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A concrete manifestation of life is the ability to transform the lives of others. This is a form of cooperation that nature has created to continue birthing, fostering and preserving all existing form of life.

CHAPTER VI

ECONOMIC OUTLOOK AND BANK INDONESIA'S POLICY DIRECTION



CHAPTER VI

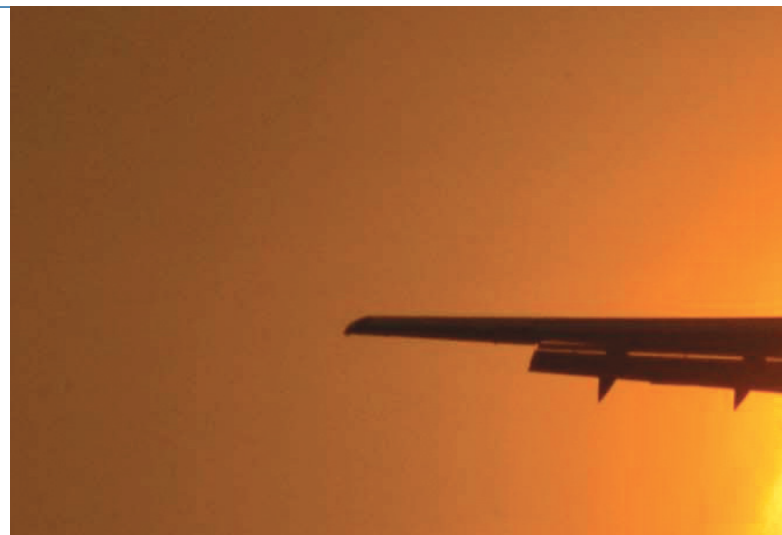
Economic Outlook and Bank Indonesia's Policy Direction

Going forward, Indonesia's economy is expected to perform better. In 2011, on the back of maintained macroeconomic stability, economic growth is expected to pick up, the balance of payments will continue to post high surplus, and the banking intermediary function will also improve. Nonetheless, the challenges faced will remain arduous. Foreign capital inflows and excess bank liquidity will remain high. Furthermore, stronger demand and soaring global food prices, compounded by adverse weather conditions, will create their own challenges in preserving price stability. Accordingly, the policy mix and coordination with the Government implemented in 2010 will be strengthened in 2011 to maintain inflation within its target corridor. In the medium-long-term, with a range of policies instituted to overcome structural constraints, the economy is projected to achieve growth exceeding 7%, coupled with lower inflation, heading toward 3.5% range.

From the external side, the global economic recovery in 2011 is expected to improve with growth approaching its long-term trend and returning to its pre-crisis levels. Economic recovery in emerging market countries will outpace that in advanced countries, due to a number of enduring challenges in advanced countries such as high unemployment and fiscal deficits. In line with robust global economic performance, international commodity prices are expected to rise. Such conditions indicate that inflation in emerging market countries will remain relatively high, followed by increasing inflation in advanced countries. Against this backdrop, emerging market countries are expected to maintain tight monetary policy, while advanced countries will also begin to tighten their monetary policy stance.

From domestic side, the Government will continue to strike the balance between fiscal consolidation and fiscal stimuli. The fiscal policy will be focused on developing infrastructure and poverty alleviation to enhance public welfare. The Government will make an attempt to allocate subsidy more effectively to targeted beneficiaries. The allocation of energy subsidies will be gradually reduced without increasing the prices of goods and services consumed by low-income families to avoid causing extra burden to them. In terms of revenues, efforts to optimise taxation will bolster state revenues in 2011. The budget deficit of 1.8% of GDP will be primarily financed by the issuance of rupiah denominated SBN.

In line with the assumptions already mentioned, domestic economic performance is expected to chart higher growth, accompanied by more balanced sources of growth. Economic expansion is buoyed by greater investment, solid export performance on the back of strong growth in trading partner countries, particularly in the Asian region, and an increase in household consumption. Optimism of higher investment is supported by encouraging progress in overcoming a number of infrastructure constraints. Investment is also driven by a sovereign credit rating upgrade, approaching an investment grade. In addition, the Government is expected to play a larger role in Indonesia's economic expansion in 2011, hence attaining a higher level of growth. From the production side, expansive economic growth is buttressed by the greater role played by the manufacturing sector. In addition, the engine of growth will also come from the trade, hotels and restaurants sector as well as transportation and





communications sector. Economic growth in 2011 is forecasted to pick up pace and arrive at 6.0%-6.5%.

The balance of payments will continue to retain a significant surplus, but more modest compared to that reported in 2010. Solid export growth will maintain the current account surplus at a high level, amid stronger import and higher interest payment on rupiah portfolio assets owned by foreign investors. Widespread global excess liquidity, coupled with solid fundamentals in emerging market countries will continue to drive capital flows into emerging markets, including Indonesia. The structure of capital inflows will improve with a greater role played by foreign direct investment (FDI). With solid support from the balance of payments, the average rupiah in 2011 will remain relatively stable compared to the average in 2010.

Concerning prices, amid potentially high inflationary pressures, Bank Indonesia and the Government will continue to steer inflation towards its target corridor, namely 5%±1% in 2011 and 4.5%±1% in 2012. This will be accomplished by reinforcing the policy mix and through close coordination with the Government. Coordination covers measures to anticipate disruptions to the production and distribution of staple goods. Infrastructure development by the Government, among others aimed at supporting national food security and improving inter-regional linkages, will help boost production and facilitate food distribution. In this context, Bank Indonesia and the Government will optimise the roles of TPI and TPID. Optimism to tame inflation within its target corridor is also based on the Government's plan to avoid raising the prices of strategic goods

and services, like the basic electricity tariff, liquefied petroleum gas (LPG), subsidised fuels, and transport tariffs.

Financial system stability will be maintained, accompanied by an improvement in the bank intermediation function. Increased economic performance will continue to be directed towards efforts to preserve macroeconomic and financial system stability. From a banking standpoint, credit growth will remain robust, with working capital credit leading the way. Consumption credit growth is expected to remain high on the back of continuing strong household consumption. Furthermore, the acceleration in investment credit growth is projected to continue in 2011 along with strong investment growth. On the non-bank financial market, the issuance of bonds and IPO will be higher, correspond to greater economic activity, the influx of capital flows and the upgraded of sovereign credit rating.

Despite widespread optimism surrounding an improvement in future economic performance, several challenges and risk factors remain and may compromise the accomplishment of the inflation target and macroeconomic performance. The challenges faced in 2010 are expected to continue to overshadow the Indonesia's economic landscape in the future, namely the deluge of foreign capital inflows, high banking excess liquidity, and high inflationary pressures. In terms of the financial sector, the challenges that require a response include how to increase financial sector resilience while at the same time provide financing to the real sector and strengthening competitiveness. In addition to these challenges, a number of risk factors as well as

uncertainty also require attention, both domestically and internationally. From external side, risk factors stem from, among others, soaring international prices of oil and food commodities. Meanwhile, widespread uncertainty over the crisis recovery in advanced countries could hamper demand for export commodities. From domestic side, the risk of disruptions to food production and distribution could place additional pressures on future inflation. Furthermore, soaring global commodity prices, especially oil, may force the Government to adjust administered prices of strategic goods and services, such as basic electricity tariff, LPG, subsidised fuels and transportation tariffs.

In the medium term, global economic growth is projected to remain high in line with its long-term trend. Supported by expected recovery in global economy, Bank Indonesia projects world trade volume to remain high. Such conditions will be followed by an uptrend in commodity prices, but at a moderate level. From domestic, the fiscal deficit will be on a downward trend, on the back

of Government's commitment to achieve fiscal sustainability. In the medium term, government policy will aim to enhance the accumulation of capital and boost productivity in order to improve competitiveness. Accordingly, economic growth is predicted to surpass 7% followed by lower inflation, which heading towards 3.5%.

In response to the economic dynamics and challenges faced, Bank Indonesia and the Government took an array of policy measures to strengthen economic recovery momentum. From a monetary viewpoint, BI policy consistently seeks to achieve the inflation target. In terms of banking, policy strives to increase bank resilience and boost competitiveness while mitigating the shock. Concerning the payment system, the policy goal is to create a payment system that is efficient, reliable, simple and secure. The complexity of the challenges faced necessitates better policy coordination and more diversified instruments, which require balanced and measured implementation based on assessment on future economic performance.

6.1

Economic Prospects



■ Short-Term Economic Prospects

Going forward, short-term Indonesian economic performance is not independent from several underlying factors. From external side, global economic growth in 2011 is projected to remain buoyant. Accordingly, world trade volume will also remain high and will be followed by rising international commodity prices. From domestic side, larger fiscal stimuli are predicted for 2011. Against this encouraging backdrop, domestic economic performance will continue to improve accompanied by more balanced sources of growth. The economic activity in 2011 will be supported by stronger investment growth, solid export performance due to robust growth in trading partner countries, particularly in Asia, and higher household consumption.

Assumptions

Global Economy

Economic Growth and World Trade Volume

Global economic growth in 2011 is projected to remain relatively sound, despite a slight slowdown compared to the rapid growth posted in 2010. The economies of advanced countries are expected not fully recover yet due to the persistence of a number of arduous challenges including fiscal austerity amid weak household consumption stemming from high unemployment. Japan and countries in the Euro zone are projected to experience slower growth in 2011.

Economic recovery in emerging market countries is expected to outpace that recorded in advanced countries. Economic expansion in emerging market countries will remain robust in 2011 despite a modest downtrend attributable to a tighter policy stance. Impressive economic growth in such countries is primarily driven by China and India due to strong domestic demand.

In 2011, global economic growth is expected to arrive at 4.4% (yoy). Emerging market countries, projected to post 6.5% growth, will remain the key drivers of the global economic growth. On the other hand, advanced countries are predicted to achieve merely 2.5% growth rate.¹⁰⁶ In line with slower global economic growth in 2011, world trade volume is also expected to decline, although remain relatively high and returning to its pre-crisis historical average, at around 7.1%.

¹⁰⁶ World Economic Outlook Update, IMF, January 2011

Global Commodity Prices and Inflation

On the back of sound global economic performance, particularly in emerging markets, international commodity prices are forecasted to pick up. The average oil price (minas) is estimated to reach USD 90 per barrel in 2011. The escalating fuel price will be driven by, among others, a weaker US dollar reflected by a surging non-commercial contracts, and relatively limited expansion in production. OPEC oil production is expected to go up by 0.4 million barrels per day, which is in stark contrast to the projected increase in global oil consumption of 1.4 million barrels per day.¹⁰⁷ In line with oil prices hike, the prices of other commodities will also trend upwards. Non-oil/gas commodity prices will rise due to relatively strong global economic growth, especially in emerging market countries.

Global inflation in 2011 is forecasted to remain relatively high, primarily in emerging market countries. High inflation is the result of economic recoveries in both emerging and advanced countries as well as soaring commodity prices. Based on IMF projections (WEO-January 2011), inflationary pressures in advanced and emerging countries in 2011 will be 1.6% (yoy) and 6.0% (yoy) respectively. Looking forward, economic growth and in advanced countries are expected to pick up despite remaining below those in emerging market countries. Therefore, monetary policy in advanced countries will, in general, remain loose with a few advanced countries beginning to tighten their monetary policy stance. On the other side, emerging market countries are expected to maintain a tighter monetary policy stance.

Domestic Economy

Fiscal Policy

The Government and People's Representative Council (DPR) concurred to provide a larger fiscal stimulus to the economy in 2011. Fiscal policy in 2011 will focus on infrastructure development and poverty reduction to improve public welfare. This objective will be achieved through a triple-track strategy, namely by expanding economic growth (pro-growth), creating job opportunities (pro-job) and introducing social safety nets for low income families (pro-poor). The fiscal policy strategy for 2011 is to balance fiscal consolidation with fiscal stimuli. This policy

direction is evident from the state budget deficit in 2011 amounting to Rp124.7 trillion or 1.8% of GDP.

In terms of revenue, efforts to optimise taxation are expected to enhance the state's revenue in 2011. A variety of policy programs, for example the extensification and intensification of taxes, improvement in the quality of inspection and investigation, refinement of the objections and appeal mechanism, extensification of excisable goods, as well as better supervision of customs and excise, are expected to raise tax ratio from 11.9% in 2010 to 12.1% in 2011. The Government also strives to increase lifting on oil/gas, improve cost recovery efficiency, optimise revenue from non-oil/gas natural resources and boost the performance of state-owned enterprises in order to maintain sources of revenue originating from non-tax state revenues (PNBP).

Government spending will focus on infrastructure development and poverty reduction. To this end, the Government has a variety of targets, namely national food security, national energy security, strengthening inter-regional linkages, bolstering virtual domestic interconnectivity, reducing the housing backlog, as well as increasing the supply of fresh water and flood defences. Meanwhile, the Government will also continue a number of health and education programs, as well as the National Community Empowerment Program and the Family Hope Program in order to alleviate the poverty level.

The Government will also make an attempt to reduce the allocation of energy subsidies without causing extra burden to low-income families. In the 2011 state budget, the Government has no plans to raise the electricity tariff and will instead demand improvements in efficiency. Furthermore, the Government is expected to maintain the price of subsidised fuel and allocate subsidies more effectively to more targeted beneficiaries. Therefore, the Government is currently considering a number of options related to the use of a subsidized fuel to prevent excessive consumption as well as maintaining subsidies for targeted beneficiaries. Regarding non-energy subsidies, the Government will continue food subsidies to 17.5 million targeted households in the form of providing cheap rice.

The budget deficit will primarily be financed by SBN issuances, particularly rupiah SBN, on the domestic market. SBN will be issued through diversification of instrument and tenor. Meanwhile, net foreign loans will remain negative. Consequently, fiscal sustainability will be

¹⁰⁷ Short-term Energy Outlook, U.S Energy Information Administration, December 2010

ensured by reducing the ratio of government debt stock to 25%-26% of GDP in 2011.

Economic Prospects in 2011

Looking ahead, domestic economic performance will continue to improve, accompanied by more balanced sources of growth. Such growth will be supported by increased investment and household consumption, as well as solid export performance due to robust growth in trading partner countries, especially in Asia. In addition, the Government's role in economic growth will be higher and, thus, catalyse further domestic growth in 2011. Future economic expansion will primarily be driven by sectors relating to household consumption and exports. The manufacturing sector, trade, hotels and restaurants sector, as well as transportation and communications sector will serve as the engine of growth in 2011. Economic growth in 2011 is projected to accelerate to a range of 6.0%-6.5%.

The balance of payments (BOP) is expected to retain a large surplus, however, smaller than the surplus recorded in 2010. Stronger domestic demand, mainly stemming from investment, will encourage demand for import. In addition to high imports, an increase in transfer payment will moderate the current account surplus. Policy stances discrepancy between advanced and emerging countries will continue to propel capital flows to emerging markets. Capital flows in the form of portfolio investment will continue in 2011 albeit lower than that in 2010. On the other hand, foreign direct investment (FDI) is expected to surge. A rising FDI will improve the structure of capital flows towards the longer term. Consequently, the BOP in 2011 is projected to run a surplus totalling USD 19.7-22.3 billion, hence, foreign exchange reserves at year end of 2011 are forecasted to reach USD 116.8-119.4 billion; equivalent to 7.2-7.4 months of imports and government

external debt services. Supported by a surplus in balance of payments, rupiah should remain stable in 2011.

Related to prices, amid potentially high inflationary pressures, Bank Indonesia expects to steer inflation within the target corridor set, at 5%±1% in 2011 and 4.5%±1% in 2012. Strong domestic demand and soaring international commodity prices will raise the prices of goods and services in general, but in a relatively limited magnitude. Disruptions to food production and distribution due to weather anomalies, as occurred in 2010, are not expected to persist. Nonetheless, infrastructure development by the Government, among others to ensure national food security and expand inter-regional linkages, will provide support for better food production and distribution. Optimism to bring inflation within its specified target corridor is also based on the Government's policy not to raise the prices of strategic goods and services, like the basic electricity tariff, LPG, subsidised fuel and transportation tariffs.

Financial system stability will be maintained accompanied by an improvement in the bank intermediation function. Enhanced macroeconomic performance will continue to be sought in harmony with efforts to preserve macroeconomic and financial system stability. Performance of the capital market and government bond market (SUN) will remain positive, among others encouraged by keen investor interest and improved macroeconomic performance.

Economic Growth Forecast

Aggregate Demand Forecast

On the demand side, economic growth in 2011 will be driven by more balanced sources of growth, with larger roles of investment and government consumption. In

Table. 6.1 Economic Growth Outlook by Expenditure

percent yoy, price 2000

| Components | 2009 | 2010 | | | | 2010 | 2011* |
|-------------------------------|-------|------|------|------|------|------|-----------|
| | | I | II | III | IV | | |
| Household Consumption | 4.9 | 3.9 | 5.0 | 5.2 | 4.4 | 4.6 | 4.5-5.0 |
| Government Consumption | 15.7 | -7.6 | -7.3 | 4.8 | 7.3 | 0.3 | 8.8-9.3 |
| Gross Fixed Capital Formation | 3.3 | 8.0 | 8.0 | 9.2 | 8.7 | 8.5 | 10.0-10.5 |
| Export of Goods and Services | -9.7 | 20.0 | 14.6 | 9.6 | 16.1 | 14.9 | 7.9-8.4 |
| Import of Goods and Services | -15.0 | 22.6 | 18.4 | 12.2 | 16.9 | 17.3 | 9.2-9.7 |
| GDP | 4.6 | 5.6 | 6.1 | 5.8 | 6.9 | 6.1 | 6.0-6.5 |

Source : BPS-Statistic Indonesia

* Bank Indonesia Projection

addition, household consumption is expected to rise on the back of solid export performance. Consequently, import growth will remain strong. As a result, economic growth in 2011 will accelerate in the range of 6.0%-6.5% (Table 6.1).

Household consumption is forecasted to grow in the range of 4.5%-5.0% in 2011 due to a variety of positive factors, in particular an increase in income. This rise in income stems from a hike in the provincial minimum wage, greater incomes for civil servants, and rising salaries of private sector employees. In general, minimum wage hike in 2011 surpassed that given in 2010.

Besides the minimum wage, strong household consumption is also due to higher incomes for civil servants, army personnel, the police force and pensioners. In the 2011 State Budget, the Government increased the basic salaries of state employees by 10%, exceeding the 5% increase awarded in the previous year. Additionally, the 13th-month salary will still be paid as in previous years.

Revenues from export proceeds further buoyed household consumption. Based on performance over the past few years, export performance has a significant influence on household consumption behavior. Strong export performance in 2011 is predicted to help boost private income and contribute to household consumption growth. Another factor that contributes to household consumption is bank financing, particularly in the form of consumption credit.

Government consumption, in real term, will increase significantly to around 8.8%-9.3% in 2011 due to central government spending for ministries/agencies. This is in line with government programs to improve budget absorption by ministries/agencies pursuant to the revised presidential decree regarding the procurement of goods and services as well as the revised Minister of Finance Regulation concerning budgets and payments to third parties. Sources of government consumption will also originate from personnel spending in order to boost the welfare of state employees and pensioners.

Investment is projected to surge by 10.0%-10.5%, particularly in response to strong consumption and solid export performance. This investment outlook is also attributable to a number of other factors, including macroeconomic stability, a potential upgrade of Indonesia's sovereign credit rating to investment grade,

a more conducive investment climate, and reduced government bureaucracy, as well as the Indonesia's potential market relative to other countries in Southeast Asia.

Any improvements in investment performance are closely linked to a more conducive investment climate in Indonesia. Surveys done by the World Bank and International Finance Corporation (IFC) in their publication entitled *Doing Business 2011* showed that the ease of doing business in Indonesia has improved in a number of specific issues: starting a business, construction permit, property registration and exports.

Investment prospects rely on foreign direct investment or FDI. Improvements in FDI can be observed from Consensus Forecasts in November 2010, which stipulate that FDI to Indonesia in 2011 will increase to USD 9.3 billion; approximately 1.2% of GDP. The prospect of FDI flows is also backed up by a survey contained in the *World Investment Report 2010* by the United Nations Conference on Trade and Development (UNCTAD), which indicates that multinational companies consider Southeast Asia as a one of priority location for future FDI. Indonesia placed second in Southeast Asia as a destination for FDI in 2010-2012.

In line with expected robust growth in world trade volume, the export of goods and services is forecast to grow in the range of 7.9%-8.4% in 2011. Based on its destination countries, exports from Indonesia to emerging market countries tend to increase. This trend is projected to persist and become a contributing factor to strong export growth. Such circumstances are evident from the contribution of emerging market countries to world trade volume, which in 2011 is expected to grow by 9.3%, compared to just 5.5% in advanced countries. Besides demand-side factors, commodity prices are projected to continue their uptrend, which will underpin solid export performance, particularly export commodities based on natural resources.

Strong domestic demand and high export growth will propel imports of goods and services to grow by 9.2%-9.7% in 2011. Increased production in response to stronger demand will boost demand for imported raw materials. In addition, strong consumption will drive imported consumption goods, although in a limited amount. A similar scenario is expected for imports of capital goods, along with promising investment prospects.

Investment undertaken to expand production capacity will help bolster imports of machinery. Meanwhile, investment in infrastructure development will invite higher imports of transport and heavy equipment. In general, surging import is in line with the ongoing acceleration in economic activity.

Aggregate Supply Forecast

From the production side, the manufacturing sector; trade, hotels and restaurants sector; as well as transportation and communications sector are the key sectors supporting growth. The contribution of these three sectors to economic growth exceeds 60%. Manufacturing sector growth will be higher in line with stronger demand. Furthermore, robust investment growth in 2010 and 2011 will provide a support for growth in the manufacturing sector. The trade, hotels and restaurants sector as well as transportation and communications sector are the sectors expected to experience strong growth in 2011 due to more upbeat economic activity. Economic growth in 2011 will remain dominated by the non-traded sector (Table 6.2).

The manufacturing sector is expected to grow by 4.3%-4.8% in 2011. The sector has been expanding its activities since the third quarter of 2009, in line with the recovery in domestic and external conditions. Optimism surrounding better manufacturing sector performance is supported by an upward trend of the Industrial Production Index (IPI). Furthermore, growing imports of raw materials indicates higher activity in the manufacturing sector. Meanwhile, the ongoing global and domestic economic recovery

provides optimism on surging demand comes from both domestic and abroad.

The trade, hotels and restaurants sector is expected to chart growth by around 8.4%-8.9% in 2011. The performance of this sector is strongly influenced by the economic activity as well as public purchasing power. A Bank Indonesia consumer survey shows an optimistic income expectation with an index exceeding 100. Such conditions point towards strong public purchasing power. Furthermore, the retail sales index is also in excess of 100 and following an upward trend, which reflects optimism on Indonesia's economic outlook and trade activities. These developments support a rising activity in the trade, hotels and restaurants sector.

The transportation and communications sector will continue to post impressive growth in the range of 12.3%-12.8% in 2011 driven primarily by the communications subsector. Investment and technological innovation from year to year, coupled with a large untapped market, are the factors behind this subsector's strong growth. Such conditions are expected to continue in the foreseeable future. The ongoing recovery in the domestic economy together with expansion in a number of economic sectors will spur transportation subsector's performance. Increased activity in a number of economic sectors will reinforce activities relating to the distribution of goods and transportation of people. The volume of air transported cargo and passengers will also pick up, supporting growth in the transportation subsector. In addition, rising trade activity will boost the loading and unloading of goods.

Table 6.2 Economic Growth Outlook by Sectors

percent yoy, price 2000

| Sectors | 2009 | 2010 | | | | 2010 | 2011* |
|---------------------------------------|------|------|------|------|------|------|-----------|
| | | I | II | III | IV | | |
| Agriculture | 4.0 | 3.0 | 3.1 | 1.8 | 3.8 | 2.9 | 3.2-3.7 |
| Mining and Quarrying | 4.4 | 3.1 | 3.9 | 2.7 | 4.2 | 3.5 | 3.3-3.8 |
| Manufacturing | 2.2 | 3.9 | 4.5 | 4.3 | 5.3 | 4.5 | 4.3-4.8 |
| Electricity, Gas and Water Supply | 14.3 | 8.8 | 5.1 | 3.4 | 4.3 | 5.3 | 6.2-6.7 |
| Construction | 7.1 | 7.3 | 7.2 | 6.8 | 6.7 | 7.0 | 7.3-7.8 |
| Trade, Hotel & Restaurant | 1.3 | 8.6 | 9.1 | 8.7 | 8.4 | 8.7 | 8.4-8.9 |
| Transportation and Communication | 15.5 | 12.0 | 13.0 | 13.2 | 15.5 | 13.5 | 12.3-12.8 |
| Finance, Rental and business services | 5.1 | 4.8 | 5.6 | 5.9 | 6.3 | 5.7 | 5.8-6.3 |
| Services | 6.4 | 4.7 | 5.3 | 6.4 | 7.5 | 6.0 | 5.9-6.4 |
| GDP | 4.6 | 5.6 | 6.1 | 5.8 | 6.9 | 6.1 | 6.0-6.5 |

Source : BPS-Statistic Indonesia
* Bank Indonesia Projection

The agricultural sector is projected to grow by 3.2%-3.7% in 2011. Corresponding to efforts to ensure national food security, the Government will push national food development in 2011. In the 2011 state budget, the Government allocated Rp122 trillion to develop infrastructure projects, which in part are designed to support national food security. The Government plans to improve irrigation services by expanding and revitalizing the irrigation network. The proposed government infrastructure projects are expected to boost domestic production.

The realisation of various infrastructure projects is expected to stimulate the construction sector, thus achieving 7.3%-7.8% growth in 2011. Besides the projects scheduled for 2011, a number of other projects were postponed in 2010 are expected to be implemented in 2011. In addition to government-backed projects, the opportunities for private participation in infrastructure development are also wide open. Besides infrastructure projects, more vigorous activity in the construction sector will also come from property construction. With more infrastructure and property projects going forward, consumption of cement is also projected to rise in 2011 in excess of the recent average of 5%-7% per annum.

Forecast of the Balance of Payments

In 2011, the Indonesian balance of payments is forecast to retain a large surplus, however, not as large as that recorded in previous years. A positive contribution is provided by the current account as well as capital and financial account. In general, the balance of payments will record a surplus of USD 19.7 – 22.3 billion, with foreign exchange reserves at year end of 2011 is expected to arrive at USD 116.8 – 119.4 billion; equivalent to 7.2 – 7.4 months of imports and servicing of government foreign debt (Table 6.3).

The current account is also expected to post a surplus of around USD 3.8-4.7 billion in 2011; lower than that reported in 2010. Amid strong export growth, high imports together with a deficit in services and income balance are expected to place downside pressures on the current account surplus. Export performance will remain positive in line with strong economic growth in Indonesia's main trading partner countries, like China and India, as well as rising commodity prices. Exports growth of natural resource-based products, such as coal and crude palm oil (CPO) will remain high. Furthermore, stronger domestic

demand will significantly stimulate demand for import, which in turn, will trigger higher cost of transportation services. In addition, growing foreign ownership in domestic securities will also raise yield payments to foreign investors.

The capital and financial account is projected to settle at a surplus of around USD 16.5 – 18.1 billion, which is not as large as that in the previous year. Capital inflow is expected to persist with a larger contribution from foreign direct investment. Maintained international perception regarding the domestic economy will sustain the influx of foreign capital flows to Indonesia. Robust domestic economic growth, an improved investment climate and the enormous Indonesia's potential market are the key factors that attract foreign direct investment to Indonesia. Meanwhile, global excess liquidity, coupled with a relatively high yield on rupiah denominated assets, will also invite foreign portfolio inflows, although with a lower magnitude relative to 2010. In addition to direct investment and portfolio investment, foreign capital flows in the form of offshore loans will also go up as a result of the higher financing requirement for production and investment. The expanding foreign direct investment will enhance the structure and orientation of the capital and financial account into longer perspective.

Exchange Rate Forecast

The exchange rate will remain relatively stable in 2011 due to the ongoing policy discrepancy between emerging and advanced countries, which attracts foreign funds to the domestic economy. Positive expectations regarding domestic economic performance will buttress rupiah stability. The current account surplus and expanding role played by foreign direct investment in the capital and financial account will underpin exchange rate stability in 2011.

In addition to the high yield on rupiah denominated investments, rupiah stability in 2011 will also be supported by the positive perception of global investors on domestic financial assets. The yield in rupiah instruments will remain attractive to foreign investors. Such conditions are congruent to expectations that The Fed will not raise its policy rate until the end of 2011. Furthermore, the positive perception of global investors on domestic financial assets will persist along with solid economic fundamentals in 2011. Accordingly, rupiah is expected to remain stable in 2011.

Table. 6.3 Indonesia Balance of Payment Outlook 20011*millions of USD*

| Items | 2010* | 2011 ^p |
|--|--------|---------------------|
| I. Current Account | 6.3 | 3.8 - 4.7 |
| A. Net Goods (Trade Balance) | 31.1 | 35 - 35.3 |
| - Export, fob | 158.2 | 190.1 - 190 |
| - Import, fob | -127.1 | (-155.1) - (-154.7) |
| B. Net Services | -9.5 | (-11.7) - (-10.8) |
| C. Net Income | -20.3 | (-24.7) - (-24.9) |
| D. Net Current Transfer | 5.0 | 5.1 - 5.2 |
| II. Capital and Financial Account | 26.2 | 16.5 - 18.1 |
| A. Capital Transaction | 0.0 | 0.0 - 0.0 |
| B. Financial Transaction | 26.2 | 16.5 - 18.1 |
| 1. Direct Investment | 9.8 | 10.6 - 10.9 |
| 2. Portfolio Investment | 15.2 | 10.8 - 12.3 |
| 3. Other Investment | 1.1 | (-5.0) - (-5.0) |
| III. Total (I+II) | 32.5 | 20.2 - 22.8 |
| IV. Net Errors and Omission | -2.2 | -0.5 - -0.5 |
| V. Overall Balance (III+IV) | 30.3 | 19.7 - 22.3 |
| VI. Reserve and Related Items | -30.3 | (-19.7) - (-22.3) |
| Memorandum: | | |
| International Reserve | 96.2 | 116.8 - 119.4 |
| In months of imports and official foreign debt repayment | 7.0 | 7.2 - 7.4 |
| Current Account to GDP Ratio (percent) | 0.9 | 0.5 - 0.6 |

** provisional figures*

Inflation Forecast

Entering 2011, amid potentially intense inflationary pressures inflation is still expected to remain within its target corridor of 5%±1%. Bank Indonesia and the Government will steer inflation towards its target by strengthening coordination and the policy mix. Optimism that inflation will remain within its target corridor is based on, among other, government plans not to raise strategic prices of goods and services, like the basic electricity tariff, liquefied petroleum gas, subsidised fuels and transportation tariff. Inflationary pressures are expected to emerge both from external and domestic. From external inflationary pressures will arise from surging international commodity prices. Strong demand for international commodities, from emerging market countries as well as advanced countries, will push up commodity prices. The oil price will tend to rise, mirrored by the prices of other commodities. The international price of gold will also follow an upward trend due to strong demand comes from the diversification of foreign reserves to gold

by advanced and emerging countries. In 2011, external inflationary pressures as mentioned above, is expected to be dampened by a stable exchange rate.

From domestic side, stronger demand from domestic economic recovery is expected to generate inflationary pressures. This is indicated by better future income stream that can be used to finance higher consumption growth. Nonetheless, existing production capacity should be sufficient to meet increase in demand; hence the effect on prices will be benign. These assumptions are based on strong investment growth in 2010 and projected investment growth in 2011, which is favorable for the supply side. On the other hand, inflationary pressures are also expected to emerge from public expectations triggered by soaring food prices and international commodity prices, especially oil.

In terms of inflation on volatile foods, the disruptions to production and distribution that occurred in 2010

are no longer expected to be an issue in 2011, owing to agricultural infrastructure development and improved inter-regional linkages. Other government policies, like the exemption of import duty on a number of food items will tame inflationary pressures from volatile foods and bring volatile food inflation to trend downward.

Forecasts of the Bank and Non-Bank Financial Markets

Demand for credit is expected to rise in accordance with more vigorous future economic activity. Furthermore, amid higher bank intermediary function, financial system stability will remain in check. In 2011, credit growth is expected to reach 20%-23%. Similar to 2010, working capital credits will continue to be a key driver of credit growth in 2011. In addition, consumption credit growth will stay high due to strong household consumption going forward. Bank capital will remain solid, providing support to strong credit growth. Deposits growth is also expected to expand in 2011. Despite increasing credit growth, the quality of credit will remain solid.

On the non-bank financial market, the issuance of bonds and IPO are expected to be higher, corresponds to greater economic activity, the strong capital inflows and an upgraded sovereign credit rating. Amid an expansion of bank intermediation function and funds being raised from the non-bank financial market, financial system stability will remain sound. The role of domestic investors in providing financing the economy through the non-bank financial market will become more apparent. A stronger basis of domestic investor will lead to more resilience domestic financial market in dealing with the shocks, in particular stemming from a change in the risk appetite of global investors.

■ Medium-Term Economic Prospects

In the medium term, global economic growth will remain robust in line with its long-term trend, which will be followed by a recovery in world trade volume and rising commodity prices, although at a slower pace. From domestic side, the fiscal deficit will fall gradually in accord with the Government's commitment to achieve fiscal sustainability. In the medium term, government policy is directed towards accumulating more capital and boosting productivity to improve competitiveness. For that reason, economic growth is expected to exceed 7% followed by low and stable inflation at around 3.5% in the medium term.

Assumptions for Medium-Term Economic Prospects

Global Economy

Economic Growth and World Trade Volume

In the medium term, global economic growth is expected to return to its normal growth trajectory, reaching 4.6% in 2015. Among advanced countries, the US economy is projected to expand by 2.8% on average from 2013-2015. During the same period, countries in Europe are expected to post 1.8% growth on average. Meanwhile, emerging countries are projected to enjoy average growth of 6.6%, driven mainly from Asian countries with average growth of 8.5%. In line with the expected global economic expansion, Bank Indonesia projects the world trade volume to reach 7.9% in 2015.

International Commodity Prices and Inflation

As global economy continues to recover, oil price is expected to follow an upward trend, albeit at slower pace. In addition to strong demand, surging prices will also prompted by limited supply. Oil consumption is expected to rise, especially in emerging market countries. Against this backdrop, Bank Indonesia expects oil prices to remain on an upward trend.

Non-oil/gas commodity prices are also expected to go up moderately in the medium term. However, the prices of metals will stay high on the back of persistently strong demand from China. Meanwhile, food commodity prices are projected to remain relatively stable, owing to adequate supply amid the risk of natural disasters that would trigger price hikes and temporary export bans in several countries to meet domestic demand. Against this backdrop, Bank Indonesia expects international commodity prices to rise steadily in the medium term at 7.6%.

Although rising commodity prices will follow recovery in the global demand, global inflationary pressures will remain in check as a result of a fiscal consolidation in advanced countries combine with tight monetary policy in emerging countries. In the medium term, inflation in advanced countries will gradually rise, approaching its pre-crisis levels. In the United States, inflation is projected to reach 1.9% in 2015; however, inflation in emerging market countries will ease to around 3.8% in the same period.

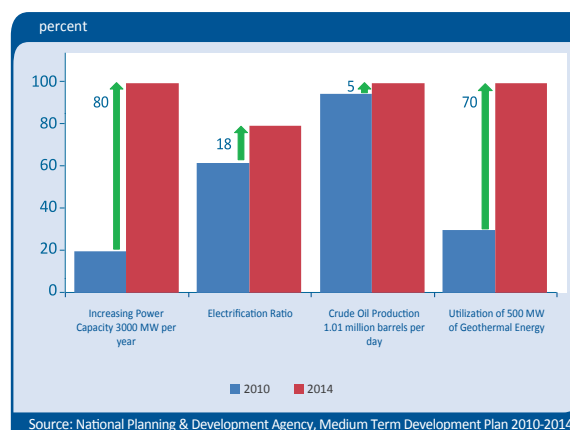
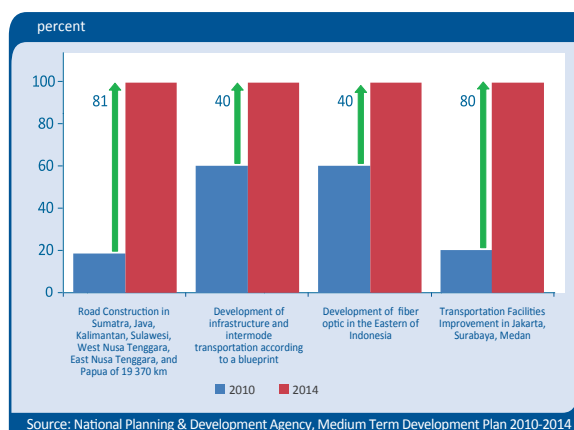


Chart 6.1 Infrastructure and Energy Policy

The Domestic Economy

Macroeconomic and Financial System Stability

The medium-term economic outlook will rely on the implementation of policies to stabilise the macro economy and financial system to preserve economic stability (elements of enabling environment for growth). From a government perspective, fiscal sustainability will be maintained in line with the Government's plan to gradually reduce the fiscal deficit in the medium term to 1.2% of GDP in 2014.¹⁰⁸ In addition, the role played by Bank Indonesia in strengthening policies on monetary and macro-micro prudential banking is expected to maintain stability and boosting financial sector performance to provide support for sustainable development. This is necessary to reinforce economic resilience in the face of shocks that emerge from a changing strategic economic and global financial environment.

Structural Policy

Medium-term economic prospects do not rely only on policies to maintain stability, but also on the implementation of structural policy instituted by the Government to strengthen the fundamental supports for growth. Reinforcing the economic structural foundations is a prerequisite to enhance economic productivity and efficiency. Increased productivity, in turn, raises the return on investment for private economic agents and public institutions, and buoys national competitiveness.

Strengthening the fundamental supports for growth will be achieved by overcoming the most binding economic

constraints in the medium term through 11 government priorities as set forth in the National Medium-Term Development Plan (RPJMN) 2010-2014 (Figure 6.1). These national priorities, among others, include developing infrastructure and the investment/business climate.¹⁰⁹ In addition, the Government will also enhance the quality of human resources in order to boost Total Factor Productivity (TFP), which is an important factor, in addition to capital, to boost economic capacity. (See Box 6.1: The Role of TFP in supporting Sustainable Long-Term Growth).

Greater economic capacity is expected to adequately respond to expansionary demand-side growth, thereby avoiding additional inflationary pressures. Greater economic capacity will also promote private income and savings. A combination of higher income coming from net exports and a declining dependency ratio – reflecting the dominance of productive age citizens in the demographic structure of Indonesia – will strengthen future domestic savings as a supply of loanable funds, which ultimately will support capital accumulation (investment) and sustainable consumption (Figure 6.2).

Economic Prospects from 2012-2015

Economic growth in the medium term is projected to be on a higher trajectory coupled with maintained macroeconomic stability. Higher capital accumulation will be a primary factor behind the sustainable economic expansion. In addition to support from private savings,

¹⁰⁸ National Medium-Term Development Plan (RPJMN) 2010-2014

¹⁰⁹ The 11 national priorities are: (1) bureaucratic reform and governance; (2) education; (3) health; (4) poverty reduction; (5) food security; (6) infrastructure; (7) investment and business climate; (8) energy; (9) natural environment and disasters; (10) least developed, frontier, post-conflict and outer areas; and (11) culture, creativity and technological innovation.

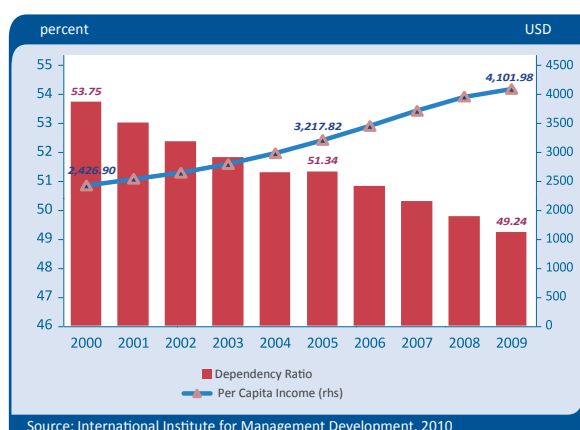


Chart 6.2 *Dependency Ratio of Indonesia*

improvements in the real sector done by the Government to catalyse FDI will also drive higher capital accumulation in Indonesia. More FDI inflows could be possible if Indonesia successfully achieves an investment grade rating in 2011 (see Box 6.2: Towards Investment Grade). In this context, investment in the medium term is forecasted to accelerate in the range of 12.2%-13.2% in 2015.

Looking ahead, sustainable economic growth will also be buttressed by a greater role of total factor productivity (TFP). Due to the phenomenon of diminishing returns on capital, sustainable economic growth cannot merely rely on capital accumulation. Since improving productivity – ranging from technological proficiency to worker expertise – is closely linked to human resources; efforts to raise the quality of human resources play a critical role in medium-term development. By enhancing the quality of human resources in Indonesia, Indonesia's economy is expected to gradually move towards a healthy and competitive economy, or in other words a Knowledge and Innovation Economy/KIE.

Government achievement to improve structural factors will alter competitiveness in the tradable sectors, thus further increasing private savings. Higher private savings and more competitive tradable sectors will sustain domestic income and consumer purchasing power in the future. The large domestic market potential, bolstered by surging capital accumulation will maintain strong consumption in the medium term. The five-yearly general election cycle will also spur private demand and investment as evidenced by its historical trend in 2004 and 2009. Based on this auspicious economic landscape, household consumption will raise gradually, peaking in 2014 when elections take place, and stay at 4.6%-5.6% in 2015.

From external side, brisk export performance is predicted as competitiveness of domestic products improved and the global economic recovery continue. Exports are projected to grow by 8.6%-9.6% in 2015 (Table 6.4). Such favorable external condition will provide support for rupiah stability. On the other hand, import growth will remain in check considering that accelerating economic growth will not be followed by a jump in imports. This is attributable to, among others, increased domestic economy productivity, which will be able to substitute a portion of consumption goods, capital goods and raw materials that previously had to be met by imports. Accordingly, imports are expected to grow steadily at around 9.8%-10.8% in 2015.

Supported by stronger investment and greater economic productivity, economic capacity will continue to build up to 2015. This expansion in economic capacity will accommodate a 6.5%-7.5% increase in demand in 2015; hence, inflation will remain within its medium term target at 3.5%±1%. However, such encouraging picture of the prospect of Indonesian economy in the medium term could be lower than expected if structural policy is not implemented timely.

Table. 6.4 *Medium Term Economic Growth Outlook (2010-2015)*

percent yoy, price 2000

| Components | 2010 | 2011 | 2012 | 2013 | 2014* | 2015 |
|------------------------------------|------|-------------|-------------|-------------|-------------|-------------|
| Household Consumption | 4.6 | 4.5 - 5.0 | 4.8 - 5.3 | 4.6 - 5.5 | 4.8 - 5.8 | 4.6 - 5.6 |
| Government Consumption | 0.3 | 8.8 - 9.3 | 1.1 - 1.6 | 1.6 - 2.5 | 3.6 - 4.6 | 1.8 - 2.8 |
| Gross Fixed Capital Formation | 8.5 | 10.0 - 10.5 | 12.6 - 13.1 | 12.1 - 13.0 | 12.9 - 13.9 | 12.2 - 13.2 |
| Export of Goods and Services | 14.9 | 7.9 - 8.4 | 8.1 - 8.6 | 8.2 - 9.1 | 8.3 - 9.3 | 8.6 - 9.6 |
| Import of Goods and Services | 17.3 | 9.2 - 9.7 | 9.8 - 10.3 | 9.5 - 10.4 | 10.7 - 11.7 | 9.8 - 10.8 |
| GDP | 6.1 | 6.0 - 6.5 | 6.1 - 6.6 | 6.2 - 7.1 | 6.3 - 7.3 | 6.5 - 7.5 |
| Inflation (percent, end of period) | 6.96 | 5.0 ± 1.0 | 4.5 ± 1.0 | 4.5 ± 1.0 | 4.0 ± 1.0 | 3.5 ± 1.0 |

* General Election 2014

6.2

Challenges, Risks and Policy Direction

Despite widespread optimism surrounding an economic outlook, Bank Indonesia continues to monitor an array of challenges and risk factors that may compromise an effort to achieve the inflation target as well as other macroeconomic performance. Some of the challenges faced in 2010 will continue to overshadow the economic landscape of Indonesia in the upcoming years, namely the strong capital flows, abundant excess liquidity and the potential of high inflationary pressures. In the financial sector, a number of challenges require an immediate response, such as to improve financial sector resilience while at the same time promote financing and enhancing competitiveness. In addition to these challenges, a number of risk factors also require attention, such as uncertainty surrounding the recovery in advanced countries, soaring international oil and commodity prices, as well as disruptions to the production and distribution of food. The risk of higher inflationary pressures would also stem from government policy to raise the prices of strategic goods and services, like the basic electricity tariff, liquefied petroleum gas, subsidised fuels and transportation tariffs. With the complexity of risk factors and challenges mentioned, policy cannot rely merely on single instrument, but require a policy mix and coordination to find an optimal configuration among a variety of conditions that are not always in line. Therefore, inflation in 2011 and 2012 is expected to be geared towards its target corridor.

Policy Challenges and Risk Factors

Some challenges faced in 2010 is expected to persist, particularly in 2011. The primary challenge is the influx of foreign capital flows following disparity of policy stance between advanced and emerging countries. In general, a proper amount of foreign capital inflows is needed as

an alternative source of economic financing. However, excessive short-term capital inflows may compromise macroeconomic stability and complicate monetary policy. Excessive foreign capital inflows can spur sharp exchange rate appreciation and make it deviate from its fundamentals. Accordingly, in addition to the risk of sudden correction, sharp rupiah appreciation will reduce export competitiveness. Furthermore, capital inflows can spur macro instability stemming from its vulnerability to negative sentiment that can trigger large and sudden capital reversal.

Another challenge related to monetary policy is excess liquidity in the banking sector. Under current circumstances, where bank's excess liquidity is high, heavy foreign capital inflows may lead to exacerbate excess liquidity. Excess liquidity may cause higher credit and money supply, which ultimately generate inflationary pressures when it is extended as consumption credit, particularly if the supply side cannot adequately respond to the increase in consumption financed by credit. Large-scale excess bank liquidity may compromise macro stability, hence should be carefully managed. Furthermore, excessive liquidity may also affect the monetary policy effectiveness done by the monetary authority.

On top of the two challenges already mentioned, the economy remains beset with relatively high inflation. Average inflation in Indonesia is relatively higher than that in neighboring countries, which affects the purchasing power and reduce economic competitiveness. The intensity of supply-side disruptions, especially for food items, escalated rapidly as a result of adverse climate condition. That condition contributed to mounting volatile food inflation. In addition to inflationary pressures

stemming from volatile foods, inflation also originates from administered prices. Furthermore, inflationary pressures that initially emanate from volatile foods and administered prices, will in turn, have a number of inherent second-round effects, such as rising inflation expectations. Consequently, core inflation will follow suit if rising inflation expectations is not addressed appropriately. Moreover, in line with stronger economic growth, a rapid surge in demand can also intensify inflationary pressures if it is not responded by adequate supply-side. Accordingly, structural policy should be reinforced to improve the supply-side capacity in responding to accelerating demand.

Another challenge faced is channelling excess bank liquidity to provide financing to productive sectors and economic development. Despite excess bank liquidity, the banks' role in economic growth remains relatively low. Compared to neighboring countries, the role played by the banks in financing economic activity is still relatively limited. This is partially attributable to high lending rates, particularly to micro, small and medium enterprises (MSMEs), as well as limited access on financial services, especially among low-income people. From the regional perspective, the competitiveness of domestic banks in terms of efficiency is comparatively low. From a capital and asset point of view, the competitiveness of Indonesian banks is also relatively low. Looking ahead, the challenge that must be addressed immediately is how to boost the competitiveness of domestic banks comparable to that of other countries in the region, as preparation to the implementation of the ASEAN Economic Community (MEA).

From the financial market, the dynamics of the global financial market are transmitted swiftly to the domestic financial market due to the nature of openness of Indonesia's financial market. Considering an increasing importance of the financial market in providing financing to the economy, the challenges faced include strengthening the resilience of domestic financial system against shocks, in particular those stemming from a change in the risk appetite of global investors. In addition, the next challenge is how to take advantage of high foreign investors appetite to the domestic financial market, to facilitate financial market deepening and economic financing.

Besides the challenges mentioned above, a number of risk factors have also been identified that may compromise

the accomplishment of the inflation target and other macroeconomic performance (Chart 6.3). From the external side, soaring oil price due to a rising demand, limited supply and speculative action, may also intensify inflationary pressures. A soaring oil price accompanied by escalating prices of other commodities may potentially push inflation outside of its target corridor. Furthermore, uncertainty regarding the crisis recovery in advanced countries may persist, among others due to more limited fiscal stimuli and weak purchasing power in advanced countries, which raises concerns over reduced demand for export.

From domestic side, several risk factors could drive inflation outside of its target corridor. The risk of disruptions to food production and distribution, particularly caused by adverse weather condition, could amplify inflationary pressures in the future. In addition, soaring global commodity prices, particularly oil, could force the Government to adjust spending on subsidies. This may push up inflation due to higher prices of strategic goods and services such as basic electricity tariff, liquefied petroleum gas, subsidised fuels and transportation tariffs. The direct and indirect effects of this policy, in addition to higher inflation, may also slow the pace of economic growth acceleration going forward.

Bank Indonesia Policy Direction

Bank Indonesia policy will be directed towards achieving macroeconomic and financial system stability to facilitate sustainable economic growth. From the monetary sector, monetary policy aims to achieve the inflation target. From the banking sector, banking policy will be formulated to enhance bank resilience and sustain bank performance, boost competitiveness and at the same time contain the crisis. From the payment system sector, payment system policy is designed to preserve more efficient, reliable, simple and secure payment system.

From the monetary sector, the challenge to maintain macroeconomic stability will remain arduous. The global and domestic environments are becoming increasingly dynamic, which complicates the policy response taken by Bank Indonesia. The influx of foreign fund and excess bank liquidity are expected to persist. Furthermore, a number of challenges will continue to beset efforts to maintain price stability amid burgeoning demand and rising global food prices as well as adverse weather conditions that may disrupt domestic food production

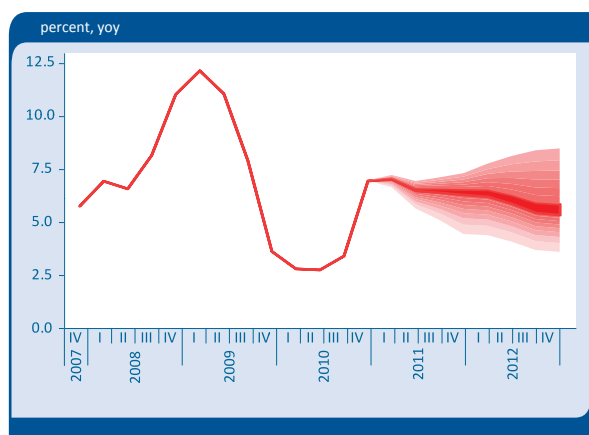


Chart 6.3 Inflation Fanchart 2011-2012

and distribution. Consequently, the policy mix instituted in 2010 will be evaluated continually and strengthened in 2011. This is expected to bring inflation back within its target corridor and at the same time maintain external stability.

The complex nature of the challenges faced demands balanced and measured monetary and macroprudential policy instruments. The policy rate (BI rate) will be directed to remain consistent with achievement of inflation target. Amid the persistence of capital inflows that complicate monetary policy, the future course of the BI rate will be determined properly so that inflation and inflation expectations are able to be directed within the inflation target. Bank Indonesia will adjust its policy rate accordingly should economic condition may lead to excessive demand and worsening inflation expectations that may jeopardize the achievement of the inflation target. Considering the behavior of economic agents (producers and consumers) are heavily influenced by expectations on future economic conditions, the ability of Bank Indonesia to manage these expectations play a central role. Interest rate policy will be further supported by the strengthening of monetary operations to effectively managed domestic liquidity.

Exchange rate policy is directed towards the achievement of the inflation target, while at the same time remain consistent with other macro targets and provide assurance to the business sector. This will be accomplished by, among others, foreign exchange market intervention when considered necessary. Meanwhile, Bank Indonesia will continue to maintain adequate foreign exchange reserves to meet the requirement for imports and servicing

government foreign debt, in addition to bolster domestic economic resilience and mitigate external shocks.

Bank Indonesia considers that a proper amount of foreign capital inflows is needed as an alternative source of economic financing. However, excessive foreign capital inflows, which is dominated by a short-term portfolio investment, make it more vulnerable to a reversal. This may compromise macro stability and reduce the effectiveness of monetary management. Consequently, Bank Indonesia will continue to evaluate and strengthen existing macroprudential policy to manage capital flows and concurrently mitigate the risk of a capital reversal. To anticipate the possibility of shocks that may trigger macro instability, Bank Indonesia will reinforce the early warning system to preemptively identify possible shocks and prepare measures to mitigate the shocks. Moreover, Bank Indonesia will also evaluate and strengthen macroprudential policy to manage persistently high bank excess liquidity.

Amid the complex challenges to be addressed, efforts to reinforce national economic performance require collaboration with the Government. Regarding the influx of capital flows, Bank Indonesia will continue to coordinate with the Government considering the majority of capital inflows have been invested in government bonds (SUN). Bank Indonesia and the Government will continue to maintain coordination to preserve stability in the government bond market. Bank Indonesia and the Government will take measures to steer capital inflows towards longer-term investment, thus supporting activities in the real sector, among others in the form of foreign direct investment (FDI) and the issuance of stock and bonds. Coordination will be directed towards strengthening infrastructure, including institutional aspects, regulations and market efficiency.

Coordination with the Government also involves policy coordination to control inflation, in particular to minimise the impact of inflation from volatile foods and administered prices. To this end, policy coordination with the Government, at the central and regional level, in the form of TPI and TPID will be strengthened. Policy coordination also aims to reinforce the supply-side response, especially by encouraging investment in infrastructure and boosting production capacity. With this policy coordination, inflation is expected to head toward its target corridor.

Banking policy is implemented to enhance the resilience of banks, which can buoy growth, improve competitiveness and simultaneously contain shocks. Bank Indonesia will bolster the banking supervision system through institutional and capital consolidation, by providing incentives and disincentives. The efficacy of the supervision function will also be improved, among others, by enhancing the early warning system. Furthermore, Bank Indonesia will also encourage the implementation of international prudential standards and strengthen policy to promote bank efficiency and the intermediation function. Bank Indonesia will also refine Indonesian Banking Architecture (IBA) by placing the banks according to their respective missions. In addition, IBA will also be complemented with a roadmap, which can guide banks from their current state towards the ideal conditions.

On the financial market, coordination between Bank Indonesia and the Government will be directed to formulate policy to enhance stability and financing for economic activity. This will be achieved by broadening the basis of domestic investor and taking advantage of foreign capital inflows to deepen the domestic financial market and financing the real sector. In this context, measures will be focused on the issuance of stock and bonds as well as strengthening financial market infrastructure, including institutional aspects, regulations and market efficiency.

On top of these measures, Bank Indonesia together with the Government will formulate an inclusive national financial strategy to widen public access to the financial sector, which currently remains quite low. This strategy will be used as a reference framework that includes

strategic measures to broaden public access to the financial services. To this end, Bank Indonesia will direct its policy towards enhancing the role played by rural banks in financing MSMEs. Moreover, Bank Indonesia will always boost bank efficiency to make lending rates more affordable and further expand the role of banks in financing the real sector.

As preparation for the economic integration as well as to facilitate the flow of bank and economic transactions, payment system policy is directed towards creating a more efficient, reliable, simple and secure payment system. Efforts are focused on developing infrastructure, system and strengthening the rule of law. Starting from 2011, Bank Indonesia will enhance the reliability of some systems, including the Bank Indonesia-Real Time Gross Settlement (BI-RTGS) system and the Bank Indonesia - Scriptless Securities Settlement System (BI-SSSS) -Second Generation, the Close to Real Time mechanism¹¹⁰ and Direct Debit module¹¹¹ under the Bank Indonesia National Clearing System (BINCS), the Interconnected Retail Payment system and Standardised Chip for ATM/debit cards. Payment system efficiency will be improved by integrating network through the National Payment Gateway (NPG) and boosting financial access further through the retail agents' payment system.

110 The Close to Real Time mechanism for BINCS is an additional settlement cycle for credit fund transfers, which was previously just twice daily and is now four times per day during operational hours. This mechanism aims to improve efficiency by expediting credit transfers, in particular those settled in the first cycles.

111 The Direct Debit module was developed to boost routine inter-bank payment efficiency.

BOX 6.1: The Role of TFP in Supporting Sustainable Long-Term Growth

Looking ahead, the economy of Indonesia is not independent from the prospect of global economy and financial condition as well as domestic macroeconomic and structural policies. Positive global economic growth will bolster GDP from the demand side, while capital growth and improved Total Factor Productivity (TFP) are the keys to balancing supply and demand. With that, robust economic growth will remain in line with disinflationary process.

Conceptually, TFP reflects the role of technology and other elements that cannot be explained by input factors like capital and labour in the aggregate production function of an economy¹. For a certain ratio of capital to labour, higher TFP will raise productivity per worker, which is the primary driver of improvements in the aggregate production function. In the theoretical and empirical literature on economic growth, a number of factors are cited as the drivers of an upward shift in the production function through improvements in TFP, including:²

1. Macroeconomic and financial system stability;
2. The level of knowledge and capacity of research/ technological development;
3. Changes in the quality of human capital (level and quality of education);
4. Changes in governance in the production process (improved managerial quality);
5. Degree of economic openness;
6. Changes in the efficiency and effectiveness of government institutions, including improving the business climate and strengthening economic fundamentals (for example the provision of basic infrastructure for education, health, transportation and energy); and
7. Diversity and cultural openness in the community.

- 1 An example of exogenous growth theory is by Solow, where real output is expressed as a function of TFP, real capital stock and labour, which can be written $Y_t = A_t K_t^\alpha L_t^{1-\alpha}$ with TFP denoted by A_t , which is exogenous, K is the aggregate of real capital goods (capital) and L is labour (total hours worked or number of workers). Output is a function of A , K , and L , known as the aggregate production function.
- 2 An example of theoretical and empirical discussion can be found by Barro, R. and Sala i Martin, X. (1995): *Economic Growth*, MIT Press.

An illustration of the impact of TFP on the economy in the long term is presented in Diagram 1. PF_1 - PF_3 is the aggregate production function in intensive form, where K/L is the ratio of capital to labor, which reflects the depth of capital in the economy (capital deepening), and Y/L is output per worker, which indicates aggregate labour productivity. PF_1 - PF_3 are not linear but curved due to the phenomenon of diminishing returns on capital accumulation. A shift in the curve from PF_1 to PF_2 and PF_3 denotes an improvement in TFP. If no improvement in TFP occurs, the capital accumulation process (increased production capacity) will only take place along the curve of PF_1 and will eventually be limited by phenomenon of diminishing returns on capital accumulation. The dynamics of the aggregate production function are subsequently reflected by long-term aggregate supply, as illustrated by the curves AS_1 , AS_2 , AS_3 , AS_4 , and AS_5 .

Macroeconomic and financial system stability is one factor that supports an improvement in TFP and there is a two-way relationship so that improvements in TFP will strengthen economic stability, and vice versa. This two-way relationship is not inconsistent with the explanation presented in Diagram 1 considering that economic policy related to TFP is a structural transformation policy to foster positive factors for robust TFP growth and higher sustainable economic growth. This transformation policy cannot be implemented under unstable macroeconomic and financial system conditions.

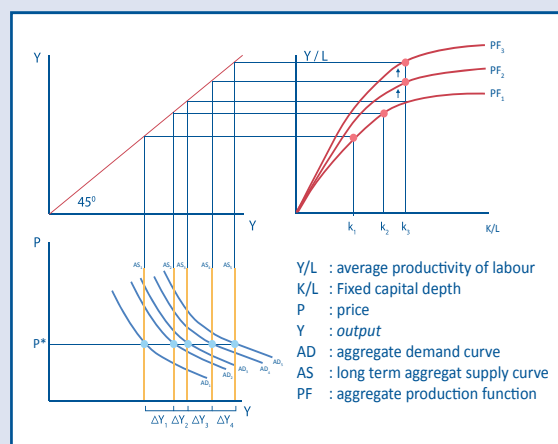


Diagram 1. Implications of TFP Changes to the Economy

Table 1. Source of Economic Growth, 1971-2007

| Periode | A | g^Y | g^K | g^N | g^{ES} | g^N+g^{ES} | g^{TFP} |
|-------------|--------|-------|-------|-------|----------|--------------|-----------|
| 1971 - 1985 | 44.07% | 5.72 | 6.98 | 2.84 | 1.04 | 3.88 | 0.64 |
| 1986 - 1997 | 48.93% | 7.22 | 10.39 | 2.30 | 1.83 | 4.13 | 0.58 |
| 1998 - 1999 | 36.95% | -6.51 | 2.78 | 3.10 | 1.72 | 4.82 | -10.52 |
| 2000-2007 | 44.54% | 5.04 | 3.66 | 1.66 | 1.13 | 2.78 | 1.90 |
| 2005 - 2007 | 42.40% | 5.84 | 4.64 | 1.32 | 1.12 | 2.44 | 2.52 |
| 1971-2007 | 45.36% | 5.40 | 7.10 | 2.42 | 1.35 | 3.77 | 0.29 |

Source: Alisjahbana (2009)*

*Alisjahbana, A.S. (2009), "Revisiting Indonesia's Source of Economic Growth and Its Projection Towards 2030", Working Paper in Economics and Development Studies, Padjadjaran University, No. 200905. Ket: = MPK, g^Y = Real GDP Growth, g^K = Capital Growth, g^N = Labour Growth, g^{ES} = return to education attainment per person.

The structural constraints of policy related to TFP can be seen from the types of impediments to higher TFP growth. In Indonesia, the constraints include:³ (1) basic infrastructure (transportation and distribution) that strengthens the interconnectedness of the economy; (2) adequate energy supply; (3) inadequate research and development activities; (4) the quality of human capital and the inclusiveness of the national education system; and (5) the digital divide.

To support structural policy as mentioned previously, the Government has set 11 national priorities to make Indonesia a prosperous, democratic and just nation, as set forth in the National Medium-Term Development Plan (RPJMN) for 2010-2014. The 11 national priorities are: (i) bureaucratic reform and governance; (2) education; (3) health; (4) poverty reduction; (5) food security; (6) infrastructure; (7) investment and

business climate; (8) energy; (9) natural environment and disasters; (10) least developed, frontier, outer and post-conflict areas; and (11) culture, creativity and technological innovation.

The 11 priorities outlined are broadly directed towards government efforts to expand the role of TFP to support sustainable long-term economic growth. For example, in terms of technological innovation, the Government prioritised the development of science and technology to that leads to the transformation of the national economy based on Indonesia's competitive advantage.

As illustrated in the review conducted by Alisjahbana (2009), TFP in Indonesia improved during the period from 2005 – 2007 after previously experiencing a worst decline during the crisis in 1998-1999. With the number of structural transformation measures currently being taken by the Government to enhance economic productivity, TFP is also expected to improve in the future.

3 Indonesian Economic Outlook (January 2011), Bureau of Economic Research, DKM – Bank Indonesia.

BOX 6.2: Towards Investment Grade

The sovereign credit rating is an indicator that reflects the ability and willingness of a country to service its foreign debt in accordance to the prevailing terms and conditions (Butler & Fauver, 2006)¹. The rating is based on several aspects that determine a government's ability to repay its debts. These aspects include government financial performance, macroeconomic conditions and prospects as well as political and legal aspects in the country.

The sovereign credit rating is an indicator used by international and domestic financial markets to determine the cost of providing funds to the Government and institutions in Indonesia that require financing. This implies that better rating suggests a greater opportunity for the Government and firms to access cheaper financing. The achievement of investment grade will create a positive perception for Indonesia and ultimately will stabilise foreign investment on the financial market and Foreign Direct Investment.

On the global financial market there are three institutions that are known as the main credit rating agencies – because of their rating are required by many financial authorities in developed countries– namely Moody's Investors Service, Standard & Poor's, and Fitch Ratings. In the case of Indonesia, in addition to these three rating agencies, two institutions from Japan, namely Rating and Investment Information and Japan's Credit Rating Agency also produce rating for Indonesia.

In January 2010, Fitch Ratings upgraded its long-term credit rating for Indonesia to BB+ with a stable outlook. This rating is only one level below investment grade. This was followed, in March 2010, by Standard &

Poor's, which upgraded Indonesia's rating to BB (two levels below investment grade). In July 2010, Moody's revised up the outlook from stable to positive, despite not changing Indonesia's rating since September 2009 (Chart 1). The positive outlook awarded by these two rating agencies provides a chance to upgrade Indonesia's sovereign credit rating should some uncertainties surrounding the economy can be addressed, such as the sustainability of positive economic performance. In the same month (July 2010), Japan's Credit Rating Agency decided to award Indonesia an investment grade rating. In mid January 2011, Moody's upgraded Indonesia's rating to Ba1 (one level below investment grade).

The basis of the improvement in Indonesia's ratings is due to better economic fundamentals and macroeconomic policy management in 2010. If the outstanding issues are well addressed, for example legal uncertainty, corruption, bureaucratic constraints and limited infrastructure, an investment grade rating may be achieved in the near future.

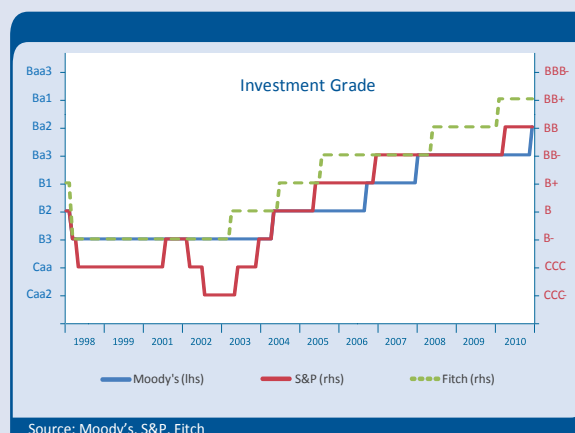


Chart 1. Sovereign Credit Rating of Indonesia

¹ Butler, A., and Fauver, L., 'Institutional Environment and Sovereign Credit Rating', Financial Management, 2006, pages 35(3).

