INDONESIA ECONOMIC QUARTERLY

June 2016

Resilience through reforms

THE WORLD BANK
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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, Ndiame Diop, Lead Economist and Hans Anand Beck, Senior Economist. Led by Elitza Mileva, Country Economist, and with responsibility for Part A, editing and production, the core project team comprises Magda Adriani, Arsianti, Masyita Crystallin, Indira Maulani Hapsari, Ahya Ihsan, Taufik Indrakesuma, Yue Man Lee, Dhruv Sharma, Violeta Vulovic, and Kelly Wyett. Administrative support is provided by Titi Ananto. Dissemination is organized by Jerry Kurniawan, GB Surya Ningnagara, Kurniasih Suditomo, Nugroho Sunjoyo, and Suryo Utomo Tomi, under the guidance of Dini Djalal.

This edition of the IEQ also includes contributions from Christopher Juan Costain and Tatiana Nenova (Part B.1, High lending rate), Babatunde Abidoye, Massimiliano Cali, and Stephen Marks (Pomona College) (Part B.2, Trade protection and domestic prices), Ndiame Diop and Fitria Fitrani (Part C.1, Reviving manufacturing competitiveness), Taufik Indrakesuma and Matthew Wai-Poi (Part C.2, Fiscal policy and inequality). The report also benefited from discussion with and in-depth comments from Nathaniel Adams, Sarah Moyer, Shudhir Shetty, Nikola L. Spatafora, Amanda Apsden and Nikhilesh Bhattacharya (Australia Department of Foreign Affairs and Trade), Ben Bingham (IMF), David Nellor (Australia Indonesia Partnership for Economic Governance).

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Table of contents

LIST OF FIGURES

LIST OF APPENDIX FIGURES

LIST OF TABLES

LIST OF APPENDIX TABLES

Executive summary: Resilience through reforms

With the global recovery yet to be realized, Indonesia's resilience stands out among commodity exporters

A string of disappointing first-quarter global data have signaled that the world recovery projected for 2016 has not yet gotten off the ground. On June 7, the World Bank downgraded its global growth forecast by half a percentage point, to 2.4 percent. Half of this revision is due to the expected significant slowdown in growth in commodity-exporting emerging and developing countries to just 0.4 percent this year. The Indonesian economy stands in sharp contrast to the performance of other commodity exporters, with GDP growth forecasted at 5.1 percent in 2016. However, when compared to regional peers, Indonesia's expected growth is higher than in Malaysia (4.4 percent) and Thailand (2.5 percent), but lower than in the Philippines (6.4 percent) and Vietnam (6.2 percent).

Sound monetary policy and higher public investment have supported the economy, while deregulation measures may have boosted business confidence…

A number of good policies have contributed to Indonesia's resilience. First, prudent monetary and exchange rate policies, along with international financial conditions that are more favorable than a year ago, have helped reduce inflation and stabilize the Rupiah. These factors, as well as lower energy prices, have supported aggregate household consumption. Second, public infrastructure spending has become a priority within Indonesia's limited fiscal space. In addition, the policy reforms enacted in the first quarter of 2016 as part of the economic policy packages are likely to yield more meaningful medium-term improvements in trade policy and the investment climate than the measures announced in the previous quarter. While the latter comprised a mix of restricting and liberalizing regulations, most recent actions are expected to be liberalizing. All of these measures, taken together, may mark a turning point in public policy-making, which in turn may be driving the recent improvement in business sentiment.

… but the downside risks to growth have recently intensified

However, Indonesia's outlook is subject to pronounced downside risks. A further slowdown in major emerging markets, anemic recovery in advanced countries, global financial market volatility, and a longer-than-expected period of low

commodity prices are the main international risks. Domestic fiscal risks are also elevated, as the draft 2016 Revised Budget submitted to Parliament on June 2 assumes considerable revenues from the tax amnesty. If the tax amnesty inflows disappoint, significant additional expenditure cuts would have to be made, putting at risk the infrastructure spending momentum. Finally, most recent deregulation measures focus on procedural improvements. An exception to this is the recent relaxation of some of the constraints to foreign investments, although many sectors still remain closed or partly closed to foreign investments. More fundamental changes in trade policy and the investment climate, as well as effective implementation at the national and subnational level, may be needed to drive a sustained rise in private investment.

GDP growth in Q1 2016 was 4.9 percent yoy, with public spending lower than expected

In the first quarter of 2016, Indonesia's real GDP grew at 4.9 percent year-on-year (yoy), a slightly slower pace than expected mainly due to weaker than anticipated public spending. Private consumption growth remained resilient at 5 percent yoy, though stagnant real incomes continue to weigh on the consumption of households in the lowest deciles of the income distribution, such as paddy farmers. Fixed investment growth decelerated to 5.6 percent yoy in Q1 2016, compared with 6.9 in the last quarter of 2015, on account of lower central government capital spending. Despite the slow start to the year, government investment is expected to accelerate in the coming quarters, following the historical trend.

The current account deficit narrowed to 2.1 percent of GDP, as imports fell faster than exports

Exports and imports continued to decline both in volume and value terms. The broad-based decrease in exports was driven by weak global demand, a real exchange rate appreciation of 3.1 percent in Q1 2016, and weaker prices for all major commodities relative to Q1 2015. Both raw material and capital goods imports declined, while consumer goods (net of fuel) imports increased year on year for the first time since Q1 2014. The current account deficit narrowed to 2.1 percent of GDP on account of a sharper quarterly fall in imports than in exports.

The private sector experienced net capital outflows in Q1 2016

Despite the improvement in the current account balance, the balance of payments recorded a small deficit in Q1 2016. Direct investment contracted slightly from the previous quarter to USD 2.2 billion. Portfolio flows remained robust at USD 4.4 billion, driven entirely by long-term government borrowing. However, other investment posted a quarterly deficit on account of private deposit outflows and a reduction in foreign borrowing by the private sector.

Fiscal risks remain, as the draft 2016 Revised Budget relies on significant tax amnesty revenues

Turning to fiscal policy, by the end of April revenue collection had declined by 9.8 percent compared to the same period in 2015, owing mainly to lower commodity prices and domestic demand, as well as several revenue policy and administration changes. At the same time, total expenditure increased by 9.2 percent. In response to the weaker revenue outlook, the Government submitted to Parliament a draft 2016 Revised Budget. Projected revenues are IDR 88.0 trillion lower than in the original budget, as the negative impact of weaker-than-expected macroeconomic conditions is offset by significant anticipated revenues from the tax amnesty. The ambitious tax amnesty goal has increased the risk of additional, potentially large expenditure cuts, including to priority spending projects, later in the year.

The baseline outlook of 5.1 percent GDP growth in 2016 remains unchanged

Looking ahead, the World Bank projects GDP to increase by 5.1 percent in 2016 and 5.3 percent in 2017, unchanged from the March 2016 *IEQ* (Table 1). Private consumption is forecasted to pick up slightly on account of moderate inflation, a relatively stable Rupiah, lower energy prices, an expected increase in the personal income tax threshold, and a 14th monthly salary for civil servants. Government expenditure, in particular on capital, is projected to increase in the next three quarters in line with the historical trend. World Bank calculations show that 90 percent of the original 2016 Budget investment target could be achieved with an even lower revenue forecast than in the 2016 Revised Budget, higher fiscal deficit of 2.8 percent of GDP, and non-priority expenditure cuts (see Section 6). Towards the end of 2016 and beyond, the outlook depends on private investment growth picking up as it responds to the Government's business climate reform efforts and the gradual recovery in global growth and trade.

Table 1: In the base case, GDP growth is projected at 5.1 percent in 2016

		2015	2016p	2017p
Real GDP	(Annual percent change)	4.8	5.1	5.3
Consumer price index	(Annual percent change)	6.4	3.9	4.4
Current account balance	(Percent of GDP)	-2.1	-2.3	-2.5
Budget balance	(Percent of GDP)	-2.6	-2.8	n.a.

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

High domestic food prices are one of the costs of trade distortions on Indonesia's economy

Over the past several months, CPI inflation moderated to 3.3 percent yoy in May. Modest headline inflation, however, has masked persistently high food price inflation (7.7 percent yoy in May). One of the reasons for high domestic food price inflation, when global food prices have declined in the past several years, is trade protectionism. According to data collected by the World Bank and Australia Indonesia Partnership for Economic Governance (AIPEG), the number of product-level non-tariff measures (NTMs) on Indonesian imports doubled between 2009 and 2015, expanding the number of products covered by NTMs by over 38 percent. The same study shows that, in 2015, the domestic price of milled rice was 68 percent higher than it would have been in the absence of trade measures. After accounting for the fact that certain products are used both as final goods and as inputs to production, the analysis suggests that, in 2015, overall trade policies have increased the cost of living in Indonesia by 7.4 percent compared to a scenario in which no trade restrictions are imposed.

High interest rates and net interest margins (NIMs) in Indonesia are the result of bank income and expenditure structure, shallow financial markets, and crowding out by government borrowing

Moderate inflation is also one of the reasons Bank Indonesia (BI) lowered its policy rate four times this year. However, the reduction in the BI reference rate has not yet been fully transmitted to bank lending and deposit rates. This has contributed to the perception that interest rates and NIMs charged by Indonesian banks are higher than necessary. A study by the World Bank shows that various challenges in the income and expenditure structure of Indonesian banks, notably low fee income, high overhead expenses, high capital ratios, and lower provisioning for bad loans, explain why NIMs are high. Further empirical analysis reveals that underdeveloped equity and debt markets and crowding out by government borrowing are key structural determinants of NIMs in Indonesia. International experience indicates that the long-term sustainable solution to this type of challenge is to augment the size of the financial market and improve competition.

Some of the Government's current policy priorities will help revive manufacturing competitiveness, but more needs to be done

With the sharp decline in commodity windfall export revenues, boosting non-commodity exports has emerged as a key priority. Indonesia's current merchandise export basket is strongly dominated by "low-tech" products (one-third of goods exports in 2014), followed by medium-tech industries' exports which were 28 percent. Hi-tech exports (mainly electronics) collapsed following the 1997 crisis. So how can Indonesia make manufacturing an engine of growth again? The Government could consider focusing its efforts on supporting the (export) industries that have been growing very fast despite many obstacles and on leveraging the country's natural resource abundance. A strategic and transparent partnership with the private sector is also important. Keeping inflation low through investments in agricultural productivity and through lower trade barriers would support export growth by limiting real exchange rate appreciation. Finally, higher infrastructure spending and regulatory reform, which have already become a policy priority, would help improve competitiveness.

Fiscal policy in Indonesia has not been very effective in reducing inequality, but the fuel subsidy reform has helped

Recent discussion of fiscal policy has focused on short-term fiscal developments and their growth impact. However, fiscal policy is also one of the main tools available to governments to reduce inequality. In Indonesia, inequality has risen since the early 2000s and many Indonesians believe urgent action is needed.[1] Tax and spending policy choices have been made with a view to reducing inequality in a number of countries. In Brazil, for example, the Gini coefficient (a measure of inequality) was 14 points lower after accounting for the impact of fiscal policy in 2009. According to a World Bank study, fiscal policy in Indonesia in 2012 reduced the Gini coefficient by only 2.5 points. Further analysis showed that the Government spent the least on the most effective programs and vice versa. However, the 2015 fuel subsidy reform, and related compensation for the poor, has helped reduce inequality, as savings were redirected into infrastructure, health, and social assistance.

[1] Part B.2 of the March *IEQ* discusses public concern about rising inequality in Indonesia.

A. Economic and fiscal update

1. The global economy is not yet supportive

Early data show no signs yet of an emergent global recovery

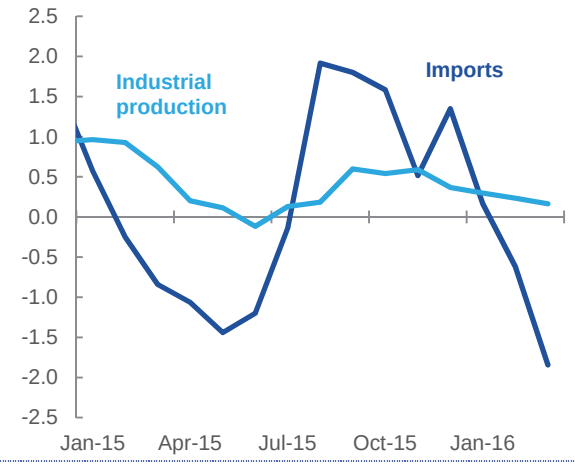
Global monthly production and trade data point to slow first-quarter economic activity. Furthermore, the risk appetite of international investors for emerging market assets weakened with renewed uncertainty regarding the timing of the next change in US monetary policy. These factors have prompted downward revisions to forecasts for 2016 world growth. According to the latest World Bank projections, global growth is projected at 2.4 percent, unchanged from the pace of 2015. A slight improvement in Indonesia's international environment has come only from somewhat higher commodity prices in recent months. Overall, the downside risks to Indonesia's near-term outlook related to external conditions have intensified.

Instead of gaining momentum, as expected, global growth and trade lost steam in Q1 2016…

Monthly global trade and industrial production data point to a weak start to 2016. According to the March 2016 CPB World Trade Monitor, global import volumes contracted by 1.8 percent in the first quarter relative to the preceding three months (Figure 1).[2] Import momentum in advanced countries was marginally positive, driven by the Euro Area and Japan, while it contracted further in emerging markets, in particular in Asia and Latin America. Global industrial production (excluding construction) grew at only 0.2 percent in the same period, with momentum negative in the US and Japan and positive and improving in the Euro Area and other advanced countries in Q1 2016. Among emerging markets, industrial production growth remains positive, but is decelerating in Asia and has remained negative in Latin America since December 2014. In addition, global financial market volatility has gone up somewhat in recent months, as the US Federal Reserve deliberates the next interest rate increase, while recent US economic data remain mixed.

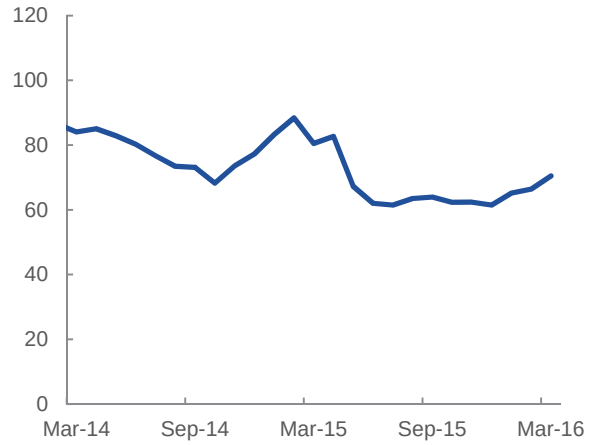
[2] CPB Netherlands Bureau for Economic Policy Analysis: http://www.cpb.nl/en/figure/cpb-world-trade-monitor-march-2016.

Figure 1: Global growth and trade momentum weakened…
(three-month on three-month growth in seasonally adjusted data, percent)



Note: Last observation is March 2016.
Source: CPB Netherlands Bureau for Economic Policy Analysis; World Bank staff calculations

Figure 2: … while Indonesia's net commodity terms of trade are slightly up
(index, 2011=100)



Note: Net trade-weighted price index of Indonesia's six main export commodities (rubber, base metals, coal, oil, gas, and palm oil).
Source: BPS; World Bank; World Bank staff calculations

… but the prices of some of Indonesia's main export commodities have increased in recent months

At the same time, some global commodity prices have risen in recent months, resulting in a small improvement in Indonesia's terms of trade (Figure 2). The prices of rubber, base metals, coal, and palm oil have risen since January or February 2016. Global oil prices also bottomed out in January, but an increase in the price of crude oil reduces Indonesia's net terms of trade as it is a net oil importer (though higher oil prices do bring in more government revenues). Overall, the World Bank's net trade-weighted price index of Indonesia's six main export commodities increased by 9.0 percent in Q1 2016 relative to the last quarter of 2015, but remained 19.6 percent below its level a year ago.

2. Weaker first-quarter activity highlights growth risks

GDP growth in Q1 2016 was 4.9 percent yoy, with public spending lower than expected

In the first quarter of 2016, Indonesia's real GDP grew at 4.9 percent year-on-year (yoy), a slightly slower pace than expected mainly due to weaker than anticipated public spending (Figure 3). Private consumption remained resilient, supported by low inflationary pressures in the first quarter and a stable Rupiah. Despite the slow start to the year, government investment is expected to accelerate in the remainder of the year following the historical trend. The growth outlook for 2016 remains unchanged at 5.1 percent yoy, supported by gradually improving domestic demand, including an acceleration in government capital spending. However, the outlook is subject to significant downside fiscal and external risks.

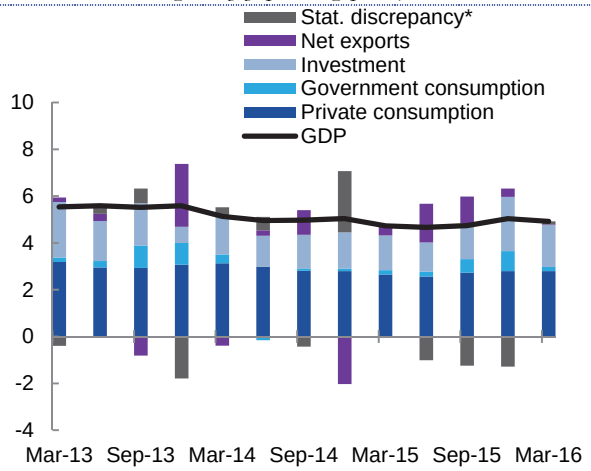
Private consumption remained resilient…

Private consumption expenditure grew at 5.0 percent yoy, the same pace as in H2 2015. The stable Rupiah and lower inflation supported overall household spending, while stagnant real incomes continue to weigh on the consumption of households in the lowest deciles of the income distribution. According to the August 2015 National Labor Force Survey (Sakernas), the national average wage increased by 0.1 percent yoy in real (CPI-deflated) terms, after declining by 2.2 percent yoy in 2014. However, the average real monthly wage in agriculture, forestry, and fisheries, where a third of the employed work, declined by 2.3 percent yoy in 2015. Among farmers, paddy farmers have recently been under particular pressure from lower real incomes. The

rice farmers' terms of trade, i.e. the ratio of the prices they receive for their output to the cost they pay for production and investment, declined in Q4 2015 (Figure 4). The terms of trade for all farmers did not deteriorate in the same period.

Figure 3: Private consumption and investment supported growth in Q1 2016…

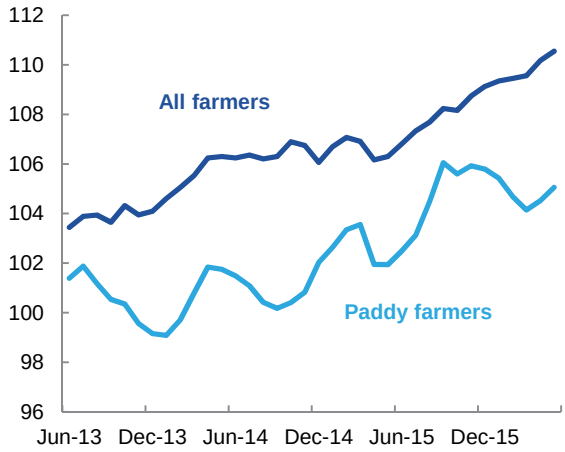
(contributions to GDP growth yoy, percentage points)



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

Figure 4: Paddy farmers' real incomes have weakened since September 2015

(farmers' terms of trade index, seasonally adjusted data)



Note: Farmers' terms of trade is the ratio of the index of producer prices received by farmers to the index of costs paid by farmers for production and investment.
Source: BPS; World Bank staff calculations

… while public consumption spending weakened

In contrast to the resilience of overall household spending, government consumption growth fell to 2.9 percent yoy, down from 7.1 and 7.3 percent yoy in the previous two quarters. However, Q1 2016 public spending was broadly in line with the historical trend of low first-quarter spending and was significantly higher compared with the average levels observed in the past five years (see Section 6).

Low government spending on capital also contributed to slower fixed investment growth

Fixed investment grew by 5.6 percent yoy in Q1 2016, compared with 6.9 in the last quarter of 2015. The slowdown was due to low central government capital spending – only IDR 10 trillion in the first three months of the year (5 percent of the annual budget target). The first-quarter share of central government investment was only 1.0 percent of total nominal fixed investment, compared with 13.3 percent in Q4 2015. Despite a significant improvement in public capital expenditure disbursement over the same period last year (see Section 6), the very low share of central government investment implies that most of the first-quarter investment growth was supported by the private sector. This may reflect the fact that corporate profits in some sectors, such as consumer goods and telecommunications, improved considerably in the last quarter of 2015 and the first quarter of this year.[3]

The contribution of net exports to growth was zero

Export volumes declined by 3.9 percent yoy, while import volumes decreased by 4.2 percent yoy. Thus, net exports contributed 0 percentage points to year-on-year GDP growth, an improvement from the negative contribution in the previous quarter. However, there are tentative signs that trade may have bottomed out as the pace of decline in both real exports and imports decelerated significantly in Q1 2016. By comparison, in the last quarter of 2015, export and import volumes declined by 6.4 percent yoy and 8.1 percent yoy, respectively.

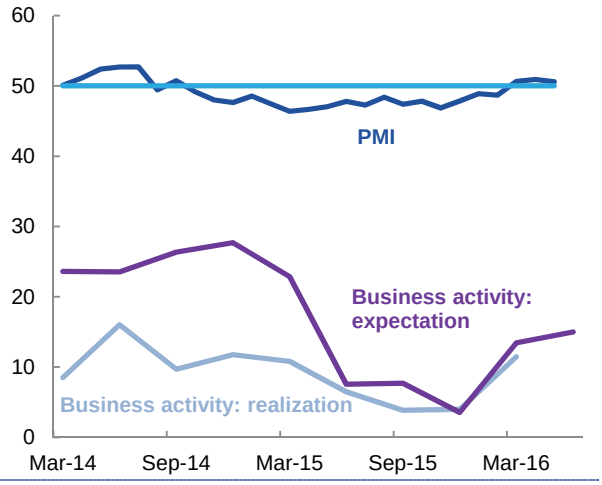
[3] This is based on data for around 100 large companies traded on the Indonesia Stock Exchange.

Sentiment indicators have improved recently, while other high-frequency data provide mixed signals

Business and consumer confidence has increased in recent months. The BI business activity indices rose sharply in early 2016 and the Nikkei/Markit purchasing managers index (PMI) increased to above 50 in March, signaling improving activity (Figure 5). After the somewhat weaker first three months of 2016, commercial cement sales growth picked up in April. However, capital goods imports contracted again in the first quarter, by 18.9 percent yoy. Similarly, consumer confidence was up in the first four months of the year but other high-frequency consumption indicators remain mixed. Motorcycle sales contracted by 8.3 percent yoy in April, while car sales growth improved to 3.6 percent yoy (following negative growth since August 2014).

Figure 5: Business confidence indicators have improved

(indices, points)



Note: A PMI value above 50 indicates an improvement in economic activity.
Source: BI; Nikkei/Markit; World Bank staff calculations

In the base case, GDP growth, at 5.1 percent in 2016, remains unchanged from the March 2016 *IEQ*…

The World Bank's projection for GDP growth remains at 5.1 percent for 2016 and 5.3 percent in 2016, despite lower than expected public spending in the first quarter. Private consumption is expected to pick up slightly on account of moderate inflation, a relatively stable Rupiah, and the April cut in energy prices. The announced increase in the personal income tax threshold from IDR 36 million to IDR 54 million per year in 2016, as well as a 14th monthly salary for civil servants, will provide an additional boost to household spending. The baseline also takes into account accelerated government expenditure, in particular capex, in the next three quarters, in line with the historical trend. However, towards the end of 2016 and beyond the outlook depends on private investment growth picking up as it responds to the Government's business climate reform efforts and the slow recovery in global growth and trade. Although still expected to decline overall in 2016, exports have been revised up on account of better-than-expected first-quarter data.

… but the downside risks to the outlook have increased

The baseline scenario is subject to significant downside risks. On the domestic side, a higher than projected revenue shortfall would constrain the Government's infrastructure plans (see Section 6), while persistently weak credit growth may limit the recovery in private investment (see Section 5). The main external risks are weaker than expected global growth and trade and the possibility of higher global financial market volatility (see Section 1). There are upside risks related to potential revenues from the Tax Amnesty program which would boost both public and private spending. Fixed investment could benefit from the capital injections into state-owned enterprises, if they are approved by Parliament as part of the 2016 Revised Budget (see Section 6).

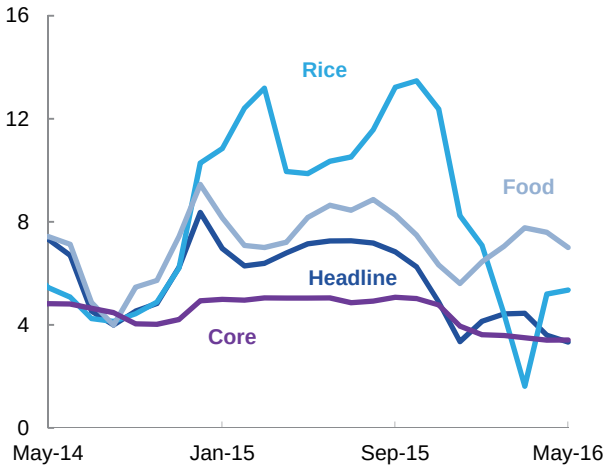
3. Headline inflation moderated but food prices remain volatile

Inflationary pressures are lower, partly on account of lower energy prices…

Year to date headline inflation has been modest, partly driven by lower energy prices. The Government lowered fuel prices by 11.5 percent in April. As a result, average transport prices declined by 2.4 percent month on month. Headline inflation declined further to 3.3 percent yoy in May, from 3.4 percent yoy in April (Figure 6). At the same time, core inflation, which excludes the more volatile food and energy prices, has decelerated in the past six months, reaching 3.4 percent yoy in May.

Figure 6: Inflation eased as energy prices continued to decline…

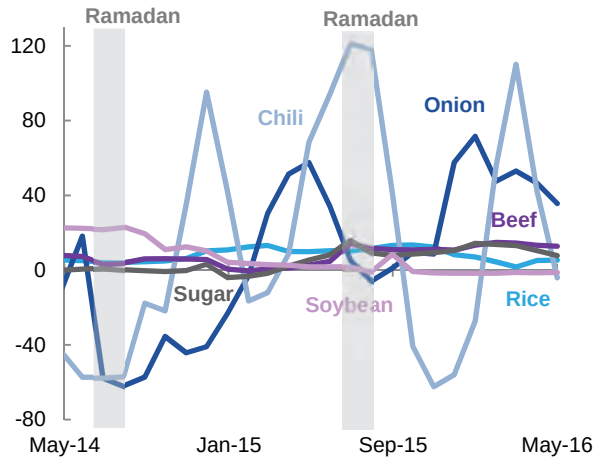
(change yoy, percent)



Note: Food prices are a weighted average of the raw and processed food price components of CPI.
Source: BPS; World Bank staff calculations

Figure 7: … while food prices remained volatile

(change yoy, percent)



Source: BPS; World Bank; World Bank staff calculations

… while food prices remain persistently high

However, the stable headline inflation masks persistently high food price inflation. In May, raw food prices increased by 7.7 percent yoy and processed food prices by 6.1 percent. The prices of several key foods, such as rice, onion, chilies and beef, remained high, reflecting insufficient supply and distribution challenges (Figure 7). Between October 2015 and March 2016, rice price inflation moderated significantly, likely on account of the Government allowing higher imports during that period. However, in April and May rice price inflation rose considerably again – to 5.3 percent yoy in May from 1.6 percent yoy in March.

Inflation is expected to remain moderate, but food prices are a significant risk ahead of Idul Fitri

The World Bank projects an annual average CPI inflation rate of 3.9 percent in 2016, rising to 4.4 percent in 2017. Inflation is expected to remain within the BI target range of 3 – 5 percent per year. Food prices are expected to remain volatile especially during Ramadan and the Idul Fitri holiday during June 5 – July 7. Section B.2 of this *IEQ* provides evidence of the inflationary impact of international trade restrictions. To limit food price inflation in the short term, the Government could allow seamless imports of key food commodities.

Table 2: In the base case, GDP growth is projected at 5.1 percent in 2016 and 5.3 percent in 2017
(percentage change, unless otherwise indicated)

	Annual			YoY in Fourth Quarter			Revision to Annual	
	2015	2016	2017	2015	2016	2017	2016	2017
1. Main economic indicators								
Total Consumption expenditure	4.9	4.8	5.2	4.8	5.0	4.0	-0.2	0.0
Private consumption expenditure	4.8	5.1	5.2	5.0	5.1	4.0	0.2	0.0
Government consumption	5.4	3.0	4.9	2.9	3.7	4.2	-3.0	-0.3
Gross fixed capital formation	5.1	5.2	5.3	5.6	4.6	4.2	0.1	0.1
Exports of goods and services	-2.0	-1.1	3.6	-3.9	3.4	2.7	2.8	0.0
Imports of goods and services	-5.8	-1.0	2.8	-4.2	1.5	2.6	-1.2	0.0
Gross Domestic Product	4.8	5.1	5.3	4.9	5.4	4.0	0.0	0.0
2. External indicators								
Balance of payments (USD bn)	-1.1	1.4	5.8	-	-	-	-0.1	-1.9
Current account balance (USD bn)	-17.8	-21.1	-24.9	-	-	-	0.0	1.1
As share of GDP (percent)	*-2.0*	*-2.3*	*-2.5*	-	-	-	0.0	0.0
Trade balance (USD bn)	4.8	4.2	3.0	-	-	-	2.1	4.9
Capital & financial acc. bal. (USD bn)	17.1	22.5	30.7	-	-	-	-0.1	-3.0
3. Fiscal indicators								
Central gov. revenue (% of GDP)	13.1	12.1		-	-	-	-0.1	-
Central gov. expenditure (% of GDP)	15.7	14.9		-	-	-	-0.2	-
Fiscal balance (% of GDP)	-2.6	-2.8		-	-	-	0.0	-
Primary balance (% of GDP)	-1.2	-1.4		-	-	-	0.0	-
3. Other economic indicators								
Consumer price index	6.4	3.9	4.4	4.8	4.0	4.7	-0.1	-0.2
GDP Deflator	4.2	2.9	4.5	4.0	3.6	4.5	-1.7	-0.4
Nominal GDP	9.2	8.1	10.1	9.2	8.8	10.1	-1.8	-0.4
4. Economic assumptions								
Exchange rate (IDR/USD)	13389	13300	13300	-	-	-	-500.0	-500.0
Indonesian crude price (USD/bl)	49	40	49	-	-	-	0.0	2.0

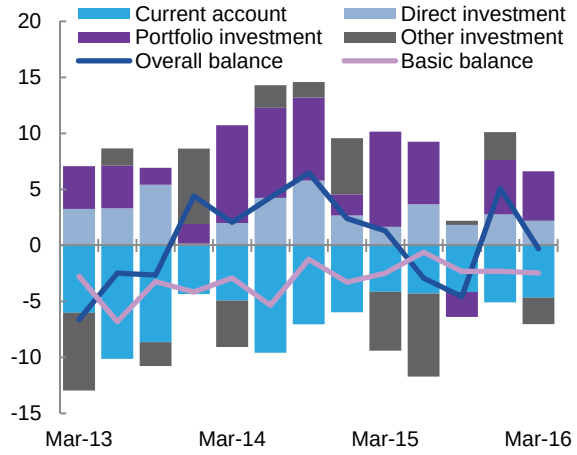
Note: Exports and imports refer to volumes from the national accounts. All figures are based on revised and rebased GDP. Exchange rate and crude oil price assumptions are based on recent averages. Revisions are relative to projections in the March 2016 *IEQ*.
Source: BPS; BI; CEIC; World Bank staff projections

4. The private sector experienced net capital outflows in Q1 2016

A decline in other investment resulted in a small balance of payments deficit

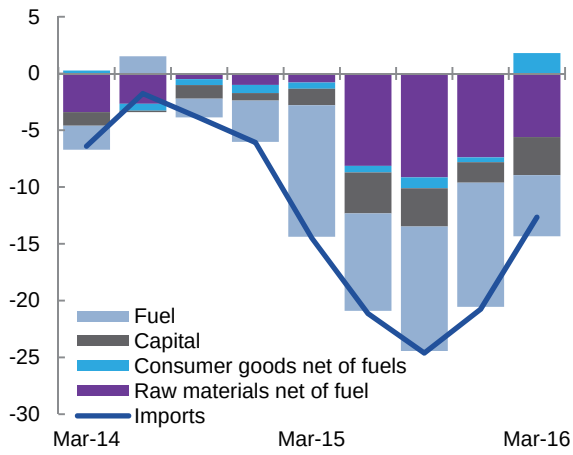
A large decline in other investment resulted in a small balance of payments deficit in the first quarter, following a large surplus in the previous quarter (Figure 8). The current account deficit narrowed to 2.1 percent of GDP. However, this improvement was due to a sharper quarterly fall in imports than in exports. In Q1 2016, Indonesia's financial account balance also declined due to net private sector capital outflows, although capital inflows into government bonds remained strong. External financing risks from weak trade and short-term capital flow volatility remain elevated.

Figure 8: A fall in other investment drove a balance of payments deficit
(USD billion)



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

Figure 9: Imports declined at a slower pace than in previous quarters
(contributions to year-on-year growth, percentage points)



Source: BI; World Bank staff calculations

The current account deficit narrowed to 2.1 percent of GDP in Q1 2016, as imports fell faster than exports

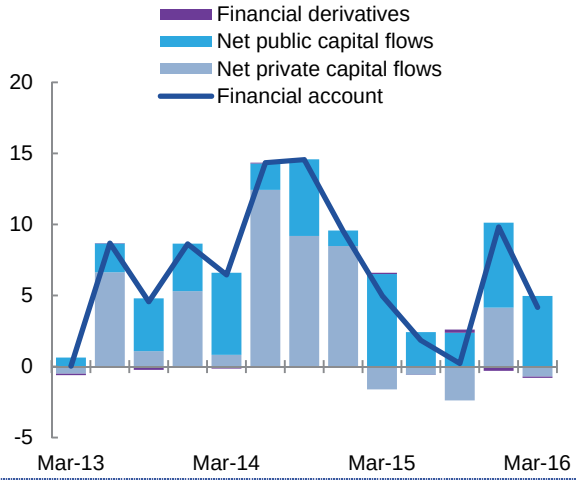
The current account deficit improved slightly to 2.1 percent of GDP, from 2.4 percent in the previous quarter. The trade balance remained in surplus at USD 1.6 billion. Both exports and imports continued to decline, by 12.3 percent yoy and 12.5 percent yoy, respectively. Exports decreased across all categories as a result of weak global demand, a real exchange rate appreciation of 3.1 percent in Q1 2016, and weaker prices for all major commodities relative to Q1 2015.[4] Both raw material and capital goods imports declined, while consumer goods (net of fuel) imports contributed 1.8 percentage points to year-on-year import growth, the first positive growth (yoy) contribution since Q1 2014 (Figure 9).

Net private sector outflows drove a decline in the financial account

Turning to the financial account, the private sector experienced net capital outflows, while net public sector inflows were positive (Figure 10). Direct investment contracted slightly from the previous quarter to USD 2.2 billion. Portfolio flows were also slightly lower, but remained robust at 4.4 USD billion, driven entirely by long-term government borrowing. However, government borrowing was somewhat lower than its level in the first quarter of previous years, due to the government's pre-financing efforts in Q4 2015. Other investment posted a quarterly deficit, driven by private deposit outflows, as well as a reduction in foreign borrowing by the private sector.

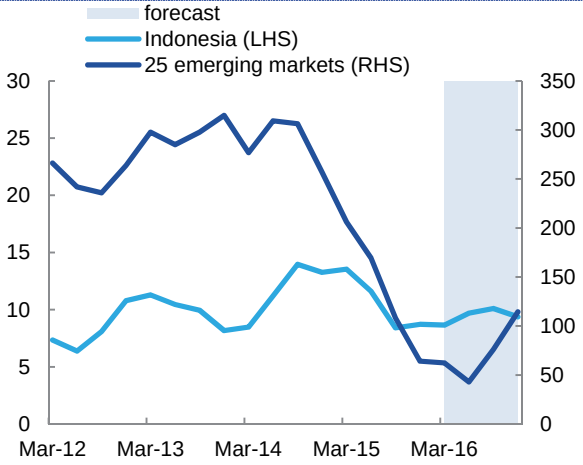
[4] The prices of crude palm oil and rubber increased in the first quarter of this year relative to Q4 2015.

Figure 10: Indonesia's private sector has reduced its foreign borrowings
(USD billion)



Source: BI; World Bank staff calculations

Figure 11: Capital inflow to emerging markets is expected to improve slightly in 2016
(four-quarter moving average, USD billion)



Source: The Institute of International Finance; World Bank staff calculations

The current account deficit is expected to widen to 2.3 percent of GDP in 2016 and 2.5 percent in 2017

The World Bank's current account deficit forecasts for 2016 and 2017 remain at 2.3 and 2.5 percent of GDP, respectively (Table 3). Given mixed commodity price developments so far in 2016, and a Q1 2016 fall in export revenues, exports are likely to remain weak in 2016. The trade balance is expected to remain positive, however, as imports are expected to fall by more than exports. Overall, capital flows into Indonesia are expected to improve slightly throughout the remainder of 2016, in line with the expected increase in capital flows to emerging economies in general (Figure 11). Net government bond flows are likely to be slightly lower than in 2015, given the Government's pre-financing of USD 3.5 billion in December 2015.

Table 3: The current account deficit is expected to widen slightly in 2016
(USD billion unless otherwise indicated)

	2015	2016	2017
Overall balance of payments	-1.1	1.4	5.8
As percent of GDP	*-0.1*	*0.2*	*0.6*
Current account	-17.7	-21.1	-24.9
As percent of GDP	*-2.0*	*-2.3*	*-2.5*
Goods trade balance	13.3	12.6	13.8
Services trade balance	-8.3	-8.4	-10.8
Income	-28.2	-30.7	-33.4
Transfers	5.5	5.4	5.5
Capital and financial accounts	17.1	22.5	30.7
As percent of GDP	*2.0*	*2.4*	*2.9*
Direct investment	9.9	9.9	11.3
Portfolio investment	16.7	13.7	18.1
Financial derivatives	0.0	0.0	-0.1
Other investment	-9.8	-1.1	1.4
Memo:			
Basic balance	-7.7	-11.2	-13.6
As percent of GDP	*-0.9*	*-1.2*	*-1.5*

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

5. Domestic credit growth remains weak despite monetary easing

Financing conditions have been relatively tight with weaker credit growth and lower capital inflows

As in most emerging markets, financial asset prices in Indonesia have been affected by an increase in global financial market uncertainty. Domestic credit conditions remain tight, with credit growth at almost seven-year lows. Furthermore, Bank Indonesia's (BI) easing of monetary policy (three consecutive rate cuts earlier in the year) has not been transmitted effectively to lending and deposit rates. In an effort

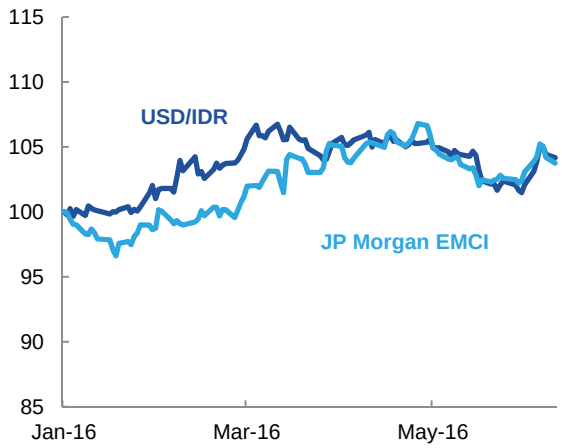
to address this challenge, BI announced a change in its monetary policy framework: from August 19, 2016 its main policy tool will be the 7-day reverse repo rate.

Financial asset prices were volatile in the second quarter

The recovery seen in the Rupiah in the first quarter of 2016 was halted in the second quarter. In line with other emerging market currencies, the Rupiah depreciated against the US dollar in May and then recovered, resulting in a 0.5 percent overall depreciation between the end of March and June 13 (Figure 12). In comparison, in the same period, the JP Morgan Emerging Market Currency Index (EMCI) depreciated by 1.5 percent. The downward trend seen since the beginning of this year in government bond yields continued in Q2 2016. The yield on the 10-year bond fell 33 basis points between March 31 and June 13 to 7.6 percent. Bond yields are significantly lower than they were a year ago when emerging markets experienced a capital flow reversal.

Figure 12: Emerging market currency volatility rose in Q2 2016

(Index, Jan 4 = 100)



Source: BI; JP Morgan; World Bank staff calculations

Indonesian equities have also seen earlier gains partly reversed

After increasing by 5.5 percent in the first quarter of 2016, the Jakarta Composite Index has decreased by 0.5 percent since March 31. The performance across sectors has been mixed, with agriculture declining by 8.3 percent between March 31 and June 14. On the other hand, on the back of stabilizing commodity prices, the mining sector gained 13.6 percent, while infrastructure gained 5.6 percent over the same period.

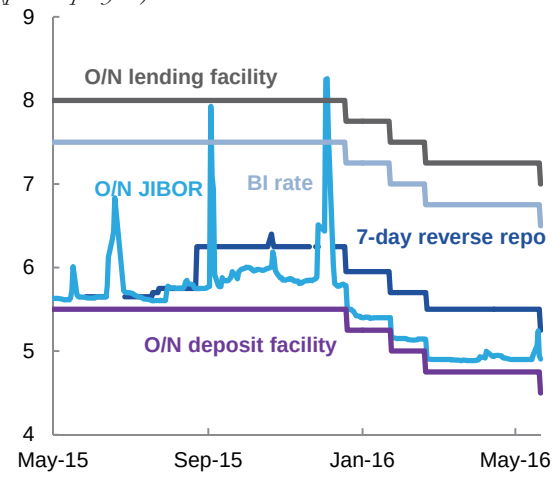
The transmission of monetary easing to lower lending and deposit rates has so far been limited…

With the Rupiah remaining relatively stable and inflation well within the target range of 3 to 5 percent, BI lowered its main policy rate from 7.5 percent in December 2015 to 6.5 percent in June 2016 (Figure 13). While monetary policy easing has been transmitted through to the JIBOR, the transmission to bank deposit and lending rates has remained muted.

… and credit and deposit growth have remained weak, while non-performing loans (NPLs) crept up

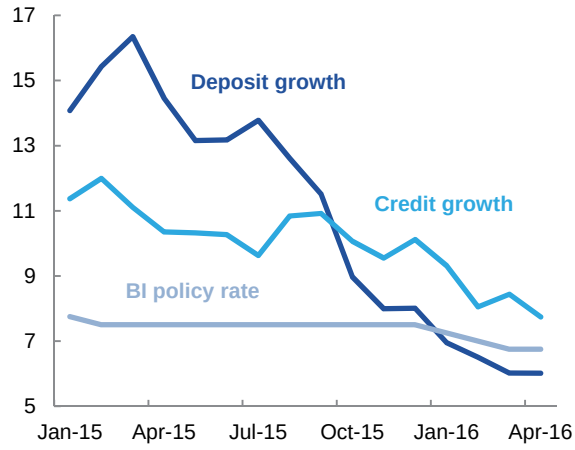
Credit growth, across almost all sectors and loan types, remained weak, reaching near seven-year lows (Figure 14). Investment loan growth increased slightly to 12.2 percent yoy in April 2016, from 11.6 percent yoy in March. Working capital loans, comprising around 45 percent of total loans, grew at a tepid 4.8 percent yoy in April, down from 6.4 percent yoy in March. Deposit growth has also continued to decline, reaching twelve-year lows. NPLs increased to 2.9 percent of total loans in April, from 2.7 percent in January. However, the capital adequacy ratio stood at 22 percent in March (the latest data), well above the BI minimum requirement of 8 percent, in line with the Basel III global regulatory framework.

Figure 13: BI's new policy rate is the 7-day reverse repo
(percent per year)



Source: BI; World Bank staff calculations

Figure 14: Credit and deposit growth continue to fall
(growth yoy, percent)



Source: BI; World Bank staff calculations

BI changed its main policy rate in an effort to improve the effectiveness of monetary policy

On April 15, BI announced a reformulation of its monetary policy framework**.** As of August 19, 2016, the main policy rate will shift from the BI (reference) rate to the seven-day reverse repo rate. BI plans to establish a symmetrical (and narrower) 75-basis point interest rate corridor above and below the BI seven-day reverse repo rate. This change in policy instrument – from a reference interest rate to an effective (reverse repo) interest rate – is intended to improve the transmission mechanism between the BI policy rate and bank rates. In the short term, the change in policy instrument is not expected to affect interbank market rates significantly, as the overnight rate has hovered close to the overnight deposit facility rate in recent years (owing to surplus bank system liquidity). The revision of the framework is a positive move but its effectiveness will require surmounting other challenges, such as a lack of interbank credit lines and uneven distribution of liquidity in the banking sector.

6. Budget execution has improved but revenues remain weak

Four months into the fiscal year, the implementation of the 2016 Budget faces challenges

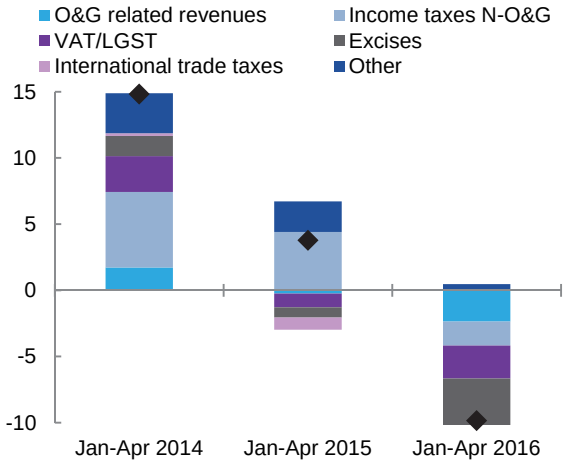
Revenue collection between January and April recorded a broad-based decline of 9.8 percent compared to the same period in 2015, owing mainly to lower commodity prices and domestic demand, as well as several revenue policy and administration changes. On the other hand, total expenditure increased by 9.2 percent, supported by strong growth in material (66 percent yoy) and capital spending (106 percent yoy). This is a significant improvement in terms of budget execution, although below expectations in terms of supporting GDP growth. Disbursement increased by 89 percent for material and by 39 percent for capital relative to the average of the past five years, likely supported by early procurement initiated by the Ministry of Public Works and Housing.

Year-to-date revenue collection weakened on account of the continued decline in oil and gas prices …

Turning to revenues, realization in the first four months of 2016 showed a broad-based decrease of 9.8 percent (Figure 15). Oil and gas-related revenues contributed 2.4 percentage points to the decline in total revenues, reflecting the 34.6 percent drop in international oil and gas prices in January-April 2016 relative to the corresponding period last year and a Rupiah appreciation of 4.7 percent. Oil and gas revenues weakened despite an increase in the average daily oil lifting of 2.6 percent relative to the first four months of 2015.

Figure 15: Year-to-date revenue collection has seen a broad-based decline …

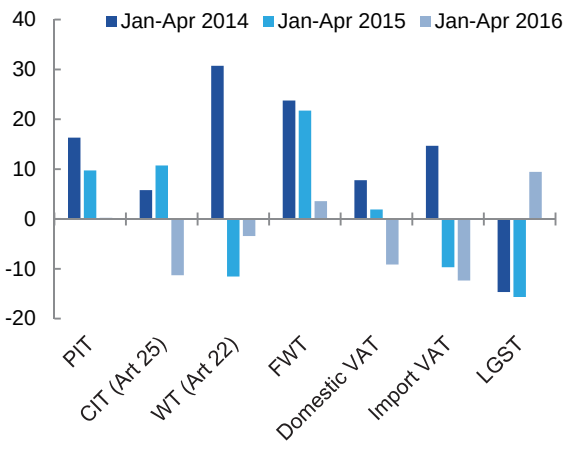
(contributions to revenue growth yoy, percent)



Note: O&G stands for oil and gas, N-O&G – non-oil and gas; LGST – luxury goods sales tax.
Source: Ministry of Finance; World Bank staff calculations

Figure 16: … including corporate income taxes and VAT

(growth yoy, percent)



Note: PIT – personal income tax collected under Article 21 and Article 25/Personal of Income Tax Law No. 36 of 2008; CIT – corporate income tax under Article 25; WT – withholding tax under Article 22; FWT – final withholding tax under Article 4(2) of the Income Tax Law; LGST – luxury goods sales tax.
Source: Ministry of Finance; World Bank staff calculations

… also in part due to the moderation in domestic demand…

Furthermore, income taxes from non-oil and gas sectors contributed 1.8 percentage points to the decline in revenues over the same period, despite an increase in Q1 2016 nominal GDP of 8.0 percent yoy. Similarly, VAT collection contributed 2.5 percentage points to the revenue decrease, driven by both domestic VAT (down 9.1 percent yoy) and import VAT (down 12.3 percent yoy) (Figure 16). While lower import VAT is in line with weak imports (-5.4 percent yoy in nominal terms in the first quarter), domestic VAT revenues declined despite 8.3 percent yoy growth in nominal private consumption. The 39 percent yoy increase in VAT refunds in the first four months of 2016 is likely to have also contributed to the 1.3-percent yoy decline in gross VAT receipts.

… as well as tax policy and administration changes…

In addition to global and domestic macro factors, changes in tax policy and administration possibly contributed to lower revenues. Personal income tax (PIT) collection grew by only 0.2 percent relative to January-April 2015 (compared with a 2014-2015 average of 13 percent). This was most likely due to an increase in the non-taxable income threshold (*Penghasilan Tidak Kena Pajak,* PTKP) from IDR 24.3 million to IDR 36.0 million, a policy introduced in 2015 to support household spending.[5] Non-oil and gas corporate income taxes (CIT) declined by 11.3 percent yoy, partly driven by lower corporate profits in some sectors, such as non-oil and gas mining. The Directorate General of Tax also reported a 66.5 percent increase in non-oil and gas corporate income tax refunds in January-April 2016 relative to the corresponding period last year. In addition, excise taxes contributed 3.6 percentage points to the revenue decrease, as the rules on the payment of excise taxes by

[5] Minister of Finance Regulation PMK-122/2015.

tobacco producers were changed.[6] Finally, the ongoing uncertainty around the Tax Amnesty Law may have negatively impacted both tax-payer morale and tax administration efforts. For example, the Directorate General of Tax was reported saying that it was pausing its audit processes while waiting for the Parliament's decision on the Tax Amnesty Law.[7]

The Government has proposed a 2016 Budget revision, including lower revenues…

In response to the continued moderation in commodity prices and slowdown in domestic demand, the Government lowered projected revenues by IDR 88.0 trillion to IDR 1,734.5 trillion in the draft 2016 Revised Budget (which is expected to be approved in July) (Table 4). In the proposed Budget revision oil and gas-related revenues have been revised down by IDR 67.3 trillion, mining non-tax revenues by IDR 24.3 trillion, and VAT by IDR 97.5 trillion. However, the projected non-oil and gas income taxes were revised up by IDR 103.4 trillion to reflect more optimistic expectations regarding revenues from the Tax Amnesty program of around IDR 165 trillion.[8]

… a larger fiscal deficit and several expenditure adjustments…

With a weak revenue outlook, the Government has proposed to reduce overall expenditure by approximately IDR 48 trillion (2.3 percent of the total budget), raise the fiscal deficit to 2.5 percent of GDP, and use the unspent 2016 balance (*Sisa Anggaran Lebih,* SAL) of IDR 19 trillion. The spending cuts are expected to come from a number of measures, including a IDR 50 trillion reduction in line ministry allocation for non-priority spending, such as travel, honorarium, meeting expenses, and others;[9] further decreasing fuel subsidy costs by IDR 23 trillion by lowering the maximum fixed subsidy per liter for diesel; and reducing regional transfers by IDR 8.3 trillion through the earmarked grant (*Dana Alokasi Khusus*, DAK) and by IDR 4.7 trillion through lower revenue sharing. On the other hand, the draft 2016 revised Budget has also proposed an increase of IDR 39 trillion in other spending areas such as the electricity subsidy,[10] non-energy subsidies, the preparation for the 2018 Asian Games, and the correctional facilities programs. Overall, the expenditure cuts are relatively modest, far below the IDR 236 trillion projected reduction in spending estimated by the World Bank (see below).

… as well as an increase in off-balance sheet funding to support infrastructure investment

The draft 2016 Revised Budget also proposes an increase in the Government's off-balance sheet investment fund allocation (*Dana Investasi Pemerintah*) from IDR 58 trillion to IDR 92.5 trillion. This includes increased capital injections of IDR 13.6 trillion for state-owned electricity company PLN (to support the program to add 35,000 MW electricity generation capacity), IDR 6.8 trillion for the Social Security Agency (*Badan Penyelenggara Jaminan Sosial*, BPJS), and IDR 16 trillion for the land bank for infrastructure development.

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[6] Minister of Finance Regulation PMK-20/2015, issued on February 2, 2015. In the past, producers were allowed to postpone the payment of excise tariffs for 2 months after they ordered the excise stamps, regardless of the month of order. Starting 2015, all stamp payments have to be made by December 31 of the current year. As a result, there were hardly any payments in January and February 2016 and the first full-month payment was received in March.

7 http://www.thejakartapost.com/news/2016/05/17/tax-office-reluctant-mood-tax-amnesty-stalls.html

8 http://jakartaglobe.beritasatu.com/business/finance-minister-big-hopes-tax-amnesty/

[9] Presidential Instruction INPRES No.4/2016.

[10] Electricity subsidy costs are higher due to delays (to July) in the implementation of the tariff adjustment for households with 450 VA and 900 VA power supply, which was initially planned for January 2016.

The World Bank has revised down slightly its 2016 revenue projection, reflecting the revised macro-economic outlook

The changes in the World Bank's macroeconomic projections -- in particular weaker nominal GDP, import, and private consumption growth, as well as a stronger Rupiah -- relative to the March *IEQ*, have prompted a revision of the 2016 revenue projection from IDR 1,547 trillion in March to IDR 1,506 trillion (Table 4). The projection does not include potential revenues from the tax amnesty, as it is still unclear when the Tax Amnesty bill will be passed and implemented.[11] With these assumptions, the revenue shortfall in 2016 could reach IDR 316 trillion (2.5 percent of GDP) relative to the Budget target. A large part of the difference between the draft 2016 Revised Budget and the World Bank's revenue forecast is likely explained by the assumed tax amnesty proceeds.

The projected 2016 fiscal deficit remains at 2.8 percent of GDP

To partly compensate for lower revenues the Government can expand the fiscal deficit within the fiscal rule of 3 percent of GDP and reduce non-priority expenditure to prioritize public investment to support growth. Assuming the Government will use these options, the World Bank projects a fiscal deficit of 2.8 percent of GDP for 2016, unchanged relative to the forecast published in the March 2016 *IEQ*. The projections reflect an expenditure disbursement rate of 89 percent of the total budget and a higher fiscal deficit relative to the target of 2.5 percent of GDP in the draft revised 2016 Budget. Despite a higher expected 2016 fiscal deficit relative to the Budget, financing risks remain contained. By June 7, 2016, the Government had already raised around IDR 440 trillion in securities and multilateral loans, compared with 2016 gross financing needs of IDR 708 trillion estimated by the Word Bank.

[11] International experience suggests that the tax amnesty revenue impact varies greatly and depends on the design of the program. Key factors include credibility that the reform is a one-off opportunity and that taxpayer information will not be used for other purposes; increased tax enforcement; higher post-amnesty penalties; as well as the applicable tax rate and penalty structure. Amnesties tend to generate more revenue when the standard tax rate is applied. For example, Ireland collected 1.9 percent of GDP in 1988 by waiving interest and penalties but not reducing the tax rate. In contrast, Italy collected just 0.1 percent of GDP in 2001, as a large tax rate reduction (in addition to other factors) contributed to a low revenue impact. Source: Baer. K. and E. Le Borgne, 2008, "Tax amnesties: theory, trends, and some alternatives," IMF.

Table 4: The World Bank projects lower revenue and expenditure than in the 2016 Budget
(IDR trillion, unless otherwise indicated)

	2015	2016	2016	2016	2016	2016
	Audited actual	Budget	Draft Revised Budget	Difference between draft revised and original Budget	World Bank (June)	Jan – Apr
A. Revenues	**1,508**	**1,822**	**1,734**	**-88**	**1,506**	**387**
1. Tax revenues	**1,240**	**1,547**	**1,527**	**-20**	**1,304**	**321**
Income taxes	602	757	844	87	652	186
Oil & Gas	50	41	24	-17	n.a.	12
Non-Oil & Gas	553	716	819	103	n.a.	174
VAT/LGST	424	572	474	-98	448	101
Property taxes	29	19	18	-1	31	1
Excises	145	146	148	2	134	19
International trade taxes	35	40	36	-4	34	11
Import duties	31	37	33	-4	31	11
Export duties	4	3	3	0	4	1
Other taxes	6	12	7	-5	6	2
2. Non-tax revenues	**256**	**274**	**205**	**-69**	**200**	**66**
Natural resources revenues	101	125	50	-75	51	17
Oil & Gas	78	79	28	-51	n.a.	11
Non-Oil & Gas	23	46	22	-24	n.a.	6
Other non-tax revenues	155	149	155	6	149	49
3. Grants	12	2	2	0	**2**	0
B. Expenditures	**1,806**	**2,096**	**2,048**	**-48**	**1,860**	**545**
1. Central government	**1,173**	**1,326**	**1,289**	**-37**	**1,150**	**276**
Personnel	281	348	n.a.		306	97
Material	233	325	n.a.		255	42
Capital	215	202	n.a.		183	18
Interest payments	156	185	192	7	183	64
Subsidies	186	183	189	6	162	40
Energy	119	102	98	-4	97	30
Fuel	61	64	41	-23	42	18
Electricity	58	38	57	19	55	13
Non-energy	67	81	91	10	65	10
Grants	4	4	8.5	5	2	0
Social	97	55	n.a.		54	12
Other	10	25	n.a.		6	2
2. Transfers to regions	**623**	**770**	**758**	**-12**	**710**	**269**
Overall Balance	**-298**	**-273**	**-313**		**-353**	**-158**
(% of GDP)	**-2.6**	**-2.2**	**-2.5**		**-2.8**	
Assumptions						
Real GDP growth rate (%)	4.8	5.3	5.2		5.1	
CPI (%)	6.4	4.7	4.0		3.9	
Exchange rate (IDR/USD)	13,458	13,900	13,500		13,300	
Crude-oil price (USD/barrel)	51	50	40		40	
Memo						
Nominal GDP	*11,541*	*12,716*	*12,635*		*12,480*	

Note: The World Bank projection does not include potential revenues from the tax amnesty.
Source: Ministry of Finance; World Bank staff projections

7. Addressing fiscal revenue constraints has become a priority

The expected global recovery remains uncertain…

Although the World Bank's outlook for Indonesia remains unchanged from the March 2016 *IEQ*, the downside risks have increased. External downside risks relate to the recent rise in uncertainty. For example, the timing and potential impact of further rate increases by the US Federal Reserve, as well as the result of the UK referendum on EU membership, have increased financial market volatility in recent weeks. In China, the pace and manner in which rebalancing and deleveraging efforts are implemented also present potential global risks. These factors have contributed to the current wait-and-see attitude of investors towards emerging markets.

… and there is a risk that the recent increase in commodity prices may not be sustained

Second, there is uncertainty regarding the outlook for commodity prices. As discussed in Section 1, they have rebounded in recent weeks. However, the upswing may prove temporary because, under the baseline scenario, global growth is forecast to pick up only moderately over the medium term. This again means higher uncertainty both for Indonesian investors and for fiscal revenues.

… while at home, fiscal risks have increased since the March 2016 *IEQ* went to press…

Uncertainty is also high with respect to domestic conditions. Economic activity, in particular public spending, lost some steam at the beginning of the year and high-frequency indicators provide mixed signals. This suggests intensifying downside risks to the World Bank outlook for Indonesia, especially related to the limited fiscal space. The Government submitted its draft revision of the 2016 Budget to Parliament on June 2. This is a very important policy step to help protect public investment spending, when the economy relies on it.

… as the draft 2016 Revised Budget needs further adjustment to better manage fiscal risk

However, as discussed in the previous section, the budget revisions proposed by the Government do not sufficiently reflect the deterioration in macroeconomic conditions since the original 2016 Budget was discussed in Parliament last year. In particular, the latest draft includes an increase in non-oil and gas related tax revenues of 48.1 percent relative to the 2015 preliminary revenue outturns. Even if the tax amnesty is approved by Parliament and implemented before the end of 2016, it may be difficult to achieve the high target set for tax collection.

B. Some recent developments in Indonesia's economy

1. Why are lending rates and net interest margins high in Indonesia?

Interest rates in Indonesia are perceived as being excessively high

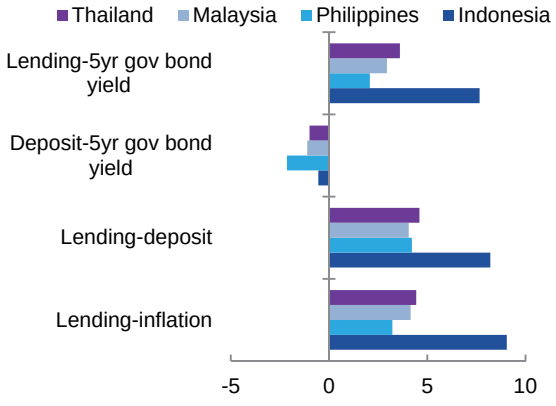
In recent months, there has been a great deal of discussion and policy debate around the perception that the interest rates and net interest margins (NIMs) charged by Indonesian banks are higher than necessary. Moreover, the transmission of the policy rate cuts, introduced by Bank Indonesia in the first three months of 2016, to bank lending and deposit rates has so far been limited (see Part A.5). In an attempt to drive deposit rates lower, in October 2014 the Financial Services Authority (*Otoritas Jasa Keuangan*, OJK) capped deposit rates charged by large banks at 200 or 225 basis points above the BI rate, depending on the level of core capital. OJK tightened the deposit rate caps to 75 and 100 basis points above the BI rate in March 2016. This article attempts to shed light on the determinants of interest rates and margins in Indonesia and the contributing role of both structural and policy factors.[12]

Indonesia does have the highest interest rates in the region, with both sovereign and private sector risk being important

Both nominal and real interest rates, as well as government bond yields, have been higher in Indonesia relative to peers in the G20 and ASEAN (Figure 17). In addition, the spread between bank rates and the government bond yield in Indonesia has been significantly higher than that of neighboring countries. This implies that, while sovereign risk factors may play an important role in interest rate determination for Indonesian banks, Indonesia remains the outlier among ASEAN countries in terms of private sector risk premia.

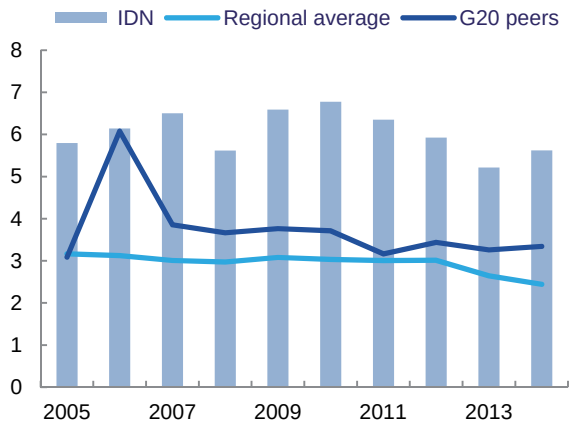
[12] An article on this topic, prompted by the slowdown in credit growth in 2009, was published in the June 2010 *IEQ* (pp. 23-27).

Figure 17: Indonesian interest rates are higher than those in peer countries
(2010-2015 average, percent per year)



Source: CEIC; World Bank staff calculations

Figure 18: NIMs are also higher in Indonesia than in ASEAN and G20 peers
(net interest revenue as a share of average interest-bearing assets, percent)



Source: Bankscope; World Bank staff calculations

a. What components drive high NIMs in Indonesia?

NIM is a measure of bank profitability

One way to understand what factors explain high interest rates in Indonesia is to examine the determinants of NIMs. NIM is the value of a bank's net interest revenue as a share of its average interest-bearing (total earning) assets. It reflects realized lending experience in contrast to the interest spread, which is an indication of the rates at which banks offer to transact.

NIMs have been high and persistent in Indonesia

The Indonesian NIM has been markedly higher and also more stable than NIMs in peers in the region and within the G20 (Figure 18).[13] The coefficient of variation of the NIM in Indonesia over the period 1999 to 2015 is the second lowest (13.4 percent) of the ASEAN countries analyzed after Vietnam (12.2 percent). It is also much lower than in the more developed financial markets of Singapore (51.1 percent), South Korea (48.1 percent), and Hong Kong (37.1 percent). High NIMs, as well as the low variation, may point to structural challenges within the Indonesian financial sector.

Indonesian banks have high overhead costs

One component of NIM is overhead costs, which are higher in Indonesia than in peer countries (Figure 19). This may reflect the particular geographic challenges of Indonesia and perhaps the low levels of financial inclusion. If banks are to achieve their required return on equity, higher overhead costs will demand a higher source of income either through fee income or NIM.

Low fee income also pushes NIMs up…

Fee income in Indonesia is lower than in other countries, leading to greater reliance on interest income (Figure 20). This implies a need for a higher NIM to generate the same return on equity. It is notable that the return on equity for Indonesian banks is not higher than in comparator countries. This does not necessarily mean that the banks are highly competitive. It would be equally possible to arrive at this outcome through inefficiencies in some areas which are compensated by high interest margins.

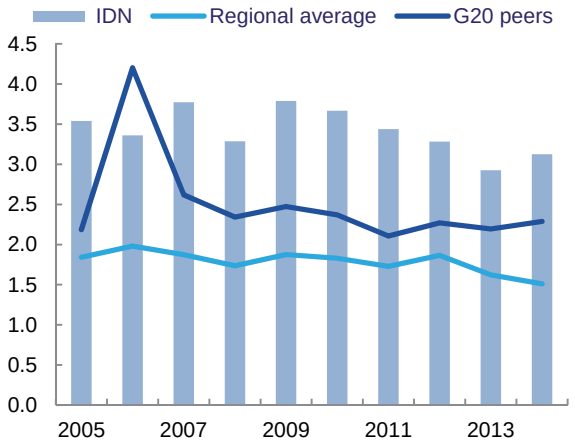
… as do high capital ratios…

It is also the case that capital ratios are slightly higher in Indonesia, which in turn increases pressure for greater income and also higher interest margins. According to

[13] ASEAN peers include Malaysia, the Philippines, Singapore, Thailand, and Vietnam; G20 peers – China, India, Mexico, South Africa, and Turkey.

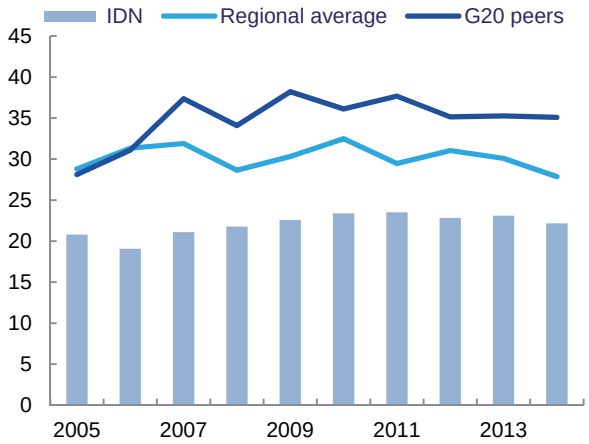
Bankscope data, capital-to-asset ratios in Indonesia were some 2 percent higher than in regional peers and 4 percent higher than in G20 peers in 2014. Higher capital also contributes directly to NIM, as it increases the amount of earning assets without a commensurate interest expense.

Figure 19: High overhead costs partly explain higher NIMs…
(overhead costs as a share of total assets, percent)



Source: Bankscope; World Bank staff calculations

Figure 20: … as does low fee income
(non-interest income as a share of total income, percent)



Source: Bankscope; World Bank staff calculations

… and lower loan loss provision

The most interesting component of NIM is that which relates to provisioning (i.e. an expense set aside as an allowance for bad loans). Non-performing loans (NPLs) have been historically high in Indonesia but have improved, this will have increased the NIM. According to Bankscope data, NPLs in Indonesia in 2010-2014, at 2.0 percent of gross loans, have been lower than in countries, such as Germany (2.8 percent) and the Netherlands (3.0 percent). It might be argued that the effect of global market conditions, the reduced prices of commodities, and the slower pace of growth in China could contribute to an economic environment in Indonesia which requires an increase in provisioning. The banks' 2016 first quarter results would suggest that this trend may be forming.

b. What are the underlying structural factors behind high NIMs?

Regression analysis helps identify the structural factors behind high NIMs

While the breakdown of the components of NIM explains the likely entry point for high interest margins in Indonesia, it does not explain what are the underlying factors in the economy which bring this about. For this purpose a regression analysis is conducted, following the academic literature.

One such factor is shallow financial markets

The results show that the limited number of non-bank financial institutions and underdeveloped equity and debt markets lead to few options for borrowers other than bank loans. In 2015, banks held 79 percent of the financial system's total assets. The value and number of stock issuances have declined since 2013. Corporate debt as a share of GDP in Indonesia is the lowest among ASEAN peers, falling behind the Philippines. Global studies point to the important role that a functional debt market can have, providing borrowers an alternative to commercial bank financing. Moreover, as international guidelines for bank capital have become stricter in recent years, in many countries the debt markets now act as an important

conduit for longer-term financing and risks that are incompatible with the short-term, highly leveraged structure of commercial banks.

Although the banking sector is not highly concentrated, there are signs of weak competition

However, the banking sector in Indonesia is not excessively oligopolistic. The Herfindahl index, a measure of market concentration, based on the total assets of the top 15 banks was 0.049 in 2015, down from 0.058 in 2011.[14] Indonesia compares favorably against other countries. For example, the Herfindahl index is 0.068 for all of the banks in the European Union, 0.210 in the Netherlands, and 0.308 in Finland. This is reflected also in the lower concentration amongst the largest institutions: the biggest 13 banks in Indonesia hold around 83 percent of the assets, a figure matched or exceeded by the top 5 banks in Belgium, Estonia, Netherlands or Finland.[15] However, low market concentration does not preclude uncompetitive behavior by banks (and vice versa). The lack of variance in interest margins discussed above may point to low interbank competition and a high degree of discretion in setting lending rates.[16]

Government borrowing reduces NIMs

The fiscal balance emerges as an important determinant of NIM. Although the analysis presented here does not identify the transmission mechanism, it is likely that this reflects pressure on deposit rates as banks and the Government compete for funds. Government bonds are a substitute for time deposits. The high loan-to-deposit ratio, at 93. 3 percent in 2014, has been a potentially exacerbating factor in this regard, as bank liquidity has tightened since 2009.

c. Inducing banks to lower rates can hurt long-term growth

Interest rate caps have hurt long-term economic growth…

Turning to the issue of constraining bank interest rates, there is a long history of governments across the globe seeking to cap rates on lending and a comprehensive literature has been developed to addresses the related arguments.[17] The evidence indicates that placing caps on interest rates is detrimental to long-term economic growth for several reasons.

… by limiting financial inclusion…

First, the very high interest rates associated with microfinance (above 40 percent per year in some countries) can be justified by the small loan size and high operating costs.[18] Even for larger loans, attempts to impose artificially low interest rates may exclude low-income households that want to borrow and would be creditworthy at the high rates needed to cover the costs of processing the loans. Although many countries still have interest rate ceilings, these have been relaxed or qualified by exemptions.[19] Where constraints on interest rates exist, banks become more and more selective as to who they have as clients, and increasingly exclude poorer clients with high transaction costs relative to income.

[14] The U.S. Department of Justice describes a market with a Herfindahl index between 0.15 and 0.25 as "moderately concentrated."
[15] Source: European Central Bank, 2014, Structural financial indicators.
[16] An analysis of coordinated behavior by banks, which is beyond the scope of this article, would be needed to provide evidence of low market competition.
[17] Notably in Demirguc-Kunt, A., T. Beck, and P. Honohan, 2008, "Finance for all? Policies and pitfalls in expanding access," Washington, DC: World Bank.
[18] See various publications prepared by the Consultative Group to Assist the Poor (http://www.cgap.org/publications)
[19] See Policis, 2004, "The effect of interest rate controls in other countries;" Helms, B. and X. Reille, 2004, "Interest rate ceilings and microfinance: the story so far," CGAP Occasional Paper No 9.

… imposing additional fees and unnecessary services…

Second, it is sometimes argued that interest caps are necessary, as lenders have an oligopolistic position which allows them to extract rent through excessive rates. While the need to respond to monopolistic practices is real, this should be done through increasing competition in the sector. Otherwise, banks will use their market power to introduce opaque cost structures, such as fees and penalties, which result in costs of credit greatly exceeding stated interest rates. Another way this is manifested is through bundling of products whereby borrowers have to buy other services to gain access to loans.

… reducing innovation…

Third, appropriate incentives are key to encouraging banks to extend services to excluded segments of the population. Particularly, banks will not invest in new technology if they cannot recover their costs and will seek to reduce the quality of services provided to accommodate lower interest rates.

… limiting banking services to higher quality clients and existing borrowers…

Fourth, if banks are not allowed to set interest rates which compensate them for the greater risk associated with lending to smaller and younger enterprises, they are likely to concentrate on larger, established companies, with whom they already have a lending relationship. This way they can avoid the higher transaction costs of a new lending relationship.

… leading to undercapitalization of firms' operations…

In addition, research in Europe indicates that, in countries which cap interest rates, companies are more likely to over-borrow, leading to greater defaults. In other words, cheaper credit encourages companies to overemphasize debt in their capital structure.[20] This tendency is also seen among retail borrowers in the US, where defaults on credit cards are significantly higher in states which cap interest rates.[21]

… and creating incentives for poorly governed credit allocation

Finally, in any market where access to a product is artificially constrained, incentives are created for the allocation of the scarce product, providing opportunities for corruption. It is also important that the focus on interest rates should not ignore depositors, who are entitled to a fair rate of return. Recent history provides many examples whereby financial repression has reduced rates of return available to savers. Financial repression was practiced in OECD countries, such as the UK and US, until market liberalization in the 1980s. More recent examples, including in East Asia, have been linked to the development of shadow banking activities and over-investment in capital equipment.

The sustainable solution is to increase market size and improve competition

Overall, the evidence suggests that while there can be instances of banks setting interest rates which are too high and occasions when credit quality is adversely affected (as entrepreneurs will only borrow for high risk, high return investments), the solution is to seek to increase the size of the market and to pursue initiatives which increase competition amongst banks. Interest rate caps only reduce competition.

[20] Policis, 2006, "Economic and social risks of consumer credit market regulations."
[21] See footnote 17.

2. The price of trade protectionism in Indonesia

The economic policy packages have dismantled some non-tariff barriers…

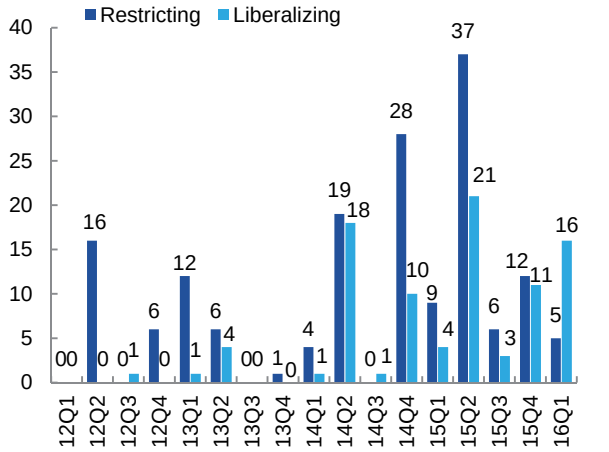
Indonesia has recently started to reverse the trade protectionist trends of previous years. Since September 2015 the government has announced and partly implemented a series of 12 reform packages with a strong focus on reducing non-tariff barriers. For example, the Ministry of Trade abolished several import and export requirements: e.g., product-specific import and export licenses for a wide range of products and applying Indonesian language labels to imported goods in producer countries before shipment. In addition, the National Agency of Drug and Food Control (*Badan Pengawas Obat dan Makanan*, BPOM) established priority service for pharmaceutical and food inputs and processed drugs and foodstuffs, which covers more than 2,000 product lines.

… resulting in more trade-liberalizing measures than restricting ones being implemented so far in 2016

These reforms follow a period during which Indonesia was among the world's top users of trade barriers according to Global Trade Alert data (Figure 21). Over the last four quarters, Indonesia's ratio of liberalizing relative to restrictive measures has increased, a trend that has strengthened in the last two quarters, culminating in Q1 2016 with three times more trade liberalizing than restricting measures. The country's world ranking in terms of restrictive measures has dropped for three consecutive quarters – from number 3 in Q2 2015 to number 8 in Q1 2016. Its ranking in terms of liberalizing measures improved from number 12 to number 6. These trade reforms are an important change in direction, given the previous rise in trade protectionism which was implemented mainly through a more intense use of non-tariff measures (NTMs).

Figure 21: An incipient trade liberalizing trend has been observed

(number of trade liberalizing and restricting measures)



Source: Global Trade Alert accessed on May 10, 2016; World Bank staff calculations

a. Why are non-tariff measures potentially harmful?

While Indonesia has been slashing import tariffs, it has increased the use of NTMs

Like most countries in the world, Indonesia has progressively slashed its import tariffs over time to the point where they no longer represent a major barrier to trade for the vast majority of products.[22] The average applied tariff rate in Indonesia declined from 7.7 percent in 1996 to 2.3 percent in 2013.[23] On the other hand, the use of NTMs has proliferated. According to data collected by the World Bank and Australia Indonesia Partnership for Economic Governance (AIPEG), the number

[22] An important exception is the increase in Indonesian import tariffs on a wide range of consumer goods introduced in August last year.

[23] Averages are computed by weighting each tariff by the corresponding product import shares for each partner country (source: World Bank's World Development Indicators). To the extent possible, specific rates have been converted to their ad valorem equivalent rates and have been included in the calculation of weighted mean tariffs.

of product-level NTMs on Indonesian imports doubled between 2009 and 2015, expanding the number of products covered by NTMs by over 38 percent.[24,25] On the export side, where NTMs are less frequent, the number of product-level NTMs grew fourfold and the number of products covered increased threefold.

NTMs are aimed at protecting consumers but can also significantly distort domestic markets

NTMs often respond to societal demands for product traceability and consumer protection against various hazards, such as unhealthy foods, environmentally damaging products, fraudulent pharmaceuticals, dangerous toys, and so on.[26] But they can also act as significant barriers to trade and, in certain instances, are used by governments to pursue purely protectionist objectives as global trading rules have made the use of import tariffs more difficult. NTMs can protect domestic producers or intermediaries, thus increasing their rents at the expense of higher prices and/or lower availability of the product for consumers.

NTMs in Indonesia are a mix of highly restrictive—product specific measures and less restrictive—widely applied measures

In Indonesia, many NTMs impose quantitative restrictions on exports and imports, such as quotas (e.g., on wheat flour imports), bans (such as on exports of unprocessed or semi-processed mineral ore, logs, and rattan), and mandatory import licensing (e.g., for sugar, rice, alcoholic beverages, fruits and vegetables, livestock and livestock products, basic steel products, cellular telephones, and tablet computers). These measures can potentially greatly distort domestic markets, as they significantly restrict the ability to import these products. Other NTMs are less trade restrictive but cover many products. For example, pre-shipment inspections are required on imports of most processed foods and beverages, personal care products, traditional medicines, virtually all apparel and other finished textile products, footwear, many household electrical appliances, consumer electronics products, and children's toys. Quarantine inspections are applied to almost all primary and manufactured products containing animal or plant materials. These inspections increase both the time and the costs of trading, which can increase the domestic price and reduce the availability of the products.

b. What is the impact of NTMs on domestic prices?

This section presents estimates of the cost of trade distortions on Indonesia's economy

Irrespective of their intended objective, one of the major effects of non-tariff measures is to raise the domestic price of traded goods by increasing the costs of trading and/or reducing the domestic supply of goods. The nominal rate of protection (NRP) provides an estimate of the impact of all trade distorting measures (tariff and non-tariff) on domestic prices. These estimates are important as they illustrate the significant cost of trade distortions on the Indonesian economy.

For example between 2011 and 2014, NTMs resulted in a domestic price of wheat flour 22-percent higher than

The ideal NRP estimation approach – which can be applied only to a few products owing to lack of data – measures the difference between the change in the Indonesian price of a good before and after the introduction of a trade measure and the same change for that good in a reference market where the trade measure was not applied. For example, the retail price of wheat flour in Indonesia remained high after 2008, while the wholesale price of wheat flour in the US declined sharply (Figure 22). This increase in the spread between the two prices resulted from a

[24] This article presents some of the findings of Marks, S.V., September 2015, "Non-tariff trade regulations in Indonesia: Measurement of their economic impact": http://research.pomona.edu/stephen-marks/files/2016/05/Analysis-of-NTMs-in-Indonesia.pdf

[25] A recent more comprehensive data collection by the Economic Research Institute for ASEAN and East Asia suggests that the share of products subject to at least 1 NTM is 62 percent in Indonesia.

[26] See Cadot and Malouche (2012) "Non-tariff measures – a fresh look at trade policy's new frontier," Washington DC: The World Bank.

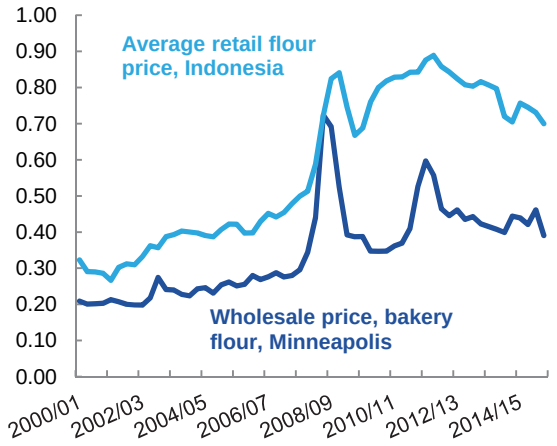
without the measures

series of policy actions taken by the Government between 2008 and 2014, including anti-dumping measures and import quotas.[27] As a result, in 2014 wheat flour imports were 73.6 percent lower than in 2011 and the price of wheat flour was 22 percent higher than would have been the case in the absence of these measures.[28]

In another case, the 2012 ban on horticultural imports at the Jakarta port caused an 8-percent increase in their prices in the capital

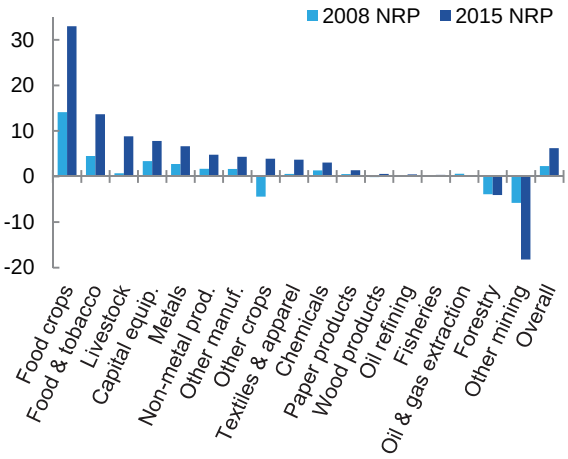
Another example of the cost of trade distortions is the ban on the use of the Jakarta port, *Tanjung Priok*, to import horticultural products into Java. Since June 2012, products which used to be imported largely via *Tanjung Priok* have had to go through the Surabaya port, *Tanjuk Perak*.[29] A comparison of the change in prices for fruits and vegetables in Jakarta vis-à-vis the change in Surabaya, while controlling for the changes in overall prices in the two cities, reveals that this restriction has raised horticulture prices in Jakarta by 8.2 percent compared to Surabaya.

Figure 22: Trade restrictions kept domestic wheat flour prices high after 2008
(US and Indonesian wheat flour prices, USD/kg)



Note: The US reference price is that of the city of Minneapolis.
Source: Ministry of Trade of Indonesia; Wheat Yearbook of the U.S. Department of Agriculture; World Bank staff calculations

Figure 23: Estimates suggest that recent trade policies increased prices across sectors
(price difference compared to a free trade scenario, percent)



Source: Marks and Rahardja (2012);[30] World Bank staff calculations

The results show that recent trade measures have contributed to higher

The estimates suggest that the overall Indonesian NRP has almost tripled between 2008 and 2015 in line with the increase in NTMs (Figure 23). The most heavily protected sector is food crops: domestic food prices in 2015 were, on average, 33 percent higher than would have been the case in the absence of trade restrictions.

[27] Specifically, the Government initiated anti-dumping investigations in October 2008 and eventually imposed antidumping duties on wheat flour imports from Turkey in 2009, a temporary 20 percent safeguard duty on all imports of wheat flour, and temporary anti-dumping duties on India, Sri Lanka, and Turkey in 2013, followed by temporary across-the-board import quotas in 2014.

[28] This approach is complemented by other, less data-intensive methods that allow the calculation of the NRP for a wide range of goods in Indonesia. One approach is to compare retail prices of identical products in Jakarta and Singapore while accounting for the cost of living difference between the two cities. As Singapore has zero import tariffs on almost all items, and is relatively free of trade restrictions, such a comparison should isolate the price effect of trade restrictions in Indonesia. The second method is to compare the domestic wholesale price of a good, net of the wholesale margin and handling charges, with its border price inclusive of cost, insurance and freight. The two prices should be identical unless there are costs associated with crossing the border.

[29] Horticultural products may be imported through Jakarta international airport Soekarno-Hatta but that is only viable for high-end products.

[30] Marks, S. V. and S. Rahardja, April 2012, "Effective rates of protection revisited for Indonesia," Bulletin of Indonesian Economic Studies 47, 53–80.

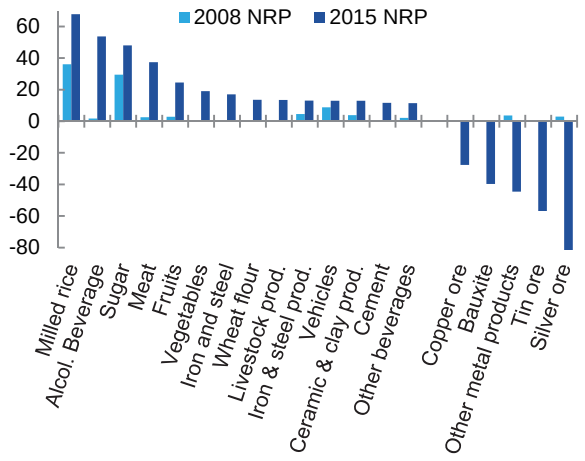
domestic prices, especially for food

Moreover, the NRP for food crops was more than double that in 2008. Similar increases in NRP were observed in other major sectors, such as processed food, beverages and tobacco (from 4.5 in 2008 to 13.7 percent in 2015) and machinery and transport equipment (from 3.4 to 7.8 percent). The increase in NRP was even larger for livestock and their products, with a jump from 0.7 percent in 2008 to 8.8 percent in 2015. These figures indicate that trade policies keep prices of food and capital equipment products high, imposing a rising cost on households and on domestic producers.

Indonesian prices of milled rice, sugar, meat, and fruit are more than 20 percent higher as a result of trade restrictions

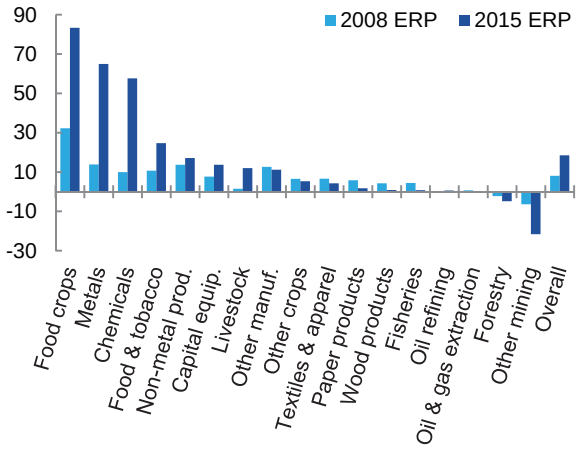
At the product level, consumer goods, and food products in particular, comprise eight of the ten products with the highest NRP in 2015 (Figure 24). In 2015, the domestic price of milled rice was 68 percent higher than it would have been in the absence of trade measures. Alcoholic beverages, sugar, meat, and fruit all had NRP above 20 percent in 2015, up from levels close to zero in 2008 (except for sugar). While trade measures did not affect the price of cement in 2008, they had raised it by 11.6 percent relative to the free trade price by 2015.

Figure 24: Consumer goods, in particular food, saw the largest price rises due to trade measures
(price difference compared to a free trade scenario, percent)



Source: Marks and Rahardja (2012); World Bank staff calculations

Figure 25: Rates of protection are even higher when calculated in terms of value added
(difference in value added per unit of output compared to a free trade scenario, percent)



Source: Marks and Rahardja (2012); World Bank staff calculations

In a few cases – non-oil and gas mining and forestry products – domestic prices are lower due to subsidies

At the other end of the spectrum, non-oil and gas mining, as well as the forestry sector, have negative NRPs. This indicates that the domestic price of these products is subsidized, for example via export taxes and/or export bans. This subsidy increased between 2008 and 2015. For example, the prices of silver ore (NRP in 2015 of -90.5 percent, from +2.9 percent in 2008) and tin ore (-56.8 percent, from 0 percent in 2008) have become highly subsidized. These large negative NRPs reflect the impact of the export ban on unprocessed minerals, the aim of which was to stimulate domestic value addition.

Trade-protection driven price increases are even higher after accounting for the

Higher prices in one sector due to trade measures also impact the rate of protection in other sectors of the economy which use those goods as inputs to production. By accounting for these effects, the estimation of the effective rates of protection (ERP) provides a more complete picture of the economy-wide price impact of trade-distorting measures, amplifying the value of the distortion captured in the NRP. The ERP is defined as the proportion by which value added per unit of

effect on input prices…

output with distortive policies exceeds the level under a free trade scenario.[31] In the ERP case, the prices of food crops are over 83 percent higher in 2015 compared with a free trade scenario (Figure 25). Similarly, the domestic prices of metals and chemicals are 65 percent and 58 percent higher, respectively, due to trade restrictions. Overall protection granted to producers in these sectors hinges not only on trade barriers on imports of the same products, but also on trade subsidies for the inputs they use (e.g., fertilizers for food crops, minerals, etc.). As in the case of NRPs, the estimates show a marked increase compared to 2008 across sectors.

… leading to an overall increase in the cost of living in Indonesia of 7.4 percent

The aggregation of the ERP estimates suggests that, in 2015, overall trade policies have increased the cost of living in Indonesia by 7.4 percent compared to a scenario in which no trade restrictions are imposed. Much of this effect is driven by the rice import restrictions: if the non-tariff restrictions on rice imports were allowed to lapse and only rice import tariffs were maintained, the trade policy impact on the cost of living would drop to 4.7 percent. Finally, if only import tariffs and export taxes remain in effect at their present levels, the increase in the cost of living falls to only 2.9 percent, confirming that most of the effect on the cost of living in Indonesia comes from NTMs.

c. Are domestic producers being protected?

Data suggest that international rice price movements are transmitted to domestic wholesale but not producer prices…

One of the most prominent public policy objectives of trade-restrictive measures is the protection of domestic producers from import competition. That is evident, for instance, in the case of paddy. The import of (medium-quality) milled rice is subject to a strict monopoly by the state-owned enterprise Bulog. However, data suggest that, while trade protectionism has substantially increased the domestic price of polished rice, it does not appear to have impacted significantly the prices rice farmers charge. During 1998-2003, when the rice import monopoly was eliminated, changes in international rice prices were to a large extent transmitted to domestic wholesale prices but not to rice producer prices.[32] On the other hand, during the period with trade restrictions (post-2003) international price changes were passed through neither to wholesale, nor to producer prices.

…consistently with high market power of wholesalers and

These findings suggest that trade restrictions largely insulate Indonesian consumer rice markets from international price movements. The lack of transmission to farmer prices during the trade liberalization period is consistent with the high degree of market power by wholesalers and millers vis-à-vis rice farmers.[33] This asymmetric

[31] The ERP is estimated by using sectoral NRPs matched with input-output tables that inform what amount of inputs a specific sector uses from the other sectors of the economy. The estimation uses the Humphrey method, which assumes that trade policies affect prices of services directly and indirectly: policies boost the prices of services to the extent that prices of tradable inputs used to produce these services increase and also because workers are assumed to demand higher nominal wages to compensate for higher prices of all goods and services so that their real wages remain constant.

[32] The analysis is based on monthly prices and uses a Vector Error Correction Model. This is a suitable model as the series are co-integrated, as confirmed through the Engle-Granger test. Each of the domestic prices (in first difference) is regressed on the international price (also in first difference) and on its own lag. The results suggest that a 10-percent price reduction in the international price led to a reduction in wholesale prices by 2 percent. On the other hand, there was no statistically significant response of producer prices.

[33] According to the 2015 OECD Services Trade Restrictiveness Index, Indonesia is the country with the highest restrictions to competition in distribution services and the second highest in warehousing services among the 42 countries surveyed. Restrictions include limits to foreign ownership, excessive minimum capital requirements, restrictions on the location of operations, and cumbersome licensing requirements.

millers vis-à-vis rice farmers

market power implies that lower international rice prices are not passed through to producers, as their margins are already squeezed by wholesalers and millers and do not leave room for further downward adjustments in the short run. It also implies that when international prices rise, the increase is retained by wholesalers and not passed through to rice farmers. Hence, trade restrictions may not be an effective tool to protect farmer income, at least in the rice sector.

C. Indonesia 2018 and beyond: A selective look

1. Reviving manufacturing competitiveness

a. Indonesia's manufacturing journey: knocked off course by the 1997 crisis

Indonesia's previous manufacturing prowess plunged after the Asian financial crisis…

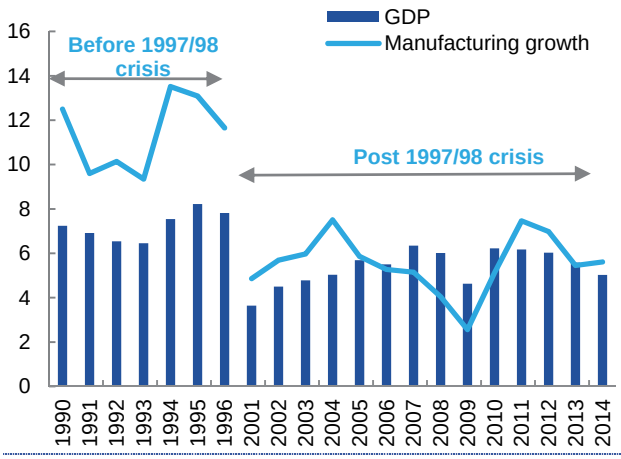
Indonesia's manufacturing growth experienced a structural break following the 1997/98 Asian financial crisis. Real manufacturing growth plummeted from 11 percent annually between 1990 and 1996 to 4.8 percent in the period from 2001 to 2014. This subdued performance of manufacturing post-2000 ostensibly reduced overall economic growth (Figure 26). The strong correlation between manufacturing growth and overall economic growth is not surprising as manufacturing still represents close to one-fifth of total output and 13 percent of total employment in Indonesia.

… and the country experienced a "premature de-industrialization"

Following a rapid rise in the 1990s, the share of manufacturing in total output has fallen sharply since 2005, giving way to a rapid expansion of low-end services absorbing labor released from rural activities.[34] That services activities take over manufacturing when an economy reaches a high level of income per capita is expected. This is because demand for services increases much more than demand for manufacturing as household income rises.[35] However, in the case of Indonesia, this structural change occurred at a low level of per capita income and before industrialization reached maturity, reflecting a premature "de-industrialization" (Figure 27).[36]

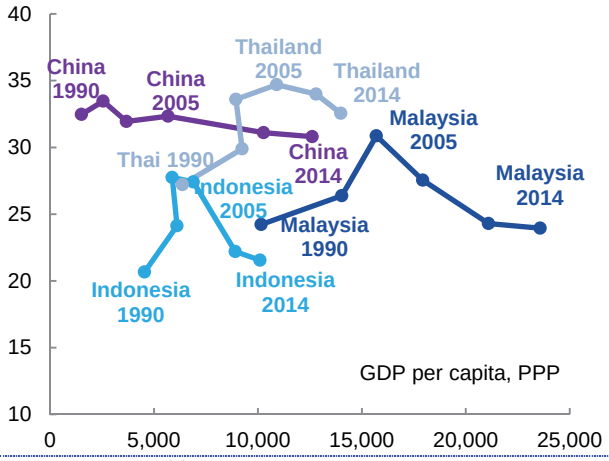
[34] See World Bank, 2014, "Indonesia development policy review: Avoiding the trap."
[35] See Chenery, H., S. Robinson, and M. Syrquin, eds., 1986, "Industrialization and growth: A comparative study," Oxford, U.S.: Oxford University Press for the World Bank.
[36] Rodrik D. (2015) attributes this phenomenon, also observed in a large number of developing countries, to globalization and labor-saving technological progress in manufacturing. See Rodrik, D., 2015, "Premature Deindustrialization," NBER Working Paper No. 20935.

Figure 26: Indonesia's manufacturing growth is no longer what it used to be…
(growth in GDP and real manufacturing output, percent)



Source: World Bank staff calculations

Figure 27: … and the economy de-industrialized prematurely
(manufacturing as a share of GDP, percent)

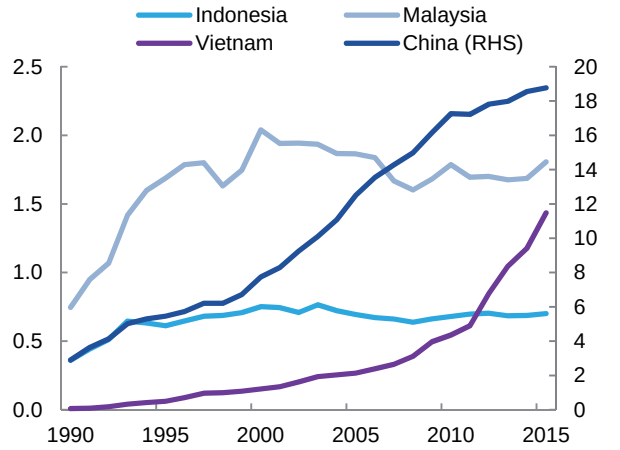


Source: UN-COMTRADE; World Bank staff calculations

Indonesia's global share of manufacturing has stagnated at a low level

The weak performance of manufacturing can also be seen from export data. Once a global manufacturing powerhouse, Indonesia's manufacturing share in global markets stagnated at about 0.6 percent over the past 15 years (Figure 28). Exports stagnated in Malaysia as well, but at double the share of Indonesia. Trends in these two countries are in sharp contrast to China whose share of global demand rose from 2.5 percent to 17 percent. Perhaps more strikingly, Indonesia is now overshadowed by Vietnam, a country that was hardly present in global manufacturing markets in the early 1990s.

Figure 28: Indonesia's global manufacturing market share is low and stagnant
(share in global manufacturing market, percent)



Source: UN-COMTRADE; World Bank staff calculations

Beginning in 2006, commodities overtook manufacturing as Indonesia's largest exports

The subdued performance of manufacturing exports is the flip side of the commodities export boom from 2003 to 2012. Between 2000 and 2010, benchmark international prices for coal, crude palm oil, rubber and crude oil each rose threefold in real US dollar terms. As a result, commodities overtook manufacturing as Indonesia's largest export by 2006. Today, seven out of the top ten export products of Indonesia are commodities and about 60 percent of the country's exports are commodities or commodity-related. Most of the commodities are exported unprocessed, suggesting a weak link between manufacturing and the commodities sectors.

b. Manufacturing exports: drilling down beyond the aggregate numbers

How has Indonesian manufacturing changed since the 1997/98 crisis?

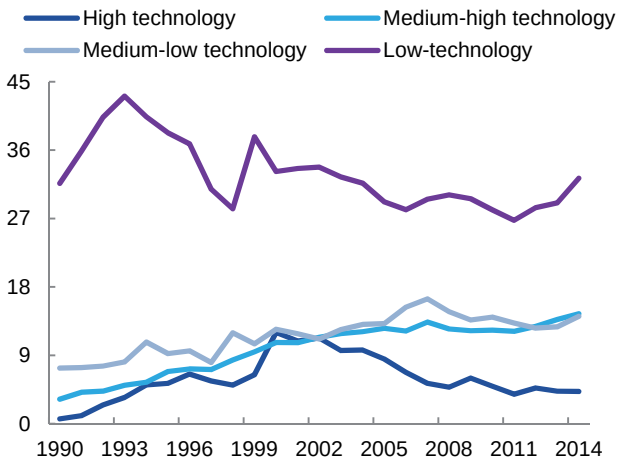
With the sharp decline in commodity windfall export revenues since 2012, boosting non-commodity exports has emerged as a key priority for Indonesia. To inform industrial policies, it is important to go beyond the aggregate numbers and examine export dynamics at the industrial branch level. Which specific industries drove manufacturing exports over the past 25 years? How did the manufacturing export basket change? What is the contribution of low-, medium- and hi-tech sectors to export performance?

Unfortunately, high-tech manufacturing exports have declined sharply

Using the methodology of Diop and Ghali (2012),[37] Indonesia's export products are classified by level of technology.[38] The analysis shows that the merchandise export basket is strongly dominated by "low-tech" products (one-third of goods exports in 2014) despite a decline since its peak of 43 percent in 1993 (Figure 29). This decline has given way to a steady increase in medium tech industries' exports which, in 2014, accounted for 28 percent of total merchandise exports, from 10 percent in 2000. However the sharpest trend is that of high-tech industries which, after an initial rise in the 1990s (from 1 percent in 1990 to 12 percent in 2000), declined sharply in subsequent years to 4 percent in 2014.

Figure 29: Low-tech products dominate Indonesia's merchandise export basket

(share in total merchandise exports, percent)



Source: UN-COMTRADE, HS4 digits and OECD industrial code; World Bank staff calculations

Within low- and medium-tech industries, palm oil, rubber tires and cars stand out as Indonesia's best export performers

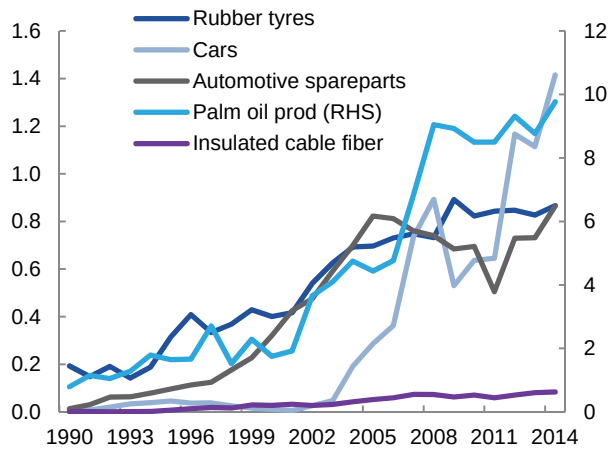
The steady growth in medium-tech exports reflects the strong performance of palm oil, rubber tires (medium-low-tech), completely built cars, automotive spare parts and insulated cable fibers (medium-high) (Figure 30). Rubber tire exports grew by an average of 24.8 percent per year between 2002 and 2011.[39] Car exports grew from 1,258 units in 2002 to 207,691 units in 2015. This expansion is impressive, but it lags Thailand's, which exports six times more cars than Indonesia and is the regional car export hub.

[37] N. Diop and S. Ghali, 2012, "Are Jordan and Tunisia's exports becoming more technologically sophisticated? Analysis using highly disaggregated export databases," MNA Working Paper No. 56, the World Bank.

[38] Products are captured at the HS-6 digit level with their sector of origin, using ISIC REV2 industrial codes. Further classification by level of technology (OECD's low, low-medium, medium-high and high tech) allows us to examine the specific products that drove growth and the extent to which Indonesia climbed the technological ladder between 1990 and 2014.

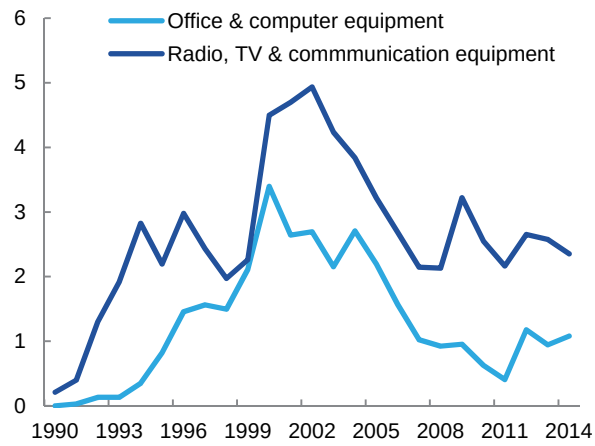
[39] Recent foreign direct investment could help this sector grow further. In 2013, Hankook Tire from the Rep. of Korea and Pirelli Tyre S.p.A of Italy opened their global production plants in Indonesia (in cooperation with PT. Astra International).

Figure 30: Several medium-tech exports have grown dramatically…
(share in total merchandise exports, percent)



Source: UN-COMTRADE, HS-4 digits and OECD industrial code; World Bank staff calculations

Figure 31: … while hi-tech exports have shrunk in recent years
(share in total merchandise exports, percent)



Source: UN-COMTRADE, HS-4 digits and OECD industrial code; World Bank staff calculations

Hi-tech exports were knocked off course after the 1997 crisis

Exports of office and computer equipment, radio, and TV and communications equipment plummeted following the 1997 crisis (Figure 31). The only bright spot in the hi-tech sector is the rise of drug and medicine exports from a very low basis.

c. Regaining competitiveness in manufacturing

i. Keeping inflation low and avoiding excessive real exchange appreciations

Real effective exchange rate appreciations played a key role in the weak performance of manufacturing in 2003-2014

A key factor behind the relative decline in Indonesia's manufacturing sector is the appreciation of the real effective exchange rate (REER). The REER is the nominal effective exchange rate (the value of a currency against a weighted average of several foreign currencies) divided by a relative price deflator or index of costs. The commodity boom from 2003 to 2012 created revenue windfalls, supported capital inflows and led to increased demand for non-tradable services (e.g., transport, logistics and real estate) and higher prices for these services. This led to an appreciation of the REER (Figure 32).

When prices rise the manufacturing sector suffers most

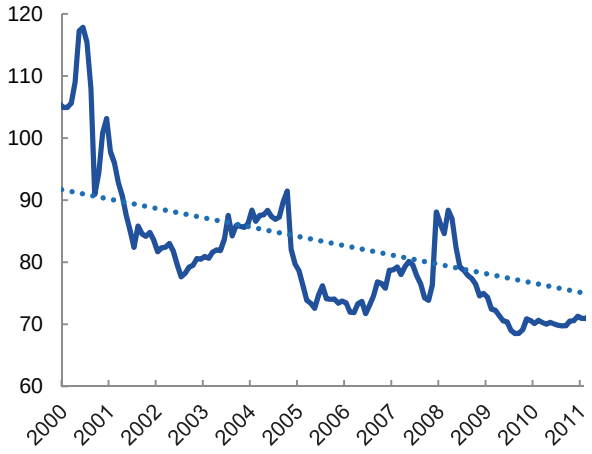
Firms in non-tradable sectors (e.g., hotels, restaurants and the retail trade) can accommodate increasing prices by passing them on to consumers. In the tradable sectors such as manufacturing, however, firms are price-takers and cannot pass on the increases in non-tradable prices. Thus, an increase in the price of non-tradable goods relative to tradable goods is an obstacle for manufacturing industries because it renders these sectors less profitable than the services sector or the booming resources sectors.[40]

[40] For related theoretical developments, see Corden, W. M., 1984, "Booming sector and Dutch disease economics: Consolidation and survey," Oxford Economic Papers 36, 359–80; and Corden, W. M. and J. P. Neary, December 1982, "Booming sector and de-industrialisation in a small open economy," Economic Journal, 92(368), 825–48. For empirical tests of these concepts, see Rodrik, D., 2008, "The real exchange rate and economic growth," Brookings Papers on Economic Activity 2008(2); and Havrylyshyn, O., 2010, "Does the global crisis mean the end of export-led open-economy strategies?", Paper prepared for the World Bank.

Going forward, the REER could support exports, provided that inflation is kept low

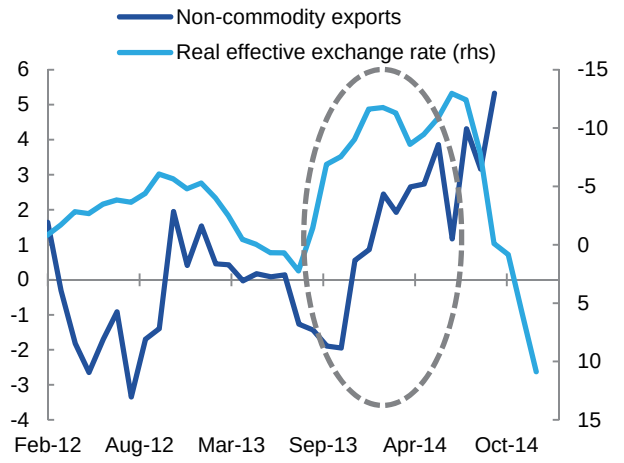
On account of mainly global factors (e.g., US dollar strength and low commodity prices), the Rupiah is no longer pressured toward sustained appreciation (Figure 33). For instance, the Rupiah has depreciated by 16 percent in nominally trade-weighted terms since December 2012. Furthermore, with low commodity prices, the relative attractiveness of manufacturing activities for investors seeking high returns is restored. Going forward, the REER could support exports, provided that inflation is kept low. Although inflation is forecast to be lower than in the past three years (3.9 percent in 2016 against 6.5 percent on average from 2013 to 2015), there is evidence that trade restrictions (tariff and non-tariff barriers) lead to higher domestic prices both for consumers and for producers (see Part B.2). It is thus important to reduce those barriers to support competitiveness.

Figure 32: The REER appreciated strongly between 2000 and 2011…
(index, 2000=100)



Note: A decline in the REER indicates appreciation.
Source: BIS; World Bank staff calculations

Figure 33: … with recent depreciation associated with rising manufacturing export growth
(non-commodity export growth yoy, LHS; REER change yoy, RHS; percent)



Note: A decline in the REER indicates appreciation.
Source: BIS; World Bank staff calculations

ii. Raising labor productivity

Although Indonesia has the lowest wage cost in Asia, the advantage is lost due to low productivity

Indonesia's labor cost patterns are striking. While Indonesia has the lowest wage cost in US dollar terms in Asia, this advantage is lost when adjusted for labor productivity (Figure 34 and Figure 35). In 2014, unit-labor costs—the ratio of how much workers are paid to how much they produce—were higher than in the Philippines, Vietnam and Malaysia, not because of how much workers were paid but because of how little they produced (the recent dramatic rise in unit labor cost in Thailand reflects the same issue). Malaysia illustrates how high labor productivity is crucial for cost competitiveness. Despite high manufacturing wages, Malaysian workers remain competitive because of their high productivity. Their unit labor cost is slightly higher than Indonesia's, despite wages that are 7 to 8 times higher. Wages in China have increased threefold since 2005, but lack of data prevents us from calculating unit labor costs. It is not clear, therefore, that China is losing cost-competitiveness, since rising wages may be offset by productivity increases.

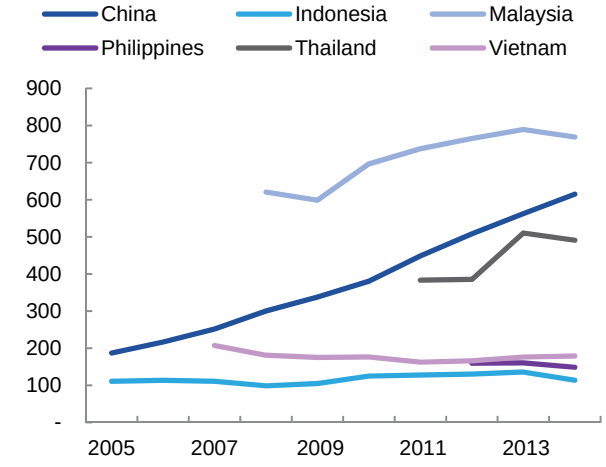
The commodities boom reversed Indonesia's rise up

Labor productivity depends on the types of production (for example, low versus higher value-added production), levels of technology used, skill levels of workers, and work disruptions. Indonesia gradually ascended the manufacturing value chain in the 1990s, but this trend was reversed by the commodities boom and as high-

the manufacturing value chain

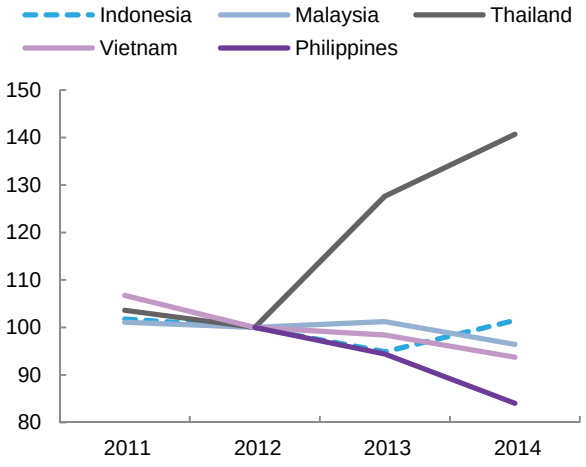
technology exports as a share of total manufacturing exports declined. What is now needed is to attract FDI again into manufacturing, but within a context of a well-designed industrial strategy focused on increasing value-addition in order to increase the overall productivity of the manufacturing sector.

Figure 34: Average monthly wages in manufacturing are low in Indonesia…
(in real 2012 US$)



Source: CEIC; World Bank staff calculations

Figure 35: … but unit labor costs are relatively high
(2012 = 100)



Source: CEIC; World Bank staff calculations

iii. Reducing logistics and doing business costs

Indonesia has higher indirect costs than its peers

In addition, surveys show that Indonesian firms incur large indirect costs due to poor logistics, gaps in infrastructure and restrictive licensing and permitting procedures. This places firms located in Indonesia at a disadvantage to their peers operating in countries where these costs are lower. Measures to reduce these costs, as well as improved trade facilitation and a reduction of non-tariff measures, are especially important in a context of growing global value chain integration where efficient importing is critical to export success.

Poor logistics is one of the main reasons for high costs

Good logistics is a vital prerequisite for supplying domestic markets efficiently and competing internationally. At about 24 percent of GDP, the cost of logistics—moving goods around the country, as well as in and out—is high in Indonesia, while Thailand spends about 16 percent of GDP.[41] For Indonesia, this difference amounts to an additional US$70 billion in costs per year.

Transport and container-handling costs are the main contributors to high logistics costs

A recent World Bank survey of manufacturers across Indonesia's major agglomerations shows a breakdown of logistics costs. Average total logistics costs reflect transport and container-handling costs (45 percent of the total), inventory costs (26 percent), warehousing (17 percent) and logistics administration (17 percent). Inventory costs are clearly much higher than in some of Indonesia's competitors: these are only 13 percent of total costs in Malaysia and 16 percent in Thailand.

[41] See Part C.1 in the March 2016 *IEQ* for a more detailed discussion of the challenges Indonesia's freight logistics system faces.

Firms hold high inventories to protect them from uncertain hinterland connections

High inventory costs reflect uncertainties in the supply chain. A key source of uncertainty lies in hinterland connections. The costs of bringing containers to Jakarta's main port, Tanjung Priok, are double those in Malaysia, although distances are similar. A survey of 83 trucking firms operating in Greater Jakarta highlights why: prolonged idle and waiting times due to congestion; long queuing at the port; and low efficiency in synchronizing cargo deliveries and pick-ups.

Obtaining permits, paying taxes and enforcing contracts are difficult

Regulatory procedures, licensing and permitting at the central level are also complex, imposing additional delays and costs. Along with construction permits, paying taxes and enforcing contracts are among the most cumbersome procedures globally (World Bank Group, 2016 Doing Business survey).[42]

iv. Devising a sound industrial strategy

Indonesia's experience suggests a lack of a sound industrial strategy

Finally, the fact that hi-tech exports (mainly electronics) quasi-vanished, following the 1997 crisis, suggests the absence of a solid, home-based industrial strategy in Indonesia. Indonesia received significant FDI from Japan, Hong Kong, Taiwan, South Korea and Singapore in the early 1990s. However, technology transfer or capacity development in terms of product design, product engineering and product development, which require some government involvement, was limited. The manufacturing operations focused mainly on blending and assembly, making Indonesia vulnerable to changes in multinationals' location strategies because no country can be competitive in assembly and light manufacturing forever. A key lesson from Indonesia's own experience is that to upgrade industries and climb the technological ladder, government's involvement and partnership with the private sector is required.

Experience in East Asia and around the world can inform Indonesia's new industrial strategy

East Asian countries, such as Japan, Korea, Singapore and Taiwan, provide good examples of industrial policies implemented successfully. But many developing countries have attempted to mimic this experience and failed because government support is captured by vested interests. Indonesia can thus draw on the cases of successes and failures around the world in devising a sound industrial policy today. What is needed is policy focus and pragmatic, accountable and transparent support to promising industries, such as those that have done well in the past 25 years in spite of many obstacles. Global experience suggests that key principles that underlie such a strategy could be: tying support to clearly defined performance criteria, an emphasis on competitiveness in world markets, and the need to preserve competition.

SEZs can be strategic tools to support industrialization under certain conditions

The government has announced the establishment of many special economic zones (SEZs), which could help to reduce immediately the regulatory burden for promising sectors and provide a hospitable environment to develop a supply base for large investors. China is an example where SEZs have been used to support industrial development in the coastal areas. However, SEZs can be ineffective if planned and designed poorly. Given what is constraining competitiveness in Indonesia (see below), SEZs should be designed as favorable micro-climates for firm productivity growth with a focus on the few sectors that have demonstrated

[42] Indonesia's three worst performance are: starting a business (173rd), enforcing contracts (170th) and paying taxes (148th). On dealing with construction permits, Indonesia is ranked 107th, below the East Asia and Pacific average (the Philippines ranked 95th, China 90th, Thailand 26th and Malaysia 18th).

strong performance and not simply places where firms enjoy tax incentives.[43] In addition, also focusing on the few promising sectors, the government could consider promoting public-private partnerships to close skills gaps through training centers and specific schools. Focused investments in research and development that target promising sectors are also key to move toward the global technological frontier.

A competitive modern service sector is also important

Finally, the industrial strategy should recognize the growing service-intensity of manufacturing and support the availability of efficient, low-cost modern services for manufacturers. This again places a premium on fostering competition and facilitating domestic and foreign investments in these sectors.

d. How to make manufacturing an engine of growth again

Four specific measures would help Indonesia to address these challenges

The end of the commodities boom provides an opportunity for Indonesia to revive its manufacturing competitiveness. Lessons from the country's own experience, the few cases of global successes and the many cases of failures can inform a new industrial strategy in Indonesia. The following are a few concrete measures that could help it succeed.

First, a strategic and transparent partnership with the private sector is important

SEZs could be a strategic tool for the Government's involvement, provided that they are designed as favorable micro-climates for firm productivity growth, with a focus on the few sectors that have demonstrated strong performance and not simply places where firms enjoy tax incentives. Focusing on these sectors, public-private partnerships can be devised to help reduce skills gaps (e.g., through focused provision of training) and to undertake focused investments in research and development targeting promising sectors to support local product development.

Second, maintaining low inflation would help limit REER appreciation

Keeping inflation low through investments in agricultural productivity and through lowering trade barriers would support export growth via lower REER appreciation pressures. Indeed, the prolonged bouts of appreciations of the REER between 2003 and 2012 undermined the competitiveness of manufacturing. The appreciation was largely driven by higher inflation in Indonesia than in trading partners.

Third, higher infrastructure spending and regulatory reform would improve competitiveness

Finally, the Indonesian government has an ambitious plan to close the infrastructure gap in the years to come. It has also started, since September 2015, to address regulatory restrictions through a series of "policy packages". To reduce logistics costs, strengthening inter-agency coordination for better logistics policy reform implementation, reducing regulatory bottlenecks in the supply chain, and closing gaps in logistics infrastructure will be key. If well implemented, these policies could crucially reduce logistics costs and the costs of doing business in Indonesia, supporting the country's overall competitiveness.

Fourth, policy could focus on promising sectors

Not all sectors can underpin a successful industrial strategy and focusing on the country's strengths is crucial. The Government could consider focusing its efforts on supporting the industries that have been growing very fast despite many obstacles and that have demonstrated a strong capacity for export over the past 25 years. Leveraging the country's natural resource abundance, where relevant, should be an integral part of the strategy. The example of rubber tire industries, which use

[43] Economic zones are normally established to act as catalysts for trade, investment, and wider economic growth. In different countries, however, the specific objectives vary, from attracting FDI to creating employment to experimenting with reforms.

the country's own rubber as raw material, process it to match international quality standards and sell the finished products to the growing domestic car industry and in global markets is an illustration of what is possible.

However, implementation challenges should be addressed. A few factors provide entry points

Indonesia is fortunate to have clear reform options and leadership geared toward addressing the country's competitiveness challenges. As is the case for other reform areas however, the difficulty lies in getting the reforms implemented in a complex institutional and decentralized framework. In this context, exploiting any entry point for pushing reforms forward is crucial. The recent "policy packages" provide a framework for implementing many needed reforms. Furthermore, the momentum created by a possible renewal of Indonesia's global engagement through the Trans-Pacific Partnership (TPP) and the free-trade agreement with the EU is another possible anchor for reforms. If Indonesia is to reach its goals, now is the time to pull out all the stops to return to its former status as a manufacturing powerhouse.

2. Fiscal policy could better target inequality reduction

Inequality in Indonesia has risen in the past 15 years

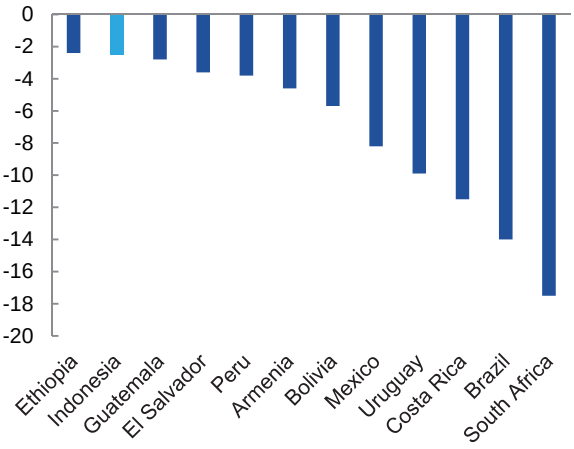
Inequality in Indonesia has risen since the early 2000s and many Indonesians believe urgent action is needed. During the 1997-98 Asian financial crisis, poverty rose sharply, while the Gini measure of inequality fell as the richest were the hardest hit. Since then, the Gini has increased from 30 points in 2000 to 41 points in 2014, its highest recorded level. The consequences of doing nothing to address high levels of inequality can be serious. High inequality can cause economic growth to stall and poverty reduction to slow. There is also evidence that Indonesian districts with higher inequality have a higher incidence of conflict. The public shares this view: 88 percent of Indonesians who were surveyed in 2014 believed that it was urgent for the Government to address inequality.

Fiscal policy is a key option to reduce inequality…

Fiscal policy is one of the main tools available to governments to reduce inequality, both in the long term and the short term. Fiscal policy – how and where the Government spends, and how it raises money to fund this spending – is one of the four main policy responses to address inequality, as identified by a recent World Bank study.[45] In the long term, increased budget allocation on health and more effective spending of the nationally mandated 20-percent budget allocation on education could help poor children and children in remote regions to receive a better start in life and develop the skills needed in the modern workplace. At the same time, greater investments in infrastructure would not only reduce prices for food and other goods consumed by the poor and vulnerable, but also make firms and workers more productive, leading to the creation of more skilled jobs for the higher-skilled workers who are coming out of the improved health and education systems. Additionally, fiscal policy can reduce inequality in the short term by raising revenues through higher taxes paid by richer households and spending in ways that benefit the poor and vulnerable the most.

Figure 36: Fiscal policy in Indonesia has not been very effective in reducing inequality

(reduction in the Gini coefficient from market income to final income, points)



Source: Armenia (Younger et al. 2014); Bolivia (Paz et al. 2014); Brazil (Higgins and Pereira 2014); Ethiopia (Woldehanna et al. 2014); Mexico (Scott 2014); Peru (Jaramillo 2014); Uruguay (Bucheli et al. 2014); Lustig (2014) based on Costa Rica (Sauma et al. 2014), El Salvador (Beneke de Sanfeliu et al. 2014), and Guatemala (Cabrera et al. 2014); South Africa (Inchauste et al. 2014); World Bank staff estimates for Indonesia based on Susenas 2012[44]

[44] Full references in Inchauste, G. and N. Lustig, forthcoming in 2016, "The distributional impact of fiscal policy: Evidence from developing countries", Washington, DC: World Bank.

[45] The 2015 World Bank report "Indonesia's Rising Divide: Why inequality is rising, Why it matters and what can be done" explores the causes, consequences, and recommended policy responses to inequality in greater detail. Available: http://www.worldbank.org/en/news/feature/2015/12/08/indonesia-rising-divide

… and several developing countries have successfully done just that

In a number of countries, often in Latin America where inequality is the highest of any region, tax and spending policy choices have been made with a view to reducing inequality. One can see how inequality in a country changes as a result of fiscal measures, when the distribution of *market incomes* from wages, interest, rents, and private transfers and remittances are compared to *final incomes* after all taxes are paid, services used along with any fees, public transfers received (i.e. after accounting for the full effects of fiscal policy). In Brazil, for example, the Gini coefficient calculated for market income was 14 points higher than the one for final income, indicating a very large reduction in inequality due to fiscal policy in 2009 (Figure 36). In South Africa, the reduction in the Gini coefficient in 2010 was even larger at 17.5 points. Declines of 6 points or more have also been observed in Costa Rica, Uruguay, Mexico and Bolivia in recent years. However, in Indonesia in 2012 the Gini coefficient was reduced by only 2.5 points, the second-lowest, after Ethiopia, in the 12-country sample.

a. Public spending in 2012 did not tackle inequality effectively

A World Bank study examined the impact of fiscal policy on inequality in Indonesia…

A "Commitment to Equity"[46] study was initiated by the World Bank to examine the impact of fiscal policy on inequality in Indonesia using data from 2012. The study looked at 57 percent of total public spending, covering social assistance, energy subsidies, and contributory pensions. The two largest components — energy subsidies (mostly for fuel)[47] and education—together made up 69 percent of total social, subsidy and pension spending (Figure 37). By law education must make up 20 percent of the total budget. Only 5 percent of the budget was spent on health and less than 3 percent on social assistance through cash transfers targeting poor and vulnerable households. For methodological reasons, the study excluded housing and urban spending and other subsidies (mostly for fertilizer and seeds), but these are relatively small.

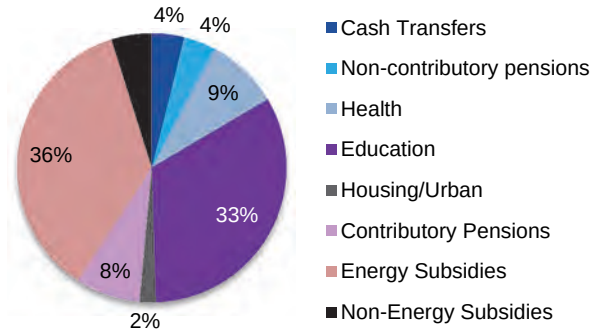
… and found that the Government spent the least on the most effective programs and vice versa

The study found that in 2012 Indonesia spent the least on programs that are most cost-effective at reducing inequality. The Government also spent the most on the least cost-effective programs. This can be shown using an effectiveness index, which is calculated as the change in the Gini coefficient from market income to final income due to a given program divided by the program spending in percent of GDP. Energy subsidies, which are the least cost-effective at reducing inequality, received by far the highest spending in 2012 (3.7 percent of GDP) (Figure 38). In contrast, direct transfers, which scored highest on the effectiveness index, had the lowest spending (0.3 percent of GDP). Education is half as effective as direct transfers, but because larger sums are spent on it (2.6 percent of GDP), it has the largest overall effect. Health is only one-third as effective in reducing inequality as direct transfers and since relatively little was spent on health (0.9 percent of GDP), it had a small overall impact on inequality.

[46] The "Commitment to Equity" is a joint project of the Center for Inter-American Policy and Research (CIPR), Tulane University, and the Inter-American Dialogue, designed to analyze the impact of taxation and social spending on inequality and poverty in individual countries.

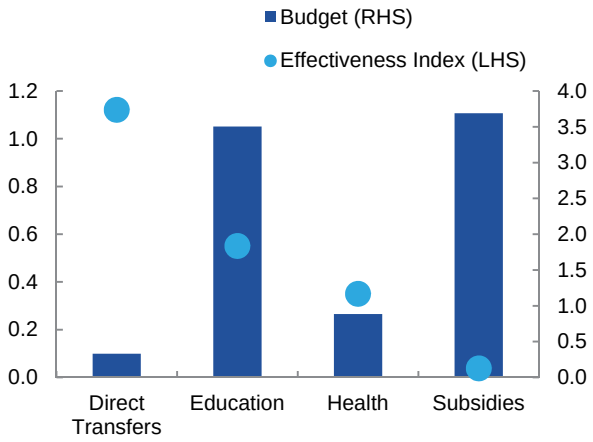
[47] Sweeping reforms by the new administration in 2015 mean that fuel subsidy spending is now much lower.

Figure 37: In 2012, Indonesia spent the most on energy subsidies and the least on cash transfers
(Public spending by type, in percent of total social, pension and subsidy spending)



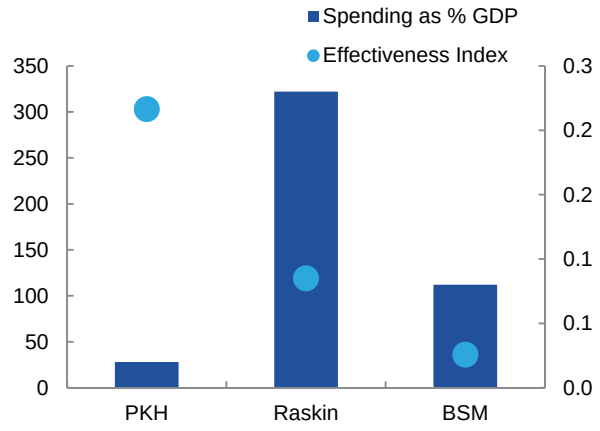
Note: For methodological reasons, housing and urban spending and non-energy subsidies are excluded from the analysis.
Source: Audited 2012 State Budget; World Bank staff calculations

Figure 38: Direct transfers – most effective at reducing inequality– had the lowest budget
(Effectiveness index, LHS; spending in percent of GDP, RHS)



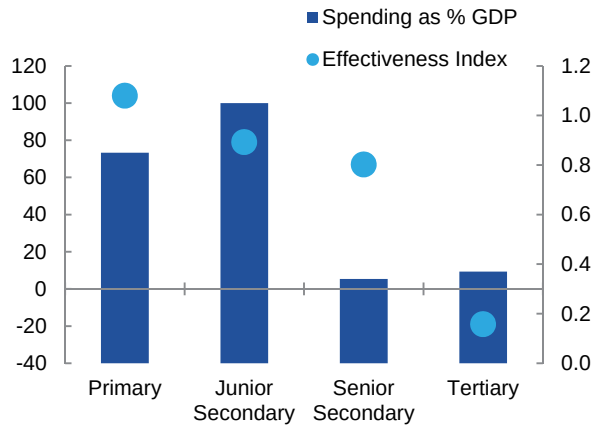
Note: Effectiveness is the change in Gini coefficient from market income to final income due to a given program divided by the program spending in percent of GDP.
Source: 2012 National Socio-economic Survey (Susenas), 2012 State Budget, World Bank staff calculations

Figure 39: Within transfer programs the most effective, PKH, also had the lowest budget
(Effectiveness index, LHS; spending in percent of GDP, RHS)



Note: See note to Figure 4.
Source: 2012 National Socio-economic Survey (Susenas), 2012 State Budget, World Bank staff calculations

Figure 40: But spending on education is inequality-reducing
(Effectiveness index, LHS; spending in percent of GDP, RHS)



Note: See note to Figure 4.
Source: 2012 National Socio-economic Survey (Susenas), 2012 State Budget, World Bank staff calculations

The most effective direct transfer program also received the lowest budget allocation

Within direct transfers, the least budget was spent on the most effective Family Hope Program (*Program Keluarga Harapan*, PKH), Indonesia's conditional cash transfer program. Every Rupiah spent on PKH reduces inequality by 2.5 times more than every Rupiah spent on Raskin, the Government's rice distribution program for the poor, yet Raskin's budget is more than 10 times higher (Figure 39). Four times more is spent on Assistance for Poor Students (*Bantuan Siswa Miskin*, BSM) than PKH, and because of bad targeting, BSM was even less effective than Raskin. In contrast, most education spending goes to primary and junior secondary schools, which have the greatest inequality-reducing effect, as poorer households tend to

have more children than richer households (Figure 40). By comparison, tertiary spending increases inequality, as very few poorer children make it to university.

International experience shows that improving tax collection can also help address inequality

While the greatest impact on inequality is likely to come through spending choices, how Indonesia raises revenue matters too. If too much is spent on redistribution and other social spending relative to revenues, the fiscal framework can become unsustainable. For example, cash transfers in Brazil now represent 4 percent of GDP. Thus, tax revenues must also be raised. In Indonesia, according to the World Bank study, indirect taxes, such as value-added tax and tobacco excise, are relatively neutral and do not have much impact on inequality. Personal income tax collection is low, making up only 10 percent of total tax revenues, or around 1.9 percent of GDP. An increase in compliance and a broader tax base would both increase revenues and lower inequality. In other countries personal income taxes raise significantly more revenue and are borne to a much greater degree by the rich, helping to reduce inequality directly, as well as funding pro-poor spending.

b. The recent fuel subsidy reform helped reduce poverty and inequality

Several rounds of subsidized fuel price rises, accompanied by compensation for the poor, culminated in a fuel subsidy reform…

In June 2013 and November 2014, in response to high international oil prices and a weak Rupiah, Indonesia raised subsidized fuel prices by 30 percent or more. As in the previous years (e.g., 2005 and 2008), in 2013 a temporary unconditional cash transfer (*Bantuan Langsung Sementara Masyarakat*, BLSM) was implemented to compensate the poor and vulnerable. The payment covered the poorest 25 percent of households and provided each household with IDR 150,000 (USD 12) per month for seven months. In 2014, President Joko Widodo increased fuel prices immediately after taking office. This was also accompanied by six monthly BLSM payments as compensation for the poor. However, by the end of December 2014, large decreases in oil prices meant that regulated prices were above market prices. The Government responded by largely removing fuel subsidies altogether and redirecting spending into infrastructure, health, and social assistance.

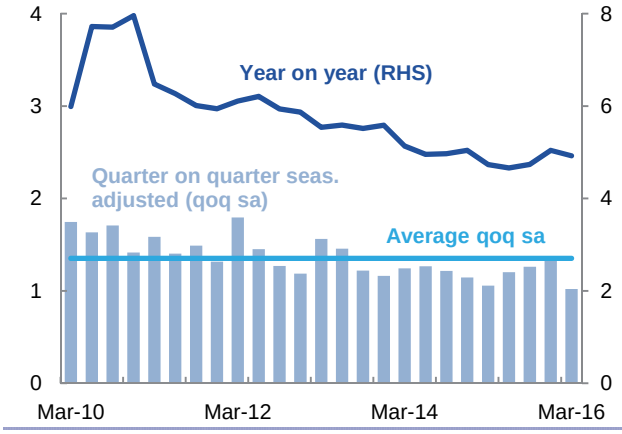
… which had a positive impact on both poverty and inequality reduction

The BLSM payments had a significant (though temporary) effect on poverty and inequality. In 2013, the World Bank estimated that poverty would have been 2.5 percentage points higher due to the direct and indirect effects of higher fuel prices, had there been no BLSM.[48] In addition, because the BLSM payments were only made to poor and vulnerable households, the transfers would have also contributed to reducing inequality. With a combination of BLSM and the redirection of spending into more effective policies, the overall impact of fiscal policy in reducing inequality for 2013, 2014, and 2015 is likely to be higher than 2012. Ongoing work by the World Bank seeks to quantify these effects and will update the "Commitment to Equity" results presented above.

[48] See Part B.2 of the December 2013 *IEQ* for a more detailed discussion.

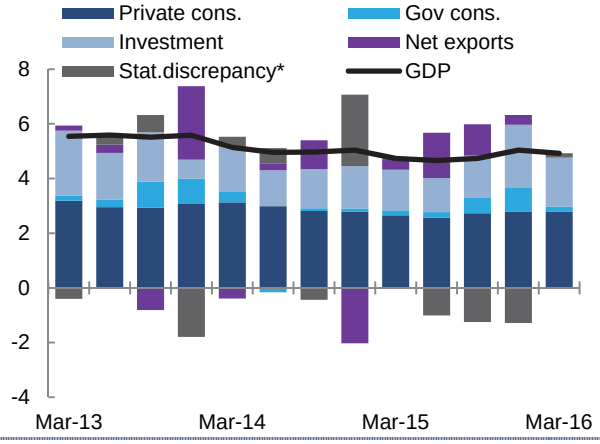
APPENDIX: A SNAPSHOT OF INDONESIAN ECONOMIC INDICATORS

Appendix Figure 1: Real GDP growth
(percent)



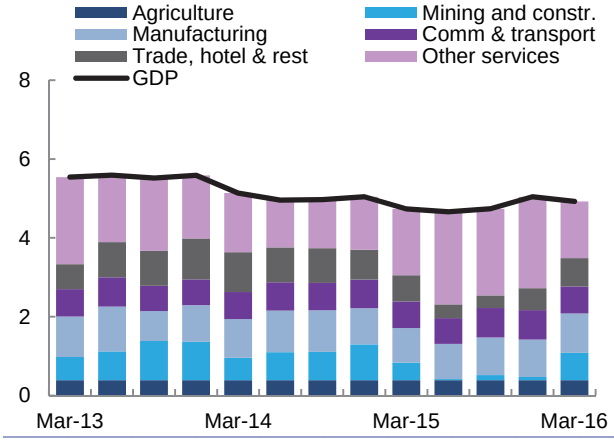
Source: BPS; World Bank staff calculations

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



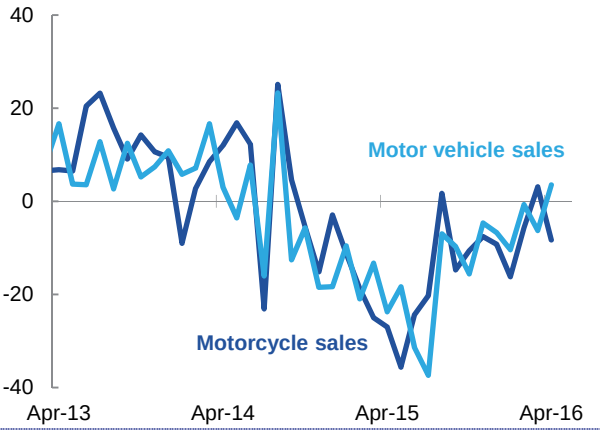
Note: * includes changes in stocks.
Source: BPS; World Bank staff calculations

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



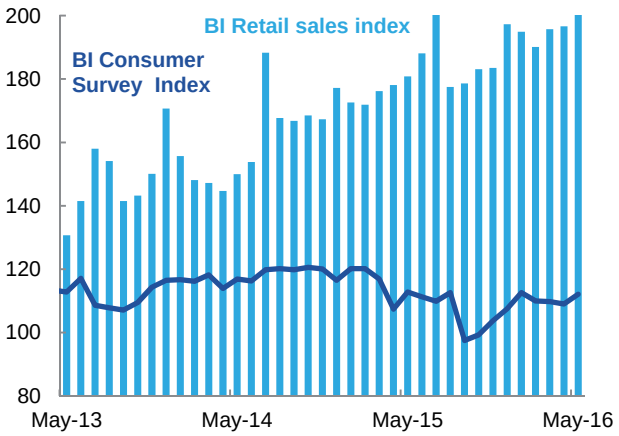
Source: BPS; World Bank staff calculations

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



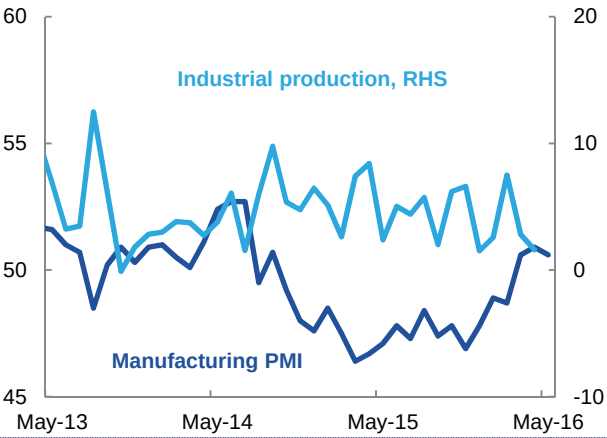
Source: CEIC; World Bank staff calculations

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



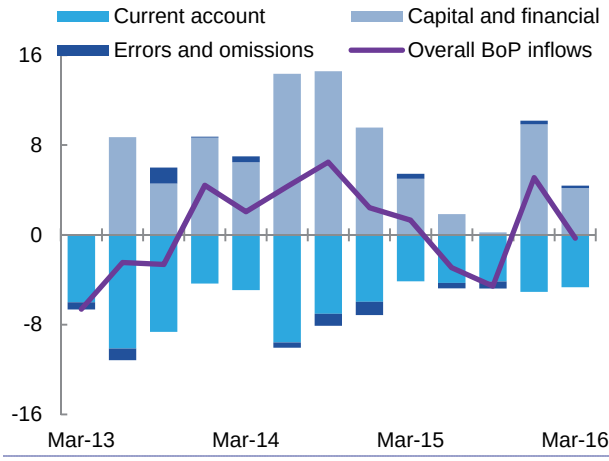
Source: BI; World Bank staff calculations

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



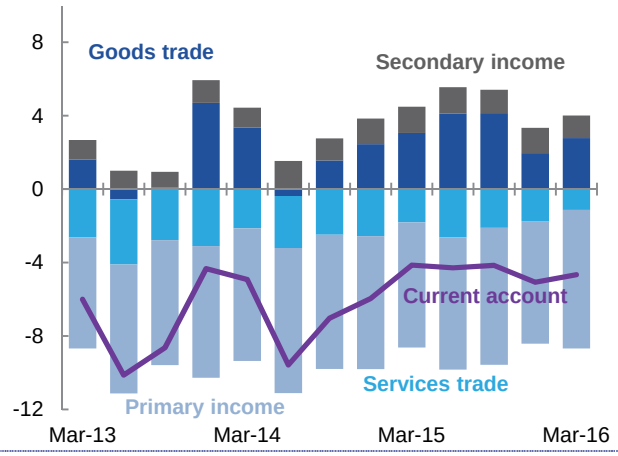
Source: BPS; Nikkei/Markit: ; World Bank staff calculations

Appendix Figure 7: Balance of payments
(USD billion)



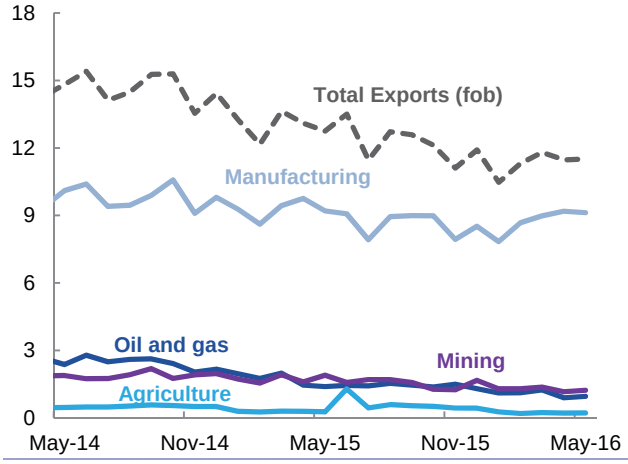
Source: BI; World Bank staff calculations

Appendix Figure 8: Current account components
(USD billion)



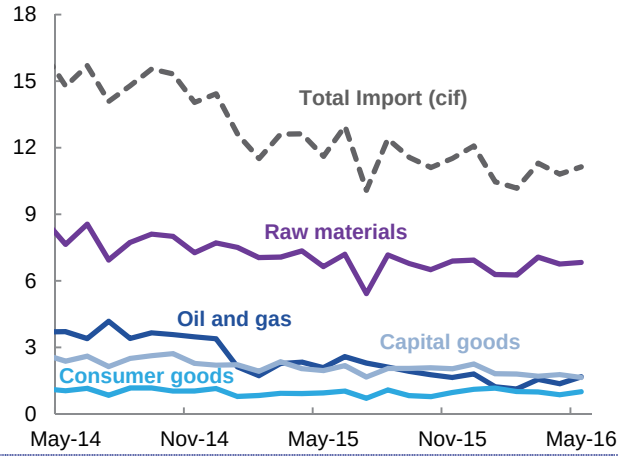
Source: BI; World Bank staff calculations

Appendix Figure 9: Exports of goods
(USD billion)



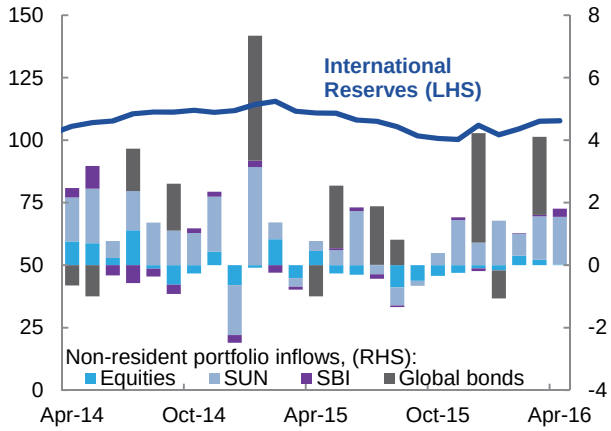
Source: BPS; World Bank staff calculations

Appendix Figure 10: Imports of goods
(USD billion)



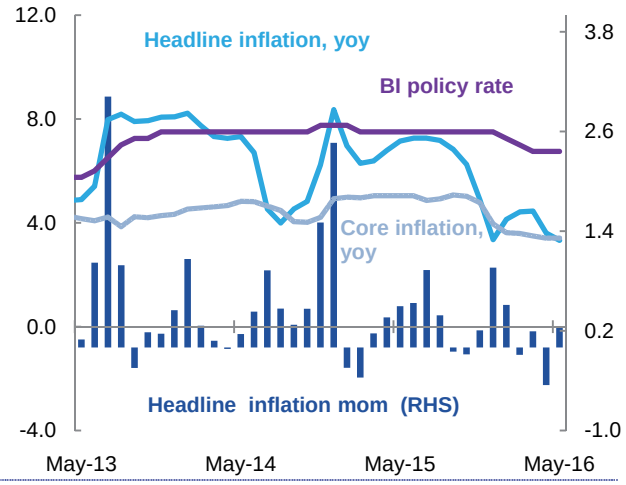
Source: BPS; World Bank staff calculations

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



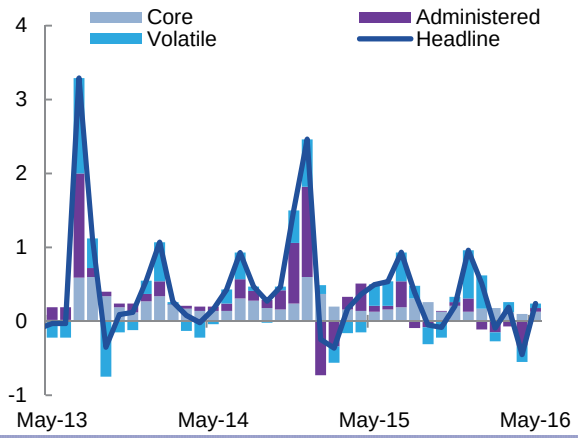
Source: BI; Ministry of Finance (MoF); World Bank staff calculations

Appendix Figure 12: Inflation and monetary policy
(percent)



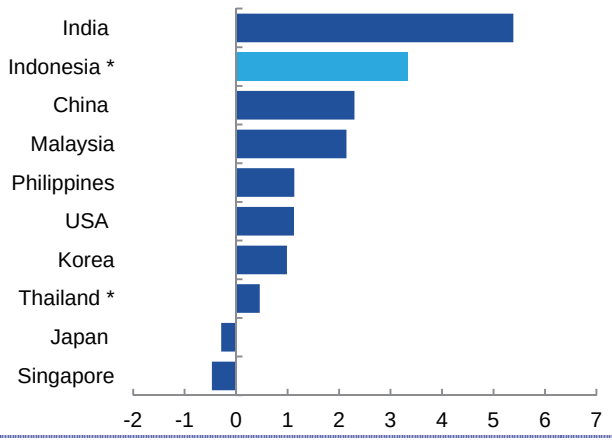
Source: BPS; BI; World Bank staff calculations

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



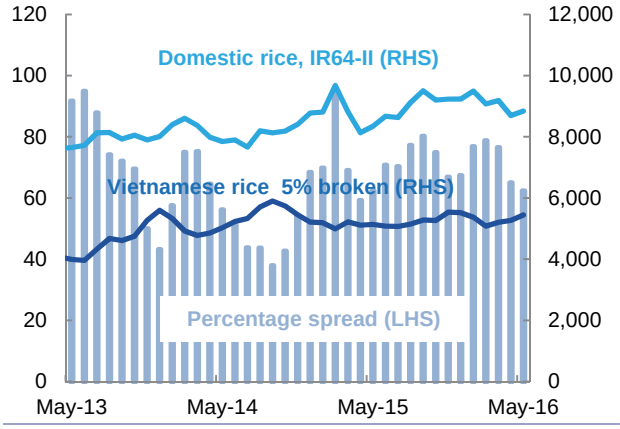
Source: BPS; World Bank staff calculations

Appendix Figure 14: Inflation comparison across countries
(change yoy)



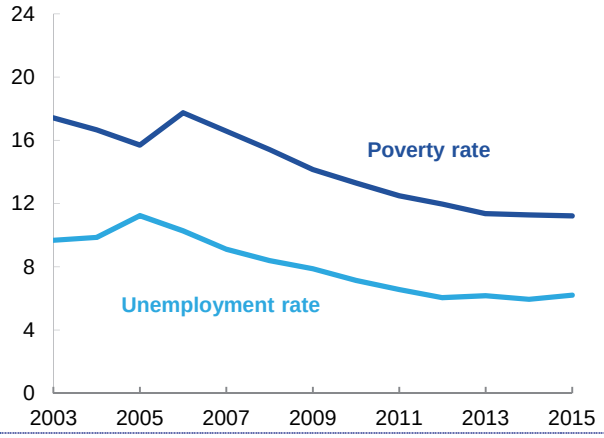
*Note: May 2016; others April.
Source: BPS; CEIC; World Bank staff calculations

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



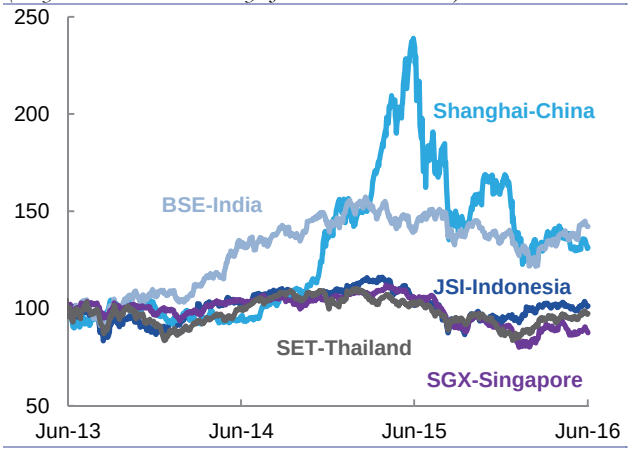
Source: Cipinang wholesale rice market; FAO; World Bank staff calculations

Appendix Figure 16: Poverty and unemployment rate
(percent)



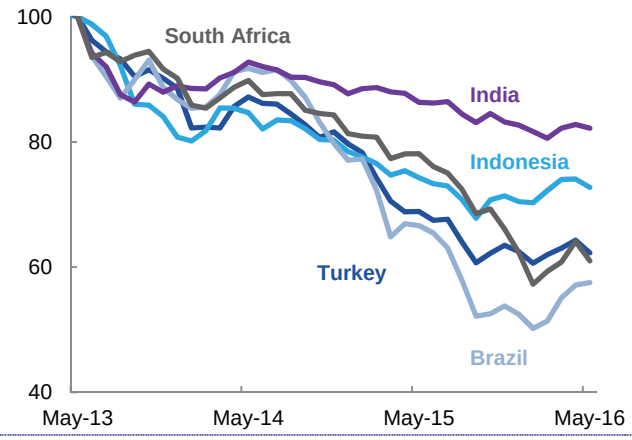
Source: BPS; World Bank staff calculations

Appendix Figure 17: Regional equity indices
(daily index in local currency, June 14 2013=100)



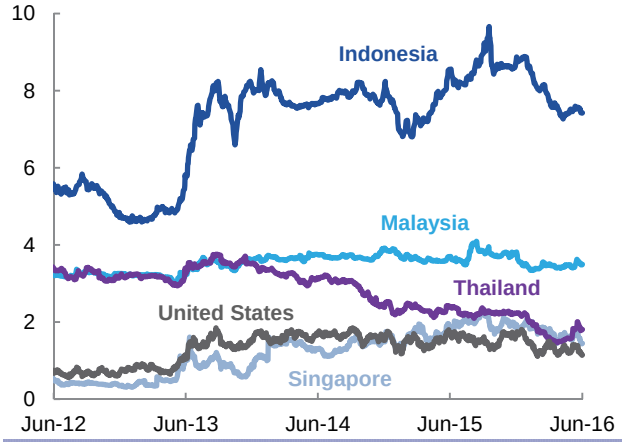
Source: CEIC; World Bank staff calculations

Appendix Figure 18: Selected currencies against USD
(monthly index May 2013=100)



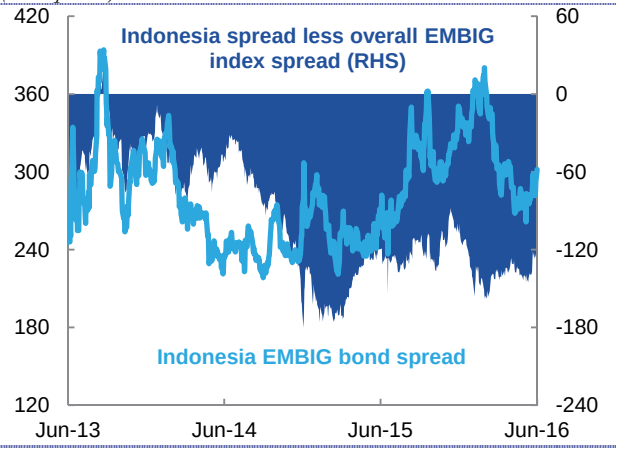
Source: CEIC; World Bank staff calculations

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



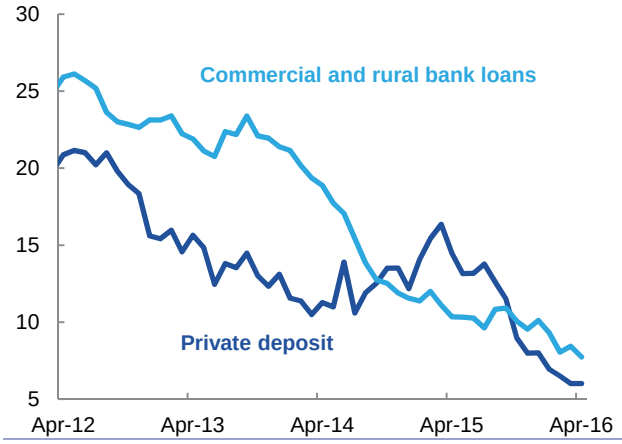
Source: CEIC; World Bank staff calculations

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



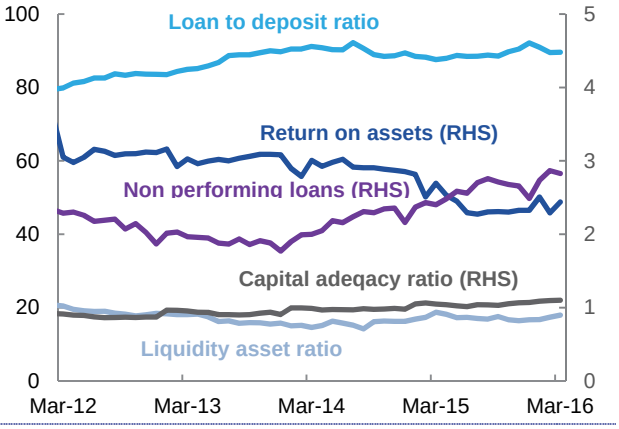
Source: JP Morgan; World Bank staff calculations

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



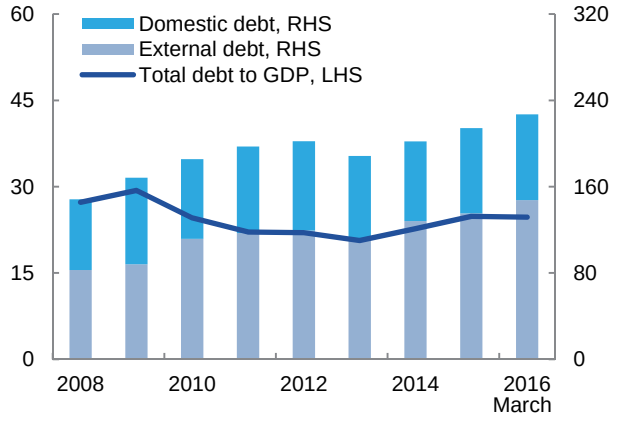
Source: BI; World Bank staff calculations

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



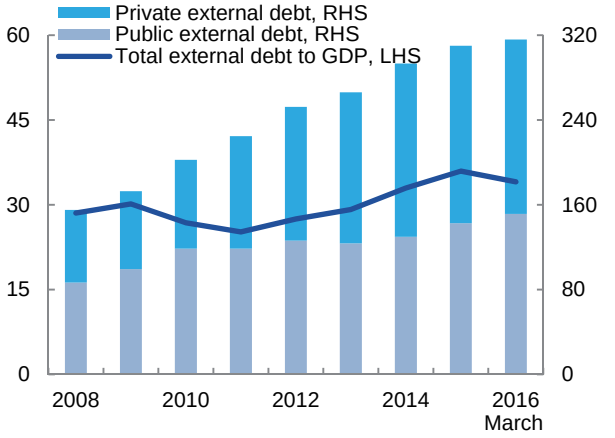
Source: BI; World Bank staff calculations

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



Source: BI; MoF; 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)

	2011	2012	2013	2014	2015	2016
	Actual	Actual	Actual	Actual	Actual	Budget
A. State revenue and grants	**1,211**	**1,338**	**1,439**	**1,550**	**1,508**	**1,822**
1. Tax revenue	874	981	1,077	1,147	1,240	1,547
2. Non-tax revenue	331	352	355	399	256	274
B. Expenditure	**1,295**	**1,491**	**1,651**	**1,777**	**1,807**	**2,096**
1. Central government	884	1,011	1,137	1,204	1,183	1,326
2. Transfers to the regions	411	481	513	574	623	770
C. Primary balance	**9**	**-53**	**-99**	**-93**	**-142**	**-89**
D. SURPLUS / DEFICIT	-84	-153	-212	-227	-298	-273
(percent of GDP)	-1.1	-1.8	-2.2	-2.1	-2.6	-2.2

Note: Budget balance as percentage of GDP uses the revised and rebased GDP.
Source: MoF; World Bank staff calculations

Appendix Table 2: Balance of payments

(USD billion)

	2013	2014	2015	2014	2015				2016
				Q4	Q1	Q2	Q3	Q4	Q1
Balance of payments	**-7.3**	**15.2**	**-1.1**	**2.4**	**1.3**	**-2.9**	**-4.6**	**5.1**	**-0.3**
Percent of GDP	-0.8	1.7	-0.1	1.1	0.6	-1.3	-1.9	2.2	-0.1
Current account	**-29.1**	**-27.5**	**-17.7**	**-6.0**	**-4.1**	**-4.3**	**-4.2**	**-5.1**	**-4.7**
Percent of GDP	-3.2	-3.1	-2.0	-2.7	-1.8	-1.9	-1.7	-2.2	-2.0
Trade balance	-6.2	-3.0	5.0	-0.1	1.2	1.5	2.0	0.2	1.6
Net income & current transfers	-22.9	-24.5	-22.6	-5.8	-5.4	-5.8	-6.2	-5.3	-6.3
Capital & Financial Account	**22.0**	**45.4**	**16.9**	**9.6**	**5.0**	**1.8**	**0.2**	**9.8**	**4.2**
Percent of GDP	2.4	5.1	2.0	4.4	2.2	0.8	0.1	4.3	1.8
Direct investment	12.3	14.7	9.9	5.0	1.7	3.7	1.8	2.8	2.2
Portfolio investment	10.9	26.1	16.7	1.9	8.5	5.6	-2.2	4.9	4.4
Other investment	-1.2	4.1	-9.8	5.0	-5.2	-7.4	0.6	2.2	-2.4
Errors & omissions	**-0.2**	**-2.6**	**-0.5**	**-1.3**	**0.4**	**-0.9**	**-0.7**	**0.7**	**0.0**
Foreign reserves*	**99.4**	**111.6**	**101.7**	**111.9**	**111.6**	**108.0**	**101.7**	**105.9**	**107.5**

Note: * Reserves at end-period.
Source: BI; BPS; World Bank staff calculations

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

	2000	2005	2010	2011	2012	2013	2014	2015
National Accounts (% change)[1]								
Real GDP	4.9	5.7	6.2	6.2	6.0	5.6	5.0	4.8
Real investment	11.4	10.9	8.5	8.9	9.1	5.0	4.6	5.1
Real consumption	4.6	64.0	4.1	5.1	5.4	5.7	4.7	4.9
Private	3.7	0.9	4.8	5.1	5.5	5.5	5.3	4.8
Government	14.2	6.6	0.3	5.5	4.5	6.7	1.2	5.4
Real exports, GNFS	30.6	16.6	15.3	14.8	1.6	4.2	1.0	-2.0
Real imports, GNFS	26.6	17.8	17.3	15.0	8.0	1.9	2.2	-5.8
Investment (% GDP)	20	24	31	31	33	32	33	33
Nominal GDP (USD billion)	165	286	755	893	918	913	890	862
GDP per capita (USD)	857	1,396	3,167	3,688	3,741	3,668	3,530	3,374
Central Government Budget (% GDP)[2]								
Revenue and grants	20.8	16.8	14.5	15.5	15.5	15.1	14.7	13.1
Non-tax revenue	9.0	5.0	3.9	4.2	4.1	3.7	3.8	2.2
Tax revenue	11.7	11.7	10.5	11.2	11.4	11.3	10.9	10.7
Expenditure	22.4	17.3	15.2	16.5	17.3	17.3	16.8	15.7
Consumption	4.0	2.8	3.6	3.8	3.9	4.1	4.0	4.5
Capital	2.6	1.1	1.2	1.5	1.7	1.9	1.4	1.9
Interest	5.1	2.2	1.3	1.2	1.2	1.2	1.3	1.4
Subsidies	6.3	4.1	2.8	3.8	4.0	3.7	3.7	1.6
Budget balance	-1.6	-0.6	-0.7	-1.1	-1.8	-2.2	-2.1	-2.6
Government debt	97.9	44.3	24.3	22.8	22.6	24.1	23.8	25.6
o/w external government debt	51.4	23.4	11.1	10.2	9.9	11.2	10.2	10.8
Total external debt (including private sector)	87.1	47.1	26.8	25.2	27.5	29.2	33.0	36.0
Balance of Payments (% GDP)[3]								
Overall balance of payments	..	0.2	4.0	1.3	0.0	-0.8	1.7	-0.1
Current account balance	4.8	0.1	0.7	0.2	-2.7	-3.2	-3.1	-2.0
Exports GNFS	42.8	35.0	22.0	23.8	23.0	22.5	22.3	19.8
Imports GNFS	33.9	32.0	19.2	21.2	23.2	23.2	22.7	19.2
Trade balance	8.9	2.9	2.8	2.7	-0.2	-0.7	-0.3	0.6
Financial account balance	..	0.0	3.5	1.5	2.7	2.4	5.1	2.0
Direct investment	-2.8	1.8	1.5	1.3	1.5	1.3	1.7	1.2
Gross official reserves (USD billion)	29.4	34.7	96.2	110.1	112.8	99.4	111.6	101.7
Monetary (% change)[3]								
GDP deflator[1]	20.4	14.3	8.3	7.5	3.8	5.0	5.4	4.2
Bank Indonesia interest key rate (%)	..	9.1	6.5	6.0	5.8	7.5	7.8	7.5
Domestic credit (eop)	..	24.3	22.8	24.6	23.1	21.6	11.6	10.4
Nominal exchange rate (average, IDR/USD)[4]	8,392	9,705	9,087	8,776	9,384	10,460	11,869	13,389
Prices (% change)[1]								
Consumer price Index (eop)	9.4	17.1	7.0	3.8	3.7	8.1	8.4	3.4
Consumer price Index (average)	3.7	10.5	5.1	5.3	4.0	6.4	6.4	6.4
Indonesia crude oil price (USD per barrel, eop)[5]	28	53	79	112	113	107	60	36

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, for 2015 based on revised State Budget), [3] BI, [4] IMF, [5] CEIC

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

	2000	2005	2010	2011	2012	2013	2014	2015
Demographics[1]								
Population (million)	213	227	242	245	248	251	254	258
Population growth rate (%)	1.3	1.2	1.3	1.3	1.3	1.3	1.3	1.3
Urban population (% of total)	42	46	50	51	51	52	53	..
Dependency ratio (% of working-age population)	55	54	51	51	50	50	49	..
Labor Force[2]								
Labor force, total (million)	98	106	117	117	120	120	122	122
Male	60	68	72	73	75	75	76	77
Female	38	38	45	44	46	45	46	46
Agriculture share of employment (%)	45	44	38	36	35	35	34	33
Industry share of employment (%)	17	19	19	21	22	20	21	22
Services share of employment (%)	37	37	42	43	43	45	45	45
Unemployment, total (% of labor force)	8.1	11.2	7.1	7.4	6.1	6.2	5.9	6.2
Poverty and Income Distribution[3]								
Median household consumption (IDR 000 per month)	104	211	374	421	446	487	548	623
National poverty line (IDR 000 per month)	73	129	212	234	249	272	303	331
Population below national poverty line (million)	38	35	31	30	29	28	28	29
Poverty (% of population below national poverty line)	19.1	16.0	13.3	12.5	12.0	11.4	11.3	11.2
Urban (% of population below urban poverty line)	14.6	11.7	9.9	9.2	8.8	8.4	8.3	8.3
Rural (% of population below rural poverty line)	22.4	20.0	16.6	15.7	15.1	14.3	14.2	14.2
Male-headed households	15.5	13.3	11.0	10.2	9.5	9.2	9.0	9.3
Female-headed households	12.6	12.8	9.5	9.7	8.8	8.6	8.6	11.1
Gini index	0.30	0.35	0.38	0.41	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	7.2
Percentage share of consumption: highest 20%	38.6	41.4	40.6	46.5	46.7	47.3	46.8	47.3
Public expenditure on social security & welfare (% of GDP)[4]	..	0.4	0.4	0.4	0.4	0.6	0.5	0.6
Health and Nutrition[1]								
Physicians (per 1,000 people)	0.16	0.13	0.29	..	0.20	..	..	
Under five mortality rate (per 1000 children under 5 years)	52	42	33	32	30	29	28	27
Neonatal mortality rate (per 1000 live births)	22	19	16	16	15	15	14	14
Infant mortality (per 1000 live births)	41	34	27	26	25	24	24	23
Maternal mortality ratio (modeled est., per 100,000 live births)	265	212	165	156	148	140	133	126
Measles vaccination (% of children under 2 years)	74	77	78	80	85	84	77	..
Total health expenditure (% of GDP)	2.0	2.8	2.9	2.9	3.0	3.1	..	..
Public health expenditure (% of GDP)	0.7	0.8	1.1	1.1	1.2	1.2	..	..
Education[3]								
Primary net enrollment rate (%)	..	92	92	92	93	92	93	97
Female (% of total net enrollment)	..	48	48	49	49	50	48	49
Secondary net enrollment rate (%)	..	52	61	60	60	61	65	66
Female (% of total net enrollment)	..	50	50	50	49	50	50	51
Tertiary net enrollment rate (%)	..	9	16	14	15	16	18	20
Female (% of total net enrollment)	..	55	53	50	54	54	55	56
Adult literacy rate (%)	..	91	91	91	92	93	93	95
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	20.6
Water and Sanitation[1]								
Access to an improved water source (% of population)	78	81	85	85	86	86	87	87
Urban (% of urban population)	91	92	93	93	94	94	94	94
Rural (% of rural population)	68	71	76	77	77	78	79	80
Access to improved sanitation facilities (% of population)	44	53	57	58	59	60	61	61
Urban (% of urban population)	64	70	70	71	71	72	72	72
Rural (% of rural population)	30	38	44	45	46	47	48	48
Others[1]								
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	17

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

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