Budi Mulya: Indonesian economy – recent developments and challenges

Address by Mr Budi Mulya, Deputy Governor of Bank Indonesia, at the Oversea-Chinese Banking Corporation (OCBC) Global Treasury Economic and Business Forum, Singapore, 9 July 2010.

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First of all, I would like to thank OCBC Bank for the invitation to join in today's global business community forum.

The event like what we have today, become more important recently since authorities as well as business leaders worldwide, have been faced with one of the most challenging episodes post 2008 and 2009 global crises. Authorities are facing high uncertain environment and have to deal with more delicate policy dilemmas to ensure the sustainability of global economic recovery process. Hence, it is always a benefit to exchange view with market and business leaders to obtain a more convergence perception with regard to the stage of the economy and authority's policy responds. This is because communication, such as through dialogue we have today, in particular with regard to the nature, the scope and the objective of policies taken by authorities, become more crucial to maintain market confidence and hence, to reduce uncertainty.

Market confidence poses an important factor to ensure the efficacy of various policies taken by authorities. It could be obtained when the rationality of the policies taken are well understood as intended. Hence, it will gain in a convinced behavior with regard to the policy implementation.

Further, maintaining market confidence is even more imperative in the aftermath of the onset of Euro zone crisis early this year, where coordination among authorities globally has been at the most challenging stage. This is because country specific factor, including political involvement, become increasingly materialize. Yet, from various international coordination forums, such as the latest G-20 meeting in Toronto last month, we all observe that the nation leaders' awareness with regard of policy coordination is held firmly. The agreement to together pursue a sustain path of global economic recovery and to achieve a more balance global growth as reflected in "growth friendly fiscal consolidation plans", is a strong evidence to that.

One thing that I would like to highlight, with regard to the communication aspect as I have mentioned, is that the demand for policy clarity and transparency – without delay – is increasing, including the demand for very details macro economic data or statistic. This fact has also been one of Bank Indonesia's concerns to always improve the policy transparency communication.

With that background I would like to briefly share what Indonesia has been through and the macroeconomic strategy to ensure the sustainability of Indonesia's economic performance in a very challenging and still fragile global economy and financial market environment.

Recent economic development

I will start my brief description on the development of the Indonesian economy by emphasizing that what Indonesia has been through and achieved, particularly during the most recent global turmoil, is mostly as a result of years of "post 1998 crisis" transformation process. Indonesia is now transformed into one of the world largest democratic and structurally different with what it was 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 that became a continuing agenda with full commitment, despite its challenging process, have provided a more resilience foundation into the Indonesian economic development. Of course, there are still many agendas to be executed to improve and to increase the efficiency of the whole business and economic activities. But, the progress so far, particularly the consistent prudent practice of macroeconomic management, has proven to contribute to shelter the domestic economy from further adverse impact of the most recent global crisis.

Among few countries in the region, Indonesia was still experiencing a positive growth of 6.0% in 2008 and 4.5% in 2009. While, in the first half of 2010, supported by a better than expected global the economic recovery is expected to grow at 6%, which is higher than previously estimated of 5.7%. In 2010, the Indonesian economy is expected to grow at 6% and slightly higher in 2011 and 2012. These were mainly sustained by high and inclusive growth of domestic demand, in particular consumption. Yet, export performance and investment has also showed a slight increase and expected to sustain their upward trend.

Inflation has also moderated at 5.05 % (year-on-year) in June 2010, held by adequate supply responses and rupiah exchange rate appreciation, despite that there was a hike in volatile price component. Hence, the June inflation is slightly higher than previously estimated. However the recent increase of the volatile food price is expected to be temporary and inflation is expected to be maintained within target range of 5% +/– 1% in 2010 and 2011. The core inflation figure is also supportive to Bank Indonesia inflation assessment. To this respect, the latest monetary policy decision to keep BI Rate at 6.50%, is considered as adequate to ensure the inflation expectation within the target range and supportive to maintain the growth momentum, as well as to encourage bank lending.

Meanwhile, the balance of payment figure shows a strong indication of improvement, brought about by strong domestic economic fundamental and conducive global economy. The current account balance in the second quarter this year to be higher than previously estimated and expected to be around USD 1.7 billion surplus. While, overall balance surplus will also improve to be at around USD 4.3 billion, higher than previous estimation. These developments have contributed to the increase of the foreign exchange reserve which now amounted to USD 76.3 billion. The current foreign exchange reserve level is equivalent to approximately 7.4 months of imported good, higher than what is observed in the peer group countries.

Those progresses have contributed to the IDR, which continue in an appreciation trend, despite some corrections in May with moderate volatility caused by market concern with regards to the rescue package in Euro zone. Since early this year, IDR has been appreciated at around 4% with a lower volatility in the second quarter this year. On this respect, Bank Indonesia's policy, consistent with the free floating system, is to ensure that IDR fluctuates in line with the economic fundamental and to avoid excessive volatility. The IDR movement recently is considered still adequate into external sector while supportive into anchoring inflation expectation.

In addition, I would like to convince you that in dealing with the mounting recent debate on short term capital flows which always have such a "double edge sword" into small open economy like Indonesia, the approach taken is consistent with the free capital mobility regime as stated in the foreign capital system law (The Law No.24/1999). However, to prevent from the negative impact of "hot money" flows, Bank Indonesia emphasize on the banking prudential and financial market deepening measures, as well as directed to encourage longer term investment. The six measures as in the latest Bank Indonesia's policy package launched at June this year is also in view of this balance approach.

Further, the banking industry and the domestic financial market also show a continued sound performance and maintained in well capitalized condition. In general, domestic financial market has recovered well from pressures observed during the peak of the crisis, which mainly triggered by liquidity scarcity perception and impact of flight to safety panic phenomenon. All money market indicators have recently returned to their normal pattern. The banking intermediation has also been showing an improvement. In the first half of this year, bank lending grew at around 19% and for 2010 is expected to grow at 22%–24% range which will ensure the economic growth. While non-performing loans (NPL) is well maintained at low around 3% (gross) and capital adequacy ratio (CAR) in average at level of 18%.

On the fiscal side, the government also showed a strong consistent effort in budget management efficiency and discipline. The fiscal deficit keeps low level of below 3% of GDP, which this year is expected to be 2.1%, and will be in a declining trend for years ahead. While, at the same time various measures are taken to continually improve its spending mechanism. Prudent fiscal policy has resulted in a significant decline in the debt to GDP ratio from 77% in 2000 to at below 30% recently.

The economic performance I have just described is an evidence that consistent prudent macroeconomic policies taken by the Indonesian authorities, as part of the more than a decade transformation process within the very dynamic political democratic development, has provided a stronger foundation to sustain the further economic development.

Those achievements has partly also been reflected in a better investor risk perception as shown in the decline of credit default swap (CDS) spread, which is now stable at around 180 bps for 5 years CDS, and recent sovereign rating improvement from major rating agencies. Yet, with regard to the later, I believe that rating agencies still tend to be too conservative in assessing Indonesia's risk profile. Hence, it is not yet fully reflects the result of the significant transformation progress that Indonesia have been through within more than a decade, while they still more in "traumatic" view relate to the 1998 crisis.

Outlook and challenge ahead

We are quite confident that the Indonesian economy is on track. The economy will move on a faster pace compare with our previous belief and will be around 7% growth within the next couple of years, given the already proven domestic resilience so far. Economic growth will also be boosted by the upturn on export and investment. Improving external demand and better risk perception toward domestic fundamental economy will also keep the current account and financial account in a good shape, and contribute to the increase of foreign exchange reserve.

However, there is of course a risk that has to be taken into account and monitored closely with regard to global financial market and economic development. Despite the still ongoing Euro zone crisis, in particular with respect to its banking sector and global financial market is also still fragile, global economy has shown a quite significant improvement. Yet, we expect that the risk will be moderate given strong world leaders commitment as I have previously mentioned.

One thing that also ensures the prospect of domestic economy is a continuous strong commitment of the Government to implement infrastructure projects, especially in transportation and energy sectors, and reform measures in investment climate. With respect to the later, it is important for us to note that the public check and balance mechanism in ensuring more efficient bureaucracy and improving business climate, has been increasing significantly compare to a decade ago.

While on inflation, we are quite confident to maintain within the target range of 5% +/– 1% up to 2011 and expect a declining trend ahead. In this regard, monetary policy will be consistently directed toward achieving low and stable inflation set by the Government. To achieve this low and stable inflation, which is now become more a common concerns, the Government and Bank Indonesia have taken measures to strengthen relevant policy coordination to better monitor and control inflation.

I would like to convince you that our agenda is priorities on how to ensure that the economy always move on the right track, despite some risk factors to take into account as I have mentioned above. Also, I am optimistic in our strong commitment to implement, step by step, some agendas to improve the environment to facilitate a sustainable growth and a better quality of economic development.

Before I conclude, I would like to also share that with regard to the global agenda on the financial sector reform and strengthening banking industry capital and risk management, as well as to encourage market disclosure and the adoption of a more convergence international accounting standard, Indonesia as a member of G-20 countries, also take step in the same spirit. Yet, the implementation will of course consider the stage and the structure of domestic financial market and banking industry. This is as partly can be observed in Indonesia participation in financial sector assessment program (FSAP).

To conclude, I am optimistic into the prospect and the direction of the Indonesian economy ahead. I do hope that you will share the same optimistic view.

Thank you.

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