

Global Financial Market Uncertainty

- Monetary Policy Divergences and the U.S. monetary policy normalization
- Greek crisis
- Yuan devaluation

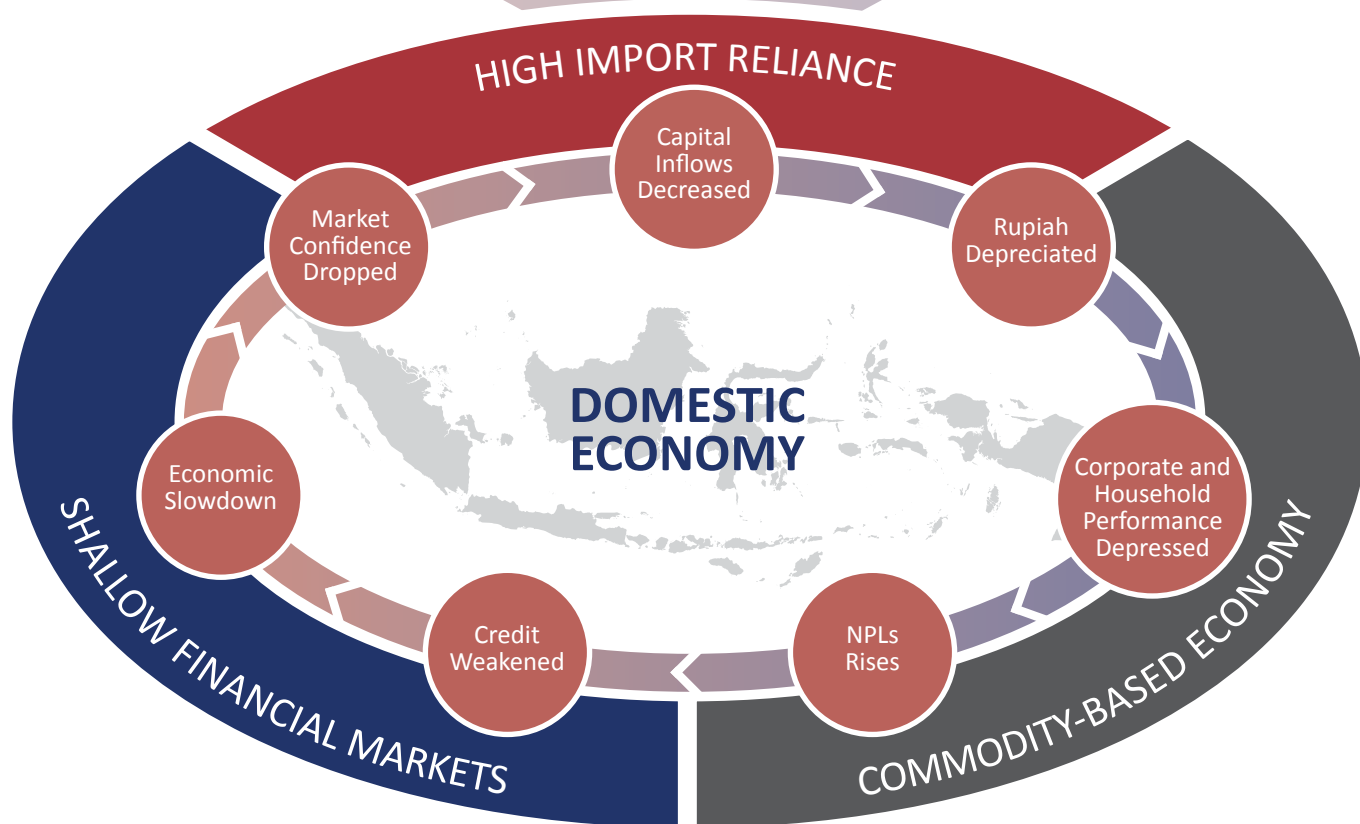
GLOBAL ECONOMY

Global Economic Slowdown

- Moderate Growth of Advanced Economies: supported by the U.S.
- Emerging Market Weakens

Declining in Commodity Prices

- Driven by China slowdown
- Declining oil prices




Government

POLICY SYNERGY


Other Authorities

Safeguarding Macroeconomic Stability and Financial System Stability

Bolstering Economic Growth Momentum

Accelerating Structural Reform

GENERAL REVIEW

Synergy in Safeguarding Stability, Realizing Structural Reforms

The Indonesian economy marked a year of positive performance in 2015. Macroeconomic stability improved while economic growth began to gather momentum. Greater macroeconomic stability was reflected in achievement of the 4±1% inflation target for 2015, amelioration in the current account deficit to a more prudent level, subdued pressure on the rupiah from the fourth quarter of 2015, and continued financial system stability. The onset of renewed economic growth momentum was marked by economic growth that began improving in the second half of 2015.

These positive developments represented no easy achievement. A considerable array of external and domestic challenges daunted the Indonesian economy during 2015. World economic growth fell short of earlier projections. At the same time, there was mounting uncertainty in global financial markets from the growing possibility of increases in U.S. interest rates and concerns over the fiscal negotiations with Greece, all of which was worsened by a surprise devaluation of the yuan. These adverse global developments negatively impacted the domestic economy through the trading and financial channels. This pressure bearing down on the domestic economy was compounded by long-standing domestic structural problems. These challenges exacerbated a number of risks such as the heightened pressure on the rupiah, diminishing confidence of economic agents, and escalating risks in the corporate sector. In the absence of proper management, these conditions could have led to mounting macroeconomic instability and further weakening of economic growth.

In response to these multifaceted challenges, Bank Indonesia and the Government reinforced policy synergy to safeguard macroeconomic stability, stimulate economic growth and accelerate structural reforms. Macroeconomic stability was successfully managed with the aid of the tight bias monetary policy in place until October 2015 and the exchange rate stabilization package. At the same time, Bank Indonesia pursued selective relaxation of macroprudential policies in a drive to create momentum for economic recovery while lowering the rupiah reserve requirement (RR). In the area of fiscal policy, the enlarged fiscal space created by reform of energy subsidies was

harnessed to increase the economic stimulus while maintaining fiscal sustainability. In the real sector, efforts were continued to speed up the implementation of structural reforms with the launching of a series of government policy packages. This coordination of monetary, fiscal, and real sector policies proved successful in managing the economy. Pressure on macroeconomic stability eased and momentum for economic growth was created.

Looking forward, the Indonesian economy is predicted to chart steady improvement accompanied by stronger fundamentals. The forecast is for higher economic growth alongside prudently managed macroeconomic stability. The progressive easing of global financial markets uncertainties in response to the narrowing monetary policy divergence among advanced countries is expected to reduce pressures on macroeconomic stability, and in particular on exchange rate stability. Meanwhile, the forecast is for higher economic growth driven by government action to accelerate the fiscal stimulus and implementation of structural reforms. It is expected that the sustained momentum for strengthening the economy will bolster optimism for the economic outlook and encourage foreign capital inflows that in turn will ease pressure on macroeconomic stability.

A close watch will need to be kept on looming challenges that include the downturn in the global economy, uncertainty in China's financial markets and further decline in prices of commodities including oil. Besides this, work is still needed to tackle a number of unresolved domestic structural problems. To this end, there will be further strengthening of the already solid coordination between Bank Indonesia and the Government. On Bank Indonesia's part, the policy mix will continue to aim at safeguarding macroeconomic and financial system stability as well as making prudent use of room for monetary and macroprudential policies relaxation. From the Government side, policy will be directed at further strengthening of economic growth momentum while accelerating the pace of structural reforms. With this strong synergy, it will be possible to safeguard macroeconomic and financial system stability and thus enable sustainable economic growth to be achieved in the medium and long-term.

Challenges to the Indonesian Economy and Performance in 2015

While facing a broad array of challenges, the Indonesian economy marked a year of positive performance in 2015. Attesting to this was steady improvement in macroeconomic stability and the onset of renewed momentum for economic growth. Improvement in macroeconomic stability was reflected in achievement of the 4±1% inflation target for 2015, reduction in the current account deficit to a more prudent level, subdued pressure on the rupiah commencing from the fourth quarter of 2015, and continued financial system stability. After having undergone a slowing trend, economic growth began to edge upwards during the second half of 2015. This positive achievement owes much to the policy synergy of Bank Indonesia and the Government for safeguarding macroeconomic and financial system stability and promoting economic growth.

Efforts to maintain macroeconomic stability and to generate momentum for economic growth faced a range of daunting challenges. From the global perspective, challenges were posed by flagging world economic growth, the widening divergence over monetary policy among advanced countries and rising uncertainty on global financial markets. The lingering weakness of global economic growth has led to a prolonged decline in world oil prices and non-oil and gas commodity prices. At the same time, differences among developing nations in the phases of economic recovery fuelled expectations of widening divergence over monetary policy. Economic growth in the United States, which is expected to keep rising, fuelled expectations of interest rate increases. However, other countries such as Japan, the EU nations, and emerging markets with flagging growth are expected to stay the course with loose monetary policy. The divergence in monetary policy was exacerbated by the considerable uncertainty over when and to what extent the U.S. will raise interest rates, concerns over the fiscal negotiations with Greece, and uncertainty on China's financial markets, including the yuan devaluation. Despite this, uncertainty on global financial markets began to ease in the fourth quarter of 2015 in line with positive sentiment in October 2015, kindled by the likelihood that increases in the Federal Funds Rate (FFR) would be deferred and the normalisation process would take place gradually.

On the domestic front, challenges were closely linked to the various structural issues that have yet to be resolved. The leading structural issue in the real sector has arisen

from an economic structure still built on commodities. Due to lack of diversification of sources of domestic economic growth, falling global commodity prices not only adversely affect the commodities sector, but also have repercussions on non-commodity sectors. Second, the high import content of Indonesia's export leaves little flexibility for exports to adjust to movements in the rupiah exchange rate, diminishing the positive effect of rupiah depreciation in bolstering Indonesia's exports. In the financial sector, the main source of structural problems lies in the shallow domestic financial market. Shocks on global financial markets that adversely impacted foreign capital inflows in Indonesia could not be properly absorbed by the still shallow domestic financial market, resulting in comparatively high market volatility. In addition, the shallowness of Indonesia's financial market has created quite high levels of corporate dependence on external financing. Due to this dependence, corporate performance is susceptible to changes in the global environment.

Uncertainty in global financial markets led to depreciation in the rupiah exchange rate during 2015. Pressure bore down on the rupiah from the first quarter and reached a peak in the third quarter of 2015. Fuelling this pressure were heightened uncertainties on global financial markets related to uncertainty over increases in the FFR, fears over fiscal negotiations with Greece, and the devaluation of the yuan. On the domestic front, pressure bore down on the rupiah from concerns over the weakening outlook for the domestic economy. In other areas, the shallow domestic foreign exchange market and corporate dependence on external financing amplified the impact of external pressure on the rupiah. Despite this, pressure for depreciation began to ease and the rupiah even appreciated during the fourth quarter of 2015. Key to this was the increase in foreign capital inflows in line with the easing of uncertainty in global financial markets. On the domestic side, amelioration of pressure on the rupiah was supported mainly by the policy actions pursued by Bank Indonesia for stabilising the exchange rate and positive investor perceptions for the outlook of the domestic economy. For the year of 2015, the rupiah recorded depreciation of 10.2% (yoy), less than that of currencies of some peer countries.

In 2015, Indonesia's balance of payments recorded a deficit despite the significant improvement that took place in the current account deficit, which came down from 3.1% of GDP in 2014 to 2.1% of GDP. This easing of the current account deficit is explained by several factors. First, falling oil prices brought improvement in the oil and gas balance. Second, non-oil and gas imports declined in

keeping with weakening demand in the domestic economy and for non-oil and gas exports. Third, the declining imports due to depreciation in the rupiah exchange rate. Meanwhile, in the capital and financial account, reduced capital inflows in response to global uncertainties led to a deficit in the Indonesia balance of payments for the year of 2015. Nevertheless, the easing of uncertainties on global financial markets and improving confidence in the outlook for the domestic economy from the fourth quarter of 2015 prompted a significant rise in capital inflows bolstered mainly by higher portfolio investment inflows in government bonds and foreign direct investment (FDI). In line with the increased surplus in the capital and financial account, Indonesia's balance of payments posted a respectable surplus in the fourth quarter of 2015.

Inflation in 2015 reached 3.35% (yoy), within the 2015 inflation target range of $4\pm 1\%$. The subdued inflation in 2015 is attributed to global and domestic factors. On the global side, plunging world oil prices created opportunity for the Government to lower domestic prices for fuel and 12 kg bottled LPG gas as well as reduce electricity billing rates. Second, the decline in global commodity prices, including prices of food staples, also kept volatile foods inflation in check. On the domestic front, despite the weakening of the rupiah, there was only limited exchange rate pass-through to inflation. Key to this was domestic demand that was kept within manageable levels alongside low imported inflation. Second, volatile foods inflation was quite subdued in 2015 albeit in the midst of the El Nino phenomenon. The subdued volatile foods inflation was in line with the intensified coordination between the Government and Bank Indonesia in increasing production, improving distribution, and minimising various price distortions for staple foods. As a result, core inflation in 2015 reached only 3.95% (yoy) and administered prices inflation recorded only 0.39% (yoy), while volatile foods inflation came to 4.84% (yoy).

In the real sector, Indonesia regained momentum for recovery during the second half of 2015. After continuing the trend of the economic slowdown that began in 2012 in tandem with the flagging global economy, the Indonesian economy managed a turnaround in the second half of 2015, bolstered by improvement in domestic demand. Government consumption mounted significantly in line with high absorption of budget expenditures. Improvement was also visible in investment, driven mainly by increased government capital expenditures and stronger investment growth in some high-growth sectors, including the automotive industry and construction. At the household level, buoyant consumer confidence helped

household consumption to maintain relatively stable, resilient growth. Overall, economic growth in 2015 slowed from 5.02% in 2014 to 4.79%. However, it should be noted that this still represents fairly strong performance compared to other nations with commodity-based economies. This attests to the considerable flexibility of the domestic economy in coping with the global economic slowdown, such as in 2009 at the time of the global financial crisis. The geographical diversification of Indonesia's economic growth has now begun. Java, which has a manufacturing-based economy generating high value added, maintained buoyant growth. In so doing, it was able to compensate for flagging performance outside Java, where growth has suffered from the impact of weakening commodity prices.

In the financial sector, financial system stability remained sound amid escalating risks arising from uncertainties in global financial markets. The banking industry remains resilient as reflected in prudent levels of credit risk and liquidity risk, high profitability, and robust capital adequacy. Credit risk is at the low end of the scale despite an upward trend due to deterioration in corporates' ability to repay debt following the decline in corporate revenues. This was reflected in a rise in non-performing loans (NPLs), albeit within safe limits. Decline in corporate revenues and household incomes also contributed to weaker growth in bank deposits, causing liquidity risk to climb. Liquidity risk, while rising, stayed within safe levels with the ratio of liquid instruments to bank deposits well below the prudent threshold. As regards bank intermediation, credit growth maintained a downward trend at only 10.4% due to weaker performance in both supply and demand as banks tightened lending standards in response to rising NPLs. To address this concern, Bank Indonesia relaxed macroprudential policy to create room for improvement on the supply side for credit. Lack of recovery in the intermediation function and mounting credit risk caused bank profitability levels to fall. Nevertheless, reduced bank profitability had no significant impact on bank resilience given that profitability remained high compared to other countries in the region, while capital adequacy also remained strong. This was confirmed by results of stress testing of credit risk and market risk which indicate that the Indonesian banking system has high levels of capital resilience for coping with worst-case scenarios.

Performance improved further in the payment system during 2015. On the part of Bank Indonesia, the improving performance was reflected in system reliability and availability and the implementation of effective contingency plans. In the meantime, no significant

disruptions took place among operators in the industry-operated payment system. Measured by transaction volume, growth climbed from 18% to 19% in 2015. The increase took place mainly in the payment system operated by the industry, involving card-based payment instruments and electronic money. This was consistent with the payment instrument electronification program carried out with the (GNNT) and Government policy for using electronic money for disbursing social assistance with the aid of electronic money. The success of this payment instrument electronification program was reflected in the increased ratio of card-based payment instruments to GDP, indicating an improvement in public preferences for use of non-cash payments. In the cash payment system front, more reliable performance was achieved in rupiah cash management with the support of rupiah cash management policy. This policy for rupiah cash management was implemented with development of a cash distribution network and cash services provided by cash custodian, an adequate cash position at Bank Indonesia, and improvement in the quality of cash in circulation through the clean money policy.

Policy Response in 2015

During 2015, the economy was daunted by three major challenges that required astute handling. The first challenge was to safeguard macroeconomic and financial system stability amid the heightened uncertainty on global financial markets. These uncertainties arose primarily from uncertainty over normalisation of the interest rate policy of the United States, fears over the fiscal negotiations with Greece and the unexpected devaluation of the yuan. These uncertainties led to a strong downward pressure on the rupiah that had to be managed carefully to avoid repercussions for macroeconomic stability. The second challenge was to bolster slow growth in a domestic economy due to the effects of flagging growth in the global economy. There was a need to mitigate the potential for prolonged slowdown in domestic economic growth in order to maintain positive sentiment for the outlook for the domestic economy. In view of the prolonged slowdown in global economic growth, efforts to bolster economic growth by stimulating domestic demand would be the key to the economic recovery process in the short-term. The third challenge was to accelerate the implementation of structural reforms. The various structural problems in the domestic economy have escalated the negative impact of external shocks on both Indonesia's macroeconomic stability and economic growth. It was therefore vital to accelerate the implementation of structural reforms in

order to reinforce the foundations of the Indonesian economy as a basis for creating sustainable economic growth.

To address these challenges to the economy, policy synergy was continuously strengthened in macroeconomic management. Bank Indonesia's policy mix focused on measures to safeguard macroeconomic and financial system stability. This policy mix was also enhanced by close coordination between Bank Indonesia, the central and regional governments, and other stakeholders. Bank Indonesia also sought to generate momentum for stronger economic growth by introducing a number of accommodative macroprudential policies. These policies were implemented in synergy with an increased fiscal stimulus by the Government to accelerate the process for recovery of economic growth. In addition, the Government and Bank Indonesia worked tirelessly to strengthen coordination in accelerating the pace of structural reforms. Within this context, the Government launched the economic policy packages I-VIII, a series of policies aimed at increasing the pace of improvements to infrastructure and building greater domestic economy's competitiveness. The Government's efforts to accelerate structural reforms were also supported by Bank Indonesia policies aimed at increasing resilience and efficiency in the domestic economy.

On the part of Bank Indonesia, the measures for safeguarding macroeconomic stability focused on bringing inflation back to within the target range, curbing the current account deficit to a more prudent level, and managing the stability of the rupiah exchange rate. Against this background, Bank Indonesia worked throughout 2015 to strengthen the monetary policy mix through policy actions involving interest rates, the exchange rate, monetary operations, foreign exchange flows, and strengthening of the buffer of international reserves. At the same time, Bank Indonesia undertook a selective relaxation of macroprudential policies and lowered the primary reserve requirement aimed at bolstering the momentum for economic growth. This relaxation sought to expand capacity for bank financing by providing additional liquidity to boost lending. The relaxation on macroprudential and monetary policies involved measured actions that took into account their impacts on financial system stability. In a drive to support structural reform, Bank Indonesia took further measures for deepening of the financial market, upscaling of financial inclusion, and strengthening of the payment system. Financial market deepening was directed at creating a resilient and efficient financial market. Alongside this, policy for

financial inclusion sought to improve access to economic financing. Meanwhile, payment system policy focused on strengthening the payment system infrastructure in order to be a secure, reliable, and efficient payment system with the requisite capacity to support an efficient economy.

The continued thrust of interest rate policy was on achievement of the inflation target, reduction of the current account deficit, and safeguarding exchange rate stability. Regarding inflation, the tight bias interest rate policy sought to manage inflation expectations and domestic demand in order to bring down inflation quickly to the target range of $4\pm 1\%$. With inflation expectations still running high in early 2015, Bank Indonesia kept the BI Rate unchanged at 7.75% in January 2015. In February 2015, BI normalized BI Rate back to the level before the increase of BI Rate in November 2014. This normalization took place by lowering the BI Rate by 25 bps after assessing that projected inflation at the end of 2015 would return to the target. Bank Indonesia subsequently held the BI Rate steady at 7.50% until the end of 2015. In the BI assessment on one hand, the interest rate at the prescribed level was still commensurate with efforts to curb domestic demand and imports in order to bring down the current account deficit to a more prudent level. The reduction in the current account deficit in turn reduced domestic demand for foreign currencies. On the other hand, BI also regarded the prescribed interest rate as sufficiently competitive to attract a greater supply of foreign currency, mainly through foreign capital inflows. This combination was expected to relieve excessive downward pressure on the rupiah fuelled by mounting uncertainties on global financial markets. The interest rate policy proved effective in safeguarding macroeconomic stability as reflected in inflation held to within the 2015 inflation target range of $4\pm 1\%$, a reduction in the current account deficit to about 2% of GDP, and the strengthening of the rupiah during the fourth quarter of 2015.

Exchange rate policy is focused on maintaining the stability of rupiah exchange rate consistent with the fundamentals. The escalation of external and domestic risks followed by deterioration in market sentiment triggered significant downward pressure on the rupiah, particularly in the second and third quarters of 2015. The steeper depreciation in the rupiah stoked expectations of exchange rate loss that subsequently led to excessive depreciation with the rupiah even falling to a low of Rp14,700 per U.S. dollar. In response to this, Bank Indonesia took action to stabilize the exchange rate and thus mitigating fallout from further weakening in the rupiah. On 9 September 2015, Bank Indonesia launched a short-term exchange

rate stabilization package built on three strategic pillars. First, safeguarding the rupiah exchange rate stability; second, strengthening the management of rupiah liquidity, including the term structure of monetary operation instruments; and third, reinforcing the management of foreign exchange supply and demand. To bolster the effectiveness of the exchange rate stabilization policy in coping with the pessimistic expectations of depreciation, Bank Indonesia announced another exchange rate stabilization package on 30 September 2015. This policy package includes strengthening of the forward market by implementing forward interventions and relaxing the threshold on forward selling transactions, as well as the launching of new instruments for monetary operations in order to optimize rupiah liquidity management. The exchange rate stabilization package launched by Bank Indonesia and supported by the policy for mandatory use of the rupiah and a series of Government economic policy packages succeeded in curbing excessive fluctuation in the rupiah, as demonstrated by the appreciation recorded in the fourth quarter of 2015.

The policy for strengthening monetary operations sought to improve the effectiveness of these operations in support of stabilising the rupiah exchange rate. As part of the exchange rate stabilization package, Bank Indonesia launched a series of actions to bolster rupiah and foreign exchange monetary operations. A strategy for strengthening rupiah monetary operations (MOs) was implemented by means of adjustments in auction pricing in open market operations (OMOs) and extension of the tenors of MO instruments. The adjustment in OMO auction pricing was introduced through a change in the OMO auction mechanism from variable rate tender to fixed rate tender. Meanwhile, MO instrument tenors were extended by issuing new longer-tenor MO instruments: the Indonesian Government Bond Reverse Repo (RR SBN) in the 2-week tenor, SDBIs in 3 to 6-month tenors, and renewed issuance of SBLs in 9 to 12-month tenors. Regarding the strengthening of foreign exchange MOs, Bank Indonesia introduced changes in pricing, extension of the tenor of foreign exchange MO instruments up to 3 months, optimization of FX swaps, issuance of a regulation on forward auctions by Bank Indonesia, and issuance of foreign currency Bank Indonesia Securities. The success of consistency of measures taken by Bank Indonesia to strengthen monetary operations in 2015 was reflected in the improved duration of monetary operations and the stability of the rupiah.

Efforts to stabilize the rupiah were also supported by a policy for management of foreign exchange flows

aimed at reinforcing the management of domestic foreign exchange supply and demand. Exacerbating the tendency for net demand on the domestic foreign exchange market was the diminishing foreign exchange supply during 2015 caused by lack of recovery in exports and reduced conversion of export proceeds. This also rendered the rupiah more vulnerable to external shocks. Within this context, Bank Indonesia introduced several policies aimed mainly at bolstering foreign exchange supply and information on foreign exchange flows. On the supply side, Bank Indonesia reduced the minimum holding period (MHP) for 1-month SBIs to 1 week in order to increase the supply of foreign currency from non-residents. The shortening of the MHP improved flexibility for investors in SBIs and was expected to boost interest among non-residents in investing capital in Indonesia. Concerning export proceeds, the Government introduced an incentive in coordination with Bank Indonesia for progressive reduction in the tax on deposit interest for exporters holding export proceeds in Indonesian banks or converting these funds into rupiah. This policy enabled fixed term deposits in Indonesia to generate competitive returns, with the expectation that this would attract higher inflows of non-resident capital that had previously been parked abroad. Regarding information on foreign exchange flows, Bank Indonesia introduced more stringent reporting requirements. Among others, parties conducting foreign exchange flows were required to enclose certain documents with their reports if transactions exceeded a specified threshold.

In addition, Bank Indonesia took further measures to strengthen the resilience of the domestic economy by bolstering the second line of defense for international reserves through collaboration with other central banks. Various episodes of exchange rate turbulence pointed to the necessity of continuing efforts to reinforce international reserves, even though reserves remained above the safe limit throughout 2015. To this end, Bank Indonesia and the governors of other ASEAN central banks extended the 2 billion U.S. dollar ASEAN Swap Arrangement (ASA) in 2015. The ASA can be used to help meet the short-term liquidity needs of member countries experiencing pressure in the balance of payments. In addition, Bank Indonesia entered into a 10 billion Australian dollar BCSA arrangement with the Reserve Bank of Australia to promote bilateral trade and underwrite the settlement of trade transactions in the local currencies of the two nations. The implementation of bilateral currency cooperation will ease the dependence on the U.S. dollar currency and thus support rupiah stability.

The greater stability in macroeconomic conditions since the fourth quarter of 2015 opened the possibility for monetary policy easing by lowering the primary reserve requirement in rupiah. On one hand, the measured monetary policy easing was consistent with the steady decline in inflation that was on track with the target range. On the other hand, the monetary policy relaxation would prevent further loss of domestic economic growth that would potentially escalate risks and macroeconomic instability for Indonesia. Despite the available headroom for monetary policy easing, the high exchange rate risk related to the possibility of an increase in the FFR compelled Bank Indonesia to exercise caution in selecting instruments for monetary policy easing. Bank Indonesia viewed that policy instruments other than interest rates could be deployed to benefit from the room for monetary policy relaxation. For this reason, Bank Indonesia lowered the Rupiah Reserve Requirement in November 2015 by 0.5% to 7.50%, effective from 1 December 2015. The relaxing of the reserve requirement was envisaged as a move that would expand bank financing capacity in support of economic activity, which began to improve in the third quarter of 2015.

Bank Indonesia managed the macroeconomic stabilization policy in synergy with the relaxation of macroprudential policies in order to create positive momentum for economic growth and to maintain financial system stability. At the end of 2014, as an anticipatory measure to cope with the outlook for slowing economic growth, Bank Indonesia designed more accommodative macroprudential policies for 2015. This accommodative macroprudential policy design was implemented by easing the Loan/Financing to Value Ratio (LTV/FTV) for property credit or financing and the down payment requirement for motor vehicle credit or financing. Bank Indonesia also encouraged banks to issue securities that would be included in the calculation of the Loan to Funding Ratio to replace the Loan to Deposit Ratio. This macroprudential policy relaxation sought to bolster bank capacity to provide financing in support of economic growth. In addition, Bank Indonesia launched an incentive mechanism for Micro, Small, and Medium Enterprises (MSMEs) to promote lending to MSMEs while continuing to uphold prudential principles. Additional support for Bank Indonesia's measures to bolster the MSMEs sector came from the strategy of Bank Indonesia to promote MSMEs development by expanding and deepening the financial infrastructure and through capacity building for MSMEs. Regarding the financial system stability, Bank Indonesia in coordination with the Financial Services Authority conducted examinations of some banks and performing

stress tests to assess the resilience of bank capital and liquidity under conditions of rupiah depreciation.

For the payment system, the thrust of Bank Indonesia policy is to strengthen the payment system infrastructure and expand the use of non-cash instruments for the purpose of ensuring the smooth operation of the payment system. In response to the growing demand for transactions conducted through the payment system and to advancements in technology, Bank Indonesia has worked consistently to strengthen the payment system infrastructure for both large value and retail transactions. These improvements to the infrastructure are designed to ensure a secure, reliable, and efficient payment system. In the large value payment system, Bank Indonesia launched the second generation of the BI-RTGS, the BI-SSSS, and the BI-ETP, which provides more rapid and secure settlement of transactions. In the retail payment system, Bank Indonesia implemented the second generation of the Bank Indonesia National Clearing System with capability for more rapid transaction processing and providing more robust consumer protection. Regarding the development of non-cash instruments, Bank Indonesia continued the initial work on development of the National Payment Gateway (NPG) that will become the point of linkage for the various electronic retail providers in Indonesia, and thus improve efficiency. These policies have also been supported by measures to improve financial literacy under the Digital Financial Services program and preparation of the electrification roadmap to support the success of the GNNT. As part of the policy mix for maintaining stability of the rupiah, Bank Indonesia introduced mandatory use of the rupiah in the territory of the Republic of Indonesia in order to curb domestic demand for foreign currency.

In the area of rupiah cash management, Bank Indonesia reformed cash distribution and cash services to meet rupiah cash needs in support of the smooth operation of cash transactions in all areas of Indonesia. In this regard, Bank Indonesia launched five policies for rupiah cash management to provide assurance of the timely availability of rupiah cash in adequate quantity, proper quality, and appropriate denominations. The first policy was to maintain sufficient cash at all Bank Indonesia offices by holding a National Iron Stock (ISN) at 20% of total currency in circulation and ensuring availability of cash to cover 1.5 months of bank outflows. The second policy was to improve the quality of rupiah cash under the clean money policy by raising the standards for worn currency while increasing the destruction of unfit notes for circulation. The third policy was to reform the cash

distribution and cash services network by opening new Bank Indonesia offices to perform the function of rupiah cash management and increase the number of cash custodian banks throughout Indonesia. The fourth policy was to bolster communication on the marks of rupiah authenticity features on a sustained basis, using both direct communication with different groups of society and communication through the electronic media. The fifth policy was to improve prevention and eradication of counterfeiting by enhancing a closer collaboration with the Indonesia National Police and the Attorney General's Office. This collaboration was supported by a laboratory for testing suspected counterfeit money and provision of a reliable information system at the Bank Indonesia Counterfeit Analysis Center (BI-CAC).

To improve policy mix effectiveness, Bank Indonesia worked steadily to strengthen coordination with the Government and other policy stakeholders involved with various aspects of the economy. Coordination was strengthened as part of the framework for managing macroeconomic stability, generating economic growth momentum, and accelerating the implementation of structural reforms. Regarding the safeguarding economic stability, coordination between Bank Indonesia and the Government was intensified to improve the effectiveness of inflation control by bolstering the role of the Inflation Monitoring and Control Team (TPI) and Regional Inflation Monitoring and Control Teams (TPIDs). Bank Indonesia and the Government also embarked on more structural management of inflation with the preparation of an Inflation Control Roadmap for 2015-2018. This roadmap encompasses mapping of inflation issues, recommendations for medium and long-term inflation control, and more specific delineation of the roles of Bank Indonesia, the Central Government, and Local Governments. Reinforcing the Inflation Control Roadmap are redoubled commitments from the regions in maintaining local price stability, accelerated construction of infrastructure and achievement of food sovereignty in the regions. Close coordination was also maintained with the Government in dealing with the excessive downward pressure on the rupiah fuelled by mounting uncertainty on global financial markets. The products of this coordination are the economic policy packages I and II, which include measures to improve management of foreign exchange supply and demand and provision of incentives for domestic retention of export proceeds. In addition, Bank Indonesia collaborated with the Government, the Financial Services Authority and the Indonesian Deposit Insurance Corporation in preparing the Draft Law concerning the Financial Safety Net, which will become the overarching

legal umbrella for crisis prevention and resolution. Regarding the payment system, Bank Indonesia worked steadily to strengthen coordination with relevant ministries and other agencies in the provision and expansion of the payment system and smoothly operating, secure, and reliable rupiah cash management.

Closer coordination was also forged between Bank Indonesia and the Government to boost the momentum for economic growth. At the national level, Bank Indonesia pursued action in synergy with the Government's fiscal stimulus by relaxing macroprudential policy. In the meantime, Bank Indonesia also played an active role in as a counterpart of the People's Business Credit Program (KUR) Policy Committee, which included tabling recommendations for development of implementation guidelines and achieving targets for KUR disbursement in planning for 2015. In addition, Bank Indonesia and the Government also cooperated in optimizing business development in the marine and fisheries sectors. This included improvement in access to and outreach of financing for MSMEs. In cooperation at the regional level, efforts were made to harmonize leading sectors that had been mapped into the government planning for development of priority sectors. Within this context, Bank Indonesia made recommendations to local governments about particular sectors with potential and high value added that can be developed to promote regional economic growth, based on assessments of a growth diagnostic exercise.

Coordination between the Government and Bank Indonesia in promoting structural reforms was targeted to strengthen Indonesia's economic fundamentals. The structural reform policies put in place focused on measures to address the root causes of fundamental problems in the Indonesian economy by improving infrastructure, building competitiveness, achieving food, energy, and water security, promoting sustainable development financing, and strengthening the economic inclusion. On the Government part, a series of economic policy packages I-VIII was put in place during 2015 in a move to improve the business climate and accelerate the pace of infrastructure development. To work towards food security, the Government engaged in development and repair of agricultural infrastructure, strengthening of production and post-harvest processes, and restructuring of markets. To support energy security, the Government revamped energy policy in the areas of new energy, renewables and energy conservation, management of oil and natural gas, and provision of electricity supply, while continuing efforts to increase value added from mining

products. In the area of water security, the Government promoted equitable and sustainable provision of water for the public. Under a series of policy packages described above, the Government also continued to work towards a more inclusive economy with measures that includes entrepreneurship promotion for beneficiaries of KUR, financing for small and medium enterprises, and improved worker welfare. To accelerate implementation of these structural reforms, Bank Indonesia had developed a common vision with the Central Government and local governments for development of leading sectors in various national coordination forums. During 2015, national coordination forums focused on development in four areas designated as leading priorities: the maritime sector, food, energy infrastructure, as well as industry and tourism.

Bank Indonesia consistently supported the implementation of structural reforms by the Government through the steadfast promotion of financial market deepening and financial inclusiveness. Besides creating a financial market capable of absorbing shocks to the economy, other objectives of financial market deepening were to support for monetary policy effectiveness, financial system stability, and easy access to financing. Bank Indonesia pursued measures for financial market deepening by expanding the scope of market participants, adding to the variety of financial market instruments and promoting efficient price formation. In this context, Bank Indonesia issued the financial market deepening blueprint that outlines five strategies: development of instruments and the investor base, more robust regulation and standards, development of infrastructure, institution building, along with effective education and dissemination. The financial market blueprint, equipped with these strategies, will serve as guidance for development of the rupiah and foreign exchange money markets, the sharia-compliant financial market, and the bond market. Meanwhile, for the public and particularly low-income people to gain improved access to financial services, Bank Indonesia continued to play an active role in promoting initiatives for financial inclusion. The Bank Indonesia policy for financial inclusion initiatives focuses on development of digital technology-based innovations to minimise impediments to the public in accessing and making use of financial services while also providing protection to members of the public.

The policy mix consistently applied by Bank Indonesia proved capable of sustaining the performance of Indonesia's economy amid adverse global developments. Reflecting this was prudently managed

macroeconomic and financial system stability combined with renewed momentum for economic growth. Improved macroeconomic stability was demonstrated by achievement of the 2015 inflation target of $4\pm 1\%$, decline in the current account deficit to about 2% of GDP, and stability brought to the rupiah from the fourth quarter of 2015. Regarding financial system stability, the various policies put in place enabled the financial system to maintain resilience in the face of external and internal shocks. In addition, the economy gained renewed momentum for more vibrant growth beginning in mid-2015.

Challenges and Future Policy Direction

The dynamics of the Indonesian economy in 2015 taught some valuable lessons for efforts to create sustainable economic growth for the future. The first lesson that came to light is about the importance of discipline macroeconomic policies, both fiscal and monetary, in ensuring macroeconomic stability and promoting sustainable economic growth. The outcomes for the economy in 2015 showed that a policy mix of tight bias monetary policy and accommodative macroprudential policies combined with a cautious fiscal stimulus was able to keep macroeconomic stability on track without unduly sacrificing economic growth. Second, efforts to boost the momentum for domestic economic growth are crucial in a time of weakening in the global economy and rising uncertainty on global financial markets. Prolonged slowdown in economic growth will lead to build-up of various risks to the economy, including exchange rate risk, corporate risk, and banking risk, that in turn can jeopardize macroeconomic stability. It was therefore necessary for macroeconomic management to be formulated carefully to generate momentum for economic growth without sacrificing macroeconomic stability. Third, a timely implementation of a policy mix is necessary to maximize its effectiveness for the domestic economy. Timing of policy implementation that is consistent with planning is therefore a key to sustaining the performance of the economy in the face of global challenges. Fourth, the complexity of problems daunting the economy points to the need for strong policy synergy among the different policy stakeholders. This includes Bank Indonesia, the central and local governments, and other related authorities. The final lesson is that the dynamics of the global economy, being fraught with uncertainty, reiterates the importance of accelerating structural reforms for strengthening economic foundations and pursuing

diversification in order to build a more resilient economy capable of sustainable growth.

Challenges Ahead for the Economy

Looking ahead, the Indonesian economy will continue to face daunting and increasingly complex challenges from developments in the global as well as domestic economy. The main challenge from the global economy stems from the lingering weak growth in the global economy. In the short term, the forecast for advanced economies is continued tepid growth. At the same time, China's economic growth is predicted to slow further, with repercussions for the outlook for recovery in Indonesia. On one hand, the lack of recovery in the global economy will lead to further weakening in global commodity prices, which in turn will put pressure on the current account. On the other hand, the slack pace of economic growth, particularly in advanced nations, will bring about a narrowing in the monetary policy divergence among advanced economies. This will reduce the level of uncertainty on global financial markets and have a positive effect on the capital and financial account. However, prolonged weakness of the economy in China may potentially become a new source of uncertainty on global financial markets. The lingering fragility in Indonesia's external performance calls for further vigilance as this could lead to significant downward pressure on the rupiah and disrupt macroeconomic stability as well as the current momentum for economic growth.

The inauguration of the ASEAN Economic Community (AEC) has potential to raise formidable challenges if proper preparations are not made for this change. The growing integration of the region in the areas of trade, finance, and investment is turning Asia into one of the most important investment venues in the global production system. However, the reduction of barriers to regional trade will pave the way for the domestic economy to be flooded by foreign products with potential to overwhelm domestic products, particularly ones that are less competitive. A similar fate may await the services sector, which portends to become extremely competitive with the launching of the AEC. Domestic economic players therefore need to build their readiness in order to gain benefits from the AEC. Against this backdrop, Indonesia's relatively low position in global value chains compared to its regional neighbours must be corrected so that Indonesia does not merely become a market for the products and services of other countries in the region.

On the domestic side, the Indonesian economy also faces multifaceted domestic structural problems that have not been fully resolved. The structural challenges that must be addressed as priorities are found in four pillars of the fundamentals of the economy: i) food, energy, and water security; ii) competitiveness in the industry, maritime, and tourism sectors; iii) sustainable development financing; and iv) an inclusive economy. Food security is still an urgent issue, particularly when viewed in terms of the limited agricultural productivity and food diversification. Energy security remains vulnerable to shocks, even though Indonesia has vast energy resources potential. Water security is also not sufficiently viable to cope properly with needs in consumption, food crop production, and energy sources. At the same time, despite substantial potential in the maritime sector, challenges persist in territorial integrity, optimising of resource management, and in connectivity. Unlike the maritime sector, competitiveness in industry remains weak due to limited use of technology and the dependence of domestic industry on natural resources. The tourism sector faces impediments with lack of adequate connectivity infrastructure to support access to tourist attractions. Problems in financing are related to the limited long-term financing support from the formal financial sector and insufficient support from FDI. In building an inclusive economy, Indonesia still faces serious disparities in development and inequalities in society in access and benefiting from the results of economic growth. These four structural challenges are closely linked to challenges in building the basic capital for development, most importantly infrastructure, human resources, the business climate, and science and technology. The growth diagnostic approach shows that the main impediments to the Indonesian economy lie in limited availability of electricity infrastructure, problems with connectivity, and the low quality of human resources.

The combination of global and the existing domestic structural problems have created complex challenges for macroeconomic management. Any slowdown in the global economy particularly China that sends commodity prices tumbling further has potential to bear down on Indonesia's exports. The commodity-dependent structure of the Indonesian economy and high import content of Indonesia's exports will exacerbate the slowdown in global economy pressure on Indonesia's future economic growth. The risk of a future downturn in economic growth also arises from mounting liquidity risk in keeping with the renewed improvement in credit growth. Added to this, a careful watch needs to be kept on the risk of more limited fiscal space for raising government expenditures, given the vital role of this in the economic recovery process.

For this reason, the risk of further slowdown in economic growth must be properly managed in order not to kindle other risks that could put even more pressure on economic growth and disrupt macroeconomic and financial system stability. Efforts are also needed to diversify the economy so that Indonesia can become stronger with the capacity for sustainable growth.

Future Policy Direction

In reflecting on the experiences of 2015 and taking account of the present risks and issues in the economy, the macroeconomic policy mix for 2016 needs to focus on safeguarding macroeconomic and financial system stability and sustaining the current momentum for economic growth. From Bank Indonesia's side, the policy mix will be aimed at keeping macroeconomic and financial system stability and making prudent use of room for relaxation of monetary and macroprudential policies. On the Government side, the policy will focus on providing a further boost to the present momentum of economic growth. For this, measures to promote domestic demand commensurate with the capacity of the economy will play a vital role, given the still flagging condition of the global economy. Measures to bolster domestic demand within the capacity of the economy will also be the key for maintaining macroeconomic stability reflected in achievement of the inflation target, control over the current account deficit and maintenance of financial system stability. In addition, the Government and Bank Indonesia will continue work to accelerate structural reforms for the creation of robust foundations for the economy in support of sustainable economic growth.

Bank Indonesia will continue to strengthen the policy mix of monetary policy, macroprudential policy, and payment system and rupiah cash management policy to ensure macroeconomic and financial system stability and to utilize the available room for cautious relaxation of monetary and macroprudential policies. In the monetary sector, Bank Indonesia will prudently steer interest rate policy, the reserve requirement, and the exchange rate to keep inflation on track with the target, manage the current account deficit at a prudent level, and nurture the momentum that has been created in economic growth. Within this framework, the interest rate policy stance will aim to manage inflation expectations and domestic demand while supporting exchange rate stability aligned with fundamentals. The reserves requirement policy will be directed to support adequate levels of liquidity commensurate with the needs of the economy while

paying close attention to macroeconomic and financial system stability. Like before, exchange rate policy will focus on maintaining stability in the rupiah in line with the value of fundamentals. To bolster the effectiveness of monetary policy, Bank Indonesia will strengthen both rupiah and foreign exchange monetary operations. These policies will be supported by prudent management of foreign exchange flows and strengthening of the international financial safety net to bolster the resilience of the domestic economy. Regarding macroprudential policies, Bank Indonesia will stay the course with accommodative and prudent measures to promote the bank intermediation function and support financial system stability. In the payment system, Bank Indonesia policy will continue to target more secure, smooth, and efficient operation. The effort to strengthen the payment system will be supported by Bank Indonesia policy in rupiah cash management with focus on meeting needs for timely provision of cash in appropriate quality and denominations throughout Indonesia.

In 2016, the Bank Indonesia policy mix will also implement in synergy with fiscal policy to improve the overall effectiveness of macroeconomic management. Coordination with the Government will focus on measures to safeguard macroeconomic stability through inflation control, particularly for volatile foods, and maintenance of a sound current account deficit, robust financial system stability, and a reliable, secure and smoothly operating payment system and rupiah cash management. To bolster momentum for economic growth, the relaxation of monetary policy and accommodative macroprudential policies will be brought into prudent synergy with the fiscal stimulus pursued by the Government. Bank Indonesia will also strengthen the role of the Coordination of Regional Economic and Financial Policy, a coordinating forum for promoting economic growth at the regional level. Regarding fiscal policy, the Government is expected to continue providing a fiscal stimulus to boost economic growth momentum while keeping the budget deficit at a safe and sustainable level. The policy mix at these different levels is expected to provide answers to short-term economic issues, namely by strengthening the current momentum for economic growth while maintaining macroeconomic stability.

An assessment of a series of policy packages launched by the Government and a mapping of domestic structural issues indicates the need for strengthening of policy, particularly in the drive to achieve food, energy, and water security, improving competitiveness in the industry, maritime, and tourism sectors, sustainable long-term

financing, building an inclusive economy, strengthening of human resources, and mastery of science and technology. Regarding food, policy needs to be directed towards responding to the challenge of relatively low productivity by such measures as enhancement and construction of agricultural infrastructure, restoration of soil fertility, and development of agricultural banks and MSME. In the energy sector, policies need to target efforts to raise production and efficiency with focus on the four priorities of energy policy. These four policy priorities include increased production and reserves of extractive energy, improvement in the energy mix, improved accessibility and greater efficiency in use of energy and electricity, and more transparent and targeted management of fuel subsidies. In water management, government policies are necessary for meeting water needs for consumption, food crop cultivation and energy sources be integrated together with conservation of water resources. This will require the construction of reservoirs, improved access to drinking water and sanitation, construction of water conservation infrastructure, protection of natural water sources, and expansion and rehabilitation of irrigation networks. For industry, policymaking is directed at efforts to improve competitiveness, productivity, and technology content. Policy will concentrate on efforts to develop industrial areas outside Java, promote growth in the industry population, reinforce integration in world supply chains, and foster improvements in competitiveness and productivity. In the maritime sector, the policy direction has the objectives of strengthening territorial integrity, management of natural resources, connectivity, and advancement of the maritime and marine economy. In tourism, policy is targeted at improvements in infrastructure and tourism facilities, as well as building of human resources capacity. The need for support from sustainable financing calls for a policy response aimed at increasing the long-term funding sources from both domestic and foreign sources. In this regard, Bank Indonesia is pressing forward with financial market deepening, with measures that include promoting the use of the General Master Repurchase Agreement and is continuing the development of rupiah and foreign exchange money market instruments. For an inclusive economy, policy must aim for equitable development and financial access. Within this context, Bank Indonesia is promoting financial inclusion by expanding the range and coverage of non-cash transactions with the support of payment infrastructure integrated into the NPG.

The reinforcement of the four pillars of structural policies has been supported by various policies for strengthening key enablers for development in the areas

of infrastructure, the business climate, human resources, and science and technology. The Government has designated 2016 as the year of accelerated construction of infrastructure to lay down the foundations for sustainable economic growth. The Government has prepared a list of 225 National Strategic Projects and 30 Priority Projects as a focus for infrastructure construction, based on The National Medium-Term Development Plan 2014-2019. The Government will also improve national connectivity and digital connectivity by establishing 24 locations for strategic ports, construction of toll roads and building a national fibre optic backbone in several regions. Regarding the business climate, the Government will work relentlessly on streamlining and simplifying licensing, improvements in service provision by increasing the number and quality of One-Stop Services, better law enforcement and greater business certainty through harmonization of central and local government regulations, tax incentives, and facilitation for industrial estates. The Government will also promote the use of science and technology to strengthen competitiveness in manufacturing and services, management of natural resources, social capital, human resources, infrastructure, institution building, networks, and development of science and techno parks. In regards to human resource development, Bank Indonesia sees the necessity for raising the quality of human resources to improve Indonesia's attractiveness as a venue for export-oriented investment in order to benefit from integration into global value chains and to diversify the Indonesian economy. It is also Bank Indonesia's view that these government policies for strengthening the key enablers for development will be crucial to improving the efficiency of the economy. To contribute to greater efficiency in the economy, Bank Indonesia will accelerate development of the infrastructure for a more efficient national payment system by expanding the payment system electronification and improving the reliability of the infrastructure for the electronic retail payment system.

Short and Medium-Term Economic Outlook

In view of prudently managed economic stability, continuation of the fiscal stimulus policy, and consistent implementation of structural reform policies, the Indonesian economy is expected to mark steady improvement. In 2016, economic growth is predicted to reach 5.2-5.6%. This short-term economic growth will be driven as before by domestic demand, led mainly by government infrastructure projects. Meanwhile, private investment is expected to grow in tandem with the impact

of the policy packages launched by the government and the use of the room for prudent relaxation of monetary and macroprudential policies while safeguarding macroeconomic and financial system stability. This improvement in domestic demand will also be bolstered by renewed gains in household consumption. However, the external sector contribution will remain limited due to the fragile nature of global economic growth, particularly in China. Inflation will stay subdued in 2016, within the 4±1% target range. Key to this will be the management of inflation expectations, close coordination between Bank Indonesia and the Government, and decline in prices for international commodities, including oil. Improvement in domestic economic growth bolstered by infrastructure projects in tandem with still limited gains in export performance will lead to a modest rise in the current account deficit. Nevertheless, in 2016 the current account deficit will remain in safe territory, below 3% of GDP, and have a more robust structure. Against this background, the forecast is for higher credit growth compared to the previous year, reaching 12-14% in 2016, while growth in bank deposits will reach 13-15%.

In the medium term, economic growth in Indonesia is predicted to climb in keeping with the commitment to accelerate implementation of structural reforms with consistency and synergy maintained across sectors and a suitable policy mix involving Bank Indonesia, the Government, and other policymakers. The improvement in economic growth is supported by the outlook for more solid global economy recovery in the future and impact from the structural reform policies consistently pursued by the Government, Bank Indonesia and other related authorities. Under these conditions, the Indonesian economy will be able to achieve vibrant growth of 6.3-6.8% by 2020. This growth will not only be higher, but also more inclusive and underpinned by a more robust structure. Household consumption will maintain stable growth in tandem with the expanding proportion of the middle class and more extensive provision of social security protection. The private sector will have an expanding role in investment, supported by the continuing infrastructure projects development, an improving business climate, and reforms to create a more efficient bureaucracy. This will be accompanied by progressive improvement in the quality of government spending reflected in the increasing proportion of capital expenditure as the government cuts back spending on subsidies. In the external sector, the balance of payments will improve in the medium term with the current account deficit maintained at a prudent level. Supporting this will be improvement in global economic growth, recovery

in commodity prices, and more robust competitiveness of Indonesia's export products. Regarding inflation, the increased capacity of the domestic economy achieved through consistency in structural reforms and Bank Indonesia's consistency in safeguarding macroeconomic stability will enable inflation to remain within the target range of $3.5\pm 1\%$ over the medium term.

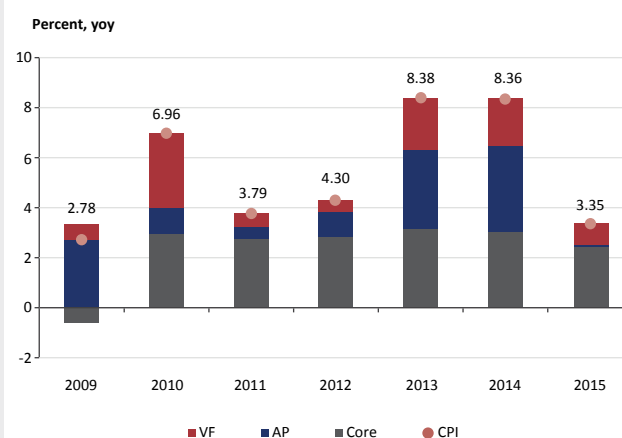
Consistent implementation of structural reforms will be the key for achieving this medium-term outlook for the Indonesian economy. The upward projection for the medium term accompanied by higher quality of economic growth will only be possible if structural reforms move forward at an optimum pace. This is because two vital factors in medium-term economic growth, namely infrastructure development and greater involvement from the private sector, will depend to a great extent on consistent implementation of structural reforms. However,

the complexity of structural problems in the domestic economy points to the existence of various impediments with potential to hamper the implementation of these reforms. Should this happen, the setback in structural reforms will have repercussions on the progress of infrastructure projects envisaged as the backbone for resolving various supply side issues. This may impede efforts to build productivity and the capacity of the economy, which will not only result in lower economic growth but also higher inflationary pressure on the demand side and a swelling current account deficit. To avoid this, measures to safeguard the implementation of structural reforms in a comprehensive synergy of macroeconomic management must be strengthened further for the Indonesian economy to achieve rapid and sustainable gains with greater inclusiveness and support maintenance of economic stability as a whole.

In 2015, CPI inflation was kept under firm control within the target range of $4 \pm 1\%$. Inflation in 2015 was recorded at 3.35% (yoy), well below the level reached in the previous year (8.36%, yoy) (Chart 1). Low inflation was recorded in all its components: the core category, volatile foods (VF) and administered prices (AP) (Chart 2). The subdued level of core inflation owes much to the role of Bank Indonesia policies in maintaining exchange rate stability, guiding inflation expectations, and managing domestic demand. The ability to contain VF inflation at below 5% despite a strong El Nino phenomenon owes to serious Government efforts in increasing production, improving distribution, and minimizing various price distortions affecting food staples. Alongside this, low AP inflation resulted mainly from the fall in global oil and gas prices and Government action in reforming energy subsidies. Following the energy reform, pricing of fuels, gas, and electricity has moved in tandem with developments in oil and gas prices and the exchange rate (Diagram 1).

Core inflation stayed remarkably low throughout 2015, consistent with soft domestic demand, minimum cost-push pressure, and subdued inflation expectations. Core inflation was recorded at 3.95% (yoy), down from 4.93% (yoy) in 2014. At the start of the year, core inflation was still fairly high at about 5% (yoy), driven by the second

Chart 2. Decomposition of Inflation 2008 - 2015



Source: BPS - Statistics Indonesia

round effects of the fuel price hike of the preceding year. Subdued inflation expectations amid the upward pressure on prices fuelled by depreciation in the rupiah, which reached a peak in September, helped keep a lid on the dynamics of core inflation during 2015. At the end of the year, renewed stability in the exchange rate helped bring core inflation down. The easing of core inflation at the end of the year is a reflection of weak pressure from demand

Chart 1. Inflation Target

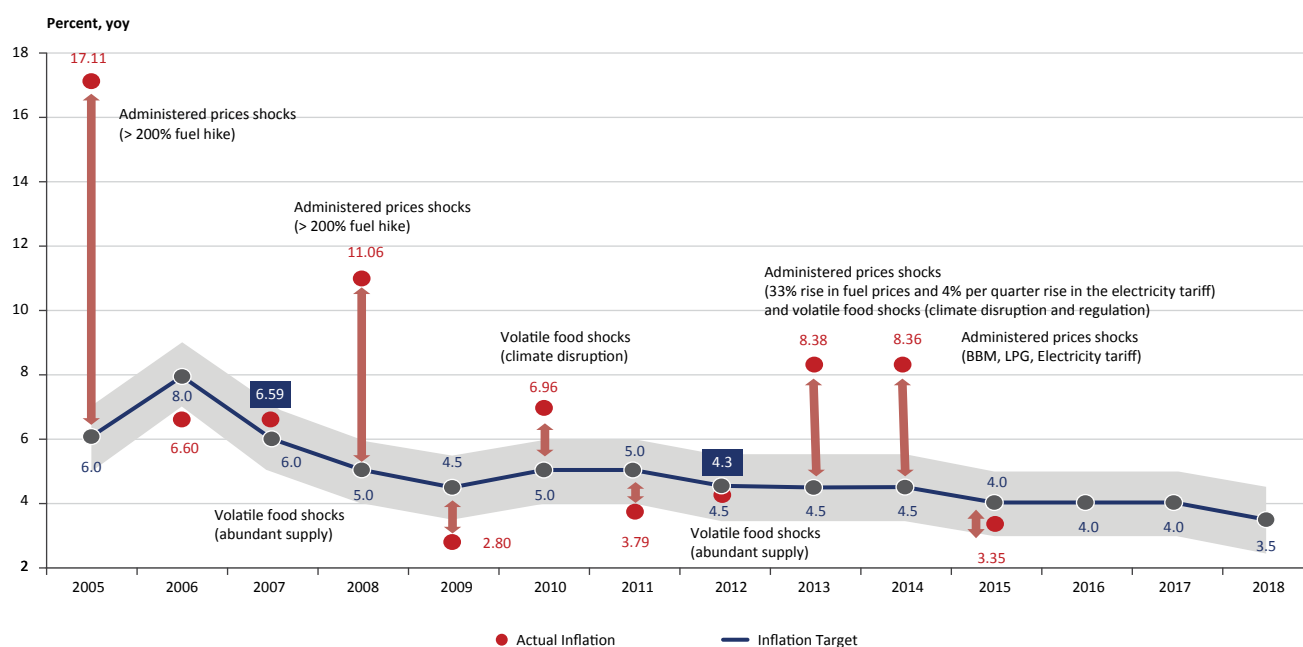
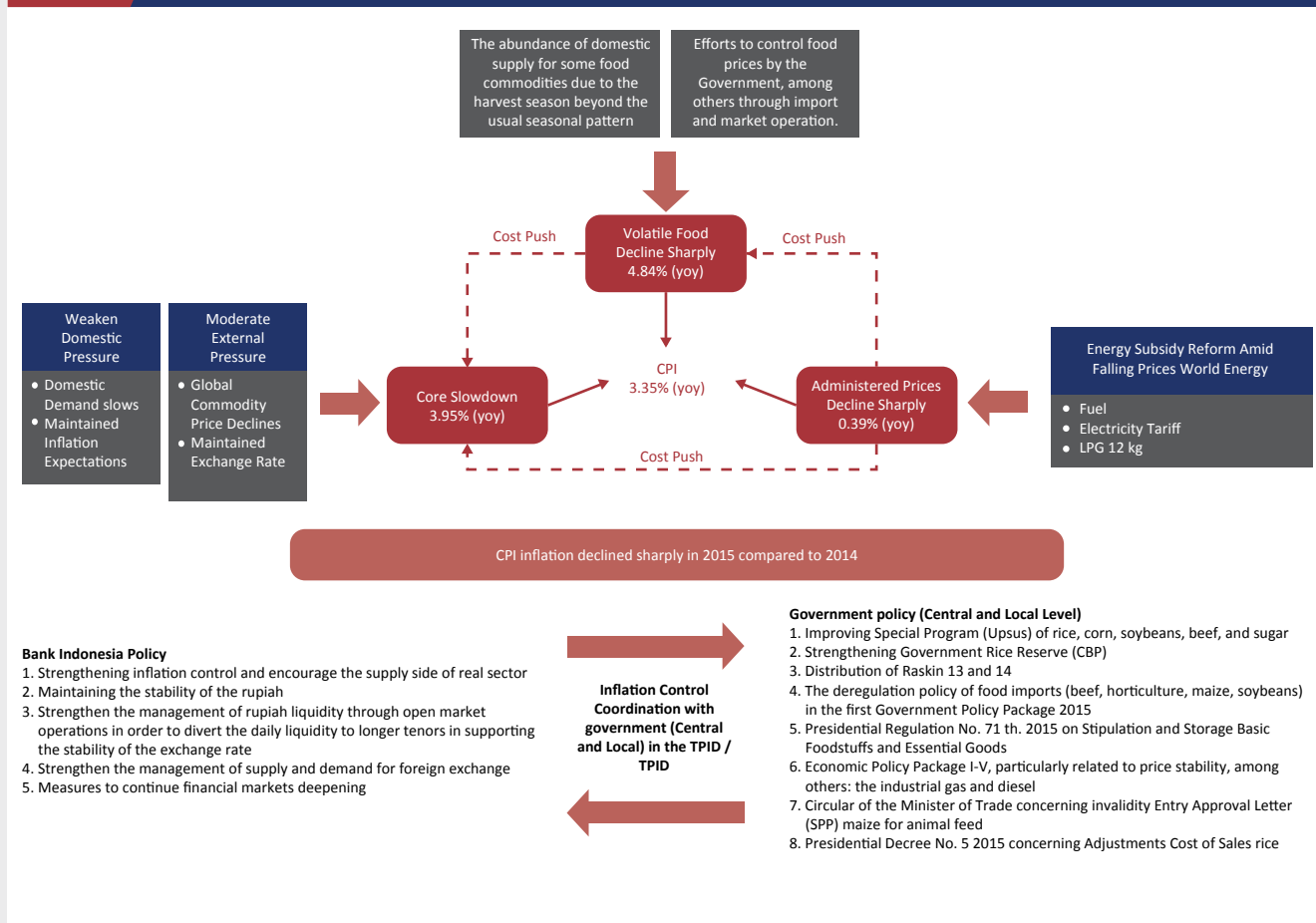


Diagram 1. Inflation in 2015 and Affecting Factors



and limited cost-push pressure demonstrated in part by low inflation in the AP and VF categories.

To support inflation control, Bank Indonesia maintained a tight bias monetary policy reflected in the steady level of the BI Rate at 7.5% since the end of the first quarter of 2015. In addition, Bank Indonesia pursued a range of policy for stabilising the exchange rate in order to anchor inflation expectations. Through this, business inflation expectations were kept well in check, thus avoiding excessive fluctuation. Inflation expectations remained subdued despite greater depreciation in the rupiah compared to that of the previous year. Mild inflation expectations were reflected in the limited exchange rate pass-through on inflation, indicating that business perceived the downturn in the exchange rate as only temporary. In addition, the limited exchange rate pass-through also caused by the effect of weakening domestic demand. In this situation, business players preferred not to pass on the full effect of exchange rate depreciation,

but instead cut their margins to avoid further decline in demand.

The minimal pressure in AP inflation was explained by the implementation of pricing for fuels and electricity at their economically viable value during a time of a downward trend in world energy prices.¹ AP inflation was recorded at 0.39% (yoy), having fallen dramatically from the previous year (17.57%, yoy) and also below the historical average for the previous five years (9.01%, yoy). Plunging

1 The Government launched a policy for energy subsidy reform at the end of 2014, with fuel prices and electricity tariffs to be adjusted in line with the underlying energy prices. Under Regulation of the Minister of Energy and Mineral Resources No. 4 of 2015, amended by Regulation No. 39 of 2015, fuel prices are based in part on movements in world prices for refined petroleum products, the rupiah exchange rate and distribution costs. The government does not subsidise the Premium RON 88 gasoline, but automotive diesel continues to benefit from a fixed subsidy of Rp1,000 per litre. Under Regulation of the Minister of Energy and Mineral Resources No. 31 of 2014, electricity tariffs are based on movement in the ICP crude price, the rupiah exchange rate and the monthly inflation rate.

world oil prices prompted the Government to announce substantial cuts in fuel prices in early 2015, which kept pressure low in the AP category.² Despite a surge in fuel prices in March, the Government policy for control of transport fares managed to curb the second round effects of increased fuel prices.³ Adjustment of electricity billing rates to economically viable prices helped bring down inflation in electricity rates during 2015 in keeping with the low ICP crude price and subdued monthly inflation.⁴ The continuation of energy subsidy reforms at a time of low and declining world energy prices became a vital element in curbing inflationary pressure in the AP category to a minimum.

Contributing to low VF inflation were adequate levels of supply and decline in global food prices. In the VF category, inflation came to 4.84% (yoy), substantially below the previous year (10.88%, yoy) and the historical average for the past five years (9.90%, yoy). The fall in VF inflation came mainly in response to the sizeable deflation in miscellaneous chilli peppers and shallots during the year, in addition to decline in global commodity prices and particularly for CPO that impacted cooking oil prices. The low inflation in milled rice amid strongly unsettled weather conditions brought on by El Nino also kept a lid on VF inflation. Low VF inflation was also driven by Government policies for strategic foodstuffs. The Government has devoted considerable attention to supporting adequate domestic supply of food staples while also pursuing other policies. These measures involved first, Special Efforts for Improvement Program (Upsus) for paddy rice, corn, soy beans, beef, and refined sugar. Second was

the strengthening of the Government Rice Buffer Stock (CBP) with assurance of 1.5 million tons of imports by March 2016. Third, measures to control prices were implemented for shallots and miscellaneous chilli peppers in: (i) the Dry Season Chilli Pepper Planting Campaign involving assistance with farming equipment and water-saving irrigation, (ii) regulation of crop growing schemes in centres of agricultural production, (iii) development of shallot and chilli pepper cultivation areas in centres of agricultural production and outside these centres, as well as development of integrated chilli pepper clusters in collaboration with Bank Indonesia in eight provinces (Bangka Belitung, West Java, East Java, West Kalimantan, South Sulawesi, West Nusa Tenggara, East Nusa Tenggara, and North Maluku), and (iv) deregulation of food import policies.⁵ The Government also launched the Gerai Maritim (maritime outlets) pilot program and the nautical highway system in 2015 to overcome impediments to distribution.⁶

The achievement of the inflation target in 2015 also supported by the closer coordination forged by Bank Indonesia and the Government through the TPI and TPIDs. In 2015, the work of the TPI and the TPID National Working Group focused on strengthening the operational of secretariat and the coordination through implementation of National Coordination Meetings and Central and Regional Government Coordination Meetings, as well as building the role of the TPI and TPIDs in price stabilization. In addition, the TPI and the TPID National Working Group also submitted various recommendations to the Government, which included design and submission of an Inflation Control Roadmap for 2015-2018 and more complete and reliable information and data on food prices. The Inflation Control Roadmap is intended as a reference for the work performed by the TPI and TPIDs. This roadmap was deliberated in December 2015 by senior ministry and agency officials serving as members of the TPI and TPID National Working Group and distributed to all heads of local government. Afterward, the program in the road map is expected to be incorporated into the Government Work Plan both at the central and regional

2 On 1 January 2015, the Government reduced prices for Premium RON 88 and automotive diesel by Rp900 per litre and Rp250 per litre. Following this on 14 January 2015, the Government announced further price cuts for Premium RON 88 and automotive diesel of Rp1,000 per litre and Rp850 per litre.

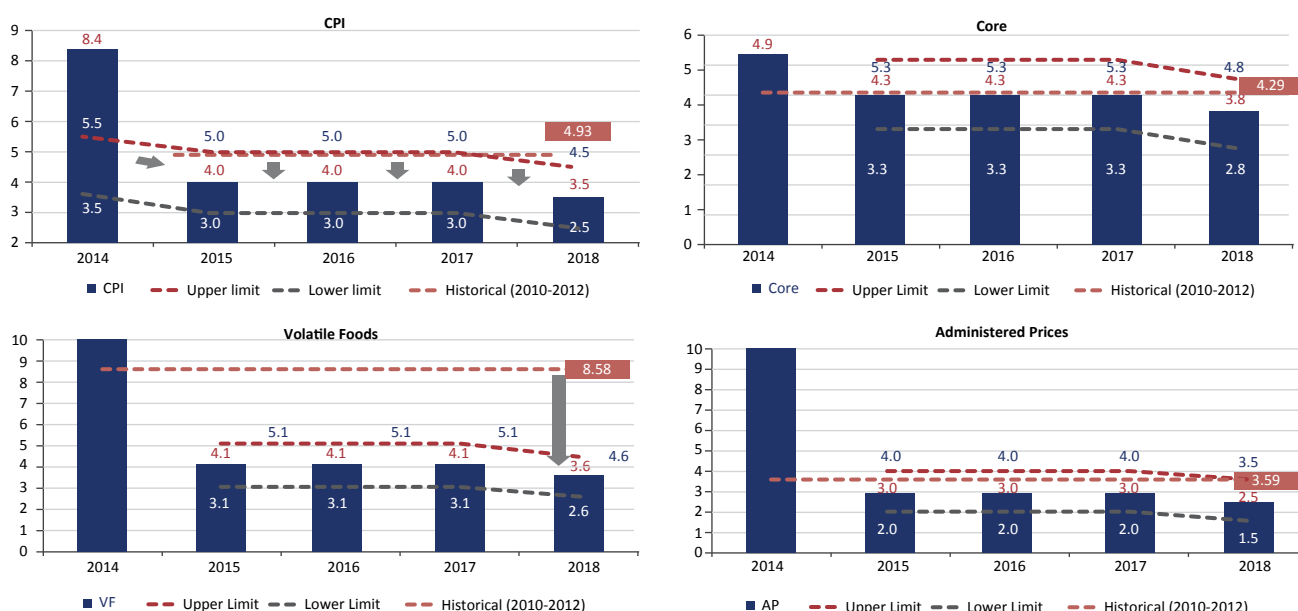
3 On 1 March 2015, the Government raised the price of Premium RON 88 gasoline by Rp500 per litre, and followed with a further increase of Rp500 per litre for both types of fuel on 28 March 2015. To curb the second round effects of these increases in fuel prices on transport fares, on 10 February 2015 the Government enacted Regulation of the Minister of Transportation No. 31 of 2015, stipulating among others that fare increases will be permitted if increases in energy prices result in a 20% change in the cost of providing transportation.

4 Under Regulation of the Minister of Energy and Mineral Resources No. 31 of 2014, electricity tariffs are adjusted to movements in the Indonesia Crude Price (ICP) the exchange rate and the monthly level of CPI inflation. The categories of electricity customers included in this formula are households (1,300VA, 2,200VA 3,500VA-6,600VA), businesses (6,600VA-200kVA, >200kVA), industry (>200kVA and >30,000 kVA), government offices (6,600VA-200kVA, >200kVA), street lighting and special services. For the 1,300VA and 2,200VA categories, implementation of the tariff adjustment was postponed from April 2015 under the original plan to December 2015.

5 The import deregulation policy has been implemented for beef, horticultural products, corn and soy beans.

6 Gerai Maritim is a collaborative program between the Ministry of Trade, the Ministry of Transportation, the Pelni national shipping line, and the Indonesian Association of Retail Businesses (Aprindo) to reduce price disparities between Western and Eastern part of Indonesia for staple goods. This program operates with the provision of transport for delivery of staple goods and subsidized freight costs to Eastern Indonesia, where the goods will be sold by local government/ designated companies at producer prices.

Chart 3. Inflation Path



levels and thus provide a reference for the work of the TPI and TPIDs.

Looking forward, the Inflation Control Roadmap will be necessary as a guide for a structured and integrated control of inflation to ensure achievement of the medium-term inflation target, set at $3.5 \pm 1\%$ for 2018.⁷ Amid the many structural issues surfacing with regard to inflation, extra effort is needed from all parties for future inflation targets to be achieved on a sustainable basis. Historical average figures (outside the periods of fuel price hikes) are 4.9% for CPI inflation, 4.3% for core inflation, 8.6% for VF inflation, and 3.6% for AP inflation. For the medium-term inflation target to be achieved, each of the components contributing to inflation must be maintained on a disinflation path (Chart 3). This means that core inflation in 2018 must be kept around the 3.8%, with VF inflation at about 3.6%, and AP inflation at 2.5%. In view of the short time remaining, Bank Indonesia and the Central Government and Local Governments will have to work harder and intensify their coordination.

The Inflation Control Roadmap is prepared for both the national level and regional level, where the design

is based on regionality (islands) according to the local characteristics of inflation. Each roadmap, both national and regional, identifies issues and presents solutions for the short term (2015-2016) and medium term (2017-2018). The national Inflation Roadmap details the ministries or government agencies in charge of each inflation control activity or program that has been adopted and the regional role that is necessary for the success of the inflation control program. For the regions, the Inflation Control Roadmap also specifies the necessities of central government support for achievement of inflation control in the regions, given that some policies represent the competency of the central government.

The roadmap for core inflation control covers management of domestic demand, expanding the capacity of the economy, management of exchange rate stability, and management of inflation expectations. The roadmap for VF inflation control covers measures to increase food production and buffer stocks and to improve market structures and pricing mechanisms. Meanwhile, the roadmap for AP inflation control addresses consistent implementation of the energy subsidy reform, diversification of energy consumption, and demand management. Following this, it is envisaged that the work program in the road map will be incorporated into the Government Work Plan at the central and regional levels in order to provide a reference for the work of the TPI and TPIDs.

⁷ In Regulation of the Minister of Finance of the Republic of Indonesia number 93/PMK.011/2014 concerning the Inflation Target for 2016, 2017, and 2018, the inflation target is set at $4 \pm 1\%$ (2016 and 2017) and $3.5 \pm 1\%$ (2018).



Like two Barongs, the global economy in 2015 was marred by a change in the landscape through sluggish economies in developing countries coupled with limited recoveries in advanced countries. On the other hand, global financial markets were blighted by escalating volatility in 2015, reflecting ubiquitous uncertainty.
