Standing Tall

Stormy wind and crashing waves. Inflicting wound, inflicting pain.
But the will still forge on strong. Keeping us standing tall.

Part 2
Indonesia's Macroeconomic Resilience

In the midst of the ongoing global economic upheaval, Indonesia's economy remained strong and showed improved performance. Economic growth in 2011 continued to keep up with increasing trend and reached 6.5%, the highest over the last decade, coupled with low inflation rate – in term of Consumer Price Index – of 3.79%. The inflation rate is below the inflation target of 5%±1%, thereby helping to accelerate disinflation process towards the much lower long-term target, a level that is at par with the inflation level of Indonesia's trading partner countries. The high level of economic growth was contributed by the strength of export performance in the midst of the global economic downturn and increasing investments. The quality of economic growth also improved as reflected in the decline in the poverty and unemployment. On spatial terms, higher economic growth and declining inflation occurred in almost all regions in Indonesia. Compared to other neighboring countries, in the midst of slower economic growth in emerging market economies including the ASEAN countries, Indonesia's economy, in contrast, showed a notable growth. As for the inflation which over the last decade was among the highest in the region, the inflation rate was similar to those of other countries in the region.

The domestic economy's resilience was reflected in the increase in exports amidst global economic slowdown and strong domestic demand. A number of factors have contributed to Indonesia's strong exports. First, the diversification of export destinations to the emerging market Asia such as China and India whose economic growth were still relatively high supported by domestic demand that continued to be strong. Secondly, the characteristic of export commodities to those countries –dominated by energy and food commodities – that were not significantly affected by shrinking volume in global trade. From a domestic perspective, Indonesia's economic resilience was also supported by several factors. Firstly, strong consumption that was supported by improving purchasing power in line with the growth of per capita income, particularly the upper middle income segment of the population. Secondly, the increase in the number of people categorized within the productive age, as well as employments in formal sector. Thirdly, increasing source of economic growth within regions thereby resulting in ever more equitable economic growth. Fourth, strong consumption was responded by an increase of investment which will expand capacity of domestic economy.

The economic resilience and improved economic outlook has enhanced foreign investors' confidence and accordingly drove FDI to play an increasingly important role. In 2011, share of FDI in the structure of capital inflow was significantly increased compared to the

share in previous year with sharp growth increase in mining and manufacture sectors. Increasing role of FDI was able to continuously support strong Balance of Payments performance in the midst of declining capital inflowa in particular foreign portfolio investments due to rising global uncertainty in the second half of 2011. Along with strong export performance, the development of FDI produced a relatively substantial NPI surplus and increased foreign exchange reserves thereby buffering impact of any external shocks. Consistent with strong Indonesia's Balance of Payment performance in 2011, rupiah exchange rate was relatively stable and tended to strengthen against US dollar. This was in line with regional currencies movements. Overall, the rupiah exchange rate in 2011 experienced a slight appreciation of 3.56%, despite the weakening trend experienced in the second half of 2011.

Inflation in 2011 was successfully maintained at a significantly low level. This was attributed to the policy coordination between Bank Indonesia and the Government. From Bank Indonesia's perspective, policies were aimed at anchoring inflation expectations, managing domestic demand and reducing the impact of rising global inflation as a result of increasing global food commodity prices. This was reflected from low and stable core inflation in the midst of accelerated domestic economic activities. From the Government's side, policies were directed at supporting food security and maintaining stable energy prices such as fuel, electricity, and gas. Those policies significantly reduced volatile food inflation and successfully maintained administered price inflation at a relatively low level. The low level of volatile food inflation was also helped by the decline in the prices for global food commodities in the second half of 2011. In the regional level, enhanced coordination through the TPID forum was also effective in reducing inflationary pressure as reflected in the lower inflation in almost all regions in Indonesia.

Optimism on continued acceleration of economic activities and macroeconomic stability was supported by structural improvements. This was reflected by, among others, improvement in infrastructure developments and Indonesia's success in obtaining an investment grade rating. The endorsement of the Land Procurement for Development Act and various Government programs to support infrastructure development such as the Infrastructure Guarantee Program and the Indonesian Economic Development Acceleration and Expansion Masterplan (Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia or MP3EI) is expected to accelerate investments in the years to come.

Chapter III

Economic Growth

Economic Growth

Indonesia's economy in 2011 grew strongly at 6.5%, improved over the previous year and reached the highest growth experienced within the last decade. On the demand side, the growth was primarily supported by an increase in consumption and investment performance, while on the supply side the primary contributor was supported by manufacturing and trade sectors performance. The growth was accompanied by an improvement in the quality of growth as reflected by increasing in investments contribution and continuing high exports contribution, declining unemployment and poverty, and rising economic growth contribution from outside of Java. The high economic growth in the midst of a weakening global economy was supported by both high growth in the domestic economy and also continued high growth of exports. The performance of the domestic economy, especially with regard to consumption, was supported by the large capacity of the domestic economy, which come from a rise in purchasing power, the growth of the middle and upper class, a high proportion of productive age population, and rising employment in the formal sector. These conditions encouraged domestic and foreign business optimism, thus enhanced investment. Meanwhile, Indonesia's strong export performance was supported by its ability to take advantage of intra-regional trade, particularly with countries whose economies were reoriented to focus on their domestic economies.

3.1 Economic Growth Performance

In the midst of an uncertain global economic recovery, Indonesia's economy strengthened. Indonesia's Gross Domestic Product (GDP) grew from 6.2% in 2010 to 6.5% in 2011 (Chart 3.1). This was the highest rate of growth since the 1997 crisis. Stable macroeconomic conditions such as low inflation, relatively stable exchange rate volatility, and stable political and security conditions in the country contributed to high economic growth.

On the demand side, economic growth came primarily from strong household consumption and from high investment growth. Stable purchasing power, which was in line with low inflation and rising incomes, was the factor that drove strong household consumption. Under these conditions, household consumption grew 4.7%, higher than the 4.4% average. Meanwhile, stable macroeconomic fundamental was sufficiently strong enough to support the more conducive business climate and to increase business optimism, thus driving investment performance. Under these favorable conditions, investment growth increased to 8.8%, outpacing its historical average of 7.4%. In addition to household consumption and investment, exports that continued to perform well despite the weakening global economy, also contributed to the development of Indonesia's economic. Strong export performance that was supported by the successful diversification of export destinations, particularly to emerging market countries in Asia, enabled export to grow 13.6%, well above historical levels of 7.5% (Chart 3.2).

On the production side, the tradables sector showed an improvement in growth, while the non-tradables sector remained stable with high rates of growth.[1] In 2011, the tradables sector grew 4.5%, a fairly significant increase compared with 4.0% in the previous year. Meanwhile, the non-tradables sector achieved high growth at 8.2%, approximately the same as in 2010 (Chart 3.3). In line with its accelerating growth, the contribution of the tradables sector to economic growth also expanded, although non-tradables remained to dominate.

1 The tradables sector comprises farming, mining and manufacturing industries, while the non-tradables sectors comprises construction ; trade, hotel and restaurant ; finance, leasing and services ; transport and communication ; and service

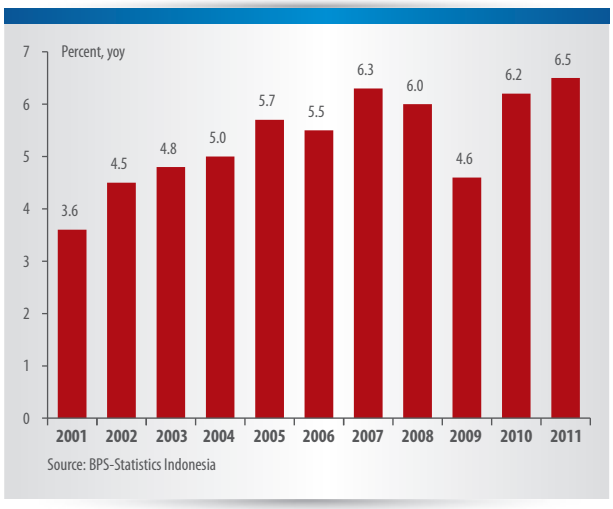


Chart 3.1 Economic Growth

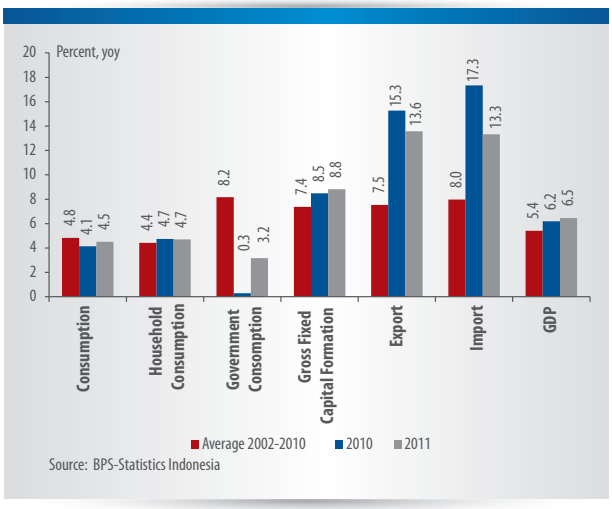


Chart 3.2 GDP by Expenditure

The acceleration of the tradables sector was primarily supported by the manufacturing sector, which recorded its highest growth rate in the last seven years at 6.2%. Strong domestic and external demand together with an increasingly conducive investment climate has improved business optimism in the manufacturing sector. Meanwhile, even though the growth in non-tradables sector was relatively the same with previous year, its growth performance was still in the high pace. The growth came primarily from the trading, hotel and restaurant sector as well as the transport and communication sector, which all achieved relatively high growth in 2011 at 9.2% and 10.7% respectively. These two sectors played a large role in growth of non-tradables sector (Chart 3.3). Growth in both sectors was driven by strong domestic demand.

Economic growth in 2011 was followed by an increasing contribution from areas outside of Java. Its share reached 42.3%, higher than that in the past (Chart 3.5). This was driven by the expansion of the manufacturing sector and agriculture sector, mainly in plantation subsector. The distribution of growth improved as well, as shown by the rising contribution of provinces outside of Java compared with the past (Chart 3.6). Such regional growth improvements further strengthened domestic demand, which was reflected by rising consumption and investment in all regions. Regional development in 2011 showed that almost all regions experienced higher growth except for areas that were affected by technical mining issues, such as Kalimantan and Bali Nusa Tenggara (Table 3.1).

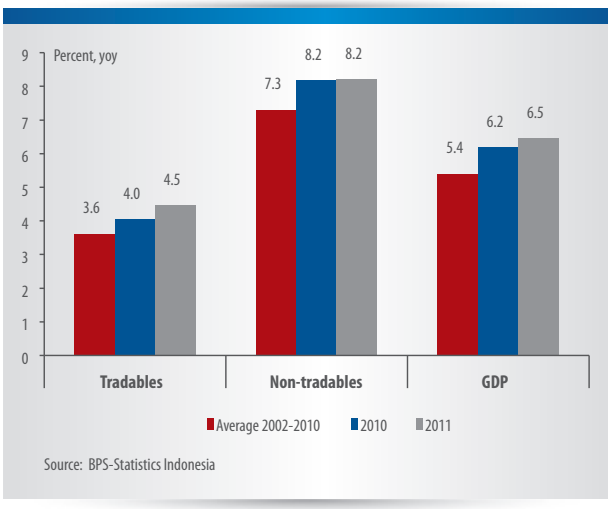


Chart 3.3. GDP by Industry Origins

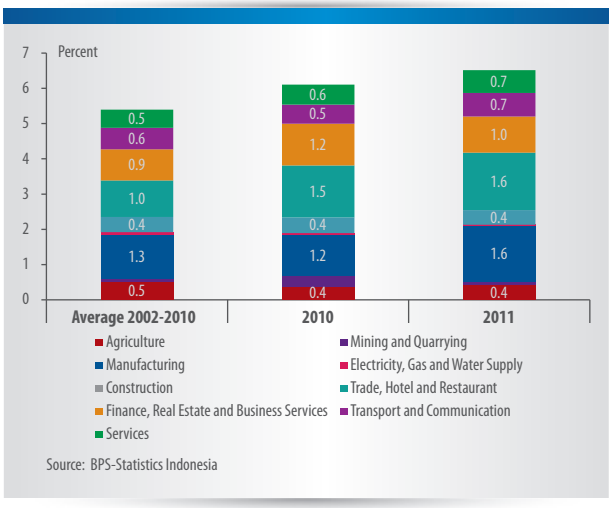


Chart 3.4 Contribution to GDP Growth by Industry Origins

Compared with neighboring countries, Indonesia's economic growth was categorized into the higher growth performance. In contrast to slowing growth in overall emerging markets and also in ASEAN countries (Table 3.2), Indonesia's economic growth particularly increased. Slowing export performance was the cause of lower economic growth in neighboring countries, whereas Indonesia's exports performed relatively well.

3.2 AGGREGATE DEMAND

Performance of aggregate demand in 2011 demonstrated the resilience of Indonesia's economy in both domestic side and external side in the face of global economic shocks. It was supported by a large domestic market, a demographic structure which was increasingly dominated by a productive age group, high

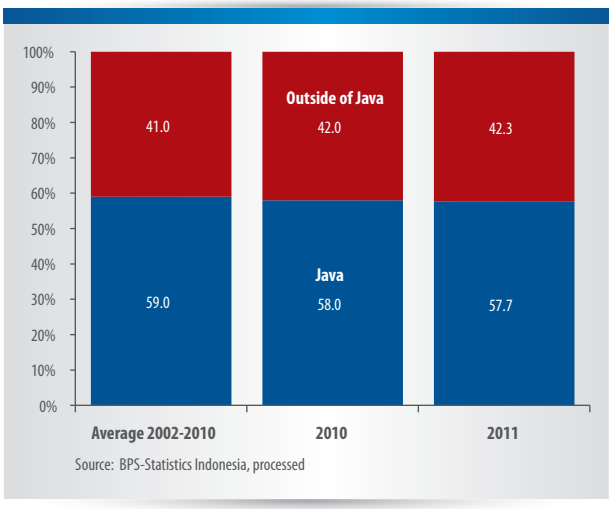


Chart 3.5 Regional Share in National Economy

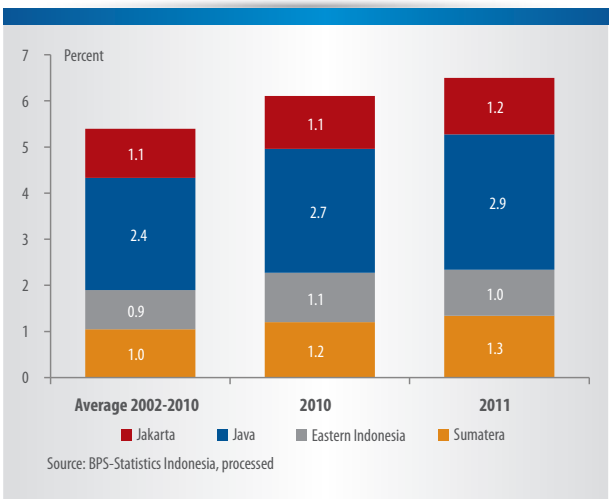


Chart 3.6 Regional Contribution to National Economy

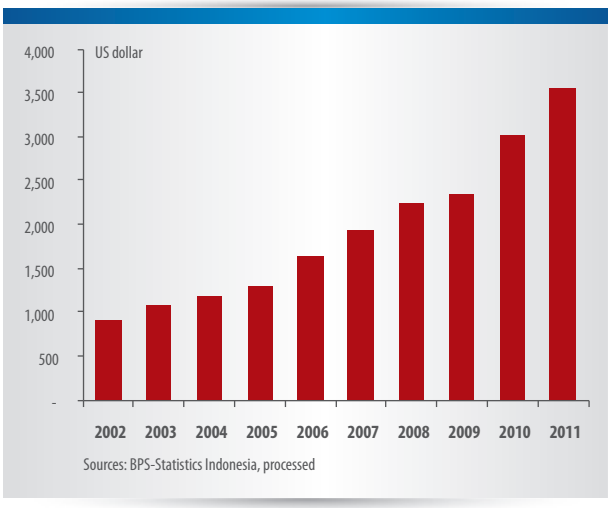


Chart 3.7 Income per Capita

consumer and business confidence, as well as export activities that were diversified between developing and emerging market countries.

HOUSEHOLD CONSUMPTION

Strong household consumption growth in 2011 was supported by improving household purchasing power. Increasing income, which directly translated into stronger purchasing power greatly supported continued strong consumption. The general improvement in income was reflected by the rise in income per capita, which has now reached 3,543 US dollar (Chart 3.7). This development was in line with an increasing share of employments in the formal sector and rising numbers of workers into the middle up incomes (Charts 3.8 and 3.9). Purchasing power improvement was also supported by the improved in farmer terms of trade as agricultural commodity prices rose (Chart 3.10). Income improvements were also seen as construction workers' incomes rose in line with growing investment in the construction sector. In addition, the rise of Provincial Minimum Wage also drove strong household consumption. On average, real Provincial Minimum Wage in 2011 rose by around 5% across all provinces, higher than last year's which was only 1%.

The resilience of household consumption was further affected by high consumer confidence as macroeconomic stability was maintained. The achievement of a stable macroeconomy with low inflation and stable exchange rate volatility has

Table 3.1 Regional Economic Growth

Area	Economic Growth (%)	
	Average 2002-2010	2011
Sumatera	4.5	5.9
Northern Sumatera	4.1	6.3
Central Sumatera	4.6	5.4
Southern Sumatera	5.0	6.3
Java	5.3	6.5
Western Java	5.2	6.3
Central Java	5.1	5.9
Eastern Java	5.5	7.1
Jakarta	5.7	6.7
Eastern Indonesia	4.3	5.0
Bali Nusa Tenggara	4.8	3.5
Kalimantan	3.7	3.8
Sulawesi Maluku Papua	5.0	7.2

Source: BPS-Statistics Indonesia, processed

Table 3.2 Economic Growth in the Region

Percent

Countries	2009	2010	2011
GDP			
Indonesia	4.6	6.2	6.5
Advanced Economies	-3.7	3.1	1.6
Emerging and Developing Economies	2.8	7.3	6.4
Malaysia	-1.6	7.2	5.2
Thailand	-2.4	7.8	3.5
Singapore	-0.8	14.5	5.3
Philippines	1.1	7.6	4.7
Vietnam	5.3	6.8	5.8

Source: World Economic Outlook September 2011.

sustained purchasing power and consumer confidence towards continuing consumption. Consumer confidence has continued to strengthen as the funds from both banks and non-banking financial institutions became more available. Strengthening consumer confidence was showed by some indicators, which were recorded by consumer surveys undertaken by various institutions. (Chart 3.11).

The resilience of household consumption was also supported by favorable demographic conditions. The Indonesian population structure has an advantageous ratio of productive to non-productive age population (Chart 3.12), in which the dominance of productive age individuals is very conducive to economic development. In terms of consumption patterns, productive population tends to consume more than their non-productive counterparts, related to their ability to generate income for greater consumption.

In term of spatial development, household consumption strengthened evenly in all regions. Overall, the regions saw consumer optimism with regard to the economy, in parallel to improved purchasing power and controlled inflation. This optimism was reflected in the results of consumer surveys from various regions which showed a trend of rising consumer confidence in general (Chart 3.13). Growing household consumption in various regions was reflected by the rise in the retail sales indices in several large Indonesian cities throughout 2011 (Chart 3.14). The retail sales goods that saw rising demand in 2011 were durable goods including household electronics.

GOVERNMENT CONSUMPTION

The contribution of government consumption to GDP growth rose in 2011. Government consumption grew 3.2%, increased from very low of 0.3% in the previous year. This was in line with a growing government

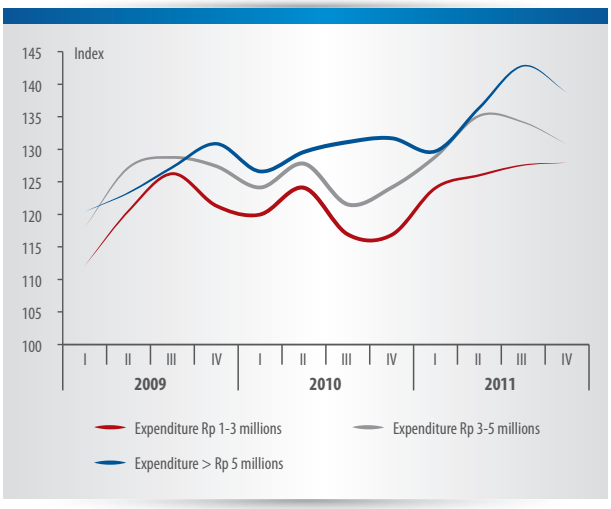


Chart 3.8 Income Index by Expenditure

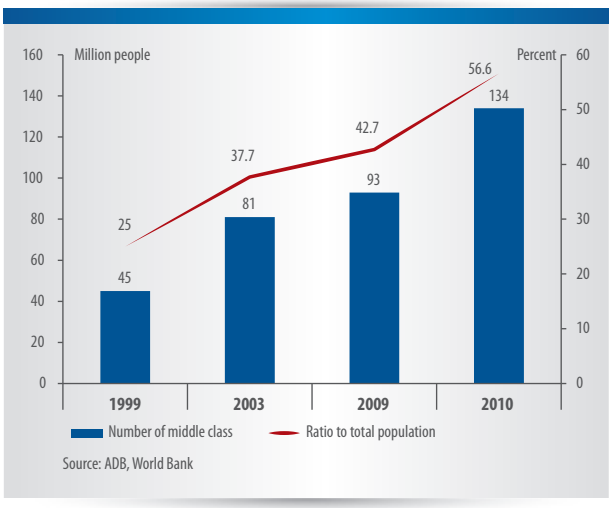


Chart 3.9 Middle Class

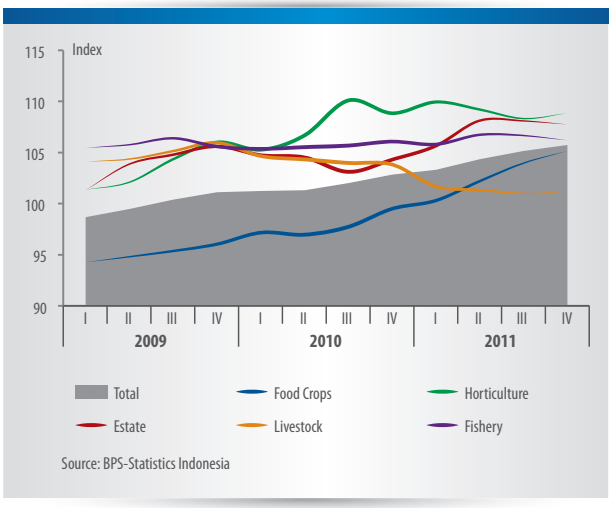


Chart 3.10 Farmer Terms of Trade

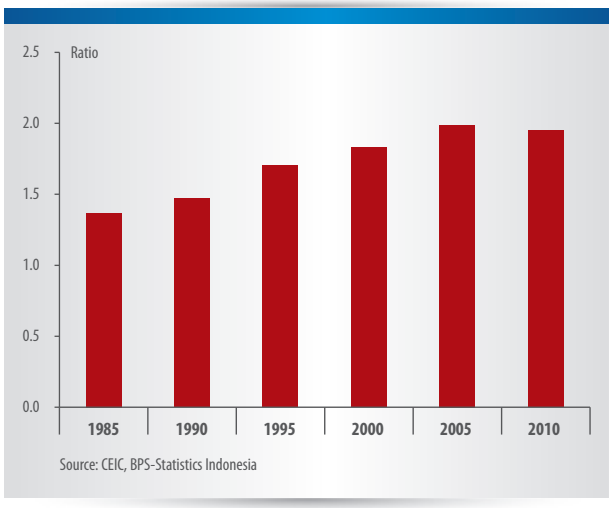


Chart 3.12 Productive Age to Non-Productive Age Ratio

budget deficit from 0.6% of GDP in 2010 to 1.2% of GDP in 2011. The increase in government consumption came from greater absorption of funds compared with the previous year. Government expenditure was primarily intended for personnel expenditure and transfers to regions. Meanwhile, spending on new goods accelerated at the end of the year.

INVESTMENT

Investment performance improved in 2011 with growth of 8.8%, an improvement compared to 8.5% last year. Given such growth, investment played an increased role in economic growth, thus strengthening the capacity of the economy to accommodate demand. The impact of this investment was magnified by the nature of investments over the year, which was directed more towards new investments rather than the replacement for existing investments (Chart 3.15). In term of investment type, the increase in investment was driven mainly by rising investment growth in non-building while building investment slowed slightly (Chart 3.16).

High investment growth was influenced by business sectors optimism and the increasingly conducive investment climate in Indonesia. The positive outlook of business sectors on Indonesia's economic prospects were reflected by the upward trend of the BPS (Statistics Indonesia) Business Tendency Index (Chart 3.17). These conditions, together with an increasingly conducive investment climate, were supportive to strong investment performance. According to the International Finance Corporation (IFC), almost in every component of the Doing Business in Indonesia scores improved. The perception of an improved investment climate was further reflected by Indonesia's sovereign

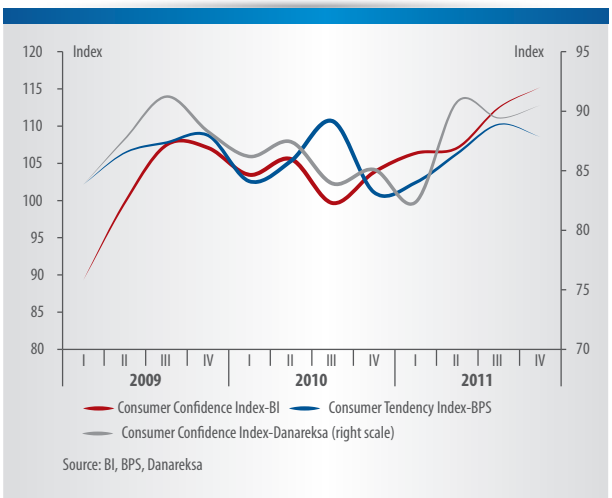


Chart 3.11 Consumer Confidence Index

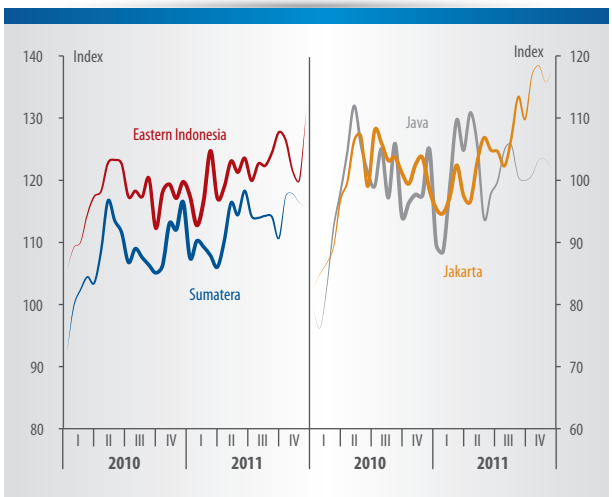


Chart 3.13 Consumer Confidence Index by Region

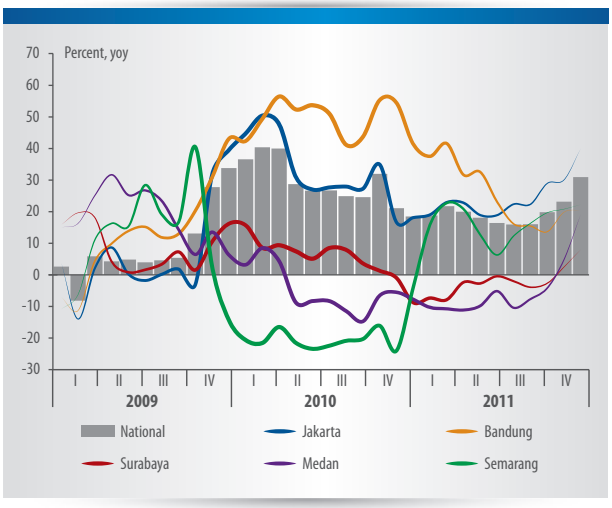


Chart 3.14 Retail Sale Index by City

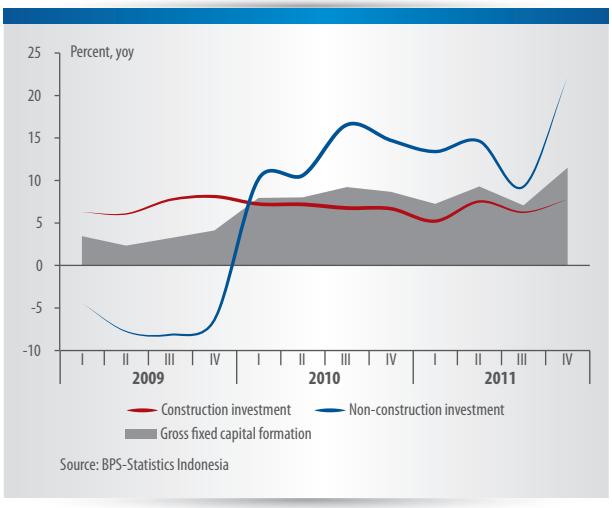


Chart 3.16 Investment by Sector

ratings, which improved to the investment grade level by a number of rating agencies at year end (Chart 3.18). The increase in investment also came as a response of the business sectors to high capacity utilization and strong domestic demand as well as export demand. In addition, rising investment over the year was influenced by the strengthening of the rupiah exchange rate which encouraged the import of capital goods.

In terms of players and funding sources, investment increased from both domestic and foreign sources. Optimism regarding the prospects of the domestic economy and an abundance of global liquidity lent momentum to capital inflows, which were increasingly directed to the real sector thus contributing positively to investment performance. According to the Investment Coordinating Board (BKPM), foreign direct capital investment continued to show excellent growth in line with domestic direct investment (Chart 3.19). Domestically, the positive condition of investment funding was reflected by the numerous Initial Public Offerings (IPO) or rights issue throughout 2011. In addition, the banking sector supported investment activities as apparent from the real growth in investment credit which increased to 23.1% in 2011 from 10.3% in the previous year. In addition, internal company funds continued to play a large role in financing investments as companies increasingly retained their earnings.

A relative slowdown in construction investment was caused by the slower than expected pace of infrastructure development, with the 10,000 MW Stage 1 project and toll roads taking longer than expected to be realized. However, realization of the second stage 10,000 MW project has progressed roughly on

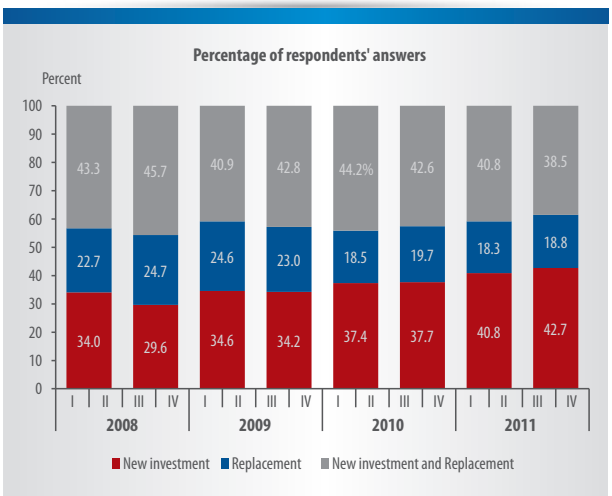


Chart 3.15 New Investment (Business Survey)

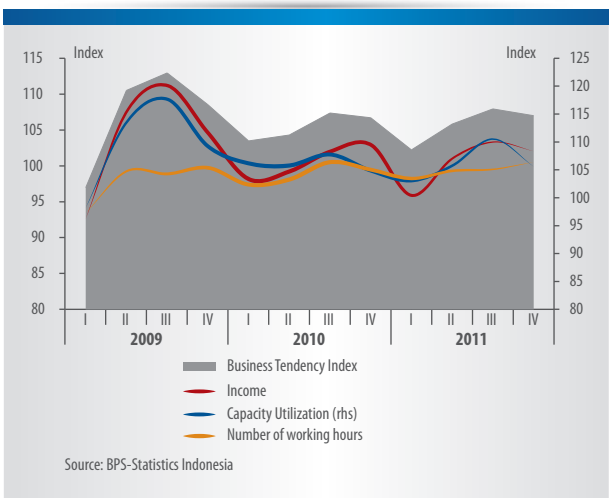


Chart 3.17 Business Tendency Index-BPS

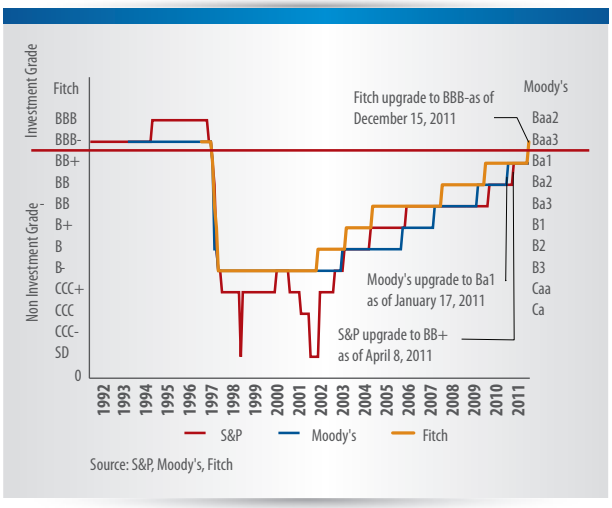


Chart 3.18 Indonesia Sovereign Credit Rating

plan. One of the factors hindering the development of infrastructure is the classic problem of land acquisition. However, the enactment of the Law of Land Procurement for Public Purposes Development in December 2011 is expected to accelerate the pace of investment in coming years (see Box 3.1). In addition, this Land Acquisition Bill should enable the Government to more effectively support investment activities through the Infrastructure Guarantee Program and the launch of the Master Plan for Acceleration and Expansion of Indonesia Economic Development (MP3EI).

EXPORT

Exports in 2011 continued to show high growth amidst the global economic slowdown. Exports grew by 13.6%, well above a historical average of 7.5%, but experienced a slight slowdown compared to that of the previous year. High growth was supported by the diversification of export destinations with increasing intra-regional trade in the Asian region.

By sector, the main contributor to the high export performance was mining exports due to sustained high demand for primary commodities from emerging markets (Chart 3.20). Meanwhile, exports of manufacturing were relatively stable despite a slight slowdown towards the end of 2011. This was related to the resilience of textile and textile products (TPT) exports as a number of TPT companies rerouted products from their main markets namely the United States and the European Union to other destinations. Meanwhile, exports of agricultural commodities trended downward due to declining cocoa beans and coffee exports. Apart from being affected by unfavorable weather at the end of 2011, the decline in cocoa bean exports was also influenced by the export taxes that have been levied on cocoa beans since April 2010 in order to spur exports of processed cocoa products. Meanwhile, the decline in coffee exports was also associated with lower trending international prices.

The considerable shrinkage in world trade volume was not mirrored by a similar decline in Indonesia's exports. It demonstrated the resilience of Indonesia's export performance. Such resilience was supported by a more diversified export structure with a grater role of emerging market countries, especially China and India (Table 3. 3) Strong economic growth in those countries magnified the benefits of Indonesia's export destination diversification.

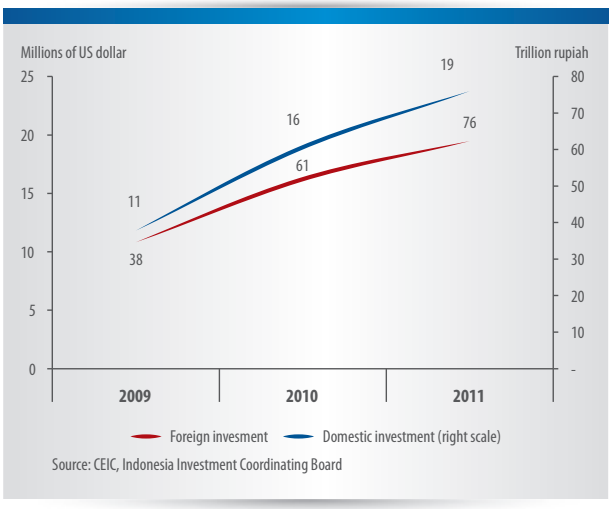


Chart 3.19 Investment by Type of Investor

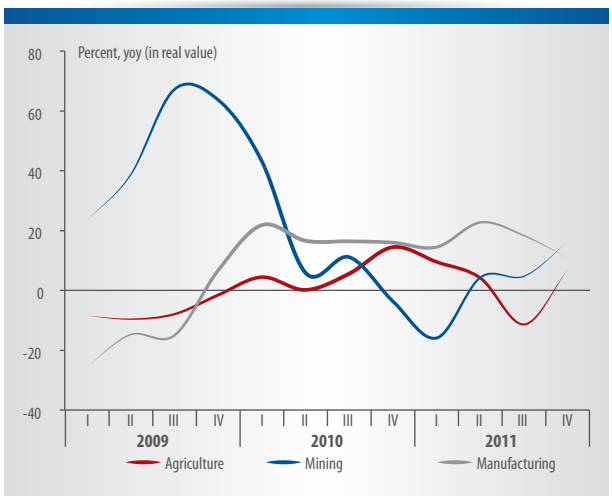


Chart 3.20 Non-oil and Gas Export by Sectors

Table 3.3 Non-oil and Gas Export by Destination Countries

Countries	2000		2005		2010		2011*	
	Billions of US dollar	Share (%)	Billions of US dollar	Share (%)	Billions of US dollar	Share (%)	Billions of US dollar	Share (%)
Asia	27.5	56.7	40.9	61.3	86.6	66.9	110.2	67.6
Japan	7.6	15.7	9.7	14.6	16.1	12.4	18.4	11.3
China	1.8	3.7	4.0	5.9	14.0	10.8	21.8	13.3
India	1	2.1	2.9	4.3	9.6	7.4	13.4	8.2
ASEAN	9.8	20.2	14.4	21.6	27.3	21.1	32.4	19.8
US	8.2	16.9	9.2	13.8	13.3	10.3	15.6	9.6
Europe	9.2	19.0	10.1	15.1	16.8	13.0	20.2	12.4
Others	3.6	7.4	6.5	9.8	12.8	9.9	17.1	10.5
Total	48.5	100.0	66.8	100.0	129.4	100.0	163.2	100.0

Economic growth in China and India continued to be strong as these countries reoriented to focus on their domestic economies. Their domestic economies were consequently able to sustain growth and limit the influence of external risks, keeping their high demand of imports. Such conditions supported the Indonesia's export resilience as exports to both these countries are dominated by energy and food commodities that intended for domestic consumption (Chart 3.21).

Related to these developments, demand for coal from China and India rose strongly, primarily to feed coal fired power plants. In addition, Chinese demand growth for Indonesian coal was influenced by lower transportation costs and faster shipping time compared to other countries.

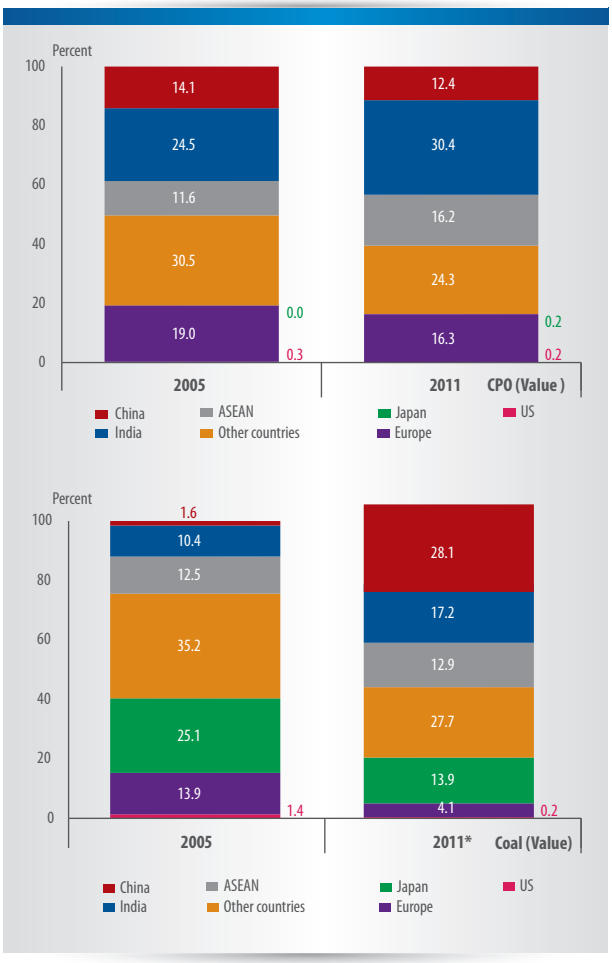


Chart 3.21 Share of Export Destination Countries for Coal and CPO

IMPORT

In line with export, import growth also slowed compared to that of 2010. Imports slowed from 17.3% in 2010 to 13.3% in 2011 (Chart 3.22). However, these import figures were still considered high for Indonesia, which has an average import growth rate of 8%. This high import growth stemmed from the growth in imports of capital goods, followed by raw materials, and consumer goods. High import growth was supported by

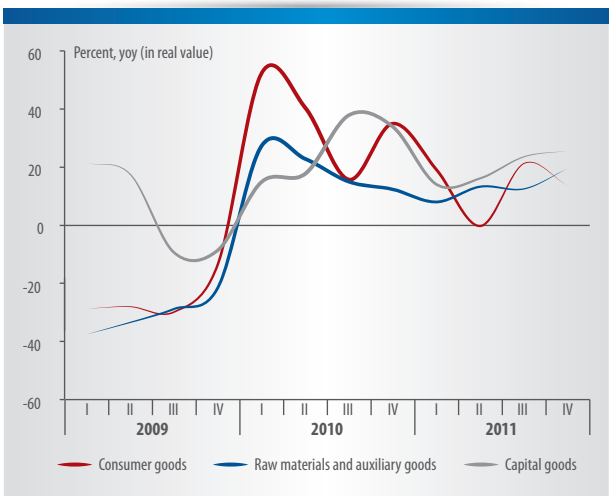


Chart 3.22 Import of Non-oil and Gas by Type of Goods

the strengthening and low volatility of rupiah exchange rate, despite the rupiah's weakening somewhat towards the end of 2011. The fairly high growth of consumer goods imports, especially in processed foods and consumer vehicles, was in line with domestic demand. Meanwhile, high export growth resulted in increases in raw materials imports as inputs to produce goods in the manufacturing industry. Rising production positively affected business actors' optimism to invest in and expand production capacity, thus driving the growth of capital goods imports.

3.3 Aggregate Supply

In 2011, economic growth from the supply side improved with an improvement in the tradables sector. It was spurred by rising growth in the manufacturing sector, which grew significantly by 6.2% over 4.2% in the previous year, and it became the highest growth in the last seven years (Chart 3.23). However, the growth of tradables sector was still below that of the non-tradables sector. This was caused by a slowdown in the mining sector and low growth in the agriculture sector, whereas the non-tradables sector continued to sustain high growth rates. Overall, economic growth by sector stemmed primarily from the manufacturing sector, the trade, hotel and restaurant sector, and the transport and communication sector.

TRADABLES SECTOR

Performance of the tradables sector was supported by the acceleration of the manufacturing sector, which mainly came from the growth in the food and beverage subsector and the textile subsector. The increasing growth in the food and beverage subsector was in line with rising growth in the food consumption, while growth in the textile subsector accelerated due to the increasing competitiveness of Indonesia's textile products. These conditions were supported by the TPT (Textile and Textile Product) Machinery Revitalization Program and the relocation of TPT industries from China due to rising cost of labor there. The improvement in TPT subsector performance took place in Central Java and Western Java which experienced a rising trend of demand, especially from the Asian region, Middle East, and Africa. Such demand growth offset the decreases resulting from the slowdown in the United States and European economies. Meanwhile, the transportation machinery subsector experienced some challenges especially in automotive industry centers in Java. It was mainly due to automotive supply chain disturbances caused by the earthquake in Japan during the second quarter of 2011 and floods in Thailand in the fourth quarter, thus causing a slowdown in growth during the year.

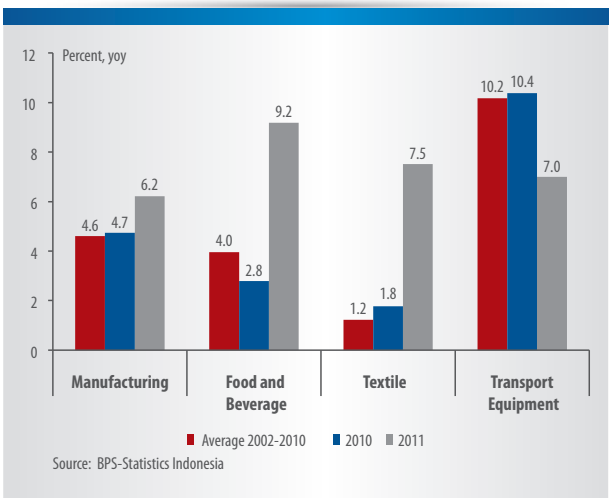


Chart 3.23 Manufacturing Sector

Prospects for the manufacturing sector remained positive with the support of Government policy. The new tax holiday regulations for five chosen sectors that were issued in mid-2011 created an increasingly positive climate for investment in the real sector ahead. These five chosen sectors were the base metal industry, the petroleum refining industry and/or organic chemicals derived from the petroleum and natural gas, the machinery industry, the renewable resources industries, and the telecommunications equipment industries.

Agriculture sector performance was still limited due to issues in the food crop subsector. The agriculture sector experienced stable growth at 3.0%, below a historical average of 3.5% (Chart 3.24). The food crop subsector continued to experience production problems especially in rice production, which faces a slowdown due to a decrease in field sizes and late rains at the end of the year. Meanwhile, the food estate and livestock subsectors showed a trend of improvement through the year, as did the fishing subsector which did better than the previous year despite being relatively stable throughout the year.

Growth slowed in the mining and quarrying sector due to natural depletion, production disturbances and low investment. Mining and quarrying sector growth decreased from 3.6% in 2010 to 1.4% in 2011, but it was slightly above its historical level, 1.2% (Chart 3.25).

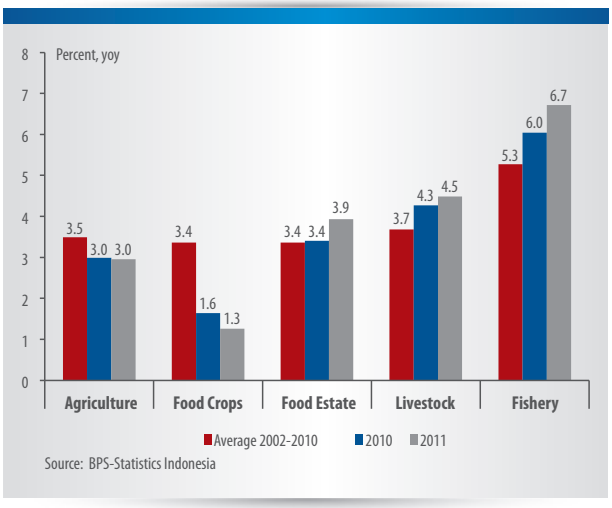


Chart 3.24 Agriculture Sector

This drop in performance was caused by both slowing in oil and gas and non-oil and gas performance. The weak performance of oil and gas mining was related to the lower realization of oil and gas under the targets set by the Upstream Oil and Gas Executive Agency (BP Migas). Natural depletion of old mines, various production disturbances and little exploration of new mines were factors in the low production of oil and gas. One of the production disturbances was the repair of pipe infrastructure, which affected all oil and gas production in Riau as a center of oil and gas production.

On the other hand, the non oil and gas mining subsector also showed weakening growth. Coal production growth was good at the beginning of the year but slowed throughout the rest of the year as high rainfall limited production activities, including the primary coal producing area of East Kalimantan. In addition, production disturbances in gold and copper took place in the middle and at the end of the year due to overlong labor strikes and low production phases in centers of such mining activity in Papua and Nusa Tenggara.

NON-TRADABLES SECTOR

In the nontradables sector, the trade, hotel and restaurant sector was able to achieve improved performance. The sector grew from 8.7% in 2010 to 9.2% in 2011 (Chart 3.26). This increase was related to the strong domestic economy as well as high exports growth as shown by the growth of the retail sales index. In addition, several long holidays, a growing number of tourists from many countries, particularly since the second quarter of 2011, and several events related to the ASEAN and SEA Games 2011 held in Jakarta and Palembang, drove the performance of this sector higher.

The performance of the financial, leasing, and services sector also improved, supported by good business conditions and relatively stable interest rates. This sector grew higher from 5.7% in 2010 to 6.8% in 2011. Banking credit and financing company funds grew consistently over the year. The growing contribution of working capital loans and growing investment credit in 2011 compared to that of 2010 reflected the financial sector's support in expanding business activities. Meanwhile, property leasing services continued to grow over the year in response to rising demand for office and business space. On the other hand, services companies experienced slowing growth until the end of the year.

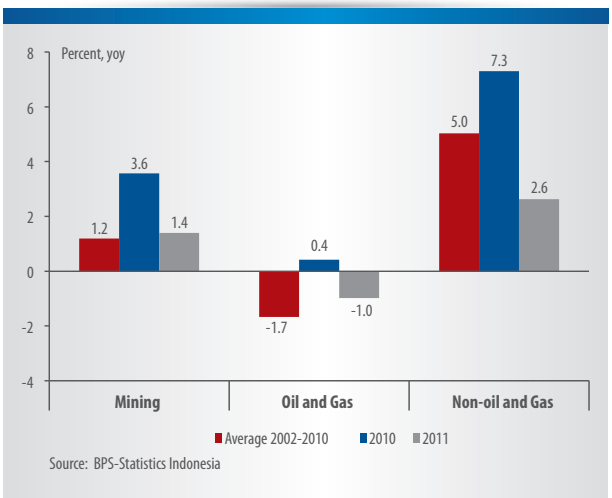


Chart 3.25 Mining Sector

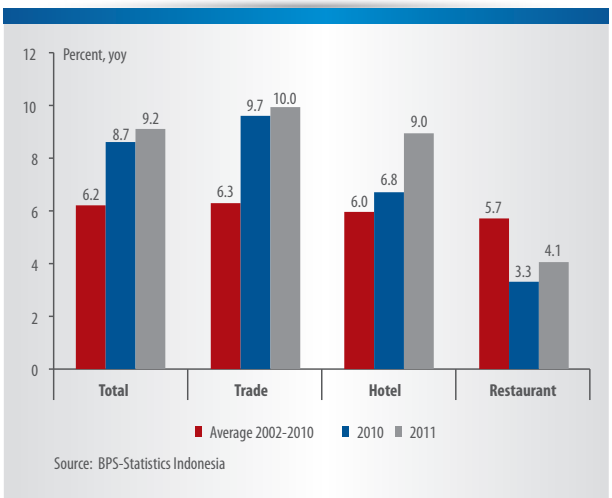


Chart 3.26 Trade, Hotel and Restaurant Sector

The non-tradables sector also saw improvements in the service sector which grew from 6.0% in 2010 to 6.7% in 2011. The improvement of this sector's performance stemmed both from the private service subsector as well as from Government services. Private service continued to grow throughout the year in the forms of social services, entertainment, as well as individual services. Meanwhile, Government services in general experienced a rising trend despite a slowdown in the second quarter of 2011.

On the other hand, construction sector's performance dipped slightly due to a slowdown in investment in the third quarter in 2011. Construction sector growth slowed from 7.0% in 2010 to 6.7% in 2011. The performance of this sector continued to improve in the first half and last quarter of 2011 with numerous construction activities, but slowed in the third quarter of 2011 due to global uncertainty and slower realization of infrastructure programs.

Weakening growth was also seen in the electricity, gas and clean water sectors due to supply and infrastructure issues. Growth in this sector fell from 5.3% in 2010 to 4.8% in 2011, due to a decline in the city gas subsector relating to supply issues. The clean water subsector also experienced a slowdown throughout the year due to limited infrastructure expansion. Meanwhile, the electricity sector showed limited improvement in line with the addition of several new generators and PLN programs to attract subscribers such as the one million connections a day program and free additional electricity capacity.

The transportation and communication sector experienced a continuous slowdown especially in the communication subsector. Growth in this sector slowed from 13.4% in 2010 to 10.7% in 2011 (Chart 3.27). The slowdown in growth primarily took place in the communication sector due to high customer penetration and a saturated market. However, this subsector continued to enjoy high growth supported by rapid data/internet communications growth, and this helped to maintain the growth of the subsector at the end of 2011. On the other hand, the growth of transportation subsector improved, which supported by better road transport performance and continued strong performance from air transport. Meanwhile, ocean, lake, river and ferry transport as well as rail services slowed. The slowdown in rail services was related to the cancellation of several train routes, limitations on passenger numbers as unseated tickets were no longer issued for long distance trains, and the temporary cancellation for several Jabodetabek trains at the end of the year. Meanwhile, air transport continued to see high growth, as marked by an increase in aircraft procurement by various airlines as well as the opening of new flight routes.

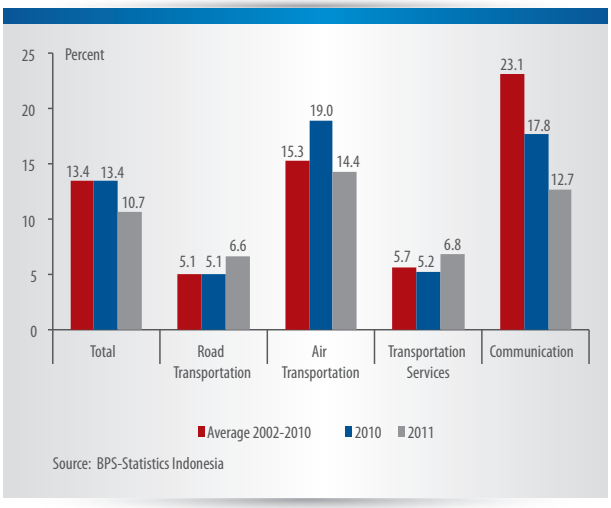


Chart 3.27 Transport and Communication Sector

Table 3.4 Labor Force and Unemployment

Million people unless noted otherwise

No	Main Activities	2009	2010	2011
1	Productive age population (15+)	169.3	172.1	171.7
	- Labor force participation rate (percent)	67.2	67.7	68.3
2	Labor Force	113.8	116.5	117.4
	- Full time worker (percent)	64.4	64.3	64.0
	- Part time worker (percent)	14.2	15.5	17.9
	- Under employment (percent)	13.5	13.1	11.5
	- Open unemployment (percent)	7.9	7.1	6.6

Source: BPS-Statistics Indonesia

3.4 Employment And Welfare

The growth of the economy in 2011 was accompanied by an improvement in the quality of growth, which was reflected in better employment and welfare.

EMPLOYMENT

Employment condition continued to improve with the decreasing unemployment rate. In line with the improving economic growth, open unemployment rates dropped from 7.1% in 2010 to 6.6% in 2011 (Table 3.4). This decline was equally distributed across all regions (Chart 3.28). In addition, the quality of labor force also improved as reflected in increased employment within the formal sector and greater numbers of workers with higher education background than primary school.

Improvement in the formal sector was supported by more sustainable economic structure with improvement in the manufacturing sector, as a sector that absorbs many formally employed and highly educated workers. However, several issues remained, namely the still high level of unemployment rate in Jakarta and West Java that was above the national rate, as well as the slight decline in full-time workers during the year.

WELFARE

Welfare improved, with the numbers and percentage of the population living in poverty decreased from 13.33% in 2010 to 12.36% in 2011 (Chart 3.29). This decline was supported by the improving Indonesian economy, increased in minimum wage, rising farmer terms of trade and low inflation. However, the decline in poverty during the reporting year was smaller than the decline in the previous year. On the spatial side, regional poverty rates were still high outside of Jakarta (Chart 3.30). During 2011, the largest of decrease in poverty rate took place in the southern Sumatera and Bali Nusa Tenggara, in line with a considerable decline in inflation in those areas.

The income gap continued to narrow, with a decrease in the poverty gap index and poverty severity index. The poverty gap index fell from 2.21 in 2010 to 2.05 in 2011 (Table 3.5), showing a rising trend in the average expenditure of the poor, coming ever closer to the poverty line. The same was true of the poverty severity index which decreased from 0.58 in 2011 to 0.35 in

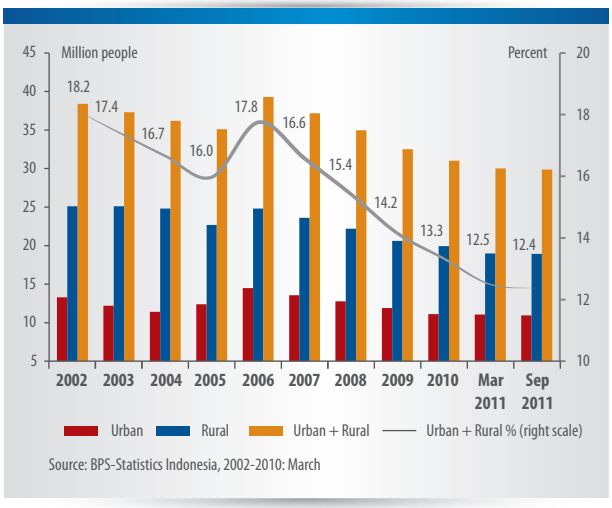


Chart 3.29 Poverty Rate

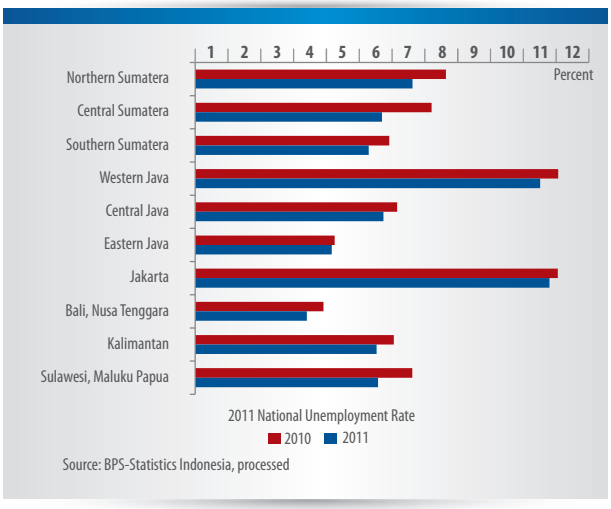


Chart 3.28 Unemployment Rate by Region

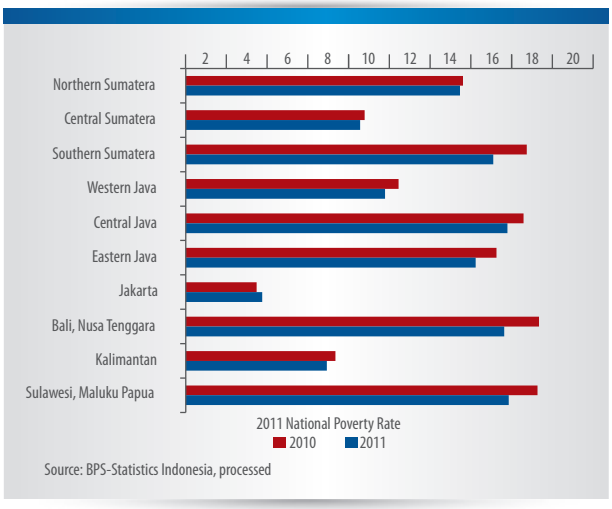


Chart 3.30 Poverty Rate by Region

Table 3.5 Poverty Gap Index

Year	Urban	Rural	Urban + Rural
2000	1.89	4.68	3.51
2001	1.74	4.68	3.42
2002	2.59	3.34	3.01
2003	2.55	3.53	3.13
2004	2.18	3.43	2.89
2005	2.05	3.34	2.78
2006	2.61	4.22	3.43
2007	2.15	3.78	2.99
2008	2.07	3.42	2.77
2009	1.91	3.05	2.50
2010	1.57	2.80	2.21
Mar 2011	1.52	2.63	2.08
Sep 2011	1.48	2.61	2.05

Souce: BPS-Statistics Indonesia.

2011 (Table 3.6), indicating a narrowing inequality gap with regard to expenditure amongst the population. Intra-island disparity also improved though the figure is still large, falling from 21.6% in 2010 to 18.4% in 2011.

The lowest poverty rates were found in Kalimantan in 2011 (6.9%) and the highest in Maluku and Papua (25.4%).

Table 3.6 Poverty Severity Index

Year	Urban	Rural	Urban + Rural
2000	0.51	1.39	1.02
2001	0.45	1.36	0.97
2002	0.71	0.85	0.79
2003	0.74	0.93	0.85
2004	0.58	0.90	0.78
2005	0.60	0.89	0.76
2006	0.77	1.22	1.00
2007	0.57	1.09	0.84
2008	0.56	0.95	0.76
2009	0.52	0.82	0.68
2010	0.40	0.75	0.58
Mar 2011	0.39	0.70	0.55
Sep 2011	0.39	0.68	0.53

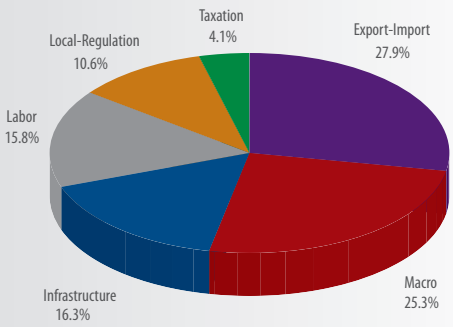
Source: BPS-Statistics Indonesia

BOX 3.1 | THE ROLE OF LAW NUMBER 2/ 2012 ON LAND ACQUISITION FOR DEVELOPMENT IN SUPPORTING INFRASTRUCTURE ACTIVITIES

Infrastructure is an important and vital aspect in speeding up the process of economic growth. The availability of infrastructure such as transportation, telecommunications and energy plays an important role as a component of economic growth, as well as laying the foundation of sustainable economic growth. In addition, the availability of infrastructure is a very important factor in expanding investment activities.

Given the importance of such infrastructure, the Government has established a Masterplan for Acceleration and Expansion of Indonesia Economic Development (MP3EI) to accelerate the process of infrastructure development. The Government has launched a number of projects to improve infrastructure conditions such as the 10,000 MW. Stage I and II power plants and the construction of a trans-Java roads as well as toll roads within the city of Jakarta. Several of these projects faced challenges, slowing their progress. In general, the quality and availability of infrastructure in Indonesia is still considered low as ranked by the Global Competitive Index 2011. According to this index, Indonesia's infrastructure is ranked 82nd out of 132 countries surveyed, below neighboring countries such as Singapore in fifth place, Malaysia in thirtieth place, Thailand in thirty-fifth place and China in fiftieth place. To improve these conditions, the Government has established MP3EI through one of it's pillar that was aimed at strengthening the physical infrastructure in a program to improve national connectivity. This program covers road development planning, bridges, harbors, airports, electricity, and the development of information technology and communications.

Factors Affecting Investment



Source: Survey of Competitiveness of Trade and Investment, Bappenas, 2008

One issue facing the development of infrastructure in Indonesia is the acquisition of land. Land acquisition for the purposes of constructing roads, bridges, dams, electricity transmissions and more often experience challenges related to the land acquisition. The difficulties surrounding land acquisition are connected to various legal/non-legal issues. In addition, the acquisition of the land/assets that are needed for development occasionally conflicts with existing laws.

Land acquisition laws do exist, but their implementation is problematic. One of the policies related to the acquisition of land for public interest is Presidential Regulation No. 36 in 2005 regarding Land Acquisition for Development in Public Interest. However, in practice the Government continues to experience difficulties in carrying out projects as planned due to land compensation issues. Related to the existence of various Government infrastructure projects as set for in MP3EI, the need to improve land compensation regulations has become ever more urgent. By improving such land compensation regulations, it is hoped that the bottlenecks affecting various infrastructure projects thus far can be overcome. In addition, disputes arising between the Government or other project implementers with landowners due to lack of agreement on compensation, can then be handled properly and fairly while upholding the integrity of land rights.

To overcome these land issues, the House of Representatives has passed Law No. 2 in 2012 regarding Land Acquisition for Public Purposes Development on December 14, 2011. Subsequently, these laws are targeted to go into effect in the middle of 2012 pending the issuance of regulations on their implementation (Presidential Regulation). Based on this law, the process of land acquisition for infrastructure projects intended to improve the welfare and prosperity of the public will be made more transparent and efficient. Meanwhile, the legal interest of parties with land rights will still be protected and landowners will receive proper and fair compensation.

The regulation of land acquisition by law is common in other countries in order to ensure the development in an even way. Several other countries such as Malaysia, Singapore, Australia, Japan and China already have provisions related to land acquisition and a number of these countries have codified these in law since 1960. In principle, the regulations set forth in the Law on Land Acquisition for Public Purposes Development are essentially the same as those in these countries. In general this law regulates, among others: (i) notice to parties affected by land acquisition; (ii) explanation of the public interest in question; (iii) damages/compensation to owners in a proper and fair manner; (iv) a fair and transparent appeal mechanism. Under such regulations, the public will feel that its rights are protected by law and public interest developments will be able to proceed smoothly.

Law No. 2 in 2012 is basically in line with practices in the aforementioned countries. The entire land acquisition process is intended to secure land for development towards improving the welfare and prosperity of the nation, country and people, while safeguarding the interest of the public as the entitled party. The process of land acquisition for public interest will take place over 4 (four) phases. First, in the planning stage, land acquisition will be based on the Spatial Planning and development priorities set forth in the Medium Term Development Plan (RPJM), the Strategic Plan, and the Government Work Plans (RKP) of the agencies in question. Second is the preparation stage, which involves drawing up planning documents by the relevant agencies in the need of land for development, which will include notification of development plans, initial data gathering at the location and a public consultation on the development plans in question. Thirdly, in the implementation phase, the agencies requiring land must submit a land procurement proposal to the Land Institution. The parties with ownership rights over the land may only transfer such rights to the government agency requiring the land through the Land Institution. Lastly, in the stage where compensation for the land is handed over, the Land Institution will deliver the results of the land compensation process to the government agency in question. During the land acquisition process, the parties entitled to the land may appeal to local courts if there is disagreement regarding the amount of compensation.

It is hoped that Law No. 2 / 2012 and its implementation procedures can help to support sustainable economic growth. While it is expected that it will only come into effect in mid-2011 and is not retroactively effective, this law will become one of the keys to resolving the classic infrastructure issue of land acquisition. It is hoped that various infrastructure projects planned by the government as reflected by plans for the groundbreaking for MP3EI projects in 2012, the start of the construction of the trans-Java toll roads and the Jabodetabek toll road areas as well as plans to auction seven private generators in 2012, can be carried out now that Law No 2 / 2012 has been passed. Going forward, this law will be an important factor in enabling the Indonesian economy to enjoy high, sustained growth with continued macroeconomic stability, through infrastructure improvements and subsequent improvements in the capacity and productivity of the domestic economy. With the support from this law, it is hoped that the Indonesian economy will be able to achieve medium term growth of approximately 7% in 2016 followed by gradually declining inflation rates to reach 4.0% ± 1% in 2016.

Chapter IV

Indonesia's Balance of Payments

INDONESIA'S BALANCE OF PAYMENTS

Indonesia's Balance of Payments (BoP) showed strong performance in 2011, recording a surplus of 11.9 billion US dollar. Fundamentally, it demonstrated the resilience of the domestic economy to cope with external shocks reflected by strong performance of trade balance and increasing share of foreign direct investment (FDI) in the structure of foreign capital inflows. The surplus of the non-oil and gas trade balance increased sharply compared to the surplus in the previous year, driven by remaining strong export performance in the midst of weakening global demand. The strong exports performance was driven by, among others, diversification of export destination to Asian emerging countries and the characteristic of natural resource based commodities as the Indonesia's main export commodities. Meanwhile, the greater role of FDI was supported by investor confidence in the economic resilience and the improving economic outlook. With these developments, the foreign exchange reserves increased and accordingly improved its capacity to cushion the impact of external shocks.

4.1 The Performance Of Indonesia's Balance Of Payments

Indonesia's BoP maintained its strong performance in 2011 despite lingering uncertainty in regard to global economic conditions. It recorded an overall surplus of 11.9 billion US dollar, contributed by surplus in the current account amounting to 2.1 billion US dollar and surplus in the capital and financial account of about 14.0 billion US dollar. On a quarterly basis, the BoP showed positive performance in the first and second quarter of 2011, driven by strong performance of the trade balance, direct –investment, and portfolio investment. In the second half of 2011, however, the BoP was under pressure due to massive capital outflows from portfolio investments and increasing imports.

Trade balance recorded a higher surplus in 2011 than in 2010. Moderating global demand, reflected either in global economic slowdown or slowing growth of world trade volume, had not significantly affected export performance yet (Chart 4.1). Export growth in 2011 remained high, supported by diversification of export destination to Asian emerging countries, advantageous characteristic of the main export commodities which were natural resource based, competitive rupiah exchange rate compare to other currencies in the region, and fairly high global commodity prices. In line with economic growth in trading partner countries and developments in global commodity prices, export performed quite well, especially in the first half of 2011. However, in the fourth of 2011, exports slightly declined due to weak global demand and decreasing commodity prices. This condition, accompanied with continued increases in imports on the back of the still firm domestic demand, caused the current account to record a deficit in quarter IV of 2011.

Global economic turmoil directly influenced the dynamics of the capital and financial account, in particular the portfolio investments. In tandem with the development of global liquidity, the portfolio investments (on the liabilities side) recorded a fairly significant surplus in the first half of 2011. Nonetheless, uncertainty regarding the resolution of European public debt crisis along with slowing US economy put strong pressure on portfolio investments, such that a deficit was recorded in the third quarter of 2011. It mainly owed to massive capital outflows from the redemption of foreign investments in domestic shares and government debt securities. In the last quarter of 2011, foreign capital returned to domestic financial market driven by growing positive market perceptions. With such dynamics in play, the portfolio investments in the whole 2011 posted a surplus, even though it was lower than the surplus in 2010, thus reducing the surplus in the capital and financial account.

Unlike the global economy whose prospect were still clouded by uncertainty, stable domestic economic conditions and increasingly conducive investment climate brought about an increasing role of FDI in the structure of foreign capital inflows. The high resilience and improving prospects of the Indonesia's economy helped bolster investor confidence. This increased the direct investment surplus, far exceeding the portfolio

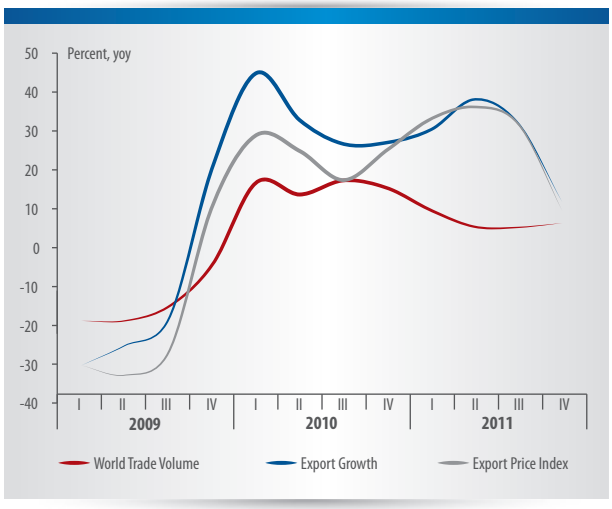


Chart 4.1 World Trade Volume, Export and Export Prices

Table 4.1. Indonesia's Balance of Payment

Millions of US dollar

ITEMS	2008	2009	2010	2011				Total **
				I*	II*	III*	IV**	
I. CURRENT ACCOUNT	126	10,628	5,144	2,072	473	468	-944	2,070
A. Goods, net	22,916	30,932	30,627	8,684	9,637	9,586	7,440	35,347
- Export, fob	139,606	119,646	158,074	45,818	51,797	52,476	51,382	201,472
- Import, fob	-116,690	-88,714	-127,447	-37,134	-42,160	-42,890	-43,941	-166,125
1. Non-oil and gas, net	15,130	25,560	27,395	8,628	10,551	9,085	7,013	35,276
- Export, fob	107,885	99,030	129,416	37,092	42,307	42,168	41,626	163,193
- Import, fob	-92,755	-73,470	-102,021	-28,464	-31,756	-33,084	-34,613	-127,917
2. Oil, net	-8,362	-4,016	-8,653	-3,439	-5,098	-4,060	-3,712	-16,310
- Export, fob	15,387	10,790	15,691	4,856	5,000	5,189	5,239	20,283
- Import, fob	-23,749	-14,806	-24,344	-8,295	-10,098	-9,249	-8,952	-36,593
3. Gas, net	16,147	9,388	11,886	3,495	4,184	4,562	4,140	16,381
- Export, fob	16,333	9,826	12,968	3,870	4,490	5,119	4,517	17,996
- Import, fob	-186	-438	-1,082	-375	-306	-557	-377	-1,615
B. Services, net	-12,998	-9,741	-9,324	-2,122	-3,379	-2,818	-3,503	-11,823
C. Income, net	-15,155	-15,140	-20,790	-5,518	-6,747	-7,344	-6,058	-25,667
D. Current Transfer, net	5,364	4,578	4,630	1,028	963	1,044	1,177	4,212
II. CAPITAL AND FINANCIAL ACCOUNT	-1,832	4,852	26,620	6,646	12,849	-4,107	-1,370	14,018
A. Capital Account	294	96	50	1	0	0	0	1
B. Financial Account	-2,126	4,756	26,571	6,645	12,849	-4,107	-1,370	14,017
1. Direct Investment	3,419	2,628	11,106	3,461	3,249	1,661	2,066	10,437
1.1 Abroad	-5,900	-2,249	-2,664	-1,529	-2,526	-1,350	-2,317	-7,722
1.2 In Indonesia (FDI)	9,318	4,877	13,771	4,990	5,775	3,011	4,383	18,160
2. Portfolio Investment	1,764	10,336	13,202	3,588	5,537	-4,665	-261	4,198
2.1 Asset	-1,294	-144	-2,511	-521	-731	154	-318	-1,416
2.2 Liabilities	3,059	10,480	15,713	4,109	6,268	-4,819	57	5,614
3. Other Investments	-7,309	-8,208	2,262	-404	4,062	-1,103	-3,174	-618
3.1 Asset	-10,755	-12,002	-1,725	-1,248	2,029	-3,203	-4,919	-7,341
3.2 Liabilities	3,446	3,794	3,987	844	2,033	2,101	1,745	6,723
III. TOTAL (I + II)	-1,706	15,481	31,765	8,718	13,322	-3,639	-2,313	16,088
IV. NET ERRORS AND OMISSION	-238	-2,975	-1,480	-1,052	-1,446	-321	-1,413	-4,232
V. OVERALL BALANCE (III + IV)	-1,945	12,506	30,285	7,666	11,876	-3,960	-3,726	11,856
VI. RESERVE AND RELATED ITEMS (A + B)	1,945	-12,506	-30,285	-7,666	-11,876	3,960	3,726	-11,856
Memorandum:								
Reserve Assets Position	51,639	66,105	96,207	105,709	119,655	114,502	110,123	110,123
(In months of imports and official debt)	4.0	6.5	7.2	7.4	7.2	7.1	6.4	6.4

* provisional figures
** very provisional figures

investment surplus. Besides, it was able to serve as cushion to support Indonesia's BoP amid decline in the portfolio investment surplus due to heightened global economic uncertainty (Table 4.1).

In line with robust BoP in 2011, various external vulnerability indicators showed an improvement. The foreign exchange reserves at the end of 2011 rose to 110.1 billion US dollar or equivalent to 6.4 months of

payments of imports and government external debt. Meanwhile, the ratio of external debt to GDP and the ratio of external debt to exports also declined.

4.2 Current Account

The current account recorded a surplus of 2.1 billon US dollar (0.2% of GDP), mainly owed to increasing surplus of the trade balance. The surplus of the trade balance was driven by a large increase in exports which surpassed the increase in imports stemming from increasing domestic economic activities. Nevertheless, the current account surplus was less than in the previous year since increasing imports also increased the services account deficit and increasing foreign investments also increased transfer payments of profits and investment returns which was reflected in increasing deficit of income account (Chart 4.2).

The increase in the trade balance was driven by an increase in the non-oil and gas trade balance surplus. Non oil and gas exports, which grew at a faster pace than imports, significantly contributed to the increase in the non oil and gas trade balance. The gas trade balance surplus was supported by higher gas prices, in line with rising oil prices, while gas export volume experienced a decline. On the other hand, the oil trade balance deficit rose almost doubled from the previous year. The main factors behind the heightened pressure on the oil trade balance were the lower national crude oil production accompanied by ever-increasing fuel consumption amid rising oil prices.

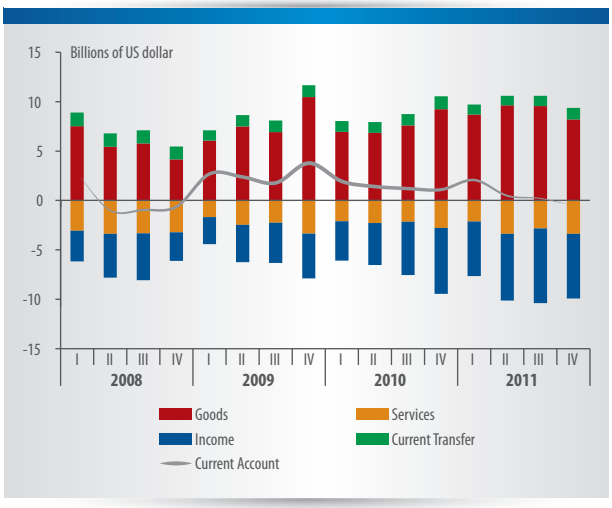


Chart 4.2 Current Account

EXPORT

Exports of goods recorded fairly strong growth, supported by mining products and natural resource based products. The value of exports reached 201.5 billion US dollar, or grew at 27.5% from the previous year (Table 4.2). Commodities which showed the strongest growth were still mining products and natural resources based manufacture products such as coal and palm oil. However, the export growth of agricultural products was quite low due to, among others, low levels of production caused by unfavourable weather conditions and policies on export duties, e.g. on cocoa to encourage domestic cocoa forward linkage industry. Improving exports performance was supported by higher non oil and gas export volumes, while oil and gas export volumes decreased. Increasing non oil and gas

Table 4.2. Export

Items	Value (millions of US dollar)		Share (%)		Growth (%)	
	2010	2011**	2010	2011**	2010	2011**
Agriculture	4,991	5,157	3.2	2.6	14.8	3.3
Manufacturing [1)]	101,740	127,269	64.4	63.2	32.9	25.1
Mining [1)]	49,733	66,719	31.5	33.1	32.6	34.2
Others [1)]	1,610	2,327	1.0	1.2	31.7	44.5
Total Export	158,074	201,472	100.0	100.0	32.1	27.5
- Non-oil and Gas	129,416	163,193	81.9	81.0	30.7	26.1
- Oil	15,691	20,283	9.9	10.1	45.4	29.3
- Gas	12,968	17,996	8.2	8.9	32.0	38.8

[1)] Including Oil and Gas
[**)] very provisional figures

export volumes was in line with higher production and increasing production capacity in some sectors such as palm oil industry and textiles and textile product industry.

At the same time, the oil and gas exports also increased despite of problems on the production side. In nominal terms, oil exports increased by 29.3% from 15.7 billion US dollar in 2010 to 20.3 billion US dollar in 2011. It was driven by higher oil prices. In term of volume, crude oil exports actually saw a decline from the previous year due to the declining national crude oil production from 0.945 million barrels per day in 2010 to around 0.902 million barrels per day in 2011. Declining oil production was caused by aging oil wells and lack of exploration of new wells. In addition, the decline of oil production was also attributable to other problems such as technical disturbances and unplanned shutdowns. The value of gas exports in 2011 increased to 18.0 billion US dollar from only 13.0 billion US dollar in the previous year. However, the volume of gas exports experienced a decline because of switching from export orientation – of which export contracts were expired – to domestic market regarding increasing domestic demand of gas. Oil and gas exports were mainly directed to several countries including Japan, South Korea, and Singapore.

The strong exports in the reporting year were also influenced by developments in the global commodity prices. The global commodity prices, especially crude oil, tended to increase as an impact of the geopolitical crisis in the Middle East which affected supply of crude oil (Chart 4.3). Increasing oil price was also attributed to speculative trading, whereby oil was regarded as a safe haven asset during global financial market turmoil. Meanwhile, the price of non oil and gas commodities also rose quite rapidly, especially at the beginning of the year, despite later slowing in the second half of 2011. The non oil and gas commodities which saw price increases included rubber, palm oil and coal, amid strong global demand especially from Asian countries .

The success to take advantage of increasing intra-Asian trade strengthened Indonesia's export growth. While demand from developed countries such as the US, European countries and Japan declined, market diversification helped to maintain Indonesia's strong export performance. Market diversification of exports was mainly to emerging market countries in Asia like China and India whose economies still grew at relatively high rate supported by strong domestic demand. Indonesia's exports also benefited from the characteristics of the export commodities to these countries which were mainly used for domestic consumption of these countries, like energy and food commodities, such that they were not significantly affected by slowing world trade volume. The export growth to these countries recorded an increase in 2011 (Chart 4.4). With this development, the share of exports to these Asian countries continued to rise.

Provided that rupiah appreciated, it remained fairly competitive (in real terms) compared to other currencies in the region, thus helping to support Indonesia's strong exports performance. In 2011, stable rupiah movements supported competiveness of Indonesia's exports. Rupiah on average appreciated by 3.6% against US dollar, down from 14.1% in 2010. Rupiah appreciation was relatively greater than the

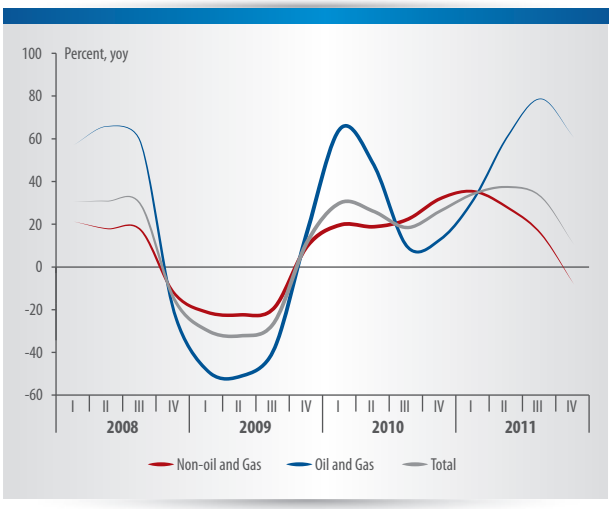


Chart 4.3 Export Price Index of Indonesia

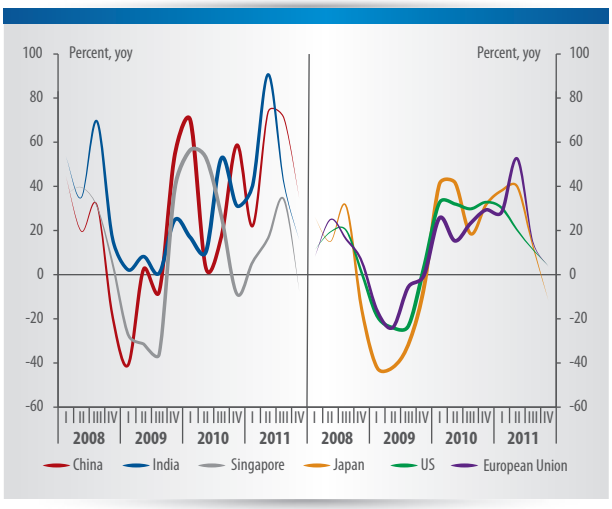


Chart 4.4. Export Growth by Country Destinations

appreciation of other currencies in the region. Yet in real terms, the rupiah was still fairly competitive, thereby helping to underpin exports performance.

From other aspects of competitiveness, natural resource based export commodities also retained Indonesia's export competitiveness. Based on the Revealed Comparative Advantage (RCA) indicator, export commodities which were highly competitive – especially natural resource based commodities like crude palm oil (CPO), coal, and rubber – still showed positive growth amidst global economic shocks (Table 4.3). Nonetheless, this presented challenges given that natural resource based commodities have a relatively low added-value and have inelastic supply to response to higher demand.

IMPORT

The import of goods in 2011 grew quite high, underpinned by stronger domestic demand for consumptions and investments. The value of imports (c&f) in the reporting year grew by 31.4% (yoy) and reached 175.8 billion US dollar. The import growth of raw materials and capital goods accelerated, in line with increasing investment and production (Table 4.4). Import growth in raw materials was mainly driven by food and drink items, and supplies for manufacturing sector. Meanwhile, import growth of consumption goods was also fairly high, even though not as high as in the previous year, in line with the higher domestic consumptions. Imports , especially capital goods and raw materials, were still dominated by goods originating from Singapore, China and Japan.

Imports of oil and gas experienced an increase due to low domestic production of oil and gas amid increasing consumptions. Imports of fuel and LPG increased in line with rapid growth of the domestic economy. Besides increasing volumes, oil and gas imports were also attributable to the fairly significant increases in prices. Crude oil was imported particularly from the Middle East, which included certain types of oil such as ALC (Arab Light Crude), with the remainder from Brunei Darussalam, China and Malaysia. Meanwhile, the increase of oil product imports, especially fuel, could not be avoided as a consequent of decreasing domestic crude oil production amidst continuously rising fuel consumption (Chart 4.5). Fuel consumption in 2011 rose to 450.5 million barrels from 404.9 million barrels in 2010, in conjunction with economic growth and large disparity between the prices of subsidized fuel and non-subsidized fuel. The increase in fuel consumption mainly owed to enormous fuel consumption for transportation.

SERVICES, INCOME, AND CURRENT TRANSFER

Services, income, and current transfer of BoP experienced a higher deficit in 2011 along with stronger domestic economy. The deficit in 2011 reached 11.8 billion US dollar, rose from a deficit of 9.3 billion US dollar in the previous year. The higher deficit was mainly attributable to the higher deficit on transportation services in line with the higher imports of goods, both oil and gas and non oil and gas (Chart 4.6). Meanwhile, travel services still recorded a surplus, supported by the increase in the number of foreign tourists who visited Indonesia. The number of foreign tourists in 2011 reached a record high of 7.7 million

Table 4.3. Competitiveness of Non-oil and Gas Export Commodities

Percent

Commodities	Growth in Volume (yoy)		Share to Total Non-oil and Gas Export	
	2010	2011**	2010	2011**
Coal	26.9	21.8	13.7	16.6
Crude Palm Oil	-3.0	2.1	10.5	10.7
Textile	12.0	-2.6	8.9	8.3
Electrical equipment	17.8	-0.5	9.9	8.1
Chemical product	18.9	15.7	6.9	7.8
Rubber	20.6	9.2	5.7	7.2
Copper	3.1	-35.3	7.5	5.3
Machinery and Mechanical	15.1	-3.7	5.5	5.3
Paper	8.6	1.6	4.3	3.5

RCA > 1 strong competitiveness

RCA < 1 or near to 0, weak competitiveness

**) Very provisional figures

Source: UN Comtrade (processed)

Table 4.4. Import (c.i.f)

Items[1)]	Value (millions of US dollar)		Share (%)		Growth (%)	
	2010	2011**	2010	2011**	2010	2011**
Consumer Goods [2)]	16,826	23,261	12.4	13.2	58.4	38.2
Raw materials/auxiliary materials [2)]	92,098	119,785	68.1	67.9	45.6	30.1
Capital Goods [2)]	24,983	32,361	18.5	18.3	28.7	29.5
Others [2)]	1,417	948	1.0	0.5	175.4	-33.1
Total Import	135,323	176,355	100.0	100.0	44.3	30.3
Non-oil and gas	108,026	135,922	79.8	77.1	39.5	25.8
Oil	26,101	38,725	19.3	22.0	64.4	48.4
Gas	1,196	1,708	0.9	1.0	146.9	42.8

[1)] Based on Broad Economic Category (BEC)
[2)] Including Oil and Gas
* Provisional figures

visitors, supported by a series of international events held in Indonesia. The foreign visitors mainly came from Singapore, Japan, and Netherland, with the main destinations still being Bali, Jakarta, and Batam.

Deficit of income rose significantly, triggered by increasing profit repatriation by foreign investors who invested their capital in Indonesia in term of direct and portfolio investments. The deficit increased from 20.8 billion US dollar in 2010 to 25.7 billion US dollar in 2011. The high profit transfers from foreign companies implied remarkable benefits foreign investors can obtain from investing in Indonesia, as well as reflecting the improving performance of companies in Indonesia. This superior performance was mainly achieved by companies operating in the major sectors such as oil and gas sector and mining sector. In addition, increasing returns of portfolio investments also reflected significant foreign ownership on domestic financial assets, except foreign ownership in Bank Indonesia Certificate (SBI) which already declined dramatically since implementation of 6-month holding period policy in May 2011.

The current transfers experienced declining surplus, mainly because of an increase in worker remittances by foreign workers in Indonesia amid stable remittances from Indonesian workers overseas . Current transfer surplus declined to 4.2 billion US dollar in 2011 after remittances sent by foreign workers increased by 2.1 billion US dollar. On the other hand, remittances sent by Indonesian workers overseas slightly increased to around 6.7 billion US dollar. It was mainly due to the decline in the number of Indonesian workers abroad that, among other things, was related to the government moratorium on sending Indonesian workers to certain countries such as Saudi Arabia and

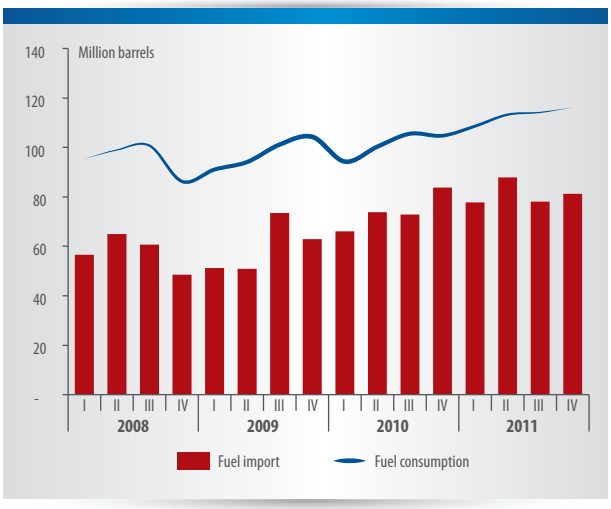


Chart 4.5 Import and Consumption of Fuel

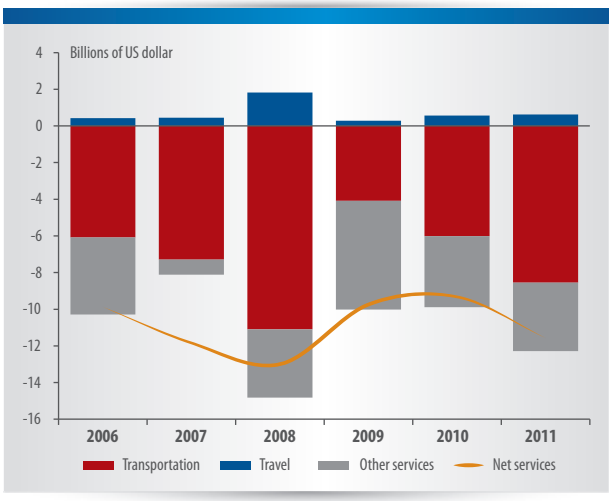


Chart 4.6 Service Account

Malaysia. This was to improve the recruitment and placement system of Indonesian workers overseas, especially in the informal sector. Despite the decline in the number of Indonesian workers overseas, stable remittances received from overseas was supported by increasing salaries, as well as increasing shifting of Indonesian workers in a number of countries from informal sector to formal sector.

4.3 Capital and Financial Account

The capital and financial account in 2011 recorded a surplus of 14.0 billion US dollar, mainly supported by direct investments. The surplus, however, was lower than surplus in the previous year (26.6 billion US dollar) due to smaller surplus on portfolio investments. With larger surplus in direct investment compared to portfolio investment, the structure of the capital and financial account improved this year (Chart 4.7). This meant that capital inflows was more stable, and thereby was able to support strong BoP performance.

DIRECT INVESTMENT

Improving resilience and prospective Indonesia's economic outlook raised foreign investor confidence, and finally increased the share of direct investment in the capital inflow structure. The surplus of FDI rose to 18.2 billion US dollar in 2011, and boosted share of FDI to total capital inflows which was far greater than in the previous year. On the other hand, Indonesia's direct investment abroad rose to 7.7 billion US dollar in 2011.

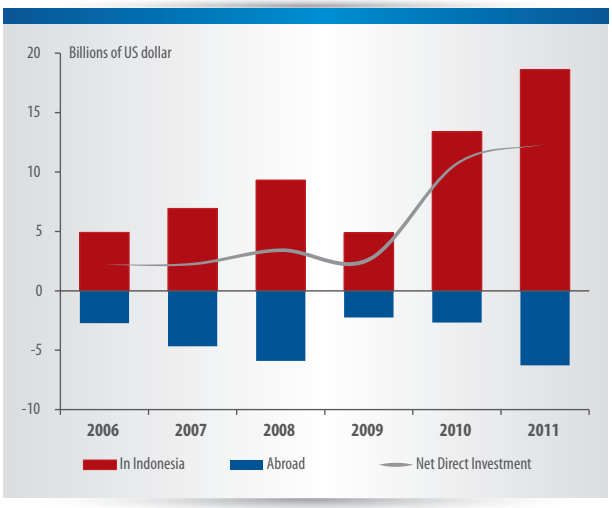


Chart 4.8 Direct Investment

With this development, net inflows of direct investment in the reporting year was at 10.4 billion US dollar (Chart 4.8).

The manufacturing sector and mining sector were still the main sectors for FDI in 2011. FDI in the manufacturing sector reached 7.4 billion US dollar (Chart 4.9). FDI in mining sector rose to 4.2 billion US dollar, from only 1.9 billion US dollar in 2010. The expectations for the high oil price and other mining commodity prices gave an incentive to foreign investors to increase their investments in these two sectors.

Based on country of origin, most of the FDI were from Japan and other ASEAN countries , in particular Singapore. FDI share of Japan's reached 25.9% of the total FDI in the reporting period, or amounting to 4.7

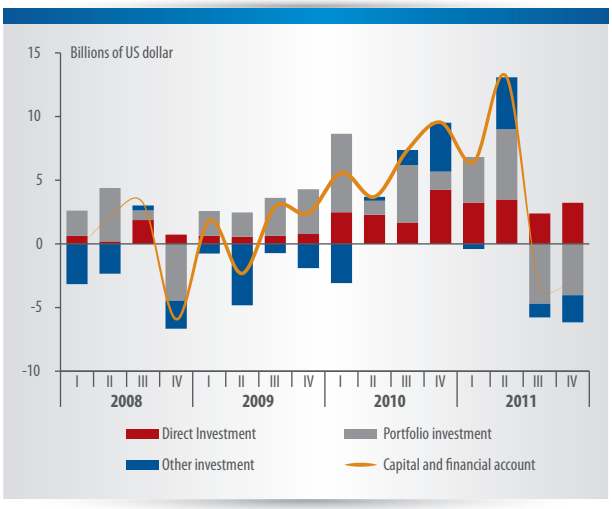


Chart 4.7 Capital and Financial Account

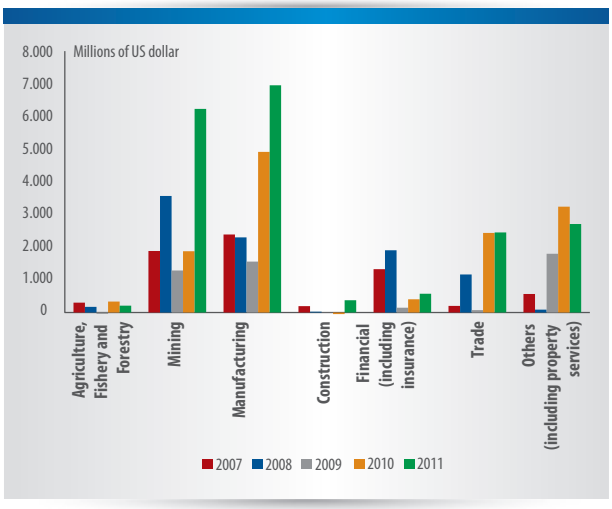


Chart 4.9 Direct Investment by Industry Origins

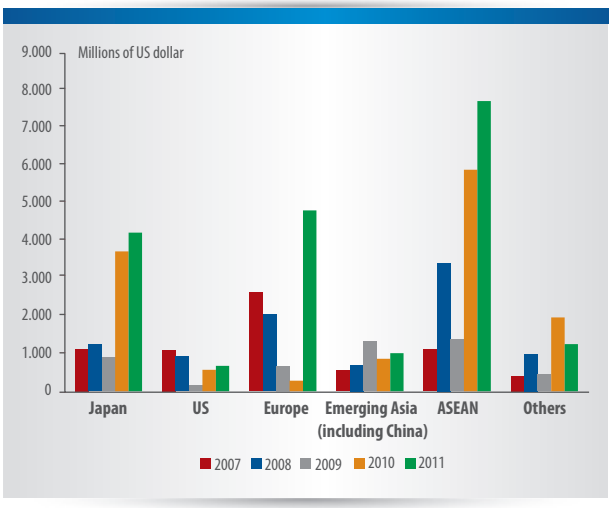


Chart 4.10 Foreign Direct Investment by Country of Origin

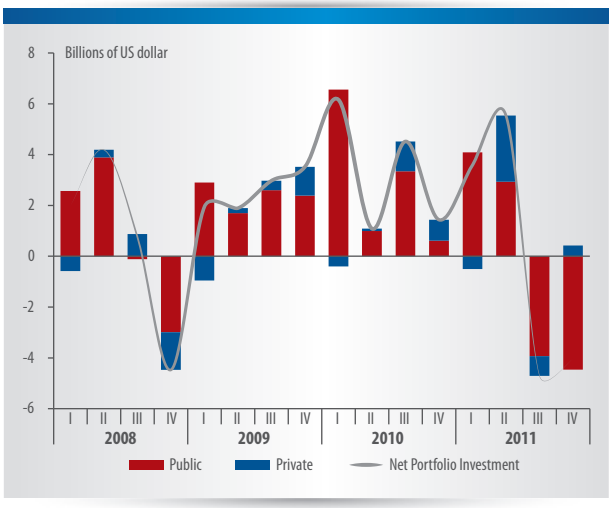


Chart 4.11 Portfolio Investment

billion US dollar. The share of FDI from ASEAN countries reached 45.5%, or equal to 8.3 billion US dollar (Chart 4.10).

The stronger foreign investor confidence on Indonesia's economic outlook was also reflected in the continued upgrades of Indonesia's sovereign ratings. In 2011, some rating agencies upgraded Indonesia's rating, and Indonesia even managed to regain its investment grade rating by the end of 2011. This achievement created greater optimism toward Indonesia's economic outlook, and thereby paving the way for even more FDI inflows going forward.

PORTFOLIO INVESTMENT

Foreign portfolio investment experienced a sharp decline in the second half of the year as the impact of global economic turmoil. Foreign portfolio net inflows (on the liabilities side) fell from 15.7 billion US dollar in 2010 to 5.6 billion US dollar in 2011. In the meantime, Indonesian portfolio investment overseas (on the assets side) also declined from 2.5 billon US dollar to 1.4 billion US dollar. Accordingly, the overall portfolio investment recorded a surplus of 4.2 billion US dollar, lower than the surplus in the previous year of 13.2 billion US dollar.

The foreign portfolio investment surplus (on the liabilities side) accumulated in the first half of 2011, shrank in the second half due to raising negative market sentiment in the global financial markets (Chart 4.11). The sharp decline in foreign portfolio investment was originated from redemption of SBI and rupiah denominated Government Bonds (SBN Rupiah) owned by foreign investors.

SBI transactions conducted by foreign investors recorded net outflows of 5.4 billion US dollar in 2011. It was trigged by shocks in the global financial markets which urged foreign investors to switch their investment in domestic financial assets to safe haven assets (dollar denominated), the large amount of maturing SBI which were not refinanced, and implementation of Bank Indonesia's regulation to impose a 6-month minimum holding period on SBI in May 2011. The later measure made SBI a less liquid instrument, and resulting in lower foreign capital inflows invested in this instrument. In the end, the share of foreign investors' ownership in SBI dropped from 27.45% of total outstanding SBI at the end of 2010 to only 6.51% at the end of 2011.

Foreign ownership in rupiah denominated SBN also experienced a sharp decline during the reporting period. The share of foreign ownership in SBN which once jumped from 29.9% in December 2010 to 35.0% in the middle of September 2011 – the highest in 2011 –, also decreased when global financial turmoil occured. Foreign investors' appetite for SBN Rupiah at this time was driven by relatively high returns, backed-up with sustainable fiscal condition, and stable macroeconomic conditions. Nevertheless, as foreign investors switched to safe haven assets in the mid of September to early October 2011, foreign investors reduced their SBN Rupiah holdings. Consequently, the share of SBN Rupiah held by foreigners dropped to 29.8%.

With this development, SBN Rupiah recorded net inflows of only 3.2 billion US dollar through 2011, which was far below the level in the previous year when SBN Rupiah net inflows reached 9.7 billion US dollar. Despite those development, positive perception on

Indonesia's fundamental economic prospects created fairly strong foreign investors' demand for global bonds and foreign currency denominated SUKUK issued by the government. In the whole 2011, the government issued 2.5 billion US dollar of global bonds and 1.0 billion US dollar of SUKUK.

Regarding foreign portfolio investment in private sector, the global financial market turbulence also had a contagion effect on the performance of the domestic stock market. It was reflected in the volatile movements of the IDX Composite throughout the year (Chart 4.12). Prospective stock performance in the first half of 2011 resulted in enormous foreign capital inflows invested in the stock market, and lifted the IDX Composite to 4,130 in July 2011, the highest record. Nonetheless, negative sentiment from global economic shocks at the end of the third quarter of 2011 encouraged foreign investors to rebalance their portfolios, which in turn pushed down the IDX Composite and led to a weaker rupiah. With this development, stock trading by foreign investors recorded net selling (outflows) of about 0.3 billion US dollar in 2011, compared to the net buying (inflows) of 2.1 billion US dollar in 2010.

By economic sector, the weakening of the IDX Composite in the second half of 2011 was mainly due to increasing selling pressure on shares in mining sector, infrastructure sector and agriculture sectors, which was down by 22.7%, 14.6%, and 6.1%, respectively. Weakening stocks in mining sector was, among others, attributable to expectations of declining oil price and other mining commodity prices in accordance with expectations of weaker global demand. Nonetheless, shares in a number of other sectors, such as the consumer and various industries sectors, still showed price increases supported by the stable domestic consumption.

OTHER INVESTMENTS

Other investment posted a deficit due to an increase of private sector deposits in banks overseas. The deficit of other investment in 2011 was around 0.6 billion US dollar after recording a surplus of 2.3 billion US dollar in the previous year. The deficit was mainly driven by increasing private sector deposits in overseas banks as non-oil and gas exports increased. On the other hand, loan disbursement by private sector also increased as financing requirement to support domestic economic activities increased. It, to some extent, could compensate increasing Indonesian deposits in overseas banks, and prevented an even higher deficit of other investments (Chart 4.13).

Increasing external debts was mostly occured in the private sector. The surplus of private sector other investments reached to 9.0 billion US dollar because of increasing loan disbursements of 24.4 billion US dollar (Chart 4.14). It still recorded a fairly large net surplus of 7.5 billion US dollar even though private sector debt repayments also increased. Besides fundamental rationale of fulfilling funding needs, increasing of private external debts was also driven by relatively stable rupiah exchange rate during 2011 which implied more moderate exchange rate risk. Regarding

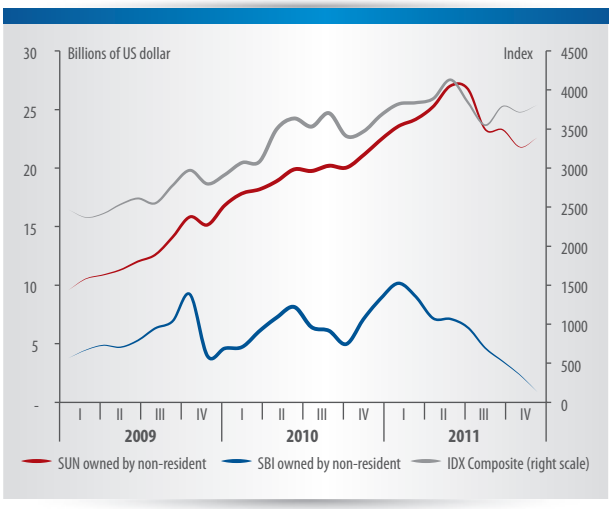


Chart 4.12 IDX Composite and Foreign Ownership in Securities

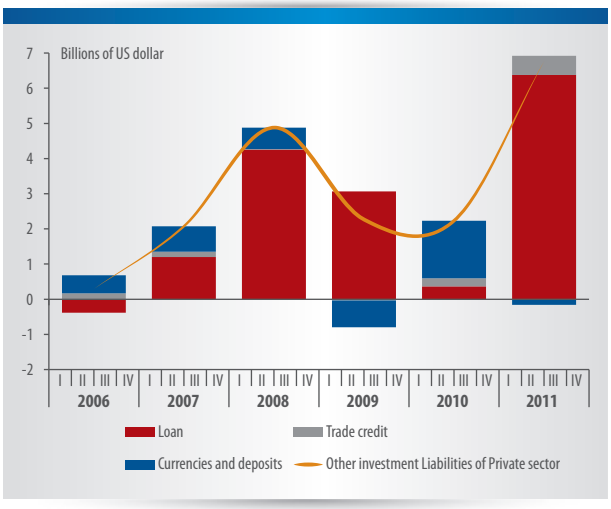


Chart 4.13 Other Investment Liabilities of Private Sector

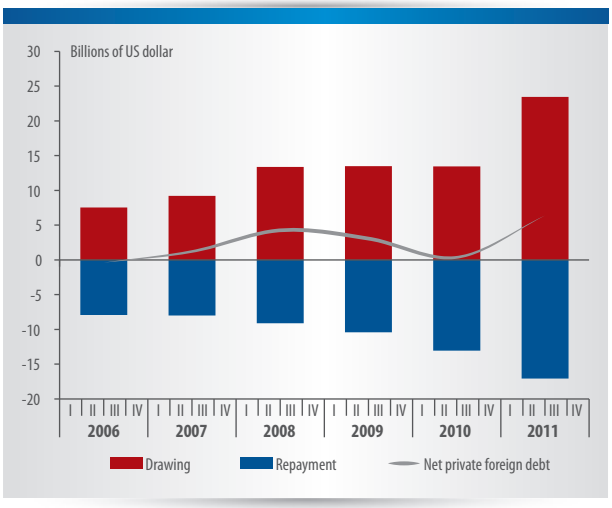


Chart 4.14 Private Foreign Debt

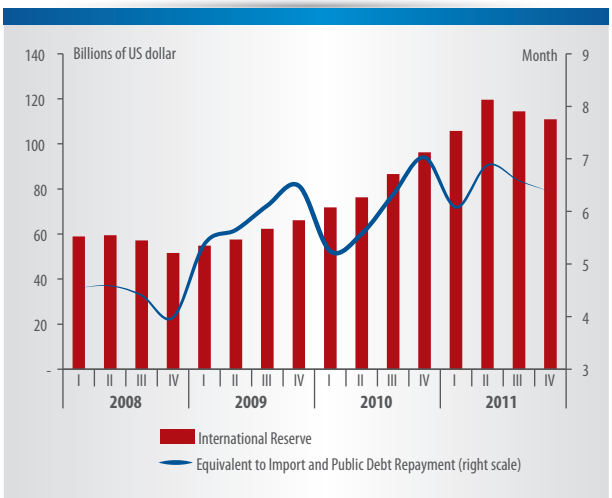


Chart 4.15 International Reserve

government external debt, loan disbursement decreased and accordingly the government external debt indicators showed improvements.

Public sector other investments experienced a deficit of 2.3 billion US dollar in 2011 compared to a surplus of 1.8 billion US dollar in the previous year. It was mainly caused by declining external debt disbursement, both program loans and project loans, which were recorded at only 1.6 billion US dollar and 1.9 billion US dollar, respectively. It was driven by lower funding needs of the government budget as actual budget deficit was below the target. Besides, government still had high SILPA (Surplus of the Budget Estimation) which can be used to meet the funding needs. In addition, the government debt repayments in the reporting year reached 5.5 billion US dollar, slightly lower than in the previous year.

4.4 Foreign Exchange Reserves And Indicators Of External Vulnerability

The foreign exchange reserves remained at a safe level amid several shocks to the foreign exchange markets. By the end of 2011 foreign exchange reserves increased to 110.1 billion US dollar (Chart 4.15). Foreign exchange reserves once reached a record high in August 2011 of 124.6 billion US dollar, supported by the enormous foreign capital inflows in the first half of 2011. Nonetheless, it then declined as Bank Indonesia intervened the market to stabilize the rupiah exchange rate amidst the occurance of external shocks triggered by heightening the public debt crisis in Europe and concerns over slowing pace of economic recovery in the US.

In line with the robust BoP performance in 2011, various indicators of external vulnerability showed an improvement (Chart 4.16). From the solvency aspect, the ratio of external debt to GDP and the ratio of external debt to exports declined to 26.5% and 96.8%, respectively. In the mean time, the debt service ratio was relatively stable at around 22.5%. On the liquidity aspect, the ratio of forex reserves to short-term external debt rose to 2.4. Meanwhile, the ratio of foreign exchange reserves to imports was still considered safe as it covered 6.7 months of imports.

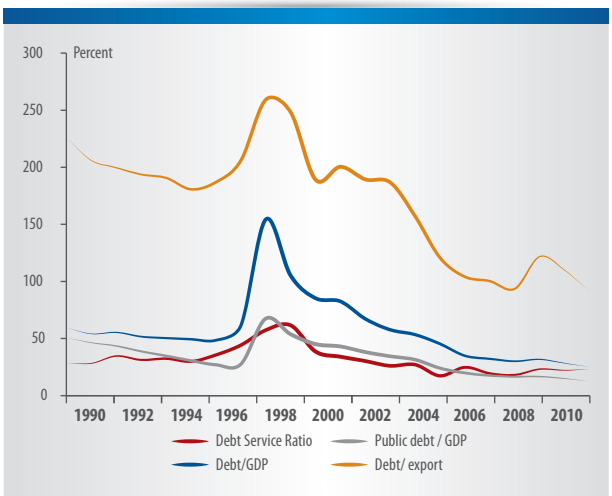


Chart 4.16 The Indicators of External Vulnerabilities

Chapter V

Exchange Rate

Exchange Rate

On average, the rupiah exchange rate tended to strengthen during 2011 in line with other regional currencies' movements. From domestic side, the exchange rate appreciation was supported by solid economic fundamentals, relatively stable risk indicators, and a high return on rupiah based assets, which impressed investor appetite to invest in domestic financial markets. Meanwhile, on the external side, rupiah exchange rate performance was affected by capital flows fluctuations, which was influenced by the dynamics of the global economy and policies. During semester I 2011, monetary easing in advanced countries led to an excess of global liquidity, which coupled with the widening interest rate differential between developed and developing countries led to a deluge of capital flows into the Asian region, including Indonesia. Such circumstances ensured the continuation of rupiah appreciation that had occurred in 2010. Notwithstanding, increased uncertainty in quarter III 2011 stemming from the debt crisis in Europe and recovery problems in the US triggered negative sentiment and capital outflows from Indonesia. Since this period the rupiah exchange rate had tended to weaken accompanied by increased volatility.

5.1 Exchange Rate Performance

In 2011, rupiah exchange rate appreciation was marked by a number of corrections associated with rising inflation expectations at the beginning of the year as well as increasing global economic risk that persisted until yearend. The rupiah appreciated in 2011, on average, by 3.56% from Rp9,080 per US dollar to Rp8,768. However, the rising of global economic uncertainty undermined the sustainability of rupiah appreciation that had occurred up until the end of semester I 2011. At yearend, the rupiah closed down by 0.64% at Rp9,068 per US dollar compared to Rp9,010 at the end of 2010 (Chart 5.1). A similar trend was also noted for the exchange rate volatility, which eased during the first half of the year to 0.32%, but subsequently increased in semester II to 0.43%. As an annual average, volatility in 2011 was 0.38%, which represents an increase over the previous year at 0.35% (Chart 5.2).

Sound domestic economic prospects coupled with such attractive returns of rupiah investments helped encourage rupiah appreciation nearly throughout semester I 2011. Concerns over an increase in inflation expectations were successfully mitigated. At the beginning of the year, escalating inflationary pressures and expectations provoked non-resident investor concerns, which led to adjustments in their rupiah investment portfolio. Nonetheless, the policy response from Bank Indonesia to mitigate the increase in inflation expectations, consisting of raising the BI Rate by 25 bps in February 2011, had a favourable impact on the exchange rate, which continued to strengthen until the end of semester I 2011. On the other hand, amid high global uncertainty, domestic macroeconomic performance, which was characterised by robust economic growth, controlled inflation, fiscal sustainability and well-managed foreign debt as well as stability on domestic financial markets, spurred a surge in foreign capital inflows in to government securities (SBN) and stock market.

In semester II 2011, heightened global risk reignited pressures on the rupiah exchange rate. Increased uncertainty surrounding global conditions was attributable to the propagation of the debt and fiscal crisis in Europe, the downgraded US credit rating by Standard and Poor's (S&P) due to the unsustainable financial position of the US Government as well as

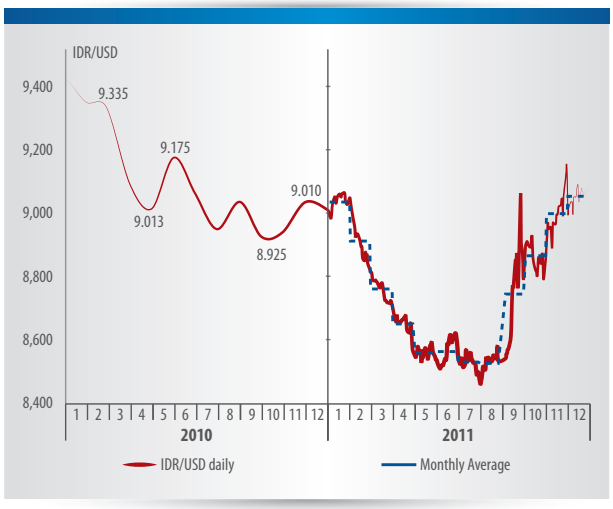


Chart 5.1 Rupiah Exchange Rate

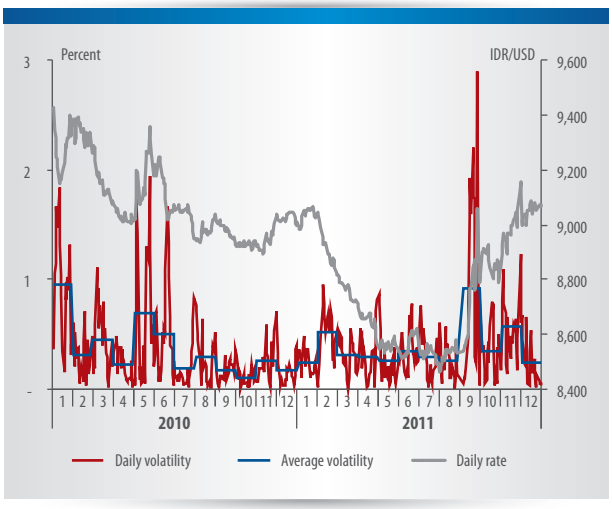


Chart 5.2 Rupiah Volatility

stronger indications of a slowdown in the global economy. Such conditions, in turn, caused investors to switch their investment portfolios from developing to developed countries perceived to be safer, like US government bonds. In Indonesia, foreign investors exited their portfolios investment such as government securities and shares. As a consequent, the rupiah experienced pressures against the US dollar until year end (Chart 5.3).

The appreciation of rupiah was controlled and congruent with shifts in other currencies in the region. In 2011, when compared to other countries in the region, the competitiveness of Indonesia remained sufficient (Chart 5.4 and chart 5.5) despite rupiah appreciated significantly against the US dollar. The competitiveness of Indonesia, as reflected by the real effective exchange rate (REER), is generally considered to be on par with that of other countries in the region. Despite an increase in the middle of the year, average REER in the region during 2011 trended downwards in line with a weaker regional exchange rate against the US dollar. The range of exchange rate fluctuations at that time was consistent with internal and external macroeconomic balances and provided assurance to economic players in the real sector and financial sector. Such conditions, together with global commodity prices, had a favourable impact on the performance of non-oil/gas exports during the reporting period (Chart 5.6).

5.2 Affecting Factors

Exchange rate stability during 2011 was bolstered by continuously improving domestic economic fundamentals amid the increasing global economic uncertainty and risk. From the external side, global liquidity excess subsequent to loosening monetary policy and liquidity injections by several central banks around the world during the crisis period of 2008 as well as the continuation of programs to buy up assets by central banks remained a source of capital inflows to emerging countries. The policy of low interest rates in advanced countries, which aimed to catalyse economic growth, encouraged investors to seek more attractive destinations for their investments. A number of emerging countries in the Asian region, including Indonesia, with more conducive economic fundamentals became major destinations for global

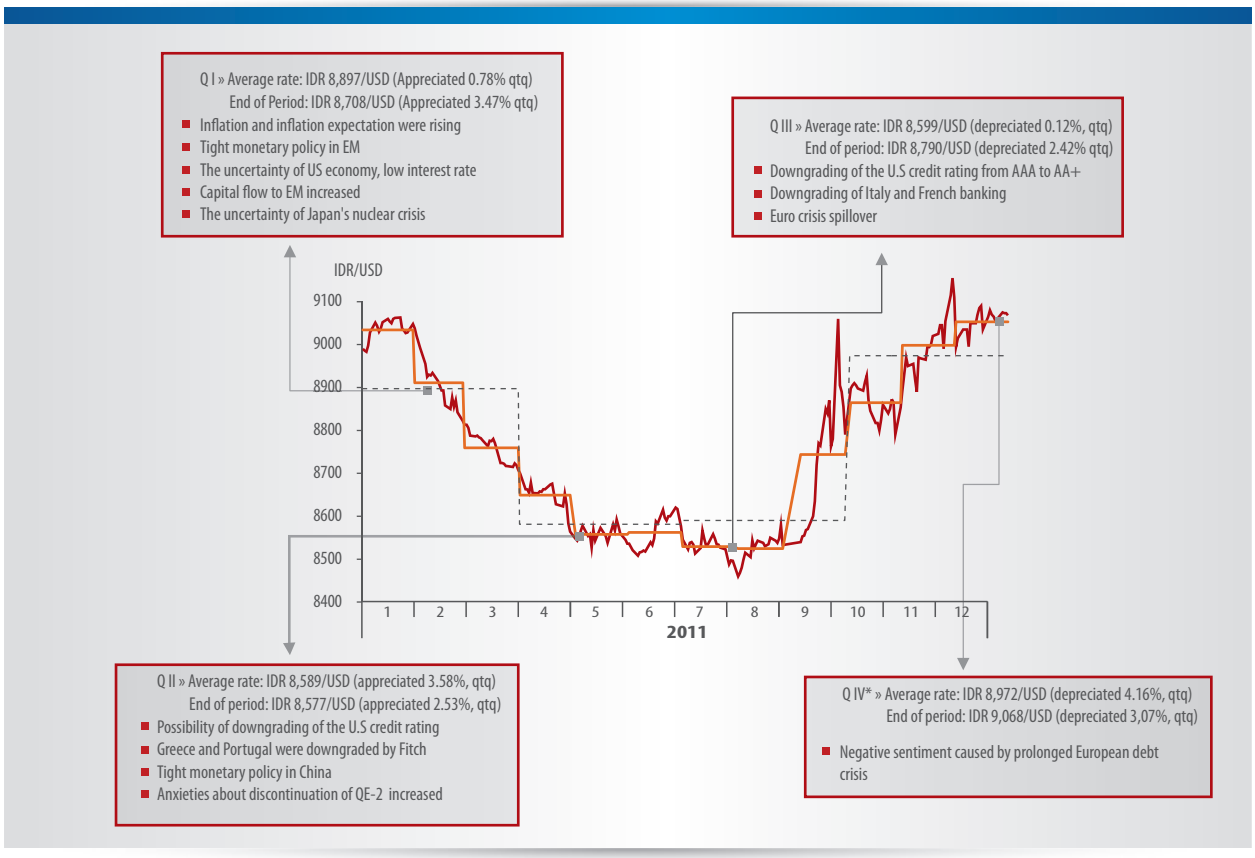


Chart 5.3 Exchange Rate and Event Analysis of Rupiah Exchange Rate

Chart 5.4 The Exchange Rate Againts US Dollar

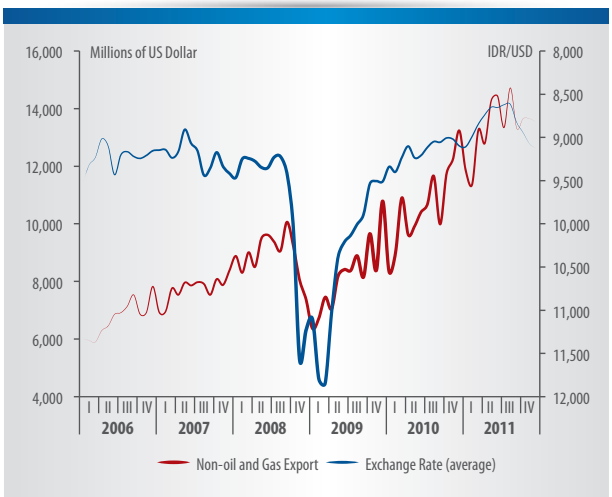


Chart 5.6 Rupiah Exchange Rate and Non-oil and Gas Export

funds. Such conditions were further strengthened by attractive returns on financial markets, which in turn led to rupiah appreciation.

The dynamics of the global economy placed additional pressures on the rupiah. The downgraded credit ratings of Portugal and Greece by Fitch in April and May 2011 eroded optimism regarding global economic prospects, which had posted positive growth at the beginning of the year. Pressures of crisis subsequently spread to Italy and Spain in September 2011, which were further exacerbated by the downgraded credit rating of the US by Moody's. Such conditions provoked a withdrawal of portfolio investment from several emerging countries, including Indonesia, and spurred depreciatory pressures on the domestic currency.

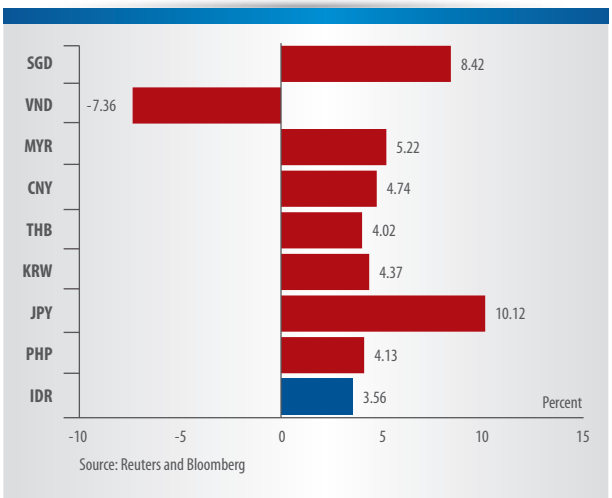


Chart 5.5 Exchange Rate Appr/Depr in The Region Countries

Rupiah fluctuations and depreciation were able to be managed through the introduction of several polices by Bank Indonesia. Persistently favourable domestic macroeconomic fundamentals combined with a surplus in Balance of Payments for a number of years have provided an exchange rate cushion against an array of external pressures. In line with the Balance of Payments' surplus, foreign exchange reserves continued to swell to 110.1 billion US dollar at year end 2011, which helped boost confidence in the rupiah exchange rate. Indonesia's foreign exchange reserves were sufficient to meet short-term import liabilities, and short-term foreign debt service payment and anticipate a sudden capital reversal, especially in the form of portfolio investment.

The continued improvement in domestic macroeconomic fundamentals also had a propitious impact on investment indicators for rupiah financial instruments. A number of risk indicators improved during 2011, as reflected by the upgrade in credit rating for Indonesia by several international rating agencies as well as the improvement in the country risk index. S&P upgraded its long-term foreign currency rating for Indonesia from BB to BB+ on 8th April 2011, with a positive outlook. Meanwhile, Indonesia's sovereign rating for long-term local currency was affirmed at BB+ with a positive outlook. This increase brought the sovereign rating of Indonesia, based on the assessment by S&P, to 1 notch to investment grade. Confidence in Indonesia's economic outlook continued to strengthen as reflected by the inclusion of Indonesia into the group of countries with investment grade status. At yearend 2011, Fitch reinstated Indonesia's BBB- investment grade status with a stable outlook. Prior to this, Fitch

Table 5.1 *Indonesia Sovereign Credit Rating* (Per December 2011)

	MOODY'S	S&P	FITCH	R&I	JCR
Investment Grade	Aaa	AAA	AAA	AAA	AAA
	Aa1	AA+	AA+	AA+	AA+
	Aa2	AA	AA	AA	AA
	Aa3	AA-	AA-	AA-	AA-
	A1	A+	A+	A+	A+
	A2	A	A	A	A
	A3	A-	A-	A-	A-
	Baa1	BBB+	BBB+	BBB+	BBB+
	Baa2	BBB	BBB	BBB	BBB
	Baa3	BBB-	**BBB- (*Stable*)**	BBB-	**BBB- (*Stable*)**
Non-Investment Grade	**Ba1 (*Stable*)**	**BB+ (Pos)**	BB+	**BB+ (Pos)**	BB+
	Ba2	BB	BB	BB	BB
	Ba3	BB-	BB-	BB-	BB-
	B1	B+	B+	B+	B+
	B2	B	B	B	B
	B3	B-	B-	B-	B-
	Caa	CCC	CCC	CCC	
	Caa2	CCC	CCC	CCC	CCC
	Caa3	CCC-	CCC-	CCC-	
	Ca	CC	CC	CC+	CC
	C	C	C	CC	C
		D	D	CC-	D

Indonesia
R & I = Rating and Investment Information, Inc.
JCR = Japan Credit Rating Agency, Ltd.

upgraded its sovereign rating for Indonesia to BB+ with a positive outlook on 24th February 2011 (Table 5.1).

Uncertainty concerning the global economy pushed up risk perception in Indonesia. In the first half of 2011, several indicators of risk showed signs of improvement. Credit Default Swaps (CDS) in the first half of 2011 continued to decline and even reached 125.19 (Chart 5.7). Meanwhile, another indicator of risk, namely the spread between the yields of Indonesian government bonds and US T-Notes, declined to 1.57% at the end of semester I 2011. The favourable achievement of risk indicators was further supported by higher returns on the rupiah, as reflected by the negative spread between the Non-Deliverable Forward (NDF) rate (offshore) and the forward rate (onshore).

Several risk indicators suffered in quarter III 2011 in line with an increase in uncertainty regarding the debt crises and fiscal sustainability in advanced countries as well as doubts over the fragile global recovery. CDS closed at 217 compared to 128.25 at year end 2010. In terms of point to point (ptp), the yield spread between Indonesian government bonds and US T-Notes experienced an increase to 2.65% (ptp) from 1.63% in 2010 (Chart 5.7). Meanwhile, assets were diverted as a result of increased global uncertainty, which triggered

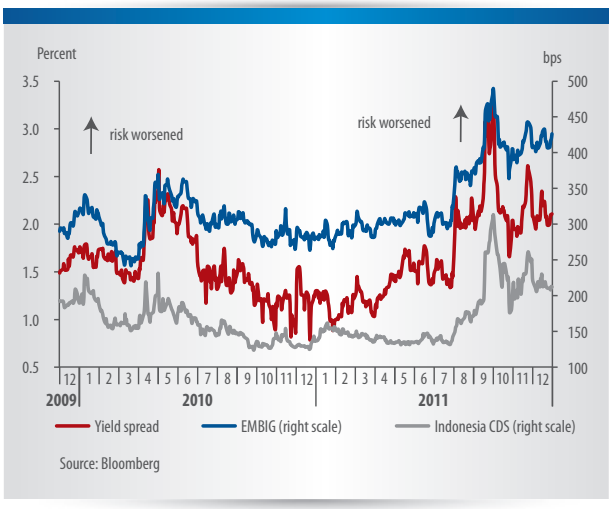


Chart 5.7 Risk Index and Yield Spread

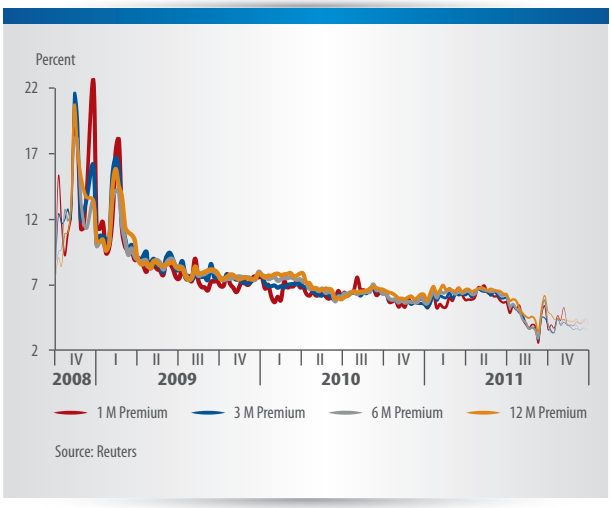


Chart 5.8 Swap Premium

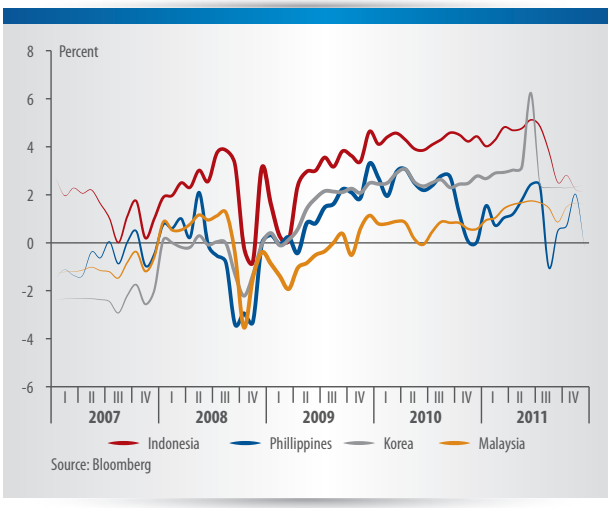


Chart 5.10 Covered Interest Rate Parity (CIP)

a return to positive NDF rate and forward rate spread. The condition of various tenor of swap premiums improved at year end after experiencing a brief decline (Chart 5.8).

Compared to regional countries, investment in rupiah assets continued to provide competitive advantage. A relatively higher uncovered interest rate parity (UIP) for rupiah-based assets reflected a greater return on investment compared to other countries in the Asian region (Chart 5.9). In fact, when taking into consideration the risk premium, the allure of investment in rupiah instruments remained high. This is reflected by the trend of covered interest rate parity (CIP), which continued to exceed that of other countries in the region (Chart 5.10).

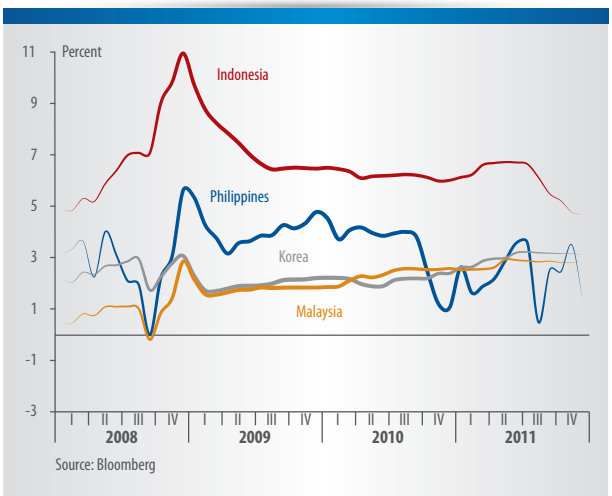


Chart 5.9 Uncovered Interest Rate Parity (UIP)

The manageability of the exchange rate's fluctuations in 2011 was linked to the policies taken by Bank Indonesia and the Government. Maintained exchange rate stability was the result of monetary and banking policy issued by Bank Indonesia, supported by sound fiscal policy and foreign debt management. The BI Rate was set to achieve low inflation target that is conducive to economic growth as well as financial system stability. In order to strengthen efforts to lower inflation, Bank Indonesia also provided greater space for rupiah appreciation in line with the inundation of foreign capital inflows as well as the growing trend of exchange rate appreciation in the region (Box 5.1). Facing increased uncertainty and vulnerabilities in the global economy, Bank Indonesia reinforced its monetary and macroprudential policy mix which had been implemented in 2010 through some policies to manage the foreign capital flows. This was intended to limit the influx of foreign capital, particularly in the form of short-term and speculative investment, from triggering excessive rupiah appreciation, domestic excess liquidity and high risk of instability on financial markets. Consequently, Bank Indonesia reintroduced banks short term external borrowing policy in January 2011 amounting to a maximum of 30% of the bank's capital, raised the statutory reserve requirement on foreign currency from 1% to 5% in March 2011 and then to 8% in June 2011, and lengthened the holding period on Bank Indonesia Certificates (SBI) from one month to six months in May 2011. Meanwhile, in order to minimise the dependence on short-term capital, sustain the supply of foreign exchange on the domestic foreign exchange market and encourage foreign exchange market deepening, Bank Indonesia issued policy on foreign exchange flows related to proceeds from export activity (DHE) as well as foreign currency disbursements

(DULN) on foreign loans through foreign exchange banks in Indonesia. This policy was announced on 3rdOctober 2011 and will become effective on 2nd January 2012. Furthermore, the DHE and DULN policy remained under the auspices of the Foreign Exchange Act, No. 24, 1999.

5.3 Performance Of The Domestic Foreign Exchange Market

Rupiah exchange rate performance was also affected by supply in the foreign exchange market, which recorded a surplus in semester I and a deficit during semester II. In semester I 2011, foreign and domestic players posted a net foreign exchange supply of 6.32 billion US dollar and 961 million US dollar respectively. Therefore, overall in semester I 2011, the domestic foreign exchange market recorded a surplus of 7.3 billion US dollar. This was in line with the inflow of foreign capital investment in rupiah portfolio in the form of shares and government bonds (SBN). The surplus on domestic foreign exchange market helped drive rupiah appreciation in semester I 2011. Meanwhile, during semester II 2011 domestic and foreign players recorded a net demand for foreign exchange totalling 4.28 billion US dollar and 9.69 billion US dollar respectively. Overall, the domestic foreign exchange market experienced a 13.97 billion US dollar deficit in semester II 2011, which precipitated rupiah depreciation.

The purchase of foreign exchange by the domestic corporate sector continued to increase in line with the yearend payments for foreign debt and import due to domestic economic expansion. Meanwhile, referring

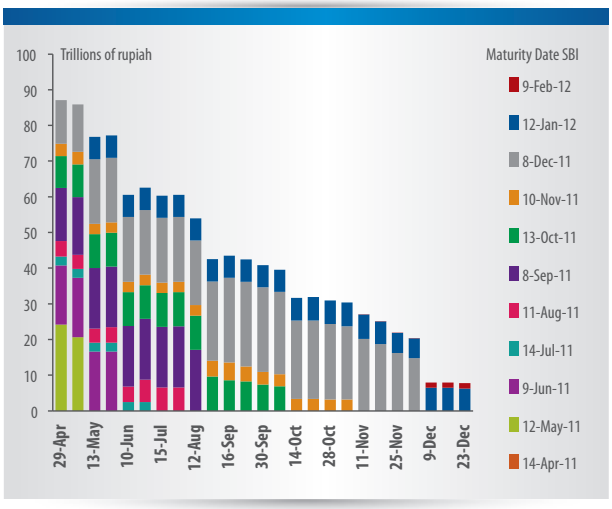


Chart 5.12 Maturity of Foreign Ownership in SBI

to foreign investors, the supply of foreign exchange increased up to August 2011 but with corrections emerged in the subsequent months. Overall, the domestic foreign exchange market experienced a deficit in 2011 totalling 6.69 billion US dollar. In terms of transaction volume, the average daily trade in foreign exchange increased by around 2.9 billion US dollar per day, which exceeded that posted in the previous year as well as levels prior to the crisis in 2008.

The management of foreign capital flows by Bank Indonesia and risk in the global economy encouraged greater foreign ownership of SBN, while foreign ownership of Bank Indonesia Certificate (SBI) declined. Persistently attractive returns on rupiah portfolio investment drove a significant rise in foreign placements in SBN up to the end of semester I 2011.

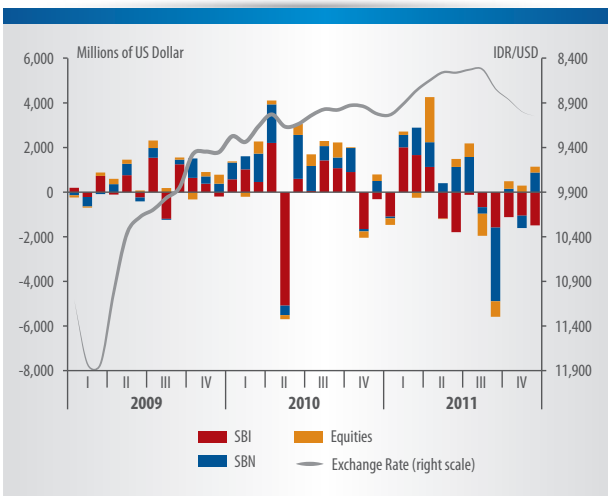


Chart 5.11 Foreign Fund Flows in Rupiah Portfolio

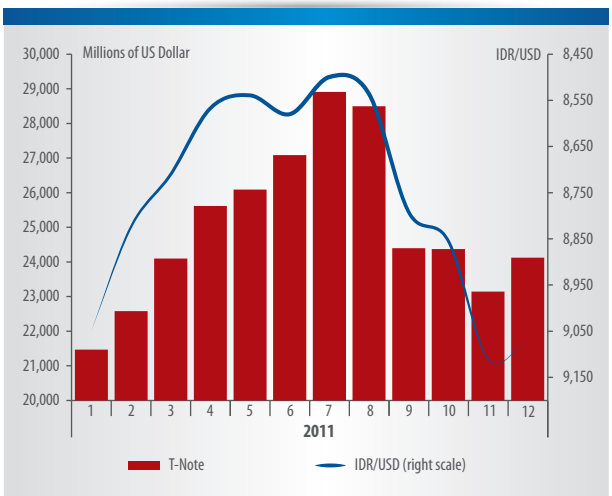


Chart 5.13 Foreign Ownership in SBN

Compared to the position at yearend 2010 of 21.7 billion US dollar, foreign placements in SBN peaked at 29.3 billion US dollar at the beginning of August 2011 before eventually returning to a more modest 23.1 billion US dollar due to adjustments in foreign portfolios to safe haven assets (dollar denominated) (Chart 5.11).

Bank Indonesia also introduced policy to deepen the money market and alleviate pressures of a sudden reversal by extending the holding period for SBI, which eased capital inflows to SBI and funnelled foreign placements to SBN. Foreign ownership in SBI declined in correspond with their maturity period to 860 million US dollar compared to 6.1 billion US dollar in 2010 (Chart 5.12). Consequently, during 2011 non-residents recorded net outflows from rupiah instruments amounting to 747.99 million US dollar, while the portion of foreign investors in SBN remained relatively steady at around 29%, and the share of foreign investors in SBI shrank from 27.45% in 2010 to 6.51% at year end 2011 (Chart 5.13).

BOX 5.1 |THE ROLE OF THE EXCHANGE RATE IN A FLEXIBLE INFLATION TARGETING FRAMEWORK

The Inflation Targeting Framework (ITF) in Indonesia has successfully passed a number of formidable challenges since its implementation in 2005. Such challenges started from the mini-crisis in 2005, followed by the global crisis in 2008 and the torrent of foreign capital inflows in the post-crisis period, and finally the pressures stemming from foreign capital outflows in 2011. Owing to sound policy rensponse and coordination, all of the challenges were overcome by the Indonesian economy. In addition, experience in dealing with the global crisis has provided a number of invaluable lessons regarding monetary policy formulation. First, in an open economy, monetary policy is faced with various challenges thereby necessitating an appropriate instrument mix. Second, the global crisis showed that macroeconomic instability could also originate from the financial sector. Third is the importance of clearly positioning the role of exchange rate within the inflation targeting framework.

These lessons learned led to the need for modification the ITF strategy ahead. Such modifying is a response to the demands of stakeholders to raise Bank Indonesia's credibility in terms of achieving the inflation target. Based on several studies, the application of a flexible inflation targeting framework is the ideal format for the economy of Indonesia.

Under the classic inflation targeting framework, a free-floating exchange rate regime is the optimal choice due to the theory of "uncovered interest rate parity" (UIP), where the exchange rate acts as an economic shock absorber. Under such circumstances, changes in the policy rate are expected to elicit a corresponding response in the exchange rate through the domestic demand channel and the financial channel, which ultimately has an impact on inflation. However, in a globally integrated financial market environment, the role of the exchange rate tends to be different from the basic assumptions used in classic ITF. Accordingly, the exchange rate tends to move exogenously and even occasionally acts as an economic shock amplifier. Under such conditions, the transmission of monetary policy through the policy rate is insufficient to influence the exchange rate.

Seeing that changing roles in the economy, the role of exchange rate within the ITF also changes. One of the most important issues to clarify within the context of flexible ITF is the role of the exchange rate. First is the desire to guide the exchange rate towards an optimal level from a macroeconomic perspective. This is governed by the magnitude of exchange rate passthrough to domestic prices and its role in terms of foreign debt. Consequently, despite the formal adoption of ITF and a free-floating exchange rate regime, the central bank intervenes in the foreign exchange market in order to alleviate instability on the financial market. Second is the need to explicitly include the role of the exchange rate in the reaction function of the central bank (policy rule). Many emerging market countries are reluctant to allow their exchange rates to float completely despite having adopted ITF (Roger et al, 2009). This is primarily found in countries that use the exchange rate as a policy anchor. Similarly, Mohanty and Klau (2005) also found that the majority of countries that have adopted ITF consider the exchange rate when setting their monetary policy stance. Nevertheless, several studies have also shown that it is not yet necessary to include the exchange rate in the reaction function of the central bank, including Taylor (2001), Mishkin and Schmidt-Hebbel (2001), Edwards (2006), and Batini et al. (2007).

Managing the exchange rate within ITF is further supported by policy related to foreign capital flows. The preliminary phase of policy to control the inflow of foreign capital involves intervention as well as the accumulation of foreign exchange reserves. Warjiyo (2005) postulated that intervention is a tool that can assist monetary policy, stabilise market expectations and limit unexpected short-term exchange rate fluctuations. In the application of flexible ITF, intervention is geared towards seeking

a more accommodative solution without allowing the exchange rate to fully float following the pure market mechanism.

Meanwhile, self-insurance is achieved through the accumulation of foreign exchange reserves. This is critical in safeguarding against the possibility of a sudden capital reversal. Additionally, an optimal amount of foreign exchange reserves, considered adequate by the international community, helps efforts to achieve investment grade status, which will ultimately reduce the cost of funding for development. The subsequent phase is capital flow management (CFM). CFM policy is applied when conventional policy fails to overcome capital inflows, the exchange rate of the respective economy is not undervalued, foreign exchange reserves are more than adequate and the economy is overheating. In general, CFM is a temporary policy choice and it is used to overcome specific risks related to certain types of capital flows because they are short term in nature. Therefore, CFM does not impede more stable, longer-term and productive capital flows. There are two types of CFM policy, (i) CFM without discrimination against non-residents, often referred to as macroprudential; and (ii) CFM that discriminates against non-residents, more commonly categorised as the capital control.

Practically, Bank Indonesia has implemented the exchange rate policy and the management of foreign capital flows in order to maintain exchange rate stability. This was mostly in evident during the post-global crisis period prior to 2008 when the Indonesian economy faced strong appreciation pressures on the exchange rate. Exchange rate stabilisation policy relied on intervention and favoured maintaining the external and internal balances amid foreign capital inflows and appreciatory pressures. This policy alsorepresented an anticipatory measure for a possible sudden capital reversal by maintaining an adequate level of foreign exchange reserves to meet the import requirement and foreign loan payment as well as to ensure self-insurance.

Meanwhile, foreign capital flows were managed through an array of macroprudential policies. First, the month holding period (MHP) on SBI that has been in effect since July 2010 obliged the buyers of SBI, on the primary and secondary markets, to maintain ownership for a minimum given period of time. Second, rupiah term deposits were introduced in July 2010 to manage liquidity more permanently all together with managing portfolio investment in monetary instruments. Third, Bank Indonesia reintroduced capital limits on short-term offshore bank loans, which aimed at applying prudential principles to the management of offshore bank loans as well as encouraged longer-term offshore bank loans. Fourth, the statutory reserve requirement, which intended to bolster bank liquidity management in anticipation of a greater requirement in 2011, was raised in phases to 5% in March and 8% in June 2011. Fifth, cross-border central bank cooperation was aimed at overcoming problems associated with the balance of payments and short-term liquidity in the region, as well as complementing existing international financial cooperation like the Chiang Mai Initiative Multilateralisation (CMIM) between ASEAN+3 member countries effective since 24th March 2010 and the Bilateral Currency Swap Arrangement (BCSA) with the People's Bank of China. The range of policies outlined was sufficiently effective in terms of maintaining rupiah exchange rate stability amid global economic shocks throughout 2011.

Chapter VI

Inflation

INFLATION

Indonesia's inflation dropped to 3,79% in 2011 amid solid economic growth of 6,5%. The level was much lower than that in the previous year of 6,96% and below its target of 5% ± 1%. Inflation declined in almost all regions in Indonesia and moved toward the level in neighbouring countries. The policies taken on by the Government and Bank Indonesia contributed to the low level of the inflation. Core inflation was stable at a relatively low level of 4.3% due to adequate economic capacity, stronger rupiah and well-anchored inflationary expectations. Meanwhile, volatile food inflation, which peaked at 17.74% last year, fell sharply to just 3.37%, as a result of adequate supplies and food price stabilization efforts by the Government. Administered prices inflation was also kept minimal at 2,78% by the absence of policies in strategic commodities such as subsidised fuel prices and electricity tariff.

6.1 Inflation Performance

The declining trend of headline inflation persisted in 2011. Despite some significant negative shocks from foodstuffs prices and fuel prices over the decade, headline inflation has shown some resilience as indicated by its declining trend (Chart 6.1). The continuing trend in 2011, though mostly happened in food components, took place in almost all categories, except for the clothing, health and education components. Based on this development, the declining trend of inflation is expected to carry on in the future. (Chart 6.2). [1]

In the beginning of 2011 inflationary pressures were high but then they subsided until the end of the year. Contributing to the inflationary pressures at the start of the year were the high inflationary expectations, pressures on domestic foodstuffs prices due to limited supply and disturbances to distribution, and harsh weather conditions. From external front, crude oil prices and agricultural commodities prices were also rising. Following the level in the end of 2010, headline inflation remained high in the first quarter of 2011, approaching 7%, which occurred in volatile food and core components (Chart 6.3). Inflation expectations for 2011 were also high at around 6.5%-6.8%.[2] The high inflationary expectations were among others affected by the Government's plan to ration the consumption of subsidized fuel – which had started since 2010 - and the uptrend in global commodity prices, including energy prices.

Afterwards, the following months were marked by significant deflation during the harvesting season. During the first half of 2011, deflation in the CPI occurred in March of -0.32% (mtm) and in April of -0.31% (mtm) which was greater than its historic average (Chart 6.4). The deflation was stemmed by the deflation in volatile food component that took place during the February-April period, longer than its historical pattern of 1-2 months and greater than its historical deflation during the harvesting months (March and April). Thus, CPI inflation in the first half of 2011 only reached 1.06% (ytd) or lower than that of the previous year of 2.42% (ytd).

1 Average in the years 2002 until 2010 (including the period when subsidised fuel prices were hiked)

2 Consensus Forecast in January-April 2011

Chart 6.1 Event Analysis of CPI Inflation

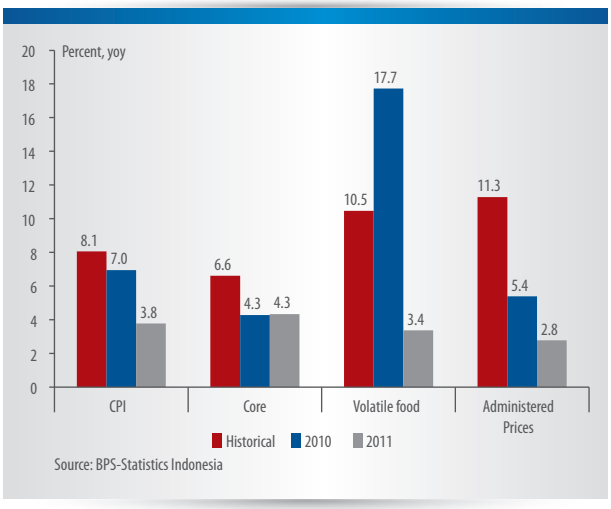


Chart 6.2 Inflation Performance vs Historical Data

Table 6.1. Pre-crisis and Post-crisis Inflation

Percent

Period	Pre- crisis	Post-crisis	Post crisis
	(1991-1997)	(2000-2011)*)	(2000-2011)**)
Average (%)	8.26	7.97	6.45
Std. Deviation (%)	1.84	3.98	2.75

*) Including a period of fuel price hike
**) excluding a period of 1st and 2nd round impact of fuel price hike in Jan 2002, Oct 2005, May and June 2008

Source: BPS-Statistics Indonesia, Processed

During the second half of 2011, headline inflation was influenced by the adverse development on the global economy. Normally, the intensity of inflationary pressure tended to increase during the second half of the year. This year, the pressure was moderated by the development in global economy. The delayed of global economic recovery drove the gold price up quite significantly thereby pushed up core inflation in August to 1.09% (mtm), far above the normal level of around 0.4% (mtm). However, gold price soon underwent major correction and along with another major correction, which was the transportation tariff correction for two consecutive months after the Ied Fitr, caused core inflation dropped from its normal monthly level. Meanwhile, deflation in the volatile food component took place again in September and October which resulted in low inflation during the Ramadhan/ Ied Fitri period of 1% (mtm), lower than its historical level of above 1%. With this development, overall CPI inflation for the year only reached 3.79%.

By component, the low level of CPI inflationary pressure in 2011 was mainly caused by low contribution of the foodstuffs component which was on the contrary to its historically largest contribution. In 2011, the contribution of foodstuffs component was only 0.84% to CPI inflation, or far below its historical level.[3] By region, Java, the nation's production centre for agriculture, experienced the largest decline in inflation than other regions, recording inflation of 3.43%, or lower than in 2010 (6.71%). The harvesting of spices and rice, mostly in the production centres in Central Java and West Java, created sufficient supply, especially for those regions close to these production center regions.

The lower contribution to CPI inflation took place in nearly all components, except clothing and education (Chart 6.5). The clothing component - especially jewellery - contributed significantly to CPI inflation - notably in the period of August to September, due to the stuttering global economic recovery. As such, the additional impact from gold price shock during the religious festivities of Ramadhan and Ied Fitr pushed up CPI inflation in August 2011 to 0.93% (mtm), higher than its August level in the past ten years. Meanwhile, in the education component, tuition fees increased

3 Average contribution of the foodstuffs component around 1.92% from 2003-2010 and 3.34% in 2010.

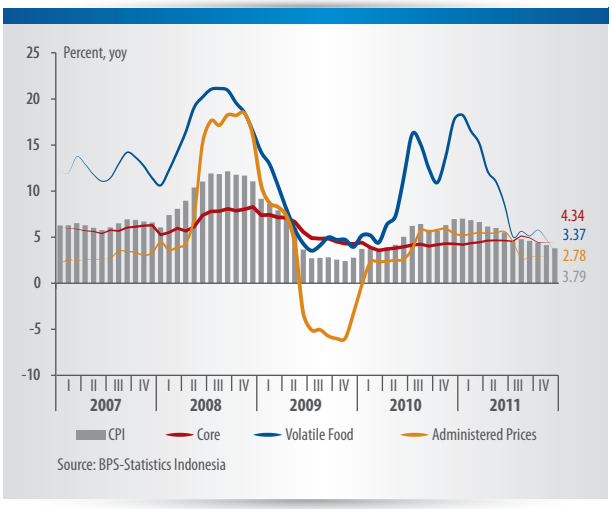


Chart 6.3 2011 Inflation Performance

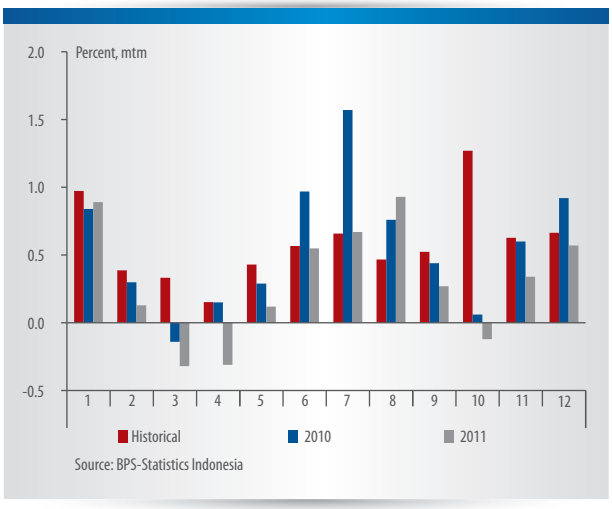


Chart 6.4 Monthly CPI Inflation

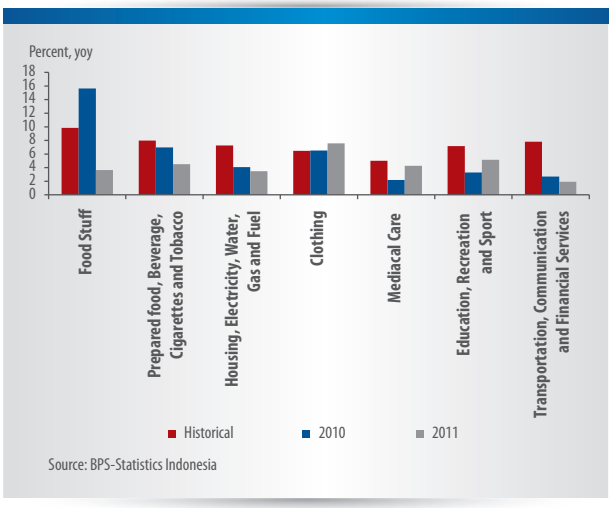


Chart 6.5 Inflation by Group of Commodities

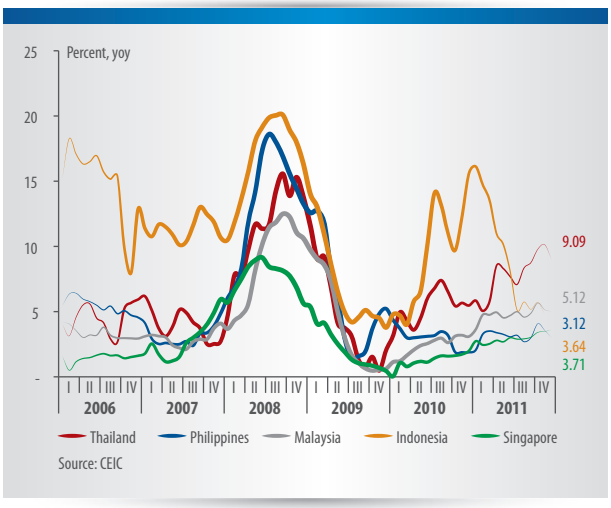


Chart 6.7 Food Inflation in the Region Countries

at elementary school up to higher education in accordance with new academic year (at the beginning of the third quarter of 2011). The increase of inflation in the education component in 2011 was higher than that in the same period in the last four years. At the higher education level, high inflation particularly took place in Sulawesi and Sumatera. Meanwhile, for Senior High School and below, high inflation occurred in Sumatera and Java.

Compared to four other countries in the region, namely Singapore, Malaysia, Thailand and the Philippines, the level of inflation in Indonesia in 2011 showed a significant decline. For the past decade, Indonesia's inflation has always been the highest in the region. Nonetheless, in 2011, inflation in Indonesia declined significantly, while inflation in the other four countries continued to rise (Chart 6.6). In Indonesia, there was

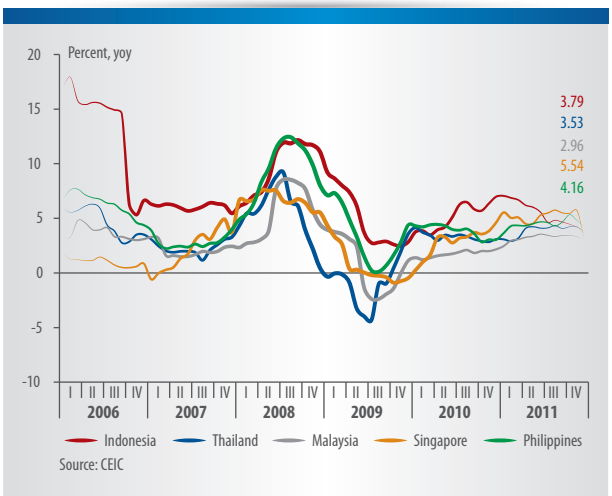


Chart 6.6 CPI Inflation in the Region Countries

an improvement on the supply side to fulfill domestic demand coming both from local production and imports which reduced significantly the prices of the domestic foodstuffs component (Chart 6.7). The level of inflation in Indonesia's foodstuffs component (the volatile foods component), upon entering the third quarter of 2011, declined to a very low level, even far lower than its historical level. Nevertheless, the levels of inflation in Indonesia and the Philippines remain relatively high compared to the ones in the other three nations.

The decline in national inflation was accompanied by the decline in inflation disparity among the regions. Of all the regions in Indonesia, 64 cities recorded lower rates of inflation compared to that of the previous year (Table 6.2)[4] and many below their historical level.[5] Nonetheless, the level of inflation was still higher compared to 2009 because of the sharp correction in 2009 after fuel price hikes in 2008. The sharpest decline in 2011 took place in Java and Sumatera (from 6.71% and 7.83%, respectively, to 3.43% and 3.98%). Furthermore, the inflation disparity among the regions also went down. The disparity, as portrayed by the standard deviation of yearly inflation, showed a decline to 1.2 compared to the previous year's figure of 1.7. The decline in the inflation disparity suggested that most of the inflation in the regions was already close to the national inflation rate.

Despite the benign inflation in the reporting year, a number of structural problems remained. The low level

4 BPS undertook a Cost of Living Survey in 2007 in 66 cities to measure inflation.

5 Average inflation in the years 2003-2010

of inflation in all disaggregated components of the CPI, and the relatively low inflation during the Ramadhan/ Ied Fitr period compared to its historical levels, demonstrated the commitment of the Government and Bank Indonesia, both at the central and regional levels, in maintaining macroeconomic stability. Nonetheless, a number of commodity prices still need to be looked out, especially rice and education. Rice inflation, though fell sharply from 30.45% in 2010 to 10.47% in 2011, was still higher than its historical level of below 10% on average. Inflation in the education sector, meanwhile, has heightened for some time despite the large budget for education. These developments added to the ongoing structural problems, such as agricultural production constraints, distribution obstacles, asymmetric information, imperfect market structure, and limited production capacity. Various government programs in infrastructure such as the Law of Land Procurement for Public Purposes' Development, the Infrastructure Guarantees Program and the launching of the Masterplan of Acceleration and Expansion of Indonesia Economy Development (MP3EI) are expected to keep inflation under control going forward.

6.2 Affecting Factors

EXTERNAL FACTOR

Global commodity prices rose during the first half of the year, however the impact to domestic prices was minimal amid rupiah appreciation. Global commodity prices and inflation in Indonesia's major trading partners upsurged during the first half of 2011, however they did not have a significant impact on the prices of domestic commodities as reflected in the relatively low and stable core inflation of 4.34% (Chart 1. Box 1). This condition was supported by the appreciation of rupiah around 3.6% (on average), although at the end of the year rupiah slightly weakened alongwith the rising uncertainty in global economic recovery. The impact of the shocks from global commodity prices were primarily coming from gold price and energy price. The impact of the latter also limited on selected component of the CPI namely the housing related component.[6]

The increase in global gold price was followed by the increase in domestic gold price. Entering the third quarter of 2011, the price of gold jewellery surged due to high demand for gold as a hedge for deteriorating global economic conditions. During 2011, the gold jewelry prices rose by 15.75%, or higher than the previous year's increase of 14.7% and its annual increase of around 11%, although at year-end, it experienced a correction which reduced core inflation of the month. The increase in the gold jewellery price in each region in Indonesia varied, yet more than 10%, on average was higher than that of the previous year. The increase in the price of domestic gold jewellery was allowed by better consumer purchasing power in most regions.

6 The weight of gold in the CPI basket of goods in the base year 2007 was 1.43%, however the weight rose significantly due to price shocks in 2011 to 2.39% in December 2011.

Table 6.2. Regional Inflation

Percent

Area	Inflation (%)			
	Average 2003-2010	2009	2010	2011
Sumatera	8.55	2.44	7.83	3.98
Northern Sumatera	8.85	2.72	7.79	3.64
Central Sumatera	7.96	1.93	7.85	4.25
Southern Sumatera	8.84	2.75	7.86	4.03
Java	7.55	2.73	6.71	3.43
Western Java	7.90	2.27	6.46	3.20
Central Java	7.46	3.26	6.96	2.86
Eastern Java	7.32	3.41	7.10	4.28
Jakarta	7.42	2.34	6.21	3.97
Eastern Indonesia	8.22	3.91	7.56	4.21
Bali Nusa Tenggara	7.78	4.39	9.05	4.85
Kalimantan	8.51	3.95	8.14	5.35
Sulawesi Maluku Papua	7.89	3.67	6.40	2.92

INTERACTION OF DEMAND AND SUPPLY

Domestic demand grew stronger but supply side was adequate so that price increases were kept minimal. This condition was reflected in the increase in the production index and capacity utilization below the 80% level in the Production Survey and the Business Survey of Bank Indonesia (Chart 6.8). tThose surveys revealed that most industries still have room for higher demand as reflected in the high growth in the industrial sector in the reporting year of 6.1%. This condition also indicated that the output gap was still negative, supported by continuous investment growth since the 2008 crisis.

Another indicator for rising domestic demand was the rise of demand for property. Increased demand for property, especially the residential category, pushed up prices by 4.13%, or higher than that of the previous year of 2.91%. However, the price hike did not yet indicate excessive inflationary pressures and still below the increase prior to the 2008 crisis of around 8%. For commercial property, prices soared by 13.01%, or higher than that of the previous year of 0.2%.[7] Besides being driven by higher demand, the increase in prices in the property sector was also driven by rising prices of construction raw materials especially cement and iron, in line with increases in energy prices. The increased demand for property was reflected in the growth of bank loans for housing reaching 23.3%, higher that that of the previous year of 13.64%. Construction loans also built up, reaching 18.56% as opposed to the decline in the loan around 0.9% last year. Nonetheless, the increase of the property prices was still negligible due to positive response of the supply side.

From regional front, the higher purchasing power in various regions did not lead to excessive price increases. At the beginning of the year, the purchasing power in the regions strengthened in line with the higher regional minimum wages for 2011 which rose by around 9% on average. Nonetheless, this increase had only a minimal impact on inflation because the prices at the producer and retailer levels are more affected by the input costs component than the employee costs. [8]

INFLATION EXPECTATION

Inflation expectations continued to decline. At the beginning of the year, inflation expectations for 2011 were initially high approaching 7% especially in relation to the high price of global commodities, both food and energy (Chart 6.9). Then, after the monetary policy response at the beginning of the year, the fall in inflationary pressures from the volatile food component and the government's decision not to raise fuel prices, inflationary expectations began and continued to decline to around 5%. This level improved than that of the previous year which was around 6%. The decline in inflation expectations was also reflected in the Retail Sales Survey on the inflation expectation for the six months ahead (Chart 6.10).

7 Survey on Residential Property Prices

8 Bank Indonesia Survey, 2011

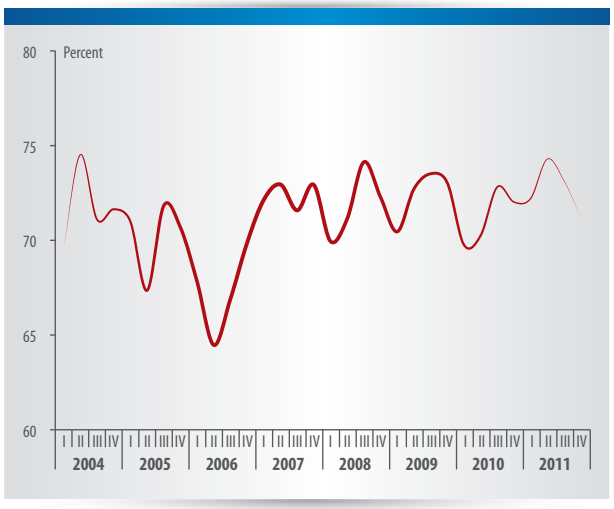


Chart 6.8 Capacity Utilization

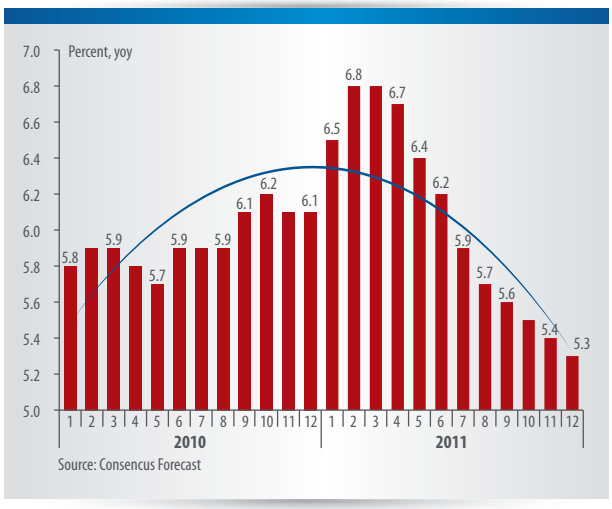


Chart 6.9 Inflation Expectation for 2011

WEATHER FACTOR

Favorable weather condition helped underpin the favourable supply of foodstuffs, thereby having a positive impact on price stability. On the contrary to wet weather conditions last year, 2011 was marked by relatively long dry season that had a positive impact on the production of several types of spices (especially garlic) and vegetables in the production centers in most regions. This was reflected in the abundant supply of vegetables in the Kramat Jati central market in Jakarta each month which was especially vital during the Ramadhan/Ied Fitr period so that price fluctuations were minimal and the volatile food inflation was much lower than its historical level during the festive months.

POLICY FACTOR

The benign inflation in 2011 owed in part to various policies taken by Bank Indonesia and the Government. Both parties adopted policies to anchor the inflation expectations as well as to increase the economic capacity. Bank Indonesia endeavoured to maintain rupiah stability against inflationary pressures from the external side. Meanwhile, the Government directly controlled the prices, especially the strategic ones such as fuel prices and electricity tariff and provided the supply of goods, especially foodstuffs. In addition, Bank Indonesia and the Government enhanced policy coordination, both in central and regional levels, through such forums as the Inflation Control Team and Regional Inflation Control Team.

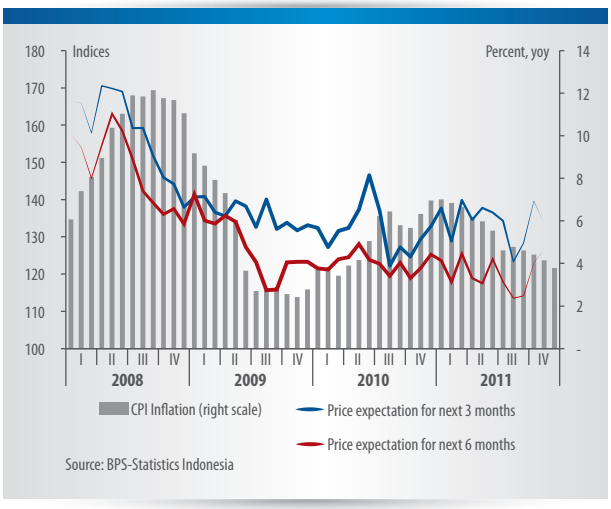


Chart 6.10 Retailers' Price Expectations-Retail Sales Survey

Monetary and Macroprudential Policy Mix

In 2011 Bank Indonesia's policy was directed at maintaining macroeconomic and financial system stability amid high volatility of foreign capital flows. Bank Indonesia continued to strengthen its monetary and macro prudential policy mix in addition to policy coordination with the Government to keep inflation within its targeted range.

In the beginning of 2011, domestic economy faced high inflationary pressures amid foreign capital inflows. In response to this condition, Bank Indonesia hiked BI Rate and took policies to give greater room for rupiah appreciation to help stem inflationary pressures from external factors. However, the extent of rupiah appreciation was still relatively competitive with regional currencies. At the end of the third quarter of 2011, domestic economy faced foreign capital outflows following the worsened global economic uncertainty triggered by the European debt crisis. Under such conditions, pressures in the financial markets, including on rupiah, intensified. Facing these pressures, Bank Indonesia adopted policies to stabilize rupiah to avoid further inflationary pressures.

Next, due to the prospect of stable inflation and anticipating the impact of global economic slowdown on domestic economy, Bank Indonesia took precautionary measures by cutting the BI rate in the fourth quarter of 2011. The policy was consistent with the efforts to manage inflation expectations and was reinforced by intensive strategic communications. The dissemination of the board of governors meeting decisions was undertaken by Bank Indonesia in an intensive manner through various media. This step was undertaken to manage the public expectations concerning the macroeconomic prospects and monetary policy prospects.

Monetary policy was also strengthened by macro prudential policy in managing foreign capital flows and banking liquidity. Various macro prudential policies were aimed at safeguarding rupiah stability which, in turn, helped reduce imported inflation and also increased imports of capital goods to boost domestic production capacity.

Government Policy (Central and Regional)

On fiscal side, the Government increased the budget to stabilize prices, especially the price of foodstuffs, and

to cancel the decision to increase the subsidized fuel prices. The energy subsidies rose from Rp139.9 trillion in 2010 to Rp255.6 trillion in 2011 that help stabilizing inflation amid rising global oil prices. The price of other energy related commodities, namely household fuels, was also minimal, though the kerosene conversion program was still ongoing, especially in eastern Indonesia. Meanwhile, non-energy Subsidies declined from Rp52.8 trillion in 2010 to Rp41.9 trillion in 2011. However, the decline in non-energy Subsidies was set off by the increase in the budget of buffer stocks for food stability (in the form of Government rice buffer stocks and buffer stocks for food price stabilization) from around Rp 2.7 trillion in 2010 to Rp 3.6 trillion in 2011. [9] Overall, Government policies contributed only relatively minimal inflationary pressures (around 5%) which was from cigarette excise duty hike in January 2011, though it was lower than last year of 15% (Chart 6.11).

Various efforts were made by the Government to overcome inflationary pressures coming from supply and distribution obstacles in order to maintain the stability of foodstuff prices. Efforts to ensure adequate supply were made by the Government, both at national and regional level, such as creating policy to mitigate the impact from weather problem and efforts to extend and intensify the agricultural production process; providing subsidies for seeds and fertilizer, national seed buffer stocks budget and direct assistance for top quality seeds; and improving distribution and market structure. In addition, the Government also allocated special funds for food security (this includes covering farmers' production costs at crop failure). Nonetheless, considering that domestic production was not optimal, additional supply from imports was still needed for foodstuffs price stabilization efforts.[10] Rice import for 2011/2012 was granted as much as 1.9 million tons for BULOG. Besides BULOG, the Government - in this regard the Ministry of Agriculture - also maintained price stability by, among other, purchasing onion during the harvesting time. The Government also announced its policy to control rice consumption by promoting consumption of alternative carbohydrate foods. Besides ensuring adequate supplies, the Government also took

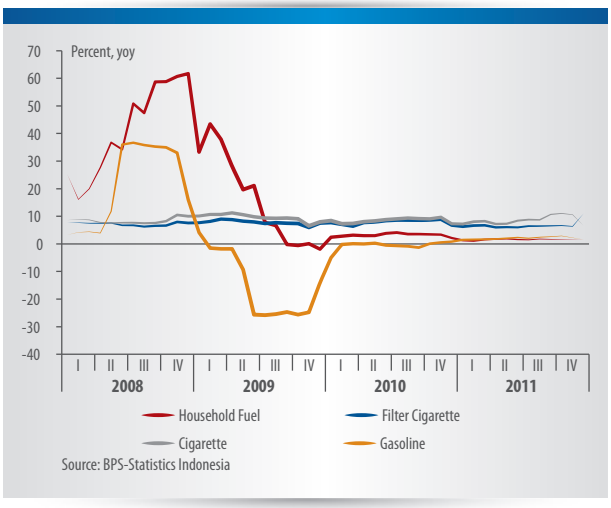


Chart 6.11 Inflation of Selected Administered Price Commodities

more intensive measures to safeguard price stability, e.g. delivering market operations for rice and low price market as well as distributing rice for poor program on 13 occasions. Market operations provided around 400,305 tons of rice[11] and were mainly done at the end of the year when supply weakened. The number of rice provided by the market operations in 2011 was very large compared to that of previous year.[12] Besides that, the distribution of rice for poor was intensified in March after initially being planned to start in April. All these efforts were able to ease the shock to foodstuff prices (Chart 6.12). Rice inflation in 2011 only gave a modest contribution of 0.54%, down from the previous year of 1.26% (Table 6.3). The low volatile food inflation also owed in part to the policies of the regional governments.

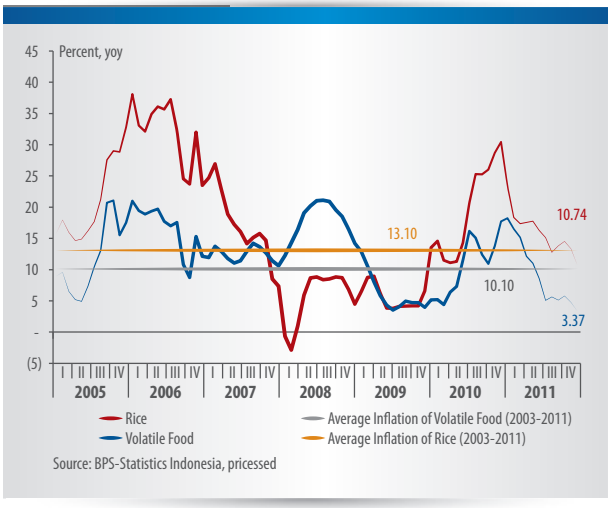


Chart 6.12 Inflation of Volatile Food and Rice

9 The non-energy subsidies declined because of the reallocation of the budget to the other spending account, namely working loans for the people, national buffer stocks of seeds, the Government rice buffer stocks, buffer stocks for food price stabilization, direct assistance for top quality seeds and direct assistance for fertilizer.

10 ARAM III BPS was published in October 2011: the production of Dry Unhusked Rice (GKG) in 2011 reached 65.38 million tons or down from 66.47 million tons in the previous year.

Table 6.3. Contribution to Inflation/Deflation of Volatile Food Commodities

Percent

Commodities	December 2011		
	Inflation (%, yoy)	Contribution (%,yoy)	Contribution (%, mtm)
Inflation			
Rice	10.74	0.54	0.12
Egg	8.92	0.07	0.03
Cooking Oil	4.60	0.06	0.00
Beef	6.73	0.06	0.00
Chicken meat	3.70	0.00	0.03
Red Chili	-15.82	-0.11	0.09
Small chili	-48.60	-0.16	0.01
Shallot	-33.21	-0.18	-0.03
Garlic	-47.55	-0.19	-0.01

Source: BPS-Statistics Indonesia

The large market operations for rice in 2011 were continuously carried out in various regions on the recommendation from the local governments.[13] Besides that, a number of local governments also carried out programs to control rice consumption. To prevent the price of rice from falling at harvesting time, a number of local governments also allocated funds to undertake purchases from the farmers at better prices. When the price of chilies rose sharply in 2010, a number of local governments encouraged the people to plant chilies such that the production of chilies increased significantly in 2011, resulting in lower chilly prices.

13 Market operation for rice took place in almost all regions in Indonesia except Central Java and East Java. The areas included North Sumatera, West Sumatera, South Sumatera, DKI Jakarta, Banten, West Java, Papua and Maluku.

Policy Coordination to Control Inflation

Better coordination between Bank Indonesia and the Government in controlling inflation was continually undertaken through optimizing the role of the Inflation Control Team at the national level and regional level. This better coordination was intended to overcome several problems, especially on the supply side and in distribution, such as price inflexibility and inefficient trade practices (see Box 6.1).

BOX 6.1 | STRENGTHENING POLICY COORDINATION TO CONTROL INFLATION

The inflation dynamics in Indonesia are typically driven by the supply side. Natural factors, such as natural disasters, prolonged dry season and pestilence, in addition to distribution obstacles, are the typical triggers for price shocks in Indonesia. These phenomena are caused by more fundamental problems, such as weak interconnectivity between regions, weak foodstuffs productivity, and other structural problems. Furthermore, government price policies in strategic commodities such as fuel, electricity and cigarette excise, are also major contributors to Indonesia's inflation.

Under such conditions, sound coordination among monetary authority, fiscal authority and sectorial authorities is needed to achieve the inflation target. Bank Indonesia and the Government have taken steps to strengthen coordination by forming a team in a single working framework to control inflation. The existence of this team facilitates intensive policy coordination among all its members such that, in turn, this team can formulate the best policy options. At the central level, this special team was formed based on the Memorandum of Understanding between the Minister of Finance No.88/KMK.02/2005 and the Governor of Bank Indonesia No.7/9/KEP.GBI/2005 under the name the Coordinating Team for the Monitoring and Controlling of Inflation (TPI). The membership of TPI includes Bank Indonesia and related Ministries/ Institutes, namely the Ministry of Finance, The Coordinating Ministry for the Economic Affairs, the Ministry of Trade, the Ministry of Agriculture, The Ministry of Energy and Mineral Resources, the Ministry of Transportation, the Ministry of Employment and Transmigration and the State Logistics Agency (BULOG).

In 2011, the activities of TPI were focused on monitoring potential inflationary pressures coming from foodstuffs and subsidised energy along with making various recommendations on controlling the prices of such commodities. At the beginning of 2011, volatile food inflation was still high, pushed up by, among other things, increases in the prices of rice and chillies, such that the forum focused on dealing with the high chilli prices. Given the persistently high prices of rice in 2011, TPI meetings on several occasions focussed on discussing the steps for stabilizing the price of rice. In regard to this matter, a number of recommendations were proposed in several forums such as recommendations on market operations, policies to safeguard supplies and the government rice purchase policy. Rice inflation showed a gradual decline from a very high level of 30.45% at the end of 2010 to 10.74% at the end of 2011. Nonetheless, as rice production was still hindered by various factors such as unfavourable weather conditions, the price of rice was still relatively high.[1] Meanwhile, to reduce the potential swelling of subsidies due to high global oil price, a number of options were considered in 2011 such as rising subsidised fuel prices and rationing subsidized fuel consumption. Meanwhile electricity tariff was recommended to be raised in 2012. Had those policies been taken by the Government, the team had recommended steps to minimize the impact on the prices of other goods. Those included recommendation for timing implementation and communications strategy to control inflation expectations.

In 2011, TPI also held a series of discussions regarding the inflation target for the years 2013-2015. Based on the Memorandum of Understanding between the Government and Bank Indonesia dated on July 1, 2004 on the Mechanism to Set the Inflation Target and Monitoring and Controlling Inflation in Indonesia, the process for setting the inflation target for 2013 onward must be undertaken in 2011. To fulfil this mandate, a series of intensive discussions was undertaken. At the technical level, it was held in October 2011 and at the executive level it was on 15 December 2011. Based on these discussions, the inflation target for the years 2013-2015 was set and proposed to the Government by the Governor of Bank Indonesia and was planned to be made public in the first quarter

1 ARAM III figure, BPS

of 2012 after being approved by the Ministry of Finance. The earlier announcement compared to usual schedule is due to urgent need for the 2013 inflation target for the formulation of monetary policy and inflation expectations. It also expressed the commitment of the Government and Bank Indonesia in safeguarding price stability going forward. The calculation of the inflation target has taken into account fundamental factors such as the characteristics of inflation, the projection and risks of the inflation going forward as well as the credibility and transmission of monetary policy. It also expressed the intention of the Government and Bank Indonesia for disinflation path to support sustainable economic growth.

In 2012, potential inflationary pressure is expected to come mainly from foodstuffs and energy components. From the foodstuffs component, potential inflationary pressures will mostly come from rice as domestic procurement problem in the stockpiling of government rice reserves is expected to remain. Meanwhile, from the energy component, potential inflationary pressures will come from the subsidized energy policy. Under such challenges, the TPI programs in 2012 will focus on formulating policy recommendations to minimize the impact of those conditions on inflation, such as conducting a series of Focus Group Discussion (FGD) on those issues. TPI will also strive to provide sufficient supplies and smooth distribution especially during peak demand periods i.e. major religious events and off-season periods. In addition to regular programs, TPI also plans to make public announcement and hold an FGD on the inflation target for the years 2013-2015 to manage the inflation expectation. Meanwhile, to enhance the central-regional policy coordination, a coordinating meeting between TPI and the National Policy Committee of the Regional Inflation Control Team (Pokjanas TPID) will be carried out more intensively.

The strategy to strengthen policy coordination was extended to the regional level through the formation of the Regional Inflation Control Team (TPID) and the National Policy Committee of the Regional Inflation Control Team (Pokjanas TPID). This move was taken because the success in achieving the inflation target depends on the characteristics of inflation in the regions.

Technically, national inflation is calculated from inflation in 66 cities observed by the central bureau of statistics with the weight of cities outside Jakarta reaching 77%. In this regard, the existence of TPID in various regions is very strategic, especially amid larger authority of regional governments in their economies. TPID serves as a partner for TPI in formulating policy recommendations in achieving the inflation target. The initiative for forming TPID - which began in 2008 - has continued to get support and there has been 65 TPIDs by the end of 2011.[2] This rapid development reflects growing awareness from local governments for the importance of inflation stability to support the economy and the welfare. The commitment of the regions to participate in maintaining price stability is reflected in the 2011 Jakarta Agenda which is the result of the National Coordinating Meeting (Rakornas) II TPID which was carried out on 16-17 March 2011. The Rakornas II TPID was also marked by stronger cooperation among Bank Indonesia, the Coordinating Ministry for the Economic Affairs, and the Minister of Home Affairs to support price stability in the regions in order to reach a low and stable national inflation target.[3] This cooperation was enhanced by forming the National Policy Committee (Pokjanas) TPID on 14 July 2011 by signing a Cooperation Agreement (PKS).[4] Pokjanas TPID functions as a forum to direct various activities carried out by the TPIDs in upholding price stability in the regions. Besides that, Pokjanas TPID also serves as a forum to enhance the central-regional policy coordination especially at times when regional problems need central government policies.

TPIDs have so far resulted in various policy recommendations to support price stabilisation. In general, TPID stresses on efforts to monitor prices, improve supply, reduce distribution obstacles,

2 Until the end of 2011 there was only one city left, Watampone, that is being approached to form a TPID.

3 MoU among the Cooordinating Ministry for Economic Affairs, Bank Indonesia, Ministry of Home Affairs No.MOU-01/M.EKON/03/2011, 13/I/GBI/DKM/NK, 300-194 dated on 16 March 2011.

4 Cooperation Agreement among the Cooordinating Ministry for Economic Affairs, Bank Indonesia, Ministry of Home Affairs No.13/D.I.M.EKON.07/2011, 13/I/DpG/DKM/SPK, 900/2361/V/BANGDA dated on 14 July 2011.

and manage the inflation expectations. A number of recommendations made by TPID, such as encouraging market operations and improving the operation mechanism for rice distribution by BULOG – including the proposal to attune the appropriate types of rice consistent with the regional consumption characteristics, had a positive impact on stabilizing prices of rice. Raising agricultural production is another important task undertaken by TPID such as by facilitating the infrastructure for farming. A number of TPIDs also strengthened cooperation with the law enforcement authorities and other groups to ensure smooth distribution of goods such as minimising stockpiling by speculators, recommending time extension for port operations and adding new loading/unloading facilities.
TPID in various regions also encouraged better communication strategies to manage the inflation expectations.

Looking ahead, TPID activities are not only striving to overcome short term problems, but also contribute solutions to more structural problems. A number of TPID coordinating meetings among the regions have already resulted in a number of important agendas related to structural solutions which then became priority for Pokjanas TPID and TPIDs in general. For 2012, the working priorities are as follows: (i) develop a price information center to minimize the information gap among agents of economy (asymmetric information problem) and increase efficiency for setting the price; (ii) carry out a comprehensive study on the optimal model for regional food buffer stocks to support the resilience of regional food security and; (iii) develop legal framework and standard operation procedure to increase the effectiveness of TPID's activities and improve the coordination and cooperation between central government and local governments and among local governments.