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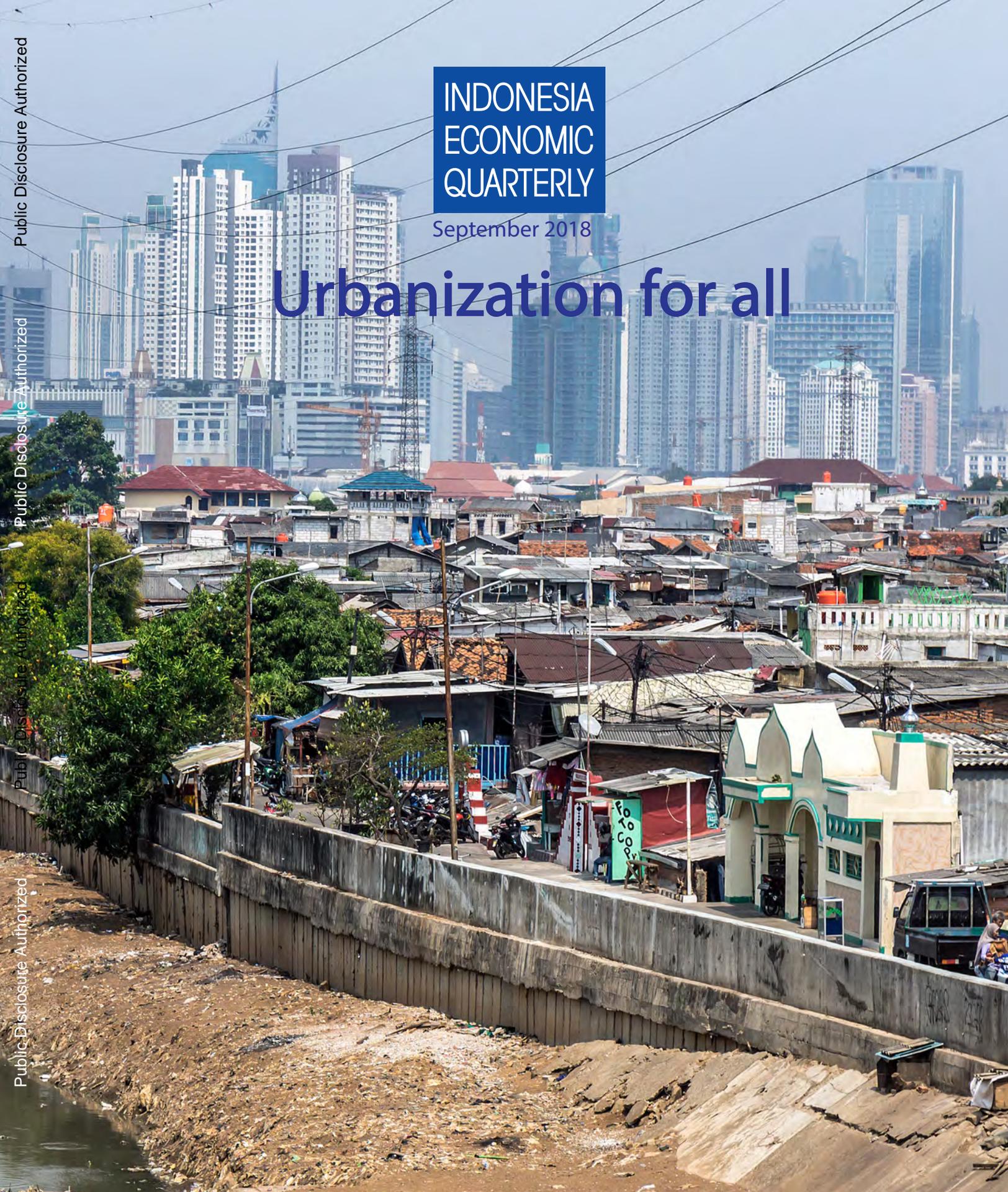
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INDONESIA ECONOMIC QUARTERLY

September 2018

Urbanization for all



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Preface

The Indonesia Economic Quarterly (IEQ) has two main aims. First, it reports on the key developments in Indonesia's economy over the past three months, and places these in a longer-term and global context. Based on these developments and on policy changes over the period, the IEQ regularly updates the outlook for Indonesia's economy and social welfare. Second, the IEQ provides a more in-depth examination of selected economic and policy issues and an analysis of Indonesia's medium-term development challenges. 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.

The IEQ is a product of the World Bank's Jakarta office and receives editorial and strategic guidance from an editorial board chaired by Rodrigo A. Chaves, Country Director for Indonesia. The report is prepared by the Macroeconomics, Trade and Investment (MTI) Global Practice team, under the guidance of Ndiame Diop (Practice Manager) and Frederico Gil Sander (Lead Economist). Led by Derek H. C. Chen (Senior Economist and lead author), the core project team comprises Abigail, Arsianti, Dwi Endah Abriningrum, Francis Addeah Darko, Indira Maulani Hapsari, Jaffar Al-Rikabi, Maria Monica Wihardja, and Pui Shen Yoong. Administrative support is provided by Sylvia Njotomihardjo. Dissemination is organized by Nugroho Sunjoyo, Jerry Kurniawan, and GB Surya Ningnagara under the guidance of Lestari Boediono Qureshi.

This edition of the IEQ includes contributions from Indira Maulani Hapsari (Part A.1, Box A.1 and A.5), Jaffar Al-Rikabi (Box A.2 and Part A.4), Adelia Surya Pratiwi (Box A.3), Pui Shen Yoong (Part A.3), Dwi Endah Abriningrum and Pui Shen Yoong (Part A.6), Maria Monica Wihardja assisted by Hamidah Alatas (Part A.7), Francis Addeah Darko (Part A.8), Derek H.C. Chen (Part A.9), Sailesh Tiwari (main author), Frederico Gil Sander, Mark Roberts, Pui Shen Yoong and Jane Park, with inputs from Abhas Jha, Judy Baker, Marcus Lee, Rizal Shidiq, Nancy Lozano-Garcia, Imam Setiawan, Ratih Dwi Rahmadanti and Lourentius Dimas (Part B), and Abigail (Appendix). The report also benefited from discussions with, and in-depth comments from Ekaterina T. Vashakmadze (Senior Economist, DECPG, World Bank), Ergys Islamaj (Senior Economist, EAPCE, World Bank) and Francesca de Nicola (Economist, EAPCE, World Bank).

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To receive the IEQ and related publications by email, please email snjotomihardjo@worldbank.org. For questions and comments, please email dchen2@worldbank.org.

Abbreviations

AFC	Asian Financial Crisis
APBN	Anggaran Pendapatan dan Belanja Negara
APINDO	Asosiasi Pengusaha Indonesia
BI	Bank Indonesia
BIS	Bank for International Settlement
BKPM	Badan Koordinasi Penanaman Modal
BLU	Off Budget Fund
BOP	Balance of Payments
BPJS	Badan Penyelenggara Jaminan Sosial
BPK	Badan Pemeriksa Keuangan
BPNT	Non-cash food assistance
BPS	Badan Pusat Statistik
BRT	Bus Rapid Transport
CAD	Current Account Deficit
CEIC	Census Economic Information Center
CPB	Central Planning Bureau
CPI	Consumer Price Index
CPO	Crude Palm Oil
DAK	Dana Alokasi Khusus
DAU	Dana Alokasi Umum
DECPG	Development Economics Prospects Group
DFAT	Department of Foreign Affairs and Trade
DIPA	Daftar Isian Pelaksanaan Anggaran
DJPPR	Direktorat Jenderal Pengelolaan Pembiayaan dan Risiko
DKI	Daerah Khusus Ibukota
DMO	Domestic Market Obligation
DRC	Development Research Center
EAP	East Asia Pacific
EAPCE	EAP Chief Economist
EE	Employment Elasticity
EMBI	Emerging Market Bond Index
EMBIG	EMBI global
EMCI	Emerging Market Currency Index
ESDM	Energi dan Sumber Daya Mineral (Energy and Mineral Resources)
FAME	Methyl Fatty Acid Ester
FAO	for agricultural output
FDI	Foreign Direct Investment
FLPP	Fasilitas Likuiditas Pembiayaan Perumahan
FLFPR	Female Labor Force Participation Rate
G20	Group of 20
GDP	Gross Domestic Product
GE	Generalised Entropy
GFCF	Gross Fixed Capital Formation
GNFS	Goods and Non-Factor Services
GoI	Government of Indonesia
HOFINET	Housing Finance Information Network
IDR	Indonesia Rupiah
IDSUN	Indonesia Sustainable Urbanization
IEQ	Indonesia Economic Quarterly
IHS	Institute Human Studies
IIF	Institute for International Finance
ILO	International Labor Organization

IMF	International Monetary Fund
IPI	Industrial Production Index
ISEAS	Institute of Southeast Asian Studies
JKM	Jaminan Kematian
Kepmenkes	Keputusan Menteri Kesehatan (Health Ministerial Decree)
KOTAKU	National Slum Upgrading Program
LFPR	Labor Force Participation Rate
LGST	Luxury Goods Sales Tax
LHS	Left Hand Side
LNG	Liquefied Natural Gas
LPG	Liquid Petroleum Gas
MDTF	Multi-Donor Trust Fund
MGI	McKinsey Global Institute
MoF	Ministry of Finance
MPWH	Ministry of Public Works and Housing
MT	Metric Ton
MTI	Macroeconomics, Trade and Investment
NAHP	National Affordable Housing Program
NCEP	National Community Empowerment Program
NIK	Nomor Induk Kependudukan (Population Registration Number)
N-O&G	Non-Oil & Gas
non-O&G	Non-Oil & Gas
NPL	Non-Performing Loans
NTI	Net Trade Index
NUDP	National Urban Development Project
NUWAS	National Urban Water Supply Program
O&G	Oil and Gas
OCBC	Overseas-Chinese Banking Corporation
OECD	Organisation for Economic Co-operation and Development
OJK	Otoritas Jasa Keuangan/Financial Services Authority
OPEC	Organization of the Petroleum Exporting Countries
PBI-JKN	Penerima Bantuan Iuran-Jaminan Kesehatan Nasional
PCBT	Program Penertiban Cukai Berisiko Tinggi
Perpres	Peraturan Presiden (Presidential Decree)
PISA	Programme for International Student Assessment
PKH	Program Keluarga Harapan (Family Hope Program)
PLN	Perusahaan Listrik Negara
PMI	Purchasing Managers' Index
PNBP	Other Non-Tax Revenues
PODES	Potensi Desa (Village Potential)
PPI	Producer Price Index
PPP	Purchasing Power Parity
PT	Perseroan Terbatas
PU-net	Pekerjaan Umum Internet
PUPR	Pekerjaan Umum dan Perumahan Rakyat
qoq	quarter-on-quarter
RHS	Right Hand Side
RIDF	Regional Infrastructure Development Fund
RON	Research Octane Number
sa	Seasonally adjusted
Sakernas	National Labor Force Survey
S&P	Standard & Poors
SBI	Sertifikat Bank Indonesia
SBN	Surat Berharga Negara
SD	standard deviation

SECO	Swiss State Secretariat for Economic Affairs
SEMEFPA	Support for Enhanced Macroeconomic and Fiscal Policy Analysis
SITC	Standard international Trade Classification
SMI	selected macroeconomic indicators
SUN	Surat Utang Negara
SURR	Social, Urban, Rural and Resilience
Susenas	National Socio-Economic Survey
TA	Tax Amnesty
THR	Tunjangan Hari Raya (allowances for the festive season)
ToT	Terms-of-trade
USTR	United States Trade Representative
VAT	Value Added Tax
WDI	World Development Indicators
yoy	year-on-year

Table of Contents

PREFACE	I
ABBREVIATIONS	II
TABLE OF CONTENTS	V
EXECUTIVE SUMMARY	1
A. ECONOMIC AND FISCAL UPDATE	4
1. Growth picked up on the back of stronger consumption, offsetting weaker investment and lower net exports	4
2. Indonesia's exports of key commodities face mixed fortunes as prices fluctuated in Q2	9
3. The current account deficit widened with higher crude prices and continued strength in capital goods imports .	12
4. Headline inflation remained unchanged in Q2.....	16
5. Indonesia macro-financial conditions generally tightened.....	17
6. Strong revenue growth supported higher spending, mostly on social assistance and subsidies.....	20
7. Labor market conditions remain buoyant with the employment rate reaching a two-decade high.....	23
8. Indonesia's poverty rate declined to a single digit for the first time.....	27
9. Economic growth outlook and risks.....	29
B. MAKING URBANIZATION WORK FOR ALL INDONESIANS	35
1. Urbanization is linked to more prosperity and less poverty, but congestion forces can undermine these benefits.	35
2. Indonesia is urbanizing at a 'normal' pace, mostly through transformation of formerly-rural areas	38
3. Better economic opportunities in metropolitan areas have helped many Indonesians escape poverty and join the middle class	42
4. Gaps between urban and rural areas remain, but most inequality in Indonesia is within places.....	44
5. Shortcomings in the transportation-housing nexus exacerbates inequality.....	49
6. Indonesia can make urbanization work for all Indonesians through three 'C's.....	52
REFERENCES	58
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS	62

FIGURES

Figure ES.1: Stronger consumption offset the weakened investment and drag of net export growth	3
Figure ES.2: The spread between Indonesian bond yields with the U.S. bond yields has widened markedly.....	3
Figure ES.3: Headline inflation remained low in Q2.....	3
Figure ES.4: Total revenues grew at the fastest pace in ten years, driven by non-O&G income tax and VAT	3
Figure ES.5: The March 2018 poverty rate saw the largest yoy reduction since March 2011	3
Figure ES.6: The goods trade surplus declined, leading to the deterioration of the current account balance	3
Figure A.1: Stronger consumption offset the weaker investment growth and lower net exports	4
Figure A.2: Commodity-related and retail sectors grew faster	5
Figure A.3: Growth in buildings and structures investment softened, but machinery and equipment investment growth was robust.....	6
Figure A.4: Global industrial production slightly slowed from Q1.....	7
Figure A.5: Global Composite Purchasing Managers' Index softened significantly	7
Figure A.6: Global financial market jitters continued to Q2.....	7
Figure A.7: Commodity-related sector and retail sector grew faster	8
Figure A.8: Industrial production growth eased and manufacturing PMI stayed in the expansionary territory for 6 consecutive months.....	8
Figure A.9: Q2 saw continued growth of gas export volumes, recovery in rubber, but a decline in exports of coal, oil and base metals exports volumes	9
Figure A.10: Prices for Indonesia's key commodities saw mixed fortunes in Q2, with crude oil up, palm oil down ..	10
Figure A.11: In H2, future markets expect crude oil to stabilize, and coal to fall sharply	10
Figure A.12: coal exports have fallen in 2018 as a share of total production.....	11
Figure A.13: ...due to a new policy that required selling to domestic markets at lower prices	11
Figure A.14: The goods trade surplus declined, leading to the deterioration of the current account balance.....	12
Figure A.15: Export growth was broad-based, but higher oil prices boosted oil and gas exports.....	13
Figure A.16: ...as well as imports of fuel and lubricants, which contributed to the acceleration in imports	13
Figure A.17: Foreigners sold Indonesian debt and equities in H1 2018.....	14
Figure A.18: ...but the financial account remained in surplus due to inflows of portfolio and other investments in Q2	14
Figure A.19: Net foreign direct investment (FDI) increased, mostly in the manufacturing sector.....	15
Figure A.20: ...but net direct investment has not covered the current account deficit in recent quarters.....	15
Figure A.21: Headline inflation remained low in Q2	16
Figure A.22: Despite rising global oil prices, there were smaller increases in retail fuel prices in Q2, with subsidized categories remaining flat	17
Figure A.23: Retail prices of chicken and eggs have continued to increase in Q2	17
Figure A.24: Both the Rupiah and emerging country currencies depreciated further against the U.S. Dollar in Q2..	18
Figure A.25: Despite appreciating in Q2, the Rupiah generally depreciated in 2018 in real effective terms.....	18
Figure A.26: The spread between Indonesian and emerging market bond yields with the U.S. bond yields has widened markedly	19
Figure A.27: The wider spread was primarily due to the heightened currency risk rather than credit risk	19
Figure A.28: Monetary policy easing cycle halted in Q4.....	19
Figure A.29: Banking indicators pointed to healthy banking condition	19
Figure A.30: Total revenues grew at the fastest pace in the last ten years, driven by non-O&G income tax and VAT	20
Figure A.31: Social spending and fuel subsidies continued to drive higher spending growth	22
Figure A.32: Social, personnel, and electricity subsidy disbursements are higher	22
Figure A.33: Employment rate (unemployment rate) reached a two-decade record high (low) in February 2018	24
Figure A.34: There has been a significant and persistent increase in the share of voluntary underemployment vis-à-vis involuntary underemployment	24
Figure A.35: There is a sign of "aging" among the labor force	25
Figure A.36: This year, the educational level of the new labor market entrants reversed the five-year trend towards a better-educated labor force	25
Figure A.37: In the past three years, structural transformation has been unprecedented	26
Figure A.38: An increase in minimum wage hampers job creation in the manufacturing sector	26
Figure A.39: The March 2018 poverty rate saw the largest yoy reduction since March 2011	27
Figure A.40: Although poverty declined nationally, the reduction was not uniform across the provinces	28
Figure A.41: Inequality continues to fall.....	28
Figure A.42: IEQ growth forecasts for 2018 remain in line with consensus forecasts	29
Figure A.43: The net trade-weighted price index – historical and forecast until 2019	30

Figure A.44: The current account deficit is expected to widen in 2018 and 2019 as import-intensive investment remains strong and terms-of-trade weaken.....	31
Figure A.45: Inflation is expected to rise in H2, averaging 3.4 percent for 2018	31
Figure B.1: Countries with higher shares of urban population tend to have higher levels of income... ..	36
Figure B.2: ...and lower levels of poverty.....	36
Figure B.3: Indonesia has not gained as much economically for its degree of urbanization as China and Vietnam... ..	37
Figure B.4: ...nor has poverty declined as much as in these countries, given the degree of urbanization	37
Figure B.5: Benchmarking Indonesia's pace of urbanization against global experience, 1950-2015	38
Figure B.6: Migration has played less of a role in driving Indonesia's urbanization, compared to China and India .	39
Figure B.7: Indonesia is at an intermediate stage of urbanization.....	39
Figure B.8: While urbanization overall in Indonesia and on Java-Bali is at an intermediate stage, for the rest of the country it is still at an incipient stage.....	40
Figure B.9: Poverty and vulnerability rates declined the fastest in metro peripheries... ..	42
Figure B.10: ...while middle-class population shares were largest in metropolitan areas.....	42
Figure B.11: Urban areas tend to offer more opportunities for formal employment... ..	43
Figure B.12: ...and a larger proportion of Indonesians in urban areas are employed outside the primary sector.....	43
Figure B.13: Metro areas have a high earnings premium relative to non-metro areas	44
Figure B.14: The consumption gap between DKI Jakarta and urban peripheries shrank.....	45
Figure B.15: Despite convergence, significant gaps remain between urban and rural areas in access to basic services	46
Figure B.16: The share of inequality is higher within places and within districts than between places and districts – and the share has risen over time, 2001 and 2017	46
Figure B.17: Inequality rose everywhere, but the Gini coefficient rose the most in urban peripheries.....	47
Figure B.18: Multi-district metros are the most unequal	47
Figure B.19: Average years of schooling and population size are also positively correlated across Indonesia.....	48
Figure B.20: Differences in educational attainment are the strongest drivers of inequality within places	48
Figure B.21: Gaps in math scores between the top and bottom 20 percent widened the most in cities	48
Figure B.22: Price-to-income ratios are high in Jakarta compared with more developed cities... ..	50
Figure B.23: ...contributing to substantial overcrowding in metro cores and single-district metros	50
Figure B.24: A fifth of urban residents live in slums... ..	51
Figure B.25: ...mostly in predominantly urban peripheries and non-metro urban areas	51
Figure B.26: High housing costs in multi-district metro cores and sprawl contribute to long, lengthy commutes in Jakarta metro area and single-district metros	51
Figure B.27: Indonesia's cities are some of the most congested in the region	52
Figure B.28: It takes far more time to travel the same distance in Indonesia than in other East Asian countries	52

APPENDIX FIGURES

Appendix Figure 1: Real GDP growth.....	62
Appendix Figure 2: Contribution to GDP growth (expenditure)	62
Appendix Figure 3: Contribution to GDP growth (production).....	62
Appendix Figure 4: Motor cycle and motor vehicle sales	62
Appendix Figure 5: Consumer indicators.....	62
Appendix Figure 6: Industrial production indicators and manufacturing PMI.....	62
Appendix Figure 7: Balance of payments.....	63
Appendix Figure 8: BOP: Current account	63
Appendix Figure 9: Exports of goods.....	63
Appendix Figure 10: Imports of goods	63
Appendix Figure 11: Reserves and capital flows	63
Appendix Figure 12: CPI inflation	63
Appendix Figure 13: Monthly breakdown of CPI inflation.....	64
Appendix Figure 14: CPI inflation comparison across countries	64
Appendix Figure 15: Domestic and international rice prices.....	64
Appendix Figure 16: Poverty and unemployment rates	64
Appendix Figure 17: Regional equity indices.....	64
Appendix Figure 18: Spot exchange rates of selected currencies against USD	64
Appendix Figure 19: 5-year local currency government bond yields	65
Appendix Figure 20: Sovereign USD bond EMBIG spread	65
Appendix Figure 21: Commercial and rural credit and deposit growth	65
Appendix Figure 22: Banking sector indicators.....	65

Appendix Figure 23: Government debt	65
Appendix Figure 24: External debt.....	65

TABLES

Table ES.1: Real GDP growth is expected to rise to 5.2 percent in 2018 with stronger domestic demand	2
Table A.1: Indonesia's Balance of Payments (BOP).....	12
Table A.2: The fall in inequality at the national level was driven by increases in the consumption shares of the bottom and middle 40 percent	28
Table A.3: Key economic indicators	29
Table A.4: Comparison of selected macroeconomic indicators, Indonesia Then and Now	33
Table A.5: The World Bank projects lower revenue and expenditure than in the 2018 Budget	32

APPENDIX TABLES

Appendix Table 1: Budget outcomes and projections	66
Appendix Table 2: Balance of payments	66
Appendix Table 3: Indonesia's historical macroeconomic indicators at a glance	67
Appendix Table 4: Indonesia's development indicators at a glance	68

BOXES

Box A.1: Favorable global economic conditions: have they disappeared?	6
Box A.2: Global Commodity Prices for Indonesia's Key Exports Moved in Different Directions	9
Box A.3: Coal exports in 2018 have not increased in line with production increases.....	10
Box A.4: How will trade wars affect Indonesia?.....	15
Box A.5: Acceleration of structural transformation and the revival of the manufacturing employment?	26
Box B.1: Indonesia's portfolio of urban places, 2016.....	41
Box B.2: A broad programmatic approach for urbanization in Indonesia	56

Executive Summary

Real GDP grew 5.3 percent in the second quarter of 2018 from the previous year, as domestic demand strengthened. Private and government consumption accelerated thanks to higher subsidy and personnel spending, a pick-up in credit growth, higher agricultural incomes, and stable inflation. Strong job markets also helped: the employment rate reached a two-decade high of 65.7 percent in February, with the unemployment rate falling to 5.1 percent. Growth of machinery and equipment investment remained robust, but overall gross fixed capital formation (GFCF) slowed because investments in structures and buildings (three-quarters of GFCF) moderated, partly due to fewer working days. Despite escalating protectionism, both exports and imports grew over the quarter. Because import volumes grew nearly twice as fast as exports, net exports contracted, weighing on overall economic growth.

The official poverty rate, based on the national poverty line, reached 9.8 percent in March 2018, down from 10.6 percent in March 2017. The decline was in part due to the expansion of social assistance programs, such as the Family Hope Program (*Program Keluarga Harapan*, PKH), which helped lower chronic poverty and reduced vulnerability, and partly due to buoyant labor market conditions.

Rising crude oil prices and continued growth in equipment investment led nominal imports to grow faster than exports, and to a narrowing of the goods trade surplus. This contributed to the widening of the current account deficit to 2.3 percent of GDP in the four quarters through Q2 – a widening of 1 percentage point of GDP over the past year. Net direct investment (direct investment in Indonesia less Indonesian investment abroad) eased to 1.7 percent of GDP in the four quarters through Q2, and has not been sufficient to finance the current account deficit since Q1 2018.

Heightened global uncertainty from ‘trade wars’ and fears of contagion from stress in other emerging markets, amid the ongoing U.S. monetary normalization, have led to portfolio outflows from emerging markets, including Indonesia. Together with the current account deficit, portfolio outflows pressured prices of Indonesian assets and the Indonesian 10-year bond yield rose by 121 basis points in Q2, reaching 8.2 percent. The Rupiah depreciated 4.8

percent against the U.S. Dollar in Q2, with an additional 2.7 percent in July and August. The Rupiah’s depreciation was much smaller than that of the Turkish lira or the Argentine peso, and depreciation against a basket of currencies of its trading partners was also less than the depreciation against the US dollar, reflecting broader dollar strength.

In response to the increased global financial market volatility, Bank Indonesia (BI) raised the policy interest rate by a cumulative 125 basis points since May to signal its commitment to stability, despite Q2 headline inflation of 3.3 percent, which is below BI’s target.

Fiscal policy reinforced monetary policy in signaling the Government’s commitment to stability. Despite 2018 and 2019 being election years, the fiscal deficit is projected to decline in both years, reducing the supply of Rupiah-denominated assets. In 2018, this has been partly due to buoyant revenue growth, which was the fastest in 10 years, owing to higher commodity prices and to reform impact, as higher and more streamlined tobacco excises and improved compliance contributed to higher non-resource revenue. Strong revenue growth offset higher spending, especially on subsidies, including of arrears from previous years. The 2019 budget anticipates further consolidation based on broadly realistic revenue and expenditure targets.

Economic growth is forecast to reach 5.2 percent this year and in 2019 (Table ES.1), and to gradually strengthen to 5.3 percent in 2020. Domestic demand is expected to continue to drive growth in the near-term. The modest acceleration in private consumption is expected to be sustained due to stable inflation, strong labor markets, and lowering borrowing rates. Government consumption is also projected to strengthen as revenue growth creates space for both fiscal consolidation and additional spending. Investment growth is expected to remain robust, initially as the momentum of public and mining investments continue, and later with reduced political uncertainty post elections.

Even though decisive and coordinated policy actions have significantly increased resilience to financial market volatility, Indonesia’s shallow financial sector and relatively low levels of exports and foreign direct

investment imply that pressures from capital outflows are likely persist. Meanwhile, the current account deficit is expected to widen to 2.4 percent of GDP in 2018 and stabilize at 2.3 percent in 2019, as lower primary income outflows are offset by weaker terms-of-trade (ToT), continued investment demand for imported capital goods, and easing growth of major trading partners.

Measures to impose withholding taxes on imports and delay public investments are unlikely to have a large impact on the current account in the near-term. These measures may in fact have unintended consequences considering Indonesia's need to expand exports, which requires facilitating imports, and its large infrastructure gap.

Table ES.1: Real GDP growth is expected to rise to 5.2 percent in 2018 with stronger domestic demand

		2017	2018f	2019f
Real GDP	(Annual percent change)	5.1	5.2	5.2
Consumer price index	(Annual percent change)	3.8	3.4	3.7
Current account balance	(Percent of GDP)	-1.7	-2.4	-2.3
Government budget balance	(Percent of GDP)	-2.5	-2.1	-1.8

Source: BI; Central Bureau of Statistics (BPS); Ministry of Finance; World Bank staff calculations

Note: 2017 actual outcome; f stands for World Bank forecast

Given the demonstrated commitment of fiscal and monetary authorities to economic stability, continued pressure from global volatility is likely to elicit additional tightening of macroeconomic conditions. Therefore, downside risks to economic growth have increased. While a cheaper currency will help contain the current account deficit and stimulate exports, it may also dampen consumer confidence and increase inflation, leading to slower consumption growth. Higher bond yields would lead to costlier financing for corporates, which could dampen the nascent credit recovery and private investment. Escalating protectionism also poses strong risks to Indonesia through either slower growth of exports or through negative spillovers from slower regional growth – in part through weaker commodity prices.

While risks of economic growth slowing down remain, risks associated with a financial crisis for Indonesia remain small due to strong policy coordination and sound fundamentals. Coming off from a record high at the beginning of the year, foreign reserves remain at a healthy 8 months' worth of imports. Despite

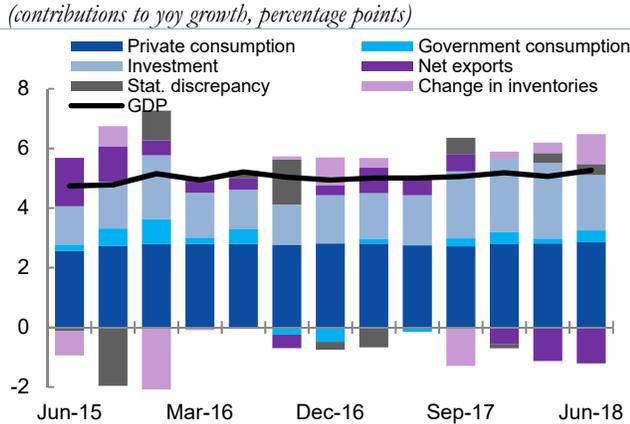
intervening to minimize volatility, Bank Indonesia has been conserving reserves by allowing market-driven depreciation rather than defending a fixed level of the exchange rate. Monetary policy has also been tightening to maintain interest rate differentials with the United States. Likewise, fiscal policy has been consistently prudent: deficits have remained low and government debt is less than half of the legal threshold of 60 percent of GDP, of which 58 percent is denominated in local currency. At the same time, the banking and financial sectors remain sound; credit growth is increasing but not rampant, and banks are well capitalized with low rates of non-performing loans. Most importantly, as noted, the fiscal and monetary authorities, as well as the executive, have given consistent and strong signals that they prioritize stability and will continue to act accordingly.

This edition also presents the challenges and opportunities Indonesia faces in leveraging its urbanization to generate greater prosperity and inclusion within the country.

Urbanization can be a powerful force for economic growth and poverty reduction, but when poorly managed its associated congestion costs can undermine potential benefits and lead to greater segregation, isolation and inequality. Indonesia continues to urbanize at a steady pace, largely brought about by the conversion of formerly rural areas into urban settlements. While better economic opportunities in cities have helped many Indonesians escape poverty and join the middle class, urbanization in Indonesia has generally not been able to provide as many widely-shared benefits compared to some other countries in East Asia. Inequality within places has increased, driven in large part by disparities in human capital and lack of spatial integration within cities. Urban areas face strong and mounting congestion costs, as evidenced by the unmet demand for affordable housing that leads to the growth of slums, and by high levels of traffic congestion and pollution.

To ensure that urbanization can work for all Indonesians, Central and local governments need to work together to enact policies that achieve three objectives: (i) **converge and expand** the delivery of basic services to ensure that all Indonesians can enjoy good quality education, health, water and sanitation services, thereby reducing the inequality of opportunity; (ii) **connect and integrate** within and between places; (iii) **customize and target** people and places that are likely to be left behind, such as those with disabilities or other groups that tend to be disadvantaged, as well as lagging regions of the country.

Figure ES.1: Stronger consumption offset weaker investment growth and lower net exports
(contributions to yoy growth, percentage points)



Source: BPS; World Bank staff calculations

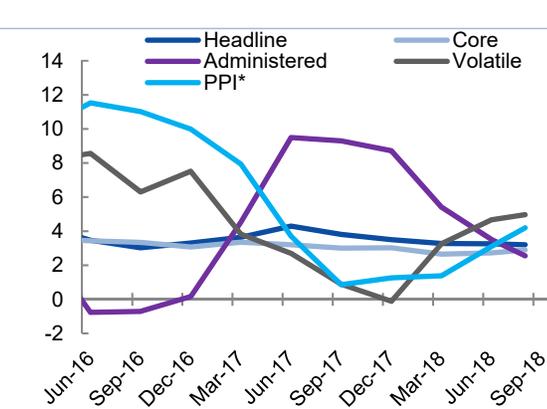
Figure ES.2: The spread between Indonesian bond yields with the U.S. bond yields has widened markedly
(percent)



Source: CEIC, World Bank staff calculations

Note: EMBI+ is a JP Morgan Emerging Market Bond Index yield to maturity

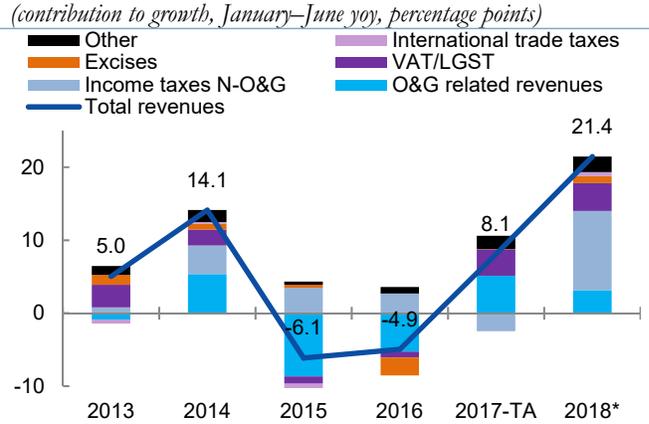
Figure ES.3: Headline inflation remained low in Q2
(change yoy, percent)



Source: BPS; World Bank staff calculations

Note: Food prices are a weighted average of the raw and processed food price components of CPI

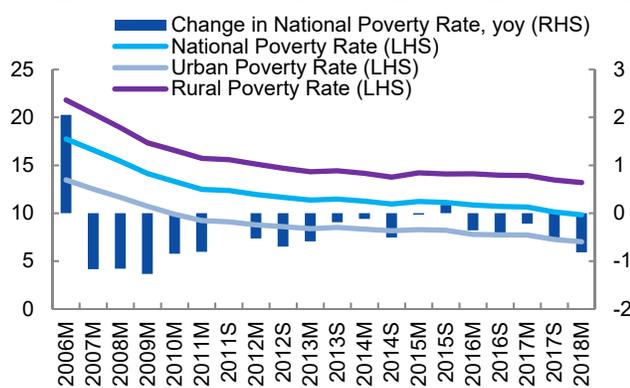
Figure ES.4: Total revenues grew at the fastest pace in ten years, driven by non-O&G income tax and VAT
(contribution to growth, January–June yoy, percentage points)



Source: Ministry of Finance; World Bank staff calculations

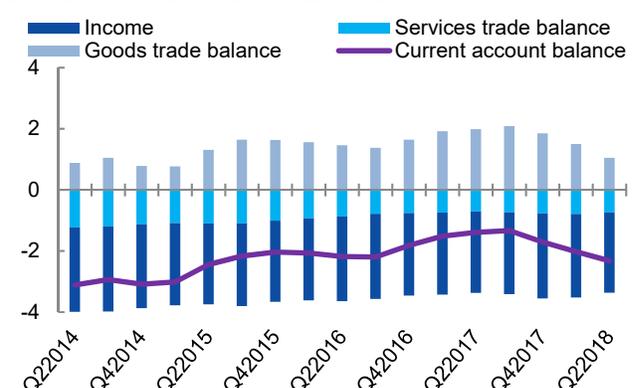
Note: See Figure A.30

Figure ES.5: The March 2018 poverty rate saw the largest yoy reduction since March 2011
(poverty rate, percent, LHS; change in poverty, percentage points, RHS)



Source: National Socio-Economic Survey (Survei Sosial Ekonomi Nasional, Susenas). M-March, S-September survey round

Figure ES.6: The goods trade surplus declined, leading to the deterioration of the current account balance
(four-quarter rolling sum, percent of GDP)



Source: BI, World Bank staff calculations

Note: Data points show the sum of the last four quarters, divided by the GDP for the last four quarters.

A. Economic and Fiscal Update

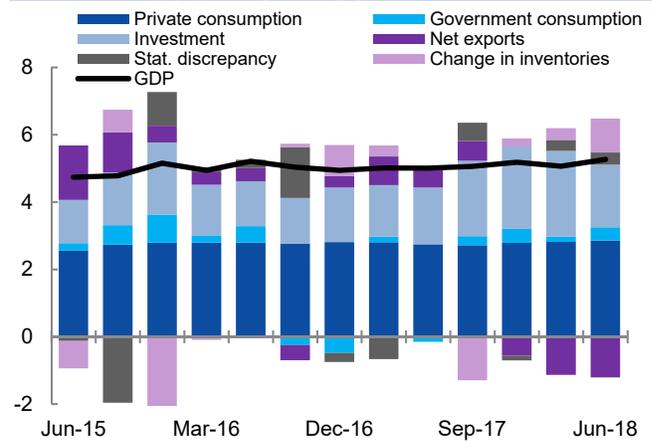


1. Growth picked up on the back of stronger consumption, offsetting weaker investment and lower net exports

Growth picked up to the 5.3 percent, the fastest pace in more than four years

Despite higher global uncertainty, the Indonesian economy grew by 5.3 percent yoy in Q2, up from 5.1 percent in Q1 and above consensus forecasts also of 5.1 percent. On a qoq seasonally adjusted annualized (saar) basis, growth strengthened to 5.5 percent from 5.1 percent in the previous quarter¹. The pickup in GDP growth was driven by stronger growth in domestic demand, more than offsetting weaker net exports. Private and government consumption accelerated, and changes in inventories contributed 1.0 percentage point (pp) to GDP growth as companies continued to restock (Figure A.1)². Construction investment eased leading to a slowdown in gross fixed capital formation (GFCF), and net exports continued to be a drag

Figure A.1: Stronger consumption offset the weaker investment growth and lower net exports
(contributions to yoy growth, percentage points)



Source: BPS; World Bank staff calculations

¹ Quarter-on-quarter, seasonally adjusted and annualized rates. World Bank staff estimates using X12 seasonal adjustment.

² After a large destocking of 1.3 percentage points of GDP growth in Q3 2017, accumulation of inventories has been accelerating since Q4 2017.

on growth as imports grew faster than exports. On the supply side, commodity-related sectors (agriculture and mining and quarrying sectors) as well as the trade, hotels, and restaurants sector provided the largest additional contribution to growth, while growth in the construction sectors weakened, in line with the slower investment growth.

Private consumption growth picked up to 5.2 percent

Lifted by relatively subdued inflation, holiday festivities, lower borrowing rates and stronger agricultural incomes, private consumption growth picked up to 5.2 percent yoy in Q2 from 5.0 percent in Q1. Underlying the strengthening of private consumption, which accounts for more than half of GDP, was the firming growth of consumption of food and beverages, as well as of transportation and communication³. Restaurant and hotel consumption continued to grow the fastest at 5.7 percent in Q2.

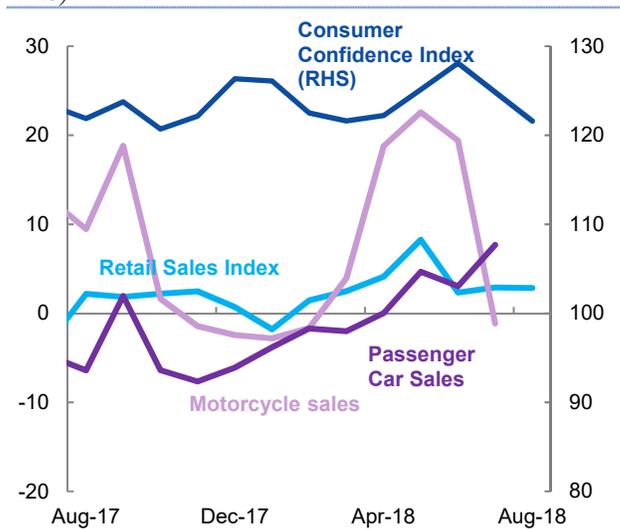
In line with more robust consumption growth, high-frequency indicators for consumption, such as motorcycle sales, passenger car sales, retail sales, and consumption credit growth all strengthened in Q2 (Figure A.2). Motorcycle sales grew 19.9 percent yoy in Q2, soaring from 4.2 percent growth in Q1, mostly due to a base effect of a contraction at the same time last year. Retail sales growth also continued to rise, reaching 4.9 percent in Q2, compared to 0.7 percent growth in Q1, reflecting broad-based strengthening, but particularly strong increase in the sales of food and beverages, and transportation and communication. These high-frequency indicators moderated in July and August, except for motorcycle sales growth that fell sharply. Higher agricultural incomes, holiday allowances (*Tunjangan Hari Raya*) for civil servants, and payment of social transfers also contributed to the pickup in the consumption growth.

Government consumption growth nearly doubled to 5.3 percent from 2.7 percent in Q1

Real government consumption growth jumped to 5.3 percent yoy from 2.7 percent in Q1, partly due to a low base in the same quarter last year. In addition, government consumption rose due to robust growth in nominal personnel spending, which in turn expanded due to the disbursement of holiday allowances for civil servants⁴.

Figure A.2: Commodity-related and retail sectors grew faster

(yoy, percent/ 3mma yoy, percent, LHS; consumer confidence index; RHS)



Source: BI, BPS; World Bank staff calculations
 Note: Retail sales index in yoy percent terms; vehicle sales in 3-month moving average (mma) percent yoy terms.

³ Consumption of food and beverages, and transportation and communication were the largest contributors to consumption growth of 1.9 pp and 1.3 pp, respectively.
⁴ CNN (2018).

Investment in building and structures weakened, while machine and equipment investment remained robust

Overall, investment growth decelerated to 5.9 percent in Q2 from 7.9 percent in Q1 (Figure A.3). This was partly due to a slowdown in public investment, as nominal capital government spending contracted 13.0 percent in Q2, partly due to the base effect of large infrastructure outlays in Q2 last year. In addition, the Hari Raya festive period wholly fell in Q2 this year, resulting in fewer working days, affecting investment activity during the quarter⁵.

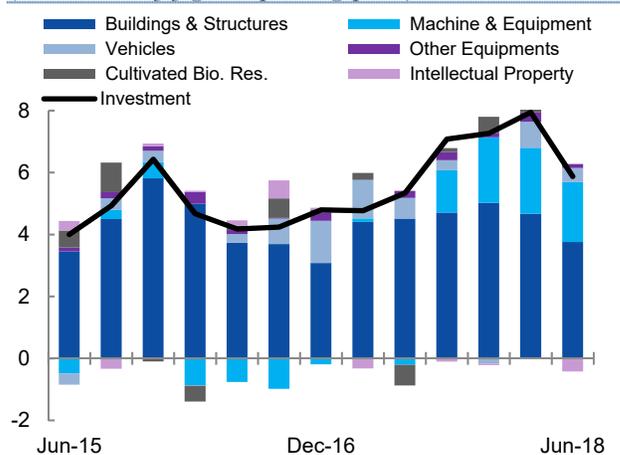
Growth of investments in building and structures, which represents three-quarters of GFCF, weakened to 5.0 percent from 6.2 percent in Q1, with its contribution shrinking from 4.7 pp in Q1 to 3.8 pp in Q2. Meanwhile, growth of investment in vehicles slowed to 8.0 percent, in line with the moderating growth of commercial vehicle sales. However, growth in machine and equipment investment remained robust with double-digit growth at 22.5 percent.

Net exports continued to be a drag on growth

Both exports and imports grew faster than in Q1, despite increase in global volatility (Box A.1). Imports still expanded faster than exports, which led to a drag from net export growth. Exports growth accelerated to 7.7 percent in Q2, while imports growth climbed to 15.2 percent. In line with higher oil and gas prices, the acceleration in exports growth was partly due to stronger oil and gas exports volumes growth, rebounding to 5.9 percent after a 6.9 percent contraction in Q1. The stronger growth in imports was also driven by a robust turnaround on oil and gas imports of 7.1 percent from a 15.0 percent contraction in Q1.

Figure A.3: Growth in buildings and structures investment softened, but machinery and equipment investment growth was robust

(contributions to yoy growth, percentage points)



Source: BPS; World Bank staff calculations

Box A.1: Favorable global economic conditions: have they disappeared?

The pickup in global economy appeared to halt in the first half of 2018. Growth in major advanced economies weakened and global trade growth slightly softened, partly on the back of increased protectionism. In line with weakening global trade, global production also slowed, and business confidence deteriorated. Global monetary conditions tightened due to gradual monetary policy normalization in both advanced and emerging economies. Global commodity prices continued to climb, benefiting commodity-exporting countries. However, there are risks that could further dampen global trade if trade disputes escalate, which would eventually affect the global growth as well as Indonesia’s outlook through the external sector.

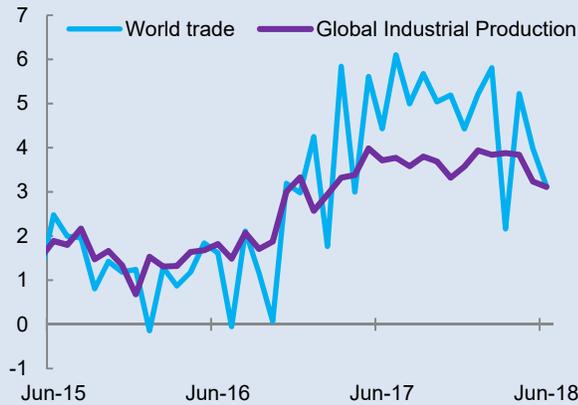
In Q2 2018, growth in the Euro Area eased to 2.1 percent year-on-year (yoy)¹ from 2.5 percent in Q1, the lowest in two years, partly due to the base effects of the high growth last year. China’s growth ticked down to 6.7 percent from 6.8 percent in Q1, as both consumption and investment softened following the tightening of its monetary policy as the Government tried to contain its rising debt². Japan recorded a growth of 1.1 percent in Q2, unchanged from Q1, but significantly lower than 1.9 percent in Q4 2017. On the contrary, the United States’ economy continued to strengthen, recording the highest growth in four years at 2.8 percent in Q2³, supported by surges in consumption and exports.

Global high frequency indicators also weakened. Global trade momentum started to dissipate and global growth decelerated to 4.1 percent yoy in Q2⁴, from 4.4 percent in Q1 (Figure A.4), following the United States’ increase in tariff on around USD 34 billion worth of China’s exports and on steel and aluminum to the European Union, Canada, and Mexico. Global industrial production growth also slowed marginally from Q1⁵, in line with the softening of the global composite PMI to 54.0 in Q2 from 54.2 in Q1 (Figure A.5). The PMI further decelerated to 53.4 in August 2018, slowing notably in the Euro Area and China, as the slowdown in exports affected other sectors, translating into weaker consumer spending and lower business investment growth⁶.

⁵ Although the number of official holidays in Q2 2018 and Q2 2017 was approximately the same, many workers took two weeks of leave following Lebaran. Half of this leave period occurred in Q3 in 2017, but in 2018 it was entirely in Q2.

Figure A.4: Global industrial production slightly slowed from Q1

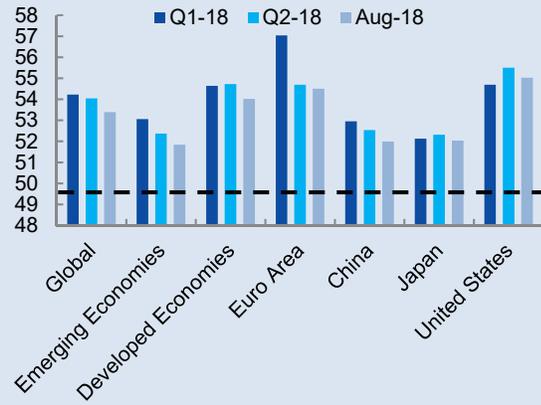
(growth yoy, percent)



Source: CPB World Trade Monitor, World Bank staff calculations

Figure A.5: Global Composite Purchasing Managers' Index softened significantly

(index)



Source: Markit Economics, Haver Analytics; World Bank staff calculation
 Note: Readings above 50 represent expansions and readings below 50, contractions.

Monetary policy normalization continued in several advanced as well as emerging countries. The U.S. Federal Reserve increased the policy interest rate in March and June, with two more hikes expected in September and December. Similarly, the European Central Bank placed its quantitative easing policy on hold, while in the Asia region, India, Malaysia, and the Philippines raised their interest rates to support weakening currencies. Since the correction of the U.S. stock market in February, global financial market jitters continued throughout the first half of 2018, as indicated by several spikes in the VIX and MOVE indices⁷ (Figure A.6) particularly during announcements of tariff increases.

Meanwhile, international commodity prices kept climbing and supported the growth of commodity-exporting countries. The World Bank energy and non-energy prices indices hit the highest level in almost four years, soaring 40.1 percent yoy and 8.4 percent respectively in Q2, higher than 21.3 percent and 3.4 percent respectively in Q1. Increases in energy prices were mostly driven by higher crude oil prices from stronger demand and supply disruption in several oil-producing countries, as well as from higher coal prices due to surging demand, particularly in China. Non-energy prices ascended, particularly of base metals, as nickel prices soared on the back of increased demand from electrical industries and the trade sanctions imposed by the United States on Russia⁸.

Figure A.6: Global financial market jitters continued to Q2

(growth yoy, percent)



Source: Bloomberg; World Bank staff calculations

¹ OECD quarterly GDP (2018).

² Bloomberg (2018).

³ OECD quarterly GDP (2018).

⁴ CPB (2018).

⁵ Posting a 3.6 percent yoy growth in Q2 from 3.9 percent in Q1.

⁶ IHS Markit (2018).

⁷ The VIX index measures volatility in the equity markets, while the MOVE index measures the volatility in the bond markets.

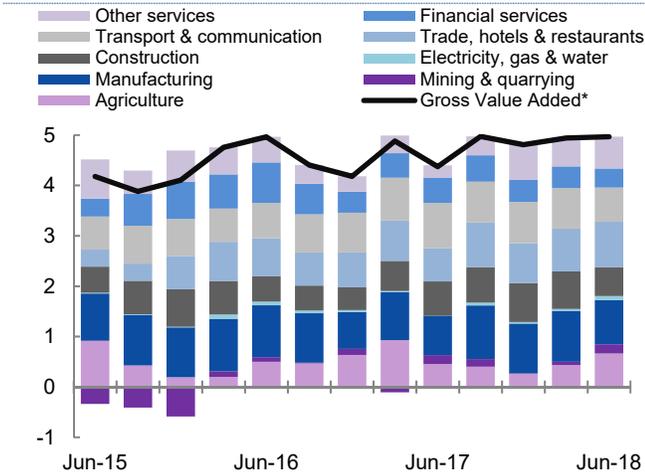
⁸ Reuters (2018).

On the supply side, commodity-related sectors and the trade, hotels, and restaurant sectors provided the largest increase in the contribution to growth

On the supply side, commodity-related sectors (agriculture and mining and quarrying sector) and trade, hotels and restaurants posted the largest increases in their contribution to growth in Q2. The agriculture sector saw growth strengthening to 4.8 percent yoy, partly due to a longer harvest period on the back of favorable weather conditions⁶. The mining and quarrying sector also continued to pick up, growing 2.2 percent in Q2 from 0.7 percent in Q1, as recent investments allowed firms to take advantage of higher global prices. The trade, hotels and restaurants sector also grew faster, with growth reaching 5.3 percent, in line with the pickup in private consumption. Meanwhile, reflecting softening investment activity, particularly in buildings and structures, the construction sector slowed to 5.7 percent in Q2 from 7.4 percent in Q1.

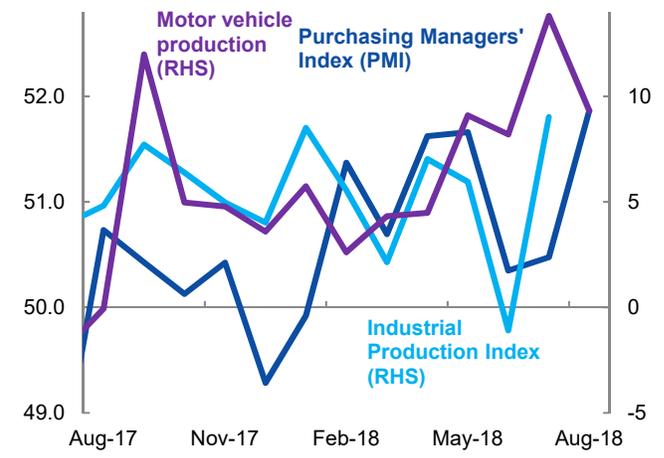
Growth in manufacturing also weakened in Q2 to 4.0 percent yoy from 4.6 percent in Q1 (Figure A.7). Manufacturing contributed 0.8 percentage points to overall growth in Q2, lower than from 1.0 percentage points in Q1. This is in line with the weakening of several high frequency production indicators, especially those representing manufacturing (Figure A.8). The Nikkei/Markit Manufacturing Purchasing Managers' Index (PMI) stayed in expansionary territory since February 2018, and reached an average of 51.2 in Q2, the highest since Q2 2014. However, motor vehicle production dipped slightly to an average of 3.2 percent yoy in Q2 from 4.9 percent in Q1, consistent with moderating investment growth in vehicles. Industrial production also saw smaller increases in Q2, with growth easing to a nine-quarter low of 4.4 percent. The direction of these indicators, however, reversed in July and August, signaling that growth in the manufacturing sector will likely recover in the next quarter.

Figure A.7: Commodity-related and retail sectors grew faster
(contributions to yoy growth, percentage points)



Source: BPS; World Bank staff calculations
Note: *Gross Value Added is derived as the sum of the value added in the agriculture, industry and services sectors. If the value added of these sectors is calculated at purchaser values, gross value added at factor cost is derived by subtracting net indirect taxes from GDP.

Figure A.8: Industrial production growth eased and manufacturing PMI stayed in expansionary territory for 6 consecutive months
(index, LHS; growth yoy/ 3mma yoy, percent, RHS)



Source: BPS; Nikkei/Markit; World Bank staff calculations
Note: IPI growth in yoy terms; motor vehicle production growth in 3-month moving average (mma) yoy terms. Manufacturing PMI above 50 points indicates expansionary territory.

⁶ BPS (2018).

2. Indonesia’s exports of key commodities face mixed fortunes as prices fluctuated in Q2

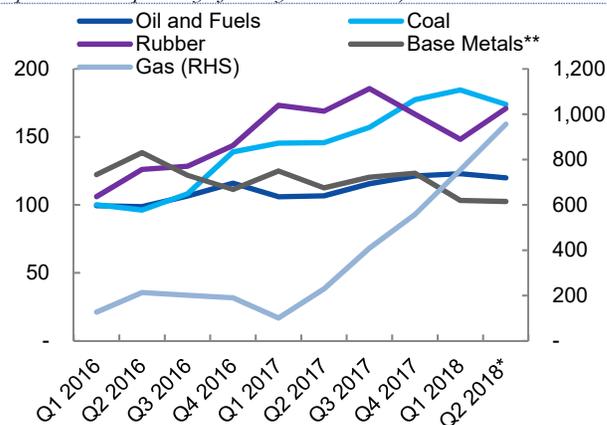
Prices of Indonesia’s key commodity exports presented a mixed picture...

Global prices for Indonesia’s key export commodities moved in different directions in Q2. Prices for crude oil, LNG, and base metals experienced strong growth, while prices for crude palm oil and rubber continued to decline. Coal prices grew but at a slower pace than in Q1. Box A.2 describes the drivers of these movements.

...contributing to the mixed performance of Indonesia’s export volumes in Q2

Boosted by stronger prices and high demand, Indonesia’s export volumes of gas continued to grow strongly (Figure A.9)⁷. Oil exports increased, but at a slower pace, as oil production challenges persisted⁸. Similarly, the growth in coal exports eased, reflecting in part the impact of a new government policy (see Box A.3)⁹. Exports of base metals fared worse, continuing a pattern of decline that began in Q1.

Figure A.9: Q2 saw continued growth of gas export volumes, recovery in rubber, but a decline in exports of coal, oil and base metals exports volumes
(exports index, quarterly, January 2016=100)



Source: CEIC; World Bank staff calculations

Note: Q2 2018 data is for April-May only. Base Metals category excludes silver and the platinum family. Oil and Fuels excludes Crude Palm Oil and refers only to Petroleum Products and Refined Fuels. SITC 2-digit and 3-digit data on export volumes is used to create weighted groupings of export volumes. An index is constructed, with January 2016 exports volumes used as base.

Box A.2: Global Commodity Prices for Indonesia’s Key Exports Moved in Different Directions

Prices for Indonesia’s key export commodities moved in different directions in Q2 (Figure A.10), and are set to take varied trajectories in H2 (Figure A.11). Crude oil continued to surge, by 44.6 percent yoy in Q2, the seventh consecutive quarter of growth since Q3 2016. This increase was in anticipation of a tighter market following the U.S. decision to impose sanctions on Iranian oil, and on the back of higher demand for energy in Europe following a heatwave. Base metals saw a similar trend, increasing to 20.4 percent yoy in Q2 from 18.4 percent in Q1. Liquefied Natural Gas (LNG) prices also grew by 11.6 percent due to strong demand from Asia, albeit lower than the 20.6 percent seen in Q1. Coal grew at a slower pace, increasing in Q2 by 9.1 percent, compared to a growth of 25.4 percent in Q1. In contrast, growth of crude palm oil (CPO) and rubber both fell for a second consecutive quarter by 7.7 percent and 13.2 percent, respectively, with the fall in palm oil linked to lower demand¹.

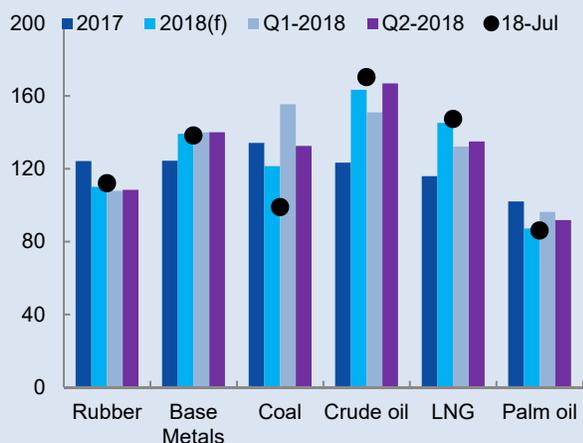
Moving forward, markets expect crude oil prices to stabilize or ease slightly in H2², supported by OPEC’s decision at its June 22 meeting to boost production following caps that have been in place since 2016³. Similarly, base metals are expected to ease slightly compared to Q2, while rubber prices are expected to make some small gains. LNG, meanwhile, is expected to continue its strong growth, owing to rising imports from China, and benefiting from the view amongst some countries that LNG can serve as a “bridge fuel” towards a low-carbon future⁴. In contrast, coal prices are expected to see a sharp fall, with markets anticipating a supply glut following strong supplies from China and India, the continued implementation of China’s green policies, and fears that the U.S.–China trade war may result in a slowdown in Chinese growth and thus of coal consumption. Finally, palm oil is expected to continue declining, on the back of high palm oil stocks and weak export demand for Malaysian and Indonesian palm oil⁵.

⁷ Demand for liquid natural gas (LNG) has remained robust and is increasing, despite higher gas prices. See The Economic Times (August 05, 2018).

⁸ Indonesia’s oil production has faced persistent challenges over the last few years resulting in decreasing production, in part due to low-investment in new fields and low investment in enhanced oil recovery tied to existing fields. See The Diplomat (June 1, 2018).

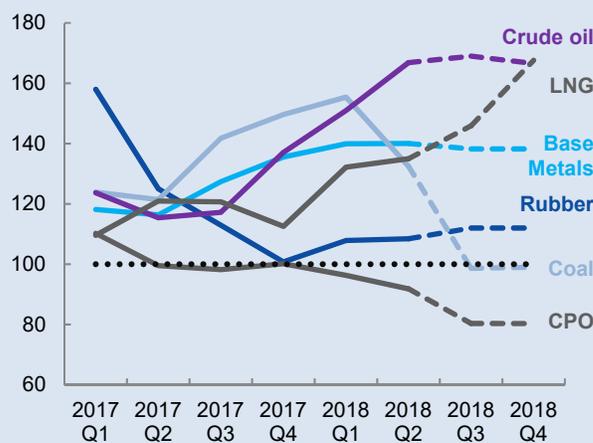
⁹ Falling exports China’s “war on pollution” is particularly noteworthy in its impact on global demand for coal. See Reuters (July 3, 2018).

Figure A.10: Prices for Indonesia’s key commodities saw mixed fortunes in Q2, with crude oil up, palm oil down
(index 2016=100)



Source: World Bank; investing.com; cmegroup.com; World Bank staff calculation
 Note: 2018(f) stands for forecast, which is constructed using historical January–May data, and futures markets data thereafter

Figure A.11: In H2, future markets expect crude oil to stabilize, and coal to fall sharply
(index 2016 = 100)



Source: World Bank; investing.com; cmegroup.com; World Bank staff calculation
 Note: LNG stands for Liquefied Natural Gas and CPO stands for Crude Palm Oil

¹ According to CIMB Equities Research, demand for crude palm oil has fallen in part due to India’s hike in import duties on the product. See The Star (June 23, 2018).
² Forward-looking analysis draws on futures market prices as a reflection of market expectations.
³ OPEC’s press release notes that “conformity” with its November 2016 targets had reached 152 percent in May 2018 and sets out instead to have conformity “down to 100” percent from July 1, 2018 onwards. See OPEC (June 22, 2018). Analysts expect that production would consequently be boosted by 600,000–800,000 barrels per day. See CNBC (June 22, 2018).
⁴ See S&P Global (June 4, 2018). The G20 meeting in Argentina reflected the view that LNG could serve as a “bridge fuel”, helping countries transition away from coal. See Shell (2018) and Reuters (June 16, 2018). This view is, however, disputed by climate scientists; see Oil Change International (June 2018).
⁵ Indonesia and Malaysia account for more than 80 percent of the world’s palm oil exports, with Indonesia the leader (more than 55 percent share). See World’s Top Exports (May 2011, 2018). On recent trends, see The Star (June 23, 2018 and The Star (June 14, 2018); and Gan, B. (June 26, 2018).

Box A.3: Coal exports in 2018 have not increased in line with production increases

The increase in coal price in H1 2018 helped boost production significantly, but less so exports. While Indonesian coal production reached 123 million tonnes in January–April 2018, growing 38.7 percent yoy, export volumes for the same period reached only 79 million tonnes, a growth of just 5.3 percent yoy. As a result, the share of total coal production exported in 2018 fell to 65.8 percent, compared to an average share of 78.8 percent in 2013–17 (Figure A.12).

One of the key factors behind the change is the Government’s Domestic Market Obligation (DMO) policy for coal that came into effect at the beginning of 2018. This DMO policy requires all domestic coal producers to sell 25 percent of their total production to domestic buyers (particularly PT PLN and independent power producers), or until a domestic target of 100 million tonnes is met for the full industry¹. The price of coal is regulated by the Ministry of Energy and Mineral Resources (ESDM) and is updated on a monthly basis. For domestic electricity suppliers (PT PLN only), the price is set at a maximum of USD 70 per tonne,² well below the Government’s Benchmark Thermal Coal Price (HBA) for domestic prices (Figure A.13). As a result, coal producers bear the cost of the divergence between international market prices and domestic regulated prices. On the other hand, PT PLN is benefiting, since coal comprises more than 50 percent of its domestic energy mix. Thus, from January to July, DMO has helped PT PLN cut expenses by an average of USD 30 per MT.

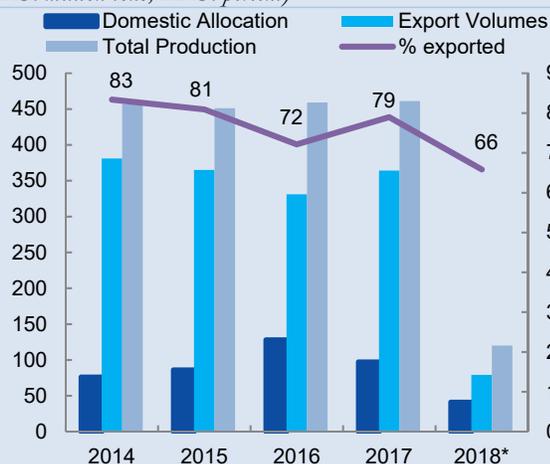
In the short-term, the regulated prices and sales add to the costs of exporting coal and hinder the ability of Indonesian coal producers to take advantage of the increasing international coal price momentum. Over the medium term, the DMO may result in reducing producers’ reinvestment capacity after being forced to sell at a lower price. A further challenge with DMO has been on compliance. ESDM has noted that 22 coal companies out of the 40 that applied for an increase in production quota had not met the domestic sales share requirement³.

To encourage exports while still implementing the DMO policy, the Government has recently introduced two measures⁴. First, it has raised the coal production ceiling by approximately 100 million tonnes, a 23.5 percent increase on the original 425 million tonnes⁵.

Second, to unlock production potential and hence exports, starting September 2018, coal producers that have more than 25 percent domestic sales out of their total production can “transfer” their extra sales to others that have not met the target.

Figure A.12: Coal exports have fallen in 2018 as a share of total production...

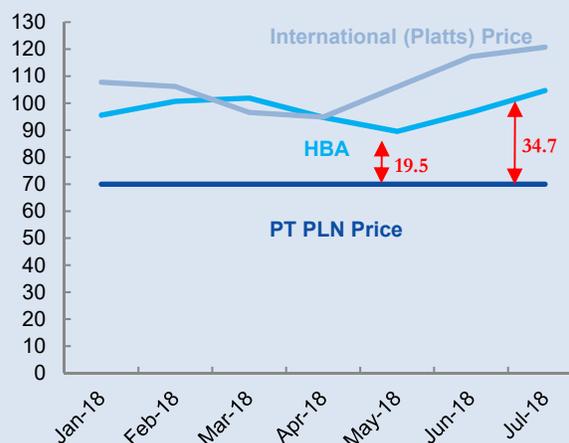
(LHS: million tons; RHS: percent)



Source: Energy and Mineral Resources Ministry; World Bank staff calculation
 Note: 2018* is for January–April 2018; % exported refers to the share of total production that is exported

Figure A.13: ...due to a new policy that required selling to domestic markets at lower prices

(USD per metric tons)



Source: World Bank; investing.com; cmegroup.com; World Bank staff calculation
 Note: LNG stands for Liquefied Natural Gas and CPO stands for Crude Palm Oil

Estimates indicate that if the DMO policy were to be cancelled for the remainder of the year and the 25 percent allocated for domestic sales were to be exported, then foreign exchange reserves would increase by USD 3.35 billion between September and December 2018⁵. However, repeal of the DMO would adversely impact PT PLN, with potential implications for the Government’s budget deficit⁷.

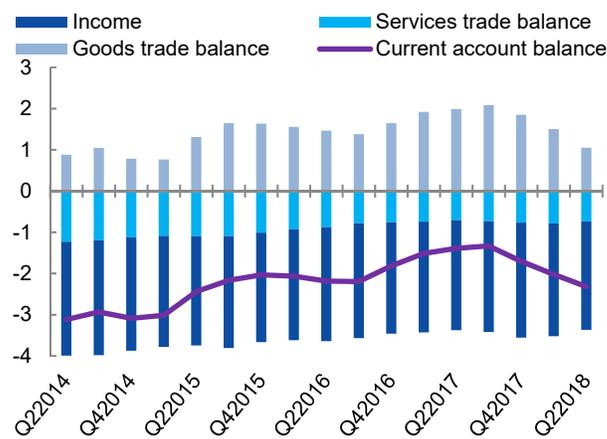
¹ The policy is to apply each year until and including 2019.
² The Government has stated that this policy is aligned with its energy policy stance of zero change in fuel prices.
³ 18 of the 22 companies had domestic sales between 12.5 to 25 percent of total production, and 4 recorded domestic sales lower than 12.5 percent of total production
⁴ The new measures were introduced as part of an attempt to reduce the growing current account deficit, in light of the recent sharp depreciation of the Rupiah.
⁵ However, not all producers are able to ramp up production for a variety of reasons ranging from being afflicted by adverse weather conditions to internal capacity constraints. ESDM has suggested that coal miners are likely to only increase production by approximately 25 million tonnes.
⁶ Berita Satu (August 15, 2018).
⁷ PT PLN has noted that if the DMO policy were to be repealed and the fuel price regulation remains unchanged until 2019, PT PLN would be exposed to an additional financial cost of more than IDR 30 trillion per year. Given PT PLN is required by the Government to keep electricity prices constant, resources from the Budget are used to cover arrears payments.

3. The current account deficit widened with higher crude prices and continued strength in capital goods imports

A smaller goods trade surplus led the current account balance to deteriorate

Amid rising crude oil prices and continued growth in equipment investment which drives up imports of capital and intermediate goods, Indonesia's current account deficit widened to 2.3 percent of GDP¹⁰ in the four quarters through Q2 from 1.7 percent in 2017 and 1.4 percent in the same period a year ago (Table A.1). The deterioration in the current account balance was primarily driven by the goods trade surplus, which declined to 1.0 percent of GDP¹¹ (Figure A.14). Although exports of goods accelerated, they continued to be outpaced by imports. Slightly larger services and primary income deficits linked to seasonal factors¹² also contributed to the wider current account deficit. Overall, the balance of payments recorded a deficit of 0.2 percent of GDP in Q2 2018, compared to a surplus of 1.1 percent in 2017 and 1.6 percent in Q2 2017¹³.

Figure A.14: The goods trade surplus declined, leading to the deterioration of the current account balance
(four-quarter rolling sum, percent of GDP)



Source: BI, World Bank staff calculations

Note: Data points show the sum of the last four quarters, divided by the GDP for the last four quarters.

Table A.1: Indonesia's Balance of Payments (BOP)

(percent of GDP, four-quarter rolling sum, unless otherwise indicated)

	Q22017	Q32017	Q42017	Q12018	Q22018
Current account balance	-1.4	-1.3	-1.7	-2.0	-2.3
Goods	2.0	2.1	1.8	1.5	1.0
Services	-0.7	-0.7	-0.8	-0.8	-0.7
Primary income	-3.1	-3.1	-3.2	-3.2	-3.1
Secondary income	0.4	0.4	0.4	0.5	0.5
Capital and financial account	3.1	3.0	2.9	2.4	2.3
Direct investment	1.8	1.8	1.9	1.9	1.7
Portfolio investment	2.1	1.8	2.0	1.3	0.5
Other investment	-0.8	-0.6	-1.1	-0.7	0.1
Errors & omissions	-0.1	-0.2	0.0	-0.1	-0.1
Overall balance	1.6	1.5	1.1	0.3	-0.2
Current account balance, in USD billion	-4.7	-4.6	-5.8	-5.7	-8.0
Capital and financial account, in USD billion	5.3	10.2	6.9	2.4	4.0
Overall balance, in USD billion	0.7	5.4	1.0	-3.9	-4.3

Source: BI; World Bank staff calculations

¹⁰ Comparing Q2 2017 with Q2 2018, the quarterly current account deficit widened from 1.9 to 3.0 percent of quarterly GDP.

¹¹ Comparing Q2 2017 with Q2 2018, the quarterly goods trade surplus shrank from 1.9 to 0.1 percent of quarterly GDP.

¹² Payments of primary income tend to increase in Q2 as dividend payments to foreign investors and interest payments are typically made in June each year. Similarly, imports of travel-related services tend to rise in June as more residents travel abroad during the Lebaran festive period.

¹³ The overall balance recorded a surplus of 0.3 percent of quarterly GDP in Q2 2017, compared to a deficit of 1.6 percent in Q2 2018.

Total imports continued to outpace total exports

Nominal growth in total imports of goods and services continued to outpace that of their total exports for the fourth consecutive quarter. Total exports picked up by 12.4 percent yoy in Q2 from 10.0 percent in the previous quarter, driven mostly by exports of goods. Services exports decelerated slightly, but remained in double-digit territory. Meanwhile, total imports accelerated to 22.9 percent in Q2 from 19.6 percent in Q1, as imports of goods offset a deceleration in imports of services.

Higher oil prices led to a surge in oil and gas exports...

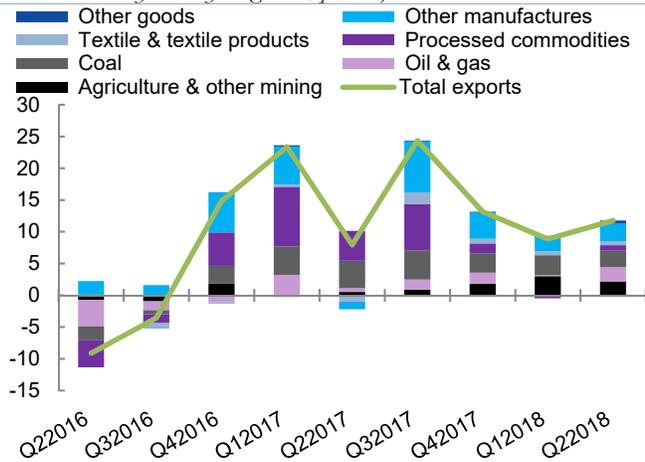
Despite rising global trade tensions, exports of goods accelerated to 11.8 percent yoy in Q2 from 8.9 percent in Q1. This was mainly due to commodity-linked exports, which contributed two-thirds of export growth (Figure A.15). Oil and gas exports surged by 30.8 percent, helped both by a rebound in volumes and higher average prices during Q2 than in Q1. Coal exports remained robust, but contributed less to growth than in Q1. On the manufacturing side, exports of textiles and other manufactured goods (especially processed foods, vehicles, and vehicle parts) accelerated. Exports of processed foods was partly linked to recent increases in foreign direct investment (FDI) into the sector.

...but also to an increase in imported fuels, contributing to the acceleration in imports

Higher oil prices and the continued strength of capital goods imports also led to a larger import bill. Overall, goods imports accelerated to 26.6 percent yoy in Q2 from 19.7 percent in Q1. In contrast to Q1, however, imports of fuel and lubricants – especially for consumption – contributed significantly to growth in Q2 (Figure A.16).¹⁴ In total, oil and gas-related imports soared by 45.6 percent yoy in nominal terms, from 6.0 percent in the previous quarter. Imports of capital goods remained robust, accelerating to 38.8 percent yoy from 26.7 percent in the previous quarter. These imports appeared to be linked to investments in electricity and transportation infrastructure, as monthly BPS data from April and May indicated increased imports of specialized and metalworking machinery, aircraft and aircraft parts, and electrical machinery. Imports of intermediate inputs, especially of industrial supplies, also remained high.

Figure A.15: Export growth was broad-based, but higher oil prices boosted oil and gas exports...

(contributions to year-on-year growth, percent)

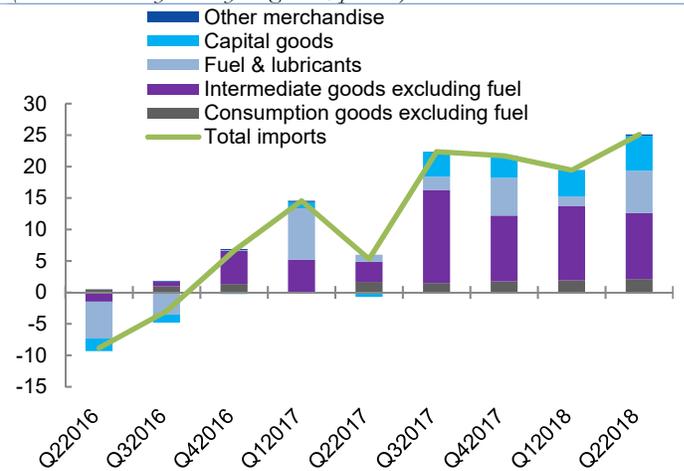


Source: BI, World Bank staff calculations

Notes: "Other manufactures" includes paper, furniture, plastics, processed foods, and chemicals

Figure A.16: ...as well as imports of fuel and lubricants, which contributed to the acceleration in imports

(contributions to year-on-year growth, percent)



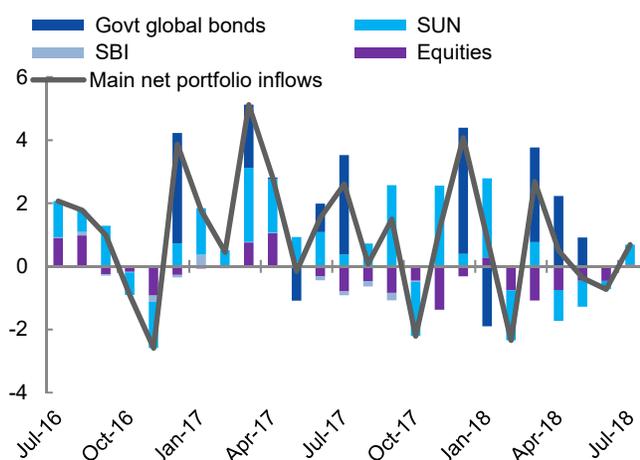
Source: BI, World Bank staff calculations

¹⁴ The Government has announced the mandatory use of blended biodiesel starting September 2018 in the hope that this measure will reduce reliance on imports of gasoil.

Despite continued outflows in portfolio investment, the financial account surplus rose

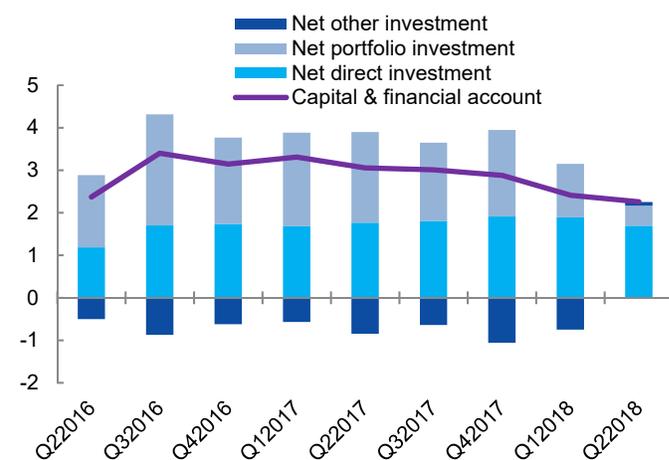
Net capital flows totaled USD 4.0 billion in Q2 2018, lower than USD 5.3 billion in Q2 2017. As pressures from the normalization of U.S. monetary policy and uncertainty generated by “trade wars” intensified in June, foreigners continued to exit emerging markets as an asset class. Indonesia was no exception and registered USD 1.6 billion of equity outflows over the quarter (Figure A.17)¹⁵. Nonetheless, net portfolio investment registered a small but positive balance of USD 53.6 million. Inflows of other investment also increased, though partially from Bank Indonesia’s (BI) transactions of swaps and term deposit facilities with domestic banks. Overall, the capital and financial account recorded a surplus of 2.3 percent of GDP in the four quarters through to Q2, lower than 3.1 percent of GDP in Q2 2017 (Figure A.18)¹⁶. Overall, international reserves fell to USD 118.3 billion, but are sufficient to finance government external debt repayments and imports for 8 months. The decline of USD 6.2 billion in reserves over the quarter was the largest seen since Q3 2015, as the Bank Indonesia intervened in currency markets to cushion the depreciating Rupiah, avoiding excessive volatility.

Figure A.17: Foreigners sold Indonesian debt and equities in H1 2018...
USD, billion



Source: BI, World Bank staff calculations
Note: Sertifikat Bank Indonesia (SBI) and Surat Utang Negara (SUN) are local currency bonds

Figure A.18: ...but the financial account remained in surplus due to inflows of portfolio and other investments in Q2
percent of GDP



Source: BI; World Bank staff calculations

Foreign direct investment rose

Foreign direct investment (FDI)¹⁷ totaled USD 5.5 billion in Q2, up from USD 3.7 billion in Q1 (Figure A.19). The manufacturing sector continued to be the main recipient of FDI, likely due to large investments in grain mill factories this quarter¹⁸. Agriculture-related sectors also posted close to USD 1 billion in net flows, while net investment in the mining sector finally turned positive after several months of regulatory uncertainty. Nonetheless, Indonesia still attracts relatively little FDI compared to peers¹⁹. Net direct investment (direct investment in Indonesia less Indonesian direct investment abroad) was 1.7 percent of GDP in the four quarters through Q2²⁰, and has not been sufficient to finance the current account deficit since Q1 2018 (Figure A.20).

¹⁵ July data, however, started to show a reversal, with positive flows from foreign purchases of equities and SUN bonds (see Figure A.3).

¹⁶ The quarterly capital and financial account surplus declined from 2.1 percent of quarterly GDP in Q2 2017 to 1.5 percent of GDP in Q2 2018.

¹⁷ Expressed on a net basis.

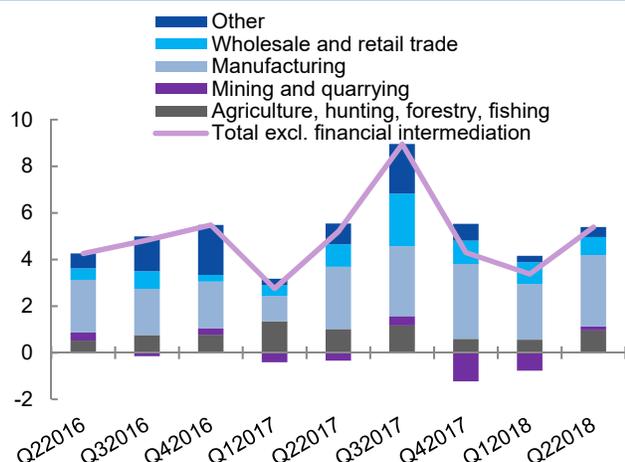
¹⁸ As indicated by data from the Investment Coordinating Board, BKPM.

¹⁹ FDI into Indonesia averaged 2.1 percent of GDP over 2013-2017, compared to Malaysia (3.5 percent), Brazil (3.7 percent), and Vietnam (5.7 percent). See WDI, World Bank staff calculations and also World Bank (2017) for a more detailed discussion on the drivers of FDI in Indonesia.

²⁰ Comparing Q2 2017 with Q2 2018, quarterly net direct investment fell from 1.7 percent to 0.9 percent of quarterly GDP.

Figure A.19: Net foreign direct investment (FDI) increased, mostly in the manufacturing sector...

USD billion

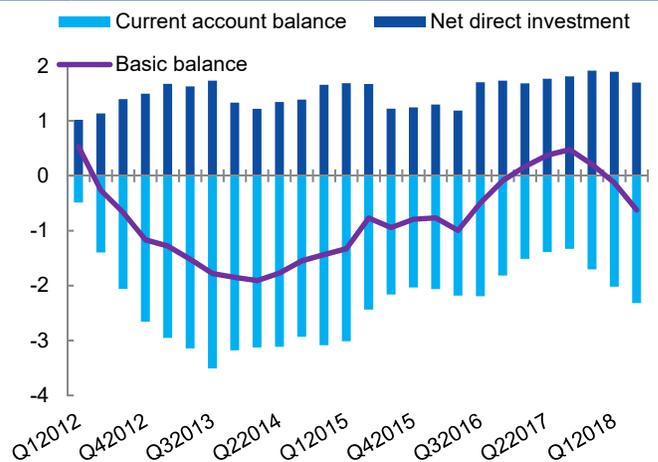


Source: BI, World Bank staff calculations

Note: Excludes financial intermediation, which experienced large one-off outflows in Q4 2016. Wholesale and retail trade includes repair of motor vehicles, motorcycles, and personal and household goods. Other includes health, education, social, community, and personal service activities.

Figure A.20: ...but net direct investment has not covered the current account deficit in recent quarters

percent of GDP



Source: BI, World Bank staff calculations

Note: Basic balance is the sum of current account balance and net direct investment.

Box A.4: How will trade wars affect Indonesia?

The United States has recently increased – or threatened to increase – the level of import protection vis-à-vis major exporters to the United States, chiefly China. Specifically, the United States has increased import tariffs by 25 percentage points on almost 1,300 products imported from China through two rounds of measures. On July 6th, the United States began applying tariffs on USD 34 billion worth of these Chinese goods; while the rest of the measures were imposed on August 23rd.¹ China started applying the same measures on equivalent amounts of imports from the United States; while the United States has also threatened to target an additional USD 200 billion worth of Chinese imports with similar tariffs. In May, the United States had already imposed new tariffs of 25 percent on steel and 10 percent on aluminum vis-à-vis all countries except the European Union, Canada and Mexico.

The Indonesian economy may be affected by these ‘trade wars’ through four channels:

- **Financial market uncertainty:** with greater uncertainty over global trade, investors may withdraw from riskier investments including emerging market equity and debt, exacerbating volatility in capital flows; the slow growth of exports and the expanding trade deficit as well as the low influx of FDI make Indonesia particularly vulnerable to this channel.
- **Direct trade channel:** Indonesia might benefit from higher exports to the United States and China, as both countries substitute away from each other towards other suppliers. Our estimates suggest that the expected drop of Chinese exports to the United States for products that Indonesia also exports to the U.S. market is worth USD 3.6 billion, or 0.4 percent of Indonesia’s GDP.
- **Indirect trade and growth channels:** In the short to medium term, Indonesia’s exports may be lower because of lower demand for intermediate inputs within supply chains, and importantly from reduced economic activity in the United States and China. Given the relatively low share of domestic value added linked to Chinese and U.S. demand, this is likely to be a relatively muted channel. At the same time commodity prices may also slump if specific commodities are targeted – as in the case of soybean, which Indonesia is a large importer of - or from lower growth and consequently lower commodity demand from China;
- **Direct investment channel:** In the near term, greater uncertainty may dampen prospects of direct investment globally, as risk premia increase and investors wait for greater clarity. In the medium-term, however, trade wars should accelerate the process of Chinese investment overseas, as Chinese firms seek to expand to other markets, including as a potential way to by-pass U.S. import tariff hikes. The potential for the relocation of Chinese investments to Indonesia would be meaningful even though not as high as the potential for Vietnam and Malaysia, whose export baskets are more similar to the Chinese one. Both countries are also more integrated into global and regional supply chains.

Indonesia can deploy several policies to mitigate the heightened external uncertainty. It can help potential domestic producers to replace Chinese exporters to the United States by facilitating access to the necessary imported inputs. This also includes ensuring availability of finance, including trade finance, required for the additional production and exports. More broadly, deepening the financial sector will provide additional buffers against volatility and increase the efficiency of the economy. Indonesia could also aim to attract potential investors trying to bypass U.S. tariffs by reducing restrictions to investments in the relevant sectors, including foreign equity limits, local content requirements and cumbersome investment permits.

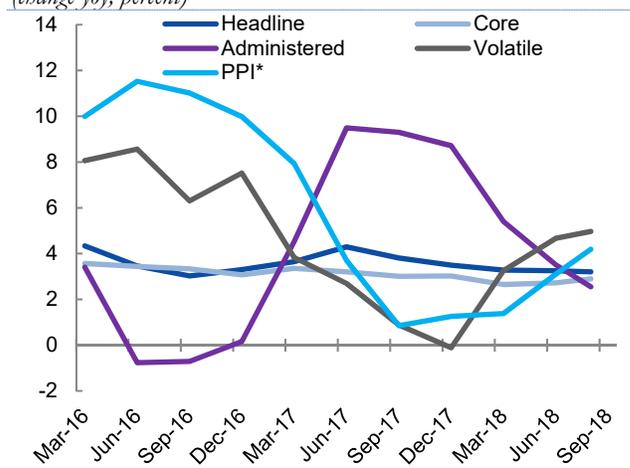
¹ See the complete lists of goods published by USTR here (first tranche): USTR (June 20, 2018) and here (second tranche): USTR (2018).

4. Headline inflation remained unchanged in Q2

Headline inflation remained unchanged in Q2, as smaller price increases on electricity and fuel offset higher food price inflation

Headline inflation remained low, averaging 3.3 percent yoy in Q2 2018, the same as Q1, despite a weakening rupiah and a recent increase in the producer price index (Figure A.21). The headline reading, the lowest since Q4 2016, was largely due to smaller increases in administered prices, such as for subsidized fuels, electricity billing rates, and transport fares. These smaller price increases were partly due to the high base effects from the triple hike in electricity tariffs in H12017 and partly due to government policy²¹. Despite higher global crude prices, increases in domestic retail fuel prices were mostly unchanged across fuel product categories. Subsidized premium gasoline (RON-88) remained fixed, and unsubsidized fuels such as RON-92 grew by only 0.1 percent yoy in Q1 and Q2, respectively (Figure A.22).

Figure A.21: Headline inflation remained low in Q2
(change yoy, percent)



Source: BPS; World Bank staff calculations
Note: PPI* stands for Producer Price Index; only the General Non-Oil & Gas category is used here. Food prices are a weighted average of the raw and processed food price components of CPI

In contrast, volatile inflation increased in Q2, averaging 4.7 percent yoy compared to 3.3 percent in Q1. This was partly driven by greater increases in food prices. The retail price of chicken grew by 12.4 percent and of eggs by 13.3 percent in Q2, following strong growth of 8.9 percent and 11.3 percent in Q1, respectively (Figure A.23). Apart from food, transportation and communication costs also saw greater increases in Q2, rising 1.8 percent up from 1.6 percent in Q1. Both food and transportation inflation were driven by Hari Raya celebrations in June as Indonesians travelled around the country visiting relatives²².

Recent monthly inflation figures continue the Q2 pattern

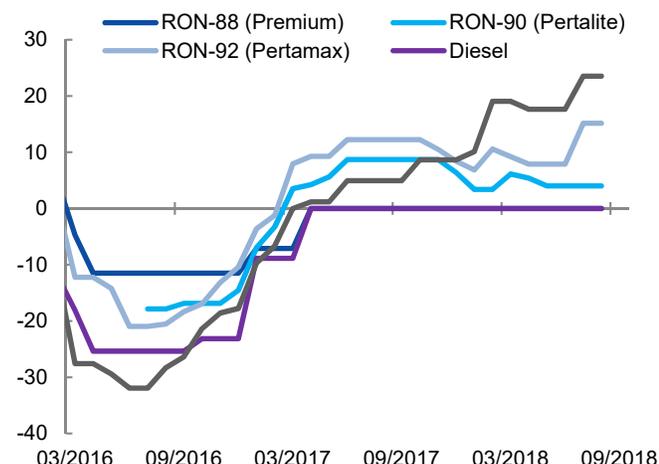
Recent monthly inflation figures tell a similar story. While housing, electricity, gas, and fuel prices saw an increase of only an average of 2.0 percent yoy in July and August, food inflation was relatively stronger, averaging of 5.1 percent over the same period. Within fuel components, the rapid increase in RON-92 by 15.2 percent yoy in July may be a sign that the unsubsidized fuels are adjusting upwards closer to global market prices in H2 (Figure A.22). Nevertheless, headline inflation in July and August remained low at 3.2 percent, well within BI's inflation target range of 2.5 to 4.5 percent.

²¹ The Government has announced a commitment to stabilizing prices for electricity and certain types of fuels until at least end of 2019. See The Jakarta Post (March 6, 2018).

²² Indonesia Investment (July 28, 2018).

Figure A.22: Despite rising global oil prices, there were smaller increases in retail fuel prices in Q2, with subsidized categories remaining flat

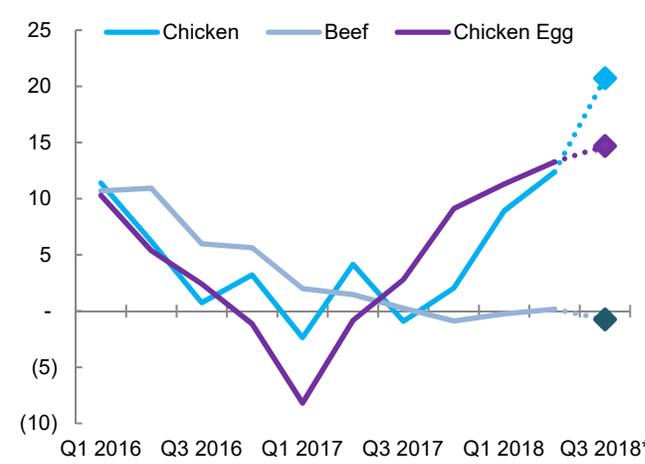
(percent, yoy growth, monthly)



Source: CEIC; World Bank staff calculations

Figure A.23: Retail prices of chicken and eggs continued to increase in Q2

(percent, yoy growth, quarterly)



Source: CEIC; World Bank staff calculations

Note: Q3 2018* includes July–August data only

5. Indonesia macro-financial conditions generally tightened

Indonesia’s macro financial conditions generally tightened in Q2

Despite faster domestic credit growth, Indonesia’s macro-financial conditions generally tightened in Q2, in line with global financial market volatility. Several concurrent external factors led investors to exit emerging markets as an asset class for traditional safe-haven destinations. Apart from surging bond yields across all tenors, these moderate capital outflows resulted in the further weakening of the Rupiah, leading BI to hike the benchmark interest rate by a cumulative 100 basis points in Q2 and another 25 basis points in August. Meanwhile, the financial system still demonstrated sound fundamentals with the continued increase in credit growth. The non-performing loan ratio decreased slightly, and the capital adequacy ratio remained stable.

The Rupiah depreciated further in nominal terms, in line with other emerging market currencies

Faster-than-expected monetary policy normalization in advanced countries, uncertainty related to escalating trade protectionism, and volatility associated with other large emerging markets such as Argentina and Turkey have led to capital flows from emerging markets to traditional safe-haven destinations. The Rupiah has continued to depreciate against the U.S. Dollar in Q2, sliding 4.8 percent over the quarter, and reaching IDR 14,404/USD at the end of June, the lowest in almost three years, and substantially larger than the 1.3 percent depreciation in Q1.

The Rupiah continued to decline into Q3, hitting IDR 14,927/USD in the first week of September, its lowest since the Asian Financial Crisis, after the Turkish lira dragged down other emerging market currencies.

The Rupiah’s depreciation in Q2 was less severe than that of the EMCI, possibly signaling a resilient investor

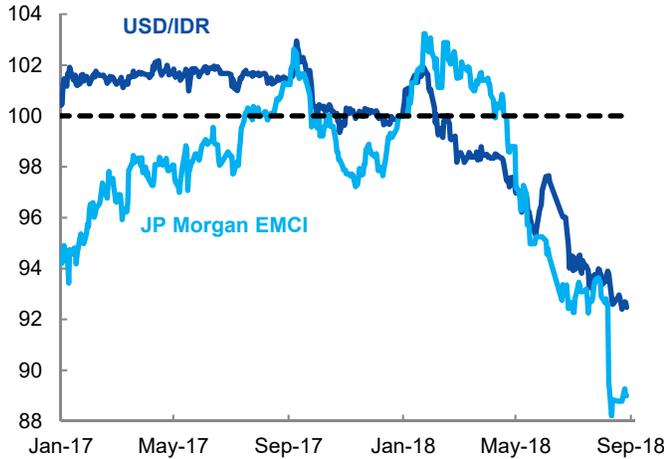
Movements in the Rupiah were in line with those of other emerging markets, represented by JP Morgan’s Emerging Market Currency Index (EMCI)²³, which also saw a significantly larger depreciation in Q2 than in Q1 (Figure A.24). However, reflecting Indonesia’s sound fundamentals and pro-active policy responses, the Rupiah’s decline in Q2 (before large devaluations in Turkey and Argentina) was less steep than that of the EMCI, with the latter declining by 8.7 percent. The overall depreciation of the EMCI in H1 2018 was 8.0 percent,

²³ The currencies included in the EMCI are the Brazilian Real, Mexican Peso, Chilean Peso, Chinese Renminbi, Indian Rupee, Singapore Dollar, Turkish Lira, Russian Ruble, Hungarian Forint and South African Rand. The steep depreciation in the EMCI were partly attributed to the recent sharp fall of the Turkish lira.

appetite for Indonesian assets

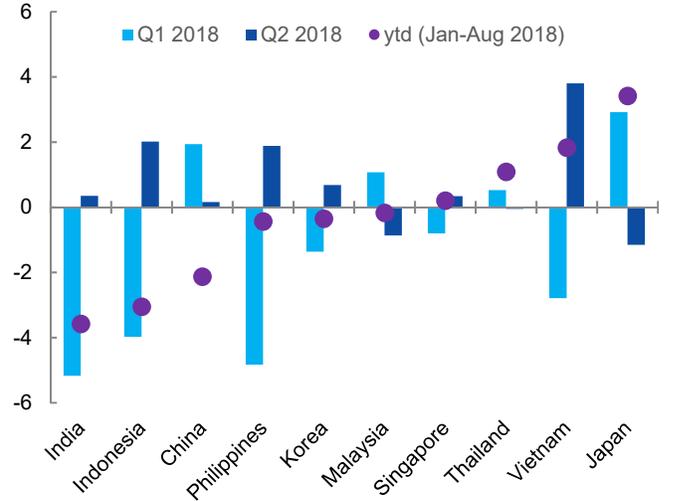
compared to the Rupiah’s drop of 7.3 percent over the same period. The downward trend of EMCI has carried over to Q3 as the index hit a record low in the first week of September, after falling by 3.3 percent in a single day in mid-August due to the plunging of the Turkish Lira.

Figure A.24: Both the Rupiah and emerging country currencies depreciated further against the U.S. Dollar in Q2
(index, January 1, 2018 = 100)



Source: JP Morgan; World Bank staff calculations

Figure A.25: Despite appreciating in Q2, the Rupiah generally depreciated in 2018 in real effective terms
(percentage change)



Source: JP Morgan Real Effective Exchange Rate, CPI based (2010=100)
Note: Downward movement represents a depreciation.

In real effective terms, despite a temporary appreciation in Q2, the Rupiah depreciated in 2018. After a depreciation of 4.0 percent in Q1, the Rupiah saw a real appreciation of 2.0 percent in Q2 2018, one of highest in the region (Figure A.25)²⁴. However, compared to its value in the beginning of the year, the Rupiah depreciated 3.0 percent in year-to-date terms.

The spread between Indonesian bond yields and the U.S. bond yields widened since the beginning of Q2

Volatility also carried over into the bond market, with both Indonesian and emerging market bond yields increasing in Q2 (Figure A.26). After rising 30 basis points in Q1, Indonesian 10-year bond yields rose by 121 basis points in Q2, reaching 8.2 percent, the highest since the end of 2016²⁵. Meanwhile, the Emerging Market Bond Index Plus (EMBI+) yield rose 73 basis points in Q2, higher than the 45-basis point increase in Q1.

The higher yields for Indonesian bonds reflect higher currency rather than credit risk (Figure A.27), which is in line with the recent ratings upgrades²⁶ from various rating agencies. The larger spread has carried over to Q3, reaching the widest of 372 percentage points in mid-August 2018 and remaining relatively unchanged since then.

²⁴ Based on J.P. Morgan REER. Bank for International Settlements (BIS) data show a similar appreciation with the Rupiah appreciating in 1.9 percent in real terms in Q2 after depreciating 3.9 percent in Q1.

²⁵ Reuters (2018). Indonesia central bank confident on yields as it assesses rate path.

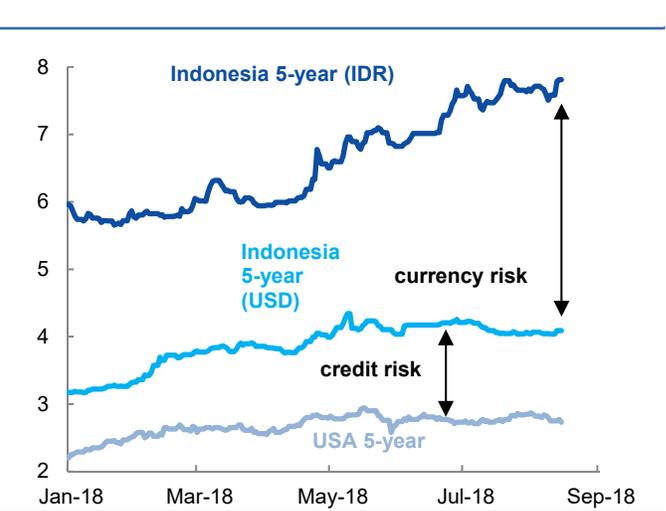
²⁶ There were four rating upgrades on Indonesia’s sovereign debt since May 2017, from Standard and Poors, Fitch, the Japan Credit Rating Agency, and Moody’s.

Figure A.26: The spread between Indonesian and emerging market bond yields with the U.S. bond yields has widened markedly



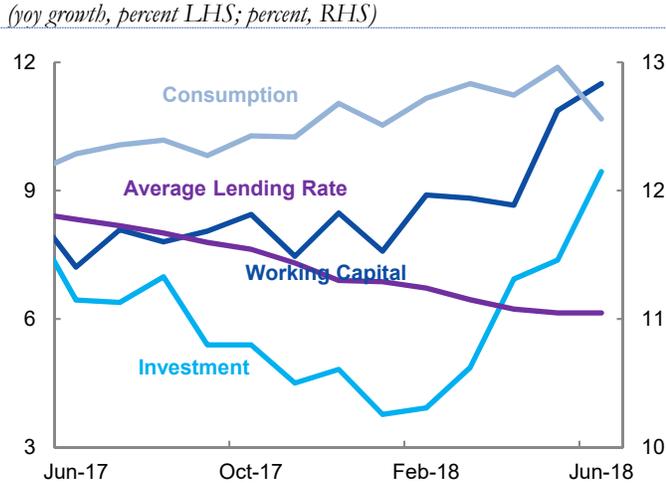
Source: CEIC, World Bank staff calculations
 Note: EMBI+ is a JP Morgan Emerging Market Bond Index yield to maturity

Figure A.27: The wider spread was primarily due to the heightened currency risk rather than credit risk



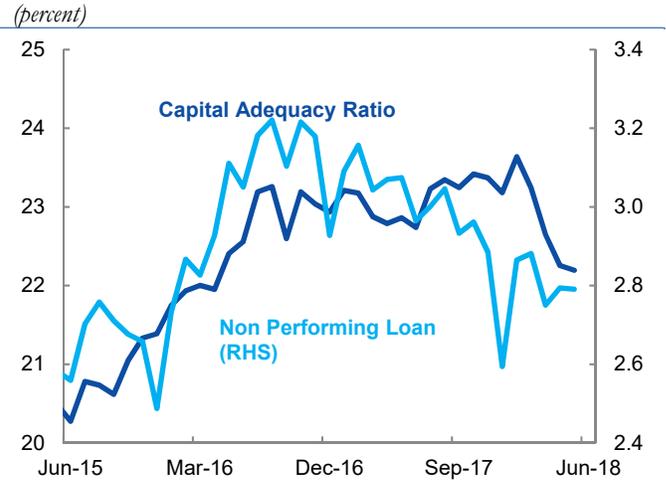
Source: CEIC, World Bank staff calculations

Figure A.28: Credit growth rates have been increasing in line with lower lending interest rates



Source: CEIC; Bank Indonesia; World Bank staff calculations

Figure A.29: Banking indicators pointed to well capitalized banks with low NPLs



Source: CEIC; Bank Indonesia; World Bank staff calculations

Bank Indonesia raised its benchmark rates three times in Q2...

After the holding its benchmark rate steady for seven months, BI responded to the pressures on the Rupiah by hiking the policy rate a cumulative 100 basis points in three board meetings²⁷ to 5.25 percent in Q2, and another 25 basis points in August. Maintaining the Rupiah exchange rate stability as well as a relatively subdued inflation were reasons for the hike²⁸.

The effect of the higher 7-day repo rate, however, has yet to be reflected by higher commercial interest rates. Average credit interest rates still declined by 30 basis points in Q2, though smaller than the decline in Q1 of 140 basis points. In line with the continued drop in credit interest rates, credit growth increased in Q2, averaging 9.6 percent yoy, higher than the pickup in Q1 at

²⁷ Including one additional meeting at the end of May 2018 after the new Bank Indonesia governor, Perry Warjiyo, was appointed.

²⁸ Bank Indonesia (2018).

8.1 percent. Consumption credit grew the most at 11.3 percent (Figure A.28), followed by working capital credit growth (10.4 percent) and investment credit growth (7.9 percent).

...and banking sector fundamentals remained sound

Meanwhile, the Indonesian banking sector remained sound in Q2. Non-performing loans stayed at an average of 2.8 percent, unchanged from Q1 (Figure A.29). This outcome continued the overall downward trend since the second half of 2016, reflecting continued improvements in lending quality. The capital adequacy ratio fell to 22.2 percent in Q2 from 23.2 in Q1 but remained well above the minimum Basel III-required level, indicating a well-capitalized banking system.

6. Strong revenue growth supported higher spending, mostly on social assistance and subsidies

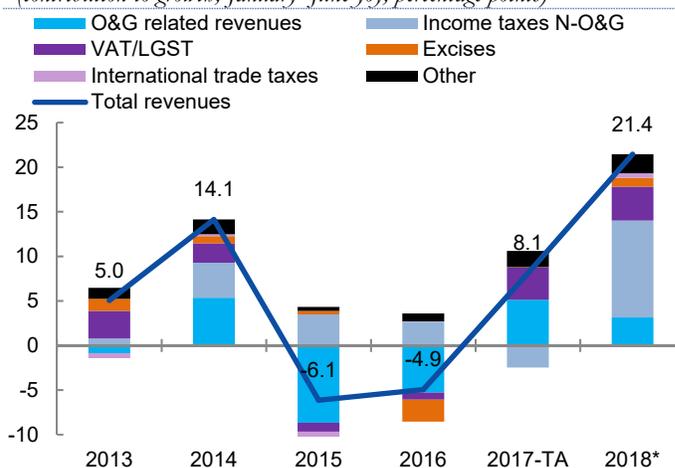
Strong revenue growth supported a pick-up in spending

Strong revenue performance was observed in the first half of 2018, partly owing to cyclical factors and partly due to ongoing reforms. While commodity prices boosted revenue performance, there was also evidence of reform impact, as the new tobacco policy contributed to double-digit growth in excise revenues and better compliance helped drive some of the increase in income taxes. Better revenues supported a pick-up in total expenditure, which grew almost twice as fast as in H1 2017 mainly due to social spending and energy subsidies. However, capital spending continued to contract. Overall, improved fiscal management through realistic revenue targets helped ensure that a revised budget was not necessary in 2018. A fiscal deficit of 2.1 percent of GDP is projected for 2018, 0.1 percentage point lower than the 2018 government target deficit of 2.2 percent of GDP.

Total revenues grew the fastest pace in the last ten years

Growth in total revenues year-to-date almost tripled to 21.4 percent yoy in nominal terms compared to the same period last year²⁹, the fastest pace in ten years³⁰ (Figure A.30). Total tax revenue collections grew by 21.6 percent yoy and contributed 16.6 percentage points to total revenue growth. Similar to the trend seen earlier this year, strong collections of

Figure A.30: Total revenues grew at the fastest pace in the last ten years, driven by non-O&G income tax and VAT
(contribution to growth, January–June yoy, percentage points)



Source: Ministry of Finance; World Bank staff calculations
 Note: O&G stands for oil and gas, N-O&G stands for non-oil and gas; LGST stands for luxury goods sales tax; “Other” includes: property taxes, other tax revenues; non-oil and gas non-tax revenues; other non-tax revenues (profits of public enterprises, revenues from Public Service Agency [BLU], and other non-tax revenues [PNBP]). 2017-TA means that total revenues exclude redemption fees collected under the Tax Amnesty Program. 2018* is a yoy comparison against 2017-TA.

²⁹ This comparison excludes redemption fees from the Tax Amnesty Program (TA) in 2017. If TA revenues are included, total revenues year-to-date grew at 16 percent yoy in nominal terms compared to 2017.

³⁰ The Government has collected IDR 833 trillion as of end-June, also the highest nominal level for the same period in the past ten years (2016-2017 revenues excluding collections from TA).

non-oil and gas income taxes³¹ and value-added taxes (VAT)³² continued to drive tax collections. Meanwhile, firmer global oil prices led to further improvement in oil and gas-related revenues³³, which contributed 3.1 percentage points to total revenue growth. Notably, January–June excise collections posted double-digit growth for the first time since 2013, making a small but positive contribution to overall revenue collections. This positive result was mainly due to tobacco excise tier simplification, the implementation of higher tobacco excise tariffs in January 2018, and the excise enforcement program³⁴.

Total government spending growth was mainly driven by social spending...

In nominal terms, total government spending rose by 5.7 percent yoy from January to June 2018, nearly double the growth rate seen in the same period last year (Figure A.31). Social assistance spending, one of the main drivers of this growth, jumped by 75 percent yoy, a six-fold increase from the same period last year, due to better disbursements of social assistance programs such as the subsidized health premium (PBI-JKN), the PKH, and non-cash food assistance (BPNT). The disbursement of PKH accelerated, as *BPJS Kesehatan* and the Ministry of Social Affairs³⁵ jointly verified and validated PBI-JKN beneficiaries' data³⁶. Overall, the disbursement of social spending (excluding subsidies) amounted to 55.5 percent of the 2018 Budget, compared to the average of 43.1 percent from 2014–17. Nonetheless, there were modest interruptions in the disbursement of BPNT due to challenges related to the readiness of local governments, verification of 2.4 million new beneficiaries, and the limited availability of *e-warong* in remote areas³⁷.

Personnel spending also picked up due to the disbursement of allowances for teachers, honorary staff, and retirees for the festive season, boosting overall government consumption (see section A.1). Material spending also grew due to early procurement of government goods and services, and spending related to the regional elections in April and to the Asian Games in August.

... and energy subsidies, especially arrears payments

Energy subsidies, especially from the payment of arrears, also drove overall growth in total expenditures. Subsidies on fuel and electricity increased in yoy terms for the first time since 2014 by 13.6 percent and 8.8 percent respectively, after consecutive years of declines (Figure A.31). This was driven by the government's current policy of maintaining fuel and electricity prices constant until end-2019 despite higher crude oil prices, as well as issues in the targeting of LPG 3-kg subsidies³⁸. Moreover, the government realized 100 percent of short-term arrears payments of IDR 12.3 trillion and IDR 5.3 trillion on fuel and electricity subsidies to Pertamina and PLN, respectively in H1 2018. These arrears payments appeared in the "other expenditures" category.

³¹ This is mainly driven by robust collections of corporate income taxes. As at end-May, income taxes from imports (Article 22 Import) and corporates (Article 25/29) grew by 30.8 percent and 29.3 percent yoy in nominal terms, respectively. Article 22 Import is a pre-payment of corporate income tax liabilities, which can be seen to be part of corporate income taxes for Indonesia.

³² VAT grew by 16.8 percent yoy as of end-May due to higher commodity prices. Meanwhile, gearing domestic demand drove the notable growth of import VAT which seen an increase of 25.6 percent yoy in nominal terms compared to the same period last year.

³³ O&G related revenues grew by 32 percent yoy in June, of which, 28.3 percentage points contributed by O&G NTR.

³⁴ The new tariff rules stipulate that cigarettes are bound to a 11.4 percent excise tariff. Meanwhile, the high-risk excise enforcement program (*Program Penertiban Cukai Berisiko Tinggi*) starting in Q3 2017 cracks down on illegal cigarettes that do not have a legal excise ribbon/stamp. Further excises on vaping liquid used in electronic cigarettes will also be effective starting October 1, 2018.

³⁵ Kontan (May 02, 2018).

³⁶ All PKH recipients are also recipients of PBI-JKN. See Tirto.id (August 15, 2018).

³⁷ Merdeka (April, 2018).

³⁸ Concerns over the validity of beneficiary data for LPG 3kg have hampered targeting of the LPG subsidies and delayed the implementation of the closed distribution system. As a measure to reduce the leakage of LPG 3-kg subsidies, starting July 1, 2018, the government allows a new variant of 3-kg LPG canisters (non-subsidized variant) to be distributed to the market, with hope more people opt for the new variant rather than the green 3-kg LPG one. See Kumparan (June 24, 2018).

Figure A.31: Social spending and fuel subsidies continued to drive higher spending growth

(January–June expenditure growth yoy, percent)

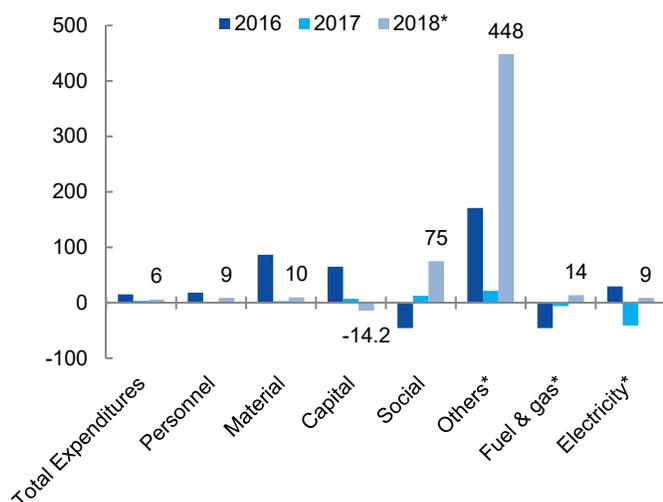
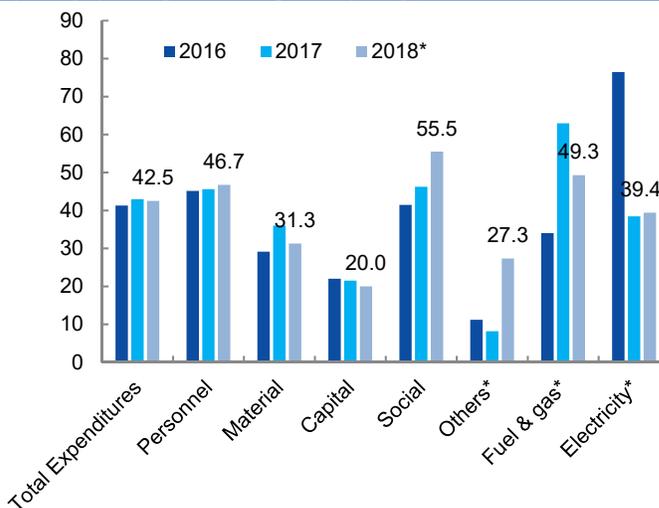


Figure A.32: Social, personnel, and electricity subsidy disbursements are higher

(January–June expenditure as percent of budget)



Source: Ministry of Finance, World Bank staff calculations

Notes: *Fuel & gas for 2018 is not the figure published by the Government’s APBN Kita, as it excludes arrears payments which are added back to “Others” spending category as per the Budget classification. *Others from 2017 onwards includes arrears payments from previous energy subsidies

Capital spending continues to contract, and disbursement remains sluggish

Capital expenditures, on the other hand, contracted by 14.2 percent in H12018, the largest yoy decline since 2014. Only a fifth of the 2018 allocation for capital expenditures has been disbursed as of end-June (Figure A.32). The sluggish disbursement was due to delays in the land acquisition process of some infrastructure projects³⁹, as well as the anticipation of new public procurement rules (Perpres 16/2018) starting July 2018⁴⁰. Slower disbursements may not necessarily equate delays in the physical progress of infrastructure projects, however, as the Central Government budget only finances about a third of total infrastructure investment. In addition, the physical progress of infrastructure projects under the Ministry of Public Works is reported to be faster than its financial disbursement⁴¹. The disbursement of capital expenditures is expected to pick up in H2 2018, as over 80 percent of budgeted spending has already been procured⁴².

The Government is on track to meet its budget deficit target for 2018

Given better than expected revenues, the Government expects to record a fiscal deficit of 2.1 percent of GDP in 2018, lower than the target of 2.2 percent of GDP and the 2017 deficit of 2.5 percent of GDP. The World Bank also maintains its fiscal deficit projection at 2.1 percent of GDP in 2018 but assumes slightly less optimistic revenue outturns and lower execution of total expenditures (97 percent), given the slow disbursement of capital expenditures so far. Overall, the Government’s debt financing requirements totaled IDR 176.2 trillion at the end of June 2018, 18.8 percent less than in the same period last year. The Government has already reduced the planned issuance of domestic bonds by tapping additional multilateral loans, as evidenced by the shift from net issuance of securities (–IDR 26.5 trillion) to foreign loans (+IDR 14.7 trillion) in H1 2018⁴³. Overall, lower borrowing requirements imply a more limited

³⁹ See Detikfinance (April 24, 2018).

⁴⁰ APBN Kita (July, 2018).

⁴¹ See PU-net (July 5, 2018). For the contractors of the projects to be eligible for payments, they have to meet certain physical development targets. Therefore, contractors tend to expedite the physical development of projects, but only collect payments closer to the project end (DIPA Tracking Study, 2009).

⁴² See APBN Kita (July, 2018). Additionally, 90 percent and 85 percent of budgeted capital spending for the Ministry of Public Works and Housing and the Ministry of Transportation, respectively, have been contracted. These ministries account for 54 percent of total Line Ministry capital spending (Ministry of Finance First Semester Budget Report, 2018).

⁴³ According to Kemenkeu (2018).

supply of IDR-denominated assets, which, along with efforts to stimulate the purchase of domestic bonds by residents, aims to limit the need for foreign portfolio inflows. The Government's prudent fiscal stance and debt management is warranted considering tightening global conditions and emerging market volatility.

Overall, the stock of total central government debt until June 2018 reached IDR 4,227.8 trillion or 29.8 percent of GDP, relatively unchanged from end of March 2018 and well below the legal threshold of 60 percent. 57 percent of debt is denominated in local currency and 10.1 percent will be due in the short-term⁴⁴, reducing exposure to exchange-rate risks.

7. Labor market conditions remain buoyant with the employment rate reaching a two-decade high

The employment rate inched up to 65.7 percent in February 2018, reaching a two-decade record high

Indonesia's overall employment rate rose to a two-decade record high of 65.7 percent in February 2018, up from 65.3 percent in February 2017⁴⁵. This was matched by the unemployment rate reaching an 18-year record low of 5.1 percent in February 2018, down from 5.3 percent in February 2017⁴⁶. Employment grew by 2 percent over the same period. Meanwhile, the broad labor force grew by 1.8 percent and the working-age population grew by 1.6 percent over the same period (Figure A.33)⁴⁷. The Labor Force Participation Rate (LFPR) increased from 69.0 percent in February 2017 to 69.2 percent from a year ago and has not changed significantly over the past 18 years from the LFPR of 69.3 percent in 2000. After the highest nominal monthly wage growth for employees since 2001 of 23.9 percent in February 2017, it saw a negative yoy growth of -1.8 percent in February 2018, partly due to high base effects and changes in the National Labor Force Survey (*Sakernas*) questionnaires⁴⁸.

Job creation saw a slowdown compared to last year, but was still strong relative to five- and twenty-year averages

There were 127.1 million employed individuals in February 2018, with the number of employed workers having grown by 2.5 million (2.0 percent) over the preceding year. Although this was higher than the long-term (1999–2018) average of 1,969,769 persons, the additional employment in February 2018 signals a deceleration in job creation back to a more normal pace compared with February 2017, when the number of employment grew by 3,891,152 persons (3.2 percent), the strongest growth since 2011⁴⁹. Restaurants and hotels and the manufacturing sectors recorded the largest absolute number of new jobs created, recording 1 million and 830,000 new jobs respectively. The utilities, restaurants and hotels, and information and communication sectors recorded the highest yoy growth of employment rates at 18.2 percent, 14.4 percent, and 17.7 percent, respectively.

⁴⁴ As of December 2017, the Government projects that 10.1, 25.4, and 39.8 percent of total public debt will be due in 1, 3, and 5 years, respectively. DJPPR (2018).

⁴⁵ The employment rate is the number of employed workers divided by the total working-age population. Its recorded value tends to be higher in the February *Sakernas* than the August *Sakernas*.

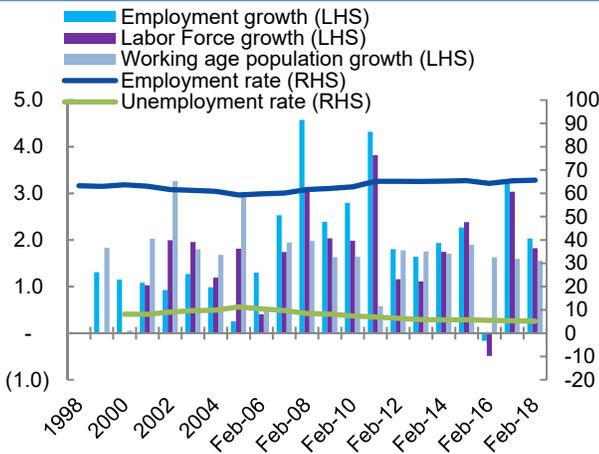
⁴⁶ Due to the lack of data in 1998–99, the analysis for unemployment rate can only be done from 2000 to 2018, instead of from 1998.

⁴⁷ In accordance with BPS convention, "working age" is defined as anyone aged 15 years or higher.

⁴⁸ Since 2015, there has been some changes in the sample, methodology and questionnaire of the *Sakernas*. Sample size change: In August 2016, the sample size was reduced from 200,000 households in August 2015 to 50,000 households. Since the stratification of the sample is based on industrial classification and location, and not the wealth index, the sample size change might affect the wage data. Questionnaire change: In August 2016, the question on income is the total income, but in February 2017, the question on income was broken down into (1) salary and allowances, (2) overtime pay, (3) transportation and meal allowances. In August 2017, the question on income was broken down into (1) salary and allowances, (2) overtime pay, transportation and meal allowances. In February 2018, the question on income was changed again to total income. These changes might affect the wage data. Methodological change: In 2015–2016, BPS-Statistics Indonesia uses the block census panel, while starting from 2017, the household panel has been used. Because of all these changes, some of the *Sakernas* data in some periods have to be treated with some caveats.

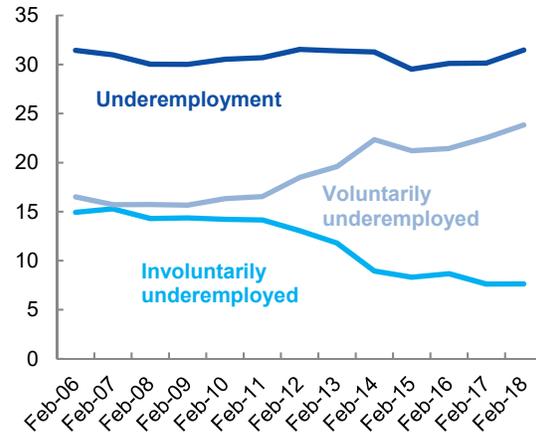
⁴⁹ The average additional employment per year since 1999, excluding February 2017, was 1,868,644 persons.

Figure A.33: Employment rate (unemployment rate) reached a two-decade record high (low) in February 2018
(employment rate, unemployment rate, growth in employment, labor force, and working age population, percentage points)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Figure A.34: There has been a significant and persistent increase in the share of voluntary underemployment vis-à-vis involuntary underemployment
(underemployment rate, involuntary underemployment rate, voluntary underemployment rate, percent)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Part-time employment has been on the rise, which may indicate the changing nature of jobs and workers’ preferences for more flexible jobs

Although the broad unemployment rate reached an 18-year record low in February 2018, the share of underemployed workers out of the total workforce, that is, those who worked less than 35 hours a week, expanded slightly to 31.5 percent in February 2018 from 30.1 percent in February 2017. The decade-long trend of the share of underemployed workers hovered at around 31 percent; however, since 2011, there has been a significant and persistent increase in the share of voluntary underemployment (“part-time”) vis-à-vis involuntary underemployment. The share of voluntary underemployment out of total employment increased from 16.5 percent in 2011 to 23.8 percent in 2017, while the share of involuntary underemployment was almost halved, declining from 14.2 percent to 7.6 percent (Figure A.34). This may indicate the changing nature of jobs, including emerging independent contractor jobs amidst the rise of gig economy, and workers’ preferences for more flexible work. Improved economic conditions may also be a factor for people’s preference for part-time over full-time jobs.

The decade-long term trend of Indonesia’s labor force participation indicates a sign of “aging”...

In absolute terms, there were 2,395,889 million entrants to the labor force over the past year, and 22.5 million entrants over the past decade. This 20.2 percent expansion in the labor force over the past decade represents a size surge in economic potential from the supply side of workers.

However, there is a sign of “aging” among these new labor force entrants, which is reflected in the changing shares of labor force by age group. The share of youth in the labor force (those between 20 and 39 years of age) has declined from 52.2 percent in the past decade to 47.8 in February 2018, while the share of the older workers (40-year-old and above) increased from 40.3 percent to 47.5 percent (Figure A.35). An aging labor force has both positive and negative implications for the economy, such as having more mature and experienced workers, but also higher rates of skill obsolescence and poorer health. Policies to encourage upskilling for older workers and to restructure the economy towards higher-productivity and capital-intensive sectors should be considered to attenuate the impact of the slowdown in the workforce growth.

...while the more recent evidence is suggestive of the low

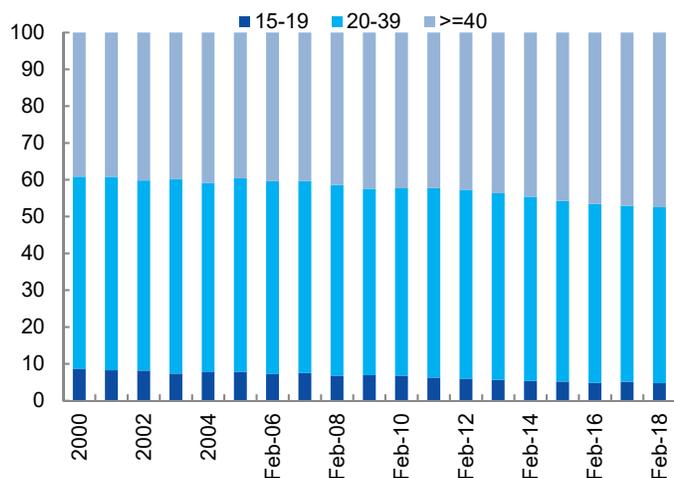
Besides an aging labor force, recent data suggest that new labor market entrants have lower skill levels, and the share of new labor market entrants with tertiary education has shrunk from 39 percent in February 2017 to 7 percent in February 2018 (Figure A.36). Meanwhile, the share of

level of skills among new labor market entrants.

new labor-market entrants with secondary education increased from 56 percent in February 2017 to 90 percent in February 2018. Over the past couple of years, there has been a net inflow of new labor-market entrants with primary education or lower, reversing the past three-year trend (2013–15) of a net outflow.

Figure A.35: There is a sign of “aging” among the labor force

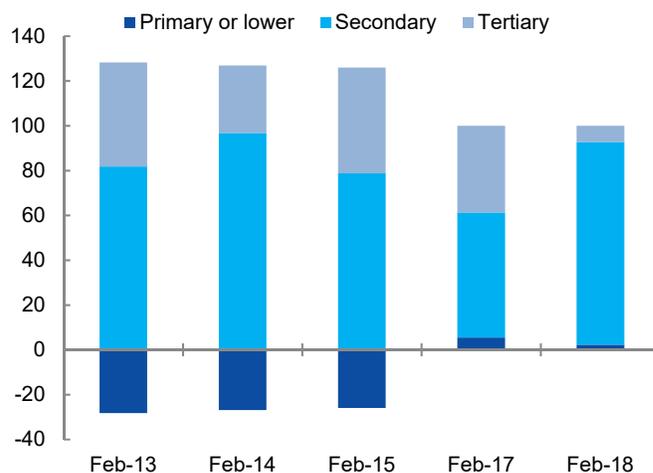
(share of labor force according to age group, percent)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Figure A.36: This year, the educational level of the new labor market entrants reversed the five-year trend towards a better-educated labor force⁵⁰

(share of new labor force entrants by educational level, percent)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

The composition of female employment has shifted from unpaid family worker to wage employees.

In terms of gender equality in the labor market, there has been a persistent, and even a widening gap in absolute terms, between the wages for men and women, although the ratio of men and women’s wages has been increasing. In February 2018, the average nominal monthly wages for women and men were IDR 2,213,282 and IDR 2,910,301 respectively. Since 2001, on average, men’s wages are around 25 percent higher than that of women.

Since the share of underemployed women is higher than that of men, differences between the average wages men and women are partly due to the differences in the shares of underemployment. However, if we decompose wages for full-time and underemployed employees, wage differences between men and women still exist and are significant. In February 2018, average wage for full-time male employees was IDR 2,984,526 while average wage for full-time female employees was IDR 2,380,790.

Female labor force participation rate (FLFPR) marginally increased from 55.0 percent in February 2017 to 55.4 percent in February 2018. Although FLFPR has reached its highest since 2000, FLFPR has been relatively sticky, with only a two percentage-point increase over the past 18 years. Indonesia’s FLFPR is among the lowest in the region. A study using panel data from 1993 to 2014 for Indonesia shows that women without immediate access to childcare are more constrained in participating in the labor market and this has economic costs due to foregone earnings and switching to lower-paying occupations after childbirth⁵¹.

On a more positive note, since 2000, the composition of female employment has shifted from unpaid family work to wage employment, with the share of female wage employees in total

⁵⁰ We exclude the 2016 observation due to suspected data quality issues that make the variable of interest look erratic relative to the trend. The inclusion of the observation will confuse readers.

⁵¹ Halim, D. (2017).

female employment increasing from 28 percent in 2000 to 35 percent in 2018, and the share of female unpaid family workers decreasing from 39 percent in 2000 to 26 percent in 2018.

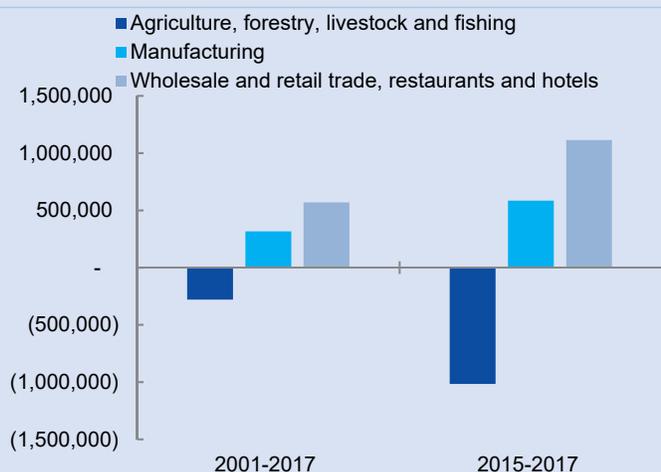
Box A.5: Acceleration of structural transformation and the revival of manufacturing employment?

The sectoral composition of job creation has been changing over the past three years, with jobs moving out of the agriculture, forestry, livestock, and fishing sector and into the wholesale and retail trade, restaurants, and hotels sector at an unprecedented pace (Figure A.37). Over the past three years, one million jobs were lost on average in the agriculture, forestry, livestock, and fishing sector, while 1.1 million jobs were created in the trade, restaurants, and hotels sector. These movements are significantly larger than the long-term trend since 2001, which saw only 279,785 jobs lost on average annually in the agriculture, forestry, livestock, and fishing sector and 569,680 jobs created on average annually in the trade, restaurants, and hotels sector. In terms of labor productivity (sectoral GDP per worker), this sectoral transformation is a positive sign, since the agriculture, forestry, livestock, and fishing sector has been a “productivity drag” on the economy: Though constituting around one third of total employment, labor productivity in the agriculture, forestry, livestock, and fishing sector is only one-fourth of that in the manufacturing sector and one-half of that in the services sector.

Over the past three years, the implied employment elasticity¹ in the manufacturing sector was significantly higher (1.2) than to its long-term trend (2000–17) of 0.5 and the pre-crisis period (1993–96) of 0.7². Preliminary reasons include the more subdued increases in the minimum wage. Using 2005–17 data, the correlation between the yoy growth of the minimum wage and in employment in the manufacturing sector was –0.86, which implies that an increase in the minimum wage does hamper job creation in the sector (Figure A.38). The trade, hotel, and restaurants sector, which is also obligated to comply with the minimum-wage policy, has also seen a significant increase in employment elasticity in the past three years to 0.8, double that of its long-term average (2000–17) of 0.4. Meanwhile, growth in the finance, business, insurance, and real estate sector has consistently been “pro-job” (with high employment elasticity) with a long-term (2000–17) employment elasticity of 1.4. The growth in the finance, business, insurance, and real estate sector has also been a source of formal female and youth employment³.

Figure A.37: In the past three years, structural transformation has been unprecedented

(average job creation, persons)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas)

Figure A.38: An increase in minimum wage hampers job creation in the manufacturing sector

(yoy growth in minimum wage, yoy growth in manufacturing employment, percent)



Source: National Labor Force Survey (Survei Angkatan Kerja Nasional, Sakernas), APINDO (minimum wage)

¹ Employment elasticity is defined as the percentage-point increase in employment for one percentage-point increase in GDP.

² Point-to-point employment elasticity estimate is sensitive to the choices of time period because of the normal year-to-year fluctuations.

³ Using a log-on-log regression model, following Kapsos (2005), employment elasticity (EE) analysis was conducted at both the national and regional levels, using the Indonesian Labor Force Survey data (Sakernas). The definition of formal is based on the simplified definition from BPS-Statistics Indonesia, in which formal workers include employees and employers assisted by permanent workers. In terms of the age groups, 15- to 24-years-olds are defined as young workers; 25–64, adult; and 65 and over, old. Source: Kapsos, Steven. 2015. The Employment Intensity of Growth: Trends and Macroeconomic Determinants. ILO

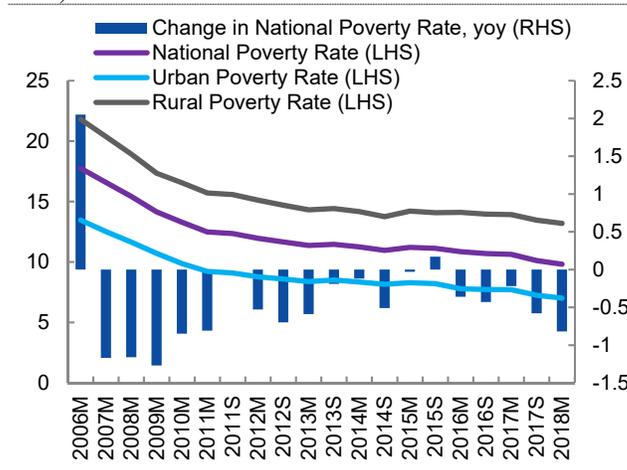
8. Indonesia’s poverty rate declined to a single digit for the first time

The poverty rate dropped to a single digit for the first time on record in March 2018

Indonesia’s poverty rate fell to a single digit for the first time on record. Statistics of Indonesia (*Badan Pusat Statistik*, BPS) reported that the poverty rate dropped from 10.6 percent in March 2017 to 9.8 percent in March 2018. The decrease was the largest yoy decline since March 2011, and the second largest since the period of marked poverty reduction in the late 2000s (Figure A.39). In absolute terms, the number of poor people reduced from 27.8 million in March 2017 to 26.0 million in March 2018. The poverty gap⁵² also fell from 2.5 percent in March 2017 to 2.4 percent in March 2018⁵³. The fall in poverty and the decline in the poverty gap partly resulted from the recent expansions in social assistance programs like PKH, which have reduced the probability of vulnerable households falling back into poverty.

Figure A.39: The March 2018 poverty rate saw the largest yoy reduction since March 2011

(poverty rate, percent, LHS; change in poverty, percentage points, RHS)



Source: National Socio-Economic Survey (Survei Sosial Ekonomi Nasional, Susenas)

The decrease in poverty is also due to buoyant labor market conditions (See Section A7). The employment rate reached a two-decade high of 65.7 percent in February, matched by the unemployment rate falling to an 18-year low of 5.1 percent. Moreover, 70 percent of the newly created jobs were in restaurants, hotels, and the manufacturing sectors, which are noted for employing low-skilled or unskilled workers who are typically at the lower end of the income distribution.

Poverty is still largely a rural phenomenon but the share of urban areas is increasing

Poverty is still largely a rural phenomenon both in absolute terms and in terms of poverty rates. In March 2018, 61.9 percent of the poor lived in rural areas; and the poverty rate in rural areas was 13.2 percent, nearly double that of the 7.0 percent in urban areas. Also, out of the 1.8 million people that were lifted out of poverty between March 2017 and March 2018, 70.9 percent lived in rural areas. Poverty is more dominant in the rural areas because they have relatively limited access to income-generating opportunities, markets, health and educational facilities, etc. when compared to urban areas. Although poverty is predominantly a rural phenomenon, the share of urban areas in poverty is gradually increasing – from 34.7 percent in March 2002 to 38.1 percent in March 2018, primarily due to urbanization.

While the national poverty rate declined, a few provinces saw an increase in poverty

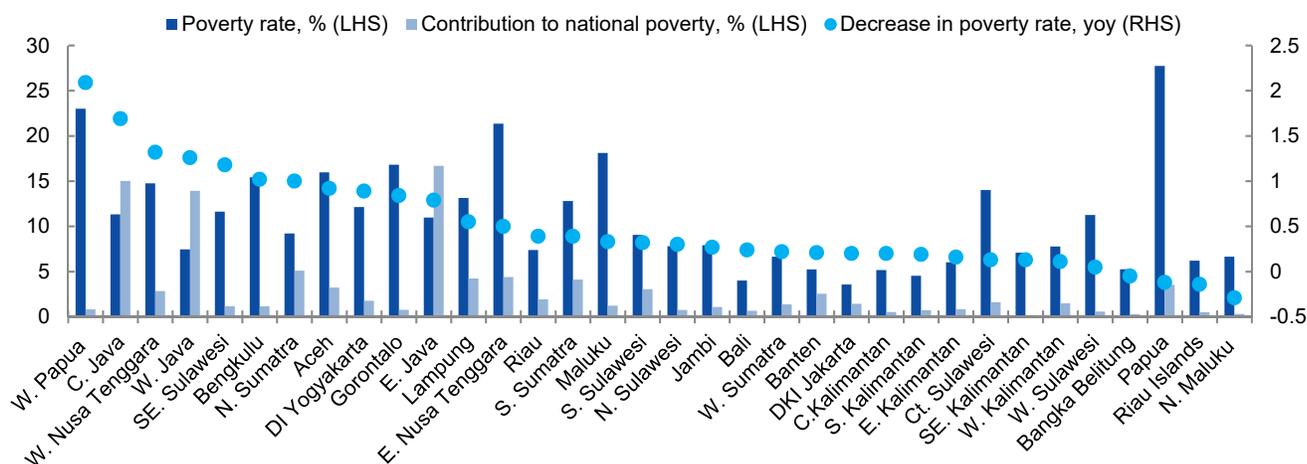
Although there was a substantial reduction in poverty at the national level, this was not uniform across Indonesia (Figure A.40). In fact, poverty was exacerbated in four provinces: Bangka Belitung Islands, Riau Islands, North Maluku, and Papua. The largest yoy reduction in poverty to March 2018 occurred in West Papua (2.1 percentage points) followed by Central Java, West Nusa Tenggara, South East Sulawesi, and Bengkulu. The rest of the provinces recorded poverty reductions of less than 1 percentage point over the same time period. Most of the poor were

⁵² The poverty gap refers to the extent to which the expenditure of poor households falls below the poverty line. It is expressed as a percentage of the poverty line.

⁵³ The poverty gap depicts the average minimum cost of eliminating poverty, hence the fall in the poverty gap means that, on average, the poor people in March 2018 are less poor compared to those in March 2017. This implies that it is easier/cheaper to eliminate poverty in March 2018 than it was in March 2017.

located in the Java Islands, but the poverty rate is highest in the Papua Islands (27.7 percent in Papua and 23.0 percent in West Papua).

Figure A.40: Although poverty declined nationally, the reduction was not uniform across the provinces
(poverty rate, percent; decrease in poverty, percentage points)



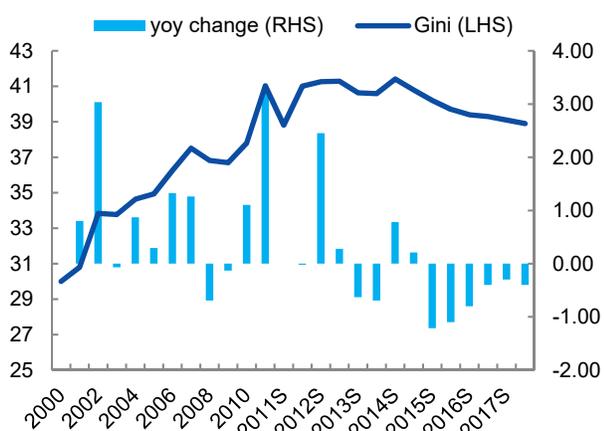
Source: National Socio-Economic Survey (Survei Sosial Ekonomi Nasional, Susenas) Note: M = March and S = September

Inequality continued to decline, mainly due to increases in the share of the bottom and middle 40 in national consumption

Inequality at the national level, measured by the Gini coefficient, declined from 39.1 in March 2017 to 38.9 in March 2018, thus continuing the downward trend that began in 2014 (Figure A.41). However, similar to poverty, the improvement was not uniform. Across the urban-rural split, inequality decreased in urban areas, but increased in rural areas. The decline in inequality at the national level and in urban areas occurred because the share of the bottom 40 percent and the middle 40 percent in total national consumption increased substantially relative to the share of the top 20 percent of the population (Table A.2). Inequality in rural areas increased because the share of the top 20 percent in total national consumption increased by 0.3 percentage points while the share of the bottom and middle 40 percent decreased by 0.2 percentage points each.

Figure A.41: Inequality continues to fall
(share of national consumption, percent)

Table A.2: The fall in inequality at the national level was driven by increases in the consumption shares of the bottom and middle 40 percent
(share of national consumption, percent)



	Period	Bottom 40	Middle 40	Top 20
National	Mar 2017	17.1	36.5	46.4
	Mar 2018	17.3	36.6	46.1
	Δ 2017-2018	+0.2	+0.2	-0.3
Urban	Mar 2017	16.0	36.9	47.1
	Mar 2018	16.5	36.9	46.6
	Δ 2017-2018	+0.4	+0.0	-0.5
Rural	Mar 2017	20.4	39.7	40.0
	Mar 2018	20.2	39.6	40.3
	Δ 2017-2018	-0.2	-0.2	+0.3

Source: Susenas
Note: M = March and S = September

Source: Susenas

9. Economic growth outlook and risks

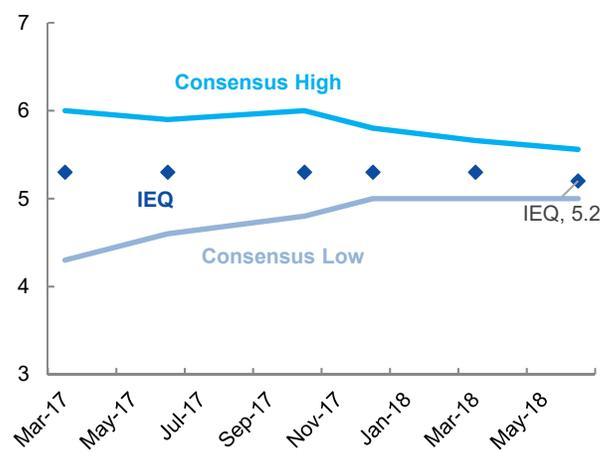
The outlook continues to be moderately positive, with larger downside risks

Despite a more volatile and uncertain global environment, the growth outlook for the Indonesian economy continues to be moderately positive on strong fundamentals and with stronger domestic demand being projected over the forecasting horizon. However, downside risks have increased.

Growth expected to reach 5.2 percent in 2018 and 2019 on stronger domestic demand

Economic growth is forecast to reach 5.2 percent this year and in 2019, and to gradually strengthen to 5.3 percent in 2020 (Table A.3). The forecast is also in line with consensus forecasts (Figure A.42). Continuing with the recovering retail and motorcycle sales and consumer confidence seen earlier this year, private consumption is expected to improve in light of next year's presidential elections, continued muted inflation, strong labor market conditions, and lower borrowing rates. Similarly, due to the expansion of fiscal space associated with ongoing revenue reform, government consumption is projected to strengthen. Amid continued strong capital imports and private sector sentiment, investment growth is expected to remain robust and rise, especially with reduced political uncertainty after the presidential elections.

Figure A.42: IEQ growth forecasts for 2018 remain in line with consensus forecasts
(real GDP, percentage change)



Source: Consensus Economics

Table A.3: Key economic indicators

(growth yoy, percent, unless otherwise indicated)

	Annual			Revision from previous IEQ
	2017	2018f	2019f	2018
1. Main economic indicators				
Gross Domestic Product (GDP)	5.1	5.2	5.2	0.0
Private consumption expenditure	5.0	5.1	5.1	0.1
Government consumption	2.1	4.0	4.5	1.0
Gross fixed capital formation	6.2	6.8	6.8	-0.8
Exports of goods and services	9.1	6.5	6.8	-0.5
Imports of goods and services	8.1	9.5	8.7	0.0
2. Other economic indicators				
Consumer price index	3.8	3.4	3.7	-0.1
3. Economic Assumptions				
Exchange rate (IDR/USD)	13381	14100	14250	230
Indonesian crude price (USD/bbl)	51	62.9	62.9	0.1

Source: BPS; BI; CEIC; World Bank staff projections

Note: 2017 figures are actual outcomes. F stands for forecast. Statistical discrepancies and change in inventories are not presented in this table. All GDP components are based on the latest GDP data. Exchange rate and crude oil price assumptions are average annual data. Revisions are relative to projections in the March 2018 IEQ

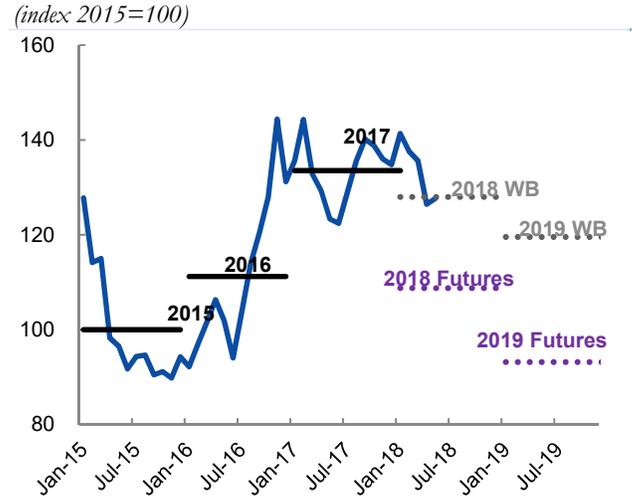
The terms-of-trade are projected to deteriorate

Terms-of-trade are projected to weaken for 2018

Indonesia's ToT are projected to weaken significantly in 2018 and 2019, a considerable swing from 2017 conditions⁵⁴. The changed ToT position is driven by expected movements in the prices of coal and palm oil, which are both declining and expected to continue to do so, as well as the recent moderation in crude oil prices, which in 2017 had been experiencing strong growth.

The 2018 year-to-date Net-Trade Weighted Price Index⁵⁵ is currently hovering below that of 2017, reflecting the projected pattern for 2018 (Figure A.43). The projected ToT for 2018 and 2019 are even weaker if future prices are assumed for coal, gas, and palm oil, instead of World Bank forecasts⁵⁶.

Figure A.43: The net trade-weighted price index – historical and forecast until 2019



Source: BPS; World Bank; investing.com; cmegroup.com; World Bank staff calculations

Note: Net trade-weighted price index is constructed over Indonesia's six major export commodities (rubber, base metals, coal, crude oil, liquified natural gas, and palm oil). 2018 and 2019 Futures projections use 2018 January–May actual historical data, and then futures prices thereafter.

⁵⁴ Terms of trade (ToT) refers to the relative price of imports in terms of exports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods.

⁵⁵ The Net Trade-Commodity Price Index or Net Trade Index (NTI) is defined as: $NTI_t = \frac{Weight_{i,p} \times Price_{i,t}}{Price_{i,t}}$ where $Weight_{i,p} = \frac{(E_{i,t}) - (I_{i,t})}{\sum(E_{N,t}) - \sum(I_{N,t})}$ and i= commodity type; t= month; p=period cycle (ex. 5 year average); N = number of commodities; T= base year; E=value of export; I=value of import.

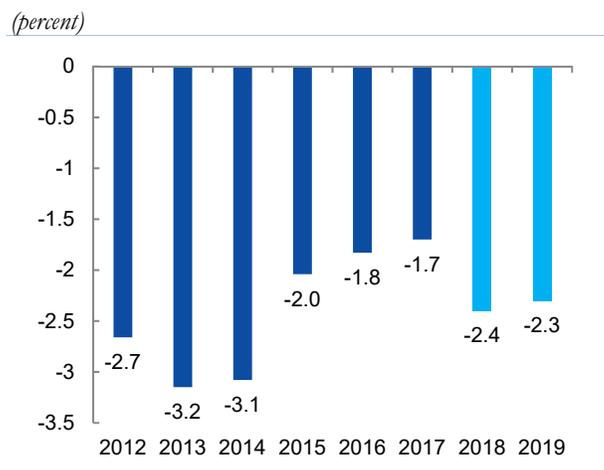
⁵⁶ The alternative NTI was calculated using average futures prices of coal (ICE, CSX), the average of the three benchmarks of oil, namely Brent, WTI and Dubai (ICE), and palm oil (Malaysian). The prices for the other key commodities were taken from World Bank (2018).

The current account deficit is expected to widen in 2018

The current account deficit is expected to widen in 2018

The current account deficit is expected to widen with weaker ToT, robust investment demand for imported capital goods, and easing growth of major trading partners. In line with the projected strengthening of crude oil prices but weakening easing of coal and palm oil prices towards the second half of the year, Indonesia's commodity ToT are expected to further weaken. At the same time, net export volumes are forecast to continue to drag on growth as growth eases in major trading-partner economies and strong investment demand lifts imports. The current account deficit as a share of GDP is therefore expected to widen to 2.4 percent this year and stabilize at 2.3 percent in 2019, tempered by the cheaper rupiah in real effective terms (Figure A.44).

Figure A.44: The current account deficit is expected to widen in 2018 and 2019 as import-intensive investment remains strong and terms-of-trade weaken



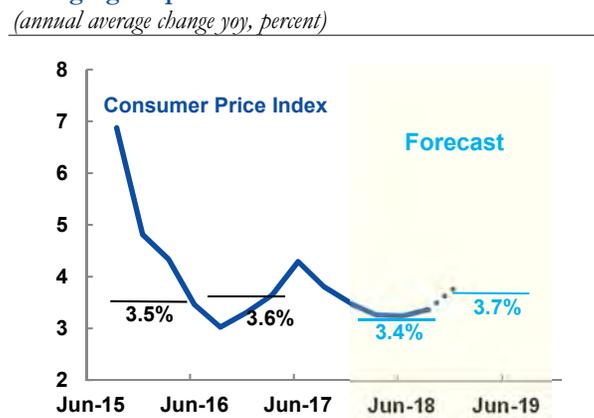
Source: CEIC and BI; World Bank Staff Calculations
 Note: 2018 and 2019 are forecasts

Consumer price inflation is expected to increase modestly, but within BI's target range

Consumer price inflation to stay within the range of BI target

While headline inflation has averaged 3.3 percent in the first half of the year, a modest increase is expected in H2 2018 due to the elections, Rupiah depreciation, and continued food price inflation. As a result, headline inflation for 2018 is forecast to average at 3.4 percent, lower than that of 2017. These moderately stronger inflationary effects are expected to carry over into next year, leading to a forecast of 3.7 percent for 2019 (Figure A.45). Upside inflation risks nevertheless exist, especially from imported inflation from the depreciation of the Rupiah and higher oil prices.

Figure A.45: Inflation is expected to rise in H2, averaging 3.4 percent for 2018



Source: BPS; World Bank staff calculations

Government budget deficit is set to narrow in 2018

Fiscal management improved; the World Bank projects a fiscal deficit of 2.1 percent of GDP in 2018

Fiscal management in H1 2018 improved due to realistic revenue forecasts, and as a consequence, a revised budget was not necessary in 2018, despite it being an election year. This is a significant departure from previous years, such as in 2016 when mid-year budget cuts were necessary. Total central government revenues are projected to grow this year by 12.1 percent yoy to IDR 1,868 trillion in nominal terms, driven largely by projected increases in collections from income taxes. The World Bank's revenue projection is 1.4 percent lower than that of the 2018 Budget. Meanwhile, total government expenditures are forecast to increase by 8.2 percent to IDR 2,172 trillion from 2017 in nominal terms, driven by projected increases in social spending, which is 2.2 percent lower than the 2018 Budget. Overall, the World Bank projects a

fiscal deficit of 2.1 percent of GDP, 0.1 percentage point lower than the 2018 budget target deficit of 2.2 percent of GDP (Table A.4).

Table A.4: The World Bank projects lower revenue and expenditure than in the 2018 Budget
(IDR, trillion, unless otherwise indicated)

	2017 Actual Audited	2018 Budget	2018 MoF Outlook	2018 World Bank	2019 Proposed Budget	Outlook 2018 vs Budget 2018 (%)	Proposed Budget 2019 vs Budget 2018 (%)
A. Revenues	1,666	1,895	1,903	1,868	2,143	0.4	13.1
(% of GDP)	12.3	12.8	12.9	13.0	13.3		
1. Tax revenues	1,343	1,618	1,549	1,520	1,781	-4.3	10.1
(% of GDP)	9.9	10.9	10.5	10.6	11.1		
Oil & Gas Income Tax	50	38	55	50	62	44.7	63.2
Non-Oil & Gas Taxes, o/w:	1,101	1,386	1,296	1,274	1,510	-6.5	8.9
Non-Oil & Gas income tax	596	817	706	700	827	-13.5	1.2
VAT/LGST	481	542	565	549	655	4.2	20.8
Land and building tax	17	17	17	17	19	0.0	11.8
Other taxes	7	10	8	8	9	-0.2	-0.1
International trade taxes	39	39	42	43	43	7.7	10.3
Excises	153	155	156	152	166	0.6	7.1
2. Non-tax revenues	311	275	349	342	361	26.9	31.3
(% of GDP)	2.3	1.9	2.4	2.4	2.2		
Natural resources revenues	111	104	169	161	178	62.5	71.2
Oil & Gas	82	80	144	130	148	80.0	85.0
Non-Oil & Gas	29	23	25	31	30	8.7	30.4
Other non-tax revenues	200	172	180	181	183	4.7	6.4
3. Grants	12	1	5	5	0.4	400	-60.0
B. Expenditures	2,007	2,221	2,217	2,172	2,440	-0.2	9.9
(% of GDP)	14.8	15.0	15.1	15.1	15.2		
1. Central government	1,265	1,455	1,454	1,407	1,607	-0.1	10.4
(% of GDP)	9.3	9.8	9.9	9.8	10.0		
Personnel	313	366	343	340	369	-6.3	0.8
Material	291	340	320	308	319	-5.9	-6.2
Capital	208	204	194	176	212	-4.9	3.9
Interest payments	217	239	249	227	275	4.2	15.1
Subsidies	166	156	228	230	221	46.2	41.7
Energy	98	95	164	176	157	72.6	65.3
Fuel	47	47	104	108	100	121.3	112.8
Electricity	51	48	60	68	57	25.0	18.8
Non-energy	69	62	65	55	65	4.8	4.8
Grants	5	1	2	1	2	100.0	100.0
Social	55	81	80	80	103	-1.2	27.2
Other	9	67	39	44	106	-41.8	58.2
2. Transfers to regions	742	766	764	765	832	-0.3	8.6
(% of GDP)	5.5	5.2	5.2	5.3	5.2		
C. Overall Balance	-341	-326	-314	-304	-297	-3.7	-8.9
(% of GDP)	-2.5	-2.2	-2.1	-2.1	-1.8		
D. Financing	367	342	314	304	297	-8.2	-13.2
1. Debt financing	429	399	387	386	359	-3.0	-10.0
SBN	441.8	415	388		386		-7.0
Foreign loans	-20	-18	-4		-27		0.5
Other	8	3	3		0.5		-8.3
2. Investment financing	-60	-66	-66		-75		13.6
3. Lending	-2	7	-7		-2		-128.5
4. Guarantee obligation	-1	1	-1		-		
5. Other financing	0.4	0.2	0.2		15		74
Assumptions							
Real GDP growth rate (%)	5.1	5.4	5.2	5.2	5.3		
CPI (%)	3.6	3.5	3.5	3.5	3.5		
Exchange rate (IDR/USD)	13,384	13,400	13,973	14,100	14,400		
Crude-oil price (USD/barrel)	51	48	70	65	70		

Source: Ministry of Finance and WB Staff calculations.

While the outlook for economic growth remains positive, downside risks have increased

External risks to the outlook include continued volatility in the financial and capital markets, tightening financial conditions, and weakening consumer confidence

Risks to Indonesia's growth outlook are strongly tilted to the downside amid heightened global uncertainty. The ongoing normalization of U.S. monetary policy, along with volatility associated with other large emerging markets, such as Argentina and Turkey, are leading investors to exit emerging markets, including Indonesia, as an asset class. As a consequence, the Rupiah has been depreciating and bond yields rising. While a cheaper currency would help contain the current account deficit, it may also dampen consumer confidence and increase inflation, leading to slower consumption growth. Higher bond yields would lead to higher financing costs for corporates, which could dampen the nascent credit recovery and hence private investment. Escalating protectionism also poses a strong risk to Indonesia either through slower growth of the export sector or negative spillovers from slower regional growth – in part through weaker commodity prices.

Monetary and fiscal policy could be further tightened weighing even more on growth

As economic conditions and inflation in the United States continue to strengthen, U.S. monetary policy normalization may not only proceed but perhaps even accelerate. There is therefore a risk that pressures from capital outflows could intensify, further weighing on the Rupiah and Indonesian bond prices. In the face of accelerated capital outflows, the government is likely to further tighten both monetary and fiscal policy to stem the outflows, weighing on growth in the immediate and medium-term.

Import restrictive measures could boost inflation; weigh on potential growth

In light of the depreciating rupiah, to ease imports and therefore the widening current account, the government has proposed and implemented measures that include sequencing infrastructure products to reduce related capital goods imports, increasing tariffs on consumer goods⁵⁷, and implementing import-substituting measures⁵⁸. Given the significant infrastructure gap in the country, these measures may have the unintended effects of weighing on potential growth and rendering longer-term consequences for the economy. Increasing tariffs on consumer goods could also lead to higher inflation, weighing on private consumption.

Table A.5: Comparison of selected macroeconomic indicators, Indonesia Then and Now

	September 2018	Taper Tantrum (2013)	Asian Financial Crisis (1998)
GDP growth (% yoy)	5.1	6.0	7.9
Credit growth (% yoy)	8.7	23.5	..
Current Account Deficit (% of GDP)	-2.3	-3.0	-2.7
Reserves (months of goods imports)	8.7	6.9	..
External Debt (% GDP)	33.0	32.9	62.1
Inflation (% yoy)	3.4	4.2	5.2

Source: BPS, BI through CEIC; IIF

Note: Taper tantrum period started in May 2013 while AFC period started in July 1997. Monthly variables: Credit growth, reserves, inflation (using 12 month average prior to the onset of the event). Quarterly variables: GDP growth, CAD (using 4 quarter average prior to the onset of the event). Yearly variables: Fiscal balance, external debt (using a 1 year figure prior to the onset of the event). Reserves is computed as in Reserves in year t / Goods Imports in year t+1. Official reserve assets that include foreign currency reserves, IMF reserves position, Special drawing rights, Gold and other reserve assets.

Risks associated with a financial crisis remain small

While downside risks to economic growth are greater, risks associated with a financial crisis for Indonesia remain small, due to strong policy coordination and firmer economic fundamentals, especially when compared to the periods of the Taper Tantrum and the Asian Financial Crisis (Table A.5). Coming off from a record high at the beginning of the year, foreign reserves remain at a healthy 8.7 months' worth of imports. Despite intervening to minimize volatility, BI has been conserving reserves by allowing market-driven depreciation rather than defending the

⁵⁷ The Ministry of Finance has announced its intention to raise import tariffs on 900 consumer goods. Asian Nikkei (August 24, 2018).

⁵⁸ Beginning September 1, 2018, all vehicles and heavy machinery that have diesel engines in Indonesia will need to use diesel that contains fatty acid methyl ester (FAME), a type of fatty acid ester which is obtained from palm oil. This new rule is part of the Indonesian government's expanded B20 program that makes it mandatory for all vehicles to use biodiesel that consists of 20 percent local biodiesel and 80 percent petroleum diesel. See Indonesia Investments (August 31, 2018).

currency at a fixed exchange rate. Monetary policy has also been tightened to maintain interest rate differentials with the United States to tame capital outflows. Likewise, fiscal policy has been prudent; deficits and debt levels remain low with government debt at less than half of the legal threshold of 60 percent of GDP, of which 57 percent is denominated in local currency. At the same time, the banking and financial sector remains sound; credit growth is increasing but not rampant, and banks are well capitalized with few non-performing loans. Most importantly, with its focus set on maintaining stability, the Government is expected to continue tightening policy to stem capital outflows, even if it weighs on growth.

B. Making urbanization work for all Indonesians⁵⁹



Urbanization can be a powerful force for economic growth and poverty reduction, but when poorly managed, its associated congestion costs can undermine potential benefits and lead to greater segregation, isolation and inequality. Indonesia continues to urbanize at a steady pace, largely brought about by the conversion of formerly rural areas into urban settlements. While better economic opportunities in cities have helped many Indonesians escape poverty and join the middle class, urbanization in Indonesia has generally not been able to provide as many widely-shared benefits compared to some other countries in East Asia. Inequality within places has increased, driven in large part by disparities in human capital and lack of spatial integration within cities. Urban areas face strong and mounting congestion costs, as evidenced by the unmet demand for affordable housing that leads to the growth of slums, and by high levels of traffic congestion and pollution. To ensure that urbanization can work for all Indonesians, Central and local governments need to work together to enact policies that achieve three objectives: (i) converge and expand the delivery of basic services to ensure that all Indonesians can enjoy good quality education, health, water and sanitation services, thereby reducing the inequality of opportunity; (ii) connect and integrate within and between places; (iii) customize and target people and places that are likely to be left behind, such as those with disabilities or other groups that tend to be disadvantaged, as well as lagging regions of the country.

1. Urbanization is linked to more prosperity and less poverty, but congestion forces can undermine these benefits

Urbanization can generate agglomeration economies that enhance prosperity and boost growth

Cities are the economic, political and social pulse of countries. As people and firms start to cluster in settlements, urbanization fosters ‘agglomeration economies’: the spatial proximity of consumers, workers and firms creates an environment that is conducive to innovation and enhances productivity. Matching talent to jobs becomes easier, ideas and knowledge are exchanged more frequently, and firms share inputs, fostering the emergence of local suppliers. Urban areas offer more opportunities for specialization, enabling firms to realize larger economies of scale. Cities also tend to offer better amenities, as the fixed costs of providing infrastructure are spread over more people. Greater mobility and connectivity across places allow for a more efficient allocation of the factors of production, boosting the overall productive potential of the economy and create opportunities for greater prosperity.

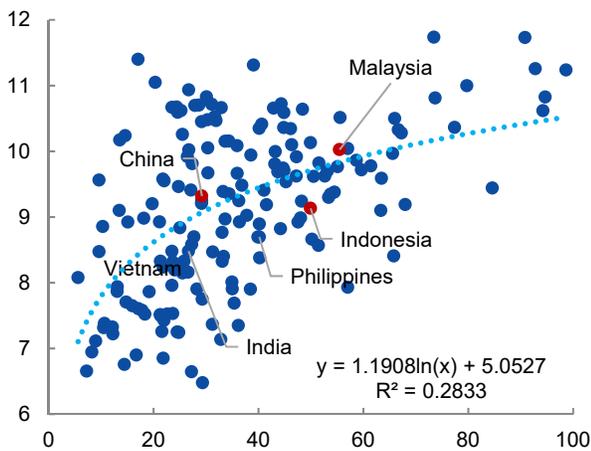
⁵⁹ Part B of the IEQ is based on, and previews, material from the World Bank’s forthcoming Indonesia Urbanization Flagship report. This is a product of the World Bank’s Poverty, Social, Urban, Rural and Resilience, and Macroeconomics, Trade and Investment Global Practices. Financial support from the Swiss and Australian Governments for the World Bank’s work on urbanization is gratefully acknowledged.

More urbanized countries have higher levels of income and lower levels of poverty...

Consistent with the existence of agglomeration economies, there is a strong positive relationship between the share of people living in urban areas and economic prosperity. Countries with a higher share of population living in urban areas have higher levels of income, as measured by Gross Domestic Product (GDP) per capita. There is also a relatively tight relationship between urbanization and poverty. Most countries that have eliminated poverty are heavily urban (Figure B.1 and Figure B.2). On average, a one percent increase in the share of urban population is associated with an increase in GDP per capita of 4 percent, and a reduction in the poverty headcount by 1.3 percent.⁶⁰ Similarly, within Indonesia, districts with higher shares of population living in urban areas also have higher per capita incomes and lower poverty rates⁶¹.

Figure B.1: Countries with higher shares of urban population tend to have higher levels of income...

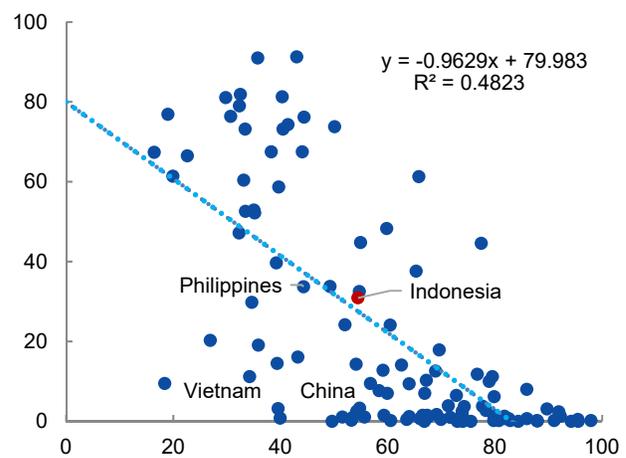
(y-axis, Log GDP per capita, 2016, 2011 international dollars; x-axis: urban population share, percent)



Source: Urban population share calculated based on application of the Dijkstra and Poelman (2014) algorithm to Landscan-2012 gridded population data. GDP per capita in constant 2011 international dollars from World Bank World Development Indicators (WDI). Note: GDP per capita data from 2016

Figure B.2: ...and lower levels of poverty

(y-axis, Poverty headcount ratio at USD 3.20 per day; x-axis: urban population share, 2016, percent)



Source: Urban population share calculated based on application of the Dijkstra and Poelman (2014) algorithm to Landscan-2012 gridded population data. Poverty rates from World Bank World Development Indicators (WDI). Note: Poverty data refer to latest year available between 2011-2016.

...but urbanization is also associated with congestion forces...

As cities become more crowded, many cannot support inhabitants' basic needs of clean air, drinking water and sanitation. Land and housing markets can become strained, leading to the emergence of sprawl and slums, and subsequently of crime, grime and disease. Urban areas are also more likely to suffer high levels of pollution, both from industrial activity and vehicle use, and are more vulnerable to the harmful effects of climate change and natural disasters. These congestion forces arising from urbanization act against agglomeration economies, constraining the prosperity benefits they generate and reducing the livability and inclusiveness of cities.

...that need to be managed through good policies and institutions

Although congestion forces are often associated with market failures, they can also be exacerbated by failures of policy. All cities suffer from congestion forces – indeed, the more successful a city is, the more attractive it will be to migrants and so the stronger the congestion forces will tend to be. However, the better a city is able to manage congestion forces with good policies and institutions, the higher the level of population and prosperity at which these congestion forces tend to balance off against agglomeration economies. It is not the absence of congestion forces per se that distinguishes London, New York, and Tokyo from Jakarta and

⁶⁰ Estimated from cross-country correlations using World Bank World Development Indicators data.

⁶¹ Estimated from cross-district correlations using data from BPS.

many other developing cities, but rather the fact that the former group have policies and institutions that more successfully offset congestion forces.

Urban areas are more prosperous than rural areas in Indonesia, but the process of urbanization has not benefited Indonesia as much as some other countries

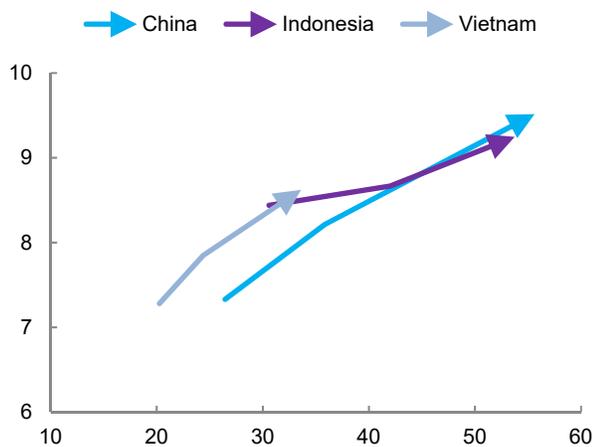
Although urban areas are generally more productive than rural ones (except in cases where mining or plantations dominate the economy), the urbanization process in Indonesia has not been associated with gains as large as in some other countries in the region. China urbanized only slightly more than Indonesia between 1990-2015⁶², yet it experienced a 9.1 percent annual growth in income per capita over this period – almost triple the pace in Indonesia (see Figure B.3). Vietnam similarly enjoyed 5.5 percentage points more growth despite experiencing a 13-percentage point smaller increase in the share of urban population. Moreover, although poverty fell substantially over 1990-2015, Indonesia has not seen as much poverty reduction as these countries. The share of the population living on USD 3.20 or less a day fell by 70 and 65 percentage points in China and Vietnam respectively over the period, compared to 43 percentage points in Indonesia (Figure B.4).

Better policies and institutions can help Indonesia make urbanization more inclusive, benefiting all Indonesians

This edition of the *Indonesia Economic Quarterly* assesses how Indonesia can make urbanization work for all Indonesians. While better economic opportunities in urban areas have supported growth and poverty reduction, there are large gaps both within and across places in terms of access to basic services and outcomes. The piece concludes with policy options that can help Indonesia make the most out of urbanization, framed through the three ‘C’s: (i) **converge and expand** the provision of good quality services such as education, health, and water and sanitation to all Indonesians, regardless of where they reside; (ii) better **connect and integrate** within urban areas, as well as across different types of urban and rural areas; and (iii) **customize and target** policy solutions for large metropolitan areas that span multiple districts, lagging regions and disadvantaged groups of people (e.g. those with disabilities, women, elderly, etc.).

Figure B.3: Indonesia has not gained as much economically for its degree of urbanization as China and Vietnam...

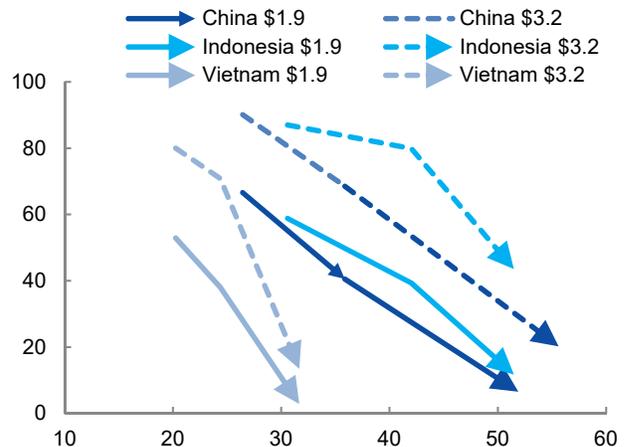
(y-axis, Ln GDP per capita in 1990, 2000 and 2015, using 2011 PPP; x-axis, urbanization rate in 1990, 2000 and 2015, percent)



Source: Calculations based on data from World Bank World Development Indicators.

Figure B.4: ...nor has poverty declined as much in these countries, given the degree of urbanization

(y-axis, share of population living on or under \$1.90 or \$3.20 a day in 1990, 2000 and 2012, percent; x-axis, urbanization rate in 1990, 2000 and 2012, percent)



Source: Calculations based on data from World Bank World Development Indicators
Note: Vietnam poverty rates are for 1992 not 1990.

⁶² China’s share of urban population grew by 29 percentage points over 1990-2015, compared with 23 percentage points in Indonesia over the same period.

2. Indonesia is urbanizing at a ‘normal’ pace, mostly through transformation of formerly-rural areas

Indonesia has urbanized rapidly since its independence in 1945...

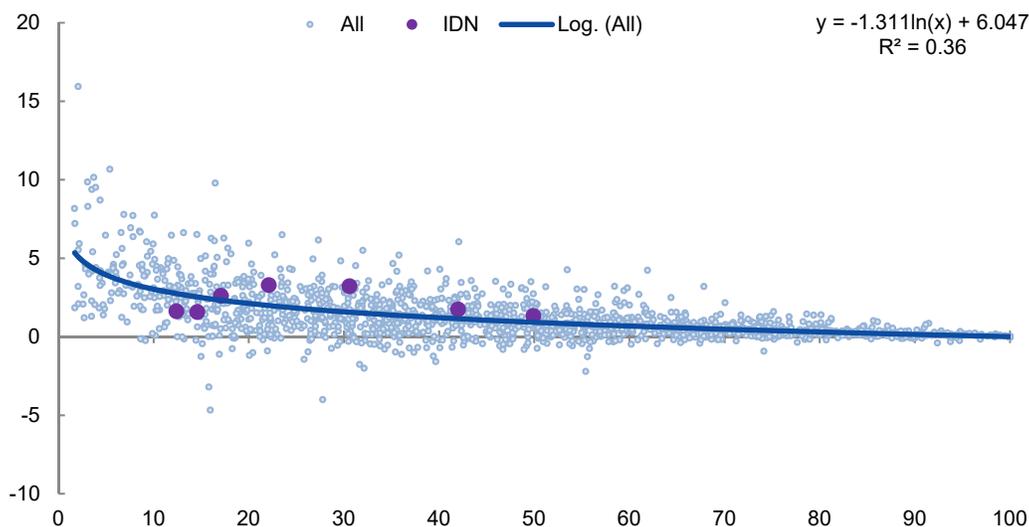
When Indonesia gained its independence in 1945, just one in eight people lived in cities, and the country’s entire urban population stood at around 8.6 million, roughly equivalent to Switzerland’s population today.⁶³ Since then, Indonesia has undergone a remarkable urban transformation. Today, nearly 55 percent of its population or nearly 148 million people lives in cities. In the 1950s and 1960s, Indonesia’s urbanization growth rate⁶⁴ averaged just over 1.5 percent a year. The pace then began to accelerate, averaging more than 3 percent a year in the 1980s and 1990s – faster than in other developing East Asian countries at the time, including China, and fast relative to Indonesia’s level of urbanization at the time (Figure B.5).

...but the pace of urbanization has moderated to more “normal” levels in recent decades

Since the turn of the century, however, Indonesia’s pace of urbanization has begun to slow, returning close to that seen in the 1950s and 1960s. Between 1990–2000 and 2010–2017, Indonesia’s pace of urbanization more than halved, lagging other countries in the region but in line with its level of urbanization⁶⁵. The recent moderation is therefore a return to what can be regarded as a “normal” or average pace of urbanization for the country (Figure B.5).⁶⁶

Figure B.5: Benchmarking Indonesia’s pace of urbanization against global experience, 1950-2015

(y-axis, growth rate of urban share, percent; x-axis, initial urban share, percent)



Source: Calculations based on United Nations World Urbanization Prospects 2018 (<https://esa.un.org/unpd/wup/>)

Note: Each data point shows the average growth rate of the share of a country’s population that lives in urban areas over a given time-period (y axis) relative to its urban population share at the beginning of that time period (x axis). Seven observations are recorded for each of 231 countries: for 1950–1960, 1960–1970, 1970–1980, 1980–1990, 1990–2000, 2000–2010, and 2010–2015. Growth rates are calculated as compound annual growth rates of the urban share of the population over 10-year intervals with the exceptions of 2010–2015.

⁶³ All population figures quoted in this paragraph are based on data from the United Nations’ World Urbanization Prospects 2018 database (<https://esa.un.org/unpd/wup/>).

⁶⁴ The growth rate of the share of the population that lives in urban areas.

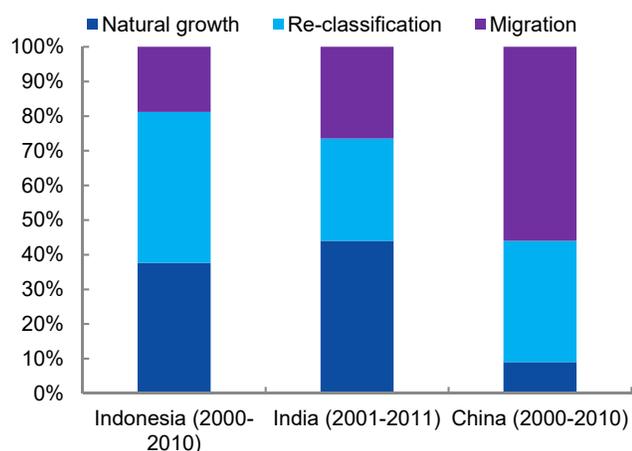
⁶⁵ Whereas during 1990–2000, it led China, Thailand, and Vietnam, by 2010–2017 its pace lagged all three.

⁶⁶ The same pattern of a slowing pace of urbanization since the turn of the century is also evident in the absolute growth of urban population.

Overall, urban population growth has been driven more by urbanization of previously rural areas, rather than by migration

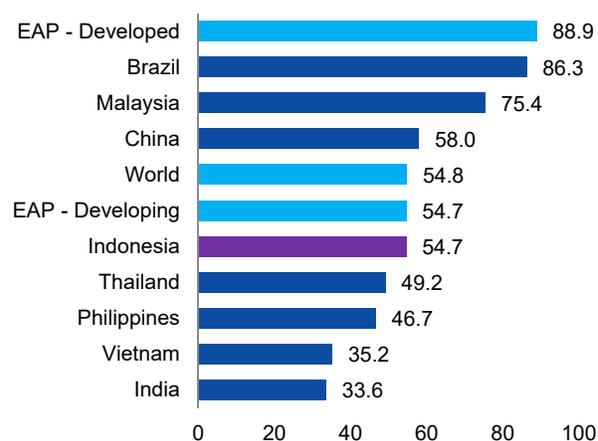
Urbanization⁶⁷ growth in Indonesia has primarily been driven by the densification of settlements, leading to their re-classification from rural to urban, followed by the natural growth of population in urban areas. These factors accounted for more than 80 percent of urban population growth in Indonesia between 2000 and 2010. By contrast, net rural-urban migration only contributed less than one-fifth of overall urban population growth in Indonesia between 2000 and 2010.⁶⁸ The role of migration in explaining urban population growth is relatively small in Indonesia compared to India and especially China (Figure B.6), although comparisons should be treated with care given differences in methodology.

Figure B.6: Migration has played less of a role in driving Indonesia’s urbanization, compared to China and India
(percent of urbanization)



Source: Derived from figures presented in Wai-Poi *et al.* (2018), World Bank – DRC (2014) and Pradhan (2013) for Indonesia, China and India respectively.

Figure B.7: Indonesia is at an intermediate stage of urbanization
(percent of population living in urban areas)



Source: Calculations based on the UN’s World Urbanization Prospects 2018 (<https://esa.un.org/unpd/wup/>).
Notes: EAP is the East Asia and Pacific region following World Bank country definitions. EAP-Developed includes only high-income economies in EAP; EAP-Developing includes only non-high-income economies in EAP.

Today, Indonesia is at an intermediate stage of urbanization...

Although it is more highly urbanized than other Asian countries such as India, Vietnam, the Philippines, and Thailand based on official national definitions of urban areas, urbanization in Indonesia is at a level that might be called intermediate. It still has a way to go to reach the level of urbanization in the developed countries of the East Asia and Pacific region, and in other more developed comparator countries such as Brazil. (Figure B.7)

...but urbanization is at a more incipient stage outside Java-Bali

While urbanization is at an intermediate stage for Indonesia as a whole and for the Java-Bali region, it is at a still incipient stage in the rest of the country⁶⁹. Java-Bali is the most populous of Indonesia’s island-regions and the most urbanized. It is the only one of Indonesia’s six island-regions where more than half of the population (60.8 percent) lives in urban areas.⁷⁰ Kalimantan is the next most urbanized island-region, with an urban population share of 43.5 percent in 2016

⁶⁷ The definition of urbanization in Indonesia used in this report follows the statistical definition (BPS Regulation 37/2010): This is based on a composite scoring system which assesses areas as either urban or rural based on their possession of certain “urban characteristics.” These are: (i) population density; (ii) the structure of the local economy; (iii) the existence of certain types of infrastructure (i.e. electricity and telephone networks); and (iv) the presence of certain urban amenities (e.g. schools, hospitals, hotels, cinema, shops, etc). Each area is assigned a score based on its characteristics and classified, for statistical purposes, as urban if its score exceeds a certain threshold.

⁶⁸ The decompositions of urban population growth are by Wai-Poi *et al.* (2018).

⁶⁹ The World Bank World Development Report (2009) defines areas of incipient urbanization as those with urban shares of about 25 percent, with low economic density. Areas with urban population shares of about 50 percent can be thought of as ‘intermediate’ urbanizers, while those that are ‘advanced’ have urban shares of about 75 percent or higher.

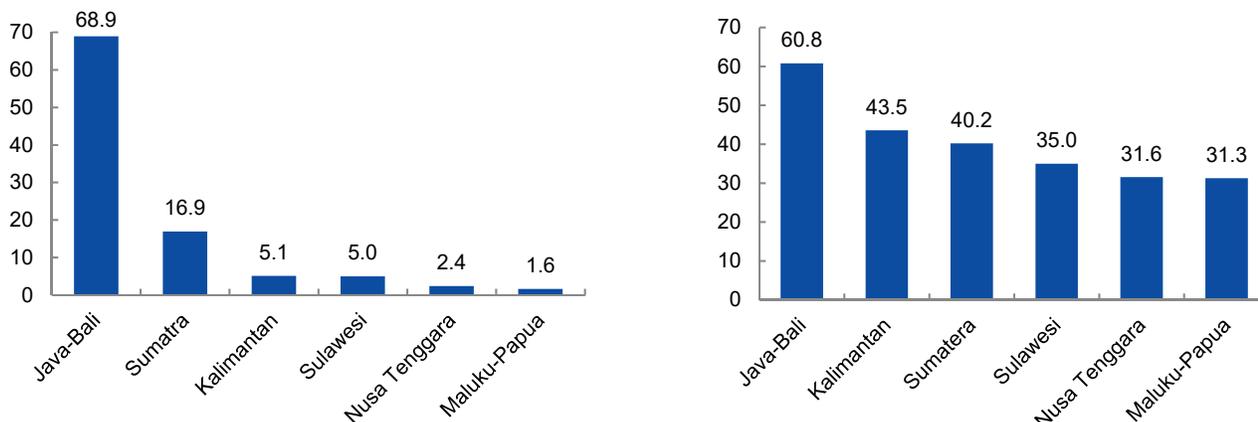
⁷⁰ Indonesia consists of more than 17,000 individual islands. Our grouping of these into island-regions follows, for example, World Bank (2012)

(Figure B.8). Nusa Tenggara and Maluku-Papua are the least urbanized, with fewer than one in three people living in towns and cities.

Figure B.8: While urbanization overall in Indonesia and on Java-Bali is at an intermediate stage, for the rest of the country it is still at an incipient stage

(share of national urban population, percent)

(share of population living in urban areas, percent)



Source: Calculations based on data from Indonesia's 2016 National Socio-Economic Survey (SUSENAS)

Economic characteristics and functions of urban areas vary across Indonesia's portfolio of places

Just as the pace of urbanization varies across island-regions, the economic characteristics and functions of Indonesian cities differ depending on their size. At the top of the urban hierarchy or 'portfolio' of urban places are metropolitan areas. This is typically led by the 'primate' city – often the dominant political, economic and cultural center of the country – followed by other large and medium-size cities that often serve as regional centers of economic activity⁷¹.

In Indonesia, half of the urban population lives in metropolitan areas. These can span multiple districts ('multi-district metros') or comprise of only a single district ('single-district metros'). For instance, the Jakarta metro area comprises 14 districts, whereas Palembang metro area only comprises a single district. Multi-district metros are further broken down into 'core' and 'periphery' districts, with the latter comprising districts that may be predominantly urban or rural. 'Periphery' districts are characterized by the fact that a large number of residents work or access services in the 'core' district.

The other half of Indonesia's urban population lives in non-metropolitan areas. About 57 out of these 434 non-metro districts are 'non-metro urban areas', or small cities and towns at the interface between rural and urban areas. These provide, for example, market centers for agricultural output produced in surrounding rural areas. The remaining districts are 'non-metro rural areas', where most of the population lives in rural areas.

Box B.1 explains Indonesia's portfolio of places in more detail.

⁷¹ In developed countries, medium-size and smaller cities tend to be more manufacturing oriented than larger cities, whose economies tend to be driven more by human capital-intensive tradable service activities, see World Bank (2008). This does not appear to be the case in Indonesia, where manufacturing tends to take place on the urban peripheries of multi-district metros.

Box B.1: Indonesia's portfolio of urban places, 2016

Four broad typologies of urban and rural places can be distinguished in Indonesia⁷².

- 1) **Multi-district metro areas** are large metropolitan areas with functional labor markets that cut across multiple districts, as defined using commuting flow data. In turn, a multi-district metro area consists of the following types of sub-areas:
 - a. **Metro core** corresponds to the district within the metro area that exhibits the highest average population density,⁷³ except in the case of Jakarta where the core is taken to be *Daerah Khusus Ibukota* (DKI, or special area) Jakarta.
 - b. **Metro periphery** corresponds to the non-core districts within the metro area. These districts are linked to the core through strong commuting flows. Metro periphery districts can be either predominantly urban ('urban periphery') or rural ('rural periphery')⁷⁴, where a predominantly urban district is one in which at least 50 percent of the population lives in urban areas.
- 2) **Single-district metro areas** are *Kota* districts⁷⁵ with a population of at least 500,000 and average population densities that resemble those of multi-district metro areas, but whose functional labor markets are, nevertheless, confined within the administrative boundaries of a single district.
- 3) **Non-metro urban areas** are districts that do not meet the criteria to be classified as either a single-district metro area or part of a multi-district metro area, but within which most of the population lives in urban areas. Such districts may be either *Kota* or *Kabupaten*. Thirty-two of 57 non-metro urban areas are *Kota*.
- 4) **Non-metro rural areas** are non-metro districts within which most of the population lives in rural areas. In practice, all such districts are *Kabupaten*. The majority of these districts (354 out of 377) are *Kabupaten*.

	Type of urban place	Description	Number of districts	Share of national urban population (%)
Metropolitan areas	Multi-district metro			
	Core	District with highest population density (except in the case of Jakarta, where DKI Jakarta is the core)	DKI Jakarta & 20 others	20.1
	Urban periphery	Predominantly urban, non-core districts	27	27.0
	Rural periphery	Predominantly rural, non-core districts	20	4.9
	Single-district metro			
		Predominantly urban Kota districts with ≥ 500,000 population & ≥ 1,500 population density	7	4.9
Non-metropolitan areas	Non-metro			
	Urban	Predominantly urban non-metro districts	57	15.3
	Rural	Predominantly rural non-metro districts	377	27.9

Source: Calculations based on data from Indonesia's 2016 National Socio-Economic Survey (SUSENAS) for % national urban population

Notes: Typology derived following the methodology described in Park and Roberts (2018). Number of districts based on 2016 district administrative boundaries.

⁷² For a description of the methodology used to derive these typologies see Park and Roberts (2018).

⁷³ The identification of the metro cores is robust to other criteria for their selection, such as a district's status as a Kota and its share of urban population, with the exception of metro Medan. Based on the 1996 boundaries, metro Medan contains three Kota districts, two of which have 100 percent of their population living in urban areas.

⁷⁴ For brevity, we will refer to 'predominantly urban' and 'predominantly rural' periphery areas as simply 'urban periphery' and 'rural periphery'. However, it is important to remember that a predominantly urban area may still have a large rural population, and vice versa.

⁷⁵ There are two types of districts in Indonesia – *Kota* and *Kabupaten*. *Kota* translates as "city", while *Kabupaten* designates what has traditionally been considered a rural district.

3. Better economic opportunities in metropolitan areas have helped many Indonesians escape poverty and join the middle class

Poverty and vulnerability declined the fastest in peripheries of metropolitan areas

Indonesia has seen large reductions in poverty and vulnerability over the past two decades, from 54 percent of the population being poor and vulnerable in 2001, down to 31 percent in 2017.⁷⁶ However, the pace of progress has differed across Indonesia’s portfolio of places. Outside of non-metro rural areas, poverty and vulnerability declined fastest in metro peripheries: the share of poor and vulnerable fell by 28.1 and 24.2 percentage points in rural and urban peripheries, respectively. In contrast, poverty and vulnerability only declined by 7.1 and 12.7 percentage points in metro cores and in single-district metros, although these were areas where poverty and vulnerability rates were relatively low to begin with (Figure B.9). By island-region, Nusa Tenggara, Maluku, Papua, and Java-Bali witnessed the fastest cumulative declines at close to 25 percentage points, while Sumatera, where progress was slowest, saw a decline of 18 percentage points.

Metropolitan areas provide the best chances for people to move into the middle class

Indonesia’s middle-class has grown from 5 percent of the total population in 2001 to 22 percent in 2017⁷⁷. While that share has grown everywhere, it grew the fastest in absolute terms in metropolitan areas: by 25 percentage points in metro peripheries, 23 percentage points in metro cores and 22 percentage points in single-district metros. These are also the areas with the largest shares of the middle-class population in 2017 (Figure B.10). In contrast, only a little more than 1 in 10 Indonesians in non-metro rural areas were in the middle class. Even after accounting for characteristics such as household size, education of the household head, and other labor market characteristics, households in metro cores and single-district metros are around 50 percent more likely to be middle class than otherwise identical households in non-metro rural areas.

Figure B.9: Poverty and vulnerability rates declined the fastest in metro peripheries...

(share of population that is poor or vulnerable, percent)

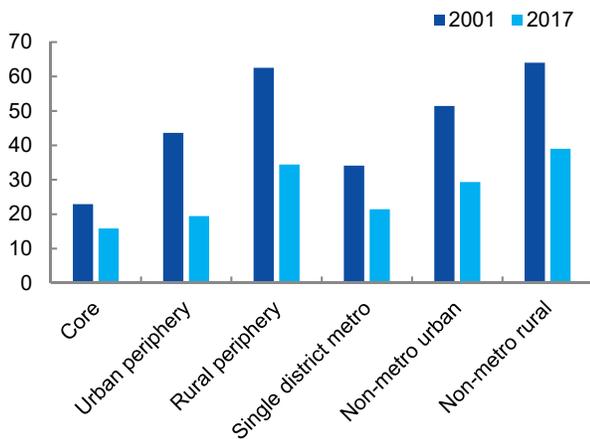
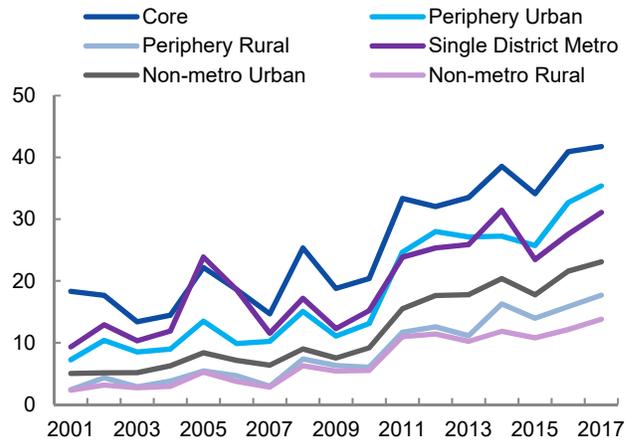


Figure B.10: ...while middle-class population shares were largest in metropolitan areas

(share of population that is middle class, percent)



Source: World Bank staff calculations from Susenas, various years

Note: Places defined following the methodology described in Park and Roberts (2018). Poverty rates are based on official poverty lines of the Government of Indonesia. Vulnerability is defined as the proportion of people with per capita consumption above the poverty line but below 1.5 x the poverty line and the share of the population that is middle class is calculated as the proportion of population with household consumption higher than 3.5 x the poverty line.

⁷⁶ Poverty is defined as the proportion of people with per capita household consumption below the poverty line, and vulnerability is defined as the proportion of people with consumption above the poverty line but below 1.5 times the poverty line and thus vulnerable to becoming poor. Note also that the numbers are combined rates for the two groups.

⁷⁷ Individuals are considered to belong to the middle class if their per capita household consumption is adequate for them not to be at a risk of falling into vulnerability. Specifically, individuals with household consumption above 3.5 times the poverty line are considered to be economically secure enough to be in the middle class. See World Bank (2018a) for more on Indonesia’s emerging middle class.

This is in part because metro areas generally provide better economic opportunities...

One reason that metro areas offer better chances of not being poor or vulnerable and of being in the middle class is that they provide better economic opportunities. Two-thirds of people living and working in metro cores are employed in formal, wage-paying jobs, compared with only 31 percent in non-metro rural areas, where unpaid family work and self-employment are more common (Figure B.11). Wage jobs are also much more prevalent in single-district metros and urban peripheries compared to non-metro rural areas. While wage jobs may not always be the highest paying,⁷⁸ in most settings they are nonetheless desirable to people who are less well off because of their higher level of stability.⁷⁹

Figure B.11: Urban areas tend to offer more opportunities for formal employment...

(share of total employed workers, percent)

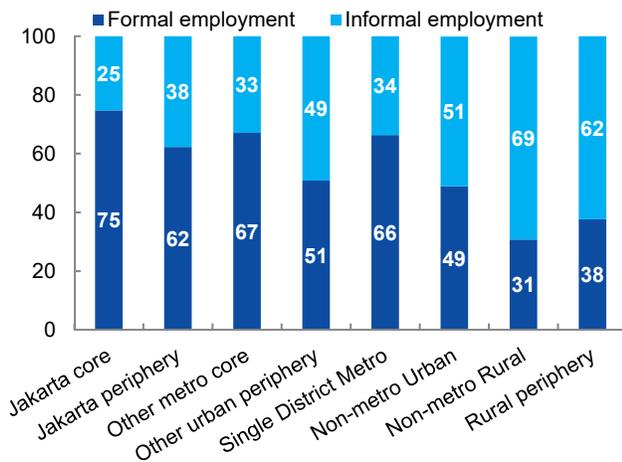
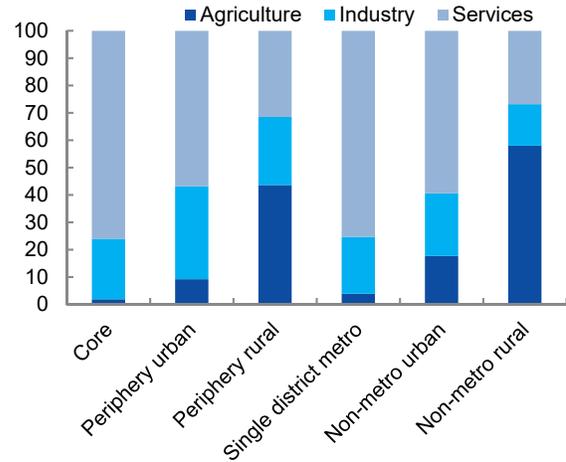


Figure B.12: ...and a larger proportion of Indonesians in urban areas are employed outside the primary sector

(share of total employed workers, percent)



Source: Calculations based on Sakernas, 2017, by place of work
 Note: Formal employment includes wage employees and permanent workers. Informal employment includes own-account workers, temporary employees, casual workers, and unpaid family workers.

Source: Calculations based on Sakernas, 2017, by place of work

...and jobs in more productive sectors

In addition, a larger share of Indonesians in metropolitan areas are employed in jobs outside the primary sector compared to rural areas. In metro cores, almost four in five jobs are in manufacturing or services. The share of jobs in manufacturing is highest in urban peripheries (especially the urban periphery of Jakarta), possibly reflecting a higher concentration of firms choosing to locate their operations close enough to benefit from the density of the cores without bearing the high costs of locating there. As expected, non-metro rural areas, and to some extent rural peripheries, have sizable population shares – about 60 percent and 40 percent, respectively– engaged in agricultural activities (Figure B.12).

Strong job creation in urban peripheries contributed to faster reductions in poverty and vulnerability

From 1996 to 2015, 12.2 million jobs were created in urban peripheries, compared with just 2.5 million in non-metro rural areas, reflecting the size and speed of population growth. Most of these new jobs have come in services and industry, especially in manufacturing. Urban peripheries added 7.0 million net service jobs between 1996 and 2015, an annualized growth rate of 5.8 percent, and 4.4 million net industry jobs at an annualized growth rate of 6.1 percent.

⁷⁸ Several forms of self-employment may generate higher earnings, especially outside of agriculture, but these paths often come with high downside risks. Coupled with having a low appetite for such risk, the poor may find such paths relatively more difficult in credit-constrained environments.

⁷⁹ No matter the type of contract, wage jobs represent a steady stream of income that enables people to plan and maintain a stable standard of living. In addition, when contracts include some security of tenure, these jobs can reduce vulnerability and facilitate entry into the middle class.

More and better jobs translate into better earnings opportunities in metropolitan areas

With more and better economic opportunities, urban areas have a high earnings premium relative to non-metro rural areas. Average monthly earnings are more than 90 percent higher in metro cores than in non-metro rural areas. Urban periphery and single-district metro areas have a similarly high premium over rural areas. Non-metro urban areas or small towns have the lowest simple (unconditional) premium – around 20 percent. Thus, there is a visible earnings gradient moving down from more urban to less urban places (Figure B.13).

Even after accounting for sorting effects⁸⁰, there are sizable earnings premia in metropolitan areas. Any individual living in multi-district metros commands around 20 percent higher earnings than comparable individuals in non-metro rural areas.

However, the upward escalator to the middle class may be slowing down for the newest migrants to metro cores

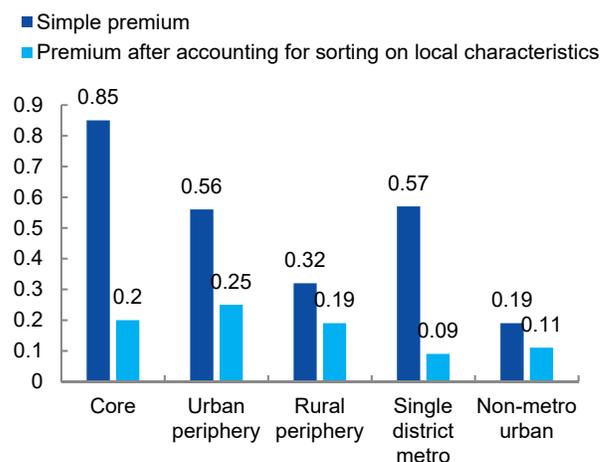
While multi-district metros have provided dwellers a robust pathway to upward mobility, the “mobility premium” offered to migrants by metro cores in particular may have diminished. Most migrants who successfully entered the middle class seem to have migrated to metro cores before the 2000s. For those who made the move after the 2000s, the upward escalator does not seem to have worked as well. Nonetheless, the prospects of middle-class entry for newer entrants into urban peripheries have remained robustly high, as urban peripheries have retained the advantages of proximity to the prosperity of metro cores while avoiding their costs.

4. Gaps between urban and rural areas remain, but most inequality in Indonesia is *within* places

Inequality of household consumption between places remains high, but is shrinking

To some extent, efforts to reduce disparities between leading and lagging regions in Indonesia have paid off. Overall, the gap in the level of household consumption⁸¹ between the core of Jakarta metro area (DKI Jakarta) and all other predominantly urban places (other metro cores, urban peripheries, single-district metros, and non-metro urban areas) shrank from 19 percent in 1993 to 7 percent in 2015 (Figure B.14). However, the gap between DKI Jakarta and non-metro rural areas widened from 33 percent to 35 percent over the same period. These persistent welfare gaps reflect the lack of cross-place integration in Indonesia and call for a stronger policy response to enable lagging regions to benefit from the growth in the leading areas.

Figure B.13: Metro areas have a high earnings premium relative to non-metro areas (percent)



Source: Setiawan et al (2018)
 Note: Reported values are calculated as $[\exp(\hat{\alpha}) - 1]$ where $\hat{\alpha}$ s are coefficients on location dummy variables of a regression of log earnings on these dummy variables with non-metro rural areas being the omitted category. The conditional versions (orange bars) control for sorting on worker characteristics (age, gender, marital status, years of education, migrant status), job characteristics (agriculture, industry or services), occupation characteristics (employee or self-employment of various kinds), geographic characteristics (island-regions), and household characteristics (size, dependency ratio). All coefficients reported in the bars are significant at the one percent level.

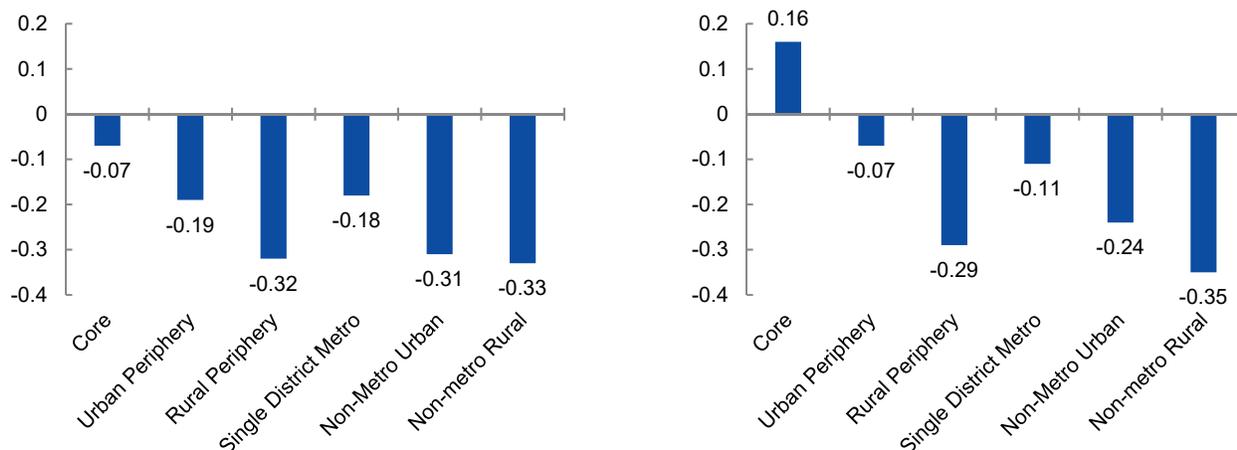
⁸⁰ It is possible that more productive workers choose to live and work in certain parts of the country and thus sort themselves into certain kinds of jobs, and that unconditional premia may just be picking up the effect of such positively sorted individuals. To account for this possibility, several observable characteristics of individuals, their household, job, and location were controlled for.

⁸¹ Welfare gaps are measured using welfare ratios, i.e. the ratios of household expenditure to the poverty line of the region, expressed in terms of DKI Jakarta Rupiahs. For those who live in DKI Jakarta, these welfare ratios are exactly equal to household expenditures. For households in a region where, say, the poverty line is half of the poverty line in DKI Jakarta, the welfare ratio will be double their household expenditure. This adjustment takes into account the cost of living differences across space.

Figure B.14: The consumption gap between DKI Jakarta and urban peripheries shrank

(a. welfare difference in 1993)

(b. welfare difference in 2015)



Source: Tiwari and Shidiq (2018)

Note: Welfare gaps are calculated using differences in welfare ratios which represent the household’s expenditure to the contemporaneous poverty line in the region of residence expressed in terms of DKI Jakarta Rupiahs.

There has also been convergence in access to basic services, but urban dwellers still generally have better access compared to rural dwellers...

Although disparities in service delivery are shrinking⁸², urban dwellers generally have better access to basic services than rural dwellers⁸³. Virtually all Indonesians who reside in metro cores and single-district metros have primary care facilities (*puskesmas*), delivery facilities and hospitals located either in or near their *desa/keurahan* (Figure B.15) By contrast, over a fifth of Indonesians residing in non-metro rural areas do not have easy access to hospitals, and over 80 percent lack easy access to doctors. Similarly, while less than a tenth of households in cores and single-district metros lack access to safe drinking water, about 40 percent of households in non-metro rural areas and rural peripheries are deprived on this dimension. Although some convergence in service delivery has occurred, significant gaps between urban and rural areas remain in access to health, education, water, sanitation and hygiene services (Figure B.15).

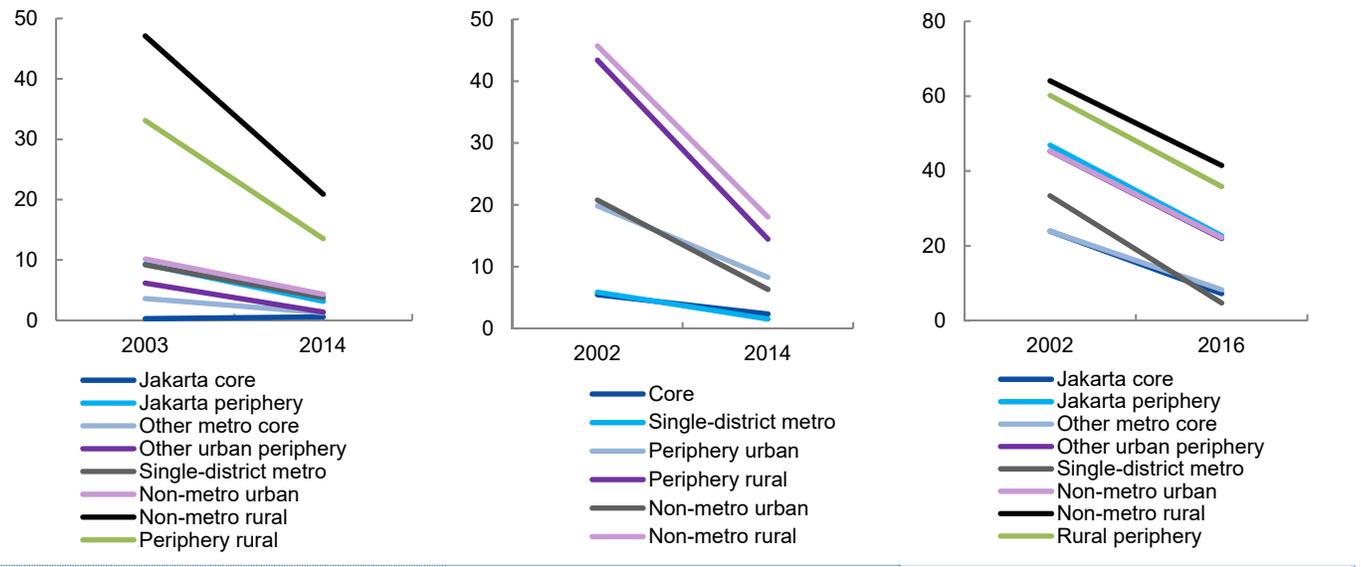
...leading to better health and education outcomes in urban metropolitan areas

With better access to services, Indonesians residing in urban areas are on average healthier and more educated than those in rural areas. Households in core and single-district metros are more likely to have infants or children who were delivered with the help of a medical professional, to be literate, and to have finished primary school compared to those in rural areas. Children in urban areas also have better nutritional outcomes. Even after controlling for differences in household characteristics and access to services, children in metro cores are taller and heavier for their age than children in non-metro rural areas by 0.21 and 0.15 standard deviations (SD) respectively. Similarly, children in urban peripheries are taller and heavier for their age by 0.33 and 0.13 SDs respectively and 6.8 percentage points less likely to be stunted than children in non-metro rural areas.

⁸² Average access to basic services increased from 48.8 percent in 2001 to 70.9 percent in 2015, while the coefficient of variation declined from 0.23 to 0.17. See the December 2017 edition of the *Indonesia Economic Quarterly*: “Decentralization that Delivers”.

⁸³ Analysis of deprivations in access to services and outcomes in this section is from Lain (2018), using data from PODES and SUSENAS.

Figure B.15: Despite convergence, significant gaps remain between urban and rural areas in access to basic services
(proportion of households living in a desa/ kelurahan lacking easy access to a pre-school, percent) *(share of households with a child less than five years that was not delivered by a skilled health worker, percent)* *(share of households deprived in access to safe drinking water, percent)*

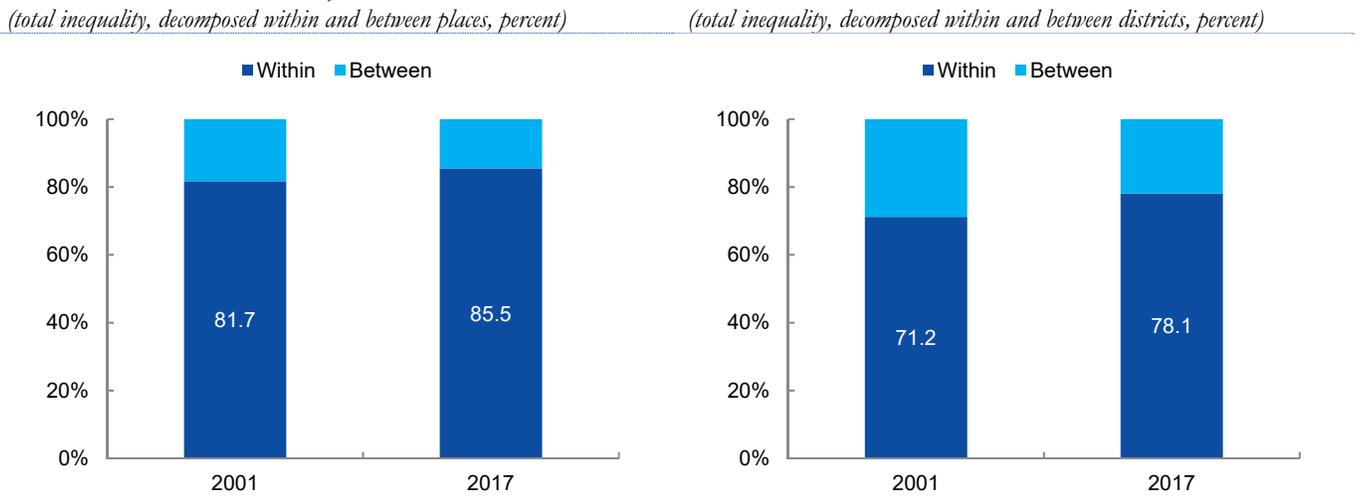


Source: World Bank staff calculations using Susenas (2002, 2014, 2016) and PODES (2003, 2014) data, based on Lain (2018)

Inequality within places accounts for a larger share of total inequality

Despite these disparities between rural and urban places, much more of the consumption inequality in Indonesia is accounted for by inequality *within* places. This is true whether looking at island regions, types of place or districts. Close to 86 percent of total inequality is accounted for by inequality within places and just 14 percent by inequality between places (for example, between metro cores and non-metro urban areas). Similarly, 78 percent of total inequality is within districts and 22 percent is between districts. Not only has the within-place inequality always been higher, but its share has grown over time (Figure B.16).

Figure B.16: The share of inequality is higher within places and within districts than between places and districts – and the share has risen over time, 2001 and 2017



Source: Tiwari and Shidiq (2018)

Note: Places refers to the portfolio of places developed for the Indonesia Urbanization Flagship Report (core, periphery, etc). The inequality shares are obtained from the decomposition of GE(0), which is also known as the mean log deviation or Theil's L.

Multi-district metros are the most

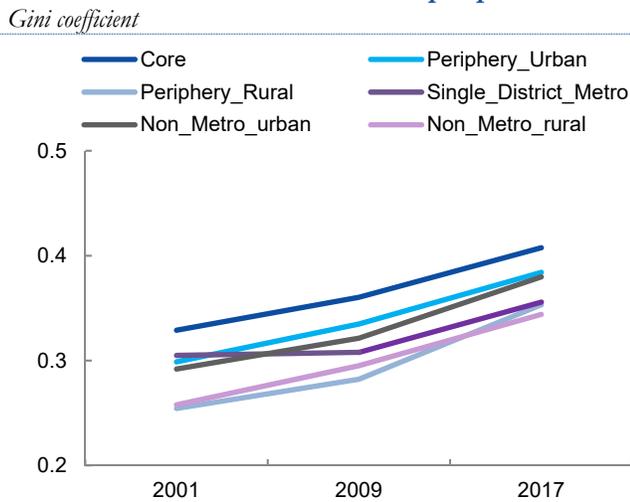
Consistent with the overall trend of rising inequality in Indonesia over 2001-2014, all types of places experienced increases in the Gini coefficient over this period. However, the highest

prosperous, but are also the most unequal places

increase in the Gini (10 percentage points) was seen in rural peripheries of multi-district metros (Figure B.17). This may be because rural peripheries are more likely than other places to have labor markets with blended characteristics of urban and rural economies: proximity to metro cores provides ample opportunities outside the primary sector, yet employment within agriculture remains large.

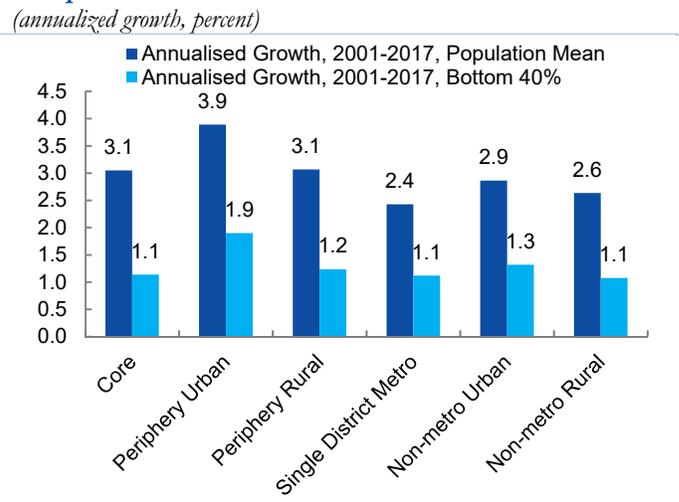
Moreover, while overall living standards – measured by per capita consumption – improved the fastest in multi-district metros, the gap between the living standards of households in the bottom 40 percent of the distribution and that of the average population increased the fastest in these areas. While the per capita consumption of the overall population in metro cores and periphery areas grew by 3.4 percent per annum on average between 2001-2017, it only grew by 1.4 percent on average for the bottom 40 percent in these areas (Figure B.18). This gap was larger than the one observed between the bottom 40 and the overall population in non-metro rural areas, i.e. 1.5 percentage points.

Figure B.17: Inequality rose everywhere, but the Gini coefficient rose the most in urban peripheries



Source: World Bank staff calculations from Susenas, various years

Figure B.18: Multi-district metros are the most unequal



Source: World Bank staff calculations from Susenas, various years

Differences in aggregate human capital drive within-place inequality

One driver of this within-place inequality is the differences in aggregate human capital within particular areas and the opportunities that this creates for groups with different levels of skills in the population. Globally, as cities grow and become denser, they acquire higher stocks of aggregate human capital⁸⁴. This occurs either through increases in the educational attainment of younger cohorts of residents, or through the skill-selective migration of individuals from other places.

While the higher concentration of human capital in urban areas is a major source of productivity in cities⁸⁵, workers do not necessarily benefit equally from overall higher levels of human capital. If complementarities are strong – that is, high and low-skilled workers are imperfect substitutes for each other – then low-skilled workers would benefit more than higher-skilled workers⁸⁶. If there are strong positive externalities, then all types of workers would benefit: the high skilled

⁸⁴ See World Bank (2018c) for more on this discussion.

⁸⁵ This occurs not only through the direct effect of skills on productivity, but through indirect spillover effects between workers as they learn from each other through, for example, observation and mimicking.

⁸⁶ This follows from standard neoclassical model. A growth in the relative supply of skilled workers drives down the wages of the high skilled and increases the wages of the low skilled.

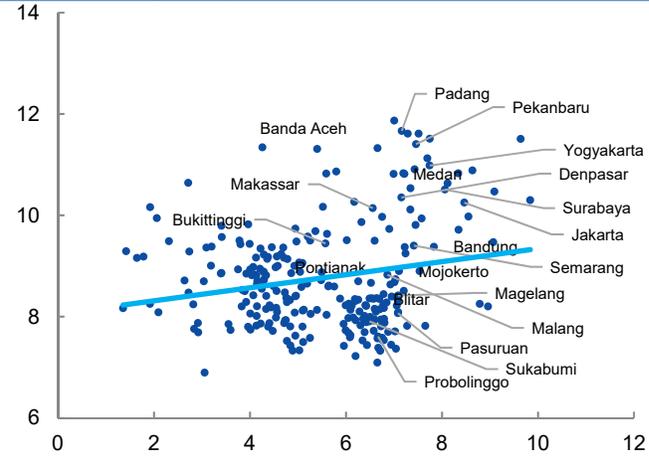
through greater cross-fertilization of ideas and learning across firms and workers, which spurs innovation, and the low-skilled through spillovers of these externalities.

In Indonesia, low-skilled workers benefit less than high-skilled workers from human capital externalities

In Indonesia, higher density places are indeed, on average, places with a higher stock of aggregate human capital (Figure B.19), which in turn is correlated with higher productivity⁸⁷. There is also evidence of human capital externalities, and that all types of workers benefit from living and working in places with a higher aggregate stock of human capital.

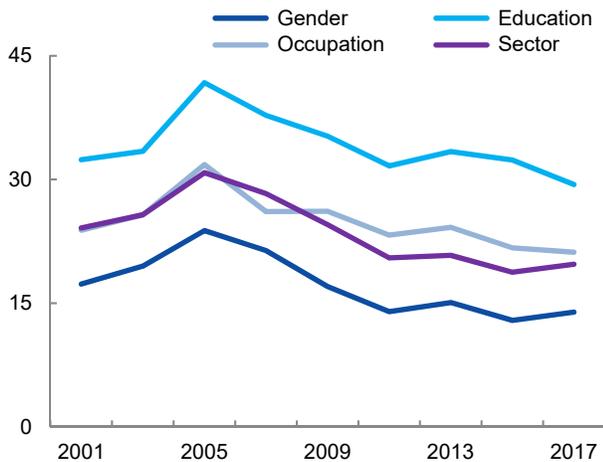
However, the size of the spillovers is relatively weak, as low skilled workers benefit to a much lesser extent than high skilled workers.⁸⁸ These differences in educational attainment account for a much larger share of inequality within places than other factors such as gender, occupation or sector of employment (Figure B.20).

Figure B.19: Average years of schooling and population size are also positively correlated across Indonesia
(y-axis, average years of schooling, 15+ years old; x-axis, log of population density, 2016)



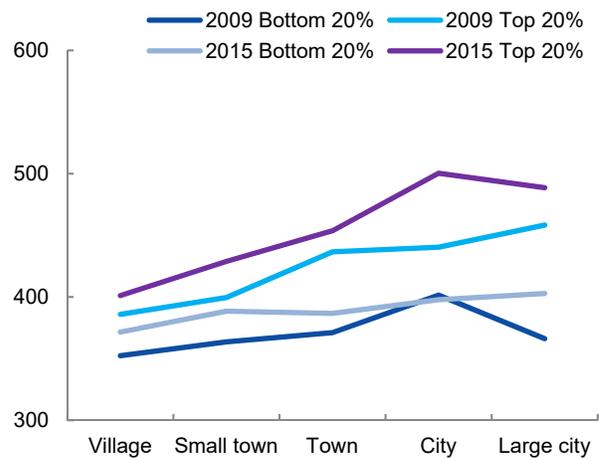
Source: Tiwari and Shidiq (2018)
Note: The unit of analysis here is districts of Indonesia, except for multi-district metros for which average years of schooling is calculated over all districts in the metro area.

Figure B.20: Differences in educational attainment are the strongest drivers of inequality within places
(share of within-group inequality, percent)



Source: Tiwari and Shidiq (2018)
Note: The shares are obtained by decomposing GE(0) – also known as mean log deviation or Theil’s L – separately for each demographic characteristic within six spatial categories: core, urban periphery, rural periphery, single-district metro, non-metro urban, and non-metro rural. Shares for each year do not need to total 100.

Figure B.21: Gaps in math scores between the top and bottom 20 percent widened the most in cities
(scores on the program for internal student assessment)



Source: Calculations based on data from PISA, OECD (2015)
Note: Villages have fewer than 3,000 people; a small town has between 3000-15,000 people; a town has between 15,000 to 100,000 people; a city has between 100,000 to 1,000,000 people, and large cities have more than 1,000,000 people. These definitions cannot be mapped into the portfolio of places used in the rest of the report.

⁸⁷ Bosker, Park and Roberts (2018).
⁸⁸ Setiawan et al (2018).

Widening learning gaps between children of different economic classes could further compound these inequalities

While average educational attainment levels are higher in Indonesian cities than elsewhere, and the quality of learning (as measured by test scores) may have improved over time, learning gaps between children of different socioeconomic classes appear to have widened. Although math test scores on the Program for International Student Assessment (PISA) improved between 2009 and 2015 for children of all socioeconomic levels regardless of where they reside (Figure B.21), gaps between children in the bottom 20 percent of the socioeconomic distribution and those in the top 20 percent widened over this time, and widened the most in cities. If productivity spillovers across skill categories remain weak, these within-place inequalities may be compounded as the current generation enters the labor market.

5. Shortcomings in the transportation-housing nexus exacerbates inequality

Lack of connectivity and integration between and within Indonesia's growing metro areas exacerbates inequality

Poor integration within Indonesia's metro areas could also partly explain why people with low skills are benefiting less from human capital externalities in cities than higher skilled individuals. Because of the dearth of affordable housing, especially in good locations, and inadequacies in transport systems that connect people to each other and to work opportunities, poorer people are forced to reside in informal settlements and to seek sparser employment opportunities locally. This leads to a proliferation of isolated enclaves that impede the wider sharing of the benefits of urbanization. Moreover, connectivity between metro areas and other types of places remains poor.

Unmet demand for housing has pushed prices up in metro cores...

With better access to services and economic opportunities in urban areas, the demand for housing has risen, contributing to congestion of land, housing, and rental markets in metro areas. Ratios of house prices to income are higher in Indonesia's cities than in its rural areas and higher than in cities in some developed countries, such as New York, Singapore, and Tokyo (Figure B.22). As a result, all households, including the poor, spend more on housing in metro cores than in other areas. On average, people residing in metro cores allocate 33 percent of their total spending to housing, compared with about 23 percent in rural areas⁸⁹. This issue is particularly worrying considering that access to mortgage finance – which makes a house of a given price more affordable at a given level of income – is lacking, as is the case for most households in Indonesia.⁹⁰

...leading large segments of the urban population to live in substandard or cramped quarters

A substantial housing deficit has led to housing unaffordability in Indonesia, with the housing backlog estimated at 7.6 million units⁹¹. While national programs have been adding 550,000 to 700,000 units annually, an estimated 820,000 to 920,000 million new units are needed each year to meet the housing demand. Moreover, 3.4 million units are deemed substandard based on one or more indicators (housing materials, lack of access to water or sanitation)⁹². For example, more than half of poor and vulnerable households in metro cores live in overcrowded⁹³ conditions. In Jakarta's core, nearly 40 percent of households were living in overcrowded conditions in 2016, double the share in 2002 (Figure B.23).

⁸⁹ World Bank staff calculations based on Susenas.

⁹⁰ Mortgage loans totaled only 2.8 percent of GDP in Indonesia in 2015, compared with almost 20 percent in Thailand and over 30 percent in Malaysia (World Bank 2018b, using data from HOFINET or Housing Finance Information Network in 2015).

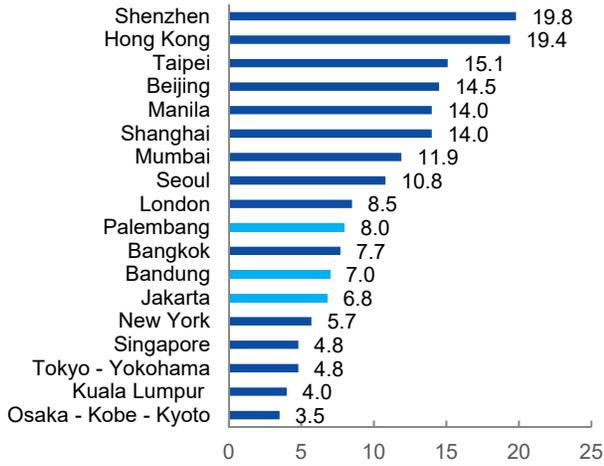
⁹¹ Backlog figure estimated for 2014 based on BPS data.

⁹² Based on data from MPWH.

⁹³ Following Health Ministerial Decree (Kepmenkes) No. 829/1999, a household is considered overcrowded if the floor area per person is less than 8 square meters.

Figure B.22: Price-to-income ratios are high in Jakarta compared with more developed cities...

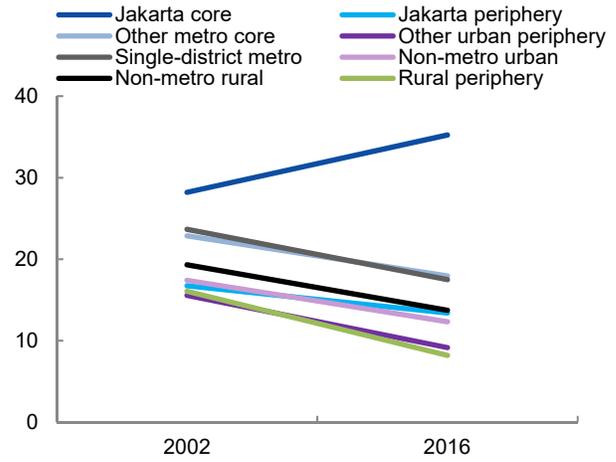
(house price-to-income ratio, percent)



Source: Demographia and Nomura for international cities, World Bank staff estimations using BPS data for Indonesian cities. House prices and median income refer to latest year available between 2015-2017.

Figure B.23: ...contributing to substantial overcrowding in metro cores and single-district metros

(share of households that are overcrowded, percent)



Source: World Bank staff calculations based on Susenas, 2002 and 2016

New affordable housing supply is often poorly located, pushing the urban poor to metro peripheries, creating sprawl...

In addition, new affordable housing supply is often poorly located, pushing the urban poor to city peripheries. In Jakarta, only 2 percent of the 2016 and 2017 built subsidized housing was located within 10 km from the city center, while 86 percent of the units were between a 25km to 40 km buffer⁹⁴. Similarly, in Surabaya and Bandung around 1 and 2 percent of new subsidized housing is located within the 10km buffer while 64 and 58 percent appear within the 25km to 40 km buffer respectively. As a result, households are pushed to the periphery and end up paying premiums for transportation costs, creating a broader negative impact through congestion and spatial development patterns that are neither economically efficient nor sustainable. Indeed, this urban sprawl might partly explain why Indonesian cities are among the largest in the world in terms of land area. Jakarta metro, for example, covers an estimated area of almost 4,300 square kilometers, almost 400 square kilometers larger than the area covered by Greater Tokyo.

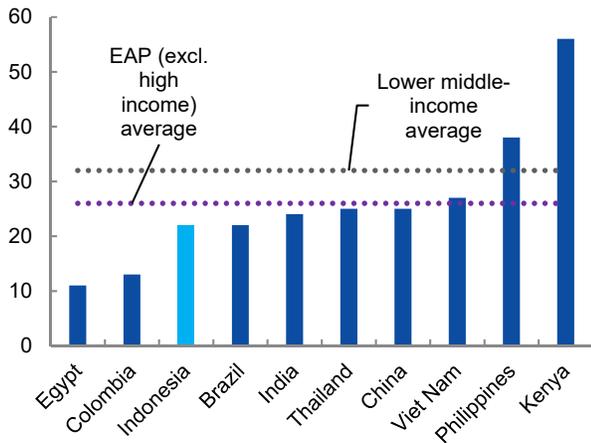
...and fostering the emergence of urban slums, especially in non-metro urban areas and urban peripheries of large metropolitan areas

High housing costs in metro cores and poor quality subsidized housing have also facilitated the emergence of slums – defined by the Government of Indonesia as dense neighborhoods with irregular buildings that lack access to basic infrastructure. According to a 2015 survey, about 22 percent of Indonesia’s urban population live in slums, including half the urban poor.⁹⁵ While lower than the regional average (Figure B.24), this still means that some 29 million Indonesians live in slums. Slum dwellers mostly lived in urban peripheries and non-metro urban areas (Figure B.25).

⁹⁴ World Bank staff analysis based on spatial data on FLPP subsidized units by MPWH.

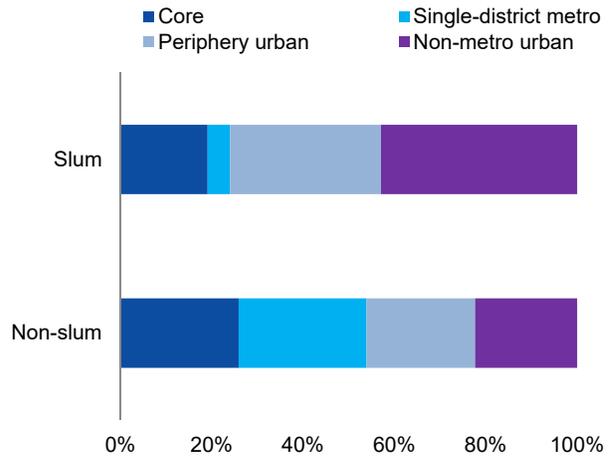
⁹⁵ National Community Empowerment Program (NCEP) Urban Slum Profiling Survey (2015).

Figure B.24: A fifth of urban residents live in slums...
(share of urban households living in slums, percent)



Source: Calculations based on data from World Bank World Development Indicators. Data refer to 2015
Note: Slums are defined by the Government of Indonesia as dense neighborhoods with irregular buildings that lack access to basic infrastructure

Figure B.25: ...mostly in predominantly urban peripheries and non-metro urban areas
(share of population, percent)

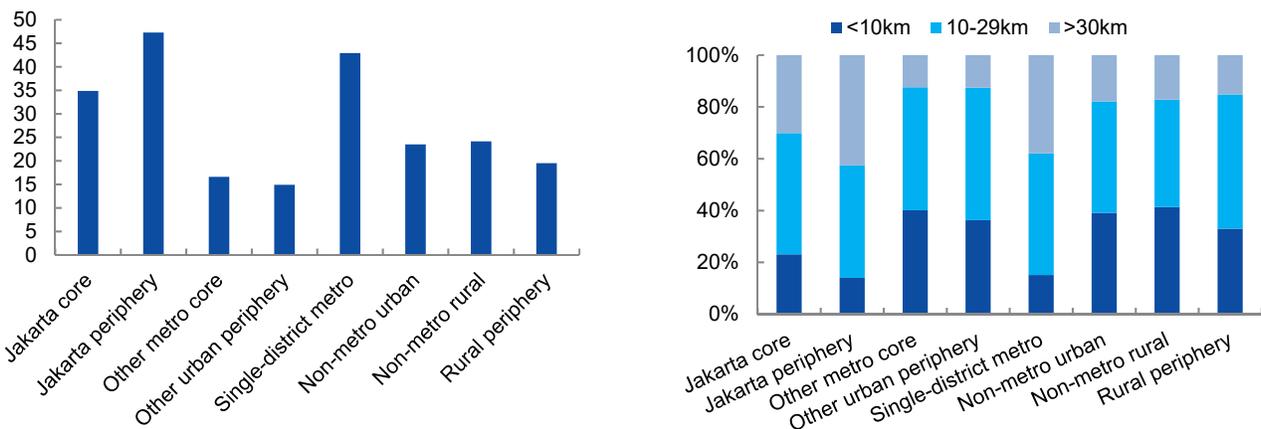


Source: Calculations based on data from Susenas (2014)
Note: Slums are defined by the Government of Indonesia as dense neighborhoods with irregular buildings that lack access to basic infrastructure

Many households contend with long commutes and traffic congestion

Due to high housing costs in metro cores and urban sprawl, together with high rates of private vehicle use, many urban households contend with long commutes to access better economic opportunities in metro cores. Some 30–40 percent of commuters in Jakarta metro area and single-district metros spend more than an hour on the road to get to work, compared with about a fifth of commuters in rural areas (Figure B.26). However, there is significant variation across metro areas and between Jakarta and other metro cores. In other metro cores, only 15 percent of commuters spend more than an hour on the road. This is in part due to shorter travel distances in other metros: 40 percent of commuters in the Jakarta metro area travel more than 30 kilometers to get to work, but just half that share travel that far in other metro areas.

Figure B.26: High housing costs in multi-district metro cores and sprawl contribute to long, lengthy commutes in Jakarta metro area and single-district metros
(share of commuters who travel more than 60 minutes to work a day) (distance travelled, percent of each distance band)



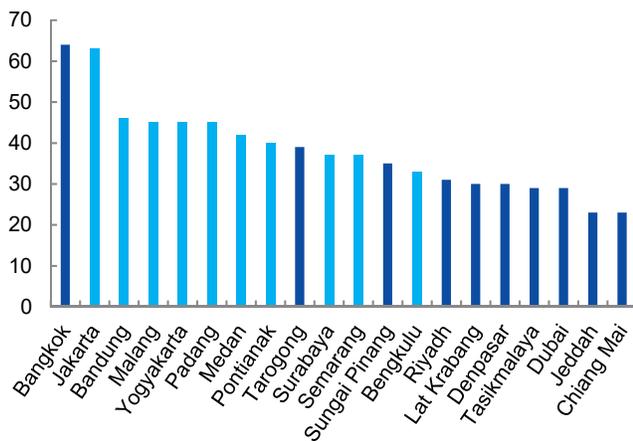
Source: Calculations based on data from Sakernas, 2015
Note: Sample includes only those employed who live in one district and commute to another for work.

Jakarta is consistently rated one of the most congested cities in the world

The lack of adequate public transport infrastructure means that most Indonesians use private transport (cars or motorcycles) to get to work. As such, Jakarta is consistently rated one of the top 10 cities in the world with the worst traffic. On the Tom Tom Traffic Congestion Index, Jakarta was the 3rd most congested city out of 18 megacities worldwide, with an estimated 58 percent extra travel time needed for any trip, anywhere in the city, at any time compared with a free flow situation.⁹⁶ Similarly, on the Global Inrix scorecard, Jakarta was rated the second most congested city in the region after Bangkok (Figure B.27). Most of the other congested cities in the region also tend to be in Indonesia. On average, it takes twice as long to travel the same distance with the same type of transport in Indonesia as it does in Malaysia (Figure B.28).

Figure B.27: Indonesia’s cities are some of the most congested in the region

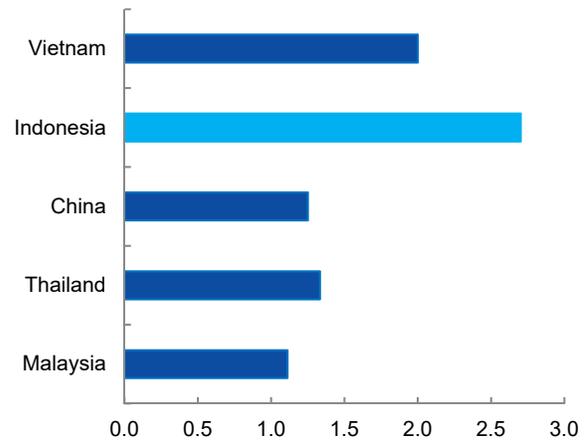
(time spent in traffic annually, hours)



Source: Inrix Global Scorecard 2017
 Note: Indonesian cities are shown in light blue.

Figure B.28: It takes far more time to travel the same distance in Indonesia than in other East Asian countries

(normalized trip time, hours per 100 km direct)



Source: Modernizing the National Road Network: A Planning Framework to Improve Connectivity and Development, IndII, 2012

6. Indonesia can make urbanization work for all Indonesians through three ‘C’s

Three policy principles for urbanization to deliver prosperity and livability for all Indonesians:

- Converge & expand,**
- Connect & integrate,**
- Customize & target**

The first principle is to aim for **convergence and expansion** in the delivery of basic services, ensuring that all Indonesians have equitable access to good quality basic services regardless of where they live. This ensures that cities are livable, and citizens have equal opportunities to become healthier, more educated, and thus more productive. This often requires expanding services in urban areas and especially in fast-transforming, newly-urban areas.

Second, policies need to be implemented to improve **connectivity and integration** between and within places. Facilitating the mobility of goods, people, businesses, and ideas will help to spread the gains of urbanization and reduce spatial disparities in economic well-being. Improving connectivity and integration *between* places requires removing barriers to goods and factor mobility, while *within* place connectivity and integration means ensuring that all households can access economic opportunities and public services. Housing options should be linked to opportunities and services through high-quality transport infrastructure to develop cities that are integrated, making them both economically inclusive and more livable.

Even with policies that successfully converge and connect, some people and places may still be left behind. Therefore, **customized and targeted** interventions may be needed to help specific groups of people (e.g. those with disabilities, women, children and the elderly), and places (e.g. remote areas and islands).

⁹⁶ Cities with population over 10 million are regarded as megacities.

To implement the 3 Cs, Indonesia needs to address cross-cutting challenges of financing and planning urban development

Providing adequate resources to local governments is the first requirement for expanding local infrastructure and basic services and building the connective infrastructure required for integration between and within places. This will require revamping intergovernmental transfers, boosting own-source revenues, and creating a prudent but flexible framework for borrowing by local governments. A second requirement is to improve the process of planning for urban growth. Local governments require more (and evolving) capacity to plan for urban development. Moreover, policies and institutions need to be designed to overcome coordination challenges between sectors, levels of governments, and jurisdictions.

Rethinking the design of intergovernmental transfers and making them more performance-based will be needed to expand services and build connective infrastructure

Although disparities between places in access to basic services have shrunk, flaws in the fiscal transfer system impede the achievement of universal access to quality basic services as well as the provision of adequate connective infrastructure. For one, the transfer formula for the *Dana Alokasi Umum* (DAU, or General Allocation Grant) uses an adjusted per region norm as the basis for equalization transfers rather than a per capita norm. This disadvantages more populous places, which tend to be urban. But the places that receive lower per-capita transfers are also those where larger numbers of poor people reside, and where investment needs are higher. Currently, large urban areas struggle to expand basic services and infrastructure in line with growing populations, which contributes to mounting congestion forces that constrain productivity and inclusion. Revising the formula to include per capita rather than per region norms could help promote greater convergence in service delivery.

Moreover, amounts spent in the lagging, less populous areas have failed to translate into more infrastructure capital, better services, and better connectivity between areas. Less populous districts, which saw sharp increases in per capita spending after decentralization, added only marginally more kilometers of roads relative to more populous districts. These districts also failed to show any improvement in water and sanitation coverage relative to more populated districts.⁹⁷ There is also no correlation between levels of spending and service delivery outcomes. In part, this is because districts spent much of the DAU on personnel: out of IDR 100 in DAU transfers, on average districts spend IDR 86 in salaries. Making transfers more performance-based, both through more top-down monitoring and bottom-up accountability, could ensure that these investments are more efficient and effective.

Increasing own-source revenues, mobilizing other revenue sources, and expanding the ability of larger cities to borrow would also enlarge the fiscal envelope for investments in service delivery

While revamping fiscal transfers will help increase resources available to more populous urban areas, the ultimate objective is to expand the overall fiscal envelope of local governments in line with growing needs of urban and urbanizing areas. That requires complementing fiscal transfers with efforts to strengthen own-source revenue collection, which is currently very low in Indonesia. Such measures could entail better management of tax registries and cadastral information on property taxes, which are lower in Indonesia than in most other countries. In addition, greater utilization of land value capture tools could help finance urban infrastructure, while boosting land and property prices. Sources of additional funding for financing public transport that connects and integrates could include dedicated taxes and fees on private transport, parking fees, fuel levies, and congestion charges. However, most of these instruments are not easy to implement, and it will take time before Indonesia can count on these additional resources.

Financing investments in urban infrastructure, especially public transport, may require going beyond resources available from the annual budget. This is particularly true for larger multi-district metro areas, where the investment requirements are higher. For example, in a large metro area like Jakarta, a mass rail system may be required, but it costs over 10 times more per kilometer⁹⁸ compared to a bus rapid system that may be sufficient for a smaller city. Developing

⁹⁷ Jasciens, V. and S. Straub (2018).

⁹⁸ Based on US case studies, MRT costs are USD 104.5/km vs. USD 8.4/km for BRT. See Cervero (2013).

a framework that would gradually empower financially sound cities to access capital markets and official financing would allow them to better meet their infrastructure needs.

Improving the planning process of local governments is also critical to achieving the 3 Cs

Although financing reforms will help provide growing urban areas with the resources they need to combat mounting congestion pressures, effective planning of cities, including planning for their future growth, can be the difference between cities that facilitate interaction and those that segregate and isolate people. Capacity for planning infrastructure projects and city development, as well as better coordination across levels of Government, across sectors and across jurisdictions is needed to ensure that resources are spent efficiently and effectively.

The capacity of local governments to plan, implement and manage public investments needs to be strengthened

The lack of local government capacity to plan, develop, and manage local investments in infrastructure inhibits intra-city connectivity and service delivery. For example, financial support from the central government for mass transit systems should be provided only after cities have developed an integrated mobility plan that addresses the spatial development of the city and articulates the demand management, transport infrastructure, and systems required to support the desired urban structure. The mobility plan should be developed with comprehensive outreach to community groups, non-governmental organizations, and the public. Public participation should continue through the subsequent planning steps of alternatives analysis, transport mode selection, and design of the infrastructure and systems elements of the mobility plan. Except perhaps for Jakarta, metro areas lack the technical capacity to plan, implement, and operate these systems. Enhancing the capacity of local governments to conduct forward-looking and integrated urban planning is therefore critical to achieving inclusive urbanization.

Meeting the evolving needs of urban areas requires the coordination of planning at the sectoral and inter-governmental levels, and the linkage of statutory plans to a concrete investment plan

Modern urban planning demands a multi-sectoral and flexible approach that integrates sectoral objectives, guided by the spatial dimensions of a city. Some Indonesian cities have taken steps in this direction. However, most cities have limited flexibility in their planning processes, which isolates sectors in silos. Currently, statutory plans are prepared without a common spatial data infrastructure and are disconnected both from each other and from an investment plan. For example, to promote mobility while managing congestion and pollution, cities need to coordinate urban transport plans with land use plans and related infrastructure plans. Integrated sectoral plans can reduce the need for long trips by locating housing, shops, services, and jobs within a short radius. Moreover, there is often limited coordination between central, provincial, and district-levels of Government, despite several concurrent responsibilities. Indonesia needs an effective framework for inter-sectoral and inter-jurisdictional coordination. To that end, the Government may consider developing a collaborative platform for organizing urban development. That platform can also be linked to the availability of financing (Box B.2).

Multi-district metros face distinct coordination challenges that requires provinces to step up their role

Coordination across districts in a multi-district metropolitan area is limited, and where it happens, it usually occurs in ad-hoc and spontaneous manner. Coordination problems are especially prominent for regional water services, metropolitan transportation, solid waste and disaster risk management where the issues span many districts. To enable more consistent delivery of services which are cross-border or multi-district in nature, metropolitan coordination should not only be the provincial government's authority (meaning that it could be interpreted as an optional affair), but also its responsibility (meaning that provincial governments are partly but formally accountable for ensuring service delivery in multi-district metropolitan settings). To encourage such coordination to take place, there could be performance evaluations and awards given to provinces and districts that engage in good metropolitan governance. Incentives for coordination should also be provided to districts, while incentives for facilitating inter-district coordination would apply to the relevant provincial government.

Transit-oriented development will support

Transit-oriented development facilitates densification and, by locating housing, retail options and transport in close proximity, integration. This may involve redeveloping residential structures or encouraging new buildings with more vertical development by permitting higher

- improvements in connectivity and quality of life...** floor-area ratios, thereby loosening height restrictions, or allowing greater density in target zones. Target zones can be selected to promote local objectives, such as reduced dependence on private vehicles or development of mixed-use, pedestrian-friendly urban spaces. Indonesian metros could follow the example of cities such as Hong Kong and Seoul, which have already intensified land use around transit stops. Seoul allows floor-area ratios that are up to 20 times higher in better-connected neighborhoods than in more distant areas. In addition, increasing the density of residential developments in a half-mile radius around public transport nodes could expand San Diego's housing stock by close to 30 percent (MGI 2016).
- ...as will the upgrade of existing slums and increase in the supply of affordable housing close to transport links** High land prices and overall land shortages in the cores of multi-district and single-district metro areas make it essential to set out the principles for the provision of land for affordable housing in Indonesia. Without them, land provided for affordable housing is unlikely to sustainably meet the needs of low- and moderate-income households and thus to end the proliferation of informal settlements and subsidized housing located far from city centers. Housing policy for urban development should focus on upgrading slums, where living conditions are substandard, but which tend to be closer to transport infrastructure, other public services and economic opportunity. Policy needs to create an environment conducive to increasing the supply of affordable housing, particularly as cities grow. This will require coordinating land use and spatial planning, prioritizing urban land for affordable housing, and accelerating land titling. Indonesia should also develop a more comprehensive housing agenda that includes rental markets and home improvement.
- Policies to improve transport and housing need to be tailored to the type of urban area** The challenges in making cities more inclusive differ in their scale and scope across the portfolio of places, requiring tailored strategies. In housing, multi-district metros need to focus on ensuring that housing is available both in core and peripheral areas, and to avoid creating pockets of poverty. For single district metros, where housing supply constraints may be more binding than demand side pressures, a focus on making serviced land available for development will be important. Non-metro urban areas, where housing demand pressures may be increasing, will need to ensure that new development remains connected with the city and that infill development for new housing is possible and attractive for the private sector. As noted earlier with respect to transport, multi-district metros are likely to require more expensive, long-term investments in infrastructure compared to smaller cities, so that better integration – both between the core and periphery, and with other areas – can be achieved.
- To ensure that all share in the benefits of urbanization, customization and targeting are needed for lagging places...** Spatially-targeted policies may also be needed to ensure full inclusion for persistently lagging regions. Rather than targeted incentives to attract firms to remote regions, which has been shown to have little impact outside Java-Bali, the Government could consider focusing more strongly on developing human capital. Such a strategy may be complemented by incentives (through dedicated infrastructure development or reduced red tape, for example) for firms, but specifically based on their contribution to the human capital agenda by investing in skills, especially skills that align with an area's comparative and competitive advantages, and creating jobs with a significant learning content. Rigorous but transparent criteria for selecting targeted industries, as well as monitoring and evaluation of the effectiveness of these policies, is important, as their cost can be high.
- ...and groups that may be otherwise disadvantaged** Finally, customized and targeted policies are also required to make Indonesian cities friendlier to women and girls, the elderly, and people with disabilities who face unique mobility challenges. The varied roles of women in society make their transport patterns more complex than men's, often incorporating journeys between the workplace, schools, and home. Fear of harassment and violence, particularly prevalent on public transportation, can limit women's access to services and jobs. Accessibility challenges in public transportation, sidewalks, and buildings in urban places curtail the mobility and opportunities of the elderly and people with disabilities. For Indonesia's cities to be truly inclusive, urban planning needs to apply design principles and

construction standards for public spaces and buildings that recognize the needs of all segments of the population.

Box B.2: A broad programmatic approach for urbanization in Indonesia

To address the challenges of urbanization in Indonesia, the World Bank is actively supporting the Government of Indonesia in the design and implementation of broad programmatic responses.

The core building blocks of this approach consist of a suite of national programs in sectors that are at the core of sustainable urban development. The National Slum Upgrading Program (KOTAKU), the National Affordable Housing Program (NAHP), and the National Urban Water Supply Program (NUWAS), are currently under implementation. Other national sector programs on solid waste management, urban transport, urban sanitation, and urban flood management, are under preparation. Although the design of each national program varies by sector, all programs focus on enabling subnational governments to implement investments and deliver better services, with clear frameworks and criteria for subnational governments to access technical and financial assistance through the program.

Complementing the national programs is a strong emphasis on building technical and financial capacities for implementation. The Regional Infrastructure Development Fund (RIDF), implemented by PT SMI, offers loans to subnational governments for infrastructure investments. In addition, a technical assistance loan is under preparation for the National Urban Development Project (NUDP), that will strengthen urban management capacity for subnational governments, particularly on integrated planning and municipal finance. In turn, subnational governments will be better able to take on the lead role in planning and implementing investments for their respective city, while the central government role focuses on providing the policy, regulatory and financing frameworks.

A consolidated approach to implementing all of this will require effective coordination: vertically between the central, provincial and local levels, as well as horizontally across sectors, government agencies, and administrative boundaries in multi-district metropolitan areas. Elevating the urbanization agenda as a national development priority, with a high-level coordination mechanism across different parts of government, will be key.

Annex B: A full list of multi- and single-district metro areas

Island	Metro	Type	Core	Peripheries	Area (km ²)	Population			
						Total	Urban	%	Density
Java-Bali	Jakarta	Multi	DKI Jakarta	Kota & Kab Bogor; Kota Depok; Kota & Kab Tangerang; Kota Tangerang Selatan; Kota & Kab. Bekasi	6,800.4	30,962,372	28,627,190	(92.5)	4,553
Java-Bali	Bandung	Multi	Kota Bandung	Kota Cimahi; Kab. Bandung; Kab. Bandung Barat	3,296.1	8,121,474	6,962,478	(85.9)	2,464
Java-Bali	Surabaya	Multi	Kota Surabaya	Kab. Sidoarjo; Kab. Gresik	1,978.4	6,167,832	5,476,349	(88.9)	3,118
Java-Bali	Surakarta	Multi	Kota Surakarta	Kab. Boyolali; Kab. Sukoharjo Kab. Karanganyar; Kab. Klaten	3,131.7	4,325,759	2,690,286	(62.2)	1,381
Java-Bali	Semarang	Multi	Kota Semarang	Kab. Demak; Kab. Kendal	2,285.4	3,713,708	2,496,601	(67.2)	1,625
Java-Bali	Malang	Multi	Kota Malang	Kota Batu; Kab. Malang	3,782.1	3,569,742	2,227,844	(62.5)	944
Java-Bali	Sukabumi	Multi	Kota Sukabumi	Kab. Sukabumi	4,196.6	2,735,825	1,328,911	(48.9)	652
Java-Bali	Denpasar	Multi	Kota Denpasar	Kab. Badung; Kab. Gianyar; Kab. Klungkung; Kab. Tabanan	2,056.4	2,581,421	1,945,334	(75.6)	1,255
Java-Bali	Yogyakarta	Multi	Kota Yogyakarta	Kab. Bantul; Kab. Sleman	1,116.5	2,552,038	2,261,131	(88.9)	2,286
Java-Bali	Pasuruan	Multi	Kota Pasuruan	Kab. Pasuruan	1,499.0	1,761,658	879,423	(50.0)	1,175
Java-Bali	Magelang	Multi	Kota Magelang	Kab. Magelang	1,147.3	1,353,586	466,733	(34.5)	1,180
Java-Bali	Probolinggo	Multi	Kota Probolinggo	Kab. Probolinggo	1,751.0	1,337,679	587,991	(43.8)	764
Java-Bali	Blitar	Multi	Kota Blitar	Kab. Blitar	1,797.1	1,277,350	568,448	(44.6)	711
Java-Bali	Mojokerto	Multi	Kota Mojokerto	Kab. Mojokerto	995.2	1,194,071	641,327	(53.8)	1,200
Java-Bali	Salatiga	Multi	Kota Salatiga	Kab. Semarang	1,056.2	1,167,503	574,426	(49.2)	1,105
Kalimantan	Pontianak	Multi	Kota Pontianak	Kab. Kubu Raya; Kab. Landak; Kab. Mempawah	19,137.9	1,741,065	849,784	(48.8)	91
Kalimantan	Banjarmasin	Multi	Kota Banjarmasin	Kab. Barito Kuala	2,397.2	959,287	714,406	(74.3)	400
Kalimantan	Samarinda	Single	Kota Samarinda		604.8	805,284	757,523	(94.1)	1,331
Kalimantan	Balikpapan	Single	Kota Balikpapan		467.6	610,741	576,559	(94.4)	1,306
Sulawesi	Makassar	Multi	Kota Makassar	Kab. Gowa; Kab. Maros; Kab. Takalar	4,007.9	2,757,084	1,837,228	(66.7)	688
Sumatera	Medan	Multi	Kota Medan	Kota Binjai; Kab. Serdang Bedagai; Kota Tebing Tinggi; Kab. Deli Serdang	4,894.0	5,192,973	4,316,753	(83.2)	1,061
Sumatera	Palembang	Single	Kota Palembang		381.2	1,556,692	1,540,981	(99.0)	4,084
Sumatera	Pekanbaru	Single	Kota Pekanbaru		609.5	1,010,371	991,496	(98.1)	1,658
Sumatera	Bandar Lampung	Single	Kota Bandar Lampung		295.9	959,224	949,563	(99.0)	3,242
Sumatera	Padang	Single	Kota Padang		704.9	890,937	853,321	(95.8)	1,264
Sumatera	Banda Aceh	Multi	Kota Banda Aceh	Kab. Aceh Besar	2,941.4	633,357	358,009	(56.4)	215
Sumatera	Bukittinggi	Multi	Kota Bukittinggi	Kab. Agam	2,294.8	592,953	276,956	(46.8)	258
Sumatera	Kota Jambi	Single	Kota Jambi		103.4	567,450	550,425	(97.0)	5,489

Notes: Table sorted by descending order of total population within each island. Population data from SUSENAS (2016). Metro areas were derived by 1996 level-2 administrative boundaries, while core and peripheral districts in this table are based on the 2016 level-2 administrative boundaries.

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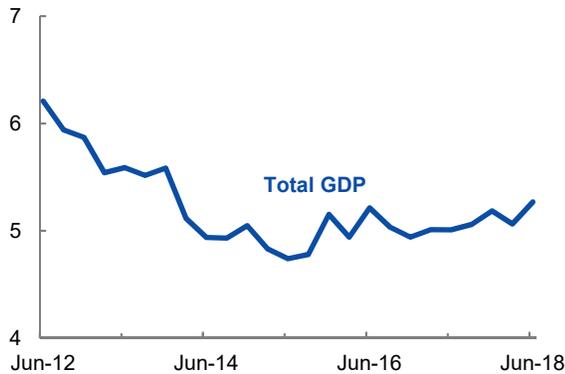
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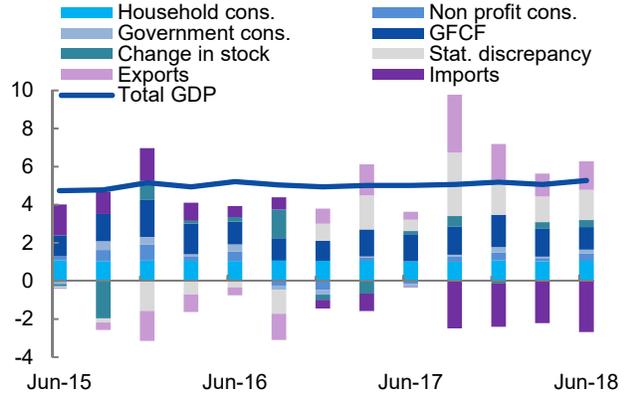
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Real GDP growth
(growth quarterly yoy, percent)



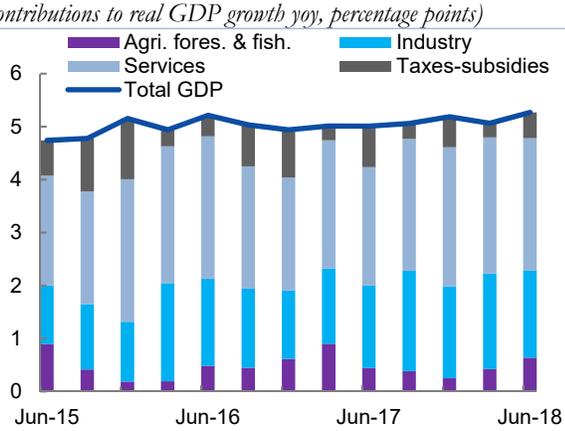
Source: BPS; World Bank staff calculations

Appendix Figure 2: Contribution to GDP growth (expenditure)
(contribution to real GDP growth yoy, percentage points)



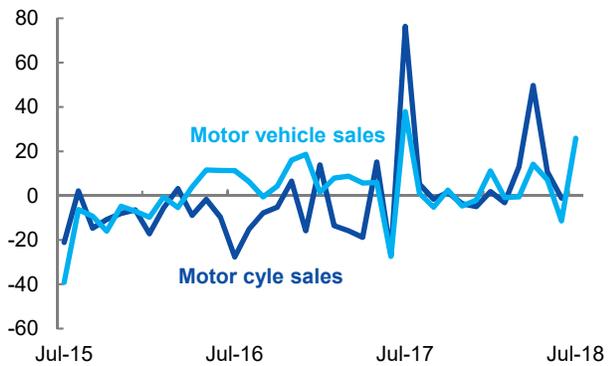
Source: BPS; World Bank staff calculations

Appendix Figure 3: Contribution to GDP growth (production)
(contributions to real GDP growth yoy, percentage points)



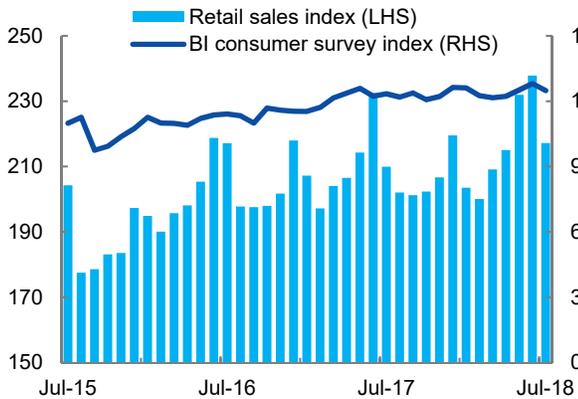
Source: BI

Appendix Figure 4: Motor cycle and motor vehicle sales
(growth yoy, percent)



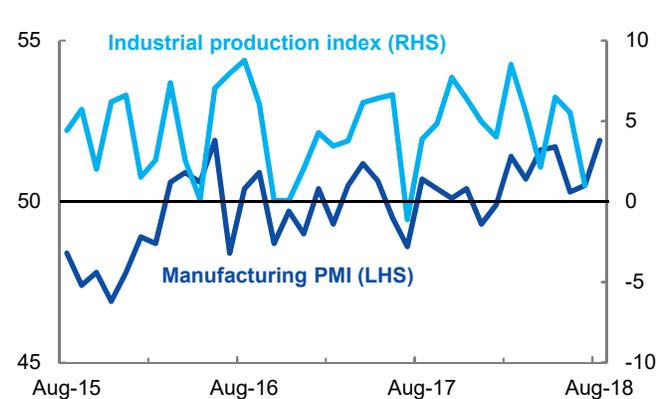
Source: BI

Appendix Figure 5: Consumer indicators
(retail sales index 2010=100)



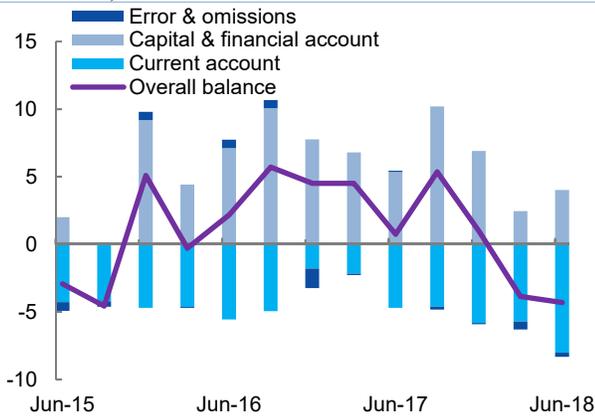
Source: BI

Appendix Figure 6: Industrial production indicators and manufacturing PMI
(PMI diffusion index; industrial production growth yoy, percent)



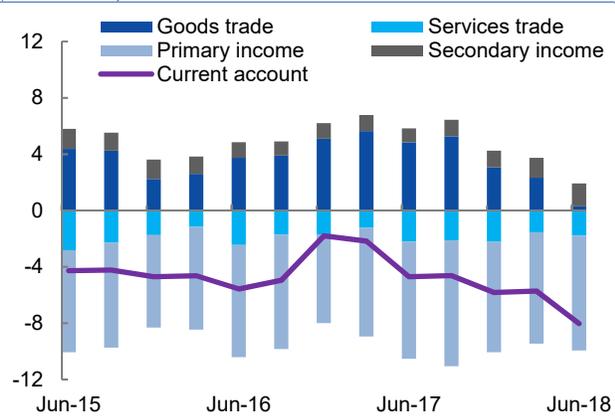
Source: BPS; Nikkei/Markit; World Bank staff calculations
Note: Manufacturing PMI above 50 indicates expansion

Appendix Figure 7: Balance of payments
(USD billion)



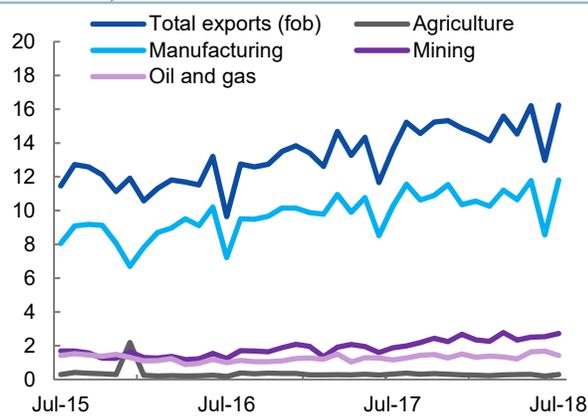
Source: BI

Appendix Figure 8: BOP: Current account
(USD billion)



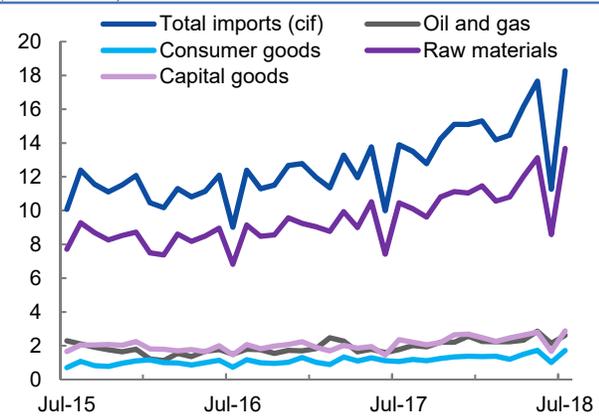
Source: BI

Appendix Figure 9: Exports of goods
(USD billion)



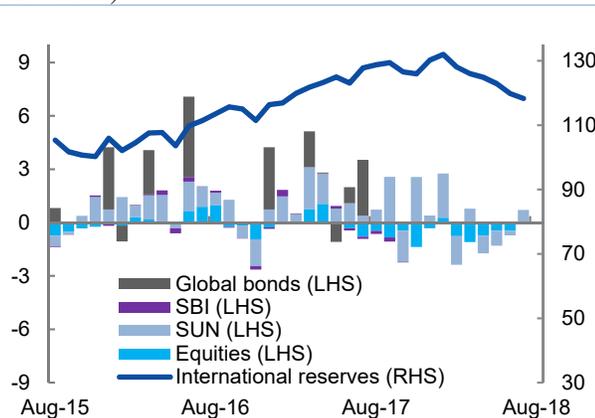
Source: BPS

Appendix Figure 10: Imports of goods
(USD billion)



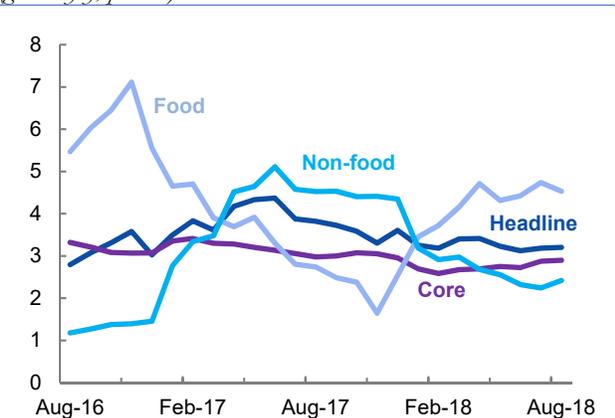
Source: BPS

Appendix Figure 11: Reserves and capital flows
(USD billion)



Source: BI; Ministry of Finance (MoF)
Note: SUN is government securities, SBI is BI certificates

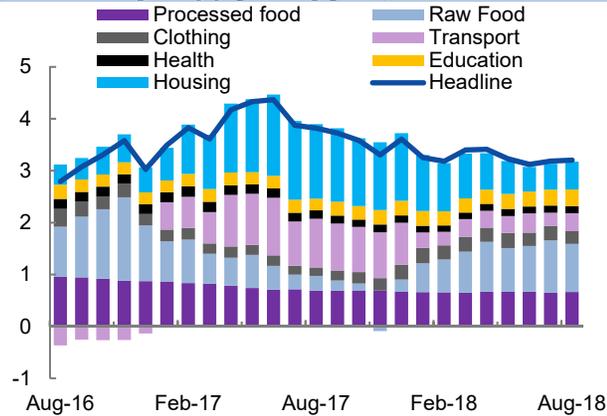
Appendix Figure 12: CPI inflation
(growth yoy, percent)



Source: BPS; BI; World Bank staff calculations

Appendix Figure 13: Monthly breakdown of CPI inflation

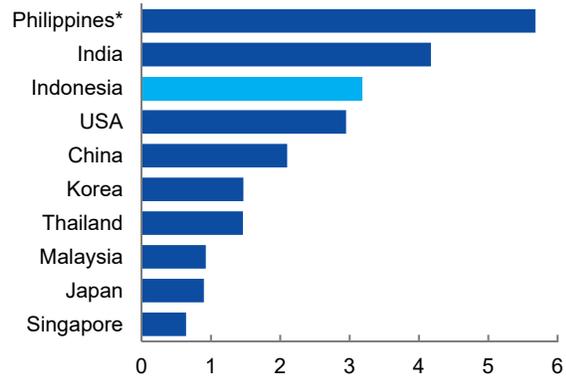
(contribution to growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Appendix Figure 14: CPI inflation comparison across countries

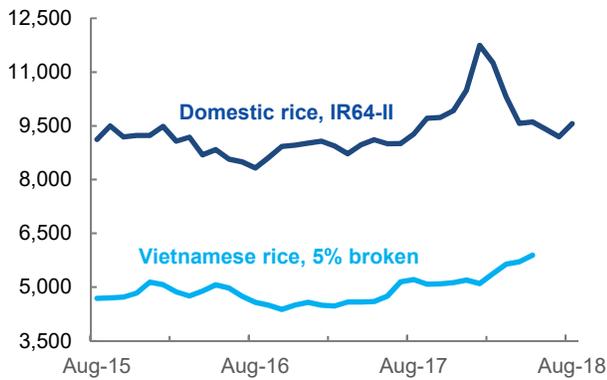
(growth yoy, percent)



Source: BPS; CEIC; World Bank staff calculations
Note: July 2018 data; *June 2018 data.

Appendix Figure 15: Domestic and international rice prices

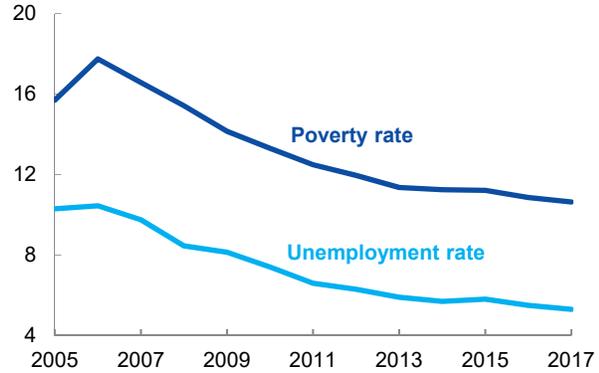
(wholesale price, in IDR per kg)



Source: Cipinang wholesale rice market; FAO
Note: "5% broken" refers to the quality of milled rice. 5 percent being the proportion of grains broken during the processing stage.

Appendix Figure 16: Poverty and unemployment rates

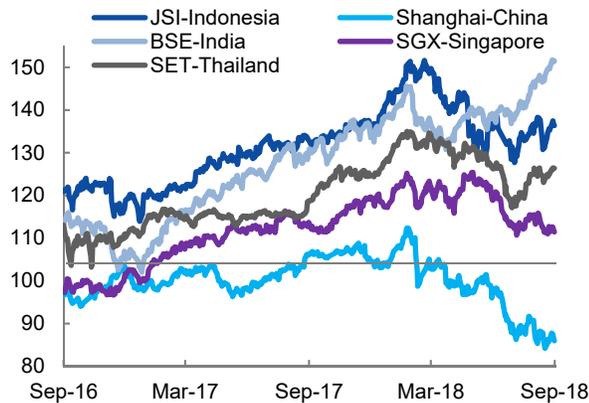
(percent)



Source: BPS
Note: Poverty line based on national poverty line

Appendix Figure 17: Regional equity indices

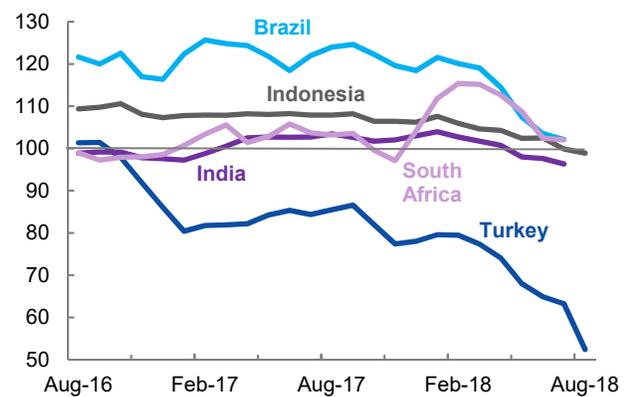
(daily index, September 1, 2015=100)



Source: CEIC; World Bank staff calculations

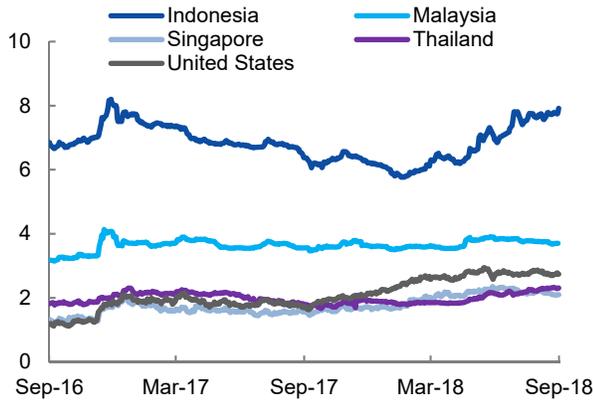
Appendix Figure 18: Spot exchange rates of selected currencies against USD

(monthly index, August 2015=100)



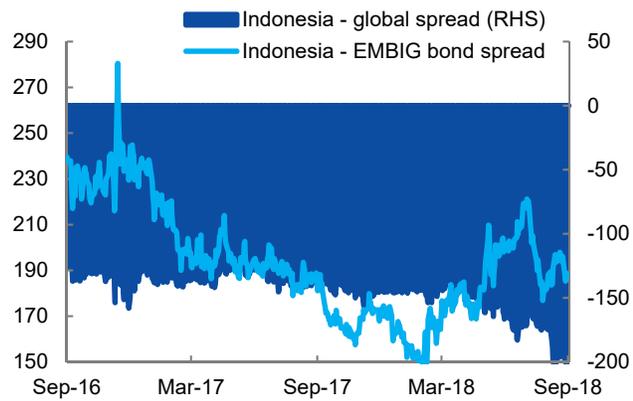
Source: CEIC; World Bank staff calculations

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



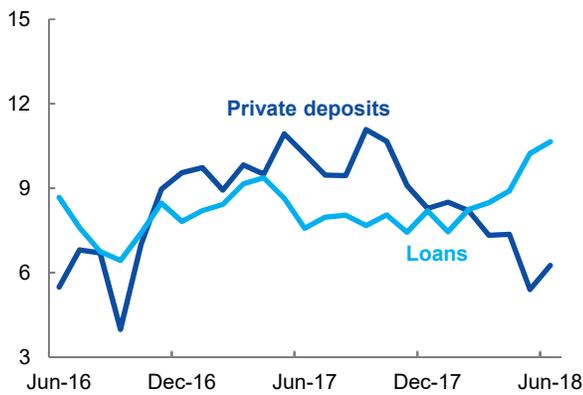
Source: CEIC

Appendix Figure 20: Sovereign USD bond EMBIG spread
(basis points)



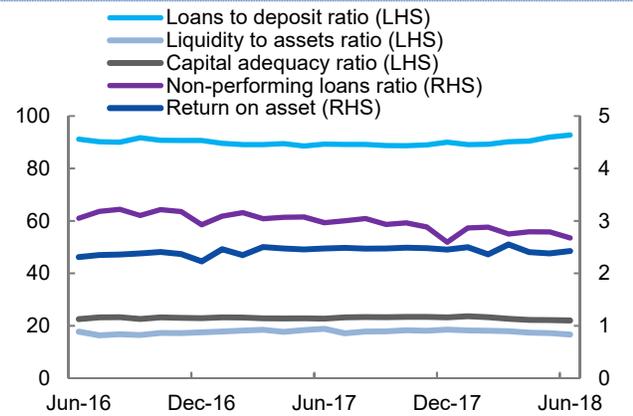
Source: JP Morgan

Appendix Figure 21: Commercial and rural credit and deposit growth
(growth yoy, percent)



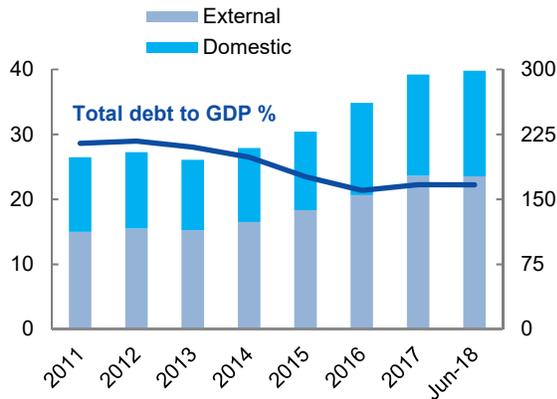
Source: BI; World Bank staff calculations

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



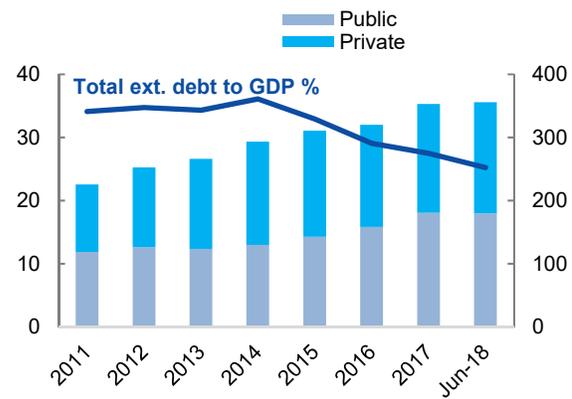
Source: BI; World Bank staff calculations

Appendix Figure 23: Government debt
(percent of GDP, LHS; USD billion, RHS)



Source: BI; MoF; World Bank staff calculations

Appendix Figure 24: External debt
(percent of GDP, LHS; USD billion, RHS)



Source: BI; World Bank staff calculations

Appendix Table 1: Budget outcomes and projections

(IDR trillion)

	2011	2012	2013	2014	2015	2016	2017
	Actual						
A. State revenue and grants	1,211	1,338	1,439	1,550	1,508	1,556	1,666
1. Tax revenue	874	981	1,077	1,147	1,240	1,285	1,344
2. Non-tax revenue	331	352	355	399	256	262	311
B. Expenditure	1,295	1,491	1,651	1,777	1,807	1,864	2,007
1. Central government	884	1,011	1,137	1,204	1,183	1,154	1,265
2. Transfers to the regions	411	481	513	574	623	710	742
C. Primary balance	9	-53	-99	-93	-142	-126	-124
D. Surplus / Deficit	-84	-153	-212	-227	-298	-308	-341
(percent of GDP)	-1.1	-1.9	-2.3	-2.2	-2.6	-2.5	-2.5

Source: MoF; World Bank staff calculations

Note: Budget balance as percentage of GDP uses the revised and rebased GDP

Appendix Table 2: Balance of payments

(USD billion)

	2014	2015	2016	2016	2017				2018	
				Q4	Q1	Q2	Q3	Q4	Q1	Q2
Balance of payments	15.2	-1.1	12.1	4.5	4.5	0.7	5.4	1.0	-3.9	-4.3
<i>Percent of GDP</i>	1.7	-0.1	1.3	1.9	1.9	0.3	2.0	0.4	-1.5	-1.6
Current account	-27.5	-17.5	-17.0	-1.8	-2.2	-4.7	-4.6	-5.8	-5.7	-8.0
<i>Percent of GDP</i>	-3.1	-2.0	-1.8	-0.7	-0.9	-1.9	-1.8	-2.3	-2.2	-3.0
Trade balance	-3.0	5.4	8.2	3.4	4.4	2.6	3.1	0.8	0.8	-1.5
Net income & current transfers	-24.5	-22.9	-25.2	-5.2	-6.6	-7.3	-7.8	-6.6	-6.5	-6.5
Capital & Financial Account	44.9	16.9	29.3	7.8	6.8	5.3	10.2	6.9	2.4	4.0
<i>Percent of GDP</i>	5.0	2.0	3.1	3.2	2.8	2.1	3.9	2.7	0.9	1.5
Direct investment	14.7	10.7	16.1	3.5	2.8	4.4	7.4	4.9	2.9	2.5
Portfolio investment	26.1	16.2	19.0	-0.3	6.5	8.1	4.0	2.0	-1.2	0.1
Other investment	4.3	-10.1	-5.8	4.4	-2.5	-7.2	-1.2	0.1	0.6	1.5
Errors & omissions	-2.2	-0.4	-0.3	-1.5	-0.1	0.1	-0.2	-0.1	-0.6	-0.3
Foreign reserves*	111.9	105.9	116.4	116.4	121.8	123.1	129.4	130.2	126.0	119.8

Source: BI; BPS; World Bank staff calculations

Note: * Reserves at end-period

Appendix Table 3: Indonesia's historical macroeconomic indicators at a glance

	2000	2010	2011	2012	2013	2014	2015	2016	2017
National Accounts (% change)¹									
Real GDP	4.9	6.2	6.2	6.0	5.6	5.0	4.9	5.0	5.1
Real investment	11.4	8.5	8.9	9.1	5.0	4.4	5.0	4.5	6.2
Real consumption	4.6	4.1	5.1	5.4	5.7	4.7	4.9	4.3	4.6
Private	3.7	4.8	5.1	5.5	5.5	5.3	4.8	5.0	5.0
Government	14.2	0.3	5.5	4.5	6.7	1.2	5.3	-0.1	2.1
Real exports, GNFS	30.6	15.3	14.8	1.6	4.2	1.1	-2.1	-1.6	9.1
Real imports, GNFS	26.6	17.3	15.0	8.0	1.9	2.1	-6.2	-2.4	8.1
Investment (% GDP)	20	31	32	33	32.5	32.4	32.4	32.2	32.6
Nominal GDP (USD billion)	165	755	893	918	915	891	861	933	1,015
GDP per capita (USD)	857	3,167	3,688	3,741	3,668	3,532	3,370	3,603	3,878
Central Government Budget (% GDP)²									
Revenue and grants	20.8	14.5	15.5	15.5	15.1	14.7	13.1	12.5	12.3
Non-tax revenue	9.0	3.9	4.2	4.1	3.7	3.8	2.2	2.1	2.3
Tax revenue	11.7	10.5	11.2	11.4	11.3	10.9	10.8	10.4	9.9
Expenditure	22.4	15.2	16.5	17.3	17.3	16.8	15.7	15.0	14.8
Consumption	4.0	3.6	3.8	3.9	4.1	4.0	4.5	4.6	4.4
Capital	2.6	1.2	1.5	1.7	1.9	1.4	1.9	1.4	1.5
Interest	5.1	1.3	1.2	1.2	1.2	1.3	1.4	1.5	1.6
Subsidies	6.3	2.8	3.8	4.0	3.7	3.7	1.6	1.4	1.2
Budget balance	-1.6	-0.7	-1.1	-1.8	-2.2	-2.1	-2.6	-2.5	-2.5
Government debt	97.9	24.5	23.1	23.0	24.9	24.7	27.4	28.3	30.8
o/w external government debt	51.4	11.1	10.2	9.9	11.2	10.2	12.7	12.3	12.8
Total external debt (including private sector)	87.1	26.8	25.2	27.5	29.1	32.9	36.1	34.3	34.8
Balance of Payments (% GDP)³									
Overall balance of payments	..	4.0	1.3	0.0	-0.8	1.7	-0.1	1.3	1.1
Current account balance	4.8	0.7	0.2	-2.7	-3.2	-3.1	-2.0	-1.8	-1.7
Exports GNFS	42.8	22.0	23.9	23.0	22.4	22.3	19.9	18.0	19.1
Imports GNFS	33.9	19.2	21.2	23.2	23.1	22.7	19.3	17.1	18.0
Trade balance	8.9	2.8	2.7	-0.2	-0.7	-0.3	0.6	0.9	1.1
Financial account balance	..	3.5	1.5	2.7	2.4	5.0	2.0	3.1	2.9
Direct investment	-2.8	1.5	1.3	1.5	1.3	1.7	1.2	1.7	2.0
Gross official reserves (USD billion)	29.4	96	110	113	99	112	106	116	130
Monetary (% change)³									
GDP deflator ¹	20.4	8.3	7.5	3.8	5.0	5.4	4.0	2.5	4.3
Bank Indonesia interest key rate (%)	..	..	..	..	..	..	6.3	4.8	4.3
Domestic credit (eop)	..	23.3	24.7	23.1	21.4	11.6	10.1	7.8	8.2
Nominal exchange rate (average, IDR/USD)	8,392	9,087	8,776	9,384	10,460	11,879	13,392	13,307	13,384
Prices (% change)¹									
Consumer price Index (eop)	9.4	7.0	3.8	3.7	8.1	8.4	3.4	3.0	3.6
Consumer price Index (average)	3.7	5.1	5.3	4.0	6.4	6.4	6.4	3.5	3.8
Indonesia crude oil price (USD per barrel, eop) ⁴	28	79	112	113	107	60	36	51	61

Source: ¹ BPS and World Bank staff calculations, using revised and 2010 rebased figures. ² MoF and World Bank staff calculations, ³ BI, ⁴ CEIC

Appendix Table 4: Indonesia's development indicators at a glance

	2000	2010	2011	2012	2013	2014	2015	2016	2017
Demographics¹									
Population (million)	213	243	246	249	252	255	258	261	264
Population growth rate (%)	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.1
Urban population (% of total)	42	50	51	51	52	53	53.7	54	55
Dependency ratio (% of working-age population)	55	51	51	50	50	50	49.2	49	49
Labor Force²									
Labor force, total (million)	98	117	117	120	120	122	122	125	128
Male	60	72	73	75	75	76	77	77	79
Female	38	45	44	46	45	46	46	48	49
Agriculture share of employment (%)	45	38	36	35	35	34	33	32	30
Industry share of employment (%)	17	19	21	22	20	21	22	21	22
Services share of employment (%)	37	42	43	43	45	45	45	47	48
Unemployment, total (% of labor force)	8.1	7.1	7.4	6.1	6.2	5.9	6.2	5.6	5.5
Poverty and Income Distribution³									
Median household consumption (IDR 000 per month)	104	374	421	446	487	548	623	697	765
National poverty line (IDR 000 per month)	73	212	234	249	272	303	331	354	375
Population below national poverty line (million)	38	31	30	29	28	28	29	28	28
Poverty (% of population below national poverty line)	19.1	13.3	12.5	12.0	11.4	11.3	11.2	10.9	10.6
Urban (% of population below urban poverty line)	14.6	9.9	9.2	8.8	8.4	8.3	8.3	7.8	7.7
Rural (% of population below rural poverty line)	22.4	16.6	15.7	15.1	14.3	14.2	14.2	14.1	13.9
Male-headed households	15.5	11.0	10.2	9.5	9.2	9.0	9.3	9.0	8.7
Female-headed households	12.6	9.5	9.7	8.8	8.6	8.6	11.1	9.8	9.3
Gini index	0.30	0.38	0.41	0.41	0.41	0.41	0.41	0.40	0.39
Percentage share of consumption: lowest 20%	9.6	7.9	7.4	7.5	7.4	7.5	7.2	7.1	7.0
Percentage share of consumption: highest 20%	38.6	40.6	46.5	46.7	47.3	46.8	47.3	46.2	45.7
Public expenditure on social security & welfare (% of GDP) ⁴	..	0.4	0.4	0.4	0.5	0.5	0.6	0.5	0.5
Health and Nutrition¹									
Physicians (per 1,000 people)	0.16	0.14	..	0.20	..	..	..	..	..
Under five mortality rate (per 1000 children under 5 years)	52	33	32	31	29	28	27	26	..
Neonatal mortality rate (per 1000 live births)	22	16	16	15	15	15	14	14	..
Infant mortality (per 1000 live births)	41	28	27	26	25	24	23	22	..
Maternal mortality ratio (modeled est., per 100,000 live births)	265	165	156	148	140	133	126	..	..
Measles vaccination (% of children under 2 years)	76	78	80	82	81	75	75	76	..
Total health expenditure (% of GDP)	2.0	2.7	2.7	2.9	2.9	2.8	..	..	..
Public health expenditure (% of GDP)	0.7	1.0	1.0	1.1	1.2	1.1	..	..	..
Education³									
Primary net enrollment rate (%)	..	92	92	93	92	93	97	97	97
Female (% of total net enrollment)	..	48	49	49	50	48	49	49	49
Secondary net enrollment rate (%)	..	61	60	60	61	65	66	66	79
Female (% of total net enrollment)	..	50	50	49	50	50	51	51	49
Tertiary net enrollment rate (%)	..	16	14	15	16	18	20	21	19
Female (% of total net enrollment)	..	53	50	54	54	55	56	55	53
Adult literacy rate (%)	..	91	91	92	93	93	95	95	96
Public spending on education (% of GDP) ⁵	..	3.5	3.6	3.8	3.8	3.6	3.5	3.3	2.98
Public spending on education (% of spending) ⁵	..	20.0	20.2	20.1	20.0	19.9	20.6	20.0	20.0
Water and Sanitation¹									
Access to an improved water source (% of population)	78	85	85	86	86	87	87	..	..
Urban (% of urban population)	91	93	93	94	94	94	94	..	..
Rural (% of rural population)	68	76	77	77	78	79	80	..	..
Access to improved sanitation facilities (% of population)	44	57	58	59	60	61	61	..	..
Urban (% of urban population)	64	70	71	71	72	72	72	..	..
Rural (% of rural population)	30	44	45	46	47	48	48	..	..
Others¹									
Disaster risk reduction progress score (1-5 scale; 5=best)	..	..	3.3	..	..	..	..	..	..
Proportion of seats held by women in national parliament (%) ⁶	8	18	18	19	19	17	17	17	20

Source: ¹ World Development Indicators; ² BPS (Sakernas); ³ BPS (Susenas) and World Bank; ⁴ MoF, Bappenas, and World Bank staff calculations, only includes spending on rice distribution for the poor (Raskin), health insurance for the poor, scholarships for the poor, and Family Hope Program (PKH) and actuals; ⁵ MoF; ⁶ Inter-Parliamentary Union



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