Overview

Macroeconomic prospects for Indonesia have improved in recent months on the back of a more robust recovery in the international environment and lower interest rates. The recovery of the external economic environments is stronger than predicted, and market confidence continues to be solid. Together with lower than expected inflation, this allowed Bank Indonesia to further lower policy interest rates. The resulting higher exports and absorption is likely to increase growth. The outbreak of Avian influenza will only have limited impact on the economy. The World Bank now expects growth rate for 2004 to be 4.5 percent, 0.5 percentage point higher than predicted 6 months ago. Growth remains consumption driven, with exports and investment under-performing compared to other Asian countries. Investment as a share of GDP is 10 percentage points below pre-crisis levels. Some indicators such as new approved credits and investment approvals suggest that growth could accelerate. At the same time concerns on the investment climate remain, and uncertainty on an incoming government will not be resolved until the end of the year. A recovery in investment this year therefore remains unlikely, and regaining sustainable higher growth will remain the government's key challenge.

Political Developments

Elections currently dominate Indonesia's political agenda. On April 5, Indonesia held parliamentary elections. 147 million voters were expected to cast their votes to elect representatives for national and regional parliaments and the newly created regional council (DPD). The elections proceeded peacefully, with only minor disruptions in the conflict-torn province of Aceh. Early polls show that President Megawati's party, the PDI-P, has lost substantially (Table 1), whereas Golkar, the vehicle of former president Soeharto is likely to become the largest party. Surprise showings came from the Democratic Party of former coordinating minister and presidential contender Yudhoyono, and PKS, an Islamic party with strong focus on an anti-corruption agenda.

Presidential elections are planned for July, with a run-off round in September, if no candidate receives a majority of the vote in the first round. A recent poll indicates that no single presidential candidate or party is likely to obtain majority support (Table 1). President Megawati still has the largest support among the others, but Yudhoyono, who is now running for president, and Amien Rais (the party leader of PAN) are gaining ground. Golkar (the ruling party during the Suharto period) has the largest support in 24 political parties contesting the election followed by PDI-P (currently the biggest party) and PAN. Interestingly, the number of uncommitted and undecided voters is substantial.

Table 1: No presidential candidate or party gets majority supports
(Percentage share in total respondents)

A. Parliamentary elections

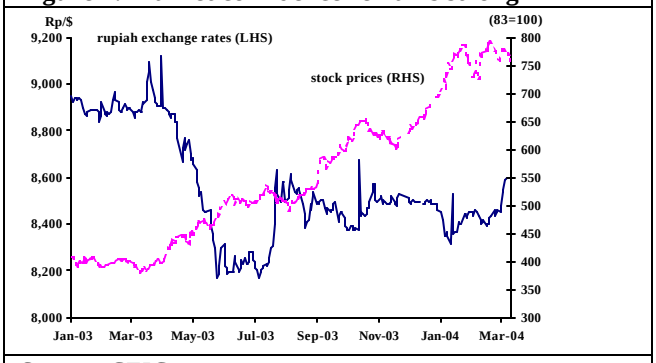
	April 04 exit poll
Golkar	**22.7**
PDI-P	**18.8**
PKB	**10.7**
Partai Democrat	**7.3**
PKS	**7.2**

B. Presidential Choice

	Dec 03	Jan 04	**Feb 04**
Megawati	13.7	13.9	**11.2**
Yudhoyono	5.0	9.1	**10.9**
Amien Rais	7.8	11.6	**9.7**
No respondent / undecided	26.7	16.9	**20.6**

Source: IFES (March 2004), and NDI exit poll

Figure 1: Market confidence remains strong



Source: CEIC

Market Sentiment

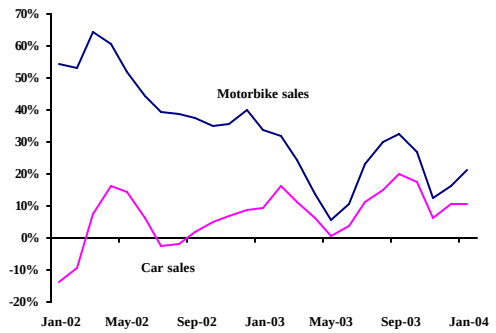
Market sentiment remained strong in 2004 (Figure 1). The Jakarta stock exchange index (1983=100) exceeded the pre-crisis high in January and rose to 794 in mid-February. Foreign investors played a major role in this, with net foreign purchase amounting to Rp.4.5 trillion

in the year until mid-March, compared to only Rp.0.2 trillion in the same period of 2003. The stock market rose almost 3 percent the day after the elections. Increasing confidence in Indonesia's macroeconomic situation and a rebound in global capital flows was also reflected in demand for Indonesia's sovereign bond issue early March. The $1 billion issue, which was already increased from the original plan of $400million, was 4 times oversubscribed.

The Real Economy

Growth for 2003 turned out to be higher than most expected. GDP growth reached 4.1 percent, slightly higher than the government projection of 4 percent and above consensus (and World Bank) forecast. This is the first time since the crisis in the late 1990s that actual growth has exceeded the government projection. Private consumption, especially non-food consumption, remained the main engine of growth, benefiting from declining interest rates and increased availability of credit. Non-food private consumption increased by 5.9 percent in 2003. Sales of cars and motorbikes sale remained strong, with growth of 10-20 percent on average, though seasonal factors caused a fluctuation in sales in late 2003 (Figure 2).

Figure 2: Car and motorbikes sales strong
(3 month moving average / yoy)



Source: CEIC

Because of its importance for short-term growth, sustainability of private consumption is one of the key concerns. So far consumer credits have supported strong private consumption, but indicators on consumer credits show mixed signals on whether this will continue. Approved consumer credits have been rising, but at the same time, the growth rates of the number of credit card holders and the value of transaction have decelerated (Figure 3). Consumer credit outstanding as a share of private consumption has been steadily rising and has now reached pre-crisis levels (Figure 4). This makes a further increase in private consumption growth unlikely, and the engine of growth should be changed to investment and exports.

Table 2: Moderate GDP growth continues
(Growth in percent compared to same period of the previous year)

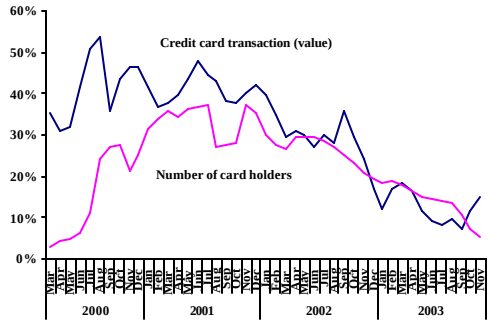
	2002		2003	
	Q3-Q4	Q1-Q2	Q3-Q4	Q1-Q4
GDP	**4.1**	**4.0**	**4.2**	**4.1**
Non-oil and gas GDP	**4.7**	**4.8**	**4.4**	**4.6**
By expenditure				
Consumption	4.8	4.4	4.9	4.6
o/w private	3.4	3.9	4.1	4.0
o/w public	17.4	8.6	10.9	9.8
Fixed investment	5.9	2.7	0.1	1.4
Exports	3.7	3.5	4.6	4.0
Imports	5.3	2.7	1.3	2.0
By sector				
Tradable				
Agriculture	3.1	3.3	1.6	2.5
Mining	5.3	0.0	0.9	0.5
Manufacturing	2.4	3.3	3.7	3.5
Non-tradable				
Construction	6.0	6.1	7.2	6.7
Finance	6.7	7.4	5.2	6.3
Transportation	5.3	7.7	8.7	8.2
Utilization	5.8	5.2	8.3	6.8
Retail trade etc.	4.8	4.0	3.5	3.7
Services	1.8	3.2	3.7	3.4

Source: Central Statistics Office (BPS)

Investment growth remains lackluster. Fixed capital formation grew by a meager 1.4 percent in 2003, and the share of investment in GDP (nominal) declined from 20.3 percent in 2002 to 19.7 percent in 2003. This is more than 10 percentage point below pre-crisis levels, and comparable to levels seen in the late 1960 and early 1970s. The share of property investment in overall investment is on the rise. Construction as a share of total investment increased from 79 percent in 2002 to 83 percent in 2003 (Figure 5). In contrast, capital goods imports declined by 22 percent in real values over the same period, suggesting that investment in productive capacity in manufacturing is even lower than overall investment numbers show. Estimates of the overall capital stock in Indonesia based on passed investments suggest that this overall stock is on the decline.[1]

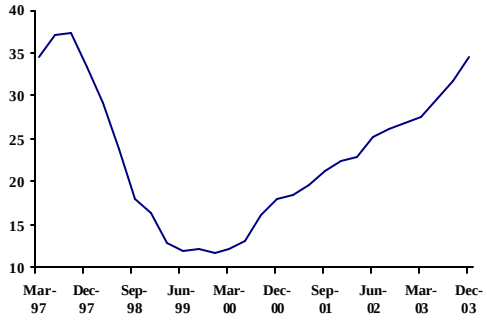
[1] The estimates are based on investment series since the 1960s, assuming an average depreciation on capital of 10 percent of installed capital.

Figure 3: Credit cards credit cooling
(3 month moving average / yoy)



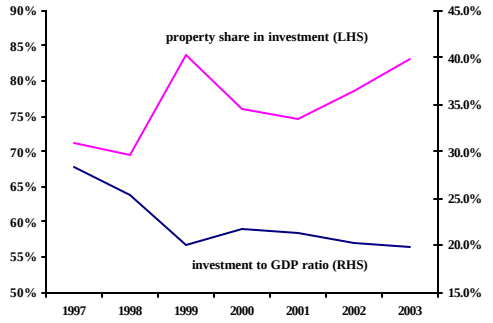
Source: Bank Indonesia

Figure 4: Consumer credit outstanding rising
(consumer credit outstanding/nominal private consumption)



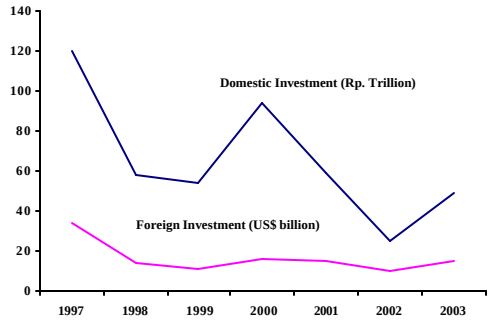
Source: Bank Indonesia, BPS, staff calculation

Figure 5: Investment remains low
(investment / GDP ratio and share of property investment in total investment)



Source: BPS, staff calculation

Figure 6: Investment approval increases
(Investment approval)



Source: BKPM (excl. oil and gas, financial sector)

Data from the investment coordinating board (BKPM)[2] shows a turnaround in both domestic and foreign investment approvals (Figure 6). However, a few large-scale projects dominate the approvals, and it seems too early to predict an *actual* investment recovery down the road. Among domestic investment approvals, one chemical project amounting to Rp.28 trillion accounts for 57 percent of the total, whereas in foreign investment approvals 3 projects account for 40 percent of total approved values.

On the production side, manufacturing growth rates have been below overall growth rates since Q2 2002. As a result, the share of manufacturing in GDP declined to 24.7 percent in 2003, 2 percentage points lower than its peak in 1997. Performance differs among industries. For example *fertilizer* production grew by 10.4 percent in 2003, while *iron* production shrank by 1.6 percent. In some industries, the low investment for the last 7 years may have started to affect production growth, as more firms are reaching their production capacity. Other sectors such as 'transportation and communication' and private services showed high growth rates in 2003, as growth in these sectors is strongly correlated with strong private consumption. Agricultural held up reasonably well, and indications are that harvests in the first quarter of 2004 are strong.

Employment

The 4 percent growth registered over 2003 was not enough to reduce unemployment. The unemployment rate[3] increased from 8.1 percent of the labor force in November 2002 to 8.5 percent in August 2003, some 8 million people. In addition, more than 30 million people work less than 35 hours/week, and they are sometimes referred to as 'underemployed'.

[2] BKPM data does not include the oil and gas, and financial sector.

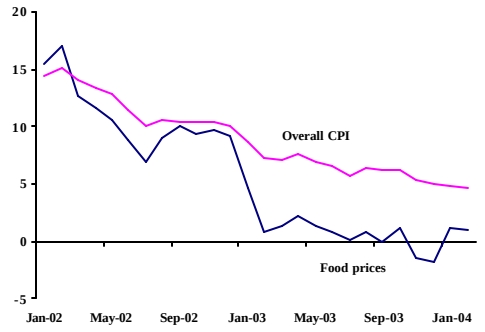
[3] Based on quarterly survey, which excludes conflicting areas such as Ache, Maluku and Papua.

Employment has been shifting from the formal sector to the informal sector. The share of the informal sector employment increased from 54 percent in 1997 to 64 percent in 2002.[4] Real wages in the formal sector rose rapidly between 19999 and 2002, and are now some 30-40 percent above pre-crisis levels, whereas those in the informal sector have been lackluster. Pending regulations following the passage of the labor laws, and pending legislation on social security may have added to uncertainty on future labor costs, and may have discouraged hiring.

Money, Interest and Prices

Inflation continues to fall, although the decline in core inflation has now stopped. Inflation amounted to 4.6 percent (yoy) in February 2004 (Figure 7), down from 4.8 percent in January.[5] Core inflation (excluding foods and beverages) increased by 6.6 percent in February 2004. A good harvest in 2003 has contributed to stable food prices, which only rose by 1 percent in February. The recent decline in headline inflation rate has enabled Bank Indonesia to further reduce policy interest rates. The SBI (certificate Bank Indonesia) rate dropped by 5.5 percent since end-2002 and reached 7.4 percent in March.

Figure 7: Inflation continues to decline
(year-on-year growth rate of CPI)

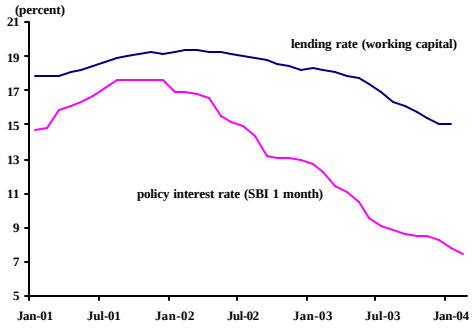


Source: BPS

Lower policy interest rates have not fully translated into lower lending rates (Figure 8), and the interest rate gap between SBI rate and lending rate has widened. In mid-2001, the gap was less than 2 percent, but reached 7 percent in January 2004.

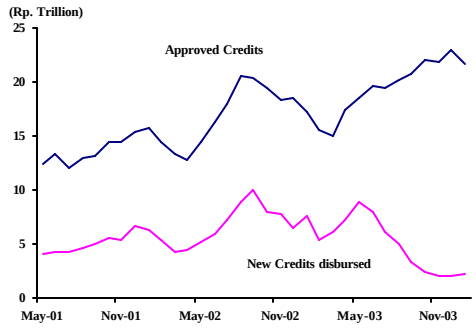
Informal evidence suggests that banks continue to be reluctant to lend because of an absence of creditworthy corporate borrowers, and the weak legal environment that hampers enforcement of repayments. Better macroeconomic prospects together with political stability are, however, starting to affect lending behavior of banks, and approved credit commitments are on the rise (Figure 9). In contrast, new disbursements have started to decline—perhaps in anticipation of the elections. The increase in committed lending could, however, a future acceleration of economic activity.

Figure 8: Widening gap between policy interest rate and lending late



Source: CEIC, Bank Indonesia

Figure 9: Higher approved credits, lower disbursements



Source: CEIC, Bank Indonesia

International Trade, Payments and External Debt

Indonesia's exports, boosted by high commodity prices, reached $61 billion in 2003, almost 7 percent higher than in 2002. Some resource based products such as ore and rubber performed particularly well. However, exports of major manufacturing products were disappointing.

Electrical product exports, the largest non-oil and gas export item, increased by 2.2 percent in 2003, but export values remain 6.2 percent below its peak of 2000.

[4] BPS definition including non-wage employment and casual employees.
[5] BPS, central statistics office, changed the base year from 1996 to 2000 in January 2004.

Transportation equipment exports, the second largest, declined by 4.0 percent in 2003. Compared with its peak in 2000, export values declined by 23.7 percent.

Exports to China continue to grow rapidly, but other countries in the region outperform Indonesia. China is the 4th largest non-oil and gas exports destination of Indonesia. Non-oil and gas exports to China increased by 23 percent in 2003. While such export growth looks promising, China's trade data indicates other Asian countries performed better (Table 3). Imports from Indonesia increased by 28 percent in 2003, while those from other countries rose by more than 50 percent (yoy). Indonesia's share among the 5 countries declined from 11.2 percent in 2000 to 7.4 percent in 2003.

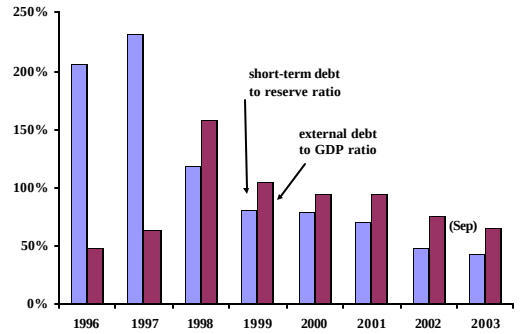
Table 3: Chinese imports from selected Asian countries
(Percent and share in 5 countries' total)

	2000		2003	
	growth	share	growth	share
Indonesia	**44.3**	**11.2**	**27.8**	**7.4**
Korea	34.7	59.3	51.0	55.3
Malaysia	51.9	14.0	50.6	17.9
Philippines	84.8	4.3	96.2	8.1
Thailand	57.5	11.2	57.7	11.3

Source: CEIC, staff calculation

External risks continue to decline. As of March 2004, international reserves reached $35.9 billion, $3.9 billion higher than at end-2002. Major external debt indicators such as the external debt to GDP ratio and the short-term debt to reserve ratio also improved (Figure 10). External debt outstanding was $135 billion at end-2003, slightly higher than at end-2002 due to the depreciation of the US dollar against other major currencies. However, the debt to GDP ratio declined from 76 percent at the end of 2002 to 65 percent at end 2003. The short-term debt to reserve ratio declined to 43 percent in September 2003.[6]

Figure 10: External risks are reducing
(external debt to GDP ratio and short-term debt to reserve ratio)



Source: Bank Indonesia, BIS, staff calculation

Budget

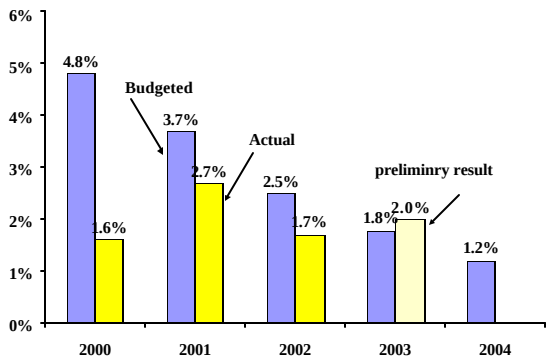
Despite some slippage on the deficit, fiscal consolidation continued in 2003 (Figure 11). Meeting the 2004 budget targets will be challenging, as the revenue shortfall of 2003 feeds into the current year. The preliminary 2003 state budget outturn shows budget deficits reached Rp.36.2 trillion or 2.0 percent of GDP. The preliminary result is almost in line with the revised budget (1.9 percent of GDP), and 0.2 percent of GDP over the originally planned deficit. The budget benefited from higher oil and gas prices as well as the decline in domestic policy interest rates, but non-oil revenues fell some 0.4 percent of GDP short of their target. Income tax revenues in particular were lower than predicted in the revised budget. The 2003 outcome suggests the tax base is considerably lower than envisaged at the time the 2004 budget was formulated. A continued improvement in tax administration is therefore essential for further fiscal consolidation.

On the financing side, substantial progresses has been made during Q1 2004. The government issued its first international bonds since 1996 in March. The 10-year bond issued amount is $1 billion with coupon rate of 6.75 percent. It was more than doubled the original plan of $400 million due to strong investor demand, which totaled over $4 billion. The yield spread over the US treasury came out to be below 280 bp, a number better than the Philippines and Pakistan, countries with a higher credit rating than Indonesia. IBRA has already transferred Rp.5 trillion to the state budget as stipulated in the budget by its closure in February. Meanwhile, Government debt is becoming less of a burden. The government debt to GDP declined from 80 percent in 2002 to 70 percent in 2003. In nominal US dollar terms, government debt outstanding increased due to the depreciation of the US dollar against the other major currencies. However, GDP in US$ rose sharply, causing the debt to GDP ratio to decline.

The formulation of the 2005 state budget may be challenging for two reasons. The first is that the 2004 general and presidential elections may affect the budget process. According to the State Finance Law, the

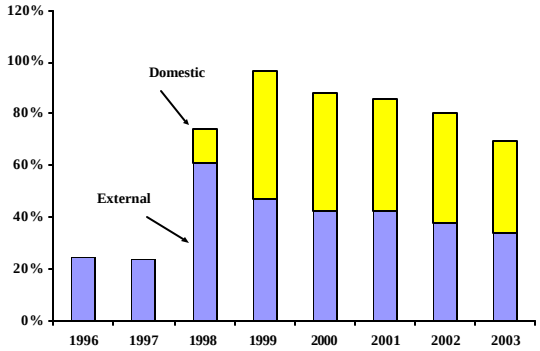
[6] Short-term debt data are derived from BIS-OECD-IMF-WB joint debt data.

Figure 11: Fiscal consolidation continues



Source: MOF

Figure 12 : Government debt burden eased
(government debt to GDP ratio)



Source : MOF, Bank Indonesia, staff calculation

government must submit fiscal policy principles together with macroeconomic framework by mid-May and the draft law is expected to be presented to parliament in August. Parliament is required to approve the budget by October, but the new parliament will only be in place by October 24. A final decision on the budget may therefore be delayed to take account of the views of the incoming Parliament and government. The second issue complicating the budget process is that the new State Finances Law requires a different budget process and different budget classification. In the new system, the Government must present a medium term outlook on the budget, and classify expenditures according to the IMF's GFS definition. Regulations for both changes are currently being prepared.

Banking and Corporate Debt Restructuring

With the closure of Jakarta Initiative Task Force (JITF) at end 2003 and the Indonesian Bank Restructuring Agency (IBRA) in February, Indonesia turns a page on the aftermath of the economic crisis.

JITF successfully mediated in 100 cases amounting US$20 billion. Despite the progress made by JITF, total corporate debt outstanding was US$142.4 billion as of August 2003. Onshore debt accounted for 65 percent of total and 45 percent of the onshore debt is distressed. After the JITF closure, the former JITF staff established Indonesian National Mediation Center (NMC) in September 2003. NMC, tanking over JITF's key function as a mediator of interested parties. It also provides training for judges.

IBRA had two main functions. The first is to restructure troubled banks. The second is to manage assets acquired by the government throughout the banking restructuring process. IBRA sold the majority share of major banks: Bank BCA, Bank Niaga, Bank Danamon, BII and Bank Lippo. IBRA's cumulative contribution to the state budget amounts Rp.168 trillion. However, total unsold assets of IBRA are about Rp.260 trillion. More than a half of it is in litigation. The Ministry of Finance now holds the unsold assets and the Asset Management Company (PPA) is responsible for the sales of the assets. Due to the quality of the assets, the recovery rate on the assets is likely to be much lower than the rate achieved by IBRA (29 percent).

Economic Policy and Structural Reforms

Six months has passed since the government introduced the Economic Policy Package or the White Paper. This package, formulated in the run-up to the exit from the IMF supported program, has 3 main goals: (i) maintaining macroeconomic stability through fiscal consolidation, low inflation and the stability of the currency, (ii) continuing financial sector restructuring, (iii) an increase in investment, exports and employment. The coordinating ministry for economic affairs has set up a monitoring team to supervise the progress of policy actions. The ministry has a regular dialogue with stakeholders such as development assistance agencies and business communities to discuss progress on the White Paper.

Achievements. The White Paper has been instrumental in clarifying the Government's program after the completion of the IMF supported program. As such it has contributed to maintaining market confidence and macroeconomic stability. Under the purview of the

White Paper, parliament passed several major laws including the Industrial Relations Law, Treasury Law, the Law on the Judiciary, and the Law on Water Resources. Regulations on the Labor Law and on Government Procurement were also passed, and the members of the anti-corruption commission were selected. The sales of government shares in Bank International Indonesia and Bank Lippo were successfully completed.

Outstanding issues. Despite the significant progresses, there are outstanding issues especially in the area of investment, exports and employment. Some examples are:

- Submission of draft tax law to parliament (due in January 2004);
- Slow progress in implementing regulations for Manpower Law No.13/2003;
- Submission of the Investment Law (due in December 2003)

The draft tax and tax administration laws sparked considerable debate, including on the plans to increase the powers of the tax administration, an organization that is generally considered to have governance issues. Moreover, the draft tax laws as they currently stand could result in lower revenues. The debate on the investment law and the plans to re-create the one-stop shop for investors under BPKM has caused considerable debate within government among line ministries as well as among levels of government. The current draft proposes to recentralize some of the powers that were decentralized to local governments before. Finally, the slow implementation of the labor laws has raised concerns, notably because uncertainty on future labor costs could impact hiring decisions by employers. Beyond the government also has to carefully handle issues not included in the White Paper, as they may affect employment and the investment climate. The social security bill is a point in case. Although the bill is rather vague, and public statements of government suggest that little will change in the short run, the uncertainty the bill creates may again affect employment prospects.

The Macroeconomic Outlook

The improving external environment with lower than expected interest rates is likely to result in higher growth (Table 4). The World Bank's forecast for 2004 is now 4.5 percent compared to 4 percent forecast in last fall. Assuming there are no major disturbances during the election and gradual improvements in the investment climate (and actual investment), this projection should stand.

The growth rate projection for World trade volume in 2004 has been revised up from 7.9 percent to 8.2 percent. Exports are expected to benefit from the recent economic recovery of major trading partners, the US and Japan. Along with this, oil price projection is revised up from $22 per barrel to $25 per barrel in 2004. According to the MODFI macroeconomic mode[7], these factors could push the growth rate by 0.3 percentage points. Domestically, the decline in inflation and the resulting cut in policy interest rates may lead to higher growth rate of around 0.2 percentage points.

Table 4: 2004 Growth Projection

	Old	New	Impact on growth
World Trade volume (%)	7.9	8.2	+0.1
Oil prices ($/bbl)	22	25	+0.2
Inflation rate (%)	5.5	5.0	+0.2

Source: staff estimates

[7] MODFI model is a macro model developed by the Ministry of Finance and was used for generating World Bank forecast.