While Indonesia has made impressive progress in reducing poverty and boosting shared prosperity, low absolute levels of human capital represent a key structural bottleneck to achieving the country·s development objectives.

The period 2010 to 2019 saw robust economic growth, job growth and poverty reduction.

In parallel, Indonesia·s performance in the World Bank (WB)·s Human Capital Index (HCI) · which quantifies the contribution of health and education to the productivity of the next generation of workers · improved from 0.50 in 2010 to 0.54 in 2020. Nevertheless, significant development challenges remain, including the need to strengthen the competitiveness and resilience of Indonesia·s economy, ramp up investments in infrastructure, manage natural assets for enduring prosperity, strengthen public finances, and further nurture human capital.

While a strong fiscal response helped mitigate even more far-reaching impacts, the pandemic led to substantial losses of labor income and business revenue that affected households· consumption and ability to invest in human capital.

However, Indonesia continues to trail its regional and economic peers in most health outcomes.

Amidst global uncertainty, commodity windfalls, private consumption and the services sectors have sustained robust growth in Indonesia in 2022, but signs of normalizing demand emerged recently. Growth strengthened to 5.3 percent in 2022, the highest in the last decade and above East Asia and Pacific countries· average. Growth came on the back of positive terms-of-trade led by commodity related exports and a recovery in private consumption (Table 1). This momentum continued in 2023 growth recording 5.1 percent in the first half of the year (H1-23).

This includes a softening in imports and investment growth, a deceleration in private sector credit, a slowdown in core inflation since the beginning of the year, and a softening of commodity-led exports. From the supply side, growth came from services (retail trade, hospitality, transport and communication) (40 percent) and manufacturing (20 percent). Those sectors have benefited from pent-up demand largely attributed to improving mobility and tourism activities.

Inflation is easing faster than anticipated and is back within Bank Indonesia·s (BI) target band,2 2 while becoming broader-based. Headline inflation declined to 3.3 percent (yoy) in August 2023.

Nevertheless, inflation became broader-based, reflecting a pick-up in goods and services demand as headline and core inflation are converging.

The narrowing current account surplus, from 0.7 percent of GDP in H1-22 to 0.2 percent in H1-23, is mostly linked to rising services imports and weakening exports.

The fiscal stance has normalized reflecting faster-than-planned fiscal consolidation owing to a broad-based rise in revenues and prudent public spending. With a fiscal deficit of 2.4 percent of GDP in 2022, the GoI returned to its fiscal rule (3 percent of GDP) one year earlier than targeted.

This trend continued with the fiscal surplus reaching 0.7 percent of GDP in July 2023, up from 0.6 percent of GDP over the same period last year.

After a cumulative 225 basis point increase last year and despite the US Fed·s successive interest rate hikes, BI has held it policy rate unchanged at 5.75 percent since January 2023.. 6 This comes as inflation expectations are now well-anchored with headline inflation dropping within BI·s target band. With inflation trending downwards and BI maintaining its policy rate unchanged, the real interest rate is picking up (from 0.8 percent in end-2022 to 2.0 percent in July 2023). This raises borrowing costs for the private sector further and could impact economic activity. In the past two years, BI has been actively using a combination of policy rate adjustments, forex interventions to stabilize the currency, and exchange rate flexibility to navigate external market pressures amidst synchronous global shocks.

This new measure is expected to release liquidity in the market to boost private sector credit growth, which decelerated to 8.5 percent yoy in July (vs. 11.6 percent in end-2022).

Growth is expected to remain robust, though the pace is moderating. With the pandemic recovery cycle now over, GDP growth is projected to moderate from 5.3 percent in 2022 to 5.0 percent in 2023 and stay broadly flat at 4.9 percent in the medium-term (Table 1). As inflationary pressures subside, growth will continue to be supported by private consumption as purchasing power of households is maintained.

As a result, weak investment could put a drag on economic activity and supress growth potential if ongoing structural reforms, like those linked to financial sector deepening or competitiveness related reforms, stall. On the supply side, services such transport, communication, trade, and hospitality will continue to benefit from the consumption drive and support growth. Manufacturing is also expected to play a more important role as more investments, linked to the downstreaming agenda, are realized.1

Inflation is projected to moderate and remain within the medium-term target.

As such, inflation is projected to drop to 3.2 percent by December 2023 (yoy). With signs of moderating demand, inflation would stabilize averaging 3.25 percent in 2024-2025. Easing inflation provides greater space for monetary policy to remain accommodative in supporting growth. Nevertheless, the planned lowering of the inflation target band by half a percentage point to 2.5±1 starting in 2024 could offset some of the policy space.

Although debt selloffs could increase, commodity prices and structural reforms over the outlook period are expected to encourage FDI. The implementation of investment reforms adopted in 2021 1 and the Omnibus Law on Health, together with the GoI·s strategy around downstreaming of minerals, are expected to further open sectors for foreign investments. External financing needs are expected to increase but remain contained as the current account deficit widens gradually from a lower pre-pandemic base (Table 2). Indonesia will have policy space to manage tighter global financial conditions while supporting growth given its macroeconomic position.

The fiscal deficit will remain below the 3 percent of GDP target in 2023-2025. In 2023, the fiscal deficit is estimated to be around 2.2 percent of GDP, lower than the 2023 Budget target of 2.8 percent of GDP. Fiscal consolidation will be maintained in 2024 with the new budget law setting a deficit target of 2.3 percent of GDP. In the medium-term, revenues are projected to improve gradually as the 2022 Tax Harmonization Law reforms generates results. Public spending is projected to remain stable at around 15 percent of GDP with a shift towards medium-term priorities such as health,1 ’, 2 social assistance, and infrastructure investment.

This is due to fiscal consolidation and ample domestic liquidity.

After rising sharply in 2020 due to exchange rate and GDP shocks, external debt is expected to return to pre-COVID levels as the economy rebounds, gross financing needs fall, and equity inflows gradually rise (Figure 3 and Table 4).

Moreover, the long election cycle in 2024 could stall structural reforms which are critical to boost the competitiveness of the economy, boost potential growth, and attract foreign direct investment. With low levels of debt, anchored inflation and adequate financial buffers, Indonesia has the fiscal and monetary policy space to stimulate the economy and mitigate those risks going forward.

Indonesia has built a strong track record of prudent macroeconomic management.

This has enabled Indonesia to maintain policy space to respond to shocks and maintain investment grade in sovereign credit ratings. The current monetary policy stance is appropriate given the current global economic circumstances.

The authorities achieved fiscal consolidation including through tax revenue reforms and the partial unwinding of energy subsidies.

The banking sector remains overall stable with strong capital adequacy as well as adequate balance sheet and liquidity indicators that provide a cushion against potential interest rate and liquidity risk shocks.

The IMF Board considers Indonesia·s forward-looking, and well-coordinated policies helped it close out the challenging global environment of 2022 with healthy growth, falling inflation, and a stable and profitable financial system. Going forward, the IMF expects Indonesia to continue with strong and inclusive growth, supported by broad-based reforms to promote an enable business environment, diversify the economy, and mitigate climate change.

The RPJPN aims to strengthen noble morals, competitiveness, democracy, security, equity, sustainability, self-reliance and Indonesia·s role in the international community. In order to realize a nation that is competitive, it aims to develop quality human capital, strengthen the economy, and utilize science and technology.

Second, it waives the restriction on the four year maximum duration of practice for specialists practicing in Special Economic Zones (SEZs);[20] SEZs are areas endowed with geo-economic and geo-strategic advantages where special facilities and incentives are extended to attract investment in industry and tourism.

The Implementation Completion and Results Report of the Fiscal Reform DPL noted (i) the importance of ASA activities to support achievement of the PDO (ii) that the design of DPLs should rest on a strategy that reflects high-impact priorities, and (iii) that evidence-based reforms that support existing government efforts are more likely to succeed.

Third, while the policy reforms will not directly and immediately improve spatial inequal
over time they are expected to help relieve relevant constraints including regarding the uneven supply of medical ca

Indonesia's forward-looking, and well-coordinated policies helped it close out the highly challenging global environment of 2022 with healthy growth, falling inflation, and a stable and profitable financial system. With the recovery underway, policies have been geared toward restoring the pre-pandemic macroeconomic policy frameworks and accelerating structural reforms, to reinforce macroeconomic stability and build policy space against future shocks. Going forward, Indonesia is well-placed for continued strong and inclusive growth, supported by broad-based reforms to promote an enabling business environment, diversify the economy, and mitigate climate change.

The Indonesian economy performed strongly in 2022, growing by 5.3 percent, driven by a recovery in domestic demand and solid export performance and amid high international commodity prices. Growth is projected to moderate slightly to 5 percent in 2023, given tighter policy settings and the normalization of commodity prices. Inflation, having peaked at 6 percent last year, is forecast to return to Bank Indonesia's target range (3±1 percent) in the second half of 2023. The current account balance stood at 1.0 percent of GDP in 2022, on the back of high commodity prices, and is projected to turn into a small deficit in 2023.

Executive Board Assessment[5]

Executive Directors noted that the Indonesian economy is performing strongly, inflationary pressures are moderating, and macroeconomic policies have been appropriately returned to their pre-pandemic settings.

Directors emphasized the importance of a concrete medium-term fiscal strategy going forward, including efforts to increase revenue mobilization, implement energy subsidy reform and expand social protection.

However, they emphasized the need for monetary policy to act decisively if inflation surprises on the upside.

A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.

Directors welcomed the recently adopted legislation on job creation and the financial sector, while noting the importance of prompt implementation and continued reform momentum, to promote an enabling business environment, enhance financial deepening, and mitigate the scarring effects of the pandemic.

They welcomed Indonesia·s ambitions to increase value added in exports, attract foreign direct investment, and facilitate transfer of skills and technology, and noted that policies should be informed by further cost-benefit analysis, and designed to minimize cross-border spillovers.

Third, while the policy reforms will not directly and immediately improve spatial inequality, over time they are expected to help relieve relevant constraints including regarding the uneven supply of medical care.

This cost is set to grow to anywhere between 2.5 and 7 percent of GDP by 2100 due to climate change, and the poorest bearing the brunt of this burden[37] 7