Budi Mulya: Indonesia – pursuing a better shape of the economy

Address by Mr Budi Mulya, Deputy Governor of Bank Indonesia, at the Deutsche Bank Access Asia Conference, Singapore, 12 May 2010.

*   *   *

It is such a great pleasure to be here today, to share and exchange view with all of you. I would like to thanks Deutsche Bank for the invitation to join at this important event where, various investors, business leaders and senior government officers gather to have a constructive dialogue.

It is increasingly recognized that intensive communication, such as what we have today, becomes more important both from the authorities' perspective as well as from investors' point of view. In particular, in the periods where despite signs of a growing global economic recovery, some uncertainties remain. The most recent concern on global recovery is on the sustainability path of the recovery and the further possible impact of the most recent sovereign debt crisis that just emerged in the Euro area. As we just observed a couple of days ago, the global financial market was again shocked by a "semi-panic" behavior brought about by the uncertainty with regard to the rescue package on the Greece debt crises, and sort of "safety net" provided for some peripheral countries in the Euro area.

Thus, having a more convergence view from various parties, with regards to the stage of the particular economy and various government measures will help to avoid unnecessary distortion into the recovery process.

With that background, I will start today with briefly describing what Indonesia has been through during the crisis and then on how Indonesia has changed within the last decade, before I discuss the prospect of Indonesian economy and its challenge ahead.

Indonesia during the recent global crisis

During the most recent global crisis, which we all knew as one of the worst global crises in history, the Indonesian economy has demonstrated to be fairly resilience. Despite some negative impacts on the economy, particularly in the domestic financial market, the Indonesian economy was still experiencing a positive growth of 6.0% in 2008 and 4.5% in 2009. That achievement was mainly sustained by high and inclusive growth of domestic demand, in particular consumption. Indonesia is relatively less exposed to external shocks than other economies in the region as its trade share to GDP is relatively small at around 50 percent of GDP, with its export is still dominated by natural resource commodities. Accordingly, the unemployment rate fell back from 9.1% in 2007 to 7.9% in 2009.

On inflation, while it has experienced an increase in 2008 of 11.68% year-on year, is now back in a significant declining trend of 2.78% in 2009 and 3.91% in April 2010. This development is mainly supported by rupiah exchange rate appreciation trend and adequate supply side responses. The balance of payments is also well maintained. The current account and capital account still record a surplus, contributed to a sizeable reserves accumulation of around US$78 billion in April 2010, in line with the exchange rate appreciation trend.

Meanwhile, the banking industry and the domestic financial market also showed a sound performance despite, as I previously mentioned, some pressures during the peak of the crisis brought about mainly by liquidity scarcity perception, and as an impact of flight to safety phenomenon. Those pressures in the Indonesian financial market was caused by an increasing money market interest rate spread, high exchange rate volatility, as well as the increase of government bonds yield along the curve. All of those indicators have recently returned to their normal pattern.

What Indonesia has achieved so far shows that various measures taken by the Indonesian authorities can be reasonably considered effective. The fiscal and monetary stimulus employed in measured manner has helped the economy to endure from external shock. The various policies were mainly aimed at maintaining confidence to cope with panic and fear of scarce liquidity, and preserving domestic purchasing power. However, we noticed that there were some doubts, in particular from foreign investor, with regard to the strength of the economy and the efficacy of the policy that has been taken. This clearly shows from the significant increase of credit default swap (CDS) during the peak of the crisis. That perception was somewhat understandable since the situation was extremely uncertain, such that there was unclear on how the impact of the crisis would be into any particular country.

From those experiences, there are at least two important lesson learned. Firstly, it has highlighted the more crucial role of transparency with regard to the economic fundamental information and macroeconomic policy rationality. Secondly, it is important to preserve the consistency of prudent macroeconomic policy. On the later, it will be very challenging recently as the policy trade-off has significantly increased.

With regard on how Indonesia was dealing with the recent global crisis, Indonesia has actually employed all that has been learned from a painful 1998 crisis. Ever since, the 1998 crisis has brought structural changes in Indonesian economy and financial system, and more importantly in political structure. Indonesia was transformed into one of the largest democratic country in the world.

Indonesia after more than a decade from 1998 crisis

As I just mentioned, Indonesia is now structurally different with what was in a decade ago. This is as a result of more than ten years of consolidation and dynamic transition in almost all sectors. The extensive transformation measures became a continuing agenda with full commitment.

In the last ten years, we have embarked upon a far-reaching transformation measures, especially in the area of improving our institutional capacity. During this process, the Government has taken steps to improve our economic efficiency through policy reform packages covering key areas of concern, such as taxes, customs, legal frameworks, and the financial sector. So to speak, one of the most notable steps are the introduction of open capital account through promulgating Law No. 24 of 1999 and increasing the investment flexibility by stipulating Investment Law No. 25 of 2007 to encourage offshore financing for the economy.

The Government and Bank Indonesia, as a central bank, are always committed to consistently undertake fiscal and monetary discipline, as well as strengthening domestic financial market resiliency. Learning from the failure of 1998 crises, our policies were focused on enhancing policy transmission, improving financial market efficiency through prudential practices and financial market deepening. The Government is also improving their capacity on fiscal budgeting by adopting a better debt and cash management. Prudent fiscal policy can partly be observed by gradually reducing the debt to GDP ratio, in particular the foreign debt. The debt to GDP ratio has declined significantly within the last couple of years, from 77% in 2000 to around 30% recently.

From a monetary policy perspective, Bank Indonesia has consistently pursued Rupiah stability as mandated by the new Bank Indonesia law that was first introduced in 1999. In practice this has been manifested in an effort to focus on achieving the medium term (three years) inflation target set by the government and avoiding excessive exchange rate volatility consistent with the free exchange rate regime adopted since 1998. On this regard, Bank Indonesia has increased the transparency and clarity of its monetary policy stance by introducing “the BI Rate” as a policy rate since June 2005. Further improvement has also been undertaken in mid of 2008 by translating the BI Rate as a short-term money market interest rate target (known as PUAB overnight target). Thus, PUAB overnight has been used as an operational target in executing the monetary policy decision through Bank Indonesia’s domestic market operation. The main reason behind this enhancement is based on two reasons. First, the increasingly importance of agents’ expectation in forming inflation along with the development of domestic financial market, in particular, the government bond market. Second, the need to increase the efficiency of domestic money market, which in turn benefits to enhance and to further strengthen banks’ liquidity management.

Steps were also taken in the area of improving the capacity of financial institution, as well as improving financial market efficiency. Banks are encouraged to strengthen their capital and compel to conduct best practices, especially in the area of risk management. On the other hand, we are also bounded to increase our supervisory capacity to ensure a prudent banking practice.

Years of strong commitment on reform has resulted in a resilient economic fundamental, at least, in the last five years. The economic growth accelerated to a 10-year high. Fiscal consolidation significantly reduces government debt, a proof of commitment of fiscal discipline. Prudent macroeconomic management has also led to the declining trend of inflation and exchange rate volatility as well. In the financial sector, the banking sector is well capitalized and in a better balance sheet structure.

Strong macroeconomic fundamentals and resilient microeconomics structures lead to better risk perception, or a more accurate valuation from my point of view, as reflected by the recent rating upgrade. But to be frank, I feel that from the sovereign risk assessment, Indonesia is still somewhat “undervalued”. It is perhaps that major rating agencies tend to be too conservative in assessing Indonesia’s risk profile. This might possibly be a reflection of the “traumatic” view relate to the 1998 crisis. However, the recent update from some rating agencies has become a promising recognition into the fundamental transformation process in Indonesia. Following Standard and Poor’s, Fitch, and Moody’s, OECD has also upgraded Indonesia’s Country Risk Classification ranks from 5 to 4 on early April 2010. Similar progress also came from the ranking upgrade of our global competitiveness index from 72 in 2003 to 54 recently.

Prospect and challenge ahead

Global recovery coupled with favorable risk perceptions support our optimism toward the outlook in 2010 and 2011. We are quite confident that the Indonesian economy will grow at around 6.0% in 2010 and to 6.0–6.5% range in 2011. This is mainly supported by the upturn on export and increasing investment. For the next periods, we expect that the economy will keep growing in an upward trend given the proven strong commitment from the Government to implement reform measures on infrastructure projects and investment climate. On the later, it is important to note that the public check and balance mechanism, to ensure a more efficient bureaucracy and to improve business climate, has been increasing significantly compare to a decade ago. Meanwhile, the continuing prudent fiscal policy by maintaining public debt at the manageable level will ensure fiscal sustainability, to sustain economic growth commitment.

We expect that inflation will continue to be moderate at the lower middle of the target of 5% +/-1% in 2010, as there is still “room” from the output gap to support the increase domestic demand. On this regard, the central bank’s monetary policy will always commit to ensure the low and stable inflation going forward. While on the external side, current account and capital account are expected to continue reasonably strong. Overall balance of payment is expected to strengthen, partly supported by an increasing trend of foreign direct investment.

Stronger macroeconomic outlook and ample domestic liquidity will maintain financial stability, especially in banking industry. Bank's loan is expected to grow at around 20% in 2010, held by strong capital adequacy ratio of around 19%, recently. While, banks' non-performing loans (NPL) is expected to be maintained at to below 5% level (gross).

However, we are fully aware that despite growing positive signs of the economic prospect, yet many domestic agendas are still required to ensure their implementation. I am optimistic on this prospect, but of course it is more in a consistent step by step progress, rather than in an instant change.

In addition, to ensure for a sustainable and strong economic growth, Indonesia will also have to ensure that access to financial services should be enhanced through a well-functioning and deep financial market. The later is needed to facilitate and to promote longer term investment, maintain markets confidence, especially on short-term investment, and thus to prevent from the unnecessary external shocked. This can be done, partly by improving market efficiency through enhance financial market liquidity and wider-range of financial instruments as well as better financial market infrastructure. As part of those concerns, Bank Indonesia will consistently improve its liquidity management strategy.

On the global economic recovery, as I previously mentioned, the risk is still quite challenging. It will much depend on the solution prospect of Euro zone debt threat. Yet, considering the Euro area authorities measures such as what they took during this weekend, and their coordination with other authorities in other region, I do hope that there will be a promising solution.

To conclude, I am very cautiously optimistic to the prospect and the direction of the Indonesian economy ahead. I do hope that you would share the same view.

Thank you.

References

Badan Koordinasi Penamanan Modal (BKPM), ***Investment Policies Statement***, June 2009.

Badan Pusat Statistik (BPS – Statistic Indonesia), several Press Releases and publications.

Bank Indonesia, various Monetary Policy Review, Quarterly Monetary Report and Press Releases.

International Monetary Fund, ***World Economic Outlook, 2009***.

Joint Asian Development Bank–World Bank Report, ***Improving the Investment Climate in Indonesia***, May 2005.

Moccero, Diego. ***Improving The Business And Investment Climate In Indonesia***, Economics Department Working Paper No. 638, OECD, September 2008.

Mulya, Budi. ***The Need To Strengthen Indonesian Financial Market*, ** Delivered at JICA's Seminar on "The Challenge in Developing Indonesia's Financial Market", held in Nikko Hotel, Jakarta, 11 December 2009.

Raldi Hendro Koestoer, ***Promoting Regulatory Reform for Investment in Indonesia***, Office of Coordinating Ministry for Economic Affairs, Republic of Indonesia (CMEA-RI), presented at APEC High Level Conference on Structural Reform, 8–9, September 2004, Tokyo, Japan.

World Bank, ***Global Competitiveness Report***, 2000 edition up to 2009–2010 editions.

World Investment Prospect 2009–2011, UNCTAD.

World Bank, ***Investing in Indonesia's Institutions for Inclusive and Sustainable Development***, Country Partnership Strategy For Indonesia Fiscal Year 2009–2012, 2008.