

INDONESIA

Indonesia's economy has shown remarkable resilience to the Bali bombing in October 2002, and the impact of the Iraqi war is likely to be limited. The increased political stability since the onset of the Megawati Government, and the more consistent implementation of reforms under the IMF supported program have been beneficial to macroeconomic stability, and inflation, and interest rates have continued to fall over the last 6 months, while the Rupiah has kept its strength towards the dollar. Indonesia's economy is also gradually becoming less vulnerable to shocks. Fiscal consolidation is continuing despite the post-Bali stimulus, and debt to GDP continues its decline. The recent commodity price increases have been supporting the trade balance and current account, whereas privatization and IBRA asset sales have reduced net capital outflow to a trickle, and boosting reserves. Banks have been reducing their non-performing loans, and their capital adequacy is on the rise, whereas financial restructuring has reduced gearing ratios in enterprises. However, there are few signs that increasing macroeconomic stability and reduced vulnerability is translating into higher growth. Although investment is showing some signs of recovery, investment approvals are still down, as numerous issues continue to cloud the investment climate. Consumers, who have been driving growth, have been losing confidence, and are increasingly constrained by consumer debt that is building up rapidly. Finally, favorable trade data in value terms hide the fact that the volume of exports is still in decline. We therefore maintain our projection of 3.3 percent growth in Indonesia's GDP for 2003, the same as in November 2002, and 0.7 percentage point below that of Government.

Market Sentiment

Market sentiment has been supportive to macroeconomic stability over the past 6 months. The Rupiah has been trading around Rp.9,000 against the (depreciating) US dollar. Trade-weighted real effective exchange rates (REER) have been also stable during the first three months of 2003, after sharply appreciating in 2002. The spread of the Yankee bond over US treasury bills has fluctuated between 350-400 bps over treasuries, albeit in a very thin market. Moody's, the rating agency, confirmed its positive credit outlook on Indonesia's sovereigns on March 12 2003, crediting political stability and progress on fiscal

consolidation. At the same time, the current rating (B3) is much lower than neighboring countries.¹ Increasing confidence and falling inflation allowed policy interest rates to drop further, with the rate on one-month central bank certificate now at 11 percent, down from 13 percent at the end of 2002.

The Real Economy

The 2002 growth outcome was a pleasant surprise (Figure 1). The feared negative impact of the Bali bombing on fourth quarter growth was hardly noticeable, and GDP growth was with 3.7 percent for the year higher than widely expected. Nevertheless, the pace of recovery pace is still slow compared to other East Asian countries, and 3.7 percent was still lower than the state budget assumption of 4 percent. Fourth quarter 2002 growth reached 3.8 percent (yoy). Private consumption growth rate accelerated compared to Q3, although hotel sector growth rate decelerated. Robust consumption spending, private as well as government consumption, remains an engine of growth. Fourth quarter private consumption growth was mainly due to increases in food consumption, and longer holidays in December 2002 may have had a positive impact. Private consumption is likely to weaken in the coming months. Consumer confidence has recently been on the decline, and saw a steep drop in February 2003, to 82.3, almost 10 points down from January.² Moreover, consumption has in part been fuelled by consumer credits. Since 1999, consumers have accumulated debt in their balance sheets (Figure 2). Although the level of debt to total private consumption is still lower than the pre-crisis level, growth in consumer credit is likely to taper off.

The sharp rise in government consumption remains puzzling. Government consumption increased with 17.9 percent (yoy) in Q4 2002, and 12.8 percent for the year. This sits uneasily with the numbers on the continued fiscal consolidation of the central government. Regional government, which, since

¹ As of March 21, 2003, Moody's ratings of foreign current long-term government bonds in other countries are Malaysia (Baa1), Thailand (Baa3), the Philippines (Ba1). Countries comparable to Indonesia are, for example, Pakistan (B3), Vietnam (B1) and Turkey (B1).

² Source: Danareksa Securities. A value of 100 indicates that optimists equal pessimists; a value below 100 indicates that pessimists outnumber optimists.

decentralization took off in 2001, now spend about one third of general government expenditures, may have contributed—but lack of data prevents verification.

Investment has started to contribute to growth again since the second quarter of 2002, and grew by 8.9 percent (yoy) in Q4 2002. International trade data suggest that investment in industrial capacity is rising, as capital goods imports increased by 21.6 percent (yoy) during the first two months of 2003. However, construction makes up some 70 percent of investment, and data from cement production indicate that much of this is either small-scale, or residential investment. Information from banking industry sources suggests that among existing foreign investors some expansion of existing facilities is taking place, and that replacement investment has picked up recently. The outlook for investment also seems to remain subdued. Although foreign investment approval (excluding oil and gas, and the financial sector) in the first two months of 2003 doubled compared to a year ago level, this was due to one single large project. Domestic investment approval is still down 10 percent (yoy) over 2002, the year with the lowest domestic investment approval since 1989 (Figure 3).

On the production side, the slowdown in manufacturing growth stands out. Manufacturing grew by 2.4 percent (yoy) in Q4 2002, the lowest growth since Q3 1999. The contribution of manufacturing to GDP sharply shrank from 55 percent in Q1 to 18 percent in Q4 2002. Transportation equipment, and machine and apparatus declined by 1.1 percent although this item grew by more than 20 percent in 2001. Some of the slowdown is likely to be explained by the lower number of working days in the fourth quarter of 2002 compared to the same quarter of 2001 in the wake of the Bali Bombings the Government granted additional holidays around Id-Ul Fitri. This would also explain the divergence between production and consumption in some of the sectors. For instance, motorbike sales still increased by 40 percent (yoy) in Q4 2002, whereas domestic production has started to decline. A similar pattern could be observed for cars. Producers are likely to have run down inventory, or in part substituted domestic production with imported goods.

The hotel sector bore the brunt of the Bali bombing impact. Output growth in the sector decelerated sharply from 3 percent (yoy) in Q3 to 0.5 percent in Q4 2002. In Q4 2002, foreign visitors arrivals declined by 10.6 percent (yoy) and in Bali –the most favorite

tourist destination- the number declined by 31 percent (Figure 4). The decline came on top of the impact of September 11 2001, which had already affected tourism. Domestic tourists replaced part of the decline in foreign tourists, but foreign visitors arrivals have kept declining in 2003 and therefore hotel sector is likely to decline further.³ The impact of SARS, which has started to affect travel to the country, is likely to further subdue the outlook in the tourism industry.

Employment, Poverty, Wages and Incomes

The modest recovery has not been enough to dent unemployment. Unemployment stood at an official 8.3 percent of the labor force in August 2002, up from less than five before the crisis (Figure 5).⁴ The trend is increasing, as employment growth is lagging the number of new entrants in the labor force: between 1997 and 2002, the labor force increased by 7 percent while employment increased by 2.9 percent. Annual increase in new labor force is about 2-2.5 million, and some calculation show that the growth rate required to absorb this increase at existing wage levels is around 5 percent.⁵

The wage between formal sector and informal sector is widening. Real wage in agriculture (a proxy for unskilled labor wage in the informal sector) increased by 0.6 percent (yoy) in September-November 2002, while that of large and medium manufacturing increased by 9 percent (yoy) in Q2 2002. The rapid rise in formal sector wages is in part due to rising minimum wages. In addition, the low level of investment combined with moderate sales growth increases enterprise's cash flows by enough to afford the wage increases. Agriculture still provides over 40 percent of total employment while manufacturing share is less than 15 percent. Therefore the number of

³ The number declining by 9 percent in total and 28 percent in Bali during the first two months of 2003 on a year-on-year basis.

⁴ The number of unemployment is counted as the numbers seeking for jobs, and then it excludes ones giving up jobs and working short time. As such, this figure may underestimate the situation.

⁵ ILO study (Islam and Nazara (2000) "Estimating Employment Elasticity for the Indonesian Economy" (technical note on the Indonesian labor market, ILO Jakarta), concludes the employment elasticity to GDP ranges from 0.49 to 0.66, and required GDP growth rate to absorb 2 million newly entered labor force ranges from 3.5 percent to 4.7 percent depending on methodologies.

employment benefited from a steady increase in manufacturing wage may be limited.

Money, Interest and Prices

Inflationary pressure has been declining since mid-2002. The CPI inflation rate decelerated to 7.1 percent (yoy) as of March 2003 or well below the 2003 state budget assumption of 9 percent, and half that of a year ago. This is partly a reflection of last year's sharp price increase in the wake of administrative hikes in electricity and transportation and the floods. Food prices increased by only 2.2 percent (yoy) in Q1 2003, which is a sharp contrast to the 15.1 percent (yoy) increase in Q1 2002. The slowing food prices increases can be mostly attributed to rice prices (Figure 6): in Q1 2003, rice prices increased by only 0.1 percent. In early 2002, sharp increase in rice prices affected poverty since the poor spend a relatively large share of their income on food and thus are especially vulnerable to changes in food prices.⁶

Lower inflation rates are translated into lower interest rates. The SBI rate fell from 12.9 percent in December 2002 to 11.4 percent as of end-March 2003 or the lowest since mid-2000. Monetary policy also has contributed to the decline in inflation rates. In December 2002 actual base money stood at Rp.132.2 trillion or Rp.6 trillion below the IMF performance criteria of Rp.138.2 trillion, and in March 2003, base money is likely to be around Rp.120 trillion even further below the IMF target of Rp.129.3 trillion. Real interest rate (SBI rate minus CPI inflation rate) now stand at 4.3 percent. Real interest rate was above 5 percent by the end of 2001, but then quickly declined to 2.6 percent in November 2002 (Figure 7).

The banking sector has taken up its financial intermediary function again. Bank lending has been increasing since mid-2002: credit outstanding rose from Rp.302 trillion in January 2002 to Rp.358 trillion in January 2003. Growth in consumer credit was particularly rapid, with 37 percent in the year to December 2002. The share of consumer credit now is 22 percent of total credit, or 7 percentage points higher than at end-2000. A sharp increase in consumer credits is consistent with strong private consumption, and if non-bank consumer credits (e.g. car finance and motorbike finance through finance companies) are taken into account, the growth in consumer credits

would be even higher. In addition working capital and investment capital credits have also been growing. Working capital increased by 12 percent and investment capital increased by 21 percent on a year-on-year basis in December 2002. However, anecdotal evidence suggests that some of these investment loans were used to buy back assets under IBRA. This is just a change in ownership and does not directly contribute to expansion of businesses. For now, the resumption of bank credits goes hand in hand with improved health of the banking system: non-performing loan ratio (NPLs) reached 7.5 percent as of December 2002 and remarkable improvement was observed since August (Figure 8). The trouble is that some of this improvement is due to the conversion of bad debt into equity—a practice allowed under central bank rules. The capital adequacy ratio (CAR) stood at 22.4 percent, not least because state bonds—with zero risk rating—form about half of the banking system's assets, whereas loans only make up one third.

International Trade, Payments and External Debt

Indonesia's international trade measured in US Dollars has been growing since mid-2002 (Figure 9). Much of this increase is a result of price increases rather than volume growth. For the first two months of 2003, export value grew by 18.3 percent (yoy). Sharp increase in oil prices contributed to that in oil and gas exports, which increased by 46 percent (yoy), but non-oil exports also increased by 11.3 percent. Machines and electrical products exports increased by 13 percent followed by woods and woods products (7 percent). In contrast, textile and footwear exports, products in which Indonesia has traditionally been strong, have been declining. In part, this is due to the real exchange rate appreciation, which has started to affect Indonesia's position in this highly competitive sector. In part, this is caused by competition from China on third markets. There is, however, a positive side to the China story as well: Indonesia's exports to the country increased by 57 percent (yoy) in the first two months of 2003, following a 36 percent increase in 2002 compared to 2001. All of the recent increase in export value has been due to price increases. Between July and November 2002, the latest data available, export value increased by 9.2 percent (yoy), while volume was still falling at a rate of 16.5 percent (yoy). Imports growth rate outpaced that of exports. In the first two months of 2003, import value grew by 37.2 percent. Machines and electrical products imports even increased by 46.5 percent,

⁶ See more analysis in Chapter 4 of World Bank (2003) "Indonesia: Maintaining Stability, Deepening Reforms"

Indonesia's reserves continue to strengthen on the back of large current account surpluses, and reduced capital outflow. Gross international reserves topped \$32 billion in March 2003, some \$4 billion higher than a year ago. The current account surplus for the first three quarters of 2002 reached \$6.0 billion and is estimated to total \$7 billion for the year. The capital account is likely to have still been in deficit in 2002 (Figure 10), but by much less so than in 2001, a development largely due to a turn for the better in private capital flows. In the first three quarters of 2002, net private capital outflow was \$1.7 billion, and for the year as a whole a net outflow of \$3 billion is expected, much lower than the \$8.3 billion outflow still recorded in 2001. Part of the improvement came from portfolio investment inflows in the wake of returning political stability in the first half of 2002. And the privatization of two banks and INDOSAT, a telecom provider helped as well. However, a considerable part of the improvement is on the account of increases in exceptional financing, i.e. arrears and rescheduling of foreign loans owned by Indonesian companies. To what extent this is part of orderly debt settlements is unclear. The Paris Club, in light of the better than expected performance on the BOP decided not to grant Indonesia an additional 50 percent interest payment rescheduling for 2003. This option was included in the 2002 agreement, which rescheduled all principle and interest for 2002, and all principal and half of the interest payments due for 2003.

External debt outstanding declined gradually in the course of 2002 and reached \$130.9 billion as of December 2002 or lower by \$2.2 billion compared with \$133.1 billion as of end-2001. Government debt (excluding IMF) increased from \$60.3 billion as of end-2001 to \$65.3 billion, while private debt (including state owned enterprises) declined from \$60.1 billion to \$55.2 billion.⁷ Japanese yen against the US dollar appreciated from 132 yen to 120 yen during the period, and the yen-dollar exchange rate appreciation worked negatively on debt outstanding. A share of Japanese yen denominated debt is around 22 percent and the appreciation pushed up debt outstanding by \$2.6 billion, and most of which (\$2.2 billion) affected government debt. In spite of the increase in debt outstanding, external debt to GDP ratio declined from 94 percent in 2001 to 75 percent. The short-term debt

to reserve ratio⁸ declined to 48.5 percent in September 2002 from 69.9 percent at end-2001.

Fiscal Consolidation

The fiscal consolidation process that started in 2001 is still continuing, despite the fiscal stimulus the Government decided to give in the wake of the Bali bombing (Figure 11). The budget deficit declined from a (budgeted) 4.8 percent of GDP in FY2000 to 1.8 percent planned for this 2003. Not all consolidation is good thing, though, as some is due to a shortfall in development spending which has been consistently below budget ever since the start of the crisis back in 1997. The 2002 preliminary result show a budget deficit of Rp.28.3 trillion or 1.8 percent of GDP, again a shortfall of 0.7 percent of GDP, largely in foreign financed projects. Expenditures fell short of target mainly due to lagging development spending: actual development expenditures were Rp.40.5 trillion or more than 20 percent below budget. This shortfall may have cost the economy as much as 1 percentage point in GDP growth. Government debt as a percent of GDP (excluding IMF loans) has been further declining. The ratio dropped to 75.4 percent at the end of 2002.

The Bali bombing in October 2002 (and changes in oil prices) forced government to revise the 2003 budget proposal that was submitted in August 2002. The budget now aims for a deficit of 1.8 percent of GDP or 0.5 percentage points higher than the draft budget in August 2002. This revision was mainly due to an increase in development spending, as parliament agreed to increase development expenditures by Rp.10.6 trillion. More financial resources were allocated to transportation, education and social welfares aiming to mitigate a negative impact of the bombing. In addition, the defense sector will get more than initially proposed to tighten securities. 35 percent of deficits are projected to be financed externally, while domestic finance is accounted for 65 percent. Part of the "stimulus package" was a reduction in taxes on luxury items such as electronics, and selected food items such as some soft drinks. After the budget was approved, the Government backtracked on the key policy measure underlying it: price increases in fuel, electricity, and phone tariffs. The measures triggered widespread protests across the country, and on the eve of the CGI donor meeting in Bali, the Government reversed the fuel price increase, and postponed the

⁷ IMF loan outstanding declined from \$9.1 billion in 2001 to \$8.8 billion in 2002.

⁸ Figures are from joint BIS-IMF-WB-OECD statistics and not necessarily consistent with Bank Indonesia figures

phone tariff increase. International donors pledged \$2.7 billion to finance the 2003 state budget in January 2003, which fits the revised requirement in the state budget.

Structural Reforms

In March 2003, the government has signed a new letter of intent (LoI), which includes the 2003 program supported by the IMF's extended fund facility. There are 3 pillars in the 2003 program: (1) consolidations of macroeconomic gains, (2) enhancement of financial system stability, and (3) improvement of the investment climate through legal and other structural reforms. Improvements in the investment climate are closely related to some of the structural reforms comprised in the LoI, including legal and judicial reforms, and tax and customs administration reforms. On the legal and judicial reforms, the government intends to further develop the Commercial Court, which has jurisdiction over bankruptcy and intellectual property rights case, and establish a Judicial Commission to strengthen the governance and administration of the judiciary. For this purpose, the Anti-Corruption Commission is projected to be fully operational by end-December. The IMF Board completed the 8th review of the program on March 28th, and released a tranche of \$469 million.

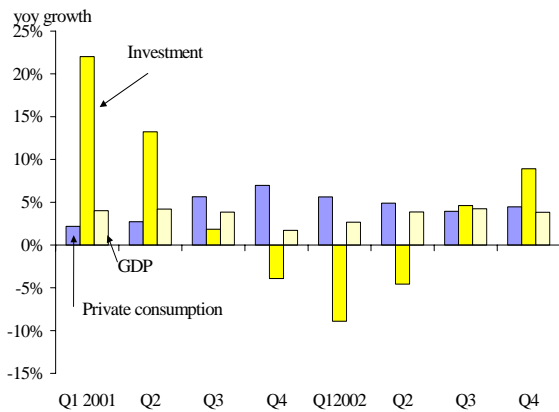
The Macroeconomic Outlook

The negative impact of the Bali bombing in October 2002 is likely to be less than initially feared.

But SARS and the Iraq war are likely to dampen activity. As these two factors are expected to by and large offset each other, our projection for Indonesia's 2003 GDP growth rate remains at 3.3 percent, the same as we projected right after the Bali bombing. In this projection, the Iraqi war is assumed to end shortly. A possible negative impact of the slower growth in world trade is likely to be offset by an increase in oil prices. On balance, a negative impact of the Iraqi war on growth rate is projected at -0.2 percent. In 2004, we expect an acceleration of growth rate to 4.0 percent assuming smooth implementation of general election. There is some upward potential in these projections, largely due to the recent terms of trade improvements. If current levels of commodity prices hold, it would imply a windfall for Indonesia and although most of this is likely to be saved as long as it is seen to be temporary, some of it may be spent and boost demand.

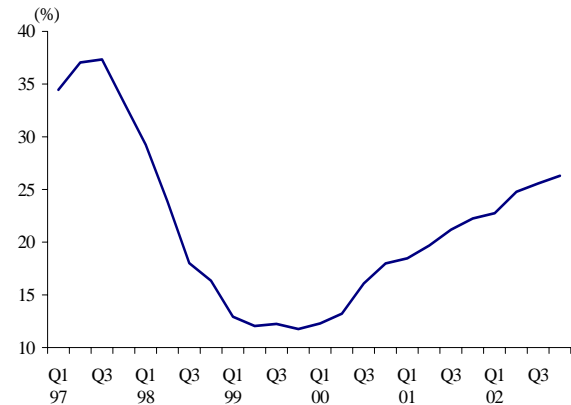
The government is expected to achieve its deficit target of 1.8 percent of GDP in 2003. The cut in luxury taxes and the costs of reversing the fuel subsidy cut are more than offset by additional oil revenues, and the likely savings in domestic interest payments due to the rapid interest rate decline. A 1 percent decline in SBI interest rate reduces domestic interest payments by Rp.2 trillion.

Figure 1: GDP growth was hardly affected by the Bali bombing



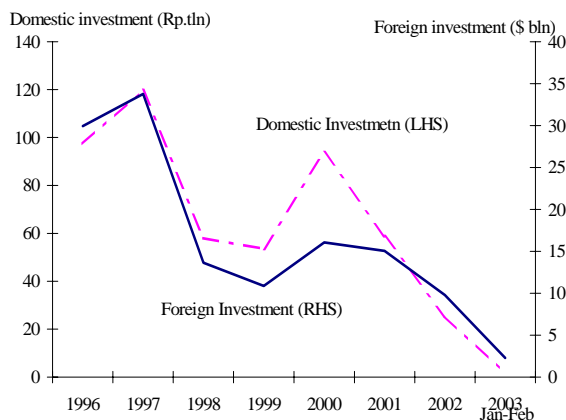
Source: BPS

Figure 2: Credit continues to feed consumption
(Consumer credit as a share of private consumption)



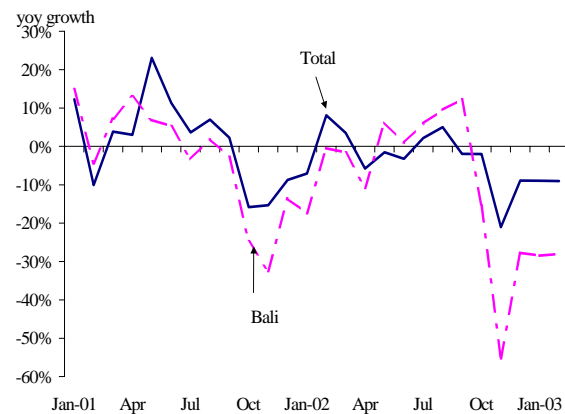
Source: Bank Indonesia, BPS, Staff calculation

Figure 3: But the investment outlook remains weak



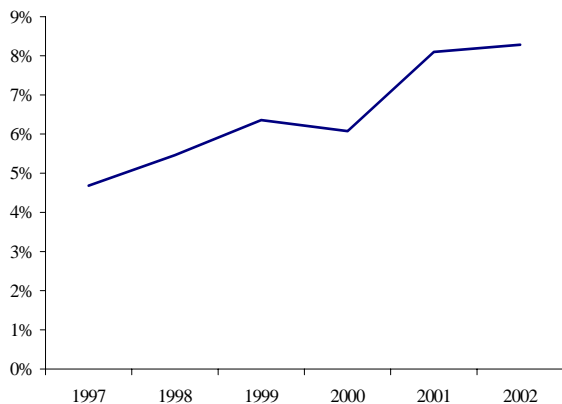
Source: BKPM

Figure 4: And tourism is yet to recover
(year-on-year growth rate of foreign visitors arrivals)



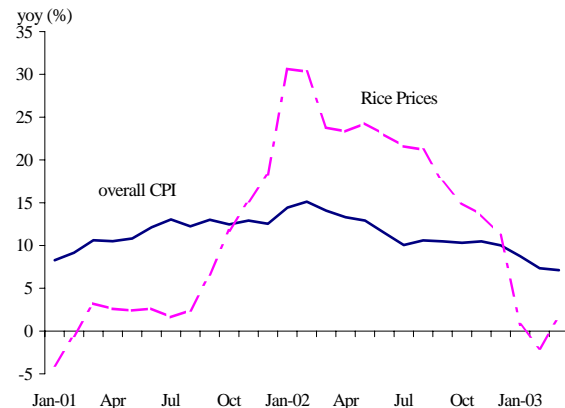
Source: BPS

Figure 5: Unemployment is rising
(Unemployment as a ratio of total labor force)



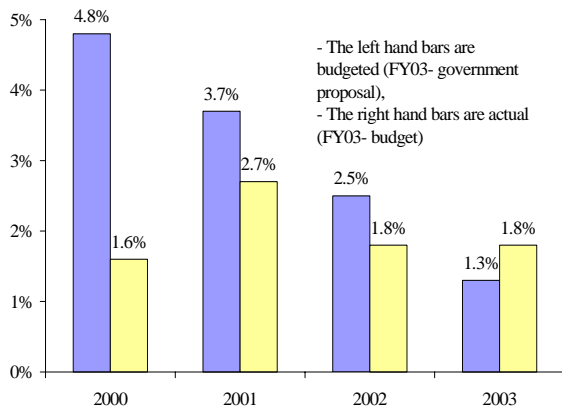
Source: BPS

Figure 6: Inflationary pressure subsided
(CPI inflation rate on a year-on-year basis)



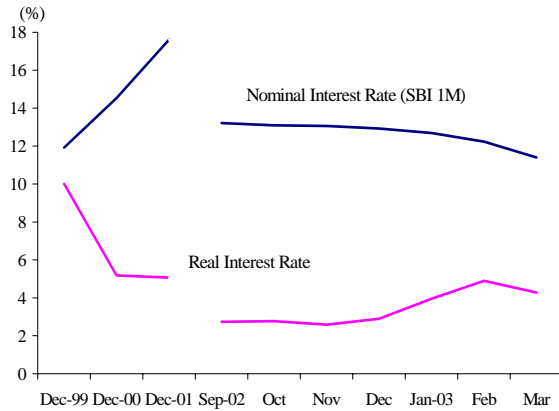
Source: BPS

Figure 7: Fiscal consolidation continues



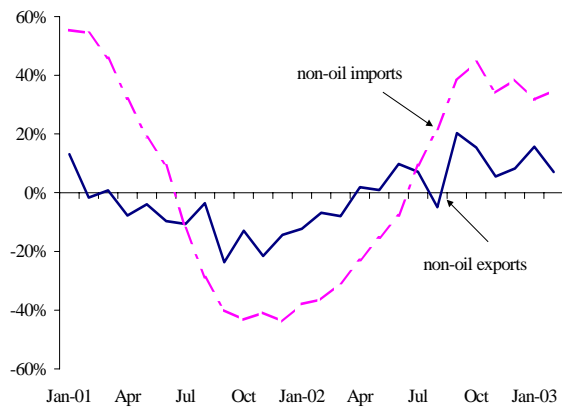
Source: Bank Indonesia, BPS, staff calculation

Figure 8: Interest rates are on the decline



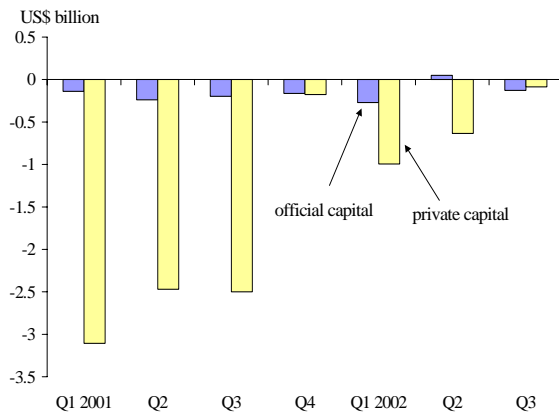
Source: Bank Indonesia

Figure 9: International trade recovers on the back of higher commodity prices



Source: BPS

Figure 10: Capital outflows are down to a trickle



Source: Bank Indonesia