Aceh Economic Update

November 2007

OVERVIEW

- Reconstruction is driving a modest economic recovery in Aceh. After a slow start in 2005, reconstruction has accelerated. Reconstruction is now the main driver of economic growth, but at an estimated 7.7 percent in 2006 (excluding oil and gas) it is only slightly higher than Indonesia’s growth rate for 2006 (5.5 percent). Given the lackluster performance of sectors not linked to the reconstruction effort (agriculture, manufacturing and oil and gas), current growth is not sustainable.
- The agricultural and manufacturing sectors remain stagnant. The ending of the conflict and assistance linked to the reconstruction effort have marginally increased agricultural production, but growth is still disappointing at 1.5 percent. Manufacturing, closely linked to the availability of cheap gas, has decreased for the third year running.
- Creating sustainable employment remains a major challenge. Reconstruction has generated short-term employment opportunities, especially in construction and services, but the primary and secondary sectors are not creating significant employment opportunities.
- Inflation continues to decline, with YoY inflation falling to 8.5 percent in June 2007. The gap with national level inflation is narrowing, a trend that is likely to continue. However, after two years of high inflation, Aceh’s competitiveness has been compromised, as reflected in higher CPI and nominal wages than in Indonesia as a whole.

I. RGDP

Excluding oil and gas, Aceh’s economy grew by 7.7 percent in 2006, driven primarily by the reconstruction effort. As the pace of reconstruction has accelerated, so the building/construction sector has shown the most impressive growth, at almost 50 percent in 2006. About 84,000 houses and 1,500km of roads had been built as of June 2007. As this is still only half of the estimated needs, growth in the building/construction and related sectors (transport, electricity and water) is likely to continue in the near term.

The structure of the economy has changed significantly since 2003. The decline of oil and gas and related manufacturing since 2003 continues unabated. The weight of the services sectors (construction, trade, transportation), which was already growing prior to the tsunami, has accelerated as a result of the reconstruction effort.

The economy continues to rely on oil and gas. Given their shares of the economy, continuing depletion of oil and gas and the related decline of manufacturing activities pose a serious challenge. The continuing decline of manufacturing is primarily the result of declining LNG production. Manufacturing production in the non-oil and gas industry grew by 1.1 percent in 2006, still below its pre-tsunami levels. Growth was led by the food and beverages and timber sectors. Other sectors, such as cement and paper production, with significant production in the early years of the decade, have still not recovered. Services sectors are growing, but primarily as a

Data Note:
This note, similar to the first Aceh Economic Update in April 2007, uses data collected from official sources, primarily BPS and Bank Indonesia. Some data have undergone significant revisions, such as 2005 GDP data and the banking sector data. Since the last update, the following new data sources have become available and are reflected in this update: preliminary GDP 2006, employment, trade, banking and inflation data for the first two quarters of 2007. In analyzing these additional data, the World Bank team compiling this note has endeavored to better understand the impact of the tsunami and the reconstruction effort on Aceh’s economy.

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1 Including oil and gas the economy grew by 2.4 percent
2 Badan Rehabilitasi dan Rekonstruksi (BRR) www.brr.go.id
result of the reconstruction effort. Without a recovery of the agricultural and manufacturing sectors, Aceh faces a structural downturn as the reconstruction effort winds down, which will have serious implications for employment and poverty alleviation efforts.

The agricultural sector remains stagnant two years after the tsunami. Despite the improved security situation and the post-tsunami relief and rehabilitation effort, growth remains sluggish. Agricultural production remains below its pre-tsunami levels (except for estate crops, which are slightly above). Although it saw slight growth in 2006, the sector’s growth remains disappointing, particularly when compared with sectors linked to the reconstruction effort.

The share of consumption (private and public) and domestic investment in the economy have increased significantly post-tsunami. The reconstruction effort is driving both consumption and domestic investment, while trade (both domestic and international) continues to decline. Although reconstruction will continue to fuel the economy for a few more years, and the public sector is likely to continue being a source of strong demand for the local economy, the continuing decline in exports is cause for concern and signals a lack of competitiveness in Aceh’s economy.

### II. EMPLOYMENT

Employment creation continues to be one of the main challenges for Aceh, given the lack of private investment and the degree to which employment growth has so far relied on the reconstruction effort. Employment opportunities resulting from the reconstruction effort are limited to sectors such as construction and transportation. Unemployment decreased to 10 percent in the first half of 2007, although this largely reflects a temporary increase due to the timing of the labor force survey rather than a permanent decrease in unemployment.

Agriculture, by far the largest employer in the province, has been shedding labor since before the tsunami. This decline in agricultural employment is in line with the rest of Indonesia, where agriculture employs a lower share of the labor force than in Aceh. Official data show a significant increase in employment

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**GDP composition based on expenditure, 2003 - 06**

<table>
<thead>
<tr>
<th>Expenditure (%)</th>
<th>2003</th>
<th>2004</th>
<th>2005**</th>
<th>2006*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private consumption</td>
<td>23</td>
<td>24</td>
<td>32</td>
<td>31</td>
</tr>
<tr>
<td>Government consumption</td>
<td>9</td>
<td>14</td>
<td>17</td>
<td>18</td>
</tr>
<tr>
<td>Investment (GDCF)</td>
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<td>7</td>
<td>12</td>
<td>14</td>
</tr>
<tr>
<td>Change in inventory</td>
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<td>1</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Export goods &amp; services</td>
<td>45</td>
<td>44</td>
<td>42</td>
<td>30</td>
</tr>
<tr>
<td>Import goods &amp; services</td>
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<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Inter-province trade</td>
<td>15</td>
<td>13</td>
<td>-</td>
<td>9</td>
</tr>
</tbody>
</table>

* Preliminary figures. ** Revised figure Source: BPS

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3 Based on LOGA No. 11/2006, Aceh will receive an additional 2 percent from the national DAU for 15 years starting in 2008.
in agriculture in Aceh in early 2007. Rather than a permanent increase in agricultural employment, this reflects the fact that the survey was fielded at the time of a late harvest in early 2007, resulting in an influx of temporary workers into agriculture. In previous years, the survey was fielded well after the harvest so that agricultural employment did not capture such temporary increases. The increasing weight of the services sector in the economy is also reflected in employment in services, which increased by over 6 percent from 2004 until 2006.

III. INFLATION

Inflation has declined steadily and is now close to the national level. After peaking at 41.5 percent in December 2005, inflation has continued to decline steadily and was 8.5 percent in June 2007, close to the national level of 5.7 percent. The gap with national price levels may increase slightly over the fasting month, but any increase is expected to be short-lived.

Persistent inflation means that Aceh’s CPI remains the highest in Indonesia. As a result, Aceh’s cost competitiveness has declined as reflected in both inflation and wage data. Although inflation has slowed down, the consumer price index (CPI) has registered steady increases since the tsunami. Using 2002 as a base, Aceh’s CPI increased to 185.6 (June 2007) while the national CPI increased to 148.2. There have been relatively large nominal wage increases in particular sectors, such as construction where, on average, workers’ nominal wages have risen to almost Rp 60,000 per day, from Rp 29,000 pre-tsunami. This is also reflected in Aceh’s minimum regional wage (UMR, or Upah Minimum Regional),\(^4\) which increased by 55 percent from Rp 550,000 pre-tsunami to Rp 850,000 in 2007, compared with an increase of 42 percent in neighboring North Sumatra, from Rp 537,000 to Rp 761,000.

IV. TRADE\(^5\)

Aceh’s exports continue to rely on oil and gas. Amid the rapid depletion of natural gas reserves, as per June 2007 total exports were US$883 million, a decrease of 21 percent YoY. This decline was driven by a marked decrease in oil and gas exports.

Aceh’s non-oil and gas exports have been declining since the beginning of the decade, as a result of conflict. However, preliminary figures to June 2007 show an increase of almost 200 percent YoY. Fertilizer exports, which all but evaporated in 2006 along with production, increased significantly in the first half of 2007. This resumption of production and exports is the result of a government commitment to subsidize gas for the fertilizer industry until 2010.

Agricultural exports are starting to recover, driven by coffee. As of June 2007, coffee exports from Aceh increased to US$6.7 million from US$2.6 million YoY. Fisheries exports increased by over 300 percent compared with the same period in 2006, from US$117,000 to over US$0.5 million. Likely causes of these increases include the improved security situation and the reconstruction effort. Although still relatively small in scale, these improvements are important in the efforts to diversify Aceh’s export base.

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\(^4\) The UMR, set by the government in consultation with labor unions, parliament and the business community, is commonly used in the industrial sector to pay workers.

\(^5\) Trade data used in this brief only capture trade going through Aceh. A large percentage of Aceh’s trade passes through Medan and is then transported by road to Aceh. Therefore, these data are likely to underestimate trade in Aceh, particularly exports of non-fuel commodities such as coffee and palm oil, and imports related to the reconstruction effort.
Imports continue to rise, fueled by an increase in private consumption and the reconstruction effort. Imports increased from US$12.9 million in 2004 to US$18.5 million in 2006. As of June 2007, imports grew by 14 percent YoY to US$15 million. This was primarily driven by a large increase in edible products (cereal, sugar), as well as manufactured goods, while imports of capital goods such as machinery and transport equipment fell.

V. BANKING SECTOR

Profit and assets in the banking sector have grown two years into the reconstruction effort. Preliminary Bank Indonesia (BI) data to June 2007 confirm this trend, with assets and credit growing YoY. A large and increasing share of deposits is government funds, estimated at 37 percent of all deposits in June 2007.

Banks’ intermediary functions improved slightly in the first half of 2007. Despite an increase in the loan-to-deposit ratio (LDR) to 29 percent by June 2007, this is still well below the national LDR of around 60 percent. The lower LDR in Aceh is to be expected in the short run, given the large increases in deposits and the fact that Aceh’s economy is unable to absorb such large inflows of additional funds.

ECONOMIC OUTLOOK FOR 2007

• Only half of the estimated reconstruction program funds have been disbursed. Sectors related to the reconstruction effort (construction, transport) are therefore likely to continue playing a key role in Aceh’s economy in the short term.
• The large investments being undertaken are likely to increase productivity in Aceh, although maintenance of these assets will also have large budgetary implications for Aceh’s sub-national governments.
• The reconstruction has created short-term employment opportunities in related sectors. In the long term, employment is likely to remain a challenge unless significant investments are made in sectors capable of absorbing large numbers of workers, such as agriculture or labor-intensive industries.