Prudent Relaxation of Monetary and Macroprudential Policies
Synergy of Monetary and Fiscal Policy to Promote Growth
Acceleration of Structural Reform

Policy Mix and Stance

Indonesia Economic Projection
2016
- Inflation 4 ± 1%
- Economic Growth 5.2 - 5.6%
- Current account deficit slightly increased, however remained sound

Medium-Term Prospects
2020
- Inflation 3.5 ± 1%
- Economic Growth 6.3 - 6.8%
- Current account deficit below the safe limit of 3% of GDP with healthier structure
The principal challenge from the global economy stems from the still inadequate global growth and continuing decline in global commodity prices. Alongside this challenge, while the global financial markets uncertainty is expected to ease in response to the narrowing divergence in advanced economies’ monetary policies, the impact of risks from China’s economy calls for vigilance. Although global economic growth is predicted to improve, there is still a downside risk in the growth given the insufficiently solid condition of the U.S. economy and the economic slowdown in China. The U.S. monetary policy normalization is expected to progress gradually, while Europe and Japan are predicted to keep quantitative easing (QE) policies in place, leading to a narrowing of the monetary policy divergence. Although the divergence of monetary policy among advanced countries has begun to ease, the still flagging condition of China’s economy could kindle negative investor sentiment towards emerging market economies which in turn might heighten uncertainties on global financial markets. Another global challenge lies in the inception of the ASEAN Economic Community (AEC), which brings both challenges and opportunities for the future. Regarding this, Indonesia has considerable opportunity to become a supplier in the ASEAN and global value chain. However, if domestic products are uncompetitive, Indonesia will simply become a market for the products of other AEC nations.

On the domestic side, the Indonesian economy also faces an array of future challenges with regard to domestic structural problems that have not been fully resolved. The first structural challenge involves achievement of food, energy, and water security, due to the importance of these input factors in the transformation process for industrialisation. In the food sector, the increasingly constrained quantity and capacity of food production is not adequately balanced by improvements in productivity and technology. In addition, demand for food is steadily mounting in line with the increasing population and heavy dependence on rice as food staple due to minimal level of food diversification. In the energy sector, the imbalance in supply and demand of energy persists. On the production side, various obstacles to the development of energy infrastructure have prevented domestic energy production from fully meeting the demand for fuels. On the demand side, the use of alternative fuels has been minimal, far from sufficient to displace the use of non-renewables energy. The second structural challenge is that of increasing the competitiveness of the industry, maritime, and tourism sectors. Regarding industrial competitiveness, the industry sector in Indonesia is still heavily based on extractive commodities with low value added. In addition, Indonesia’s comparative advantage has also been steadily eroded, particularly in sectors with medium and high technology content. To address this, a strategy is needed to improve competitiveness in investment to create a manufacturing base for supply in the global value chains. In connection with the maritime sector, Indonesia faces challenges involving territorial integrity, optimization of natural resources management, and development of a maritime economy. In the tourism sector, the principal challenge for developing this industry lies in the limited infrastructure that in turn hampers access for tourists and the time they are able to spend exploring the country. The third structural challenge is that of strengthening capacity to support a sustainable long-term financing and promoting foreign capital inflows in the form of foreign direct investment (FDI). The fourth structural challenge is that of expanding the level of grassroots participation in the economy and of benefits derived from economic development.

These four challenges arising from domestic structural issues are closely tied to a range of problems in key enablers for development, in particular those related to infrastructure, human resources, the business climate, and science and technology. According to a growth diagnostic approach, the most important challenges to the economy in almost every region of Indonesia have their origin in problems with electricity infrastructure, connectivity and quality of human resources. Electricity, a source of energy, is still in short supply, particularly outside Java.
Meanwhile the lack of integration of infrastructure in regard to connectivity hampers efforts to cut logistics costs in domestic value chains, to strengthen internal integration and to improve the competitiveness of Indonesian products. Regarding the quality of human resources, the majority of the work force has only primary and secondary school education, and this is not compatible with the effort to strengthen economic structures in the medium and high technology sectors. Although the business climate is remarkably better compared to the preceding year, further improvements will be necessary, including streamlining of investment licensing, taxation mechanisms, simplification of the bureaucracy, and improvements in government management. In science and technology, there has not been optimum support for improving the competitiveness of production and service sectors and this is an issue that must be watched closely.

Bank Indonesia will keep working to strengthen the monetary, macroprudential, payment system and rupiah cash management policy mix to safeguard macroeconomic and financial system stability while continuing to bolster the momentum of economic growth. In the monetary sector, Bank Indonesia will work consistently and prudently in managing interest rate policy, the reserve requirement, and the exchange rate to keep inflation on track with target, manage the current account deficit at a prudent level, and nurture the momentum now created in economic growth. In this regard, interest rate policy is aimed at managing inflation expectations and domestic demand and maintaining stability in the rupiah exchange rate in line with fundamentals. These in turn will support achievement of the inflation target and a sound current account deficit while supporting the ongoing momentum for growth. The reserves requirement policy will be calibrated prudently to support adequate levels of liquidity that appropriate to the needs of the economy while paying careful attention on macroeconomic and financial system stability. Exchange rate policy will continue focusing on maintaining stability in the rupiah in line with the value of fundamentals. These measures for stability of the rupiah are crucial to support achievement of the inflation target and maintenance of financial system stability and will thus improve the overall performance of the economy.

To bolster the effectiveness of monetary policy, Bank Indonesia will continue strengthening both rupiah and foreign exchange monetary operations. These various policies will be supported by Bank Indonesia, among others, through prudent capital flows management and reinforcement of the international financial safety net through collaboration with international stakeholders in monetary policy and financial system stability.

Bank Indonesia will also continue working on deepening of the financial market and expansion of access to financial services in support of financial system stability, economic efficiency, and sustainable and inclusive economic growth. To move forward with financial market deepening, Bank Indonesia is promoting such measures as use of the General Master Repurchase Agreement (GMRA) and is continuing the development of rupiah and foreign exchange money market instruments. In the context of financial access, Bank Indonesia will pursue a policy for expanding access with focus on development of Digital Financial Services (DFS). Parallel with these measures, the policy direction for MSME development will remain focused on supporting Bank Indonesia’s tasks in controlling supply-side inflation and balancing bank’s intermediation function. As a balance to the rapid expansion of the payment system, Bank Indonesia has adopted a mission of regulating and safeguarding a secure, efficient, and smoothly-operating payment system. In tandem with the expanding role of the capital market, Bank Indonesia is also helping to protect the security and smooth operation of transaction activity and settlement on this market.

To ensure the timely provision of high quality rupiah currency throughout Indonesia in adequate volume and suitable denominations, Bank Indonesia will enhance the coordination with the Government and industry to strengthen the infrastructure for rupiah cash management. Meanwhile, the Government will continue increasing the fiscal stimulus to bolster the momentum for economic growth, increase production capacity, and improve competitiveness. The Government and Bank Indonesia are also working together to accelerate structural reforms to strengthen the key enablers for development, namely quality, equitably-distributed infrastructure, human resources with high levels of expertise, a conducive...
investment climate and mastery of science and technology. The key enablers for development will be used in support of measures to strengthen food, energy, and water security, boost competitiveness in the industry, maritime, and tourism sectors, expand and increase sources of long-term development funding, and build an inclusive economy. These reinforcing measures will bring about greater diversification in the structure of the Indonesian economy to make it more robust and able to support sustained economic growth.

Indonesia’s economic outlook for 2016 is projected to show modest improvement amid limited growth in the global economy. Although global commodity prices are predicted to decline further, the global economic growth is projected around 3.4% in 2016, ahead of the previous year. Indonesia’s economic growth is predicted to improve over 2015 to about 5.2-5.6% in 2016. Like before, this growth will be driven by domestic demand and investment. From economic sector point of view, manufacturing is expected to stay the course as the main pillar of the economy, followed by the transportation and communications sector, and the construction sector. These three sectors are set to maintain their leading position, with the construction sector in particular bolstered by construction of Government infrastructure projects. The regional economies are also upbeat for 2016, particularly in the regions of Java, Sumatra, and Kalimantan. With the improvement in economic activity, the current account deficit is projected to slightly increase in 2016, albeit below the safe threshold of 3% of GDP. On the other hand, the capital and financial account is predicted to chart an increased surplus. Taken together, external sector performance in the Indonesia balance of payments in 2016 is set to improve over the previous year. Meanwhile, the inflation forecast for 2016 is expected remains within the target of 4±1%. Moderate and subdued pressure is expected in core inflation, while administered prices inflation is also expected will be lower than in the past year. However, volatile foods inflation is projected to rise slightly in keeping with the El-Nino effect. Financial system stability will remain well in hand, supported by the resilience of the banking system and improving financial market performance. The upbeat outlook for the economy is expected to boost growth in bank deposits (DPK) and credit to 13-15% and 12-14% respectively.

In the medium-term, the Indonesian economy will move towards greater quality, supported by consistency of policy in safeguarding macroeconomic and financial system stability and structural reforms. With implementation of structural reforms under way, the domestic economy is expected to gather momentum. In the medium-term, economic growth is expected to climb steadily towards 6.3-6.8% in 2020. This growth projection is supported by improvement in the global economy, success in structural reforms as visible in construction of infrastructure, streamlining of investment processes, and increased investment in Indonesia. Household consumption will gather strength in line with the growing numbers of the middle class and improvements in social protections. Structural reforms carried out by development of infrastructure will pave the way for increased direct investment and create a conducive business climate. Further reduction in subsidies will create substantial room for Government capital expenditures for development of infrastructure. The current account deficit is predicted to improve in line with the growing competitiveness of Indonesian products. Stronger performance is also envisaged in the capital and financial account in keeping with the progress in the Indonesian economy. Overall, the Indonesia’s balance of payments will show significant improvement. From the regional perspective, the increased allocation of transfers to the regions will strengthen regional economies and support equitable development in the regions. With the increased capacity of the domestic economy, achieved through consistent implementation of structural reforms and Bank Indonesia’s resolute safeguarding of macroeconomic stability, inflation will be curbed within the targeting range of 3.5±1% over the medium-term. Consistent implementation of structural reforms will be crucial for achieving the positive performance envisaged in the medium-term outlook for the Indonesian economy.
Exploring new areas is always fraught with various challenges. Nevertheless, even the toughest challenges can be overcome with an appropriate strategy and anticipatory measures for all eventualities.
Chapter 15

Economic Challenges and Policy Direction

The Indonesian economy will still face an array of challenges. On the external side, the principal challenge will arise from the risk of continued weak growth in the global economy and decline in commodity prices. On the domestic side, the structural challenges are related to: (i) food, energy, and water security; (ii) competitiveness in the industry, maritime, and tourism sectors; (iii) long-term financing; and (iv) an inclusive economy. Besides this, strengthening is needed in the key enablers for development and the financial system. To this end, the policy mix aims to safeguard stability, generate momentum for economic growth, and accelerate structural reforms. Looking forward, the structure of the Indonesian economy is expected to attain greater diversity and support sustainable economic growth.
The momentum for future growth in the domestic economy will face multiple challenges, both global and domestic. From the global perspective, risks of uncertainty on global financial markets have eased in response to the narrowing of the monetary policy divergence among advanced economies. However, there is a risk of slow-moving world economic growth accompanied by the lingering downward trend in global commodity prices. Despite the decline in risks from uncertainty on global financial markets, global financial markets are still daunted with risk of uncertainty from the prolonged weak condition of China’s economy. Under these conditions, foreign capital inflows into emerging markets, including Indonesia, are set to improve albeit on a moderate scale and in spite of the appreciating trend in the US dollar currency. On the regional scale, the growing integration of economies in the region and the sizeable role of China in the economies of other developing countries engender a risk of suffering the consequent impacts of the rebalancing process in China’s economy, whether from weakening of commodity prices or through the trading channel or the financial channel.

On the domestic front, efforts to strengthen the domestic economy continue to be daunted by structural issues. First is the challenge of attaining security in food, energy, and water, the three most important inputs necessary to a process of transformation towards industrialization. Second, Indonesia continues to lag behind in global value chains vis-à-vis competitors in the region, given the imbalanced structure of industry and low productivity that leaves Indonesia in relatively weak position regarding the competitiveness of manufactured products. Third is to reinforce the basis for long-term, sustainable financing to support investment as a foundation for turning the wheels of the economy. Fourth is to create equity for the public for the purpose of participating in and reaping the benefits of development and economic growth.

In the face of these challenges, work will continue to reinforce the policy synergy between Bank Indonesia and the Government. At the national level, the policy mix is aimed at safeguarding macroeconomic stability, sustaining economic growth momentum, and accelerating structural reforms in order to create a more diversified economic structure and achieve sustainable economic growth in the medium to long-term. From Bank Indonesia’s side, the policy mix will be aimed at macroeconomic and financial system stability and prudent use of the available room for relaxation of monetary and macroprudential policies. On the Government side, policy will be aimed at providing a further boost to the present momentum of economic growth. Aside from this, the Government and Bank Indonesia will work together to accelerate structural reforms to support the creation of robust key enablers for development. This will take the form of quality, equitably-distributed infrastructure, human resources with high levels of expertise, a conducive investment climate, and mastery of science and technology. These key enablers for development will be used to: (i) support the strengthening of food, energy, and water security; (ii) promote competitiveness in the industry, maritime, and tourism sectors; (iii) expand and increase sources of long-term development financing; and (iv) create an inclusive economy.

15.1. ECONOMIC CHALLENGES

Global Economic Challenges

In looking at the future, global economy is set to improve, but will continue to be daunted by various risks that call for vigilance. There are several challenges associated with the uncertainties in the global economy, most importantly the risks from a fragile outlook for global economic growth and continued weakness in commodity prices. Despite the outlook of predicted improvement in global economic growth, there is still a risk of weaker growth. This is partly related to the tepid outlook for improvement in the United State economy, which is the locomotive for the global economy. Added to this, the less than upbeat condition of China’s economy also indicates for the risk of lower global economic growth in the near future. As concerns global financial markets, the present uncertainty on financial markets is set to improve, but the condition of the economy in China is still not stable and this could kindle resurgent uncertainty on global financial markets.

Risks of uncertainty on global financial markets have eased with the narrowing of the monetary policy divergence among advanced economies, but careful watch must be maintained for risks from the continued weakness of the economy in China. The narrowing divergence in monetary policy is related to the expected gradual normalization of U.S. monetary policy alongside the continuation of Quantitative Easing (QE) policies by Europe and Japan. Normalization of U.S. monetary policy is expected to move forward in 2016, but with moderate increases in the Federal Funds Rate (FFR) in keeping with the still fragile condition of the U.S. economy. On the other hand, the QE policy maintained in Europe by the European Central Bank (ECB) is certain to remain in place until the first quarter of 2017 and may be prolonged if necessary. However, the risks in China’s economy have potential to trigger a reversal of investor sentiment towards emerging
markets, which could result in an increased risk premium and volatility in foreign capital inflows. Accordingly, the forecast is for appreciation in the US dollar exchange during 2016. The combination of these different factors has potential to bring pressure to bear on the capital and financial account, macroeconomic stability, and financial system stability.

Commodity prices are expected to decline further in line with the ongoing slowdown in China’s economy. In the short-term, the process of rebalancing the economy in China, the world’s largest consumer of commodities, will still be accompanied by slowing growth in the domestic economy that will affect demand and prices for global commodities. At the same time, world oil prices are predicted to stay weak in the short-term in the absence of significant production cuts by OPEC and non-OPEC oil exporters. The decline in oil and commodity prices is also driven by the behavior of investors who are shifting investments out of commodities and into US dollar assets. This in turn has potential to bear down on improvement in the current account.

In regard to the risk of strengthening of the U.S. dollar, the role of large foreign funds in corporate financing structures points to another risk. Corporate external debt has been on an upward trend since 2010, driven by inexpensive sources of global funds in line with the monetary relaxation pursued by advanced economies. Compared to other countries, Indonesia’s corporate dependence on external borrowing is considerable. Corporate dependence on external debt has created a point of vulnerability in the domestic economy at a time of relatively little awareness about hedging of foreign currency liabilities in the corporate world. This condition must be watched carefully, as it could exacerbate risks for the corporate sector in the event of pressure bearing down on the rupiah exchange rate.

The launching of the ASEAN Economic Community (AEC) will create increasingly diversified challenges and opportunities for the future. Indonesia has considerable opportunity to become a manufacturing base for supplying ASEAN and global value chains. The removal of tariff barriers (free trade) will increase the total potential market and domestic products will be expected to be competitive against the products of other countries. However, if the groundwork is not laid properly to seize these opportunities, it is feared that Indonesia will simply become a target market for goods and services produced by other AEC countries.

### Domestic Economic Challenges

On the domestic side, reaching the target of strong, sustainable, and inclusive economic growth will still face a number of challenges. Despite relatively high average of domestic economic growth rate in the past 10 years, Indonesia is still daunted by structural problems that stand in the way of achieving potential growth. These problems include vulnerabilities in adequate supply of food, energy, and water, the imbalanced structure of industry and low productivity that has left it behind in the global value chain, the persistently shallow structure of the domestic financial market, and widening economic disparities (Chart 15.1).

Based on the policy direction of national development, four pillars of structural challenges should be prioritized for remedial action (Picture 15.1). The four pillars of development priorities are: (i) food, energy, and water security; (ii) competitiveness in the maritime, industry and tourism sectors; (iii) sustainable development financing; and (iv) an inclusive economy. Essential to the remedial measures under way is support from key enablers for development, namely quality infrastructure networks with full coverage, availability of quality human resources, a conducive investment climate, and a significant role for science and technology. In addition, macroeconomic and financial system stability is also a prerequisite for building sustainable economic growth.

Accordingly, policy priorities will focus on creating robust structures for the domestic economy that will build a sustainable, balanced economy. Economic diversification and structural transformation will have a vital role in supporting economic growth and buttressing domestic
economic resilience against external shocks. Care must be taken to ensure that the economic transformation process moves forward as appropriate for each stage. The transformation will be carried out with attention to the supporting factors of the domestic economy, which include vibrant domestic consumption and a strong labor market, low, stable energy and food prices, robust water security, comprehensive infrastructure and connectivity, a conducive investment climate, growing integration into global supply chains, and diversification of export products, mainly in order to reduce dependence on primary commodities. In addition, it is vital that the low contribution of productivity, which even comes below the average for countries in the South East Asia region (Chen, 1997), is made a focus of concern in policymaking. The growing complexity of structural challenges and the slowing trend in domestic economic growth visible since 2012 underscores the urgency for implementing structural reforms. The acceleration of structural reforms is expected not only to speed up Indonesia’s transition to a high income country, but also ensure sustainable and quality economic growth that will bring further reductions in levels of income disparity and poverty (Chart 15.2).

Challenges to Food, Energy, and Water Security

Security in food, energy, and water, which comprise essential human needs, represents a fundamental issue that requires resolution. The growth of the population and increase in life expectancy and incomes will require increased availability of food, energy, and water at affordable prices and in sufficient quantities. Availability and price stability for food, energy, and water, as sectors that generate production inputs, are essential to support productivity and sustainable economic growth. The steady upward trend in food, energy, and water prices in the medium-term, climate and demographic change, rising urbanisation, conversion of land use, and changes in consumption patterns are factors that need to be taken into account in boosting national production of food, energy, and water.

At this time, food security in Indonesia remains comparatively low, particularly in terms of quality and public purchasing power. On the production side, the quantity and capacity of food production is becoming more limited, hampered by limitations in production inputs, mainly in order to reduce dependence on primary commodities. In addition, it is vital that the low contribution of productivity, which even comes below the average for countries in the South East Asia region (Chen, 1997), is made a focus of concern in policymaking. The growing complexity of structural challenges and the slowing trend in domestic economic growth visible since 2012 underscores the urgency for implementing structural reforms. The acceleration of structural reforms is expected not only to speed up Indonesia’s transition to a high income country, but also ensure sustainable and quality economic growth that will bring further reductions in levels of income disparity and poverty (Chart 15.2).

1 Based on the global food security index.
productivity and technology. During the 2006-2013 period, only 47,000 ha of new land was cleared for agricultural use each year, while land conversion for housing areas and industrial estates was moving forward at 100,000 ha per year (National Development Planning Agency, 2015). On the other hand, the steady rise in food consumption has not been matched by commensurate increases in food production.

As far as energy is concerned, while Indonesia has sizeable potential in energy reserves, the country faces the risk of substantial vulnerability in energy security. Domestic energy production is unable to keep pace with the ever-growing need for fuels. The most important problems hampering domestic energy production are obstacles to development of such infrastructure as transmission towers and power plants, in addition to the limited diversification into new and renewable energy. Furthermore, the minimal use of alternatives such as biofuels means that it has not been possible to shift away from the high dependence on fossil fuel resources. This is an area that demands attention, because not only will this lead to increasing scarcity of fossil fuels, but also result in environmental damage and global warming (Chart 15.3). Although the Government has introduced energy reforms, including reductions in the fuel subsidy, the high level of oil and gas imports and limited oil reserves in Indonesia will continue to burden the balance of payments (Chart 15.4). If not managed properly, the current account deficit could potentially leave the economy more susceptible to risks in the medium to long-term.

Availability of water in sufficient quantity and quality is vital to the welfare and health of human beings and the environment. The strengthening of national water security

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2 The US Energy Information Association or EIA (2015) predicts world energy consumption to climb from 97.1 quadrillion Btu (2013) to 100.8 quadrillion Btu (2020).

3 Biofuel production accounts for 4.4% of total primary energy production, ranking after crude oil, coal and biomass. Biofuel is consumed in the transportation sector, where it accounts for a 22% share in comparison to 78% for petroleum-derived fuels.

4 Indonesia’s emissions now stand at 523 million tons and the country ranks as the world’s 9th largest producer of CO2 (World Bank, June 2015). In 2018, CO2 production is predicted to climb from 116 million to 270 million tons. Of this 270 million tons of CO2, 84.5% will be generated from burning coal. In 2015, the Government shifted fuel subsidies into productive sectors, including village funds, ship and port construction, social benefits provided through the prosperous family card and families with hope card schemes, agricultural subsidies, special allocation funds, the Indonesia health card scheme, a border fleet, maritime information and logistics system, infrastructure projects including dams, drinking water, roads and expressways, and support for school attendance under the smart Indonesia card scheme.

5 The four key thrusts of food policy in 2015-2019 are: (i) increased production, (ii) stabilization of prices and supply, (iii) improvement in the quality of food consumption and public nutrition, and (iv) dealing with disruptions to food security.
and water, the Government is aware of the necessity of remedial changes to structures and systems in the agriculture, energy and water management sectors. For the agriculture sector, remedial measures have been pursued through such actions as policy reforms, development and repair of infrastructure, crop production and post-harvest handling, and management of markets. In the energy sector, improvements to be made to energy policy include the development and use of new and renewable energy and energy conservation, management of oil and natural gas including reallocation of the fuel subsidy, provision of electricity needs, and increased value added for mining products such as coal. In water security, the Government has issued the 6th policy package that deals with sustainable and equitable provision of water for the public.

A series of policy packages launched in 2015 sent a positive signal for the direction of renewal in national development. However, it has not been possible to evaluate the success of these packages so far. In the agriculture sector, policy reforms will promote greater efficiency in labor costs and production costs, which will also be combined with higher productivity to raise output by 10%-20%. This in turn may be able to reduce dependence on imported food products, thus keeping food prices more stable and generating higher incomes for farmers. In the energy sector, the development of solar-powered, micro-hydro and biomass power plants will increase availability of energy and the installed capacity of powerplants while improving the electrification ratio and primary energy mix. At the same time, exploration for oil and gas reserves and the operation of the refinery at Cilacap will reduce fuel imports and improve resilience in the supply of fuels. Water security, on the other hand, encompasses people’s right to water, conservation of the environment, monitoring and control of water and the role of state in water management.

**Challenges to Competitiveness in the Industry, Maritime, and Tourism Sectors**

For the future, the Indonesian economy will continue to face structural challenges related to competitiveness in the industry, maritime, and tourism sectors. The strategy for the Indonesian economy cannot perpetually rely on extractive commodities, but must shift more to the competitive advantages of high value added industry. Even so, this strategy faces challenges that mainly concern productivity, diversification, technology content, and integration into the global economy. For this purpose, it is necessary to strengthen non-wage competitiveness through productivity-oriented structural reforms. This is important given that during the past decade, domestic industrial productivity has tended towards stagnation and has not kept pace with pressures for wage increases (Chart 15.5). Therefore, the national industrial development strategy, particularly for labor-intensive manufacturing, cannot depend forever on the low wage regime. These efforts to raise productivity, which constitute a non-cyclical policy, will not only strengthen economic growth in the short-term, but also bring permanent improvement in potential growth.

In the industry sector, economic development is confronted with fundamental structural challenges because the economy is based on extractive commodities with low value added and that may harm the environment, particularly in provinces outside Java. The introduction of the policy prohibiting exports of raw minerals will encourage investment in the downstream side of the mineral resources sector, particularly outside Java. Nevertheless, this must be followed by productivity improvements and diversification of economic sectors to create a more competitive and productive business environment. Economic development outside Java needs to be supported by business players’ self-discovery process, that is to say a process of innovation characterised by growth of new industries. However, the

### Chart 15.5. Comparison of Real Wage and Manufacturing Productivity (Index 2000 = 100)

- **Source:** Ministry of Manpower and BPS-Statistics Indonesia, processed

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6 Savings in use of foreign exchange amounted to Rp52 trillion.

7 Based on the Investment Coordinating Board Report (2016).

8 The concept of self-discovery is found in Hausmann, R. and D. Rodrik (2002). “Economic Development as Self-Discovery”. Economic development requires a process of self-discovery where private agents undertake risky innovations in pursuit of financial incentives. This process involves a reallocation of resources from those that are not viable to those capable of more productive growth, bringing an aggregate benefit to the economy. It is essential for public policy to create an environment that supports this self-discovery.
innovation process requires strong funding and carries the risk of failure, and therefore needs to be supported by the availability of key enablers for development. In this regard, Java is further along the road as it already has more sufficient infrastructure and a better business climate. Meanwhile, the structural reforms outside Java are aimed at strengthening internal integration for the archipelago to become a production base for the world.

Another challenge is the need to maintain the continuity of the industrialization process so that it will be able to drive the economic transformation to become an advanced economy. In Indonesia’s position as an emerging market, economic growth is supported mainly by investment, natural resources and energy. As a consequence, to avoid becoming trapped in premature de-industrialization, it is important for Indonesia to catch up with the global economy through improvements in technological capability supported by expertise, improvements to the innovation system, and upgrading in global value chains. Furthermore, to maintain consistency in the policy for improving industrial competitiveness, manufacturing activities need to be structured to form individual clusters of activities supported by other sectors, such as services, trade and connectivity of logistics, energy, and quality manpower.

In regard to technology content, Indonesia’s comparative advantage has been steadily eroded, particularly in sectors with medium and high technology content. The deterioration of Indonesia’s export competitiveness has occurred mainly in highly dependent sectors, such as electronics and machinery, where Indonesia’s export products are less sophisticated than those of regional competitors. On the other hand, the products that still hold an advantage in Indonesia’s exports are resource-based products and their derivatives. This is an area of concern, given greater competitiveness in medium and high technology sectors is essential to the creation of industry capable of producing high value added products to international standards. To this end, support from adequate numbers of quality personnel is also a key factor. Besides this, it is also necessary to build the competitiveness of these sectors to support a successful transition for Indonesia to an advanced economy (see Box 15.1).

Furthermore, to deal with the challenges of globalisation, including the AEC, Indonesia needs to build greater attractiveness for investment in order to become a production base supplying global value chains. Indonesia’s poor competitiveness in global value chains is evident from the country’s limited ability to generate value added after importing raw materials where products are subsequently re-exported to various countries. A comparison among ASEAN countries’ characteristics of FDI shows that investment in Indonesia provides employment on a large scale, but is more domestic-oriented. At the same time, other countries in the region are able to attract better quality investment to promote export growth and provide jobs to skilled workers. Indonesia therefore needs to improve its attractiveness as a venue for investment for export to world markets and to take advantage of integration into global value chains in order to expand markets, harness advancements in technology, improve the quality of human resources, and promote the development of small and medium-sized industries. Issues in the quality of human resources are found nearly everywhere in Indonesia. A study by Affandi and Anugrah (2015) points to the highly significant impact from improved quality of human resources in promoting economic growth in Indonesia.10

The challenges confronting the maritime sector concern territorial integrity, optimization of natural resources management, connectivity, and development of a maritime economy. One of the issues concerning territorial integrity is related to maritime border agreements with neighbouring countries. While a maritime border agreement has been reached with one neighbour, in this case Papua New Guinea, there are still nine other neighbours with whom Indonesia still has to complete negotiations. In regard to natural resources management, the enormous potential of the capture and farmed fisheries sector has not been managed for optimum benefit, and therefore the scale of Indonesia’s exports continues to lag behind that of other countries such as Thailand. At the same time, Indonesia’s problems with connectivity arising from inadequate basic infrastructure lie at the cause of poor efficiency in domestic value chains. This is explained by the better availability of power infrastructure, cargo handling ports, digital connectivity, and supporting services in the Java region compared to the maritime region of Eastern Indonesia.

Indonesia’s tourism sector still faces infrastructure-related challenges that hamper access for tourists and the time they are able to spend exploring, particularly

9 Based on mapping of product space.


11 According to the Ministry of Maritime Affairs and Fisheries Report, as of the third quarter of 2012, growth in captured and farmed fisheries reached 5.05% and 3.98% respectively.
in destinations where tourists are attracted by the stunning beauty of nature. Indicators of competitiveness in travel and tourism place Indonesia in 50th place out of 141 countries. In general, Indonesia still benefits from comparative advantage in terms of prices, natural attractions, and government support, but weaknesses persist in the areas of infrastructure and the supporting environment, such as in health and hygiene, technological progress, tourist facilities, and the capacity of human capital. Besides this, safety and security factors, particularly in relation to terrorism, are still matters of concern to tourists, and this has reduced the potential for domestic tourists (Chart 15.6). This is an area that must be watched closely, given that tourism not only contributes to economic growth and foreign exchange, but is also one sector of the economy capable of providing employment to surplus labor in agriculture.

Challenges for Sustainable Financing of Development

Another challenge that concerns the fundamentals of the Indonesian economy is limited capacity of long-term financing from the formal financial sector in national development. The financial services sector in Indonesia is dominated by the banking sector that has a short-term funding base, and therefore faces the risk of mismatch, while use of the capital market remains very limited. Current efforts to bolster long-term investment financing continue to be constrained by a number of structural issues. First is the high cost of capital in line with the expensive structure of banking liabilities, due to stubbornly high perceptions of risk regarding the real sector and uncertainties. Second is the sizeable portion of foreign ownership of Indonesian Government Bonds and the foreign contribution to share trading, which frequently leads to high volatility in price on secondary markets (Chart 15.7). Third is the still limited availability of long-term financing sources on the capital market, which in fact lags behind the region, as does the capacity and liquidity of Indonesia’s financial market (Chart 15.8).

A further challenge for financing national development is the importance of promoting foreign capital inflows in the form of foreign direct investment (FDI). FDI in export-oriented manufacturing is not only a vital source of financing, but also has potential to improve the competitiveness of the relevant industry within the global value chain (Box 15.2). The limitations faced in long-term financing are evident from the changes in the basic balance of the Indonesia balance of payments, which is frequently in deficit. Among the most important issues hampering inflows of FDI into Indonesia are limitations in infrastructure and the slow and complicated procedures for investment licensing. The effect of this is evident in Indonesia’s ratio of FDI to GDP, which comes far below that of some neighbouring countries (Chart 15.9).

13 At 1.8%, Indonesia’s ratio of FDP to GDP (2004-2014) is below that of peer countries such as Vietnam (5.9%), Malaysia (3.2%), Thailand (3.0%) and China (2.1%).

14 The basic balance indicates the capacity for funding the current account from long-term funding sources. The basic balance represents the sum of the current account, net direct investment, and other long-term net investment.

15 The present investment policy is guided by Act No. 25 of 2007 concerning Investment. This Act replaced Act No. 11 of 1970 concerning Foreign Investment and Act No. 12 of 1970 concerning Domestic Direct Investment. The reforms are aimed mainly at ease of investment, equal treatment of foreign and domestic parties and provision of legal certainty.
According to data for the past five years, investment has been dominated primarily by the manufacturing sector (Table 15.1), but without focus on export-oriented industries.

Challenges for an Inclusive Economy

The Indonesian economy faces other challenges with stubbornly high disparities in development and lack of equity for the public in participation and reaping the benefits of economic growth. Indonesia’s buoyant economic growth at 5.8% over the past five years has not been sufficient for Indonesia to gain entry to the group of upper middle income countries. Although economic gains have reduced the poverty ratio and unemployment levels, this has not brought equitable improvement as reflected in steady rise in the Gini ratio, particularly in Eastern Indonesia. The World Bank (2012) reported that 30 million or 40% of people living in Indonesia are at risk of falling below the poverty line, particularly in the event of food price shocks.16

The gap between rural and urban development has led to formation of centers of growth and agglomeration that ultimately fuels migration from rural communities to urban areas (Chart 15.10). With the high rate of urbanisation, it is estimated that 70% of the population will be living in urban areas by 2050 (United Nations, 2012). To address this, policy support is essential, particularly in provision of infrastructure and business climate that supports job creation and a proper living conditions. The minimum provision of quality infrastructure represents one of the most important challenges in promoting economic growth (Chart 15.11), while geographical disparities also exist in community access to basic needs such as education, health care, clean water, electricity, sanitation, telecommunications, and housing. Most affected in all this is Eastern Indonesia. A similar situation exists in the

16 As many as 14.3% of the rural population live below the poverty line, significantly higher than the 8.4% of urban dwellers living in poverty (Vujanovic, 2015).
financial sector, where access to financial services for people from various income levels in society and living different regions is not inclusive nor available on an equitable basis.

Challenges in Key Enablers for Development

In strengthening the fundamentals of the economy, Indonesia still faces structural challenges related to the key enablers for development, and in particular infrastructure, human resources, and science and technology. Related to infrastructure development, Indonesia needs to sustain the momentum for structural reform by maintaining the credibility, effectiveness, and speed of policy implementation.\(^{17}\) In the short-term, credibility may influence the behavior of economic agents through their expectations, thus encouraging consumption and investment. Similarly, effectiveness and speed may influence the extent of improvement in potential economic growth.\(^{18}\) To achieve greater effectiveness, structural reforms also need to take account of development priorities.

According to the growth diagnostic approach, the most important hindrances to the economy in almost every region of Indonesia are rooted in problems with electricity infrastructure, connectivity, and quality of human resources.\(^{19}\) Electricity is needed to meet the considerable energy needs for industry in Java and the unmet needs of households and industrial users outside Java. Infrastructure for connectivity, such as ports and roads, are essential to bring down the logistics cost in domestic value chains, strengthen internal integrity, and improve competitiveness and thus pave the way for the entire archipelago to become an export-oriented manufacturing zone. Outside Java, quality of infrastructure is crucial to bring a more competitive business environment in order to promote economic diversification (see Box 15.2).

Regarding human resources, it is necessary to increase the numbers of available qualified workers and improve school participation in rural areas. Although Indonesia has gained demographic bonus in terms of working age population, the majority of the workers have completed only primary and secondary school education (Charts 15.12 and 15.13). On the other hand, reinforcing the economic structure in medium-high technology sectors will require large numbers of workers with higher levels of education or skills. As of now, Indonesia still has to deal with a substantial gap in the quality of education of the workforce, as reflected in the PISA scores in science and mathematics that lag considerably behind those of other countries in Asia (Table 15.2). Furthermore, the pace of Indonesia’s transformation into an industrialised country must also be supported by improved agricultural productivity in rural areas, particularly in reaching the target of food self-sufficiency. Lower educational levels in rural areas may hamper efforts to improve productivity, and it is therefore necessary to improve school participation in rural areas, particularly in secondary and

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17 Credibility means results achieved according to plan, while effectiveness is the percentage of achievement and speed is the time taken for development.


19 In 2015, Bank Indonesia conducted a Growth Diagnostics study for 11 provinces. For full details, see Box 15.2.
tertiary education. Balanced levels of productivity between the rural and urban population will have a positive impact in reducing poverty and creating more inclusive economic growth.

Institutional reforms are urgently needed to support improvement in the business climate in order to be globally competitive and to attract investment. The indicator for ease of doing business shows that Indonesia has improved its ranking in this area from 120 (2015) to the 109th place (2016). This positive achievement is explained mainly by improvements in tax payments, construction permits, and access to credit. However, improvements are still needed regarding some issues:

(i) time, costs, and procedures in starting a business; (ii) time required and mechanism for tax payments; and (iii) time and costs for processing property registration. In addition, issues related to ease of doing business also arise in the areas of legal certainty, construction permits, and trade facilitation. In trade facilitation, lengthy times and high costs incurred in export-import processing result mainly from hindrances to onshore access and the loading and unloading processes in port. Another aspect that demands attention is the streamlining of bureaucracy and management of government that is oriented towards public services and clean governance.

Challenges in Reinforcing Macroeconomic and Financial System Stability

The creation of macroeconomic and financial system stability is a fundamental factor in accelerating structural reforms and providing assurance of sustainable economic growth. The globalisation trend that is fostering a progressive integration of national economies into the global economy can take place through three mechanisms: increasingly competitive trade, global supply chains involving multinational production, and integration of financial markets. To this end, a strong and stable macroeconomic structure represents a prerequisite for strengthening the resilience of the domestic economy, particularly in coping with various shocks arising at home and abroad. For the future, the risks of domestic economic slowdown and lack of equilibrium in the global economic recovery represent concerns that call for vigilance. For this reason, macroeconomic stability must be managed so that market expectations can be guided by inflation target and exchange rate stability. However, these measures are daunted by formidable challenges, particularly with the

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20 Classification of sectors by low, medium and high technology is based on the OECD Technology Intensity Definition (11).
still high price fluctuations for some food commodities, risk of capital reversal, and the prolonged decline in world commodity prices. For these reasons, coordination of fiscal and monetary policy supported by structural reform policies is essential among other efforts for bolstering macroeconomic stability. This will be done through strengthening of the functions of the capital market and money market, the labor market, the market for goods and services, and also the economic sectors.

Financial system stability also faces daunting challenges, particularly in view of the growing integration of Indonesia’s financial system and trade. To support the realization of macroeconomic and financial system stability, efforts must be continued to strengthen macroprudential policies and activities for surveillance of the financial system. These policy responses concerning financial system stability were also pursued in synergy with monetary and payment system policies, as part of the coordination among Bank Indonesia, the Government, and other related authorities. On the other hand, financial system stability must also be supported by equitable availability and provision of rupiah cash in the needed denominations in each region. The highly variability of quality of money, particularly in remote areas and the outermost islands of Indonesia, combined with limited capacity to supply rupiah cash in the needed denominations, poses challenges that must be addressed, and this has become a focus of Bank Indonesia policy.

Meanwhile, the increased circulation of counterfeit money in 2015 presents Bank Indonesia with a challenge to maintain credibility and confidence in the rupiah currency as legal tender in Indonesia.

15.2. POLICY DIRECTION

Looking ahead, it is necessary to stay alert to a range of external and domestic challenges to avoid adverse impact on Indonesia’s economic performance. To this end, there will be further strengthening of the policy synergy between Bank Indonesia and the Government. The policy mix will focus on safeguarding macroeconomic and financial system stability and bolstering momentum for economic growth to enable achievement of sustainable economic growth in the medium and long-term (Diagram 15.1). From Bank Indonesia’s side, the policy mix will be aimed at macroeconomic stability and prudent use of the available room for relaxation of monetary and macroprudential policies. On the Government side, policy will be aimed at providing a further boost to the present economic growth momentum. In addition, the Government and Bank Indonesia will continue work to accelerate structural reforms for the creation of robust foundations for the economy in support of sustainable economic growth.

Bank Indonesia Policy Mix

Bank Indonesia will continue to strengthen the mix of monetary policy, macroprudential policy, and payment system and rupiah cash management policy to protect macroeconomic stability and prudent use of the available room for relaxation of monetary and macroprudential policies. In the monetary sector, Bank Indonesia will work consistently and prudently in applying interest rate, statutory reserve requirement and exchange rate policies to steer inflation in line with the target, manage the current account deficit at a prudent level, and support the momentum created for economic growth. Within this framework, the direction of interest rate policy is to manage inflation expectations and domestic demand while supporting exchange rate stability to be aligned to fundamentals. This policy is consistent with the goal to achieve the inflation target and a sound current account deficit while supporting the ongoing momentum for growth. The reserves requirement policy will be calibrated prudently at all times to support adequate levels of liquidity that commensurates with the needs of the economy while paying close attention to macroeconomic and financial system stability. Exchange rate policy will continue to focus on maintaining stability in the rupiah in line with the value of fundamentals. These measures for stability of the rupiah are crucial to support achievement of the inflation target and maintenance of financial system stability and will thus improve the overall performance of the economy. To strengthen the effectiveness of monetary policy, Bank Indonesia will continue to strengthen both rupiah and foreign exchange monetary operations. These various policies will be progressively supported among others through prudent management of foreign exchange flows and reinforcement of the international financial safety net through collaboration with the various authorities that hold a stake in monetary policy and stability of the international financial system.

In the area of macroprudential policy, Bank Indonesia will pursue strategic actions to strengthen the macroprudential policy framework. First is to define more precisely the functions, duties, and powers for Bank Indonesia in financial system stability. Second, Bank Indonesia will keep coordinating with the Financial Services Authority (OJK) to improve banking capital resilience, safeguard adequate levels of liquidity, and deepen the financial market. Third is to promote equitable distribution of
growth in credit and deposits in the regions through improvements to the bank intermediation function at the national and regional level. Fourth, Bank Indonesia will collaborate with OJK to keep expanding the role of the sharia-compliant economy and financial system within the Indonesian economy. This will be pursued in part through development of sharia-compliant monetary instruments and financial instruments.

Bank Indonesia will also continue efforts for financial market deepening to improve financial market resilience to shocks and strengthen the market role as an efficient source of financing. Efforts for financial market deepening will be reinforced by building a common vision among different authorities, with particular focus on supporting economic financing. For this purpose, the Coordinating Forum for Development Financing through the Financial Market will be established by the Ministry of Finance, OJK, and Bank Indonesia. This forum will be important to efforts for market deepening and will have the tasks of preparing policy proposals and recommendations for each authority in promoting financial market deepening and expansion. The three authorities are now at the stage of finalising a MoU.

Another important initiative is information dissemination and education for all market participants, which will be carried out on a continuous basis in the future. Not all business players share the same vision for the financial market; instead, some opt for very conservative behavior by relying only on self-financing to expand their business. Improvement of financial literacy has become highly important to efforts to expand and deepen the financial market. In this regard, there will be comprehensive and integrated planning of public dissemination, coordination and education programs, which will be undertaken not only with market participants, but also law enforcement, arbitration, auditors, and other relevant agencies.

Efforts will continue with the policy for expanding financial access to support the creation of financial system stability, efficiency in the economy, and inclusive, sustainable economic growth. Bank Indonesia will work on building synergy between the policy for expansion of access with focus on the development of Digital Financial Services (DFS), which serves as a point of access, and the policy for electronification, which creates an ecosystem for DFS (Picture 15.2). This synergy is being pursued because of the awareness that the effectiveness of increasing financial access will be inadequate if conducted through the distribution system alone, in the absence of social adaptation to the ways of using payment services. One form of applying the synergy of this strategy is in Bank Indonesia’s efforts to encourage and facilitate the non-cash disbursement of Government assistance, a measure it believes will bring significant improvement in financial inclusion in Indonesia.

Efforts to improve financial access are focused on development of innovation-based digital technology, use of electronification, and innovation of retail payments in financial technology. Development of digital technology-based innovations will be steadily expanded, particularly to resolve the problem related to the lack of bank branches in rural and remote areas. Meanwhile, development of the electronic payments ecosystem will take place by

21 Electronification includes all measures for non-cash processing of retail transactions.
introducing the concept to communities and industry actors as well as in cooperation with the Government. On the other hand, retail payment innovations are needed as an engine for driving the payment system in Indonesia and are therefore expected to promote the use of e-payments in Indonesia and deliver a positive contribution to the economy.

Bank Indonesia will also work continually to promote MSME development through expansion and deepening of the financial infrastructure and building MSME capacity. This will be achieved by increasing MSME financial capacity and access to the banking system through cluster development implemented in an empowered growth approach and by financing in a commercial approach. A key area of attention is ease of access to financial services for MSMEs, including use of the warehouse receipt system, capacity building involving training in recording of transactions and in preparation of financial statements with the use of information technology (smart phones). Furthermore, in order to strengthen the policymaking basis for improving access to financial services, Bank Indonesia will conduct studies related to access to sharia-compliant financial services for certain communities currently not reached by banking services, such as Islamic boarding schools.

For the payment system, the direction of Bank Indonesia policy will remain focused on the regulation and safeguarding of a secure, efficient, and smoothly operating payment system. Bank Indonesia will keep making refinements to a more comprehensive blueprint for the Indonesia’s Payment System while considering future trends of payment system both in domestic and on the global level, as well as trends in other payment system-related sectors such as banking, the capital market, information technology, telecommunications, e-commerce, financial markets, financial inclusion, and international best practices. Besides this, the capital market has a steadily expanding role in the domestic economy, and policy direction will therefore focus on ensuring security and smooth operation of transaction activity and settlement, among others by implementation of Central Bank Money (CeBM). Nevertheless, it should be noted that the development of various payment system service innovations (internet, smart phones, Near Field Communication) also has potential to exacerbate risk in various forms, such as operational risk, liquidity risk, and legal risk. It is essential for these risks to be mitigated without obstructing the pace of innovation. This mitigation will require regulation of the infrastructure for processing of payment transactions and encompasses governance, implementation of risk management, prudential principles, and security in the operation of the processing infrastructure for payment transactions.

In the area of rupiah cash management, Bank Indonesia faces complex challenges in achieving the mission of ensuring that rupiah currency needs are met in terms of adequate amounts, appropriate denominations, timely availability, and proper quality throughout the territory of Indonesia. To this end, measures include strengthening of policy coordination with the Government, improvements to rupiah cash processing, and expansion of cooperation with industry. The governance aspect has also been strengthened by: (i) forging closer cooperation with the Government for refinement of policy for multi-year planning of rupiah currency printing and minting; (ii) strengthening of the infrastructure for rupiah currency management through modernisation of rupiah cash
processing equipment at all Bank Indonesia offices; (iii) expansion of the role of banks and business enterprises through provision of incentives to the industry operating in remittances and cash services for the banking system and the public; and (iv) mitigation of risks in multi-year planning of currency printing and minting, such as mitigation against the dynamics of macroeconomic indicators, changes in prices and quality of currency materials, and medium-term supply of raw materials. In addition, measures will be taken to strengthen the system for supervision of banks holding cash stocks for distribution and regulation of commercial entities providing rupiah cash management services.\textsuperscript{22}

\textbf{Fiscal Policy}

In the midst of the economic slowdown and uncertainty in the financial sector on a global scale, fiscal policy has gained an increasingly important role in turning the wheels of the Indonesian economy. Any weakening of the global economy, fall in commodity prices and declining performance of the domestic economy will put pressure on government revenues and reduce fiscal space.\textsuperscript{23} To address this, measures are needed to optimise fiscal policy by directly delivering an economic stimulus through disbursement of government expenditures as well as implementing various structural policies. The Government has therefore launched a series of policy packages to strengthen the fundamentals of the economy and support domestic economic resilience. These policy packages are aimed at increasing production capacity and strengthening competitiveness, improving fiscal resilience, safeguarding the implementation of development priority programs and controlling fiscal risks and safeguarding fiscal sustainability in the medium to long-term.

In the short-term, the Government aims to increase production capacity and competitiveness and to promote the implementation of development priorities with use of the fiscal stimulus. In moving forward with these government measures, there will be inevitable challenges, including limitations of fiscal space and shortcomings in budget absorption accompanied by a tendency for build-up at the end of the year. To overcome these challenges, it is necessary to work for efficient and quality management of the budget in terms of revenues, expenditures, and financing of the state budget.

Concerning revenues, the Government focus on revenue enhancements is directed toward policies for tax revenues and non-tax revenues. Tax revenues will be optimized without disrupting the investment climate and the stability of the economy, while maintaining public purchasing power, strengthening the competitiveness and value added of national manufacturing, and also curbing the consumption of goods subject to excise. In addition, targets for taxation receipts will be achieved under an extra efforts policy with the following actions: (i) optimizing audits with focus on individual high-performing sectors, transfer pricing and fraud; (ii) broadening of the tax base and intensification of tax receipts through measures to optimise use of IT, e-tax invoices and improvements to regulations; and (iii) campaigning 2016 as the year of law enforcement.

The focus of central government expenditures in the 2016 State Budget encompasses the three dimensions of development and one prerequisite for development to take place (Picture 15.3). The human development dimension is an elaboration of Nawa Cita (nine priority programs) and covers improvements to the quality of human lives through education, housing, drinking water, sanitation, and health care. The dimension of development in leading sectors consists of improvements in productivity and international market competitiveness as well as economic self-reliance, to be achieved by promoting activity in the strategic sectors of the domestic economy. The development priorities are food sovereignty, energy and electricity sovereignty, the maritime, tourism and industry sectors, and science and technology. The aim of the dimensions of equity and regionalization is to improve quality of life through equitable incomes and reductions in development disparities among regions. Besides this, support for continuity of development requires support from legal certainty and law enforcement, security and order, politics and democracy, and governance and bureaucratic reforms. As concerns state expenditures, the Government is striving to enlarge the fiscal space by optimising revenues, further efficiency measures for subsidies and expenditures, control of earmarking and mandatory expenditures, and the strengthening and harmonisation of fiscal decentralization.

Reforms in energy subsidies have been introduced by reallocating energy subsidies to more productive expenditures, consisting of food subsidies, People

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\textsuperscript{22} Regulation of these commercial entities comprises part of the transformation of Bank Indonesia. In general, these regulations will provide guidelines on rupiah cash distribution, rupiah cash processing that includes counting, sorting and packaging, cash in safe, cash replenishment in ATMs and collection of rupiah cash at CDMS, the latter two including monitoring the adequacy of rupiah cash held in ATMs and/or CDMs.

\textsuperscript{23} Under Act No. 17 of 2003 concerning Government Finances, the fiscal deficit is restricted to no more than 3% of GDP.
Business Credit program (KUR) subsidised loans, seeds, and Public Service Obligations (Chart 15.14). This policy was subsequently revised in early 2015 by implementing a fixed subsidy scheme for automotive diesel and premium-grade gasoline. These reforms will be continued in 2016, in particular for electricity rates and bottled LPG prices, for even more efficient and appropriately targeted channelling of subsidies, and for reallocation of budget resources to more productive expenditures in infrastructure, education, and health (Chart 15.15). In addition, the direction of fiscal policy will also be aligned with efforts to develop leading sectors and promote equity and regionalization.

Structural Reform Policies

During 2015, the Government launched a number of policy packages for strengthening the fundamentals of the Indonesian economy. Even so, there is still room for improvement by complementing these measures with other structural policies (Chart 15.4). The policy packages generally focused more on enhancing industrial competitiveness and growth, improving the investment climate, development of infrastructure, and development of MSMEs. There were relatively few policies devoted to food and energy or to sustainable financing. Although it is premature to evaluate the impact of these policy
packages, positive signals and trends are emerging from developments in investment and economic growth. For this, the structural reform agenda needs to be taken to a higher level, particularly in responding to related structural issues such as food, energy, and water security, improving the competitiveness of the maritime industry and tourism, sustainable development financing, a more inclusive economy, building stronger human resources, and mastery of science and technology.

The different policy packages seek primarily to strengthen productivity and efficiency in order to improve competitiveness. For food staples, the development policy is essential to respond to the challenge of raising productivity. Regarding energy, there is still a need for policies targeting increased production and efficiency. For industry, the thrust of policymaking is to improve competitiveness, productivity, and technology content. In the maritime sector, the policy direction must aim for strengthening territorial integrity, management of natural resources, connectivity, and economic advancement. The tourism sector is in need of policies aimed at strengthening infrastructure, tourism facilities, and human capacity. Support from sustainable financing requires a policy for expanding long-term funding from domestic and foreign sources. For an inclusive economy, the policy thrust must aim for equitable development and financial access. Regarding human resources and science and technology, policies are needed that will support Indonesia’s success in transitioning to a high-income country.

**Strengthening Food, Energy, and Water Security**

The vast potential of the agriculture sector has not been harnessed for optimum benefit, and therefore cannot yet undergo transformation to become a source of prosperity and welfare for the people of Indonesia. The agriculture sector still accounts for a relatively small share of the GDP, despite being the source of livelihood for a major proportion of Indonesians (34%), most of whom are...
classified as poor households. To address low productivity and various problems in production, distribution and marketing, in addition to institutions and policy, comprehensive reform of structural policies is essential. The focus on achieving food security is primarily about increasing production to achieve self-sufficiency, bolstering the stabilization of prices and supply, improving the quality of consumption and nutrition in society, and dealing with disruptions to food security, as set out in a number of policy programs. These programs cover areas including the opening of new land for cultivation, repair and construction of irrigation systems, construction of markets and transportation infrastructure, restoring soil fertility, expansion and construction of warehouses with adequate facilities, development of agricultural and MSME banks, capacity building for farmers, development of grassroots agribusinesses, control of food imports and reform of land management regulations.

To bring about energy security, the thrust of policy focuses on four priority areas: increased production and reserves of extractive energy, improvement in the energy mix, expanded accessibility and greater efficiency in use of energy and electricity, and more transparent and targeted management of fuel subsidies. The urgency of resolving national energy problems is described in the 2015-2019 Medium-Term National Development Plan (RPJMN), in which energy and electricity sovereignty is among the 7 priorities of the Nawa Cita priority programs for achieving economic self-reliance by generating momentum in the strategic sectors in the domestic economy. Energy sovereignty is a goal for the energy and mineral resources sector. The targeted government revenues from this sector are Rp1,994 trillion, while total investment and funding in energy and mineral resources is targeted at USD273 billion with Rp71.5 trillion to be funded from the state budget. To improve national water security, Government policy has been integrated into conservation of water resources. Policy actions in this area include construction of water reservoirs, improved access to drinking water and sanitation, development of water conservation infrastructure, protection of natural water resources, and expansion and rehabilitation of irrigation systems.

**Improving industrial, maritime, and tourism competitiveness**

In responding to the challenge of competitiveness in the industry, maritime, and tourism sectors, the Government will focus on implementing a series of development strategies. Industry policy will concentrate on industrial development outside Java, expanding the industry population, reinforcing integration in global value chains and improving competitiveness and productivity. Development of industrial areas outside Java will take place through facilitation for development of industrial estates, centers for small and medium-scale industry, supporting infrastructure for industry and facilities to support the quality of life of personnel. Expansion of the industry population will involve promotion of investment in the downstream development of resource-based industries to meet consumption needs on the domestic and export markets, provide employment on a large scale and integrate into global value chains. The Government will also extend support for small and medium industries to become affiliated with large-scale manufacturing linked to global value chains. To promote competitiveness and productivity, the Government will improve technical efficiency, encourage mastery of science and technology and the art of innovation, and promote higher levels of qualifications in human resources as a part of the labor reform in Indonesia. This also requires the involvement of foreign investors through FDI in expanding the industrial base and improving productivity as part of a comprehensive strengthening of the industry structure in Indonesia. To this end, the Government will take further steps with the institutional reforms already in place to improve legal certainty and bureaucratic efficiency in support of efforts to strengthen Indonesia's industrial competitiveness. The principal strategy is to move through the process for catching up with high income countries by increasing the participation of Indonesian manufacturing in global value chains. This will be supported by improvements in the basic capital for investment, provision of basic capital for development and implementation of a strategy for accessing the global market. The policy direction in support of greater industrialization requires sustained momentum in view of the slowing growth in per capita income in Indonesia due to the limited proportion of Indonesian labor employed in the industry sector (Chart 15.16).

Programs to be undertaken for the maritime sector include strengthening of maritime sovereignty, eradication of illegal fishing, development of national connectivity, and development of a maritime and marine economy. The Government will reach a resolution on marine borders and register small islands with the UN, regulate and control the Indonesian Archipelagic Sea Lanes (ALKI), and bolster marine surveillance and security. Illegal fishing will be curbed by increasing the number of days of coastguard operations and aerial surveillance. Development of national connectivity will involve the expansion of 24 strategic ports to support the nautical highway system and the maritime axis program (Picture 15.5), provision of pioneer routes and vessels, construction of passenger
and cargo vessels for pioneer routes, and revitalisation of dockyard industry locations. Development of the maritime and marine economy will take place through expansion of fishing fleets, particularly of high-tonnage vessels, development of integrated marine and fisheries areas and hatcheries, and development of fish farming areas.

Tourism development will involve facilitating the development of tourist destinations, stronger marketing, building the tourism industry, and institutional reinforcement. The Government has set targets for increased numbers of domestic and foreign tourist visits with foreign exchange earnings projected to reach Rp172.8 trillion. Development of tourist destinations will take place by facilitating the development of tourism zones, strengthening the image of tourism, improving governance, and empowering the public. To boost marketing, the Government will forge closer international cooperation in tourism. Development of the tourism industry will be pursued through local community development, investment facilitation, development of standards and certification, and integration of the tourism ecosystem. For institutional reinforcement, policy will focus on human resources development in collaboration with higher education, facilitation for raising worker skills levels, improving research quality, and change management.

**Strengthening the basis for development financing**

To respond to the challenge for strengthening the funding basis for economic development, coordinated actions are needed from Bank Indonesia, the Government, and other financial authorities. The main challenge in funding economic development lies in the limited availability of long-term funding sources. The growing integration of Indonesia into the global economy has created opportunities to secure long-term sources of finance, including finance through FDI. To this end, much depends on the Government role in strengthening the fundamentals of the economy, a role that includes infrastructure development and the creation of a more favourable business climate. These improvements are expected to bring positive benefits to Indonesia’s internal integration and the nation’s attractiveness for offshoring activities by global manufacturers. The role of fiscal policy in optimising fiscal space is also a further area in need of attention.

Regarding the financial market, the funding basis for development will be strengthened within the context of
financial sector reforms aimed at sustained efforts for financial market deepening to bring about a more liquid and efficient domestic financial market. The condition of the financial market will be crucial to monetary stability, financial system stability, and financing of domestic economic development. A thriving financial market will offer greater resilience to internal and external pressures and support effective monetary policy transmission while contributing as an alternative financing source for the economy. The Bank Indonesia role in financial market deepening, in response to challenges on the rupiah and foreign exchange money market and the sharia-compliant financial market, is guided by the blueprint for Indonesian financial market deepening. This blueprint sets out the design of the framework, strategy, work program, and roadmap for long-term deepening. On the capital market and other financial markets, Bank Indonesia is an active participant in coordinating with other authorities for fostering the development of these markets. In coordination with OJK, Bank Indonesia will continue seeking solutions for development of the bond market by extending facilities and expediting the issuance of permits for corporate bond issues.

Deepening of the rupiah money market will take place by absorbing surplus liquidity with the use of long-term instruments while expanding the range of money market instruments and bolstering market participants’ confidence to engage in transactions. In a related move, Bank Indonesia has prepared a number of policies for developing the repo market. Meanwhile, deepening of the rupiah money market will be pursued by expanding the interbank money market to improve efficiency in unsecured transactions. This will be achieved by promoting growth in interbank credit lines and expanding the role of reference rates with the introduction of a hittable JIBOR. To develop the repo market, Bank Indonesia is collaborating with OJK in encouraging more banks to sign on to Indonesia’s Global Master Repo Agreement (GMRA) and to conduct repo transactions using the Indonesia GMRA. BI and OJK will conduct an integrated dissemination and education campaign, working directly to raise awareness and understanding among market participants about repo transactions and the use of the GMRA as a solid transaction agreement. To improve governance in money market transactions, Bank Indonesia will introduce a framework for regulation of the money market, regulation of money market instruments, prudential principles governing transactions, regulation of infrastructure, and reporting and surveillance mechanisms set forth in the Bank Indonesia Regulation governing the Money Market, which will provide a regulatory umbrella for transactions and trading in instruments on the money market. Bank Indonesia will also promote the issuance of negotiable certificates of deposit (NCDs) by establishing criteria for NCDs eligible for trading on the money market. To expand the range of instruments on the money market, Bank Indonesia is now exploring possibilities for development of commercial paper as an instrument for short-term liquidity management for non-bank corporations.

Similarly, the most important objectives for development of the foreign exchange market are to foster the development of foreign exchange market instruments, increase the volume of interbank credit lines, and continue the development of various derivative instruments. Foreign exchange market instruments will be developed in part by providing limited space for development of structured products in support of the hedging obligations that apply to non-bank corporations. To bolster liquidity on the derivatives market, Bank Indonesia will work in coordination with the Ministry of SOEs to promote SOE use of hedging transactions. Bank Indonesia will work towards a standardised format for derivative transaction contracts not only in line with best practice, but also to be more easily understandable for market participants and other stakeholders, as well as to comply with the applicable regulations and be adapted to domestic financial market conditions, thus ensuring that these contracts will be straightforward in their implementation. Bank Indonesia will collaborate with OJK in revisions to a number of regulatory provisions seen as no longer appropriate to present conditions.

**Strengthening the Inclusive Economy**

Efforts to bring about and strengthen an inclusive economy have become a focus of Government attention as elaborated in a number of policy strategies. The scheme for equitable development among regions is set out in a number of the Nawa Cita policies. In the short and medium-term, the Government will keep working to increase quality and quantity in human development by providing access to basic needs, as well as in equity in development and regionality.24 In addition, strategic actions have been defined for urban development aimed at creating clean, comfortable and habitable cities, supported by environmental and technology-based enhancements.

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24 This encompasses village development, border areas, least-developed areas and development of economic centers outside Java.
The drive for strengthening the inclusive economy also requires support from creation of an inclusive financial system. To promote this inclusion, Bank Indonesia is expanding access to financial services that play a vital role in poverty alleviation and reducing income disparities. At this time, the people of Indonesia have relatively limited access to the formal financial system, which has a reach extending to only about 52% of the total population (World Bank, 2010). Only 50% of the public hold their money in banks, which represent the formal financial sector. This calls for proper, structured engagement and cooperation between Bank Indonesia and regulators, government ministries and other government agencies.

Bank Indonesia will also continue efforts to promote efficiency in the national economy through more widespread use of non-cash transactions. The non-cash payments initiative will be promoted in collaboration with the central government, local governments, and the payment system industry, and will involve expansion of digital payments integrated into the development of the National Payment Gateway (NPG). This expansion will take place under the strategic plan for development of the NPG prepared by Bank Indonesia, which covers the business strategy, functions and service coverage, development phases and priorities, ownership and operation and the method for NPG infrastructure development. The strategic plan will serve as a reference for Bank Indonesia, which will have the capability of broad, integrated servicing of many different kinds of retail transactions according to the needs of the national economy while prioritising the role of national participants.

**Strengthening the key enablers for development**

To build sustainable economic growth, the strengthening of the four pillars of the economy as described above must be supported by structural reforms in the areas of infrastructure, human resources, the business climate, and science and technology. As a theme for the 2016 Work Plan, the Government has pronounced the year of accelerated infrastructure development in order to lay the foundations for quality development through improvement in the public capital stock. The Government has also prepared a list of 225 National Strategic Projects and 30 Priority Projects as a focus for infrastructure development. These projects include enhancing energy capacity, strengthening national connectivity, and improvement of digital connectivity (Picture 15.6). It is envisaged that achievement of these infrastructure development targets will have a positive impact on the economy for sustaining the momentum of structural reforms. In the short-term, business and household expectations will remain prudently upbeat, thus encouraging higher investment and consumption. In the long-term, the reforms will bring increased productivity and improvements in competitiveness.

### Infrastructure Development Plan of 2016 and Target of 2019

<table>
<thead>
<tr>
<th>Infrastructure</th>
<th>2016 Development Plan</th>
<th>Target of 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity</td>
<td>The addition of 7,994 MW power</td>
<td>35,000 MW</td>
</tr>
<tr>
<td>Port</td>
<td>24 port locations have been set. The most ready project to be built is the port of Kuala Tanjung International.</td>
<td>24 new ports</td>
</tr>
<tr>
<td>Airport</td>
<td>15 airports construction phase</td>
<td>15 new airports</td>
</tr>
<tr>
<td>Highway</td>
<td>Construction of 112.66 km of Toll Road</td>
<td>1,000 km</td>
</tr>
<tr>
<td>Railroads</td>
<td>Construction of 185.85 km railways</td>
<td>3,258 km railways</td>
</tr>
<tr>
<td>Dam</td>
<td>8 construction of new dams</td>
<td>33 new dams</td>
</tr>
<tr>
<td>Oil refinery</td>
<td>Two refineries in the preparation stage, the tender will be held in 2016</td>
<td>2 new refineries</td>
</tr>
<tr>
<td>ICT</td>
<td>10% broadband in 57 districts</td>
<td>10% broadband in 57 districts</td>
</tr>
</tbody>
</table>

*Source: Committee for Acceleration of Priority Infrastructure Delivery*
The current account deficit sustained by Indonesia since the end of 2011 is explained in part by the flagging performance of Indonesia’s exports. This has been influenced by two important factors: the domestic factors of structural problems in industry and trade, and the external factor of the decline in commodity prices. The susceptibility of the current account is related to the structure of Indonesia’s exports, currently dominated by resource-based processing industry where performance is dependent on commodity prices. To resolve these issues and optimise the nation’s potential, Indonesia needs to undergo an economic transformation by improving the competitiveness of industry on the global market. Industry is central to this transformation as it is the engine of growth for becoming a developed country, creates employment on a large scale, is able to generate substantial value added, and can ultimately become a fundamental source of foreign exchange.

The trade competitiveness diagnostics developed by Reis and Farole (2012) can be used to measure Indonesia’s international trade performance and the competitiveness of factors contributing to this export performance. In this analysis, Indonesia’s performance is compared with that of its peer countries.\(^1\)

In the first phase, competitiveness is analysed in terms of trade performance (exports) in the four dimensions of intensiveness, extensiveness, quality, and sustainability margin.\(^2\) The analysis show that Indonesia’s exports lag behind other ASEAN countries such as Malaysia and Thailand. Indonesia’s exports come within the low-middle income country classification, being predominantly resource-based with low value added. Indonesia has undergone a visible decline in performance in all four of these dimensions, with the most important issues in intensive and quality margin.

The intensive margin dimension is represented by trade openness (ratio of exports and imports to GDP), which measures the extent to which an economy is integrated into world trade. In 2009-2013, Indonesia’s openness stood at 50%, down from the level in 2004-2008 (60%) (Chart 1). Trade openness in peer countries has mostly increased, with higher levels achieved in countries such as Vietnam (150%) and the Philippines (65%). On the extensive margin dimension, the reach of Indonesia’s exports also lags behind that of other countries. In 2013, Indonesia exported a total of 3,906 products, but only about 53% or 2,099 of these products were sold in more than 10 markets. This figure suffers in comparison to China, a country that managed to sell 4,133 products or 88% of the total to more than 10 markets. In addition, Indonesian products have a high death rate, and products that retain high value are resource-based products.

Regarding the dimension of quality margin, Indonesia is superior in primary products but does not compare well in high-tech products (Chart 2).\(^3\) During the past two decades, indications have pointed to a shift in Indonesia’s export products from low and high-tech to med-tech and resource-based (Chart 3). Indonesia’s exports also have low levels of sophistication and have experienced a downward trend compared to other countries (Chart

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1 Specific comparisons were made with Malaysia, Thailand, the Philippines, Vietnam, China and India.

2 The first is the intensive margin created by selling more of the same products in the same market. The second dimension, that of the extensive margin, is new export flows generated by selling new products or selling existing products in new markets. Next, a quality margin is created if there is an increase in the quality and sophistication of the exported products. Products with higher value added in terms of originality (ingenuity), skill and technology will fetch higher prices on the market. The last dimension, that of sustainability margin, evaluates the survival rate of exports, both of new goods and goods that have long been exported.

3 Classification of export products by technology components is possible with the use of the 3-digit SITC based on Hatzichronoglou (1997) and Lall (2000).
Another indicator is a product space (Hidalgo et al., 2007), which depicts the network of interproduct linkages in international trade. In product space (Chart 5), a high value product is normally located in the core area, representing an industry cluster with a dense forest of interproduct linkages such as in machinery, metallurgy, and automotive production. Conversely, low value products are found in areas with low density linkages. It is generally easier for a country to produce goods that are close to products that it already manufactures. Therefore, a country that has a comparative advantage in an industry cluster with high density linkages will work faster in upgrading its export products. Analysis of Indonesia from 2000 to 2013 indicates that the product space in Indonesia has moved progressively further from core areas with dense linkages. This is evident in the decline in number of products with comparative advantage in the garments and textiles industry, such as machines, electronics and furniture, where comparative advantage tends to be held by upper-middle countries. According to Hidalgo et al. (2007), the low competitiveness of these industry clusters will hamper transition to a higher income group, meaning that Indonesia faces the risk of a middle income trap.
Another dimension, that of sustainability margin, is represented by an indicator of the ability to maintain trading links. During the period of 2003-2013, the share of Indonesia’s surviving new export relationships was 61.2% (Chart 6). This export duration was superior only to the Philippines and Malaysia, but came below that of Vietnam, Thailand, China, and India.

Indonesia’s trade performance must also be seen from the aspect of competitiveness in global value chains. Global economic developments in the 21st century point to a change in the pattern of trade from competition in producing certain products to competition to be involved in production processes, i.e. manufacturing, pre-fabrication, or post-fabrication. Indonesia’s ability to be involved in any of these production processes will be determined more by competitiveness as a location of choice, according to the characteristics of input factors. Indonesia needs to increase its attractiveness for investment in order to encourage export-oriented investment. A comparative analysis of FDI characteristics among ASEAN countries shows that investment in Indonesia provides employment on a large scale, but is more domestic oriented. Other countries in the region, however, are able to attract higher quality investment. In Thailand, FDI boosts exports; in Vietnam, FDI drives exports and employment; and in Malaysia, FDI strengthens skills-based export products (Table 1).

Furthermore, analysis using a triangular trading scheme approach indicates that the most competitive ASEAN countries in the global value chain are Singapore, Malaysia, and Thailand (Chart 7). This measurement of competitiveness is obtained from the level of import productivity, i.e. the ability to export after importing raw materials and intermediate goods. The measurement of competitiveness also takes account of the scale of exports in global value chains.

The second stage of the competitiveness analysis seeks to analyse the competitiveness of factors contributing

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6 Based on the characteristics of value added and input factors, each stage of this production can be illustrated in the form of a smiley curve.

7 For the concept of the triangular trading scheme, refer to Lejour et al (2013) and Johnson-Noguera (2011). According to this method, trading data that is initially bilateral is reconstructed into trade between three countries, namely the supplier of raw materials (origin), the connecting point (hub) and the final destination. Information obtained from this scheme of trading by three countries includes the following: (1) imports of raw materials that are processed for export (production hub); (2) imports of raw materials that are processed for the domestic market; (3) exports of raw materials to the world; (4) exports of products manufactured with domestically-sourced raw materials; and (5) self-sufficient activities (sourcing, processing, and consumption in-country).
to Indonesia’s export performance. Competitiveness is measured by the three dimensions of market access, supply-side factors, and trade promotion support. Each of these dimensions shapes export performance through its influence on companies through the channels of entry costs, cost of factors and transactions that determine the competitiveness of production at the manufacturing level, and the level of technology and efficiency of the sector or company. Results of the analysis show that the challenges facing Indonesia’s exports are mainly attributable to poor worker competitiveness (skill set), high costs of production and logistics, lack of a conducive business environment and complex bureaucracy with regard to domestic policy and institutions, and poor market access.

Regarding the dimension of conditions, the costs for labor in Indonesia are high. After factoring in the level of productivity, the minimum wage is higher than that of advanced economies (Chart 8). The high minimum wage is a reason for job losses through mass layoffs and relocation of factories to provinces with a lower minimum wage. The cost of dismissals is also very high compared to peers at about 50 times the weekly wage (Chart 9). Besides this, there are several implicit costs such as the large number of trade unions that complicate negotiation processes, frequent demonstrations, and rising operational risks. As regards skills, more serious issues are at stake. The World Bank (2014) claims that a skills mismatch exists in which 50% of graduates from high school or equivalent education and 15% of university graduates work in unskilled positions. Seventy percent of manufacturers claim it is very difficult to fill skilled positions. At the same time, only 5% of workers have received on-the-job formal training.

The condition of logistics in Indonesia poses serious obstacles to building competitiveness. The Indonesian Logistics and Forwarders Association (2015) claims that the cost of logistics in Indonesia is about 24% of GDP, far higher than the average logistic cost in Asian countries. Although WDI data indicates that Indonesia’s Logistic Performance Index has slightly improved (Chart 10), it still ranks lower in comparison to peers. Another issue related to conditions is the lack of international certification and compliance with regard to export products and industrial processes (Chart 11).

Regarding the framework of business incentives, in Indonesia the policies for streamlining FDI (Chart 12) and improving the ease of doing business (Chart 13) rank the lowest in ASEAN. In several aspects, such as
starting a business, processing construction permits, registering property, paying taxes, and enforcing contracts, Indonesia lags far behind its peers. As regards market access under trade agreements, Brunei, Malaysia, Singapore, and Vietnam are in a superior position to Indonesia. Indonesia’s FTA has mostly been concluded within the ASEAN regional trading system. In regional block trading, Indonesia is currently negotiating the Regional Comprehensive Economic Partnership (RCEP) with participation from other ASEAN countries. This does not form part of the Trans Pacific Partnership (TPP). Other obstacles faced by Indonesia’s export products arise from non-tariff measures such as sanitary and phytosanitary provisions and technical barriers.

Regarding support from promotion of trade, exports, and investment, Indonesia is in a comparatively weak position. Another issue is inadequate use of Special Economic Zones (SEZs). Indonesia has a similar number of SEZs as do peer countries, but when compared to the geographical area of its territory, the number is small (UNIDO, 2015). In addition, SEZs have seen only limited development, as they are not supported by adequate infrastructure such as integration into energy supply and transport links. Some SEZs have been established at considerable distance from supporting infrastructure, such as sea ports. There has also been a lack of effectiveness in the management of industrial zones, with weak promotional support.
To respond to these challenges, it is necessary to improve industrial competitiveness by upgrading and deepening the industry sector, creating value added, and developing export-oriented industry. The industries affected by these concerns are all industries in a general sense, whether resource-based, labor-intensive, medium technology or high technology. This calls for a national industry strategy that covers seven essential elements: (i) institutions and leadership; (ii) trade and investment incentive schemes; (iii) human resources and labor; (iv) infrastructure; (v) technical efficiency and business services; (vi) access to finance; and (vii) access to markets (Picture 1).
Box 15.2  
Growth Strategy for Supporting Structural Reform in Indonesia

One of the challenges to carrying out structural reforms is to formulate a growth strategy that can have significant impact on the economy of a country. Therefore, it is necessary to formulate a development strategy based on priorities determined by the most important obstacles. Structural reforms also need to take account of regional identity, give that each region may have differences in resources and structural constraints.

Within this context, Hausmann, Rodrik, and Velasco (2005) introduced an alternative growth diagnostic approach to identify the major obstacles to promoting investment and economic growth. Analysis of these major obstacles is performed by diagnosing each branch of the decision tree, beginning with the two major factors of high financing and low economic returns (Picture 1). To formulate development priorities on the basis of these major obstacles, a policy simulation process is carried out with the use of the Computable General Equilibrium (CGE)-IndoTERM model. Use of this model is necessary to analyse the impact of structural reforms on regional and national macroeconomic parameters, such as economic growth, exports, and employment. Bank Indonesia (2015) has conducted growth diagnostic studies for 24 provinces in Indonesia in which the decision tree analysis was combined into the CGE model.

As a rule, the most important obstacles in nearly all areas of Indonesia arise from the quantity and quality of human resources and capacity and reliability of electricity supply. Regarding human resources, the average duration of school education in Sumatra, Java, Kalimantan, and Eastern Indonesia is 8.6, 8.1, 8.1, and 7.9 years respectively. Nationwide, this average is still less than 9 years. This is a matter of concern as Indonesia needs large numbers of highly educated technical personnel to manage the transition to an advanced country, particularly in order to reinforce economic structures in the medium and high technology-related sectors of industry. In the regions outside Java, skilled workers are also needed to strengthen the diversification of high value added sectors of the economy. Historically speaking, the phenomenon of shortages of qualified personnel outside Java is evident from the widespread employment of workers from other regions. Furthermore, analysis in some provinces also indicates that in general, the lesser educated workers are found in rural areas, and these workers are mostly active in the agriculture sector. The low quality of the workforce in the agriculture sector may hamper the process of increasing agricultural productivity, particularly in order to attain self-sufficiency. If self-sufficiency is not achieved or food supplies diminish, prices for food items will increase at a faster rate than for industrial goods. High prices for foodstuffs, which represent an essential need, will drive up the cost of living in cities, which will ultimately stoke the pressure for wage increases demanded by industrial workers. In the end, this will slow employment and affect the pace of Indonesia’s transformation into an industrial country. Following this, a policy simulation using the CGE-IndoTERM model confirmed the identification of obstacles in human resources. According to the simulation results, increased productivity achieved through accelerated development of human capital has potential for significant impact across the entire archipelago, particularly in strengthening mainstay manufacturing sectors in individual regions (Chart 2). Implemented nationwide, a policy program for development of human capital would have potential to boost economic growth by 0.25% per annum and employment by 0.50% per annum (deviation from baseline scenario without such policy).

Regarding electricity, there is relatively adequate supply for household needs in Java, but the large industrial population has also created similarly heavy demand for energy, necessitating further increases in electricity capacity. However, outside Java, both business and households suffer electricity shortages. In addition, the persistently high number of companies that attempt to provide their own electricity attests to the inadequate reliability of electrical power. According to the World Bank Enterprise Survey (2009), losses attributable to power cuts in Indonesia could reach as much as 1.6% of the value of production. Results from policy simulation with the CGE-IndoTERM model also confirm the importance

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1 IndoTERM is a bottom-up multisectoral, interregion CGE model developed under collaboration by several institutions: the Center for Economics and Development Studies, Padjadjaran University; Center for Policy Studies, Victoria University; Asian Development Bank; AusAID; and the National Development Planning Agency.

2 The 24 provinces selected for the Bank Indonesia Growth Diagnostic study of 2015 are Aceh, North Sumatra, West Sumatra, Riau, the Riau Islands, South Sumatra, Bengkulu, Lampung, Jakarta, Banten, West Java, Yogyakarta, Central Java, East Java, East Kalimantan, Central Kalimantan, West Kalimantan, South Kalimantan, North Sulawesi, South Sulawesi, Maluku, North Maluku, West Nusa Tenggara and Bali.

of electricity development. Based on these results, a policy for building electricity capacity has potential to boost national economic growth by 0.25% per annum and employment by 0.13% per annum (deviation from baseline scenarios without such policy). Development of electricity capacity also has potential to boost export growth and employment while providing opportunity for each region in Indonesia to develop their mainstay industries (Chart 3). This demonstrates that provision of electricity infrastructure is desperately needed by business for both carrying out expansion and to improve productivity where businesses now face potential losses.

Besides human capital and energy infrastructure, connectivity also poses major obstacles for many regions in Indonesia. In particular, these obstacles are attributable to the capacity and quality of ports, roads, and airports. Dwelling times, turnaround times and port capacity shows that the efficiency of ports in Indonesia lags far behind that of competing ASEAN countries such as Malaysia and Singapore. Regarding roads, for many industries the extent of road damage remains high, added to which is the imposition of illegal levies. This occurs even in Java, where infrastructure is in relatively better condition. In addition, some provinces in Indonesia also face other, quite varied

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**Chart 2. Impact of Human Capital Development in 4 Indonesia Regions (Industry with the biggest incremental in each region)**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percent Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vegetable oil</td>
<td>Sumatra</td>
</tr>
<tr>
<td>Electronic</td>
<td>Java</td>
</tr>
<tr>
<td>Oil Refineries</td>
<td>Kalimantan</td>
</tr>
<tr>
<td>Food processing</td>
<td>KTI</td>
</tr>
</tbody>
</table>

(a) Industrial Output

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percent Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vegetable oil</td>
<td>Sumatra</td>
</tr>
<tr>
<td>Electronic</td>
<td>Java</td>
</tr>
<tr>
<td>Vegetable oil</td>
<td>Kalimantan</td>
</tr>
<tr>
<td>Fish processing</td>
<td>KTI</td>
</tr>
</tbody>
</table>

(b) Export Industry
obstacles, such as problems with bureaucracy and security, as well as problems with the quality of human resources and infrastructure. These problems affect both infrastructure for connectivity (roads, ports, and railways) and electricity infrastructure.
The future is always filled with uncertainty. Nonetheless, the future is also imbued with hope for those who aspire. The Indonesian economy has the potential for stronger growth and more solid fundamentals.
Chapter 16

Outlook

The Indonesian economy is expected to grow stronger, more sustainable and inclusive. The optimism for Indonesian economic growth is to a large extent attributable to commitments and consistency in accelerating the implementation of cross sectoral structural reforms. In the short-term, economic growth will continue to be driven by domestic demand bolstered by investment in infrastructure projects. In the medium-term, economic growth is set to increase as infrastructure projects begin delivering benefits by expanding capacity in the economy. With these developments, macroeconomic and financial system stability will be kept well under control.
Against the backdrop of limited global growth, the upward growth trend for the Indonesian economy is expected to be sustained in line with the implementation of structural reforms. The overall outlook for the global economy is improved from the previous year, albeit a fairly limited growth. The global economy, led by advanced economies, is forecasted to begin showing improvement, particularly in the United States. On the other hand, the economy in China is predicted to slow further with impact that will continue to hold back increases in commodity prices. Against the background of this global economic outlook, the future momentum of the Indonesian economy will be determined to a great extent by the structural reforms implemented by the Government and Bank Indonesia. Bank Indonesia predicts an upbeat economic outlook for 2016 with growth in the range of 5.2-5.6% accompanied by subdued inflation on track with the target of 4±1%. In keeping with rising economic growth, credit expansion is forecasted to reach 12-14%. However, a slightly enlarged current account deficit is predicted in comparison to 2015 due to intensive work on infrastructure projects. Hence, the forecasted current account deficit is still at a safe level, which is below 3% of Gross Domestic Product (GDP).

The medium-term forecast is for steadily improving and more sustainable economic growth that in 2020 is projected to reach 6.3-6.8%. Growth in household consumption will remain stable, buoyed by the expanding proportion of the middle class and more extensive provision of social security. Investment will forge ahead with rising growth momentum as work progresses on infrastructure projects and improvements are made to the business climate. The quality of government expenditures will improve with greater emphasis on capital expenditures in keeping with cutbacks in the portion allocated to subsidies. In addition, state budget allocations for transfers to the regions and Village Funds will be increased over past years to bring about greater equity in development for all regions. Implementation of the structural reform programs will be crucial to increase capacity and capability on the production side that will pave the way for the economy to achieve stronger, more sustainable, and inclusive growth.

### 16.1. SHORT-TERM ECONOMIC OUTLOOK

#### Global Economic Outlook

The global economy will show improvement, albeit still relatively limited. The forecast for global economic growth in 2016 is 3.4%, bolstered by the continued recovery in the U.S. economy. The improvement in the U.S. economy will be driven by the rising consumption in response to increase in employment and low oil prices. Despite a fairly solid recovery, the monetary normalization policy through increases in the Federal Funds Rate (FFR) is predicted to move forward gradually in 2016, although various risks still overshadow the U.S. economy. Meanwhile, improvement in the economy of Europe is becoming visible on the demand side, supported by accommodative monetary policy. Improvement has been driven mainly by increased consumption and labor productivity. In addition, the continuation of the Quantitative Easing (QE) policy by the European Central Bank (ECB) may offset some of the negative impact of the Fed’s policies on the global capital flows to Emerging Markets (EM). On the other hand, China’s economy is expected to slow further as a result of the ongoing rebalancing process. With recovery in the global economy predicted to progress at an uneven pace, the world trade volume is expected to see only moderate growth in 2016.

The trend in global commodity prices is expected to remain negative. The decline in commodity prices points to the end of the super-cycle era in global commodity prices brought about by weakening economic growth in EM economies and particularly China as the traditional major buyer of global commodities. In addition, world oil prices will stay at a low level due to the limited recovery in the global economy and the continuing glut in world oil supply.

#### Domestic Economic Outlook

##### GDP Outlook by Expenditure

Domestic demand will continue to provide the main driver for economic growth in 2016, which is expected to reach 5.2-5.6% amid the limited recovery in external conditions. Overall growth in household consumption in 2016 is forecasted to reach 5.0-5.4% (Table 16.1). Acceleration of structural reforms through construction of infrastructure is expected to promote job creation. Wage increases and payment of the 13th and 14th month salary for civil servants, members of the police and military, and pensioners will also boost household incomes. Public purchasing power will be bolstered not only from higher incomes, but also supported by targeted inflation within the range of 4±1%.

In 2016, investment is projected to grow more robust at 7.2-7.6%, up from the preceding year. Similar to 2015, infrastructure investment will become the leading contribution to future investment growth. This outlook is based mostly on the confidence over improvement of
implementation of government infrastructure projects to support economic growth. The government is also pursuing efforts to improve the effectiveness of state spending by increasing allocations for productive expenditures. Productive expenditure allocations will focus on improving the key enablers for development, particularly by building infrastructure in order to boost competitiveness and expand production capacity. Steady improvement is also predicted for private sector investment growth as domestic demand begins to climb and in keeping with forecasts for more robust external demand for Indonesia’s exported products. Support for the growing role of the private sector role is also provided by more accommodative monetary and macroprudential policies.

The Government has launched the National Strategic Projects (PSN) to accelerate the development of infrastructure. To expedite progress on the government plan, the Government has designated 225 projects worth over Rp100 billion as National Strategic Projects (Diagram 16.1), for which pre-feasibility studies have been completed. For 30 of the 225 projects, The Government has assigned the Committee for Acceleration of Priority Infrastructure Delivery (KPPIP) to accelerate construction work. In most cases, these 30 infrastructure projects offer potential for funding under the private-public partnership scheme. Of these 30 priority projects, tendering for 13 has been concluded and some projects have entered the construction phase (Diagram 16.2). To support the successful implementation of National Strategic Projects, the Government issued Presidential Regulation No. 3 of 2016 concerning Acceleration of The Implementation of National Strategic Projects, which provides facilities and streamlining of requirements related to licensing, procurement, land acquisition, and guarantees by the Government. Electricity infrastructure benefits from additional facilities besides those stipulated in the PSN Presidential Regulation. These added facilities, which remove some obstacles to the development of electricity infrastructure, are set forth in Presidential Regulation No. 4 of 2016. This Presidential Regulation stipulates definite powers for PLN as the provider for construction of electricity infrastructure, funding assistance from the Ministries of Finance, SOEs, and Energy and Mineral Resources, and freedom for PLN to solicit domestic and foreign funding with the backing of guarantees issued by the Government.

On the external side, exports are forecasted to maintain negative growth in 2016. The flagging performance of exports is consistent with predictions of continued economic slowdown in China, one of Indonesia’s major export markets. As a result, export commodity prices are also expected to maintain negative growth in

<table>
<thead>
<tr>
<th>Variable</th>
<th>Realization 2015</th>
<th>Outlook 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth (%, yoy)</td>
<td>4.8</td>
<td>5.2-5.6</td>
</tr>
<tr>
<td>Household Consumption*</td>
<td>4.8</td>
<td>5.0-5.4</td>
</tr>
<tr>
<td>Government Expenditure</td>
<td>5.4</td>
<td>6.4-6.8</td>
</tr>
<tr>
<td>Gross Fixed Capital Formation</td>
<td>5.1</td>
<td>7.2-7.6</td>
</tr>
<tr>
<td>Goods and Services Export</td>
<td>-2.0</td>
<td>-5.5 - (-5.1)</td>
</tr>
<tr>
<td>Goods and Services Import</td>
<td>-5.8</td>
<td>-5.1 - (-4.7)</td>
</tr>
</tbody>
</table>

Source: BPS-Statistics Indonesia, processed

*Consist of (i) Household Consumption and (ii) Non-profit Institutions Servings Household Consumption

<table>
<thead>
<tr>
<th>Other Ministry/Agency’s Projects</th>
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<tbody>
<tr>
<td>225 National Strategic Projects and 1 Electricity Program</td>
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<tr>
<td>30 KPPIP Priority Projects</td>
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<tr>
<th>National Strategic Projects (PSN) Priority Projects</th>
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<td>Road</td>
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<td>Airport</td>
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<td>Port</td>
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<td>Housing</td>
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<td>Energy</td>
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<th>Priority Projects</th>
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<td>Water</td>
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<tr>
<td>ICT</td>
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<tr>
<td>SEZ</td>
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</tbody>
</table>

Source: Committee for Acceleration of Priority Infrastructure Delivery
2016. Although higher growth is forecasted for some of Indonesia’s major export destinations, this will not be sufficient to offset the overall fall in demand for Indonesia’s export products. Indonesia’s real export growth in 2016 is projected at about -5.5 to -5.1%.

Import growth is expected not to differ significantly from the previous year’s figure. With a situation of expanding domestic demand, while exports continue to chart negative growth, import growth in 2016 is projected at -5.1% to -4.7%. The lacklustre performance of imports at a time of rising investment is explained by the fact that the largest source of investment growth is investment in construction and infrastructure. Due to the less elastic nature of imports for construction/infrastructure investments compared to investment in machinery/equipment, the impact from higher investment on imports will be relatively limited. In addition, the downward trend in imports of raw materials in early 2016 also resulted from Indonesian manufacturing not yet operating at high capacity.

**GDP Outlook by Industrial Origin**

In keeping with improvement in domestic demand, the manufacturing sector will remain the leading contributor on the production side, followed by the transportation and communications sector and the construction sector. In 2016, similar to 2015, these three sectors will provide the main driver for the economy, particularly the construction sector driven by the public infrastructure development by the Government. Manufacturing sector growth is forecasted to reach 4.8-5.2% in 2016 as domestic demand begins to regain momentum (Table 16.2). The relatively limited growth in this sector is explained by the downbeat outlook for global commodity prices that can potentially become a disincentive for exporters of manufactured goods to increase their production capacity. Furthermore, growth in this sector is also supported by the metal industry, due to the public infrastructure investment.

The transportation and communications sector is expected to maintain the positive trend of past years. In 2016, this sector is predicted to grow by 9.2-9.6%. This growth will be driven by the expected progress on projects for expansion of ports and airports along with provision of transportation services.

### Table 16.2. GDP Projection by Industrial Origin

<table>
<thead>
<tr>
<th>Industry Segment</th>
<th>Realization 2015</th>
<th>Outlook 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>4.0</td>
<td>3.4-3.8</td>
</tr>
<tr>
<td>Mining</td>
<td>-5.1</td>
<td>-6.6 - (-6.2)</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>4.2</td>
<td>4.8-5.2</td>
</tr>
<tr>
<td>Electricity, Gas, and Water</td>
<td>1.6</td>
<td>3.3-3.7</td>
</tr>
<tr>
<td>Construction</td>
<td>6.6</td>
<td>8.7-9.1</td>
</tr>
<tr>
<td>Wholesale and Retail Trades, Accommodation, and Food Service Activities**</td>
<td>2.8</td>
<td>4.1-4.5</td>
</tr>
<tr>
<td>Transport, Storage, Information, and Communication***</td>
<td>8.5</td>
<td>9.2-9.6</td>
</tr>
<tr>
<td>Financial Services****</td>
<td>7.0</td>
<td>8.8-9.2</td>
</tr>
<tr>
<td>Other Services Activities*****</td>
<td>6.5</td>
<td>7.0-7.4</td>
</tr>
</tbody>
</table>

Source: BPS-Statistic Indonesia, Bank Indonesia calculation

**Consist of 2 industrial origins: (i) Electricity and Gas Supply and (ii) Water Supply**

**Consist of 2 industrial origins: (i) Wholesale and Retail Trades, Repair of Motor Vehicles and Motorcycles and (ii) Accommodation and Food Service Activities**

**Consist of 2 industrial origins: (i) Transport and Storage and (ii) Information and Communication**

**Consist of 3 industrial origins: (i) Financial Services, (ii) Real Estate and (iii) Business Services**

modes undertaken by the government as part of the medium-term infrastructure development plan. Within this context, the Government will undertake procurement of about 1,050 rapid transit buses for 32 provinces, construction of 10 ships for pioneer routes, procurement of 3 ferries for the Merak-Bakauheni crossing, expansion of 34 major and minor airports in 17 provinces, and expansion of 40 ports in 14 provinces. The Soekarno-Hatta Airport Terminal 3 Ultimate is slated to enter operation by the end of 2016. This project will support an increase in air transportation capacity while stimulating growth for other modes of transportation. Meanwhile, under the strategy for improving national connectivity, the Government will also develop mass transit systems including rail-based mass rapid transit and urban rail developments in 10 metropolitan centers.

Growing needs in data and communications will spur growth in the communications subsector. The need for communications networks will lead to steady growth in data and communications traffic in line with technological advancements and the burgeoning growth of the middle class. The government is pressing forward for expansion of broadband coverage in Indonesia by exploring possibilities for collaboration with various parties in the provision of telecommunications networks in areas with difficult access. Besides this, the development of the new 4G technology with high download and upload speeds is expected to bring about increased data use in Indonesia. Accelerated development of information and communications technology (ICT) infrastructure will boost development of the digital economy throughout Indonesia. This advancement of the digital economy will have a positive effect on future economic growth (see Box 16.1).

Higher growth in the construction sector is predicted at 8.7-9.1% in 2016. This sector will benefit mainly from the greater stimulus for acceleration of infrastructure projects following the issuance of Presidential Regulation No. 3 of 2016 concerning Acceleration of The Implementation of National Strategic Projects. After a period of delay in 2015 due to a consolidation process in government administration, the Government renewed efforts in 2016 to expand and speed up tender and procurement processes and embarked on construction for projects spread among eight sectors. These sectors are aviation, telecommunications and informatics, maritime transport, railways, electricity and energy, land and road transportation, housing and urban settlements, and water resources. Meanwhile, several projects are under way, including the construction of Terminal 3 Ultimate at the Soekarno-Hatta Airport, construction of the Kertajati Majalengka Airport, expansion of the Ahmad Yani Airport in Semarang, construction of the Kalibaru Priok terminal, construction of the Teluk Lamong multipurpose terminal, construction of the Trans-Java toll road (Cikampek-Palimanan, Bawen-Salatiga, and Solo-Ngawi-Kertosono), and construction of the Trans-Sumatra toll road (Bakauheni-Tegineneng, Pekanbaru-Dumai, and Kayuagung-Betung).

**Regional GDP Outlook**

In 2016, the aggregate growth outlook for various regions, notably Java, Sumatra, and Kalimantan, is brighter in comparison to 2015. In Java, the economy is forecasted to grow in the range of 5.6-6.0% on stronger investment performance driven by expansion in government development of infrastructure for agriculture (reservoirs, retention basins, and irrigation networks) and connectivity (roads, railways, seaports, and airports). In addition, the ongoing improvement in consumption and exports of manufactured goods will contribute to economic expansion in Java in line with improving expectations of private incomes and demand from export markets for Indonesian manufactured products. By comparison, the growth forecast for Sumatra is in the range of 4.2-4.7%. Upbeat economic growth in Sumatra is also expected in relation to the work in progress on large-scale infrastructure projects such as the Trans-Sumatra toll road, power plants, and sport facilities for the 2018 Asian Games. Meanwhile, Kalimantan is predicted to see stronger growth albeit on the lower end of the scale at 2.1-2.5%. The Kalimantan economy are expected to recover on stronger industry performance with the continuing development of downstream industry in some regions (smelters and manufacturing of CPO derivatives). In addition, it is also predicted a more upbeat performance in agriculture and mining sectors. However, further improvement in the Kalimantan economy will be limited in view of the gloomy outlook for mining commodity prices. In other developments, economic growth in Eastern Indonesia is forecasted at 7.1-7.5%, down in comparison to 2015 due to flagging performance in mining exports and private investment.

**Inflation Outlook**

Inflation in 2016 is forecasted to remain within the inflation target range of 4-4.1%. Moderate pressure is expected from core inflation. External factors affecting core inflation are kept under control with the prudently managed exchange rate volatility and sustained low international prices for non-oil and gas commodities. On
the domestic front, rising domestic demand is expected to meet with supply side response without giving rise to significant inflationary pressure. Inflation expectations are predicted to remain well anchored, in keeping with support from policy and close coordination between Bank Indonesia and the Government. Against this background, demand-side inflationary pressure is expected to remain relatively moderate.

Slightly higher inflation in the volatile foods category is expected for 2016 compared to 2015. This rise in volatile foods inflation is related to the persistent strength of domestic demand and potential for a shift in the planting season. The Indonesian Rice Millers and Rice Traders Association (PERPADI) announced that the most critical shortage of food supply, which normally falls in January-February each year, could stretch to January-March in early 2016 due to the El Nino. The very low rainfall in October 2015 meant that farmers, particularly those working in rain-irrigated cultivation, were unable to plant crops. As a result, the harvest in February 2016 will be less than in previous years due to postponement of the planting season. To ease pressure from volatile foods inflation in future periods, it is necessary to reinforce buffer stocks and increase production to curb price movements in foodstuff commodities.

In 2016, overall administered prices inflation (AP) is predicted to ease compared to the previous year. The forecast for the low AP inflation is bolstered by the implementation of a more flexible scheme for energy prices that are set according to market prices and the forecast for lower world oil prices in 2016 compared to the year before. However, in view of the likelihood of further subsidy reforms, price increases for government-regulated commodities such as electricity and subsidised bottled LPG gas cannot be ruled out in the future.

**Balance of Payments Outlook**

In 2016, the current account deficit is predicted to remain below 3% of GDP. This forecast for current account deficit is explained by rising non-oil and gas imports driven by domestic economic activities. While global demand is on the rise, the ongoing correction in global commodity prices and stubbornly low oil prices will limit the extent of export growth in 2016. On the other hand, non-oil and gas imports are predicted to climb in keeping with growth of domestic demand, which also linked to the government’s accelerated construction of infrastructure.

The outlook for lower global oil prices in 2016 will have an adverse effect on the outlook for oil and gas exports. The slide in world oil prices has potential to diminish investment in the oil and gas industry, which could worsen the existing contraction in oil and gas lifting caused by natural declining in ageing oil wells. This will reduce oil and gas exports, which in turn will bring downward pressure to bear on the oil and gas trade balance. As regards to imports, oil import volume is forecasted to rise in keeping with increasing consumption of fuels, but the value of these imports will decrease in response to low global oil prices. Overall, this will bring about a slight reduction in the oil and gas trade deficit.

The capital and financial account is expected to record an increased surplus on rising inflows of foreign capital through direct investment and a reduced deficit in other investment. The larger foreign direct investment surplus is consistent with the predicted increase in gross fixed capital formation supported by improving economic fundamentals. At the same time, the shrinking deficit in other investment is explained mainly by a fall in private sector fund placements in banks abroad. On the other hand, the impact of increases in the FFR will be to reduce inflows of non-resident capital. The more robust surplus in the capital and financial account is expected to cover the current account deficit, enabling the overall Indonesia balance of payments to stay in surplus.

**Outlook for Financial System Stability**

In 2016, financial system stability is predicted to hold steady, bolstered by the resilience of the banking system and improving performance on the financial market. In the forecast, the capital adequacy ratio (CAR) will remain high, well above the 8% regulatory minimum. In addition, non-performing loans (NPLs) will stay low and stable. Improvement is predicted in banking liquidity in response to the launching of more expansionary government financial operations. In keeping with the upbeat growth in the economy, stronger growth is forecasted for bank deposits and credit at 13-15% and 12-14%, respectively. The range of the projected credit expansion is still consistent with Bank Indonesia’s efforts to safeguard macroeconomic and financial system stability. Bank Indonesia will continue to promote an active banking role in support of efforts to manage the economy on a more prudent course in coordination with the Financial Services Authority. Meanwhile, upbeat performance is also predicted on the stock market and government bonds market, buoyed by positive investor perceptions of future improvement in the fundamentals and outlook of the Indonesian economy.
16.2. MEDIUM-TERM OUTLOOK FOR THE ECONOMY

In the medium-term forecast to 2020, economic growth will maintain an upward trend. This is supported by an improving outlook for the global economy and the beneficial effects of various structural policies enacted by the Government. Medium-term growth in the economy may reach as much as 6.3-6.8% in 2020 (Chart 16.1). On the domestic side, investment is set to grow in tandem with construction of infrastructure projects, improvement in the business climate, reform of the bureaucracy, and increased FDI. Government spending directed more towards capital expenditures and greater efficiency in allocation of subsidies will also contribute to higher investment. Implementation of structural reform programs and a series of policy packages will pave the way for increased productivity and thus bolster the production side, which in turn will help ease dependence on imports of intermediate and capital goods. These conditions will enable volatility in the rupiah to be curbed more easily and support the achievement of low, stable inflation (Chart 16.2).

Steady growth in household consumption is predicted for the medium-term. This trend is supported by the rising proportion of the working age population, which will increase the total workforce while simultaneously bringing down the dependence ratio (Chart 16.3). The steady downward trend in poverty and growing middle class population will also stimulate growth in household consumption. In other developments, predicted improvement of the contribution from exports will strengthen public purchasing power from export earnings, thus increasing household consumption. Government consumption is projected to record higher growth, buoyed by rising government revenues in tandem with stronger economic growth and the various measures taken by the government to enhance revenues.

In the medium-term, investment growth will be closely linked to the structural reforms now under way. A very important fulfilment of the structural reforms is construction of infrastructure, which represents a major focus in the government development plan. Numerous infrastructure projects which are now under construction in a various parts of Indonesia are expected to strengthen economic growth in the regions, particularly outside Java. Structural reforms will also involve necessary improvements to the investment climate to attract more investment to Indonesia and increase the contribution of MSMEs to economic growth. This is reflected in the various policy packages launched so far to support improvement in the investment climate. Surveys by a number of international institutions show that Indonesia remains a major destination country for investment, an indication that Indonesia is steadily gaining competitiveness. Besides this, Indonesia’s large and steadily growing market, particularly among the middle class, is a key driver for investment (Chart 16.4). To meet the growing and increasingly varied demand for goods and services for domestic consumption and export, it is necessary for investment to grow at a level commensurate with economic growth. In addition, there is considerable potential for investment in the MSME sector and outside Java to become a source of future economic growth.

Export growth is forecasted to improve in line with stronger global economic growth. More vibrant economic growth particularly in trading partners, positive growth in
commodity prices, and greater capacity for producing a wider variety of export goods are key to the forecast where contribution of exports to economic growth is expected to expand. Although some of Indonesia’s major export destinations, such as China and Europe, are forecasted to experience a moderate growth trend, some of the major destination countries and regions for Indonesian exports, such as the U.S., Japan and India, are predicted to maintain an upward growth trend. In addition, the operation of smelters, exports of minerals, and processing of mining products is expected to have a positive impact on exports from increased value added. In the medium-term, export growth is predicted to climb, bolstered by measures to improve competitiveness that include a competitive exchange rate, subdued inflation and diversification of markets and products.

Imports are also forecasted to climb in line with the economic growth trend. In view of the projection for higher investment growth, imports of capital goods in the form of machinery and equipment are also predicted to rise. Added to this, mounting levels of production to meet domestic and foreign demand will also drive demand for imports of raw materials. Imports of consumer goods are expected to grow in line with growth in household consumption.

Inflation in the medium-term is forecasted to be in the range of 3.5\%±1\% in 2020. Inflationary pressure from external factor will maintain a moderate trend consistent with expectations of only limited improvement in international commodity prices in the medium-term and low volatility in exchange rate movements. From the domestic side, it is expected that rising domestic demand will meet with a more robust supply-side response as structural reforms gain traction in increasing the capacity of the economy. Under these conditions, inflationary pressure from the demand side is predicted to be largely minimal. Inflation expectations will also remain low in line with implementation of monetary policy consistent with the prescribed inflation target, bolstered by strengthened policy coordination by Bank Indonesia and the Government.

In the medium-term, the balance of payments is set to improve with a sound current account deficit maintained at a sustainable level. This improvement will be driven mainly by non-oil and gas exports, where steady improvement is forecasted in line with continuing progress in global economic recovery and assumption of positive growth in non-oil and gas export commodity prices. On the other hand, higher domestic and export demand coupled with development of infrastructure will boost imports of raw materials and capital goods. In the oil and gas sector, the prospect of a gradual rebound in oil prices will affect potential improvement to oil export revenues. However, room for this improvement will become increasingly limited due to the natural decline in output from ageing oil wells. Gas exports are forecasted to maintain growth in line with the increase in assumed gas production, even in spite of the obligation to meet domestic oil and gas needs with 25% of oil and gas production. Meanwhile, oil imports are predicted to keep climbing in line with the growth of the middle class and the associated increase in fossil fuel consumption.

The forecast of steady improvement for the capital and financial account will enable it to finance the current account deficit. The more robust fundamentals of the economy achieved through implementation of the
government’s structural reform policies will create opportunity to stimulate capital inflows for both foreign direct investment (FDI) and placement in portfolio instruments. Through the increase in foreign capital inflows, it will be possible to meet the growing funding needs of development. Thus in the medium-term, with a prudently managed current account deficit and a surplus in the capital and financial account, Indonesia is predicted to chart a balance of payments surplus.

Risks

Looking forward, there are a number of risk factors that could still have adverse impact on the outlook for the economy. On the external side, the limited and unevenly distributed global economic growth may constrain future growth in the Indonesian economy, particularly in trade. The present composition of exports means that Indonesia’s export growth is heavily influenced by demand from emerging market nations and especially China. If growth in these countries declines further than expected, Indonesia’s exports may see reduced growth. Lower export growth will not only occur in terms of volume, but also value, given that the dynamics of growth in the world economy also influence international commodity prices.

Weaker international commodity prices may also trigger a reduction in potential output. If commodities remain the dominant component in Indonesia’s export structure, this will carry the risk of limited growth in the potential output of Indonesia. The reason for this will be slowing investment growth in response to the depressed prospects for commodity prices. The risk arising from limited growth in potential output will then be significant inflation at the time that economic growth gathers momentum.

Despite predictions of more gradual increases in the FFR, global financial markets still pose risks related to uncertainty of further monetary policy normalization. On one hand, the prolonged lack of clarity about the consistency of economic improvement in the U.S. suggests that increases in the FFR will be gradual. On the other hand, this uncertainty could also exacerbate investor perceptions of risk. The risk of investors engaging in risk on-risk off behavior may in turn exacerbate volatility in capital flows, and fluctuation in foreign capital inflows will then increase volatile movement in the exchange rate. This may lead to postponement of investment, rising domestic inflation, and escalating risks in corporate balance sheets.

The implementation of structural reform policies also carries some risks. When structural reforms are not implemented in accordance with the initial concepts set out in the National Medium-Term Development Plan (RPJMN 2015-2019), this may affect the achievement of economic growth targets. In addition, execution of infrastructure projects with high import content has potential to exacerbate the current account deficit, given the continuing limitations of domestic capacity. This in turn may disrupt macroeconomic stability. A further concern related to the current account and structural reforms is the risk that short-comings in the downstream development of the mining sector could undermine the external balances of the economy if the potential for maximum contribution to exports from refined mining products is not realized. If the various programs and policies announced in the past are not implemented properly and fail to meet their stated targets, this will exacerbate the risk that higher levels of economic growth will not be achieved. In view of these risk factors, the implementation of structural reforms will be crucial for the economy to achieve strong, sustainable and inclusive growth.
In recent times, the digital economy has become an issue of growing interest, both in Indonesia and worldwide. The digital economy itself is defined as “the virtual arena in which business actually is conducted, value is created and exchanged, transactions occur, and one-to-one relationship mature by using any internet initiative as medium of exchange” (Hartman, 2000). Initially, the concept of a digital economy consisted of three main components. First is supporting infrastructure, which includes but is not limited to hardware, software, telecommunications, networks, and so on. Second is e-business, or how the business process takes place, encompassing every process an organisation conducts over computer networks. Third is e-commerce, or how the process of transferring goods and services is also conducted over a computer network (Mesenbourg, 2001).

The rapid advancements in concept of the digital economy mean that it now exists in many varied forms and has taken hold in many sectors in the economy. This has implications not only for information and communication technology (ICT), but also other sectors, such as trade, transportation, finance, and health. In the retail sector, the most classical concept is that of e-commerce. In the transportation sector, the digital economy has given birth to the e-ticket concept and even automated vehicles in mass transportation. Even in the education sector, many have adopted the digital economy with open online courses, a concept initiated by Harvard University and MIT. Many books and journals are now bought and sold over the internet and in the form of soft files. In the health sector, the concept of the digital economy has been adopted in numerous forms, such as electronic records or even medical diagnoses presented with numbers and charts on a monitor.

The rapid expansion of the digital economy across the world is illustrated by a number of indicators. Investment in telecommunications is high and on a steady upward trend. The OECD (2015) notes that since 2000, worldwide investment in telecommunications has averaged 200 billion US dollars per year. As a result, the total number of telephone connections, consisting of analogue, digital (IDSN and DSL), modem, fibre optic, and cellular connections, reached about 2.1 billion in 2013. Fixed line telephones have been in decline since 2001, an indication of the growing preference of the world’s citizens for mobile telephones. The number of internet users also continues to grow, particularly in Asia (Chart 1). In 2016, the internet-based digital economy is expected to reach 5.5% of GDP in the G20 members with advanced economies and 4.9% of GDP in the developing countries of the G20 (Chart 2). This phenomenal growth in the digital economy has been spurred by the positive impact of its use. The study by OECD (2014) has shown that industries operating in information technology in the OECD nations enjoy higher labor productivity compared to that of the economy as a whole (Chart 3). This demonstrates that the use of digital technology has increased worker productivity. OECD data also points to the resilience of revenues earned by the top 250 ICT corporate players when the global financial crisis struck. While the revenues of these companies
indeed declined, they bounced back quickly. The positive impact of the use of digital technology is also evident in World Bank study showing that each additional 10 mobile telephones per 100 persons will bring about an 0.8% increase in the GDP in developing countries.

The digital economy has not only made economies more efficient, but also has consequences for the process of creative destruction (Schumpeter, 1942). An example is the competition between conventional transportation services and those using digital technology, as well as the competition between conventional shops and online shops. Due to its various advantages, digital technology will gradually displace conventional ways of doing business. During this transition process, there will be potential for adverse impact on the economy. On one hand, the use of digital technology will raise productivity and reduce production costs so that as a rule, customers will be better off. On the other hand, the conventional ways of doing business generally provide more jobs. Use of digital technology has the potential to displace conventional business and thus reduce employment.

In Indonesia, growth in the digital economy is expected to gather pace. At this time, the level of advancement lags somewhat behind, as indicated by the lower index for use of ICT compared to world and ASEAN averages (Chart 4). However, with the accelerated completion of ICT infrastructure projects, the digital economy is expected to gain more rapid momentum in Indonesia in keeping with the vast size of the market. Several studies about Indonesia (BCG, 2012) point to the impact of using the digital economy. In particular, internet use is predicted to climb from 0.1% of total sales in 2010 to 0.3% in 2016. Shopping purchases conducted with the method of Research Online Purchase Offline (ROPO), meaning that the buyer selects goods via online media and purchase offline, average about 16 US dollars per online user. With the growing activity of online shopping, spending on online advertising is also expected to climb from about 0.6% of total shopping advertising in 2010 to 2.1% in 2016 (Chart 5). The latest research also suggests that digital involvement of small and medium enterprises (SMEs) would boost Indonesia’s annual economic growth rate by 2% (Deloitte, 2015).

To prepare the way for the development of the digital economy and its significant effects on the economy as...
a whole, the Government has prepared an e-commerce road map with emphasis on seven issues of strategic importance: (i) logistics, (ii) funding, (iii) consumer protection, (iv) communication infrastructure, (v) taxes, (vi) education and human resources, and (vii) cyber security. In logistics, preparations involve the use of the National Logistics System (SISLOGNAS) blueprint to increase the speed of e-commerce logistic deliveries and reduce delivery costs. In funding, efforts include the finalisation of the Draft Government Regulation concerning e-commerce and establishment of a Public Services Agency that would be able to extend grants to digital MSMEs. Preparations in consumer protection include the building of consumer confidence through regulation, protection of industry participants and the phased development of the national Payment Gateway that will offer improved electronic retail payment services.

As envisaged in government programs, communications infrastructure will be upgraded and improved as it comprises the backbone to growth in the e-commerce industry. In addition to infrastructure, a further strategy to promote the digital economy is being pursued in taxation. The strategy to be executed includes simplification of taxation obligations and taxation procedures for e-commerce startup and provision of tax incentives for e-commerce investors. In addition, education will be provided for the entire e-commerce ecosystem in an effort to improve the education and qualifications of human resources working in this field. This will be complemented by awareness raising for online retailers and the public about cybercrime and the importance of security in electronic transactions. These government policies are expected to help the growth of the digital economy to generate positive impact for the economy as a whole.