ECONOMIC AND SOCIAL SURVEY OF ASIA AND THE PACIFIC 2014

Regional Connectivity for Shared Prosperity

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INDONESIA

Country briefing notes

Economic growth moderated

- Indonesia's large domestic market helped the economy weather the global financial crisis more resiliently than most other regional peers. The economy grew by over 6% annually during 2010-2012, outperforming its pre-crisis trend. Growth however slowed to 5.8% in 2013, and likely eases further to 5.4% in 2014.

- Private consumption continued to drive growth in 2013, benefiting from employment growth, higher minimum wages, cash transfers and tax reductions. Increased government spending also supported the economy.

- In contrast, fixed investment growth, which had earlier propelled the economy, moderated amidst tighter credit conditions and weaker commodity exports. Exports faltered due to softer global commodity prices, although a decline in imports resulted in positive net exports in 2013.

- On the supply side, services activities, including transport, communications, finance and hotels, expanded well. The manufacturing sector grew at a similar pace to 2012, while agriculture and mining decelerated.

Inflation rose from fuel subsidy cuts

- The annual inflation rate increased from 4.3% in 2012 to 6.4% in 2013. Inflation jumped to over 8% in the third quarter, due to higher gasoline and diesel prices following fuel subsidy cuts. Recent price rises remained notable, at 7.3% in May 2014. Price pressures were further boosted by the weaker Indonesian rupiah, driven by large capital outflows.

Exports faltered while capital flow volatility increased

- Exports were subdued in 2013 on softer global prices of key export commodities such as coal, copper and palm oil. Imports also fell from a weaker currency and policy measures, such as higher import taxes aimed at narrowing the current account deficit. Still, partly due to sizeable oil imports, the current account recorded a deficit of 3.3% of GDP in 2013, up from 2.8% of GDP in 2012.

- Despite weak exports, FDI inflows remained strong in 2013 at around $20 billion. In recent years, Indonesia has attracted the highest FDI inflows in South-East Asia after Singapore. Portfolio inflows were also solid, although the prospects of a tapering of quantitative easing in the United States triggered a sharp reversal in midyear. The rupiah lost over 20% against the United States dollar in 2013.

- Increased financial market volatility in 2013 highlighted vulnerabilities in the economy, including the heavy reliance on commodity exports and the sizeable portion of local-currency debt held by foreign investors.

Policy developments and challenges

- Monetary policy tightened markedly in the second half of 2013 amidst high inflation, large capital outflows, and a widening current account deficit. The policy interest rate was raised by a total 175 basis points between June and November 2013, to 7.5%.

- To restore the current account surplus, the Government provided tax breaks to labour-intensive industries that export at least 30% of their production while increasing taxes on luxury goods imports. The fuel subsidy cut in mid-2013 also constrained the import bill, despite triggering high inflation. To mitigate the impact on the poor, targeted cash transfers were introduced.

- The fiscal deficit widened steadily to 2.3% of GDP in 2013, from 1.1% of GDP in 2011. This was partly due to weaker revenue collection amid slowing domestic demand but also a result of an improvement in the budget disbursement of capital and social spending. Public investment in infrastructure increased to about 3% of GDP in 2013, the highest level since the 1997 Asian financial crisis.

- To secure adequate fiscal space for development expenditures, it is important to broaden the tax base and improve tax administration. The tax-to-GDP ratio remains relatively low at around 12%, despite recent improvements in the number of registered taxpayers.

- Taking into account Indonesia’s economic structure, ESCAP analysis suggests that tax revenue could be raised by almost 40%. Among others, policies to enhance domestic resource mobilization include rationalizing the tax system to create a larger tax base, tackling tax evasion and tax fraud, and strengthening tax administration. The government is already addressing some of these issues.

- Greater fiscal space will allow sustainable financing of needed social expenditures, such as in education, vocational training and social protection. This especially matters in light of relatively high unemployment and underemployment rates and income inequality. Between early 1990s and late 2000s, the Gini index increased from 29.1 to 38.1.