

November 2007

OVERVIEW

- Reconstruction is driving a modest economic recovery in Aceh.** After a slow start in 2005, reconstruction has accelerated. Reconstruction is now the main driver of economic growth, but at an estimated 7.7 percent in 2006 (excluding oil and gas) it is only slightly higher than Indonesia's growth rate for 2006 (5.5 percent). Given the lackluster performance of sectors not linked to the reconstruction effort (agriculture, manufacturing and oil and gas), current growth is not sustainable.
- The agricultural and manufacturing sectors remain stagnant.** The ending of the conflict and assistance linked to the reconstruction effort have marginally increased agricultural production, but growth is still disappointing at 1.5 percent. Manufacturing, closely linked to the availability of cheap gas, has decreased for the third year running.
- Creating sustainable employment remains a major challenge.** Reconstruction has generated short-term employment opportunities, especially in construction and services, but the primary and secondary sectors are not creating significant employment opportunities.
- Inflation continues to decline, with YoY inflation falling to 8.5 percent in June 2007.** The gap with national level inflation is narrowing, a trend that is likely to continue. However, after two years of high inflation, Aceh's competitiveness has been compromised, as reflected in higher CPI and nominal wages than in Indonesia as a whole.

Data Note:

This note, similar to the first Aceh Economic Update in April 2007, uses data collected from official sources, primarily BPS and Bank Indonesia. Some data have undergone significant revisions, such as 2005 GDP data and the banking sector data. Since the last update, the following new data sources have become available and are reflected in this update: preliminary GDP 2006, employment, trade, banking and inflation data for the first two quarters of 2007. In analyzing these additional data, the World Bank team compiling this note has endeavored to better understand the impact of the tsunami and the reconstruction effort on Aceh's economy.

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I. RGDP

Excluding oil and gas, Aceh's economy grew by 7.7 percent in 2006,¹ driven primarily by the reconstruction effort. As the pace of reconstruction has accelerated, so the building/construction sector has shown the most impressive growth, at almost 50 percent in 2006. About 84,000 houses and 1,500km of roads had been built as of June 2007.² As this is still only half of the estimated needs, growth in the building/construction and related sectors (transport, electricity and water) is likely to continue in the near term.

The structure of the economy has changed significantly since 2003. The decline of oil and gas and related manufacturing since 2003 continues unabated. The weight of the services sectors (construction, trade, transportation), which was already growing prior to the tsunami, has accelerated as a result of the reconstruction effort.

The economy continues to rely on oil and gas. Given their shares of the economy, continuing depletion of oil and gas and the related decline of manufacturing activities pose a serious challenge. The continuing decline of manufacturing is primarily the result of declining LNG production. Manufacturing production in the non-oil and gas industry grew by 1.1 percent in 2006, still below its pre-tsunami levels. Growth was led by the food and beverages and timber sectors. Other sectors, such as cement and paper production, with significant production in the early years of the decade, have still not recovered. Services sectors are growing, but primarily as a

Economic Growth, 2003-06

Sector (%)	2003	2004	2005**	2006*
Agriculture	3.2	6.0	-3.9	1.5
Oil, Gas and Mining	9.8	-24	-22.6	-2.6
Manufacturing	1.6	-17.8	-22.3	-7.9
Electricity and water	16.9	19.5	-2.0	12.0
Building / construction	0.9	0.9	-16.1	48.4
Trade, hotel and restaurants	2.4	-2.6	6.6	7.4
Transport & communication	3.8	3.6	14.4	11.0
Banking & other financial	30.9	19.4	-9.5	11.8
Services	6.3	20.1	9.7	4.4
Total incl oil and gas	5.5	-9.6	-10.1	2.4
Total w/o oil and gas	3.7	1.8	1.2	7.7

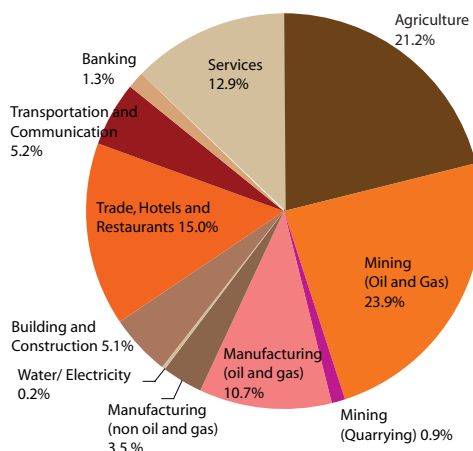
*Preliminary figures. ** Revised figures
 Source: BPS

Structure of the economy 2003-06

Sector (%)	2003	2004	2005	2006
Agriculture and fisheries	17.0	20.0	21.4	21.2
Oil, Gas and Mining	36.1	30.4	26.2	24.9
Manufacturing Industries	20.2	18.3	15.9	14.3
Electricity and water supply	0.1	0.1	0.2	0.2
Building / construction	3.4	3.8	3.5	5.1
Trade, hotel and restaurants	11.2	12.0	14.3	15.0
Transport & communication	3.3	3.8	4.8	5.2
Banking & other financial	0.9	1.2	1.2	1.3
Services	7.8	10.4	12.7	12.9

Source: BPS (2002=100)

Aceh's economy, 2006



Source: BPS

¹ Including oil and gas the economy grew by 2.4 percent

² Badan Rehabilitation and Rekonstruksi (BRR) www.brr.go.id

result of the reconstruction effort. Without a recovery of the agricultural and manufacturing sectors, Aceh faces a structural downturn as the reconstruction effort winds down, which will have serious implications for employment and poverty alleviation efforts.

The agricultural sector remains stagnant two years after the tsunami. Despite the improved security situation and the post-tsunami relief and rehabilitation effort, growth remains sluggish. Agricultural production remains below its pre-tsunami levels (except for estate crops, which are slightly above). Although it saw slight growth in 2006, the sector's growth remains disappointing, particularly when compared with sectors linked to the reconstruction effort.

The share of consumption (private and public) and domestic investment in the economy have increased significantly post- tsunami. The reconstruction effort is driving both consumption and domestic investment, while trade (both domestic and international) continues to decline. Although reconstruction will continue to fuel the economy for a few more years, and the public sector is likely to continue being a source of strong demand for the local economy,³ the continuing decline in exports is cause for concern and signals a lack of competitiveness in Aceh's economy.

GDP composition based on expenditure, 2003 - 06

Expenditure (%)	2003	2004	2005**	2006*
Private consumption	23	24	32	31
Government consumption	9	14	17	18
Investment (GDCF)	7	7	12	14
Change in inventory	4	1	1	3
Export goods & services	45	44	42	30
Import goods & services	3	3	4	6
Inter-province trade	15	13	-	9

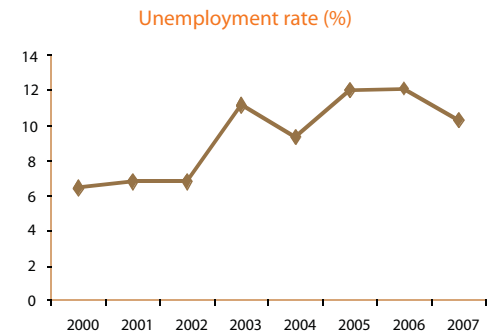
* Preliminary figures. ** Revised figure
Source: BPS

The increase in domestic investment, from 7 percent of RGDP in 2004 to 14 percent in 2006, is fueled by the reconstruction effort. According to official figures, the combined value of domestic investment in 2005 and 2006 was about US\$400 million. This figure is surprisingly low given the large funds spent in Aceh by the reconstruction effort (estimated at US\$2.8 billion to end-2006). Official figures could be low because many reconstruction projects are off-budget or not finished and, as such, may not be captured yet in official statistics. High operational costs and programs that do not immediately translate into new assets (e.g. technical assistance or capacity building) may further reduce the share of reconstruction funds captured as investment. Most investment in Aceh has been public, and the operation and maintenance of these new assets will have significant budgetary implications for Aceh's sub-national governments.

II. EMPLOYMENT

Employment creation continues to be one of the main challenges for Aceh, given the lack of private investment and the degree to which employment growth has so far

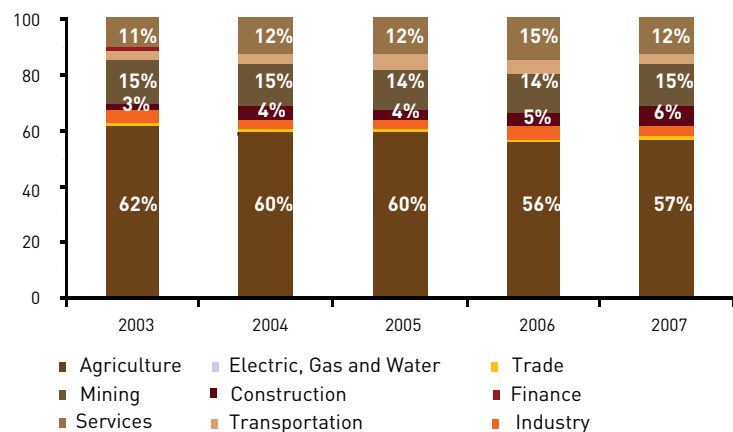
relied on the reconstruction effort. Employment opportunities resulting from the reconstruction effort are limited to sectors such as construction and transportation. Unemployment decreased to 10 percent in the first half of 2007, although this largely reflects a temporary increase due to the timing of the labor force survey rather than a permanent decrease in unemployment.



Source: BPS

Agriculture, by far the largest employer in the province, has been shedding labor since before the tsunami. This decline in agricultural employment is in line with the rest of Indonesia, where agriculture employs a lower share of the labor force than in Aceh. Official data show a significant increase in employment

Sectoral Employment Composition (%)



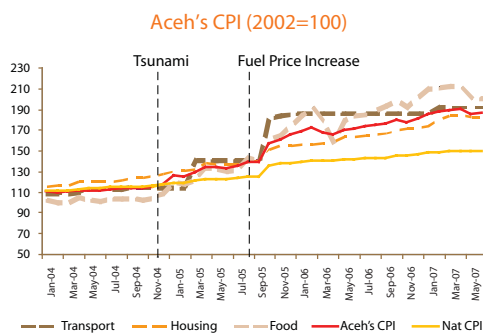
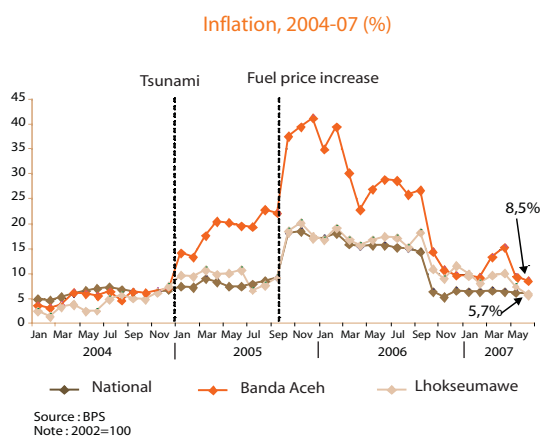
Source : BPS

³ Based on LOGA No. 11/2006, Aceh will receive an additional 2 percent from the national DAU for 15 years starting in 2008.

in agriculture in Aceh in early 2007. Rather than a permanent increase in agricultural employment, this reflects the fact that the survey was fielded at the time of a late harvest in early 2007, resulting in an influx of temporary workers into agriculture. In previous years, the survey was fielded well after the harvest so that agricultural employment did not capture such temporary increases. The increasing weight of the services sector in the economy is also reflected in employment in services, which increased by over 6 percent from 2004 until 2006.

III. INFLATION

Inflation has declined steadily and is now close to the national level. After peaking at 41.5 percent in December 2005, inflation has continued to decline steadily and was 8.5 percent in June 2007, close to the national level of 5.7 percent. The gap with national price levels may increase slightly over the coming month, but any increase is expected to be short-lived.



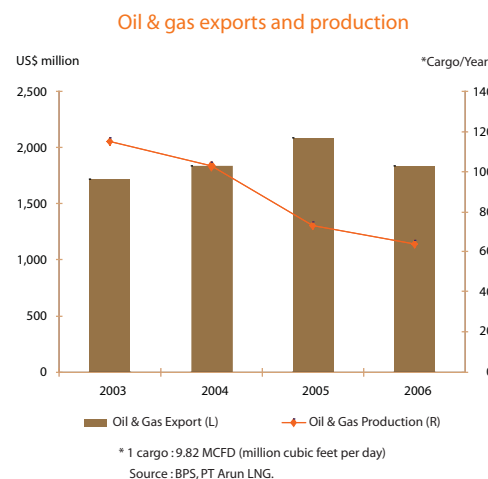
Persistent inflation means that Aceh's CPI remains the highest in Indonesia.

As a result, Aceh's cost competitiveness has declined as reflected in both inflation and wage data. Although inflation has slowed down, the consumer price index (CPI) has registered steady increases since the tsunami. Using 2002 as a base, Aceh's CPI increased to 185.6 (June 2007) while the national CPI increased to 148.2. There have been relatively large nominal wage increases in particular sectors, such as construction where, on average, workers' nominal wages have risen to almost Rp 60,000 per day, from Rp 29,000 pre-tsunami. This is also reflected in Aceh's minimum regional wage (UMR, or Upah Minimum Regional),⁴ which increased by 55 percent from Rp 550,000 pre-tsunami to Rp 850,000 in 2007, compared with an increase of 42 percent in neighboring North Sumatra, from Rp 537,000 to Rp 761,000.

IV. TRADE⁵

Aceh's exports continue to rely on oil and gas. Amid the rapid depletion of natural gas reserves, as per June 2007 total exports were US\$883 million, a decrease of 21

percent YoY. This decline was driven by a marked decrease in oil and gas exports.



Aceh's non-oil and gas exports have been declining since the beginning of the decade,

as a result of conflict. However, preliminary figures to June 2007 show an increase of almost 200 percent YoY. Fertilizer exports, which all but evaporated in 2006 along with production, increased significantly in the first half of 2007. This resumption of production and exports is the result of a government commitment to subsidize gas for the fertilizer industry until 2010.

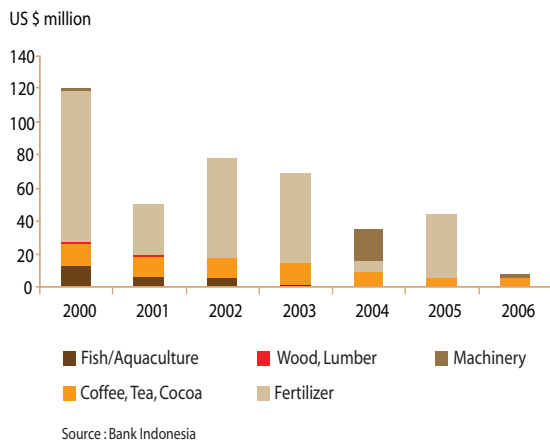
Agricultural exports are starting to recover, driven by coffee.

As of June 2007, coffee exports from Aceh increased to US\$6.7 million from US\$2.6 million YoY. Fisheries exports increased by over 300 percent compared with the same period in 2006, from US\$117,000 to over US\$0.5 million. Likely causes of these increases include the improved security situation and the reconstruction effort. Although still relatively small in scale, these improvements are important in the efforts to diversify Aceh's export base.

⁴ The UMR, set by the government in consultation with labor unions, parliament and the business community, is commonly used in the industrial sector to pay workers.

⁵ Trade data used in this brief only capture trade going through Aceh. A large percentage of Aceh's trade passes through Medan and is then transported by road to Aceh. Therefore, these data are likely to underestimate trade in Aceh, particularly exports of non-fuel commodities such as coffee and palm oil, and imports related to the reconstruction effort.

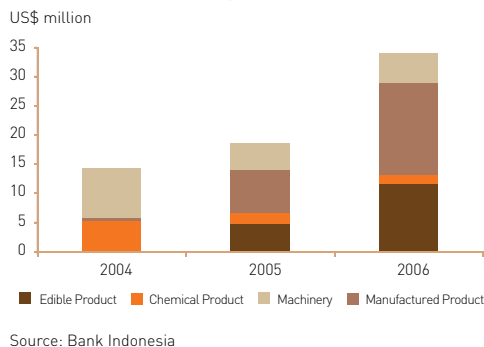
Aceh's major commodity exports, 2000-06



Imports continue to rise, fueled by an increase in private consumption and the reconstruction effort.

Imports increased from US\$12.9 million in 2004 to US\$18.5 million in 2006. As of June 2007, imports grew by 14 percent YoY to US\$15 million. This was primarily driven by a large increase in edible products (cereal, sugar), as well as manufactured goods, while imports of capital goods such as machinery and transport equipment fell.

Aceh's imports 2004-06



V. BANKING SECTOR

Profit and assets in the banking sector have grown two years into the reconstruction effort. Preliminary Bank Indonesia (BI) data to June 2007 confirm this trend, with assets and credit growing YoY. A large and increasing share of deposits is

government funds, estimated at 37 percent of all deposits in June 2007.

Assets and Liabilities in Aceh's Banking Sector

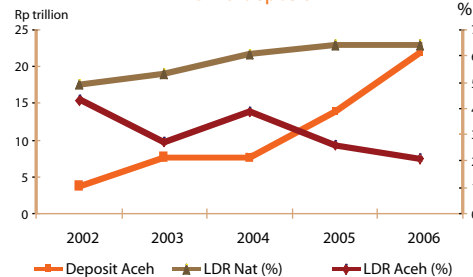
Indicators	2003	2004	2005	2006	Δ04-06 (%)
Asset (Rp bn)*	9,946.4	10,461.8	16,463.2	27,403.9	162
Third Party Funds (Rp bn)*	7,626.0	7,704.9	13,850.5	21,928.1	185
Credit (Rp bn)*	2,094.0	2,971.9	3,599.2	4,598.0	55
Profit/Loss (Rp bn)*	68.6	55.6	(6.3)	371.0	567
NPL Aceh (%)	3.00	2.70	2.92	1.19	-56
NPL Nat (%)	8.2	5.8	8.3	7.0	20
LDR Aceh (%)	27	39	26	21	-46
LDL Nat (%)	53.7	61.8	64.7	64.7	4

* Revised figures
Source: Bank Indonesia

Banks' intermediary functions improved slightly in the first half of 2007.

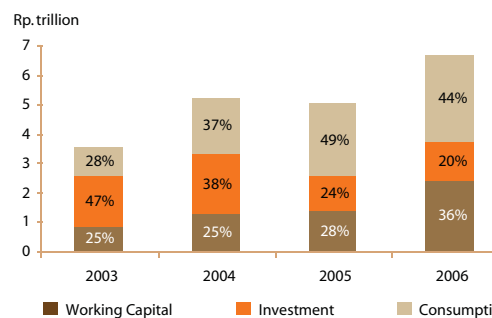
Despite an increase in the loan-to-deposit ratio (LDR) to 29 percent by June 2007, this is still well below the national LDR of around 60 percent. The lower LDR in Aceh is to be expected in the short run, given the large increases in deposits and the fact that Aceh's economy is unable to absorb such large inflows of additional funds.

LDR & deposit



banks are predominantly lending to businesses. Preliminary Bank Indonesia data to June 2007 show an increase in credit of 21 percent YoY, a trend that is likely to continue as long as inflows of reconstruction funds continue.

Credit allocation*



ECONOMIC OUTLOOK FOR 2007

- Only half of the estimated reconstruction program funds have been disbursed. Sectors related to the reconstruction effort (construction, transport) are therefore likely to continue playing a key role in Aceh's economy in the short term.
- The large investments being undertaken are likely to increase productivity in Aceh, although maintenance of these assets will also have large budgetary implications for Aceh's sub-national governments.
- The reconstruction has created short-term employment opportunities in related sectors. In the long term, employment is likely to remain a challenge unless significant investments are made in sectors capable of absorbing large numbers of workers, such as agriculture or labor-intensive industries.

Consumer credit dominates bank credit allocations in Aceh.

At the national level, consumer credit accounts for only 30 percent of allocated credit, compared with 44 percent in Aceh. While consumer credit dominates the credit portfolio of both government-owned and foreign banks, national private

