Outlook for the Indonesian economy, 2006

The forecasted numbers indicating the economic outlook for 2006 are as follows:

Table 1: Forecast for Macroeconomic Indicators, 2005-2006

(%, y-o-y)

	2005	2006
GDP:	**5.3 – 5.6**	**5.0 – 5.7**
Consumption	3.3 – 3.8	4.0 – 5.0
- Household Consumption	3.4 – 3.9	3.0 – 4.0
- Government Consumption	2.6 – 3.1	12.8 – 13.8
Investment	9.6 – 10.1	8.4 – 9.4
Exports of Goods and Services	7.6 – 8.1	7.4 – 8.4
Imports of Goods and Services	10.5 – 11.0	9.1 – 10.1
Inflation:		
CPI	± 18.0	7.0 – 9.0

Assumptions

This outlook for the Indonesian economy is based on assumptions including external and internal conditions and the policy stance in monetary and fiscal affairs.

External conditions:

- World economic growth is predicted to remain generally stable at 4.3%, buoyed by economic performance in the United States and Japan.
- World oil prices are forecasted to move up slightly from the average of US$53 per barrel recorded in 2005 to US$57 per barrel in 2006.
- The monetary tightening cycle in the US is thought likely to end in the second half of 2006.
- The rupiah exchange rate will remain stable throughout 2006.

Table 2: Assumptions of External Conditions

Variable	2005	2006
Oil Price (USD/barrel)	53	57
World Output (%)	4.3	4.3
Volume of World Trade (%)	7.0	7.4
World Interest Rates (%)	3.6	4.5

Internal conditions:

- Public purchasing power will see some decline, but this will be partially offset by increases in civil servant salaries, the provincial minimum wage, and continued expansion in consumer credit.

Monetary Policy:

- Existing measures to ease inflationary pressures will remain in place.
- Increases in BI Rate and tight liquidity control will continue until there is easing of inflationary pressure. This will begin putting downward pressure on private sector investment, particularly in early 2006.

Fiscal Policy:

- The Government will achieve further progress in its policies for improvement of the investment climate and real sector, including the new Investment Law, taxation, industrial relations, the infrastructure summit, and coordination between the central government and regions. In addition, the expected streamlining of Government fiscal administration will enable procurement and capital expenditures to proceed more rapidly in 2006 compared to 2005.

Economic Growth Forecast

Based on these assumptions, Bank Indonesia predicts that overall economic growth in 2006 in the range of 5.0%-5.7%, despite some slowing in Q2 and Q3/2006. The less vigorous growth during these periods is explained by falling private consumption and investment as a result of increased fuel prices, weakening in the exchange rate, and mounting interest rates. At the same time, no significant gains are expected in exports because of difficulties with competitiveness and falling international commodity prices.

Economic growth in 2006 will be determined to a great extent by consumption and investment, which are both predicted to improve in Q4/2006. The predicted strengthening in domestic demand that will fuel economic performance is supported by progress in building a better investment climate and real sector and the impact of the direction pursued in monetary and fiscal policy. In regard to monetary policy, interest rates can be gradually lowered to stimulate consumption and investment once there is easing in inflationary pressure. In the area of fiscal policy, if government capital expenditures from the 2006 budget and funds carried forward from the 2005 budget can be realized to their maximum extent, economic growth is seen likely to reach the upper limit to the 5.0%-5.7% range.

On the financing side, investment financing in 2006 will face substantial challenges. With credit expansion reaching 21% as of October 2005, bank lending is predicted to expand in the range of 15%-20% during the coming year. Major challenges are also likely to daunt efforts to tap alternative financing from non-bank sources. Even so, financing for the economy will be supported by inflows of financing from foreign sources, especially when moving into the second half of 2006. This is consistent with the improvement in macroeconomic conditions in the second half of 2006 and the expected launching of cooperation and bilateral investment projects with some foreign investors.

Table 3: Banking Indicators

Key Indicator	Dec-03	Dec-04	Mar-05	Jun-05	Jul-05	Aug-05	Sep-05	Oct-05	(+/-) Oct'05 – Dec'04	(%) Oct'05 – Dec'04
Total Assets (Rp trillions)	1,196.2	1,272.3	1,280.6	1,344.6	1,353.2	1,346.6	1,418.6	1,420.3	148.0	11.6
Deposit Funds (Rp trillions)	888.6	963.1	959.3	1,011.0	1,016.0	1,046.8	1,077.5	1,071.1	108.0	11.2
Credit (Rp trillions)*	477.19	595.1	617.8	664.3	677.6	702.2	715.3	719.9	124.8	21.0
Earning Assets (Rp trillions)	1,072.4	1,146.8	1,128.4	1,239.9	1,257.7	1,290.5	1,283.3	1,279.5	132.7	11.6
NII (Rp trillions)	3.2	6.3	6.0	6.1	5.7	6.0	5.9	6.0	-0.3	-5.0
LDR (%)	43.2	50.0	51.3	53.1	53.9	54.5	54.2	54.8		
ROA (%)	2.5	3.5	3.4	2.9	3.0	2.8	2.6	2.7		
NPLs Gross (%)	8.2	5.8	5.6	7.9	8.5	8.9	8.8	8.4		
NPLs Net (%)	3.0	1.7	1.9	3.7	4.5	5.0	5.0	4.7		
CAR (%)	19.4	19.4	21.7	19.5	19.4	18.9	19.4	19.4		
Credit/Earning Assets (%)	44.5	51.9	54.7	53.6	53.9	54.4	55.7	56.3		
NIM (NII/AP) (%)	0.3	0.6	0.5	0.5	0.5	0.5	0.5	0.5		
Liquid Assets/TA (%)	15.1	14.9	16.6	15.3	13.9	13.3	12.7	12.3		
Core Deposits/TA (%)	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5		
Operating Exp./Revenues (%)	88.8	76.7	81.2	88.8	95.0	88.8	90.0	91.1		

Overall, the condition of the banking system will see further improvement. The increase in Statutory Reserves with the linkage to the LDR is expected to encourage banks to expand their lending. Banks are expected to retain sufficient liquidity because of adequate levels of reserves. High deposit rates will encourage the public to hold their funds in banks, and this will produce growth in all components of deposit funds. At the same time, a stable and appreciating rupiah will also mitigate the market risk faced by the banking system. With the Net Open Position held at a relatively low, non-speculative level (well below 20%), banks are expected to manage their market risk properly. With capital at levels still regarded as adequate, banks are expected to be able to take on and manage market risk (changes in interest rates and exchange rate) with good results.

Analyzed by sector, economic growth will be driven by agriculture, manufacturing and processing, trade, and transport and communications, all expected to show strong expansion. In the agricultural sector, government measures to ensure sufficient supplies of seeds, fertilizers, and other agricultural chemicals are expected to increase production. Other important factors predicted to boost performance include actions to promote expansion of arable land and the minimal disruption from climate factors. Performance in the manufacturing and processing sector will be driven more by increased consumption and demand from trading partners, as well as government efforts to realize planned investments in 2006.

Indonesia's Balance of Payments

Despite the declining performance of the balance of payments, a balance of payments surplus is predicted for 2006 with increased capital flows, most importantly through FDI. The current account will record a USD1.5 billion surplus, down from the USD2.3 billion surplus in 2005. The capital account will receive a boost from private capital inflows in the form of FDI and portfolio investments. The rise in FDI is linked to the launching of infrastructure projects, improvement in the investment climate, and bilateral cooperation projects. In the area of portfolio investments, yields on rupiah placements remain attractive, as reflected in the interest rate and improvement in the risk index. This will be offset to extent by a government capital deficit following the expiration of the debt moratorium.

With the continued balance of payments surplus, international reserves in 2006 are predicted to remain largely stable at the level of USD33.9 billion, up slightly from the USD33.8 billion recorded in 2005. These reserves will be sufficient to cover imports and foreign debt servicing for about 4 months.

Table 4: Indonesia's Balance of Payments

Items	Amount (USD millions)			Growth (%, y-o-y)		
	2004	2005*	2006**	2004	2005*	2006**
CURRENT ACCOUNT	**3,108**	**2,334**	**1,500**			
Balance of Trade	**21,552**	**23,172**	**22,950**	-12.3	7.5	-1.0
Exports	72,167	86,906	95,716	12.6	20.4	10.1
Oil and Gas	17,684	23,161	27,510	16.1	31.0	18.8
Non-Oil and Gas	54,482	63,745	68,207	11.5	17.0	7.0
Imports	-50,615	-63,734	-72,766	28.0	25.9	14.2
Oil and Gas	-11,159	-16,437	-17,428	42.6	47.3	6.0
Non-Oil and Gas	-39,456	-47,297	-55,338	24.4	19.9	17.0
Services	-18,444	-20,838	-21,450	12.1	13.0	2.9
Oil and Gas	-5,289	-7,114	-6,846	2.3	34.5	-3.8
Non-Oil and Gas	-13,155	-13,724	-14,605	16.6	4.3	6.4
CAPITAL ACCOUNT	**2,612**	**3,303**	**164**			
Public Capital Flows (Net)	-1,777	1,221	-2,790			
Private Capital Flows (Net)	4,389	2,082	2,954			
Foreign Direct Investment 1/	1,023	2,257	4,264			
Portfolio Investment	3,136	2,401	2,098			
Others	231	-2,576	-3,407			

* Preliminary Figures
** Very Preliminary Figures
1/ FDI including privatization and bank restructuring

Exchange Rate

Throughout 2006, the rupiah exchange rate is predicted to remain on a stable trend. Pressure on the rupiah could surface in Q1/2006 from the continued monetary tightening cycle in the US and Indonesia's dependence on inflows of portfolio capital. Significant inflows of capital in the form of foreign direct investment (FDI) are not expected until the second half of 2006.

In regard to fundamentals, the appreciation and stability in the exchange rate will be supported by higher inflows of capital for portfolio investments and FDI. This will be, among others, related to the sustained interest rate differential, the predicted easing in the tightening cycle in global monetary policy, improvement in the risk premium, and the commencement of Government-backed infrastructure projects. Other factors supporting the strengthening of the rupiah will include reduced demand for foreign currency to pay for oil imports following the increase in domestic fuel prices.

Inflation

Bank Indonesia envisages substantially lower inflation at end-2006 compared to 2005. Measured quarterly (q-t-q), inflation is expected to ease, with quarterly inflation at about 3.19% in Q1/2006 because of a planned hike in electricity billing rates and falling to about 0.88% and 1.08% in Q2 and Q3/2006. In Q4/2006, inflation is predicted to rise to about 2.36% in line with religious festivities. Nevertheless on a statistical level, annual CPI inflation (y-o-y) will remain high at about 18.0% in Q1/2006 and 16.7% in Q3/2006 before easing gradually to about 8% at the end of the year.

The lower inflation forecast for 2006 is based on the assumption that fuel prices were raised to the full extent necessary in 2005, and thus inflationary pressure from administered prices will be considerably less in 2006. The predicted downturn in inflation also takes account of the planned 30% increase in electricity billing rates. Bank Indonesia also forecasts stable conditions in supply and distribution of goods and relative stability in the rupiah during 2006, so that any impact from exchange rate pass through will not be significant. In regard to the output gap, economic expansion will remain below potential capacity, and this will help ease inflationary pressures through the end of 2006.

Despite the opportunity for improved growth in economy activity in 2006, along with more stable monetary conditions in the second half of the year, some risks and uncertainties, such as in oil prices and global imbalances, could potentially slow the rate of economic growth.