Executive Summary: Clearing skies

Indonesia's economic recovery has gained steam following the turbulence of the start of the year

In the first half of 2009, Indonesia's economy has established a solid recovery from late last year. Quarterly growth has accelerated since the start of 2009, after stalling in the final quarter of 2008, although the year-on-year growth rate has continued to slow, recording 4.0 per cent in the year to Q2. This trend of a gradual recovery is projected to continue into 2011.

Indonesia's recovery coincides with an improved external environment. Q2 GDP outcomes across its major export destinations were better than expected, and most trading partners exited recession by mid-year. International prices of many of Indonesia's exports have recovered much of their late 2008 falls. These developments have supported Indonesia's economy, with exports recovering faster than imports.

Domestic consumption has remained robust

Domestic consumption continued to contribute strongly to growth in the second quarter. In the first quarter, large amounts of spending by campaign teams for the parliamentary election lifted private consumption. On the other hand, spending for the presidential election campaign in the second quarter appears to have been much smaller, and private consumption in Q2 was little changed from Q1. Higher government consumption has been a key driver of growth in Q2, as the government accelerated disbursement of its 2009 budget. Ongoing resilience in domestic consumption has supported the services sector, with output accelerating compared with Q1. Most other indicators of domestic economic conditions have also strengthened from the start of the year, with consumer confidence at historical highs and rising, retail and vehicle sales improving, and industrial activity recovering from its downturn in late 2008.

…although investors have become very cautious

Despite this resilience in the overall economy and the improving business environment, investors have remained cautious into mid-2009. Purchases of capital equipment continue to be cut, although investment growth in new buildings has remained buoyant. The slowdown in overall investment coincides with flat lending to firms for investment and working capital from late 2008, in contrast to the rapid lending growth earlier that year.

The banking sector has proved far sturdier than many commentators expected, although new loan approvals have remained constrained

Indonesia's banking sector has remained in good health overall. Non-performing loan ratios are stable, despite expectations at the turn of the year that they would rise as borrowers affected by the weaker economy would be unable to meet their commitments. In September, Bank Indonesia left its policy interest rate unchanged, following an easing of 300 basis points over the previous 9 months. Only a limited proportion of these cuts in the policy rate have been passed onto commercial banks, leading BI in late August to ask the 14 largest banks in the country to progressively lower their savings deposit rates to no more than 150 bps above the BI policy rate. BI hopes that this will reduce the cost of funds for banks, allowing them to lend more and at lower interest rates.

Financial markets have continued strengthening through mid-2009

Indonesia's financial markets have continued to strengthen through Q2, generally by more than markets elsewhere in the region. The rupiah has continued to appreciate against the weakening USD, although at a slowing rate, and stabilized around 10,000 per USD by early September. The stock market also performed strongly in Q2, rising over 20 per cent from late May to early September. By mid-June, yields on sovereign rupiah bonds had returned to early 2008 levels, while the spread on Indonesian government USD bonds had fallen below the global emerging market average. From late June to September, local currency bond yields have remained broadly stable, while spreads on USD bonds have fallen another percentage point. These improved market conditions have allowed the government to continue financing its budget through the bond market, accessing funds for longer terms and at lower yields.

…and portfolio investors have returned to Indonesian markets. Roll-over rates on debt have been high, leaving the balance of payments in a small surplus in Q2

Improved financial market conditions have coincided with somewhat less volatile flows on Indonesia's capital accounts, rendering Indonesia's external position in September 2009 more robust than at the start of the year. The overall balance of payments remained in surplus in the second quarter, although by less than in Q1. The current account surplus increased slightly, as the improved external environment lifted exports more than imports. While non-resident investors returned as net purchasers of Indonesian financial assets, overall the capital account switched to deficit, largely due to slower net foreign direct investment following several quarters of record inflows. Indonesia's scheduled external debt was largely rolled over through the first half of 2009, countering concerns early in the year that roll-over rates may be low and that the amount of debt due may be greater than officially reported. Foreign reserves were stable through mid-2009, near USD 58 bn.

Inflation, after being more subdued than expected earlier in the year, has started to rise since August

After remaining subdued for longer than expected, inflation started to pick up in July and August. Headline inflation rose slightly to 2.8 per cent y-o-y while the poverty basket inflation rate rose to 3.8 per cent. Core inflation, which excludes the effects of the cuts in regulated fuel prices around the turn of the year and stable food prices through the first semester, remained much higher than the headline, at 4.8 per cent. Indonesia's inflation has fallen at a faster rate than seen in most of its trading partners, but still remains at a higher level.

Employment has grown at a faster rate than the working age population, although few of the new jobs are formal

Employment grew faster than the working age population in the year to February, allowing the unemployment rate to fall even with a larger share of the working age population entering the labor force. However, most new jobs are in the informal sector, especially for women. Higher employment, stabilizing prices, the final tranches of the government's unconditional cash transfer program (BLT), and a limited slowdown in growth led to a 1.2 percentage point fall in the poverty rate in the year to March 2009, to 14.2 per cent.

Public finances in the first half of 2009 have been more stimulatory than in recent years

Public finances in 2009 have been more stimulatory than in recent years. Through to July, the government budget overall was in deficit, whereas normally it records sizeable surpluses in the first semester. Revenues were down, due to cuts in tax rates scheduled in the government's stimulus package, and to weaker profits as a result of lower commodity prices and external demand, although the July data showed signs of recovery. During this time, the government spent more on its core programs compared with the same period in 2008, but significantly less on energy subsidies, lowering government spending overall. After a very slow start, disbursement of the government's stimulus package accelerated from mid-July.

…and there is scope for more ambitious spending in 2010 than the government's proposed budget envisages

The realized fiscal deficit in 2009 is likely to be a little smaller than originally budgeted, near 2.2 per cent of GDP. The government's proposed 2010 budget projects a deficit of 1.6 per cent of GDP, but the government's conservative nominal GDP growth and oil price assumptions suggest that the realized deficit may be much smaller under its proposed spending plan, creating scope for more ambitious spending.

The trend of a gradually recovering economy should continue into 2011, with accelerating output, and prices, and the end of the government's cash transfers slowing the gains in poverty

The mid-2009 trend of gradual recovery is expected to continue over the coming year and a half. Quarterly growth is expected to rise slowly from its Q2 rate, and year-on-year growth should start picking up by the end of the year and rising gradually towards its potential of a little over 6 per cent by 2011. (
Table 1)

Domestic demand is likely to continue as the main driver of growth, as the government continues to disburse its stimulus and, in 2010, investors regain confidence. Net exports are unlikely to continue making their recent contribution to growth into 2010 since the Indonesian economy is expected to continue growing faster than its trading partners. Net exports should be more supportive in 2011 as the global economy slowly returns to trend growth. With a weakening trade surplus and recovery in commodity prices, the current account is likely to move closer to balance or even to a small deficit by 2011. But the balance of payments should remain in surplus, and reserves are likely to slowly accumulate, as Indonesia's scheduled financing needs remain sustainable and global financial market conditions become more supportive of emerging markets.

Table 1: Growth is projected to gradually return to more typical rates in the coming years
(annual percentage change)

	2008	2009	2010	2011
Gross domestic product	6.1	4.3	5.4	6.0
Consumer price index	9.8	4.7	5.6	6.5
Major trading partner growth	2.1	-1.8	3.3	3.4
Poverty rate	15.4	14.2	13.6	11.5

Sources: MoF, BPS via CEIC and World Bank

Rising domestic demand and global commodity prices will lift both headline and poverty basket inflation through the forecast horizon unless BI shifts policy more aggressively to limit inflation and inflation expectations than it has done historically. These developments, together with the conclusion of the BLT program, are projected to slow the decline in poverty over the coming 18 months.