INDONESIA ECONOMIC QUARTERLY

October 2013

Continuing adjustment

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. The core project team, with responsibility for Part A (economic update), editing and production, comprises Arsianti, Magda Adriani, Brendan Coates, Fitria Fitrani, Ahya Ihsan, Shakira Jones, Alex Sienaert, 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, Randy Salim and Marcellinus Winata, under the guidance of Dini Sari Djalal.

This edition of the *IEQ* also includes contributions from Alex Sienaert (Section B.1 on policy package), Natalia Cubillos Salcedo and Henry Sandee (Section B.2 on container dwell times at Tanjung Priok), Ahya Ihsan and Bill Wallace (Director, AIPEG) (Section C.1 on infrastructure investment), and Samer Al-Samarrai (Section C.2. on local governance and education performance). Key input and comments were also received from Djauhari Sitorus, Pamitra Wineka and The Fei Ming (banking sector, credit and corporate sector update), Ririn Purnamasari and Matthew Wai-Poi (BLSM and poverty update), Rubino Sugana (public revenues), Mark Ahern, Enda Ginting and Hari Purnomo (budget execution), and Yue Man Lee, Mattia Makovec, Arvind Nair, Sjamsu Rahardja, Connor Spreng and Della Temenggung (policy package), Wahyoe Soerdarmono, Paul Lemaistre and Jon Sariatmadja (infrastructure investment). The team also benefited from discussions and comments from Deepak Mishra, David Hawes and Roland Rajah (AusAID), and Bill Wallace (AIPEG).

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Indonesia is undergoing significant economic adjustments precipitated by a weakening in its external balances…

Indonesia's economic growth is slowing, weighed down by the cumulative impact of the weakening in key commodity prices which has been underway since 2011 and by tightening domestic and international financing conditions, and challenged by aspects of the policy environment. At the same time, external financing needs have increased, in part due to the widening current account deficit. The pace of adjustment to these developments has intensified in recent months. Along with other major emerging market economies (EMEs), Indonesian financial markets have experienced considerable turbulence, with the Rupiah depreciating significantly against the US dollar. Policy settings are also responding, with monetary policy, for example, being tightened.

…bringing slower growth and increasing the focus on policies

Reflecting these developments, the World Bank's projection for 2014 growth has been lowered to 5.3 percent – still relatively resilient, but a notable downgrade on the near-term economic outlook. The current phase of economic adjustment also brings with it risks of a more material, and longer-lasting, down-shift in growth, in the absence of the support provided by cheap international financing costs and strong commodity demand. This places a premium on continued macroeconomic policy adjustment, enhancing ongoing efforts to lift competitiveness and the sustainable growth rate of the economy, and on protecting the vulnerable from the impact of moderating growth and future economic shocks.

International financial market volatility has been at the fore, although global growth is turning more supportive…

Recent months have seen marked international financial market turbulence, triggered by the prospect of gradually normalizing monetary policy in the US. Portfolio investment flows and debt and equity financing costs for EMEs, including Indonesia, have responded abruptly to the sharp rise in US interest rates. At the same time, and one of the contributors to the recent market volatility, there has been a general strengthening in the performance of high income economies as their recovery continues.

…but key commodity prices have remained under pressure, with the exception of oil…

In part reflecting the moderation in China's growth and investment outlook, international commodity prices have generally remained under downward pressure, the key exception for Indonesia being global fuel prices. The export-weighted US Dollar price index of Indonesia's top six commodity exports (accounting for just under half of total exports) fell by 8 percent in 2013 through the end of August, to be 35 percent lower than its post-2008/09 peak in January 2011. The price of Brent crude oil, in contrast, rose 7 percent from January 2011 to August 2013, and is broadly flat year-to-date. This divergence between global energy prices and non-energy prices has been an important driver of the weakening in Indonesia's balance of trade since 2011, and places additional pressures on the Government's fiscal position.

…presenting a challenging picture for Indonesia's external balances

Global economic growth is set to continue improving, with Indonesia's major trading partners projected to grow by 3.4 percent over 2013, the same rate for the year as a whole as in 2012 but reflecting a pick-up in the second half of 2013, and moving up to 3.9 percent in 2014. However, in the baseline commodity prices are not projected to turn significantly more supportive for Indonesia's terms of trade. Furthermore, as global financial markets continue to adjust to the implications of reduced monetary accommodation in high income economies, the volatility of capital flows, and external financing costs, appear set to remain elevated, for Indonesia as for other EMEs. Indonesia's economic and policy adjustment to weaker external balances, now well underway, is therefore likely to remain center-stage.

Growth slowed in the second quarter, but despite this an unexpectedly wide current account deficit was recorded

A moderation in demand has an important role to play in moving the current account, and hence overall external financing needs, into alignment with the tighter external financing conditions. Indonesia's economy has indeed slowed over 2013 so far, with investment growth being the major drag. Growth in the second quarter was 5.8 percent, dipping under 6.0 percent for the first time since 2010. Despite the incipient weakening in domestic demand, seasonal factors, coupled with the sustained weakness in export revenues, contributed to an unexpectedly large widening of Indonesia's quarterly current account deficit to 4.4 percent of GDP. The release of these data, and the reactions of investors already rebalancing their portfolios in favor of high income economy assets, placed considerable pressure on the Rupiah in late August. These pressures contributed to Bank Indonesia's decision to lift interest rates further, taking the cumulative increase in key interest rates since June to 150 basis points, and to introduce additional macro-prudential measures to dampen credit growth and new policies to support foreign exchange liquidity, which had tightened.

GDP growth is projected to slow and the current account deficit to narrow modestly through 2014…

In light of recent events, a more pronounced moderation in Indonesia's economic growth to 5.3 percent in 2014, from 5.6 percent in 2013, is now projected than was previously expected (Table 1). This compares with the July 2013 *IEQ* projections of a dip to 5.9 percent for 2013 and then return to 6.2 percent in 2014. The current account deficit is projected to remain sizeable, though with a narrowing bias, to come in at 2.6 percent of GDP in 2014. Having been pushed higher temporarily by the June increase in subsidized fuel prices, inflation is expected to peak in year-on-year terms in the fourth quarter and, absent significant cost-push shocks, to moderate to an annual average of 6.7 percent in 2014.

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	7.3	6.7
Current account deficit	(Percent of GDP)	0.2	-2.8	-3.4	-2.6
Budget balance	(Percent of GDP)	-1.1	-1.9	-2.5	-2.3
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

…but risks remain elevated…

Downside risks to the economic outlook are sizable. Domestic risks stem from domestic demand being impacted more than expected by higher prices, higher interest rates, and the negative wealth and corporate investment activity effects from the stock price, and especially

currency, volatility seen since May. External risks to the outlook center on the trajectory of non-oil commodity prices, international fuel costs, and external financing conditions. Much also depends on the performance of China's economy, and investment demand, and the quality of the policy responses in both high income and developing economies as global liquidity becomes less abundant. Should these factors play out favorably, there is also a chance that the global recovery through 2014 proves stronger than expected in the base case, lifting Indonesia's growth prospects and providing some relief for its external position, so long as it can capitalize on the opportunities generated by stronger global trade and investment dynamics.

…placing a premium on continued macroeconomic policy flexibility to facilitate near-term adjustment…

Indonesia's fiscal and monetary policy settings will continue to play a key role in facilitating the adjustments now taking place and in minimizing associated risks. There are, however, trade-offs between the objectives of restraining inflation, supporting growth and adjusting the current account deficit to the tighter financing environment. Monetary policy faces the challenge of calibrating interest and exchange rates so as to guard against rising inflationary pressures as cost pressures rise (such as from the pass-through of the weaker currency or wage increases) while facilitating improvements in the external balances, and without unduly crimping economic growth and weakening public and private sector balance sheets. With the 2014 Budget under discussion with Parliament, fiscal policy faces the challenge of slower revenue growth, and higher energy subsidy and nominal debt-financing costs, raising the importance of lifting further the quality of spending and of revenue mobilization. Maintaining a prudent overall fiscal stance, coordinated with the tightening in monetary policy, can help to meet this challenge. Building on the important June increase in subsidized fuel prices, further reforms to the current system of inefficient and distortionary energy subsidies could play an important role in freeing up spending for key development expenditures such as infrastructure and health, as well as in limiting the sizeable fiscal risks they generate to fluctuations in the exchange rate or shocks to global oil prices.

…reducing uncertainties through communication and contingency planning…

Given the uncertainties generated by moderating growth momentum, and volatile but generally tightening external financing conditions, maintaining strong communication around policy changes and a strong focus on implementation can help to support confidence. Policy also has a role to play in mitigating the negative impacts of particularly adverse scenarios, should tail risks materialize. The Government has put considerable efforts into enhancing its crisis preparedness in recent years. Monitoring and response coordination mechanisms are in place to facilitate a flexible response to any major market dislocations. The Government now has contingent fiscal financing equivalent to approximately USD 5 billion to draw on in the event of a significant deterioration in financing conditions, while Bank Indonesia has recently made efforts to secure additional bilateral US Dollar swap lines.

…and continuing to drive progress on reforms to lift Indonesia's sustainable growth rate

The recent pressures on the external balances and growth serve as a reminder of the need for further efforts to improve the diversification of Indonesia's exports and to lift the competitiveness of the economy in order to sustain a more rapid pace of growth and development. The depreciation of the Rupiah to date should provide a short-term boost to competitiveness, but this will only prove lasting if not eroded by domestic cost pressures, such as from wage increases, and if policies and investments are put in place to enhance the flexibility of the supply-side of the economy. Measures to increase competitiveness and improve the regulatory environment can thus assist not only to alleviate near-term external funding pressures by stimulating exports and encouraging foreign direct investment, but also help to lift longer-term employment and economic growth.

The Government's policy package announced in August contained measures to support exports and investment, but implementation will be key

In response to the intensification of financial market pressures, and in conjunction with the monetary policy and currency market measures mentioned above, on August 23 the Government announced a policy package containing measures intended to improve the current account, safeguard purchasing power and facilitate growth, contain inflationary pressure, and maintain investment flows. Some of the reform measures involved retracting interventionist policies on trade and proposals for improving certainty in the business environment. However, the details and implementation of the measures, and their contribution to achieving the required adjustment in the external balances, remain to be

seen. While political interests in policymaking as the election approaches are likely to increase, there is also the opportunity for reforms to be strengthened in the near-term, given the potential costs and consequences of not doing so in the current economic environment.

In the near-term, improving international connectivity, such as through the logistics performance at Indonesia's gateway Tanjung Priok port, can provide a welcome lift to competitiveness

Efforts to improve Indonesia's international connectivity have a crucial role to play in increasing the country's export competitiveness and encouraging investment. One of the key practical challenges for improving Indonesia's international connectivity is reducing dwell times at Indonesia's most important port, Tanjung Priok (handling over two-thirds of Indonesia's entire international trade), which have almost doubled for inbound containers since the start of 2011, to an average of over ten days as of August. A number of important steps have already been taken to address this situation. Additional regulatory reforms and procedural improvements can further reduce upstream processing times, for example, by increasing the use of priority clearance channels and parallel customs processing, as well as providing incentives for the early submission of import declarations and improving the performance of the Indonesian National Single Window.

The level and quality of infrastructure spending remains a key determinant of long-term trade and growth performance

As well-recognized by the Government, improvements in Indonesia's physical infrastructure can also unlock another well-known constraint on Indonesia's competitiveness and sustainable growth rate. Better infrastructure can also enhance other development outcomes, such as in health and education, by improving accessibility. Recent evidence compiled by the World Bank suggests that there have been insufficient additions to Indonesia's infrastructure capital stock since the Asian financial crisis, causing it to fall relative to both the total capital stock and to the size of the economy. Over the 2001-2011 period, initial simulations suggest that moving the annual growth in the infrastructure capital stock up to 5 percent, against the actual estimated rate of 3 percent, could have lifted average annual GDP growth to 5.8 percent, 0.5 percent above the actual average, resulting in a 5 percent higher level of GDP in 2011. While results such as these are sensitive to assumptions, they do point to the need to improve both the quantity and quality of public investment, while also providing a strong enabling environment for private sector infrastructure investments. Continuing to increase the budget allocation for infrastructure plays a role, but fiscal sustainability and competing demands for public funds also argue for a strong focus on efficiency, including ensuring the smooth operation and maintenance of existing infrastructure, and further efforts to improve the quality of public investment management. Improved data availability and quality in this area to inform policy is also needed.

Education performance is also critical for development, requiring more improvements in local governance

Also vital for growth, as well as being a key development goal in its own right, is Indonesia's human capital – the knowledge and skills of its people. In the last fifteen years, Indonesia has introduced a comprehensive package of education reforms designed to expand access and improve quality. A key component of the reform process has been the devolution of responsibility for basic education services to local governments and schools, and improvements in local governance can thus play a vital role in raising the quality of basic education and ensuring children leave school with adequate skills. Indeed, the Indonesian Local Education Governance (ILEG) surveys, conducted in 2009 and 2012, suggest that the quality of local governance is important for improving district education performance, making it important to continue to address key governance constraints, and to better coordinate and integrate central government financing in local education planning.

A. Economic and fiscal update

1. International market volatility as external financing costs have risen

International financial market volatility has been at the fore…

The external picture for Indonesia, and other emerging market economies (EMEs), has been dominated by international financial market volatility, and a rise in external financing costs, triggered by the prospect of the gradual normalization of monetary policy in the US. Between early May (as speculation mounted that a reduction in the US Federal Reserve's bond purchases would be announced) and early September (when market expectations that the Federal Reserve would begin to "taper" its purchases later in the month peaked), the benchmark 10-year US Treasury bond yield rose by 135 basis points, to just under 3 percent, its highest level since May 2011. In response, debt and equity financing costs for EMEs, including Indonesia, moved up abruptly (Figure 1), and investment outflows were seen.

…although economic conditions in high income economies are improving…

Market developments have also reflected a continued strengthening of growth in high income economies. The Euro Area emerged from its long recession in the second quarter, and the economies of both Japan and the US expanded at a solid pace. Third quarter data suggest that this has continued, and the pick-up is expected to be sustained, as high income economies continue to recover from the 2008/09 global financial crisis and its aftermath. This ongoing recovery can support Indonesia's exports, both directly (as close to a third of exports are sold to the Euro Area, Japan and the US) and indirectly, through its spillover into global demand and Indonesian export prices. However, the outlook for Indonesia's other trading partners is more mixed.

…adding to a mixed picture for major developing economies…

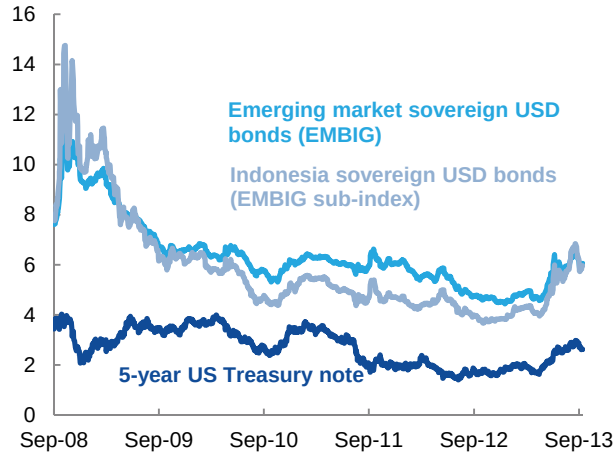
Currency and stock market sell-offs were most pronounced for those EMEs with significant current account financing requirements, notably Brazil, Turkey, South Africa, India and Indonesia. Part of the selling pressure in emerging markets experienced through early September, however, can be attributed to the pricing in of a smaller growth differential between emerging and high income economies, reflecting slower growth in the former and, as discussed, faster growth in the latter. This, coupled with the expectation of less abundant global liquidity, presents a challenging combination for many EMEs, and the outlook for Indonesia's major developing country trading partners is indeed mixed. China (the

destination of approximately 11 percent of Indonesian exports, and a key driver of global commodity prices) appears on track to meet its official target of 7.5 percent growth in 2013, down just slightly from 7.8 percent in 2012, while in contrast growth has declined significantly in India (which accounts for approximately 7 percent of total exports and is a major market for selected export products such as coal and palm oil).

…while non-energy commodity prices have continued to weaken

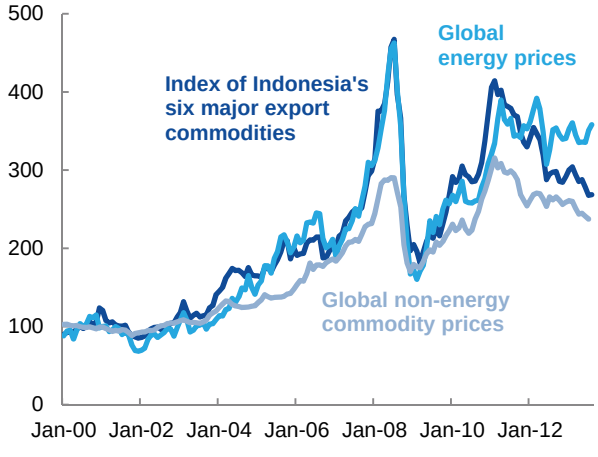
International commodity prices have generally weakened further in recent months, influenced by the strengthening in the US Dollar, the key exception being global fuel prices (which were affected by concerns over the conflict in Syria). The export-weighted US Dollar price index of Indonesia's top six commodity exports (accounting for just under half of total exports) fell by 8 percent in 2013 through the end of August, to be 35 percent lower than its post-2008/09 peak in January 2011 (Figure 2). The price of Brent crude oil, in contrast, rose 7 percent from January 2011 to August 2013, and is broadly flat year-to-date. The divergent trend between global energy and non-energy prices since 2011 is in stark contrast to their more typical close correlation, and is a key aspect of the significant deterioration in Indonesia's trade balance since 2011 (see Section 3), and adds to fiscal pressures given energy subsidy spending.

Figure 1: International financing costs increased sharply over the past quarter…
(yields, percent)



Source: JP Morgan

Figure 2: …while commodity prices, including for Indonesia's major export products, stayed under pressure
(US dollar price index, 2000 average=100)



Source: World Bank and staff calculations

The global growth backdrop is expected to continue improving, but the risks remain high amidst financial market volatility and the increase in external financing costs

The World Bank continues to expect a gradually improving global economic backdrop for Indonesia, whose major trading partners are expected to grow by 3.4 percent in 2013, picking up to 3.9 percent in 2014, supporting demand for Indonesia's exports. However, persistent, and often interrelated, risks to the international economic outlook remain, both on the upside and downside. Much depends on the continued positive trajectory of high income economies, the outlook for China, and the avoidance of significant dislocations in both high income and developing economies as international liquidity becomes less abundant. As financial markets continue to adjust to the implications of reduced monetary accommodation in the US, the volatility of portfolio investment, and level of financing costs, appears set to remain elevated, for Indonesia as for other EMEs.

2. Indonesia's economy is expected to continue decelerating into 2014

Economic growth has moderated so far in 2013 and this is expected to continue

As experienced by many other major EMEs, Indonesia's economy has slowed over 2013, weighed down by weaker investment momentum. Growth in the second quarter moderated to 5.8 percent, below 6.0 percent for the first time since 2010. The World Bank has lowered its projection for GDP growth in 2013 to 5.6 percent, down from the 5.9 percent projection in the July 2013 *IEQ,* and has also lowered the projection for growth in 2014 to 5.3 percent from 6.2 percent previously. The sizeable downgrade for 2014 reflects a more subdued outlook for domestic demand, as the economy adjusts to tighter financing conditions and lower commodity prices. While export prices, particularly for commodities, are expected to be weak, export volumes are expected to continue to stage a mild recovery as growth in advanced economies recovers. Import growth will likely remain relatively subdued, consistent with the outlook for domestic demand and the (lagged) effects of the Rupiah depreciation. Consequently, unlike in 2012, when net exports were a drag on growth, it is expected that net exports will add to growth over 2013 and 2014.

Domestic demand eased slightly in Q2…

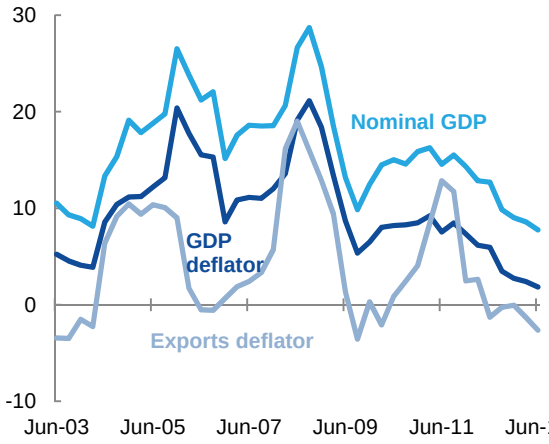
Indonesia's real GDP growth slowed in the second quarter of 2013, to 5.8 percent year-on-year (yoy) versus 6.0 percent in the first quarter. Quarter-on-quarter growth in seasonally adjusted terms of 1.4 percent was marginally higher than the first quarter result of 1.3 percent. On the expenditure side, a continued easing in investment growth was the key driver behind the yoy moderation, though there was also some contribution from consumption, with overall domestic demand growth slowing to 4.7 percent yoy, from 5.0 percent yoy in Q1. Partially offsetting the moderation in domestic demand has been net exports, which added to growth in the first half of 2013, as growth in export volumes has continued to improve, outpacing that of imports.

…and growth in nominal GDP remains subdued, consistent with lower terms of trade

More marked has been the continued decline in nominal GDP growth to 7.8 percent yoy in the second quarter, down from 8.6 percent in the first quarter and the lowest yoy growth rate in over thirteen years (Figure 3). This largely reflects a significant drop in the growth of the GDP deflator, broadly in line with the large fall in Indonesia's terms of trade since 2011 as global commodity prices have softened. The GDP deflator grew by a mere 0.3 percent qoq-sa and 1.8 percent yoy in the second quarter, well below consumer price inflation. With global commodity prices and also the nominal exchange rate not expected to strengthen appreciably in the base case, the terms of trade, GDP deflator and hence nominal GDP growth will likely remain subdued in the near-term. The negative terms of trade shock, the impact of which has been playing out through the economy since late 2011, will continue to have significant negative implications for profitability and income growth, particularly in commodity-related sectors and geographic areas.

Figure 3: Nominal GDP growth has decelerated sharply, in line with falling export prices

(yoy growth, percent)



Source: BPS; World Bank staff calculations

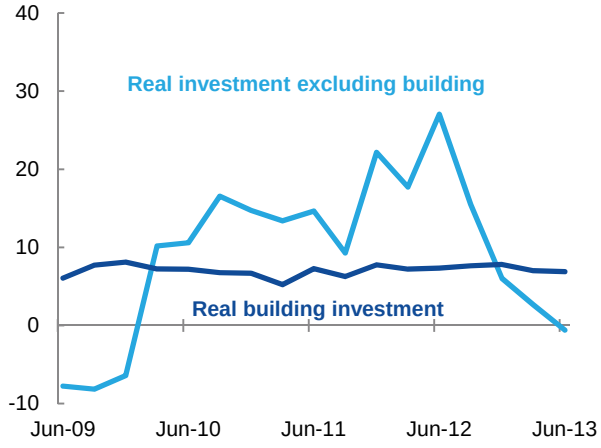
Investment growth continues to moderate, coinciding with the significant fall in commodity-related activity

Weaker investment growth has been a key driver behind the slowing in real GDP growth. In yoy terms, investment growth moderated to 4.7 percent in the quarter, down from 5.8 percent in Q1 and 12.5 percent a year ago (Q2 2012). There was some pickup in the quarterly growth rate (to 2.4 percent qoq-sa), though it is difficult to draw conclusions from quarterly movements in investment due to its lumpy nature. To date most of the weakness in investment growth has been due to investment in machinery and equipment and transportation (Figure 4), as reflected in drops in capital goods imports. This has coincided with a significant fall in commodity-related activity, particularly in nominal terms, putting downward pressure on export earnings and profitability, which has fed through into lower investment and production. In contrast, the growth in real building investment (85 percent of total investment) has remained solid but could come under additional pressure going forward.

…and investment is expected to weaken further, with the tightening in credit conditions expected to weigh on building investment

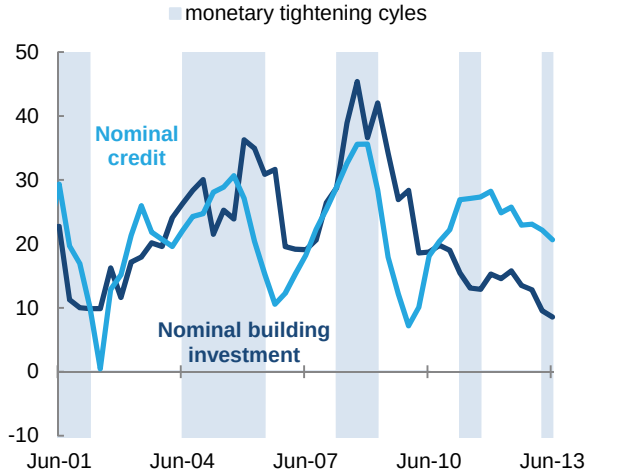
The outlook for investment has weakened since the July *IEQ*. The cost of a number of key inputs has increased significantly. The depreciation of the Rupiah has led to higher imported costs, for capital goods and fuel inputs, and minimum wages have seen sizeable increases. As discussed below, domestic financing conditions have tightened and, for commodity-related corporates, the scope for internal financing through retained earnings has been affected by the fall in commodity prices. Consistent with historical experience, tighter monetary policy is expected to dampen credit and investment, putting pressure on investment, including building-related investment (Figure 5). With historical experience suggesting that higher interest rates impact economic activity with a lag of a couple of quarters, the negative impact on activity, particularly investment, will mostly occur towards the end of 2013 and into 2014. Given the significant risks to investment, such as a further tightening in financing conditions but also regulatory changes or uncertainties, particularly as the political cycle intensifies ahead of national elections, Box 3 highlights the marked sensitivity of the outlook for GDP growth in 2014 to the trajectory of investment.

Figure 4: While building investment has continued to grow robustly, other investment spending has slowed sharply…
(growth in investment yoy, percent)



Source: BPS; World Bank staff calculations

Figure 5: …but tighter monetary policy is likely to weigh increasingly on building investment
(growth in nominal building investment and credit yoy, percent)



Notes: Monetary tightening cycles represent periods when benchmark interest rates increased (BI reference rate, 2005-13; 30-day SBI rate, 2001-2004)
Source: BPS; World Bank staff calculations

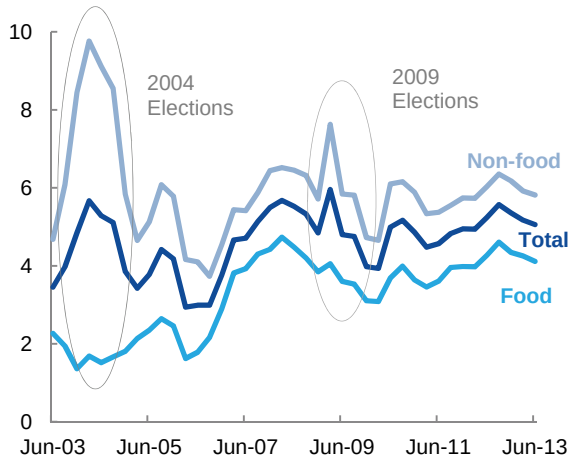
The outlook for private consumption growth has also weakened, as fuel prices have increased, food prices have remained high and consumer confidence has dipped

The outlook for consumption growth has also weakened. Growth in private consumption picked up slightly in Q2, increasing 5.1 percent yoy . The pickup in sequential terms (by 1.3 qoq-sa) reflected a strengthening in both food (up 1.0 percent qoq-sa) and non-food (up 1.5 percent qoq-sa) consumption, which had both been adversely impacted in Q1 by significant increases in food prices, many of which have since come down (see Section 5). Consumption growth is expected to moderate in the third quarter, with higher fuel prices and persistently high prices for a number of key food staples in the second and third quarter expected to adversely impact on consumer purchasing power. These developments have been weighing on consumer confidence, with the BI consumer confidence index dropping in July and August, retracing the gains it has made over the past 18 months. Higher interest rates, tighter credit conditions, lower confidence and, on the margin, wealth effects of the recent financial market turbulence will also impact on private consumption. Spending in the lead up to the 2014 Parliamentary and Presidential elections, however, should provide some positive offset for consumption growth in late 2013 and into 2014 (Figure 6).

Net exports are expected to add to growth in 2013 and 2014, after subtracting over much of 2012

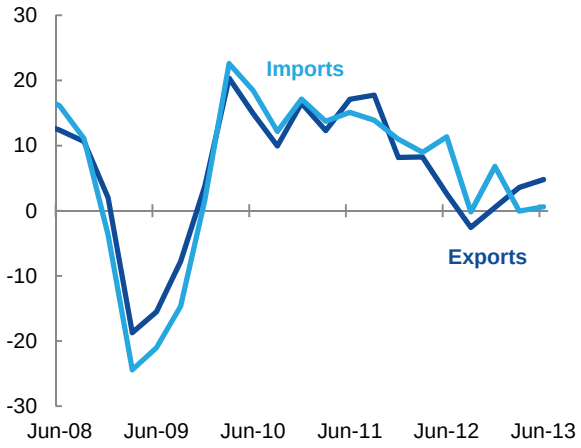
After subtracting from growth over much of 2012, net exports have added to yoy growth for the past two quarters, as export growth has outpaced import growth (Figure 7). Real export growth (as measured by the national accounts) was positive, if subdued, in the second quarter, up 0.8 percent qoq-sa and 4.8 percent yoy. Imports rebounded in the quarter, increasing 3.7 percent qoq-sa but were only 0.6 percent higher yoy in Q2. In the base case, net exports are expected to add to growth over 2013 and 2014 as export volumes are expected to stage a mild recovery, in line with firming demand from high income economies and import volumes are expected to remain subdued in line with domestic demand.

Figure 6: Recent history suggests a rise in consumption growth around national elections
(consumption growth yoy, percent)



Source: BPS; World Bank staff calculations

Figure 7: Export volumes have continued to recover, while imports have remained subdued
(export and import volume growth yoy, percent)



Source: BPS; World Bank staff calculations

On the production side, much of the moderation in growth has been driven by the industrial sectors, particularly mining and quarrying…

On the production side, the moderation in yoy growth in the second quarter was broad-based, with the agricultural and industrial sectors having the biggest impact on overall growth. Mining and quarrying activity remains weak, contracting by 1.2 percent yoy, with oil and gas down 4.7 percent yoy. Other industrial sectors generally performed robustly, such as manufacturing (up 5.8 percent yoy) and construction (up 6.9 percent yoy). The majority of the services sectors continued to perform well, with transport and communication up 11.5 percent yoy and trade, hotel & restaurants up 6.5 percent yoy, though down from over 10 percent growth in late 2011.

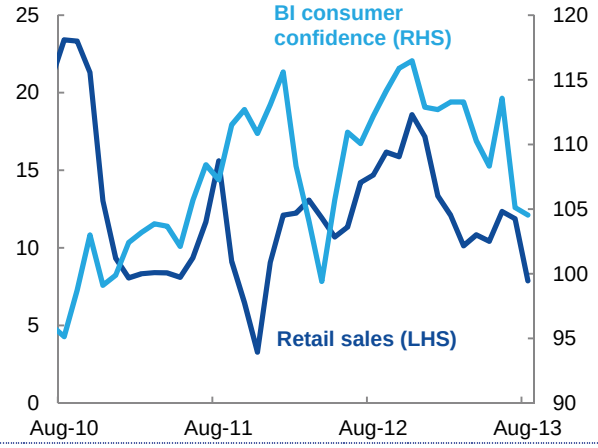
…and a further, broad-based moderation across sectors is anticipated in the base case…

The outlook is for weaker growth across most sectors as credit conditions tighten and global commodity prices remain subdued. The performance of non-commodity related manufacturing is likely to be mixed, with export-orientated sub-sectors supported by improving global growth and the depreciation in the Rupiah. However, with a number of Indonesia's manufacturing industries dependent on imported inputs, the weaker exchange rate will raise some input costs, likely dampening some activity.

…as pointed to by a number of high frequency economic activity indicators…

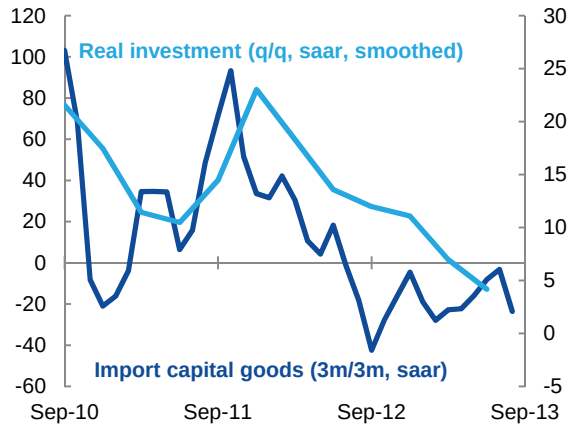
High frequency indicators for July and August suggest there will be a continued moderation in growth, though the Ramadan period complicates inference from these data. Consumption growth indicators are in line with a weakening in the third quarter, with consumer confidence well off recent highs, and motorcycle, car sales and retail sales also showing some weakness over July and August (Figure 8). Growth in industrial production remains subdued, at only 3.2 percent yoy in July. Cement sales, a key indicator of building investment, have also weakened. Monthly capital goods imports, an important component of investment, remained subdued through August in seasonally adjusted sequential terms (Figure 9).

Figure 8: High frequency data suggest consumer demand is softening…
(retail sales index, growth in 3-month moving average yoy, and BI consumer confidence index, 2010 average=100)



Source: BPS; World Bank staff calculations

Figure 9: …while capital imports remain subdued
(change versus previous period, seasonally-adjusted annualized rate, percent)



Source: BPS; World Bank staff calculations

GDP growth is forecast at 5.6 percent for 2013 and 5.3 percent for 2014

The World Bank's projection for GDP growth is 5.6 percent and 5.3 percent in 2013 and 2014, respectively (Figure 10). The sizeable downgrade in the 2014 projection, from 6.2 percent in the July *IEQ*, largely reflects a weaker outlook for domestic demand as the economy continues to adjust to a number of pressures. The adjustment that is needed in domestic demand will depend on how a number of factors play out and associated policy responses, as discussed further below.

Figure 10: Real GDP growth is expected to slow
(real GDP growth, percent)

Note: "sa" stands for seasonally adjusted
Source: BPS; World Bank staff calculations

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	5.0	5.1	3.9	5.6	4.8	0.1	-0.5
Private consumption expenditure	5.3	4.8	5.1	5.4	4.7	5.0	-0.1	-0.5
Government consumption	1.2	6.1	4.5	-3.3	10.1	4.1	1.7	-0.3
Gross fixed capital formation	9.8	5.3	4.9	7.3	4.9	4.9	0.9	-1.2
Exports of goods and services	2.0	5.6	5.7	0.5	6.1	6.7	-0.2	-0.4
Imports of goods and services	6.6	2.4	4.5	6.8	-0.1	4.9	1.4	-0.7
Gross Domestic Product	**6.2**	**5.6**	**5.3**	**6.1**	**5.2**	**5.5**	-0.2	-0.9
Agriculture	4.0	3.4	2.4	2.0	4.5	2.6	-0.8	-0.7
Industry	5.2	4.3	4.1	5.4	3.5	4.4	-0.2	-1.0
Services	7.7	7.3	7.0	7.6	6.7	7.0	-0.2	-1.0
2. External indicators								
Balance of payments (USD bn)	0.2	-15.4	-4.0	n/a	n/a	n/a	-10.6	-9.2
Current account bal. (USD bn)	-24.4	-29.2	-22.1	n/a	n/a	n/a	-4.0	0.1
Trade balance (USD bn)	-1.7	-7.9	-1.0	n/a	n/a	n/a	-2.9	-0.4
Financial account bal. (USD bn)	25.1	15.1	18.1	n/a	n/a	n/a	-5.4	-9.3
3. Other economic measures								
Consumer price index	4.3	7.3	6.7	4.3	9.8	4.4	0.1	0.0
Poverty basket Index	6.5	7.2	6.3	5.4	8.3	5.9	-0.2	-1.6
GDP deflator	4.6	2.6	4.2	2.7	3.3	4.7	-1.7	-2.0
Nominal GDP	11.0	8.4	9.7	9.0	8.6	10.4	-2.1	-3.1
4. Economic assumptions								
Exchange rate (IDR/USD)	9419	10400	11400	9630	11400	11400	650.0	1700.0
Indonesian crude price (USD/bl)	113	106	105	108	110	105	0.0	0.0
Major trading partner growth	3.4	3.4	3.9	3.1	4.0	4.0	0.0	-0.1

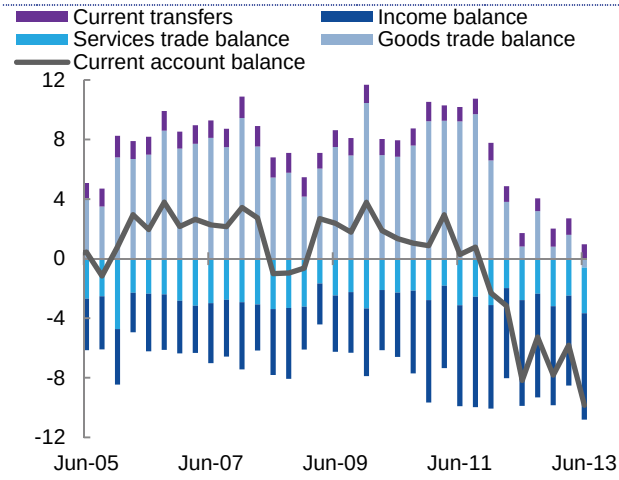
Note: Projected trade flows relate to the national accounts. Exchange rate is an assumption based on recent averages. Revisions are relative to projections in the July 2013 *IEQ*
Source: MoF; BPS; BI; CEIC; World Bank projections

3. Indonesia's current account deficit persists despite slowing imports

Indonesia's current account deficit widened to 4.4 percent of GDP in Q2 2013, pressured by seasonal factors and price effects, which dominated a recovery in export volumes

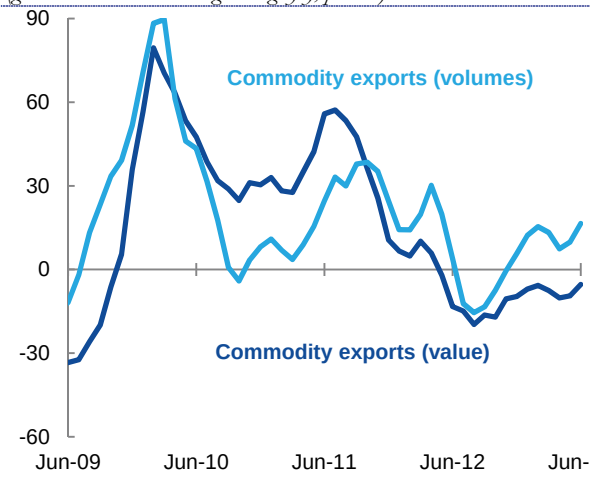
Despite the incipient signs of slower growth in the second quarter, Indonesia's current account deficit widened to USD 9.8 billion in Q2 (Figure 11), or 4.4 percent of GDP, compared with USD 5.8 billion (2.6 percent of GDP) in Q1. This is the largest quarterly deficit by value on record. The current account balance typically exhibits a seasonal deterioration in the second quarter, with import demand, and corporate debt servicing and profit-repatriation outflows in the income sub-account, tending to pick up. This year this seasonal weakening was amplified by the timing of Ramadan, which contributed to a strong rebound in non-oil and gas imports. In addition, ongoing weakness in the prices of Indonesia's major commodity exports offset a recovery in many of their volumes (Figure 12), pushing non-oil and gas goods export revenues down 4.9 percent yoy 3-month moving average (3mma) in August. The average of the 12 month commodity trade surplus has now declined from USD 5.5 billion in June 2011 to USD 3.4 billion in June 2013, according to BPS monthly trade data.

Figure 11: The current account deficit widened to USD 9.8 billion in Q2, as the goods balance fell into deficit…
(account balances, USD billion)



Source: BI

Figure 12: …as price falls suppressed commodity export revenues, despite improving volume growth
(growth in 3-month moving average yoy, percent)



Source: CEIC; World Bank staff calculations

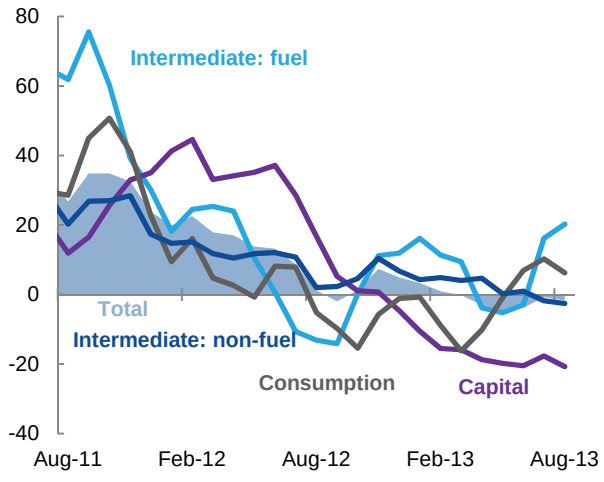
Import demand picked up ahead of Ramadan but, on a longer view, has moderated over 2013

Supported by pre-Ramadan demand, goods imports in July were just 0.8 percent down yoy in 3mma terms, but softened again in August to be down 1.7 percent yoy 3mma (Figure 13). Overall imports were supported by a sharp increase in imports of fuel, up 20.2 percent yoy 3mma in August, and consumption goods, up 6.3 percent yoy 3mma over the same period. Imports of non-fuel intermediate goods (about 52 percent of total imports), and particularly capital goods (about 18 percent of total imports), however, remain subdued.

The oil and gas trade deficit remains a particular challenge

Indonesia's monthly oil and gas trade balance has been in deficit since August 2012, and continues to be a major drag on the overall trade balance. The oil and gas trade deficit stood at USD 2.4 billion in Q2 (narrowing from USD 3.4 billion in Q1), and subsequently widened sharply to USD 1.9 billion in July alone (affected by seasonal factors as in August it narrowed to USD 0.9 billion). Domestic crude oil production continues to decline, with the crude oil balance entering into deficit, while limited onshore oil refining capacity has seen the processed oil trade deficit widen to USD 5.4 billion in Q2, albeit down from USD 6.2 billion in Q1, according to BPS.

Figure 13: Imports of consumer goods and fuels drove aggregate imports higher ahead of Ramadan
(3 month-moving-average import value growth yoy, percent)



Source: BPS; World Bank staff calculations

Figure 14: FDI flows are likely to be affected by weaker commodity revenues
(growth in 4-quarter moving average of inbound FDI yoy, percent, Indonesia export weighted commodity price index)

Source: CEIC; World Bank staff calculations

Indonesia continues to rely on portfolio and other investment inflows to finance the current account deficit…

Overall inflows on the capital and financial account of USD 8.2 billion were seen in Q2, an improvement from a deficit of USD 0.3 billion in Q1. These inflows were not sufficient to offset outflows on the current account, and reserves fell by USD 2.5 billion over the quarter. The deficit of Indonesia's basic balance, i.e. the sum of the current account and net direct investment inflows, has risen to USD 6.5 billion in Q2, up from USD 1.9 billion in Q4 2012. This places an increased reliance on financing from portfolio (USD 2.5 billion in Q2) and "other" investment (USD 2.3 billion) inflows. The portfolio investment inflows included USD 3.0 billion in global government bond issuance, offsetting significant net outflows from Indonesian domestic bonds and equities. The surplus in "Other" investment in Q2 represented a swing from a deficit of USD 7 billion in Q1, as a result of strong recorded deposit and currency inflows (USD 4.6 billion), partly reflecting seasonally strong foreign currency demand from bank customers to service external debts and repatriate profits, prompting banks to repatriate deposits onshore.

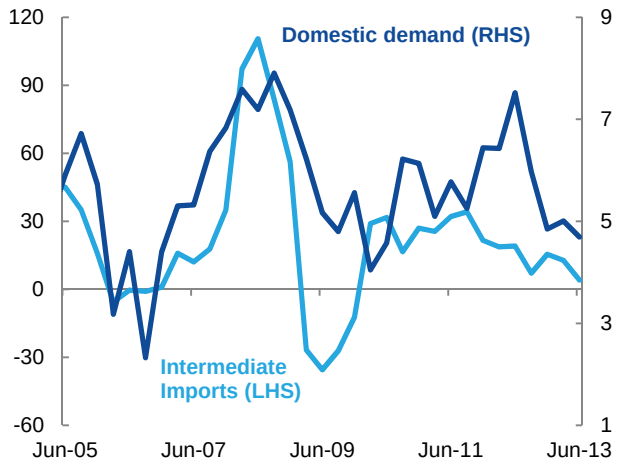
…while FDI inflows remain broadly stable

Net direct investment inflows of USD 3.3 billion in Q2 were down from USD 3.9 billion in Q1, on account of stronger outbound direct investment. Inbound direct investment inflows, as measured in the balance of payments, remained relatively stable at USD 4.2 billion (up slightly from USD 4.1 billion in Q1), but down on the average of just under USD 5 billion seen over 2011 and 2012, during which inflows moved up rapidly. Despite the growing sectoral diversification of inbound FDI, with manufacturing accounting for almost half of total FDI inflows in Q2, overall inbound FDI flows remain closely correlated with movements in global commodity prices, likely reflecting the channeling of commodity-related revenues into investments in other economic sectors in Indonesia (Figure 14). As a result, weaker global commodity prices, along with policy and political uncertainty in the run-up to the 2014 elections, pose risks to the outlook for FDI inflows.

Economic developments and recent policy adjustments are supportive of a modest narrowing of the current account deficit…

As growth continues to moderate through 2014, slowing imports will support a modest narrowing in the current account, especially intermediate and capital goods imports, which have moved down in line with the deceleration of investment already seen since mid-2012 (Figure 15). As highlighted above, fuel imports continue to weigh on the trade balance. The increase in subsidized fuel prices in June may provide some modest relief by dampening fuel import demand, hence narrowing the current account deficit by around 0.1 to 0.2 percentage points of GDP (based on estimates in the July 2013 *IEQ*). The recent sharp nominal depreciation in the Rupiah – down 20 percent so far this year – will also provide some support to the trade balance by increasing Indonesia's external competitiveness (though in trade-weighted terms the depreciation has been more modest, as shown in Section 4, below). Finally, export revenues are projected to pick up on the back of strengthening major trading partner growth, together with a stabilization of commodity export prices into 2014.

Figure 15: Import demand is expected to continue to slow in line with slower domestic demand growth into 2014
(intermediate import and domestic demand growth yoy, percent)



Note: Intermediate imports in Rupiah terms
Source: BPS; World Bank staff calculations

…but gross financing needs more broadly remain substantial and external financing conditions have tightened

Indonesia's gross external financing needs are substantial, and those arising from the servicing and repayment of external debt are considerably larger than those generated by the current account deficit. Gross external debt repayments in Q2 totaled USD 43.1 billion, while, as discussed above, the quarterly current account deficit stood at USD 9.8 billion (Figure 16). Tighter external financing conditions and Rupiah depreciation make for a more costly and challenging environment for refinancing existing external debt, over half of which (or 15 percent of GDP) now consists of private external debt. This is particularly the case for corporates without access to natural currency hedges (through US Dollar revenues) and those heavily exposed to the recent weakening in global commodity prices. Official reserves remain more than sufficient to cover Indonesia's short-term external financing needs, although the ratio of short-term external debt to official reserves has risen to around 50 percent, from 40 percent at end-2011. However, more importantly, external liquidity risks have risen, with the debt service ratio rising to 80 percent in June 2013, from around 30 percent in mid-2011. Bank Indonesia projects that repayments of external debt excluding trade finance, revolving loans and currency and deposits will total USD 32.6 billion over August to December 2013, of which USD 28.8 billion is private debt, with a further USD 33.4 billion in gross repayments expected in January-July 2014.[1]

The CAD is projected to be 3.4 percent in 2013 and 2.6 percent in 2014…

Overall, the World Bank projects a current account deficit of USD 29 billion in 2013, or 3.4 percent of GDP, wider than the deficit of 2.8 percent of GDP in 2012. In 2014, the current account deficit is expected to narrow to 2.6 percent of GDP, as the anticipated slowdown in economic activity into 2014 dampens import demand, while recent Rupiah depreciation and a pick-up in growth among Indonesia's major trading partners provide some support to exports.

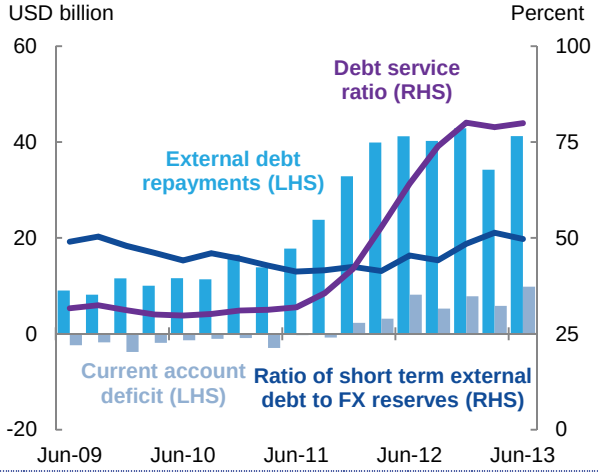
[1] Calculated by Bank Indonesia based on gross external debt outstanding in July 2013, excluding trade finance, revolving loans and currency and deposits.. See *External Debt Statistics of Indonesia*, Table 1.9.

…assuming that a significant external financing difficulty can be avoided…

As always, current account balance projections are sensitive to the trajectory of domestic demand and of non-oil commodity prices (for exports) and international fuel costs (for imports). At the present time of heightened concern over the external financing requirements of major EMEs, including Indonesia, however, an additional assumption underpinning the above baseline projection is that the adjustment process to tighter external financing conditions remains orderly. This assumption depends crucially upon the path of domestic and international policies and their interrelationship with investor confidence. Some policy changes to support foreign investment and trade competitiveness can be put in place in the short term (see Sections B.1 and B.2). However, other improvements in competitiveness are likely to take longer, including addressing the costs and bottlenecks caused by Indonesia's infrastructure gap (see Section C.1). In the near-term, therefore, much focus will remain on the adjustment of import demand, both through expenditure switching (as Rupiah depreciation lifts import prices) and compression (as monetary and credit conditions tighten and more expensive imports discourage discretionary expenditure on goods with few or imperfect domestic substitutes in the short-run). Moderating domestic demand can play a role in easing balance of payments pressures, making policy coordination and communication paramount, particularly against the backdrop of an intensifying political cycle, as discussed further in Section 7, below.

Figure 16: Gross external financing needs are substantial and liquidity risks have risen…

(USD billion, percent)



Note: Repayments of all external debt, excluding only domestic securities, currency and deposits owned by non-residents, and other liabilities to non-residents

Source: BI; World Bank staff calculations

Table 3: …with investment inflows key to the overall BOP outlook as the CAD is likely to narrow only gradually

(USD billion)

	2011	2012	2013p	2014p
Overall Balance of Payments	**11.9**	**0.2**	**-15.4**	**-4.0**
Current Account	1.7	-24.4	-29.2	-22.1
Trade	*24.2*	*-1.7*	*-7.9*	*-1.0*
Income	*-26.7*	*-26.7*	*-25.6*	*-25.4*
Transfers	*4.2*	*4.0*	*4.3*	*4.3*
Capital & Financial Accounts	13.6	25.1	15.1	18.1
Direct Inv.	*11.5*	*14.0*	*14.1*	*12.3*
Portfolio Inv.	*3.8*	*9.2*	*4.0*	*6.5*
Other Inv.	*-1.8*	*1.9*	*-3.0*	*-0.7*
Reserves	**110.1**	**112.8**	**91.8**	**87.8**

Source: World Bank staff projections

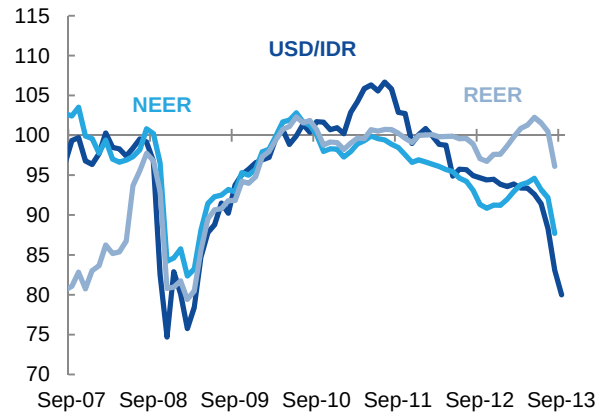
4. The currency has weakened and financing conditions are tightening

Indonesian financial markets experienced a turbulent third quarter

As noted earlier, as in many other EMEs, Indonesia's financial markets experienced another volatile quarter, reacting strongly to changes in global risk appetite, as well as domestic economic and policy developments. Amidst a global sell-off in emerging market assets, Indonesian equities fell by 8.6 percent over 19-20 August alone. After subsequent fluctuations (with gains following the postponement in "tapering" and helped by a significant number of company share buy-backs, followed by renewed weakness at the end of September), the index ended the quarter down 10.4 percent, to be unchanged for the year to date (reflecting previous strong gains in the index through May). Foreign investors were net sellers of a sizable IDR 8.5 trillion (approximately USD 800 million) in stocks over the quarter. Meanwhile the five-year Rupiah-denominated government bond yield increased by 180 basis points from the start of the quarter to reach 8.24 percent on September 11, before retracing 40 basis points to end the quarter at 7.85 percent. Looking through the volatility in financial asset prices, the most pronounced trends in the financial sector have been the depreciation in the Rupiah and the tightening in domestic and external financing conditions.

Figure 17: The Rupiah has depreciated significantly in nominal but not real terms since 2011…

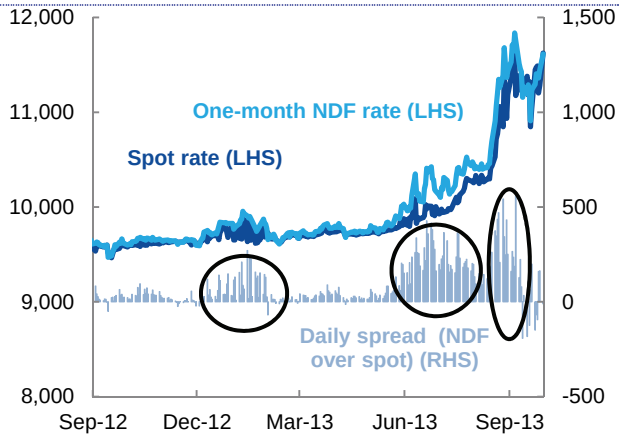
(nominal effective exchange rate, real effective exchange rate, and bilateral US Dollar exchange rate, index, 2010 average=100)



Note: Figures to end-August 2013
Source: World Bank staff calculations based on data from IMF (IFS) and JP Morgan

Figure 18: …with bouts of significant US Dollar illiquidity, as indicated by spreads between onshore and offshore rates

(IDR per USD; IDR per USD spread; percent)



Note: IDR spot rate figures from Bloomberg to 30 September 2013
Source: Bloomberg; World Bank staff calculations

The Rupiah has continued to depreciate, and there has been tightness in onshore dollar liquidity

Following the abrupt moves of mid- to late-August, the Rupiah has continued to depreciate in September, down to IDR 11,593 per US Dollar at the end of Q3, and has now depreciated by 20 percent since the end of 2012, to its weakest level since early 2009. However, despite the sizeable nominal depreciation in the Rupiah between May and August, Indonesia's real effective (trade-weighted) exchange rate as of August was down only 4 percent from its 2010 average (Figure 17), reflecting nominal falls against the US dollar of the currencies of some of Indonesia's major trading partners and the rise in domestic inflation. The nominal adjustment has created challenges for the currency market, and for firms managing external liabilities. Dollar liquidity tightened significantly in early July, and again in mid- to late-August (Figure 18). Bank Indonesia has been managing the pace of adjustment in the Rupiah, with official reserves declining to USD 93 billion as of end-August 2013, equivalent to five months imports and government debt servicing needs, and down from USD 112.8 billion at end-2012. Bank Indonesia has also now taken a number of steps to support greater liquidity in onshore foreign exchange markets, including relaxing US Dollar purchase rules for exporters, extending the maturity of its USD term deposit facility to up to 12 months, and conducting US Dollar swap auctions to reduce spot US Dollar demand by facilitating commercial hedging against currency risks.

Monetary policy has been tightened significantly, through rate increases…

Since June the monetary policy stance has shifted markedly towards tightening, displaying a focus on facilitating the adjustment in external balances and limiting inflationary pressures. Pre-empting the increase in subsidized fuel prices, and with pressure on the Rupiah intensifying since May, BI surprised markets on June 11 by increasing its overnight deposit facility (FASBI) rate by 25 basis points, followed by a 25 basis point increase in its reference rate at its subsequent June policy meeting. This was followed by a 50 basis point increase in these key policy rates in July. Policy rates were left unchanged at the scheduled Board of Governors meeting in August, though some new macro-prudential measures were announced. Following the release of weak second quarter balance of payments statistics and intensifying pressure on the Rupiah, the FASBI and reference rates were lifted by a further 50 basis points at an extraordinary policy meeting held on August 29 (in addition, the upper bound of the interest rate corridor, the BI lending facility rate, was also increased by 25 basis points). This was followed by a further 25 basis point increase in the FASBI, reference and lending facility rates at the scheduled meeting on September 12. Thus, since June, BI has raised its overnight deposit facility and reference rates by 150 basis points (to 5.5 and 7.25 percent, respectively), and its key lending rate by 50 basis points (to 7.25 percent).

…and macro-prudential measures

A number of macro-prudential measures with a tightening bias have also been taken, with the upper band of the loan-to-deposit ratio target having been lowered from 100 to 92 percent alongside more stringent loan-to-valuation ratios for residential mortgages, while the secondary reserve requirement ratio is set to be raised to 4 percent (from 2.5 percent) by December. BI has also taken a number of steps to facilitate liquidity management: allowing both government bonds and BI certificates of deposit to be counted against banks' secondary reserve requirements, and introducing shorter tenor BI deposit securities.

Bank credit growth is slowing, while aggregate banking sector health indicators remain sound

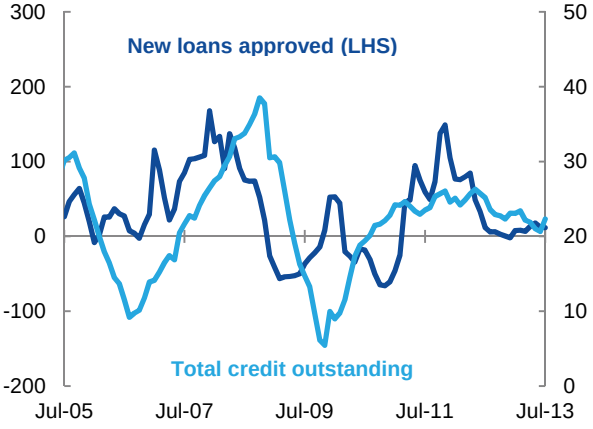
In additional to the recent rises in the cost of borrowing, there are signs of a slowing in the credit cycle, in line with the softening in economic growth and BI's macro-prudential policy measures. Real (ex post) yoy credit growth slowed to 13 percent yoy to July, its weakest pace since May 2010, in part reflecting temporarily higher inflation following the June increase in fuel prices. In nominal terms, aggregate credit growth has been broadly stable at 22 percent yoy to July, up slightly from 21 percent in June, with investment lending growth steady at 34 percent to July, up from 23 percent in May. Working capital loan growth has come down to 19 percent yoy in July, from around 24 percent yoy in early 2013, and consumption lending growth has been stable at around 20 percent yoy. Aggregate banking sector indicators remain stable, with non-performing loans remaining below 2 per cent, while Indonesian bank profitability has remained high. However, despite this performance to date, the banking sector could still face pressures on margins and credit quality from further decelerating growth or additional financial market volatility in upcoming months.

New loan approvals signal a turning in the credit cycle in response to recent monetary policy tightening…

Indeed, credit growth is expected to ease further, as signaled by weakening growth in new loan approvals, which tend to lead lending growth (Figure 19). Growth in the supply of funds for lending is slowing as deposit growth has come down. Meanwhile deposit rates have picked up since June, as have headline rupiah lending rates for working capital and investment loans, while rates for consumption lending have continued their steady decline over recent years. Higher rates and slower deposit growth are likely to weigh particularly on lending activity smaller banks, while larger banks are expected to be comparatively less affected, especially those with greater access to current and savings account deposits. As part of the macro-prudential measures mentioned above, BI reduced the upper bound of its target for a bank's loan-to-deposit ratio from 100 to 92 percent, and increased the secondary minimum reserve requirement for rupiah deposits to 4 percent, from 2.5 percent. [2] Aggregate deposit growth slowed to 14 percent to July, in line with further weakening in nominal GDP growth to 7.8 percent in the year to June, resulting in a rise in the overall bank loan-to-deposit ratio to 88.7 percent in July, up from 83.6 percent at end-2012 (Figure 20).

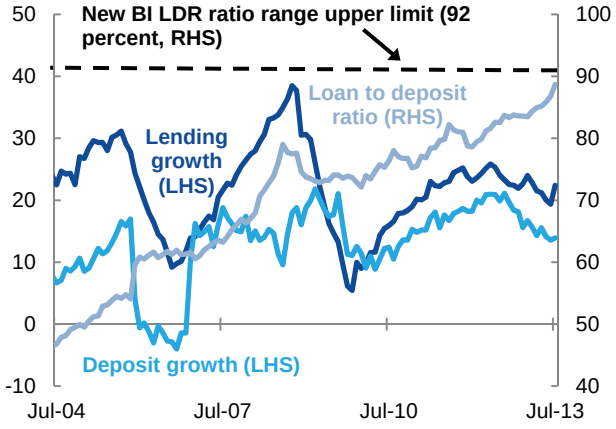
[2] Banks with loan-to-deposit ratios above the upper limit of the range, and a capital adequacy ratio below 14 percent, will have to place additional reserves with Bank Indonesia.

Figure 19: Weak new loan approvals point to a further slowing in bank credit growth going forward…
(3 month moving average yoy growth in new loan approvals, yoy credit growth; percent)



Source: CEIC; World Bank staff calculations.

Figure 20: …while slowing deposit growth will also weigh on lending activity
(yoy growth in bank lending and deposits; banking sector loan-to-deposit ratio; percent, ratio)



Source: CEIC and World Bank staff calculations.

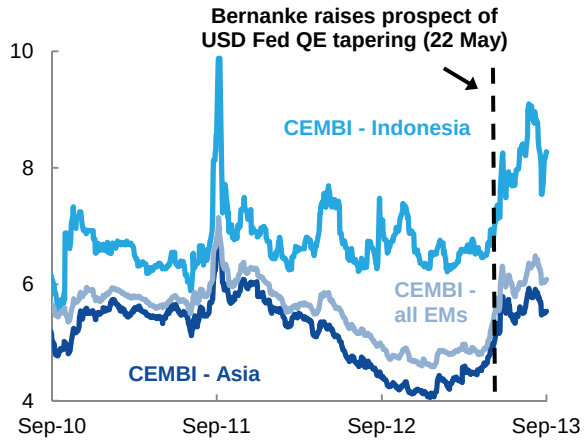
…which is likely to weigh on growth…

A tightening availability of credit and higher domestic financing costs can be expected to weigh on domestic economic activity going forward, and especially investment. At the same time, the projected moderation in growth may well reduce the demand for credit, with Bank Indonesia reducing its 2013 target for lending growth to 18 percent. Historical correlations suggest that a 4 to 5 percentage point fall in nominal bank credit growth is associated with a 1 percentage point decline in real economic growth. Overall, nominal credit growth is expected to ease to around 15 percent yoy in coming quarters, from 22 percent in July.

…particularly investment, with a notable tightening in financing conditions for Indonesian corporates

Beyond bank credit, access to other forms of financing has also tightened. Corporate bonds are emerging as an alternative source of financing to bank lending, although they still account for only 6 percent of total Indonesian financial assets as of end-2011, which remain dominated by banking assets (75 percent). Growth in onshore corporate bond issuance has slowed to 5 percent quarter-on-quarter 4qma to September from 50 percent to March.[3] Secondary market yields on Indonesian USD corporate bonds also point to sharply higher offshore USD corporate funding costs, with benchmark yields rising by around 170 basis points since early May (Figure 21).[4]

Figure 21: Indonesian corporates face rising financing costs offshore
(yield to maturity, percent)



Note: data to 30 September 2013
Source: JP Morgan

[3] Calculated as a four quarter moving average (4qma) based on issuance data for Q3 to September 29.
[4] Of the USD 15 billion in USD corporate bonds on issue at end 2012, the mining sector accounted for 71 percent, followed by infrastructure (14 percent), and finance (7 percent).

Residential property price growth stabilized in Q2 but remains elevated in some market segments

Indonesian nationwide residential property price growth eased slightly in Q2, to 10.7 percent yoy in June, down from a record pace of 11.2 percent yoy in March. Smaller homes (with floorspace of less than 36 square meters) continue to exhibit the strongest price growth, up 16 percent yoy to June, and remain exempt from BI's more stringent loan-to-value requirements for residential mortgages for first home buyers. Commercial property also showed continued robust price growth, growth rates in the selling prices of residential apartments and industrial land, and of office space rentals, all remained above 25 percent on a yoy basis to June 2013 across the greater Jakarta (Jabodetabek) region. As noted in the March 2013 IEQ, such robust property price growth merits ongoing monitoring. However, property sector activity and price growth may well be impacted by tighter financing conditions, with bank lending for residential mortgages easing to 17.3 percent yoy in July, the announcement of further macro-prudential measures by BI to contain credit risks in the property sector[5], as well as slower nominal GDP growth.

[5] Bank Indonesia announced it will tighten loan-to-value ratio limits for secondary and subsequent mortgages (including for smaller homes), and expand their coverage to home offices, home shops and property-backed consumption, from 30 September 2013. Further, loan funds will only be disbursed only once the property has been constructed. Loan-to-valuation ratio requirements will remain unchanged for first home buyers at between 70 to 80 percent (depending on the size and type of property).

5. Inflation has picked up on higher fuel prices

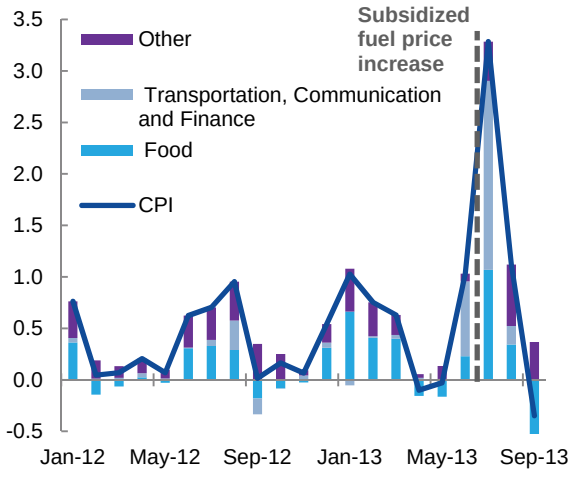
Headline yoy inflation increased to 8 percent at the beginning of the third quarter on the back of increased fuel and food prices

Inflation dynamics over the third quarter were dominated by the effect of fuel subsidy reform and the seasonal impact of Ramadan. The Government's move to increase the subsidized diesel price by IDR 1,000 per liter and the petrol price by IDR 2,000 per liter on 22 June has led to a sharp rise in headline inflation, pushing up year-on-year inflation for the next four quarters. Month-on-month inflation, however, is expected to stabilize relatively quickly, in line with past episodes of fuel price reform, with Bank Indonesia's recent rate hikes and the ongoing tightening of credit conditions helping to dampen the feed-through into second-round effects and inflationary expectations. The combination of the residual effects of trade restrictions introduced in October 2012 and the rise in demand over Ramadan period caused food price inflation to pick up, with chili, onion and garlic being particularly impacted. Trade restrictions have been at least partially unwound, and food prices now appear to be on a downward trend.

Higher subsidized fuel prices are estimated to have contributed close to half of mom inflation in July…

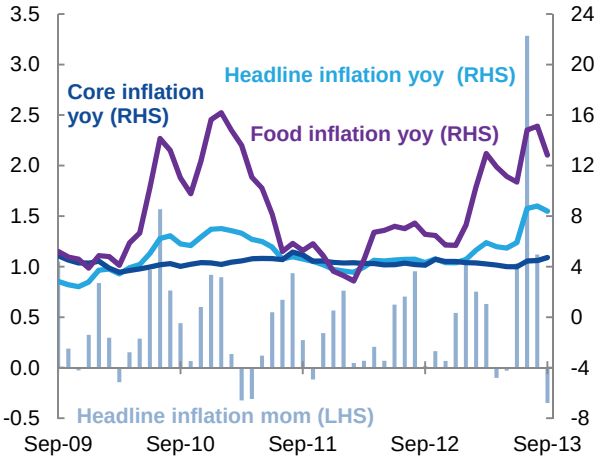
Increased fuel prices likely contributed just over half of the 3.3 percent month-on-month rise in headline CPI in July (Figure 22). As a result, headline inflation has moved to 8.6 percent yoy in July, from 5.9 percent in June, and edged up further to 8.8 percent in August, before declining somewhat to 8.4 percent in September (Figure 23). Core consumer prices have picked up slightly, to 4.5 percent yoy in August, and to 4.7 percent in September. During previous fuel price increases in October 2005 and June 2008, core consumer price increases quickly reverted to their levels prior to the reforms (Figure 24). Changes in core inflation, however, have to be monitored on a longer term horizon, as higher fuel prices may feed with a lag into higher input costs. The fact that subsidized fuel prices remain well below international prices also means that higher prices are currently being artificially suppressed by the subsidy regime.

Figure 22: Inflation rose sharply at the beginning of Q3 driven by food and fuel prices…
(inflation, month on month, percent)



Source: BPS; World Bank staff calculations

Figure 23: …causing a small uptick in core inflation
(inflation, percent)

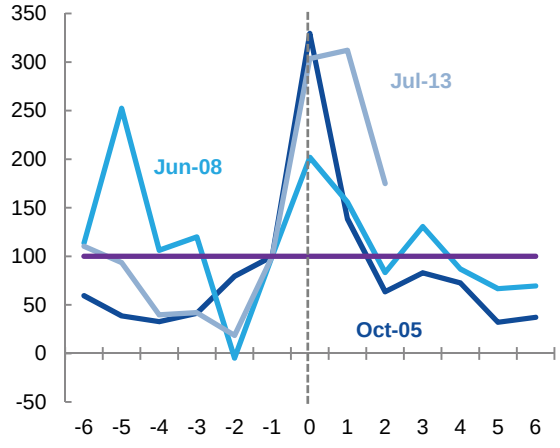


Source: BPS; World Bank staff calculations

… and food prices an additional one-third

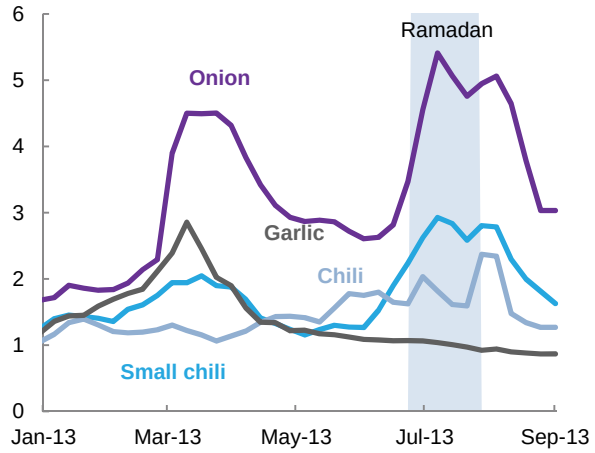
Along with fuel, prices of selected food items also spiked in the second quarter of 2013, following the introduction of the Food Law, which was passed in October 2012 (Figure 25). A number of trade restrictions linked to the Food Law have now been reversed, including beef quotas now being replaced by a switching tariff depending on domestic prices, setting prices on a downward path. The Ramadan period in July-August, however, also had the usual, upward impact on prices. Increased food prices – with some items up two- to five-fold from their levels in October 2012 – contributed 1.1 percentage points to month-on-month (mom) inflation in July. Prices for these food items appear now to be on a downward path, indicating welcome relief from inflationary pressures from this source.

Figure 24: Core inflation normalized rapidly after the subsidized fuel price increases in 2005 and 2008
(prices, index where 100=core CPI mom at month -1, months from the price increase)



Source: CEIC; World Bank staff calculations

Figure 25: The prices of certain foods spiked due to trade restrictions and Ramadan…
(prices, index, 1 = October 2013)



Source: BPS; World Bank staff calculations

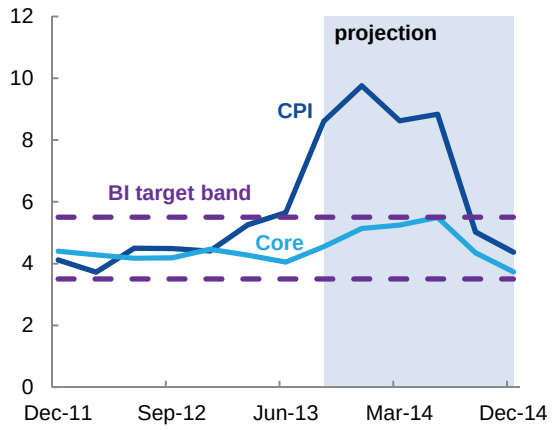
Further inflationary pressures could come from the second round effects of the fuel price increase, the recent weakening of the Rupiah, and minimum wage rises for 2014 …

The recent depreciation of the Rupiah poses risks to inflation in the short run, by driving up the cost of imports. Depreciation in the second quarter likely contributed up to 0.5 percentage points to headline CPI. In principle, the effect of the currency depreciation on inflation is likely to be non-linear, increasing in the short run as increased import prices feed into the CPI basket, and decreasing thereafter as the price shock drops out of the base. In light of this, further inflationary pressures are to be expected from the recent depreciation, and the movement of the exchange rate is one of the main risks to the baseline inflation outlook. Additional supply-side risks to inflation are also to the upside, notably from potential further increases in minimum wages for 2014 (following the large increases granted for 2013), and the possibility of second- and third round effects from the reduction in the fuel subsidy.

… although the baseline projection is for a decline in inflation over the forecast horizon

Notwithstanding the above risks, the baseline outlook is for inflation to remain well anchored, consistent with a general slow-down in aggregate demand growth. The World Bank anticipates price disinflation in month-on-month terms over the next 3-6 months, with inflation projected to stay in the 8-10 percent band through the second quarter of 2014. Subsequently, when the subsidized fuel price hike drops out of the base, inflation is projected to return to within Bank Indonesia's target band (Figure 26). Core inflation is expected to rise on the back of moderate second-round effects of higher fuel prices and imported inflation, and then revert to lower levels, consistent with the lower growth outlook and unwinding of the second round effects of the fuel price hike.

Figure 26: Inflation is projected to peak in year-on-year terms in Q4
(inflation, percent)



Source: CEIC; World Bank staff calculations

6. The fiscal risks from energy subsidy costs are to the fore again

The fiscal deficit through August was notably higher than in the same period in 2012…

The ongoing slowdown in nominal GDP growth, subdued international commodity prices, and nominal depreciation of the Rupiah, are impacting Indonesia's fiscal sector. During the January-August 2013 period, an overall deficit of IDR 101 trillion was recorded, versus a deficit of IDR 35 trillion in the same period last year (Table 4). Revenue collection growth has slowed, recording the lowest yoy growth since 2009. Realized expenditure growth has also come down, but overall disbursement rates have shown some improvement.

…due to a broad-based reduction in revenue collection…

The first eight months of 2013 saw a broad-based moderation in yoy growth of revenue collection, which reached 56 percent of its 2013 target in January-August. In particular, non-oil and gas income taxes, which represent the bulk of income taxes (around 86 percent) and just under one-third of total revenues, recorded a noticeable slowdown in yoy growth (6 percent relative to a 14 percent average growth for the corresponding periods of 2010-2012). Value-added tax (VAT) collections growth has also slowed (to 13 percent relative to a 22 percent average for the corresponding period of 2010-2012). International taxes, particularly exports duties, actually contracted by 13 percent yoy, on the back of lower commodity prices which also affected non-tax revenues, both from the oil and gas and other resource sectors. Overall non-tax revenues in the first eight months of 2013 grew by only 3 percent yoy compared to a 19 percent average for the corresponding periods of 2010-2012.

… whereas Budget execution performance has slightly improved…

By the end of August, about IDR 946 trillion, or 55 percent of total annual budgeted expenditure in the revised 2013 Budget, had been spent, just above the corresponding level of 54 percent in 2012. Spending growth in the first eight months of 2013 reached 14 percent yoy, down from 23 percent in 2012. Energy subsidy spending accounted for just over 30 percent of spending excluding transfers, reaching 65 percent of the revised 2013 Budget allocation. Capital spending appears to have gained some traction, growing by 18 percent relative to the corresponding period last year. However, disbursements remain back-loaded, with only 32 percent of allocated capital spending for the full year realized in the first eight months, although this was an improvement on the equivalent level of 29 percent in 2012.

…though the *bintang* challenge remains…

As of end-June 2013, the Ministry of Finance reported that IDR 32 trillion of line ministries' budgets (5 percent of total) was still on hold (such that the budget warrants are allocated a star or *bintang*), declining from the level at the end of April 2013 of IDR 87 trillion (or 15 percent of line ministries' total budgets).[6] These conditional approvals, which have tended to significantly impede disbursements, are due to activities requiring Parliamentary approval, incomplete supporting documents such as terms of reference (TORs), detailed costing, and Spending Responsibility Letters.

…and some new policies and regulations have been introduced to address budget execution challenges

To address a number of impediments to budget execution the Government has recently taken steps to improve the regulatory environment. In particular, a new Government regulation (PP 45/2013) has been issued that eliminates the requirement to reappoint spending unit (Satker) officials each year. This measure will allow the Satkers to function from the beginning of the fiscal year, thereby accelerating spending; introduces commitment controls which, alongside other benefits, will help the Ministry of Finance to monitor the amounts committed by line ministries and take early action where there are delays in implementation; allows advance procurement before the start of the fiscal year, allowing contracts to be signed earlier in the fiscal year; and provides a legal basis for the carryover of the budget to the next year for national priority activities and multiyear contracts.

The Ministry of Finance (MoF) has also issued a new ministerial regulation (PMK 94/2013) which includes measures to streamline budget execution. The regulation, which sets out how the budget documents are prepared and reviewed, includes provisions to: eliminate the use of budget blocks (*bintang*), with line ministries now being given responsibility for addressing

[6] http://www.anggaran.depkeu.go.id/dja/acontent/Perkemb_blokir_24%20Juni%202013_1A.pdf

any conditions attached to a budget item without the need to submit documents to the Ministry of Finance for prior clearance; and involve the line ministries' internal audit unit as verifiers of the budget document prior to its release (while the role of the internal auditors is still being resolved, the intention is that they will not create a new cause of delay in budget management). The new regulations are a positive step, but the extent to which they prove effective will depend on dissemination and implementation progress.

Table 4: Moderate revenue collection was the standout feature of the Jan – Aug 2013 period, relative to previous years
(IDR trillion, unless otherwise indicated)

	Nominal Value (Jan - Aug) (IDR trillion)				Share (Jan - Aug) of Revised Annual Budget (Percent)				Nominal Growth YoY (Percent)			
	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013
A. Revenues	**603**	**719**	**798**	**845**	**60.8**	**61.4**	**51.1**	**56.3**	**21.0**	**19.2**	**11.0**	**5.9**
1. Tax Revenues o/w	448	535	615	657	60.3	60.9	52.5	57.2	15.6	19.5	14.9	6.9
Income (O&G)	34	41	51	50	61.2	62.7	64.0	66.8	-2.5	20.7	25.8	-3.5
Income (N-O&G)	197	232	256	272	64.1	63.4	51.0	58.5	13.7	18.1	10.1	6.3
Sales Tax (VAT)	137	157	204	230	51.9	52.7	52.1	54.3	20.9	15.2	29.9	12.6
Excises	43	49	62	72	73.3	72.3	63.8	68.8	18.6	13.3	26.2	16.0
Int'l Trade Taxes	16	37	33	29	71.0	79.1	59.8	59.8	31.3	131.8	-10.4	-13.0
2. Non-Tax Rev.	155	182	181	186	62.5	63.5	46.6	53.4	39.7	17.7	-0.4	2.8
NTR (O&G)	83	106	92	91	54.4	61.3	40.2	50.6	55.4	28.7	-13.2	-0.9
NTR (N-O&G)	12	14	15	16	94.5	73.7	67.1	69.2	32.6	12.7	9.4	5.5
A. Expenditures	**557**	**678**	**833**	**946**	**49.4**	**51.3**	**53.8**	**54.8**	**7.1**	**21.8**	**22.9**	**13.6**
1. Central Gov't, o/w	348	432	533	616	44.6	47.5	49.8	51.4	4.7	23.9	23.4	15.6
Personnel	98	125	137	153	60.1	68.5	64.7	65.5	8.8	28.2	9.6	11.2
Material	45	52	63	70	40.0	36.6	38.8	34.6	21.8	16.1	20.4	11.3
Capital	27	37	51	61	28.7	26.1	29.1	32.2	-11.1	35.3	39.3	18.0
Interest Payments	58	63	66	73	54.8	58.9	56.3	64.8	-9.7	8.3	5.7	9.9
Subsidies	87	128	170	213	43.0	54.1	69.2	61.1	48.9	48.3	32.2	25.4
Energy	73	114	155	195	50.9	58.3	76.5	64.9	69.4	55.5	35.8	25.8
Fuel	43	84	106	132	47.9	64.6	77.3	66.2	167.5	96.8	26.7	24.7
Electricity	31	30	48	62	55.6	45.9	74.6	62.2	12.3	-1.8	61.0	28.2
Social	31	24	42	46	44.0	29.5	49.1	56.7	-6.2	-22.9	74.6	8.2
2. Transfers	208	246	300	330	60.4	59.7	62.7	62.4	11.2	18.2	21.9	10.0

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

Box 1: An update on unconditional cash transfers and the poverty rate

Following the increase in subsidized fuel prices on June 22, temporary unconditional cash transfers (*Bantuan Langsung Sementara Masyarakat*, BLSM) have been distributed to 15.5 million households by the state owned post office (PT POS) using Social Protection Cards (*Kartu Perlindungan Social*, KPS). As described in the July *IEQ*, the BLSM is one of the four compensation packages implemented by the Government to mitigate the impact of higher fuel prices to poor and vulnerable households. The other three programs include the expansion of conditional cash transfers (*Program Keluarga Harapan*, PKH) and scholarships (*Bantuan untuk Siswa Miskin,* BSM), and the temporary increase of rice for the poor (*Beras Miskin*, Raskin). According to PT POS, 94 percent of the IDR 4.7 trillion allocation of the first phase has been disbursed. The undisbursed 6 percent is due mainly to difficulties in locating targeted beneficiaries. The second phase, which commenced on September 2 has reached 94 percent of the allocation (as of 1 October), indicating relatively smooth distribution. In order to correct any inaccuracies in the beneficiary lists, the Government has increased flexibility by allowing communities at the village level to verify and revise beneficiary lists through community meetings.

Turning to the broader picture on poverty, on July 1, Statistics Indonesia (*Badan Pusat Statistik*, BPS) announced that the national poverty rate for March 2013 was 11.4 percent. This represents a 0.6 percentage point decline from the 12.0 percent level in March 2012. The rural poverty rate (14.3 percent) remains nearly double that of urban poverty (8.4 percent), but continues to decrease faster, down from 15.1 percent and 8.8 percent the previous year, respectively. The national average poverty line was increased by 9.2 percent from IDR 248,707 per person per month to IDR 271,626, driven by increases in both food and non-food prices, across both urban and rural areas. Regional variation in poverty is high, with poverty in Maluku and Papua, for example, double the national average, at 24.0 percent, while Kalimantan has the lowest poverty rate at 6.4 percent, or around half the national average.

The 0.6 percentage point decline in the poverty rate this year was roughly the same as the 0.5 percentage drop experienced between 2011 and 2012. This continues the trend of slowing poverty reduction in recent years, with the last two years seeing the smallest declines in percentage point terms in a decade, with the exception of the increase in 2006 accompanying the global food price shocks. As discussed in the March 2013 *IEQ*, slowing poverty reduction is not unexpected as poverty approaches 10 percent, since the remaining poor are increasingly further below the poverty line, and thus faster consumption growth is required to maintain the same pace of poverty reduction as measured by the official poverty rate. Ordinarily, this trend, along with the slower economic growth projected through 2014 and elevated inflation, would limit expectations of poverty reduction in 2014. However, the disbursement of BLSM in the second half of 2013 is likely to mitigate the upward pressure on the poverty rate. As a consequence, the likelihood of achieving the Government's RPJM target of reducing poverty to 8 to 10 percent in 2014 is unclear. However, the concurrent expansion of long-term safety net programs – in particular BSM and PKH – is an important strategy for increasing the speed of poverty reduction beyond 2014.

Note: See the July 2013 *IEQ* for details on the 2013 compensation package
Source: Ministry of Finance, BPS and PT Pos Indonesia (http://blsm.posindonesia.co.id/main.php)

The World Bank projects that the Budget deficit in 2013 will be 2.5 percent of GDP and 2.3 percent of GDP in 2014

Taking into account the outturn in January-August, the reduction in commodity prices, depreciation of the Rupiah, and weaker nominal GDP growth, the World Bank has revised up its projection of the Budget deficit for 2013, from IDR 189 trillion in the July *IEQ* (2.1 percent of GDP) to IDR 226 trillion (2.5 percent of GDP) (Table 5). Projected revenues have been revised downwards by 1.0 percent, and projected total expenditures revised upwards by 1.4 percent (due mostly to higher projected energy subsidy spending, despite June's subsidized fuel price increases, see Box 2). For 2014, the World Bank's preliminary projection is for a Budget deficit of 2.3 percent of GDP, though much will clearly depend on the final features of the approved 2014 Budget.

The 2014 Budget is making its way through Parliament

The proposed 2014 Budget is currently under discussion in Parliament and it is expected to be approved (with potential amendments) by the end of October. The projected Budget deficit in the draft Budget was 1.5 percent of GDP, but the Finance Minister has recently announced that the latest estimate for the 2014 deficit is 2.02 percent of GDP.[7]

In terms of some of the main expenditure categories, personnel expenditure is proposed to increase by 19 percent relative to the 2013 revised Budget, reflecting on-going bureaucracy reform, and increases in basic salary and pension payments by 6 percent and 4 percent, respectively. The Government is implementing a flat budget policy for material expenditure, particularly for expenses relating to operational, official travel, and meetings. Capital expenditure is proposed to increase by 7 percent, implying only a modest increase in real terms following several years of very strong real capital spending growth, albeit from a low

[7] http://www.thejakartapost.com/news/2013/09/17/budget-deficit-2014-estimated-reach-202-percent.html

base. The proposed Budget also foresees the implementation of new policies, such as the health dimension of the new National Social Security Law, and a proposal to adjust electricity tariffs for selected customers to further improve the quality of spending. As in the 2012 and 2013 Budgets, the proposed Budget includes provisions relating to crisis preparedness to grant the Government the flexibility to respond to rapidly changing macroeconomic developments.

Table 5: The World Bank projects a fiscal deficit in 2013 of 2.5 percent, up from 2.1 percent in the July 2013 IEQ
(IDR trillion, unless otherwise indicated)

	2011	2012	2013	2013	2014	2014
	Actual	Actual	Revised Budget	WB	Proposed Budget	WB
A. State Revenues and Grants	**1,211**	**1,338**	**1,502**	**1,434**	**1,663**	**1,569**
1. Tax Revenues	874	981	1,148	1,082	1,310	1,215
2. Non-Tax Revenues	331	352	349	347	351	349
B. Expenditures	**1,295**	**1,491**	**1,726**	**1,660**	**1,817**	**1,790**
1. Central Government, o/w	884	1,011	1,197	1,131	1,230	1,204
Personnel	176	198	233	228	277	268
Material	125	141	203	179	204	180
Capital	118	145	188	166	206	182
Subsidies, o/w	295	346	348	346	336	364
Fuel Subsidies	165	212	200	198	195	205
2. Transfers to the Regions	411	481	529	529	586	586
C. Primary Balance	**9**	**-53**	**-112**	**-100**	**-35**	**-95**
D. Surplus/Deficit	**-84**	**-153**	**-224**	**-226**	**-154**	**-221**
as percent of GDP	**-1.1**	**-1.9**	**-2.4**	**-2.5**	**-1.5**	**-2.3**
E. Net Financing	**131**	**175**	**224**	**n.a.**	**154**	**n.a.**
1. Domestic Financing	149	199	241	n.a.	173	n.a.
2. Foreign Financing	-18	-23	-17	n.a.	-19	n.a.
Key Economic Assumptions						
Economic growth (percent)	6.5	6.2	6.3	5.6	6.4	5.3
CPI (*yoy*, percent)	3.8	4.3	7.2	9.8	4.5	4.4
Exchange rate (IDR/USD)	8,779	9,384	9,600	10,400	9,750	11,400
Crude oil price (USD/barrel)	112	113	108	106	106	105
Oil production ('000 barrels/day)	899	861	840	840	870	870

Source: Ministry of Finance; World Bank staff calculations

The depreciation of the Rupiah has placed renewed upward pressure on subsidy costs

The depreciation of the Rupiah through September places upward pressure on a range of expenditures, particularly fuel subsidy spending (see Box 2). As a result of the weaker Rupiah, fuel subsidy spending for 2013 is likely to increase by IDR 21 trillion relative to the projection in the July *IEQ*. Hence, in the baseline scenario, the projected net saving for 2013 (including spending on BLSM and compensation programs) from the June 2013 increase in subsidized fuel prices of IDR 13.1 trillion will not be realized, although the subsidy costs would be even higher without this price adjustment. This development highlights the fiscal risks from the current system of fixed subsidies, subjected to ad hoc periodic adjustments, from movements in the exchange rate or oil price. It also stresses the urgency and importance of pushing ahead with further reforms to energy subsidies, such as a move to a more rule-based approach, to make sustained progress in raising the quality of public spending.

Box 2: The fiscal impact of changes in the Rupiah exchange rate and oil prices

Simulations can be used to examine the direct risks to the budget deficit from shifts in the exchange rate and international oil prices. For example, a 10 percent weaker Rupiah against the US dollar compared with the World Bank's base case assumptions is estimated to lead directly to a roughly 0.7 percentage point of GDP increase in the fiscal deficit in both 2013 and 2014, to 3.2 percent and 3.0 percent respectively. This clearly assumes that there are no adjustments in other spending levels in response, which would likely be the case given the 3 percent of GDP national deficit rule. A 10 percent increase in oil prices relative to the baseline is projected to add roughly 0.3-0.4 percentage points of GDP to the baseline fiscal deficit.

The significant estimated sensitivity of the fiscal deficit to both the exchange rate and oil prices comes mainly from the expenditure side, due primarily to an increase in energy subsidy costs, in intergovernmental transfers to the regions from shared revenue from oil and gas, and an increase in spending on education (given the mandate that education spending be 20 percent of total spending). Although the impact on revenues is not as significant as for expenditures, projected nominal revenues are negatively impacted; changes in exchange rates have an effect on VAT and customs collection (both imports and exports duties), while changes in oil prices affect revenues through income taxes from oil and gas, VAT (through the sensitivity of imports to oil price changes, and though the increase in prices and resulting changes in private consumption), customs duties (both imports and exports duties), and non-tax revenues from natural resources.

These simulation results should be treated as indicative only. In particular they focus on the first-round direct fiscal impacts and abstract from the indirect impacts through broader economic effects of the shocks. In addition, they require a number of assumptions (due to data and statistical limitations), and do not take into account the policy reaction function to such shocks, for example, in terms of cutting other spending or moving forward with other fiscal reforms.

Table 6: The direct impact of a 10 percent Rupiah depreciation or increase in the oil price is an increase in the Budget deficit of at least 0.4 percentage points of GDP

(IDR trillion, unless otherwise indicated)

	Baseline		Simulation 1 Rupiah Depreciation		Simulation 2: Increase in Oil Price	
	2013	2014	2013	2014	2013	2014
Revenues	**1,434**	**1,569**	**1,431**	**1,565**	**1,460**	**1,592**
Expenditures	**1,660**	**1,790**	**1,721**	**1,860**	**1,716**	**1,853**
Energy subsidies	297	312	342	362	335	355
Fuel	198	205	234	246	231	243
Electricity	100	107	108	116	105	112
Transfer to region	529	586	536	594	533	591
20% additional expenditures on education			10	12	9	10
Surplus/Deficit	**-226**	**-221**	**-290**	**-295**	**-256**	**-261**
as percent of GDP	**-2.5**	**-2.3**	**-3.2**	**-3.0**	**-2.9**	**-2.7**
Key Economic Assumptions						
Exchange Rate (IDR/USD)	10,400	11,400	11,440	12,540	10,400	11,400
Crude Oil Price (USD/barrel)	106	105	106	105	117	115

Source: World Bank staff calculations

Gross debt financing is broadly on track

Following the revised 2013 Budget and IDR 70.9 trillion increase in the projected deficit, gross debt financing needs for 2013 increased by IDR 51.4 trillion relative to the original 2013 target, to IDR 330.8 trillion, according to the Debt Management Office (DMO). Debt issuance is broadly on track, with 25 percent of the revised debt target for 2013 remaining to be met at the start of the final quarter, and issuance conditions have improved markedly since June, with IDR 104.9 trillion in debt issued since the beginning of July, of which IDR 76 trillion constitutes debt with a maturity of longer than one year.[8]

[8] See Directorate General of Debt Management, September 2013 Investor Meeting Presentation, available online.

7. Policy settings and ongoing reform progress can play a key role as external balances adjust

External balance developments pose the greatest near-term risk to growth…

In the base case, the pace of Indonesia's economic growth is expected to moderate and then stabilize at a level which is still solid but more commensurate with a more sustainable current account deficit under tighter global liquidity conditions. Economic developments and policy settings, notably moderating domestic demand growth, the June increase in subsidized fuel prices, the subsequent tightening in monetary policy, and the continued depreciation of the Rupiah, are conducive to maintaining macroeconomic stability, a prerequisite for growth and development. The key risk to this baseline scenario is that the adjustments now underway, and projected in the base case to continue, are overtaken by a significant increase in external financing strains, for example due to significant further weakening in key export commodity prices or net inward investment dynamics. This would require a more rapid adjustment via further significant depreciation in the Rupiah, placing pressure on reserves, and requiring monetary policy tightening to stabilize Indonesia's external balances, denting confidence and further reducing growth (see Box 3 for a discussion of growth sensitivities via investment impacts).

…placing a premium on continued macroeconomic policy flexibility to facilitate near-term adjustment…

Indonesia's fiscal and monetary policy settings will continue to play a key role in facilitating the adjustments now taking place and in minimizing associated risks. There are, however, trade-offs between the objectives of restraining inflation, supporting growth and adjusting the current account deficit to the tighter financing environment. Monetary policy faces the challenge of calibrating interest and exchange rates so as to guard against rising inflationary pressures as cost pressures rise (such as from the pass-through of the weaker currency or wage increases) while facilitating improvements in the external balances, and without unduly crimping economic growth and weakening public and private sector balance sheets. With the 2014 Budget under discussion with Parliament, fiscal policy faces the challenge of slower revenue growth and higher nominal debt-financing costs, raising the importance of lifting further the quality of spending and of revenue mobilization. Maintaining a prudent overall fiscal stance, coordinated with the tightening in monetary policy, can help to meet this challenge. Building on the June increase in subsidized fuel prices, further reforms to the current system of inefficient, distortionary energy subsidies could help to free up spending for key development expenditures such as infrastructure and health, as well as limiting the fiscal risks they generate to fluctuations in the exchange rate or shocks to global oil prices.

…reducing uncertainties through communication and contingency planning…

Given the uncertainties generated by moderating growth momentum, and volatile but generally tightening external financing conditions, maintaining clear communication around policy changes and a strong focus on implementation can help to support confidence. Policy also has a role to play in mitigating the negative impacts of particularly adverse scenarios, should tail risks materialize. The Government has put considerable efforts into enhancing its crisis preparedness in recent years. Monitoring and response coordination mechanisms are in place to facilitate a flexible response to any major market dislocations. The Government has contingent fiscal financing equivalent to approximately USD 5 billion to draw on in the event of a significant deterioration in financing conditions, while Bank Indonesia has recently made efforts to secure additional bilateral US Dollar swap lines.

…and continuing to drive progress on reforms to lift Indonesia's sustainable growth rate

The recent pressures on the external balances and growth serve as a reminder of the need for further efforts to improve the diversification of exports and to lift the competitiveness of the economy in order to sustain a more rapid pace of growth and development. The depreciation of the Rupiah should boost competitiveness in the short-term, but this will only prove lasting if not eroded by domestic cost pressures, such as from wage increases, and if policies and investments are put in place to enhance supply-side flexibility. Measures to increase competitiveness and improve the regulatory environment can thus assist not only to alleviate near-term external funding pressures by stimulating exports and encouraging foreign direct investment, but also help to lift longer-term employment and economic growth. The Government's policy package, announced on August 23 contains measures which aim to address some of these issues; see Section B.1.

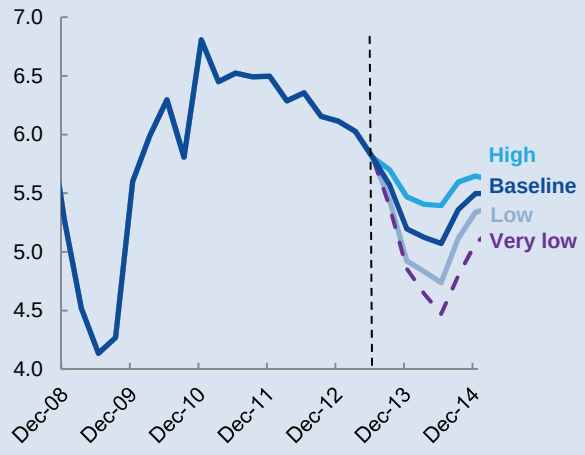
Box 3: The sensitivity of GDP growth to investment

Accounting for around 33 per cent of GDP and having been a key contributor to Indonesia's growth performance in recent years, investment is at the heart of the overall economic outlook. The World Bank base case for investment assumes that investment growth remains subdued over the rest of 2013 and into 2014. This projection is predicated on a moderation in corporate profits and tighter financing conditions. Investment may also face headwinds as the political cycle intensifies ahead of national elections in 2014, and from ongoing regulatory and policy uncertainties.

This base case for investment, however, is subject to significant risks, with investment likely to be sensitive to the future trajectory of domestic monetary policy, global commodity prices, the exchange rate, external financing conditions, and domestic credit conditions. For example, further tightening in domestic monetary policy will act to dampen investment growth, with the IMF (2012) finding that a 1 percent higher real interest rate leads to a 0.2 percent decline in investment growth. However, this analysis also finds that it is actually the volatility in short-run interest rates that is the most significant factor impacting investment in Indonesia, followed by exchange rate volatility. As a result, a continuation of recent financial and currency market volatility has the potential to weigh more significantly on investment. Further falls in the prices of Indonesia's principal commodity exports, leading to a further decline in Indonesia's terms of trade, and possible policy responses necessitated by adverse developments in the external balances, will also act both to reduce profitability and retained earnings, and the cost and availability of investment financing.

Figure 27: Forecast GDP growth is sensitive to the outlook for investment

(GDP growth, year on year, percent)



Note: The "high" and "low" trajectories assume investment growth is 1 percentage point higher and lower than the 2014 baseline. The "very low" scenario assumes that investment is 2 percentage points lower than the baseline in 2014, a deceleration comparable to that seen in the 2008/9 global financial crisis
Source: BPS; World Bank staff projections

The outlook for GDP growth in 2014 is sensitive to the trajectory of investment (Figure 27). A 1 percentage point deviation in investment growth from the baseline forecast in 2014 would lead to around a 0.3 percentage point deviation in GDP growth in 2014, taking annual growth up to approximately 5.6 percent (up from baseline growth of 5.3 percent), or down close to 5.0 per cent. Under a more adverse scenario, where investment weakens as much as it did in the global financial crisis (around 2 percentage points lower than the baseline), then GDP growth for 2014 would be around 0.6 percentage points lower, at around 4.7 percent (Figure 27).

Note: See IMF (2012) Selected Issues Paper, September 2012, IMF Country Report No. 12/278

B. Some recent developments in Indonesia's economy

1. The Government's August policy package

Following market pressures, the Government announced a policy package in August…

As discussed in Part A, financial market pressures on Indonesia intensified in mid-August, following the release of second quarter balance of payments statistics that showed a wider than expected current account deficit, against the backdrop of a reduction in investor appetite for emerging market assets globally. In response to this, the Government of Indonesia announced a policy package ("the package") on 23 August, in order to address Indonesia's external imbalances, by boosting exports and restraining imports, promoting inbound investment to boost supply side capacity and raise productivity, while supporting employment during a likely slowing in the pace of economic growth in the near-term. This section provides a brief overview of the measures that have been announced. An outline of the parallel policy responses announced by Bank Indonesia and *OJK* is provided in the Part A discussion.

…aimed at stabilization and structural reforms, organized around four pillars

The policy package is focused on economic stabilization and structural reforms and has four pillars. First, supporting foreign direct investment by removing impediments to progressing with key strategic investment projects ("de-bottlenecking"), simplifying licensing requirements, and expediting the revision of the negative investment list. Second, measures aimed at improving the current account balance, by providing tax breaks for export-oriented firms, raising taxes on some luxury goods imports, and raising domestically produced biodiesel requirements in the fuel mix (to help dampen fuel imports). Third, measures aimed at maintaining employment growth, including tax breaks for labor-intensive sectors, relaxation of some restrictions in bounded zones, and revisions to the minimum wage-setting process. Fourth, measures to counter inflation, mainly by replacing import restrictions with price-based mechanisms for beef and horticultural products.

a. Measures to support foreign direct investment

A revised negative investment list (DNI) has been announced…

Initial implementation of the investment-support measures has focused on an accelerated revision of the Revised Negative Investment List (*Daftar Negatif Investasi*, DNI), which stipulates limits to foreign investment across Indonesia's business sectors. Revisions to the DNI have been discussed by the Executive and consultations with the private sector have been underway since the earlier part of 2013.

…informed by a number of guiding principles

The Government has announced that the revision of DNI will be based on a number of guiding principles. First, the revised DNI should be "investor-friendly", as far as allowed by existing laws, since these limit Presidential regulation prerogative. For example, the Law on Horticulture limits foreign equity in horticulture businesses to 30 percent, a restriction which will be incorporated in the forthcoming DNI. Second, changes to the DNI proposed by Ministries which have the effect of increasing restrictions should not be accepted. Third, industrial classifications are to be simplified, and the regulatory oversight of industries is to be harmonized, such that duplication is avoided (for example, if a business sector is currently regulated by two ministries, this should be reduced to just one ministry, with the least restrictive of the overlapping regulations selected). The principles informing the revised DNI suggest that a revised list would continue to incorporate the restrictions on foreign equity investment which apply, through existing law, in the horticulture sector, but relax foreign equity limits in a handful of other sectors, notably tourism, pharmacy, industry and transport.

An "investor-friendly" revised DNI would help to reduce regulatory uncertainty, even as considerable challenges remain, both around the Government's broader strategy…

The new DNI has not yet been published and applied, and this delay is unfortunate, as it would bring with it more certainty around foreign participation limits across sectors. In general, the emphasis under the guidelines for the accelerated revision is for a more open foreign investment framework. In principle, this would be positive for foreign investment. In addition to the issuance and application of a revised DNI, there continues to be room for improvement in the overall regulatory environment for foreign investment. A clearer revision procedure for investment limits and communication strategy could help increase the clarity and transparency of policy. In addition, ensuring that the DNI serves as the single comprehensive list of investment restrictions would be desirable, as in the past the DNI has been superseded by new restrictions on investment introduced in sectoral laws, such as in horticulture and the postal law, adding complexity to the regulatory environment.

…and red tape in investment, with work underway to simplify licensing…

Additional steps are also being taken to cut red tape, by improving the effectiveness of integrated one-stop services for investment-related procedures (*Pelayanan Terpadu Satu Pintu di Bidang Penanaman Modal*, PTSP), and reducing the types of licenses relating to investment activities. As a first step, the Government will focus on simplifying licenses in the strategically important oil and gas sector, reducing the current sixty-nine types of licenses for oil and gas investments to eight licensing groups. The Coordinating Ministry of Economic Affairs and Presidential Working Unit for Supervision and Management of Development (*Unit Kerja Presiden Bidang Pengawasan dan Pengendalian Pembangunan*,UKP4) are working on an action plan to implement this reform within a year.

…which could be embedded in a broader, cross-sector reform plan for the regulatory environment

An increased emphasis on simplifying the investment licensing system is a welcome step, as the current system is highly complex, often requiring investors to obtain licenses and authorizations from multiple ministries and agencies. Yet rather than taking an ad hoc approach to license simplification for each sector – beginning with oil and gas – it may ultimately be more efficient to plan, communicate and implement licensing requirement and process changes within the broader context of a reform plan to improve the regulatory environment for business across all sectors. This should include sectors which tend to have smaller investors than the oil and gas sector, who may find complex regulations more of an impediment than the generally large-scale companies operating in the oil and gas industry.

b. Measures to improve the current account deficit and maintain Rupiah stability

Trade measures are focused on supporting exports…

Downward pressure on the current account balance has stemmed from a combination of weakening export revenues and generally strong import demand, as discussed in Part A. The announced package seeks, first, to support exports (and employment as discussed below) by providing tax deductions for labor-intensive sectors (textiles, footwear, furniture, children's toys and confectionary), and reducing corporate income taxes by 25-50 percent of total income payable, depending on the degree of export-orientation. The tax break is temporary, applying for the remainder of the tax year at the time of the implementing regulation (i.e. from September-December 2013), and also allows for tax payments to be delayed without penalty for up to three months. As is common with such incentives it can be difficult to assess *ex ante* their impacts, and their application, and fiscal costs, should be as transparent as possible. Second, the package aims to boost mineral exports by allowing approved exporters to submit revisions to their annual 2013 work plan in order to increase their export volume for 2013. In a press release on 29 August, the Vice Minister of Energy and Mineral Resources emphasized that the measures announced in the package apply only until January 2014. The ban on raw mineral ore exports (effective January 2014) therefore still appears likely to be implemented.

…and reducing certain categories of imports

Measures to discourage import demand center on fuel imports and luxury consumer goods. First, biodiesel blending requirements for domestic fuels are being increased, with the aim of reducing reliance on imported fossil fuel-based diesel. This measure is longer-term in nature, with the implementing regulation stipulating annual increases in biodiesel in the fuel mix through 2025, tailored by user group. The implementation challenges, and broader impacts of such a policy, for example on the environment and agriculture sector, will be important to assess. It is not yet certain how quickly these measures will be implemented or what their ultimate impact will be on the current account deficit, given their potential to induce substitution away from palm oil exports. Second, taxes on selected luxury goods, such as imported luxury cars and other high-end branded consumer goods, are increased 25-50 percent. This measure, while symbolic, is unlikely to have a material impact on overall import demand, given that consumer goods account for less than 10 percent of total imports. As part of the implementing regulation, taxes on some categories of goods are also being reduced, which may also offset some of the overall impact of this measure on imported goods demand.

c. Measures to support employment

Focus on labor-intensive industries in the bounded zones…

In addition to tax breaks for labor-intensive firms, described above, employment support measures in the package are essentially two-fold. First, regulations pertaining to bounded zones are relaxed, for example allowing firms in these areas to sell a higher proportion of their output domestically (up from 25 to 50 percent), and to make more use of sub-contracting. Bounded zones are where labor-intensive, light manufacturing factories are overwhelmingly located, and these receive incentives in exchange for exporting the bulk of their output. Although the measures announced as part of the August package may prove positive for employment, international experience suggests that measures which open the domestic market to firms in bounded zones may also bring additional regulatory challenges and costs, and affect firm incentives. For example, with firms potentially subject to different tax requirements on different portions of their output, this could potentially reduce incentives for firms to export.

…and on minimum wage-setting

Second, changes are proposed to the mechanism for setting provincial minimum wages (*Upah Minimum Provinsi*, UMP) to prevent layoffs caused by excessive increases in minimum wages. The reform proposal outlines a mechanism for achieving a more certain, simple, and fair minimum wage setting process, aiming to make employers, workers and job seekers better off, by promoting a more evidence-based and less politicized wage-setting process, leading to more predictable annual increases, and by introducing improvements in the governance structure that reduce the scope for discretionary decision making.[9]

Reform of the minimum wage negotiation process and implementation is complex…

Reform of the minimum wage-setting process is complex. Negotiations and final agreements take place at the province and sectoral level (and often at the district and sub-sector level), making communication and compliance with new formula-based adjustments more difficult. More generally, ensuring the compliance of firms and employers to minimum wage regulations (whether revised or not) is not easy, and requires monitoring and coordination at the central level, between the Ministry of Manpower and relevant ministries for effective implementation, as well as between central and local governments and relevant actors (District Governors and Wage Councils).

…but could have a positive labor market impact

The formula-based adjustment, if implemented, should make future minimum wage increases more predictable, reflect more closely local labor market developments, and be better able to adjust to shocks. Improved governance and enforcement of stricter monitoring policies should also improve compliance with the system. If applied appropriately, this reform therefore has the potential to improve certainty, simplicity and transparency in minimum-wage setting, supporting equity and balancing trade-offs in the setting of minimum wages, which is a vital price for many workers and businesses, both directly, and indirectly through its impact on wage-setting across the economy.

d. Measures to reduce inflation

Quantitative import restrictions on some foods are being replaced by price-based mechanisms

Reductions in luxury sales taxes for some products, as mentioned above, as well as the elimination of VAT on educational and religious books, will cut the costs of these products. But the small share of these products in the consumer price index limits the impact of these measures on the general price level. In contrast, trade restrictions imposed in 2012 had a very marked impact on food inflation in the first half of 2013, before being partially unwound. As part of the policy package, additional steps are being taken to shift from restricting import quantity to managing the difference between the domestic and international prices of beef and horticultural products, which should improve transparency and somewhat reduce the risks of sharp price increases due to a lack of imported supplies. Subsequent to the announcement of the policy package, there have also been some additional moves towards relaxing trade restrictions, notably on soybeans, with the scrapping of import permits and (temporary) elimination of a 5 percent tariff. However, given the challenges in coordinating policy across agencies, it remains to be seen whether the revised policy stance on imports of these products can be implemented effectively.

[9] See the December 2012 edition of the *IEQ* for more details on the previous minimum wage negotiation round and system.

e. Assessing the policy package

Achieving an optimal policy response to shifting economic conditions, and when faced by volatile markets, is complex

There is no off-the-shelf set of optimal policies for reacting to deterioration in market conditions and shifting economic conditions. Rather, Indonesia's policymakers face complex challenges, though with some common aspects to those in other emerging market economies such as Brazil and India (where external financing conditions have also tightened, and growth has slowed). While there may be many potential policy levers, there are also implementation costs and potential trade-offs to consider, as well as the overall communication strategy. For example, maintaining strong employment and wage growth is clearly desirable, but introducing measures to support employment which stimulate the economy can go against the moderation in overall demand growth which may be necessary to address the current account deficit. Policy interventions may also impede other adjustments, such as in key relative prices, which can help maintain domestic and external balances, and introduce additional uncertainty over the regulatory environment.

The Government's policy package appears broadly positive for the economy and can be further built upon…

In light of the current challenges faced by the Indonesian economy, the policies announced by the Government seem well-focused at the micro-level. As always, the timing and nature of the implementation of the announced measures will be crucial in determining how effective they are ultimately in achieving their goals. For instance, the regulations in respect of the negative list are yet to be finalized some six weeks since the package was announced. The policy package should also be evaluated from the perspective of Indonesia's broader strategy to lift the sustainable pace of economic growth and development over the medium-term. In this context, the policy package should be seen as part of an ongoing process of policy reform and implementation, which can be built on further.

…with additional "quick wins" in the trade arena…

Given the pressure on Indonesia's external balances and consequent need to lift competitiveness, additional "quick wins" in the trade arena could be explored, notably in trade facilitation, for example by improving risk management and pre-clearance procedures to reduce import dwell time (see the following Section).

…and maintaining progress on fiscal sector reforms

To build on the August policy package in the fiscal policy arena, a very positive policy signal, which would help the overall quality of spending, would be progress on further energy subsidy reforms, such as moving towards a more predictable and transparent fuel price adjustment mechanism, combined with deepening and expansion of the social protection framework. In addition, the Government could proactively enhance its preparedness for slower growth by putting in place a systematic monitoring and response mechanism to provide social protection in a targeted and effective manner. It will be important to ensure that the fiscal stance, as outlined in the 2014 Budget under consideration, remains prudent and coordinated with monetary policy. A big push on revenue administration can support this by limiting debt financing needs, consolidating the strengthening in the public balance sheets which Indonesia has already achieved, while further improvements in budget execution can help to support growth. While some of these steps may seem like longer-term measures, they can have a positive near-term impact by signaling the direction of Indonesia's policy and growth trajectory.

2. Enhancing connectivity through improved port performance

Improvements in international connectivity, such as through reducing dwell times at major ports such as Tanjung Priok, can play a crucial role in supporting export and investment…

As highlighted in the Government's Master Plan for the Acceleration and Expansion of Indonesia's Economic Development (*MP3EI*), poor connectivity is well-recognized as one of the major impediments to growth in Indonesia, undermining the country's development agenda. Capacity constraints in connectivity infrastructure and weaknesses in institutional arrangements continue to affect Indonesia's logistics performance adversely, pushing up costs and reducing export competitiveness. Poor connectivity also undermines efforts to attract investment in manufacturing process activities, as transport costs of imported materials become more expensive.

Efforts to improve Indonesia's international connectivity performance therefore have a crucial role to play in increasing the country's export competitiveness and its attractiveness for long-term investment, both of which are policy areas under particular focus in light of the recent deterioration in Indonesia's external balances. This section examines one of the key, practical challenges to improving Indonesia's international connectivity – reducing dwell times at Indonesia's major international container port, Tanjung Priok.

…in enhancing the long-term competitiveness of Indonesia's manufacturing sector through moving up value chains…

Improvements in international connectivity can support the ability of Indonesian firms to move up the value chain. Indonesia's sizeable potential for growing its manufacturing sector and international trade is well-known, but realizing this potential faces a number of challenges. Most Indonesian manufacturing firms currently engage mainly in basic processing activities, and consequently operate in low positions in regional and global value chains. For Indonesian industry to move up value chains, thus increasing the value-added of its output and generating more high quality jobs, wide-ranging policy and infrastructure improvements will be required, including significant reforms to the business environment, labor regulations, access to finance, innovation and better connectivity. Not all of these factors can be addressed overnight. However, in the short and medium term, the competitiveness of Indonesian firms would benefit significantly from being able to access quality international inputs at world prices.

…and facilitating productivity growth through technology transfers via access to imported inputs

Better international connectivity can also help to deliver improvements in productivity and growth over the long run. Globally, declining unit costs for transport and information technology are reducing the cost of managing distant activities. As a consequence, multinational manufacturing companies have fragmented their value chains and perform production stages in different countries, based on their endowments and comparative advantage. In the long run, participating in these global production networks facilitates technology transfers which, in turn, will likely lead to increased productivity and growth, and to an increase in demand for domestic inputs as well.[10] Thus, ensuring that the process for importing goods is as efficient as possible is crucial for Indonesia's long-run development.

a. Improved port performance: the key to unlocking trade

Transport and trade facilitation issues are some of the biggest constraints to traders in Indonesia

Currently, Indonesia compares poorly to other developing Asian countries on transport and logistics measures such as cost, efficiency, and quality, including infrastructure, customs, and the competence of the logistics industry. (Figure 28). Under-investment in ports and roads infrastructure in Indonesia has contributed to serious congestion problems and hence to Indonesia's relatively poor logistics performance. While improving physical infrastructure is crucial, this is a longer-term endeavor, leaving performance improvements as the key short-term measure for alleviating capacity constraints. This is the case at Tanjung Priok port, Indonesia's main trade gateway, handling over two-thirds of the country's entire international trade. Tanjung Priok has long reached full capacity, and given that the new international container terminal is not scheduled to be operational until 2018, the Government is focusing on steps to improve port efficiency.

[10] For an overview of recent value-added trade statistics that show the importance of intermediate imports for Indonesia's manufactured exports, see the March 2013 edition of the *IEQ*.

Port performance is one of the most critical areas of trade facilitation reform…

As gateways to the global markets, ports serve as a critical key nodes and principal interchange points for domestic and international freight movements. Ports are where most trade transactions take place and, therefore, where most of the delays occur. On trade corridors, at least 50 percent of delays happen at the port of entry.

…with port dwell time a particularly important element of port performance

Dwell time is defined as the elapsed time that cargo spends within the port limits, from the moment it is unloaded from the vessel and is on the ground until it leaves the port premises by road or rail. Lowering dwell times allow ports to increase volume, revenue and foster competition with other similar ports in the country or regionally. Dwell time figures are commonly used to attract shipping lines and cargo traffic to a port, giving port authorities and container terminal operators strong incentives to improve this performance indicator.

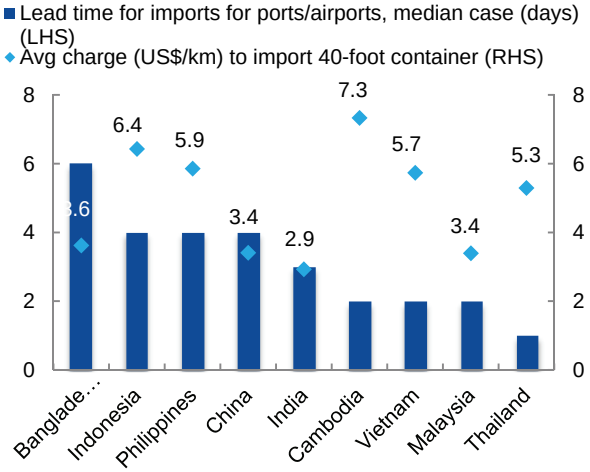
Long dwell times increase overall trade costs, impacting productive activities, especially for export and re-export-oriented industries

For goods that are intermediate products in a supply chain, on-time delivery is valuable. Unreliability and uncertainty bring costs that can potentially discourage investments, increase inventories and associated storage costs, dampen the scale expansion of an enterprise and dissuade the start of new export initiatives. Delays also dramatically affect terminal capacity, performance and investment needs, which in turn increases cost and results in even more uncertainty, forming a vicious cycle. Lastly, for ports located in dense urban areas, it is essential to maintain the flow of goods and traffic, as episodes of congestion and surges in dwell time can be extremely disruptive for trade and the port-city environment.

Dwell time for imports in particular is vital for port performance as imports often involve greater costs and time delays than exports

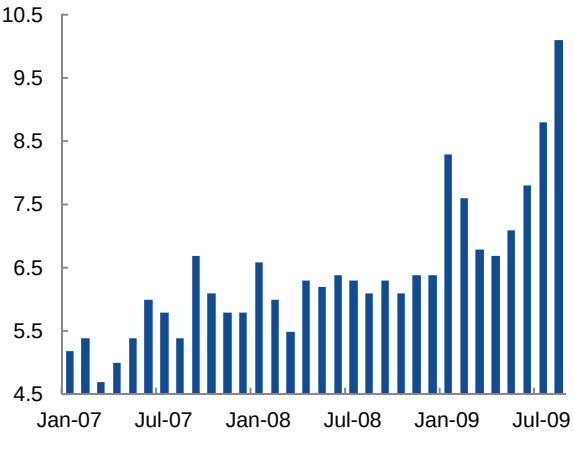
A focus on improving container dwell times for imports (i.e. inbound containers) is generally appropriate in developing countries such as Indonesia. For many countries the aggregate volume of exports is often lower than that of imports but, more importantly, the dwell time for outbound containers is usually low (on average one or two days). Imports involve most of the border controls, and incur greater costs and time penalties than exports. In any case, both directions of trade use the same service providers, so an improvement in the quality of these services benefits all traders.

Figure 28: Indonesia currently lags its Asian peers in the cost and speed of logistics…
(import lead time, days, and container charges, US Dollar)



Source: Logistics Performance Indicators 2012, World Bank

Figure 29: …and container dwell times at its most important port, Tanjung Priok, have been increasing
(average import dwell time, days)



Source: Jakarta International Container Terminal (JICT)

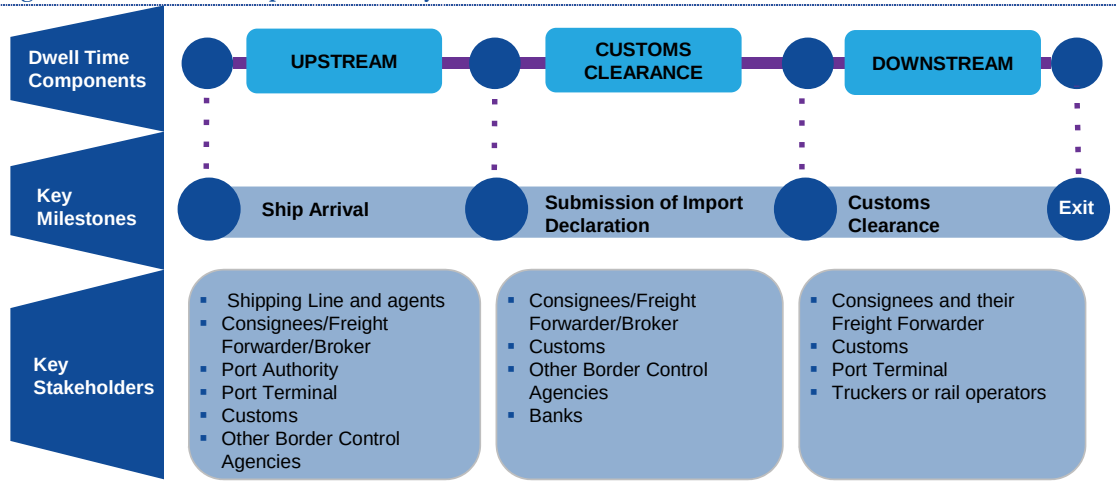
b. Buckling under the pressure to keep up

Dwell time at Tanjung Priok has almost doubled in the last two years

According to the most recent estimates, the average import container dwell time at Tanjung Priok has almost doubled from 5.2 days in January 2011 to 10.1 days in August 2013 (Figure 29). To understand the reasons behind this rapid lengthening in the time needed to clear and remove containers from the port, it is necessary to have a closer look into the components

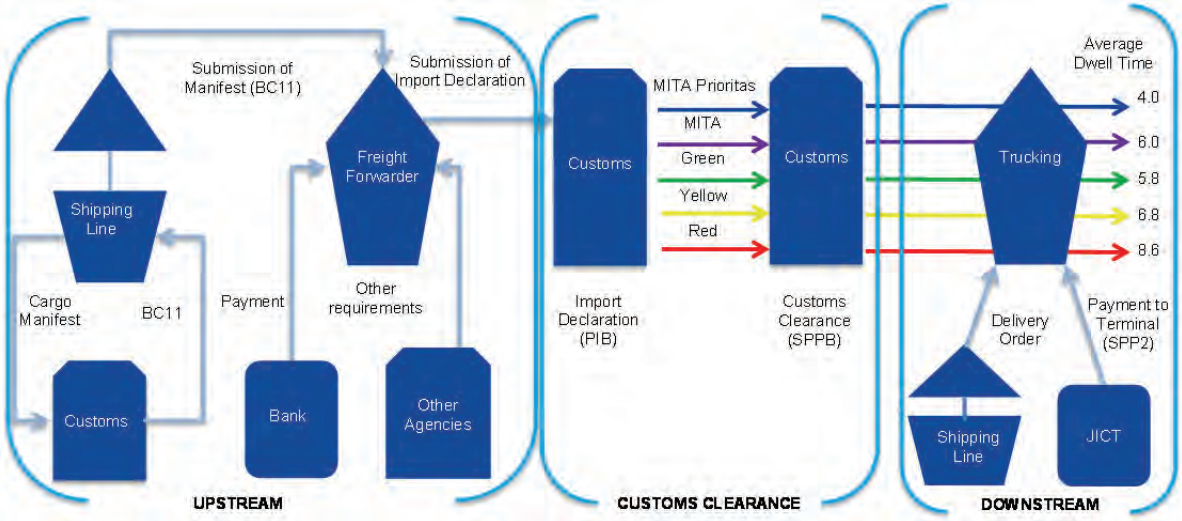
of dwell time. Import containers' dwell time can be broken into three distinct stages that correspond to different processes, different responsibilities and agency relationships (Figure 30). The upstream component comprises the time between the arrival of the ship and the submission of the import declaration to Customs. The customs clearance segment corresponds to the elapsed time from the submission of the import declaration until the clearance is obtained. The downstream component spans from the receipt of customs clearance until leaving the port premises, in this case, the gates of the Jakarta International Container Terminal (JICT). The import processes by phase are outlined in Figure 31.

Figure 30: Dwell time components and key stakeholders



Source: World Bank

Figure 31: Import processes at Tanjung Priok



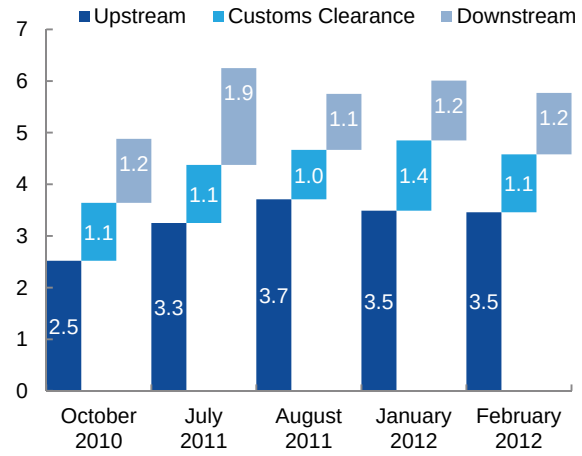
Source: World Bank based on interview, 2010

c. Where are the main challenges?

The main dwell time delays occur in the upstream stage…

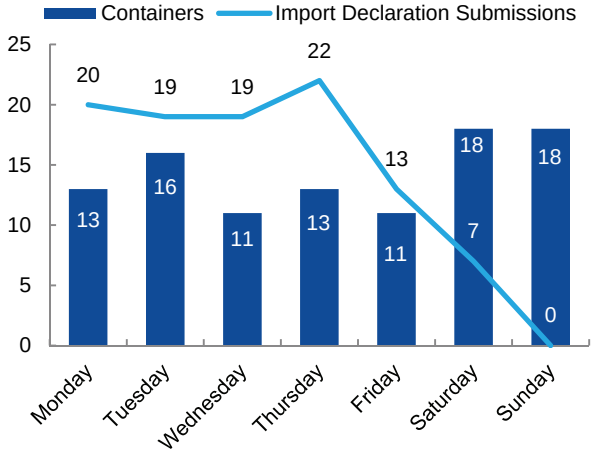
Contrary to widespread perceptions of poor performance of Customs Clearances and abuses of port facilities by importers, a recent study shows that 58 percent of the average dwell time occurs in the upstream (pre-customs) stage (Figure 32). Although many sources of delay can be seen throughout the import process, focusing on efficiency gains in the upstream component could therefore have a significant impact on the overall dwell time average of Tanjung Priok. Major sources of delays in the upstream component are the inefficiency of the 24/7 system, delays in the submissions of import declarations, and the underperformance of the Indonesian National Single Window (INSW).

Figure 32: The upstream stage poses the key challenge for overall dwell times
(dwell time, days)



Note: Dwell time disaggregation data available only through February 2012
Source: JICT and DG Customs

Figure 33: Mismatch between container arrivals and import declarations point to 24/7 system challenges
(percentage, days)



Source: JICT and DG Customs, May 2012

…attributable to gaps in the 24/7 system…

While port operations are nominally "24/7" (i.e. port services, including customs, banks, the terminal, truckers, freight forwards, customs brokers and warehouses, operate outside of normal business hours and on weekends), in practice timing gaps currently lengthen upstream dwell times. A large percentage of vessels arrive on Saturdays and Sundays, averaging 38 percent of the total of containers that arrive in one week (Monday through to Sunday). Most of the freight forwarders, shipping-line companies and banks do not work over the weekend or after business hours, pushing back the submission of the Customs import declaration (PIB) until the following Monday, and delaying the start of the clearance process. Thus, while the number of containers arriving at the weekend is higher per day than during the week, the number of submissions for Customs clearance is lower per day over the weekend (Figure 33). Customs services are also only available on request during weekends or after business hours, adding an extra step if the importer wants to clear goods over the weekend.

…significant delays in the submission of import declarations…

The delays in the submission of import declarations can be traced back to lags in the submission of the manifest to Customs from vessels coming from a trans-shipment in Singapore or Malaysia. These routes sometimes have very few hours to consolidate the manifest, thus this information is delivered only a few hours before a vessel docks in Tanjung Priok and sometimes even after the vessel has already docked. The manifest information is needed to submit the import declaration, and thus delays in obtaining this information impacts the time when the Customs clearance process starts.

…limited usage of the priority risk channel…

Based on the importer's information, the type of goods being imported, the country of origin, the tax profile of the company and other factors, Customs assigns one of five risk categories available (the standard green, yellow and red plus two additional categories for pre-approved importers). Depending on the risk channel assigned, the importer will obtain a different treatment for Customs clearance, thus determining the length of the stay in the port from there on. The priority risk channel (MITA Prioritas) has a relative short dwell (an average of 4 days) but this channel only accounts for 16 percent of the containers and comprises a small group of only 105 importers. Importers in this risk channel are allowed deferred payments for Customs duties and taxes, and they do not need to submit the manifest number in the import declaration, allowing the earlier submission of the import declaration than in other channels.

…and the underperformance of the Indonesian National Single Window (INSW)

The INSW is a limited space for notifications and information on the status of the processes in different government agencies. Customs clearance and other border agency document requirements function in separate systems and are not integrated into one seamless process. On well-functioning national single windows, users submit the information required by several agencies in a single entry, with a single sign-on, including payments. Such a system reduces physical interactions and paper-based transactions. Currently, however, payment processes need to be done separately for all government agencies and port institutions, including payment of import duties, taxes, agencies' fees, terminal operator charges and others. In addition, the Quarantine Agency does not have access to the information on the arrival of the vessel. An estimated 15 percent of all import containers require quarantine documentation and approvals. Some imports also require entry permits and unloading permits so, in the absence of pre-arrival information, the work performed by the Quarantine Agency relies heavily on the importer.

d. A number of important steps have already been taken to address the situation…

Despite the increase in average dwell time over the past year, the container terminal operators and the Government have had some success in remedying the situation

A number of measures have already been put in place to tackle the increase in dwell time. For example, cash payments on container terminal premises have been abolished and replaced with ATM transactions. Although not yet optimal, reducing cash transactions is a first step in reducing delays in the downstream component. Exchange rate publication has been shifted from Mondays to Wednesdays, allowing importers to submit their import declarations before the weekend with the most up-to-date information. The previous publication of the exchange rate on Monday provided another reason to delay the submission of the import declaration.

The i-Care system (integrated cargo release) was recently launched in Tanjung Priok to integrate all services in the downstream component, aiming to eliminate face-to-face interactions between truck drivers and Customs officials at the gate. A pilot was launched in TPK Koja in November 2012 and it is also integrated with the INSW. The Government has also set up an Integrated Physical Inspection Facility (TPFT), allowing Customs, Quarantine and BPOM to conduct inspections at the same time, reducing the movement of containers and allowing for faster physical inspection times in the yellow and red channels. The TPFT was developed in conjunction with Pelindo II (the state-owned company operating Tanjung Priok) and all the government agencies and began operations in February 2013. This initiative should help to reduce the average dwell time of containers arriving in the yellow and red channels.

e. …and a number of further practical measures have been identified

Further regulatory reforms and procedural improvements can reduce upstream processing times…

Beyond the above steps, further reducing dwell times requires cooperation amongst all stakeholders, including Customs, Pelindo II, container terminal operators, the association of shippers, the association of importers, banks and other government agencies based at the port. Multiple discussions at both the technical and political level, and consultations with academia and development partners have taken place to identify additional available measures which could reduce the upstream component of dwell time.

…including increasing the number of importers in the MITA Priority lane…

Establishing clear, reasonable, and transparent criteria for more importers to join the MITA Priority Customs channel, in consultation with key stakeholders, will help reduce average dwell times. An assessment by DG Customs on the options to increase the number of MITA Priority importers is therefore an important step to facilitate eligible importers to access this higher speed channel.

…allowing for more parallel processes to take place during the Customs clearance component…

Adopting more flexible procedures that can occur in parallel, instead of sequenced steps, could potentially help to reduce times for the pre-clearance component. For example, payment could be allowed before the Customs clearance, but after the submission of the import declaration. Currently, the importer has to pay all duties and taxes to Customs before starting the clearance process. In addition to this parallel process, Customs could explore

giving an exception to authorized operators, like traders of large, trustworthy freight forwarders, to have a direct account with Customs, allowing direct debits or deferred payments. Parallel processes that would allow the clearance process to start while simultaneously matching the information on the contents of the containers would also help to reduce the number of steps in the upstream component.

…providing incentives for early submission of the import declaration…

Other measures by DG Customs and the terminal operator to promote the early submission of import declarations by importers and freight forwarders could also help reduce processing times. A good communication campaign aligned with incentives for early submission might encourage importers to start the pre-clearance process earlier. Incentives to encourage early submission of the import declaration could include tax discounts, duties discounts, as well as reduced container terminal fees. Such incentives might compensate freight forwarders and importers for the extra cost of operating on Saturdays and Sundays, when many containers arrive. Conversely, DG Customs could undertake evaluation and profiling of freight forwarders to identify and penalize those companies that delay the submission of import declarations. Finally, 24/7 service provision may be improved by introducing service-level agreements between the Terminal operator and the shipping lines, as well as for government agencies to facilitate weekend operations.

… and continuing to strengthen the INSW and introduce one-stop services

Ongoing improving to the INSW will be required if it is to deliver on its potential to improve the efficiency of the import process. As an interim step, a one-stop service space could be prioritized, where various institutions have access to all information, including Quarantine, Customs and BPOM. Implementing a single payment for all import processes, including all government agency fees, taxes and import duties, as well as all terminal charges, could also have a major positive impact.

C. Indonesia 2014 and beyond: A selective look

1. Estimating the stock of infrastructure in Indonesia

There has been more than a decade of under-investment in infrastructure in Indonesia…

For many years infrastructure investment in Indonesia has struggled to reach 3 to 4 percent of GDP, far below the pre-1997/98 Asian Crisis level of above 7 percent and well behind neighboring countries, such as China, Thailand, and Vietnam, where it has exceeded 7 percent of GDP.[11] Against a sharp decline in private sector, and moderation in state-owned enterprise (SOE), investment in recent years, the Government's contribution to overall infrastructure investment has increased markedly, led by sub-national governments. However, despite the Government's commitment to improve infrastructure provision and spending, the overall level of infrastructure investment has barely returned to pre-1997/98 levels in real terms and has failed to keep pace with increasing demand.

…with economic implications that merit closer examination

Using new data on infrastructure investment compiled by the World Bank, and building on the analysis of these data presented in the March 2013 *IEQ*, this section delves further into the underinvestment in infrastructure in Indonesia and its growth implications. In particular, it explores two questions: how has the level of investment affected the accumulation of infrastructure capital stock; and how might a more rapid accumulation of infrastructure have affected Indonesia's recent growth trajectory?

Data limitations are a key constraint for the analysis of Indonesia's infrastructure capital stock and need to be addressed to help

In the analysis presented below, infrastructure is considered to include energy, roads, bridges, ports, irrigation and telecommunication infrastructure. The limited availability and lack of comprehensive data on investment in, and the stock of, such infrastructure have been a challenge to pursuing in-depth analysis on the above questions. These data constraints, as outlined in the March 2013 *IEQ*, mean that the calculations in this section should be treated with caution. However the findings presented below aim to provide the foundation for

[11] See the March 2013 *IEQ* for the World Bank's recent estimates of infrastructure investment in Indonesia and for the regional context see Asian Development Bank; World Bank; Japan Bank for International Cooperation (2005) *Connecting East Asia: A New Framework for Infrastructure.*

better inform evidence-based decision making

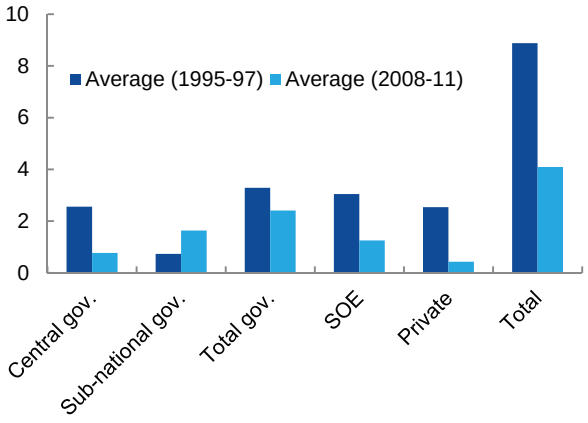
improved analysis at the national, subnational and sector levels and to stimulate further data collection and analysis to inform evidence-based policy making in Indonesia on this important issue.

a. Infrastructure investment relative to GDP has fallen since 1997/98

Indonesia's infrastructure investment levels fell sharply following the 1997/98 Asian Crisis…

According to the World Bank data, infrastructure investment in Indonesia fell markedly following 1997/98 and has recently stabilized at around 3 to 4 percent of GDP (Figure 34). In contrast, the level of gross fixed capital investment (including construction, machinery and equipment, and transportation equipment) has recovered as a share of GDP, reaching 33 percent in 2012, surpassing levels seen before the Asian crisis. This recovery was driven by construction investment, particularly visible in increased housing, shopping outlets and other buildings.

Figure 34: Infrastructure investment levels to GDP have fallen with the exception of subnational government
(nominal infrastructure investment levels as share of GDP, percent)



Source: Infrastructure investment data as detailed in Box 5 in the March 2013 IEQ and World Bank staff calculations

…with broad-based falls across entities, but particularly for the private sector

As detailed in the March 2013 *IEQ*, the fall in infrastructure investment as a share of GDP was broad-based across government, state-owned enterprises (SOEs), and the private sector. Private sector investment experienced the biggest fall, by 2.1 percent of GDP, from an average of 2.3 percent of GDP during 1995-97 to below 0.4 percent of GDP in 2008-11. The sharp fall in private sector infrastructure investment is of particular concern, given an increasing focus on Public Private Partnerships (PPP) to finance Indonesia's infrastructure development. SOE investment also dropped by about 1.8 percent of GDP. Total (local and central) government investment declined by 0.9 percent from an average of 3.3 percent of GDP during 1995-1997 to 2.4 percent of GDP over 2008-11 (Figure 34).

Government infrastructure investment, although down relative to GDP, has almost recovered in real terms, driven by sub-national government investment…

In constant price terms (using the national accounts investment deflator), total infrastructure investment during 2008-11 was about a third lower than its level in 1995-97. However, by 2008-11 annual average government (central and local) infrastructure investment in constant prices had recovered to 1995-97 levels, while SOEs and the private sector remained down around 30 and 70 percent. The government sector contribution to overall infrastructure investment has therefore increased, led by sub-national government spending on local road investment. The rising importance of sub-national investment reflects the impact of fiscal decentralization in 2001 in which spending assignments and financing were transferred to sub-national governments. Prior to decentralization, about 80 percent of the government infrastructure investment came from the central government, with only 20 percent provided by sub-national governments. Subsequently this has shifted to about 65 percent of spending implemented by sub-national government and 35 percent by the central government.

…as well as a recent major boost in central government capital spending, reflecting the Government's commitment to improve infrastructure provision

The Government recognizes Indonesia's infrastructure challenges and has committed to address them through the Medium-Term Development Plan (*Rencana Pembangunan Jangka Menengah Nasional*, RPJMN) and the Master Plan for the Acceleration and Expansion of Indonesia Economic Development (*Master Plan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI). Indonesia has also introduced a number of policies and initiatives, including significant budget increases for capital spending and a strengthened institutional and regulatory framework for Public Private Partnerships (PPP). However, despite a sizeable rise in nominal capital spending by the central government, overall progress on infrastructure investment on the ground remains relatively slow, due to a range of implementation and coordination challenges.[12]

b. Indonesia's stock of infrastructure capital has likely declined relative to the total…

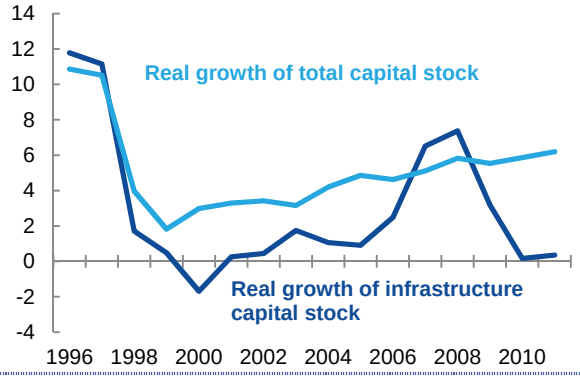
Led by robust construction investment growth Indonesia's total capital-to-output ratio has increased in recent years

As mentioned above, Indonesia's aggregate investment growth has been strong in recent years, with gross fixed capital formation growing in real terms at 8 percent on average between 2001 and 2011, largely driven by construction. As a result, Indonesia's overall capital stock ratio-to-GDP has risen from an estimated 1.7 times GDP in 1995 to 2.1 times GDP in 2011. Has infrastructure capital stock, which is a key input to productivity and growth, kept track with this overall trend? The following section will explore this important question, including the likely implication on output growth.

In contrast, estimates suggest that the infrastructure capital stock has likely declined relative to the size of the economy and the total capital stock

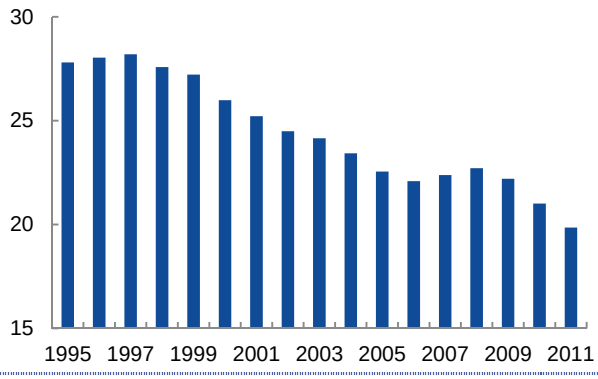
The Perpetual Inventory Method (PIM), combined with the assumptions outlined in Box 4, can be used to estimate the level of Indonesia's infrastructure capital stock. Preliminary estimates indicate that the declining real infrastructure investment rate in the face of depreciation and rapid economic growth have likely resulted in a declining level of infrastructure stock relative to the size of the overall economy. For example, after depreciation, the average real growth of the infrastructure capital stock between 1996 and 2011 was 3 percent, below the average real GDP growth rate of 4 percent (including the 1997/98 crisis period). The pace of infrastructure investment growth has also not kept pace with the real growth in the overall capital stock, which averaged 4.4 percent over this period (Figure 35). As a result, Indonesia's infrastructure capital stock has gradually declined from an assumed starting value of 28 percent of total capital stock in 1995 to 20 percent in 2011 (Figure 36). The recent pick up in public infrastructure investment has been only sufficient to slow the rate of relative decline. The rise in the growth rate of overall investment in the last decade has been led by the non-infrastructure construction sector. While these estimates are subject to a range of caveats the broad findings do appear relatively robust to different assumptions (see Box 4).

Figure 35: The total capital stock has grown at a faster real rate than the infrastructure capital stock.…
(real growth of total and infrastructure capital stock, percent)



Source: World Bank staff calculations

Figure 36: …resulting in a decline in the ratio of the infrastructure capital stock relative to the total capital stock
(share of infrastructure capital stock to total capital stock, percent)



Source: World Bank staff calculations

[12] For further analysis on implementation challenges in infrastructure sector see the June 2012 *IEQ*.

Box 4: Methodological note on estimating infrastructure capital stock in Indonesia

In this analysis, total infrastructure capital is defined as capital stock invested by the general government, state-owned enterprises (SOEs), and private sector within core infrastructure sectors such as transport, irrigation, water and sanitation, energy (electricity) and the telecommunications sectors. It excludes military structures and equipment and other infrastructure such as hospital, education buildings, and other public buildings. This analysis uses monetary indicators (e.g. infrastructure investment flows and accumulated value) to measure infrastructure assets instead of physical indicators (e.g. road kilometers). This definition follows the infrastructure investment data compiled by the World Bank, as detailed in the March 2013 *IEQ*. A clear caveat with this approach is that the relationship between investment and the provision of infrastructure services, which matter for growth and development outcomes, is dependent upon the quality and efficiency of the investments.

Table 7: The growth of the infrastructure capital stock is sensitive to the assumed initial level of the infrastructure stock and depreciation rate

	Level of infrastructure capital stock (share of total capital stock, percent)			Growth of infrastructure capital stock (percent)
	Starting period (1995)	End period (2011)	Average 2001-11	Average 1996-2011
Baseline: 28 percent initial level of infrastructure capital stock; 5 percent depreciation rate	28	20	23	3.0
Scenario I - Different initial level of infrastructure capital stock				
A. +5% of baseline	33	21	24	2.2
B. -5% of baseline	23	19	21	4.0
Scenario II - Different depreciation rates				
A. 3.5 percent	28	23	25	3.9
B. 6.1 percent	28	18	21	2.1

Source: World Bank staff calculations

The Perpetual Inventory Method is used to estimate the infrastructure capital stock, by taking an estimate of the initial capital stock value (in 1995 from when the infrastructure investment data are available) to which gross investment flows are added and from which depreciation of the existing stock is subtracted. Based on this approach, Indonesia's estimated infrastructure capital stock in 2011 of 49 percent of GDP is close to McKinsey Global Institute (2013) average estimates (over 1992-2011, including capitalized maintenance) for India at 58 percent of GDP but below averages for middle and high income economies of 70 percent of GDP.

Due to data limitations, a number of assumptions have been made to construct the capital stock estimates. First, following Van der Eng (2008) who estimates the capital stock in Indonesia between 1950 and 2007, the initial value of the total capital stock is assumed to be 1.7 times GDP in 1995 and the initial level of infrastructure capital stock is assumed at 28 percent of total capital stock. (Although the initial value of total and infrastructure capital stock use Van der Eng's estimate, the trends and levels of total and infrastructure capital stock for the subsequent period of analysis are different due to different methodologies).

Second, the annual depreciation rate for infrastructure assets is assumed at 5 percent, following the Ministry of Finance's assumption for tax accounting purpose for building and transportation equipment (MoF, 2009). This rate is in-between the implicit depreciation rate of 6.1 percent used by Van der Eng for Indonesia, and a 3.5 percent rate used by Arslanalp (2011) for middle-income countries.

Finally, it is important to note that the use of investment data may underestimate the contribution of maintenance spending on sustaining asset life. However, this may be offset by the likely overestimation implied by assuming a one-to-one relationship between infrastructure investment and the accumulation of productive assets. For example, Pritchett (2000) argues that there is lack of relationship between investment spending (flow) and the accumulation of productive assets, particularly in developing countries, owing to inefficiencies and waste.

The estimates of the infrastructure capital stock are sensitive to the assumptions on the initial level of the infrastructure stock and the depreciation rate (Table 7); if initially in 1995 the infrastructure capital stock was 33 percent of total capital stock (5 percentage points higher than the baseline), then the annual growth of the infrastructure capital stock over the period would have averaged 2.2 percent, lower than the baseline, as the higher initial stock would result in more depreciation relative to the new investment flows, but the final estimated level in 2011 would be higher. Depreciation rate assumptions also affect the growth rate and infrastructure capital stock level; a lower depreciation rate of 3.5 percent (below the baseline of 5 percent) would result in a higher average growth rate of the infrastructure stock and its estimated level relative to the total capital stock would be higher than the baseline.

Note: See Van der Eng, Pierre (2008) 'Capital Formation and Capital Stock in Indonesia, 1950-2007.' Working Papers in Trade and Development No.24. Canberra: School of Economics, ANU College of Business and Economics, Australian National University; McKinsey Global Institute (2013), 'Infrastructure Productivity: How to save $1 trillion a year'; MoF Regulation (PMK No. 96/PMK.03/2009); Arslanalp, S. et.al (2011), 'Investing in Growth', Finance & Development, March 2011. IMF; Pritchett, L (2000), 'The Tyranny of Concepts: CUDIE (Cumulated, Depreciated, Investment Effort) Is Not Capital', Journal of Economic Growth, 5:361-384.

c. …affecting Indonesia's growth trajectory

The weak growth of infrastructure capital stock has likely hampered Indonesia's recent economic performance

Capital stocks, including infrastructure, reflect the capacity of the economy to produce goods and services. The quality and quantity of the infrastructure capital stock - particularly core infrastructure such as roads network, railways, bridges, ports, airports, electricity, telecommunication facilities, and water systems - is a critical input to economic productivity and competitiveness. The majority of empirical studies find a positive relationship between infrastructure capital stocks and output (Box 5). As such, and as expected from the impacts of infrastructure weaknesses on businesses and households on a daily basis, the relatively low growth in Indonesian's infrastructure capital stock has likely hampered Indonesia's economic performance over the past decade.

Box 5: Empirical studies on the links between public and infrastructure capital stocks and growth

A number of studies have found a positive relationship between infrastructure capital stocks and growth, although the estimated magnitude varies by country depending on factors such as measures of infrastructure, period of analysis, and quality of investment. Results tend to be stronger if the measures of infrastructure are physical. The quantitative assessments in this area took-off with the seminal work of Aschauer (1989) which explained the productivity growth slowdown in the 1970s in the USA. Aschauer found that a rise in the public capital stock was associated with a large increase in private output, with a 1 percent rise in the public capital stock increasing private output by 0.39 percent. Since then, many studies have been undertaken for the USA, OECD countries, cross-country and at the regional level. However, country-specific studies for developing countries are still limited. One relevant country-specific study is Sahoo et al. (2010) that examines the role of infrastructure in promoting economic growth in China for the period 1975 to 2007. Infrastructure development was found to have made a significant positive contribution to growth with an output-to-infrastructure elasticity in the range of 0.20 to 0.41.

Table 8: Selected studies of estimates of the elasticity of output with respect to infrastructure

Country/ region	Authors	EOI*	Infrastructure measure
USA	Aschauer (1989)	0.39	Public capital
Developing countries	Easterly and Rabelo (1993)	0.16	Transport & communication
Cross country	Calderon and Serven (2003)	0.16	Transport & communication
Cross country	Esfahani and Ramires (2003)	0.12	Physical capital stock
South Asia	Sahoo and Dash (2008)	0.18 to 0.22	Physical capital stock
Cross country (meta-analysis)	Ligthart and Bom (2009)	0.15	Public capital
China	Sahoo et al. (2010)	0.20 to 0.41	Physical capital stock

Note: * EOI indicates the elasticity of output with respect to infrastructure
Source: Adopted from Sahoo et al (2010) and Ligthart and Bom (2009)

For simplicity, in the simulations an elasticity of output to infrastructure capital stock of 0.15 was assumed, along the lines of the empirical findings of Ligthart and Bom (2009) and Corong et al (2012). On the one hand, this relatively conservative elasticity assumption takes into account the concerns over the weak linkages between monetary investment, physical capital stock, and infrastructure service provision. On the other hand, this assumption could underestimate impact of positive externalities of accumulated infrastructure capital, for example on improving accessibility to education and health services. It also is recognized that the multiplier of infrastructure investment to growth varies between types of infrastructure investment. For example, OECD (2009), using measures of physical infrastructure per capita, estimates a range of multipliers for various type of infrastructure, for example, roads (0.3 – 0.46), railway infrastructure (0.39 – 0.53), motorways (0.42-4), electricity (0.39), telephone mainline infrastructure (0.39 – 0.42), and telephone subscriptions (0.34 – 0.45). Due to data limitations, this disaggregated analysis by type of infrastructure is not conducted for Indonesia.

Source: Sahoo, Pravakar., Dash, Ranjan Kumar, Nataraj, Geethanjali. (2010). 'Infrastructure development and economic growth in China' IDE Discussion Paper No. 261. Institute of Developing Economies; OECD (2009), 'Infrastructure investment: links to growth and the role of public policies', Douglas Sutherland, Sónia Araújo, Balázs Égert and Tomasz Kozluk, OECD Working Paper No. 686, 24 March 2009; Ligthart, Jenny E., and Bom, Pedro RD. (2009). 'How Productive is Public Capital? A Meta Regression Analysis' International Studies Program. Andrew Young School of Public Policy Studies. Georgia State University

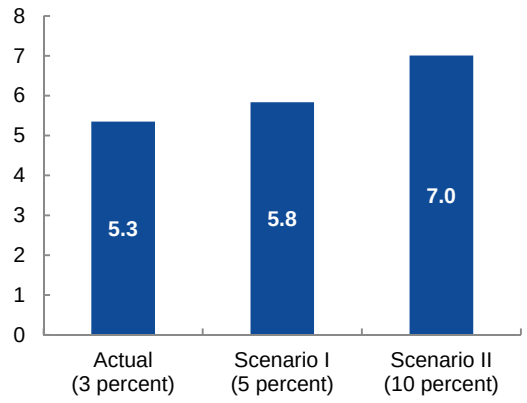
A simple counterfactual exercise can be used to illustrate the potential impact on growth of improving Indonesia's infrastructure capital stock growth

A simple counterfactual exercise serves to illustrate how the weak pace of infrastructure investment may have affected growth in Indonesia, or put another way, the potential benefits from achieving higher levels of infrastructure investment, if this investment is implemented in an efficient and effective manner. As a baseline, a relatively high elasticity assumption of output to the infrastructure capital stock of 0.15 is used, given the current relatively low rate of infrastructure provision in Indonesia – i.e. a 10 percent increase in the capital infrastructure stock is assumed to lead to a 1.5 percent rise in GDP. As discussed in Box 5, it is recognized that the multiplier of infrastructure to growth varies by the type of infrastructure, however, due to data constraints this disaggregate analysis cannot be carried out. For the scenario analysis, two scenarios of alternative annual growth of infrastructure capital stock of 5 and 10 percent are applied.

Higher growth rates in infrastructure stocks would have delivered higher levels of GDP growth…

The average growth rates of the estimate of Indonesia's real infrastructure capital stock and of real GDP were 3.0 and 5.3 percent, respectively, for the period 2001-2011. Assuming a causal relationship between changes in the infrastructure capital stock and output, if the growth rate in infrastructure capital stock had been 5 percent annually, rather than 3 percent, the estimated average annual GDP growth over this period would have been 5.8 percent, 0.5 percent higher than the actual annual average GDP growth of 5.3 percent (Figure 37). Cumulatively, the level of GDP would have been 5 percent higher in 2011. If the annual growth in infrastructure capital stock had been even higher, at 10 percent, GDP growth would have averaged 7 percent for the period 2001-11, about 1.7 percentage points higher than the actual average, and the level of GDP would have been 19 percent higher in 2011, reflecting the cumulative impact of higher average annual growth (Figure 37).

Figure 37: Greater investment in infrastructure capital would have been associated with higher average growth
(average real GDP growth over 2001-11 under different infrastructure capital stock growth scenarios, percent)



Source: World Bank staff calculations

… which would have contributed to faster poverty reduction and improved development outcomes

Extensive empirical analyses suggest that higher GDP growth often contributes to poverty reduction. Given the official poverty line and Indonesia's consumption distribution - that is, how many people lie within 1 percent of the poverty line - in recent years, for every 1 percent growth in the incomes of the poor, the national poverty rate declines by 0.5 percentage points. Applying this rough rule of thumb, and some assumptions about how much GDP growth passes through to household consumption growth of the poor, a higher growth of infrastructure capital stock of 5 percent (than actual average of 3 percent), could increase the growth of poor consumption by an additional 0.3 percent per annum, and be associated with an additional 0.15 percentage point fall in poverty per year. From 2001-11, this would mean a 1.5 percentage point lower poverty rate (i.e., this year's poverty would be 9.9 percent rather than its current 11.4 percent). If the growth of infrastructure capital stock would have been averaging 10 percent, this number would be 4.5 percentage points over the period, or a current poverty rate of 6.9 percent. These estimates are clearly simplifications but are intended to be illustrative. It is also important to recognize that the extent to which infrastructure-supported growth may support further poverty reduction is influenced by many factors, such as the type of infrastructure, its geographical location, condition, and the period of analysis.

A continued focus on lifting the quality and quantity of infrastructure spending is critical for Indonesia to realize its growth potential...

Since the 1997/98 crisis, Indonesia has had difficulties in achieving sustained growth of its infrastructure capital stock. In fact, while there are significant data limitations, the evidence suggests that infrastructure stock has not increased greatly over this period, causing it to fall relative to both the total capital stock and to the size of the economy. With demand for better infrastructure services only likely to increase, the need to continue improving infrastructure investment is clear. In this regard, improving both the quantity and quality of public investment is important. Continuing to increase the budget allocation for infrastructure development plays a role, through redirecting spending, for example, from energy subsidies, and supporting improved revenue mobilization. In parallel, the Government's efforts, mentioned in Part A, to support spending execution and project implementation should be sustained. Fiscal sustainability and competing demands for public funds also argue for a strong focus on efficiency, including ensuring the smooth operation and maintenance of existing infrastructure, and, more broadly, on improving the quality of public investment management to deliver effectively on the priority public infrastructure needs of the economy. In addition, it will be important to support policies, regulations and institutions, such as in relation to public private partnerships (PPPs), which can build a stronger enabling environment for private sector infrastructure investments.

…and further data collection and analysis can help to inform the quality of evidence-based policy making in support of this goal

As discussed, measuring the size of Indonesia's total and infrastructure investment, capital stocks and their impact on growth has been challenging due to a range of data limitations and required assumptions. The estimations and simulations presented above are an initial step in this analysis. Improving the quality, timeliness and coverage of the data is an important step for enhancing this analysis and to inform better evidence-based policies on infrastructure needs and performance. Extensions to this analysis can also support these objectives, for example, by linking the investment and capital stock estimates to real sector indicators, by disaggregating the investment and stock by type and by region, by linking spending on operations and maintenance to the capital stock estimates, by making adjustments to take into account the quality of investments, and by examining in more detail their relationships with outcomes including growth and inclusiveness. Estimates of the current economic costs of infrastructure weaknesses can also further enrich this analysis. This includes not only the economic costs of congestion but also the opportunity costs of the private sector's responses, such as purchasing in-house generation capacity or adding additional trucks to compensate for fewer deliveries per day by each truck due to congestion.

2. Local governance and education performance

A core task of any education system is to equip young people with the skills they need, and this is vital for development

A strong and versatile education system is vital to the long-term development of any country.[13] The core task of any education system is to equip young people with the skills they need to participate fully in social, economic and political life. Providing a good quality basic education to all children can raise productivity, increase the rate of economic growth and support the foundations for a peaceful future. For example, recent international research has shown that ensuring all children leave school with basic literacy and numeracy skills can raise annual per-capita growth by up to one percentage point.[14] Such an advantage would have a significant positive impact on Indonesia's medium-term growth trajectory and development outlook. This section discusses recent survey evidence on the important role that improvements in local governance can play in raising the quality of basic education and ensuring children leave school with adequate skills.

Education reform has led to expanded school access but more modest improvements in learning

In the last fifteen years, Indonesia has introduced a comprehensive package of education reforms designed to expand access and improve quality. A key component of the reform process has been the devolution of responsibility for basic education services to local governments and schools. These reforms, coupled with an unprecedented increase in government investment in education have resulted in significant improvements in education access particularly for the poorest children.[15] However, improvements in learning achievement have been more modest and children still leave school with inadequate skills for the needs of the labor market. As with other education systems around the world, improving the quality of basic education continues to be a central challenge.

Strengthening local government capacity is a crucial ingredient for improved education quality

Strengthening the capacity of local governments to manage their education systems effectively is vital if efforts to raise education quality are to be successful. The ability of local governments to deliver good quality basic education services varies considerably across Indonesia. Identifying the key dimensions of governance that underpin effective education service delivery can provide a starting point for addressing existing weaknesses and raising education performance.

[13] This section draws on the forthcoming World Bank study 'Local governance and education performance: A survey of local education governance in 50 Indonesian districts'.
[14] Hanushek, E. and L. Woessmann (2008). "The role of cognitive skills in economic development." Journal of Economic Literature 46(3).
[15] For further analysis on recent trends in education spending and outcomes in Indonesia, see World Bank (2013), *Indonesia - Spending more or spending better: improving education financing in Indonesia*. http://documents.worldbank.org/curated/en/2013/03/17536528/indonesia-spending-more-or-spending-better-improving-education-financing-indonesia.

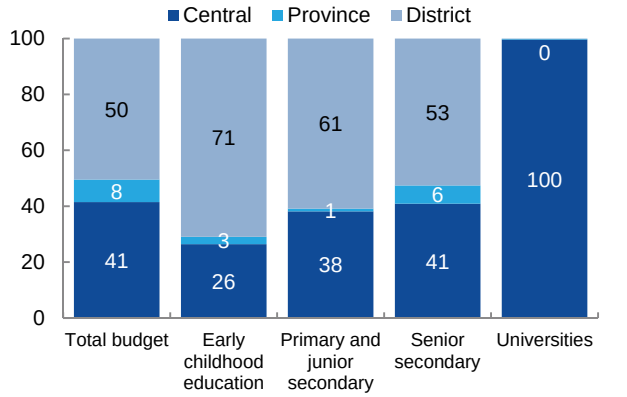
a. Local education governance is important for improving performance

Decentralization has put local governments at the heart of basic education service delivery…

Decentralization has put local governments, particularly district administrations, at the heart of basic education service delivery. District responsibilities include the overall management of the education system, the licensing of schools and the planning and supervision of the teaching force. Districts also provide the bulk of public financing for primary and junior secondary schools (Figure 38).

Figure 38: Local governments provide the bulk of education financing for basic education

(source of government education spending by level, percent, 2009)



Source: World Bank staff estimates based on MoF and APBD data

…and their capacity to manage their education systems is a key determinant of education outcomes

Since district governments play a central role in delivering basic services, their capacity to manage their education systems effectively is a key determinant of performance. Educational opportunities vary enormously across Indonesian districts; average national examination scores at the primary level in 2009 varied from a low of 48 percent in Sumba Barat Daya in the province of Nusa Tenggara Timur to a high of 83 percent in Kota Mojokerto in Jawa Timur province. Poverty, geography and other socio-economic factors explain some of this variation but research has shown that the quality of local governance is also important. In particular, studies have shown that education outcomes are better in districts that have more effective planning and budgeting systems and have lower levels of perceived corruption.[16] These findings suggest that efforts to improve education outcomes will need to address weaknesses in local governance to be successful.

b. The Indonesian Local Education Governance (ILEG) survey

A survey of the quality of local education governance was conducted across 50 districts in 2009 and 2012…

In order to assess the state of local education governance, a survey was conducted in 50 districts (across nine provinces) in 2009 and 2012. The participating districts were selected by the Ministry of Education and Culture to take part in the Basic Education Capacity (BEC) Development project (which, as described in Box 6, provided technical assistance and grants to the selected districts). The survey aimed to:

1. Provide an assessment of districts' capacity to deliver basic education services
2. Explore the relationship between governance and district education performance
3. Track recent changes in education governance
4. Assess the effect of donor-supported capacity building activities

The districts participating in the ILEG survey are not representative of Indonesia as a whole. In particular, the districts that participated in the survey tended to be poorer than other districts but had similar levels of education access and achievement.

[16] See for example, World Bank (2010). *Governance matters to education outcomes. The Indonesia local education governance index (ILEGI): A report card of 50 local governments* and Suryadarma, D. (2012). "How Corruption Diminishes the Effectiveness of Public Spending on Education in Indonesia." Bulletin of Indonesian Economic Studies 48(1): 85-100.

…and included measurements of education governance which were organized into five main categories…

In the ILEG survey, education governance is broken down into four key dimensions that seek to measure the effectiveness of local government institutions associated with the delivery of education services:

- Transparency and accountability. The practices and regulatory efforts made by local governments to enable transparent, accountable and participatory governance of the education sector.
- Management control systems. Assesses the extent to which systems are in place to incorporate decisions made by local and school level planning processes into annual district education work plans.
- Management information systems. Measures the availability of good quality information on local education systems that can be used for education planning and monitoring processes.
- Efficient resource use. Establishes whether the systems are in place to effectively plan, budget and monitor resource use.

A fifth component, education service provision standards, provides a summary measure of the level and quality of primary and junior secondary education services in a district and can be used to explore associations between the dimensions of governance and education performance.

…resulting in five weighted sub-indices, and an overall ILEG index to provide a summary measure of the quality of local education governance

For each dimension, a set of indicators is used to evaluate the quality of local governance. Indicators are weighted according to whether they are measures of regulatory compliance, process or performance. Indicators of performance are given the highest weight and regulatory indicators the lowest. In order to summarize the quality of local governance, the set of indicators in each area are combined into a sub-index. For example, the sub-index for transparency and accountability is a weighted average of ten indicators. These sub-indices are averaged to construct the ILEG index which is an overall measure of the quality of local education governance. The index ranges from 0 to 100 percent with low scores indicating that key components of governance that drive better education performance are not in place and high scores indicating that these components already exist.

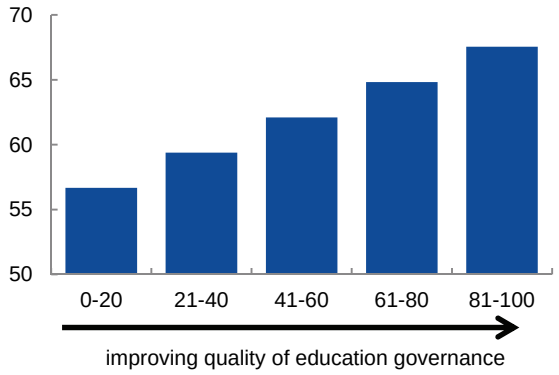
c. The main findings of the ILEG survey

The survey results indicated that better governed districts tended to have higher quality, and more efficiently distributed, education inputs and better education performance

The results of the survey show that decisions on the priority given to education, the quality of the inputs provided and their distribution tend to be better in districts with higher quality governance. For example, districts with a better ILEG index tend to have more qualified teachers and these teachers are more equitably distributed. These results remain even after other factors (e.g. poverty, age of the district etc.) are controlled for. Intermediate outcomes are also positively related to education enrolment rates and examination scores. Districts that devote a greater share of their budgets to education and hire more qualified teachers, for example, tend to have better enrolment rates and examination scores. Putting the results together suggests that better quality local governance is associated with better education performance (Figure 39).

Figure 39: Higher quality local education governance is associated with better education performance

(estimated primary and junior examination scores, y-axis, for different local education governance scores, x-axis)



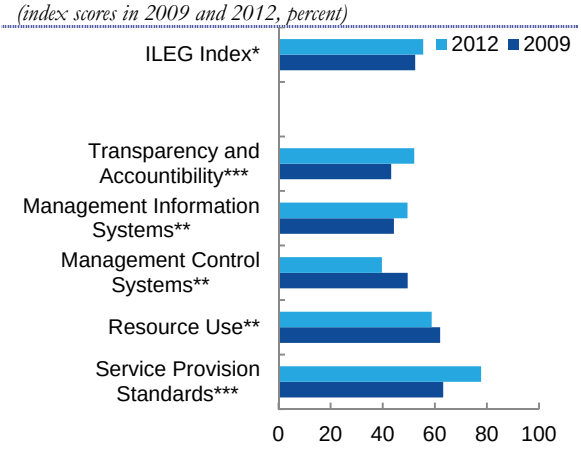
Note: The results presented here show the estimated relationship between the ILEG index and the UN examination score having controlled for other factors that could determine district examination scores (e.g. poverty levels)

Local education governance is improving, but only slowly,…

Education governance has improved between 2009 and 2012 but overall these improvements have been small (Figure 40). The overall ILEG index increased by 3 percentage points and the quality of local education governance remains firmly in the middle of the performance range. However, there have been some notable shifts in the distribution of districts along the performance range. The percentage of districts that were classified as low performers in terms of governance (with ILEG index scores of 45 percent or less) fell from 28 percent to 16 percent. These results show that district governments are moving in the right direction, albeit slowly.

Figure 40: Small overall improvements in education governance but big shifts in some dimensions

(index scores in 2009 and 2012, percent)



Note: Asterisks indicate the level of statistical significance of a test of the difference between the 2009 and 2012 indices - *** - significant at the 1 percent level, ** - significant at the 5 percent level, * - significant at the 10 percent level

Source: Indonesian local education governance survey, 2009 & 2012

…and weaknesses in key aspects of local governance remain

Performance across the areas of governance measured by the survey also shows large differences. Local governments appear to perform strongly in terms of the education service provision standards the survey measured. However, districts were rated relatively poorly on the effectiveness of their management control systems and districts were rated as only average in the quality of their management information systems and in the processes they had in place to make education decision-making transparent and accountable.

There have been some improvements in the quality of education management information systems and processes to strengthen transparency…

Despite the weaknesses in management information systems, and transparency and accountability, identified by the survey, some progress has been made (Figure 40). In terms of transparency and accountability, improvements have been made in the efforts that local governments have made to encourage greater community participation in decision-making and oversight activities. For example, between 2009 and 2012 the proportion of districts that allowed public participation in parliamentary accountability and audit reporting sessions increased from 14 percent to 52 percent. However, in 2012, only half of the surveyed districts allowed public access to parliamentary budget and audit discussions.

…but weakness remain, with only a third of districts having systems in place to collect accurate and timely information

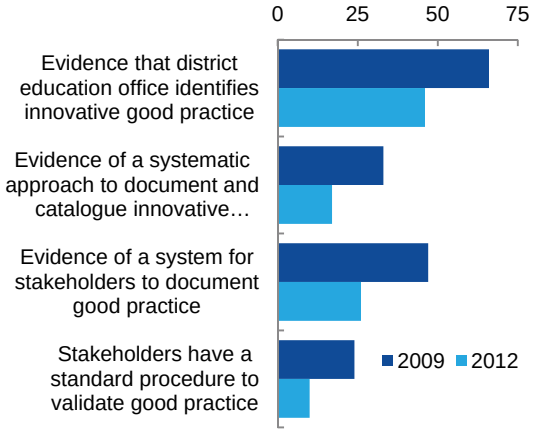
Accurate and timely information is vital for effective planning and monitoring of local education systems. Local governments registered some modest improvements in this area between 2009 and 2012. For example, a slightly higher number of district education offices had written procedures and protocols for data collection and verification in 2012 than in 2009. However, only about a third of all districts had these systems in place by 2012 and this is a contributory factor in the large discrepancies seen in key district education variables when different data sources are compared.

Weaknesses in the way districts manage and use their education resources appear to have grown, particularly in relation to the documentation of innovation and best practice

The deterioration of the effectiveness of management control systems was largely the result of a drop in the number of districts that systematically documented and disseminated examples of innovation and best practice (Figure 41). For example, in 2009 two-thirds of districts made efforts to identify and document good practice whereas in 2012 this had fallen to less than a half. Other components of this dimension of governance also appear to be weak. In 2012, only 12 percent of districts consolidated school development plans to use in their district education planning process. This undermines school based management reforms which have encouraged schools to develop school development plans as part of a bottom-up planning process designed to link district resources more closely to the needs of schools. Despite these setbacks, some aspects of management control have improved over the last few years. In particular, asset management systems appear to have been strengthened and a greater proportion of districts are carrying out yearly stock inventories and have passed local legislation on asset management.

Figure 41: District capacity to catalogue and disseminate good practice has declined

(percentage of surveyed districts, 2009 and 2012)



Source: Indonesia local education governance survey data, 2009 and 2012

Differences between planned and realized spending point to weaknesses in budgeting for education…

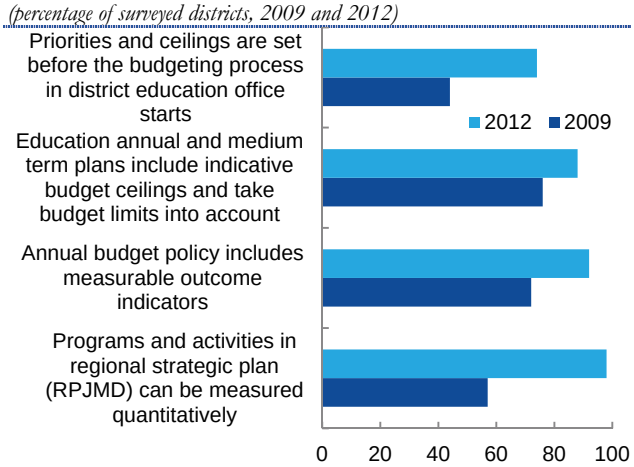
The factors underlying the decline in the dimension of governance associated with efficient resource use are more complex. This area of governance is most closely associated with an assessment of the effectiveness of district education offices to plan, budget and monitor the use of education resources. A key indicator of effectiveness in this area is the difference between planned and realized education spending. This indicator deteriorated between 2009 and 2012; the number of districts reporting gaps between planned and realized spending of less than 10 percent over the last three years fell from 46 percent to 32 percent. However, the large adjustments in the revised budgets are partly due to revisions in intergovernmental transfers that local governments cannot control.

…but other indicators suggest that local planning and budgeting processes are beginning to improve

Although the sub-index on efficient resource use declined between 2009 and 2012, local governments have also registered some important gains in the processes which determine how public resources are used (Figure 42). For example, the proportion of districts that include measurable outcome indicators in their annual budgets increased from 72 to 92 percent. Improvements to the functioning of local planning and budgeting processes have also shown progress. Between 2009 and

Figure 42: Some aspects of the local planning and budget process have improved

(percentage of surveyed districts, 2009 and 2012)



Source: Indonesian local education governance survey data, 2009 and 2012

2012 the proportion of districts that set budget priorities and ceilings before sector offices (e.g. the education office) start their own planning exercises increased from 44 percent to 74 percent. These improvements reflect recent efforts by the central government to introduce performance based budgeting and medium term expenditure frameworks.

Box 6: The effect of capacity development grants provided to district education offices

The Basic Education Capacity (BEC) program provided support to all of the sampled districts in the ILEG survey through technical assistance and the provision of local capacity development grants of approximately USD 255,000. While the grants were relatively small (on average less than one percent of average annual education expenditure) they were designed to strengthen local education governance and improve education performance.

It was expected that local governments would use the capacity building grants to focus on the main areas of weakness identified in 2009 partly through the first round of the ILEG survey. However, it appears that areas assessed to be the weakest were allocated less grant resources than the strongest areas. For example, in 2009 districts ranked relatively highly on the ILEG sub-index for education service provision standards, yet this area received the largest share of BEC grant resources. It is not possible to directly attribute the changes in the quality of local education governance reported by the ILEG survey from 2009 to 2012 with capacity building efforts. However, the weak targeting of resources for capacity building is likely to have played a part in the mixed picture of improvements in governance recorded by the survey. Future capacity-building support programs should build on the experience of the BEC program, which points to the importance of carefully targeting support, cutting across governance sectors, and tailoring support to district characteristics.

d. Without addressing key governance constraints, performance is unlikely to improve

District education performance will not improve without strategies to address key governance constraints

The findings of the ILEG survey demonstrate the importance of the quality of local governance in improving district education performance. Put simply, district education performance is unlikely to improve without strategies to address the key governance constraints highlighted in this section. However, progress in strengthening local education governance over the last four years has been slow, despite efforts to strengthen district capacity. Major challenges therefore need to be addressed if local education governance is to be improved.[17]

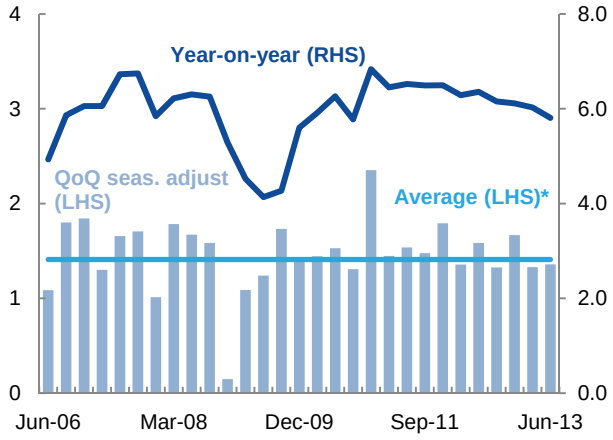
Better coordination and integration of central government financing in local education planning is needed

While strengthening local governance is crucial for sustained progress in the education sector it is also important to recognize that central government transfers and education sector programs present a number of challenges to district level education governance. The current intergovernmental transfer system introduces incentives for higher salary spending which may distort the decision-making process and result in mismatches between school needs and district allocations. While local governments provide the bulk of funding for basic education, the central government still contributes significantly. In order to reduce the risk that central government programs undermine district efforts to improve education sector management and governance there is a need for improved coordination and integration of central and local government programs. This includes efforts to clarify roles and responsibilities and an increased effort to incorporate central government programs into local planning processes are clearly needed.

[17] A fuller discussion of these issues is contained in the forthcoming World Bank study, 'Local governance and education performance: A survey of local education governance in 50 Indonesian districts'.

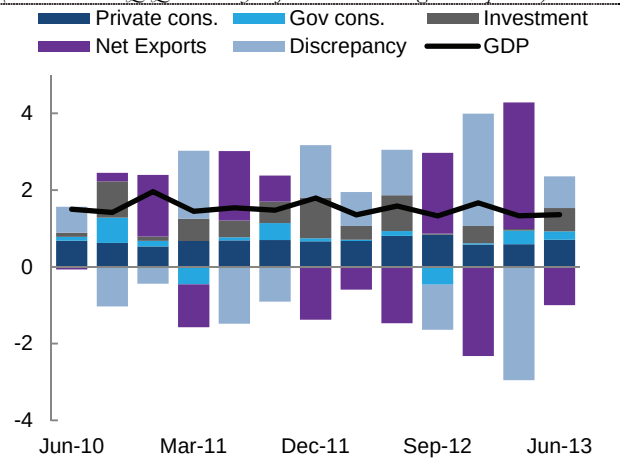
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

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



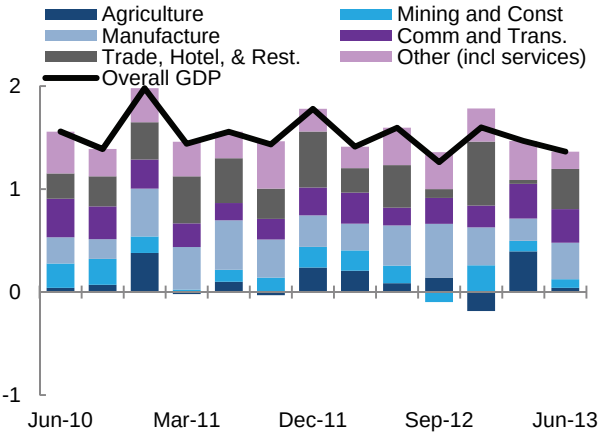
Note: *Average QoQ growth between Q2 2003 – Q2 2013
Source: BPS; World Bank seasonal adjustment

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



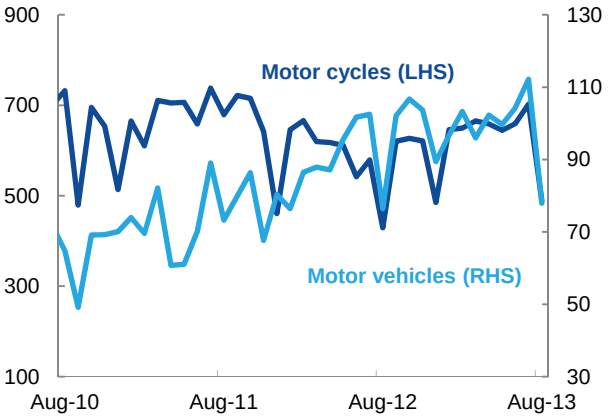
Source: BPS; World Bank staff calculations

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



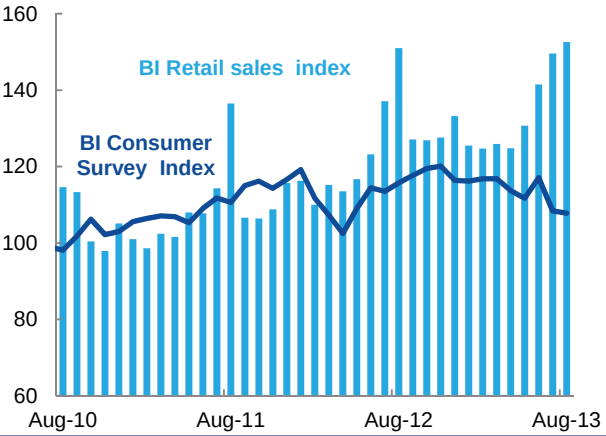
Source: BPS; World Bank staff calculations

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



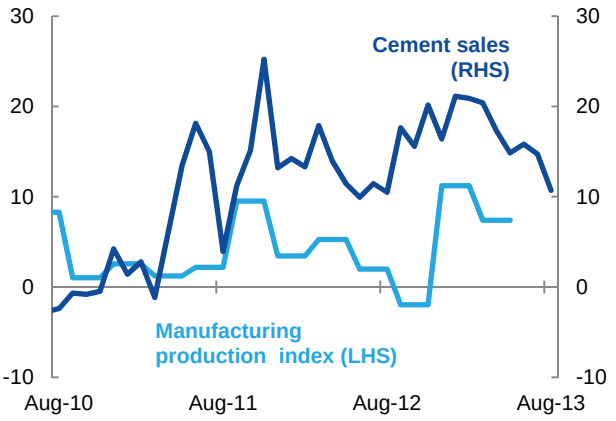
Source: CEIC

Appendix Figure 5: Consumer indicators
(index)



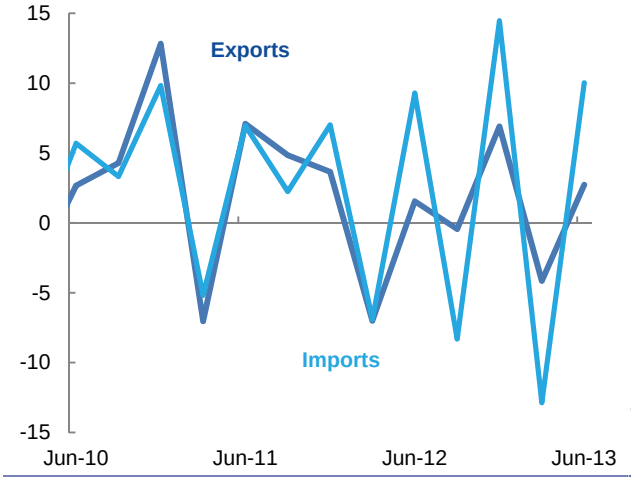
Source: BI

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



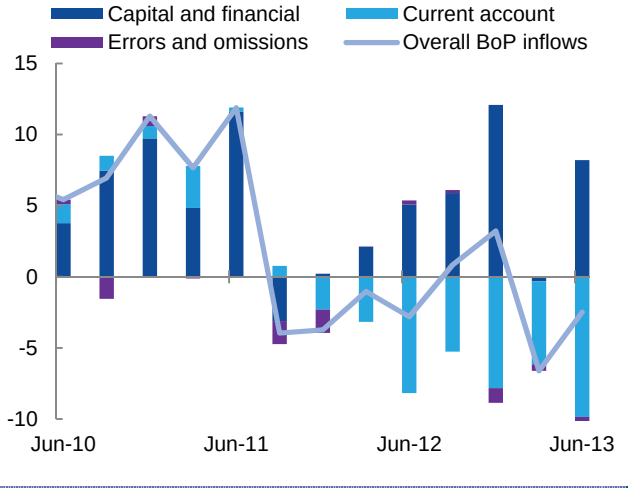
Source: CEIC

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



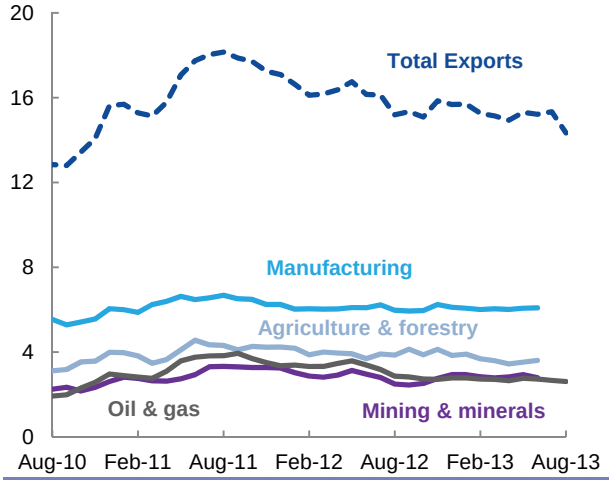
Source: BPS

Appendix Figure 8: Balance of payments
(USD billion)



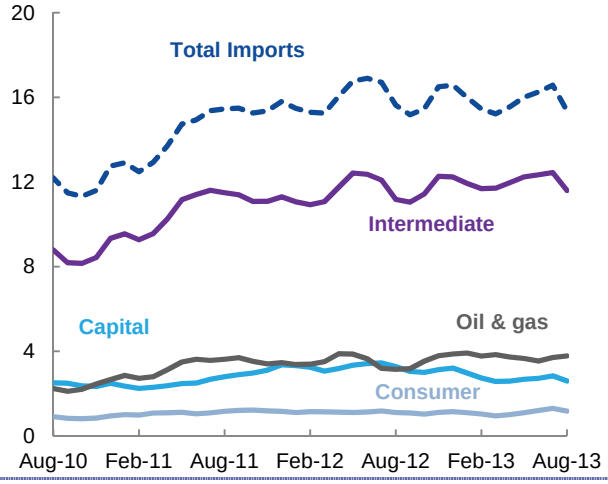
Source: BI

Appendix Figure 9: Exports of goods
(USD billion)



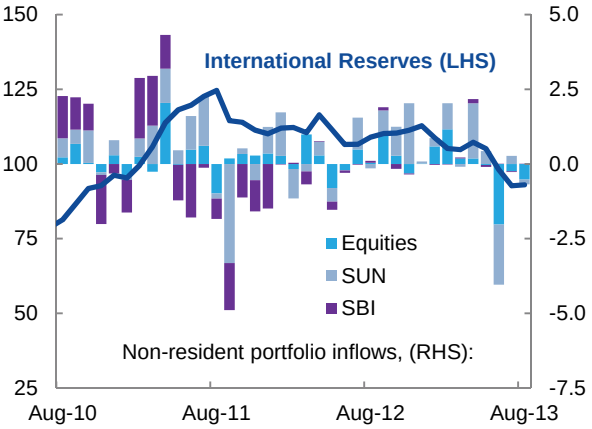
Source: BPS

Appendix Figure 10: Imports of goods
(USD billion)



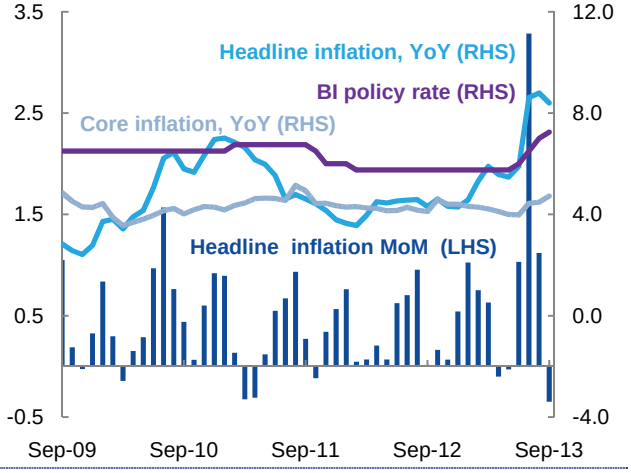
Source: BPS

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



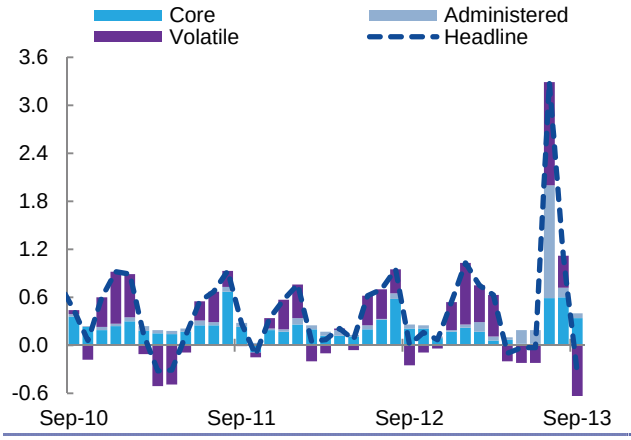
Source: BI; CEIC; World Bank staff calculations

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



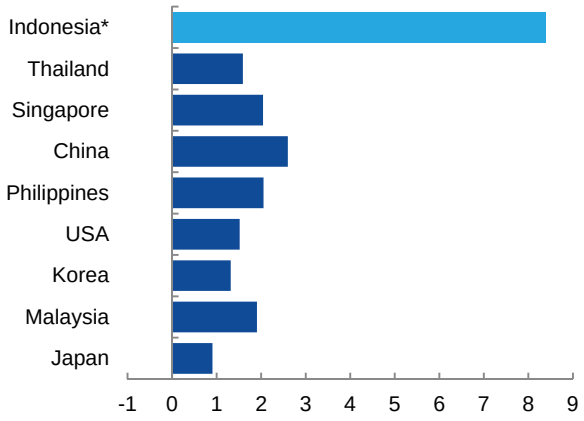
Source: BPS; World Bank staff calculations

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



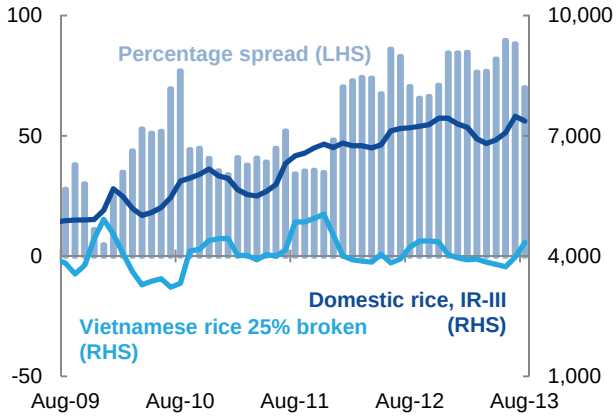
Source: BPS; World Bank staff calculations

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



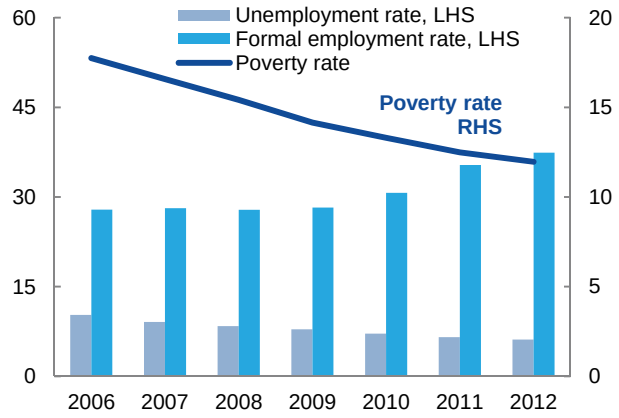
*September inflation figure for Indonesia
Source: National statistical agencies via CEIC; BPS

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



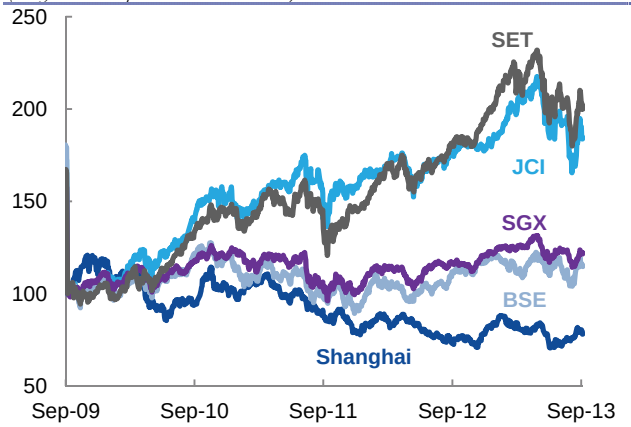
Source: PIBC; FAO; World Bank

Appendix Figure 16: Poverty and unemployment rate
(percent)



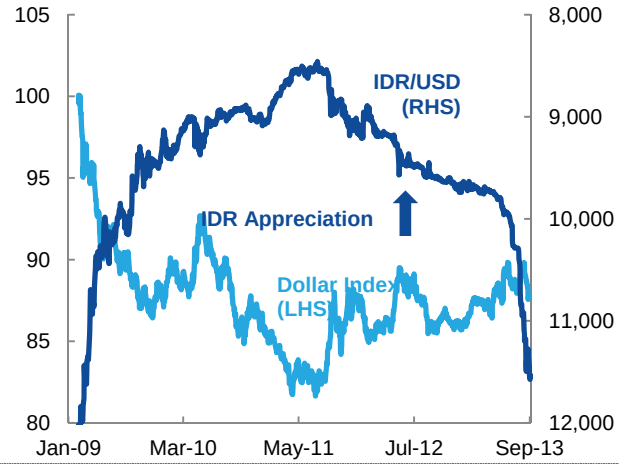
Source: BPS

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



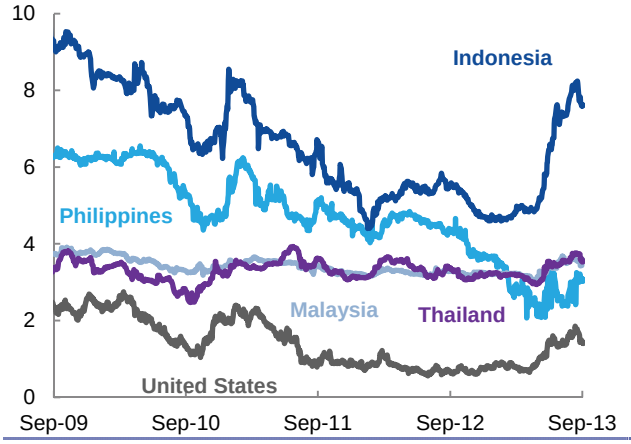
Source: CEIC; World Bank staff calculations

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



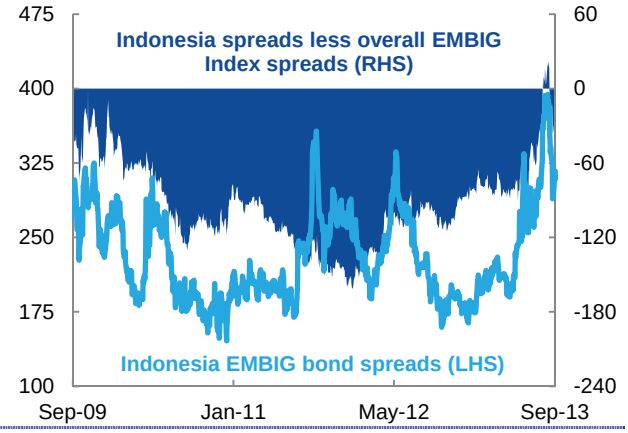
Source: CEIC; World Bank staff calculations

Appendix Figure 19: 5-year local currency government bond yields
(daily, percent)



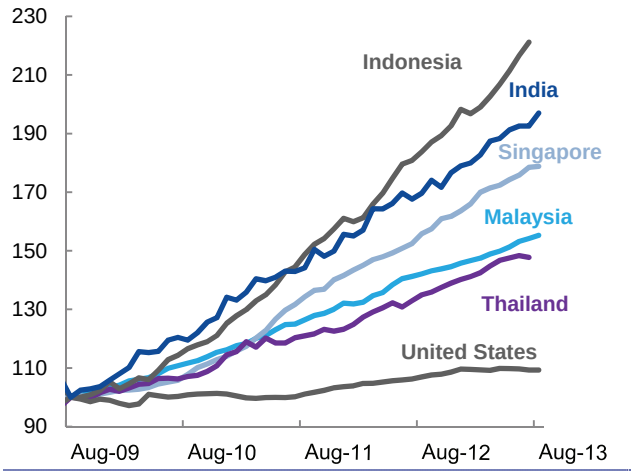
Source: CEIC; World Bank staff calculations

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



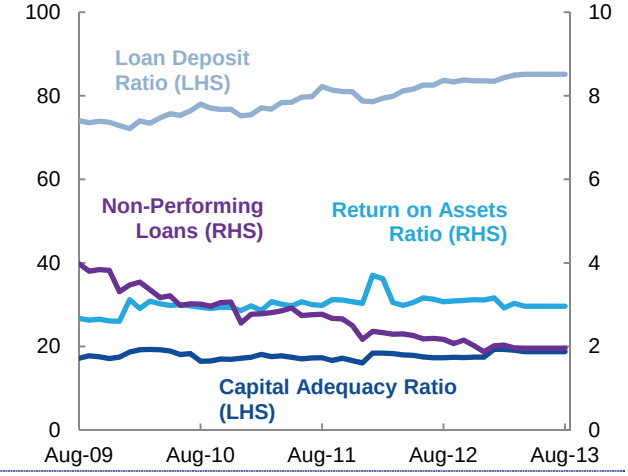
Source: JP Morgan; World Bank staff calculations

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



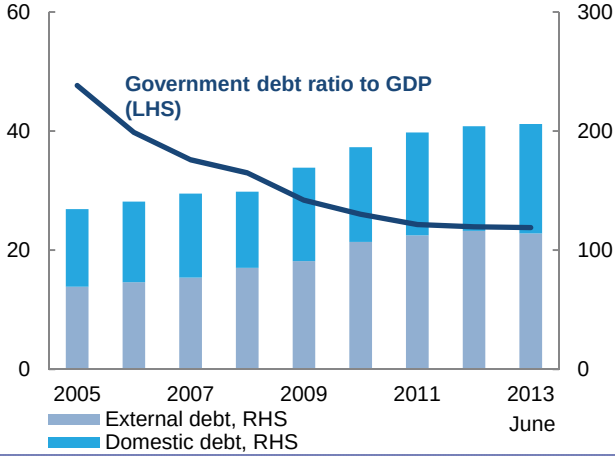
Source: CEIC; World Bank staff calculations

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



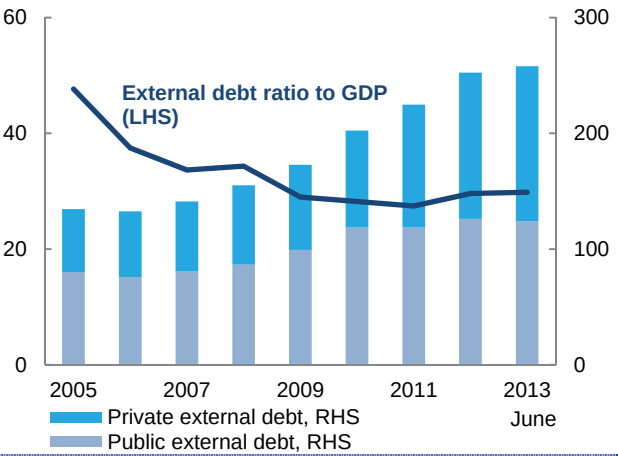
Source: BI

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	2010	2011	2012	2013	2014
	Outcome	Outcome	Outcome	Outcome	Revised budget	Proposed budget
A. State revenue and grants	**849**	**995**	**1,211**	**1,338**	**1,502**	**1,663**
1. Tax revenue	620	723	874	981	1,148	1,310
2. Non-tax revenue	227	269	331	352	349	351
B. Expenditure	**937**	**1,042**	**1,295**	**1,491**	**1,726**	**1,817**
1. Central government	629	697	884	1,011	1,197	1,230
2. Transfers to the regions	309	345	411	481	529	586
C. Primary balance	**5**	**42**	**9**	**-53**	**-112**	**-35**
D. SURPLUS / DEFICIT	-89	-47	-84	-153	-224	-154
(percent of GDP)	-1.6	-0.7	-1.1	-1.9	-2.4	-1.5

Source: MoF

Appendix Table 2: Balance of Payments

(USD billion)

	2010	2011	2012	2011		2012				2013	
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Balance of Payments	**30.3**	**11.9**	**0.2**	**-4.0**	**-3.7**	**-1.0**	**-2.8**	**0.8**	**3.2**	**-6.6**	**-2.5**
Percent of GDP	4.3	1.4	0.0	-1.8	-1.7	-0.5	-1.3	0.4	1.5	-3.0	-1.1
Current Account	**5.1**	**1.7**	**-24.4**	**0.8**	**-2.3**	**-3.2**	**-8.2**	**-5.3**	**-7.8**	**-5.8**	**-9.8**
Percent of GDP	0.7	0.2	-2.8	0.3	-1.1	-1.5	-3.8	-2.4	-3.6	-2.6	-4.4
Trade Balance	21.3	24.2	-1.7	7.1	3.5	1.8	-2.0	0.8	-2.4	-0.9	-3.7
Net Income & Current Transfers	-16.2	-22.5	-22.7	-6.4	-5.8	-5.0	-6.2	-6.1	-5.4	-4.9	-6.2
Capital & Financial Accounts	**26.6**	**13.6**	**25.1**	**-3.1**	**0.2**	**2.1**	**5.1**	**5.9**	**12.1**	**-0.3**	**8.2**
Percent of GDP	3.8	1.6	2.9	-1.4	0.1	1.0	2.3	2.6	5.5	-0.1	3.6
Direct Investment	11.1	11.5	14.0	2.1	3.1	1.6	3.7	4.5	4.1	3.9	3.3
Portfolio Investment	13.2	3.8	9.2	-4.6	0.2	2.6	3.9	2.5	0.2	2.8	2.5
Other Investment	2.3	-1.8	1.9	-0.7	-3.2	-2.1	-2.5	-1.2	7.7	-7.0	2.3
Errors & Omissions	**-1.5**	**-3.4**	**-0.5**	**-1.6**	**-1.6**	**0.0**	**0.3**	**0.2**	**-1.0**	**-0.5**	**-0.8**
Foreign Reserves*	**96.2**	**110.1**	**112.8**	**114.5**	**110.1**	**110.5**	**106.5**	**110.2**	**112.8**	**104.8**	**98.1**

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 (include 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 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

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