



WORLD BANK GROUP

Indonesia Economic Quarterly July 2015

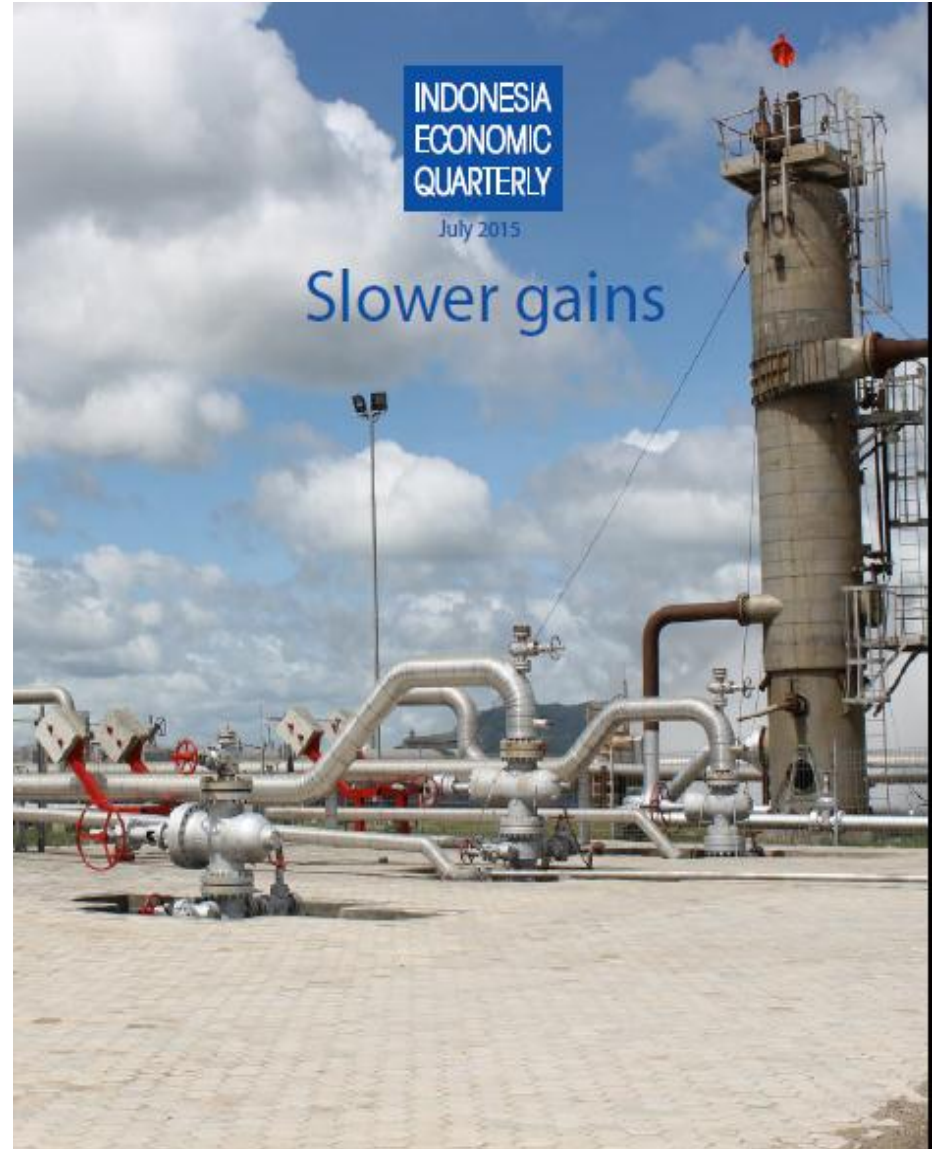
Slower Gains

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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.



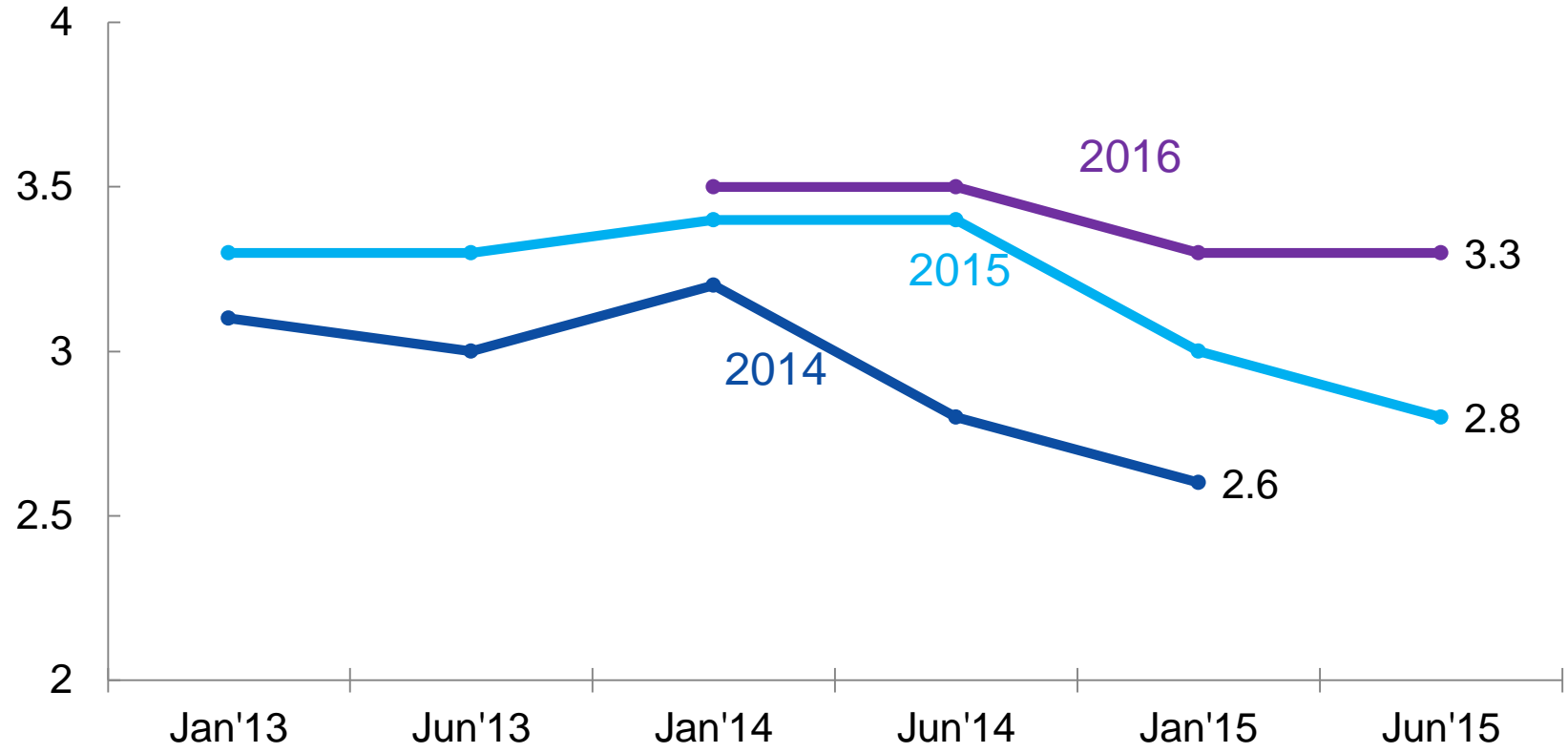
Three facts about the global economy

Indonesia: recent developments and near-term outlook

Effective policy response

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

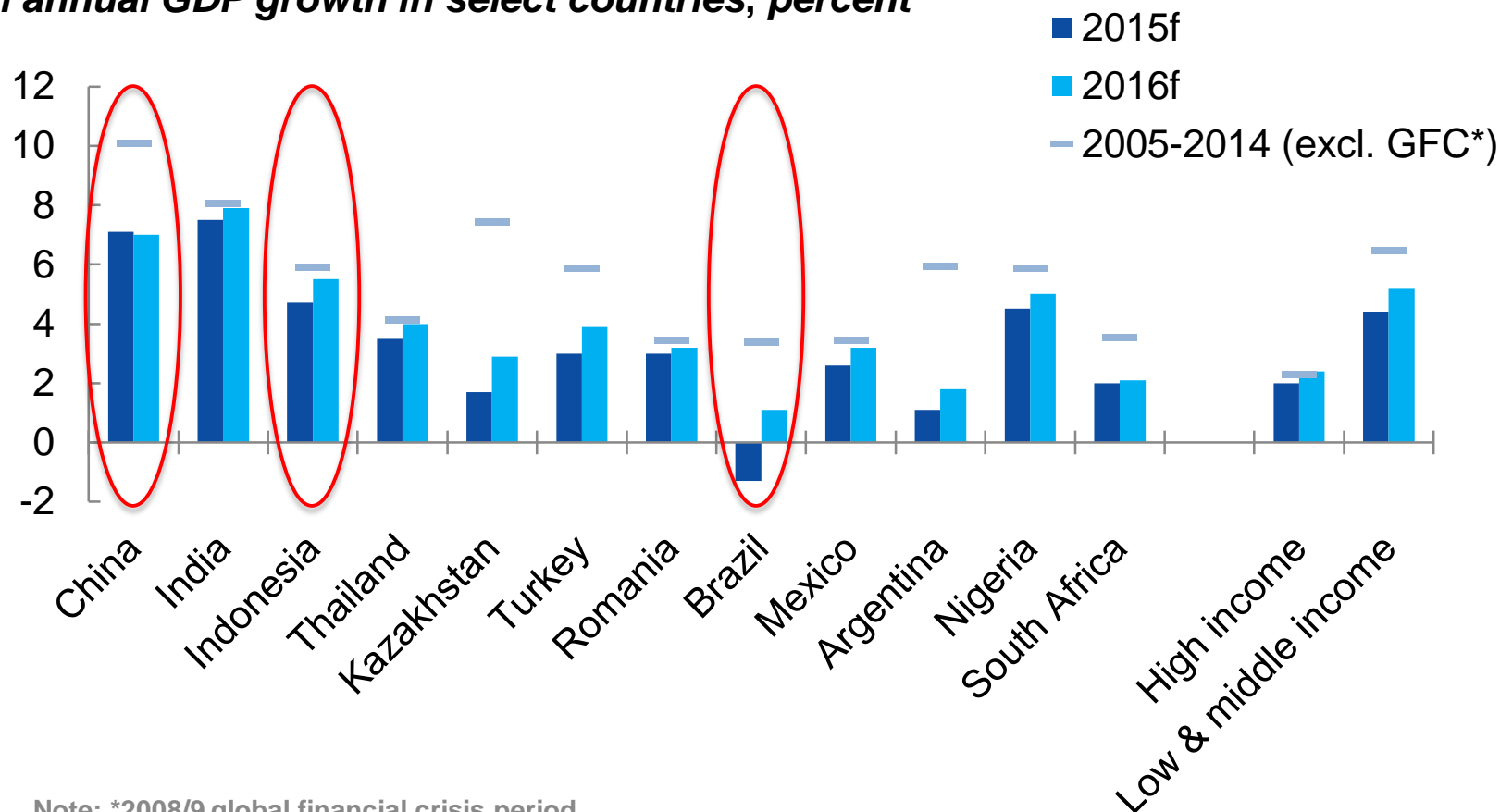
World Bank projections for global growth in 2014, 2015 and 2016, percent



Source: World Bank Global Economic Prospects

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

Real annual GDP growth in select countries, percent

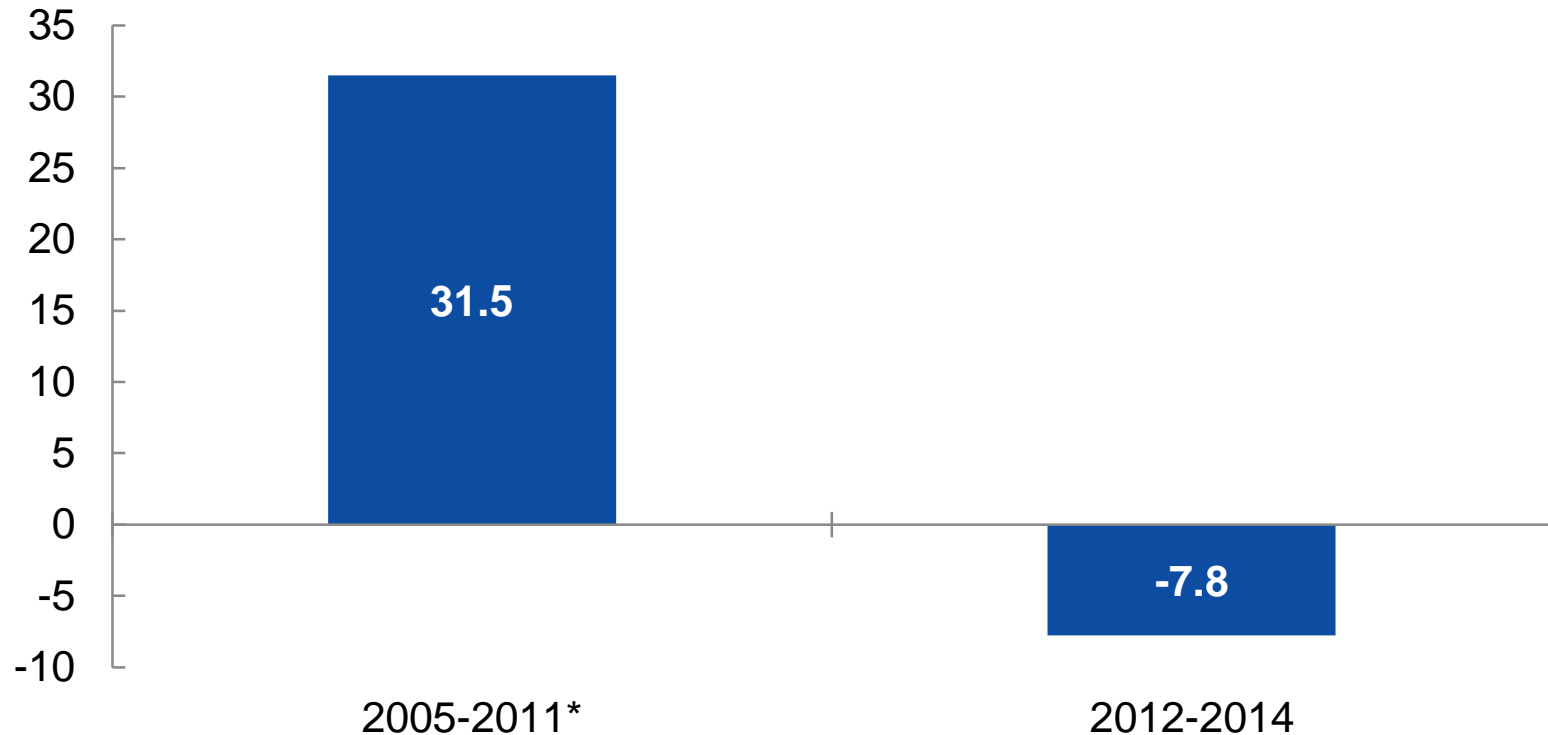


Note: *2008/9 global financial crisis period.

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

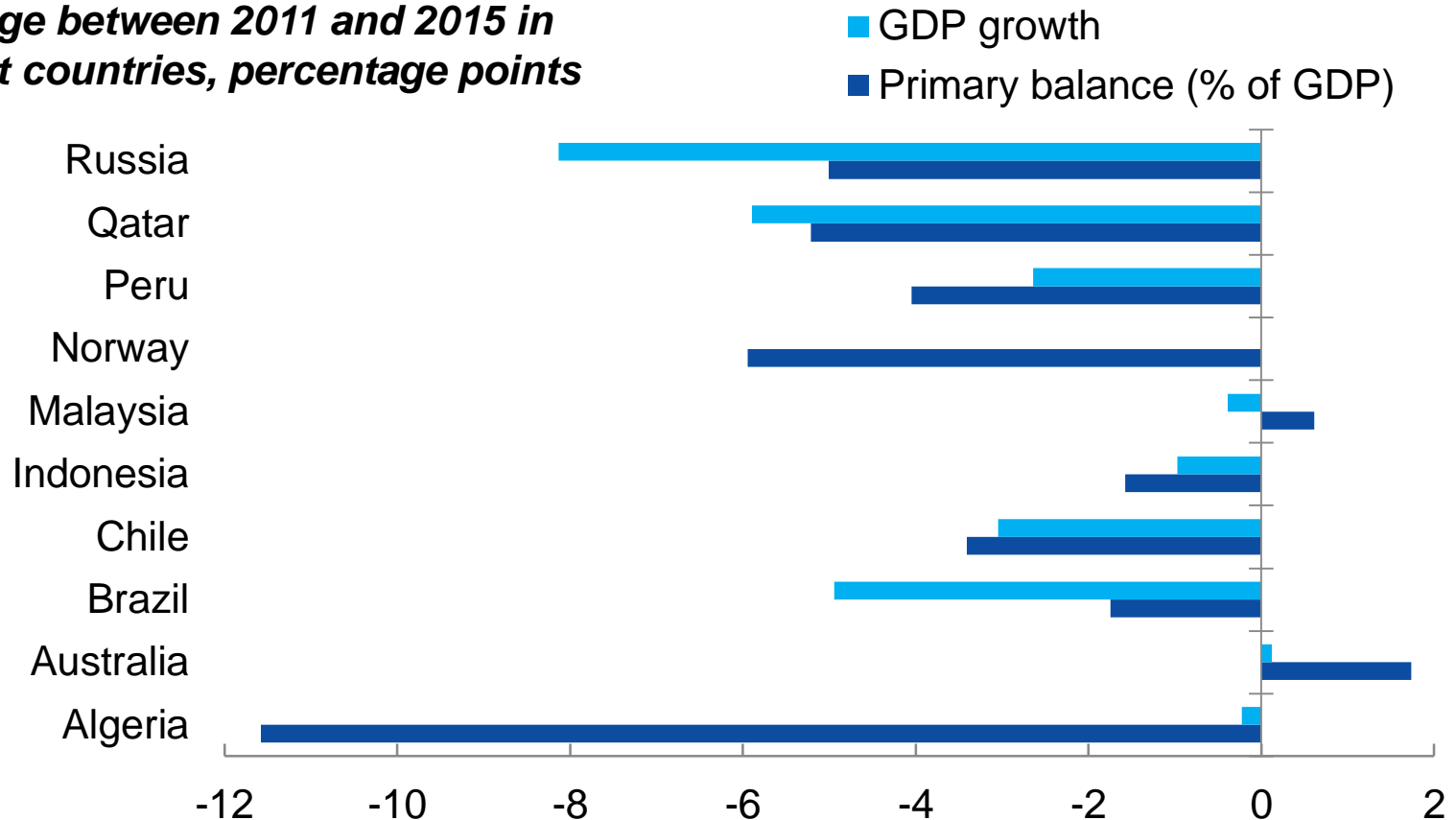


Note: * excludes 2009 global financial crisis period.

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



Source: IMF World Economic Outlook; World Bank staff calculations

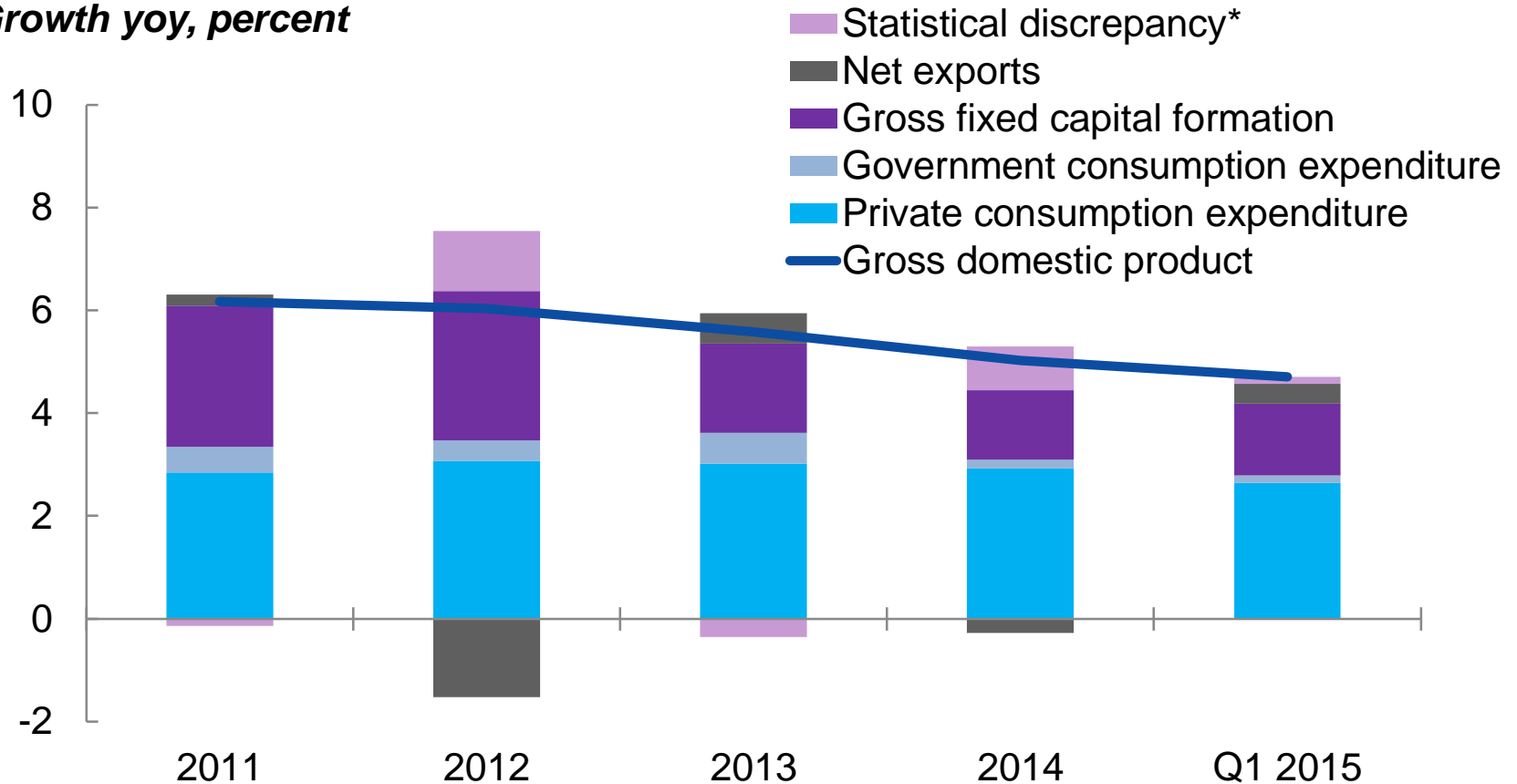
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Weaker GDP growth in Q1 2015, with investment still subdued...

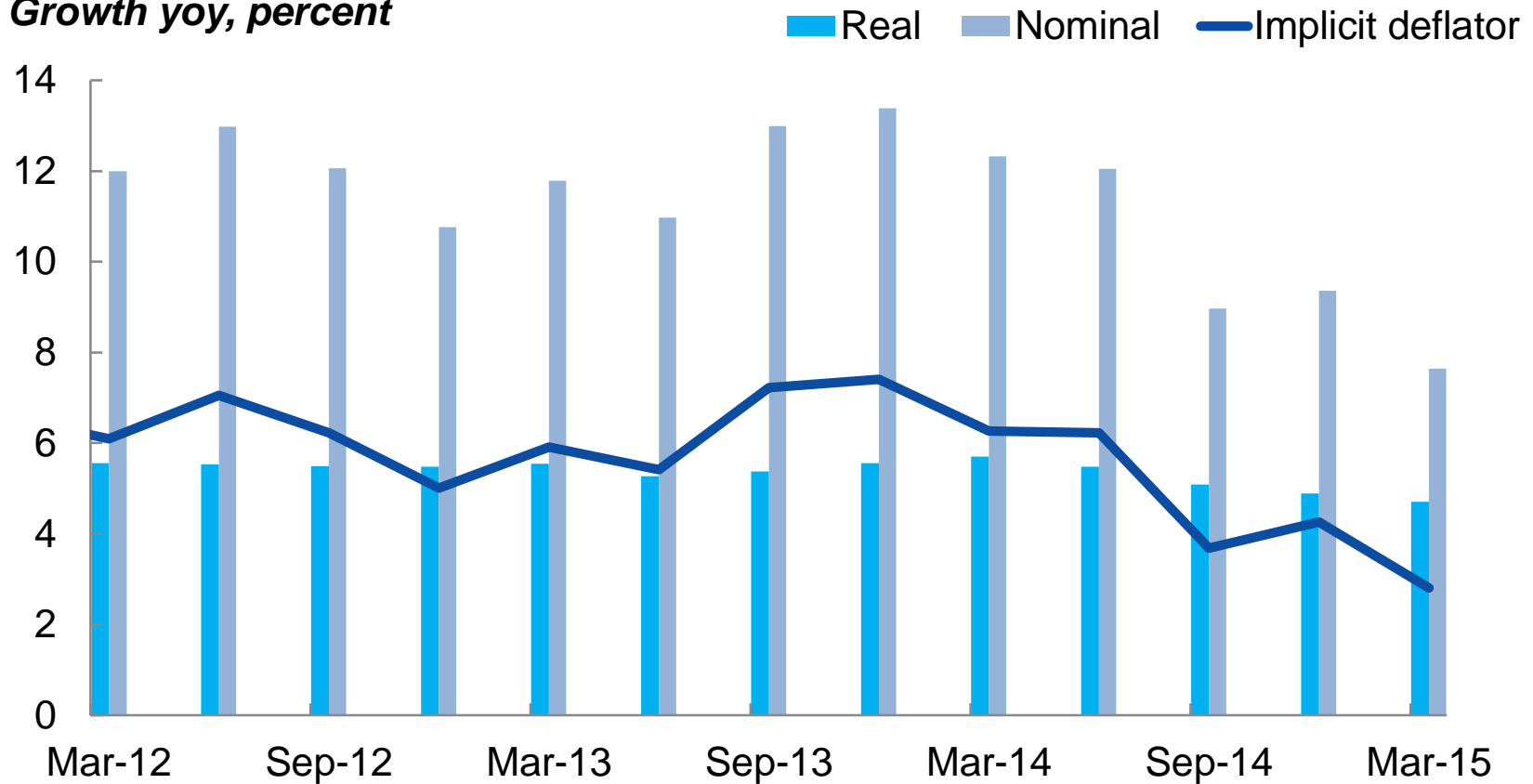
Growth yoy, percent



Note: *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

Growth yoy, percent

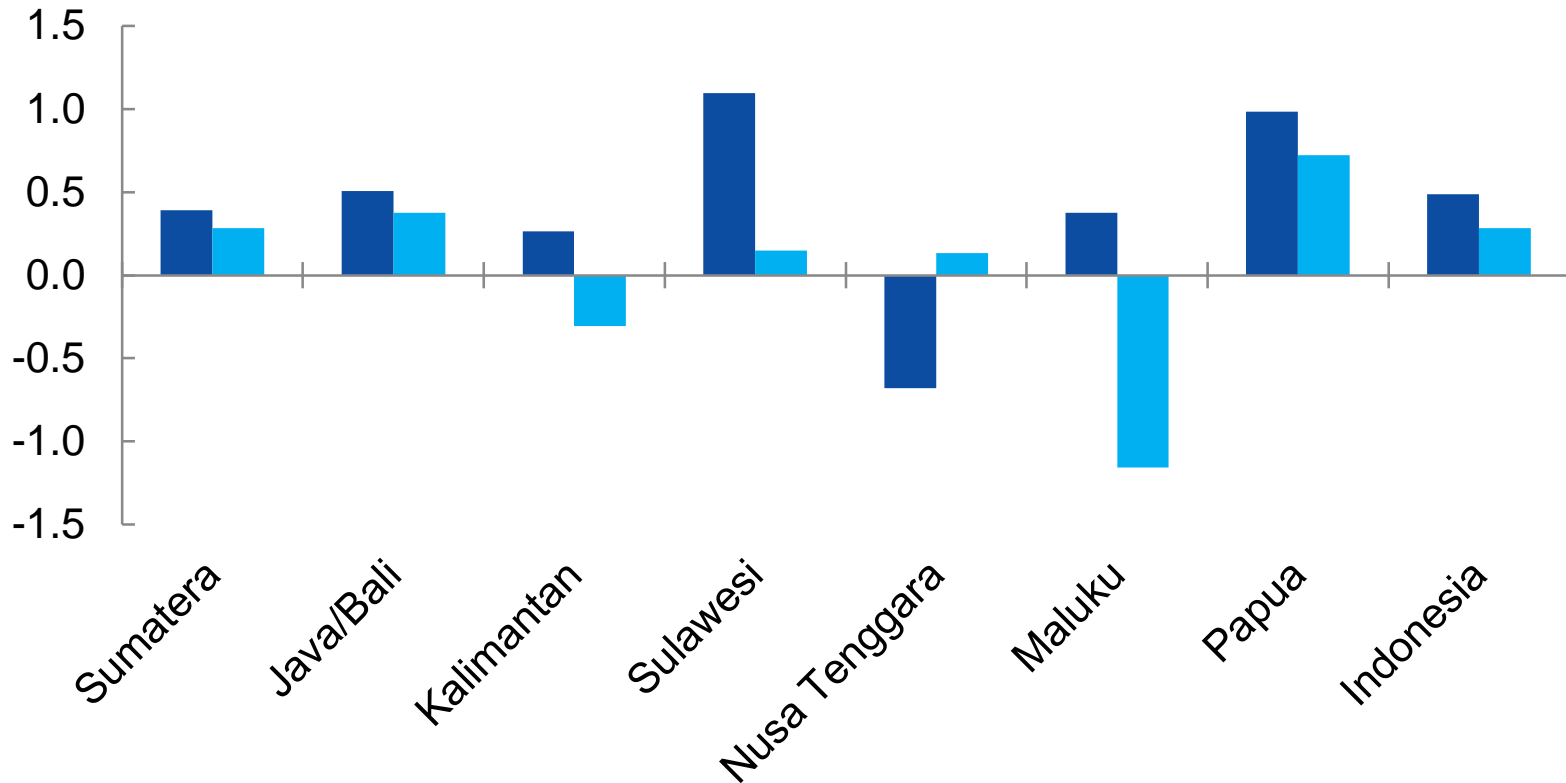


Source: BPS; World Bank staff calculations

Employment growth has slowed across Indonesia

Average annual difference in employment rates, percentage points

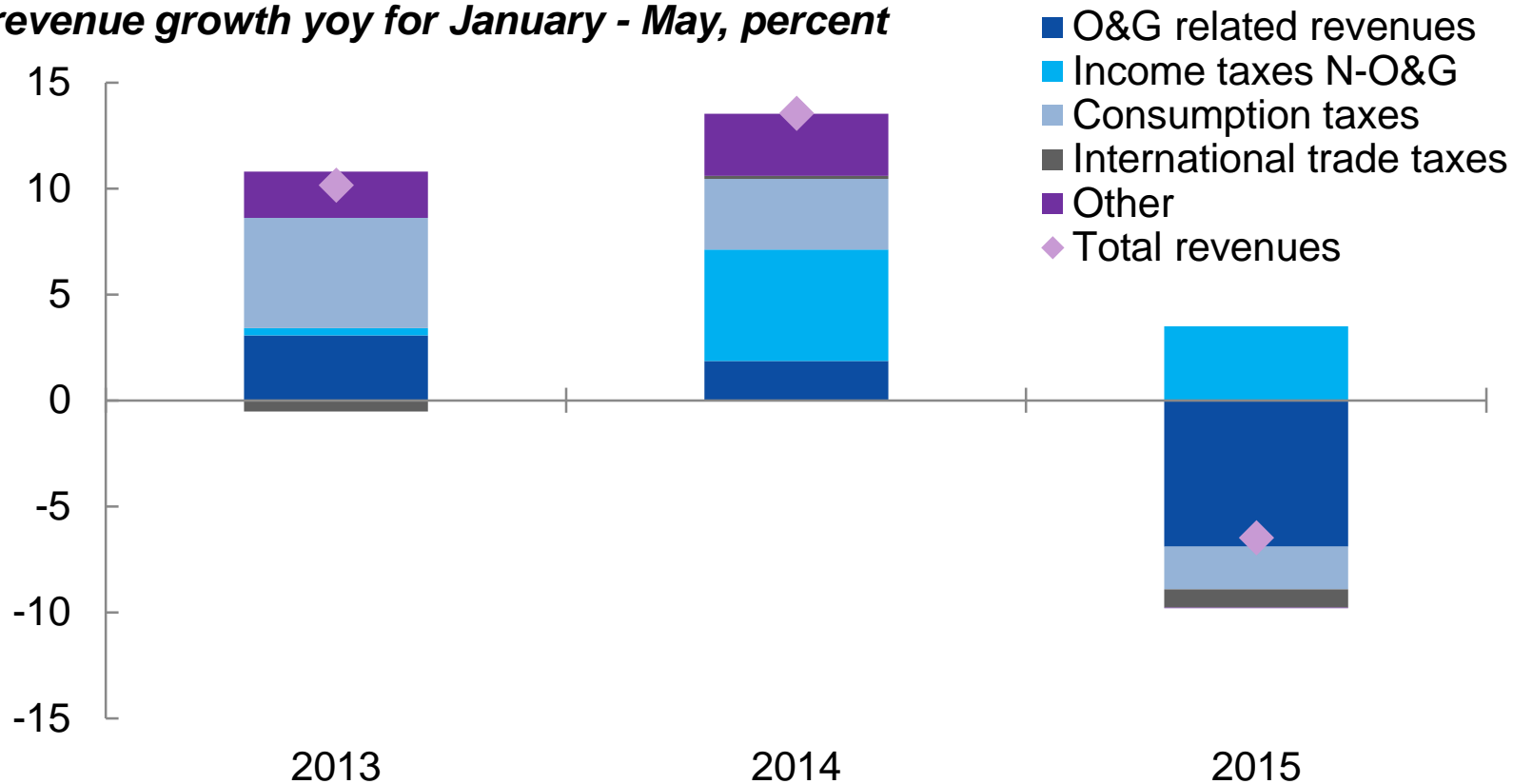
- Commodity boom (2007-2011)
- Post-commodity boom (2012-2014)



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

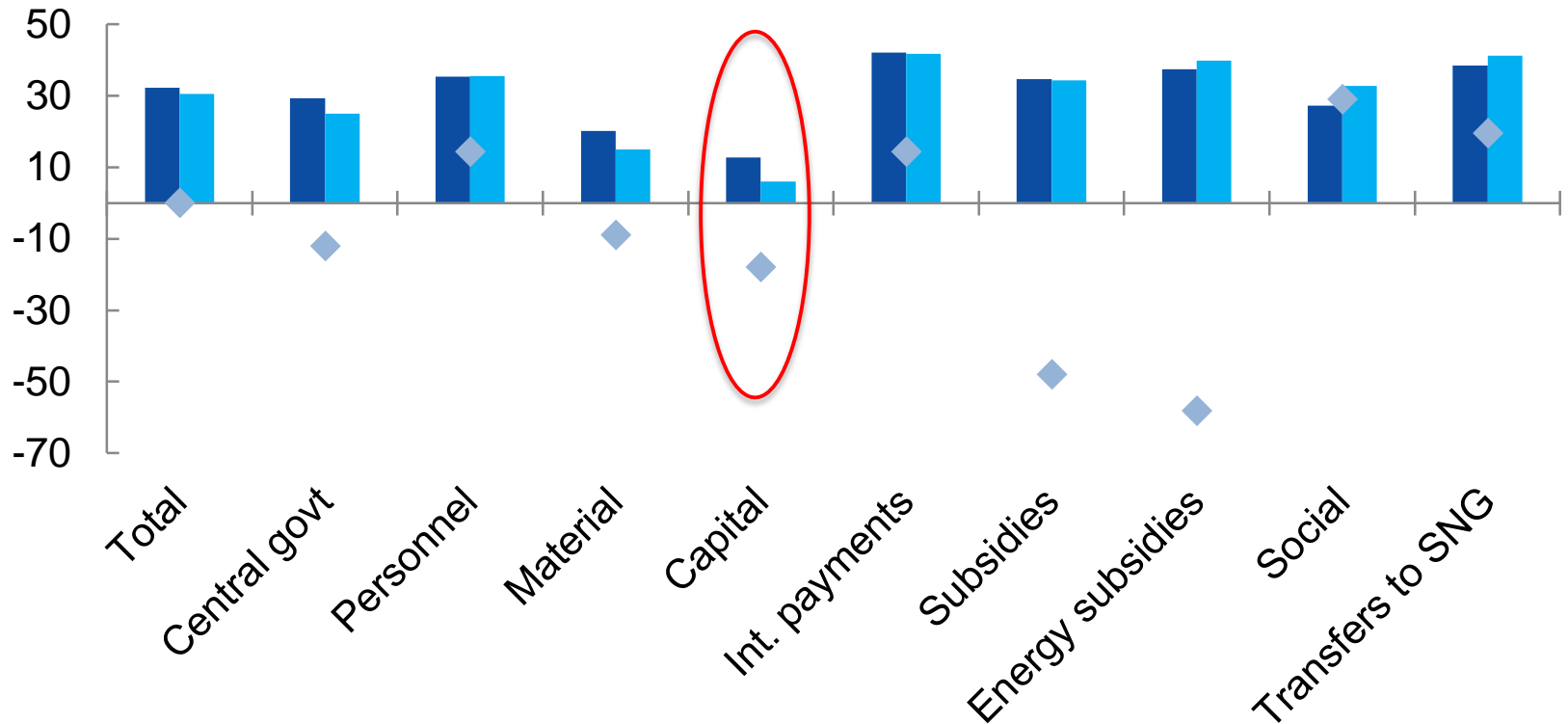


Source: Ministry of Finance; World Bank staff calculations

Capital budget execution challenges have further curtailed the development agenda

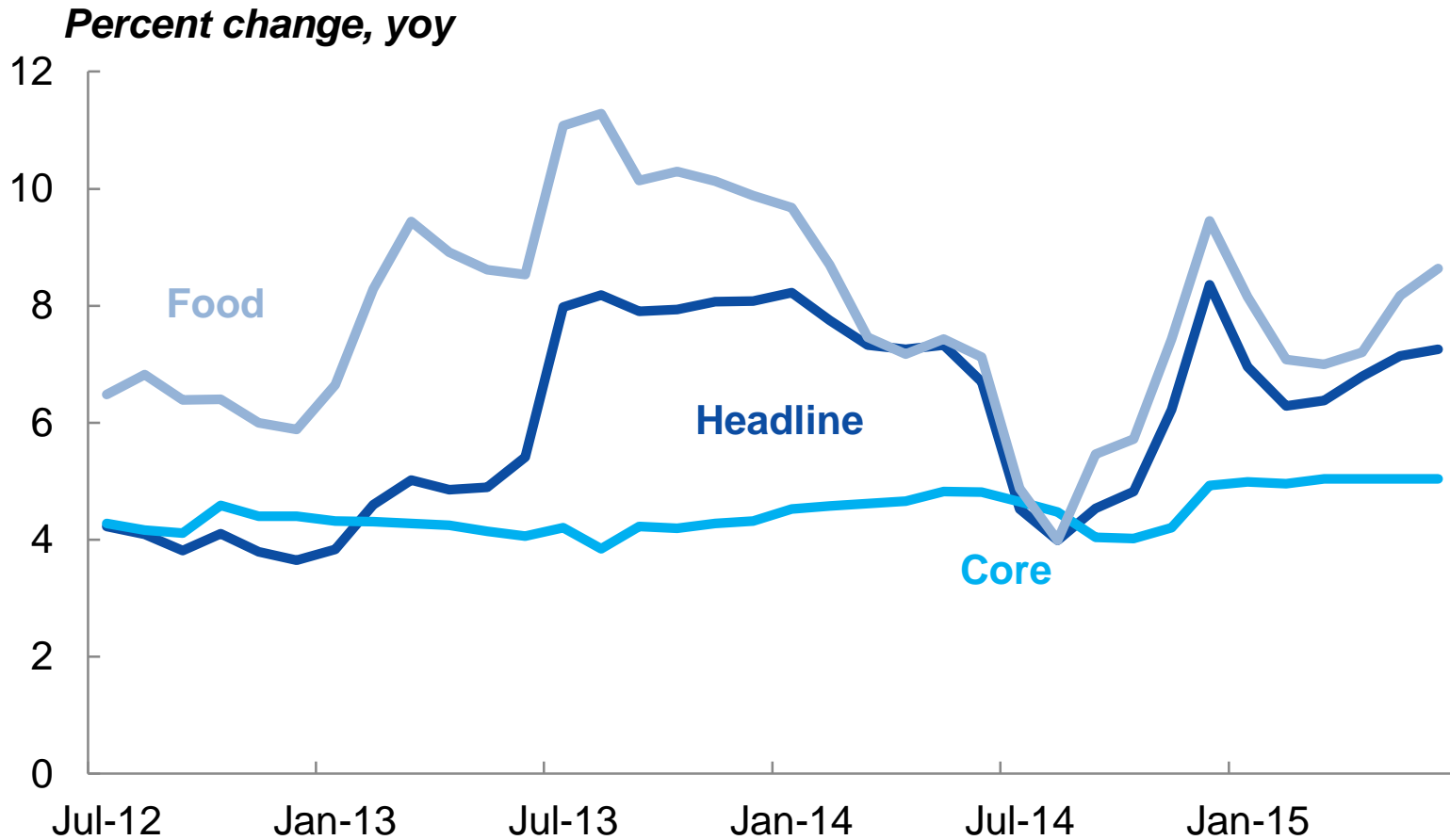
January-May realization as a share of total revised Budget, percent; nominal growth yoy, percent

- 2014 Jan-May share of total rev. Budget
- 2015 Jan-May share of total rev. Budget
- ◆ 2015 Jan-May nominal growth (yoy)



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

	July 2015 IEQ			Revisions	
<i>(percentage change, unless otherwise indicated)</i>	2014	2015p	2016p	2015	2016
Real GDP	5.0	4.7	5.5	-0.5	0.0
Consumer prices	6.4	6.8	5.3	0.3	0.2
Current account balance (% of GDP)	-2.9	-2.7	-2.9	0.3	0.3
Fiscal balance (% of GDP)	-2.2	-2.5	-	0.0	-

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

Private consumption

- Sticky inflation;
- Fuel price uncertainty;
- Further Rupiah depreciation;
- Lower consumer confidence.

Government consumption

- Revenue shortfall;
- Budget under-execution.

Fixed investment

- Weaker business confidence;
- Subdued credit growth;
- Lower government capital spending.

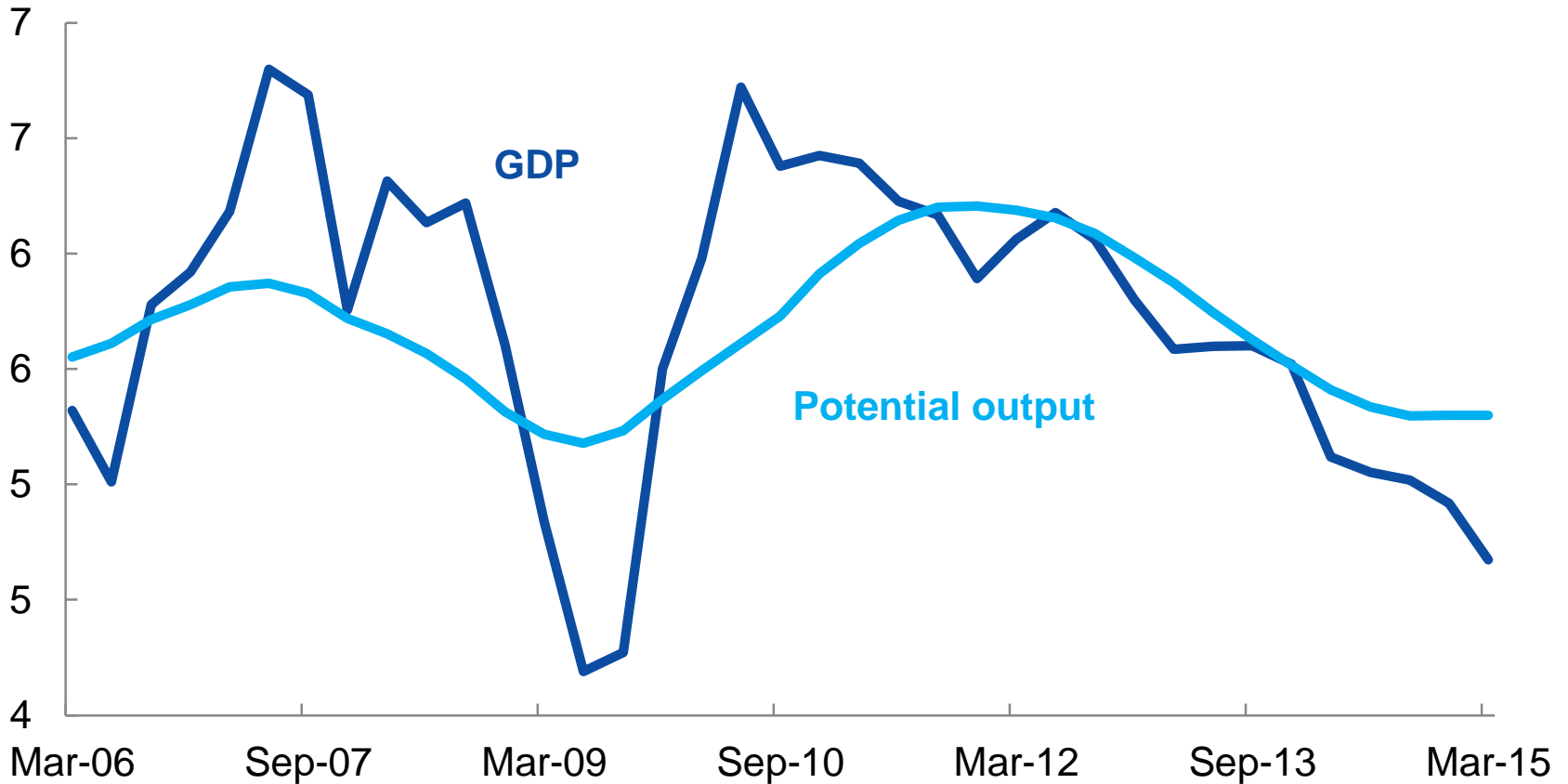
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Deep reforms are needed to sustain growth of more than ~5.5%

Growth yoy, percent

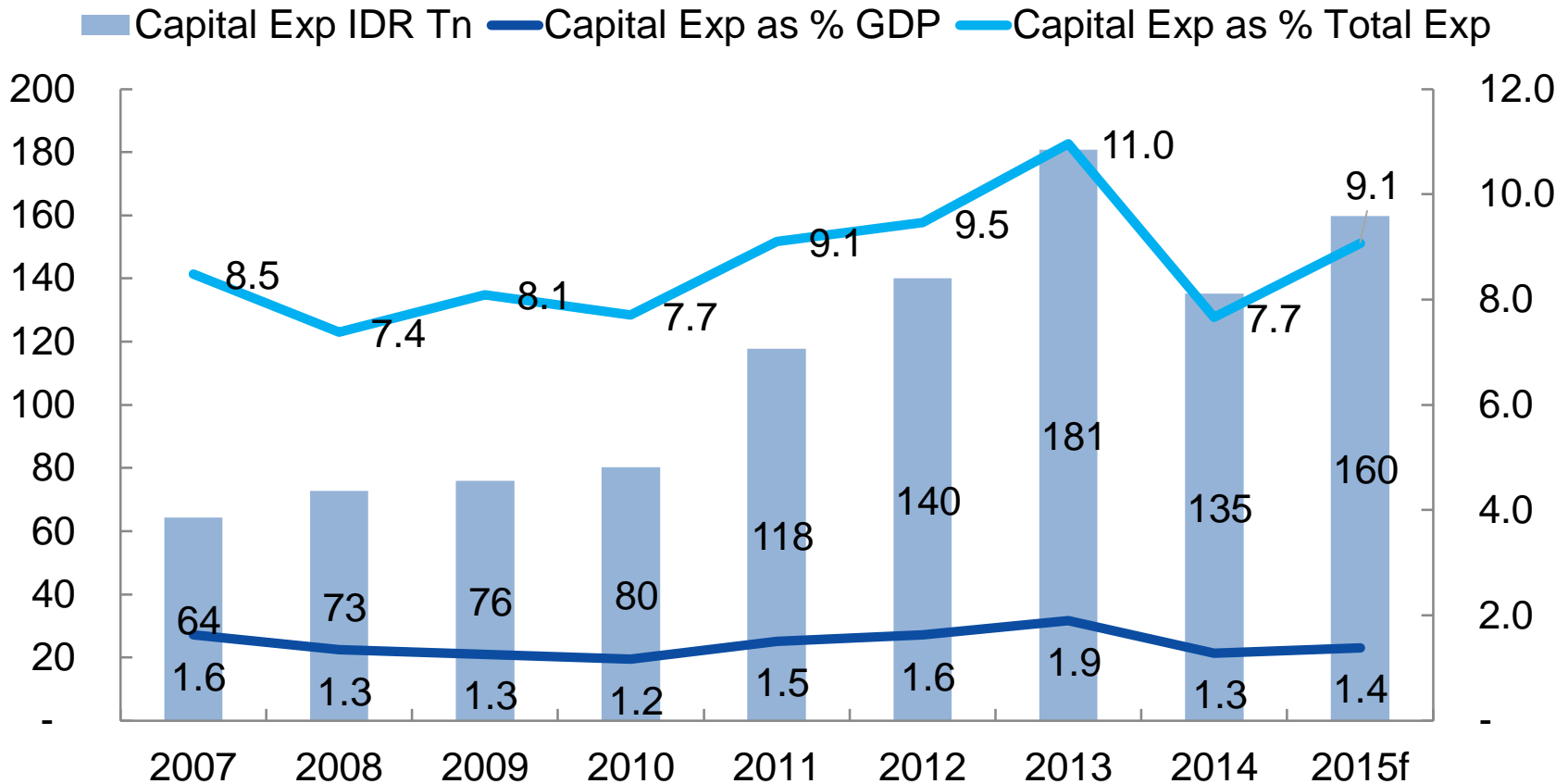


Source: BPS; World Bank staff estimates

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 tax payers 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

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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