

4. Economic Outlook

Overall, the accelerated pace of economic growth of 2007-2008 is predicted to carry forward, being accompanied by sustained macroeconomic stability. In 2007, economic growth is expected to surpass the original forecast, reaching 6.2% (y-o-y) on the strength of improved performance in household consumption and exports. In 2008, economic activity will gather even more momentum with growth predicted in the range of 6.2%-6.8%, supported by household consumption spending, investment and exports. CPI inflation in 2007 and 2008 is predicted to remain on track with established targets of 6±1% and 5±1%.

ASSUMPTIONS AND SCENARIOS

Condition of the International Economy

World economic growth is predicted to remain strong in 2007, accompanied by continued high inflationary pressure. This growth will be driven by the US economy, now showing signs of improvement, the more expansive Eurozone and the high-growth economies of China and India. Inflationary pressures in developed economies are predicted to continue in line with high rates of capacity utilisation, tight labour markets, strong commodity prices, particularly for oil, and high inflation expectations. On the other hand, inflation in Asia, with the exception of China and India, is on the decline. The appreciating trend in domestic currencies will ease inflationary pressure in the region. Inflation in China and India, however, is driven primarily by rising food prices. Given the likelihood of continued inflationary pressures, global monetary policy in 2007 is predicted to maintain a tight bias. The tight bias is forecasted for the US, Eurozone and China. Monetary policy for countries in other regions, however, is expected

Table 4.1
World GDP Projection

	WEO - April 2007		Consensus Forecast (yoy) ¹⁾					
	2007	2008	2007	Q1	Q2	Q3	Q4	2008
World	4.9	4.9						
AS	2.2	2.8	2.4	2.3	2.3	2.5	2.7	3.0
*)CF April'07			2.3	2.2	2.2	2.4	2.5	2.9
*)CF May'07			2.1	2.1	2.0	2.1	2.2	2.8
*)CF June'07			2.1	1.9	2.0	2.2	2.3	2.9
Euro	2.3	2.3	2.3	2.8	2.3	2.3	1.9	2.1
*)CF April'07			2.4					2.2
*)CF May'07			2.5					2.2
*)CF June'07			2.7	3.0	2.7	2.7	2.4	2.3
Jepang ³⁾	2.3	1.9	2.1	1.9	2.0	2.4	1.7	2.2
*)CF April'07			2.2					2.2
*)CF May'07			2.2					2.2
*)CF June'07			2.3	2.7	2.1	2.5	1.8	2.2
Cina	10	9.5	9.7	9.8	9.8	9.5	9.4	9.6
*)CF April'07			10.0					9.6
*)CF May'07			10.3					9.8
*)CF June'07			10.4	11.1	10.5	10.2	10.0	9.8
India	8.4	7.8	8.1	8.6	8.5	8.0	7.8	na
*)CF April'07			8.0					7.7
*)CF May'07			8.1					7.8
*)CF June'07			8.2	9.1	8.5	8.3	8.2	7.9
Singapura	5.5	5.7	5.5	4.8	5.2	5.5	5.7	5.6
*)CF April'07			5.5					5.9
*)CF May'07			5.5					5.7
*)CF June'07			6.0	6.1	5.9	5.9	6.4	6.0
Thailand	4.5	4.8	4.2	3.5	4.0	4.6	4.6	5.0
*)CF May'07			4.2					4.9
*)CF April'07			4.0					4.8
*)CF June'07			4.1	4.3	3.9	4.0	4.2	4.9
Korea	4.4	4.4	4.5	3.9	4.3	4.7	5.1	5.0
*)CF April'07			4.4					4.9
*)CF May'07			4.5					5.0
*)CF June'07			4.5	4.0	4.5	4.6	4.8	5.0
Malaysia	5.5	5.8	5.5	5.2	5.4	5.6	5.9	5.7
*)CF April'07			5.6					5.8
*)CF May'07			5.6					5.8
*)CF June'07			5.7	5.3	5.3	5.6	6.0	5.8

1) Quarter I = as of March 2007.

to be neutral. Concerning excess global liquidity, private foreign capital inflows in the Asia Pacific are predicted to dominate in 2007, albeit not to the same extent as in 2006.¹

Fiscal Policy Scenario

Fiscal policy in 2007-2008 will seek a balance between fiscal stimulus and fiscal sustainability. Reflecting this is the enlarged contribution of fiscal expenditures to economic growth. In Q3/2007, the fiscal stimulus for the domestic economy came largely from government investment. Continued expansion in government consumption and investment is forecasted for 2007 overall, although at a slower rate than in 2006. This is explained by the slowing pace of increases in various budget expenditure components compared to the increases in 2006. In 2008, the budget deficit will again be high at about 1.5%-1.9% of GDP. The increased fiscal deficit is expected to strengthen the government contribution to economic growth. Nevertheless, the high fiscal deficit will be accompanied by efforts to strengthen fiscal sustainability, such as the ongoing reduction in the government debt stock to GDP.

ECONOMIC GROWTH OUTLOOK

Indonesia's economic growth in 2007 is predicted to surpass the original 6% growth forecast, rising to 6.2% (y-o-y). The upwardly revision in growth is attributable to household consumption and exports of goods and services, while investment will maintain growth at a robust pace albeit below the optimistic levels in earlier projections. Stronger real incomes - reflected in higher real wage levels in most provinces and in inflation projections below earlier forecasts - have spurred household consumption. Exports of goods and services have also benefited from sustained high commodity prices for some of Indonesia's exports. Despite this, the sluggish progress on infrastructure projects has somewhat dampened optimism for investment. Concerning sectoral composition, the more optimistic levels of household consumption are expected to boost growth in relevant sectors, including manufacturing; trade, hotels and restaurants; and transport and communications.

The upward trend in the economy will continue into 2008 with growth predicted in the range of 6.2%-6.8% (y-o-y). Household consumption and exports will continue to provide the main driving force for economic growth, as will investment. Nevertheless, investment is less likely to meet earlier projections in view of the current state of infrastructure projects. The expanding roles of household consumption and investment will spur growth in manufacturing; trade, hotels and restaurants; and the construction sector. The mounting pace of economic activity is also expected to produce multiplier effects in transport and communications.

1 Source: IIF — *Capital Flows to Emerging Market Economies*, 31 May 2007

Outlook for Aggregate Demand

Developments in various factors augur for more robust expansion in household consumption (Table 4.2). The exchange rate appreciation in 2007 has made imported consumer goods more affordable and contributed to a lower inflation forecast for the year. The more modest inflation has strengthened real public purchasing power and encouraged more aggressive household consumption. In addition, the downward movement in interest rates has boosted consumption spending. Under these conditions, the public prefers to step up consumption rather than keep money in the bank. The lower interest rates have also created more room for the public to take on more consumption credit.

From the policy side, the National Social Empowerment Programme (PNPM) implemented in rural areas and the provision of school bursaries and direct cash transfers to the poor will enable the public to allocate part of their incomes to consumption. This will be possible because some basic needs - such as education and health - are provided free of charge. Against a background of declining inflation, household consumption is predicted to mount further in 2008. In Q4/2008, strong growth in private consumption is expected from the flurry of activities related to preparations for the 2009 national elections.

%Y-o-Y, Base Year 2000

Item	2006				2006	2007*				2007*	2008*
	I	II	III	IV		I	II*	III*	IV*		
Total Consumption	3.8	5.6	2.8	3.5	3.9	4.5	4.7	4.7	7.1	5.3	5.4
Private Consumption	2.9	3.0	3.0	3.8	3.2	4.5	4.8	4.9	5.0	4.8	5.3
Government Consumption	11.5	28.8	1.7	2.2	9.6	4.3	4.1	3.8	19.9	8.9	6.1
Total Investment	1.1	1.1	1.3	8.2	2.9	7.5	8.8	10.6	11.6	9.7	13.4
Domestic Demand	3.1	4.4	2.4	4.6	3.7	5.2	5.7	6.2	8.2	6.4	7.4
Export of Goods and Services	11.6	11.3	8.2	6.1	9.2	8.9	9.1	9.4	11.2	9.7	10.8
Import of Goods and Services	2.8	7.5	10.1	9.7	7.6	8.4	9.0	11.0	14.3	10.7	13.3
GDP	5.0	5.0	5.9	6.1	5.5	6.0	6.1	6.2	6.3	6.2	6.5

* Bank Indonesia Projection figures

The upward trend in consumption is confirmed by several indicators. Leading consumption indicators show that household consumption is in an expansionary phase. In 2007, minimum wage increases exceeding local rates of inflation in some provinces – such as Jakarta, West Java and East Java – have resulted in higher than usual real increases in provincial minimum wages.

Government consumption is predicted to rise further in 2007 and 2008. With the fiscal deficit revised upwards to 1.8% of GDP in 2007 and easing to

1.7% of GDP in 2008, government consumption will expand at a slowing rate. Most components of central and regional government consumption are projected to record nominal increases in 2007 and 2008, but with growth tapering off with each year.

Investment growth is predicted to mount, even though not to the optimistic levels of earlier projections. The strong investment growth in 2007 is being driven by domestic and external factors. At home, rising demand – reflected in higher economic growth compared to 2006 – and low interest rates have fuelled investment expansion. Externally, lower world commodity prices and the appreciation in the rupiah have resulted in more affordable prices for imported goods, and especially

capital goods. Lower prices for capital goods have spurred investors to move forward with their investments. Mounting domestic economic activity and the outlook for sustained low world commodity prices are predicted to carry forward into 2008, resulting in even more vigorous investment activity compared to 2007. Overall, rising investment momentum in 2007-2008 will come from construction and non-construction investment.

Vigorous growth in exports and imports is predicted for 2007-2008. In 2007, rising export growth is explained largely by lower prices for imported raw materials due to appreciation in the rupiah and also attractive world commodity prices. Declining import prices will offer an incentive for investors to buy more capital goods, most importantly machinery for non-construction investment. Increased investment of this nature creates added potential for future export growth, as it strengthens production capacity. In addition, the strengthening of the ratio of export prices to domestic prices is a further incentive for exporters to boost export volume. In 2008, export growth will mount even higher than in 2007 due to rising volume of world trade and increased production capacity.

Import growth in 2007-2008 will be driven more by strengthening domestic demand, in addition to further appreciation in the exchange rate. A stronger exchange rate will result in lower prices for imported goods, thus encouraging economic agents to step up their purchases of imports.

Outlook for Aggregate Supply

Economic growth on the production side in 2007 is forecasted at about 6.2% (Table 4.3). Increased private consumption will be followed by faster growth in manufacturing; trade, hotels and restaurants; and transport and communications sectors. Strong prices for mining products are also expected to boost output in the mining and quarrying sector.

Manufacturing, the single largest sector in the economy, is predicted to see faster growth in 2007 compared to 2006. This outlook is supported by leading manufacturing indicators pointing to an ongoing expansionary phase with steady growth in capacity utilisation since Q3/2006. High-growth industry subsectors include transportation manufacturing, machinery and tools, the food, beverages and tobacco subsector, chemicals and rubber products. Improved performance in the transportation manufacturing subsector is closely linked to the prospects for higher private incomes and

%Y-o-Y, Base Year 2000

Tabel 4.3
Economic Growth Projections - Supply Side

Sector	2006				2006	2007*				2007*	2008*
	I	II	III	IV		I	II*	III*	IV*		
Agriculture	6.4	1.5	2.2	1.8	3.0	-0.5	3.2	2.5	3.3	2.1	2.8
Mining & Quarrying	2.7	4.0	1.6	0.7	2.2	5.6	3.6	2.8	-1.6	2.5	3.0
Manufacturing	2.9	3.7	5.9	5.9	4.6	5.4	5.5	5.9	6.1	5.7	6.0
Electricity, Gas & Water Supply	5.1	4.4	5.7	8.1	5.9	8.2	7.8	8.1	7.8	8.0	8.4
Construction	7.4	8.7	9.3	10.4	9.0	9.3	9.2	10.5	11.3	10.1	10.3
Trade, Hotels & Restaurants	4.4	5.5	7.5	7.0	6.1	8.5	7.5	7.5	7.9	7.8	8.0
Transportation & Communication	11.5	13.3	13.6	15.9	13.6	11.1	13.6	14.4	15.3	13.7	13.8
Financial, Rental & Business Services	5.7	5.3	4.7	6.8	5.6	7.1	6.1	6.2	6.2	6.4	6.5
Services	5.8	6.1	6.9	6.0	6.2	7.0	5.3	5.4	6.0	5.9	5.5
GDP	5.0	5.0	5.9	6.1	5.5	6.0	6.1	6.2	6.3	6.2	6.5

* Bank Indonesia Projection figures

further lowering of interest rates. Continued strong performance in the food, beverages and tobacco subsector is predicted as incomes improve. Alongside this, appreciation in the rupiah is expected to boost output in the chemicals industry and rubber products because of reduced costs for imported raw materials.

Growth in the trade, hotels and restaurants sector is forecasted to surpass that of 2006. Stronger public purchasing power will boost performance in goods-producing sectors which in turn will generate more activity in wholesale and retail trading. Financing will also contribute to added growth in this sector, due to the ongoing decline in interest rates. Mounting business activity will generate increased value added in the hotels and restaurants subsector. The looming trend in this sector is confirmed by leading indicators for the trade, hotels and restaurants sector, which point to an ongoing expansionary phase.

The outlook for agricultural sector is one of weaker growth in 2007. In the agricultural sector, rice cultivation in the foodstuffs subsector plays a major role. The effect of the shifting in the harvest season with the diminished first quarter harvest and the looming threat of La Nina on the planting season is expected to impact rice production for 2007 as a whole. The change in the 2006/2007 planting season has resulted in a partial shifting of the harvesting season (first quarter). The forecast for the estates subsector is continued high production, driven mainly by output from oil palm estates. Key factors in this are high estate productivity and the incentive of attractive international market CPO prices.

The transport and communications sector is set for another year of high growth in 2007. The buoyant economy is driving activity in the transportation subsector. At the same time, intense activity is again predicted for communications. Rising public purchasing power, the ever-spreading coverage of cellular telephone services and more affordable calling rates are key factors spurring growth in this subsector. According to a study by *Wireless Intelligence*, Indonesia's cellular market is projected to expand 25% in 2007. At year-end, Indonesia will have 78.7 million subscribers, bringing the penetration rate to 34%.

The construction sector will again chart high growth in 2007. Growth will be stronger than in 2006, but on slightly pessimistic level compared to earlier forecasts. The downward revision comes in response to progress on various infrastructure construction projects, mainly toll roads, which are behind schedule. The falling trend in interest rates is expected to provide added momentum to construction – and especially property development – during 2007. One indicator of the ongoing property boom is flurry of office building developments in the Jakarta area.

The financial sector is forecasted to see continued expansion in 2007. This is explained by the more vigorous pace of economic activity that will also see stronger performance in the financial industry. The banking subsector is predicted to see a continued strong net interest margin with deposit rates declining more rapidly than lending rates. The non-bank financial institutions subsector, which includes consumer

finance and leasing companies, will also profit from the upward trend in economic activity and lower interest rates. The Indonesian Association of Finance Companies targets aggregate financing by multifinance companies to rise to Rp 135 trillion.

In 2008, the economy is set to chart even better performance than in 2007. Growth is predicted to surpass 2007 levels in most sectors, including manufacturing, trade, hotels and restaurants, agriculture and construction. Rising private consumption will be followed by more robust growth in the manufacturing and the trade, hotels and restaurants sectors. Agricultural output is predicted to improve over 2007 through higher productivity involving the use of hybrid seeds, adequate supply of fertilisers and improvements to irrigation systems. Many infrastructure projects are expected to be in the construction phase, which will strengthen performance in the construction sector and related industries, such as cement and non-metal quarrying products and in the basic metals, iron and steel subsector.

INFLATION FORECAST

CPI inflation in 2007 and 2008 is forecasted to come within the established targets of $6\pm 1\%$ and $5\pm 1\%$. This is explained by declining pressure in CPI inflation alongside softer pressures in core inflation and volatile foods.

Inflationary pressure from expectations is predicted to remain low. In Q2/2007, the downward trend in actual inflation figures alongside appreciation in the rupiah and the absence of increases in administered prices for strategic goods eased inflation expectations for 2007. This assessment is supported by findings from various surveys that point to falling price expectations at the consumer and retailer levels for the next three to six months. In 2008, a slight increase in inflation expectations is predicted as a result of strengthened economic activity. Nevertheless, the government commitment not to raise administered prices for strategic items, most importantly fuel and electricity billing rates, is expected to keep inflation expectations in check.

Only minimum demand pull inflationary pressure is predicted for 2007 and 2008. This is reflected in the sustained negative output gap. On one hand, steadily rising demand over the next two years is predicted to reduce the output gap. However, the albeit narrowed output gap is still predicted to be negative. In other words, the supply side is still expected to provide adequate response to rising demand in 2007 and 2008.

Inflationary pressure from external factors is predicted to ease in 2007 but rebound slightly in 2008. Reduced external pressures on inflation are forecasted for 2007 due to appreciation in the exchange rate and lower inflation forecasts for Indonesia's trading partners. In 2008, rising global inflation – due to high rates of capacity utilisation – is expected to bring greater pressure to bear on domestic inflation.

Reduced inflationary pressure is predicted from non-fundamentals in 2007-2008. This is explained by the forecasts for low inflationary pressure in administered prices and volatile foods. The government commitment to refrain from hikes in fuel prices

and electricity billing rates and to avoid excessive price increases for non-strategic items – instead keeping increases to a minimum – will keep administered prices inflation at a low level. At the same time, reductions in volatile foods inflation are expected from more plentiful supply of foodstuffs and stability in the exchange rate.

Inflationary pressure in administered prices is predicted to remain low, easing further in 2007 and 2008. The government is not expected to announce price increases for strategic items and especially not for fuel and electricity. This has had a positive effect not only on stability in transportation tariffs, but has also calmed rising expectations of inflation for 2007 and 2008. Despite this, prices increases are predicted in 2007 for some non-strategic items, affecting mainly water billing rates, toll road charges, maritime transport fares and bottled LPG prices. The round of water tariff hikes during the first half of 2007 is likely to be repeated in more cities. Vehicle charges on 12 stretches of toll roads will also rise by an average of 20%. Added to this, fares for sea travel are expected to go up 30% in Q3/2007. In the last quarter of 2007, prices for 12 kilogram bottled LPG are also predicted to rise by an average of 30%.

Inflationary pressure in the volatile foods category will maintain an overall decline as a result of adequate supply of foodstuff commodities and the stability in the rupiah. The adequate supply of foodstuffs is the result of government efforts to improve effectiveness in domestic rice procurement and the decision to resume rice imports. By May 2007, rice procurement - targeted at 1.7 million tons for 2007 – reached 1.1 million tons. Similarly, by June 2007, rice imports for the year - targeted at 1 million tons – came to 0.7 million tons. At the same time, mounting cooking oil prices triggered by soaring prices for CPO are predicted to be only temporary with no major impact on commodities in the volatile foods category.

In 2008, further decline is predicted in volatile foods inflation, consistent with the decision to allow imports to continue and increased production of food commodities. The government is expected to continue importing rice to replenish the national buffer stock and thus maintain food price stability, especially in the run up to the 2009 national elections. The outlook is for continued expansion in domestic production of foodstuffs and especially rice, following successful intensification and expansion of agricultural land and assuming normal weather and climatic conditions. Actions taken by the government – such as assistance with high-yield seeds, subsidised fertilisers, agricultural extension services and improvements in irrigation networks - are predicted to boost the rice crop in 2008. Assuming smooth, trouble-free distribution of foodstuffs, there will no longer be any food shortages triggering price increases.

RISKS

The inflation outlook is daunted by risks that could at any time result in upward or downward deviation in the inflation projection from the original forecast.

Risks that could push inflation above the forecasted level include:

- Government plans for fare increases for various modes of transportation, such as economy-class trains.
- Inadequate output of food crops due to diminishing cultivating area.
- Disruptions in fertiliser distribution.
- Unstable climatic conditions.
- Susceptibility in external factors that could trigger depreciation in the rupiah and increases in international commodity prices.
- Further increases in CPO and cooking oil prices that could trigger higher prices for other goods produced with the two commodities.
- Kerosene shortages, among others caused by distribution problems.

Risks that could result in lower than forecasted inflation include the following:

- Delayed increases in administered prices for non-strategic items, such as water billing rates and 12 kilogram bottled LPG.
- Appreciation in the rupiah.
- Lower world oil prices.
- Rice imports in excess of target.