Indonesia

Growth edged up last year on stronger domestic investment and consumption. Inflation was lower, but the current account deficit widened under higher imports for large infrastructure projects. As it strengthens further, domestic demand should counter weaker exports to sustain growth in the near term, with inflation and the current account little changed. Harnessing technology, as called for in the recently announced Indonesia 4.0 development strategy, is key to realizing national growth potential.

Economic performance

GDP growth accelerated marginally from 5.1% in 2017 to 5.2% last year. Stronger domestic investment and robust domestic consumption more than offset weaker export growth, enabling the economy to grow at its fastest pace since 2013 (Figure 3.24.1). While exports of goods and services expanded more slowly than in 2017, down from 8.9% to 6.5% last year, fixed investment increased from 6.2% in 2017 to 6.7% (Figure 3.24.2). Strong investment was driven largely by public infrastructure projects in transportation and energy. Private investment into plantation agriculture recovered somewhat after slower growth in 2017, in response to the government's Biodiesel 20 program, which requires all diesel vehicles and heavy machinery to use blends that are at least 20% biofuel.

Meanwhile, domestic consumption improved slightly on growth in 2017 at about 5%, helped by higher public consumption, sustained momentum in private spending, and low and stable inflation. A continuing rise in household incomes thanks to a robust increase in formal employment underpinned growth in private consumption and a decline in the incidence of poverty to single digits, at 9.7% in September. Last year saw continued improvement in household welfare, as evidenced by gains in access to better-quality housing.

Growth last year spanned economic sectors. While agriculture maintained its 2017 growth rate, industry and services improved upon theirs (Figure 3.24.3). Industry growth accelerated from 4.1% in 2017 to 4.3%, and services edged up from 5.7% growth in 2017 to 5.8%. Within industry, mining output rose from 0.7% expansion in 2017 to 2.2% last year as growth in manufacturing remained steady at 4.3% and growth in construction moderated from 6.8% in 2017 to 6.1%.

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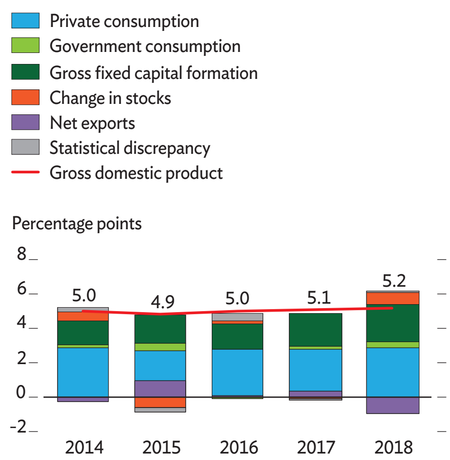
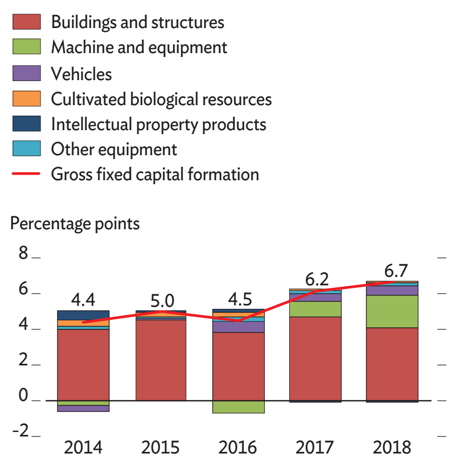
3.24.1 Demand-side contributions to growth



Source: CEIC Data Company (accessed 8 March 2019).

3.24.2 Contributions to fixed investment growth



Source: CEIC Data Company (accessed 8 March 2019).

Mining benefited from a sustained rise in coal prices along with increases in production quotas and 2017 policies to allow more metal ore exports. Manufacturing growth was buoyed by stronger exports of manufactures such as apparel and footwear, as well as higher production of food and beverages mostly for domestic consumption. Strong expansion in information and communication technology—and in transport and storage, which grew by 7.0%—underpinned expansion in services, the sector supplying roughly half of GDP growth last year.

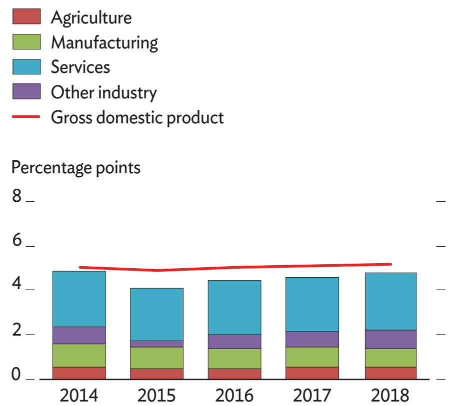
Even as growth edged up, inflation moderated from an average of 3.8% in 2017 to 3.2% with ample food supplies owing to sustained agricultural production, deft food supply management, limited pass-through from currency depreciation, and fuel and electricity prices kept stable by government subsidies (Figure 3.24.4). Core inflation remained subdued as monetary policy steadily tightened. Average inflation hovered around the lower end of the 2.5%–4.5% target range set by Bank Indonesia, the central bank.

Strong domestic demand saw merchandise imports expand last year by 20.7% in US dollar terms, up from 16.2% growth in 2017, while growth in the dollar value of merchandise exports slowed from 16.9% in 2017 to 7.0%. The trade balance thus declined from a surplus of $18.8 billion in 2017 to a small deficit of $0.4 billion (Figure 3.24.5). Improvement in net service exports—driven by rising tourism revenues, telecommunication service receipts, and remittances from workers overseas—partly offset the deterioration in the trade balance. The current account deficit rose from the equivalent of 1.6% of GDP in 2017 to 3.0% last year.

Meanwhile, the surplus in the financial account narrowed. Although portfolio investment recovered ground in the last quarter of 2018, the year as a whole witnessed higher outflows as the US Federal Reserve raised its federal funds rate. Net foreign direct investment (FDI) similarly weakened as Indonesians invested more abroad. The overall balance of payments thus fell into a deficit of $7.1 billion, causing foreign exchange reserves to slip from an all-time high of $132.0 billion in January 2018 to $120.7 billion by the end of the year (Figure 3.24.6). Reserves were still sufficient to cover 6.5 months of imports and repayment of government external debt.

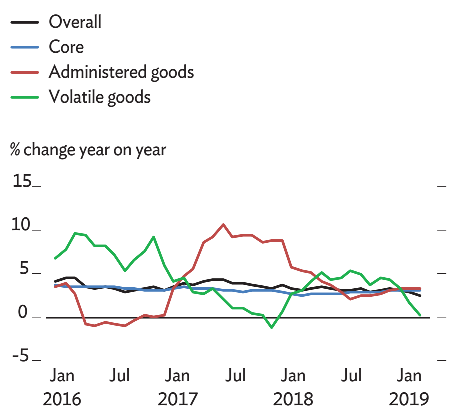
Pressure on the balance of payments and foreign currency reserves saw the Indonesian rupiah depreciate by 5.7% in the course of 2018. It fell to a low of Rp15,253 to the US dollar on 11 October and recovered to Rp14,481 by the end of the year (Figure 3.24.7). In response to currency depreciation, the central bank raised its policy interest rate, the 7-day reverse repo rate, five times last year by a total of 175 basis points, taking the rate to 6.00% by the end of the year.

3.24.3 Supply-side contributions to growth



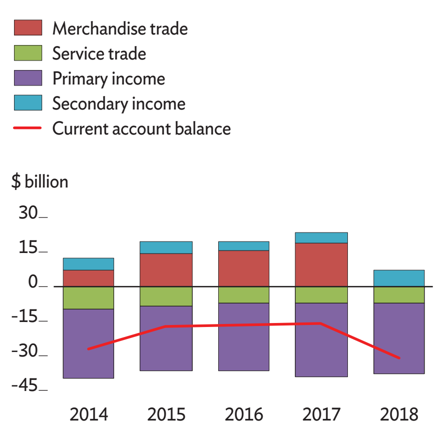
Source: CEIC Data Company (accessed 8 March 2019).

3.24.4 Inflation



Source: CEIC Data Company (accessed 8 March 2019).

3.24.5 Current account components



Source: CEIC Data Company (accessed 8 March 2019).

Meanwhile, the fiscal deficit as a share of GDP narrowed from 2.5% in 2017 to an estimated 1.7% last year, the lowest since 2011. Fiscal deficit reduction was achieved last year by both raising revenue and containing expenditure growth. Revenue was equal to 13.2% of GDP, surpassing the original budget target, while expenditure was contained at 14.9%. Revenue was boosted by previous gains from the tax amnesty program and higher commodity prices. Subsidies for energy increased from the equivalent of 0.7% of GDP in 2017 to 1.0%, but infrastructure spending was unchanged from 2017 at 2.8%.

Economic prospects

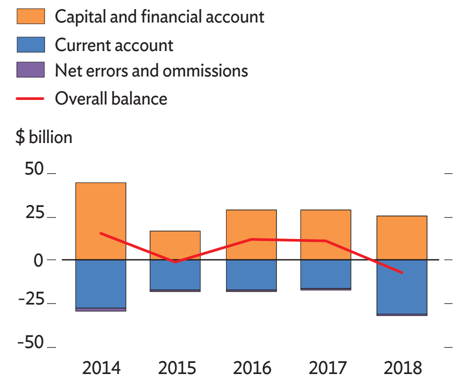
Weakening global growth and world trade may pull down Indonesian exports and hence economic growth in the near term. Yet this effect is likely to be offset by continued strength in domestic demand. Fiscal and monetary policies have some room to maneuver to support growth. GDP growth is thus seen being sustained at 5.2% this year and edging up to 5.3% in 2020.

With key public infrastructure projects such as the Trans-Java Toll Road now approaching completion, strong foundations are laid for private investment. In addition, recent reforms to improve the business environment, such as streamlining tax administration and simplifying business licensing, should give a fillip to private investment. Coupled with these reforms, improved macroeconomic management saw the three major international credit rating agencies upgrade Indonesia's sovereign credit rating to investment grade in 2017 and reaffirm that higher rating last year. Positive investor sentiment is reflected in steady improvement in the amount of new capital raised and in the number of companies listed (Figure 3.24.8). Recent initiatives to strengthen shareholder protection should further boost private investment.

Private consumption should remain robust in the near term as formal employment continues to expand, the government scales up its social assistance programs, and inflation remains modest. In the first half of 2019, consumption is likely to get an additional boost from spending in the run-up to a national election in April. Yet another boost to private consumption is likely from sustained improvement in household access to credit, as evidenced by a near quadrupling in the percentage of households that report having business loans from 8.2% in 2014 to 28.7% in 2018 (Figure 3.24.9).

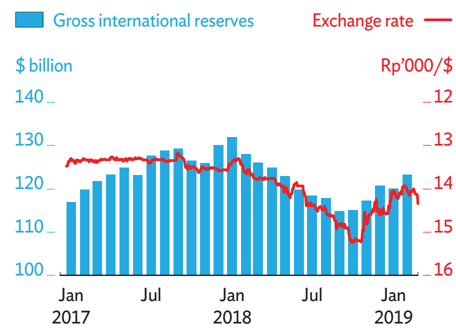
Growth this year and next is likely to span sectors, with agriculture, industry, and services all forecast to sustain 2018 growth rates in 2019 and agriculture and industry to accelerate in 2020. Continued strength in footwear and apparel manufacturing is expected yield robust industrial growth in 2019 and 2020. Trends in investment registrations reported

3.24.6 Balance of payments



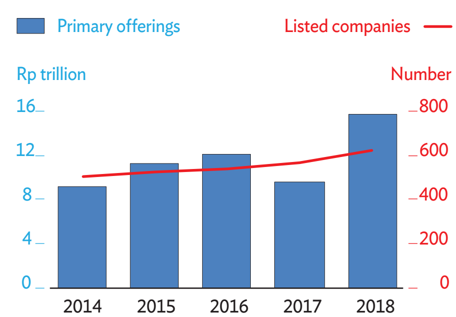
Source: CEIC Data Company (accessed 8 March 2019).

3.24.7 Gross international reserves and exchange rate



Sources: Bloomberg, CEIC Data Company (both accessed 8 March 2019).

3.24.8 New capital raised and number of listed companies



Source: CEIC Data Company (accessed 13 March 2019).

by the Indonesia Investment Coordinating Board indicate sustained growth in industry, as does the purchasing managers' index (Figure 3.24.10). The service sector is similarly likely to maintain last year's growth pace, with strong performances from wholesale and retail trade, hotels and restaurants, and information and communications. Transportation and storage will benefit from improved transport logistics, customs regulations, and warehousing.

With growth sustained this year and edging up next year, inflation is similarly likely to remain unchanged at 3.2% this year and edge up to 3.3% in 2020, in both years near the middle of the central bank target range of 2.5%–4.5%. As international oil prices decline, the government is unlikely to change administered prices of domestic fuel. A new pricing formula for unsubsidized fuels is expected to keep prices contained.

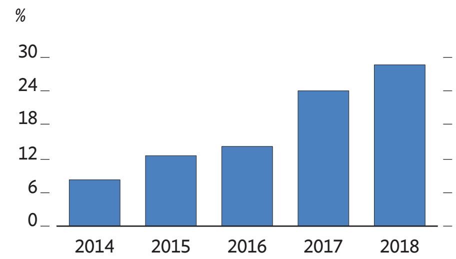
Merchandise exports are expected to grow more slowly in US dollar terms as economic growth in Indonesia's trading partners weakens and as international commodity prices subside for coal, rubber, and palm oil. At the same time, import growth will be lower as well as global oil prices soften and demand for capital goods ease with the completion of large infrastructure projects. Growth in imports will likely continue to outpace that of exports. Net service receipts should grow robustly, however, as gains from tourism revenue look set to continue. The current account deficit is thus expected to narrow to the equivalent of 2.7% of GDP both this year and next.

Improvement in portfolio investment seen in the last quarter of 2018 is expected to continue. FDI should remain robust with manufacturing again, as last year, receiving a dominant share of inflows, followed by trade. In addition, investors have already provided Indonesian startups with fresh capital injections this year. The government recognizes the need to attract more FDI by improving the business and investment climate, and thereby improve the balance of payments.

Fiscal policy is likely to remain supportive. The 2019 budget sets a fiscal deficit equal to 1.8% of GDP, as in 2018. Public infrastructure spending is higher at 17% of total expenditure and is more focused on investments with high returns. Additional allocations have been made for disaster risk management and mitigation. The budget prioritizes making conditional cash transfers to poor and vulnerable households in the countryside more effective. Depending on how the macroeconomic situation unfolds in the near term, the central bank may adjust policy to sustain steady growth, keep inflation low, and maintain a stable exchange rate.

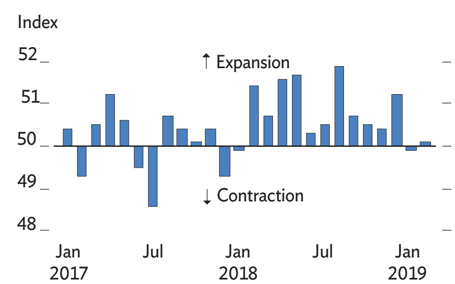
Risks to the outlook tilt downwards. Any escalation of current trade tensions between the US and the People's Republic of China is a major external risk. Domestic risks could

3.24.9 Households receiving business loans



Source: Statistics Indonesia. 2018. Welfare Statistics, Jakarta. https://www.bps.go.id.

3.24.10 Manufacturing purchasing managers' index



Note: Nikkei, Markit.
Source: Bloomberg (accessed 8 March 2019).

3.24.1 Selected economic indicators (%)

	2019	2020
GDP growth	5.2	5.3
Inflation	3.2	3.3
Current account balance (share of GDP)	–2.7	–2.7

Source: ADB estimates.

stem from dry weather under El Niño or from any newly imposed nontariff restrictions on imports that cause uncertainty for investors and businesses.

Policy challenge—harnessing new technologies to accelerate growth

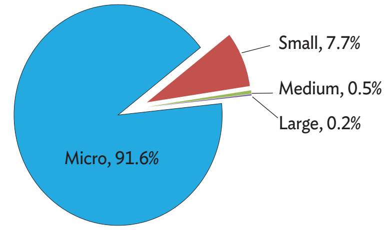
Estimates of Indonesia's potential GDP growth rate in 2020–2024 range from 5.5% to 6.3%. For the country to bring actual growth more in line with potential growth, manufacturing has to expand to create more and better jobs. However, any transformation of the manufacturing sector in Indonesia faces a key constraint: More than 99% of manufacturing firms are micro and small enterprises (MSEs) (Figure 3.24.11). Such firms suffer low productivity and have little capability to expand and adopt emerging technologies.

Given MSE predominance in manufacturing, the sector makes very little use of the digital technologies—cloud computing, big data, artificial intelligence, machine learning, and the internet of things—that enable manufacturers elsewhere to streamline logistics, develop new products quickly, and grow. Global technological rankings for 2018–2022 compiled by the Economist Intelligence Unit place Indonesia near the bottom among Asian economies for technological readiness, reflecting limited internet access and the low quality of digital services (Figure 3.24.12). In a similar vein, the World Economic Forum ranks Indonesia behind many other countries in the region in its *Readiness for the Future of Production Report 2018*.

Encouragingly, the government, recognizing the constraints that hamper faster adoption of new technologies in manufacturing, recently announced a medium- to long-term development strategy called Making Indonesia 4.0. Abbreviated as I.4.0, the strategy focuses on technology and productivity upgrades in five manufacturing subsectors: food and beverages, textiles and garments, automobiles, electronics, and chemicals. To ramp up performance in these subsectors, 10 priority areas that cut across them are identified: improving upstream capabilities, optimizing industrial zones, embracing sustainability, empowering small enterprises, building digital infrastructure, improving human capital, adopting technology, attracting FDI, establishing an innovation ecosystem, and ensuring policy coherence.

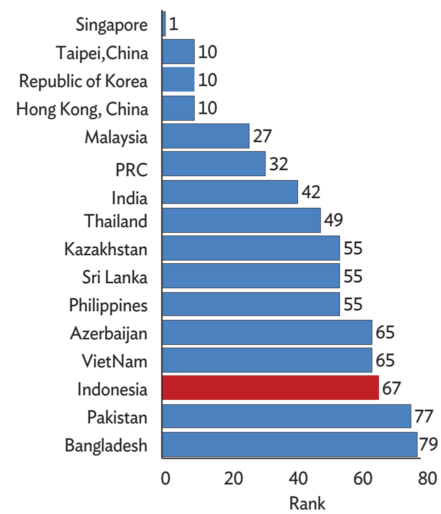
I.4.0 is an ambitious strategy for faster and more efficient industrialization. However, as is common with ambitious development strategies, it announces long-term goals but is short on implementation details. In particular, I.4.0 does not articulate how the government will address the intertwined problems of MSE predominance and the low use of new

3.24.11 Distribution of manufacturing firms in Indonesia by size, 2015



Source: Badan Pusat Statistik. http://www.bps.go.id (accessed 27 March 2019).

3.24.12 Technological readiness ranking, selected developing Asian economies



PRC = People's Republic of China.

Note: Many economies share a rank because of identical scores.

Source: The Economist Intelligence Unit. 2018. *Preparing for disruption: Technological Readiness Ranking*.

technologies in manufacturing. For I.4.0 to make headway in achieving its goals, it would be useful to develop a policy roadmap, in consultation with industry and business to ease these twin constraints.

The policy roadmap should focus on, among other things, how to help MSEs grow and expand so they can reap benefits of scale when adopting new technologies. It needs to pay special attention to improving MSE access to finance, investing in digital infrastructure, and enhancing technology diffusion across firms. One in four manufacturing MSEs in Indonesia cites inadequate finance as the main constraint on expansion. Policies to ease this constraint could aim to lower the cost of finance and simplify the cumbersome procedures required of businesses for obtaining bank loans.

To enable businesses to take advantage of the opportunities offered by new technologies, higher investment in digital infrastructure is crucial. Public efforts are needed as well to adopt advanced technology offered by foreign firms and to foster indigenous innovation. This may require the establishment of knowledge forums at which foreign and local companies exchange information and experiences, as well as forums at which domestic firms raise their awareness of the benefits of the technologies emerging.