



WORLD BANK GROUP

Indonesia Economic Quarterly June 2016

Resilience through reforms

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Introduction

Global economy: weaker than expected

- The world recovery is yet to be realized;
- Hence, external conditions remain unsupportive.

Indonesia's resilience stands out

- Private consumption has held up in the aggregate;
- But is private investment recovering?

Further reform momentum is needed

- Sound monetary policy, but rigid bank interest rates;
- Higher public investment despite fiscal constraints;
- Trade policy and the real incomes of the bottom 40 percent;
- Long-term policies to improve manufacturing competitiveness and reduce inequality.



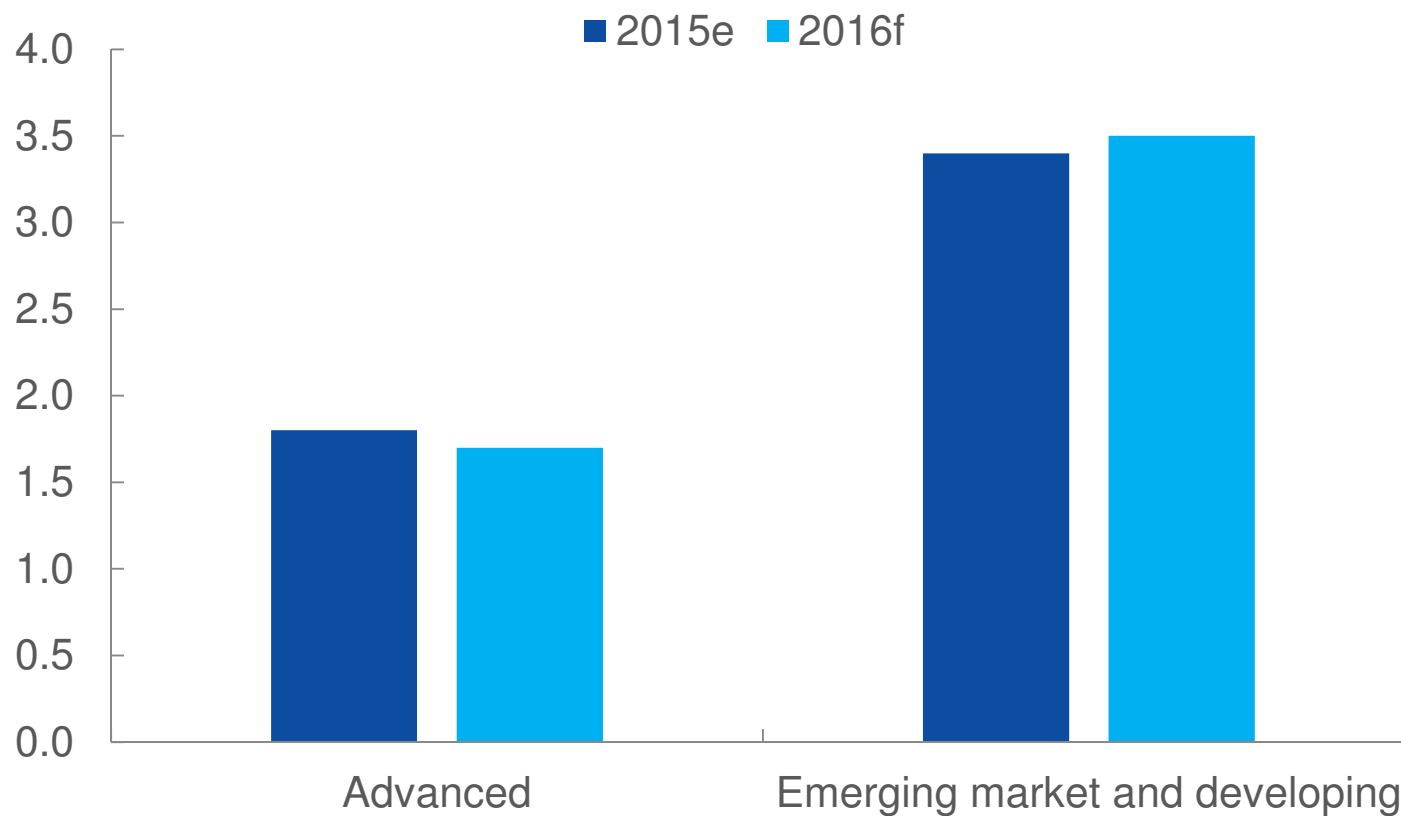
Indonesia: growth resilience

Macroeconomic outlook and risks

Further reform momentum

Global economy: no recovery yet

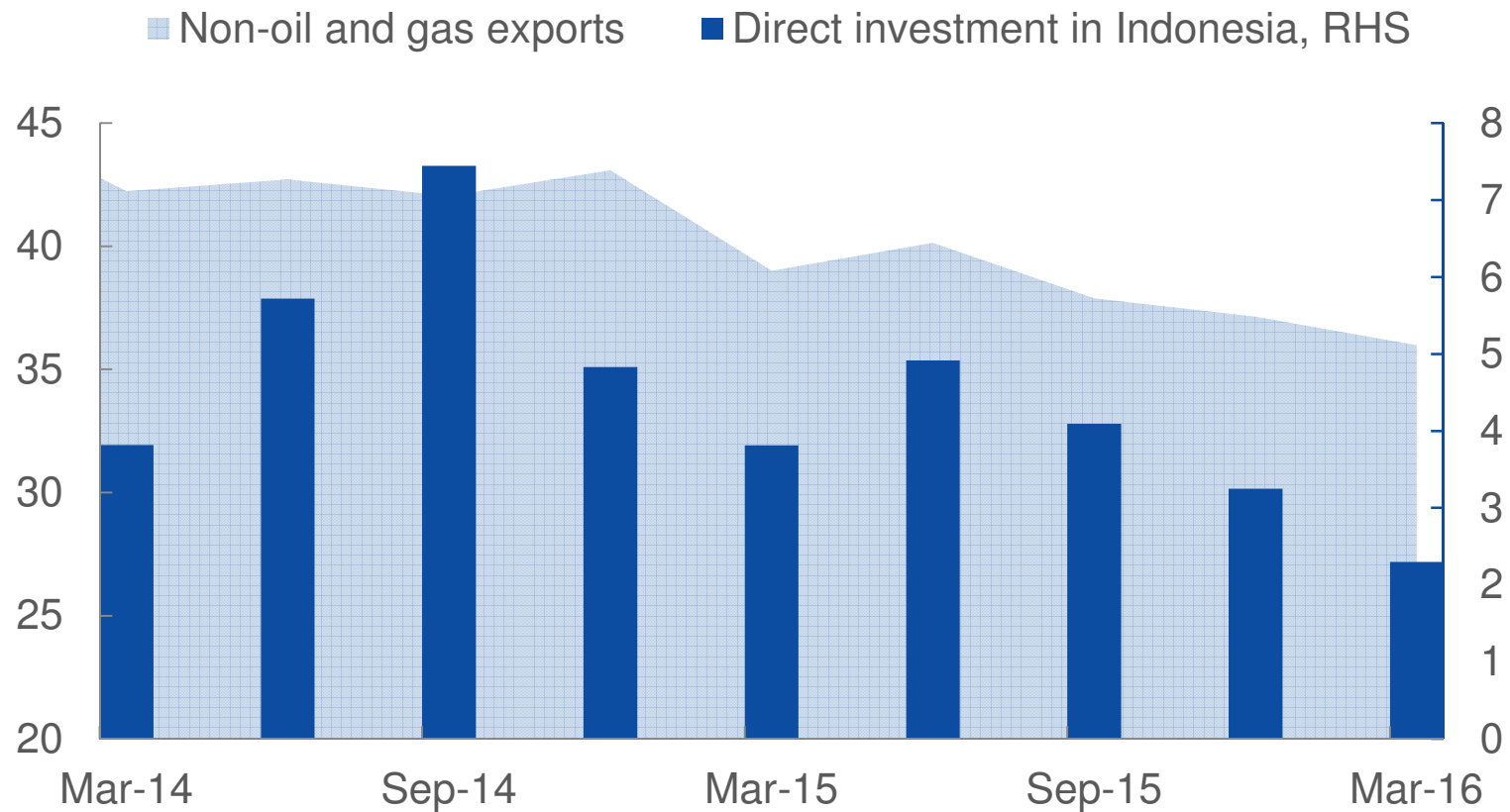
Annual growth, percent



Source: World Bank, June 2016 Global Economic Prospects

Gloomy global trade and investment: a drag in Q1

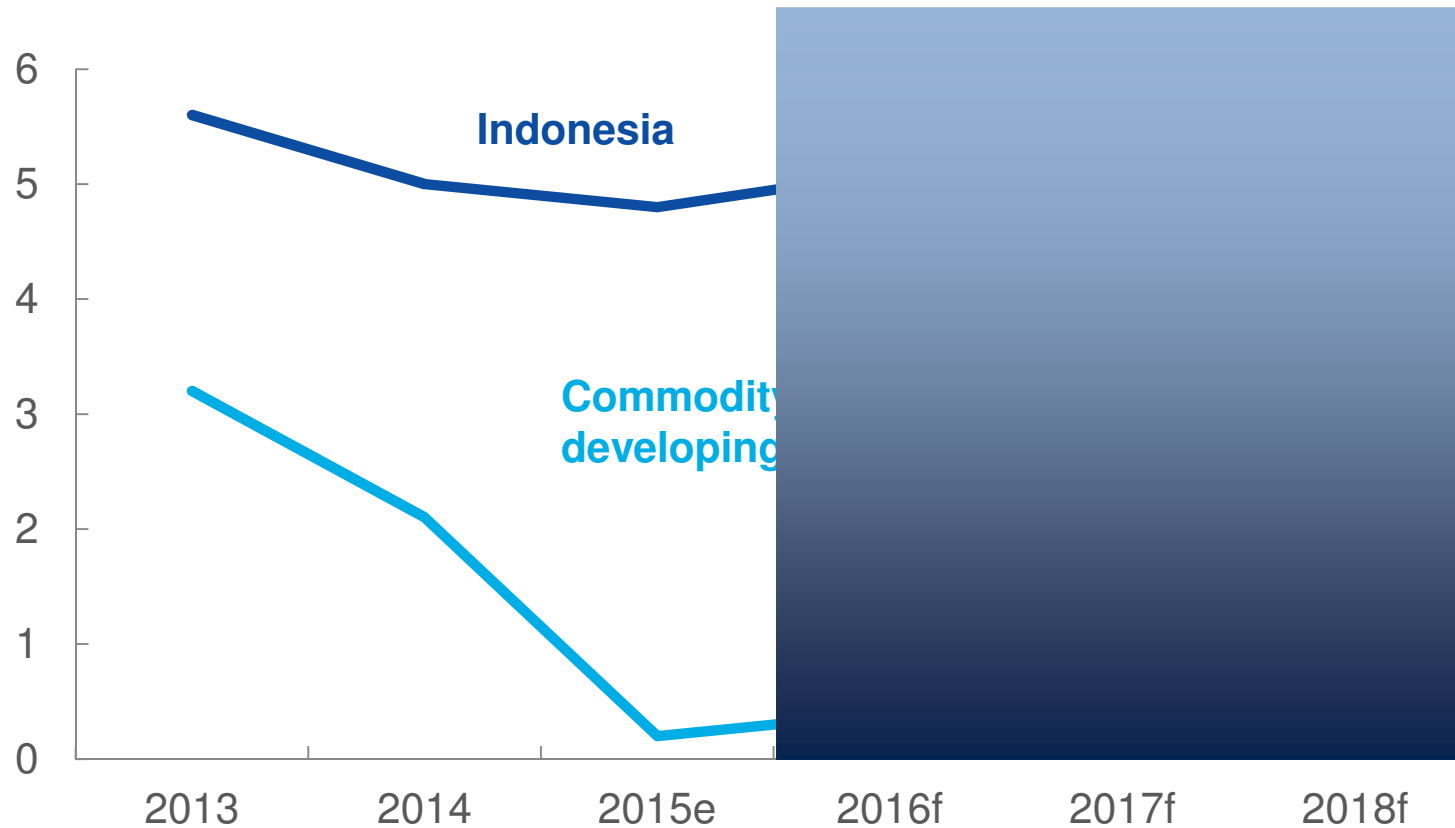
USD billion



Source: BI; World Bank staff calculations

But Indonesia's economy remains resilient

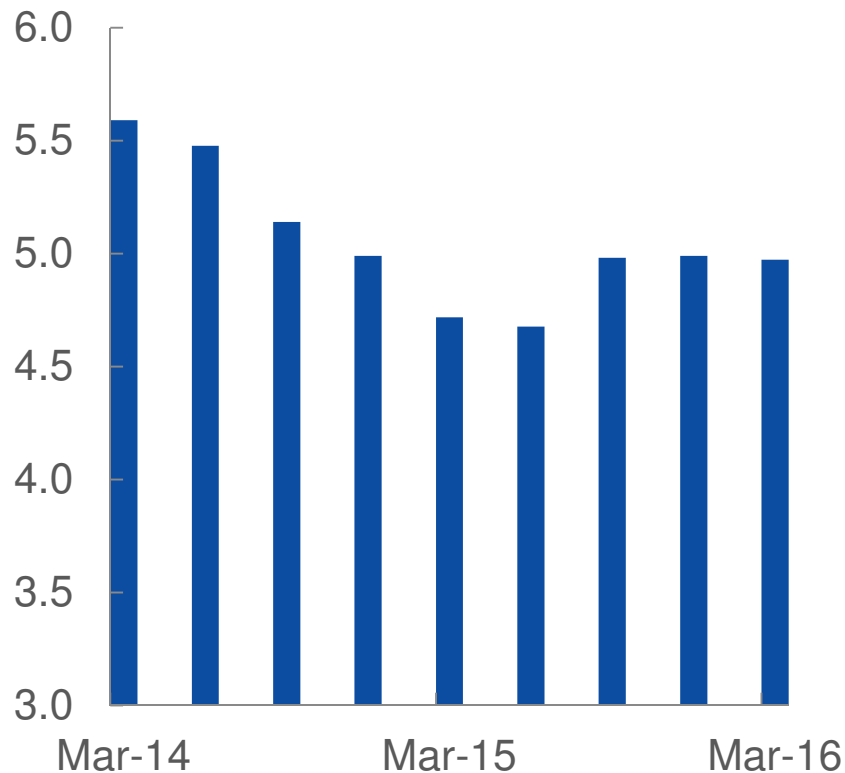
Annual growth, percent



Source: World Bank, June 2016 Global Economic Prospects

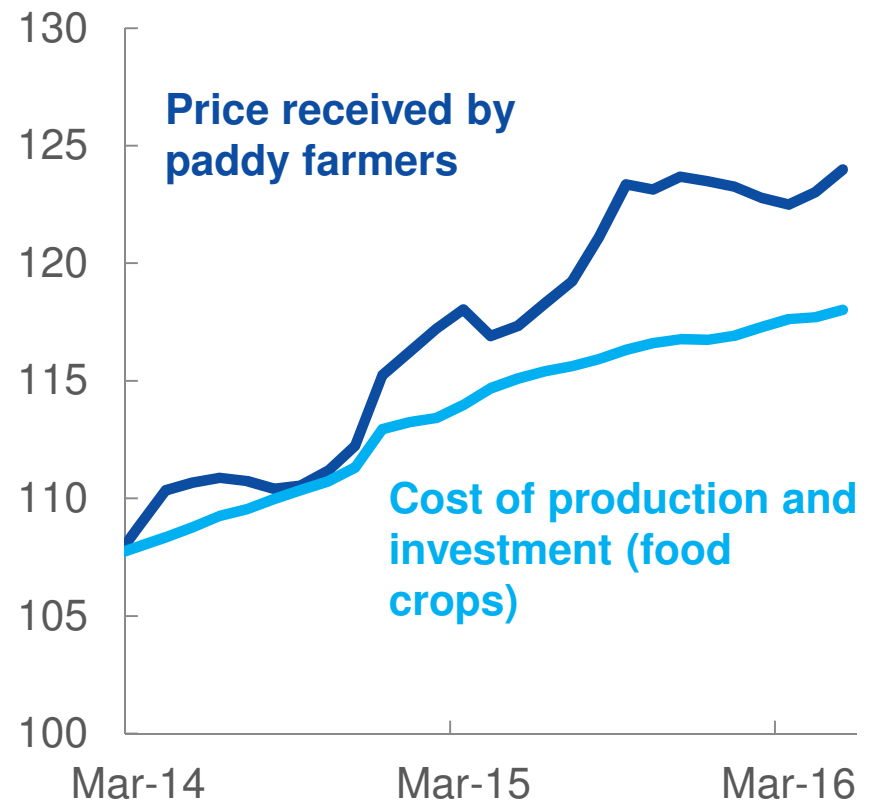
Private consumption holding up in the aggregate, although not for all

Private consumption growth yoy, percent



Source: BPS; World Bank staff calculations

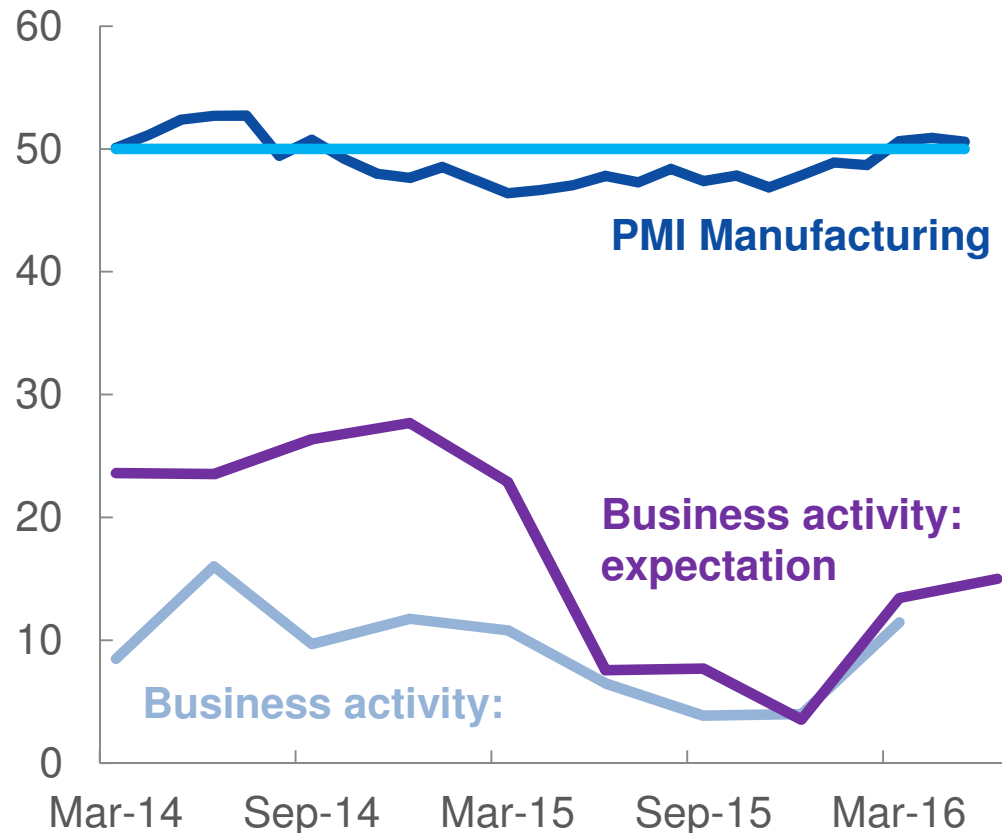
Paddy farmers' income and costs, indices 2012 = 100



Source: BPS; World Bank staff calculations

....Private investment recovering?

Business confidence indicators, indices



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

Estimates of the public investment multiplier:

- **0.4** in short term and **1.4** in medium term in advanced countries (IMF, 2015);
- **0.6** in short term and **1.6** in long term in developing countries (Ilizetzi et al., 2010)

Indonesia: growth resilience

Macroeconomic outlook and risks

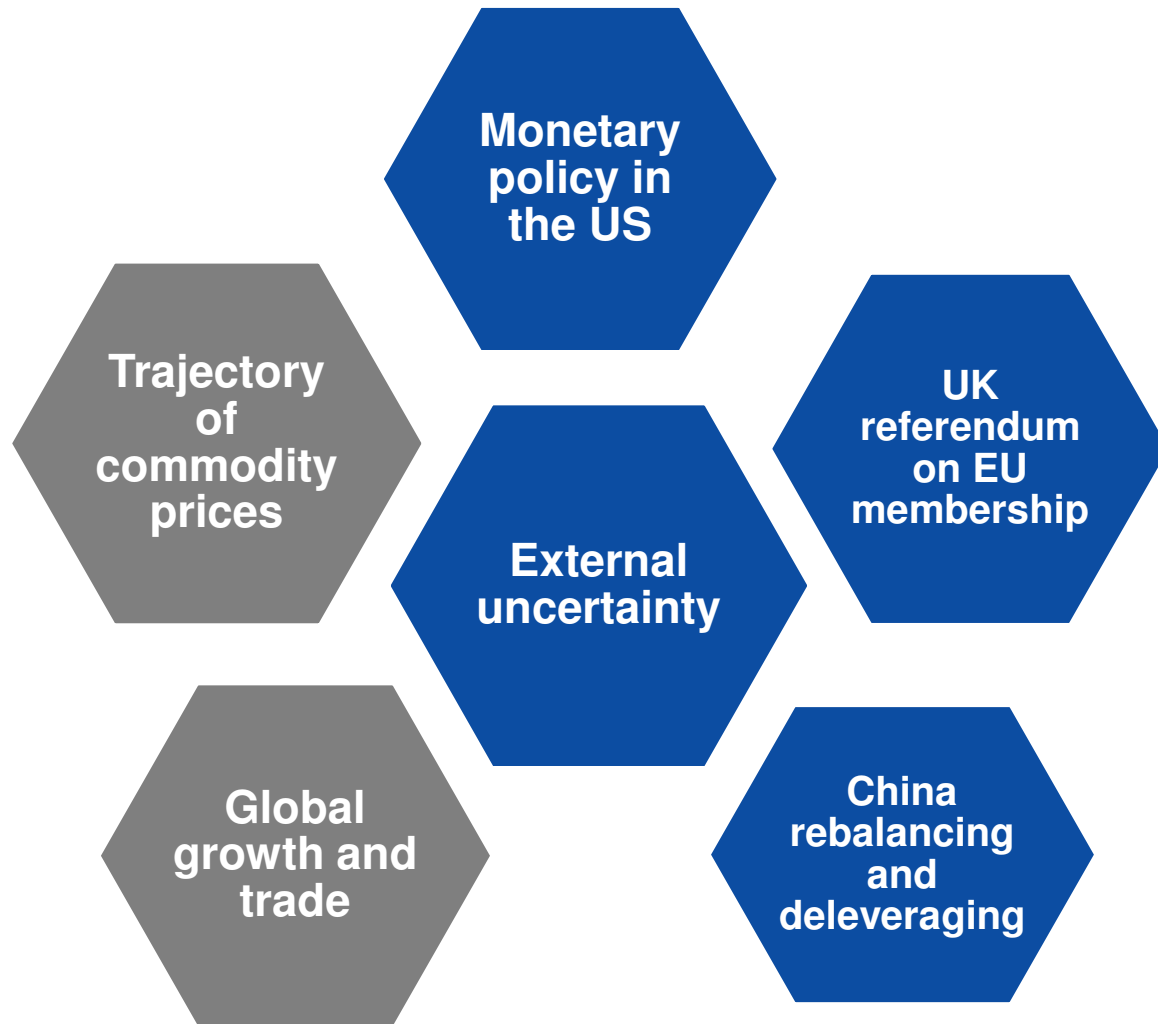
Further reforms

Baseline outlook

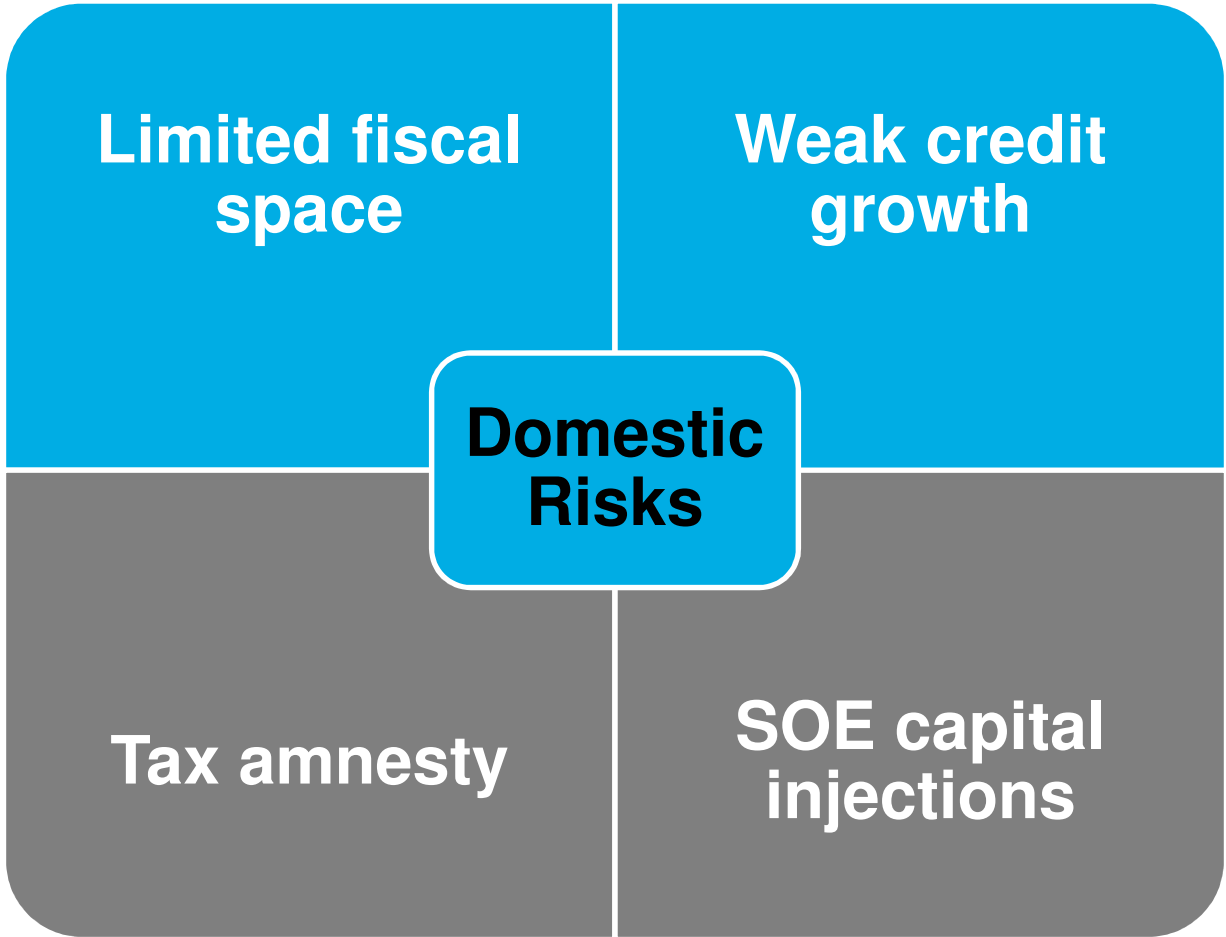
	2015	2016f	2017f
Real GDP (annual % change)	4.8	5.1	5.3
Consumer prices (annual % change)	6.4	3.9	4.4
Current account balance (% of GDP)	-2.1	-2.3	-2.5
Budget balance (% of GDP)	-2.6	-2.8	n.a.

Source: BPS; World Bank staff projections

External risks and uncertainties



Domestic risks



Indonesia: growth resilience

Macroeconomic outlook and risks

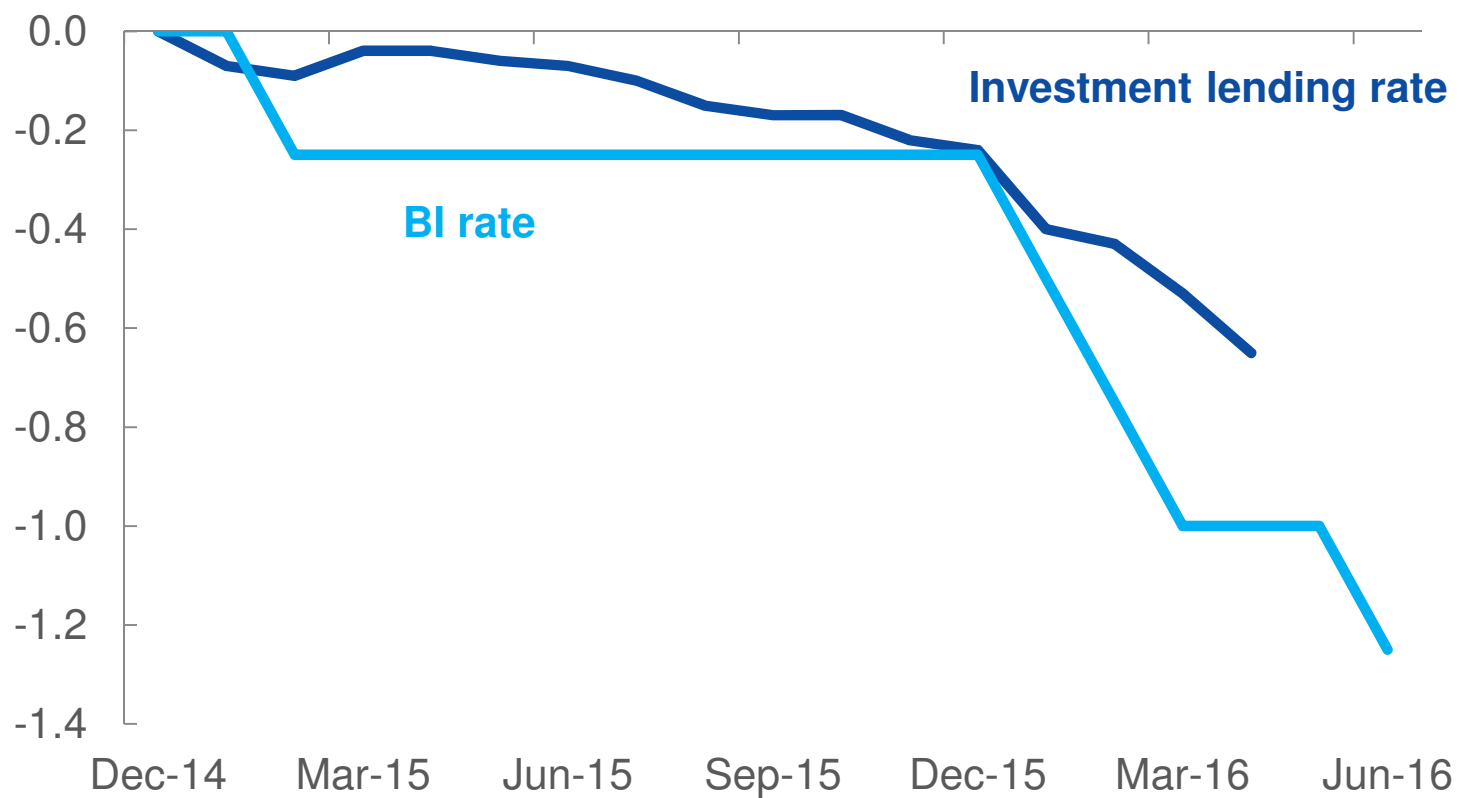
Further reform momentum

Hence, Indonesia needs to work harder



Monetary easing but rigid bank interest rates

Cumulative change since December 2014, percent



Source: BI; World Bank staff calculations

Why are Indonesian interest rates higher than in peer countries?

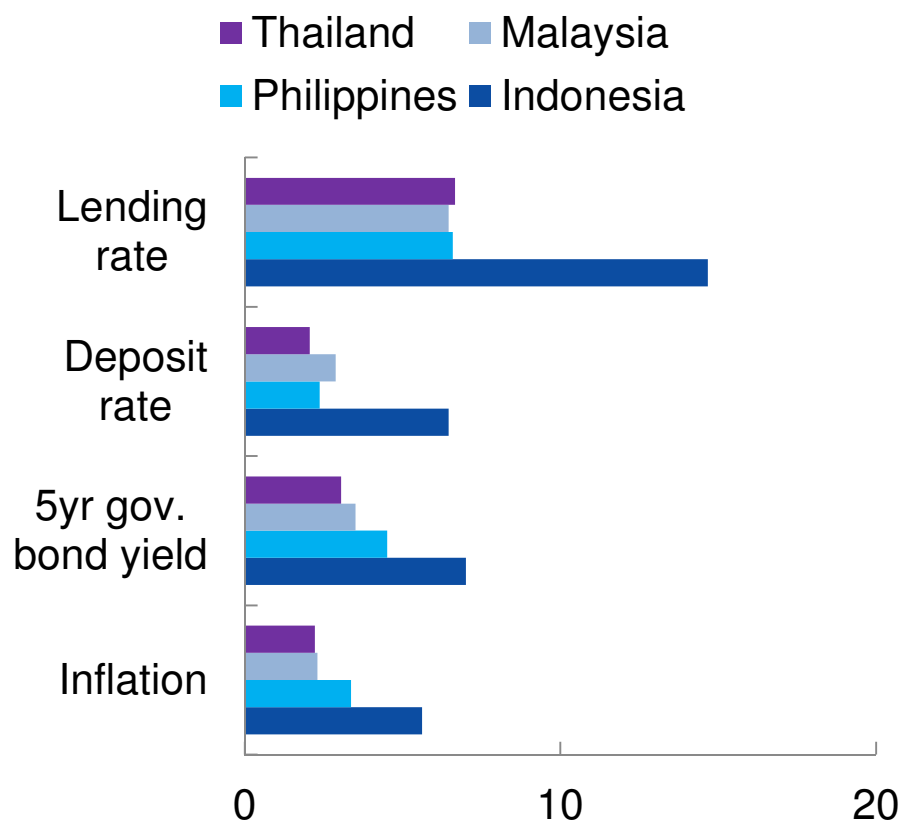
Bank interest and expense structure:

- High overhead costs;
- Low fee income;
- High capital ratios;
- Low loan loss provision.

Structural factors:

- High inflation;
- Underdeveloped financial markets;
- Crowding out by government borrowing.

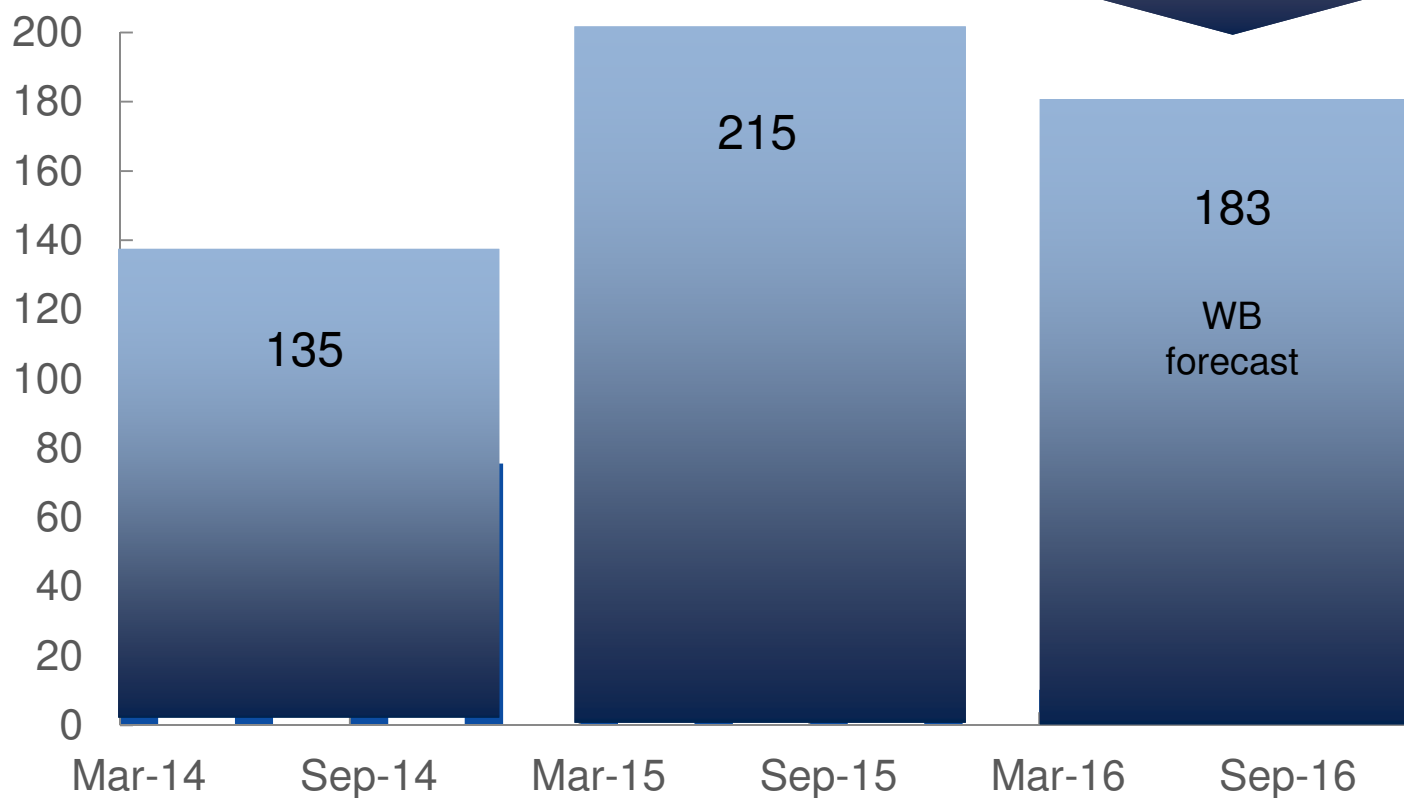
Percent per year



Source: WDI; World Bank staff calculations

Public investment maintained within limited fiscal space

Central government capital spending, IDR trillion



Source: Ministry of Finance; World Bank staff projections

Fiscal policy could better target inequality

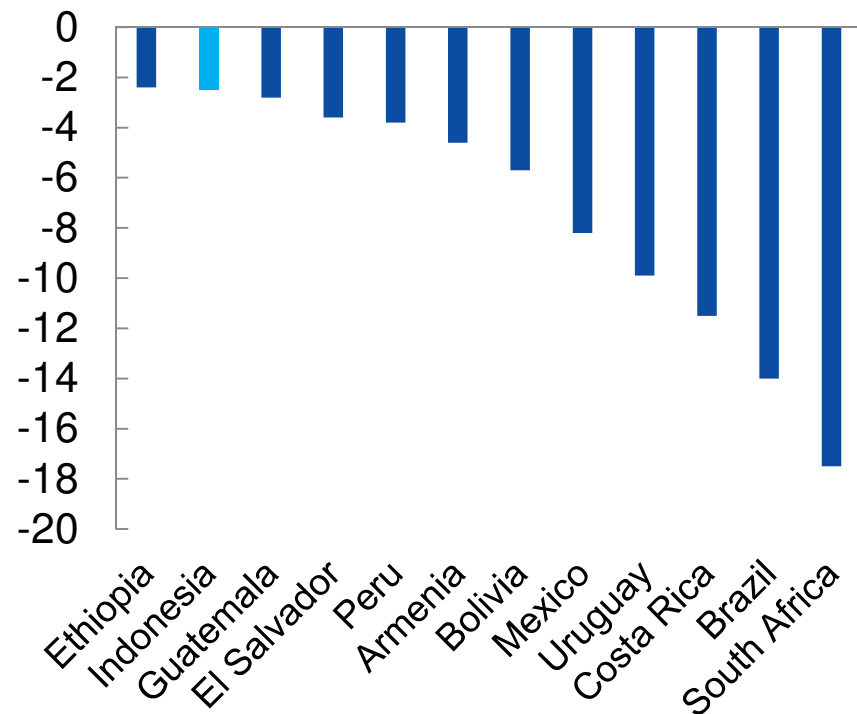
What can be improved?

- The Government spends the least on the most effective programs (e.g. direct cash transfers);
- Compliance and the size of the tax base must be increased.

What has already worked well?

- Fuel subsidy reform, accompanied by compensation for the poor, has had a positive impact on both poverty and inequality reduction.

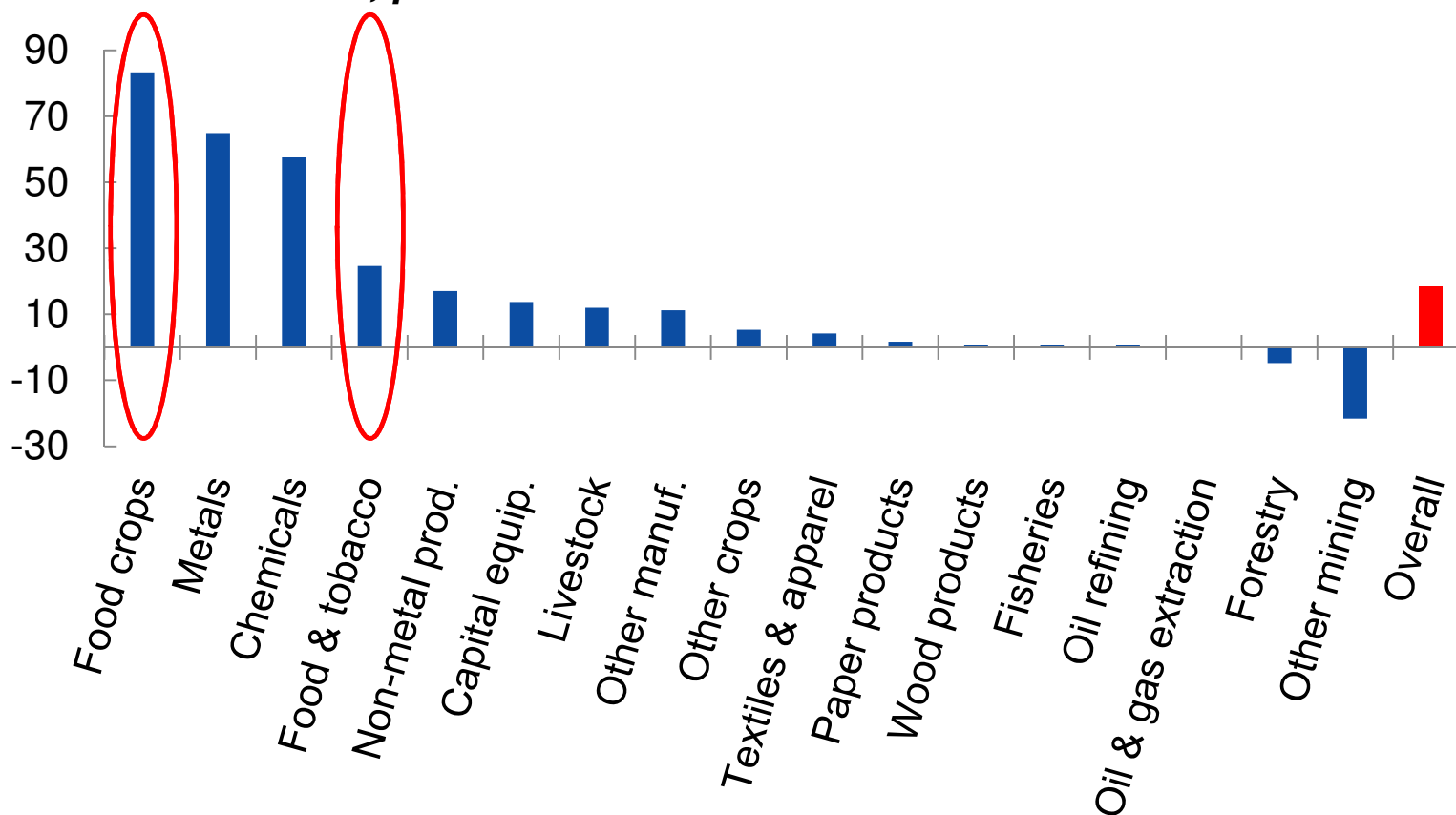
Reduction in the Gini coefficient due to fiscal policy



Source: Various; World Bank staff estimates for Indonesia based on Susenas 2012

Trade policy can hurt the people with the lowest incomes

Difference in value added per unit of output compared to a free trade scenario in 2015, percent

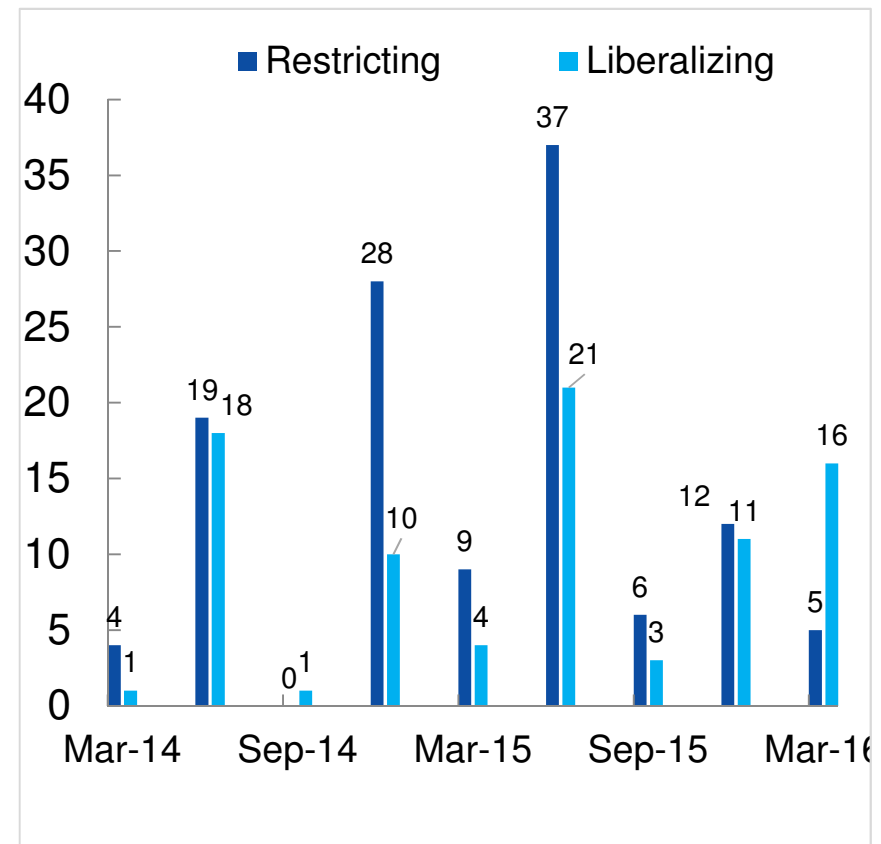


Source: Ministry of Finance; World Bank staff projections

The good news: an emerging trade liberalizing trend

- Until last year, Indonesia was among the world's top users of trade barriers.
- Over the last four quarters, the Government has introduced fewer trade restrictions and more trade liberalizing measures. In Q1 2016, the number of liberalizing measures exceeded the number of restricting.

Number of trade measures



Source: Global Trade Alert; World Bank staff calculations

Reviving manufacturing competitiveness

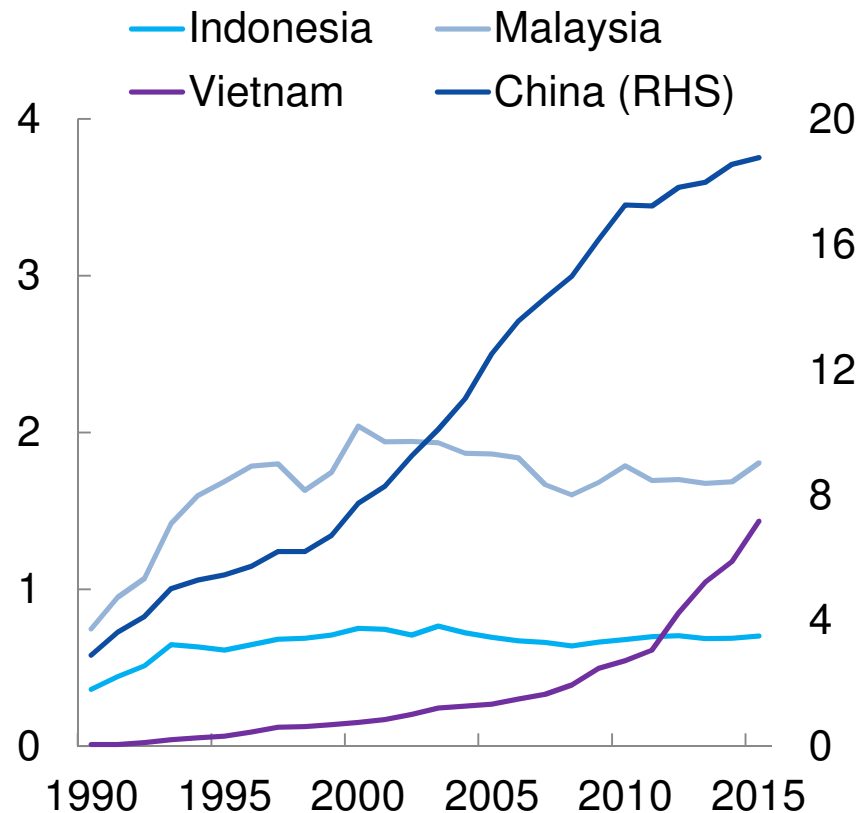
What can be improved?

- Partnership with private sector;
- Sustainably low inflation;
- Focus on promising sectors.

What reforms have already begun but need to gain momentum?

- Better fiscal budget allocation, including higher infrastructure spending;
- Regulatory reform to improve competitiveness.

Share in global manufacturing, percent



Source: UN COMTRADE; World Bank staff calculations