Perry Warjiyo: Indonesian economic outlook this year and the years ahead

Keynote speech by Mr Perry Warjiyo, Deputy Governor of Bank Indonesia, at BNP Paribas Economic Outlook 2016, Jakarta, 23 March 2016.

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Introduction

Following the success of strong macroeconomic policy adjustments since the Fed tapper tantrum Mei 2013, Indonesia economy is already surpassing its turning point since second half of 2015. Macroeconomic and financial stability have been intact at the back of continued turbulences in the global economic and financial environments. There was an unintended consequence of the policy adjustments, though, that the domestic economic growth has been slowing, albeit still at relatively comfortable level compared to other emerging countries.

I do believe Indonesia economy will be better this year. And even it will accelerate further next year and years to come. Let me persuade you on this.

- First, we will continue to stress the importance of macroeconomic and financial stability as a prerequisite for sustainable growth. We already show our commitment and long-standing track record on this, and we will continue to do so. The recent global economic and financial condition is still challenging and uncertain. But compared to last year, which was I reckon the challenging year, there are some elements of certainty that will make 2016 better than 2015, including the likelihood of FFR increases.
- Second, this is the time where all the three policy mix of Indonesia economic developments, i.e. fiscal, monetary, and structural reforms, are working together and reinforcing each other. This is where actually Indonesia differs with other countries. Following the brave removals of subsidies, fiscal stimulus has been in effect and accelerated for higher economic growth. Structural reforms have been speed up too. The government has done remarkably well in accelerating reforms in many key areas: better investment climate, infrastructure developments, manufacturing and industry, agriculture, maritime, and tourism.
- Third, central bank policies have been reinforcing the fiscal stimulus and structural reforms by the government. Last year, at the backdrop of uncertainty surrounding FFR increases, we started to relax our macroprudential policy of LTV ratio and reserve requirements to support bank lending for economic growth. This year we already cut our BI policy rates three times in January, February, and March a total of 75 bps to 6.75%. We believe that monetary and macroprudential easing are consistent with our forecast of stable macroeconomic condition and higher economic growth.

These three reasons why I am very confident that in 2016 Indonesian economic prospect will be better, with higher economic growth and sound macroeconomic and financial stability. And I believe it will be even more promising in 2017 and beyond.

Now let me talk on these three following aspects: first, our assesment on the global economic and financial outlook, and the challenges that we saw; second, Indonesian economic outlook, how we try to stimulate our economic growth and maintain the stability; and third, how BI policy mix plays a key role in this road to Indonesia promising outlook to the future.

Global Outlook and Risks

We particularly put emphasize on these three aspects of global economic and financial outlook and risk: global economic growth, commodity prices, and divergence of monetary policies. In addition, we also monitor closely the development in China, as its important role in the global and regional economy.

On the global economic growth. It is still a challenging year. IMF just released in January the world economic outlook for this year and next year of 3.4% and 3.6%, respectively, a 0.2% lower than earlier forecasts. The US is still the main engine of the global economic growth, at 2.6% for both 2016 and 2017. We see slower recovery in Europe at 1.7% for both years, slightly higher than 1.5% in 2015. So I think that parts of developed economies have started their economic recovery albeit at slow pace. The challenge is, of course, on China, which is forecasted to grow around 6.3% this year and 6.0% next year. These are the main challenges from the global economic growth, which force us to rely more on domestic demand to support our growth.

On the commodity prices. Last year, we saw a decline on our export commodity price index. This year it still declines before rebound in 2017 with slightly positive increase. This means that the commodity prices will reach at the bottom this year, and will start rising next year. In fact, palm oil price already stated to rebound, forecasted to increase this year. Though volatile in the short-term, oil prices will likely be around $35 per barrel, much lower than $50 per barrel assumed in the budget. That means our inflation will be lower, even though it puts pressures on budget revenues. All in all, it is imperative for Indonesia to ladder up from commodity export base to manufacturing.

On the divergence of monetary policy. After the first FFR increase of 25bps at the end of last year, most of the markets predicted another 50bps increases this year, once probably in June and another at the end of year. We already included this scenario in our policy making. Although it is still challenging, but compared to 2015 I think the uncertainty and volatility will be lower this year. We closely monitor the negative policy rates of Euro and Japan. Frankly, I am in doubt that these will be effective to address their deflation problems compared to their quantitative easing. All in all, these FFR outlook and negative rates in Europe and Japan as the ‘push factors’, with the positive outlook in our part as the ‘pull factor’, will be positive for FDI and portfolio inflows to Indonesia and rupiah exchange rate.

On China. There are three channels that we need to anticipate from China factors: trade, renmimbi depreciation, and investment. On trade, China slowdown and commodity price declines continue to put pressures on our export. Our simulation shows that every 1% of economic slowdown in China corresponds to 0.3% slowdown in Indonesian economic growth. On renmimbi, I do not believe there will be big devaluation as we saw last year. I think PBoC will continue to intervene and reckon that renminbi depreciation will be gradual this year. The challenge in China is of course the policy adjustments that being implemented right now, i.e.: further capital account liberalization, financial market development, as well as greater exchange rate flexibility. This leads to the third China factor that we must not forget. China is aggressively pursuing its outward investment to support economic growth, embedded into its ambitious silk road strategy. So we have to prepare and open our arms for greater investments from China, as we have done to Japan and South Korea.

These are what we see from the global economic and financial condition. Last year up until September was the most difficult time, but after December we see some improvements. The uncertainty is still there, but overall we are more confident now. We have incorporated these uncertainties in our policy making. Indonesia has shown its resilience in the past, and it poises to progress well now and to the future.

Indonesia Economic Outlook and Risks

With stimulus from both fiscal and monetary fronts, as well as accelerated structural reforms in many key areas, we will be seeing significant improvements on Indonesia economy this year and beyond. The fiscal stimulus started to kick in in the third and fourth quarter last year, and budget absorption has been accelerated since early of this year, notably in capital expenditures. The continuous series of deregulation packages from the government will provide greater impetus for better investment climate, competitiveness, and buoyant economic activities. We are seeing accelerated completions of key infrastructure projects: toll road, airports, energy, irrigation, and more. Our macroprudential relaxation and monetary easing will also provide supports for higher economic growth.

Let me provide our latest economic outlook for this year and next year.

On economic growth. Last year, we recorded an economic growth of 4.79%. With the fiscal stimulus, the economic growth reached the bottom of 4.66% in the second quarter of last year and picked up to 5.04% in the last quarter. Investment in construction related to government projects together with private and government consumptions support the recovery. This year will be much better. Compared to early of last year, where the government must deal with the administrative procedures, this year fiscal stimulus through the acceleration of government projects already started to kick-in in the first quarter. With that, our economic growth forecast for this year will be around 5.2–5.6%. It will be supported by fiscal stimulus as well as the monetary policy easing to accelerate economic growth. Private consumption will still be robust. Government related expenditures, especially investment in infrastructures, will boost the economy, as we saw since Q3-2015. That is why the sectors that start rebounding will be construction, transportation, communication, and electricity, which are most of the government related fiscal stimulus sectors. I am sure that trade and manufacturing sectors will follow as the economic growth starts to gain broad momentum. This is the dynamic of the stimulus to economic growth that we will be seeing to the future.

On inflation. We managed to lower inflation from 8.3% in 2014 to only 3.3% in 2015, which I think a part of its success owes to our monetary policy credibility that we gain since 2013. This year and next year we forecast inflation within our range of 4±1%. In the past, the challenge of price stability mainly came from administered prices, namely the subsidy of fuel and electricity. But the government has succeded in reforming these subsidies. This helps the central bank to be more certain in forecasting and controlling inflation. Unlike in the past, both CPI and core inflations will be convergent and under controlled. Exchange rate passthrough has been benign, because of the weak domestic demand, commodity price declines, and very well anchored inflation expectation.

On current account deficit. Our macroeconomic adjustments in the past have succeded in lowering the CAD from the peak 4.4% of GDP in Q2-2013 to about 2% for the whole year 2015. For Indonesia, a CAD of 2.5–3% is still sustainable, because we still need to grow and for that we need sustainable financing from FDI and other long-term financing. That is why, with 2% CAD in 2015, we have room for monetary easing without worrying to external sector stability. This year, with the economic recovery gains momentum, CAD will be expected to widened but still within our long term sustainable CAD norm of 2.5–3% of GDP. We expect more than enough external financing for these deficits, with FDI constitutes the majority of the capital inflows and to a lesser extent long-term private external borrowing and portfolio investments.

On financial system stability. Overall banking industry is sound, with CAR relatively high at about 21%. Lending growth is slowing, only about 10% in January 2016. But with economic stimulus from both fiscal and monetary, as well as liquidity injection with 1% reduction of reserve requirement that Bank Indonesia decided recently, we expect lending growth to increase to about 12–14 % this year. Overall NPL is low at 2.7% (gross) or 1.4% (net), although a bit increasing for some banks especially for the mining sectors. We have done analysis on the corporate risks as well as household risk. Last year we record corporate earnings were declining as economy was slowing down. But overall corporates are adjusting quite well, as they are doing a lot of efficiency and early repayments of their debts, both local and external debts. With economy is rebounding, overall corporate performances will also improving this year.

Bank Indonesia Policy Mix

Bank Indonesia mandate is to achieve price stability (inflation) and maintain exchange rate stability to support economic growth. We also support financial system stability. For our policy making, we analyze and forecast macroeconomic condition two years ahead: inflation, economic growth, exchange rate, current account balance, and bank lending, taking into account the latest assessment on fiscal and financial system conditions as well as on global economic growth, interest rates, and commodity prices. We do not rely only one instrument, i.e. interest rate, but employ a policy mix of monetary, macroprudential, capital flow management and payment systems. As such, in every monthly board meeting we formulate interest rate, exchange rate policy, monetary operation, capital flows management, and macroprudential measures based on the latest assessment and forecast on overall macroeconomic and financial system.

Early last year, we noted the need for balancing of macroeconomic stability and supporting economic growth. We forecasted at the time that inflation would be under controlled within target, current deficit narrowed, while economic growth slowed because of both external and domestic factors. That was the theme of policy coordination between Bank Indonesia and the government. We agree to accelerate fiscal stimulus for supporting economic growth, benefiting the savings from subsidy reforms in 2014. At Bank Indonesia, we also rebalance our policy mix. While interest rate cut was not possible at that time because of possibility of FFR increases, we have started to relax our macroprudential policy. We relaxed LTV ratios by an average 10% in June 2015 and lower reserve requirements in June and December 2015. Following the first FFR increase in December 2015 and less uncertainty about the future courses of possible FFR increases, we started to cuts our policy rates this year. Thus, both of our monetary and macroprudential policies are now on easing modes. Together with fiscal stimulus and structural reforms by the government, all of the national policy mix, i.e. fiscal, monetary and structural reforms, are reinforcing for accelerating economic growth while maintaining macroeconomic and financial stability.

Let me brief on the latest board decision of Bank Indonesia policy mix.

On the monetary policy. With inflation will remain low and within target for this year and next year, and current account deficit under controlled witin sustainable range, there has been room for monetary easing. We have communicate since October last year, and started to cut our BI policy rate by 25bps in January 2016. We cut again the BI Rate in February and March by 25bps each to 6.75%. More than that, we cut again our reserve requirement by 1% to 6.50% in February 2016, which we count would add liquidity in the banking system by about IDR 34 trillion (about USD 2.6 billion) and with money multiplier of about 4.8 times add liquidity in the economy of about IDR163 trilliun (USD12.5 billion). Our signal is clear, that macroeconomic stability provided us rooms for monetary easing for supporting economic growth through interest rate cuts and ample liquidity in the banking system. Eventhough there is still room, we will be cautious in deliberating our further monetary easing. We will assess throughly overall economic and financial developments, both domestic and global, when we formulate monetary policy in every monthly board meeting. In the meantime, we will focus on strengthening our monetary operations to reinforce the monetary policy transmission mechanisms.

On the exchange rate policy. We adopt greater exchange rate flexibility. We will let the market mechanism to determine the exchange rate according to evolving supply and demand. And we are proud that with continuous financial market deepening the size and price mechanisms in the foreign exchange market has been much developed now. That is why in most cases the exchange rate reflect the market mechanism. But we do not shy away to intervene in the market if exchange rate moves excessively and there is jittery in the market, especially in cases of large foreign capital reversals. If necessary, we intervene by both supplying the foreign exchange and buying government bonds from the secondary market. That is why you do not see excessive volatility both in the exchange rate as well as in the government bond yield. Last year was a bit difficult because there was capital outflows from the equity due to turbulences in the global market. But it has been reversed this year, with accumulated inflows from both fixed income and equity. Our exchange rate appreciated by 5.5% year-to-date to mid March. Going forward, with the economy rebounding, I do believe that both domestic and global factors will provide favorable environment for our exchange rate and financial market.

On the macroprudential policy. We started with relaxing our loan to value ratio, on average about 10% in June last year. We also ease liquidity in the banking system, both through our monetary operation as well as reductions in the reserve requirement. Overall lending growth is still low at about 10% now as demand is just rebounding and not as strong as yet. However, looking closer to each sectors, the construction loan increased by 20% and real estate loan increased by 23%, showing that significant demand for bank lending from the fiscal stimulus related activities. We haven't seen the impact on mortgage loan yet, it grew by about 10% last month, as demand for housing is not recovering yet. On the second half of last year, with the fiscal stimulus and monetary easing, the domestic demand will keep a pace and it will be so for demand for bank lending. We are seeing now increasing demand for lendings to government project related activities, but we will be seeing increasing demand for bank loans to other economic sectors as domestic economic growth becomes more broad based.

Final Remarks

I have shared my optimisms about positive Indonesian economic outlook this year and the years ahead. Economic growth will be higher, and macroeconomic and financial stability will be sound. There are some risks, of course, that we need to closely monitor and address, e.g. FFR increases, China factors, commodity price declines, and fiscal revenues. This is the time for Indonesia to move forward, and we will. All the three policy mix at the national level, i.e. fiscal stimulus, monetary easing, and accelerated structural reforms, are reinforcing to support higher economic growth. We know it, and investors see it. That is why investors already make differentiation of their views and valuations among emerging countries, where Indonesia as one of the promising economies. That will support for the better Indonesia to the future.

Hope I bring more optimisms to you. I thank you.