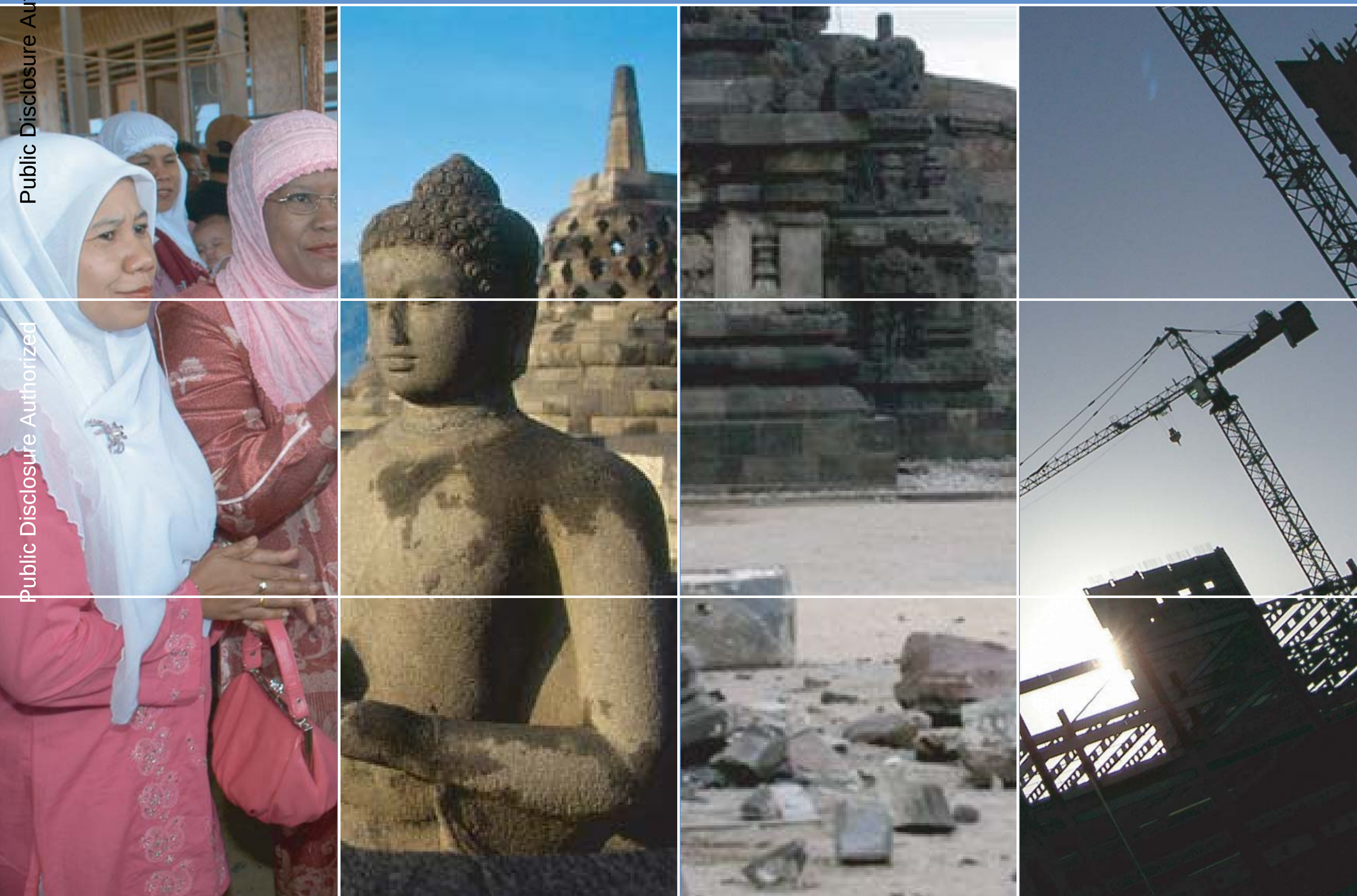
THE WORLD BANK

Indonesia:
Economic and Social Update

October 2006



Indonesia: Economic and Social Update[1]

Summary Introduction

By Mid 2006 Indonesia was showing signs of a solid recovery from the dramatic fiscal and monetary policy adjustments in late 2005 which slowed the economy in the first half of 2006 and increased poverty. Unfortunately this year's economic slowdown was also accompanied by additional natural disasters. On a more positive note, reconstruction in Aceh and Nias is now well underway, with thousands of houses built and more under construction. However, there was another devastating earthquake in Yogyakarta and Central Java (while loss of life was much lower, property and livelihood destruction levels were close to those in Aceh do to the concentration of population), there was another tsunami in West Java and now a mud volcano in East Java.[2] These all continue to add to the toll of destroyed homes and businesses and displaced people. The key economic challenge facing the country involves turning an accelerating cyclical upturn into sustained longer term growth while addressing poverty and improving disaster preparedness and response.

Last year's administered fuel price increases totaling a cumulative 143 percent effectively transferred an estimated US$10 billion of disposable income from consumers to regional and central governments. This shock, combined with interest rate increases of 400bps (between August and December), brought Indonesian growth to below 5 percent in the first half of 2006. Despite the economic slowdown, these adjustments designed to put Indonesian fiscal and monetary policy on solid footing, were very well received. The exchange rate strengthened, the interest rate cycle reversed, new stock market highs were reached and rating upgrades were announced (by Moody's from B2 to B1 in May and by S&P from B+ to BB- in July).

The slowdown was milder than expected in part because the slowdown in private consumption in the first half was milder than expected (growth of 3.0 percent*)* but investment was badly hit contracting by -0.1 percent as businesses took a wait and see attitude. The short-run negative shock was contained with stronger than expected growth in exports (total exports were up 17.2 percent in the first eight months) and a substantial pick up in government spending. Government spending was up 38 percent over relatively low levels in 2005 and included cash transfers of approximately US$30 per households per quarter to over 19 million households. These increases in central spending were in part offset by the inability of regional governments to program and spend resource transfers that averaged an increase of over 50 percent per region. These transfers were created from their share of higher revenues and lower subsidies due to high international fuel prices and higher domestic fuel prices. Higher (in fact, record) exports and slowing growth in imports raised the current account balance to US$4.6 billion in the first half, (much higher than US$0.8 billion a year earlier). Exports clearly benefited from higher international commodity prices with agriculture commodities up 12 percent and mining 46 percent while industrial exports

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[1] This paper is prepared by Yoichiro Ishihara (World Bank Office Jakarta, Economist) under the supervision of William Wallace (Lead Economist). Financial sector is contributed by P.S. Srinivas and Djauhari Sitorus.

[2] Approximately one hundred sixty five thousand tons of mud flow each day from an oil and gas drilling well close to Indonesia's second largest city Surabaya. In less than six months this flow has cut the main toll and rail links, forced the closing of many factories and driven an estimated 10,000 people from their homes.

lagged. The fuel price increase and slowing growth contained imports (total imports grew 6 percent while fuel and lubricants were only up 4 percent.

Unfortunately, despite the increased spending on poverty programs, poverty rose from 16 percent to 17.75 percent between 2005 and 2006. The cash compensation program was calibrated to compensate the poor for the direct and indirect impacts of higher fuel prices, but rice prices had also increased by over 30 percent by early 2006.[3] As the poor spend close to a quarter of their income on rice naturally poverty rose.

A turnaround in the current account, balance in the capital account[4] and a strengthening Rupiah allowed Bank Indonesia to add substantial international reserves. Reserves which had fallen to a low of US$30 billion in September 2005 were at US$41 billion in September despite prepaying almost US$8 billion to IMF. By end September inflation had fallen to 14.5 percent from of 17.1 percent at year end 2005 as the impact of last year's fuel price increase works it way through. In fact as the base effect is removed from the year-on-year inflation in October the inflation rate is expected to fall below Bank Indonesia's inflation target of 7 to 9 percent. As inflation and inflation expectations have fallen the Central Bank has gradually reduced interest rates from a high of 12.75 percent. Single digits or close is expected by year end. The central government budget deficit is currently estimated to be approximately 1 percent of GDP and the government debt to GDP ratio should be below 40 percent by year end.

As noted markets had been anticipating accelerating growth and recent data confirms this. By August/September most real indicators (cars, motorcycles, cement, etc.) are turning sharply upward. The import of capital goods, which had turned down and was largely responsible for low investment, began to recover in the third quarter and August saw the largest single month's capital imports since September 1997 (US$855 million).

The government's policy recognizes the need to reinforce this improving macroeconomic position with investment climate reforms. To accomplish this three key policy packages are being implemented:

Investment climate reforms are divided into five categories: (i) general investment policies; (ii) customs; (iii) tax; (iv) labor; and (v) SMEs. Among the many measures included are completion of an investment law with new regulations designed to increase transparency and reduce red tape; cuts in corporate and personal income tax rates; business friendly revisions to tax administration; and improved procedures in customs.
Infrastructure includes four main policy items: (i) establishing an effective framework for policy, regulation, and new institutions; (ii) sector specific reforms; (iii) facilitating increased local government participation in infrastructure; and (iv) improved project preparation. One of the key framework measures has been the creation of a Risk Management Unit at the Ministry of Finance which can offer guarantees to private sector infrastructure providers on

[3] This increase in rice prices reflects the rapid increase in domestic and not international prices due to ban on rice imports that has recently been relaxed.
[4] The capital account improved from an outflow of US$2.3 billion in H1 2005 to an outflow of only US$0.4 billion in H1 2006. Net FDI is close to balance and strong portfolio investment compensates for official outflows.

behalf of the Government, and specific budget allocations for the contingent liabilities taken on.

The **financial** reform package was formulated with three broad objectives (i) increasing access to finance (ii) reducing the cost of finance and (iii) diversifying the financial sector and reducing its vulnerability to shocks. Among other things this latest package has provisions that allow State Banks to provision and write down bad debts and begins the long sought after clean-up of the insurance sector.

Each of these packages includes important reform measures but there have been implementation problems. Measures have sometimes slipped or been dropped and the quality of the reforms enacted has not been consistent. Revisions to Labor Law 13/2003 designed to foster increased employment met a negative reaction from labor and other groups and the submission of the Law was put on hold. The government is now discussing changes to regulations that would provide more flexibility in severance and out-sourcing provisions. The investment law is on this year's Parliament agenda but the implementing decrees that will actually improve transparency and reduce red tape, have to await final enactment. The submission of business friendly tax measures was held up in Parliament and are now expected to take effect in 2008 and lack of capacity has slowed the development of infrastructure projects.

In sum both fiscal and monetary polices are now supportive of higher growth. Bank Indonesia's monetary easing has reduced policy interest rates by two percent since May with room for further easing into 2007 as inflation continues to fall. This should spur demand for corporate investment and recovery in consumer durables. Both central and regional government spending is also rising and there is fiscal space to expand public investment into 2007 and beyond. The current policy momentum should result in increased investment and bring the economy into the 6 percent growth range by early 2007. Growth for the year should be 6 to 6.5 percent. There are two challenges. First is to maintain this growth throughout 2007 and into the longer term. This will require investment and financial sector reforms that trigger business confidence and ramping up public and private infrastructure spending to overcome binding energy and transport constraints. The second challenge is to reverse the negative impact on the poor that policy adjustments and rice prices have created through more and better pro-poor public spending.

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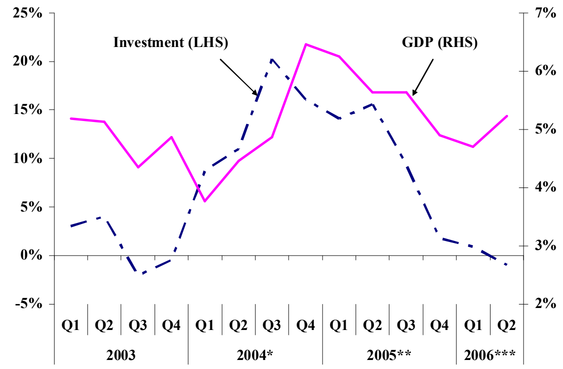
1. Growth and Investment

Economic growth bottomed out in the first half of 2006. The results of Q2 2006 GDP are almost in line with earlier projections. Economic growth accelerated from 4.7 percent (revised up from 4.6 percent) in Q1 to 5.2 percent in Q2 (Figure 1). Higher growth was supported by higher public spending (both central and regional) as well higher net exports. With growth rates accelerating the economy is set to achieve mid 5 percent growth in 2006.

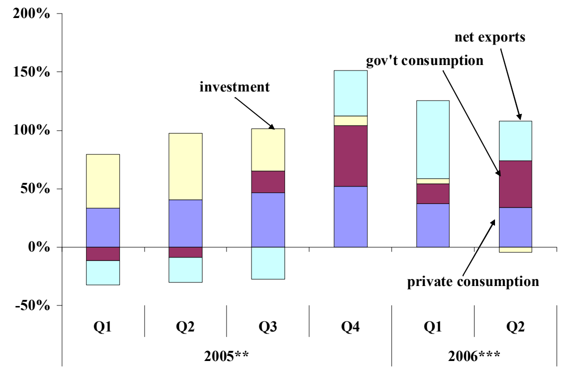
Figure 1: Growth and Investment
(year-on-year growth rate, percent)



Source: BPS, World Bank

Sources of growth have shifted (Figure 2). Net exports continued strong contributing 34 percent to year-on-year GDP in Q2. Exports picked up on higher commodity prices (including oil and gas). Increases in the fuel prices and declines in fuel imports also added to net exports (please see external sector). Government consumption (including central and regional governments) has been contributing significantly for a number of quarters up from a very low base in 2005. By contrast investment growth has been weak for several quarters and was negative in Q2 for the first time since Q4 2003 (Figure 1). As a result, the investment to GDP ratio (nominal) fell to 21.4 percent, 1.4 percent below the peak in Q4 2004.

Figure 2: Source of Growth Shifted
(year-on-year growth rate, percent)



Source: BPS, World Bank

Reversing a long-term trend growth in oil and gas turned positive supporting higher overall growth and natural resources more broadly (please see sectoral growth rates in Table 1). Natural resource sector growth (i.e. oil and gas plus mining) increased from 0.8 percent (yoy) in Q1 to 3.0 percent in Q2 whereas growth in the remainder of the economy (non-

Table 1: Growth by Sector and Category
(Year on year, percent)

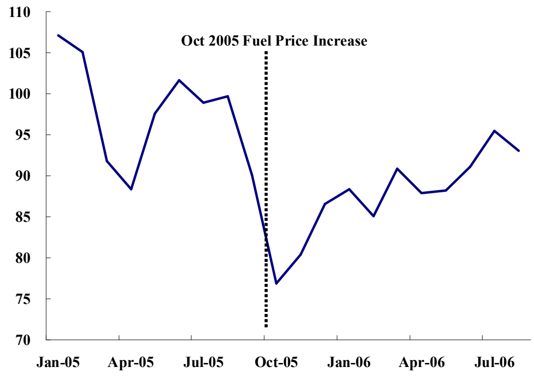
	2005	H1 06	Q1 06	Q2 06
Tradable	**3.5%**	**3.7%**	**3.4%**	**4.0%**
Agriculture	2.5%	4.5%	3.9%	5.0%
Mining	1.6%	4.5%	3.6%	5.4%
Manufacturing	4.6%	3.1%	3.1%	3.0%
Non-Tradable	**8.0%**	**6.3%**	**6.1%**	**6.5%**
Construction	7.3%	7.7%	7.2%	8.3%
Finance	7.1%	5.2%	5.4%	5.1%
Transport & Commu.	13.0%	12.2%	11.0%	13.3%
Utility	6.5%	5.7%	5.8%	5.7%
Trade, Hotel & Restaurant	8.6%	4.7%	4.7%	4.6%
Services	5.2%	5.7%	5.4%	5.9%
Non Resource Based	**7.1%**	**5.6%**	**5.6%**	**5.7%**
Resource Based	**-0.8%**	**2.9%**	**0.8%**	**3.0%**
Total	**5.6%**	**5.0%**	**4.7%**	**5.2%**

Source. BPS, World Bank

natural resources) was relatively flat at 5.7 percent. By contrast manufacturing growth slowed abruptly. Non-oil and gas manufacturing grew by 7.5 percent in 2004, slowing to 4.6 percent in 2005 and 3.1 percent in the first half of this year. In the manufacturing sector (i) chemicals, fertilizer and rubber; (ii) cement and non-metals; and (iii) transportation equipment fell in the wake of higher fuel prices and slowing economic activity.

Signs of economic recovery. A number of key economic indicators improved in the third quarter. The monthly growth rates of motorbike sales has now been positive for 5 straight months (between May and September), though year-on-year growth rates remain negative and August automobile sales are up by 28 percent. These signs of recovery are supported by consumer confidence indicators. The consumer confidence index (Figure 3) fell sharply in October 2005 but has been continuously recovering since then and is now approaching pre-fuel price hike levels. Continuing declines in interest rates (see section 4) are expected to support the recovery in durable goods sales in the near term.

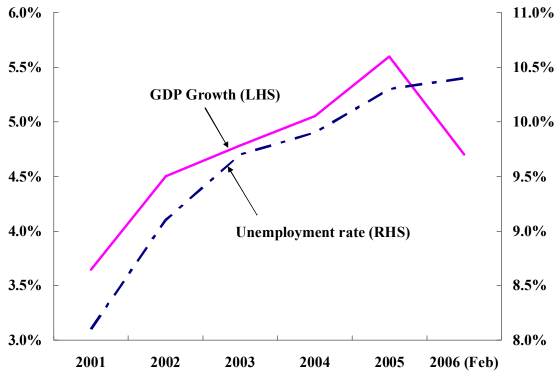
Figure 3: Confidence Recovering
(consumer confidence index, 2000=100)



Source: Bank Indonesia, World Bank

Employment weak. With slowing growth overall unemployment edged up from 10.3 percent in February 2005 to 10.4 percent in February 2006 (Figure 4) and labor force participation fell from 68.0 to 66.7 percent. Even more troubling youth unemployment, already high, rose from 28.7 to 30.6 percent. The combination suggests that employment growth continues to stagnate despite moderate economic growth (4.9 percent for H1 2006 over H1 2005) and that workers are becoming more pessimistic about job prospects. The combination of moderate economic growth and limited job creation reflects the growth in relatively less labor intensive sectors and that labor productivity growth continues to be high. The current level and sources of growth are not creating enough job opportunities but the latest survey will have been affected by the fuel price increase and slow down in late 2005.

Figure 4: Rising unemployment rate
(growth rate and unemployment rate)



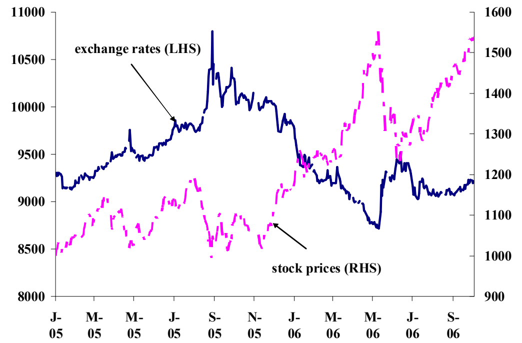
Source: BPS, World Bank

2. Markets

Rating upgraded. In light of recent improvements in Indonesia's macroeconomic situation (including improvements in debt indicators) and political stability, major rating agencies upgraded ratings. Moody's began the most recent upgrades in May (from B2 to B1) followed by Standard & Poors in July (from B+ to BB-) and a Japanese ratings firm (R&I) in October (from BB- to BB). Although ratings are still below the investment grade, these ratings upgrade reflect and support rising market confidence.

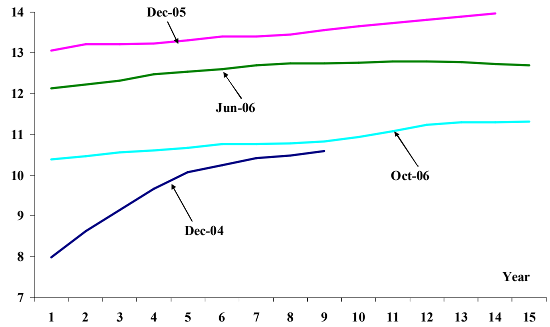
Rupiah, stock prices and yield curve improve. Financial markets are increasingly confident about financial stability and macroeconomic prospects. The exchange rate has been less volatile trading between Rp.9,000-9,500 for months and stocks have been traded at historic highs(Figure 5). Bond yields have fallen markedly at all maturities (Figure 6). At the longer end yields are closing on end-2004 lows. The declines in these long-term yields also reflects improving market sentiments, with short-term yields affected by policy interest rates (please see inflation and monetary policy).

Figure 5: Market Confidence is back
(rupiah exchange rate and stock index)



Source: CEIC, World Bank

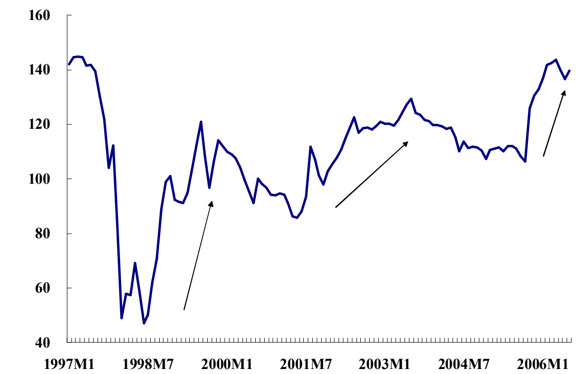
Figure 6: Declining interest rates
(domestic bond yield curve, percent)



Source: CEIC, World Bank

Real exchange rate appreciates. While the nominal exchange rate stabilized, the real effective exchange rates (REER) appreciated substantially through July 2006 (latest data available). Between September 2005 and July 2006, the nominal exchange rate appreciated by 11.2 percent, while REER appreciated by 31.3 percent (Figure 7).[5] While September 2005 was a recent low, the latest increase represents the third steep appreciation in the REER since the crisis and it is now approaching its

Figure 7: Real exchange rates appreciated
(REER 2000=100)



Source: BPS, World Bank

[5] The real effective exchange rate (REER) adjusts for the currency composition and relative rates of inflation between trading partners and is thus a better measure of competitiveness than the nominal exchange rate in USD.

pre-crisis level. The recent REER appreciation was caused by a combination of higher inflation and nominal exchange rate appreciation.

3. External Sector

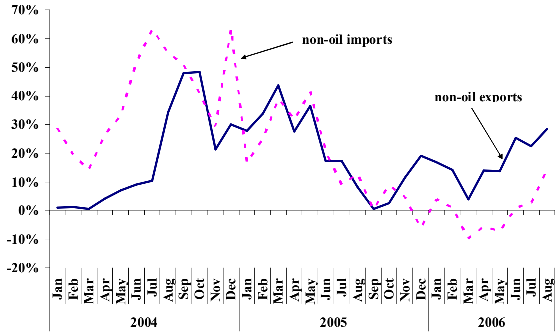
Exports hit record highs. Non-oil and gas trade has been picking up speed since the second quarter. Though exports and imports have both accelerated, export growth rates have outstripped the import growth rate (Figure 8). As a result, the year to date non-oil and gas trade balance improved from US$18.2 billion in 2005 to US$23.0 billion as of August 2006. Among non-oil and gas exports, mining (e.g. nickel, copper, iron, etc.) were standouts in light of higher prices, while electronics have been sluggish.

Capital good imports finally reach pre-crisis levels. Capital goods imports continue on a rising trend and at US$855 million in August were the highest since 1997. The slump in capital goods imports (Figure 9.) was the main cause of the recent decline in investment (construction the other main contributor remained strong). With this pickup investment should begin to recover in the third quarter.

The Oil and gas balance remains positive, though smaller. After the fuel price increase in October 2005, oil and gas imports fell sharply, contributing to a positive oil and gas balance. However, in Q2 and Q3, economic recovery appears to be linked to rising imports. By contrast, export growth was modest. The sharp import increase in June was caused by the loss of refinery capacity, (the oil and gas balance turned temporarily negative).

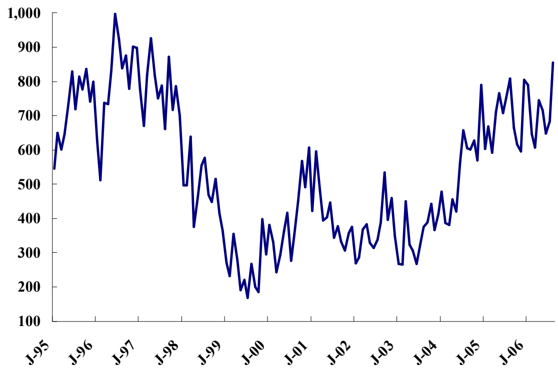
Balance of payments improves. In the first half of 2006, the current account surplus reached US$4.5 billion, much higher than US$0.8 billion in the same

Figure 8: Widening Growth Gap
(non-oil and gas exports and imports, year-on-year growth, percent)



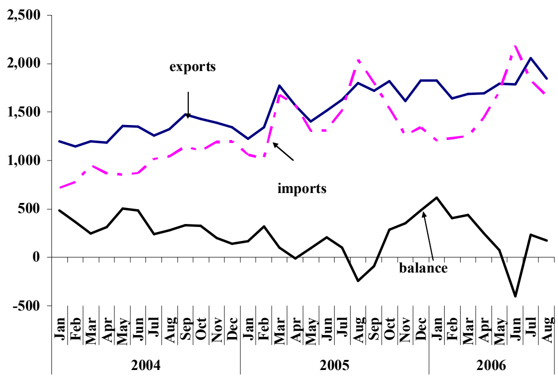
Source: BPS, World Bank

Figure 9: Capital goods imports reached pre-crisis
(US$ million)



Source: BPS, World Bank

Figure 10: Oil and Gas Balance Remains Positive
(US$ million)

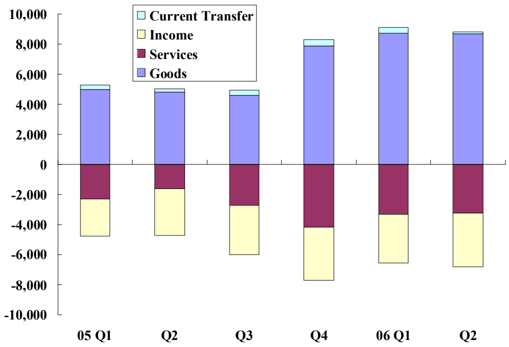


Source: BPS, World Bank

period in 2005. Although the service balance deteriorated, the goods balance more than compensated (Figure 11). On the capital account gross FDI inflows (equity and retained earnings) were steady at US$2.5 billion a quarter (Figure 12) suggesting strong investor sentiment despite the fuel price increase in 2005 and the resulting economic slowdown.

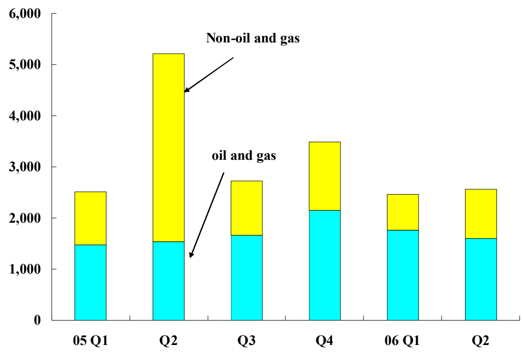
External risk indicators improved. Two key indicators of external risks international reserves and external debt improved. International reserves had fallen to US$30 billion in September 2005 but have been continuously increasing since to reach US$40 billion in October despite prepayments of approximately US$8 billion to the IMF. As of August (the latest trade data available), international reserves were 7.5 months of good imports. The external debt to GDP ratio is continuing its downward trend, falling to 41 percent in June 2006, compared with 48 percent in 2005.

Figure 11: Higher current account surplus
(US$ million)



Source: Bank Indonesia, World Bank

Figure 12: Stable Gross FDI Inflows
(US$ million)



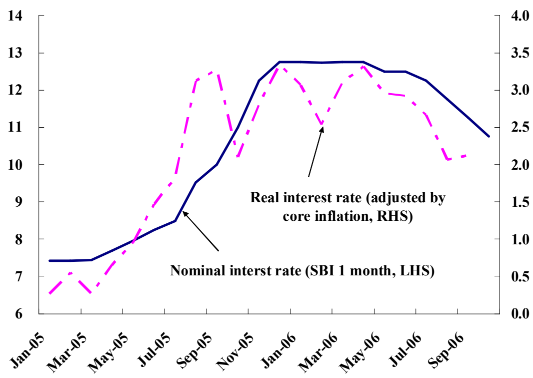
Source: Bank Indonesia, World Bank

4. Inflation and Monetary Policy

Inflation decelerates. Inflation reached as high as 18.4 percent (yoy) in November 2005 after the 114 percent fuel price increase in October. However, tight monetary policy, exchange rate appreciation, and a slowdown in economic activity contained inflation pressure. Overall inflation has decelerated to 14.5 percent (yoy) in September 2006 and second round impacts have been contained. Core inflation (excluding volatile food and administrative prices) has fallen from 10.2 percent in February to 9.1 percent in September 2006.

Monetary policy stance changed. After increasing policy interest rates by 500 bps between March and December 2005, Bank Indonesia began to cautiously lower them in May 2006. Caution has been needed as Bank Indonesia has been lowering rates while global interest rates (e.g. Federal Fund rate in US) have been rising and

Figure 13: Monetary Policy Changed
(interest rates, nominal and real, percent)



Source: CEIC, World Bank

currency volatility remains a real possibility. Most recently Bank Indonesia lowered its policy interest rate (SBI 1 month) to 10.75 percent in October. Real interest rate (adjusted by core inflation) also fell from a peak of 3.3 percent in December 2005 to 2.1 percent in September 2006 (Figure 13). As signs of inflationary pressure recede Bank Indonesia has room for additional policy interest cuts.

5. Fiscal Policy

<u>2006 Revised Budget</u>

Higher budget deficit projected. In September, parliament approved the revised 2006 budget (APBN-P). The budget deficit as a share of GDP was revised from 0.7 percent (Rp.22 trillion) to 1.3 percent (Rp.40 trillion) due to higher expenditures from (i) carry-over of elements of the unspent 2005 budget; (ii) additional expenditures related to disasters (Aceh and Nias reconstruction and Yogyakarta reconstruction) and (iii) added non-fuel subsidies (mainly electricity). However, the 2005 budget deficit ended the year at (0.5 percent) smaller than the government projection at (0.9 percent) and lower spending is likely in 2006 as well. In sum a small increase in the 2006 budget deficit (which may or may not happen) will not impact on Indonesian fiscal stability.

Table 2: Macroeconomic Assumption in 2006-2007

	2006 APBN	2006 APBN-P	2007 APBN
Nominal GDP (t.Rp)	3,041	3,119	3,531
GDP growth rate (%)	6.2	5.8	6.3
CPI Inflation (average, %)	8.0	8.0	6.5
Exchange rate	9,900	9,300	9,300
SBI Interest rate (3M %)	9.5	12.0	8.5
Oil price (ICP, US$)	57	64	63
Oil prod (m bbl/day)	1.05	1.00	1.00

Source: MOF various materials

Macroeconomic assumptions revised (Table 2). Economic growth was revised down from 6.2 percent to 5.8 percent. The oil price was revised from US$57/bbl to US$64/bbl and oil production was also revised from 1.05 million barrels a day to 1.0 million barrels a day. The exchange rate was revised from Rp.9,900 to Rp.9,300. The net effect of all the revisions is relatively minor negative adjustment to budget balances.

Table 3: Government Revenues
(% GDP)

	05 Act	06 APBN	06 Rev	07 APBN
A. Total Revenues	**18.1**	**20.6**	**21.1**	**20.5**
I. Domestic Revenues	18.1	20.4	21.0	20.4
1.Tax Revenues	**12.7**	**13.7**	**13.6**	**14.4**
a. Domestic Tax	12.2	13.1	13.2	14.0
i. Income Tax	6.4	6.9	6.9	7.4
- Non-Oil&Gas	5.1	5.7	5.6	6.2
- Oil & Gas	1.3	1.2	1.2	1.2
ii. Sales tax (VAT)	3.7	4.2	4.3	4.6
iii. Building Tax	0.6	0.5	0.6	0.6
iv. Duties on Land	0.1	0.2	0.1	0.2
v. Excises	1.2	1.2	1.2	1.2
vi. Other taxes	0.1	0.1	0.1	0.1
b. Int'l Trade Tax	0.6	0.6	0.5	0.4
i. Import duties	0.5	0.5	0.4	0.4
ii. Export tax	0.0	0.0	0.0	0.0
2. Non Tax Receipts	**5.4**	**6.8**	**7.4**	**6.0**
a. Natural Resources	4.0	5.0	5.3	4.1
- Oil and Gas	3.8	4.8	5.1	4.0
i. Oil	2.7	3.6	4.0	3.0
ii. Gas	1.1	1.2	1.2	1.0
- Non-Oil and Gas	0.2	0.2	0.2	0.2
iii. Public Mining	0.1	0.1	0.1	0.1
iv. Forestry	0.1	0.1	0.1	0.1
v. Fishery	0.0	0.0	0.0	0.0
b. Profits of SOEs	0.5	0.8	0.7	0.5
c. Other Non-tax	0.8	1.0	1.3	1.3
II. Grants	0.0	0.1	0.1	0.1

Source: MOF, World Bank

Revenues (Table 3). However, revenues projections were raised from 20.6 percent of GDP to 21.1

percent mostly due to higher oil and gas revenues. Non-oil and gas domestic tax revenues remained 12.0 percent. In the area of non-tax revenues, financial resource transfers from Pertamina (the state-owned oil company) are still a concern. For example, the approved budget envisaged that Pertamina would transfer outstanding arrears. However, with continuing cash flow problems at Pertamina, the government has revised down revenue projections from this source.

Expenditures (Table 4)**.** Expenditures rise from 21.3 percent to 22.4 percent. Domestic interest payments increase by 0.3 percentage points due to higher interest rates. Subsidies rise by 0.9 percentage due to higher fuel (0.3 percent) and electricity subsidies (0.5 percent). These increases are the direct outcome of higher international oil prices and government's decision to not to increase the electricity tariff in 2006 by the 20-30 percent assumed in the approved budget.

Preliminary results through September show that revenues reached 59.2 percent of the revised estimate and expenditures 57.7 percent. As a result, the budget balance was a deficit of Rp.13 trillion, much lower than the projected deficit of Rp.40 trillion assumed for the year. Non-oil income tax at 67 percent of the revised budget and VAT at 65 percent are almost in line with original projections and should be on track as revenues accelerate toward the end of year. Disbursements continue to be slow with capital only 37 percent of the revised budget, social assistance 55 percent and subsidies 38 percent. Spending on capital and social assistance also accelerates toward end of fiscal year and should rise steeply although possibly the year will end under spent. Although worse than usual more than 70 percent of capital spending was done in the fourth quarter in 2005.

2007 Approved Budget

Lower budget deficit. Parliament has now also approved the 2007 budget (mid-October). The government proposal to parliament has the following features.

- **A Reasonable growth assumption:** The government growth rate projection at 6.3 percent (Table 2) is close to the market consensus as well as the World Bank projection at 6.2 percent. In line with recent market trends the oil price assumption was reduced from US$65/bbl to US$63/bbl.

- **Declining budget deficit:** The budget deficit as a share of GDP is projected to decline again

Table 4: Expenditures and Budget Balance
(% GDP)

	05 Act	06 APBN	06 Rev	07 APBN
B. Expenditures	**18.6**	**21.3**	**22.4**	**21.6**
I. Central Government	13.1	14.1	15.3	14.3
1. Personnel Expenditures	2.1	2.6	2.5	2.8
2. Material Expenditures	1.1	1.8	1.8	2.0
3. Capital Expenditures	1.2	2.1	2.2	2.2
4. Interest Payments	2.1	2.5	2.6	2.4
a. Domestic	1.6	1.6	1.9	1.7
b. External	0.5	0.9	0.8	0.8
5. Subsidy	4.4	2.6	3.5	2.9
a. Fuel	3.5	1.8	2.1	1.8
b. Non-Fuel	0.9	0.8	1.4	1.2
6. Grants	0.0	0.0	0.0	0.0
7. Social Assistance	1.0	1.2	1.3	1.4
8. Others	1.1	1.2	1.4	0.5
II. Transfer to Regions	5.6	7.2	7.1	7.3
1. Balancing Funds	5.3	7.1	7.0	7.1
a. Revenue Sharing	1.9	2.0	1.9	1.9
b. General Allocation	3.3	4.8	4.7	4.7
c. Special allocation	0.2	0.4	0.4	0.5
2. Special Autonomy	0.3	0.1	0.1	0.2
C. Primary balance	**1.6**	**1.8**	**1.4**	**1.3**
D. SURPLUS / DEFICIT	**-0.5**	**-0.7**	**-1.3**	**-1.1**

Source: MOF, World Bank

from 1.3 percent in 2006 (revised budget) to 1.1 percent in 2007 budget. The primary balance is expected to be a 1.3 percent of GDP surplus.

- **Non-oil and gas tax revenues increase**: With continued efforts to improve tax administration and the delay of the corporate and individual tax cut non-oil and gas domestic tax revenues are projected to increase from 12.4 percent in the 2006 revised budget to 13.2 percent in the 2007 budget. This is comprised of non-oil income taxes (from 5.6 percent to 6.2 percent), VAT (from 4.3 percent to 4.6 percent) as the main sources.

- **Central government discretionary expenditures[6] decline:** Discretionary expenditures decline from 6.5 percent of GDP in the 2006 revised budget to 6.2 percent in the 2007 budget. Though lower than 2006, this amount of discretionary spending (fiscal space) remains much higher than recent years, for example in 2004 and 2005 it averaged 4.0 to 4.5 percent of GDP. Appropriate spending choices and public financial management will continue to be key if Indonesia is to use these increased resources wisely.

- **Capital expenditures rise:** Capital spending by the central government approximately doubled in the 2006 budget (from 1.2 percent of GDP in 2005 to 2.1 percent in 2006) and rose again to 2.2 percent in the revised 2006 budget where it is projected again in 2007. These levels of central government capital spending especially when coupled with estimated increases in regional capital spending are quite substantial.

6. Financial Sector Development

Financial Performance of the Banking Sector (Table 5)

Banks interest margins and total earnings remained healthy as the banking sector generally withstood the adverse impact of the interest rate increases beginning in 2005. Capital adequacy ratios remained high at 20 percent despite some deterioration in the quality of commercial and consumer loans as banks made sufficient loan loss provisions. The two largest state banks did not have the authority to commercially restructure corporate NPLs but an amended Government regulation allows state banks the same rights as private ones which should speed the process of NPL resolution and increase lending. From macro perspective, the decision of Bank Indonesia to reverse the interest rate cycle signals the start of a more benign interest rate environment that will continue to be favorable for NPL resolution.

[6] Defined as total expenditures minus personnel expenditures, interest payments, subsidy and transfers to regions.

Table 5: Banking Sector Financial Indicator (percent)

	2001	2002	2003	2004	2005	2006	
	Dec	Dec	Dec	Dec	Des	Mar	June
CAR	19.90	22.40	19.40	19.40	19.30	21.84	20.47
NIM	3.60	4.10	4.60	5.90	5.63	5.70	5.88
NPL(Gross)	12.20	7.50	6.80	4.50	7.56	8.19	8.33
ROA	1.50	2.00	2.60	3.50	2.55	2.57	2.54
ROE	13.90	15.00	21.40	23.00	18.02	21.8	19.1
Op.Ex/Op.Inc	98.40	94.80	88.10	76.60	89.50	101.11	88.77
LDR	33.00	38.20	43.50	50.00	59.66	61.14	61.21

Source: Bank Indonesia, World Bank

Bank loans are still a modest 25 percent of GDP and 2006 has been marked by sluggish growth across all types of loans thus far after strong growth in 2005 (24 percent). As of June 2006 loan growth was 14 percent year-to-date. Bankers indicate that this is due to weaker loan demand and substantial loan repayments. On the other hand, bank deposits are growing and are now the equivalent of 40 percent of GDP a steady growth of 17 percent. As a result Banks' balance sheets have significant amounts of Bank Indonesia certificate (SBI) (10 percent of assets) and Rupiah government bonds (18 percent of assets). The spread between lending (working capital) and deposits (3-month time deposits) has fallen from around 7 percent in 2005 to 5 percent in 2006. In early 2006 Bank Indonesia targeted 20 percent year-on-year loan growth in 2006 but this now appears unlikely.

Banking Regulation and Supervision

Bank Indonesia has issued a number of new regulations to improve regulation and supervision of the banking sector including new regulations on earning asset classifications, consolidated risk management for banks' subsidiaries and conduct of corporate governance practices. Bank Indonesia's risk management certification program for bankers is considered successfully and has been expanded.

To increase banks intermediation and encourage consolidation Bank Indonesia issued 14 new regulations in October which consist of (i) a regulation relaxing the legal lending limit; (ii) a regulation on special treatment for debtors in disaster areas; (iii) regulations on rural bank licenses, capital adequacy, productive asset and financial reporting; (iv) regulations on syariah banks' operations; (v) a regulation on incentives when banks merge; (vi) a regulation improving GCG rules for banks and finally (vii) a regulation on the Single Presence Policy (SPP). The SPP is designed to reduce the concentration of bank ownership in Indonesia by December 2010.

Performance of Domestic Stock and Corporate Bond Markets.

The Jakarta Composite Index (JCI) reached a new record in October 2006. At first week of October it stood at 1,550 an increase of 32 percent year-to-date. By early October 2006, the corporate sector had raised Rp13.8 trillion in the equity market (Rp7.1 trillion in IPOs and Rp6.7 trillion in secondary offerings). In the bond market, through September 2006 the corporate sector raised Rp7.1 trillion and the Government issued bonds amounting to Rp32 trillions – including some debt switching and the first successful offering of retail bonds with par value of Rp3.2trillions.

Foreign investors are playing an increasingly substantial role in domestic capital markets. Foreign investor holdings are now 12 percent of total Rupiah government bonds (June 2006) and foreigners are the largest non-bank investor in the government bond market. Foreign investors are consistently net-buyers of listed shares on the Jakarta Stock Exchange.

<u>Improvements in the enforcement of NBFI regulations</u>

The regulator and supervisor of capital markets and NBFI (Bappepam & LK), has begun stringent enforcement of Know Your Customer (KYC) rules. In June 2006, the authority froze operations of 22 finance companies and 10 venture capital companies for failure to comply with the KYC regulations. In the pension fund industry, the authority has increased oversight to enforce the requirement that defined benefit structured pension funds submit actuarial reports and financial statements for the year 2005.

7. Policy Direction

Government has issued three key policy packages in 2006- investment climate and infrastructure packages in March and a financial sector reform package in July.

The Investment Climate Package is divided into five categories: (i) general investment policies; (ii) customs; (iii) tax; (iv) labor policy; and (v) SME policy. Highlights of the investment climate package include: completion of the investment law and reductions in red tape; business friendly revisions to the tax law; and improved procedures in customs. Most items in the package are not new, having existed in one form or another in previous policy statements. Some items are general, stating what the government hopes to accomplish without detailing them but some reforms are specific, such as cutting the Red Lane to 10 percent of importers and compiling a transparent negative list. Most targets include deadlines to ensure rapid implementation (which has begun) and specify the responsible Minister.

Despite policy progress there are areas of concern for example labor reform. As part of the investment policy package, revisions to Labor Law 13/2003 were proposed for April 2006. But following a strong negative reaction from organized labor and other groups the revision assumed in the April target was dropped representing a setback for workers who do not have formal sector jobs and investors. The 2003 law significantly raised hiring costs with severance pay now far higher than in other countries, effectively discouraging employers from hiring new workers on a permanent basis. The proposed changes would have addressed this bias against employers with the proposal to bring labor regulations into line with neighboring countries such as Thailand and Malaysia.

Drafts of four implementing decrees for the new investment law have been prepared and discussed within the economic cabinet and beyond with the government indicating that the implementing decrees will be issued when Parliament passes the investment law. However, it is unlikely that the investment law will pass in 2006 and several issues remain. For example, there are numerous redundant, overlapping and excessively complex business licenses, some of which need to be eliminated and others streamlined. The number of steps to establish and register a limited liability company is excessive and should be reduced.

The Infrastructure Package focuses on a number of areas but an important element is the establishment of public private partnerships (PPP). It includes a risk sharing framework (allowing contingent liabilities on budget), improved coordination mechanisms and progress on sectoral issues in anticipation of an Infrastructure Summit. The package includes four main policy items, namely: (i) establishing an effective policy, regulatory, and institutional framework; (ii) sector reforms; (iii) local government participation; and (iv) project transactions.

The government is encouraging private investment in roads, power, and other infrastructure, which may require government support in the form of subsidies or risk sharing. At the same time, the government has a limited budget and support can be costly and create moral hazard if not well designed. To help it make decisions about support and manage fiscal risks, the Government is developing a risk management framework to assess, price, monitor, and manage contingent liabilities that arise from selective guarantees for PPP projects. The specific risks covered should relate to policies and performance of the Government and its agencies. In view of the links to its existing budgeting, fiscal accounting and debt management systems, MOF is playing a key role. In October 2005, the Minister of Finance issued a decree on the establishment of the Risk Management Committee, which specifies the structure of the Committee and its principal tasks. Apart from making recommendations on the appropriate risk management policy, the Committee performed the risk management function in anticipation of a Risk Management Unit that was established in MOF during 2006. The RMU will examine requests for government support for PPP projects submitted by the contracting authorities, screened by the line ministries, and endorsed by the KKPPI.

The inter-ministerial National Committee for the Acceleration of Infrastructure Development (KKPPI) has been strengthened to formulate infrastructure strategies and policies, coordinate and supervise implementation by line ministries and local governments, formulate public service obligation policy for infrastructure services, and solve problems that impede infrastructure development.

A tentative allocation of Rp.0.5 trillion and Rp.2 trillion has been approved for infrastructure expenditure in the 2006 revised budget and 2007 budget, although the proposed allocation has not yet been earmarked to specific expenditure items such as subsidies and guarantees for support to PPP transactions. In the meantime, with Perpres 67 and the PMK 38, the Government has created a framework for decisions about government support for private infrastructure.

A financial sector policy package was issued in July, which outlines short-term policies, work programs and actions that Government and Bank Indonesia to address key issues. The matrix covers financial stability, banking, non bank financial institutions, capital markets, export finance and privatization of State Owned Enterprises (SOEs). While most of the areas covered are not new, the matrix clearly facilitates stronger coordination amongst related stakeholders, sharpens the focus and assigns clear time-bound results and responsibilities to agencies. Implementation has begun and the results are encouraging. Some of important accomplishments are an amendment to allow state banks to write-off NPLs, improvements to regulations on conduct and license of mutual fund agents, issuance of Bank Indonesia regulation on GCG and incentives, issuance of retail government bonds, improved access to Bank Indonesia's government bonds settlement system and improved price discovery and reporting mechanism for bonds transaction.

Financial stability and coordination are to be improved through the provision of Financial Safety Law by the end of this year that stipulates among other things the creation of a forum on policies to spur development of the financial sector as a whole, and to initiate preparation of an improved financial sector architecture and FSAP.

The deposit guarantee scheme continues to be phased out with the amount of coverage reduced from Rp5 billion to Rp1 billion in September 2006. Thus far, the transition has been smooth and there have not been any reported deposit runs or adverse impacts to major banks.

Financial sector diversity remains a challenging issue. The financial sector remains bank-centric - at around 80 percent of financial assets - reflecting too much reliance on the banking sector and a lack of choices of instruments and maturities for borrowers and savers that would be provided by robust NBFIs. Thus the emphasis on policy measures related to the NBFI sector is welcome.

7. 2006-2007 Outlook

Both fiscal and monetary polices are now supportive of higher growth. Bank Indonesia monetary easing has already reduced policy interest rates by two percent since May with room for further easing into 2007 as inflation continues to fall. This should spur demand for corporate investment and recovery in consumer durables. Both central and regional governments are increasing spending and have fiscal space to expand public investment into 2007 and beyond. The current policy momentum will increase investment and bring the economy to into the 6 percent growth range by early 2007 and growth for the year as a whole should be 6 to 6.5 percent. The key economic challenge is to maintain this growth through 2007 and into the longer term. This will require investment and financial sector reforms that trigger business confidence in new investments and ramping up public and private infrastructure spending to overcome binding energy and transport constraints.

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