Agus D W Martowardojo: Building resilience, diversifying growth

Keynote address by Mr Agus D W Martowardojo, Governor of Bank Indonesia, at the Euromoney Indonesia Investment Forum, Jakarta, 22 March 2016.

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Honorable speakers, Distinguished guests; Ladies and Gentlemen,….Good Morning.

1. It has always been a great pleasure to be part of the Euromoney Indonesia Investment Forum. Let me first thank the organizers for inviting me to this prestigious event.

2. This morning, I would like to share my views, on how we should build resilience and diversify growth engines, and how Bank Indonesia's role in supporting the Indonesian economy as we venture ahead in the volatile world.

Ladies and Gentlemen

3. The past few years have brought us many economic surprises and challenges. Even today the global economy is still surrounded by substantial risks and uncertainties.

4. Concerns and uncertainty about the global outlook have weighed heavily on world financial markets. Last year, Emerging Market have been particularly hard hit and their currencies have weakened and sovereign credit spreads have continued to widen.

5. Entering 2016 market developments have taken a further turn for the worse. Concerns about growth and financial stability in China came back to the fore in early January 2016 that struck global investor risk appetite.

6. Coupled with worries about the broader Emerging Market economic outlook and ample supplies, these concerns affected heavily on commodity prices, with oil and metal prices falling to their lowest level in years.

7. Indeed, growth in Emerging Markets – while still accounting for over 70 percent of global growth – declined for the fifth consecutive year.

8. What may be most disconcerting is that the rise in global risk aversion is leading to a sharp retrenchment in global capital and trade flows. Last year, for example, Emerging Markets saw about – $735 billion in net capital outflows, compared with – $111 billion in net capital outflows in 2014.

9. Heavy capital outflows from emerging markets have fed into falling official reserves, as some EM central banks have consistently intervened to support their currencies.

10. Global trade flows, meanwhile are being pulled down by weak export and import growth in large Emerging Markets such as China, Russia, and Brazil, which have been under considerable pressure.

11. Everywhere, inflation has fallen to historical lows. At the recent G20 meetings in China there was broad recognition of the risk of a prolonged low global demand, and adverse feedback loops between the real economy and financial markets may engender the global economy fall into deflation.

12. The global risks of deflation are clearly much more pronounced than before, whose vicious and self-reinforcing dynamics—in the form of higher real interest rates, falling nominal GDP, and rising unemployment—are notoriously difficult to combat once they become deep-rooted.

Ladies and Gentlemen

13. Notwithstanding headwinds from (i) the taper tantrum episode in 2013, (ii) the economic slowdown in China, (iii) the continued fall in commodity prices, (iv) the normalization of US interest rate policy, and (v) the increased volatility in global financial

markets, the Indonesian economy has thus far held up well, emerge with its economic standing intact, standing out among the fastest growing and stable emerging economies.

14. Certainly, this has been made possible owing to mix of prudent and consistence monetary and fiscal policies, exchange rate flexibility – while managing to enact a comprehensive set of bold reforms, which mutually reinforce each other to bring in macroeconomic stability while nurturing stronger growth.

15. Growth has continued at a solid pace and remains among the highest in Emerging Market. Private consumption remains solid with domestic demand compensating for the slowdown in the external sector.

16. Inflation is well contained at 3.35 percent (yoy), which is within the target of 4±1 percent for the year. Well-managed inflation expectations, lower exchange rate pass-through, and a small negative output gap, have all contributed to lowering core inflation.

17. Indonesia is convincingly in an era of structurally lower inflation, in my view. This was evidently reflected from the trajectory of Consumer Price Inflation (CPI) which have been converging towards Core Inflation.

18. The stability over growth strategy demonstrated in monetary policy tightening since mid-2013, fuel subsidy reform, and greater exchange rate flexibility, have helped improve the external position. In 2015, the current account deficit falling to a healthy level at 2.06 percent of GDP, from – 3.00 percent of GDP in 2014.

19. Furthermore, international reserves continued to be sufficient at US$105.9 billion as of end-2015, which is equivalent to 7.45 months of imports and official debt repayments.

Ladies and Gentlemen

20. Going forward, Indonesia's economic outlook remains solid. We are confident that growth will pick up to the 5.2–5.6 percent range in 2016. Domestic demand would be the main driver of growth, while exports are expected to remain weak reflecting low commodity prices.

21. Growth will be led by capital spending of the government in the first half of the year, and by private investment later in the year conditioned on positive reform momentum. Private investment is fairly pro-cyclical and should therefore improve as public sector infrastructure spending accelerates and the overall growth outlook improves, in my view.

22. The current account deficit (CAD) is projected to increase to around –2,5 percent of GDP in 2016, on the back of a pickup in fixed investment and a further deterioration in commodity export prices, while the balance of payments (BOP) is projected to return to a surplus.

23. Inflation in 2016 is expected to stay within the 4±1 percent target, backed by well managed domestic capacity utilization, anchored inflation expectations, and declining commodity prices.

Ladies and Gentlemen

24. Indonesia, being a small open economy, cannot escape from greater volatility in the global economy and financial markets. Therefore, positive outlooks, such as the one I just described, may change quickly as subject to critical risks tilted to the downside.

25. While global financial markets in recent weeks appear to be coping better, risks and vulnerabilities could elevate at some time in the future. Monetary policy developments in advanced economies will continue to shape EM capital flows in important ways, particularly volatile portfolio flows.

26. The fact that the long-awaited beginning of the Fed's interest rate hiking cycle did not spark excessive market volatility was encouraging, given the long road of policy normalization that lies ahead for the Fed. Nonetheless, we have to be mindful with the

unpredicted shifts in investor expectations of Fed tightening speed which again would likely to spark periods of volatility in coming quarters.

27. Hence, in an unforgiving global environment we need to make ourselves as resilient as possible to ride the waves, being prepared and well equipped with buffers and policies to cope with adverse shocks, and require a high degree of vigilance and ingenuity.

28. On domestic front, we should also acknowledges that there remain key challenges, including (i) low productivity in the agriculture sector, (ii) land acquisition problems for infrastructure projects, and (iii) bottlenecks at the local government level.

29. The headwinds blowing from abroad and challenges at home calls for a broad-based policy mix focused on the need to manage short-term vulnerabilities and to boost potential growth as well as diversify growth engine in the medium-term.

30. In the short term, we face the inescapable task to reduce some vulnerabilities to put Indonesian economy on a strong footing to deal with some turbulence on the external front ahead. Countries with large current account and fiscal deficits, high levels of FX corporate indebtedness, and questionable macro policy frameworks typically come under particular pressure in the event of global market risk-off.

31. Over the medium term, we need a mix of mutually-reinforcing demand and supply policies, which both supports growth in the short term and essentially lifts "potential growth" over the longer term.

32. At the current juncture, both fiscal and monetary policies are sharing burden to lift aggregate demand. Nonetheless, in tandem with demand-side policies, we need to boost supply side in order to unlock the long-run potential growth through structural reforms. Without structural reform long run growth prospects will be inadequate.

33. In this context, a wide ranging reform initiatives taken to address long-standing infrastructural bottlenecks and improve the business climate are currently seem gaining traction, with the government continuing to emphasis on a more consistent basis the need to improve implementation.

34. Structural reforms to close the infrastructure gap, streamline business regulation, improve the trade and investment regime, enhance the functioning of the labor market, and foster human resource development, remain critical to strengthen the export base connected to global values chains, create jobs, and raise growth potential.

35. And, this can benefit greatly from the favorable demographics, abundant natural resources, and large domestic market. Hereafter, provided that we could unwaveringly sustain the reforms' momentum, I am convinced that GDP growth will turn up above 6,0 percent in the medium term.

Ladies and Gentlemen

36. I hope we are now in the same page about the need of Indonesia to move forward with structural reform. This brings me to the final part of my address about Bank Indonesia commitment to safeguard economic resiliency and sustainable growth path.

37. We believe the relatively tight monetary stance of 2015, which reflected the our emphasis on stability, allowing exchange rates flexibility, together with modest use of international reserves to ensure orderly market conditions, has enabled the economy to weather external turbulence, bring inflation back to within the target, without putting much risk on growth.

38. Against the background of much lower inflation and a small negative output gap, the Board Meeting carefully adjusted the degree of policy stance to ensure sufficient support to domestic demand since December 2015. Indeed, with a more volatile and uncertain external environment, calibrating monetary policies towards supporting growth have become a delicate task.

39. Moving forward, priority would continue to be placed on stability, although with policy calibrated carefully and gradually to support economic growth.

40. We will remain vigilant and stress the importance of monitoring risks to price stability closely, while stand ready to respond if external pressures resume or inflationary pressures reemerge. This holds particularly true given the high volatility of food prices as well as potential pressure on the financial account in an uncertain external environment.

41. To help manage external financial volatility, we will further progress on financial market deepening as a continued priority, allowing exchange rate volatility as automatic stabilizer while its extreme movements will be carefully managed through judicious foreign currency interventions, and preserving the relatively comfortable international reserves as the first line of defenses.

Ladies and gentlemen,

42. To end my address, allow me to conclude that with a strong buffer, Indonesia has fared well from external headwinds. However, this does not mean we can be complacent.

43. As the world economy is in transition to a new steady state, we are still facing greater volatility ahead. Hence, we have to continuously build a robust macroeconomic policy management -primarily well-tailored, consistence, and prudent monetary and fiscal policy mix-, which should be underpinned by a well implemented structural reforms.

44. We are convinced that with maintaining reform momentum would shore up public confidence and create investment-friendly environment. Apart from that, it would allow the country to diversify economic growth away from its reliance on natural resources, in a better position to withstand against global shock, and ultimately to sustain its economic growth in the longer term.

45. We applaud the government bold steps and moving rapidly in implementation of many of the reforms initiatives. At the same spirit, Bank Indonesia will continue to strengthen coordination with government to ensure that monetary policy, fiscal policy, and structural reform mutually support each other, to preserve macroeconomic stability and achieve a strong and sustainable growth.

46. I hope that this investment forum will also provide us with a clearer understanding and pave way for effective preparation to meet future challenges as well as to smooth our journey towards the sustainable growth.

Thank you very much.