Synergy, Transformation and Innovation towards an Advanced Indonesia

Structural shifts in the global economy, which have adversely impacted world economic growth, also posed challenges for the Indonesian economy in 2019. The 2019 Indonesia's economic growth was not as strong as the year before, but displayed resilience owing to brisk domestic demand and prudently managed stability. These developments represent the outcome of stronger policy synergy between the Government, Bank Indonesia and other relevant authorities. In the medium term, steady improvement is predicted for the Indonesian economy despite downward revisions to the 2020 growth outlook, due to the effects of the COVID-19. A strong medium-term outlook will require continued support from all parties working in synergy in order to accelerate economic transformation and foster innovation, including digital innovation, so as to pave the way for Indonesia to become an advanced country.

OVERVIEW

The economic dynamics of 2019 highlight three strategic elements that will underpin the continuity of economic growth, namely Synergy, Transformation and Innovation. Synergy has emerged as a key element after highly productive cooperation among policy makers played a visibly strong role in addressing the global challenges that impacted the Indonesian economy in 2019. This synergy enabled the Indonesian economy to remain resilient in 2019, yielding prudently managed stability and sound economic growth, notwithstanding a mild slowdown from 2018. Policy synergy has also gained importance as it will support an accelerated transformation of the Indonesian economy with a more robust structure and new sources of economic growth. Furthermore, policy synergy aims at sustained development of innovations, including economic and financial digital innovations, which will promote quality, inclusive economic growth.

These three strategic elements have become key in responding to growing structural shifts in the global economy. These shifts began with more inward-looking policies that have spread to many countries, including with regard to international trade relations. The second shift is related to the rising volatility in international capital flows that have kept world financial markets in a state of heightened uncertainty. On-going integration of world financial markets has exacerbated this condition. Further along these lines, the shifts are related to rapid advances in economic and financial digitalization, which have transformed the behavior of economic agents. This combination of factors has increased the complexity of macroeconomic management, due to resulting changes in policy effectiveness. As a result, macro strategy can no longer rely upon a single policy or instrument; it must be supported by other policies within an integrated policy framework.

These shifts in the global economy, particularly inward-looking behavior and rising volatility on financial markets, led to weaker world economic growth in 2019. The 2019 global growth slowed to 2.9% from 3.6% in 2018, with concomitant declines in world trade volume and commodity prices. In response, global financial uncertainty remained high until the third quarter of 2019, leading to reduced capital flows into emerging markets, including Indonesia. Uncertainty on global financial markets began to ease in the final quarter of 2019, following the fiscal and monetary stimulus actions launched in various countries to mitigate the risk of economic slowdown. These responses include action by the US Federal Reserve Board, which initiated further reductions in the Fed Funds Rate (FFR) at the end of June 2019. In addition to anti-cyclical policies, many countries also pursued structural policies to bolster economic resilience, despite slow progress due to the ongoing weakness in the world economic cycle.

Resilience of the Indonesian Economy

Slower global economic growth led to decline in Indonesia's exports in 2019 (Diagram 1). In that year, exports contracted by 0.87%, in sharp contrast to the 6.55% growth recorded in 2018. The decline in exports was fairly steep during the first half of 2019, before easing in the second half of the year in response to increased demand for some export products, notably crude palm oil (CPO) and coal. The upturn in exports for some products represented the effect of diversification of products and export destinations, as well as some domestic policies. Diversification of export products was further supported by improved competitiveness of some goods including iron and steel, automotive products, pulp and wastepaper, gold and textile fibers. Export destinations also diversified to include potential markets as ASEAN (Association of Southeast Asian Nations) countries and Saudi Arabia, particularly for iron and steel products. This was accompanied by improvement in nickel and copper exports in response to domestic policies.

In the face of this downturn in exports, domestic demand was moderately only slightly, helping to sustain the Indonesian economy at the healthy growth rate of 5.02% in 2019. Private consumption edged upwards, bolstered by sustained purchasing power from steady incomes and low inflation alongside buoyant consumer confidence. Private consumption was also boosted by the 2019 national elections that spurred growth in consumption by non-profit institutions serving households (NPISHs). Investment remained strong, supported mainly by sustained high activity in construction, spurred by development of infrastructure; work on national strategic projects; and upbeat performance in private sector construction. However, non-construction investment was down mainly due to the contraction in exports and the mild moderation in domestic demand compared to the preceding year. Resilience of the economy also reflected adjustments in the domestic economy that led to a decline in imports.

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Overall, sustained growth in 2019 had a positive effect on general welfare as reflected in lower rates of poverty and unemployment.

The resilience of Indonesia’s economic growth was supported by efforts in many regions to optimize interregional trade. This led to growing interregional trade, such as in palm oil products related to the implementation of the B20 program, which supported economic growth in Sumatra. Similarly, higher economic growth in the Bali-Nusa Tenggara (Balinusra) region was fueled by an upward trend in exports of copper and nickel ore. Economic growth in Kalimantan benefited from rising exports of primary commodities, including coal to China. However, economic growth in the Java and Sulampua (Sulawesi-Maluku-Papua) regions slowed mainly due to declining exports and constraints impacting copper production in the Sulampua region.

Resilience of the domestic economy attracted foreign capital inflows, which strengthened rupiah and contributed to a surplus in the overall balance of payments. The balance of payments recorded an overall surplus of USD4.68 billion in 2019 versus a deficit of USD7.13 billion the year before. This 2019 balance of payments surplus was partly accounted for by a wider surplus in the capital and financial account (CFA). This strength was consistent with investor optimism towards Indonesian economic outlook; the attractiveness of financial returns in the domestic financial market; and reduced uncertainty in world financial markets during fourth quarter 2019. A narrower current account deficit (2.72% of GDP in 2019 versus 2.94% in 2018) also contributed to the 2019 balance of payments surplus.

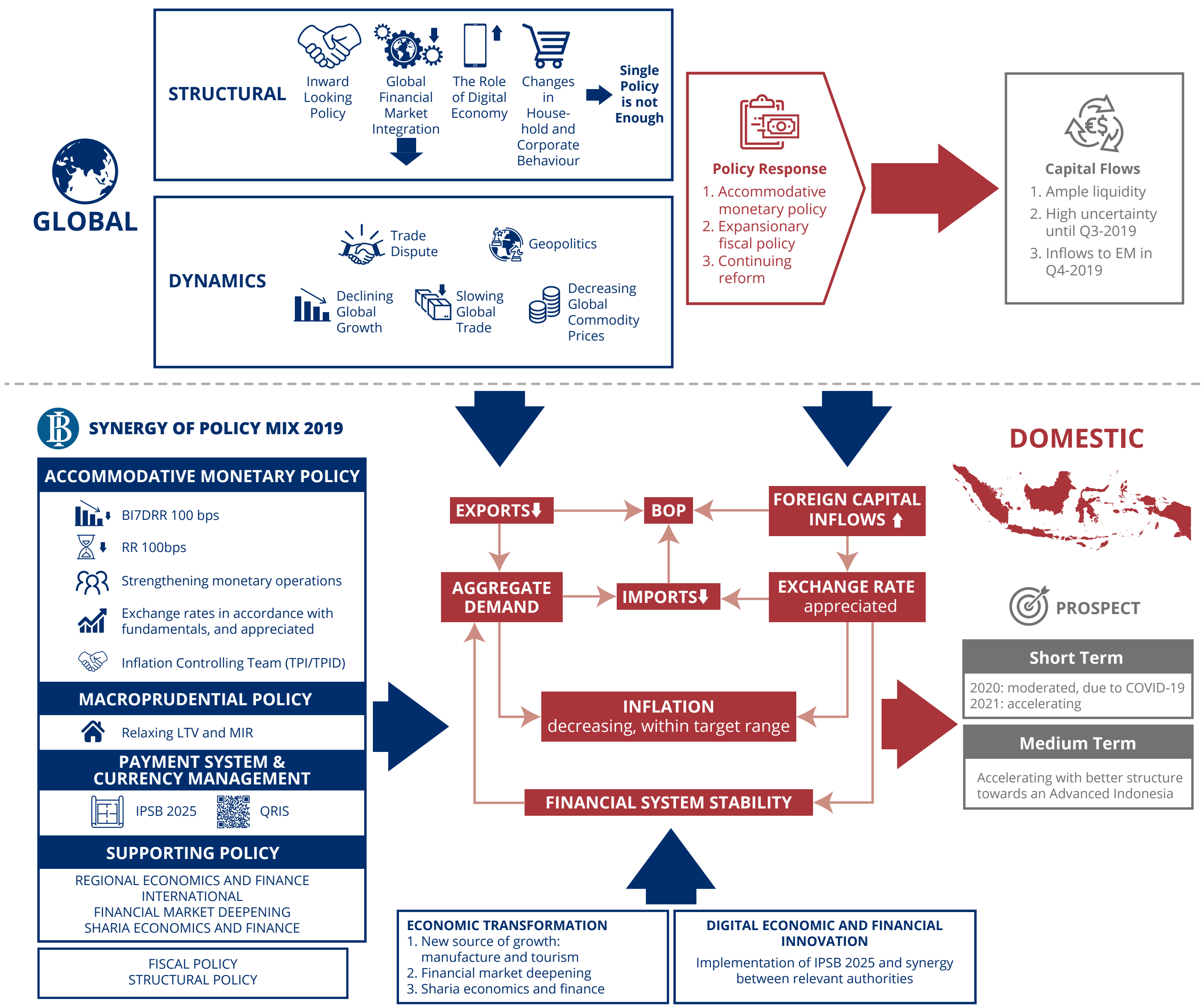
During 2019, official international reserves increased to USD129.18 billion, the equivalent of 7.33 months of imports and servicing of official external debt. This is well above the three months of imports that represents the international standard of adequacy. The strong external sector performance contributed to an appreciation of the rupiah, which gained 0.76% on average in 2019. Measured on a point-to-point (ptp) basis, it strengthened by 3.58% during 2019, closing the year at IDR13,883 per US dollar. Stability of the rupiah was supported by a deeper and more efficient structure of the forex market, including the Domestic Non-Deliverable Forward (DNDF) market.

Inflation remained subdued in 2019, helping to maintain macroeconomic stability. Consumer Price Index (CPI) inflation during 2019 was 2.72%, down from 3.13% a year before, and it remained within the target range of 3.5±1%, continuing the pattern of the past four years. The low inflation in 2019 is explained by prudent management of cyclical factors in domestic demand; appreciation in the exchange rate; and low administered price inflation. In addition, inflation remained low in response to structural improvements, such as the growing role of inflationary expectations in shaping and anchoring inflation; the declining impact of the exchange rate on inflation; and the positive effect of synergy between the Government and Bank Indonesia in controlling food inflation.

Financial system stability also remained well, supported by sound monetary policy transmission. During 2019, the Financial System Stability Index (ISSK) remained within the normal range, bolstered by healthy performance of financial institutions and financial markets, as evidenced by a strong Capital Adequacy Ratio (CAR); a low level of Non Performing Loan (NPL); and a high ratio of bank liquid assets to non-core deposits. Transmission of monetary policy, especially into the money market, further supported this stability. Furthermore, liquidity remained adequate in the money market and in the banking system, although the transmission to bank interest rates was suboptimal.

The bank intermediation function in 2019 demanded attention. Bank credit expansion was 6.08% during 2019, down considerably from the 11.75% during 2018. On the demand side, lower credit growth was driven by the behavior of corporates, which delayed credit applications in response to flagging exports and falling non-construction investment. On the supply side, banks

Diagram 1. Global Economy and the Dynamics of Domestic Economy



exercised greater caution in lending due to global uncertainties that could impact the performance of domestic corporates. Low credit expansion impacted growth in board money (M2); its growth was 6.5% during 2019, up only slightly from 6.3% the year before.

The payment system continued to operate smoothly. Growth in cash outside banks remained positive amid a brisk pace of innovation and growth in non-cash instruments. In the position for December 2019, non-cash payments carried out with ATMs, debit cards, credit cards and electronic money were up by 2.45% (yoy), with growth dominated by ATM/debit card instruments which represent a 92.92% share. Electronic money transactions soared by 188.31% (yoy), which points to the public's mounting preference for using digital money in conducting transactions.

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Policy Synergy to Support Economic Resilience

The resilience of the Indonesian economy amid deteriorating global economic conditions is partly the result of policy synergy among the Government, Bank Indonesia and related authorities. The overall policy response was directed at stimulating the economy growth back to its optimum trajectory. The dynamics of the economy in 2019 pointed to the need for further stimulus of Indonesia's economic growth and for higher credit growth. This stimulus was intended to boost the economic growth and to shorten the cycle of slowdown, so as to return growth quickly to an optimum level. This policy response was possible in view of the prudently managed stability of the economy that created space for accommodative policies to boost economic growth without derailing stability.

The policy synergy aimed at boosting economic growth; maintaining economic and financial system stability; and strengthening the economic structure. To this end, the Government increased the fiscal policy stimulus in 2019 to boost economic growth while continuing to safeguard fiscal sustainability. Fiscal policy was eased through three key strategies in 2019: mobilization of revenues while supporting improvement in the investment climate; improving the quality of expenditures for greater effectiveness and productivity in support of priority programs; and promoting efficiency and innovation for creative financing. The three strategies contributed to the maintenance of fiscal sustainability with a realized 2019 budget deficit of 2.2% of GDP, well below the legal limit of 3%. In that note, government debt remained at sound level in 2019, namely 30.2% of GDP.

Structural policy was another part of the policy synergy to accelerate the economic transformation of Indonesia into a developed country. Implementation of the 2020-2024 National Medium Term Development Plan (RPJMN) will have great strategic importance for achieving Indonesia's vision of becoming an advanced economy given that it represents the final phase of the 2005-2025 RPJPN. In this context, the Government has laid down five key strategies for accelerating economic transformation. These are: human resources development involving the building of competent expertise and mastery of science and technology; development of infrastructure to support connectivity for industry and tourism; streamlining regulations via omnibus laws with priority accorded the Law on Job Creation and the Law on General Provisions and Taxation Facilities for Strengthening the Economy; streamlining the bureaucracy; and policies to reduce economic dependence on natural resources, by shifting towards competitive, high value added manufacturing and services. The economic transformation will be supported by policy synergy involving Bank Indonesia, the Government, the Financial Services Authority (OJK) and related agencies that have maintained a consistent course in pursuing structural reforms.

In 2019, Bank Indonesia pursued accommodative policy mix for an optimum combination of maintaining economic stability and promoting economic growth. This policy direction has been taken after careful assessment of economic stability, which has been maintained while economic growth and credit expansion have fallen below their optimum levels. These conditions allowed room for Bank Indonesia to stimulate economic growth without disrupting stability of the economy. Bank Indonesia is confident that the current policy mix, consisting of monetary policy, macroprudential policies and payment system policy, as well as other supporting policies, have mutually complementing and reinforcing linkages that will support the sustainability of economic growth.

The selection of instruments and determining timing for implementing accommodative monetary policy took due consideration of the dynamics in global financial markets in 2019. In the first half of the year, Bank Indonesia took careful account of heightened uncertainty in global financial markets, especially by keeping unchanged the level of its key policy rate (the BI 7-Day Reverse

Repo Rate, BI7DRR). In these adverse global conditions, Bank Indonesia consistently focused on efforts to maintain adequate banking liquidity for prudent management of financial system stability. These efforts were reinforced by strengthening monetary operations and maintaining rupiah stability. The policy response produced visible results concerning financial and economic stability, thus creating space to ease monetary policy for purposes of bolstering economic growth. In view of the heightened uncertainty on global financial markets during the period through June 2019, Bank Indonesia only opted to relax monetary policy by lowering the rupiah-denominated statutory reserve requirement in June 2019. After global financial market uncertainties eased following the cut in the FFR in July 2019, Bank Indonesia take the additional step of lowering the BI7DRR policy rate. Subsequently, Bank Indonesia took additional accommodative steps, including using macroprudential policies, the payment system and other supporting policies.

Bank Indonesia has pursued an accommodative monetary policy by lowering the statutory reserve requirement and the policy rate. It was not until almost mid-year when Bank Indonesia loosened monetary policy, bearing in mind the available space afforded by reduced pressures from inflation, the exchange rate and prudently managed financial system stability. Even then in June 2019, Bank Indonesia opted to use a quantity-based instrument for loosening money policy; it lowered the rupiah statutory reserve requirement by 50 bps to 6.00%, thus providing IDR25.3 trillion in direct, additional liquidity to the banking system. Then, during the second half of 2019, Bank Indonesia took advantage of further space for relaxation, by lowering the BI7DRR after uncertainties eased on global financial markets. In July 2019, the BI7DRR was reduced by 25 bps to 5.75%, and there were further cuts in August, September and October 2019. The BI7DRR was reduced by 25 bps on each of these occasions, to 5.00%, where it remained through December 2019. These cuts reflected more favorable conditions on global financial markets; the continued attractiveness of domestic financial assets; low inflationary pressure; and a steady exchange rate. Lastly, Bank Indonesia again employed the rupiah statutory reserve instrument in November 2019, when it was lowered further by 50 bps to 5.5%, with effect from 2 January 2020.

Bank Indonesia took other steps to reinforce the monetary operations in managing money markets and the rupiah exchange rate. In the money market, Bank Indonesia sought to ensure adequate liquidity, while accelerating monetary policy

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transmission. To this end, Bank Indonesia implemented two-sided monetary operations by redistributing liquidity on both the absorption and injection sides. Moreover, Bank Indonesia strengthened monetary operations by standardizing the instruments for open market monetary operations with the launching of the government securities reverse repo (RR SBN) in all tenors from 7 days to 12 months. Concerning the rupiah exchange rate, Bank Indonesia consistently safeguarded the value of rupiah to avoid excess volatility and in so doing support expectations held by economic actors and ease their decision-making. Relating to this, Bank Indonesia pursued a rupiah stabilization policy with a strategy of triple intervention in the spot market, DNDF market and purchases of government securities on the secondary market.

Bank Indonesia also continued accommodative macroprudential policies by promoting financing to offset the sub-optimal state of the economic and financial cycles, while upholding prudential principles. In this regard, Bank Indonesia relaxed the Macroprudential Intermediation Ratio (MIR)/Sharia MIR to 84-94% and broadened the source of funds used in calculating the MIR, to include prudent external borrowings. The Loan to Value/Financing to Value (LTV/FTV) regulation was also eased to an average of 5-10% to facilitate home and vehicle ownership, including ownership of environmentally friendly vehicles. Further support for accommodative macroprudential policies was provided by policies for development of the sharia economy and MSMEs. Macroprudential policy also ensured adequate capital and liquidity; in 2019, Bank Indonesia maintained the Countercyclical Capital Buffer (CCB) and Macroprudential Liquidity Buffer (MLB) at 0% and 4%, respectively. Prudently managed financial system stability was also supported by policy synergy among the authorities involved in the financial sector, such as in the Financial System Stability Committee (KSSK).

Further measures, with digitalization as key element, were taken to strengthen the payment system in order to support economic growth. In this regard, Bank Indonesia will keep working for broader-based and accelerated electronification of non-cash payments through, for example: distribution of government social assistance; payment transactions in the transportation sector; and management of regional government financial transactions in various provinces, districts and municipalities. For the private sector, Bank Indonesia has launched the Indonesia Payment System Blueprint (IPSB) 2025, which is a comprehensive policy to address disruptions from digital transformation. The Blueprint is designed to support the integration of the digital economy and finance on a national scale and thus safeguard the central bank functions in the currency circulation process; monetary policy; financial system stability; and financial inclusion. In the area of cash currency, the coverage of currency circulation will be expanded to various regions within the territory of the Republic of Indonesia in tandem with efficiency improvements, while safeguarding the quality of currency in circulation.

Constrained Economic Growth in 2020, Promising Outlook in Medium Term

Looking forward, Bank Indonesia forecasts that economic growth in 2020 will be below the 2019 rate due to the impact of the coronavirus 2019 (COVID-19), which has spread worldwide. In early 2019, Bank Indonesia predicted that Indonesia's economic growth would be in the range of 5.1%-5.5% in 2020. This forecast was influenced by optimism for global economic recovery and improvements in commodity prices that would boost exports and investment, most importantly in non-construction investment. However, in the wake of COVID-19 that broke out in China during February 2020, Bank Indonesia scaled back its 2020 forecast to 5.0-5.5%. This outlook considered the direct and indirect impact of losses in China's economy. Influencing this forecast was China's sizable role in the Indonesian economy, especially in tourism, exports and investments.

In March 2020, Bank Indonesia projected that the spread of COVID-19 to many countries would deteriorate global economy outlook, including Indonesia. Consequently, the forecast for Indonesia's economic growth in 2020 was revised further downwards to take account of declining supply and demand, including the impact of disruptions to production and loss of confidence. These are largely due to containment measures against the spread of COVID-19, which restrict the mobility of economic actors in many countries, including Indonesia. This will impact heavily on many sectors of the economy, such as tourism, trade and manufacturing, with a domino effect on other sectors. These conditions will harm exports of goods and services and reduce the growth of private consumption and investment. Uncertainty has also mounted in financial markets due to the deterioration in the global economic outlook that has impacted investment in emerging markets, including Indonesia, by via short-term capital flows. This will ultimately put pressure on many of the world's currencies, including the rupiah. In light of developments through March 2020, Bank Indonesia revised downwards the outlook for Indonesia's economic growth in 2020 to 4.2-4.6%.

Amid the deteriorating economic outlook, economic stability is predicted to hold firm. The 2020 balance of payments is projected to remain in safe territory, bolstered by a lower current account deficit in the range of 2.5-3.0% of GDP. In 2020, subdued inflation is forecast in the 3.0±1% range. Contributing to this is a safe level of core inflation due to the anchoring of inflationary expectations to the target corridor whereas moderate demand will help keep core inflation down. Meanwhile, financial system stability is forecast to remain strong, despite renewed challenges faced by bank intermediation due to the fall in economic growth. Bank Indonesia has revised the credit growth projection for 2020 to 6.0-8.0%, while growth in third party funds (DPK) is similarly forecast at 6.0-8.0%.

The global and domestic economic outlooks for 2020 would depend on the effectiveness of measures to contain the impact of COVID-19 and the speed of economy recovery. The risk of prolonged spreading of COVID-19 to more parts of the world carries the risk of a more pronounced slowdown in global growth and the world trade volume. If this happens, it could lead to further corrections in the economic growth outlook for Indonesia. The growing interconnectedness in trade and the financial system across international borders means that the impact of a downturn in global growth will be transmitted more rapidly to other nations.

Indonesian economy is projected to regain upward momentum in 2021 in line with the post-COVID-19 global economic recovery. This forecast is supported by projections of higher, post COVID-19 global growth in 2021, as the pressures from COVID-19 fade. On this basis, Indonesia's economic growth would recover to 5.2-5.6% in 2021, while inflation would be in the range of 3.0±1%. This inflationary outlook is anchored in low inflationary expectations; prudently managed demand; and improvements in external conditions that will help keep core inflation low and stable. The outlook for volatile foods inflation remains well under control, with food inflation in most regions predicted to remain within safe limits. Underpinning this outlook is the work of the Regional Inflation Control Teams (TPIDs) in forging stronger interregional cooperation for safeguarding food stocks, which will help support achievement of the inflation target at the national level.

In the medium term, Indonesian economy is projected to gather strength in line with the global economic recovery and increased domestic economy productivity. A global economic recovery that stimulates world trade and boosts global commodity prices will create opportunities for Indonesia to strengthen external sector performance. In addition, productivity is predicted to improve in Indonesia in keeping with positive outcomes from the structural reforms under way and by tapping into the demographic bonus. For the medium term, Bank Indonesia forecasts economic growth at 5.5-6.1% with steady inflation inside the target range and a current account deficit in the range of 2.2-2.7% of GDP over the period ending in 2024. The balance of payments will remain in good condition over the medium term, with a prudently managed current account deficit and increased foreign capital inflows. The medium term will also see subdued inflation on a downward trend in response to steady productivity gains and expansion in the capacity of the economy. The forecast for subdued inflation is accompanied by a reduction in disparity of inflation across regions of Indonesia and over time. Overall, with this path going forward, Indonesia is forecast to become a high-income developed country by 2045.

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Economic Transformation and Digital Innovation to Support Medium-Term Growth

Bank Indonesia is confident that the Indonesian economy will achieve the goals envisaged in the medium- to long-term outlook with support from an accelerated economic transformation. This process will be crucial because economic transformation is a precondition for Indonesia to join the ranks of high-income countries by 2045. Part of the economic transformation involves strengthening the role of priority sectors that can generate high value added for the economy. The priority sectors are those capable not only of driving economic growth, but also of strengthening external resilience through improved performance in exports of goods and services. Similarly, the economic transformation also relates to strengthening of production sectors through increased investment. Further support for increasing value added in the economy will come from empowerment of various domestic resources used as production inputs and the strengthening of supporting infrastructure, including infrastructure in the financial sector.

There are several priority sectors that can be strengthened to serve as new sources of economic growth. Manufacturing sector is one of a number of sectors envisaged to accelerate Indonesia's economic transformation. The building of a more robust manufacturing sector involves a two-pronged approach of expanding the role of manufacturing sector in driving export performance and in generating increased value added. Strengthening of manufacturing sector is moving forward under a comprehensive, integrated and inclusive end-to-end strategy. Economic transformation also envisages the development of tourism as a source of foreign exchange and a new source of economic growth. Under these conditions, it is expected that development of the tourism sector, especially the revenues from inbound tourists, will support a narrower current account deficit, which underscores the importance of realizing the potential of tourism destinations in terms of their quality and competitiveness. The drive to expand the tourism sector involves the 3A2P approach (Access, Attractions, Amenities, Promotion and Providers) supported by the policy synergy among the relevant authorities.

Economic transformation will be further accelerated by optimizing the potential of the sharia economy and finance, and by increasing the pace of financial market deepening. Development of the sharia economy targets an increased role for halal manufacturing and Muslim-friendly tourism, which in turn can boost demand for sharia compliant financing. This strategy is being pursued by an integrated approach through development of the halal value chain ecosystem with support from sharia compliant financing and improved literacy in the sharia economy and finance. In parallel, Bank Indonesia and the relevant authorities have been working in synergy for financial market deepening with focus on developing sources of financing and risk management; development of financial market infrastructure; and establishment of a regulatory framework. A further aim of financial market deepening is to support the development of infrastructure, which represents one of the priorities of the medium-term development plan.

Efforts to support innovation for greater integration of the digital economy and finance will be another key to strengthening the outlook for the Indonesian economy in the medium- to long-term. This strategy is important as the expanding digital role in various economic and financial activities has changed the behavior of economic agents. In turn, these changes will necessitate an appropriate and comprehensive policy response.

On one hand, the rapid pace of digital technology innovation in the financial industry has boosted efficiency and created new sources of growth. Changes in private consumption and the increasingly modular industrial linkages among economic actors offer opportunity for new and ever faster, easy and low-cost business models. New players have emerged in industry and won over consumers, compelling longer-established players to undergo digital transformation. On the other hand, the risks associated with these changes need to be properly mitigated. In the financial sector, the risk of shadow banking is looming, as is the risk of concentrated control of data that can lead to monopolization of key parts of the digital economy. Cyber risks and digital disruption of the labor market must also be taken into account.

Bank Indonesia has developed IPSB 2025 as a policy response to promote the integration of the national digital economy and finance while ensuring the continued operation of central bank functions and supporting economic and financial inclusion. The IPSB 2025 is fully oriented to the development of a healthy ecosystem to set the course for development of the digital economy and finance in Indonesia. Five visions of Indonesia Payment System (IPS) 2025 have also been formulated as the end-state of the long-term policy direction of Bank Indonesia. The overarching IPS 2025 vision will be pursued through five initiatives. To implement this vision, Bank Indonesia will focus on three key aspects: data openness; development of payment system infrastructure; and integrated regulation of the payment system.