Darmin Nasution: Indonesia – sustaining growth during global volatility

Keynote speech by Dr Darmin Nasution, Governor of Bank Indonesia, at a seminar, Jakarta, 13 February 2012.

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Fellow Speakers, Distinguished Guests, Ladies and Gentlemen:

Assalamu alaikum Wr. Wb.

Good morning and May God Bless Us All,

To open my speech here today, I would like to invite you all to join me in expressing thanks and praise to God Almighty who has blessed us again with the opportunity to come together here for this seminar.

This seminar is held to have a better understanding on the improvement of macroeconomic management and banking regulation that Indonesia has achieved following Asian crisis in 1997–98, as documented in the new IMF book titled "***Indonesia: Sustaining Growth during Global Volatility***".

Distinguished Guests, Ladies and Gentlemen

It has come to our common understanding that changes in the constellation of the global economy since the global financial crisis of 2008 and its aftermath had left a profound and widespread consequence. Against the backdrop of lingering effects from the global crisis, significant challenges in managing an increasingly complex macroeconomic stability has risen considerably. External shock and uncertainties seem becoming a constant dimension that continually shadows us in the process of policy formulation and implementation. The problem is we do not know when, how big and through which channel the shock will happen.

As we might be aware, the unprecedented global financial turmoil from 2007 to 2009 was a big shock to the global economy, and represented the deepest deterioration since the 1930s. Thus far, Indonesia's economy has weathered the global storm well. Indonesia has continued to record strong macroeconomic performance with sustained high economic growth. Provided that many economies had negative growth in 2009, Indonesian economy in that year still grew by 4%, which was one of the highest in the region.

In the following years Indonesian economy continued improving with well-maintained macroeconomic and financial system stability. Economic growth in 2011 was recorded at 6.5%, increased from the growth in 2010 at 6.1%. This strong growth was supported by strong private consumption and investment along with good export performance. Looking forward in ***2012***, we believe Indonesian economy would expand in the range of 6.3%–6.7%. The main source of the growth is expected to come from domestic demand as investment activity gains momentum, owing to stronger economic fundamentals and improved business climate.

The recent upgrades of Indonesia's rating by Fitch and Moody's will help boost growth up to its potential level, as long as it is accompanied by efforts to utilize our large potential and address various structural issues. We believe that the upgrade may lead to a wider investor base not only to government bond market, but also to corporate bond and equity markets. This will eventually lower borrowing cost for the country in a more structural manner, complementing the growing stream of FDI inflows to investment activities.

Looking at ***inflation***, although historically Indonesian inflation rates were relatively higher compared to other emerging countries in the region, in recent years Indonesia has successfully reduced inflation to single digits. Last year Indonesia's inflation rate was recorded at only 3.79% (yoy). And the declining trend in inflation still continues, in which inflation in January 2012 was only 3.65% (yoy).

The achievement of the low inflation rate was supported by policies to bring down core inflation as well as inflation of volatile food prices and administered prices. For 2012, we expect that inflation pressure will still be manageable within the range of inflation target 4.5%+1%, even taking into account the impact of limitation on fuel subsidy or rise in administered prices. The coordination between Bank Indonesia and the government in controlling inflation will certainly play an important role to bring down inflation. Thus far, this coordination is carried out, among others, through inflation control taskforce at national level (TPI) and regional level (TPID).

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The performance of Indonesia's external sector also shows resiliency. Amidst escalated global economic uncertainty, Indonesia's balance of payments in 2011 continued recording a considerable surplus. The composition of capital account has further improved as reflected by FDI flows surpassing net portfolio flows beginning in the second half of 2011. This change in the nature of inflow to more long-term flows will definitely enhance the resilience of the economy.

In line with the development in balance of payment, the international reserves has increased significantly in recent years. International reserves at the end of January 2011 reached USD112 billion. Indeed, the reserves have been depleted compared to mid 2011, but remain adequate to cover 6.3 month of imports and short-term government debt repayment. This depletion merely reflects the process of recycling the international reserves in response to the depreciating pressure on rupiah during the last several months of 2011 triggered by mounting European debt crisis.

As policy response to preserve macro and financial system stability, Bank Indonesia also implemented dual intervention strategy in the FX and government bond markets simultaneously. This strategy had stabilized both the currency and government bond price from further drop, while also increase the stock of government bond in Bank Indonesia portfolio for monetary operation purpose such as Reverse Repo. Currently, we hold around Rp 70 trillions of government bond.

On the financial sector, our financial system stability has been well-preserved during the recent global turbulences. This goes back to more than a decade of repairs and improvement since the ASIAN crisis

1997/1998 which has made our financial system, including the banking sector, more resilient and able to absorb instability risk as big as the 2008 and 2011 turmoil. The banking industry has been more resilient, as indicated by secure level of capital adequacy ratio (CAR) above the minimum level, reaching 16.0% at the end of 2011 and gross non-performing loans (NPLs) managed at comfortably safe level of 3.0%.

Nevertheless, I believe the role of Indonesian banking sector and its efficiencies can still be further strengthen in supporting the economic development. Last year, bank lending grew by 25% dominated by productive loan such as investment loan (36%) and working capital loan (24%). Despite this encouraging progress, the ratio of bank credits to GDP in Indonesia is still very low, only standing at 30%, well below other countries such as Malaysia, Thailand and China, which ratio has reached above 100%. This is in line with BI survey which indicated limited role of banking as companies still rely more on internal fund. At the end, this condition reflects the remaining large potential for business expansion.

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The prevalent opinion points toward the improvement of macroeconomic management where Indonesia has implemented a program of wide-ranging policy reforms, particularly since the 1997–98 Asian financial crisis. As pointed out above, the source of Indonesia's resilience includes a prudent monetary and fiscal policy, a sound banking system, a large stock of international reserves, and a more flexible exchange rate.

These underlying strengths allowed Bank Indonesia and the government to respond with standard “countercyclical” monetary and fiscal policies to mitigate the adverse impact of the global economic crisis. Yesterday, at the board meeting we decided to cut BI Rate further down by 25 bps to 5,75%. This kind of policy reaction contrasts sharply with past episodes such as the 1997–98 Asian crisis, 2005 mini-crisis, and 2008 global financial crisis when Indonesia responded “procyclically” by raising interest rates and tightening fiscal policies.

This edited volume prepared by IMF staff, entitled ***Indonesia: Sustaining Growth during Global Volatility,*** elaborates the substantial improvement in the quality of macroeconomic management and banking regulation that Indonesia has achieved in the midst of a volatile global environment. In addition, this book also highlights the most binding constraints that need to be addressed to sustain and increase economic growth as well as to further lower vulnerability going forward.

Overall, this book provides a deep and balanced perspective on the Indonesian economy that might help to further enrich the framework of macroeconomic management in Indonesia. We appreciate the thorough analysis of IMF staff on various issues regarding Indonesia’s economy. This in-depth and balanced analysis benefited from candid discussions between the Indonesian authorities and IMF staff during the Article IV consultations.

Their analysis has provided insight to our policy discussions which should contribute to improving Indonesia’s economic performance. I sincerely hope that publication of this book will help to better understand the progress made by Indonesia in macroeconomic management and policy that can be used to further strengthening not only Indonesian economy but also other economies.

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Needless to say, we cannot and may not assume that our macro stability will definitely continue in the future. This assumption can lead us to comfort zone that would reduce our ability to anticipate future challenges early on.

I believe this seminar will be the right place to discuss both global and domestic challenges and how we should deal with them. At the global perspective, the immediate policy challenges is certainly how to mitigate the impacts of global economic slowdown and uncertainties. Meanwhile, at the domestic front, a lot of domestic unfinished issues to be addressed which most of them are structural issues we never solve and thus have created inefficiencies both in the financial and real sectors.

I hope this seminar will give us various perspectives on how to strengthen Indonesian economy amidst those global and domestic challenges. May Allah Almighty always be with us, bless us and lighten our way towards a better future.

Thank you.