

INDONESIA

The next few months are crucial to Indonesia's medium-term economic picture. A new economic policy package and early implementation steps by the new government would draw further attention from investors and markets. There are already signs of investment recovery and the external economic environment is supportive. Together with high capacity utilization –serving as proxy for investment demand-, a credible economic policy package and its implementation are likely to be rewarded by further increases in investment. In contrast, the bombing at the Australian embassy in mid-September renewed concerns about security, although the impact on the market was limited. Despite these recent improvements, Indonesia's investment climate remains uncompetitive in international comparisons. In sum, the new government faces two economic policy challenges. First, to remain consistent with the core economic policies that brought macroeconomic stability. Second, the government needs to extend the economic reform agenda, especially to improve the investment climate and to reinforce the improving growth picture.

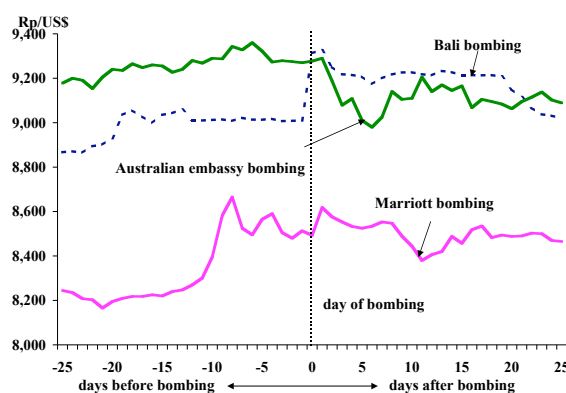
I. Recent Economic and Social Developments

Progress...

Peaceful presidential election. In the run-off election on September 20th, Susilo Bambang Yudhoyono (SBY), former coordinating minister for security and political affairs, was elected the next president. Receiving approximately 60 percent of the votes SBY will be the Indonesian President until 2009. The election and its aftermath have been smooth, indicating that democracy is taking root.

Market sentiment is strong. The markets have welcomed the peaceful election and the stock index is trading at historical highs. The negative reaction after the bombing at the Australian embassy was especially short-lived. The stock index declined by 3 percent almost instantaneously but started to recover the same day. The rupiah exchange rate and stock index declined less than 1 percent that day and recovered to the pre-bombing level the following day. In fact the rupiah exchange rate ended up appreciating slightly in September and the stock index (1983=100) rose to over 850, well above its historic high. A comparison of exchange rates movements following the three recent bombing episodes suggests that the market is becoming more resilient to these shocks (Figure 1).

Figure 1. Less affected by shocks
(Rupiah exchange rate before and after bombings)



Source: CEIC, World Bank staff calculation

Table 1. Moderate GDP growth continues
(2000 base year growth in percent compared same period of the previous year)

	2002	2003	2004	
	H1	H1	H2	H1
GDP	5.1	5.2	3.9	4.7
Non-oil and gas GDP	5.9	6.3	4.5	5.3
By Expenditure				
Private consumption	3.5	3.3	4.4	5.5
Public consumption	17.7	8.8	11.1	8.8
Fixed investment	8.4	3.5	0.4	8.3
Exports	3.5	8.5	4.7	2.0
Imports	9.1	3.9	1.8	8.6
By Sector				
Tradable				
Agriculture	3.8	3.1	3.1	3.5
Mining	3.0	0.2	-3.3	-4.8
Manufacturing	5.8	5.8	4.3	5.6
Non-Tradable				
Construction	6.3	5.7	6.9	7.4
Finance	6.0	7.9	5.9	4.6
Transportation etc.	8.9	10.4	12.7	12.7
Utility	7.2	6.1	5.6	5.5
Retail trade etc.	5.9	7.0	3.6	6.9
Services	2.9	3.9	4.2	4.5

Source: BPS

Moderate growth continues. In the first half of 2004, the economy grew by 4.7 percent (yoy) (Table 1)¹. Though slightly higher than the 3.9 percent in the second half of 2003, growth remained in the 4-5 percent range. The good news is that investment grew by 8.3 percent (yoy), much higher than 0.4 percent in the second half of 2003. The investment growth in Q2 2004 extends beyond property investment (still strong at 7 percent) to include machinery and transport equipment (domestic and imported). In contrast, exports grew by only 2.0 percent (yoy), while

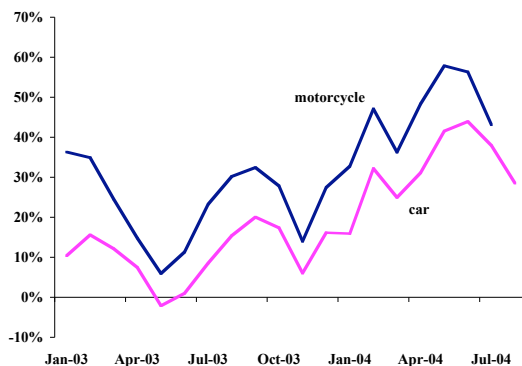
¹ 2000 base year

imports accelerated to 8.6 percent. As a result, the contribution to growth from external demand shrank, though remaining positive. In the production accounts, manufacturing and sectors related to private consumption (i.e. trade, hotel and restaurant, and transportation and communication) were the main sources of growth. In manufacturing, cement and transportation equipment grew the fastest.

Strong durable goods sales supported by credit growth.

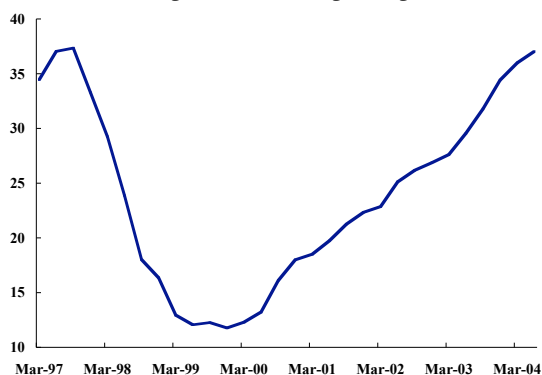
Private consumption especially non-food consumption continues to contribute to growth. Motorbike and automobile sales have accelerated since mid-2003 (Figure 2). An analysis of lending data suggests that consumption lending is supporting non-food consumption. Consumption loans outstanding as a share of private consumption reached pre-crisis levels in June 2004 (Figure 3). On the positive side, rising durable goods demand is increasing the output of related industries (above). On the other hand, the current growth in consumption credit may not be sustainable and further growth in private consumption may be limited.

Figure 2. Motorbike and car sales accelerated
(Year-on-year growth rate, 3 month moving average, percent)



Source: CEIC, World Bank staff calculation

Figure 3. Credits support private consumption
(Consumption credit outstanding as a share of private consumption, percent)



Source: BPS, CEIC, World Bank staff calculation

Signs of investment recovery. In addition to the growth in gross fixed capital formation in the national accounts, other investment indicators show signs of recovery. Capital goods imports in January-August increased by 33.4 percent (yoy). Investment approvals (number of projects, and sum of domestic and foreign) also increased in 2004. In the first quarter, these investment approvals averaged 85 per month, but increased to 120 a month in the second quarter. There are two caveats. First these numbers start from a low base in 2003. Second, this will be the third cyclical recovery since the crisis. Clearly sustained increases in investment will require improvements in the investment climate. Nevertheless these indicators are positive sign.

An improving employment picture. Quarterly labor statistics show that the unemployment rate declined from 8.5 percent in August 2003 to 7.4 percent in May 2004 with the labor participation rate increasing from 65.5 percent to 66.2 percent. This is the first sign of improvement in the labor market, though validation of this trend will require the more reliable annual data². Also the survey continues to indicate slow formal sector growth with the share of informal sector edging up slightly from 64.4 percent to 64.6 percent.

Improving fiscal and external risks (Figure 8). Fiscal and external risk indicators also continued to improve. The government debt to GDP ratio declined from 59 percent at end-2003 to 53 percent in June 2004. The external debt to GDP ratio also declined from 56 percent at end-2003 to 53 percent in June 2004. The short-term external debt to reserve ratio, a measure of liquidity risk, was 45 percent at end-2003, a significant improvement from 231 percent in 1997 and now comparable with neighbors such as Malaysia and Thailand.

...And Challenges

Bombing at the Australian embassy raises renewed security concerns. The bombing had little impact on markets, but it has renewed concerns about the security situation and negatively affects the investment climate. After the Bali bombing in October 2002 and the Marriott bombing in August 2003 investment approvals (units) declined reflecting investor sentiment (Figure 4).

Investment climate remains weak. Despite signs of investment recovery, Indonesia's investment climate remains weak as compared to regional competitors. The World Bank's Doing Business Survey 2005 shows, for example, that it takes 151 days in Indonesia to start business, much higher than regional competitors such as

² Annual labor force survey (Sakernas) and quarterly survey (Indikator Ketenegakerjaan) are not entirely comparable. The quarterly survey focuses on selected indicators, has a smaller sample sizes and varying coverage of provinces.

Thailand (33 days) and Malaysia (30 days). In fact when non-wage costs are included, Indonesia's labor costs are

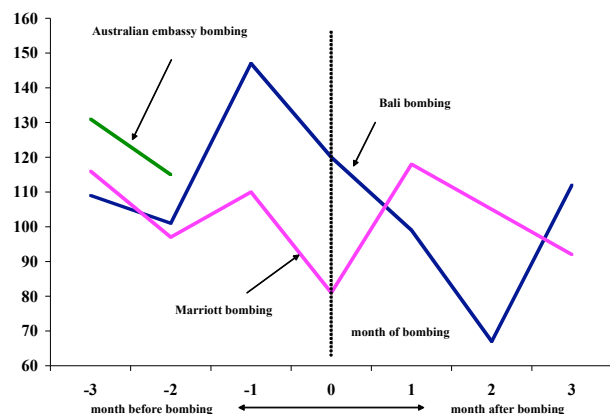
higher than generally thought. Finally, the time to enforce contracts in Indonesia reflects the weak legal environment.

Table 2. Indonesia's investment climate in regional comparison.

	Indonesia	Thailand	Malaysia	Philippines	Vietnam	China
Time to start business (days)	151	33	30	50	56	41
Time to Enforce Contract (days)	570	390	300	380	404	241
Time to go through Insolvency (years)	6.0	2.6	2.3	5.6	5.5	2.4

Source: World Bank (Doing Business 2005)

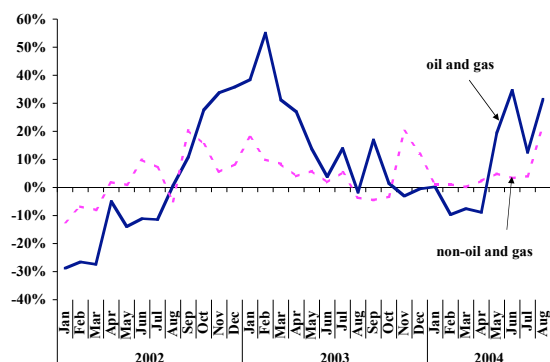
Figure 4. Bombings affected investment
(Investment approvals, units)



Source: CEIC, World Bank calculation

Exports are stagnant and losing share in the world markets. In contrast to strong imports, exports remain relatively weak (Figure 5). During the first eight months, on a balance of payments basis oil and gas exports increased by 7.9 percent, while non-oil and gas exports increased by 5.1 percent. The rapid increase in oil and gas prices indicates that volumes are declining. Also, according to the World Bank's latest projections, world trade volume is likely to increase by more than 10 percent in 2004. Lower export growth in Indonesia compared to the growth in world trade suggests that Indonesia is losing market share.

Figure 5. Exports remain weak
(year-on-year growth rate, percent)



Source: CEIC, World Bank staff calculation

Higher inflation. CPI inflation rate reached 6.3 percent (yoy) in September, about 1 percentage points higher than the low reached in February. Food prices, which account for 25 percent of total, declined by 1.4 percent in September although remain up by 6.8 percent (yoy). However, Indonesia's inflation rate remains low in part due to fuel subsidies. Currently, fuel prices (weighted average) are about half international prices. If fuel prices were increasing with international prices, inflation would be substantially higher³.

Fiscal policy. Parliament approved the revision of 2004 budget (APBN-P) and 2005 budget (APBN). The 2004 budget was revised upward in both revenues and expenditures, though the budget deficit as a share of GDP remains almost unchanged at 1.3 percent (budget 1.2 percent). The upward revisions are mainly due to the change in oil price assumption from US\$22/bbl to US\$36/bbl. On the revenue side, oil and gas revenues (both tax and non-tax) are revised upward, while fuel subsidies and revenue sharing with regions are revised up on the expenditure side. Although the net impact of an oil price change on budgetary balance is almost zero, fuel subsidies are increased from budgeted Rp.14.5 trillion (0.7 percent of GDP) to Rp.59.2 trillion (3 percent of GDP) in the revised budget. The fuel subsidy is now close to development expenditures (Rp.71.9 trillion or 3.6 percent of GDP). From the viewpoint of efficiency, reducing the fuel subsidy is one of the most important challenges for the new government. The government will also need a strong effort to achieve the 2004 budget estimate for tax collection. As of September, non-oil and gas income tax collections were about 65 percent of the budgeted amount.

The just approved 2005 budget (APBN) continues to focus on fiscal consolidation. Budget deficits are projected at 0.8 percent of GDP. On the revenue side, non-oil and gas tax revenues are projected to increase from 12.2 percent of GDP in 2004 APBN-P to 12.8 percent. On the expenditure side, subsidies (total) are projected to decline to 1.4 percent of GDP, as oil prices are assumed to be US\$24/bbl. In the

³ The long-run relationship between fuel price and overall inflation rate suggests that a 10 percent increase in fuel prices roughly leads to 0.6 percent of overall inflation rate.

2005 budget, financing remains a challenge despite fiscal consolidation. Gross financing needs⁴ are projected at 3.8 percent of GDP. External debt rescheduling is not available without Paris Club, and domestic debt principal repayments are high. In contrast, the contribution from asset sales by PPA (the asset management agency replacing IBRA) will be smaller. Although parliament has approved the 2005 budget, there is a strong possibility that the new government will revise it.

Table 3. Snapshot of the state budget
(As a percent of GDP)

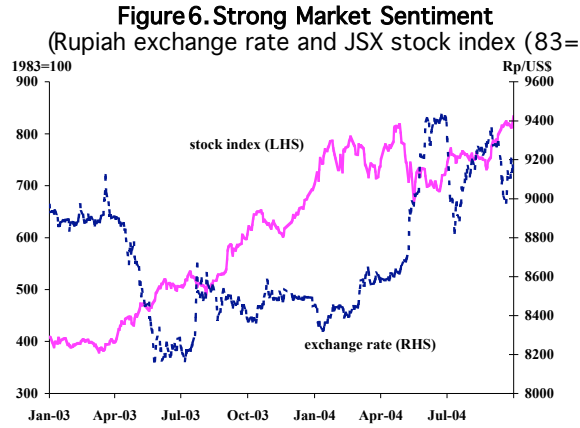
	2003 pre. actual	2004 APBN-P	2005 APBN
Revenues	19.1	20.3	17.4
o/w oil and gas	4.6	5.6	3.0
Expenditures	21.2	21.6	18.2
o/w fuel subsid	1.7	3.0	1.0
Budgetary balan	-2.1	-1.3	-0.8

Note: based on 1993 base GDP

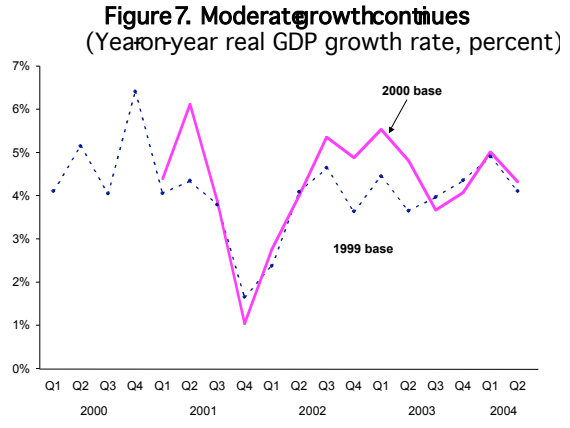
Source: Ministry of Finance

⁴ Gross financing needs are the sum of budget deficits and debt principal repayments (domestic and external).

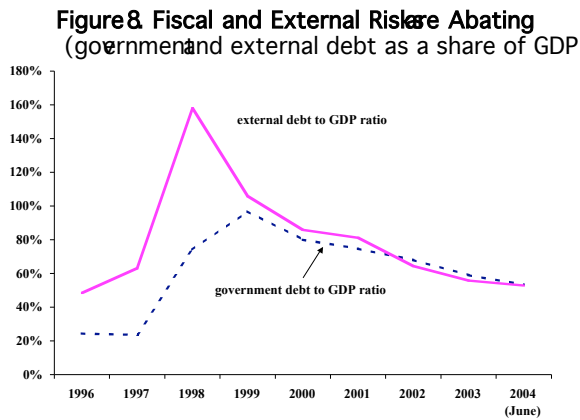
A Snapshot of Indonesia's Economic and Social Developments



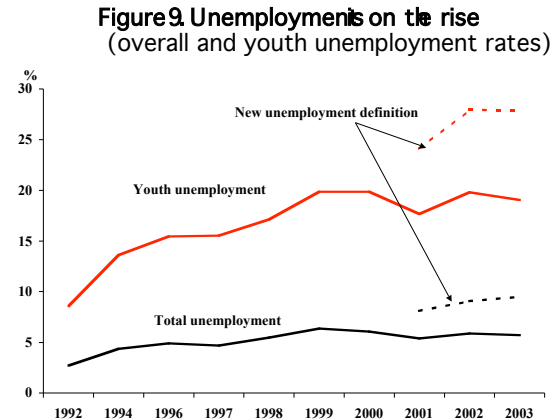
Source: CEIC



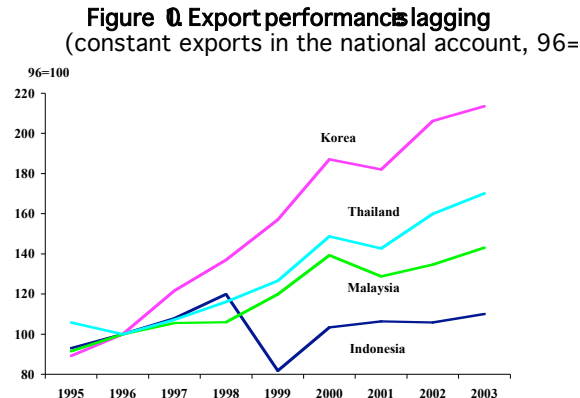
Source: BPS, Bank Indonesia, staff calculation



Source: BPS, Bank Indonesia, staff calculation



Source: BPS, staff calculation



Note: Indonesia is based on 1996 base national account
Source: CEIC, staff calculation

II. Economic Outlook

Growth projection revised upward. Indonesia's economic outlook is gradually improving. The growth rate is now projected at 4.9 percent in 2004 and 5.4 percent in 2005⁵. We expect the investment climate to continue to improve and the primary source of growth to change from consumption to investment. The investment acceleration in the first half of the year supports this view.

Better external environment. A brighter picture in the external environment would also help. The world trade volume growth rate was revised upward from 8.2 percent to 10.6 percent in 2004 and from 7.9 percent to 8.3 percent in 2005 in the latest global economic projection. The oil price projection was revised from US\$25/bbl to US\$36/bbl in 2004 and from US\$21/bbl to US\$32/bbl in 2005 (Table 4). Higher world trade volume is likely to contribute to more growth through exports, and higher oil prices will have a positive impact on the economy through the terms of trade effect, since Indonesia is net exporter of oil and gas.

Table 4 Better external environment projection

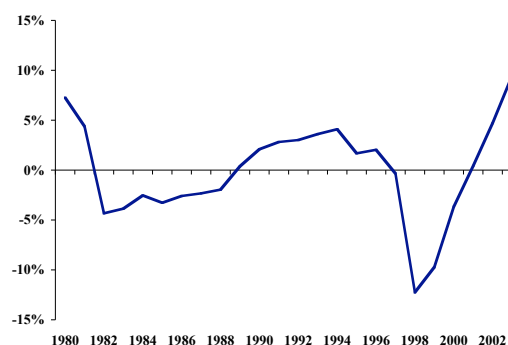
	As of March		As of September	
	2004	2005	2004	2005
World Growth (%)	3.5	3.0	4.0	3.5
World Trade Volume (%)	8.2	7.9	10.6	8.3
Oil Prices (\$/bbl)	25	21	36	32

Source: World Bank

Capacity utilization suggests potential demand for investment will be high. Indonesia faces two challenges regarding capacity. First, the estimated capacity utilization rate is much higher than historical averages (Figure 11). Second, the average age of capital has increased sharply in recent years, serving as a proxy for a deterioration of the quality of capital (Figure 12). Current high capacity utilization results from low investment for 7 years and a moderate increase in growth recently. The historical relationship between capacity utilization, investment and growth suggests that high current capacity utilization rates should be generating investment growth rates around 20 percent. The current rate, while picking up, is well below this, suggesting that investors still consider Indonesia's investment climate unattractive. However, it also suggests that continued growth and improvements in the investment

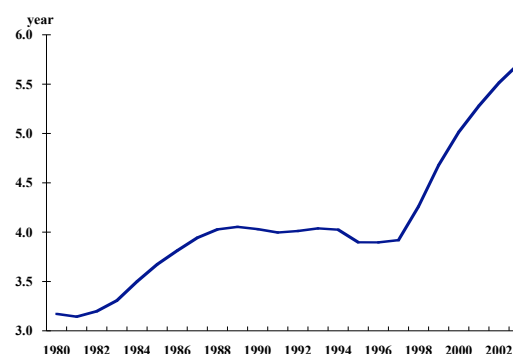
climate could have a large, direct impact on additional investment.

Figure 11. Deviation from the average capacity utilization rate 1980-2003



Source: World Bank staff estimates

Figure 12. Average Age of Capital



Source: World Bank staff estimates

Improving the investment climate and further reform are key to accelerating growth. Growth accounting can be used to assess what it would take to achieve and maintain 6 percent growth rate in the medium term. For the period 1967-2003 the annual average growth rate was 6.2 percent. Of this the contribution from growth in the capital stock was 1.8 percent, labor force 1.8 percent, years of schooling (a proxy for labor quality) 1.7 percent and TFP (total factor productivity) 0.9 percent (Table 5). A comparison of three periods shows that TFP growth rates are quite similar and changes in capital stock (i.e. investment) have driven changes in growth rates. To reach 6 percent growth for the period 2007-8 with TFP growth at 1 percent, the historical average, investment growth would need to average approximately 20 percent⁶. In contrast, if TFP is raised to 2 percent as a result of the acceleration of reforms, the required investment growth would be 14 percent. In 2003, investment growth rate was about 2 percent (Table 1).

⁵ Growth rate projection is based on 2000 base year GDP. Three months ago, growth was projected at 4.5 percent in 2004 and 5.0 percent in 2005 on the 1993 base.

⁶ This estimate assumes labor force growth rates and schooling years are exogenous.

Table 5 Growth Accounting Indonesia

	1997 2000	1998 2003	1990 1997
GDP growth	6.2	3.2	7.4
Capital Stock	1.8	-0.2	3.0
Labor force	1.8	1.5	1.8
Years of Schoolir	1.7	1.1	1.8
TFP	0.9	0.8	0.9

Source: World Bank staff estimates

II. Economic Policies

Overall. The White Paper issued in September 2003 (The Economic Policy Package Pre and Post IMF) combined with a good implementation record and a monitoring mechanism contributed to bridging the so-called “credibility gap”. In part this is seen in the strengthening macroeconomic stability. As of September 2004, the government successfully accomplished more than 70 percent of its action plan. Major achievements and outstanding issues are summarized in Table 6.

Major achievements.⁷ The government has achieved remarkable progress in recent months. The **State Audit Law No.15/2004** was enacted in September and clearly stipulates the role of BPK (state audit agency). Together with State Finance Law No.17/2003 and State Treasury Law No.1/2004, the Audit Law underpins a significant strengthening of state finances. In addition, 3 implementing regulations for the State Finance Law were completed and were used to issue the 2005 budget in a unified format and GFS presentation. In the investment climate area the **Bankruptcy Law was amended** in September. Under the amendment the Ministry of Finance approval is needed to declare insurance firms bankrupt. This addresses concerns that arose around the court cases of Manulife and Prudential and is expected to address investor concerns. **Law No.22/1999 on decentralization and Law No.25/1999 on fiscal decentralization were amended.** According to the amended Law No.25, for example, regions will get 26 percent of domestic revenues from 2008, up by 0.5 percentage points. And, regions may issue bonds in domestic market with prior approvals of DPRD (regional parliament) and the Ministry of Finance.

Outstanding issues. The **Investment Law** has not progressed since the law was discussed at the cabinet meeting in July. The Investment Law should provide the legal framework for both domestic and foreign investors. The **electricity regulator** has been established, but is not operational. A **Social Security Law** passed Parliament despite resistance from both labor and employer groups. This law has controversial provisions that raise uncertainty

about labor and fiscal costs potentially damaging the investment climate.

Economic policy package in the new era. The implementation and monitoring of the current Economic Policy Package contributed significantly to bridging the “credibility gap” as Indonesia exited the IMF program. Now a new policy package is needed. This new economic policy package should focus on consolidating the achievements to date, and shift from focusing on the “credibility gap” to focusing on the “development gap” and especially to improving the investment climate to help Indonesia achieve its medium term development potential.

⁷ Major achievements and outstanding issues as of May 2004 are summarized in “Economic and Social Update in June 2004”.

Table 6. The White Paper- Major Achievements and Outstanding Issues

	Achievements	Outstanding Issues
Macroeconomic Stability	<ul style="list-style-type: none"> • Treasury Law (No.1/2004) • Revised rules on public procurement (Keppres 80/2003) • MOF reorganization; • Divestment of Bank BNI and PGN • Amendments of Law 22/99 and 25/99 • State Audit Law (No.15/2004) • 3 implementing Regulations on State Finance Law No.17/2003 	<ul style="list-style-type: none"> • Revision of tax and tax administration law
Financial Sector Restructuring	<ul style="list-style-type: none"> • Draft LPS Law (Deposit Insurance) • Divestment of Bank Lippo and BII • Amendment of Bank Indonesia Law 	<ul style="list-style-type: none"> • Privatization of Bank Permata • Strengthening of the governance of state banks • Draft OJK Law (Financial Service Authority)
Investment, Exports and Employment	<ul style="list-style-type: none"> • Law on Judiciary Commission • Blueprint for the Supreme Court • Anti-corruption commission members appointed • National investment and export team • One-roof licensing system for investment approval • Electricity market supervisory agency • Amendments to the Bankruptcy Law • Amendments of Low 22 and 25/1999 on decentralization 	<ul style="list-style-type: none"> • Outstanding regulations on Labor Law and Industrial Dispute Law • Investment Law

Source: Coordinating Ministry for Economic Affairs, World Bank Staff