

INDONESIA

Economic and Social Update

I. Aceh

Total estimated tsunami damage is US\$4.5 billion. Sadly, 2004 will be remembered for the tragic tsunami that claimed at least 200 thousand lives in Aceh, and left more than 400 thousand homeless. The total estimated financial impact, measured at replacement cost, is Rp.41.4 trillion (US\$4.5 billion), equivalent to 2.2 percent of national GDP or 97 percent of Aceh's GDP (Table 1). Damages –the impact on assets- are estimated at US\$2.9 billion and losses –the impact on future cash flows- are estimated at US\$1.5 billion. Among sectors, housing losses account for US\$1.5 billion, 32 percent of total damage followed by transportation US\$0.5 billion (12 percent) and fishery US\$0.5 billion (11 percent). The direct impact of the tsunami is estimated to lower the national GDP growth rate by 0.1-0.4 percentage points in 2005. However the final impact would depend on offsetting impact of reconstruction activities. Assuming that Indonesia receives US\$2 billion in additional assistance, the net impact would be a positive 0.3-0.5 percent¹. Accordingly, the net impact of the tsunami would be close to zero.

Table 1. Damage and Loss Assessments
(US\$ billion)

	Damage	Losses	Total
Housing	1.4	0.0	1.4
Transportation	0.4	0.1	0.5
Fisheries	0.1	0.4	0.5
Others	1.0	1.0	2.1
Total Impact	2.9	1.5	4.5

Source. Indonesia: Preliminary Damage and Loss

Strong international commitment. The tsunami summit held in Jakarta on January 6th, 2005 was a strong signal of the commitment of the international community to assist affected countries. At the following CGI (Consultative Group on Indonesia) at the end of January, the donors pledged US\$1.6 billion in additional assistance to Aceh related activities for 2005². Additional private sources (NGOs, corporate and private contributions) have also pledged significant assistance again reflecting the unprecedented response to the tragedy.

Nevertheless, challenges remain. A draft needs assessment has just been published (March 26, 2005). The government has begun a process of consultation with the people of Aceh. The document is the result of working groups, spatial, infrastructure, local government, financing, etc. that were set up in both Jakarta and Banda Aceh. Key issues for

¹ This assumes half of assistance is offset by imports.

² World Bank staff calculation. Total assistance of US\$1.6 billion consists of US\$0.9 billion through the central government state budget and US\$0.7 billion through other channels (e.g. NGOs, technical assistance).

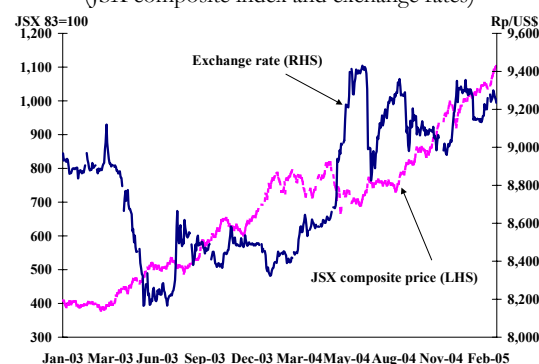
consideration have included (i) the establishment of an implementing agency in Banda Aceh (capital of Aceh province) with clear roles and responsibilities for reconstruction vis-à-vis national and regional governments, (ii) donor coordination, especially NGOs, in light of the large sums involved, and (iii) reestablishing land tenure and (iv) the amounts and delivery mechanisms for housing compensation and other support.

II. Macroeconomic and Social Overview

1. Markets

Markets are supportive. Despite the tragic tsunami, market sentiment has been strong. The Jakarta stock exchange composite index (1983=100) has been trading above 1,000 in 2005 up by 33 percent since end of October. Even after the announcement of fuel price hikes on February 28th, the composite index increased by more than 1 percent. Exchange rates remained in the Rp.9,000-9,400 range against the US dollar for last few months (Figure 1).

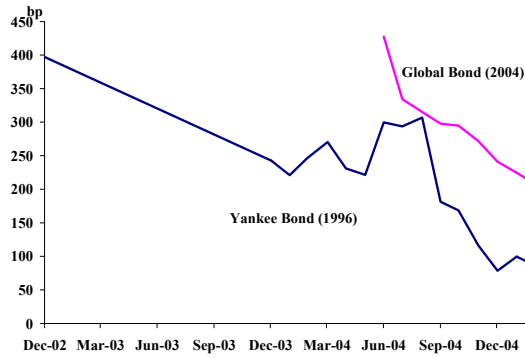
Figure 1. Stock prices are historic high
(JSX composite index and exchange rates)



Source. CEIC

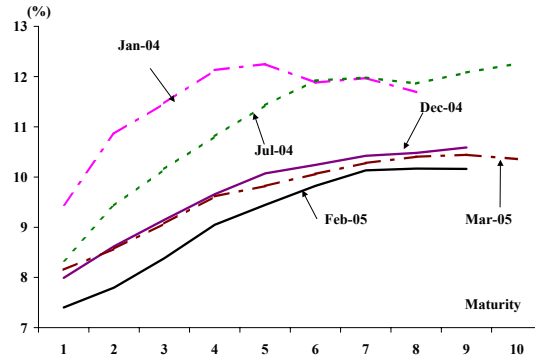
Positive market sentiment is also reflected in improving international and domestic risk premiums. The international risk premium measured by the yield spread over US treasury bonds improved since 2003 (Figure 2). The government interest rates on domestic bonds declined substantially and the yield curve flattened reflecting improving perceptions on economic policy and implementation by the new government (Figure 3). For example, between January and December 2004, the 1 year government bond yield declined from 9.5 percent to 8.0 percent, while the 8-year government bond yield declined from 11.7 percent to 10.5 percent. The flattening of the yield curve is especially positive as it reflects an improvement in long-term risk assessment by investors and reduces financing costs. In response international rating agencies have raised credit ratings. Fitch raised the rating from B+ to BB- in January 2005, and S&P raised it from B to B+ in December 2004, though ratings remain 3-4 notches below the investment grade.

Figure 2. International risk premium is falling
(yield spread over US treasury, basis points)



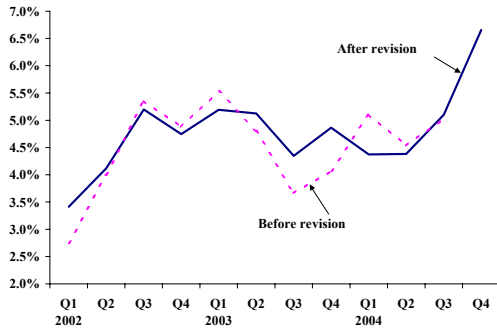
Source. Bank Indonesia, World Bank staff

Figure 3...and so is its domestic risk premium
(government bond yield curve percent)



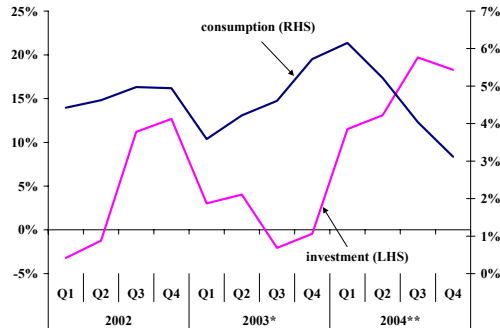
Source. CEIC, World Bank staff

Figure 4. Growth acceleration
(real GDP growth, year-on-year, percent)



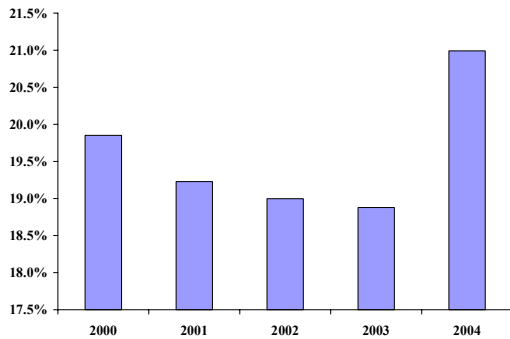
Source. BPS, World Bank staff calculation

Figure 5. A source of growth shift
(year-on-year growth rate, percent)



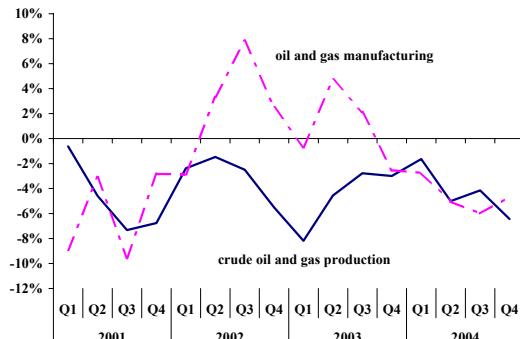
Source. BPS, World Bank staff calculation

Figure 6. Investment recovery
(investment to GDP ratio, nominal, percent)



Source. BPS, staff calculation

Figure 7. Weak oil and gas sector
(year-on-year growth rate)



Source. BPS, staff calculation

2. National Accounts

Growth acceleration. During Q4 2004, the economy grew by 6.7 percent on a year-on-year basis, the highest growth since the crisis, Q1 1997 (7.5 percent) (Figure 4). With this, the 2004 annual growth rate reached 5.1 percent, the highest growth rate since 1996 (7.8 percent) exceeding the government projection of 4.8 percent in the revised state budget. The 2002 and 2003 growth rates were revised upward from 4.3 percent to 4.4 percent and from 4.5 percent to 4.9 percent, respectively. In these years investment was revised slightly downward but net exports were sharply revised upward.

From consumption to investment. In 2004, the source of growth shifted from consumption to investment especially by end year (Figure 5). Investment (i.e. gross fixed capital formation) grew by 18.3 percent (yoy) in Q4. Although the import of capital goods rose, in part due to technical factors³, two other investment components (construction and domestic capital good production) also increased sharply. The investment to GDP ratio –widely used indicator of investment- increased to 21 percent in 2004, up by 2 percentage points from 2003 (Figure 6). In contrast, consumption growth decelerated to 3.1 percent in Q4, the lowest growth since Q2 2001 at 2.9 percent. Private consumption growth decelerated to 3.8 percent in Q4 from 5.0 percent in Q3. Government consumption (including central and regional) fell by 1.3 percent, negative for 2 straight quarters.

Manufacturing recovery. The flipside of the investment recovery is the acceleration in manufacturing growth. Manufacturing grew by 7.2 percent in Q4 2004, the highest growth since Q4 1999. Among industries, transportation equipment, machinery and others (including electrical products) grew by 17.4 percent based on strong car and motorbike, and electrical product sales. In contrast, oil and gas manufacturing declined by 4.6 percent, now negative for 5 straight quarters (Figure 7). Crude oil and gas production (the mining sector) also declined, falling by 6.4 percent in Q4, and is now negative for more than 4 years. This weak performance in the oil and gas sector reflects the lack of investment since the crisis.

Non-tradable sectors lead the economy. While manufacturing growth, especially non-oil and gas manufacturing was high, other tradable sectors were relatively weak. Thus non-tradable sectors played a major role in growth acceleration. In 2004, the economic growth rate was 5.1 percent. Tradable sectors grew by 3.5 percent, while non-tradable sectors grew by 7.1 percent (Table 2). Agriculture grew by 4.1 percent pulled down by a disappointing performance in Q4 and mining declined by 4.6 percent due to crude oil and gas production. In contrast,

most non-tradable sectors were strong. For example, transportation and communication grew by 12.7 percent.

Table 2. Sector Growth Rate
(2000 base year, year-on-year growth rate)

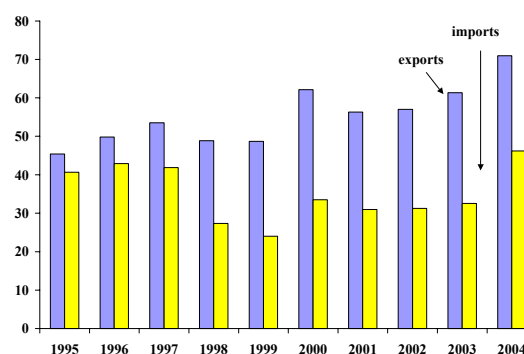
	Q3 04	Q4 04	2004
Tradable	3.0%	5.0%	3.5%
Agriculture,	5.3%	1.9%	4.1%
Mining & Quarrying	-5.0%	3.3%	-4.6%
Manufacturing Industries	4.8%	7.2%	6.2%
Non-Tradable	7.6%	8.5%	7.1%
Construction	8.2%	8.3%	8.2%
Financial, Ownership & Business Services (FOB)	8.3%	8.4%	7.7%
Transport & Communication	13.5%	11.5%	12.7%
Electricity, Gas & Water			
Supply	3.1%	7.9%	5.9%
Trade, Hotel & Restaurant	6.9%	9.4%	5.8%
Services	4.7%	5.0%	4.9%
GDP	5.1%	6.7%	5.1%

Source. BPS, staff calculation

3. External Sector

Historic highs reached in 2004. Exports reached US\$71.0 billion, 15.7 percent higher than 2003, while imports reached US\$46.2 billion, 41.9 percent higher than 2003. Both exports and imports recorded historic highs in 2004 (Figure 8). In exports, oil and gas increased by 12.1 percent mainly due to higher prices, while non-oil and gas increased by 16.8 percent. In imports, oil and gas increased by 52.7 percent, while non-oil and gas increased by 38.6 percent. The oil balance worsened in 2004 to –US\$5.0 billion from –US\$2.4 billion in 2003, though the oil and gas balance remained positive at US\$1.6 billion.

Figure 8. Historic high trade
(US\$ billion)



Source. BPS

Adjustments to trade data. Technical issues may have driven the sharp increase in 2004. Starting in January and then May 2004, imports and exports respectively had their data collecting system changed from hardcopy to softcopy. This appears to have resulted in wider coverage and trade levels and growth is likely overstated. For example by January 2005, the first month with comparable annual data under the new system, non-oil and gas imports increased by

³ Starting in 2004, the submission of international trade data was changed from hardcopy to softcopy. As a result, coverage improved and measured trade increased.

12 percent, still respectable but much lower than the monthly average of 38.9 percent in 2004.

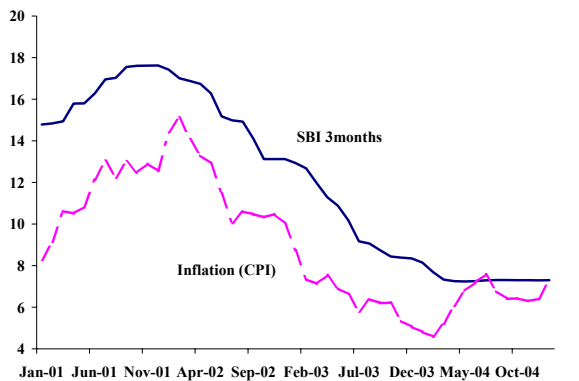
Current account surplus falls, FDI turns positive. In 2004, the current account surplus reached US\$2.9 billion, much smaller than US\$7.8 billion in 2002 and US\$8.1 billion in 2003. However, this in part reflects a positive reversal in capital imports. Last year also saw a turn around in net FDI to a positive US\$1.0 billion from –US\$0.6 billion in 2003.

External debt to GDP ratio improves. External debt as a share of GDP improved from 57 percent in 2003 to 53 percent in 2004. While external debt outstanding was US\$136.1 billion in 2004, almost the same as US\$135.4 billion in 2003, nominal GDP increased from US\$239 billion in 2003 to US\$258 billion.

4. Money and Inflation

Inflation up, interest rate flattens out (Figure 9). In February 2005 inflation, measured by the CPI, was 7.2 percent (yoy) higher than 2004 year end at 6.4 percent. Food prices, which account for 25 percent of total CPI, rose sharply from 5.9 percent at the end of 2004 to 7.2 percent 2005 (Jan-Feb). Despite the gradual increase in inflation rate, the SBI (Bank Indonesia Certificate) 1 month interest rates have been stable at 7.4 percent since October 2004.

Figure 9. Inflation on the rise as interest rates flattens out
(year-on-year inflation and SBI 3 months, percent)



Source. Bank Indonesia, BPS

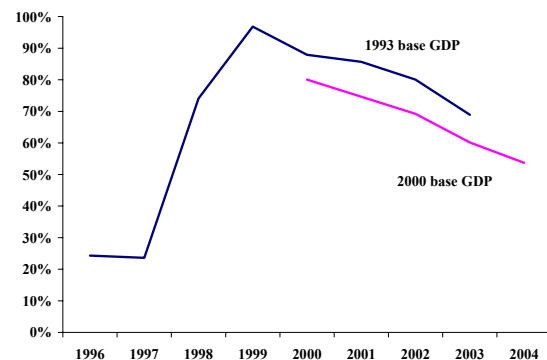
Impact of fuel price hikes. The fuel price hike March 1, 2005 will put upward pressure on prices in coming months as fuel prices feed through especially on transportation costs. A preliminary estimate shows that a fuel price increase of 29 percent would increase overall inflation by 1.5-2 percentage points other things equal.

6. Fiscal Policy

2004 Budget Preliminary Result. The preliminary 2004 budget indicates a deficit of Rp.28.6 trillion (1.2 percent of GDP), slightly higher than Rp.26.3 trillion (1.1 percent of

GDP) envisioned in the revised budget (APBN-P). Non-oil and gas tax revenues reached Rp.258 trillion (11.2 percent of GDP), slightly higher than the APBN-P Rp.256 trillion (11.1 percent of GDP). On the expenditure side, fuel subsidies turned out to be Rp.69 trillion (3.0 percent of GDP), about Rp.10 trillion higher than envisaged in the APBN-P. While oil production (1.04 million barrel a day) was below projected levels by 3 percentage points, oil prices (Indonesia crude oil price averaged US\$37.2/bbl) were above the projected levels by US\$1.2/bbl. These led to more imports and higher prices and contributed to higher spending on fuel subsidies. For the year fuel subsidies were equal to development spending at Rp.69 trillion or 3.0 percent of GDP. The budget deficit as a share of GDP improved from 1.7 percent in 2003 to 1.2 percent in 2004. The budget deficit decline and the increase in nominal GDP (12.6 percent) resulted in an improvement in the government debt to GDP ratio from 60 percent in 2003 to 54 percent in 2004 (Figure 10).

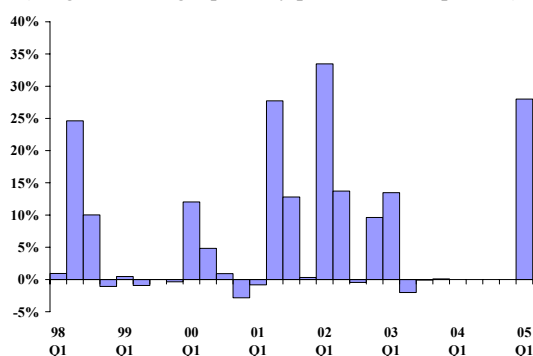
Figure 10. Declining government debt burden
(Gov't debt to GDP ratio, percent)



Source. World Bank staff calculation

2005 Revised Budget Proposed. The 2005 budget was approved by parliament in September 2004. The government decided to propose a revised 2005 budget due to changes in the economic environment, policy with respect to fuel prices (including funding for compensation programs for the poor) and the impact of the tsunami. The growth assumption was revised from 5.4 percent to 5.5 percent, and oil price assumption from US\$24/bbl to US\$35/bbl and Rp. 11 trillion is earmarked for tsunami reconstruction activities. The budget deficit in 2005 is projected to increase from 0.7 percent to 0.8 percent of GDP. Support from the CGI, domestic and foreign borrowing and additional international assistance, including a moratorium on Paris club debt payments should allow the government to manage the financing situation in 2005.

Figure 11. Pattern of Fuel Price Hikes
(weighted average quarterly price increase, percent)



Source: CEIC, World Bank staff calculation

Fuel Prices Hiked in March (Figure 11). The government cut the fuel subsidy on March 1 based on Presidential regulation No.22/2005. Average fuel prices were increased by 29 percent, although official household kerosene prices remained constant at Rp.700 per liter. In the approved state budget fuel subsidies were estimated to be Rp.19 trillion at a crude oil price assumption of US\$24/bbl. However, when oil prices are assumed to be US\$35/bbl fuel subsidies are predicted to reach Rp.60 trillion. The 29 percent average increase in fuel prices will reduce fuel subsidies by Rp.20 trillion. Some of these savings (Rp.10 trillion) are proposed to be allocated as compensation for the poor on education and healthcare, and rural infrastructure. As the government had already targeted Rp.7 trillion in compensation the total compensation package is Rp.17.8 trillion. This additional spending includes (i) scholarships for 9.6 million students (Rp.5.6 trillion) and rice for 8.6 million poor people (Rp.5.4 trillion). While the Bank estimates that this increase in fuel prices could add 1.5-2 percentage points to the inflation rate, the medium-term impact on growth will be positive as resources are reallocated to more productive (and less regressive) uses such as infrastructure. The other Rp. 10 trillion from the fuel price savings are being used to keep the deficit below 1 percent.

5. Social Sector.

Poverty headcount index at 15.2 percent in 2004 (Table 3). The preliminary results show that poverty headcount index at the national poverty line is 15.2 percent in 2004. Although the poverty headcount index is almost same as 2003, it remains below the pre-crisis level at 15.7 percent.

Table 3. Change in poverty headcount index from 1996 to 2004

	96	99	02	03	04
National poverty line	15.7	27.1	16.0	15.1	15.2
International poverty line					
1 dollar a day	7.8	12.0	7.2	7.2	-
2 dollar a day	50.5	65.1	53.5	52.9	-

Source: World Bank staff estimates, not including Tsunami impact.

III. Economic Outlook

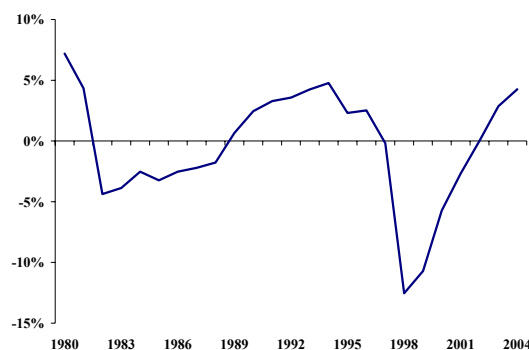
1. Growth and Investment

Further growth acceleration in 2005-2006. The World Bank foresees a continuing pick up in the economy with GDP growth reaching 5.5 percent in 2005 and 6.0 percent in 2006. This growth is expected to continue to be driven by economic and investment momentum, together with a supportive external economic environment. The real challenge will be to sustain this cyclical growth through 2007-2009.

Investment and productivity are key determinants of medium-term growth.

For the past few years, consumption, supported by rapid growth in consumer credit, has driven economic growth in the 4 to 5 percent range. Towards the end of 2004, the source of growth shifted from consumption to investment. A standard growth accounting exercise (Table 3) suggests that a further increase in investment and TFP (total factor productivity- a rough measure of efficiency) will be required to reach and sustain a growth rate of 6 percent over the medium term. On average, real investment growth rates will need to average 14 percent and the TFP growth rate will have to be 2.5 to 3 percent. This TFP growth is above long term historical averages but equal to TFP growth in 2002-2004 and sustainable but only with significant progress on investment climate reforms. Historical capacity utilization, measured by the gap between actual and trend output-capital ratio and real investment growth have a strong relationship. The bigger the gap the stronger the potential demand for investment. This gap has been widening since 2000 as the weak investment climate delayed investment decisions and/or implementation (Figure 12). As the investment climate improves the gap between actual and trend output-capital ratios will narrow. If the investment growth averages 14 percent the large gap will close. Thus improving the investment climate is the key to increasing not only productivity but also the quantity of investment⁴.

Figure 12. Historically high capacity utilization
(Gap between actual and trend output-capital ratio, percent)



⁴ For details, please see 2005 CGI Brief (Indonesia: New Directions)

Table 4. Growth Accounting Exercise (annual average 1/)

	1970-1980	1980-1990	1990-2000	1990-1997	2000-2004	2005-2009 (projection)
GDP growth	7.9	4.3	4.3	7.4	4.6	5.9
Capital Stock	2.0	2.8	2.0	3.0	0.0	1.3
Labor Force	1.9	2.1	1.7	1.8	1.5	1.5
Years of Schooling	1.7	0.5	1.6	1.8	1.1	1.0
TFP	2.2	0.9	-1.0	0.9	2.0	2.1

1/ geometrical average.

Source: World Bank staff estimates.

2. Fiscal Policy

Changing role of fiscal policy. The role of fiscal policy is changing from ‘macroeconomic stability through fiscal consolidation’ to ‘support for higher quality growth’. In order for this to happen, fiscal consolidation must be balanced with an increase in investment (public and private) in key infrastructure and social sectors (i.e. health and education). Currently, the Bank’s baseline projects continuing fiscal consolidation, with deficits projected at no more than 1 percent of GDP. This will result in a substantial decline in the debt to GDP from 54 percent current to 36

percent by 2009. Despite this central government development spending would increase from 3.0 percent in 2004 (preliminary actual) to an estimated 6-7 percent of GDP in 2009. With regional governments expected to add another 3 percent of GDP, total development spending would be back to pre-crisis level of approximately 9 percent. This increase in development spending would be financed by the reallocation of fuel subsidies to other spending in 2006-2007, a trend decline in domestic interest rates, and a gradual increase in non-oil and gas tax revenues.