PART II

DOMESTIC ECONOMY

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Indonesia's economic performance in 2013 was not immune to the effects of the changes on cyclical patterns that characterized global economic dynamics. These changes affected domestic economic performance not only through the trade channels, but also through the financial market channels. In addition to global influences, domestic factors that are structural in nature also served as one of the root causes for the economic problems. Structural problems that became increasingly prominent amidst the disrupted stability, along with global challenges, affected domestic economic performance.

Global cycle changes such as declining global demand and falling global commodity prices led to a contraction in export growth, thereby affecting the performance of the current account, which had been experiencing a deficit since the fourth quarter of 2011. In addition to these cyclical factors, export performance was also affected by structural problems such as the composition of Indonesia's export structure that is predominantly derived from natural resource-based commodities. In the midst of these conditions, the continuing decline in global commodity prices therefore failed to stem Indonesia's declining export performance. Meanwhile, the current account deficit also came about as a result of imports that remained strong due to structural problems that have persisted for long time such as the limited capacity for domestic industries to fulfil demand. This problem becomes increasingly evident in line with the rising composition of middle class segment with more complex needs. In addition to this, the pressure on the current account was also driven by the continued persistence of deficit in services and income account. Structural problems also had a contribution to this deficit, such as the limitation in domestic transportation services to facilitate international trade.

The global economy in 2013 was also marked by uncertainty in the global financial markets over issues regarding the reduction of the monetary stimulus (tapering off) in the US. The turmoil in the financial markets subsequently triggered foreign capital outflow from emerging markets to developed countries, particularly to the US, in line with the expectations of interest rate increase in the US. Indonesia, which became one of the countries targeted by foreign portfolio investors, was not immune from the effects of this tapering off plan, wherein significant foreign capital outflow was observed. In addition to this, the foreign capital outflow from Indonesia was also triggered by the negative perception of foreign investors about the rising inflation pressures following the subsidized fuel price hike as well as the widening current account deficit. All this resulted in the diminishing surplus in the capital and financial accounts. Both the widening current account deficit and the diminishing capital and financial account surplus caused Indonesia's Balance of Payments (BOP) to record a deficit after previously experiencing a surplus.

The widening current account deficit resulted in the weakening of the rupiah's exchange rate. The pressure on rupiah had been escalating since mid of May 2013 and lasted until the end of September 2013, at a time when the foreign capital outflow in the financial markets intensified as a result of the taper-off plans in the US as well as investors' negative perceptions of Indonesia's economic fundamentals. Overall, the Rupiah depreciated sharply in 2013, which was higher than in 2012, both in terms of point-to-point and average.

The dynamics in the global economy also affected domestic economic performance. The economic growth moderated since the initial quarter, thereby for the entire year of 2013, Indonesia's economic growth charted only 5.8%, or slower than the 6.2% growth in 2012. The moderation in economy mainly derived from investments that fell since the beginning of the year due to the declining businesses confidence towards a perceived economic slowdown. Meanwhile, export growth continued to be fairly limited in line with the weak global economic growth and a decline in global commodity prices. On the other hand, consumption continues to register stable growth and was not much affected by global conditions, as it is still the main engine for economic growth.

Amidst the slowdown of domestic economy, inflation increased significantly as a result of the subsidized fuel price hike and rising food prices. Meanwhile, core inflation remained under control in 2013 due to slowing domestic demand, limited second round impact of the Rupiah's depreciation, as well as the decline of global commodity prices. Inflation in 2013 reached 8.4%, higher than the 2012 inflation of 4.3%, and was well above the inflation target range of 4.5±1%. Sumatera is the region with the highest level of inflation in 2013, which was due to high level of volatile food and administered price inflation.

The combination of economic slowdown and rising inflation has stalled the recovery trend in employment and welfare. The open unemployment rate in August 2013 registered a slight increase compared to the same period in 2012. Meanwhile, the poverty rate also rose slightly in September 2013 compared to March 2013.

In view of these unfavourable economic developments, Bank Indonesia and the Government responded with a variety of policies. In general, the policy responses adopted by Bank Indonesia and the Government were able to stabilize the economy in 2013 as shown by positive development in the fourth quarter of 2013. Monthly inflation returned to its normal path since September 2013, even settling below its historical trend. These policies also successfully directed inflation in 2013 to levels lower than inflation during the previous episodes of fuel price hike in 2005 and 2008 that recorded double-digit inflation.

Bank Indonesia and the Government's policy responses were also able to steer the economy towards a more balanced direction. The current account deficit declined significantly in the fourth quarter of 2013. Indonesia's balance of payments (BOP) recorded a surplus and was followed by easing in the pressure for Rupiah's depreciation. Household consumption remained intact while real imports contracted. Overall, the economic adjustment process was maintained thereby avoiding unnecessary economic downturn. The economic growth observed was even relatively high compared to the growth of peer countries. The controlled economy's adjustment was supported by fiscal resilience, as reflected in the deficit of 2013 State Budgetthat was managed at 2.3% of GDP following the Government's decision to increase the subsidized fuel price in late June 2013.

The domestic economic adjustment process that continued to be under control was also supported by stability in the financial system, particularly the resilient banking sector. The banking sectors continued resilience was reflected in the high level of Capital Adequacy Ratio (CAR) and low level of Non Performing Loan (NPL). Strong banking's resilience was a positive note amidst the decelerating economic growth which in turn slowed credit growth in 2013. Meanwhile, Micro, Small and Medium Enterprise (MSME) loans registered higher growth than in the previous year, although a slowing trend was beginning to be apparent since September 2013. The high growth of MSME loans indicated the significant role of MSME in supporting the domestic economy amidst the strong impact of the global economic slowdown. On the other hand, the bond and stock markets' performance was in a downward trend driven by rising uncertainties in the global economy and the moderating domestic economic performance.

The orderly economic adjustment process was also sustained by payment systems that continued to operate efficiently, safely and smoothly. The reliability of the non-cash payment systems as the financial system's infrastructure was reflected in the availability of the payment systems in accordance with the established 2013 service level . Meanwhile, the positive performance of currency circulation management in 2013 was reflected in Bank Indonesia's ability to provide sufficient currency in appropriate denominations, timely delivery, and in a decent condition, amidst increased demand.

CHAPTER

3

Economic Growth and Employment

In 2013, the global economy that fell below expectation amidst a weak and unbalanced domestic economic structure, contributed to the decline in Indonesia's economic growth in 2013. Bank Indonesia and the government introduced a range of pre-emptive policies in order to bring a more balanced economy geared towards supporting sustainable future economic growth. Policies adopted by Bank Indonesia and the government began to deliver expected results in the fourth quarter of 2013. Despite the economic slowdown stalling the improvement trends in unemployment and welfare, the depth of the economic downturn was not as severe. Moreover, the level of Indonesia's economic growth was higher than its peer countries and was also driven by a more balanced sources of growth.

Lower-than-expected global recovery amidst relatively weak domestic economic structure had an unfavorable impact on Indonesia's economic growth in 2013. The global economy in 2013 was marked by a slowing growth, declining commodity prices and a reversal of capital flows which exerted pressures on Indonesia's economy, both through trade and financial channels. At the same time, the domestic structure was unable to cushion the shocks from these external dynamics, thereby stalling the economic adjustments. On the one hand, imports continued to remain sizable due to insufficient capacity of the domestic industry to meet domestic demand from growing middle class population. On the other hand, investment, particularly non-construction investment, was trending downward attributable to its close links to declining exports performance and to rising economic uncertainty.

Due to these unfavorable global and domestic economic conditions, Indonesia's economic growth, particularly during the first three quarters of 2013, took a downward trend accompanied by unbalanced sources of growth. The decline in the economic growth was also attributed to limited real exports performance and slowing investment, particularly non-construction investment. Amid the tepid real exports performance, household consumption continued to be considerably high, thereby driving real imports to register a positive growth. Moreover, real imports growth managed to record a higher figure in the third quarter of 2013. Overall, unbalanced sources of economic growth subsequently contributed to rising current account deficit during the first three quarters of 2013. This condition need to be addressed carefully as it would exert pressure on the Rupiah and, in turn, adding pressure on investment and future economic growth.

Bank Indonesia and the government introduced various policy measures in attempts to manage the unfavorable domestic economic condition. The policy synergy was largely aimed at shifting the economy to a more stable and balanced state, which is vital to support sustainable economic growth in the future. Policy responses taken by Bank Indonesia and the government mainly consists of three groups of policies. The first policy related to the policy mix adopted by Bank Indonesia, which was not only utilizes interest rate policy, but also reinforced by the optimization of other policies such as exchange rate, monetary operations, macroprudential and cooperation with other central banks. The second policy was the policy mix on monetary and fiscal policies aimed at managing domestic demand to curb excessive imports and lowering the current account deficit. In this regard, government took fiscal policy to reduce fuel subsidy as well as tax instruments to reduce imports. The third policy was associated with short-term cyclical and structural policies such as the improvement of the investment climate and efforts aimed at promoting self-sufficient economy, which in turn supports sustainable balance of payments and future economic growth.

Pre-emptive policy responses taken by Bank Indonesia and the Government began to show expected results in the fourth quarter of 2013. Economic growth in the fourth quarter of 2013 headed for a more balanced direction as reflected by the decline in domestic demand, in line with slowing consumption and investment, particularly for non-construction investments. Imports also fell in line with declining domestic demand and weakening rupiah. Meanwhile, exports recorded a higher figure sustained by increased demand from developed countries such as US and Japan, as well as supported by the competitive rupiah. These developments led to an economic growth of 5.7% (yoy) in the fourth quarter of 2013, a slightly higher figure compared to the previous quarter figure. The more balanced sources of economic growth also contributed to the decline in current account deficit amounted to 2.0% of GDP in the fourth quarter of 2013, a lower figure compared to the previous quarter deficit of 3.9% of GDP.

Overall, the policy mix adopted by Bank Indonesia and the government in 2013 was able to sustain economic growth adjustment amidst tepid global recovery. Despite recording a lower figure compared to the previous year, Indonesia was still able to maintain an economic growth of 5.8%, higher than the economic growth of its peer countries. Nevertheless, the economic slowdown hampered the efforts to reduce the level of unemployment, which was underway since 2005. The poverty rate also rose slightly in September 2013 compared to the level in March 2013.

3.1. GDP – Expenditure Side

Indonesia's economic growth in 2013 was in a slowing trend due to global conditions that fell below expectations, as well as inadequate support by the domestic economic structure. The slowdown in global economy, accompanied by declining global commodity prices affected real exports performance. Weak exports and high uncertainty subsequently reduced investment, particularly for non-construction investment. Meanwhile, household consumption continued to be sizable, which was mainly driven by a growing middle class population.

Inadequate support from the domestic industrial capacity subsequently drove imports higher. Furthermore, these conditions eventually affected the economic growth which was already in a downward trend. Thereby, Indonesia's economy recorded a 5.8% growth in 2013, accompanied by unbalanced sources of growth (Table 3.1).

Real export performance continued to be limited due to global economic slowdown and declining commodity prices. These two global factors, which subsequently drove world trade volume downward resulted in relatively weak exports growth, despite rising competitiveness from weakening trend of rupiah. (Chart 3.1). Real exports grew below 5% (yoy) up to the third quarter of 2013. Structural issues related to export composition, which were dominated by natural resource-based commodities also contributed to the weak exports performance. Under this structure, the performance of natural resource-based export commodities closely follows declining global commodity prices. Based on commodities, limited exports performance was mainly attributed to weak manufacturing and mining commodities. The export slowdown in manufacturing sector occured in textile and textile products (TPT), crude palm oil (CPO), and rubber goods (Table 3.2). Meanwhile, mining commodity export growth was also declined, in line with the limited growth in the main destination countries, such as China and India.

Relatively weak export amidst the high uncertainty has subsequently driven investment growth down significantly in 2013. Investment grew by 4.7% in 2013, decreased sharply from the growth of 9.7% in 2012. This slowdown was mainly due to the limited demand for exports as a result of the global economic uncertainty. This, subsequently, resulted in investment

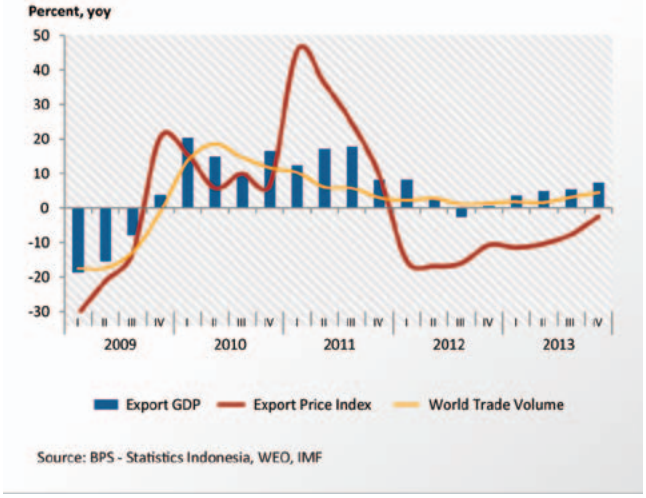


Chart 3.1. Real Export, Export Price Index, and World Trade

delays, both for construction investment and non-construction investment. Furthermore, the slowdown in investment in 2013 was also affected by the decline in Indonesia's competitiveness. In the publication titled "Doing Business 2014", Indonesia ranked 120, lower than the previous year's rank of 116 (Table 3.3). The decline in competitiveness occurred in 9 of the 10 standard indicators used in the "Doing Business 2014" publication, primarily on aspects such as the processing of building permits (IMB) and the supporting infrastructures which showed less encouraging developments. Aside from these structural factors, the slowdown of investment in 2013 was also attributed to the low capital expenditure of the Government.

Although construction investment was declining, the slowest growth of investment was recorded in the non-construction investment amounted to 0.1%. This

Table 3.1. GDP Growth by Expenditure

Percent, yoy

	2008	2009	2010	2011	2012	2013				
						Q1	Q2	Q3	Q4	Total
Household Consumption	5.3	4.9	4.7	4.7	5.3	5.2	5.2	5.5	5.3	5.3
Government Consumption	10.4	15.7	0.3	3.2	1.3	0.4	2.2	8.9	6.5	4.9
Gross Fixed Capital Formation (GFCF)	11.9	3.3	8.5	8.3	9.7	5.5	4.5	4.5	4.4	4.7
Building GFCF	7.6	7.1	7.0	6.1	7.4	6.8	6.6	6.2	6.7	6.6
Non-building GFCF	25.3	-6.7	13.1	14.9	15.8	2.4	-0.6	0.4	-1.5	0.1
Export	9.5	-9.7	15.3	13.7	2.0	3.6	4.8	5.3	7.4	5.3
Import	10.0	-15.0	17.3	13.3	6.7	0.0	0.7	5.1	-0.6	1.2
Gross Domestic Product	6.0	4.6	6.2	6.5	6.3	6.0	5.8	5.6	5.7	5.8

Source: BPS - Statistics Indonesia

Table 3.2. **Non Oil and Gas Export by Commodities**

Commodity	2011		2012		2013	
	Growth (% yoy)	Share (%)	Growth (%yoy)	Share (%)	Growth (%yoy)	Share (%)
Textile and Textile Products	9.6	15.8	-3.4	15.0	3.9	14.9
Coal	12.6	10.7	7.9	11.3	11.6	12.0
Electrical Equipment	-9.4	5.8	-0.2	5.7	12.5	6.1
Rubber Goods	28.7	6.3	-18.7	5.0	-2.7	4.7
Palm Oil	0.3	4.5	16.8	5.2	6.5	5.3
Others	15.5	57.0	2.8	57.7	3.8	57.1
Total	12.4	100.0	1.5	100.0	5.0	100.0

Source: BPS - Statistics Indonesia

was primarily affected by capacity utilization rate which was on the lower end of its historical average (70-75%) (Chart 3.2). In addition, high investment growth in 2012 also led businesses to restrain their response to increase investments in 2013. In the construction investment, slowing growth was attributed to the restrained demand for properties, especially commercial properties. Meanwhile, infrastructure developments continued to be limited. This is reflected, among others, in the realization of the first phase of of the 10,000 MW electricity infrastructure project in 2013, which only achieved 69% of the target. Infrastructure investment which recorded a positive figure was the toll road infrastructure whose operations increased from 3.7 km in 2012 to 30.2 km in 2013.

Data from the Investment Coordinating Board (BKPM) showed that the slowdown in investments were mainly attributed to the decline in Domestic Investment, while Foreign Direct Investment maintained a steady growth. Slowing domestic investment primarily occurred in the second half of 2013 (Chart 3.3). On sectoral front, the decline in domestic investment occurred in the secondary sector (non-mineral and textiles industry) and the primary sector (plantations). Meanwhile, investment in the service sector, particularly the electricity, gas and drinking water recorded a significant increase. Foreign Direct Investment mainly targeted the industrial sector, with a higher share flew to transportation equipment subsector. This was primarily due to increasing demand and the commencement of the low cost green car (LCGC) program. Meanwhile, a decline in FDI was recorded in warehousing and communications sector.

In contrast to export and investment, household consumption remained high in 2013, supported by rising trend of income and growing middle-class population.

Table 3.3. **Ease of Doing Business in Indonesia**

Rank	Indonesia	
	2013	2014
Doing Business Rank	116	120
Starting a Business	171	175
Dealing with Construction Permit	77	88
Getting Electricity	121	121
Registering Property	97	101
Registering Credit	82	86
Protecting Investors	51	52
Paying Taxes	132	137
Trading Across Borders	52	54
Enforcing Contracts	146	147
Resolving Insolvency	142	144

Source: *Doing Business* 2014

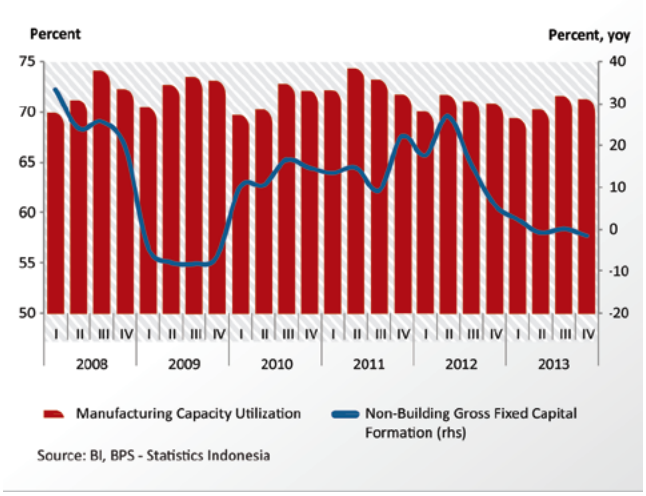


Chart 3.2. **Manufacturing Sector Capacity Utilization and Non Building Capital Formation GFCF Growth**

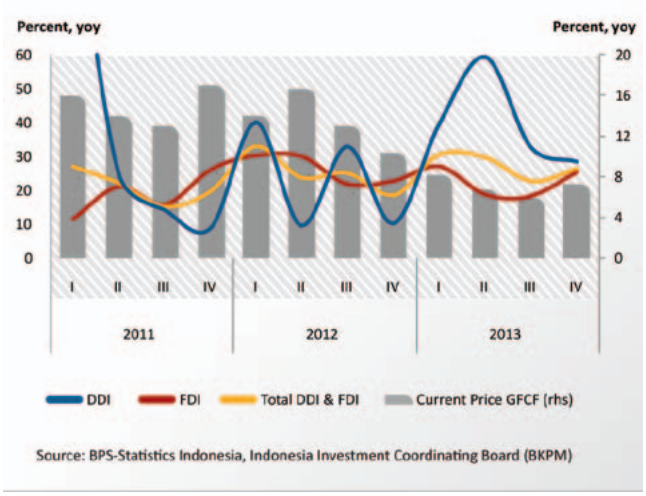


Chart 3.3. **Indonesia Investment Coordinating Board Investment Realization**

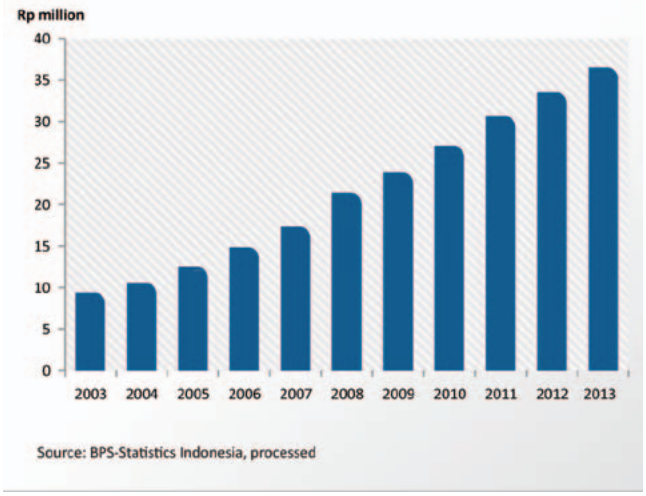


Chart 3.4. **GDP per Capita**

Data in 2013 showed that Indonesia's per capita income grew from Rp33.5 million in 2012 to Rp36.5 million (Chart 3.4)[1]. Based on such per capita income level, Indonesia therefore was still categorized within the lower middle-income countries, but was edging closer to the lower limits of the upper middle income countries[2]. Based on income group, this household consumption was supported by the consumption of the upper middle class group. This is reflected in the figure which showed that approximately 20% or 50 million Indonesians have consumption growth greater than the 2008-2012 average expenditure per capita growth of 4.8% (Chart 3.5). In line with the rising trend in revenue, the growth in household consumption which remained high was also influenced by a stable consumer confidence. Bank Indonesia and BPS' Consumer Confidence Index in 2013 also recorded a relatively stable figure and was further bolstered by optimism over current economic conditions (Chart 3.6). Overall, these developments drove household consumption in 2013 to grew at the same pace as the figure in 2012, amounted to 5.3% (Table 3.1).

Aside from the role of the middle class, high household consumption was also underpinned by the stable lower middle class household consumption. Moreover, this development was further supported by the preservation of purchasing power as a result of improvement in the labor compositions, increase in earnings attributed to the Provincial Minimum Wage (UMP) hike, increase in non-taxable income (PTKP), and Direct Cash Transfer (BLSM). Improved labor compositions was driven by higher labor absorption in the formal sector, resulted in the rising number of people which belong to the fixed income group. On the income front, the real UMP in 2013 increased by an average of 14%, higher than the previous year's increase of 7.0%. Additional revenues were also attributed to the increase in taxable income which was in effect from January 1, 2013. Meanwhile, in the low-income household group, the timely distribution of BLSM in 2013 was able to cushion the impact of declining purchasing power following the subsidized fuel price hike.

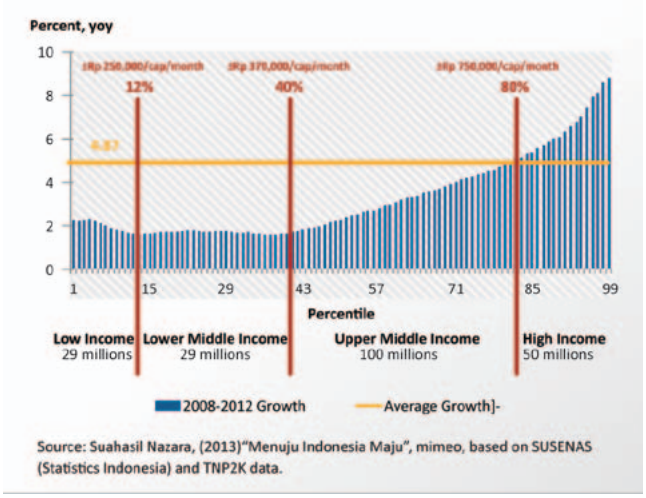


Chart 3.5. **2008 -2012 Per Capita Spending Growth**

1 Per capita income in 2013 is equivalent to US$3,499.9; slightly lower compared to the previous year's income due to the exchange rate.

2 According to the World Bank, the classification of countries based on per capita income are: low income (≤ US$1,005); lower middle income (US$1,006-3,975).

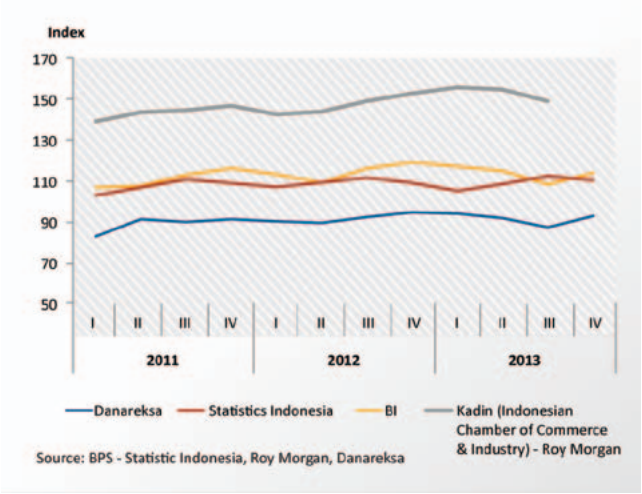


Chart 3.6. **Consumer Confidence Index**

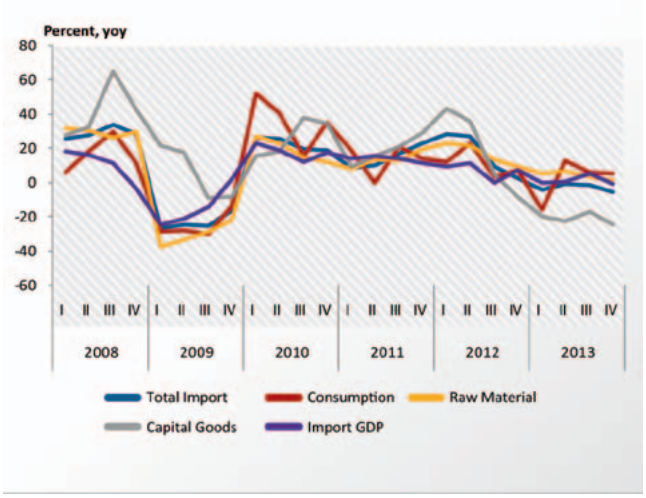


Chart 3.7. **Non Oil and Gas Import Based on Goods**

In line with high household consumption, real government consumption was also increased in 2013, mainly driven by accelerated absorption of government expenditure in the second semester. The fastest acceleration came from personnel expenditures, which was primarily related to the termination of moratorium on recruitment of civil servants in December 2012. Meanwhile, goods expenditure was also picked up stemming from rising expenditure for social assistance and expenditure for ministries and agencies, such as the General Election Commission (KPU) and the Ministry of Public Works.

Household consumption which remained high subsequently contributed to the positive import growth throughout the first three quarters of 2013. This relatively high import was primarily related to the structure of the industrial sectors with high import contents (see Box 3.1. Import Export Structure by Economic Sector). Import growth in the third quarter of 2013 recorded an increase of 5.1% (yoy) (Table 3.1). On type of goods front, sizeable imports were especially influenced by imports of consumer goods, while import of capital goods and raw material were declining (Chart 3.7). Raw material import was also declined, in line with slowing production activities.

Pre-emptive policy responses taken by Bank Indonesia and the Government began to show expected results in the fourth quarter of 2013. Economic growth in the fourth quarter of 2013 headed for a more balanced direction as reflected by the decline in domestic demand, in line with slowing consumption and investment, particularly for non-construction investments. Imports also contracted in line with declining domestic demand and weakening rupiah exchange rate. Meanwhile, exports bounced back to record a higher figure. These developments led to an economic growth of 5.7% (yoy) in the fourth quarter of 2013, a slightly higher figure compared to the previous quarter.

Overall, the policy mix adopted by Bank Indonesia and the government in 2013 was able to sustain economic growth adjustment amidst tepid global economic recovery. Despite recording a lower figure compared to the previous year, Indonesia was still able to maintain an economic growth of 5.8%, higher than the economic growth of its peer countries such as India, Malaysia, Singapore, and Thailand (Chart 3.8).

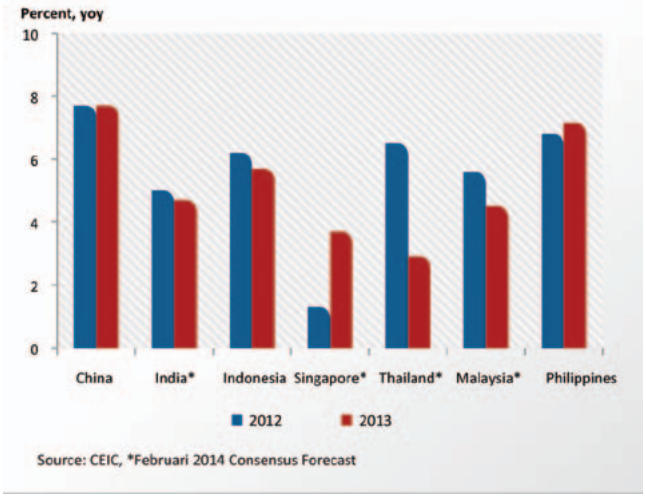


Chart 3.8. **Regional Countries' Economy**

3.2. GDP – Production Side

On sectoral front, the slowing growth mainly derived from the tradable sectors. This development was also attributed to the limited export growth, which resulted in the declining growth in the tradable sectors, such as agriculture, mining, and manufacturing sector (Table 3.4). Meanwhile, non-tradable sector such as transport and communications; finance, real estate and service; as well as the services sector continued to record higher growths (Table 3.4).

The agriculture sector's growth slowed in 2013 due to slowing export demand for palm oil based commodity and low paddy production. The growth of the agricultural sector in 2013 recorded a figure of 3.5%, slightly lower than the historical pattern of 3.6% from 2003 to 2012 (Chart 3.9). The subdued growth in major CPO export destinations, such as China and India, became a major factor for the slowing performance of the palm oil subsector. In the food crops subsector (Tabama), the paddy production in 2013 according to BPS' provisional figures (Asem) grew by 3.2%, lower than in the previous year (5.0%). This decline was attributed to the higher conversion of agricultural land compared to the creation of new farmland.

Growth in the mining sector also slowed in 2013 (Chart 3.10). The decline in oil production along with weakening demand for non-oil and gas export became the primary cause for the slower growth in this sector. The declining trend in oil production continued in 2013. Oil production in 2013 fell by 4.2 % to 826 barrels per day (bpd) from last year's 862 bpd. This is due to the natural decline in production and the limited production of new sources

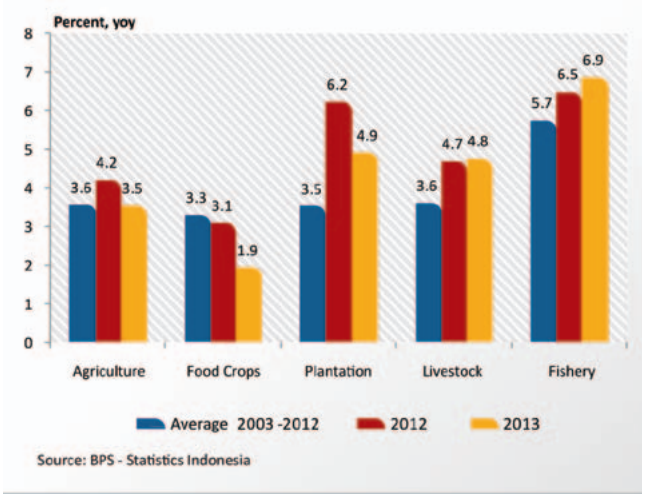


Chart 3.9. **Agriculture Sector's Growth**

of oil. On the other hand, the non-oil and gas mining subsector also witnessed a slowdown in exports attributed to weak demand and lower commodity prices. In addition, the production of copper and gold was disrupted due to the halted operation in Freeport Indonesia for two months during the first half of 2013 following the collapse of the mine in the Big Ghossan area.

The manufacturing sector in 2013 grew by 5.5 %, lower compared to the previous year's growth (Chart 3.11). This lower growth was mainly attributed to limited export growth. This is evident from the slowdown in the export-oriented subsector such as food and beverage subsector, chemical and rubber product subsector, and the basic metals, iron, and steel subsector. The declining performance in the food and beverage sub-sector was due to weakening crude palm oil (CPO) export as a result

Table 3.4. **GDP Growth by Sector**

Percent, yoy

Sector	2008	2009	2010	2011	2012	2013				
						Q1	Q2	Q3	Q4	Total
Agriculture	4.8	4.0	3.0	3.4	4.2	3.7	3.3	3.3	3.8	3.5
Mining	0.7	4.5	3.9	1.6	1.6	0.1	-0.6	2.0	3.9	1.3
Manufacture	3.7	2.2	4.7	6.1	5.7	6.0	6.0	5.0	5.3	5.6
Electricity, Gas, and Water	10.9	14.3	5.3	4.7	6.3	7.9	4.0	3.8	6.6	5.6
Construction	7.6	7.1	7.0	6.1	7.4	6.8	6.6	6.2	6.7	6.6
Trade, Hotel, and Restaurant	6.9	1.3	8.7	9.2	8.2	6.5	6.4	6.1	4.8	5.9
Transportation and Communication	16.6	15.8	13.4	10.7	10.0	9.6	10.9	9.9	10.3	10.2
Finance, Real Estate, and Service	8.2	5.2	5.7	6.8	7.2	8.2	7.8	7.6	6.8	7.6
Services	6.2	6.4	6.0	6.8	5.3	6.5	4.5	5.6	5.3	5.5
Gross Domestic Product	6.0	4.6	6.2	6.5	6.3	6.0	5.8	5.6	5.7	5.8

Source: BPS - Statistics Indonesia

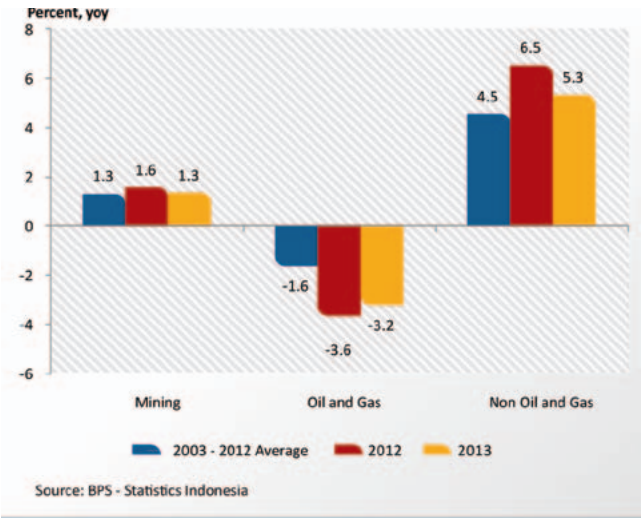


Chart 3.10. **Mining Sector's Growth**

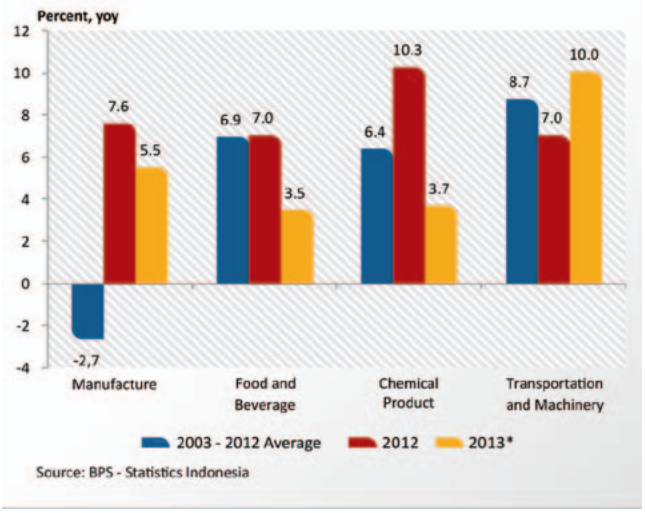


Chart 3.11. **Manufacturing Sector's Growth**

of falling commodity price. Mean while, the performance of the basic metals subsector was also declining due to weakening exports, as well as the slowdown in the construction sector which subsequently lowered the demand for construction input goods.

Apart from the export-oriented subsector, slowdown in manufacturing growth also attributable to the declining performance of the oil and gas industry subsector following the reduction in oil production. Meanwhile, the transportation, machinery, and equipment subsector continued to grow significantly. Vehicle sales in 2013 recorded a solid growth, supported by strong demand and the commencement of a Low Cost Green Car (LCGC) car program. However, its positive performance was not supported by improvements in the production structure which required input with high import contents. Although (LCGC) required to have domestic parts content of 80%, in the early stages, manufacturers could only fulfill domestic content of approximately 40%.

In contrast with the tradable sector, the performance of a number of non-tradable sectors recorded increases. The improvement in growth was registered in the transport and communications; finance, real estate and service; as well as in the services sector. The transport and communications sector experienced higher growth compared to the previous year (Chart 3.12). In the transportation subsector, all modes of transport recorded higher growths, with the exception of air transport, which experienced a moderate growth. In the communications sub-sector, the increasing use of data and internet communications was the primary driver of growth in the midst of relatively limited usage of mobile communications (voice and SMS). The improvement in this sector was supported by election-related activities which began in the second half of 2013. The performance of the financial, real estate, and service sector improved in 2013, supported by bank subsector which was able to record a higher growth. In addition, the performance of the business services subsector also registered higher growth brought about by election-related factors.

The performance of other non-tradable sectors recorded slowdowns, such as in the trade, hotels and restaurants; the construction sector; and the electricity, gas and water supply sector. Lower growth in hotel and restaurant sector mainly due to the decline in trade subsector brought about by the limited performance of export trade and

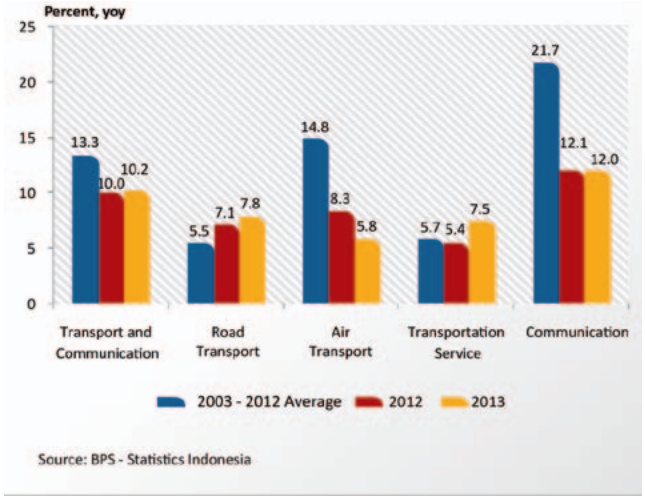
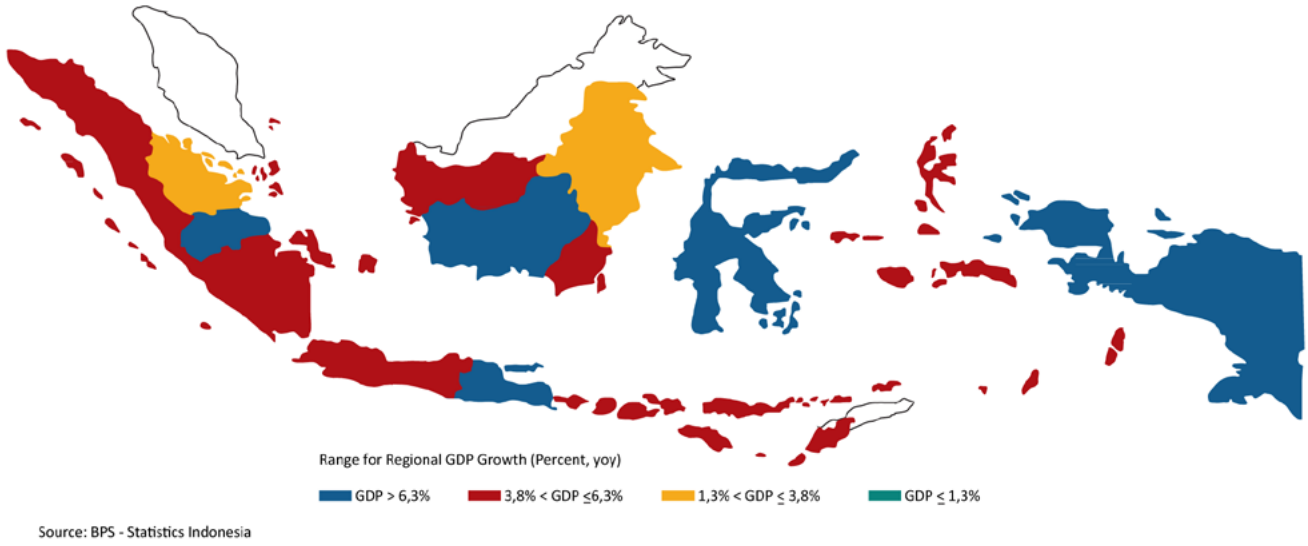


Chart 3.12. **Transportation and Communication Sector's Growth**



Picture 3.1. **Regional Economic Growth**

slowing tradable sector (Chart 3.13). Meanwhile, the hotel subsector and restaurant subsector registered improved growths attributed to increasing tourist arrivals and rising election activity within the second half of 2013. In the building sector, slowdown in growth was caused by the decline in investment and construction activities. This condition was consistent with the results of Bank Indonesia's survey of commercial and residential properties which showed limited supply of additional properties, particularly for commercial properties and industrial land. Furthermore, property companies also held back expansion projects due to rising interest rates and the implementation of Loan To Value (LTV) policy.

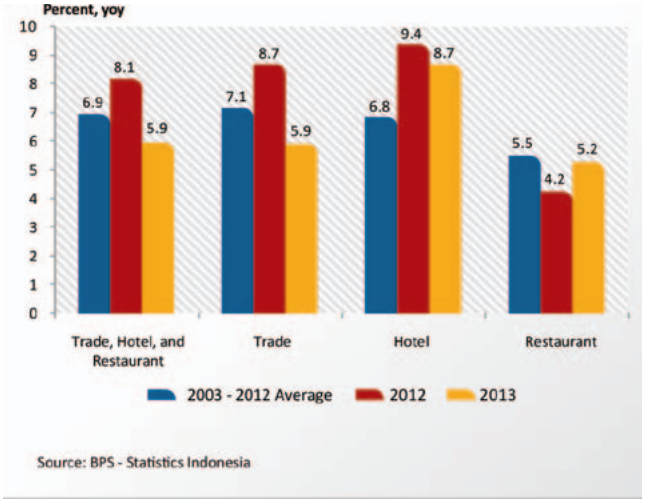


Chart 3.13. **Trade, Hotel, and Restaurant Sector's Growth**

3.3. Regional Economic Growth

Spatially, the economic slowdown occurred in almost all regions, with the largest slowdown occurred in Jakarta and Java (Table 3.5 and Figure 3.1)[3]. Economic growth in Jakarta and the Java regions declined from 6.5% and 6.6% in 2012 to 6.1% in 2013 respectively. Meanwhile, the regions of Sumatera and Eastern Indonesia also declined slightly from 5.7% and 5.9% in 2012 to 5.6% and 5.7% respectively.

The economic downturn in Jakarta was attributable to the slowdown in the construction sector; the financial, real estate, and service sector; as well as the manufacturing sector (Chart 3.14). One of the reasons for the decline was, among others, the retention of a number of construction projects due to rising prices for construction materials, particularly imported goods, and limited demand brought about by Bank Indonesia's stabilization policy. Furthermore, the performance of the finance, real estate, and service sector was also slowed, in line with the economic downturn in Jakarta. The sources of slowdown in this sector were derived from the limited performance of banks and non-bank financial

3 Bank Indonesia divided its regional economic analysis into four regions ,namely: Sumatera (the Provinces of Aceh, North Sumatera, South Sumatera, Bengkulu, Jambi, Lampung, West Sumatera, Riau, Bangka Belitung and the Riau Islands); Jakarta (DKI Jakarta); Java (West Java, Banten, Central Java, East Java, and Yogyakarta); Eastern Indonesia (Provinces of Bali, NTB, and NTT, West Kalimantan, Central Kalimantan, South Kalimantan, East Kalimantan, North Sulawesi, Gorontalo, Southeast Sulawesi, Central Sulawesi, South Sulawesi, West Sulawesi, Maluku, North Maluku, Papua and West Papua).

Table 3.5. **Regional Economic Growth**

Percent, yoy

Region	2011	2012				2012	2013				2013
		I	II	III	IV		I	II	III	IV	
SUMATERA	**6.2**	**5.9**	**5.7**	**5.9**	**5.8**	**5.7**	**5.4**	**5.2**	**5.0**	**5.5**	**5.6**
Northern	6.3	6.0	6.0	6.1	5.9	5.9	5.9	5.7	5.5	5.4	5.6
Central	5.9	5.4	5.2	5.7	5.5	5.2	4.7	4.5	4.2	5.0	4.6
Southern	6.5	6.5	6.2	5.9	6.2	6.2	6.0	5.8	5.6	6.4	5.9
JAKARTA	**6.7**	**6.5**	**6.8**	**6.4**	**6.5**	**6.5**	**6.5**	**6.3**	**6.2**	**5.6**	**6.1**
JAVA	**6.6**	**6.7**	**6.8**	**6.6**	**6.2**	**6.6**	**6.1**	**6.4**	**6.1**	**6.0**	**6.1**
Western	6.5	6.3	6.5	6.4	5.6	6.2	6.0	6.1	5.7	6.2	6.0
Central	5.9	6.6	7.3	5.8	6.1	6.2	5.5	6.2	6.0	5.4	5.8
Eastern	7.2	7.3	6.5	7.4	7.1	7.3	6.6	6.9	6.5	6.2	6.5
EASTERN INDONESIA	**5.8**	**6.2**	**6.5**	**5.0**	**6.0**	**5.9**	**5.9**	**4.6**	**6.1**	**6.6**	**5.7**
Bali and Nusa Tenggara	5.1	3.4	5.2	3.2	4.3	4.0	6.1	5.2	5.9	5.8	5.8
Kalimantan	5.0	6.1	5.7	3.9	3.7	4.8	3.1	3.2	3.8	3.8	3.5
Sulawesi, Maluku and Papua	7.2	7.6	8.1	7.0	9.7	8.1	9.4	6.2	9.1	10.4	8.7
TOTAL	**6.5**	**6.3**	**6.3**	**6.2**	**6.2**	**6.3**	**6.0**	**5.8**	**5.6**	**5.7**	**5.8**

Source: BPS - Statistics Indonesia

institutions, the deteriorating performance of the capital market, and the slowdown in leasing and property sales activities. The declining banks performance was also reflected by the slowdown in the realized disbursement of loan.

Java's economic downturn was primarily caused by declining performance of trade, hotels and restaurant sector (Chart 3.14). Motor vehicle sales in Java declined, particularly during the middle of the year. This was also thought to be influenced by the government's policy to increase subsidized fuel prices. In contrast, the performance of Java's other main sectors such as, manufacturing sector continued to register a modest growth. However, the manufacturing sector's growth was mainly constrained by the unfavorable performance of the chemical and paper processing industry as a result of the decline in commodity prices in the international market.

In Sumatera region, the economic slowdown mainly derived from the downturn in the mining and agricultural sectors (Chart 3.14). The slowdown in the mining sector in Sumatera was mainly due to the declining oil and gas lifting in the provinces of Riau, Southern Sumatera. This decline was largerly attributed to the aging petroleum wells. Meanwhile, the application of new technology to improve productivity has yet to show its effectiveness. Furthermore, there were no attempts to open or search for new wells. Slowing agricultural sector performance in Sumatera, particularly in the plantation subsector could not be separated from the limited global demand and relatively low commodity prices. This is also reflected in the decline of exports from the Sumatera region, particularly exports of CPO (Chart 3.15).

In Eastern Indonesia (KTI), slowing economic growth was primarily driven by the downturn in the manufacturing sector in Sulawesi-Maluku-Papua (Sulampua) and Kalimantan (Chart 3.14). The slowdown occurred mainly in the Liquefied Natural Gas (LNG) manufacturing sector in the Provinces of West Papua and East Kalimantan. This condition was caused by a natural decline in production, as well as damages in the production factor (train) since the end of 2012 which subsequently affected LNG

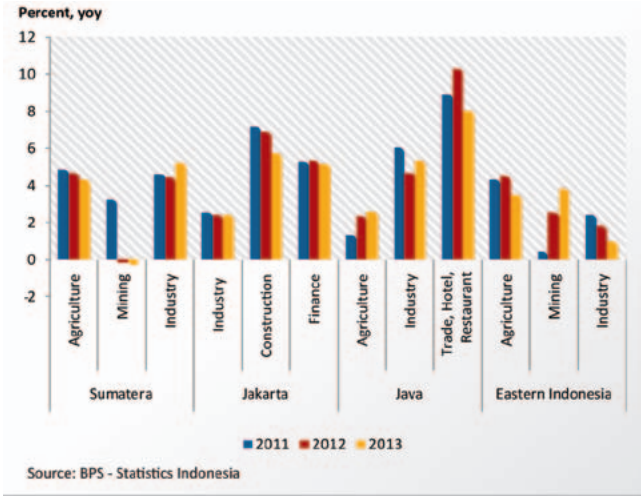


Chart 3.14. **Sectoral Growth by Region**

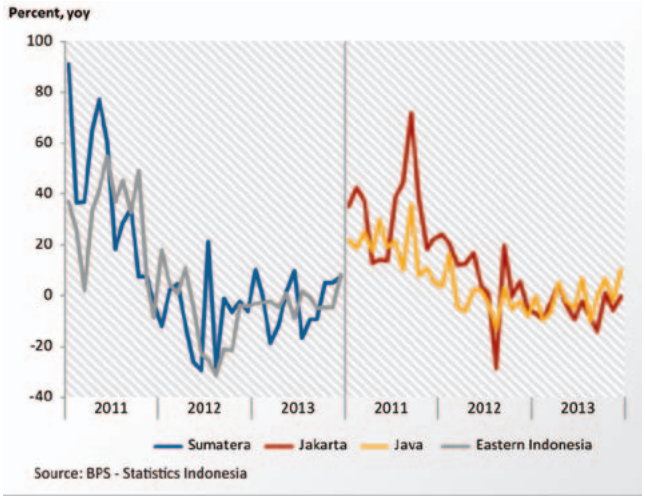


Chart 3.15. **Export Growth by Region**

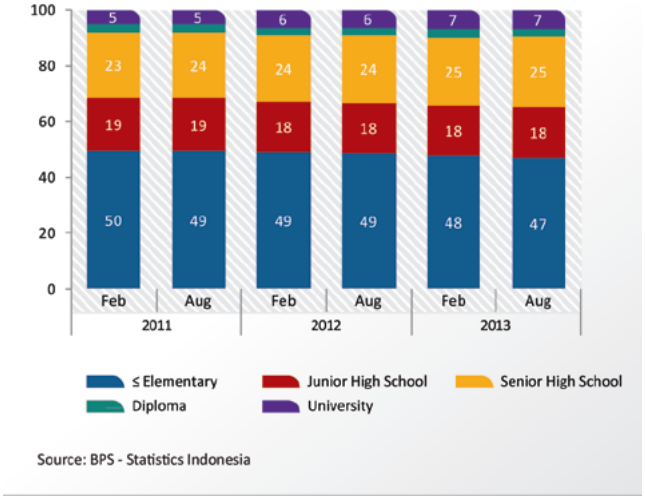


Chart 3.16. **Labor Force by Level of Education**

production in West Papua. The contribution of production derived from the new gas wells in South Mahakam remained marginal in reducing the deficit from the old Mahakam gas wells. The slowdown also occurred in the CPO processing industry due to reduction in palm oil production, particularly in the Provinces of South Kalimantan and West Kalimantan.

3.4. Employment and Welfare

In line with the restrained economic activity, the economy's capacity to absorb the labor force in 2013 was also weakened. In August 2013, the open unemployment rate amounted to 6.3%, higher compared to previous year figure of 6.1%, reversing the declining trend since 2005 (Table 3.6). The reduction in the labor absorption mainly occurred in the agriculture and manufacturing sectors, in line with weak export demand. Moreover, slowing performance in construction sector has also led to the decline in demand for labor in this sector.

In terms of quality, the labor compositions continued to show improvements in terms of the share of formal labor which rose from 40.0% in 2012 to 40.4% in 2013. In terms of education, labor composition also recorded an improvement as reflected in the growing share of high school graduates and above in the workforce (Chart 3.16).

However, unfavourable conditions were shown by the labor composition which slightly shifted from full-time workers (62.6%) to part-time workers (21.9%).

The economic downturn was also unfavourable for welfare. Overall, the number of poor population in September 2013 comprised of 28.55 million people (11.5% of the total population), or 0.14% lower compared 28.59

Table 3.6. **Labor Force and Unemployment**

In million people, unless otherwise stated

No	Main Activities	2011		2012		2013	
		Feb	Aug	Feb	Aug	Feb	Aug
1	**Productive Age (≥ 15yrs)**	170.7	171.7	172.9	173.9	175.1	176.7
	- Labor Force Participation (%)	70.0	68.3	69.7	67.9	69.2	66.9
2	**Labor Force**	119.4	117.4	120.4	118.0	121.2	118.2
	- Full Time Worker (%)	64.6	64.0	64.2	64.8	64.6	62.6
	- Part Time Worker (%)	15.5	17.9	17.2	18.2	18.3	21.9
	- Partial Unemployment (%)	13.2	11.5	12.3	10.8	11.2	9.2
	- Open Unemployment (%)	6.8	6.6	6.3	6.1	5.9	6.3

Sumber: BPS - Statistics Indonesia

Table 3.7. **Poverty Gap Index**

Year	Urban Area	Rural Area	Urban + Rural Area
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
Mar 2012	1.40	2.36	1.88
Sep 2012	1.38	2.42	1.90
Mar 2013	1.25	2.24	1.75
Sep 2013	1.41	2.37	1.89

Source: BPS - Statistics Indonesia. 2000-2013; (September)

Table 3.8. **Poverty Severity Index**

Year	Urban Area	Rural Area	Urban +Rural Area
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
Mar 2012	0.36	0.59	0.47
Sep 2012	0.36	0.61	0.48
Mar 2013	0.31	0.56	0.43
Sep 2013	0.37	0.60	0.48

Source: BPS - Statistics Indonesia. 2000-2013; (September)

million people (11.7% of total population) in September 2012 (Chart 3.17). However, compared to conditions in March 2013, the number of poor population in September 2013 was higher by 1.7 %. This increase in poverty rate was largely influenced by the economic downturn and higher prices brought about by the impact of the subsidized fuel price increase in June 2013.

The rising poverty level from March 2013 to September 2013 was also followed by a stagnant income gap. The poverty gap index was relatively unchanged, recorded a figure of 1.89 in September 2013 compared to 1.90 in September 2012 (Table 3.7)[4]. The poverty gap index figures showed that the average distance of the poor's expenditure from the poverty line did not improve compared to the previous year's figure. Similarly, the poverty severity index remain unchanged at 0.48 in September 2013 (Table 3.8)[5]. This indicated that the expenditure inequality among the poor remained similar to that of the previous year. The persistent gap figure was also reflected in the Gini ratio in 2013 of 0.41, which was unchanged compared to the previous year[6].

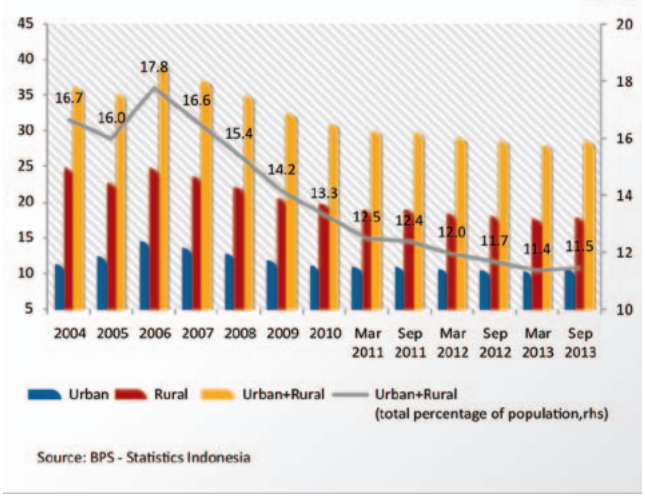


Chart 3.17. **Poverty Rate**

4 Poverty Gap Index is the average size of each expenditure gap of the poor against the poverty limit.

5 Poverty Severity Index is a measure of the expenditure distribution among the poor.

6 Source: BPS. The Gini ratio is a measure of income distribution that is calculated based on income class.

Box 3.1. Export Import Structure by Economic Sector

Understanding the structure of the import-export in the manufacturing sector can serve as the basis for determining sectoral policies, relating to efforts to minimize the current account deficit. Aside from being the leading sector to contribute improvement in Indonesia's exports, manufacturing sector is also the sector that significantly contributes to the demand for imports, although not all its subcategory have the same characteristics. Some of these subcategory have postive, balanced, and negative net exports (export value minus import value). Considering this diversity, policies related to the current account balance cannot be applied generally within the manufacturing sector, but requires specially directed to each type of businesses.

Based on the 2008 Input Output (I/O) Table, manufacturing sector has the highest import content, but also become a leading exporting sector (Chart 1). Accordingly, by using the import export data from 350 companies representing approximately 50 % of total imports[1] in 2012, manufacturing sector remains the sector with the largest exports and imports compared with the other sectors (Chart 2).

By sub-sectors, the transportation, equipment and machinery subsectors have relatively high exports value compared to other subsectors. However, this subsector also imports with a value greater than the value of exports. Products derived from corporations engaged in the transportation and electronic equipment is mainly intended to fulfill the demand of the domestic market. In addition, the chemical, as well as the food and beverage industry subsector also have a relatively high import content compared to its exports with a largely domestic-oriented market (Chart 3).

By its domestic market target, the end product from the chemical industry subsector is primarily intended for the agricultural sector, especially for food crops. In the food industry, part of its domestic market directly penetrates consumers and the other part is directed towards the poultry feed industry. These

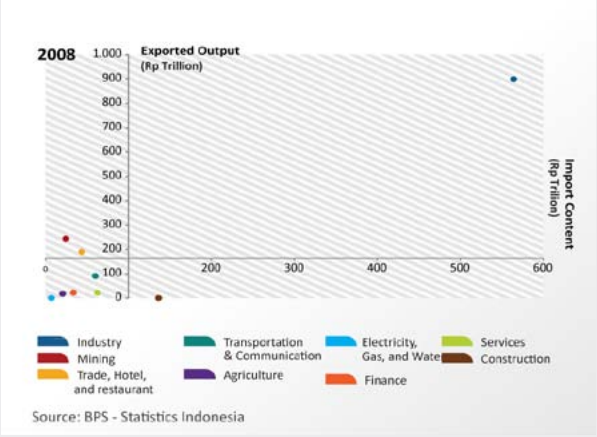


Chart 1. **Export Import Based on 2008 I/O**

products from the poultry feed corporation is used by the agricultural sector, particularly the livestock subsector. Meanwhile, the domestic market for means of transportation subsector is largely directed to the end consumer.

Corporations which need high imports but has a more domestic-oriented market require careful attention. Particularly if the product is mainly targeted towards the end consumer as a consumptive type of products, such as, product from the transportation equipment industry. Dampening demand for these transportation

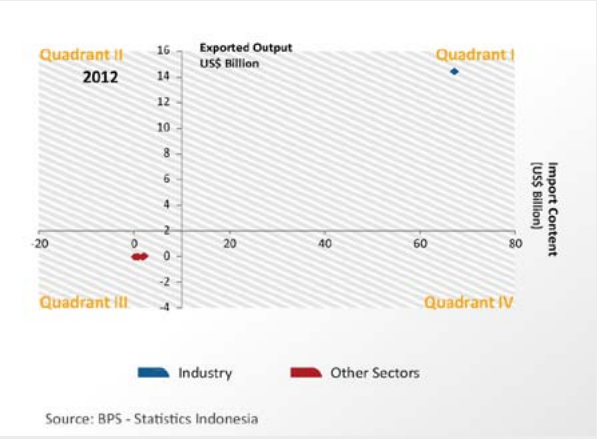


Chart 2. **Export - Import Based on Corporation Export - Import Data**

1 Grouping of corporate sector is based on its exported output

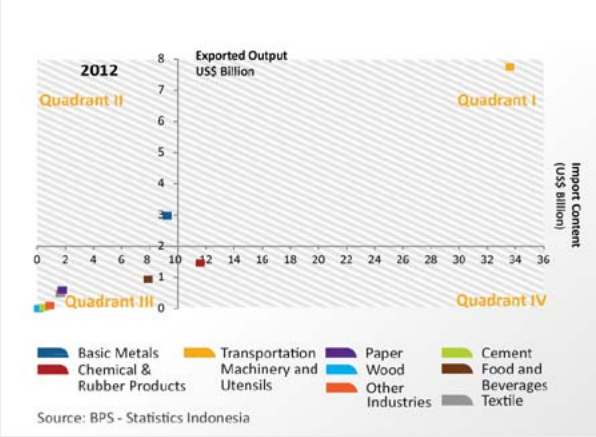


Chart 3. **Export - Import in the Manufacture Subsector**

products become something that deserves to be considered to maintain a sustainable current account. Meanwhile, for sectors that has substantial imports, yet possess a strong forward linkage, the provision for imported raw material substitution policy may become an option.

CHAPTER

4

Indonesia's Balance of Payments

During 2013, Indonesia's balance of payments came under mounting pressure. This condition represented the effects of the slowing global economy, falling commodity prices and diminishing capital inflows in emerging market economies amid the domestic economic structure that was inadequately supporting economic resilience. Working in synergy, Bank Indonesia and the Government pursued a range of measures to bring down the current account deficit and shore up the balance of payments. The policy responses were visible in initial movement of the current account deficit towards a more sustainable level in the last quarter of 2013 that brought the balance of payments back into surplus, accompanied by prudently managed external sector resilience.

In 2013, the weakening global economy combined with lack of a supportive domestic economic structure led to mounting pressure on Indonesia's balance of payments. On one hand, the global economic slowdown resulting from weaker growth in emerging market countries sapped demand for Indonesia's exports. Exports contracted yet further because of the concomitant deterioration in Indonesia's terms of trade consistent with the downward movement in global commodity prices. Amid structural problems related to the traditionally predominant role of resource-based commodities in exports, the worsening terms of trade resulted in weaker performance of Indonesia's commodity exports. At the same time, imports remained high due to the structure of domestic production that unable to keep pace with the burgeoning demand from the middle class, particularly for high technology goods. Oil imports were also stubbornly high due to heavy reliance on oil in the national energy supply structure, while gas exports showed a declining trend. Taken together, these conditions led to a widening current account deficit.

On the other hand, indications of improvement in the US economy prompted the US monetary authority to embark on tapering off the monetary stimulus. This response later gave an impact of gradual reduction in the supply of liquidity to emerging market countries, including Indonesia. As a result, foreign capital inflows into Indonesia began to weaken, particularly from May 2013. Negative perceptions among foreign investors were exacerbated by the rising current account deficit and inflation expectations. In turn, these conditions bore down on the capital and financial account surplus, and thus the decline in Indonesia's balance of payments performance persisted until the third quarter of 2013.

The negative pressure on Indonesia's balance of payments was intensified during the second and third quarter of 2013. The current account deficit mounted in the second quarter of 2013 to 4.4% of GDP from 2.7% of GDP in the previous quarter. In the capital and financial account, capital outflows gathered momentum in June 2013, triggered by global concerns over the planned tapering off by the Fed. In the third quarter, the current account still posted a sizeable deficit at 3.9% of GDP. Capital outflows lasted through July-August 2013 due to strong lingering concerns over the tapering off and perceptions on deteriorating current account, hence putting more pressure on the financial account.

Bank Indonesia and the Government pursued a range of policies designed to bring down the current account deficit to a more sustainable level. These policy responses can be grouped into three major areas. First is the policy mix implemented by Bank Indonesia that worked not only through interest rate policy, but also by optimising other areas of policy such as the exchange rate and macroprudential policy. Second is a fiscal policy mix implemented through reductions in the fuel subsidy and tax instruments for reducing imports. The synergy in both monetary policy and fiscal policy mix is directed towards managing domestic demand in order to curb excessive imports. The third policy mix concerns structural policies such as for improvement of the investment climate and measures to promote economic self-reliance, which in turn will support the balance of payments in the long run.

The stabilisation policy implemented by Bank Indonesia and the Government has successfully brought the current account deficit to a more balanced level and shored up the overall balance of payments. The current account deficit dropped significantly to 2.0% of GDP in the fourth quarter of 2013. This was induced by a fall in imports along with more moderate domestic demand and depreciation in the exchange rate which consistent with its fundamentals. Also bolstering the current account were stronger exports in line with improved economic growth in advanced countries and a more competitive rupiah exchange rate. Added to this was a renewed increase in the capital and financial account surplus that resulted from corporate drawing of foreign borrowings, withdrawals from offshore deposits held by domestic banks and stable inflows of direct investment. The surplus in the capital and financial account was sufficient to fund the current account deficit, with the result that in the last quarter of 2013, after three straight quarters of deficit, the balance of payments returned to surplus. This positive development contributed to an increase in the international reserves position from US$95.6 billion in the third quarter of 2013 to US$99.4 billion in the fourth quarter of 2013.

Following the developments of the fourth quarter, the overall 2013 balance of payments posted a US$7.3 billion deficit that contrasted with the US$0.2 billion surplus of 2012. The 2013 balance of payments deficit reflects the influence of the current account deficit at US$28.4 billion or 3.3% of GDP, up from the 2012 deficit of US$24.4 billion or 2.8% of GDP. With that deficit in 2013, international reserves position fell from the previous US$112.8 billion at end-2012 to US$99.4 billion at end-December 2013 (Table 4.1). Nevertheless, amid the weakening fortunes of the balance of payments, several indicators affirmed the sustained level of Indonesia's external resilience.

Table 4.1. **Indonesia's Balance of Payments**

US$ million

ITEMS	2008	2009	2010	2011	2012*	2013**				
						I	II	III	IV	Total**
I. Current Acoount	**126**	**10,628**	**5,144**	**1,685**	**-24,418**	**-5,905**	**-9,998**	**-8,529**	**-4,018**	**-28,450**
A. Goods, net	22,916	30,932	30,627	34,783	8,618	1,628	-517	145	4,894	6,149
- Export	139,606	119,646	158,074	200,788	188,496	45,231	45,554	44,148	48,616	183,548
- Import	-116,690	-88,714	-127,447	-166,005	-179,878	-43,603	-46,071	-44,003	-43,722	-177,399
1. Non Oil and Gas	15,130	25,560	27,395	35,433	13,857	4,483	1,587	2,771	7,011	15,851
a. Export	107,885	99,030	129,416	162,721	152,925	36,758	37,640	35,610	39,951	149,960
b. Import	-92,755	-73,470	-102,021	-127,288	-139,068	-32,276	-36,053	-32,840	-32,941	-134,109
2. Oil	-8,362	-4,016	-8,653	-17,526	-20,436	-6,356	-5,102	-5,664	-5,354	-22,476
a. Export	15,387	10,790	15,691	19,576	17,891	4,298	4,243	4,812	4,536	17,889
b. Import	-23,749	-14,806	-24,344	-37,102	-38,327	-10,654	-9,345	-10,476	-9,890	-40,365
3.Gas	16,147	9,388	11,886	16,876	15,197	3,501	2,998	3,038	3,237	12,775
a. Export	16,333	9,826	12,968	18,491	17,680	4,175	3,670	3,725	4,129	15,700
b. Import	-186	-438	-1,082	-1,615	-2,483	-674	-672	-688	-892	-2,925
B. Service, net	-12,998	-9,741	-9,324	-10,632	-10,331	-2,511	-3,365	-2,675	-2,877	-11,428
C. Income, net	-15,155	-15,140	-20,790	-26,676	-26,800	-6,126	-7,130	-6,881	-7,090	-27,227
D. Current Transfers, net	5,364	4,578	4,630	4,211	4,094	1,104	1,014	883	1,056	4,056
II. Capital & Financial Account	**-1,832**	**4,852**	**26,620**	**13,567**	**24,896**	**-394**	**8,300**	**5,587**	**9,238**	**22,731**
A. Capital Account	294	96	50	33	51	1	7	5	8	21
B. Financial Account	-2,126	4,756	26,571	13,534	24,845	-395	8,293	5,582	9,230	22,710
- Assets	-17,949	-14,395	-6,901	-15,657	-16,242	-7,930	2,643	-3,084	-966	-9,337
- Liabilities	15,823	19,151	33,471	29,191	41,087	7,535	5,650	8,666	10,196	32,047
1. Direct Investment	3,419	2,628	11,106	11,528	13,716	3,789	3,700	5,681	1,597	14,767
a. Abroad	-5,900	-2,249	-2,664	-7,713	-5,422	-206	-901	-87	-2,482	-3,676
b. In Indonesia	9,318	4,877	13,771	19,241	19,138	3,996	4,601	5,768	4,079	18,444
2. Portfolio Investment	1,764	10,336	13,202	3,806	9,206	2,760	3,389	1,942	1,756	9,848
a. Assets	-1,294	-144	-2,511	-1,189	-5,467	-965	202	-670	140	-1,293
b. Liabilities	3,059	10,480	15,713	4,996	14,673	3,726	3,187	2,612	1,617	11,141
3. Other Investment	-7,309	-8,208	2,262	-1,801	1,922	-6,945	1,203	-2,041	5,877	-1,906
a. Assets	-10,755	-12,002	-1,725	-6,754	-5,353	-6,759	3,342	-2,328	1,376	-4,368
b. Liabilities	3,446	3,794	3,987	4,954	7,275	-187	-2,139	287	4,501	2,462
III. Total (I + II)	**-1,706**	**15,481**	**31,765**	**15,252**	**478**	**-6,300**	**-1,698**	**-2,943**	**5,221**	**-5,720**
IV. Net Errors and Omissions	**-238**	**-2,975**	**-1,480**	**-3,395**	**-262**	**-315**	**- 779**	**297**	**-808**	**-1,605**
V. Overall Balance (III + IV)	**-1,945**	**12,506**	**30,285**	**11,857**	**215**	**-6,615**	**-2,477**	**-2,645**	**4,412**	**-7,325**
VI. Reserves and Related Items Memorandum:	**1,945**	**-12,506**	**-30,285**	**-11,857**	**-215**	**6,615**	**2,477**	**2,645**	**-4,412**	**7,325**
- Reserve Assets Position	**51,639**	**66,105**	**96,207**	**110,123**	**112,781**	**104,800**	**98,095**	**95,675**	**99,387**	**99,387**
- In Months of Import and Servicing of Official External Debt	4.0	6.5	7.4	6.5	6.1	5.7	5.4	5.2	5.5	5.5
Current Account to GDP Ratio (%)	0.02	1.95	0.72	0.20	-2.78	-2.66	-4.41	-3.85	-1.98	-3.26

*) Provisional Figures
**) Very Provisional Figures

4.1. Current Account

The current account began to chart deficit in the fourth quarter of 2011. This carried forward into 2013, followed by escalation in the deficit itself. In 2013, the current account deficit reached US$28.4 billion (3.3% of GDP), up from US$24.4 billion (2.8% of GDP) in 2012. The surge in the current account deficit was explained most importantly by a fall in the trade surplus alongside mounting deficits in the services account and income account. The diminished trade surplus came from more rapid decline in exports compared to imports. Exports in 2013 were down from 2012, having sustained 2.6% correction, while imports underwent 1.4% correction from the preceding year.

The swelling current account deficit was closely linked to the ongoing deterioration in global economic conditions. On one hand, the decline in world economic growth from 3.1% in 2012 to 3.0% in 2013 due to economic slowdown

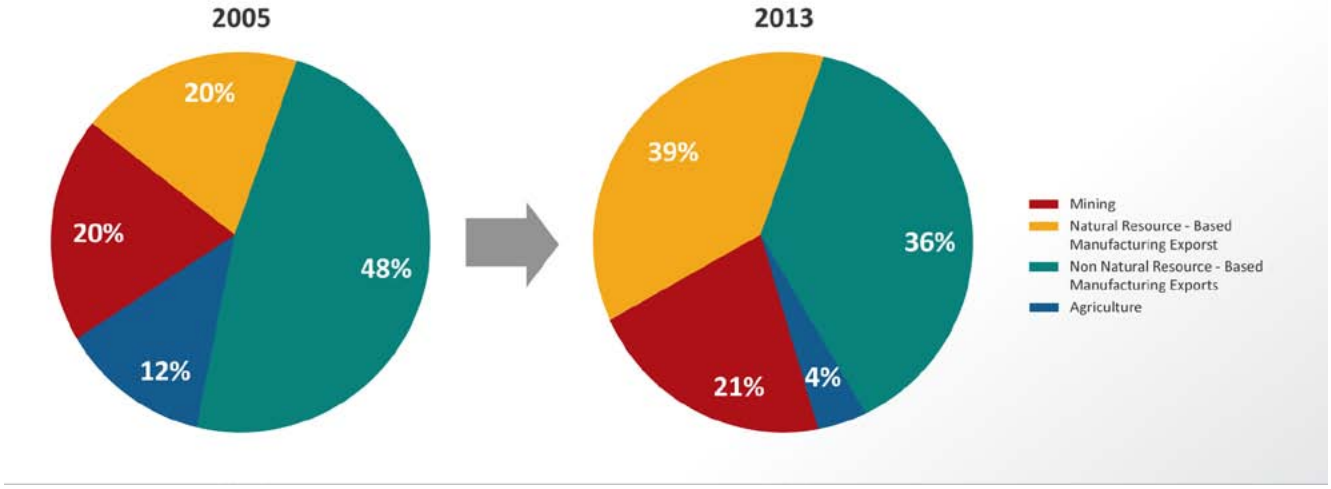


Chart 4.1. **Indonesia's Non Oil and Gas Export Profile (2005 and 2013)**

in emerging market countries, led by China and India, dampened demand for export goods from Indonesia[1]. On the other hand, the world economic slowdown also brought an end to era of high commodity prices. This eroded Indonesia's terms of trade and ultimately put more pressure on the trade surplus.

The current account deficit continued to widen because of the traditionally heavy reliance on resource-based exports in Indonesia's economic structure. In fact, the contribution of resource-based exports to total non-oil and gas exports increased from 52% in 2005 to 64% in 2013 (Chart 4.1). This issue became more concerning since the efforts to boost the role of non-resource based exports through direct investment is inadequate . Although there has been steady growth in foreign direct investment, with manufacturing accounting for the largest share, the export-oriented portion, particularly in manufacturing, has been on a downward trend since 2000 (Table 4.2). This indicates that foreign investment in Indonesia is more oriented to meeting domestic demand than boosting exports.

Another structural problem that has exacerbated the current account deficit is the high level of dependence on imported goods in the domestic economy. The high import content in domestically produced goods means that domestic industry continues to rely heavily on imported raw materials. Added to this, domestic production capacity is insufficient to meet domestic demand, including the higher demand from middle-income society, and this has exacerbated Indonesia's dependence on imported goods. Similar conditions beset the energy sector. Robust domestic demand has spurred unrelenting growth in energy imports, in particular oil, due to the limited supply of energy in domestic. According to a Bank Indonesia study, the inability of domestic production to keep pace with growing demand has resulted in an upward trend in elasticity of imports to domestic demand since 2000.

The dynamics of these cyclical and structural issues were manifested in the quarterly figures for the current account in 2013. Pressure in the current account deficit met its peak in the second quarter of 2013 (4.4% of GDP) as a result of a diminishing non-oil and gas trade surplus. Driving down this surplus were high imports, led by imports of raw materials and consumtion goods, in line with surging domestic demand that historically always runs

Table 4.2. **Share of Exported Output**

Percent

Sector	Share of Exported Output		
	2000	2005	2008
1. Agriculture	2.4	3.3	1.9
2. Mining	39.2	49.5	34.1
3. Manufacturing	36.2	27.1	23.7
4. Electricity, Gas, and Water	0.0	0.0	0.0
5. Construction	0.0	0.0	0.0
6. Trade, Hotel, and Restaurant	14.4	13.8	14.2
7. Transport and Communication	17.6	14.9	13.8
8. Finance, Real Estate, and Service	7.4	4.6	3.1
9. Services	4.9	4.6	2.5
Total	**21.1**	**17.2**	**14.1**

Source: Input - Output Table 2000, 2005, 2008: BPS-Statistics Indonesia

1 For a comprehensive analysis of global economic developments, see Chapter 1. The Global Economy and Chapter 2. The Global Economic Policy Response.

high in the second quarter. A further contribution to the widening current account deficit during this period came from an enlarged deficit in services and income account. The increase in the services account coincided with the rise in non-oil and gas imports and the widening income account deficit caused by the surge in interest/coupon payments abroad, in keeping with the quarterly trend. In the later developments, the current account still posted a sizeable deficit in the third quarter at 3.9% of GDP, albeit less than that in the second quarter 2013.

The current account deficit dropped back to 2.0% of GDP in the last quarter of 2013 (Chart 4.2). This indicates that the stabilisation policy pursued by Bank Indonesia and the Government succeeded in bringing down the current account deficit to a more sound and sustainable level. The improvement in the trade balance had a major contribution to the reduction in the current account deficit in the fourth quarter of 2013 with a surplus of US$4.9 billion. The more robust trade balance is mainly supported by the non-oil and gas trade balance driven by rising non-oil and gas exports. These exports, in turn, were spurred by the onset of recovering demand in advanced countries, led by the US and Japan, as well as the more competitive exchange rate. On the other hand, non-oil and gas imports were relatively unchanged from the previous quarter. It was influenced by several factors included depreciation in the rupiah and weakening domestic demand in line with the monetary and fiscal tightening policies conducted by Bank Indonesia and the Government. In other developments, oil and gas trade again posted a deficit, mainly due to the continually high fuel consumption.

Non-Oil and Gas Trade Balance

In analysis by component, the widening current account deficit that peaked in the third quarter of 2013 was strongly influenced by the drop in the non-oil and gas trade surplus during that period. However, the non-oil and gas trade balance showed renewed improvement in the last quarter 2013, fuelled by rising exports. In response to these developments, the non-oil and gas trade balance booked a US$15.8 billion surplus in 2013, ahead of the 2012 surplus of US$13.9 billion.

The flagging non-oil and gas trade balance that lasted until the third quarter of 2013 was explained by the struggling performance of Indonesia's non-oil and gas exports. During the first three quarters of 2013, non-oil and gas exports contracted by 3.9% (yoy) due to falling demand from leading trading partners, including China, Europe, Japan and the US (Chart 4.3). Besides this, the continuing downward trend in global commodity prices also had substantial impact on non-oil and gas exports, dominated as before by resource-based products. In 2013, exports of primary products fell by 3.5%, while manufactured exports remained in positive territory albeit a small growth at only 0.2% (Chart 4.4).

A further reason for diminished surplus in non-oil and gas trade was the milder correction in non-oil and gas imports compared to non-oil and gas exports. During the first three quarters of 2013, non-oil and gas imports experienced 2.5% (yoy) contraction, while non-oil and gas exports fell by a steeper 3.9% (yoy). Non-oil and gas imports were impacted by the moderation in domestic

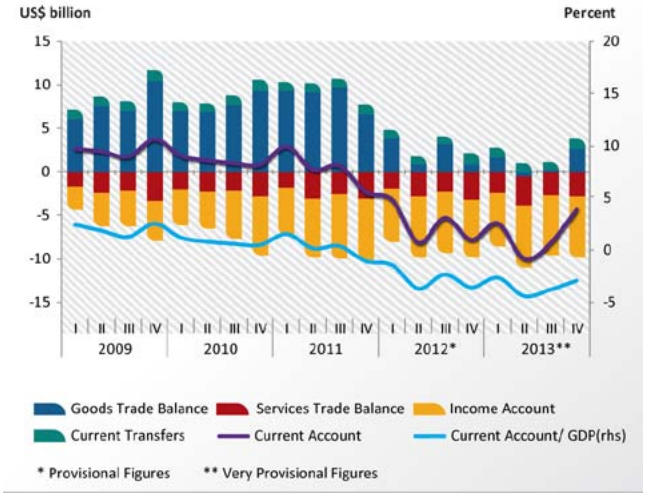


Chart 4.2. **Current Account Balance**

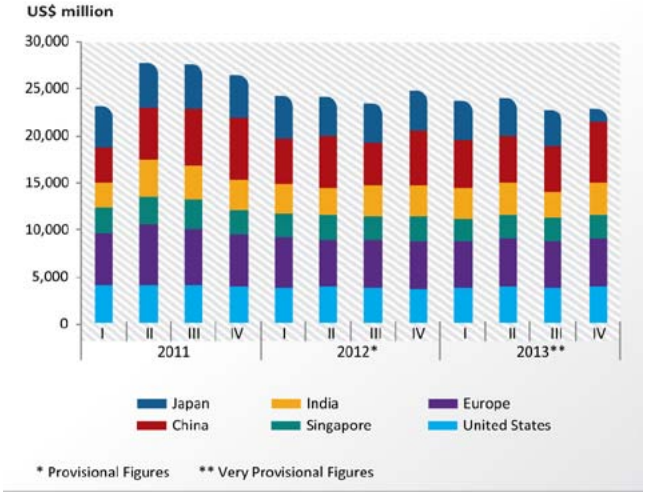


Chart 4.3. **Non Oil and Gas Exports by Major Destination Countries**

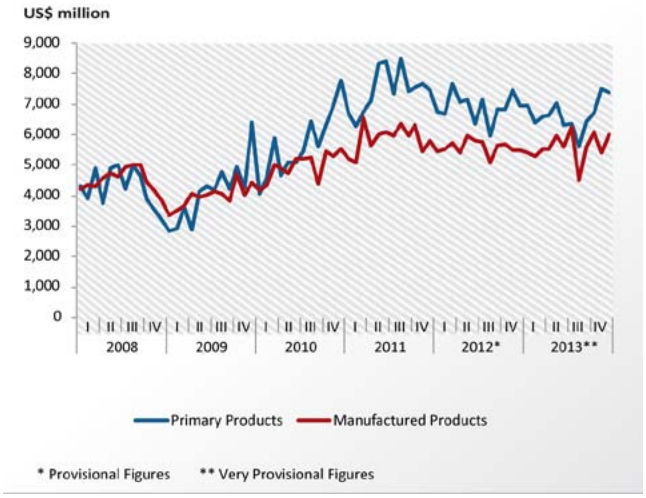


Chart 4.4. **Exports of Primary Products and Manufactured Product**

demand consistent with the slowing trend in domestic economic growth, depreciation in the exchange rate and the various import control policies pursued by Bank Indonesia and the Government since the third quarter of 2013.

Amid the slowing trend of domestic demand, imports of consumtion goods continued to climb by 3.2%. At the same time, imports of raw materials, which account for a 69% share, were down by 0.6%, while imports of capital goods experienced the steepest drop to 14.3% from the previous year.

Oil and Gas Trade Balance

The most dominant factor in the deteriorating current account deficit during 2013 was the yawning deficit in oil and gas trade. In 2013, the oil and gas trade deficit reached US$9.7 billion, considerably greater than the deficits of US$0.7 billion in 2011 and US$5.2 billion in 2012 (see Box 4.1, Oil and Gas Trade Balance).

This expanding deficit was closely tied to the effect of sustained high oil imports. In 2013, oil imports reached US$40.4 billion, a fairly strong increase over the previous year's level of US$38.3 billion. This rise in oil imports has been driven by burgeoning domestic consumption of oil-based fuels in the transportation sector, while alternative energy sources remain limited. The upward trend in imports also represented the effect of structural issues related to the steady decline in oil production, down from 862 thousand barrels per day in 2012 to 827 thousand barrels per day in 2013 (Chart 4.5).

An added factor in the oil and gas trace deficit was a substantial fall in gas exports. In 2013, gas exports declined by 11.2% from previous year, totalled US$15.7 billion. This decline was among others induced by the government energy conversion policy to substitute petroleum-based fuels with gas supplied from domestic gas output. Although this had brought an abrupt fall in gas exports, the benefit of the policy was that it will prevent an even greater rise in oil imports.

Services, Income and Current Transfers

One factor contributing to the enlarged current account deficit was the persistent deficit in the services account. The deficit in fact widened over the preceding year. In 2013, the services account posted an US$11.4 billion deficit, ahead of US$10.3 billion one year earlier (Chart 4.6).

Similar to previous years, the deficit in services account was dominated by the deficit in transportation services. Transportation services recorded a deficit of US$8.9 billion in 2013, up from the 2012 deficit of US$8.7 billion. Nevertheless, analysis of components reveals a change in the composition of factors driving transportation services deficit. In 2013, the rise of deficit in the services account was spurred mainly by an increased deficit in passenger transportation services, which climbed from US$1.14 billion to US$1.42 billion. This development is

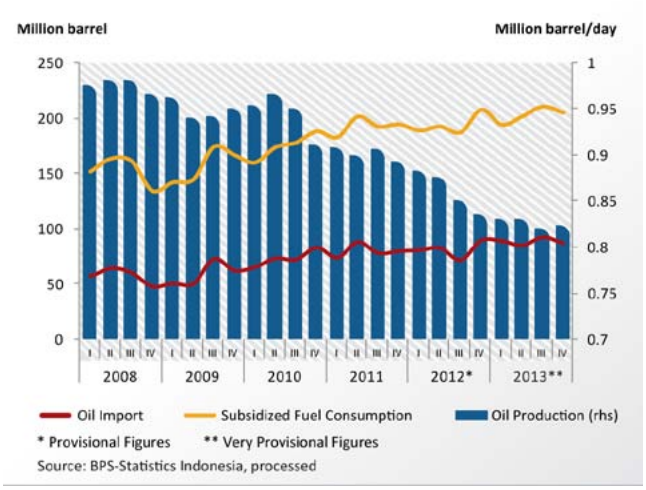


Chart 4.5. **Oil Production, Oil Imports, and Subsidized Fuel Consumption**

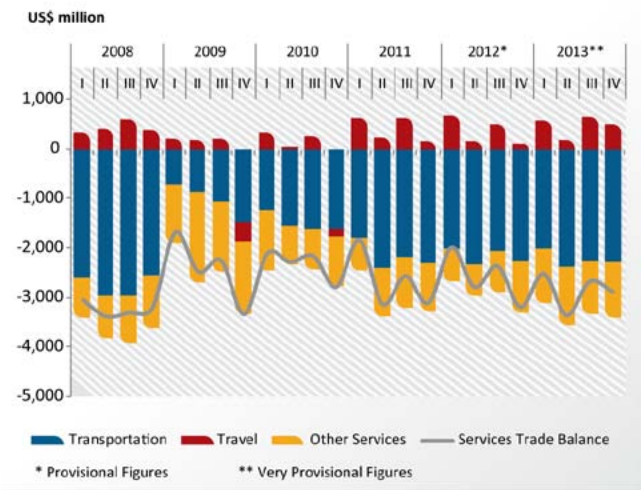


Chart 4.6. **Services Trade Balance**

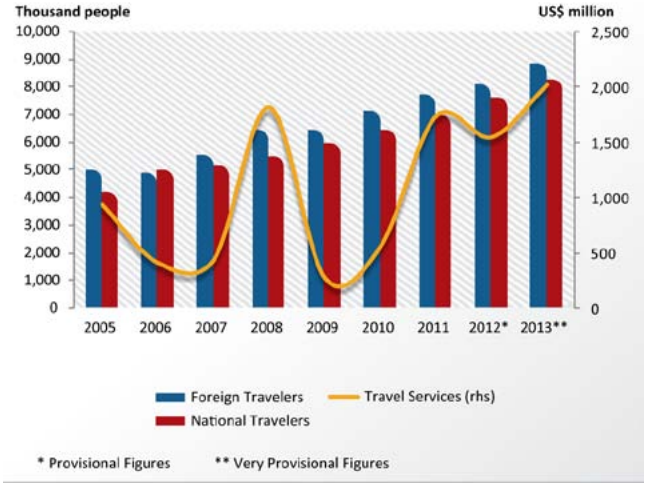


Chart 4.8. **Number of Foreign and National Travelers & Travel Services**

an indication of growing numbers of Indonesia's middle class travelling abroad using foreign carriers. In contrast, the deficit in freight services eased in 2013 from US$7.56 billion to US$7.33 billion. This was due to the declining of imports (Chart 4.7). Although having eased, the chronic deficit in freight services is a continuing reminder of the structural problem related to the limited number of domestic service providers operating in freight. This limitation is causing most exports and imports of goods are transported by foreign carriers.

The deficit in services account was slightly offset by an increased net surplus in travel services. The rise in the surplus was explained by higher numbers of inbound travellers, partly as a result of the various international events held in Indonesia including the APEC summit (Chart 4.8).

The income account, also marked by a lingering deficit, similarly contributed to the widening current account deficit. In 2013, the income account posted yet another deficit at US$27.2 billion, representing an increase over US$26.8 billion in 2012 (Chart 4.9). The income account deficit was partly related to the effect of the significant growth in foreign direct investment (FDI) since 2010. Any rise in FDI will generally lead to an increase in investment income payable to foreign investors in the form of dividend payment or as reinvested earnings, and this will ultimately widen the income account deficit.

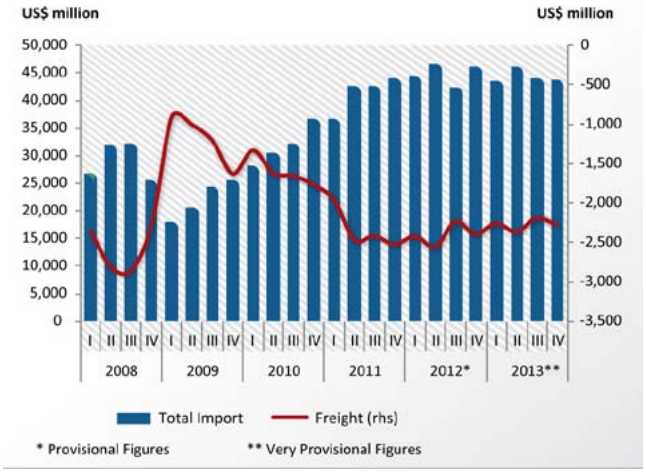


Chart 4.7. **Total Imports and Freight**

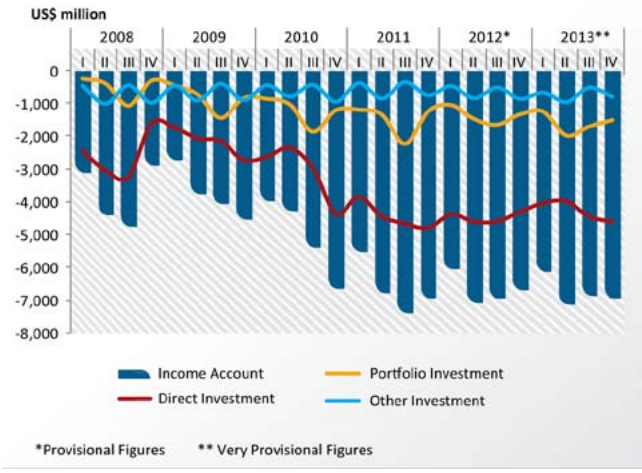


Chart 4.9. **Income Balance**

In other developments, the current transfers, another component of the current account, posted a surplus roughly on par with that of the previous year. In 2013, the current transfers surplus was bolstered mainly by an increase in remittances from Indonesian migrant workers employed overseas. Worker remittances climbed from US$7.1 billion in 2012 to US$7.4 billion in 2013. This was a quite positive development, given the reduction in numbers of Indonesian migrant workers employed overseas following the imposition of a moratorium on migrant worker deployment to Middle Eastern countries such as Saudi Arabia, Kuwait, Syria and Jordan. This was an indication of higher average wages received by Indonesian workers employed overseas (Chart 4.10).

4.2. Capital and Financial Account

A diminished surplus in capital and financial account contributed to the negative pressure on Indonesia's balance of payments in 2013. During the year, the capital and financial account surplus dropped by 8.7% to US$22.7 billion from the previous year's surplus of US$24.9 billion (Table 4.1). The reduced surplus was mainly came from the deficit in other investment. Nevertheless, increased surpluses were recorded in direct investment and portfolio investment.

The decline in the surplus was induced by heightened uncertainty on global financial markets over the plan for tapering off the monetary stimulus in the US, which slowed capital inflows into Indonesia, as well as

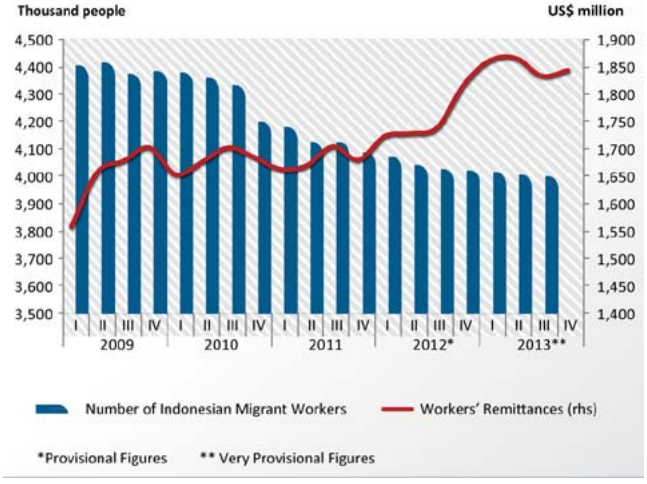


Chart 4.10. Number of Indonesian Migrant Workers and Workers' Remittances

negative perceptions of the current account deficit and rising inflation expectations in the wake of the June 2013 hike in subsidised fuel prices. The capital outflows from Indonesia began climbing in May 2013 and lasted through July until August 2013. However, a more drastic fall in the capital and financial account surplus was averted by parallel decline in resident investment abroad as a response to the weaker than expected outlook for global economic growth.

In a quarterly analysis, various responses pursued by Bank Indonesia and the Government to steer the economy towards more balance structure had resulted positive developments in the last quarter of 2013. These policy responses succeeded in restoring investor perceptions of the outlook for investment in Indonesia. In this period, the capital and financial account booked a surplus of US$9.2 billion, higher than that of the previous quarters. The rise in the capital and financial account surplus was attributable to foreign capital inflows in other investments and portfolio investments, in particular Indonesian government bonds. Meanwhile, the direct investment still marked a surplus, albeit down from that of the previous quarter.

Direct Investment

Adverse global and domestic factors have borne down on foreign direct investment (FDI) in Indonesia. Direct investment slipped from US$19.1 billion in 2012 to US$18.4 billion. Transactions by domestic investors taking up foreign-held shares in Indonesia-based retail companies and oil and gas companies also contributed to the reduction in foreign direct investment in Indonesia. On the other hand, Indonesian direct investment abroad also fell significantly from US$5.4 billion in 2012 to US$3.7 billion, in keeping with slowing growth in the global economy. The steeper drop in Indonesian direct investment abroad compared to that of foreign direct investment in Indonesia (FDI) had resulted to bigger surplus in the net direct investment from US$13.7 billion in 2012 to US$14.8 billion in 2013.

In analysis by country of origin, the foreign direct investment flowing into Indonesia was dominated by investors from Singapore and Japan. Investment from the two countries came to US$14.8 billion, or 78% of total FDI in Indonesia, but fell short of the 82% share achieved in 2012 (Chart 4.11). Meanwhile, direct investment from ASEAN countries in 2013 totalled 47% of total foreign direct investment in Indonesia, with Singapore in the lead followed by Malaysia and Thailand.

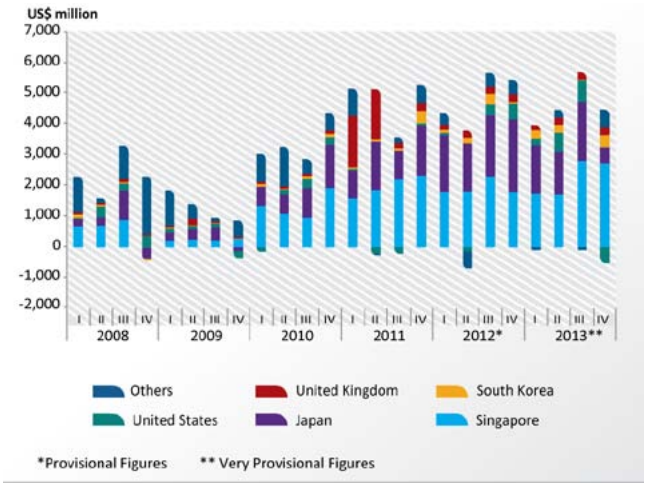


Chart 4.11. **Foreign Direct Investment by Country of Origin**

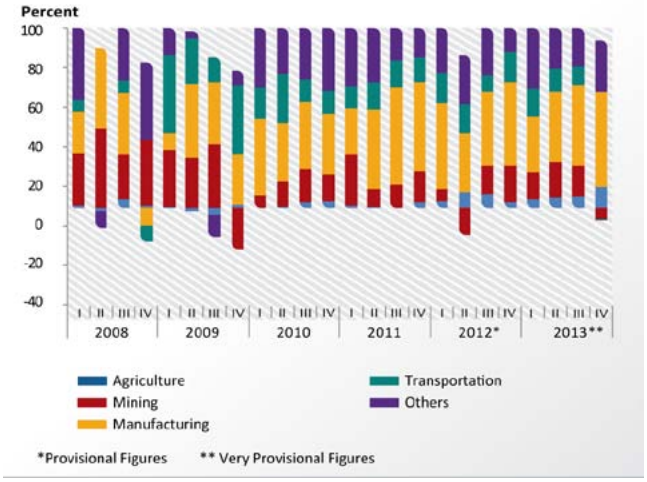


Chart 4.12. **Foreign Direct Investment by Economic Sector**

Similar to previous years, foreign investors interested in Indonesia were attracted to three main sectors: manufacturing, mining and transportation. In manufacturing, foreign direct investment totalled US$8.8 billion or reached 48% of the total for 2013, with the largest share of investment coming from Japan and Singapore. In mining and transportation, investment reached US$2.3 billion and US$1.9 billion (Chart 4.12). The keen foreign interest in investing in the three sectors is closely linked to the high rate of domestic consumption and reliance of exports on the energy sector. Strong interest for investing in manufacturing and mining is also indicated in the data published by the Investment Coordinating Board (BKPM). In 2013, these two sectors accounted for 72% of total foreign direct investment in Indonesia[2].

Portfolio Investment

Problems arose in global economy and domestic economy had also affected the portfolio investment in Indonesia (liabilities side) with a contraction in 2013. However, Indonesia's portfolio investment abroad (asset side) dropped significantly exceed that of the decline in foreign portfolio investment in Indonesia. This resulted in the net surplus in portfolio investment which mounted higher, from US$9.2 billion in 2012 to US$9.8 billion.

In 2013, foreign capital inflows in form of portfolio investment fell sharply from the previous year. Foreign portfolio investment was recorded at US$11.1 billion, down from the 2012 level of US$14.7 billion. A steep decline of capital inflows occurred mainly in the third and fourth quarters of 2013. This was due to the global uncertainty related to taper off the monetary stimulus in the US, negative perceptions of foreign investor concerning the current account deficit and a surge in inflation expectations following the fuel-subsidized price hike.

The downturn in portfolio investment in Indonesia mainly sourced from the private sector (Chart 4.13), particularly on the stock market. During 2013, the stock exchange recorded net foreign selling of US$1.8 billion, in contrast to the US$1.7 billion net purchase one year before. This in turn contributed to a downward trend in the Jakarta Composite Index (JCI). On the corporate bond market, however, the correction in foreigner holdings was not as deep as on the stock market. The private sector recorded US$2.7 billion in securities purchases by foreigners, down from US$3.7 billion in the previous year. This foreign purchases mainly occurred in the first half of 2013, when economic conditions were still favourable for bond issues.

In contrast to private sector, foreign portfolio investment in the public sector booked more robust surplus. The increased surplus came largely from issuances of government global bonds in the form of Global Medium Term Notes (GMTN) and the sharia-compliant Sukuk instruments. Also reinforcing the public sector surplus

2 Realised investment recorded by BPKM comprises the total project value of companies of Foreign Direct Investment (FDI) status, as reported each quarter in the Investment Activity Report (LKPM). This value excludes investment in the following sectors: oil and natural gas, banking, non-bank financial institutions, insurance and leasing. Investment licensing in these sectors is handled by the competent technical agencies.

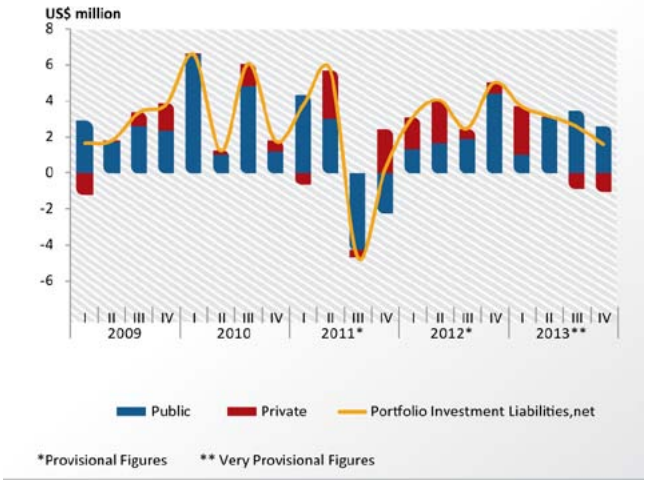


Chart 4.13. **Foreign Portfolio Investment**

were foreign inflows into SBIs (Bank Indonesia Certificates) after the change in the minimum holding period policy, which was reduced from six months to one month effective from September 2013. In 2013, SBIs recorded a net foreign purchase of US$305 million, following the previous year's net foreign selling of US$789 million.

The expanding surplus of foreign portfolio investment in the public sector was restrained by a drop in foreign investor purchases of Indonesian government bonds. In 2013, net placements by foreigners in rupiah-denominated Indonesian government bonds came to US$4.7 billion, a drop of US$0.7 billion from the previous year. Unlike the stock market, the decline in foreigner holdings of rupiah government bonds had occurred since May 2013 until the end of third quarter of 2013. This had much to do with global jitters over the planned tapering off since May 2013 and concerns over government shutdown in the US. Otherwise, domestic conditions related to perceptions of the current account and the surge in inflation expectations also influenced foreigner holdings of Indonesian government bonds.

Other Investment

The diminished surplus in the capital and financial account was also influenced by the 2013 deficit in other investment transactions. Other investment recorded a net deficit of US$1.9 billion, contrasting with the previous year's US$1.9 billion surplus.

Flagging global and domestic economic developments have also led to a downturn in capital inflows for other investment in Indonesia. In 2013, other investment in Indonesia (liabilities side) fell significantly, with the previous US$7.3 billion surplus dropping to US$2.5 billion. During the same period, Indonesian other investment abroad (asset side) recorded a lower deficit, down from US$5.4 million to US$4.4 million.

Other investment in public sector contributed mostly to the reduced surplus in other investment in Indonesia. Foreign other investment in the public sector experienced a deficit consistent with the net government external debt servicing of US$0.5 billion, down from the previous year. Meanwhile, other investment in the private sector posted a surplus bolstered by net disbursement of non-affiliated foreign borrowing and expansion of non-resident deposits held in domestic banks. Non-affiliated private sector loans recorded net disbursements of US$2.2 billion, having dropped from US$3.4 billion in net disbursements one year before. Alongside this, non-resident deposits in domestic banks climbed to US$1.4 billion, ahead of US$1.1 billion in the previous year (Chart 4.14).

In quarterly figures, net other investment returned to a sizeable surplus in the last quarter of 2013. The US$5.9 billion surplus was driven mainly by increased corporate drawing down of external loans and withdrawal of domestic deposits held offshore, visible in the asset components of other investment in the private sector. Deposits were withdrawn mainly by domestic banks to meet their customer liquidity needs and for placement in instruments offered by Bank Indonesia.

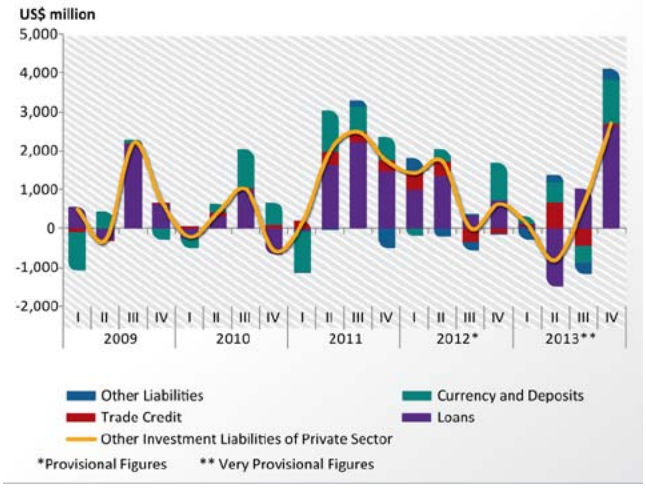


Chart 4.14. **Other Investment Liabilities of Private Sector**

4.3. External Resilience

Despite the considerable pressure on the balance of payments, several indicators affirmed Indonesia's external resilience. The improving fortunes of the balance of payments in the last quarter of 2013 also enhanced capacity for financing the current account deficit from long-term sources of funds, as reflected in improvement in the basic balance (Chart 4.15)[3].

While international reserves, another indicator of external resilience, were down from the previous year, the year-end position reached US$99.4 billion, equivalent to US$5.5 months of imports and servicing of external debt. These numbers are well above international standards of adequacy (Chart 4.16).

The external debt development also suggests that Indonesia's external debt exposure remains within comfortably safe limits. The growth in Indonesia's external debt in 2013 showed a downward trend from 12.0% (yoy) in 2012 to 4.6% (yoy). The moderation in external debt was closely linked to the slowing economic growth that reduced the need for financing economic activity. The overall external debt to GDP ratio in 2013 remained quite viable at 30.2%, despite having mounted slightly from the previous year's ratio of 28.7%. The external debt to GDP ratio remained in comfortably safe territory, within the range of ratios for peer group countries (Chart 4.17).

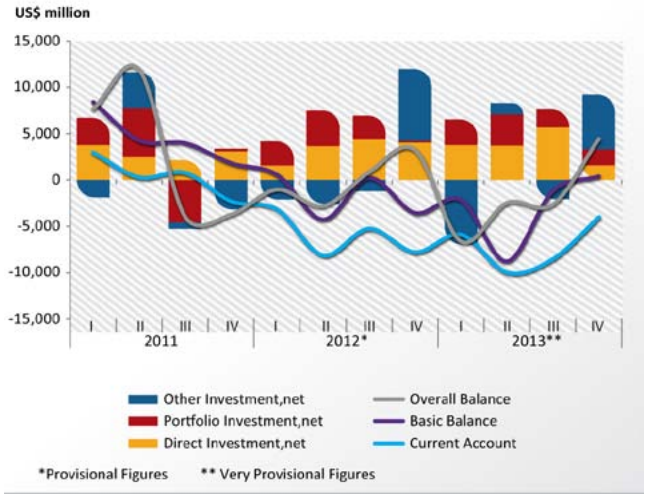


Chart 4.15. **Basic Balance**

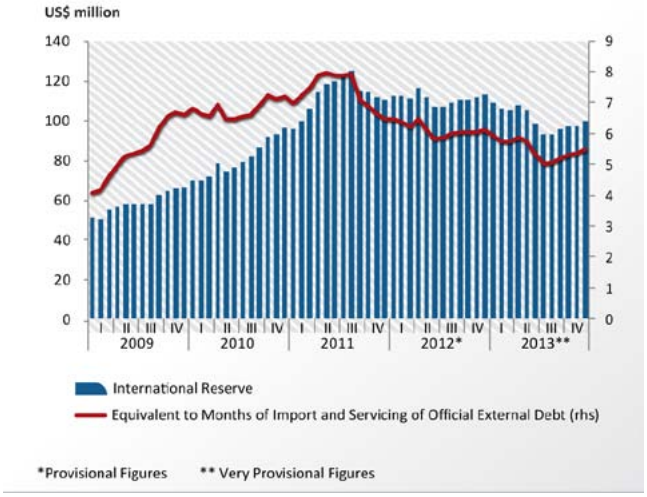


Chart 4.16. **Official Reserve Assets**

The slowing growth in Indonesia's external debt is reflected in both public sector and private sector external debt. In December 2013, Indonesia's external debt position stood at US$264.1 billion (30.2% of GDP), consists of US$123.5 billion of public external debt and US$140.5 billion of private external debt (Chart 4.18). Public external debt underwent 2.0% (yoy) contraction in 2013, reaching a lower position compared to 2012. Meanwhile, private external debt experienced a slower growth having reached only 11.3% (yoy) in 2013, down from 18.3% (yoy) in 2012 (see Box 4.2. Private External Debt).

In analysis by maturity profile, Indonesia's external debt structure remained in a sound condition, as it was dominated by long-term external borrowing. In December 2013, long-term external debt retained a

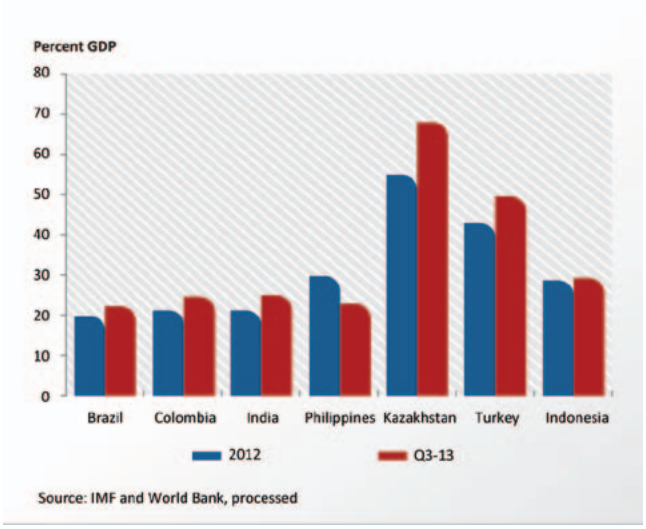


Chart 4.17. **Debt to GDP Ratio of Peer Group**

3 The basic balance of the balance of payments is an indicator of ability to finance the current account from long-term funding sources. The equation used is: basic balance = current account + net direct investment + net other long-term investment.

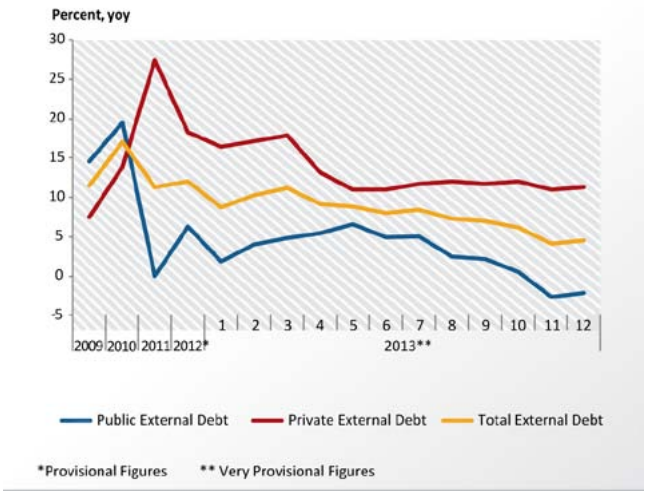


Chart 4.18. **External Debt Growth by Group of Borrower**

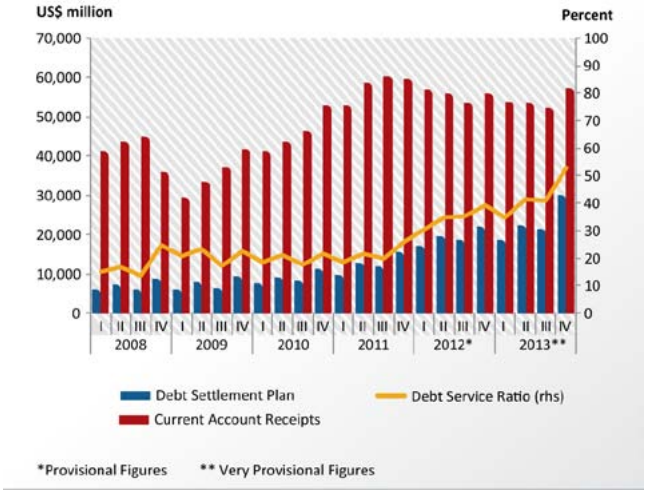


Chart 4.20. **Debt Service Ratio**

dominant position at 82.1% of total external borrowing. This dominance was reflected in both public and private external debt. Long-term external debt in the public sector accounted for 94.6% of total public external debt, while long-term external debt in the private sector represented 71.1% of private external debt (Chart 4.19). With both long-term and short-term external debt experienced a slower growth in 2013 compare to in the previous year, the downward trend of short-term external debt growth was even steeper in comparison to the trend of long-term growth.

One key indicator with regard to sustainability of external debt is the debt service ratio (DSR). The overall DSR for 2013, calculated from the ratio of principal instalments and interest payments on long-term and short-term external debt to current account receipts, was recorded at 42.7%, up from the previous 35.0% level in 2012. It was consisted of the public sector DSR of 3.1% and the private sector DSR of 39.6%. The rise in the DSR, on one hand, was closely linked to the receipts from the current account, which fell 2.4% in 2013 in keeping with contraction in exports. On the other hand, principal instalments and interest payments on external debt were up 19% in 2013 on 2012, consistent with the total external debt position that maintained positive growth.

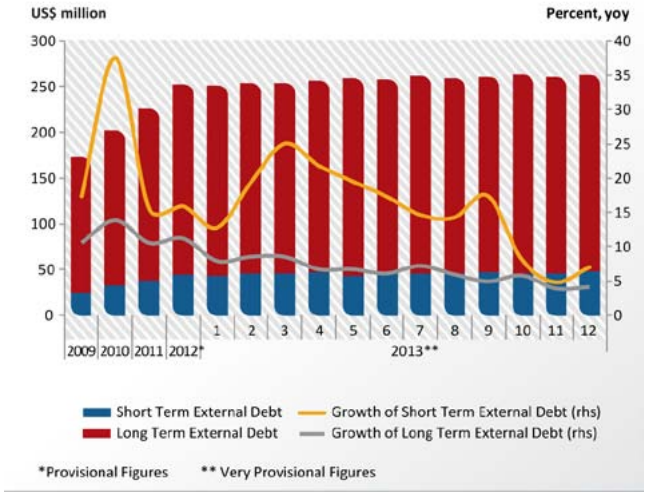


Chart 4.19. **External Debt Position by Original Maturity**

The rise in Indonesia's DSR during 2013 does not directly imply a growing vulnerability in Indonesia's ability to service external debt. The method applied by Bank Indonesia in calculating the DSR is more conservative than that of the World Bank. Unlike the World Bank method, the DSR calculated by Bank Indonesia includes repayment of short-term debt, such as trade credits. This broader scope of calculation is quite conservative, given the fairly low risks of short-term debt related to trading activities and working capital because these debts can be repaid quickly from a company's operating results and do not normally have large outstanding balances. In addition, part of the short-term debt comprises inter-company transactions within the same corporate group, or transactions with long-standing partners, which also carry low risk of default. Without factoring in short-term debt, such as in the World Bank's calculations, Indonesia's DSR in the fourth quarter of 2013 would have come in the 33% range, far below the figure calculated using the Bank Indonesia method at 52.7% (Chart 4.20), and lies within the range of the ratios for peer group countries.

Box 4.1. Oil and Gas Trade Balance

In view by its structure, the oil and gas trade balance shows a steadily widening deficit trend. This condition is due to declining oil production that contrasts with the steady rise in fuel consumption. The gas surplus is no longer sufficient to offset the growing of oil deficit thereby the oil and gas trade balance has ran a deficit since 2011. In the subsequent years, this deficit progressively widened, contributing significantly to the current account deficit in 2012 and 2013. The mounting oil deficit in 2013 was accompanied by a diminishing surplus in the gas account in line with the policy for reallocating gas as a substitution of petroleum fuel[1].

On the import side, the transportation sector has steadily dominated the consumption of petroleum fuels. Fuel consumption in the transportation sector was up 3% over the preceding year in keeping with the 6% growth of the motor vehicle industry in Indonesia. With this development, the share of transportation sector reached to 72% of total fuel consumption in 2013. Regarding other sectors, not only was their share quite small, but the growth of their consumption was below that of the transportation sector. In fact, some sectors reported negative growth (Chart 1).

In breakdown by type of fuel, the most dominant imports of oil products was premium-grade gasoline. For the past five years, premium has consistently ranked as the largest imported oil product (Chart 2). Imports of premium accounted for 70% of total oil imports in 2013, followed by automotive diesel and HOMC (high octane mogas components).

On the export side, oil export volume increased about 4.7% in 2013 compared to the preceding year. However, with a downward trend of oil and energy prices in the international market, oil export prices were 6.1% lower than one year before. With that, higher export volume was set off by lower export prices and thereby the performance of oil exports reached US$17.89 billion in 2013, about the same as the value of oil exports one year earlier.

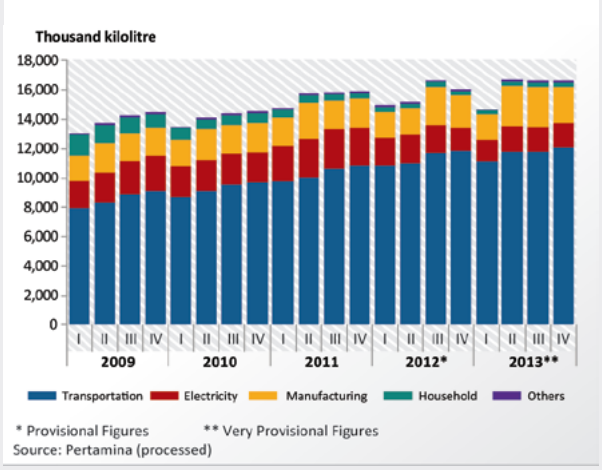


Chart 1. **Fuel Consumption by Sector**

In other developments, the gas account performance in 2013 was lower than the previous year. The gas account recorded a diminished surplus due to falling volume of exports and lower prices, consistent with the downward trend in world commodity prices (Chart 3). In 2013, volume of gas exports (liquefied natural gas/LNG and natural gas/NG) was recorded at 1.2 billion Million Metric British Thermal Units (MMBTU), representing 6.5% decline from 1.3 billion MMBTU one year before. The extra allocation of gas for domestic consumption has had a visible impact through the reduction in volume of gas for exports (Chart 4).

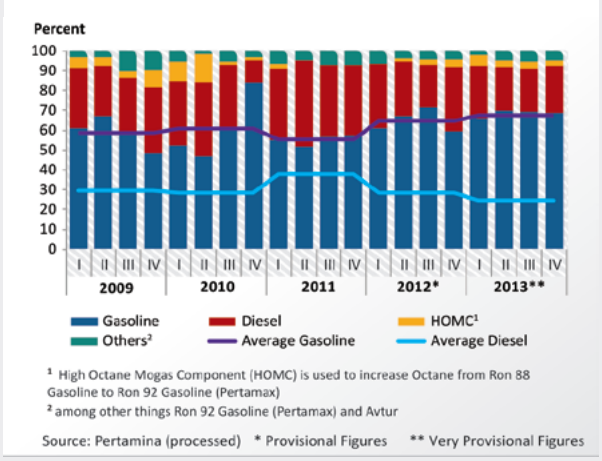


Chart 2. **Oil Product Import Share**

1 By reallocating gas as a substitute for petroleum-based fuels, even higher growth in oil imports can be averted.

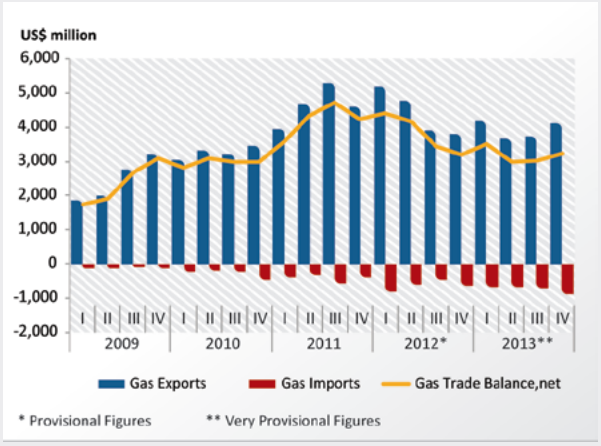


Chart 3. **Gas Trade Balance**

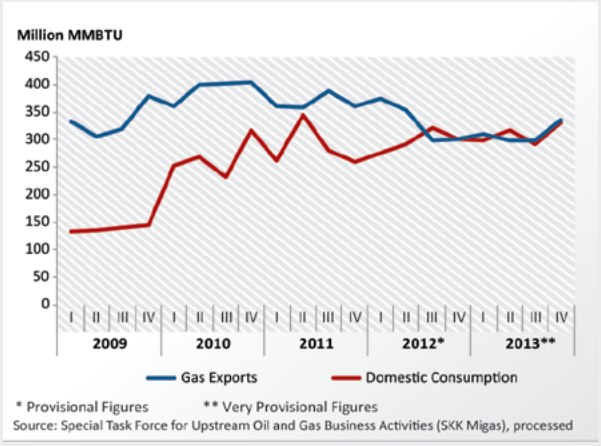


Chart 4. **Gas Exports and Domestic Consumption**

On the other hand, imports of gas (liquefied petroleum gas/LPG) were up in 2013. During 2013, the value of gas imports reached US$2.9 billion, an increase of 18% over the 2012 imports of US$2.5 billion. This rise in gas imports has been driven more by volume rather than price. Volume of gas imports mounted 29% in line with the increase in gas consumption that cannot yet be supplied from domestic production.

Box 4.2. Private External Debt

During 2013, Indonesia's private external debt was marked by more moderate growth. Despite the increasing level of private external debt in 2013 compared to 2012, the growth of private external debt showed a slowing trend. In 2013, it expanded by 11.3% (yoy), below the growth in 2012 that reached 18.3% (yoy).

Of the total private external debt recorded in 2013 at US$140.5 billion, the share of non-bank external debt reached 82.8%, while bank external debt represented only 17.2%. In the non-bank private sector category, external borrowing by non-financial corporation companies and non-SOEs (State Owned Enterprise) comprised a dominant share at 62.5% of total private external debt. In analysis by sector, the highest level of external debt were recorded in the financial, manufacturing and mining sectors. However, in analysis by debt instrument, 66.8% of this debt came under loan agreements, while 18.2% was extended in debt securities and 5.2% comprised trade financing facilities (Chart 1). In breakdown by creditor, 34% of private external debt[1] was obtained from affiliated creditors comprising parents companies and subsidiaries, while the remainder was sourced from non-affiliated creditors.

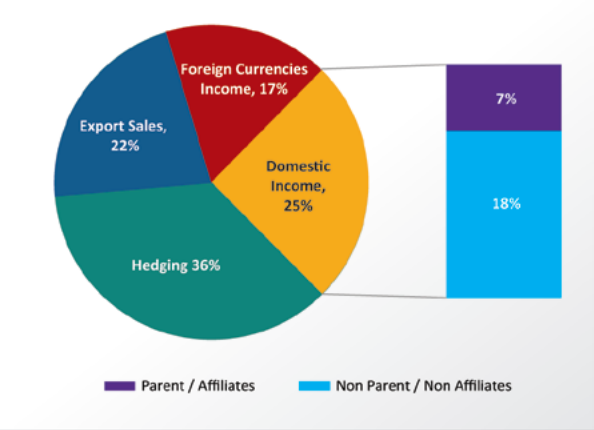


Chart 1. **Risks Profile of Private External Debt**

The risk of currency mismatch in private external debt was relatively low as a result of formal hedging or natural hedging. A survey of the largest private external debtors in the second half of 2013 suggested that fewer companies were not taking out hedging. Among the approximately 64% of companies that did not avail hedging in 2013, only 25% earned revenues in rupiahs. The remainder, on the other hand, earned revenues in foreign currency, whether from export proceeds or from other foreign currency placements. Among the companies earning revenues in rupiahs,

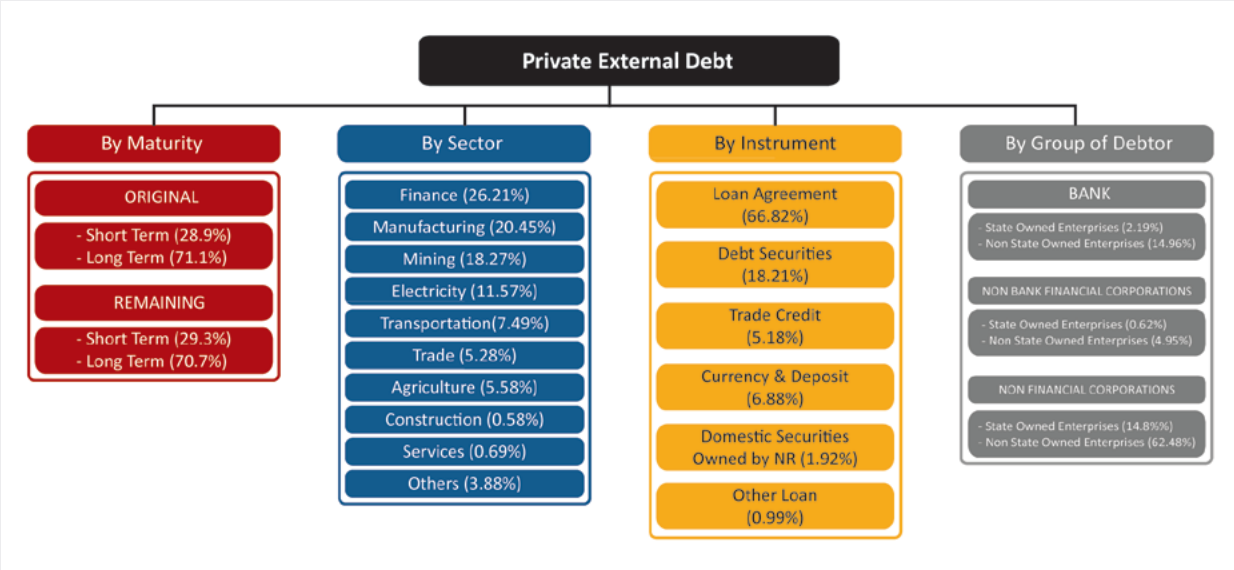


Diagram 1. **Profile of Private External Debt in 2013**

1 Excluding domestic debt securities, non-resident foreign currency deposits and other liabilities to non-residents

about 18% obtained borrowings from non-affiliated creditors, and therefore these companies were seen as most susceptible to exchange rate risk. For the most part, this condition indicates that most companies holding external debts have engaged in natural hedging, and were therefore relatively sheltered against the risk of currency mismatch (Chart 1).

CHAPTER

5

Exchange Rate

The Rupiah exchange rate weakened in 2013 as Indonesian Balance of Payments performance worsened. Increased depreciation pressure was particularly evident since May 2013 triggered by external factors, such as plans to reduce the monetary stimulus in the US, as well as domestic factors, through rising inflation expectations and investors' negative perception of the current account deficit. Pressure on the weakening Rupiah began to subside in the fourth quarter of 2013 as a result of a set of policy mix taken by Bank Indonesia, including exchange rate policy, which was geared towards reducing inflationary pressure and the current account deficit. The Government's policy response aimed at reducing the current account deficit also eased the pressure on the Rupiah.

The Rupiah exchange rate exhibited a weakening trend throughout 2013. This pressure on the Rupiah exchange rate was also due to the impact of the global economic slowdown and falling international commodity prices, which eventually widened Indonesia's current account deficit. The pressure on the Rupiah exchange rate heightened since the end of May 2013, which was characterized by foreign capital outflows from the domestic financial market. This increase in foreign capital outflows was triggered by global uncertainty prompted by plans to reduce monetary stimulus in the US (tapering off), the mounting inflation figure and inflation expectations in the aftermath of the fuel price hike in June 2013, as well as investors' negative perception towards the prospects for the current account deficit. The domestic foreign exchange market's thin structure also contributed to the sizeable Rupiah's depreciation since in such a situation the small amount increased demand for foreign currencies can potentially lead to significantly weaken the Rupiah.

Bank Indonesia and the Government applied a number of policies aimed at reducing the current account deficit and inflation expectations thereby alleviating the pressure on a depreciating Rupiah. These policies have, by the fourth quarter of 2013, begun to revealthe positive results. The current account deficit shrank in the fourth quarter of 2013 while capital account surplus rose. In line with these fundamental improvements, the rate of depreciation was reduced from 14.3% in the third quarter of 2013 to 4.9% in the fourth quarter of 2013 (Figure 5.1). This positive development was also coupled by the declining volatility of the Rupiah from 17.6% to 15.3%[1]. In addition to this, the policy responses also improved the micro structure in the foreign exchange market as reflected in the growth of daily transactions volume and the narrowing spread between the customer's transaction rate and the interbank transaction rate[2].

Through these developments, by the end of 2013, the Rupiah closed at a rate of Rp12,170 per US dollar, or down 20.8% compared to the same period in 2012 of Rp9,638 per US dollar. The Rupiah, on average, also depreciated by 10.4% from Rp9,358 per US dollar in 2012 to Rp10,445 per US dollar. The weakening Rupiah was followed by increased volatility of the Rupiah, which on a daily average was recorded at 0.6%, or 0.3% higher than in the previous year (Chart 5.1). Overall, the depreciation of the Rupiah's real exchange rate in 2013 helped improve export competitiveness as well as overall performance of the external sector.

5.1. Exchange Rate Dynamics

The Rupiah exchange rate's weakening trend throughout 2013 began in the beginning of the year, albeit the intensity was limited. In the first quarter of 2013, the Rupiah closed at a level of Rp9,718 per US dollar, or 0.82% lower compared to its closing at the end of the fourth quarter of 2012. On average, the Rupiah in the first quarter of 2013 also fell 0.70% to Rp9,680 per US dollar compared to Rp9,613 per US dollar in the fourth quarter of 2012.

The intensity of the Rupiah's weakening was still fairly limited in the first quarter of 2013 as the negative pressure on the external sector was still modest. Current account deficit that amounted to 2.7% of GDP in the first quarter of 2013 was offset by sizeable non-resident financial market inflows (Diagram 5.1). This foreign capital inflows was driven by attractive returns on investments in Rupiah assets compared to other countries within the region. Despite this, a number of disruptions to foreign capital inflows occurred within this quarter due to rising global uncertainty and domestic inflation expectations. Some of these global uncertainties, among others, pertain to the possibility of fiscal tightening and concern over US debt ceiling resolution, as well as uncertainty towards the prospects for an economic recovery in Europe.

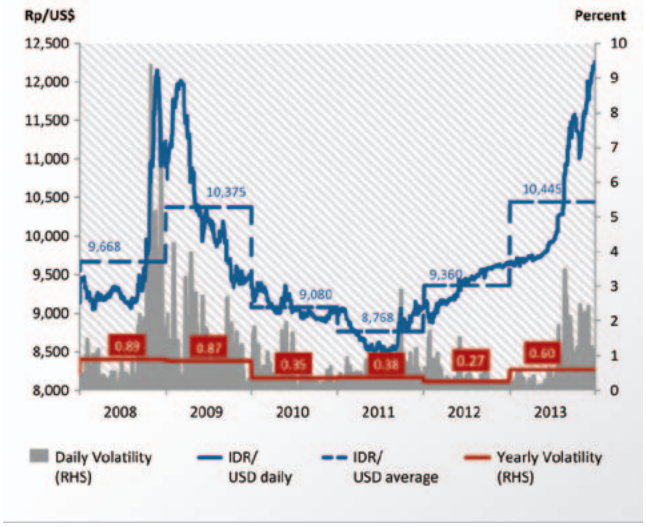
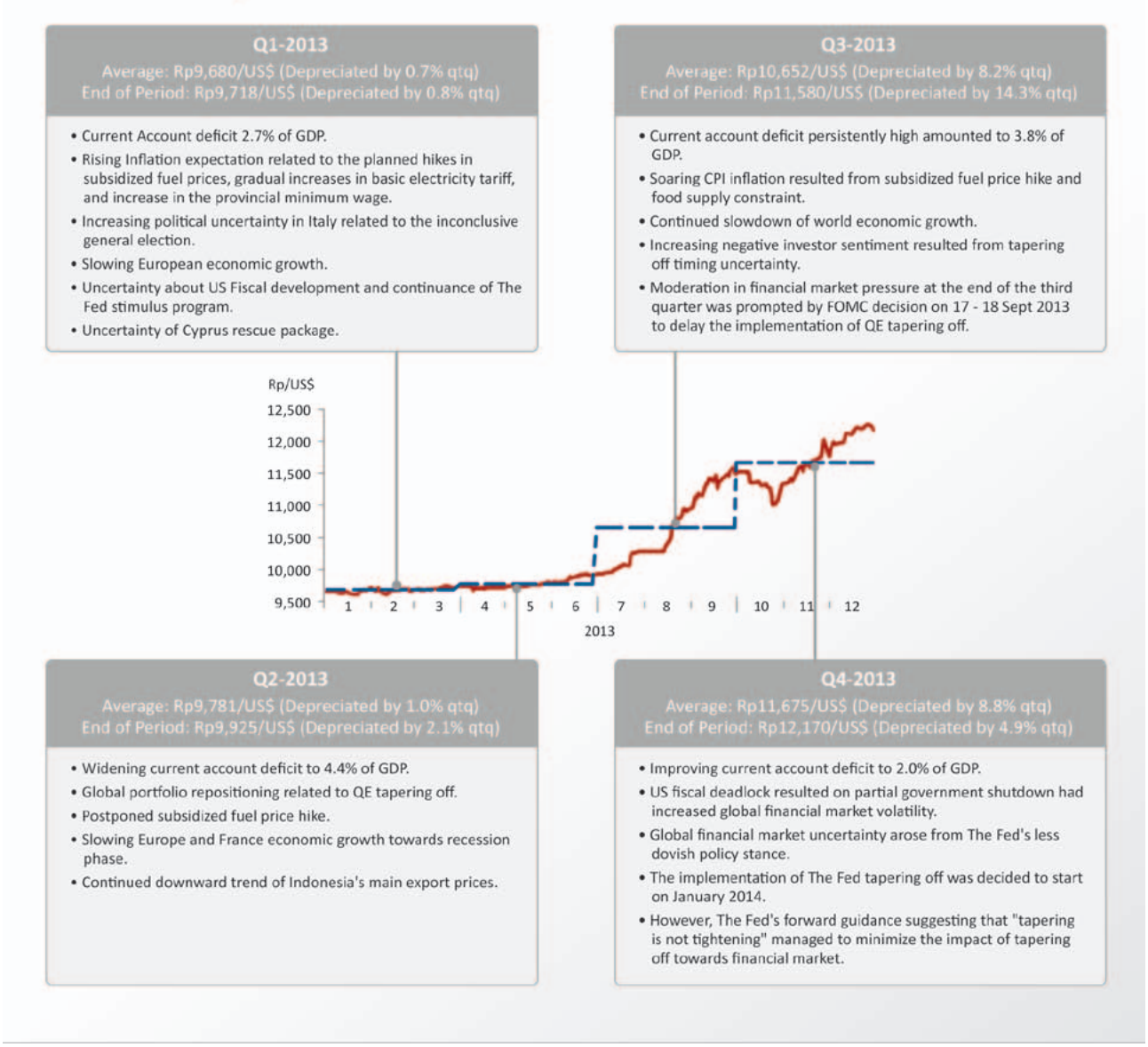


Chart 5.1. **Rupiah Volatility**

1 Volatility is calculated by using the daily average for the related year calculated from the daily rate deviation against the average 10 day movement. If calculated using annualized factor therefore exchange rate volatility increase from 4.3% (2012) to 9.7% in 2013.

2 Details of the Exchange Rate Policy is discussed in Chapter 10

Diagram 5.1. **Factors Affecting Rupiah Exchange Rate in 2013**



Pressure on the Rupiah's depreciation continued to grow in the middle of the second quarter of 2013. This was driven by rising global uncertainty induced by plans to reduce the monetary stimulus by the Fed (tapering off) amidst indications of the continuing decline in economic activity and global commodity prices. This increased global uncertainty was reflected in the VIX (S&P 500's volatility index) which rose sharply since May 2013 (Chart 5.2). Global uncertainty eventually led to higher foreign capital outflows from the financial markets of the developing countries, including Indonesia. In addition to global factors, capital outflows from Indonesia was also caused by rising inflation expectations in anticipation of the increase in subsidized fuel prices. Overall, the foreign capital flows in Indonesia's financial markets within the second quarter of 2013 registered a net deficit of US$ 2.6 billion (Chart 5.3). This capital outflow subsequently put additional pressure of the exchange rate depreciation.

Pressure for the depreciation of the Rupiah's exchange rate increased as the current account deficit simultaneously widened to 4.4% of GDP in the second quarter of 2013. This condition fundamentally raised demand for foreign currency. As a result, the Rupiah weakened 2.1% at the end of the second quarter of 2013 compared to the end of March 2013, higher than the weakening felt in the first quarter of 2013 of 0.8%. The biggest weakening took place from Rp9,766 per US dollar at May 22, 2013 to Rp9,925 per US dollar at the end of June 2013, or down 1.6%.

Chart 5.2. **S&P 500 Risk Index Volatility (VIX)**

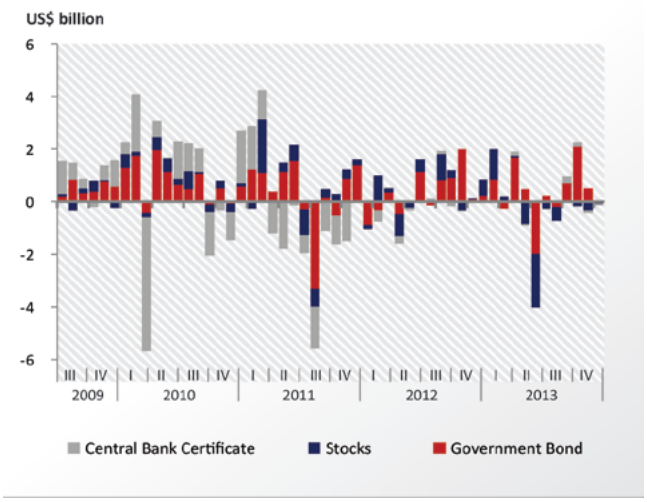


Chart 5.3. **Foreign Capital Flows in Financial Market**

The pressure towards a weakening Rupiah became more intense in the third quarter of 2013. At the end of the third quarter of 2013, the Rupiah was recorded at Rp11,580 per US dollar or 14.3% lower compared to its level at the end of June 2013. On average, the Rupiah weakened 8.2%, which was higher than the weakening experienced in the second quarter of 2013. The Rupiah's weakening was also coupled by increased volatility of the Rupiah to 17.7% compared to 3.1% in the second quarter of 2013.

The increase in the Rupiah's rate of depreciation was also due to the immense negative pressure on the balance of payments, both for current account as well as capital and financial account. Despite receding compared to the previous quarter, the current account deficit continues to be sizeable in the third quarter of 2013, amounting to 3.9% of GDP. In the same period, capital and financial account surplus plummeted as a result of substantial capital outflows from domestic financial market, particularly in July - August 2013 (Chart 5.3). This capital outflows was triggered by deteriorating investor perceptions regarding prospects for the current account deficit following the publication of the current account deficit for the second quarter of 2013 at the beginning of August 2013, which registered an increase to 4.4% of GDP, as well as rising inflation expectations resulting from fuel and food price increases. Investor's negative perception was reflected by various risk indicators such as rising Credit Default Swaps (CDS) and widening yield differences between the Indonesian government bond and UST Notes (U.S. Treasury Note) (Chart 5.4). Moreover, the capital outflows from domestic financial market was also influenced by heightened expectations for the tapering off by the Fed.

Bank Indonesia strengthened its policy mix, including exchange rate policies, in response to the external sector's declining performance and restored the stability of the exchange rate. The government also applied various policies aimed at reducing the current account deficit, which could further contribute towards stabilizing the Rupiah. The exchange rate policy adopted by Bank Indonesia sought to maintain the stability of the exchange rate's movement in line with its fundamental value. Maintaining Rupiah's stability was important given that the exchange rate's increasing volatility can lead to

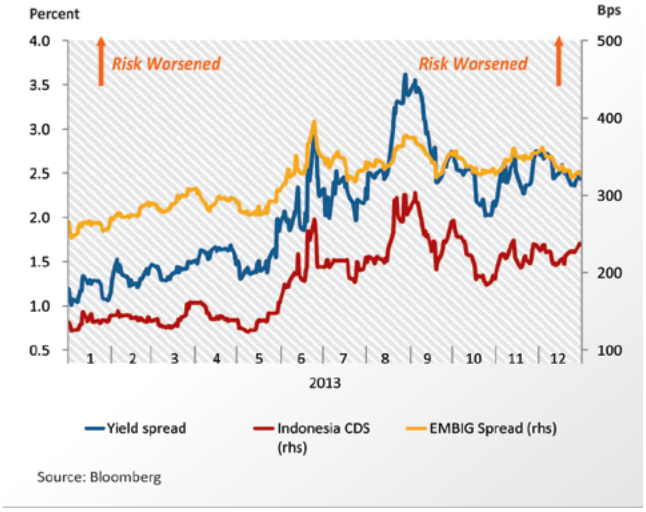


Chart 5.4. **Risk Indicators**

what so called “depreciation-inflation vicious circle”. The exchange rate was also directed to move aligned with its fundamental value, thereby reducing the current account deficit to a more sound level. In this regard, the exchange rate is allowed to be more flexible thereby spurring adjustment to reduce the current account deficit.

Within the framework of the Rupiah exchange rate policy, Bank Indonesia pursued a dual intervention strategy, which comprised simultaneously intervening in the foreign exchange and government securities (SBN) markets. The intervention policy in the foreign exchange market was measurably applied so as to minimize the Rupiah’s volatility in the midst of the shallowness foreign exchange market conditions. At the same time, intervention in the government securities market was aimed at ensuring that the Rupiah’s liquidity remains adequate as it was previously reduced as a result of the intervention in the foreign exchange market. Therefore, by intervening in the government securities market, the financial system’s stability is expected to be maintained so as not to put additional pressure on the economy.

In addition to this exchange rate policy, Bank Indonesia also strengthened the management of capital flows so as to maintain the external sector’s resilience. Bank Indonesia coordinates with the Government to manage the foreign exchange demand of state-owned companies. Bank Indonesia also issued a regulation regarding hedging transactions for banks. In this regulation, gains derived from hedging transactions that meet the accounting criteria for hedging is considered as hedge income. Conversely, if a loss occurs this should then be considered as an expense or premium derived from hedge transactions. Foreign exchange management is also carried out by regulating foreign debts of banks by relaxing provisions on short-term foreign debts of banks by increasing the types of exceptions. Meanwhile, expanding the coverage of hedging swaps, increasing the variations for foreign exchange term deposit (TD) tenors, and the use of JISDOR applied by Bank Indonesia as part of its effort to deepen the market thereby supporting efficiency in pricing within the foreign exchange markets and stability of Rupiah exchange rate. Within the context of this foreign exchange management, policy was aimed at strengthening monetary operations by reducing the Minimum Holding Period (MHP) for SBI from 6 months to 1 month.

The policy mix adopted by Bank Indonesia backed by the government policies managed to dampen pressure on the Rupiah in the fourth quarter of 2013. Depreciation of the Rupiah in the final quarter of 2013 was registered at 4.9%, lower than the depreciation in the third quarter of 2013 amounting to 14.3%. This positive development was also accompanied by the declining volatility of the Rupiah to 15.3% compared to 17.7% in the third quarter of 2013. Reduced pressure on the Rupiah is also reflected in improvements on the domestic foreign exchange market’s micro structure. This improvement was in the form of narrowing differences between the transaction rate and the quoted exchange rate to a level below 100 points, from its highest point close to 900 points at the end of August 2013 (Chart 5.5). This development simultaneously shows that the price setting process in the market is improving. In line with these improvements, the differences between the bid-ask at the spot market was also relatively narrowing, although this increased slightly once again in December 2013 as a result of heightened speculation concerning an accelerated tapering off following the Fed’s decision at the FOMC in December 2013 (Chart 5.6).

Rupiah depreciation pressures eased in the fourth quarter of 2013 due to improved economic fundamentals in line with the policy response taken by Bank Indonesia and the government. The current account deficit in the fourth quarter of 2013 declined sharply to 2.0% of GDP due to the slowdown in domestic demand, which in turn decreased imports and improvement in external demand, which in turn increased exports thereby contributing to the decline in foreign exchange demand. At the same quarter, capital and financial account surplus picked up as a result of increased capital inflows for domestic financial instruments, such as Government Securities, in October

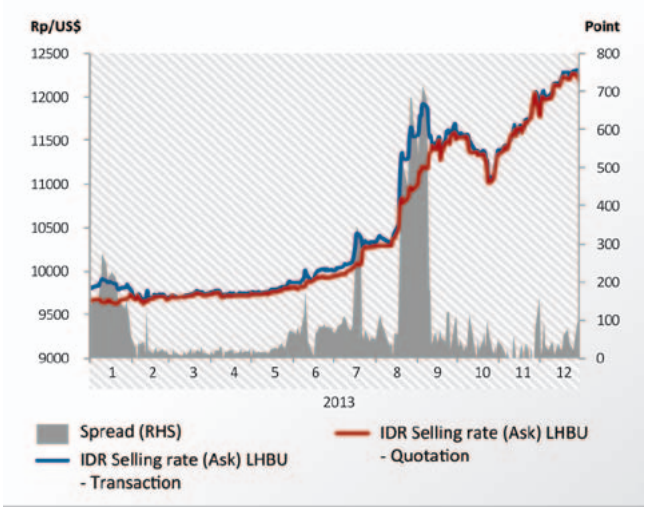


Chart 5.5. **IDR Transaction - Quotation Rate Spread**

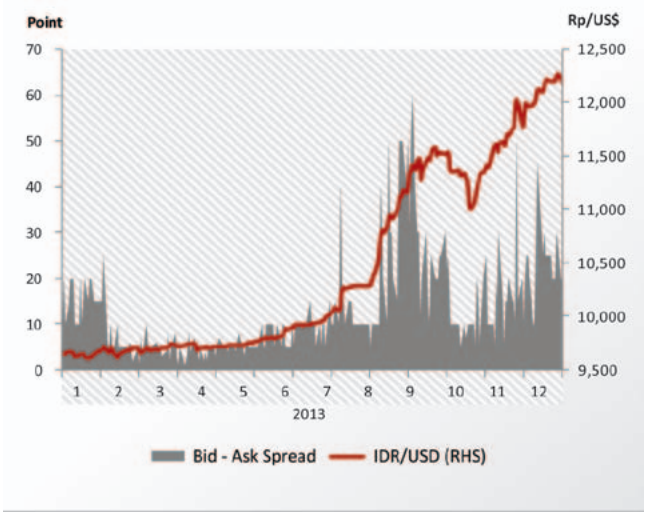


Chart 5.6. **IDR Bid - Ask Spread**

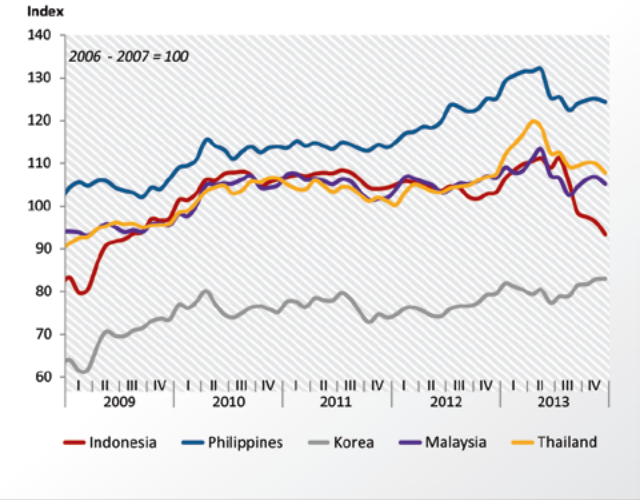


Chart 5.8. **Real Effective Exchange Rate**

2013. Increased capital inflows was driven by improved investor perceptions in line with declining current account deficit and reduced inflationary pressure. Improved foreign investor perceptions was reflected by, among others, the decline of the CDS to the 185 level in October 2013 and the fall in swap premium for all tenures (Chart 5.7). Increased capital inflows were also influenced by improved global conditions such as postponement of the Fed's tapering off policy and improved indicators for the global economy in the fourth quarter of 2013.

In the midst of these developments, the Rupiah closed at Rp12,170 per U.S. dollar in 2013, or down 20.8% compared to its closing level in 2012 of Rp9,638 per US dollar. On average, the Rupiah depreciated 10.4% to Rp10,445 per US dollar from Rp9,358 per US dollar in 2012. The weakening Rupiah led to increased volatility for the Rupiah, which on a daily average was registered at 0.6%, compared to 0.3% in the previous year. In line with the nominal weakening of the Rupiah, the Rupiah's real exchange rate in 2013 was also significantly weaker thereby strengthening export competitiveness and improved the external sector's overall performance. The Rupiah's Real Effective Exchange Rate, or REER, for base year of 2006, in late 2013 was registered at 93.41, or around 16 % weaker compared to May 2013 of 111.21 (Chart 5.8).

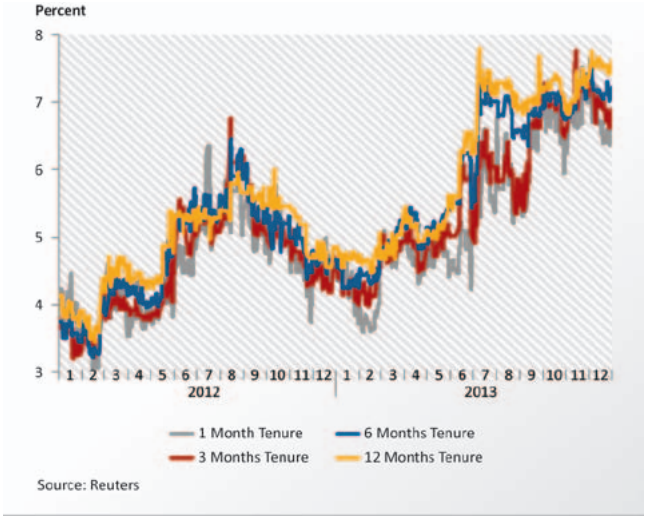


Chart 5.7. **Swap Premium**

5.2. Domestic Foreign Exchange Market Structure

In line with worsening balance of payments in 2013, the foreign exchange market registered a deficit due to the robust demand. The domestic foreign exchange market experienced rising demand in 2013 thereby registering a net deficit amounting to USD34.9 billion. Foreign exchange demand mainly derived from domestic players amounting to USD33.96 billion, which is in line with the high demand for foreign currency for imports and foreign debt repayments. Meanwhile, non-resident players booked a much smaller net foreign exchange demand amounting to USD949 million, which is in contrast to the previous year wherein it was a supplier of foreign currency. This condition shows that the supply of foreign currency remains inadequate to meet the growing demand. Since the implementation of obligation

to execute the export proceeds (DHE) through the domestic banking sector in early 2012, the DHE portion in domestic banks against export transactions continues to increase whereby in 2013 was at around 84%, or up from 80% in 2011. However, the rising the DHE portion within the domestic banks does not necessarily increase the domestic supply of foreign currency as not all of this DHE was converted into Rupiah.

Downward pressure on the Rupiah also reduced the volume of foreign exchange transactions, especially since May 2013. After experiencing upsurge, the average daily volume for foreign exchange transactions in the third quarter of 2013 was registered at a level around USD1.9 billion per day, which is sharply lower than in the previous quarter of USD2.6 billion per day (Chart 5.9). The development of the daily trading volume also generally reflects Indonesia's foreign exchange market structure which has yet to be sufficiently profound. Shallow foreign exchange market conditions led the Rupiah's exchange rate to be more exposed to volatility in the event of a slight increase in demand for foreign currency, similar to that in 2013. Historical data shows that the domestic foreign exchange market has yet to reach the scale of the foreign exchange market in the region. The volume of interbank foreign exchange transactions in the domestic market in 2012 was approximately USD500 million, which is much lower compared to other ASEAN countries such as Malaysia, the Philippines, and Thailand (Chart 5.10). The volume of transactions, which continues to be limited, is still dominated by spot market transactions (Figure 5.11).

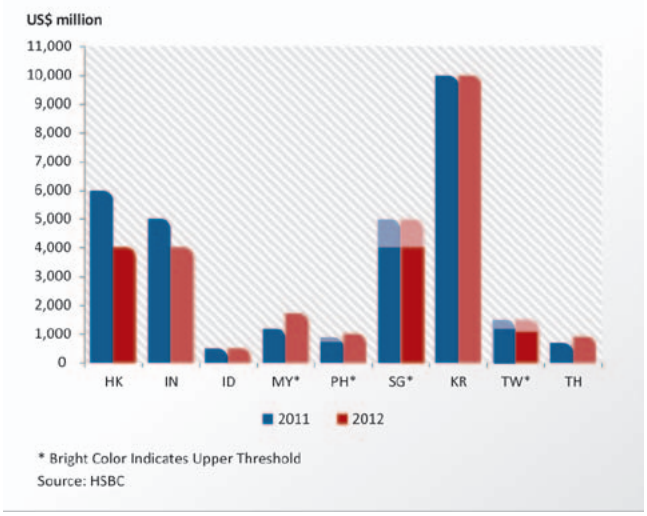


Chart 5.10. **Daily Average Interbank Spot Volume**

Throughout these developments, the foreign exchange market structure tended to improve in the fourth quarter of 2013. Various policy responses applied, particularly in regards to the use of JISDOR as well as foreign exchange term deposits and foreign exchange swap auctions, managed to improve foreign exchange market performance as reflected in the increase in the foreign exchange market's volume. Meanwhile, foreign exchange transactions that use forward transactions were also on the rise. The difference between the transaction rate and quotations were also narrowing to a level below 100 points and was followed by shrinking bid-ask differences in the spot market.

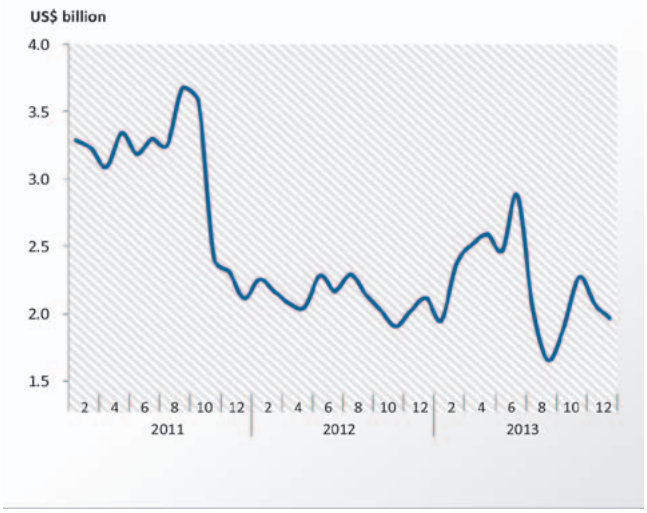


Chart 5.9. **Daily Foreign Exchange Transaction Volume**

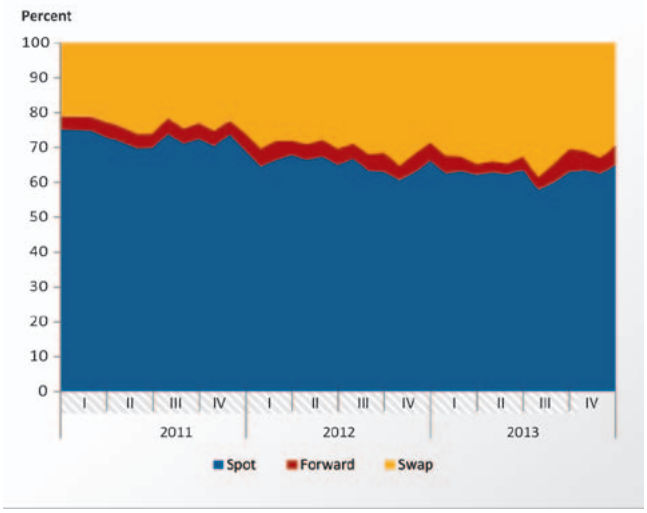


Chart 5.11. **Share of Foreign Exchange Transaction**

CHAPTER

6

Inflation

Inflationary pressures in 2013 increased substantially, driven mainly by the rising food and subsidized fuel prices as well as a number of structural problems that still persist. Bank Indonesia strengthened its policy mix and bolstered coordination with government to bring inflation quickly back on course with the targeted range of 4.5±1% in 2014 and 4.0±1% in 2015. The various policy mix responses proved effective in returning inflation to normal levels in September 2013 and managed to curb inflation within the single digit range, unlike 2005 and 2008 when hikes in subsidized fuel prices resulted in double-digit inflation.

Significant increase of inflationary pressures in 2013 was attributed to rising prices of food and subsidized fuel (Chart 6.1). In the first quarter of 2013, inflationary pressures were largely driven by the rising food prices brought about by policy restrictions on imports of horticultural products and climatic anomalies. Inflationary pressures intensified since June 2013 when the government raised subsidized fuel prices as part of its effort to maintain fiscal resilience. The subsidized fuel price hikes also led to second round effects on prices for other commodities such as transport fares. At the same time, volatile food inflation during the months of June-August 2013 also increased due to the lingering impact of the subsidized fuel price hike and disruptions to domestic production as a result of the delayed harvest. The price increases of these two groups subsequently continued to impact core inflation, which then pushed overall inflation upwards to 8.8% in August 2013 (yoy).

These developments in 2013 inflation also raised a number of structural issues that eventually contributed to increased inflationary pressures. Volatile food inflationary pressure was also caused by a relatively fragile of food security, thereby causing domestic food prices vulnerable to the shocks of global prices and supply of imports. In addition to this, distribution problems resulting from inadequate infrastructure also added to the price pressure, particularly in areas that are less accessible. Price pressures that resulted from the impact of rising fuel prices also raised issues concerning domestic energy security and its management system. This is associated with domestic production that continued to decline, amidst growing energy demand driven by relatively low prices due to the significant amount of fuel subsidies. The impact of food and energy security on inflation became increasingly evident as other issues pertaining to the market structure for a number of items that tends to be oligopolistic both in terms of production and distribution. This in turn widened the disparity between prices set at the producer and the consumer, such as what occurred among the producers of onions and red chillies. In addition to this, businesses still put more weights on backward looking expectations than forward looking expectations that also pose as a challenge to control inflation in Indonesia.

Bank Indonesia and the government took a number of policies to curb rising inflation. Immediate and anticipatory policy response were taken to ensure that rising food and subsidized fuel price hikes do not lead to excessive rising inflation expectations and risk further permanent inflationary impact on other goods. In this regard, Bank Indonesia strengthened the range of policies to ensure that inflation immediately return to the target trajectory range of 4.5±1% in 2014 and 4.0±1% in 2015. Policies adopted

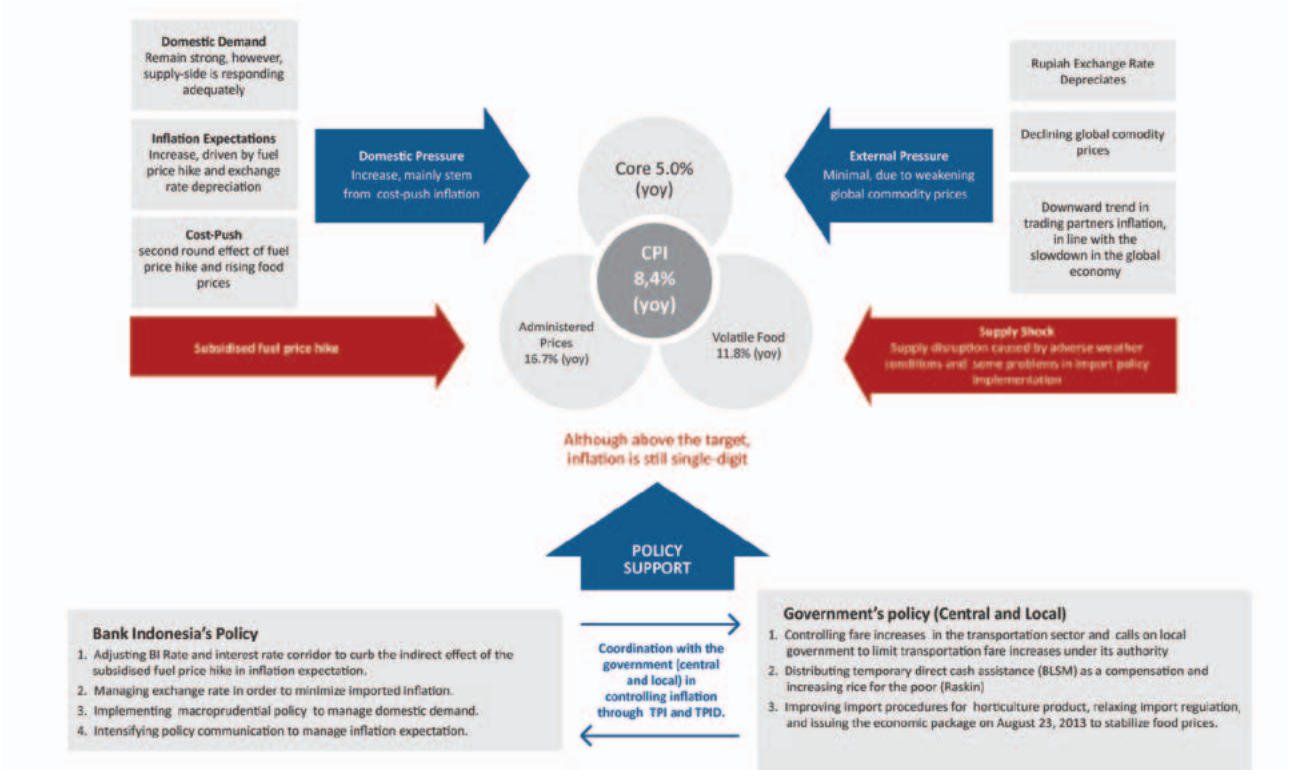


Diagram 6.1. **Inflation in 2013 and Affecting Factors**

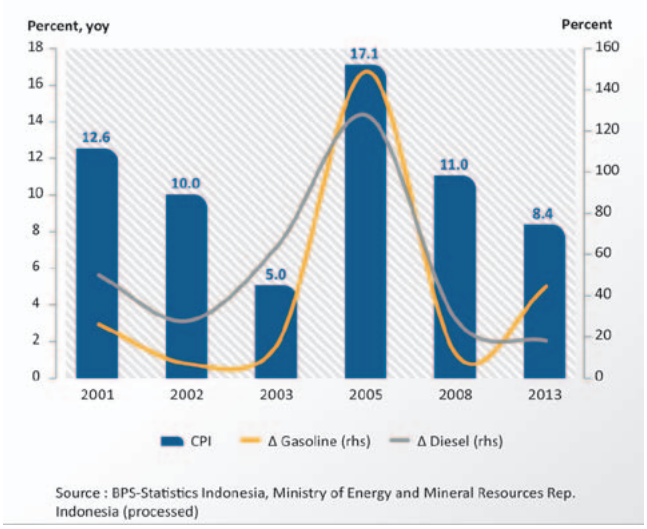


Chart 6.1. **Inflation in Periods of Fuel Price Hikes**

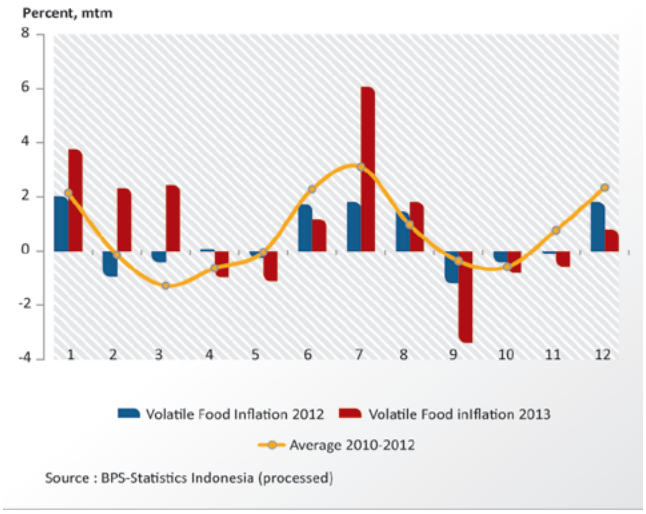


Chart 6.2. **Historical path of Volatile Food**

by Bank Indonesia also sought to balance the economy so as to reduce the current account deficit towards a more sound level and support sustainable economic growth. Bank Indonesia's policy response was also strengthened by policy coordination with the Government to control inflation both at the national as well as regional levels.

Policies adopted by Bank Indonesia and the government had a positive effect on inflation that started to drop back to its historical pattern in September 2013. This condition was influenced by food price pressures, which eased and even registered a deflation. The subsequent impact of the fuel price increase also began to subside as inflation expectations eased. In addition to this, the effects of the Rupiah's depreciation to inflation (exchange rate pass-through) were also minimal wherein pressure on core inflation remained under control. These positive developments pushed monthly inflation back to its normal trend beginning in September 2013, which fell below the historical pattern.

Inflationary pressures that eased at the beginning of September 2013 pushed overall inflation in 2013 under two-digit Chart, lower than those during periods of rising subsidized fuel prices in 2005 and 2008 (Chart 6.1)[1]. Consumer Price Index (CPI) inflation in 2013 was registered at 8.4%, higher than the inflation rate in 2012 of 4.3%, and is above the targeted range of 4.5%±1% (Chart 6.2). Based on its components, the increase in inflation was mainly caused by the high inflation in administered prices and volatile food inflation, which respectively reached 16.7% and 11.8%. Meanwhile, core inflation continued to be under control at 5.0%, despite the slight increase compared to the previous year's core inflation of 4.4%.

6.1. Volatile Food Inflation

Volatile food inflation pressures were high in 2013, reaching 11.8%, mainly occurring in the first quarter of 2013 and the months of June-August 2013 (Chart 6.3). In the first quarter of 2013, volatile food inflation hike was influenced by the increase in the price of spices as well as various vegetables and fruits due to reduced supply brought about by climatic disruptions, minimal domestic production, and policy on horticultural imports[2]. The increase in volatile food inflation in the first quarter of 2013 was also driven by the continued rise in the price of beef due to limited import quota amidst inadequate domestic production. During June-August 2013, the pressure of volatile food price soared for the second time caused by the second round effect of fuel price hike. However, volatile food inflation resumed a waning trend at the end of the year in line with the positive impact brought about by various policy responses taken by Bank Indonesia and the government.

1 Prior to 2013, the CPI inflation during the period of subsidized fuel increase reached double digits, with the exception of 2003. The subdued inflation in 2003 is mainly driven by very deep volatile food deflation.

2 Import provisions are based on the Ministry of Trade Regulation No. No.60/M-Dag/PER/9/2012 and Ministry of Trades Regulation No. 60/OT.140/9/2012

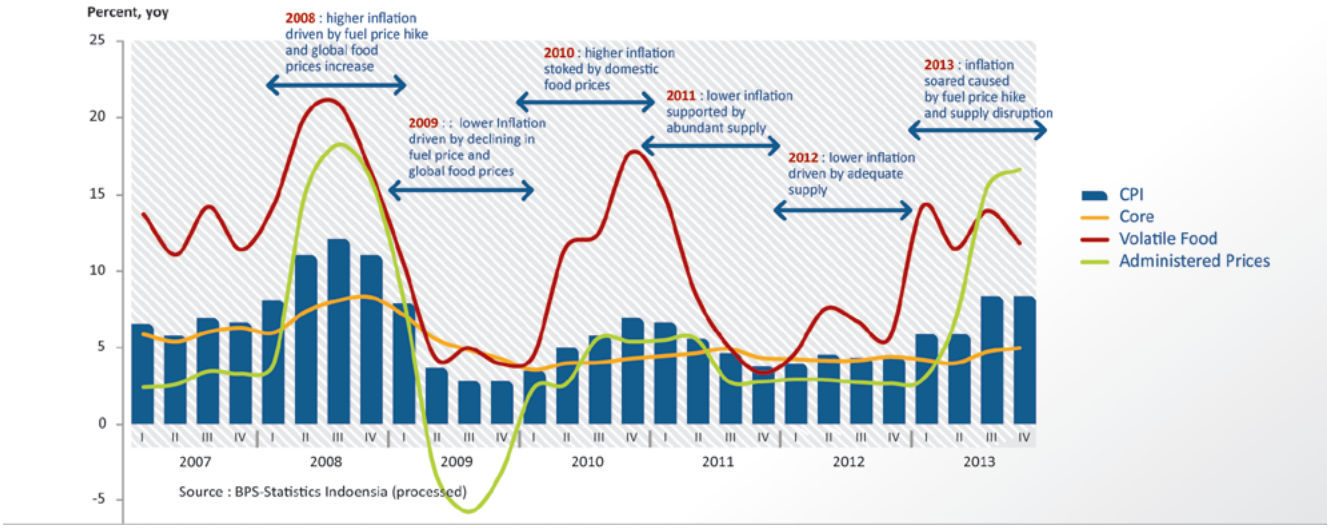


Chart 6.3. **Inflation**

Volatile food inflation in 2013 continued to be generally influenced by numerous structural issues. First of all, it was influenced by the limited domestic supply to meet demand. Domestic supply constraints were later addressed by imports as occurred with commodities such as shallots and garlic (Table 6.1). In this condition, the constraints for the implementation of policies regulating imports such as horticulture and beef will push domestic prices higher. The second factor relates to the lack of infrastructure support that subsequently increases distribution costs such as transportation costs as well as loading and unloading costs, which occurred with red chillies (Chart 6.4)[3]. The third factor relates to the price setting mechanism due to the lack of transparency that, among others, sparked by market structure which tend to be oligopolistic. Bank Indonesia's identification showed that this third factor widened the disparity between the prices set by the producer and consumers, as occurred with commodities such as shallots and red chillies.

To overcome these structural problems, the government's policy on food area was geared toward promoting food sovereignty by increasing domestic production and maintaining adequacy of supply, stability of price, and continuity of distribution. The government continued to strive to increase local food production through an agricultural development target employed since 2009 by achieving self-sufficiency and a continuous self-sufficiency program in 2014.

Based on commodities, inflationary pressures mainly derived from price increases for shallots, red pepper, beef, rice, oranges, and chicken meat (Table 6.2). Prices for shallots and red chillies respectively grew by 90.0% and 113.4%, with each respectively contributing 0.4% and 0.3% to inflation in 2013. The high inflation for these two commodities was caused by horticultural import restriction policies amidst minimal domestic production due to unfavourable climatic conditions in the first half of the year. However, the increase in prices of shallots and red peppers was restrained in fact prices have gone through a correction since September due to previously

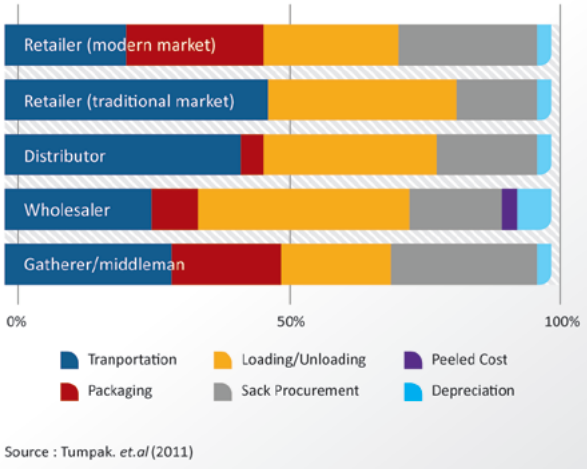


Chart 6.4. **Distribution Cost Structure of Red Chili**

3 Studies of Tumpak et.al (2011) and Ridhwan et.al (2012) shows that the portion of transportation costs and loading and unloading costs in the distribution cost for red chilies is substantial. For the complete analysis see Tumpak et.al. (2011). "Mapping the Market Structure and Distribution Pattern of Strategic Commodities contributor to inflation". Working Paper. Bank Indonesia; Ridhwan, MH., et.al. (2012). "Inter-Regional Trade, Distribution, Transportation, and Food Commodities Strategic Stock Management in Indonesia". Working Paper. Bank Indonesia.

Table 6.1. Imports of Horticulture Products

Percent

Commodity	2000	2005	2009	2010	2011
Shallot	6.9	6.8	6.3	6.3	15.1
Garlic	74.7	93.2	96.4	97.6	96.6
Chili	0.1	0.0	0.1	0.1	0.4
Potato	0.2	0.5	2.2	2.2	7.6
Cabbage	0.0	0.0	0.1	0.1	0.1
Carrot	0.1	1.6	7.7	7.7	7.4
Pineapple	0.0	0.0	0.0	0.0	0.0
Melon		0.3	0.4	0.4	0.3
Banana	0.0	0.0	0.0	0.0	0.0
Papaya		0.0	0.1	0.1	0.0
Mango	0l0	0.1	0.1	0.1	0.0

Source : Ministry of Agriculture, BPS-Statistics Indonesia (processed)

Table 6.2. Main Contributors to Volatile Food Inflation

Commodity	2013	
	%,yoy	Contribution (%, yoy)
Inflation		
Shallot	90.0	0.4
Red Chili	113.4	0.3
Rice	3.4	0.2
Orange	18.2	0.1
Purebred Chicken Meat	7.9	0.1
Beef	11.1	0.1
Deflation		
Garlic	-22.2	-0.1
Carrot	-4.9	-0.0

Source : BPS-Statistics Indonesia

delayed harvest resulting from unfavourable weather conditions. The decline in shallots and red chilli prices was caused by the Government's policy response to relax restrictions on horticultural imports. This is in line with Inflation Controlling Team's (TPI) recommendations in the need to relax regulations and accelerate the realization of imports given the limited domestic supply. The impact of the relaxation of policies on horticultural imports was also evident in commodity prices for garlic that continued to deflate from April to December 2013 (Table 6.2)[4].

Pressure brought about by the increase in beef prices that occurred in 2012 continued on in 2013. Beef prices rose by 11.1%, with contribution to inflation amounting to 0.1%. The increase in beef prices have started to ease in the third quarter of 2013 due to government policies. The government applied, so as to stabilize beef prices, policy measures through the Joint Decree (SKB) between the Ministry of Agriculture and the Ministry of Commerce, which comprises releasing of import quotas for certain types of meat, accelerating the realization of imports, and assigning Logistics Agency (Bulog) to take participation in efforts to stabilize prices[5]. In due course, the Government continued to refine these regulations by, among others, changing the procedures for the import mechanism of beef and horticultural products from one based on quotas to a reference price in August 2013 (see Box 6.1. Food Price Stabilization Policy within the context of Inflation Control).

Amidst these rising commodity prices for food, the price for rice was restrained. Throughout 2013, the increase in the price of rice was registered at 3.4 %, which was below the historical average over the last five years of 11.4%. The increase in the price of rice within the last months of 2013 was lower than in the previous year. This is supported by domestic production that was able to meet domestic demand as reflected, among others, by Bulog's ability to absorb domestic rice well by reaching 3.5 million tons, or almost 99.8% of the 2013 target. Bulog's ability to acquire domestic rice was also accompanied by effective distribution as reflected in the distribution of rice to poor households (Raskin) that achieved nearly 100 % of its 2013 target and market operations that achieved 107 thousand tons.

6.2. Administered Prices Inflation

Administered prices inflation in 2013 surged by 16.7%, largely influenced by the subsidized fuel price increase by Rp2,000/litre for premium gasoline and Rp1,000/litre for diesel on June 22, 2013[6]. This subsidized fuel price hike led to an increase in administered prices inflation in June and July 2013, which contributes to the escalating

4 Improvements on the policy on horticultural imports contained in the Minister of Trade Regulation No. 16/2013 (Revised Minister of Trade Regulation No. 60/2012) and Minister of Trade Regulation No. 47/2013 (Revised Minister of Trade Regulation No.. 60/2012).

5 Strengthening the role of Bulog lies in the distribution of imported beef and soybeans.

6 Analysis of the government's policy to increase subsidized fuel prices and its impact on the Government's Financial Operations can be seen in Chapter 7 Fiscal.

in overall CPI inflation of 1.2% in 2013 (Chart 6.5 and Table 6.3). This Government policy was applied as part of efforts to maintain fiscal resilience amidst economic risks that can widen the budget deficit in 2013.

In general, the indirect impact of the subsidized fuel price increase in 2013 on prices of other goods was quite restrained. This was, among others, evident in the indirect impact (second round effects) it had on transport rates as well as core inflation and volatile food inflation that was moderate. BPS' data shows that domestic transport rates on average increased by 31.5% thereby contributing to higher CPI inflation of 0.8% in 2013 (Table 6.3). Moreover, Bank Indonesia estimates showed that the impact of the subsidized fuel price hike on core inflation and volatile food inflation contributed to inflation increase of 0.6%[7]. With this development, the impact of the subsidized fuel price increase in 2013 to inflation was lower compared to the previous years when fuel prices were increased in March 2005, October 2005, and May 2008.

The second round impact of the rising fuel price on prices of other goods that are limited came about as a result of coordination measures, both on national as well as a regional level, between Bank Indonesia and the Government through the Inflation Control Team. These coordination measures contributed to subtle increases in intercity and provincial transport rates. This was carried out to encourage regional governments to control inner city transport rates as well as improve the surveillance of smuggling and hoarding of fuel[8]. In addition to this, the range of policies adopted by Bank Indonesia was also able to control rising inflation expectations.

In addition to the subsidized fuel price increase, the sources of inflationary pressure also derived from the increase in electricity tariff household fuel increases, and the cigarette excise tax increase. The electricity tariff increase was gradually carried out on a quarterly basis contributing for 0.4% of inflation (Table 6.3)[9]. While the

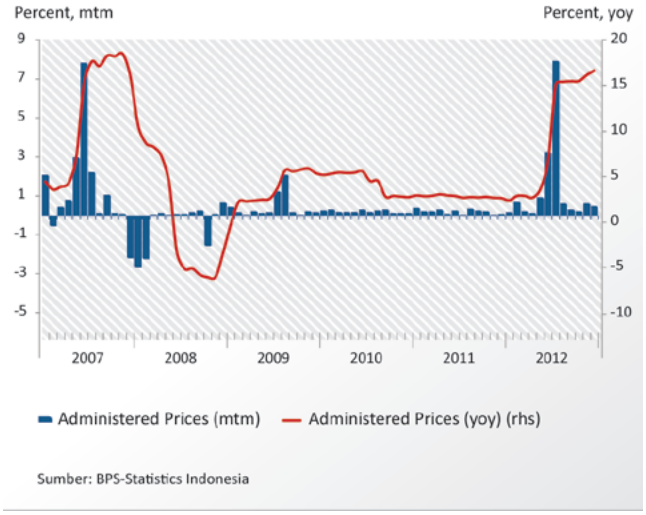


Chart 6.5. **Adminstered Price Inflation**

rising household fuel price was triggered by the scarce supply and distribution cost adjustments, which accounted for 0.2% of inflation. The cigarette excise tax rate increase set by the Government amounted to an average of 8.5% and subsequently pushed up retail prices for cigarettes and contributed 0.2% to inflation[10]. Meanwhile, the policy on other administered prices had minimal impact. These policies include adjustments for toll rates, rail rates, and the water billing rates for a number of regions.

6.3. Core Inflation

Amidst the mounting in volatile food inflation and administered prices inflation, core inflation in 2013 remained manageable. Core inflation for the year was at 5.0%, a slight increase from the previous year of 4.4%. Despite the increase, core inflation in 2013 was lower than those during previous subsidized fuel price hike in 2005 and 2008, which soared well above 8% (Chart 6.6).

The increase in core inflation in 2013 was triggered by the impact of rising food prices as well as the subsidized fuel price increase policy that directly placed pressure on production costs (cost push inflation). The prevailing impact of the cost push on core inflation occurred on processed food category that increased from 5.5% in 2012 to 7.9% in 2013 (Chart 6.7). Meanwhile, rising core inflation for the non-food category, such as housing, was limited.

7 This is supported by the fact that the elasticity of core inflation and volatile food inflation towards a 10% increase in subsidized fuel prices in 2013 is lower compared to the period of rising subsidized fuel prices in the previous years.

8 In an effort to soften the impact of the continued increase in fuel prices on inflation, TPI and Pokjanas TPID recommended that the tolerable limits for rate increase on land transportation between cities be made by taking into consideration the people's capability and its impact on inflation.

9 The Electricity Tariff (TTL) increase is set per January 1, 2013 at an average amount of 4 % (per quarter). The TTL increase is applicable for household and industrial customers above 1,300 VA.

10 The Finance Minister's Regulation No. 179/PMK.011/2012 On Tobacco Excise Rates on 12 November 2012 , with the excise tariff provisions taking effect on December 25, 2012 .

Table 6.3. **Main Contributors to Administered Price Inflation**

Commodity	2013	
	%,yoy	Contribution (%, yoy)
Inflation		
Gasoline	41.9	1.2
Intercity Transport	31.5	0.8
Electricity Fare	15.9	0.4
Filter Cigarette	8.7	0.2
Householdd Fuel	6.7	0.2

Source : BPS-Statistics Indonesia

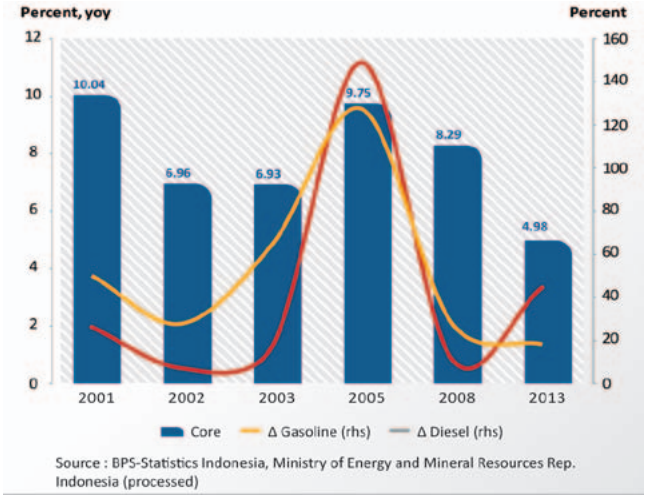


Chart 6.6. **Inflation and Fuel Price Hike**

Beyond this cost push effect, the pressure on other factors that generally affected core inflation was still under control. Inflationary pressures from domestic demand seemed moderately affected by economic growth, which slowed from 6.2% in 2012 to 5.8% in 2013[11]. The waning pressure from domestic demand was reflected in a number of early indicators such as real sales growth that was in a downward trend. In addition to this, capacity utilisation indicators continued to be around 70%, which indicated that pressure from domestic demand on core inflation was modest.

Core inflation pressure from the demand side occurred mainly in the housing sector as reflected in the housing-related inflation that was on an upward trend. Continuing strong demand in this sector is reflected in the number of early indicators, such as increased capacity utilisation in the cement industry, non-metal mineral products and iron and steel basic metals industries.

Core inflation pressure derived from external factors, in line with demand pressures, was also minimal. This is due to the continuing decline in global commodity prices and the limited impact of the Rupiah's depreciating exchange rate. The impact of the tumbling global price was reflected in the imported inflation price index that decreased by as much as 12.3% (Chart 6.8)[12]. Overall, the minimal impact that external factors had was reflected in the declining traded core inflation that in the previous year was 3.9% to drop to 2.6%[13]. The limited impact that external factors had on core inflation remains obvious upon calculation by removing the effects of the plunge in gold prices in 2013[14]. The results of calculation show that traded core inflation excluding gold increased slightly from 3.2% in 2012 to 3.5%.

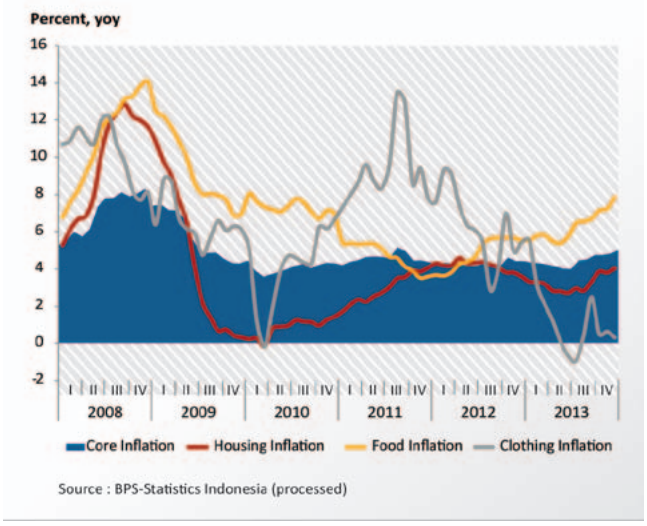


Chart 6.7. **Housing, Food and Clothing Component of Core Inflation**

11 The complete analysis of the development of economic growth in 2013 is found in Chapter 3 Economic Growth and Employment.

12 The composite global price index with weighted average (based on the percentage of imports and weight in the CPI) of food commodities (CPO, wheat, sugar, corn and soybeans) and non-food (world oil WTI), gold, cotton, and steel).

13 Definition of 'traded' are goods that are traded both in terms of exports as well as imports, which is reflected in the trade balance.

14 Gold prices throughout 2013 decreased by -5.3% (yoy) and contributed to deflation of -0.1% (yoy).

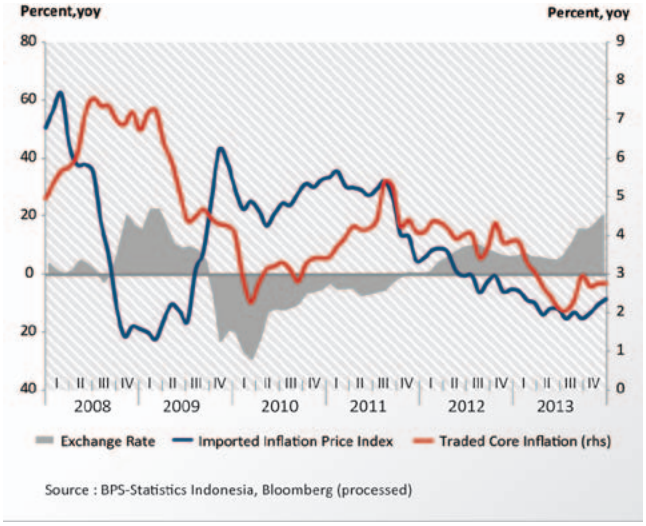


Chart 6.8. **Core Inflation and External Factors**

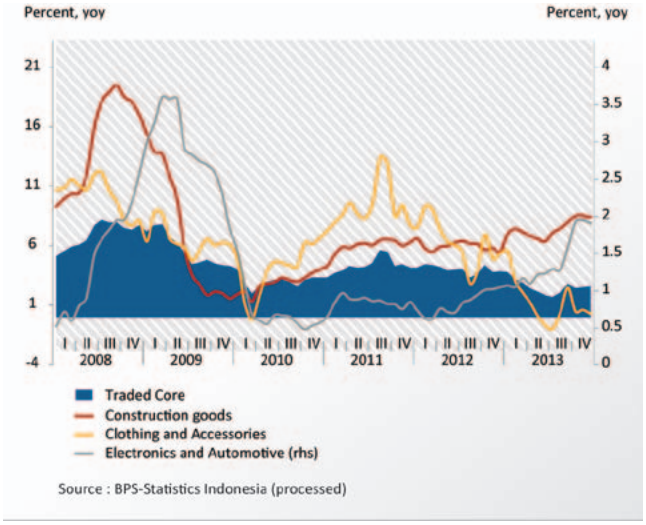


Chart 6.9. **Traded Core Inflation and Inflation of Some Category of Goods**

Several factors were associated with the limited impact of the weakening Rupiah towards the increase in core inflation, although its influence on a number of commodities such as construction materials and electronic goods was quite strong (Chart 6.9). Bank Indonesia's survey found that there are at least three factors that held the businesses from not raising prices immediately, or even keeping sales price amidst the weakening Rupiah. First of all, economic growth slowed and subsequently led to declining purchasing power leading producers to not fully transmit the impact of the Rupiah's weakening exchange rate to the consumer price level. Secondly, price setting was influenced by business contracts that have a certain timeframe whereby producers cannot be flexible to raise prices despite the Rupiah's weakening. Third, the high level of competition that has driven businesses to become price takers and even if the price adjustment must be made therefore this will be done on a gradual basis.

The limited increase in core inflation was also influenced by inflation expectations that turned into a manageable level after escalating in the previous periods. The rising inflation expectations had been affected by the impact of the subsidized fuel price increases and the depreciation of the exchange rate. Heightened inflation expectations became more intense particularly after the implementation of the subsidized fuel price increase in June 2013 and remained high until August 2013. Afterwards, inflation expectations turned into a declining trend in line with the policy responses taken by Bank Indonesia and the Government. The range of monetary policies adopted by Bank Indonesia to rein in inflationary pressures, as well as a number of policies taken by the Government to reduce the pressure of rising food prices, worked effectively in managing inflation expectations and subsequently withstood higher inflationary pressures.

The consensus forecast survey showed that inflation expectations that had risen as a result of the subsidized fuel price increase in June 2013, subsequently started to ease in September 2013. The consensus forecast survey even showed that inflation expectations for 2014 will return to the inflation target of within 4.5± 1% (Chart 6.10). The inflation expectation survey at the consumer and retailer level showed similar results with reduced pressure in the final quarter of 2013.

6.4. Regional Inflation

In regional terms, Sumatra was the region with the highest inflation in 2013. The Province of West Sumatra was registered with the highest inflation rate in 2013 of 10.9%, followed by North Sumatra and Bengkulu Provinces by 10.2% and 9.9% respectively. Other province that also registered high inflation in 2013 was North Maluku, which amounted to 9.8%. Conversely, the lowest inflation rate in Indonesia in 2013 was in Gorontalo Province amounting to 5.8% (Picture 6.1). The high inflation found in a number of provinces in Sumatra generally led to inflation in the

Chart 6.10. **Consensus Forecast Inflation Expectation**

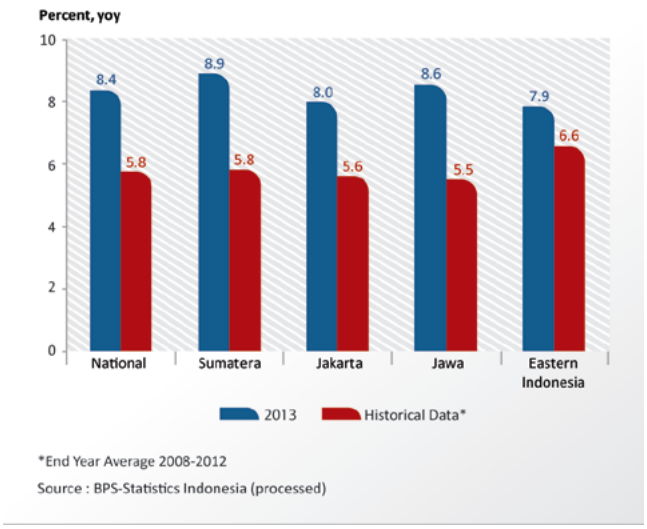
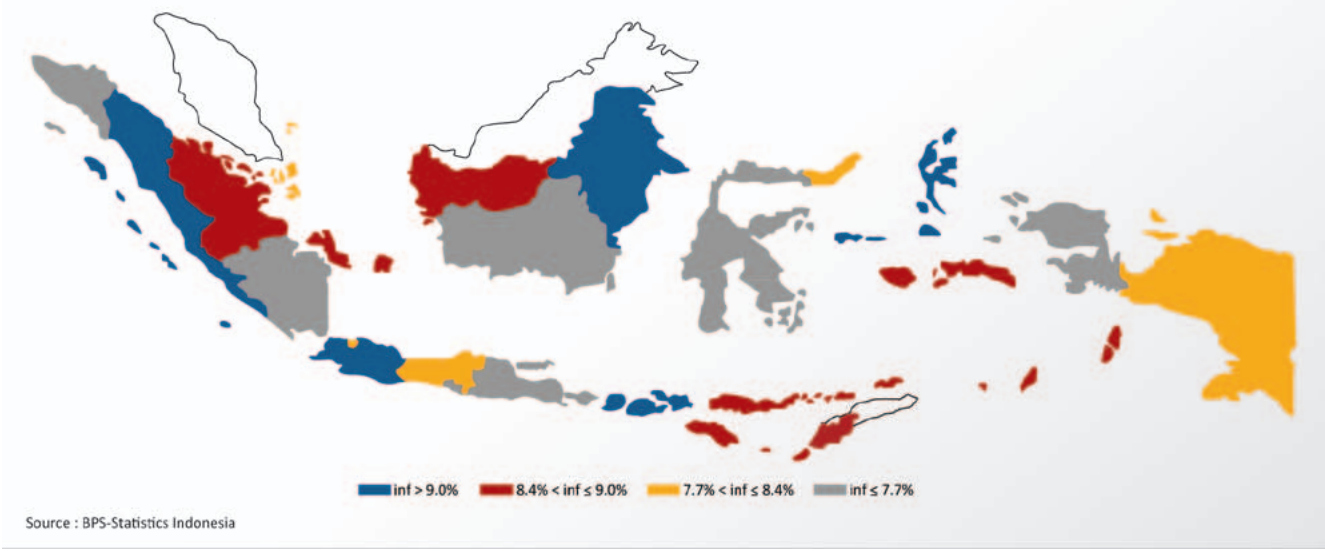


Chart 6.11. **Regional Inflation in 2013**

Sumatera region of 8.9% in 2013, which was higher than in three other regions namely, Java (8.5%), Jakarta (8.0%) and Eastern Indonesia (7.9%) (Chart 6.11).[15]

Inflation in Sumatera was higher than other areas as it was more affected by the high levels of volatile food inflation and administered prices inflation, while core inflation was lower. Volatile food inflation, which was registered at 12.3%, was affected by supply disruptions brought about by the eruption of Mount Sinabung and the lingering effects of the subsidized fuel price increase. These conditions led to volatile food inflation to remain high in Sumatra within the second half of 2013. The high second round effect of the fuel price hike on transport fares in Sumatra compared with other regions led to high administered prices inflation in Sumatra. This development is reflected in the prevalent number of

15 Bank Indonesia distributes regional economic analysis in 4 (four) areas, namely: Sumatra (the Provinces of Aceh, North Sumatra, South Sumatra, Bengkulu, Jambi, Lampung, West Sumatra, Riau, Bangka Belitung, and Riau Islands); Jakarta (DKI Jakarta); Java (Provinces of West Java, Banten, Central Java, East Java, and Yogyakarta); Eastern Indonesia region (The Provinces of Bali, NTB, and NTT, West Kalimantan, Central Kalimantan, South Kalimantan, East Kalimantan, North Sulawesi, Gorontalo, Southeast Sulawesi, Central Sulawesi, South Sulawesi, West Sulawesi, Maluku, North Maluku, Papua, and West Papua).



Picture 6.1. **Map of Indonesia's Inflation in 2013**

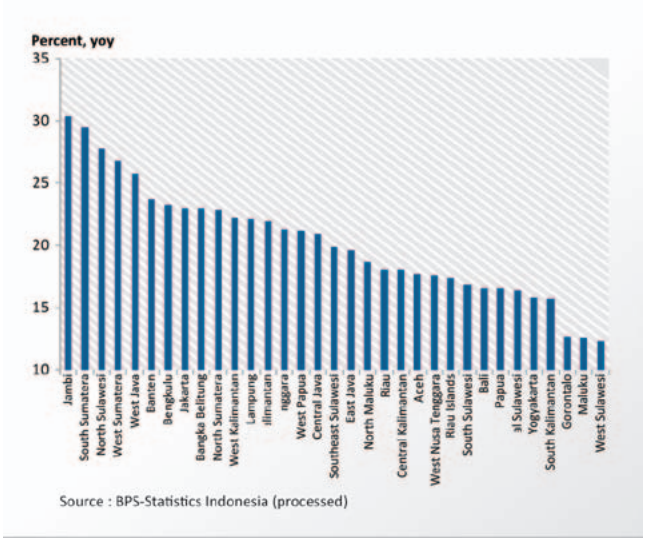


Chart 6.12. **Inflation of Transportation Subgroup (July 2013)**

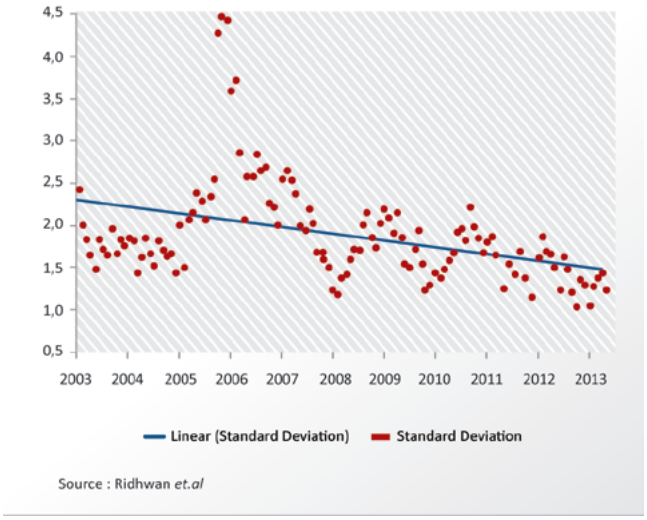


Chart 6.13. **Inter-Province Inflation Convergence**

regions in Sumatra that registered high inflation in the transport subgroup (Chart 6.12).

Volatile food inflation in Java and Jakarta were not as high as in Sumatera, which registered at 11.6% and 11.4% respectively. Volatile food inflation in Java in the first quarter of 2013 faced issues associated with the shortage of supply due to import licensing issues that held back trucks carrying imported horticultural products at the Port of Tanjung Perak in Surabaya. Catastrophic floods that affected several areas in Jakarta also added to the pressure on food inflation. The mounting food inflation was caused by the constrained distribution and even stopped for some time due to the disruption to the distribution route into a number of areas in Jakarta. Volatile food inflation pressures also emerged from the meat and its products, particularly for chicken meat and beef.

Positive development of inflation was shown in Eastern Indonesia (EI), which in 2013 was registered as the region with the lowest inflation in Indonesia of 7.9%. This condition was different from the situation in 2012 when the EI became the region with the highest inflation rate in Indonesia amounting to 5.2%. Several provinces in EI that registered low inflation include Gorontalo and Southeast Sulawesi at 5.8% and 5.9% respectively. The low inflation in EI was caused by subdued volatile food inflation.

Overall, inflation dynamics on a spatial perspective in 2013 showed that inflation between provinces in Indonesia had a tendency to converge in accordance with the results of Bank Indonesia's study (Chart 6.13)[16]. This finding is a positive development for controlling inflation in Indonesia since it shows narrowing differences in terms of factors that influence the inflation pattern in Indonesia.

16 Ridhwan, MH., Werdaningtyas, H., and Grace, MV (2013), "Decomposition, Determinants, and Regional Inflation Convergence Analysis in Indonesia ", Bank Indonesia, mimeo, shows a decline in the standard deviation of inflation among provinces in Indonesia in the last 10 years (2003-2013). Estimation is based on monthly inflation data in 30 provinces from 2003 to 2013 by using the fixed effects data panel approach. Calculation of speed of convergence is by using the half-life deviation obtained of ±29 months.

Box 6.1. Food Price Stabilization Policy within The Context of Inflation Control

The government's efforts to promote food sovereignty comprise control over food imports. Efforts to promote food sovereignty sought to protect agricultural production within the domestic market. Import controls were gradually carried out and began to be implemented in mid-2012 by limiting entry points and regulating import procedures. This policy was continued in 2013 in the form of import provisions through restrictions as well as quota limits.

In terms of its implementation, these import control policies faced constraints as it simultaneously encountered inadequate domestic production thereby hampering supply. Limited supply led to high inflationary pressures, especially in horticulture and beef products. In response, the government issued several regulations related to price stabilization so as to overcome these price pressures. These regulations were expected to address limited supply problems, thereby reducing volatile food inflationary pressures. In this regard, the government issued four regulations and administrative provisions aimed at relaxing restrictions on beef imports in order to increase domestic market supply. In general, the first three rules governing the import procedures and requirements, both for the import activities and types of meats imported. Meanwhile, the fourth rule was aimed at regulating the import mechanism system of cattle/beef (Table 1).

In regards to the relaxation of imports, the government also changed the import mechanism of cattle/beef from a quota-based to a price-based system. This was set within the Ministry of Trade Regulation No.46/M-DAG/KEP/8/2013 that consists of three main aspects, including: the imposition of a reference price, the criteria of import triggers, and guidance technical matters. The reference price[1] set by the government for 2013 amounted to Rp76,000/kg. This price was set based on the average retail prices in recent years and the calculation of the cost of production and distribution. Imports may be allowed or banned based on the deviation of the retail price from the reference price. The tolerable deviation was defined static and asymmetric with a range set between 5% and 15%. If the projected price of beef for the next 2 months was below the reference price therefore beef imports were postponed until the price returns to the reference price. If the projected price for 2 months ahead is 15% well above the reference price, therefore the import restrictions are lifted. Meanwhile, technical matters regulated on ministerial regulation include the timeframe for requesting import approval that is divided into four quarters, the amount of imports that must be realized to a minimum of 80% of the accumulated approved import for 1 year, and exception for prime cut meat types from the reference price provision (Chart 1). However, there are some issues that require attention relating to beef price stabilization policy. These essential issues relate to the determination of the initial import quota in the beginning of the year so as to avoid price fluctuations, the mechanism of setting reference price and its deviation, as well as monitoring the realization of imports and its sanctions.

On the other hand, government policies related to horticulture were aimed at promoting domestic production while simultaneously protecting the consumer in accordance with Law No.13 of 2010 regarding Horticulture. Some of the policies that were applied included import entry point restrictions for horticultural products, setting import licensing procedures and new import mechanism of horticultural products. Inadequate domestic production in the midst of the import control policy eventually led to price pressure on horticultural commodities. In relation to this, the government issued four regulations aimed at stabilizing domestic prices (Table 2).

The government also changed import mechanism of horticultural products[2], especially for chillies and shallots, to that based on a reference price[3], such as that applied for beef. This is intended to reduce price pressures in view that it contributed significantly to

1 The reference price is the suggested retail price that is set by the Beef Price Monitoring Team. The reference price will be periodically evaluated.

2 Horticultural products for industrial processing needs are excluded from the reference price regulations

3 The reference price is set by the Horticultural Products Price Monitoring Team

Table 1. **Beef Price Stabilization Regulation**

No.	Regulation	Regarding	Description	Effective Date
1	Regulation of the Ministry of Trade No.22/M-DAG/PER/5/2013	Export and import regulation of livestock and meat	Simplification of import administration and licensing procedures and to promote business certainty.	28 May 2013
2	Ministry of Trade No.699/M-DAG/KEP/7/2013	Beef price stabilisation	Import Procedures for additional beef supply.	18 July 2013
3	Regulation of the Ministry of Agriculture No.84/Regulation of the Ministry of Agriculture/PD.410/8/2013	Importation of carcass, meat , Offal and/or their derivatives into the territory of the Republic of Indonesia	Procedures, business unit, requirements of country of rigin, purpose and recommencation application for the importation of carcass, meat , Offal and/or their derivatives into the territory of the Republic of Indonesia.	28 August 2013
4	Regulation of the Ministry of Trade No.46/M-DAG/KEP/8/2013	Export and import regulation of livestock and meat	to replace import quotas with a price-based system for meat and live cattle imports	30 August 2013

Source: Ministry of Trade

inflation. Through the Decision of the Director General of Domestic Trade No.118/PDN/KEP/10/2013, the reference price for red chillies amounts to Rp26,300/kg, bird's eye chillies at Rp28,000/kg, and shallots at Rp25,700/kg. The reference price is based on the cost structure approach and had taken into account the coefficient variability of as much as 9%. Meanwhile, restriction on imports of chillies and shallots were relaxed. Import licenses for chillies and shallots for consumption may be filed at any time considering the reference price set by the Horticultural Products Price Monitoring Team[4]. In line with the provisions for beef imports, the imports of horticultural products were also imposed with required realized imports of at least 80% of the approved imports for each period.

Policies to relax beef and horticultural imports indicated the success in controlling commodity prices. Throughout its development, volatile food inflation pressure declined following the enactment of this policy. In the short term, to further improve the effectiveness of the above-mentioned food price stabilization policies, several aspects need to be addressed. This relates to the determination of import quotas, the construction of reference price and its tolerable deviations, the mechanism and the timing to evaluate reference prices, as well as monitoring the realization of imports along with its sanctions. Furthermore, in the longer term, structural policies continue to be required to support increased domestic production. Increased capability on the supply-side is expected to reduce inflationary pressures resulting from volatile food on a more permanent basis thereby enhancing the economy's resilience and sustainability.

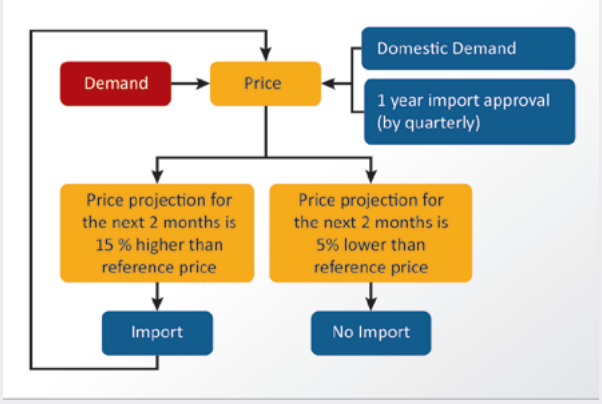


Diagram 1. **Beef Import Mechanism**

4 Import permits for other horticultural products were proposed using the periodization system: December of the previous year for the first semester of the current year, June for Semester II. This permit is valid for up to 6 months.

Table 2. Regulation to Stabilize Chili and Shallot Prices

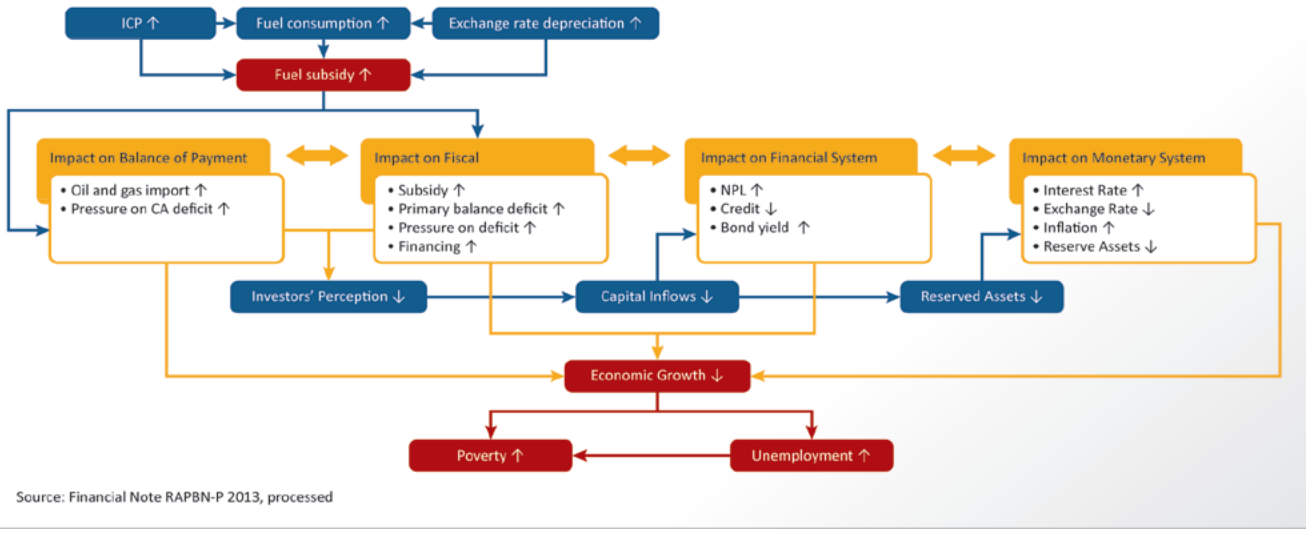
No.	Regulation	Regarding	Description	Effective Date
1	Regulation of the Ministry of Agriculture No.47/Regulation of the Ministry of Agriculture/ OT.140/4/2013	Import Recommendation of Horticulture Products	Precedures for online import application and issuing Import Recommendation for Horticulture products every semester (twice a year).	19 April 2013
2	Regulation of the Ministry of Trade No.16/M-DAG/ PER/4/2013	Provision on Import of Horticulture Products	Procedures for importers application and import permits, tariff post reduce to 39 commodities (from 57 commocities), and implementation of import realization monitoring card.	22 April 2103
3	Regulation of the Ministry of Agriculture No.86/ OT.140	Import Recommendation of Horticulture Products	To regulate chili and shallot import based on determined reference price.	30 August 2013
4	Regulation of the Ministry of Trade No.47/M-DAG/ KEP/8/2013	Amendement to The Regulation of Minister of Trade No No.16/M-DAG/ PER/4/2013 Regarding Provision on Import of Horticultural products	Import system change from quota to reference price apply to shallot and chili.	30 August 2013

Source: Ministry of Trade and Ministry of Agriculture

CHAPTER
7

Fiscal

Fiscal conditions in 2013 encountered a number of daunting challenges and risks that hindered prospects for fiscal sustainability. The government's response, which included increasing prices for subsidized fuel, managed to control the fiscal deficit to the level of 2.3% of GDP, as well as contributed to a manageable domestic demand and current account deficit that began to recover towards a sustainable level. Going forward, some fiscal policy strengthening both at the central and regional levels have yet to be implemented to support fiscal resilience in order to maintain a sustainable economic growth.



Picture 7.1. **Risks to the State Budget 2013**

2013 fiscal conditions were also faced with formidable challenges spurred by global and domestic economic conditions which resulted in the deviation from the assumptions set in the 2013 State Budget. The main component that has been by these adverse global and domestic conditions is the risk of increasing fuel subsidies due to the continued strong consumption for subsidized fuel, in line with domestic demand that remains sizeable. In addition to this, weakened exchange rate and higher actual oil prices than 2013 State Budget assumptions also further increased fuel subsidy burdens. Risks associated with increased fuel subsidy needs to be addressed. Furthermore there were also risks of reduced revenues due to declining oil and gas lifting as well as lower growth in tax revenues. Based on calculations, the risk of increased fuel subsidy amidst the condition of declining revenue potential can increase the budget deficit in 2013 much higher than initially estimated at 1.7% of GDP to over 3.8% of GDP[1].

The challenges encountered by fiscal policy in 2013 raised structural issues pertaining to the role of fiscal policy in optimally and sustainably stimulating economic growth. These issues largely related to the composition of the budget spending that was mainly absorbed by fuel subsidies. The fuel subsidies have reduced fiscal space to promote economic growth and may even hinder fiscal resilience. On the one hand, excessive fuel subsidy reduced the quality of government spending as it will largely be absorbed by fuel subsidies. As a result, allocated capital expenditure that can provide a broader multiplier effect to the economy became fairly limited. On the other hand, excessive fuel subsidy can trigger inefficient allocation of natural resources. Overall, the magnitude of the fuel subsidies burden can interfere with fiscal sustainability and further pressure the economy in the form of disruptions to the balance of payments, monetary conditions, the financial system stability, and ultimately disrupt efforts to maintain sustainable economic growth in the medium to long term (Picture 7.1).

The government took several strategic steps to control the budget deficit in 2013 in order to maintain fiscal sustainability. Various macroeconomic assumptions that were previously used including economic growth, inflation, exchange rate, international oil prices, as well as the oil and gas lifting, were subsequently adjusted as they did not match existing conditions (Table 7.1). In addition to this, another strategic decision to increase subsidized fuel prices was also taken (Chart 7.1). On the one hand, increasing prices on subsidized fuel sought to control the burden of fuel subsidies and the expected adjusted State Budget deficit in 2013 of 2.4% of GDP (Table 7.2). On the other hand, the strategic decision to raise fuel prices was also aimed at improving the efficiency for natural resource allocation as well as supporting efforts to manage domestic demand towards a more balanced direction. Furthermore, the government also issued a

1 In the opening of the 2013 National Development Plan Deliberation (Musrenbangnas) 2013 dated May 1, 2013 in Jakarta, President Susilo Bambang Yudhoyono said that if the subsidy is not controlled, the fiscal deficit could increase to 3.8% of GDP (Source: http://www.esdm.go.id/berita/migas/40-migas/6272-kenaikan-bbm-agar-subsidi-lebih-adil-dan-tepat-sasaran.html).

Table 7.1. **Macroeconomic Assumptions in 2013**

Macroeconomic Assumption	2012			2013		
	State Budget	Revised Budget	Realization	State Budget	Revised Budget	Realization
Economic growth yoy (%)	6.7	6.5	6.2	6.8	6.3	5.8
Inflation yoy (%)	5.3	6.8	4.3	4.9	7.2	8.4
Exchange rate (Rp to USD)	8,800	9,000	9,638	9,300	9,600	10,452
Average of 3-month SPN (Government Treasury Bills) interest rate (%)	6.0	5.0	3.2	5.0	5.0	4.5
International oil price (US dollar/barrel)	90	105	113	100	108	106
Indonesia oil lifting (thousand barrels per day)	950	930	860	900	840	825
Indonesia gas lifting (thousand barrels oil equivalence per day)	-	-	1,260	1,360	1,240	1,213

Source: KESDM and Central Government's 2012 Financial Report (LKPP), Ministry of Finance press release 5th January, 2014

number of technical regulations through policy packages so as to ensure consistency in implementing structural improvements within the medium to long term[2]. Overall, the direction of the 2013 State Budget and a range of supporting technical regulations have strong synergy with Bank Indonesia's policy direction in managing the domestic demand to reduce the current account deficit to a healthy level and maintain sustainable future economic growth.

The results of fiscal policy's response to the economic challenges of 2013 were positive, both for government's financial position as well as for economic activities. Although higher than the 2012 deficit amounted to 1.9% of GDP, the Revised 2013 Budget deficit was managed to 2.3% of GDP (Table 7.2). Realization of the Revised 2013 Budget deficit was lower than the provisions set within

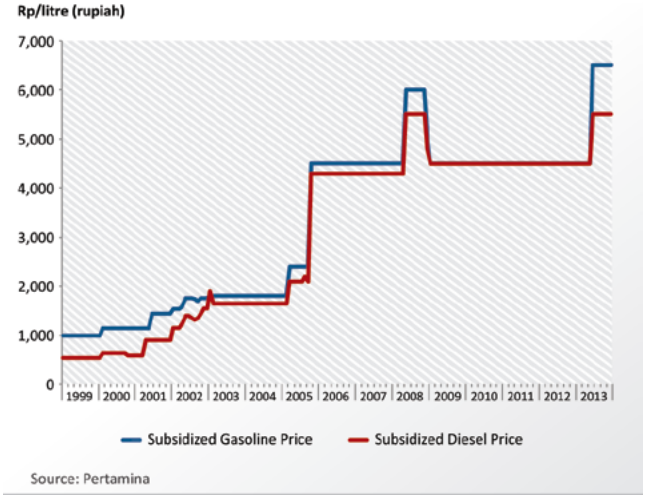


Chart 7.1. **Subsidized Fuel Price**

Law No. 33 of 2004 in the amount of 3% of GDP as well as the initial target of 2.4% of GDP. Furthermore, positive synergy between the fiscal and Bank Indonesia's policy response also positively contributed to guiding domestic demand into a more balanced state and support the reduction of the current account deficit in the fourth quarter of 2013.

Going forward, a number of aspects need to be strengthened to support fiscal resilience, both nationally as well as regionally. These measures are aimed at reinforcing primary balance condition which recorded a deficit of 1.1% of GDP in 2013. In terms of revenues, taxes need to be both intensified as well as extensified to support for increased domestic-based revenues. Efforts to increase oil and gas lifting also need to be carried out. The expenditure absorption capacity, both in terms of quantity and time of absorption, as well as the role of capital expenditure needs to be strengthened in order to improve the quality of the expenditure. In this regard, optimizing the use of subsidized fuel and 3 kilogram-LPG becomes important, including via energy conversion program. Various efforts to strengthen revenue and expenditure components also need to be conducted by fiscal policy in the regional areas. Local revenues need to be increased. The local government's capacity to absorb expenditure also needs to be further optimized, including efforts to increase the role of capital expenditure to strengthen economic growth in the region.

Strengthening fiscal resilience in the years to come is also needed to support sustainable economic growth, including improving people's welfare. The role of fiscal policy in improving the welfare of the community are, among others, related to poverty reduction, which was registered at 11.4% in 2013, above the maximum limit of the 2010-2014 National Medium-Term Development Plan (RPJMN) target range of 8.0-10.0% in 2014. In addition,

2 Details on the Government's policy package can be viewed in Chapter 13, Policy Coordination.

Table 7.2. **Government Financial Operation 2012-2013**

Items	Revised Budget 2012 Rp Trillion	Actual 2012				Revised Budget 2013 Rp Trillion	Actual 2013*			
		Rp Trillion	%GDP	%yoy	% Revised Budget		Rp Trillion	%GDP	%yoy	% Revised Budget
A. Government Revenues and Grants	1,358.2	1,338.1	16.2	10.5	98.5	1,502.0	1,429.5	15.7	6.8	95.2
I. Domestic Revenues	1,357.4	1,332.3	16.2	10.5	98.2	1,497.5	1,425.0	15.7	7.0	95.2
1. Tax Revenues	1,016.2	980.5	11.9	12.2	96.5	1,148.3	1,072.1	11.8	9.3	93.4
- Domestic Tax	968.3	930.9	11.3	13.6	96.1	1,099.9	1,024.8	11.3	10.1	93.2
- International Trade Tax	47.9	49.7	0.6	-8.3	103.6	48.4	47.4	0.5	-4.6	97.9
2. Non Tax Revenues	341.1	351.8	4.3	6.1	103.1	349.2	352.9	3.9	0.3	101.0
II. Grants	0.8	5.8	0.1	10.1	701.3	4.5	4.5	0.0	-22.5	99.6
B. Government Expenditure	1,548.3	1,491.2	18.1	15.1	96.3	1,726.2	1,639.0	18.0	9.9	94.9
I. Central Government Expenditure	1,069.5	1,010.6	12.3	14.4	94.5	1,196.8	1,125.7	12.4	11.4	94.1
1. Personnel Expenditure	212.3	197.9	2.4	12.6	93.2	233.0	221.4	2.4	11.9	95.0
2. Goods Expenditure	162.0	140.9	1.7	13.0	87.0	206.5	167.8	1.8	19.1	81.2
3. Capital Expenditure	176.1	145.1	1.8	23.1	82.4	192.6	171.8	1.9	18.4	89.2
4. Debt Interest Payment	117.8	100.5	1.2	7.8	85.3	112.5	112.8	1.2	12.2	100.2
5. Subsidies	245.1	346.4	4.2	17.3	141.4	348.1	355.0	3.9	2.5	102.0
6. Grant Expenditure	1.8	0.1	0.0	-75.0	4.2	2.3	1.3	0.0	1,644.6	56.9
7. Social Aids	86.0	75.6	0.9	6.4	87.9	82.5	92.1	1.0	21.8	111.7
8. Other Expenditure	68.5	4.1	0.0	-25.5	5.9	19.3	3.6	0.0	-12.1	18.6
II. Transfers to Regions	478.8	480.6	5.8	16.9	100.4	529.4	513.3	5.7	6.8	97.0
1. Balancing Fund	408.4	411.3	5.0	18.4	100.7	445.5	430.4	4.7	4.6	96.6
2. Special Autonomy and Adjustment Fund	70.4	69.4	0.8	8.2	98.5	83.8	82.9	0.9	19.5	98.9
C. Primary Balance	-72.3	-52.6	-0.6	-696.4	72.7	-111.7	-96.8	-1.1	84.0	86.6
D. Budgetary Surplus/Deficit	-190.1	-153.1	-1.9	81.3	80.5	-224.2	-209.5	-2.3	36.9	93.5
E. Financing	190.1	182.7	2.2	39.5	96.1	224.2	230.1	2.4	26.0	102.6
I. Domestic Financing	194.5	198.6	2.4	33.5	102.1	241.1	243.4	2.6	22.6	101.0
II. Foreign Financing (net)	-4.4	-16.0	-0.2	-10.3	360.6	-16.9	-13.3	-0.1	-16.7	78.7

Source: Ministry of Finance
*Provisional figures (*unaudited*) (Ministry of Finance Press Release 5th January, 2014)

efforts to improve welfare also relates to attempts to reduce the unemployment rate registered at 6.25% in 2013, or still above the 2010-2014 RPJMN target of 5.0-6.0% in 2014[3].

7.1. State Revenues and Grants

The Revised 2013 Budget realization revealed that some indicators of state revenues and grants were in a declining trend compared to 2012. Although in nominal it increased from Rp1,338.1 trillion in 2012 to Rp1,429.5 trillion, a number of other indicators showed that the state revenues and grants were in a slowing trend. Growth in revenues and grants in 2013 was registered at 6.8%, slower than the previous year's growth of 10.5% (Table 7.2). The ratio of state revenue and grants to GDP also declined from 16.2% to 15.7% (Chart 7.2). Realization of State revenues and grants in 2013 was registered at 95.2% of the Revised 2013 Budget target, also lower than the 2012 figure amounted to 98.5% of the Revised 2012 Budget target.

The revenue and grants deceleration in 2013 were mainly affected by lower growth in tax revenues. Apart from the impact of the slowdown in economic growth, the

3 Further discussions regarding poverty and unemployment can be viewed in Chapter 3, Economic Growth and Employment.

restrained in tax revenue was also due to the constraints associated with a weak tax database. This is partly due to, among others, the less than optimum implementation of Article 35A of Law No. 28 of 2007 regarding the General Provisions and Procedures on Tax (KUP), despite the Government's issuance of supporting regulations in 2012. This provision requires every government institution, agency, association, and other parties to provide tax data and information to the Directorate General of Tax.

In 2013, Tax revenues increased by 9.3%, lower than the tax revenue growth in 2012 at 12.2% (Table 7.2). Based on its components, this development was affected by the decline in non-oil and gas Income Tax (PPh), Value Added Tax (VAT), excise, and international trade taxes. On a sector basis, tax revenues derived from the mining sector as one of the leading sectors for tax revenues, also registered a significant decline in growth from 14% to 0.5%. The increase in tax revenue growth from other sectors such as the manufacturing, property, financial services, construction and retail seemed unable to cover the decline in the mining sector[4].

Overall, tax revenue deceleration in 2013 caused the tax ratio to decline. The tax-to-GDP ratio decreased from 11.9% to 11.8% in 2013, indicated declining tax contribution in the economy (Chart 7.2). These developments need to be monitored as, compared to countries within the region, Indonesia's tax ratio is still lower than a number of countries within the region, despite the fact that the corporate and personal tax rates in Indonesia are above the average rates (Table 7.3)[5].

Another factor that contributed to the slowdown in state revenues and grants was the actual petroleum and natural gas lifting, which recorded a figure below its target. This condition, in turn, resulted in a drop of non-tax state revenues (non-tax revenues), particularly oil and gas non-tax revenues in 2013 than in 2012. In addition, the performance of the non-oil and gas non-tax revenues was also lower due to the economic slowdown and dividend payment delays from a number of large companies resulting from operational disruptions. Despite exceeding the target set within the revised state budget, this year's non-tax revenues only reached Rp352.9 trillion,

4 Source: http://www.republika.co.id/berita/ekonomi/makro/14/01/06/myz70e-penerimaan-pajak-negara-turun

5 Average effective income tax rate for entities in Asia-Pacific are 26,9%/26,6% (D. Endres et al (eds)," Company Taxation in the Asia-Pacific Region, India, and Russia," Springer, 2010). There are two average rates since countries such as India applies different rates for corporate profits that are distributed in the form of dividends or retained earnings.

Table 7.3. Tax Ratio and Tax Rate In Regional Comparison

Countries	Tax Ratio	Effective Corporate Rate Tax	Maximum Personal Tax Rate
Thailand	17.6%	30.0%	37.0%
China*	17.0%	35.0%	45.0%
Malaysia	15.3%	25.0%	26.0%
Vietnam*	13.8%	25.0%	35.0%
Philippines	12.4%	30.5%	32.0%
Indonesia	11.8%	28.0%	30.0%
India[1]	10.4%	45.2%/34.0%	33.0%
Cambodia	10.0%	20.0%	n.a.

Source:
Tax Ratio: World Bank Indicators 2011, *Heritage Foundation 2012
Pajak Badan: D. Endres et al (eds), "Company Taxation in the Asia-Pacific Region, India, and Russia," Springer, 2010

1 India applied 45.2% tax over corporate profits paid out as dividend. A 34% is applied over retained earnings.

or 2.1% lower compared to the previous year. Based on its composition, non-tax revenues derived from Natural Resources dropped from 16.9% to 15.9%, while other non-tax revenues fell from 9.8% to 8.9% (Chart 7.3). This decrease in non-tax revenues, in turn, contributed to the decline in state revenues.

7.2. State Expenditure

The Government's response in maintaining fiscal resilience amidst the increase in various economic risks resulted in declining state expenditure growth in 2013. State expenditure realization reached Rp1,639.0 trillion, grew by 9.9% or lower than 2012 growth of 15.1% (Table 7.2).

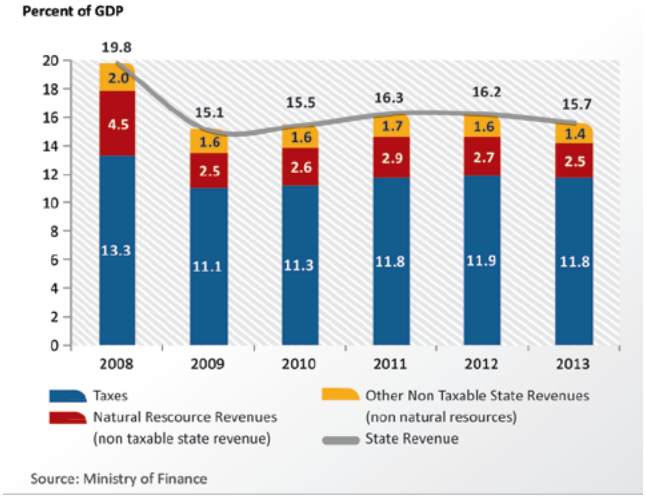


Chart 7.2. Ratio of Revenue to GDP

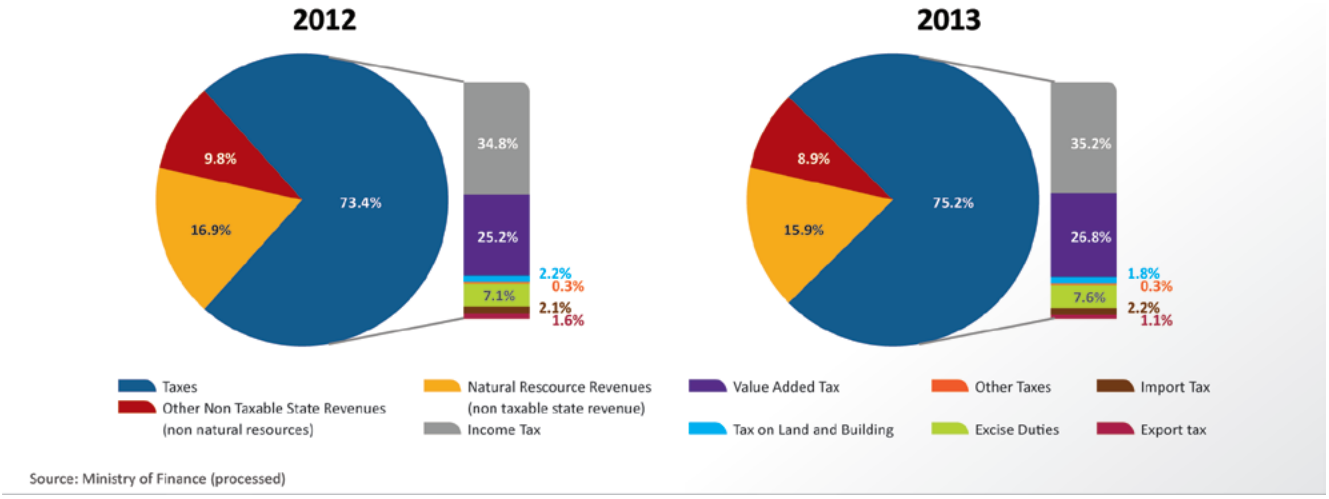


Chart 7.3. **The Composition of Government Revenues in 2012 and 2013**

This decrease consequently resulted in a lower state expenditure to GDP ratio from 18.1% in 2012 to 18.0% in 2013 (Chart 7.4). The amount of expenditure absorbed compared to the ceiling set within the revised state budget also declined from 96.3% in 2012 to 94.9% in 2013 (Table 7.2). This lower expenditure absorption was, among others, brought about by the impact associated with the decline in state revenues. This condition prompted the Government at the end of the year to apply a number of measures to control the budget.

The decline in the growth of state expenditure in 2013 was largely caused by the subsidized fuel price hike policy. Spending on subsidies in 2013 amounted to Rp355.0 trillion, or 102.0% of the Revised 2013 Budget ceiling. Although the value of these subsidies slightly exceeded the ceiling set within the Revised 2013 Budget, the policy to increase subsidized fuel prices was able to lower the portion of subsidized expenditure relative to the total expenditure from 23.2% in 2012 to 21.9% in 2013. The reduction in the subsidies portion has particularly driven down by reduced fuel energy subsidies from 14.2% in 2012 to 12.8% of the total subsidies (Chart 7.5). This decline was also attributed to the slowdown of subsidized fuel consumption, achieving a figure lower than the revised state budget ceiling. he realization excluded the carry over obligation for the 2013 fuel and 3 kilogram-LPG subsidies that will be paid in subsequent years.

Another component of state expenditure which significantly brought down growth in government expenditures are capital expenditures and transfers to the

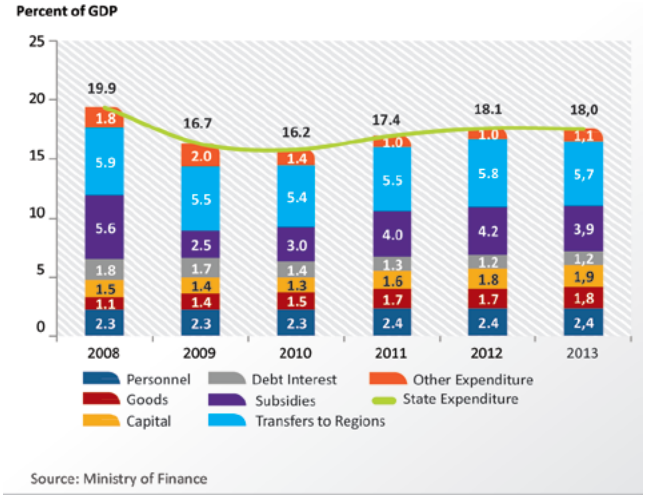


Chart 7.4. **Ratio of Expenditure to GDP**

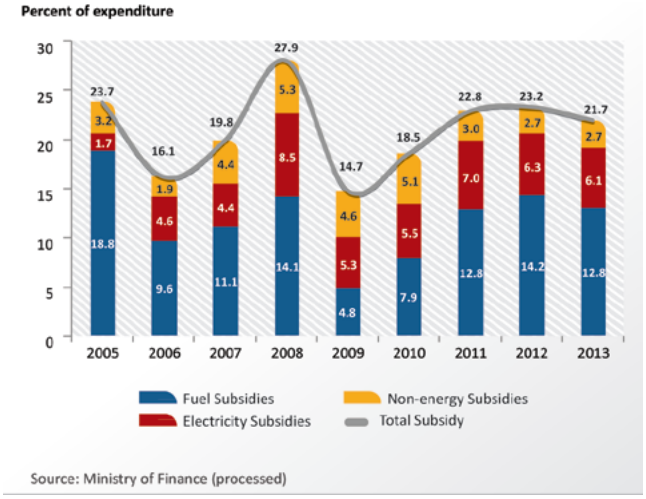


Chart 7.5. **Ratio of Subsidy to State Expenditure**

regional areas. In 2013, capital expenditure growth was registered at 18.4%, lower than growth in 2012 of 23.1%. in line with this development, the growth of regional transfers in 2013 fell sharply from 16.9% in 2012 to 6.8% with the share of regional transfers to the Government's spending fell slightly from 32.2% to 31.3%. The slowdown in regional transfer growth was attributed to the decline in the budget's absorption against the allocated budget ceiling. Absorption of regional transfers reached 97%, or lower compared to the optimum absorption rate in 2012 of 100.4%.

Other components of expenditure such as personnel expenditure, interest payments and other expenditures generally recorded higher absorption than in 2012. Absorption of personnel expenditure increased from 93.2% to 95.0%, influenced by the termination of the moratorium on new civil servants in December 2012. Debt interest payments were in line with the budget ceiling, recorded a higher figure compared to 2012 amounted to 85.3% of the budget ceiling. Debt interest payments increased in line with the depreciation of the Rupiah exchange rate and rising interest rates. Meanwhile, goods expenditure absorption declined to 81.2% in 2013 although in nominal it showed an increasfrom 13.0% in 2012 to 19.1% in 2013.

Capital expenditure also registered an increase in budget absorption. Capital expenditure absorption increased to 89.2% in 2013 from 82.4% in 2012. This increase was driven by the government's efforts to intensify capital expenditure absorption by, among others, simplifying budgetary disbursement procedures, coordination across Ministries/Agencies, extensification and intensification of permits under one roof and communications between the Ministry of Finance and the technical ministries. The capital expenditure buildup in the second half of 2013 was largely geared towards building infrastructures that can effectively boost economic activity in the cement, iron, steel, and construction industries.

Increased absorption on expenditure was also evident for social assistance. Absorption for social assistance exceeded the budget, increased to 111.7% of the allocated budget from 87.9% in 2012. Increased absorption for social assistance programs was influenced by the government's policy to minimize the impact of the subsidized fuel price increase, particularly towards maintaining the purchasing power of the poor. The government, in its Revised 2013 State Budget, sought to reduce Ministry/Agency expenditure amounting to Rp13.2 trillion and allocated funds amounting to Rp29.4 trillion for social assistance.

The social assistance covers four main programs. First, Temporary Public Direct Assistance Program (BLSM), which comprised a direct cash assistance of Rp150,000 per month for a period of four months for 15.5 million Targeted Households (RTS) distributed in two stages. The amount disbursed for the BLSM was 98.5% for phase I and 98.1% for phase II. Second, allocation of additional food subsidies in the form of Rice for the Poor (Raskin) of as much as 15 kilograms per household for three months, in June, July, and September 2013, whereby the rice allocated per Poor Household (RTM) amounts to 30 kilograms per month. Third, higher support and larger number of recipient coverage for the Poor Student Assistance (BSM). BSM's coverage increased from 8.7 million school-age children previously to 16.6 million school-age children. Fourth, higher support for 2.4 million household participants of the Hope Family Program (PKH) from an average of Rp1.4 million per year to Rp1.8 million per year. In addition, the Government also carried out the Infrastructure Acceleration and Expansion Development Program (P4I) comprising of: (i) Housing Infrastructure Program covering 13,000 villages and 1,200 districts, (ii) Drinking Water System Supply Program which covers 159 regions in 28 provinces, 341 urban districts in 31 provinces, and 260 villages in 29 provinces that lack access to clean water, and (iii) Water Resources Infrastructure Program in 27 provinces that lack access to clean water.

Increased absorption for some components of government expenditures such as personnel expenditure, capital expenditure and social assistance was also accompanied by improvements in the time of absorption.. This is reflected in the fourth quarter of 2013 expenditure absorption, which was lower compared with the pattern in the previous years. The fourth quarter of 2013 expenditure absorption amounted to 33% of total expenditures, lower compared to fourth quarter of 2012 figure of 35% of total expenditure (Chart 7.6). The absorption pattern in the fourth quarter of 2013 was better than the average absorption in the fourth quarter over the last 6 years of 36.2%.

In 2013, the Government's measures managed to increase budgetary absorption for some components of expenditure. However, expenditure's absorption generally remained below its optimum capacity. This condition was driven by a number of constraints on the revenue side as well as issues related to the Government's expenditure absorption such as technical constraints related to permits/land acquisition. (See Box 7.1. Central Government Expenditure Absorption).

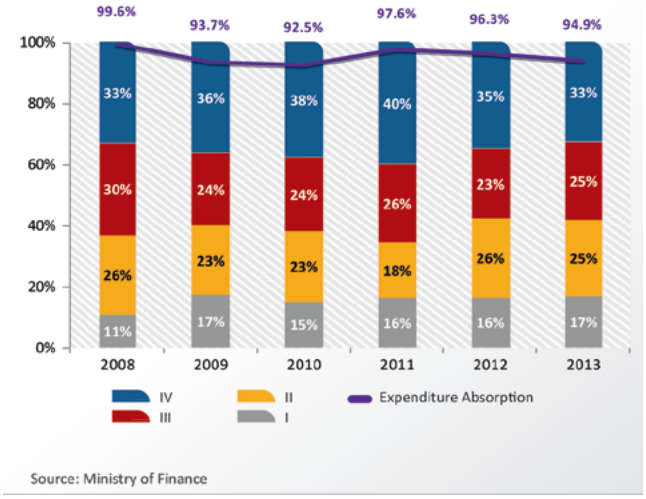


Chart 7.6. **Quarterly Budget Absorption**

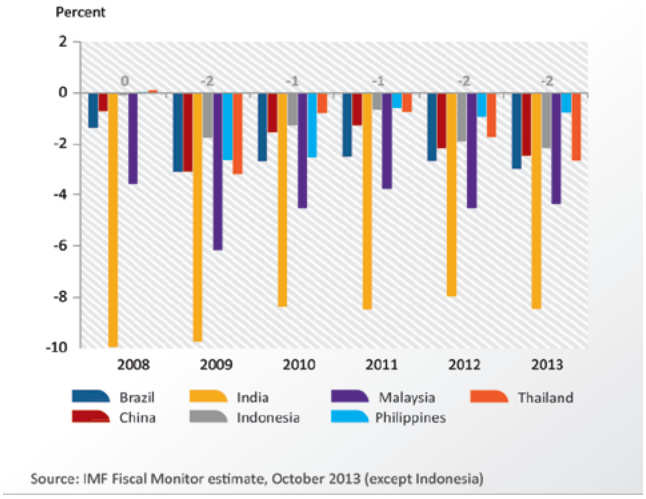


Chart 7.7. **Ratio of Fiscal Deficit in Emerging Market Countries**

7.3. Financing

Overall, the Government's responses to mitigate risks that may interfere with fiscal sustainability in 2013 was adequately able to bring the Government's financial operations under control. The Revised 2013 Budget deficit was maintained to a level of Rp209.5 trillion or the equivalent of 2.3% of GDP, Despite the increase compared to the revised 2012 state budget deficit amounted to Rp152.9 trillion or equivalent to 1.9% of GDP. Realization of the Revised 2013 Budget deficit was also much smaller than the potential increase of up to 3.8% of GDP if the government did not respond to various risks associated with the fuel price increase. In comparison to other emerging market countries, the Revised 2013 Budget deficit was also notably smaller, with the exception of the Philippines (Chart 7.7).

However, primary balance of the Revised 2013 Budget once again registered a deficit despite the manageable deficit of the Revised 2013 Budget. This development was spurred by sizeable amount of state expenditure excludiong debt interest payments. Primary balance deficit in 2013 was registered at Rp96.8 trillion or 1.1% of GDP, a higher than last year's deficit of Rp52.6 trillion or 0.6% of GDP. Nevertheless, Indonesia's primary balance deficit was still relatively manageable, as reflected in the Revised 2013 Budget deficit that was smaller compared to the deficits in a number of emerging market countries (Chart 7.8)[6].

In 2013, the financing for the Revised 2013 Budget deficit was supported by a strategy to improve efficiency and reduce financing risks. Government funding sources mainly derived from domestic financing. The front-loading strategy was no longer used, yet It modified with the adjustment in the Government Securities (SBN) issuance time in line with the needs of the state treasury. This strategy, in the majority of observations, resulted in lower realization of government securities issuance compared to the same period in the previous year. However, this efficiency advance encountered challenges related to substantial increase in SBN yields in line with rising inflation following the subsidized fuel price hike on June 22, 2013. SBN yields continued to increase and reached its peak by the mid-September 2013.

To finance this Revised 2013 Budget deficit, in addition to the issuance of the regular SBN, the Government also issued Indonesia Retail Bonds (ORI), global bonds, and foreign currency-denominated government securities (SUN) in the domestic primary market. The global bond issuance was part of the plan to issue the Global Medium Term Notes (GMTN) totaling US$25 billion, while the issuance of the foreign currency-denominated SUN and ORI for the domestic market represented part of the government securities market deepening strategy to. These issuances generally received a fairly good response from the market.

Overall, the financing strategy for the Revised 2013 Budget resulted in a Budget Financing Surplus (SiLPA) amounting to Rp20.5 trillion[7]. Total financing in 2013

6 With the exception of Indonesia, the 2013 data represents IMF's GDP projection whereby the GDP is calculated using Purchasing Power Parity (PPP).

7 Based on the Ministry of Finance's Press Conference on January 5, 2014, the current year's budget financing surplus is called SiLPA and

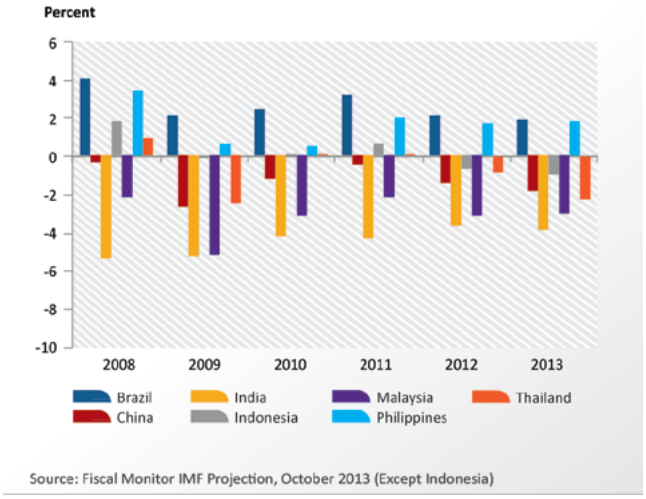


Chart 7.8. **Primary Balance in Emerging Market Countries**

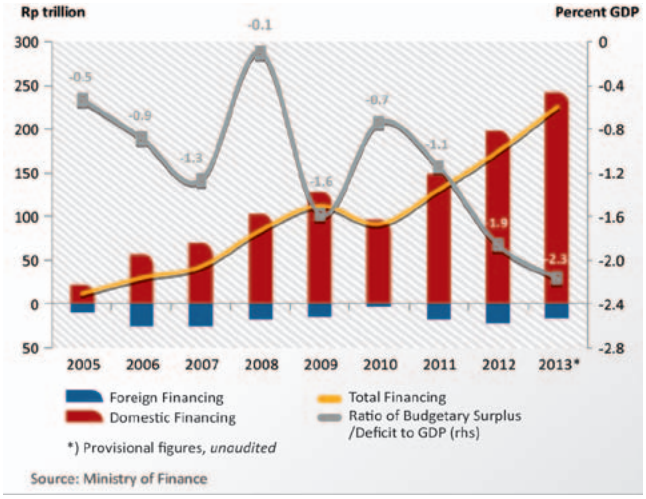


Chart 7.9. **State Budget Financing**

amounted to Rp230.1 trillion or 102.6% of the financing in the Revised 2013 Budget (Chart 7.9). The higher financing figure was a result of the full issuance of government securities in accordance with the budget and the Government's investment plan that were not realized in 2013. SiLPA accumulation can be used to fulfill carry over debt payments in subsequent years such as partial payment for fuel and LPG 3 kilograms subsidies in 2013 that has not been paid in 2013.

The 2013 Revised Budget deficit which was supported by this financing strategy subsequently supported the government debt to remain within a healthy level. Despite the nominal increase from Rp1,991 trillion in 2012 to Rp2,371 trillion, the government debt to GDP ratio in 2013 was only increase slightly from 24.0% of GDP to 26.1% of GDP in 2013 (Chart 7.10). Historically, this increase in debt to GDP ratio occurred for the first time following the declining trend in debt ratio since 2001. Despite some monitoring are needed for these developments, the ratio remained below the maximum debt ratio limit set in Law No.17 of 2003 regarding State Finance amounting to 60% of GDP[8]. This debt ratio showed that the government debt can still be optimized to increase the economy's capacity.

7.4. Regional Fiscal

Amidst manageable the Central Government's finances within the Revised 2013 Budget , regional fiscal performance was still below optimum. In terms of regional revenues, growth in 2013 showed that the role of balanced funds was still quite dominant as a source of income in most regions. Although the growth in locally generated revenues (PAD) increased quite significant at 24.5% in 2013, nationally, balance fund continues to be fairly sizeable, amounting to Rp432.7 trillion or about 66.3% of the total regional revenue (Chart 7.11).

The significant role of balance funds in regional revenues occurred in most of the regions. This is reflected in the average self-sufficiency ratios in a number of areas

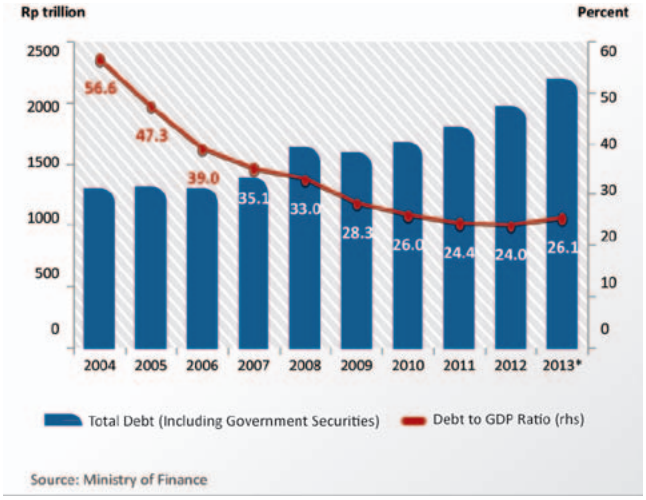


Chart 7.10. **Government Debt**

the Budget Financing Deficit is called SiKPA, while the accumulated results is referred to as Budget Balance Surplus (SAL).

8 Explanation of article 12, paragraph 3 of Law No. 17 of 2003 on State Finance stated that "The amount of loans (debt) is limited to a maximum of 60% of the Gross Domestic Product". This figure refers to maximum limit in the Maastricht treaty.

that remained to be quite low at around 29.5% (Chart 7.12)[9]. In this regards, the Jakarta area was an exception with share of locally generated revenues (PAD) to total revenues in the last 3 years amounted to more than 60%.

The high locally generated revenue in the Jakarta area mainly derived from tax revenues, specifically Land and Building Tax (PBB), motor vehicle tax and advertisement tax. The role of PAD in Jakarta was also reflected in the self-sufficiency ratio that remained high and on an upward trend since 2011 (Chart 7.12).

In terms of expenditure, the role of regional fiscal is still inadequate. This was reflected in the less than optimum absorption of regional expenditure towards the budget, although absorption towards the balance fund has increased. The data indicated that the absorption of regional government expenditure to balance funds in 2013 was slightly higher from 95.4% in 2012 to 101.1%. However, the average absorption of regional expenditure seemed to continue to be less than optimum as it is estimated to reach 92.5% of the budget. This figure was lower compared to the same period in 2012 (96.2%) and in 2011 (98.8%). Identification results showed that there were 13 provinces with below average expenditures and the lowest estimated expenditures occurred in Riau, which amounted to 79.7%. In contrast, there were 20 provinces with above average expenditures and the province of Central Sulawesi recorded the highest absorption of 99.7% (Chart 7.13). The underperformance of regional expenditures absorption subsequently affected the

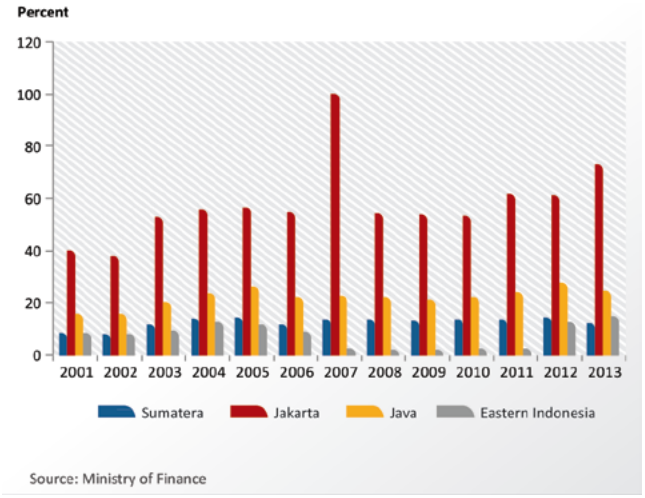


Chart 7.12. **Ratio of Regional Self-Sufficiency**

regional government account positions in banks which remained to be at a fairly high level amounting to Rp181.1 trillion, or an increase of Rp15 trillion relatived to the end of 2012.

The regional expenditure's role, which continued to remain under its optimum capacity, was also reflected in the regional expenditure components. Nationally, personnel spending in the regions continued to dominate regional expenditure, amounted to Rp296 trillion or 41.9% of total expenditure in 2013 (Chart 7.14). regionally, the largest figure of personnel expenditure

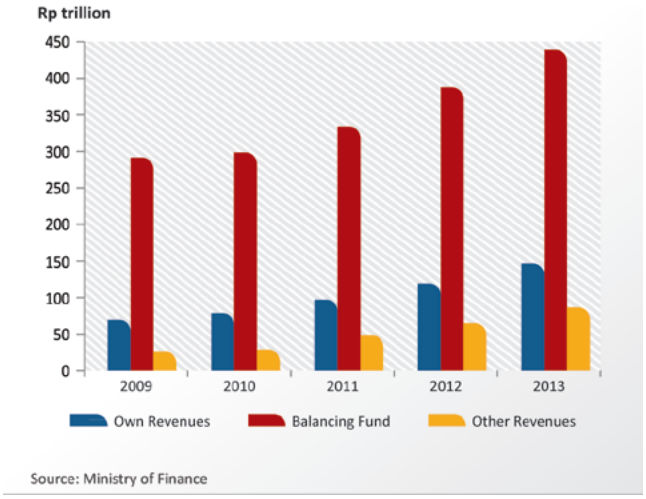


Chart 7.11. **Composition of Regional Revenues in APBD**

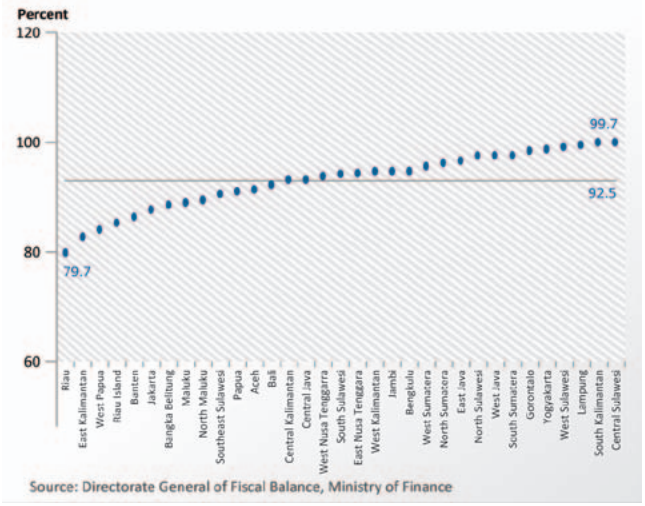


Chart 7.13. **Estimated Regional Expenditure (September 2013)**

9 The ratio of regional financial self-sufficiency is the ratio of locally generated revenues to total regional revenues.

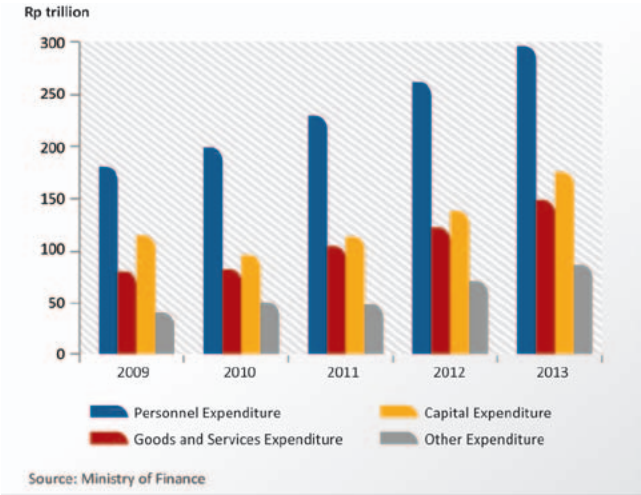


Chart 7.14. **Composition of Regional Expenditure in 2009-2013**

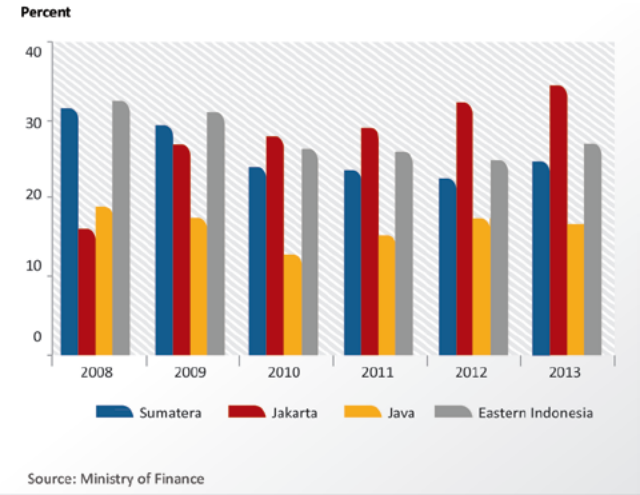


Chart 7.15. **Share of Capital Expenditure in the Regional Expenditure**

to total regional expenditure was in Java and Sumatra regions, while Jakarta recorded a relatively low figure. Meanwhile, capital expenditure has yet to increase significantly, reached 24.8% in 2013 compared to 23.2% in 2012. The low absorption of capital expenditure is partly due to agrarian issues related to land acquisition for infrastructure projects as well as procurement administrative constraints. The low capital expenditure was also associated with the main priority of expenditure allocation for a number of regional governments, which were largely absorbed towards the construction and renovation of government buildings (Chart 7.15).

Box 7.1. Absorption of Central Government Expenditure

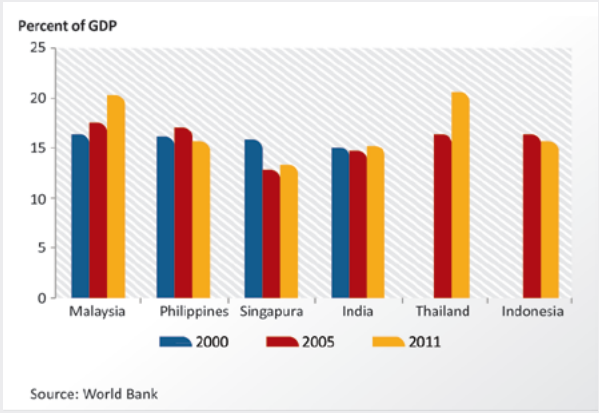


Chart 1. **Goverment Expenditure**

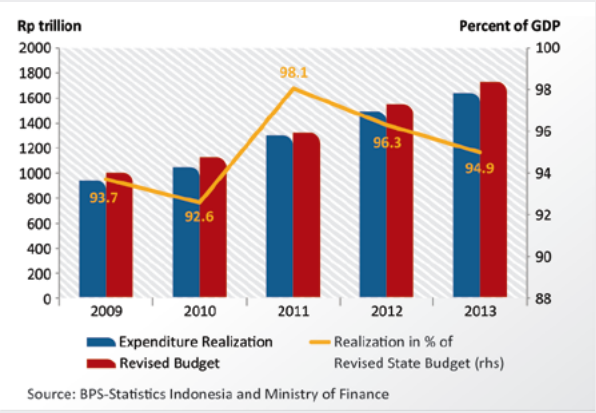


Chart 2. **Central Government Budget Absorption**

Through fiscal policy, the government has a vital role in maintaining and promoting economic growth. One of the tools that can be used by the government to maintain economic performance is through government spending. During times when the economy overheats, the government controls its expenditure as part of its effort to maintain economic stability. Meanwhile, in the event of an economic slowdown, the need to increase government spending arises to boost economic growth. Similarly, during times of external shocks, government expenditure acts as a stabilizer for the economy[1]. An empirical study using a sample of 30 developing countries showed a positive and significant relationship between government expenditure and economic growth[2].

Comparing between countries in the region, Indonesia's government expenditure ratio was relatively similar to countries within the region. The government's budget expenditure throughout the 2005-2011 reached an average of 16.6% of GDP, higher than in Singapore and India, while expenditure in Malaysia, Thailand, and the Philippines, were respectively averaging at 19.2%, 18.2% and 16.8% (Chart 1).

Nevertheless, the government's budget expenditure absorption has yet to be maximized. This was evident from the absorption of central government expenditure, which was always below the target since 2008 and even experienced a downward trend over the last three years (Chart 2). In line with this, the contribution of government consumption to GDP was also relatively stagnant in the last five years (Chart 3).

If subsidies and debt interest payments are excluded, the declining trend in government expenditure absorption is evident over the last 5 years, despite the

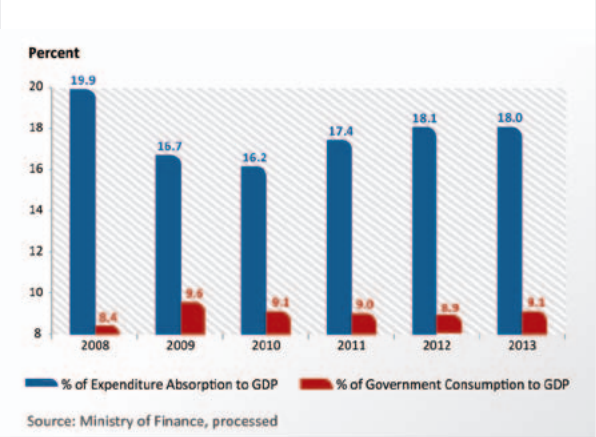


Chart 3. **Share of Government Expenditure and Consumption in the GDP**

1 Fiscal policy as a stabilizer to economic growth is referred to as countercyclical.

2 Bose, Niloy et al, Public Expenditure and Economic Growth: A disaggregated Analysis for Developing Countries, June 2003 includes Indonesia as a sample.

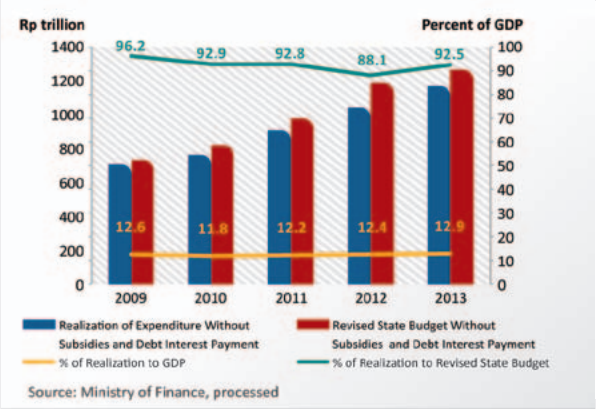


Chart 4. **Share of Government Expenditure Without Subsidies and Interest Payment**

slight increase in 2013[3] (Chart 4). The large increase in expenditure is mainly derived from the goods expenditure component, driven by activities related to the elections, as shown by the increase in the portion of goods expenditures to total expenditures (Chart 5).

Absorption of government expenditure in 2013 was hindered by factors related to land acquisition, level of prudence, and declining revenues. Land acquisition problems and the level of prudence have also affected the pace and effectiveness of the budget absorption. In addition to the inherent constraints on expenditure, declining revenue, particularly tax revenue, also affected absorption of the budget in 2013. Declining tax revenues led the Government to restrain its expenditure to maintain a sustainable fiscal condition that, among others, was indicated by the total deficit and primary balance. The realization of total in 2013 amounted to 2.3% of GDP, higher than 2012 deficit of 1.9% of GDP. Since the previous year, primary balance has registered higher deficit from 0.6% of GDP in 2012 to 1.1% of GDP in 2013.

On the other hand, the Government must also bear the cost for the Budget Financing Surplus (SiLPA) which represents a deviation between financing acquired by the Government and government deficit realization. In the last five years, the registered SiLPA was considerably large, with an average of 25.4% of total financing. The presence of SiLPA implied that there are potential funds that can still be used, while the Government must already paid the interest or yield on these funds. By the end of 2013, the Government's financial operations have used the Budget Surplus Balance (SAL) of Rp30.0 trillion but is expected to generate additional new SiLPA amounting to Rp20.5 trillion (Chart 6).

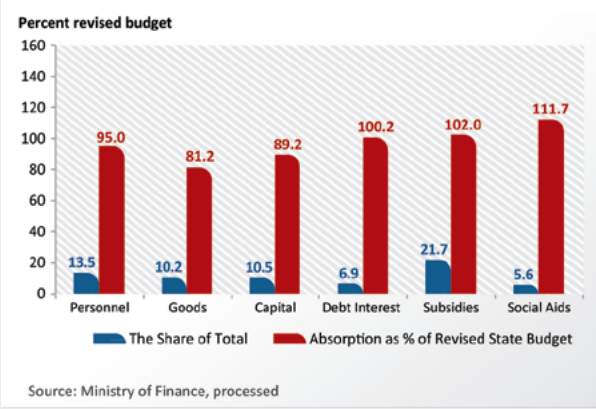


Chart 5. **Absorption and the Composition of Expenditure in 2013**

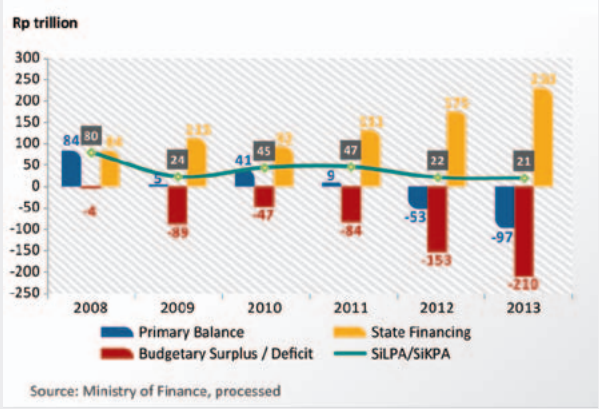


Chart 6. **Amount of Idle and Non-Disbursed Funds (SILPA)**

3 In this case, subsidy and interest are viewed as expenditure incurred by society (private consumption).

CHAPTER

8

Financial System

Financial system stability was generally well maintained thereby supporting economic adjustments. The financial system stability was primarily supported by a resilient banking sector. On the other hand, declining performance within equity market and bond market were due to rising global uncertainties and slowing domestic economy.

Financial system stability (FSS) was well maintained during 2013, despite coming under pressure in the second half of 2013 due to economic slowdown and global financial market turmoil. This was reflected in the Financial System Stability Index in 2013 which stood at 1.08 or relatively stable in comparison to 2012.

The well maintained FSS was in line with improved performance within the domestic banking sector, as shown by its ability to grow lending and profit, while supported by improved efficiency. Notwithstanding, these conditions prevailed as a result of various efforts carried out by the banks to maintain profitability amidst the domestic economic slowdown. Improved performance by the domestic banking sector was also supported by strong banking resilience. These factors, strong banking resilience and improved performance, provided the banking sector with ample room to absorb increased risks, particularly the potentially increasing credit risk. Nevertheless, these potential risks would still need to be adequately mitigated.

Meanwhile, the pressure on FSS was particularly felt within the equity and bond markets, despite recovering back at the end of 2013. Domestic equity market performance fell due to rising risk factors, both external and domestic. Despite falling, equity market performance in Indonesia was relatively better than that of in other countries within the region, such as China and Thailand. At the end of 2013, the Jakarta Stock Exchange Composite Index (JCI), whose performance previously fell, was able to rebound and avoided further fall. The bond market for Government Securities (SBN) was also able to achieve positive correction. The SBN market falling performance was reflected in the increased yield across all tenors, including the 10-year tenor. This momentum of increased yield and simultaneously reduced price was utilized by non-resident investors to increase their ownership.

8.1. Banking Sector Performance

Banking sector, as a part of Indonesia's financial sector, performed solidly while well maintaining credit, liquidity and market risks. Financial system stability was supported by positive performance of the banking sector, both in terms of its intermediary function as well as its efficiency.

Overall, the banking industry, which comprises commercial banks and rural banks (BPR), continues to dominate Indonesia's financial market structure. It is reflected in the growth of banking sector market share as a percentage of the financial system total assets, which stood at 78.8%, an

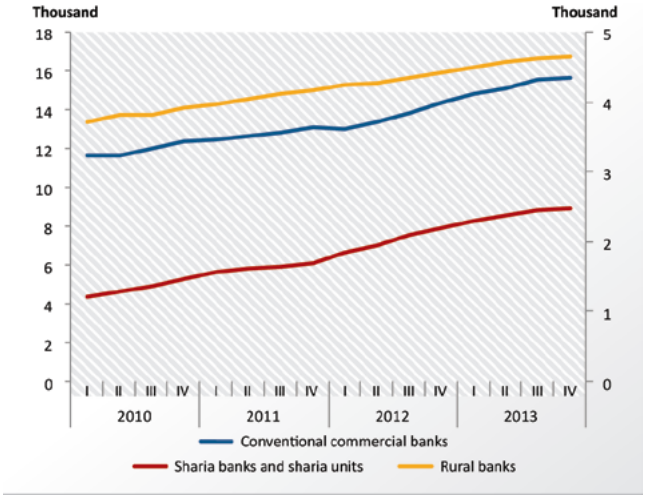


Chart 8.1. **Number of Bank Offices in 2010-2013**

increase from 77.9% in 2012[1]. The increase in total assets was supported by the expansion of banking network, while the number of commercial banks remained at 120 banks, comprising 109 Conventional Commercial Banks (BUK) and 11 Islamic Banks (BUS)[2]. This expanding network is evident from the increase in the number of BUK branches as well as BUS and Islamic Business Unit (UUS) branches (Chart 8.1). The number of BUK branches stood at 16,062 branches, an increase from 2012 which stood at 14,398 branches. Meanwhile, the number of BUS and UUS branches stood at 2,492, an increase from 2,227 branches in 2012[3]. In contrast, the number of rural banks at the end of 2013 declined by 14 rural banks, resulting from revocation of banking licenses (5 rural banks) and mergers (17 rural banks), followed by the opening of new rural banks (8 rural banks). Revocation of banking licenses and mergers of several rural banks were carried out in order to improve the resilience of the Rural Banks industry[4].

Growth in the network of bank branches, aside from supporting business expansions, was also geared to support improved public access towards the financial system (financial inclusion). This enhanced access can be measured, among others, by the ratio between total number of bank branches and total population (density ratio). With each coming year, the density ratio continues

1 Financial Stability Study, March 2014.

2 Total Sharia Business Unit was registered at 554 units, an increase compared to 493 in 2012.

3 The temporary figure is based on BUS and UUS data November 2013.

4 In 2013, the total number of Rural Banks amounted to 1,639 Rural Banks that comprise of 1,378 Rural Bank Corporations, 228 Regional Rural Bank Companies, and 33 Cooperative Rural Banks.

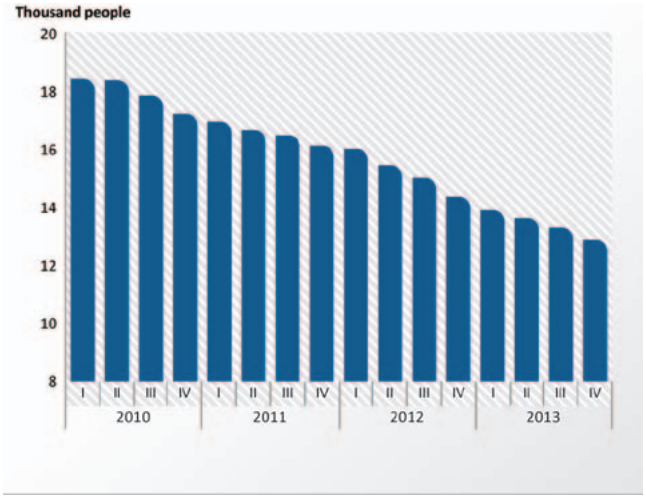


Chart 8.2. **Density Ratio**

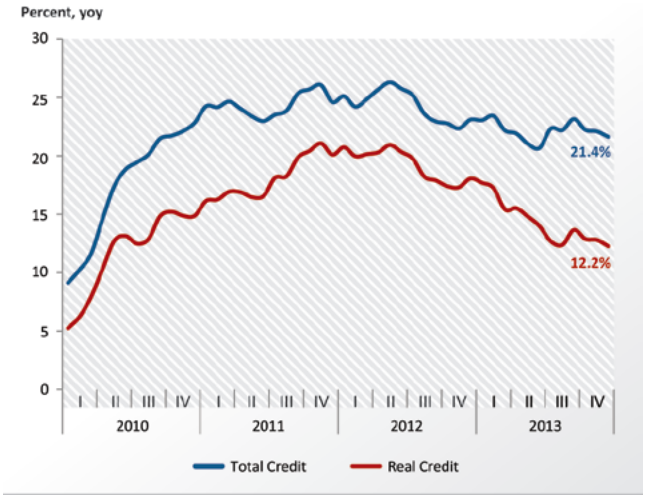


Chart 8.3. **Bank Credit Growth**

to show encouraging development. By the end of 2013, each bank branch serves 12,878 people, improving from 14,294 people per branch at the end of 2012 (Chart 8.2).

In terms of intermediation, banking sector performance continued to show positive growth despite slowing. In line with the economic slowdown, banking industry has adjusted its pace of credit expansion so that lending grew by only 21.4%, from an expansion of 23.1% in the prior year. It was carried out by banks in order to mitigate potential increase in credit risk (Chart 8.3). In real terms, credit growth slowed down significantly from 18.02% during the prior year to 12.2% during the latter year. The slowdown of lending growth mainly occurred within the consumption sector, particularly mortgage and motor vehicle loan, due to the Loan to Value (LTV)[5] policy enacted by Bank Indonesia since June 2012. In addition, banks also halted credit expansion towards corporates deemed sensitive to economic slowdown.

Meanwhile, banking role in national economic development intensified, as reflected in Indonesia's bank loan-to-GDP ratio at the end of 2013 which stood at 36%, higher than 32% in 2012. However, this ratio is deemed low in comparison to Indonesia's regional neighbours, such as Singapore, Malaysia, and Thailand, all of whom were above 100% (Chart 8.4). The relatively low bank loan-to-GDP ratio was the result of, among others, relatively high lending interest rates, in comparison to other countries, due to the high cost of funds.

In terms of purpose, productive sectors continued to dominate in comparison to consumer sectors. This condition was triggered by significantly increasing growth of Investment Loan (IL) towards 35%, compared to 27.4% in 2012 (Chart 8.5). In real terms, IL growth also increased towards 24.5%, from 22.16% in 2012. Growth of IL amidst the declining contribution of investment towards GDP showed that the business sector remained optimistic about national economic condition in the medium-to-long term. Furthermore, it also showed that corporates whom were financed by IL during 2013 would still require time in order to contribute to the economy. Meanwhile, growth of Working Capital Loan (WCL) tended to slow. WCL growth was only 20.43%, declining from 23.21% during the previous year. Within Consumer Loan (CL), growth was 15.25%, falling from 19.87% during 2012.

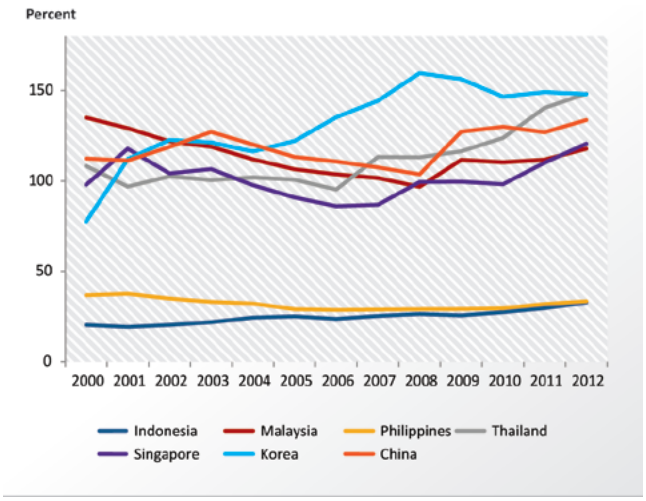


Chart 8.4. **Credit per GDP**

5 More explanation regarding the adjustments to the LTV policy is found in Chapter 11 Macroprudential and Microprudential Policy.

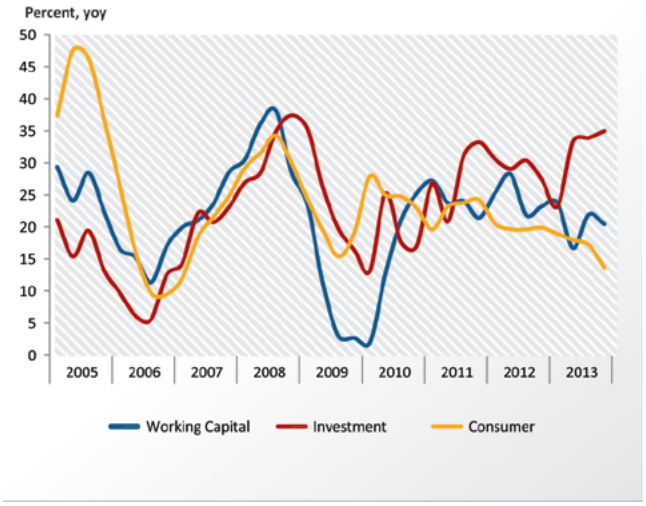


Chart 8.5. **Credit Growth by Type**

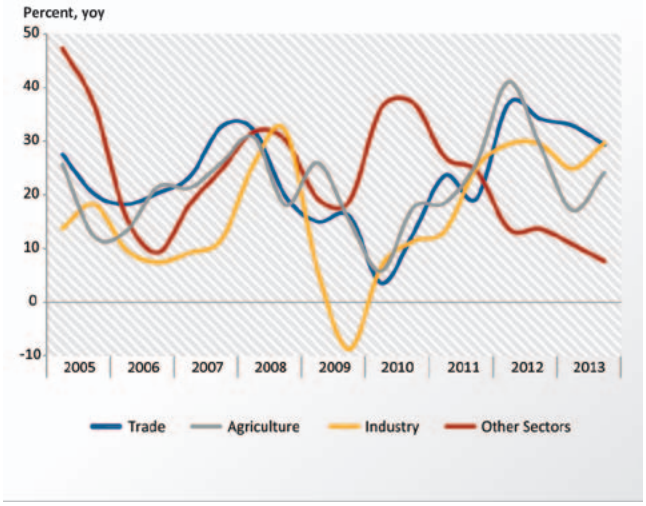


Chart 8.6. **Credit Growth in Four Main Sectors**

This was an impact of the LTV and Down Payment (DP) policy which came into effect since June 2012, and the further expanded LTV policy which has been in effect since September 30, 2013. In another note, the slowdown in CL growth was also due to increasingly selective lending by banks. It was meant to mitigate the potential risk of declined ability to repay debts within the low-to-middle class population, due to the impact of economic slowdown and rising inflation.

In terms of economic sectors, during 2013, almost all economic sectors experienced slowdown in loan growth compared with the previous year. Amongst the four economic sectors whose loan market shares are largest, the slowdown mainly occurred within the following sectors: trade, agriculture, and others (Chart 8.6). Slowdown in loan growth towards others sector was in line with the slowdown in consumer loan. Meanwhile, the slowdown in loan towards trade sector was in line with the economic slowdown and the government policy of price hike for subsidized fuel, thereby inducing merchants to act in a rational manner through maintaining adequate inventory of goods for fulfilling the respective demand. The slowdown in trade loan was also in line with the slowdown in sales of imported goods resulting from the policies to control the current account deficit by the Government and Bank Indonesia. Furthermore, growth slowdown in loan towards agricultural sector was specifically for loan towards the palm oil sub-sector. It was due to continually declining trend of Crude Palm Oil (CPO) prices in the international market since 2012. Economic slowdown and weakening of each respective currency against the US Dollar within several export destinations, such as China and India, had also led to a decline in Indonesia CPO exports in comparison to the prior year. On a further note, negative issues on Indonesia's CPO that was deemed not environmentally-friendly by several European countries and the US as well as declining production related to disturbance in the crop cycle, had also triggered the slowdown in Indonesia's CPO exports.

On the other hand, amidst the economic slowdown, growth in Micro, Small, and Medium Enterprises (MSME) loan until December 2013 stood at 15.7%, higher than 14.9% during the previous year (Chart 8.7). Compared with growth of non-MSME loan which had slowed since the beginning of the year, the slowdown in MSME loan had only started since September 2013 when it stood at 21.21%. Characteristics of MSME entrepreneurs who were generally oriented towards the domestic market and

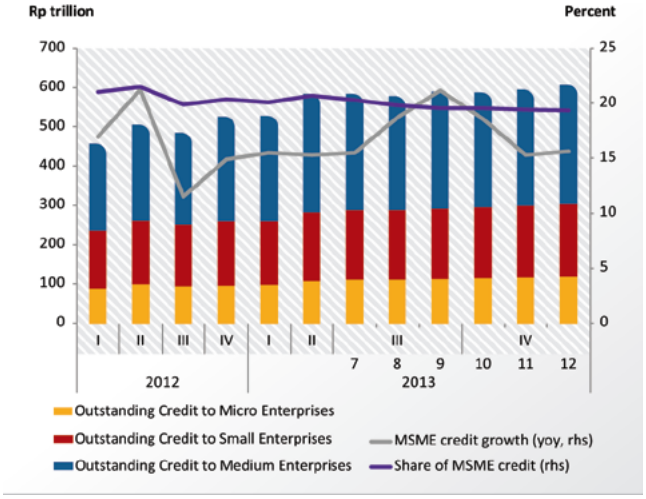


Chart 8.7. **Micro Small Medium Enterprise Credit**

targeting the low-to-middle class markets have led MSME entrepreneurs to be more resistant towards the weakening of Rupiah exchange rate. MSME loan were also largely targeted towards the trading sector with low import content. Notwithstanding, the decline in MSME loan which had occurred since the fourth quarter of 2013 was largely due to the economic slowdown and rising inflation, which then depressed consumer purchasing power. Against that backdrop, banks prioritize prudent principles in order to mitigate the potential for bad debts.

Despite increasing credit growth, the growth had not been able to boost the market share of MSME loan as a percentage of total bank lending. It can be observed from the ratio of MSME loan to total bank lending in 2013 which amounted to 19.4%, lower than 20.4% in 2012. The allocation was still dominated towards the medium-sized businesses. On a sector basis, the largest allocation of MSME lending remained towards the following sectors: wholesale and retail trade (53.1%), manufacturing (9.9%), and agriculture (7.9 %). The dominance of MSME lending towards trade-related sectors correlated with the human resources competencies of MSME's credit analysts who are generally more competent about the trade sector, as well as the potential credit risks which are more measurable. Furthermore, infrastructure support and location of banks within the urban areas which are mostly in closer proximity with the trade sectors have facilitated distribution and monitoring for loan towards the sector. The high allocation of MSME lending towards the trade sector is reflected in the loan growth towards this sector, growing to 29.8% from 22.9% in 2012.

In general, credit risk of MSME lending continues to be manageable, as reflected in the non-performing loan (NPL) figures which remain within a range between 3.2% and 3.6%, improving from a range between 3.2% and 3.9% during the prior year. It also shows that the credit risk of MSME lending continues to be well mitigated by banks. Therefore, share of MSME lending still has potential to be increased in order to achieve the minimum lending target allocated to MSME of 20% by 2018.

Meanwhile, distribution of small business loan (KUR) during 2013 had also recorded positive developments. Based on data from the Coordinating Ministry of Economic Affairs, KUR distribution during 2013 amounted to Rp40.8 trillion and achieving 113.4% of the target for 2013. Cumulative KUR realization from 2007 to 2013 amounted to Rp137.7 trillion. Geographically, KUR continued to be unevenly distributed and remained largely concentrated in Java (48.6%) which is the centre of the national economy, followed by Sumatera (22.6%), Kalimantan (10.4%), Sulawesi (10.9%), Bali (4.5%), and Papua-Maluku (3%). KUR dominance in Java correlates with the better availability of infrastructure and human resources for bank lending.

In terms of economic sectors, KUR remained dominated by the trade sector (62.9%) and the agricultural sector, including fisheries (19.9%). Dominance of KUR loan allocated to the trade sector was due to higher turnover and profitability of the trading business, and more measurable risks in comparison to other sectors. On the other hand, the low allocation of KUR towards the agricultural sector was due to its high assessed risk, as it was heavily influenced by nature factors.

To support lending growth, banks continued to rely on Third Party Funds (TPF) as the main funding source. TPF at the end of 2013 amounted to Rp3,526.2 trillion, growing 13.6% year-on-year, which was slower than its annual growth of 15.8% at the end of 2012 (Chart 8.8). The highest growth occurred within checking accounts and term deposits as a result of a shift in funding allocation from savings to term deposits due to tighter monetary policy.

Increase in lending which were not supported by an increase in TPF has prompted banks to liquidate their liquid assets. Relatively higher lending growth compared to TPF growth was also shown in the relatively higher nominal increase of loan growth compared to nominal increase of TPF. These then pushed the Loan-to-Deposit Ratio (LDR) to 89.9% (2013) from 83.8% (2012). To close the gap brought about by the shortfall of loan

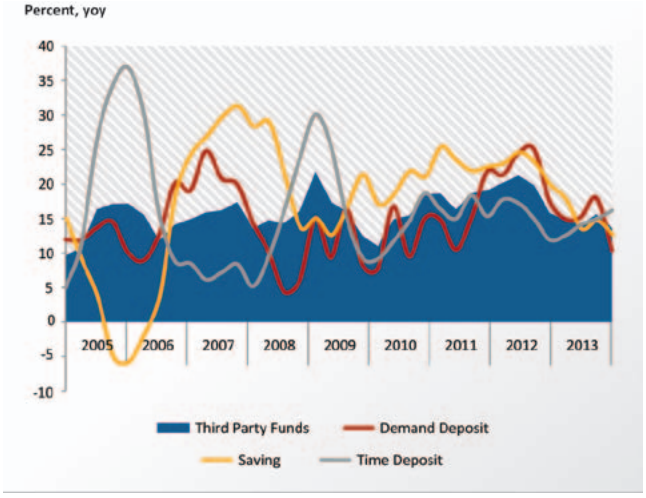


Chart 8.8. **Third Party Funds**

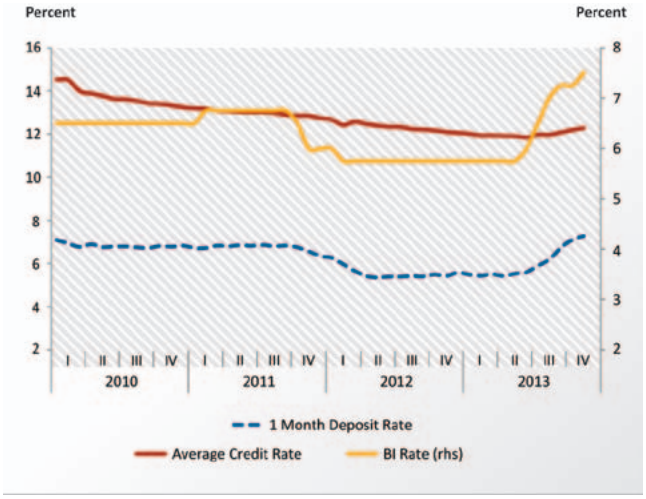


Chart 8.9. **Average Credit Rate, Rupiah Time Deposits Rate and BI Rate**

Chart 8.10. **Return on Assets (ROA)**

financed through TPF, banks liquidated their liquid assets comprising deposits at Bank Indonesia and other banks. The partial liquidation of deposits which were placed at Bank Indonesia up to the end of 2013 had not impacted the liquidity risk of the banking system. This was due to the industry's fairly high level of liquidity ratio, which was still sufficient to anticipate potential risk of fund withdrawals in the coming periods.

Unbalanced funding structure between lending and TPF has driven banks competition for TPF to increase. This has prompted some banks to raise their interest rates and even provide a special rate for large depositors thereby depressing banks interest rate spread. This condition was also reflected by the impact of BI rate hike, which was immediately responded by banks through raising TPF rates but not lending rates. This was consistent with the behaviour of banks which would generally adjust their lending rates between five and six months after a BI rate hike (Chart 8.9).

In terms of profitability, banks registered positive earnings growth and maintained Return on Assets (ROA) within the range of 3% (Chart 8.10). The banking industry average monthly net profit increased from Rp7.74 trillion in 2012 to Rp8.9 trillion. The increased profit was derived from interest income in line with higher lending volume and interest rates. Further, the increase in profit was also derived from other non-operating income, such as Allowance for Impairment Loss (CKPN). Nevertheless, economic slowdown as well as tighter spread between TPF and lending rate since the second half had resulted in the decline of Net Interest Margin (NIM) ratio for 2013 to 4.9%, lower than its level of 5.5% for 2012. The NIM was still relatively high in comparison to other ASEAN countries, such as Malaysia and Singapore, which were within the range of 2.6%.

In terms of banking efficiency, the ratio of operating expenses to operating revenue had improved. The ratio stood at 74.0% in 2013, better than 74.2% in 2012 (Chart 8.11). In terms of operating expenses components, the cost of funds increased in line with the hike in BI Rate. Notwithstanding, banks managed to enhance efficiency so that non-interest operational expenses (overhead cost) could be reduced. In terms of revenue, aside from the increase in interest income, there was also an increase in non-interest income (such as fee-based income) and a sizable improvement in Allowance for Impairment Loss (CKPN). As a result, the growth in operating expenses was relatively lower than the growth in operating revenue.

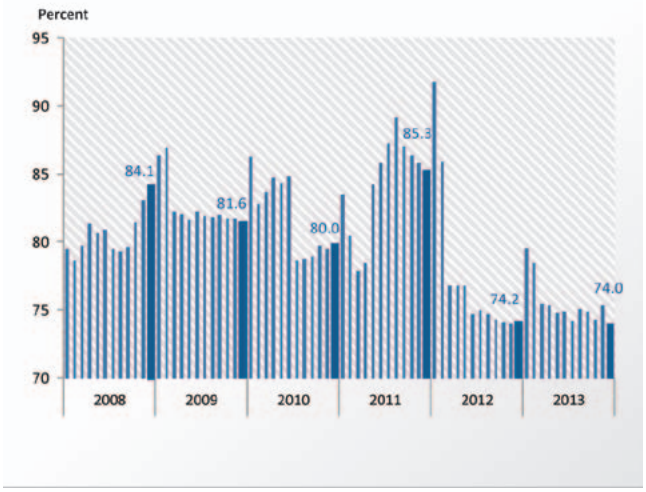


Chart 8.11. **Operation Expenses to Operation Income Ratio**

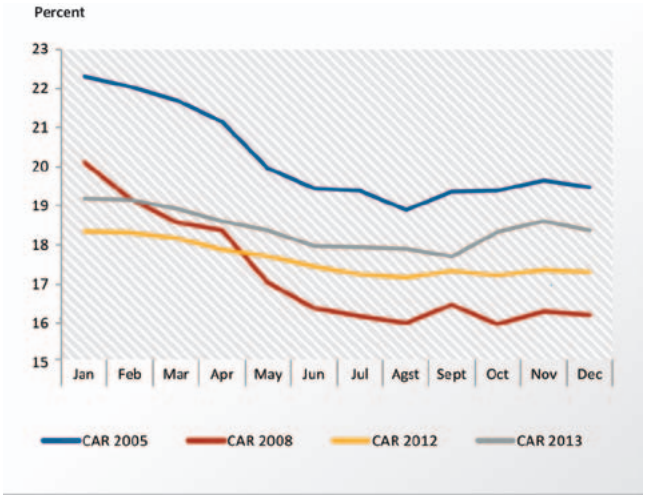


Chart 8.12. **Capital Adequacy Ratio**

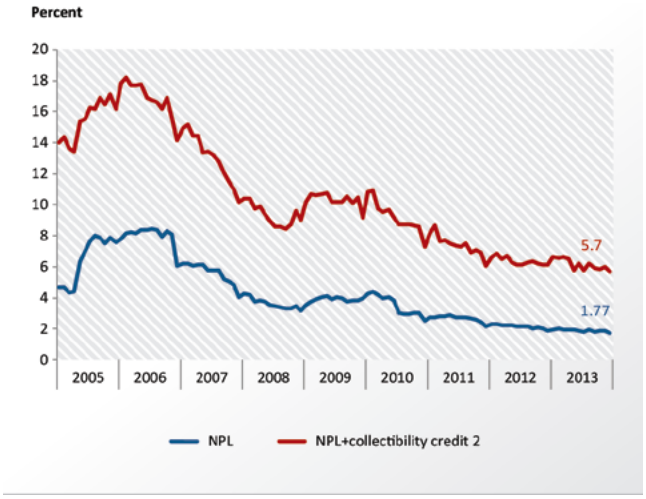


Chart 8.13. **Credit Risk**

From the capital aspect, domestic banking sector resilience improved amidst pressures brought about by the economic slowdown. This was reflected in bank capital that stood at Rp643.4 trillion in 2013, higher than Rp496.8 trillion in 2012. The Capital Adequacy Ratio (CAR) in 2013 was 18.4%, higher than 17.3% in 2012 (Chart 8.12). This increase came about due to policies enacted by Bank Indonesia wherein banks' capital ratios remained above the minimum required level[6], even higher than during the crisis of 2008. The increase in capital was primarily contributed by additional core capital of Rp135 trillion which was mostly derived from state-owned banks and several large commercial banks. Banks capital structure continued to be dominated by core capital (Tier 1), which amounted to Rp582.1 trillion (90.5%), while other components of capital (Tier 2 and Tier 3) only amounted to Rp61.3 trillion (9.5%)[7]. The industry high capital ratio provided banks with ample room to expand their business and to absorb additional risk potentially resulting from the economic downturn.

The credit risk of banks was generally also well maintained. This is reflected in the banking industry gross NPL ratio in 2013 which was 1.77%, lower than the NPL in 2012 which was 1.87% (Chart 8.13). The decline in NPL was the result of banks intensive application of prudential policy for lending, amidst weak economic growth, rising inflation, and depreciating exchange rate. Banks have also mitigated credit risk towards, among others, several sectors which were deemed sensitive to economic downturn, debtors which receive foreign currency loan while generating Rupiah cash flow, and debtors which were deemed sensitive to increases in lending rates. The efforts carried out by the banks are expected to intensify during 2014, thereby maintaining the stability of the financial system.

NPL of MSME was also relatively manageable within the range between 3.2% and 3.6%. The highest NPL was in the construction sector which stood at 4.8%, due to increases in raw material prices, which are mostly imported goods. This culminated as a result of weakening Rupiah exchange rate against the US$ and rising interest rates. However, given the relatively small share of MSME loan towards the construction sector, it did not have any significant impact on the overall NPL of MSME.

Meanwhile, the increase in NPL of KUR during 2013 was also manageable in line with the available support from the loan guarantee scheme. NPL of KUR was 3.1% in 2013, lower than 3.5% during the previous year, as a result of various risk mitigation efforts carried out by banks along with the government.

In the liquidity context, liquidity risk continued to be well-maintained amidst external shocks and tight monetary policy. Banking industry liquidity slightly declined during the second half of 2013 but remained relatively safe. The decline in liquidity was due to relatively higher credit

6 Based on BI Regulation No. 14/18/PBI/2012 regarding CAR whereby Banks are required to allocate minimum capital in accordance with the risk profile, banks are required to have an Internal Capital Adequacy Assessment Process (ICAAP), Bank Indonesia will carry out a review of the ICAAP or referred to as a Supervisory Review and Evaluation Process (SREP). The calculation for minimum capital in accordance with the risk profile was initially carried out for the March 2013 position by using the risk profile ranking as of December 2012.

7 Tier 1 Capital refers to the paid up capital added with accumulated profit. Tier 2 Capital is the supplementary capital. Further explanation can be found in BI Regulation No. 10/58/PBI/2008 regarding Minimum Capital Adequacy Requirements for Banks.

expansion in comparison to TPF increase during 2013, which therefore encouraged banks to utilize alternative sources of funding, such as liquidating some of their placements at Bank Indonesia. Nevertheless, the industry liquidity ratio continued to be adequate in anticipating potential risks of fund withdrawals in the coming period. To ensure adequate banking liquidity, Bank Indonesia issued a range of policy-mix during the second half of 2013. The policies, among others, comprised reducing the upper limit on Secondary Reserve Requirement and LDR-based Reserve Requirement[8]. These efforts had culminated in increased liquidity of banks, beginning since the fourth quarter of 2013, while LDR remained stable at 89.9% in December 2013.

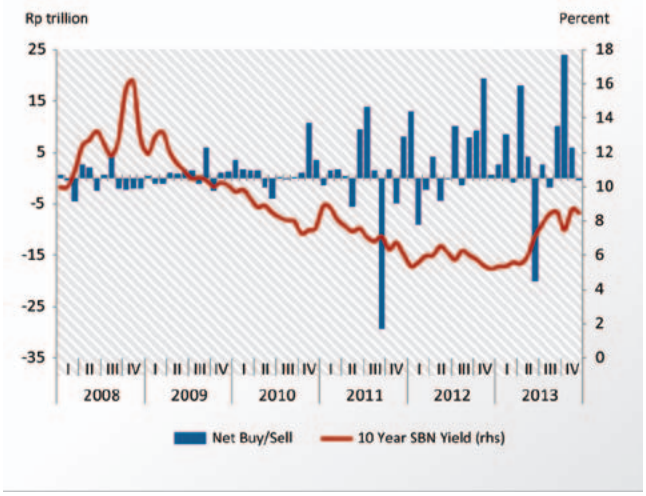


Chart 8.14. **SBN Yield and Net Buy/Sell of Foreign Investors**

8.2. Financial Markets and Non-Bank Financial Institutions

Bond Market

The negative sentiment stemming from global and domestic economic developments has caused the decline of the Government Securities (SBN) performance in the market. In global terms, sentiment was driven by risks over global uncertainty and concerns over the tapering off by the Fed. Bernanke's statement in May 2013 which indicated that the tapering-off was to be implemented in the near future was one of the initial triggers for the declining performance of the SBN market (Chart 8.15). On the domestic front, the sentiment derived from fears of rising inflationary pressure resulting from the subsidized fuel price increase, slowing economic growth, external imbalances and the weakening Rupiah exchange rate. The tight monetary policy response by increasing the BI Rate in 2013 on June 13 (25 bps), July 11 (50 bps), August 29 (50 bps), September 12 (25 bps), and November 12, 2013 (25bps), also had a significant impact on rising yields on SBN. The general upward trend of SBN yields continued until the end of 2013.

SBN's declining performance was restrained as a result of Bank Indonesia's policies. The declining performance of the SBN market is reflected by the increase in the yield for each tenor including the 10-year SBN (Chart 8.14). The yield on the benchmark 10-year SBN at the end of 2013 was registered at 8.5% or an increase of 329 bps compared to the same period in 2012 of 5.2%. Despite this, the rising trend on SBN yields was somewhat restrained, which was due to Bank Indonesia's strategy to implement a dual intervention strategy in the SBN and foreign exchange (forex) market. Bank Indonesia's strategy was intended to mitigate risks while at the same time continue to manage the liquidity of the Rupiah in the money market. In addition to this, the August release regarding improved NPI projections also played a role in restraining the increase in SBN yields (Chart 8.15).

In line with efforts to restrain rising yield or declining prices within the SBN market, non-resident investors registered an increase in their SBN holdings (Chart 8.16). Following the net sale experienced in June 2013, non-resident investors registered net buying in the months of September and October 2013 amounting to Rp10.1 trillion and Rp24.0 trillion respectively. Non-resident buying was a result of the positive market perception on improved economic fundamentals of Indonesia.

In the primary market, the performance of the SBN market declined as reflected in the high yields offered. For example, yield for 1-year tenor SBN at the end of 2013 was 6.6%, higher than in 2012 of 4.2%. The high yields prompted the Government to hold back SBN auctions on multiple occasions, without disrupting fiscal financing. Meanwhile, amidst rising SBN yields throughout 2013, SBN (net) issuance amounted to Rp232.7 trillion, which represents an increase compared to Rp177.1 trillion in 2012.

8 Bank Indonesia Regulation No. 15/7/PBI/2013 dated 26 September, 2013 regarding Second Changes to Bank Indonesia Regulation Number 12/19/PBI/2010 regarding Required Minimum Deposit for Banks in Bank Indonesia denominated in Rupiah and Foreign Currency.

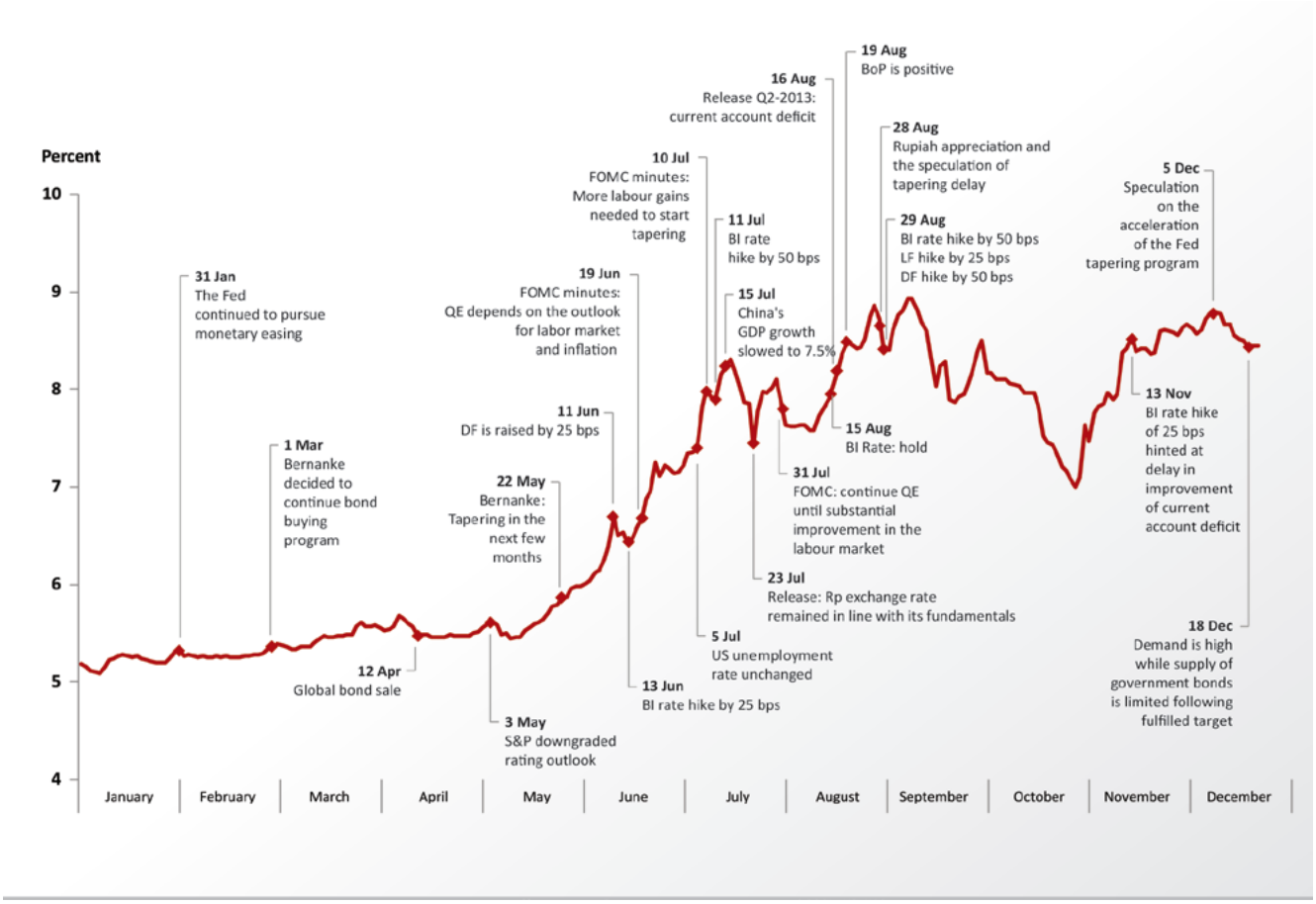


Chart 8.15. **Factors Influencing SBN Yields in 2013**

The corporate bond market's performance declined slightly, particularly within the primary market. Corporate Bond issuances throughout 2013 amounted to only Rp55.3 trillion, which was significantly lower than Rp65.7 trillion achieved in 2012. Corporate bond issuances were dominated by multi-finance companies followed by banks. Although the Government continued to relax capital market regulation regarding continuous bond issuances[9], the corporate bond issuances had yet to perform as good as expected . The high risks faced by corporates when issuing bonds within the second half of 2013 cast bond issuances down. These risks, specifically pertaining to global uncertainty and higher interest rates, can result in higher costs for issuers. Some companies tended to delay their planned bond issuance in 2013 pending more favourable market conditions in the coming year.

Stock Market

The domestic stock market registered a decline in performance in 2013, despite showing some signs of strengthening within the first half of 2013. In the first half of 2013, the Jakarta Composite Index (JCI) performance continued to strengthen and was characterized by expectations of great performances. However, throughout its development, external and domestic risk factors intensified leading to a correction for the JCI. By the end of 2013, the JCI reached a level of 4,274.2, or down 0.98% compared to 2012 that amounted to 4,316.7 (Chart 8.17). The Indonesian stock market's performance was still better than those of other countries within the region, such as China and Thailand (Chart 8.18).

The domestic stock market, which strengthened up to May 2013, was influenced by positive sentiment from China and the US (Chart 8.19). The positive sentiment from China was related to its improved economic data in January 2013. Meanwhile, the statement of the Federal Reserve Governor, Ben Bernanke, to maintain the bond-buying program in March 2013, was deemed positive

9 Continuous Bond is a new variety of Bond, whereby BAPEPAM-LK (OJK) provided the flexibility for companies to issue bonds within a timeframe of 2 years, by only requesting a 1 time effective permit (BAPEPAM-LK Regulation IX.A.15 regarding Continuous Offering dated December 30, 2010)

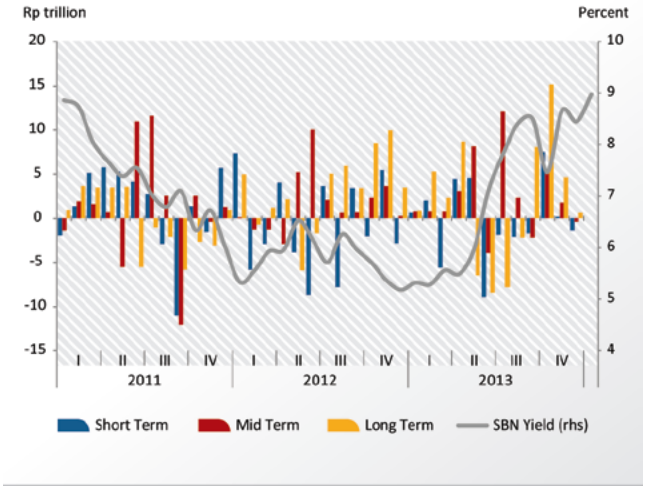


Chart 8.16. **Net Buy/Sell of Foreign Investors in the Government Bond Markets by Tenor**

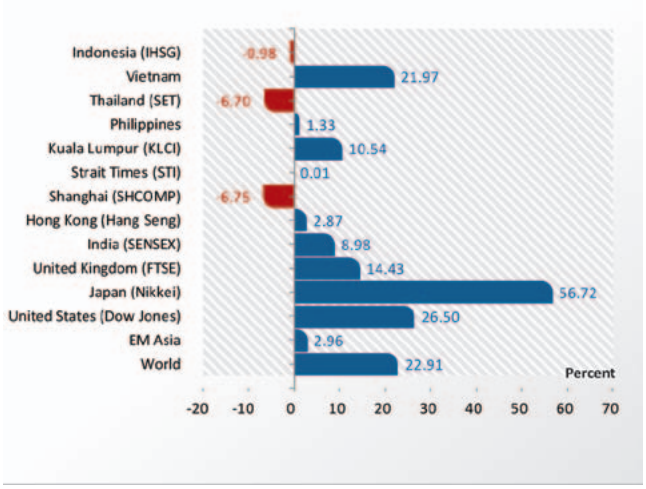


Chart 8.18. **JCI and Global Stock Markets in 2013**

and strengthened the JCI even further. In line with this improved performance, non-resident investors registered a net purchase of Rp18.77 trillion within the first quarter of 2013.

The stock market's performance after the months of May 2013 experienced pressure along with portfolio adjustments made by investors in emerging market countries, including Indonesia. The pressure on the stock market was triggered by negative sentiment stemming from both domestic and global economic shifts. On the domestic side, the negative sentiment originated from fears of rising inflationary pressures, a depreciating exchange rate and widening current account deficit. Balance of payments data released in the second quarter of 2013 indicated that the reasonably wide current account deficit has had an added pressure of correction on the JCI. From a global perspective, the negative sentiment derived from concerns for the Fed's intention to apply the 'tapering off' as well as concerns due to increased geopolitical tensions in the Middle East. Bernanke's statement in May 2013 that indicated the tapering off will be applied within the next few months served as the initial trigger for a correction on the stock index.

The negative sentiments stemmed from both domestic as well as global developments led non-resident investors to reduce their holdings in the stock market. In the second quarter of 2013, non-resident investors booked a net sale amounting to Rp19.8 trillion. Meanwhile, in the second half of 2013, non-resident investors continued to register a net sale amounting to Rp19.7 trillion (Chart 8.20).

Bank Indonesia and the Government pursued successfully a range of policies to cope with the pressures, which had an indirect positive impact as the stock market rebounds. By the end of 2013, the JCI rebounded and was thereforerestrained from an even deeper correction. In this context, investors reacted positively to the implementation of tight monetary policy and the government's policy packages aimed at controlling the current account, maintaining the exchange rate, sustaining economic growth, as well as protecting purchasing power and managing inflation. These range of monetary and fiscal policy served as guidance for the market on the direction and prospects for Indonesia's economy that will improve in the years to come. The optimistic view was indicated by increase in the domestic

Chart 8.17. **JCI and BI rate**

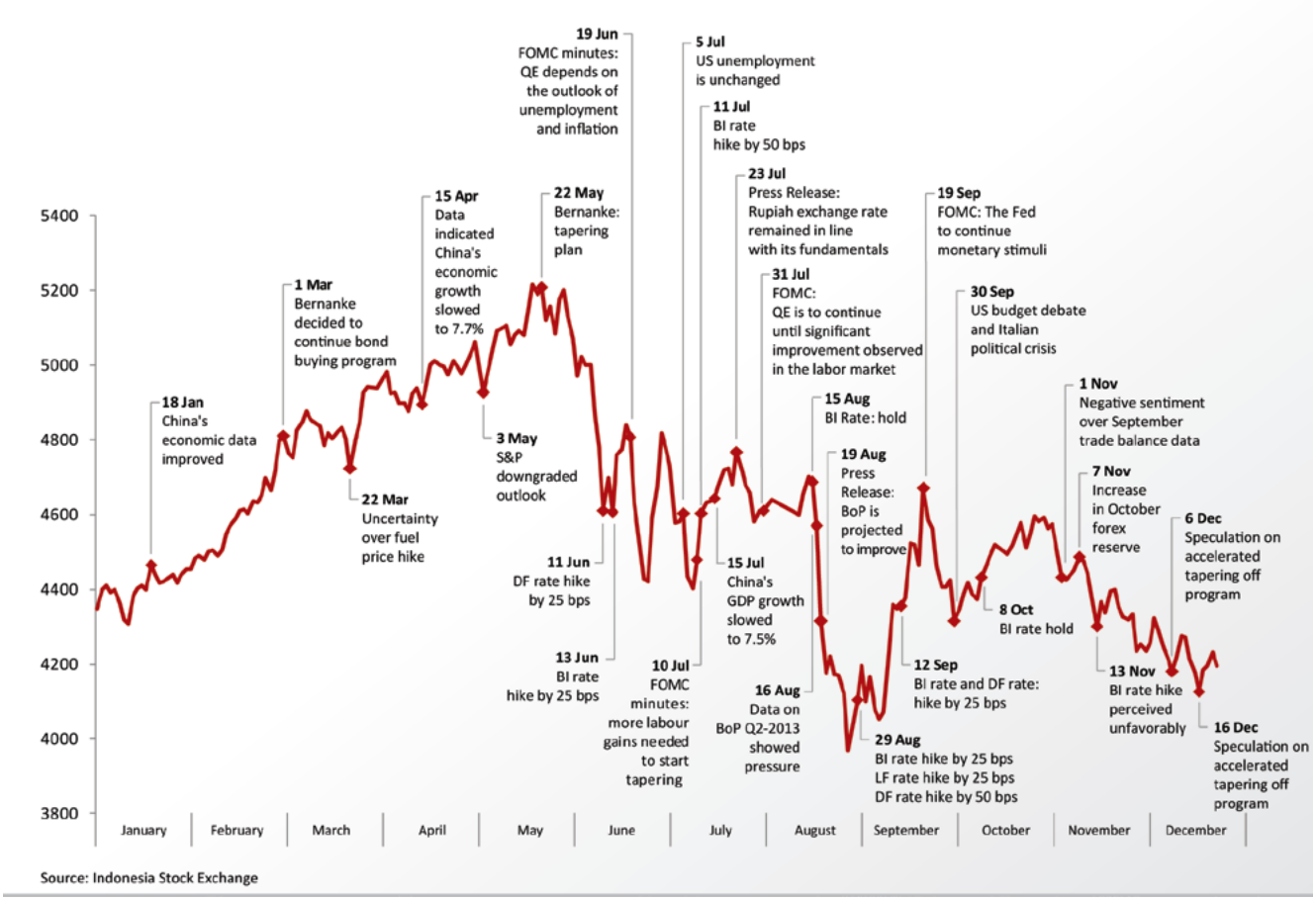


Chart 8.19. **Factors Influencing JCI in 2013**

stock market capitalization, which amounted to Rp4,219 trillion in 2013, higher than 2012 of Rp4,127 trillion. Overall the JCI in 2013 declined slightly compared to that of 2012.

The rebounding JCI's also provides an indication of a better fundamental for both issuers and economic sectors. In terms of a issuers' fundamentals, corporates net profit growth of 8.3% in 2013[10] served as a positive factor to drive the JCI. Meanwhile, on a sector basis, the contribution of key sectors that played a major role in the JCI's formation underwent a significant shift. The role of commodity sector stocks declined, while consumer and trading sector shares once again showed substantial contribution to the JCI.

Amidst the domestic and global upheavals, the primary market's performance showed signs of improvement. Throughout 2013, the amount of financing in the form of rights issues was valued at Rp40.8 trillion, which represents an increase compared to Rp19.8 trillion in 2012. Meanwhile, after a decline in 2012, the amount of financing in the form of Initial Public Offering (IPO) grew. In 2013, the total value of IPO was registered at Rp16.7 trillion, representing an increase compared to Rp10.4 trillion in 2012.

Non-Bank Financial Institutions (NBFI)

Amidst the turmoil in the financial markets, the insurance industry, mutual funds, finance companies and pension funds continued to show a sound performance. The total assets of the insurance industry increased significantly to Rp623.6 trillion. Similar condition is also reflected in the increase in Net Asset Value (NAV) of mutual fund companies, which amounted to Rp185.5 trillion. Meanwhile, finance companies and pension fund providers registered an increase in the value of assets amounting to Rp420.3 trillion and Rp162.5 trillion respectively. Overall, the share of financial assets

10 The Issuers Financial Statement Data as of September 2013 compared with September 2012, Indonesia Stock Exchange (IDX).

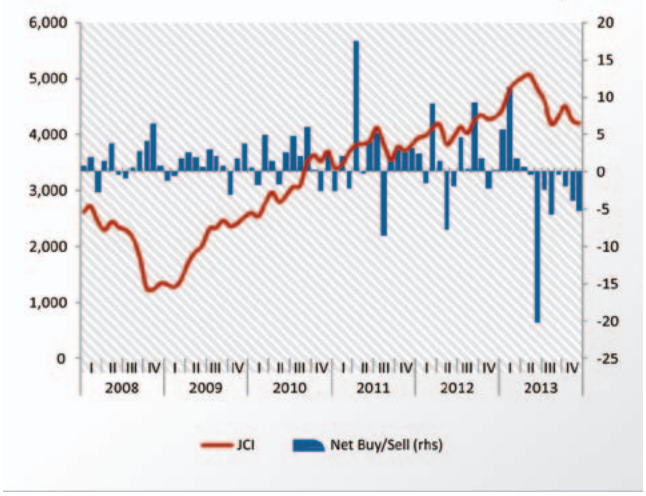


Chart 8.20. **JCI and Net Buy/Sell by Foreign Investors**

held by the insurance industry as well as finance companies and pension funds amounted to 9.9%, 6.7% and 2.6% of the financial system's total assets respectively[11].

Overall, NBFI registered positive growth in 2013. Insurance companies recorded significant growth in 2013, whereby its role in managing risk in the financial market was well maintained. This is demonstrated by the growth in total assets in 2013 that amounted to 9.2%. Finance companies also recorded significant growth in 2013, whereby its contribution to the economy was well maintained. In 2013, assets of finance companies grew by 15.3%. Meanwhile, pension fund's assets also grew positively, albeit in limited rate of 2.6%.

NBFI's positive growth, particularly in Insurance and Pension Funds, is also due to changes in investment strategy and improvements in the industrial structure. The investment policy direction of insurance companies and pension funds has begun to shift. This is partly reflected by, among others, the increasing types of stock-based investments, bonds and mutual funds on a proportionate basis. Previously, the dominant type of investment was in the form of time deposits. In addition to its positive impact on the development of domestic financial markets, this improvement drove better financial performance for NBFI. Meanwhile, continuing on the trend of previous years, improvements to the industrial structure, among others, are characterized by the increasing role of pension funds compared to employer pension funds (EPF).

11 Insurance and Financing Company Data as of September 2013, Pension Fund Data as of October 2013 and Mutual Fund Data as of December 2013 (Source: Bank Indonesia and Financial Services Authority).

Investor Structure

Developments within the national stock market show that the role of domestic investors has declined. This is reflected by the share of domestic investors in 2013 of 37.1% that was lower than the 41.2% in 2012. As a result, the contribution of foreign investors continues to be dominant with a share of 62.9 % in 2013. Moreover, the contribution of institutional investors, for both foreign and domestic, was still quite substantial.

Despite the declining role of domestic investors in the stock market, domestic investors continue to play a major role as a shock absorber to offset the dominance of foreign investors. This is reflected in the still-solid JCI despite foreign investors continuing to post net selling in the stock market. Going forward, the relatively more balanced market structure will enhance the role of domestic investors as a shock absorber. This in turn will contribute positively in maintaining the stability of the financial markets.

In the government securities market, non-resident investors and domestic banks continued to dominate price movements in 2013 (Chart 8.21). As in 2012, the high appetite of foreign investors on the SBN market in 2013 was a reflection of the global investor's strong confidence over favourable economic conditions in Indonesia as well as attraction to its competitive yields. This is reflected in the growing holdings of foreign investors in the SBN market despite rising yields. Throughout 2013, non-resident ownership in SBN amounted to Rp323.8 trillion, which represents an increase compared to Rp270.5 trillion in 2012. Although the role of foreign investors continues to be dominant, domestic investors have, however, gradually been able to offset the effects of adjustment made by foreign investors.

Meanwhile, the increasing role of banks, insurance institutions and domestic pension funds within the SBN market simultaneously was able to be a

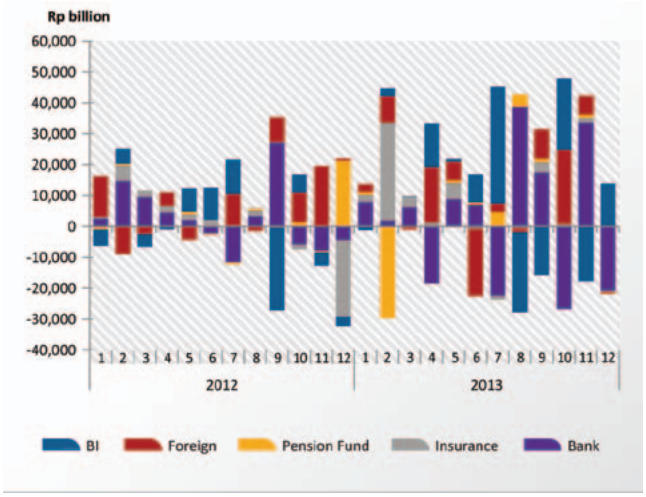


Chart 8.21. **Investors of SBN**

stabilizer for selling pressure employed by non-resident investors. The dynamics of the SBN market throughout 2013 also showed the increasingly balanced composition of SBN holdings among investors, particularly the banking sector. This was also attributable to Bank Indonesia's intent to use SBN as a monetary instrument. The more balanced market structure has also contributed positively to the better price formation in the SBN market.

Financial Market Products

Greater array of investment products offered brought about improved performance of the domestic financial markets. The increasingly varied products on offer sought to broaden the coverage of investors as well as to diversify risks for the benefits of investors and issuing firms. Various products that combined features of insurance and investment that continued to be introduced were positively accepted by the public. Increased variety of investment products was also driven by the mutual fund industry. In this regard, collective investment products based on asset-backed contracts, including Real Estate Investment Trust (REIT), and limited participation fund products have became alternative investment options. Total value of assets under management of mutual fund companies amounted to Rp185.5 trillion.

Meanwhile, finance companies were increasingly focusing their businesses on short-term consumption sectorsgiven that their main source of funding derive from bank loans. This is carried out while simultaneously taking into consideration efforts to improve risk management. Total financing throughout 2013 amounted to Rp348 trillion, which among others, were in the form of consumer finance (Rp223 trillion), leasing (Rp117.3 trillion), factoring (Rp7.7 trillion) and credit cards (Rp4 trillion).

CHAPTER
9

Payment System

In 2013, payment system was secure, efficient, smooth, and well maintained. This condition was represented both in the non-cash payment system and currency management. The advanced payment system supported a robust economic development and financial system stability.

The performance of non-cash payment system and currency management in 2013 managed to support monetary and financial system stability as well as expediting national economic activities. The reliable payment system as infrastructure of the financial system was reflected by the availability of payment system based on the service level agreement. In 2013, the payment system operated by Bank Indonesia served about 4.0 billion transactions without any system down. The number of transactions increased 22.6% from 2012 which saw 3.3 billion transactions. The good performance of non-cash payment system was a result of consistent Bank Indonesia's policy to ensure the non-cash payment system could run efficient, secure, smooth and well-maintained as an Indonesia's economic pulse.

Meanwhile, the performance of currency management was reflected by Bank Indonesia's capability in providing sufficient amount of cash in different denominations, a timely manner and proper conditions, amidst the increasing needs for cash. The higher needs for cash aligned with Indonesia's economy growth, despite slightly slowing from 2012. In 2013, the daily average figure of currency in circulation (UYD) was recorded at Rp420.9 trillion, increase from 2012 which reached Rp370.6 trillion. The increasing needs for cash was also due to several government policies which increased the people's purchasing power, such as the increase in Provincial Minimum Wage (UMR), the increase in Non-Taxable Income (PTKP) and the disbursement of Direct Cash Transfer to the People (BLSM). Moreover, the needs for cash also rose as the higher people engagement, particularly on religious holidays and holiday seasons. To meet the increasing demand for cash, Bank Indonesia anticipated by ensuring all phases of currency management activities -- planning, printing, issuing, circulating, withdrawing and destroying rupiah banknotes -- to be well-performed.

As the authority that issued rupiah currency, Bank Indonesia continued to maintain the condition of banknotes and coins circulation and optimize the prevention of counterfeit banknotes. In maintaining the condition of rupiah currency, Bank Indonesia pursued a clean money policy, by withdrawing currency unfit for circulation (UTLE) to be replaced with new banknotes and coins. Bank Indonesia also consistently and continuously encouraged banks and community to report banknotes with a suspected authenticity to Bank Indonesia.

9.1. The Performance of Non-Cash Payment System

The role of non-cash payment system in supporting the economic activities remained resilient amidst domestic economic slowdown and high inflationary pressure. The performance of payment system in the reporting period was efficient, secure, smooth and well-managed in functioning as a settlement medium for all non-cash payment system transactions. It is demonstrated with zero system down recorded in the reporting period, particularly in the system operated by Bank Indonesia. Throughout 2013, payment system performed both by Bank Indonesia and the industry managed to serve transactions worth Rp97.5 thousand trillion, despite its decline of 6.9% from 2012 which reached Rp104.8 thousand trillion. The decline in transaction value was not caused by the decline in performance of payment system infrastructure; it was rather due to the decline in value of monetary operation (OM) transactions conducted by Bank Indonesia, in line with its monetary policy stance. Throughout 2013, the OM transaction value was recorded at Rp46.2 thousand trillion, down 23.6% from 2012 which reached Rp60.5 thousand trillion. Meanwhile, the total volume of non-cash payment system transactions in 2013 was recorded at 4.0 billion transactions, a 22.6% increase from 2012 which reached 3.3 billion transactions.

The role of retail payment system in supporting economic activities increased along with higher transaction value of retail payment system. Transaction value through retail payment system, which consisted of transaction value from Bank Indonesia National Clearing System (SKNBI), Card Based Payment Instruments (APMK) and electronic money, with a portion amounting to 6.0% of total non-cash payment system transaction value, was recorded at Rp6,566 trillion. The value rose 20.7% from the 2012 transaction value which reached Rp5,439 trillion. The increasing role of retail payment system in supporting economic activities was also shown through the rising ratio of retail payment system value to the GDP. In 2013, the ratio was recorded at 0.72, increasing from 0.66 in 2012. This is in line with the increase in nominal value (current price) of consumption in 2013 which grew to 12.0%. The ratio of retail payment system transaction value to nominal value (current price) of

consumption in 2013 was 1.29, higher than the previous period which reached 1.21 (Chart 9.1)[1].

The increase in non-cash payment system transaction volume was boosted by the development of retail payment system as an alternative of payment instrument. The retail payment volume in 2013 stood at 3.9 billion transactions, rose 23.0% from 2012 which reached 3.2 billion transactions. This is a result of Bank Indonesia's policy in increasing the usage of non-cash payment instruments, among others by pushing for interconnection between principles of Automated Teller Machine (ATM)/ debit card in payment system operation particularly fund transfer feature between principles, and Bank Indonesia's policy to boost electronic money usage.

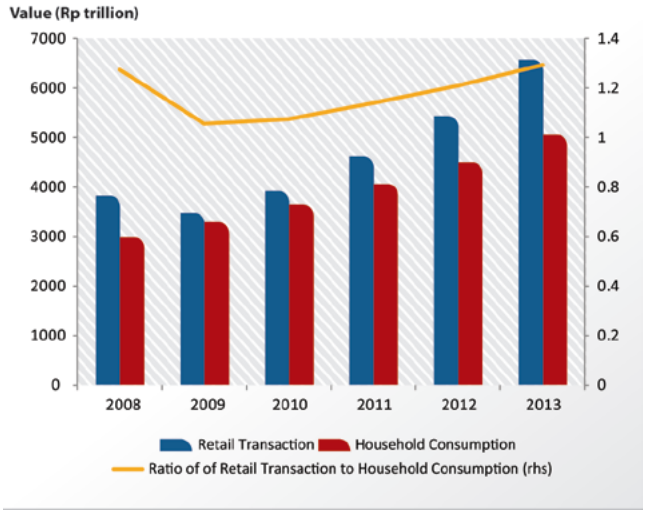


Chart 9.1. **Ratio of Retail Transaction to Household Consumption**

Non-Cash Payment System Operated by Bank Indonesia

Bank Indonesia Real Time Gross Settlement (BI-RTGS)

For settlement of high value payment transactions, BI-RTGS[2] in 2013 processed Rp90.9 thousand trillion, a 8.0% decrease in the usage of BI-RTGS system as compared to 2012 which amounted to Rp99.4 thousand trillion. However, in terms of volume, growth did increase compared to 2012[3]. On daily average, transactions using BI-RTGS system reached Rp368.5 trillion in value, down 9.1% from 2012 which reached Rp404.1 trillion (Chart 9.2). The decline in transaction value of non-cash payment system processed through the BI-RTGS system in 2013 was caused by the decline in transaction value of monetary operations (OM) conducted by Bank Indonesia. Throughout 2013, OM transaction value was recorded at Rp46.2 thousand trillion or down 23.6% from Rp60.5 thousand trillion in 2012[4]. On daily average, OM transactions dropped from Rp245.9 trillion in 2012 to Rp187.1 trillion in 2013. The contribution of OM transaction value through BI-RTGS system in 2013 was recorded at 50.8% of total non-cash payment system transaction value, while in 2012 it was at 60.9%. However, transaction value of non-cash payment system through BI-RTGS system without taking into account OM transactions saw an increase. This is shown by the transaction value which reached Rp44.8 thousand trillion or increased 15.1% from 2012 which recorded Rp38.9 thousand trillion. On daily average, BI-RTGS transactions excluding OM transactions rose from Rp158.1 trillion to Rp181.2 trillion (Chart 9.3). The increase was in line with the increase in transactions carried out on behalf of customers in 2013.

The increasing volume of payments through BI-RTGS system in 2013 was supported by the reliability and availability of BI-RTGS system. This is reflected by the success of BI-RTGS system in fulfilling two predetermined service level. BI-RTGS system which is classified as a Systemically Important Payment System (SIPS) showed a satisfactory performance with no system failure throughout 2013. The total transaction volume of BI-RTGS system throughout 2013 was recorded at 17.6

1 The ratio of retail payment system transactions to the household consumption in 2009 declined along with the decline in ratio of UYD to consumptions and transactions via BI-RTGS. This was a consequence of the decline in household consumption value in the period.

2 BI-RTGS system is an electronic fund transfer system in which every settlement is made immediately in real time basis. BI-RTGS plays an important role in the process of payment transaction activities, particularly to process payment transactions which are categorized as High Value Payment System (HVPS) or high value transactions of Rp100 million or more.

3 Payment transaction activities settled through BI-RTGS comprise transactions on monetary operations, government, on behalf of customers, capital market, Interbank Money Market (PUAB), settlement of interbank foreign currency trade in rupiah currency, settlement of foreign currency transactions between banks and BI in rupiah currency and others.

4 Further explanation on Bank Indonesia's policy stance in monetary operations can be read in Chapter 10 Monetary Policy.

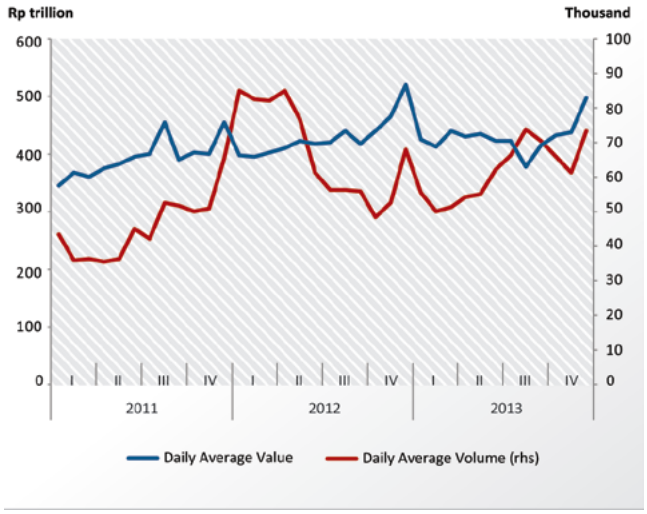


Chart 9.2. **BI-RTGS Transaction**

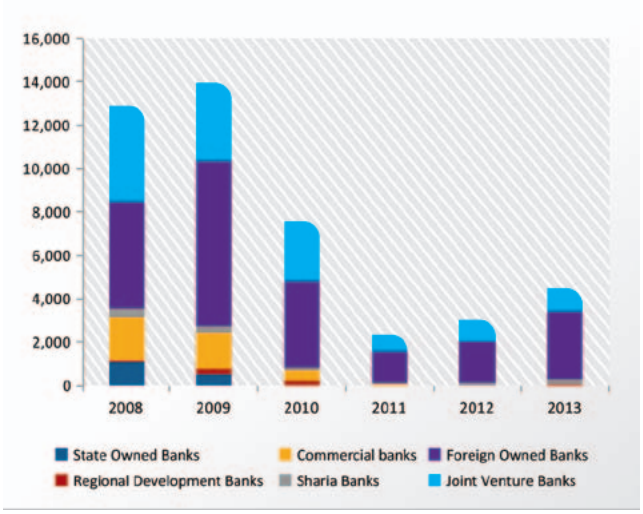


Chart 9.4. **Volume of Cumulative Queing in the BI RTGS System by Type of Banks**

million transactions, with a daily average of 71.4 thousand transactions. The highest recorded daily transactions volume, 123.1 thousands, occured on December 27, 2013, which was the first operational day after Christmas holiday. Transaction volume in 2013 was recorded to rise 0.8% compared to 2012 with 17.5 million transactions and 2013 daily average rose 0.1% compared to 2012 with 71.3 thousand transactions.

In 2013, liquidity condition in the BI-RTGS system had a slight decrease compared to 2012. This was shown by the increasing number of queue in 2013 which reached 5,070 queues, rising 48.6% from 2012 of 3,412 queues (Chart 9.4), even though if compared to the total volume of BI-RTGS system in 2013 which reached 17.6 million transactions, the queue volume had a very small portion of 0.029%. The increasing volume of queue showed the higher needs for liquidity to settle transactions, even though the current account balance of participants at the beginning of the day in the BI-RTGS system in 2013 rose 10.2% compared to 2012.

Besides transaction queues, another liquidity indicator in BI-RTGS system is unsettled transactions meaning the number of transactions that is not settled because of insufficient liquidity until the end of operating hours. Throughout 2013, there were 72 unsettled transactions in the BI-RTGS system with a total value of Rp1.99 trillion, even though the volume and value of unsettled transactions relative to the total transactions were only 0.004 permil and 0.02 permil, respectively.

Based on the two liquidity indicators in BI-RTGS system, transaction queue and unsettled transactions, it is concluded that liquidity in the BI-RTGS system was in robust condition, which means there was sufficient liquidity to settle transactions, and majority of the transactions could be settled in real time. This is in line with the expectations of Bank Indonesia and all users of BI-RTGS system which is the high value transactions settlement system in real time and gross (per transaction).

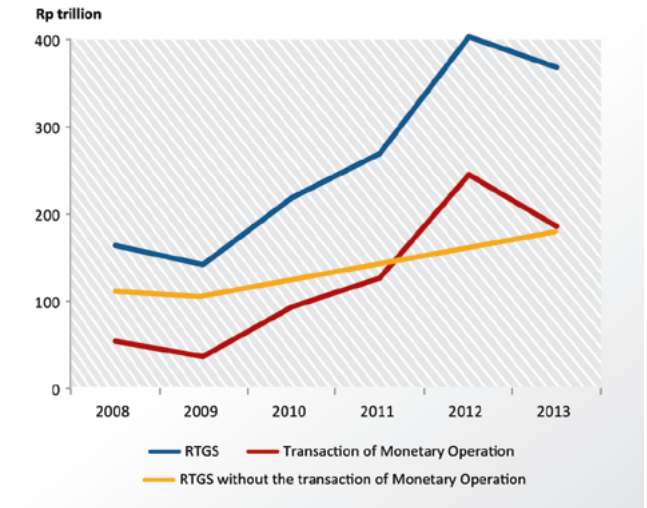


Chart 9.3. **Daily Average of BI-RTGS Transaction**

Bank Indonesia Scripless Securities Settlement System (BI-SSSS)

In 2013, buying and selling of government bonds and Bank Indonesia Certificates (SBI) through BI-

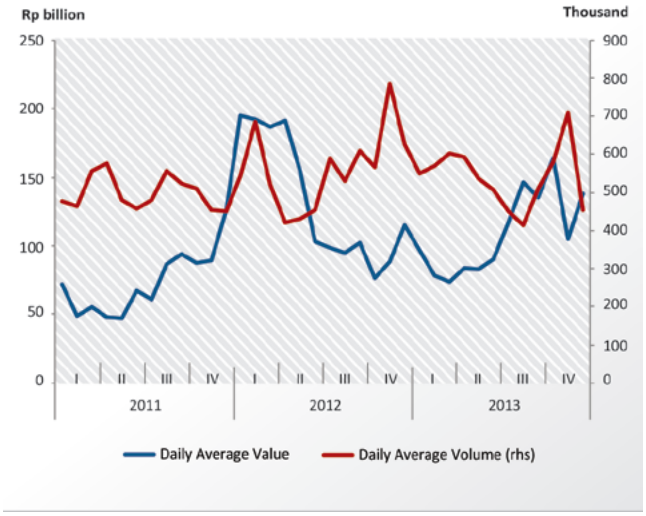


Chart 9.5. **BI-SSSS Transaction**

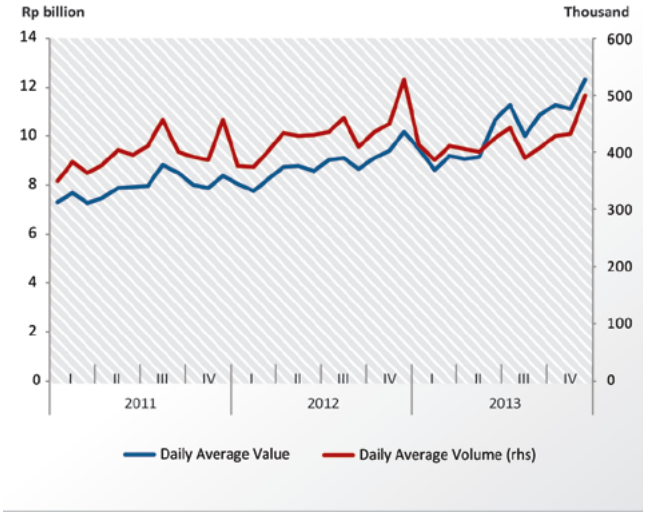


Chart 9.6. **National Clearing (SKNBI) Transaction**

SSSS, of which paymentis settled via BI-RTGS system, showed a decrease (Chart 9.5). The value of securities administered through BI-SSSS reached Rp26.6 thousand trillion, down 18.2% compared to 2012 which amounted to Rp32.5 thousand trillion. The average daily transactions value conducted through BI-SSSS system reached Rp108.1 trillion, down 18.0% compared to 2012 which amounted to Rp131.9 thousand trillion. The volume of securities transactions administered through BI-SSSS reached 131.7 thousand transactions, down 4.0% compared to 2012 of 137.2 thousand transactions. The average daily volume was recorded at 535 transactions, down 4.2% from 2012 of 558 transactions. The decline in transaction value of non-cash payment system in 2013 was caused by the decline in transaction value of monetary operations (OM) conducted by Bank Indonesia.

Bank Indonesia National Clearing System (SKNBI)[5]

The increase in economic activities was also reflected by higher transaction value of SKNBI. As one of the retail payment system means, SKNBI in 2013 processed as much as Rp2,542.3 trillion, up 17.2% compared to 2012 which processed Rp2,170.2 trillion. On daily average, transaction value through SKNBI reached Rp10.3 trillion, rose 16.4% from 2012 which amounted to Rp8.8 trillion.

In contrast to transaction value, the transaction volume through SKNBI in 2013 was recorded to decline 1.7%, from 106.1 million transactions in 2012 to 104.3 million transactions in 2013. Meanwhile, the average volume of daily transactions made through SKNBI was recorded at 422.2 thousand transactions, down 2.4% from 2012 which reached 432.7 thousand transactions (Chart 9.6). The declining transaction volume through SKNBI was expected to improve the efficiency through Bank Indonesia policy which increased the maximum limit of credit clearing value from Rp100 million to Rp500 million[6]. The effectiveness of the policy can be seen from the ratio of value per transaction volume in 2013 which reached 24.4, rising from 20.5 in 2012.

Non-Cash Payment System Operated by Industry

Card Based Payment Instruments (APMK)

In 2013, transaction value and volume through APMK, comprising ATM cards and/or debit cards as well as credit cards, rose in line with economic growth. Transaction value through APMK reached Rp4,020.7 trillion, increased 23.1% compared to 2012 which reached Rp3,266.9 trillion. The average daily transactions through APMK reached Rp11.0 trillion, increased 23.4% compared to 2012 of Rp8.9 trillion (Chart 9.7). The increasing transaction value through APMK showed that consumption remained strong, and in consequences it increased payment transaction value.

5 SKNBI is electronic fund transfer system which comprises of debit and credit clearing of which transaction settlement is made nationally.

6 Bank Indonesia Circular Letter No.15/8/DASP dated April 30, 2013, concerning the Changes of Bank Indonesia Circular No.11/13/DASP dated May 4, 2009, concerning the Nominal Limit of Debit Note and Credit Transfer in SKNBI Operations.

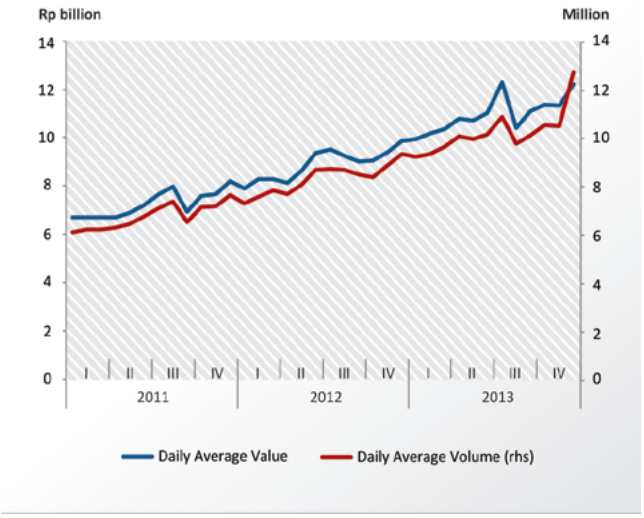


Chart 9.7. **Card Based Payment Instrument Transaction**

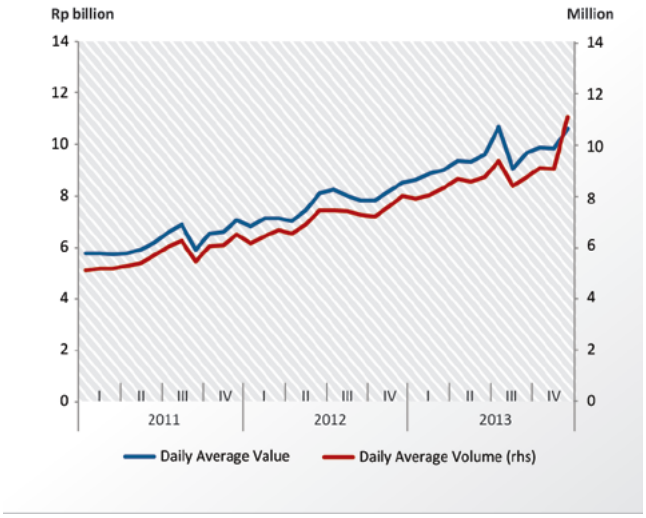


Chart 9.8. **ATM and ATM/Debit Transaction**

In 2013, transaction volume through APMK was recorded at 3.7 billion transactions, increased 23.1% compared to 3.0 billion transactions in 2012. The average daily volume of transactions by APMK was recorded at 10.3 million transactions, increased 23.4% compared to 8.3 million transactions in 2012 (Chart 9.7). Higher transaction volume was in line with the increase in supporting infrastructure such as ATM machines and Electronic Data Capture (EDC) machines. In 2013 the number of ATM machines was 75.9 thousand units, increased 19.7% compared to 2012 at 63.4 thousand units. EDC machines used for ATM/debit cards in 2013 were 634.7 thousand units, increased 77.5% from 2012 at 357.5 thousand units.

ATM and ATM/Debit

Bank Indonesia's policy to boost interoperability between principles and issuers of ATM/debit cards has increased the usage of ATM/debit cards as a non-cash payment instrument[7]. In 2013, transaction value of ATM cards and ATM/debit cards reached Rp3,797.4 trillion, increased 23.9% compared to 2012 of Rp3,065.9 trillion. The daily average value of transactions using ATM cards and ATM/debit cards reached Rp10.4 trillion, increased 24.2% compared to Rp8.4 trillion in 2012 (Chart 9.8). Aside from Bank Indonesia's policy, the increase was also supported by the growing number of ATM/debit cards circulated, which reached 89.5 million cards as compared to 2012 with 77.8 million cards. In addition, the increasing volume and transactions were results of the growing number of issuing banks in which in 2012 there were 102 issuers and in 2013 there were 106 issuers. Issuing banks were dominated by conventional commercial banks with 87 issuers, followed by rural banks with 11 issuers and sharia commercial banks with 8 issuers (Table 9.1).

In line with the increasing transaction value, transaction volume using ATM/debit cards in 2012 was recorded at 3.7 billion transactions, increased 23.1% compared to 3.0 billion transactions recorded in 2012. On daily average, the volume of transactions made through APMK was recorded at 9.6 million transactions, increased 24.6% compared to 2012 with 7.7 million transactions.

The increasing transaction value and volumes using ATM/debit cards has raised the transactions value and volume of APMK considering the largest contribution of APMK transactions was supported by ATM/debit cards. Throughout 2012 and 2013, the growth rate in

Table 9.1. **ATM/Debit Card Issuers**

Issuers	Total
Conventional Commercial Banks	87
Sharia Commercial Banks	8
Rural Banks	11
Total	**106**

7 ATM cards are APMK which can be used for cash withdrawal and/or fund transfer. The obligation of card holders is fulfilled in real time by reducing the savings of card holders. ATM/debit cards are APMK which can be used to make payments for obligations that arise as a result of economic activities, including shopping transactions. The obligation of card holders is fulfilled in real time by reducing the savings of card holders.

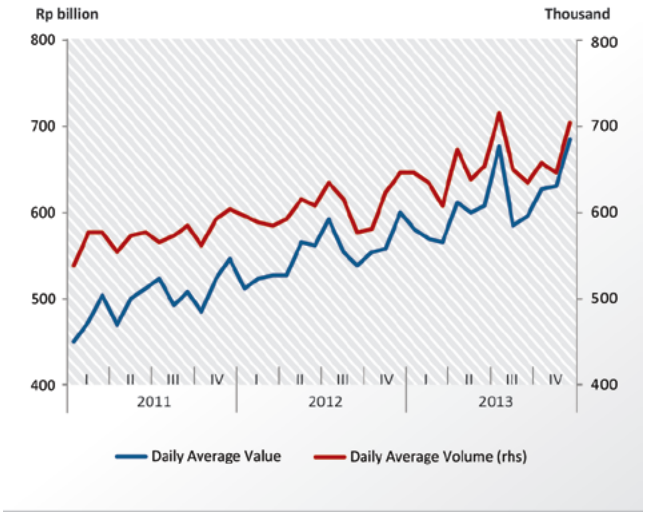


Chart 9.9. **Credit Card Transaction**

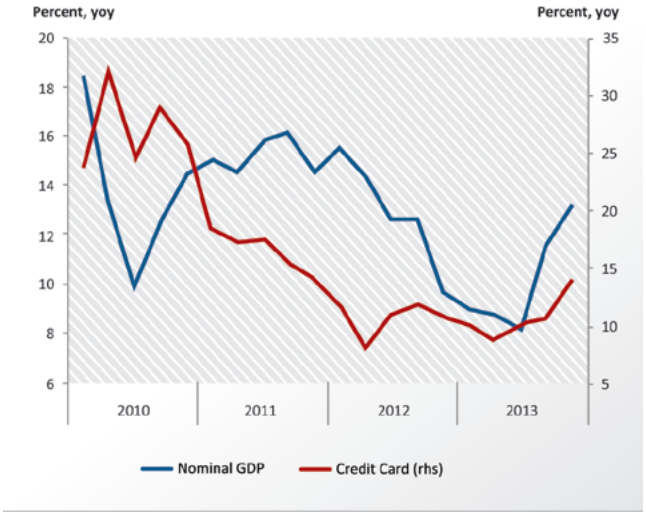


Chart 9.10. **Nominal GDP Growth and Credit card**

transactions value and volume using ATM/debit cards was in line with APMK.

Credit Cards[8]

In accordance with the growth of consumption, payment transactions using credit cards also rose. In 2013, transaction value using credit cards reached Rp223.4 trillion, increased 10.7% as compared to Rp201.8 trillion in 2012. On daily average, transaction value through credit cards in 2013 reached Rp611.6 billion, increased 10.9% as compared to Rp551.3 billion in 2012 (Chart 9.9). This was supported with the increasing number of credit cards circulated, reaching 15.1 million cards, grew by 1.9% from 2012 of 14.8 million cards.

Along with higher transaction value, the volume of transactions using credit cards in 2013 was recorded at 239.1 million transactions, increased 7.9% as compared to 2012 with 221.6 million transactions. On daily average, the volume of transactions using credit cards was recorded at 654.9 thousand transactions, increased 8.2% as compared to 2012 with 605.3 thousand transactions. The increasing volume and transactions were a result of the growing number of issuers in 2013 which was recorded at 22 issuers, compared to 20 issuers in 2012.

The growth trend of credit card transaction value was always in line with the growth trend of GDP (current price) since the beginning of 2012 until the end of 2013 (Chart 9.10). This indicates that credit cards is one of the alternative of non-cash payment instruments which support the economy, particularly consumption.

Growth in the credit card industry was maintained by keeping the industry soundness through, among others, Bank Indonesia's policy which limited credit card ownership. The limit of credit card ownership was based on consideration of financial ability of credit card holders as well as oversight of credit card operators activities by Bank Indonesia. PBI No.14/2/PBI/2012 concerning Amendment to PBI 11/11/PBI/2009 concerning Operational Activities of Card Based Payment Instruments (APMK) which was effective from January 2013 regulated, among others, requirements in providing credit card facilities such as minimum age limit, minimum income limit, maximum credit ceiling limit and maximum number of issuers that could give credit card facilities.

The effectiveness of Bank Indonesia's policy and oversight to credit card operators in keeping the soundness of credit card industry could also be seen from the decline in Non-Performing Loan (NPL) ratio in 2013 which was recorded at 2.5% compared to the previous period of 3.5% (Chart 9.11). The relatively low NPL ratio that could be maintained throughout 2013, reflected the implementation of prudential principles and risk mitigation by credit card operators as well as understanding and discipline of the credit card users.

8 Credit cards are APMK which can be used for settlement of obligations that arise from an economic activity including shopping transactions and/or for cash withdrawal, where payment obligation of the card holders is fulfilled initially by the acquirer or issuer, and card holders are obliged to make payments at an agreed time either fully (charge card) or in installments.

Table 9.2. **E-Money Issuers**

Issuers	Type of e-Money	Name of Product
Bank Central Asia Tbk	chip based	Flazz
Bank Mandiri (Persero) Tbk	chip based	Indomaret Card, Gaz card dan E-Toll
Bank Mega Tbk	chip based	Studio Pass Card dan Smart Card
Bank Negara Indonesia 1946 (Persero) Tbk	chip based	Java Jazz Card dan Kartuku
Bank Rakyat Indonesia	chip based	BRIZZI
B.P.D DKI Jakarta	chip based	Jak Card
PT. Indosat	chip based	Dompetku
PT. Skye Sab Indonesia	server based	Skye Card
PT. Telekomunikasi Indonesia	chip based, server based	Flexy Cash dan i-Vas Card
PT. Telekomunikasi Selular	server based	T-Cash
PT. XL Axiata	server based	XL Tunai
PT. Finnet Indonesia	server based	FinChannel
PT. Artajasa Pembayaran Elektronis	server based	MYNT
Bank Permata Tbk	server based	BBMMoney
PT. Nusa Satu Inti Artha	server based	DokuPay
PT. Bank CIMB Niaga, Tbk	server based	Rekening Ponsel
PT. Bank National Nobu	server based	Nobu E-Money

Electronic Money[9]

Bank Indonesia's policy in advancing interoperability and interconnection in electronic money industry played a role in boosting the increase of electronic money usage as an alternative of retail payment system[10]. In 2013, the value of transactions using electronic money reached Rp2.9 trillion, increased 47.5% from 2012 which reached Rp2.0 trillion. On daily average, the value of transactions using electronic money reached Rp7.9 billion, increased 47.8% compared to 2012 which reached Rp5.4 billion. The increase was part of Bank Indonesia's effort through its policy, as well as the growing amount of electronic money particularly chip based in 2013 which reached 36.2 million cards, increased 65.6% from 2012 of 21.9 million cards.

Along with the increase in transaction value, the volume of transactions using electronic money in 2013 rose 37.0% which was recorded at 137.9 million transactions as compared to 2012 with 100.6 million transactions. On daily average, the volume of transactions using electronic money was recorded at 376.7 thousand transactions, increased 37.1% as compared to 2012 with 274.8 thousand transactions (Chart 9.12).

The growing value and volume of electronic money transactions were not only supported by Bank Indonesia's policy in creating interoperability and interconnection of electronic money and the development of Less Cash Society (LCS) area but also by the increased number of electronic money issuers in 2013 which reached 17 issuers as compared to 12 issuers in 2012 (Table 9.2). The rising number of issuers was in line with the

Chart 9.11. **NPL of Credit Card**

9 Electronic Money is a payment instrument which fulfills elements as follows (i) issued based on the amount of money paid initially by the users to issuers; (ii) the amount of money is stored electronically in media such as server or chip; (iii) used as payment instrument to merchants who are not the issuers of the electronic money; and (iv) the amount of electronic money paid by the users and managed by the issuers is not considered as savings as stipulated by the laws regulating banking.

10 Interoperability and interconnection in the electronic money industry are designated to support the usage of one electronic money instrument for many payments, as well as the development of Less Cash Society (LCS) area.

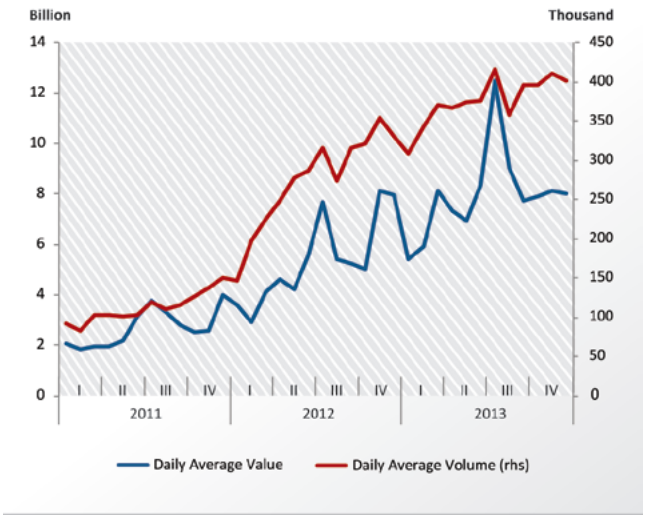


Chart 9.12. **E-Money Transaction**

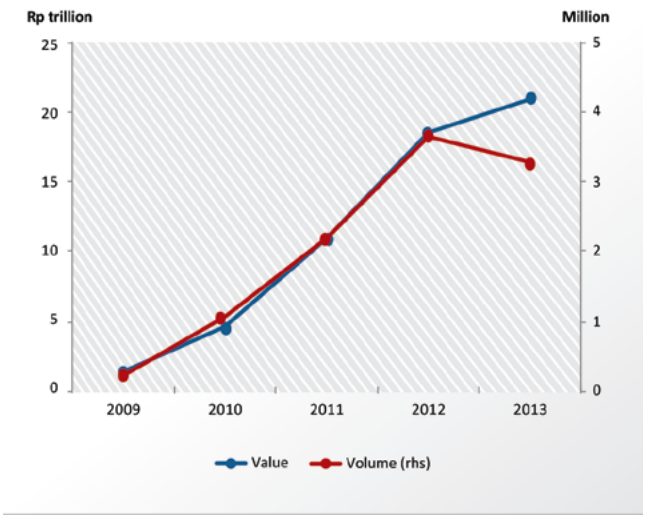


Chart 9.13. **Fund Transfer Transaction**

increasing number of electronic money holders and infrastructure, particularly the reader equipment or EDC which reached 139.2 thousand units in 2013, grew by 43.8% as compared to 96.8 thousand units in 2012. The electronic money issuers are dominated by conventional commercial banks (9 issuers), followed by non-bank institutions (8 issuers).

Non-Bank Fund Transfer Operations[11]

In 2013, transaction value of fund transfer operations by non-bank institutions rose, even though declining in volume (Chart 9.13). Transaction value of fund transfers reached Rp20.8 trillion, increased 13.3% as compared to 2012 which reached Rp18.4 trillion. The average value of fund transfer daily transactions reached Rp57.2 billion, grew by 13.6% as compared to 2012 which reached Rp50.4 billion. The biggest portion of fund transfer transactions was fund transfers from overseas to Indonesia (incoming) with a portion of 47% in value and 87% in volume (Chart 9.14 and Chart 9.15). This is in line with the initial aim of non-bank fund transfer operations which is mainly to accommodate fund transfer activities by Indonesia workers overseas. Generally, the users of this fund transfer service by non-bank institutions are workers who engage in informal sectors and are not familiar with banking. The growing value of fund transfers or remittance particularly incoming transactions from overseas also plays a role in increasing the economy of people in regions which are the basis of Indonesian workers working overseas.

The number of licensed fund transfer non-bank operators which have operated and are named at Bank Indonesia website is recorded at 114 operators in 2013, increased 7.5% from 2012 with 106 operators. Based on the location distribution of non-bank fund transfer operators in Bank Indonesia's operation areas, they were concentrated in Greater Jakarta with 48 operators which accounted for 42.0% of the total operators nationwide (Chart 9.16).

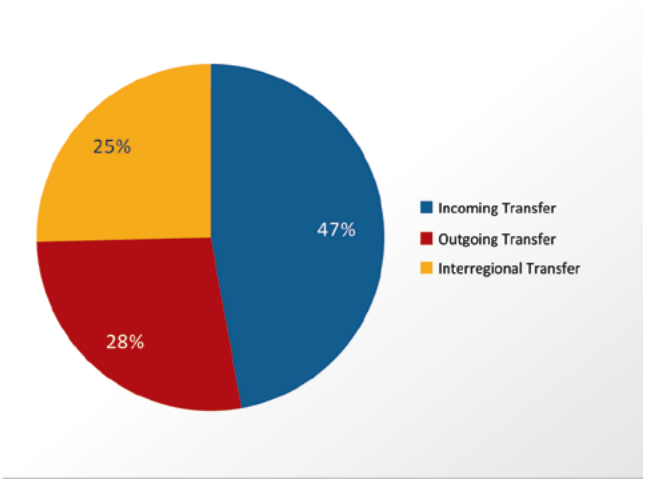


Chart 9.14. **Share of Fund Transfer Value in 2013**

11 Fund transfer is a series of activities starting from the main sender order which is aimed at transferring a certain amount of funds to the recipient mentioned in the fund transfer order until the fund is received by the recipient.

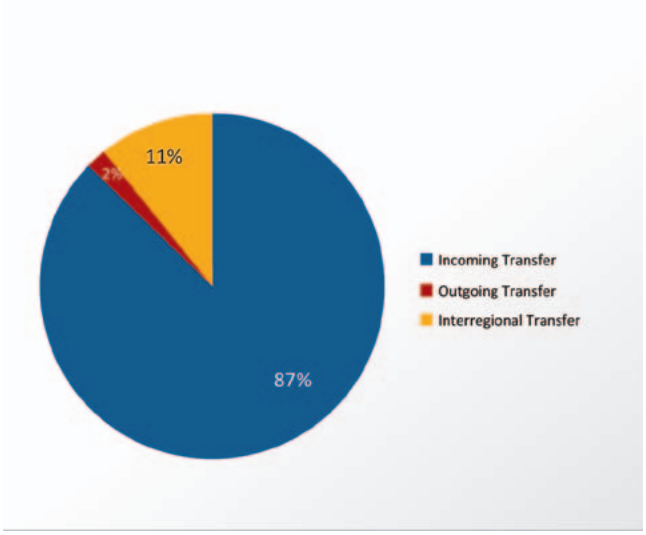


Chart 9.15. **Share of Fund Transfer Volume in 2013**

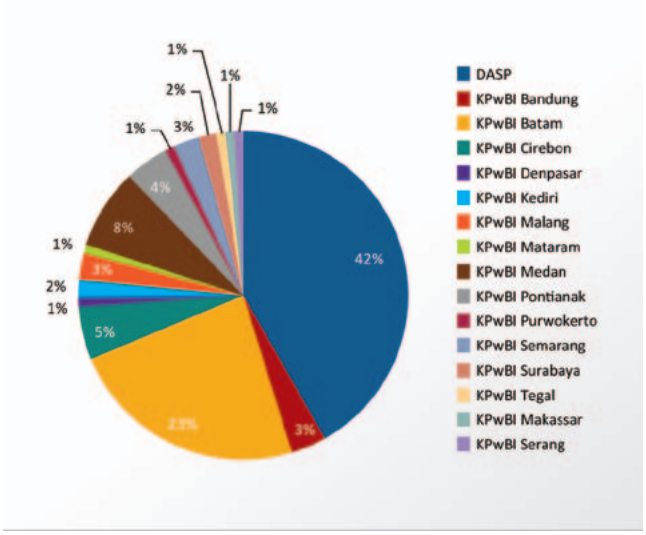


Chart 9.16. **Share of Fund Transfer Value in 2013 by Region**

Non-Bank Foreign Exchange Trader (PVA)[12]

In 2013, the non-bank PVA activities of Foreign Bank Notes (UKA) rose significantly. The total transaction value of buying and selling UKA reached Rp188.3 trillion, increased 32.6% as compared to 2012 of Rp142.0 trillion (Chart 9.17). In 2013 there were 898 non-bank PVAs, increased 0.1% as compared to 2012 which saw 897 non-bank PVAs. Based on locations, most of non-bank PVAs resided in Jakarta area with 347 non-bank PVAs. There were 153 non-bank PVAs in Padang area, which is the entrance for tourists from Singapore and Malaysia. Meanwhile in Denpasar, with high number of foreign tourists, there were 135 non-bank PVAs (Chart 9.18).

Throughout 2013, Bank Indonesia as the licensing provider and supervisor of PVA has revoked the license of 33 PVAs across Indonesia. The license revocation either on the PVA initiative for not continuing or on Bank Indonesia initiative as sanctions for violation of PVA's obligation to report. This sanction is aimed at keeping the soundness of PVA industry's as well as enforcing compliance to existing regulations such as the Law on Anti-Money Laundering and Counter Terrorism Financing.

12 Non-Bank PVA is a registered Limited Liability Company whose aim was to buy and sell Foreign Exchange Bank Notes (UKA) and buying Traveller's Cheque (TC).

9.2. The Performance of Currency Management

Availability of Currency in Circulation

The demand for banknotes and coins increased along with the growing Indonesia's economic growth. Strong domestic consumption as the driver of Indonesia's economic growth became the main factor for rising needs of banknotes and coins was also supported by several policies made by of Indonesia's government, there were increasing the people's purchasing power, such as the increase in UMP, PTKP and the disbursement of BLSM. The government's policy to raise the price of subsidized fuels has increased the price of foodstuffs

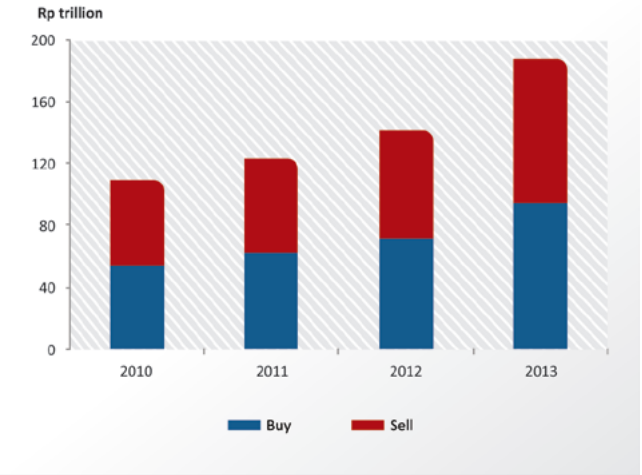


Chart 9.17. **Foreign Bank Notes Transaction**

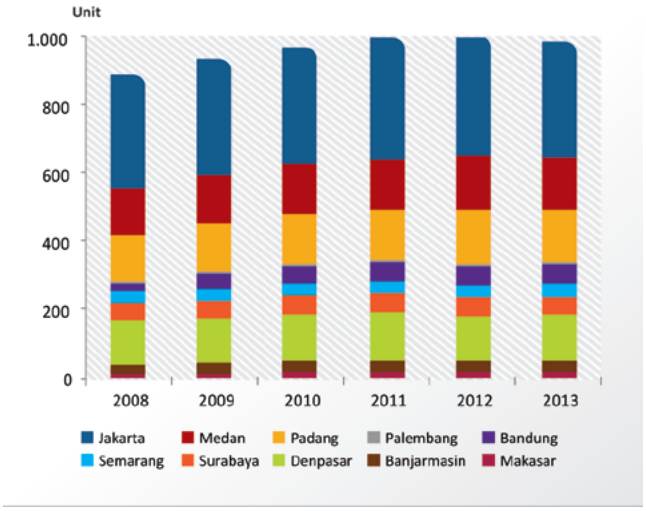


Chart 9.18. **Number of Non-bank Money Changer by Location**

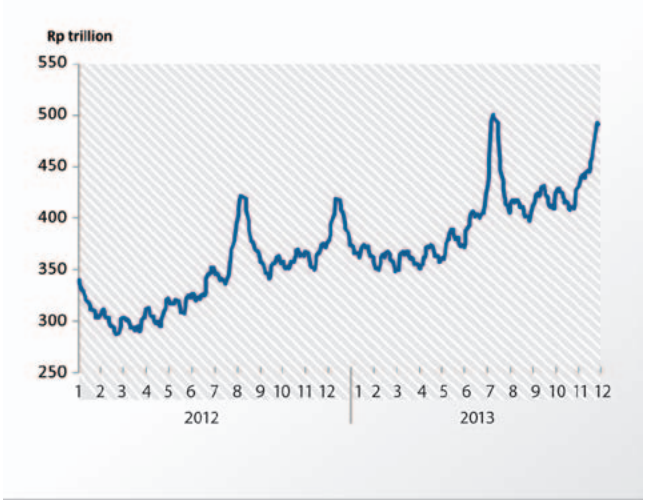


Chart 9.20. **Daily Movement of Currency in Circulation**

and transports which eventually increased demand for rupiah. Another factor was increasing the banknotes and coins' demand was the seasonal factors, particularly during Ramadan and Eid al-Fitr, Christmas as well as 2013 year-end holidays. The demands can be fulfilled by Bank Indonesia by providing sufficient banknotes and coins, in different denominations, a timely manner and proper conditions for circulations.

A strong household consumption was shown with the increase of currency in circulation throughout 2013. The daily average of currency in circulation (UYD) was recorded at Rp420.9 trillion or increasing from 2012 which reached Rp370.6 trillion. Nevertheless, the daily growth average of UYD slowed to 13.6%, lower than 2012 which reached 15.7% (Chart 9.19). This showed that the slowdown in Indonesia's economic growth affected UYD throughout 2013. The increasing demand for banknotes and coins was also reflected through the cyclical pattern of UYD daily movement throughout 2013. The highest UYD value occured on August 5, 2013, following to Ramadan and Eid al-Fitr, amounting to Rp508.3 trillion. Similarly during the Christmas period and year-end holidays, the highest UYD value was Rp501.3 trillion on December 30, 2013 (Chart 9.20). These seasonal conditions when the people's needs for banknotes and coins increased.

The role of banknotes and coins in economic activities is reflected by the ratio of UYD to Gross Domestic Product

Chart 9.19. **Currency in Circulation**

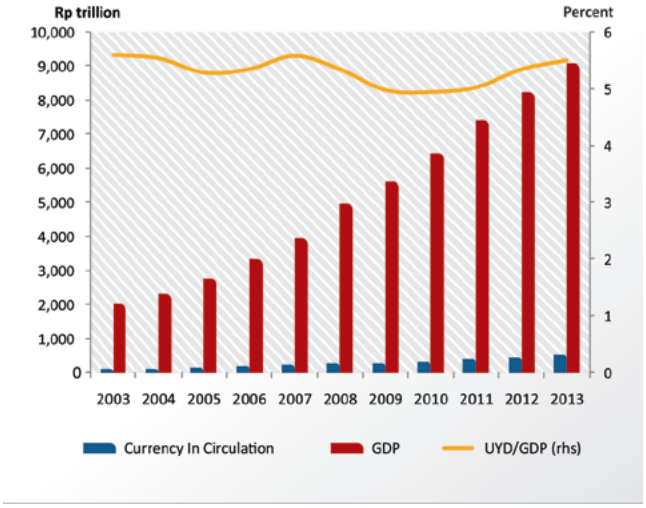


Chart 9.21. **Currency in Circulation and GDP**

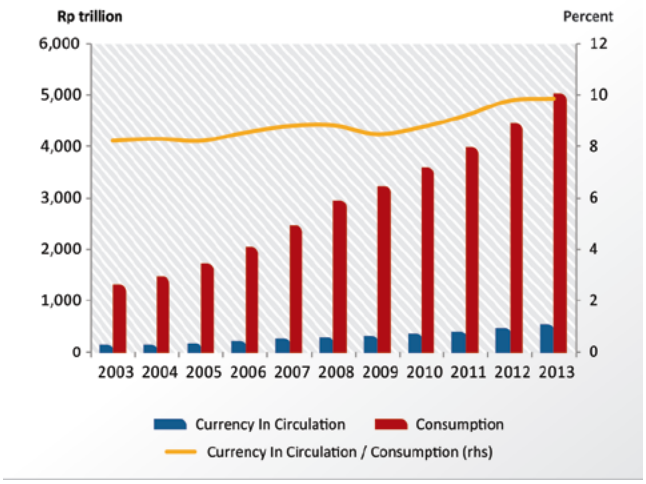


Chart 9.22. **Currency in Circulation and Household Consumption**

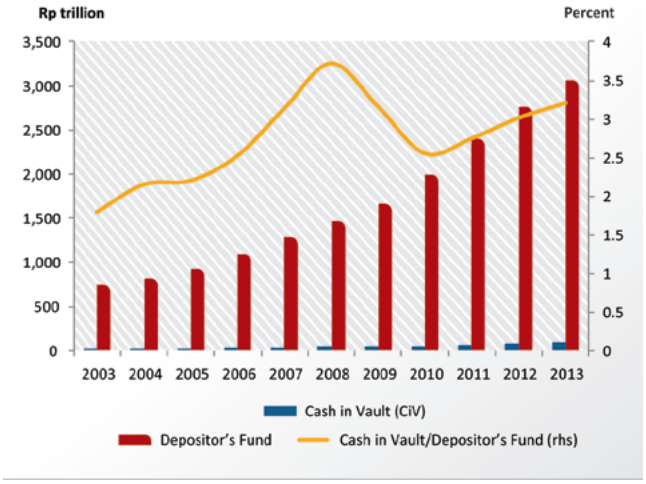


Chart 9.24. **Cash in Vault and Depositor's Fund**

(GDP) and velocity of GDP to UYD. In recent years, the ratio of UYD to Gross Domestic Product (GDP) was relative stable in the range of 5.3% (Chart 9.21). While the velocity of GDP to UYD was also relatively stable at the range of 18.8. This development shows that when the economy is growing, the availability of banknotes and coins in the society also increases. The increase in UYD was in line with economic activities, it did not further affect inflationary pressure. In addition, the role of banknotes and coins can be measured by the ratio of UYD to household consumption. In the recent years, the ratio of UYD to household consumption relatively increased from 8.2% in 2003 to 9.9% in 2013. This development shows the role of banknotes and coins in payment transactions was quite high, particularly for consumption activities (Chart 9.22).

The role of banknotes and coins in economic activities through the banking system is seen in the ratio of Currency Outside Banks (COB) to people's savings which tended to be stable in the recent years in the range of 13.5%. This development shows the process of collective payment and money creation has run well (Chart 9.23). Meanwhile the role of banknotes and coins in supporting a smooth payment system is seen through the increasing ratio of banknotes and coins in treasury and ATM machines (cash in vault) to people's savings in the banking sector, which rose quite significantly from 1.8% in 2003 to 3.2% in 2013. This shows with the increase in ATM machines, the number from 63,406 in 2012 to 73,362 machines at the end of 2013, where the banks had to provide more banknotes in ATM. machines for withdrawal purpose (Chart 9.24).

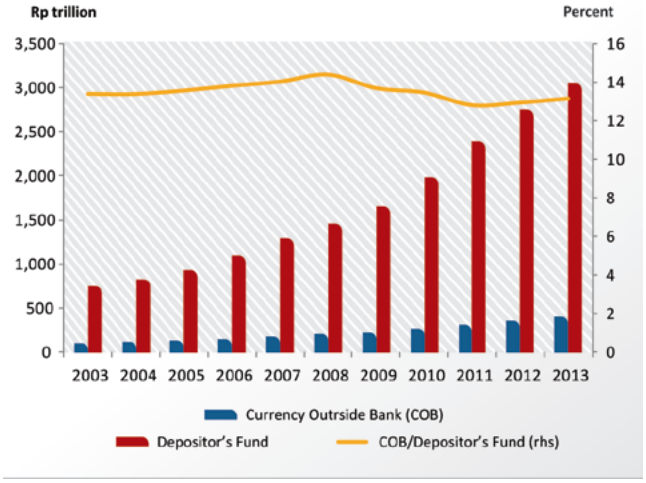


Chart 9.23. **Currency Outside Banks and Depositor's Fund**

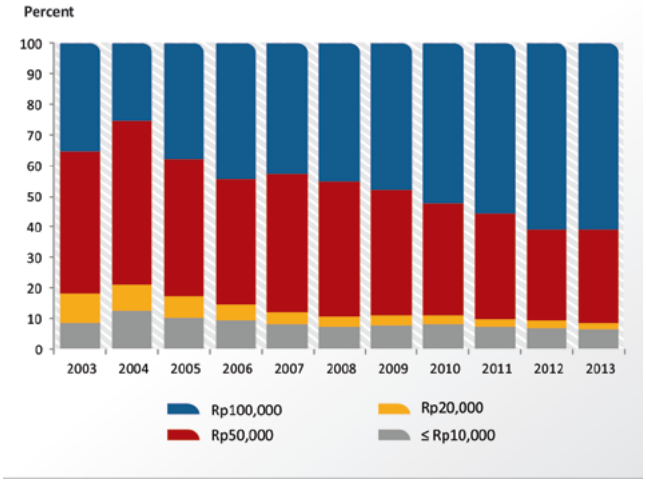


Chart 9.25. **Composition of Currency in Circulation by Denominations**

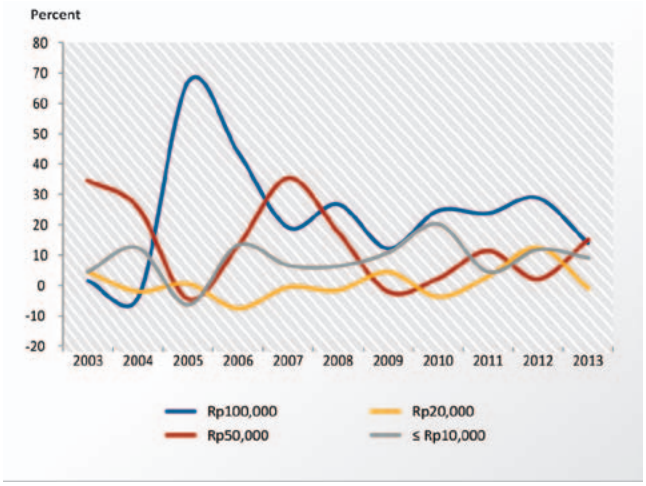


Chart 9.26. **Currency in Circulation Growth by Denomination**

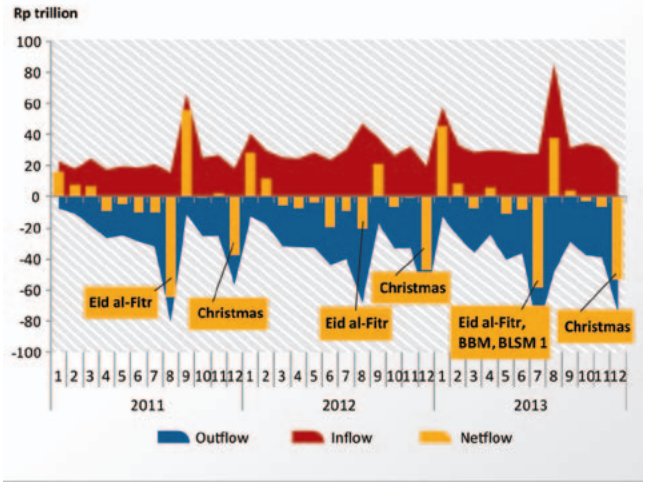


Chart 9.27. **Outflow and Inflow through Bank Indonesia**

On the denominations of UYD, there was a shift in the compositions, from Rp20,000 note to other notes particularly Rp50,000. This is shown by negative growth of Rp20.000 notes by 0.9%, while Rp50.000 notes grew higher than the previous year from 2.0% to 15%. The shift for Rp50,000 banknotes indicated the people's demand, the change in banks' policy to replace Rp20.000 banknotes with Rp50,000 or Rp100,000 notes in ATM machines (Chart 9.25). With the development, the portion of Rp50,000 banknotes to the total UYD had the highest increase compared to other denominations, from 30.1% in 2012 to 30.4% in 2013. On the other hand, the massive campaign for electronic money usage, particularly in major cities, also affected the decline in demand for banknotes with small denominations (Rp10,000 and smaller) from 6.8% in 2012 to 6.5% in 2013 (Chart 9.26).

The Flow of Banknotes and Coins through Cash Services of Bank Indonesia

Throughout 2013 Bank Indonesia managed to meet the people's demand for banknotes through the banking sector, including when the demand for cash rose significantly. The increasing demands happened in the Ramadan and Eid al-Fitr holidays in July until the first week of August 2013, and during Christmas and New Year at the last week of December 2013. Moreover, the sufficiency of banknotes and coins occurred after Indonesia's government policy to increase the price of subsidized fuels on June 21, 2013, and the disbursement of Direct Cash Transfer to the People (BLSM) in first stage in July until August 2013 and second stage in September until October 2013. The sufficiency of banknotes and coins both in nominal as well as denominations was to support the government's policy and the people's economic activities, as well as delivered significant contributions to the banking sector performance in providing cash for customers.

The flow of banknotes and coins through Bank Indonesia sawn a net outflow of Rp53,1 trillion. The outflow of banknotes and coins from Bank Indonesia to the banking and the people grew 14.1% from Rp429.6 trillion in previous year to Rp490.0 trillion in 2013. Meanwhile the inflow of banknotes and coins to Bank

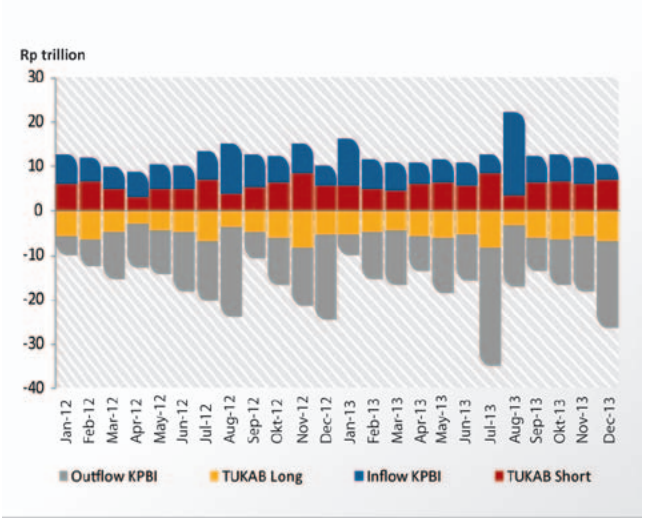


Chart 9.28. **Inter-Bank Cash Exchange (TUKAB) and Cash Transaction through BI Headquarter**

Indonesia had a growth of 19.3% from Rp366.3 trillion to Rp436.9 trillion (Chart 9.27). The growth of inflow and outflow of banknotes and coins through Bank Indonesia in 2013 had a declining trend as compared to the growth in 2012 (inflow 24.8% and outflow 23.6%) and 2011 (inflow 39.1% and outflow 40.6%).

The development in 2013 was the a result of Bank Indonesia's policy implemented since mid-2011 which encouraged the commercial banks to optimize Interbank Banknotes Exchange (TUKAB), in one area as well as nationwide, to pace up cash flow between one regional office to another regional affoce as to fulfill customer needs for rupiah banknotes. Throughout 2013, the TUKAB value in Jakarta and surrounding areas was Rp69.2 trillion or reaching 31.7% of all withdrawal transactions through Bank Indonesia's Headquarters as well as through TUKAB. The TUKAB value in 2013, 5.5% higher compared to the previous year, which reached Rp65.6 trillion (Chart 9.28).

Based on types of banks, the highest amount of banknotes and coins transactions through Bank Indonesia were made by State Banks and National Private Commercial Banks (BUSN). The transactions made by State Banks was recorded at a net outflow of Rp205.1 trillion, with Rp61.0 trillion inflow and Rp266.2 trillion in outflow. Conversely, banknotes and coins transactions by BUSN were recorded at a net inflow of Rp278.9 trillion, with Rp 345.3trillion in inflow and Rp66.3 trillion in outflow. It shows that the net outflow from Bank Indonesia to State Banks was used for the payments of central government transactions, either for government projects or salaries of Civil Servants/ Indonesian Military. Meanwhile, the net outflow of Regional Development Banks (BPD) reflected the payments of regional government transactions. On the other hand, net inflow from BUSN as well as joint venture banks and foreign banks to Bank Indonesia reflected that these types of banks became the place for private or individually-owned companies to save their funds (Chart 9.29).

Based on economic areas, in the recent years Java Island area (excluding Jakarta) showed net inflow patterns. In 2013 net inflow reached Rp53.8 trillion. While the other three areas, Sumatra Island, Jakarta and Eastern Indonesia (KTI) showed net outflow which respectively reached Rp23.6 trillion, Rp55.3 trillion and Rp28.0 trillion (Chart 9.30). The net outflow patterns in Sumatra and Eastern Indonesia (KTI) areas indicated that the people in both areas still had strong preference in using banknotes and coins. There were possibilities the money was flowing in to several areas in Java Island, as shown by the net inflow in the island. The condition also indicated that economic activities were still centralized in Java Island, even though regional economies continuous to grow. Hence, this was also supported with the populations of more than 50% Indonesians living in Java areas, which resulted in more money circulated in Java areas.

In 2013, cash withdrawal by the from Bank Indonesia to the people's needs for cash increased along with the establishment of new custodian banks (KT). The aim of the establishment of custodian banks was to provide the people's need for cash particularly in remote area,

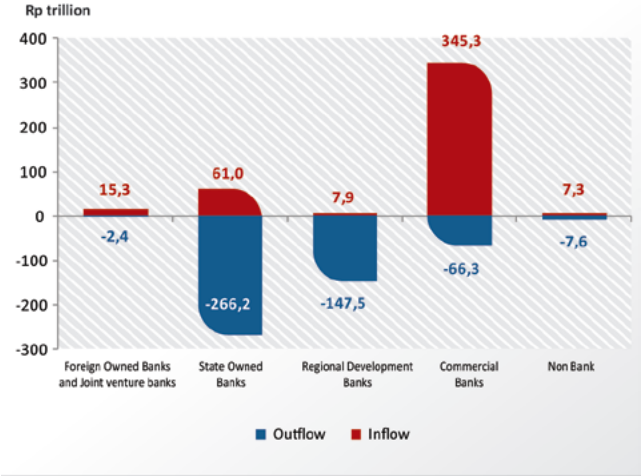


Chart 9.29. **Cash Flow by Types of Banks in 2013**

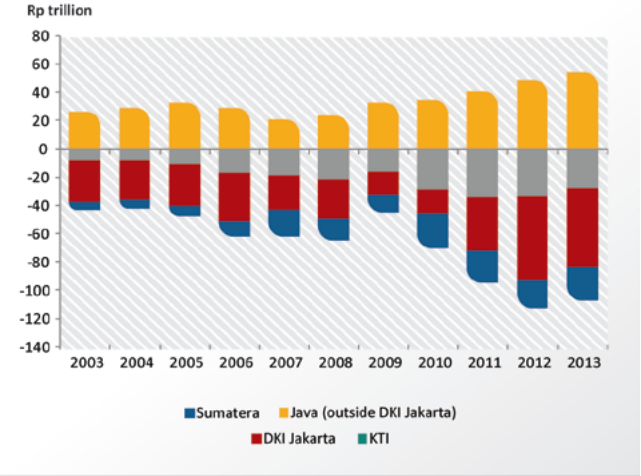


Chart 9.30. **Cash Netflow by Regions**

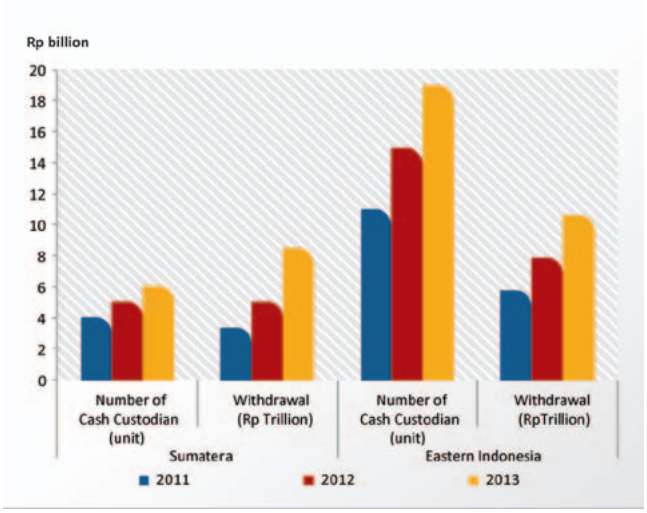


Chart 9.31. **Cash Withdrawal in Cash Custodians**

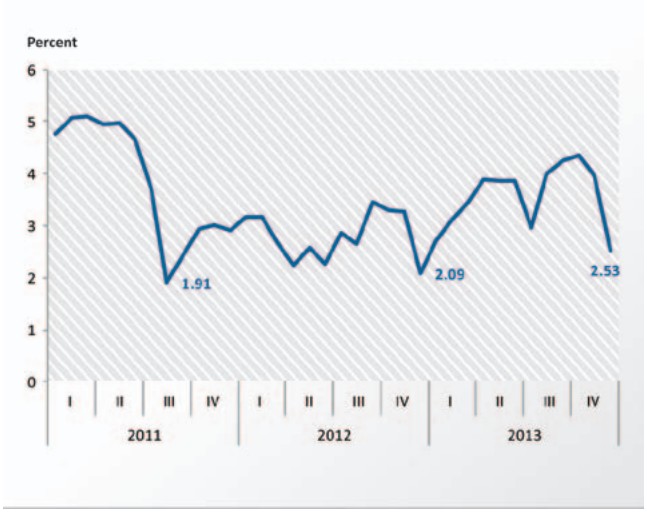


Chart 9.33. **Ratio of Cash Position to the Average of Monthly Outflow**

in areas which unreachable by Bank Indonesia cash services (blank spot area). Throughout 2013, Bank Indonesia prioritized cash service policy by cooperating with six commercial banks to open new cash custodians. With this policy, by the end of 2013 there were 25 cash custodians, spread in Eastern Indonesia and Sumatra areas. Cash withdrawal through custodian banks in 2013 was recorded at Rp19.1 trillion, increasing 47.9% from the previous year at Rp12.9 trillion (Chart 9.31).

Meanwhile, cash service activities performed by Bank Indonesia in form of mobile cash services saw a decline frequency, which caused the amount of withdrawal by the people dropped 3.3% to Rp1.4 trillion in 2013. Since the last two years, the highest frequency and amount of withdrawal in mobile cash services occurred in Eastern Indonesia (KTI) areas (Chart 9.32).

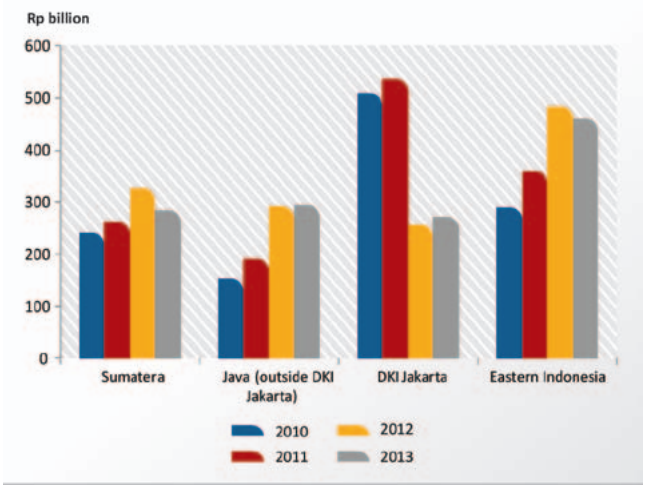


Chart 9.32. **Cash Withdrawal from Mobile Cash Services**

Bank Indonesia Cash Position

Amidst the increasing needs for banknotes, Bank Indonesia's cash position remained resilient. Various policies conducted by Bank Indonesia simultaneously throughout 2013 became a factor for the resilience in Bank Indonesia's cash position. The policy, among others, was to optimize the distribution of Currency Fit for Circulation (ULE) by recirculating ULE from bank deposits. This was done through dropshot[13] policy, either in one area or cross areas, and the enforcement of TUKAB nationwide. With this policy, the distribution of ULE in all banks in regions through Bank Indonesia's regional representative branches was spread more evenly. Other policies are the sorting policy of banknotes and coins and intensive co-operations with printing company Perusahaan Umum Percetakan Uang Republik Indonesia (Perum Peruri) to increase the supply of perfectly printed rupiah (HCS)[14], have supported Bank Indonesia to maintain cash position throughout 2013 at a sufficient level. The ratio of Bank Indonesia's cash position at the end of 2013 reached about 2.5 months of average outflow, higher than the previous year which reached 2.1 months (Chart 9.33).

13 Dropshot policy is a payment policy for currency fit in circulation (ULE) from bank deposits to the same bank (bank which deposits the money) or to other banks, without thorough calculation and sorting by Bank Indonesia. Payments from Bank Indonesia to the bank is made in one transparent plastic packaging (10 brood) which is still intact, sealed and has the label of the bank.

14 Perfectly printed rupiah (HCS) is printing result which technical specifications is suitable with Bank Indonesia's requirements.

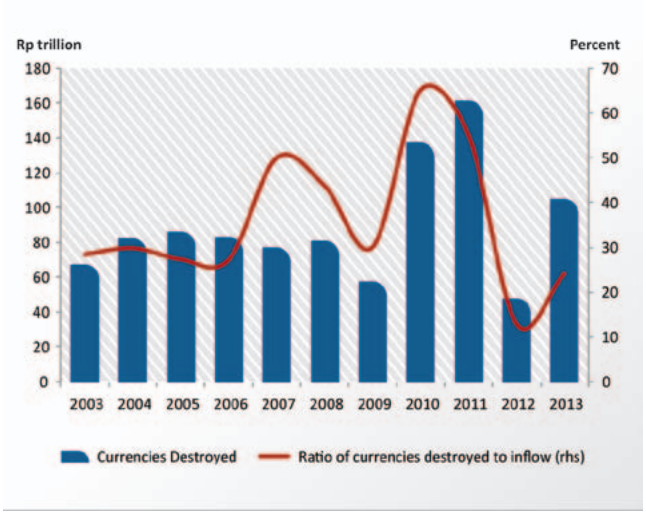


Chart 9.34. **Currency Destroyed and Ratio to Inflow**

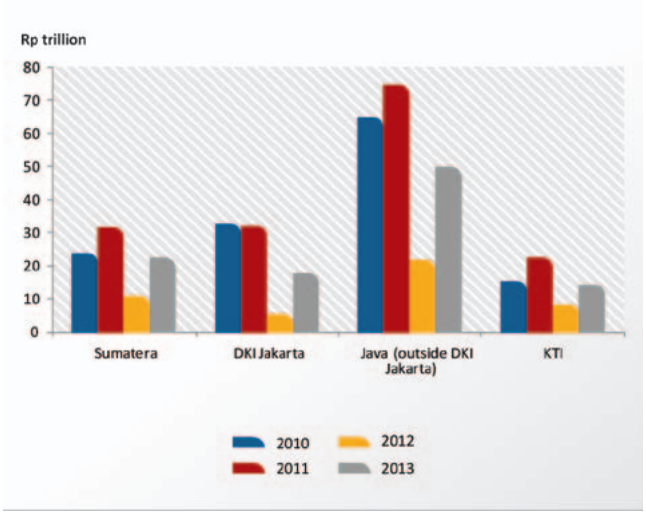


Chart 9.36. **Currencies Destroyed in 2013 by Region**

The Destruction of Currency Unfit for Circulation

The destruction of rupiah banknotes is conducted as an effort to increase the quality standard of banknotes and coins circulated to the people (clean money policy). The rupiah destruction is performed to worn out banknotes , defective banknotes or coins and have been withdrawn from circulation, which were obtained from bank deposits and the people. The destroyed banknotes and coins (currency unfit for circulation/UTLE) will be replaced with new perfectly printed rupiah (HCS) and currency fit for circulation (ULE) which gained from bank deposits and the people.

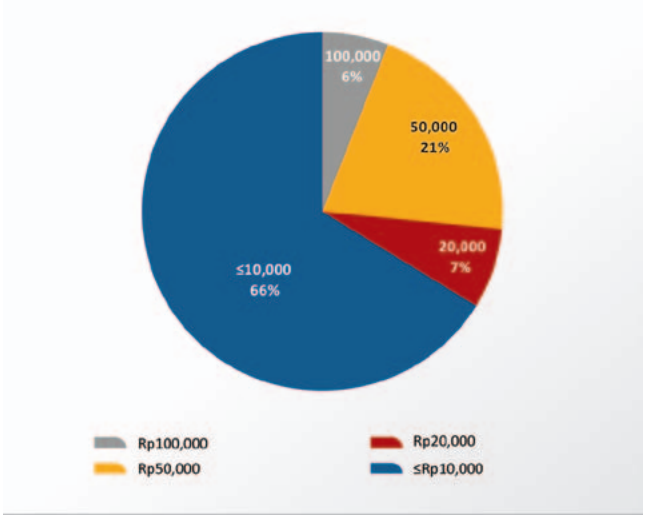


Chart 9.35. **Composition of Currencies Destroyed in 2013 by Number of Bank Notes**

During 2013 the destruction of UTLE reached Rp105.3 trillion or increasing 121.4% as compared to the previous year which reached Rp47.6 trillion. The ratio of UTLE destruction to inflow of rupiah in 2013 was 24.1%, increasing from 2012 of 13.0% (Chart 9.34). in term of value, Bank Indonesia identified Rp105.28 trillion in banknotes and Rp18.0 billion in coins as unfit for circulation and replaced the accordingly. In term of denominations, the portion of small denominations (UPK) destroyed which is Rp10,000 and smaller, reaching 66.2% of the total UTLE destruction (Chart 9.35). The high portion of UPK destroyed showed that the circulation of UPK in the society was more frequent than high denominations (UPB). Moreover, the high frequency of UPK circulation also affected it physical conditions, hence they are destroyed quicker.

Based on regions, throughout 2013 the highest destruction of rupiah was in Java Island areas (excluding Jakarta). The amount of UTLE destroyed was Rp50.1 trillion or as much as 47.6% of the total UTLE destroyed nation wide (Chart 9.36). The high money destruction in Java areas (excluding Jakarta) was in line with the pattern of banknotes and coins flow in the areas which tended to be net inflow and consisted mostly of UTLE.

Counterfeit Rupiah Banknote Findings

The number of counterfeit rupiah found in 2013 were 141,266 notes, increasing 52.4% from 2012 which reached 92,686 notes. In ratio, the findings of counterfeit rupiah also rose to 11 notes per 1 million notes of rupiah in circulations in 2013 compared to 8 notes per 1 million

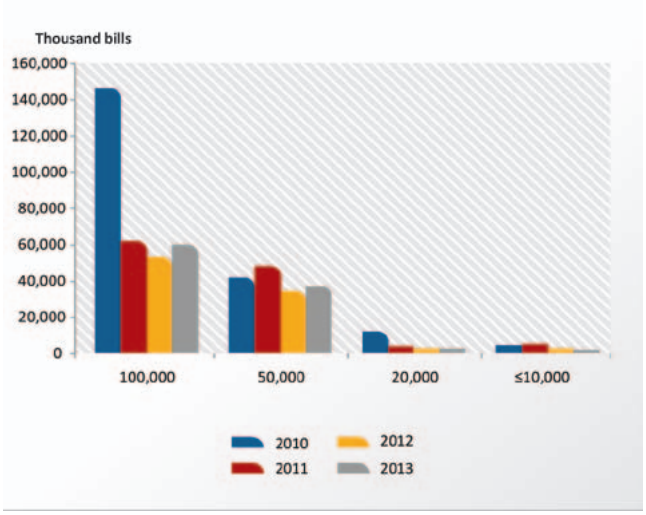


Chart 9.37. **Counterfeit Money by Denomination**

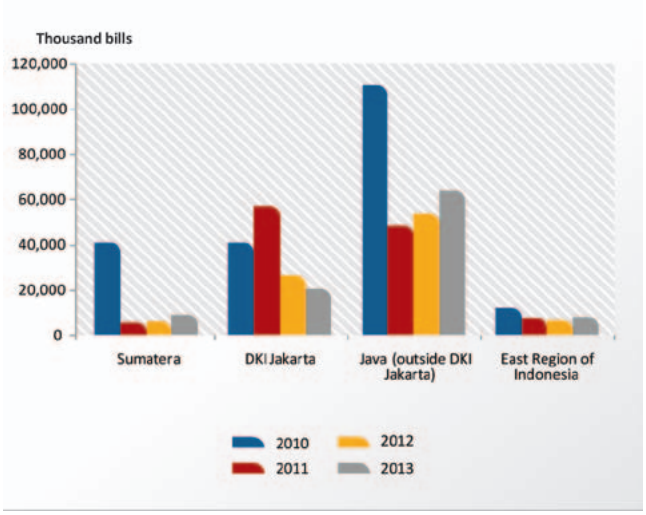


Chart 9.38. **Counterfeit Money by Region**

notes of rupiah in circulations in 2012. The increasing number of counterfeit rupiah findings was caused by the improving compliance from banks and the people's awareness in reporting banknotes with suspected authenticity to Bank Indonesia, as well as the disclosure of criminal case on counterfeit money by the Police.

Counterfeit money findings were dominated by high denominations banknotes (UPB) and in Java Island areas. Based on the composition per denomination, counterfeit banknotes findings were dominated withRp100,000 notes with 92,075 notes or 65.2% and Rp50,000 with 42,061 notes or 29.8% (Chart 9.37). Meanwhile based on regions, the largest amount of counterfeit banknotes findings were in Java Island areas (89,817 notes or 63.6%) particularly in East Java Province and West Java Province where as counterfeit banknotes findings in Jakarta Province was 29,256 notes or 20.7% (Chart 9.38).