



Indonesia: Economic and Social Update

November 2007



Indonesia: Economic Social Update¹

Summary Introduction

The last six months have witnessed a pick-up in the momentum of growth. After a moderate slowdown in 2005, economic growth in Indonesia has increased appreciably. By 2Q 2007, year-on-year growth was up to 6.3 percent compared with 5 percent in early 2006. Most monthly indicators signal a further rise in the third quarter of 2007, despite recent turbulence in international financial and oil markets.

The main drivers of recent growth have been investment and net exports. Investment growth has been running around 7-8 percent *per annum* since 2Q 2006 with indications of a further pick-up in the near-term. For their part, net exports were neutral or a slight drag on growth in the second half of 2006. In the first half of 2007, they added more than 1 percent to growth in GDP. In nominal terms, exports have surged to record levels, owing only in part to the world commodity price boom. Exports of agricultural and mining and mineral commodities (accounting for about 1/3 of merchandise exports) increased by 18 and 42 percent in US\$ terms respectively earlier this year. Exports of manufactured products (which account for almost half of the total) also increased at a robust rate of 15 percent; with forestry products up by 24 percent.

Reflecting the strength in exports, the current account surplus is projected to widen further to US\$10.8 billion in 2007 (some 2½ percent of GDP) versus virtual balance in 2005. Some of these recent gains have been offset by the capital account, which is currently projected to record a narrower surplus in 2007 than the year before. Net international reserves have climbed steadily during this period, to almost US\$53 billion in late September, compared with US\$42.6 billion at end-2006.

Financial markets quickly absorbed the recent turbulence in international markets with what appears to be minimal disruption of overall economic performance to date. As examples, the Jakarta Stock Exchange, after plunging by 20 percent in the 3 weeks between late July and mid-August, rebounded quickly and was back at record highs by mid-October. The Rupiah exchange rate, which was around 9000/US\$ in the months prior to the turmoil slid to 9500 before recovering to 9100 by October. Medium- and long-term interest rates rose by some 200 basis points across the yield spectrum during the crisis. As of early September, the yield curve had reversed about half of the rise, and there was a further moderate improvement (especially at the shorter end of the spectrum) through early October.

Inflation has been a growing concern recently. It fell dramatically in the wake of the major 2005 fuel price increases from a high of 18.4 percent (y-o-y) to 5.3 percent in November 2006. However since then inflation has been creeping higher, reaching 6.9 percent by October 2007, very near the upper end of Bank Indonesia's target band of 5-7 percent by end-2007. Foodstuffs, which account for almost 25 percent of the CPI in Indonesia, have been the main source of inflation in the past several months; they have outpaced general inflation since early 2006, often by several percentage points. By contrast, administered prices (fuel, transportation and electricity among others) have been holding down inflation during the past year, running at less than 2 percent (measured on a 12-month basis).

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Reflecting concerns about inflation, Bank Indonesia held its key policy rate steady at 8.25 percent since early July. This shift in stance followed a series of cuts in steps of 25-50 basis points from a peak of 12.75 percent in April 2006. Reflecting the stronger economy, including investment, credit growth has accelerated in 2007, reaching 22.5 percent (y-o-y) by August.

Fiscal deficits have narrowed significantly in recent years, from above 4 percent of GDP in 1998 to 0.5 percent in 2005. However, the deficit widened a little to 0.9 percent of GDP in 2006, and it looks likely to widen further in 2007, to 1.5 percent of GDP. This wider deficit stems, in part, from temporary factors (e.g., large, once-only settlements of arrears in payment of VAT refunds and spending for disaster relief). But it also reflects more lasting factors, e.g., increased spending on priorities, including health, education and infrastructure. Notwithstanding these wider deficits, the ratio of government debt to GDP is projected to continue to decline, from 39 percent at end-2006 to less than 35 percent by end-2007, owing to continued strong growth.

The incidence of poverty dropped in 2007, to 16.6 percent from 17.8 percent in 2006. This reverses about 75 percent of the deterioration in 2006. Analysis of this latest data is underway but it appears that strong economic growth, falling inflation and targeted cash transfers contributed to the decline in 2007. Nevertheless, a large proportion of the population remains vulnerable with many households tightly clustered around the poverty line. Viewed in relation to the eight Millennium Development Goals (MDGs), poverty alleviation (as measured by the percentage of the population living on US\$1/day) is one of Indonesia's successes. Other MDG successes include: enrollment in primary schools; child mortality; and access to improved water facilities. Other indicators are less positive, but overall the majority of Indonesia's indicators are on-track to achieve the MDGs

Reform momentum continues, especially in budgeting and investment climate reforms. The Government is using increased fiscal space to scale up spending on poverty alleviation through a large National Community Empowerment Program and two conditional cash transfer pilots, one directed at households and the other at communities. The 2008 budget proposes a substantial reallocation of spending to priority areas, including infrastructure, education and social assistance. In July 2007 the Government issued an integrated economic policy package aimed at improving the investment climate and building upon a series of individual policy packages issued in 2006 covering investment policy, infrastructure, financial sector reform and SME policy. The Government has established teams to monitor progress on each part of the package and has designated a minister responsible for each item. There have been a number of specific reform initiatives as well, including passage of an investment law and associated regulations on the negative list designed to improve transparency. There was also a new tax administration law that addresses business concerns about arbitrary treatment and a Government Regulation in lieu of Law that clarifies the status of Batam (Indonesia's largest and most active free trade zone).

Looking ahead, growth is expected to reach 6.3 percent for 2007 as a whole and to rise a bit further, to 6.4 percent in 2008. Investment is expected to remain strong, but exports are expected to slow modestly, due to the projected slowdown in the world economy. A mild fiscal stimulus will help growth prospects with the slight widening of the budget deficit to 1.8 percent of GDP. Spending on pro-poor programs and key priority areas such as infrastructure and social programs (poverty reduction) will increase (in part through a reallocation from fuel subsidies), while achieving reductions in government debt (measured as share of GDP).

Rangkuman Pendahuluan

Kita dapat menyaksikan momentum pertumbuhan yang positif dalam enam bulan terakhir. Sejak perlambatan di tahun 2005, pertumbuhan ekonomi di Indonesia telah kembali meningkat cukup tinggi. Sampai dengan triwulan kedua tahun 2007, pertumbuhan *year-on-year* meningkat sampai 6,3 persen dibandingkan dengan 5 persen di awal tahun 2006. Sebagian besar indikator bulanan mengisyaratkan peningkatan lebih lanjut pada triwulan ketiga tahun 2007, meskipun baru saja terjadi goncangan dalam pasar keuangan dan peminyakan internasional.

Penyebab utama pertumbuhan tersebut adalah investasi dan ekspor neto. Pertumbuhan investasi mencapai sekitar 7-9 persen per-tahun sejak triwulan kedua 2006 dengan indikasi peningkatan lebih lanjut dalam waktu dekat. Sementara ekspor neto tidak banyak berubah atau sedikit mengangkat pertumbuhan pada semester kedua tahun 2006. Pada semester pertama tahun 2007, ekspor neto menyumbang lebih dari 1 persen pertumbuhan dalam PDB. Secara nominal, ekspor telah mencetak rekor dalam pertumbuhannya, yang sebagian disebabkan oleh melonjaknya harga komoditas dunia. Ekspor komoditas pertanian serta pertambangan dan mineral (yang mencapai sekitar sepertiga dari ekspor barang) masing-masing meningkat sebesar 18 dan 42 persen dalam dollar AS pada awal tahun ini. Ekspor-ekspor produk manufaktur (yang mencapai hampir setengah dari jumlah keseluruhan) juga meningkat dengan persentase yang tinggi sebesar 15 persen, di mana produk kehutanan meningkat sebesar 24 persen.

Sebagaimana mencerminkan kekuatan ekspor, surplus neraca berjalan diproyeksikan meningkat mencapai AS\$10,8 miliar di tahun 2007 (sekitar 2,5 persen dari PDB) dibandingkan keseimbangan yang terjadi pada tahun 2005. Beberapa dari keuntungan yang baru diperoleh telah diimbangi (*offset*) dengan rekening modal, yang saat ini diproyeksikan akan mencatat surplus yang lebih sedikit pada tahun 2007 dibandingkan tahun sebelumnya. Cadangan internasional bersih telah meningkat secara stabil selama periode ini, mencapai hampir AS\$53 miliar di akhir September, dibandingkan dengan 42,6 miliar Dollar AS pada akhir tahun 2006.

Pasar-pasar keuangan dengan cepat menyerap goncangan yang baru-baru ini terjadi dalam pasar internasional akan tetapi hal ini tidak terlalu mengganggu keseluruhan kinerja ekonomi. Sebagai contoh, Bursa Efek Jakarta, setelah jatuh sebesar 20 persen dalam 3 minggu antara bulan Juli dan pertengahan Agustus, dengan cepat meningkat kembali dan mencapai rekor tertinggi pada pertengahan Oktober. Nilai tukar rupiah, yang mencapai sekitar 9.000/\$AS di bulan-bulan sebelum guncangan tersebut, melemah mencapai angka 9.500 kembali pulih ke angka 9.100 pada bulan Oktober. Tingkat suku bunga jangka menengah dan panjang meningkat sekitar 200 basis poin di sepanjang spektrum hasil selama krisis tersebut. Sejak awal bulan September, *yield curve* telah berbalik sekitar setengah dari peningkatannya dan terdapat peningkatan moderat lebih lanjut (khususnya pada akhir spektrum yang lebih pendek) sampai awal bulan Oktober.

Inflasi semakin menarik perhatian belakangan ini. Inflasi turun secara dramatis pada awal peningkatan harga BBM yang tinggi pada tahun 2005 dari sebesar 18,4 persen (*y-o-y*) sampai dengan 5,3 persen pada bulan November 2006. Akan tetapi, setelah inflasi merangkak naik, mencapai 6,9 persen pada bulan Oktober 2007, sangat mendekati titik atas dari target Bank Indonesia sebesar 5-7 persen pada akhir tahun 2007. Bahan makanan, yang mencapai hampir 25 persen dari CPI di Indonesia, telah menjadi sumber inflasi utama di beberapa bulan terakhir; bahan makanan telah melebihi inflasi umum sejak awal tahun 2006, seringkali mencapai beberapa persen. Sebaliknya, harga-harga yang diatur (antara lain harga BBM, transportasi, dan listrik) telah menahan inflasi sepanjang tahun kemarin pada laju kurang dari 2 persen (diukur per 12 bulan).

Berkaitan dengan inflasi, Bank Indonesia mempertahankan kebijakan tingkat suku bunga stabil pada angka 8,25 persen sejak awal bulan Juli. Pergeseran kedudukan tersebut mengikuti serangkaian penurunan sebesar 25-50 basis poin dari titik puncak sebesar 12,75 persen di bulan April 2006. Sebagaimana mencerminkan ekonomi yang lebih kuat, termasuk investasi, pertumbuhan kredit mengalami peningkatan di tahun 2007, mencapai 22.5 persen (*y-o-y*) pada bulan Agustus.

Defisit fiskal menurun secara signifikan dalam beberapa tahun belakangan, dari di atas 4 persen pada tahun 1998 sampai 0,5 persen dari PDB pada tahun 2005. Akan tetapi, defisit tersebut sedikit meningkat mencapai 0,9 persen dari PDB di tahun 2006, dan sepertinya akan terus tumbuh di tahun 2007, mencapai 1,5 persen dari PDB. Defisit yang lebih tinggi tersebut sebagian disebabkan oleh beberapa faktor sementara (seperti, penyelesaian tunggakan pembayaran restitusi PPN sekali dalam jumlah besar dan belanja untuk bantuan bencana). Akan tetapi hal tersebut juga mencerminkan faktor-faktor yang cukup bertahan lama, misalnya, peningkatan belanja untuk hal-hal prioritas, termasuk kesehatan, pendidikan, dan prasarana. Tanpa memperhatikan defisit yang lebih tinggi tersebut, rasio utang pemerintah terhadap PDB diproyeksikan akan terus menurun, dari 39 persen pada akhir tahun 2006 mencapai kurang dari 35 persen pada akhir tahun 2007, yang disebabkan oleh pertumbuhan ekonomi yang semakin kuat.

Tingkat kemiskinan menurun pada tahun 2007, mencapai 16,6 persen dari 17,8 persen pada tahun 2006. Hal ini membalikkan sekitar 75 persen dari kemerosotan pada tahun 2006. Analisis data terakhir tersebut sedang dilakukan akan tetapi sepertinya pertumbuhan ekonomi yang kuat, penurunan inflasi dan transfer kas yang menjadi sasaran memberikan kontribusi terhadap penurunan yang terjadi pada tahun 2007. Akan tetapi, sebagian besar penduduk tetap dalam keadaan yang rawan dengan banyaknya rumah tangga yang berkelompok dekat dengan garis kemiskinan. Dilihat dalam kaitannya dengan delapan Tujuan Pembangunan Milenium (MDG), pengentasan kemiskinan (sebagaimana diukur dengan persentase penduduk yang hidup dengan AS\$1/hari) merupakan salah satu keberhasilan Indonesia. Keberhasilan MDG lainnya mencakup: pendaftaran siswa ke sekolah dasar; tingkat kematian anak; dan akses ke sarana air bersih yang lebih baik. Indikator-indikator lainnya belum mencapai tingkat pencapaian yang sama, akan tetapi secara umum sebagian besar indikator-indikator Indonesia berada dalam jalur yang benar untuk mencapai MDG.

Momentum reformasi terus berlanjut, khususnya dalam reformasi penganggaran dan iklim investasi. Pemerintah menggunakan ruang fiskal yang meningkat untuk meningkatkan belanja pengentasan kemiskinan melalui Program Pemberdayaan Masyarakat Nasional yang besar dan dua proyek uji coba transfer kas bersyarat; satu diarahkan untuk rumah tangga dan yang lainnya untuk masyarakat. Anggaran tahun 2008 mengusulkan realokasi belanja dalam jumlah besar untuk bidang-bidang yang diprioritaskan, mencakup prasarana, pendidikan, dan bantuan sosial. Pada bulan Juli 2007, Pemerintah menerbitkan paket kebijakan ekonomi terpadu yang ditujukan untuk meningkatkan iklim investasi dan mengembangkan serangkaian paket kebijakan individual yang diterbitkan pada tahun 2006 yang mencakup kebijakan investasi, prasarana, reformasi sektor keuangan, dan kebijakan UKM. Pemerintah telah membentuk tim-tim untuk memantau kemajuan setiap bagian dari paket tersebut dan telah menunjuk menteri yang bertanggung jawab atas masing-masing bidang. Selain itu juga terdapat sejumlah prakarsa reformasi khusus, termasuk pemberlakuan undang-undang investasi dan peraturan-peraturan terkait mengenai daftar negatif yang dirancang untuk meningkatkan transparansi. Selain itu juga ada undang-undang administrasi pajak yang baru yang mengatasi kekhawatiran usaha terhadap perlakuan yang sewenang-wenang

dan sebuah Peraturan Pemerintah pengganti Undang-Undang yang mengklarifikasi status Batam (zona perdagangan bebas yang terbesar dan paling aktif di Indonesia).

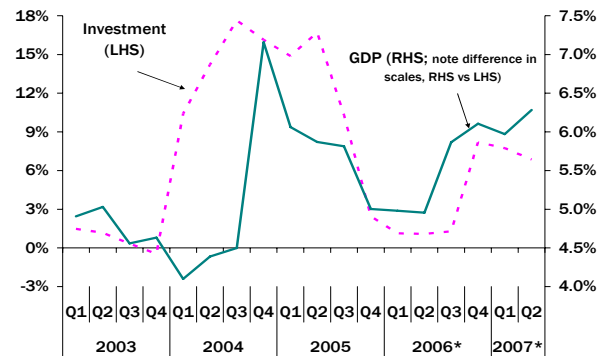
Di masa yang akan datang, pertumbuhan diperkirakan mencapai 6,3 persen untuk tahun 2007 secara keseluruhan dan mungkin akan mengalami sedikit peningkatan mencapai 6,4 persen pada tahun 2008. Investasi diperkirakan tetap tinggi, akan tetapi ekspor diprediksikan sedikit melambat, dikarenakan proyeksi perlambatan ekonomi dunia. Sedikit rangsangan fiskal akan membantu prospek-prospek pertumbuhan dengan sedikit peningkatan defisit anggaran mencapai 1,8 persen dari PDB. Belanja untuk program-program yang berpihak kepada kaum miskin dan bidang-bidang prioritas seperti infrastruktur dan program-program sosial (pengentasan kemiskinan) sementara akan meningkat (sebagian karena realokasi subsidi BBM), sambil mencapai penurunan utang pemerintah (yang diukur berdasarkan besaran *share* dari PDB).

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1. Growth, Investment & Employment

Economic growth in Indonesia is re-gaining momentum, after a moderate economic slowdown in 2005 due to major increases in fuel prices and interest rates (Figure 1). By the second quarter of 2007, year-on-year growth was up again to 6.3 percent and monthly indicators were pointing towards higher growth in the third quarter, despite recent turbulence in international financial markets (Section 2). On the expenditure side on the national accounts, the main drivers of recent growth have been investment and net exports. Investment has been expanding at 7-8 percent *per annum* since late 2006.

Figure 1: GDP Growth and Investment
(year-on-year growth rate, percent)



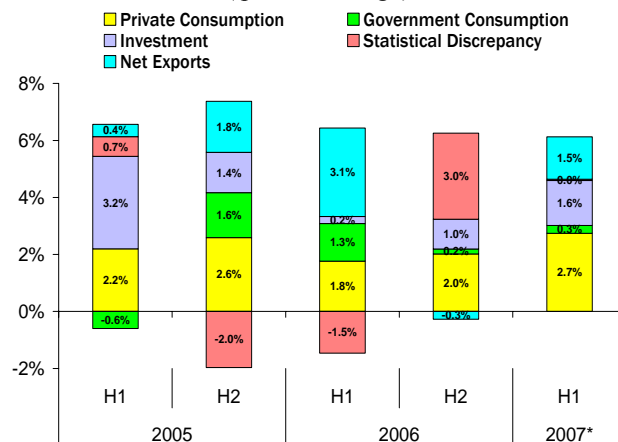
Source: BPS

This overall performance of investment is a particularly welcome development, as stronger investment has been a target of the Government's economic policies for several years now. The ratio of investment to GDP (nominal) has climbed from 19.4 percent in 2002 to 23.9 percent by mid-2007, and looks likely to exceed 24 percent for 2007 as a whole. Notwithstanding these sizable gains, much more is possible, noting that this ratio was near 30 percent just before the severe crisis of 1997/98. In a regional perspective, Indonesia is about halfway between the Philippines (at 15 percent) and Vietnam, Korea and Thailand (all around 30 percent).

For their part, net exports were neutral or a slight drag on growth in the second half of 2006 but since then, have added more than 1 percent to growth in GDP. This is mainly due to merchandise exports, which have surged to record levels, owing only in part to the world commodity price boom (Section 3, below).

Among the other components of GDP, private consumption and government spending have picked up in recent quarters (Figure 2). Both have accelerated by roughly 1 percentage point since late 2006, reaching 4.7

Figure 2: GDP components
(percent change)

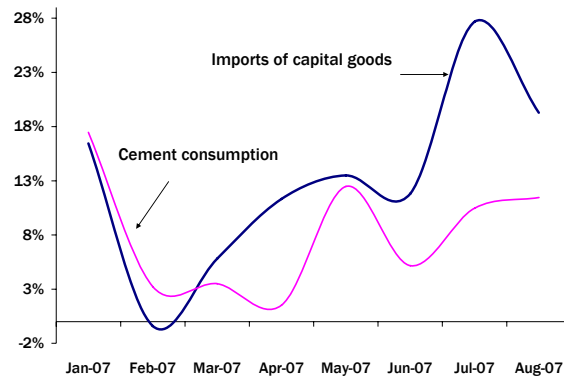


Source: BPS

percent and 3.7 percent (yoy), respectively by mid-2007. Import growth has slowed from about 10 percent in the second half of 2006 to just over 7 percent in the second quarter of 2007.

Forward-looking indicators suggest that investment will continue to improve in the coming quarters. For example, imports of capital goods (a key, near-term indicator for gross fixed investment) were strong through the second quarter of 2007 and have jumped again early in the third quarter. Similarly, cement consumption (a coincident indicator of construction activity) surged early in the third quarter (**Figure 3**).

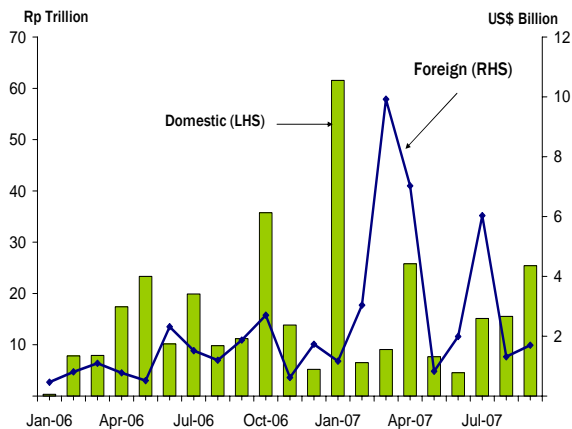
Figure 3: Near-term Investment Indicators
(y-o-y growth; 3-month MA)



Source: BPS and CEIC

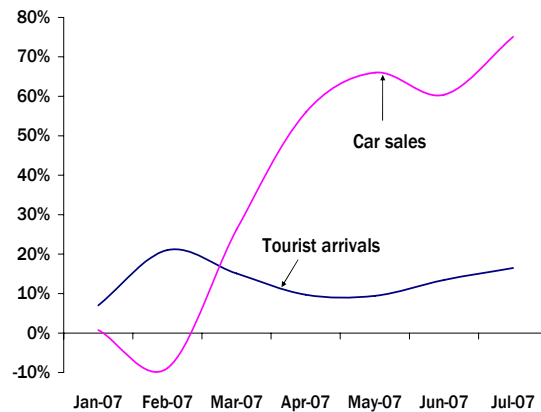
Investment approvals tend to have sharp spikes (**Figure 4**), but both foreign and domestic have been unusually strong in 2007, which points towards continuing strength as projects come to fruition. On balance, other key monthly indicators (cars, tourist arrivals), which are generally coincident indicators for consumption, have also shown continuing strength (**Figure 5**).

Figure 4 : Trends in Investment Approvals



Source: BPS and CEIC

Figure 5: Key Monthly Indicators
(y-o-y growth; 3-month MA)



Source: BPS and CEIC

On the output side of the national accounts, high growth has been accounted for by the non-tradable sectors. Every major non-tradable sector has been expanding faster than the most robust tradable sector (manufacturing). A leader among the non-tradables has been Transportation and Communications, which has been expanding at double-digit rates for several years, due to the popularity of telecommunications services (like subscriptions of cellular phone and internet services, which have been increasing at 40-50 percent *per annum*). Among tradables, manufacturing has been leading the way and accelerating slowly (**Table 1**).

By contrast, the oil and gas sector (which accounts for a substantial fraction of the mining component of tradables) continues its secular decline. Agriculture tends to be volatile in the near-term, owing to fluctuations in local harvest conditions and natural disasters. In the first quarter of 2007, the planting and harvesting were delayed owing to an El Nino drought; there was a modest rebound in Q2 that is expected to gather strength during the rest of the year.

2. Financial Markets

Prior to July 2007, Indonesia's key financial markets were exhibiting heightened confidence, due to continued macroeconomic and political stability. The rupiah was strong and the Jakarta Stock Exchange (JSX) was regularly hitting new record highs. However, in late July a bout of turbulence suddenly hit international financial markets and immediately spilled over into Indonesia's thin financial markets. The international turbulence was fallout from the crisis in the US sub-prime market, magnified by an unwinding of positions in the so-called 'carry trade' (borrowing in low interest-rate currencies, like the Japanese yen, and investing in riskier, high-return currencies, like the Indonesian rupiah). As indicated below, this wave of turbulence dissipated quickly, without sustained impact on economic activity.

The impact of the turbulence was apparent in several sensitive financial indicators. For instance, the JSX plunged by 20 percent in 3 weeks between late July and mid-August. But it rebounded quickly, more than recapturing the lost ground by October (Figure 6). The rupiah exchange rate, which had been stronger than 9,000/US\$ during the months prior to the turmoil slid to 9,500 before returning to approximately 9,100 by mid-October.² (Figure 7) Interest rates rose by some 100-200 basis points across the yield spectrum during the crisis. As of early October, most of this had been reversed and the position of the yield curve was a major improvement on its position a year previously (in Figure 7, compare 'Early October 07' to 'Mid-September 06').

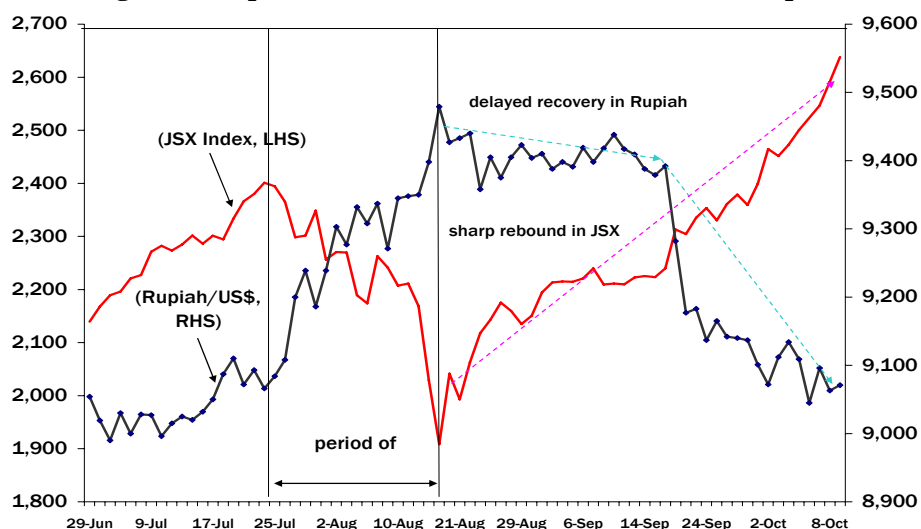
Table 1: Output Side of National Accounts
(y-o-y growth in percent)

	GDP	2006	Q1 2007	Q2 2007
Total	1.0	5.5	6.0	6.3
Tradables	0.5	3.7	3.7	4.3
Agriculture	0.1	3.0	-1.1	2.4
Mining	0.1	2.2	6.5	3.4
Manufacturing	0.3	4.6	5.3	5.5
Non-Tradables	0.5	7.4	8.4	8.4
Utilities	0.0	5.9	8.5	10.5
Construction	0.1	9.0	9.4	7.8
Trade, Hotel & Rest.	0.2	6.1	8.1	8.3
Transport & Comm.	0.1	13.6	11.3	11.9
Financial	0.1	5.6	7.9	7.7
Other Services	0.1	6.2	6.8	7.1
Non-oil & Gas	0.9	6.1	6.5	6.9
Oil & Gas	0.1	-1.3	0.2	-1.4

Source: BPS

² Bank Indonesia's official international reserves were little changed during the period of turmoil. By end-August, they stood at US\$51.4 billion as compared to US\$51.9 billion at end-July.

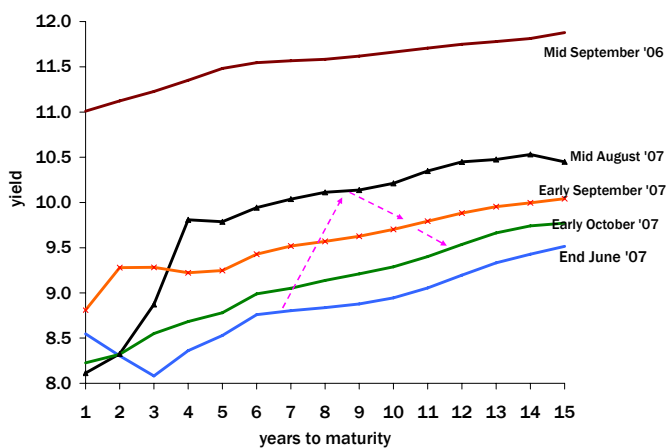
Figure 6: Impact of Financial Turbulence on JSX & Rupiah



Source: CEIC

Looking at the impact of the turbulence on Indonesian financial entities, commercial banks' *direct* exposure to the endangered US financial instruments appears to have been negligible. *Indirect* effects (including exposure of high net worth investors) also appear small, with the main effects stemming from the impact of higher interest rates on the value of (tradable) bonds on bank's balance sheets. It's also notable that during the period of turmoil on the JSX, key rights issues for listed companies went ahead as planned, with the issuers accepting lower prices than expected. For its part, the Ministry of Finance accepted a relatively low proportion of bids at one Treasury bond auction (on 22 August), owing to pricing considerations; by late August, outcomes were more normal.

Figure 7: Impact of Turbulence on Bond Yields



Source: CEIC

3. External Sector & External Debt

Indonesia currently has a strong balance of payments position, including record exports. In 2006, the surplus on current account reached US\$9.9 billion, much higher than in 2004 (US\$1.6 billion) and 2005 (US\$0.3 billion). This significantly larger surplus was partly due to high commodity prices, which pushed exports over US\$100 billion for the first time. Higher commodity prices boosted exports of agricultural and mining and mineral commodities (which account for about one third of merchandise exports); these increased by 18 and 42 percent (y-o-y), respectively, earlier this year.

However, non-commodity exports are also doing well. Exports of manufactured products (which account for almost half of the total) increased at 15 percent whereas forestry products increased by 24 percent. Imports increased at a more measured pace, reflecting the relatively slow pace of economic activity in 2006, with a tendency to accelerate through the first half of 2007.

On the capital account, the balance (excluding errors and omissions) has also been in surplus recently, including an exceptionally large US\$ 2½ billion in 2006. Transactions on public account have been in a large surplus in both 2005 and 2006, as sales of Indonesian government securities more than compensate for net repayments on official financing. The balance on private account was smaller but also positive in 2006 and volatile, due to wide swings in portfolio investment and other (short-term) transactions. Foreign direct investment has been in a large surplus position in recent years, owing to strong gross inflows.

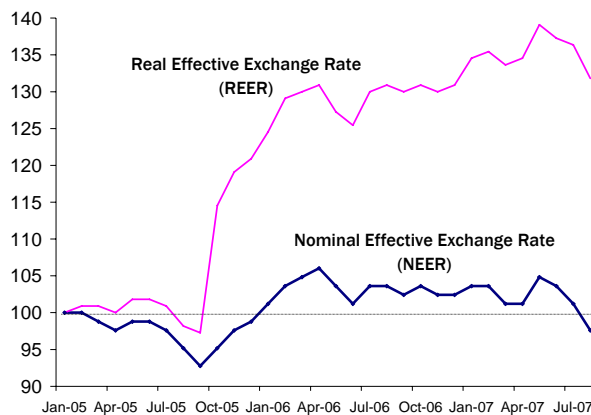
After a sizable appreciation in 2005, Indonesia’s exchange rate competitiveness has remained largely unchanged. During the past 12 months, Indonesia’s nominal effective exchange rate (NEER) depreciated, in part as it paralleled weakness in the US\$ versus third currencies. However, this was been offset by Indonesia’s inflation rate, which was higher than the rest of the world, resulting in a small real appreciation of the rupiah through August (REER, **Figure 8**).

Strong performance on both current and capital accounts has sustained the rupiah and resulted in an accumulation of official international reserves. Reserves surpassed US\$50 billion at mid-2007 and rose further to US\$52.9 billion by late September, despite the turbulence in international financial markets. These amounts now give Indonesia an increased cushion against external shocks. To put this increase in context, reserves have increased by 50 percent since end-2005, when they stood at US\$34.7 billion. It’s notable the large reserve accumulation during 2006 occurred despite early re-payment of some US\$7 billion to the IMF.

Total external debt to GDP, another key external risk indicator, has also improved dramatically in recent years. By end-2006, it was down to 33 percent of GDP versus a peak of 158 percent in 1998. External debt is currently split roughly evenly between government and private debt; as mentioned in Section 5, government is on a sharp decline, whereas private debt is rising.

After placing Indonesia’s credit ratings on review in late July

Figure 8: Effective Exchange Rates
(index 2005=100)



Source: IMF

for a possible upgrade, **on October 18 Moody's Investors Services upgraded Indonesia to Ba3**, three levels below investment grade. The upgrade was made in light of Indonesia's fiscal prudence and improvements in government debt ratios and its external payments position. This move brings Moody's into line with both Standard & Poor's Ratings Services and Fitch Ratings. Previously, in September 2007 the Japan Credit Rating Agency upgraded Indonesian long-term senior debt ratings in both foreign and domestic currency.

4. Inflation & Monetary Policy

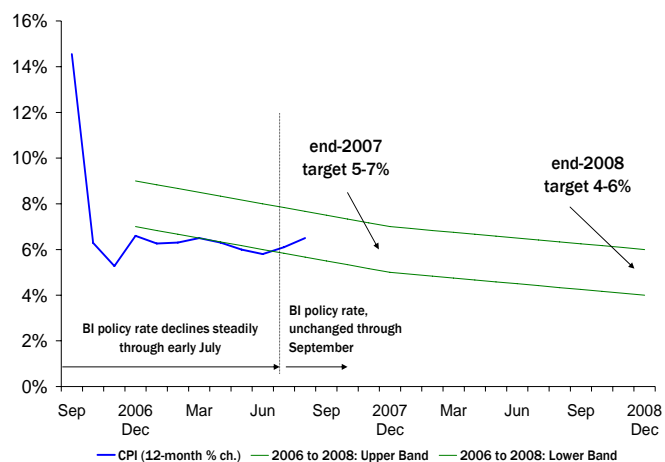
CPI inflation, which dropped dramatically towards the end of 2006 (one year after major fuel price increases), has crept upwards recently. For about 9 months in 2006/07, inflation was running below Bank Indonesia's targets (Figure 9).

However, last June inflation began to creep upwards and by October, it was running at 6.9 percent, near the upper edge of BI's target band. Core inflation, which excludes the volatile components of the CPI, has been steady in the 5.5-6.0 percent range since late 2006.

Like many other developed and developing countries, higher commodity prices have been pushing up food prices and consumer inflation in Indonesia (Figure 10). The persistent nature of these pressures has raised concerns that higher food prices may not be a temporary, cyclical phenomenon. A more serious, structural component may be developing for three reasons: the substitution of bio-fuels (which use inputs like palm oil, sugar and corn) for hydrocarbons; climate change that would reduce global supplies of important commodities like wheat and rice; and soaring demand for higher-protein foodstuffs from countries like China and India.

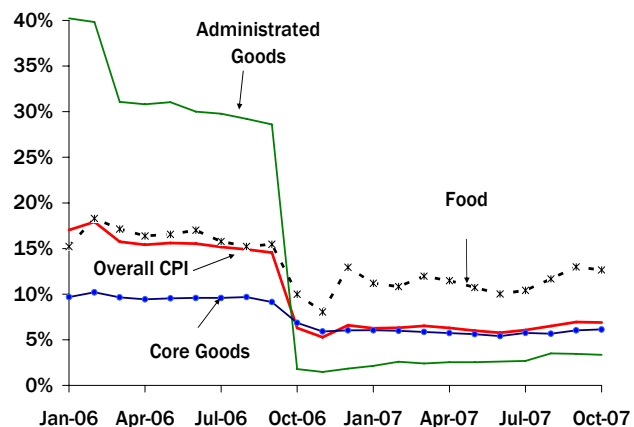
Since July 2005, Bank Indonesia has been operating

Figure 9: Inflation and Bank Indonesia's Targets 2007-08



Source: BPS, BI and World Bank staff estimates

Figure 10: Major Components of Inflation



Source: BPS

within an Inflation Targeting Framework that uses interest rates as its main policy instrument. As inflationary pressures abated after the major fuel price increases of late 2005, Bank Indonesia (BI) reduced its key short-term policy instrument in a series of measured (25-50 basis point) steps between April 2006 and June 2007. Since then, BI has held its key short-term policy interest rate steady at 8.25 percent. BI indicates that this shift is consistent with the July-August volatility in international financial markets, inflationary developments, and its inflation targeting regime (Figure 9). On current indications, there may be limited room for further short-term interest rate declines, especially in light of strong, recent growth in credit (see immediately below).

Commercial bank credit (in rupiah and foreign currency) is reflecting the stronger economy, growing investment and lower interest rates. It accelerated steadily during 2007 and by August growth was up to 22 ½ percent (y-o-y) versus 14 percent at end-2006. Growth is now strong across almost all types of classification. By type of lending, consumer credit, investment credit and working capital are all increasing in the range of 19-25 percent *per annum*. There is more variation by economic sector, with mining (which accounts for only about 2 percent of the total) exceptionally strong (almost 75 percent, y-o-y) and manufacturing lagging (about 11 percent). Among special categories, one notably strong area is lending to the property sector, which is expanding at about 28 percent.

5. Labor Markets and Wages

Reflecting stronger economic growth, unemployment declined in 2007, from 10.4 percent in February 2006 to 9.8 percent in February 2007. Employment increased by 2.4 million whereas the labor force increased by 1.8 million, reducing the number of unemployed by 0.6 million. The new jobs were concentrated in formal employment and the non-tradables sector (Table 2), which is fully consistent with developments on the output side of the national accounts.

This increase in total employment is consistent with the historical relationship between GDP growth than has been the case in recent years (March 2006 Update) suggesting that the impact of Indonesia's 2003 Labor Law may be wearing off. For its

Table 2: Labor Force Developments 2006-2007
(change in percent)

	Feb-06	Feb-07
Unemployment Rate (in %)	10.4	9.8
Male	8.6	8.5
Female	13.7	11.8
Youth (age 15-24)	30.6	25.4
Labor Force, Total	0.5	1.7
Population 15+ (change in %)	2.4	1.9
Participation Rate (in %)	66.7	66.6
Employment, Total (change in %)	0.2	2.5
By: Formal Sector	0.1	4.8
Informal Sector	0.3	1.3
By: Tradables	1.1	1.6
Non-tradables	-0.8	3.8
Memo Items:		
GDP growth (y-o-y, in %)	5	6
Implied productivity growth (in %)	4.8	3.5
Elasticity of employment w.r.t. GDP	0.04	0.58

Source: BPS

part, the labor force increased by 1.8 percent, accounted for by an expansion of 1.9 percent in the population of labor force age and a marginal decline in the overall participation rate.

Among other notable developments, unemployment dropped sharply (from 30.6 to 25.4 percent) for young persons and for females (13.7 percent to 11.8 percent); there was a marginal decline for males (Table 2). Males tended to move from the informal to the formal sector, whereas females moved from unemployed to the informal sector. By region, there were sharp drops in unemployment in Sumatra and NTT/Maluku and it edged down in Java/Bali. In Papua, there was an especially large (some 60 percent) increase in formal sector employment, perhaps reflecting increased government spending.

Turning to wages, in the first half 2007 nominal wages for the urban, informal sector increased by about 4-6 percent (depending upon the sub-sector) from a year earlier (Table 3) implying a real decline for the second consecutive year. Wages for the rural agricultural sector fared better, with the national average rising in real terms by some 2 percent (Table 4). By region, consistent with strong commodity prices, gains were concentrated off-Java, where real wages increased by 8 ½ percent; real wages on-Java declined by some 2 percent.

Table 3: Urban Informal Sector Wages

	Woman			Woman			Woman		
	Construction	Hair Dresser	Household Maid	Construction	Hair Dresser	Household Maid	Construction	Hair Dresser	Household Maid
	(Rp/day)			Nominal (YoY, %)			Real (YoY, %)		
Jan-Jun 2004	26,366	6,351	139,618						
Jan-Jun 2005	29,943	6,865	151,043	13.6	8.1	8.2	5.5	0.3	0.5
Jan-Jun 2006	33,831	7,627	160,396	13	11.1	6.2	-2.8	-4.4	-8.6
Jan-Jun 2007	35,455	7,907	169,644	4.8	3.7	5.8	-1.3	-2.4	-0.4
Jul-06	34,142	7,716	161,678						
Aug-06	34,382	7,757	162,450						
Jul-07	36,142	7,940	171,731	5.9	2.9	6.2	-0.6	-3.4	-0.3
Aug-07	36,164	7,953	172,146	5.2	2.5	6	-1.2	-3.7	-0.5

Source: BPS

Table 4: Rural Agriculture Wages

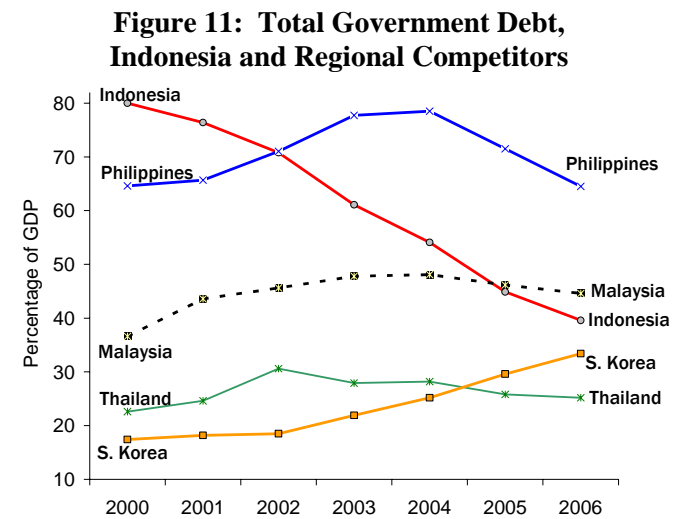
	Average Rp/Day (nominal)			YoY (% nominal)			YoY (% real)		
	National	Java	Off-Java	National	Java	Off-Java	National	Java	Off-Java
Jan-Jun 2004	10,736	9,180	13,485						
Jan-Jun 2005	11,713	10,516	13,745	9.1	14.6	1.9	22.5	29.5	13.2
Jan-Jun 2006	13,476	12,001	15,960	15.1	14.1	16.1	-3.9	-3.4	-4.4
Jan-Jun 2007	14,913	13,067	18,174	10.7	8.9	13.9	2.2	-2.1	8.6
Jun-06	13,689	12,260	16,213						
Jun-07	15,057	13,168	18,394	10	7.4	13.5	1.4	-1.8	6

Source: BPS

6. Fiscal Policy & Government Debt

Following an extended period of fiscal consolidation, the Government's budget deficit looks likely to widen a little. In recent years, budget deficits have been running below 1 percent of GDP (0.5 percent in 2005 and 0.9 percent of GDP in 2006). However, the deficit is expected to widen in 2007 to 1.5 percent of GDP (in the revised budget compared with 1.1 percent in the original budget). This larger deficit stems, in part, from lower-than-expected income tax collections and from large, one-off settlements of arrears of VAT refunds. There has also been increased spending in the 2007 revised budget, including infrastructure and disaster response. Notwithstanding this increased deficit, the ratio of government debt to GDP is projected to decline, from 39 percent in 2006 to less than 35 percent by end-2007, as the deficit remains relatively low and economic growth picks up.

Looking back over a longer time horizon the Government's success, in reducing debt (measured in relation to GDP), merits special emphasis. After the severe crisis of 1997/98, total government debt has continuously been on a sharp downward trend, particularly when viewed in relation to regional comparators (Figure 11). These gains stem mainly from a concentration on fiscal consolidation and increasingly robust GDP growth while the Rupiah has been relatively stable since end-2000.



Source: Ministry of Finance and World Bank WDI

The Government's proposed budget for 2008 projects another small increase in the deficit to 1.7 percent of GDP (Table 5 and Box 1). There will be a decline (relative to GDP) in revenues partly offset by limits on some categories of spending. Lower revenues are the result of lower oil and gas revenues (both tax and non-tax) as GDP growth outpaces increases in oil and gas production (which are assumed to increase as new fields are expected to come on line). Another factor behind lower revenues is a reduction in payments to the Government by Bank Indonesia, which were exceptionally large (more than $\frac{1}{4}$ percent of GDP) in 2007. On the spending side, fuel subsidies (at an assumed international price of oil of US\$60 per barrel) are assumed to decline as PLN switches from oil to coal and as consumers substitute LPG for kerosene. But other subsidies are expected to increase. Among other spending items, transfers to the regions are projected to decline, while central government social and capital spending (poverty programs and infrastructure, respectively) will increase.

Table 5: Indonesian Fiscal Accounts, 2006-08

	<u>2006</u>	<u>2007</u>	<u>2007</u>	<u>2008</u>
	(Actual)	(Budget)	(Projected)	(Budget)
Revenues	19.1	19.1	18.2	18.1
Non-oil domestic tax	10.6	12.0	11.4	12.3
o/w Non-oil & gas income tax	5.0	5.8	5.5	6.1
o/w VAT	3.7	4.3	4.0	4.4
Oil & gas	6.0	4.8	3.9	3.7
Other	2.5	2.3	3.0	1.7
Expenditures	20.0	20.2	19.8	19.8
Central Govt.	13.3	13.6	13.3	13.7
Personnel	2.2	2.7	2.6	3.0
Materials	1.4	1.9	1.6	1.2
Interest Payments	2.4	2.3	2.2	2.1
Subsidies	3.2	2.7	2.8	2.3
Social Assistance	1.2	1.4	1.3	1.6
Other Current	1.1	0.5	0.8	0.8
Capital	1.6	1.9	1.6	2.4
Transfers to Regions	6.7	6.6	6.5	6.2
Primary Balance	1.5	1.2	0.7	0.4
Overall Balance	-0.9	-1.1	-1.5	-1.7
Net Financing	0.9	1.1	1.5	1.7
Bonds	1.7	1.5	1.9	2.1
Official finance	-0.8	-0.4	-0.3	-0.4
Assumptions (actual for 2006):				
GDP growth (%)	5.5	6.3	6.3	6.8
Inflation (%)	13.1	6.5	6.5	6.0
Exchange rate (Rp/US\$)	9,159	9,300	9,100	9,100
Oil Price (US\$/bbl)	\$64.30	\$63	\$60	\$60

Source: Ministry of Finance and Bank Staff projections

There have been marked increases in available financial resources and in responding to development needs. Good progress has been made over the past two years in reallocating inefficient spending (most notably, fuel subsidies) towards pro-poor programs. Fiscal space (for both central and sub-national governments) increased from an estimated 6.3 percent of GDP in 2001 to 10.5 percent in 2007.³ Increased revenues (oil and gas revenues, and taxes), and decreasing fuel subsidies and debt repayments are the main factors behind the 2007 fiscal space of some US\$15 billion.

³ Fiscal space is defined here as discretionary spending (that is, total expenditures minus salary, interest payments, subsidies and transfers to regions).

Box 1: Sensitivity of the 2008 Budget to International Oil Prices

At the drafting of this Update, international oil prices are above US\$ 90 a barrel and the price for Indonesian benchmark crude is in the range of US\$80-85/bbl versus US\$60 in the Budget for 2008. This raises important issues concerning the impact on the fiscal accounts, if oil prices were to be sustained near this level.

There are likely to be sizable impacts on both the expenditure and revenue sides of the fiscal accounts at prices in this range. On the revenue side, Bank calculations indicate that oil tax and non-tax revenues increase appreciably, in total by approximately 0.75 percent of GDP for each US\$10/bbl increase in international oil prices sustained over the entire year (with GDP assumed unchanged). On spending, fuel subsidies expand, as do transfers to regions owing to revenue sharing arrangements, especially with regions that are oil and gas producers. In total, spending is estimated to increase by around 0.9 percent of GDP for each US\$10/bbl increase in international prices. With these assumptions the 2008 deficit would widen by up to 0.15 percent of GDP for a sustained US\$10/bbl increase in global oil prices or approximately 0.2 percent of GDP at the US\$72 a barrel average for 2008 assumed in the EAP Update.

However, other, less quantifiable factors are important. Some reduce the overall impact of the deficit whereas others increase it. Among the factors that hold down the deficit is potential fuel switching especially in PLN. In addition, profits (and corporate tax collections) may be higher than assumed, especially if the government's share of oil revenues rises at higher prices. However, there are effects that increase the deficit as well. The deficit is especially sensitive to the level of oil and gas production assumed because there are no offsetting impacts, i.e. while subsidies remain the same revenues decline. In addition smuggling and substitution of subsidized for non-subsidized fuels grows as international prices diverge significantly (e.g., kerosene is used to dilute industrial diesel, lower octane gasoline is substituted for higher octane in cars). The net effect of these is almost certainly to make the estimated impact on the deficit on the optimistic side.

There are significant increases budgeted for the infrastructure and social sectors. The former is particularly welcome as total public infrastructure investment (public, state-owned enterprises and private sector combined) stands at 3.4 percent of GDP, still significantly below pre-crisis levels of around 5-6 percent of GDP. As a result, Indonesia has fallen behind most other countries in the region, scoring some of the lowest rates of access to clean water, energy and sanitation services.

Regional governments have become a dominant player in service delivery. Indonesia's move towards decentralization in 2001 has changed the fiscal fundamentals of the country and the regions are now responsible for almost 40 percent of total government spending. This has occurred because transfers from the central government to the regions increased between 2005 and 2006 by almost two percentage points of GDP. Transfers now dominate sub-national finances, particularly for district governments because their own-source revenues are relatively low.

Today, the main fiscal policy challenge is not the need for additional financial resources but to spend effectively. Both central and regional governments are having

difficulty spending their available resources effectively. Indeed, regional governments have been saving a large share of their revenues. For example, their deposits with commercial banks reached 2.4 percent of GDP by March 2007. Recently, growth in these deposits has slowed, but they are still rising by 10-15 percent annually.

7. Financial Sector Development

Despite some diversification in recent years, Indonesia's financial system remains dominated (more than 75 percent) by the banking system. Important financial ratios for the banking sector indicate considerable improvement and overall performance is rated sound at present with some exceptions (Table 6). In particular Loan-to-Deposit ratios (LDR) remain low, reflecting in part the holdings of recap bonds (a legacy of the crisis) and SBIs (Bank Indonesia Certificates). Also, the state banks under-perform the overall banking sector, most importantly for non-performing loans and high financing costs. For example Bank Mandiri, accounting for some 15 percent of total assets has 15.5 percent of its assets rated as NPL versus 10 percent for the industry as a whole, although this level is down from almost 25 percent in June 2006.

Table 6: Financial Performance of the Banking Sector
(in percent)

	Dec-04	Dec-05	Dec-06	Jun-07
CAR	19.4	19.3	21.3	21.2
o/w State Banks	20.7	19.4	21.2	19.6
NIM	5.9	5.6	5.8	5.8
o/w State Banks	6.2	5.8	5.8	6
NPL (Gross)	4.5	7.6	6.1	5.8
o/w State Banks	5.9	14.8	10.7	10
ROA	3.5	2.6	2.6	2.9
o/w State Banks	3.5	2.5	2.2	2.7
OpExp/OpInc	76	89.5	87	84.4
o/w State Banks	75.7	95.2	97.1	92
LDR	50	59.7	61.6	63.6
o/w State Banks	49.9	51	59.9	61.9

Source: Bank Indonesia

There has been a change in strategy with respect to state-owned banks. The share of total bank assets held by state-owned banks has been shrinking rapidly and now account for around 36 percent (mid-2007), down from over 46 percent (end-2002). In July 2007, the Government conducted a secondary shares offering of BNI, the second largest state bank. The offering brought the Government's ownership down to 73 percent from 99 percent previously. Three of the four state-owned banks have now been partially privatized and discussions are underway as to whether the fourth, BTN, should be privatized or merged with another state bank.

In recent years, Bank Indonesia's policies on banking development have stressed consolidation in the banking sector and better institutional arrangements for maintaining financial stability. Their main instruments for consolidation are minimum capital requirements and the so-called 'Single Presence Policy'. On minimum capital, as of December 2007 minimum Tier I capital will be raised to Rp80 billion for all commercial banks, and between 2008 and 2010 minimum capital will be raised further to

Rp100 billion. Bank Indonesia has indicated that only a few small-sized commercial banks will be unable to comply, and some mergers and acquisitions are expected. While these amounts of minimum capital are still not large by international standards, BI's merger policy has been criticized as *reducing the number of banks*, whereas the higher objective should be *increasing the number of good banks*.

As for the Single Presence Policy, it was originally promulgated as a BI regulation in October 2006 intending to prevent a person or company from owning shares in more than one bank. However, implementation has been delayed and terms amended significantly, most notably to exclude the government (which, as mentioned, is the majority or sole owner of 4 large state banks) from the policy. In practice, it seems likely that the policy will only be applicable to a very few, mostly foreign bank owners.

On better institutional arrangements, another legacy of the crisis has been ended with deposit insurance successfully reduced to a maximum of Rp100 million per account as of March 2007, without any noticeable 'flight-to-quality'. In addition, Bank Indonesia and the Ministry of Finance have issued regulations on mechanisms for releasing emergency liquidity assistance for systemically important banks.

Other recent regulatory changes are mainly directed at strengthening Sharia banking operations. Sharia banking is still very small (about 2 percent of the total banking sector), but it is growing very rapidly, at about 50 percent *per annum*, including expansion by foreign banks into the fields.

Turning to the non-bank financial sector, some key developments related to the Jakarta Stock Exchange were discussed in Section 2, above. Other notable developments during the first half of 2007 concern average trading volume, which was up about 80 percent compared with end-2006 and market capitalization, which was up some 15 percent. For year to date through August 2007, eight companies conducted IPOs with a total share value of Rp 4.15 trillion. Fourteen other companies raised fresh capital through right issues with a total value of Rp12.7 trillion. With these new IPOs, there are 452 listed shares on the Jakarta Stock Exchange with total market capitalization of about Rp298 trillions as of August 2007.

In the corporate bond market, thirty-six companies conducted bond issuances, raising Rp25.9 trillions. A majority of these companies are financial institutions (banks and finance companies). Total nominal of listed bonds on the Surabaya Stock Exchange was Rp84.9 trillion, up 25 percent from December 2006.

In September, **the Surabaya Stock Exchange was officially merged with the Jakarta Stock Exchange** and renamed the Indonesian Stock Exchange. It is expected to begin operations 1 December 2007. The move could deepen trading because existing participants will have access to a broader range of financial instruments, due to the different specializations of the two markets.

After a redemption crisis in 2005, **the mutual funds industry has expanded rapidly** through the first half of 2007. Total mutual fund net asset value, which grew by 75 percent during 2006 expanded by another 44 percent through the end of July to Rp74.46 trillion. Fixed income funds still take the largest portion of total net asset value (37 percent), followed by equity funds (25 percent), capital protected funds (16 percent), balance funds (15 percent), money market funds (7 percent) and index funds (less than 1 percent).

8. Poverty and the Millennium Development Goals (MDGs)

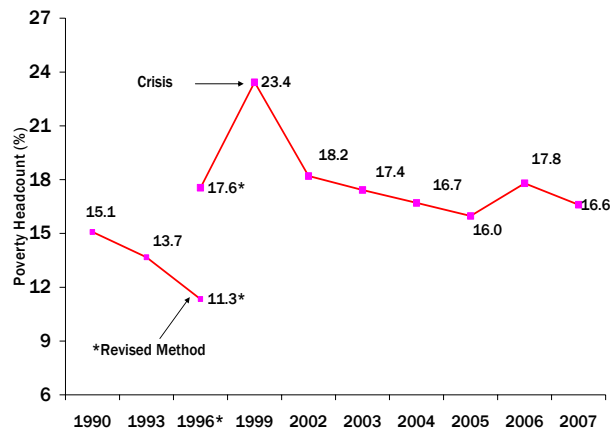
Poverty declined in 2007, reversing the deterioration in 2006 (Figure 12). The absolute number of poor fell by 2.1 million to 37.2 million in 2007 resuming the decline in poverty since the 1998 financial crisis.

Strong growth, falling inflation, and targeted cash transfers all contributed to the decline in poverty between 2006 and 2007. The Indonesian economy performed well over the period (roughly February to February) with real GDP growth close to 6 percent and private consumption growth of 4.7 percent. The cash transfer program, provided over 19 million poor households with Rp300,000 (roughly US\$30) per quarter, compensating these households for fuel price increases and undoubtedly helping to reduce measured poverty in 2007.

Nonetheless, a large percentage of the population remains vulnerable to poverty. Measurement of poverty in Indonesia is volatile because of the large number of households clustered around the poverty line. For example, raising the poverty line 20 percent from roughly US\$1.50 (just below the government’s poverty line) to US\$1.80 per capita per day would increase the poverty rate from 17 to 29 percent. Consequently, small price changes in critical goods—like rice—have disproportionate effects on the proportion of households classified as poor.

Large gaps remain between the poorer east and the more prosperous west. Poverty incidence is highest in the eastern islands, including Papua, Maluku, and Nusa Tenggara, at 41, 26, and 23 percent, respectively. In contrast, poverty rates are 16.5 percent on-Java and -Sumatra. However, Java and Sumatra are the most populous regions and contain over three quarters of the country’s poor. There is also a continuing disparity between urban and rural regions; the poverty rate is 20 percent in rural areas versus 13 percent in urban areas. The urban-rural poverty gap remained constant

Figure 12: Poverty Headcount



Source: Susenas, World Bank staff estimates

between 2006 and 2007, with poverty falling by roughly 1.1 percentage points in each area.

Performance with regard to the Mugs has been mixed. Of the eight Millennium Development Goals (MDGs), the majority are on-track for Indonesia (Table 7). Among the best performers, the percentage of people living on less than US\$1 a day in 2006 over-performed relative to the MDG target of 10.3 percent; net enrollment in primary schools remains high, including a good gender balance; under-five child mortality is falling steadily; and access to improved water facilities has increased dramatically. Other indicators are less positive. Reductions in malnutrition have stagnated since 2002, undermining the progress made in the other indicator in the poverty

Table 7: Indonesia's Progress Towards MDGs

Goal	Targets	2015 Target	Current Data	When ?	On-Track?
1. Eradicate extreme poverty and hunger	Halve the proportion of people living under \$1 per day (<i>indicator</i> : proportion of people living under \$1 a day)	10.3	8.5	2006	Yes
	Halve the proportion of people suffering from hunger (<i>indicator</i> : prevalence of malnutrition)	19	25.8	2005	No
2. Achieve universal primary education	Ensure that all children can complete a full course of primary education (<i>indicator</i> : net enrollment in primary school)	100	93.2	2005	Yes
3. Promote gender equality and empower women	Eliminate gender disparities in primary and secondary education, preferably by 2005, and in all levels of education no later than 2015 (<i>indicator</i> : net enrollment girls in primary school)	100	99.7	2005	Yes
4. Reduce child Mortality	Reduce by 2/3 the under-5 child mortality rate (<i>indicator</i> : no of U5M per 1,000 live births)	33	46.0	2005	Yes
5. Improve maternal health	Reduce by 3/4 the maternal mortality ratio (<i>indicator</i> : MMR per 100,000 live births)	105	307	2005	No
6. Combat HIV, Malaria and other diseases	Have halted, by 2015, and begun to reverse the spread of HIV/AIDS and other major diseases (<i>indicator</i> : HIV/AIDS prevalence)	Insufficient information			
	Have halted, by 2015, and begun to reverse the incidence of TB (<i>indicator</i> : TB prevalence per 100,000)	N/A	262	2005	Yes
7. Ensure environmental sustainability	Halve, by 2015, the proportion of people without sustainable access to safe drinking water (<i>indicator</i> : proportion of people with access to safe water)	86	77	2004	Yes
	Halve, by 2015, the proportion of people without sustainable access to basic sanitation (<i>indicator</i> : proportion of people with access to basic sanitation)	73	55	2004	No
	By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers	Insufficient information			
	Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources	Insufficient information			
8. Develop a global partnership for development	In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. (<i>indicator</i> : youth unemployment rate)	...	30.6	2005	No

alleviation goal, and maternal mortality fell by only 20 percent between 1993 and 2005, probably insufficient to meet the MDG target by 2015. Finally, despite recent progress, access to improved sanitation also remains significantly short of the MDG target for the environment goal.

The Government is scaling up spending on poverty alleviation through a National Community Empowerment Program. The program is being expanded to over half of the country's sub-districts in 2007, with full coverage planned for 2009. The community empowerment program builds upon Indonesia's accumulated experience with community driven development programs, in particular the World Bank funded Kecamatan Development Project (KDP) and Urban Poverty Project (UPP). These programs focus on improving local governance and service delivery at the sub-district and village level, by encouraging participatory planning and providing block grants. Funds are generally used for rural roads, or education and health related projects.

Indonesia is also piloting two major conditional cash transfer (CCT) programs, one directed at households and the other at communities. The household CCT is modeled after similar programs in Latin America, as well as the 2005-06 targeted cash transfer program. The household CCT provides poor households with an average transfer of about US\$140 per year, conditional upon utilizing a basic set of health and education services. In the community CCT, which is an important component of the National Community Empowerment Program, communities receive a grant that is aimed at increased utilization rates of the same basic services that are targeted by the household CCT. Facilitators guide the process of decision-making and provide technical advice on how to improve health and education outcomes. Conditionality is introduced in the form of financial incentives, by making a portion of the block grant in the second and subsequent years dependent on exceeding community-specific targets established in the initial year.

9. Policy Priorities & Developments

The Government has committed to continuing its reform program in 2008, a pre-election year. For example, the 2008 budget proposal submitted to Parliament proposes a substantial reallocation of spending to priority areas, including infrastructure, education and social assistance. This represents a break from a long tradition of incremental budgeting wherein allocations typically resembled those of the previous year and only new proposals were subjected to scrutiny and analysis.

The 2008 budget proposal is closely aligned with the priorities defined in the Government's Annual Work Plan especially as regards significant increases in capital and social assistance spending. Capital expenditures are focused on areas with expected higher economic returns, such as the construction of roads, bridges, irrigation tracks, and transportation infrastructure and facilities. Underpinning the high priority placed on economic infrastructure and investment-led growth, significant spending increases are proposed for the Ministry of Public Works (33.1 percent in real terms) and the Ministry of Transportation (54.8 percent in real terms). However, concern remains about these

departments' ability to absorb the entirety of these increases in spending in 2008, especially on capital projects.

In other important policy initiatives, in July 2007 the Government issued an integrated economic policy package (Inpres No. 6), building upon the previous year's separate policy packages. The package covers four broad areas: investment policy, infrastructure, the financial sector and SME policy. It drills down to about 180 specific reform measures to be achieved by July 2008.

With regard to improving investment policy, the package comprises three sections: investment procedures and institutions, customs, and taxation. Major initiatives include streamlining business start-up and licensing procedures; cutting VAT refund time; launching a pilot project for the National Single Window at the main port; improving risk profiling for customs clearance; and establishing 43 small taxpayer offices. The impact of the package will be greatly enhanced by the recent passage of the Tax Administration Law, which strengthens the rights of taxpayers and limits arbitrary decision-making by tax officials. This holds true for the Investment Law, which (as reported in the April Update) creates a single piece of legislation covering both foreign and domestic investment and states the principle of equal treatment for all investors regardless of national origin. Investor concerns were raised with publication of a negative list that proposed increased limits to foreign involvement in key sectors, and a lack of clarity about the grandfathering of existing investors. Clarification of these issues continues. Also notable is the issuance of a Government Regulation (in lieu of a Law) that clarifies the status of the Batam free trade zone (Indonesia's largest and most active FTZ).

The economic policy package also addresses policy blockages to infrastructure investment and includes a particular emphasis on private investment. A central element of last year's package was the framework for public-private partnership (PPP), which included arrangements for project preparation, vetting, and competitive bidding, and specific PPP transactions. As follow-up, the Government has established and staffed a Risk Management Unit in the Ministry of Finance, with this unit responsible for government guarantees and the allocation of risk between private investors and the Government. The Government has identified ten projects intended to serve as models of good practice in project preparation but progress on these has been slow. *Cross-sectoral reform issues* addressed included infrastructure financing, land acquisition, decentralization of infrastructure responsibilities, and public service obligations (subsidy policy). *Sector-specific reforms*, applying to energy, transport, water and sanitation, and telecommunications, address strategic planning, regulatory arrangements, tariff policy, removal of state-owned enterprise monopolies, and governance. Key achievements included draft laws on transportation, state-owned enterprises, electricity, the postal service, and energy.

In addition, the economic policy package deepens financial sector reform. Key areas covered by the package include strengthening financial system stability, including through greater coordination across regulators; improving financial intermediation through strengthening credit information systems; improving regulation

and supervision of pension funds and insurance firms; increasing efficiency and liquidity of capital markets; and harmonizing regulations and tax treatment across different segments of the financial sector.

As with previous policy packages implementation is the key to success. The Government has strengthened its emphasis on implementation by establishing teams to monitor the progress of each part of the package and by designating a Minister to be responsible for each item. Although not all of the activities in the policy packages are necessarily of the highest priority and some reflect compromises driven by political considerations and capacity limitations, the overall content of the packages—if implemented with determination and accountability would assist considerably in further strengthening Indonesia’s economic development.

9. The Outlook & Risks

Looking ahead, economic growth is expected to increase from 5.5 percent in 2006 to 6.3 percent for 2007 as a whole and to increase slightly to 6.4 percent in 2008 (Table 8). In response to higher government spending, the lagged effect of falling interest rates and continued reforms, investment growth is expected to rise. This higher investment is expected to offset a slowdown in exports in 2008 due to slowing world demand growth due to the impacts of higher oil prices, sub-prime debt and a US slowdown. Continued demand from Asia for Indonesia’s exports is estimated to partly offset a downturn among the industrial countries. Imports are expected to accelerate owing to rising economic growth, led by import-intensive investment spending. The current account should narrow. It should be noted that a precondition for sustained growth of 6 ½ percent or higher, is quality investment, especially infrastructure, both private and public. On the public side, this is well within reach due to the increase in “fiscal space” noted previously.

Table 8: Indonesia: The Outlook

	2006	2007	2008
Growth Rates			
Real GDP (in %)	5.5	6.3	6.4
o/w Gross Fixed Investment	2.9	7.7	10.6
Consumer Inflation (in %)	13.1	6.5	6.0
Central Govt. Budget (as % of GDP)^[1]			
Total Revenues	19.1	17.5	17.7
Total Expenditures	20	19	19.4
Deficit	-0.9	-1.5	-1.8
Total Govt. Debt	39.7	34.5	31.9
Balance of Payments			
Current Account Balance (US\$ billion)	\$9.90	\$10.80	\$8.80
(as % of GDP)	2.7	2.5	1.8
Merchandise Exports (US\$ billion)	103.5	116.1	125.8
(% change)	19	12.1	8.4
Merchandise Imports (US\$ billion)	73.9	83.3	93.7
(% change)	6.3	12.8	12.4

Source: World Bank Staff Estimates

Inflation projected at 6.5 percent for 2007 is projected to decline to 6 percent in 2008 in line with Bank Indonesia's inflation targeting framework assuming that Bank Indonesia will adopt the inflationary stance needed to deliver this result.

After widening a bit in 2007, the fiscal deficit is expected to stabilize around 1.8 percent of GDP in 2008. This deficit is consistent with increased financing for public spending and continued declines in the government debt-to-GDP ratio. Indeed, by the end of the forecast horizon, total government debt (foreign and domestic) is projected to be below 32 percent of GDP. Despite declining debt (in relation to GDP), the Bank projects the government's gross financing needs to remain large (US\$15 to US\$20 billion annually) reflecting the increase in the deficit as well as continued large principle repayments

There are considerable risks to the downside. This outlook assumes that world oil prices return to the US\$72 range, that there is limited further impact on world economic growth stemming from the US sub-prime housing crisis and that the slowdown in US growth is modest (i.e. to 2 percent annual growth in 2008). With these assumptions, vibrant domestic demand in Indonesia (and Asia more generally) is expected to insulate growth somewhat from a downturn in overall world demand.⁴ However, if one more of these turn out to be worse (or far worse) than expected the result for Indonesia's growth and/or budget and inflation would also be worse (or far worse)

⁴ It appears that the slowdown in the OECD countries has already begun. OECD growth in 2006 was 3.9 percent and is projected to be 3.5 percent in 2007, a period associated with rising growth in Asia (and Indonesia), i.e. emerging Asia growth is projected to grow slightly from 8.3 percent to 8.4 percent and Indonesia from 5.5 percent to 6.3 percent over the same period.

than projected. For example, the IMF, in its April 2007 World Economic Update indicates that a 1 percent decline in US growth would, on average, lead to a 0.5 percent reduction in Asian growth. Using this relationship for Indonesia, a recession in the US (assuming zero growth), would lead to a projected slowdown in growth for Indonesia to the 5-5.5 percent range for 2008. Likewise, sustained high global oil prices (in the US\$90 range) would create inflationary pressures, and rising fiscal risks due, among other things, to the impact of fuel substitution and smuggling on subsidies. And, if there are continuing disclosures of large losses due to sub-prime debt, emerging markets spreads could widen.

Interestingly, while the balance of risks is to the downside there are also upside risks. If the outlook turns out to be in line with the base case increased domestic demand linked to rising investment including infrastructure risk triggering significant inflation and import pressures. On balance, by far the greatest risk appears to be the international oil and financial situation but there is also the possibility that rising domestic demand and imported pressures (especially on food) will spill over into higher inflation.
