

## **Statement to Parliament on the Macroeconomic Framework and Key Points of Fiscal Policy**

Under Act Number 17 of 2003, the Central Government is required to present information on the macroeconomic framework and key points of fiscal policy for the upcoming budget year no later than mid-May during the current year. For this purpose, the Minister of Finance, representing the Central Government, delivered a statement to Parliament on the macroeconomic framework and key points of fiscal policy on 22 May 2007. This information will be discussed by the Central Government and Parliament during consultations on general policy and budget priorities to be used as a guide for ministries and statutory agencies in preparing their individual budget proposals.

The information covered by the macroeconomic framework and key fiscal policies includes the following:

- 1) Review of the Latest Economic Developments and Challenges in 2007
- 2) National Economic Development Targets, Macroeconomic and Sectoral Targets
- 3) Fiscal and Monetary Policy Support
- 4) Fiscal Policy and the Draft 2008 Budget, including macro assumptions for 2008.

### **Description of the Latest Economic Developments and Challenges in 2007**

Ongoing developments in indicators show that the Indonesian economy is gaining strength and momentum. Economic growth and activity are in the rise while the nation has robust, well-managed economic fundamentals and stability. This progress is indicated by such developments as the mounting trend in economic growth, subdued inflation, stable exchange rate and steadily rising international reserves.

1. Economic growth in Q1/2007 reached 6%. The improved growth performance was driven by stronger performance in investment, exports of goods and services and private consumption. In the industrial sector, growth momentum came from more vigorous performance in service sectors and particularly transport and communications, followed by the trade, hotels and restaurants sector and construction.
2. The improved condition of the economy also provided added impetus to public purchasing power and economic activity, indicated among others by taxation (VAT), electricity consumption, growth in automotive sales and expansion in consumption credit within the banking system.
3. A mounting trend was evident in investment to the end of April 2007, reflected in various investment indicators such as: higher rate of realised foreign and domestic investments, growing imports of capital goods and

stronger earnings performance by state-owned and private sector companies that will support higher levels of retained earnings available for reinvestment. In the banking system, the improvement in the LDR since the end of 2006 alongside growth in depositor funds and credit reflects more vigorous disbursement of banking funds to the business community. Investment credit and working capital credit continued to expand during Q1/2007. The positive trend in investment indicators was also supported by expanded capital expenditures by the Central Government and Regional Governments. These positive developments are predicted to continue throughout 2007.

4. In international trade, the improvement in export performance is reflected in stronger export growth, particularly in the non-oil and gas sector. This upward trend will be sustained in line with stronger investment, rising global market prices mainly for primary commodities and expanded trade volume with Indonesia's trading partners. On the other hand, imports will also mount in response to increased public purchasing power. The twin trends in exports and imports will have a positive impact on Indonesia's trade balance.
5. Various government policies put into place to ensure unimpeded supply and distribution of foodstuff commodities and especially rice have delivered the intended results. Inflationary pressure in the foodstuffs category diminished further in April 2007. That month recorded -0.16% deflation, bringing cumulative CPI inflation for January-April 2007 down to 1.74% from the previous month's level of 1.91%.
6. In the monetary sector, policy shifted to a cautious easing in interest rates following the achievement of macroeconomic stability. The BI rate, already at 9.0% in April 2007, was lowered further by 25 bps in May 2007 to 8.75%. The reduction in the BI rate produced a further narrowing in the spread against the Fed Funds rate to 350 bps. Since mid-2006, the Fed Funds rate has held steady at 5.25%.
7. Another indicator pointing to upbeat economic conditions was the rupiah, which traded at about Rp 9,096 to the US dollar with an appreciating trend. International reserves continued to mount, reaching US\$49.3 billion in April 2007, having climbed US\$2.1 billion from March 2007.
8. Strengthening economic conditions and rising market confidence in domestic economic performance was reflected in the upward movement in the Jakarta Composite Share Price (JSX) Index. In April 2007, the JSX index pushed past the 2000 barrier with market capitalisation at Rp 1,394.7 trillion, up 11.7% over 2006. Foreign net buying in April 2007 reached Rp 5.6 trillion, well above the March 2007 level of Rp 2.3 trillion. Factors driving this positive trend include favourable sentiment among market players over the condition of the domestic economy, results reported in quarterly financial statements and low rate of inflation.
9. The market not only gained added confidence in the domestic economy, but also in government policies. Reflecting this was the decline in the

yield curve, indicating improved performance and rising market interest in government bonds. Net buying by foreigners in April 2007 climbed to Rp 7.7 trillion, well above Rp 4.5 trillion in March 2007. The global economy continues to offer favourable conditions for domestic economic growth in 2007, despite some challenges that call for vigilance.

10. Economic growth remained strong despite some decline brought on by slowing growth in the United States economy in 2007. The rise in Japanese interest rates may affect capital flows to the region, but this is seen as having very little impact on the Indonesian economy.
11. Other challenges include instability in primary commodity prices and the global money market, which if not monitored carefully could bear down on the national economy.
12. Global monetary liquidity remains at fairly high levels, fuelling competition in world interest rates and capital flows. This may have undesirable consequences for international financial stability.
13. Challenges on the domestic front include the need to proceed urgently with infrastructure development programmes and deregulation for creation of an attractive investment climate.

### **National Economic Development Targets, Macroeconomic and Sectoral Targets**

14. The national economic development targets for 2008 were developed for achievement of the objectives in the long-term development plan. The development theme adopted for 2008 is acceleration of economic growth in pursuit of reductions in poverty and unemployment. To this end, the government has established certain targets with measurable indicators: economic growth at 6.6%-7.0%, unemployment reduced to 8%-9% and percentage of the population living below the poverty line at 15.0%-16.8%.
15. These measurables will be achieved through eight development priorities: (i) increased investment, exports and employment opportunities, (ii) revitalisation of agriculture, forestry and fisheries and activities in rural development, (iii) accelerated infrastructure development and improved energy management, (iv) improved access and quality in the education and health sectors, (v) heightened effectiveness in poverty reduction, (vi) eradication of corruption and faster implementation of bureaucratic reforms, (vii) strengthened defence capabilities and enhanced domestic security, and (viii) disaster relief, reduction in disaster risks and improved eradication of contagious diseases.
16. In addition to these measures, development targets will be pursued through achievement of macroeconomic and sectoral objectives. To achieve the predicted 6.6%-7.0% economic growth for 2008, efforts will focus on sources of growth with targets for household consumption at 5.7%-6.2%, government consumption at 6.0%-6.5%, investment at

14.5%-18.2% and exports and imports at 12.0%-13.6% and 17.3%-19.1%. Alongside this, the targeted industry growth will be supported by growth in agriculture of 3.5%-3.7%, manufacturing at 7.7%-8.1%, construction at 10.0%-10.5% and transport and communications at 13.6%-14.4%.

17. The targeted growth in consumption will be pursued through actions to boost real incomes and public purchasing power. This will include a subdued level of inflation and continued price stability, decline in interest rates, launching of a National Programme for Community Empowerment and disbursement of conditional Direct Cash Transfers and appropriate subsidies.
18. Actions for achievement of the investment growth targets will involve performance improvements in sources of investment, including lower interest rates and improvement in the bank intermediary function, policies to promote higher levels of approval and realisation in foreign and domestic investment projects, improved disbursement of state capital expenditures, approval and monitoring of regional budget capital expenditures, government support for projects under the public-private partnership, supervision of capital expenditures by state enterprises and more vigorous activity in IPOs and investment on the capital market.
19. Policies and actions for export growth will include the establishment and expansion of the National Single Window (NSW) and ASEAN Single Window (ASW), mapping and analysis of mainstay and potential commodities and the implementation of FTA and EPA.

### **Fiscal and Monetary Policy Support**

The Government and Bank Indonesia will coordinate actions and policies in support of achievement of national development targets for 2008, including the following:

20. Macroeconomic stability will be maintained by keeping inflation low in order to allow room for easing in loan interest rates. To this end, the rupiah will be managed to ensure an optimum level of stability in support of growth and purchasing power.
21. The monetary and fiscal policy direction will be coordinated through firmer measures to safeguard joint targets and harmonisation of monetary and fiscal policies in order to promote optimum growth and control of economic liquidity.
22. Fiscal and decentralisation policy will be coordinated through improvements in budget operations at the regional level to accelerate the pace of development, faster approvals for regional government budgets, reporting and use of regional budget expenditures, improvement in legal certainty and harmonisation of central government and regional government regulations.

## **Support from Fiscal Policy and the Draft 2008 Budget**

23. The orientation of fiscal policy and drafting of the state budget are two processes that have undergone change. Up to 2006, policy was oriented toward fiscal consolidation, but since then has been steered towards delivering an economic stimulus. During 2008, the government will again use the State Budget as a stimulus for economic growth, as indicated by the projected budget deficit at 1.6%-1.8%.
24. Various policies and improvements will be put in place to achieve the increased revenue targets for 2008, in which the ratio of tax revenues to GDP will be raised to 13.5%-14%. To this end, the government will take further actions in reform of tax administration, broadening of the tax base and intensified tax collection.
25. Increased central government expenditures will be complemented by improved quality of expenditures through precise planning, faster and more effective deliberation of budget items with Parliament, execution of expenditures in keeping with prudential principles, restriction of revisions to regional government budgets to changes in budget assumptions and cases of emergency and a tidy, disciplined reporting system.
26. Concerning the policy direction for regional expenditures, the government will consolidate the national budget and regional budget deficits and strengthen fiscal decentralisation in support of regional autonomy. In this regard, the government will work towards reduction in fiscal disparities between the central and regional levels and among the regions themselves, regional government capacity building for maximising the potential for regional government revenues, phased transfer of deconcentration and assistance funds designated for funding activities for which regions are already responsible with the use of Special Allocation Funds and the rescinding of hold harmless with no allocation of adjustments funds to be made during 2008.
27. On the financing side, the Government will focus on domestic sources of budget financing and other low-cost, low risk sources.
28. In 2008, the development of the Draft Budget will take place alongside a fiscal risk analysis of factors likely to affect achievement of the Draft Budget targets. Fiscal risks that may arise include the risk of changes in assumptions (sensitivity), risk of increased expenditures related to natural disasters and other events, risks from government commitments and support for infrastructure projects and debt risk influenced by movements in interest rates, the exchange rate and other factors.
29. In developing the Draft 2008 Budget, the government has taken existing economic conditions into account and adopted the following underlying assumptions:
  - GDP growth at 6.6%-7.0%
  - Inflation (y-o-y) at 6.0%-6.5%

- Rupiah in the range of Rp 9,100-9,400 to the US dollar.
- 3-month SBI rate at 7.5%-8.0%
- International oil prices at US\$57-60 per barrel
- Lifting of Indonesian crude (MBCD) from 1.034 to 1.040 million barrels per day.

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