



Indonesia: Economic and Social Update

March 2006



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Summary Introduction

The Indonesian economy ended 2005 with overall GDP growth of 5.6 percent, the highest rate in nine years. However, by year-end the growth story was mixed, with growth running well over 6 percent early in the year, then slowing as interest rates rose and consumers adjusted to increases in fuel prices (114 percent in October alone, and 143 percent for the year). The slowdown reflected a difficult economic adjustment needed to bring Indonesian energy prices closer to market prices, a vital step to sustainable and higher, longer-term growth. The impact of the slowdown was mitigated by strong exports and by an expansionary fiscal policy (including a program of cash transfers to the poor) that held up growth in the 4th quarter. Expansionary fiscal policy is also expected to limit the pace of contraction during the first half of 2006, before higher consumer and investment spending raise growth in the second half of the year. Currently interest rates are high and likely to remain so for at least the first half of 2006. However, they are expected to fall later in the year as inflationary momentum slows, further boosting the economic recovery. In sum, 2006 is likely to be the mirror image of 2005, with the growth cycle bottoming in the first quarter before rising later in the year.

There has also been good progress in non-economic areas. The anti-corruption campaign continued with a growing number of prosecutions (and convictions) for corruption. The Anti-Corruption Commission is playing a leading role in this area and in broader reform, including, most recently, taking the lead in a proposal for fundamental civil service reform. The Supreme Audit Agency continued breakthrough audits (including dissemination of results) on government agencies and public enterprises. In addition a peaceful process of regional direct elections has continued with the electorate frequently rejecting incumbents. Moreover rebuilding in Aceh has gained momentum. Fifteen months after the Tsunami, houses are being built in large numbers, the school year started on-time, and health services are available in most affected areas. However, Aceh's greatest hope for sustainable recovery is the peace agreement between the Indonesian Government and GAM, which so far has been implemented without major disruptions. 2006 will be a crucial test for both the success of the reconstruction effort and the peace agreement.

The waning months of 2005 also brought a reshuffle in the Economic Team. Former Finance Minister Boediono took the Economic Coordinating Minister portfolio and the Planning Minister Sri Mulyani moved to Finance. The new team completed two policy packages by end-February, one on infrastructure and the other on investment climate, with a third on financial sector reform under development. The investment and infrastructure packages address policy issues in corporate regulation, tax, customs, labor and infrastructure that have been under review for some time. However, the packages also demonstrate a willingness to tackle a number of difficult decisions that had been on hold and provide a time-bound matrix with clearly defined Ministerial responsibilities. The investment package enjoys heightened political commitment owing to its issuance as a Presidential instruction. Highlights of the investment package include: completion of the investment law and reductions in red tape; business friendly revisions to the tax law; and improved procedures in customs. The infrastructure package includes continued progress on public private partnerships, including a risk sharing framework (allowing contingent liabilities on budget), improved coordination mechanisms and progress on sectoral issues in anticipation of an Infrastructure Summit. A third package addressing issues in the financial sector is expected in the next month to address weaknesses in state-owned banks; to deepen the bond market; and to resolve long standing monetary issues between the Ministry of Finance and Bank Indonesia. The reaction to the new economic team has been positive with the Indonesian Rupiah strengthening appreciably and the stock market reaching historic highs. The recent policy packages have also been well-received. However, given the problems with implementation in

recent years, there is some uncertainty whether the government will be able to fully deliver on the new policy packages.

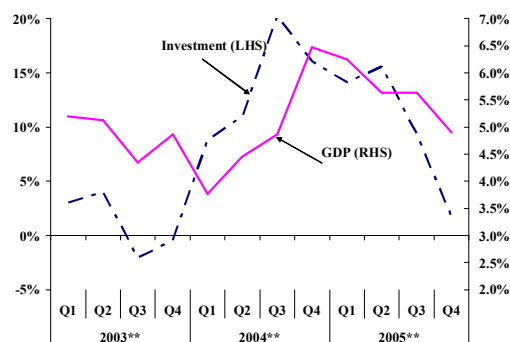
Fiscal and monetary policies were central to economic outcomes in 2005. By year-end, the central government budget deficit stood at 0.5 percent of GDP, while the government debt-to-GDP ratio improved to 47 percent from 55 percent in 2004, and from close to 100 percent at its post-crisis high. The lower fiscal deficit in 2005 builds on the recent track record of low deficits and a rapidly improving the debt-to-GDP ratio; it also reflects low spending in early 2005, especially on capital projects. These low disbursements resulted from delays as the administration and Parliament changed in late-2004 and from efforts to improve fiscal management (e.g., reorganization of the Ministry of Finance and new public financial management systems) in 2005. As noted above, by the fourth quarter of 2005, fiscal policy had turned expansionary and this should continue in 2006. However, regional governments' share of total public expenditures is expected to increase significantly from 2005 to 2006. To date, one-third of central government expenditures have been transferred to the regions. With their own resources, regional governments are now responsible for half of total spending and higher shares of capital spending. There was some build up reserves by regional governments in the banking system in 2005, leading to concerns that this will continue in 2006 (especially early in the year), reducing the needed fiscal stimulus. On the side of monetary policy, through August 2005, Indonesia was slow to raise key policy interest rates in line with rising world rates, causing depreciation of the rupiah, a loss in reserves, and sharply higher long-term interest rates. Beginning in September 2005, administered rates were increased aggressively (up by 5 percentage points in a series of moves) which restored stability to the Rupiah and allowed a buildup in reserves (which are now higher than a year ago). Current projections are for interest rates to decline in line with falling inflationary expectations later in the year, adding economic stimulus.

The Bank projects growth of 5.5 percent in 2006. The current slowdown should bottom out in the first half, mitigated by strong government spending (financed by reduced subsidies) and net exports (partly driven by markedly lower fuel imports). In the second half, government spending should remain strong with overall growth picking up on higher private investment and a recovery in consumer durable spending. Good progress on infrastructure, investment, and financial reforms would reinforce this underlying trend and crowd in private investment, earlier and stronger. Assuming good progress on the reform agenda and a favorable global environment, growth should accelerate to above 6 percent in 2007.

1. Growth, Investment and Employment

Growth deceleration: The annual growth rate in 2005 was 5.6 percent, the highest since the crisis that began in mid-1997 (7.6 percent in 1996). However, the quarterly profile has been slowing since late 2004, largely due to weaker investment, especially towards the end of 2005 (Figure 1). A series of fuel price increases, delays on investment climate reforms, and mid-year financial market jitters hurt investment. Reflecting weaker investment, the growth of capital imports fell significantly from 19 percent (yoy) in Q3 to 0.6 percent in Q4.

Figure 1: Growth and investment decelerate
(year-on-year growth rates, percent)



Source: BPS, World Bank

Government consumption and net exports

propped-up growth: In Q4 2005, government consumption was up 30 percent (yoy) due to countercyclical fiscal policy (see Section 5 below). This stimulus was aided by surprisingly strong net exports (exports minus imports) for the first time since Q3 2003. This was driven by steady growth in exports and a fall in oil and gas imports.

Variable growth: However, recent growth has been uneven. Non-oil and non-tradable sectors have been the main drivers for the past few years. For example, in 2005, the non-oil and gas sector grew by a relatively robust 6.5 percent; in contrast, oil and gas contracted by 3.3 percent. This decline in the oil and gas sector was reflected in other tradable sectors (see below), which only increased by 3.5 percent in 2005, a rate below that of any non-tradable sector (Table 1). Despite the significant increases in international oil and gas prices, low investment has continued to reduce production levels in the oil and gas sector.¹

Rising Unemployment:

Despite the relatively strong economic growth (especially non-oil and gas), the unemployment rate increased by 2 percentage points between 2001 and 2005 reaching 10.3 percent. The corollary is that labor productivity (GDP per worker) accelerated from 3.4 percent growth in 2002 to 4.2 percent in 2005. On the one hand, the improvement in labor productivity contributes to growth acceleration; on the other, it reduces job creation and remains a concern.

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

	2004	2005	Q2	Q3	Q4
Tradable	2.9%	3.5%	2.8%	3.4%	3.3%
Agriculture	2.1%	2.5%	0.9%	2.9%	5.5%
Mining	-4.9%	1.6%	-0.5%	1.0%	1.9%
Manufacturing	6.4%	4.6%	4.9%	4.5%	2.9%
Non-Tradable	7.2%	8.0%	8.9%	8.2%	6.6%
Construction	6.9%	7.3%	8.2%	6.9%	6.9%
Finance	7.9%	7.1%	8.9%	7.9%	5.2%
Transport & Commu.	14.0%	13.0%	14.1%	13.0%	10.8%
Utility	4.2%	6.5%	6.9%	6.6%	6.1%
Trade, Hotel & Restaurant	5.8%	8.6%	10.0%	8.6%	6.0%
Services	5.4%	5.2%	4.4%	5.6%	6.0%
Non-oil and gas	5.8%	6.5%	6.6%	6.5%	5.7%
Oil and gas	-3.5%	-3.3%	-3.9%	-3.1%	-3.3%
Total	4.9%	5.6%	5.6%	5.6%	4.9%

Source: BPS, World Bank

¹ For more analysis, see the Economic and Social Update (October 2005)

2. Financial Markets

Confidence returns: In August 2005, the Rupiah suffered a mini-crisis, fuelled by a loss of market confidence in monetary policy and concerns over the impact of high oil prices on the budget. The central bank's quick decision to tighten monetary policy through an appreciable increase in interest rates and the government's decision to slash fuel subsidies quickly restored market confidence in the Rupiah. With higher interest rates and a turn around in the balance of payments (due to a drop in fuel imports), by early March 2006, the exchange rate had appreciated by 20 percent and stood at Rp.9,200 to the US dollar, well above the depths of the August 2005 turbulence (Figure 2).

Capital inflows are increasing to virtually all emerging economies these days. However recent developments imply that financial markets are increasingly confident about Indonesia's financial stability and longer term growth prospects. Bond yields at the longer end of the maturity spectrum fell markedly to levels closer to the previous year's level (Figure 3). This reflects market optimism regarding long-term inflation and the likelihood that short-term rates will fall later in the year.

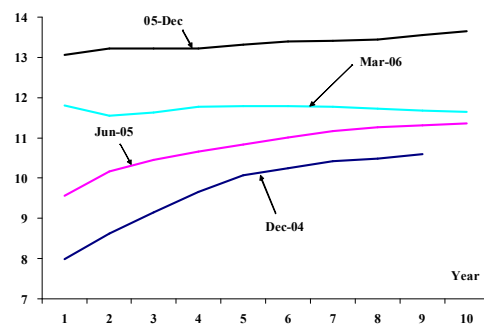
In another sign of confidence, Indonesia had a very successful international bond issuance in March 2006. The total issuance was US\$2 billion, Indonesia's biggest ever off-shore fund raising. The issuance comprised US\$1 billion in new 2017 bonds and US\$1 billion in a re-opening of its 2035 issue; in total, they were 3 ¾ times oversubscribed. Pricing of the bond, which was determined in New York on 2 March 2006, was very favorable for Indonesia.² The 2017 bonds were sold at a yield of 7 percent (235 basis points over comparable US Treasuries) while the 2035 bonds were priced to yield 7.375 percent (264 basis points over Treasuries). Both were at the lower end of the guidance set by the Government. This pricing was also favorable in comparison to bonds issued by other countries, for instance the Philippines, which has a slightly better credit rating than Indonesia.

Figure 2: Market confidence is back
(Rupiah exchange rate against US\$)



Source: CEIC, World Bank staff

Figure 3: Declining interest rates
(domestic bonds yield curve, percent)



Source: CEIC, World Bank staff

² Previously, international rating institutions had altered Indonesia's credit rating. For example, on 9 February 2006, Standard & Poor's (S&P) raised the rating for Indonesia from "stable" into "positive"; while on February 27, 2006 Moody's announced its intention to upgrade its rating for Indonesia.

3. External Sector

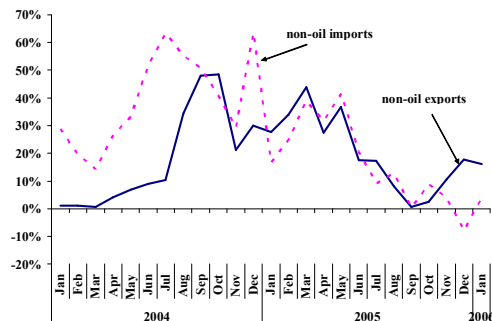
Heightened importance of trade: The growing importance of trade to the Indonesian economy is evidenced by the share of international trade (exports plus imports), which grew from 45 percent in 1999 to 77 percent in 2005³. Moreover, in Q4 2005, the economic slowdown was mitigated by strength in net exports. Export growth accelerated from 4.8 percent in Q3 to 7.4 percent (yoy) in Q4, while imports decelerated from 10.6 percent to 3.7 percent (yoy), mainly due to a drop in oil imports.

Non-oil exports, a key to rebounding growth: In 2005, the growth in both non-oil exports and imports was high (18.6 percent and 15.4 percent, respectively). However, the gap in growth rates between them has widened noticeably in recent months (Figure 4). Non-oil exports are higher for high commodity priced mining exports⁴ and for other commodities that are shifting from domestic markets to exports amid weakening domestic demand. Among non-oil imports, raw materials and intermediate goods and capital goods decelerated sharply; only consumption goods remained strong. If maintained, this drop is a worrisome leading indicator for manufacturing exports, because they rely heavily upon imported raw materials and intermediate goods.

Oil and gas balance turns positive: In Q3 2005, Indonesia posted a deficit on oil trade for the first time in 20 years, the result of rising demand for fuel products and a concurrent decline in domestic oil production. The deficit shifted to surplus in Q4, owing to the October increase in domestic fuel prices (Figure 5).

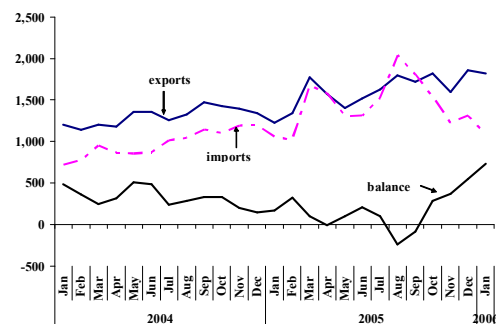
High oil prices create a positive terms of trade shock for Indonesia: Being a resource-rich country, recent increases in international commodity prices have had a positive terms of trade impact on the economy. Through the terms of trade impact, higher international oil prices are estimated to have increased Indonesia's GDP by 0.4 percent in 2005. Consequently, gross domestic income (GDP plus terms of trade effect) grew by 6.2 percent, higher than the GDP growth of 5.6 percent.

Figure 4: Widening growth gap
(non-oil exports and imports, year-on-year growth, percent)



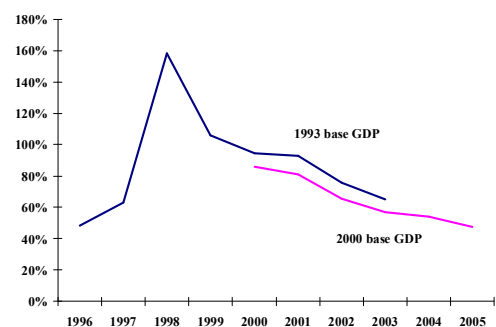
Source: BPS, World Bank staff

Figure 5: Oil and gas balance
(US\$ million)



Source: CEIC, World Bank staff

Figure 6: External risk improves
(external debt to GDP, percent)



Source: World Bank staff

³ As indicated by shares of real GDP, to eliminate the impact of shifts in relative prices.

⁴ In January-October 2005, mining products like copper and coal contributed about 40 percent of the increase in total non-oil and gas exports relative to the previous year.

Current account in small surplus; capital account in deficit⁵: In 2005, the current account recorded a surplus of US\$1.0 billion (0.3 percent of GDP), slightly narrower than the US\$1.6 billion in 2004 (0.6 percent of GDP). By contrast, the capital account balance shifted to a deficit of US\$2.0 billion in 2005, compared to a surplus of US\$1.9 billion in the previous year. The 2005 deficit mainly stemmed from outflows during the Rupiah's mini-crisis in July/August. Gross FDI inflows increased to US\$16 billion, up from US\$10 billion in 2004.

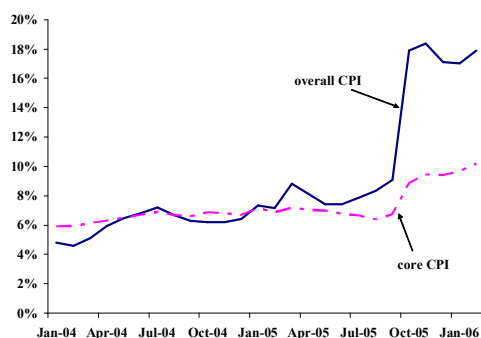
External risk indicators improved: Two key indicators of external risk, namely, international reserves and external debt, have improved recently. During August 2005, foreign exchange reserves fell by 20 percent (to US\$30 billion) due to the need to finance higher oil imports. Nonetheless, by March 2006, reserves had recovered to pre-August levels (US\$35-36 billion). External debt as a share of GDP continued its downward trend during 2005, falling to 48 percent in 2005, compared to a peak of 160 percent in 1998 (Figure 6).

4. Inflation and Monetary Policy

Fuel price increases led to higher inflation: Inflation was stable at about 6-7 percent in 2003-2004. However, the 114 percent increase in fuel prices in October pushed inflation to over 17 percent (Figure 7). Core inflation⁶ is well below overall or headline inflation but it is on the rise, standing at 10.2 percent (yoy) in February 2006, compared to 6.7 percent in September 2005.

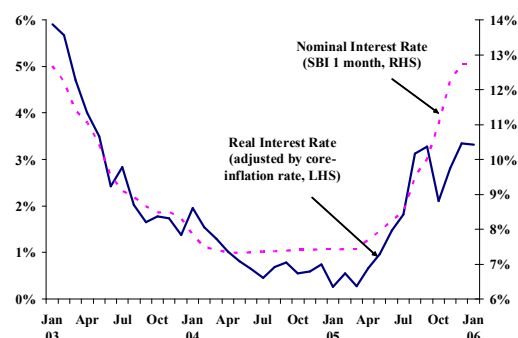
Tight monetary policy: To restore stability in August 2005, Bank Indonesia significantly tightened monetary policy. Subsequently, nominal interest rates (1-month SBIs) increased by more than 5 percentage points to 12.8 percent and real interest rates (adjusted by the core-inflation rate as a proxy for expected inflation) rose by 3 percentage points to 3.3 percent (Figure 8). This has undoubtedly contributed to the Rupiah's recent appreciation and will help to contain inflationary pressures. Once it is clear that inflationary pressures are receding, generally

Figure 7: Inflation is way up
(Consumer price index, year-on-year, percent)



Source: CEIC, World Bank staff

Figure 8: Monetary policy is tighter
(interest rates, nominal and real, percent)



Source: CEIC, World Bank staff

⁵ The 2005 balance of payments data are presented in a new and improved classification by Bank Indonesia. The current account balance was US\$1.0 billion in the new format, compared with US\$3.0 billion in the old format. The central difference is that previously private capital inflows and outflows were netted on the capital account. Now corporate retained earnings in Indonesia are logged as an outflow on the income account (an element of the current account) and an inflow on the capital account.

projected to occur by mid-2006, monetary policy could be eased with interest rates reversing their recent increase.

5. Fiscal Policy

Continued Fiscal consolidation: In 2005, the budget deficit (relative to GDP) was 0.5 percent, about half the deficit foreseen in the second 2005 revised budget (Table 2). The smaller budget deficit (together with sizable increases in nominal GDP) contributed to the continuing sharp drop in the government debt-to-GDP ratio which stands at 47 percent (end-2005) from 55 percent in 2004, and 100 percent in 1999.

Low expenditures: Improved tax administration helped to raise non-oil and gas domestic tax revenues from 9 percent of GDP in 2001 to 11 percent in 2005. However, fiscal consolidation in 2005 has been mainly due to low expenditures stemming from delays in disbursements, caused by the changes in administration and Parliament, as well as in budget procedures. Government budget execution documents were only available in April due to a number of complicating factors. The outgoing government did not provide a full budget and the new government (and Parliament) had to prepare its own. In addition there was a major reorganization at the Ministry of Finance that accompanied the introduction of a new fiscal management system. This contributed to

Table 2: Snapshot of the 2005-2006 State Budget (% of GDP)

	2005		Gap	2006
	Second Revision (APBN-P2)	Preliminary Result 1/		Approved Budget (APBN)
A. Revenues	20.4	18.1	-2.3	20.6
- oil and gas	6.7	5.1	-1.6	6.0
- grants	0.3	0.0	-0.3	0.1
B. Expenditures	21.3	18.6	-2.7	21.3
- capital expenditures	2.1	1.3	-0.8	2.1
- subsidies	4.5	4.4	-0.1	2.6
o/w fuel subsidy	3.4	3.5	0.1	1.8
- social assistance	1.1	0.9	-0.2	1.2
- transfers to regions	5.8	5.5	-0.3	7.2
C. Primary Balance	1.4	1.6	0.2	1.8
D. Budgetary Balance	-0.9	-0.5	0.4	-0.7
E. Financing	0.9	0.7	-0.2	0.7
- Bank financing	0.2	0.2	0.0	0.8
- Foreign loan disbursements	1.3	0.9	-0.4	1.2
- Foreign loan amortization	-1.5	-1.4	-0.1	-2.1
F. Economic Assumptions				
- GDP growth rate	6.0	5.5	-0.5	6.2
- Inflation rate	8.6	10.5	1.9	8.0
- Exchange rate	9,800	9,700	-100	9,900
- Crude oil price (US\$/bb)	54	51	-3	57.0
- Interest rate (SBI 3M)	8.0	9.2	1.2	9.5

1/ Based on 2005 GDP assumption by World Bank

Source: Ministry of Finance, World Bank staff calculations

⁶ Excluding volatile foods and administrative prices. BPS began to publish core inflation data in March

**Box 1: Contractionary or Expansionary Fiscal Policy in 2005?
Conclusions of Fiscal Impulse Analysis**

Fiscal impulse analysis (*) indicates that fiscal policy was quite contractionary in the second half of 2004 and even more contractionary in the first half of 2005, before becoming strongly expansionary in the second half of 2005. As discussed in the main text, spending in the first half of 2005 was severely constrained by the changes in government and budgetary procedures. Starting in Q3 2005, spending on key items such as subsidies, regional transfers and capital increased significantly (relative to a year earlier). In contrast, changes in revenues accounted for a small proportion of the shifts in the fiscal impulse.

Looking ahead to 2006, we project a mildly expansionary fiscal policy with additional central government spending of roughly 0.5 percent of GDP. This would be in line with the 2006 state budget projection, including a carry-over from the 2005 budget at around 0.3-0.5 percentage of GDP.

(*) Fiscal Impulse is an analytical tool to quantify the extent to which fiscal policy has a contractionary or expansionary impact on the economy. It is calculated in 2 steps. The first step is to measure the fiscal balance excluding revenues and spending that does not have a direct impact on the local economy (e.g. external interest payments). The second step is to calculate changes in the balance from one year to the next (relative to GDP). This change provides estimates of the 'fiscal impulse'. A positive fiscal impulse is contractionary, whereas a negative one is expansionary

delayed disbursements of key expenditure items, particularly in capital expenditure during the first half of the year. This low spending contributed to the economic slowdown, as noted at the outset. While the situation improved later in 2005, capital spending for the year reached only 1.3 percent of GDP, versus the 2.1 percent budgeted in the second budget revision. The fact that more than half of total capital expenditures were disbursed in the last 2 months in 2005 helped cushion the growth slowdown in the fourth quarter (Box 1).

6. Policy Developments

(1) 2007 RKP

To be finalized in May: The government is just completing a draft version of the 2007 work program (RKP) which reflects government priorities for the year, and expects to deliver it to parliament in May as a presidential decree and as the basis for the 2007 budget.

Nine priority areas: The government indicates that the RKP has 9 priority areas for 2007 that entail certain action plans. Seven areas are the same as the 2006 RKP, with the last two areas listed below representing new priorities.

- (i) Alleviation of poverty and disparity
- (ii) Enhancement of job opportunities, investment and exports
- (iii) Revitalization of agriculture and rural investment
- (iv) Enhancement of accessibility and quality of education and health
- (v) Law enforcement, eradication of corruption, and bureaucratic reforms
- (vi) Strengthening defense capacity, security and order, and conflict resolution
- (vii) **Mitigating natural disasters** (renamed from rehabilitation and reconstruction of Aceh and Nias)
- (viii) **Infrastructure**
- (ix) **Development of isolated/border regions**

2006. Data on core inflation are only available back to January 2005.

(2) Economic Policy Packages

The new economic team completed two policy packages by end-February 2006, one on infrastructure and the other on the investment climate, with a third on financial sector reform under preparation. The packages demonstrate a willingness to tackle a number of difficult decisions that have been on hold for some time, and they provide a time-bound matrix with clearly defined Ministerial responsibilities.

Investment policy package: The investment package enjoys substantial political commitment through its issuance as a Presidential instruction⁷. It is divided into five categories: (i) general investment policies, (ii) customs, (iii) tax, (iv) labor policy, and (v) SME policy. Highlights of the package include:

- Submission of a draft investment law to Parliament
- Creation of a new investment negative list
- Issuance of a Keppres to revitalize PEPI⁸
- Cutting the time to start a business from 150 days to 30 days
- Acceleration of the review process of non-business-friendly local regulations (*Perda*).
- Increasing the number of companies with the right to use the customs priority lane from 71 to 130 by the end of the year
- Cutting the percentage of shipments going through the red-lane at the port. And,
- Submission of revisions to the Labor Protection Law (Law 13/2003)

Most items in the package are not new, having existed in one form or another in previous policy statements. Many of the items are also quite general, stating only what the government hopes to accomplish without detailing how to accomplish them. However, some of the reforms are specific, such as cutting the Red Lane to 10 percent and compiling a transparent negative list, and most targets include deadlines to ensure rapid implementation and specify the responsible Minister. On the whole, the package has been well-received. However, as implementation has been problematic in recent years, there is some uncertainty whether the government will be able to fully deliver on the new policy packages. The business community has already expressed some skepticism in light of the fact that many of the reforms have been promised in the past.

Infrastructure package: This package includes continued progress on public-private partnerships, including a risk sharing framework (allowing contingent liabilities on budget), improved coordination mechanisms, and progress on sectoral issues in anticipation of an Infrastructure Summit. The package includes four main policy items, namely:

- Establishing an effective policy, regulatory, and institutional framework;
- Sector reforms;
- Local government participation; and,
- Project transactions.

Key features of this package are:

- Having 153 activities completed by end-2006;
- Focusing on public-private partnership;
- Risk sharing with the private sector;
 - Developing a policy framework on land acquisition

⁷ The package was announced March 2, 2006 but Inpres 3/2006 is dated February 27, 2006

⁸ PEPI stands for the *National Team to Promote Exports and Investment*

- Establishing a Risk Management Unit

Unfortunately there is perhaps even more skepticism about the government's ability to quickly deliver needed infrastructure, especially in partnership with the private sector. Few well-prepared projects appear to be in the pipeline, and there remains a relatively large number of hold-over projects tendered before the crisis that could be problematic. It will be important for the government to quickly address project development, while simultaneously putting in place improved coordination mechanisms and a risk management framework, and addressing financing issues.

Financial sector reform: A third package addressing issues in the financial sector is expected to address weaknesses in state-owned banks; to deepen the bond market; and to resolve long standing monetary issues between the Ministry of Finance and Bank Indonesia.

7. 2006 Outlook

Steady growth expected in 2006:

The Bank foresees 5.5 percent growth in 2006, at the low end of the range of our previous projection (5.5-6 percent) and almost unchanged from 2005 (5.6 percent). Growth is expected to bottom out in the first or second quarter before picking up in the second semester to above 6 percent (Table 3). Government consumption and investment are expected to be high throughout 2006, with private investment and consumer durable spending expected to pick up in the second half as the impact of higher fuel prices runs its course, and inflation and interest rates come down. The deceleration of private investment is expected to be more severe than previously envisaged.

Table 3: 2006 Growth Pattern (year-on-year growth)

	Q1	Q2	Q3	Q4	Annual
Private consumption	1.0	2.0	2.5	3.0	2.1
Investment	11.4	12.0	11.4	16.8	12.9
o/w private	0.0	1.0	3.0	8.0	3.0
o/w governments	55.8	55.1	44.3	51.2	51.5
GDP	4.6	5.0	6.2	6.3	5.5

Source: World Bank staff

The main economic factors affecting 2006 growth are:

- **Central and regional fiscal policy:** As mentioned, budgeting revisions delayed the disbursement of key expenditures in 2005. By contrast, the 2006 budget preparations are going more smoothly, and spending should be spread out more evenly throughout the year than in the past. In addition, the central government carried over unspent expenditures from 2005 to 2006, in the amount of 0.3-0.5 percentage points of GDP. This carryover is slated to be spent before April 2006 and will entail a large increase in overall spending relative to the first half of 2005.

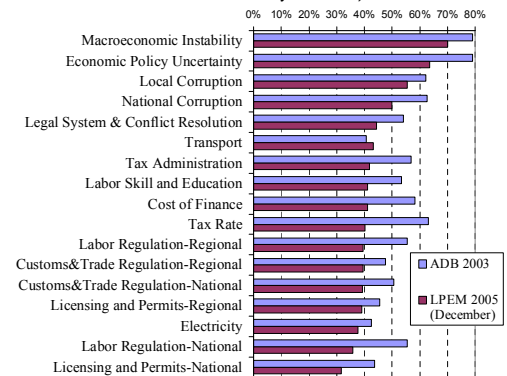
The fiscal policy of regional governments is an equally, if not more, important factor. In 2004 (the latest, available regional data), regional governments (provinces plus kabupatens/kotas) accounted for about 50 percent of total capital spending. In 2006, transfers to regions from the central government increased to Rp.219 trillion from Rp.143 trillion in 2005, an increase by over 50 percent (US\$8 billion). Regional spending, especially on capital, will be critical for economic growth. The concern is that regional fiscal management capacity will be strained by these increases, with funds either accumulated in the banking system or inefficiently allocated and spent, risking slower growth this year and beyond.

- **Financial sector:** Credit growth is likely to slow in the first half of 2006, especially on consumption credits. However, the recovery in the second half. 2006 would return the

growth to last year's rate. Anecdotal evidence suggests that non-performing loans (NPLs) among consumption credits have started to increase due to high interest rates. Although lending to corporations has showed down and the banking sector remains cautious towards new lending, there have been recent signs of a recovery. IPO activity in the bond and equity markets has been slow recently, and this could limit firms' financial resources. In this regard, the banking sector is expected to be the main source of financing for the economic recovery in the second half of 2006.

- **Macroeconomic stability:** Macroeconomic stability is a prerequisite for underwriting a strong investment-led recovery. Doubts in this regard continue to concern investors in Indonesia, though perceptions from the business sector did improve between 2003 and 2005 (Figure 9)⁹. Macroeconomic stability is central for the government's strategy and this motivates Bank Indonesia's policy to keep interest rates high. If the government can maintain a sound policy mix of expansionary fiscal policy and tight monetary policy through the first half, the current economic slowdown is likely to be mitigated and stronger growth recovery likely to eventuate in the second half.

Figure 9: Constraints to Investment
(% of firms reporting constraint to be moderate, severe or very severe)



Source: ADB, LPEM-FEUI

⁹ In 2003, the Asian Development Bank and World Bank surveyed 700 manufacturing firms throughout Indonesia. In April and December 2005 the University of Indonesia (LPEM-FEUI) surveyed 500-600 manufacturing firms in five major metropolitan areas (Medan, Jabotabek, Semarang, Surabaya and Makassar). Perception-based questions were included only in the 2003 ADB/WB survey and the December 2005 LPEM survey.