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INDONESIA ECONOMIC QUARTERLY

Looking Forward

September 2010

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THE WORLD BANK | BANK DUNIA

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Investing in Indonesia's Institutions

for Inclusive and Sustainable Development

The Indonesian Economic Quarterly reports on and synthesizes the past three months' key developments in Indonesia's economy. It places them in a longer-term and global context, and assesses the implications of these developments and other changes in policy for the outlook for Indonesia's economic and social welfare. Its coverage ranges from the macroeconomy to financial markets to indicators of human welfare and development. It is intended for a wide audience, including policy makers, business leaders, financial market participants, and the community of analysts and professionals engaged in Indonesia's evolving economy.

This Indonesian Economic Quarterly was prepared and compiled by the macroeconomic analysis team at the World Bank's Jakarta office, under the guidance of Lead Economist Shubham Chaudhuri and Senior Country Economist Enrique Blanco Armas: Magda Adriani (rice prices), Andrew Blackman (trade flows, balance of payments), Andrew Carter (government revenues), Andrew Ceber (national accounts, domestic demand, medium term macroeconomic projections, executive summary), Fitria Fitrani (trade flows and ASEAN-China FTA), Faya Hayati (prices and real incomes), Ahya Ihsan (government expenditure), Diva Singh (financial markets, monetary conditions, banking sector). Banking sector input was also provided by Neni Lestari and P.S. Srinivas. Andrew Ceber, Tia Chandra, Ashley Taylor and Tim Bulman shared the editing and production. Enrique Blanco Armas provided detailed comments on earlier drafts.

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Executive Summary: Looking forward

Indonesia's robust growth continues, with the medium-term challenge being to sustain and strengthen this performance

Indonesia's economy continues to record robust growth, in contrast with the volatility and uncertainty characterizing major economies globally. The robustness of growth has allowed the policy focus to shift from near-term uncertainty towards achieving the investments and reform required to achieve sustained and strong growth over the longer-term. Meeting the Government's target of over 7 percent growth by 2014 requires strong rises in investment, particularly in infrastructure, and in skills and productivity.

Domestic demand continues to underpin Indonesia's growth performance

Quarterly output accelerated in Q2, resulting in year-on-year growth of 6.2 percent, the highest since the onset of the global economic crisis two years earlier. Domestic demand, particularly private consumption, underpins the growth performance and has been associated with rising imports, particularly for investment and intermediate goods. Slow disbursement of government expenditures continue to act as a drag on growth, but less so than in Q1. Indonesia's trading partners also recorded stronger growth than expected, although the overall contribution of net external demand to growth was negative in Q2. Correspondingly, domestic-oriented sectors outperformed externally-oriented sectors.

In the near term these patterns of growth are broadly expected to continue. Rising domestic consumption and increasing private and public investment will contribute to a contraction in the current account surplus. Investment is expected to pick up further, with strong growth in credit for investment and working capital seen in recent months, and with a reallocation of public spending towards capital expenditures planned for 2011. The projection for GDP growth in 2010 has been revised up slightly from the June *IEQ*, reflecting the improved strength of domestically-oriented sectors, while the GDP forecast for 2011 remains unchanged at 6.2 percent.

Table 1: The outlook remains for robust growth in 2010 and 2011

		2009	2010	2011
Gross domestic product	<i>(Annual per cent change)</i>	4.5	6.0	6.2
Consumer price index	<i>(Annual per cent change)</i>	4.8	5.1	6.4
Budget balance*	<i>(Per cent of GDP)</i>	-1.6	-1.5	-1.7
Major trading partner growth	<i>(Annual per cent change)</i>	-0.8	6.5	4.3

* Ministry of Finance projection, 2011 figure is proposed budget

Sources: Ministry of Finance, BPS and other national statistical agencies via CEIC, Consensus Forecasts Inc., and World Bank

Temporary factors drove the rise in headline inflation with increasing local rice prices moving poverty basket inflation up sharply

Core inflation has risen in recent months along with expanding domestic demand. By August the monthly rate had returned to its historical averages, although it is too early to assess whether this will persist as incipient capacity constraints become binding. Headline inflation, as is often the case, has been much more volatile, rising strongly in June through August, mainly due to one-off supply-side shocks, particularly the extremely wet 'dry' season. This initially impacted chili prices especially, but soon also other food prices, particularly rice prices, which rose significantly on the local market, creating a widening gap with the international price. These increases notably affected poorer households, whose largest single expenditure item is rice. Poverty basket inflation reached 11.3 percent in August, around 5 percentage points higher than the headline rate. These disruptions are expected to be transitory, and to the extent they do not feed into inflation expectations should have limited impact on underlying inflationary pressures. But, in the short-term, such rises in the prices of goods and services consumed by the poor may offset some of the future poverty-reducing effects of Indonesia's robust growth performance, which contributed to the fall in the poverty rate to 13.3 percent in March 2010 from 14.2 percent a year earlier.

Capital inflows have returned strongly, creating a challenge for monetary policy

Confidence in the country's prospects, combined with high yields relative to developed markets, has seen the strong return of capital inflows. Around USD 7.3 billion of net foreign capital inflows were seen from June to August. But, the USD 5.7 billion of outflows in May highlight the continued sensitivity of such flows to both domestic and international shocks to sentiment. The volume of recent inflows has put renewed upward pressure on the Rupiah which, if realized, and combined with rising domestic prices, adds to the

competitiveness pressures facing export-orientated sectors. Productivity-enhancing policy reforms and investments, such as in infrastructure, can help to meet such pressures. A policy challenge in the near-term is how to address rising inflationary pressures while ensuring less volatile and more sustainable capital inflows. In light of these issues, Bank Indonesia tightened reserve requirements while leaving the policy rate unchanged. Managing the volatility of short-term flows motivated policy measures introduced in June, such as a one month minimum holding period for SBI investments.

The Government plans to boost capital expenditure to finance infrastructure development and continue pro-poor social programs

The Government has reduced its projected 2010 deficit, to 1.5 percent of GDP, reflecting factors including modified assumptions and the weakness in disbursement early in the year. In July 2010 the Government increased average electricity tariffs by 8 percent. This adjustment is the most substantial reform to electricity tariffs since January 2003, and is a small step towards the Government's 2010-2014 RPJMN goal of improving the targeting of energy subsidies while minimizing their burden on the budget. Such reforms can free up further fiscal space for investment and social protection.

The Government's proposed 2011 budget takes a new direction, allocating significantly more resources to capital investment (28 percent more than allocated in 2010), while improving the efficiency of subsidy outlays, most notably by proposing to reduce the large electricity subsidies. Overall the Government does not expect this reprioritization to affect its fiscal position, with the projected 2011 budget deficit near that of 2010. Given the strength of the nominal economy, this is likely to see public debt levels continue to fall towards 25 percent of GDP. Assuming stronger growth in the nominal economy, due to growth in economy-wide prices returning towards the average rates of the last half-decade, and only a modest improvement in disbursement on the rates achieved in the first half of 2010, would put downward pressure on the projected deficit (see Part B of the June 2010 *IEQ* for a full discussion).

Near-term risks remain sizeable but have diminished, while policy challenges remain

The overall risks to Indonesia's near-term outlook remain sizeable, although have diminished somewhat since the last *Quarterly* reflecting the continued robust economic growth. The risks to the inflation outlook on the other hand have increased to the upside, especially if continued strong domestic demand and transitory supply shocks translate into more persistent price pressures. The focus is now on the aforementioned policy challenges associated with the volatility of capital inflows. In the medium-term, as capacity constraints start to bind in some sectors, creating inflationary pressures, the challenge will be to ensure the growth in available infrastructure and skilled workers, and improvements in the business climate, to support expanding production, employment and incomes.

Meeting the Government's medium-term targets for growth and poverty reduction requires progress across a range of structural reforms, supported by targeted expenditures

The Government faces some immediate priorities to support growth and to ensure that it benefits all Indonesians, especially the poorest. Addressing the constraints on private sector activity due to Indonesia's stretched infrastructure will require substantial public investment, and the 2011 budget starts to reflect this. Infrastructure improvements will help to promote growth going forward by enhancing connectivity between economic regions, fostering the formation of industrial clusters and centers of economic activity, and improving the efficiency of the structure of Indonesia's urban areas.

All Indonesians need access to opportunities to benefit from the higher growth flowing from these investments. For example, at present, about half of Indonesia's population does not have access to formal financial services. Improving access to financial services for households and firms can not only enhance their ability to invest in productive opportunities but also allow them to build up savings to smooth shocks to their real incomes. In relation to labor markets, policy makers face challenges in identifying which policies and programs will spur the creation of good jobs while, at the same time, ensuring that workers are better protected from the risks that threaten their job security. Reforms to improve labor regulations, infrastructure and the investment climate are all important elements for a national "pro-jobs" strategy. Reducing the mismatch between the skills of school leavers and the skills demanded by employers will also help increase employment, and raise productivity. Improving education and health outcomes in lagging areas, where the PNPM *Generasi* block grant scheme has shown strong results, will, in line with the Government's priorities and the Millennium Development Goals, also help further reduce poverty, maternal and child mortality, and promote universal access to basic education.

A. ECONOMIC AND FISCAL UPDATE

1. Indonesia's robust recent growth performance is expected to continue

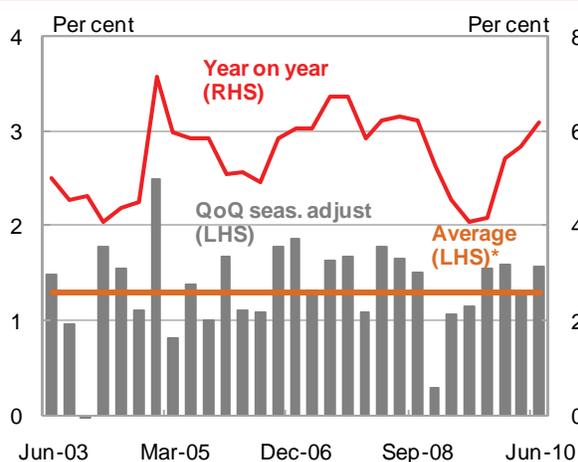
Annual growth in Indonesia has now returned to rates not seen since 2008, and is expected to remain there until the end of 2011

Indonesia's economy continued to grow strongly in the first half of 2010, with year on year growth returning to rates not seen until prior to the global instability of 2008. Growth in Q2 once again exceeded the past decade's average (Figure 1). Year on year growth rose to 6.2 percent, up from 5.7 percent in Q1. Indonesia's economy is expected to expand at around these rates for the rest of the year, bringing annual growth to 6 percent in 2010, and to 6.2 percent in 2011.

Growth in Indonesia's trading partners has been revised up, while commodity prices are expected to continue to grow strongly

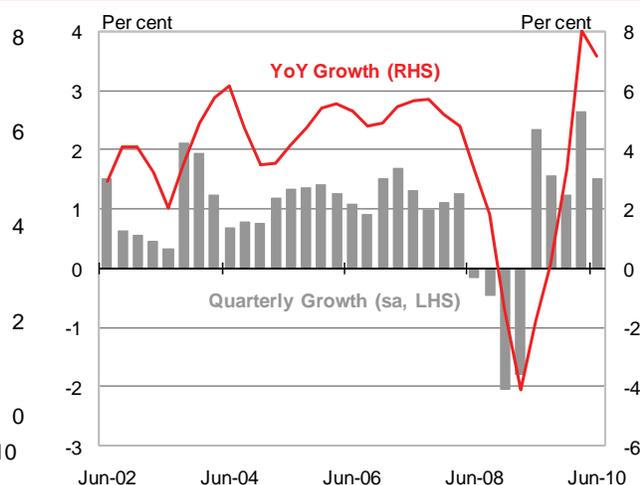
Growth across Indonesia's major trading partners (MTP) continued to rebound very strongly in Q2, driven by Singapore, China, and Korea (Figure 2). Consensus forecasts for Indonesia's major trading partners have been revised up to 6.3 percent, but most of this growth was already realized by the middle of 2010. International commodity prices movements have been mixed since the large falls experienced in May. The World Bank Energy Commodity Price Index was flat, reflecting stable oil prices, while the Non-Energy Commodity Price Index has reached the highest level since September 2008. The increases were led by strong gains in base metals and food prices. Energy and non-energy commodity prices are expected to grow by 20 percent in 2010 and both indices are also projected to be around 4 percent lower in 2011.

Figure 1: Quarterly GDP growth remains strong (percentage change)



* Average QoQ growth between Q1 2000 and Q2 2010
Source: BPS, World Bank seasonal adjustment

Figure 2: Strong trading partner growth dipped slightly in Q2 (average MTP growth, weighted by Indonesia's export shares)



Sources: BPS, national statistical agencies via CEIC, Consensus Forecasts Inc. projections, and World Bank

a. Private demand accelerated in the first half of 2010, offsetting a slowdown in government spending

Private consumption led growth in Q2

Private consumption was the major contributor to expenditure growth in Q2, while investment growth remained steady. Imports continued to outpace exports. Government spending remained weak in Q2 as slow disbursements continued (Figure 3).

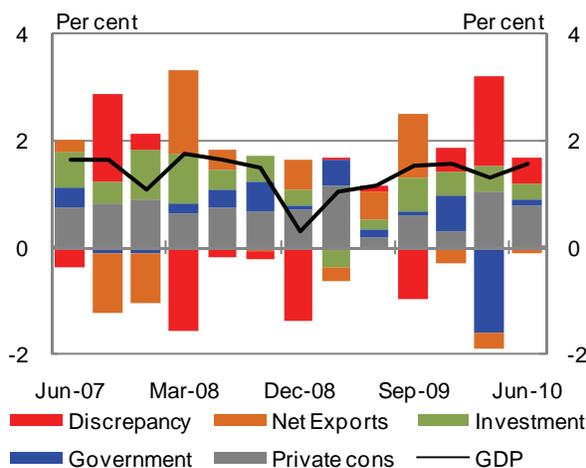
Strong consumption in the first half of 2010 was due to favorable trends including moderate price growth and rising incomes

Private consumption supported growth in Q2, with year on year growth returning to around 5 percent. This has predominantly come from growth in expenditures on discretionary consumption goods, as food expenditure growth has remained steady. The strength in private consumption is consistent with rising domestic incomes and moderate price growth in the first half of the year. The robust private consumption growth appears to have continued into mid-year. Motorcycle and motor vehicle sales increased strongly into Q3, with sales at record highs (see Appendix). The Bank Indonesia (BI) retail sales index also remains at high levels. Credits to consumers grew very strongly in Q2, further supporting consumption. On the downside, consumer confidence has weakened slightly, perhaps reflecting rising expectations of inflation (see discussion in Part B).

Real investment spending has steadied after a recovery which began at the beginning of 2009

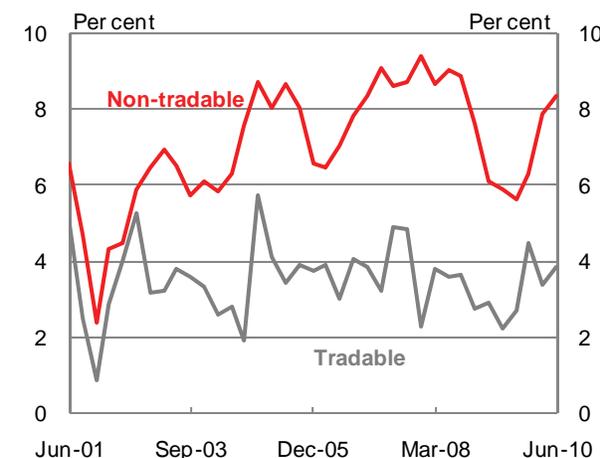
Quarter-on-quarter investment growth slowed slightly in Q2, at 1.2 percent, down from 2 percent in Q1. The annual growth rate in investment expenditures is still recovering after a significant slowdown at end-2008 and during 2009, and remains below rates seen during 2007 and the first half of 2008. Much of the rebound in investment over the last year has been from the small, but volatile investment in 'foreign machinery and equipment'. The improvement in investment since mid-2009 can be attributed to factors including the favorable price impact of the appreciating exchange rate for imports of capital equipment, improved finance conditions as seen in the small fall in (nominal) lending rates and pickup in new loans, and more recently the recovery in inflows of foreign direct investment (FDI). Indicators of future investment in Indonesia, such as capital imports and cement production, remain robust (see Appendix).

Figure 3: Private consumption continues to drive growth (contribution to quarter-on-quarter growth, seasonally adjusted)



Sources: BPS and World Bank staff calculations

Figure 4: 'Non-tradable' growth expands ahead of the growth of 'tradables' (percentage change, year-on-year)



'Non-tradables' includes services sectors that may have tradable components such as finance; 'tradables' are largely goods-producing sectors. Source: BPS and World Bank staff calculations

Growth continues to be driven by domestically-oriented sectors...

'Non-tradable' output continued to grow strongly in Q2, driven by wholesale and retail trade, transport and communications, and finance and business services (Figure 4). Growth rates across most other 'non-tradable' sectors were stable in Q2. 'Tradable' output improved slightly, with the manufacturing sector driving most of that improvement, while agricultural production and construction were steady in Q2. Higher frequency indicators suggest production growth remained robust into mid-2010, with the growth in cement sales at its highest levels since 2008 and industrial electricity consumption growing solidly (see Appendix Charts).

...with the slight increase in tradable output coming from the manufacturing sector

Indonesia's manufacturing sector grew slightly in Q2, but year-on-year growth rates are still below those of 2007 and 2008. Much of the recent recovery in manufacturing is driven by transport equipment and machinery, consistent with the growth in private investment, while food and tobacco are a distant second.

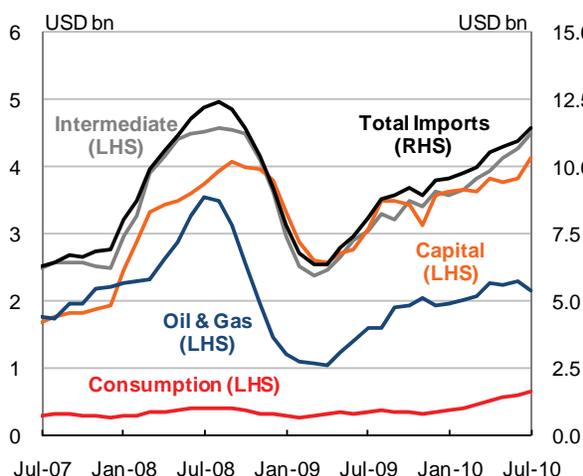
b. Import growth continues to outpace that of exports

Import volumes continue to recover more quickly than exports, but rising commodity prices saw the trade surplus and current account surplus remain stable in Q2

In the second quarter of 2010, the growth in real imports of goods and services continued to outpace that of exports. The demand for imports has been supported by robust domestic economic activity and the strengthening Rupiah. The faster pace of real imports growth saw net external demand subtract 0.1 percentage points from GDP growth in Q2. Rising commodity prices also supported increased trade values. Trade values, as measured by Bank Indonesia (BI), had exports growing at a similar pace to imports, leaving the trade surplus stable in Q2. The stable trade surplus recorded by BI, combined with a widening in the income deficit (as oil & gas companies' profit repatriations increased), resulted in a slight contraction in the current account surplus for Q2.

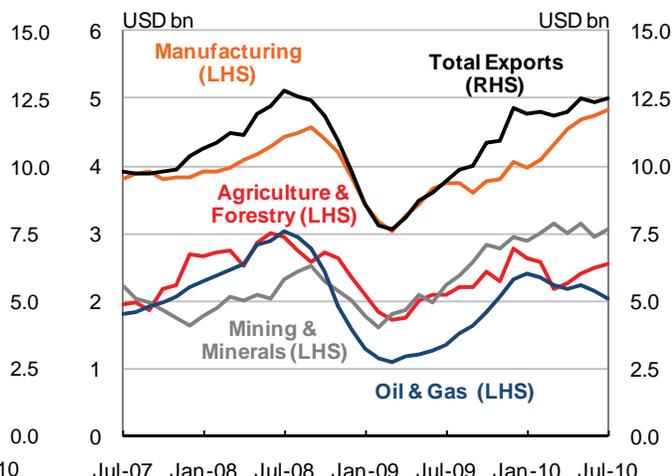
Looking at the monthly trade data, the rise in import values has been driven by intermediate and capital goods, with machinery, electronics, vehicles and plastics realizing the strongest gains by sector (Figure 5). The recovery in exports has slowed, following the strong rebound during the earlier phase of the global recovery (Figure 6). Exports of vehicles, electronics, rubber, and clothing & footwear continue to rise, on the improved first half demand from the Euro zone. Mineral fuel and mining exports have stagnated, due to a pause in demand from China and India following restocking during the earlier phase of the global recovery. As a result of these trends, the monthly trade balance moved to a small deficit of USD 100 million in July (see Appendix), with the three month moving average surplus declining to USD 1 billion.

Figure 5: Imports values are growing strongly...
(billions of USD, 3 month moving average)



Source: BPS and World Bank staff calculations

Figure 6: ...while exports values continue to stagnate
(billions of USD, 3 month moving average)



Source: BPS and World Bank staff calculations

c. Indonesia's economic growth is likely to rise further

Growth projections for 2010 have been raised slightly, reflecting the strong performance in Q2 and expectations that domestic demand will continue to be supportive

Indonesia's economy is expected to grow by 6.0 percent in 2010, increasing to 6.2 percent in 2011 (Table 2). The forecast for 2010 has been raised slightly from 5.9 percent due to improved domestic and international conditions into the second quarter, while recognizing the downside risks associated with volatile financial markets and uncertain developed economy growth prospects.

Private demand is projected to continue to support growth, offsetting a reduction in net external demand as imports outpace export growth. The growth rate of private consumption is expected to rise gradually, up from 5.2 percent in 2010 to 5.3 percent in 2011. This will continue to be supported by stable employment and improving incomes, offsetting the rise in prices in mid-2010. Sectors focused on domestic demand (transport, communications, various consumer and business services) are likely to continue to perform better than those more dependent on external markets (manufacturing and resource-related industries). However, the latter offers greater scope for upside surprises as the international environment improves. Investment is also expected to continue accelerating in 2010, stimulated by the increase in commodity prices, prospects for higher foreign direct investment, stronger credit growth, and the need to invest to expand capacity in some domestically-focused industries. Government consumption is likely to continue growing less quickly than the overall economy into 2011, although the weakness of core and developmental government spending in early 2010 suggests scope for some pick up later in the year.

The current account surplus is expected to narrow in 2010 before moving into deficit in 2011, as the trade surplus narrows

Reflecting the relative strength of domestic to external demand, the outlook remains for import growth to outpace export growth through 2010 and 2011. Imports are expected to be led by capital and machinery imports, driven by robust growth in domestic investment. In part these will contribute in due course to improving the competitiveness and capacity of exporters, but much will also expand production capacity for the domestic market, supporting domestic demand and incomes, and to a large extent these two processes are

likely to have offsetting impacts on the overall current account balance. Meanwhile, in the shorter term, increasing demand for raw materials from China and India is expected to see commodity exports reaccelerate through 2010-2011.

The trade surplus is expected to contract by a little over USD 7 billion to around USD 14 billion in 2010, and by another USD 3-4 billion in 2011. Meanwhile, the income deficit is expected to widen, as higher commodity prices result in greater profit repatriation, particularly by oil & gas companies. Together these forecasts suggest the current account surplus is likely to register a small surplus in 2010, before moving into deficit in 2011.

Table 2: Domestic demand is projected to continue to support a gradual rise in Indonesia's growth (percentage change, unless otherwise indicated)

	Annual			Year to December quarter			Revision to Annual	
	2009	2010	2011	2009	2010	2011	2010	2011
1. Main economic indicators								
Total Consumption expenditure	6.2	5.2	5.4	5.9	7.3	4.3	0.1	-0.1
Private consumption expenditure	4.9	5.2	5.3	4.0	5.6	5.1	0.1	-0.1
Government consumption	15.7	5.4	6.4	17.0	15.5	0.4	0.0	0.0
Gross fixed capital formation	3.3	8.3	9.2	4.2	9.0	9.3	-1.3	0.9
Exports of goods and services	-9.7	11.5	11.0	3.7	4.3	13.7	-3.4	-0.1
Imports of goods and services	-15.0	15.0	11.6	1.6	7.0	12.9	-2.4	-0.1
Gross Domestic Product	4.5	6.0	6.2	5.4	6.3	6.1	0.1	0.0
Agriculture	4.1	3.0	3.1	4.6	2.9	2.0	-0.4	0.1
Industry	3.5	4.3	5.3	5.1	4.4	5.1	0.0	-0.1
Services	5.7	8.6	8.0	5.9	8.8	8.0	0.3	0.0
2. External indicators								
Balance of payments (USD bn)	12.5	19.0	8.8	n/a	n/a	n/a	12.9	3.7
Current account balance (USD bn)	10.5	1.8	-1.2	n/a	n/a	n/a	-0.7	-1.7
Trade balance (USD bn)	21.0	13.9	10.5	n/a	n/a	n/a	-0.3	-2.7
Financial account balance (USD bn)	3.6	16.4	9.7	n/a	n/a	n/a	13.6	5.1
3. Other economic measures								
Consumer price index	4.8	5.1	6.4	2.6	6.4	6.1	0.0	0.1
Poverty basket Index	5.8	7.8	7.4	2.9	8.4	7.5	1.0	0.2
GDP Deflator	8.5	8.8	12.2	6.6	10.5	11.9	-0.6	0.0
Nominal GDP	13.4	15.4	19.2	12	17.4	18.8	-0.5	0.0
4. Economic assumptions								
Exchange rate (IDR/USD)	10356	9091	9000	9475	9000	9000	-127.3	-200.0
Interest rate (SBI, 1 month)	7.3	6.4	6.5	6.5	6.5	6.5	0.0	0.0
Indonesian crude price (USD/bl)	61.6	77.5	77.0	75.1	77.0	77.0	-0.2	-1.0
Major trading partner growth	-0.8	6.5	4.3	3.3	5.4	5.0	1.5	0.0

Note: Projected trade flows relate to the national accounts, which may overstate the true movement in trade volumes and understate the movement in prices due to differences in price series.

Source: MoF, BPS, BI, CEIC and World Bank projections

2. The balance of payments surplus was near historic highs in Q2, but future narrowing is expected

The BoP surplus remained near historic highs in Q2, as strong capital inflows more than offset a slight contraction in the current account surplus

The balance of payments (BoP) surplus remained near historic highs in Q2, at USD 5.4 billion, down only slightly from the USD 6.6 billion surplus in Q1. The cumulative BoP surplus for the first half of 2010 is the highest on record. Further strong capital inflows in Q3 have seen reserves rise to over USD 81 billion at the end of August. These record inflows have been driven by continued strong demand from foreign investors for government bonds and short-term paper, as well as strong direct investment inflows. This reflects the strong domestic economic performance, the yield differential relative to developed economy assets and also expectations of continued exchange rate strength. The capital inflows more than offset the slight narrowing in the current account surplus (see Appendix).

The balance of payments is expected to remain high in 2010, before narrowing in 2011

A continuation of net capital inflows into the second half of 2010 is expected to support an annual BoP surplus in excess of the historic high of USD 14.5 billion in 2006. However, higher bond amortization and a move into current account deficit should see the BoP surplus contract in 2011 (Table 3). The regular fluctuations in public debt issuances and loans drawings & repayments will continue to create volatility in the quarterly BoP.

Table 3: The BoP surplus is projected to reach record highs in 2010, then to narrow in 2011
(billions of USD)

	2007	2008	2009	2010	2011
Balance of Payments	12.7	-1.9	12.5	19.0	8.8
Current Account	10.5	0.1	10.7	1.8	-1.2
<i>Trade Balance</i>	20.9	9.9	21.0	13.9	10.5
<i>Income Balance</i>	-15.5	-15.2	-15.1	-17.2	-17.4
<i>Transfers Balance</i>	5.1	5.4	4.9	5.1	5.6
Capital & Financial Accounts	3.6	-1.8	3.5	16.6	10.0
Capital Account	0.5	0.3	0.1	0.2	0.3
Financial Account	3.0	-2.1	3.5	16.4	9.7
<i>Direct Investment</i>	2.3	3.4	1.9	5.4	4.6
<i>Portfolio Investment</i>	5.6	1.8	10.3	14.3	10.5
<i>Other Investment</i>	-4.8	-7.3	-8.8	-3.3	-5.4
Foreign Reserves (a)	56.9	51.6	66.1	81.3	

Notes and sources: (a) 2010 foreign reserves value at end of August. BI and World Bank projections.

The underlying drivers of capital inflows are expected to continue into the medium-term, with the potential for Indonesia's government debt to attain investment-grade rating also a supporting factor. Net capital inflows are expected to continue to underpin the BoP surplus and to support reserve accumulation. But, portfolio inflows remain sensitive to shocks to confidence and risk aversion. In conjunction with the strong portfolio inflows, firm net direct investment inflows are projected over 2010 and 2011, as the global economic recovery and improved financing conditions see firms scale up investment. Government policies to improve the investment climate, and to expand private sector involvement in infrastructure investment programs, should also support increased direct investment. The BoP surplus, combined with continued high roll-over rates on private short-term debt, support the funding of Indonesia's external financing requirements.

3. Indonesian financial markets strengthened with the return of strong capital inflows

a. Indonesian asset prices strengthened in line with renewed capital inflows

The return of capital inflows has more than reversed the outflows seen in May...

After the strong outflows of May (USD 5.7 billion), foreign capital inflows to Indonesia have returned strongly in recent months, across equities, SUNs and SBIs (Figure 7). Approximately USD 7.3 billion of net foreign capital inflows were seen over June-August. This brings year-to-date net capital inflows to USD 11 billion. The high volume of recent inflows has contributed to gains across domestic asset classes.

...with Indonesian asset prices rising across the board...

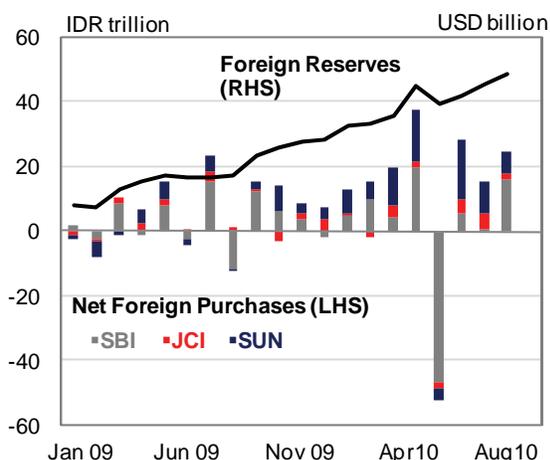
In terms of equities, the Jakarta composite index, after dropping 5.5 percent in May, rose by 13 percent from June to September. Around USD 1.3 billion of net capital inflows entered the equity market from June to August, compared with USD 1.5 billion in the whole of 2009, and USD 2 billion in 2008. Indonesian Rupiah and USD denominated sovereign bonds have also strengthened (see Appendix). For example, after reaching 8.75 percent in May, 5-year local currency sovereign yields fell to record lows in late June and have remained below 8 percent. Again, foreign purchases of SUNs have been a key supporting factor. June to August saw USD 3.9 billion in net foreign purchases of SUNs, bringing year-to-date net inflows to USD 7.9 billion. Foreign investors now own a record

28 percent of SUNs outstanding. In addition to the inflows into SUNs and equities, there were inflows of USD 2.1 billion into SBIs. Indonesian EMBI USD bond spreads, which serve as a proxy for 'country risk', have also narrowed. Strong economic growth, the potential for further sovereign ratings upgrades and relatively high yields are supporting foreign investors' demand for Indonesian fixed income assets.

... including upward pressure on the exchange rate

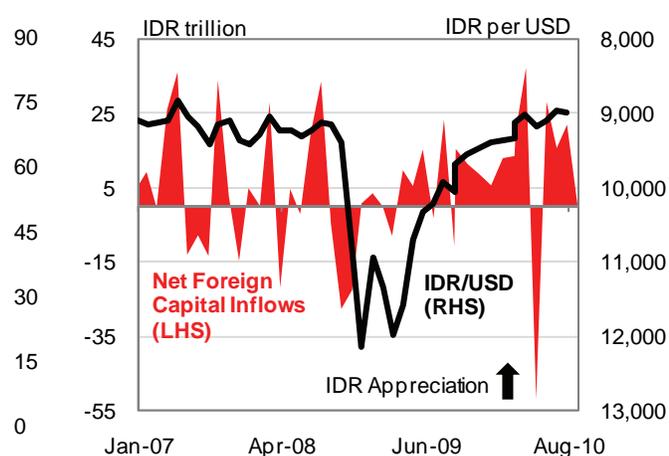
The high volume of recent inflows has also renewed upward pressure on the Rupiah, reversing the weakening in May (Figure 8). The Rupiah has appreciated by 3.5 percent since the beginning of 2010 and reached a three-year high against the USD in early August. It is noteworthy that the appreciation would have likely been much sharper in the absence of central bank intervention to stem the rate of appreciation and currency volatility (BI's foreign currency reserves rose by nearly USD 6 billion in June-August, after plummeting by USD 4 billion in May when the bank intervened to support the Rupiah).

Figure 7: Large recent foreign capital inflows were seen across asset classes
(non-residents' net purchases of SBIs, equities and SUNs in trillions of IDR; foreign reserves in billions of USD)



Source: BI, CEIC and World Bank

Figure 8: ...contributing to the appreciation of the Rupiah to a 3-year high against the USD in early August
(net foreign capital flow in trillions of IDR; IDR per USD)



Source: CEIC and World Bank

The real effective exchange rate has also continued to appreciate since March 2009 but the IMF detects no major misalignment from fair value at this stage

In addition to the nominal strength of the Rupiah against the USD, the real effective exchange rate (a trade-weighted basket of key bilateral Rupiah exchange rates, taking into account inflation) has appreciated markedly. It was 22 percent higher in July 2010 than a year earlier, 16 percent up on the pre-crisis levels of July 2008. This has recently led to some debate on whether the currency is overvalued at current levels. Based on the IMF's latest Article IV report on Indonesia, their models do not suggest any major misalignment at this stage.¹ It will be important to continue monitoring the REER in coming months, and comparing its movement and trajectory to the real effective exchange rates of other countries in the region, as this can have a significant impact on the competitiveness of Indonesia's economy.

The impact of unpredictable capital flows on exchange rate volatility triggered BI to introduce new monetary measures in June, but their effectiveness in curbing short-term flows into SBIs is still uncertain...

The impact of large capital flows on the nominal exchange rate poses challenges for central banks wishing to curb currency volatility through intervention in the foreign exchange market. Historically, the most volatile capital flows in Indonesia have tended to be foreign investments in Bank Indonesia Certificates (SBIs), due to the short-term nature of these money market instruments. In an attempt to manage the volatility of such flows, BI announced new monetary measures in June (IEQ June 2010) such as a one month minimum holding period for SBI investments as well as a move towards reducing shorter tenor SBIs and issuing 9- and 12-month paper. It is still early to gauge the effectiveness of these measures; while net foreign purchases of SBIs fell significantly in July, August saw a resurgence of net inflows amounting to USD 1.4 billion. (Figure 9) Moreover, foreign holdings of SBIs as a percentage of total SBIs outstanding (a volatile series) went from

¹ Available at <http://www.imf.org/external/pubs/ft/scr/2010/cr10284.pdf>.

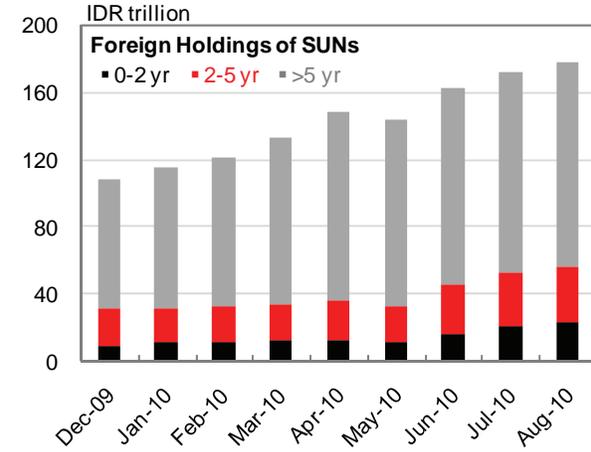
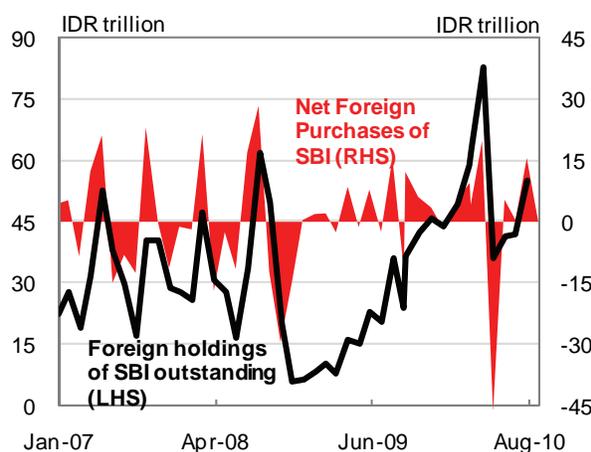
15.5 percent at the end of June to 20.5 percent at the end of August. Nonetheless, BI's introduction of a one month holding period may have helped limit daily volatility.

...although there does seem to have been a rise in foreign investors' interest in short-term government bonds since June, putting downward pressure on short-end yields

One consequence of BI's June monetary measures may have been to increase foreign investors' interest in short-term government bonds (in lieu of SBIs). At the end of May, foreign investors' holdings of longer-term (over 5 year maturity) SUNs accounted for 77 percent of total foreign holdings of SUNs. This share fell to 68 percent by the end of August. In contrast, the value of foreign holdings of short-term (0-2 year) SUNs almost doubled over this period and as a share of total holdings went from 8 percent to 13 percent. (Figure 10) Given the Ministry of Finance's intention to reduce short-term bond issuance in favor of longer-term tenors, foreigners may not be able to continue this trend. However, temporarily at least, the increased interest appears to have put downward pressure on short-end yields which dropped more aggressively than 5 year and longer-end bond yields between June and August.

Figure 9: Net foreign purchases of SBIs fell sharply in July after BI's new measures, but climbed again in August... (non residents' holdings of SBIs and net purchases of the same, in trillions of IDR)

Figure 10: ...while foreign investment in short-dated SUNs increased after BI's June measures (non-residents' holdings of SUNs by maturity, in trillions of IDR)



Source: BI, CEIC and World Bank

Source: CEIC and World Bank

b. With money supply growth and inflation picking up, BI has raised the statutory reserve requirement for commercial banks

Rising foreign reserves have been accompanied by an expansion of base money over June-August, with SBIs outstanding remaining flat

The USD 7.3 billion of net capital inflows between June and August led to a rise in foreign reserves of over USD 5 billion. Base money expanded by USD 3 billion while SBIs outstanding remained relatively flat (a USD 4 billion increase in 6 month and 3 month SBIs was offset by an equivalent reduction in 1 month SBIs) indicating that BI did not sterilize the reserve increase to the same extent as in previous months. (Figure 11).

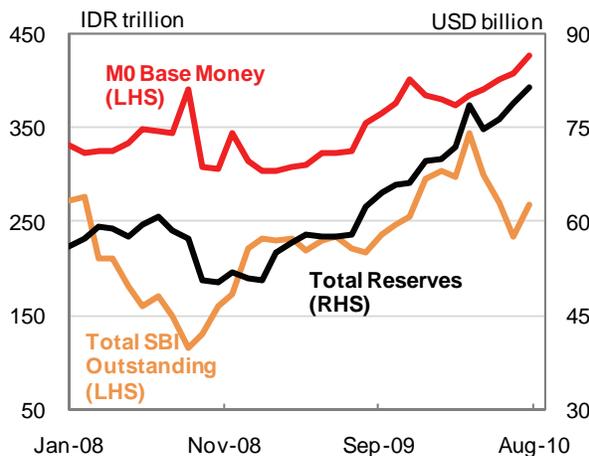
Money growth also picked up steam in Q2, after an unusually slow start to the year

In addition to the increase in base money, M1 and M2 growth picked up significantly in Q2, after a very subdued start to the year. M1 grew by 10.3 percent in Q2, corresponding to an annualized growth rate of 41 percent, while M2 grew by 5.6 percent, or 22 percent in annualized terms. If growth in broad and narrow money were to continue at this pace, it would top the 2006-08 annual growth averages for M1 and M2, of 24 percent and 18 percent, respectively. In year-to-date terms, the growth numbers are much more muted given the slow start to the year (Figure 12).

With money supply growth and inflation rising, BI raised its statutory reserve requirement from 5 to 8 percent in early September

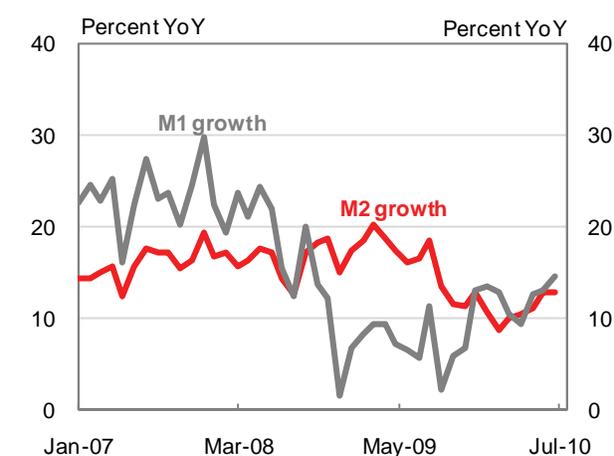
Given the increase in money supply growth and the recent pickup in headline and core inflation figures, in early September BI raised its statutory reserve requirement for commercial banks from 5 to 8 percent, effective November 1. The increase in the reserve requirement will drain approximately IDR 53 trillion from banking system liquidity. At this stage, most market participants expect the central bank will raise its policy interest rate from 6.5 percent by the end of this year or early next year, depending on the evolution of prices and credit in coming months.

Figure 11: Base money increased from June to August
(base money and SBI outstanding in trillions of IDR; reserves in billions of USD)



Source: BI, CEIC and World Bank

Figure 12: ...and M1 and M2 growth rates also picked up pace in Q2 after an unusually sluggish start to the year
(M1 and M2 growth in year-on-year percentage change)



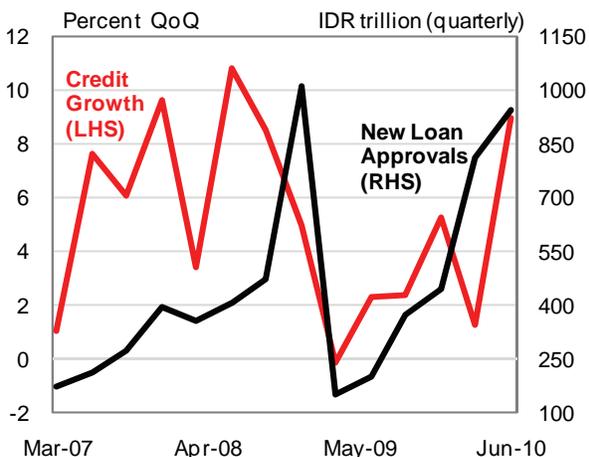
Source: BI, CEIC and World Bank

c. Credit growth increased significantly in Q2, boosted by working capital and investment loans

Credit growth rose to almost 20 percent year-on-year in June, driven by investment and working capital loans

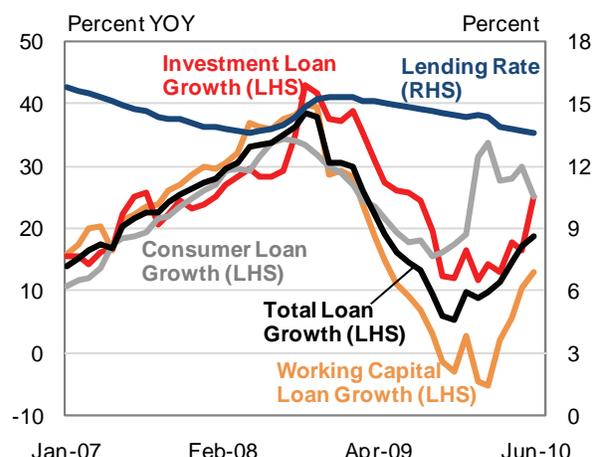
Overall, credit growth was up 18.8 percent year-on-year in June and average lending rates were down to 13.62 percent, the lowest level this decade. (Figure 14). Quarterly credit growth was positive for a fifth consecutive quarter and increased significantly in Q2, as quarterly new loan approvals continued to rise. (Figure 13). Pickups in investment and working capital loan growth were the main drivers of the credit acceleration, while consumer loan growth dropped off from Q1 levels (although it remains high in year-on-year terms). Investment loan growth was up 10 percent month-on-month, 25 percent year-on-year in June, while the corresponding growth numbers for working capital loans (which constitute 48 percent of total loans) were 5 percent and 13 percent, respectively. To the extent that these loans actually finance new projects, they are supportive of productive investment, and the outlook for growth going forward.

Figure 13: Quarterly credit growth and new loan approvals rose sharply in Q2...
(new loan approvals in IDR trillion; credit growth in quarter-on-quarter percentage change)



Sources: BI and World Bank

Figure 14: ... driven by pick ups in working capital and investment loan growth
(investment, consumer and working capital loan growth in year-on-year percentage change; lending rate in percent)



Sources: BI and World Bank

In order to support lending further, BI introduced a target LDR range of 78-100 percent, below or above which, banks will be penalized

In an attempt to promote continued loan growth, in early September BI announced a target range for commercial bank loan-to-deposit ratios (LDRs) of 78-100 percent. Effective March 2011, penalties involving an increase in statutory reserve requirements will be imposed upon banks with LDRs outside this range (although for banks above the stated range, penalties will be waived as long as their capital adequacy ratios exceed 14 percent). This policy change is in addition to the previously mentioned rise in commercial banks' statutory reserve requirements from 5 to 8 percent. Although the two policies may look contradictory at first glance, they are actually *complementary* if BI's goal was for banks to meet the increased reserve requirement by reallocating their loanable funds, rather than by reducing their lending.

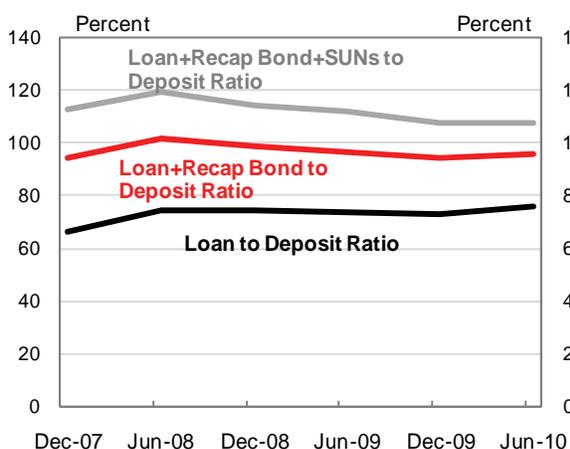
There are different views on the actual level of commercial bank liquidity based on alternative LDR calculations ...

BI's policy change is set in the context of the 75 percent LDR for the overall banking sector, and the considerably lower LDR of some of the largest banks. However, a closer look at the numbers suggests that banks may not be as liquid as headline LDR figures indicate. For example, including banks' recapitalization bonds² on the asset side in addition to loans, gives an adjusted LDR of 96 percent for the overall banking sector. (Figure 15) Going one step further in adding banks' investments in SUNs to the "loan" assets raises the LDR even further to 107 percent. Although commercial banks are not obligated to invest in SUNs, if they were to liquidate a large portion of their SUN holdings (currently 36 percent of SUNs outstanding) to free up funds for loans to corporates or households, this would have a wider impact on yields. While the addition of SUNs to loans and recapitalization bonds may result in an overstatement of banks' true LDR, the point is that the system wide figure of 75 percent may be an understatement. The actual liquidity of banks may be somewhere between this figure and the different adjusted values.

...and rising undisbursed loans

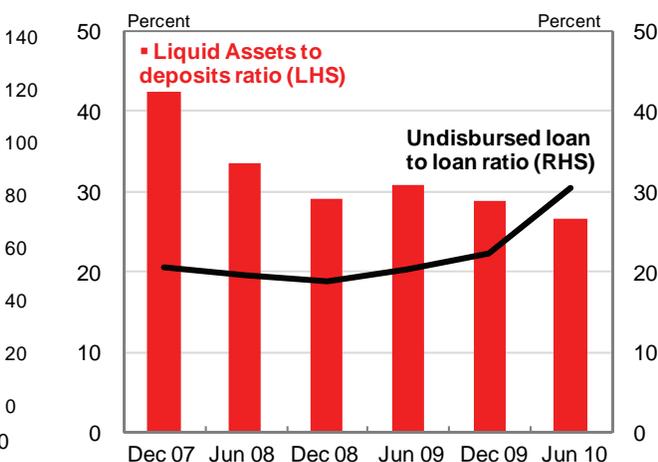
Another noteworthy factor is the significant increase in undisbursed loans in the year-to-date (Figure 16). At the end of June, undisbursed loans on commercial bank balance sheets were 50 percent higher than in December 2009, and the ratio of undisbursed loans to total loans climbed from 22 percent to 30 percent. This has a major impact on banks' available liquidity for lending as they must set aside funds to provide for undisbursed loans.

Figure 15: Banks' LDRs rise considerably if recap bonds and SUNs are included on the asset side...
(loan to deposit ratio and adjusted loan to deposit ratios in percent)



Sources: BI and World Bank

Figure 16: ...and the recent sharp rise in undisbursed loans also impacts their liquidity
(liquid assets to deposits ratio and undisbursed loan to loan ratio, in percent)



Sources: BI and World Bank

² Recapitalization bonds were introduced by the Indonesian government to support commercial banks' balance sheets at the time of the 1997-98 crisis, by replacing written off loans. They still exist on banks' balance sheets.

4. Core inflation continues to recover while headline inflation accelerated sharply due to temporary food supply shocks

a. CPI inflation rose in mid-2010 because of weather-related supply disruptions

Consumer prices have picked up sharply following their slow recovery in the first months of 2010

The headline annual inflation rate almost doubled from 3.4 percent in March to 6.4 percent in August largely because of volatile food prices (Figure 17). Core inflation (a measure of underlying inflation that excludes volatile items and administered items) steadily increased over the same period from 3.6 percent to 4.2 percent. Inflation outcomes outstripped market expectations in June and July but were lower than expected in August. Indonesia's headline inflation rate is now well above its major trading partners' (see Appendix). The growth in the GDP deflator, a broader measure of prices in the economy, fell from 7.5 percent in Q1 to 6.9 percent year-on-year in Q2.

Food prices were a key source of the acceleration in consumer prices over this period although most of the increases are expected to be temporary

Headline CPI inflation accelerated sharply in August, reaching its highest level in 16 months driven by the negative food supply shocks of mid-2010. An unusually wet 'dry' season impacted various spice and, later, rice prices. From March to July spice prices grew by 54 percent, contributing more than one-fifth of the total increase in CPI inflation over this period despite a weight of only 1.5 percent in the CPI basket. There was significant variability in spice price growth with the average raised by considerably higher growth throughout Sumatra. These increases are expected to be temporary with chili prices already retreating and by mid-September had almost fully unwound.

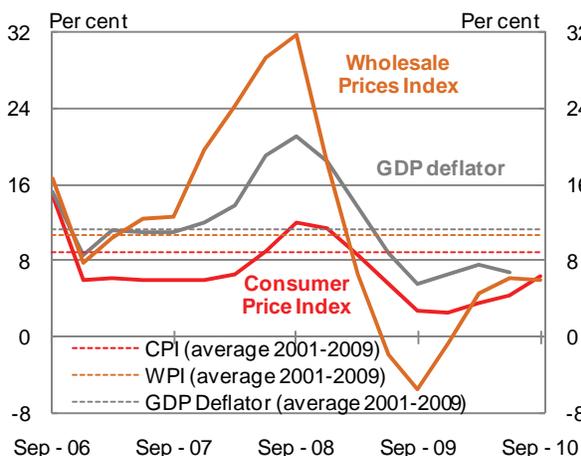
Higher food prices drove the poverty basket inflation rate above 10 percent and led to the largest gap between the poverty basket inflation rate and the headline rate since 2007

The unusual growing season and weather-related supply disruptions also affected Indonesian domestic wholesale rice prices which remain well-above international price levels (see Box 1 on recent rice price developments). Increases in such basic food prices particularly affect poor households. Food items make up 63 percent of poor households' consumption basket on average, and the relatively strong growth in these prices lifted the poverty basket inflation rate above 10 percent for the first time since 2008. At 11.3 percent the poverty basket inflation rate is around 5 percentage points higher than the headline rate – the largest gap between the two series since 2007 (see Appendix).

Several administered price increases in recent months, including electricity tariffs and vehicle registration, also contributed to the sharp acceleration in prices

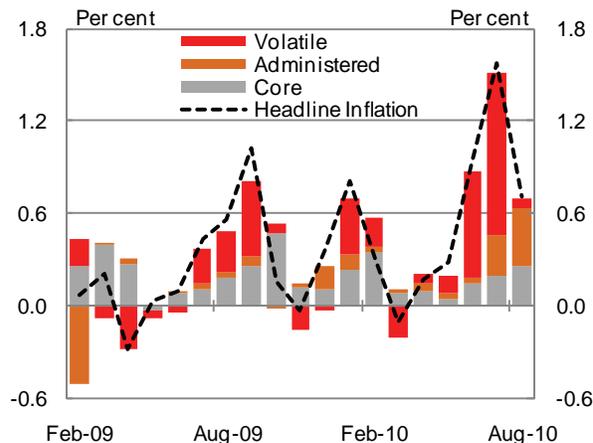
In July and August there were also price adjustments to several administered items. For example, rising costs of vehicle registration contributed 0.21 percentage points to headline inflation and electricity tariffs, which were increased by an average of 8 percent in July 2010, directly contributed 0.35 percentage points (see Box 2 on electricity tariff adjustments). The impact of the electricity rate increase on industry and its subsequent pass-through to consumer prices will become clearer in Q3.

Figure 17: Inflation has risen over the year but remains below historic averages (year-on-year percentage change)



Sources: BPS and World Bank

Figure 18: Volatile and administered items drove the recent spike in headline inflation with core inflation rising steadily (contributions to monthly inflation)



Sources: BPS and World Bank

Core inflation, generally unaffected by the recent volatility, picked up, with monthly outcomes returning to historic averages

In contrast to the sharp rise in the headline rate, core inflation continued to increase steadily (Figure 18). This gradual increase suggests that underlying price pressures within the economy, while rising, remain stable despite the abrupt acceleration in the headline rate. The monthly core inflation outcomes have gradually returned to historical rates in July and August reflecting four consecutive quarters of above average GDP growth and rising credit growth. The effects of the food supply shock do not appear to have led to broader price adjustments as yet, reflecting recognition of the temporary nature of the supply shock. Initially inflation expectations increased sharply in July but by August this rise had been fully unwound. The strong Rupiah, which appreciated for the sixth consecutive quarter against the USD, has also provided some dampening of inflationary pressures from rising import prices.

Economy-wide price growth was also below trend

GDP deflator growth was weak in Q2 relative to the past decade, growing by 6.9 percent year-on-year, reflecting broad-based trends in implicit price deflators. Investment prices growth continued to be around 8 year-lows, as construction costs fell for a second quarter while transportation prices growth continued to recover but remain well below pre-crisis levels. The sluggish recovery in the growth of investment prices kept the gap between growth in the CPI and the GDP deflator relatively low in late 2009 and the first half of 2010.

b. The inflation outlook for 2010 remains unchanged, but stronger price growth is expected in 2011

The inflation outlook for 2010 remains unchanged as recent food price increases are expected to unwind by the end of the year

The outlook for consumer prices growth in 2010 remains unchanged relative to the June *IEQ* at 5.1 percent. This reflects an expectation that most of the food price shocks in the last three months will be temporary and unwind. However, the large price increases of low quality rice in the past three months appear less likely to fully retract by the end of 2010 and will significantly affect poorer households. Accordingly, the outlook for the poverty basket inflation rate was revised up to 7.8 percent in 2010.

The forecast for the GDP deflator for 2010 was revised lower to 8.8 percent as the Q2 outcome was weaker than expected. The faster recovery in import prices compared with export prices pulled down the terms of trade to near record lows in Q2 which led to a downward revision in the GDP deflator growth forecast.

Inflation is expected to rise in 2011

Looking ahead to 2011, most of the short-term supply disruptions are likely to have abated. However, inflation rates are expected to remain above BI's 4-6 percent target band as the recovery in new lending and acceleration in the money base experienced since late 2009 support domestic demand, and the adjustment in energy prices towards their economic price continues, and the exchange rate stabilizes. There is expected to be some rise in imported inflation, as the outlook for Indonesia's major trading partners improves in 2011. This, combined with a more favorable investment outlook and stronger credit growth, led to a small upward revision in the headline inflation rate to reach 6.4 percent in 2011.

Box 1: Recent rice price developments

Domestic rice prices rose significantly and reached a record high in August 2010, due to unusually wet weather which caused crop losses and distribution disruptions. The average wholesale rice price for the lowest quality (IR64-III) was IDR 5,848 per kg in August, compared with IDR 4,882 per kg in August last year.³ Rice price growth on a year-on-year basis has increased by almost 20 percent in August – far faster than the general rate of inflation (which reached 6.4 percent in August). Prices remained elevated until early September. The rise in prices was caused by an unexpected drop in rice supply in several regions, as unusually prolonged wet weather caused various kinds of pestilences to break out in several main production areas. Moreover, continuous rain also disrupted the inter-city and inter-island rice distribution channels.

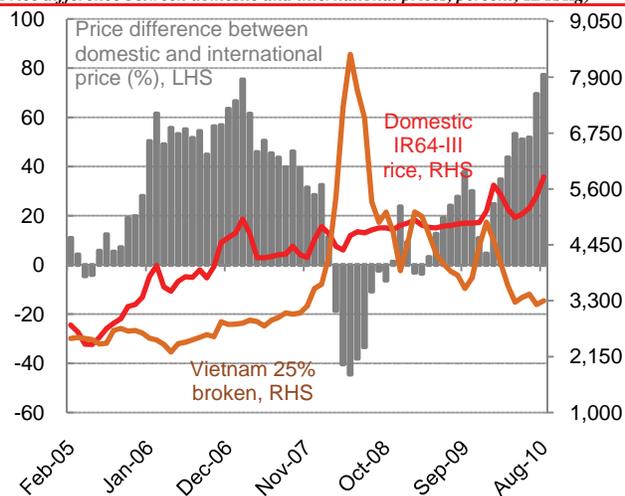
Although historically more stable, the domestic rice price is currently much higher than the world rice price. As seen in Figure 19, the domestic rice price is relatively stable but has shown an increasing trend. The Government of Indonesia has succeeded in stabilizing the domestic rice price through a combination of rice procurement and imports.

³ IR64-class III is the lowest quality rice price in the Jakarta Wholesale Rice Market (PIBC).

After a sharp rise and fall in 2008 during the global food price crisis, international rice prices have been on a declining trend, in contrast to domestic price movements, and are currently at a much lower level.⁴ The fall in prices in international markets between December 2009 and July 2010 was due to an abundant supply of traded rice. For example, the Vietnam 25 percent broken rice price fell from USD 488 per metric ton in December 2009 to USD 325 per metric ton in July 2010.⁵ There were some upward movement in August this year, up 2.2 percent to USD 332 per metric ton, on the back of strong demand and concerns that erratic weather across major food grain growing regions in the world would damage rice crops.

As a result of these divergent price trends, the price that Indonesians pay for their rice has been rising considerably above the international price. This positive price differential has not always been the case, with domestic prices below the elevated international prices of 2008. However, over the course of 2010 the gap has widened markedly. For example, the domestic price was only 4 percent more expensive than the international price in December 2009, but this gap increased to 77.2 percent in August 2010. This stark difference between domestic and international prices occurs while rice imports are prohibited. This not only encourages illegally imported rice to enter the domestic market, but also does not facilitate price convergence, leaving most rice consumers in Indonesia to buy their staple food at prices higher than otherwise.

Figure 19: Domestic and International Rice Price Comparison
(Price difference between domestic and international prices, percent; IDR/Kg)



Source: PIBC, FAO and staff calculation

Rice is the most important commodity in Indonesia. It is the main staple of the majority of the population and also plays an important part in Indonesia's rural economy. Although the trend is declining, in 2009 around 25 percent of all rural households in Indonesia worked in rice planting, and many more are connected to the rice economy through services, trade and labor. While food constitutes more than 50 percent of expenditure for half of the population in Indonesia, rice constitutes around 17 percent of all expenditure for the poorest 20 percent of the population, in contrast with only 3.8 percent for the highest quintile (Table 4). As a result increases in the domestic rice price significantly impact the purchasing power of the poor and near poor, with more adverse effects on those who are net rice consumers.

Table 4: The importance of food and rice in per capita expenditures

Expenditure quintile	Total expenditure (IDR/month)	Food expenditure (IDR/month)	Rice expenditure (IDR/month)	Share of food expenditure (%)	Share of rice expenditure (%)	Share of rice to food expenditure (%)
Lowest	178,920	100,511	30,521	56.18	17.06	30.37
	267,225	155,504	39,308	58.19	14.71	25.28
	358,602	202,234	42,976	56.40	11.98	21.25
	504,500	262,269	43,881	51.99	8.70	16.73
Highest	1,084,432	388,894	40,999	35.86	3.78	10.54

Source: World Bank staff calculations based on Susenas 2009

⁴ Insurance, freight, transportation and other costs have been added to the international price to convert it into a wholesale domestic price equivalent.

⁵ The price of Vietnam 25 percent broken rice traded in the international market is chosen due to its similar quality to the IR64 class III rice traded in domestic market.

Unlike beef or other food prices, rice price fluctuations are not affected by festive events such as Ramadhan, Idul-Fitri or the New Year. Rice price movements are more affected by the availability of domestic rice supply which is related to rice crop cycle. In general, Indonesia has three crops per year: the biggest in March/April, followed by July/August and December. The rice price commonly peaks before harvest time (in February/January, and September) when there is a shortage in rice. In contrast with the previous rice harvest season, the rice harvest in July/August 2010 did not result in a decrease in rice price. According to rice traders, supply in main production areas remained weak in August, driven by crop failures in several regions due to pests and wet weather. Therefore, the current rice price increases in many regions in Indonesia are mainly due to shortage of rice supply and the disruptions to distribution caused by heavy rains related to the La Nina phenomenon. While prolonged rains could benefit areas which rely on rain in rice planting there is evidence that pest attacks have been more severe in 2010 than in previous years.

Improvements of the quality of domestic infrastructure, as well as the provision of reliable data related to rice are important aspects for domestic rice price stabilization. A trade policy which allows the private sector to trade in rice while including a specific tariff could also maximize benefits for the country and protect farmers. Distribution of rice from main production areas to other areas should be supported by appropriate infrastructure to avoid high distribution costs. The role of Bulog in distributing rice to remote areas remains significant, but the availability of reliable infrastructure is very critical to transport rice and other food commodities in an efficient and effective way. Moreover, availability of accurate information related to rice such as production, consumption and value of stocks would allow the Government to take appropriate, and timely, action to manage rice price stability.

5. Poverty continues to trend downwards

The 2010 Susenas survey points to a continuation of the trend of poverty reduction in Indonesia...

The robust recent growth performance contributed to the improvements seen in the March 2010 Susenas poverty numbers. The absolute number of urban poor and rural poor fell below 11.5 million and 20 million (respectively) for the first time since 2004. This meant year-on-year declines in urban and rural poverty rates of approximately 0.85 and 0.80 percentage points (respectively). The overall poverty rate declined to 13.3 percent, from 14.2 a year earlier. Going forward, poverty reduction performance in urban areas will account for an increasing share of overall poverty performance: preliminary figures from the 2010 census indicate that more than 50 percent of Indonesians now live in cities and that the long migration of the labor force from rural to urban areas continues (see Part C for a discussion of the relationship between development and urbanization and the associated policy challenges).

... but with regional variation in the reductions achieved

The greatest year-on-year percentage point declines in poverty headcount rates were found in Sulawesi, particularly Sulawesi Barat, Sulawesi Tenggara, and Gorontalo. These provinces were top performers on all three measures: urban, rural, and combined. Among these top performers, Gorontalo managed relatively large poverty rate reductions in both urban and rural areas even though it began 2009 with one of the largest divides between urban and rural: 2009 headcount poverty rates approached 35 percent in rural areas but were less than 8 percent in urban areas. The worst performers in Kalimantan and Sumatera had essentially no year-on-year reduction in poverty, but those provinces began 2009 with already-low overall headcount rates of under 10 percent.

Looking forward, the benefits of growth for poverty reduction may be dampened by the impact of rising living costs

The poverty rate is expected to continue to decline over the next year. Although overall economic growth is expected to be strong, at 6.2 percent, growth in the agriculture sector, where many of the poor are employed, is projected at 3.6 percent. More importantly, the annual increase in the cost of living for the poor is expected to be 7.8 percent, nearly 3 percentage points higher than non-food non-fuel inflation. Such increases in the prices of goods and services consumed by the poor dampen the poverty-reducing effects of growth with preliminary estimates projecting a fall in the poverty rate to 12.75 percent by March 2011, a 0.6 percentage point decrease from 2010.

Labor force growth has been accompanied by a fall in the open unemployment rate

In terms of recent labor market developments, in May 2010, BPS reported that the labor force had grown by 2.2m people in the six months to February 2010, reaching 116m, of whom 107m were working, resulting in an open unemployment rate of 7.4 percent, down from 7.9 percent in August 2009 and 8.1 percent in February 2009. Employment in the agricultural sector actually fell by 0.5 percent and by 2.2 percent in transportation.

6. Reallocating and improving the quality of fiscal spending is on the Government's agenda

a. The Government proposes a reallocation of expenditures in the 2011 budget

The Government announced the 2011 budget proposal in mid August ...

The Government has reduced its projected 2010 deficit, to 1.5 percent of GDP, reflecting both modified assumptions, strong revenue realizations, and the weakness in disbursement early in the year. The 2011 budget proposal was announced in mid-August and includes an increase in expenditures of approximately 6.5 percent relative to the 2010 revised budget. The projected revenues are up by 9.5 percent (by slightly less relative to the latest 2010 forecast). The deficit in the Government's proposed 2011 budget is 1.7 percent of GDP. Given the strength of the nominal economy, this is likely to see public debt levels continue to fall towards 25 percent of GDP.

...which plans to increase expenditure to address the Government's strategic goals while targeting improved quality of spending

The proposed budget is designed to achieve 10 strategic goals; higher economic growth and international competitiveness, increased economic stability and improvements to domestic finance, higher employment, lower poverty levels, increased per capita income, improved food, water and energy security, and strengthened efforts to protect the environment.

While the headline deficit figure is only slightly higher than that projected by the Government for 2010, the proposed 2011 budget takes a new direction, allocating significantly more resources to capital investment, while improving the efficiency of subsidy outlays, most notably by reducing the large electricity subsidies. Such improvements in the quality of spending are a key priority and a number of other steps to make improvements in this regard have been outlined. These include, amongst other things, speeding up the implementation of performance based budgeting and the medium-term expenditure framework (MTEF), expanding the implementation of bureaucracy reform and improving budget disbursement through revision of Presidential Decree no. 80/2003 regarding procurement procedures.

The Government proposed to boost capital expenditure to finance infrastructure development and continue pro-poor social program

In an effort to improve the country's severe infrastructure weaknesses, the Government has allocated a significant increase to capital expenditure in 2011, of 28 percent (Table 5). Energy, irrigation and transport sectors are to receive the highest budget increase next year. This is in line with targets set by the Government to build 2,800 km of toll roads, connect more households to the electricity grid, and to raise rice production. Given the experience of recent years, realizing such increases in budget allocation for infrastructure investment, if approved, would likely require improvements in absorption capacity and disbursement rates.

The Government will also continue with the bureaucratic reform initiative in part funded by an 11 percent increase for personnel expenditure in 2011. There is a commitment to continue pro-poor programs such as BOS, Jamkesmas, PKH, and PNPB with a poverty reduction target also outlined. However, some sectors are experiencing budget reductions. For example, the reduction in central spending for education is due to a movement of the BOS program (IDR 16.8 trillion) from central spending to transfers to sub national government.

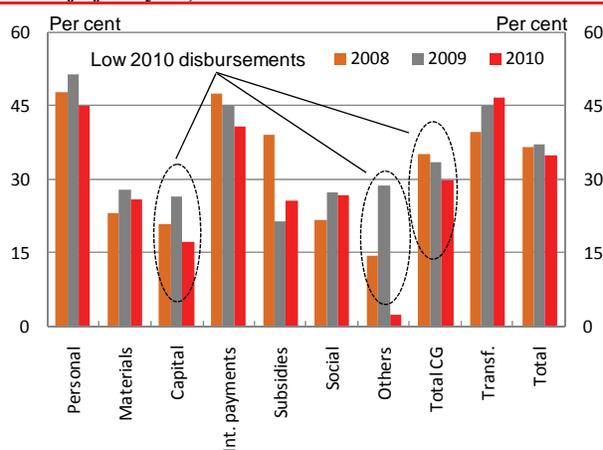
The Government has also proposed further reforms to improve the effectiveness of its energy subsidies in 2011. It has proposed to increase the average electricity tariff by 15 percent starting January 2011, although, at the time of press, this was still being negotiated with members of Parliament, who were prioritizing cuts in the monopoly electricity suppliers' (PLN) operating budget ahead of increasing tariffs towards the economic cost of supply. These plans follow the Government's July 2010 increase in average electricity tariffs by 8 percent. This adjustment is the most substantial reform to electricity tariffs since January 2003, and is a small step towards the Government's 2010-2014 RPJMN goal of improving the targeting of energy subsidies while minimizing their burden on the budget. In addition, the Government has indicated that it plans to improve the targeting of fuel subsidies. Such reforms can free up further fiscal space for investment and social protection.

Table 5: A strong rise in the allocation to capital expenditure is proposed for the 2011 budget (level and percentage change by expenditure categories)

	2010 (Revised Budget) IDR trillion	2011 (Proposed Budget) IDR trillion	Growth (Per cent)
Total Expenditure	1,126	1,202	6.7
Central Govt	782	824	5.4
Personnel	163	181	11.0
Material	113	132	16.8
Capital	95	122	28.0
Int. payments	106	116	10.2
Subsidy	201	185	-8.2
Social assistance	71	62	-13.6
Others	33	26	-20.1
Transfers	345	378	9.8

Sources: MoF

Figure 20: Disbursements rates remain low in 2010 (percent of total full-year budgeted expenditure disbursed in the first half of the year)



Sources: MoF, 2010 data are estimates

b. Slow disbursement rates have continued through 2010

Disbursement rates continue to be low, particularly for capital spending

In the first half of 2010 the ratio of realized to budgeted expenditures was 35 percent, slightly below 2008 and 2009 spending rates of 37 percent. The low level of central spending was mainly driven by capital, personnel, 'others', and non-energy subsidy expenditures which were particularly weak (Figure 20). On capital spending, the top 10 line ministries, which account for 91 percent of total budgeted capital expenditures in 2010, spent only 16.5 percent of their budgeted expenditure compared with 30 percent in 2009. By end-August, cumulative disbursements were only 45 percent of budgeted allocations.

The Government has identified a range of bottlenecks to disbursement

Some long-standing issues constraining timely budget disbursement still persist. These include, for example, delays in the appointment of heads of implementing units (Satkers), improper project planning, incomplete project information, and a lack of procurement plans by implementing unit. Early budget revisions in Q1-2010 also contributed to the slow disbursement whereby most line ministries held the budget execution until the budget revision was approved.

Other factors contributing to slow disbursements in the first half of 2010, as identified by the Government include the following.⁶ Late procurement and a lack of understanding by implementation units regarding the disbursement procedures, which hampered materials and capital spending. For personnel expenditures factors included the low realization of a new remuneration scheme in piloted line ministries, and the late disbursement of the 13th month salary, restrained expenditures. Some technical and incomplete payments procedures led to payment delays for non-energy subsidies. Low levels of disbursements were also recorded for "other" expenditures due to low levels of contingency expenditures which are included in this category.

c. World Bank projections are for the budget deficit for 2010 to be slightly lower than previously anticipated

The World Bank projects a lower deficit for 2010 than the Government due to a stronger assumed growth in the nominal economy and lower forecast expenditures

The Government's revised 2010 budget projects a deficit of 1.5 percent of GDP. Using an alternative methodology based on an assumption of stronger growth in the nominal economy, and that disbursements improve only modestly over the rates achieved in the first half of 2010, the World Bank projection is for a deficit of 0.9 percent of GDP (see Appendix).

⁶ Perkembangan Realisasi Belanja Pemerintah Pusat semester I dan Prognosis Semester II Tahun 2010

This difference reflects both a lower expenditure projection and higher revenue forecast by the World Bank. On the expenditure side, the forecast is revised down relative to the Government's reflecting the consistent trend of under 100 percent disbursement of planned expenditures. On the revenue side, the World Bank continues to project higher revenues relative to the Government which are largely responsible for the difference in the deficit estimates. The key factor driving the divergence in revenue estimates is the difference in the nominal price index used to inflate real growth to project the level of nominal GDP. Recent trends show the economy-wide prices growing faster than the CPI, and this implies faster growth in nominal GDP, and hence in tax revenues (see Part B, June 2010 Indonesia Economic Quarterly for further detail). This higher projected level of nominal GDP also reduces the budget deficit to GDP ratio.

Expenditures are expected to rise in the second half of 2010, but overall annual spending is likely to be below budget

Spending rates in the second half of 2010 are expected to improve, in particular since the budget revision has been completed in the second quarter. However, the first half spending performance and recent developments in macroeconomic assumptions suggest that the 2010 budget outcome will likely be below initial projections. The implementation of the new remuneration scheme may not fully materialize within this fiscal year, and the remaining challenges with budget execution may contribute to low spending of core government programs. A stronger Indonesian Rupiah and relatively stable SBI rates suggest that interest payments will also be lower than budgeted. The lower central government expenditures, offset slightly by higher transfers to sub-national governments, mean that the World Bank projection for total spending in 2010 is in line with that made in the June *IEQ*; a minor negative revision of just under IDR 1 trillion has been made.

Government revenues in 2010 are expected to be slightly stronger than the June *IEQ* projections

Aside from some compositional changes, the World Bank projections for government revenues in aggregate have changed little on those of the June 2010 *IEQ*. Revenue growth of 18.2 percent is forecast for 2010. Revenues are projected to fall as a share of nominal GDP. This fall as a proportion of GDP is explained through various changes to revenue policy.

Tax revenue growth projections for 2010 have been lowered slightly in line with revisions to nominal GDP...

Tax revenue is expected to grow by 16.6 percent, a little less than projected in June 2010, which is in line with the slight slowing in growth for nominal GDP. Over the last quarter tax collections in most categories have slowed. Non-oil income tax and weak VAT revenues are responsible for most of the revision, offset by some strength in excise duties. The reduction of the corporate income tax rate in 2010 from 28 to 25 percent is likely to explain some of the weakness in income tax, along with the continued recovery of taxable incomes from the economic slowdown in 2009.

...offset by mildly stronger projections for non-tax revenues

The outlook for non-tax revenues has improved slightly from the June 2010 projections, with annual growth expected of 22.8 percent. Most of this revision is due to mild strength in the oil and gas natural resources sector and to continued strength in the 'other non-taxes' category in recent months, such as visa fees, drivers' license fees, unclaimed tax revenue etc., which have consistently been performing ahead of expectations all year.

In terms of financing of the 2010 deficit, the Government has already met 87 percent of its revised gross bond issuance target for 2010

With regard to the Government's financing needs for 2010, the Government entered the year with a financing surplus rolled over from 2009's smaller-than-expected deficit and anticipatory financing strategy (Table 6). In addition, the downward revision in the projected deficit by the Ministry of Finance has led to a reduction in the Government's gross bond issuance target for the year from IDR 175 trillion to IDR 158.3 trillion. By early September 2010, the Government had issued IDR 140 trillion of government bonds (IDR and non-IDR denominated), equivalent to 88 percent of the revised gross bond issuance target. Given the continued expected strong international demand for Indonesian sovereign debt, both local and foreign currency, the Government is unlikely to face difficulty in issuing the remainder. The Government of Indonesia plans to make its second samurai bond issuance in Q4.

Table 6: The Government of Indonesia's financing position for 2010 is favorable
(trillions of IDR, unless otherwise indicated)

		2008	2009	2010 (p)		2011 (p)
				APBN-P	WB	RAPBN
Net financing needs:						
A	Primary deficit	-84.3	-5.2	0.0	-35.9	-0.7
B	Total interest payments	88.4	93.8	105.7	95.1	116.4
		<i>of which:[1]</i>				
	Total commercial bonds:	66.8	63.8	71.9	77.4	80.4
	Official external loans	-63.4	30.1	33.8	33.4	36.0
A+B	Overall deficit:	4.1	88.6	105.7	59.2	115.7
Amortizations:						
C	Commercial bonds [2]	46.8	49.1	64.1	64.1	60.5
D	Official external loans	57.9	68.0	54.1	53.5	60.1
E	Subsidiary Loan Agreement		3.0	16.8	16.8	12.0
C+D+E	Total amortization:	104.7	120.1	135.0	186.4	132.5
Gross financing needs:						
A+B+C+D+E	Total gross financing needs:	108.8	208.8	240.7	245.6	248.2
		(in billions of USD)	11.2	20.1	26.2	27.0
Financing sources: [3]						
	Official borrowing	50.2	69.3	70.8	69.9	57.1
	Total commercial bonds:	85.9	142.4	158.3	156.4	186.0
	Domestic banking	16.2	56.6	45.5	19.2	7.7
	Other	2.9	3.1			
	Total gross financing sources:	155.2	271.3	274.6	245.6	250.7
		(in billions of USD)	15.9	26.1	29.8	27.0
Memo items:						
	Variable interest rate (SBI-90 day rate)	9.47%	6.59%	6.50%	6.44%	6.50%
	IDR/USD exchange rate	9,757	10,408	9,200	9,091	9,300
	Share USD bonds (prevailing exchange rate)	11.8%	14.8%			

Note: [1] Interest payments by component may not sum to totals due to different data sources, timing and rounding issues. [2] No USD bonds are due over this period. [3] World Bank deficit projection is derived from revenue forecasts which are based on a different methodology to the Government to project the nominal GDP (see Part C of the June 2010 IEQ for a full discussion). Sources: CEIC, Ministry of Finance, World Bank projections.

Box 2: The July 2010 electricity tariff adjustment: a modest first step to better targeted energy subsidies at a lower burden on the budget

In July 2010 the Indonesian Government increased average electricity tariffs by 8 percent. This modest adjustment is the most substantial reform to electricity tariffs since January 2003, and is a small step towards the Government's 2010-2014 RPJMN goal of improving the targeting of energy subsidies while reallocating their burden on the budget to investment in Indonesia's physical infrastructure and human development.

The July 2010 increase of 8 percent on average was modest. Between January 2003 and July 2010, prices across the board increased by 71 percent for the average urban household, and by 84 percent for the average poor household. Prices economy-wide (including investment goods and trade prices) rose by 121 percent. Even in the year leading up to the July increases, a period of relatively low inflation by Indonesia's historical standards, the 8 percent increase does not appear excessive, given CPI inflation of 6.2 percent and growth in the GDP deflator of 6.9 percent. Meanwhile, since 2003, the economic cost of PLN's fuels to generate electricity and the resources required to distribute it have also risen substantially. Crude oil prices rose almost two-and-one-half fold and gas prices tripled in IDR terms, while Indonesian construction materials prices (a very rough indicator of the cost of maintaining and building distribution lines) increased by 175 percent.

Indonesia's electricity tariffs are generally lower than in neighboring and other major economies, for both residential and industrial users. In many cases the difference is very large. Tariffs have increased substantially in most other economies over the past decade; Indonesia's have been fairly stable. (Figure 21 and Figure 22)

Figure 21: Indonesia's tariffs are low for both household...
(US cents / kWh)

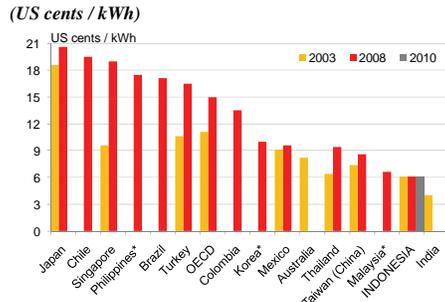
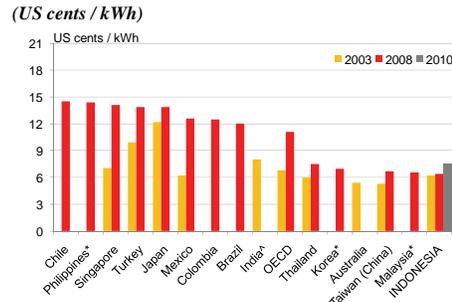


Figure 22: ...and industrial users, even after the 2010 increase
(US cents / kWh)



* 2007. ^ 2000. Sources: International Energy Agency, OLADE for Latin America

Yet this modest and long-delayed increase was controversial. The controversy may largely be due to different customers experiencing very varied tariff movements. Indonesia's electricity customers pay an electricity connection charge and per-unit tariff based on what sort of customer they are (household, business, etc) and their connection capacity (i.e., the maximum amount of electricity they can consume at once), and may receive a discounted or higher usage tariff depending on their actual use.

About 87 percent of households experienced no change in tariff – most of these have the lowest capacity connections, while 1.3 percent or almost a half million, with the highest capacity connections, are already paying above the economic cost of supply, and further increases may make it cheaper for these households to switch to their own supply. PLN bills make up about 3 percent of most households' total spending (a little less for the very highest spending households) and have a base weight of 3.05 percent in the current CPI series, so even a 10 percent increase directly raises a household's cost of living by about 0.3 percentage points. Yet, surprisingly, the BPS reported that the far smaller July 2010 increased household fuels by 5.8 percent, with the increase in PLN tariffs contributing 0.35 percentage points to the 0.8 percent increase in the CPI from July to August.

The tariff adjustment faced by businesses varied widely, depending on their use, and often on when they established their supply arrangement with PLN. Many newer business and industrial customers negotiated special supply agreements with PLN, whereby they agreed to pay a premium tariff in exchange for premium quality of supply, and larger users have also been subject to higher tariffs. Older customers, particularly those with supply contracts dating from 2003, continued to enjoy the lower 2003 regulated tariffs plus any excess usage charges. Such agreements may mean that two otherwise identical business customers pay markedly different electricity tariffs. Businesses were complaining against the discriminatory nature of this system. So a goal of the July 2010 increases was to consolidate the tariffs for commercial users into a common tariff for like commercial customers. It simplifies commercial tariffs, by unifying the separate connection and usage charges, and the higher tariffs for higher users, into one usage tariff for each connection capacity. For some customers, this means significant increases in their overall electricity bill; other users' bills fell.

Even for most businesses experiencing the larger increases, the impact on overall costs appears likely to be moderate. PLN bills make up about 5 percent of most medium and large manufacturing firms' total costs, although the share is notably higher for most non-metallic mineral product

Table 7: The tariff increase varies significantly across different customer groups, with most customers experiencing no increase

	Average tariff		Change (%)	Share of use	Share of customers
	Rp / kWh	2009			
TOTAL	676	740	9.4%	100%	100%
Households	597	637	6.6%	41%	92%
s/d 450 VA	418	418	0.0%	33%	52%
900 VA	609	609	0.0%	32%	34%
1300 VA	672	793	18.0%	15%	10%
2,200 VA	675	797	18.1%	10%	3%
2,200 - 6,600 VA	755	891	18.0%	7%	1%
> 6,600 VA	1,330	1,330	0.0%	3%	0%
Business	926	979	5.7%	17%	4%
<450 VA	538	538	0.0%	1%	19%
<900 VA	634	634	0.0%	2%	19%
<1,300 VA	685	795	16.1%	3%	18%
<2,200 VA	782	907	16.0%	5%	17%
2,200 - 200 KVA	1,104	1,104	0.0%	44%	26%
>200 KVA	811	908	12.0%	45%	0%
Industry	628	718	14.4%	34%	0%
<450 VA	486	486	0.0%	0%	1%
<900 VA	604	604	0.0%	0%	1%
<1,300 VA	724	767	5.9%	0%	2%
<2,200 VA	746	790	5.9%	0%	23%
2,200 - 14 KVA	840	916	9.0%	0%	0%
14 - 200 KVA	805	878	9.1%	8%	55%
> 200 KVA	641	737	15.0%	68%	18%
> 30,000 KVA	529	608	14.9%	24%	0%
Social	591	642	8.7%	2%	2%
Government	802	901	12.3%	4%	1%
Other	915	1,089	19.0%	1%	0%

Note: based on the draft of tariff adjustment. The increase actually implemented in July was somewhat smaller, especially among the groups subject to the larger increases. Source: PLN

producers (e.g., cement) (11.9 percent), textiles (7.4 percent) and electronics manufacturers (6.2 percent), according to firms' responses in the Industry Survey. For the average manufacturer, this means a 15 percent higher electricity bill increases total costs by less than 1 percent. In the extreme case of a firm being charged only the 2003 base tariff, a 90 percent increase in overall tariffs would increase total costs for paper & paper products and apparel industries by 4 to 5 percent. More significant for many of these firms is the cost of unreliable electricity supply –other fuels make up 5.4 percent of the average manufacturer's costs and much of this may be for fuel for in-house generation used to fill in when the grid supply fails.

Even after the July 2010 increase, electricity tariffs remain a significant burden on the budget, consuming 5 percent of total spending or about IDR trillion. To further address this, the Government has announced that it will introduce another round of modest tariff increases at the start of 2011, with its proposal of a 15 percent average increase overall being negotiated with Parliament at the time of press, with Parliamentarians arguing for a smaller increase and reduced operational budget for PLN. At the same time, the realization of the first stage of the 10,000 megawatt generation crash construction program will stabilize and start lowering PLN's generation costs.

7. The focus of risks is shifting towards the medium-term

While short-term risks have stabilized, there are risks around whether Indonesia can sustain, or increase, current levels of growth into the medium term,

The distribution of risks to Indonesia's near term outlook has diminished over the last three months following the continued period of robust economic growth and relatively stable financial markets. The focus is now on Indonesia's capacity to meet further robust growth in domestic demand into the medium-term and the policy challenges associated with ongoing significant capital inflows. Without further investment in physical and human capital, as well as other reforms to enhance productivity, there are risks around whether Indonesia can average growth rates above 7 percent by mid-decade.

a. If demand exceeds supply capacity there may be a reemergence of inflation

The short-term risks on the downside have diminished...

The risks around a rapid slow-down emanating from Europe have decreased since the last *Quarterly*, with the focus shifting towards the weakness in the recovery in the US. Given that Indonesia's external exposure is relatively low, the impact from a more protracted slowdown is likely to be limited. In terms of the risks to domestic demand, there is a downside risk for growth if government disbursement rates continue to be less than projected for the remainder of 2010 and into 2011.

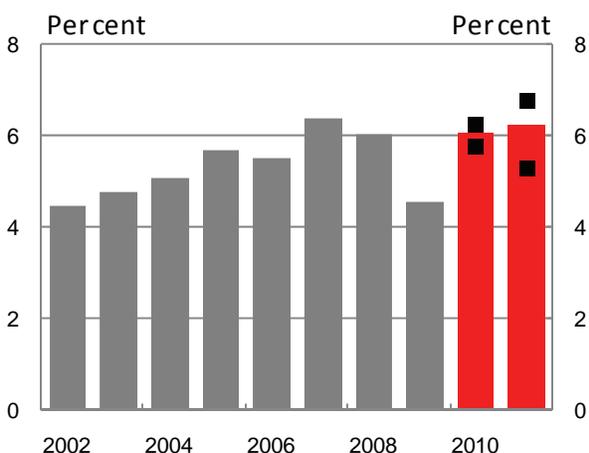
... however the continued growth in domestic demand and capital inflows is creating policy challenges

The sustained growth in domestic demand may feed through into increases in domestic prices with some increase in core inflation seen in recent months. The uncertainty over the international outlook for commodity prices further creates risks around inflation prospects (see Section B-3 in the June *IEQ*) while further reforms of administered prices toward their economic cost would also put upward pressure on prices, and the challenge will be for policy makers to again succeed in ensuring that an adjustment in price levels does not translate into a persistent rise in inflation expectations and inflation outcomes.

At the same time, the strength of the domestic economy has been one factor which has driven the strong capital inflows of recent months, along with the perceived prospects for exchange rate appreciation. The interest rate differential with developed economies has also played an important role, as it has elsewhere in the region. Monetary tightening through the policy rate in response to inflationary pressures may encourage further capital flows into Indonesia. In turn this would put increasing upward pressure on the exchange rate which could have a dampening effect on externally orientated industries, and BI has indicated that it is seeking to manage this constraint. At the same time, capital inflows are highly sensitive to international financial market conditions, as seen in May's sharp withdrawal of non-resident funds, and to the domestic policy stance. A balance is required in policies so as to address any incipient signs of domestic inflationary pressures while at the same time limiting the impact on the real economy of volatile external flows.

Figure 23: Scenario analysis of risks to GDP growth in 2010 and 2011

(GDP growth, percent)



Notes: BPS and World Bank staff calculations

Scenario analysis is a useful way to examine the distribution of risks around a central forecast. In this *Quarterly* two scenarios were conducted, a high and a low scenario (Figure 23). In the high scenario it was assumed that global growth picks up faster than anticipated, putting upward pressure on commodity prices aiding Indonesia's external sector. It is also assumed that in this scenario that credit growth expands quicker than currently anticipated leading to stronger domestic demand. The higher-than-anticipated strength in Indonesia's economy may also put upward pressure on the exchange rate through stronger capital inflows. In this scenario GDP growth is expected to be one-quarter of a percentage point higher in 2010, and one-half of a percentage point higher in 2011 compared to the baseline forecast. In the low scenario it is assumed that there is a protracted weakness in the high income indebted economies, hurting Indonesia's external sector. It is also assumed that commodity prices are weaker than currently anticipated. Investor sentiment towards Indonesia could weaken in this scenario, leading to an exchange rate weakening relative to the baseline. In this scenario, GDP is projected to be ¼ percent lower in 2010 and 1 percent lower in 2011 compared with the baseline forecast.

b. There is a risk that Indonesia's economy will not grow as quickly as expected if the reform agenda is slowed

The pace of reform needs to continue for growth rates above 7 percent to be achieved by the middle of the decade

While the short-term risks remain, the robust quarterly growth of recent quarters leads to the question of the sustainability of such growth rates, or indeed if they can be increased, into the medium-term. There are sizeable reform challenges for Indonesia to sustain average growth rates above 7 percent in the medium-term. Indeed, the medium-term development plan (RPJMN) outlines an ambitious reform agenda towards achieving stronger and more inclusive growth. Given that the typical financial market investor appears to have a strongly positive outlook for Indonesia's reform efforts, should outcomes fall short of these expectations there is the risk of a sharp reversal of sentiment with significant outflows responding, again destabilizing domestic market conditions and the exchange rate.

Strong investment growth, improvements in human capital and productivity enhancing reforms will be required to reach a higher potential rate of growth

To illustrate the need for Indonesia to expand the supply potential of the economy through greater investment in human and physical capital, section B-3 focuses on Indonesia's medium-term macroeconomic projections, and finds that without strong investment and productivity growth it is going to be difficult to reach the growth projections outlined in the Government's medium-term development plan. Various policy areas for enhancing productivity and investment in human and physical capital are analyzed in Section C, for example in relation to health and education, access to finance and labor market regulations. Finally, achieving sustained and inclusive growth going forward must also address the challenges of increased urbanization which is the focus of the final piece in Section C.

B. SOME RECENT DEVELOPMENTS IN INDONESIA'S ECONOMY

1. Update on the ASEAN-China Free Trade Agreement

Full implementation of ACFTA in 2010 drove a publicized concern that it would prompt a surge of cheap Chinese imports but the evidence suggests that this has not been the case with previous tariff reductions under the agreement

The ASEAN-China Free Trade Agreement, which took force on 20 July 2005, has resulted in a gradual reciprocal lowering in the import tariffs amongst the signatory countries. On 1 January 2010, the near complete implementation of ACFTA was achieved by the ASEAN-6 economies, including Indonesia, and China, with zero tariffs applied to 90 percent of products or almost all of their tariff lines⁷. The remaining four countries (Cambodia, Laos PDR, Myanmar and Vietnam) are to achieve this objective by 2015.

The implementation of ACFTA in 2010 has led to a publicized concern over the potential for a surge of cheap Chinese imports which would undercut domestic producers. However, the tariff cuts under the ACFTA were relatively small in 2010, and historically the tariff reductions made by Indonesia on Chinese imports are in line with cuts made by other signatories of the agreement which benefit Indonesian exporters. Furthermore, preliminary statistical analysis in this section does not support the view that ACFTA tariff reduction in itself increased the rate of Indonesia's import growth from China, once common trends are controlled for. Instead the increasing trend of imports from China, which are dominated by capital goods, appears to be rather a reflection of robust domestic demand.

a. The implementation of ACFTA tariff reductions

Tariff reductions implemented under the ACFTA since 2005 are consistent with those implemented by other partners to the agreement and also with reductions made by Indonesia under other regional trade agreements and via unilateral reductions in its MFN rates

Tariff reductions under the ACFTA – including by Indonesia – began in 2005, with gradual, annual cuts in tariff rates. The reductions implemented under the ACFTA are consistent with Indonesia's reductions in its tariffs on the imports of other major trading partners made under a host of regional agreements – the ASEAN FTA (AFTA), the ASEAN-Korea FTA (AKFTA), the Indonesia-Japan Economic Partnership Agreement (IJEPA) – and with the unilateral reductions in Indonesia's Most Favored Nation (MFN) preferential tariff rates (Figure 24). Indonesia's tariff reductions are also consistent with those implemented by other countries, including China, under the ACFTA which are of benefit to Indonesian exporters.

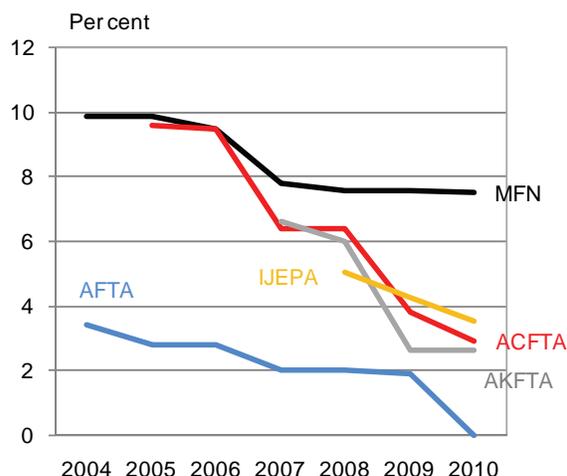
Indonesia cut tariff rates substantially in 2007 and 2009, in line with other economies under the ACFTA. However, Indonesia's average tariff reductions under ACFTA in 2010 were comparatively small. In addition, evidence suggests that historically the majority of goods imported from China have not utilized the preferential tariff rates under the ACFTA. Instead they have applied to export using the Most Favored Nation (MFN) tariff rates, which are – on average – marginally higher than the preferential rates (Figure 1). It has been suggested that the administrative costs associated with applying under the ACFTA mean that the financial incentives to use the ACFTA rates can be diluted. In particular, most of the preferential tariffs require complicated rules of origin terms. Under the ACFTA, a product imported into the territory of a member country from another member country must satisfy one of the following conditions: the product must be wholly produced or obtained in the exporting member country or that at least 40 percent of the product's value content must originate from a member country.

Figures for Indonesia's exporters illustrate the low utilization of preferential tariffs under ACFTA. Of the total USD 11.5 billion exports from Indonesia to China in 2009, only just under a quarter, or USD 2.6 billion, used the ACFTA facility (Antara, March 2010). This is consistent with related studies on Free Trade Areas. For example, Baldwin (2006) noted that the utilization rates under AFTA were about five to ten percent.

But, with the differential tariff rates applying under MFN and ACFTA increasing in 2009 and 2010, there may now be sufficient incentive for Chinese importers to increasingly utilize ACFTA rates. In turn, this could lead to increased competition for some domestic industries. However, greater utilization should also lead to benefits for Indonesian consumers, producers and exporters, in terms of lower prices for final and intermediate products.

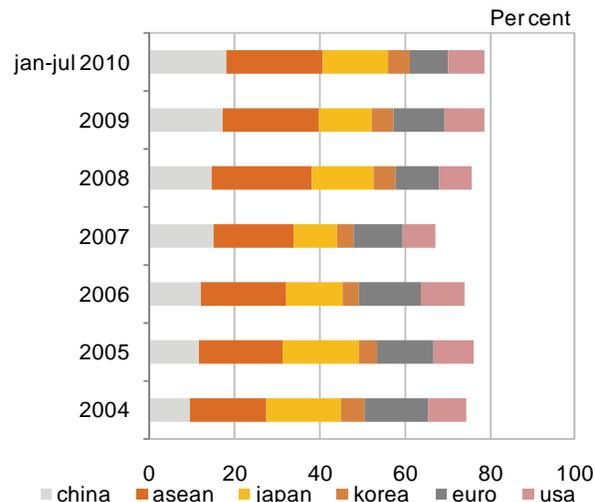
⁷ The ASEAN 6 consists of Brunei, Malaysia, Singapore, Indonesia, Thailand, and Philippines.

Figure 24: Indonesia's tariff rates on imported goods by trade agreement, simple average (percent)



Source: Ministry of Finance, World Bank calculation

Figure 25: Share of Indonesia's non-oil and gas imports (percent)



Sources: BPS.

b. The rising importance of China in Indonesia's imports reflects a range of factors

Strong growth of capital goods, especially personal computers, laptops, and cellular-phones, has driven China's rising share of Indonesia's imports

China's share of Indonesia's imports has increased steadily since 2004, growing the fastest among Indonesia's other FTAs and major trading partners (Figure 25). This is similar to the trend observed for the share of China in other countries' total imports. In the first seven months of 2010, China's share of Indonesia's non-oil and gas imports was 18.2 percent, double the 9.5 percent level in 2004. In addition, since 2007, China has become Indonesia's largest source of imports, replacing the long-time lead contributions of the Japan and US.

The continuing increases in Indonesia's imports from China were mainly driven by capital goods. Products under this category, especially personal computers, laptops, and cellular-phones, expanded most rapidly during 2007 and 2009 when there were also significant tariff cuts. The total share of those three products was only 0.2 percent in 2005. This jumped significantly to 0.9 percent in 2007 and continued rising to reach 2.6 percent in 2010 (Table 8). The increasing imports of these products reflect the strong growth of Indonesia's telecommunications and digital media industry.

Sector-specific factors shed light important on the overall rise in Indonesia's imports from China

High demand from local consumers for cheap information technology (IT) and telecommunication products has opened a big opportunity for China's producers to enter the large Indonesian domestic market. As an example of how large the market is for these products, Buddecomm consulting group (March 29, 2010) reported that Indonesia's mobile phone service penetration was around 65 percent of the population, meaning that Indonesia's mobile service subscribers had passed 150 million by the end of 2009, up from only 12 million subscribers in 2003. The penetration is predicted to grow to 76 percent or 180 million subscribers in 2010. Meanwhile, the number of internet connections grew strongly by 44 percent in 2009, and estimated to grow by 38 percent in 2010. All these figures give an illustration of the scale of the hardware required to support this industry, which must all be imported due to the absence of local products.

The import share of assorted machines and parts from China, including pumps, lifts, conveyors, machinery for plants, and power generating machines also increased from 2 percent in 2005 to above 4 percent in 2009 and 2010. The 10,000 Megawatt electric power projects undertaken by the state electricity company (PLN) were one of the reasons why the power generating machine imports increased in 2009. So, again, this part of the rise in imports from China was not necessarily triggered by the ACFTA tariff reduction.

The import of consumer goods such as textile, clothing and footwear (TCF) from China, which may compete directly with local producers, has actually stagnated as a share since 2007 although the tariff was lowered continuously up to 2010. Meanwhile, the expanded share of fruits imports were also not necessarily because of the tariff reductions, because their tariffs were already zero percent since the initial reductions made in “Early Harvest” 2004. All these cases suggest the need for further empirical investigation into whether the tariff reduction under ACFTA indeed influenced the import growth from China.

Table 8: ACFTA tariff reductions and imports from China as a share of Indonesia's total imports by broad economic classification and significant products (percent)

ITEM	ACFTA tariff (%)				Imports from China as share of Indonesia's total imports (%)			
	2005	2007	2009	2010	2005	2007	2009	2010*
Raw Material	6.6	5.2	2.1	1.2	4.2	5.2	4.7	4.6
Chemical products	6.2	5.0	2.0	1.8	1.3	1.6	1.8	1.8
Irons & steels	9.9	6.9	4.4	3.2	1.5	1.6	1.0	1.1
Fuels	3.5	2.6	0.6	0.6	2.2	0.8	0.6	0.6
Capital goods	3.6	2.9	0.9	0.2	2.3	3.6	7.1	6.9
Data processing parts	0.5	0.2	0.1	0.0	0.1	0.2	0.3	0.4
Computers & laptops	0.0	0.0	0.0	0.0	0.0	0.1	0.6	0.8
Power generating machines	7.0	6.3	3.8	0.0	0.1	0.1	0.4	0.3
Telecom & internet parts	8.8	1.2	0.6	0.0	0.1	0.2	0.2	0.2
Cellphones	7.7	1.2	0.8	0.0	0.1	0.6	1.4	1.4
Lifts & conveyors	1.5	1.7	0.9	0.0	0.1	0.0	0.1	0.1
Pumps	2.8	3.3	1.3	0.9	0.0	0.1	0.1	0.1
Machinery for plants	5.4	3.6	0.6	0.0	0.0	0.1	0.1	0.1
Other machines and parts	3.5	3.0	0.9	0.2	1.7	2.2	4.0	3.4
Transports	25.7	15.1	14.6	14.4	0.3	0.4	0.8	0.7
Consumer goods	11.7	9.0	6.5	5.0	1.1	1.5	1.8	1.8
ICs	13.4	8.9	6.3	3.7	0.1	0.2	0.2	0.2
Onions	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.2
Fresh fruits (apple, orange)	0.0	0.0	0.0	0.0	0.2	0.3	0.4	0.4
Other consumer goods	11.4	9.3	6.8	5.6	0.7	0.9	1.0	1.0
TOTAL	9.5	6.3	3.8	2.9	10.1	11.5	15.1	14.6

* Imports in non bounded zones up to May 2010.

Sources: Ministry of Finance, BPS, World Bank staff calculation

c. ...but initial statistical analysis does not support the arguments that import growth from China has been impacted by the ACFTA tariff reductions

A simple statistical model is used to analyze the relationship between past ACFTA tariff reductions and Indonesia's import growth by product

To investigate the effect of ACFTA on Indonesia's import in more detail, we run a simple statistical model following the approach of Pardo et al (2009)⁸ in examining the impact of AFTA on regional trade. This exercise uses Indonesia's tariff data that are applied for unilateral partners (MFN) and partners under preferential agreements. The data is highly disaggregated – at the 6 digit Harmonized System classification level – with annual data used from 2005 through 2009.

The baseline model is designed to test the relationship between import growth and tariff changes at the product level. The impact of changes in tariffs is estimated relative to the trend in import growth from different groups of trading partners and the overall growth of Indonesia's imports in different periods (i.e. after inclusion of group and year fixed effects).⁹

$$\ln(M_{jtq}) = \gamma_g + \gamma_t + \beta_1 \ln PREF_{jt} + \beta_2 \ln MFN_{jt} + \varepsilon_{jt} \quad (1)$$

M_{jtq} corresponds to the volume of imports of product j to Indonesia, at period t , from group g where \ln indicates the growth rate (calculated as the log difference across periods).

⁸ Pardo, Hector Calvo, et al (2009). The ASEAN Free Trade Agreement: Impact on Trade Flows and External Barriers

⁹ Fixed effects estimation is a method of estimating parameters from a panel data set. This approach is relevant when one expects that the averages of the dependent variable will be different for each cross-section unit, or each time period, but the variance of the errors will not.

There are five groups of countries. There are four groups representing members of Indonesia's preferential partners – ACFTA, AFTA, IJEP, AKFTA – and the fifth group is all other countries. $PREF_{jt}$ indicates Indonesia's preferential tariffs (in percentage points) enjoyed by the exporters of product j in period t , while MFN_{jt} corresponds to the unilateral tariff (in percentage points) that exporters of product j have to incur. Finally, γ_g is the group fixed-effect and γ_t the year fixed effect.

As the model variables are expressed in terms of percentage change¹⁰, the coefficients of the independent variables are interpreted as elasticities. Coefficient β_1 represents the elasticity of the growth of imports from group g with respect to changes in $PREF$ tariff, controlling for changes in the MFN tariff. A negative β_1 means that falls in preferential tariff rates are associated with growth in imports from the preferential trading partner. The coefficient β_2 has a similar interpretation as the elasticity of imports with respect to changes in the MFN tariff, controlling for changes in preferential tariffs.

To examine the impact of changes in tariffs under different preferential tariff agreements, particularly the ACFTA, equation (1) is modified to equation (2):

$$\ln(M_{itg}) = \gamma_g + \gamma_t + \beta_{1a} \text{chn} * \ln PREF_{jt} + \beta_{1b} \text{asean} * \ln PREF_{jt} + \beta_{1c} \text{jpn} * \ln PREF_{jt} + \beta_2 \ln MFN_{jt} + \varepsilon_{jt} \quad (2)$$

Now the coefficient β_{1a} represents the elasticity of imports from China with respect to changes in preferential tariffs under the ACFTA, and similarly for β_{1b} and β_{1c} for the AFTA and Japan FTA; all controlling for changes in the MFN tariff. (The interaction with Korea for the AKFTA is not included for reasons of multicollinearity).

Controlling for general import trends and changes in MFN tariffs, evidence does not support the view that ACFTA tariff cuts were associated with import growth from China

The results of the exercise are shown in Table 9. The first two columns include the group fixed effect to control for the average growth of imports by Indonesia from each group. In column one the coefficient on changes in tariffs under ACFTA is associated with falling imports from China relative to trend. This runs contrary to the claim of ACFTA leading to rising imports. However, the coefficient becomes insignificant when controlling for changes in MFN tariffs (column 2). As expected, Indonesia's import growth by product is significantly negatively correlated with changes in MFN tariffs.

Table 9: Estimated impact of tariff changes on the growth of Indonesia's imports by product line

	(1)	(2)	(3)	(4)
$\text{chn} * \ln \text{pref}$	3.86***	1.74	3.97***	1.95
$\text{afta} * \ln \text{pref}$	-0.09	-2.3	-0.02	-2.14
$\text{jpn} * \ln \text{pref}$	-2.92	-5.28	-2.99	-5.25
$\ln \text{mf}$		-2.66***		-2.54***
group fe*	yes	yes		
group-prod fe**			yes	yes
group-time fe				
obs	180838	180829	180838	180829
R2	0.0009	0.001	0.0015	0.0015

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Sources: World Bank staff calculations, BPS, Ministry of Finance.

Notes: * Group fixed effect, ** Group-category product fixed effect. Year fixed effects included in all regressions.

Similar outcomes are observed with other specifications. In columns 3 and 4 the regression includes group-product effects, i.e. controlling for general trends in imports of different products from partner groups. This attempt to avoid misspecification and misattributing the impact of changes in the preferential tariffs with possibly correlated group specific trends in the imports of individual products (for example, the fall in tariffs on capital goods may coincide with the rise in demand for capital goods from China).

¹⁰ For tariffs, the \ln means $\ln(1+PREF/100)$ and $\ln(1+MFN/100)$.

Similar results were also observed when looking at sub-samples of products, such as capital goods and consumer goods; and also when looking at annual growth rates of Indonesia's monthly import data up to May 2010. However, it should be noted that these are initial results. However, these preliminary results are in line with the findings of Pardo et.al. (2009) on AFTA that suggested that imports appear to be more negatively affected by changes in MFN tariffs than changes in preferential tariffs.

d. Look at the ACFTA as the media to exchange market access

ACFTA should be viewed as an opportunity to strengthen and enhance economic, trade and investment co-operation between Indonesia and China

These initial findings suggest that, on the basis of previous tariff cuts, fears of an aggressive influx of cheap China's products into country because of tariff reduction under ACFTA do not appear to be statistically proven. The pattern of imports from China, which is dominated by capital goods and rising as a share of Indonesia's total imports, is rather a reflection of robust domestic demand.

Similarly, the increasing Indonesia's exports to China in the last five years largely reflects China's enormous hunger for natural resources to fuel its economy rather than the utilization of tariff reductions made in 2005. The structure of Indonesia's exports to China has been relatively unchanged, dominated by resource-based commodities, such as energy, including oil, gas, and coal; metals; and estate crops (Table 10).

Thus the ACFTA should be viewed as an opportunity to strengthen and enhance economic, trade and investment co-operation between Indonesia and China. Among other things this includes greater technological transfer and greater specialization and investment within the region. Many of the benefits from the agreement are expected to accrue over the long-term – and as such are difficult to quantify, for example as Indonesian firms realize new market opportunities in China or improve their competitiveness relative to an expanded set of imports..

Table 10: ACFTA tariff reductions and exports to China as a share of Indonesia's total exports by broad economic classification and significant products (percent)

ITEM	China's tariff to Indonesia (%)				Export to China as share of world export (%)			
	2005	2007	2009	2010	2005	2007	2009	2010*
Oil & gas	4.7	4.6	2.4	2.1	3.2	2.6	2.2	0.7
Agriculture commodities	12.0	7.9	3.3	0.4	1.3	1.9	2.5	1.5
Rubber	5.4	5.1	0.2	0.0	0.4	0.6	0.6	0.6
Palm Oil	0.0	0.0	0.0	0.0	0.6	0.8	1.4	0.5
Mining & mineral commodities	3.4	3.4	0.1	0.0	0.6	1.3	2.7	3.4
Copper	3.9	3.9	0.0	0.0	0.4	0.3	0.3	0.3
Coal	4.2	4.2	0.0	0.0	0.1	0.4	1.8	2.6
Forestry products	2.7	2.6	2.1	1.2	1.0	0.8	0.7	0.6
Paper and Paper Products	7.5	7.5	5.0	0.0	0.2	0.2	0.1	0.1
Pulp and Waste Paper	0.0	0.0	0.0	0.0	0.4	0.4	0.4	0.3
Manufacture products	8.7	7.0	3.4	1.3	1.7	1.8	1.8	1.4
TCF	12.3	9.4	5.7	2.4	0.2	0.2	0.2	0.2
Electronic & parts	7.1	5.5	3.0	1.4	0.3	0.4	0.4	0.2
Chemicals	6.2	5.6	1.4	0.7	0.9	1.0	0.7	0.7
TOTAL	8.3	6.6	3.0	1.0	7.8	8.5	9.9	7.5
TOTAL Non-oil & gas					5.9	7.2	8.7	10.0

* Export up to May 2010. Sources: Ministry of Finance, BPS, World Bank calculation

2. Piecing together insights into the movements in household purchasing power

Recent increases in inflation and particularly poverty basket inflation have raised questions about the impact on households' consumption, particularly that of poor households

The sudden price increase of several food items in recent months, accompanied by declines in consumer confidence, have raised concerns about their impact on household consumption levels, particularly poor households, due to their adverse effect on household purchasing power. A household's purchasing power reflects its ability to consume goods and services. It is determined by household income and the price of the goods and services that the household consumes. The discussion below sets these recent developments in the context of previous episodes of falling consumer confidence and rises in inflation and within the longer-term trends of rising household consumption levels.

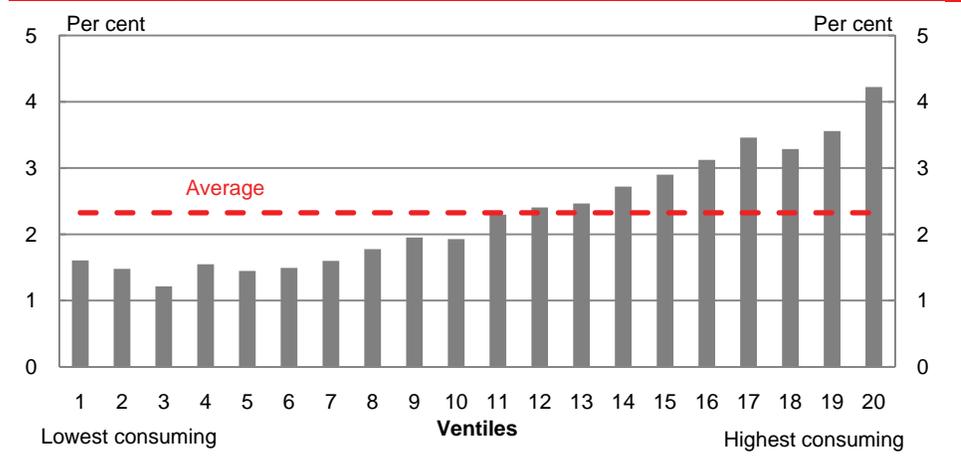
a. During the previous decade households experienced large increases in real consumption

Real consumption over the longer term has increased for all households but the growth was less for poor households

Recent movements in purchasing power are better understood in the context of longer-term trends in consumption growth as well as the medium-term outlook. Real consumption levels and how they evolve each year can be observed through the annual Susenas household survey. Figure 26 illustrates that between 2001-2009 real consumption increased across all ventiles (20 population groupings of 5 percent each ordered by consumption level). However, consumption growth was lower for poorer households. The average real consumption growth for the bottom ventile (the poorest group) was 1.6 percent, compared with the average for the entire population of 2.3 percent. The growth rate for the bottom ventile was around one-third of the growth for the highest consumption ventile. Nevertheless, real consumption growth for poorer households contributed to a fall in the poverty rate, which has dropped from 18.4 percent of the population in 2001 to a low of 13.3 percent in March 2010 – a reduction of 6.9 million people. The profile for real consumption growth across the different ventiles does however vary depending on the time-period. For example, over the period of 2006-2009 the highest expenditure ventile experienced the lowest growth rate while the middle ventiles had the highest growth rate.

Over the same period as the Susenas data, aggregate real private consumption in the national accounts grew at an annual rate of 4.2 percent. This trend is expected to strengthen in the medium-term with real private consumption growth forecast to be above 5 percent in 2010 and 2011 (see Table 2).

Figure 26: Real consumption growth 2001-2009
(annual average growth by ventiles ordered lowest consuming household to highest)



Source: Susenas (2001-2009)

b. Consumer confidence indices and inflation measures provide real-time insights into developments in real consumption

Consumer confidence indices and monthly inflation movements provide additional insights into developments in household real consumption

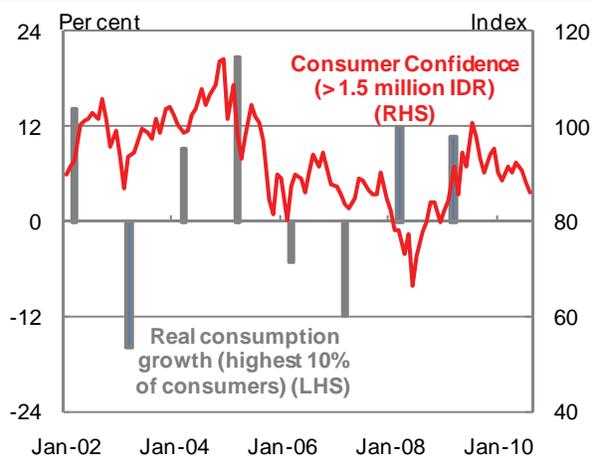
The Susenas data depicted above only provides an annual snapshot of real consumption and is published with several months delay. The once-a-year reporting is not sufficient for policy makers who require more timely and frequent insights into developments in household purchasing power. Accordingly, alternative data sources are required to garner insights into real consumption growth between the annual data points reported in the Susenas. Consumer confidence indices (CCI) are helpful for this purpose as they act as a proxy indicator of households' likelihood of undertaking consumption and are produced monthly with only a few weeks lag by BI and Danareksa. Similarly, the change in the cost or price to consume a set of goods or services is a key determinant in consumption decisions, and this is summarized in the monthly inflation series produced by BPS.

CCI and inflation broadly map real consumption movements in the Susenas, making them useful as real-time and high frequency proxies of real consumption

The degree of their correlation with the detailed Susenas real consumption data is a gauge of the high frequency CCI's and inflation measures' usefulness as proxies for developments in real consumption. The correlation (or lack of) between the CCI and real consumption can be examined by overlaying the monthly movements in the CCI on the annual Susenas real consumption growth (Figure 27 and Figure 28). Over the past eight years, it appears that the CCI of the different income groups broadly reflects the real consumption growth profile of the relevant households, particularly for the highest consumers of the Danareksa survey. The correlation of the lowest expenditure group in the CCI was not as strong in 2007 and 2008 and this may reflect government programs such as the temporary unconditional cash transfer BLT (Bantuan Langsung Tunai) for poor households or the piloted conditional cash transfer program PKH (Program Keluarga Harapan) which improved real consumption but may not equally affect respondents views on economic conditions – a key component in the CCI. Overall, the higher frequency data are a useful indicator for real consumption developments as they provide real-time insights and intra-year movements.

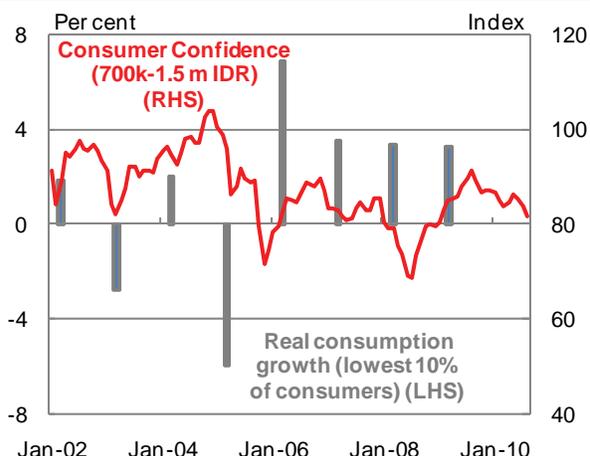
Figure 27: Consumer confidence for the highest expenditure group broadly tracks their real consumption growth...

(consumer confidence index, real consumption growth)



Sources: Danareksa and Susenas
 Note: The consumer confidence index is smoothed to reduce monthly volatility (two month moving average)

(consumer confidence index, real consumption growth)

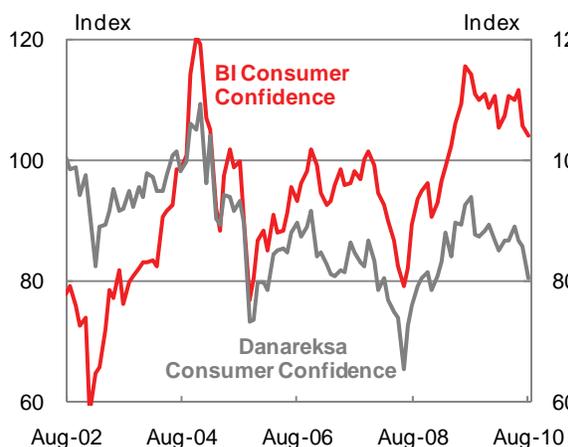


Sources: Danareksa and Susenas
 Note: The consumer confidence index is smoothed to reduce monthly volatility (two month moving average)

Consumer confidence levels produced by BI and Danareksa move in similar directions but the Danareksa CCI is generally lower due to a higher proportion of poor households and the inclusion of rural households in their sample

Bank of Indonesia and Danareksa each produce CCI, which generally track in the same direction but the outlook for Danareksa is usually more pessimistic than the BI index (Figure 29). This likely reflects the larger representation in the Danareksa survey of households who spend less than IDR 5 million a month, including respondents who spend less than IDR 1,000,000 a month, which the BI survey does not capture at all. The BI survey also excludes rural households who comprise around 30 percent of the Danareksa survey. Both CCI are highly sensitive to movements in inflation with a negative relationship between the two, whereby price shocks (temporary or permanent) are followed by large contemporaneous declines in consumer confidence (Figure 30). The greater coverage of poor and rural households in the Danareksa CCI leads to a significantly greater correlation with the poverty basket inflation rate than the headline rate while the BI Consumer Confidence Index is more highly correlated with the headline inflation rate. A key feature of the relationship between CCI and both inflation measures is CCI rebound just as quickly when the effects of a temporary inflation increase unwind.

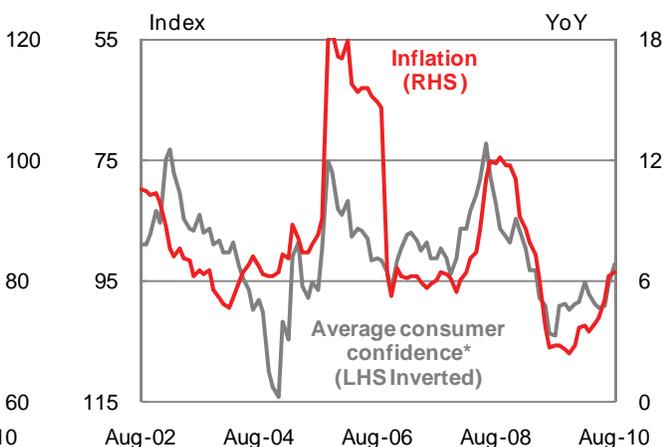
Figure 29: Consumer confidence measures fell in recent months... (index)



Sources: BI and Danareksa

Note: CCI are constructed by a Balanced Score Method (net balance + 100), where the index is above 100 points indicate optimism (positive responses) and vice versa

Figure 30: ...as inflation increased (consumer confidence index inverted; inflation year-on-year percent)



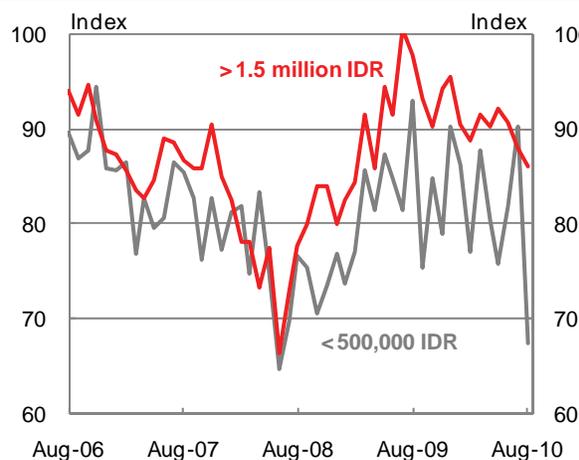
Sources: BPS, Danareksa, BI

Note: The average consumer confidence series is the simple average (midpoint) of the BI and Danareksa consumer confidence indices shown in Figure 29

Consumer confidence levels vary according to income group and setting with lower levels for rural and poor households

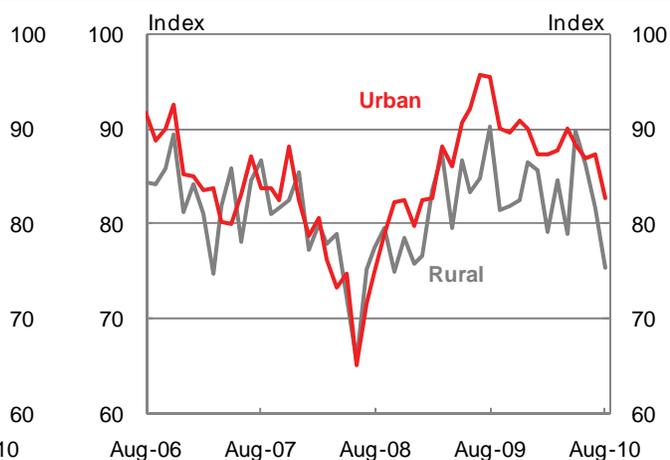
As was the case with real consumption growth (Susenas data), there are also differences in consumer confidence when examined by expenditure level. This is apparent when comparing the headline BI and Danareksa CCI, but also explicitly by their series for different expenditure levels. A breakdown of the Danareksa CCI by expenditure levels reveals that poorer household's confidence levels are consistently lower (Figure 31). Similarly, consumer confidence levels are generally lower for rural consumers (Figure 32). This is partially explained by the higher share of poor households in rural settings and may also reflect broader connectivity related issues associated with rural and remote areas including lower job prospects, poor infrastructure and less competition for goods and services. These factors negatively impact rural consumers' purchasing power as well as businesses ability to produce products at competitive prices.

Figure 31: Poorer households' consumer confidence is lower and fell more severely with recent price increases (consumer confidence index levels by household expenditure)



Source: Danareksa

Figure 32: Rural households also have lower consumer confidence, again falling sharply during recent price rises (consumer confidence index levels by setting)



Source: Danareksa

c. Recent increases in some volatile food items particularly affected the purchasing power of poor and rural households

BI and Danareksa CCI in recent months indicate sizeable falls and appear to be largely associated with the recent food price increase

Susenans data for 2010 will not be available until early 2011, which make the CCI and inflation measures crucial to gain a timely understanding of the impact of the recent price increases in volatile food items on real consumption. In recent months, BI and Danareksa CCI indicate sizeable falls (Figure 29) and appear to be largely associated with the spike in inflation (Figure 30). The Danareksa Consumer Confidence Index fell for the third consecutive month in August and remains below the peak of August 2009. According to BI, consumer confidence fell because of rising consumer expenditure on basic needs reducing their ability to consume durable goods.

The recent food price increase had a more severe affect on poor households' consumer confidence levels

The recent food price hike led to a greater decline in the confidence of households who spend less than IDR 500,000 a month (Figure 31). This is not surprising given the higher share of food that poorer households consume in their basket of goods and services. This reflects a similar divergence between the headline inflation rate and the poverty basket inflation rate in recent months (see Appendix) which indicates that poor households faced higher inflation rates and subsequently experienced larger falls in purchasing power, feeding into the greater drop in consumer confidence. However, consumer confidence levels should recover over the next few months given the temporary nature of the recent increase in certain volatile food items.

In conclusion, several high frequency indicators suggest the recent food price increases led to declines in consumer confidence and purchasing power but as those price rises unwind and strong economic growth continues purchasing power is expected to continue improving in the medium-term

Overall, a number of different indicators point to a fall in household purchasing power and consumer confidence in recent months on the back of higher food prices but as those prices unwind purchasing power is expected to continue improving. The impact was most sharply felt by poor and rural households, which consume a greater share of food in their consumption basket and generally possess fewer savings to withstand the temporary shock. Longer-term increases in real consumption provide a necessary context to understand recent developments, as previous falls in purchasing power and consumer confidence triggered by sudden movements in prices were temporary. Over the previous decade strong economic fundamentals drove rising household consumption levels, despite periods of volatile inflation. Therefore, the fall in purchasing power in recent months should also be temporary, considering the temporary nature of the recent price hike. The challenge for policy makers in the medium-term is to help develop greater market mechanisms to deal with temporary supply side shocks whilst providing temporary and targeted relief in the short-term for those most adversely affected.

3. Medium-term macroeconomic projections

Raising longer-term economic growth is a key objective of policy makers	One of the aims of policy makers is to raise the longer term growth trajectory of their economy in order to improve the living standards of the population. This is particularly important for countries such as Indonesia where income levels are relatively low. In order to raise the potential growth of the economy it is important to understand what are its main drivers and how these are expected to evolve in the medium term. Credible medium-term projections of economic growth may also be useful to feed into the private sector outlook and investment decisions and for government planning in other areas, for example the potential fiscal balance in the medium term.
A supply-side framework is useful in estimating the medium-term growth potential of the economy	A useful way of quantifying Indonesia's potential medium-term output is through the use of a supply-side framework based on the inputs to production. Major inputs include physical capital, human capital, land, energy and materials. A supply-side framework focuses on the way in which these inputs interact with one another, and the efficiency at which they are used. This framework can help policy makers by highlighting the need to improve constraints facing investment in infrastructure, investment in human capital through better targeted education spending, and other regulatory or microeconomic reforms which may lead to stronger productivity growth. Part C of this publication deals with a number of such reform challenges facing Indonesia, for example, in the areas of access to finance, education, health and labor regulations.
This note focuses on the estimation and the projections of Indonesia's potential GDP	This rest of this section sets out a supply-side framework for estimating and forecasting potential GDP. This note outlines the methodology for estimating and projecting potential growth in Indonesia. The note attempts to draw policy implications from the resulting estimates, and then outlines the advantages and disadvantages of this particularly approach. This note finds that for the Government to reach its growth targets laid out in its medium term development plan (RPJM) then strong rates of investment growth are required, combined with improving productivity.
a. Drivers of potential growth in the economy	
The potential rate of growth in the economy is the trend rate of growth in productivity capacity	The potential rate of economic growth can be defined as the trend rate of growth in the productive capacity of the economy. It can also be interpreted to be the trend rate of growth that is consistent with stable inflation. Therefore when the economy is operating above trend growth, or when output growth exceeds that of productive capacity, there tends to be inflationary pressures.
The potential rate of growth in the economy depends on the quantity and quality of inputs to production which are available in the economy,	The potential rate of growth in the economy depends on the quantity and quality of inputs to production, which are available in the economy, and the efficiency with which they are used. The inputs can include physical capital such as plant and equipment, labor, material and energy. The more of these inputs available in the economy, and the higher their quality, the greater the potential output of the economy. A simple way to analyze potential output is to focus on two key factor inputs, namely labor and capital (as in the famous "Solow" model of economic growth). The relationship between these two inputs and real GDP growth is assumed to be summarized by a simple mathematical production function. While it is possible to have production functions for each sector of the economy, and then aggregate the results to obtain a potential GDP estimate, the approach here is a top-down estimate where there is only a production function for the whole economy. The production function can be manipulated to decompose the sources of growth using a technique known as "growth accounting".
Total factor productivity is a major driver of growth	The efficiency with which inputs are used in production, referred to as total factor productivity (TFP), can be the driver of potential growth. Examples of more efficient uses of resources are numerous. Through research and development (R&D) firms may be able to produce more or new products by rearranging their existing capital and labor. When new technology is transferred from overseas, for example via foreign direct investment, domestic firms may be able to adopt and adapt this technology to enhance the efficiency of their production processes to produce more from their existing inputs. When distortions are removed from sectors of the economy by the lifting of inefficient market regulations or changes in inefficient taxes then resources may shift between sectors leading to a more efficient allocation of production. When measured TFP often captures more than these efficiency improvements because it is often calculated as a residual.

b. Growth accounting revisited

Total factor productivity is measured as being the difference between input and output growth

A growth accounting exercise uses an assumed production function to decompose measured output growth into the contribution from the measured growth of inputs and a residual component which is taken to represent growth in total factor productivity. This framework can then be used to obtain an estimate for potential output going forward. To obtain projections for potential output, projections for the factor inputs and total factor productivity are required. The Organisation for Economic Co-operation and Development (OECD) and the Congressional Budget Office in the United States use this approach for their estimates of potential output.¹¹

The Cobb-Douglas production function is commonly employed in economics

To compute estimates for potential output using the growth accounting framework, a standard production function (Equation 1) is employed, where Q, A, K, L represents output, total factor productivity, capital inputs, and labor inputs respectively. One version of this function in Equation 2, known as the constant returns-to-scale "Cobb-Douglas" function is commonly employed in economies due to its convenient mathematical properties.

$$Q = A f(K_t L_t) \quad (\text{Equation 1})$$

$$Q = A L^{(1-a)} K^a \quad (\text{Equation 2})$$

If the natural log is taken of Equation 2 followed by the total differential, then Equation 3 outlines the core equation behind growth accounting

$$\% \Delta Q = \% \Delta A + (1 - a) \% \Delta L + a \% \Delta K \quad (\text{Equation 3})$$

Where $\% \Delta Q, \% \Delta A, \% \Delta L, \% \Delta K$ are the percentage change in GDP, total factor productivity, labor force and capital stock respectively. $(1 - a)$ is the labor share of economy and a is the share of the economy that is returned to capital. This equation states that growth in GDP is the weighted share of labor and capital plus total factor productivity growth. Therefore to project GDP in the medium term using this framework only three variables are required, capital stock, labor force and total factor productivity.

Unfortunately there are no official estimates of capital stock

Capital stock data for Indonesia is very limited, however fortunately a number of researchers have attempted to calculate their own in the absence of an official estimate from BPS. This note uses a capital stock series for 1980-2007 that was constructed by Van Der Eng (2008) using the perpetual inventory measure (PIM).¹² The PIM is calculated by taking an existing measure of the capital stock, then sums annual investment for each year, while adjusting for depreciation. This series was extrapolated to 2009 using gross fixed capital formation data. The labor force data comes from the Survei Angkatan Kerja Nasional (Sakernas) but, for reasons of simplicity, is not adjusted for labor quality, for example in terms of educational attainment. Real GDP data is obtained from the BPS quarterly National Accounts. Given there are no income accounts in Indonesia it hard to obtain an estimate of the labor and capital shares of output so a 67 percent labor share has been assumed, this is consistent with OECD (2008) which estimated potential GDP in Indonesia.¹³ Using the data for real GDP, capital and labor, the growth in total factor productivity can be calculated as a residual from Equation 3. This means that any growth that is not accounted for in movements in the weighted share of labor and capital is recorded in TFP.

Total factor productivity averaged around 2.2 percent during 2000s

Total factor productivity grew by around 0.8 percent in 2009. The 2000s decade average for TFP growth was around 2.3 percent.¹⁴ Apart from 2009 when TFP growth was 0.8 percent, growth was trending up over most of the decade (Figure 33). Smoothing the estimates for TFP, capital and labor using the Hodrick-Prescott filter removes the effects

¹¹ See, for example, Congressional Budget Office (CBO) (2001), 'CBO's Method for Estimating Potential Output: An Update'.

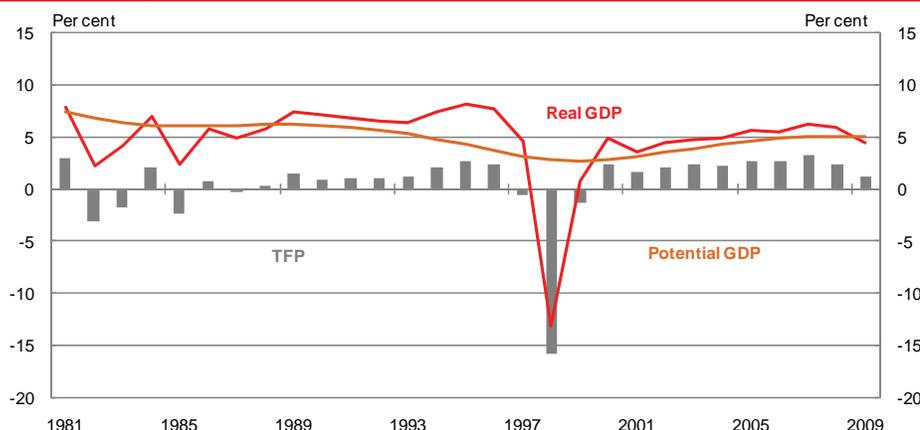
¹² Van Der Eng, P. (2008), 'The sources of long-term economic growth in Indonesia, 1880-2007', Australian National University, Working Papers in Economics & Econometrics

¹³ OECD (2008), 'OECD Economic Surveys – Indonesia Economic Assessment', pp 49-51.

¹⁴ As an illustration of the sensitivity of the estimates to the model assumptions, increasing the labor share by 10 percent, increases the decade average TFP growth estimate by around 0.2 percent.

of the business cycles and allows an estimate for potential GDP. Using this methodology, in 2009 Indonesia's potential GDP grew by around 5.2 percent, compared with actual growth of 4.5 percent. In terms of contributions to total GDP growth, consistent with other studies, it was found that input accumulation was responsible for much of Indonesia's growth from the 1980s. For all of the 2000s input accumulation contributed around 55 percent of total GDP growth.

Figure 33: Potential GDP versus actual growth since 1980 (percent annual growth)



Sources: World Bank staff calculations and BPS

c. Baseline projections

The short-term projections from Part A are used to extend the projections for total factor productivity and hence potential GDP

This framework can be used to produce projections for potential GDP into the medium term. For 2010 and 2011 projections in Part A for gross fixed capital formation are used to calculate the capital stock until 2011. ILO projections for the working age population are also used to calculate employment growth for 2010 and 2011. This is combined with the World Bank near-term real GDP projections of 6.0 percent and 6.2 percent for 2010 and 2011 to calculate a total factor productivity series which extends until 2011 (Figure 4).

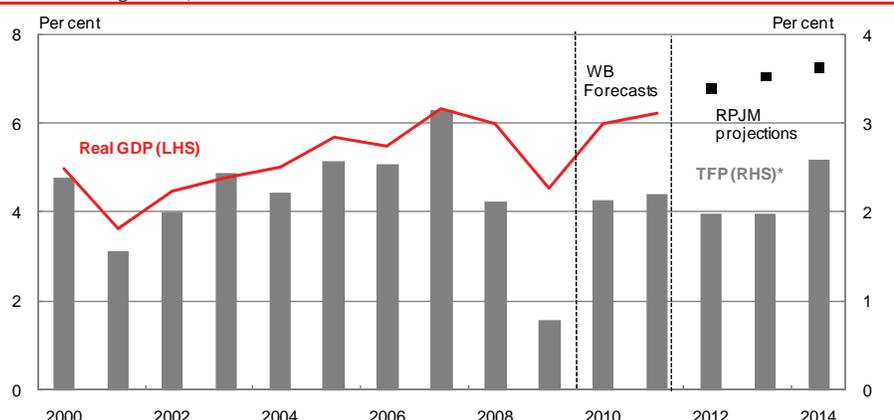
If the Government's RPJM projections for GDP, and investment are assumed, this implies strong TFP growth in the medium term

From 2012 until 2014 long-term assumptions have to be made regarding the capital stock, the labor force and total factor productivity. For the baseline projections, it is assumed that GDP grows at the Government's projections assumed in the medium term development plan or RPJM. It is assumed that annual investment increases at the rate consistent with the Government's RPJM. By the end of the projection period investment is assumed to grow above 10 percent. World Bank projections for the working age population are then used to calculate employment growth until 2015. Total factor productivity is assumed to change to meet the Government's RPJM projections.

Growth in Indonesia's economy relies heavily on the RPJM investment targets

The RPJM projects growth to increase from around 6.0 percent today, to around 7½ percent by 2014 (Figure 4). The RPJM relies on significant increases in investment. This will however require a continuation and deepening of reform efforts undertaken by the Government to encourage private sector investment, both domestic and international, and to address the country's significant infrastructure needs.

Figure 34: Projections of Indonesia’s potential growth (percent annual growth)



Notes: RPJM projections are mid-points of range. *Implied TFP projections based on RPJM GDP projections and RPJM investment
Sources: World Bank staff calculations and BPS

Scenario analysis illustrates the sensitivity of the growth projections to assumed investment and TFP growth rates

Scenario analysis is important to understand the possible variations around the central projection. Scenarios were conducted around the central RPJM projection, where investment and total factor productivity growth were able to vary. In the low investment growth scenario it was assumed that investment growth averages around its 2000 rate over the projection period, while in the high scenario it is assumed investment growth averages around rates prior to the Asian Financial Crisis in 1998. The low TFP growth scenario assumes that TFP grows around 1.5 percent on average over the projection period, while the high TFP growth scenario assumes that TFP accelerates to around 3 percent over the projection period (Table 11).

Table 11: Sensitivity analysis (annual average growth rate over 2012-14 unless otherwise specified)

Average 2012-2014*	Investment Varies (TFP as in RPJM)			TFP varies (Investment as in RPJM)		
	Low	RPJM	High	Low	RPJM	High
Investment	8.0	11.0	12.0	11.0	11.0	11.0
TFP	2.2	2.2	2.2	1.5	2.2	3.0
GDP	6.6	7.0	7.3	6.0	7.0	7.4
GDP/cap (USD 2010 prices)*	3470	3530	3570	3410	3530	3570

*GDP/cap at 2014
Sources: World Bank staff calculations and BPS.

If TFP is assumed to stay at the rate required to meet the baseline RPJM projections, then under a low investment scenario, GDP could average around 6.6 percent, whereas if investment grows at a more rapid pace, GDP could average as high as 7.3 percent over 2012-2014. If investment is assumed to stay at the rate required to meet the RPJM projections then under a low TFP scenario GDP could be as low as 6 percent, while under a high scenario it could grow as strong as 7.4 percent.

d. Advantages, disadvantages and further work

The simplicity of this approach is both an advantage and disadvantage

One of the key attractions in using this framework to make growth projections is that it is based on a very simple supply side representation of the economy, where potential output is the sum of growth rates of only three factors of supply, labor, capital and total factor productivity. However, this simplicity can also be a drawback, for example the labor and factor shares were assumed to remain constant in this approach rather than econometrically estimated or sourced from input-output data. More sophisticated approaches can be used to estimate the production function econometrically but are not without their own technical problems.

This approach rests on the quality of the data for factor inputs, particularly the capital stock data

Another difficulty for this approach is that it relies on data for capital stock, when there are no official estimates of capital stock in Indonesia. Estimating the capital stock using the perpetual inventory method relies on accurate fixed investment figures and the usage of appropriate assumptions on depreciation. It also does not control for the quality of the capital stock. Even in countries where official capital stock data are available such problems remain. Similar issues relate to the data on labor inputs and the difficulty of adjusting for the quality of human capital.

Disaggregated approaches for estimating potential output can be employed

In this exercise potential GDP was estimated at the aggregate level. This framework can be extended to estimate potential output for each of the economic sectors. Estimating sectoral output can provide further insight into the drivers of economic growth which are not captured at the aggregate level. For example, capital stocks for different sectors may be of different quality and vintage. This is especially important given that some sectors would have a higher information technology penetration requiring different depreciation rates. However, the data difficulties mentioned at the aggregate level are amplified at the sectoral level in terms of obtaining reasonable capital stock and labor data.

e. Implications and conclusions

The Government needs to maintain its commitment to reform for the economy to expand toward 7 percent by the middle of the decade

There are a number of key points to take away from this exercise. For the Government to reach its growth targets laid out in its medium term development plan (RPJM) very strong rates of investment growth are required, combined with improving productivity. For this to happen it requires that the government maintain its strong reform commitment outlined in the development plan. Reforms such as lowering entry barriers for new business by reducing the time and cost to start a business as well as encouraging more foreign investment through fewer restrictions on foreign ownership are especially important. Policies that spur job creation in the formal non-agriculture sectors which tend to have higher productivity growth could also contribute to advance aggregate economy productivity. Without these reform measures the growth of potential output may not meet the government's targets. This also has implications for inflation looking forward. If domestic demand continues its strong recent growth then inflationary pressures may eventuate in the coming years as the economy is estimated to grow more than the growth in potential output in both 2010 and 2011.

The Government in its medium term development plan (RPJM) set out a strong commitment to undertake these reforms

Considerable attention is given in the RPJM to both the better mobilization of all main types of economic inputs as well as measures to improve productivity. The advantage of this approach is that it sends a strong signal to both public sector agencies as well as the private sector that the government gives high priority to creating the environment for a sound expansion of economic activity.

On the inputs side, it is recognized that for many reasons, economic inputs such as land, labor, capital, and entrepreneurship are often not mobilized effectively in Indonesia. The RPJM notes that numerous problems relating to the acquisition of and the efficient use of land are holding back much investment. Labor is seen to be underutilized as well. In recent years the bulk of new entrants to the labor force have been absorbed in low productivity activities in the informal sector in small and micro enterprises. Further, it is noted that large amounts of investment will be needed to underpin faster economic growth. Measures to improve the investment climate for both domestic and foreign investors are therefore listed as a priority. And the crucial role that entrepreneurs play in promoting, especially, private sector growth is acknowledged in the growth strategy set out in the RPJM.

C. INDONESIA 2014 AND BEYOND: A SELECTIVE LOOK

1. Improving Access to Financial Services: Analysis and ideas for policy-makers

Access to formal financial services is fundamental to increasing financial and economic inclusion and helping to reduce poverty and inequality

Access to formal financial services is widely recognized as critically important to increase economic and financial inclusion, reduce income inequality and alleviate poverty around the world. However, only about half of Indonesia's population has access to formal financial services. Commercial banks, which dominate the Indonesian financial sector, serve a relatively small proportion of Indonesian households. Less than half of Indonesia's population saves at banks, while a mere 17 percent of Indonesians borrow from banks. Increasing access to formal financial services does not only lead to social and economic benefits for households but it is also advantageous to the Government, as well as the commercial banks.

Owing to a number of factors, there are large areas of unmet consumer demands for financial services in Indonesia

In Indonesia, there are large areas of unmet demand where consumers want formal financial services but are unable to obtain them, owing to issues such as lack of appropriate products and geographic isolation. Past policies have focused on maintaining overall stability while neglecting accessibility, even though both can be achieved simultaneously. This section provides an overview of the data, analysis, and recommendations for policy-makers that can assist in improving access to financial services in Indonesia.

a. What is access to finance/financial inclusion and where does Indonesia stand?

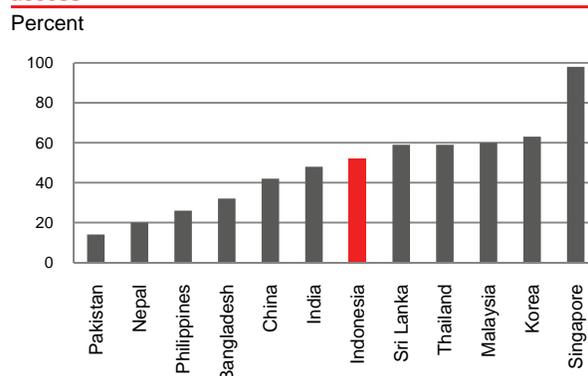
Access to finance and financial inclusion refers to an individual's or enterprise's accessibility to financial products and services such as savings, loans and insurance

Microfinance has gained immense popularity in recent years and micro credit operations are flourishing worldwide. Small-scale loans given to entrepreneurs from poor households have been instrumental in helping them generate income and exit poverty. However, contrary to common perceptions, access to finance is not limited to micro credit. From microfinance is often linked to the broader concept of access to finance and financial inclusion, which refer to an individual's or enterprise's accessibility to financial products and services such as savings, loans, transaction channels and insurance. It includes financial asset-building in the form of savings products, as well as access to products providing financial risk mitigation of unexpected events through insurance schemes.

About half of Indonesia's population does not have access to formal financial services

Research indicates that about half the population in Indonesia does not have access to formal financial services. Indonesia has lower levels of financial access than regional comparators such as Malaysia, Thailand and Sri Lanka. However, Indonesia is better placed than Bangladesh and the Philippines (Figure 35). To look into the degree of access to finance in Indonesia in more detail, the World Bank has conducted a study of the demand-side and supply-side aspects of access to financial services, along with the current regulatory framework.¹⁵

Figure 35: Share of the population with formal financial access



Sources: World Bank (2008, 2009b)

¹⁵ See World Bank (2009a), "Improving Access to Financial Services in Indonesia" (available at <http://go.worldbank.org/ZYCJR4KHE0>). For an international perspective see, for example, World Bank (2008), "Finance for All: Policies and Pitfalls in Expanding Access" (available at <http://go.worldbank.org/7BAOC2SP90>), and World Bank (2009b), "Banking for the Poor, Measuring Access in 54 Economies".

b. Demand-side aspects: what products and services do people need? What is currently available to them?

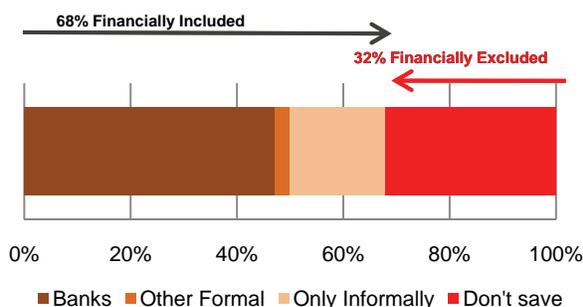
The single most important financial service is a bank account

Results of household surveys indicate demand for a wide range of financial services. Of these, the single most important financial service is a bank account; more than 40 percent of respondents have a bank account compared with only 15 percent who have a bank loan. The primary reason stated for wanting or holding a bank account was 'security'. In terms of access to the services, commercial banks, while having a wide regional reach, do not penetrate deeply into the poorer strata of Indonesian society.

Relatively high levels of informal saving reflect poor perceptions of formal savings products

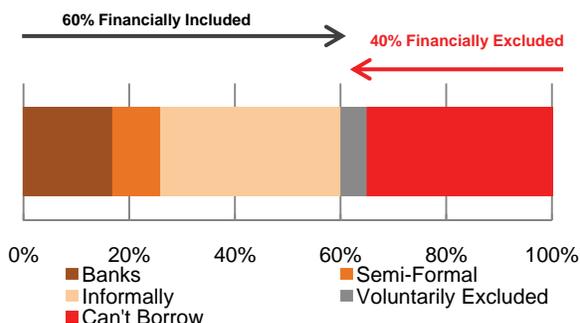
Sixty eight percent of Indonesians save, but only 47 percent do so using formal banks (Figure 36). These data point to a large potential market for commercial banks. Limited reach to bank customers is not caused by physical accessibility to bank branches/ATMs. The problem lies in the poor perception of saving products such as bank accounts offered by commercial banks. These are viewed as costly to maintain and there is low financial literacy regarding formal means of saving. High monthly fees and high minimum account balance requirements are also impediments to access.

Figure 36: Savers' financial inclusion in Indonesia
(means of saving, percentage out of total population)



Source: World Bank (2009a)

Figure 37: Borrower's financial inclusion in Indonesia
(Means of borrowing, percentage out of total population)



Source: World Bank (2009a)

Sixty percent of Indonesians borrow money, but only 27 percent use formal institutions

Household surveys on the demand for loans indicate that a fairly large proportion (60 percent) of Indonesians borrow money (Figure 37). However, only 27 percent of the population does so from a formal bank or microfinance institution. The rest borrow using informal means, such as friends and family. Survey results also show that formal sources of finance are used for business loans, whereas informal sources are tapped for consumption purposes.

...with wide variation on loan interest rates

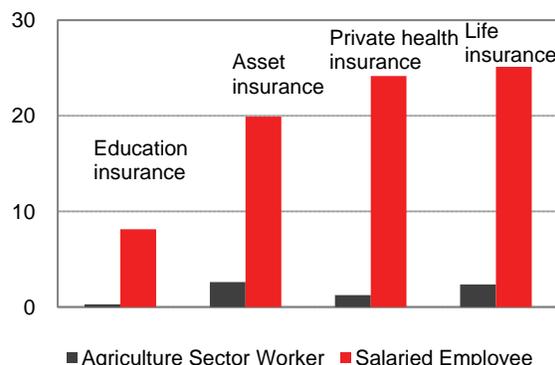
Interest rates charged on loans vary widely. Loans from commercial banks can be obtained at a rate of about 25 percent per annum. This is followed by loans from microfinance institutions (MFIs) and community welfare schemes at over 40 percent. High interest rates are also viewed as one of the main obstacles to finance for small and medium enterprises which are a main source of employment in the economy (see discussion in Box 3).

It is noteworthy that banks and some MFIs charge markedly less interest if the borrower has a bank account. Thus, a simple way to reduce costs for borrowers is to open bank accounts, as this serves as an indicator for creditworthiness.

There is a dramatic difference in insurance take-up between agricultural workers and salaried employees

Turning to insurance services, there is a dramatic difference in take-up between agricultural workers and salaried employees (Figure 38). The latter are more than 10 times as likely to buy insurance as the former. In Indonesia, insurance sales are heavily tilted towards the urban, upper-income groups. The bulk of insurance is accounted for by the compulsory coverage of government workers and travel insurance. Thus, voluntary insurance, where customers are willing to pay the premium, is low. Survey results suggest a demand for micro-insurance products for poor households that are geared towards low-cost protection from illness and poor business performance, such as harvest failures.

Figure 38: Take-up of insurance is highly geared towards salaried employees (insurance ownership as percentage of sample group)



Source: World Bank (2009a)

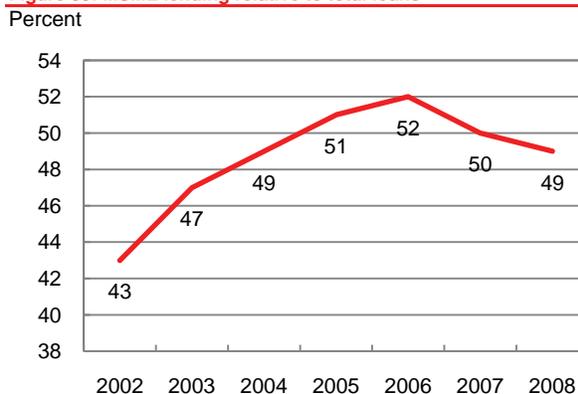
Box 3: Focus on Micro, Small and Medium Enterprises (MSMEs)

MSMEs are widely recognized as crucial for the economic development of countries. International evidence indicates that they generally account for about 98 percent of all enterprises and employ about 60 percent of the private sector workforce. However, they face numerous barriers in accessing financing. The results of a Bank Indonesia survey show that the main obstacle for micro businesses is collateral and for SMEs are high interest rates. Their greatest needs from the Government are for credit, training and market information.

Loans to MSMEs in Indonesia comprise a significant proportion of banks' total loan portfolios. The proportion of such loans is currently at around 50 percent (Figure 39).

People's Business Credit or KUR (Kredit Usaha Rakyat) is a newly established government program to help farmers and MSMEs with credit accessibility. KUR provides risk mitigation for commercial banks and thus accelerates primary sector development and empowers small-scale businesses. Through KUR, commercial banks can lend to MSMEs with a 70 percent credit guarantee. As of January 2008, KUR disbursement was Rp 1,397 trillion through six executing banks. There is great potential for this program to expand and improve credit accessibility for poorer households.

Figure 39: MSME lending relative to total loans



Sources : Bank Indonesia

c. Supply-side Aspects: Who are the market players and what is their role in providing access to financial services?

The different players in the banking sector each have a potential role to play in improving access to finance

Indonesia has various market players in the banking system. In summary, these include the first-tier banks, which are the commercial banks, and second-tier banks, such as people's credit banks (BPRs) and BKDs (Badan Kredit Desa, Village Credit Institutions). Other players include cooperatives, LDKPs (Lembaga Dana Kredit Pedesaan, Rural Fund and Credit Institutions), and other non-banking financial institutions (NBFIs).

Commercial banks can take two important steps in extending wider access to financial services. As innovators, the banks are the most likely institutions to introduce new technologies to deliver relatively high-cost services to low-income clients in costly, remote

areas. The banks will also be helpful in extending access because they will put competitive pressures on the other service providers, thereby holding down prices and improving the quality of services.

In terms of micro-finance, BRI's Unit Desa is Indonesia's premier micro-finance provider and has a large client base. There is great potential for it to better serve lower income clients. A policy decision on the part of management may be needed regarding the current fee structure and lending policies, which can be viewed as hindering Unit Desa's ability to reach potential customers with low incomes.

People's Credit Banks (BPRs) offer great opportunities for wider access to finance for poorer households and MSMEs. BPRs are relatively low-cost operations and are close to the community, as they have better local knowledge than regular commercial banks. However, lack of human-resource capacity hinders the extent to which BPRs can serve low-income households. Also, these rural banks have limited operations, as they are restricted to certain geographic areas.

The Know-Your-Customer policy was designed to enhance transparency but hinders access to finance for lower-income households

In 2001, Bank Indonesia (BI) mandated Know-Your-Customer (KYC) principles for commercial banks and BPRs in an effort to strengthen transparency and increase customer information. KYC regulations that demand the presentation of a full set of documentation to access financial services reduce access to financial services for lower-income households. Identification requirements such as identity cards (KTP), driver's licenses and taxpayer numbers are difficult to obtain, especially for those with minimal resources. To address such concerns over their impact on access to finance, a flexible approach in complying with KYC and Anti-Money Laundering issues has been implemented in other countries, such as South Africa.

d. The role of ICT in improving access to finance

Information and communication technology (ICT) has an essential role in improving access to financial services

The role of information and communication technology (ICT) is essential in improving access to financial services without increasing costs for the institutions. Banks have numerous ICT options to replace transactions using bank branches. Of these the most common are ATM machines that can accept, store and dispense cash, as well as point of source (POS) devices such as mobile phones. However, as ATMs must be regularly re-filled and emptied, it is more cost effective to place them in densely populated areas with a large number of customers. Thus, banking through mobile phones is one of the best low-cost options to reach potential customers in remote villages¹⁶.

Mobile phone banking has been adopted successfully in other developing countries

Recent years have seen a boom in mobile phone banking operations to improve financial outreach in developing countries. There is a transformation from cash to electronic value, stored and conveyed by mobile phones. In Kenya, the mobile wallet service offered by Safaricom attracted 1 million registered users in 10 months (in a country where fewer than 4 million people have bank accounts). In the Philippines, the country's two leading mobile network operators offer small-scale transactional banking to an estimated 5.5 million customers¹⁷.

High mobile phone penetration rates offer much promise in providing financial services to the poor in rural Indonesia

With Indonesia's wide geographic spread, reaching the unbanked poor in remote areas using cost-efficient means is an issue. Because of its wide reach, mobile-phone banking offers much promise in providing financial services to the poor in rural regions. Mobile-phone penetration in Indonesia is at 37 percent of the population, whereas only 8.4 percent of Indonesians have fixed-line telephones.

But, mobile financial service provision to the poor remains relatively limited and is constrained by certain regulatory factors

Indonesia is moving ahead with mobile phone banking services and as of end-2007, 23 banks offered different kinds of mobile banking services to their customers. But these services are limited to existing customers and do not reach out sufficiently to the unbanked population.

¹⁶ See Consultative Group to Assist the Poor, CGAP, "Using Technology to Build Inclusive Financial Systems" (2006).

¹⁷ See CGAP's "Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance" (2006)

Indonesia is also among the few countries with regulations allowing non-banks to issue e-money through popular cellular provider Telkomsel. However, on the whole, the services that mobile-phone providers can offer do not meet all the needs of the poor. Specifically, these limitations include no cash-out and no person-to-person fund transfer capabilities. In countries such as the Philippines, remittances from one person to another can be made easily using mobile phones. However, in Indonesia the current regulatory framework does not permit this. Currently, fund transfers are only permitted from one bank account to another.

e. Policies to promote access to finance

Various policy reforms could be employed to promote access to finance

There are a number of policy areas on both the demand- and supply-side which could be addressed in order to promote and facilitate access to finance in Indonesia:

In terms of regulations, changes in the policy framework for commercial banks will help in improving access to finance for poor households. For example, Know-Your-Customer could be simplified for small accounts. Similarly, the requirements for taxpayer numbers could be waived for small loans below a pre-specified threshold. Other areas for policy focus could include the provision of incentives for insurance companies so that they actively pursue micro-insurance among rural populations. Suitable insurance products should be available to meet demand from lower-income groups.

The TabunganKu (My Saving) product is a welcome move to improve access to savings

The Government has placed high importance on the issue of improved access and the authorities are initiating policies aimed at overcoming constraints to formal financial services. The launch of a new saving product called TabunganKu (My Saving) in early 2010, is a step in the right direction as this provides access to banking services for the millions of Indonesians who have the financial capacity to save money, even if only small amounts¹⁸. However, a continuation of these efforts on a larger scale is needed to provide rural populations with the incentive to save using formal sources such as the commercial banks. The economic impact of TabunganKu should also be assessed. TabunganKu is currently limited to being a good entry point for unbanked populations. However, ideally, incentives should be provided for customers to begin banking with normal commercial banks.

Facilitating the expanded usage of ICT to improve access to finance is another important area for policy

Finally, there are a range of regulatory issues related to the promotion of financial services through improved and expanded usage of ICT. To use ICT such as mobile phones and provide cheap services to improve outreach, the economies of scale offered by retail agents are vital to reduce unit costs to a commercially viable level. As Indonesia has the world's fourth largest population, there is great potential to promote mobile-phone banking operations and reduce costs. Thus, a necessary condition for success in mobile banking is a regulatory framework that permits commercial agencies to operate on a large scale. As mentioned earlier, the regulatory framework should also allow for a wider range of financial services, such as person-to-person money transfers.

¹⁸ TabunganKu is a 'no frills' account with zero administrative fees and a minimal initial deposit of Rp 20,000.

2. Labor Reform in Indonesia – Balancing Job Creation and Employee Protection¹⁹

The pace of job creation must be accelerated to employ Indonesia’s growing workforce.

Indonesia has enjoyed a demographic dividend over the past forty years. The working population has been growing faster than the population of non-working dependents. This presents a major opportunity to employ a workforce, which will grow by an estimated 20 million workers over the next ten years. The pace of job creation in the formal and non-agricultural sectors, however, needs to be accelerated in order to provide better employment opportunities for the growing workforce. Today’s policy makers face challenges in identifying which policies and programs will spur the creation of good jobs while, at the same time, ensuring that workers are better protected from the risks that threaten their job security. Reforms to improve labor regulations, infrastructure, and the investment climate are all important elements for a national “pro-jobs” strategy. Attempts to reform labor regulations, however, have been deadlocked, slowing Indonesia’s ability to generate better jobs.

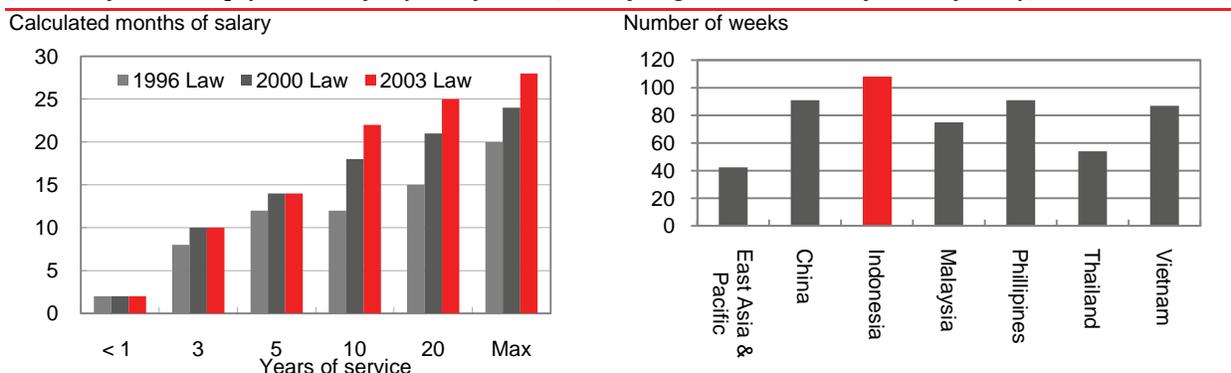
The Manpower Law increased the rigidity of Indonesia’s labor regulations

The Manpower Law (No. 13/2003) substantially increased the rigidity of Indonesia’s labor regulations. It increased severance rates for workers with three or more years of service and added a 15 percent gratuity payment (Figure 40). As a result, severance pay is estimated to be equivalent to a “hiring tax” of around one third of a worker’s annual wage. This compares to a “hiring tax” of around 2 months of wages in 1996 and 3.4 months in 2000.²⁰ While the Manpower Law made it more difficult for employers to terminate or reallocate employees, it also restricted firms’ ability to hire temporary employees. The use of fixed-term contracts (FTCs) and outsourcing services was restricted to non-core positions and the maximum length of a temporary contract was reduced from five to three years. The law also introduced some welcome changes. The minimum wage-setting process was improved by reforming the use of price surveys and strengthening the role of local wage councils.

Indonesia’s current severance pay rates are high, both by international and regional standards

Cross-country surveys of regulations indicate that severance pay rates in Indonesia and above the levels in China, Malaysia, Philippines and Vietnam for example (Figure 41). While most Asian economies limit the use of FTC work to certain activities and stipulate both the duration of the contract and the conditions for renewal, Indonesia falls into the group of countries with more restrictive regulations governing FTC work, alongside Cambodia, the Philippines, and Vietnam.²¹

Figure 40: The Manpower Law made it more costly for employers to terminate or reallocate employees (amount of severance pay received after years of service) **Figure 41: Indonesia’s firing costs are high relative to regional comparators (firing costs in number of weeks of salary)**



Source: UNPAD/GIAT (2004). "Indonesia’s employment Protection Legislation: Swimming Against the Tide?" p.18 **Source: World Bank, Doing Business 2010. For more details see www.doingbusiness.org**

¹⁹ This section is based on Chapter 4 of World Bank (2010), “Indonesia Jobs Report – Towards Better Jobs and Security for All”.

²⁰ LP3E FE UNPAD and GIAT (2004), “Indonesia’s Employment Protection Legislation: Swimming Against the Tide?” Faculty of Economics, University of Padjadjaran Bandung and Growth through Investment, Agriculture and Trade (GIAT) Project.

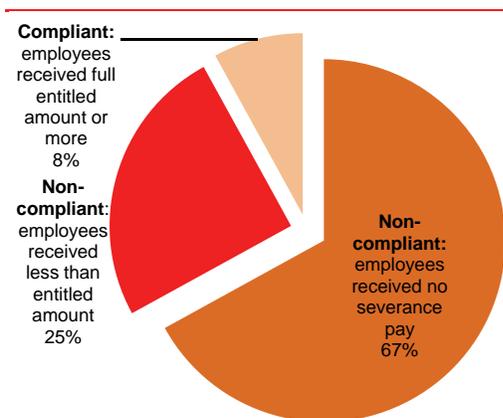
²¹ Based on country-specific regulation data from the ILO (LABORSTA on-line database, 2008) on the duration of temporary contracts and the conditions under which they are permitted.

The current stalemate traps workers and employers in a lose-lose situation that leaves employees inadequately protected and constrains job creation.

Recent analysis has shown that the regulations have not been effective in protecting employees who are terminated and face unemployment. Only 34.4 percent of all eligible employees who separated from a job in the last two years reported that they received any severance pay (Figure 42). Of those employees who received severance pay, 78.4 percent reported that they collected less than amount to which they were legally entitled. The burden of non-compliance falls disproportionately on workers who, arguably, need more income protection: women, temporary staff and low-wage employees (Figure 43). Small firms are more likely to avoid compliance because they are too small to form unions and fall under the radar of labor inspectors.

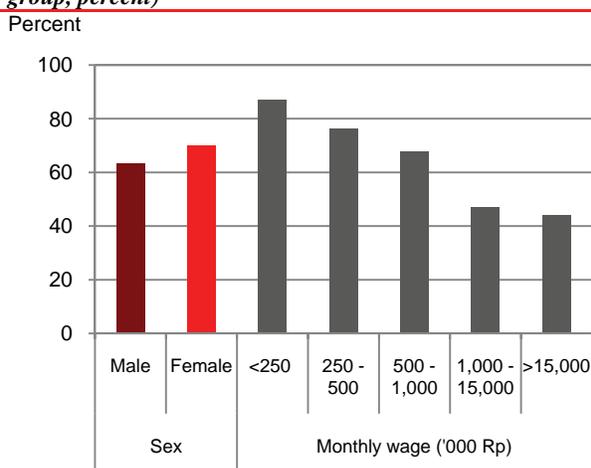
These current regulations not only leave workers unprotected but may dampen job creation too. Indonesia's high de jure severance rates deter foreign investment and discourage entrepreneurs from creating new businesses. The business community in Indonesia has argued that excessively generous severance regulations stunt job creation by worsening the investment climate and discouraging the creation of new businesses. To avoid high firing costs for permanent employees, firms are increasingly relying on fixed-term contract arrangements, including temporary staff and outsourced employees that are significantly less likely to be eligible for both severance pay and employer-provided pensions.

Figure 42: Severance regulations have not been effective in protecting employees
(percentage of employees who received severance pay)



Source: Sakernas, 2008

Figure 43: ...especially those who are more in need of protection
(eligible workers who report not receiving severance pay by group, percent)



Source: Sakernas, 2008

International evidence indicates that rigid labor regulations hamper job growth, worsening labor market outcomes for workers

Empirical evidence of the actual impact of increased rigidity of job creation is not available for Indonesia because data on severance payment and contract status has not been consistently collected. International research, however, generally finds that developing countries with onerous labor regulations also experience lower rates of investment, productivity and investment in manufacturing.²² Rigid labor regulations can hamper job growth by limiting the benefits of trade openness and discouraging entrepreneurs from starting new businesses. This has a direct, negative impact on workers. Developing countries with rigid labor regulations are more likely to experience lower (male) participation in the labor force, lower employment rates, and high unemployment rates – especially among women and young people.

²² Djankov, S. and Ramalho, R. (2008), "Employment Laws in Developing Countries". World Bank.

Labor reform efforts need to focus on finding a win-win solution for firms and unions, while ensuring that vulnerable workers are better protected.

There is scope to find a win-win solution that works both for employers and employees. This section presents reform options that may be considered in an effort to reach conciliatory agreement between employers and employees. The reform options are presented not only with the interests of employers and unions in mind, but also consider the voice of vulnerable workers who have been excluded from the debate. Although poor and low-income workers – especially those working in small-sized firms – are among the most vulnerable to unemployment shocks, they are the least likely to be protected through the current system. Employer associations and unions represent their members around the negotiating table, but not necessarily informal workers and contract-less employees who would benefit from policies that expand job creation in the formal sector.

By negotiating a bargain – lowering severance rates in exchange for introducing unemployment benefits – the Government can improve labor market flexibility while increasing protection for employees

First, simplifying the legal complexities of current severance regulations and adjusting rates downward will bring Indonesia in-line with regional standards. This will not only improve labor market flexibility but it will also improve Indonesia's investment climate and global competitiveness. At the same time, efforts should be made to simplify severance calculations in order to make it easier for employees to understand what they are entitled to and easier for firms to know what they are responsible for paying.

Complementary new programs are needed, however, to provide effective protection for unemployed formal sector workers in compensation for reduced severance rates. Shifting towards a monthly contributory approach – where firms make monthly contributions to an account that is managed centrally with government oversight – will improve the predictability of firms' labor costs without influencing their hiring and firing decisions. It will also likely increase the level of compliance by employers, which will help reduce reliance on the Industrial Relations Courts that are backlogged with disputes concerning employment termination. This will be a relief to both employees and employers who find the dispute resolution process costly and time-consuming.

There are a range of unemployment benefit systems that should be considered and assessed for inclusion in the future National Social Security system

Indonesia is ready to begin following the lead of other middle-income countries that have adopted unemployment benefit systems. There is a range of reform options that can improve the predictability of labor costs and compensate workers for lowered severance rates. The options include a pooled fund from which terminated employees can draw, an individual account severance system, or a flat-benefit unemployment assistance program (Box 4). Each option has its respective advantages and disadvantages, and varies in terms of the level of institutional complexity to manage the program.

The reform process can be started by initiating the necessary analytical studies to identify which option best fits Indonesia. Simulation studies are needed to assess the anticipated impact of the alternative systems and the institutional implications and demands associated with each reform option. Based on the best-suited model, a reform roadmap is needed to lay the foundations for the future system, which should be linked to the future National Social Security (NSS) system mandated by the Social Security Law (No. 41/2004).

Box 4: Severance reform options

Option One: Severance Fund: Firms make regular severance payments to a pooled fund that is administered by a central government agency or private firm(s). Terminated employees receive severance according to years of service. Individual pooled funds may be created for each firm, or shared among all contributing firms.

Option Two: Individual accounts: Employers and employees regularly deposit contributions in individual accounts managed and disbursed by a central agency. Unemployed contributors draw from their own accounts upon confirmation of unemployment status.

Option Three: Flat-benefit unemployment assistance: Create a fund that eligible workers can draw from when unemployed. Funds are managed and disbursed by an appointed agency, not the employer. Unemployed workers receive a low benefit from a common fund for a specified period of time. Eligibility based on active job search and availability of suitable work. Possibility to make benefits contingent on means-tested family income.

Source: Revenga and Rigolini (2007) and Vroman (2007).²³

Easing the rigidity of current regulations can contribute to spurring job creation in the formal sector, but complementary strategies are still needed.

Even with major labor regulation reforms, many workers will still remain employed without a formal contract or in the informal sector for the foreseeable future. For this reason, while regulatory reform is necessary, it is not sufficient to improve the prospects for most Indonesian workers. Additional strategies are therefore needed to empower and protect Indonesia's excluded and vulnerable workers, including developing a comprehensive skills development strategy and designing effective safety nets to protect vulnerable workers from wage and employment shocks. The World Bank's Indonesia Jobs Report (2010) examines the performance of Indonesia's labor market over the last twenty years and discusses how regulatory reform, skills development and safety nets can support the acceleration of job creation while providing more effective protection for all workers.

²³ See Revenga, A. and Rigolini, J. (2007), "International Evidence on Severance Pay Reforms: Some Food for Thought for Indonesia's Current Reform Proposal", World Bank, and Vroman, W. (2007), "Reforming Social Protection for Workers in Indonesia", World Bank Office Jakarta.

3. Education, training and labor market outcomes for youth in Indonesia

Demand for skilled workers in Indonesia has increased in recent decades but there is a mismatch with the skills of new workers entering the labor force

Indonesia's robust growth performance and prospects is likely to be accompanied by an increasing demand for educated workers as production away from agriculture towards the increasingly sophisticated manufacturing sector and the services sector. At the same time the education levels of those leaving their studies and entering the labor market has increased. However, surveys indicate that the skills of secondary school leavers do not meet the expectations of employers. Concern over the quality of graduates includes those from both the General and Vocational secondary education streams. Meeting the challenge of matching the supply with the demand for skills is a key ingredient in enhancing labor market outcomes for the youth of Indonesia and improving productivity in the economy more generally.

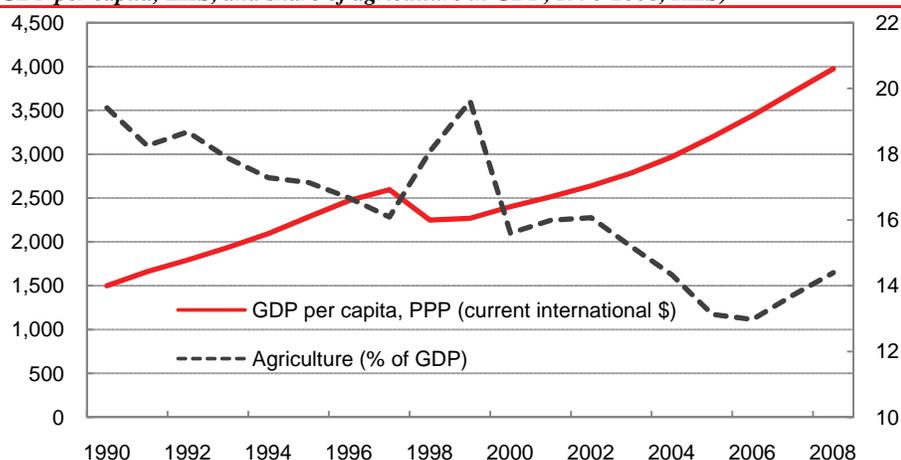
a. Economic context: growth, transformation and the demand for skills

Fast growth and rapid urbanization over the last two decades significantly increased the share of non-agriculture GDP

Over the last two decades Indonesia has experienced fast sustained growth and rapid urbanization, significantly increasing the share of non-agriculture GDP despite an important setback during the 1997 financial crisis. The achievements are impressive—GDP per capita in real terms increased 160 percent from 1990 to 2008, and the share of agriculture in GDP decreased from 20 to 13 percent by 2006, although this rose slightly to just over 14 percent in 2008 (Figure 44).

Figure 44: Rising real income in Indonesia has been accompanied by a fall in the share of agricultural output

(GDP per capita, LHS, and share of agriculture in GDP, 1990-2008, RHS)



Source: World Development Indicators (1990-2008).

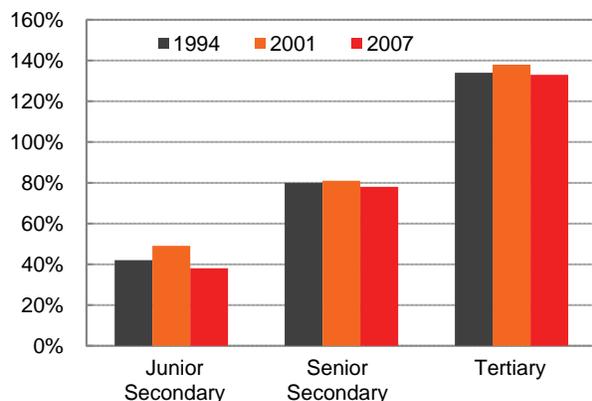
Service and manufacturing are low labor-intensity sectors but their growth is expected to result in sustained demand for skilled workers

Employment by economic sector followed a similar pattern as the share of GDP, but the lower labor intensity in the education-intensive manufacturing and service sectors has resulted in slower job creation for educated youth. Almost 70 percent of workers in the service sectors who are employed for wages have completed senior secondary education. The share in manufacturing is lower – 40 percent – but this is still double that of agriculture (based on Sakernas data 1994-2007). The growing importance of the service sector in the economy and the increased sophistication of the manufacturing sector are expected to result in a sustained demand for skilled workers. The overall trend should ensure sustained, and potentially increasing, demand for skills in the economy.

However there is evidence that integration of educated workers into the labor market is becoming more difficult, even with the expansion of education

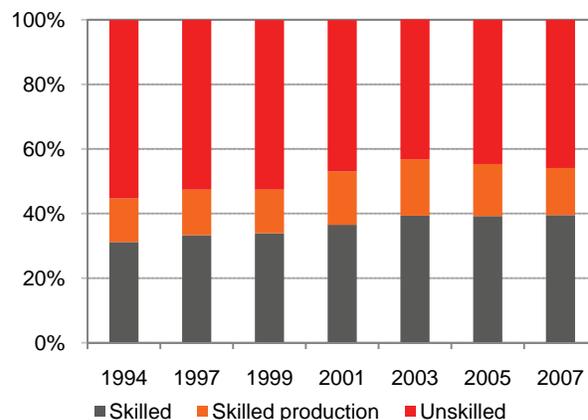
At the macro-economic level, there is evidence of sustained demand for skilled workers but there are signs that integration of educated workers into the labor market is becoming more difficult. Despite the large influx of more educated youth into the labor market, the returns to education have remained largely constant in the last decade, indicating that the demand for educated workers has so far been able to absorb the increased supply without decreasing returns (Figure 45). The supply of educated workers, however, is likely to continue increasing significantly with the expansion of education, so it is critical to ensure that new graduates can access good quality jobs.

Figure 45: The returns to education have remained largely flat over the past decade (wage premium relative to primary education)



Source: Indonesia Skill Report 2010, Sakernas 1994-2007.
 Note: Only includes salaried employees.

Figure 46: The share of skilled jobs has been constant during the past decade after rising in the 1990s (skilled, unskilled and skilled production jobs as share of total jobs, 1994-2007)



Source: Sakernas Indonesia Skills Report (2008).
 Note: Only includes salaried employees.

Younger generations are more educated than ever, however the occupational share of skilled jobs has not kept pace, resulting in difficulties in entering the labor market

Each year over 3.3 million youth leave the formal education system to enter the labor market, and younger generations are more educated than ever before. In 2008, the proportion of labor market entrants who have completed senior secondary or higher education (that is those considered “skilled”) surpassed 50 percent, confirming the trend of increased educational attainment in the population. However, the occupational share of skilled jobs has not kept pace with the increase in education levels. The share of jobs considered “skilled” increased during the 1990s but has remained broadly constant during the last decade (Figure 46), questioning the ability of the labor market to absorb these new graduates at their appropriate education level. This has resulted in over-qualified entrants and a difficult transition into the labor market, especially for senior secondary school graduates who are the least skilled workers.

b. A difficult transition to the labor market

Youth unemployment rate is higher than the population unemployment rate

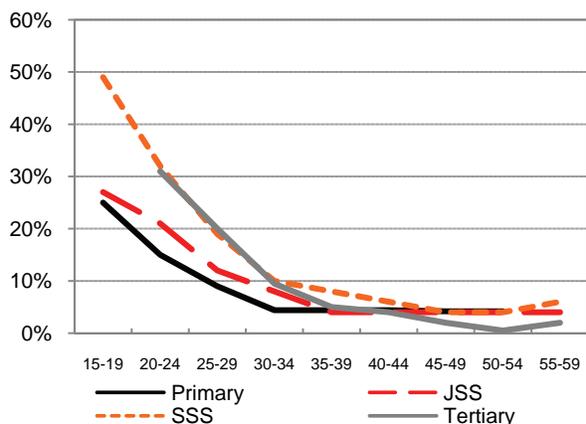
In Indonesia, the unemployment rate of youth in the 20 to 24 age group is about two and a half times that of the overall population, and it is higher for more educated youth, especially senior secondary school graduates (Figure 47). Over 40 percent of 15-24 year olds with completed senior secondary school in the labor market are unemployed and, although the rate decreases for older age groups, it does not converge to the country average until the 35-39 year age group. Rural areas, with less educated workers and greater availability of unskilled jobs have lower unemployment rates; stressing the current dichotomy in the types of jobs in the urban and rural areas in the country.

Even though there is a clear positive association between education and formality, access to salaried jobs is difficult for senior and junior secondary school graduates

In terms of type of employment, there is a clear positive association between education and formality, but access to salaried jobs is difficult for senior secondary school graduates. Only 60 percent of young senior secondary school graduates in the labor force have a salaried job and this share falls with age. Unlike the case with unemployment patterns, the outlook for workers with junior secondary school or lower qualifications in terms of the quality of jobs is especially bad, with only one-third of junior secondary school graduates in the labor force holding a salaried job (Figure 48). But while senior secondary school graduates fare better, on average only about 50 percent of senior secondary school graduates are salaried employees.

Figure 47: Unemployment rate by age group and education level

(unemployment rate as percentage of age group, 2007)

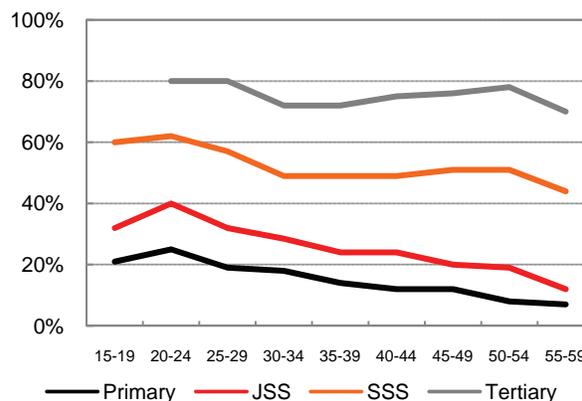


Source: Sakernas (2007)

Note: JSS—junior secondary school; SSS—senior secondary school.

Figure 48: Share of labor force in salaried jobs by age group and education level

(percentage of age group, 2007)



Source: Sakernas (2007)

Note: JSS—junior secondary school; SSS—senior secondary school.

c. Senior Secondary Education, Skills and Labor Market Entrance

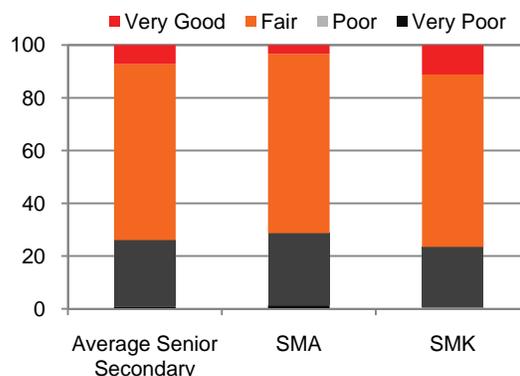
Lack of access to information about labor markets may be a reason for difficulties in transition to work and can lead to inequality in labor market outcomes

The share of workers employed for wages that have a senior secondary education or higher qualification has increased significantly during the last 15 years (from 35 percent to over 50 percent), but the growth mainly occurred during the 1990s and has remained constant in the past decade. A lack of mechanisms to access information about the labor market, returns and types of work available may contribute to the difficulties in transition to work for young graduates. As senior secondary education expands, the new students progressing through the education system are more likely to come from disadvantaged backgrounds and may have less access to job networks or information about job possibilities from peers. In the absence of efficient mechanisms to gain access to this information, this may lead to inequality in labor market outcomes even if all graduates meet the skill requirements of existing jobs. Also, the observed differences in returns by parental education may also reflect differences in the quality of the education received by students. As an illustration, according to PISA (the Programme for International Student Assessment), average cognitive skills in math and language have increased in recent years, but there are vast differences by socio-economic characteristics, which are largely driven by parental education.

Employers are concerned about the quality of graduates from both senior secondary vocational (SMK) and general stream (SMA)

The results from a recent Employer Skills Survey confirm that the skills of senior secondary graduates do not meet the expectations of employers. A quarter of recent hires with a senior secondary education are considered poor or very poor quality (Figure 49). Only 7 percent of them are considered very good, and most of them are considered “fair”. While employers are concerned about the quality of graduates from both streams of schools, the types of skills and jobs of graduates vary.

Figure 49: Employers’ opinion of the quality of employees with senior secondary education
(percentage of respondents)



Source: Employer Skills Survey (2008)

Despite the differences in the skills provided by the two education streams, the unemployment rates for recent SMA and SMK graduates with no higher education are high and very similar

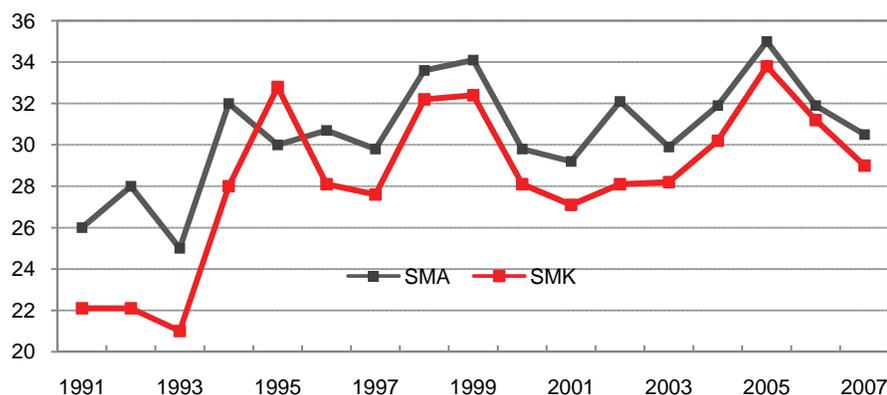
In principle, the vocational school (SMK) stream is geared towards more job-specific skills, seeking to equip graduates with the skills necessary for a quick and effective transition to the labor market. The general stream (SMA) provides a more general education, which serves as the basis for further education. As such, one might expect that if demand for specific skills is high, SMK graduates would be better suited for the labor market in their initial years. However, the unemployment rate of recent SMA and SMK graduates 20-24 years of age is very high (30 percent), with SMK graduates faring only slightly better (Figure 50). In the overall population, SMK graduates used to have significantly lower unemployment rates, but it has converged to the level of SMA graduates.

Comparing the labor market outcomes for the two educational streams points to the need to improve the quality of both streams and pay attention to equity in access

In terms of income, there is a small positive wage premium for the general stream, especially when considering the higher transition rate to higher education. The transition rate to higher education is higher for the general SMA stream than for vocational school graduates (30 percent compared to 15 percent), which, combined with the very high returns from higher education, results in a higher adjusted salary for SMA graduates. There is also a large wage penalty for vocational school for males, especially those with low ability (as measured by test scores), which has become larger in recent years, indicating either a deterioration of the quality of graduates or a lower demand for their skills.

A comparison of the labor market outcomes of both streams does not support a drastic guided expansion of vocational school enrollment, suggesting instead that the priorities should be to improve the quality of both streams and pay special attention to equity in access.

Figure 50: Unemployment rates for SMA and SMK graduates, age 20-24 (1991-2007)
(unemployment rate as percentage of total graduates from stream)



Source: Sakernas (1991-2007)

Cognitive skills matter more than the education stream for future earnings

Cognitive skills matter more than the education stream for future earnings and better cognitive skills are associated with higher wages—even more so for general stream graduates. The exit exam in junior secondary school is a good predictor of future earnings, which implies that a strong knowledge base in basic cognitive skills is critical for success in higher levels of education and ultimately in the labor market. Since cognitive skills are usually correlated with socio-economic characteristics and also affect the future education path (better cognitive skills are more likely to attend the general stream), the inequalities in cognitive skills observed in PISA scores need to be addressed through specific interventions targeting low-performing students and schools in early grades.

Employers complain about inadequate generic skills such as thinking and behavioral skills

In line with the observed earnings, employers value basic mathematics and reading skills as very important, but complain about inadequate generic skills, which may be a cause of the difficult transition to the labor market. Core skills are in high demand, especially basic mathematics and reading, thinking and behavioral skills, which are the cornerstones of general education. Few employers consider that their employees have a significant gap in their basic skills. However, 40 percent of employers consider their staff to lack thinking and behavioral skills, which points to the need to strengthen generic/life skills for

Indonesian graduates. Vocational skills that are transferable between jobs like computer literacy and English language proficiency are also noted as important gaps in employees' skills.

The private sector should participate in the provision of job-specific skills

While transferable vocational skills should be part of the vocational school curriculum, the education sector cannot aim to provide all the skills necessary to perform any job in the productive sector. Private firms should participate in the provision of job-specific skills, both through on-the-job training and through copayment of institution-based training for their employees. It is clear from employer surveys that the productive sector values practical on-the-job training more than theoretical training, which is difficult to adapt as quickly as the shifting demands in the market.

Non-formal vocational training can help reduce the mismatch between skills supply and demand

A strong system of non-formal vocational training should serve two purposes: provide tangible skills to unskilled workers and meet the increasing demand for sector/industry-specific training for individuals with completed formal education. The effectiveness of the system, however, depends on the provision of quality training, the crucial connection with the productive sector and, ideally, some form of interaction with the formal education sector that allows dropouts to return to the path of formal education upon completing basic competencies. Standards for different training courses and providers are not developed and the quality assurance systems are still in very early stages. Resources devoted to training are still inadequate and the coordination between agencies is limited.

4. PNPM Generasi final impact evaluation – the preliminary findings²⁴

The Government of Indonesia launched two large pilots of conditional cash transfer programs in 2007...

In 2007, the Government of Indonesia launched a large pilot of two Conditional Cash Transfer (CCT) programs applying different approaches: a conditional cash transfer to households, and an incentivized block grant scheme to communities. These two pilot projects began in six provinces. They are designed to achieve the same objectives and goals, in line with the Indonesian Government's priorities and the Millennium Development Goals: to reduce poverty, maternal and child mortality, and to ensure universal coverage of basic education.

...one of them is PNPM *Generasi Sehat dan Cerdas*, a community block grant scheme which concentrates on health and education

The community block grant scheme, PNPM *Generasi Sehat dan Cerdas*, seeks to improve twelve basic health and education indicators (See Box 5). Applying the principles of community-driven development, communities, with the assistance of trained facilitators, decide how best to use the block grants to reach the education and health targets. PNPM *Generasi* is currently implemented in 178 sub-districts in five provinces as part of the Government's flagship poverty program, the National Community Empowerment Program or *Program Nasional Pemberdayaan Masyarakat* (PNPM- Mandiri).

Box 5: PNPM *Generasi* target indicators

Health

1. Four prenatal care visits for pregnant women
2. Iron tablet intakes during pregnancy
3. Assisted delivery by a trained professional
4. Two postnatal care visits
5. Complete childhood immunizations
6. Monthly weight increases for infants
7. Regular weighing for children under five
8. Vitamin A twice a year for under-fives

Education

9. Primary school enrollment of all children between 6 to 12 years old
10. Minimum attendance rate of 85% for all primary school-aged children
11. Junior secondary school enrollment of all children between 13 to 15 years old
12. Minimum attendance rate of 85% for all junior secondary school-aged children

Incentives based on past performance are used to motivate communities' choice of the intervention methods to be funded by the block grants

PNPM *Generasi* takes the idea of performance incentives from CCT programs and applies it in a way that allows communities the flexibility to address supply or demand constraints, or some combination of both. As an incentive for communities to focus on selecting the most effective intervention method, the distribution of 20 percent of the sub-district PNPM *Generasi* block grant for the subsequent year is determined by the village's performance on each of the twelve indicators.

Surveys have been used to evaluate the impact of the pilot program

The final PNPM *Generasi* evaluation survey examines the program's impact after two-years of implementation as well as the effect of community incentives within the program. PNPM *Generasi* was designed to be rigorously evaluated by randomly selecting which *kecamatan*s would receive *Generasi* and which would remain as a control group. The impact of community incentives can also be assessed by comparing the two versions of PNPM *Generasi*: the incentivized version and the non-incentivized version that does not link village performance to fund distribution. The baseline survey was conducted in June–September 2007, followed by an interim evaluation survey in October–December 2008, and a final evaluation survey in October–December 2009, after the program had been in operation for 27-30 months.

***Generasi* had a statistically significant positive impact on the 12 health and education indicators it targeted**

The final impact evaluation found that PNPM *Generasi* had a statistically significant positive impact on the 12 indicators it was meant to address. The strongest improvements among the health indicators were in the frequency of weight checks for young children. The program also increased the number of iron sachets received by pregnant mothers through antenatal care visits. These improvements were supported by dramatic increases of mothers and children's participation in Posyandu activities to receive the targeted maternal, neonatal and child health services. Education indicators also saw improvements in the final evaluation, reversing the zero or negative impact found at the interim evaluation, most notably in the increased school participation rate among the primary school-age group.

²⁴ This section draws on the forthcoming Final Impact Evaluation Report and the Interim Impact Evaluation Report on the PNPM *Generasi* Program by Benjamin A. Olken, M.I.T. Department of Economics, Junko Onishi, World Bank and Susan Wong, World Bank.

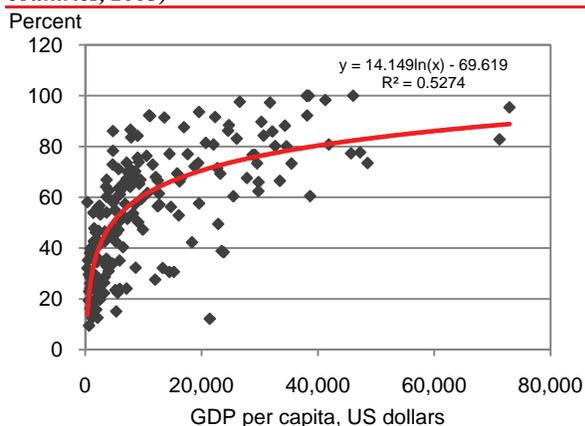
...particularly in relation to childhood malnutrition	The primary long-term impact was a decrease in childhood malnutrition. On average, over the two year implementation, childhood malnutrition was reduced by 2 percentage points or about a 10 percent reduction from the baseline level. This reduction in malnutrition was stronger in areas with higher malnutrition rates prior to project implementation, most notably in the Nusa Tenggara Timur (NTT) Province. However, there was no evidence of an improvement in infant and childhood mortality rates. Although reductions in infant and child mortalities were observed in the interim evaluation, the same rates of decrease were not sustained in the final evaluation.
The impact of <i>Generasi</i> was most apparent in areas with low baseline health and education indicators	The impact of <i>Generasi</i> was most apparent in those areas with low baseline health and education indicators. Lower pre-project levels of health and education indicators imply more room for improvements. The greater impacts in areas with lower baseline values appeared more prominently in the final evaluation survey than in the interim results, with stronger improvements found in education indicators in such areas. However, these improvements in health and education indicators in areas with low baseline coverage did not appear to have resulted in improving long-term health and education outcomes in these areas. Furthermore, the greater impacts observed in health and education indicators were not simply correlated with pre-project levels of poverty, but instead driven by the level of health and education indicators in the area.
The use of incentives improved program effectiveness in promoting health outcomes but not for education	Making grants conditional upon performance improves program effectiveness in health. On average, the incentivized group outperformed the non-incentivized group in improving health indicators, particularly in the increase of antenatal care services and improving coverage of childhood immunization coverage. However, the incentivized group did not appear to do better, or worse, than the non-incentivized group on the education indicators. The overall mixed results for the performance of community incentives may suggest that the incentives are effective in certain sectors where communities have greater control over improvements, but not in others.
Further expansion should prioritize areas with low health and education indicators	The findings of the impact evaluation point to areas where policies may be adapted or modified to further improve performance. First, as mentioned, the results show that <i>Generasi</i> had strong impacts in areas where health and education indicators are low. This suggests that future expansion of <i>Generasi</i> implementation should prioritize areas where these indicators are lagging behind and not necessarily in areas identified as poor.
...which will require stronger coordination with the relevant ministries	Second, although <i>Generasi</i> has proven to be effective in improving performance in lagging areas through community mobilization and strong partnership with local health and education service providers, an expansion into less developed areas will pose challenges. In particular it will require stronger coordination with the Ministries of Health and Education.
The use of indicators is an effective mechanism in community development and they can potentially be used to address other issues	The planning, targeting, and delivery mechanisms for PNPM can be used as a platform for other forms of local assistance. <i>Generasi</i> proved that communities are able to understand, embrace and effectively work towards improving targets provided by the project. Providing communities with target indicators within the framework of PNPM is an effective delivery mechanism for the Government to guide community development. The target indicators must be relevant to communities yet reflect development priorities of the Government. Although it is important not to overload the project, additions to the existing target indicators may allow <i>Generasi</i> to address other government development priorities such as early childhood development or higher education.
Further evaluation is needed to monitor the long-term impact of the project	Finally, two years of project implementation is a very short timeframe for a development project to show sizeable impacts. The current <i>Generasi</i> project set up allows for future evaluation (e.g., after 5 years of project implementation) if the current randomization is maintained. If the government considers identifying the impact of <i>Generasi</i> in the long-term, planning is required at this time to ensure that the control areas are maintained for future evaluations.

5. Lumpy, evolving and constrained: Regional and urban economic development in Indonesia

Spatially concentrated urbanization and economic development are intimately linked

Over the past two decades, there has been a resurgence of interest in economic geography. Policy researchers in both developed and developing countries have launched a range of studies examining the relationship between urbanization, economic development and geography.²⁵ Spatially concentrated urbanization and economic development go hand-in-hand (Figure 51). Indonesia's growth in recent decades has also been accompanied by increasing urbanization (Figure 52). As the World Bank World Development Report of 2009 noted: "No Country has grown to middle income without industrializing and urbanizing. None has grown to high income without vibrant cities". High levels of population density, and efficient and low cost access to production inputs, have allowed economies to transform from agrarian to industrial and to service activities. Sub-national regions that can manage the rural to urban transition successfully are able to rapidly grow their economies, increase incomes and raise living standards. Those that cannot do so, tend to lag economically and socially.

Figure 51: Urbanization and economic development go hand-in-hand
(urban population percentage and GDP per capita across countries, 2005)

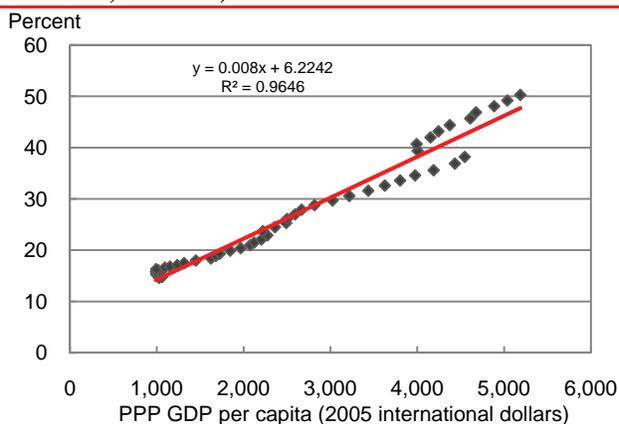


Source: UN DESA World Urbanization Prospects and World Bank World Development Indicators

Note: The line is the fit from a regression of the urban population share on the log of per capita GDP

Figure 52: ...Indonesia also follows this trend

(urban population percentage and PPP per capita real GDP, 1960-2007, Indonesia)



Source: UN DESA World Urbanization Prospects and the University of Pennsylvania Penn World Table, version 6.3

Note: The line is the fit from a linear regression model

Addressing the policy challenges of urbanization can involve a focus on 'people' or 'place'

Uneven patterns of economic development across geographic areas have raised policy challenges for governments for decades. Many countries have aggressively pursued a variety of policies to foster more inclusive and spatially balanced growth across their territorial space. These include, for example, attempts to control internal migration, the formation of growth poles, financial incentives to induce firms to locate in lagging regions, the creation of economic zones, or establishment of new towns.

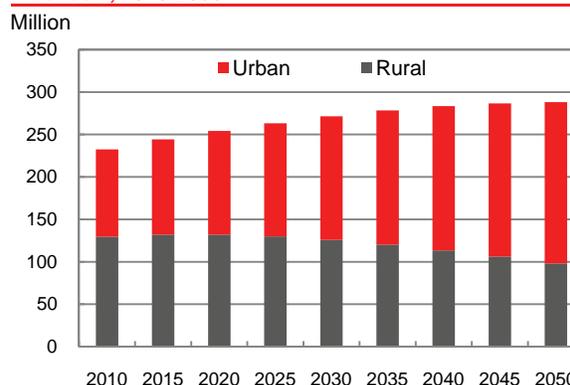
The overall impact of these efforts is very mixed. Based on their focus, there are two ways to characterize regional development policy. One is on "people" prosperity - the use of policy instruments in areas such as education and human capital development, or promoting labor utility and migration. The other is on building "place" prosperity by spending scarce resources to build up lagging regions.

²⁵ See, for example, the World Bank's 2009 World Development Report: Reshaping Economic Geography, available at www.worldbank.org/wdr2009.

Indonesia has urbanized rapidly over the past 40 years, with two thirds of its population projected to live in urban areas by 2050

Indonesia has urbanized rapidly over the past 40 years, and is on track to join the “urban club”—countries with most of their population living in urban areas—by 2025 (Figure 53). The United Nations estimates that by 2050, two thirds of Indonesia’s population will live in urban areas, and between 2025 and 2030, the country’s rural population will start to decline in absolute terms.

Figure 53: UN Urban and rural population projections for Indonesia, 2010-2050



Sources: UN DESA, World Population Prospects, 2009

Urbanization can promote growth through agglomeration economics

Overall, Indonesian policymakers should not be concerned about increasing urbanization. There is strong evidence that urbanization will drive economic growth through the formation of agglomeration economies. Many policymakers are concerned about the dominance of the Jakarta Metropolitan Region (JMR). But while it is indeed quite large, population projections of the JMR and other large cities between 2010 and 2025 indicate that most population growth will take place in secondary and smaller cities (Table 12). Although Jakarta is still expected to grow, its relative share of Indonesia’s total urban population is set to decline due to the faster growth of smaller cities. Large medium agglomerations will grow slowly as well and their share of the total urban population will decline slightly or remain stable. A notable trend is that smaller cities will account for nearly 83.2 percent of Indonesia’s total urban population, up from 81.7 percent in 2010. What this means is that while Indonesia will still continue to urbanize, urban concentration will spread to other centers.

Table 12: Indonesia’s urban concentration is set to spread (projected population and percentage of total urban population)

City	Population				Percent of Total Urban Population			
	2010	2015	2020	2025	2010	2015	2020	2025
Jakarta	9,210	9,709	10,256	10,850	8.90%	8.70%	8.40%	8.10%
Surabaya	2,509	2,576	2,738	2,923	2.40%	2.30%	2.20%	2.20%
Bandung	2,412	2,568	2,739	2,925	2.30%	2.30%	2.20%	2.20%
Medan	2,131	2,266	2,419	2,586	2.10%	2.00%	2.00%	1.90%
Semarang	1,296	1,334	1,424	1,528	1.30%	1.20%	1.20%	1.10%
Makassar	1,294	1,409	1,512	1,621	1.30%	1.30%	1.20%	1.20%
Other Urban	84,108	92,367	101,169	110,986	81.70%	82.30%	82.80%	83.20%
Total Urban	102,960	112,229	122,257	133,419	100%	100%	100%	100%

Source: UN DESA, World Population Prospects, 2009

Improved connectivity is key to promoting inclusive development by reshaping economic geography without fighting economic concentration

The experience of successful countries suggests that inclusive development is about reshaping economic geography without fighting economic concentration. From a policy perspective, it makes sense to connect lagging regions to growing large and medium centers to increase demand and to attract industries which are less dependent on agglomeration and localization economies such as agriculture, agro-processing, and labor-intensive manufacturing. If there is efficient connectivity, industries with mature product cycle outputs are likely to be attracted to areas with low labor and other input costs. In some areas, agglomeration of activities may eventually develop, leading to the creation of their own (smaller) growth poles in the lagging regions.

The economies of small and medium sized urban areas in Indonesia have grown faster than the larger cities

Output trends between 1993-2006 also demonstrate evidence of the spread of production through a decentralized concentration of economic activity (Table 13). While Jakarta and Java are still dominant in terms of economic output, economic and demographic trends points toward a larger urban footprint for Indonesia.

Table 13: Regional GDP distribution by major urban agglomerations, other areas and rural areas, 1993-2006 (percent of non-oil and gas GDP)

Metro Agglomeration	1993	1999	2003	2006
Jakarta (Jabodetabek)	25.1	26.1	26.3	25.5
Surabaya (Gerbangkertosusila)	6.9	6.7	6.8	7.1
Medan (Mebidangro)	2.5	2.1	2.8	3
Bandung (Bandung Raya)	1.7	1.5	2	2.2
Semarang (Kedungsepur)	1.5	1.5	2	1.9
Denpasar (Sarbagita)	0.9	0.7	0.6	0.6
Kota				
Balikpapan/Samarinda/Bontang	2.3	2.6	2.3	2.5
Kota Manado/Bitung	0.3	0.3	0.3	0.3
Makassar (Maminasata)	1.1	1.9	1.9	0.9
Other Urban	8.7	8.9	10.3	11.3
Rural	48.8	47.7	44.6	44.8
Total	100	100	100	100

Sources: World Bank staff calculations and BPS

Many industrial

activities, such as manufacturing and food and beverage production, have begun to decentralize. While the share of non-oil and gas gross regional product as a percentage of the national total for Jakarta, Balikpapan and Manado remained constant, there were slight increases in Surabaya, significant increases in the shares of Medan, Bandung and Semarang, and declines for Denpasar and Makassar. However, the most significant trend in the table is the substantial increase in the share of output accounted for by small and medium sized urban areas. The economies of these cities have grown faster than the large agglomerations and their share have consequently increased from 8.7 to 11.3 percent from 1993-2006. Also notable is the downward trend in rural area economic output, with the share falling from 48.8 to 44.8 percent over the same period. This pattern is consistent with trends in other countries.

There are challenges to Indonesia's competitiveness including inadequate intra- and inter- island transportation networks

However, there are challenges that impede the country's economic competitiveness. Considering Indonesia's complex archipelagic geography, regional planning and development is challenging. Providing efficient connectivity and accessibility for logistics, commercial and demographic mobility requires the formulation of extensive systems of intra- and inter-island transportation networks. However, in Indonesia's large metropolitan regions, mobility is impeded by rapid motorization and inadequate investments in transportation systems, especially in mass transit. This is also the case with inter-city and inter-island transportation networks, even on Java. A range of factors have led to this situation, including poor planning and implementation, and inadequate investment in transportation systems.

... as well as other infrastructure services such as water, waste, electricity, due to poor planning and under-investment

Furthermore, other infrastructure services are also inadequate. Many of Indonesia's large cities have inadequate water supply and distribution networks, and extremely limited wastewater treatment. Power generation and transmission systems are constraining economic development in many areas. Many cities and rural areas face significant exposure to natural hazard risks. These limitations adversely affect economic competitiveness and place undue burdens on the poor and disadvantaged groups. The Government's under investment in infrastructure is an overarching constraint. Currently, the national and local governments devote less than four percent of gross regional domestic product to infrastructure—about half of what is necessary to promote accelerated economic growth.

...while complex urban land markets hamper the formation of industrial clusters

Urban land markets are complex in Indonesia. This makes it very difficult to assemble land for industrial estates and commercial centers, constraining the ability to foster the formation of industrial clusters. The absence of clusters impedes growth, because localization economies are weak or non-existent.

Lack of planning, implementation and inter-governmental coordination contribute to inefficient spatial structure of medium and large cities

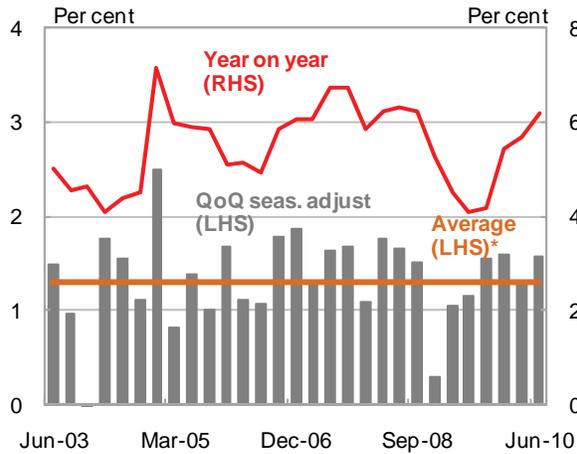
Finally, large and medium cities suffer from inefficient spatial structure. While both the central and local governments prepare spatial plans, they do not fully implement them by investing in required infrastructure or enforce implementation of plans through zoning and development controls. In cases where cities straddle districts or provinces, there is a lack of inter-governmental coordination, despite the adoption of new laws on coordinated spatial planning and management.

Accessibility, infrastructure, industrial clusters, spatial structure and intergovernmental coordination are key to promoting competitiveness and economic development

The forces of economic geography point to increased urbanization going forward. The challenge for the Government is to put in place regional and urban economic development policies to enhance economic performance and promote inclusive development. This covers infrastructure issues such as enhancing accessibility within and between urban regions and improving urban and regional infrastructure systems (especially transportation, power, water supply and distribution, wastewater collection and treatment). It also relates to policies and institutions which can foster the formation of industrial clusters and economic activity centers and improve the efficiency of urban spatial structure and land markets. Finally, given the cross-cutting nature of regional and urban development issues across different levels of government, effective policies will require enhanced intergovernmental coordination.

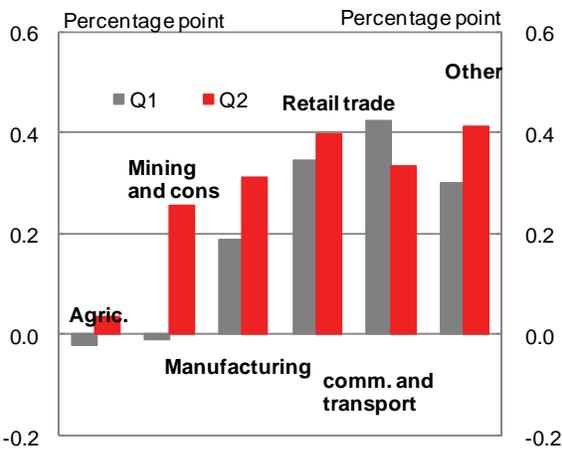
APPENDIX: SNAPSHOT OF THE INDONESIAN ECONOMY

Figure 1: GDP growth (percent growth)



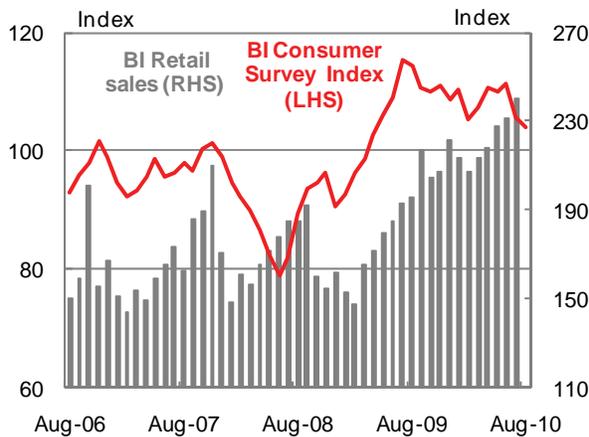
*Average QoQ growth between Q1 2000 – Q2 2010.
Sources: BPS, World Bank seasonal adjustment

Figure 3: Contributions to GDP(P) (year-on-year, seasonally adjusted)



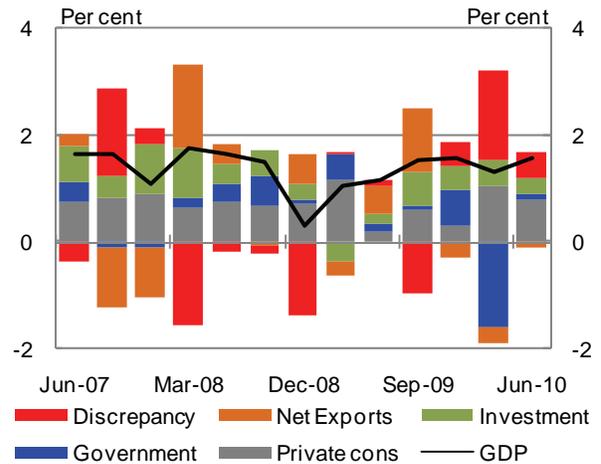
Source: BPS via CEIC

Figure 5: Consumer indicators (index levels)



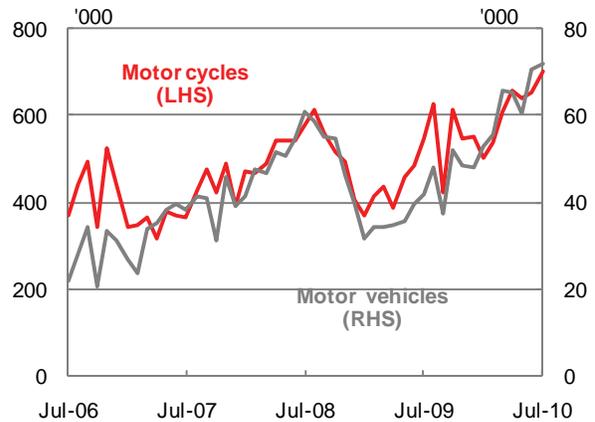
Source: BI via CEIC

Figure 2: Contributions to GDP(E) (year-on-year, seasonally adjusted)



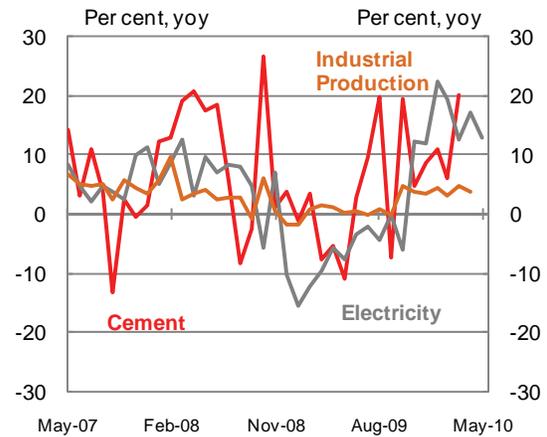
Source: BPS via CEIC and World Bank

Figure 4: Motor cycle and motor vehicle sales (levels)



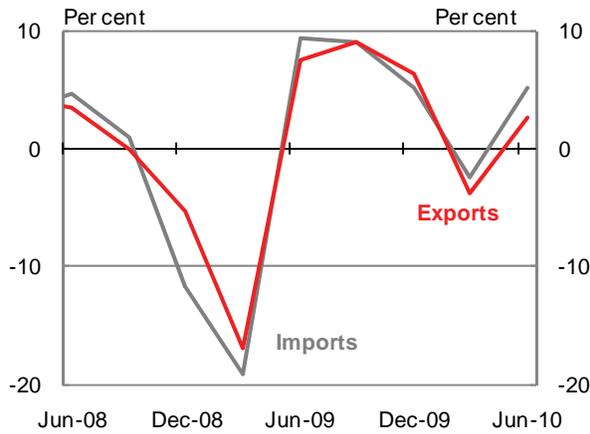
Source: CEIC

Figure 6: Industrial partial indicators (year-on-year growth)



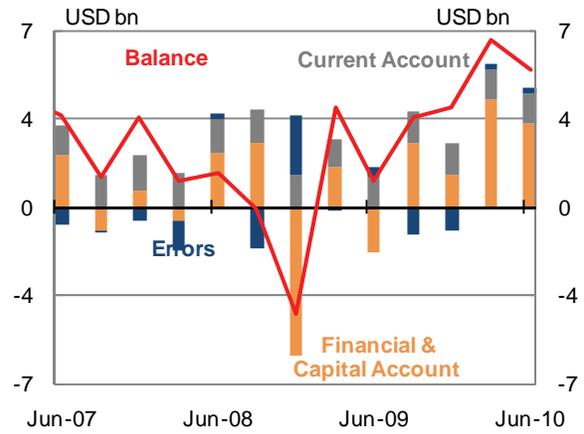
Source: CEIC

Figure 7: Real trade flows
(quarter-on-quarter growth)



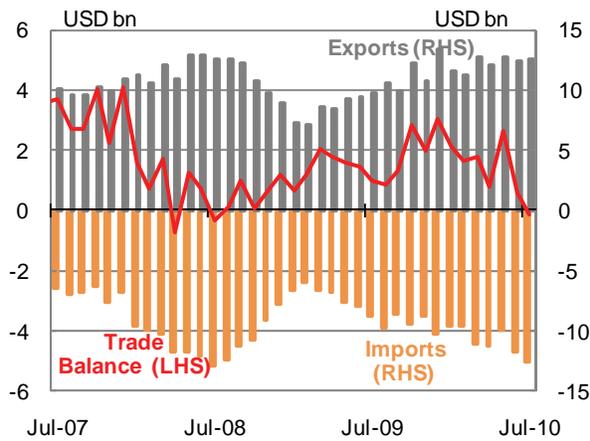
Source: CEIC

Figure 8: Balance of Payments
(USD billions)



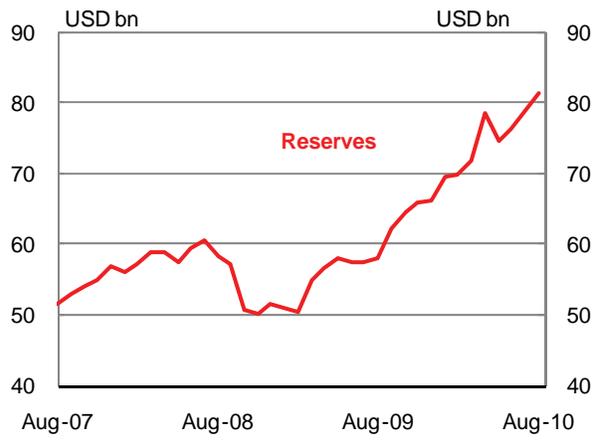
Source: BPS and World Bank

Figure 9: Trade balance
(values, USD billions)



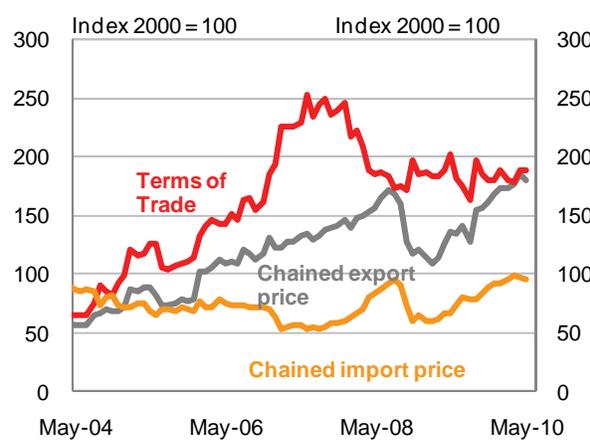
Source: BPS and World Bank

Figure 10: International reserves
(USD billions)



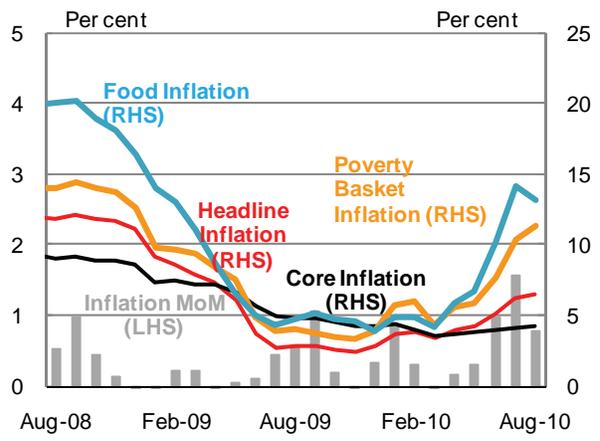
Source: BPS

Figure 11: Terms of trade and monthly export and import chained Fisher-Price indices
(index)



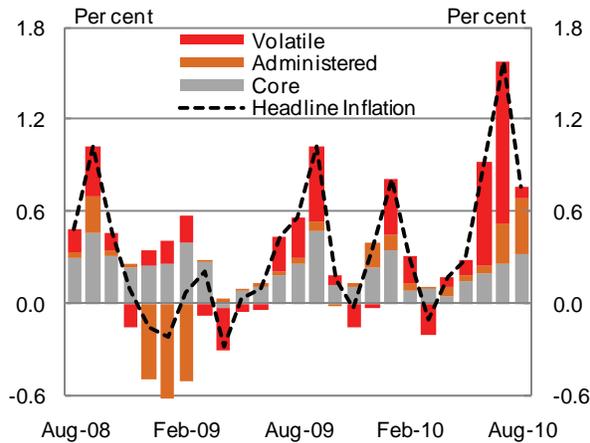
Source: BPS and World Bank

Figure 12: Inflation
(month-on-month & year-on-year)



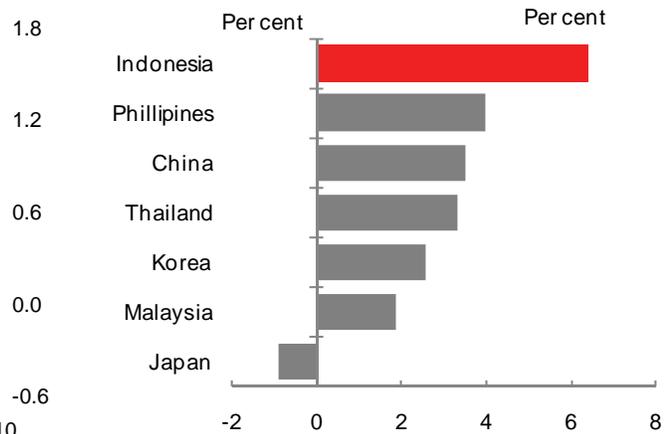
Source: BI and BPS

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



Sources: BPS, World Bank

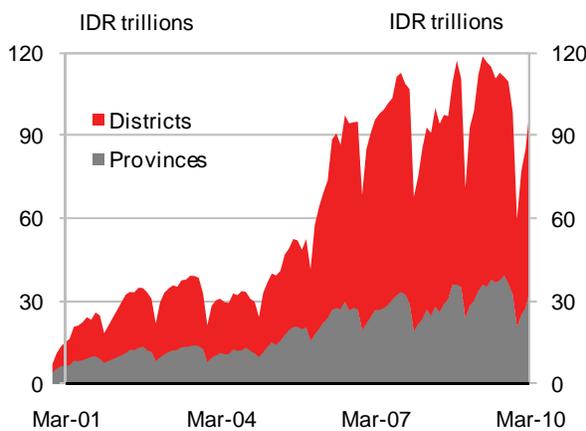
Figure 14: Inflation amongst neighboring countries (year-on-year, August 2010)



*August is latest data point

Sources: National statistical agencies via CEIC and BPS

Figure 15: Sub-national government bank deposits since decentralization (IDR trillions)



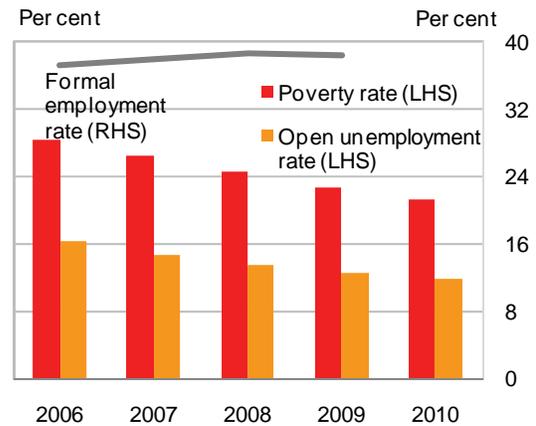
Sources: BI

Figure 17: Regional equity indices (daily, rebased index)



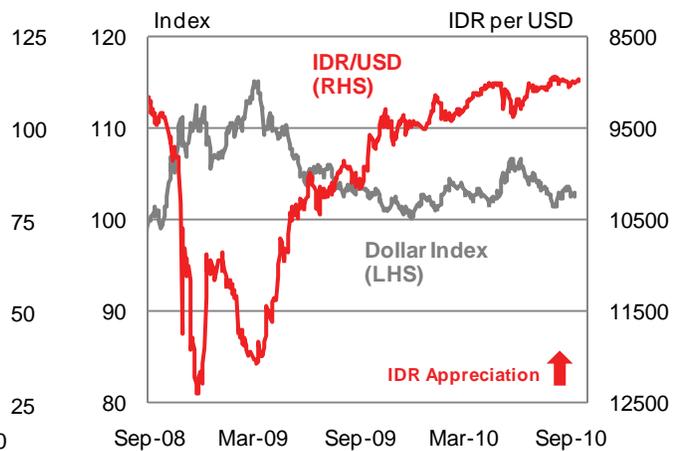
Sources: World Bank and CEIC

Figure 16: Poverty, employment, and unemployment rates (percent)



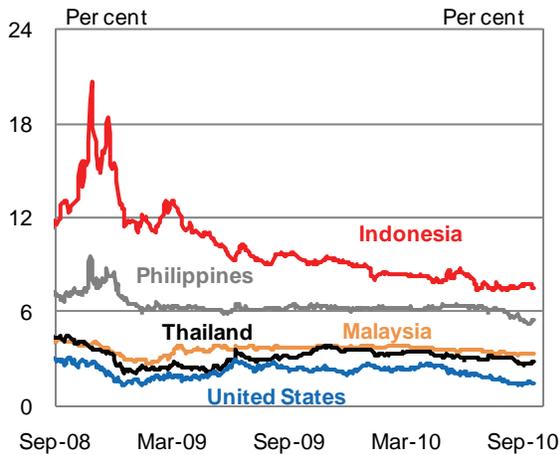
Source: BPS, Sakernas and World Bank

Figure 18: Broad USD Index and Rupiah spot (daily, index and levels)



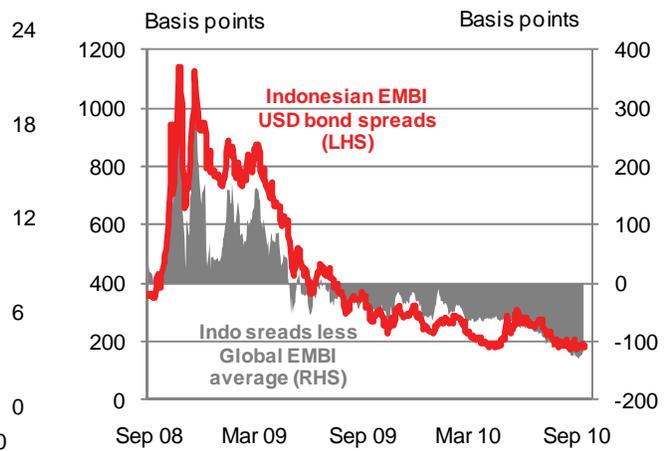
Sources: World Bank and CEIC

Figure 19: 5 Year local currency bond yields (daily, percent)



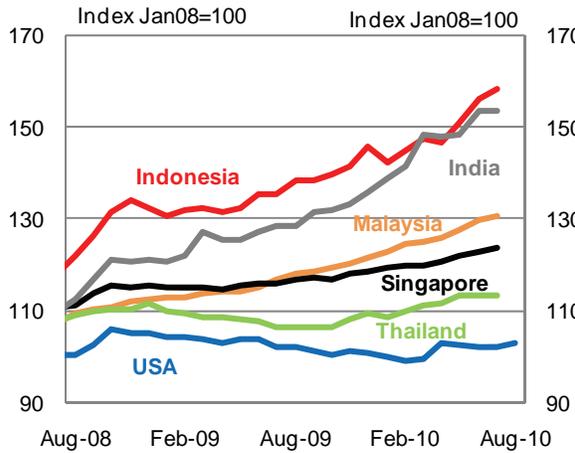
Sources: World Bank and CEIC

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



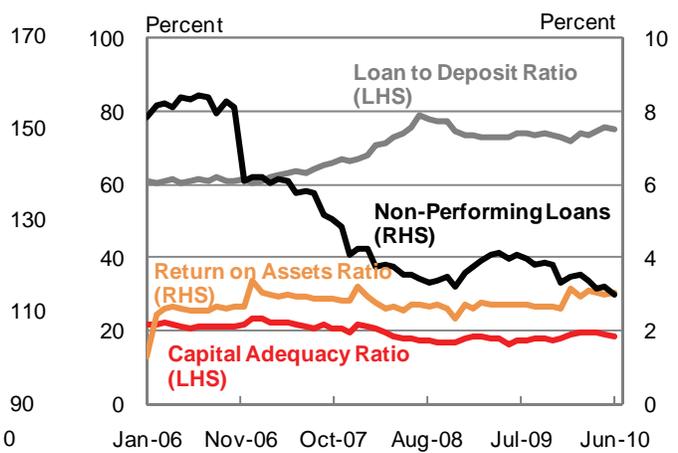
Sources: World Bank and CEIC

Figure 21: International commercial bank lending (monthly, index)



Sources: World Bank and CEIC

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



Sources: World Bank and BI

Table 14: Budget outcomes and estimates
(IDR trillion)

	2008	2009	2010 (p)	2010 (p)	2011 (p)
	Actual	Actual	Semester I report	WB estimates*	Proposed budget
A. State revenues and grants	981.6	848.8	994.7	1,020.1	1,086.4
1. Tax revenues	658.7	619.9	738.9	747.5	839.5
<i>o/w natural resources</i>	327.5	317.6	360.9	370.0	414.5
- Oil and gas	77.0	50.0	55.3	63.8	54.2
- Non oil and gas	250.5	267.5	305.6	306.2	360.3
2. Non tax revenues	320.6	227.2	253.9	272.7	243.1
<i>o/w natural resources</i>	224.5	139.0	164.7	170.6	158.2
i. Oil and gas	211.6	125.8	151.5	155.3	145.3
ii. Non oil and gas	12.8	12.8	13.2	15.3	12.9
B. Expenditures	985.7	937.4	1,089.8	1,079.3	1,202.0
1. Central government	693.4	628.8	742.4	736.4	823.6
2. Transfers to the regions	292.4	308.6	347.4	342.9	378.4
C. Primary balance	84.3	5.2	5.7	35.9	0.7
D. SURPLUS / DEFICIT					
(per cent of GDP)	(4.1)	(88.6)	(95.1)	(59.2)	(115.7)
	(0.1)	(1.6)	(1.5)	(0.9)	(1.7)

Note: *World Bank revenue forecasts are based on a different methodology to the Government to derive projections for nominal GDP (see Part C of the June 2010 *IEQ* for a full discussion)

Source: MoF and World Bank estimates.

Table 15: Balance of Payments
(USD billion)

	2007	2008	2009	2009				2010	
				Q1	Q2	Q3	Q4	Q1	Q2
Balance of Payments	12.7	-1.9	12.5	4.0	1.1	3.5	4.0	6.6	5.4
<i>Per cent of GDP</i>	3	-0.4	2.3	3.5	0.8	2.4	2.6	4.1	3.1
Current Account	10.5	.1	10.7	2.5	2.5	2.2	3.6	2.1	1.8
<i>Per cent of GDP</i>	2.4	0.0	2.0	2.2	1.9	1.5	2.4	1.3	1.1
Trade Balance	20.9	9.9	21.0	4.1	5.1	5.0	6.8	4.8	5.3
Net Inome & Current Transfers	-10.4	-9.8	-10.3	-1.6	-2.6	-2.8	-3.2	-2.8	-3.5
Capital & Financial Accounts	3.6	-1.8	3.5	1.6	-1.8	2.5	1.3	4.3	3.3
<i>Per cent of GDP</i>	0.8	-0.4	0.6	1.4	-1.4	1.7	0.8	2.6	1.9
Direct Investment	2.3	3.4	1.9	.5	.4	.5	.6	1.7	1.2
Portfolio Investment	5.6	1.8	10.3	2.0	1.9	3.0	3.5	6.2	1.1
Other Investment	-4.8	-7.3	-8.8	-8	-4.1	-1.0	-2.9	-3.6	1.0
Errors & Ommissions	-1.4	-2	-1.8	-.1	.4	-1.1	-.9	.3	.3
Foreign Reserves*	56.9	51.6	66.1	54.8	57.6	62.3	66.1	71.8	76.3

Note: * Reserves at end-period

Source: BI and BPS