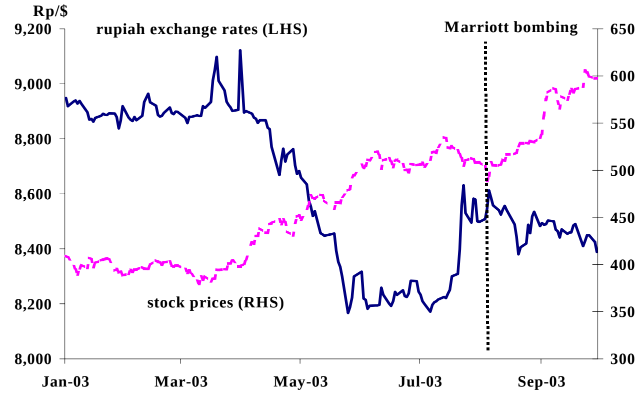
Macroeconomic stability is strengthening in Indonesia. The external environment is likely to be supportive for the economy. This positive trend is reflected in the recent upgrade of Indonesia's credit rating by Moody's and Standard and Poor's.[1] However, growth is still largely consumption driven, and investment remains lackluster because of a weak investment climate. The Marriott bombing in August had little direct impact on the markets. The exchange rate has been stable around Rp.8,500 and the Jakarta stock exchange index reached a 3-year high in September. The impact of the bombing on the real sector remains to be seen. Anecdotal evidence show the hotel occupancy rate went down again after the bombing and new investors may have cancelled or delayed investments.

The government decision not to renew the IMF program beyond 2004 found broad acceptance inside and outside Indonesia. The draft 2004 budget is consistent with this decision, and the emerging financing picture seems manageable. To support confidence, the government issued the *Economic Policy Package Pre and Post IMF* in September, spelling out policies to be implemented over the next 18 months. If implemented according to plan and intent, this package promises to improve the investment climate, and reduce policy uncertainty in the run-up to the elections next April.

Market Sentiment

Market sentiment has remained favorable despite the Marriott bombing on August 5 (Figure 1). On that day, the rupiah exchange rate depreciated by 1 percent, and the share index dropped by 3 percent. However, the markets recovered quickly. The rupiah exchange rate stabilized around Rp.8,500, and the share index surpassed 600 or a 3-year high in September. However, the markets are still sensitive to external developments. For example, the sharp depreciation of the rupiah exchange rate in July was caused by the increase in the US interest rates.

Figure 1: Markets are supportive



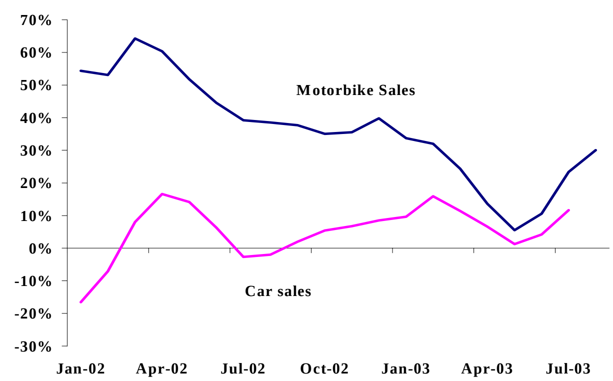
Source: CEIC

The Real Economy

Over the first half of 2003, the economy performed well amid the Iraq crisis and SARS outbreak. Growth totaled 3.6 percent in the first half (year on year), still below the Government's government target of 4 percent for the year, but better than could have been expected given the shocks. The World Bank now expects growth for this year to be 3.5 percent, slightly above earlier expectations.

Private consumption remains the main source of growth. In Q2 2003, GDP grew by 3.8 percent year on year (yoy), while private consumption grew by 4.7 percent (yoy). While non-food consumption growth rate has been decelerating for 6 straight quarters, signs are that this decline may halt. Sales of durable goods show a sign of rebound. Motorbike sales volume grew by 30 percent (yoy, June-August) and car sales (units) grew by 11.6 percent (May-July) (Figure 2).

Figure 2: Car and motorbike sales rebound (3 month moving average / yoy)



Source: CEIC

[1] Moody's upgraded Indonesia's rating from B3 to B2 on September 29, and S&P upgraded from B- to B on October 8, 2003.

The recent decline in interest rates as well as improvement in consumer sentiment may have had a positive impact on the sales. Government consumption continued its strong growth with 7 percent in Q1 followed by 9.2 percent in Q2. As central government budget figures suggest modest growth in central government consumption, regional governments seem to be the driving factor.

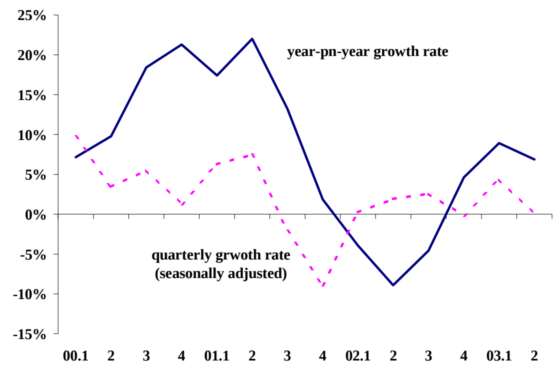
Table 1: Modest GDP growth amid two shocks
(growth in percent compared to same semester the previous year)

	2002		2003
	H1	H2	H1
GDP growth	**3.3**	**4.0**	**3.6**
Non-oil GDP	**3.4**	**4.4**	**4.6**
By expenditure			
Consumption	5.5	5.5	4.7
o/w private	5.3	4.2	4.3
o/w government	7.8	17.4	8.1
Fixed investment	-6.8	6.8	5.9
Exports	-5.6	3.5	0.4
Imports	-23.2	10.8	3.5
By sector			
Tradable			
Agriculture	0.4	3.2	2.9
Mining & quarrying	0.3	4.2	1.8
Manufacturing	4.8	3.3	2.5
Non-tradable			
Construction	2.6	5.6	5.3
Finance	4.8	6.3	6.0
Transport	8.9	6.8	7.1
Utilities	5.5	6.8	6.6
Retail trade etc.	3.0	4.2	4.4
Services	2.3	1.7	2.1

Source: Central Statistics Office (BPS)

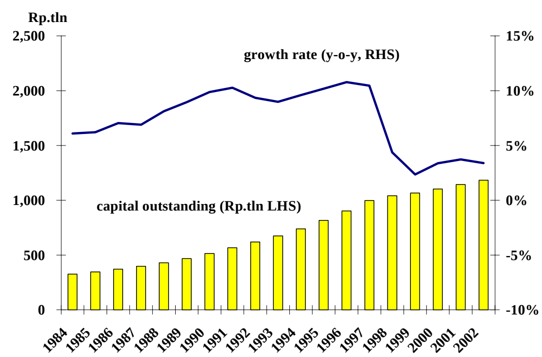
Investment growth slowed down further. Fixed capital formation increased by 4.9 percent (yoy) in the second quarter, and the estimated quarterly growth rate (seasonally adjusted) shows almost no growth in Q2 2003 (Figure 3). The low levels of investment in the last 6 years are affecting the growth in the capital stock (Figure 4). This was some 10 percent per annum before the crisis, but has been less than 5 percent per annum since the crisis. Data from the investment coordinating board (BKPM) [2] suggest that low investment growth is likely to continue for some time, as investment approval data have not yet turned around. In January-August, approval of investment permanent licenses (a proxy for investment realization) for domestic investment was Rp.4.3 trillion and for foreign investment was US$.1.8 billion, much below that of the same period last year (Figure 5). Capital good imports data supports the investment picture. Capital goods imports declined by 8 percent (yoy) in January-August.

Figure 3: Investment is stagnant
(yoy growth rate of fixed-investment in the national account)



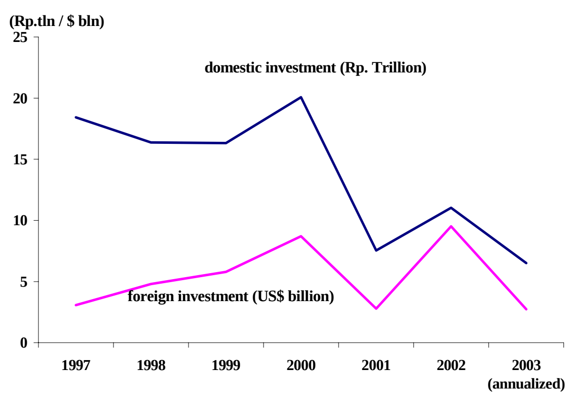
Source: BPS, staff estimates

Figure 4: Slower pace of capital accumulation



Source: staff estimates

Figure 5: Less investment realization
(investment permanent license)



Source: BKPM

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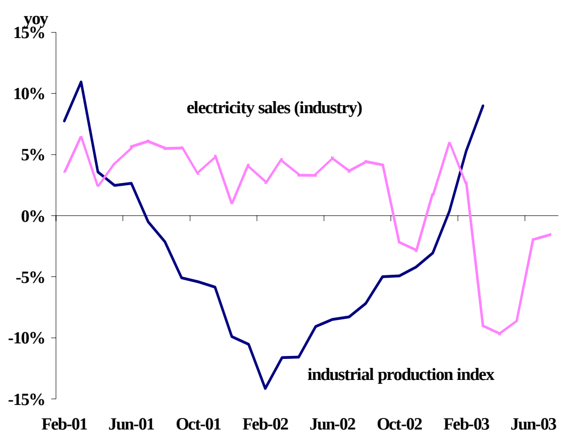
[2] Data from BKPM does not include the oil and gas, financial sectors.

On the production side, manufacturing shows a mixed picture. Industrial production data shows sharp recovery until March (Figure 6), but over the first half of 2003, manufacturing output grew by 2.5 percent (yoy) or the lowest since H1 1999. Although non-oil and gas manufacturing grew by 3.8 percent, oil and gas manufacturing such as oil refinery declined by 11.4 percent. Low levels of investment in the oil and gas sector are affecting output, which in turn reduces refinery outputs, as most Indonesia's oil refinery facilities can only refine domestic oil. The low levels of investment in oil and gas are in part due to uncertainties surrounding extensions of production sharing contracts. Electricity consumption for industry (volume) has been declining for most of in 2003, confirming the lackluster growth on industrial production, although this decline in part also reflects further tariff increases during the year. Construction has been expanding with over 5 percent since Q3 2002 in the national account. Cement consumption growth rate (yoy) were also positive in June-July. In addition, Bank Indonesia's data on property lending shows loan outstanding increased by 22 percent in June 2003.

Figure 6: Mixed Production Indicators



Source: BPS, CEIC

The Iraq crisis and SARS affected tourism, aborting a hesitant recovery that had set in after the Bali bombings of October 2002. The number of foreign visitors declined by 21 percent (yoy) in March or more than the 9 percent drop in February 2003. Tourism was further hit by the Marriott bombing in August. In this month, the number of visitors increased by only 1 percent (month on month), after 22 percent in July.

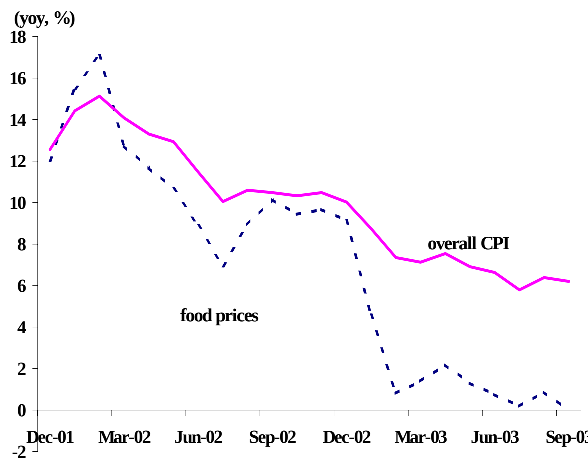
Employment, Poverty, Wages and Income

Unemployment is still on the rise. Despite modest growth and continued macroeconomic stability, the unemployment rate reached 8.5 percent in February 2003 (excluding conflict-affected areas such as Aceh, Maluku and Papua), up from was 8.1 percent in May 2002. The number of unemployed increased by 400k between two periods.[3] This suggests that current moderate growth is not enough to improve an employment condition.

Money, Interest and Prices

Inflation is showing a remarkable decline over the year. Inflation further decelerated to 6.2 percent (yoy) in September 2003 (Figure 7). During the first nine months, prices increased by only 2.5 percent. Even though prices are likely to increase later this year due to seasonal factors, annual inflation rate would be in line with the revised government projection of 6 percent.[4] Exchange rate appreciation as well as fewer administrative price hikes has contributed to moderate inflation.

Figure 7: Low inflation rate
(y-o-y growth rate of CPI)



Source: Bank Indonesia

The decline in inflation has enabled Bank Indonesia (central bank) to reduce key policy interest rates. SBI

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[3] These figures are based on quarterly labor statistics. The sample household number (15k thousands) is less than Sakernas (Annual survey). The annual survey shows the unemployment rate increased from 8.1 percent in 2001 to 9.1 percent in 2002;

[4] In the revised 2003 state budget, the government lowered inflation rate assumption from 9 percent to 6 percent.

(Bank Indonesia Certificate) 1-month rate declined to 8.7 percent in late September. Lower policy interest rates have a significant impact on the state budget, as yields on state bond are linked to them.[5] But lending rates of commercial banks are not dropping in line. While SBI 1 month rate declined by more than 4 percent since December 2002, lending rates (working capital by commercial banks) declined by less than 1 percent until June. Commercial banks are reluctant to lower lending rates mainly for two reasons. First, creditworthiness of traditional customers is re still low. Second, large commercial banks (recapitalized banks) have to achieve profits target agreed with the government.

Despite high lending rate, commercial bank lending is growing rapidly. As of June 2003, credit outstanding was Rp.391 trillion or 25 percent higher than a year earlier level. Consumption credit outstanding reached Rp.90 trillion, an increase of 31 percent over the same period, feeding strong private consumption growth. However, consumer credit carries relatively high interest rates (around 20 percent with commercial banks), and income growth is slow compared with interest rates.

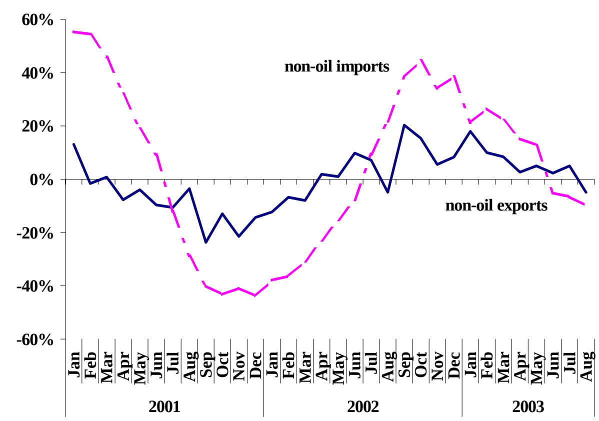
Base money growth remained well under the IMF's indicative target. In part, this performance reflects a shift in composition of broad money demand, notably a shift from deposits into mutual funds. As of June, base money was Rp.129 trillion or below the IMF's indicative target of Rp.135 trillion. Lower interest rates and tax incentives have prompted people to transfer their savings from bank deposits to mutual funds. Investment in mutual fund outstanding increased from Rp.8 trillion in end-2001 to Rp.68 trillion in June 2003. Transfer from deposits to mutual funds may have had contractionary impact on base money. Currently, the minimum reserve requirement is 5 percent of third party liabilities. The shift into mutual funds would therefore have reduced base money by Rp.3 trillion. The surge in mutual fund investment is of concern, as the market is relatively under-regulated. Mutual funds are large holders of government bonds, and a disruption in the market could cause liquidity to dry up, and increase the costs of financing the government's deficit.

[5] In the draft 2004 budget, domestic interest payments are projected at 12.7 percent of total revenues.

International Trade, Payments and External Debt

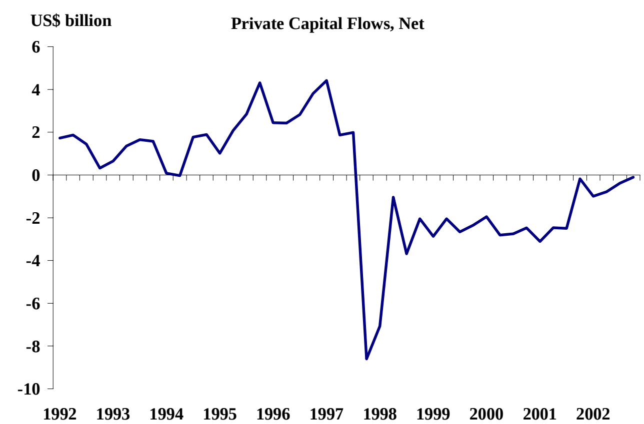
Growth rates of non-oil and gas trade slowed down (Figure 8). In August 2003, non-oil exports growth rate declined by 5 percent, the first decline since August 2002. Non-oil imports have been declining as well over the last quarter. The decline in machinery imports reflects the modest growth in investment in equipment, most of which is imported.

Figure 8: International trade declined (Year-on-year growth rate)



Source: BPS

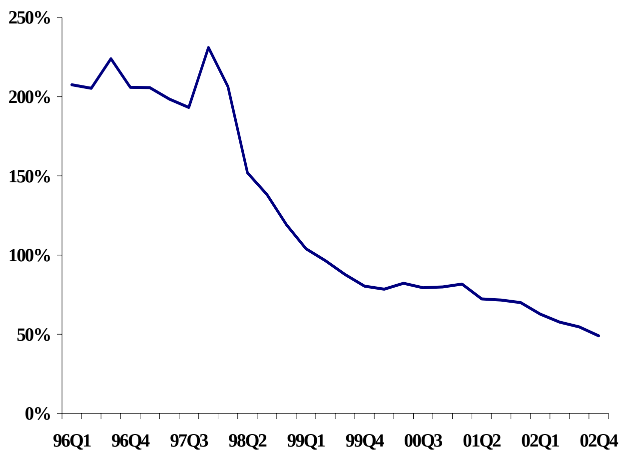
Figure 9: Less private capital outflows (Net private capital flows in BOP)



Source: Bank Indonesia

International reserves further accumulated in 2002 due to less capital outflows and a continued current account surplus. Gross reserve reached \$32.0 billion or 6.0 months of imports. Current account surplus was \$7.5 billion or 4.3 percent of GDP. Net capital outflows declined from \$9.0 billion in 2001 to \$2.7 billion in 2002 mainly due to private capital flows (figure 9). However, it is still to early to judge private capitals come back to Indonesia or at lease outflows stopped. The recent movement was caused by the increase in exceptional financing and portfolio investment. The increase in exceptional financing suggests the private sector repaid less than originally planned.[6] On the other hand, net FDI flows[7] were -$7.1 billion in 2002 or worse than -$5.9 billion in 2001. Q1 2003 net FDI was -$2.6 billion or the worst in history. In the first half of 2003, relatively higher domestic interests rate and reallocation of financial resources from SARS-affected countries may have led to positive portfolio investment. However, the composition of private capital flows suggests confidence has not yet fully resumed.

Figure 10: Less external debt risks (short-term debt to reserve ratio)



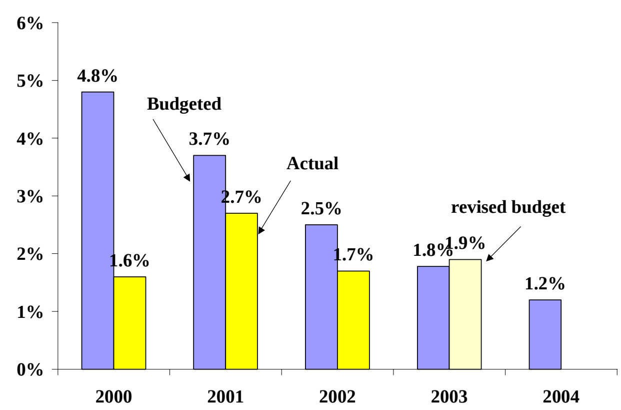
Source: BIS-IMF-WB, staff estimates

As of June 2003, external debt outstanding was $130.7 billion. Compared with the peak in 1998 ($150.9 billion), the outstanding declined by 13.4 percent. The external debt to GDP ratio declined to 69 percent from 158 percent in 1998 on the back of a stronger Rupiah. During the periods, private sector debt declined by 31 percent,[8] while the government debt increased by 12 percent. The external debt situation has improved in terms of risk as well (Figure 10). The short-term debt to reserve ratio declined to 49 percent in end-2002.[9] Although the ratio is still higher than neighboring countries (e.g. Korea 39 percent and Malaysia 28 percent), the ratio declined from over 200 percent in late 1990s.

Budget

Fiscal consolidation is continuing (Figure 11), but persistent under-spending of development expenditures is of concern. The 2003 revised state budget in September is on track to achieve the original budget deficit target, despite significantly higher spending on fuel subsidies.[10] The price mechanism for fuel, which was to link all prices except those for household kerosene at 100 percent of international prices, has not yet resumed, after being suspended in January this year. Higher oil revenues offset these higher expenditures, but non-oil and gas revenues, notably income tax and value added tax, are sluggish. The realization of development expenditures in the year to date is still low. While the revised budget presented to Parliament in September still assumes that the budgeted amount will be spent, but this seems increasingly unlikely. During the 2003 budget discussion last year, parliament opted for higher development expenditures to stimulate the economy. Then, development expenditures (as a share of GDP) were increased from 2.8 percent (government plan) to 3.4 percent in the budget, but unless implementation of development expenditures is further accelerated, economic stimulus impact from the budget is likely to disappoint.

Figure 11: Fiscal consolidation continues
(2004- draft state budget)



Source: Ministry of finance

The 2004 draft state budget submitted to parliament in August shows the government's commitment to

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[6] This may be due to debt restructuring (rescheduling and write-off and/or accumulation of arrears)

[7] Contrary to international convention, FDI in BOP includes all financial transactions of FDI companies. The figure should therefore be carefully interpreted.

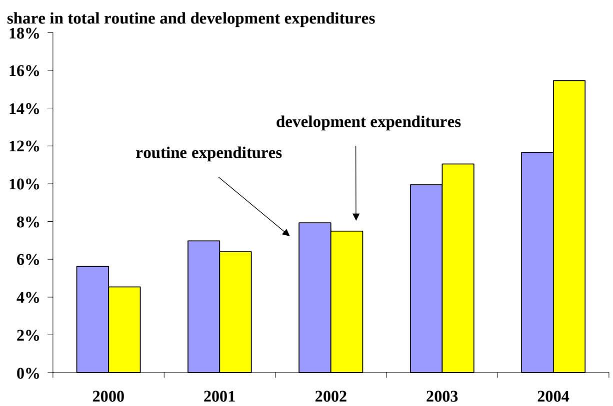
[8] However, private debt outstanding is not consistent with flow data in balance of payments.

[9] As Bank Indonesia does not release remaining maturity base short-term debt data, the ratio is based on BIS data.

[10] Although budget deficits remain same, the budget the deficits to GDP ratio was increased by 0.1 percent due to the change in nominal GDP.

further fiscal consolidation. The budget deficit is projected at 1.2 percent of GDP. Projected fiscal consolidation is likely to mainly come from expenditures rather than revenues. In addition, the draft budget is important in terms of how the government fulfill the financing gap in 2004 without the IMF program. On the revenue account, non-oil and gas tax revenues are projected to increase from 12.3 percent in 2003 to 12.9 percent. The improvement in tax administration such as the expansion of Large Tax Office (LTO) function are expected to contribute. Oil and gas revenues are projected to declined sharply from 2003 realization prospects, in part because of lower output, but also because the draft budget assumes an oil price of $21/bbl, which seems rather low in light of current levels. On expenditures, interest payments are projected to decline to 3.4 percent of GDP, down from 4.2 percent this year, reflecting the positive impact macroeconomic stability has on fiscal consolidation. Development spending is planned to remain at 3.4 percent of GDP. But the share of the national defense and security sector is proposed to sharply increase from 11 percent in the 2003 budget to 15.5 percent.

Figure 12: Increasing share of national defense and security (as a share of routine / development expenditures on a budget basis)



Source: Ministry of Finance

On the financing side, the government focuses more on domestic resource mobilization rather than relying on foreign sources. New domestic bond issue (1.4 percent of GDP) and domestic bank financing (i.e. withdrawal from the government's deposits at the central bank of 1.3 percent of GDP) are two big-ticket items. Again, macroeconomic stability is a key for these items, since bank financing may affect money supply and international reserves, and domestic demands on government bonds may depend on macroeconomic situation. Contributions from privatization and IBRA asset sales are expected to be less, since the 2004 political situation may be taken into consideration. On the other hand, net negative foreign financing (-0.7 percent) is negative for the first time since FY1995/96 budget. An expiration of the Paris Club rescheduling will push up amortization from 0.9 percent of GDP in 2003 budget to 2.2 percent of GDP next year. Gross foreign disbursement would be more or less the same, and the government plans to substitute some concessional funding with an international bonds issue of $0.4 billion.

Box 1: The Government's Economic Policy Package (White Paper)

This is the first government economic policy package, which include a concrete action plan for policies, unlike the five-year plan (PROPENAS) and annual plan (REPETA). Under the IMF supported program, a Letter of Intent to the IMF has been considered as the government's main policy document.

The white paper consists of three parts: (i) macroeconomic stabilization program, (ii) financial sector restructuring program, and (iii) a program to increase investment, exports, and employment creation.

(i) **The macroeconomic stabilization** program details the policies underlying budget, monetary and balance of payments. The policies aim at achieving fiscal sustainability, low inflation, and adequate international reserves. For example, in fiscal policy, the government aims to gradually reduce the deficit to zero by 2006.

(ii) **The financial sector** program aims at improving the strength of the financial sector. This program, for example, includes policies to solidify a financial sector safety net, to continue bank restructuring, strengthen state bank governance, and improve capital market supervision.

(iii) The program to improve **investment, export and job creation** aims to create conducive climate for private sector, and improve the functioning of critical state institutions. The program intends to improve the investment and trade policy framework, improve the rule of law, develop and rehabilitate infrastructure, increase public service transparency, and further equitable growth.

Economic Policy and Structural Reforms

In July the government decided to complete the IMF supported program by the end of end-2003. This decision is consistent with the parliament decree (No, VI/MPR/2002), which ordered the government *not* to extend the IMF program. The general perception is that Indonesia's macroeconomic conditions have improved enough to warrant the decision. Compared to other countries at the time of graduation from the IMF, only Indonesia's credit rating stands out as being below par. (Table 2).

Despite political pressures for early repayment the decision takes a flexible approach with regard to principal repayment to the IMF. Although the government will stick to the current repayment schedule, the decision left a room to accelerate repayment for the next government depending on economic conditions. Indonesia will have post program monitoring (PPM) from the IMF as long as drawings remain higher than the quota.

The government issued its long-awaited *Economic Policy Package Pre- and Post IMF*, the new economic policy package for the next 18 months (Box 1) on September 15. The objective of the new package is to ensure a smooth transition from the IMF supported program. The paper comprises three parts: (i) macroeconomic stabilization, (ii) financial sector, and (iii) investment, exports and job creation. The economic policy package lays out an impressive time-bound program of economic reforms that, if implemented, would ensure continued macroeconomic stability, lower interest rates and risk premiums, and higher investment and growth.

The Macroeconomic Outlook

Assuming no major disturbance during the 2004 election, and progress on structural reforms embedded in the Economic Policy Package, we expect a gradual improvement in the investment climate, which would, in turn, lead to higher investment growth rate in the medium run. We expect growth to accelerate from 3.5 percent this year to 5 percent by 2006. The external environment is likely to be supportive of this projection. The latest World Bank projection (Global Economic Prospect 2004) foresees the world GDP growth to accelerate from 1.9 percent in 2002 to 2.9-3.0 percent in 2004-05, and an increase in world trade volume growth from 3 percent in 2002 to 7.9 percent in 2004-05.

Increase Indonesia's investment ratio will be a challenging task given the recent decline in saving rate and external debt service pressures in coming few years. The saving rate declined to just above 20 percent in 2002 from well over 30 percent in the pre-crisis period. In addition, the increase in external debt service pressures in coming years means less financial resources for investment. Therefore, in order to satisfy investment needs in the medium-term, Indonesia needs to attract foreign savings through the improvement of investment climate.

Table 2: International Comparison of Major Indicators at the IMF graduation 1/

Country	Last Purchase	Credit rating (S&P	Real GDP growth rate	Inflation rate	Budget balance (% of GDP)
Indonesia	**Dec 2003**	**B (current)**	**3.5**	**6.5**	**-1.9**
Korea	May 1999	BBB	10.9	0.8	5.8
Thailand	June 1999	BBB	4.4	0.3	6.7
Brazil	Dec 1999	B+	0.8	8.9	5.0
Mexico	Dec 1995	BB	-6.2	35.0	-0.2

1/ Indicators are a year of graduation; Indonesia's economic figures are the World Bank estimates
Source: World Bank staff

Table 3: Medium-Term Macroeconomic Project

	2002 Actual	2003	2004	2005	2006	2007
Real GDP growth rates (%)	3.7	3.5	4.0	4.5	5.0	5.0
Inflation rate (CPI, average %)	11.9	6.5	6.0	5.0	5.0	5.0
Interest rate (SBI 3 months)	15.2	9.5	9.0	8.0	8.0	8.0
Current account (% of GDP)	4.3	2.5	1.5	1.6	1.1	0.8
Budgetary balance (% of GDP	-1.7	-1.9	-1.3 1/	-0.8	-0.4	0.0

1/ This is due to lower nominal GDP projection by the World Bank
Source: staff estimates

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