Introduction

- The government announced and initiated ambitious policy reforms (e.g., fuel subsidy, business licensing) and infrastructure development plans (doubling of capital budget allocation in 2015).

- These raised expectations about the results they can achieve…

- …but so far gains remain smaller than expected.

- In this IEQ, we try to understand why this is the case and discuss options for addressing ongoing challenges.
Three facts about the global economy

Indonesia: recent developments and near-term outlook

Effective policy response
Fact 1. Global growth still subdued despite recovery in the US

World Bank projections for global growth in 2014, 2015 and 2016, percent

Fact 2. Major developing countries growing below past 10-year average…

Real annual GDP growth in select countries, percent

Note: *2008/9 global financial crisis period.
Source: World Bank Global Economic Prospects June 2015; World Development Indicators; World Bank staff calculations
...China’s slowing and changing growth pattern particularly far-reaching

Chinese imports from Indonesia, average annual growth, percent

Note: * excludes 2009 global financial crisis period.
Source: BPS; World Bank staff calculations
Fact 3. Commodity exporters: growth and fiscal buffers declining

Change between 2011 and 2015 in select countries, percentage points

- Russia
- Qatar
- Peru
- Norway
- Malaysia
- Indonesia
- Chile
- Brazil
- Australia
- Algeria

Source: IMF World Economic Outlook; World Bank staff calculations
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Effective policy response
Weaker GDP growth in Q1 2015, with investment still subdued...

*Statistical discrepancy also includes change in inventories. Q1 2015 quarterly growth in year on year terms. Source: BPS; World Bank staff calculations.
...and weaker private consumption growth, especially in nominal terms

Source: BPS; World Bank staff calculations
Employment growth has slowed across Indonesia

Average annual difference in employment rates, percentage points

Source: BPS; World Bank staff calculations
Weak revenue collection has limited the fiscal space

Contributions of select revenue categories to nominal revenue growth yoy for January - May, percent

Source: Ministry of Finance; World Bank staff calculations
Capital budget execution challenges have further curtailed the development agenda.

January-May realization as a share of total revised Budget, percent; nominal growth yoy, percent

Source: Ministry of Finance; World Bank staff calculations
Inflation remains sticky due to rising food prices

Source: BPS; World Bank staff calculations
Baseline GDP growth in 2015 has been revised down

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<td>(percentage change, unless otherwise indicated)</td>
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<tr>
<td>Real GDP</td>
<td>5.0</td>
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<td>Consumer prices</td>
<td>6.4</td>
<td>6.8</td>
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<td>Current account balance (% of GDP)</td>
<td>-2.9</td>
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<td>Fiscal balance (% of GDP)</td>
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<td>-2.5</td>
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Note: Revisions are relative to March 2015 IEQ.
Source: BI; BPS; Ministry of Finance; World Bank staff projections
Main risks to outlook are firmly on the downside

**External**
- Foreign currency financing costs;
- Lower trend output growth in developing countries;
- A setback in the still-fragile Euro Area recovery.

**Domestic**

<table>
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<th>Private consumption</th>
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<td>Lower consumer</td>
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WORLD BANK GROUP
Three facts about the global economy

Indonesia: recent developments and near-term outlook

Effective policy response
Deep reforms are needed to sustain growth of more than ~5.5%

Source: BPS; World Bank staff estimates
Fiscal reforms: “spend the capital budget”

Central government capital spending
(Nominal IDR trillion and percent of Total expenditure and of GDP)

Source: BPS, Ministry of Finance, World Bank staff calculation
Fiscal reforms: measures to collect more in the medium-term

Recently adopted policies:
• VAT electronic tax return submission, effective July 1;
• Improvements in income tax audit strategy (e.g. focus on taxpayers more likely to rely on transfer pricing), effective 2015;
• Removal of luxury sales tax on certain goods to lower cost of tax administration, effective July 9.

Further options to mobilize revenues:
• Optimize the tax regime (e.g. revisions to sales and excise taxes for vehicles, fuels and tobacco);
• Improve corporate income tax (e.g. reduce firms’ incentives to remain small);
• Revise VAT exemptions to increase equity (e.g. for electricity consumption of high consuming households).
Support the rebalancing of the economy

- With low commodity prices, relative profitability is expected to now favor manufacturing industries and services over most commodity sectors...

- Policy support to businesses and investments in manufacturing and services is thus crucial:
  - Improve logistics services (dwell time)
  - Facilitate firms’ access to key inputs (incl. imports)
  - Speed up licensing approval process (e.g. one stop shop)
  - Realign sector-specific regulations with the provisions of the investment law

- Invest more and better in human capital to raise long-term growth
Three facts about the global economy

Indonesia: recent developments and near-term outlook

Effective policy response

Also in this IEQ: geothermal, BOS and CAD
July 2015 IEQ Contents

- Regular update on economic developments and the outlook

- Indonesia’s current account deficit going forward

- Fuel subsidy reform: a major one but how to make it sustainable?

- Realizing Indonesia’s potential in geothermal.

- Ten years of school grant program (BOS): successes and challenges
Main takeaways

- **“Slower gains”:**
  - Output and employment growth are weakening.
  - Major policy initiatives are facing implementation challenges – fuel pricing, infrastructure.

- **Indonesia is not alone in facing these challenges:**
  - EMEs worldwide are slowing down and need to confront structural constraints

- **Indonesia is still in a good position to respond by:**
  - Expanding infrastructure spending, to the extent possible given deficit limit
  - Following through on measures to improve revenues and the business environment
  - Communicating in a consistent way about new policies and decisions to investors, as consistent communication reduces uncertainty.

- **But slower gains are a sign of serious constraints and a shifting economy:**
  - Supporting a rebalancing of the economy key