FOR INFORMATION

FO/DIS/20/29

February 19, 2020

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Indonesia—Assessment Letter for the World Bank**

Board Action:	Executive Directors' **information**
Publication:	Not yet decided*
Questions:	Mr. Helbling, APD (ext. 36051) Mr. Kinda, APD (ext. 39538)

***If the authorities consent to the publication of this assessment, it may be published by the World Bank.**

Indonesia—Assessment Letter for the World Bank
February 18, 2020

Recent Developments, Outlook, and Risks

Recent Developments. Growth slightly decelerated from 5.2 percent in 2018 to 5 percent in 2019, as a contraction in import growth largely offset the impact of the slowdown in domestic demand and weaker exports. The slowdown in domestic demand growth in 2019, particularly fixed investment, reflected weaker global economic growth and the lagged effects of tighter external financial conditions in 2018 and the related policy response. Inflation eased to 2.7 percent (y/y) in January 2020 and is now in the lower half of the official target band (3±1percent), reflecting by subdued increases in administered prices, the recent appreciation of the rupiah, and slowing domestic demand growth. The current account deficit narrowed to 2.7 percent of GDP in 2019 (3 percent in 2018) on the back of weaker import growth, declines in commodity export prices notwithstanding. Gross international reserves reached US$129 billion as of end-December 2019, or 119 percent of the IMF's reserve adequacy metric.

Outlook and Risks. Growth is expected to remain at around 5 percent in 2020 and 2021, as external and domestic financial conditions have eased while global growth appears to have stabilized. Inflation is projected to remain within the target band. The balance of risks to the outlook is tilted to the downside. The main risks are external and include a slowdown in the global economy; weaker-than expected growth in China; the possible negative impact of the novel coronavirus outbreak, particularly on tourism; a renewed escalation in trade tensions; a sharp tightening of global financial conditions; and commodity prices remaining low for longer than expected. On the domestic side, a further slowdown in domestic demand could weigh on private and public sector balance sheets. Implementation of ambitious structural reforms could create upside potential for the economy. Indonesia's external and public debt are moderate and sustainable, and systemic macrofinancial risks are contained. However, with a large share of foreign portfolio holdings, the economy is vulnerable to a sharp tightening of global financial conditions or capital flow reversals.

Policy Framework and Settings

Fiscal policy. The government budget deficit in 2019 is estimated to have widened to 2.1 percent of GDP from 1.8 percent of GDP in 2018, primarily due to a revenue shortfall reflecting weaker economic activity. The shortfall amounted to 1 percent of GDP, but it was partially offset by what is estimated to be a broad-based reduction in expenditures of about 0.6 percent of GDP, including goods and services and capital spending. While fiscal policy conduct has been prudent given external vulnerabilities, the projected turn to neutral fiscal stance in 2020 would be appropriate, given the near-term outlook and risks. The authorities should use the fiscal space provided under the deficit ceiling of 3 percent of GDP and let automatic stabilizers play out if the economy is weaker than expected. There is a critical need to put in place a medium-term revenue strategy to create additional fiscal space for priority spending in infrastructure, education, health, and social protection (See also section on *Macrostructural issues*). However, current reform proposals—including a corporate income tax cut—would further reduce the already low tax-to-GDP ratio. The government should also continue to improve the composition and efficiency of spending, including by reducing energy subsidies through automatic adjustments of fuel prices, while strengthening means-tested social assistance.

Monetary policy. Against the backdrop of contained inflation risks, weaker domestic demand, and a more benign external financial environment, Bank of Indonesia (BI) appropriately reduced its interest rates by 100 basis points cumulatively to 5 percent in the second half of 2019. With the small widening of the expected output gap in 2020 to around ½ percent and downside risks to the growth outlook, BI could use the space it has for a few (data-dependent) additional rate cuts, while considering the impact of the recent policy easing. Looking ahead, BI should continue to allow the exchange rate to move in line with market forces and limit FX intervention to addressing disorderly market conditions. Clear and focused communication should remain an integral part of the monetary policy framework.

Financial sector. The banking system is well capitalized, and profitability is high, with the return on assets at 2.5 percent. System-wide liquidity remains adequate, although some small non-systemic banks are vulnerable to liquidity shocks, including FX liquidity shortfalls. Nonperforming loans (NPLs) were at 2.7 percent in October 2019, up from 2.4 percent in December 2018, and the share of problem loans (the sum of NPLs, special mention, and restructured loans) increased from 9 percent to 10.5 percent of total loans over the same time horizon. The increase in NPLs was mainly driven by loans to nonfinancial corporates, whose profitability has worsened on the back of weaker domestic and external demand. Nonfinancial corporate external debt continued to rise. While corporate FX regulations has helped nonfinancial corporates to increase the share of hedged FX loans, their elevated foreign-currency debt levels (close to half of total nonfinancial corporate debt) leaves them exposed to FX volatility. The authorities should continue to closely monitor corporate and financial vulnerabilities, as most bank loans are extended to the nonfinancial corporate sector. The corporate prudential FX regulation should be further improved by extending its coverage to all FX liabilities of systemic corporates, which could reduce enforcement and compliance costs. As further weakening of domestic demand and exports could trigger an adverse macro-financial feedback loop, the authorities should pursue their efforts to strengthen financial oversight and crisis management.

Macrostructural issues. Achieving higher potential growth and harnessing the young and growing labor force will require ambitious reforms. The reform priorities are revenue mobilization to finance increased development spending (infrastructure, education, health, and social safety nets), and financial deepening to lessen reliance on volatile capital inflows and promote financial inclusion. Such reforms would support complementary reforms in the labor and product markets, including human capital development, higher female labor force participation, and improvement of the business environment. Early implementation of a medium-term revenue strategy (MTRS) that centers on tax policy reforms and improved tax administration is critical. In addition to raising revenue for higher development spending, an MTRS would also help improve business conditions and boost productivity, including by streamlining tax regimes, removing distortions, and improving the efficiency of tax filling and collection. Efforts to streamline regulations should target areas with the largest potential gains for the economy, such as improving governance and reducing state control, antitrust exemptions, and barriers in the network sector. Rationalizing nontariff measures and easing restrictions on foreign direct investment would support linkages with global value chains, strengthen competitiveness, and facilitate technology transfer.

IMF Relations

Indonesia is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded by the IMF's Executive Board on July 3, 2019.

Table 1. Indonesia: Selected Economic Indicators, 2016–2021

Nominal GDP (2019): Rp 15,924 trillion or US$1,126 billion
Population (2019): 266.9 million
Main exports (percent of total, 2018): coal (13.3), oil and gas (9.6), palm oil (9.2), textile & textile products (7.4)
GDP per capita (2019): US$4,219
Unemployment rate (2019): 5.28 percent
Poverty headcount ratio at national poverty line (Sep. 2019): 9.22 percent of population

	2016	2017	2018	2019	2020 Proj.	2021 Proj.
Real GDP (percent change)	5.0	5.1	5.2	5.0	4.9	5.0
Domestic demand	4.6	5.0	6.1	4.0	4.8	5.0
Of which:						
Private consumption 1/	5.0	5.0	5.0	5.2	4.9	5.0
Government consumption	-0.1	2.1	4.8	3.2	4.0	4.0
Gross fixed investment	4.5	6.2	7.9	4.4	4.8	5.5
Change in stocks 2/	0.2	-0.1	0.4	-0.6	0.1	0.0
Net exports 2/	0.1	0.3	-1.2	1.4	0.2	0.1
Saving and investment (in percent of GDP)						
Gross investment 3/	33.9	33.7	34.4	33.6	33.7	33.8
Gross national saving	32.0	32.1	31.4	30.9	31.1	31.3
Prices (12-month percent change)						
Consumer prices (end period)	3.0	3.6	3.1	2.7	3.1	3.1
Consumer prices (period average)	3.5	3.8	3.2	2.9	2.9	3.1
Public finances (in percent of GDP)						
General government revenue	14.3	14.1	14.9	13.9	13.9	13.9
General government expenditure	16.8	16.6	16.6	16.0	16.0	15.9
Of which: Energy subsidies	0.9	0.7	1.0	0.8	0.7	0.7
General government balance	-2.5	-2.5	-1.8	-2.1	-2.1	-2.0
Primary balance	-1.0	-0.9	0.0	-0.4	-0.5	-0.4
General government debt	28.0	29.4	30.1	30.3	30.8	30.9
Money and credit (12-month percent change; end of period)						
Rupiah M2	11.7	9.6	5.8	6.8	…	…
Base money	4.6	9.7	-1.5	3.9	…	…
Private Sector Credit	7.7	7.2	10.3	15.6	12.4	12.5
One-month interbank rate (period average)	6.5	5.6	6.2	6.4	…	…
Balance of payments (in billions of U.S. dollars, unless otherwise indicated)						
Current account balance	-17.0	-16.2	-31.1	-30.4	-31.5	-31.6
In percent of GDP	-1.8	-1.6	-2.9	-2.7	-2.6	-2.5
Trade balance	15.3	18.8	-0.4	3.5	-0.9	-2.9
Of which: Oil and gas (net)	-4.8	-7.3	-11.6	-10.3	-12.7	-12.2
Inward direct investment	3.9	20.6	21.8	23.4	23.7	25.4
Overall balance	12.1	11.6	-7.1	4.7	4.5	11.5
Terms of trade, percent change (excluding oil)	0.4	1.3	0.4	-3.7	4.3	0.6
Gross reserves						
In billions of U.S. dollars (end period)	116.4	130.2	120.7	129.2	129.1	140.6
In months of prospective imports of goods and services	7.6	7.1	7.1	7.3	7.0	7.4
As a percent of short-term debt 4/	213	237	201	187	174	172
Total external debt 5/						
In billions of U.S. dollars	320.0	352.5	377.4	421.8	466.5	512.5
In percent of GDP	34.3	34.7	36.2	37.5	38.5	39.8
Exchange rate						
Rupiah per U.S. dollar (period average)	13,306	13,383	14,231	14,140	…	…
Rupiah per U.S. dollar (end of period)	13,473	13,568	14,390	13,866	…	…
Memorandum items:						
Jakarta Stock Exchange (12-month percentage change, composite index)	15.3	20.0	-2.5	1.7	…	…
Oil production (thousands of barrels per day)	820	815	800	740	710	707
Nominal GDP (in trillions of rupiah)	12,402	13,590	14,838	15,924	17,166	18,593

Sources: Data provided by the Indonesian authorities; and IMF staff estimates and projections.

1/ Includes NPISH consumption.
2/ Contribution to GDP growth (percentage points).
3/ Includes changes in stocks.
4/ Short-term debt on a remaining maturity basis.
5/ Public and private external debt.