

## Indonesia's Economic Outlook for 2007: Growing Optimism

Bank Indonesia looks forward to 2007 with optimism for continued improvement in the economy and stable macroeconomic conditions. This was the conclusion reached in the Bank Indonesia Board of Governors' Meeting convened on Tuesday, 21 November 2006, to discuss the outlook for the Indonesian economy in the coming year. This forecast is based on several considerations, including the stable positive trends as of November 2006 and various factors influencing the economic outlook.

**Growth in 2007 is predicted to reach 6.0%, up from the 5.5% growth estimated for 2006.** During the first half of 2007, the economy will be driven mainly by consumption, while private investment is not expected to undergo significant expansion. Private consumption will be spurred by rising purchasing power in keeping with pay rises for civil servants and increases in regional minimum wage levels in the first half of the year. Economic growth is predicted to gather momentum in the second half of 2007, with significant expansion in private investment and hefty increases in government capital expenditures. The forecast for more aggressive private foreign and domestic investment in the second half is supported not only rising confidence among economic participants in the growth outlook, but also a positive contribution from the downward trend in domestic interest rates.

**The conditions described above are expected to push growth in private consumption and investment to higher levels in 2007 compared to 2006.** In fiscal management, prompt and properly targeted government expenditures will deliver an effective growth stimulus. Added

to this, implementation of key government agenda in 2007, such as energy and transport infrastructure and the restructuring of textile industry machinery, is also seen as supporting the 2007 growth outlook.

**On the external front, robust expansion in exports is predicted to continue, despite a slowing trend as world economic growth tapers off in comparison to 2006.** Alongside this imports of goods and services are set to climb in step with escalating domestic demand. With exports in recent months driven by resource-based commodities, the downward trend in world commodity prices calls for a more aggressive push in manufactured exports. Among Indonesia's leading exports are textiles, electrical appliances, chemicals and machine tools.

**The balance of payments in 2007 is predicted to record another surplus albeit below that of 2006.** The reduced balance of payments surplus is explained by such developments as growing demand for imports in line with mounting economic activity. Non-oil and gas exports are predicted to climb 6%-8%, with expansion in non-oil and gas imports reaching 12%-14%. The current account in 2007 is thus forecasted to chart a US\$6-8 billion surplus. In the capital account, FDI inflows are expected to strengthen in the second half of 2007, catching up with previous gains in portfolio investment. Balance of payments performance in 2007 is thus predicted to boost international reserves to about US\$47 billion. The increased balance of payments surplus in 2007 will in turn strengthen the value of the Rupiah, which is predicted to maintain a stable trend.

**The more robust economic activity in 2007 is not expected to generate excessive upward pressure on most prices. Accordingly, CPI inflation in 2007 is forecasted to**

**come within the government-targeted range of 6%±1%.** Improvements on the supply side will still be adequate to offset rising demand driven by the stronger growth, alleviating pressure on core inflation. The CPI inflation forecast for 2007 is also supported by low pressure in administered prices component in the absence of government plans for increases in strategic administered prices. Reinforcing this is continued low pressure from volatile foods inflation, in keeping with the government commitment to ensure smooth distribution of foods and especially of staple goods.

**The Board of Governors wishes to draw attention to some factors that may affect the 2007 growth forecast.** There is potential for even faster growth in 2007 if the above agenda can be completed ahead of schedule. In this case, the Board of Governors predicts that economic growth could reach as much as 6.3%. The expanding role of the banking system in provision of financing is a key factor in this prediction. Credit expansion in 2007 is forecasted at 15%-18%. Added to this, the recent expansion in non-bank financing is predicted to continue.

**The reverse could also happen with economic growth reaching only 5.7% if various constraints and downside risks are not properly addressed.** These constraints are related to flexibility in production capacity to keep pace with rising demand. Flexibility in production capacity will be crucial, as this will have major bearing on the overall outlook for sustainable economic performance, including macroeconomic stability. Also important to the outlook will be the capacity for adjustment in the domestic economy in response to various global risks that may emerge during 2007. These risks are related to indications of a downward trend in world commodity prices and planned increases in administered prices that are feared could affect the overall economic outlook.

**In view of these downside conditions that necessarily form part of an objective forecast for 2007, the Board of Governors believes that hard work, close co-ordination with the relevant agencies at the policy level and in implementation, and the active role of economic participants will be vital to achieving the higher level of growth.** In the monetary sector, policy will remain focused on macroeconomic stability in support of sustainable economic growth. In the banking system, Bank Indonesia will keep working to strengthen the banking intermediary function so that it effectively meets business financing needs.