Indonesia

Moderating investment and sluggish external demand curtailed growth in Southeast Asia's biggest economy in 2013. The authorities took steps to dampen domestic demand after inflation spiked, the rupiah weakened, and the current account deficit widened. Growth is forecast to dip slightly in 2014 before recovering next year. Inflation is seen easing and the external position improving through the forecast period.

Economic performance

GDP growth moderated to 5.8% in 2013 from an average of 6.3% over the previous 3 years, as investment decelerated sharply (Figure 3.24.1). Bank Indonesia, the central bank, raised interest rates to restrain domestic demand at a time of rising inflation and a widening current account deficit.

Growth in fixed investment slowed to 4.7% in 2013 after strong increases of about 9% annually in 2010–2012. This largely reflected the impact higher interest rates and rupiah depreciation had on investment in machinery and equipment. Investment in buildings held up relatively well. The central government's capital spending moderated, though it still expanded by 18.4%. Gross fixed investment as a share of GDP edged down to 31.7% (Figure 3.24.2).

Private consumption remained robust in 2013, expanding by 5.3% and contributing half of the growth in GDP on the expenditure side. Consumption spending was supported by tax reductions for lower-income earners and government cash transfers to poor households in the second half of the year, which helped to counter the impact of rising inflation and tighter consumer credit.

Government consumption grew by 4.9%, which signaled some improvement in budget execution. Higher net exports of goods and services made a significant contribution to GDP growth last year, despite weakness in major export markets. This improvement resulted from import restraint caused by the rupiah depreciation and slower investment, together with modest growth in export volumes.

From the production side, growth in services ebbed to 7.1%, but this sector still contributed 3.3 percentage points of total growth. Robust growth of at least 7.0% was recorded in transport, communications, finance, and hotels. Manufacturing expanded by 5.6%, little changed from the previous year, and it added 1.4 percentage points to GDP growth.

Bad weather and sagging global prices for palm oil and rubber slowed growth in agriculture to 3.5%. Mining output grew by just 1.3%, reflecting growth in coal and metals but contraction in oil and natural gas. Crude oil production fell to 826,000 barrels a day last year,

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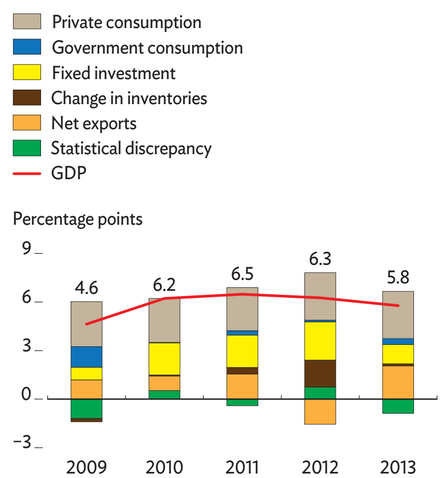
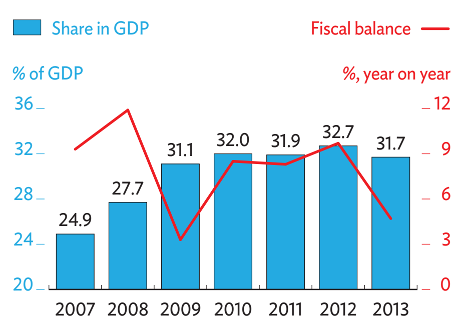
3.24.1 Demand-side contributions to growth



Sources: Asian Development Outlook database; CEIC Data Company (accessed 15 March 2014).

3.24.2 Fixed investment



Sources: Asian Development Outlook database; CEIC Data Company (accessed 15 March 2014).

about half the amount produced in 1995 because oilfields had aged and received little investment.

Inflation accelerated sharply from 3.8% at the start of 2013 to a peak of 8.2% in August, propelled by increases of 44% in the price of gasoline and 22% for diesel in June when the government cut fuel subsidies (Figure 3.24.3). Inflation was also spurred by disruptions to supplies of some foodstuffs because of bad weather and import restrictions. For the year, inflation averaged 6.4%. The statistics office rebased the consumer price index and changed the regional weightings in 2014, which lowered historical inflation. The government made cash transfers to the poor for 4 months to compensate for the rise in fuel prices. By February 2014, inflation had subsided to 7.7%.

Higher inflation and a weakening rupiah prompted the central bank to raise its policy interest rate by 175 basis points to 7.5% between June and November. The monetary authorities lifted the overnight deposit rate, also called the Fasbi rate, by 175 basis points to 5.75%.

Bank Indonesia also introduced macroprudential measures to curb credit growth, including more stringent loan-to-valuation ratios for certain mortgages and a reduction in the upper band of the loan-to-deposit ratio for banks. By December 2013, growth in credit eased to a still-robust 21.6%. Commercial banks raised lending interest rates but by much less than the policy rate hike.

Fiscal policy provided some support as the economy slowed. The fiscal deficit widened to equal 2.3% of GDP from 1.9% in 2012 (Figure 3.24.4). Government spending on social policies rose while tax revenue was eroded by declines in prices for export commodities and weaker imports.

The government secured all its funding of $27.2 billion for the budget, though it needed to raise yields on government debt and increase its issuance of securities with maturities of 1 year or less. Rupiah depreciation contributed to an increase in the ratio of national government debt to GDP to an estimated 26.1% in 2013. The average time to maturity for government debt shortened only marginally to 9.6 years from 9.7 years. However, a high 44.6% of government debt is in foreign currency.

Slower economic growth weakened the labor market. The unemployment rate rose to 6.3% in August 2013, the first such increase since 2005 (Figure 3.24.5). The economy lost 10,000 jobs in the 12 months through August, compared with employment generation of 1.2 million in the year-earlier period.

A weaker labor market and higher inflation nudged up the poverty rate to 11.5% in September 2013 from 11.4% in March 2013, an increase of 480,000 people.

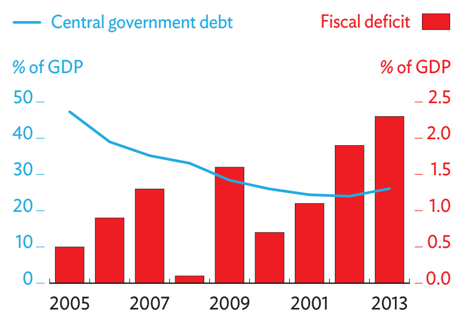
External accounts deteriorated sharply last year. Lower global prices for export commodities such as coal, copper, and palm oil reduced the value of merchandise exports by 2.6% from 2012, to $183 billion. Merchandise imports fell by 1.4% to $177.4 billion, reflecting the softening in machinery and equipment imports and the rupiah's depreciation.

Consequently, the trade surplus fell to $6.1 billion, the smallest in a decade. The smaller trade surplus, coupled with deficits in income and services, widened the current account deficit to 3.3% of GDP.

3.24.3 Monthly inflation

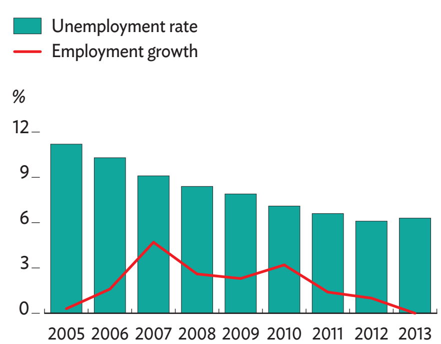
Note: Inflation is based on consumer price index (2012 = 100).
Source: CEIC Data Company (accessed 15 March 2014).

3.24.4 Fiscal indicators



Sources: Asian Development Outlook database; Indonesia Debt Management Office. http://www.dmo.or.id (accessed 15 March 2014).

3.24.5 Labor indicators



Note: Data refer to August unemployment rates.
Source: CEIC Data Company (accessed 14 March 2014).

Inflows of foreign direct investment in the balance of payments fell slightly, but at $18.4 billion they remained substantial. Despite financial market turbulence in the second half of 2013, portfolio investment recorded a net inflow of $9.8 billion for the year. A surplus in the capital and financial account was more than offset by the current account deficit, pushing the balance of payments into a deficit of $7.3 billion, the first such deficit since 2009 (Figure 3.24.6).

Gross international reserves declined by $13.4 billion to $99.4 billion over 2013, a result of the widening current account deficit and central bank actions to support the rupiah in May and June (Figure 3.24.7). Reserves at year-end represented 5.4 months of imports and government debt payments. Since late July 2013, Bank Indonesia has allowed greater flexibility in the rupiah's exchange rate to help correct the external imbalance.

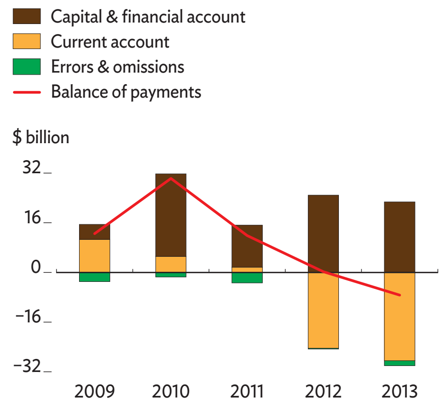
High inflation, a widening current account deficit, and declining foreign reserves shook financial markets. The Jakarta Stock Exchange index of share prices dropped by 15.5% from May to December, though the index closed for the year with a loss of only 1%. Yields on 5-year government bonds rose by 327 basis points, and the rupiah depreciated by 20.7% against the US dollar in 2013.

In addition to the steps to stabilize the economy, the authorities introduced a package to strengthen the supply side. To support exports, the government provided tax breaks to labor-intensive industries that export at least 30% of their production, relaxed quotas on mineral exports, and lowered taxes on imports of raw materials used in exporting industries. To reduce fuel imports, the government increased the mandatory minimum percentage of diesel that must be derived from biofuel made using domestic palm oil. To rein in other imports, it raised taxes on luxury goods from overseas.

Recognizing the need to attract investment to finance the current account deficit and support economic growth, the authorities provided tax holidays and tax allowances to investors in selected industries and simplified the application process for investment permits.

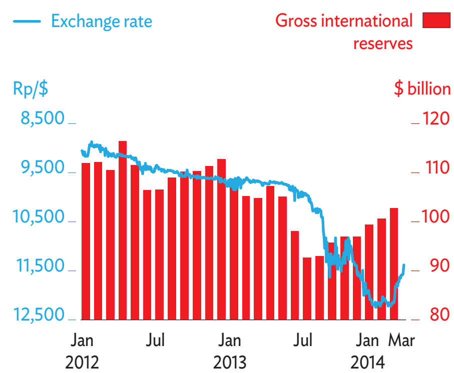
Quotas on some food imports were eliminated to ease upward pressure on food prices. To support the stock market, the Financial Sector Supervisory Authority made a temporary change that allowed companies to buy back shares without having to hold a stockholders meeting.

3.24.6 Balance of payments components



Source: CEIC Data Company (accessed 14 March 2014).

3.24.7 Gross international reserves and exchange rate



Sources: Asian Development Outlook database; CEIC Data Company; Bloomberg (both accessed 14 March 2014).

Economic prospects

Forecasts assume that the government follows through with the stabilization policies rolled out in the second half of 2013 and that parliamentary elections in April and presidential elections in July go smoothly. Projections also assume that steps are taken to improve the investment environment.

On this basis, GDP growth is forecast at 5.7% in 2014 picking up to 6.0% in 2015 (Figure 3.24.8).

The fiscal stance is expected to be similar to the one taken last year. The 2014 budget targets a fiscal deficit of 1.7% of GDP, but a revised budget is expected in May that could widen the deficit to 2.5% in view of

3.24.1 Selected economic indicators (%)

	2014	2015
GDP growth	5.7	6.0
Inflation	5.7	4.8
Current account balance (share of GDP)	–2.9	–2.0

Source: ADB estimates.

unexpectedly weak tax revenue and declining oil production. Reductions in electricity subsidies are scheduled to come into effect in May.

As for monetary policy, further increases in interest rates are possible in 2014, if financial market sentiment weakens or the external position does not improve as anticipated. As the year progresses, though, a projected deceleration in inflation should stem pressure to raise interest rates.

Private consumption is expected to remain reasonably robust, assisted by election-related spending in the first half of 2014 and by easing inflation over the forecast period. While global commodity prices are anticipated to remain soft, the depreciation of the rupiah will support the incomes of commodity exporters. The cash transfers to cushion the impact of the fuel price increase in 2013 expired in December. Nevertheless, a Bank Indonesia consumer survey in January showed consumer confidence improving (Figure 3.24.9).

Growth in fixed investment in 2014 is projected to be similar to last year's pace. Uncertainties over domestic election outcomes and over the impact of the US tapering its monetary stimulus will dampen investment in the first half. Against this, continued solid growth in lending and improved international investment rankings support the outlook. Indonesia's ranking in the World Economic Forum's 2013 Global Competitiveness Index rose by 12 places to 38th out of 148 economies, reflecting in part improvements in infrastructure over recent years. In a survey of Japanese manufacturing companies conducted in 2013, Indonesia was ranked the favored investment destination.

Investment is forecast to pick up in 2015 as the newly elected government clarifies its policies and likely accelerates investment in infrastructure. Investment prospects will improve on considerably lower inflation and current account deficits projected for 2015, as well as on strengthening world trade.

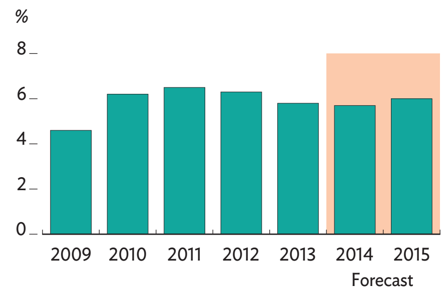
Net foreign trade is expected to contribute to GDP growth this year and next, though not as strongly as in 2013.

As a sign of how the year started for industry, the Manufacturing Purchasing Managers' Index for February 2014 indicated that conditions had improved for a sixth consecutive month but that the pace of improvement had slowed (Figure 3.24.10).

In external accounts, the stabilization policies in the second half of 2013 helped to rein in the current account deficit to 2.0% of GDP in the fourth quarter from 4.4% in the second quarter. In part this reflected the bringing forward of exports of unprocessed ores such as copper and nickel in anticipation of a scheduled ban on their export that came into effect in January 2014. This ban, aimed at impelling mining companies to add value to mineral exports, cut exports of unprocessed ores early this year. Exports of mineral ores usually account for 3.5% of total exports.

Manufactured exports improved in the fourth quarter of 2013 and are expected to benefit during 2014 from the rupiah depreciation. Total exports are forecast to rise by 4.5% in US dollar terms this year and by 6.0% in 2015, underpinned by gradual economic recovery in the US, euro area, and India. The rupiah's depreciation will restrain imports, but they are nevertheless projected to rise by 3.4% this year and 4.2% in 2015.

3.24.8 GDP growth



Source: *Asian Development Outlook* database.

3.24.9 Consumer and business confidence indexes

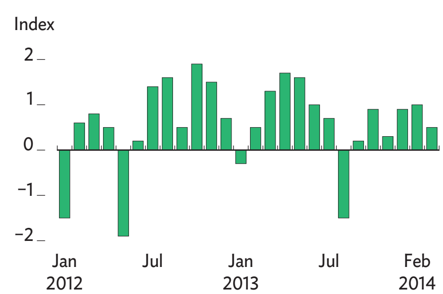
[a] From a quarterly Statistics Indonesia survey among business executives.

[b] From a monthly Bank Indonesia survey among households.

Note: A score above 100 means that respondents are optimistic and vice versa.

Source: CEIC Data Company (accessed 14 March 2014).

3.24.10 HSBC Manufacturing Purchasing Managers' Index



Source: Bloomberg (accessed 15 March 2014).

The impact of these factors, and of the other measures taken since last year to dampen imports and support exports, are expected to narrow the current account deficit to 2.9% of GDP in 2014 and 2.0% in 2015 (Figure 3.24.11). Portfolio investment inflows, which bounced back since the fourth quarter of 2013, and inward foreign direct investment also will contribute to strengthening the balance of payments.

Inflation has eased since August 2013 and is expected to moderate further as the effect of the fuel price hike subsides. In February 2014, month-on-month inflation was down to 0.3%, though the year-on-year rate was still elevated at 7.7%. The base effect of the June 2013 fuel price increase is projected to drive inflation down to average 4.2% in the second half of 2014.

The pass-through to consumer prices of last year's rupiah depreciation is expected to have a modest impact on the consumer price index. Moreover, the rupiah appreciated by 6.9% against the US dollar from the end of 2013 to mid-March 2014. Inflation this year is expected to average 5.7%. Next year, inflation is seen decelerating to an average of 4.8%, near the top of Bank Indonesia's 3.0%–5.0% target range for 2015. However, inflation would be higher if fuel prices were raised again or food supplies disrupted by bad weather.

Downside risks to this outlook center on further deterioration of export performance and changes in market sentiment that cause capital outflows. Deficits in the current account and the budget reinforce the importance of maintaining capital inflows. Gross funding to cover the fiscal gap remains sizeable at 3.8% of GDP in 2014. To manage risks the government has maintained a $5 billion contingent funding facility with development partners and increased currency swap agreements to more than $40 billion.

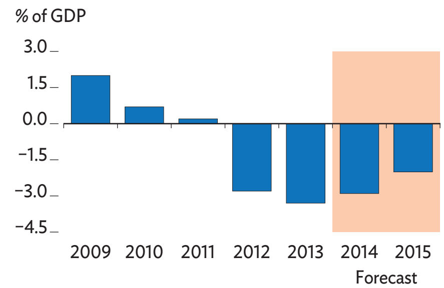
Policy challenge—the current account deficit

Financial markets were rattled by last year's sharp deterioration in the current account deficit, to the equivalent of 4.4% of GDP in the second quarter, the widest gap since the 1997 Asian financial crisis.

A major immediate cause was the slump in export earnings stemming from a downturn in prices for agricultural and mineral export commodities, as well as soft demand from major trading partners. Imports have also played a role. Over several years, robust domestic demand pushed up imports of the capital goods demanded by stronger investment, and of consumer goods for a burgeoning middle class. Imports of capital and consumer goods together climbed by an average of about 18% annually during the years from 2008 to 2012.

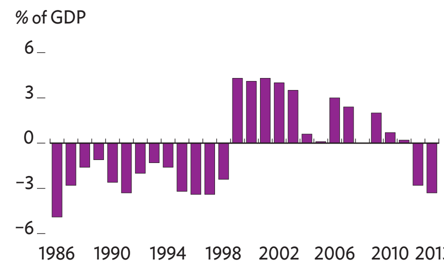
Structural factors have contributed to the problem. The current account fell into deficit in 2012, but the deterioration had started in 2003 (Figure 3.24.12). This suggests that Indonesia's export competitiveness, particularly in manufactures, has eroded. The rupiah has appreciated in real effective terms, and labor productivity in manufacturing has fallen below rates achieved in neighboring countries (Figure 3.24.13). Further, the share of commodities in Indonesia's exports has increased, making its external accounts more vulnerable to cyclical swings in global commodity prices (Figure 3.24.14).

3.24.11 Current account balance



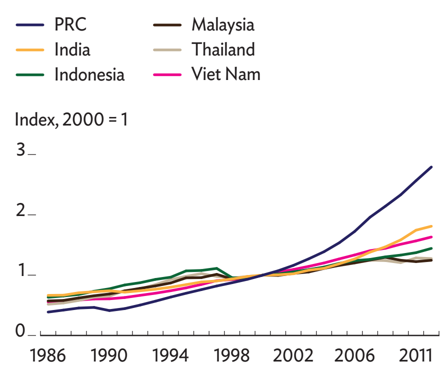
Source: Asian Development Outlook database.

3.24.12 Current account balance



Sources: ADB Statistical Database System online; *Asian Development Outlook* database.

3.24.13 Labor productivity (based on employment)



PRC = People's Republic of China.

Source: APO Productivity online database. http://www.apo-tokyo.org/about/measurement.html#apo_database (accessed 14 March 2014).

Another structural factor—a doubling in the cost of oil imports since 2005—stems from declining domestic oil production and government subsidies on fuel. The subsidies stimulate fuel consumption and discourage the development of alternative energy sources. Imports of oil products cost $40 billion in 2013.

As noted, steps taken last year to slow domestic demand, spur exports, and dampen imports started, together with the rupiah's depreciation, to rein in the current account deficit. Nevertheless, the impact may be relatively short-lived. The depreciation of the rupiah in 2008 boosted manufacturing exports for only a couple of years.

Longer-term strengthening of the current account requires structural reforms to achieve sustained gains in productivity and competitiveness. One such reform is phasing out fuel subsidies by raising fuel prices. The government took a step in this direction in 2013 and should take more in the years ahead.

Further reduction in subsidies would help to curtail fuel imports and free up substantial budget funding for infrastructure and education, which would improve the country's competitiveness.

Government investment in infrastructure, including that from state enterprises, has returned to the level of 3% of GDP, last seen before the 1997 Asian financial crisis. However, private investment in infrastructure is largely missing. Faster development of infrastructure requires that the private sector participate more to complement the government's limited resources.

Continued efforts to enhance the investment climate are key to attracting a substantial and steady inflow of foreign investment, which not only provides financing to cover current account deficits but, over the longer term, can spur technological innovation to improve productivity and competitiveness. In this regard, proposals to open more sectors to foreign direct investment are welcome.

Progress on structural reform has been uneven, as difficult policy changes are often delayed when the economy is performing well. Much could be gained if the government improved its process of formulating structural reforms and then implemented reforms in a more predictable manner.

Improvements in labor productivity also require better education outcomes, stronger incentives for firms to develop the skills of their employees, and a more flexible labor market.

3.24.14 Primary commodity exports

Note: Data refer to exports of food and live animals, beverage and tobacco, inedible crude materials, mineral fuels, lubricants and related materials.

Source: United Nations COMTRADE online database (accessed 15 March 2014).