INDONESIA ECONOMIC QUARTERLY

December 2013

Slower growth; high risks

THE WORLD BANK | BANK DUNIA
Sharing Development Solutions
for an Emerging Indonesia

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Preface

The Indonesia Economic Quarterly (*IEQ*) has two main aims. First, it reports on the key developments over the past three months in Indonesia's economy, and places these in a longer-term and global context. Based on these developments, and on policy changes over the period, the *IEQ* regularly updates the outlook for Indonesia's economy and social welfare. Second, the *IEQ* provides a more in-depth examination of selected economic and policy issues, and analysis of Indonesia's medium-term development challenges. It is intended for a wide audience, including policymakers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

The *IEQ* is a product of the World Bank's Jakarta office. The report is compiled by the Macro and Fiscal Policy Cluster, Poverty Reduction and Economic Management (PREM) Network, under the guidance of Jim Brumby, Sector Manager and Lead Economist, Ndiame Diop, Lead Economist and Economic Advisor, and Ashley Taylor, Senior Economist. Led by Alex Sienaert, the core project team, with responsibility for Part A (economic update), editing and production, comprises Arsianti, Magda Adriani, Brendan Coates, Fitria Fitrani, Ahya Ihsan, Elitza Mileva, Violeta Vulovic and Michele Savini Zangrandi. Administrative support is provided by Titi Ananto and Sylvia Njotomihardjo. Dissemination is organized by Farhana Asnap, Indra Irnawan, Jerry Kurniawan, Nugroho Sunjoyo, Randy Salim and Marcellinus Winata, under the guidance of Dini Sari Djalal.

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Executive summary: Slower growth; high risks

Looking ahead to 2014, Indonesia faces slower growth, and significant economic risks…

The final quarter of 2013 has seen the continuing adjustment of the Indonesian economy to more subdued commodity prices and tighter external financing conditions, and to the related pressures on external balances. Policies have responded, particularly through tighter monetary conditions, the Rupiah has depreciated substantially in real terms, and investment spending and output growth have weakened. These developments are broadly supportive of continued macroeconomic stability, including by helping to lower the current account deficit, although their impact continues to play out, adding additional uncertainty to the path of the domestic economy. At the same time, the international environment is also shifting, with global growth expected to improve, bringing potential policy changes, notably in US monetary policy, which could add to the pressures on Indonesia's external financing position.

…requiring a policy focus not only on macro adjustment but also on credible implementation of longer-term investment- and export-enhancing reforms

In light of the slower pace of growth, and the risks facing the economy, there is a strong need for Indonesia to augment the recent macro focus on tighter monetary policy, exchange rate adjustment and import compression, with deeper reforms to lift export performance and support investment inflows, especially FDI. Progress on the credible implementation of such measures can help to limit the vulnerability of Indonesia's external balances to tighter, or more volatile, global financing conditions and can help to support a sustainable virtuous cycle of strong investment, including foreign investment, and output growth over the medium term. The political dynamics of an election year may play an important role in framing policy choices in 2014 but this backdrop also adds importance to the need for clear communication and coordination of such deeper reforms, both in the formulation and implementation stages, and for the avoidance of policy missteps. This would support local and foreign investor confidence in Indonesia's future economic trajectory, and external financing inflows.

The performance of the global economy is expected to improve further in 2014…

Economic conditions amongst the world's largest economies, and Indonesia's major trading partners, remain uneven. Growth in the US has picked up steam over 2013, the Euro Area has finally exited its long recession but its recovery remains subdued, while growth in Japan, though positive, has weakened. China's economic activity accelerated in the second half of 2013, joined in recent months by India, but activity in some other major developing economies like Brazil has remained more subdued. Moving into 2014, the baseline expectation is for global economic conditions to strengthen, as high income economies gain more traction, supporting growth in developing economies, notably including China, and resulting in a continued modest expansion in the demand for Indonesia's exports.

…and commodity prices have stabilized…

International commodity prices have generally increased in recent months lifting the price index of Indonesia's top ten commodity exports by 3.8 percent since August (though it remains 2 percent lower in 2013 and 22 percent below its recent peak in February 2011), helped by higher coal, natural gas, and palm oil prices. If sustained, the nascent stabilization in commodity prices would help arrest the decline in Indonesia's terms of trade which has driven much of the deterioration in the external balances. However, the baseline outlook of only a moderate pick-up in global growth, coupled with the likelihood of tightening global liquidity conditions and more structural downward pressure on prices from supply-side factors, does not suggest a major upswing in commodity prices in 2014.

…but international policy risks and financial conditions continue to pose challenges for Indonesia

The international outlook, although improving, still contains sizeable policy challenges and uncertainties. In Europe, the recovery is fragile and will likely be uneven due to ongoing deleveraging and considerable reform challenges. In Asia, the pace and manner in which ambitious structural reform efforts in China and Japan are implemented, and elections in India, will shape the outlook. Above all, the timing and pace of the phasing out of the US Federal Reserve's asset purchase program (so-called "tapering") is uncertain, but keeps the risks of global market volatility and more difficult external financing conditions to the fore.

Domestic policy and economic adjustments over 2013 have been significant…

As highlighted in the October 2013 *IEQ*, the expectations of tapering, and related tightening external financing conditions, beginning in May, combined with the gradual transmission of lower commodity prices since 2011, have precipitated a number of important economic and policy adjustments in Indonesia over the second half of 2013, which are ongoing. Bank Indonesia (BI) has raised its policy interest rate corridor by 175 basis points (bp) since June, when the Government increased subsidized fuel prices by an average of 33 percent. The Rupiah has depreciated by 24 percent against the US Dollar year-to-date, largely since August, and in real trade-weighted terms fell by 12.5 percent from its recent peak in May through October.

…and growth has slowed notably, reducing import demand, especially of capital goods, helping to stabilize the current account deficit

Indonesia's economic growth has slowed notably, to 5.6 percent year-on-year (yoy) in the third quarter, marking the fifth consecutive quarter of declining growth from the recent high of 6.4 percent yoy in Q2 2012. Most of the slowdown has been driven by softening investment spending, which was up a relatively modest 4.5 percent yoy in the third quarter, reflecting contractions in machinery and equipment investment from their year-ago levels. Weaker investment spending has cut capital goods imports, the US Dollar value of which was 16.3 percent lower yoy over the three months to October. Overall import volumes have been subdued, and contracted significantly in Q3. Export volumes also contracted in sequential terms in Q3, but not by as much as imports, such that net exports added significantly to output growth. Overall, indications are that Indonesia's trade balance is shifting in such a way as to stabilize and begin to narrow the overall current account deficit.

Macroeconomic adjustments to date have been broadly positive for stability, but do carry some costs…

The monetary policy and exchange rate adjustments seen in 2013 are broadly positive for macroeconomic stability, with the depreciation of the Rupiah acting as a "shock absorber" for the weaker terms of trade by supporting export earnings and dampening import demand. However, these adjustments carry costs, and can bring potential risks, notably by placing pressure on public and private sector balance sheets by raising the Rupiah value of external debt—particularly if there are currency mismatches—and eroding incomes through higher debt servicing and import costs.

…and while the 2014 Budget maintains a prudent stance it does not contain any major fiscal reforms

The above monetary policy and exchange rate changes are carrying the burden for near-term macro adjustment. On the fiscal side, the 2014 Budget, approved by Parliament on October 25, maintains a non-expansionary stance, projecting a smaller overall fiscal deficit of 1.7 percent of GDP. However, the Budget does not include any major revenue or expenditure reforms, though it does incorporate a reduction in the allocation to electricity subsidies by 29 percent relative to 2013, reflecting the intention for ongoing upward tariff adjustment. With the impact of the June 2013 price hike offset by the weakness in the Rupiah, the budget allocation to fuel subsidies is set to remain significant in 2014 at IDR 211 trillion (or 2.0 percent of GDP), up IDR 11 trillion on the 2013 revised Budget level.

The World Bank projects GDP growth to slow to 5.3 percent in 2014, and the current account deficit to narrow…

As the impact of less buoyant commodity prices, tighter external financing conditions, higher real domestic interest rates, and the depreciation of the Rupiah, continues to play out, Indonesia's GDP growth is projected by the World Bank to slow to 5.3 percent yoy in 2014 in the base case (Table 1), from 5.6 percent in 2013. Helped by relatively subdued import growth and a mild pick up in exports, the current account deficit should narrow, to USD 23 billion in 2014 (2.6 percent of GDP), from USD 31 billion (3.5 percent of GDP) in 2013.

Table 1: Indonesia's economic growth rate is projected to slow to 5.3 percent in 2014

		2011	2012	2013p	2014p
Real GDP	(Annual percent change)	6.5	6.2	5.6	5.3
Consumer price index	(Annual percent change)	5.4	4.3	7.0	6.1
Current account deficit	(Percent of GDP)	0.2	-2.8	-3.5	-2.6
Budget balance	(Percent of GDP)	-1.1	-1.9	-2.5	-2.1
Major trading partner GDP	(Annual percent change)	3.6	3.4	3.4	3.9

Source: BI; BPS; Ministry of Finance; World Bank staff projections (2013p and 2014p)

…but risks around this base line are skewed towards slower growth…

These projections, however, are subject to significant uncertainty, and risks are tilted towards weaker domestic growth. In particular, the baseline view is contingent on external financing conditions being sufficiently supportive to avoid precipitating a more abrupt external balance adjustment, causing economic disruption and a knock-on impact on growth. Such a deterioration could be triggered by international market developments, or be specifically due to domestic economic and policy developments. In addition to the risks around growth, there are also risks to the fiscal outlook. For example, the World Bank estimates that a 10 percent depreciation of the Rupiah increases the fiscal deficit by 0.3-0.4 percentage points of GDP, largely by raising fuel subsidy costs (see the October 2013 *IEQ*).

…with a particular focus on risks to investment growth, but also to the resilience of private consumption

Indonesia's GDP forecasts are particularly sensitive to the investment outlook which faces risks from further real interest rate increases and exchange rate volatility, or from a greater-than-expected tightening in credit conditions impacting the thus-far solid growth in building investment. There is also the risk that private consumption growth—although notably resilient to date—may come under more pressure from higher prices and interest rates, weaker income growth and negative wealth and confidence effects. Even mildly weaker domestic demand growth than currently anticipated (e.g. a 0.5 percentage points reduction in private consumption and investment growth relative to their base lines) could reduce 2014 growth to below 5 percent. A more severe moderation in domestic demand, for example, due to an intensification of external financing constraints or negative confidence effects associated with policy missteps, could feasibly move 2014 growth to below 4.5 percent.

There is a need for policies to support exports and FDI inflows, and to avoid potentially damaging measures aimed at import suppression

With consumption goods accounting for less than 10 percent of Indonesia's imports, the slowdown in imports, while supporting a reduction in the current account deficit, mainly means less raw material and intermediate products for manufactured goods production, and fewer capital goods. In the absence of available, competitive, domestic substitutes this will likely come at a direct cost to current and future export and output growth. While import compression due to relative price and income effects can play a useful short-term role in the adjustment process, the real policy challenge for Indonesia is therefore not to focus on additional import suppression through regulatory measures, but rather to increase exports, and to secure more and higher quality external financing, particularly FDI.

Measures to support improvements in the business environment have an important role to enhance Indonesia's underlying attractiveness to FDI inflows…

While FDI into Indonesia has so far proved resilient, if still at lower levels relative to GDP than many regional peers, it is underpinned by three factors which have all come under varying degrees of recent pressure: Indonesia's huge natural resource base (undercut by generally softer global commodity prices and regulatory uncertainties), the large and growing domestic market (undercut, at least in the near-term, by the headwinds facing domestic demand), and Indonesia's potential as a regional production hub in Asia (undercut by regulatory uncertainties, and skills and infrastructure gaps). Consequently, there is a clear need to make more progress to support FDI, including by moving forward on a pro-investment revision of the negative investment list (DNI), a centerpiece of the Government's August policy package still awaiting implementation, and strengthening the quality of the overall investment policy formation process to minimize policy uncertainty. The Government has also launched a significant policy package to improve the ease of doing business, with an action plan announced on October 25 across eight "Doing Business" areas. The challenge now is to implement this package on the ambitious February 2014 timeline, providing a positive signal as to the trajectory of the business environment and commitment to reform implementation.

…and process and regulatory improvements in trade facilitation and logistics could also deliver "quick wins" to lift exports

The real depreciation of the Rupiah over 2013, by boosting international competitiveness, presents an opportunity for Indonesia to improve its export performance. Furthermore, the weakening in commodity prices could also shift investment more towards the non-resources sector, including export-oriented manufacturing. As highlighted in the October 2013 *IEQ*, a number of "quick wins" are available in trade facilitation and logistics, focusing on the performance of import cargo clearance in ports such as Tanjung Priok in Jakarta, which by improving efficiency and predictability in trade logistics could boost exports and strengthen Indonesia's participation in the global production network. Supporting longer-term export competitiveness also requires a continued focus on plugging infrastructure and skills gaps.

A continued emphasis on the quality of spending, including, through subsidy reform, can help to meet longer-term development goals…

As highlighted in this and previous *IEQ*s, fuel subsidies remain a major source of fiscal risk, dent the ability of the flexible exchange rate to absorb shocks, and divert spending away from more efficient uses, including the needed increases in public investment. Although any fuel price increases appear politically unpalatable ahead of elections, there is clearly a strong need for further reforms, while at the same time improving the safety net for the poor and vulnerable. Reform options include those that may not result in an immediate increase in prices, such as implementing a rule-based approach for setting subsidized fuel prices in such a way as to gradually limit the fiscal exposure to higher Rupiah-denominated fuel prices.

…along with measures to make further progress in the fight against poverty, …

Reallocating spending from subsidies could support a strengthening of Indonesia's social assistance programs. While the recent expansion in long-term social assistance programs from the third quarter of 2013 is welcome, social assistance spending (at about 0.5 percent of GDP) remains low by global standards and commitment to the ongoing growth of social assistance, and effective program implementation, will be required to help speed up poverty reduction. For example, poverty in Indonesia fell by 0.6 percentage points in the year to March 2013, to 11.4 percent as measured by the official rate. Moving into 2014, higher prices and slower economic growth add to the poverty reduction challenge. Indeed, the World Bank projects the March 2014 poverty rate to be 11.0-11.1 percent, indicating a continuation of the ongoing slowing of poverty reduction and suggesting that the Government's 2014 target of an 8-10 percent poverty rate will likely be missed.

…to address longer-term labor market challenges and support governance capacity at the local level

To make further progress in achieving Indonesia's medium-term development objectives, it will be necessary to support ongoing positive structural change in the labor market. This requires steps to enhance productivity and facilitate formal sector employment growth in higher value-added sectors, including by increasing the skills base of the labor force. This edition of the *IEQ* also considers the insights from recent survey results on another key element for delivering on Indonesia's development goals, namely strengthening local governance capacity for effective service delivery.

A. Economic and fiscal update

1. Slowly improving global demand, external financing risks remain

The growth performance of Indonesia's major trading partners remained mixed through the end of 2013…

Economic conditions amongst the world's largest economies, and Indonesia's major trading partners, remain uneven. The Euro Area finally exited from recession in the second quarter of 2013, following six consecutive quarters of contraction, but growth softened again in the third quarter (to 0.4 percent at a seasonally-adjusted annualized rate, qoq saar), suggesting that its path to recovery remains bumpy. Growth also weakened in Japan in the third quarter, to 1.1 percent qoq saar, while, in contrast, US growth firmed to 3.6 percent qoq saar, suggesting that the US economy has continued to gain steam fairly steadily through 2013. Amongst major developing economies, growth in China moved up to 9.3 percent qoq saar, but in Brazil output contracted in Q3 versus Q2, by 0.5 percent (seasonally adjusted), and growth has been relatively subdued in India (at 4.8 percent year-on-year, yoy, in Q3), though recently showing signs of re-accelerating.

…but global demand is expected to stage a modest improvement in 2014…

Looking ahead to 2014, high income economy growth is expected to remain at or above its recent pace, with the Euro Area's still-fragile recovery expected to continue, and the US economy expected to expand at close to its current rate. Supported by this mild expansion, developing country growth is also expected to increase, with China's economy growing by 7.7 percent in 2014, and developing country growth excluding China climbing to above 4 percent in 2014, up from approximately 3.5 percent in 2013. Consequently, the World Bank projects the weighted average growth of Indonesia's major trading partners to increase to 3.9 percent in 2014, up 0.5 percentage points from 2013. In the base case, therefore, international demand should increase moderately through 2014, supporting a continued modest expansion in the demand for Indonesia's exports.

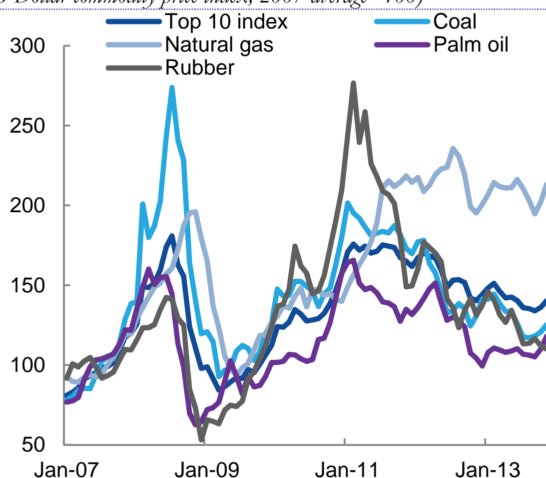
…and Indonesia's major commodity prices may be stabilizing, following over two years of sustained losses

International commodity prices have generally increased in recent months. The weighted US Dollar price index of Indonesia's ten most important export commodities, accounting for approximately half of total export revenues, troughed in September and picked up through the end of November, helped by higher coal, natural gas, and palm oil prices (Figure 1). As a result the year-to-November decline was trimmed to 2.5 percent from 7 percent in September. However, the index remained down 22 percent from its February 2011 peak, with the prices of coal (down 40 percent), palm oil (down 37 percent) and copper (down 27 percent) having fallen most precipitously from their 2011 highs. Should it prove sustained, the nascent stabilization in commodity prices would help arrest the decline in Indonesia's terms of trade which has driven much of the deterioration in its external balances. However, the base line outlook of only a moderate pick-up in global growth conditions through 2014, coupled with the likelihood of tightening global liquidity conditions and more structural supply-side factors placing downward pressure on prices, does not suggest a major upswing in commodity prices. In addition, as noted in the October 2013 *IEQ*, Indonesia's terms of trade continue to suffer from the fact that global oil prices, impacting the country's sizable fuel imports, remain relatively elevated compared with non-energy commodity prices.

However, ongoing policy uncertainties cloud the international outlook…

While the expected modest increase in global growth in 2014 should be broadly positive for Indonesia by supporting overall export demand, the international outlook continues to be clouded by major policy uncertainties, keeping the risks of more adverse global growth scenarios elevated. In Europe, high unemployment (12 percent for the Euro Area), large output gaps, and continued credit contractions in the periphery generate deflation risks, while reform fatigue may mean that the reforms necessary to boost structural growth prove hard to deliver, complicating the economic recovery. In Asia, the pace and manner in which ambitious structural reform efforts in China and Japan are implemented, and national elections in India, will shape the outlook.

Figure 1: Key commodity export prices show signs of stabilizing at broadly flat levels compared with a year ago
(US Dollar commodity price index, 2007 average=100)



Note: Top 10 index is index of USD prices of Indonesia's 10 most important export commodities, weighted by share in 2012 exports
Source: World Bank

Figure 2: Global and emerging market sovereign debt funding costs remain on an up-trend
(yields, percent)

Note: Emerging market and Indonesia USD bond yields as measured by JP Morgan EMBIG index and Indonesia sub-index
Source: JP Morgan

…and external financing and market conditions pose ongoing challenges

Above all, the global financial market and ultimately real economy impact, and timing, of the gradual phasing out of the US Federal Reserve's asset purchase program (so-called "tapering") is uncertain, but keeps the risks of international market volatility and more difficult external financing conditions to the fore. US yields remain well up from their levels before tapering came into focus in May, with the US 10-year Treasury yield at 2.9 percent on 11 December up from 1.6 percent in April. Dollar sovereign borrowing costs for emerging markets have increased by approximately 160 basis points in 2013 on average (as measured by the blended yield of the JP Morgan Emerging Market Bond Index). As the US Federal

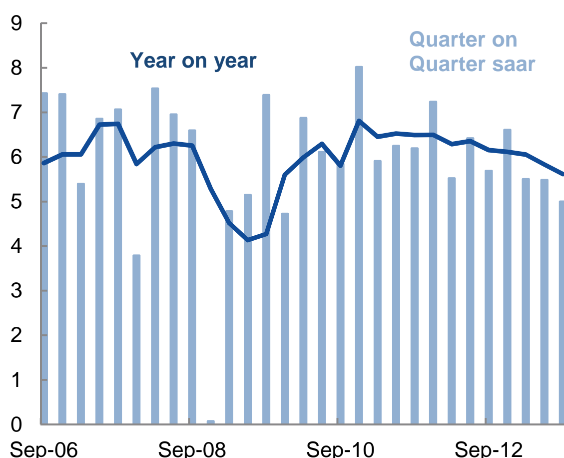
Reserve negotiates the normalization of monetary policy, the likelihood of upward pressure on longer-term borrowing costs globally, along with bouts of market volatility as experienced during the tapering "dress rehearsal" period of May-August, will remain a concern. Emerging markets, including Indonesia, therefore face tighter global liquidity conditions, placing upward pressure on their external funding costs and potentially making it more difficult to rely on net portfolio investment inflows to meet external financing needs.

2. Despite strong consumption, Indonesia's economic growth is slowing

Economic growth in Indonesia continued to moderate in Q3…

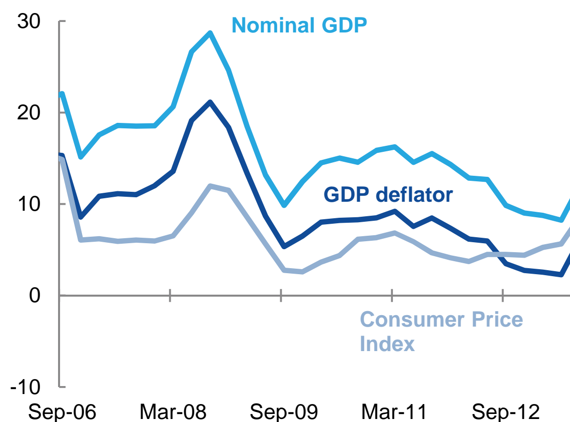
Tightening external financing conditions, beginning in May, have compounded the gradual transmission of lower commodity prices since 2011, precipitating a number of important economic and policy adjustments in Indonesia, and weighing on growth. The pace of expansion of Indonesia's economy has slowed down, a trend which the World Bank expects to continue at least into the early part of 2014. Real GDP in the third quarter was up 5.6 percent yoy, marking the fifth consecutive quarter of weakening growth in year-on-year terms, down from the recent high of 6.4 percent in Q2 2012 (Figure 3). In sequential terms, growth in Q3 slipped to 5.0 percent qoq saar, down from 5.5 percent in the previous two quarters and the recent high of 6.6 percent in Q4 2012. In contrast to real GDP, nominal GDP growth picked up sharply, to 12.1 percent yoy in Q3 from 8.2 percent yoy in Q2, reflecting an increase in the growth of the GDP deflator—the broadest measure of prices across the economy—which had previously fallen to very low levels. This is line with the sharp rise in consumer prices following the June subsidized fuel price increase (Figure 4), and likely also reflects higher import prices as a result of the Rupiah depreciation.

Figure 3: Real GDP growth is moderating, falling to 5.6 percent yoy and 5.0 qoq saar in Q3…
(real GDP growth, percent)



Source: BPS; World Bank staff calculations

Figure 4: …though nominal GDP growth increased sharply in Q3 on the back of rising economy-wide prices
(growth yoy, percent)



Source: BPS; World Bank staff calculations

…mainly reflecting weak investment growth…

The key driver of the moderation in growth in Q3 was fixed investment, which expanded by a weak 2.6 percent qoq saar to be 4.5 percent higher yoy. Investment growth, while volatile across quarters, has been on a downward trend since its recent peak of 12.5 percent yoy in Q2 2012 (Figure 5). Building investment, which accounts for approximately 85 percent of total nominal fixed investment spending, has remained resilient, in fact expanding at a rapid 9.5 percent pace (qoq saar) in Q3. The slowdown in overall investment has been driven by the smaller but more volatile components of investment spending. Spending on foreign machinery, equipment and transportation goods (together accounting for the bulk of non-building fixed investment) was close to flat in Q3 compared with Q2, leaving them well below their year-ago levels (with foreign machinery and equipment and foreign transportation goods down 0.5 percent and 8.4 percent yoy, respectively).

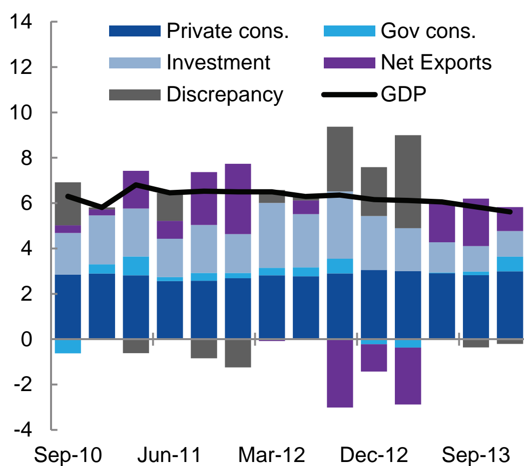
…which has put downward pressure on imports, while export volumes stayed subdued

Flat or contracting demand for machinery and equipment, in turn, has limited imports. Import volumes contracted sharply in the third quarter, by 3.0 percent from the second quarter in seasonally-adjusted terms. Export volumes were little-changed from the second quarter (declining by 0.8 percent, seasonally adjusted). In combination, net exports therefore added significantly to output growth in the third quarter.

In contrast, consumption growth has stayed strong

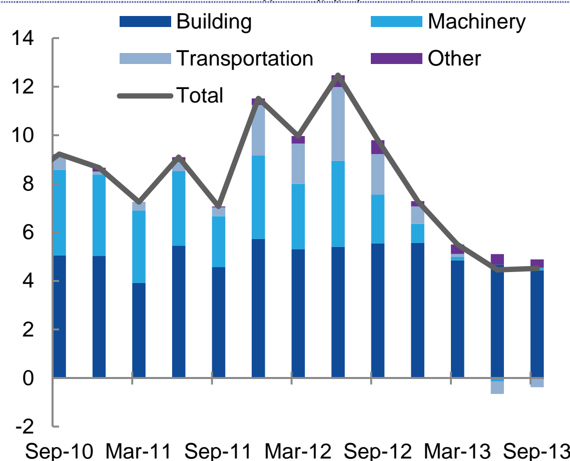
Private consumption, which accounts for about 55 percent of total expenditure, continued to increase strongly in Q3, by 6.9 percent qoq saar to be up 5.5 percent yoy, despite the June increase in subsidized fuel prices and the monetary policy tightening, as well as the financial market turbulence and currency depreciation experienced over the quarter. The resilience of household spending reflects in part the positive impact of the Government's IDR 30 trillion compensation package following the fuel price increase (which began to be disbursed during Q3, as discussed further in section B.1, and compares with the estimated rise in consumption over the quarter of IDR 111 trillion). Other reasons likely include lags in the transmission of monetary policy to the real economy, consistent with the still rapid pace of credit expansion recorded through September, delays in the impacts of the asset price movements seen over the quarter (which have increased import and financing costs) on domestic prices, and relatively limited near-term linkages between asset prices and consumer spending (that is, only modest wealth effects).

Figure 5: Investment growth has slowed markedly while consumption growth has remained strong…
(real GDP and expenditure constituents growth yoy, percent)



Source: BPS; World Bank staff calculations

Figure 6: …with only building investment driving overall positive investment growth
(contributions to overall investment growth yoy, percent)



Source: BPS; World Bank staff calculations

The construction sector remained strong in Q3, and the services sector continues to drive growth

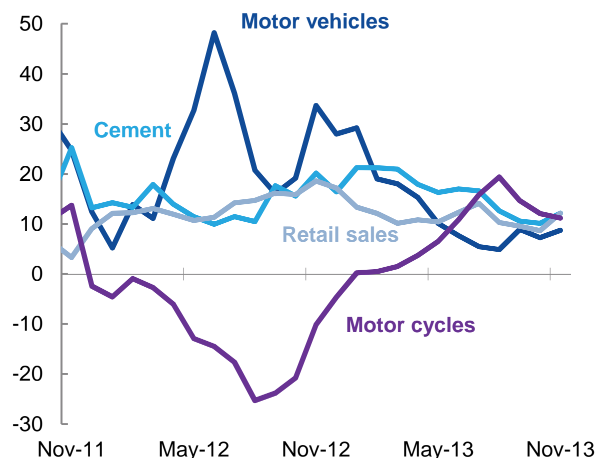
On the production side, reduced growth was broad-based across sectors in Q3, but most concentrated in manufacturing and trade, hotels and restaurants. The construction sector grew by 5.9 percent qoq saar to be up 6.2 percent yoy; a slightly slower pace than in Q2 but broadly consistent with the strong pace of building investment discussed above. Services sector growth remained generally solid, at 6.3 percent qoq saar (up 7.3 percent yoy), but a moderation in the biggest services sub-sector—trade, hotels and restaurants—was visible, with output growth slowing to 2.8 percent qoq saar, leaving Q3 output up 6.0 percent yoy, compared with a 6.5 percent increase yoy in H1 2013. Industrial output growth, excluding mining, slipped to 2.4 percent qoq saar (3.8 percent yoy). Mining output was flat compared with Q2 on a seasonally-adjusted basis, with output 1.6 percent higher yoy, but this masked diverging trends in the two main mining sub-sectors: crude oil and natural gas output remains subdued (down 3.0 percent yoy), while non-oil and –gas mining output picked up, increasing by 3.2 percent qoq saar, potentially reflecting a pick-up in production ahead of the raw mineral export ban beginning in January 2014 (see Box 1).

High frequency indicators are mixed but are consistent overall with a more moderate pace of domestic demand growth…

High frequency economic activity indicators suggest that consumer sentiment remains below the highs seen in the first half of 2013 (i.e. before the June subsidized fuel price increase), though not that sentiment is on a sustained down-trend. BI's survey measure of retail sales picked up to 12.1 percent yoy in November, but its growth rate remains lower than the Q4 2012 highs of around 17 percent yoy. Vehicle sales growth has also slowed relative to the high levels of 2012 and early 2013, while motor cycle sales have been high since Idul Fitri but with declining momentum. On the production side, cement sales over the available 2-month period since Ramadan (i.e. September and October) were up 12.9 yoy, roughly halving from growth of over 21 percent yoy seen early in 2013 (Figure 7). The HSBC Purchasing Managers Index (PMI) for Indonesia's manufacturing sector suggests marginally expansionary conditions, standing at 50.3 for November.

Figure 7: High frequency indicators are mixed but are below their previous highs

(BI retail sales index, vehicle sales and cement volumes, 3mma yoy, percent)



Source: BPS; World Bank staff calculations

…and output growth is projected to slow further

The World Bank expects that Indonesia's GDP growth will slow further, to 5.3 percent in 2014 in the base case (Table 2). Domestic demand faces headwinds from tighter financial conditions, as discussed further in Section 5, but also from potentially longer-term constraints due to less supportive commodity prices and terms of trade than in recent years. In particular, private consumption, the mainstay of the Indonesian economy, has so far remained notably resilient, but is likely to come under more strain, denting growth. The investment outlook hinges on building investment, which in the face of tighter credit, reduced investable funds from commodity-related profits, and increased import costs (as discussed in Section 4) is also likely to slow. Election-related spending in 2014 will likely add materially to domestic demand, as campaign-related activity adds to private consumption, but is temporary in nature, and may in part substitute for other spending. Overall, risks to the growth outlook are skewed to the downside, as discussed in Section 7.

Table 2: Under the baseline scenario GDP growth of 5.6 percent is projected for 2013 and 5.3 percent for 2014
(percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual	
	2012	2013	2014	2012	2013	2014	2013	2014
1. Main economic indicators								
Total consumption expenditure	4.8	5.1	4.8	3.9	4.8	5.2	0.1	-0.2
Private consumption expenditure	5.3	5.1	4.9	5.4	4.4	5.2	0.2	-0.3
Government consumption	1.2	5.0	4.4	-3.3	7.0	5.0	-1.1	-0.1
Gross fixed capital formation	9.8	4.4	4.4	7.3	3.1	5.4	-0.9	-0.5
Exports of goods and services	2.0	4.4	5.4	0.5	3.8	7.0	-1.3	-0.3
Imports of goods and services	6.6	0.5	3.4	6.8	-1.9	4.0	-1.9	-1.2
Gross Domestic Product	**6.2**	**5.6**	**5.3**	**6.1**	**5.1**	**5.4**	0.0	0.0
Agriculture	4.0	3.7	2.7	2.0	5.3	2.6	0.3	0.3
Industry	5.2	4.5	4.2	5.4	3.8	4.4	0.1	0.2
Services	7.7	7.1	6.8	7.6	6.2	6.8	-0.2	-0.2
2. External indicators								
Balance of payments (USD bn)	0.2	-14.0	-12.8	n/a	n/a	n/a	1.4	-8.8
Current account bal. (USD bn)	-24.4	-30.6	-22.8	n/a	n/a	n/a	-1.4	-0.7
Trade balance (USD bn)	-1.7	-9.1	-2.5	n/a	n/a	n/a	-1.2	-1.5
Financial account bal. (USD bn)	25.2	17.1	10.0	n/a	n/a	n/a	2	-8.1
3. Other economic measures								
Consumer price index	4.3	7.0	6.1	4.4	8.6	5.1	-0.3	-0.6
Poverty basket Index	6.5	7.8	6.7	5.4	9.7	5.2	0.6	0.4
GDP deflator	4.6	4.4	6.4	2.7	6.6	5.8	1.8	2.2
Nominal GDP	11.0	10.3	12.0	9.0	12.0	11.6	1.9	2.3
4. Economic assumptions								
Exchange rate (IDR/USD)	9419	10600	11800	9630	11800	11800	200.0	400.0
Indonesian crude price (USD/bl)	113	104	103	108	105	103	-1.9	-2.0
Major trading partner growth	3.4	3.4	3.9	3.1	4.0	4.0	0.0	0.0

Note: Projected trade flows relate to the national accounts. Exchange rate is an assumption based on recent averages. Revisions are relative to projections in the October 2013 *IEQ*
Source: MoF; BPS; BI; CEIC; World Bank projections

3. Headline inflation has normalized but core inflation is rising

Consumer inflation has been volatile over 2013…

Consumer prices have been volatile over 2013, reflecting first the impact of trade restrictions on certain foods (later unwound), and then the impact of the June increase in subsidized fuel prices. While the direct impact of the fuel price increase has now faded and food price disinflation has set in following Idul Fitri, underlying inflation pressures (as measured by core CPI) have increased significantly since May. Going forward, the challenge for monetary policy will be to gauge ongoing risks of higher pass-through from the exchange rate into consumer prices (sometimes called "imported inflation"), and rising price expectations, broadly offset by the expected continued moderation in domestic demand.

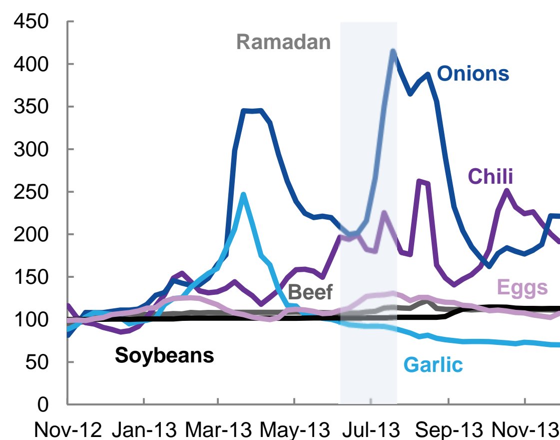
…but headline inflation momentum is now subdued as the effects of the fuel subsidy reform and Ramadan have faded…

Consumer prices as measured by the headline consumer price index (CPI) surged by 5.5 percent from June to August, largely as a result of the 33 percent average increase in subsidized fuel prices implemented on June 22, but also the seasonal impact of Ramadan, which this year fell in July/August. This abrupt increase in the price level has elevated year-on-year inflation to 8.4 percent in November. However, headline inflation momentum has abated since August, with the headline CPI essentially flat month-to-month over this period, as transportation-related price increases have flattened out and food prices have fallen back significantly from their Ramadan-related increases in the middle of the year (Figure 9).

…with welcome food price deflation having set in following a volatile 2013 for some key food prices

Domestic food prices in Indonesia have been volatile in 2013, climbing early in the year on the back of trade restrictions which significantly pushed up the prices of items such as onions, chili and garlic. The subsequent unwinding of these measures provided some price relief in the second quarter, before the seasonal impact of Ramadan in July/August brought renewed upward pressure on many food prices (Figure 8). Helped by the seasonal post-Ramadan decline in many food prices, three consecutive months of overall food price deflation in month-on-month terms through November has now lowered raw food price inflation from a peak of 15.1 percent yoy in August, to 12.2 percent in November.

Figure 8: The prices of some key foods are stabilizing after a volatile year
(price index, November 2012 average=100)



Source: BPS; World Bank staff calculations

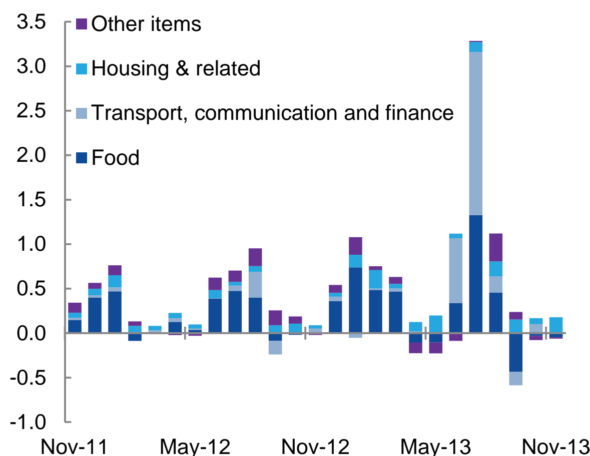
Rice prices have increased fairly modestly, though remaining well above international prices

The domestic price of rice, a key component of the consumption basket of poor households in Indonesia, increased by 5.1 percent yoy in November. This fairly modest increase was due to relatively favorable production. Indonesia's rice production in 2013 is estimated officially to have increased by 2.6 percent following the final harvest of the year, to 70.87 million tons (44.6 million tons on a milled basis), mainly reflecting expanded acreage, as yields are estimated to have remained at 2012 highs of 5.1 tons per hectare. The modest rise in domestic rice prices has also contributed to a reduction in the gap between Indonesian and comparable international prices (from Thailand or Vietnam). Indonesian prices were a record 90-110 percent higher (depending on quality) than international prices in June, falling to 50–60 percent higher in November. The reduction of the Indonesian-international rice price gap was also driven by an increase in Rupiah-denominated international rice prices (including an 8 percent and 29 percent increase for medium quality rice from Vietnam in US Dollar in Rupiah terms, respectively).

The pick-up in core inflation, however, suggests caution is still needed around inflation risks…

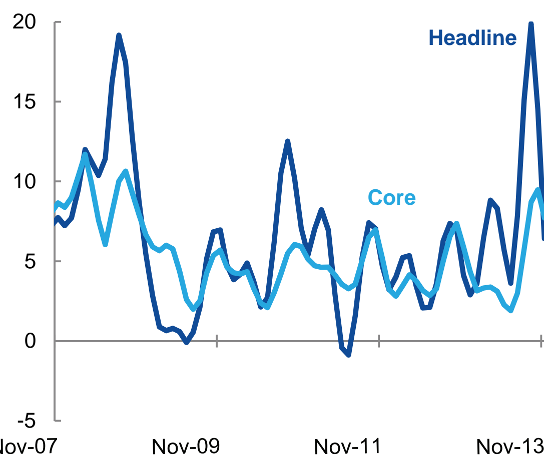
Although the lack of upward momentum in headline CPI is an encouraging indication that overall consumer price pressures remain contained, the recent pattern of core inflation—which excludes volatile items such as food and fuel—argues for caution (Figure 10). Core CPI increased by 4.8 percent yoy in November, its highest monthly reading since September 2011, and its recent pace of increase, a 7.7 percent annualized rate from September to November over the previous three months, has been significant.

Figure 9: Seasonal food deflation and fading transport price rises have pushed down headline monthly CPI inflation…
(composition of monthly increase in headline CPI, percentage points)



Source: BPS; World Bank staff calculations

Figure 10: …but core inflation momentum has increased notably
(annualized 3-month/3-month change, percent)



Source: BPS; World Bank staff calculations

…especially in light of cost-push pressures from the weaker Rupiah

One source of upward pressure on core inflation since May has likely been the depreciation of the Rupiah which, while broadly supportive for Indonesia's economic adjustment to external constraints, adds to cost-push inflation pressures through the price of imported goods. Given the significant 24 percent nominal depreciation of the currency year-to-date, the rise in core inflation has so far been relatively modest. However, in the absence of a counterfactual, it is important to note that inflation may have been more subdued in the absence of the Rupiah depreciation. It is also likely that the weaker Rupiah will continue to feed into inflation with a lag, as importers may absorb higher import costs for a time in order to preserve market share, but later pass on increases as a result of ongoing margin erosion. Finally, with much of the Rupiah's adjustment to date having occurred only since August, it is too soon to know for sure how Rupiah depreciation will feed through into inflation. As a rule of thumb, however, it is estimated that a 10 percent Rupiah depreciation adds approximately 0.5 percentage points to inflation in a given quarter.

In the base case, headline inflation is expected to remain below its recent peak, but core inflation pressures to remain on the rise through the first half of 2014

In the base case, inflation pressures are expected to remain contained, consistent with the weaker growth outlook, with headline inflation declining gradually through Q2 2014 to approximately 7.5 percent. Headline inflation is then expected to fall sharply as the impact of the June 2013 fuel price change drops out of the base in Q3 2014, following which headline CPI should return to below the ceiling of BI's current target band of 3.5-5.5 percent yoy. Core inflation, however, is expected to be pushed higher in coming months (to approximately 5.5 percent in Q1 2014) by the exchange rate and wage rises, including from the impact of new minimum wage increases for 2014 (including the 11 percent increase agreed for the District of Jakarta). Risks to the base case expectations for inflation are balanced, with the outlook depending on the interplay between Rupiah depreciation, wage-setting for 2014 and temporary factors such as higher election-related spending in Q1 2014, set against the weaker domestic demand growth trend and tighter financial conditions.

4. Indonesia's current account deficit remains in focus, despite slowing imports

External balance pressures remain central to the outlook for Indonesia's economy

Indonesia's current account deficit showed signs of stabilizing in the third quarter, but at USD 8.4 billion remained well above net direct investment of USD 5.1 billion, implying a significant "basic balance" deficit (of USD 3.3 billion in Q3). This gap highlights Indonesia's continuing reliance on potentially volatile portfolio investment inflows, a potential vulnerability that is likely to remain a strong focus for policymakers and investors. In addition, although Indonesia's overall external debt burden is low, external debt repayments are significant, adding to the currency and refinancing risks faced by the Government and corporate sector in the context of ongoing international financial market uncertainties. In the base case, the current account balance is expected to narrow through 2014, but the modest likely pace of improvement, and economic costs of import compression, argue for a continued policy focus on improving export performance and supporting foreign direct investment as a source of high quality external financing.

Indonesia's current account deficit narrowed to 3.8 percent of GDP in Q3 from 4.4 percent in Q2

In the third quarter of 2013, the current account deficit was USD 8.4 billion, or 3.8 percent of GDP (Figure 11), narrower than the USD 10 billion or 4.4 percent of GDP deficit seen in the second quarter. Early indications for the final quarter of 2013 are that this gradual narrowing of the deficit is set to continue, with the monthly goods trade balance, as measured by BPS, albeit volatile, returning to a small (USD 42 million) surplus in the month of October.

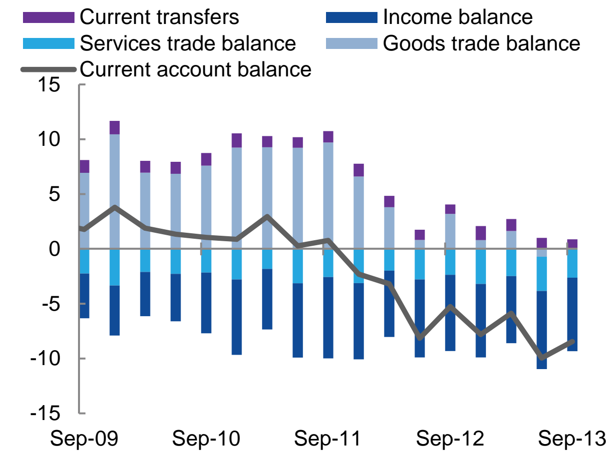
Non-oil and gas export revenues were weak in Q3 but show some signs of having picked up into Q4…

The non-oil-and-gas goods trade balance returned to surplus in August after four consecutive months of deficit, and remained positive through October (Figure 12). Non-oil and gas exports slowed through Q3, reflecting in part further weakening in the global prices of major commodity exports in the early part of the quarter, and the dampening impact of Idul Fitri holidays on exports. Within non-oil and gas exports, manufacturing export revenues dropped by 2.8 percent relative to Q3 2012 and non-manufacturing (including all major commodities ex-oil and gas) export revenues were down by 8.1 percent relative to Q3 2012. Early indications of export performance in the fourth quarter are encouraging, with exports across the region firming, and Indonesia's non-oil and gas export revenues rising by 2.5 percent yoy in October, likely helped by improving demand from key trading partners such as the US and China. As discussed in Section 2, export volumes also appear to have broadly held up through the latest available, third quarter data, being up 5.3 percent yoy, showing the depressing effect on export revenues of low prices and pointing to the possible rebound of export revenues in coming quarters should commodity prices indeed have stabilized and external demand continue to increase modestly. A significant risk to exports, however, is the mooted ban on raw mineral exports, discussed in Box 1.

…while the oil and gas trade deficit appears largely unaffected by the increase in subsidized fuel prices

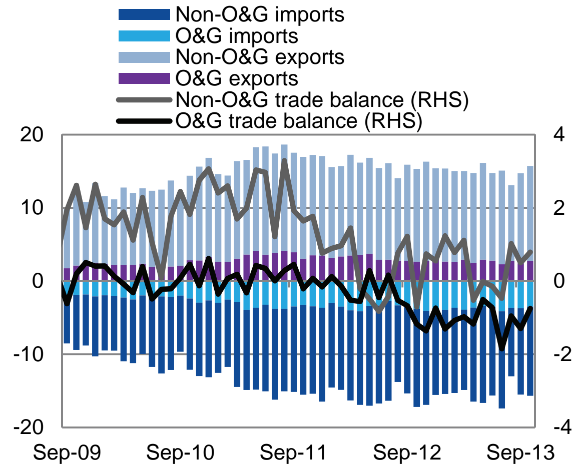
Most of the weakening in Indonesia's overall current account balance since late 2011 has been due to the collapse of the non-oil and gas trade surplus, driven mainly by declining commodity export prices. However, Indonesia's monthly oil and gas trade balance also remains a major drag on the overall trade balance, and has moved into deficit since August 2012. The oil and gas trade deficit stood at USD 2.4 billion in Q2 and widened to USD 3.9 billion in Q3, amplified by higher holiday season-related fuel demand but also suggesting that oil import demand has been relatively insensitive to the sharp increase in subsidized fuel prices implemented in June. Subsequent monthly data, for October, does show a significant drop in oil-and-gas imports—with the oil and gas deficit shrinking by 50 percent mom to USD 750 million—but given the volatility of the monthly data this is insufficient to gauge whether significant fuel import relief is now filtering through.

Figure 11: The current account deficit stabilized at USD 8.4 billion in Q3…
(account balances, USD billion)



Source: CEIC; World Bank staff calculations

Figure 12: …helped by the non-oil-and-gas trade balance returning to surplus since August
(account balances, USD billion)

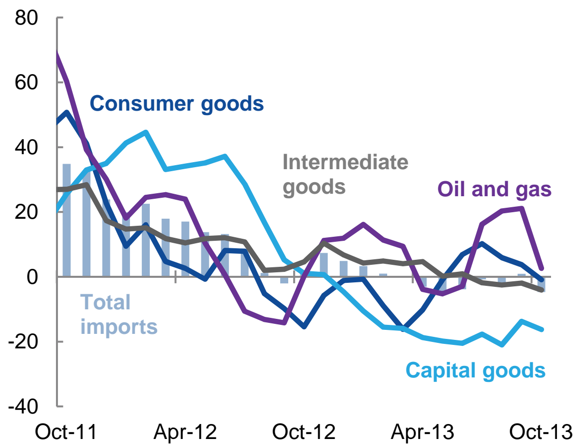


Note: O&G: oil and gas
Source: CEIC; World Bank staff calculations

Import compression is now clearly visible, providing relief for the trade and overall current account balance…

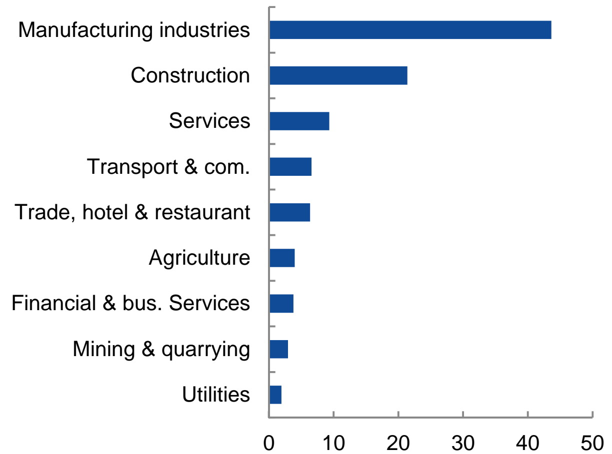
As real growth moderates and the Rupiah has depreciated, slowing imports are supporting the trade balance and the gradual narrowing in the overall current account. Capital goods in October were 20 percent lower yoy (and down 16 percent on a 3-month moving average basis, yoy), consistent with subdued machinery and equipment spending as outlined in Section 2. Imports of intermediate goods, excluding oil and gas, were down 4.1 percent yoy in October, on a 3-month moving average basis. Consumer goods imports account for only a small share of imports (7 percent of total import costs, over the 12 months through October) but have been flat since August at similar levels to one year ago. Oil and gas imports are the only major import category to have remained stubbornly high during Q3 but, as noted above, even these recorded a significant slowdown in October (Figure 13).

Figure 13: The weakness in overall imports has been led by a contraction in capital goods
(growth of 3-month moving average of import components yoy, percent)



Note: Intermediate goods excludes oil and gas
Source: BPS; World Bank staff calculations

Figure 14: Manufacturing and construction together absorb almost 70 percent of Indonesia's imports
(sectoral allocation of nominal imports in real terms, percent)



Source: World Input-Output database 2011; World Bank staff calculations

…and may have further to run, but with real economic costs

The economic sectors which make the heaviest use of imports are manufacturing and construction (Figure 14), together absorbing close to 70 percent of total imports. Three quarters of these—or half of total imports—are intermediate products from foreign

manufacturers. In addition, about 50 percent of manufactured imports into the most import-heavy sectors comprises of specific inputs to production, notably chemical and metal products, and equipment. Consequently, the expected ongoing moderation in manufacturing and construction growth in 2014 will likely assist in continuing to lower the import bill (Figure 14), but may also have implications for employment and income generation in those sectors. In addition, as described in the March 2013 *IEQ*, there is a sizable component of imported inputs used in the production of Indonesia's non-commodity exports. Higher costs of imported inputs to production—due either to ongoing Rupiah depreciation or other policies aimed at import suppression—therefore may also potentially weigh on export competitiveness, offsetting some of the benefits from the real exchange rate depreciation.

As the trade balance adjustment plays out, the focus on Indonesia's external financing vulnerabilities is likely to remain

Overall, indications are that Indonesia's trade balances are shifting in such a way as to stabilize and begin to narrow the overall current account deficit. As mentioned above, quarterly goods and services export volumes, as measured by the national accounts, have held up, and goods export revenues as measured by the monthly BPS trade data increased in year-on-year terms in October for the first time since March 2012 (albeit by a modest 2.6 percent). Import compression is visible, as described above, and even the oil and gas trade deficit which has opened up since August 2012 shows some signs of narrowing. While positive for returning Indonesia's overall external balances to a sustainable position, however, import compression comes with costs, and the pace of improvement so far has been gradual, keeping external financing vulnerabilities very much in focus.

Financial account inflows declined in the third quarter as net portfolio inflows weakened and currency and deposit flows turned negative…

Turning to the financial account side of the balance of payments, Indonesia's capital and financial account posted a surplus of USD 4.9 billion in Q3, narrowing from USD 8.4 billion in Q2, reflecting a weakening in portfolio investment inflows and other investment outflows, despite strengthening net direct investment inflows. Net portfolio inflows eased to USD 1.8 billion (from USD 3.4 billion in Q2), driven by weak net inflows into both debt and equity securities, as also experienced by other major emerging market economies, and partly reflecting uncertainty during the quarter regarding the timing and pace of tapering by the US Federal Reserve. Weaker offshore bond issuance in Q3 also played a role. Other investment recorded a deficit of USD 2.1 billion largely due to currency and deposit outflows. This reversed the surplus seen in Q2, which was due to a combination of seasonal USD currency inflows aimed at servicing seasonal corporate US Dollar demand.

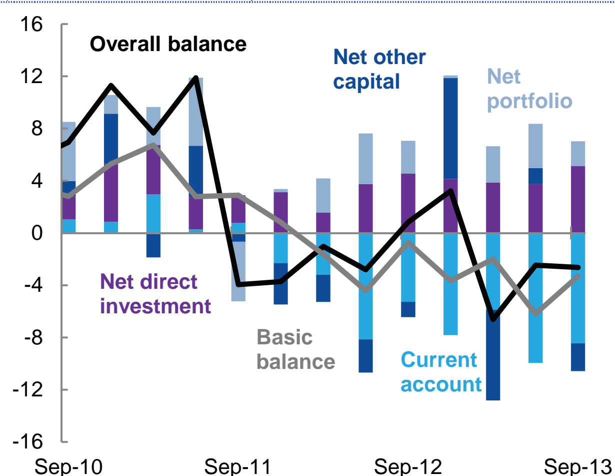
…making Indonesia more dependent on supporting FDI inflows

Net direct investment recorded a surplus of USD 5.1 billion (from USD 3.8 billion), reflecting strong inbound direct investment inflows of USD 5.4 billion together with a weakening in outward direct investment abroad to USD 0.3 billion. FDI into debt instruments in Q3 2013 was at its highest level since Q4 2011 in Q3, USD 1.9 billion, up from USD 453 million in Q2. FDI into equity on the other hand dropped by 17 percent from Q2, at USD 3.5 billion. Overall, direct investment inflows appear to be holding up in the face of the weakness in global commodity prices in recent quarters and heightened regulatory uncertainty in key sectors for inbound investment, especially mining. These inflows, however, can be lumpy and are based on long-term decisions which are affected by the policy environment, which is subject to risks as described in Section 7.

The current account deficit is projected to narrow to 2.6 percent of GDP in 2014

The current account deficit is projected to reach to 3.5 percent of GDP or USD 30.6 billion in 2013 as a whole, on the back of a narrowing in the current account deficit for the fourth quarter to approximately USD 6.4 billion (or 3.2 percent of GDP). In 2014, the current account deficit is projected to persist, although narrowing to USD 22.8 bn (2.6 percent of GDP) supported by subdued import growth and a mild pick up in export demand (Table 3). This baseline view, however, remains contingent on external financing conditions being sufficiently supportive, in light of the fact that Indonesia will likely continue to run a basic balance of payments deficit through 2014, increasing its reliance on potentially volatile portfolio investment flows. In addition, a specific additional risk to the trade balance is the impact of the ban on raw mineral exports, scheduled to come into effect in January 2014 (Box 1).

Figure 15: Weaker portfolio investment led to a lower capital and financial account surplus in Q3 relative to Q2…
(account balances, USD billion)



Source: CEIC; World Bank staff calculations

Table 3: The persistence of a current account deficit is likely to keep the need to support FDI in focus
(USD billion)

	2011	2012	2013	2014
Overall Balance of Payments	**11.9**	**0.2**	**-14.0**	**-12.8**
As percent of GDP	***1.4***	***0.0***	***-1.6***	***-1.5***
Current Account	1.7	-24.4	-30.6	-22.8
As percent of GDP	*0.2*	*-2.8*	*-3.5*	*-2.6*
Trade	24.2	-1.7	-9.1	-2.5
Income	-26.7	-26.8	-25.8	-24.6
Transfers	4.2	4.1	4.2	4.3
Capital & Financial Accounts	13.6	25.2	17.1	10.0
As percent of GDP	*1.6*	*2.9*	*2.0*	*1.2*
Direct Inv.	11.5	14.0	16.5	13.2
Portfolio Inv.	3.8	9.2	9.9	3.1
Other Inv.	-1.8	1.9	-9.4	-6.3
Memo:				
Basic Balance	13.2	-10.4	-14.1	-9.6
As percent of GDP	*1.6*	*-1.2*	*-1.6*	*-1.1*

Note: Basic balance = current account balance + net FDI
Source: CEIC; World Bank staff calculations

The current account deficit, combined with sizeable external debt amortizations, contribute to Indonesia's high external financing needs

While the current account deficit is projected to continue narrowing gradually, Indonesia's gross external financing needs remain high. Significant external debt amortizations add to a still sizeable level of the current account deficit. For example, gross external debt repayments will total USD 21.0 billion in Q4 2013, and USD 25.7 billion over the first three quarters of 2014, according to Bank Indonesia (Table 4). Projected total external debt amortizations on this basis, of USD 41.2 billion over 2013, compare with the World Bank's projection for the 2013 current account deficit of USD 31 billion.

Table 4: External debt repayments in Q4 2013 have been high, likely adding to Rupiah pressures…
(projected gross external debt repayments, USD million)

	Oct - Dec 2013	Jan-Sep 2014
Government and Central Bank	2,131	10,087
Private	**18,894**	**15,617**
Bank	*3,720*	*3,074*
Non-bank	*15,174*	*12,543*
Non-bank financial institutions	*1,738*	*2,199*
Non-financial corporations	*13,436*	*10,345*
Total	**21,025**	**25,704**

Note: Based on external debt position as of September 2013; debt repayments exclude domestic securities owned by non-residents, currency and deposits, and other liabilities
Source: Bank Indonesia

Box 1: The potential near-term impact of the proposed ban on unprocessed mineral exports on Indonesia's trade balance

As 2014 approaches, attention has turned to the potential impact of the proposed ban on unprocessed exports, which is set to come into effect from January 2014. The 2009 Mining Law (UU 4/2009) requires all mining business permit (IUP) and Contract of Work (CoW) holders to 'add value' to mining products through domestic refining and processing with a five year compliance horizon. Initially set to come into force in May 2012, the proposed ban was delayed until January 2014, where based upon current regulations, IUP and CoW holders will no longer be permitted to export mineral ores or refined products of copper, nickel, tin, bauxite and iron ore, among others, that are below the minimum mineral content– all requiring smelting capacity.*

At the time of writing, the implementation details of the proposed ban are still under discussion. In part this reflects concerns about the potential near-term impact on Indonesia's mineral exports, at a time when Indonesia already faces significant external financing pressures. Commodities account for the bulk of Indonesia's exports, comprising roughly two-thirds of merchandise exports by value. Exports of processed and unprocessed minerals in 2012 alone totaled USD 10.4 billion, around 5 percent of total exports. The overall share of processed exports in mineral exports has increased steadily, from 40 percent in 2001 to 52 percent in 2012.

In broad terms, there are three direct trade channels through which the export ore ban can have an impact on Indonesia's trade balance. The first is a negative impact, via lower exports of unprocessed minerals. The second effect on exports (positive) would occur if there are increased volumes of exports of processed minerals. The third effect, through imports of capital and intermediate goods to build and operate smelters, would have a negative impact on the trade balance. Estimating these effects requires a range of assumptions, from the future external demand for processed and unprocessed minerals through to the share of imports in the operational and capital costs of smelters and, crucially, on the timing and scale of future investments in smelting capacity. As such, any estimates are subject to considerable uncertainty.

A large number of smelter plans have been proposed, yet it is possible that not all the proposals that have been announced will be built. Further, of those likely to be economically feasible, significant uncertainty persists regarding whether proposed smelters will be operational by early 2014, especially given the long lead times required to construct smelters before commencing operations. Noting this uncertainty, two potential scenarios may be considered, relative to a baseline where no export ban is enforced, to simulate the potential impact of enforcing the ban on Indonesia's trade balance, reflecting differences in the pace with which new proposed smelting capacity comes on-line. In the first scenario all the proposed additional smelters that are considered realistic by a recent Support for Economic Analysis Development in Indonesia (SEADI) study on this topic are built on schedule – these smelters are due to become operational in 2014 and 2015. In the second scenario none of the new proposed smelters becomes operational within the timelines set by the law and the export ban is enforced.

In the first scenario, where feasible smelters come online as anticipated by SEADI, the impact of the increase in processed mineral exports on the trade balance is more than outweighed by the fall in unprocessed mineral exports, at least in 2014. Further, capital imports to build the smelters would be expected to provide a further significant drag on the trade balance. In 2014 the ban is projected to add an additional USD 6 billion to the trade deficit. However, from 2015, the ban would result in a relatively neutral impact on the trade balance, relative to the baseline, as capital imports resulting from smelter construction start to tail off and gains from higher value processed exports begin to offset the loss unprocessed mineral exports arising from the ban.

In the second scenario, where no new smelting capacity comes online, the fall in unprocessed mineral exports weighs heavily on the trade balance, without any corresponding increase in processed mineral exports. The nominal value of lost export earnings increases steadily each year from around USD 5 billion in 2014 to almost USD 8 billion in 2017, reflecting foregone increases in unprocessed mineral exports over this period.

This simulation exercise demonstrates the potential significant downside risks to Indonesia's trade balance from the ban's enforcement, particularly should new domestic smelting capacity be subject to significant delays, resulting in insufficient capacity to process raw minerals onshore, with flow on impacts to mineral exports. Even in the comparatively more optimist scenario (i.e. Scenario 1), where all smelters evaluated by SEADI as being economically feasible come online, the ban would still result in a significant, negative shock to Indonesia's trade balance of around USD 6 billion in 2014. Such a shock would add around 0.6 percentage points of GDP to Indonesia's current account deficit in 2014 moving the projected current account deficit from 2.6 percent to 3.2 percent of GDP, all other things being equal. This would lead to increased external financing needs at a time when global financing conditions become less favorable. In addition, to the extent that investors view enforcement of the ban as a further negative signal of the quality of the domestic policy environment, this could affect portfolio and FDI capital flows (offsetting any FDI inflows associated with any new smelting projects). Relatedly, it is important to note that the above simulations do not cover the longer-term, potentially distortionary, implications of the ban on economic production structures nor cover a detailed assessment of the ban's underlying economic policy objectives or of its likely effectiveness in achieving these objectives.

*MEMR regulation 7/2012 required COW and IUP holders to formulate smelting plans, define minimum standards for domestic processing and refining, and imposed a ban on the export of raw mineral ores within three months of the regulation (by May 2012). Partly due to lack of capacity, the ban was subsequently pushed back by MEMR 11/2012 to January 2014. In the interim period from May 2012 to January 2014, COW holders have been permitted to continue to export unprocessed minerals without additional restrictions. IUP holders have been permitted to continue exporting unprocessed minerals provided they pay a 20 percent export tax and are able to renew monthly export permits.

Note: The list of proposed new smelters used in this analysis is drawn from the report "The Economic Effects of Indonesia's Mineral-Processing Requirements for Export", USAID, 2013, under the SEADI project for the Indonesian Ministry of Trade

5. Credit conditions are expected to tighten further moving into 2014

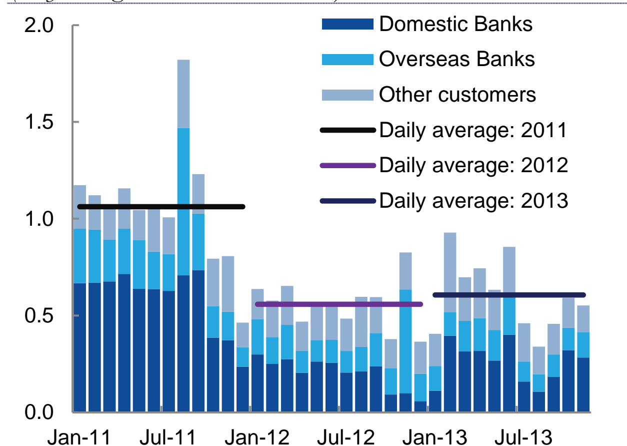
The Rupiah has depreciated recently, with significant gross external funding needs in Q4 a likely factor…

Indonesia's sizeable external debt servicing and financing needs, and the resultant increased foreign currency demand, are likely an important factor behind the renewed weakening of the Rupiah since October. After strengthening to IDR 11,020 per USD in late October, the Rupiah spot rate has subsequently weakened to IDR 12,000 on 11 December, leaving the Rupiah down 24 percent against the US dollar so far this year. The Rupiah has now depreciated by almost 18 percent on a nominal trade-weighted basis through 12 December 2013, and by 8 percent in real effective terms through October.

…but measures of currency market liquidity conditions have improved on the levels seen in Q3…

Significantly, however, the recent renewed depreciation has not coincided with a pronounced tightening in currency market conditions through November, as measured by average turnover in the onshore spot market. This follows a number of measures taken by Bank Indonesia to improve onshore market liquidity, and facilitate adjustment in the Rupiah exchange rate towards its equilibrium level. These measures have included relaxing US Dollar purchasing requirements for exporters, extending the maturity of the BI US Dollar term deposit facility to up to 12 months, as well as holding regular US Dollar swap auctions to facilitate hedging of currency risks. Daily turnover on the onshore spot FX market has averaged around USD 500-600 million through end-November, well above the daily average of around USD 350 million seen through late August and early September (Figure 16), while spreads between the onshore spot rate and offshore forwards have remained tight.

Figure 16:…but measures of onshore FX spot market liquidity conditions have improved since mid-year
(daily average turnover, USD billion)



Note: Average daily spot FX market turnover by counterparty; 2013 daily average to end-November
Source: CEIC; World Bank staff calculations

…while BI has maintained a strong focus on facilitating external balance adjustment

Commensurate with the flexible approach to the Rupiah seen in recent months, Bank Indonesia has stated clearly that its near-term focus is on supporting the improvement in the external balance. Since the previous October 2013 *IEQ*, BI has increased its policy interest rate corridor by 25 bp (at its scheduled November Board of Governors meeting), taking cumulative interest rate increases since June to 175 basis points. The level of foreign reserves also stabilized and then gradually increased, to USD 97.0 billion at end-October where it remained through end-November, up from the recent low of USD 92.7 billion at end-July. As of September, BI had a short net open forward position of USD 5 billion, built up mainly as a result of the US Dollar swap auctions conducted since July to support the commercial availability of foreign currency hedging.

Domestic bonds and equities have experienced renewed weakness in Q4

The depreciating Rupiah, increase in short-term rates, and deceleration in output have taken their toll on domestic bonds and equities which, after rebounding strongly from their late-August to early-September lows, have since October experienced renewed weakness. The domestic bond market rallied strongly from mid-September until late October, but yields have subsequently backed up again, returning long-term domestic interest rates to close to their highest levels of the year (with the 10-year benchmark yield at 8.80 percent, an increase of 350bp over the course of the year). Domestic equities initially bounced back strongly from their late-August lows, but stock prices have subsequently softened, leaving the Jakarta Composite Index down 2.6 percent for the year through 12 December. In October and November, offshore investors remained net sellers of Indonesian equities, selling a net IDR 6.9 trillion worth of stocks over this period, compounding a period of sustained net selling since the downturn in global risk appetite for EM assets, with a cumulative IDR 36 trillion worth of Indonesian equities sold since the end of April. In contrast, offshore bond investors have been significant net purchasers of bonds, with cumulative net purchases of IDR 42.8 trillion worth of bonds since inflows resumed in early September (through 6 December), to take their holdings of total domestic government bonds to 32.5 percent

Nominal credit growth remained strong through October, boosted by exchange rate effects, but has come down in real terms…

Despite the tightening in monetary policy since June, bank lending growth has remained buoyant in nominal terms, up 22.2 percent yoy in October. However, it is important to note that credit extension has been boosted by exchange rate effects, which has increased the Rupiah value of foreign currency-denominated lending, which accounts for 15 percent of bank credit outstanding; year on year growth in foreign currency lending in Rupiah terms has risen from 15 percent yoy in May to 24 percent yoy in October (Figure 17). Furthermore, real credit growth (deflated by contemporaneous CPI inflation) has continued to ease, to 12.8 percent yoy in October, from 18 percent yoy at end-2012 (Figure 18).

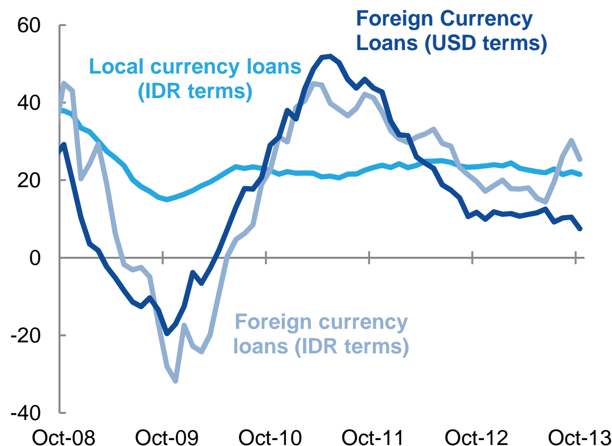
…and while residential mortgage activity accelerated in Q3 market reports point to a tightening in property-related credit conditions…

Although the most recent data point to strong growth rates, market reports now point to a tightening in property-related credit by some major banks, likely weighing on future property price growth. Growth in property-related credit rebounded to 30 percent year on year to September, up from 20 percent in June, the fastest pace of growth since the introduction of tighter loan-to-value (LTV) requirements for residential mortgages in July 2012. The recent strength in property credit reflects a pickup in growth in residential mortgages, which account for 60 percent of total property related credit. These figures also suggest that macro prudential measures to contain the pace of property lending have so far had a limited impact, with Bank Indonesia having introduced further tightening in LTV ratios for residential mortgages financing second and third homes in July 2013. Supported by strong property lending, residential house prices continued to show robust growth through Q3; national residential house prices were up 14 percent in the year to September, led by price growth in smaller homes. Residential apartment price growth has eased modestly since late 2012, yet remains strong at 30 percent yoy, as do rental prices for office space and sales prices of industrial land.

…but credit growth is likely to slow going forward…

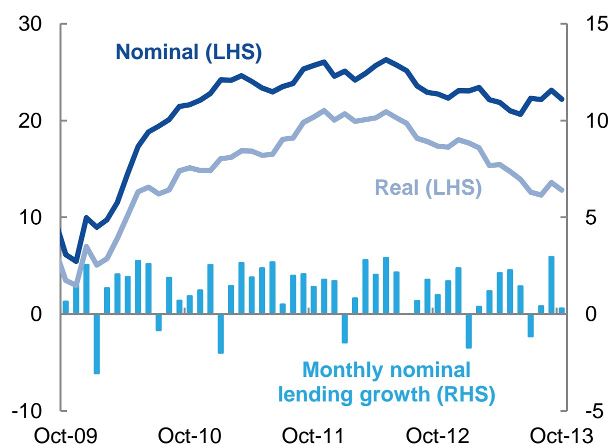
Going forward, bank credit growth is expected to fall, to approximately 15 percent yoy in coming quarters according to World Bank projections. In October, broad money (M2) growth stood at 13 percent yoy, and the growth in time and savings deposits in particular was 11.6 percent yoy, well down from end-2012 growth rates of close to 20 percent. The aggregate loan to deposit ratio (LDR) stood at 88.9 percent in September, up from 84 percent at end-2012 and not far off the 92 percent ceiling of BI's target LDR band, and suggesting limited headroom for credit growth to continue to outstrip deposit growth.

Figure 17: Bank credit growth has been inflated by exchange rate effects…
(growth yoy, percent)



Source: CEIC; World Bank staff calculations

Figure 18: …but has slowed, particularly in real terms…
(bank credit growth yoy and mom, percent)

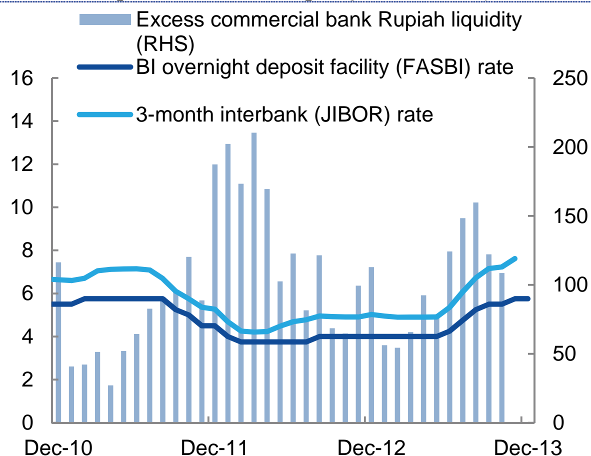


Note: Real credit deflated by CPI; October inferred from 22.2 percent yoy growth, as stated by BI
Source: CEIC; World Bank staff calculations

…amidst a tightening in domestic liquidity conditions…

Alongside weaker deposit growth, banks are also navigating tighter liquidity conditions. Excess commercial bank liquidity as measured by BI, though still substantial, is down from its mid-year highs, and BI's tightening cycle has increased inter-bank lending rates, with 3-month JIBOR rising from 4.9 percent before BI began its current tightening cycle in June, to 7.6 percent in early December (Figure 19). Market reports also point to a tightening in domestic liquidity conditions, especially for some small- to mid-sized banks, with interbank credit limits being reduced due to concerns over rising counterparty risks, related to a lack of liquid interbank or wholesale funding markets and the narrowness of deposit bases. Moreover, foreign banks' offshore funding costs have increased, consistent with general tightening in external financing conditions for Indonesian corporates.

Figure 19: Rupiah liquidity has tightened and interbank borrowing costs have risen
(interest rates, percent, and excess liquidity, IDR trillion)



Note: Excess liquidity data available through end-October
Source: CEIC

Aggregate domestic banking sector risk metrics remain sound

Increasing interest rates and competition for deposits, alongside tighter liquidity, implies upward pressure on banks' costs of funds, compressing net interest margins, though by how much varies depending on particular banks' funding structures and ability to re-price their credit. Profitability metrics, however, were still strong through end-October, and other aggregate banking sector indicators have remain stable, with non-performing loans remaining below 2 per cent, capital adequacy well above minimum standards, and strong profitability metrics. Furthermore, systemic risks from the weaker Rupiah and higher long-term interest rates appear contained; Bank Indonesia stress tests published in the March 2013 *Financial Stability Review* suggest that a 10 percent depreciation in the Rupiah would result in a decline in the aggregate bank capital adequacy (CAR) ratio of 1.0 percent. A 20 percent decline in the value of government bonds would result in decline in the aggregate bank CAR of 1.5 percent, with relatively larger CAR falls for state-owned and foreign banks, given their relatively larger holdings of government bonds.

Non-bank financing activity is also decelerating

Beyond bank credit, access to other forms of financing has also tightened. Growth in finance company lending, which accounts for around 10 percent of total financial system assets, has slowed to 14 percent year on year to September 2013, from 32 percent growth a year earlier. Non-bank lending is expected to weaken further going forward, in line with tighter domestic credit conditions and higher offshore financing costs (with borrowings from foreign banks accounting for 22 percent of total finance company liabilities, compared with 35 percent comprising domestic bank borrowing). Corporate bond issuance has also fallen off sharply since June, with issuance to end-November equivalent to only 15 percent of total issuance in Q4 2012.[1]

6. Public expenditure and tax revenue growth has slowed over 2013

The fiscal deficit through November 2013 was 50 percent larger than in the same period last year…

The Indonesian fiscal sector continues to be impacted by weaker international commodity prices and the depreciation of the Rupiah. Based on the outcome of the first eleven months of 2013, the fiscal deficit for the full year is likely to be broadly in line with the revised 2013 Budget projection, as the expected slight under-shooting of revenues is likely to be balanced by overall lower disbursement of expenditures (with subsidy spending in excess of the targeted amount being offset by lower than targeted capital and material spending). During January to November 2013, Indonesia recorded a fiscal deficit of IDR 163 trillion (or 1.7 percent of GDP), versus IDR 106 trillion in the same period last year. Revenue collection experienced slightly higher growth over this period than in 2012, while expenditure growth slowed relative to 2012 but showed higher disbursement rates (Table 5).

.. due to higher Budget disbursement …

The major reason for the significantly higher fiscal deficit in the first eleven months of 2013 compared with the corresponding period last year was an increase in the disbursement of allocated spending. This was especially the case for social spending (including the completion of an unconditional cash transfer, *Bantuan Langsung Sementara Masyarakat,* BLSM, compensation following the June increase in subsidized fuel prices) and capital spending, even though social and capital spending recorded slower nominal growth overall for this period in 2013 than in 2012. Budget execution rates in these areas were likely aided by the fact that their allocations in the 2013 revised Budget projected modest nominal growth relative to the revised 2012 Budget. Fuel subsidy spending over January-November recorded a lower disbursement rate relative to the revised Budget allocation in 2013 than last year, reaching 87 percent of targeted spending for this year. The likelihood is that actual fuel subsidy spending in 2013 will again overshoot the revised Budget allocation (with November fuel subsidy disbursement still to be added to the above figures, in addition to December). Electricity subsidies have recorded slightly faster nominal yoy growth in 2013 than last year, despite the phased tariff increases in 2013, and a marginally higher disbursement relative to the revised Budget. However, this may reflect differences in payment schedules rather than a real annual increase in spending.

[1] Onshore corporate bond issuance data to 27 November 2013.

… while revenue collection relative to the Budget target was at a similar level to last year

Total revenue collection trends in the first eleven months of 2013 were broadly similar to those in the same period of 2012, in terms of realization of the revised Budget target, although nominal yoy growth was slightly higher. This resulted from a moderation in growth for tax revenue collection, to 9 percent yoy from 13.9 percent yoy in 2012, on the one hand, and a slight improvement in non-tax revenue collection on the other hand. International trade taxes contracted over their year-ago level, particularly because of a decline in export tax collection, consistent with subdued exports, as discussed in Section 4. Income tax collections from the oil and gas sector have slowed down, whereas natural resource revenues from oil and gas accelerated, with this pattern likely attributable to timing differences in the collection of these two revenue types. Despite relatively robust private consumption, VAT collection in the first eleven months of 2013 recorded substantially slower nominal yoy growth than last year (13.6 percent against 28.5 percent respectively), as well as a lower realization against the annual target. Since around 40 percent of Indonesian VAT collection comes from imports, the slowdown of imports has likely contributed significantly to this weakness.

Table 5: Higher Budget disbursement characterized the Jan – Nov 2013 period, relative to previous years

	Nominal value (Jan - Nov) (IDR trillion)			Share (Jan - Nov) in revised budget (Percent)			Nominal growth (yoy) (Percent)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
A. Revenues	**1,023**	**1,102**	**1,224**	**87.4**	**81.1**	**81.5**	**22.8**	**7.7**	**11.1**
1. Tax revenues, o/w	753	858	936	85.7	84.5	81.5	22.2	13.9	9.0
Income tax (O&G)	65	74	72	99.5	108.5	96.5	39.8	13.5	-2.7
Income tax (N-O&G)	317	340	368	86.3	76.2	79.2	19.9	7.4	8.2
Sales tax (VAT)	226	291	330	75.8	86.5	77.9	18.6	28.5	13.6
Int'l trade taxes	50	46	42	105.6	95.1	86.3	107.6	-8.0	-8.3
2. NTR, o/w	267	240	286	93.3	70.5	81.8	23.9	-10.1	18.8
NRR (O&G)	154	122	156	89.2	61.6	86.6	33.6	-20.9	28.1
NRR (N-O&G)	18	19	22	97.7	100.6	94.6	18.0	3.2	15.3
B. Expenditures	**1,001**	**1,209**	**1,387**	**75.8**	**78.1**	**80.3**	**22.5**	**20.8**	**14.7**
1. Central gov't, o/w	648	779	910	71.3	72.8	76.0	23.2	20.2	16.8
Personnel	159	182	204	86.9	85.8	87.8	19.7	14.6	12.2
Material	85	101	118	59.5	62.1	58.0	17.9	18.4	16.9
Capital	67	91	107	47.2	51.6	57.0	39.7	36.6	18.1
Interest payments	84	91	104	79.1	77.2	92.6	7.2	7.9	14.6
Subsidies	201	250	298	84.7	101.9	85.7	55.7	24.3	19.4
Energy	175	218	260	89.4	107.8	86.6	62.9	24.9	19.1
Fuel	111	148	174	85.4	107.7	87.1	86.8	33.5	17.6
Electricity	64	70	86	97.3	107.9	85.8	33.3	9.9	22.3
Non energy	26	32	38	62.6	74.0	79.7	20.4	20.4	21.7
Social	47	61	77	57.8	70.3	95.0	-13.7	27.9	26.6
2. Transfers	353	430	477	85.7	89.9	90.1	21.2	21.8	10.8

Note: O&G denotes oil and gas, N-O&G denotes non-oil and gas; NTR denotes non-tax revenues, NRR denotes natural resource revenues
Source: Ministry of Finance; World Bank staff calculations

Gross security financing targets for 2013 will be met

Gross securities financing requirements of IDR 326.9 trillion as per the Government's revised Budget for 2013 have essentially been met, with IDR 323.0 trillion worth of debt securities issued through 3 December. Issuance recovered well from the period of difficult issuance conditions from May to August, during which only limited amounts of longer-tenor debt were issued, increasing the Government's reliance on Treasury bills with a duration of 1 year or less. As of 3 December, IDR 42.4 trillion worth of Treasury bills had been issued over 2013, compared to total Treasury bill issuance in 2012 of IDR 30.5 trillion. Nevertheless, the risk profile of the Government's debt stock as at the end of 2013, as projected by the Debt Management Office (DMO), remains generally robust, with the average time to maturity of government debt declining only marginally, to 9.6 years (from

9.7 years in 2012). In addition, only 15.7 percent of total debt is variable rate, though currency exposure remains significant with 44.6 percent of total debt projected by DMO to be foreign-currency denominated at the end of 2013.

The World Bank projects that the Budget deficit in 2013 will be 2.5 percent of GDP and 2.1 percent of GDP in 2014

Considering the outturn in the first eleven months of 2013, weaker commodity prices and the depreciation in the Rupiah, but also the slight improvement in nominal GDP growth in Q4 on the back of higher price growth, the World Bank has revisited its fiscal projections for 2013 and 2014. The projected fiscal deficit for 2013 remains unchanged from the October *IEQ*, at 2.5 percent of GDP. For 2014, taking into account announced policy changes and also revised macroeconomic assumptions, the World Bank has revised down its projection of the 2014 fiscal deficit slightly from 2.3 percent of GDP in the October 2013 *IEQ* to 2.1 percent of GDP. Section B.1 provides a detailed overview of the approved 2014 Budget, and further details on the World Bank's assumptions for the fiscal sector in 2014.

Table 6: The World Bank projects a fiscal deficit of 2.1 percent of GDP in 2014, narrowing from 2.5 percent in 2013
(IDR trillion, unless otherwise indicated)

	2012	2013		2014	
	Audited actual	Revised budget	WB	Budget	WB
A. Revenues , o/w	**1,338**	**1,502**	**1,462**	**1,667**	**1,603**
1. Tax revenues	981	1,148	1,115	1,280	1,246
2. Non tax revenues	352	349	342	385	353
B. Expenditures	**1,491**	**1,726**	**1,686**	**1,842**	**1,819**
1. Central gov't, o/w	1,011	1,197	1,159	1,250	1,234
Personnel	198	233	230	263	261
Material	141	203	174	216	184
Capital	145	188	169	184	185
Subsidies, o/w	346	348	369	334	391
Fuel subsidies	212	200	221	211	239
Electricity subsidies	95	100	100	71	100
2. Transfers to the regions	481	529	527	593	585
C. Primary balance	**-53**	**-112**	**-109**	**-54**	**-88**
D. Surplus/deficit	**-153**	**-224**	**-225**	**-175**	**-216**
as percent of GDP	**-1.9**	**-2.4**	**-2.5**	**-1.7**	**-2.1**
E. Net Financing	**175**	**224**	**n.a.**	**175**	**n.a.**
1. Domestic Financing	199	241	n.a.	196	n.a.
2. Foreign Financing	-23	-17	n.a.	-21	n.a.
Key Economic Assumptions					
Economic growth (percent)	6.2	6.3	5.6	6.0	5.3
CPI (yoy, percent)	4.3	7.2	7.4	5.5	6.8
Exchange rate (IDR/USD)	9,384	9,600	10,563	10,500	11,800
Crude oil price (USD/barrel)	113	108	104	105	103
Oil production ('000 barrels/day)	861	840	840	870	870

Source: Ministry of Finance; World Bank staff calculations

7. Given prevailing risks, further progress on pro-growth reforms is needed

Economic risks to the 2014 outlook are significant…

While the baseline expectation is for Indonesia's economy to continue to decelerate only modestly, with quarterly growth remaining above 5.0 percent yoy through the end of 2014, and for the current account deficit to narrow in coming quarters, these projections are subject to significant uncertainty. A further abrupt deterioration in external financing conditions is a particular ongoing risk, in light of Indonesia's sizable external financing needs. Such deterioration could be triggered by international market developments, or specifically due to domestic economic and policy developments. This would spill over negatively into real economic activity by placing further upward pressure on interest rates, downward pressure on asset prices and the Rupiah, and could result in localized corporate sector stresses with damaging effects on private sector confidence.

…particularly to the investment outlook, but private consumption could also weaken more than anticipated…

Indonesia's GDP forecasts are particularly sensitive to the investment outlook, which depends crucially on the path of the real interest rate the exchange rate (as described in the October 2013 *IEQ*). In addition, there is also the risk that private consumption growth may slow more than anticipated in the base case, for example, if higher prices and interest rates, particularly if coupled with more asset price volatility, take their toll by eroding confidence, household income and corporate profitability. This would be a material drag on growth, given that private consumption accounts for approximately 55 percent of total expenditure.

…and there is a material risk of GDP growth for 2014 falling below 5 percent

Overall, therefore, risks are skewed towards weaker domestic demand than in the base case. Even mildly weaker domestic demand growth than currently anticipated (e.g. a reduction of 0.5 percentage points in private consumption and investment) could reduce GDP growth to below 5 percent. A more severe moderation in domestic demand (with private consumption and investment growth dropping by 1 percentage point relative to the baseline), for example due to an intensification of external financing constraints, could feasibly lead to GDP growth in 2014 of below 4.5 percent (Table 7).

Table 7: Modestly weaker than expected consumption and investment growth could move 2014 GDP growth down to below 5 percent
(real growth, percent, unless otherwise indicated)

	Private consumption	Investment	Overall GDP	GDP growth relative to baseline (ppt)
2014 Baseline	4.9	4.4	**5.3**	n.a.
Mildly weaker domestic demand*	4.4	3.9	**4.7**	-0.6
Significantly weaker domestic demand**	3.9	3.4	**4.3**	-0.9
2009 Historical (reflecting GFC impact)	4.9	3.3	**4.6**	-0.7

Note: Scenarios assume private consumption and investment are *0.5 ppt and **1.0 ppt weaker than in the baseline, respectively; GFC: Global financial crisis
Source: World Bank staff projections

Macroeconomic adjustments to date have been broadly positive for stability, but carry costs…

The monetary policy and exchange rate adjustments seen in 2013 are broadly positive for macroeconomic stability, with the depreciation of the Rupiah acting as a "shock absorber" for weaker terms of trade by supporting export competitiveness and encouraging substitution away from imports. Higher interest rates have helped to dampen domestic demand, and import demand, and are supportive of portfolio investment inflows. However, these adjustments carry costs, including by placing pressure on public and private sector balance sheets by raising the Rupiah value of external debt (particularly if there are currency mismatches), and eroding incomes through higher debt servicing and import costs, as well as introducing less easily quantifiable risks and uncertainties, such as the impact on sentiment.

…and import suppression in particular is no panacea…

Import growth has slowed and in the base case this is likely to continue, albeit fairly gradually, supporting a reduction in Indonesia's current account deficit and external financing needs. However, as discussed above, import compression means fewer capital goods, and raw material and intermediate products for manufactured goods production, and so comes at a direct cost to current and future output growth. The real policy challenge for

Indonesia is therefore not to focus on import suppression through regulatory measures, but rather to increase exports, and to secure more and higher quality external financing, particularly FDI.

…highlighting the need for more policy reforms to support exports and FDI inflows…

Moving into 2014 and beyond, the recent, necessary focus on near-term macroeconomic stability, should continue to be augmented with more steps to support a virtuous cycle of strong investment, including foreign investment, and output growth. To do so, an emphasis on supporting exports to ensure that the increased international competitiveness generated by the weaker Rupiah is not lost, on increasing investment efficiency, and on supporting, and enhancing, FDI inflows, is needed. While FDI, in nominal terms, has so far proved resilient, it is underpinned by three factors which have all come under varying degrees of recent pressure: Indonesia's huge natural resource base (undercut by generally softer global commodity prices), the large and growing domestic market (undercut somewhat, at least in the near-term, by headwinds to domestic demand), and Indonesia's potential as a regional production hub in Asia (undercut by regulatory uncertainties and skills and infrastructure gaps). Box 2 examines the recent uneven progress on improving Indonesia's investment climate. More progress towards addressing these challenges can pay off not only in higher sustainable growth in the medium-term, but also for managing near-term risks as well, by supporting local and foreign investor confidence in Indonesia's future trajectory and hence external financing inflows.

…and a continued emphasis on improving the quality of spending, including through energy subsidy reform

In the fiscal sector, fuel subsidies remain a major source of fiscal risk, dent the ability of the flexible exchange rate to absorb shocks (given the significant impact of a depreciation in increasing fuel subsidy costs), and divert spending away from more efficient uses, including needed public investment in infrastructure, social protection and health programs, for example. As described in the October *IEQ*, the World Bank estimates that a 10 percent depreciation of the Rupiah increases the fiscal deficit by 0.3-0.4 percentage points of GDP, largely by raising fuel subsidy costs. This stresses the importance of further reforms, such as implementing a rule-based approach to determine subsidized fuel prices in such a way as to limit the Government's fiscal exposure to higher Rupiah-denominated fuel prices, while at the same time improving the safety net for those least able to cope with shocks, including to fuel-related prices.

Box 2: Update on the policies to improve the investment climate in Indonesia

As of the writing of this report, the implementation of the components of the August economic policy package designed to accelerate investment has been further delayed. Three of four committed actions are outstanding: (1) expediting and simplifying investment licensing; (2) expediting revision of the "Negative Investment List" (DNI) to make the Indonesian economy more open to foreign investment; and (3) expediting agro-based investment programs (crude palm oil, cocoa, rattan) and metallic minerals (bauxite, nickel, and copper) by providing tax holidays and tax allowances as incentives. For example, the mooted reduction of the required number of licenses in the oil and gas sector from sixty-nine to eight licenses has not yet been implemented, and there are concerns that the change will be limited to the grouping of the licenses without meaningful simplification of the procedures and time to obtain those licenses. The revision of the implementing regulations on tax incentives, and the implementation mechanisms, are still to be completed.

The Government continues to give conflicting messages on the progress of the DNI revision. Early in November, the Government announced that a revised DNI was almost ready and repeated its commitment to open additional sectors to foreign investment by opening up Private-Public Partnerships (PPPs) in infrastructure and relaxing foreign participation in several sectors (such as pharmacies, specialized hospitals, and transport). This announcement was widely criticized by different parties in the media*, arguing that the Government is failing to protect the national interest. Domestic business interests have also voiced their support for the protection of selected sectors from foreign competition. The Government subsequently sought to soften the earlier announcement by declaring that the discussion is far from final and reaffirming their commitment to protect the national interest. The discussion on how these interests are to be balanced in a revision of the DNI continues at this time.

The protracted attempts to update the negative investment list (DNI) are indicative of a broader debate in Indonesia on the relative importance of openness to international trade and investment for supporting Indonesia's economic growth prospects . Despite the Government's announcement that updating the DNI was a policy priority, based on the latest progress, it is not clear whether the upcoming DNI revision will in fact make it more investor-friendly and thus improve the investment climate, as intended in the August policy package. With a national election approaching in 2014, it remains to be seen how much influence nationalist, protectionist sentiments will exert on economic policy formation in the coming months.

Going forward, strengthening the quality of the policy formation process, for example through improving coordination mechanisms and consultative processes and enhancing regulatory reform processes (through "whole of government" approaches and regulatory reviews) is critical to ensure that policy uncertainty is minimized, to support the FDI inflows that help to cover Indonesia's external financing needs, and to ensure that Indonesia benefits as fully from FDI as it should. Strengthened policy formation processes would also better address the legitimate concerns of Indonesians that policies be made in the broader public interest, while enabling the Government to weigh the general public interest more effectively against more narrow business interests and requests for protection that do not benefit the economy overall.

On a positive note, on October 25, the Government launched an ambitious policy package to improve the ease of doing business. The announced action plan consists of seventeen actions across eight "Doing Business" areas (aligned to eight of the ten indicators in the World Bank Group's "Doing Business" country rankings) and is expected to be implemented by February 2014. To ensure the implementation of this policy package, and in a signal of good coordination towards making progress on these reforms, the Government has established a joint monitoring team with different government agencies, including the Presidential Working Unit for Control and Supervision on Development (UKP4). The private sector has responded favorably to the announcement of the (domestically focused) policy package, emphasizing that the reforms are urgently needed. Indonesia currently ranks 120 (out of 189 economies) in the World Bank Group's Doing Business 2014 rankings, a slight improvement over the past few years. However, this performance is below the regional (East Asia and Pacific) average and peer countries' performance: Philippines, China, Thailand, and Malaysia ranked 108th, 96th, 18th, and 6th respectively. Indonesia's overall performance is only slightly better than India and Cambodia.

Notes: *See, for example, Kompas, 7 November 2013 *Asing Makin Mendominasi Indonesia* and Bisnis Indonesia, 7 November 2013 *Daftar Negatif Investasi Dihapus, Asing makin Leluasa.*

B. Some recent developments in Indonesia’s economy

1. A closer look at the 2014 Budget

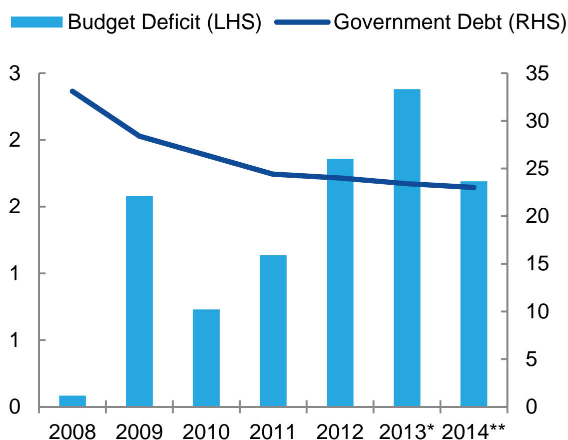
The 2014 Budget approved by Indonesia’s House of Representatives projects a deficit of 1.7 percent of GDP, but there are sizeable downside risks to the revenue and expenditure projections

On October 25, 2013, Indonesia’s House of Representatives approved the Government Budget for 2014. The approved Budget is non-expansionary and does not include any major revenue or expenditure reform, except potential electricity tariff adjustment. The Budget projects an overall fiscal deficit of 1.7 percent of GDP (Table 8). Total revenues are projected to reach IDR 1,667.1 trillion, an 11.0 percent increase from revised 2013 projected revenues—revised down slightly from IDR 1,662.5 trillion in the Government’s August Budget proposal—while total expenditures are targeted in the amount of IDR 1,842.5 trillion, a 6.7 percent increase from the projection for 2013 and a small 1.8 percent increase from the initial proposal for 2014. There are, however, significant downside risks to the revenue and expenditure outlooks, mainly due to optimistic macro-economic assumptions and increasing fiscal financing needs. The World Bank macroeconomic and price assumptions for 2014 differ from those of the approved Budget (Table 9), resulting in the World Bank projecting a somewhat higher projected deficit of 2.1 percent of GDP. This section examines in further detail the 2014 Budget outlook.

The projected narrowing in the deficit relative to 2013 helps to maintain a prudent overall fiscal stance but gross fiscal financing needs remain sizeable at 3.8 percent of GDP

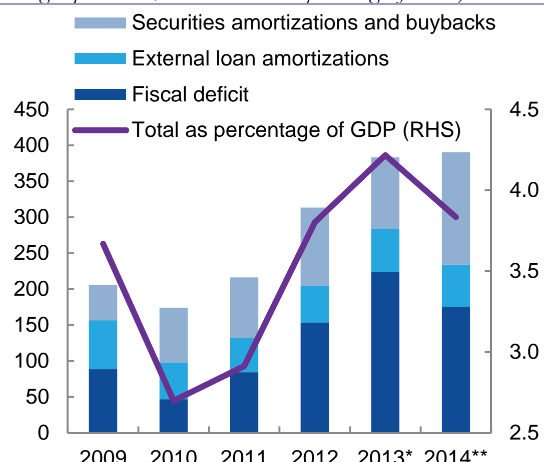
The 2014 Budget anticipates a slight decline in the government debt-to-GDP ratio, to 23 percent of GDP (Figure 20), reflecting the modest targeted deficit, coupled with assumed GDP growth in 2014 of 6.0 percent and inflation of 5.5 percent. These factors are offset somewhat by the impact of the projected depreciation in the Rupiah on the local currency value of the Government’s external debt. Bond redemptions and buybacks are projected, provisionally, to increase to IDR 156 trillion in 2014, up from IDR 100 trillion under the revised 2013 Budget. Consequently, gross financing needs are set to rise in 2014 in nominal terms (Figure 21), down slightly relative to GDP to 3.8 percent. Gross securities financing needs are projected to be IDR 362 trillion (3.5 percent of GDP), up from IDR 330 trillion in 2013, 80.7 percent of which is expected to be met through domestic securities issuance.

Figure 20: The 2014 Budget targets a smaller deficit than in 2013 and further reduction in the ratio of debt-to-GDP…
(percent of GDP)



Note: *Revised budget, **Budget
Source: Ministry of Finance

Figure 21: … but despite this, gross fiscal financing requirements are likely to be similar to 2013's high levels
(financing requirements, IDR trillion and percentage of GDP)



Note: Based on provisional targets for 2014; *Revised budget, **Budget
Source: BI; Ministry of Finance

The most significant increase on the revenue side is higher projected sales tax/VAT receipts

On the revenue side, the projected 11.0 percent increase in revenues comes from both tax revenues (up 11.5 percent from those projected for 2013), and non-tax revenues (up 10.4 percent from 2013, significantly higher than the 1.0 percent increase in the Government's August proposal). The tax-to-GDP ratio is projected to move up only slightly to 12.3 percent. The single most significant increase in revenues is of the sales tax/VAT, which sees a 16.3 percent increase from the 2013 revised Budget level (although this is below the August Budget proposal of a 22.5 percent increase). While election-related spending in 2014 may buoy sales tax receipts by lifting consumption spending, the evidence from the previous two national elections on the possible magnitude of the effect is unclear given the differing economic conditions. In addition, expected underachievement of the sales tax/VAT in 2013 (collection through November 2013 reached 77.9 percent of the revised 2013 Budget target) contributes to the World Bank's caution regarding the approved Budget projections.

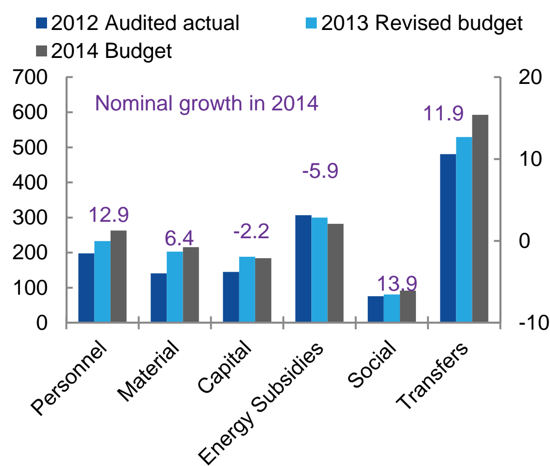
The Government plans to further increase electricity tariffs in 2014…

On the expenditure side, a key feature of the 2014 Budget is a 28.6 percent reduction in the spending on electricity subsidies relative to 2013 (IDR 71.4 trillion in 2014 from IDR 100.0 trillion in 2013). On October 1, PLN (*PT Perusahaan Listrik Negara,* the state-owned electricity company) introduced the final installment of 2013's electricity price hike. Electricity tariffs have been raised by 4.3 percent each quarter of 2013, to reach a total of about a 15 percent annual increase, relative to 2012. The price adjustments have not affected households with consumption of 450 to 900 VA. However, the Government has also set aside an IDR 10.4 trillion contingency budget for electricity subsidies in 2014. The parliament has agreed to the Government's proposal to increase, electricity tariffs in 2014 for certain categories of industrial and commercial users to the cost recovery level, but the detailed proposal is reportedly still being discussed . The Government is also planning to remove electricity subsidies for large industrial customers, but the timing of this is still being discussed.

… but overall energy subsidy spending is set to remain a significant part of total spending

Total expenditures are projected to decrease slightly as a percentage of GDP, from 18.3 in 2013 to 17.8 percent in 2014 (Figure 21). The 2014 Budget includes a 4.1 percent reduction in subsidy spending compared to the 2013 Budget (IDR 333.7 trillion in 2014 versus IDR 348.1 trillion in 2013). This reduction results from the 28.6 percent reduction in electricity subsidies discussed above, partially offset by a 6.8 percent increase in non-energy subsidies, including fertilizers, rice for the poor, and seeds (from IDR 48.3 trillion in 2013 to IDR 51.6 trillion in 2014). The spending allocation to fuel subsidies in 2014 is IDR 210.7 trillion, IDR 10.8 trillion higher than projected under the revised 2013 Budget, reflecting primarily the higher projected Rupiah market price of fuel, offsetting the impact of June's subsidized fuel price increase. Energy subsidy spending therefore remains a significant part of total spending (Figure 22), at 15.0 percent of total government spending under the 2014 Budget (relative to 17.0 percent projected for 2013) or 22.6 percent of central government spending.

Figure 22: Energy subsidies still consume a significant part of the Budget
(IDR trillion)



Source: Ministry of Finance

Personnel spending is projected to rise significantly…

The 2014 Budget also projects a 12.9 percent increase in personnel spending (from IDR 233.0 trillion in 2013 to IDR 263.0 trillion), reflecting a planned 6 percent increase in basic salaries and a 4 percent increase in pensions, and the ongoing bureaucratic reform process in the fourteen line ministries (through which the line ministries will receive additional funding to increase basic salaries). Material expenditures in 2014 are projected to increase by 6.4 percent compared to the target in the revised 2013 Budget, despite a planned decrease of operational spending. Social spending is budgeted to increase by 13.9 percent, to IDR 91.8 trillion in 2014, including spending on the new social security system (SJSN, *Sistem Jaminan Sosial Nasional*) in the amount of IDR 19.9 trillion. The phasing out of the temporary cash transfer (BLSM) at the end of 2013, however, limits the increase in overall social spending.

…while capital spending is targeted to reach a modest 1.8 percent of GDP

Capital spending is targeted to reach IDR 184.2 trillion, down 2.2 percent from the revised 2013 allocation. This is a notable development given the previous sizeable annual increases in the budget allocations to capital spending, although raising disbursement rates would allow room for larger increases in actual nominal spending than in the budget allocation. Relative to GDP, this targeted level of spending is only 1.8 percent, the same level as in 2012. Though this level of capital spending appears relatively modest comparing to the pressing needs to address Indonesia's infrastructure gaps, budget execution challenges have been the main constraints in delivering infrastructure projects.[2]

The World Bank projects a somewhat larger deficit of 2.1 percent of GDP in 2014

The World Bank projects that the fiscal deficit in 2014 will be 2.1 percent of GDP, based on less favorable macroeconomic assumptions to those in the Budget (Table 8). Given the uncertain effect of the elections on boosting consumer spending, and the projected further decline in international oil prices and depreciation of Rupiah, the World Bank projects that

[2] For further discussion on Indonesia's budget execution challenges in the infrastructure sector see the July 2012 *IEQ*. The March and October 2013 *IEQ*s also contain analysis of Indonesia's recent infrastructure investment spending and capital stock and discuss the importance of higher quality infrastructure for the growth of economic activity.

total nominal revenues will grow by 9.7 percent relative to 2013, which is below the Government's nominal growth target of 11 percent. In addition, the weaker Rupiah puts further pressure on expenditures, especially through fuel subsidies; as highlighted in the October 2013 edition of the *IEQ*. As a result, a reduction in the total cost of fuel subsidies is not expected to be achieved in 2014 compared with 2013 despite the June 2013 increase in subsidized prices, as anticipated savings have been eroded by higher Rupiah-denominated fuel prices. Depending on the trends in international fuel prices and the exchange rate, the possibility of overshooting the target in 2014 cannot be ruled out.

Table 8: The approved fiscal deficit in 2014 is 1.7 percent of GDP, slightly higher than previously proposed
(IDR trillion, unless otherwise indicated)

	IDR trillion				Percent of GDP			
	2012 Audited actual	2013 Revised budget	2014 Proposed budget	2014 Budget	2012 Audited actual	2013 Revised budget	2014 Proposed budget	2014 Budget
A. Revenues, o/w	**1,338**	**1,502**	**1,663**	**1,667**	**16.2**	**15.9**	**16.1**	**16.1**
1. Tax revenues	**981**	**1,148**	**1,310**	**1,280**	**11.9**	**12.2**	**12.7**	**12.3**
Income tax	465	539	592	586	5.6	5.7	5.7	5.7
Oil & gas	83	74	68	76	1.0	0.8	0.7	0.7
Non-oil & gas	382	465	523	510	4.6	4.9	5.1	4.9
Sales tax/VAT	338	424	519	493	4.1	4.5	5.0	4.8
Property taxes	29	27	26	25	0.4	0.3	0.2	0.2
Excises	95	105	114	116	1.2	1.1	1.1	1.1
International trade tax	50	48	54	54	0.6	0.5	0.5	0.5
2. Non-tax revenues	**352**	**349**	**351**	**385**	**4.3**	**3.7**	**3.4**	**3.7**
Natural resources	226	204	198	226	2.7	2.2	1.9	2.2
Oil & gas	206	181	171	197	2.5	1.9	1.7	1.9
Non-oil & gas	20	23	27	29	0.2	0.2	0.3	0.3
Other non-tax	126	145	153	159	1.5	1.5	1.5	1.5
B. Expenditures	**1,491**	**1,726**	**1,817**	**1,842**	**18.1**	**18.3**	**17.6**	**17.8**
1. Central Gov't, o/w	**1,011**	**1,197**	**1,230**	**1,250**	**12.3**	**12.7**	**11.9**	**12.0**
Personnel	198	233	277	263	2.4	2.5	2.7	2.5
Material	141	203	204	216	1.7	2.1	2.0	2.1
Capital	145	188	206	184	1.8	2.0	2.0	1.8
Interest payments	101	113	120	121	1.2	1.2	1.2	1.2
Subsidies	346	348	336	334	4.2	3.7	3.2	3.2
Energy subsidies	306	300	285	282	3.7	3.2	2.8	2.7
Fuel	212	200	195	211	2.6	2.1	1.9	2.0
Electricity	95	100	90	71	1.1	1.1	0.9	0.7
Non-energy subsidies	40	48	52	52	0.5	0.5	0.5	0.5
Social	76	81	56	92	0.9	0.9	0.5	0.9
2. Transfers to regions	**481**	**529**	**586**	**593**	**5.8**	**5.6**	**5.7**	**5.7**
C. Primary balance	**-53**	**-112**	**-35**	**-54**	**-0.6**	**-1.2**	**-0.3**	**-0.5**
D. Overall balance	**-153**	**-224**	**-154**	**-175**	**-1.9**	**-2.4**	**-1.5**	**-1.7**
E. Net financing	**175**	**224**	**154**	**175**	**2.1**	**2.4**	**1.5**	**1.7**
I. Domestic financing	199	241	173	196	2.4	2.6	1.7	1.9
II. Foreign financing (net)	-23	-17	-19	-21	-0.3	-0.2	-0.2	-0.2

The Medium-Term Budget Framework projects reaching overall surplus by 2016…

The approved Budget for 2014 also includes an updated Medium-Term Budget Framework (MTBF) over the period 2015-2017, which projects a move to an overall budget surplus by 2016 (Table 10) and a further decline in debt-to-GDP to 23 percent. The Government expects to continue with the net negative flow of official foreign financing. This expected fiscal outlook is supported by an optimistic economic growth target range moving above 7 percent of GDP in 2015 and beyond, coupled with a stable inflation rate (3-5 percent) and an exchange rate of up to 10,000 Rupiah per USD. Oil production is expected to increase

gradually during the next three years, though projections are downgraded from those in the MTBF in the 2013 Budget (1,010 - 1,030 thousand barrels per day in 2016). Total nominal revenues are expected to grow by 13 percent on average between 2015 and 2017, while expenditures are planned to fall gradually as a share of GDP, from almost 18 percent of GDP to slightly over 16 percent by 2017.

…a target which may prove difficult to achieve

In light of the recent moderation in economic growth and the World Bank's base case expectations, the macroeconomic projections in the updated MTBF appear difficult to achieve. In addition, the move to a budget surplus of 0.2 percent of GDP by 2016 will likely be very difficult, as it requires a reduction of spending by 2 percentage points, and an increase in revenues of 1 percentage point, of GDP relative to the 2013 revised Budget figures. The latter may be feasible, but a 2 percentage point reduction in spending would be a challenge given limited discretionary space, except if achieved through reducing subsidies, which would require major reform. Given Indonesia's development needs, working towards improving the spending mix while increasing the level of revenue-to-GDP share may be preferable to reducing total spending in order to achieve a positive fiscal balance.

Table 9: Macroeconomic and price assumptions have been revised in a conservative direction from those in the August proposal

	2012	2013	2014	2014	2014
	Actual audited	Revised budget	Proposed budget	Budget	WB
Real GDP growth (percent)	6.2	6.3	6.4	6.0	5.3
CPI (yoy, percent)	4.3	7.2	4.5	5.5	6.1
Exchange rate (IDR/USD)	9,384	9,600	9,750	10,500	11,800
Crude oil price (USD/BBL)	113	108	106	105	103
Oil production ('000 BBL per day)	861	840	870	870	870

Source: Ministry of Finance and World Bank staff estimates

Table 10: The Medium-Term Budget Framework projects an overall surplus by 2016
(IDR trillion, unless otherwise indicated)

	2013		2014		2015		2016		2017	
	Revised budget		Budget				Projections			
	IDR tn	% of GDP	IDR tn	% of GDP	IDR tn	% of GDP	IDR tn	% of GDP	IDR tn	% of GDP
A. Revenues, o/w	**1,502**	**15.9**	**1,667**	**16.1**	**1,891**	**16.5**	**2,129**	**16.4**	**2,381**	**16.8**
1. Tax revenues	1,148	12.2	1,280	12.3	1,513	13.2	1,746	13.4	2,003	14.2
2. Non-tax revenues	349	3.7	385	3.7	374	3.3	381	2.9	377	2.7
B. Expenditures	**1,726**	**18.3**	**1,842**	**17.8**	**1,944**	**17.0**	**2,104**	**16.2**	**2,306**	**16.3**
I. Central gov't, o/w	1,197	12.7	1,250	12.0	1,268	11.1	1,346	10.4	1,473	10.4
Line ministries	622	6.6	n.a.	n.a.	663	5.8	725	5.6	823	5.8
Non-line ministries	575	6.1	n.a.	n.a.	606	5.3	620	4.8	650	4.6
II. Transfers to regions	529	5.6	593	5.7	675	5.9	759	5.8	833	5.9
C. Primary balance	**-112**	**-1.2**	**-54**	**-0.5**	**75**	**0.7**	**155**	**1.2**	**207**	**1.5**
D. Overall balance	**-224**	**-2.4**	**-175**	**-1.7**	**-53**	**-0.5**	**25**	**0.2**	**75**	**0.5**
E. Net financing	**224**	**2.4**	**175**	**1.7**	**53**	**0.5**	**-25**	**-0.2**	**-75**	**-0.5**
I. Domestic financing	241	2.6	196	1.9	98	0.9	28	0.2	-22	-0.2
II. Foreign financing, net	-17	-0.2	-21	-0.2	-46	-0.4	-53	-0.4	-53	-0.4
Key economic assumptions										
Real GDP growth (percent)	6.3		6,0		6.4 - 7.2		6.5 - 7.4		6.7 - 7.6	
CPI (yoy, percent)	7.2		5,5		3.0 - 5.0		3.0 - 5.0		2.5 - 4.5	
Exchange rate (IDR/USD)	9,600		10.500		9,700 - 10,000		9,700 - 10,000		9,700 - 10,000	
Crude oil price (USD/BBL)	108		105		100 - 115		100 - 115		100 - 115	
Oil production ('000 BBL per day)	840		870		960 - 980		940 - 960		920 - 940	

Source: Ministry of Finance; World Bank staff calculations

2. An update on poverty in Indonesia

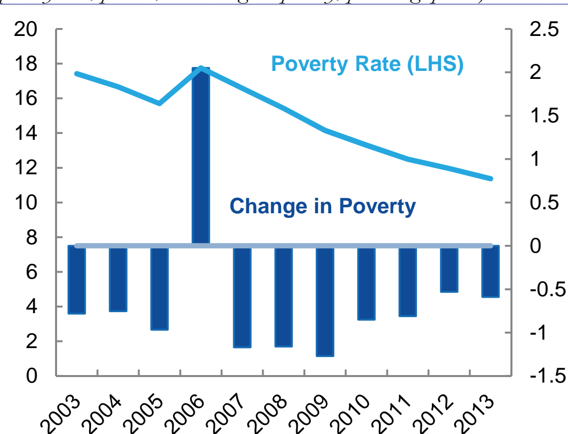
This section examines recent trends in poverty, and the prospects for further reduction in the short- to medium-term

The rate of poverty reduction in Indonesia has been slowing in recent years. This section examines contributory factors to this phenomenon. Moreover, in the light of slowing economic growth, continued inflationary risks and relatively high rice prices, the prospects for the national poverty rate in the second half of 2013 and first half of 2014 are examined. The section concludes by looking at what can be done to accelerate poverty reduction in the future.

Indonesia's national poverty rate declined by 0.6 percentage points in the year to March 2013, continuing a slowing trend of poverty reduction in recent years

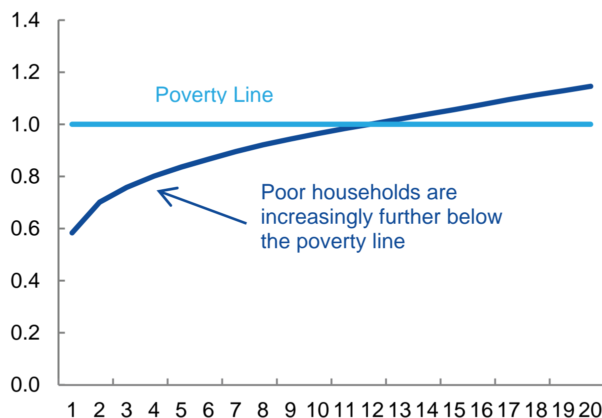
The official Indonesian poverty rate for March 2013, according to BPS (*Badan Pusat Statistik*), was 11.4 percent, representing a 0.6 percentage point decline from 12.0 percent in March 2012. For the past four years, the annual reduction in the poverty rate has been below 1 percentage point, and the 0.5 and 0.6 percentage point declines in 2012 and 2013 respectively are the lowest declines in over a decade, with the exception of the nearly 2 point increase in 2006 due mainly to food price shocks (Figure 23).

Figure 23: The pace of poverty reduction in recent years has been the slowest in over a decade
(poverty rate, percent, and change in poverty, percentage points)



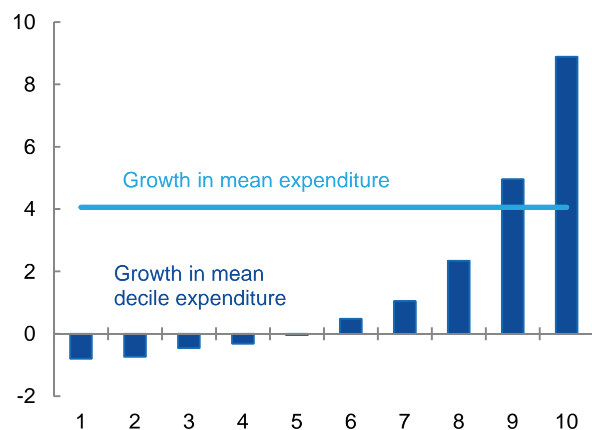
Source: BPS; World Bank staff calculations

Figure 24: The remaining poor households in Indonesia are further below the poverty line than earlier in the 2000s…
(2013 average per capita household consumption by percentile, as a ratio of the national poverty line)



Source: Susenas; World Bank staff calculations

Figure 25: …while the poor and vulnerable also participate less in Indonesia's recent economic growth
(2013 annual change in average per capita household consumption by decile, percent)



Source: Susenas; World Bank staff calculations

Contributing factors to this slowdown are that the remaining poor are increasingly harder to reach, and that economic growth continues to be unequally shared

There are a number of reasons for slowing poverty reduction. One important factor is that as poverty in Indonesia approaches 10 percent, the remaining poor households are further and further below the poverty line (Figure 24), meaning that higher consumption growth is required in order to maintain the annual rate of poverty reduction as in the past. At the same time, the poor and vulnerable have participated less in recent economic growth than wealthier Indonesians. The poorest half of Indonesians saw zero or slightly negative growth in real per capita consumption between 2012 and 2013, compared to a growth in mean consumption across the entire population of 4 percent and an average of 7 percent for the

richest two deciles (Figure 25). While these Growth Incidence Curves (GIC) are very sensitive to the choice of start and end dates, the pattern in Figure 25 is consistent with previous GICs since 2003.[3]

Box 3: BLSM, Susenas and measuring poverty

With higher food and non-food prices due to the rise in subsidized fuel prices in June 2013 expected to adversely affect poor and vulnerable households in the short term, the Government of Indonesia prepared a compensation package totaling IDR 29.05 trillion or about 74 percent of the total fuel subsidy savings. It included two main components: (a) the Special Compensation Program (*Program Kompensasi Khusus*), and (b) the Social Protection Acceleration and Expansion Program (*Program Percepatan dan Perluasan Perlindungan Sosial*, P4S) (see the June 2013 *IEQ* for further discussion). A key component of the P4S was an unconditional cash transfer (*Bantuan Langsung Sementara Masyarakat*, BLSM) in the amount of IDR 150,000 per household per month for a duration of four months, provided to 15.5 million households in two payments.

The BLSM was intended to prevent a temporary increase in poverty due to the temporary increase in poverty basket inflation as a result of the increase in subsidized fuel prices. The World Bank projects that instead of an increase to 12.1 percent poverty in September 2013, which would have occurred without the BLSM, poverty will have continued to fall. The extent of that fall, as measured in the September SUSENAS (the national socio-economic survey conducted by BPS, from which poverty estimates are made) depends on a number of factors. In particular, the timing of BSLM disbursements, and how this money is used, will have a significant effect on how much BLSM affects measured poverty.

The SUSENAS consumption module asks households detailed question about food and non-food consumption. For various food commodities consumption over the last week is asked for, and for non-food commodities the survey asks for consumption over the last three months. SUSENAS was conducted over September 2013. The first tranche of benefits was disbursed in July and August. If this was spent on food, it would not be counted in SUSENAS, as it did not happen in the week before the survey. If this was spent on non-food, then it would be counted as occurring in the last three months, but could be reported with recall error by respondents. If the money was used instead for debt repayment or savings, then it would not be captured by the survey at all, which asks only about consumption. The second tranche was disbursed in September, at the same time as SUSENAS was conducted. Whether the money was received before the survey will determine whether it is picked up by the survey.

What does past experience with BLSM's predecessor (*Bantuan Langsung Tunai*, BLT) tell us about how households respond? In its 2012 *Social Assistance Program and Public Expenditure Review* series, World Bank analysis reports that the money was generally consumed within one week of receipt (meaning the timing of the disbursements relative to the survey matters considerably), and that it was generally spent on basic necessities – food, as well as non-food items such as clothing or education expenses. The 2008-09 experience of the BLT saw a greater amount spent on education, as the disbursement was just before the beginning of the school year, whereas in 2005-06 more was weighted towards food. With the two disbursements in 2013 being just after the beginning of the school year, covering Ramadan, and leading up to Lebaran, households are likely to have consumed more and saved less, but whether this was on food or non-food is unclear.

Note: For further analysis of the BLT experience see World Bank. 2012. ***Bantuan Langsung Tunai (BLT) temporary unconditional cash transfer*****.**

The use of the BLSM unconditional cash transfer to compensate poor and vulnerable households for June's fuel price increase will likely prevent a short-term increase in the September 2013 poverty rate

This year has been characterized by slowing growth and higher inflation. In particular, the year-on-year increase in the poverty basket price index (a measure of the price of a basket of goods and services commonly consumed by the poor) in the third quarter of 2013 was 8.8 percent, driven by the effects of the rise in subsidized fuel prices from June. With this increase in the cost of living for the poor likely to have been higher than increases in household earnings or wages, the September 2013 poverty rate would have been expected to increase. Applying the macroeconomic outcomes to a household micro-data model of poverty in Indonesia, and abstracting from the impact of the compensation package associated with the subsidized fuel price increase, the September poverty rate is projected to have been 12.1 percent, a 0.4 percentage point increase on September 2012 (and 0.7 points on March 2013). However, the poverty rate should benefit in the short-term from the temporary impact of the BLSM payments in the middle of the year, which saw two payments of IDR 300,000 to 15.5 million households in July/August and September. As a consequence, the temporary increase in inflation is likely to be offset by the temporary increase in income for poor and vulnerable households, and the World Bank projects that the September poverty rate will indicate a fall in poverty. Whether this decline is small or substantial depends on the timing of the disbursements, how the money is used, and when household consumption is surveyed (see Box 3).

[3] See, for example, the discussion on Indonesia's changing patterns of consumption growth from 1996 to 2010 in the March 2011 *IEQ*.

However, the Government's target poverty rate of 8-10 percent in 2014 is likely to be missed…

The temporary BLSM payments will not affect the longer-run poverty trend, as they lasted for only four months. With poverty as of March 2013 at 11.4 percent, even if the rate of poverty reduction returns to 1 percentage point per year, the Government's 2014 target of 8-10 percent (RPJM 2009-14) would be missed. Moreover, slowing growth (projected by the World Bank to be 5.1 percent year-on-year to March 2014) and high inflation (7.2 percent year-on-year to March 2014) mean achieving even a 1 percentage point reduction in the year to March 2014 is unlikely. The World Bank's poverty model projects the March 2014 poverty rate to be 11.0-11.1 percent (0.3-0.4 points lower than March 2013), indicating a further slowing of poverty reduction.

…although depends in part on the uptake of the recent expansion of long-term social assistance programs

However, the expansion of long-term social assistance which began in the third quarter of 2013 (see following discussion) could affect this outcome. In addition to the temporary BLSM, the Social Protection Acceleration and Expansion Program, P4S (see Box 3 and IEQ July 2013), also included a significant expansion in benefits of two long-term social assistance programs – a conditional cash transfer program and a cash transfer program for poor students Significant uptake of these programs (as well as the timing of disbursement – see Box 3) could result in faster poverty reduction, and possibly mean the 2014 poverty target may be met. However, significant uptake is more likely in the second half of 2014.

Continued poverty reduction will require continued expansion of social assistance…

Indonesia has historically spent less on social assistance as a percent of GDP (roughly 0.5 percent) compared to other countries in the region (1.0 percent) and middle-income countries in general (1.5 percent).[4] While the recent expansion in long-term programs mentioned is welcome progress, commitment to the ongoing growth of social assistance will be required to help speed up poverty reduction. As importantly, getting implementation right for these programs will also determine their effectiveness as poverty reduction tools.[5].

…with the Government recently significantly expanding its conditional cash transfer program…

The Conditional Cash Transfer program (*Program keluarga Harapan*, PKH) was expanded from 1.1 million beneficiary households to 2.4 million in 2013, with a further expansion in 2014 to 3.2 million planned. At the same time, average benefit levels will increase from IDR 1.4 million to IDR 1.8 million per year per household. This increase in benefits is likely to improve appreciably the adequacy of program benefits in off-setting the costs of health and educational services for poor families.

…and cash transfer program for poor students

Similarly, eligibility among poor students for cash transfers (*Bantuan untuk Siswa Miskin*, BSM) will almost double in 2013 from 8.7 million to 16.6 million beneficiaries. However, its effect on poverty will depend on the uptake of the program by students in poor households. The benefit levels will also significantly increase: primary school (SD) benefits will increase from IDR 360,000 to IDR 450,000 per year per student, while junior secondary (SMP) benefits will increase from IDR 550,000 to IDR 750,000 per year per student.

The Government also scaled up temporarily the Raskin rice subsidy for low-income group program, although this continues to face delivery challenges

Other permanent social assistance programs were also modified under P4S, but only on a temporary basis, which is likely to imply only modest impacts on poverty reduction in the long run. Under the Rice Subsidy for the Low-Income Group program, (*Subsidi Beras bagi Masyarakat Berpendapatan Rendah,* or Raskin), beneficiary households were able to purchase an additional 15 kg of rice per month for three months (June, July, and August), at heavily subsidized rates. This second allotment was in addition to the original allocation of 15 kg of rice beneficiaries were eligible to purchase per month. However, due to challenges in the Raskin delivery system, at-risk households were likely only able to purchase much less subsidized rice than has been allocated to them through the compensation program. This affects the *de facto* benefit households receive through the Raskin program, and lessens program benefits and impact. (See the World Bank's *2012 Social Assistance Program and Public Expenditure Review* for a longer treatment of Raskin delivery challenges).

Importantly, recent social assistance

P4S program reforms have been been undertaken alongside the introduction of a Social Protection Card (*Kartu Perlindungan Sosial,* KPS) and in alignment with a Unified Database of

[4] See World Bank (2012) Protecting the Poor and Vulnerable in Indonesia.
[5] See also World Bank (2012), Protecting the Poor and Vulnerable in Indonesia.

reforms have been accompanied by the introduction of a Social Protection Card and Unified database of beneficiaries

potential social protection program beneficiaries (*Basis Data Terpadu,* BDT). The use of both the Social Protection Cards and the BDT has important implications on potential benefits across programs, especially for the very poor. For example, PKH beneficiary families will automatically have access to BSM, BLSM, and Raskin. When deployed in concert, these programs have the potential of amplifying individual program benefits, leading to more robust poverty reduction.

Future poverty reduction will be supported not only by improved social protection programs but also by measures to build inclusive growth, for example, focusing on skills and quality job creation

Continued expansion in benefits and coverage of permanent social protection programs, including PKH and BSM, can help boost poverty reduction in the future. The introduction of new programs that protect currently uncovered risks, including cash or in-kind programs that target the elderly and disabled, will also help protect vulnerable populations. Through further expansion and integration of existing social protection programs, and the introduction of new programs to address uncovered risks, the social protection system will be better able to adequately protect families from shocks and help them manage risks that affect them throughout the lifecycle. Programs that provide skills training and bolster formal sector employment are also needed to encourage labor market development and further enhance poverty reduction (as discussed in the next Section).

C. Indonesia 2015 and beyond: A selective look

1. The labor market in Indonesia: recent achievements and challenges

Indonesia has been successful at creating jobs, now its expanding labor market has to address several challenges…

Indonesia's labor market has shown a continuous recovery since the mid-2000s, after the downturn following the 1997/1998 East Asian financial crisis, and its performance in terms of increase in employment rate has been among the strongest in the East-Asia Pacific region. Indonesia's success in generating employment is explained mainly by sustained economic growth, a favorable economic environment, and a rapidly expanding service sector. This has led to a gradual increase in service sector jobs and formalization of the economy, particularly in urban areas, largely through the increase in paid dependent employment. Despite these encouraging developments, Indonesia faces challenges in creating more and better jobs as the country continues its structural transformation (i.e., the movement of workers from poorly productive to highly productive activities). This section provides an overview of the recent achievements in Indonesia's labor markets and outlines the main challenges faced.

…such as expanding employment growth in higher productivity sectors and to address still high levels of informality and shortages of skilled workers

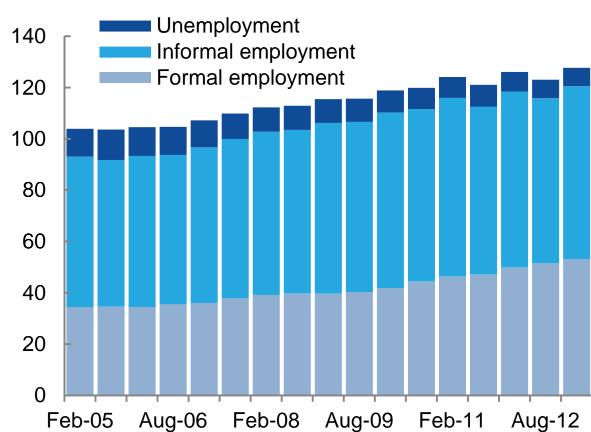
Specifically, three main challenges should be addressed. First, the largest economic sectors in terms of employment are still low value added, and job creation since 2001 has been driven by the expansion of low productivity sectors. Second, the informal sector remains large, employing more than 50 percent of total workers, with informal jobs paying lower wages, providing less stability and not giving access to benefits. Third, investments in higher productivity sectors are hampered by the limited availability of skilled workers. If such challenges remain unaddressed, there is a risk that the recent welfare gains might be undermined, with a consequent slowdown in poverty reduction and increase in inequality.

Indonesia's labor force, the 4th largest in the world, reached 121 million workers in early 2013 and employment is expanding…

According to the most recent data available from the February 2013 Sakernas labor force survey, out of a population of 175 million people aged over 15, Indonesia's total labor force was 121 million, of which 114 million are employed (Figure 26). Since February 2006, the labor force participation rate to the total working age population increased slowly but steadily, rising from 66.7 percent to 69.2 percent, while, over the same period, the share of the employed to the working age population rose faster, from 59.0 percent to 65.1 percent,

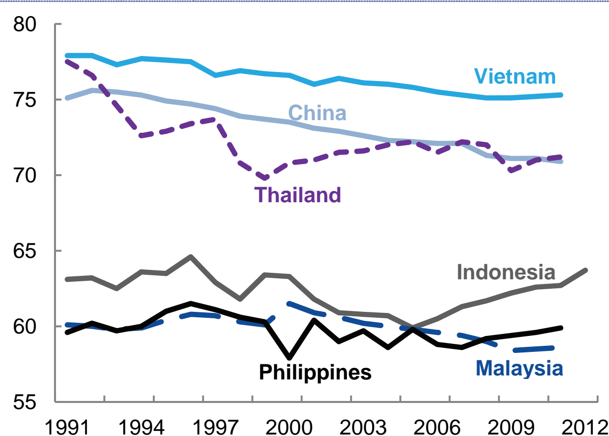
reaching its mid-1990s levels. Consistently, between 2006 and 2012, the elasticity of employment to (real value-added) growth[6] has reached 0.56 (meaning that a 1 percent increase in real value added translates into a 0.56 percent increase in employment, on average across sectors, over the period), against 0.47 registered between 2001 and 2005, and 0.79 registered in the early 1990s, with an average estimated elasticity equal to 0.5 between 1990 and 2012 (and not significantly different from 0 during the 1998-99 crisis). In addition to such a positive employment trend, the total unemployment rate has been continuously declining (from 10.4 percent in February 2006 to 5.9 percent in February 2013). The aggregate unemployment rate, however, remains a relatively less telling labor market indicator in Indonesia, as in other similar middle-income countries, given the high level of informal employment, as discussed below.

Figure 26: Of Indonesia's labor force of 121 million workers, 114 million are employed (less than half in the formal sector)
(employment, unemployment, and formal employment, millions,)



Source: World Bank staff calculations using Sakernas

Figure 27: The rise in the employment rate in Indonesia since 2005 has been among the strongest in the region
(employment rate, percent; employment rate is defined as employed aged 15+ as percent of total population 15+)



Source: World Bank World Development Indicators and World Bank staff calculations using Sakernas for Indonesia

…although Indonesia's employment rate continues to lag some regional peers,

At the regional level, Indonesia has been outperforming the Philippines and Malaysia during the second half of the 2000s (Figure 27), although is still lagging behind some other regional peers, namely, Vietnam, China and Thailand, largely because of the relatively poor labor market participation of women and youth. Indonesia's female employment rate in fact reached only very recently the threshold of 50 percent, and the employment rate of the youth aged below 25 still lies below 40 percent, and has not returned yet to its early 1990s levels (47 percent), after a continuous decline and a slow recovery started only in the mid '00s. Most worryingly, youth's low labor market participation is accompanied by persistent high rates of NEETs (young people not in employment, education or training), as discussed below.

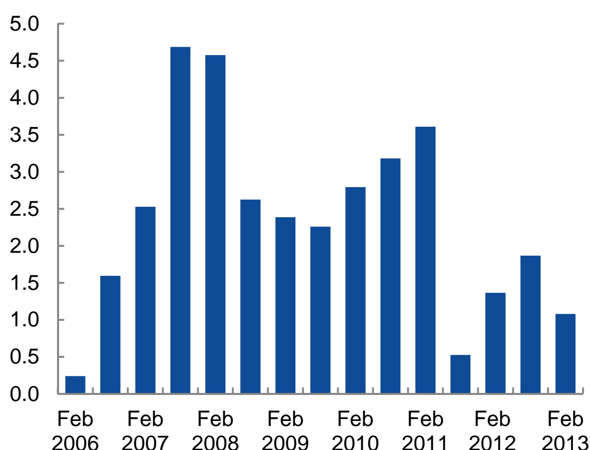
Most job creation has been in the formal sector, and in services

Between August 2001 and August 2012, a total of over 20 million new jobs were created (growth of 22 percent), with an average of 2.3 percent annual employment growth since February 2006 (Figure 28). Out of the 20 million jobs created, 16.4 million (82 percent) were formal jobs, according to new the definition of formal employment adopted by the National

[6] Estimated using panel data of employment and real value added for 9 economic sectors (defined in Figure 30) between 1990 and 2012.

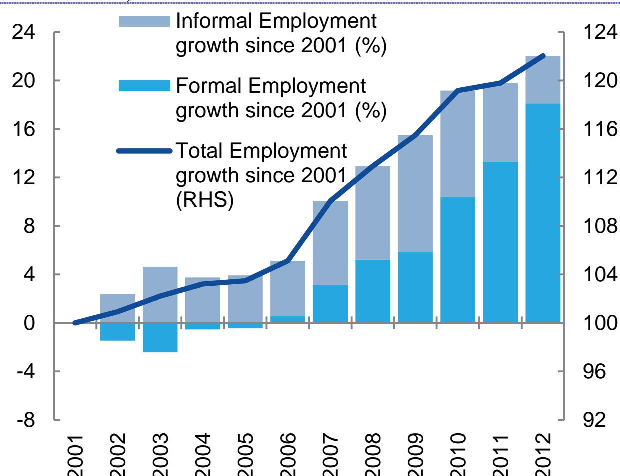
Statistical Institute (BPS) since 2001[7]. The services sector contributed the vast majority of this rise in employment, with 16.8 million new jobs created by the sector (84 percent of the total), and as a result services' share in total employment has reached 43 percent. The industry sector was able to create only 4 million new jobs and currently accounts for 21 percent of total employment, while in agriculture (where 35 percent of total workers are still employed) some 860,000 jobs were lost over this period. The expansion of employment in services has also driven the rise of the formal sector, with 85 percent of the jobs created in services since 2001 being formal jobs, as opposed to 57 percent in industry.

Figure 28: Year-on-year employment growth has been sustained since 2005, although slowing down after 2011
(year-on-year employment growth, percent)



Source: World Bank staff calculations using Sakernas

Figure 29: Formal employment contributed four-fifths total job creation between 2001 and 2012
(cumulative contribution to total employment growth with employment in 2001=100)



Source: World Bank staff calculations using Sakernas

Job creation has been stronger in urban areas, and important geographic differences in employment rates persist

Job creation has been stronger in urban areas, where employment grew by 45 percent since 2001 against 6 percent growth seen in rural areas. Urban employment growth has gradually outpaced rural areas' over the last decade, and since 2008 jobs in urban areas have been growing faster than the working age population. Also, urbanization has been importantly associated with the rise in formality, with 72 percent of jobs created in urban areas being formal. The increase in formalization can be also explained by the rise in the number of salaried employees (or dependent workers), which contributed to almost 70 percent of total job creation (Figure 30). At the geographic level, although some convergence of Provincial level employment rates towards the national level can be observed over the last decade, important differences can still be registered between areas with high employment rates (over 75%) such as Bali and Papua (whose performance is likely to be explained by the natural resources extraction industries boom, in particular palm-oil), and districts with persistently low employment rates (slightly above 55%) such as North Sulawesi and Aceh.

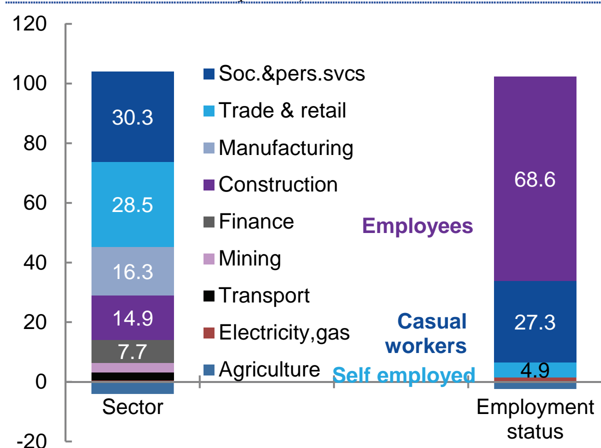
[7] According to the new definition of informality adopted by BPS since 2001, informal workers are defined according to a combination of characteristics related to the "Status of employment" and "Occupation". "Occupation" includes 9 categories: Professional, Technical and Related Workers, Administrative and Managerial Workers, Clerical and Related Workers, Sales Workers, Services Workers, Agricultural & Forestry Workers Fishermen & Hunters Production, Transportation and Unskilled Workers, Others. "Status of Employment" includes 7 categories: Own Account, Employer assisted by temporary worker(s), Employer assisted by permanent worker(s), Employee, Casual worker in agricultural sector, Casual worker in non-agricultural sector, Unpaid family worker. Informal workers are defined as: all unpaid family workers; all casual workers and own-account (or self-employed) workers, except those working as Professional, Technical and Administrative and Managerial Workers, Clerical and Related Workers; employers assisted by temporary worker(s) in agriculture and other occupations. The main change with respect to the old definition, is that before 2001 there was no "casual worker" category in the Sakernas, so casual workers in agriculture and construction were included in the formal sector as salaried employees.

a. The challenges of an ongoing but incomplete structural transformation

Employment growth occurred mostly in low-value-added, low-skilled sectors

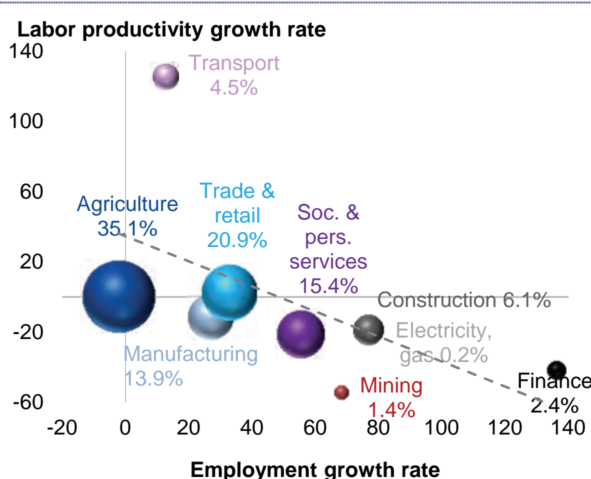
The flip side of the above encouraging labor market developments, however, is that low-labor productivity sectors (with labor productivity defined as value added divided by the number of workers), with a lower share of workers with tertiary education, still dominate employment, and that employment creation has been mainly concentrated in low-productivity, non-skill-intensive sectors. Of the total employment growth seen over 2001 to 2012, 30 percent occurred in community, social and personal services (where 6.9 million new jobs were created), and 28 percent in wholesale, trade and retail (5.7 million). Manufacturing contributed only to 16 percent of total growth (3.3 million), slightly above construction (14 percent, corresponding to 2.9 million new jobs). The negative correlation between employment growth and productivity growth between 2001 and 2012 (Figure 31), seems to suggest that job creation has not been fully productivity enhancing, and that there is room for improving the efficiency of labor reallocation from agriculture to industry and services and from low to high productive activities both within and across sectors.

Figure 30: Low value-added sectors in services have contributed mostly to job creation between 2001 and 2012
(sector and employment status contribution to total employment growth between 2001 and 2012, percent)



Source: World Bank staff calculations using Sakernas

Figure 31: Employment growth and labor productivity growth are negatively correlated
(employment and labor productivity growth, 2001-2012, percent)



Note: bubble size indicates each sector's share in total employment in 2012. Source: World Bank staff calculations using Sakernas

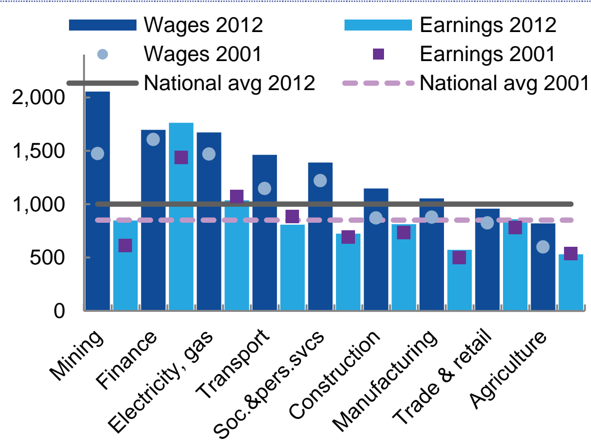
As a result, wage growth has been moderate, but important income gaps persist between formal dependent and non-dependent workers…

This evidence is consistent with the findings that average real wage growth has been relatively modest compared to aggregate productivity growth, over the 2002 to 2012 period. Real wages (including wages from formal sector employees) grew by 21 percent since 2001 (Figure 32), averaging 2 percent in terms of real annual growth, which appears quite moderate compared to an average yearly real GDP growth rate of 5.4 percent, and to a total growth in labor productivity of nearly 50 percent over the same period. Figure 32 also suggests that the growth in real earnings (income from work for the self-employed and casual workers, both formal and informal) has been much slower, only 5 percent over the whole period, resulting in persisting income gaps between formal dependent (salaried employees) and non-dependent workers.

…and there is considerable variation in wage growth amongst sectors

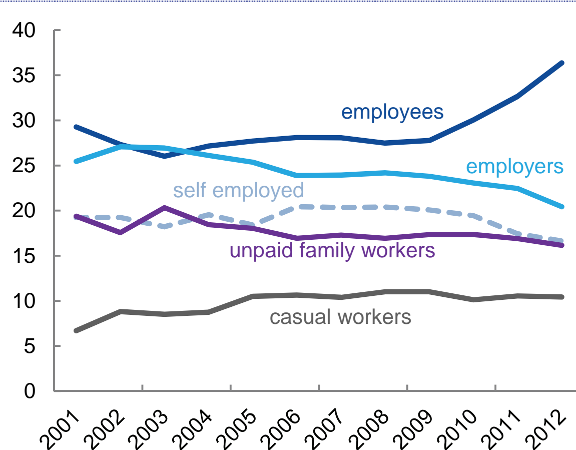
The sectorial breakdown also shows other important differences: wages in mining have been growing twice as fast as the national average, reflecting the boost to incomes in the sector from global commodity prices and demands over this period. However, the job expansion potential of this sector remains limited. In contrast, total wages in a potentially skill-intensive sector such as manufacturing have grown less than the national average, reflecting poor productivity growth. Finally, the variation in real wages within services, ranging from finance down to trade and retail, is marked, again reflecting differences in skill intensities.

Figure 32: Important wage differences exist between sectors, and within sectors between types of employment
(real average monthly income from work by sector, thousand IDR, ref. year 2007)



Note: Earnings refers to income from work for the self-employed and casual workers, both formal and informal
Source: World Bank staff calculations using Sakernas

Figure 33: Dependent employment is on the rise, but most workers are still employed in vulnerable forms of work
(employment composition by status, percent)



Source: World Bank staff calculations using Sakernas

b. "Good jobs" rising, but many workers remain informal and vulnerable

Although "good jobs" are increasing, more than 50 percent of total employment is still informal and vulnerability remains high for many workers

The presence of a large informal sector still employing more than 50 percent of total workers (70 percent in rural areas) remains one of the most serious challenges for the Indonesian labor market. Although the share of "good jobs" in total employment (defined here simply as the share of formal dependent employees) rose from 27.7 percent to 36.4 percent between August 2001 and August 2012 (Figure 33), a large share of the employed pool is still highly vulnerable, including nearly 18 million unpaid family workers and some 11.5 million casual workers (16 percent and 10 percent of total employment, respectively). In addition, a decrease in the number of casual workers in agriculture has been offset by the rise of casual workers in non-agriculture sectors, and although the number of employers with permanent workers is increasing, those with temporary workers still represent 82 percent of total employers. Finally, workers on own account (or self-employed in a strict sense), which are more likely to be vulnerable and low-productivity, although declining in number, still add up to some 18.5 million (17 percent of total employment). Vulnerable forms of work offer less protection against risk and shocks, do not enable access to social benefits, and provide lower income. For example, as of August 2012, casual workers and self-employed average earnings amount to 48 percent and 65 percent of employees' average wage, respectively, compared to 45 percent and 75 percent as of 2001, which could explain part of the overall rise in inequality seen in Indonesia over this period.

There is a high variation in the share of vulnerable workers across sectors and geographic areas

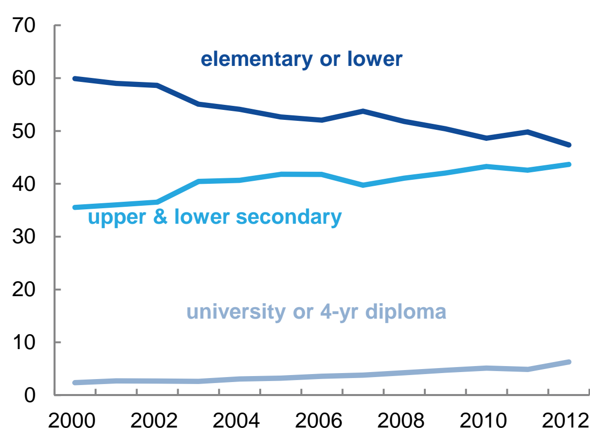
The incidence of vulnerable forms of employment shows a high variation across sectors and provinces, also because of persistent non-compliance with Minimum Wages policies (see the December 2012 *IEQ*). Data constraints limit the possibility of assessing the impact on employment of the spike in Minimum Wages levels across provinces in 2013, (in Jakarta, the increase was over 40 percent). However, the Sakernas data show that as of 2012, the largest employment sectors (Wholesale and retail trade, and Community, Social and Personal Services) exhibit high shares of workers paid below minimum wages: 50 percent and 45 percent respectively, which rise dramatically for informal workers (80 percent and 86 percent, respectively). These figures are even higher in agriculture, where nearly 80 percent of all workers are paid below the Minimum Wage. At the provincial level, non-compliance is above 60 percent in West Nusa Tenggara and West Sulawesi (over 75 percent for informal workers), and close to or above 50 percent in other 12 provinces (including Jakarta and Yogyakarta, and particularly high in Lampung, Aceh, South Sulawesi and South Kalimantan).

c. Coping with a largely unskilled labor force

Indonesia's workforce remains largely unskilled, with only 6.3 percent with tertiary education…

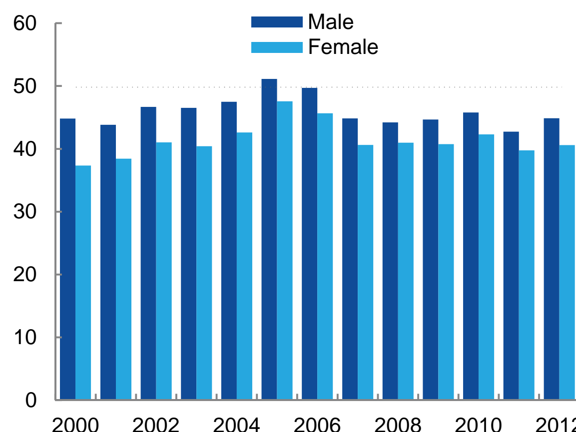
Nearly 50 percent of Indonesia's workforce still possesses at most elementary education, while only 6.3 percent has a university, or 4-year diploma, degree (Figure 34). This is despite the substantial progress Indonesia made in increasing enrolment rates in secondary and tertiary education for the youngest generations, and the rise in the share of the labor force with upper or lower secondary education from 35 percent up to 44 percent between 2001 and 2012. A low-skilled labor force represents a serious challenge for improving productivity and for meeting employers' demands in a rapidly changing labor market, in particular given the low propensity of Indonesian firms towards providing training. As a result of this mismatch problem, a dramatic share, over 40 percent, of youth aged 15-24, remains out of education, training or work as of 2012 (Figure 35), without showing improving trends since 2001, which can seriously undermine their possibility to find good jobs in the future.

Figure 34: Although the labor force has become more skilled, less than 8 percent has a university degree
(labor force composition by highest educational attainment, percent)



Source: World Bank staff calculations using Sakernas

Figure 35: Over 40 percent of Indonesia's youth aged 15-24 are not in employment, education or training
(youth aged 15-24 not in employment, education or training, percent)



Source: World Bank staff calculations using Sakernas

…representing one of a number of labor market challenges facing policymakers

In summary, the Indonesian labor market, sustained by strong job creation, is transforming towards greater formalization of its workforce. However, a number of important challenges remain: most of the jobs created over the last decade are in low-productivity sectors; over 50 percent of existing jobs are still informal, offering no protection to workers; the labor force is still largely unskilled, and finally women and young people still exhibit low labor force participation rates. These challenges need to be addressed by policymakers and all stakeholders, before the demographic bonus of an expanding labor force expires. In addition, greater regional integration following the onset of the ASEAN Economic Community in 2015 will lead to more competitive pressure on the domestic labor market.

2. Local capacity and development in Indonesia

New study evidence sheds light on the changes of rural community capacity and the role of village government to address local problems in a decentralized, democratic Indonesia

Democratization and decentralization in Indonesia during the post-1998 *Reformasi* period have brought with them changes in the relationship between the State and society. In rural communities villagers are now free to exercise their electoral rights to choose the village head without first having to secure approval from the district level. Village heads now have better access to resources in the district. There has also been an increased emphasis on community-driven development (CDD) throughout the country, giving more voice and decision-making authority to communities in choosing and implementing development projects that best suit local needs. This section aims to shed light on whether and how community capacity is affected over time, by these shifts of national policies on democratization, decentralization and CDD and their complex interactions at the local level, drawing on the newly-released results of the third round of the World Bank Local Level Institutions Study (LLI3), conducted in 2012.[8]

a. A brief history of community-driven development in Indonesia

Indonesia's flagship community-driven development program, PNPM, was grounded in community capacity …

The year 2013 marks fifteen years of implementation of the Indonesia National Community Empowerment Program (*Program Nasional Pemberdayaan Masyarakat*, PNPM), the largest CDD program in the world. Since its initiation in 1998 as the Kecamatan Development Program (KDP), PNPM has operated based on the tenet that the local community has the capacity to identify, prioritize, select and implement development projects that best meet their needs in improving their well-being.[9] This principle was informed by the first Local Level Institutions Study (LLI1), carried out in 1996 by the World Bank.

…following a study which found that while communities still had capacity for collective action to solve their common problems, this was undermined by top-down government development policies and projects that did not take into account local needs

Reflecting the growing focus of the global development community on local institutions and social capital at that time, the LLI1 was conducted with the objective of understanding the role of local level institutions and social capital in the delivery of basic services and welfare improvement. The study – carried out in 48 villages in 3 provinces (Central Java, Jambi, Nusa Tenggara Timur) – found that, despite the fact that Indonesia at that time was still under a highly centralized, authoritarian regime, local capacity – defined as the ability to solve common problems collectively – remained strong in most of the study villages. This capacity, however, was constantly undermined by local governments, which delivered top-down development projects that did not take into account specific needs at the local level.[10] These findings paved the way for the design and implementation of the KDP, which provided local communities with alternative open spaces for deliberating their development needs and resources to carry out chosen projects. Barely a year after KDP started, Indonesia underwent massive political changes with the demise of the Suharto regime in 1998 and the beginning of decentralization era in 2001

Democratization and decentralization began opening the space to improve relationships between communities and their village governments, and to strengthen local capacity…

The dawn of democracy and decentralization raised the question of what impacts these changes would have on local capacity and the relationship between the State and society. In particular, would the opening up of political space bring better opportunities for the local community to be involved in decision-making over development projects and thus improve the match between projects and local needs? To answer these questions, the follow-up LLI2 study was commissioned in 2000-2001 to focus in particularly on the changes in local state-society relationships and how these changes influenced welfare and local governance.

The study found that local capacity still existed in most study areas and that there were

[8] This note draws on Wetterberg, A., Dharmawan, L., & Jellema, J.R. (2013, forthcoming) The Local Level Institutions III: Overview Report. World Bank/PNPM Support Facility. Jakarta. For more information about PNPM Support Facility, please visit http://pnpm-support.org/.
[9] In 2007, the Government of Indonesia scaled up KDP and its urban sister the Urban Poverty Project, UPP, and launched the programs under one umbrella program called PNPM.
[10] Chandrakirana, K. (1999). Local capacity and its implications for development: The case of Indonesia. *World Bank/Bappenas. Local Level Institutions Study*, Jakarta; Evers, P. (2003). Village governments and their communities. *World Bank/Bappenas. Local Level Institutions Study*, Jakarta..

indications of increased opportunities for local community participation in decision-making over development projects, although most projects still did not deliver satisfactory outcomes. For example, incidents of protests against village heads increased, but without typically precipitating any real or lasting changes. New elected village councils (BPD, *Badan Perwakilan Desa*), which were tasked to hold village government accountable, began to operate in some areas, although confusion over their functions and limitations in terms of operational support somewhat limited their ability to perform.[11] This perceived lack of change, however, was not entirely unexpected considering that the study was conducted only a few years after the economic and political turmoil of 1997/1998, and around the time of the 2001 decentralization reforms.

…but have the changes been sustained after more than a decade?

More than a decade after the political shift in 1998, decentralization in 2001, and the implementation of KDP/PNPM in over 60,000 villages, these changes were expected to affect local capacity. To better understand these changes, a third round of the LLI Study was conducted in 2012, with the objective of tracing developments in local capacity since LLI2, over a decade before, and to determine whether there had been shifts in the influence of different community groups over government decision-making, project implementation, and state resources at the district and village levels, and whether these shifts have any link with changes in local capacity.

b. Understanding changes in local capacity since 2001

The LLI studies collect data on the type and number of common problems, if they were addressed and, if so, whether successfully

In the LLI studies, local capacity is defined as the ability to solve common problems collectively. To measure this, the studies collect and trace data on the type and number of common problems existing in study villages and investigate whether those problems were addressed collectively and, if so, whether successfully. Villages are then grouped into three categories of capacity (high, medium, low) based on the frequency of collective actions and degree of success in addressing problems. Box 4 provides an overview of the survey methodology.

Communities report fewer social problems in 2012 than in 2001, but more economic and service delivery problems

In order to trace changes in capacity since LLI2, the LLI3 study first tabulated the numbers and type of problems found in study villages and then looked at how many problems have been successfully solved collectively. The study finds that communities experienced fewer common problems compared to LLI2 and that the nature of the problems has shifted. In particular, communities reported more economic and service delivery-related problems, while social problems (such as gambling and drinking) were barely mentioned. There is also an apparent increase in "overwhelming" problems that are difficult to solve at the local level such as natural disasters and high prices of inputs for agricultural production.

Overall, the likelihood of a community successfully resolving a problem was unchanged but there was substantial variation in the changes in capacity across villages

The number of collective actions to solve common problems declined in all study areas. This could partly be explained by the increasing number of "overwhelming" problems that are beyond a community's capacity to address. The degree of success in solving common problems, the study finds, remains largely the same as in LLI2. These general patterns, however, mask the substantial variation in changes of capacity across surveyed villages. Of the twenty villages revisited in LLI3, almost half (nine) retain similar capacity. In particular, more than half of the high capacity villages, as classified by LLI2, have built on their earlier successes in addressing more recent problems, showing persistence. This suggests that high capacity villages are resilient, even in the face of the political shifts faced during the past decade.

Villagers' own efforts supported by reformist village leaders have helped to improve capacity

A quarter of surveyed villages (five) had increased their capacity. It is particularly encouraging that all but one of the villages with improved capacity were low capacity villages in LLI2. Low capacity villages, by definition, have a history of not mobilizing collectively, and their increased capacity appears to have been driven mostly by villagers' own efforts, such as finding better income resources, regaining control over natural resources, and

[11] Dharmawan, L. (2002).Dynamics of Local Capacity and Village Governance: Findings from the Second Indonesian Local Level Institutions Study *Central Java Report*..

engaging various mechanisms to hold village leaders accountable . Other factors that also reinforce the community's efforts in these villages are reformist village leaders who listen to and work for villagers' interests and, to a lesser extent, external agents such as non-governmental organizations (NGOs), especially related to land and forest use disputes.

Persistent problems with issues related to deteriorating natural resources, such as access to drinking water or land disputes, exacerbated by non-reformist leaders destroy local capacity

About a third of villages (six) experienced a decline in capacity. These villages suffer from persistent problems with issues relating to deteriorating natural resources, such as access to drinking water and land disputes. There are also signs of reduced reciprocity (*gotong-royong*) in these villages, signaling a decrease in social capital. Three of the villages that experienced declines in capacity were villages that experienced a status change from village (*desa*) to urban ward (*kelurahan*). This means that these villages no longer have elected village heads who are accountable to the villagers.[12] In addition, most village heads in the remaining three villages are weak (unable to implement decisions), and having unresponsive leaders who do not work in villagers' interests is one of the main factors causing decline in village capacity.

Box 4: Local Level Institutions Studies methodology

Table 11: Comparison of Key Research Aspects in LLI1, LLI2, and LLI3

	LLI1 (1996)	LLI2 (2000/2001)	LLI3 (2012)
Key issues	• Local capacity • Social capital • Village governance	• Local capacity • Social capital • Village governance • Crisis response	• Local capacity • Social capital • Village governance • District governance • PNPM
Research methods	• Qualitative data collection • HH survey	• Qualitative data collection • HH survey • Ethnography	• Qualitative data collection • HH survey
Districts (re-)visited	1. Batanghari 2. Merangin 3. Banyumas 4. Wonogiri 5. Ngada 6. Timor Tengah Selatan	1. Batanghari 2. Merangin 3. Banyumas 4. Wonogiri 5. Ngada	1. Batanghari 2. Merangin 3. Muara Jambi 4. Banyumas 5. Wonogiri 6. Ngada 7. Nagakeo
Number of villages	48	40	20 (qualitative) 40 (quantitative)

The Indonesian Local Level Institutions (LLI) studies are longitudinal, using both qualitative and quantitative methods, aiming to identify the preconditions for and constraints on local capacity—defined as the ability to solve common problems collectively—and the extent to which state structures complemented or impeded villagers' problem-solving efforts. The LLI was first conducted in 1996 in 48 villages in three provinces (Central Java, Jambi, and NTT). The locations were chosen to ensure geographic and socio-economic variation. The Batanghari and Merangin districts in Jambi represent Sumatra, with economies mostly based on plantations and cash crops (rubber, palm oil, coffee, etc.), relatively good transport infrastructure and a mid-range population density. The Banyumas and Wonogiri districts in Central Java represent the island of Java, the most densely populated area of Indonesia. Ngada and Timor Tengah Selatan (TTS) districts in NTT represent Eastern Indonesia, which is more arid, less densely populated, and has lower than average incomes. Village research sites were chosen to capture upland and lowland communities with varying access to the sub-district capital. In LLI2, only 40 villages were revisited because TTS was at that time inaccessible for security reasons. In the latest, third, round of LLI, 20 villages were revisited for qualitative data collection while quantitative data collection was conducted in all 40 villages from LLI2. Table 11 shows the comparison of key research aspects of the three rounds of LLI.

For the qualitative component of the studies, researchers conducted interviews with relevant key informants at district and village levels, such as the district head (or secretary), officials from district offices (planning, rural/community development), district parliament (DPRD, *Dewan Perwakilan Rakyat Daerah*) members, NGOs/CSOs, village heads, representatives from community empowerment bodies (BPM, *Badan Pemberdayaan Masyarakat*/LPM, *Lembaga Pemberdayaan Masyarakat*) and religious/*adat*/community figures. The interviews helped collect data on, among others, problem solving; leadership, network and institutional profiles; as well as projects profiles (including PNPM). The studies also conducted a series of focus group discussions (FGDs) with community members. Topics of the FGDs included (1) land use, power relations, and natural resources threats, (2) production, consumption, threats to survival and getting ahead, (3) Government role and relations, and (4) problem-solving.

For the quantitative component, the studies conducted a panel household survey, including modules on household characteristics and consumption, household involvement/membership in organizations (formal and informal) and the benefits, common problems that households faced in their areas, patterns of ownership of land and other resources, social interaction and trust, recent crises and crisis resolution mechanism, village government (satisfaction, transparency and accountability).

Note: see Wetterberg et al 2013 (forthcoming) for more information

[12] *Kelurahan* is lead by a *lurah* who is appointed by district head and thus responsible only to the district, not to the villagers.

c. Democratization, decentralization, CDD and local capacity…

Democratization has enabled villagers to choose reformist, pro-community village heads that support local capacity…

With democratization, village heads are democratically elected by villagers. During the Suharto era candidates had to obtain the approval of the district government to be able to run and be inaugurated. Elections now take place periodically and candidates are not imposed by supra-village governments. Further, term limits, involving a maximum of two 6-year terms, for village heads have been enforced post-2001. The democratization also helps reduce space for dynastic leadership, which was common in the past, and has broadened candidate slates.

…and provided new prominence for village heads, enabling them to play a bigger role in problem solving

Free elections have made village heads more responsive to villagers' interests and seen them play a stronger role in solving identified collective problems. Strong village heads can be more effective in dealing with external actors (e.g., investors) and supra-village governments to solve community problems. For example, one village head in the study area participated in a network of thirty village heads to have the repair of the provincial road passing their villages approved just before the re-election of the incumbent governor, demonstrating a strong organizational ability to obtain benefits from the district level. Another village head mobilized his network, including working with regional and national NGOs, to reclaim villagers' land from concessions issued by the central government (although, unfortunately, villagers also suspected that he disproportionately benefited from this effort).

Decentralization has increased village heads' access to district-level resources…

The strength of the village head position is increased further by the fact that decentralization gives village heads direct access to district heads (*bupati*) and the district sectoral offices which manage large funds from the central government. Previously, this contact was intermediated through the sub-district. However, in order to obtain funds (and projects) from the district, village heads have to be pro-active and have good networks, visiting sectoral offices and the Parliament and actively seeking support for projects. Village heads with limited networks have to rely on the formal process of annual development planning (*Musrenbang*, *Musyawarah Perencanaan Pembangunan*) to obtain projects, a process which some village heads see as an unproductive formality. This benefits village heads who can exploit the additional direct, and sometimes informal, access provided by decentralization.

…but without control mechanisms, villagers are unable to pressure village heads to work for the community's interests

Strengthening village heads does not, however, translate directly to strengthening the village community, especially when control mechanisms are lacking to pressure village heads to work for the community's interests. These can be seen in villages with strong village heads but low in capacity. Communities in these villages have not been able to capitalize on changes in the political environment and demand that village heads work for the community's interests. These villages mainly rely on elections to oust unresponsive leaders at the end of their terms. Higher capacity villages, however, are able to make village heads use their stronger position to solve community problems and to hold village heads accountable through mechanisms such as customary laws and traditions (*adat*) or the BPD that has retained its original role as found in LLI2.

The weakening of the village council position vis-à-vis village heads has undermined local capacity…

The BPD was first mandated in Law 22 of 1999 on Regional Government, as a village representative council with elected members to provide checks and balances in village government. The village head was thus accountable to the BPD and the district head (who provided funds for village government). However, this mechanism was later changed by Law 32 of 2004, and so was the name, although the abbreviation remained the same. The BPD is now *Badan Permusyawaratan Desa*, or village consultation council and the members are appointed by consensus and essentially have no power over the village head. These changes also reduce villagers' ability to monitor the village head and to ensure that village government is working for the broader collective interest, rather than for exclusive individual or elite benefits.

The BPD as conceived in 1999 proved to be an effective accountability mechanism in the subset of villages where the council had time to operate before it was weakened by the 2004 legislation. A small number of villages in Central Java for example, have retained the BPD's

original role while a few villages in Jambi maintained their *adat* control mechanisms. In these communities, the BPD and *adat* institutions have enhanced local capacity by channeling villagers' needs to officials and ensuring that village government is working to address identified community priorities.

…with district government not providing control and supervision over village heads, potentially leading to power abuse and corruption

Despite the lack of checks and balances mechanisms in villages caused by the weakening of the BPD, there has been no offsetting increase in the control or supervision of village heads by districts to hold village heads accountable. Districts provide little supervision and monitoring of whether village heads are performing their duties or whether funds are used effectively. Under these circumstances, the stronger position of village heads could potentially lead to power abuse and corruption. In one of the villages in the LLI3 study, for example, the village head built a new, expensive village hall, the idea of which was conceived in his first term but was blocked by the BPD in 2001. To finance the hall he used the village development budget, reportedly coerced villagers into giving financial contributions, and reportedly even denied poor households their subsidized rice to help pay for construction.

CDD projects work better in higher capacity villages rather than improving governance in lower capacity villages

The LLI3 study also sheds light on the influence of CDD programs on local capacity. Participatory projects could potentially be one means to improve local capacity by providing space for collective decision-making to solve local problems and by increasing accountability. However, while LLI3 villagers report higher satisfaction, more transparency, and better maintenance for PNPM relative to other non-CDD projects, levels of participation in village development planning have not increased overall. In particular, in villages with lower capacity, CDD projects have not facilitated improvement in participatory decision-making and governance. High-capacity villages, on the other hand, are better able to take advantage of the open planning and decision-making in these projects to solve some of their collective problems.

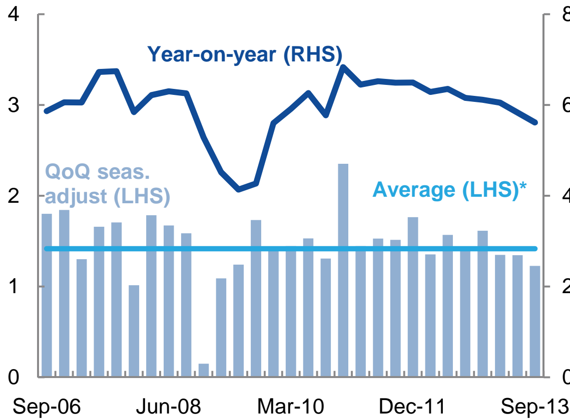
d. …and the importance of enhanced checks and balances at the village level

Stronger checks and balances mechanisms at the village level and a better strategy in CDD projects is needed to help support local capacity

Overall, the LLI3 study suggests that local capacity in the sampled villages in Indonesia has been largely maintained, with high capacity villages being able to capitalize on the opportunities brought forth by changes in national policies. Some low capacity villages have been able to improve their capacity organically by addressing resource constraints and using existing control mechanisms to hold village government accountable. These villages have also benefited from democratization, which allows villagers to elect reformist, pro-community village heads that work for villagers' interests, and from decentralization, which gives reformist village heads direct access to the district to obtain the support needed to solve identified problems. However, some villages have experienced capacity declines, being unable to address persistent problems related to deteriorating natural resources and to hold village government accountable. In a number of cases, this decline in local capacity can be ascribed to losing the ability to elect a village head because of a change of status from village to ward. These findings strongly point to the need to strengthen checks and balances mechanisms at the village level to help villagers hold village government accountable. Thus, while CDD projects have assisted high and medium capacity villages in solving some of their collective problems, more needs to be done to allow lower capacity villages to benefit from the process as well.

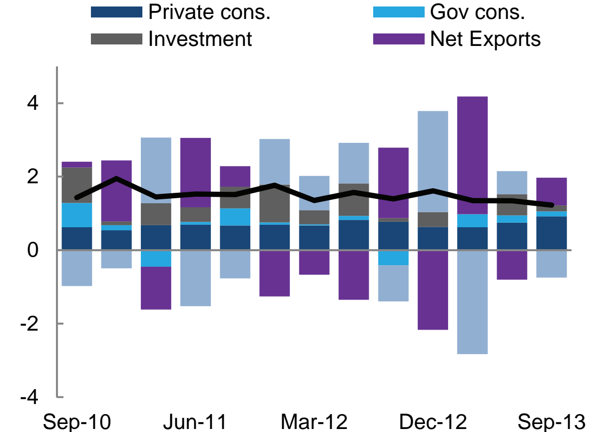
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Quarterly and annual GDP growth
(real GDP growth, percent)



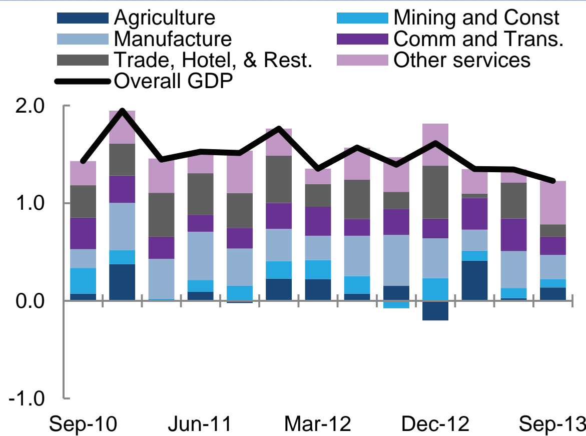
Note: *Average QoQ growth between Q3 2003 – Q3 2013
Source: BPS; World Bank seasonal adjustment

Appendix Figure 2: GDP expenditure contributions
(contribution to QoQ seasonally-adjusted real GDP growth, percent)



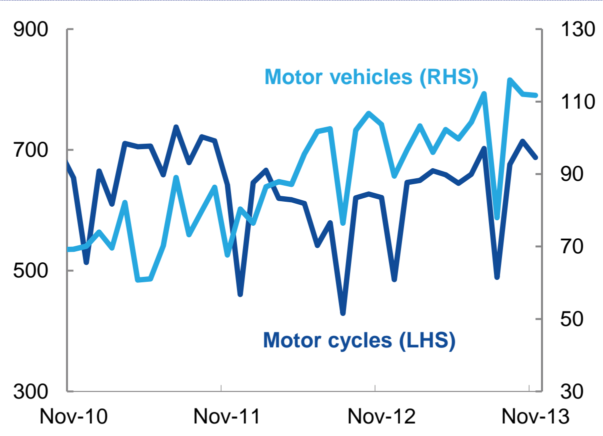
Source: BPS; World Bank staff calculations

Appendix Figure 3: Contributions to GDP production
(contribution to QoQ seasonally-adjusted real GDP growth, percent)



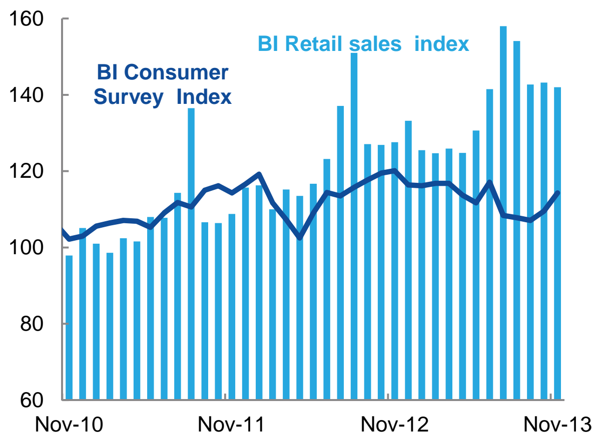
Source: BPS; World Bank staff calculations

Appendix Figure 4: Motor cycle and vehicle sales
(monthly sales, 000 unit)



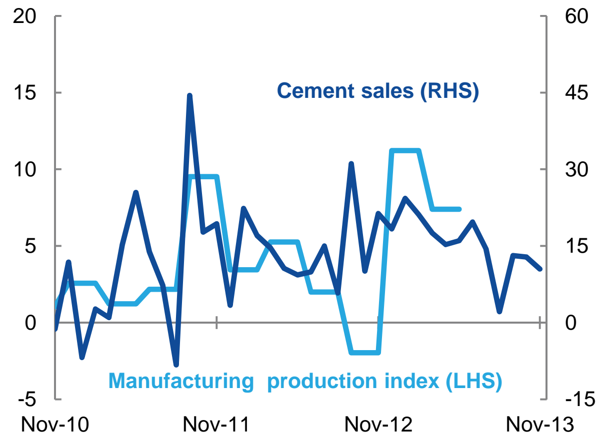
Source: CEIC

Appendix Figure 5: Consumer indicators
(index)



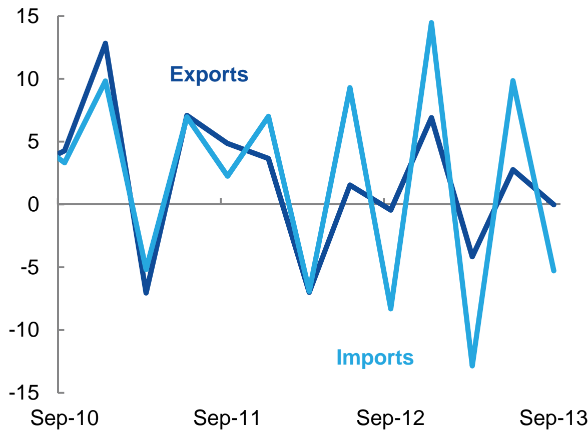
Source: BI

Appendix Figure 6: Industrial production indicators
(3 month average, year-on-year growth, percent)



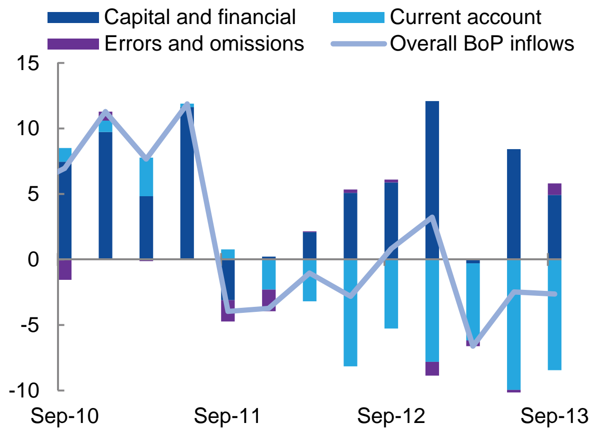
Source: CEIC

Appendix Figure 7: Real trade flows
(quarter-on-quarter real growth, percent)



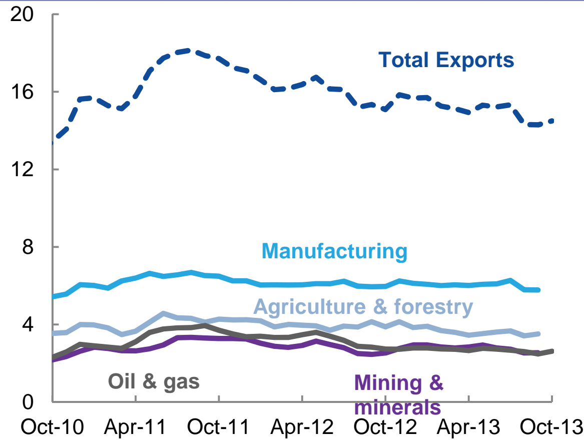
Source: BPS

Appendix Figure 8: Balance of payments
(USD billion)



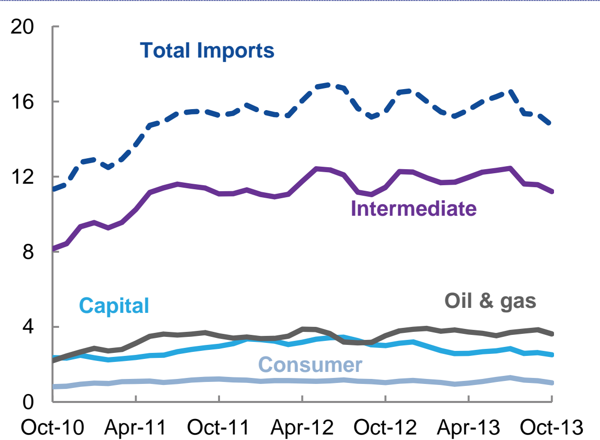
Source: BI

Appendix Figure 9: Exports of goods
(USD billion)



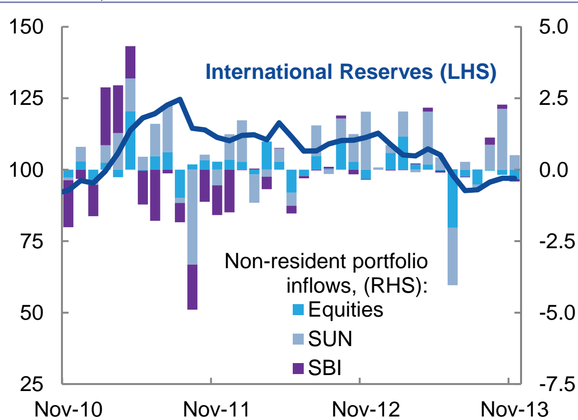
Source: BPS

Appendix Figure 10: Imports of goods
(USD billion)



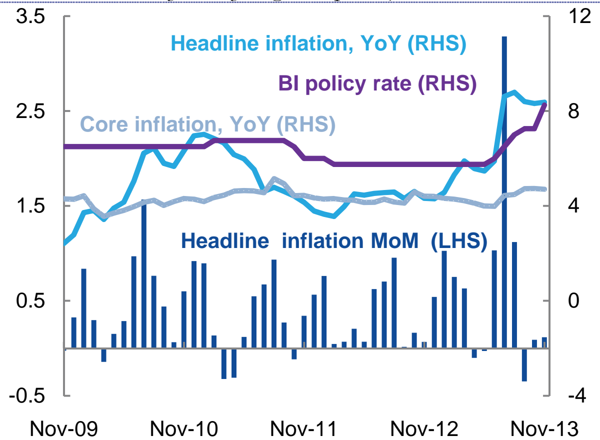
Source: BPS

Appendix Figure 11: Reserve and capital inflows
(USD billion)



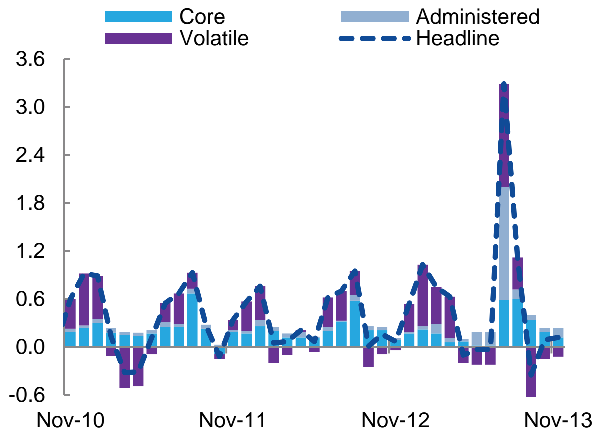
Source: BI; CEIC; World Bank staff calculations

Appendix Figure 12: Inflation and monetary policy
(month-on-month and year-on-year growth, percent)



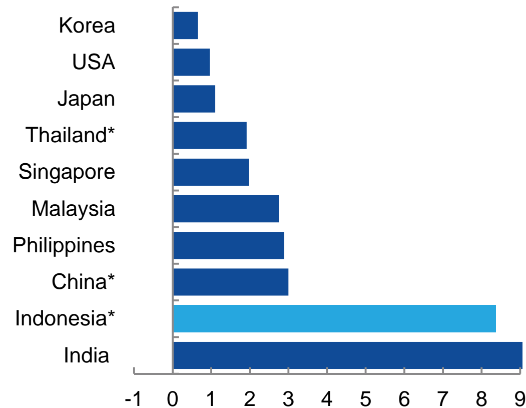
Source: BPS; World Bank staff calculations

Appendix Figure 13: Monthly breakdown of CPI
(percentage point contributions to monthly growth)



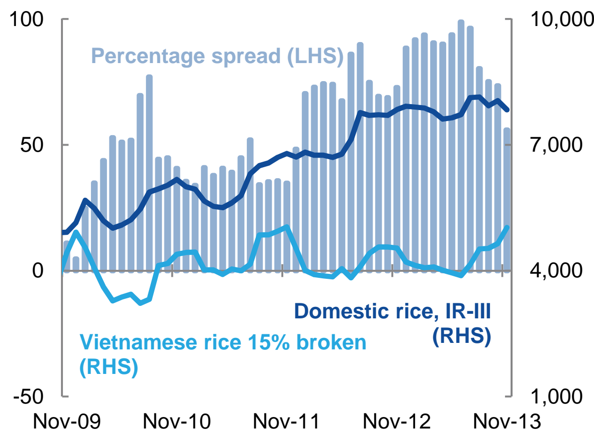
Source: BPS; World Bank staff calculations

Appendix Figure 14: Inflation across countries
(year-on-year, October 2013)



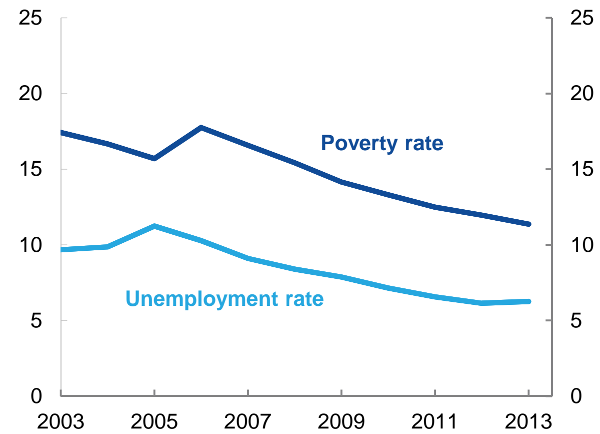
*November inflation figure otherwise October
Source: National statistical agencies via CEIC; BPS

Appendix Figure 15: Domestic and international rice prices
(percent LHS, wholesale price, in IDR per kg RHS)



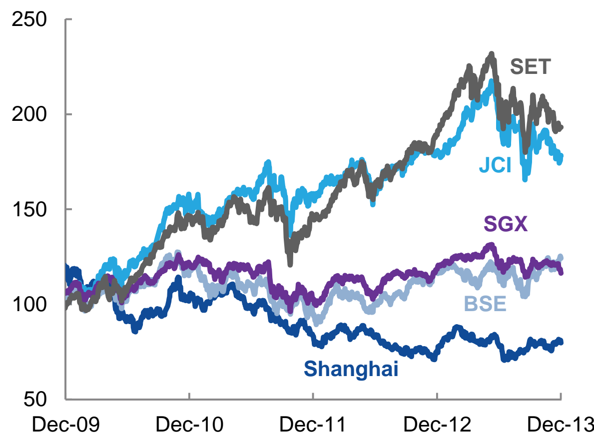
Source: PIBC; FAO; World Bank

Appendix Figure 16: Poverty and unemployment rate
(August unemployment data, percent)



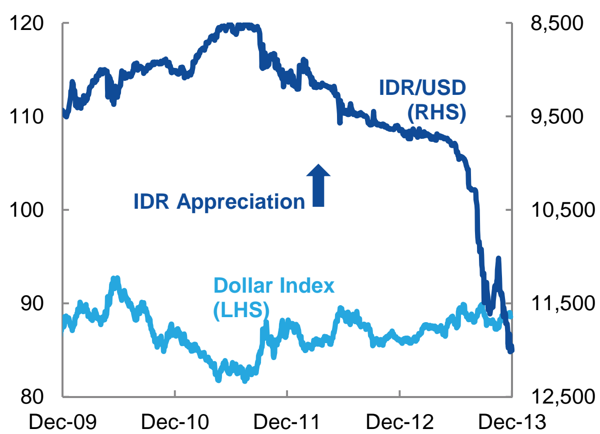
Source: BPS

Appendix Figure 17: Regional equity indices
(daily index September 2009=100)



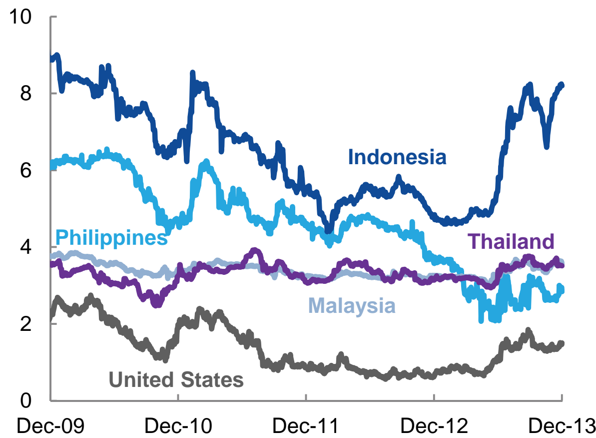
Source: CEIC; World Bank staff calculations

Appendix Figure 18: Dollar index and Rupiah exchange rate
(daily index, LHS and IDR/USD, RHS)



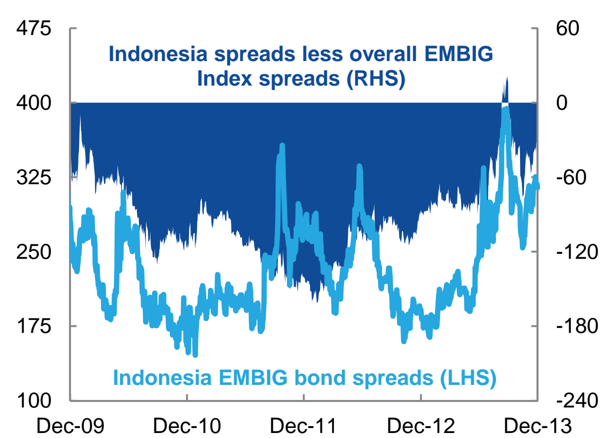
Source: CEIC; World Bank staff calculations

Appendix Figure 19: 5-year domestic govt. bond yields
(daily, percent)



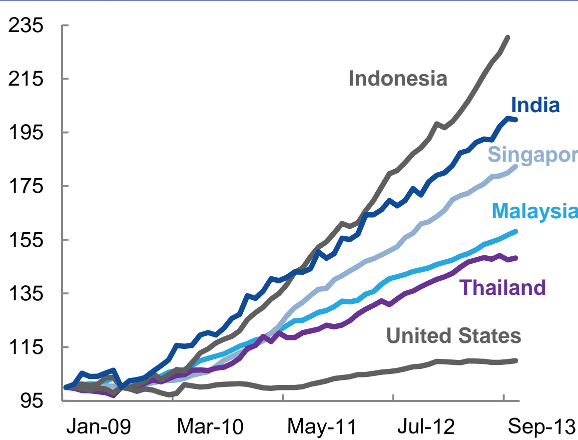
Source: CEIC; World Bank staff calculations

Appendix Figure 20: Sovereign USD Bond spreads
(daily, basis points)



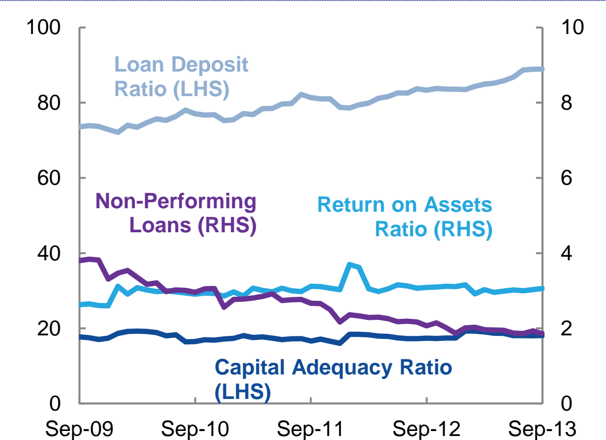
Source: JP Morgan; World Bank staff calculations

Appendix Figure 21: International commercial bank lending
(monthly, index January 2009=100)



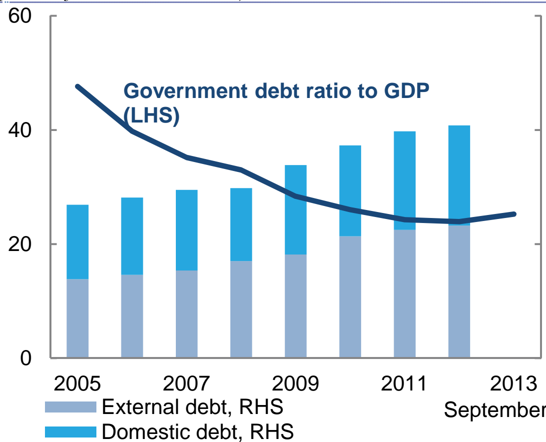
Source: CEIC; World Bank staff calculations

Appendix Figure 22: Banking sector indicators
(monthly, percent)



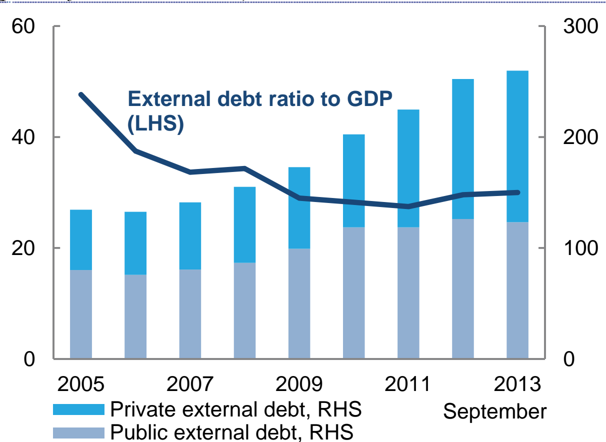
Source: BI

Appendix Figure 23: Government debt
(percent of GDP; USD billion)



Source: MoF; BI; World Bank staff calculations

Appendix Figure 24: External debt
(percent of GDP; USD billion)



Source: BI; World Bank staff calculations

Appendix Table 1: Budget outcomes and projections
(IDR trillion)

	2009 Outcome	2010 Outcome	2011 Outcome	2012 Outcome	2013 Revised budget	2014 Budget
A. State revenue and grants	**849**	**995**	**1,211**	**1,338**	**1,502**	**1,667**
1. Tax revenue	620	723	874	981	1,148	1,280
2. Non-tax revenue	227	269	331	352	349	385
B. Expenditure	**937**	**1,042**	**1,295**	**1,491**	**1,726**	**1,842**
1. Central government	629	697	884	1,011	1,197	1,250
2. Transfers to the regions	309	345	411	481	529	593
C. Primary balance	**5**	**42**	**9**	**-53**	**-112**	**-54**
D. SURPLUS / DEFICIT	-89	-47	-84	-153	-224	-175
(percent of GDP)	-1.6	-0.7	-1.1	-1.9	-2.4	-1.7

Source: MoF

Appendix Table 2: Balance of Payments
(USD billion)

	2010	2011	2012	2011	2012				2013		
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Balance of Payments	**30.3**	**11.9**	**0.2**	**-3.7**	**-1.0**	**-2.8**	**0.8**	**3.2**	**-6.6**	**-2.5**	**-2.6**
Percent of GDP	4.3	1.4	0.0	-1.7	-0.5	-1.3	0.4	1.5	-3.0	-1.1	-1.2
Current Account	**5.1**	**1.7**	**-24.4**	**-2.3**	**-3.2**	**-8.1**	**-5.3**	**-7.8**	**-5.9**	**-10.0**	**-8.4**
Percent of GDP	0.7	0.2	-2.8	-1.1	-1.5	-3.7	-2.4	-3.6	-2.7	-4.4	-3.9
Trade Balance	21.3	24.2	-1.7	3.5	1.8	-2.0	0.8	-2.4	-0.8	-3.8	-2.6
Net Income & Current Transfers	-16.2	-22.5	-22.7	-5.8	-5.0	-6.2	-6.1	-5.4	-5.0	-6.1	-5.8
Capital & Financial Accounts	**26.6**	**13.6**	**25.2**	**0.2**	**2.1**	**5.1**	**5.9**	**12.1**	**-0.3**	**8.4**	**4.9**
Percent of GDP	3.8	1.6	2.9	0.1	1.0	2.3	2.6	5.5	-0.1	3.7	2.3
Direct Investment	11.1	11.5	14.0	3.1	1.6	3.7	4.5	4.1	3.9	3.8	5.1
Portfolio Investment	13.2	3.8	9.2	0.2	2.6	3.9	2.5	0.2	2.8	3.4	1.9
Other Investment	2.3	-1.8	1.9	-3.2	-2.1	-2.5	-1.2	7.7	-6.9	1.2	-2.1
Errors & Omissions	**-1.5**	**-3.4**	**-0.5**	**-1.6**	**0.1**	**0.2**	**0.2**	**-1.1**	**-0.4**	**-1.0**	**0.9**
Foreign Reserves*	**96.2**	**110.1**	**112.8**	**110.1**	**110.5**	**106.5**	**110.2**	**112.8**	**104.8**	**98.1**	**95.7**

Note: * Reserves at end-period
Source: BI; BPS

Appendix Table 3: Indonesia's historical macro-economic indicators at a glance

	1990	1995	2000	2005	2010	2011	2012
National Accounts (% change)[1]							
Real GDP	9.0	8.4	4.9	5.7	6.2	6.5	6.2
Real investment	25.3	22.6	11.4	10.9	8.5	8.8	9.8
Real consumption	23.2	21.7	4.6	4.3	4.1	4.5	4.8
Private	23.9	22.7	3.7	0.9	4.7	4.7	5.3
Government	18.8	14.7	14.2	6.6	0.3	3.2	1.2
Real exports, GNFS	22.5	18.0	30.6	16.6	15.3	13.6	2.0
Real imports, GNFS	30.2	29.6	26.6	17.8	17.3	13.3	6.6
Investment (% GDP)	28	28	20	24	32	32	33
Nominal GDP (USD billion)	114	202	165	286	709	846	878
GDP per capita (USD)	636	1035	804	1,300	2,984	3,498	3,563
Central Government budget (% GDP)[2]							
Revenue and grant	18.8	15.2	20.8	17.8	15.5	16.3	16.2
Non-tax revenue	1.0	4.8	9.0	5.3	4.2	4.5	4.3
Tax revenue	17.8	10.3	11.7	12.5	11.3	11.8	11.9
Expenditure	11.8	13.9	22.4	18.4	16.2	17.4	18.1
Consumption	..	3.9	4.0	3.0	3.8	4.0	4.1
Capital	..	4.6	2.6	1.2	1.3	1.6	1.8
Interest	..	1.4	5.1	2.3	1.4	1.3	1.2
Subsidies	..	..	6.3	4.3	3.0	4.0	4.2
Budget balance	0.4	1.3	-1.6	-0.6	-0.7	-1.1	-1.9
Government debt	41.9	32.3	97.9	47.6	26.0	24.3	23.9
o/w external government debt	41.9	32.3	51.4	22.3	9.5	8.3	7.4
Total external debt (including private sector)	61.0	61.5	87.1	47.7	28.2	27.5	29.6
Balance of Payments (% GDP)[3]							
Overall balance of payments	..	..	..	0.2	4.3	1.4	0.0
Current account balance	-2.6	3.2	4.8	0.1	0.7	0.2	-2.8
Exports GNFS	25.6	26.2	42.8	35.0	24.7	26.2	24.1
Imports GNFS	24.0	26.9	33.9	32.0	21.6	23.3	24.3
Trade balance	1.6	-0.8	8.9	2.9	3.0	2.9	-0.2
Financial account balance	..	..	..	0.0	3.7	1.6	2.9
Net direct investment	1.0	2.2	-2.8	1.8	1.6	1.4	1.6
Gross official reserves (USD billion)	8.7	14.9	29.4	34.7	96.2	110.1	112.8
Monetary (% change)[3]							
GDP deflator[1]	7.7	9.9	20.4	14.3	8.3	8.1	4.5
Bank Indonesia interest key rate (%)	..	..	..	9.1	6.5	6.6	5.8
Domestic credit	..	..	..	28.7	17.5	24.4	24.2
Nominal exchange rate (average, IDR/USD)[4]	1,843	2,249	8,422	9,705	9,090	8,770	9,387
Prices (% change)[1]							
Consumer price Index (eop)	9.9	9.0	9.4	17.1	7.0	3.8	4.3
Consumer price Index (average)	7.7	9.4	3.7	10.5	5.1	5.4	4.3
Poverty basket inflation (average)	..	..	..	10.8	8.7	8.2	6.5
Indonesia crude oil price (USD per barrel)[5]	..	17	28	53	79	112	113

Source: 1 BPS and World Bank staff calculation; 2 MoF and World Bank staff calculation (for 1995 is FY 1995/1996, for 2000 covers 9 months); 3 Bank Indonesia; 4 IMF; 5 CEIC

Appendix Table 4: Indonesia's development indicators at a glance

	1990	1995	2000	2005	2010	2011	2012
Demographics[1]							
Population (million)	184	199	213	227	241	244	247
Population growth rate (%)	1.7	1.5	1.3	1.2	1.3	1.3	1.2
Urban population (% of total)	31	36	42	46	50	51	51
Dependency ratio (% of working-age population)	67	61	55	54	53	53	52
Labor Force[2]							
Labor force, total (million)	75	84	98	106	117	117	118
Male	46	54	60	68	72	72	73
Female	29	31	38	38	45	45	45
Agriculture share of employment (%)	55	43	45	44	38	36	35
Industry share of employment (%)	14	19	17	19	19	21	22
Services share of employment (%)	31	38	37	37	42	44	43
Unemployment, total (% of labor force)	2.5	7.0	8.1	11.2	7.1	6.6	6.1
Poverty and Income Distribution[3]							
Median household consumption (IDR 000)	..	..	104	211	374	421	446
National poverty line (IDR 000)	..	..	73	129	212	234	249
Population below national poverty line (million)	..	..	38	35	31	30	29
Poverty (% of population below national poverty line)	..	..	19	16	13	12	12
Urban (% of population below urban poverty line)	..	..	14.6	11.7	9.9	9.2	8.8
Rural (% of population below rural poverty line)	..	..	22.4	20.0	16.6	15.7	15.1
Male-headed households	..	..	15.5	13.3	11.0	10.2	9.5
Female-headed households	..	..	12.6	12.8	9.5	9.7	8.8
Gini index	..	..	0.30	0.35	0.38	0.41	0.41
Percentage share of consumption: lowest 20%	..	..	9.6	8.7	7.9	7.4	7.5
Percentage share of consumption: highest 20%	..	..	38.6	41.4	43.5	46.5	46.7
Public expenditure on social security & welfare (% of GDP)[4]	..	..	..	4.4	3.9	3.9	4.2
Health and Nutrition[1]							
Physicians (per 1,000 people)	0.14	0.16	0.16	0.13	0.29	..	0.20
Child malnutrition weight for age (% of children under 5)	..	27.4	24.8	24.4	18.6	..	..
Under five mortality rate (per 1000 children under 5 year)	98	67	52	42	34	32	31.0
Neonatal mortality rate (per 1000 live births)	27	26	22	19	16	15.5	15.0
Infant mortality (per 1000 live births)	67	51	41	34	28	26.7	25.8
Maternal mortality ratio (estimate, per 100,000 live births)	600	420	340	270	220	..	..
Skilled birth attendance (% of total births)	36	..	66	..	82	..	..
Measles vaccination (% of children under 1 year)	..	63	74	..	76	..	..
Total health expenditure (% of GDP)	..	1.8	77.0	2.8	2.8	2.7	..
Public health expenditure (% of GDP)	..	0.7	89.0	89.0	1.0	0.9	..
Education[3]							
Primary net enrollment rate, (%)	..	..	..	92	92	92	93
Female (% of total net enrolment)	..	..	..	48	48	49	49
Secondary net enrollment rate, (%)	..	..	..	52	61	60	60
Female (% of total net enrolment)	..	..	..	50	50	50	49
Tertiary net enrollment rate, (%)	..	..	..	9	16	14	15
Female (% of total net enrolment)	..	..	..	55	53	50	54
Adult literacy rate (%)	..	..	..	91	91	91	92
Public spending on education (% of GDP)[4]	..	..	..	2.7	3.4	3.5	3.5
Public spending on education (% of spending)[4]	..	..	..	14.5	19.7	19.8	18.9
Water and Sanitation[1]							
Access to an improved water source (% of population)	70	74	78	81	84	84	..
Urban (% of urban population)	91	91	91	92	93	93	..
Rural (% of rural population)	61	65	68	71	75	76	..
Access to improved sanitation facilities (% of population)	32	38	44	53	58	59	..
Urban (% of urban population)	56	60	64	70	73	73	..
Rural (% of rural population)	21	26	30	38	43	44	..
Others[1]							
Disaster risk reduction progress score (1-5 scale; 5=best)	..	..	..	..	..	3.3	..
Proportion of seats held by women in national parliament (%)[5]	..	..	8	11	18	18.2	18.6

Source: 1 World Development Indicators; 2 BPS (Sakernas); 3 BPS (Susenas) and World Bank; 4 MoF and World Bank staff calculation, only includes spending on Raskin, Jamkesmas, BLT, BSM, PKH and actuals (except 2012 from revised budget); 5 Inter-Parliamentary Union

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Slower growth; high risks

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