

INFOGRAPHICS: OVERVIEW

SYNERGY IN STRENGTHENING RESILIENCE, CAPITALIZING THE MOMENTUM OF ECONOMIC RECOVERY



GLOBAL CHALLENGES

Sluggish Global Economic Growth & World Trade Volume

- Lower than previous year
- Lower growth in advanced country
- Higher growth in emerging countries
- World trade volume slowed down

Low Global Commodity Prices

- Oil prices remained low
- Commodity prices started to increase in the fourth quarter of 2016

High Uncertainty in Financial Market

- Uncertainty of FFR hiked
- Geopolitics increased
- Brexit and Trump Effect



Short Term Domestic Challenges

- Export performance slowed down
- Internal consolidation of corporation and banking sectors
- Tax revenues slowed down that reinforce fiscal consolidation
- Capital flows volatility that affected rupiah exchange rate

DOMESTIC ECONOMIC

Remained resilient supported by increased economic growth and well maintained economic stability



Medium Term Domestic Challenges

- Improve the export of structure
- Strengthen the role of industrial sectors
- Promote market competition and fair commerce
- Strengthen domestic financing structure

SHORT TERM RESPONSES



STRUCTURAL REFORM

LONG TERM RESPONSES

POLICY MIX RESPONSES



Maintain Macroeconomic Stability and Financial System Stability (FSS)
Capitalizing Momentum of Economic Recovery

OVERVIEW

Synergy in Strengthening Resilience, Capitalizing the Momentum of Economic Recovery

In 2016, the Indonesian economy remained resilient. The major role played by domestic demand and policy responses set in motion proved adequate to mitigate multifaceted risks from the global economy that could have weighed down on the performance of the economy. Indonesia's economic growth returned to an upward trend in 2016, buoyed by sustained macroeconomic stability. The gains in the economy were also accompanied by more robust synergy in both cyclical and structural policy. Looking forward, the outlook for economic recovery will continue despite various global and domestic risks that call for vigilance. Therefore, policy synergy will be strengthened further to forge greater economic resilience that will serve as a vital pillar in accelerating sustainable economic recovery.

In 2016, the Indonesian economy held its ground amid sluggish global economic conditions replete with uncertainty. Key to this achievement was the structural predominance of domestic demand and support from adequate policy responses. In turn, the combination of these two factors mitigated the risk of fallout from weak global economic growth, protracted low global commodity prices, and the heightened uncertainty hanging over global financial markets. In 2016, Indonesia's economic growth climbed from 4.9% in 2015 to 5.0%. Higher growth was also supported by a sound level of economic stability marked by low inflation, decline in the current account deficit, stable exchange rate, and well maintained financial system stability with low systemic risks.

Overall, the economic dynamics of 2016 indicated positive improvements in the Indonesian economy. The economic stability maintained through consistency in policies previously set in motion provided a robust foundation for domestic economic adjustment and enabled the Indonesian economy to resume an upward growth trend. The economic growth achieved by Indonesia in 2016 stands in contrast with the stagnated growth in many leading economies. In addition, Indonesia has forged more robust policy synergy both in the cyclical policies responding to short-term conditions and in structural policies. In turn, this synergy will support the economic recovery process and strengthen economic resilience in the medium and long term.

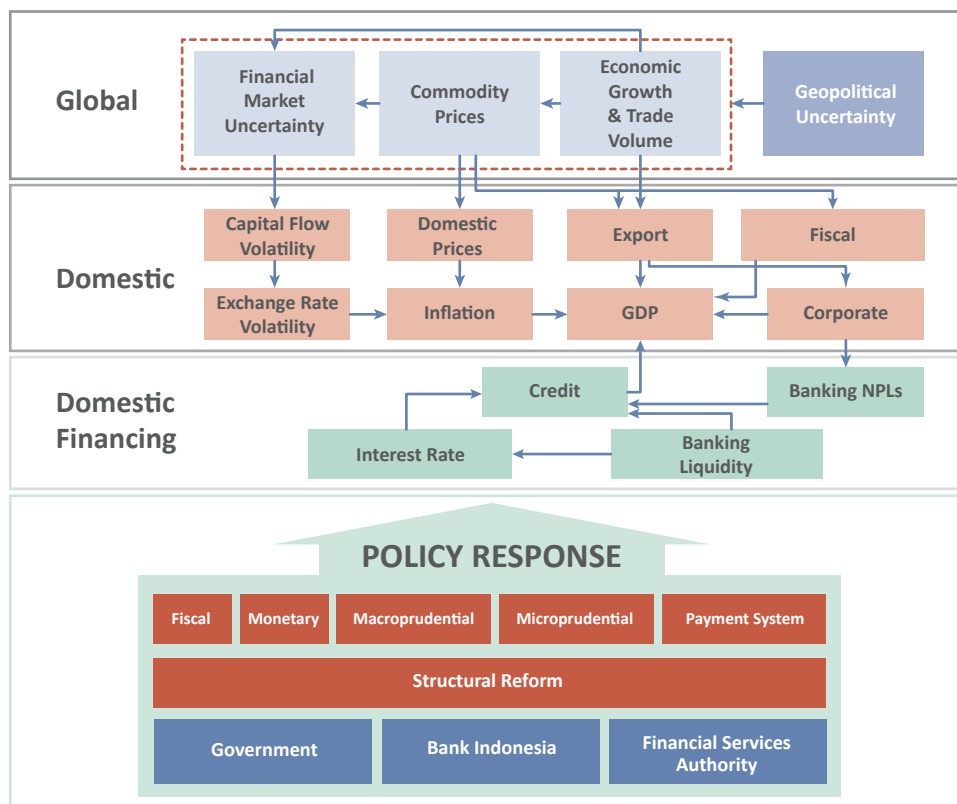
The Global Economy in 2016

The global economy continued to struggle with three main issues as it had in 2015. These three issues posed renewed challenges to Indonesia's economy in 2016. The three issues weighing down on the world economy are interrelated and have kept global economic recovery moving at a slow pace (Diagram 1). Adding to the complexity of problems facing the global economy were geopolitical uncertainties, including outcomes in the Brexit referendum and US election that are radically different from market expectations. These conditions then contributed to the already high uncertainties and in the final outcome disrupted the process of global economic recovery.

The first issue was related to the depressed and unevenly distributed global economic growth. Due to the ongoing consolidation in the global economy, including in China, global growth remained weak at 3.1% in 2016, below the 3.2% level recorded in 2015 (Table 1). In the quarterly dynamics, global economic growth actually picked up in the fourth quarter of 2016, but this was insufficient to raise growth for the overall 2016 beyond the level achieved in 2015.

The impact of lethargic growth in the global economy spread far and wide, as many countries responded to the weakness in the global economy by switching to more domestic-oriented strategies for growth. This growth strategy in tandem with indications of decline in global value chains undermined the linkages between global economic growth and world trade volume. As a result, growth in world trade volume weakened further, slipping

Diagram 1. Global Economy, Indonesian Economy Challenges, and Policy Responses 2016



Source: Bank Indonesia

from 2% in 2015 to only 1% in 2016 and eroding export performance in many countries around the world.

The second issue concerns the persistently low level of global commodity prices, at least until the third quarter of 2016. Energy and non-energy commodity prices stayed low until the third quarter of 2016, representing the effect of weak demand and plentiful supply. Regarding energy commodities in particular, world oil prices remained weak, despite having bottomed out in January 2016. *Minas* crude

oil price averaged USD38.8 per barrel until the third quarter of 2016, before recovering in fourth quarter to USD47.6 per barrel (Table 1). Prices lingered at depressed levels for various non-energy commodities, including Indonesian exports such as coal, crude palm oil, and copper. In the first half of 2016, the composite price for Indonesia’s major non-oil and gas export commodities also remained low, before climbing significantly in the fourth quarter of the year.

Table 1. Key Indicators of World Economic

Components	2013	2014	2015	2016				
				I	II	III	IV	Total
World Economic Growth (%)	3.3	3.4	3.2	3.1	3.0	3.0	3.1	3.1
World Trade Volume Growth (%)	2.2	2.7	2.0	0.8	1.1	1.1	2.2	1.0
World Oil Prices (US dollar/barrel)	98.0	92.9	48.8	33.6	45.6	44.9	49.3	43.5
<i>Minas</i> Prices (US dollar/barrel)	108.4	98.7	49.0	30.9	43.3	42.0	47.6	41.0
Price Index of Non-Oil and Gas Export (% yoy)	-9.8	-4.3	-15.0	-11.6	-5.0	7.0	27.9	5.4
Average DXY (Index, increase-dollar appreciation)	81.5	82.6	96.3	97.4	94.6	95.8	99.8	96.9
Average VIX (Index, increase-volatility increase)	14.1	14.1	16.6	20.5	15.7	13.2	14.1	15.8

Source: Bloomberg and Bank Indonesia

The third issue concerns the high uncertainties persisting on global financial markets. Reflecting this uncertainty was the rise in the VIX index, especially in the first and fourth quarters of 2016 (Table 1). Uncertainty in global financial markets also mounted in response to the planned increase in the Fed Funds Rate (FFR) by the US central bank. This led to changes in capital flows on global financial markets that spurred appreciation in the dollar and weighed on the currencies of many other countries, including Indonesia. Reflecting this was the upward movement in the average DXY index in the first and fourth quarters of 2016 in line with US dollar gains.

World economy recovery slowed further and uncertainty remained high on global financial markets as a result of political transition in some of the major world powers at the time. At the end of the first half of 2016, uncertainty spiked after the United Kingdom referendum that resolved to leave the European Union (Brexit), as this was not what markets had expected. Uncertainty also mounted in response to the outcome of the US presidential election that also caught markets by surprise. Market players perceived the various policies in the platform of US president-elect Donald Trump as liable to derail the process of global economic recovery. The concerned US policy platform includes a more expansionary fiscal policy concurrent with a burgeoning government debt burden, plans for more restrictive international trade policies, and new policies in immigration.

Challenges for the Indonesian Economy in 2016

The absence of improvement in the global economy brought with it challenges for the Indonesian economy. Unfavorable global conditions carried the risk of impairing Indonesia's economic recovery in 2016. If allowed to persist, this risk would not only hamper improvement in economic growth, but also weigh down on economic and financial system stability (Diagram 1). The correlation between the two was mutually reinforcing, as feeble economic growth poses a risk of upsetting economic and financial system stability that will then bear down on economic growth itself.

The challenges for the Indonesian economy began with the risk of a renewed slump in economic growth, triggered by the slack outlook for exports. This risk had considerable relevance given the sluggish pace of global economic growth that could weaken demand for products exported by Indonesia, particularly non-commodity. Exports were increasingly susceptible to decline because low commodity prices could put pressure on Indonesia's terms of trade. With a considerable portion of primary commodities in the Indonesian exports, deterioration in Indonesia's terms

of trade could then lead to even further loss of export performance.

The risks from the sluggish export outlook assumed greater urgency due to the possible impact on corporate and banking performance. Falling export revenues could result in greater corporate susceptibility to difficulties. Corporate vulnerability could then worsen if domestic demand remained slack, including weakness resulting from the second-round effect of corporate responses opting more for internal consolidation rather than business expansion. Corporate performance facing risk of decline could ultimately impact performance in the financial sector, including the banking industry. Banking performance would be faced with downside risk from escalation in credit risk caused by sluggish corporate performance.

The risk of deteriorating performance in the banking industry could in turn impair the effectiveness of monetary policy transmission through the interest rate and credit channels. Escalating credit risk could then influence bank behaviour in setting interest rates, particularly lending rates. Loan interest rates would then be less elastic to changes in the central bank policy rate if, at the same time, credit risk was on the rise. In addition, mounting credit risk could deter banks from extending credit. Taken together, problems in the interest rate and credit channels would then carry the risk of diminishing the banking role in promoting economic growth.

The fiscal space for stimulating the economy was also at risk of contraction due to reduction in potential tax revenues. The risk of decline in taxes was not only due to direct impact from contraction in non-tax revenues due to falling commodity prices, but also the effect of indirect impacts leading to shrinking income tax and value added tax revenues. Overall, the risk of reduced tax revenues could in turn restrict capacity for government expenditures in supporting economic recovery, given the necessity on the other hand for continued efforts to safeguard the prospects of fiscal sustainability.

The challenges facing the economy involved even greater complexity as they could spread on a wider scale and possibly derail macroeconomic and financial system stability. The risk of a deteriorating domestic economic prospect could adversely impact the outlook for investment in Indonesia, including inflows of portfolio investment. Portfolio investment would face an escalating risk of contraction accompanied by heightened volatility if uncertainty broke out on global financial markets, including uncertainty over increases in the FFR and geopolitical risks. If this persisted, it could put pressure on the rupiah exchange rate and domestic financial system stability. The

weakening in the rupiah would in turn stoke inflationary pressure, affecting not only core inflation but also inflation in volatile foods and administered prices.

Overall, these multifaceted challenges to the domestic economy demanded prompt action. Had issues been allowed to fester, they could have become mutually reinforcing with disruption to the process of economic recovery. Feeble economic growth could increase corporate risk and bank credit risk while impairing monetary policy transmission and diminishing fiscal space to deliver a stimulus. These risks to the economy could also have exacerbated the risks to macroeconomic and financial system stability that in turn could again derail the process of economic recovery. Aside from cyclical response, structural responses also had to be bolstered further to strengthen matters of geographical relevance, such as interregional connectivity and cost efficiency of logistics.

Policy Response in 2016

In general, the macroeconomic policy adopted in 2016 sought to mitigate risks that could impair the sustainability of economic growth, macroeconomic stability, and financial system stability. The responses set in motion encompassed four main policy directions. First, to mitigate the risk of slowing economic growth by strengthening the role of domestic demand as a source of growth. This policy response was crucial, because a flagging economy may set off various interrelated risks that if allowed to persist would derail the recovery of the economy as a whole. Second, to maintain the prudently managed economic stability and financial system stability that has become the cornerstone for economic recovery. Third, to pursue structural reinforcement of the economy through efficiency and productivity gains aimed at achieving sustained improvement in competitiveness over the medium and long term. Fourth, to ensure that the various policies in operation kept within the corridor of sound macroeconomic policy in support of sustainable economic growth.

The macroeconomic policy direction is taken by policy synergy among Government, Bank Indonesia, and the Financial Services Authority (OJK). Policy synergy was implemented in a policy mix of fiscal, monetary, macroprudential, microprudential, and structural policies, including policy for the payment system and currency management. The policy mix not only sought to mitigate short-term cyclical risks, but also to reinforce the structure of the economy in the medium and long term. Bank Indonesia also pursued a policy mix by combining monetary

and macroprudential policies as well as policy for the payment system and currency management.

Consistent with the macroeconomic policy stance, the Government strengthened the fiscal stimulus by increasing expenditure for productive sectors while consistently safeguarding the outlook for fiscal sustainability. This policy direction was incorporated into the 2016 State Budget. The budget targeted a 17% increase in government spending to be funded by a substantial 21.6% increase in domestic revenues. Under this budget plan, the 2016 state budget deficit was targeted at 2.15% of GDP.

As events unfolded, the fiscal policy strategy for 2016 encountered challenges. During the first half of the year, domestic tax revenues underperformed as a result of protracted low commodity prices and only modest improvement in the domestic economy. Meanwhile, actual government spending by the end of the first half of 2016 was quite high at 44.3% of target. This in turn produced a budget deficit for the first half of 2016 at 1.9% of GDP.

The government responded to this challenge by taking steps for fiscal consolidation in the second half of 2016 in order to maintain the credibility of fiscal sustainability. On the revenues side, the government lowered the tax revenue target to a more realistic level while pressing forward with the optimization of existing potential, including the tax amnesty program. By the end of 2016, the tax amnesty program had raised a total of Rp 107 trillion in tax redemptions. The success of the tax amnesty not only covered the short term need for state revenues, but also represented a step forward for strengthening the future tax base. By the end of the year, the various fiscal consolidation measures pursued by the government contained the deficit under the Revised 2016 State Budget to 2.5% of GDP, below the 2.6% level of the previous year. This achievement thus maintained a low, prudent, and sustainable government debt position at 27.8% of GDP.

Bank Indonesia responded to the macroeconomic policy stance by strengthening the policy mix of monetary, macroprudential, payment system and currency management policies. In line with the Government, Bank Indonesia policy mix sought not only to provide a response to short-term cyclical issues, but also to strengthen economic resilience in the medium and long term. In the short-term cyclical response, the policy sought to mitigate the risk of contraction in economic growth that if allowed to persist would lead to renewed susceptibility weighing down on macroeconomic and financial system stability. The medium-term structural policy response was implemented in various measures to strengthen the effectiveness of

monetary policy transmission in managing the stability of the economy. The measures pursued by Bank Indonesia in 2016 were part of the Bank Indonesia transformation launched in 2014.

Monetary policy focused on creating space for strengthening the momentum of economic recovery and bolstering financial system stability while consistently safeguarding the macroeconomic stability that is already in place. The monetary policy stance was adopted in view of steady improvement in macroeconomic stability, reflected in low inflation in line with the target, a sound and declining level of current account deficit, and stable rupiah exchange rate. In turn, these conditions provided space for monetary policy easing. In line with the policy stance, the Bank Indonesia policy rate was lowered 150 bps in 2016, bringing the new policy rate, the BI 7-Day (Reverse) Repo Rate (BI7DRR), to 4.75% in December 2016. In addition, the statutory reserve requirement (RR) was reduced to 6.50%.

Exchange rate policy sought not only to keep exchange rate movement aligned to fundamentals, but also to improve effectiveness in maintaining economic stability. Bank Indonesia pursued stabilization of the rupiah in order to prevent excessive volatility, as this would carry the risk of renewed pressure on the exchange rate and inflation. The exchange rate policy was also reinforced by measures to improve the management of foreign exchange demand and supply, including the implementation of prudential principles (KPPK) in managing external debt of the non-bank corporation and implementation of regulations on mandatory use of the rupiah currency in the territory of the Republic of Indonesia. Furthermore, the strategy was continued for improve external sector resilience in support of the rupiah exchange rate policy by maintaining adequate international reserves in terms of both first line of defense and second line of defense.

Monetary policy was also strengthened by reformulation of the monetary policy operation framework, representing one part of the transformation undertaken by Bank Indonesia. The principal objectives of this reformulation were three-fold: to strengthen the signalling of monetary policy, to improve the effectiveness of monetary policy transmission, and to promote financial market deepening. This reformulation was carried out in a changeover of the policy rate from the BI Rate to the BI7DRR, effective from 19 August 2016. This reformulation was also accompanied by measures to accelerate financial market deepening on both the rupiah and foreign exchange money markets.

Bank Indonesia policy mix was also supported by macroprudential policy aimed at strengthening bank intermediation while consistently maintaining financial system stability. In 2016, Bank Indonesia updated the regulations for the loan/financing-to-value ratio in a further increase in loan-to-value (LTV) or financing-to-value (FTV) ratio for property loan. Bank Indonesia also made changes to the regulation on the loan-to-funding ratio (LFR) related to RR by raising the lower limit of the target ratio from 78% to 80% in order to stimulate the bank intermediation function. Following this, Bank Indonesia reset the Countercyclical Capital Buffer (CCB) to 0% after careful consideration of the most recent conditions in the economy and the systemic risk of credit growth.

The OJK also introduced various microprudential policies in support of policy synergy for safeguarding financial system stability. In 2016, OJK policy was aimed at ensuring that activities in financial services operate in a regulated, fair, transparent, and accountable manner that in turn can strengthen financial system resilience and consumers protection. The main function of the OJK is to regulate and supervise financial services activities in the banking industry, capital market, insurance, pension funds, multifinance companies, and other institutions operating in financial services.

Bank Indonesia also pursued policies in the payment system to strengthen the payment system infrastructure in keeping with international standards. These policies are among the measures taken in support of structural reinforcement of the economy through the creation of an efficient payment system. Following the smooth launching of the second generation of Bank Indonesia Real Time Gross Settlement (BI-RTGS) and the second generation of Bank Indonesia National Clearing System (SKNBI), Bank Indonesia updated and made changes to service features in the payment system with a bulk payments service implemented on 2 May 2016. Bank Indonesia also introduced the concept of the National Payment Gateway (NPG) to serve as infrastructure for integration of various payment channels in order to facilitate electronic payment transactions. In this area of the payment system, Bank Indonesia also established closer policy synergy with the Ministry of Social Affairs when integrating the non-cash payment system with disbursement of social assistance under the Family Hope Program (PKH). In the cash payment system, policy sought to meet the need for cash in society in regard to adequate cash volume, appropriate denominations, timeliness of supply, and fit for circulation.

The Bank Indonesia policy mix was implemented by forging closer policy coordination with the Government and

other stakeholders. Policy coordination involved actions for inflation control both at the central government and regional levels. Bank Indonesia also coordinated with other authorities to promote financial market deepening and financial inclusion, as well as with the Financial System Stability Committee (KSSK) concerning measures for ensuring financial system stability. Coordination in financial system stability was strengthened with the adoption of the Act concerning Prevention and Resolution of the Financial System Crisis (PPKSK). In addition, policy coordination focused on acceleration of structural reforms in support of sustainable economic growth. The policy mix and policy coordination was also bolstered by an effective strategy for policy communication to the public.

The various policy initiatives were supported by structural policies to improve efficiency and productivity in the economy. In this regard, the Government has moved forward with multifaceted development of infrastructure, including energy infrastructure with construction of power plants and infrastructure for connectivity, such as toll roads, airports, light rapid transit (LRT), and so on. In 2016, the Government also focused on policies such as harmonization of regulations, ease of licensing procedures, and fiscal incentives. The Government set out the policy focus in the Economic Policy Packages IX-XIV, which carried forward from the policy packages launched in 2015. Prominent key points that stand out in the 2016 Economic Policy Packages include Government actions to improve ease of doing business in Indonesia as an initiative to encourage investment. In addition, the Government also pursued efforts to strengthen export-oriented economic activities by providing financing facilities to micro, small, and medium enterprises (MSMEs) under the Export-Oriented People's Business Credit (KURBE) scheme.

Performance of the Indonesian Economy in 2016

The policy synergy undertaken by the Government, Bank Indonesia, and the OJK, with support from the predominant role of domestic demand, successfully charted the course for ensuring the continued resilience of the Indonesian economy in 2016. The combination of the two factors proved adequate to mitigate risk from adverse global conditions. The structure of the economy, which is still approximately 60% driven by private consumption, helped to minimize the impact of limited performance in the external sector. The sizeable role of private consumption was also closely linked to the effect of stimuli from fiscal, monetary, and macroprudential policies, and the positive impact of well managed economic and financial system stability. In turn, these conditions enabled the economy to

resume an upward growth trend with continued support from macroeconomic and financial system stability.

Indonesia's economic growth improved from 4.9% in 2015 to 5.0% in 2016, buoyed by domestic demand despite slack performance in real exports. The predominant role of domestic demand was driven by the fiscal stimulus channelled through a range of infrastructure projects, particularly in the first half of 2016, in addition to the positive impact of monetary and macroprudential policies relaxation. The infrastructure spending in the first six months of 2016 provided a boost to construction investment that went on to strengthen economic growth until the third quarter of 2016 (Table 2). The policy response also maintained the level of consumer confidence and helped to sustain buoyant growth in household consumption at 5% in 2016. However, the role of private sector was limited due to internal consolidation strategies pursued in the private sector in response to sluggish conditions in the global economy. Under these strategies, corporates held back from expansion, and as a result non-construction investment remained weak until the third quarter of 2016.

Based on quarterly dynamics, the contribution of real exports and private corporations to economic growth began to improve in the fourth quarter of 2016. In that quarter, growth in real exports reached 4.2% (yoy), the first such positive growth recorded since the third quarter of 2014. Performance improved for private sector corporations as reflected growth in non-building gross fixed capital formation in the fourth quarter of 2016 that strengthened to 7.1% (yoy), the highest level since 2013. The positive developments in real exports and non-building investment acted to curb the risk of slowdown in economic growth from cutbacks in the fiscal stimulus during the fourth quarter of 2016.

In spatial analysis, improved economic growth during 2016 was recorded primarily in the regions of Sumatra, Java, and Kalimantan. Economic growth in the most provinces in Sumatra and Java mounted higher than the preceding year. Similar progress was visible in Kalimantan, with increased economic growth in nearly all provinces. Economic growth in these different regions was driven mainly by buoyant household consumption and renewed growth in exports in the fourth quarter of 2016 in line with commodity price increases in the global markets. Alongside this, economic growth remained strong in various regions of Eastern Indonesia in 2016 despite slowing a little compared to 2015 due to the depressed mining sector.

Table 2. Key Indicators of Indonesian Economy

Components	2013	2014	2015	2016				
				I	II	III	IV	Total
Economic Growth (% ,yoy)	5.6	5.0	4.9	4.9	5.2	5.0	4.9	5.0
Household Consumption (% ,yoy)	5.4	5.2	5.0	5.0	5.1	5.0	5.0	5.0
Government Expenditure (% ,yoy)	6.8	1.2	5.3	3.4	6.2	-3.0	-4.1	-0.2
Gross Fixed Capital Formation (% ,yoy)	5.0	4.5	5.0	4.7	4.2	4.2	4.8	4.5
Building (% ,yoy)	6.7	5.5	6.1	6.8	5.1	5.0	4.1	5.2
Non Building (% ,yoy)	0.6	1.6	2.0	-1.2	1.7	2.2	7.1	2.5
Export (% ,yoy)	4.2	1.1	-2.1	-3.3	-2.2	-5.7	4.2	-1.7
Import (% ,yoy)	1.9	2.1	-6.4	-5.1	-3.2	-3.7	2.8	-2.3
CPI Inflation (% ,yoy)	8.4	8.4	3.4	4.4	3.5	3.1	3.0	3.0
Core Inflation (% ,yoy)	5.0	4.9	4.0	3.5	3.5	3.2	3.1	3.1
Volatile Food Inflation (% ,yoy)	11.8	10.9	4.8	9.6	8.1	6.5	5.9	5.9
Administered Prices Inflation (% ,yoy)	16.7	17.6	0.4	2.8	-0.5	-0.4	0.2	0.2
Indonesia's Balance of Payments (BOP)								
Current Account Deficit (% GDP)	3.19	3.09	2.03	2.14	2.25	1.92	0.75	1.75
Overall Balance (USD billion)	-7.32	15.25	-1.10	-0.29	2.16	5.71	4.51	12.09
Reserves (USD billion)	99.39	111.86	105.93	107.54	109.79	115.67	116.36	116.36
Exchange Rate (Average, Rp per USD)	10,445	11,876	13,392	13,525	13,313	13,130	13,247	13,305
Composite Stock Price Index	4,274	5,227	4,593	4,845	5,017	5,365	5,297	5,297
Government Bond Yield 10 years (%)	8.45	7.80	8.76	7.67	7.45	7.06	7.97	7.97
Banking								
Credit Growth (% ,yoy)	21.80	11.65	10.40	8.52	8.78	6.35	7.85	7.85
CAR (end of periode, %)	18.36	19.38	21.39	21.76	22.29	22.34	22.69	22.93
NPL ratio (end of periode, %)	1.77	2.16	2.49	2.83	3.05	3.10	2.93	2.93
State Budget								
Tax (% GDP)	11.3	10.9	10.7	1.7	2.6	3.0	3.1	10.3
Budget Deficit (% GDP)	2.2	2.1	2.6	1.2	0.7	0.1	0.7	2.5

Source: Bank Indonesia, Ministry of Finance, BPS - Statistics Indonesia, IDX - Indonesia Stock Exchange

Unemployment and poverty levels eased in line with the improvement in economic growth. During 2016, open unemployment dropped from 6.2% recorded in 2015 to 5.6%. The numbers of people living in poverty also fell from 11.2% of the total population in 2015 to 10.7%. The positive impact of various improvements result led to reduction in income disparities reflected in decline in the Gini ratio from 0.402 in 2015 to 0.397 in 2016.

Improvement achieved in the Indonesia balance of payments helped to bolster external sector resilience. In 2016, the balance of payments recorded a USD12.1 billion surplus with contribution from a reduced deficit in the current account (CA) and a heftier surplus in the capital and financial account (CFA). The drop in the CA deficit from 2.0% of GDP in 2015 to 1.8% of GDP in 2016 was a heartening development amid slack performance in exports due to unfavorable global economic conditions. The lower CA deficit is explained in part by the subdued level of imports that represented a positive contribution from adjustments

by domestic business agents to cope with falling external demand and the impact of rupiah exchange rate movement in line with fundamentals. Meanwhile, the increase in the CFA surplus came in response to high capital inflows spurred by positive perceptions among foreign investors of the outlook for the Indonesian economy, including the effect of the successful outcome of the tax amnesty program. The positive outcome in the balance of payments produced an increase in Indonesia's international reserves from USD105.9 billion in 2015 to USD116.4 billion in 2016. Total external debt also remained at a prudent level of 34% of GDP, down from 36% of GDP in 2015 in line with the consolidation process of the corporate sector.

The balance of payments surplus recorded in 2016 had a positive impact on the rupiah exchange rate, which remained stable during the year. Unlike other regional currencies that suffered depreciation, the average value of the rupiah in 2016 appreciated by 0.7% over 2015. Point-to-point, the rupiah in 2016 closed at Rp13,473 per USD,

up 2.3% over the level at the end of 2015. The rupiah gains were mostly evident in the first three quarters of 2016, in line with the rise in foreign capital inflows to Indonesia and improvement in the structure of foreign exchange demand. Steady improvement was visible in foreign exchange demand, representing a positive outcome of the implementation of prudential principles (KPPK) in managing external debt of the non-bank and mandatory use of the rupiah within Indonesian territory. Foreign capital inflows, much of which were placed in Indonesian financial market instruments, also strengthened the performance of Indonesian stock market and bond market. Following gains in 2016, the IDX Composite Index closed the year at 5,296, up from 4,593 in 2015. Yield on 10-year government bonds also declined 77 bps to 7.97%, among others from the effect of reductions in interest rates and lower inflation.

In 2016, improving economic conditions in Indonesia were also bolstered by subdued inflation. Inflation in 2016 was recorded low at the level of 3.02%, representing a continuation of level reached in 2015 within the 4±1% targeting range. Contributing to this achievement were persistently low commodity prices, more stable rupiah exchange rate, prudently managed aggregate demand, and diminished inflation expectations. These factors contributed to low core inflation at 3.07%. The low inflation was also attributed by inflation in administered prices due to falling prices, mainly in the first six months of 2016, for such strategic energy commodities as petroleum-based fuels, electricity billing rates for customers in the 1,300 VA brackets and above, and 12 kg LPG cylinder. Alongside this, volatile foods inflation remained well under control despite a modest increase over 2015 due to disruptions in supply from the La Nina effect.

Financial system stability also remained firm, despite concerns over increased credit risk. Various banking resilience indicators remained strong, including the liquidity and capital adequacy indicators. Improvement in bank liquidity indicators in 2016 was reflected in the ratio of liquid assets to deposits, which climbed to 20.9%. The increase in liquidity resulted in part from the expansionary fiscal operations by the government and the effect of Bank Indonesia's relaxation of the statutory reserve requirement (RR). Capital adequacy ratio strengthened from 21.2% in 2015 to 22.8% in 2016. However, credit risk mounted higher, as reflected in the rise in non-performing loans (NPLs) from 2.5% to 2.9% in 2016 even though still within safe level at less than 5%.

Increased credit risk prompted banks to carry out internal consolidation, which affected monetary policy transmission through both the interest rate and the credit channel. In

the interest rate channel, indications suggest that higher credit risk put a brake on decline in loan interest rates. Loan interest rates eased by just 80 bps in significant difference to the policy rate and deposit rates that had previously reduced by 150 bps and 123 bps. In the credit channel, mounting credit risk deterred banks from lending. During the times of weak corporate demand for credit and less than optimum decline in loan interest rates, banks also undertook internal consolidation that in turn resulted in lacklustre credit growth at 7.95% in 2016. This represented a downturn compared to the 2015 growth of 10.4%.

The financial system stability that was prudently maintained and the low systemic risk were closely linked to the healthy condition of the national payment system. Various payment system indicators showed an upward trend and operation of the payment system by Bank Indonesia and the industry proceeded well without any significant disruption. The payment system operated by Bank Indonesia and the payments industry achieved growth in transaction value. For non-cash retail transactions in particular, transaction value climbed 15.5% in 2016. In the cash payment system, currency management exerted a positive influence reflected in the timely provision of cash currency in adequate volume, appropriate denominations, and in fit condition for circulation.

Outlook for the Economy in 2017 and the Medium Term

The Indonesian economy is predicted to achieve further gains in 2017, bolstered by improvement in the global and domestic economic outlook. At the global side, economic growth is projected to improve in comparison to 2016, which may keep energy and non-energy commodity prices at high levels. On the domestic side, the economic outlook is also predicted to improve as consolidation process of corporations and banks begins to ease. Corporations, buoyed by renewed business optimism, partly driven by increases in global commodity prices, are expected to move forward with business expansion as already evident in the fourth quarter of 2016. In tandem with corporate optimism, banks are also predicted to begin increasing lending, spurred by forecasts that credit risk will begin to ease.

The outlook for improvement in the economy is also bolstered by the fiscal policy stance for a continued stimulus for the economy in 2017, targeting sectors with higher multiplier effects. In 2017, the Government budget target for infrastructure spending is Rp387 trillion, up significantly from the Rp267 trillion in 2016. The increase in infrastructure budget will bring the proportion of infrastructure spending to total budget expenditures in 2017 to 18.6%, well ahead of

the proportion in 2016 recorded at 14.4%. Nevertheless, this policy strategy remains within the corridor of prudent fiscal management in which the 2017 budget deficit is targeted at about 2.4% of GDP.

In view of these global and domestic factors, in 2017 Indonesia's economic growth is projected to climb to 5.0-5.4%. This growth, like before, will be driven to a large extent by domestic demand, i.e. consumption and investment, although improvement has now also become visible in exports. Private consumption is forecast to remain strong, buoyed by household confidence and the effect of the expanding middle income class. Investment will also mount, spurred by the ongoing government-sponsored development of infrastructure and a renewed increase in private investment. Meanwhile, real exports are predicted to climb in tandem with the effects of more robust global economic growth and higher global commodity prices. In analysis by sector, increases in commodity prices are expected to improve the fortunes of the mining and agricultural sectors that in turn will benefit secondary sectors, such as manufacturing, and also tertiary sectors.

Economic stability is predicted to hold firm and in doing so contributes to the outlook for higher economic growth. While increased inflation is projected for 2017, it will remain manageable within the $4\pm 1\%$ targeting range. The rise in inflation during 2017 will be fuelled primarily by increases in the administered prices category linked to the Government policy for targeted provision of electricity subsidies to 900 VA customers. The predicted increase in inflation will also represent the impact of rising global energy prices that can potentially lead to hikes in prices for fuels and electricity. Meanwhile, the effects of increased aggregate demand in keeping with higher economic growth will remain within manageable limits, with core inflation staying low. Prudently managed economic stability will be accompanied by a current account deficit that is predicted to remain sound at below 2.5% of GDP.

Improving economic growth and well maintained economic stability are expected to bring improvement to the performance of the banking system. The outlook for higher economic growth, declining credit risk, and probability for further interest rate reductions will stimulate increased bank lending in 2017. Credit growth in 2017 is projected in the range of 10-12%. This increase in credit growth may deliver multiplier effects including increased bank funding, where growth in 2017 is projected in the 9-11% range.

The medium-term outlook for improvement in Indonesia's economic growth is predicted to remain on track with support from falling inflation and a prudent current account

deficit. This forecast is supported by the positive impact of various structural reforms that currently in place. The structural reforms are expected to achieve greater efficiency and productivity in the economy, which will include the impact of improvement in interregional connectivity that will build more strength into production and distribution structures and reduce production costs. Overall, the outlook for improved efficiency and productivity will in turn boost economic growth without excessive pressures driving up inflation and the current account deficit. Inflation is forecast to stay within the $3\pm 1\%$ range for 2021. In addition, the current account deficit will be held at a prudent level below 2.5% of GDP.

Challenges Ahead for the Economy

The prospects for the Indonesian economy described above still call for prudent management in view of short and medium-term risks that could still arise in a global and domestic context. These risks could bring renewed disruption to the economic outlook. Economic growth may not only underperform forecasts, but could also weigh down on economic stability with such effects as increased inflation and depreciation pressure on the rupiah exchange rate. This instability will create pressure returning back to weigh down on economic growth in the short term and in the medium term.

In 2017, the first risk from the global aspect is related to recovery in global economic growth and trade volume that may disappoint expectations. Commodity prices may also fall short of forecasts. Global economic growth could again underperform forecasts if the process of economic consolidation in major countries has not reached fruition. If these conditions persist in 2017, the outlook for commodity prices may fall short of forecasts and put further pressure on Indonesia's exports and economic growth in 2017.

The second risk is related to the international trade policies in developed countries that are tending towards greater protectionism and come accompanied by populist political policies. This second risk brings with its various second-round effects. Initially, the policy stance may lead to reduction in world trade volume. The risk may then spread to decline in global economic growth and falling commodity prices. Trade protectionism issues and populist policies could then spread further afield, this increasing uncertainty on global financial markets.

The third global risk concerns the US macroeconomic policy stance that could increase the risk of capital reversal to the US and uncertainty on global financial markets. The

US macroeconomic policy stance is related to the plan for expansionary fiscal policy. If this happens, it could increase yields on US treasury bonds with the risk of triggering capital reversal from emerging markets, including Indonesia. This risk would become even greater if the Fed acts more aggressively than expected by markets in raising the FFR. The various conditions that could trigger capital reversal, compounded by geopolitical risks in many countries, will ultimately create susceptibility that will increase uncertainty on global financial markets and weigh more heavily on currencies around the world, including the rupiah.

The latter risk is related to a resurgence in global inflation if global commodity prices, including energy, continue to increase. This risk, if allowed to persist, could stoke domestic inflationary pressure. In addition, a rise in global inflation may bring changes in monetary policy stance around the world from the present loose bias to a neutral stance or tight bias. Attention will be needed to any change in monetary policy responses as this will affect global capital flows and heighten uncertainty on financial markets with depreciation pressure on the currencies of emerging markets.

The multifaceted risks in the global economy pose challenges for the Indonesian economy in maintaining economic and financial system stability and strengthening economic growth. These challenges to the economy call for greater attention because of a number of interrelated short-term domestic issues that are also crucial to accelerating economic recovery. The first is related to capacity for increasing tax revenues as a base for expanding fiscal space for an economic growth stimulus. The second concerns the speed for completion of the consolidation process for corporate entities and banks, which in part is also influenced by the capacity for fiscal stimulus. The third is about renewed measures for strengthening of the effectiveness of monetary policy transmission, which had previously been halted due to the consolidation of the banking system and corporate sector. The last concerns refinement of the strategy for curbing the risk of higher than predicted inflationary pressure. The risk of mounting inflation is linked primarily to likelihood of an increase in energy prices. This is a matter of considerable importance, as higher global energy prices can lead to increases in strategic administered prices and other prices.

In the medium and long-term, the challenges to the economy are related to actions for structural reinforcement of the economy for greater resilience. The thrust of these actions is to strengthen the economy for greater competitiveness in order to support sustainable economic growth while preventing Indonesia from becoming caught in the middle income trap. The medium-term challenges

for the economy include measures for improvement in the composition of export products in favor of high value-added manufactured products, strengthening the role of the manufacturing sector, promoting market competition and healthier trading regimes, and structural reinforcement of domestic financing.

Policy Direction for 2017

Macroeconomic policy in 2017 will focus on measures for maintaining macroeconomic and financial system stability to ensure the continuity of economic recovery. The policy direction will take account of the various risk and uncertainties that could impair short-term economic stability and hinder the economic recovery process going forward. The safeguarding of macroeconomic stability is of considerable importance, given that empirical experience, including that of 2016, has shown that economic stability forms the bedrock for promoting economic growth. At the same time, it is necessary to pursue efforts for sustainable improvement in economic growth in the short term and for structural reinforcement of the economy in the medium term.

As in 2016, the policy direction will be implemented in policy synergy involving the Government, Bank Indonesia, and the OJK. The policy synergy will be implemented in a policy mix that brings together fiscal, monetary, macroprudential, microprudential, and structural policies, including policy for the payment system and rupiah currency management. The policy synergy is not only aimed at mitigating short-term cyclical risks, but also at sustaining the momentum for economic recovery. This synergy will also be directed towards continued structural reinforcement of the economy for greater resilience and competitiveness.

In 2017, in line with the macroeconomic policy focus, Bank Indonesia will maintain a consistent track in safeguarding macroeconomic stability. Within this context, Bank Indonesia will employ a policy mix of monetary, macroprudential, and payment system-currency management. Monetary policy will focus on maintaining macroeconomic stability and will be synergized with macroprudential policies aimed at protecting financial system stability. Meanwhile, payment system and rupiah currency management policies will aim to improve transaction efficiency within the economy that in turn will support the operation of monetary and macroprudential policy transmission.

Regarding monetary policy, Bank Indonesia will consistently pursue a policy of curbing inflation in line with the target and maintaining the current account deficit at a prudent

level. Consistent with this monetary policy stance, the BI7DRR will be managed for curbing inflation in line with target. The monetary policy stance will be reinforced by an exchange rate policy aimed at maintaining stability in the rupiah in line with its fundamental value. The exchange rate policy will also be supported by management of domestic foreign exchange supply- demand and efforts to deepen the foreign exchange market. To reduce dependence on the US dollar, Bank Indonesia will engage in bilateral collaboration with other regional nations for local currency settlement.

The monetary policy stance will also be strengthened by the monetary policy operation strategy. First, Bank Indonesia will implement the Averaging Reserve Requirement in mid-2017. The aim of the Averaging Reserve Requirement policy will be to provide flexibility to banks for more efficient management of liquidity that in turn will strengthen monetary policy transmission. Second, Bank Indonesia will also optimize the use of government securities as monetary policy instruments in a phased replacement of Bank Indonesia Certificates (SBIs). The objective of this strategy is to promote financial market deepening and also to implement the mandates stipulated in the Act of Bank Indonesia and the Act of State Treasury. Third, Bank Indonesia will reintroduce the Variable Rate Tender (VRT) mechanism in monetary operations, replacing the Fixed Rate Tender (FRT) system.

Macroprudential policy will continue to focus on ensuring financial system stability while allowing space for measures to boost economic recovery. In this regard, macroprudential policies will target the mitigation of accumulated risk arising from procyclical behaviour and systemic risks in the financial system. Macroprudential policy can serve as a counter-cyclical instrument for promoting economic recovery. In relation to measures for mitigating systemic risk, Bank Indonesia will strengthen and expand the scope of macroprudential surveillance of households, corporate sector, and non-financial corporate groups. This expansion follows from an assessment that points to potential risk in the financial system and particularly banks due to the impact of deteriorating corporate performance. The policies for ensuring financial system stability will also be strengthened through coordination with the Financial System Stability Committee (KSSK) for integrated early detection of risks.

Bank Indonesia will also pursue a number of initiatives to accelerate financial market deepening in support of financial system stability in combination with financial system resilience. Under this policy direction, Bank Indonesia will continue working for development and expansion of the financial market under an ecosystem approach. This development and expansion will be conducted with the

seven pillars of instruments, users/providers of funds, intermediation institutions, infrastructure, regulatory framework, the benchmark rate, and coordination/ education. To support this initiative, Bank Indonesia will forge closer cooperation with the relevant authorities in accelerating financial market deepening, including in forums such as the Coordinating Forum for Development Financing through Financial Market (FK-PPPK), the Indonesia Foreign Exchange Market Committee (IFEMC), and the Association Cambiste Internationale (ACI).

Bank Indonesia will also support the development of the sharia economy and finance as a complement to conventional system. To this end, Bank Indonesia will prepare and launch a blue-print for development of the sharia economy and finance, covering both the commercial and social aspects. To support the deepening of the sharia financial market, Bank Indonesia will promote sharia money market instruments by using Sharia Government Securities as underlying transactions and implementing the Waqf-linked Sukuk. In regard to sharia social finance, Bank Indonesia will promote various efforts to expand the role of zakah (obligatory contribution) and waqf (endowment) and move forward with initiatives for establishment of a regulatory standardization institution and policy formulation at the international level.

Bank Indonesia will also participate in developing micro, small, and medium enterprises (MSMEs). To maintain control over volatile food prices, Bank Indonesia will promote the expansion of clusters based on MSMEs in a downstream approach. These clusters will also become one of the available instruments for the Regional Inflation Control Teams. In addition, Bank Indonesia will also carry forward the program for expansion of MSME infrastructure credit in order to mitigate the asymmetric information between MSME and banks.

Regarding the payment system, policy will focus on strengthening the institutional, infrastructure, and promoting financial inclusion. Payment system policy will be directed towards improving the efficiency of economic transactions in a way that will contribute to the building of more robust structures for the economy. Within this policy direction, policy initiatives cover four main areas. First, to implement the regulation on Provision of Payment Transaction Processing (PTP) for all payment system service providers, including financial technology (fintech) operators. Second, to optimize the role of Fintech Office and the regulatory sandbox function to promote the sound development of fintech. Third, to accelerate the establishment of an institution to operate the management functions of the National Standard of Indonesian Chip Card Specification (NSICCS). Fourth, to accelerate the National

Payment Gateway (NPG) and to require payment system service providers to conduct the processing of financial transactions within Indonesia territory. As concerns rupiah currency management, Bank Indonesia will continue to promote the clean money policy by extending coverage to remote and border regions under a master plan set out in the Centralized Cash Network Plan (CCNP). Meanwhile, in working for greater financial inclusion, Bank Indonesia will take further actions to expand financial access and improve efficiency by integrating the electronic non-cash ecosystem into Government assistance programs and public services.

In 2017, the Bank Indonesia policy mix will operate in synergy with the policies of the Government and the OJK. This policy synergy is intended to strengthen policy effectiveness in safeguarding macroeconomic and financial system stability and in promoting economic recovery. The policy synergy includes coordination with the Government in managing inflation in line with the target.

Bank Indonesia will also keep supporting various Government initiatives for strengthening the fiscal sustainability outlook in the firm belief that this will support the future sustainability of economic growth. Regarding this, priority needs to be devoted to efforts to strengthen the tax revenue structure and improve the quality of government expenditures, as this will improve fiscal resilience in the medium and long term.

In addition, Bank Indonesia will also support a range of Government measures for acceleration and more precise targeting in various structural policies that are believed will also contribute significantly to the future quality of economic growth. Regarding this, action is needed in a number of policy priorities by creating equilibrium in availability of resources. The priorities for policy action include policies for strengthening resilience and self-sufficiency in energy, food, and water supply; industrialization policies in a range of sectors including the maritime industry; policies for accelerated construction of physical and non-physical infrastructure, and policies for strengthening the financial sector.

In development of non-physical infrastructure that will support the structural reinforcement of the economy, attention will be needed to the commitment for continued strengthening of various key enablers for development. The key enablers include human capital, innovation and technology, and a robust institutional framework. Human capital innovation and technology are vital to improving economic productivity. Regarding the institutional framework, commitments must be strengthened further for eradication of corruption and improvement of legal certainty. In addition, it is also necessary to sustain the various efforts for improving the ease of doing business, including taking work forward on a range of deregulation and administrative reform policies that the Government has instituted to date.

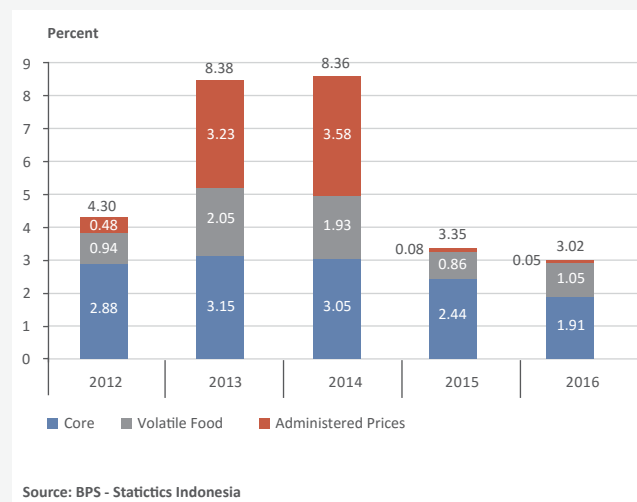
Box Accountability for Achievement of 2016 Inflation Target

In 2016, CPI inflation well maintained within the targeted range of $4 \pm 1\%$. Inflation in 2016 was remarkably low at 3.02%, the lowest since 2010. At this level, CPI inflation was again within the targeted range as had been achieved in 2015 (Chart 1). The low CPI inflation was supported by performance in all components, core inflation kept low, administered prices (AP) inflation at a minimum, and adequate curbing of inflation in volatile food (VF).

Core inflation was substantially low at 3.07%, decreased from 3.95% in 2015. This in turn contributed to low CPI inflation in 2016 at 1.91% (Chart 2). The low core inflation was influenced by several factors, in particular well managed aggregate demand, minimum external pressures, including rupiah exchange rate appreciation, and decline in inflation expectations. The low core inflation was also contributed by the minimal second-round effects of AP inflation and VF inflation on core inflation.

The low core inflation was supported by positive contribution from Bank Indonesia policies in keeping inflation on track with the target. Bank Indonesia implemented monetary policy that consistently focused on efforts to manage inflation in line with the established target. In addition, monetary policy included actions to maintain rupiah exchange rate in line with its fundamental value. Bank Indonesia also worked in coordination with the Government to strengthen public confidence that future inflation would be curbed in line with inflation target (Diagram 1).

Chart 2. Decomposition of CPI Inflation 2012-2016



Inflation in the AP category was remarkably low throughout 2016 at 0.21%, down from the 0.39% level reached in the preceding year. This positive achievement came largely in response to the second-round effect of low global oil prices and rupiah appreciation. These two positive developments created room for the Government to reduce prices for various strategic commodities. In the second half of 2016, the Government lowered fuels prices that was followed by reductions in public transport fares and in the upper and lower limits of air fares. Prices of non-subsidized fuels and 12 kg LPG cylinder were also reduced. The modest AP inflation was also contributed by the delayed implementation of the

Chart 1. Realization and Target of CPI Inflation

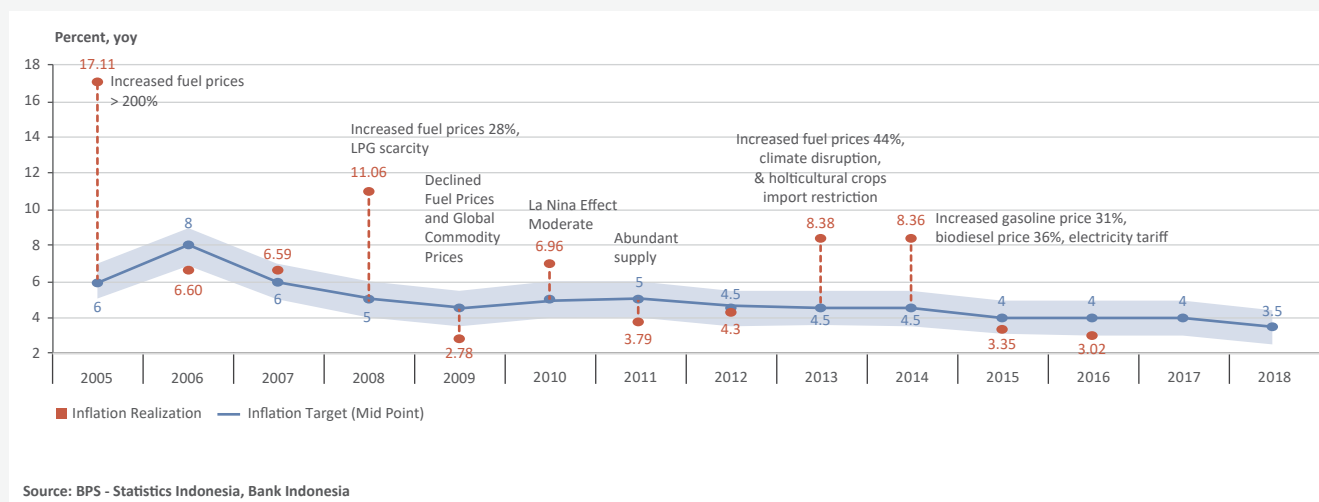
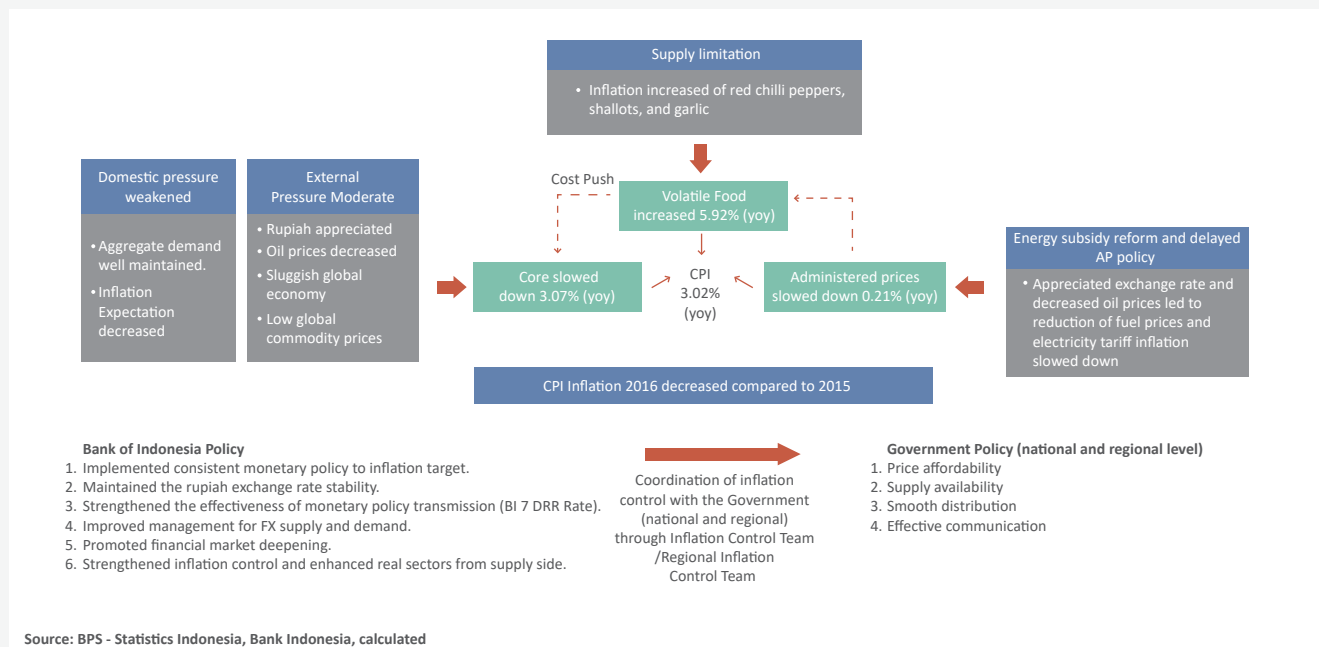


Figure 1. Inflation 2016 and Affecting Factors



targeted subsidy policy for 900 VA electricity customers and the price increase for 3 kg LPG cylinder.

In 2016, VF inflation remained under control despite a modest increase over the preceding year. In the VF category, inflation was recorded at 5.92%, slightly increased from 4.84% in 2015. However, the VF inflation outcome in 2016 was still below the historical trend for 2005–2016 marked by an average level in the 6–8% range.¹

The main commodities contributing to higher VF inflation in 2016 were red chilli peppers, shallots, and garlic. Price increase for the three commodities were triggered by supply side problems caused by high rainfall and virus attacks in some producing areas, while price stabilization instruments still limited. Further increases in VF inflation were curbed by prices reduction for other commodities, notably rice, meat and eggs from commercially bred chickens, and beef. In addition, the Government pursued fairly intensive actions to bolster the supply of food staples, which also curbed pressure for further increases in VF inflation.

The Government has implemented a range of policies for ensuring adequate supply of food staples in support of VF inflation control. The policies put in place include a policy for

increasing domestic rice production and for carry-over of rice imports from 2015. These policies kept rice in adequate supply. In 2016, the Government rice buffer stock was increased by 25%, enabling it to support market operations. In addition, the supply of beef was largely well maintained throughout 2016, supported by supply from domestic sources and foreign beef imported by Bulog. The strategic role assumed by Bulog in controlling food prices was as envisaged in the Government policy, in which Bulog is tasked with securing the availability of food and stabilising food prices at the producer and consumer levels. In addition, the Government also implemented various policies aimed at overcoming problems in food distribution and access, among others through the Maritime Counter and Our Food House programs.

Achievement of the inflation target in 2016 was also supported by intensive coordination between Bank Indonesia and the Government at both the national and regional levels. The coordination operated mainly through the TPI and TPID forums. In 2016, TPI and the TPID carried forward programs focused on raising production, improvements to market structures, improvements to distribution, strengthening regulations, maintaining inflation expectations, and public education about inflation. The positive outcomes achieved through coordination were reflected in improvement in food inflation during the 2016 religious festive seasons compared to the historical trend. Price stabilization was carried out in market operations and cut-price markets for main commodities to inflation,

¹ Annual inflation in the VF category at end-of-year in the period 2005–2016 (except in 2005, 2006, 2008, and 2013–2015, the years of fuel price hikes) averaged 7.69%.

such as market operations for chilli peppers and beef. The TPID also promoted interregional collaboration, such as that undertaken by the Jakarta provincial government with West Java and Banten in controlling the supply of rice and beef. Furthermore, the TPID activities are also focused on increasing production of chilli peppers, mass cultivation of garlic seedlings, regulation of chilli pepper planting, optimization of the warehouse receipt system, provision of financial aid for transportation costs, and development of access to food price information.

