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Indonesia: Reforms to Meet Development Challenges

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Introduction

The Indonesian economy is experiencing structural changes and must deal with new challenges in an uncertain international setting. In the past decade, its industry has undergone reprimarization (focus on mining and energy resources, palm oil, etc.), which was boosted by the sustained level of commodity prices (before the downward trend that occurred in 2011 and accelerated from June 2014). Logistics and connectivity costs in Indonesia are high due to infrastructure deficiencies, though this must be put into the context of the country's parceled and dispersed nature (17,000 islands spread over a surface area of 2 million km^2). The deficit in the productive supply of the industrial sector–at a time when demand from Indonesian households and enterprises is increasingly dynamic–partially explains the rise in imports of goods and services (76% of imports of raw materials and intermediary goods is accounted for by enterprises for their production). This situation has led to imbalances in Indonesia's net international investment position (NIIP) since 2011, with the emergence of a current deficit in its balance of payments and a significant rise in its NIIP.

Nevertheless, Indonesia enjoys solid macroeconomic and financial foundations. The beginnings of an improvement in the overall business environment can be seen since Joko Widodo (former mayor of the capital Jakarta) was elected president in 2014. An ambitious reform plan seeking in particular to strengthen investment rate was introduced and may eventually improve the country's growth potential. Also, economic growth seems favorably oriented since 2016, following a slowdown, especially due to the elimination of the current account deficit and a rise in public expenditures. However, these latter remain limited by the structural weakness of budgetary income, which is caused by the narrow tax base. The medium-term prospects for growth seem favorable for Indonesia, despite a more uncertain international environment. In the longer term, the major challenge for Indonesia will be to invest in its human capital so that it can benefit fully from its demographic dividend (around 2030).

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1 / Significant territorial variance: a big challenge for the young democracy

The Republic of Indonesia is a young democracy with a population of 247 million people. Its president is elected by direct universal suffrage for a five-year term. The members of the bicameral parliament (one chamber represents the regions and the other forms the House of Representatives) are elected every five years. Since the decentralization reform of 2001, Indonesian citizens elect their local representatives in each of the 33 provinces making up the archipelago; their term of office is also five years. All these characteristics make Indonesia a democracy. The country is a lower middle-income country (LMIC), with moderate socio-political risk.

1.1. Consolidation of Indonesian democracy since the fall of the dictatorship

Democracy consolidated, but corruption remains endemic

On August 17, 1945,[1] Indonesia (until then called the Dutch East Indies) declared its independence after an occupation of nearly 400 years by its colonial power, the Netherlands. The new Republic of Indonesia was formed by a very heterogeneous population (see following subsection) and a huge territory spread over 17,000 islands (its current boundaries are those inherited from the former Dutch occupants).[2] The national identity was forged from the independence struggle and then developed around *Pancasila*, the five founding principles of the Indonesian state: 1) the belief in a one and only God, 2) a just and civilized humanity, 3) the unity of the country, 4) the principle of democracy, and 5) social justice for all.

National unity was also strongly imposed through the authoritarianism of presidents Sukarno (1945-1965) and Suharto (1966-1998). After the fall of President Suharto in 1998, a process of democratization, *Reformasi*, was established, enabling the first free elections to be held in 1999. The citizens of Indonesia met these elections with great enthusiasm: voter turnout was 90%. Constitutional reform led in 2004 to elections of the president of the Republic by direct universal suffrage, following legislative elections. Since that time, Indonesia is often described as the world's third-largest democracy (after India and the United States), enjoying voter turnout rates of around 70%.

During the regime of President Suharto, only three political parties were authorized. Since then, the Indonesian political offer has broadened and become quite dispersed (for more details, cf. MacroDev No. 14 on Indonesia, dated April 2014). The high degree of political pluralism and the absence of a clear and distinctive political line have led to strategic alliances for both forming the government and forming the opposition. Another distinctive feature of Indonesian democracy is the search for consensus as a method of governing. In accordance with the fourth pillar of the official doctrine *Pancasila*, Indonesian Parliament (in which 27 political parties are represented) passes laws not by majority vote but by consensus. In fact, each political party has veto rights that it is free to use, thereby explaining the delays in the legislative processes and the difficulties encountered for establishing reforms.

The electoral process can be qualified as credible, because of the holding of free elections without intimidation or violence, this despite some irregularities (cf. MacroDev No. 14, *op. cit.*). Indonesia is thus consolidating its democratic transition, even if economic and political power is mainly in the hands of a powerful oligarchy and the notions of majority and opposition remain flexible.

[1] The Dutch colonized Indonesia in the beginning of the 17th century, via the Dutch East Indies Company (a monopoly created by the Dutch State to control the spice trade). Following the 1945 declaration of independence, it took four years of armed conflict and diplomatic struggle (the period the Indonesians call *Revolusi*) before Indonesia finally managed to break free of its former colonial power. The Netherlands recognized the country's independence on December 27, 1949.

[2] Raillon F. (2006), « Comment peut-on être Indonésien ? », *Hérodote*, n° 120, La Découverte, Paris. Indonesia is spread over a surface area of nearly 2 million km^2, about three times the size of France (including its overseas departments and territories).

Decentralization reform was established in 2001 to assuage the regionalism existing in various places throughout the country. As a result, administrative divisions were redrawn and a certain number of central government prerogatives transferred to the local level (education, health, management of natural resources, etc.). Since 2005, the leaders of the 510 municipalities and 33 provinces making up Indonesia are elected by direct universal suffrage. Decentralization brings democracy closer to society's grassroots and provides for better management of the huge Indonesian territory. However, its negative side is the spread of corruption via the transfer of powers.[3] Corruption in the Indonesian public sector is in fact systemic and is part of a culture of reciprocal gift-giving (especially during elections). The pervasiveness of corruption at all administrative levels also acts as a strong barrier to the functioning of public administration and weighs on citizen trust. However, some improvement can be observed, thanks mainly to the Corruption Eradication Commission (*Komisi Pemberantasan Korupsi* – KPK), an independent administrative body created in 2003 to fight this scourge. Indeed, by 2016 Indonesia's rank in the Corruption Perceptions Index produced by the international non-governmental organization Transparency International had climbed to 90th out of 176 countries, in contrast to 2001, when it was among the three most corrupt countries in the world[4].

A secular republic for a diverse population

The Indonesian population is characterized by its diversity: there are nearly 300 different ethnic groups, 583 languages and regional dialects, and 5 official religions. There are nevertheless dominant groups within this significant multiculturalism spread over a dispersed territory. On the one hand, Sunni Islam plays a preponderant role in Indonesia, where nearly 90% of the population is Muslim.[5] On the other, the Javanese (from the island of Java[6]) are the largest ethnic group, representing 40% of the population of Indonesia. The Javanese also form the political and cultural core of the Republic. But despite this apparent domination, the Indonesian nation has been built on a secular and non-exclusive foundation, by including non-Javanese in the Indonesian system (cf. MacroDev No. 14, *op. cit.*). The official language adopted by the founding fathers of the Indonesian nation (Sukarno and Mohammad Hatta) is not Javanese but *Bahasa Indonesia*, a less inegalitarian language practiced by traders in limited coastal zones. This was done to calm the fears of Javanese domination over the other minorities. Preservation of an interethnic and religious consensus is thus fundamental for the Republic of Indonesia, whose slogan is "Unity in Diversity" (*Bhinneka Tunggal Ika*), in relation with the *Pancasila* doctrine.

But the Javanese maintain a privileged position in the administration and the Army,[7] and they wish to maintain domination over the country, in ways that are subtle or not. Moreover, for some nationalists, the Indonesian nation-state must be based on Javanism and its propensity to Javanize the country.[8] While minor in the country as a whole, ethnic and religious conflicts and vague separatist tendencies are sometimes recurrent (cf. MacroDev No. 14, *op. cit.*).

A new government that tends to be reformist

The Indonesian socio-political environment has been unsettled since 2013. This "change in Reformasi continuity" is distinguished by the 2014 election of Joko Widodo (nicknamed "*Jokowi*") as President of the Republic, in what is considered a fair election. His term of office has been characterized by a lack of any clear ideological stand and by his pragmatism and will for reforms (elimination of energy subsidies, support for public investment, etc.). The cabinet reshuffle in August 2016 saw Sri Mulyani become Minister of Finance, a position she held from 2005 to 2010, before becoming managing director of the World Bank. Government action in Parliament has been facilitated by the recent rallying by Golkar[9] to the President Joko Widodo's party, the PDI-P.[10] In 2015 and 2016, several economic reform packages were adopted. They are being set up gradually and among other things aim at improving the business climate and at opening up sectors to foreign investors (see Part 2).

[3] Raillon F. (2006), *op. cit.*

[4] Transparency of the national budget has also improved along with online publication of monthly budget execution reports and detailed financial notes.

[5] The percentages of followers of the main religions in Indonesia are (in descending order): Muslim 88%, Protestant 6%, Catholic 3%, Hindu 2%, Buddhist 1%.

[6] The capital Jakarta and the second-largest city Surabaya are located here.

[7] The Army is considered as guardian of national unity. It had strong links to power under the regime of former president Suharto and is well established in the economic sphere. The Army has nonetheless seen its influence diminished since the *Reformasi*.

[8] Raillon F. (2006), *op. cit.*

[9] Golkar (from *Golongan Karya, literally* "Party of the Functional Groups") was founded by the Army in 1964, in the Sukarno era, as a movement to counter the influence of parties.

[10] *Partai Demokrasi Indonesia Perjuangan* (Indonesian Democratic Party of Struggle).

The current president enjoys strong popularity despite some disappointment, especially with regard to his supposed lack of involvement in the fight against corruption. The next presidential and legislative elections, which this time will occur simultaneously, are planned for 2019. Joko Widodo seems to have a good chance of winning, and some observers think he may run on a ticket with Sri Mulyani as vice president.

1.2. Dynamic but rather non-inclusive growth

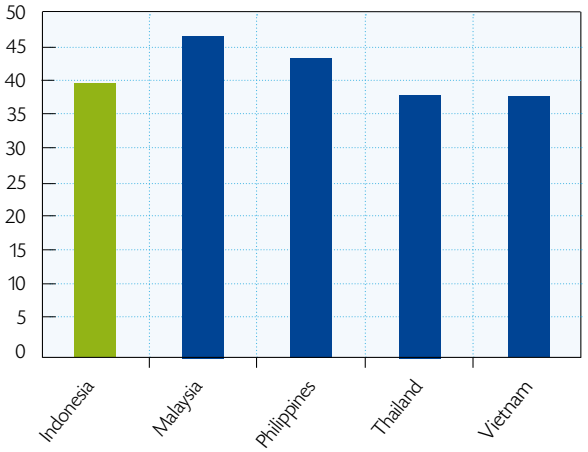
Indonesia's strong growth after the 1997 crisis enabled a significant rise in the level of per capita wealth, which more than doubled between 1998 and 2015 (see Part 2). However, this remarkable progress in per capita GDP did not necessarily lead to a decrease in inequalities after the shock of the crisis. On the contrary, these inequalities can be seen to have grown:

(i) The Gini index grew between 1999 and 2013, from 29.9 to 39.5, reflecting a rise in income inequality[11] (see Figure 1.1). The richest 20% of Indonesians thus saw their wealth grow between 1999 and 2013. During that period, the level of wealth in relation to GDP owned by that population segment grew from 39% to 47%.

(ii) Regional inequalities remain pervasive despite decentralization, with a great share of activity concentrated in Java (nearly 60% of GDP). The level of per capita wealth thereby reflects large variance between the country's regions (see Figure 1.2).

Figure 1.1.

Gini Index [0-100]

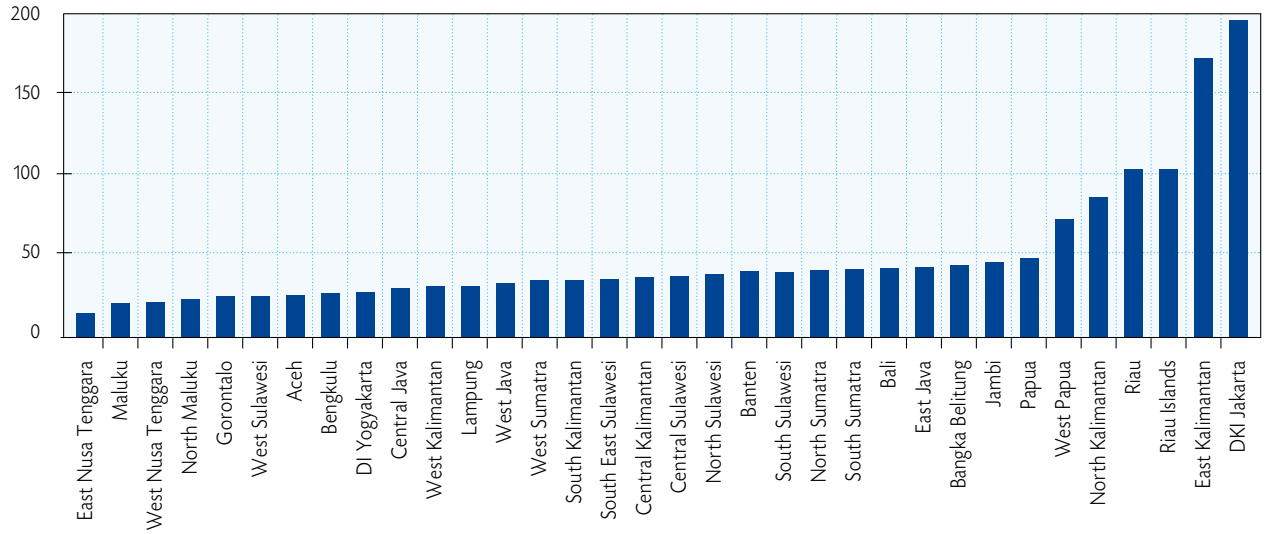


Source: World Development Indicators (WDI), World Bank.

[11] The Gini index (or coefficient) measures inequalities in wages (incomes, lifestyles, etc.). The closer the coefficient is to 100, the greater the inequalities of income are.

Figure 1.2.

GDP per capita (2015, in millions of rupiah)

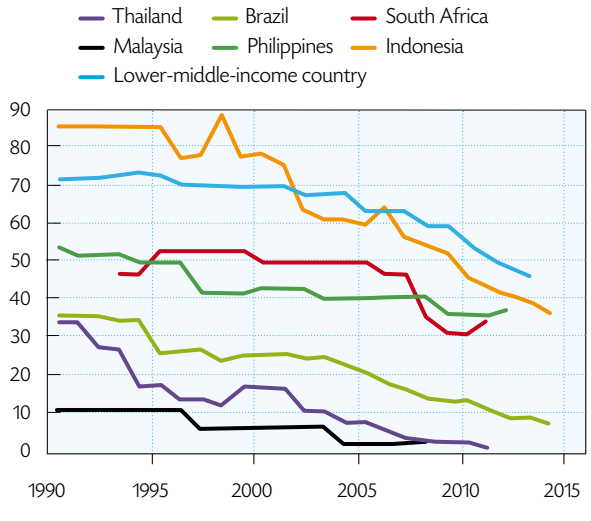


Source: Badan Pusat Statistik, Organisation for Economic Co-operation and Development (OECD).

Indonesia's economic growth thus does not seem very inclusive. However, such wealth inequality is close to the average of middle-income countries (MICs) or countries from the South-east Asia zone. The percentage of Indonesians living below the poverty line–at less than USD 2 per day in purchasing power parity (PPP)–was high in 2014, at 36%. However, this figure is close to the average for countries of the same income level and has dropped sharply since the Asian Financial Crisis (82% of the population was poor in 1999 – see Figure 1.3).

Figure 1.3.

Poverty rate
(poverty line of US$ 2/day in PPP)



Source: WDI (World Bank).

Access to primary education in Indonesia is satisfactory: the school enrollment rate was 90% in 2014. On the other hand, a smaller proportion of the population has access to secondary education (enrollment rate of 75% in 2014), although this figure remains close to the average among countries of the same income level. Likewise, the enrollment rate of youth age 19 to 24 is very small (15.8% according to local data). Moreover, the employment rate is relatively low (70% of the population of working age in 2014, including 86% for men and 54% for women). The unemployment rate (6.2% of the labor force in 2014) has been on a constant decrease since 2005. This figure is average for the MICs but remains higher than the rate observed in the countries of Southeast Asia. Finally, the unemployment rate of youth age 15 to 24 was estimated at 20% in 2011. This figure has tended to decrease since 2005, in relation with the acceleration of the pace of economic growth observed over the same period.

The training of human capital is a major challenge for sustaining growth and represents a significant vulnerability for Indonesia (in particular so that it can take better advantage of its demographic dividend: 18% of the population was under 15 years of age in 2015).

2 / Resilient economic growth and diminishing structural vulnerabilities

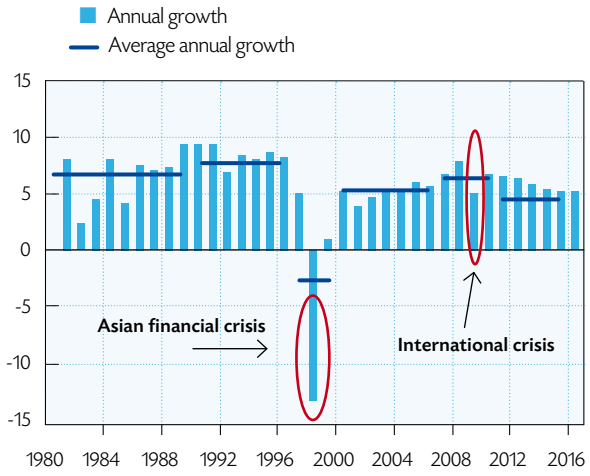
2.1. Strong growth, recently introduced reforms

Since the end of the 1960s, the Indonesian economy has experienced remarkable economic growth, estimated at 6% on average per year. Two external shocks affected the country in different ways: the Asian Financial Crisis of 1997-1998 and the international crisis of 2008 (see Figure 2.1 below and MacroDev No. 14, *op. cit.*). The 1998 crisis punished the nepotic excesses of the Suharto era and above all the overdevelopment of a financial system lacking supervision. The economic and social consequences of this crisis led the country to carry out major structural, economic and institutional reforms. Thanks to this, the effects of the international crisis of 2008–of a different nature from that of the preceding decade–were of lesser intensity; Indonesia's weak level of international integration also helped mitigate the effects. This low level of volatility in the Indonesian growth regime (lower than that of the BRICS group[12] since 2000) can be explained by its low level of economic openness, which limits the economy's exposure to the vagaries of the international economic situation.

The vitality of domestic demand combined with the drop in the prices of mining products from the middle of 2011 helped to generate a current account deficit in the balance of payments (see Section 2.3 below) and has weighed on the pace of growth (see Figure 2.2).

Figure 2.1.

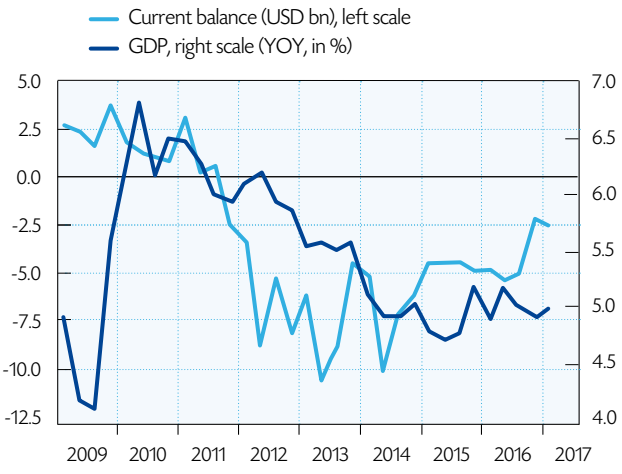
GDP growth (constant prices, in %)



Sources: World Economic Outlook (WEO) and author's calculations.

Figure 2.2.

Real quarterly GDP (YOY, %) and current balance (USD bn)



Sources: Bank Indonesia (BI), BPS (OECD), and author's calculations.

[12] Group of five countries (Brazil, Russia, India, China and South Africa) that have held annual summits since 2011.

Introduction of structural reforms

A set of structural reforms was started up after President Joko Widodo took office in October 2014. Its first concerns were improvement in the country's business climate and the strengthening of its competitiveness. Since September 2015, 14 economic reform plans (*Paket Ekonomi* – see Box 1 below) have been announced and gradually introduced. Among other things, they seek to unblock economic sectors in order to stimulate foreign investments (35 economic sectors are concerned by this reform) and to lighten rigid local and administrative standards (especially for setting up an import or export business). The regime associated with foreign direct investment (FDI) was also partially liberalized; up to then, Indonesia had given priority to a nationalist approach to investment. A tax amnesty program, conducted in three phases, has also been in force since September 2016. Its main objective is to repatriate Indonesian funds from overseas. In addition to an impact on tax revenue, the amnesty is expected to have an effect on support for investment (see Part 2) and on restoring trust in the private sector.

All of these reforms seem to have rather quickly generated positive effects on the perception of the business climate, as the World Bank's "Doing business" index indicates. Indeed, compared to its 2016 ranking, Indonesia went up 18 positions in the 2017 index, in which it was ranked 91st out of 189 countries.

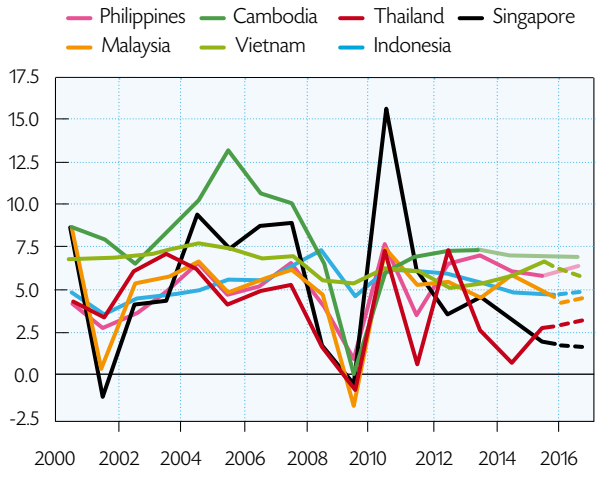
Overall, growth seems to be favorably oriented since the third quarter of 2015, backed up mainly by vigorous domestic consumption. It should continue to accelerate in 2016, with more than +5% YOY (after +4.8%). Indonesian economic growth has demonstrated its resilience. It should remain strong in 2017 and could progress at a pace close to its potential. In the medium and longer terms, the major challenge for Indonesia will be to invest in its human capital, so as to be able to better benefit from its demographic dividend (in 2030 – see next section).

Strong but mixed regional dynamics

At the regional level, Indonesian growth has been among the most dynamic since the 2000s (see Figure 2.3). Nevertheless, the level of per capital wealth is close to the average of ASEAN[13] countries excluding Singapore (see Figure 2.4 below), both in real terms and in PPP terms (cf. MacroDev No. 14, *op. cit.*).

Figure 2.3.

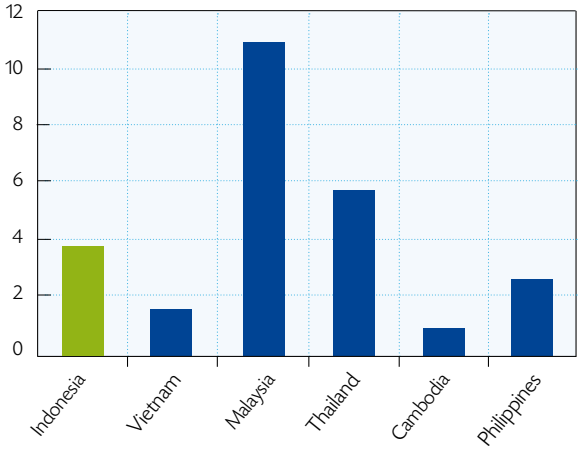
Real GDP growth (%)



Sources: WEO and author's calculations.

Figure 2.4.

Per capita GDP in PPP (constant prices, in USD thousands, average 2000-2015)



Sources: WEO and author's calculations.

[13] The Association of Southeast Asian Nations is a political, economic and cultural organization that currently brings together 10 countries from Southeast Asia: Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Vietnam, Laos, Myanmar (Burma) and Cambodia.

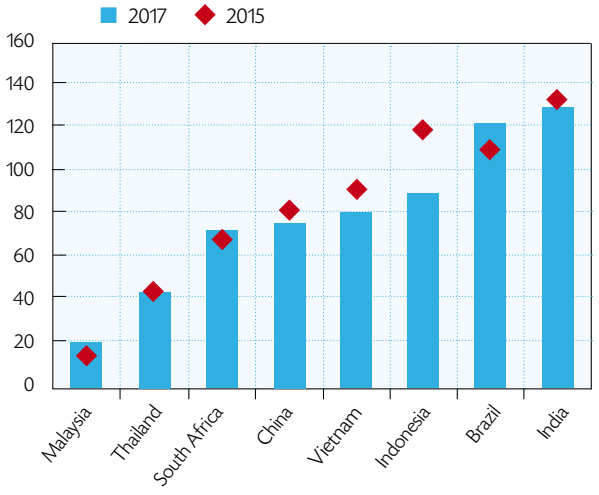
Box 1 *The economic reforms of Indonesian President Joko Widodo*

One of the priorities of President Joko Widodo after he began his term at the end of 2014 was to improve the business climate. Indonesia has shortcomings in this area, especially at the international level, according to the World Bank's *Doing Business* index (Indonesia ranked 91st out of 189 countries in 2017). The country's business climate has nevertheless tended to improve since 2015 (see Figure 2.5), thanks to the structural reforms introduced by the 14 economic packages.

These economic reform packages seek to (i) reduce the costs inherent in administrative red tape for registering a business, (ii) introduce tax incentives for the activities in special economic zones, (iii) simplify the calculation method for the minimum wage (see Table 2.1), and (iv) partially liberalize the FDI regime (see Table 2.1). These various reforms come in the wake of that on fuel subsidy reduction adopted from January 2015.

Figure 2.5.

Business climate index



NB: A low score indicates a better business climate.
Source: World Bank.

Table 2.1. *Economic reforms adopted between September 2015 and August 2016 (Paket Ekonomi)*

Number	Date	Package details
1.	11 September 2015	• Improve investment climate by cutting bureaucracy and more one-stop shops. • Accelerate national priority projects. • Deregulate housing and property investment.
2.	29 September 2015	• Rationalise permit and license services in special economic zones. • Fast process for tax allowance and tax holiday (25 days). • Expedite forestry licenses processing. • Income tax cut for interest paid on savings deposits of exporters.
3.	7 October 2015	• Electricity price cut for industries and labour-intensive industries to defer payment. • Increase coverage of micro and small businesses to financing (KUR) • Simplify land permits for investments
4.	10 October 2015	• Clear and transparent formula for wage increases. • Lower interest rate and increase coverage of micro and small businesses financing.
5.	22 October 2015	• Tax incentives through asset revaluation. • Eliminate double taxation on real estate, property and infrastructure. • Simplify regulation in Islamic banking.
6.	5 November 2015	• Tax incentives in special economic zones including tax holidays, tax allowances and allowing property ownership by foreigners. • Simplify permit and license process for import of raw materials for the production of pharmaceuticals.

7.	4 December 2015	• Income tax rate cut for labour-intensive industries for two years, minimum 5 000 employees and 50% of output exported. • Accelerate land certification process for street vendors and small and medium businesses (free of charge for those having CCT card KKS).
8.	21 December 2015	• One Map policy to harmonise land utilisation. • Incentives for aviation industries. • Incentives for investing in oil refineries.
9.	27 January 2016	• Single billing system for port services conducted by SOEs. • Integrate National Single Window system national port IT system. • Mandatory use of Indonesian rupiah transportation-related payments. • Remove difference in prices for public and private postal services.
10.	11 February 2016	• Remove foreign ownership cap on 35 business sectors. • Protect small & medium enterprises as well as cooperatives.
11.	29 March 2016	• Lower tax rate on property acquired by local real estate investment trusts. • Harmonise customs checks at ports (to curtail dwell time). • Subsidised loans for export-oriented small & medium enterprises. • Roadmap for the pharmaceutical industry.
12.	28 April 2016	• Reduce time to register a business and to acquire a construction permit, register a property, and lower frequency of paying taxes. • Make taxes payable online.
13	26 August 2016	• Reduce red tape in the construction of housing for the poor.

Source: OECD, Economic Surveys, October 2016.

Minimum wage is set at the provincial and district levels. Its annual increase is decided at the local level; until 2016 there was no criterion providing for a ceiling on it. Since then, greater heterogeneity in minimum wage has been observed among the various provinces, without their being tied to economic performances at the regional level (see Figure 2.6). Moreover, decisions concerning increase involve only the formal sector, which–in a great many places–is represented primarily by public employment. The wages of local public servants are paid by the central government in Jakarta, via transfers to the local governments (representing 34% of total public expenditures). Strong increases in wages that are not associated with an increase in productivity affect the competitiveness of the regions concerned and thus the attractiveness of investments (OECD 2016). In order to introduce greater transparency and harmony in the increase processes, the minimum wage is calculated according to the following equation: Minimum Wage t+1 = Minimum Wage t × (1 + National Inflation Rate t + National GDP Growth Rate t).

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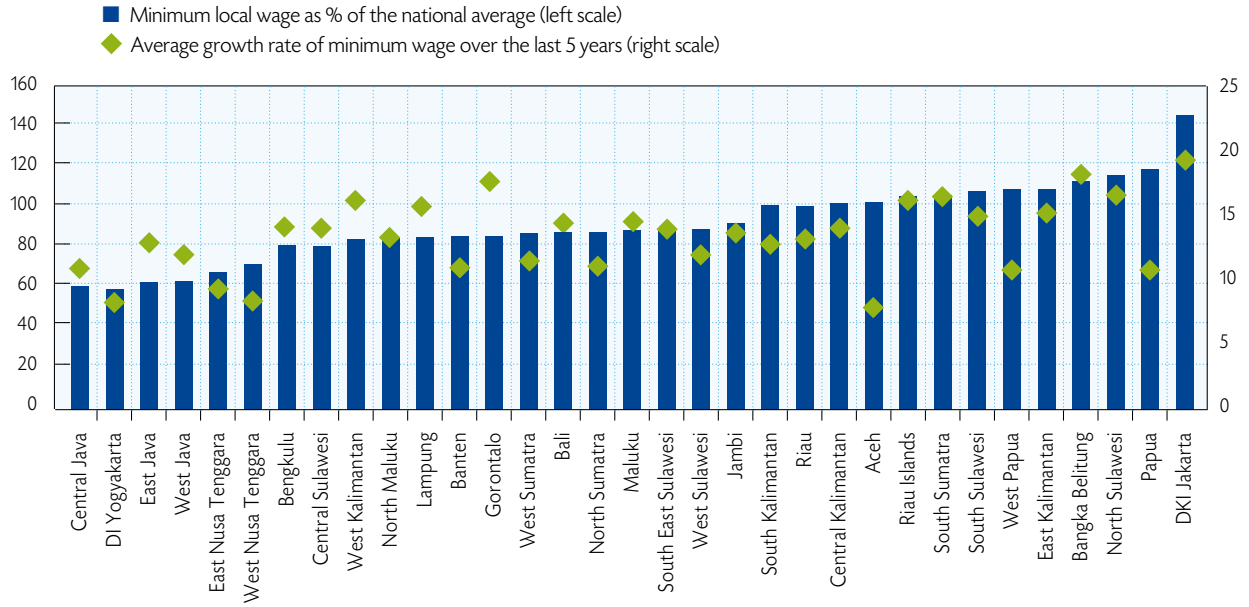
Figure 2.6.

Business climate index



Source: BPS, OECD.

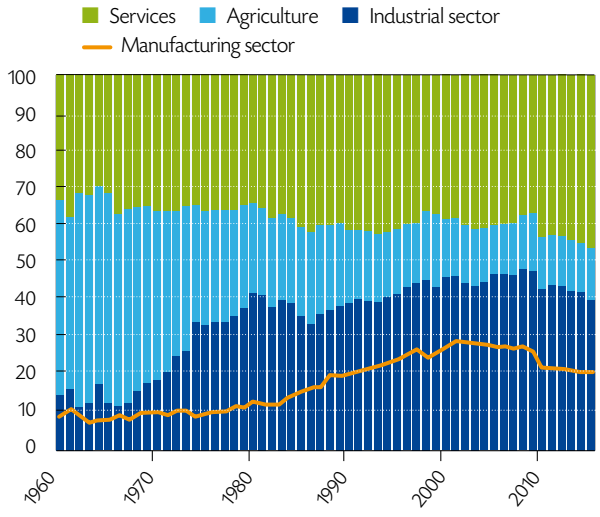
2.2. A growth model that remains focused on primary products

2.2.1. Shift in the growth model in the past few decades

The different phases in the development process of the Indonesian economy have led to significant growth in industrial value added (VA), this in contrast to a big decrease in that of the agricultural sector (cf. MacroDev No. 14, *op. cit.*). In 2015, service activities became the top economic sector of Indonesia in terms of share of overall VA, ahead of industry (43% for services versus 40% for industry in 2015 – see Figure 2.7).

Figure 2.7.

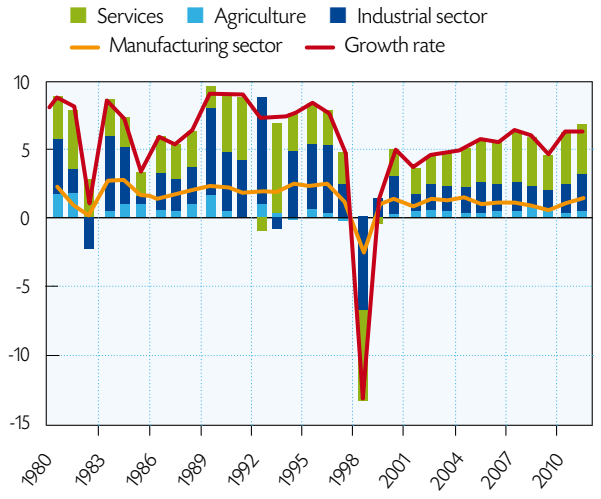
GDP breakdown by sector (in %)



Sources: WDI (World Bank) and author's calculations.

Figure 2.8.

Contributions by sector to real GDP growth (in %)



Sources: WDI (World Bank) and author's calculations.

Furthermore, analysis of sectoral contributions to real growth of GDP (see Figure 2.8) makes it possible to affirm that it is the dynamism of service sector activities that contribute most to real growth in GDP. Indeed, nearly 50% of real growth in GDP between 1999 and 2015 comes from services. More specifically, the development of telecommunication activities has strongly contributed to the growth of the services sector (cf. MacroDev No. 14, *op. cit.*). These activities have been the most dynamic services since the early 2000s, with an average annual growth rate of more than 20%. In contrast, the other sectors do not seem to be developing more. Moreover, the importance of the services sector and its dynamism can be linked to the strength of domestic demand (see Part 2.3).

The contribution of the industrial sector to growth has been less unstable since the Asian Financial Crisis, but not necessarily more significant. Indeed, it is estimated at 37% of total growth of activity between 1999 and 2015, including one fourth solely for the manufacturing sector.

The decrease in share of the manufacturing sector since the start of the 2000s, as much in VA as in contribution to growth in GDP, is structural in nature. It reflects the reprimarization of the industrial sector, i.e. industry's increased dependence on natural resources (mining and energy resources, palm oil, etc.). The reprimarization of the Indonesian productive sector can be characterized by two opposing trends:

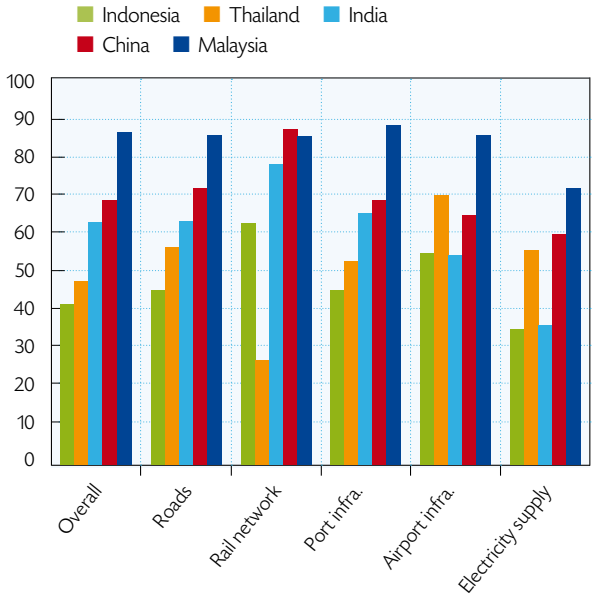
(i) Before 1960, the Indonesian industrial sector was concentrated heavily on the exploitation of natural resources (raw materials). Between 1960 and the beginning of the 2000s, rapid development in manufacturing industry (as much in VA in the GDP as in contribution to growth in GDP) can be observed. At this time, the share of the manufacturing sector in total industrial VA was more than one half.

(ii) From the middle of the 2000s, a flight of part of manufacturing VA towards exploitation of raw materials can be seen. In fact, manufacturing VA currently represents less than half of the industrial sector. This shift is consistent with trends in the structure of exports (which are more concentrated in raw materials exploitation, representing 45% of all goods exports) and in the quality of jobs created.

This tendency highlights the country's infrastructure deficiencies, which have affected the competitiveness of the manufacturing sector (cf. MacroDev No. 14, *op. cit.*). This competitiveness was furthered by a sustained price level for raw materials (before the downward trend that began in 2011 and accelerated from June 2014). However, these deficiencies should be put into perspective, considering the parceled out and dispersed nature of the country (more than 17,000 islands).

Figure 2.9.

Index of infrastructure quality

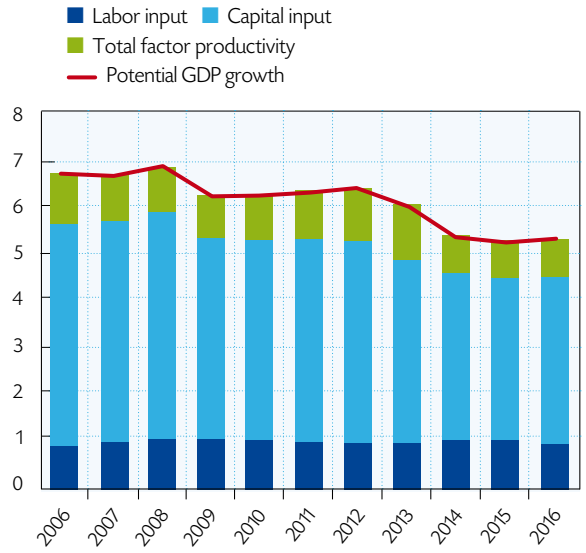


Source: World Economic Forum, Global Competitiveness Report 2016-2017.

Furthermore, according to the International Monetary Fund (IMF), the decline in growth potential reflects the drop in the capital production input and in total factor productivity, which is connected with the downturn in commodity prices observed since 2012 (see Figure 2.10).

Figure 2.10.

Contribution to potential GDP growth (in %)



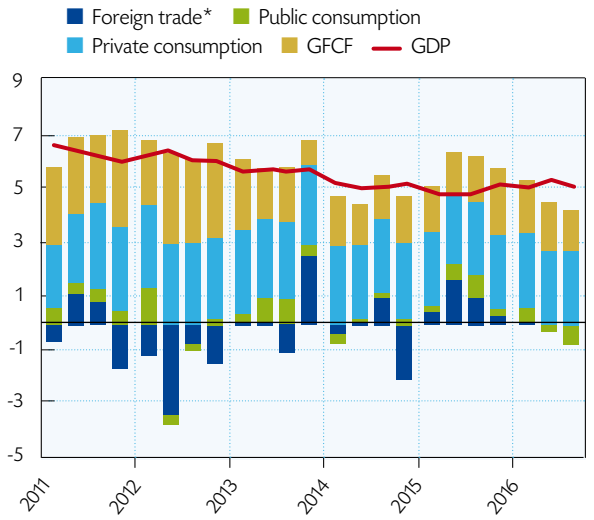
Source: IMF (Article IV, December 2016).

2.3. Domestic demand as main source of growth and activity

Domestic demand has been the main source of economic growth in Indonesia since the Asian Financial Crisis of 1997-1998. In particular, household consumption has been the number one component of demand in GDP, representing 54% (on average between 2010 and 2016). The average annual increase is estimated at 5.2% between 2011 and 2016.

Figure 2.11.

Contribution to real GDP by drivers of demand (in %)



NB: For better readability, the "inventory change" component has not been included in the figure.

** Net balance of external trade (exports - imports of goods and services).*

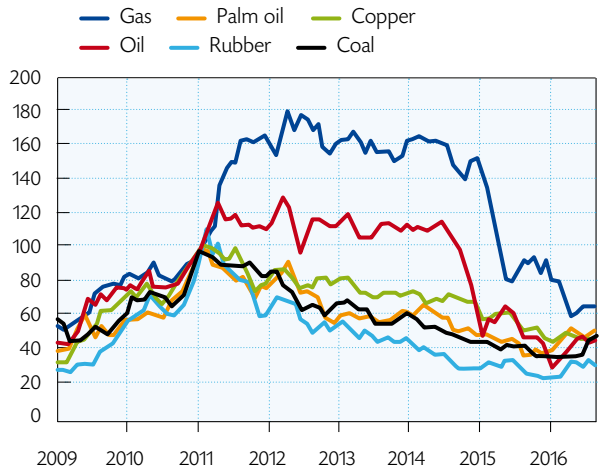
Sources: BPS (OECD) and author's calculations.

GFCF: Gross fixed capital formation.

However, the flight of some manufacturing VA towards raw materials exploitation has strengthened the elasticity of domestic demand for the import of intermediate goods, which represent nearly 80% of total imports of goods. This helps partially explain the decrease in net contribution of the external sector to economic growth. The other factor of this downtrend can be explained by *(i)* the cycle of low commodity prices that automatically affect exportation of Indonesian goods, which are mainly made up of natural resources (palm oil, coal, natural gas, rubber and copper combined make up 45% of exports of goods) and thus the terms of trade of the country (see Figures 2.12 and 2.13 below), and *(ii)* the loss of competitiveness of the manufacturing industry, which is a consequence of contraction of investments in this sector. Improvement in terms of trade in 2016, thanks to a change in direction of the downward trend of commodity prices, has helped stabilize the deficit of the current account of the balance of payments (-2% of GDP, see Part 5).

Figure 2.12.

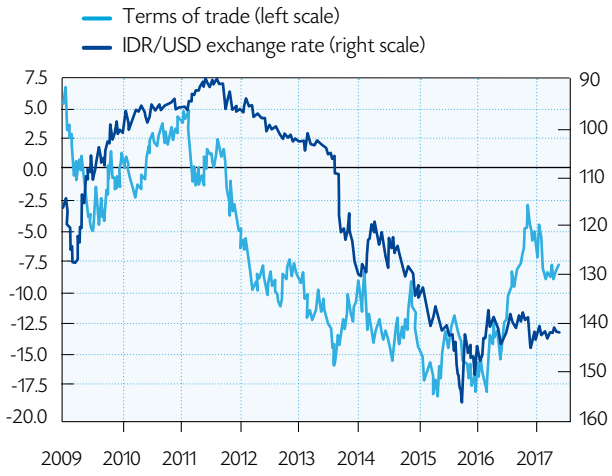
Prices of the main commodities exported by Indonesia (base 100 = January 2011)



Sources: IMF, OECD and author's calculations.

Figure 2.13.

Terms of trade (change in %) and IDR/USD exchange rate (inverted scale, base 100 = January 2010)



Sources: BPS (OECD) and author's calculations.

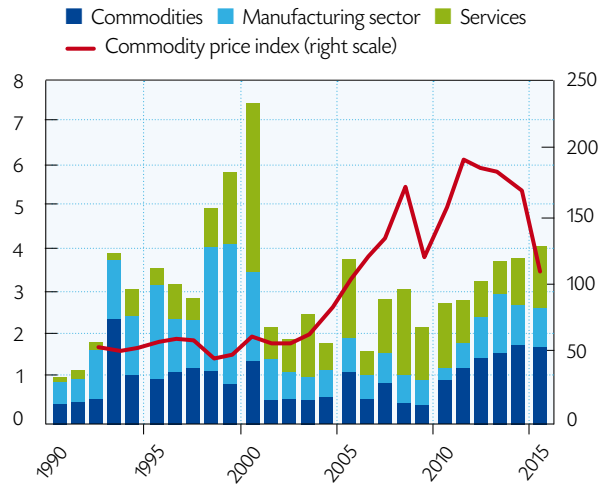
Investment is the second most dynamic component of domestic demand (32% of GDP between 2010 and 2016), with an annual average growth rate of more than 6% over the period. This favorable cycle for investments, combined with the high cycle for raw materials during the 2000s, was related to the higher concentration of investments in raw materials (see Figure 2.14). In fact, during this period raw materials represented half of investments made.[14] During the 2010-2011 period, investments in the mining and plantations sectors contributed an average of 47% to growth in total investments.[15] It should be noted that the exploitation of certain natural resources, especially wood and palm oil, was accompanied by significant deforestation.

Since the downward trend in commodity prices, contraction of private investment has led to a slowdown in investments as a whole. Public sector investments have thus taken over from private ones, thanks to a program of reforms set up in 2015 by the new government (see Figure 2.15). This investment program focuses more on the sector of infrastructures, which are mainly introduced by public enterprises. Capital expenditure by public enterprises doubled in 2016 and could increase nearly 40% in 2017 according to the IMF.

[14] IMF, *Selected Issues* (December 2016).
[15] IMF, *Selected Issues* (September 2012).

Figure 2.14.

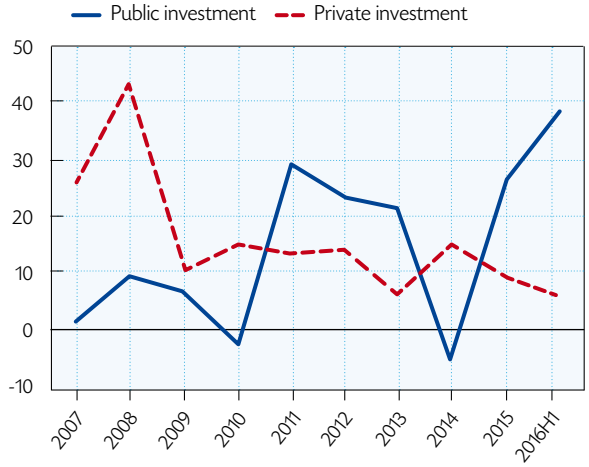
Investment realization (in % of GDP)



Source: IMF, Selected Issues (December 2016).

Figure 2.15.

Annual rate of growth of investment (in %)



NB. 2016H1 refers to the 1st semester of 2011.
Source: IMF, Selected Issues (December 2016).

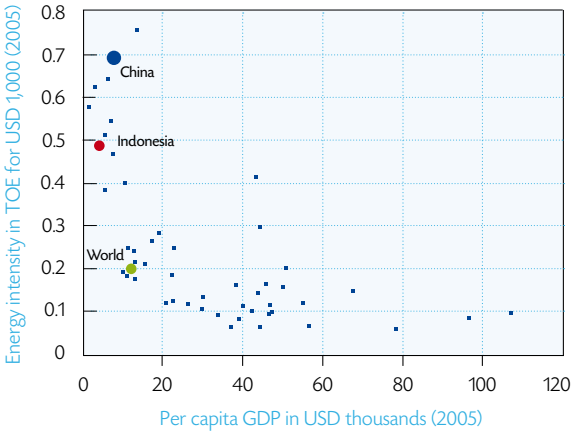
Box 2 *GDP energy efficiency in Indonesia*

Energy is a key factor of production for economic growth. In fact, energy plays a crucial role in the development processes of the countries of the South. It embodies both the unambiguous causal relationship between growth in energy consumption and growth in GDP on the one hand, and the importance of elasticity of GDP in relation to the consumption of primary energy. The energy intensity of GDP is the quantity of energy consumed (TOE, or ton of oil equivalent) per unit of GDP: this is the relationship between the consumption of primary energy (including electricity) and GDP measured in constant dollars and at market exchange rates. Energy intensity helps explain the energy efficiency of an economy. At the global level, 0.2 TOE was needed to produce USD 1,000 of GDP in 2015.

Compared to its income category, the Indonesian economy as a whole does not seem abnormally energy inefficient. Considering its level of development measured by average per capita income, Indonesia's energy consumption seems compliant with international standards over time and compared to the countries of its income category, as much in terms of per capita consumption (about 1 TOE) as in energy consumed per unit of income (GDP intensity of around 0.5 TOE per USD 1,000). In comparison, China, which has a higher level of per capita wealth (USD 6,500 per capita versus USD 3,800 per capita for Indonesia) has a much higher GDP energy intensity at 0.7 TOE per USD 1,000 of GDP. This indicates under-efficiency of energy production.

Figure 2.16.

Energy intensity of Indonesia's GDP



Sources: "Beyond Ratings" and AFD.

By analyzing the sectoral breakdown of the VA, it can be seen that the downward trend in energy intensity, observed over time and space, ensues foremost from a GDP structure effect, via services replacing industry. Indeed, the share of industry's VA in GDP slightly declined (to represent 40% of total VA in 2015), whereas that of services grew nearly 10 percentage points

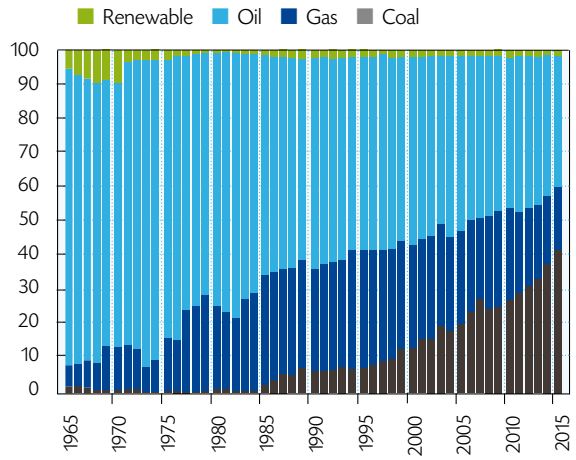
• • •

between 1980 and 2015 (representing 43% of total VA). As service activities are less energy-intensive, their upward trend in total VA largely explains the improvement in Indonesia's energy efficiency.

As for Indonesia's energy mix, 95% is made up of oil, gas and coal combined, making the country one of the biggest fossil energy producers (according to the Indonesian Ministry of Energy and Mineral Resources and the OECD). The heavy share of fossil energies in final energy consumption in Indonesia is structural in nature.

Figure 2.17.

Energy mix in Indonesia (in %)



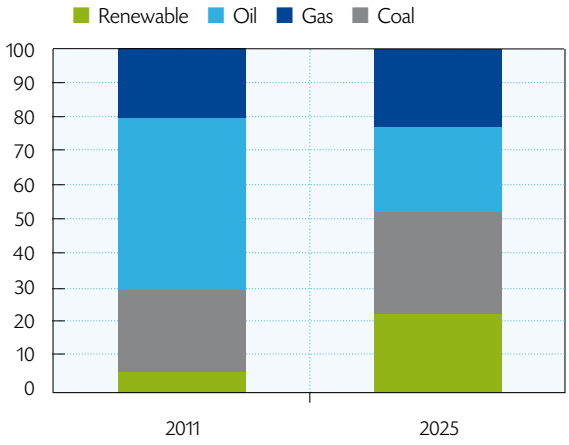
Sources: British Petroleum (BP) and AFD.

This situation is especially due to the fact that the country is strongly endowed with fossil energy resources: its level of proven oil reserves represents 11 years of the current production level, or 830,000 barrels per day in 2015 compared to 1.7 million barrels per day in 1991; for gas, Indonesia is among the top world producers, with an estimated 35 years of production reserves. But it is above all coal production that has seen considerable expansion since the middle of the 1990s (production has grown eightfold to reach 400 million tons per year), so much so that there are more than 70 years of production reserves. Coal therefore represents a prominent place in Indonesia's energy mix (35% of primary energy consumption over the last five years).

Because of its geographical characteristics, Indonesia has both a potential and variety of renewable energy resources that are first-class and that could help meet its long-term needs. The Indonesian authorities are consequently seeking to have the share of renewable energy in the overall energy mix grow to 23% by 2015, compared to 6%. This is an ambitious but probably necessary objective according to the International Energy Agency.

Figure 2.18.

Energy mix in Indonesia (in %)



Sources: Indonesian Ministry of Energy and Natural Resources and OECD.

3 / Sustainable public debt, but with a narrow tax base

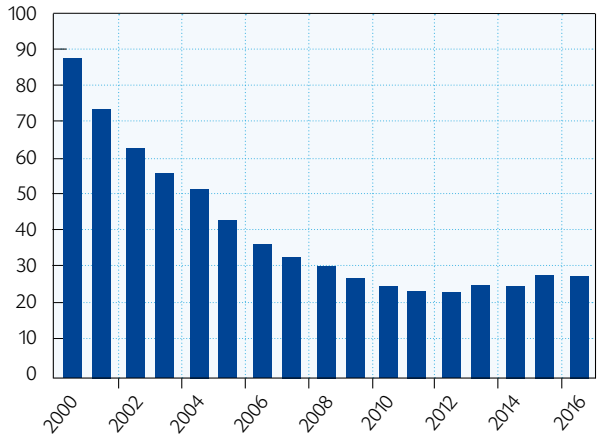
3.1. Public debt remains low

Low public debt

The Asian Financial Crisis of 1997-1998 came at a very high cost to the State, which had to finance bank recapitalizations. This in turn led to an explosion in the public debt, which grew from 25% of GDP in 1997 to 95% in 2000. After four Paris Club renegotiations on its public debt and a large-scale budget adjustment,[16] Indonesia's gross public debt took on a downward trend, reaching 24% of GDP in 2012 (see Figure 3.1). Since then, public debt has increased slightly, reaching 28 % of GDP in 2016; this was due to the drop in tax revenue from natural resources (see Figure 3.2) and to the rise in real interest rates combined with the introduction of a public investment program (see Subchapter 3.2.).

Figure 3.1.

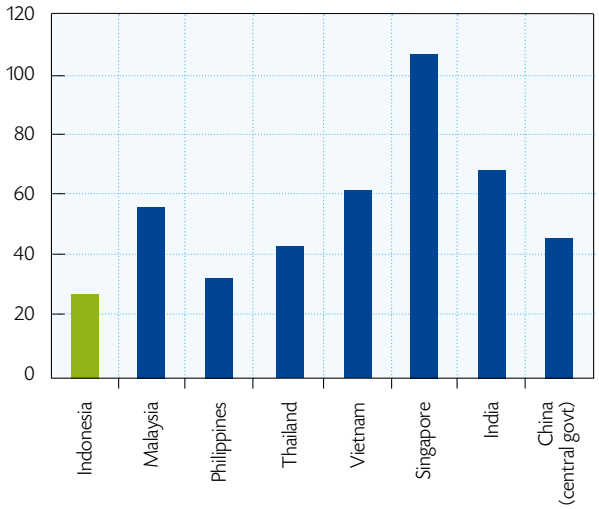
Gross public debt (in % of GDP)



Source: IMF (estimate for 2013).

Figure 3.2.

Gross public debt in 2016 – regional comparison (in % of GDP)



Source: IMF.

For more than a decade, Indonesia's public debt situation has been quite unique compared with other Southeast Asian countries and the emerging Asian countries: while the Asian Financial Crisis directly led to Indonesia suffering the highest public debt, in 2016 it had the lowest among the Asian countries (see Figure 3.2). The shock of this crisis and its negative effects were such that safeguards were established to limit State indebtedness. The 2003 budget law, for example, put ceilings of 60% of GDP on public debt and 3% of GDP on budget deficit.[17] Finally, the dynamics of public debt have been favorable for more than a decade, and it should remain sustainable in the medium term (cf. MacroDev No. 14, *op. cit.* for further details).

[16] This budget adjustment was carried out as part of the structural adjustment program implemented by the IMF.

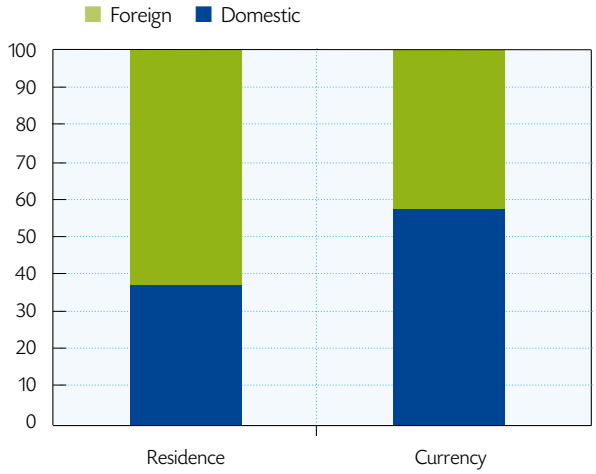
[17] Indonesia's 33 regions cannot obtain credit from foreign financial institutions. They can obtain credit via the granting of loans to the State with onlending to local authorities and/or by the direct granting of loans by the central government. Furthermore, an annual budget is transferred by the central government to the regions according to an allocative key that among other things takes into account production based on local resources.

Composition of Indonesia's public debt

Indonesia's public debt is mainly denominated in local currency (58% of stock in 2016). Its average maturity is 9.2 years: that with maturity of less than three years represented 16% of total stock in 2016, that between three and ten years 45% of stock, and that over ten years 39% of stock. Furthermore, 60% of the public debt was held by non-residents in 2016: these were private banks, insurance companies, and pension funds (see Figure 3.3). According to the Indonesian authorities, external debt remains necessary due to cash shortages and lack of depth in the local bond market. This is why the Indonesian central bank (*Bank Indonesia* – BI) and the supervisory authority (OJK[18]) would like to increase the size of the domestic bond market (see Part 3).

Figure 3.3.

Public debt, according to the criterion of residence and currency



Sources: Indonesian Ministry of Finance (MoF) and IMF.

Finally, the Indonesian State guarantees the debt of some public enterprises, at up to a maximum of 2.6% of GDP per year, within the framework of a presidential decree made in mid-2015 intended to promote the development of priority infrastructures. The debt of public enterprises has been increasing rapidly. In this matter, the burden of contingent assets for the Indonesian State, amounting to USD 16.2 bn in explicit guarantees at the end of September 2016 (representing 1.7% of GDP),[19] is relatively limited. However, it should be closely observed due to the vulnerability of enterprises in the energy sector.

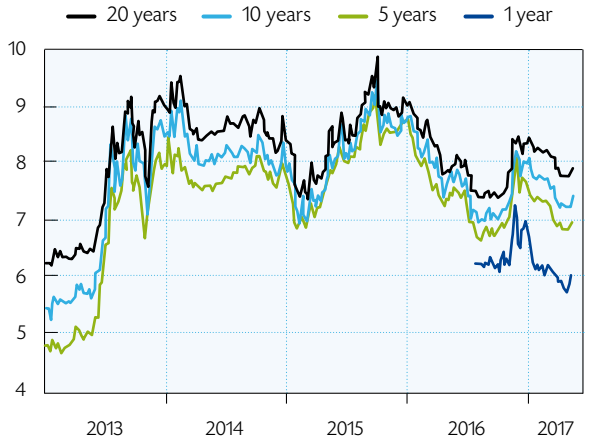
How Indonesian public debt is financed

The method with which the Indonesian public debt is financed illustrates the prudent and balanced way it is managed: in 2016, more than 70% of the debt was financed through bond issues (domestic and internal) and the rest through loans. Out of the total public debt stock, more than half is financed through sovereign bonds. Furthermore, the growing share of non-residents in the public debt, including in local currency, is indicative of the appeal of Indonesian public bonds to non-resident economic agents due to its investment grade status since 2012 and to the prospect of good yields (see Figure 3.4). The bond securities held by non-residents and denominated in local currency (the Indonesian rupiah), in proportion to all sovereign bonds, rose from 18% in 2009 to more than 37% at the end of December 2016, representing a doubling of its share (see Figure 3.5). These represented 60% of all treasury bills in 2016.

[18] *Otoritas Jasa Keuangan.*
[19] Source: *Fitch Ratings,* September 2017.

Figure 3.4.

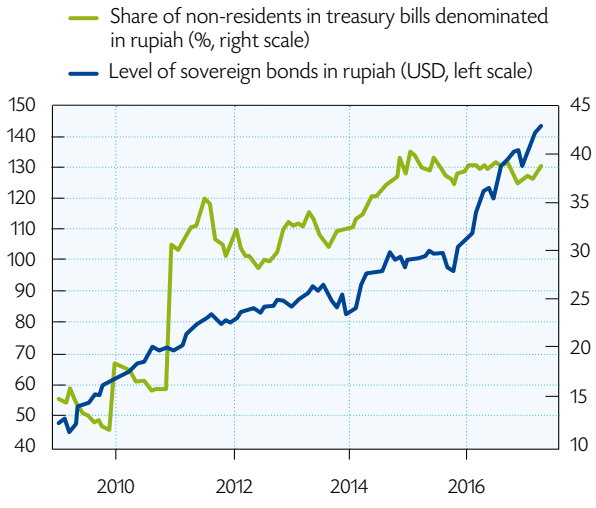
Indonesian government treasury bill yields (in %)



Source: Indonesia Stock Exchange and author's calculations.

Figure 3.5.

Share of non-residents in Indonesian treasury bills in rupiah and level of sovereign bonds in rupiah

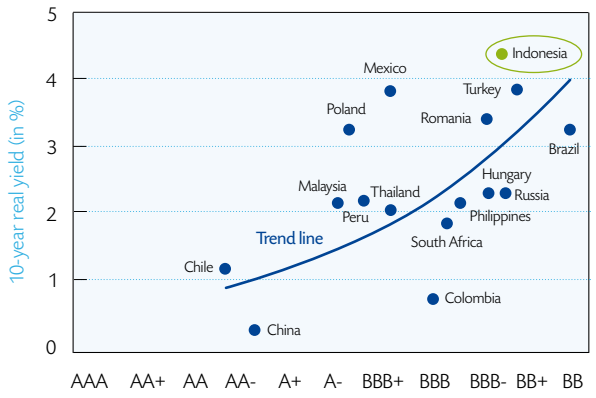


Sources: Indonesian MoF and author's calculations.

Furthermore, the Indonesian treasury bills are the most attractive financial instruments for foreign investors out of all the portfolio flows recorded since 2010. They represent 83% of portfolio flows between 2010 and 2016, or 1.5% of GDP on average (Source: IMF). In international comparison, the yields on Indonesian government bonds denominated in local currency are some of the most attractive (see Figure 3.6).[20]

Figure 3.6.

Real yield of Indonesian government treasury bills and rating by rating agencies



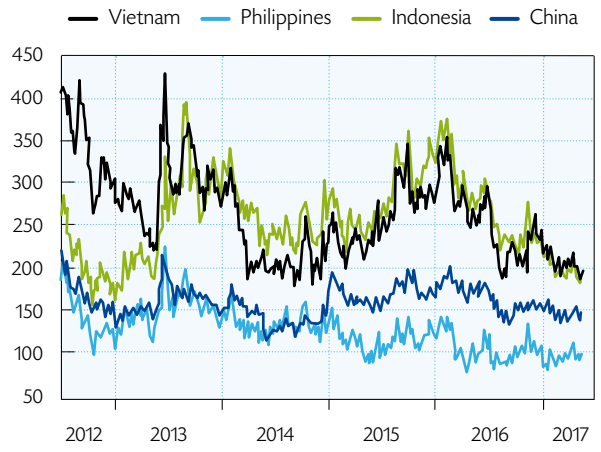
NB. The real yield of treasury bills is defined as the nominal yield minus the inflation rate. The rating represents the average of the grades of the 3 main credit rating agencies.

Source: IMF, Selected Issues (December 2016).

[20] Foreign central banks and foreign investment funds hold nearly half of treasury bills denominated in rupiah.

Figure 3.7.

Sovereign spread (gap in yield to maturity between the local bond of Asian countries and those of the Fed)



Sources: JP Morgan and author's calculations.

In a context of favorable assessment of the Indonesian sovereign risk, bond issues are thus a key means for financing the public debt and represented a total of 12% of GDP in 2016.[21] In the medium term, the authorities managing the public debt wish to limit these sovereign tradable debts to 12% of GDP. The significant proportion of non-residents in the sovereign debt and the appeal to foreign investors of holding treasury bills in local currency equates to a return of confidence. This is particularly true in view of the trends in currency exchange rate and of the US monetary policy, and consequently of the instability of the markets: Indonesian treasury bill yields increased sharply after Donald Trump was elected president of the United States on November 8, 2016, and after correction turned downwards following the Fed's decision to increase its key interest rates (see Figure 3.7).

3.2. Satisfactory budget execution, but with a tax base that remains weak

Partially thanks to the 3%-of-GDP budget role, budget execution is under control, as can be seen by the limited level of budget deficit in the last few years (see Table 3.1). However, the low level of tax revenue (12% of GDP on average) represents a major vulnerability for public finances.

[21] In December 2016, the Indonesian government successfully issued a debt offering on the international market amounting to USD 3.5 bn.

Table 3.1. *Structure of public revenues and expenditures (in % of GDP)*

	2012	2013	2014	2015	2016 e
Total budgetary revenues	17.2	16.9	16.5	14.9	14.5
Tax revenues	12.5	12.5	12.1	11.9	12.2
Non-tax revenues	4.5	4.3	4.4	2.8	2.4
Total government expenditures	18.8	19.1	18.6	17.4	17.2
Central government expenditures	11.3	11.7	11.9	11.4	-
1 – Current expenditures	9.2	9.1	9.1	7.5	7.3
1. a – Personnel expenditures	*2.3*	*2.3*	*2.3*	*2.4*	*2.4*
1. b – Subsidies	*4.0*	*3.7*	*3.7*	*1.6*	*1.3*
of which oil subsidies	*2.5*	*2.2*	*2.3*	*0.5*	*0.4*
1. c – Interest payments	*1.2*	*1.2*	*1.3*	*1.4*	*1.5*
1. d – Others	*1.7*	*1.8*	*1.8*	*2.1*	*2.4*
2 – Capital expenditures	1.7	1.9	1.4	1.9	2.0
Transfers to regions	5.6	5.4	5.4	5.4	5.7
Overall balance	-1.8	-2.2	-2.1	-2.6	-2.7

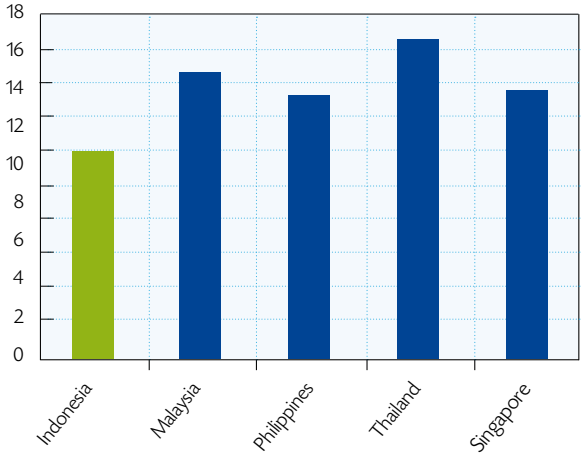
NB. 2016e: estimated figures.
Source: Indonesian MoF, BI and author's calculations.

3.2.1. A tax base that remains narrow

Tax revenues in relation to GDP are among the lowest in the world (see Figure 3.8) and have been on a downward trend since 1980 (see Figure 3.9). Tax revenues in relation to GDP have shrunk sharply during economic crises (as in 1997-1998 and 2008) without regaining their pre-crisis level. This can be explained by two factors: 1) some activities shift from the formal to the informal sector following a crisis and then gain in VA, and 2) tax evasion has been increasing. Since the early 2010s, the Indonesian central government's tax revenues have stagnated at 12% on average of GDP.

Figure 3.8.

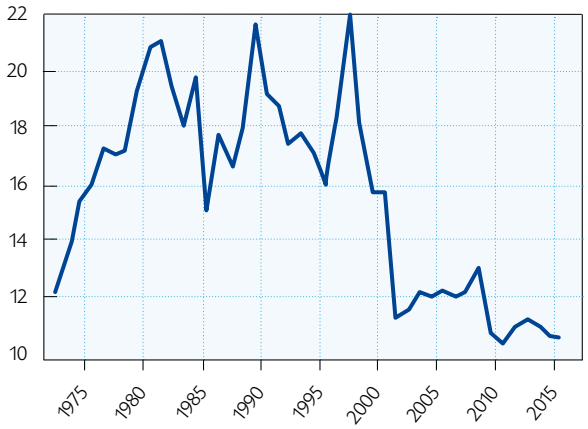
Tax revenue of the Indonesian central government in 2015 – comparison with other Asian countries (in % of GDP)



Source: WDI (World Bank).

Figure 3.9.

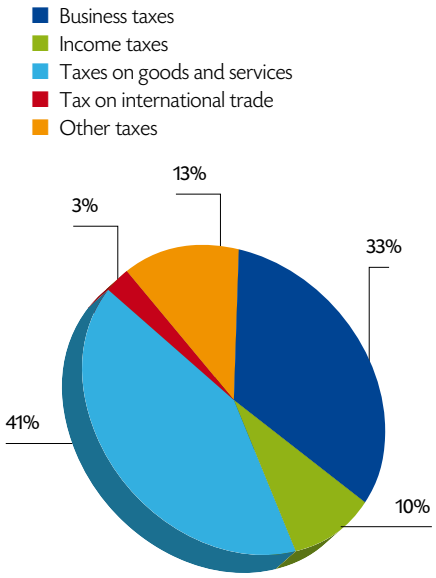
Tax revenues of the Indonesian central government (in % of GDP)



Source: WDI (World Bank).

Figure 3.10.

Composition of tax revenues in 2015 (in %)



Sources: Indonesian MoF, IMF and author's calculations.

Tax revenues primarily from enterprises

The composition of tax revenues shows the shortcomings of the tax base. Their source is mostly companies (more than one third of tax revenues in 2016, compared to 29% for the ASEAN countries). In contrast, tax revenue from individuals is low (only 9.5% of tax revenues). The shortcomings can be explained by tax evasion and a low rate of tax payment.[22] According to the OECD, out of the 27 million people registered with the Indonesian tax administration (out of a total population of 260 million), only 900,000 people really pay taxes. Nonetheless, the tax administration can be seen to have improved tax payments and levies. For example, it facilitated the procedure for obtaining a tax identification number for citizens obliged to pay taxes. Similarly, the authorities expanded their identification process by referring to the tax forms of private enterprises and by targeting civil service employees (including public enterprises). This targeting work has moreover had a snowball effect among the Indonesian population and has furthered the latter's familiarity with the process of tax identification.[23] Overall, these efforts have made it possible to quadruple the number of individuals subject to tax between 2005 and 2015 and to increase the number of enterprises paying corporate tax by nearly 2.5 times.

Revenue from the oil and gas sector: significant but on a downward trend

According to the OECD, the predominance of the tax on corporate profit within tax revenues as a whole can be explained by the high level of profits in the natural resources sector. In fact, this sector represents more than one fourth of revenues stemming from corporate tax. Further, the tax burden weighing on the sectors linked to the exploitation of natural resources, such as mining,[24] is close to that borne by the other sectors and may seem low compared to the money-generating nature of these sectors. Furthermore, the tax and non-tax revenues of the oil and gas sector are on a downward trend in proportion to total budgetary revenues (see Figure 3.11). This is especially linked to the diversification of public revenue undertaken by the Indonesian authorities. Nonetheless, this revenue remains significant, and the drop in oil prices from 2014 caused a decrease of 62% in 2015 and 25% in 2016 in nominal value.

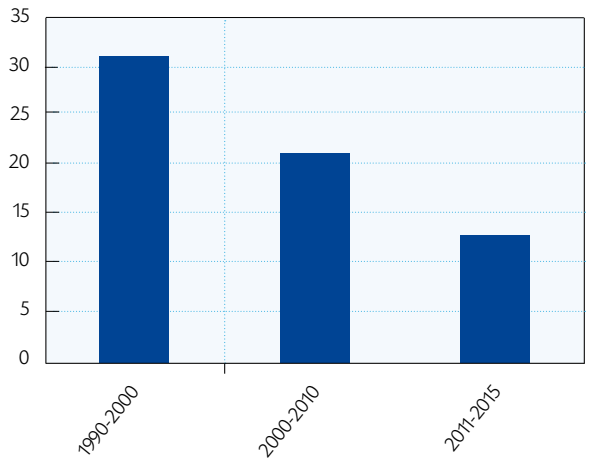
[22] Globalization has created opportunities for tax avoidance. The countries that had not established a tax base before globalization seemed to have trouble doing so since it started spreading. On the other hand, multinationals, banks and oligarchies know how to benefit from the resulting tax competition.

[23] Cf. *Beyond Ratings,* Dali S. (2015), « Vulnérabilités énergétiques et conséquences macroéconomiques en Indonésie ».

[24] IMF, *Selected Issues, op. cit.*

Figure 3.11.

Revenues (tax and non-tax) from the oil and gas sector (in % of total budget revenues)



Sources: Indonesian MoF and author's calculations.

Tax amnesty program established

In addition, the Indonesian government set up a tax amnesty law in July 2016. Its aim is to repatriate Indonesian assets placed abroad (in three phases, with increasing penalties). The stock of assets (domestic and foreign) concerned by this amnesty is estimated to be between USD 300 bn and 400 bn (representing around 40% of GDP). Of this amount, USD 200 bn seems to be placed in Singapore.[25] The first phase of the tax amnesty program, which ended on October 2, 2016, made it possible to repatriate USD 10 bn (below the government objective of USD 77 bn). The program improved the tax collection objective for 2016, by making up 8% of the central government's tax revenue for this initial phase (representing 0.9% of GDP).

The fiscal impact of this program has only a one-off effect in the short term. In the medium term, this program could strengthen the tax levy applied to declared enterprises. President Joko Widodo has announced the goal of reaching a tax revenue level of 16% of GDP by 2019 (compared to 12% currently). Finally, the funds declared and repatriated as part of the amnesty program will remain located in Indonesia for a period of at least three years. In this way, the Indonesian authorities hope to support investment in the real economy and in the local financial system.

3.2.2. Energy subsidy expenditures reduced and allocated to infrastructure expenses

On average since 2000, the Indonesian State has been allocating around 70% of budgetary revenue for central government expenditures and the balance (30%) for the regions. The local authorities remain very dependent on Jakarta for their budget, because only 10% of their expenditures are covered by their own revenues. In this way, 90% of their expenditures were financed in 2016 by transfers from the central government and were distributed as follows: 50% from the DAU (*Dana Alokasi Umum*) for current expenditures, 27% from the DAK (Dana Alokasi Khusus) for investment expenditures (compared to 8.9% in 2015), 14% from the DBH (*Dana Bagi Hasil*), and 9% for rural development (only the provinces of Aceh and Papua, which benefit from a special status, are concerned).

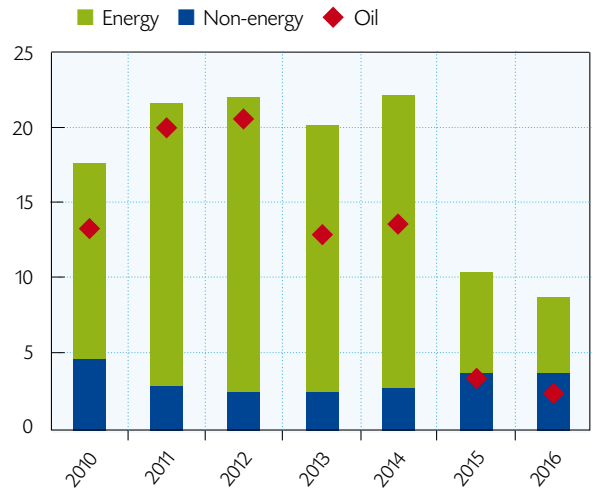
From among the central government expenditures, the debt burden remains stable (8% of total revenue since 2011, compared to 24% in 2000). This is due in particular to the significant reduction in interest rates and in personnel expenditures (15% of revenue on average).

Energy subsidies, especially for petroleum products, tapped nearly 20% of the State's total budgetary revenues until 2015 (cf. MacroDev No. 14, *op. cit.* for more details). They were sharply reduced by the Joko Widodo government that year and in 2016 represented only 5% of budgetary revenues compared to 20% in 2014 (see Figure 3.12). Joko Widodo had made the elimination of fuel subsidies a campaign promise at the end of 2013; he was deftly able to apply it after the drop in oil prices that started in June 2014.

[25] The tax amnesty program provides for a penalty of 2% on funds declared and repatriated by the end of the first phase. For funds declared but not yet repatriated, a 4% penalty is applied. Some Singaporean banks have reportedly offered to pay the extra 2% penalty for holders of Indonesian assets located in Singapore if they do not repatriate them to Indonesia (Source: Economic Service of the French Embassy to Jakarta). According to the public Indonesian bank Mandiri, most of the assets targeted by the tax amnesty program seem to concern the funds generated by Indonesian exporters and invested in Singapore. These funds are transformed into deposits in the Singaporean financial sector (liquid assets) or into property assets (assets thus not liquid and more difficult to repatriate as part of the amnesty program).

Figure 3.12.

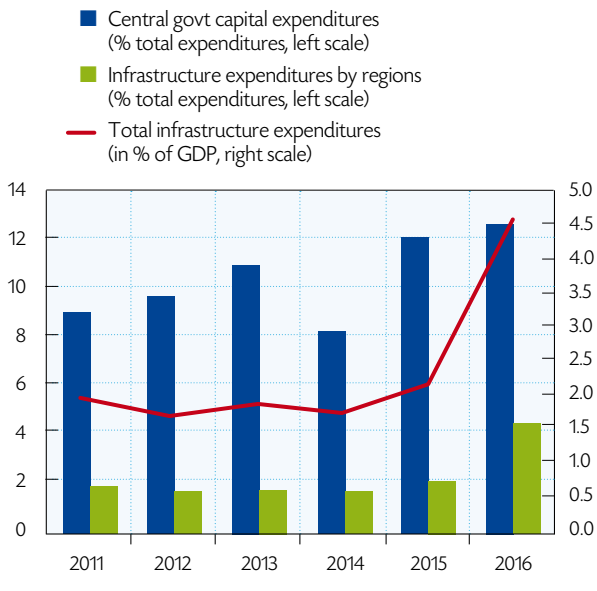
Subsidies (in % of total expenditures)



Sources: Indonesian MoF and author's calculations.

Figure 3.13.

Capital Expenditures (in %)



Sources: Indonesian MoF and author's calculations.

The resulting savings in government budget helped finance infrastructure projects (+0.9 point of GDP between 2014 and 2016 – see Figure 3.13), and thus responded to one of the structural insufficiencies of the country. And, more marginally, it helped compensate for the drop in tax revenue in the energy sector. Looking at the combined total of capital expenditures by the central government and transfers to regions intended for such expenditures (DAK), Indonesia devoted 2.6% of its GDP to capital expenditures in 2016 (17.3% of total expenditures), compared to 1.8% in 2011. This budget effort is part of the development program introduced by the new president (the Medium-Term Development Plan 2015-2019), which provides for IDR 4.9 trillion (about USD 400 million, or more than 40% of GDP) for infrastructure expenditures.[26] For now, this plan is being implemented at a slow pace, in particular due to technical weaknesses at the local level. The 2017 budget provides for a catch-up effect, with an increase of 22% in this type of expenditure.

Finally, the Indonesian government has been encouraging public enterprises to increase their investment expenditures. Capital expenditure of such enterprises consequently doubled in 2016, and an increase of 35% is forecast in 2017.

[26] The Indonesian government has announced that the public finance corporation PT *Sarana Multi Infrastruktur* (PT SMI) is to be transformed into a public investment bank in 2017, in order to support the Bappenas investment program and to guarantee certain loans within a public-private partnership. The capital endowment of this public bank will reportedly be IDR 30 to 40 trillion (between USD 2 and 3 bn).

4 / A financial system that is well supervised but that lacks depth

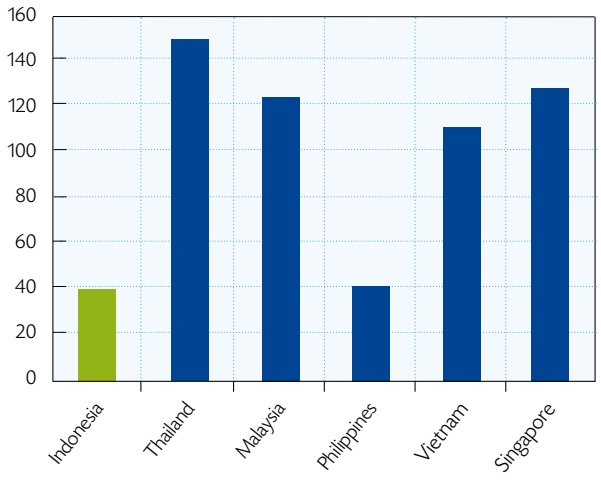
4.1. A concentrated bank sector with limited financing of economic activity

The 1997-1998 Asian Financial Crisis enabled in-depth restructuring of the financial system in general and the banking system in particular, by sharply reducing the size of the latter (cf. MacroDev No. 14, *op. cit.*). Today, the banking sector is characterized by both its limited size (a result of the big shock created by the crisis) and by its great concentration: the top 10 banks of the country hold 68% of bank deposits and represent 65% of the sector (cf. MacroDev No. 14, *op. cit.*).

Furthermore, the degree of bank intermediation–although on an upward trend–still remains weak in Indonesia (39% of GDP in 2015, – see Figure 4.2). This is particularly true when a comparison is made with the other ASEAN countries (see Figure 4.1 below), thereby reflecting the weak capacity of the bank sector to finance economic activity. At the same time, the level at which the economy's resources can be attracted by the bank sector seems insufficient in relation to the proportion of bank deposits compared to GDP (more than 40% of GDP) and in comparison with the other countries of Southeast Asia (more than 110% of GDP on average).

Figure 4.1.

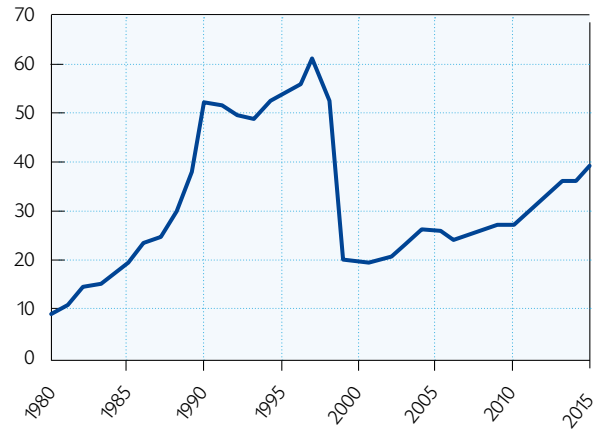
Domestic credit to the private sector in 2015 – regional comparison (in % of GDP)



Sources: WDI (World Bank) and author's calculations.

Figure 4.2.

Domestic credit to the private sector (in % of GDP)



Sources: WDI (World Bank) and author's calculations.

The weak level of bank intermediation in Indonesia, when compared with the relatively high level of investment (nearly 35% of GDP in Indonesia, compared to 25% on average in ASEAN) is of concern. A large portion of investment would thus be due to self-financing by enterprises, big Indonesian conglomerates (possibly up to 30-40%), and corporate (family, private, or professional) affiliates. The IMF estimated the share of intra-affiliate loans in the external debt of non-financial enterprises at two thirds as of the end of September 2016.[27] The share of non-intermediated financing is thus not non-negligible and by nature is not subject to any form of supervision.

The monetary authorities wish to increase financial inclusion by setting up social protection programs for the population. To be able to benefit from these programs, citizens (households) would need to have a bank account. The target is to increase the percentage of the population holding a bank account to 75% by 2018, but this would seem to be an ambitious objective, as the figure is only 20% currently.

[27] FMF, AIV, *Selected Issues 2016*. According to BI data, 1/3 of external debt of the private sector is granted as part of financing between head/sister companies and subsidiaries. This represents USD 50 bn, or 5.5% of GDP. The IMF considers that the large share of intra-group loans reduces the risk of roll over.

4.2. High profitability of bank sector related to strong selectivity of banks

4.2.1. Slowdown in private sector loans

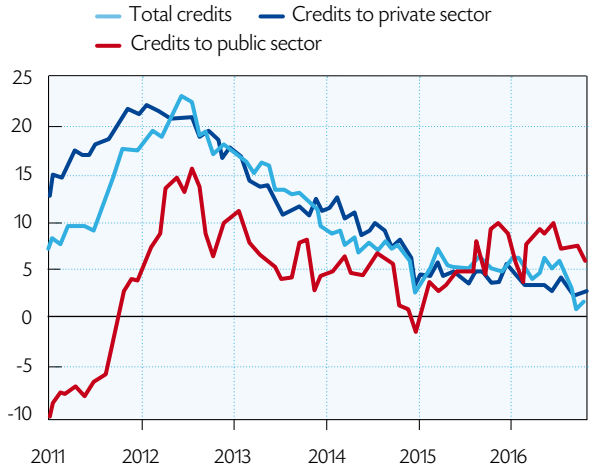
Analysis of the structure of bank resources shows that these are essentially made up of deposits (90%, mostly current accounts). It also reveals that this share has been consolidating over the years, representing a sign of stability in the bank sector. The Indonesian banks also seek to diversify their resources, as they are the top issuers in the domestic bond market.

After an upward cycle that followed the 2009 international crisis, credit activity slowed sharply from 2013: +13% in volume YOY between 2010 and 2013, and then +6% between 2014 and 2016 (see Figure 4.3). This slowdown partially results from a restrictive monetary policy established by BI in 2013 to reduce the depreciation trend of the rupiah (see Section 4.3.2) and also to curb the strength of domestic demand. In fact, BI's objective was especially to reduce household demand, which is largely made up of imports, within a context of the emergence of the current account deficit in the balance of payments in the middle of 2011.

The growth in credit to the private sector has not recovered the rhythm that prevailed before 2013, this despite the return to a policy to support domestic demand in 2016. This policy was introduced via a gradual reduction of 150 basis points in the key interest rate (credit growth corrected for 2% YOY inflation in October 2016, compared to 5.6% in December 2015 and 7.4% on average for 2014). The credit slowdown in 2016 is a manifestation of decreased credit demand, because overall economic activity slowed down in 2014 and 2015. As for credit supply, the increase in non-performing loans (see next section) has led commercial banks to be more selective.[28] Finally, the continued slowdown in the growth of credits in volume terms–despite a more accommodating policy in 2016–is indicative of the deficiencies of this monetary policy on the mechanisms of transmission towards the real economy. These deficiencies might be resolved by the recent introduction of a new monetary policy (cf. Section 4.3.2).

Figure 4.3.

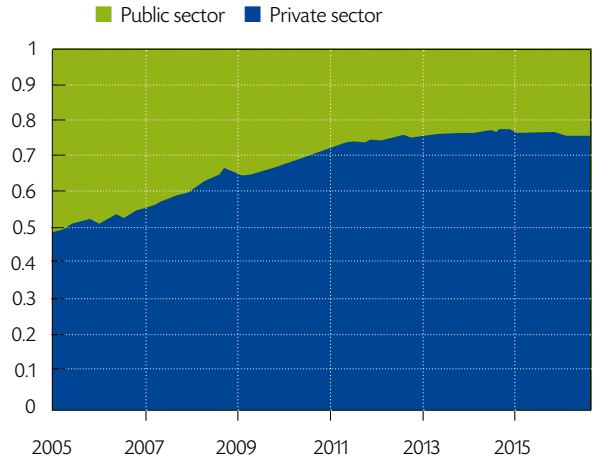
Change in credit volume YOY (in %)



Sources: International Financial Statistics (IFS) and author's calculations / last calculation: Oct. 2016.

Figure 4.4.

Credit volume, breakdown by sector (in % of total credits)



Sources: IFS and author's calculations / last calculation: Oct. 2016.

[28] Bank Indonesia, *Monetary Policy Review,* December 2016.

4.2.2. *Bank sector profitable but experiencing rise in non-performing loans*

The slowdown in economic activity in Indonesia between 2012 and 2015 affected credit flows towards the agricultural, manufacturing and mining sectors. The result was an increase in non-performing loans, which reached 3% of total outstanding loans in the second quarter of 2016, compared to 1.7% in 2013 (see Table 4.1). However, this ratio remains acceptable as long as the non-performing loan provisions stay at a good level. Furthermore, the ratio of bank solvency (regulatory capital compared to risk-weighted assets) is high and remains quite above the norm imposed by the banking regulations stemming from the Basel II and Basel III Accords (8% and 10.5% respectively). This enables the Indonesian bank system to absorb the shocks.

Table 4.1. *Balance sheet ratios of the banking sector (in %)*

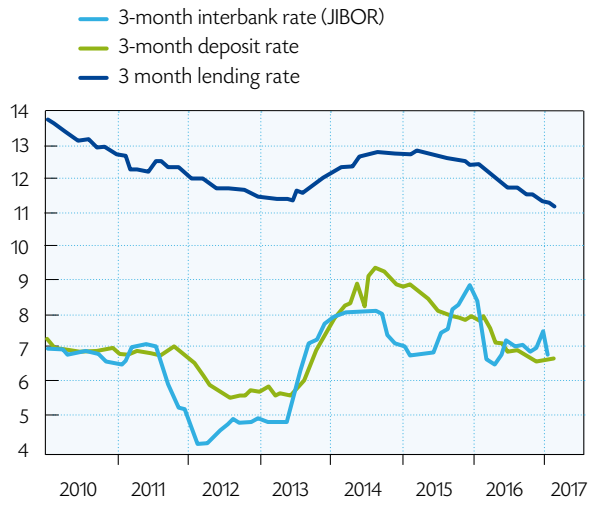
	2010	2011	2012	2013	2014	2015	T2 2016
Bank solvency ratio	16.2	16.1	17.3	19.8	18.7	21.3	21.2
Rate of non-performing loans	2.5	2.1	1.8	1.7	2.1	2.4	3.0
Provision rate of non-performing loans	57.1	60.7	52.0	50.9	46.8	51.5	51.8
Return on assets (ROA)	2.7	2.3	3.1	3.1	2.7	2.2	2.2
Return on equity (ROE)	26.1	20.3	25.3	24.5	21.3	17.3	15.4

Sources: BI and author's calculations.

Even though return on assets has been down slightly since 2013, it remains at an adequate level, in relation with the high level of interest margins of the principal Indonesian banks. These are close to 5% and remain among the highest of the Southeast Asian region. Return on equity is also very good, even though declining since 2010. This corresponds to the recapitalization of the bank sector carried out in 2010 and 2011, which led to strengthening the equity of the main commercial banks.

Figure 4.5.

Interest margin and 3-month interbank rate (in %)



Sources: BI, IFS and author's calculations.

4.3. Financial system well regulated but faces continued exposure to rise in the Fed's interest rates

4.3.1. *Bank supervision remains satisfactory and complies with international criteria*

The following two institutions are the ones mainly responsible for the Indonesian financial system:

- *(i)* OJK (*Otoritas Jasa Keuangan*) is responsible for regulating and supervising financial enterprises, insurance companies, pension funds and securities firms (previously under the responsibility of the Bapepam-LK agency[29]), as well as for supervision of the bank system.

- *(ii)* The central bank (*Bank Indonesia* – BI), whose independence is legally guaranteed, is responsible for regulating the country's bank system and part of the supervision of the system. The two institutions OJK and BI plan to work closely together, with OJK taking care of microeconomic monitoring and BI taking care of macroprudential supervision (cf. MacroDev No. 14, *op. cit.* for further details).

Prudential rules have been increasingly strengthened along with the 2012 implementation of the three regulatory pillars of Basel II. Implementation of the regulatory principles of Basel III started in 2014 and should be completed in 2018.

In March 2016, the Indonesian Parliament adopted a new legal framework for strengthening the stability of the financial system, the "Financial System Crisis Prevention and Mitigation Law." This law set the number of systemically important banks at 10 (cf. Section 4.1 above) and introduced both a legal basis for response in the event of bank crisis and greater coordination by BI, OJK and LPS [30] (Indonesia Deposit Insurance Corporation) in terms of the response to be given. It was operational by April 2017.

At the same time, the sharp rise in the external debt (+10 points of GDP between 2010 and 2015) led BI to strengthen its macroprudential framework, especially on coverage mechanisms. Thus, to take out external loans in foreign currency, an enterprise must *(i)* have at least a BB grade from a ratings agency, *(ii)* have a coverage ratio of at least 25% relative to loans denominated in foreign currency, and *(iii)* have a cash reserves ratio of at least 70% relative to the short-term assets and liabilities denominated in foreign currency.

BI has introduced several measures in order to limit the volatility of the exchange rate of the Indonesian rupiah compared to the US dollar and its implications in terms of inward and outward capital flows. Use of the dollar as a means for payment for domestic transactions has been forbidden since July 2015 (law on the mandatory use of the rupiah for financial transactions), and daily purchases of dollars without collateral (unsecured transactions) are limited.

4.3.2. *Monetary policy tools put to the test by rupiah depreciation*

New monetary policy tools

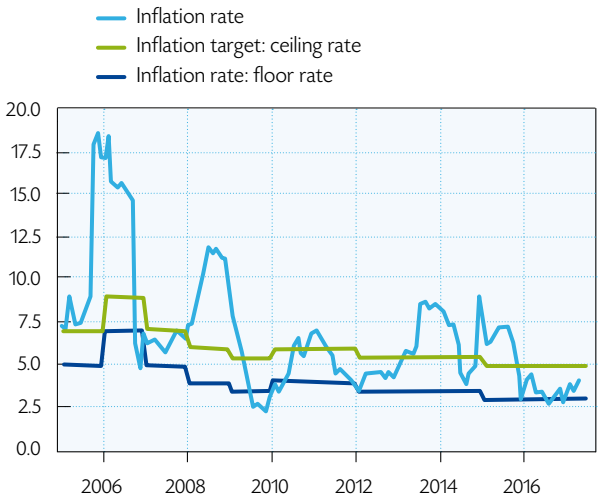
BI's monetary policy is based on achieving a major objective: maintaining the stability of the rupiah. Its stability is defined, among other things, by the stability of the prices of goods and services, and the main instrument to deal with this is the key interest rate (cf. MacroDev No. 14, *op. cit.*).

Within a context of severe inflationary tensions in 2013 and 2014 (7-8% YOY) and a strong depreciation of the rupiah compared to the dollar, BI decided to tighten its monetary policy. The result was a slowdown in the growth of credits to the economy from 2013. Then, owing to the slowdown in inflation (3% YOY in December 2016) and in domestic demand, BI lowered its key interest rate five times in 2016 (see Figures 4.6 and 4.7).

[29] *Badan Pengawas Pasar Modal dan Lembaga Keuangan.*
[30] *Lembaga Penjamin Simpanan.*

Figure 4.6.

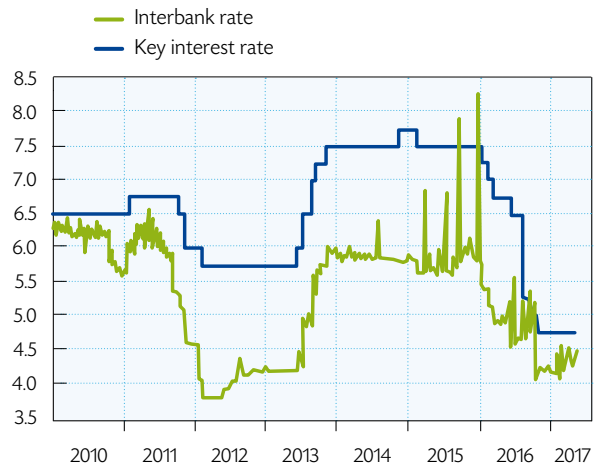
Inflation target and inflation rate (in %)



Sources: BI and author's calculations.

Figure 4.7.

Interbank rate (Overnight, JIBOR) and key rate (in %)

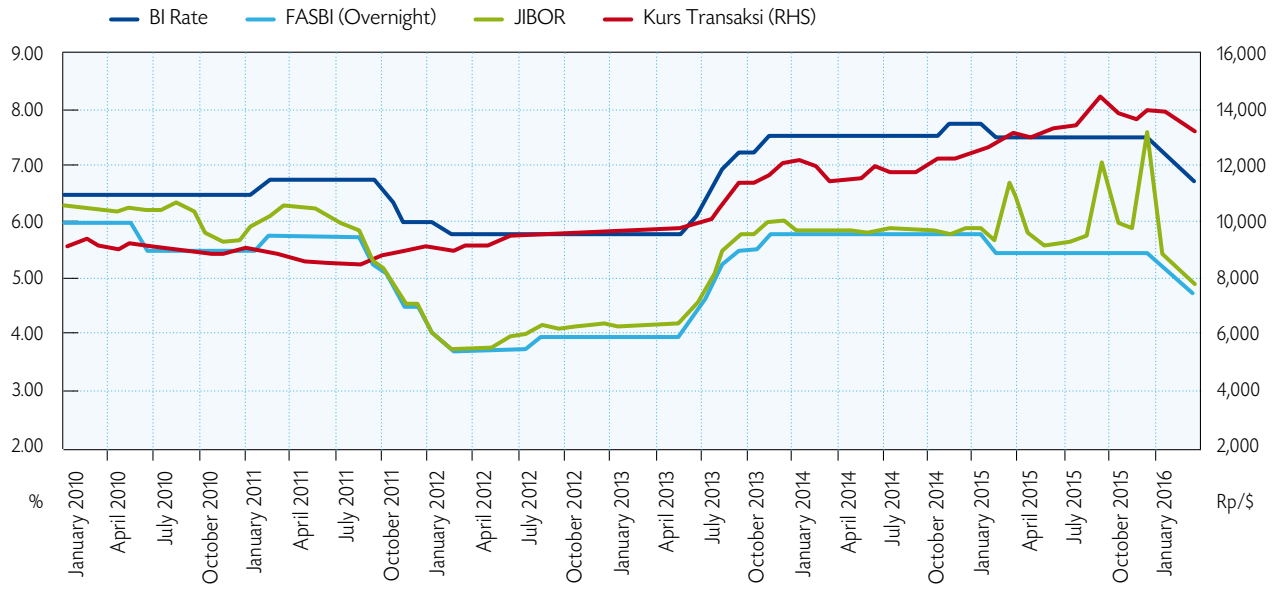


Sources: BI and author's calculations.

Since 2010, a gap of 200 basis points between the key interest rate and the overnight interbank rate can be observed (see Figure 4.7). This is due to the significant gap between the deposit facility and credit rates. Among other things, it is indicative of the surplus of liquidity on the market, linked to the inflow of capital and the low level of transfer of the key interest rate to commercial banks on the money market and to the real economy.

Figure 4.8.

Deposit facility rate (FASBI[31]), credit facility rate (Kurs Transaksi), interbank rate (JIBOR) and BI key interest rate (in %)



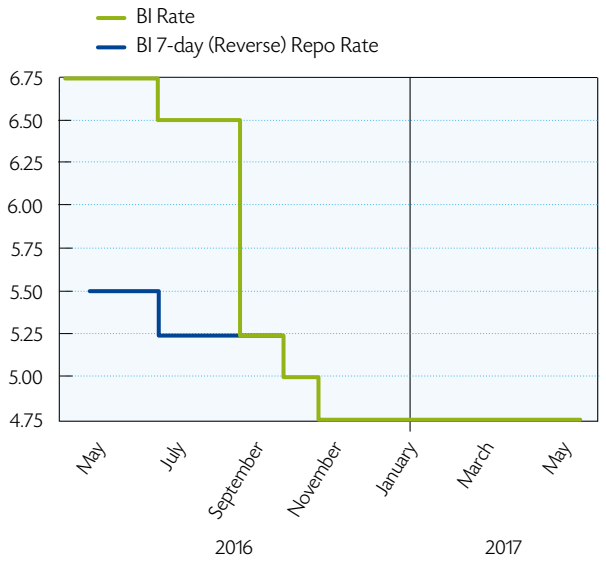
Source: Bank Indonesia (BI).

[31] *Financial Accounting Standards Board Interpretations.*

Therefore, in order to improve the transmission of its monetary policy, BI adopted a new monetary policy instrument in August 2016: the 7-Day Reverse Repo Rate (see Figure 4.9). This instrument is a short-term interest rate from which commercial banks can borrow from BI. By reducing the maximum period between the two transactions to seven days (compared to one year previously), it helps to narrow the gap between the deposit-facility and loan rates and can thereby strengthen incentives to commercial banks (and, through a transitive process, improve the effectiveness of the mechanisms of transmission of the monetary policy to money supply).

Figure 4.9.

Bank Indonesia key interest rate (in %)



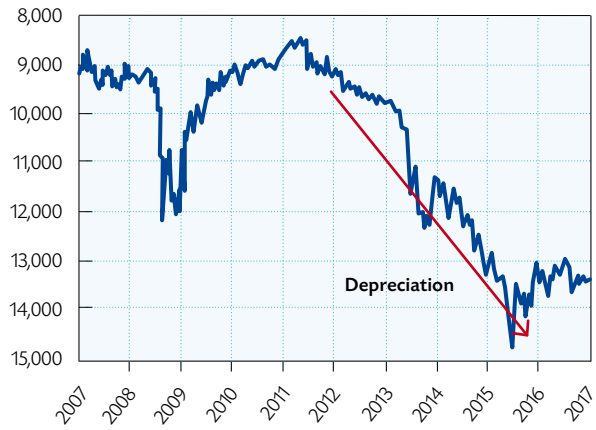
Source: Bank Indonesia (BI).

Less tension on the Indonesian rupiah, but exposure to the rise in the Fed's interest rates

In May 2013, after the US Federal Reserve System (Fed) announced that it might end its unconventional monetary policy, the Indonesian rupiah dropped sharply against the US dollar (cf. MacroDev No. 14, *op. cit.*). Between May 2013 and July 2015, the Indonesian currency lost 40% of its nominal value compared to the US dollar (8% in real terms). This was the reflection of an outflow of capital and of growing imbalances in the current account of the balance of payments (see Figures 4.10 and 4.11).

Figure 4.10.

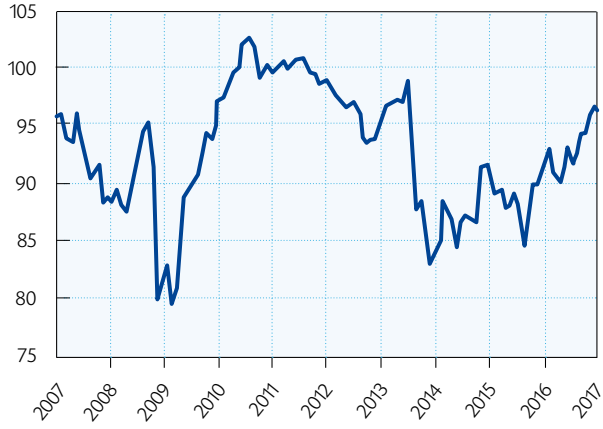
USD/IDR exchange rate (IDR, inverted rate)



Sources: BI and author's calculations / last calculation: May 2017.

Figure 4.11.

Real effective exchange rate (index, IDR)

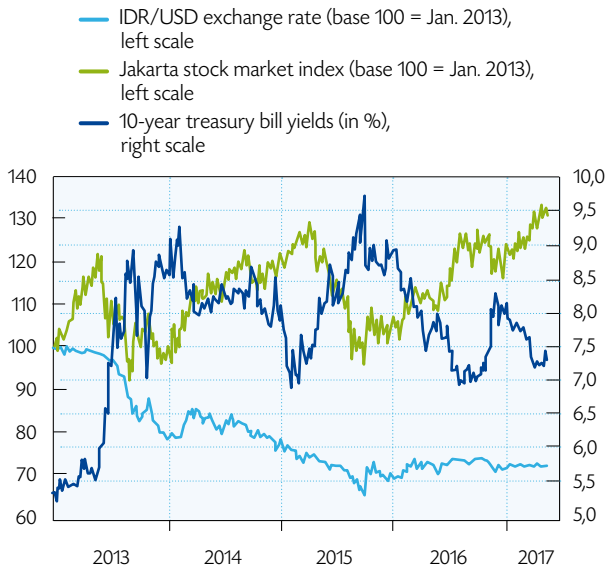


Sources: BI and author's calculations / last calculation: March 2017.

The tensions have subsided since then, and there has been a reorientation characterized by a return of foreign capital to Indonesia (especially portfolio flows) and, additionally, by the confidence foreign investors have in treasury bills, in the context of local macroeconomic improvement (see Figure 4.12). With the Indonesian financial market lacking depth, bond yields from the Indonesian government seem crucial for attracting foreign capital flows. Furthermore, in a regional comparison, yields of Indonesian treasury bills are some of the most attractive (see Figure 4.13).

Figure 4.12.

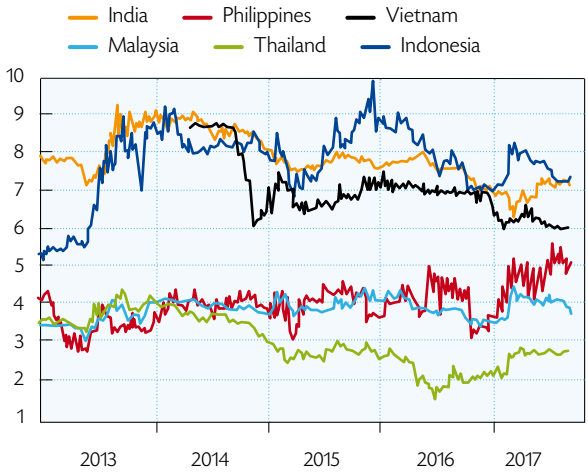
Stock market index, government bond yield and exchange rates



Sources: BI and author's calculations.

Figure 4.13.

10-year Indonesian treasury bill yields (regional comparison, in %)



Sources: BI, MacroBond and author's calculations.

In the coming months, one of BI's major challenges will be how it steers its current expansionary monetary policy, in order to maintain the differential in interest rate with that of the Fed by anticipating the next gradual rise in the latter's key interest rate. It seems BI is prepared for the challenge and has the instruments to meet it.

5 / Reducing external imbalances

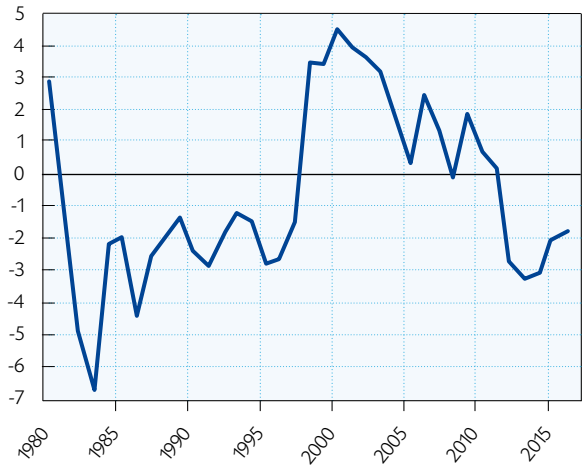
5.1. A decreasing need for external financing

5.1.1. Cyclical reduction of current account deficit

Indonesia remains an country with an economy relatively closed to the outside world. The degree of openness of its economy is in fact among the weakest of the region: it was estimated to represent 33% of GDP in 2015, on a downward trend since the beginning of the 2000s. After the 1997-1998 Asian Financial Crisis, the current account balance of the balance of payments recorded surpluses over 14 years before a deficit was formed in the middle of 2011 (cf. MacroDev No. 14, *op. cit.* for further details).

Figure 5.1.

Balance of the current account of the balance of payments (in % of GDP)



Sources: WEO and author's calculations.

Figure 5.2.

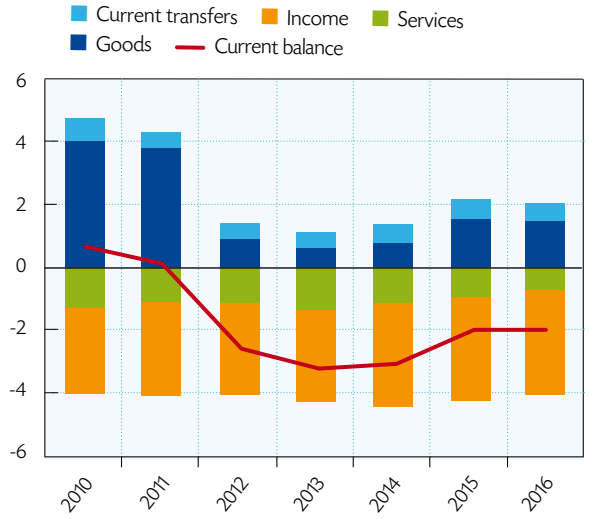
YOY exports and imports of goods and services (in %)

Sources: BI and author's calculations.

The current balance-of-payments deficit dropped one percentage point of GDP, from 3.1% in 2013 to 2.1% in 2015, mainly due to recessive adjustment of imports (see Figure 5.2). There was in fact a significant fall in imports (-21% in 2015) due to the slowdown in domestic demand (which is largely made up of imports), whereas the drop in exports, following unfavorable trends in commodity prices, was less straightforward (-15.4% in 2015). In 2016, it is estimated that the current account deficit will be 2.1-2.3% of GDP (see Figures 5.3 and 5.4).

Figure 5.3.

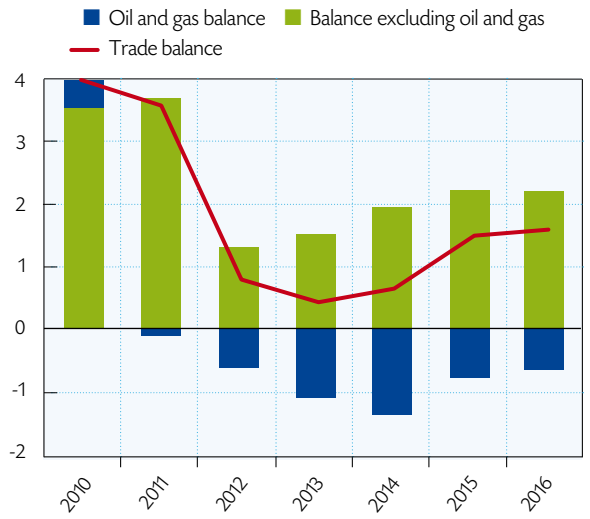
Composition of the current balance (in % of GDP)



Sources: BI and author's calculations.

Figure 5.4.

Composition of the trade balance (in % of GDP)



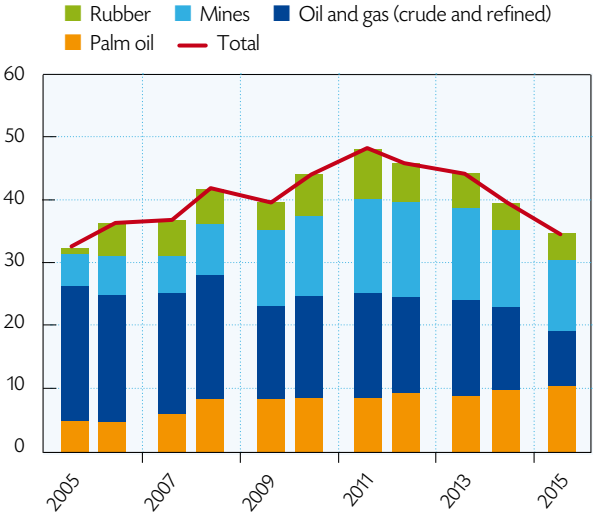
Sources: BI and author's calculations.

5.1.2. *High proportion of commodities in goods exports remains a source of vulnerability*

Indonesia's exports of goods are made up mostly of natural resources (60% of exports of goods, cf. MacroDev No. 14, *op. cit.* for further details). The four main Indonesian export products (gas and oil, coal, palm oil and rubber) represent 45% of total exports in value terms (see Figure 5.5).

Figure 5.5.

Structure of goods exports (in %)

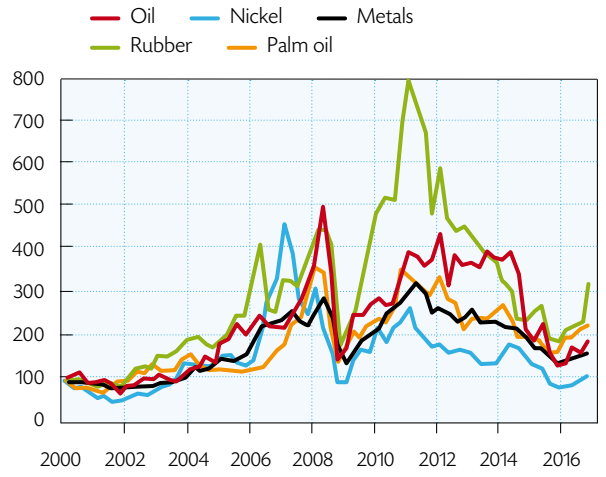


Sources: BI and author's calculations.

The drop in commodities prices that began in 2012 thus led to the deterioration of Indonesia's terms of trade (see Figures 5.6 and 5.7). However, these improved thanks to more favorable prices for metals, palm oil and rubber in 2016.

Figure 5.6.

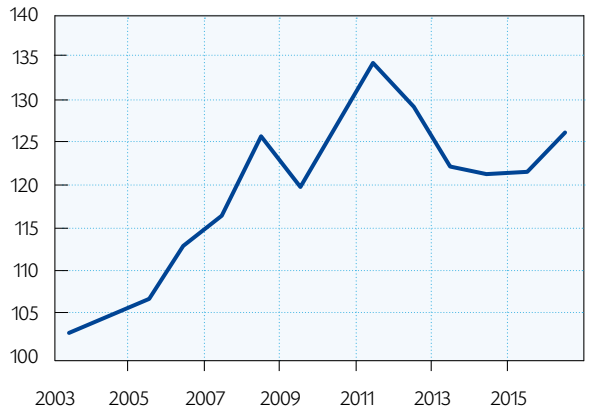
Commodities prices (base 100 = 2000)



Sources: World Bank, Bank of New York, OECD, and author's calculations.

Figure 5.7.

Terms of trade (base 100 = 2000)



Sources: UNCTAD [32] and author's calculations for 2016).

5.1.3. External financing needs decrease, while coverage becomes more exposed to the volatility of external financial flows

After 14 years of surpluses in the current account balance, the emergence since the middle of 2011 of the current deficit has been contributing to the increase in Indonesia's external financing needs (EFN).[33] EFN increased more than five points in GDP between 2010 and 2013 (to 7% of GDP) before decreasing, essentially following a recessive adjustment of imports. It may represent between 3 and 4% of GDP for 2016 (see Table 5.1).

[32] United Nations Conference on Trade and Development.

[33] External financing needs (EFN) is defined as the sum of the current balance excluding grants and of the amortization of the external debt. In Indonesia's case, EFN is low: 6% of GDP on average since 2011.

Table 5.1. *External Financing needs (EFN) and EFN coverage (in % of GDP)*

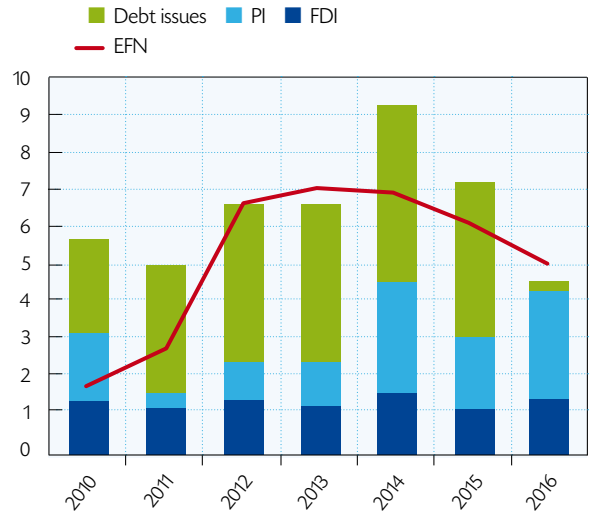
	2010	2011	2012	2013	2014	2015	2016*
1 – Current account balance excl. grants	0.6	0.2	-2.7	-3.2	-3.1	-2.1	-2.1
2 – External debt amortization	-2.5	-3.0	-4.0	-3.8	-3.8	-4.0	-3.0
External Financing Needs	1.8	2.8	6.7	7.0	6.9	6.1	5.0
EFN coverage	**5.6**	**4.7**	**6.6**	**6.6**	**9.0**	**7.2**	**4.5**
1 – Non-debt-creating flows	3.3	1.8	2.5	2.6	4.6	3.2	4.3
a – FDI	*1.5*	*1.3*	*1.5*	*1.3*	*1.7*	*1.3*	*1.5*
b – Portfolio flows	*1.7*	*0.4*	*1.0*	*1.2*	*2.9*	*1.9*	*2.8*
c – Grants	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
2 – Debt-creating flows	2.5	3.3	4.1	4.1	4.7	4.1	0.3
3 – Errors and omissions	-0.2	-0.4	0.0	0.0	-0.2	0.0	-0.1
Change in reserves (-/+ = a positive/negative change)	-3.7	-1.9	0.1	0.4	-2.1	-1.2	0.5

*Sources: BI and author's calculations (*data estimated based on the first three quarters of 2016).*

Indonesia's need for external financing thus remains low. Its coverage may, on the other hand, potentially become a problem in the longer term. This is because the FDI and portfolio investments remain relatively low as a share of GDP and have contributed only slightly to the external financing of the economy since the beginning of the 2000s (respectively 1.4% and 1.5% on average since 2011). In fact, the financial gap is ensured by issuing external debt and/or by drawing on reserve currency (see Figure 5.8). In the medium term, the Indonesian economy is exposed to the rise of US interest rates, because the rate gap is one of the determining factors of incoming flows (cf. IMF, *Selected Issues*, 2016).

Figure 5.8.

External financing needs (in % of GDP)



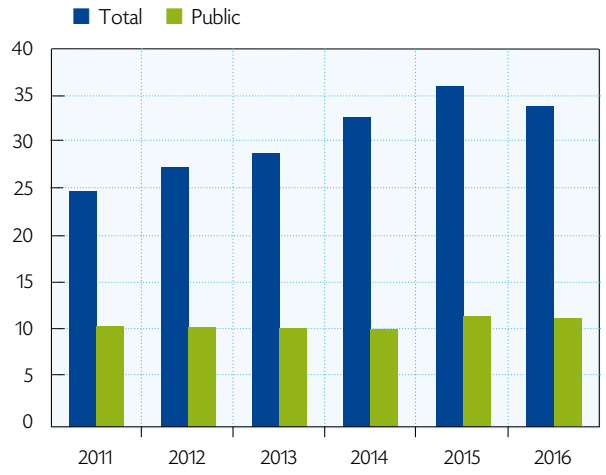
Sources: BI UNCTAD and author's calculations (author's estimates for 2016).

5.2. Liquidity and solvency of the external sector remain satisfactory

Since 2010, external debt has thus been on an upward trend. It represented 36.1% of GDP in 2015 (after 25.2% in 2010), one third of which was linked to the central government (See Figure 5.9). This increase was largely due to public enterprises in the energy sector (PLN and Pertamina, which are not included in the government's external debt), the private sector, and the depreciation of the rupiah (the external debt stock of public enterprises was nearly USD 28 bn in the third quarter of 2016, representing more than 3% of GDP – see Figure 5.10). The Indonesian currency has lost 35% of its nominal value since May 2013 but has undergone an upswing since BI set up measures (see Part 4). This, along with moderation in the rise of external debt in nominal value and with acceleration of the pace of growth, are together helping to slightly decrease the external debt in 2016 (to 34% of GDP according to initial estimations).

Figure 5.9.

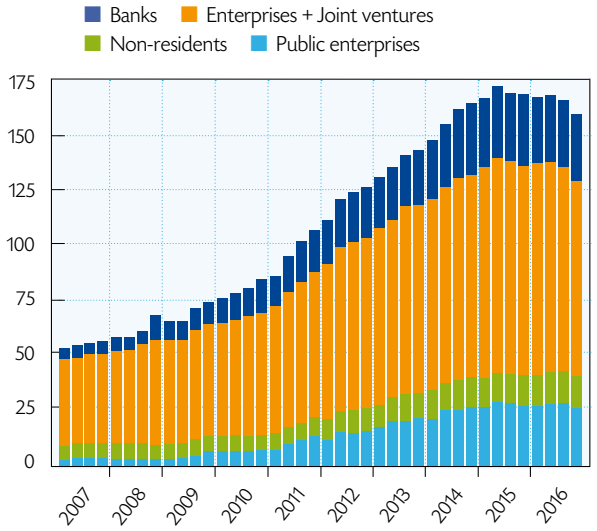
Total external debt (in % of GDP)



Sources: WEO and author's calculations (IMF forecast for 2016).

Figure 5.10.

Private external debt by entity (USD bn)



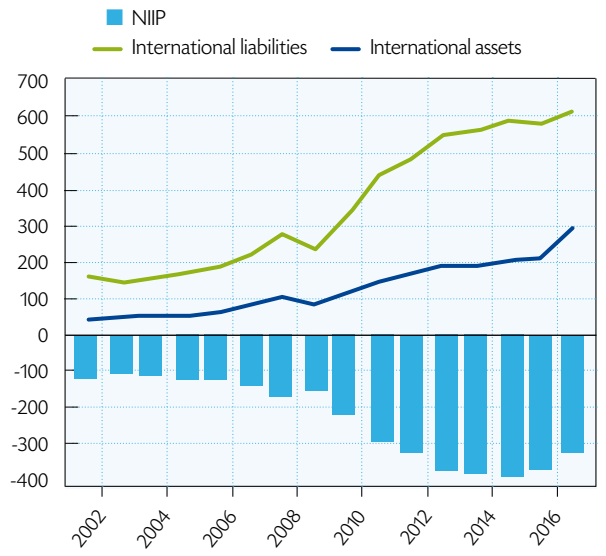
Sources: BI and author's calculations.

Due to a rise in its commitments, Indonesia's net international investment position (NIIP) is on a negative trend, reflecting the growth of its external liabilities, (see Figure 5.11). The country is thus dependent on foreign savings to finance the dynamics of its current account deficit and its investments. These net international investments represented 42.5% of GDP in 2015, nearly 7 points higher than total external debt (which is included in the NIIP).

Finally, external liquidity remains at a comfortable level (reserves of more than eight months of imports of goods and services on average, representing twice the short-term debt) and is favorably oriented (see Figure 5.12).

Figure 5.11.

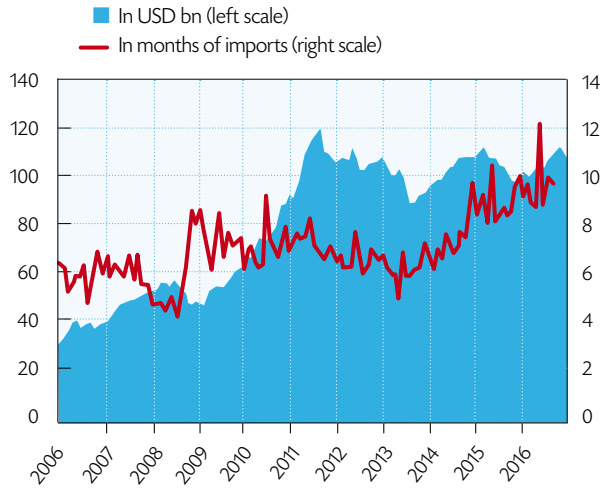
Indonesia's Net International Investment Position (NIIP) (USD bn)



Sources: BOPS (IMF) and author's calculations.

Figure 5.12.

Currency reserves



Sources: BI and author's calculations.

List of acronyms and abbreviations

AIV	Article IV of the IMF
ASEAN	Association of Southeast Asian Nations
BI	*Bank Indonesia* (central bank of Indonesia)
bn	billion
BP	British Petroleum
BPS	*Badan Pusat Statistik* (Statistical Institute of Indonesia)
BRICS	Brazil, Russia, India, China, South Africa
EFN	External Financing Needs
FASBI	Financial Accounting Standards Board Interpretations
FDI	Foreign Direct Investment
Fed	Federal Reserve System (central bank of the United States)
GDP	Gross domestic product
GFCF	Gross fixed capital formation
IDR	Indonesian rupiah (official currency of Indonesia)
IFS	International Financial Statistics
IMF	International Monetary Fund
KPK	*Komisi Pemberantasan Korupsi* (Corruption Eradication Commission)
LMICs	Lower-middle-income countries (World Bank)
LPS	*Lembaga Penjamin Simpanan* (Indonesia Deposit Insurance Corporation)
MICs	Middle-income countries (World Bank)
MoF	Ministry of Finance
NIIP	Net International Investment Position
OECD	Organisation for Economic Co-operation and Development
OJK	*Otoritas Jasa Keuangan* (Indonesia Financial Services Authority)
PDI-P	*Partai Demokrasi Indonesia Perjuangan* (Indonesian Democratic Party of Struggle)
PI	Portfolio investment
PPP	Purchasing power parity
TOE	Ton of oil equivalent
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollar
VA	Value added
WDI	World Development Indicators (World Bank)
WEO	World Economic Outlook (IMF)
YOY	Year-over-year

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