STRENGTHENING COORDINATION AND THE POLICY MIX TO MAINTAIN ECONOMIC STABILITY AND ONGOING REFORMS

The Government, Bank Indonesia and Financial Services Authority (OJK) are strengthening coordination and implementing an optimal policy mix to maintain economic stability and ongoing development efforts. In general, national economic dynamics in Indonesia remain solid. The pressures on stability, particularly rupiah exchange rate stability, tend to originate more from tighter liquidity and a build-up of global risks as a corollary of policy change in the United States (US). Stronger coordination prioritises short-term stability while nurturing medium-term economic growth.

National Economic Dynamics in Indonesia Remain Solid

1. Economic fundamentals in Indonesia remain sound. Economic growth stood at 5.06% in the first quarter of 2018. Low inflation was maintained in April 2018 at 3.41% and is predicted to remain within the inflation target of 3.5±1% in 2018. Congruent with cyclical trends, the current account deficit increased to 2.1% of GDP in the first quarter but is narrower than the 2.61% of GDP recorded during the Taper Tantrum in the first quarter of 2013. Furthermore, Bank Indonesia expects the current account deficit to be maintained well within the safe threshold of 3% of GDP in 2018. The position of official reserve assets is currently more than adequate to offset imports and government external debt servicing, as well as to anticipate a potential capital reversal of non-resident capital from Indonesia. Financial system stability remains solid and the bank intermediation function continues to improve. Meanwhile, state budget implementation is sound beyond expectations. At the end of April 2018, tax revenue had grown 14.9%, with Value Added Tax (VAT) increasing by 14.1% and corporate
income tax by 23.6%. Broad-based tax revenue growth is indicative of vibrant economic activity and a flourishing business community. The state budget deficit stood at 0.37% of GDP and the primary balance recorded a surplus of Rp24.2 trillion, thereby confirming stronger budget dynamics and maintained fiscal balance. The international community (including domestic investors) has recognised such solid economic fundamentals and the national economic outlook is promising.

2. **Financial services sector stability and financial market liquidity in Indonesia remain solid.** Financial services institutions have maintained adequate capital and liquidity, with the Capital Adequacy Ratio (CAR) in the banking industry recorded at 22.38%, the RBC of the general insurance and life insurance industries recorded at 310% and 454% respectively, as well as an excess reserve in the banking industry standing at Rp618 trillion. In terms of intermediation, as of April 2018, financial services sector performance was still improving. Growth of loans disbursed by the banking industry and financing receivables expanded at 8.94% (yoy) and 6.36% (yoy) respectively, while deposit growth stood at 8.06% (yoy). Premiums in the life insurance and general insurance/reinsurance industries achieved robust growth at 38.44% (yoy) and 18.61% (yoy) respectively. As of 21st May 2018, funds accumulated in the capital market had reached Rp61 trillion with the addition of 16 new corporate issuers, up on conditions in the same period one year ago. Furthermore, 58 corporations have public offerings in the pipeline with an indicative value of Rp66.35 trillion. Total managed investment funds (mutual funds) have continued to track an upward trend, reaching Rp739.71 trillion in April 2018. On the other hand, credit risk and market risk remain manageable, as corroborated by the gross non-performing loans (NPL) ratio of 2.79% in the banking industry and non-performing financing (NPF) ratio of 3.01% reported
by finance companies. Meanwhile, the deposit guarantee coverage of the Deposit Insurance Corporation (LPS) has reached 99.9% of customers and 52.15% in terms of value, demonstrating public confidence and trust in the national banking system.

3. **Pressures on rupiah exchange rate stability stem more from broad US dollar appreciation against most global currencies, including the rupiah.** The economic gains and rising inflation in the United States are placing added pressure on the Federal Reserve to hike the Federal Funds Rate (FFR), with some market players expecting aggressive hikes up to four times this year. Meanwhile, US tax reforms and expansive fiscal spending will exacerbate the fiscal deficit, which is predicted to reach around 4% of GDP this year and 5% of GDP in 2019. Those two policy changes have sparked a vertiginous increase in the US Treasury Bond yield, with the benchmark 10-year tenor hitting 3.1%, along with broad US dollar appreciation. Global financial market uncertainty has also returned, triggered by the looming US-China trade war, coupled with simmering regional geopolitical tensions. Prevailing global developments have prompted a foreign capital outflow and amplified pressures on financial markets in advanced economies and emerging market economies (EMEs), including Indonesia, manifesting in lower stock prices, higher bond yields and exchange rate depreciation against the US dollar.

4. **Indonesia’s economy remains resilient to external pressures, as effectively demonstrated in previous periods of global shocks.** Year-to-date (as of 25th May 2018), the rupiah has depreciated by 3.91% (ytd), which is not as severe as in other EMEs such as Turkey, the Philippines and Brazil. The Jakarta Composite Index (JCI) has experienced controlled corrections, totalling 5.98% (ytd), due to the outflow of non-
resident capital from the stock market. Economic resilience in Indonesia is backed by solid and prospective economic fundamentals, combined with a macroeconomic policy mix and sound structural policies, with strong policy coordination between the Government, Bank Indonesia and Financial Services Authority (OJK). Indonesia has already enacted the Financial System Crisis Prevention and Resolution Act (No. 9) of 2016, which provides a solid legal foundation for the Government in conjunction with Bank Indonesia, the Financial Services Authority (OJK) and Deposit Insurance Corporation (LPS) to maintain financial sector stability, while remaining vigilant of the various potential threats.

The Targets and Measures of Strengthening Policy Coordination

5. Confronting the rapid developments occurring in the global landscape, the Government, Bank Indonesia, Financial Services Authority (OJK) and Deposit Insurance Corporation (LPS) continue to coordinate and build vigilance, while remaining prepared to take the policy measures necessary to maintain economic stability and sustainability. In the near term, policy coordination prioritises strengthening national economic stability and resilience to global shocks, namely through rupiah exchange rate stability, low inflation, a sound fiscal deficit and a manageable current account deficit. This is achieved by strengthening the mix of monetary policy by Bank Indonesia and fiscal policy by the Government, while ensuring adequate availability of the basic necessities, strengthening the supervision of financial institutions by the Financial Services Authority (OJK) and increasing the monitoring and development of deposits by the Deposit Insurance Corporation (LPS). Furthermore, the authorities will continue to accelerate structural reforms in the real
sector, including by enhancing competitiveness, improving the investment climate and
developing strategic infrastructure to stimulate economic growth in the medium term.

6. **In the near term, Bank Indonesia will prioritise monetary policy oriented towards rupiah exchange rate stability.** *First,* a pre-emptive, front-loading and ahead-of-the-curve policy response will be pursued to stabilise the rupiah exchange rate, while consistently maintaining low and controlled inflation within the 2018-2019 target corridor of 3.5±1%. *Second,* dual intervention in the foreign exchange market and SBN market will constantly be optimised to stabilise the rupiah exchange rate along with fair price adjustments in the financial markets, while maintaining adequate liquidity in the money market. *Third,* the monetary operations strategy will be oriented towards maintaining adequate liquidity, particularly in the rupiah money market and interbank swap market. *Fourth,* intensive communication with market players, the banking industry, business community and economists will be used to form rational expectations, thus helping to mitigate the rupiah overshooting the currency’s fundamental value. In addition, to maintain and build the current pace of domestic economic growth momentum, Bank Indonesia is preparing follow-up measures to ease macroprudential policy, while also coordinating with the Coordinating Ministry for Economic Affairs, Ministry of Finance and the Financial Services Authority (OJK) to accelerate financial market deepening, particularly for private sector infrastructure financing.

7. **The Government’s fiscal policy is oriented towards maintaining a credible State Budget in 2018, while bolstering budget soundness to create adequate fiscal space for stabilisation measures and to guarantee fiscal sustainability in the medium**
Fiscal policy management and state budget implementation are currently on track. The relevant authorities are mobilising state revenues to maintain the investment climate, while backing tax reforms as planned. As of April 2018, tax revenue growth stood at 14.9% (yoy). Furthermore, income tax and value added tax have both grown at an impressive pace. Broad-based tax growth has stemmed from all sectors. State expenditure remains effective, on target and on time, which has enhanced budget efficiency. In addition, a positive primary balance is sought in the medium term. As of April 2018, the budget deficit was recorded at 0.37% of GDP, down from 0.53% of GDP in the same period one year earlier. The Government remains avowedly committed in the medium term to maintaining a narrower state budget deficit by increasing state revenues, while preserving spending effectiveness and productivity. In terms of financing, front-loading at the beginning of 2018 has proven to be an effective strategy, with state budget realisation recorded at 57.9% as of April 2018. In the near term, the Government will optimise its mix of bilateral, multilateral and market financing to ensure optimal and sound deficit financing for the state and the economy. Furthermore, the Government will continue to monitor the global financial markets to ensure a prudent and innovative financing strategy and financial management.

8. **The Government will also maintain the financial soundness, governance and transparency of state-owned enterprises.** Accordingly, state-owned enterprises continue to play a key role as drivers of the national economy through good corporate governance and by prioritising prudential principles focused on increasing corporate value, while simultaneously maximising community services. By executing the development mission, state-owned enterprises will continue to optimise their use of equity financing and maintain a safe level of leverage. To drive the national economy,
state-owned enterprises use various alternative forms of innovative financing, such as asset securitisation, asset-backed securities – collective investment contracts, Komodo Bonds, cooperation with strategic investors and by increasing synergy amongst state-owned enterprises. This is achieved through coordination with the Coordinating Ministry for Economic Affairs, Ministry of Finance, Bank Indonesia and the Financial Services Authority (OJK). The Government will also allocate special attention to the financial condition of Pertamina and PLN, which are assigned to provide energy, including the development of refineries, power stations and disbursement of subsidised energy, safely and on target. The Government will also consider the financial condition of state-owned enterprises engaged in public works to develop infrastructure.

9. **Financial sector supervision conducted by the Financial Services Authority (OJK) is focused on maintaining a healthy financial sector.** OJK continues to back the financial market deepening program in terms of supply and demand, while strengthening market infrastructure and facilitating municipal bond issuances and asset securitisation. OJK maintains financial services sector stability through industry resilience, strengthening issuer fundamentals and implementing appropriate policy measures when the financial markets experience pressures. OJK nurtures credit growth and financial sector financing by prioritising financing that targets export commodities. In addition, OJK will continue to advocate financial inclusion to stimulate quality economic growth through the development of People’s Business Loan (KUR) clusters, waqf-based microfinance and FinTech.

10. The Deposit Insurance Corporation (LPS) will intensify the monitoring and evaluation of deposit guarantee schemes along with the Magnitude and Guarantee Rate. **LPS is**
open to make any necessary adjustments to the Guarantee Rate at the first opportunity in accordance with the latest data available and assessments of financial system stability. LPS will intensify monitoring and evaluation in order to maintain public confidence in the national banking system of Indonesia.

11. Indonesia will continue to strengthen the external balance (balance of payments) by stimulating export activity through increased economic competitiveness and productivity as well as an improved investment climate and ease of doing business ranking, while accelerating and deepening structural reforms in the real sector to underpin sound and sustainable economic growth. With solid economic fundamentals, Indonesia has a promising domestic economic outlook in the medium term. The main sources of growth are exports and investment. Exports are also key to reducing the structural current account deficit. Structural reforms will be achieved by improving infrastructure, licensing, customs and others. Furthermore, the investment climate will be enhanced by accelerating the business licensing process at the ministerial and local government levels through implementation of Online Single Submission (OSS). In addition, the government will offer investment incentives in the form of Tax Holidays, Tax Allowances and Super Deductions to replace the cost of education and vocational training as well as the cost of R&D development in order to draw investment to the downstream and upstream industries. Through the Ministry of Finance, the Government has issued regulations to provide 100% Tax holidays to pioneering industries. In general, the panoply of structural reforms outlined above will catalyse investment and stimulate exports to foster national economic growth in the medium term.