

INDONESIA
ECONOMIC
QUARTERLY

July 2015

Slower gains



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Preface

The Indonesia Economic Quarterly (*IEQ*) has two main aims. First, it reports on the key developments over the past three months in Indonesia's economy, 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 analysis of Indonesia's medium-term development challenges. It is intended for a wide audience, including policymakers, 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 Chaves, Country Director for Indonesia. The report is compiled by the Macroeconomics and Fiscal Management Global Practice team, under the guidance of Shubham Chaudhuri, Practice Manager, and Ndiame Diop, Lead Economist. Led by Alex Sienaert, Country Economist, and with responsibility for Part A, editing and production, the core project team comprises Arsianti, Magda Adriani, Masyita Crystallin, Fitria Fitriani, Ahya Ihsan, Elitza Mileva (Part A lead) and Violeta Vulovic, with additional editing and input from Edgar Janz, Yue Man Lee, Peter Milne, Bede Moore, Arvind Nair and Rinin Purnamasari. Administrative support is provided by Titi Ananto. Dissemination is organized by Surya Ningnagara, Kurie Suditmo, Indra Irnawan, Jerry Kurniawan, Desy Mutialim and Nugroho Sunjoyo, under the guidance of Dini Djalal.

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Executive summary: Slower gains



Progress towards Indonesia's development goals has slowed due to uncertain external conditions, weaker growth, and policy challenges...

...and responding effectively will require careful prioritization and follow-through of key reforms, especially to strengthen the fiscal sector and unlock more investment

Midway through 2015, Indonesia remains confronted with an uncertain external environment, and domestic economic policy challenges have intensified. GDP decelerated to below 5 percent in the first quarter and private consumption expenditure, Indonesia's engine of growth in recent years, is also slowing. Weaker growth has resulted in slower job creation, with recent employment rising only just enough to absorb the increase in working age population. While the commodity downturn since 2012 and policy responses have affected output growth the most in resource-rich provinces, employment creation has come under pressure across Indonesia. Yet the scope for policy stimulus is limited and monetary policy in particular is constrained due to sticky inflation and persistent external vulnerabilities.

To achieve a sustainable return to higher economic growth, much depends on the success of the government's ambitious infrastructure development plans, and on further improvement of the business environment to reignite private investment. Support to the economy from the fiscal sector, however, is being impeded by weak revenues and very low capital spending year-to-date. In response, on the expenditure side, allocations to priority infrastructure projects should be safeguarded so that these can move ahead. This requires a fiscal deficit that is higher than the 1.9 percent of GDP planned in the 2015 revised Budget, while still within the 3 percent of GDP legal limit. On the revenue side, the government has already introduced important measures, such as electronic tax return submission and improvements in the income tax audit strategy. There is also scope to further optimize the tax regime, improve corporate income taxation, and revise value-added tax (VAT) exemptions to increase equity. On the other hand, improving the business environment hinges on greater consistency of regulations that define the functioning of markets, including firm entry, competition, trade and investment.¹

¹ See Indonesia Development Policy Review: "Avoiding the Trap", The World Bank, 2014.

In many developing countries, particularly in commodity exporters, growth is slowing down and fiscal positions are weakening

Despite gradually improving global economic conditions, the balance of international risks to Indonesia's outlook remains on the downside. Although the recovery in high income economies is picking up speed, many emerging market economies are experiencing a slowdown, growing at rates considerably below their recent ten-year trends. Furthermore, persistently low global commodity prices mean that, in the near term, net commodity-exporting countries are likely to face both weaker economic activity and deteriorating fiscal balances relative to the period before 2012, when global commodity prices were rising. In addition to growth and fiscal risks, commodity-dependent economies, especially those with limited official reserve buffers and relatively large external financing exposures, may need to manage risks arising from further currency depreciation.

GDP growth in Indonesia declined to 4.7 percent yoy in Q1 2015, driven mainly by fixed investment but also by private consumption...

Real output grew by 4.7 percent year-on-year (yoy) in the first quarter of 2015, the slowest pace since 2009. Nevertheless, growth in Indonesia has remained resilient in comparison with growth in other countries which depend on Chinese demand for commodities (e.g. Brazil and South Africa). Lower fixed investment growth continues to drive Indonesia's slowdown, contributing only 1.4 percentage points yoy to GDP growth in the first quarter, which is about half of the average quarterly growth contribution in 2010-2012. However, private consumption expenditure growth, which had previously remained resilient, is also moderating, to 4.7 percent yoy in the first quarter. Since its share in total GDP expenditures is about 55 percent, weakening private consumption is likely to weigh heavily on overall growth. In addition, the sizable decline in nominal consumption growth to 7.6 percent yoy in the first quarter, from 9.4 percent in the previous quarter and from 12.3 percent a year ago, has had a negative impact on the government's VAT receipts.

...contributing, together with the drop in global oil prices, to a somewhat narrower current account deficit

The continuing growth slowdown, as well as lower global oil prices, helped narrow the current account deficit to 1.8 percent of GDP in the first quarter. Goods imports contracted by 14.4 percent yoy in the first quarter, as domestic demand moderated. Trade data for April and May show a further decline in imports, which is unusual for the months before Ramadan and suggestive of a further deceleration in domestic demand. Goods exports fell by 13.9 percent yoy, mainly due to lower commodity-related exports but also weak manufacturing exports. The latter was driven partly by subdued demand from China and Southeast Asian neighbors, both for intermediate inputs used in production chains and for final goods. Finally, the oil trade deficit declined by over 40 percent, to USD 3.2 billion, as the Indonesian Crude Price dropped from an average of USD 73 in Q4 2014 to USD 51 in Q1 2015. The decrease in the oil deficit was closer to 50 percent when compared to its level a year ago. Nevertheless, the current account deficit in Q1 2015 was only 0.1 percent of GDP narrower relative to its seasonally-comparable year-ago level, indicating that external adjustment has so far remained sluggish.

The current account deficit is partly structural and appears sustainable, but merits policy steps to increase competitiveness and reduce external financing risks

The government's ambitious plans to ramp up infrastructure spending will, if successful, push up overall investment and increase Indonesia's current account deficit in the short-term. While such an investment-driven increase could enable the economy to achieve a higher sustainable growth path, it could also place the risk of external imbalances in renewed focus, particularly if global financial market conditions become more challenging, as last occurred during the 2013 "taper tantrum". Since then, the current account deficit has narrowed only modestly, despite significant import compression. While this owes mainly to continuing downward pressures on exports, a range of longer-term, structural factors also mean that current account deficits are likely to continue; Indonesia is still in the relatively

early stages of economic convergence to higher-income trading partners, implying a faster growth rate, a higher domestic return on capital, and an excess of investment spending over domestic saving. Running moderately-sized current account deficits appears sustainable for Indonesia, especially if supported by policy measures to boost international competitiveness and to raise the efficiency of given levels of investment in generating growth, jobs and incomes. Securing a resilient mix of external financing sources, including foreign direct investment (FDI), and mobilizing more domestic saving, by improving access to finance and strengthening the domestic financial sector, can also reduce Indonesia's vulnerabilities to volatile global financial market conditions.

Despite the moderation in domestic demand, stable fuel prices, and weaker credit growth, inflation remains sticky

As domestic demand conditions have softened, credit growth slowed down further in the first four months of 2015, to 10.2 percent yoy in April (and only 3.2 percent yoy in real terms). The credit growth slowdown appears to have been driven increasingly by reduced credit demand, as deposit growth has steadily increased in the last four quarters, reaching 14.5 percent in April. Despite the moderation in credit growth, weaker economic activity, and unchanged gasoline and diesel prices since March, inflation has accelerated in recent months, exceeding 7 percent yoy in May and June. The key reason for the significant rise in consumer prices has been a broad-based rise in food prices.

The challenging economic environment has prompted BI to keep interest rates unchanged and loosen macro-prudential policy

The above-mentioned macroeconomic conditions, coupled with continued nominal exchange rate depreciation pressures, have tested monetary policy in recent months. In response, Bank Indonesia (BI) has kept its main policy rate unchanged since February 2015, while introducing several accommodative macro-prudential measures, such as lowering bank loan-to-deposit ratios by including securities in the definition of deposits, and increasing the loan-to-value ratios for mortgages and car and motorcycle loans. In addition, BI has intervened to smooth currency volatility and issued new regulations to deepen the foreign exchange market and ease depreciation pressures. One of these regulations, effective on July 1, requires the use of Rupiah for all domestic cash and non-cash transactions.

In the base case, GDP growth is expected to slow down to 4.7 percent in 2015 on weaker consumption growth...

Looking ahead, the World Bank expects GDP growth of 4.7 percent for 2015 (Table 1), as private consumption growth is expected to weaken further in the near term. High-frequency indicators, such as car and motorcycle sales, the BI consumer sentiment index, and monthly trade data, provide strong signals that private consumption growth softened in the second quarter. Fixed investment growth is still expected to increase in the second half of the year but by less than projected in the March 2015 *IEQ*, owing to lower than expected public capital spending and associated crowding-in of private investment. Downward revisions to domestic demand have prompted an adjustment to the projected current account deficit, which is now expected to reach 2.7 percent of GDP in 2015.

... with risks to the outlook firmly to the downside

The main risks to the outlook, stemming from persistently lower commodity prices and tighter credit conditions, have not changed substantially since the March 2015 *IEQ* and are tilted to the downside. Weaker terms of trade continue to put pressure on corporate profits and household incomes, which is a key risk to the outlook for domestic demand. Similarly, there is a risk that domestic credit conditions do not start to ease by the end of 2015 as expected in the baseline scenario. In addition, the uncertainty with respect to international financing conditions, as the Federal Reserve normalizes US monetary policy, remains elevated.

Table 1: Under the baseline scenario, GDP growth is projected at 4.7 percent in 2015

		2014	2015p	2016p
Real GDP	(Annual percent change)	5.0	4.7	5.5
Consumer price index	(Annual percent change)	6.4	6.8	5.3
Current account balance	(Percent of GDP)	-2.9	-2.7	-2.9
Budget balance*	(Percent of GDP)	-2.2	-2.5	n.a

Note: *Preliminary outturn (2014) and World Bank staff projections (2015).

Source: BI; BPS; Ministry of Finance; World Bank staff calculations

Achieving durable gains from the difficult fuel subsidy reforms undertaken by the government will require more consistent, transparent application of the new pricing system

Fuel subsidy reform is one recent policy change that supports Indonesia's external balances and policy buffers in the face of potential external financing risks, as well as conferring a host of other economic benefits. Budgeted fuel subsidy costs have been slashed to 0.6 percent of GDP in 2015 (a quarter of their 2011-2014 level), following a bold reform which became effective in January. However, the implementation of the new pricing system for previously-subsidized low octane gasoline, and diesel, has been uneven so far, and the government has sent mixed signals regarding additional changes. This has caused some confusion, and contributed to ongoing concerns over whether wasteful and regressive subsidy spending could increase again, particularly if Rupiah-denominated fuel prices rise further. Adhering on a transparent and consistent basis to the automatic price adjustments, as stipulated by the new regulations, during what could be a temporary window period of relatively low global oil prices, could go a long way towards building the public's comfort with, and de-politicizing, fuel price changes.

Indonesia has tremendous geothermal energy resources but harnessing them requires a more conducive regulatory environment for investment in the sector

Regardless of the future direction of global oil and other energy prices, Indonesia's energy needs are rising fast, and the country is fortunate to have one of the world's largest endowments of renewable, clean geothermal energy. Although it is already the world's third largest generator of electricity from geothermal sources, this still accounts for only about 3 percent of installed capacity and exploits only a fraction of potential. Ambitious plans to develop the sector have not so far resulted in the necessary investments, which have been hampered by high initial costs, risks, and complexity, including due to regulatory factors. More investment could be unlocked by revising geothermal tariff structures, improving project tendering processes, reaching closure on power purchase agreements and addressing institutional roadblocks and financing issues.

Indonesia's large-scale school grants program is delivering resources to 220,000 schools and, after establishing a decade-long track record, can be developed further to drive improvements in basic education

This edition of the *IEQ* also takes stock of Indonesia's school grants program (*Bantuan Operasional Sekolah*, BOS). Since its inception ten years ago, the BOS program has become central to the government's strategy for delivering good quality basic education, providing operational funds to 220,000 primary and junior secondary schools, and madrassahs. The BOS program now has a proven track record in delivering resources to schools on a regular and timely basis. Other countries, having also successfully established school grant programs and their financing mechanisms, have further developed them to address other education challenges, including to allocate a greater share of school funding in an effort to promote more efficient spending, which is an urgent priority for Indonesia as well. Consolidating a larger share of budgetary resources, and in particular teacher remuneration, into the program has the potential to improve the quality of education spending. For example, linking teacher resources for schools to student numbers could create incentives for local governments to reduce the large number of small schools currently in operation in many parts of the country.

A. Economic and fiscal update



1. A growth slowdown is underway in many developing countries, particularly in commodity exporters

Different growth paths are projected for advanced and low- and middle-income countries...

After a weaker than expected start to 2015, global growth is projected to pick up gradually, supported by low commodity prices and ample liquidity. The diverging growth trends between high income and developing countries, observed earlier in the year, have become more pronounced. Many low- and middle-income economies are likely to see their economic activity slow down in 2015. Since the downturn in the commodity price cycle began in 2012, GDP growth and fiscal balances in commodity-exporting countries have worsened significantly.

...as developing economies face below-average growth in 2015...

According to the World Bank's June 2015 *Global Economic Prospects*, the recovery in advanced economies is expected to pick up speed towards 2016. In fact, this group of countries is projected to grow at rates close to the recent ten-year average (excluding the crisis years of 2008 and 2009) (Figure 1). At the same time, many developing economies are experiencing a slowdown this year. The expected 2015 and 2016 growth rates in many emerging markets are considerably lower than their long-term average. However, the slowdown in economic activity in Asia, excluding China, is less pronounced than in other regions.

... and commodity exporters contend with weakened fiscal positions

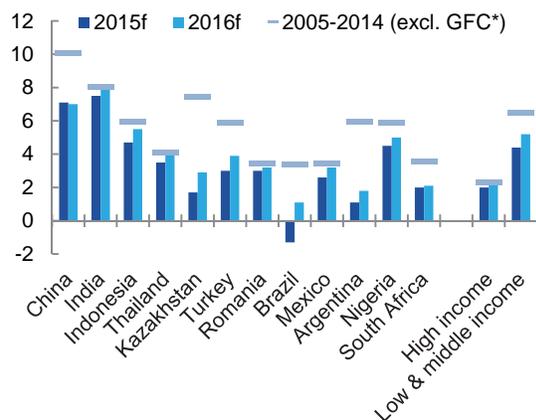
Apart from a subdued growth outlook, commodity-exporting countries are expected to see their fiscal balances worsen compared with the period before 2012 when global commodity prices were rising (Figure 2). Indonesia's fiscal position is deteriorating but by less than other major commodity exporters. Only the primary deficits of Australia and Malaysia are expected to improve this year relative to 2011²,

² The fiscal deficits of Australia and Malaysia were relatively wide in 2011 on account of the stimulus packages introduced in response to the global financial crisis, among other country-specific factors.

the peak of the commodity cycle. In addition to growth and fiscal risks, Indonesia and other commodity-dependent economies, especially those with limited official reserve buffers, are exposed to currency risk and continuing external vulnerabilities.

Figure 1: Growth trends in high income and developing countries are diverging

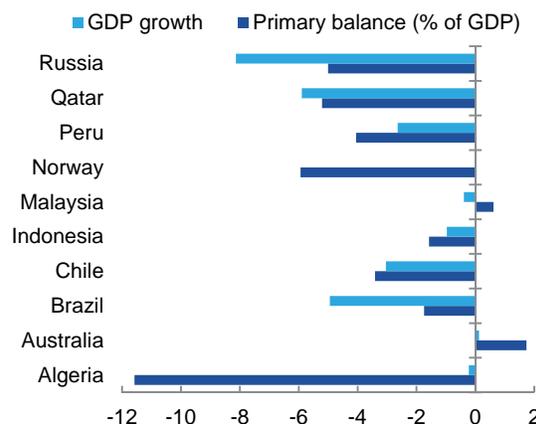
(real annual GDP growth in select countries, percent)



Note: 2015 and 2016 figures are forecasts; * 2005-2014 annual average excludes the global financial crisis of 2008-2009.
Source: World Bank Global Economic Prospects June 2015; World Development Indicators; World Bank staff calculations

Figure 2: In commodity-exporting countries, fiscal buffers and growth are declining

(change in the primary balance and GDP growth between 2011 and 2015 in select countries, percentage points)



Source: IMF World Economic Outlook; World Bank staff calculations

2. Indonesia's economic activity decelerated further, with private consumption weakening too

Real GDP grew by 4.7 percent yoy in Q1 2015, the slowest pace since 2009

In the first quarter of 2015, Indonesia's real GDP grew at 4.7 percent year-on-year (yoy), surprising analysts and extending the recent pattern of weaker output growth compared with an annual average pace of 6-6.5 percent in 2010-11 (Figure 3).

Although the main driver of the slowdown remains lower fixed investment growth, private consumption, Indonesia's growth engine in recent quarters, is weakening too. In the first quarter of 2015, private consumption, whose share in total GDP is about 55 percent, grew at a more moderate 4.7 percent yoy, contributing to the overall growth slowdown. Accounting for the Q1 2015 national accounts data release and latest high-frequency indicators of economic activity and financing conditions, the baseline forecast for annual GDP growth in 2015 has been revised down to 4.7 percent, with risks tilted to the downside.

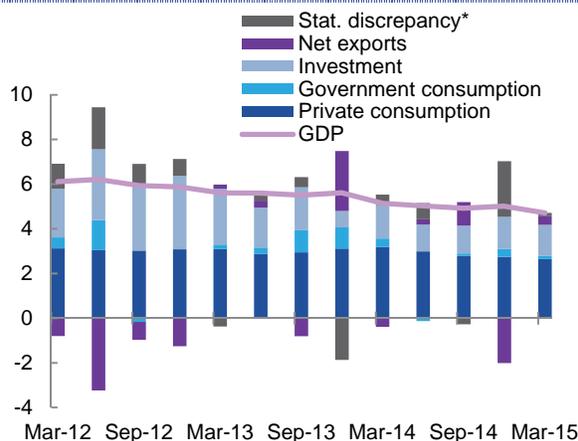
The growth slowdown was partly driven by private consumption...

Private consumption growth moderated to 4.7 percent yoy in Q1 2015, from 4.9 percent in the final quarter of 2014 (Figure 4). This was partly due to high base effects from Q1 2014 when election-related spending boosted consumption temporarily. However, private consumption growth weakened significantly in nominal terms to 7.6 percent yoy, from 9.4 percent in the previous quarter and from 12.3 percent a year ago. The implicit private consumption deflator, calculated as the ratio of nominal to real private consumption expenditure, grew at 2.8 percent yoy in the first quarter, compared with a corresponding quarterly increase in the consumer price index (CPI) of 6.5 percent yoy. This discrepancy suggests that consumers substituted from goods whose prices are rising to goods whose prices are stable or falling. Since the CPI basket is fixed in a particular year (currently 2012), the CPI

may be failing to capture such substitution effect in recent quarters. The slowdown in nominal private consumption has had a negative impact on the government's VAT receipts (see Section 6).³

Figure 3: The real GDP deceleration continued in Q1 2015, with investment still subdued...

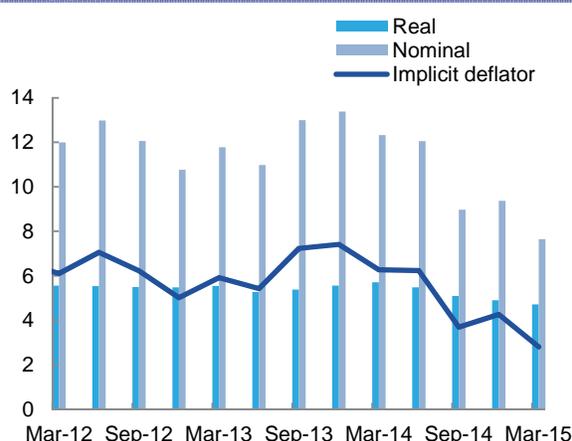
(contributions to GDP growth yoy, percentage points)



Note: *Stat. discrepancy includes changes in inventories.
Source: BPS; World Bank staff calculations

Figure 4: ... and weaker private consumption growth, especially in nominal terms

(growth yoy, percent)



Note: The implicit deflator is the ratio of nominal to real private consumption expenditure.
Source: BPS; World Bank staff calculations

... but mainly due to slow fixed investment growth and very weak net exports, as was the case in previous quarters

The main cause of the GDP growth moderation in the first quarter remained slower fixed investment growth which, at 4.4 percent yoy, has more than halved since 2012. Weaker terms of trade and the related policy responses have continued to drive the investment slowdown during this period. However, structural impediments related to the business environment (e.g. challenges to free market entry, competition, and trade) may have also precluded a faster investment recovery. The growth contribution of net exports, 0.4 percentage points yoy in Q1 2015, has been broadly neutral across the last two years. In the first quarter, export volumes declined by 0.5 percent yoy, while imports decreased considerably more – by 2.2 percent. However, further weakening of exports, mainly of commodities, has fed through into slower growth via the deterioration in the terms of trade and lower incomes. Evidence of these effects is the slower employment growth across Indonesia, including importantly in Java and Bali, since the commodity cycle downturn began in 2012 (see Section 7).

On the production side, the January 2015 fuel subsidy reform is reflected in lower value added of economic activities

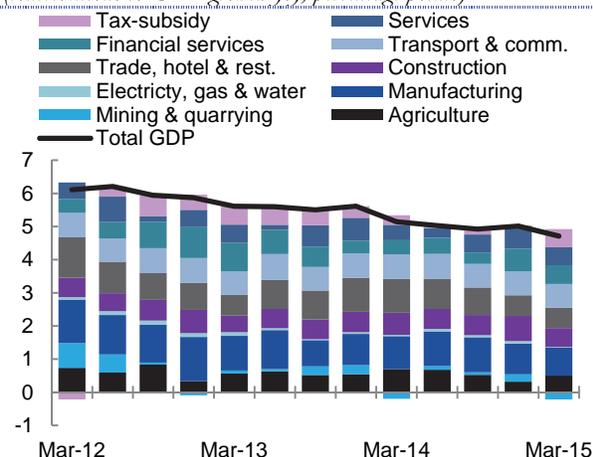
From the production perspective, the growth moderation was broad-based, with only agriculture growth increasing to 3.8 percent yoy, from 2.8 percent yoy in Q4 2014. Mining and quarrying recorded the weakest growth since Q3 2004, falling by 2.3 percent yoy. Manufacturing sector growth declined for a second quarter, to 3.9 percent yoy, but still accounted for 0.8 percentage points of total GDP growth (Figure 5). After a strong Q4 2014 (7.7 percent yoy), construction growth declined to 6.0 percent yoy, contributing 0.6 percentage points yoy to GDP growth. Indirect taxes net of subsidies, which are added to GDP calculated through the production approach to obtain GDP at market prices (i.e. expenditure approach), increased by 22.7 percent yoy in the first quarter, contributing 0.5 percentage points of total

³ Similarly, negative nominal import growth in Q1 2015 has weighed on import VAT revenues (see Section 6).

GDP growth. According to Statistics Indonesia (*Badan Pusat Statistik*, BPS), the main reason for this high growth rate is the reduction in fuel subsidies implemented by the government in January this year.

Figure 5: Most sectors recorded weaker growth in the first quarter

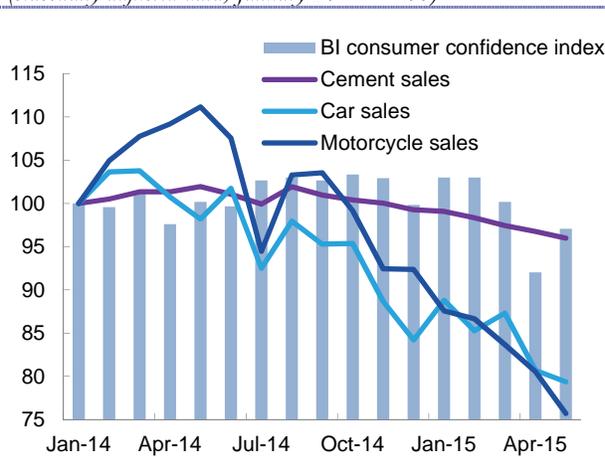
(contributions to GDP growth yoy, percentage points)



Source: BPS; World Bank staff calculations

Figure 6: Monthly economic activity indicators suggest a further slowdown in Q2 2015

(seasonally adjusted data, January 2014 = 100)



Source: CEIC; World Bank staff calculations

High-frequency indicators signal further weakening in economic activity in the second quarter

Monthly indicators point to continued softening in output growth, including in private consumption growth, during the second quarter. Car and motorcycle sales declined by an average of 20.7 and 32.2 percent in April and May compared with their year-ago levels. Despite an uptick in May, ahead of the fasting month of Ramadan, the Bank Indonesia (BI) consumer confidence index remained below 100, indicating pessimistic consumer attitudes, in the first two months of Q2 2015 (Figure 6). Industry-related indicators, such as cement sales (down 14.1 percent yoy in May) and HSBC’s purchasing managers index (PMI) at 47.8 in June, signal weaker activity too, as do the monthly trade data (see Section 4).

In the base case, GDP growth is expected to slow down to 4.7 percent in 2015 on weaker consumption growth...

Looking ahead, the World Bank expects GDP growth of 4.7 percent for 2015, with risks to the outlook firmly to the downside. In the base case, the projection anticipates weakening private consumption growth in the near term and a recovery to recently observed levels in 2016. A slight uptick in Q4 2015 household consumption due to partial local elections has been incorporated in the forecast. Fixed investment growth is still expected to increase in the second half of the year but by less than projected in the March 2015 *IEQ*, owing to lower than expected public capital spending and associated crowding-in of private investment (see Section 6).

... with recent data driving the negative forecast revision and risks to the outlook tilted to the downside

The baseline GDP growth forecast of 4.7 percent for 2015 is revised down from 5.2 percent in the March 2015 *IEQ* (Table 2). This downward adjustment is mainly due to weak first-quarter national accounts data and April and May high-frequency indicators. The main risks to the outlook, related to persistently lower commodity prices and tighter credit conditions, are tilted to the downside. Weaker terms of trade continue to put pressure on corporate profits and household incomes, which may have a stronger than expected negative impact on domestic demand. Similarly, there is a risk that domestic credit conditions do not ease at the expected rate or

international financing tightens by more than currently foreseen as the Federal Reserve normalizes US monetary policy.

Table 2: In the base case, GDP growth is expected to be 4.7 percent in 2015, picking up to 5.5 percent in 2016
(percentage change, unless otherwise indicated)

	Annual			YoY in Fourth Quarter			Revision to Annual	
	2014	2015	2016	2014	2015	2016	2015	2016
1. Main economic indicators								
Total consumption expenditure	4.8	4.5	4.9	4.5	4.5	5.0	0.0	0.0
Private consumption expenditure	5.3	4.7	5.2	4.9	4.8	5.3	0.0	0.0
Government consumption	2.0	3.7	3.3	2.8	3.6	3.2	-0.1	0.1
Gross fixed capital formation	4.1	4.9	6.1	4.3	5.5	6.1	-0.3	0.0
Exports of goods and services	1.0	2.2	5.7	-4.5	4.4	6.0	-0.4	0.0
Imports of goods and services	2.2	1.0	6.1	3.2	2.6	6.3	-3.0	0.0
Gross domestic product	5.0	4.7	5.5	5.0	4.9	5.5	-0.5	0.0
2. External indicators								
Balance of payments (USD bn)	19.0	10.9	17.1	-	-	-	1.9	8.2
Current account balance (USD bn)	-25.4	-24.9	-29.0	-	-	-	4.2	5.5
<i>As share of GDP (percent)</i>	-2.9	-2.7	-2.9	-	-	-	0.3	0.3
Trade balance (USD bn)	-3.0	-0.5	-3.8	-	-	-	4.3	4.4
Capital & financial acc. bal. (USD bn)	44.4	35.8	46.1	-	-	-	-2.2	2.9
3. Fiscal indicators								
Central gov. revenue (% of GDP)	14.6	12.7	-	-	-	-	-0.1	-
Central gov. expenditure (% of GDP)	16.7	15.3	-	-	-	-	-0.1	-
Fiscal balance (% of GDP)	-2.2	-2.5	-	-	-	-	0.0	-
Primary balance (% of GDP)	-0.9	-1.2	-	-	-	-	0.0	-
4. Other economic indicators								
Consumer price index	6.4	6.8	5.3	6.5	5.9	5.1	0.3	0.2
GDP deflator	5.4	4.3	5.3	3.7	5.4	5.3	0.2	0.0
Nominal GDP	10.7	9.2	11.0	8.9	10.0	11.1	-0.2	-0.1
5. Economic assumptions								
Exchange rate (IDR/USD)	11800	13200	13200	-	-	-	600	600
Indonesian crude price (USD/bl)	98	59	64	-	-	-	4.0	7.0

Note: Export and import figures refer to volumes from the national accounts. All figures, including fiscal ratios, are based on revised and rebased GDP. Exchange rate and crude oil price are assumptions based on recent averages. Revisions are relative to projections in the March 2015 IEQ.

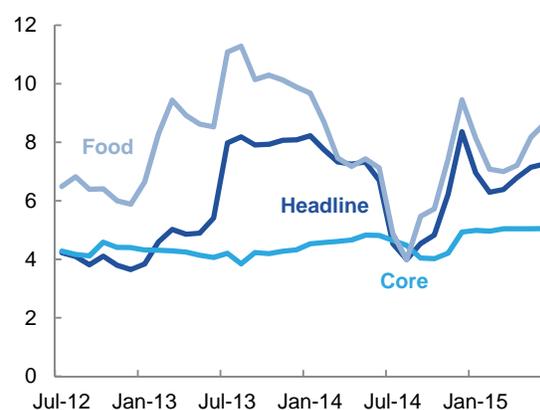
Source: MoF; BPS; BI; CEIC; World Bank staff projections

3. Inflation remains sticky despite weaker domestic demand growth

Headline inflation rose over April-June despite unchanged fuel prices and the moderation in GDP growth

After declining during the first two months of the year as a result of the January 2015 fuel price reforms and lower food prices, CPI inflation rose to above 7 percent yoy in May and June (Figure 7). The main reason for the increase in headline inflation was a broad-based rise in food prices. In recent months, inflation has accelerated despite unchanged gasoline and diesel prices since March and the opening up of a

Figure 7: CPI inflation increased over April-June on account of high food prices
(change yoy, percent)



Source: BPS; World Bank staff calculations

small negative output gap (according to World Bank estimates). At the same time, core inflation, which excludes the more volatile food and energy prices, has remained stable at around 5.0 percent yoy.

Inflation momentum is expected to stay moderate, capping headline inflation at an average of 6.8 percent for 2015

The World Bank expects an annual average CPI inflation rate of 6.8 percent in 2015, which reflects a small upward revision from the March 2015 *IEQ* based on recent monthly data. Inflation is projected to decline to an average rate of 5.3 percent in 2016. The risks to the inflation outlook remain balanced. Lower than projected GDP growth, and consequently a larger negative output gap, could pull inflation lower. Conversely, further Rupiah depreciation and future fuel price increases may raise inflationary pressures. In addition, the lack of transparency regarding the adjustment of fuel prices (see Section B.2), in particular as oil prices rose by 15 percent between March and May, may adversely affect inflation expectations. Finally, according to Indonesia's National Meteorology, Climatology and Geophysics Agency (*Badan Meteorologi, Klimatologi dan Geofisika*, BMKG), this year's El Niño is expected to moderately affect parts of Indonesia until November, raising temperatures by 1-2 degrees Celsius, though with relatively low risks for economic activity, including in the agriculture sector. BPS estimates rice paddy production in 2015 at 75.5 million tons, up 6.6 percent from 70.9 million tons in 2014.⁴

4. The current account balance narrowed further on account of low oil prices and weak imports

The current account deficit narrowed to 1.8 percent of GDP in Q1 2015...

The current account deficit narrowed further in Q1 2015, mainly as a result of the decrease in imports driven by continuing growth moderation (Figure 8). Exports declined too, albeit by less than imports, contributing to the smaller current account deficit. However, when compared to its year-ago level, the current account deficit was broadly unchanged, indicating that external adjustment has remained sluggish. On the financing side, overall inflows were weaker due to lower FDI and foreign deposits. Portfolio inflows, on the other hand, have remained strong, helped by the frontloading of government bond issuance in the first quarter of the year. Looking ahead, the key external risks to Indonesia's balance of payments are lower commodity prices or a rise in the demand for imported capital goods stemming from the expected increase in infrastructure investment, and a tightening in global financial conditions.

... mainly owing to a lower oil deficit

The current account deficit narrowed to 1.8 percent of GDP or USD 3.9 billion in Q1 2015 (from 2.6 percent in Q4 2014) due to a combination of an increase in the goods trade surplus of USD 0.6 billion, and decreases in the services trade and income deficits by USD 0.7 billion and USD 0.5 billion, respectively. The trade surplus expanded to USD 3.1 billion, from USD 2.4 billion in the last quarter of 2014, mainly on account of a significantly lower oil deficit (Figure 9). The oil trade deficit dropped by over 40 percent to USD 3.2 billion, as the Indonesian Crude Price (ICP)⁵ declined from an average of USD 73 in the last three months of 2014 to USD 51 in the first quarter of this year. Despite the strong decline in the oil deficit, and looking beyond any seasonal effects, the current account deficit in Q1 2015 was only 0.1 percent of GDP narrower than in the first quarter of last year.

⁴ Data on rice production in Indonesia, however can be unreliable; for more on recent rice price dynamics, see the March 2015 *IEQ*.

⁵ The ICP is determined by Indonesia's national oil company, Pertamina, based on moving average spot price of a basket of five internationally traded crudes: Minas (Indonesia), Tapis (Malaysia), Gippsland (Australia), Dubai (UAE), and Oman.

Hence, the external adjustment over the past year has remained subdued, mainly on account of the continued weakness in exports.

Figure 8: The current account deficit narrowed, while direct and other investment flows were relatively weak
(balance of payments main account balances, USD billion)

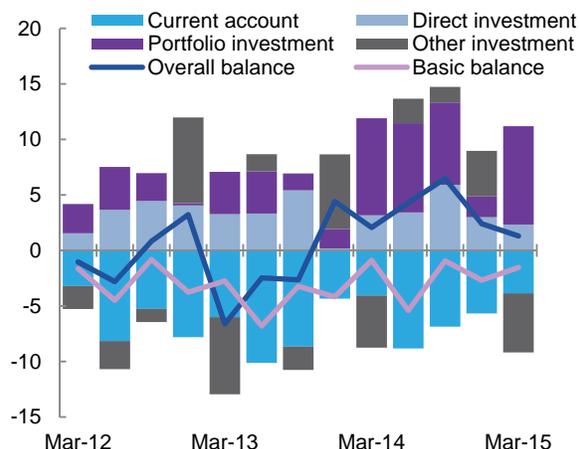
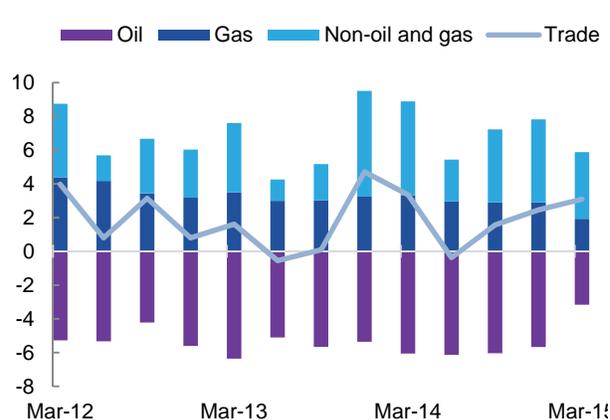


Figure 9: The goods trade surplus rose on the back of a considerably smaller oil deficit
(quarterly trade balance, USD billion)



Note: Basic balance = direct investment + current account balance. Source: BI; World Bank staff calculations

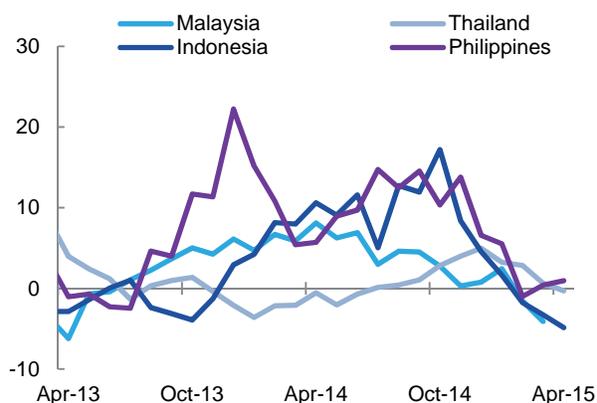
Goods exports recorded another quarter of significant decline...

In Q1 2015 Indonesia’s goods exports fell by a sizeable 13.9 percent yoy. Commodity-related exports contributed 12.3 percent yoy to the total decrease, as external demand and global prices remained weak. Manufacturing exports declined by 3.3 percent yoy, partly on account of lower demand from China and Southeast Asian neighbors. These countries import chemicals, electronics, and machinery parts and components, which together comprise around 30 percent of Indonesia’s manufacturing exports and are used both as intermediate inputs in production chains and as final goods. The recent negative trend in manufacturing export growth is not unique to Indonesia – the country’s ASEAN partners have experienced a similar slowdown (Figure 10). Finally, monthly trade data for April and May show no improvement in manufacturing and commodity exports, the latter despite small increases in copper and liquefied natural gas prices.

...as did the imports of raw, capital and consumer goods

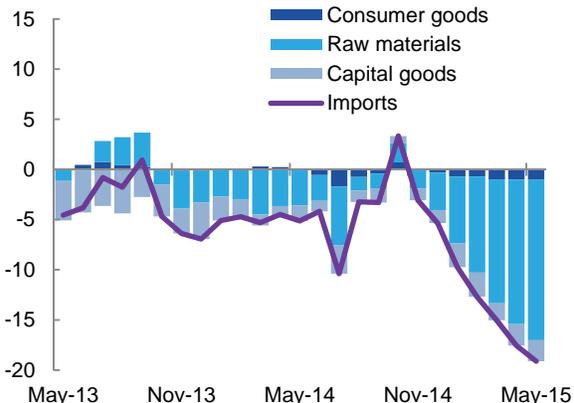
Goods imports contracted significantly, by 14.4 percent yoy in the first quarter, and monthly data for April and May indicate a further decrease (Figure 11). In Q1 2015, raw, capital and consumer goods imports fell by 16.2, 10.2 and 14.3 percent yoy, respectively. In addition to lower oil prices, the continuing weakness in imports was due to the slowdown in domestic demand. Another factor contributing to the decline in imports may be subdued external demand for Indonesia’s manufacturing exports which use imported inputs. Low imports in April and May, which is unusual for the months before Ramadan, coupled with weak monthly sales data, is consistent with domestic demand continuing to slow in the second quarter (see Section 2).

Figure 10: Manufacturing exports have weakened in Indonesia and across the region
(three-month moving average of year-on-year growth, percent)



Source: CEIC; World Bank staff calculations

Figure 11: Goods imports have continued to decline
(contributions to growth yoy of three-month moving average, percentage points)



Source: BPS; World Bank staff calculations

The financial account balance weakened despite strong government portfolio inflows

On the financial account side of the balance of payments, first-quarter net capital inflows, at USD 5.9 billion, declined both when compared to Q4 2014 (USD 8.9 billion) and to Q1 2014 (USD 7.1 billion). The decline in the financial account balance was due to both net direct investment and “Other” investment, which includes foreign currency and deposits (Figure 8). Due to lower inflows, net direct investment totaled USD 2.3 billion, the lowest level since Q4 2013. “Other” investment recorded a deficit of USD 5.3 billion in Q1. Net portfolio flows reached USD 8.9 billion, of which USD 6.9 billion were net foreign purchases of government debt. Foreign exchange reserves declined slightly from USD 111.9 billion in December 2014 to USD 110.8 billion in May 2015.

The projected current account balance is revised up, adjusting for the Q1 realization and subdued growth

Looking forward, the expected 2015 current account balance has been revised up by 0.3 percentage points to -2.7 percent of GDP (Table 3), mainly due to the first quarter realization, and weaker domestic demand growth. Imports, which have been the source of current account improvement over the past two years, are likely to remain weak this year. Monthly trade data through May have shown a continuous decrease in imports and exports, with a larger decline in the former. In 2016, with an expected improvement in government investment spending and output growth, the current account deficit is likely to widen again, to 2.9 percent of GDP. See Section B.1 for more analysis on Indonesia’s current account dynamics.

Table 3: In the base case, a current account deficit of 2.7 percent of GDP in 2015 is projected
(USD billion unless otherwise indicated)

	2014	2015	2016
Balance of payments	15.3	16.1	17.1
As percent of GDP	1.7	1.8	1.7
Current account	-25.4	-24.5	-29.0
As percent of GDP	-2.9	-2.7	-2.9
Goods trade balance	7.0	9.0	7.7
Services trade balance	-10.0	-9.5	-11.5
Income	-27.6	-29.0	-30.0
Transfers	5.2	5.0	5.0
Capital and financial accounts	44.4	40.6	43.8
As percent of GDP	5.0	3.9	4.6
Direct investment	15.5	10.9	12.4
Portfolio investment	26.1	24.5	26.3
Financial derivatives	-0.2	-0.1	-0.2
Other investment	3.0	5.3	7.3
Memo:			
Basic balance	-9.9	-13.6	-16.4
As percent of GDP	-1.1	-1.5	-1.6

Note: Basic balance = current account balance + direct investment

Source: BI; World Bank staff calculations

Box 1: Indonesia's new CPO export levy may affect global CPO prices, but not necessarily positively

According to regulations passed on May 25, 2015¹, the government plans to impose a new export levy on crude palm oil (CPO) in order to fund an increase in biodiesel subsidies. In April, the new administration mandated an increase in biofuel blending in diesel from 10 percent to 15 percent. The rest of the funds collected through the new CPO export levy will go to a Palm Oil Plantation Fund (*Dana Perkebunan Kelapa Sawit*) that will be used for replanting, research and development, marketing, facilities and infrastructure, as well as human resource development in the palm oil sector.

With a 48-percent share in global CPO exports, Indonesia is the world's largest palm oil exporter, having overtaken Malaysia in 2012 (Figure 12). This means that a re-allocation of CPO production from exports to domestic biofuel production, due to the new export levy, could have a global impact on palm oil supply, prices, and demand. To quantify the impact of the new levy on the demand for and supply of Indonesia's CPO exports, a simultaneous supply-demand regression analysis is run.² The demand equation controls for global demand using a monthly proxy of economic activity growth in China³, and for the price of the key substitute product, soybean oil. The supply equation controls for current and lagged temperature and rainfall, as well as for the effects of El Niño and La Niña weather events.

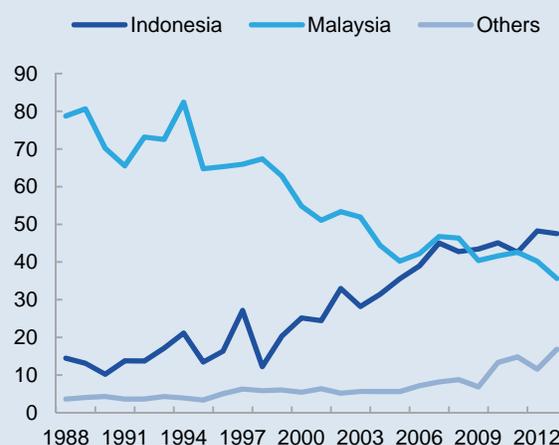
The results show that a one-percent increase in the CPO price results in a 0.7 percent decrease in Indonesia's palm oil exports.⁴ Furthermore, a one-percent decline in the price of soybean oil results in a 0.5 percent decrease in exports as demand shifts to the cheaper substitute. A one-percentage point decline in China's economic activity (in year-on-year terms) results in a 3.3 percent decrease in the export demand for Indonesia's CPO. Supply side estimates show that a one-percent decrease in export supply results in a 5.5 percent rise in the Rupiah price of CPO.

These estimates suggest that Indonesia can affect the world price of CPO in the short term as a price-maker with a high share of the global CPO market. However, the initial price increase after the export levy is imposed may lead to a subsequent decline in the demand for palm oil (e.g. from China), including as imports shift to soybean oil. As a result, prices in the medium run may actually decline because of lower demand relative to supply.

Other factors may also work against the export levy increasing global CPO prices. If palm oil producers reduce export volumes as a result of the export levy, and, for example, at the same time China's demand for palm oil declines because of weaker GDP growth (which is not an unreasonable near-term assumption as China's economy is currently slowing down), then the initial price increase expected by the government may be neutralized. In sum, the overall impact of imposing the export levy on palm oil would depend on several factors affecting producer profits in different directions, and these should be evaluated carefully and comprehensively in weighing its overall impacts.

Figure 12: Indonesia is the world's leading palm oil producer

(share of global CPO export market, percent)



Source: COMTRADE; World Bank staff calculations

Note: ¹ Presidential Regulation No.61, 2015, and Government Regulation No.24, 2015.

² Three-stage least squares (3SLS) is used to estimate the system of structural equations.

³ To obtain a monthly GDP proxy, China's real GDP was interpolated using monthly industrial production.

⁴ Owing to lack of monthly data, exports of vegetable oil and fats are used as a proxy for CPO exports. Between 1988 and 2013, CPO exports contributed, on average to around 80 percent of total vegetable oil and fats exports.

5. Credit growth continued to weaken despite improving liquidity conditions

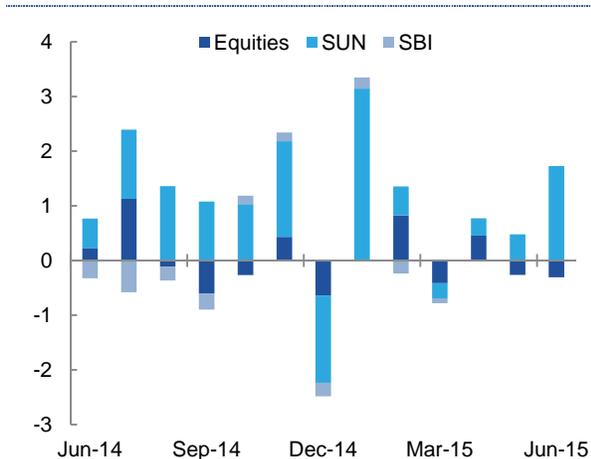
Tight financing conditions, among other factors, have prompted Bank Indonesia to loosen macro-prudential policy

Credit growth slowed down further in the first four months of 2015 and, as discussed in Section 2, domestic demand conditions have softened. In addition, since the end of March 2015, equity and bond prices have declined, and the Rupiah has continued to depreciate against the US Dollar. In response to this challenging macro-financial environment, combining tighter financing conditions, moderating GDP growth, sticky inflation, and currency depreciation pressures, Bank Indonesia kept its monetary policy stance steady during the second quarter, while adopting accommodative macro-prudential measures.

Equity and bond markets declined as foreigners invested less in Indonesian assets

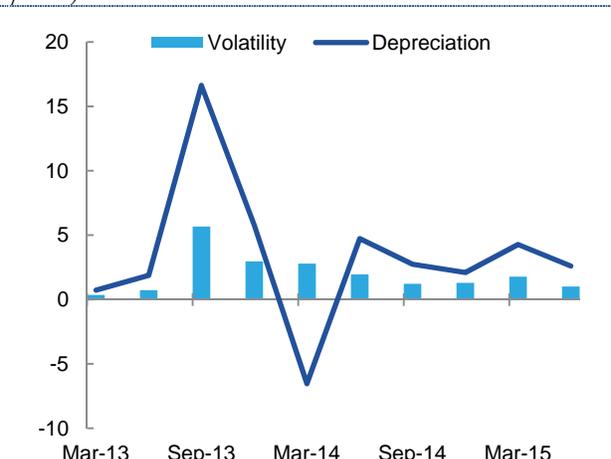
After a strong first three months of the year, the Jakarta Composite Index (JCI) of equity prices decreased sharply, by 11.0 percent, between the end of March and June 30. Foreign investors purchased a total of USD 426.7 million of Indonesian equities in Q1 2015, but became net sellers of equities worth USD 112.9 million in Q2 (Figure 13). Between March 31 and June 30, domestic government bond yields increased by between 55 and 103 basis points across the maturity range. Although net foreign purchases of Indonesian government bonds (SUN) were resilient in the first quarter (see Section 4), they decreased significantly in April and May, before picking up again sharply in June. At the same time, on May 21, 2015, ratings agency Standard and Poor’s revised up its outlook for Indonesia from stable to positive on the basis of the new administration’s policy reforms and institutional improvements.

Figure 13: Net foreign purchases of Indonesian assets were subdued in April and May but picked up in June (monthly net purchases, USD billion)



Note: SBI data until April 2015.
Source: BI, DG Debt Management, JP Morgan; World Bank staff calculations

Figure 14: The Rupiah continued to depreciate but at a moderate pace (quarterly depreciation and standard deviation of daily depreciation, percent)



Source: BI; World Bank staff calculations

The Rupiah maintained an orderly depreciation trend against the US Dollar

The Rupiah weakened by 2.0 percent against the US Dollar between March 31 and June 30, after depreciating by 5.6 percent in the first quarter. Currency volatility, as measured by the standard deviation of Rupiah returns, has remained generally stable since June 2014, after four quarters of heightened volatility following the “taper tantrum” emerging market asset sell-off in 2013 (Figure 14). The relatively low volatility of the Rupiah likely reflects in part BI’s interventions to smooth currency volatility. In an effort to deepen the foreign exchange market and ease depreciation

pressures, BI issued a new regulation on March 31, effective on July 1, requiring the use of Rupiah for all domestic cash and non-cash transactions.⁶ As of June 1, BI also revised regulations on foreign exchange transactions⁷ and on the net open positions of commercial banks⁸, including allowing cross-currency swaps. The revisions also shorten the time needed to settle derivative transactions for foreigners from one week to three days and allow banks to meet the maximum net open position requirement of 20 percent of capital at the end of the day (as opposed to every 30 minutes, as required previously).⁹ The latter change is expected to enable banks with lower capital to participate in the foreign exchange market.

BI has not changed the key interest rate for four months but has loosened macro-prudential policy

With respect to local currency liquidity conditions, BI has kept the key policy rate at 7.5 percent and the deposit facility rate at 5.5 percent since February 2015, and the lending facility rate at 8.0 percent since November 2014. At the same time, BI has introduced several accommodative macro-prudential measures. At its April policy meeting, the central bank lowered bank loan-to-deposit ratios (LDR) by including securities in the definition of deposits and relaxed the LDR upper threshold for banks that meet minimum required lending levels for small and medium-sized enterprises.¹⁰ In May, BI increased the loan-to-value ratio for mortgages from 70 percent to a maximum of 80 percent and lowered the minimum downpayment for car and motorcycle loans.¹¹ Overall, BI has employed a mix of maintaining the monetary policy stance unchanged while loosening macro-prudential policy in response to a challenging economic environment. On the one hand, GDP growth has moderated considerably (see Section 2) and credit growth slowed down (see below). On the other hand, inflation has remained sticky and external balances relatively weak (see Sections 3 and 4), and the Rupiah has continued to depreciate.

The credit growth slowdown appears to have been driven increasingly by reduced credit demand

Although deposit growth has steadily increased in the last four quarters, reaching 14.5 percent in April, credit growth has not yet shown signs of a pick-up (Figure 15). Credit growth, at 10.2 percent yoy in April (and only 3.2 percent yoy in real terms), has been on a continuous downward trend since mid-2012. Consequently, the aggregate loan-to-deposit ratio for commercial banks fell to 87.6 percent in March, from 89.4 percent in December 2014. Non-performing loans, however, increased somewhat to 2.5 percent of total loans in April, from 2.2 percent in December. Overall, recent banking sector developments point to weaker demand driving the continued credit growth slowdown rather than credit supply conditions. The World Bank's measure of financial conditions¹² indicates that financing has remained tight since the third quarter of 2013 (Figure 16). However, while the fall

⁶ PBI 17/3/2015. The following transactions are exempt from the new regulation: (i) certain government budget-related transactions (e.g. foreign debt, government spending abroad, revenue from bonds denominated in foreign currencies, etc.); (ii) receipt or payments of grants to/from foreign entities; (iii) international goods and services trade transactions; (iv) savings in foreign currencies; and (v) international financing payments where at least one party is located abroad. According to the new regulation, some standard foreign currency-denominated transactions, such as seaport and airport services (e.g. container loading and unloading, airplane parking at airport), will now have to be quoted and paid in Rupiah, which may drive transaction costs up. In addition, there may be ways of circumventing the regulation by, for example, using offshore bank accounts.

⁷ PBI 16/16/2014 and PBI 16/17/2014.

⁸ PBI 5/13/2003.

⁹ <http://www.bi.go.id/id/ruang-media/info-terbaru/Pages/BI-Sempurnakan-tiga-Peraturan-2015.aspx>.

¹⁰ http://www.bi.go.id/en/ruang-media/siaran-pers/Pages/sp_172915.aspx.

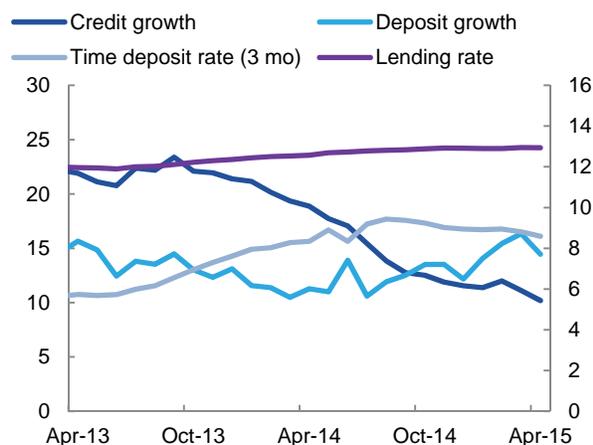
¹¹ http://www.bi.go.id/en/ruang-media/siaran-pers/Pages/sp_173815.aspx.

¹² For details see Box 1 in the December 2014 *IEQ*.

(in year-on-year terms) in equity prices, as measured by the JCI, was the main driver of the deterioration in financial conditions until March 2014, the decline in domestic credit growth has subsequently become a more prominent factor.

Figure 15: Credit growth continued to fall despite improving bank funding conditions

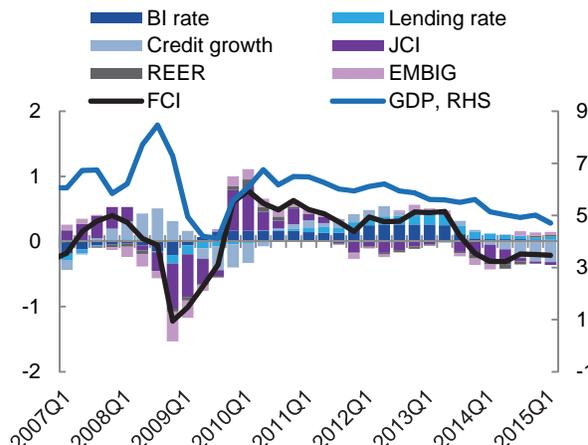
(credit and deposit growth yoy, LHS; time deposit and lending interest rate, percent, RHS)



Source: BI; World Bank staff calculations

Figure 16: Tighter financing conditions have been driven by weak credit growth in recent quarters

(contributions to financial conditions index, GDP growth yoy, percent)



Note: EMBIG – JP Morgan sovereign bond index spread; REER – real effective exchange rate; FCI – financial conditions index. Source: BI; BIS; JP Morgan; World Bank staff calculations

6. The implementation of the 2015 revised Budget is proving challenging

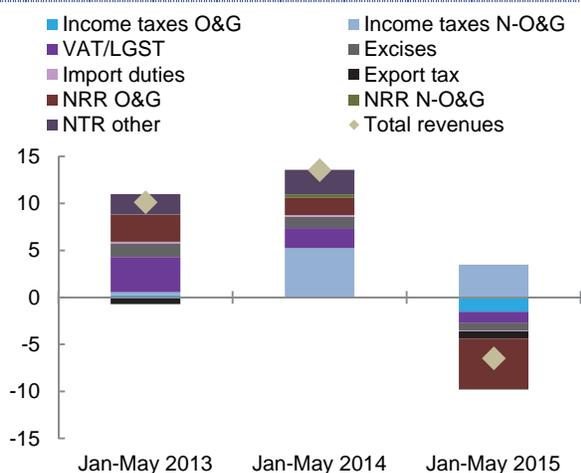
The execution of the revised 2015 Budget is proving difficult

The key features of the 2015 revised Budget, passed in February 2015, include: i) an ambitious target for total revenues to increase by 14.6 percent (of which tax revenues are expected to increase by 30 percent); (ii) a 60 percent reduction of energy subsidies (from IDR 342 to 138 trillion); (iii) a doubling of capital spending (from IDR 135 to 276 trillion); and (iv) a decrease in the fiscal deficit from 2.2 to 1.9 percent of GDP. However, budget implementation in the first five months shows significant challenges, with weak revenue outturns severely limiting the fiscal space for the government’s ambitious infrastructure development plan. In view of Indonesia’s sound debt position, an increase in the fiscal deficit to the legal limit (3 percent of GDP for the general government) would allow for an increase in investment spending, supporting economic growth.

Revenue realization in the first five months of 2015 was lower than in the same period in 2014

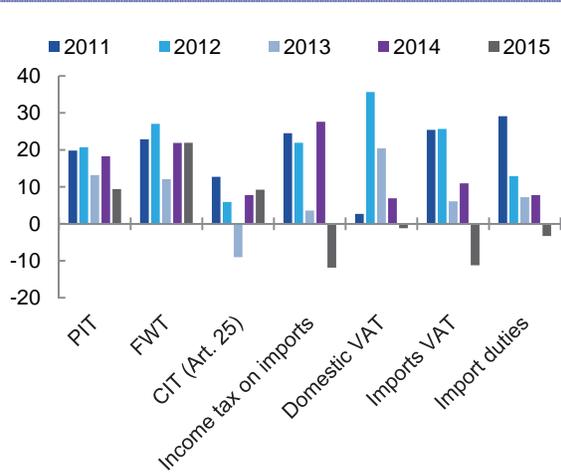
Weak revenue realization in the first five months of 2015 is a strong signal that the revised 2015 Budget target may not be met. By the end of May, total revenues reached IDR 533.4 trillion, a nominal decline of 6.4 percent yoy (Figure 17). The revenue outturns represent only 30.3 percent of the annual target, compared with an average of 35.3 percent in the last five years. Nominal tax revenue declined by 1.3 percent yoy in January-May 2015, in sharp contrast to the targeted increase of 30 percent for the full year in the 2015 revised Budget. Revenues from all major tax categories contracted, with the exception of non-oil and gas income taxes, which contributed a positive 3.5 percentage points to the nominal year-on-year growth of total revenues. Non-tax revenue also declined by 24 percent yoy in nominal terms.

Figure 17: The first five months of 2015 saw broad-based weak revenue collection ...
(contributions of select revenue categories to nominal revenue growth yoy, percent)



Note: O&G stands for “oil and gas”, N-O&G – “non-oil and gas”; LGST – “luxury goods sales tax”; NTR – “non-tax revenues”; NRR – “natural resource revenues”; “NTR other” includes all non-tax revenues other than those from natural resources.
Source: Ministry of Finance; World Bank staff calculations

Figure 18: ... with all import-related tax revenues being particularly low
(nominal growth from January-May vs. year-ago, percent)

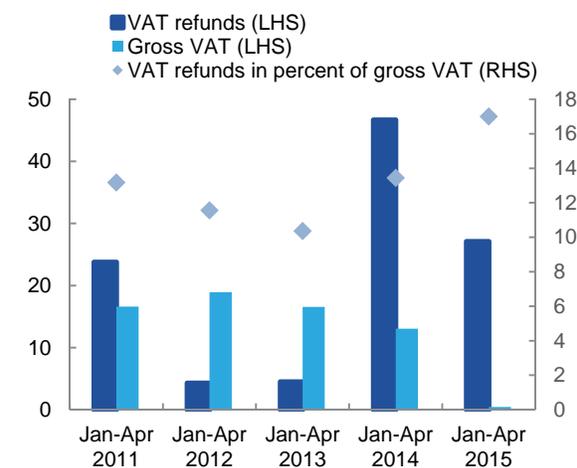


Note: PIT stands for personal income tax; FWT – final withholding tax; CIT is corporate income tax under Article 25 of the Income Tax Law; Income tax on imports.
Source: Ministry of Finance; World Bank staff calculations

Tax revenues recorded a broad-based nominal decline

In January-May 2015, VAT, which accounted for one-third of tax revenues in 2014 and was budgeted to increase by 42 percent in 2015, declined by 4.7 percent yoy, contributing -1 percent yoy to overall nominal revenue growth. Both domestic and import VAT decreased (Figure 18), which is in line with the weaker growth of domestic consumption and the nominal decline in imports during the first quarter of 2015 (see Section 2). As a result, VAT refunds as a share of gross VAT receipts

Figure 19: VAT refunds grew slowly in January-April 2015 but rose as a share of gross VAT receipts
(nominal growth yoy, percent; VAT refunds / gross VAT, percent)



Source: Ministry of Finance; World Bank staff calculations

increased significantly in January- April 2015¹³ relative to the corresponding period in 2014 (Figure 19). Like import VAT, all other import-related taxes, particularly income taxes on imports¹⁴ and import duties, have been impacted by the decline in nominal imports. Furthermore, export tax collection declined significantly as international CPO prices have remained below the threshold of USD 750 per metric

¹³ Data on VAT refunds for May are not yet available.

¹⁴ Certain imported goods are taxed under Article 22 of the Income Tax Law because they are considered assets purchased with the intention to gain profit.

ton since October 2014, resulting in a CPO export tax rate of zero percent. Finally, the weaker growth of personal income tax (PIT) and final withholding tax¹⁵ collection relative to 2014 is consistent with slower nominal GDP growth.

To raise tax collections, the government has announced a number of policy measures, but only some have been implemented

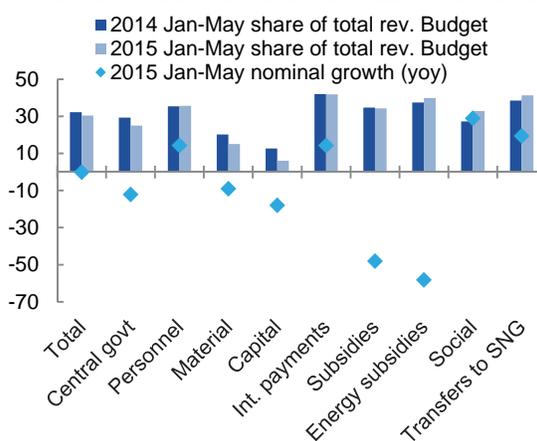
The revised 2015 Budget revenue target of IDR 1,762 trillion is very ambitious, especially given more challenging macroeconomic conditions. In an effort to reach the revenue target, the government has announced a number of measures that aim to increase tax collection in 2015.¹⁶ These include introducing VAT on the electricity consumption of households with higher capacity (2,200-6,600VA) power supply and on tolls. However, to date, only some of the announced policies have been enacted, such as the reduction in the threshold defining certain goods as “super-luxury”.¹⁷ The Ministry of Finance has also introduced measures to improve tax administration and compliance: e-tax invoicing, a revamped tax auditing process that focuses on certain businesses (e.g. corporations using transfer pricing, oil and gas companies, and coal-mining companies) and wealthier taxpayers, and a six-month overseas travel ban on tax debtors issued in December 2014.¹⁸ A waiver of interest and fines on onshore tax arrears and late tax payment submission has also been implemented.¹⁹

On the expenditure side, with around one-third of the revised Budget spent, capital and material expenditure disbursement rates were particularly low in the first five months...

Total expenditure reached IDR 605 trillion in May, driven by disbursements of personnel expenditure, interest payments and transfers to regions, all tracking closely to budgeted rates. Subsidy spending has fallen sharply (see Section B.2 for an update on these reforms). However, capital spending is down by 18 percent relative to 2014, undermining the government’s intention of a big push in infrastructure investment (Figure 20). While capital spending is traditionally skewed

towards the fourth quarter of the fiscal year, disbursement by the end of May has been particularly low this year, reaching only IDR 17 trillion (6 percent of budgeted capital spending for 2015), down from IDR 20 trillion in 2014 (13 percent of budgeted capital spending in 2014). The new government transition and restructuring in a number of ministries, particularly the Ministry of Public Works and Housing and the Ministry of National Education, has slowed down project

Figure 20: Budget disbursement of capital and material expenditure remained low
(January-May realization as a share of total revised Budget, percent; nominal growth yoy, percent)



Source: Ministry of Finance; World Bank staff calculations

¹⁵ Article 21, Article 25 (personal) and Article 4(2) of the Income Tax Law No. 7/1983. Final withholding tax is the full and final payment of income tax due from the recipient of the income.
¹⁶ For a discussion of these measures see the March 2015 *IEQ*.
¹⁷ Regulation No. 90/PMK.03/2015. “Super-luxury” goods are taxed under the Income Tax Law because they are seen as assets purchased with the intention to gain profit.
¹⁸ Law 19/1997 (amended by Law 19/2000), Article 29-32.
¹⁹ Regulation No.29/PMK.03/2015 and Regulation No. 91/PMK.03/2015.

preparation, adding to long-standing capital budget execution challenges such as land acquisition and inter-ministerial and inter-governmental coordination.

...but disbursement is expected to accelerate in the second half of the year

Despite the relatively low disbursement rate in the first five months, the government has indicated that it will accelerate budget execution in the second half of the year, targeting 90 percent realization for total expenditure by year-end. Some efforts to improve budget execution are underway. As of May, 95 percent of line ministries' budget documents (*Daftar Isian Pelaksanaan Anggaran*, DIPA) had been completed. According to the Ministry of Public Works and Housing, contracts for 54 percent of its capital budget have already been awarded.²⁰ The revised land acquisition regulation, effective March 17, 2015, is also expected to accelerate the land acquisition process by facilitating timelier funding for land acquisition,²¹ though this is only likely to have a major impact in 2016. In an attempt to ramp up infrastructure development further, two regulations have also been issued to facilitate the government's capital injection of IDR 5 trillion (out of IDR 70.4 trillion allocated in the 2015 revised Budget) into two state-owned enterprises (SOEs) in the construction industry.²²

The World Bank projects a fiscal deficit of 2.5 percent of GDP in 2015, driven by an expected significant revenue shortfall

The World Bank's baseline budget deficit projection for 2015 remains at 2.5 percent of GDP, unchanged from the March 2015 *IEQ* outlook (Table 4). On the revenue side, a significant shortfall of IDR 296 trillion (2.6 percent of GDP) is expected. This is higher than the IDR 282 trillion projected in the previous *IEQ*, due mainly to generally weaker macroeconomic assumptions (Table 4), offset only partly by higher oil and gas related revenues (due to an upward revision of oil price and exchange rate assumptions, see Table 2). Finally, as the international CPO price is no longer expected to exceed the USD 750 per metric ton threshold, the World Bank assumes that the CPO export tax rate will remain at zero, prompting a reduced export tax forecast. The baseline revenue projection is consistent with the revenue outturns in the first five months of 2015. It does not incorporate significant improvements in revenue collection in the second half of 2015 from the policy measures that have been undertaken so far, as the magnitude and timing of their potential effects are difficult to quantify.

²⁰ <http://hariansib.co/view/Headlines/59514/Defisit-APBN-Makin-Menciut--Penerimaan-Pajak-Mulai-Bergerak-Lebih-Cepat.html>.

²¹ Presidential Regulation No. 30/2015, which is the third revision of Presidential Regulation No 71/2012. Under the new regulation, private investors, provided they have an agreement with the central or sub-national government, can provide funding for land acquisition at an early stage with assurance that the funds will be refunded directly by the state budget, or through revenue arrangements as the project proceeds. This is in contrast with previous arrangements whereby land acquisition had to wait for disbursement of the state budget, which is often limited and subject to a long budgeting cycle. (<http://setkab.go.id/perpres-no-302015-badan-usaha-bisa-talangi-dana-pengadaan-tanah-untuk-kepentingan-umum/> and <http://www.eastasiaforum.org/2015/06/10/how-to-solve-indonesias-infrastructure-crisis/>).

²² <http://setkab.go.id/en/government-injects-the-capital-of-hutama-karya-and-adhi-karya-of-rp-5-trillion/>.

Table 4: The World Bank projects a fiscal deficit of 2.5 percent of GDP in 2015

(IDR trillion, unless otherwise indicated)

	2014 Preliminary Actual	2015 Revised Budget	2015 World Bank March	2015 World Bank July
A. Revenues	1,537	1,762	1,480	1,467
1. Tax revenues	1,143	1,489	1,199	1,165
Income tax	547	679	541	550
Oil and gas	87	50	36	44
Non-oil and gas	460	630	508	507
VAT/LGST	405	577	450	420
International trade taxes	43	49	44	32
Import duties	32	37	34	32
Export taxes	11	12	10	3
2. Non-tax revenues	391	269	277	298
B. Expenditures	1,764	1,984	1,774	1,760
I. Central government	1,191	1,320	1,109	1,091
Personnel	243	293	262	278
Material	176	239	175	176
Capital	135	276	200	160
Interest payments	133	156	156	158
Subsidies	393	212	192	199
Energy subsidies	342	138	140	149
Fuel	240	65	67	67
Electricity	102	73	79	82
Non-energy subsidies	51	74	52	52
Grants	1	5	5	5
Social	98	104	105	104
Other expenditures	12	36	9	9
II. Transfers to regions	574	665	664	669
C. Primary balance	-94	-67	-138	-135
D. Overall balance	-227	-223	-294	-293
as percent of GDP*	-2.2	-1.9	-2.5	-2.5
<i>Key economic assumptions</i>				
Real GDP growth (percent)	5.1	5.7	5.2	4.7
CPI (yoy, percent)	8.4	5.0	6.5	6.8
Exchange rate (IDR/USD)	11,878	12,500	12,600	13,200
Crude-oil price (USD/barrel)	97	60	55	59
Oil production ('000 barrels/ day)	794	825	826	826

Source: Ministry of Finance; World Bank staff calculations

Weaker revenues are expected to limit the scope for capital expenditure increases

In the base case, the World Bank assumes that the government would spend 2 percent of GDP (IDR 225 trillion) less than planned in the 2015 revised Budget and expand the deficit by 0.6 percent of GDP to respond to the expected revenue shortfall.²³ The revised 2015 total expenditure projection is broadly flat in nominal terms compared with 2014 but with a markedly different composition. Social and grants expenditures, as well as the main regional transfer categories are projected to be disbursed as stated in the 2015 revised Budget. Personnel and other expenditure categories are forecasted to be disbursed at the 2011-2014 average disbursement rates of 95 percent and 25 percent, respectively.²⁴ The remaining revenue sharing balance, energy subsidies, and interest payments are driven by macroeconomic assumptions. For the other expenditure categories, projections assume that the

²³ In a scenario of full budget execution the fiscal deficit for 2015 would reach 4.6 percent of GDP.

²⁴ The projection for personnel expenditure for 2015 is slightly higher than in the March 2015 IEQ, which assumed that efficiency measures will be taken and a second round of Budget revisions, both of which are now unlikely.

government will prioritize capital spending by constraining material and non-energy subsidy spending to 2014 nominal levels. This would yield sufficient fiscal space for capital spending to reach IDR 160 trillion in 2015, an 18-percent nominal increase from 2014 levels but significantly less than the targeted IDR 276 trillion in the 2015 revised Budget.

Gross financing needs in 2015 could exceed those in 2014, but risks are mitigated by front-loading securities issuance and the deployment of new multilateral financing

Gross government financing needs for 2015 could reach IDR 576 trillion (5.0 percent of GDP), comprising: i) debt amortizations of IDR 223 trillion (1.9 percent of GDP); ii) non-debt financing needs of IDR 62 trillion (0.5 percent of GDP) primarily from SOE recapitalization; and iii) a fiscal deficit of IDR 291 trillion (2.5 percent of GDP). These projected 2015 financing needs are higher than those in 2014 (4.6 percent of GDP), but associated risks are mitigated by the strong pace and foreign take-up of domestic bond issuance so far on 2015. As of June 30, nearly 65 percent of the current gross annual securities issuance target, the source of 89 percent of the intended total annual financing, was already met. This generates some headroom to meet a higher securities financing target merely by reducing the rate at which gross securities issuance is tapered down over the remainder of 2015, assuming that market conditions, including global appetite for Rupiah-denominated bonds, remain conducive. There is also ample scope to increase bi-lateral and multi-lateral program loans in 2015, from very low initially-budgeted levels.

Increasing the fiscal deficit to boost public investment would support economic growth

Given Indonesia's relatively low government debt level, at 24 percent of GDP in 2014, and credible fiscal rule, raising the 2015 fiscal deficit to the maximum level allowed by law is a good policy option to accelerate public investment spending in line with the government's ambitious infrastructure plans and to support economic growth. The maximum legal fiscal deficit level of 3 percent of GDP applies to the general government (i.e. the central and sub-national governments combined). The threshold for each level of government is determined each year in a regulation by the Ministry of Finance. The maximum threshold for the sub-national government was set at 0.3 percent of GDP and for the central government at 2.7 percent of GDP for 2015.²⁵ If the central government deficit were increased to 2.7 percent of GDP, then capital expenditure could be raised by an additional IDR 23 trillion (0.2 percent of GDP), pushing it up by a significant 35 percent from the 2014 level.

7. Ongoing labor market challenges may intensify due to lower growth

Employment growth over the past decade has been strong...

Job creation in Indonesia has been strong over the last decade, with employment growth averaging 1.8 percent per year. Over 24 million net new jobs were created between 2000 and 2014 (Figure 21), increasing the ranks of the employed to 114.6 million. Indonesia's success in job creation over this period is explained mainly by sustained economic growth, a favorable economic environment, and a rapidly expanding service sector, particularly in urban areas.

...but job creation slowed down in 2013 and 2014

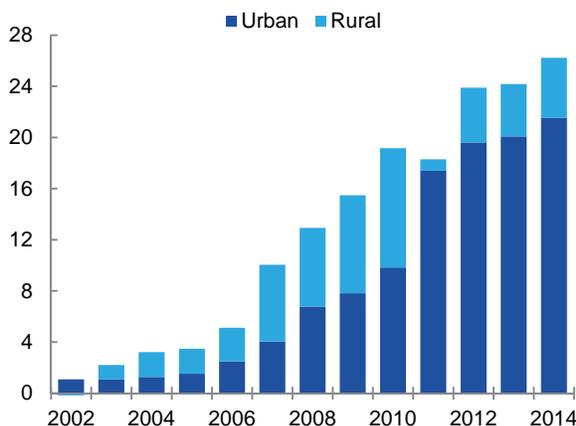
However, job creation has slowed in recent years as a result of slower economic growth, with net new jobs rising only by 0.2 percent in the year to August 2013 and by 1.6 percent in the year to August 2014 (the most recent data). The recent employment increase has only just equaled the increase in the working age population, leaving the total employment rate stable at 62.6 percent in 2013 and in 2014 (Figure 22). The growth in employment contributed to a slight decline in the

²⁵ PMK No.183/PMK.07/2014.

unemployment rate to 5.9 percent, from 6.2 percent in 2013, while the overall labor force participation rate remained unchanged at 66.6 percent.

Figure 21: Employment has risen by 26 percent since 2001, mostly in urban areas...

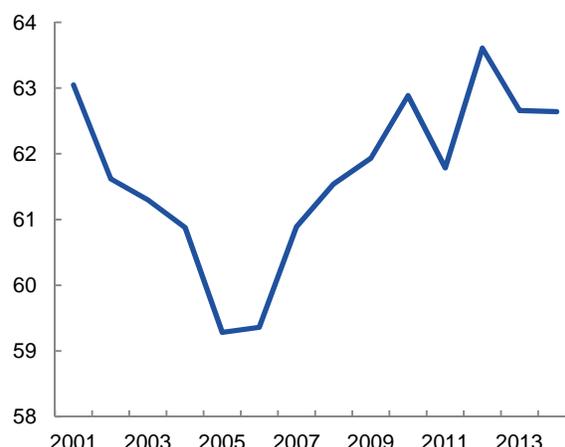
(cumulative employment growth since 2001, percent)



Source: BPS; World Bank staff calculations

Figure 22: ...but the employment rate has stagnated since 2012

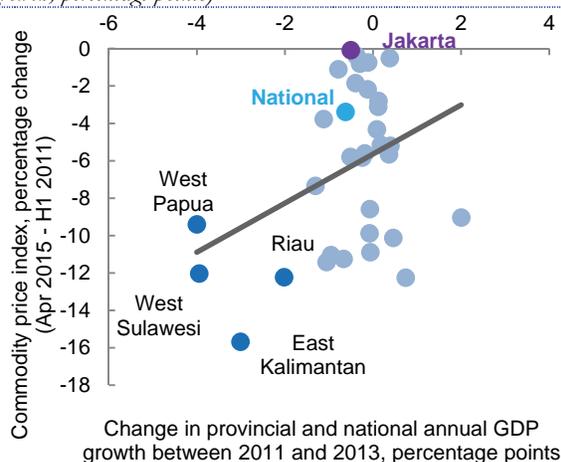
(share of working age population in employment, percent)



Source: BPS; World Bank staff calculations

Figure 23: Growth has slowed down significantly in provinces more exposed to the commodity sector...

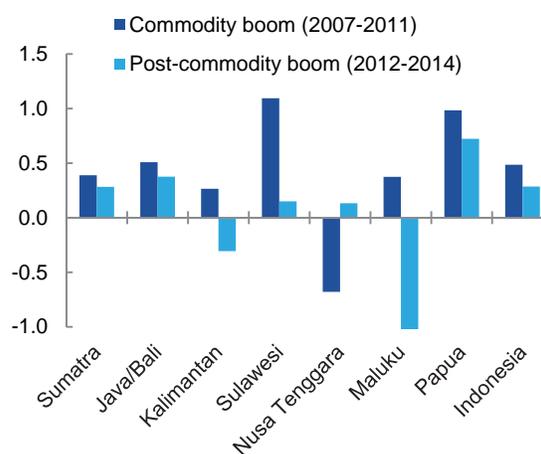
(change in commodity price index, percent; change in annual GDP growth, percentage points)



Note: Commodities include oil, gas, rubber, crude palm oil, coal, copper, nickel, aluminum, lead, zinc and iron ore. The commodity price index, for each province and at the national level, is weighted by each commodity's share in provincial and national GDP; *2014 is not included in the calculation due to lack of data.
Source: BI; BPS; World Bank; World Bank staff calculations

Figure 24: ...while the average annual increase in employment rates has declined across most regions

(average annual difference in employment rates, percentage points)



Source: BPS; World Bank staff calculations

Commodity-dependent provinces recorded significantly slower

While the commodity downturn since 2012 and policy responses have affected output growth the most in resource-rich provinces, employment creation has also come under pressure in Java and Bali. According to BI estimates of provincial GDP²⁶, East Kalimantan, Riau, West Papua, and West Sulawesi have seen annual

²⁶ Bank Indonesia, Regional Economic Report (*Laporan Nusantara*).

GDP growth, but employment growth weakened across Indonesia

GDP growth rates significantly below the national average (Figure 23). In terms of employment growth, after the commodity boom the average annual employment rates declined in Kalimantan and Maluku and job creation slowed down significantly in Sulawesi (Figure 24). However, declining employment growth was observed across Indonesia, except in Nusa Tenggara. In Java and Bali, an average of 1.4 million new jobs were created annually between 2012 and 2014, compared with an average increase in the working-age population of 1.6 million people. The employment situation in Java and Bali also reflects demographic trends, as the population of working age increases faster in those regions than elsewhere partly due to rural-urban migration.

Employment growth is hampered by long-standing structural issues, which have become more prominent with slower growth

In addition to recent macroeconomic conditions, employment trends in Indonesia are affected by several ongoing labor market challenges, which may have worsened with weaker demand and growth. First, low value-added sectors (e.g. agriculture) are the largest employers, and low productivity sectors (e.g. social and personal services and wholesale and retail trade) create the most jobs. Second, the informal sector is still large. According to World Bank estimates, over 60 percent of workers are either self-employed, casual workers, unpaid family workers, or employers who hire temporary workers among the rest of the workforce, only around 35 percent of employees have written contracts. Third, investment in higher productivity sectors is constrained by the limited availability of skilled workers, as less than 9 percent of the workforce has tertiary education. The new government has prioritized reforms, such as increasing infrastructure spending and reducing the barriers to starting and running a business, which address some of the above challenges by enhancing competitiveness.

8. More public investment can help to reinvigorate Indonesia's weakening economy

Indonesia faces persistent international risks in the context of tighter financing conditions and weaker commodity prices...

The balance of risks to the World Bank's economic outlook for Indonesia is on the downside. In terms of the international environment, there is uncertainty around the trajectory of public and external financing costs and availability in the context of the normalization of US monetary policy (with Indonesian domestic government bond yields having already increased significantly in 2015). International financial market dislocations may induce more currency and external financing pressures, constrain policy options, and further weaken domestic demand growth. There are also ongoing risks to external demand, given lower trend output growth in developing countries (including some of Indonesia's major trading partners), which has contributed to the decline in global commodity demand and prices. A key risk to the global outlook is a setback in the still-fragile Euro Area recovery, including perhaps because of concerns about Greece's financial strains.

... whereas on the domestic front, macroeconomic management faces a complex mix of challenges, placing a focus on the fiscal sector...

Turning to domestic macroeconomic conditions, GDP growth decelerated to below 5 percent in Q1 2015 on account of weak trade and fixed investment, but private consumption, Indonesia's engine of growth in recent years, appears to be slowing down too. Monetary policy is constrained due to sticky CPI inflation, persistent external vulnerabilities and the need to manage the risks from currency volatility. This places the focus on the fiscal sector and the regulatory environment. In particular, the government can support a sustainable return to higher economic growth by moving ahead with its ambitious infrastructure development plans and other reforms to boost private investment.

... where managing expenditures and allowing the fiscal deficit to expand could help keep ambitious infrastructure development plans on track...

The World Bank projects that fiscal revenues this year will fall significantly short of budgeted levels (by 2.6 percent of GDP). This, together with a very low capital spending year-to-date, risks undermining the government's development agenda. In this context, raising the general government deficit to 3 percent of GDP (or, equivalently, the central government deficit to 2.7 percent of GDP) in 2015, may be an appropriate response for the government to consider. In addition, budget reductions or under-execution, which appear likely given revenue constraints, will need to be managed well by continuing to move ahead with high-priority infrastructure projects, enabling capital spending to accelerate past last year's level and contribute to overall fixed investment and GDP growth.

...in addition to measures aimed at sustainably raising revenue collection

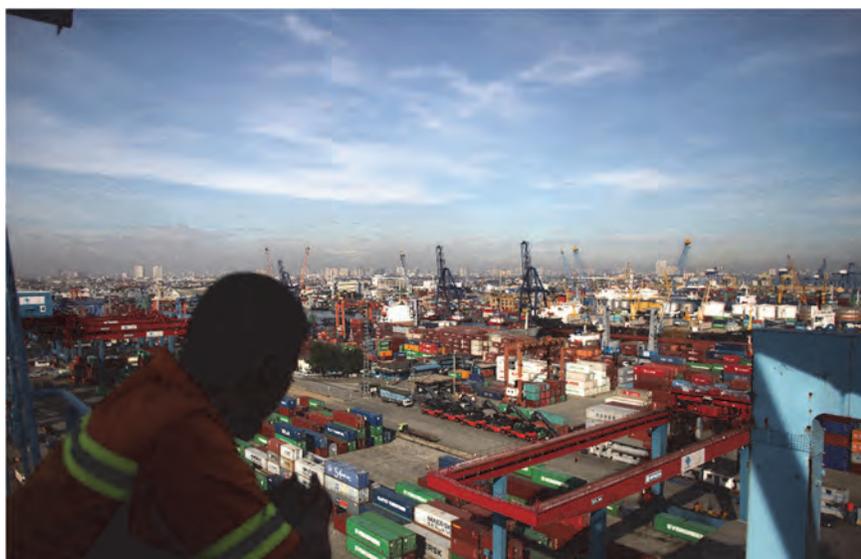
Revenue-improving measures should take account of the risk of potential counterproductive long-term effects. For example, the government's planned tax amnesty for offshore assets and income that would provide exemptions from all charges of financial crimes – including corruption, money laundering, and tax evasion – in exchange for repatriating assets to Indonesia, may provide tax revenue gains when implemented. However, it also carries the risk of lowering tax morale, and hence impeding revenue mobilization, in the future.²⁷ The implications for governance and efforts to combat corruption of the planned waiver of legal charges for financial crimes should also be carefully evaluated.

Reforms to improve revenue performance over the medium- and long-term need to be implemented in parallel

Apart from the challenging external environment, long-standing structural issues, such as poor tax compliance rates, are among the reasons for Indonesia's weak revenue performance. Therefore, the government could also focus on measures to sustainably improve revenue collection over the longer term. Some tax administration measures which the government has already introduced, such as electronic tax return submission and improvements in the income tax audit strategy, fall into this category (as discussed in Section 6). Additional reforms that could be considered relate to optimizing the tax regime, including revisions to sales and excise taxes for vehicles, fuels and tobacco. These measures would reduce market distortions and negative externalities (e.g. pollution, congestion), improve public health, and, at the same time, raise revenues. There is also scope to improve corporate income taxation to reduce firms' incentives to remain small. Finally, some other measures have the added advantage of increasing equity, such as the revision of VAT exemptions for the electricity consumption of households with 2,200-6,600VA power supply, which was announced as part of the revised Budget.

²⁷ See Section 7 in the March 2015 *IEQ* for a brief discussion of this topic.

B. Some recent developments in Indonesia’s economy

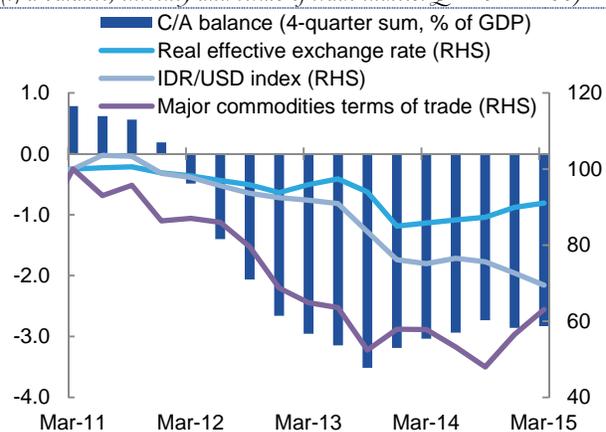


1. Indonesia’s current account – deficits are here to stay

Indonesia’s current account deficit has remained little-changed since 2013, despite significant policy and economic adjustments

The current account of the balance of payments is the broadest measure of a country’s international trade, covering transactions in goods, services, factor income (from assets and labor), and transfers. Indonesia’s current account balance moved into deficit in Q4 2011 and has stayed negative ever since. This has worried policymakers and investors, most notably during the mid-2013 “taper tantrum”, when Indonesia was amongst those emerging market economies (EMEs) widely considered to be at risk from the effects of tighter US monetary policy. Since 2013, Indonesia has acted to reduce macroeconomic risks and external financing conditions have remained generally favorable; indeed, Indonesia received record portfolio inflows in 2014. Yet to date the current account deficit has remained little-changed since 2013, at close to 3 percent of GDP on an annualized basis (Figure 25). This section examines recent current account dynamics, placing them in the context of longer-term trends, and discusses policy implications.²⁸

Figure 25: The current account deficit has held at close to 3 percent of GDP despite currency adjustment (c/a balance; currency and terms of trade indices: Q1 2011=100)



Note: Lower exchange rate index values indicate depreciation.
Source: BI; BIS; CEIC; World Bank staff calculations

²⁸ This Section summarizes a forthcoming World Bank staff report on Indonesia’s current account.

a. A major trade shock has dominated current account dynamics in recent years

Since 2011, the current account has been affected by a major trade shock, compounded through 2014 by rising net oil imports...

The stand-out recent feature of Indonesia's current account is the sharp contraction of the non-oil and gas goods trade surplus, beginning in 2011 and becoming strongly apparent in 2012 (Figure 26), caused mainly by declines in global commodity prices and the demand for Indonesia's key commodity exports. This has been due to a moderation of growth in China, as well as generally sluggish global growth. It has been a major trade shock, cutting Indonesia's commodities export revenues by approximately one-sixth over 2011-2014, amidst an approximate halving in its terms of trade for major commodities. A large and, until 2014 growing, oil and gas trade deficit also contributed. All told, the narrower non-oil and gas goods trade surplus accounts for about half (49 percent) of the USD 30.5 billion deterioration in the current account balance from 2010 to 2014, oil and gas trade somewhat under a third (29 percent), and higher income outflows about a quarter (23 percent, most of which occurred in 2010).

...resulting in significant monetary policy and exchange rate adjustments...

Monetary and exchange rate policy reacted decisively after mid-2013 to the trade shock, after external financing conditions deteriorated markedly for Indonesia and many other EMEs. Bank Indonesia (BI) tightened monetary policy through interest rate increases and macroprudential measures, aiming to moderate domestic demand growth and compress imports. Flexible exchange rate management since mid-2013 has also contributed to macroeconomic stability. The Rupiah has fallen by 33 percent against the US Dollar since July 2013, when BI adopted a more hands-off approach to the currency. Depreciation in real effective (i.e. trade-weighted) terms has been a more moderate 10 percent, and an initially sharp adjustment in H2 2013 has been followed by a generally orderly depreciation trend. This has helped to cushion the trade shock by reducing export price falls in Rupiah terms, improved currency market liquidity, and supported a recovery in gross foreign reserves.

...with energy subsidy reform also expected to alleviate additional pressures that were being placed on Indonesia's external balance

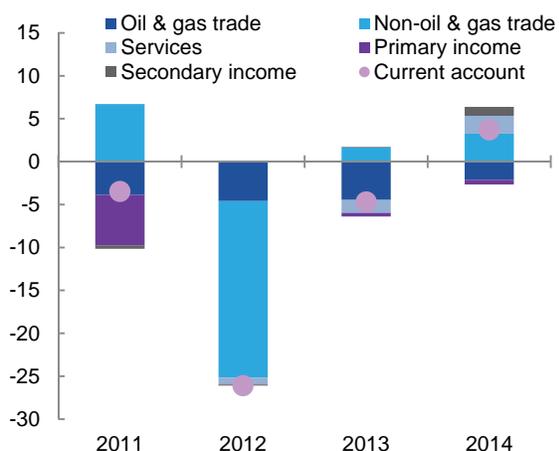
Large energy subsidies, especially for fuel, contributed through 2014 to the increase in the current account deficit. They did so directly by keeping retail fuel prices artificially cheap, which increased fuel demand and imports, and indirectly by placing upward pressure on the fiscal deficit (hence contributing to a shortfall of national saving relative to investment). Recent reforms have cut budgeted fuel subsidies to 0.6 percent of GDP in 2015, reducing budgeted energy subsidies (for fuels and electricity) to 1.2 percent of GDP in 2015, down from an average of 3.3 percent in 2011-2014 (see Section B.2). This should contribute to the future sustainability of Indonesia's external position and reduce fiscal risks from, and increase the expenditure-switching power of, any further Rupiah depreciation.

Despite these changes, Indonesia's current account deficit has remained sticky, due mainly to weak commodity exports

The effects of lower commodity prices and demand, and of the needed policy responses to facilitate Indonesia's adjustment to these shifts, have continued to filter into the economy. Domestic demand growth has slowed markedly (see Part A). Yet despite this, and the sharp fall in global oil prices since mid-2014, the current account deficit has so far remained sticky, at 2.9 percent of GDP for 2014. In Q1 2015 the deficit stood at 1.8 percent of GDP, but this reflected favorable seasonal factors, and was only 0.1 percentage points of GDP narrower than its 1.9 percent of GDP level in the comparable quarter (Q1) of 2014. The reason is that imports have compressed significantly (by 4.5 percent in 2014 on the back of a lagged response to weaker exports, domestic demand and, moving into 2015, also lower imported fuel prices), but export revenues have also continued to fall, by 3.7 percent in 2014.

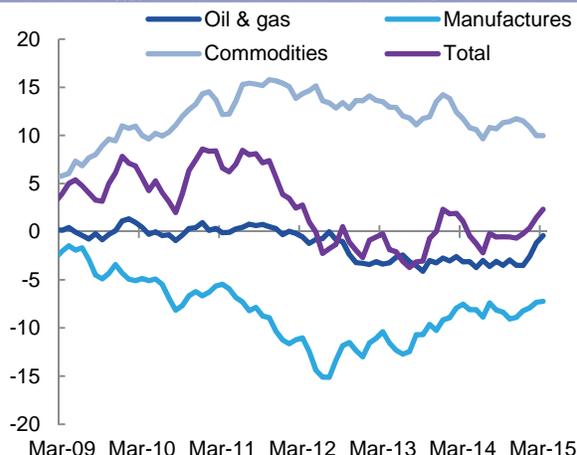
Broadly, net commodity exports have remained a drag on Indonesia’s current account balance, while the manufactures trade deficit has closed gradually (mainly due to import compression since 2013), and the more recent drop in global oil and prices has helped lift the goods trade balance back into surplus (Figure 27).

Figure 26: The current account balance has been recovering slowly from a large trade shock...
(annual change in sub-account balances, USD billion)



Source: BI; World Bank staff calculations

Figure 27: ...with net commodity exports staying weak but the manufactures trade deficit slowly narrowing
(3-month rolling goods trade balances, USD billion)



Note: “Manufactures” aggregate non-commodity SITC 2 categories (mainly chemicals, manufactured goods, machinery & transport, other transport products); “commodities” is a residual item = total goods exports – manufactures – oil & gas.
Source: BPS; World Bank staff calculations

b. ...but Indonesia’s current account balance has also declined due to longer-term structural factors...

Recent current account changes also need to be placed in the wider context of Indonesia’s investment and saving trends...

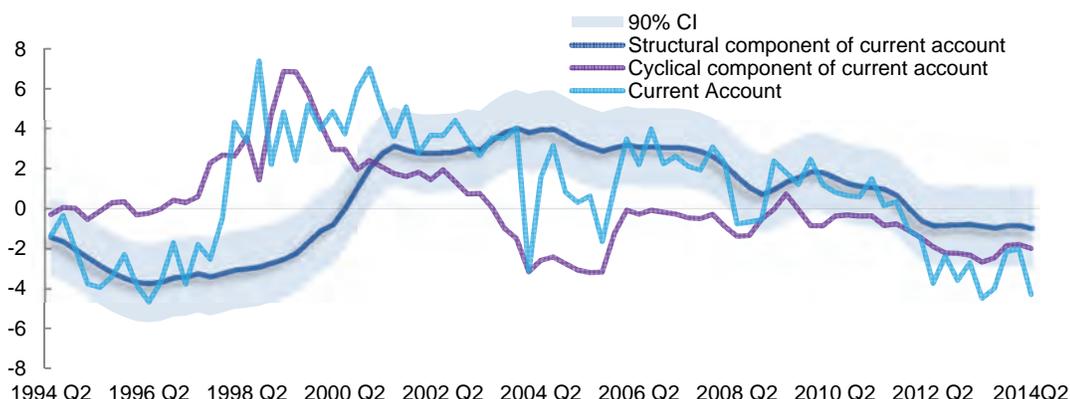
In addition to the recent, highly visible impacts of the trade shock and policy responses, the current account has also continued to be driven by a complex mix of other forces. Recent detailed analysis by World Bank staff decomposes these forces into four blocks of interacting short, medium and long run factors: external shocks, domestic policies, international integration, and stage of development and demographics. This wide range of factors reflects that the current account results from the interaction of domestic saving and investment, each of which is subject to both medium-term trends and cyclical factors. The balance of this interaction is that amount that a country borrows from the rest of the world to finance investment and consumption in excess of its level of production.

...which point to a modest structural current account deficit...

The analysis suggests that based on structural factors, a modest negative balance on Indonesia’s current account is to be expected, with a mid-point of -1 percent GDP, but with a wide confidence interval of +/- 2 percent of GDP (i.e. a structural current account deficit of -3 to 1 percent of GDP, Figure 28). This result is broadly in line with the IMF’s recent assessment that a current account deficit of 1.5 percent of GDP +/- 1 percent is normal for Indonesia.²⁹

²⁹ IMF, March 2015, 2014 Article IV Consultation (Staff Report).

Figure 28: Based on structural factors alone, it is normal for Indonesia to record current account deficits
(estimated structural, cyclical and total current account components, percent of GDP)

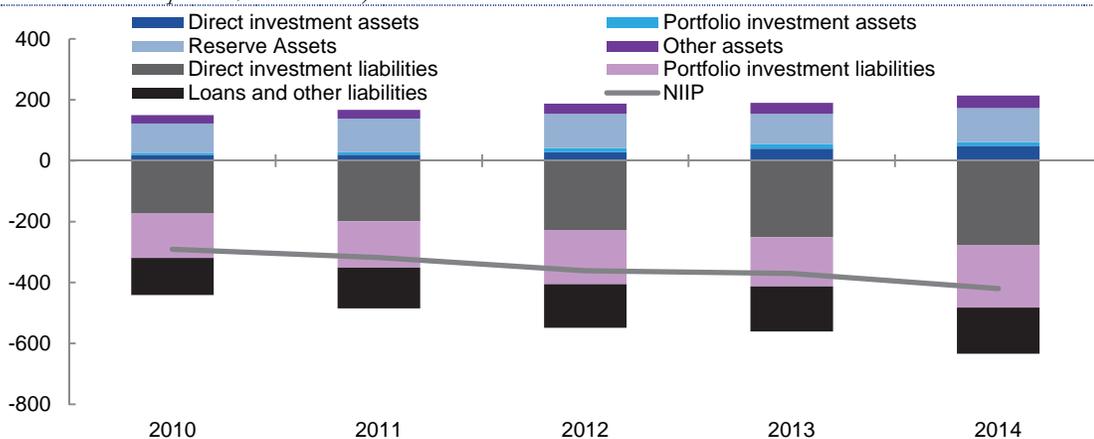


Note: CI denotes confidence interval (estimated to contain the true structural current account balance with 90 percent probability); irregular component of current account balance not shown (residual of estimated structural and cyclical components).
Source: World Bank staff calculations

...resulting in a growing, but sustainable, net foreign liabilities position...

While running a current account deficit may be natural, it still means that Indonesia is accumulating net foreign liabilities, something which may pose sustainability concerns if these liabilities grow over time, generating debt payment obligations that burden the economy. Indeed, according to BI, Indonesia’s net international investment position (NIIP) declined by USD 129 billion from 2010, the last full year of current account surpluses, to 2014 (Figure 29). The NIIP as of the end of 2014 was USD 420 billion (47 percent of GDP, up from 38 percent of GDP in 2010). Examining the composition of the increase is important in gauging the sustainability of these changes.

Figure 29: Most of the increase in net foreign liabilities has been in FDI or other Rupiah-denominated assets
(net international investment position, USD billion)



Source: BI

...helped by a preponderance of Rupiah-denominated liabilities

Crucially, the bulk of the increase in Indonesia’s net foreign liabilities from 2010 to 2014 has been through an increase in the stock of direct investment holdings of non-resident investors in Indonesia (by USD 104 billion). Such liabilities are commonly considered to be “bolted down”, representing longer-term commitments by non-resident investors in the economy, and come with ancillary benefits including technological transfers. A further USD 58 billion consists of increased

portfolio liabilities, and most of this, in turn, comprises increased foreign ownership of domestic government debt. Consequently, most of the total increase in Indonesia's foreign liabilities has been Rupiah-denominated. Currency depreciation reduces the value of these liabilities in foreign currency terms, strengthening the mechanism for currency depreciation to facilitate external adjustment, as has been occurring since 2013. The IMF's latest assessment is that the NIIP remains "...at moderate levels and [is] projected to remain stable".³⁰

c. ...and appropriate policy responses are also longer-term in nature

Indonesia can, and most likely will, continue to run current account deficits...

Indonesia's current account deficit is due to a complex mix of factors, many of which are structural and long-term in nature. Indonesia is still in the relatively early stages of economic convergence to higher-income trading partners, implying a faster growth rate, a higher domestic return on capital, and an excess of investment spending over domestic saving, tending to push the current account towards deficits. Policy measures to force the current account back into surplus, for example by suppressing imports directly through regulatory measures or through fiscal contraction, would push the economy far off its trend path, at a cost to growth. Fortunately, Indonesia does not have to pay such a price. Assuming no short-term financing difficulties (liquidity constraints), moderately-sized current account deficits can be run indefinitely (sustainably), so long as these deficits contribute to a rapid enough pace of economic expansion relative to the growth, and servicing costs, of accumulated foreign liabilities.

...but policy actions can play an important role to strengthen the external balance and ensure continued sustainability...

Although powerful structural factors are reflected in the current account, there is still a role for policies to help maintain the external balance of the economy. These include the need for measures to increase integration in global markets, and high quality spending to address infrastructure and skills gaps. Such steps can boost international competitiveness (helping Indonesian exports gain global market share and reducing import penetration by making domestic production of import substitutes more competitive), and raise the efficiency of given levels of investment in generating growth, jobs and incomes. Addressing the regulatory uncertainties and costs facing both domestic and international investors could help Indonesia achieve its potential as a regional production and export hub in Asia and support foreign direct investment, a large and relatively stable source of external financing.

...and a focus on securing a resilient mix of external financing, and domestic financial market deepening, is merited to reduce short-term financing risks

Such long-term measures would address socioeconomic policy priorities directly, while also being positive for the current account balance. In the near-term, however, Indonesia's ongoing vulnerability to external financing crunches must also be continually monitored. Risks are due not only to the net foreign currency demand generated by the current account deficit, but also from the need to roll-over public and private external debt, which has also increased sharply in recent years (although to still-moderate levels relative to the size of Indonesia's economy). This argues for a strong policy focus on securing a resilient mix of external financing sources, and on mobilizing more domestic savings, via improving access to finance and deepening the domestic financial sector. Such a focus on financing, particularly in Rupiah, can help to ensure Indonesia's continued ability to invest more than it saves, including for the government's ambitious infrastructure development program.

³⁰ IMF, March 2015, 2014 Article IV Consultation (Staff Report), page 12.

2. Fuel subsidies - a major reform, but not yet a durable one

Fuel subsidy reform has been a major early achievement of the current government, but achieving durable benefits will require more progress in implementation

Sharply reducing fuel subsidies has been a stated priority of the Indonesian government, and is a necessary condition for achieving many of its ambitious development goals, including redirecting spending towards much-needed infrastructure investment. Major fuel pricing reforms have been made, but the implementation of these measures has so far been uneven, and the government has sent mixed signals regarding more changes, including introducing price ceilings, and reducing the frequency of price adjustments.³¹ This has caused some confusion amongst consumers, and contributed to ongoing concerns over the durability of this cornerstone reform, particularly if and when Rupiah-denominated fuel prices rise further. This section provides a brief overview of the fuel price reforms and their significance, the implementation of the announced measures thus far, and discusses priority areas to help ensure that lasting benefits are achieved.

a. The announced fuel subsidy reforms are a major positive step...

Under the new system, fuel prices are to adjust regularly, with no gasoline subsidy and a much-reduced diesel subsidy...

In one of its first acts after taking office, the administration of President Widodo in November 2014 increased subsidized fuel prices by an average of 34 percent. Subsequently, on December 31, 2014, the government announced a major reform of the fuel pricing system. The reform took effect on January 1, 2015, under Presidential Regulation (*Perpres*) No. 191/2014 and an implementing regulation of the Ministry of Energy and Mineral Resources (*Permen ESDM* No. 39/2014). The regulation stipulated that gasoline and diesel prices would track the movement in international oil prices and the exchange rate. The subsidy for gasoline with a research octane number (RON) of 88 (“Premium”) was eliminated, and the new regulated price was a little higher outside Java, Madura and Bali, to account for higher transportation costs. A subsidy for diesel was maintained, but at a much reduced level compared to that of recent years, and consisting of a fixed amount per liter, capped at IDR 1,000 per liter. Prices of gasoline and diesel would be announced every month, or more than once a month if deemed necessary, by the Ministry of Energy and Mineral Resources, based on the monthly average of the reference international oil price (e.g. Mean of Platts Singapore) and the USD/IDR exchange rate.

...addressing what had become a critical impediment to the effectiveness and fairness of public spending

This critical reform substantially frees Indonesia’s fiscal sector from a wasteful, regressive and increasingly unsustainable form of spending, which was also so volatile that it significantly complicated fiscal planning and execution, and increased fiscal risks. By 2014, fuel subsidies had swollen to about a fifth of central government spending, or 2.3 percent of GDP. In addition to crowding out allocations for more productive purposes such as infrastructure, education and healthcare, this spending was highly regressive, since fuel consumption is correlated with income; the richest (poorest) 10 percent of households captured 33 percent (2 percent) of gasoline and diesel subsidy spending.³² Finally, not only did fuel subsidy spending trend higher over the years due to rapidly increasing domestic demand as a result of solid economic growth, but fluctuating global oil prices and exchange rates

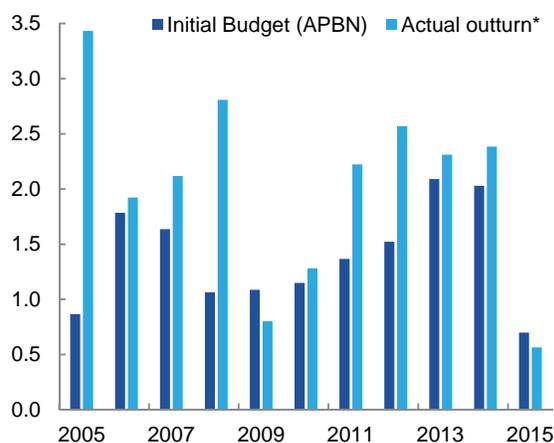
³¹ <http://en.tempo.co/read/news/2015/06/01/056671215/Govt-to-Quarterly-Adjust-Fuel-Prices>.

³² World Bank staff estimate based on March 2014 Susenas Household Survey. For a more detailed overview of the evidence in favor of removing fuel subsidies in Indonesia, see Diop, N., “Why is reducing energy subsidies a prudent, fair and transformative policy for Indonesia?”, Economic Premise, World Bank, March 2014, available at: <http://siteresources.worldbank.org/EXTPREMNET/Resources/EP140.pdf>.

also made subsidy costs difficult to project accurately and to plan for. Over 2010-2014, fuel subsidy spending averaged 2.2 percent of GDP per year, and exceeded initially budgeted costs by an average of 0.5 percent of GDP (Figure 30). Fuel subsidy costs drove about half (0.75 percent points) of the 1.5 percent of GDP deterioration in the fiscal deficit from 2010 to 2014 (Figure 31), and as a result contributed to the widening of the current account deficit (see Section B.1).

Figure 30: Until 2015, fuel subsidy costs were high and almost always under-budgeted...

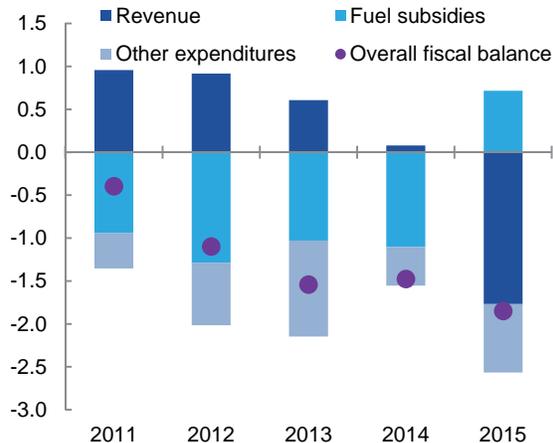
(fuel subsidy costs, initially-budgeted and actual, percent of GDP)



Note: *2015 outturn is World Bank projection.
Source: Ministry of Finance; World Bank staff calculations

Figure 31: ...and, until 2015, contributed significantly to the increase in the fiscal deficit since 2010

(difference in outturns relative to 2010, percent of GDP)



Note: 2015 figures are World Bank projections.
Source: BPS; World Bank staff calculations

b. ...but implementation of the new pricing system has so far been uneven and will need to be improved to achieve durable gains...

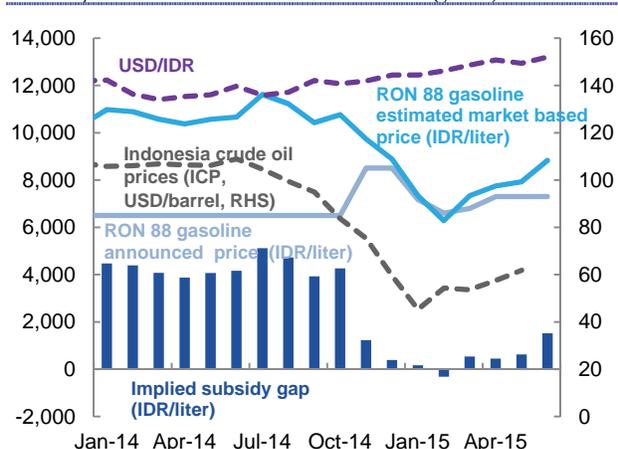
Regulated prices have not been adjusted consistently or transparently...

Implementation of the reform has so far been uneven. Large price reductions were announced on January 19, around the time when the world oil price fell to its lowest level in six years, despite the regulation specifying that the price adjustment would generally be announced at the end of each month. This created some early uncertainty about the frequency and timing of regulated fuel price changes. Prices were then held constant in February, before being adjusted again at the start of March (gasoline only) and the end of March (gasoline and diesel).

Regulated prices have not been adjusted consistently or transparently...

The Ministry of Energy and Mineral Resources subsequently issued a regulation dated May 4, 2015, detailing the pricing formula for each type of fuel, a positive development toward improved transparency.³³ However, from April to June, regulated gasoline and diesel prices were again kept unchanged, despite significant shifts in global oil prices and the exchange rate over the period, partly on account of the authorities' concerns to keep inflation in check leading up to Ramadan and Idul Fitri.³⁴ Consequently, the implied gap between non-subsidized RON88

Figure 32: The retail RON88 gasoline price has not changed since April 2015
(RON 88 gasoline announced and estimated economic price, IDR per liter; oil price USD/barrel; USD/IDR exchange rate)



Note: Market-based price of RON 88 gasoline is linearly interpolated using the differences in price between unleaded 92 and 95 and unleaded 92 and 98. Announced and estimated market-based prices from January 2015 onward use averages from the preceding month.

Source: Ministry of Energy and Mineral Resources; Ministry of Finance; CEIC; World Bank staff calculations

gasoline and the regulated price has narrowed significantly over 2015, but it has not closed, and in June is estimated to have been about IDR 1,500 per liter, or 17 percent of the estimated unsubsidized price (Figure 32).

...after the move to the new pricing system, which benefited initially from lower global oil prices...

Why the need for more transparent, consistent implementation, especially given that lower oil prices since 2014 mean that the government is expected to save almost 2 percent of GDP in subsidy costs, despite the uneven implementation of the new system? The reason is that the government has made bold moves to slash subsidies, but it has done so in the context of a sharp fall in global oil prices, making it possible to cut subsidies with only a relatively modest increase in retail fuel prices. Gasoline and diesel prices are up 12 percent and 25 percent compared with their levels before the November 2014 once-off price increase, yet fuel subsidy spending is expected to be almost three-quarters lower in 2015. A number of other developing countries have also taken the opportunity to improve their fuel pricing systems, strengthen their budgets, and provide better support to vulnerable households for energy costs (Box 2).

...and adding to uncertainty over the durability of the reform, especially when fuel prices begin to rise again

Global fuel prices are most unlikely to remain at the current level for long. Brent crude, the global oil price benchmark, is already up 34 percent since January in US Dollar terms, and 40 percent in Rupiah terms. If and when global fuel costs do climb further, there is a risk that subsidy costs will accumulate again too, without more progress to embed regular fuel price adjustments based on market prices. The lack of clarity about how binding the new regulations are makes it difficult to know

³³ See <http://jdih.esdm.go.id/peraturan/Kepmen-esdm-2856-2015.pdf>.

³⁴ <http://thejakartaglobe.beritasatu.com/multimedia/bps-warns-government-raising-fuel-prices-ahead-ramadan-will-drive-inflation/> and <http://www.jawapos.com/baca/artikel/18198/bps-minta-bbm-tak-naik-jelang-lebaran>.

whether they will prove durable, or if instead the fiscal sector will again become burdened by future rises in global oil prices or currency depreciation, against the backdrop of the ever-rising energy needs of Indonesia's growing economy. In contrast, adhering on a transparent and consistent basis to the automatic price adjustments as stipulated by the new regulations, during what may prove to be a temporary window period of relatively low global oil prices, could go a long way towards building the public's comfort with, and de-politicizing, fuel price changes. In short, the appeal of retaining discretion in the setting of sensitive prices such as for fuels is understandable, but international experience demonstrates that such discretion comes at the cost of the credibility of commitments to prevent wasteful and unsustainable subsidies from growing again in the future. This is particularly true at times of political pressure, for example related to the election cycle, or higher global fuel prices.³⁵

Box 2: Moving to market-based fuels pricing and raising government revenue while protecting the poor: recent examples from around the world

Developing countries across the world have seized the opportunity afforded by the fall in global oil prices since mid-2014 to move towards more optimal fuel pricing and strengthen their budgets by increasing fuel taxes. From May 2015, **Vietnam** tripled its environmental protection tax on gasoline to the equivalent of IDR 1850, that on diesel to IDR 925, and that on kerosene to IDR 185 per liter. **China** in three successive steps between November 2014 and January 2015 increased the excise tax on gasoline by a total of 52 percent and diesel by 50 percent, to about IDR 3,200 and 2,500 per liter, respectively. **India** similarly nearly doubled the excise tax on regular gasoline and tripled the tax on diesel over three successive months in 2014 to IDR 3,700 and 2,100 per liter, respectively. **Mexico** turned its negative taxes (that is, subsidies) on gasoline and diesel in 2014 to positive taxes in 2015. For example, the tax on regular gasoline in March 2014 was IDR -930 per liter, but by February 2015 the tax was IDR +3,425 per liter. Similarly, the corresponding taxes on diesel were IDR -900 and IDR +3,765 per liter, respectively.

Liquefied Petroleum Gas (LPG) prices are important where LPG is the primary cooking fuel for many vulnerable households. Indonesia has implemented a large-scale program converting households from kerosene to cleaner LPG, and subsidizing the price of smaller (3kg) LPG canisters. LPG subsidy costs have consequently increased significantly, to a budgeted 0.25 percent of GDP in 2015.

A number of developing countries that have also historically subsidized LPG have taken steps to minimize distortions in the market and wasteful spending due to weak targeting of the poor households who most need support for their energy costs. **India** in February 2015 stopped price subsidies for LPG for cooking, historically intended for household use but exploited for decades by restaurants, hotels, and other commercial consumers of LPG, who managed to obtain residential LPG cylinders illegally. Under the new system, price subsidies are no longer provided at the point of sale, arguably making illegal diversion to commercial establishments much more difficult. Instead, consumers wishing to receive cash assistance are required to sign up for the Direct Benefits Transfer for LPG and receive deposits in their bank accounts. Those without bank accounts are provided one free of charge. The bank account is also linked to the consumer's LPG customer identification number and the national 12-digit individual identification number being rolled out by the government, which contains each resident's biometric information. Cash transfers are provided up to 12 times a year to refill 14.2-kg cylinders. **Peru** in 2013 created a fund, financed by surcharges on energy consumers, to help poor households consume LPG. The eligibility criteria are strict to ensure that better-off households do not benefit from the assistance. Recipients of the program receive a voucher that provides a discount of 16 soles (approximately IDR 67,000) on the first refill of a 10-kg LPG cylinder each month. The refill price in June 2015 was about IDR 150,000.

³⁵ See IMF Staff Report "Energy Subsidy Reforms: Lessons and Implications", January 2013, available at: <http://www.imf.org/external/np/pp/eng/2013/012813.pdf>.

c. ...as part of ongoing, wider efforts to strengthen energy pricing policies

Beyond more consistent and transparent application of the new pricing system, Indonesia stands to gain from potential additional measures...

In addition to being applied consistently and transparently, the existing fuel pricing policy can be further improved to help manage the impact of oil price and exchange rate volatility on the economy and the fiscal position, while strengthening protections for the poor and vulnerable. There are concerns that Indonesian consumers and the economy will find it difficult to adjust to regular fuel price changes. However, these are mitigated by the fact that Indonesian fuel prices remain low by international standards, and only more experience with the new system will generate the data and evidence required to definitively address these questions and consider effective policy responses. In the meantime, it seems unlikely that the best solution is to revert to the past system of absorbing market fuel price volatility in the fiscal sector by fixing retail fuel prices, especially at an artificially low level. This suppresses retail fuel price volatility, but at a high cost to fiscal planning, generating fiscal risks and macroeconomic management risks from sporadic large price adjustments, and distorting the economy (for example by blunting consumers' incentives to economize on fuel at times of higher prices).

...including to manage the impacts of price volatility on the most vulnerable, while preserving automatic price adjustments...

Rather, to help manage the impacts of volatile fuel prices, Indonesia could consider mechanisms such as a sliding-scale fuel tax that increases with falling oil prices and decreases above a given retail fuel price ceiling. Such an adjustable fuel tax could support government revenues at times of low oil prices and mitigate the impact of price increases on consumers and the economy at times of high prices. Another option is to provide targeted compensation for high oil prices to those who need it most, for example through targeted cash transfers (as Indonesia has done, for example through the *Bantuan Langsung Tunai*, BLT, program). Such cash transfers could even be automated through the use of agreed trigger prices, based for example on transparent, fuel affordability measures.

...and building on reform progress in non-fuel energy subsidies, including electricity

Finally, while the elimination of gasoline subsidies is a major step forward, Indonesia continues to spend significant sums subsidizing diesel and LPG (about 0.25 percent and 0.3 percent of GDP under the 2015 Budget, respectively), and a smaller amount on kerosene. Rather than subsidizing LPG, international evidence suggests that targeted direct transfers are possible with LPG and support vulnerable households better and more efficiently (see Box 2). Electricity also remains subsidized at a cost of approximately 0.6 percent of GDP, with mixed progress in reforming electricity tariffs. Effective in January 2015, tariff adjustments for ten non-subsidized customer categories (out of twelve customer categories for which a floating tariff adjustment is to be applied) now reflect changes in production costs and macroeconomic developments (e.g. inflation, oil prices, and the exchange rate).³ However, the application of a similar floating tariff system for two large household customer categories, those with 1,300 volt-ampere (VA) and 2,200VA power supplies, which consume 12 percent of the electricity produced by the state-owned electricity company (*Perusahaan Listrik Negara*, PLN), have been postponed.⁴

C. Indonesia 2016 and beyond: A selective look



1. Geothermal energy in Indonesia: realizing the potential

Indonesia has not yet unlocked its significant geothermal energy potential...

Indonesia lies on the Pacific “ring of fire”, a geological belt that makes the Indonesian archipelago one of the most active seismic regions in the world. This has obvious major drawbacks in terms of volcanic eruptions and earthquakes, but it also means that Indonesia is one of the most ideally located countries in the world for exploiting geothermal energy. This energy is derived from the earth’s inner heat and exploited by pumping water into the earth’s crust and using the steam produced to drive turbines and so produce electricity. Geothermal energy is clean and renewable, and can also act as a natural hedge against volatile global fossil fuel prices. Despite these advantages, Indonesia has not yet harnessed much of its large geothermal energy endowment. This section provides a brief overview of the sector and discusses options to unleash more investment.

...which is significant but currently only accounts for a fraction of installed electricity capacity

Indonesia was the third-largest generator of electricity from geothermal energy in the world in 2014, after the US and the Philippines, with installed production capacity of almost 1,395 MW from eleven geothermal fields in Central and West Java, North Sumatra, Lampung, East Nusa Tenggara and North Sulawesi (Figure 33).³⁶ However, most of Indonesia’s geothermal potential still remains untapped. Estimates of available geothermal resources vary, but Indonesia may have about 40 percent of the world’s potential geothermal resources, sufficient to generate 27,000 megawatts (MW) of electricity.³⁷ Consequently, Indonesia remains heavily reliant on gas, oil and (especially) coal for its electricity, with geothermal energy contributing only 3 percent of electric power in 2014.³⁸

³⁶ Source: World Bank staff estimate.

³⁷ Source: Indonesian Ministry of Energy and Mineral Resources, Geological Agency Annual Geothermal Area Distribution Map, and Annual Report on Geothermal Potential in Indonesia.

³⁸ Source: State-owned electricity company PLN’s Electricity Supply Business Plan (RUPPL), 2015-2024.

Figure 33: Geothermal working areas are located across Indonesia but still tap only a fraction of potential



Source: Geothermal Agency, Ministry of Energy and Mineral Resources

Recognizing the potential, successive governments have laid out ambitious plans for the sector...

Indonesia's governments have recognized the potential contribution of geothermal energy in Indonesia's future energy mix, and have put major efforts into promoting the sector's development. A Geothermal Fund under the Ministry of Finance was established in 2012, and seeded with over USD 200 million in public funds, with a mandate to help fund exploration drilling, thus reducing investment costs and risks. A Roadmap of Geothermal Development 2012-2025 was issued and subsequently incorporated into the National Energy Policy (NEP) of 2014. Also in 2014, a new geothermal ceiling tariff was implemented and a Geothermal Law, No.21/2014, was passed. Plans for the development of the sector have been ambitious, including to build 44 new geothermal plants, to more than triple capacity to 4,000 MW by 2014, and then to increase capacity to 6,000 MW by 2020.³⁹ This would make geothermal energy an important contributor to the goal under the NEP of generating 23 percent of primary energy from renewables by 2025 (and 31 percent by 2050).

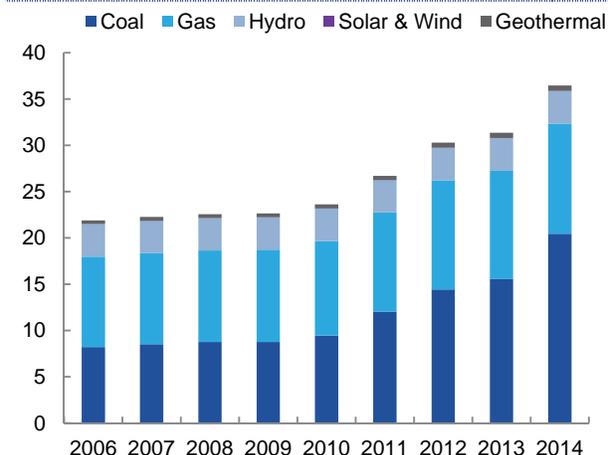
³⁹ Source: Government Fast Track 2 Power Program (Presidential Regulation no 4/2010), subsequently revised by MEMR Decrees, most recently MEMR Decree 32/2014.

a. Investment has been impeded by high upfront costs and pricing difficulties...

...but investments have so far been limited...

Progress has fallen far short of these ambitious goals. From 2010-14, just 175 MW in new geothermal capacity was added (Figure 34). No new power purchase agreements (PPAs), governing new private investment in the sector, were signed under the government’s feed-in tariff policy (discussed further below) since it was established in 2012. Indeed, there is a widespread perception that the Indonesian geothermal program has stalled. Four main sets of issues have impeded the development

Figure 34: Geothermal energy has not contributed significantly to increasing power generation (installed capacity operated by PLN, thousand megawatts)



Note: PLN operations only; excludes approximately 800MW of independently-operated geothermal capacity.
Source: PLN Statistics 2014

of geothermal energy in Indonesia. These are (i) the geothermal tariff, which affects both currently stalled and future projects; (ii) tendering processes, (iii) price negotiations and difficulties in reaching closure on power purchase agreements and (iv) institutional roadblocks and financing issues.

...hampered by high initial investment costs and risks

These four sets of issues are interlinked and developing geothermal energy in Indonesia requires simultaneous and coordinated action across all these areas. The main underlying problem is one of capital mobilization for what is a highly capital-intensive sector, with long lead times from exploration through to power generation. For instance, indicatively, 30 percent of equity financing is required for geothermal projects, which means that achieving an additional 3,000 MW of geothermal capacity would require USD 4 billion in equity, and USD 9.5 billion in debt financing.⁴⁰ The high levels of upfront investment involved make the level and certainty as to pricing—that is, tariffs—critically important. Tariffs must be set at an adequate level, and periodically reviewed over the project implementation cycle, otherwise capital-intensive exploration and exploitation of geothermal resources will continue to be perceived as uneconomical, or overly risky. The regulated returns from the electricity sector are currently too low to cover the risks inherent in geothermal exploration and exploitation.

⁴⁰ Assuming USD4,500/kW total cost and 30 percent equity financing. For detailed geothermal cost estimates, see World Bank Energy Sector Management Assistance Program (ESMAP), 2012 “Geothermal Handbook: Planning and Financing Power Generation”, Technical Report 002/12, 2012.

b. ...and resolving this will require more aligned public stakeholder goals and less regulatory complexity...

Increased cooperation will be needed amongst public sector stakeholders...

Many state institutions are involved in the geothermal sector. A lack of cooperation, and even outright competition, amongst these entities has added complexity in the sector, damaged the investment climate, and likely reduced investment. Addressing this situation will require a comprehensive and coordinated approach amongst government entities, so that the required resources and incentives are in place to develop the sector.

...including multiple ministries and state-owned enterprises

The Ministry of Energy and Mineral Resources (MEMR) is the primary promoter of the geothermal sector and is responsible for implementing the Geothermal Law and for tariff-setting. The Ministry of Finance (MOF) is responsible for the USD 200 million Geothermal Fund, but, naturally given its different mandate, lacks in-house technical expertise around the planning, implementation, supervision and review of drilling activities. The MOF is concerned with minimizing the fiscal burden of electricity subsidies paid to the state-owned electricity company (*Perusahaan Listrik Negara*, PLN). The Ministry of State-Owned Enterprises, in contrast, has a mandate to ensure the sound commercial performance of both PLN and Pertamina, the state-owned oil company. Pertamina has had little incentive to allocate scarce capital to PT Pertamina Geothermal Energy (PGE)—its division responsible for geothermal energy—given that it can generate far higher returns from its numerous oil and gas interests. Finally, there are overlapping roles amongst PGE, PT Geo Dipa Energi, another state-owned enterprise for geothermal development set up in 2002, and PLN Geothermal, which focuses on geothermal power generation. More cooperation amongst all these key government stakeholders is clearly needed, to mobilize geothermal financing and investment.

c. ...a strengthening of the tendering process...

Tendering processes can be strengthened to ensure that projects are awarded to committed and adequately-resourced bidders...

The Geothermal Law stipulates competitive tendering for licenses to exploit geothermal energy resources, with the aim of encouraging efficient and transparently-allocated investments. Previously, winning bids for geothermal projects often had unrealistically low prices and bidders may have lacked adequate technical knowledge and financial capacity. Purported weaknesses of the system have included poor technical knowledge of the selection committee at the local government level, inadequate bid bonds (some as low as USD 100,000), and performance bond requirements that were not imposed (bid and performance bonds aim to ensure that only committed contenders participate in the tender process). Hence, there is a need for improved tendering processes, including by applying international best practice principles. For instance, the minimum bid bond size could be increased substantially and calculated as a percentage of total project cost, rather than the first year's exploration cost. Winners' bid bonds could then be converted into performance bonds that would only be released upon evidence of tangible exploration drilling, reducing speculative activity by uncommitted or under-resourced bidders.

...backed by higher quality geological information

International experience also shows that the quality of information on available resources is crucial in improving the quality of tender processes. In view of this, concession areas in Indonesia should be put out to tender only with a complete and independently certified package of geology, geophysics and geochemistry ("3Gs") information, ideally based on analysis from a minimum of three exploration wells.

Currently, tenders often lack any subsurface geological information, making it difficult for bidders to reliably estimate costs.

d. ...a strengthening of the tariff system...

Appropriate tariff levels and structures, including flexibility, can be critical factors...

Appropriate tariffs have proved to be a major impediment to private investment in Indonesia's geothermal sector. In 2012, the government made a major attempt to unblock the sector by introducing a feed-in tariff (FIT), providing fixed tariffs for developers. However, perhaps due to insufficient stakeholder consultations, the FIT failed to break the deadlock over pricing between electricity buyers and prospective sellers. In addition, the FIT system was flawed because it relied on fixed tariffs. This turned the selection process for investment bids into a "beauty contest", based on hard-to-measure non-price qualifications. International best practice suggests that allowing competitively determined bids is a more effective way of conducting the bid process, guided by a maximum ("ceiling") price. This provides information on the maximum acceptable tariff (which is vital should competition for licenses prove limited), while maintaining flexibility for competition to drive winning bids down, and for gauging efficiency and competitiveness gains over time. In Indonesia's case, a ceiling price of USD 9.7 cents/kWh was originally set in 2009, and this was updated in 2014 through MEMR Decree no 17/2014. The new regulation sets the ceiling prices by region (3 alternatives, based on main generation sources), and target commercial operation date (COD) year. While this is a promising start, international experience also demonstrates that tariff-setting should be seen as part of a process that will change over time. Indeed, most countries conduct regular tariff reviews based on full stakeholder consultation and a published methodology. Such an approach recognizes that a tariff ceiling set today may have little relevance when commercial operations start 7-9 years in the future and that for tariffs to be acceptable and de-risked they need to involve some degree of flexibility.

...and could be informed by ceiling prices reflecting the benefits to Indonesia of geothermal power

One approach for achieving more flexible tariffs that may be appropriate for Indonesia is to set ceiling prices on the basis of the estimated benefits of geothermal energy to the country. "Avoided-cost" approaches have been used for these sorts of estimates, based on a transparent methodology for forecasting a reasonable price for projects whose commercial operation is 7-9 years away. While there are many benefits to Indonesia of using geothermal energy, the most important is the potential avoided costs for PLN of having to invest in other sorts of costly power plants. Another major benefit relates to local economic development, given that one of the main goals of the government is to encourage economic development in the eastern islands, for which geothermal energy holds great promise. Finally, there are also benefits in terms of avoided externality costs of thermal generation, notably avoided greenhouse gas (GHG) emissions. The government would need to decide on the value it should place on avoided GHG emissions and whether this should be higher than the current price in global carbon markets.

e. ...and making power purchase agreements work

Power purchase agreements are the cornerstone of private investment in the sector...

Power purchase agreements (PPAs) are the contracts that need to be agreed between geothermal project developers and PLN, as the state-owned electricity company and distributor of electricity. To date, a stumbling block in concluding PPAs has been the time-consuming and ad hoc negotiation of tariff escalation terms after tenders have been issued. An alternative could be to use a single tariff escalation formula, consistent with international best practice for renewable energy projects, agreed at the time of tender.

...and, to be effective, should be comprehensive

The comprehensiveness of PPAs is also important. For example, PPAs should specify in advance how the new geothermal power source will be connected to the grid (transmission connection). One option is to call for the developer to build a transmission line to the nearest PLN substation and then recover the costs through a non-escalating tariff ladder. These costs would be relatively small and hence not relevant in selecting a developer. PLN would later take over the line at the time of commercial operation and be responsible for maintenance thereafter.

There is a need to address the backlog of stalled projects...

One immediate problem concerning PPAs is how to resolve projects that are currently stalled due to factors including: low tariffs (resulting in the license-owner not having an incentive to exploit the resource), unresolved land acquisition or access issues, or a lack of technical and financial capability on the part of license-owners. In these stalled cases, PPA renegotiation may be required. For instance, under the 2014 ceiling tariff decree, geothermal license holders were required to sign PPAs by December 2014. PPA renegotiation is allowed when the developers completing the exploration program find that the proven resource is less than expected. In addition, for PGE to conclude private partnerships, prices that were set up a decade ago and are now obsolete would need to be reset. New projects, by contrast, should be helped by the declassification of geothermal exploitation as a mining activity in an amendment to the Geothermal Law, allowing the Ministry of Forestry and the Environment to issue permits to developers within national forests.

...including the possibility of renegotiating stalled projects' PPAs, subject to clear principles

To mitigate uncertainties generated by the possibility of PPA renegotiations, the scope for this to occur could be guided by clearly communicating principles, including the circumstance under which a renegotiation could be considered and the process that would be applied. For example, renegotiations could be limited to three situations: (i) delays attributable to government error; (ii) projects where drilling after tender reveals significantly larger or smaller potential than was estimated in the tender; and (iii) projects where developer capacity was set at the time of tender, but where the developer subsequently wishes to install larger units and not risk incurring a penalty.

2. Ten years of Indonesia's school grants program (BOS) – successes and challenges⁴¹

Indonesia's school grants program (BOS) provides operational funding to 220 thousand schools and madrassahs...

Indonesia's school grants program (*Bantuan Operasional Sekolah*, BOS) is central to the country's strategy to expand access to good quality basic education. In 2012, the program accounted for 8 percent of all government education spending and provided IDR 24 trillion (USD 2.5 billion) of operational funding to 220 thousand primary and junior secondary schools and madrassahs. This section provides a brief assessment of the program and its contribution to the education sector. An assessment is timely since the program has now reached its tenth year of operation and efforts are underway to expand the program beyond basic education.

...joining many other countries in granting schools more management and spending autonomy, often with positive results when accompanied by effective implementation

Education policymakers around the world have increasingly recognized the importance of empowering schools to make their own decisions in the quest to improve education outcomes. This has led many countries to grant schools greater autonomy by introducing school-based management reforms. This has included increasing the participation of parents and communities in school governance, in order to improve the accountability and performance of schools. The increasing focus on school-based management has usually gone hand-in-hand with direct funding to schools to support various improvements. This kind of funding differs from regular public funding as it provides schools with some discretion on how funds are spent. Such funding can provide a more predictable income stream, allowing schools to plan quality improvement activities more effectively. School-based management and school grant programs have shown some success in improving education access and raising education outcomes, as well as reducing education inequality.⁴² However, programs can take time to yield results and their success depends critically on political support and effective implementation.

a. The nuts and bolts of the BOS program

BOS aims to help fund school operating costs, poor students' costs, and strengthen school management

The BOS school grants program aims to improve access to, and raise the quality of, the 9-year basic education system through three main channels. First, direct support for school operating costs: this channel has the potential to reduce fees charged to parents and increase enrolment and participation particularly for poor households. Second, financial assistance for poor students: school grants can provide direct support to poor students to cover transportation, stationery, uniform and clothing expenses. Third, strengthened school-based management: grants are intended to lead to greater school autonomy by providing resources to finance activities which schools themselves feel will raise local enrolment rates and education quality. The management of funds within schools is expected to increase transparency, strengthen school accountability and lead to improved education outcomes.

⁴¹ This section is based on Al-Samarrai, S., Fasih, T., Hasan, A and Syukriyah, D., "Assessing the role of the school operational grant program (BOS) in improving education outcomes in Indonesia", World Bank study, December 2014, available at: <http://documents.worldbank.org/curated/en/2015/05/23167187/indonesia-assessing-role-school-operational-grant-program-bos-improving-education-outcomes-indonesia>.

⁴² See for example, AusAID ERF (2011), 'School grants and school-based management' and Bruns, B., D. Filmer, et al., 2011, Making schools work: new evidence on accountability reforms, World Bank.

BOS funding for schools is significant and has doubled in real terms since 2005

The BOS school grant is allocated based on an amount for each student and currently covers approximately 43 million primary and junior secondary school students. The real value of the per-student allocation has more than doubled since the introduction of the program in 2005 (Figure 35). In 2014, the program provided funds to the average primary school of approximately USD 10,000, and of USD 20,000 for a junior secondary school. The program is financed by

the central government and allows schools to utilize funds according to lists of authorized and unauthorized categories of expenditure. BOS funds can be used for a wide range of improvement activities and schools have considerable flexibility over what they use funds for. However, restrictions on the total amount of funds for spending on contract teachers were introduced in 2009 after concerns were raised about teacher over-hiring.

Funds are governed at the school level by BOS teams, distinct from school committees

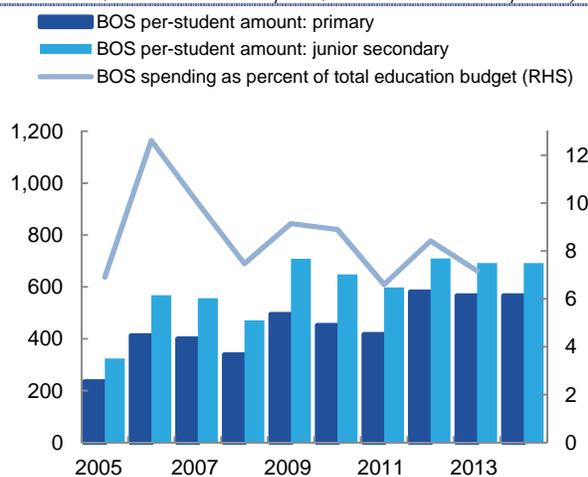
BOS teams are established in all levels of government and at the school level. The school BOS team, made up of the school principal, a treasurer and a parent representative, is the main focal point in the school and manages all administrative procedures associated with the BOS program. It is expected to work closely with the school committee that also oversees the planning and use of BOS funds and participates in the overall school improvement process.

b. BOS has had a limited impact on reducing households' education costs

BOS appears to have reduced households' education costs, especially for poorer households...

The evidence suggests that BOS has had a discernable, but limited, impact on reducing household education costs, especially for poorer households. Annual education spending for households with children in primary and junior secondary fell by about 6 percent in the first year after BOS was introduced (Figure 36). However, the drop in education costs faced by households has been relatively small compared to the size of the per-student grants given to schools through the BOS program.⁴³ Initial drops in household spending were concentrated amongst poorer households and for children attending government schools. Immediately after the introduction of the BOS program, household spending for the poorest households

Figure 35: The value of BOS assistance for each student has increased considerably
(BOS program allocations per-student and as a share of govt. spending, 2005-2014, in constant 2012 prices, thousand IDR and percent)



Source: World Bank calculations from Ministry of Education and Culture and Ministry of Finance BOS and budget information

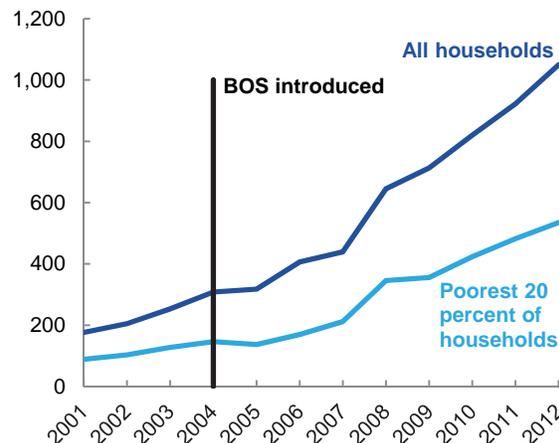
⁴³ Given that the BOS program was national in scope it is difficult to use formal methods to evaluate its effect. A second-best approach is adopted which uses available data to look at trends before and after the program was introduced and also simple regression analysis to control for other factors (e.g. household income). This approach cannot provide definitive conclusions on the effect of the BOS program but can provide some insights into its overall effect.

fell by the equivalent of around 5 percent of the BOS grant at primary school level and 30 percent at the junior secondary level.

...but perhaps only temporarily, with costs rising steadily again in real terms since 2009...

However, drops in households' education spending, corresponding with the introduction of the BOS program, appear to have been a relatively temporary phenomenon; by 2009 household education spending in real (inflation-adjusted) terms began to increase steadily again. These findings support other more detailed study results showing that the allocation and level of education charges for parents fell with the introduction of BOS but then began to rise over time as schools became more familiar with the workings of the BOS program.

Figure 36: The introduction of the BOS program led to an initial drop in education spending by households (annual household per-student education spending, thousand IDR)



Note: Average education spending per-student for households with primary and junior secondary education children.
Source: Susenas household surveys

...consistent with evidence that BOS has increased overall school funding, and that a significant amount of BOS funding has been allocated to hiring additional teachers

If BOS has had only a limited impact on reducing charges faced by households, this raises the question of where else BOS funds have been allocated. It is also possible that BOS only had a limited effect on households' education costs because other sources of school funding fell when BOS was introduced. However, there appears to have been a strong increase in schools' discretionary resources after the introduction of BOS. In particular, the number of teachers hired directly by schools increased sharply in the years after BOS was introduced. In 2012, there were approximately six hundred-thousand school-hired teachers in the education system and approximately half of these were recruited after the introduction of the BOS program. This suggests that schools had more resources to spend after BOS was launched and that they devoted a significant share of these resources to hiring additional teachers.

c. BOS has contributed to rapidly rising junior secondary enrolment rates

BOS has likely contributed to the strong rise in junior secondary enrolment since 2005...

Enrolment rates in primary school have been very high for a considerable time and so, as might be expected, BOS has had no discernable effect on these rates (Figure 37). However, enrolment in junior secondary school, particularly for children in the poorest households, increased significantly after the introduction of the BOS program. Between 2000 and 2005, junior secondary enrolment rates for the poorest 20 percent

remained relatively stable but increased 26 percentage points between 2005 and 2013. There is tentative evidence that the BOS program contributed to approximately 5 percentage points of this strong increase, especially amongst poor households. Like the apparent impact on household costs, however, this effect seems to have also been temporary, with enrolment rates settling back onto a long term trend that did not fluctuate with subsequent increases in the per-student amount of the BOS grant. Further support for these findings comes from the different rate at which poor households closed the participation gap in junior and senior secondary schools; the period since BOS was introduced has seen the senior secondary enrolment gap narrow but at a slower rate compared to junior secondary (Figure 37).

...but there is no evidence that BOS has increased transition rates between primary and secondary school

Enrolment rates are only one measure of the potential effect of BOS on school participation. The program was expected to improve the proportion of children completing the full nine years of compulsory education, by improving transition rates between primary and junior secondary education. Transition rates of this kind have indeed increased since the introduction of BOS and have followed a similar trend to the enrolment rates shown in Figure 37. However, further analysis shows that the introduction of the BOS program and subsequent increases in its level were not associated with jumps in transition rates.

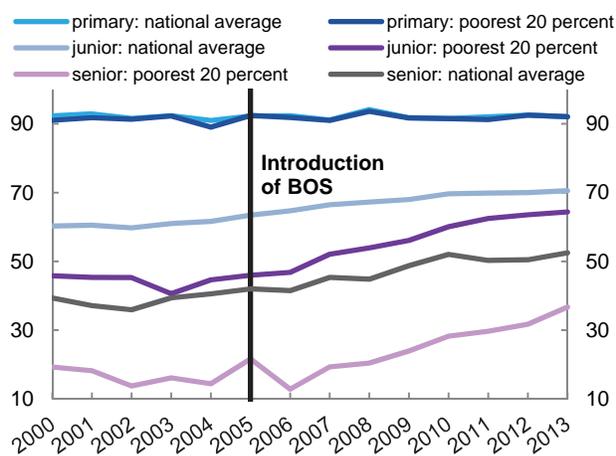
d. BOS is at the center of efforts to improve school-based management

BOS is an important part of reforms to strengthen school-based management

Improvements in school-based management have been shown to raise levels of learning achievement in Indonesia.⁴⁴ For example, primary schools with better parental and school committee participation have better learning outcomes, due to improved resource allocation decisions and higher teacher attendance rates. The

Figure 37: Enrolment in secondary schooling has been growing

Primary, junior and senior secondary net enrolment rates, 2000-2013



Source: Susenas household survey

⁴⁴ See for example, Chen, D. (2011), "School-based management, school decision-making and education outcomes in Indonesian primary schools", World Bank Policy Research Working Paper No. 5809, and Heyward, M. O., R. A. Cannon, et al., 2011, "Implementing school-based management in Indonesia: impact and lessons learned.", Journal of Development Effectiveness.

in Indonesia, which has been shown to improve learning outcomes

BOS program has been a vital component of government efforts to implement school-based management reforms. In 2001, the responsibility for basic education service delivery was largely devolved to local governments. Further reforms were introduced in 2003 that provided the legal basis for school-based management and school committees, in an effort to encourage local community participation and strengthen accountability between schools and parents. The BOS program supported these reforms by providing resources to fund school improvement plans and by making use of established school-based management structures and processes to govern the use of its funds.

School committees have been established in most schools but concerns remain over the selection of members

Most schools in Indonesia have the institutions and processes required for school-based management. A nationally representative survey conducted to explore school-based management issues showed that all schools had established school committees.⁴⁵ However, the selection of committee members was not very transparent. For example, in primary schools, members were commonly either appointed or selected by consensus; less than fifteen percent of school committee chairs and less than twenty-five percent of committee members were elected.

BOS has been central to opening up school decision-making ...

Principals reported that they had considerable autonomy over school affairs but only involved school committees in about forty percent of the decisions they made. The role of school committees centered around the use of BOS funds and overseeing financial matters more generally. These findings highlight the importance of the BOS program in opening up school decision-making to the broader school community.

...but school committees are rarely actively involved ...

Despite the role that BOS has provided for school committees, there are significant weaknesses in how effective they have been. Focus group discussions with the BOS team and school committee members, conducted as part of the survey, generally agreed that committee members were rarely, if ever, actively involved or consulted in making BOS fund allocation decisions. In practice, it was common for the school principal and teachers to agree on the allocation of BOS funds and then to communicate their decision to the school committee chair for approval.

...and their role is further weakened by a requirement to have separate BOS teams

The role of the school committee in managing BOS funds is further weakened by the requirement for schools to establish a separate BOS management team. Rules on the formation of this team explicitly prohibit membership for parents from the school committee. Given that all schools already have school committees, a separate team for the management of BOS funds dilutes the potential role of the school committee.

e. There is scope to significantly strengthen the impact of BOS spending

Steps can be taken that could strengthen BOS' positive impact, by linking funds to making education quality gains...

These findings suggest a number of key policy directions that could strengthen the existing BOS program. First, BOS could have an enhanced focus on improving education quality. BOS funding could be linked more directly to education standards. Establishing a more formal link between BOS funding and education standards has the potential to signal to schools the importance of using BOS resources to fulfil these standards. BOS funding could also be tied to quality assurance systems by providing an incentive for schools to obtain and maintain accreditation status. The list of eligible items under BOS could also be reviewed, to

⁴⁵ World Bank, "School based management in Indonesia", 2012.

give schools the flexibility to invest in quality-enhancing inputs, for example teaching and learning materials such as audio-visual equipment.

...by increasing the focus on poverty reduction...

Second, BOS could have an increased focus on reducing poverty. The value of BOS could be adjusted periodically to account for regional price differences and inflation, to ensure that all schools can meet operating standards and to recognize that education costs per-student vary greatly across Indonesia. The BOS formula could also be adjusted to provide more funding to schools serving poor and vulnerable children. Schools serving poor and disadvantaged students need additional support to ensure that they are able to provide a quality of schooling similar to schools in wealthier areas of Indonesia. In addition, it would likely be effective to phase out the use of BOS resources to cover “out of pocket” expenses of poor students, because large cash transfer programs (e.g. *Kartu Indonesia Pintar*) already exist. While these programs require strengthening, they should be the principal way of reducing the direct costs of schooling.

...by improving the coordination of BOS with other school funding...

Third, the coordination between BOS and other sources of school funding could be strengthened. Fees and charges remain a significant proportion of out-of-pocket expenses, despite efforts to clarify the rules governing voluntary contributions to schools. Alongside continuing these efforts, consideration should be given to strengthening the role of school committees in managing the level of contributions. Regulations should also be clearly communicated to parents and other stakeholders. There is also a need to coordinate more closely with local governments, as many local governments also run school grant programs to support school operating expenses beyond basic BOS funding. It is important that these funds are used to raise overall school standards beyond the level provided by BOS.

...and through strengthening the role of school committees...

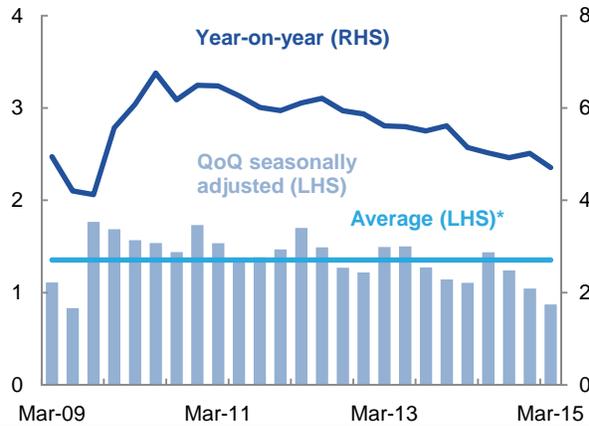
Finally, there is scope to revitalize the role of the BOS program in empowering schools and local communities. School-level management of the funds could be strengthened, to improve their effectiveness, for example, regarding the role of the school committee, by transferring the responsibilities of the BOS team to the committee, and ensuring better representation in the committee.

...and such measures could help build on the success of BOS' first 10 years, to spend not only more, but better, on Indonesia's schools

In the ten years of its existence, the BOS program has established itself as a program that is able to deliver resources to schools on a regular and timely basis. Other countries, having also successfully established school grant programs and their financing mechanisms, have further developed them to address other education challenges. For example, they have used them to allocate a greater share of school funding in an effort to promote more efficient spending, which other studies have shown is also an urgent priority for Indonesia. Consolidating a larger share of budgetary resources, and in particular teacher remuneration, into a BOS-type formula has the potential to improve the quality of education spending. For example, linking teacher resources for schools to student numbers could create incentives for local governments to reduce the large number of small schools currently in operation in many parts of the country. The challenge now is to build on the initial successes of the BOS program, and explore how it and the mechanisms it has introduced for allocating and managing resources can be adapted to make an even bigger contribution to improving education outcomes in Indonesia.

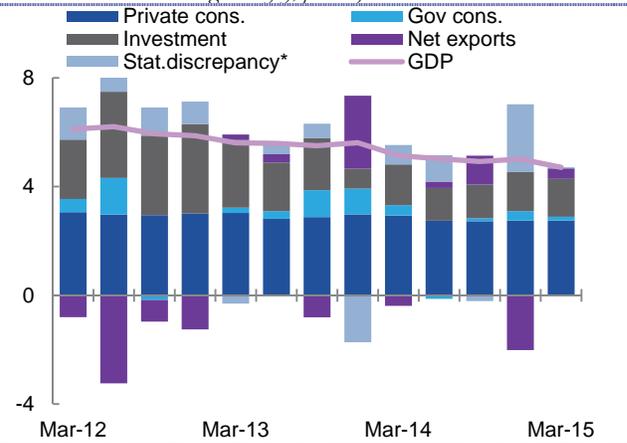
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Quarterly and annual GDP growth
(real GDP growth, percent)



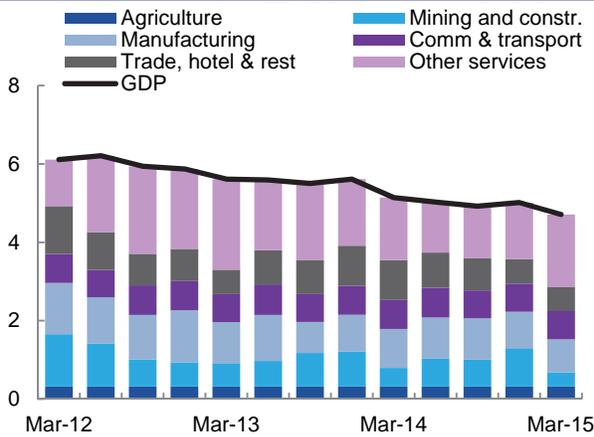
Note: *Average QoQ growth, Q1 2009–Q1 2015
Source: BPS; World Bank staff calculations

Appendix Figure 2: Contributions to GDP expenditures
(contribution to real GDP growth yoy, percent)



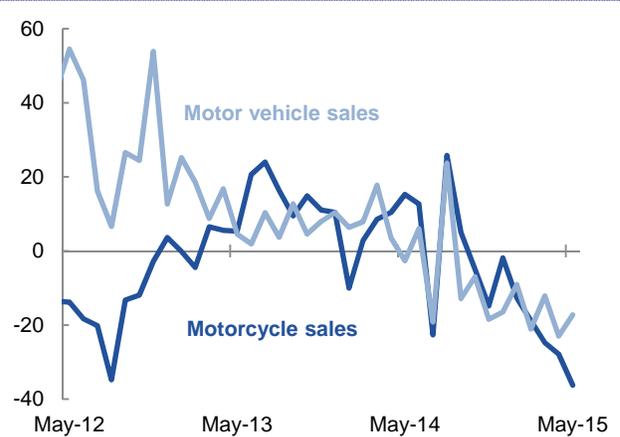
Note: *includes changes in stocks.
Source: BPS; World Bank staff calculations

Appendix Figure 3: Contributions to GDP production
(contribution to real GDP growth yoy, percent)



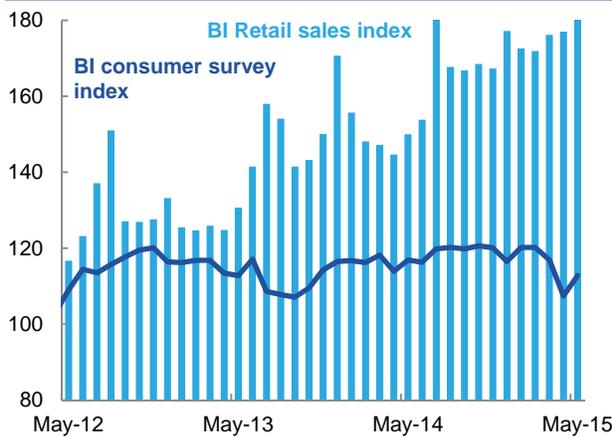
Source: BPS; World Bank staff calculations

Appendix Figure 4: Motorcycle and motor vehicle sales
(seasonally-adjusted sales growth yoy, percent)



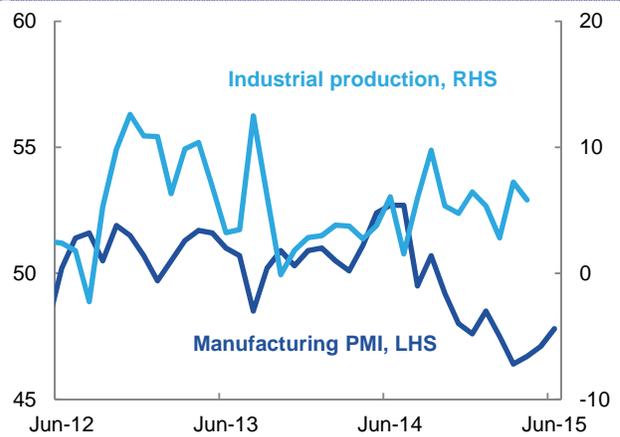
Source: CEIC; World Bank staff calculations

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



Source: BI

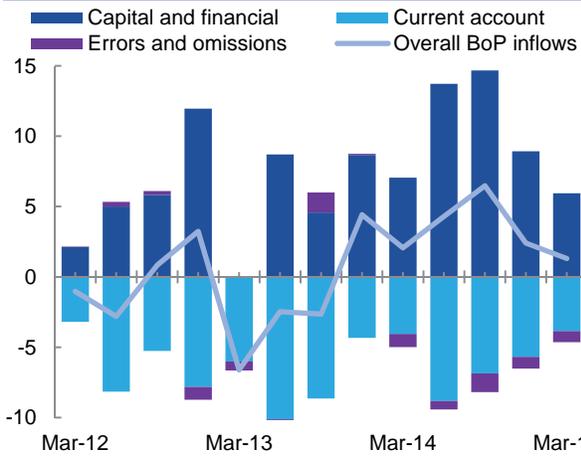
Appendix Figure 6: Industrial production indicators
(PMI diffusion index and production index: growth yoy, percent)



Source: BPS; Markit HSBC Purchasing Managers Index

Appendix Figure 7: Balance of payments

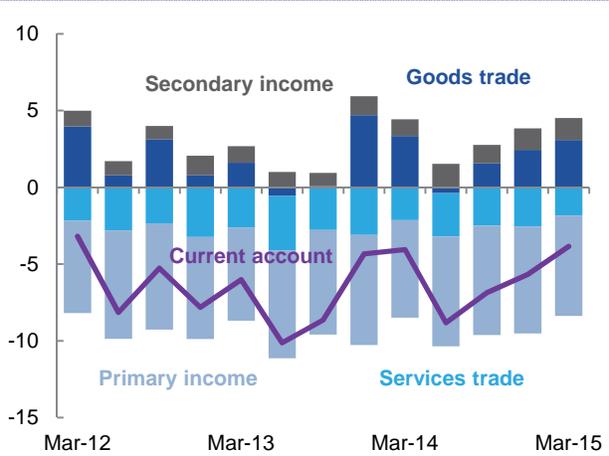
(USD billion)



Source: BI

Appendix Figure 8: Current account components

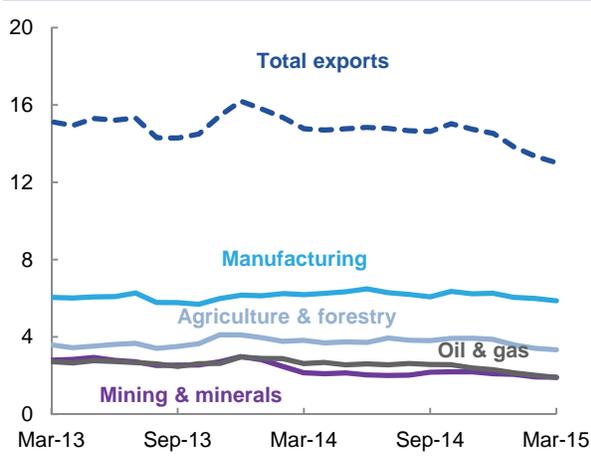
(USD billion)



Source: BI; World Bank staff calculations

Appendix Figure 9: Exports of goods

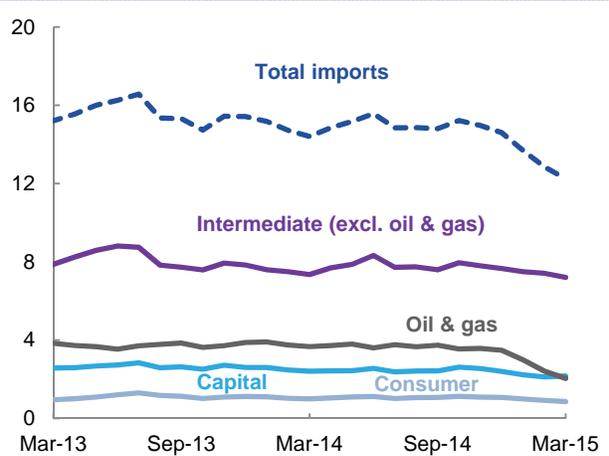
(3-month moving average, USD billion)



Source: BPS

Appendix Figure 10: Imports of goods

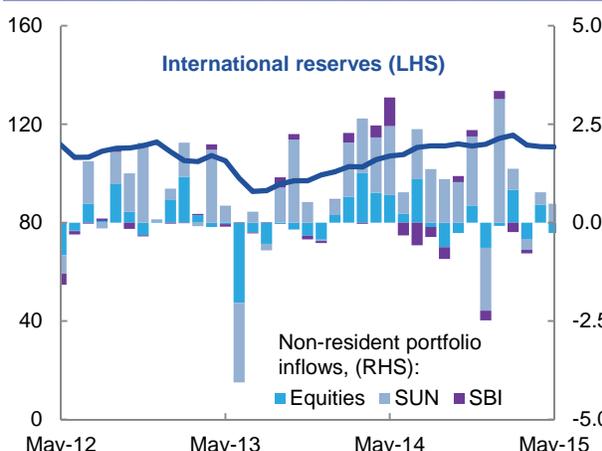
(3-month moving average, USD billion)



Source: BPS

Appendix Figure 11: Reserves and capital inflows

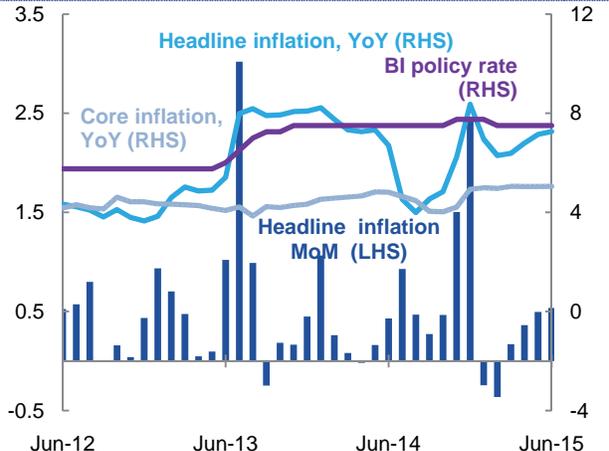
(USD billion)



Source: BI; CEIC; World Bank staff calculations

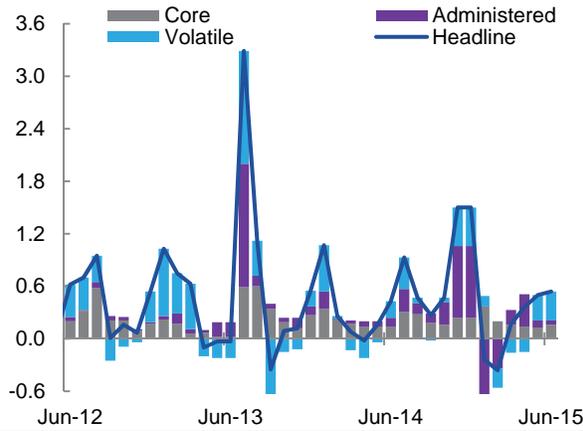
Appendix Figure 12: Inflation and monetary policy

(month-on-month and year-on-year growth, percent)



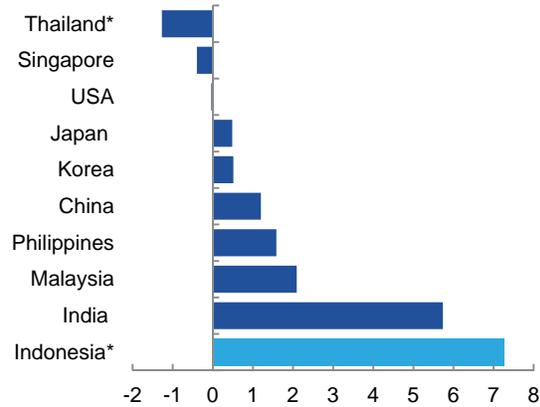
Source: BPS; World Bank staff calculations

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



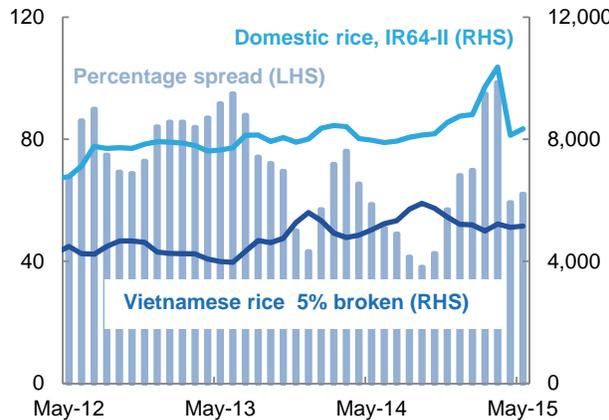
Source: BPS; World Bank staff calculations

Appendix Figure 14: Inflation comparison across countries
(year-on-year, June 2015)



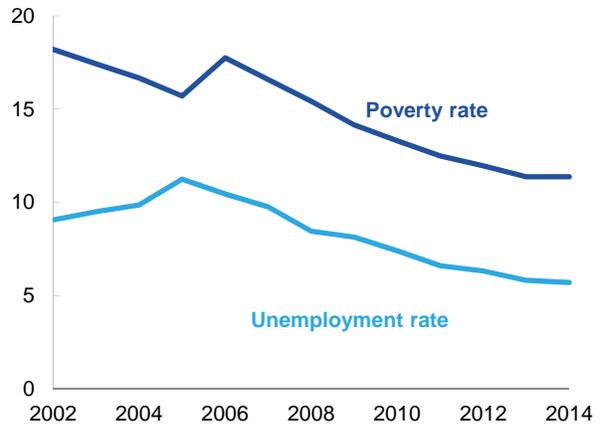
*June is the latest available month, others January
Source: National statistical agencies via CEIC; BPS

Appendix Figure 15: Domestic and international rice prices
(percent LHS, wholesale price, in IDR per kg RHS)



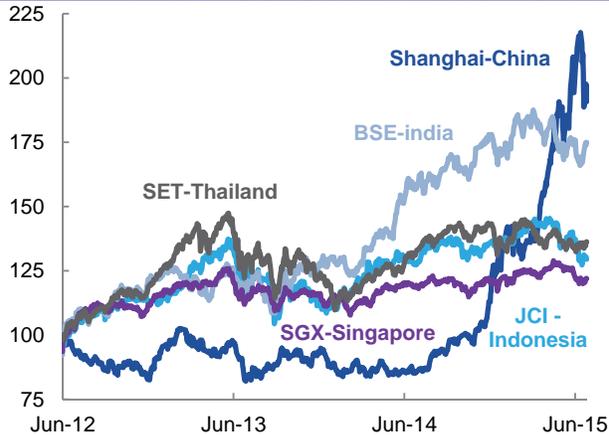
Source: Cipinang wholesale rice market; FAO; World Bank

Appendix Figure 16: Poverty and unemployment rate
(percent)



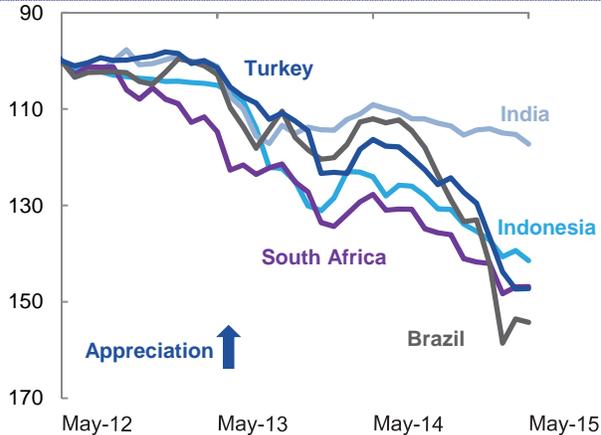
Source: BPS

Appendix Figure 17: Regional equity indices
(daily index in local currency, June 1, 2012=100)



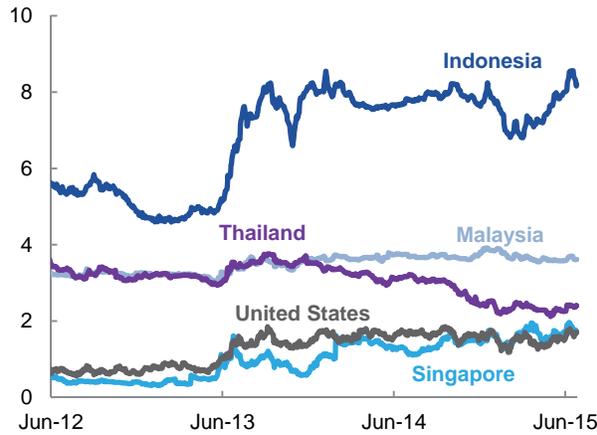
Source: CEIC; World Bank staff calculations

Appendix Figure 18: Selected currencies against USD
(monthly index May 2012=100)



Source: CEIC; World Bank staff calculations

Appendix Figure 19: 5-year local currency gov't. bond yields
(percent)



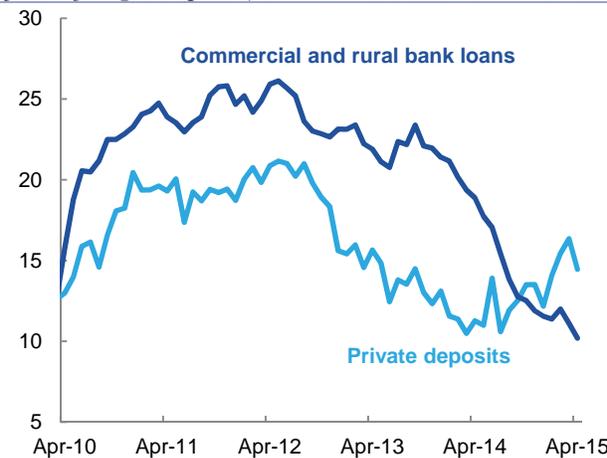
Source: CEIC

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



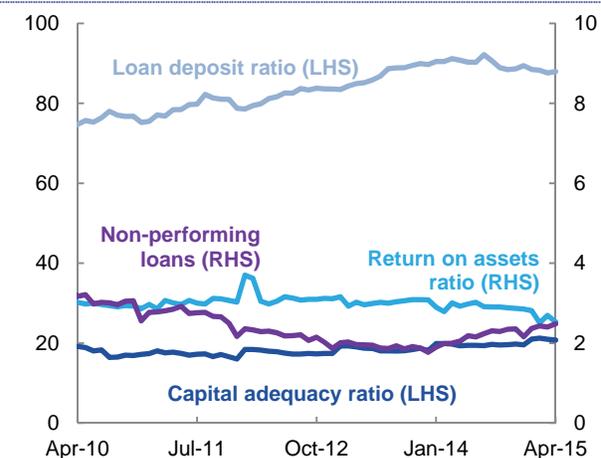
Source: JP Morgan; World Bank staff calculations

Appendix Figure 21: Commercial and rural credit and deposits growth
(year on year growth, percent)



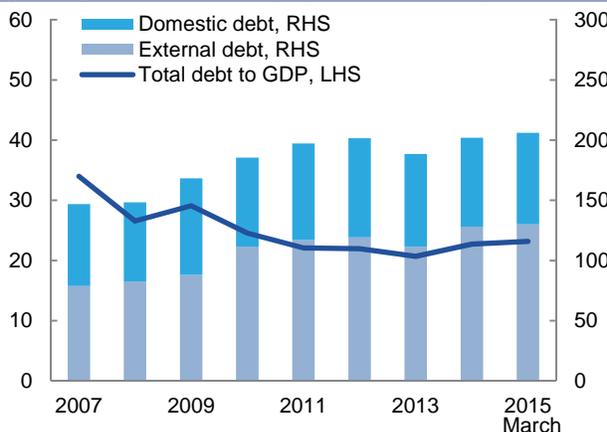
Source: BI; World Bank staff calculations

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



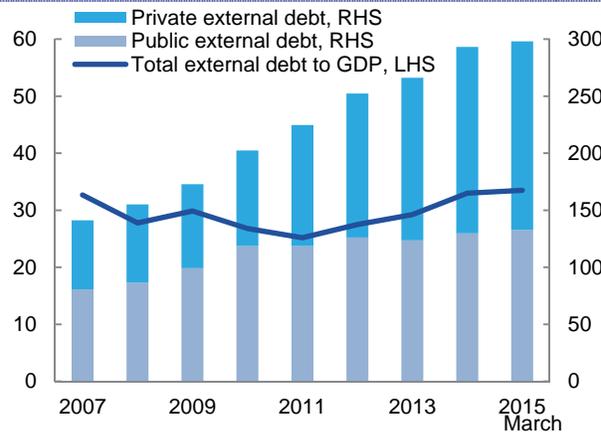
Source: BI

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



Source: MoF; BI; World Bank staff calculations

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



Source: BI; World Bank staff calculations

Appendix Table 1: Budget outcomes and projections

(IDR trillion)

	2009	2010	2011	2012	2013	2014	2015
	Actual	Actual	Actual	Actual	Actual	Preliminary actual	Revised budget
A. State revenue and grants	849	995	1,211	1,338	1,439	1,537	1,762
1. Tax revenue	620	723	874	981	1,077	1,143	1,489
2. Non-tax revenue	227	269	331	352	355	391	269
B. Expenditure	937	1,042	1,295	1,491	1,651	1,765	1,984
1. Central government	629	697	884	1,011	1,137	1,191	1,320
2. Transfers to the regions	309	345	411	481	513	574	665
C. Primary balance	5	42	9	-53	-99	-94	-67
D. SURPLUS / DEFICIT	-89	-47	-84	-153	-212	-227	-223
(percent of GDP)	-1.5	-0.7	-1.1	-1.8	-2.2	-2.2	-1.9

Note: Budget balance as percentage of GDP is using revised and rebased GDP.

Source: Ministry of Finance

Appendix Table 2: Balance of payments

(USD billion)

	2012	2013	2014	2013			2014				2015
				Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Balance of payments	0.2	-7.3	15.2	-2.5	-2.6	4.4	2.1	4.3	6.5	2.4	1.3
<i>Percent of GDP</i>	0.0	-0.8	1.7	-1.0	-1.2	2.1	1.0	1.9	2.8	1.1	0.6
Current account	-24.4	-29.1	-25.4	-10.1	-8.6	-4.3	-4.1	-8.8	-6.9	-5.7	-3.8
<i>Percent of GDP</i>	-2.7	-3.2	-2.9	-4.3	-3.8	-2.1	-1.9	-4.0	-3.0	-2.6	-1.8
Trade balance	-1.9	-6.2	-3.0	-4.1	-2.7	1.6	1.2	-3.2	-0.9	-0.1	1.2
Net income & current transfers	-22.5	-22.9	-27.5	-6.0	-5.9	-5.9	-5.3	-5.6	-5.9	-5.6	-5.1
Capital & Financial Account	24.9	22.0	44.4	8.7	4.6	8.7	7.1	13.7	14.7	8.9	5.9
<i>Percent of GDP</i>	2.7	2.4	5.0	3.7	2.0	4.1	3.3	6.1	6.3	4.1	2.8
Direct investment	13.7	12.2	15.5	3.3	5.4	0.2	3.2	3.4	5.9	3.0	2.3
Portfolio investment	9.2	10.9	26.1	3.8	1.5	1.7	8.7	8.0	7.4	1.9	8.9
Other investment	1.9	-1.1	2.8	1.6	-2.4	6.7	-4.8	2.2	1.3	4.0	-5.2
Errors & omissions	-0.3	-0.2	-3.7	-1.0	1.4	0.1	-0.9	-0.6	-1.3	-0.8	-0.8
Foreign reserves*	112.8	99.4	112.0	98.1	95.7	99.4	102.6	107.7	111.2	111.9	111.6

Note: *Reserves at end-period.

Source: BI; BPS

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

	1995	2000	2005	2010	2011	2012	2013	2014
National Accounts (% change)¹								
Real GDP	8.4	4.9	5.7	6.4	6.2	6.0	5.6	5.0
Real investment	22.6	11.4	10.9	6.7	8.9	9.1	5.3	4.1
Real consumption	21.7	4.6	64.4	4.1	5.1	5.4	5.6	4.8
Private	22.7	3.7	0.9	4.1	5.1	5.5	5.4	5.3
Government	14.7	14.2	6.6	4.0	5.5	4.5	6.9	2.0
Real exports, GNFS	18.0	30.6	16.6	15.3	14.8	1.6	4.2	1.0
Real imports, GNFS	29.6	26.6	17.8	16.6	15.0	8.0	1.9	2.2
Investment (% GDP)	28	20	24	31	31	33	32	33
Nominal GDP (USD billion)	202	165	286	755	893	918	910	889
GDP per capita (USD)	1229	948	1,560	3,233	3,663	3,718	3,644	3,524
Central Government Budget (% GDP)²								
Revenue and grants	15.2	20.8	17.9	14.5	15.5	15.5	15.1	14.6
Non-tax revenue	4.8	9.0	5.3	3.9	4.2	4.1	3.7	3.7
Tax revenue	10.3	11.7	12.5	10.5	11.2	11.4	11.3	10.8
Expenditure	13.9	22.4	18.4	15.2	16.5	17.3	17.3	16.7
Consumption	3.9	4.0	3.0	3.6	3.8	3.9	4.1	4.0
Capital	4.6	2.6	1.2	1.2	1.5	1.7	1.9	1.3
Interest	1.4	5.1	2.4	1.3	1.2	1.2	1.2	1.3
Subsidies	..	6.3	4.4	2.8	3.8	4.0	3.7	3.7
Budget balance	1.3	-1.6	-0.6	-0.7	-1.1	-1.8	-2.2	-2.2
Government debt	32.3	97.9	47.2	24.3	22.8	22.6	24.1	23.8
o/w external government debt	32.3	51.4	23.4	11.1	10.2	9.9	11.2	10.2
Total external debt (including private sector)	61.5	87.1	47.1	26.8	25.2	27.5	29.2	33.0
Balance of Payments (% GDP)³								
Overall balance of payments	..	..	0.2	4.0	1.3	0.0	-0.8	1.7
Current account balance	3.2	4.8	0.1	0.7	0.2	-2.7	-3.2	-2.9
Exports GNFS	26.2	42.8	35.0	22.0	23.8	23.0	22.5	22.4
Imports GNFS	26.9	33.9	32.0	19.2	21.2	23.2	23.1	22.8
Trade balance	-0.8	8.9	2.9	2.8	2.7	-0.2	-0.7	-0.3
Financial account balance	..	..	0.0	3.5	1.5	2.7	2.4	5.0
Direct investment	2.2	-2.8	1.8	1.5	1.3	1.5	1.3	1.7
Gross official reserves (USD billion)	14.9	29.4	34.7	96.2	110.1	112.8	99.4	112.0
Monetary (% change)³								
GDP deflator ¹	9.9	20.4	14.3	7.3	7.5	3.8	4.7	5.4
Bank Indonesia interest key rate (%)	..	..	9.1	6.5	6.6	5.8	6.5	7.5
Domestic credit	..	..	28.7	17.5	24.4	24.2	22.1	15.9
Nominal exchange rate (average, IDR/USD) ⁴	2,249	8,422	9,705	9,090	8,770	9,387	10,461	11,865
Prices (% change)¹								
Consumer price Index (eop)	9.0	9.4	17.1	7.0	3.8	3.7	8.1	8.4
Consumer price Index (average)	9.4	3.7	10.5	5.1	5.3	4.0	6.4	6.4
Indonesia crude oil price (USD per barrel, eop) ⁵	17	28	53	79	112	113	107	60

Source: ¹ BPS and World Bank staff calculations, using revised and 2010 rebased figures. ² MoF and World Bank staff calculations (for 1995 is FY 1995/1996, for 2000 covers 9 months), ³ Bank Indonesia, ⁴ IMF, ⁵ CEIC.

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

	1995	2000	2005	2010	2011	2012	2013	2014
Demographics¹								
Population (million)	199	213	227	241	244	247	250	..
Population growth rate (%)	1.5	1.3	1.2	1.3	1.3	1.2	1.2	..
Urban population (% of total)	36	42	46	50	51	51	52	..
Dependency ratio (% of working-age population)	61	55	54	53	53	52	52	..
Labor Force²								
Labor force, total (million)	84	98	106	117	117	120	120	126
Male	54	60	68	72	73	75	75	77
Female	31	38	38	45	44	46	45	49
Agriculture share of employment (%)	43	45	44	38	36	35	35	35
Industry share of employment (%)	19	17	19	19	21	22	20	21
Services share of employment (%)	38	37	37	42	43	43	45	44
Unemployment, total (% of labor force)	7.0	8.1	11.2	7.1	7.4	6.1	6.2	5.7
Poverty and Income Distribution³								
Median household consumption (IDR 000 per month)	..	104	211	374	421	446	487	548
National poverty line (IDR 000 per month)	..	73	129	212	234	249	272	303
Population below national poverty line (million)	..	38	35	31	30	29	28	28
Poverty (% of population below national poverty line)	..	19.1	16.0	13.3	12.5	12.0	11.4	11.3
Urban (% of population below urban poverty line)	..	14.6	11.7	9.9	9.2	8.8	8.4	8.3
Rural (% of population below rural poverty line)	..	22.4	20.0	16.6	15.7	15.1	14.3	14.2
Male-headed households	..	15.5	13.3	11.0	10.2	9.5	9.2	11.2
Female-headed households	..	12.6	12.8	9.5	9.7	8.8	8.6	11.9
Gini index	..	0.30	0.35	0.38	0.41	0.41	0.41	0.41
Percentage share of consumption: lowest 20%	..	9.6	8.7	7.9	7.4	7.5	7.4	7.5
Percentage share of consumption: highest 20%	..	38.6	41.4	40.6	46.5	46.7	47.3	46.8
Public expenditure on social security & welfare (% of GDP) ⁴	..	..	0.4	0.4	0.4	0.4	0.6	0.5
Health and Nutrition¹								
Physicians (per 1,000 people)	0.16	0.16	0.13	0.29	..	0.20	..	..
Under five mortality rate (per 1000 children under 5 years)	67	52	42	33	32	31	29	..
Neonatal mortality rate (per 1000 live births)	26	22	19	16	15	15	14	..
Infant mortality (per 1000 live births)	51	41	34	27	26	25	25	..
Maternal mortality ratio (estimate, per 100,000 live births)	420	340	270	210	..	..	190	..
Measles vaccination (% of children under 2 years)	63	74	77	78	80	85	84	..
Total health expenditure (% of GDP)	1.8	2.0	2.8	2.9	2.9	3.0	..	..
Public health expenditure (% of GDP)	0.7	0.7	0.9	1.1	1.1	1.2	..	..
Education³								
Primary net enrollment rate (%)	..	..	92	92	92	93	92	93
Female (% of total net enrollment)	..	..	48	48	49	49	50	48
Secondary net enrollment rate (%)	..	..	52	61	60	60	61	65
Female (% of total net enrollment)	..	..	50	50	50	49	50	50
Tertiary net enrollment rate (%)	..	..	9	16	14	15	16	18
Female (% of total net enrollment)	..	..	55	53	50	54	54	55
Adult literacy rate (%)	..	..	91	91	91	92	93	93
Public spending on education (% of GDP) ⁵	..	..	2.7	3.5	3.6	3.8	3.8	3.6
Public spending on education (% of spending) ⁵	..	..	14.5	20.0	20.2	20.1	20.0	19.9
Water and Sanitation¹								
Access to an improved water source (% of population)	74	78	81	84	84	85	..	..
Urban (% of urban population)	91	91	92	93	93	93	..	..
Rural (% of rural population)	65	68	71	75	76	76	..	..
Access to improved sanitation facilities (% of population)	38	44	53	57	59	59	..	..
Urban (% of urban population)	60	64	70	70	73	71	..	..
Rural (% of rural population)	26	30	38	44	44	46	..	..
Others¹								
Disaster risk reduction progress score (1-5 scale; 5=best)	..	..	..	..	3.3	..	..	..
Proportion of seats held by women in national parliament (%) ⁶	..	8	11	18	18	19	19	17

Source: ¹ World Development Indicators; ² BPS (Sakernas); ³ BPS (Susenas) and World Bank; ⁴ MoF, Bappenas and World Bank staff calculation, only includes spending on Raskin, Jamkesmas, BLT, BSM, PKH and actuals; ⁵ MoF; ⁶ Inter-Parliamentary Union



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