Budi Mulya: Investment opportunity in Indonesia – looking toward a better future

Keynote speech by Mr Budi Mulya, Deputy Governor of Bank Indonesia, at the New York Society of Security Analysts (NYSSA) seminar, New York, 15 April 2010.

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Let us start by expressing our gratefulness to the God almighty. I'm very proud and honor to be here today and have all the opportunity to share with you. For that reason, let me deliver my sincere gratitude to my fellows NYSSA, speakers, my colleagues in Indonesian Embassy and Bank Indonesia Representative Office, as well as to you all of being here today and make this happen.

Distinguished guest, ladies and gentlemen

Indonesia is a rich country and proven to earn a strategic position and potentials across the region and the world. Shares borders with Malaysia, Papua New Guinea, East Timor, Singapore, Malaysia, Philippines, and Australia, Indonesia is a big archipelago with 17,508 islands scattered over the length of 741,050 sq mi or almost at the same distance between California to Maine. Indonesia's size, tropical climate and archipelagic geography offer rich and extensive natural resources and support the world's second highest level of biodiversity right after Brazil. Indonesia also records as the world's fourth most populous country as well as a huge consumption base as the population reaches around 231 million people by 2009 and is expected to grow to almost 300 million by 2050. Almost 45 percent from almost 114 million workforces are in agriculture sector, with the remaining employed in the expanding manufacturing industry, mining, and services.

Indonesia is also the largest economy in Southeast Asia and a member of the G-20. In 2009, Indonesia's nominal GDP reach almost US$515 billion with nominal per capita GDP was US$2,590, and per capita GDP PPP was US$4,150. All together, the tertiary sector is the economy largest and accounts for about 45% of GDP proving the strong character of a domestic driven economy. Major industries include petroleum and natural gas, textiles, apparel, and mining while major agricultural products include palm oil, rice, tea, coffee, spices, and rubber. Indonesia is also an open economy with a sizable trade surplus in 2009, consisting of export revenues of almost US$120 billion and import expenditure of about US$84 billion with Japan, United States, Singapore, and China as our main trading partners.

Nonetheless the story is not always wonderful. After enjoying a period of high economic growth, the 1997–98 financial crises brought out structural consequences in the domestic financial system and governance, damping investment, and private sector development. As a result, the average annual growth 4–5% since the 1997–98 crises is not sufficient to significantly increase per capita income, accommodate the increasing number of new entrants in the labor market, and reduce poverty. Similarly, the current investment share of about 25% of GDP is still too far to achieve the pre-crisis growth average of 7–8% when investment shares were more than 30%.

On that account, creating new jobs by encouraging investment is very essential for us. This is a daunting challenge, given the many structural impediments concerning the macro fundamentals, governance and institutions, and infrastructure in the economy. All of these lessons emphasize us the urgent need for an improvement in the overall investment climate. Measures have been taken and significant progress has been achieved in the last five years. The recent *World Investment Prospect 2009–2011*, UNCTAD, for instance, reported Indonesia ranks number 9 of 15 countries as the most prospective investment destination by foreign investors. A number of key factors of Indonesia's attractiveness for investments include growth prospects and market size, access to natural resources, and relatively competitive labor costs.

Distinguished guest, ladies and gentlemen

Today, Indonesia has emerged a very different country compared with a decade ago. It has embarked upon a far-reaching institutional transformation and has become one of the region's most vibrant democracies. The first stage of this transformation, from 1998 to 2003, was a period of political and economic change, characterized by democratization and decentralization of government. Indonesia's almost 500 provincial, district and city governments now undertake nearly 40 percent of public spending. Despite obstacles it brought, decentralization contributed to the consoling of regional conflicts and promotes political stability as well as offers an emerging more vibrant spatial geographic distribution of economic development throughout the country. The second stage, from 2004 was a period of democratic institutions consolidation as well as returning to political and macroeconomic stability, most notable in Indonesia's first direct presidential elections and in its debt levels falling to below 35% of GDP[1].

Among others, the Government has taken steps to address different aspects of the investment climate through policy reform packages covering key areas of concern of private investors, such as taxes, customs, investment frameworks, and the financial sector. On the institutional transformation, the Government is working to set up the institutional framework, coordinating mechanisms and enhancing governance. On the provincial side, a number of sub-national governments have undertaken major reforms of their public sector systems, introducing among others performance-based budgeting and one-stop public services. The legal arrangement is also directed to improve investment climate, both directly by promulgating Investment Law No. 25 of 2007 and indirectly by imposing open capital account through promulgating Law No. 24 of 1999. The later is set up to improve the financial infrastructure to support capital inflows, both for direct investment and portfolios.

To enhance macroeconomic stability, government and so does the monetary authority works hand in hand and commits to enhance fiscal and monetary discipline as well as strengthening the financial architectures. Learning from the failure of 1997–1998 crises, our policies were focused on enhancing policy transmission, improving financial market efficiency through prudential practices and financial market deepening. To this point forward, the Government was improving their capacity on fiscal budgeting, to be more specific, the adoption of active debt and cash management. They are also fully committed to improve fiscal sustainability by reducing debt to GDP ratio. Steps were also taken in the area of monetary policy framework. Since 1999, Bank Indonesia was mandated to achieve single objective of price stability, both in terms of inflation and the exchange rate and at the same time was given independency on our policy conduct. In 2005, Bank Indonesia has fully adopted Inflation Targeting Framework marked by the introduction of BI Rate as the policy rate to increase the policy effectiveness in achieving the inflation target set by the Government. In 2008, further enhancement has been done in the area of monetary policy implementation by the introduction of overnight interbank rate as our operational target to improve the effectiveness of the monetary policy.

Institutional reform in the financial sector has been done by improving the soundness and efficiency of the financial market through the combination of imposing prudential practices and enhancing market deepening. Financial sector reforms are crucial to raising Indonesia's growth rate and enhancing the economy's resilience. In banking industry, reform is conducted by strengthening bank's capital, introducing risk management practices and

[1] World Bank, Investing in Indonesia's Institutions for Inclusive and Sustainable Development, 2008.

governance, and not to mention improving supervisory capabilities. These were done by adopting Basel core principles and promoting mergers and acquisitions. The same reforms have conducted in the capital market, debt market, as well as non-bank financial institution. One of the most important breakthroughs can be observed in the development of the debt market following the issuance of marketable government bond in 2002, which is not only useful to deepen the financial market but also significantly reduced the need for foreign financing and thus increase the economic resiliency.

Distinguished guest, ladies and gentlemen

Strong commitment to reforms has yielded a progressive and more resilient fundamental performance, especially in the last five years. Indonesia resumed higher levels of growth and has re-emerged as a confident middle-income country as well as increasing regional and global standing as the world's strongest economic performers close to those of India and China. Indonesia's economic growth accelerated to a 10-year high and proven to be robust during the wake of the 2008–2009 global economic crisis. Real GDP has been growing at 5 to 6 percent annually since 2002 and, in 2009 per-capita real GDP exceeded the level reached in 1997, immediately prior to the Asian crisis. The legacy of Government's prudent fiscal management and a strategy of fiscal consolidation have contributed to the significant reduction in government debt levels, which are estimated to fall to 31.5% by end-2009. Investment share to GDP is improving though is still below pre-crisis levels. In 2009, Indonesia's was 23% of GDP, or significantly improves from 19 percent of GDP in 2002 signaling a structural improvement on the business climate. Increasing efficiency on the institutional framework as well as strong fiscal and monetary discipline has also been able to reduce inflation markedly and so does the exchange rate. In the financial sector, the banking sector, which account for about 80% of the financial industry's assets, is in sound shape and is relatively unexposed to developments in troubled financial markets elsewhere. Indonesia has a well-developed and well-regulated banking sector and has made major advances over the past five years in establishing a sound legal and administrative framework for the modernization of public financial management in line with good international practice.

On the last April 2nd, 2010, OECD upgrades Country Risk Classification (CRC) ranks of Indonesia from the previous level of 5 to 4. Indonesia was the only country of the 161 countries, given the CRC upgrade in the latest OECD committee meeting session on April 2010. The main factor supporting the upgrades is Indonesian impressive macroeconomic indicators as the economy is one of the most resilient amid the global financial crises and Indonesia is one of the few countries that experienced positive economic growth in 2009. Improvement in macroeconomic performance and economic stability is the result of a combination of good and forward looking economic policy, ongoing structural reforms, as well as good debt management. Prior to this upgrade, on March 12, 2010, Standard and Poor's also upgraded Indonesia long-term foreign currency rating to BB (from BB–) and long-term local currency rating stays at BB+. Outlook for both are "positive". The upgrade was also observe in the rank of global competitiveness as publicized by the World Economic Forum. On the 2009–2010 Global Competitiveness Index, Indonesia rank was increasing to 54 from previously 72 in 2003. The upgrade would certainly put Indonesia in a better position before its creditors in negotiating, particularly export credit creditors.

During the 2008–2009 worldwide contraction, Indonesian economy still enjoyed a positive growth of 6.0% in 2008 and 4.5% in 2009 and held by high and inclusive growth of domestic demand, particularly consumption. Indonesia is less exposed to external shocks than other economies in the region as its trade share to GDP is relatively small at about 50 percent of GDP. Inflation is moderated and achieved year-on-year increases of only 3.4% in March 2010 held by adequate supply responses and rupiah exchange rate appreciation. As a result, the unemployment rate fell back from 11% in 2005 to 7.9% in 2009. This development supports the fall of the poverty rate that has fallen by about one percentage point per year since 2003 and reached 15 percent in 2009. On the external balance, balance of payments is strong and achieved a current account surplus of US$10.5 billion and capital account surplus of US$2.3 billion in 2009. This has contributed to a sizeable accumulation of official international reserves, which to date approached US$71.8 billion in March 2010, providing Indonesia with a cushion against external shocks. Strong fundamentals have been proven as the key cushion to the adverse impact of global economic downturn and quickly revive market risk appetite toward Indonesian asset classes. The exchange rate has been appreciated about 24% at Rp9090 per US$ by the end of March 2010 from its weakest level of Rp12,020 per US$ in February 2009 on the back of net foreign capital inflows. Constraint on liquidity following the recent global credit squeezing has been recovered as the counterparty risk revived quickly and the market spreads narrowed.

Indonesia's economic outlook is favorable. Growth is projected to reach the upper level of 5.5–6.0 percent range in 2010, rise to 6.0–6.5 percent in 2011 and is expected to gradually returning to trend growth rates approaching 7.0 percent thereafter, on the back of the upturns in export growth following ongoing global economic recovery as well as investment acceleration. Investment is expected to grow 9 percent in 2010 and rise even faster by 11 percent in 2011 on the back of higher public capital spending on infrastructure that driven better private investment and lower risk premium. On the fiscal side, Indonesia has been able, through prudent fiscal policy, to bring its public debt to GDP ratio lower. Projections indicate that this trend is likely to continue. Inflation will continue to moderate and is likely to be at the lower end of its target range of 5%±1% in 2010 and 2011 as the output gap is still wide enough to response to the acceleration in demand side and supported by stable rupiah exchange rate. In the medium term, inflation is expected to converge to its regional average at 3.5–4.0%. On the external side, current account and capital account is expected to continue in surplus of US$5 billion and US$ 8 billion consecutively, support the continuingly surplus balance of payments and drive to higher international reserve. Favorable development on the fundamental sides along with ample market liquidity will maintain stability on the financial market especially in banking industry i.e credit will grow of 17–20% in 2010, along with high CAR around 19% and subdued NPLs below 5%. Well maintained macroeconomic fundamentals, strengthening external liquidity position, gradually declining government debt ratio, supported by prudent fiscal policy and smooth implementation of structural reforms, is expected to sustain higher economic growth in the coming years to keep the positive momentum for further rating improvement.

Distinguished guest, ladies and gentlemen

Despite these achievements, new challenges are waiting in front of us and hence much progress is still needed. The main constraint for Indonesia's economic development is to translate the available resources into better outcomes. Delivering better development outcomes now depends largely on improving government effectiveness through strengthening accountability and capacity at all levels, as well as ensuring that much of future growth is driven by private sector development[2].

There are much to be done in the area of resource allocation, incentives system, and transparency. Investment rates are improving, but are still below pre-crisis levels. The Government has taken steps to address different aspects of the investment climate through policy reform packages but several challenges remain. Institutional capture is a major obstacle in this area, with many reforms still to be implemented effectively and evenly on the ground. Improving the quality of Indonesia's infrastructure is another essential aspect of strengthening Indonesia's competitiveness and we are still work on it with full commitment. As far as recent development and prospect of the economy, challenge emerge as the global

[2] World Bank, Investing in Indonesia's Institutions for Inclusive and Sustainable Development, 2008

recovery process makes is still highly uncertain and will determine the degree to which Indonesia's growth accelerates in 2010 and beyond.

I believe that the future success will depend on improving the policy conduct and quality of our institutions, particularly the public sector. Our top priority is to maintain stability as well as increase the resiliency of domestic financial market from possible liquidity shock. Our policy will always be directed consistently on achieving medium term inflation target and thus promote macroeconomic stability.

For sustainable growth, Indonesia will have to ensure effective implementation of key reforms to the investment climate to both permits the private sector to drive growth and to increase public institutions capacity. On my view, access to financial services should be enhanced through a well-functioning and deep financial market. The later is needed to facilitate and promote longer term investment, maintain markets confidence especially on short-term investment, and thus prevent the economy from sudden reversal. This can be done by improving market efficiency through prudent practices of the market players, existence of liquid market, strong liquidity risk management, and wider-range financial instruments including hedging instruments. The presence of credible credit information system is also needed to lessen credit risks and lowers borrowing costs. Against this backdrop, we are committed to improve regulatory quality, the rule of law, and good governance through accountability and enhancing institutional capacity.

Distinguished guest, ladies and gentlemen

Building on its existing economic and political fundamentals, Indonesia today has the opportunity to create this virtuous cycle of sustainable and inclusive growth. Overall, Indonesia has a strong willingness to improve the condition. I am very optimistic to the direction of Indonesian economy ahead and expect you all would share the same few. Before I end up my remarks, I would like to deliver my sincere gratitude to all distinguished speaker Mr. John Chambers, Dr. Richard Clarida, and Mr. Russell King, who has dedicated their valuable time to share with us today, and for that reason, let's us proceed to the Seminar and have a fruitful discussion.

God bless you all.

Indonesia 2005-2011 - Key Macroeconomic Indicators and Projections

Indicators	Actual					Projection	
	2005	2006	2007	2008	2009	2010	2011
Real GDP Growth (% annual, yoy)	5.7	5.5	6.3	6.0	4.5	5.6	6.0
Export (US$ bn)	87.0	103.5	118.0	139.6	119.6	140.0	151.9
Imports (US$ bn)	69.5	73.9	85.3	116.7	84.4	106.6	121.4
Current Account Balance (US$ bn)	0.3	10.9	10.5	0.1	10.5	5.1	-0.4
Budget Deficit (% of GDP)	-0.5	-0.9	-1.7	-0.1	-1.6	-2.1	-1.9*
Inflation (% change, yoy)	17.11	6.60	6.59	11.68	2.78	4.80	5.50

* Bank Indonesia Assumption

Source: Central Bureau Statistics and Bank Indonesia Projections

Indonesia's external debt 2005–2009

	2005	2006	2007	2008	2009
ST Debt to Total Debt Ratio	17.7%	15.6%	19.5%	19.0%	18.3%
ST Debt to Reserve Ratio	68.6%	48.5%	48.3%	57.1%	47.9%
Debt Service Ratio	17.3%	24.8%	19.4%	18.1%	22.7%
Debt to Export Ratio	124.3%	107.2%	100.3%	93.5%	121.4%
Debt to GDP Ratio	46.5%	35.9%	32.2%	30.1%	31.5%
ST MATURITY (in USD million)	23,838	20,641	27,493	29,512	31,666
TOTAL DEBT (in USD million) 1/	134,504	132,633	141,180	155,080	172,871
RESERVE(in USD million)	34,724	42,586	56,920	51,639	66,105
NET DISBURSEMENT (in USD million) 2/	1,042	(6,724)	1,817	5,962	10,356
DSP (PRINCIPAL + INTEREST) (in USD million)	18,709	30,675	27,319	30,013	32,293

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