

# Indonesia

*GDP growth picked up in 2004 and a smooth transition in government was achieved, paving the way for a further acceleration in the economy over 2005–2007 if the investment climate improves. The private sector could play a much greater role in the development of infrastructure to support stronger economic expansion. Key requirements are to increase spending that benefits the poor, create jobs for at least 2 million people who enter the workforce each year, improve the investment climate, and combat corruption.*

## Macroeconomic assessment of 2004

The economy expanded by a stronger than expected 5.1% in 2004 on the back of a 4.9% increase in private consumption and a 15.7% rise in fixed capital formation. Although fixed capital spending recovered strongly, much of it was concentrated in property development.

Improved productivity and higher prices helped push up growth in agriculture to 4.0%. Construction grew by 8.2%, spurred by investment in property, and the retail sector rose by 5.8%, as private consumption expanded. Transport and communications achieved a buoyant 12.7% growth. Manufacturing, lifted by booming demand for cement and transport equipment, grew by 6.2%. Mining and oil production, however, could not match this pace, despite higher global prices for minerals and oil.

Mining output fell by 4.6%, due to obsolete equipment, poor security at some mines, and lack of investment. Similar impediments held back oil production, which averaged 1.0 million barrels a day in 2004, down from 1.4 million barrels in 2000 and about 20% below the country's OPEC quota. Higher oil prices pushed up the cost of the Government's subsidies for fuel prices, to about \$6.8 billion for all of 2004, a quadrupling from 2003. The higher fuel subsidies meant that much-needed development expenditures had to be curtailed.

The higher rate of growth helped reduce the poverty incidence (based on a daily minimum food requirement of 2,100 calories and locally accepted requirements for shelter and clothing) from 17.6% in 2003 to 16.6% in 2004. However, an annual labor force survey showed the unemployment rate rising from 9.1% in February 2003 to 9.6% in February 2004. Of particular concern is a decline in formal-sector employment, by 4.7% in 2003, while the proportion of people employed in the informal sector has risen. Firms indicate that current labor regulations have terms that discriminate against employers' interests which, together with higher minimum wages, discourage hiring in the formal sector.

Inflation eased in the second half of 2004, from a year-on-year rate of 7.2% in July to 6.4% in December. It averaged 6.2% in 2004, the lowest rate in 4 years. This enabled Bank Indonesia, the central bank, to lower the reference interest rate—the rate on its 1-month certificates of deposit—from 8.3% in December 2003 to 7.4% in December 2004. In line with this reduction, lending rates for consumer loans declined by 195 basis points to 16.7%, and the rates charged on loans for working capital and investment dropped by 150 basis points to 13.6% and 14.2%, respectively. Commercial bank deposit rates fell, spurring a 26% rise in lending by commercial banks at end-2004. Lending for housing was

particularly strong, soaring by 84% in August 2004 from the year-earlier month. As a result, the loan-to-deposit ratio went up to 57.4% in December 2004 from 48.5% a year earlier. The proportion of total loans to SMEs increased from 44% in 2003 to 51% in 2004, partly reflecting greater optimism about SME activities. Gross NPLs of commercial banks declined by 1.6 percentage points to 6.6%.

Stock prices surged as a consequence of the rate reductions, the smooth transition in government, and improved earnings at several blue-chip companies. By the end of December, the stock-price index had climbed 47% over 12 months to touch a record high.

After holding at around Rp8,450–8,600/\$1 during the first 5 months of 2004, the rupiah depreciated to Rp9,000–9,300 in subsequent months, taking down the average exchange rate for the year to Rp8,940, 3.9% lower than in 2003. Although the dollar depreciated against most currencies, a relatively high domestic demand for dollars to meet debt repayments and rising imports kept the rupiah weaker against the dollar and regional currencies. This depreciation benefited tourism, with the number of visitors rising by 23.6% in 2004.

On the fiscal front, with revenues expanding more rapidly than expenditures despite a heavy fuel subsidy burden, the Government improved its fiscal performance in 2004. Revenues increased to 20.3% of GDP from 16.7% in 2003, while expenditures came in marginally higher at 21.6%, up from 18.3%. The deficit was contained at 1.3% of GDP. The Government met its 2004 bond issuance target of Rp32.3 trillion, including \$1 billion in sovereign bonds sold in March. Bond issues were oversubscribed by two to four times, with most buyers from the banking sector and pension funds. Remaining financing needs were met through external sources and privatization.

In 2005, the Government plans to raise Rp43 trillion from bond sales to finance the budget deficit, against a background of reduced scope for large-scale privatizations. Indeed, foreign investment approvals by the Capital Investments Coordinating Board fell by 26.8% to \$10.3 billion in 2004, mainly because there were fewer privatizations on offer to foreign investors. Also, foreign companies invested less

**Table 2.7 Major economic indicators, Indonesia, 2004–2007, %**

Item	2004	2005	2006	2007
GDP growth	5.1	5.5	6.0	6.5
GDI/GDP	21.3	22.3	24.2	26.1
Inflation (CPI)	6.2	5.9	5.4	5.5
Money supply (M2) growth	8.1	12.0	12.0	12.0
Fiscal balance/GDP	-1.3	-0.8	-1.0	-0.5
Merchandise export growth	9.4	6.0	7.0	8.0
Merchandise import growth	13.3	9.6	11.0	12.0
Current account/GDP	2.6	2.1	1.5	1.0

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Badan Pusat Statistik; Bank Indonesia; Ministry of Finance; staff estimates.

in expanding their plants in 2004 than in 2003. However, the value of new foreign-invested project approvals rose slightly to \$5.4 billion.

Strong world prices for oil and commodities produced by Indonesia, plus the depreciation of the rupiah, lifted merchandise exports by 9.4%. Merchandise imports grew faster, by 13.3%. The trade surplus rose slightly to \$25.2 billion, but the current account surplus as a share of GDP fell to 2.6% and is on a declining trend. Foreign exchange reserves were steady over 12 months at \$36.3 billion at end-2004, representing almost three times outstanding short-term debt repayments, and providing cover for 6 months of imports. The overall ratio of public debt to GDP declined to 53% at end-September, from 59% in December 2003.

### Macroeconomic policy developments

The smooth transition to a new administration after parliamentary and presidential elections in 2004 raised hopes for a period of stable government that will address the long list of challenges facing the country. Prior to its departure in October, the previous Government completed some key initiatives. These included amendments to laws on regional autonomy and the adoption of new laws on planning and social security. The Bankruptcy Law was amended to provide greater clarity for insolvency rulings on financial intermediaries, in particular. The Ministry of Finance was

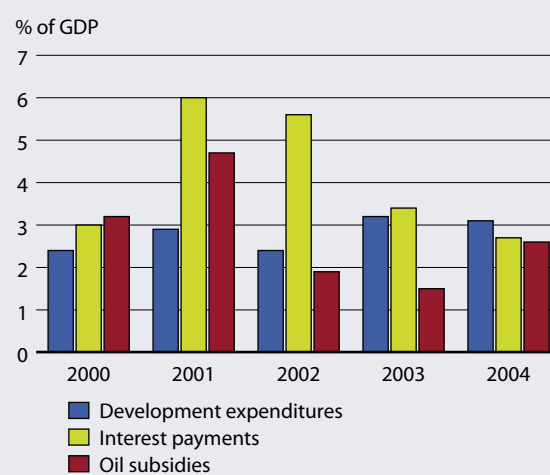
reorganized, a new treasury division was formed, and a unified budgeting system was adopted.

However, several challenges that faced governments in previous years remain. For instance, the overall legal and regulatory environment for investment is uncertain. Amendments to the Investment Law have not been finalized. These were intended to provide policies that do not discriminate between foreign and domestic investors, to open new sectors to foreign investors, and to streamline procedures on investment approvals. The previous Government issued a presidential decree to simplify the investment approval process, but resistance from various ministries and local governments has rendered the decree ineffective. Impediments to investments caused by problems, such as poorly managed decentralization and the issuance of conflicting regulations by local governments, can only be overcome by policy, legal, and role clarity to be provided by the central Government.

Exacerbating these impediments, the Constitutional Court in November 2004 annulled the Electricity Law No. 20/2002 on the grounds that it allowed for competition and the separation of generation and distribution in the electricity industry, which the court ruled was incompatible with the 1945 constitution. The court's decision, which throws into doubt the legal framework for the power industry, has created further uncertainty about the future direction of reforms. The Government has since issued a new regulation that allows private sector participation in the form of a partnership with state-owned utility company Perusahaan Listrik Negara. The partnership will be established by the utility calling for bids for new power generation projects; the utility will also act as the single buyer. To provide a legal framework for this proposal, the Government has undertaken to revise the 1985 Electricity Law, taking into account the Constitutional Court's concerns, and will submit the revised law to Parliament.

Fraudulent activity was disclosed in 2004 at three large state banks—Bank Mandiri, Bank Negara Indonesia, and Bank Rakyat Indonesia—reflecting the fact that risks remain in the banking sector. In addition, Bank Indonesia suspended regular banking operations of Bank Global and put Bank Persyerikatan Muhammadiyah under surveillance. Further progress is required in

Figure 2.7 Selected budget components, Indonesia, 2000–2004



Sources: Badan Pusat Statistik; Ministry of Finance.

improving corporate governance in the banking system, with more stringent and coordinated supervision required by the central bank. Bank Indonesia has announced new regulations to facilitate bank mergers, which would pave the way for the implementation of a banking sector development blueprint unveiled in 2004.

At its inauguration, the new Government announced a near-term reform agenda based on identifying key issues quickly and achieving some tangible outcomes within its first 100 days, adopting a “shock therapy” approach to reduce corruption and to restore public trust in government through well-defined reforms that go beyond routine activities with a minimum burden on the budget.

Notwithstanding significant challenges imposed by the 26 December tsunami disaster, the Government went ahead with an infrastructure summit in January 2005 and hosted a government-donor consultative group meeting. Recognizing the infrastructure challenges facing the country, with investment needs estimated at upward of \$70 billion over 2005–2009, the Government is doing the following: focusing on ways to mobilize finance for infrastructure development; formulating a framework for risk management in infrastructure; creating a sound policy, legal, and regulatory environment in sectors such as energy, transport, and telecom-

munications; and tapping the private sector. The Government has offered 91 infrastructure projects with a total value of \$22.5 billion for potential private sector investment. The tender process for some projects has been initiated, while the rest will be pursued in the second half of 2005.

In order to strengthen SOEs and to facilitate their privatization, the new Government is preparing a blueprint for restructuring SOEs, including those with public-service obligations. As part of this, it plans to form a holding company to oversee more than 160 SOEs with combined assets of more than \$77 billion, to be modeled along the lines of the Singapore Government's Temasek Holdings. Various issues need to be resolved, though, before this restructuring can be implemented.

In December 2004, the Government announced its National Poverty Reduction Strategy, which adopts a "rights-based approach" to poverty reduction. Efforts will be directed to ensuring that the poor are given 10 basic rights, including adequate food, access to health care, decent housing, and work. The strategy envisages meeting these goals through budgetary mechanisms, with government intervention to be designed in accordance with the socioeconomic conditions of various regions.

The near-term reform agenda announced at the Government's inauguration was overshadowed by the tsunami tragedy, so that some key measures were not fulfilled by March, including the resolution of high-profile disputes with foreign companies in the cement and the oil and gas industries.

### **Outlook for 2005–2007 and medium-term trends**

Indonesia's economy is on a moderate growth path with GDP expected to rise by 5.5% in 2005 and 6.0–6.5% in 2006–2007, supported by stronger domestic consumption and investment. Starting from a low base, gross investment is expected to increase to 22–26% of GDP, stimulated by the new Government's planned measures to enhance certainty for investors.

The impact of the tsunami disaster on GDP is estimated to reduce growth by 0.1–0.5 percentage point, although this could be offset by spending

on relief and reconstruction. The province of Aceh—the province most seriously affected by the disaster—accounted for 2.2% of total GDP in 2003. Of this contribution, 30% came from agriculture and 40% from production of oil and gas (these production facilities were not damaged on 26 December). A strong earthquake in March 2005 devastated Nias island. Reconstruction of housing and infrastructure, as well as labor-intensive projects and the revitalization of agriculture (including fishing), would help restore livelihoods.

In February, the Government raised the price of petroleum products by 29%, although the price of household kerosene, used mainly by the poor, was not increased. It is estimated that the higher fuel prices will add 0.7–1.0 percentage point to the inflation rate. This could be balanced to some extent in the short term by lower rice prices because the fuel price rises were made at harvest time, when rice prices usually decline. Inflation is forecast to average less than 6% annually in the next 3 years, although inflationary pressures will be greater if the rupiah continues to depreciate against the dollar. Bank Indonesia is likely to keep the benchmark interest rate on its 1-month certificates of deposit in the 7.5–8.0% range in 2005.

On the assumption of no downward pressures on commodity prices, exports may well grow steadily, though their full potential is constrained by the country's low productivity, competitiveness problems, and lack of financing for exporters. Given recent trends in domestic demand and investment, imports are likely to continue to grow strongly, and the ratio of the current account surplus to GDP is forecast to decline from 3.2% in 2003 to 1.0% in 2007.

The Government's new Medium-Term Development Plan for the next 5 years, signed by the president in January, raises the economic growth target to 6–7% a year. It aims to lower the unemployment rate from 9.1% in 2003 to 6.7% in 2009, and to achieve a reduction in poverty incidence from 16.6% in 2004 to 8.2% in 2009. Meeting these goals will, however, require greater public and private investments. These targets are ambitious, and achieving them depends on the containment of governance risks and enhancement of trade competitiveness.

The 2005 budget will likely be revised to take

into account the rehabilitation and reconstruction needs in tsunami- and earthquake-affected areas, reduced fuel subsidies resulting from the increase in fuel prices, and the additional social welfare spending made possible by the reduction in subsidies. The revised budget deficit will likely be 1% of GDP, above the previous projection of 0.8%.

The political risks of raising fuel prices are significant, although the Government's approach of better targeting subsidies by leaving the price of kerosene for household use unchanged will partly cushion the impact of increases in other fuel prices. Also, the Government aims to spend more than \$1 billion of savings made by reducing fuel subsidies on additional health care and education for the poor. It will establish a system to direct the additional spending to targeted groups, with help from local governments and the Family Planning Bureau. However, the continuing rise in global oil prices could have major implications for public expenditures, since raising domestic fuel prices again will not be a palatable option.

A major challenge is job creation, because at least 2 million people enter the labor market every year. The authorities have acknowledged that one way to unlock the economy's potential for growth is by raising productivity through shifting labor into the formal sector, which employs just one third of the workforce. In addition to efforts under way, the creation of more jobs in the formal sector is likely to require greater labor market flexibility, an improved investment climate, lower transaction costs, more legal certainty, and better infrastructure.

Combating corruption is a key part of improving the investment climate. The president

issued an instruction in December laying out principles aimed at improving integrity in central and local government institutions, and requiring all state officials to declare their wealth for review by the Commission on Eradication of Corruption. The instruction also sets in motion streamlined procurement procedures aimed at reducing bureaucratic discretion. The National Development Planning Agency has been asked to draft a national anticorruption action plan to guide the Government's efforts in this area until its term ends in 2009. The apparently tough stance, along with the prosecution of a few high-profile corruption cases in the early days of the new Government, is expected to have a positive impact, although it remains to be seen how the cases are resolved.

While external debt is at a manageable level, the economy is still vulnerable to sudden changes in investor confidence that may lead to capital outflows and sudden currency depreciation. Confidence may suffer if higher fuel prices, security problems, or regional disputes generate social unrest. The Government is aware of these risks and its agenda acknowledges the need to ensure peace and security.

There is a risk that the public is unrealistically optimistic on what the Government can achieve in the near term. For a start, the Government's ability to work with Parliament is yet to be tested. On balance, the Government has performed well in the first few months, given the challenges it has faced, including the tsunami disaster. The risk of losing momentum with regard to the reform agenda should be managed through monitoring and evaluation of progress.