total external debt minus JPY denominated debt

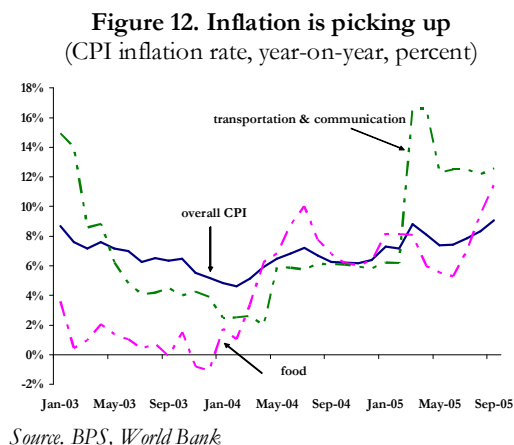
2/ end of period exchange rate

3/ period average exchange rate

Source: World Bank staff calculation

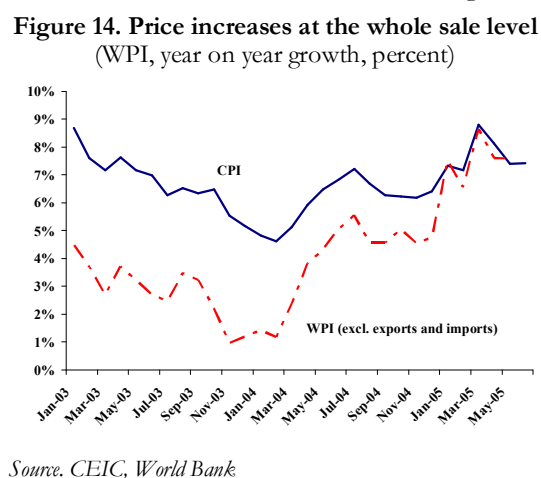
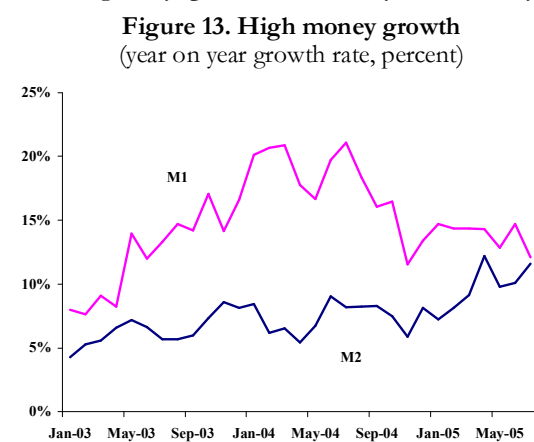
4. Money and Inflation

Inflation rises. High fuel prices replaced high food costs as the primary inflation driver in the first half of this year. A 29 percent increase in fuel prices this year resulted in the inflation rate (measured by Consumer Price Index) peaking at 9.1 percent (yoy) in September, although the core inflation (excluding foods and fuel prices component) remained at 6.7 percent. Immediately after the fuel-price hike, year-on-year inflation in transportation, communication and finance was 16.6 percent in March, up 6.2 percent (yoy) in February (Figure 12).



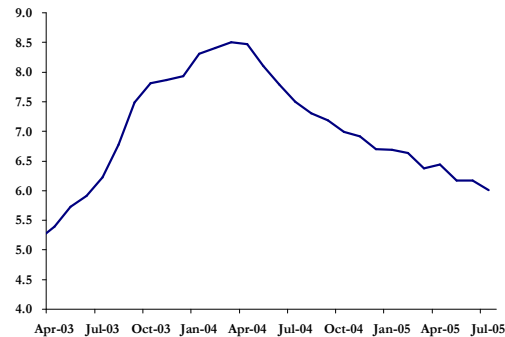
Fuel price increases, WPI, money supply and inflation expectations suggest future inflation risks. With fuel price hikes in excess of 100 percent inflation will pick up. Fuel makes up 3.1 percent of the Consumer Price Index and transport costs add another 4.6 percent. Assuming a 20 percent increase in transportation costs the October fuel price increase could add 4-6 percentage points to CPI over the next year. Core inflation is also likely to increase due to the indirect impact of the October fuel price increase. Growth rates in monetary aggregates were also relatively high (Figure 13). The growth in M2 was 10.5 percent (yoy) and M1 growth was 13.2 percent (yoy) through July 2005. Finally the WPI (the whole sale price index excluding exports and imports) started to increase rapidly in mid-2004 (Figure 14).

Declining real interest rates. Real interest rates fell due to higher inflation and a lagged policy response to counter it. SBI interest rates were stable until March at 7.3 percent, before gradually increasing to 9.25 percent in September and 12.1 percent for 3 month SBI by October. As a result, real SBI interest rates were negative in March-April, before moving into marginally positive territory from May onwards. There have been fears that higher



interest rates would slow economic growth. But between January and July 2005 (latest available data), while time deposit rates increased by 0.7 percent lending rates on working capital remained almost unchanged. As a result, the bank spread between lending and deposit rates declined from its peak of 8.5 percent in March 2004 to 6.0 percent in July 2005, and the margin remains high by historical standards (Figure 15).

Figure 15. Shrinking interest margin
(interest rate gap between working capital lending rate and time deposit (3 month) rate)



Source: CEIC, World Bank

5. Fiscal Policy

Revised macroeconomic assumptions, revised budgets. A month after the parliament approved the first revision to 2005 budget, the government submitted a second proposed revision to 2005 budget and 2006 budget was submitted in mid-August. The second revision was approved

in late September and the 2006 budget is scheduled to be approved by end-October. In the first revision in July, the government concentrated on relatively few items, including rehabilitation and reconstruction in Aceh and Nias, regional elections, and fuel subsidy and compensation programs. The second revision takes into better account the changed macroeconomic situation. Of particular concern have been the key macroeconomic assumptions (Table 3) used as the basis for budget formation, especially the 2006 crude oil price assumption. The experience of the past 4 years' shows that the government uses relatively low oil price assumptions in the budget (Table 4) before adjusting the assumption in the revised editions (the second row in Table 4).

Table 4. Oil Prices: Budget and Actual
(ICP, US\$/bbl)

	2001	2002	2003	2004
Budget	22.0	22.0	22.0	22.0
Revised budget	24.0	22.8	27.9	36.0
Actual	24.5	23.5	28.8	37.2

Source: Ministry of Finance, World Bank

• 2005 Second Revised Budget

Slightly higher budget deficit projected. In the second revised budget the budget balance was changed to -0.9 percent of GDP, from -0.7 percent of GDP in approved budget (APBN) and -0.8 percent in the first revised version (APBN-P) (Table 5). Based on higher

Table 3. Key Macroeconomic Assumptions in the State Budget

	2004		2005			2006	
	Actual	H1 actual	APBN	APBN-P	APBN-P2	RAPBN	Agreed
1. GDP (nominal, Rp.trillion)	2,303	-	2,560.9	2,624.3	2,651.2	2,996	3,021
2. Real GDP growth rate (%)	5.1	5.9	5.4	6.0	6.0	6.2	6.1
3. Inflation	6.4	7.7	5.5	7.5	8.6	7.0	8.0
4. Exchange rate (Rp/\$, average)	8,939	9,400	8,600	9,300	9,800	9,400	9,900
5. SBI rate (3 months)	7.4	7.5	6.5	8.0	8.4	8.0	9.5
6. Oil Prices (ICP, US\$/bbl)	37.2	49.4	24.0	45.0	54.0	40.0	57.0
7. Oil Production (mil barrel/day)	1.072	n.a.	1.125	1.125	1.075	1.075	1.110

Source: Ministry of Finance, World Bank staff

oil prices US\$54/bbl and a strong domestic revenue performance in the first half of 2005, the revenue projection was increased to 20.4 percent of GDP from 18.7 percent in APBN-P.

Non-oil and gas domestic tax revenues were revised upwards by 0.3 percent of GDP to 11.2 percent in the second revision. Oil and gas revenues (including both tax and non-tax) were changed from 2.4 percent in APBN, to 5.6 percent in APBN-P to 6.7 percent in the second revision. Expenditures rose from 15.5 percent in first budget to 21.3 percent in the current revision. This increase in expenditures is largely due to increase in fuel subsidies from 0.7 percent in the initial budget, to 2.9 percent in APBN-P and 3.4 percent in the second revision although the subsidy level of 89.2 trillion for the entire 2005 implied a very large fuel price increase given that subsidies were already close to 80 trillion in mid September.

Non-oil and gas domestic tax revenues. Tax revenues were stronger in the first semester this year compared to 2004. Non-oil and gas income tax revenues were revised from 5.2 percent (Rp.136.8 trillion) in the APBN-P to 5.4 percent of GDP (Rp.143.0 trillion). Last year in the 1st semester the government collected 44.4 percent of the budgeted amount (APBN-P), while in 2005 47.3 percent of APBN-P estimate of tax revenues had already been received. In part this increase reflects the one off impact of the expiration of loss carry forward provisions that are limited to five years. Value-added tax revenues were also revised up from 3.8 percent (Rp.99.4 trillion) in APBN-P to 3.9 percent (Rp.102.7 trillion).¹² Excise

Table 5. A Snapshot of the 2005-2006 State Budget (% of GDP)

	<u>2005</u>		<u>2006</u>	
	Approved Budget (APBN)	Revised Budget (APBN-P)	Second Revision (APBN-P2)	Government proposal (RAPBN)
A. Revenues	14.9	18.7	20.4	18.0
- oil and gas	2.3	5.6	6.7	3.8
- grants	0.0	0.3	0.3	0.2
B. Expenditures	15.5	19.5	21.3	18.7
- capital expenditures	1.7	1.9	n.a.	1.5
- subsidy	1.2	3.7	4.5	2.7
o/w fuel subsidy	0.7	2.9	3.4	2.3
- social assistance	0.7	1.1	n.a.	1.0
- transfer to regions	5.1	5.6	5.8	6.1
C. Primary Balance	1.8	1.5	1.4	1.8
D. Budgetary Balance	-0.7	-0.8	-0.9	-0.7
E. Financing	0.7	0.8	0.9	0.7
- bank financing	0.4	0.0	0.2	0.7
- Foreign loan disbursement	1.0	1.1	1.3	1.0
- Foreign loan amortization	-1.8	-1.4	-1.5	-2.0
F. Economic Assumption				
- GDP growth rate	5.5	6.0	6.0	6.2
- Inflation rate	5.5	7.5	8.6	7.0
- Exchange rate	8,600	9,300	9,800	9,400
- Crude oil price (US\$/bbl)	24	45	54	40
- Interest rate (SBI 3M)	6.5	8.0	8.0	8.0

Source. Ministry of Finance, World Bank staff calculation

¹² In 2004, 1st semester result was 39.6 percent, while in 2005 1st semester result was 43.7 percent.

collections are expected to improve in the coming months due to a 15 percent hike in the statutory retail prices of cigarettes in June 2005, however, the excise revenue target was unchanged at 1.2 percent (Rp.32.2 trillion).

Poor oil and gas revenue performance in the first semester. The second revised budget projects oil and gas revenues at 6.7 percent of GDP (Rp.176 trillion). In contrast, the actual revenues in the first semester were only Rp.40.5 trillion, 26 percent of the revised budget estimate. Non-tax oil and gas revenues appear particularly low compared with oil and gas tax revenues perhaps due to lower oil production. If non-tax oil and gas revenues in the first semester were proportional oil and gas tax revenues, the budget surplus would reach Rp.40 trillion in the first semester.

Fuel subsidies more than quadruple. Spending on fuel subsidies was revised from 0.7 percent of GDP (Rp.19 trillion) in the APBN, to 2.9 percent of GDP (Rp.76.5 trillion) in the APBN-P to 3.4 percent of GDP (Rp.89.2 trillion) in the second revision even though this incorporates the announced fuel price hikes in October. The higher crude oil assumption (US\$54 per bbl), lower oil production (1.075 million barrel a day), a depreciated exchange rate (Rp.9,800) and higher fuel consumption volume (65 million kl) led to the revision in the fuel subsidy assumption.

Slow progress on capital spending and social assistance: When the government increased fuel prices by 29 percent in March 2005, they promised to allocate about half of the saving to a compensation fund. The first revised budget, as well as the current version, earmarks Rp.11 trillion for (i) education: school grants (Rp.5 trillion), (ii) health (Rp.3 trillion) and (iii) rural infrastructure (Rp.3 trillion). The parliament only agreed to these new social expenditures in June 2005 but social disbursements on the original budget were particularly slow in the first semester. For example, realized expenditures on social assistance were 6.0 percent and capital expenditures 6.8 percent. Slow disbursement resulted from a very late start to the budget year due to the change in government, budgets due in November/December were only completed in March and a new budget system introduced in 2005 to improve transparency, accountability and efficiency introduced start-up problems.

- **2006 Initial Government Budget Proposal**

Continued fiscal consolidation. The 2006 government budget was prepared before the recent fuel price hike and substantially different macroeconomic assumptions and the final outcome will undoubtedly be very different. However, at the time the Government projected a deficit at 0.7 percent of GDP. Revenues are 18.0 percent of GDP, lower than the expected realization when compared to 19.6 percent in 2004, due to lower oil and gas prices and revenues. Non oil and gas tax revenues are ambitiously projected to rise to 12.6 percent, higher than the 11.9 percent in this year's revised budget proposal implying the government estimates that the impact of proposed new tax laws will be manageable or that there will be a significant improvement in tax administration. Due to lower a lower budget oil price, oil and gas revenues are projected at 3.9 percent of GDP, lower than 5.9 percent in the current 2005 budget (based on an estimated international oil price of US\$40 per bbl).

An additional Rp.10 trillion budgeted for Aceh and Nias rehabilitation and reconstruction. Total expenditures are budgeted at 18.7 percent of GDP, down by 1.9 percentage points from the current 2005 budget revision, again assuming lower oil prices and implicitly subsidies. The 2006 budget earmarks another Rp.9.6 trillion for Aceh and Nias rehabilitation and reconstruction. Financing is from different sources including grants (Rp.3.9 trillion), domestic revenues (Rp.3.6 trillion) and foreign project loans (Rp.2.2 trillion). Central government capital expenditures are budgeted at 1.5 percent of GDP (Rp.45 trillion), lower than the second revision to the 2005 budget (Rp.53.5 trillion, or 2.0 percent of GDP). With the international crude oil price assumed at US\$40/bbl, the fuel subsidy is projected at 2.3 percent of GDP (Rp.68.5 trillion) and again this does not take October fuel price hike into account.

Financing needs grow. Gross financing needs¹³ are projected to reach Rp.110 trillion (US\$12 billion) in 2006, substantially higher than the Rp.82.4 trillion (US\$9 billion) indicated in the latest budget proposal for 2005. In addition to the higher nominal budget deficit, there are higher foreign debt principal repayments as the Paris Club debt moratorium ends. The main financing sources include government bonds (domestic and foreign) at Rp.56.3 trillion, bank financing at Rp.19.6 trillion and foreign financing (program and project loans) of Rp.30 trillion.

A significant revision will be needed. The current budget proposal is based on macroeconomic assumptions that have been significantly revised (last column in table 3) and do not factor in the 100 percent plus increase in fuel prices. For example, inflation was revised to 8 percent from 7 percent in the proposal, exchange rates from Rp.9,400 to Rp.9,900, crude oil prices from US\$40/bbl to US\$57/bbl. These revisions plus the increase in domestic fuel prices would significantly affect revenue and expenditures including but not limited to oil and gas revenues, fuel subsidies, expenditures on capital and social spending, and transfers to the regions all of which would be expected to increase substantially.

Budget sensitivity analysis. A budget sensitivity exercise¹⁴ for 2006 based on the government proposal shows that

- (i) A 1 percent increase in real growth rate improves the budget balance by Rp.1.3 trillion (0.05 percent of GDP)
- (ii) A 1 percent increase in interest rates reduces the budget balance by Rp.2 trillion (0.07 percent of GDP)
- (iii) A Rp.100 depreciation in the Rupiah reduces the budget balance by Rp.0.7 trillion (0.02 percent of GDP)
- (iv) A US1/bbl increase in crude oil prices reduces the budget balance by -Rp.1.0 trillion (0.03 percent of GDP)¹⁵,
- (v) A 1 percent decline in oil production reduces the budget balance by Rp.1.6 trillion (0.05 percent of GDP).

¹³ Sum of the budget deficit, domestic debt principal repayment and foreign debt principal repayment.

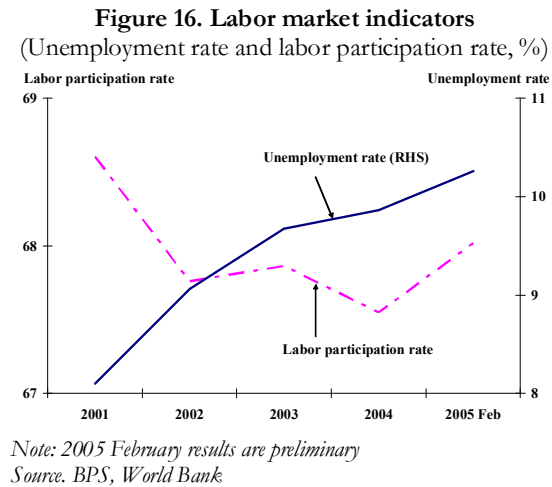
¹⁴ World Bank staff estimates

¹⁵ Due to the increase in domestic fuel prices in October this impact would certainly be reduced and probably reversed, i.e. the impact of a 1 dollar increase would be positive on the budget.

6. Social Sector

Unemployment continues to rise but there are signs of a possible employment recovery.

Preliminary results from the National Labor Force Survey show that the unemployment rate increased from 9.9 percent in August 2004 to 10.3 percent in February 2005. These levels of unemployment indicate that the current employment growth is significantly lagging the government projection in the 2006 Annual Work Plan (RKP) where the unemployment rate of 9.6 percent in 2005 is projected to decline to 6.7 percent by 2008. Of particular concern is youth (15 to 24) unemployment, which remains high at 28.7 percent, although marginally better than 29.6 percent in August 2004.



A possible indication that job prospects are improving is an increase in labor force participation, which rose by two and a half percent to 68.0 percent. (Figure 16). In addition, jobs appear to be shifting from the informal to the formal sector driven by gains in retail trade.

7. Banking Sector and NBFIs

• BANKING SECTOR

Policy measures by Bank Indonesia. In the first half, Bank Indonesia took steps to improve the viability of the banking sector and encourage consolidation. On July 1, 2005, Bank Indonesia announced the criteria for anchor banks i.e. a bank that can acquire other banks (June 2005). An anchor bank should be a High Performance Bank (HPB) which satisfies the following criteria among others: Minimum CAR (Capital Adequacy Ratio) is 12 percent, minimum ROA (Return on Asset) 1.5 percent; minimum loan growth 22 percent, LDR (Loan to Deposit Ratio) 50 percent and net NPL (Non-Performing Loan) below 5 percent. The bank should be listed or plan to list in the near future; and, have the capability to accept other merged banks. BI's deputy governor indicated that approximately 30 percent of 132 banks have the potential to be anchor banks. In addition Bank Indonesia issued a regulation requiring banks to increase their minimum capital to Rp.80 billion by end of 2007 and Rp.100 billion by end of 2010. Banks unable to achieve this level of minimum capital will be offered the option of merger or being acquired.

Blue print for the financial system architecture introduced. Another key step was the introduction of a Blue Print for the Financial System Architecture in April 2005. The blue print includes banks, non bank financial institutions (NBFIs) and the financial system infrastructure. Under this blueprint the government is taking initial steps to create an

integrated supervisory and regulatory agency for NBFIs by merging Bapepam and the Directorate General of Financial Institutions. Creating a unified financial institution will require improved coordination between Bank Indonesia and NBFi regulators.

Indonesian deposit insurance company (LPS) in place. Parliament and the government agreed to provide initial capital of Rp.4 trillion to the LPS to an LPS which was established October 3, 2005. With the establishment of LPS, the coverage of the deposit guarantee will be phased out according to the following schedule:

- September 27, 2005-March 21, 2006; only third party deposits covered, but no limit. [The current blanket guarantee includes inter-bank loans.]
- March 22, 2006- September 21, 2006: Maximum Rp.5 billion
- September 22, 2006- March 21, 2007: Maximum Rp.1 billion
- After March 22, 2007: Maximum Rp.100 million

Privatization in the Banking Sector. It is unlikely that the new government will make any aggressive moves to privatize banks this year. Till September 2005, PT Perusahaan Pengelola Asset (PT PPA), the government owned asset-management company, had divested equity in 4 ex-IBRA banks: 15.25 percent of Bank International Indonesia in January 2005, 5.22 percent of Bank Niaga in April 2005, 10.5 percent of Bank Danamon in August 2005 and 5.02 percent of Bank Central Asia in September. The government received Rp 6.3 trillion from the sale of these equity stakes. Later this year the PT PPA plans to sell equity stakes in BII (5.25 percent). In contrast, so far there is no indication on the government's plans to privatize state banks.

Key financial ratios as of June 2005 (Table 6). The capital base of the banking sector remains strong with a Capital Adequacy Ratio (CAR) at 19.5 percent. Financial intermediation continues to improve as the Loan to Deposit Ratio (LDR) increased 53.1 percent in June 2005. However, the Net Interest Margin (NIM) finally declined falling from 5.9 percent in December 2004 to 5.8 percent in June after increasing for three years. As deposit rates have begun to rise while lending rates are generally lagging the trend in funding side, banks margin started to lower. In particular, there have been some indications that increased competition had caused banks to start lowering lending rates to corporate borrowers, but this may be reversed in the face of recent interest rate hikes.

Table 6. Banking Sector Financial Indicator

	2001	2002	2003	2004			2005		
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	June
CAR	19.90%	22.40%	19.40%	23.50%	21.10%	20.80%	19.40%	21.80%	19.50%
NIM	3.60%	4.10%	4.60%	5.90%	5.80%	5.80%	5.90%	5.80%	5.75%
NPL(Gross)	12.20%	7.50%	6.80%	6.30%	6.20%	5.60%	4.50%	4.40%	7.00%
ROA	1.50%	2.00%	2.60%	2.70%	2.70%	3.00%	3.50%	3.40%	2.20%
ROE	13.90%	15.00%	21.40%	29.20%	27.60%	25.80%	23.00%	25.50%	19.07%
Op.Ex/Op.Inc	98.40%	94.80%	88.10%	90.40%	90.30%	83.60%	76.60%	81.20%	88.80%
LDR	33.00%	38.20%	43.50%	43.70%	46.40%	48.10%	50.00%	51.20%	53.10%

Source. Bank Indonesia, World Bank Staff

The quality of asset and bank profitability, indicated by Return on Asset (ROA) and Return on Equity (ROE), has fallen. Due to a Bank Indonesia regulation requiring stringent loan classifications, the Non Performing Loan (NPL) ratio of state banks, has increased from 5.9 percent in December 2004 to 13 percent in June 2005. The two large state banks: Bank Mandiri and Bank Negara Indonesia (BNI) experienced a significant increase in NPLs from 7.1 percent to 24.6 percent and from 4.6 percent to 12.98 percent respectively in this period.

Secondary Mortgage Facility (SMF). In February 2005, the government issued Presidential Decree No. 19/2005 creating a SMF. The SMF will ease the maturity mismatch in the banking system and provide further liquidity to underwrite mortgage loans. This is expected to assist the government's low cost housing efforts. The Parliament agreed to an initial capital of Rp.1 trillion in the revised 2005 state budget and the Government appointed the management of SMF in July 2005.

Management of State Banks changes. The Government changed the Board of Commissioners (BoC) and Board of Directors (BoD) at Bank Mandiri and Bank Rakyat Indonesia (BRI). The change in Bank Mandiri occurred after allegations of improper lending and losses. In fact after the appointment of the new BOC and BoD, former directors of Bank Mandiri were detained by the Attorney Office General.

• NON-BANK FINANCIAL INSTITUTIONS

Performance of Stock and Bond Markets (Table 7). Till July 2005 equity markets performed well. The JCI closed at 1,182, or 18 percent higher than its closing at the end of 2004. But the recent instability in the economy, in the form of rising interest rates, increasing oil prices and the depreciation of rupiah, have impacted the markets. In August 2005 JCI has declined sharply to below 1,000 before recovering in September and October due to the market reaction to the Government policy measures (1,105 on October 11, 2005).

In the secondary bond market, government bond trading dominates trading activity at the expense of corporate bond trading. With the economic uncertainty, this imbalance has grown. In August 2005 trading in government bonds was up 52 percent over December 2004, while corporate bond trading fell to 13.9 billion transactions from 17.3 billion for the same period.

Table 7. Equity and Bond Markets

Year	Jakarta Stock Exchange Trading				Surabaya Stock Exchange Trading			
	JCI	Vol	Value	Mkt Cap.	Corporate Bond		Government Bond	
Dec-02	425	171	120,763	268,423	Vol	Mkt Cap	Vol	Mkt Cap
Dec-03	692	234	125,438	460,366	6,092	21,520	130,787	397,967
Dec-04	1,000	412	247,007	679,949	14,244	45,390	314,059	390,482
Jun-05	1,122	232	243,924	765,810	17,347	58,791	512,989	399,304
Jul-05	1,182	267	266,581	805,449	11,639	61,390	317,574	404,985
Aug 05*	1,088	288	287,820	719,547	12,968	65,524	325,848	404,985
					13,923	64,049	330,098	404,985

*Up to August 19, 2005

All values in Rp.billion and volume in billion

Source. Bapepam

Master Repurchase Agreement (MRA) launched. In June 2005, the government created an MRA to serve as a benchmark for market participant’s repo transactions. With an MRA in hand, it is expected that participants and repo transaction will increase liquidity and lower the risk of government bonds.

Redemption of mutual funds continues. Fixed income investors reacted nervously to the rise in interest rates, resulting in massive redemptions equaling almost half of the net asset value of the mutual fund industry. The net asset value of the mutual fund industry reached Rp 113 trillion in February 2005 but by August 2005 redemptions had touched Rp 50 trillion. In part these redemptions reflect normal re-allocations due to rising interest rates but also reflect a misperception (on the part of both funds and purchasers) of mark to market rules and a growing nervousness on part of the investor community.

Insurance industry grows (Table 8). Total assets in the insurance sector increased by 25 percent to Rp.117 trillion in 2004. Total gross premium collected by the industry in 2004 grew 25 percent to Rp 29 trillion y-o-y. Although as of December 2004, the industry is dominated by few of the 167 insurance companies that exist. To enhance the growth in the sector, the industry and government are co-developing a blueprint for the insurance industry. “The Indonesian Insurance Blueprint” will be launched in 2006.

Table 8. Insurance Sector Development (Rp. Billion)

	1999	2000	2001	2002	2003	2004
Number of Registered Insurance	178	178	174	173	173	167
Total Asset	38,161	41,612	64,826	77,589	94,094	117,595
Increase	-	3,451	23,214	12,763	16,505	23,501
Total Investment	37,186	42,331	52,916	63,856	79,679	97,213
Increase	-	5,145	10,585	10,940	15,823	17,534

Source. Directorate of Insurance, DGF-I-MoF; Investor Magazine July 2005

Policy Developments

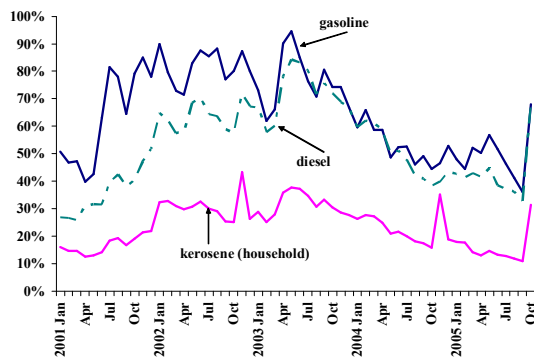
1. Fuel Price Increase and Compensation Programs

• Fuel Price Increase

Fuel Price Developments (Table 9).

Although by far the largest, the October price increase is one of many fuel price increases this year. In March 2005 fuel prices were increased by a weighted average of 29 percent. In July and August, fuel prices were raised to international levels for large industries accounting for 15-20 percent of total consumption. The October 1st increase was applied to the remaining highly subsidized categories of premium gasoline, diesel for transport, and kerosene for household use. Premium gasoline prices were increased by 88 percent to Rp.4,500. Household kerosene prices were increased by 186 percent to Rp.2,000. Automotive diesel prices were increased by 105 percent to Rp.4,300. As the price of Kerosene was not raised in March the cumulative impact of price increases this year are similar; kerosene (186 percent), gasoline (149 percent) and automotive diesel (161 percent).

Figure 17. Domestic Fuel Sales Price
(Percent of international Prices)



Source. World Bank staff calculation

Closer to International Prices. As a result of the price increases this year, domestic fuel prices are now significantly closer to international prices (Figure 17).¹⁶ With the latest increase and international oil prices in the mid-US\$60 range, premium gasoline prices are 68 percent of international prices up from 36 percent, household kerosene is 31 percent up from 11 percent, and automotive diesel is now 68 percent of the current international prices up from 33 percent.

Table 9. Price Developments of Regulated Fuel Products (Rupiah per liter)

	Jan 2003-Feb 2005			Mar-Sep 2005		Oct 2005-		
	Floor Price	Ceiling Price	Fixed Price 1/	Price	% change from Feb 05	Price	% change from Mar 05	% change from Feb 05
Gasoline	1,650	2,100	1,810	2,400	33%	4,500	88%	149%
Kerosene (Household)	700	700	700	700	0%	2,000	186%	186%
Automotive Diesel	1,650	2,100	1,650	2,100	27%	4,300	105%	161%

1/ Prices were fixed during the period

Source. Keppress No.90/ 2002, Keppress No.22/ 2005, Perpres No.55/ 2005, World Bank staff

¹⁶ International prices are calculated as MOPs (Mid Platts Singapore) by category (premium, automotive diesel, kerosene) +15 percent. The 15 percent reflects a transport/distribution margin. Domestic sales prices are reduced by taxes (10 percent VAT and 5 percent local tax for gasoline and diesel). The international price is multiplied by the rupiah exchange rate to give the equivalent price in rupiah.

Fuel Prices Linked to International Prices with Remaining Subsidies Phased Out. A new system for establishing domestic fuel prices is being put in place. According to Keppres No. 55/2005 in 2006 the remaining subsidy on domestic fuel prices will be phased out although no schedule is provided. Domestic prices will also be linked to international prices and will rise and fall as they do. The extent of fuel price changes will then depend on international prices and exchange rates.

Impact on State Budget, Inflation and Growth. The Government estimates that the October fuel price increase will reduce fuel subsidies by about Rp.25 trillion in 2005. Of this Rp.4.7 trillion is allocated to the cash transfer program. Subsidy reductions come from two sources. Directly through higher prices and indirectly as demand falls (through reduced smuggling and conservation, for example). Fuel makes up 3.1 percent of the Consumer Price Index and transport costs are another 4.6 percent. Assuming a doubling of fuel prices and 20 percent increase in transport costs, the October fuel price increase would add 4-6 percentage points to the rate of inflation over the next year. However, this estimate does not include the impact on other goods. Econometric evidence suggests that inflation may rise by 0.5 to 0.6 percent for every 10 percent increase in administered fuel prices, implying an overall impact of up to 6 percentage points on inflation. However, inflation forecasting is made difficult by 1) the fact that many fuel prices had already been increased, reducing the share of the prices increased on October 1, and 2) the fact that fuel shortages had become endemic forcing up prices as well, and 3) the magnitude of the increase reduces the value of marginal estimates from the econometric evidence. In any event most of the impact of higher fuel prices will be felt in the next few months. Given the size of the increase the immediate impact on growth is likely to be negative, although medium to longer-term impact will be positive as resources are reallocated to higher value uses. The challenge for the government is to reallocate resources quickly and efficiently to infrastructure and government services (including on poverty reduction) so that the transition is smooth and the economic shock minimized.

- **Cash Transfer Program**

Program Summary. To mitigate the impact of the fuel price hikes, the government launched a cash transfer program for 15.5 million poor and near-poor families. The cash transfer program covers over 60 million people, making it possibly the largest such program in the world.¹⁷ The cash transfer is intended to compensate these households for the income losses due to the direct and indirect impacts of price increases in fuel and of other commodities. Each beneficiary family is to receive Rp.300,000 on a quarterly basis. The total amount budgeted for the program in 2005 is estimated at Rp.4.7 trillion (or close to 20 trillion on an annual basis). Three key elements of the programs are (i) targeting, (ii) delivery and (iii) monitoring and oversight.

Targeting. BPS (Indonesia's Central Statistics Bureau) has undertaken a massive effort to develop a database for poor households. The database was developed by first interviewing village leaders and crosschecking other sources (e.g. from a previous poverty census in certain provinces) to develop a roster of potentially poor and near poor households. Second, a survey was undertaken of these households to ascertain key economic and social

¹⁷ For example, it is larger than the conditional cash transfer programs in Brazil and Mexico that cover on the order of 20 million people each.

characteristics. Third, poverty rankings were determined using a proxy means test that correlates observable household characteristics with household income. Fourth, the budgetary allocation for the cash transfer for each region is determined from previous household survey data, with household eligibility set by the household's score on the proxy means test.

Delivery Mechanism. Delivery of cash to eligible households throughout Indonesia, especially in isolated areas, is an enormous task. The distribution system is as follows:

- a) BPS produces and distributes the payment list to the payment agency (i.e. the Post Office- PT Pos);
- b) PT Pos prints beneficiary cards and receipt coupons. The cards identify the eligible households. Then, PT Pos gives the cards and coupons to BPS to distribute to beneficiaries.
- c) BPS, local activists and village leaders distribute cards and vouchers to beneficiary households, verifying that the right household gets the cards and vouchers;
- d) On designated days for a particular area, beneficiaries visit the local PT Pos to collect their funds. (Where PT Pos is inaccessible, the Government will set up temporary cash distribution points). The funds are channeled through the Government to PT Pos through accounts set up at BRI for each PT Pos especially for this purpose.

Monitoring and Oversight. An effective monitoring and evaluation system is critical to proper functioning of this effort. Effective communication on procedures and audits is needed, along with the support of NGOs, press, activists and universities to monitor outcomes. Key elements that need to be monitored and supervised are (i) appropriate targeting of households (ii) appropriate distribution of funds as planned; (iii) did the beneficiaries receive the correct amount of funds and; (iv) did the program successfully assist the intended group of poor and near poor. Assessing the targeting, delivery and impact of such a program is critical to its future sustainability and effectiveness.

- **An Incentive Package**

The government announced a series of incentives to further reduce the impact of the fuel price hike on the poor, farmers, workers, businesses and transportation costs. The details are still unclear but the package is grouped into fiscal, trade and transportation measures. Regrouping by target groups selected items include:

Workers, farmers and consumers. The threshold for withholding and paying income taxes was raised by 10 percent, the floor price of rice raised, and specific tariffs on sugar reduced.

Business. Tariffs on capital goods are eliminated, agriculture products made free of VAT, planned additional fees on exports and imports delayed, and handling charges reduced. There will be improved access to the green line for producer importers, while general importers of labor-intensive goods like garments, shoes and electronics will be subject to additional customs procedures.

Transport. High transport costs are addressed by reducing or eliminating tariffs on public transport vehicles and spare parts, eliminating local regulations (Perdas) that raise the costs of local transport and cutting the number of weigh stations in half (from 127 to 64).

2. August Budget Speech

The president delivered the budget speech on August 16 to the plenary session of DPR (House of Representatives).¹⁸ In the statement, the president emphasized some key areas of the reform agenda:

Corruption Eradication: The National Movement for Corruption Eradication launched in December 2004 was followed up by Presidential Instruction No.5/2004 designed to accelerate corruption eradication. Among other measures, government officials are required to sign pledges declaring their wealth. In May 2005 the President set up a multi-functional team, staffed with prosecutors, police officials and state auditors to implement this agenda. The team will coordinate with the KPK (Corruption Eradication Commission), the body responsible for investigating corruption cases. By mid-August the KPK had handled 25 cases and lawsuits, a number of them involving high-profile individuals.

Cooperation with major trading partners: Indonesia and China signed a MOU in late July which aims to increase investment from China by US\$20 billion in 3 years. Indonesia also signed an Economic Partnership Agreement (EPA) and Strategic Investment Action Plan (SIAP) with Japan in June that was also designed to increase economic cooperation between the two countries.

Fuel subsidy and compensation: A government exercise indicated that the fuel subsidy in 2005 could reach Rp.140 trillion if the oil prices continued at the same level until end-2005 and there was no increase in domestic prices. This was Rp 60 trillion higher than the 2005 Budget revision. The current fuel subsidy policy was characterized by the President as ‘missing the target and unjust’, anticipating the government price hike in October 2005. The President also anticipated the direct “cash” subsidy policy that was to be put in place after accurate data on the poor was made available (again put in place in October).

Tax and custom reforms: The government sent amended tax laws to Parliament and indicated that they should be enacted in time to be in force in 2006. The amendments will include the following features; increase the income-tax thresholds and reduce the highest marginal rates. The government presentation focused on the goal of the amended law to simplify personal and corporate income tax tariffs and change administrative procedures to ease matters for taxpayers. In order to increase the quality and reduce time and costs for ‘compliant importers’, customs will increase the access to the priority track.

¹⁸ State Address of the President of the Republic of Indonesia and the Government Statement on the Bill on the State Budget for the 2006 Fiscal Year and its Financial Note

3. The 2006 RKP (the Government's Annual World Plan)

Seven priority areas: The government indicated that it had chosen 7 priority areas for 2006 and that it would set quantitative targets and policy direction for each. The areas are:

- (i) Alleviation of poverty and disparity:
- (ii) Enhancement of job opportunities, investment and exports:
- (iii) Revitalization of agriculture and rural areas:
- (iv) Enhancement of accessibility and quality of education and health:
- (v) Law enforcement, eradication of corruption and bureaucracy reform:
- (vi) Strengthening defense capacity, security and order and conflict resolution:
- (vii) Rehabilitation and reconstruction of Aceh and Nias.

These priorities are then divided by policy, program, activities and institutions responsible. The State Development Agency and line ministries indicate that they will focus on improved consistency between these priorities and budgeted projects in 2006.

4. Selected Progress in Economic Policy Reforms

Improving the investment climate. The government reaffirmed its commitment to improving the investment climate to accelerate economic momentum. In particular the Government updated the Investment Climate CGI Working Group in late June and again in September 2005 emphasizing the following:

- **Regulatory framework:** Government Regulations on electricity, toll roads, water, land acquisition and an Infrastructure Coordinating Committee (KKPPI) were issued, and the revision to Government Regulation No.7/1998 on private sector participation in infrastructure is near completion.
- **Draft Investment Law:** The government continues to work on a draft Investment Law with the following provisions:
 - **Unified national law:** There will be a single new law for foreign and domestic investors replacing Law No.1/1967 and Law 6/1968 on Foreign and Domestic Investment respectively;
 - **Market oriented principles:** The draft law removes forced divestment, and moves away from a controlled investment approval regime to a simple registration paradigm, thereby streamlining business start-up procedures.
 - **Equal treatment of all investors:** The draft law provides "equal national treatment to all investors, regardless of their country of origin," and allows for investment facilities including tax and non-tax incentives.
 - **Protection against expropriation:** The draft law forbids nationalization or expropriation "unless in the interests of the nation or the wider community." If such an action is taken, "full market value compensation" is to be swiftly paid.
 - **Repatriation of capital:** The draft law establishes the freedom to sell assets to parties of choice. It also provides the right to transfer capital, profit, royalties, interest, dividends, and other types of expenses.

- **"Short and clear" negative list:** Rather than specifying which sectors are open to investment (thus requiring Parliamentary approval for subsequent changes), the law indicates that these will be spelled out in a separate regulation.
 - **Dispute resolution:** In the event of a dispute, the draft law permits the resolution of differences through an arbitration institution.
 - **Use of foreign expertise:** Investors will have to prioritize Indonesian employees, but can utilize foreign experts in specified positions and with necessary skills according to prevailing laws and regulations.
- **Challenges ahead.** Despite progress on improving the investment climate and the rapid increase in investment, a study by LPEM (University of Indonesia) with World Bank funding shows room for improvement. Key findings include:
 - **A "Discretionary and nontransparent" foreign investment approval process:** BKPM takes on average seven weeks to approve a foreign investment, and rejected the average investor's application twice prior to final submission. BKPM approval time ranged from five days to nine months. However, the 50 notaries who responded to the survey reported that it takes on average only 80 days to establish and register a limited liability company, much less than the 151-day figure cited in the World Bank's "Doing Business in 2005" report but still above regional means.
 - **Widespread customs corruption and slow customs clearance times:** 82 percent of survey respondents reported making informal payments to customs; about half reported doing so "frequently." Informal payments amounted to an average of 2.3 percent of import value. It takes on average six days to clear imports shipments into Indonesia (as compared to two days in the U.S. and Germany and three days in Japan).
 - **Burdensome tax regulations and corruption among tax officials:** 57 percent of survey respondents reported that they made informal payments to tax officials and negotiated to obtain VAT refunds. It takes on average five months to receive a VAT refund, and the net amount refunded is only 87 percent of the claim. Businesses must file seven different tax returns each month requiring an average of 45 person-days to prepare.
 - **Excessive bureaucracy:** Survey respondents indicated they received an average of 28 visits a year by officials from all levels of government, 12 of which are from the police or military.
 - **Decreasing levels of bribery and other improvements:** On a positive note the survey indicated that bribes to government officials as a share of production costs dropped from 10.8 percent in a 2001 survey to 6.4 percent in the current survey. The percent of senior management time spent dealing with government officials also dropped from 12.8 percent in the 2001 survey to 4.9 percent in the current survey.

Tax laws revisions. The government submitted amendments in the following tax laws to the State Secretariat in August. (i) General taxation rules and procedures, (ii) income taxes, and (iii) value added and luxury taxes. The purpose of the amendments is to improve legal certainty and broaden the tax base. This will be achieved by

- Simplifying rate structures;
- Improving tax administration and service delivery;
- Speeding up tax refunds;

- Giving wider access to data and information by DG Tax, with appropriate safeguards in place;
 - Imposing stiffer sanctions on delinquent tax payers or those who have not registered.
- **Simplifying tax rates.** The maximum rate for personal income tax will be reduced by 2 percentage points to 33 percent in 2007 and 30 percent in 2010. In addition the individual income threshold will be raised from Rp.2.88 trillion to Rp.12 trillion.¹⁹ There will be a single corporate income tax rate at 30 percent in 2006 which will be reduced to 28 percent in 2007 and 25 percent in 2010.
 - **VAT refund:** Significant delays in value added tax (VAT) refunds continue to be an ongoing constraint to investment. According to the draft proposal, companies with a good tax record (defined as compliant tax payers), will be able to claim refunds in one month, although it will continue to take 12 months for other tax payers. The exact criterion for compliant tax payers is still to be decided.
 - **Higher taxes for those without taxpayer registration numbers (NPWP).** In order to broaden the tax base, income taxes for non-NPWP holders, an identification number, will be raised by 20-100 percent. According to DG Tax data, in 2004, the number of individual tax papers was 2.6 million and institutional taxpayers were 1.0 million.²⁰
 - **Challenges ahead.** The initial reaction to the draft amendments by the business community is mixed and there are concerns about its revenue neutrality and the potential introduction of a Tax Amnesty. In particular the business community is concerned that these tax proposals increase the power of the tax authority without addressing concerns of tax payers about the abuse of tax assessment, audit and collection procedures. Without supporting administrative reforms, these amendments could end up hurting the investment climate and threaten fiscal sustainability.

¹⁹ For workers at or below the minimum wage the government had agreed to pick up taxes beginning in 2004. This higher rate will now apply to all workers.

²⁰ <http://www.pajak.go.id> – However, given that companies continue to report and pay most workers on a single tax payer number the number of taxpayers is significantly underestimated.

Outlook

1. Growth expected to slow in second half:

The growth rate in the first half of 2005 was 5.9 percent (yoy) well above the Bank's earlier projection of 5.5 percent growth for calendar year 2005. However, there are reasons to believe that growth will slow in the second half and the Bank projects 5.4 percent for the second half of 2005 and 5.7 percent for the year as a whole (Table 9).

Table 9. Indicative Growth Rate Projection
(year-on-year growth rate, percent)

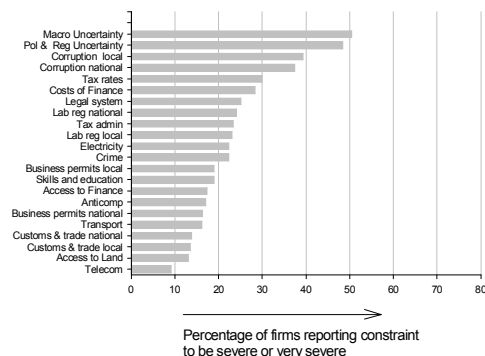
	05 H1 Actual	05 H2 Proj.	2005 Proj.	2006 Proj.
Agriculture	0.3	2.5	1.4	2.0-3.0
Industry	5.2	5.0	5.1	5.0-5.5
Services	8.8	7.0	7.9	7.0-7.5
GDP	5.9	5.4	5.7	5.5-6.0

Source: BPS, World Bank staff estimates

Factors adversely affecting Indonesia's growth in 2005.

- Exchange rate depreciation.** The exchange rate depreciation has had a mixed impact on the economy but the fluctuations raised concerns that have played into domestic interest rates which will affect investment. The currency depreciation reflects a correction to the rapid reversal of the current account (high imports and growth in the tradable sector), it adds to export competitiveness and protects domestic manufactures from imports. However, when currency depreciation is excessively volatile, it raises inflation expectations, reduces policy credibility and raises interest rates.
- Electricity, fuel and gas shortages and supply stability.** Shortages have impacted economic activity and fostered negative perceptions about government policy making. A primary cause of the fuel shortage has been late subsidy payments by the Ministry of Finance to PT. Pertamina, Indonesia's state oil company that have affected Pertamina cash flow and resulted in shortages in July. Electricity shortages are also evident in Java where there was a major electricity outage for in mid-August. Since August this year, PGN (the main gas distributor) has been limiting the supplies of natural gas to manufacturing companies in East Java.
- Macroeconomic stability.** Macroeconomic stability is the most important concern of investors (Figure 18). In particular they indicate that macroeconomic factors include (i) a low inflation rate, (ii) a realistic exchange rate, (iii) sufficient foreign reserves, (iv) an appropriate budget balance and (v) reduced debt. Although these assessments are subjective (and difficult to interpret) recent trends are worrisome. If macroeconomic uncertainties continue investors will delay or cancel investments.

Figure 18. Firms' perception of constraints



Source: World Bank (2005)

- Oil prices.** Higher international oil prices have two impacts, the direct impact from higher prices on the economy and an indirect impact from the external sector. Recent balance of payments data suggest that Indonesia is marginally a net exporter of oil and

gas. Accordingly, higher oil and gas prices generate a positive terms of trade impact on the economy, although small. In contrast, if world trade volume shrinks by 1 percent, it is estimated that Indonesia's growth could fall by 0.4 percentage points (please see 'global economy' below).²¹

- **Fuel prices.** Higher domestic fuel prices are likely to have negative impacts on industry. In the past major fuel product prices were immune to changes in international prices since domestic fuel prices were controlled. However, since July 2005, Pertamina has been charging industry users market prices. The contribution of fuel, electricity and gas costs in the total manufacturing costs is high for industries such as textiles (11.3 percent), motor vehicles (10 percent) and non-metallic minerals (35 percent). Profitability and long-term competitiveness in these industries will depend on the ability to pass on higher costs to consumers, although it should be noted that many other countries and competitors already pay world prices plus taxes for fuel.
- **Fiscal policy.** Slow government spending is likely to have a negative impact on the economy. For example, the national accounts indicate that government spending fell for the fourth straight quarter. It fell by 5.6 percent (yoy) in Q2 2005. While we expect some catch up in the third and fourth quarter, lower than expected expenditures would affect growth prospects especially if disproportionately capital and infrastructure spending.
- **Global economy.** External macroeconomic conditions are not expected to be as supportive as estimated earlier. According to the latest global economic outlook of the World Bank (April 2005), world trade volume projections have been reduced from 8.4 percent in November 2004 to 7.5 percent in April. The world growth rate was also revised down from 3.2 percent to 3.1 percent. As international crude oil prices continue to rise, prospects for the global growth may be revised downwards again.

2. Fiscal Policy

Fiscal policy should be consistent with national priorities. The role of fiscal policy has been changing from 'macroeconomic stability through fiscal consolidation' to 'support for higher quality growth'. In order to make this happen, fiscal consolidation must be balanced with an increase in investment in key infrastructure and social sectors, such as health and education. There are 3 key considerations.

- **Improved Spending.** Reallocating the resources from fuel subsidies to much-needed infrastructure and social spending will improve growth prospects and reduce poverty. Addressing this problem will require: (i) a medium-term fuel pricing strategy (including reinstating the automatic link to market prices), (ii) designing and implementing programs that reallocate the dividend from reduced untargeted subsidies to programs

²¹ A US\$10/bbl increase in oil prices would negatively affect global economic growth by 0.5 percentage points in the following year (Global Economic Prospects 2005, p.13, World Bank). Also, please refer to footnote 3 on the change in world trade volume growth projections.

that deliver effective government infrastructure and social services, and (iii) special programs designed to deliver services or direct transfers to the poor. All of this will only prove effective if adequate monitoring and evaluation systems are put in place.

- **Revenues and financing.** Stemming the decline in oil production, increasing non-oil and gas tax revenues, and establishing long term and low-cost financing options are critical priorities. Non-oil and gas domestic tax revenues, as a share of GDP increased from 9.8 percent in 2002 to 10.4 percent in 2003 and 10.9 percent in 2004. Clearly, government efforts to improve and modernize tax administration appear to be successful but need to be intensified. With the end of the Paris Club and IBRA (now PPA) sales the contribution from debt relief and non-debt asset sales (privatization) have declined, with the exception of the one-off debt rescheduling in 2005 due to the Tsunami. As Indonesia's reliance on domestic and international debt financing increases, it is important that policy makers have a clear debt management strategy that balances foreign exchange, roll-over and interest rate risks and continues to prioritize low-cost, long-maturity concessional loans. The Government borrowing and debt management presentation to Parliament in September represents a good move in this direction.
- **Better budget execution.** The government needs to improve budget implementation. A new budget management system was introduced and major re-organization of the Finance Ministry took place this year. But preliminary data for the year shows that there are teething problems that need to be rectified. In the first semester just 6-7 percent of the annual budget was spent. As a result, the real government expenditures declined by 5.6 percent (yoy) in Q2. Improving the budget process, requires better program design as the government moves toward performance based budgets and a Medium Term Expenditure Framework.

Medium-term picture. Despite recent economic difficulties, the Bank foresees an improvement in the fiscal situation especially in the aftermath of fuel prices increases. In view of the slow disbursement the 2005 budget deficit will likely be less than 1 percent in 2005.²² As per our baseline scenario, growth will be 5.7 percent this year, 5.5-6.0 percent in 2006 and 6.5-7.0 percent for 2007-2010. The government debt to GDP ratio will decline from 54 percent in 2004 to 27 percent in 2010. With a continued reduction in fuel subsidies, capital and social expenditures will roughly double from 2.5 percent in 2005 (budget) over the next few years.²³ Non-oil and gas tax revenues are projected to increase from 11.7 percent in 2004 to 13 percent in 2010 (0.2 percent of GDP annually). This ratio is expected to rise, despite reductions in marginal tax rates, as the changing economic structure (modern retailing, recovery in the tradable sector, etc.), and as well as tax reform and tax modernization improve overall collection. If not, additional tax measures may need to be taken.

²² Assuming disbursement of capital expenditures at 80 percent.

²³ This assumes fuel subsidy is zero in 2008

Appendix: Oil Prices and the Indonesian Economy²⁴

Summary. There is widespread market concern about the government's inadequate management of the challenges facing Indonesia's energy sector. High global oil prices, declining domestic oil and gas production and high fuel subsidies are expected to impact macroeconomic stability and hamper growth.

Indonesia has significant energy resources and is a net exporter of oil and gas. However, it has been registering a deficit in the oil balance since 2003 and the positive impact of higher oil prices on the economy has been declining. The country's production and consumption of oil and gas is declining, leading to concerns that high oil prices have a negative impact on the economy. Oil production declined to a low of 1.0 million barrels a day from a high of 1.4 million barrels in 1991. This decline is due to under-investment in exploration and refining capacity since the financial crisis in 1996.

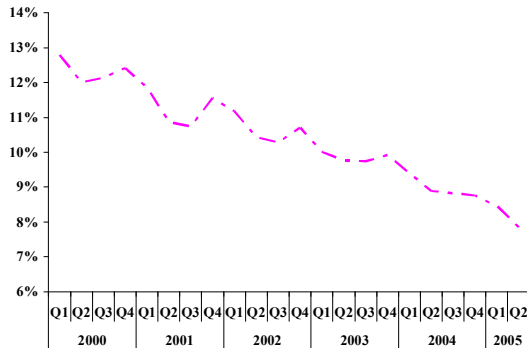
Meanwhile consumption levels have risen rapidly reaching 1.2 million barrels a day spurred by faster economic growth and subsidized prices. Gasoline, before the October price increase, was approximately US\$0.24 a liter, among the cheapest in the world. However, the low price encouraged wasteful consumption and a lack of investment in conservation. Fuel subsidies were and are a drain on the national budget, utilizing resources that are better spent on other priorities, such as infrastructure, health and education. The cost of fuel subsidies in 2005 might have reached US\$14 billion, or roughly a third of central government total expenditures without the October price increase.

The government has taken steps towards addressing the fuel subsidy issue. Fuel prices to consumers were increased in March and again in October. Since July large industries are being charged a market rate for fuel. The government indicates that it intends to continue to increase retail gasoline and diesel prices until they are on par with international prices.

Oil and Gas Sector in the Economy. The importance of the oil and gas sector in the economy, measured by its contribution to GDP, has declined in the past 10 years, and rapidly after the crisis. The share of this sector declined from 13 percent in 2000 to 8 percent in the first half of 2005 (Figure 19). The growth rate of the oil and gas sector has been negative for 11 straight quarters and the gap between oil and gas and the non-oil and gas sector has been widening. For example, in the first half of 2005, non-oil and gas sector grew by 7.0 percent, while oil and gas sector declined by 5.6 percent (Figure 20).

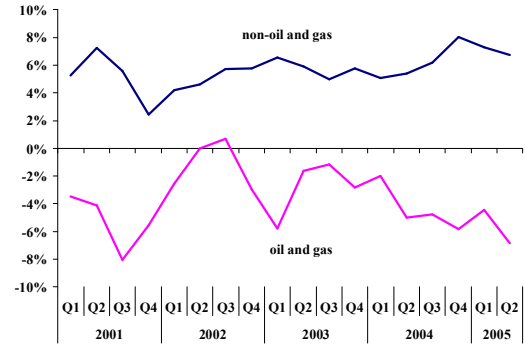
²⁴ Please see detailed discussion on fuel subsidy in Policy Development

Figure 19. Declining share of the oil and gas sector
(share in total constant GDP, percent)



Source. BPS, World Bank staff

Figure 20. Widening growth rates gap
(year-on-year growth rates, percent)

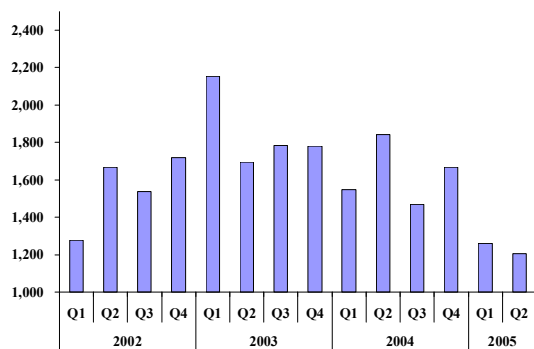


Source. BPS, World Bank staff

Balance of Payments. The Q2 2005 oil and gas balance of payments position was still positive at net US\$0.3 billion. The quarterly oil and gas trade balance shrank from US\$2.2 billion in the first quarter of 2003 to US \$1.2 billion in Q2 2005 (Figure 21). While the negative oil balance was getting wider, the positive gas balance was also growing. The oil balance was -US\$2.1 billion in 2002 and -US\$5.2 billion in 2004, and is already -US\$4.0 billion in the first half of 2005. In contrast, the positive gas balance increased from US\$3.6 billion in 2002 to US\$6.4 billion in 2004, and is now at US \$ 3.9 billion in the first half of 2005. Despite of recent higher prices, oil and gas export volumes have been stagnant. Oil export volumes (sum of crude and refinery products) declined from 389 million barrels in 1994 to 234 million barrels in 2004 and declined again in the first half of 2005 (Figure 22).

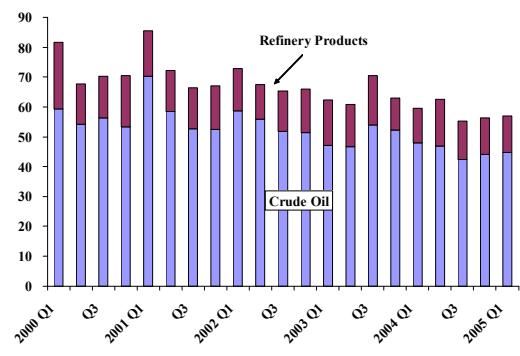
The impact of an oil price change on balance of payments is still marginally positive,²⁵ since the positive effect on gas neutralizes a deteriorating oil balance. A US\$1/bbl increase in oil prices positively affects trade balance by US\$11 million on an annual basis.²⁶ While the gas balance would improve by US\$174 million, the oil balance would deteriorate by US\$ 163 million.

Figure 21. Shrinking oil and gas trade surplus
(US\$ million)



Source. Bank Indonesia, World Bank staff

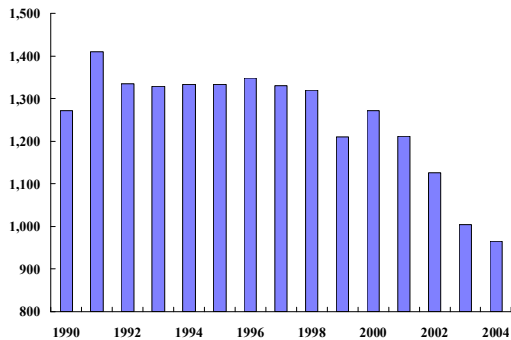
Figure 22. Exports decline
(oil exports volume, million barrels)



Source. BPS, World Bank staff

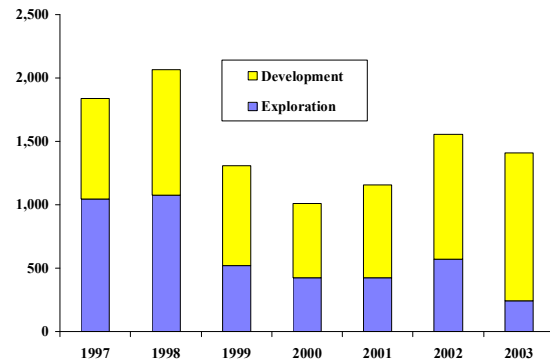
²⁵ The calculation is based on preliminary Q2 2005 result.

Figure 23. Oil Production declined
(daily production, million barrel a day)



Source. CEIC, World Bank staff

Figure 24. Sluggish investment
(million US\$)

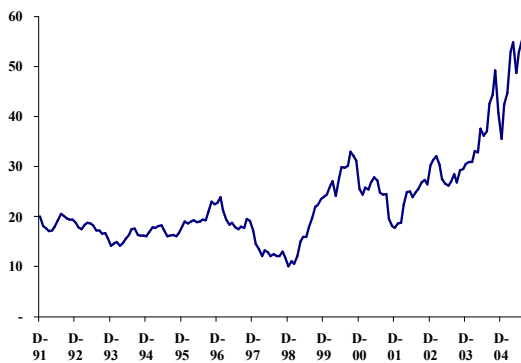


Source. BPS, World Bank staff

Production and Investment. Due to lack of investment post crisis daily crude oil production shrank from 1.4 million barrels a day in 1991 and above 1.3 million barrels a day before the crisis, to 0.97 million barrels a day in 2004 (Figure 23). Gas production, natural gas and LNG production were stable, but LPG production declined significantly in recent years. The investment by oil and gas companies (sum of exploration and development expenditures) fell from over US\$2 billion in 1998 to US\$1 billion in 2000 (Figure 24). Though investment increased in 2001-2003, expenditure on exploration in 2003 was still one-fourth of pre-crisis period.

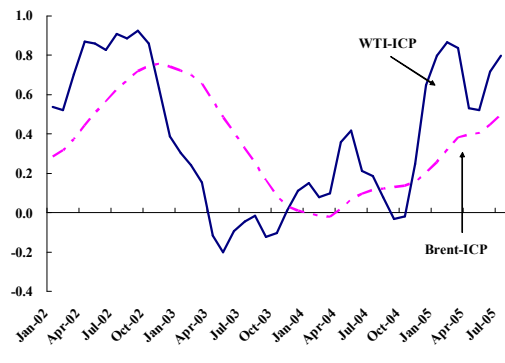
Price Developments. Indonesia's crude oil price (ICP) increased to US\$61/bbl in August and may have risen in September given international oil markets. The current prices are 3 times the price in the 1990s (Figure 25). Despite the sharp increase in ICP price, there is a widening price gap from 2 sources that negatively affect Indonesia. One is the price gap between Indonesia's crude exports (ICP) and international crude prices (WTI and Brent). The other gap is between crude oil prices and fuel product prices (e.g. gasoline). The price gap between ICP and international benchmark prices is US\$0.4-0.8/bbl (Figure 26). In

Figure 25. high oil prices
(US\$/barrel)



Source. CEIC

Figure 26. Lowering ICP prices
(price gap between int'l oil prices and ICP, US\$/bbl)



Source. CEIC, World Bank staff

²⁶ The positive impact is much smaller than the previous exercises, since the positive oil and gas balance has

particular, as Indonesia exports and imports crude oil and fuel products these changing terms of trade have negatively affected the trade balance. For example, the difference between gasoline prices and crude oil prices was below US\$20/bbl in early 2003. However, as world refinery capacity came under pressure, the price gap rose and now exceeds US\$25/bbl. As Indonesia imports fuel products and exports crude (and even imports relatively more expensive crude for its refineries) these differentials have negatively affected the oil and fuel trade balance.

been shrinking.