





# Lesson from The Past

Steps across the tidal wave, thousands inscriptions left behind.  
Sweats adorn the fighting spirit, struggling to reach the iridescent future.

# PART 4

## ECONOMIC PROSPECT, CHALLENGE AND BANK INDONESIA'S POLICY DIRECTION


*In 2012 the Indonesian economy is expected to move ahead with its long held resilience along with its well maintained macroeconomic stability. Despite global economic slowdown, the economy is projected to post a relatively high growth, at a 6.3%-6.7% range. The driving factor of the economy mainly stems from a strong domestic demand along with a rising role of investment and consumption. An expectation for a higher growth of investment is to be underpinned by a well-guarded economic stability, improving investment climate and sovereign rating, a considerable market potential, and a relatively low interest rate. Household consumption is predicted to advance due to growing income, high consumer's confidence, and low interest rates. Meanwhile, it is estimated that exports of goods and services are to reach a relatively high growth though at a lower level than the previous year's. With robust domestic demand and exports, import is projected to gain a high growth. On the production front, the sectors related to domestic demand, such as agriculture and construction, are expected to gain higher growth.*

*The BoP is expected to book a considerable amount of surplus in 2012. Such a surplus mainly comes from capital and financial transaction account which is estimated to rise along with the growing role of FDI. Capital flows in the form of portfolio is expected to remain high due to a solid economic fundamental, attractive returns, low risk perception, as well as mounting global excess liquidity. Meanwhile, a prediction of current account deficit will be in line with stronger growth in domestic demand. With an excellent NPI performance, supported by prudent macroeconomic*

*policy, as well as sufficient amount of foreign exchange reserves, rupiah exchange rate is projected to remain relatively stable.*

*Under a strengthening coordination of a variety of policies taken by Bank Indonesia and the government, inflation is predicted to be under control and within the targeted range in 2012. The monetary and exchange rate policy is expected to be capable of suppressing inflationary pressure stemmed from the external side, maintaining a controllable domestic demand, besides anchoring on a low inflation expectation. Such a low inflation expectation is also attributable to steps to be taken by the government aiming at ensuring supply condition to remain adequate and distribution to run smoothly, especially on food and energy. This policy is also to be taken to control volatile food inflation. Meanwhile, the plan to raise electricity tariff at an average of 10% and to limit subsidized fuel consumption is projected to lift administered inflation moderately to a rate well below the level in the case of government's scenario to raise subsidized fuel price. In the wake of such a condition, inflation is estimated to rise significantly.*

*It is hoped that macroprudential policy mix that has been taken by Bank Indonesia and the government since 2011 will show its capability in maintaining financial system stability in 2012. The expanding intermediation function in 2011 is expected to continue in 2012 while at the same time bolstering banks' profitability. Despite having an expectation of rapid credit expansion, banking credit risk is set to be under control. In addition, a strengthening banking efficiency*



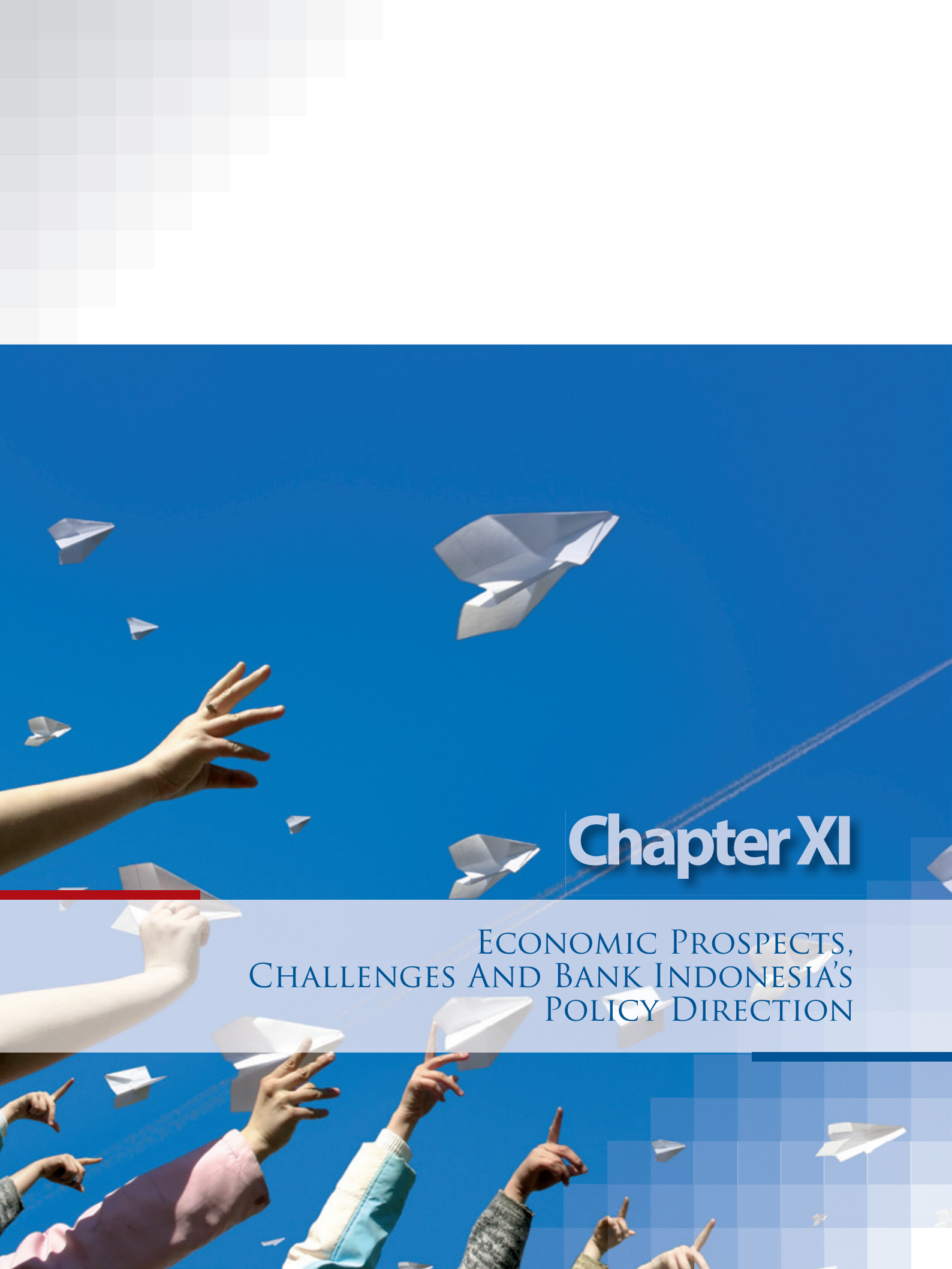
*and resilience will safeguard banking liquidity at its safe level and to maintain banking capital at a high level in order to make it be able to absorb risks that may arise due to global economic uncertainty. As for the financial market, its performance is expected to continue to improve in addition to its growing resilience. It is estimated that an improvement in investors' education and the presence of bond stabilization framework will be capable of dampening the volatility in the government bond market as well as boosting investor's confidence on domestic financial market so that it can serve as a foundation for a promising prospect of the financial market in the future.*

*In the middle term, with the ongoing structural improvement, an improving economic capacity and productivity, and a gradually recovering global condition, the Indonesian economy has a prospect of a high and sustainable growth with an under-controlled macroeconomic stability. National economy looks forward to grow by 6.6%-7.4% and inflation level is envisaged to further decline to 4.0%+/-1% by 2016. Such a high medium term economic growth is supported by improvement in productivity and economic capacity in line with investment expansion, in terms of both physical and human capital. In relation to financing issue, such a high investment is attributable to the rising FDI and high public saving. FDI inflows is foreseen to increase due to strong economic fundamentals and the regaining of investment grade status. Meanwhile, demographic advantages in the form of a rising number of people in their productive age and the people's rational behavior on consumption will create a favorable condition for public savings to accumulate.*

*Despite a substantial optimism over future economic performance, a number of challenges, either from domestic or external sides, will highlight macroeconomic performance and stability.. On the external front, challenges include an expectation for the global economy to undergo a worse than expected slowdown and massive global excess liquidity. On the domestic front, challenges include efforts to manage capital flows which is possibly to become more volatile and large excess liquidity in the banking sector. On financial sector, a challenge needs to be responded is on how to improve financial sector's resilience while at the same time to encourage development financing and improve competitiveness. Furthermore, the potential food production and distribution disruptions are another kind of challenge that needs to be anticipated.*

*Considering the future macroeconomic management which has to confront global risks and considerable complexity of domestic issues, Bank Indonesia will direct its policy in 2012 to focus on 5 areas as follows: (i) to optimize the role of monetary policy and to improve coordination in order to maintain price stability, increase economic capacity, and mitigate risks of global economy slowdown. (ii) to improve banking efficiency in order to increase its contribution to economy, while strengthening banking resilience. (iii) to raise the efficiency, reliability, and safety of payment system, in both national and international contexts. (iv) to strengthen macro resilience by improving coordination in crisis prevention and resolution (crisis management protocol). (v) to support real sector empowerment efforts including to continue the expansion of banking access (financial inclusion) to the public.*





# Chapter XI

ECONOMIC PROSPECTS,  
CHALLENGES AND BANK INDONESIA'S  
POLICY DIRECTION



# ECONOMIC PROSPECTS, CHALLENGES AND BANK INDONESIA'S POLICY DIRECTION



Indonesia's economy in 2012 is expected to remain strong and grow within the range of 6.3% – 6.7%. The crisis in Europe and the US is expected to continue, however, its impact on the domestic economy's performance is expected to be fairly limited. Domestic demand is expected to remain strong in line with investment's increasing role. This investment growth will also be supported by higher FDI, wherein Indonesia's Balance of Payments is expected to continue posting a large surplus hence supporting exchange rate stability. In the meantime, inflation will remain manageable within a target range of  $4.5\% \pm 1\%$ , which is in line with aggregate level of demand that is well below its potential output, declining international commodity prices, and well anchored inflation expectations. Financing support from both bank as well as non-bank financial institutions will likely increase followed by a continuing stable financial system. Economic capacity and productivity will continue to improve in accordance with sustaining structural improvements. As a result, Indonesia's economy is likely to be stimulated to achieve faster growth in the medium term with preserved macroeconomic stability and inflation aimed at its medium term target of  $4\% \pm 1\%$  in 2015. Nevertheless, Indonesia's economy is expected to continue to face a number of challenges in the years to come which could bring economic growth to the lower limit of the projected range. As a result of the complexity associated with domestic and global risks, various policies applied by Bank Indonesia will continue to be strengthened and coordination with the Government will continue to be enhanced thereby macroeconomic stability will continue to be maintained and economic growth will be brought to the upper limit of the projected range.



## 11.1 ECONOMIC PROSPECTS FOR 2012

Indonesia's economic prospects in 2012 will be influenced by developments on a number of assumptions related with the global as well as the domestic economy.

### The Global Economy

The global economy is expected to experience a slower growth. The global economy, which grew by 3.8% in 2011, is expected to slow to 3.3% in 2012. Developed countries are expected to experience slower growth in 2012 from 1.6% to 1.2%. The economic slowdown in the developed countries is primarily caused by continued weakening domestic demand, particularly in terms of consumption, as well as the existence of the deleveraging process. Developing countries are expected to continue to shore up the global economy with the growth of 5.4% in 2012, in spite of it being lower than the 6.2% growth achieved in 2011.

International commodity prices are expected to be lower in 2012. The global economic slowdown is expected to result in a decline in commodity prices to 12.8% following an increase of 15.8% experienced in 2011. The decline in commodity prices is expected for non-oil and gas commodities, while a correction of the oil prices are expected to be largely limited. Global inflation is expected to be relatively low as a result of the declining trend in commodity prices. Inflation in the developed countries is expected to decline from 2.7%

in 2011 to 1.6% in 2012, while inflation in the emerging markets will decline from 7.2% to 6.2%.

Monetary policy in the developed countries will continue to ease, as a response to the global economic slowdown and declining commodity prices. Accordingly, central banks in the emerging markets will also implement accommodative monetary policies. Fiscal policy is expected to continue to be directed at providing stimulus for growth, which tends to decline. However, the room for fiscal stimulus in the developed countries will largely be limited to fiscal consolidation as part of efforts to reduce the level of fiscal deficit.

### The Domestic Economy-Fiscal Policy

In accordance with the Government's 2012 Budget, fiscal policy seeks to provide impetus for the economy (fiscal stimulus) by maintaining economic stability and fiscal sustainability. This objective is expected to be accomplished through four main objectives, which includes enhancing economic growth (pro-growth), creating and enhancing employment opportunities (pro-job), and enhance public welfare while preserving the environment (pro-environment). The strategy for the 2012 fiscal policy seeks to balance fiscal consolidation and stimulus as reflected in the 2012 budget deficit projected to be as much as Rp123.9 trillion or 1.5% of GDP.

### AGGREGATE DEMAND

In the midst of the global economic downturn, Indonesia's economy is expected to remain strong. Indonesia's economic growth in 2012 is projected to reach between 6.3% - 6.7% (Table 11.1). The strong growth is supported by the continued strong domestic demand, being consumption and investment expected to register higher growths. Increase in consumption occurs both in terms of household and government, while increase in investment that occurred since 2010 will continue on in 2012 in line with strong domestic demand and favorable investment climate. Export of goods and services are expected to continue to increase sharply, especially in terms of exports of oil and gas and natural resource-based commodities, despite the slower pace of growth compared to 2011 due to the correction in international prices. In response to increased domestic demand and strong exports, imports are also expected to grow significantly higher.

**Table 11.1 GDP Forecast by Expenditures**

% yoy, 2000 Price

Component	2010	2011				2011*	2012*		
		I	II	III	IV*				
Private Consumption Expenditures	4.6	4.5	4.6	4.8	4.9	4.7	4.7	-	5.1
Government Expenditures	0.3	2.8	4.5	2.5	6.9	4.5	7.4	-	7.8
Gross Fixed Capital Formation	8.5	7.3	9.4	7.1	7.2	7.7	9.7	-	10.1
Export Goods and Services	14.9	12.5	17.5	18.5	17.3	16.5	11.7	-	12.1
Import Goods and Services	17.3	14.4	15.3	14.2	14.1	14.5	13.5	-	13.9
GDP	6.1	6.5	6.5	6.5	6.5	6.5	6.3	-	6.7
* Bank Indonesia Projection									

Source : BPS-Statistics Indonesia

Household consumption growth is expected to be significantly higher in 2012 at a range of between 4.7% – 5.1%. Real income is generally expected to increase. In 2012, the Government will allocate salary increases by 10% and a 13th monthly salary for civil servants, members of the Armed Forces/Police and retirees, which is expected to maintain the purchasing power of both civil servants and retirees. In addition to this, the purchasing power of laborers/workers will be maintained through improvements in their wages. A number of regions/provinces has determined Provincial/Regional Minimum Wage Requirements (UMP/UMK) that are generally higher compared to the Minimum Wage Requirement increases in 2011.

In addition to improved purchasing power, high consumer confidence, relatively low levels of household debt, and relatively low interest rates support higher household consumption growth. A number of surveys have shown that Indonesian consumers' level of confidence are on the rise. Consumer surveys carried out by Bank Indonesia in December 2011 indicates that the confidence index continues to register an upward trend. In addition to this, the results of the survey shows that, in comparison to other countries, the level of consumer confidence in Indonesia continues to be high. Indonesia is, based on the Nielsen Global Online Survey (August-September 2011), one of the countries whose consumers are considered to be the most optimistic in the world, after India and Saudi Arabia.

In 2012, Government real consumption is projected to grow significantly by 5.7% - 6.1%. The relatively low fiscal deficit, of around 1.5% of GDP in 2012, seeks to provide stimulus to the economy (fiscal stimulus) by maintaining economic stability and fiscal sustainability. This is in line with Government efforts to achieve

budget surplus in 2015. In 2012, state expenditure is projected to be Rp1,435.4 trillion, particularly for expenditure of personnel, goods, and subsidies. Apart from its design to support fiscal sustainability, the Government's financial operations also seeks to enhance the quality of the state expenditure.

Investment in 2012 is expected to grow by 9.6% - 10.1%. In the midst of the global economic downturn, Indonesia's robust economic prospects over the medium term and sizeable domestic market will be the main factors which attract more investment in Indonesia. In addition to this, improved investment climate, both in terms of infrastructure as well as regulations, is expected to drive investment growth further. The Government's capital expenditure in 2012 is expected to increase, of which a sizeable portion will be allocated towards infrastructure development, thereby expected to have a highly follow up impact. Support towards investment performance is also expected to derive from low interest rates and improvement to Indonesia's sovereign rating. Furthermore, FDI is expected to continue to increase in 2012.

In line with the global economic downturn, the pace of export growth is projected to be slower, despite its continued relatively high growth within a range of 10.6% - 11.1%. Optimism towards continued high export performance is supported by diversified export destinations to emerging market countries in Asia such as China and India that focus their economic growth towards fulfilling domestic demand. Indonesia's exports to these countries are mainly energy and agricultural products, and used for domestic consumption thereby reducing their sensitivity to the global economic downturn. Also, Indonesia's major export destination

countries are expected to have slightly lower economic growths in 2012. In fact, the economic growths in several of these trading partner countries are projected to be higher in 2012 (Chart 11.1). From domestic factors, supports toward export performance will derive from, among others, low interest rates as well as manageable inflation.

Rising domestic demand and high export growth will drive imports of goods and services to continue growing significantly at a range of 11.6%-12.0% in 2012. Production activities, which is expected to remain strong, will continue to drive high demand for imported raw materials. In addition to this, strong consumption will also drive import of consumer goods, although in limited quantity. The similar trend follows for capital goods imports, which in line with investment prospects, is expected to continue to improve. Investments aimed at increasing production capacity will drive machinery imports while investments in the form of infrastructure development will drive imports of heavy machinery and transportation higher.

## AGGREGATE SUPPLY

From the production side, sectors associated with domestic demand will generally tend to increase. In the meantime, sectors associated with external demand are expected to experience a slowdown. The construction sector is expected to grow significantly higher in line with the projection of higher growth of investment and government capital expenditure. With the support from infrastructure improvements and climate that is expected to be conducive, the

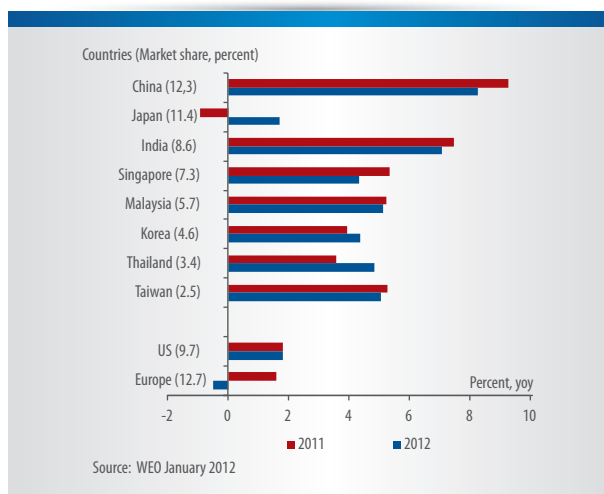


Chart 11.1 GDP Forecast of Trading Partners

agricultural sector is expected to grow significantly. The trading, hotel, and restaurant sector is expected to continue to grow significantly in line with the household consumption that is expected to increase. An increase in economic activity is expected to support growth in the transportation and communications sector that continues to grow significantly, despite the expected slowdown in exports. The impact of the global economic downturn will be reflected in the manufacturing as well as the mining and quarrying sectors, which are expected to experience slower pace of growth (Table 11.2).

The manufacturing sector in 2012 is expected to experience a slower pace of growth, despite achieving relatively high figure of around 6.0% - 6.4%. The more significant slowdown in industrial sector growth due

Table 11.2 GDP Forecast by Industry Origin

% yoy, 2000 Price

Sector	2010	2011				2011*	2012*	
		I	II	III	IV*			
Agriculture	2.9	3.7	3.9	2.7	2.0	3.1	3.1 - 3.5	
Mining and Quarrying	3.5	4.2	0.8	0.3	0.4	1.4	0.8 - 1.2	
Manufacturing Industries	4.5	5.0	6.1	6.6	6.4	6.1	5.6 - 6.0	
Electricity, Gas and Water Supply	5.3	4.3	3.9	5.2	5.1	4.6	4.6 - 5.0	
Construction	7.0	5.3	7.6	6.4	6.5	6.4	8.2 - 8.6	
Trade, Hotels and Restaurant	8.7	8.0	9.6	10.1	9.9	9.4	9.3 - 9.7	
Transport and Communication	13.5	13.7	10.7	9.5	10.2	10.9	9.9 - 10.3	
Financial, Ownership and Business	5.7	7.3	6.9	7.0	7.0	7.0	6.8 - 7.2	
Services	6.0	7.0	5.7	7.8	7.0	6.9	6.5 - 6.9	
GDP	6.1	6.5	6.5	6.5	6.5	6.5	6.3 - 6.7	

\* Bank Indonesia Projection

Source : BPS-Statistics Indonesia

to expected lower external demand can be prevented by higher domestic demand. The cement industry is expected to grow higher in line with investments, which is expected to grow significantly, including investments in building and infrastructure. Manufacturing industry growth, which continues to be strong in 2012, will also be attributed to the significantly high growth of investment in the manufacturing sector in 2011 as well as lower interest rates.

The trade, hotel, and restaurant sector in 2012 is still expected to grow significantly by 8.7% - 9.2%. The slowdown in export and import activities is expected to affect performance in the trade, hotel, and restaurant sector, particularly the wholesale and retail trading subsectors. However, with domestic consumption expected to grow strongly, the performance of the wholesale and retail trading subsectors are expected to grow significantly.

The transportation and communications sector is projected to experience a slowdown in 2012 by 9.9% - 10.4%. The transportation subsector is expected to experience slower growth driven by, among others, downturn in economic activities associated with exports and imports. However, with domestic demand's tendency to increase, the transportation subsector is expected to continue its strong growth. The communications subsector, although declining, is also expected to continue its high growth. Data/internet communications are expected to support the growth of the communication subsector.

The agricultural sector is expected to increase moderately in 2012 by 3.0% - 3.5%. The Government's efforts to improve agricultural infrastructure and inter-regional links are expected to enhance the agricultural sector's performance. In addition to this, food production is expected to increase through the Corporation-Based Food Production Enhancement Movement (GP3K). Through this program, farmers can participate by providing and cultivating the land, while corporations, in the form of State-Owned Enterprises (SOE), can participate by providing partnership and the capital needed for land cultivation, such as seeds, fertilizer, and pesticides.

In 2012, the construction sector is expected to increase and grow by 7.5% - 8.0%. This is in line with the projected growth in investment, which includes construction investment. The Government's capital expenditure is expected to increase in 2012 and the largest portion of the expenditure will be allocated

towards infrastructure projects and enhance the performance of the construction sector. In addition to this, the 2011-2025 Masterplan for Acceleration and Expansion of Indonesia Economic Development (MP3EI) program will foster inter-corridor economic connectivity as well as promote the construction sector's growth.

## **BALANCE OF PAYMENT AND EXCHANGE RATE**

Indonesia's balance of payments in 2012 is expected to continue posting a significant surplus. In the midst of the global economic downturn, Indonesia's balance of payments is projected to produce a surplus of around 11.0-11.6 billion US dollar in 2012 (Table 11.3). The surplus largely derives from capital and financial accounts that are mainly supported by increasingly high foreign direct investment (FDI) inflows. The surplus in capital and financial accounts is by far larger than the deficit in current accounts.

Current account is expected to register a deficit amounting to 2.2-3.9 billion US dollar in 2012. The deficit is mainly caused by the high growth in the value of oil and gas, as well as non-oil and gas imports in line with strong domestic demand. In addition to this, the substantial amount paid associated with transportation and insurance services for imports as well as large profits transferred and interest paid for foreign investment both in terms of FDI, portfolio investment as well as foreign debts serves as affecting factors of the current account deficit. Meanwhile, despite continuing to be relatively high, growth in export value in 2012 is expected to decline in line with the decline in the volume of international trade and commodity prices.

Capital and financial account is expected to register a surplus amounting to 13.9-14.9 billion US dollar in 2012. The size of the surplus is mainly supported by FDI's increase in line with higher investment growth. In the meantime, portfolio investments, will continue to be invested in Indonesia and is even expected to be higher than in 2011 in line with large global excess liquidity and more stabilized global financial markets. The increase in foreign capital inflow reflects investors' confidence towards the strength of Indonesia's economic fundamentals in line with the improving Indonesia's sovereign rating, as well as the attractive returns. The increase of FDI, which is substantially higher compared to the increase of portfolio capital inflows, solidifies FDI's composition within the capital and financial account thereby enhancing its sustainability.

**Table 11.3 Balance Of Payment Projections**

Billions of US Dollar

ITEMS	2011*	2012**	
I. CURRENT ACCOUNT	2.1	-3.9	-2.2
A. Goods, net	35.3	30.5	31.8
- Exports, fob.	201.5	205.0	205.0
- Imports, fob.	-166.1	-17.5	-173.2
B. Services, net	-11.8	-12.2	-11.9
C. Income, net	-25.7	-26.5	-26.5
D. Current transfers, net	4.2	4.3	4.3
II. CAPITAL & FINANCIAL ACCOUNT	14.0	14.9	13.9
A. CAPITAL ACCOUNT	0.0	0.0	0.0
B. FINANCIAL ACCOUNT	14.0	14.9	13.9
1. Direct investment	10.4	14.6	14.1
2. Portfolio investment	4.2	5.4	4.8
3. Other investment	-0.6	-5.1	-5.1
III. TOTAL (I+II)	16.1	11.0	11.6
IV. NET ERRORS & OMISSIONS	-4.2	0.0	0.0
V. OVERALL BALANCE (III+IV)	11.9	11.0	11.6
VI. RESERVES AND RELATED ITEMS (A+B) <sup>1)</sup>	-119	-11.0	-11.6
Memorandum:			
Reserve Assets Position <sup>2)</sup>	110,1	121,1	121,8
(equivalent in month of imports and external debt services)	6,4	6,8	6,9

<sup>1)</sup> Negative represents surplus and positive represents deficit.

<sup>2)</sup> Using the IRFCL concept (SDDS-IMF) based on current price with Official Reserve Asset (ORA) format.

\* Very provisional figures

\*\* Projections

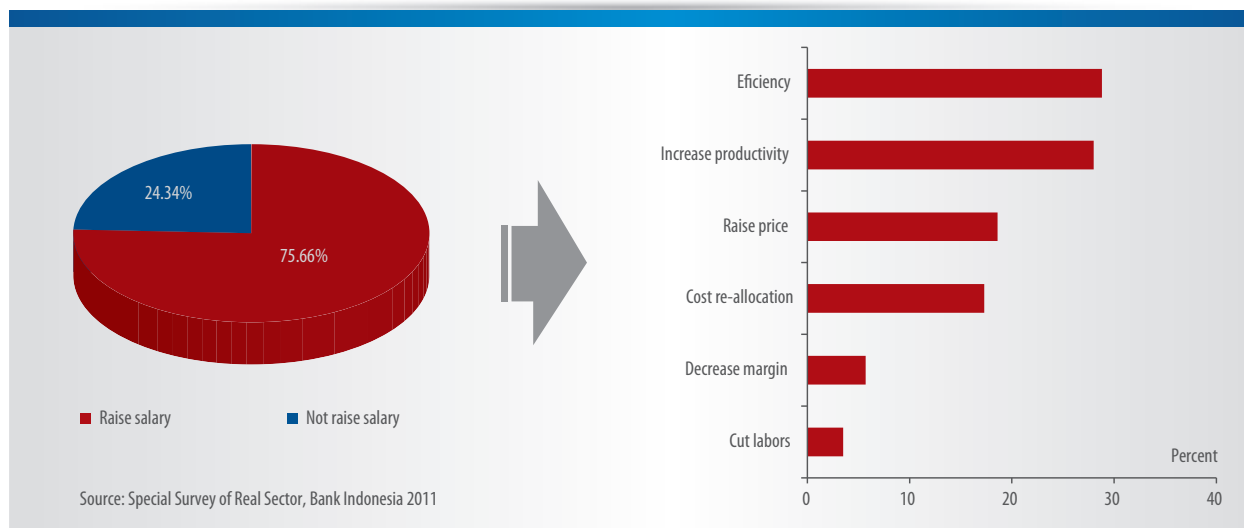
As a result of these developments, foreign exchange reserves is expected to increase to reach 121.1-121.8 billion US dollar by the end of 2012. The rupiah exchange rate's movement going forward will remain stable and tend to strengthen, bolstered by the adequacy of foreign exchange reserves, the strong performance of Indonesia's balance of payments, as well as the support provided by the implementation of prudent and consistent macroeconomic policies.

## INFLATION

By virtue of enhanced policy coordination between Bank Indonesia and the Government, inflation in 2012 is expected to be manageable within the targeted range of 4.5% + 1%. Bank Indonesia's continuous efforts to strengthen monetary and macroprudential policies mix will be able to control fundamental pressures on inflation arising from international commodity prices, domestic demand, and inflation expectation. At the same time, the Government's commitment to maintain adequate supply and undisrupted distribution of foods, including basic needs for the poor, will support the continued controllable volatile

food inflation. Meanwhile, the government's plans to increase electricity tariff and limit subsidized fuel consumption will moderately increase inflation deriving from administered prices hence bringing CPI inflation to be manageable within the target. In addition to this, the administered prices policy is believed to have a temporary impact on inflation due to adequate economic capacity.

Core inflationary pressures from the demand side and prices of imports are expected to remain low in 2012. Increase in the demand side is sufficiently matched by expansion in the supply side in line with economic growth, which remains below its potential capacity. The expansion of economic capacity will be buttressed by continuously improved investment activities, especially non-building investment. In terms of import prices pressures, well behaved core inflation is supported by declining international commodity prices. Commodity prices in 2012 are expected to decline by 12.8% compared to the 15.8% increase in 2011, while oil prices is expected to fall from 117 US dollar per barrel to 105 US dollar per barrel. This decline in international commodity prices will push external



**Chart 11.2 Salary Adjustment Respond**

inflationary pressures significantly lower in 2012. Bank Indonesia's policy measures to maintain the Rupiah's exchange rate stability will also be able to control imported inflation.

Core inflationary pressures arising from wage increase and inflation expectation also continue to be manageable. Despite the substantial increases in the provincial minimum wages in 2012, its impact on increased prices is expected to be minimal. This is in line with Bank Indonesia's survey, which shows that most companies will respond to the increase in overall wages with enhanced efficiency and productivity (Chart 11.2). From an estimated 75% of corporate respondents who increased wages, not more than 20% of those planned to increase their sales prices. Meanwhile, various surveys carried out by Bank Indonesia, both from producers as well as consumers, indicate declining inflation expectation. Inflation expectation indicators among the financial market practitioners also show a similar tendency, and even at a much larger rate of decline. Inflation, which was maintained at a relatively low level over several recent periods, as well as relatively stable, and even strengthened, Rupiah exchange rate will lead to the improvement of inflation expectation.

Inflationary pressure from volatile foods is also expected to be relatively low despite being higher compared to 2011. Domestic food supply up to the end of the year is expected to be adequate, both due to domestic production as well as imports. The increase in domestic food production is also supported by agricultural infrastructure development and enhanced inter-regional links. Controllable volatile food inflation is also backed by the Government's strong commitment

to maintain stable food prices, as reflected in the inclusion of food security program as one of the priorities in the national development agenda. Externally, the declining trend of international food commodities and the Rupiah exchange rate stability will also support the stability of domestic food prices.

Meanwhile, inflation from administered prices in 2012 is expected to increase. In line with the Government's 2012 budget, as part of efforts to reduce the burden of subsidies on the budget, the Government plans to increase electricity tariff by as much as 10% and limit the use of subsidized fuel (such as premium and solar (diesel) fuel) only for public transportation and motorcycles within Java and Bali beginning in April 2012. With the current electricity tariff for industries and the middle to upper income households at levels at par or close to its economic value, the plan to increase the tariff is expected to have a moderate impact on inflation. A more significant impact on inflation will derive from the Government's plan to limit the use of subsidized fuel.<sup>1</sup> Despite this, by taking into account the impact of the electricity tariff increase and the limitation of the subsidized fuel consumption, CPI inflation by the end of 2012 is expected to be within

<sup>1</sup> At the time this report was made, there was a view within the Government to increase the subsidized fuel prices (Premium and Solar types) rather than applying limits on the use of subsidized fuel. The impact on higher inflation will depend on the amount of such increase, aside from the subsequent impact it will have on the increase in public transportation cost, production expenses, and inflation expectation. The amount of compensation that will be granted by the Government both to public transportation companies as well as social support for the poor will also depend on the scale of impact that the fuel price increase will have on inflation.

the targeted range of 4.5% + 1%. Close coordination between Bank Indonesia and the Government to implement measures needed to mitigate the impact of these planned policies will successfully bring inflation to be under control.

## **BANK AND NON-BANK FINANCIAL MARKET PROJECTION**

Indonesia's financial sector performance in 2012 is expected to continue its positive trend accompanied by well maintained the financial system's stability. From a financial institution perspective, Indonesia's economy, which continues to grow stronger, will provide the stimulus to enhance the performance of banks, insurance, and financing institutions. The banking sector's improved performance is reflected in the level of loan growth and profitability, which continues to be high with relatively low credit risk. In addition to this, the banking sector's strong resilience and improved efficiency will likely continue in 2012, supported by adequate levels of liquidity and relatively high levels of capital to absorb any potential risks that may arise. In 2012, based on the Bank Business Plan (BBP), loan growth is expected to be around 24.4% along with Bank Indonesia's policies and the banking sector's efforts to enhance efficiency thereby resulting in lower interest rates.

From a financial market perspective, the financial market is expected to continuously show improved performance supported by stable macroeconomic conditions and strong companies' fundamentals. In line with the process to resolve the European crisis, the financial market's volatility will likely continue in early 2012. Developments in the succeeding period is expected to be improving whereby the inflows of foreign capital is expected to be higher and positively contribute to enhanced performance and stability of Indonesia's financial system. Correspondingly, as well as the continued strength of Indonesia's economic activities and sovereign rating upgrades, corporate financing that derive from sources other than bank loans, such as bond issuances and IPOs, is expected to gain momentum/intensify.

Financial system stability will also be supported by close policy coordination between Bank Indonesia and the Government. To stabilize the Rupiah exchange rate, Bank Indonesia will continue to maintain its presence in the market by intervening in the foreign exchange market as well as buying government securities (SBN)

in the secondary markets to respond the financial market dynamics. At the same time, the Government will stabilize the government bond market through the bond stabilization framework along with the issuance of Government Securities in the primary market to finance the budget. Policy coordination between Bank Indonesia and the Government is being strengthened through the crisis prevention and resolution management protocol that will be strengthened further and integrated nationally in 2012.

## **11.2 ECONOMIC PROSPECTS FOR 2013-2016**

In the medium term, Indonesia's economy is expected to grow higher and sustainably with a maintained macroeconomic stability. This optimism is supported by investment and domestic consumption growth that remain high as well as the continued recovery of the global economic conditions. Investment that grew relatively high in 2011 is expected to be even higher in future, including investment in a number of infrastructure projects, thereby boosting the economic capacity and productivity. Indonesia's economy in the medium term is expected to grow by around 6.6% - 7.4% in 2016, while inflation is expected to gradually decline towards 4.0% ± 1% in 2016.

### **The Global Economy**

Following the slowdown experienced in 2012, global economic growth is expected to gradually expand in the medium term. In the developed countries, the fiscal consolidation process to reduce sovereign debts to an acceptable level as well as the need to further strengthen domestic demand are expected to result in gradually implemented efforts to bring the level of economic growth to its longer term trend. With such conditions, economic growth in the developed countries is expected to reach a level of as much as 2.7% throughout the 2014-2016. As for the emerging countries, through the support of increased domestic demand, they are expected to achieve a strong growth of around 6.7% within the same period. In line with this, growth of the world trade volume in the medium term will moderately increase towards 7.4% in 2016.

In line with the gradual economic recovery, international commodity prices for both oil and gas as well as non-oil and gas is forecasted to rise causing the global inflationary pressure to moderately increase in

the medium term. In the medium term, inflation in the developed countries is expected to slowly increase close to a level prior to the crisis of around 1.7% in 2016. On the contrary, inflation in the emerging markets is expected to decline to around 4.2% within the same year.

### The Domestic Economy

In the medium term, efforts towards structural improvements to enhance the economic capacity and productivity, particularly through physical infrastructure improvements and quality of human capital, has become the key factors to achieve a sustainable economic growth. The continuing macroeconomic and the financial system stability to date has instilled a conducive environment for the national economy. Therefore, progress in implementing various structural policies in the years to come will strengthen the economy's foundation in achieving higher growth. In addition to enhancing economic capacity, structural enhancements will drive higher productivity (Total Factor Productivity—TFP) and efficiency thereby in turn increasing return on investment and the national economy's competitiveness.

Improvements on the structural side will provide opportunities to the economy in the medium term to remain on a higher growth path with sustained macroeconomic stability. Combination of fiscal and monetary policies is believed to be able to ensure that aggregate demand expansions will be sufficiently responded by aggregate supply hence higher economic growths will not disrupt macroeconomic and financial system stability. If this condition is achievable, Indonesia's economy in the medium term is expected to be able to grow by 6.6% - 7.4% in 2016. Meanwhile, inflation is expected to gradually decline toward its medium term target of 4.0% ± 1% in 2015-2016 (Table 11.4).

Investment performance as the main factor that drives the economy in the medium term is expected to expand continuously. Investment growth is expected to reach 13.1% - 13.9% in 2016. Positive sentiment towards macro and micro risks of Indonesia's economy serves as the investment's pull factors<sup>2</sup> that put Indonesia as one of the most preferred destinations for Foreign Direct Investment (FDI).<sup>3</sup> In the meantime, the push factor that drive this investment growth are the foreign capital flows to the emerging countries in the midst of the excess global liquidity. Recent upgrades of Indonesia's sovereign rating to investment grade status will also boost FDI needed to expand investment and the economy.<sup>4</sup>

Apart from the greater support of FDI, investment growth will also be driven by accumulated private savings in the medium term. Growth in public savings, which had previously declined as a result of the Asian financial crisis, has increased in line with the rise in public income (Chart 11.3). The demographic strength and rational consumption behavior positively contributed to the increase of private savings.

The demographic strength will be in the form of the increase of productive age population that is accompanied with the growth of the middle class income<sup>5</sup> in Indonesia thereby providing demographic dividend to the economy. Larger composition of the productive age population to the total population

2 Refer to Box "Investment Growth Optimism Post Investment Grade Rating (Investment Grade)"

3 Based on the UNCTAD 2011 survey, Indonesia ranked 7th as the preferred investor destination, up 2 places compared to that achieved in 2010.

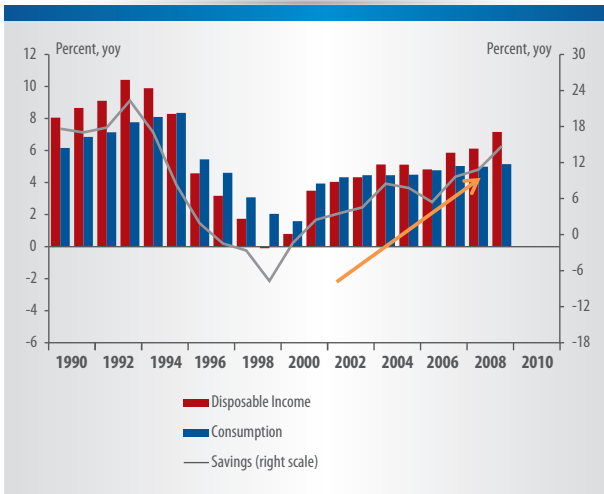
4 Based on China's experience, which achieved investment grade status much earlier, it shows a positive correlation between Foreign Investment inflows with sovereign rating development.

5 The Asian Development Bank classifies middle class income as people with income of between \$2-\$20 per day.

**Table 11.4 Mid Term Indonesia Economic Outlook (2011-2016)**

Component	2011	2012*	2013*	2014*	2015*	2016*
Private Consumption Expenditures	4.7	4.7 - 5.1	4.6 - 5.0	4.7 - 5.3	4.8 - 5.6	4.8 - 5.6
Government Expenditures	3.2	5.7 - 6.1	4.2 - 4.6	3.6 - 4.1	3.3 - 4.1	3.0 - 3.8
Gross Fixed Capital Formation	8.8	9.6 - 10.1	11.5 - 11.9	12.4 - 13.0	12.9 - 13.7	13.1 - 13.9
Export Goods and Services	13.6	10.6 - 11.1	12.3 - 12.7	12.6 - 13.2	13.0 - 13.8	13.4 - 14.2
Import Goods and Services	13.3	11.6 - 12.0	14.3 - 14.7	15.5 - 16.1	16.1 - 16.9	16.4 - 17.2
GDP	6.5	6.3 - 6.7	6.4 - 6.8	6.4 - 7.0	6.5 - 7.3	6.6 - 7.4
Inflation	3.8	4,5%±1%	4,5%±1%	4,5%±1%	4,0%±1%	4,0%±1%

\* Bank Indonesia Projection

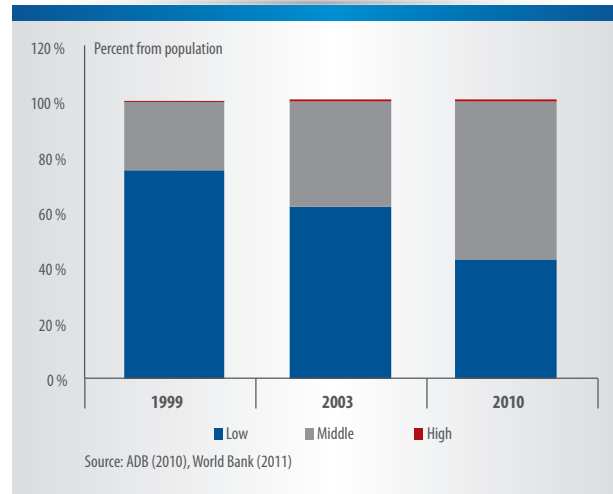


**Chart 11.3 Savings, GDP, Consumption Growth**

will also reduce the dependency ratio<sup>6</sup> thereby the productive age population will be able to save more. (Chart 11.4).

The growing number of the middle class income is the result of its steady growth over a decade following the Asian crisis of 1997/98. It also reflects improvements in people's income that ultimately supports growth in private savings (Chart 11.5).

In addition to this, savings growth is also supported by the people's consumption behavior, which has become increasingly rational. Increase in income for those within the productive age category has driven people



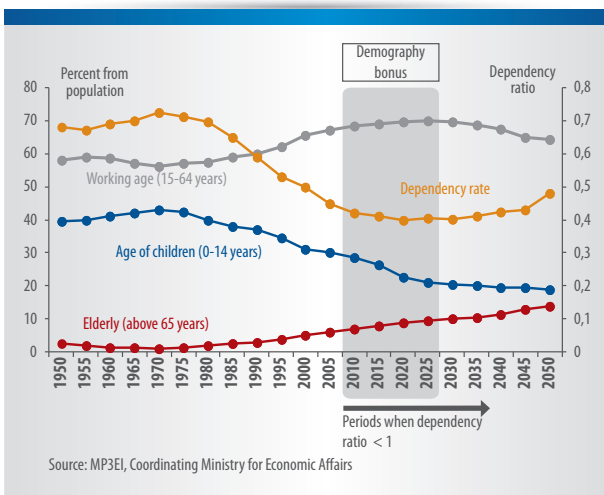
**Chart 11.5 Middle Class**

to increase their spending for long-term needs such as housing and education. This behavior, among others, is reflected in the private consumption to GDP ratio, which has actually declined during times when people's income tends to increase (Chart 11.6).

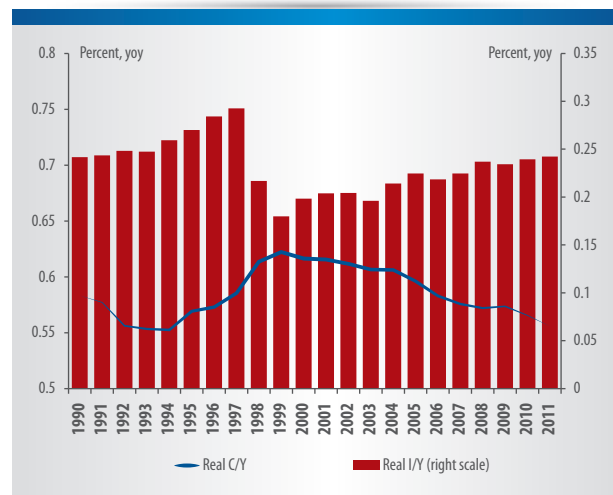
Investment performance not only depends on improved macro and micro conditions but also on improved efficiency of the use of production factors. The efficiency is highly dependent on the infrastructure's competitiveness, which to date has been the main obstacle of Indonesia's economy.<sup>7</sup> Infrastructure competitiveness aspects cover the physical infrastructure as well as the quality of human

6 Dependency ratio is the ratio of non-productive members of the population that is supported by one productive member of the population

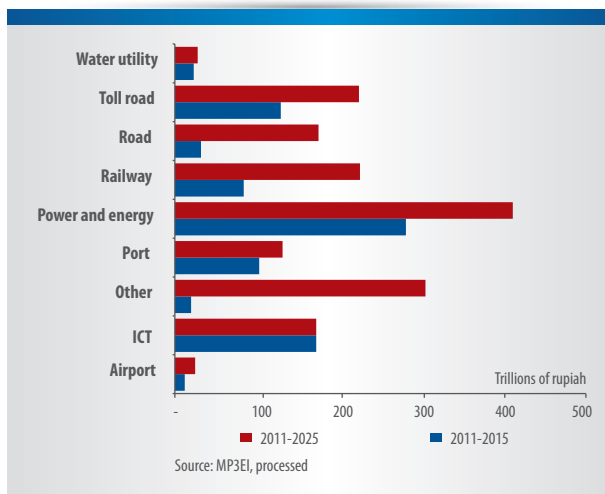
7 Decymus and Hermansyah, Investment Dynamics and Its Affecting Factors, Working Paper No.6, 2011, Bank Indonesia.



**Chart 11.4 Indonesia Demography Structure**



**Chart 11.6 Consumption and Investment Ratio**



**Chart 11.7 Plan of Infrastructure Project in MP3EI**

resources such as: lack of available transportation infrastructure and energy, low quality and level of inclusiveness of the education system, and the extent of the digital divide (technological gap). Development of physical infrastructure is expected to be achieved by implementing Masterplan for Acceleration and Expansion of Indonesia Economic Development or MP3EI. One of the pillars of the MP3EI program is aimed at strengthening physical infrastructure, or referred to as Strengthening National Connectivity, by building roads, bridges, ports, airports, electricity power, as well as the development of information technology and communications (Chart 11.7). Realization of physical infrastructure development through the MP3EI is expected to improve significantly once the Draft Law for the Law Land Acquisition for Public Purposes Development is passed and made into Law.

Aside from this, the other important pillar of the MP3EI, involving enhancing human resource quality as well as science and technology, is expected to be able to improve national productivity as a preparation towards a knowledge-based economy. Human resource development that focuses on the development of a higher educational system is expected to enhance Total Factor Productivity (TFP) while simultaneously reduce technological gaps.<sup>8</sup> In addition to this, efforts to enhance TFP is also carried out through technological development thereby elevating economic capacity to a higher level.

<sup>8</sup> Mastery of technology is related to expertise, human capital, and educational level of human capital (Duncome, 2000)

Meanwhile, the level of private consumption is expected to remain strong in the medium term. Increased domestic investment activities will improve economic capacity thereby positively impact price stability and in turn improve people's purchasing power. Larger economic capacity will also boost job creation and improve income thereby strengthening the accumulation of private savings. This cycle of income creation has been established in recent years, which is reflected in the income growth trend and savings ratio that continue to increase in the last ten years. This trend is expected to persist in the future thereby ensuring sustainable private consumption for the years to come. As a result, household consumption is expected to grow strong to reach around 4.8% - 5.6% in 2016.

On the external front, export growth can potentially return to its normal path in line with the global economic recovery. Also, substantial investment in export oriented business, including the industrial sector, and export diversification to other developing countries are expected to increase the volume of exports. Diversification of export destinations is clearly an evident in recent years with the gradual shift in export market share from the traditional countries such as the US, Japan, and the Euro zone to emerging countries such as China, India and the ASEAN region. Based on this development, exports growth is projected to return to the normal path at the range of 13.4-14.2% in 2016.

## 11.3 ECONOMIC CHALLENGES AND BANK INDONESIA'S POLICY DIRECTION

### ECONOMIC CHALLENGES

A number of external and domestic challenges can affect Indonesia's future economic prospects. These challenges, if they are not responded with appropriate and measured policies, will potentially disrupt the prospects of high economic growth and continued macroeconomic stability.

On the external front, continued fragility of the global economic recovery process can deteriorate the global economic condition to a level far worse than initially expected (downside risk). Specifically, the complexity

of the European crisis can lead to a deeper recession to the region and trigger contagious effects to the global economic performance. The close relationship between the government's debt crisis, fragile conditions of the banking sector, and slowing economic activity, can result in an adverse feedback loop that can prolong the recovery process. The US economic recovery process is also expected to take a substantial amount of time to return to its long-term trends. Through the trade channel, the risks associated with the economic downturn in the developed countries can result in slower economic growth in the emerging countries, including Indonesia.

On the other hand, through the financial channel, increased global economic uncertainty can heighten volatility of the of portfolio investment flows to emerging countries, including Indonesia. Foreign portfolio investments in 2012 can be lower and tend to be two-way capital flows. Pull effect between the looming high excess global liquidity and investor desire for higher returns from emerging markets on one hand, with the possibility of deteriorating economic risks in the developed countries on the other hand, can result in either positive or negative news that affects the volatility of foreign capital flows. This poses as policy challenges for authorities in the emerging markets in its efforts to maintain the macroeconomic and financial system stability, including Indonesia.

On the domestic front, one of the risks is the Government's policy regarding prices of strategic commodities. In the 2012 Budget the Government plans to limit the consumption of subsidized fuel for privately-owned four-wheeled vehicles in Java and Bali, in addition to the 10% Electricity Rate (Tarif Tenaga Listrik or TTL) increase. Other alternatives is that the Government is considering to increase the subsidized fuel prices. On one hand, this policy is needed to reduce ballooning subsidy allocation due to higher oil prices and to provide more budget allocation to capital expenditure and people's welfare. But on the other hand, the policy is likely to increase risks associated with mounting inflationary pressures. Certainty regarding the decision and timing of the implementation will affect the course of economic growth and inflation in 2012.

In stabilizing the rupiah exchange rate, the challenge remains to be the structurally high excess demand in the foreign exchange market. Up to now, excess demand for foreign exchange is fulfilled by foreign capital inflows, particularly portfolio inflows. This

condition, combined with the underdeveloped domestic foreign exchange market, exacerbated the volatility of the Rupiah exchange rate caused by external shocks. Bank Indonesia's policy to require foreign exchange proceeds derived from exports and foreign exchange disbursements of foreign debt (DHE and DULN) to be accepted using domestic foreign exchange banks, which takes effect in 2012, serves as a fundamental effort to overcome this issue. The next steps to be taken are efforts to deepen the foreign exchange market and to improve the banking sector's capability in utilizing foreign exchange inflows from DHE and DULN for handling larger foreign exchange transactions, servicing the customers, as well as for financing the economy.

Other domestic challenges include optimizing the use of excess liquidity in the banking sector to finance the economy. To date, the excess liquidity is placed in monetary instruments and Government Securities (Surat Berharga Negara or SBN). Beside originated from foreign capital inflows, huge amount of excess liquidity is derived from accumulated funds that the banking sector have not been able to channel to the real sector, both because of the bank's internal conditions as well as limited absorption capacity of the real sector. This condition resulted in the condition in which large banking industry's assets has not been followed by equal increase of its contribution to the economy. The excess liquidity problem represents a decoupling phenomenon between the banking and the real sectors, which in turn reduced the effectiveness of Bank Indonesia's monetary policies.

In addition to the relatively low role of the banking industry in financing the economy, the banking sector's low efficiency serves as one of the challenges that need to be resolved. Bank Indonesia not only constantly strives to maintain the banking sector which is not only sound and strong, but also operates effectively and efficiently in financing the economy. The banking sector's level of efficiency, which continues to be low, has contributed to high interest rates. The low level of efficiency is illustrated by the ratio of operational expense to operational income that amounted to 85.4% (December 2011). In comparison, the ratio of operational expense to operational income of banks within the ASEAN region is between 40%-60%.

In a longer term perspective, there are a number of structural challenges that needs to be resolved to support sustainable economic growth. To strengthen food security program and simultaneously control

inflation, efforts to boost domestic production and strengthened steps to anticipate risk of disruptions to production and distribution, particularly food, need to be continuously implemented, including through the TPI and TPID forums. In addition to this, challenges that need to be addressed are efforts to strengthen the economy's competitiveness and resilience towards disruptions derived from overseas (external shocks) thereby ensuring macroeconomic stability and performance. Other challenges that are equally important is ensuring the implementation of the MP3EI program, particularly in terms of enhancing investment and accelerating the development of infrastructure projects, to support enhanced productivity as well as economic efficiency to boost economic competitiveness and resilience. Various steps towards structural improvements are vitally needed to ensure that a higher level and quality of growth is achieved with macroeconomic stability and financial system that is continues to be maintained in the long term.

## POLICY DIRECTION

To support the achievement of macroeconomic prospects going forward, in the midst of a number of challenges both derived externally and domestically, Bank Indonesia's policy direction in 2012 will focus on 5 (five) of the following aspects.

Firstly, Bank Indonesia will continue to optimize the role of monetary and macroprudential policies mix in maintaining macroeconomic and financial system stability as well as simultaneously providing stimulus to the economy. Interest rate response is directed to be consistent with the CPI inflation target of 4.5 %  $\pm$  1 % in 2012 and 2013. By focusing on efforts to achieve the inflation target, the interest rate response is also meant to simultaneously provide stimulus to the economy so as to mitigate the risks associated with the global economic downturn. Strengthening of monetary operations will continue to be carried out to ensure that the interest rate responses will be taken in accordance with the banking sector's liquidity condition as well as to support the preservation of the financial market stability and deepening. This interest rate policy will be equipped with macroprudential policies to manage economic liquidity as well as to promote banking sector's loan growth in accordance with the future direction of the macroeconomy, including controlling credit to selected consumptive sectors that tend to grow excessively and pose risks.

With regards to the exchange rate, Bank Indonesia's policy is directed to ensure the stability of the rupiah exchange rate by providing room for its flexibility in line with the conditions of the economy. This exchange rate stability is maintained by ensuring the economy's internal and external balances. Monetary operations by means of symmetric interventions in the foreign exchange market will continue to be carried out to ensure the rupiah exchange rate stability and supported by buying the Government bonds in the secondary market in accordance with developments. Beginning in January 2012, the exchange rate stabilization policy will also be supported by the implementation of policy governing foreign exchange receipts of DHE and DULN using domestic banks. To deepen the foreign exchange market, Bank Indonesia is also in the midst of reviewing existing rules to reinforce the range of foreign exchange market instruments that can be used as hedging tools. In addition to this, Bank Indonesia will continue to reinforce macroprudential policies to manage foreign capital flows thereby supporting the exchange rate policy and strengthening the financial system stability, particularly from the risks of external upheavals.

Through these range of monetary and macroprudential policies, the effectiveness of monetary policy transmission in influencing the economy and controlling inflation through a range of transmission channels either interest rate, exchange rate, money under circulation, loans, financial asset price, as well as inflation expectation can be enhanced. Strengthening of monetary policy communications strategy will also continue to be enhanced to support the effectiveness of monetary policy and provide certainty to economic agents. Moreover, coordination with the Government, both in the central as well as regional levels will continue to be enhanced particularly through the role of the Inflation Control Team and Regional Inflation Control Team (TPI and TPID). TPID's tasks in future will also be supported by, among others, the development of an information system for strategic goods particularly information regarding national food production and stocks with the cooperation of related agencies such as the Coordinating Ministry for Economic Affairs, the Ministry of Agriculture, Ministry of Trade, and also the Regional Government.

Secondly, Bank Indonesia will continue to enhance the banking sector's efficiency to optimize its contribution to the economy by continuing to enhance the banking sector's resilience. Banking sector's loan growth continues to be driven in accordance with the economy's future direction and the internal condition

of the respective bank. To enhance the banking sector's efficiency and competitiveness, the base lending rate (Suku Bunga Dasar Kredit or SBDK) policy will be strengthened thereby supporting monetary policy's effectiveness through optimal interest rate and the banking sector's loan growth. This is meant to ensure that the market mechanism operates effectively thereby ensuring its policy targets are achieved. As a follow up from the perspective of banking supervision, enforcement of decisions that require banks to specify the efficiency achievement targets and reduce borrowing rates to a fair level in their business plan will be intensified. In the meantime, the banking sector's resilience continues to be driven by strengthened supervision, risk management, and improved capital. Various measures will be implemented so as to strengthen banking policies and strengthen the role of banks to support future economic growth and anticipate changes to the business cycle.

Bank Indonesia views the banking sector's customer protection and good corporate governance as two aspects that require attention. A number of fraud cases involving banks that caught the attention in 2011, points to the need to review related policies with the two above-mentioned aspects. Therefore, in 2012, Bank Indonesia will continue to pursue its policy to improve customer and prospective customer protection aspects. Moreover, to enhance the quality of the banking sector's corporate governance, Bank Indonesia will improve regulations pertaining to transparency of financial statements, particularly relating to the published financial statements, and regulation pertaining to public accountants used by banks. Bank Indonesia will also continue to study ownership policies and multi-license policies in line with the growing complexity of banking activities.

Third, Bank Indonesia will continue to enhance the efficiency, reliability, and security of the payment system, both in terms of the national and crossborder payment system. The policy pertaining to the payment system is reinforced through a number of measures, which includes: (i) enhance security and reliability of providing payment services by implementing risk mitigation including using technological advancements, strengthening legal framework, strengthening supervision, as well as enhancing the role of national payment industry; (ii) enhance efficiency of national payment services provider, including promoting interoperability and interconnection between various payment service providers; and (iii) enhance consumer protection by improving transparency by providers

of the payment services, as well as strengthening consumer protection regulations.

In the field of currency circulation, to fulfill public demand that is expected to increase in 2012, Bank Indonesia will implement the policy's three pillars which are: (i) enhance the quality of money in circulation and provide sufficient supply of currency to meet public demands; (ii) enhance efficiency of cash handling in Bank Indonesia and the banking sector; and (iii) improve Bank Indonesia's cash services for the public by including the role of the banking sector and related institutions. Strengthening of regulations in the field of currency circulation as well as coordination with the Government and other related institutions is also carried out in relation with implementing the mandate of the Currency Act. In addition to this, policy of developing Bank Indonesia's cash services in the remote and farthest areas of Indonesia is also strengthened through a Memorandum of Understanding between Bank Indonesia and the Indonesian Navy. Through this memorandum of understanding, continuous cooperation in terms of the availability of transportation to reach the remote and farthest areas areas is assured.

Fourth, Bank Indonesia will continue to strengthen and reinforce coordination with the Government and related authorities within the context of a Crisis Management Protocol (CMP) as the framework and mechanism to prevent and handle crisis in line with the global economy's relatively high uncertainty. Close coordination among agencies/institutions is needed not only to synchronize the CMP within the jurisdiction of each agency/institution but also within the context of developing a comprehensive and integrated a national CMP, while simultaneously strengthening its legal foundation. One of the steps that can be implemented is to integrate the National CMP into the framework of the Financial Sector Safety Net (FSSN) that is currently being drafted by the Government. The draft of FSSN Act serves as the legal basis of coordinated efforts among financial sector authorities/agencies. Meanwhile, in lieu of endorsement of the draft of FSSN Act, Bank Indonesia, the Ministry of Finance, and the IDIC (LPS) has agreed on a Memorandum of Understanding as the basis to coordinate efforts towards crisis prevention and resolution.

And fifth, apart from the channeling of bank loans and the reliability of the payment system, Bank Indonesia will also continually strive to support efforts to empower the real sector including pursuing efforts to

expand access to the banking sector (financial inclusion) for the public. This is particularly geared towards providing banking services to low income people within the rural areas, including enhancing the quality of the My Savings Program (Program Tabunganku), developing financial education, applying a financial identity number and implementing a financial literacy survey. To empower the real sector, Bank Indonesia will facilitate intermediary functions to support financing for various potential sectors by cooperating with various government agencies. To meet financing needs of sectors that are non-commercially attractive for banks but possess a strategic role in the economy, Bank Indonesia in close cooperation with the Government will develop various financing schemes. In addition to this, Bank Indonesia will also develop Islamic (Syariah) banking products and activities. The development strategy of Islamic rural bank going forward is directed in accordance to its characteristic as a community bank that is sound, strong, productive as well as focused on providing financial services to the MSME and members of the community.

Bank Indonesia realizes that the complexity of the challenges and the effectiveness of implementation of various policies to support economy require close coordination with the Government's policies as well as the support from the banking sector, the business entities, and the public. For that purpose, policy coordination, which has been running effectively with related agencies to date, will continue to be

strengthened, both to ensure the stability of the macroeconomy and the financial system, to control inflation, as well as to drive the real sector. To maintain macroeconomic stability, close coordination between monetary and fiscal policy is carried out both within the process of formulating the Government budget as well as in implementing the Government's financial operations, including efforts in stabilizing the rupiah exchange rate that is carried out by Bank Indonesia and the Government bond market that is carried out by the Government. This macroeconomic policy coordination with the Government will also strengthen policy coordination in other aspects, such as inflation with controlling the Inflation Control Team and the Regional Inflation Control Team, domestic financial market deepening, strengthening of financial system stability, develop national CMP, currency circulation, payment system, empowering the real sector and expanding access to banks for the public (financial inclusion) as stated above. Reinforced coordination with the Government and related agencies is carried out both at the central as well as the regional levels. In relation to this, Bank Indonesia will continue to optimize the functions of Bank Indonesia's regional offices (Kantor Bank Indonesia or KBI) to support inflation control and promote development in the regions through close relations with the regional government. Acceleration of regional development will be prioritized to eastern part of Indonesia that experiences substantial disparities in terms of development.

## BOX 11.1 | OPTIMISM OF IMPROVING INVESTMENT FOLLOWING THE ACHIEVEMENT OF INVESTMENT GRADE

Amid the high global economic uncertainty, Indonesia's economic performance continued with a strong growth and was recognized by the international. Strong domestic fundamentals and the optimism on improving prospects of domestic economy have pushed Indonesia's ratings to the investment grade. The investment grade was granted by two of the three international rating agencies, ie Fitch in December 2011 and Moody's in January 2012. It was obtained amid an increased uncertainty in the global economy stemming from the debt crisis in Europe and recovery problems in the US. This showed the resiliency of Indonesia's economy, even under global economic slowdown, and improved international confidence on the domestic economy, especially after an economic crisis in 1997/1998.

There are several advantages gained from the achievement of investment grade as it indicates the higher ability of countries to repay the loan (credit risk). On the government side, obtaining investment grade is expected to be followed by lower cost of financing from the financial market. While for private sector, rating improvement will in turn be followed by improved debt ratings for private or corporate sector that will ultimately reduce the cost of funds. On the portfolio investment, investment grade will encourage a greater and more diversified form of capital inflows into stock and bond market, thus potentially leads to higher stock index and lower bond yields. On the foreign direct investment (FDI), investment grade will improve perception and confidence of foreign investors to the domestic economy. FDI is expected to increase significantly, thus providing a greater contribution to domestic investment. In the long term such conditions will promote higher economic growth and structural improvements to the economy.

Expected reduction in the cost of fund related to debt ratings improvement was among others shown by the study by Jaramillo (2010)<sup>1</sup>. Jaramillo found that the acquirement of investment grade have caused countries' financing cost to decrease significantly. This is derived by improved market expectations on the domestic economy as reflected in the declining risk premium, which in turn encourages larger foreign capital inflows and more diversified types of investors. This study also found that following the achievement of investment grade, countries' foreign debt to GDP ratio significantly decline because they gain more benefit from capital inflows. It is in line with the study conducted by Bank Indonesia (2011)<sup>2</sup> which found that the increase of country's rating amplifies inflows of capital into the country either through FDI or portfolio investment at different speeds. The increase in FDI will occur after three quarters, while the flow of foreign capital into the financial market in the form of portfolio investments will occur faster, after one month.

To support and reinforce the optimism of investment, the development of investment's supporting factors needs to be done. In the real sector, the improvement and acceleration of the implementation of physical infrastructure projects are needed to boost FDI and pave the way for higher and sustainable economic growth. Meanwhile, in the financial markets, deepening the market is necessary in order to cope with high volatility of short-term capital flows amid the high global economic uncertainty.

1 The study was done by comparing 6 countries with newly achieved investment grade, such as Bulgaria, Rusia, Kazakhstan, Rumania, India and Peru, and compare it with the 5 years prior the investment grade was achieved.

2 Yanfitri, "Potential Impact of Sovereign Ratings' Improvement to Indonesia's Capital Inflow". Estimated ordered logit approach in calculating the Z score as a quantitative indices representing a more dynamic ranking.

