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

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

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

*Private consumption growth yoy, percent*

*Paddy farmers’ income and costs, indices 2012 = 100*

Source: BPS; World Bank staff calculations

Price received by paddy farmers

Cost of production and investment (food crops)

Source: BPS; World Bank staff calculations
Private investment recovering?

Business confidence indicators, indices

- PMI Manufacturing

Business activity:
- Expectation

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 (Ilzetzki et al., 2010)

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

Macroeconomic outlook and risks

Further reforms
## Baseline outlook

<table>
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<th>2015</th>
<th>2016f</th>
<th>2017f</th>
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<tbody>
<tr>
<td>Real GDP (annual % change)</td>
<td>4.8</td>
<td>5.1</td>
<td>5.3</td>
</tr>
<tr>
<td>Consumer prices (annual % change)</td>
<td>6.4</td>
<td>3.9</td>
<td>4.4</td>
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<tr>
<td>Current account balance (% of GDP)</td>
<td>-2.1</td>
<td>-2.3</td>
<td>-2.5</td>
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<tr>
<td>Budget balance (% of GDP)</td>
<td>-2.6</td>
<td>-2.8</td>
<td>n.a.</td>
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Source: BPS; World Bank staff projections
External risks and uncertainties

- Monetary policy in the US
- UK referendum on EU membership
- Trajectory of commodity prices
- Global growth and trade
- China rebalancing and deleveraging

External uncertainty
Domestic risks

Limited fiscal space

Weak credit growth

Tax amnesty

SOE capital injections
Indonesia: growth resilience

Macroeconomic outlook and risks

Further reform momentum
Hence, Indonesia needs to work harder

This was supposed to get me there faster

That’s counting without headwinds and reform impact lags!
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.

Source: WDI; World Bank staff calculations
Public investment maintained within limited fiscal space

Fiscal deficit at 2.8% of GDP and cuts to non-priority spending

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.

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.

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.

Source: UN COMTRADE; World Bank staff calculations