



## Chapter 12

# Economic Outlook and Policy Direction for 2008

# Chapter 12: Economic Outlook and Policy Direction for 2008

Amid the turbulence in the global economy, Indonesia's economic growth is forecasted to reach 6.2%, a decline from 2007. On one hand, domestic demand in the form of household consumption and investment will play a stronger role in driving the wheels of the economy. On the other hand, exports will play a more moderate role in consequence to adverse global conditions. The effect of the external shocks also reflected in lower surpluses in the current account and overall balance of payments. External challenges will bear down heavily on domestic macroeconomic stability. These pressures are predicted to fuel inflation, while exchange rate is forecasted to be stable. Synergy of monetary and fiscal policy will take on even greater importance in mitigating the negative impact of external shocks on the economic outlook. Bank Indonesia will maintain a consistent monetary policy stance to achieve inflation target in support of sustainable economic growth. The Government will stay the course with maintaining fiscal sustainability while delivering a fiscal stimulus. Furthermore, to stimulate activity in the real sector, the Government will make further improvements to the investment climate and accelerate the pace of infrastructure construction. In the banking sector, Bank Indonesia will maintain a strong focus on improvement of the banking intermediary function and institution building in the banking system. Accompanying this will be payment system policies to support increased economic activity, effectiveness of monetary and banking policy and safeguarding of financial system stability.

Economic performance in 2008 is daunted by predictions of adverse global economic developments. In the global economy, international commodity prices are running at high levels. World economic growth is predicted to slow in comparison to the previous year due to the impact of the high oil price and the prolonged US subprime mortgage crisis. Despite the likelihood of rising inflationary pressure fuelled by high commodity prices, global monetary policy will maintain a loose bias to counter a weakening in global economic expansion. Foreign capital inflows into emerging markets, including the Asia-Pacific, are therefore expected to remain strong. Domestic factors supporting economic growth will include the stable exchange rate, availability of financing and continued robust public purchasing power. On the fiscal side, policy will be consistently implemented within sustainable fiscal deficit while providing room for fiscal stimulus.

In view of the global and domestic outlook, economic growth in 2008 is predicted to ease slightly to 6.2%. On the demand side, the economy will be buoyed by private consumption. The implementation of a series of investment policy packages and work on infrastructure projects will stimulate a higher level of investment growth. The optimization of the budget expenditures will also provide an added boost to government investment. On the other hand, the forecasted slowdown in world economic growth will affect the economy, most importantly in exports, while imports are set to rise in 2008 in response to higher domestic demand. Analyzed by sector, economic activity is forecasted to mount, most importantly in sectors linked to consumption activities. Manufacturing, the trade, hotels and restaurants sector and the transport and communications sector are forecasted to be the main contributors to economic growth.

In 2008, the balance of payments is predicted to post a healthy surplus, albeit less than in 2007. Softer performance in the balance of payments will be reflected in the current account and the capital and financial account. The reduced current account surplus will result from declining performance in non-oil and gas exports in keeping with the outlook for global economic slowdown. At the same time, a slightly lower financial account surplus is predicted in response to smaller inflows of portfolio capital.

The rupiah exchange rate is predicted to remain stable. During 2008, rupiah stability will be bolstered by solid performance in the balance of payments reinforced by consistency, prudence and coordinated management of macroeconomic policy. Attractive yields on rupiah investments compared to regional neighbors will keep attracting capital inflows that in turn will keep the equilibrium in forex market.

Strong upward pressure is predicted for CPI inflation in 2008, mainly from external factors. Imported inflation is seen likely to mount in response to external shocks. An added source of inflationary pressure is predicted to come from rising inflation expectations. Nevertheless, it is expected that the higher inflationary pressure can be mitigated by the stable exchange rate. In the administered prices category, inflationary pressure will remain low in line with the government commitment to hold back from raising administered prices for strategic items. However, pressure from volatile food inflation is predicted to remain strong despite some decline. Overall, the effort to achieve the inflation target in 2008 will face challenges, most importantly from external factors. Inflation is predicted to reach 6.0%-6.5%, tending towards the upper limit of the forecasted range. This is consistent with the figure proposed by the Government in the Revised 2008 Budget, which assumes inflation to reach 6.5%, above the Government-set inflation target.

Further improvements are predicted in banking performance during 2008. Bank lending is forecasted to expand in line with the healthy outlook for the economic prospects and underpinned by financial system stability. Credit expansion is expected to reach 22%-24%, supported by bank funds mobilisation at 16%-18% over the preceding year. Accompanying this will be improvement in credit quality reflected in declining NPLs.

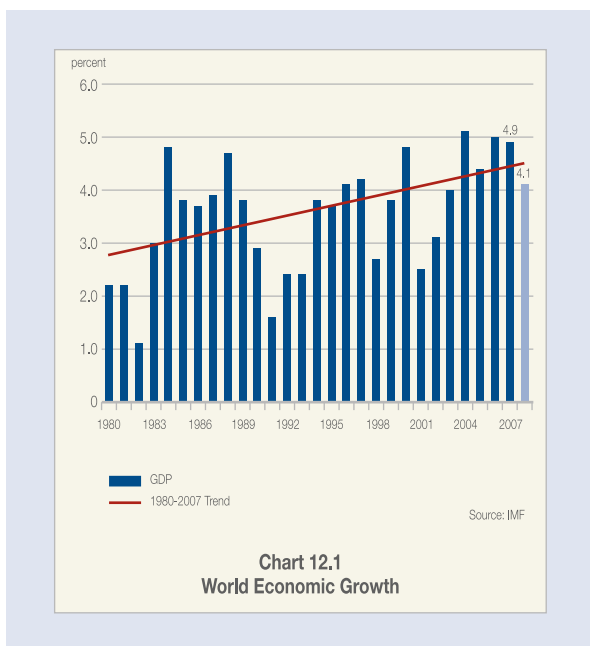
Economic activity in 2008 will again be daunted by risks. The most important risks are from external factors, namely a steeper downturn in the world economy, higher than forecasted international commodity prices and continued turbulence on global financial markets. These factors could bear down on the Government budget, the balance of payments and the overall economy. Domestic challenges to the economy will come from lower than predicted lifting of oil and micro-level issues hampering improvement in the investment climate and holding back progress on infrastructure projects. The lack of optimum policy response could potentially blunt economic growth and employment. These conditions combined with the inadequate state of infrastructure, disruptions to supply of goods and distribution of staple needs could spur inflation. Failure to address these risks properly could cause economic growth to disappoint predictions, while inflation could potentially surge ahead of forecasted levels.

To respond to these challenges, the Government and Bank Indonesia will intensify their policy synergy. Fiscal policy will consistently target the safeguarding of fiscal sustainability while delivering an economic stimulus. Monetary policy will stay the course for achievement of the medium-term inflation target. This policy synergy will help build confidence among economic agents in the maintenance of macroeconomic stability, which will provide a vital basis for achieving sustainable economic growth. In the banking system, Bank Indonesia will move forward with the consolidation programme designed to bring about a sound, strong and competitive banking system while taking further actions to strengthen the banking intermediary function. In the payment system, policy for cash and non-cash payments will focus on meeting public needs, supporting monetary and banking policy effectiveness and maintaining financial system stability.

## **Key Assumptions**

### **The Global Environment**

The global economy is predicted to grow by 4.1% in 2008, reflecting slowing performance compared to 4.9% in the preceding year (Graph 12.1). The world economic slowdown will bear down most severely on developed countries due to the impact of the prolonged US subprime mortgage crisis. In its January 2008 revision of the World Economic Outlook (WEO), the



International Monetary Fund (IMF) revised downward the growth forecast for developed nations such as the United States, Euro zone and Japan (Table 12.1). Nevertheless, this slowdown can still be offset by economic expansion in developing countries. Under these conditions, economic growth is predicted to remain fairly high, albeit below the long-term growth trend. The flagging growth in the world economy augurs for a slowdown in volume of world trade.

Non-oil and gas commodity prices are predicted to decline in the face of the world economic slowdown, while remaining on the higher end of the scale. The steep 14% rise in 2007 will be followed by the onset of price correction in 2008. Major decline is especially likely for basic metal commodities in response to improvements in market supply delayed since mid-2007. Improvement is expected following various difficulties at the producer level previously constricting supply, ranging from natural disasters to labour and machinery capacity. However, high prices for some food commodities, such as corn, CPO and sugar, are again forecasted due to robust demand stimulated by ongoing efforts to develop alternative energy sources.

Crude oil prices are predicted to remain high throughout 2008. Concerning fundamentals, the current level of world oil prices is the result of an ongoing lack of spare production capacity, geopolitical and climate factors and robust oil demand from China

**Table 12.1**  
World Economic Outlook

	2005	2006	2007	Projection 2008
<b>World Output</b>	<b>4.4</b>	<b>5.0</b>	<b>4.9</b>	<b>4.1</b>
<b>Developed Countries</b>	<b>2.5</b>	<b>3.0</b>	<b>2.6</b>	<b>1.8</b>
– United States	3.1	2.9	2.2	1.5
– Europe	1.5	2.8	2.6	1.6
– Japan	1.9	2.4	2.1	1.5
– Others	3.2	3.7	3.8	2.8
<b>Developing Countries</b>	<b>7.0</b>	<b>7.7</b>	<b>7.8</b>	<b>6.9</b>
Africa	5.9	5.8	6.0	7.0
Eastern and Central Europe	5.6	6.4	5.5	4.6
Commonwealth	6.6	8.1	8.2	7.0
Developing Asia	9.0	9.6	9.6	8.6
– China	10.4	11.1	11.4	10.0
Middle East	5.6	5.8	6.0	5.9
Latin America	4.6	5.4	5.4	4.3

Source: IMF, WEO, January 2008.

and India. Upward pressure on prices has also come from speculation by financial market players on the commodity market. This switch to commodity markets is triggered by depreciation in the US dollar that has lowered the value of US dollar-denominated assets. Looking ahead, the world economic slowdown augurs an easing in world oil prices. In addition, the recovery on world financial markets following the decision by central banks to increased liquidity will encourage a shift away from speculative activity. According to several institutions, world oil prices in 2008 will average about US\$75-90 per barrel (Table 12.2).

Unrelentingly high world commodity prices portend mounting world inflationary pressure in 2008. As predicted by IMF in the WEO October 2007, inflation in developed economies would edge upwards to 2.2% while inflation in the developing could reach 4.8%. However, latest developments shows that both core inflation and CPI inflation are on an upward trend, and therefore forecasts are now suggesting inflation at above the IMP-predicted level.

**Table 12.2**  
Oil Price Projection

	2008	Description
IMF	75.0	Average of WTI, Brent, Dubai
Consensus Forecast	78.5	End of December 2008
EIA	86.0	Energy Inform. Adm. US-Feb 08
Bloomberg, 13 Feb 08	80.0	27 Respondents
World Bank	84.1	January 2008 Publication

**Table 12.3**  
**Capital Flow to Emerging Markets**

	billions of \$			
	2005	2006	2007*	2008**
Current Account	274.1	380.2	419.5	374.0
Net External Financing				
Net Private Investment	519.6	572.8	620.3	593.1
Net Equity Investment	251.3	228.3	265.1	277.3
Net Direct Investment	200.6	167.3	212.9	223.2
Net Portfolio Investment	53.7	62.0	52.2	54.0
Net Private Creditor	265.5	343.6	355.2	315.9
Net Commercial Banks	145.7	202.3	188.5	145.8
Net Non Banks	119.5	141.3	166.6	170.0
Net Government Capital Flow	-64.2	-65.0	3.3	9.5
International Financial Institution	-38.6	-32.9	1.9	6.8
Bilateral Creditor	-25.6	-32.1	1.3	2.7
Net Resident Borrowings/others <sup>1</sup>	-287.3	-334.1	-286.8	-269.0
Foreign Reserve	-442.2	-554.0	-756.2	-707.0

\* estimated figure

\*\* IIF Projection

<sup>1</sup> Including net lending, monetary gold, and errors and omissions.

In view of the forecasts for slowdown in the world economy, the global outlook is for a loose monetary policy, particularly in developed countries. This policy course will be taken to anticipate a more pronounced economic slowdown, despite the upward trend in inflationary pressure. The likely outcome of this global monetary policy is that capital inflows will continue to pour into emerging markets, although not at the same rate as in the previous year (Table 12.3). Increased capital flows will consist primarily of FDI and portfolio investments.

### Fiscal Policy Scenario

In 2008, fiscal policy will focus on maintaining fiscal sustainability while also delivering a fiscal stimulus. This fiscal policy includes such actions as the food price stabilization programme. Fiscal policy will operate through a twin-track process of fiscal consolidation through control of the fiscal deficit and a budget financing strategy aimed at reducing the government debt burden and associated risks. To augment the fiscal stimulus, early in the year the Government targeted the 2008 budget deficit at 1.7% of GDP.

Looking ahead, the 2008 Budget will face external and internal pressures. Externally, the unrelenting climb in world commodity prices could potentially drive up domestic prices. To ensure macroeconomic stability, the Government will subsidise energy and strategic food commodities on a considerable scale. Internally,

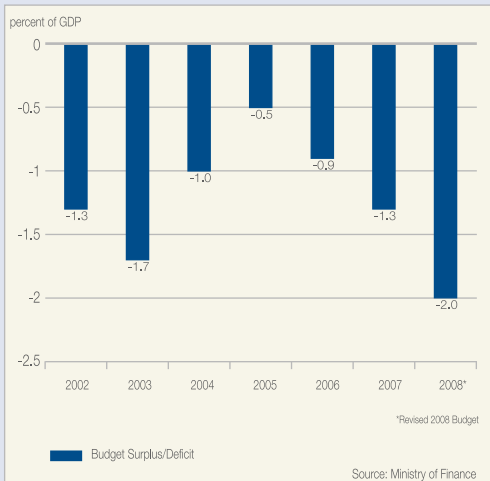
the government faces the risk of oil lifting falling short of the budget assumption. These two conditions are set to expand the budget deficit in 2008. However, the government will pursue a range of fiscal consolidation measures to curb the deficit in the Revised 2008 Budget at 2% of GDP (Graph 12.2). (Box: Nine Measures for Securing the 2008 Budget.)

Fiscal policy on the revenue side will seek to increase state revenues while continuing to provide limited fiscal incentives<sup>1</sup>. Consolidation of taxation is targeted at increasing the tax ratio in the GDP through broadening of the tax base, intensified tax collection and tax administration reforms. Key non-taxation policies will also be introduced, including measures to increase crude oil lifting volume, optimized collection of non-oil and gas natural resources revenues, intensified efforts to combat illegal logging, illegal mining and illegal fishing, application of Good Corporate Governance at SOEs and improved oversight of collection of non-tax revenues at various line ministries and state institutions.

On the expenditures side, the Government will give greater emphasis to quality of expenditures. This is a response to the mounting constraints on state revenues, especially from taxation. Actions will include improved remuneration for state officials, fulfilment of interest payment obligations, improvement in the quality, efficiency and effectiveness of government services and administration, increased budget for infrastructure, support for price stability through subsidies, increased budget allocations for education and continuation of education and health assistance targeting the poor.

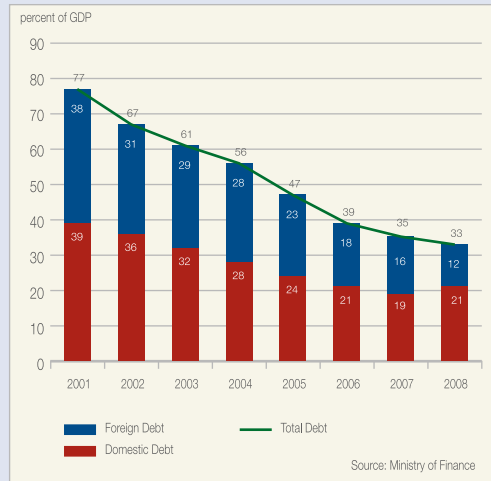
On the financing side, the Government will prioritize financing from domestic sources (Table 12.4). The higher deficit will be funded through an increase in the net issuance of Government Securities from Rp91.6 trillion in the 2008 Budget to Rp116.6 trillion in the draft Revised 2008 Budget (Table 12.4). Building on the strategy in 2007, the Government in 2008 will again

<sup>1</sup> Fiscal incentives for 2008 include Minister of Finance Regulation No. 122/PMK.011/2007 dated 28 December 2007, effective retroactively from 16 July 2007, concerning Import Duties Exemptions for Goods Used in Upstream Oil, Natural Gas and Geothermal Activities, Minister of Finance Regulation No. 178/PMK.011/2007 dated 28 December 2007, valid 1 January 2008-31 December 2008, concerning Government-Paid VAT for Goods Imported for Upstream Oil, Natural Gas and Geothermal Exploration, Minister of Finance Regulation No. 179/PMK.011/2007 dated 28 December 2007, effective 1 January 2008, concerning Import Duties for Floating or Submerged Drilling or Production Platforms.



**Chart 12.2**  
**Budget Deficit**

Source: Ministry of Finance



**Chart 12.3**  
**Government Debt**

Source: Ministry of Finance

issue Government Securities in a range of tenors to broaden the investor base. Included in this is a plan for issuing rupiah and foreign currency-denominated Sharia Government Securities. On the other hand, the targeted receipts from PT PPA (Asset Management Indonesia) and SOE privatization are minimal at about Rp2 trillion. As envisaged in the long-term debt management strategy directed towards domestic borrowing sources, a net repayment of foreign debt is again predicted for 2008. The Government will also provide Rp2.8 trillion funding for infrastructure projects under the Public-Private Partnership (PPP).

The fiscal consolidation pursued by the government is predicted to ensure a continued fiscal surplus through positive growth in government consumption and investment. The rise in the Revised 2008 Budget deficit is attributable to a doubling in almost all subsidy items compared to the 2008 Budget in order to maintain public purchasing power. At the same time, consumption and investment will continue to expand but at a slower rate. At the central government level, increased government consumption will be driven mainly by the approximately 20% rise in basic pay for civil servants. Increased material expenditures are linked, among others, to unit reorganization and establishment of new units. The increase in other expenditures, which includes higher budgeting for policy measures, covers budget allocations for the 2009 national election and procurement of Government

rice stocks, social and security emergency relief funds and other supporting expenditures. In a parallel move, investment expenditures will be boosted by larger budget allocations for infrastructure. The two line ministries receiving sizeable budget allocations for infrastructure are the Ministry of Public Works and the Ministry of Communications.

An increased fiscal contribution is also predicted at the regional level. Regional government consumption and investment will be marked by increased expenditure allocations for regions in line with the strengthening of domestic revenues, as reflected in the rise in the tax ratio to 14% of GDP in the Revised 2008 Budget. Higher budget allocations for social aid and subsidies will also result in increased transfers to the real sector. The more robust social aid budget contains higher budget funding for disaster relief, increased social assistance channelled through line ministries/statutory agencies and social aid programmes in operation for the past several years. These programmes include the Operational Assistance for Schools (BOS), free health services at community health centres (Puskesmas), class III government hospitals and appointed private hospitals and the Families with Hope programme that has taken over from the Direct Cash Transfers programme. At the same time, increased subsidies are explained by higher energy subsidies necessitated by forecasts of further escalation in crude oil prices, as well as subsidies for strategic food staple commodities.

**Table 12.4**  
**State Budget and Revised State Budget for 2008**

trillions of Rp

Item	State Budget 2008		Revised State Budget 2008	
	Trillions of Rp	% GDP	Trillions of Rp	% GDP
A. Total Revenue and Grants	781.4	18.1	839.4	19.6
I. Domestic Revenue	779.2	18.1	836.7	19.5
1. Tax Revenue	592.0	13.7	601.5	14.0
2. Non-Tax Revenue	187.2	4.3	235.2	5.5
Oil and Natural Gas	117.9	2.7	152.2	3.6
II. Grants	2.1	0.0	2.7	0.1
B. Expenditures	854.7	19.9	926.2	21.6
I. Central Government Expenditures	573.4	13.3	641.4	15.0
1. Line Ministries and Agencies Expenditure	311.9	7.2	272.1	6.3
2. Non Line Ministries and Agencies Expenditure	261.5	6.1	369.3	8.6
– Interest Expenditure	91.4	2.1	94.2	2.2
i. Domestic Debt	62.7	1.5	65.0	1.5
ii. Foreign Debt	28.6	0.7	29.1	0.7
– Subsidies	97.9	2.3	208.6	4.9
i. Energy Subsidies	75.6	1.8	161.2	3.8
ii. Non Energy Subsidies	22.3	0.5	47.4	1.1
– Other Expenditures	25.0	0.6	19.3	0.5
II. Regional Government Expenditures	281.2	6.5	284.8	6.6
1. Balancing Fund	266.8	6.2	274.8	6.4
a. Profit Sharing Fund	66.1	1.5	74.1	1.7
b. General Allocation Fund	179.5	4.2	179.5	4.2
c. Special Allocation Fund	21.2	0.5	21.2	0.5
2. Special Autonomy and Balancing Fund	14.4	0.3	10.1	0.2
C. Primary Balance	18.1	0.4	7.4	0.2
D. Budget Surplus/(Deficit)	(73.3)	(1.7)	(86.8)	(2.0)
E. Financing	73.3	1.7	86.8	2.0
I. Domestic Financing	90.0	2.1	104.2	2.4
1. Domestic Bank Financing	0.3	0.0	(11.7)	(0.3)
2. Domestic Non-Bank Financing	89.7	2.1	115.9	2.7
a. Privatization (net)	1.5	0.0	1.5	0.0
b. Assets Recovery	0.6	0.0	0.6	0.0
c. Net Government Bond Sale	91.6	2.1	116.6	2.7
d. Government Investment Fund	(4.0)	(0.1)	(2.8)	(0.1)
II. Net Foreign Financing	(16.7)	(0.4)	(17.4)	(0.4)
1. Gross Drawings	43.0	1.0	44.2	1.0
a. Program Loan	19.1	0.4	23.8	0.6
b. Project Loan	23.9	0.6	20.4	0.5
2. Repayment of Principle of Foreign Loan	(59.7)	(1.4)	(61.6)	(1.4)
Assumptions:				
Economic Growth (%)		6.8		6.4
Inflation (%)		6.0		6.5
Average Exchange Rate (Rp/\$)		9,100		9,150
Average 3-month SBI Rate (%)		7.5		7.5
International Oil Price (\$/barrel)		60		83
Indonesia Oil Lifting (million barrel per day)		1,034		0,910

Source: Ministry of Finance

Accordingly, the fiscal impulse<sup>2</sup> indicator points to a fiscal policy commensurate to the needs of the economy.

### Sectoral Policy

The Government will implement a series of policies to boost investment and sectoral economic performance. The fiscal stimulus will be aimed at strengthening the real sector, in part through increased capital expenditures. Besides reinforcing investment policy implementation, government policy will also seek to accelerate the completion of infrastructure projects. Part of this will include development of several schemes for land expropriation, which represents one of the major roadblocks to infrastructure projects. A range of sectoral policies is designed to provide incentives and promote growth in particular economic sectors. These incentives include income tax relief for some investments, exemption and reduction of import duties and VAT on capital goods, machinery or equipment for production purposes that cannot yet be produced in Indonesia and favorable land and property tax treatment for specified lines of business and selected regions. In an added move, the Government has also launched Visit Indonesia Year 2008, which will stimulate economic activity in areas related to the services sector and hotels and restaurants. Activity in the communications sector is also set to climb further following the announcement of new interconnection rates in 2008.

Policy will be strengthened in support of inflation control. To ensure adequate market supply, the Government has allocated subsidies for fertilizers, low interest loans and seeds, in addition to budget funds for construction and restoration of agricultural infrastructure and eradication of pests and diseases. The Ministry of Agriculture targets the opening of new land for rice paddy cultivation in 2008 to offset the conversion of existing paddies to other use, with new rice paddies to be developed outside Java on the islands of Sumatera, Sulawesi, the Moluccan islands and Papua. The Government has also delegated greater powers to the State Logistics Agency (Bulog) to import rice. In further actions, the government will lower the import duty on rice by Rp100 to Rp450/kg in 2008. To boost public purchasing power, the Government will also strengthen the social safety net through such

actions as increasing the volume of rice allocated for the poor (the *raskin* programme) and operational assistance for schools.

### Forecast for Aggregate Supply and Demand

Economic growth in 2008 will be chiefly driven by increased domestic demand. Improvement in public purchasing power from the planned pay rise for civil servants and increases in provincial minimum wage levels (Graph 12.4) will spur growth in private consumption. The downward trend in interest rates in 2007 will also generate added momentum for private consumption from the financing side. Investment will grow in response to escalating domestic demand and improvement in the investment climate. The external shocks taking place in the global economy are expected to slow exports, although the impact will be limited. At the same time, imports will rise to keep pace with mounting domestic demand.

### Forecast for Aggregate Demand

Economic growth in 2008 will be driven more by increased domestic demand. Improvement in public purchasing power from the planned pay rise for civil servants and increases in provincial minimum wage levels (Chart 12.4) will spur growth in private consumption. The downward trend in interest rates in 2007 will also generate added momentum for private consumption from the financing side. Investment will grow in response to escalating domestic demand and improvement in the investment climate. The external shocks taking place in the global economy are predicted to slow exports, although the impact will be limited. At the same time, imports will rise to keep pace with mounting domestic demand.

### Private Consumption

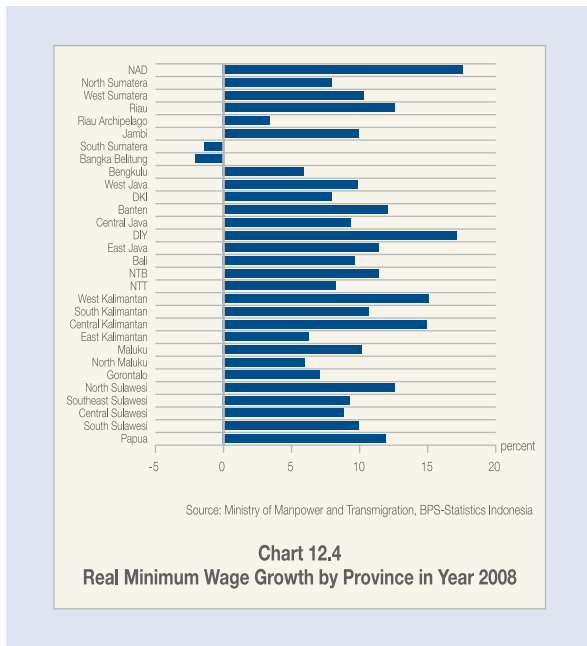
Private consumption is predicted to maintain robust expansion in 2008 on the strength of buoyant purchasing power and availability of financing.

**Table 12.5**  
Economic Growth Outlook by Expenditure

Component (percent, yoy)	2007	2008*
<b>Gross Domestic Product</b>	<b>6.3</b>	<b>6.2</b>
Private Consumption	5.0	5.4
Government Consumption	3.9	3.8
Gross Fixed Capital Formation	9.2	9.3
Export of Goods and Services	8.0	7.9
Import of Goods and Services	8.9	9.4

\* Bank Indonesia Projection.

<sup>2</sup> For explanation of the fiscal impulse, refer to the chapter on Government Finances.



**Chart 12.4**  
Real Minimum Wage Growth by Province in Year 2008

Purchasing power will be reinforced by real increases in incomes, including gains from the approximately 20% pay rise for civil servants and higher provincial minimum wage levels. The surge in the capital market, which offers opportunities for capital gains, has also strengthened public purchasing power in the middle and upper classes. Looking ahead, Government fiscal policies are expected to provide added boost to purchasing power. In addition, preparations for the elections in 2008 and the election of regional government heads will generate even more private consumption. On the financing side, higher consumption will be supported through financing from banks and other financial institutions. The resurgent growth in consumption credit extended by banks and in financing from financial institutions since mid-2007 is predicted to continue.

#### Government Consumption

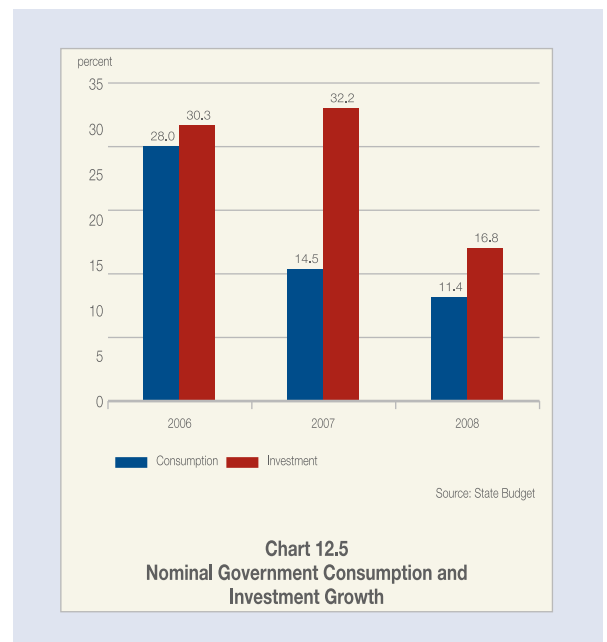
Government consumption is predicted to expand further in 2008, although at a slower rate. Despite the significantly increased deficit, the direct contribution of the fiscal sector to the real sector will narrow due to increased allocations for subsidies. Central government and regional government consumption will expand at a slower rate, commensurate with reduced growth in personnel expenditures, material expenditures and General Allocation Funds for the regions.

#### Investment

Investment activity in 2008 is predicted to show slightly increased growth. Improvements in the investment climate are expected to boost investment expansion in 2008. The fiscal stimulus through government investment will also have a role in strengthening investment levels in 2008, despite reduced growth compared to the preceding year (Chart 12.5). At the same time, private investors are expected to play an increased role in promoting investment.

Analyzed by type of investment, construction investment is predicted to advance at a rapid pace in 2008, driven by work on a range of government and private sector infrastructure projects. One of the largest of these is the construction of a toll road. Although these projects are predicted to fall behind their original schedules, Government actions to resolve various obstacles in the field, particularly in relation to land expropriation, are expected to pave the way for construction investment on a larger scale.

Alongside this, investment in non-construction investment is on a positive growth track. The expected improvement in the investment climate will stimulate investor activity in Indonesia. In data from the Investment Coordinating Board (BKPM), applications for domestic and foreign investment approvals were up in 2007 compared to 2006 (Chart 12.6 and 12.7). Investment interest has focused more on business investment in secondary sectors, such as food



**Chart 12.5**  
Nominal Government Consumption and Investment Growth

processing, paper and printing and the chemical and pharmaceutical industries.

### Exports and Imports of Goods and Services

Export growth is likely to slow in 2008 compared to the preceding year. The potential for less vigorous export performance arises from the downturn in world economic growth with flagging world demand for Indonesian products. However, a steeper downturn will be avoided through greater diversification of export destinations. The share of non-oil and gas exports to the US is steadily declining, while non-oil and gas exports to emerging markets, led by China and India, are on the rise (Box: Emerging Markets Intra Trade). In addition, future exports will continue to be dominated by resource-based products. The buoyant demand for the commodities in emerging market countries and sustained high prices will prevent further decline in export performance.

Real import growth for goods and services in 2008 is still predicted to forge ahead on the strength of continued high domestic demand. The ongoing economic expansion is expected to generate increased imports. Raw material imports are predicted to rise in line with more vigorous demand for domestic economic activity. Alongside this, expanding domestic investment activity will stimulate imports of capital goods.

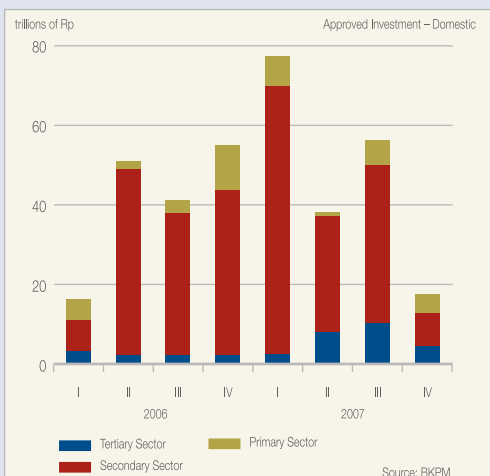
### Forecast for Aggregate Supply

Analyzed by sector, economic growth in 2008 will be driven by growth in manufacturing, the trade, hotels and restaurants sector and the transport and communications sector (Table 12.6).

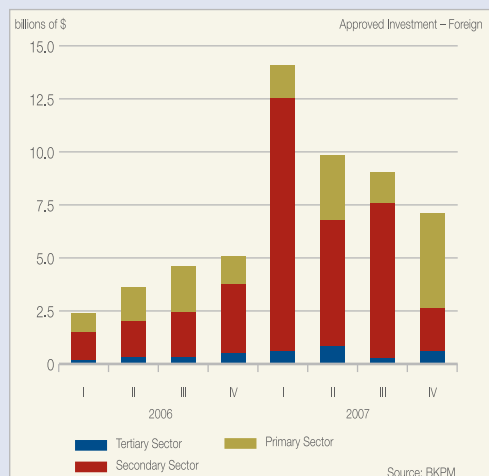
An upsurge is predicted in manufacturing, the most important contributor to sectoral growth, with redoubled performance in the non-oil and gas manufacturing subsector. Higher production will come in response to increased demand generated by robust public purchasing power.

Activity in the trade, hotels and restaurants sector is also predicted to climb. Rising public consumption is expected to boost activity in the wholesale and retail trade subsector. Added to this, mounting business activity and the government's launching of Visit Indonesia Year 2008 will generate increased added value in the hotels and restaurants subsector.

The transport and communications sector is predicted to maintain high growth, fuelled mainly by the communications subsector. The impressive performance in the communications subsector, like before, will be bolstered by strong public purchasing power. Rising demand for communications has been followed by higher supply capacity following the investment made by telephone operators in recent years. While cellular services have improved, calling rates have also become more affordable. According



**Chart 12.6**  
Domestic Investment Approval



**Chart 12.7**  
Foreign Investment Approval

**Table 12.6**  
**Economic Growth Projection by Sectors**

Component (percent)	2007	2008*
<b>Gross Domestic Product</b>	<b>6.3</b>	<b>6.2</b>
Agriculture	3.5	3.5
Mining and Quarrying	2.0	1.2
Manufacturing	4.7	5.0
Electricity, Gas and Water Utilities	10.4	11.4
Construction	8.6	9.3
Trade, Hotels and Restaurants	8.5	8.7
Transportation and Communication	14.4	14.6
Finance, Leasing and Services	8.0	8.1
Services	6.6	3.3

\* Bank Indonesia Projection.

to Indonesia's Telecommunications Regulation Agency, subscriber calling rates are set to come down significantly during 2008.

Agricultural sector growth for 2008 is forecasted above the historical post-crisis average. Performance in agriculture will be strengthened mainly by the food crops and estates subsectors. In the food crops subsector, high output will be driven by increased productivity, particularly for rice. This projection is consistent, among others, with the First Quarter 2008 Forecast Figures released by the Central Statistics Agency (BPS). The 2008 rice crop is projected at 58.27 million tons of dry unhusked rice, up 2.13% from the 2007 output of 57.05 million tons. Increased production is also forecasted for corn and soybeans. In the estates subsector, the forecast is for sustained high production driven mainly by output from oil palm estates. Key factors in this are high estate productivity and the incentive of attractive international market CPO prices.

Weaker performance is predicted for the mining and quarrying sector. The slowing volume of world trade in 2008 is expected to produce some softening in demand for Indonesian mining products, such as nickel and copper.

Construction sector growth is predicted to mount in 2008. Infrastructure construction with private sector participation is expected to generate considerable growth momentum in this sector. In addition, construction of commercial property in Jakarta is forecasted to rise, providing added boost to construction sector performance. Government investment in infrastructure projects will also play a

major role in this sector, albeit with reduced growth compared to 2007.

Financial sector performance is predicted to remain strong in 2008. The high level of economic activity will boost demand for financial intermediary services. The outlook for improvement in the financial sector is borne out in bank business plans for lending and plans by some non-bank financial institutions to issue bonds in 2008 to finance future business expansion. Increased leasing, primarily for heavy equipment purchases, is also predicted in line with the ongoing work on government-sponsored infrastructure projects.

### **Balance of Payments Forecast**

In 2008, the balance of payments is predicted to post a healthy surplus, albeit less than in 2007 (Table 12.7). The reduced balance of payments surplus will result from softer performance in the current account and the capital and financial account. Despite this decline, direct investment is predicted to mount higher with support from Government policy actions in support of the real sector and improvement in the investment climate. In the current account, slowing global economic growth with reduced volume of world trade will bear down on Indonesia's export performance. At the same time, imports will maintain vigorous growth in line with the vibrant activity in the domestic economy. This forecast augurs for a reduced current account surplus, albeit still at a healthy level. The balance of payments in 2008 is predicted to chart a US\$11.3 billion surplus, bringing international reserves at end of year to US\$68.2 billion or equivalent to 6.2 months of imports and servicing of official debt..

### **The Current Account**

The current account surplus in 2008 will be slightly less than in 2007. The reduced surplus will result mainly from slowing growth in non-oil and gas exports in keeping with the global economy slowdown and an escalating services and income deficit. However, Indonesia is expected to avoid a steeper decline in the surplus due to support from increased oil prices and restraint in non-oil and gas import growth. The current account is also predicted to benefit from higher numbers of foreign tourist arrivals under the Visit Indonesia Year 2008 programme.

The non-oil and gas trade balance is forecasted to post about the same surplus as in 2007. The outlook

**Table 12.7**  
**Forecast for Indonesian Balance of Payments**

millions of \$

Description	2007	2008*
I. Current Account	11,009	10,102
A. Goods, net (Trade Balance)	33,083	33,550
– Exports, fob.	118,014	128,918
– Imports, fob.	-84,930	-95,368
1. Non-Oil/Gas	27,048	27,109
– Export	93,142	102,456
– Import	-66,094	-75,347
2. Oil/Gas	6,036	6,440
– Export	24,872	26,461
– Import	-18,836	-20,021
B. Services, net	-11,103	-11,586
C. Income, net	-15,875	-16,737
D. Current transfers, net	4,903	4,875
II. Capital and Financial Account	2,753	1,225
A. Capital Account	530	192
B. Financial Account	2,223	1,003
1. Direct Investment	1,164	3,055
2. Portfolio Investment	6,981	6,050
3. Other Investment	-5,922	-8,072
III. Total (I+II)	13,726	11,328
IV. Errors and Omissions	-1,220	0
V. Overall Balance (III+IV)	12,543	11,328
VI. Monetary Flows <sup>1)</sup>	-12,543	-11,328
A. Changes in International Reserves	-12,543	-11,328
B. IMF	0	0
Notes:		
International Reserves	56,920	68,249
(In month of imports and official debt repayment)	5.7	6.2

1) - (minus) indicates surplus and + (plus) indicates deficit.

\* Bank Indonesia projection

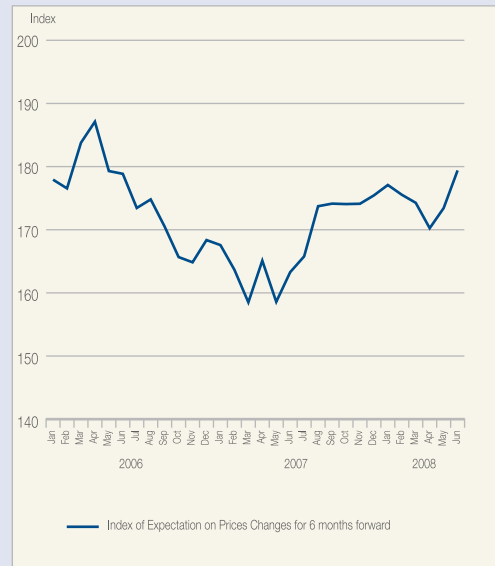
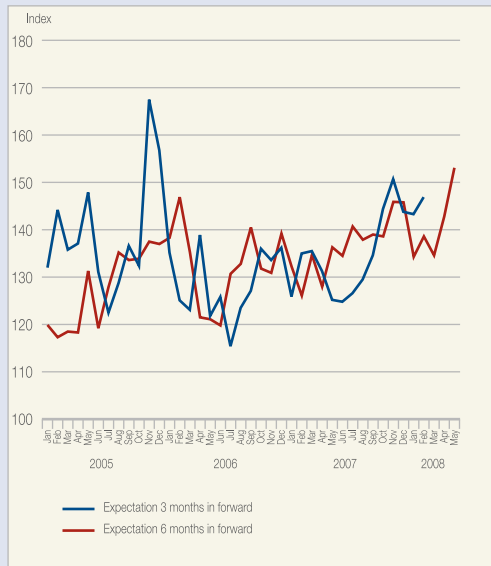
for a world economic slowdown will dampen non-oil and gas export performance. Non-oil and gas imports will maintain vigorous growth in keeping with vibrant domestic demand. However, the oil and gas balance of trade is set for an increased surplus compared to 2007. Oil and natural gas exports will grow at a slower pace due to declining production of LPG and LNG. At the same time, growth in oil and natural gas imports is similarly projected to ease in keeping with the government policy to cut back oil imports.

The service and income deficit is predicted to rise in 2008, while transfers will remain largely unchanged. High oil prices and imports will lead to an increased deficit in the services account, particularly for freight services used for imports. Similarly, the income deficit is predicted to rise as a consequence of added foreign

capital entering Indonesia. Overall, the surplus in the transfers account will be largely unchanged

### **The Capital and Financial Account**

The capital and financial account is predicted to chart a reduced surplus due to falling portfolio investment and growth in investment assets. On the other hand, the outlook is for increased long-term capital inflows in the form of FDI in keeping with the improved domestic investment climate. Investor interest is expected to mount in the oil and natural gas sector, stimulated by high oil prices and tax incentives offered by the Government. In 2008, a smaller surplus is forecasted for short-term capital inflows (portfolio capital). This decline comes in response to the impact of the subprime mortgage crisis in the US, the full extent of which has yet to be revealed. Capital inflows are



**Chart 12.8**  
**Inflation Expectation – Consumer and Retail Sales Survey**

predicted to mount only gradual recovery, with inflows in 2008 falling short of the level reached in 2007.

### Forecast for the Rupiah

The rupiah exchange rate is predicted to maintain stable movement throughout 2008. This prediction is supported by carefully managed domestic macroeconomic fundamentals and especially the healthy condition of the balance of payments. Overall, demand and supply on the forex market will remain adequately balanced. Demand for foreign currency will be spurred mainly by growing economic activity that will in turn stimulate imports. On the supply side, foreign currency sources are predicted to remain adequate, bolstered by non-oil and gas export earnings and capital inflows, comprising mostly portfolio investments. Export earnings will remain a major source of foreign currency, despite slowing growth in non-oil and gas exports. Under these conditions, the current account surplus will provide a cushion for mitigating possible external shocks in the capital and financial account related to portfolio investments. This is expected to provide key support for maintaining stability in the rupiah.

### Inflation Forecast

Strong pressure is predicted for CPI inflation in 2008, principally from the external factors of high international

commodity prices and rising inflation in trading partner countries. Also contributing to inflationary pressure will be escalating inflation expectations. However, the stable value of the rupiah is expected to mitigate these inflationary pressures. In the administered prices category, inflationary pressure will remain low in line with the government commitment to hold back from raising administered prices for strategic items. However, pressure from volatile foods inflation is predicted to remain high despite some decline. The strong inflationary pressure in volatile foods is related to persistent high international food commodity prices. Taken together, CPI inflation in 2008 is predicted to come within the 6.0%-6.5% range, tending towards the upper limit of the range or above the Government-set 5%±1% target.

### Fundamentals

Rising inflationary pressure from fundamentals is predicted for 2008, mainly from external factors. Mounting pressure in externals is explained by escalating inflation in trading partner nations and high international commodity prices. An added source of inflationary pressure will be rising inflation expectations. With public purchasing power fairly strong, for example, due to the increase in provincial minimum wage levels (Table 12.8), public inflation expectations are predicted to mount. Confirming this are the results of

**Table 12.8**  
**Provincial Minimum Wage Increase**

Province	2007 (Rp)	2008 (Rp)	Increase (%)
NAD	850,000	1,000,000	17.65
North Sumatera	761,000	822,205	8.04
West Sumatera	750,000	800,000	6.67
Jambi	658,000	724,000	10.03
Bengkulu	644,838	683,528	6.00
West Java	447,654	568,193	26.93
DKI Jakarta	816,100	972,605	19.18
Banten	661,613	837,000	26.51
Central Java	500,000	547,000	9.40
DI Yogyakarta	460,000	586,000	27.39
East Java	448,500	500,000	11.48
Bali	622,000	682,650	9.75
West Nusa Tenggara	550,000	730,000	32.73
East Nusa Tenggara	600,000	650,000	8.33
Central Sulawesi	615,000	670,000	8.94
South Sulawesi	673,200	740,520	10.00
Papua	987,000	1,105,500	12.01

the Retail Sales Survey (SPE) and Consumer Survey (SK) (Chart 12.8). Nevertheless, it is expected that mounting inflationary pressure can be mitigated by the stable exchange rate. Added to this, the Government is committed to hold back from raising prices for strategic items, such as fuel and electricity billing rates, and this will also ease pressure from inflation expectations. On the demand side (the output gap), inflationary pressure is predicted to remain low in view of measures to secure supplies and distribution. Contributing to secure supplies will be increased production capacity in response to stronger investment growth. Furthermore, the envisaged improvements to infrastructure are expected to support the smooth distribution of goods and in so doing minimise the possibility of shortages.

#### **Non-fundamentals**

Inflationary pressure from administered prices will be kept at a subdued level throughout 2008. The government commitment to hold back from hikes in administered prices for strategic items, such as fuel and electricity billing rates, is predicted to minimise pressure from rising administered prices on CPI inflation. Pressure from rising prices in this category is expected from non-strategic items, including cigarette excise, water billing rates, river and waterway transport fares, toll charges and intercity and interprovincial bus services. Improvements in supply and distribution of goods are also expected to minimise inflationary

pressure from administered prices. The kerosene shortages of the second half of 2007 are not expected to repeat themselves in 2008.

Pressure from volatile foods inflation is set to remain high, despite a downward trend. Inflationary pressure will come from strong international food prices. However, the mounting pressure may be mitigated by adequate supply of foodstuffs, most importantly rice. Factors safeguarding rice stocks include increased production and flexibility in rice imports. Higher rice production is closely linked to government efforts for further improvement of agricultural infrastructure, such as irrigation systems and use of hybrid seeds capable of lifting farmer productivity. On the supply side, procurement of imported rice will be made more effective with BULOG given wider powers to import rice. To keep rice prices under control, the Government has also issued a ruling on import duty reduction for rice. In 2008, the government will lower the rice import duty from Rp550 to Rp450 per kilogram in support of the price stabilization programme for domestic rice.

#### **Banking Forecast**

Further improvement in bank performance is predicted for 2008 in keeping with the continued upbeat outlook for the economy, with support from growing financial system stability. The combination of a buoyant economic outlook for 2008 and conducive trend in interest rates offers a vital opportunity for business and banks to promote activity in the real sector. With support from improving financial system stability and banking system resilience, bank lending is predicted to expand by 22%-24% on the back of funding growth at 16%-18%, bringing the LDR to as much as 72%. Accompanying this expansion will be improvement in credit quality reflected in relatively low NPLs gross at less than 5%. Growth in bank lending will be supported primarily by ongoing infrastructure projects, which in turn are expected to boost credit expansion in other productive sectors through multiplier effects.

Like the overall forecast for the banking system, the Sharia banking system is predicted to chart further performance gains. The upbeat outlook for the Indonesian economy in 2008 coupled with the programme for accelerated expansion of Sharia banking is expected to boost industry volume and funds mobilisation by Sharia banks. Contributing to the expansion is the potential for establishment

of new Sharia banks in 2008 and the increasingly attractive profit sharing returns that have raised the competitiveness of Sharia bank investment products. Improving conditions in the real sector and expansion in the Sharia banking network will also stimulate demand for financing. Financing, like before, will be dominated by sale-and-purchase based financing, with focus on the services and trade sectors. Given their limited financing capacity, Sharia banks will pursue a strategy of syndicated financing to boost financing growth. With a target established for Sharia banking assets to expand to 5% of total national banking assets, support extended by the Government, finalization of the Sharia Banking, Taxation and Sharia Government Securities laws, asset growth at Sharia banks is expected to outpace that of the national banking system. Under these conditions, steady growth is forecasted for asset volume, depositor funds and financing extended by Sharia banks in 2008.

### **Payment System Forecast**

In view of the continued healthy growth projection for the Indonesian economy and the high rate of worn currency in public circulation, added demand for cash outside banks in 2008 is predicted to reach Rp109.2 trillion. This added demand for currency outside banks is 5.4% lower than the realized additional currency outside banks in 2007. A range of efficiency measures put into place since 2006 to optimize the provision of cash at BI Regional Offices with inflowing cash trends combined with more effective cash management at banks has reduced added volume in the cash distribution plans.

Concerning non-cash payments, the continued high economic growth projection for 2008 is expected to promote increased transaction activity by the public. Payment transaction activity is forecasted to reach about Rp51,000 trillion. Most of the transactions (about 93% or Rp47,500 trillion) will take place in the BI-RTGS system, a further 3% (about Rp1,500 trillion) in clearing and the remaining 4% (about Rp2,000 trillion) with the use of card-based payment instruments and other payments.

### **Risks**

Indonesia's economic outlook for 2008, like before, is daunted by various risks in relation to external shocks and domestic conditions, while also challenged by the high level of permanent component of inflation.

External risks consist of the potential for a more drastic world economic slowdown, higher than predicted international commodity prices and persistent lack of stability in financial markets. In addition, domestic risks include the possibility of below-forecasted domestic oil production, delays in ongoing implementation of infrastructure projects and persistence of distribution bottlenecks for staple goods.

### **External Risks**

Higher than predicted international prices for both oil and non-oil commodities represent the most serious risk factor. The impact of the rise in world oil prices is visible in the balance of payments. High oil prices may exacerbate world inflation, which in turn will affect Indonesia's export performance due to mounting prices for imported raw materials. In addition, high oil prices could widen the price disparity between subsidized and non-subsidized fuels, encouraging higher consumption of oil-based fuels. The increased consumption in turn could cause oil imports to rise beyond the forecasted level. High world oil prices, potential for production shortfalls and continued high domestic demand for oil could spur increased demand for foreign currency to pay for oil imports, which could subsequently influence future movement in the exchange rate. High international commodity prices could send prices climbing further in trading partner countries, resulting in imported inflation that will increase prices for imported raw materials that could potentially be passed on to selling prices on foreign and domestic markets. On the consumption side, the rise in imported inflation could dampen growth in private consumption, particularly for non-food items.

Another external risk is that of a steeper downturn in the world economy. World economic growth in 2008 is predicted to slow in comparison to 2007 primarily in response to flagging economic growth in the US. The US economy still has potential for lower than forecasted growth in view of the situation in the housing sector, which has yet to recover from the knock-on effects of the US subprime mortgage crisis. Any sharper decline in the US economy could put further brakes on world economic growth, in turn sapping the volume of world trade. In consequence, Indonesian exports could fall short of the growth forecast.

At the same time, prolonged instability in global financial markets could slow the rate of portfolio capital inflows

to emerging market countries, including Indonesia. This in turn may impact the capital and financial account. The secondary effects of the subprime mortgage crisis in the US are predicted to bear down on Indonesia's foreign capital inflows. In addition, the predominance of short-term (portfolio investment) capital in the structure of Indonesia's capital inflows and the shallow condition of the domestic financial market render the market more susceptible to global risks compared to other countries in the region and will therefore influence exchange rate fluctuation.

### **Domestic Risks**

In view of oil lifting in 2007 at only 899 thousand barrels per day and the lag in tangible results from the tax incentives offered to the oil and gas sector, oil production in 2008 could well fall below the assumed level. Lower domestic oil production will necessitate higher imports of oil, which may affect the balance of payments (Box: Sensitivity of Indonesia's 2008 Balance of Payments to Changes in Oil Prices and Production Levels).

Delays in infrastructure projects also represent a risk factor on the domestic front. The potential for delays is related to the current limitations of the legal and regulatory framework, with its shortcomings in transparency and effectiveness at the sectoral and intersectoral levels. This is reflected in such conditions as obscurity in the regulations on land expropriation and the weak synchronisation of central government and regional government policies. Other factors hampering progress in infrastructure projects include limited project planning and risk management resources, domestic financing and lack of clarity in the cost recovery mechanism.

The difficulties with progress on infrastructure and conditions in some regions prone to natural disasters are factors with potential for disruption in the distribution of goods, and particularly staple items. Any disruption in staple goods distribution will drive up prices for these items, which may trigger heightened expectations of price increases that in turn could fuel inflation.

All of these risks, if not managed carefully, will exacerbate the potential for flagging economic performance. Economic growth could drop below the forecasted level. Upward pressure on prices may

lead to higher than forecasted inflation. (Box: Moving Towards Quality, Sustainable Economic Growth: Opportunities and Challenges).

## **Policy Direction**

### **Monetary Policy Direction**

The monetary policy pursued by Bank Indonesia will remain focused on building macroeconomic stability in support of sustainable economic growth through application of the Inflation Targeting Framework (ITF). Monetary policy direction will focus on achievement of the Government-set inflation target, taking into account economic forecasts and risks. This commitment and consistency in monetary policy is expected to engender a shift in the perceptions and expectations for economic actors in favour of more forward looking expectations of inflation. However, achievement of the inflation target is daunted by the challenge posed by the considerably high level of permanent inflation-forming components. For this reason, coordination of monetary, fiscal and real sector policies will be continued to ease the level of these permanent components.

In actions related to achievement of the inflation target, monetary policy will focus on deepening of the domestic financial market. A deeper, more robust and liquid financial market will strengthen the resilience and stability of the financial system and ultimately minimise the negative impact of global financial market turmoil on the domestic economy. The revitalization and enrichment of monetary instruments is vital to this objective. Measures include the issuance of Bank Indonesia Certificates (SBIs) in longer tenors of 6 and 9 months and the activation of repurchase agreements (repo) with underlying government bonds to support liquidity management. The use of government bonds in repo transactions is also envisaged as a means of encouraging greater activity and liquidity on the government bonds market, thus improving market efficiency and resilience to potential shocks. Liquidity management will also be supported by the use of foreign exchange swaps (FX swaps). This policy is expected to help market actors achieve more effective liquidity management and improve risk diversification.

The direction pursued in monetary policy also aims to strengthen the effectiveness of the ITF. To improve operation of the ITF, actions will be pursued to maintain overnight rates stability in the interbank money

market, which serves as a vehicle for monetary policy transmission and a mechanism for forming more consistent short-term yield curves (Box: Improvements to the Monetary Policy Operational Framework). These measures will be pursued to strengthen the effectiveness of monetary policy transmission in order to manage public expectations and promote an expanded financial sector role in support of the economy. To this end, liquidity conditions and overnight rates on the money market will be monitored on a daily basis, enabling quick response in the event of any disruptions with the use of the Fine Tuning Operations (FTO) mechanism, repo transactions with SBIs or government securities and FX swap transactions.

The monetary policy direction will also be supported by exchange rate policy. Bank Indonesia will consistently apply a flexible exchange rate policy, allowing the rupiah to move in line with economic fundamentals. To manage volatility in the rupiah, Bank Indonesia will also conduct forex market interventions. These exchange rate support measures are expected to dampen inflationary pressure from exchange rate movement and guide inflation expectations of economic agents consistent with inflation target. Reinforcing this are standby facilities under the ASEAN+3 cooperation in the Chiang Mai Initiatives, in which Bank Indonesia has concluded bilateral swap arrangements with Japan, Korea and China. These regional self-help measures are of strategic importance in maintaining future economic and financial stability in the region.

Actions for strengthening monetary policy will also be reinforced by a communications and dissemination strategy. Press releases and publication of monthly, quarterly and annual economic reports will continue. In addition, seminars, discussions and other events for educating the public on monetary policy and economic developments will be organized on a consistent basis. These actions are expected to strengthen monetary policy transparency in the eyes of the public and thus support actions to guide public expectations towards the prescribed inflation target.

Further measures in support of achievement of the inflation target and macroeconomic stability will be pursued through policy and strategic partnerships coordinated with the Government and other economic actors. Coordination and synchronisation of monetary, fiscal and sectoral policies has been established in

various coordinating meetings between Bank Indonesia and the Government. In addition, the Inflation Control Coordination Forum has been established for policy coordination in steering inflation towards target. The primary task of this forum is regular monitoring of inflation control-related activities. At the technical level, the work of the Inflation Control Team in support of securing the supply and distribution of major staple goods will be intensified through implementation of the inflation control road map. In a parallel action at the regional level, the role of the Bank Indonesia Regional Offices will be strengthened for empowerment and acceleration of local economic development and operation of local inflation control measures. Among these is the establishment of Regional Inflation Control Teams to coordinate actions between Bank Indonesia Regional Offices and relevant agencies. In the envisaged actions, inflation levels will be managed through coordination of comprehensive price controls at the central and regional levels designed to guide public inflation expectations towards the established inflation target.

Concerning the financial system, interagency coordination with Bank Indonesia has been pursued through establishment of the Financial System Stability Forum (FSSK). The objective of the FSSK is to strengthen and maintain financial system stability<sup>3</sup> through regular meetings. In 2008, the FSSK plans to finalise the Crisis Management Protocol and the Macro Early Warning System (EWS) while taking work forward on programmes under the initiatives in the Indonesian Financial System Architecture (ASKI).

### **Policy Direction for the Banking System**

In the area of banking, Bank Indonesia will continue pressing forward with the consolidation programme for a sound, strong and competitive banking system. Added to this will be further strengthening of the bank intermediary function to ensure that business financing needs are met without sacrificing attention to prudential banking. The policies for strengthening the resilience of the banking system consist partly of continuation of the banking consolidation policy, improvement of good corporate governance, customer education and the envisaged launching of Basel II. In further moves, the banking intermediary function will be reinforced through policy for promotion of productive business ventures,

<sup>3</sup> The financial system consists of the banking system, capital market, insurance companies and other financial institutions.

expanded credit to MSMEs, introduction of universal banking, optimized role for foreign-owned banks and exploration of possibilities for establishment of a policy bank. Rural bank development will focus on building rural banks as a pillar of strength for local economic activity with focus on local economic potential and social capital. This policy will involve such actions as mapping of the rural bank profile, strengthening of quality and competence in oversight of rural banks, capacity building for rural bank personnel and establishment of a centre of micro-financial institution studies. In other moves, Sharia banking policy will focus on various actions to accelerate the growth of the Sharia banking industry, including a public awareness programme, improvement in quality of human resources, product enrichment and finalization of three underlying laws: Sharia Banking, Taxation and Sharia Treasury Notes.

#### *Strengthening the Bank Intermediary Function*

The strengthening of the bank intermediary function will be pursued in several areas. First is technical guidance for productive business, which requires each bank to provide guidance to productive business actors within a specific region or sector with unrealized potential. One compliance indicator in this area is the ratio or portion of total credit and debtors with reference to a range of indicators, such as the comparison with consumption credit in the bank portfolio.

Second is promotion of economic development through micro, small and medium-scale credit, which involves four main policies. Commercial bank loans for MSME customers will be channelled through rural banks under the Linkage Program. This programme is organized for the reason that commercial banks have greater funding capacity than rural banks, but are constrained in their outreach to MSME customers by the limitations of their operating networks and analysis capability.

A loan guarantee scheme will also be established to support access to credit for feasible but not yet bankable MSME customers. This scheme involves regional governments, commercial banks and especially Regional Development Banks, relevant sectoral offices in the regions, Business Development Service Providers (BDSPs) and loan guarantee institutions.

There will also be a study of possibilities for reduction in the Risk-Weighted Assets calculation for People's Business Credit (KUR). With the backing of loan guarantees from Askrindo, risk-weighted assets may be lowered about 30%-40%. This reduction is also possible for credit guaranteed by insurance companies other than Askrindo, insofar as they satisfy requirements to be established at a future date.

Third is incorporation of universal banking into the Indonesian banking system to support financial market deepening. This will bring a positive contribution to financial stability and economic growth. Universal banking using the in-house model is planned for launching at end-2010, with the expectation that the amendment to the Banking Act will be finalized no later than the end of 2008.

Fourth is the policy for strengthening the bank intermediary function at the 49 commercial banks with majority foreign ownership (46% of total banking assets). This policy includes actions to promote higher quality lending by channelling funds to productive MSME ventures, promoting active involvement in training for productive business ventures in a particular region or sector and strengthening the role of these banks under the corporate social responsibility programme.

Fifth is exploration of possibilities for establishment of a policy bank, in view of the limited availability of long-term financing to support infrastructure development. The limited national budget funds for infrastructure projects and the long-standing predominance of short-term funds in the bank financing structure have kept financing for infrastructure projects at a relatively limited level. The funds mobilized by the policy bank will be channelled into various projects and long-term development programmes, with infrastructure an important focus.

#### *Strengthening Bank Resilience*

Actions for strengthening bank resilience will involve a range of policies. *First*, to establish the direction of bank consolidation, the criteria for High Performing Banks and Anchor Banks will be defined in a regulation. Added to this will be an audit of the effectiveness of the increase in bank capital to Rp80 billion.

*Second* is implementation of Basel II, covering Pillar 1 (minimum capital adequacy), Pillar 2 (supervisory review process) and Pillar 3 (market discipline). In Pillar 1, there will be an assessment of accurate use of internal models in the calculation of capital charge for market risk taking account of (i) general requirements, including the management of the bank risk management system; (ii) qualitative requirements, such as active oversight by the board of commissioners and board of directors, possession of internal validation standards and periodic internal audit of the use of the internal model; and (iii) quantitative requirements, such as daily calculation of Value at Risk (VaR) and use of data for one year (250 working days). For Pillar 2, the work programme for 2008 is still in the stage of translation of the four principles of the system for risk-based bank supervision. The implementation of Principle 1 (Internal Capital Adequacy Assessment Process – ICAAP) by means of clearer regulations to guide banks in the capital adequacy calculation, implementation of Principle 2 (Supervisory Review Evaluation and Process – SREP), Principle 3 (CAR above minimum) and Principle 4 (early intervention) will take place through improvements to the existing formal bank supervisory actions, including clarification of the regulation that supervisors may order banks to add capital commensurate to the risk profile. For Pillar 3, the work programme continues to be directed towards improvements to the bank published report framework in keeping with the approach used in Pillar 1 of Basel II and other international standards, including International Accounting Standards (IAS). The implementation of Pillar 3 will also be followed by broader outreach and intensification in the public education process.

*Third*, a circular letter was issued on Good Corporate Governance (GCG) on the technical guidelines for bank GCG, requiring banks with assets exceeding Rp10 trillion or publicly listed banks to implement GCG by the end of June 2007. Banks with less than Rp10 trillion in assets or not listed on the stock exchange are required to comply with the full GCG regulations by end of June 2008, so that in mid-2008, GCG will be fully implemented at all banks (self-assessment basis).

*Fourth*, the public education programme marked by the launching of Banking Education Year 2008 is aligned with efforts to promote financial deepening by

building public awareness of the benefits and risks of banking products.

*Fifth* is the Corporate Social Responsibility programme for the banking industry, aimed at providing strategic assistance in education.

#### *Rural Bank Development*

Rural bank development will aim at providing support for empowerment of local economic actors, the target and focus of their business. For this purpose, the redefinition and redirection of future policy for rural bank development will take place as follows:

*First*, move forward with the implementation of the rural bank blue print for strengthening the strategic role and contribution of rural banks as community banks in support of local economic development.

*Second*, prepare a stratification (grouping) of rural banks in order to optimize their role and contribution. This stratification is based on Tier 1 capital as appropriate to the capacity and risks carried by the rural banks and parallels the banking structure envisaged in the Indonesian Banking Architecture (API). In future actions, changes will be to the regulation and supervision system for different strata of rural banks.

*Third*, conduct research for mapping the rural bank profile based on capacity, customer needs and risks. It is envisaged that these issues will be identified according to rural bank strata, enabling solutions to be found. Furthermore, a comprehensive study will be performed for the rural bank regulatory policies and supervision systems commensurate to the capacity and risks of each strata of rural bank, which will be set out in the rural bank blue print.

*Fourth*, launch Rural Bank Apex institutions operating at the regional level. This will involve an awareness campaign for establishment of regional Apex institutions in other regions. Preparations will also follow for establishment of an Apex institution capable of operating on a national scale. Reflecting the results of an Apex pilot project and borrowing from best practices in some countries, the envisaged form of the national Apex institution is a commercial bank or unit of a commercial bank committed to operating as an umbrella for member rural banks with a policy commitment in MSME development.

*Fifth*, build the quality and competence of rural bank supervisors in keeping with advancement in rural bank products and services and to anticipate a range of cases involving rural bank operations.

*Sixth*, build the quality and competence of rural bank personnel to maintain competitiveness against other institutions offering MSME credit and strengthen rural bank capacity for financing productive sectors.

*Seventh*, found a micro finance institution with the aim of refining a range of measures undertaken by the Government and other parties in order to promote the economic development and empowerment of low-income populations in isolated regions and rural areas.

### *Sharia Banking*

The expansion policy for sharia banking for achievement of a 5% share of total banking assets will face challenges from limited capital, inadequately qualified human resources and thin service coverage. These challenges can be essentially addressed from two sides: the expansion policy pursued by the authorities and the expansion strategy on the part of banking institutions. For the authorities, the development policy includes regulation of establishment and office networks, operations and technical assistance. For banking institutions, the expansion strategy involves marketing approaches, provision and development of product variety and organizational management. Sharia banking policies will be guided as follows.

*First*, provide incentives or facilities to attract new investors, involving the establishment of an investor forum with stakeholders. This is envisaged as a move to bring added capital into the sharia banking system. Besides the establishment of the investor forum, an entry point for new investors will come with the finalization of the revised Taxation Act. At the same time, the upward trend in ROA and ROE among sharia banks is expected to stimulate entry by new investors.

*Second*, conduct public awareness campaigns for sharia banking to inform the public and encourage the use of sharia bank financial services. Public awareness campaigns will apply an approach stressing the advantages and unique characteristics of

banking operations that uphold the values of fairness, community and benefit. The campaigns will include public service advertising in various media and the organization of Sharia Economic Festival in the first month of the Islamic calendar year (Muharam).

*Third*, provide training for MSE business consultants and Sharia bank account officers to build understanding of the real sector. This is expected to pave the way for expanded financing by Sharia banks. The programme will involve government agencies, and in particular, regional governments, consultancy firms or educational institutions and companies with corporate social responsibility programmes targeting MSE development.

*Fourth*, broaden Sharia banking involvement in government projects, both in financing of government projects and opportunity for management of government sources of funds. In addition, the Sharia banking system will also be involved in a deposit insurance programme for MSE customers in cooperation with government agencies, banking institutions and guarantee institutions.

*Fifth*, issue or amend various regulatory provisions in support of accelerated growth of Sharia banking, among others with the completion of the Sharia Banking Act, the National Sharia Securities Act and amendment to the Taxation Act.

*Sixth*, strengthen human resources quality through technical assistance programmes for banks aimed at building competency and expertise, including certification for Sharia bank directors, cooperation with educational institutions in building the expertise of Sharia bank managers, curriculum recommendations and provision of literature on Islamic economics, finance and banking for higher educational institutions.

*Seventh*, enrich the selection of financial products and services offered by Sharia banks through preparation of a book codifying international sharia-compliant banking products with information on various Sharia bank products in the international community. This book is envisaged as a reference for domestic Sharia banks to broaden their financial products.

### **Policy Direction for the Payment System**

Payment system policy continues to focus on meeting public demand for payment instruments and services, supporting monetary and banking policy effectiveness and maintaining financial system stability. In the area of currency circulation, policy in 2008 will represent a continuation of the preceding year, built around three pillars: (i) increasing the circulation of secure, reliable and efficient circulation of currency, (ii) cash service excellence, and (iii) improvement in the quality of currency. In the area of non-cash payments, payment system policy will maintain a consistent focus on 4 (four) key principles: risk mitigation, efficiency improvements, equitable access and consumer protection.

The strategy for meeting demand for cash currency will involve the provision of currency in adequate quantities and outsourcing of currency distribution to third parties. To supply the need for currency, Bank Indonesia will arrange for procurement of 5.86 billion bank notes and 1.16 billion coins. The currency distribution strategy will be implemented through dispatch and return from Bank Indonesia Regional Offices receiving net inflow and expanded cooperation with transportation operators. The policy for primary level cash services will involve pilot implementation of cash centres and evaluation of outsourcing of cash services. To improve currency quality, Bank Indonesia plans to issue and circulate bank notes in the Rp2,000 denomination.

To ensure the reliability and operational continuity of the payment system while mitigating risks, Bank Indonesia is involved in ongoing testing of the main and backup systems at both the operator and among members.

Added to this, a study will examine the operation of foreign currency transfers using the payment versus payment (PVP) mechanism and progress in the funds transfer risk mitigation model at Bank Indonesia, accommodated into the Second Generation RTGS development. This is to anticipate growing interest among foreign investors in need of improved settlement efficiency in multi currency settlement within the expanded scope of cross border settlement. Parallel with the development of the Second Generation RTGS, development of the Second Generation BI-SSSS will accommodate the market need for securities transactions with government bonds and SBIs as underlying instruments, such as securities lending and borrowing and collateral management. To improve efficiency primarily in the retail payment system, the interoperability principle will be implemented in the card-based payment instrument industry. The principle of equitable access will be set out in the regulation specifying the system operating procedures, with emphasis on Bank Indonesia's position as regulator, operator and member. This regulation will also enable the operation of payment system functions by non-bank institutions. Alongside this, consumer protection will be strengthened through the introduction of a regulation on e-money and industry-wide application of rule on money remittances. To reinforce policy coordination between Bank Indonesia and the Government, the payment service infrastructure operated through the BIG-eB facility will be equipped with additional modules for rupiah transactions, foreign currency transactions and foreign currency transaction information. The BIG-eB facility will act as a support for the Treasury Single Account (TSA) mechanism slated for launching at all State Treasury Offices.

## Sensitivity of Indonesia's 2008 Balance of Payments to Changes in Oil Prices and Production Levels

Oil prices and production levels have an important bearing on the balance of payments, mainly in the oil and natural gas trade balance. The conclusion reached from simulations of changes in both assumptions in the 2008 balance of payments projection is that change in oil production exerts greater influence on the oil and natural gas trade balance compared to change in oil prices. Each 1 percent rise (fall) in oil prices will increase (diminish) the oil and natural gas trade surplus by US\$80 million. On the other hand, each 1 percent rise (fall) in oil production will increase (diminish) the oil and natural gas trade surplus by US\$248 million.

The change in the assumed oil price in the balance of payments forecast will be transmitted to Indonesia's oil exports and imports. In addition, movement in oil prices will also influence gas exports and imports, given the

inclusion of an oil price component in the formulation of the gas selling price. At the same time, the change in the assumed domestic oil production in the balance of payments forecast is transmitted to oil export and import volume. If oil production falls below the assumed level, export oil volume will decline and conversely import volume will rise<sup>1</sup>.

In this regard, the outlook for the 2008 balance of payments depends on such factors as the outlook for oil prices, which have recently surged, and the declining capacity of domestic crude oil producers in the past few years. The table below indicates the sensitivity of the oil and natural gas balance of trade when oil prices rise and production falls, both in comparison to the assumptions used in the 2008 balance of payments projection<sup>2</sup>.

**Table of BOP Sensitivity to Changes in Price and Oil Production to 2008 BOP Projection**

Detail	Impact on BOP (in million \$)		
	Price ↑ 1%	Production ↓ 1%	Price ↑ 1% Production ↓ 1%
Oil Transaction:			
– Oil Exports (fob)	136 ↑	-131 ↓	3 ↑
– Oil Imports (fob)	-190 ↑	-117 ↑	-308 ↑
Oil Trade Balance	-54 ↑	-248 ↑	-305 ↑
Gas Transaction			
– Gas Exports	134 ↑	0	134 ↑
– Gas Imports	–		
Gas Trade Balance	134 ↑	0	134 ↑
Oil & Gas Trade Balance	80 ↑	-248 ↓	-171 ↓

1 Assuming ceteris paribus, including but not limited to no change in domestic oil fuel consumption levels.

2 Note: the assumed price and production levels are averages over one year.

## Nine Measures for Securing the 2008 Budget

In recent developments, crude oil prices, domestic lifting of oil and escalating international commodity prices have swollen the 2008 Budget deficit. Crude oil prices steadily climbed since Q1/2007, reaching an average of US\$72.30 per barrel for 2007. At this level, crude prices were above the assumed US\$60 per barrel price used in the Revised 2007 Budget and the 2008 Budget. The surge beyond the assumed oil price has boosted the 2008 budget deficit mainly because of developments in the various parameters for calculating the subsidies for fuel and electricity billing rates, resulting in a soaring expenditure burden for the fuel subsidy and electricity subsidy. These parameters include the increased estimated quota for subsidized fuel consumption; increased proportion of fuel used in power generation; and failure to achieve the target for energy conversion from kerosene to LPG. In addition, oil lifting in 2007 reached only 899,000 barrels per day, below the 950,000 barrels per day assumption in the Revised 2007 Budget. In 2008, lifting is forecasted

at less than 1 million barrels per day, below the 2008 Budget assumption of 1.034 million barrels per day. In addition, the upward trend in some international prices for foodstuff commodities such as soybeans, wheat and corn, brought on by rising world demand and energy conversion, also carries the risk of expanding the 2008 Budget deficit through increased subsidies for these commodities to maintain domestic price stability. The combination of these factors could push the deficit in the Draft Revised 2008 Budget to 4.2% of GDP.

To address the risk of a spiralling deficit, the Government is adopting a series of policies for securing the Draft Revised 2008 Budget deficit level while reducing the burden to the public and sustaining growth momentum. The policies are set out in the Nine Actions for Securing the 2008 Fiscal Deficit Outcome, which provide fiscal incentives for the real sector and incentives for stabilization of foodstuff prices. The nine actions involve state revenues, state expenditures and

**Table 1**  
**Factors Escalating 2008 Budgets Deficits**

<b>Factors</b>	
Oil Price	Above \$80/barrel
Oil Lifting	Below 1 million barrel/day
Quota for subsidized Fuel Consumption	Up from 35,8 million kilo liter to 39 million kilo liter partly due to only 50% of the 2 million kilo liter target of conversion of kerosene to LPG was achieved and taking into account the high 2007 realization of fuel consumption (38,2 million kilo liter).
Food Subsidies	Higher subsidies allocation to rice for the poor program, cooking oil market operation and program for direct assistance to soybean cakes producers.
Package for Stabilization of Strategic Food Commodity Price	Partly including the lowering of rice import tariff; government covering for cooking oil VAT; lowering of flour import tariff; government covering of wheat and flour VAT; reducing of soybean import tariff; lowering of income tax on soybean import; increase of <i>bea keluar</i> CPO, biofuel
Tax Revenue	Reduction of non oil and gas income tax resulting from a lower 2007 realization than targeted in the revised 2007 budget that is applied as the base calculation for the 2008 budget and a lower economic growth assumption.

Source: Ministry of Finance, February 2008

**Table 2**  
**2008 State Budget Outlook With and Without Security Measures**

trillions of Rp

Explanation	State Budget 2008	State Budget without security measures	Security Measures	Revised Draft State Budget 2008	Changes
State Revenues	781.4	806.8	32.6	839.4	58.0
of which					
Non Oil & Gas Tax	550.3	534.3	20.4	554.7	4.4
SOE Dividends	23.4	23.4	8.0	31.4	8.0
Other Non Tax Revenues	37.6	39.1	3.4	42.4	4.8
State Expenditures	854.7	985.6	(59.3)	926.2	71.6
Central Government Expenditures	573.4	697.2	(55.8)	641.4	68.0
Line Ministries/Agencies Expenditures	311.9	311.9	(39.9)	272.1	(39.9)
Non Line Ministries/Agencies Expenditures of which	261.5	385.3	(16.0)	369.3	107.8
– Fuel Subsidies	45.8	116.2	(10.0)	106.2	60.4
– Electricity Subsidies	29.8	65.0	(10.0)	55.0	25.2
– Non Energy Subsidies	22.3	39.5	7.9	47.4	25.1
Transfer to Regions of which	281.2	288.3	(3.5)	284.8	3.6
Oil and Gas Profit Sharing Fund	23.6	28.5		28.5	4.9
Infrastructure Fund	4.6	4.6	(4.6)	0.0	(4.6)
Budget Deficit	(73.3)	(178.8)	91.9	(86.8)	(13.5)
(Share to GDP)	(1.7)	(4.2)		(2.0)	(0.3)
Budget Financing	73.3	71.2	15.6	86.8	
Domestic Financing	90.0	90.3	13.9	104.2	
Foreign Financing	(16.7)	(19.1)	1.7	(17.4)	

Source: Ministry of Finance, February 2008.

deficit financing. The fiscal incentives extended to the real sector include expansion of the scope of sectors benefiting from income tax incentives (Government Regulation No. 1 of 2007), reduced income tax rates for companies listing on the stock exchange and fiscal facilities for specified sectors (including tax and import duty incentives for investment in oil, natural gas and geothermal production and in capital goods not produced in Indonesia). The Government will also maintain budget support for the infrastructure programme, albeit with a reduction from Rp4 trillion in the 2008 Budget to Rp2.8 trillion in the Draft Revised 2008 Budget.

These actions will enable the Government to keep the Draft Revised 2008 Budget deficit at a level consistent with fiscal sustainability while still contributing to the real sector. Accordingly, the Government expects to control the deficit in the Draft Revised 2008 Budget to

2% of GDP, representing an increase of Rp14 trillion over beginning of year target of 1.7% of GDP. This enlarged deficit will also be accompanied by growth in Government consumption and investment, although at a slowing rate. Budget cuts for line ministries and agencies will result in slower growth in Government consumption and investment compared to initial targets. On the other hand, transfers to the real sector will run ahead of target due to rising subsidies. The increased subsidies are expected to sustain public purchasing power and domestic demand to offset slowing growth in Government consumption and investment. On the financing side, constraints in deficit financing sources mean that the increased deficit will be followed by greater volume of T-Note issues compared to the plan at the beginning of the year. Neither of these are expected to disrupt the outlook for fiscal sustainability, given the surplus in the primary balances and the ongoing decline in the official debt ratio.

**Table 3**  
**Nine Measures for Securing the 2008 Budget**

<b>A. Revenue Optimization</b>	
1. Optimization of Tax, non tax revenues and SOE dividends	• Adjustment to Fixed Income Tax tariff: 30% for corporate, 35% for individuals
	• Intensifications of tax for “booming” sector (mining and plantation)
	• Intensification of excise revenues
	• Additional export tax for CPO and its derivatives
	• Export tax for mining products (coal, gold, nickel, tin)
	• Interim dividend from SOE (Pertamina and Non Pertamina)
<b>B. Expenditure Savings</b>	
2. Use of Budget Reserve Fund	• Policy measures in other expenditures
3. Savings and Prioritization of Line Ministries/Agencies Expenditures	• 15% deduction from Line Ministries/Agencies Expenditures (Minister of Finance Decree No. S-1/MK 02-2008 dates 2 January 2008)
	• Elimination of infrastructure Adjustment Fund
	• Savings in Line Ministries/Agencies project loan
4. Improvement of Fuel and Electricity Production and Consumption	• Optimization of oil production/lifting; tax and excise tax incentives had been provided to the investment/exploration of oil and geothermal; 2008 oil lifting higher than 2007 realization
	• Conversation program from kerosene to LPG can be carried out by eliminating operational barriers, provision of infrastructure and regional licensing
5. Energy Conversation and Efficiency Program in Pertamina and PLN	• Fuel subsidies: alpha lowered by 1% from 13.5% to 12.5%; limitation on subsidized premium and solar consumption through the use of smart card and kerosene consumption through the use of a control card
	• Electricity subsidiaries: 5% alpha for the sale price of High Speed Diesel from Pertamina to PLN; PLN network loss maintained at 11.4%; electricity subsidiaries savings through incentives and disintensives; as certain a 27% maximum on the ratio of fuel use for electricity generator
<b>C. Widening of Deficit and Optimization of Financing</b>	
6. Use of Windfall Gains in Oil and Gas Producing Regions through the Use of Debt Instrument	• Cash Surplus of oil and gas producing regions placed in risk-free instruments such as between government securities.
	• To save on intermediation cost, regions directly purchase SBN and directly gain the benefits.
7. Widening of deficit through bond issuance, optimization of program loan and acceleration of investment fund repayment.	• Upsizing of sharia bonds (government sharia securities), indonesia retail bonds and treasury notes
	• Optimization of program loan
<b>D. Price Stabilization Program</b>	
8. Reduction of Tax burden on strategic food commodities.	• Rice : lowering of import tariff ( Rp550/kg to Rp450/kg)
	• Cooking Oil : Continuation of and widening of coverage of government borne VAT; application of export tax to CPO above \$1050, biofuel and other CPO derivatives.
	• Flour : lowering of import tariff; VAT for wheat and flour under government coverage.
	• Soybean : lowering of import tariff (10% to 0%); lowering of income tax for soybean import (2,5% to 0,5%).
9. Additional food subsidies.	• Increasing volume of rice for the poor for targeted households, 5 kg per poor households.
	• Continuation of cooking oil market operation.
	• Direct Assistance to soybean cake producers.

Source: Ministry of Finance, February 2008.

# Moving Towards Quality, Sustainable Economic Growth: Opportunities and Challenges

Quality, sustainable economic growth is a vital prerequisite for building a more prosperous society. In terms of potential, Indonesia's geographical and demographic conditions offer fertile ground for high growth, supported by abundant natural resources and a large workforce. Indonesia's huge population also underpins the enormous potential of the domestic market. In addition, the open Indonesian economy offers wide open opportunities for imports and exports and for tapping capital inflows. However, this vast growth potential cannot yet be harnessed for optimum benefit. During the last 5 years, economic growth was still hovering around 5% per annum, the long-term growth trend<sup>1</sup> for virtually the last three decades. At this level, growth is far from sufficient to absorb the ever expanding workforce. The issue of low absorption into the workforce is exacerbated by the deteriorating elasticity of economic growth towards employment. At the same time, inflation, while being brought more under control, still runs at an average above the pre-crisis level while also registering higher volatility.

The marks of quality, sustainable economic growth are a high growth rate accompanied by low, stable inflation, with new employment exceeding the growth of the workforce. How does an economy achieve this? In growth theory, analysis of sources of growth lead to an evaluation of the production side of the economy, which involves study of the adequacy and efficiency of input factors in production processes. In simple terms, in the long run it is only expanded production capacity in an economy that will bring about higher economic growth. In the short run, it is possible for a growth surge to be driven by increased aggregate demand. However, in the long run, only demand-side growth matched by supply-side expansion will enable the economy to achieve higher growth without sacrificing price stability.

1 The long-term trend was obtained by calculating average economic growth for the Q1/1981 to Q2/2007 period. For full information, see "Economic Structure and Implications for the 2008-2009 Inflation Target," Affandi, Yoga (2007).

Furthermore, expansion of production capacity is also expected to create greater demand for labour, which will increase employment.

Going from there, the question arises as to whether in the next five years the Indonesian economy will be capable of growing beyond the current level of long-term growth? Is this direction supported by developments in production factors?

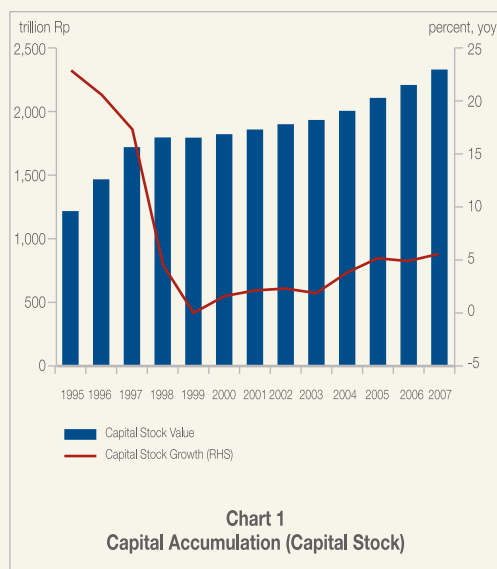
## Developments in Growth Production Factors

The condition of economic capacity is showing an improving trend, although still far short of the conditions preceding the economic turmoil of 1997-1998. In the aftermath of the crisis, capital accumulation began to improve, despite some levelling in 2005 due to the slowdown in economic activity in the wake of the fuel price hike. The increased capital accumulation is borne out by indicators of improved efficiency in use of capital. This is reflected in the downward trend in the ICOR since 2004 (see Chapter 2, Macroeconomic Conditions). However, the efficiency gains in use of capital are thought to be driven more by higher production capacity utilisation taking advantage of existing under used capacity.

Unfortunately, these gains on the capital side have not been supported by improvement in worker productivity. Growth in the workforce<sup>2</sup> has not been matched by improvement in human capital, as reflected in stagnant worker productivity<sup>3</sup> at the national level (Chart 2) and lack of significant improvement in the proportion of educated workers since the crisis. Added to this, educated workers are still concentrated in particular

2 As of August 2007, the workforce had expanded by 3.55 million workers from one year earlier.

3 Calculated with the ratio of output value (Rp millions) to workers. For full information, see Working Paper, "Sectoral Growth, Strategy for Quality Economic Growth," Permata, Meiliy (2007) and Research Notes, "Studying 2007 Economic Growth, Review from the Production Side," Yanuarti, Tri and Kurniati, Yati (2007).



sectors, namely the financial sector, electricity, gas and water utilities and the services sector.

### Indonesia's Medium-Term Economic Outlook: Can Growth Rise Above the Long-Term Trend?

To answer this question, it is necessary to examine the factors that have a role in long-term economic growth. According to the Formel-G model<sup>4</sup>, long-term economic growth is driven by four major factors: population growth, ratio of investment to GDP, human capital and trade openness.

Data reveals that the post-crisis ratio of investment to GDP (average only 21% in 2003-2006) was well below the pre-crisis level. The low level of investment is one reason for the low post-crisis economic growth rate. In regard to trade openness, Indonesia is in a better position to seize advantage from the open global economy, as reflected in the significant rise in the ratio of exports and imports to GDP from 27% (1993-1996) to 38% (2003-2006). Concerning population growth, the high growth rate has unfortunately not been matched by improvement in human capital.

Referring to the growth formula in the Formel-G model, there is still chance of achieving higher medium to long-term growth as long as Indonesia is able to keep improving the investment to GDP ratio, strengthen external performance and build human capital.

Increased investment must be supported by a conducive investment climate. It is true that in the short-term, investment activity can be stimulated solely by domestic demand. However, without improvement in the investment climate, investment activity becomes almost impossible to sustain over the long-term. The Global Competitiveness Report 2007-2008 reveals that the investment climate remains the most problematic factor in conducting business in Indonesia. For this reason, the agenda for improvement in the investment climate is a key prerequisite for future economic development. The combination of large market potential and a healthy investment climate will stimulate FDI. Inflows of FDI will not only result in expanded business capacity, but also bring in new technology and innovations that will ultimately strengthen the productivity of the economy<sup>5</sup>. Growth theory states that long-term sustainable economic growth can only be created through improvement in TFP, while the contributions from capital accumulation and human resources will ultimately lessen due to the decline in incremental productivity in the two factors. Besides more robust TFP, human capital is also assumed to see significant improvement, and thus the human contribution to production processes will also increase.

Indonesia's economic outlook is closely linked to forecasts for world economic developments. World oil prices are predicted to subside as more supply

4 Formel-G: Foresight Model for Evaluating Long-term Growth, developed by Deutsche Bank Research, 2005.

5 Dollar et. al. 2003 offers empirical proof of the linkage between the quality of the investment climate and growth through improved TFP (productivity).

	2007	2008*	2009*	2010*
Growth of Components (%)				
Gross Domestic Product	6.3	6.2	6.2-6.8	6.8-7.4
– Private Consumption	5.0	5.4	5.6-5.9	5.6-6.0
– Government Consumption	3.9	3.8	4.0-5.0	7.0-9.0
– Investment	9.2	9.3	10.5-10.8	11.0-13.0
– Exports of Goods & Services	8.0	7.9	8.1-9.1	10.5-11.5
– Imports of Goods & Services	8.9	9.4	10.4-10.7	12.5-13.5
Others				
Income per Capita (\$)	1.947.1	1980-2005	2145-2180	2375-2410
Unemployment (%)	9.1	9.0-10.0	9.0-10.0	8.5-9.5
Inflation (%)	6.4 <sup>1)</sup>	6.0-6.5	4.5±1% <sup>2)</sup>	4.0±1% <sup>2)</sup>

\* Bank Indonesia Projection

1) Yearly Average

2) Inflation Target

comes on stream. Domestically, relaxation in world oil prices will ease pressure on fiscal conditions, affording the Government opportunity to refocus on maintaining fiscal sustainability. Reflecting this will be a steady reduction in the fiscal deficit. These actions provide assurance of added reinforcement of macroeconomic stability. With oil prices on the way down, a fairly upbeat outlook for world demand<sup>6</sup> also promises considerable headroom for export growth. This improvement in external capacity is also supported by increased investment in machine capacity expansion. Stronger FDI in line with improvement of the investment climate will also provide a safety valve for the overall condition of the balance of payments, and as a result, the exchange rate will remain on a stable trend. The synergy between exchange rate stability and supply-side improvement will provide greater room in capacity utilisation, which in turn will engender a steady downward trend in the inflation outlook and promote private consumption. If these various assumptions hold, the Indonesian economy could be pushed to approximately 8% growth within the next three years.

## Policy Implications

The above scenario analysis leads to the conclusion that the Indonesian economy can be taken to a higher level in the future as long as various prerequisites can be met, such as higher investment to GDP ratio and improvement in human capital. The commitment and hard work of all stakeholders will be essential to this objective. Essential policies for achieving higher economic growth are:

- **Macroeconomic Policy (Monetary and Fiscal)**

Monetary policy will stay a prudent, consistent course in order to safeguard macroeconomic stability. Fiscal policy will be directed towards improving the condition of infrastructure, refinement of the education programme and monitoring the effectiveness of education budget expenditures. The refinements to the education programme are aimed at strengthening human capital. Besides these actions, it is necessary to bolster fiscal and monetary coordination so that policies are complementary (mutually supporting) and not substitutionary (mutually obscuring).

- **Microeconomic (Sectoral)**

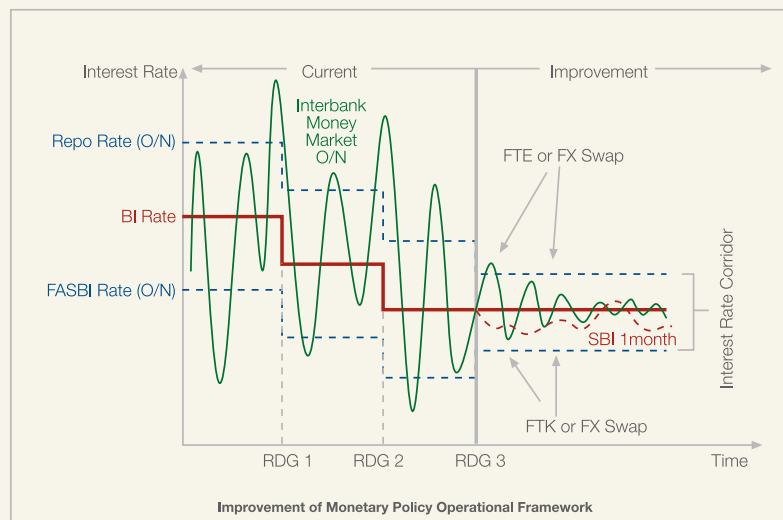
Policy Construction of infrastructure is key to accelerating the pace of activity in the real sector. Good infrastructure will ensure the smooth flow of capital goods and inputs in order to support smoothly operating production processes capable of flexibly responding to market demand and ensuring expeditious distribution of commodities and industrial products. In addition, revamping of government institutions related to supply-side improvements must also be given high priority. These improvements are related to investment (licensing, security and certainty of business), human capital development (skills, education and health), production efficiency and productivity.

<sup>6</sup> The WEO Update for January 2008 downgraded the world economic growth forecast from 4.9% (WEO October 2007) to 4.1%, but this decline is predicted to take place mainly among developed nations.

# Improvements to the Monetary Policy Operational Framework

An interest rate-based monetary policy operational framework has been implemented under the Inflation Targeting Framework since early July 2005. Over time, changes have been necessary to the implementation of the framework for better adaptation to current developments. In 2008, improvements will emphasise the operational aspects of monetary policy. As formally explained by the Governor of Bank Indonesia at the annual bankers' dinner, these improvements take into account the magnitude of daily fluctuation and steep short-term yield curve on the money market. These conditions lead to uncertainty in both liquidity and interest rates, and encourage the proliferation of transactions aimed solely at profiting from short-term interest rate differentials. This is not a conducive environment for financial institutions to manage assets over a longer-term horizon<sup>1</sup>.

In addition, the underlying thought in improvements to the monetary policy operational framework is that a properly functioning, efficient interbank money market is essential to the effectiveness of the monetary policy transmission mechanism for influencing the formation of longer-term yield curves relevant to economic activity in the real sector. In this regard, monetary policy operations will focus on implementing the monetary policy stance (BI Rate) on the money market. Within this context, Bank Indonesia will maintain stable rates on the overnight interbank market at a level consistent with the BI Rate<sup>2</sup>. This is not in any way intended to modify the policy stance reflected in the level of the BI Rate<sup>3</sup>.



1 Keynote Speech by the Governor of Bank Indonesia at the Annual Bankers' Dinner, 18 January 2008.

2 "Monetary policy operating framework establish the means by which central banks implement the desired monetary policy stance ... the liquidity management operations that support the stance by seeking to ensure that a short term market rate is consistent with the policy rate." (Borio, Claudio and William Nelson, BIS Quarterly Review, March 2008).

3 The BI Rate is set in the monthly Board of Governors' Meeting and changes only when Bank Indonesia sees movement in indicators that demand a response to safeguard achievement of the inflation target.

On a technical level, the fine tuning of the monetary policy operational framework will take place through liquidity management operations on the money market. To achieve this, Bank Indonesia will bring into operation a range of regular and non-regular OMO instruments, supported by standing facilities. The regular OMOs will be conducted using instruments with a broader range of maturities (1, 3, 6 and 9 months), traded with the variable rate tender mechanism. Accompanying this will be non-regular OMOs involving fine tuning operations (FTOs)<sup>4</sup> and FX swaps at the discretion of Bank Indonesia. Overnight standing facilities will operate as second-tier instruments. These will consist of standing deposit facilities and standing lending facilities that will form a narrower interest rate corridor compared to the present, established in symmetry with the BI Rate<sup>5</sup>. These liquidity management tools will operate with or without the use of securities as underlying assets. These securities may comprise SBIs or other instruments, such as government securities<sup>6</sup>.

The existence of a more diversified range of monetary instruments and their underlying assets will also support the financial market deepening process. The issuance of SBIs with tenors beyond 1 and 3 months will not only absorb structural excess liquidity, but also strengthen the effectiveness of liquidity management in the banking system. A further benefit is that the longer tenor instruments will be conducive to pricing of other short-term financial assets and banking products. At the same time, the use of Government Securities<sup>7</sup> will boost activity and liquidity, thus strengthening the resilience of the Government Securities market in the face of potential shocks. The FX Swaps are an OMO instrument designed to assist liquidity management on the rupiah money market.

In practice, the improvements to the monetary policy operational framework will involve measured, phased actions. To this end, communications with stakeholders will be intensified through various forums and media. At a suitable time, Bank Indonesia will publicly announce the full implementation of these improvements, taking account of various factors reflecting the readiness and stability of the money market.

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4 May be contractionary or expansionary with a tenor of 2-14 days.

5 Press Release, Keynote Speech by the Governor of Bank Indonesia at the Annual Bankers' Dinner, 18 January 2008.

6 Since 21 January 2008, there has been more intensive use of FTOs. In early February 2008, the SBI auction system was changed back to a fully variable rate tender system with weekly auctions for the 1 and 3 month tenors. Window time for standing facilities was changed to 15:00-17:00 for SBI Repos and the FASBI. In addition, underlying assets for repo transactions were expanded with 100% ceiling for SBIs and government securities.

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7 In repo transactions.