



Chapter 5

Inflation

Chapter 5: Inflation

The Consumer Price Index (CPI) touched 6.59% in 2007, in line with the target of 6.0%±1.0% set by the Government. Stable exchange rate, adequate supply of food, and modest increases in administered prices contributed to the relatively stable inflation in 2007 compared to the previous year, when the CPI reached 6.60%. This achievement also stemmed from the support of the Government in controlling factors that influenced inflation, especially those which originated from increases in the prices of commodities in international markets. This condition, in turn, increased policy credibility, thereby giving a positive contribution toward efforts to keep the public's inflationary expectations in line with the inflation target.

Inflation Developments

In general, prices of goods and services at the consumer level were relatively under control in 2007. The reasonably stable inflation was the result of the fairly low inflation in the first half of 2007. The CPI in the calendar year up to June 2007 was recorded at 2.08% (ytd), including deflation of 0.16% (mtm) in April. The inflation rate in the first half of 2007 was lower than in the corresponding period of the previous year of 2.87% (ytd). A breakdown of inflation by component¹ showed that nearly all components of the CPI experienced lower inflation compared to the previous year with the biggest decline occurring in the foodstuffs component, edging down from 5.16 % (ytd) in the first half of 2006 to 2.45% (ytd) in the same period of 2007. Moving into the second half of 2007 (July-December), however, inflationary pressures elevated fairly substantially. Increases in the prices of international commodities, such as crude oil, crude palm oil (CPO), wheat, and gold, combined with the weakening rupiah, were behind the higher inflation in the second half of 2007.

In addition, seasonal factors such as religious festivities, the start of the new academic year, and the year-end

holidays resulted in further inflationary pressures. With such developments, CPI inflation climbed in the second half of the year to around 4.51%. The higher inflation rate reflected price increases in nearly all types of goods, especially foodstuffs. Overall in 2007, CPI inflation retained its stability at 6.59% compared to 6.60% in the previous year.

Factors Affecting Inflation

Based on the influencing factors², the relatively stable inflation in 2007 was mainly attributable to improvements in non-fundamental factors, with inflation from fundamental factors being reasonably controllable. From the non-fundamental side, lower volatile food inflation³ coupled with government policy in leaving administered prices unchanged⁴ for strategic goods, such as subsidized fuel and electricity tariffs, were the two main reasons for the improved inflation conditions. From the fundamental side, the fairly stable core inflation⁵ was mainly attributable to inflationary expectations remaining

1 According to the COICOP (Classification Of Individual Consumption by Purpose), 744 CPI commodities are grouped by the BPS into 7 groups of goods and services. They are (1) the foodstuffs group, (2) the processed foods, drinks, cigarettes, and tobacco group, (3) the housing, electricity, water, gas, and fuels group, (4) the clothing group, (5) the health group, (6) the education, recreation, and sports group, along with the (7) transportation, communications, dan financial services group.

2 Based on the characteristics of developments in commodity prices, CPI inflation can be grouped into volatile food inflation, administered prices inflation, and core inflation.
3 Volatile food inflation is inflation in the group of food commodities whose prices are highly fluctuates because of certain factors such as the time of the harvesting season, distribution bottlenecks, natural disasters, and plagues.
4 Administered prices inflation is inflation in the group of commodities whose prices are set by the government.
5 Core inflation is commodity inflation whose movements are influenced by economic developments in general (fundamental factors such as inflation expectations, the exchange rate, and aggregate demand and supply balances) which will have an impact on price changes in general and which tend to be permanent in nature.

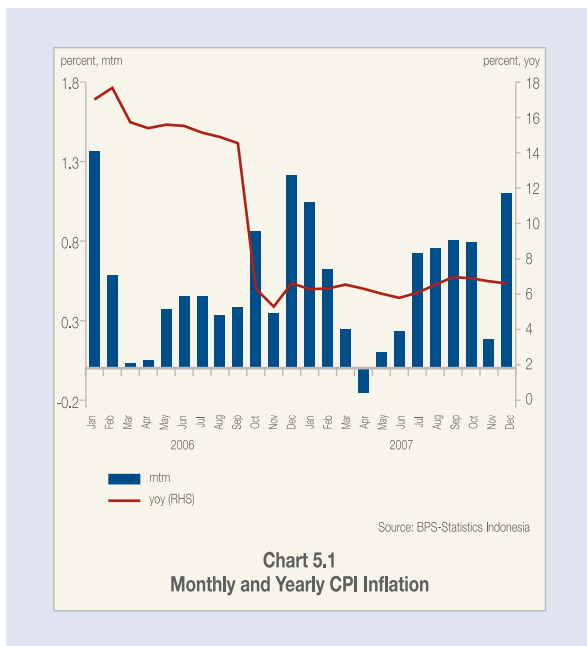


Chart 5.1
Monthly and Yearly CPI Inflation

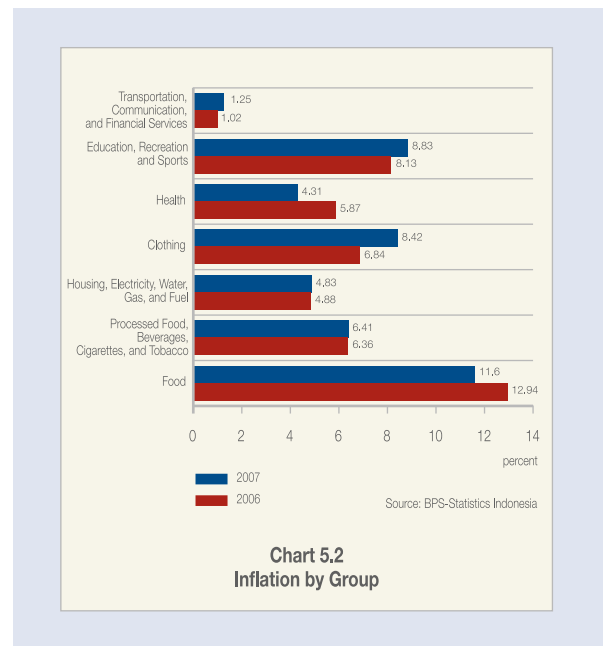


Chart 5.2
Inflation by Group

in-check and the minimal pressures from the interaction between aggregate demand and supply. Meanwhile, amidst a pick-up in imported inflation, pressure from the external side remained subdued as the average rupiah exchange rate strengthened in 2007 (Chart 5.3).

These inflation dynamics indicated that the role of lower volatile food inflation was reasonably important in safeguarding the stability of CPI inflation in 2007. The lower volatile food inflation meant that its contribution in forming inflation experienced a decline from 2.75% in 2006 to 2.09% in 2007. The lower inflation from the volatile food group was able to offset the increased inflation contribution coming from core inflation and administered prices such that, overall, the yearly inflation was relatively stable (Table 5.1).

Non-fundamental Factors (Shocks)

Volatile Food

The year 2007 witnessed a drop in volatile food inflation to 11.41% from 15.27% in 2006. The decline was mainly attributable to the fall in the prices of rice, underpinned by adequate supply and smooth distribution. Aside from increased production, efforts to safeguard sufficient supplies of rice were also achieved through imports conducted by the State Logistics Agency (Bulog). The Inflation of rice commodity, which has the largest weight in calculating the CPI, fell sharply from 32.0% in 2006 to 8.49% in 2007. This decline started to be apparent in

April after the government allowed Bulog to import rice, as part of the efforts to safeguard stocks of rice. Overall, the contribution of rice toward the overall inflation moved down from 1.58% in 2006 to 0.52% in 2007 (Table 5.2).

Although, in general, volatile food inflation in 2007 experienced a decline, inflation of a number of commodities in this group increased due to rising prices of a number of commodities in international markets and the occurrence of some natural disasters. The surging prices of CPO in global markets had a significant impact on volatile food inflation through higher prices of cooking oil which rose 41.40% (Table 5.2). The upsurge in cooking oil inflation was followed by increases in prices of products made from CPO such as margarine and butter which mounted 14.28% and 29.81%, respectively (Table 5.4).

Meanwhile, the soaring price of corn in international markets which were accompanied by surges in the prices of livestock feed pushed up the prices of chicken meat and eggs by 12.30% and 19.04%, respectively. The occurrence of flood also put pressures on volatile food inflation, as reflected in higher inflation of red onions, hiking sharply to 124.50%, or far higher than in 2006 when deflation of 18.8% was recorded (Table 5.2). Seen from its contribution to inflation, rice gave the largest contribution amounting to 0.52%. Meanwhile, cooking oil and red onions – which both experienced high inflation – also contributed quite significantly

Table 5.1
Core and Non-Core Inflation and Its Contribution

Year	Core		Volatile Foods		Administered Prices		CPI Inflation
	Inflation	Contribution	Inflation	Contribution	Inflation	Contribution	
2006	6.03	3.48	15.27	2.75	1.84	0.37	6.60
2007	6.29	3.75	11.41	2.09	3.30	0.75	6.59

percent

Source: BPS-Statistics Indonesia

toward volatile food inflation, that is 0.49% and 0.47% respectively (Table 5.2).

Administered Prices

During 2007, pressures from administered prices inflation was relatively minimal given that the government did not raise the price of strategic administered goods such as subsidized fuel (premium, diesel, and kerosene) and electricity tariffs. The impact of this policy was reasonably significant in efforts to safeguard the stability of inflation this year considering the fairly large weighting of administered goods in the CPI basket of goods, and given that the knock-on impact on other commodities is quite high.

Although relatively subdued, inflation of administered goods in 2007 experienced a slight increase compared to 2006, from 1.84% to 3.30%. This rise was mainly due to policies taken in regard to a number of non-strategic goods (Table 5.3), among others the 7% increase in the retail selling prices of cigarettes in March 2007, the adoption of specific excise taxes on cigarettes on 1 July 2007⁶, increases in drinking water tariffs in a number of cities, toll road tariff hikes, and upsurges in the prices of non-subsidized fuel (Pertamax, Pertamax Plus, and Pertamina Dex).

In addition to that, administered prices inflation was also influenced by supply shortages of kerosene and Liquefied Petroleum Gas (LPG) although the government did not make adjustments (at the agents' level). The price of kerosene saw increases at the retail level, especially in the third quarter of 2007. This occurred as a result of problems in the implementation of the government's program to get consumers to convert from kerosene to LPG sold in 3 kg canisters. Under such conditions, kerosene inflation in 2007 rose to 2.7% and contributed

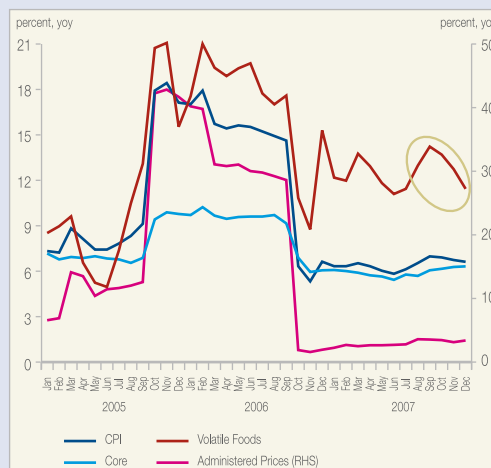
0.07% to inflation. Besides kerosene, the price of LPG also climbed as a result of a scarcity of supplies in a number of regions due to distribution difficulties. LPG inflation was recorded at 2.1%, contributing 0.01% toward inflation (Table 5.3).

Fundamental Factors

Core Inflation

From the fundamental side, developments in core inflation were still relatively under control although core inflation showed an increase compared to the previous year. Core inflation was recorded at 6.29%, or higher than the previous year's 6.03%. The higher rate of core inflation stemmed from escalating pressures from imported inflation as the prices of a number of international commodities such as crude oil, CPO, gold, and wheat moved up.

Nonetheless, these imported inflation pressures were mitigated somewhat by the relatively stable rupiah exchange rate. At the same time, other factors



Source: BPS-Statistics Indonesia

Chart 5.3
Inflation Disaggregation

6 Based on Minister of Finance (PMK) Decree Number 118/PMK.04/2006 concerning Fiscal Policy, the government imposed two Policies in relation to cigarette excise taxes, that is increases in the retail selling prices (HJE) and the imposition of specific excise taxes on group I cigarettes of Rp7/stick, group II by Rp5/stick, and group III by Rp3/stick.

Table 5.2
Volatile Foods Inflation and Several Volatile Foods
Commodities Contribution to Inflation

percent

Commodities	2006		2007	
	Inflation	Contribution	Inflation	Contribution
Rice	32.00	1.58	8.50	0.52
Cooking Oil	6.70	0.08	41.40	0.49
Shallot	-18.80	-0.09	124.50	0.47
Broiler Chicken Meat	10.40	0.14	12.30	0.17
Broiler Chicken Egg	4.90	0.04	19.00	0.13

Source: BPS-Statistics Indonesia

influencing core inflation, that is the interaction between aggregate demand and supply (the output gap), along with inflationary expectations, indicated relatively stable developments.

Broken down by each type of product, the impact of hikes in international prices can be seen in gold and various types of food. Gold jewelry contributed the most to core inflation, with inflation of this product arriving at 27.50% and giving a contribution of 0.33%. Various foods also showed higher inflation, especially various types of noodles, various types of cake and bread, as well as soybean cake (Table 5.4).

Inflation Expectations

The public's inflation expectations were relatively stable at around 6%-7% in 2007. In general, market players were still convinced that inflation in 2007 would be around 6%-7%, or still in the range of 6%±1% targeted

Table 5.4
Contribution of Several Food Commodities in Core
Inflation to Inflation in Year 2007 and Its Developments

percent

Commodities	2007	
	Inflation	Contribution
1 Gold	27.50	0.33
2 CPO		
Margarine	14.28	0.01
Butter	29.81	0.00
3 Wheat		
Flour	35.92	0.03
Varieties of Noodles	16.19	0.06
Biscuit	7.52	0.02
Varieties of Cakes and Bread	9.81	0.20
4 Soybean		
Moulded Soybean	18.60	0.09

Source: BPS-Statistics Indonesia

Table 5.3
Several Administered Prices Commodities Contribution
to Inflation in Year 2007

percent

Commodities	2006		2007	
	Inflation	Contribution	Inflation	Contribution
Filtered Clove	7.10	0.16	1.02	0.24
Cigarettes				
PAM Drinking Water Tariff	7.80	0.08	12.90	0.14
Clove Cigarettes	6.90	0.09	0.00	0.12
Fuel	0.10	0.00	2.90	0.10
Kerosene	1.80	0.04	2.70	0.07
Cigarettes	5.60	0.02	7.10	0.03
Toll Road Tariff	11.20	0.01	24.10	0.02
LNG	1.10	0.01	2.10	0.01
Parking Fee	3.20	0.01	3.10	0.01

Source: BPS-Statistics Indonesia

by the government. Based on the Consensus Forecast survey, inflation estimates for 2007 from a number of institutions demonstrated that inflation expectations in 2007 were relatively stable at around 6.3%-6.7% (Chart 5.4). This result was also confirmed by the results of a survey conducted by Bank Indonesia, that is the Market Perceptions Survey (SPP), which showed that the majority of respondents expected inflation in 2007 to be around 6%-7%. Even the number of respondents who believed that inflation would be in the range of 6%-7% experienced an increase, while the number of respondents who said inflation would rise (in the range of 7.1%-8.0%) declined further (Chart 5.5). The stability in inflation expectations reflects the confidence of the majority of market players that the Government and Bank Indonesia were consistent in implementing policies to reach the predetermined inflation targets.

Although relatively stable, the level of inflation expectations going forward still needs to be scrutinized. This is related to the rise in expectations of price increases ahead, especially at the end of 2007. The consumer survey at the end of the year showed that consumer expectations for prices 3 months and 6 months ahead intensified (Chart 5.6). This may be the result of soaring prices of international commodities which, it is feared, will push up production costs and, ultimately, the prices of domestic goods. Additionally, the higher inflation expectations also reflect the dominance of backward looking reasoning in the formation of inflation expectations such that it took longer for inflation to be brought down.

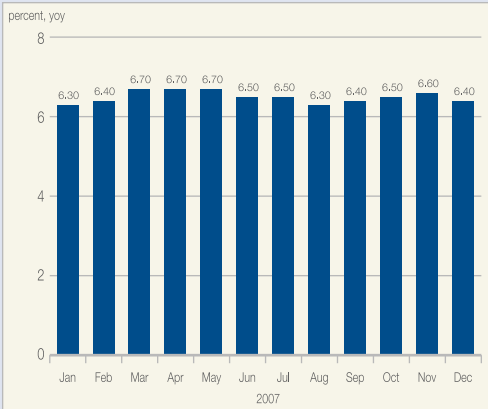


Chart 5.4
Consensus Forecast Inflation Expectation

Source: Consensus Forecast

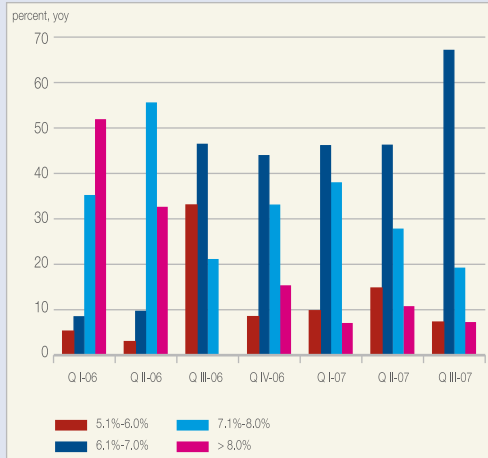


Chart 5.5
Inflation Expectation of Year 2007 (SPP)

External Factors

In 2007, inflationary pressures from external factors were primarily the result of higher imported inflation, emanating from upsurges in the prices of international commodities, especially crude oil, CPO, and wheat. This condition heightened inflationary pressures in a number of countries, leading to higher inflation rates in Indonesia's trading partners (Chart 5.7). This higher inflation was then transmitted to domestic inflation, as reflected in WPI imported inflation which rose from 7.01% in 2006 to 25.60%. Nonetheless, the increase

in WPI imported inflation was not fully transmitted to the prices of domestic goods at the consumer level. This was indicated by the fact that the increase in the inflation of imported commodities was not as large as the increase in WPI imported inflation. The rate of inflation of CPI imported commodities rose slightly from 5.83% in 2006 to 7.20% in 2007 (Chart 5.8). The phenomenon of lower inflation of imported commodities compared to WPI imported inflation may be attributable to several factors: (1) a number of imported goods formed the input components in the production process such that

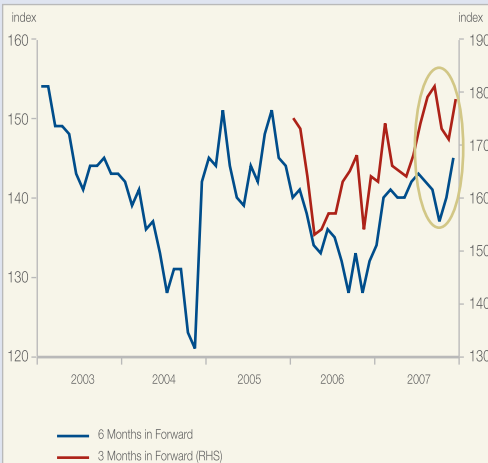


Chart 5.6
Consumer Price Expectation

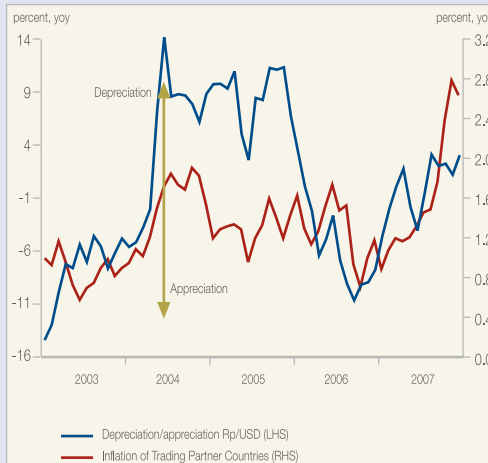


Chart 5.7
Exchange Rate and Inflation of Trading Partner Countries

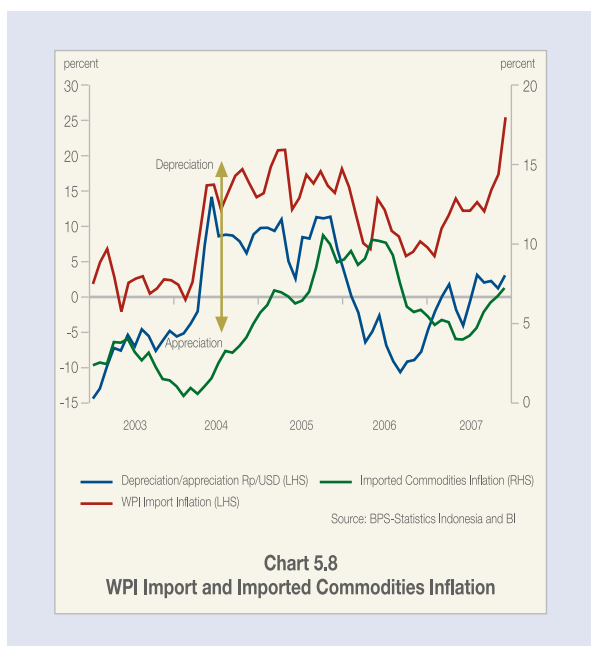
Source: BPS-Statistics Indonesia and BI

Table 5.5
Comparison of Assumption and Realization of Inflation
Target in Year 2007

	Variable	2007	
		Inflation Target	Realization
Assumption	• Exchange Rate (Rp/\$)	9,300	9,140
	• Oil Price (\$/barrel)	60	72.3
Projection	• GDP (%)	6.0	6.3
	• Core Inflation (%)	6.30	6.29
	• CPI Inflation (%)	6.60	6.59
Influencing Factors	• Exchange Rate	slightly weaken	relative stable
	• Inflation Expectation	stable but remain high	stable but remain high
	• Output Gap	Low	Low
	• Administered Prices	Low	Low
	• Volatile Foods	high, rice import limitation	high, no rice import limitation
	CPI Inflation Target	6.0% ± 1%	

the proportion in the increase in the final price of goods will be lower than the proportion in the increase in the price of imported goods; (2) there were indications that producers tried not to pass on all the increases of prices in input goods onto consumers after considering conditions related to consumer demand and business competition.

On the other front, the relatively stable exchange rate lessened pressures arising from imported inflation. On



average, the rupiah stood at Rp9,140 per dollar in 2007 although it did for a time come under pressure due to the US sub-prime mortgage crisis.

Interaction between Aggregate Demand and Aggregate Supply (Output Gap)

Inflationary pressures from the interaction of demand and supply was still minimal, as reflected negative output gap. The supply side turned out to be able to meet the higher level of demand. The response on the supply side is reflected in the elevated the production index in the production survey carried out by the Statistics Indonesia. The production index climbed from 116.9% on average in 2006 to 123.12%. In addition, SKDU in the fourth quarter of 2007 demonstrated capacity usage of 73.26%, indicating that most industries still had room to raise production if demand increased.

Evaluation of Realized Inflation

In 2007, the Government set the CPI inflation target at 6% with a deviation of $\pm 1\%$ ⁷. The target was set based on assumptions at the beginning of the year in regard to fundamental and non-fundamental factors (shocks) causing inflationary pressures (Table 5.5). With regard to the fundamental factors, inflation was expected to originate from external factors in terms of the weakening of rupiah. As to other external factors, it was assumed that the price of crude oil in international markets was US\$60/barrel. With pressures from the output gap anticipated to be minimal and inflationary expectations expected to remain stable, the core inflation was estimated to arrive at around 6.3%. As regard the non-fundamental factors, volatile food inflation was expected to remain high, although experience a decline. Meanwhile, administered prices inflation was anticipated to have a minimal impact on CPI inflation given the government's commitment to neither hike fuel prices nor electricity tariffs.

In reality, the factors which influenced inflation, either fundamental or non-fundamental, were actually similar to the original expectations, such that CPI inflation in 2007 was in the range of the predetermined inflation target. This achievement was the result of improving coordination between Bank Indonesia and the Government. Consistency in monetary policy to ensure

⁷ This was decided in a coordinating meeting on macroeconomics at the Office of the Coordinating Minister for the Economy on 17 March 2006. The inflation target revised the inflation target as set by the government at 5.0% with a deviation of 1%, which is stated in Ministry of Finance decision No. 399/KMK.011/2004 dated 6 September 2004.

the predetermined inflation targets were met and the ability of the Government to control price shocks through various sectorial policy packages were key to the 2007 inflation target being fulfilled. With these developments, core inflation – which portrayed developments in fundamental factors – hit a level of 6.29%. This shows that there was still an adequate response from the side of aggregate supply toward increasing aggregate demand along with inflationary expectations that were relatively stable. Nonetheless, in terms of external factors, the oil price in fact soared sharply to US\$72.3 per barrel, resulting in greater pressures on imported inflation. Nonetheless, the relatively stable rupiah exchange rate helped to lessen the pressures of imported inflation toward domestic inflation.

On the non-fundamental factors, the government's commitment to refrain from elevating the prices of strategic administered goods led to low administered goods inflation. Meanwhile, volatile food inflation was still at a high level although sliding slightly. The decline in volatile food inflation stemmed from lower inflation of the rice commodity which has a large weight in the CPI basket of consumer goods.

Policy Initiatives to Control Inflation

The achievement of the 2007 inflation target reflected the enhanced coordination between Bank Indonesia and the Government in controlling factors which influence inflation, as well as in the pursuing macroeconomic and financial system stability. In regard to Bank Indonesia, its consistent monetary policy in 2007 was conducted to ensure that the inflation target could be met. This was achieved through the management of liquidity which was in line with the needs of the economy and the safeguarding of rupiah stability amidst unfavorable developments on the external front.

In keeping the public's inflationary expectations at the level targeted, Bank Indonesia also continued to strengthen its communication strategy. Other than through regular press announcements and press conferences which revealed the decisions made at the Governors' Board Meeting and the publication of Monetary Policy Reports, better communication strategy was carried out through the program to disseminate monetary policy to all stakeholders, such as academics, the business community, journalists, and financial players, which was conducted either centrally or at the regional level. The dissemination explained overall

Bank Indonesia's assessments concerning the latest developments on the macroeconomic front, inflation and monetary conditions, along with estimates of inflation going forward and the monetary policy response needed to bring inflation down to the targeted level. By strengthening such communications, the behavior of inflation expectations in Indonesia is directed toward the inflation target already set by the government (forward looking).

On the other hand, the government has tried to maintain fiscal sustainability while, at the same time, also safeguarding the supply of goods especially those of basic needs. These efforts were undertaken through various sectorial policies such as the abolishment of Value Added Tax (VAT) and subsidies on food commodities (such as cooking oil) which are susceptible toward shocks. In addition, the Government was committed to safeguarding the supply and distribution of goods so that their prices did not move sharply (such goods include rice, kerosene, and sugar). In accordance with its original commitment, the Government did not opt to hike the prices of administered goods deemed strategic (fuel and electricity tariffs).

The government's commitment was strengthened through the formation of the Coordinating Team to Stabilize Basic Foodstuff Prices which comprises technical departments involved with a number of duties including: the planning and formulating of policies to stabilize the prices of basic foodstuffs (rice, sugar, and cooking oil), and coordinating the realization of these plans, along with the monitoring and evaluation of such stabilization policies. Additionally, the Government also issued Presidential Instruction No. 6/2007 which, among other things, contains policies to accelerate development of the real sector as well as to empower SMMEs which include policies to improve the investor climate and policies to encourage infrastructure development. To strengthen policy coordination, Bank Indonesia and the Government improved further their coordination in the Inflation Control Team which was assigned to formulate policies needed to tackle the problem of rising inflationary pressures. The Team also discussed and formulated proposals for the inflation targets in the years 2008-2010 (Box: Inflation Targets for the Years 2008-2010). This policy coordination are very much needed, given that the permanent component of inflation in Indonesia is still quite high (Box: Efforts to Comprehend the Behavior of Inflation in Indonesia: The Permanent Component of Inflation and the Persistency of Inflation).

Efforts to Comprehend the Behavior of Inflation in Indonesia: The Permanent Component of Inflation and the Persistency of Inflation

Efforts to control inflation demand deep understanding and knowledge regarding the behavior of that inflation. Two aspects of inflationary behavior which have for some time been a challenge in efforts to lower or even control inflation in Indonesia are the difficulty in lowering the pace of inflation to a lower level¹ and the high persistency of inflation. The difficulty of bringing the rate of inflation down raises the question of whether there really is one inherent inflation level for Indonesia. Comprehension on this matter is very useful - for example in determining a certain inflation target in a realistic manner. The establishment of an unrealistic target will force the central bank to adopt monetary policy which is too extreme, such that there will be a large cost for the economy. Meanwhile, the matter of persistency is related to how quickly inflation will return to equilibrium after experiencing a shock. Persistent inflation means that when a shock occurs, the rate of inflation will tend to take some time to return to its level prior to the shock. The condition of persistent inflation will also hamper efforts to bring the rate of inflation to a lower level. Therefore, the understanding of the persistency of inflation is also very important as it will determine how preemptive Bank Indonesia should be in responding to economic shocks that affect price stability.

Studies show, however, that Indonesia's inflation has the characteristic of being rather stubborn in returning to a lower level (sticky inflation). By calculating average inflation, the long-term inflation trend for the period 1980-2007 was 9.8%, while for the period 2000-2007 the long-term inflation trend is 8.8%. The high level of Indonesia's long-term inflation trend raises the question whether there is one level of permanent component in forming inflation in Indonesia. An econometrics approach proposes the technique of decomposing inflation into permanent and transitory components². The permanent

inflation component is split into the two elements, that is the deterministic trend and the stochastic trend. The deterministic trend is represented by a long-term trend which is linear. The stochastic trend is the accumulation of shocks that are permanent in nature which will affect inflation³. It can be said that the stochastic trend has a correlation to inflation which tends to have a high level of persistency.

The results of the calculation of data for the permanent inflation component show that the lowest level which can be reached is around 5.3%, occurring in the post crisis period, during the second quarter of 2003 until the first quarter of 2004. In the pre crisis period permanent inflation tended to be above its long-term trend (Chart 1), while in the post crisis period permanent inflation tended to be below the long-term trend (Chart 2). This signals that the stochastic trend is lower in the post crisis period. This result is in line with research findings which indicate that the degree of persistent inflation in Indonesia is declining further. Studies carried out using the simple auto-regression model have found that in the period 1990-2006 the level of persistency in Indonesia actually experienced a change from over time⁴. The study shows a decline in the degree of persistent CPI inflation, from 0.27 in the pre crisis period to 0.12 after the crisis. The change in the degree of persistent inflation was also confirmed by the results of estimating rolling regression of the persistency coefficient.

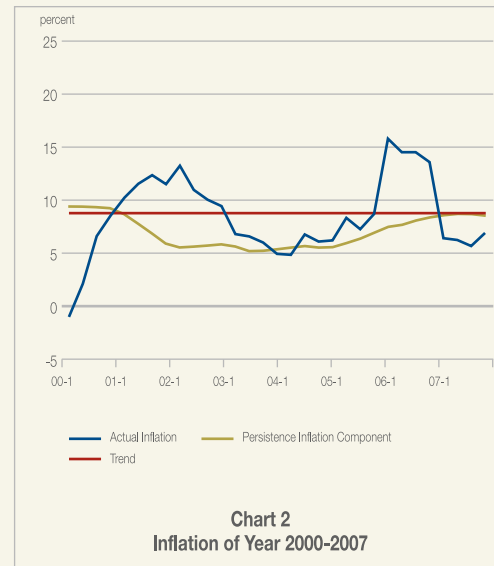
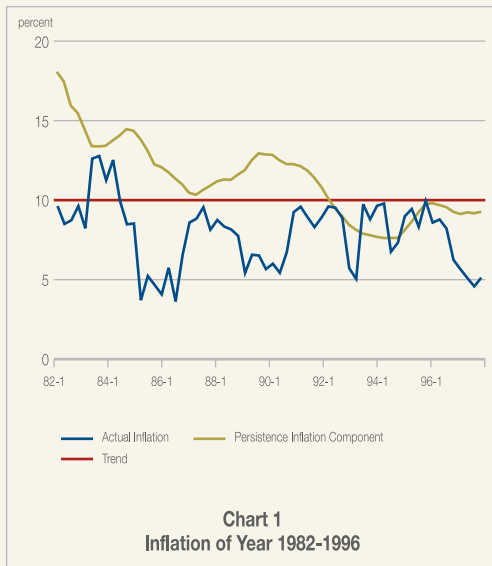
Lower persistent inflation implies that if there are economic shocks, inflation will return more quickly to its average level. From the aspect of controlling inflation, the lower persistent inflation will also make it easier to reduce inflation, because the people's tendency to anchor inflationary expectations to the past will lessen. The results of the research which confirm that a

1 The lowest level of inflation was around 5%. This was seen in 1992, 1996, and 2003.

2 Affandi, Yoga (2007): "A Small Monetary System for Indonesia". Bank Indonesia Working Paper.

3 A shock which is transitory in nature in cumulative terms will disappear.

4 Yanuarti, Tri (2007), "Has Inflation Persistence in Indonesia Changed?," Bank Indonesia Working Paper.



permanent inflation component in Indonesia is still fairly high remains as an obstacle in efforts to reduce inflation to a lower level. The continuing high level of permanent inflation component indicates the presence of more fundamental problems in regard to the phenomenon of inflation in Indonesia, especially matters that are related to productivity, efficiency, and the structure of the economy. The close connection between inflation and economic productivity and efficiency implies that

dis-inflationary policy needs to always be adopted in consideration of the principals of gradualism and balance. Monetary policy which is excessively tight when economic productivity and efficiency is low can contribute toward the recession. In contrast, monetary policy which is too loose, will only lead to inflator and not pro-poor economy. The close connection between inflation and structural aspects also implies that for a credible process of deflation then good coordination between the government and Bank Indonesia is deemed important.

Inflation Targets for the Years 2008-2010

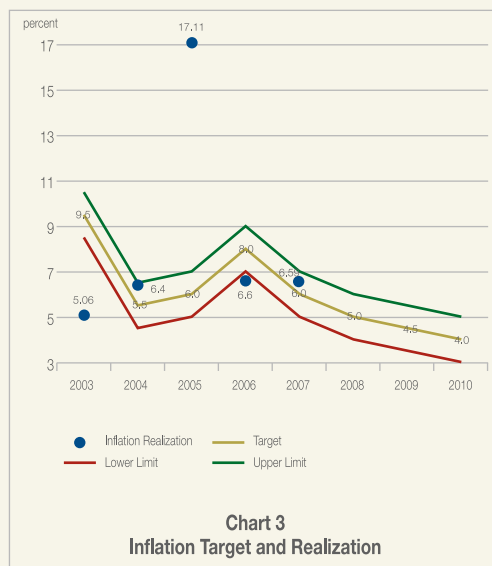
Low and stable inflation is a precondition for increased prosperity and the basis for balanced economic growth. In line with Act No. 23/1999 concerning Bank Indonesia which was being superseded by Act No 3/2004, Bank Indonesia is tasked with achieve and maintain the stability of rupiah exchange rate. Based on the Acts (explanation of article 10 clause 1a), the inflation target is determined by the Government after coordinating with Bank Indonesia. In turn, the inflation target is used by Bank Indonesia as the basis in formulating and carrying out monetary policy by taking into account the stability of the financial system and the overall economy.

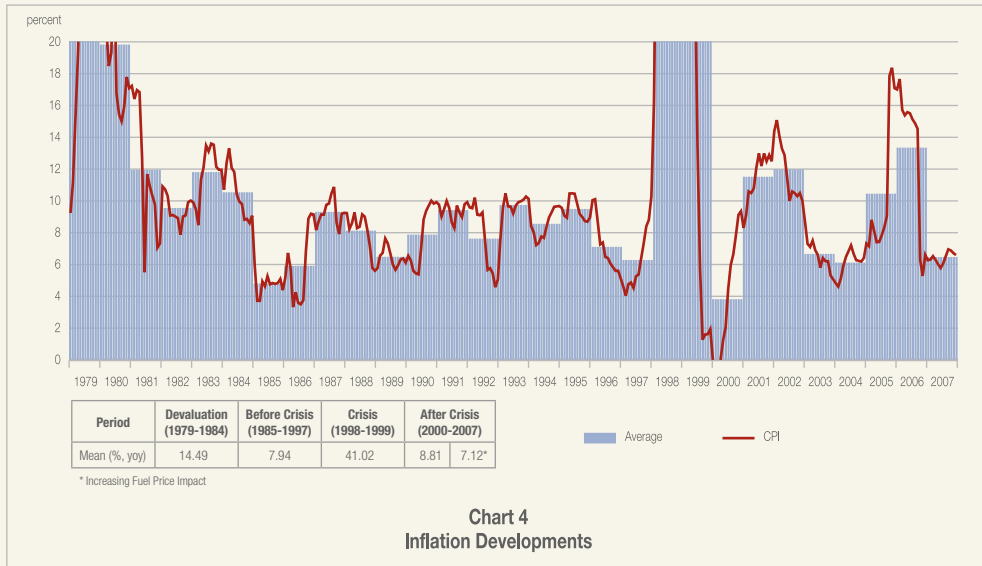
Based on the decision by the Minister of Finance No. 399/ KMK.011/2004 dated 6 September 2004, the inflation targeting period is fixed for 3 years, while the type of inflation targeting used is the yearly CPI. In this decision the inflation target for the years 2005-2007 was also agreed, which was 6%±1% for 2005, 5.5%±1% for 2006, and 5.0%±1% for 2007. Later, the government and Bank Indonesia agreed to revise the target on 17 March 2006. The inflation target for 2006-2008 was

agreed at 8.0%, 6.0%, and 5.0%, respectively, with a deviation of ±1%. Subsequently, at the beginning of 2008, the government set the new inflation targets for the period 2008-2010, that is of 5.0%, 4.5%, and 4.0%, respectively, with deviation of ±1% through the decision of the Finance Minister No.1 year 2008 (Chart 3). In general, the inflation target is set by taking into consideration the inflation projection and the policies which need to be taken such that the inflation target is realistic.

The determination of inflation target is needed as a reference for each player in the economy in taking economic decisions, including for the government and Bank Indonesia in formulating the appropriate policies. The setting of a lower inflation target demonstrates the government's commitment to continue the disinflation process on a gradual basis such that domestic inflation will be relatively similar to inflation rates in other countries in the region. The inflation target is also expected to become anchor in the formation of inflation expectations of each economic player (forward looking). This is seen to be important given the role that inflationary expectations have in forming inflation.

The Government is well aware that such a goal requires commitment and hard work from various parties taking into account Indonesia's historically high inflation on average. Based on historical data over the last 30 years, the lowest inflation on average occurred in the post-crisis period – edging down at 7.12%, a level of inflation which was still fairly high (Chart 4). Nonetheless, the achievement of lower inflation than the historical average is not impossible given that in the years of 1992, 1996, and 2003, inflation had reached around 5%. In each of those three years, the achievement of low inflation was underpinned by the fact that non-fundamental factors were under control – that is volatile food inflation (Chart 3) and administered prices. Aware of the various factors that affect inflation, which not only cover monetary policy





yet also cover policies on production and distribution, the government has decided to form the Coordinating Forum to Control Inflation aside from strengthening of the existing teams such as the Inflation Control Team and the Coordinating Team to Stabilize Basic Foodstuff Prices.

It is expected that these forums will be able to monitor the undertaking of activities involved with controlling inflation. This forum is directly chaired by the Minister for the Economy, with the permanent members being the Finance Minister, the Governor of Bank Indonesia, and the Minister of Trade.