Indonesia Economic Quarterly
July 2015

Slower Gains

Ndiamé Diop
Lead Economist, Indonesia

July 8, 2015

Introduction

- The government announced and initiated ambitious policy reforms (e.g., fuel subsidy, business licensing) and infrastructure development plans (doubling of capital budget allocation in 2015).
- These raised expectations about the results they can achieve…
- …but so far gains remain smaller than expected.
- In this IEQ, we try to understand why this is the case and discuss options for addressing ongoing challenges.

WORLD BANK GROUP

Three facts about the global economy

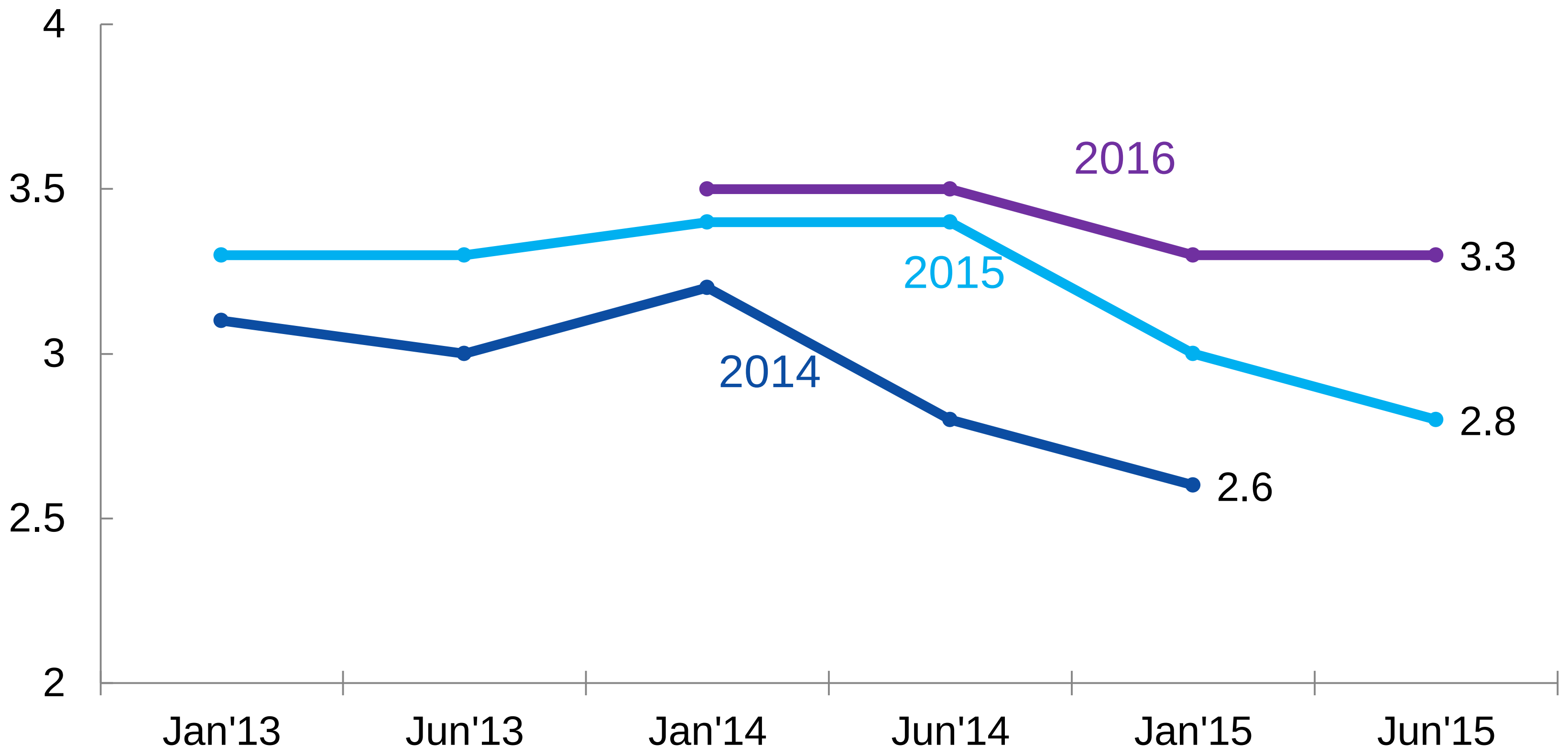
Indonesia: recent developments and near-term outlook

Effective policy response

WORLD BANK GROUP

Fact 1. Global growth still subdued despite recovery in the US

World Bank projections for global growth in 2014, 2015 and 2016, percent

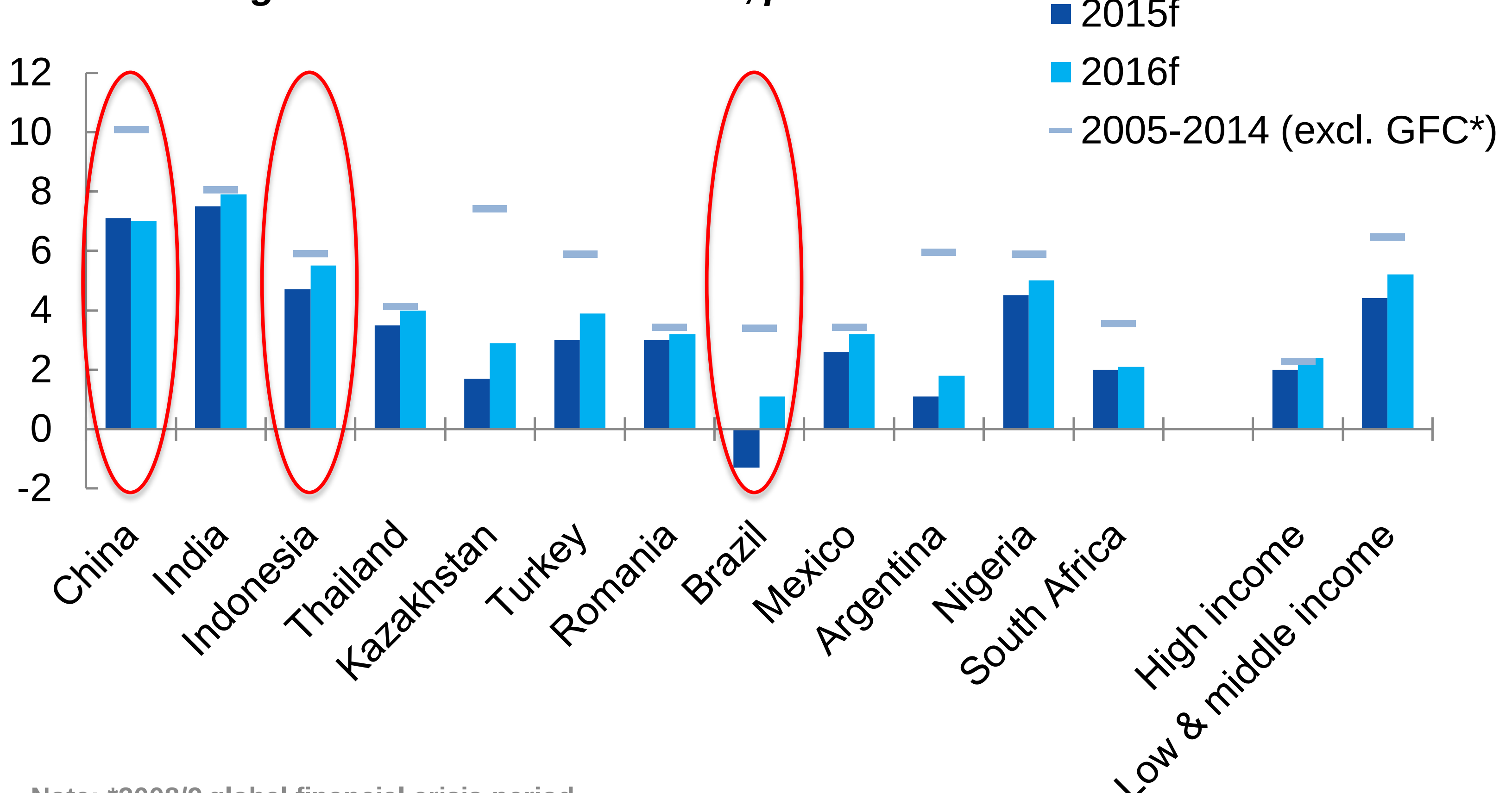


Source: World Bank Global Economic Prospects

WORLD BANK GROUP

Fact 2. Major developing countries growing below past 10-year average…

Real annual GDP growth in select countries, percent

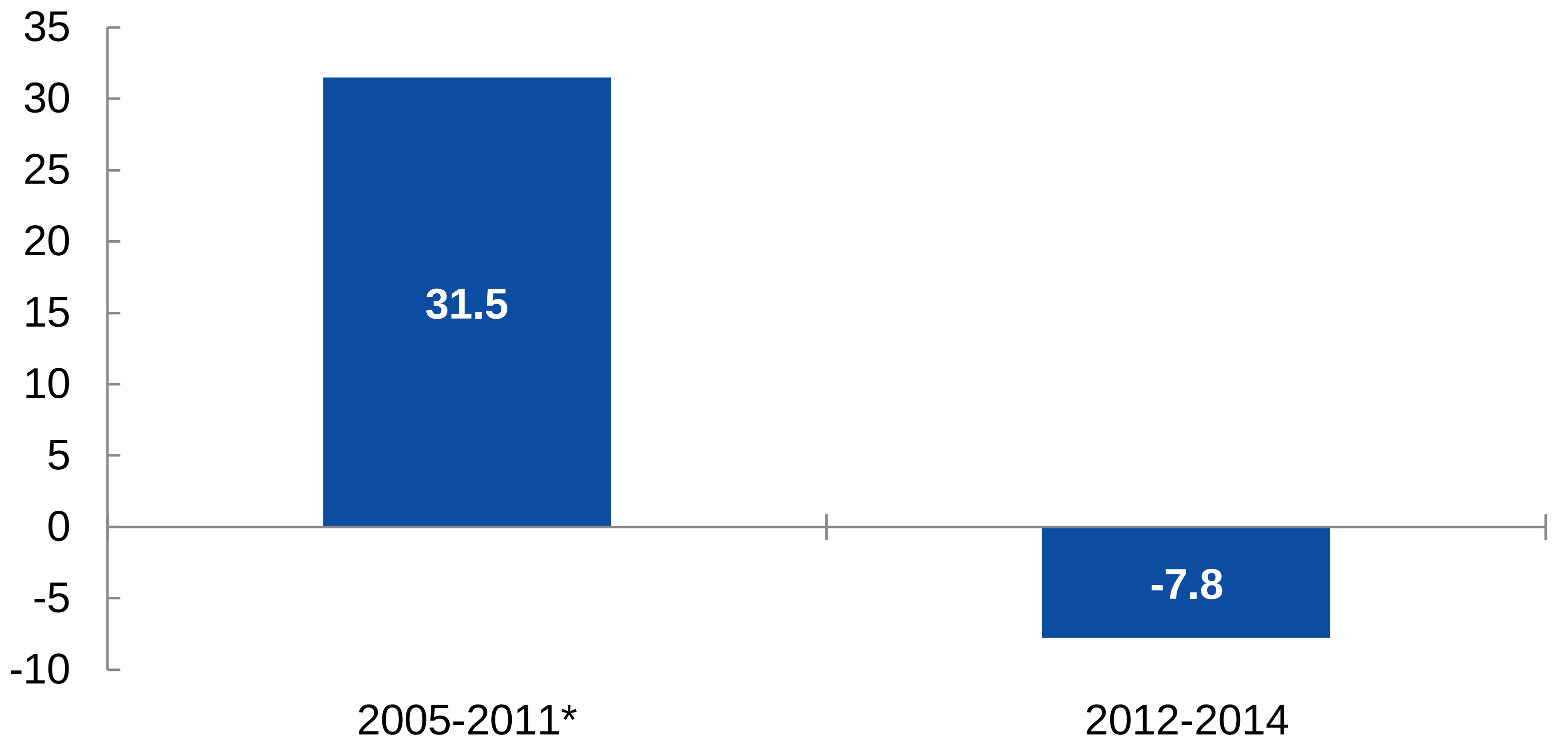


Note: *2008/9 global financial crisis period.
Source: World Bank Global Economic Prospects June 2015; World Development Indicators; World Bank staff calculations

WORLD BANK GROUP

…China's slowing and changing growth pattern particularly far-reaching

Chinese imports from Indonesia, average annual growth, percent

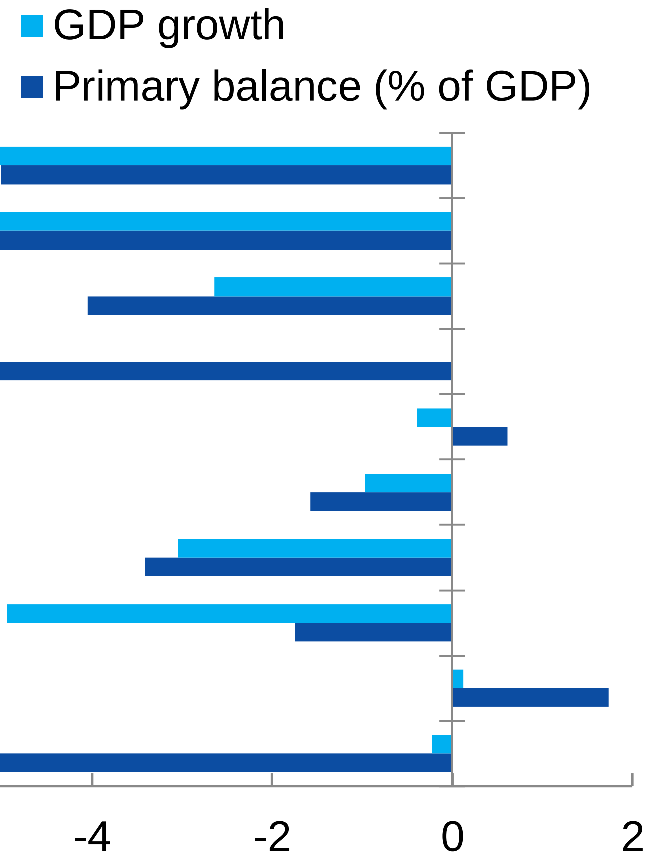


Note: * excludes 2009 global financial crisis period.
Source: BPS; World Bank staff calculations

WORLD BANK GROUP

Fact 3. Commodity exporters: growth and fiscal buffers declining

Change between 2011 and 2015 in select countries, percentage points



Source: IMF World Economic Outlook; World Bank staff calculations

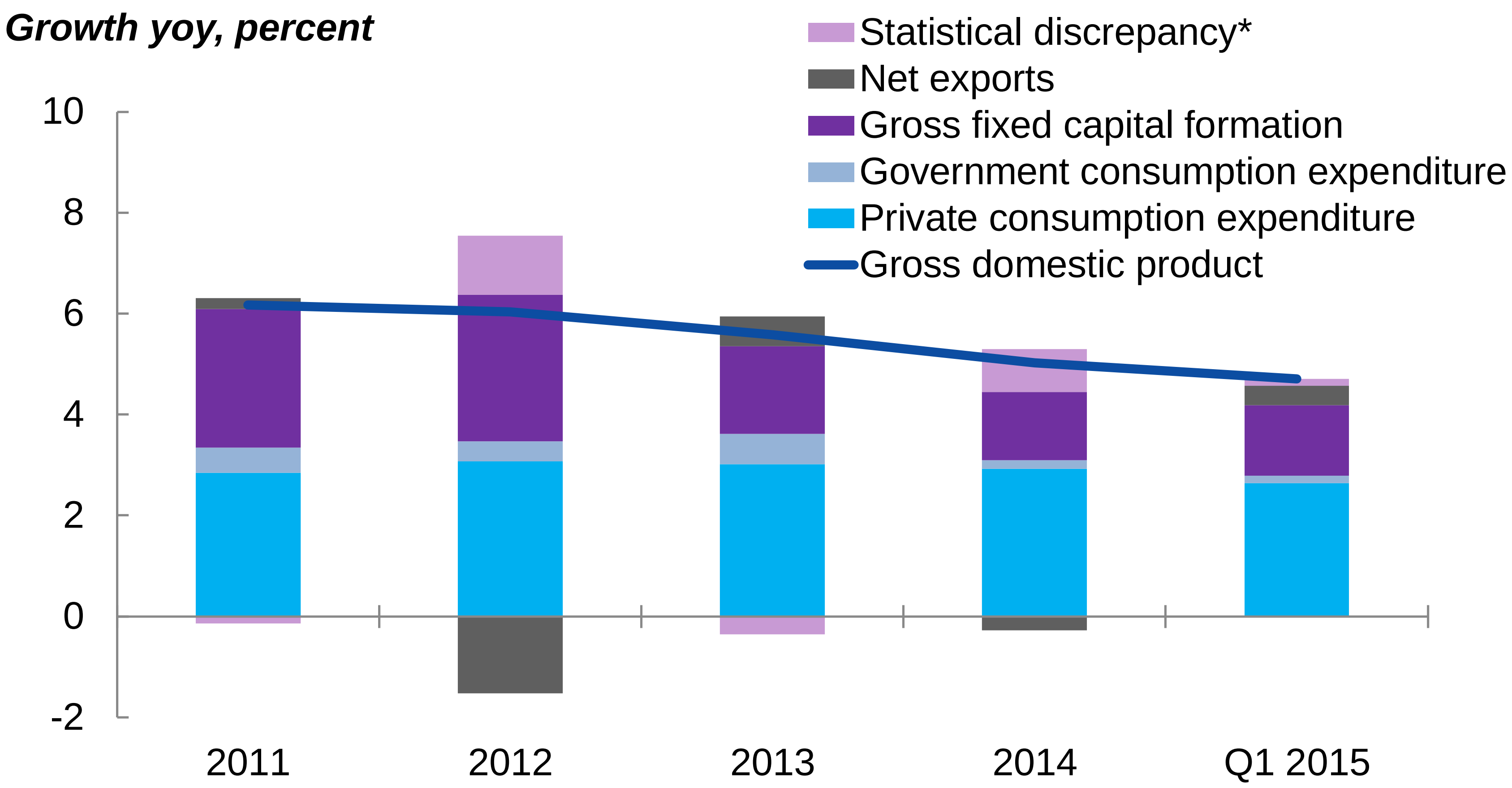
WORLD BANK GROUP

Three facts about the global economy

Indonesia: recent developments and near-term outlook

Effective policy response

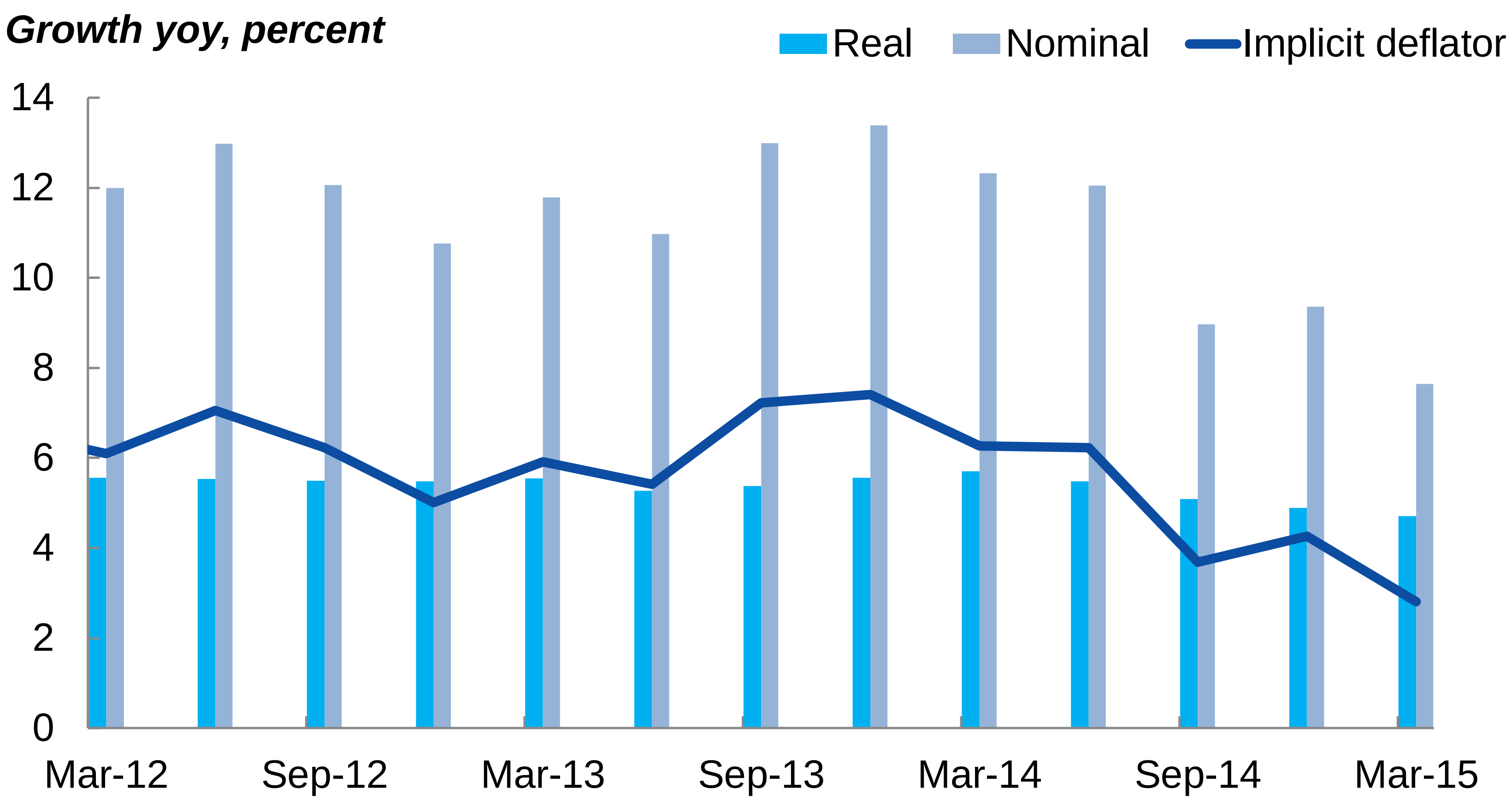
Weaker GDP growth in Q12015, with investment still subdued…



Note: *Statistical discrepancy also includes change in inventories. Q1 2015 quarterly growth in year on year terms.
Source: BPS; World Bank staff calculations

WORLD BANK GROUP

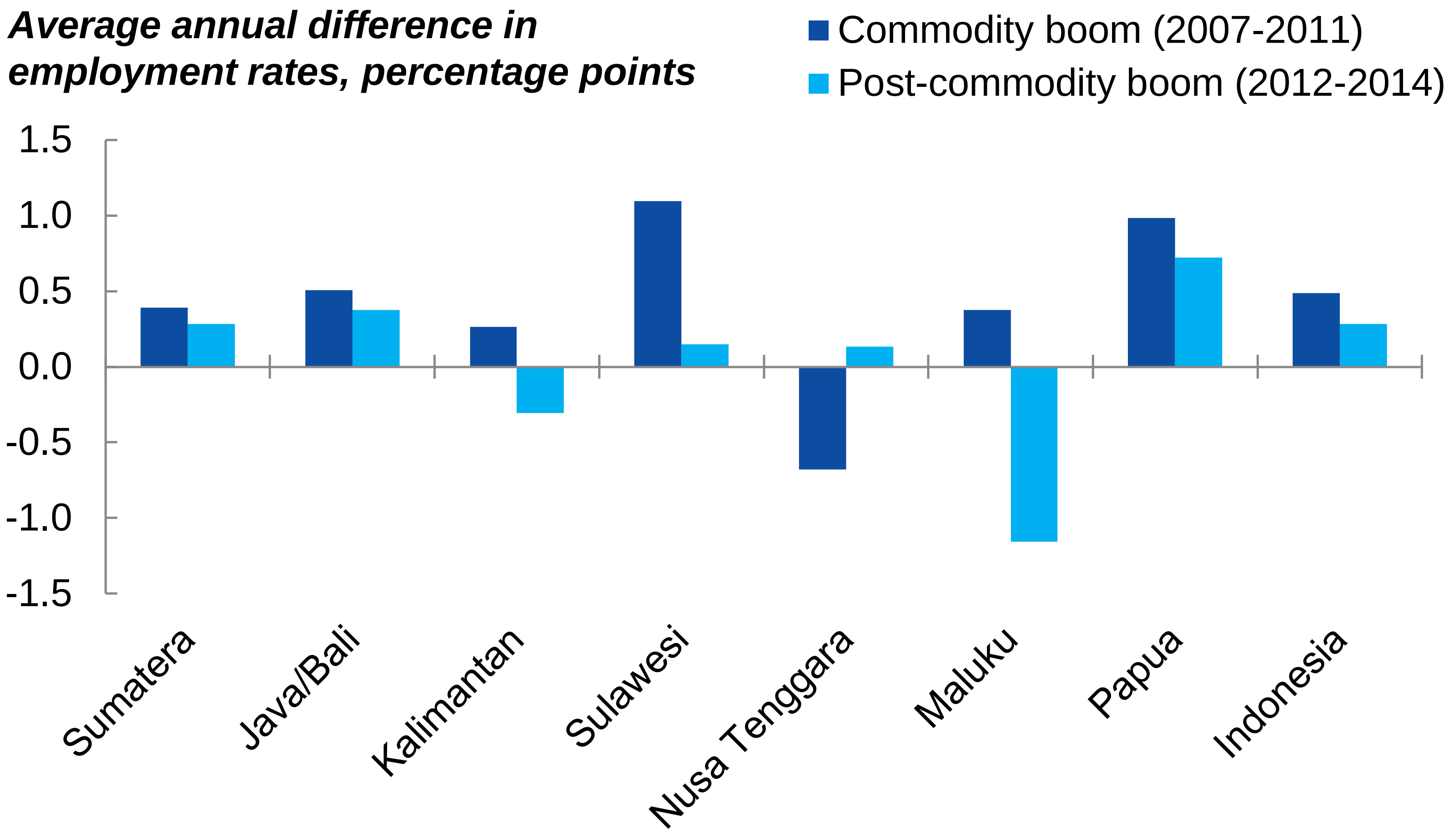
…and weaker private consumption growth, especially in nominal terms



Source: BPS; World Bank staff calculations

WORLD BANK GROUP

Employment growth has slowed across Indonesia

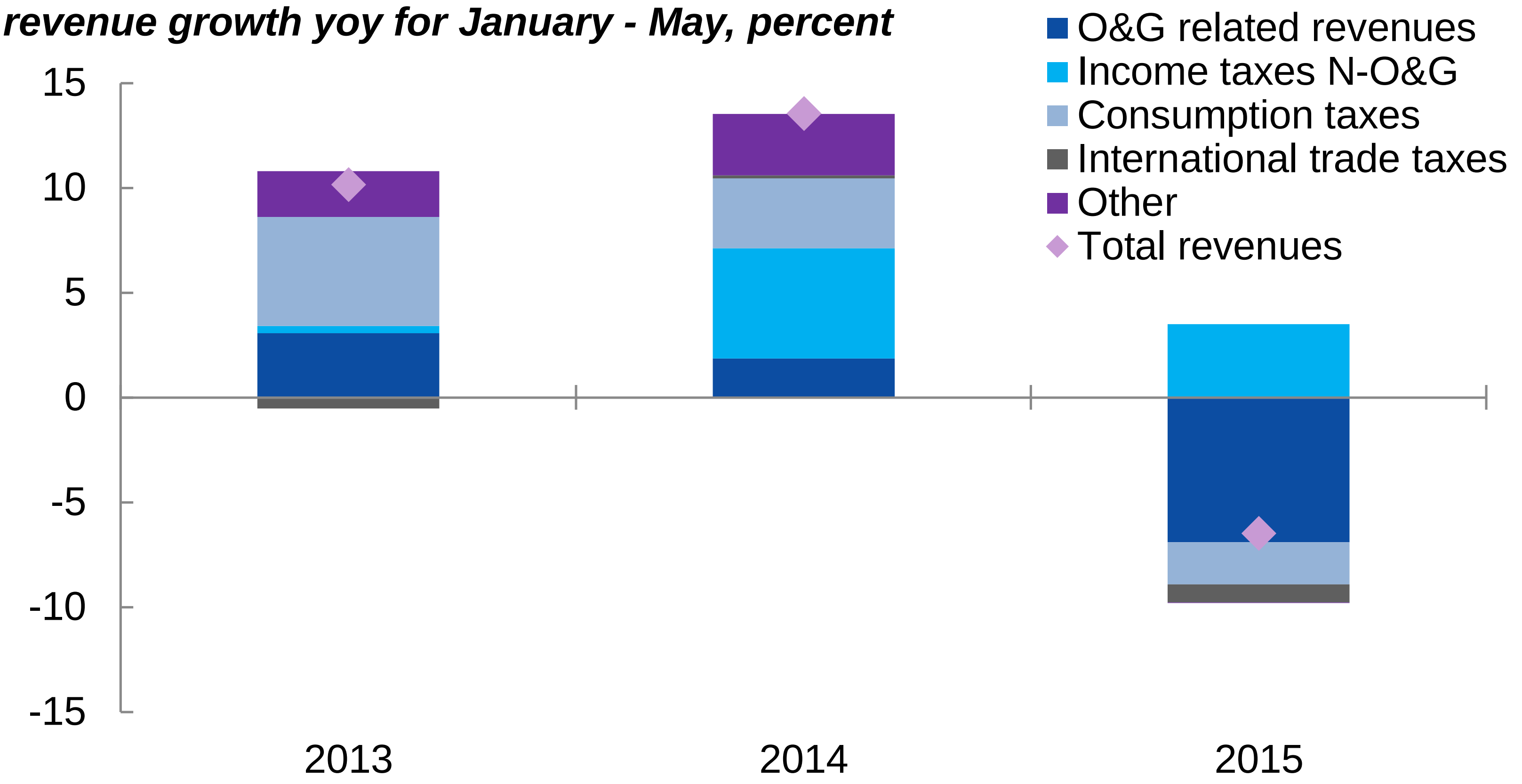


Source: BPS; World Bank staff calculations

WORLD BANK GROUP

Weak revenue collection has limited the fiscal space

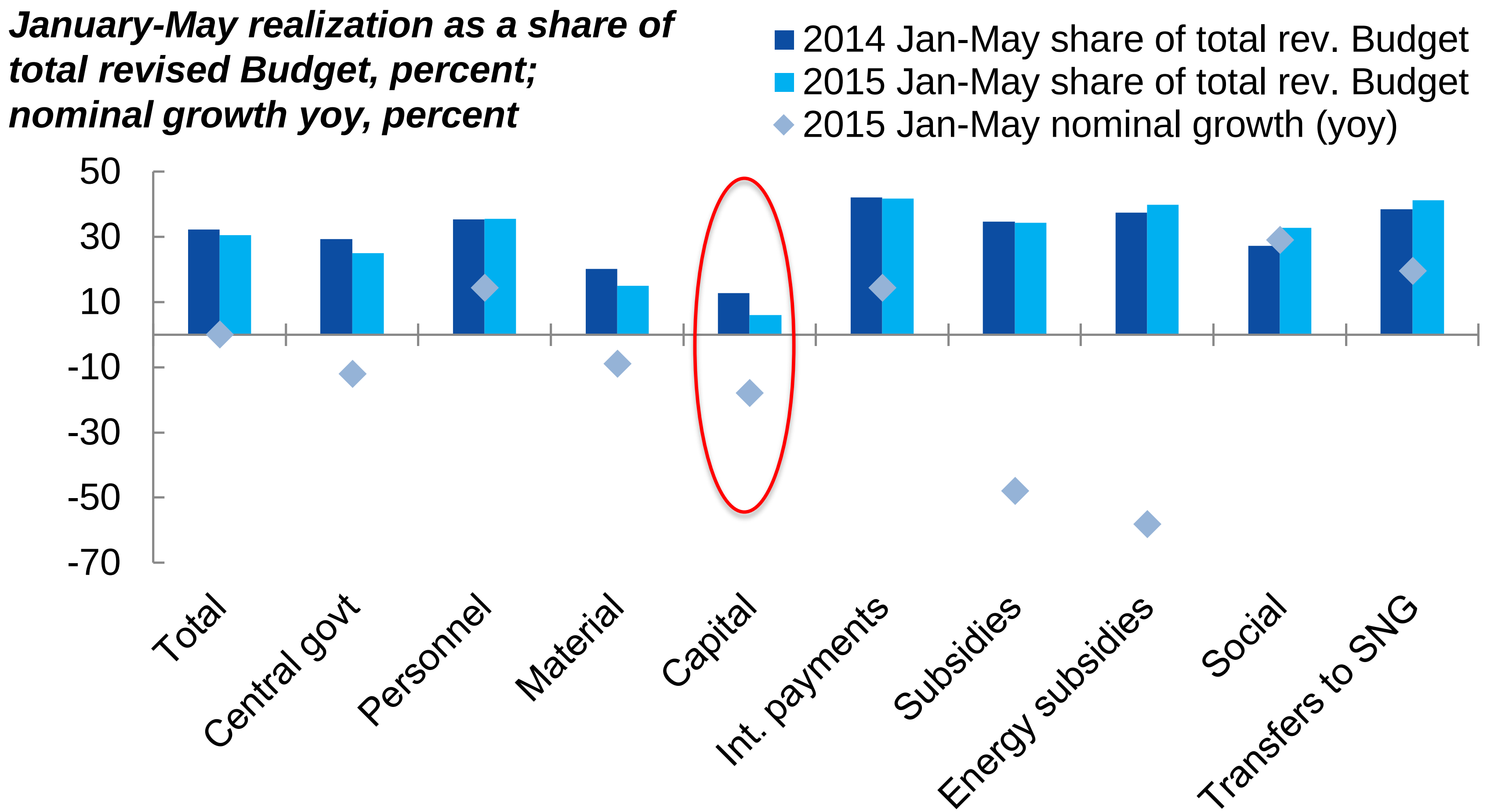
Contributions of select revenue categories to nominal revenue growth yoy for January - May, percent



Source: Ministry of Finance; World Bank staff calculations

WORLD BANK GROUP

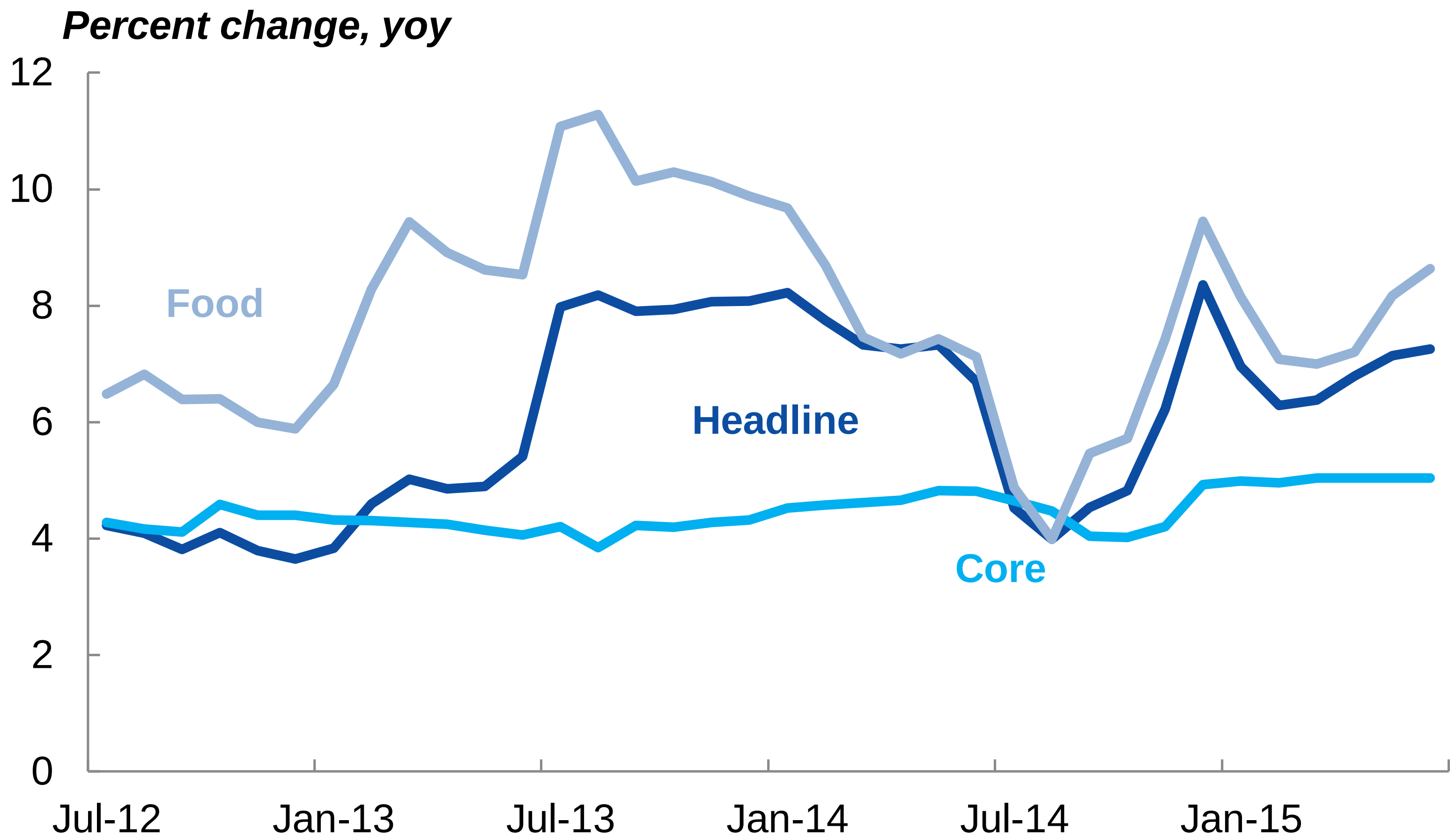
Capital budget execution challenges have further curtailed the development agenda



Source: Ministry of Finance; World Bank staff calculations

WORLD BANK GROUP

Inflation remains sticky due to rising food prices



Source: BPS; World Bank staff calculations

WORLD BANK GROUP

Baseline GDP growth in 2015 has been revised down

(percentage change, unless otherwise indicated)	July 2015 IEQ			Revisions	
	2014	2015p	2016p	2015	2016
Real GDP	5.0	4.7	5.5	-0.5	0.0
Consumer prices	6.4	6.8	5.3	0.3	0.2
Current account balance (% of GDP)	-2.9	-2.7	-2.9	0.3	0.3
Fiscal balance (% of GDP)	-2.2	-2.5	-	0.0	-

Note: Revisions are relative to March 2015 *IEQ*.
Source: BI; BPS; Ministry of Finance; World Bank staff projections

Main risks to outlook are firmly on the downside

External

- Foreign currency financing costs;
- Lower trend output growth in developing countries;
- A setback in the still-fragile Euro Area recovery.

Domestic

Private consumption	Government consumption	Fixed investment
• Sticky inflation; • Fuel price uncertainty; • Further Rupiah depreciation; • Lower consumer confidence.	• Revenue shortfall; • Budget under-execution.	• Weaker business confidence; • Subdued credit growth; • Lower government capital spending.

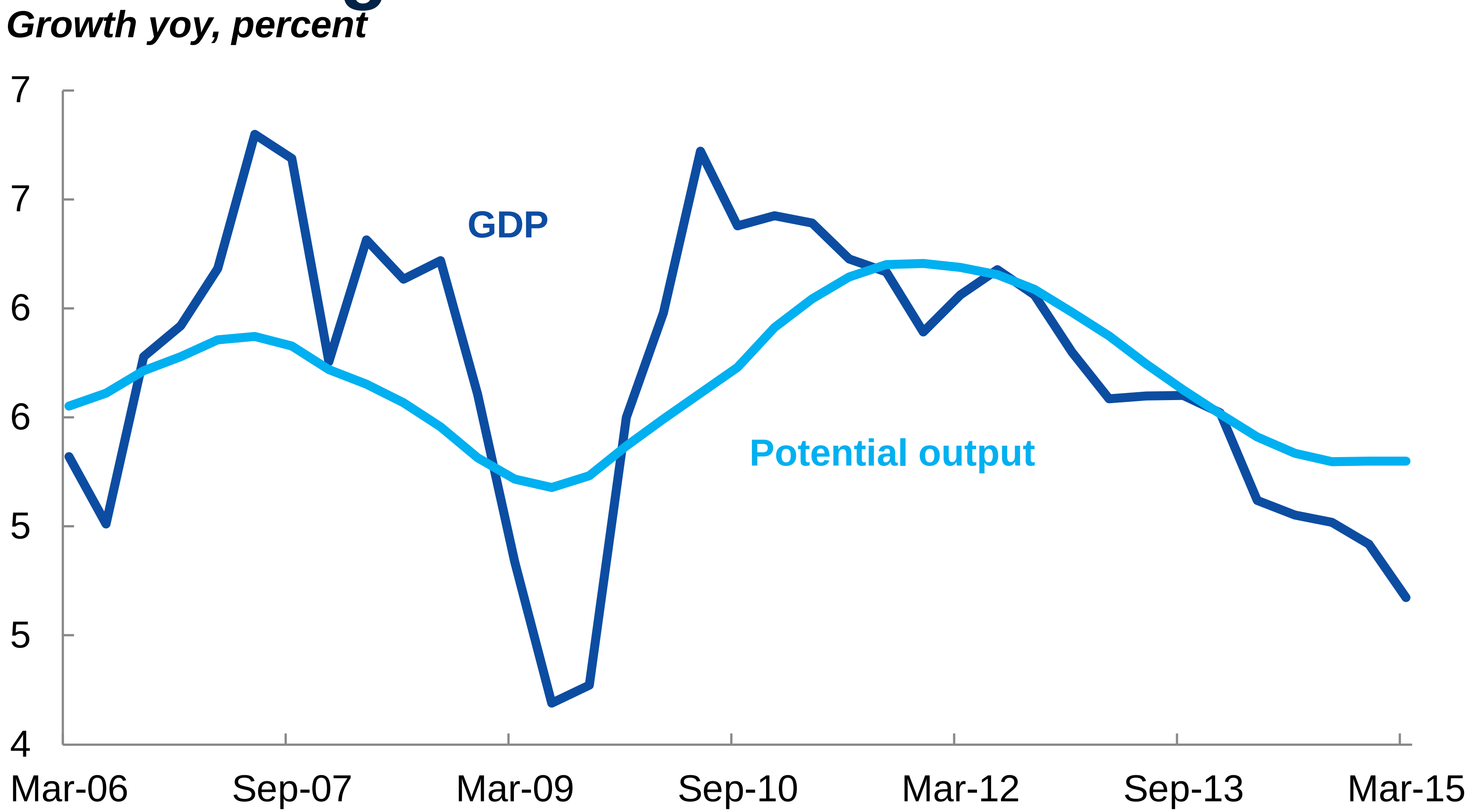
WORLD BANK GROUP

Three facts about the global economy

Indonesia: recent developments and near-term outlook

Effective policy response

Deep reforms are needed to sustain growth of more than ~5.5%

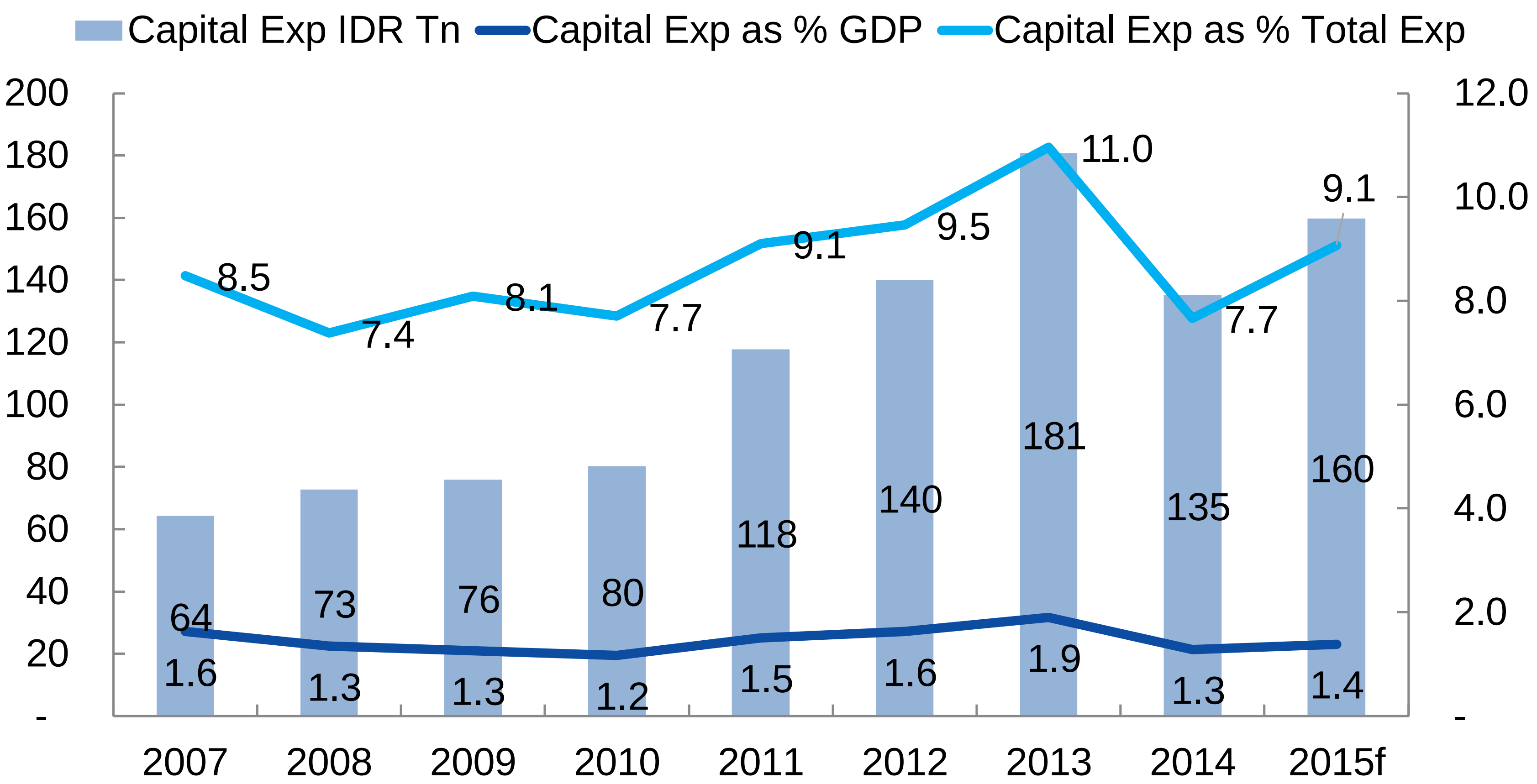


Source: BPS; World Bank staff estimates

WORLD BANK GROUP

Fiscal reforms: "spend the capital budget"

Central government capital spending
(Nominal IDR trillion and percent of Total expenditure and of GDP)



Source: BPS, Ministry of Finance, World Bank staff calculation

WORLD BANK GROUP

Fiscal reforms: measures to collect more in the medium-term

Recently adopted policies:

- VAT electronic tax return submission, effective July 1;
- Improvements in income tax audit strategy (e.g. focus on tax payers more likely to rely on transfer pricing), effective 2015;
- Removal of luxury sales tax on certain goods to lower cost of tax administration, effective July 9.

Further options to mobilize revenues:

- Optimize the tax regime (e.g. revisions to sales and excise taxes for vehicles, fuels and tobacco);
- Improve corporate income tax (e.g. reduce firms' incentives to remain small);
- Revise VAT exemptions to increase equity (e.g. for electricity consumption of high consuming households).

WORLD BANK GROUP

Support the rebalancing of the economy

- With low commodity prices, relative profitability is expected to now favor manufacturing industries and services over most commodity sectors…

- Policy support to businesses and investments in manufacturing and services is thus crucial:
  - Improve logistics services (dwell time)
  - Facilitate firms' access to key inputs (incl. imports)
  - Speed up licensing approval process (e.g. one stop shop)
  - Realign sector-specific regulations with the provisions of the investment law
- Invest more and better in human capital to raise long-term growth

Three facts about the global economy

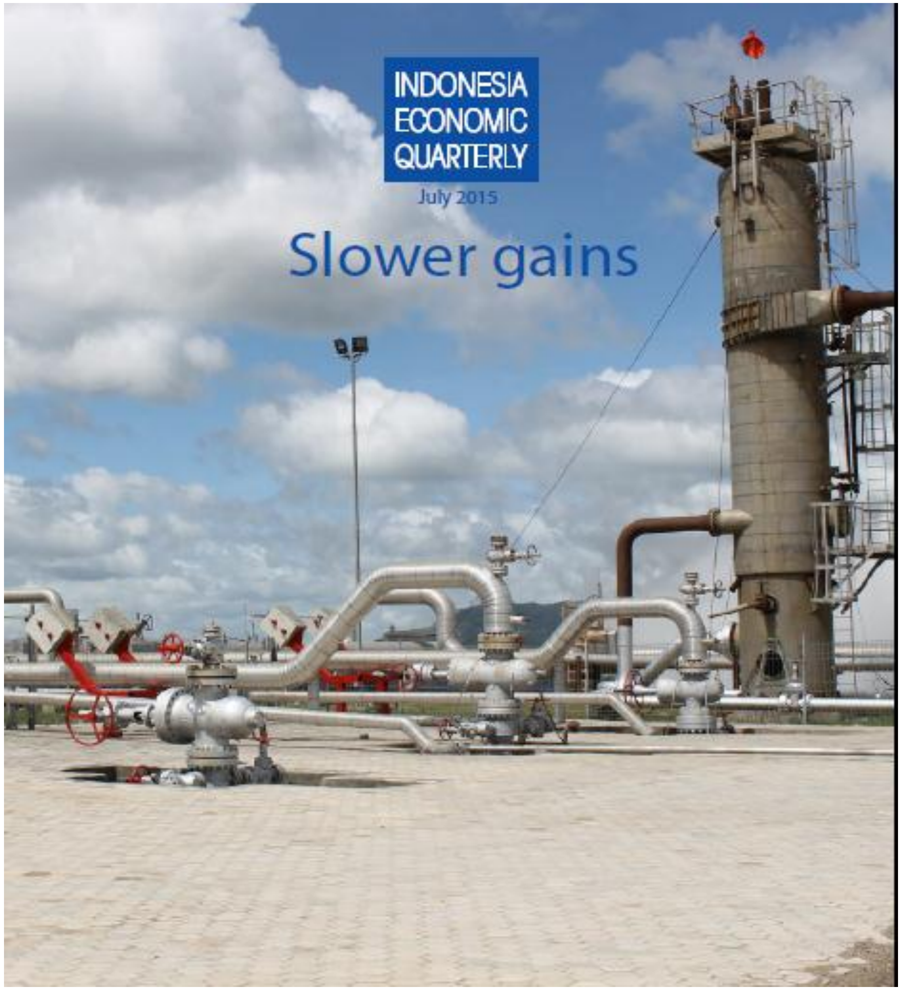
Indonesia: recent developments and near-term outlook

Effective policy response

Also in this IEQ: geothermal, BOS and CAD

July 2015 IEQ Contents

- *Regular* ***update on economic developments*** *and the outlook*
- *Indonesia's* ***current account deficit*** *going forward*
- ***Fuel subsidy reform****: a major one but how to make it sustainable?*
- *Realizing* ***Indonesia's potential in geothermal****.*
- *Ten years of* ***school grant program (BOS):*** *successes and challenges*



Main takeaways

- **"Slower gains":**
  - Output and employment growth are weakening.
  - Major policy initiatives are facing implementation challenges – fuel pricing, infrastructure.
- **Indonesia is not alone in facing these challenges:**
  - EMEs worldwide are slowing down and need to confront structural constraints
- **Indonesia is still in a good position to respond by:**
  - Expanding infrastructure spending, to the extent possible given deficit limit
  - Following through on measures to improve revenues and the business environment
  - Communicating in a consistent way about new policies and decisions to investors, as consistent communication reduces uncertainty.
- **But slower gains are a sign of serious constraints and a shifting economy:**
  - Supporting a rebalancing of the economy key