BANK INDONESIA

ECONOMIC REPORT ON INDONESIA

2013

MAINTAINING STABILITY, ADVANCING STRUCTURAL REFORM FOR SUSTAINABLE ECONOMIC GROWTH

Cover Information:
Fahombo, Hombo Batu or stone jumping is a rite of passage for young men of the Nias tribe in North Sumatera. If the intrepid jumper can clear a height of two metres he is considered an adult and therefore eligible to serve as a warrior or deserve to get married. The jumper needs not only great vision but also reselience, stability and proper soft landing technique.

2013
ECONOMIC REPORT
ON INDONESIA

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Vision

To be a credible institution and the best central bank in the region by strengthening the strategic values held as well as through the achievement of low inflation along with a stable exchange rate.

Mission

1. To achieve rupiah exchange rate stability and maintain the efficacy of monetary policy transmission in order to drive quality economic growth.

2. To nurture an effective and efficient national financial system that can withstand internal and external shocks in order to support the allocation of funding/financing that contributes to national economic stability and growth.

3. To ensure a secure, efficient and smooth payment system that contributes to the domestic economy and helps maintain monetary as well as financial system stability whilst broadening access in the national interest.

4. To build and maintain the organisation and human resources of Bank Indonesia, who are performance based and honour integrity, as well as to enforce good corporate governance in the implementation of tasks as mandated in prevailing laws.

Strategic Values

Trust and Integrity – Professionalism – Excellence – Public Interest – Coordination and Teamwork

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Governor

2 | Mirza Adityaswara
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Deputy Governor

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Deputy Governor

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Deputy Governor

6 | Hendar
Deputy Governor

Board of Governors

Darmin Nasution
Governor
until May 2013

Hartadi A.Sarwono
Deputy Governor
until June 2013

Foreword

The year 2013 was no easy time for the Indonesian economy. Time and again, a broad array of challenges put our economic resilience to the test. Global economic conditions that fell short of expectations led to pressure on the Indonesian economy through both the trade and financial channels. The influence of the global economy on Indonesia became yet stronger because the underpinnings of Indonesia's economic structure lacked the strength to withstand and absorb global shocks. This structural problems included heavy reliance on exports of resource-based products, lack of self-sufficiency in food, energy and technology, and an underdeveloped financial market. This combination of global and domestic conditions had in turn put pressure on the Indonesian economy all the way through the third quarter of 2013, a period marked by rising inflation, widening current account deficit, depreciating rupiah, and the financial market performance.

Agus D. W. Martowardojo

Governor of Bank Indonesia

"We believe that every episode in the story of our nation, the ups and downs, including the economic dynamics of 2013, is a historical moment with lessons of great value"

For sure, these emerging issues called for an urgent response due to the heightened risk of disruption to Indonesia's economic growth. Bank Indonesia took a series of pre-emptive measures to deal with these challenges. A policy mix was introduced and further reinforced to ensure that inflation would quickly return to the targeted 4.5±1% range in 2014 and the 4.0±1% range in 2015, while bringing down the current account deficit to a more sound level. Regarding this, Bank Indonesia set the BI Rate at a level consistent with the effort to achieve the inflation target. Accordingly, the BI Rate was raised 175 bps during 2013 to 7.50% by the end the year. This interest rate policy was also reinforced through stabilisation of the exchange rate to keep the rupiah in line with its fundamentals and other policies to strengthen monetary operations and safeguard financial stability. Bank Indonesia also intensified its coordination with the Government and forged closer collaboration with other central banks. During 2013, the policy coordination of Bank Indonesia and the Government was focused on controlling inflation in line with the inflation target, bringing down the current account deficit to a more sound level, and improving the economic structure.

Economic performance in the fourth quarter of 2013 was moving in the desired direction. The pre-emptive responses taken by Bank Indonesia and the Government had succeeded in easing the pressure on economic stability. Notwithstanding the higher (8.38%) than the targeted (4.5±1%) inflation rate in 2013, as inflationary pressures dissipated in the last quarter of 2013, inflation rate was expected to decline toward the targeted range of 4.5±1% in 2014 and 4.0±1% in 2015. Bank Indonesia's policy response also succeeded in moderating the economic growth towards a more balanced sources of economic growth, as reflected in the declining current account deficit to a more prudent level during the fourth quarter of 2013. Despite the moderation, the economic growth in 2013 came to 5.78%, ahead of growth in peer countries. The process of controlled adjustment in the Indonesian economy was also bolstered by carefully managed financial stability, in particular the solid condition of the banking industry. Within the banking industry, credit risk, liquidity risk and market risk were all well-maintained and backed by strong bank capital.

The encouraging development in the fourth quarter of 2013 should not lead us into complacency. Like nature, we are currently like being in an inter-monsoon period or season of change. The era of easy money has come to an end and now the world economy must gear itself for a new era of tighter monetary conditions. Portfolio capital flows also carry the risk of reversing from emerging markets to advanced economies. Added to this is the potential influence of economic slowdown in China as the adjustment process in that nation moves forward. At home, attention is also needed to the risk of mounting inflationary pressure spurred by increases in food prices and administered prices in addition to the pass-through effect of exchange rate depreciation. Beyond these short-term risks, the economy is also beset with structural challenges, such as the sub-optimal structure of development financing sources and the limited manufacturing capabilities that put constraint on the supply-side of the economy in responding to increasing demand. If these structural issues are not quickly rectified, they could adversely impact economic stability and lead Indonesia into a middle-income trap.

For 2014, Bank Indonesia policy remains focused on maintaining economic and financial stability, as well as to steer the economy towards more balanced growth that will bring down the current account deficit to a more sound and sustainable level. This consistency in monetary policy is important because the economic dynamics of 2013 have left behind a valuable lesson on the importance of discipline in pursuing macroeconomic policy as a basic element of maintaining stability and continuity of economic growth. Another important message that came to the fore in 2013 was the need for macroeconomic policy to be accompanied by accelerated progress in structural policies. Without structural policies, each external shock would require a substantial demand-side adjustment with the risk of creating even greater turbulence. The agenda for more rapid progress in structural policies has gained increasing urgency if we are to maintain growth and transition to a high income country. In this regard, the Indonesian economy requires an upgrade in its manufacturing capabilities and a development of innovation capacity that can take the economy to a higher level and in so doing bring about a more prosperous society.

With these various policy responses in place and effective synergy from all elements of our nation to bolster the structures of the economy, Bank Indonesia predicts a year of greater economic stability in 2014 accompanied by more balanced economic growth. The forecast for economic growth is about 5.5-5.9% with inflation expected to return to the 4.5±1% target range. The current account deficit is also predicted to come down to a more prudent level.

The Economic Report on Indonesia 2013 now presented to readers represents an effort by Bank Indonesia to document the dynamics of the Indonesian economy during 2013, the policies implemented to move past these challenges, and the outlook for the road ahead. We believe that every episode in the story of our nation, the ups and downs, including the economic dynamics of 2013, is a historical moment with lessons of great value. In relation to this historical journey, permit me to express my respect and appreciation for Mr. Darmin Nasution and Mr. Hartadi A. Sarwono, who stepped down from active duty in mid-2013. The journey of Indonesia's economy in 2013, as described in this book, is one that is greatly indebted to these two officials for their utmost dedication while serving as Governor and Deputy Governor of Bank Indonesia.

Finally, on behalf of the Board of Governors of Bank Indonesia, I would like to welcome readers to the Economic Report on Indonesia 2013. Our hope is for this report to serve as a trusted, quality reference in devising our steps to negotiate our way through this season of transition fraught with uncertainty, a journey that demands our resoluteness of spirit and untiring labors.

May God the Almighty bestow upon us the abundance of His Grace and protection in every step of our endeavors.

Jakarta, March 2014

Governor of Bank Indonesia

Agus D. W. Martowardojo

Overview

MAINTAINING STABILITY, ADVANCING STRUCTURAL REFORM FOR SUSTAINABLE ECONOMIC GROWTH

The year 2013 was replete with changes and challenges for the Indonesian economy. While a range of structural issues had yet to be resolved, changes in global economic conditions during 2013 brought with them new threats to macroeconomic stability and the sustainability of economic growth. The policy mix pursued by Bank Indonesia and the Government successfully steered the economy towards a more balance growth and restored macroeconomic stability. Looking ahead, Indonesia's economic outlook is expected to improve, despite the various risks that call for anticipatory measures. In 2014, Bank Indonesia policy will remain focused on maintaining macroeconomic stability. These efforts, however, still need support from accelerated structural reforms with the objective of pursuing sustainable economic growth.

In the aftermath of the 2008 global crisis, the Indonesian economy achieved high growth accompanied by prudently managed stability. This had taken place within a context of two global trends that had arisen in recent years. First, terms of trade improved in response to higher prices for primary export commodities, enabling the domestic economy to chart brisk growth without building up a current account deficit. Commodity prices rebounded on high demand from emerging market countries like China and India, the engines of world economic growth in recent years. Second, the monetary stimulus in advanced countries following the global crisis created a flood of global liquidity that subsequently poured into emerging market countries promising higher returns, including Indonesia. These capital inflows boosted liquidity in the Indonesian economy, allowing interest rates to be held at quite low levels for a sustained period. This in turn spurred domestic demand and created spiralling prices for assets, including property.

In 2013, these upbeat economic conditions gave way to change triggered by a shift in global factors that had previously worked to Indonesia's advantage. In trade, slowing growth in emerging market countries, led by China and India, brought an end to the era of high commodity prices, bore down on Indonesia's terms of trade and ultimately put pressure on primary commodity exports. Amid strong domestic demand that fuelled imports, the downturn in exports widened the current account deficit. In the financial sector, indications of improvement in the United States (US) economy prompted its monetary authority to plan tapering off the monetary stimulus, a move that gradually reduced the supply of liquidity to emerging market countries, including Indonesia. This had created external imbalances in the balance of payments, marked by a widening current account deficit and declining in foreign capital inflows that in terms of fundamentals put pressure on the rupiah exchange rate. Downward pressure on the rupiah mounted in particular after

May 2013, when the first signal of tapering off in the Fed's monetary stimulus became public. This downward pressure increased further in response to domestic factors related to inflation expectations following the introduction of import restrictions on food commodities. The policy decision to cut back the fuel subsidy in order to curb the fiscal and current account deficits also stoked inflationary pressure, which led to progressively worsening sentiment.

Responding to these challenges, Bank Indonesia and the Government worked in synergy to pursue a policy mix to bring economic stability back under control and maintain balance economic growth. These policy responses can be grouped into three major areas of the policy mix. The first involves a synergy between monetary policy, in this case interest rate and exchange rate policy, and macroprudential policy, to enable policy objectives to be pursued with optimum results. The second part of the policy mix comprises fiscal policies designed to curb the current account deficit through reductions in the fuel subsidy and tax instruments for reducing imports. Working in synergy, the monetary policy and fiscal policy mix was then directed towards managing domestic demand in order to curb excessive imports. The third part of the policy mix is related to structural policies, such as improvement in the investment climate and efforts to promote economic self-sufficiency.

The objective of the Bank Indonesia policy response is to ensure that inflation can return quickly to the inflation target range and the current account deficit can be brought down to a safer level. In this regard, the policy strategy is focused on stabilisation that involves steering the economy on a path that enables the economy to grow at a more balanced and healthier level. This strategy has been implemented by means of a policy mix aimed at regaining macroeconomic stability without generating excessive impact on the economy. First, a tight monetary policy was launched to keep inflation expectations at a subdued level while simultaneously curbing excess domestic demand in order to cut back imports (expenditure absorption). The decision to raise the BI Rate represented a pre-emptive response to mounting inflation expectations leading up to the hike in subsidised fuel prices. Second, macroprudential policies were tightened to rein in excess domestic demand and mitigate risks in the banking sector. This included stricter Loan to Value (LTV) requirements, calculation of the minimum reserve requirement factoring in the loan to deposit ratio (LDR RR) and introduction of the secondary minimum reserve requirement. Third, a more flexible exchange rate policy aimed to keep the value of the rupiah commensurate to its fundamentals, consistent with efforts to bring down the current account deficit. Fourth was a policy for management of capital flows to reinforce the structure of capital inflows and thus bolster the resilience of Indonesia's balance of payments. Fifth, Bank Indonesia launched structural policies through deepening of the rupiah and foreign exchange markets to create a more liquid money market for curbing excess volatility during times of turbulence. Sixth, BI strengthened coordination with the Government for control of inflation in 2013, most importantly to curb the second round effects of the hike in subsidised fuel prices.

The Government policy response was directed towards maintaining fiscal sustainability, reining in domestic demand and inflation and bringing down the current account deficit. Within this context, the government decision to raise subsidised fuel prices in June 2013 was aimed at safeguarding fiscal sustainability, ensuring more efficient allocation of natural resources and at the same time curbing domestic demand and easing the current account deficit. The Government also pursued a number of other policies related to food to curb rising inflation by simplifying import procedures and amending the restrictive trading scheme for horticultural imports and other imported food products. Government policy was also directed towards resolving various structural issues related to the current account deficit and the investment climate. To bring down the current account deficit, the Government pursued structural reforms in the energy sector by trimming the subsidy for fuel prices and promoting the use of biodiesel to help curb oil and gas imports. The Government also raised taxes on luxury goods to curb consumption of imported goods by the middle class and promote consumption of domestic goods. To boost exports, the Government introduced tax incentives for labour-intensive export-oriented sectors, and extended special facilities for imports of goods used for raw materials in export production. Meanwhile, the Government simplified investment procedures to bring improvement to the investment climate in the drive to attract foreign direct investment.

In the events that followed during the fourth quarter of 2013, the various policy mix responses proved effective in quickly mitigating pressures bearing on macroeconomic stability. Inflationary pressure was gradually brought under control, returning to its normal level in September 2013. The inevitably forceful impact of the hike in subsidised fuel prices saw inflation climb to 8.4% in 2013 from 4.3%

in 2012, well above the inflation target set at 4.5±1%. Nevertheless, if a comparison is made with inflation at the time of hikes in subsidised fuel prices in 2005 and 2008, inflation in 2013 remained below 10%, which contrasts with 2005 and 2008 when inflation climbed past 10%. This positive outcome can be attributed in part to the pre-emptive policy responses by Bank Indonesia to fend off rising inflation before raising subsidised fuel prices, and the close coordination with the Government in curbing the second round effects of the fuel price hike.

In the fourth quarter of 2013, as indicated by developments in the economy, the policy mix response had begun to steer the economy on a more balanced path while continuing with measured adjustments designed not to trigger excessive pressure. On one hand, the curbing of domestic demand brought results with more moderate demand and investment followed by decline in imports. On the other hand, the adjustment in the exchange rate in keeping with its fundamentals also provided a boost to previously ailing manufactured exports. Accordingly, while growth was slower than in 2012, the Indonesian economy recorded 5.8% growth in 2013, ahead of peer countries. In other developments, a turnaround in exports and falling imports brought about a significant reduction in the current account deficit to 2% of GDP in the third quarter of 2013, well below that of preceding quarters. The capital and financial account also improved in response to drawing down of corporate offshore borrowings, withdrawal of funds from overseas deposits held by domestic banks and stable inflows of foreign direct investment. In 2013 overall, the current account recorded an increased deficit over the previous year at 3.3% of GDP, albeit short of earlier forecasts. International reserves were maintained at a comfortably safe level of US$99.4 billion, equivalent to 5.5 months of imports and servicing of official external debt.

The responses in the policy mix also bolstered financial system stability during 2013, which paved the way for transferring bank supervision functions to the Financial Services Authority (OJK). Amid the slowing trend in the domestic economy and depreciation in the exchange rate, Indonesia's financial sector maintained solid performance, notably in the banking industry. Bank credit expansion eased from 23.1% at the end of 2012 to 21.4% in December 2013 in keeping with Bank Indonesia's efforts to steer the economy on a more prudent path. Banking risks, reflected in credit risk, liquidity risk and market risk, were also managed at safe levels with the support of robust capital resilience. The sound condition of the banking industry is essential for the stabilisation policy to operate effectively without creating excessive dilemmas and was also necessary to pave the way for successful and trouble-free transition of the bank supervision function from Bank Indonesia to the Financial Services Authority.

For the future, the upbeat direction of the economy in the fourth quarter of 2013 can serve as a positive basis for further improvement in the economy in 2014. Bank Indonesia predicts economic stability to remain comfortably secure accompanied by improved equilibrium in economic growth that will enable the current account deficit to be brought down to a safer level. Economic growth is forecasted to come within the 5.5-5.9% range, accompanied by more balance sources of growth. The current account deficit is predicted to drop below 3.0% of GDP in view of the outlook for stronger exports and constraints on imports against a background of sustained moderate domestic demand. Consistent with the pace of economic growth, credit expansion is forecasted in the 15-17% range. Meanwhile, subdued inflation is predicted for 2014, within the target range of 4.5±1%.

Despite this, the outlook for improvement in the economy remains contingent on strengthened coordination between Bank Indonesia and the Government, given the multiplicity of risks that continue to emerge. At the global level, risks have emerged from the ongoing shift in the global economic landscape that has reversed the direction of portfolio capital flows in favour of advanced countries, led by the US. The rebalancing process in China also has potential to bear down on the Indonesia's economy through exports. At home, rising food prices, increases in administered prices and the second round effects on inflation from exchange rate depreciation all pose risks.

Against the background of this outlook and the challenges to the economy, Bank Indonesia policy in 2014 will remain focused on safeguarding macroeconomic stability and financial system stability through strengthening the policy mix. In monetary policy, a consistent course will be maintained to curb inflation in line with target and bring down the current account deficit to a more prudent level through interest rate policies and stabilisation of the exchange rate in line with its fundamentals. Strengthening of monetary operations, capital flows management and financial market deepening will all be intensified to support the effectiveness of interest rate and exchange rate transmission while reinforcing the structure and capacity of the financial system in financing development. In macroprudential area, policy seeks to mitigate systemic risk in the financial sector and to manage credit and liquidity at levels appropriate for management of macroeconomic stability. In a similar vein, Bank Indonesia will also expand public access to the banking system in a program known as financial inclusion. In the payment system, policy will stay the course for ensuring the reliable operation of the large value payments system capable of accommodating higher volume of transactions and advancements in technology, as well as the development of a more efficient retail payments industry meeting the needs of all levels of society. All these policies will be bolstered by a range of policy coordination actions pursued jointly with the government and authorities in the financial sector. In addition, Bank Indonesia will maintain an active stance and coordinate with the Government to promote more rapid structural reforms to boost the competitiveness of the nation's economy, strengthen national economic self-sufficiency and build a sustainable financing base.

In the medium-term, the Indonesian economy is predicted to chart higher growth accompanied by reduced inflation and a more viable posture in the current account. However, this prognosis depends to a great extent on the ability to resolve various structural challenges that continue to beset the domestic economy. These challenges relate to structural issues in financing and domestic production, including energy resilience and food resilience and their impact on subsidy management in the state budget, and the need to strengthen the basic capital for development. Various structural reforms have been instituted by the Government and Bank Indonesia to address these challenges. However, aside from results achieved, the accelerated implementation of policies put into place for structural reform is still needed. The scope of these structural policies includes the domestic financial market deepening, production-side policies and optimum management of energy subsidies to create greater fiscal space without impairing fiscal resilience. The acceleration of these structural reforms is expected to prevent Indonesia from becoming caught in the middle income trap.

Challenges to the Economy in 2013

The challenges daunting the economy in 2013 were closely tied to the structural problems that continued to surface in Indonesia. Indonesia's economic growth has relied to a large extent on buoyant household consumption and exports of primary commodities. In structural terms, the buoyant pace of household consumption has been fuelled by expansion of the middle class over the years, supported by Indonesia's demographic structure in the productive age group and rising per capita income. The household consumption was steadily climbing while domestic interest rates had been kept low amid heavy capital inflows spurred by ultra-relaxed policies of advanced countries. The strength of this middle class consumption has in turn fuelled demand for imported goods, such as transportation and communications equipment and other middle class essentials.

Structural issues in the Indonesian economy are also apparent from the structure of exports. Indonesia's exports have been dominated by primary commodities, a trend driven by growing demand for primary commodities in emerging market countries such as China, the engine of global economic growth. At the same time, the manufacturing role has seen gradual decline both in contribution to economic growth and in exports. In keeping with this trend, the proportion of resource-based exports to Indonesia's total exports climbed from 20% in 2005 to 39% in 2013. At the same time, the proportion of non-resourced based manufactured exports fell from 48% in 2005 to 36% in 2013.

In the financial sector, structural issues manifest themselves in the thin financial market heavily dominated by foreign actors. A cyclical susceptibility of the financial sector surfaced when the domestic economy was subjected to heavy inflows of global liquidity in response to the monetary stimulus policies of advanced countries. Foreign holdings of government securities mounted quickly to about 31% at end-2012, compared to 18% in 2009. This flood of liquidity pushed down interest rates, which in turn stimulated lending and escalation in asset prices that increased vulnerability in the financial sector. First, the high volume of foreign holdings on a thin financial market heightened price volatility during times of movement in foreign funds. Second, more rapid credit expansion buoyed by rising prices for collateral assets brought with it potential for escalating risks in the banking sector.

Taken together, these structural issues presented formidable challenges to efforts to maintain economic stability and safeguard the sustainability of Indonesia's economic growth. First, the growing numbers of middle class consumers generally in need of high technology goods spurred import growth. Second, exports relied heavily on demand from emerging market countries needing vast quantities of primary commodities and also on developments in commodity prices. Third, the first two factors produced an imbalanced structure in the economy that could bring pressure to bear in the external sector and in turn disrupt economic stability. Fourth, the domestic financial market had become highly susceptible to even modest shocks caused by changes in foreign investor behaviour.

Amid the urgency of these structural economic issues, the domestic economy came under mounting challenges in 2013 as a result of changes in global economic conditions. Developments in the global economy during 2013 took an unexpected turn with the prolonged global economic slowdown accompanied by significant levels of uncertainty on global financial markets. The global economy grew by 3.0% in 2013, down from 3.1% in the preceeding year. The slowdown in world economic growth caused mainly by slowing growth in emerging market countries such as China and India led to steady decline in world commodity prices. On financial markets, mounting global financial uncertainty was also triggered by the planned tapering off of the monetary stimulus in the United States that prompted a massive exodus of capital from emerging markets and put pressure on the exchange rates of some emerging market countries, including Indonesia.

The changes in global economic conditions during 2013 were influenced by shifting in the three global cycles. First is the global growth cycle, marked by a shift in the global growth landscape from the former reliance on growth in emerging market countries, led by China and India, to one driven more by recovery in advanced countries, notably the US. China, previously a major driving force for global economic growth, shifted to a slowing trend as part of its adjustment to cool the overheating economy. Economic growth in India also shifted into lower gear from the influence of various structural issues that have stoked inflationary pressure and widened the current account deficit. Second is the global commodity cycle, which has undergone a prolonged downward trend in world commodity prices caused by slackening economic growth in emerging market countries such as China and India. Third is the global financial cycle marked by capital reversal to advanced countries, a development related to the US plan to taper off the monetary stimulus that has fuelled expectations of an increase in US interest rates.

Global economic conditions at variance with these expectations have led to pressure on the Indonesian economy through the trade and financial channels. The influence of the global economy on the Indonesian economy became yet stronger because the underpinnings of Indonesia's economic structure were inadequate to quell the global turmoil, due to structural issues that continued to surface.

These global dynamics led to weakening performance in the Indonesia balance of payments that in turn exacerbated pressure on the rupiah. The deterioration in the balance of payments resulted from a widening in the current account deficit to 4.4% of GDP in the second quarter of 2013, consistent with declining exports amid high imports that continued unabated. The sizeable current account deficit carried forward into the third quarter of 2013, reaching 3.9% of GDP (Table 1). The weaker balance of payments were explained by a reduced capital and financial account surplus in the third quarter of 2013 in response to negative sentiment over the planned

Table 1. **Balance of Payments**

US$ million

Items	2008	2009	2010	2011	2012*	2013				
						Q1*	Q2*	Q3*	Q4**	Total
Current Account	**126**	**10,628**	**5,144**	**1,685**	**-24,418**	**-5,905**	**-9,998**	**-8,529**	**-4,018**	**-28,450**
Export	139,606	119,646	158,074	200,788	188,496	45,231	45,554	44,148	48,616	183,548
Import	-116,690	-88,714	-127,447	-166,005	-179,878	-43,603	-46,071	-44,003	-43,722	-177,399
Services + Income + Transfer	-22,789	-20,303	-25,484	-33,097	-33,036	-7,533	-9,481	-8,674	-8,911	-34,599
Capital & Financial Account	**-1,832**	**4,852**	**26,620**	**13,567**	**24,896**	**-394**	**8,300**	**5,587**	**9,238**	**22,731**
Direct Investment	3,419	2,628	11,106	11,528	13,716	3,789	3,700	5,681	1,597	14,767
Portfolio Investment	1,764	10,336	13,202	3,806	9,206	2,760	3,389	1,942	1,756	9,848
Other Investment	-7,309	-8,208	2,262	-1,801	1,922	-6,945	1,203	-2,041	5,877	-1,906
Overall Balance	**-1,945**	**12,506**	**30,285**	**11,857**	**215**	**-6,615**	**-2,477**	**-2,645**	**4,412**	**-7,325**
Memorandum										
Reserve	**51,639**	**66,105**	**96,207**	**110,123**	**112,781**	**104,800**	**98,095**	**95,675**	**99,387**	**99,387**
In months of import & Servicing of Government External Debt	4.0	6.5	7.4	6.5	6.1	5.7	5.4	5.2	5.5	5.5
Current Account (% GDP)	**0**	**2.0**	**0.7**	**0.2**	**-2.8**	**-2.7**	**-4.4**	**-3.9**	**-2.0**	**-3.3**

Table 2. **Economic Indicators**

Percent, yoy

Indicator	2008	2009	2010	2011	2012	Q1-2013	Q2-2013	Q3-2013	Q4-2013	2013
GDP	**6.0**	**4.6**	**6.2**	**6.5**	**6.2**	**6.0**	**5.8**	**5.6**	**5.7**	**5.8**
Household Consumption	5.3	4.9	4.7	4.7	5.3	5.2	5.1	5.5	5.3	5.3
Government Consumption	10.4	15.7	0.3	3.2	1.2	0.4	2.2	8.9	6.4	4.9
Gross Fix Capital Formation	11.9	3.3	8.5	8.8	9.8	5.5	4.5	4.5	4.4	4.7
Export	9.5	-9.7	15.3	13.6	2.0	3.6	4.8	5.2	7.4	5.3
Import	10.0	-15.0	17.3	13.3	6.6	0.0	0.7	5.1	-0.6	1.2
Inflation	**11.1**	**2.8**	**7.0**	**3.8**	**4.3**	**5.9**	**5.9**	**8.4**	**8.4**	**8.4**
Core Inflation	8.3	4.3	4.3	4.3	4.4	4.2	4.0	4.7	5.0	5.0
Administered Price	16.0	-3.3	5.4	2.8	2.7	2.9	6.7	15.5	16.7	16.7
Volatile Food	16.5	3.9	17.7	3.4	5.7	14.2	11.5	13.9	11.8	11.8
Exchange Rate (average) Rp/ USD	9,692	10,408	9,087	8,776	9,358	9,694	9,789	10,670	11,689	10,445
Budget Deficit (% to GDP)	-0.1	-1.6	-0.7	-1.1	-1.9	-0.2	-0.4	-0.6	-1.1	-2.3

Source: BPS-Statistics Indonesia, Ministry of Finance

tapering off of the US monetary stimulus that bore down on capital inflows in emerging markets, including Indonesia. The condition of the balance of payments inevitably resulted in pressure bearing down on the rupiah. The rupiah was hit by even steeper depreciation when capital outflows soared on the financial market from mid-May 2013 to near the end of September 2013 due to the planned cutback in the US monetary stimulus and negative investor perceptions of the outlook for the current account deficit. The weakening in the rupiah took place at a time of mounting capital outflows because at that time, the domestic foreign exchange market structure lacked depth so that even a modest increase in foreign exchange demand would trigger significant depreciation in the rupiah.

Amid the escalating external challenges, mounting inflation at home added to the existing pressures. The heightened inflationary pressure in 2013 was driven mainly by the impact of rising food prices in the first quarter of 2013 and the hike in subsidised fuel prices in June 2013 (Table 2). Alongside this, core inflation was held down in 2013 with support from weak domestic demand, only moderate second round effects from exchange rate depreciation and the downward trend in global commodity prices. The surge in food prices was triggered by the effect of import restrictions on horticultural products and anomalous weather conditions. As a result, domestic supply of food staples suffered disruption that ultimately drove up food prices. Inflationary pressure gathered momentum from June to August 2013, around the time that the Government raised subsidies fuel prices. The decision to raise fuel prices not only spurred inflation in administered prices, but also led to second round effects in other categories, such as transport fares. Accompanying this was mounting inflationary pressure in the food category from June to August 2013, also caused by the second round effects of the fuel price hike and tight supply of food staples (Table 2).

This pressure on the external sector and surge in inflation put brakes on economic growth. Economic growth was on a slowing trend up to the third quarter of 2013, mainly as a result of slackening investment and especially non-construction investment. In contrast, household consumption and imports maintained vibrant growth, notably in the third quarter of 2013. In other developments, real exports resumed an upward trend in early 2013 (Table 2).

Policy Mix Response

In responding to this multiplicity of economic challenges, Bank Indonesia and the Government have worked in synergy to pursue a range of policies to regain a comfortably secure level of economic stability and bring immediate improvement to economic balances. In this regard, the thrust of the policy response is to ensure that inflation is brought back in line with the inflation target and the current account deficit is quickly reduced to a safe level, while ensuring continued support from fiscal sustainability and prudently managed financial system stability.

The synergy of policy response can be categorised into three policy mixes. The first is related to the Bank Indonesia policy mix, which relies not only on interest rate, but also seeks to optimise other instruments. This policy mix is steered so that it can address cyclical issues within the framework of controlling domestic demand, curbing imports and boosting exports, and in turn act quickly to ensure that inflation is returned quickly to the targeted range. The second is a mix of monetary policy and fiscal that interacts optimaly in pursuit of policy targets. In particular, fiscal policy is directed towards maintaining fiscal sustainability through cutbacks in the fuel subsidy, while also reining in domestic demand. The third policy mix is related to the drive to strengthen the basis of the economy in the medium-term. In this regard, the Government is addressing various issues on a structural level through policy packages.

For Bank Indonesia, the objetive of the policy strategy was to steer inflation back on course for the target, bring down the current account deficit to a more prudent level and restore confidence in the rupiah exchange rate. Within this context, Bank Indonesia strengthened the policy mix through application of interest rate policy, exchange rate policy, reinforcement of monetary operations, capital flows management, financial market deepening, macroprudential and microprudential policies and strengthening of coordination with the Government and relevant authorities as well as of cooperation with other central banks. The tight policy bias in the BI Rate aimed primarily at curbing inflation in line with the inflation target. The policy decision to raise interest rates in conjunction with macroprudential tightening also sought to rein in excessive domestic demand. The exchange rate policy was targeted at keeping exchange rate movement aligned to economic fundamentals in order to achieve expenditure switching by boosting exports and curbing demand for imports. Meanwhile, policies in management of foreign exchange flows and financial market deepening were sought to build external sector resilience and improve financial market efficiency in order to withstand shocks amid conditions of shrinking capital inflows during 2013.

Interest rate policy was directed towards curbing inflation expectations and the second round effects of the hike in subsidised fuel prices through increases in the BI Rate, the Deposit Facility rate and Lending Facility rate. Bank Indonesia set the BI Rate at a level consistent with efforts to bring inflation quickly back on course with the targeted range of 4.5±1% in 2014 and 4.0±1% in 2015. Early in 2013, Bank Indonesia was cognizant of the escalation in inflation expectations driven both by rising food prices and the planned hike in subsidised fuel prices. Bank Indonesia also kept a close watch on developments in the current account deficit, which had begun to widen, bringing with it risks of disrupting economic stability and the sustainability of economic growth. In a pre-emptive measure, Bank Indonesia initially raised the BI Rate from the previous 5.75% to 6.00% on 13 June 2013, just before the hike in subsidised fuel prices. This was followed by a series of BI Rate increases in response to stubbornly high inflation expectations in the aftermath of the fuel price hike at the end of June 2013 and the burgeoning current account deficit. Taken together, during 2013 Bank Indonesia raised the BI Rate by 175 to 7.50% at the end of the year.

The exchange rate policy focused on measures to bring down the current account deficit by steering rupiah exchange rate movement in line with the condition of its fundamentals. This policy was implemented through stabilisation of the rupiah on the spot market and swap market. The aim of the stabilisation is to narrow the demand-supply gap on the foreign exchange market against the background of lack of depth in the foreign exchange market structure. In this regard, Bank Indonesia also engaged in dual intervention, particularly when the government bonds market was beset by heavy capital outflows. This strategy was pursued in support of stabilising the exchange rate while safeguarding rupiah liquidity and financial system stability, most importantly on the Indonesian government bonds market. Meanwhile, in a further measure to bolster rupiah stability, Bank Indonesia coordinated actions with the Government in calling on state-owned enterprises to manage risks by taking out hedging.

The policy for capital flows management in 2013 was directed towards reinforcing external sector resilience during a time of limited capital inflows. It was within this context that Bank Indonesia eased the rule for the holding period for Bank Indonesia Certificates (SBIs), shortening it from the previous six months to one month. In addition, Bank Indonesia relaxed the regulations governing external borrowings by adding exemptions for short-term external bank borrowings in the form of rupiah vostro accounts (non-resident demand deposits) used to hold divestment proceeds. The objective of this policy is to manage non-resident demand for foreign exchange without sacrificing banking prudence in offshore borrowing. During this period, in a move to bolster the structure of foreign exchange supply, Bank Indonesia eased the rules governing foreign exchange purchases for exporters having previously sold export proceeds. This provided greater ease for exporters in buying foreign exchange against underlying documents for sale of export proceeds. Bank Indonesia also opened foreign exchange-related window facilities, such as repos on Indonesian government bonds, export usance bill of exchange, and swap hedging.

The year 2013 was also marked by various Bank Indonesia policies for strengthening monetary operations and deepening of the financial market. Policy within the context of reinforcing monetary operations involved a strategy of prolonging instrument tenors to reduce the structural concentration of excess liquidity in short-tenor instruments within the banking system and thus enable monetary policy transmission to operate more effectively. The prolonging of these tenors was phased in by shifting away from issuances of 1-month tenor SBIs towards longer tenors of 3, 6 and 9 months. This strategy was maintained through the second half of 2013, consistent with the market behaviour of the growing volume of liquid assets held in short-tenor instruments for precautionary purposes, due to heightened uncertainty. Under these conditions, the position of short-tenor monetary instruments, such as the deposit facility and reverse repo on Indonesian government bonds, showed steady expansion. At the same time, placements in rupiah Term Deposits (TD), a non-tradable instrument, and SBIs were marked by decline. In response, Bank Indonesia launched the Bank Indonesia Certificates of Deposit (BICDs) as a new instrument for open market operations to accommodate the non-tradable characteristic of TDs and enrich the range of money market instruments for financial market deepening.

Within the context of financial market deepening, policy was directed towards creating a more efficient and liquid money market. On the rupiah money market, the development of the repo market became a leading priority in 2013. In the past, the rupiah money market was traditionally dominated by non-collateralised interbank transactions in prevailing short tenors (less than 1 month, and mostly O/N). Under these conditions, escalating uncertainty would increase exposure to credit risk in interbank transactions. However, with banks using collateralised repo transactions, this risk could be minimised. To this end, Bank Indonesia encouraged the development of the Mini Master Repo Agreement (Mini MRA) in December 2013. As an initial step, eight banks signed the Mini MRA and agreed on the use of standard contracts in interbank repo transactions as a way of facilitating the operation of these transactions. In support of creating a more efficient and liquid foreign exchange market, Bank Indonesia established a reference exchange rate known as the Jakarta Interbank Spot Dollar Rate (JISDOR) in May 2013. The reference rate is expected to yield credible information to serve as a reference for financial market actors in conducting transactions and to support the creation of efficient price formation on the foreign exchange market, including minimised deviation in price formation among market actors. Bank Indonesia also held auctions of FX swaps in order to enrich the available instruments for open market operations and bolster the strategy for exchange rate management. The implementation of the FX swap auctions was aimed at supporting rupiah monetary operations and management of bank liquidity, promoting broader availability of hedging instruments for stimulating investor interest in Indonesia and encouraging more transparent price discovery in line with market prices.

Alongside these measures, Bank Indonesia also forged closer coordination and collaboration with other central banks in monetary policy and financial system stability with the purpose of bolstering external sector resilience through swap mechanisms with ASEAN+3 counterparty countries. Bank Indonesia also initiated collaboration in the form of bilateral swap transactions with Japan, China and Korea for added reinforcement of regional financial arrangements (RFAs) within the Chiang Mai Initiative Multilateralisation (CMIM) scheme. This collaboration is expected to form a second line of defence in the face of stubbornly high uncertainty in the global economy In other developments, Bank Indonesia and the Bank of Japan have also agreed to implement a Cross Border Collateral Arrangement (CBCA) mechanism.

Macroprudential policy, in addition to maintaining financial system stability, has pursued a direction alongside other initiatives of bolstering efforts to manage domestic demand to avoid fuelling demand for imports on a scale that widens the current account deficit. First, Bank Indonesia introduced stricter rules on Loan to Value (LTV)/Financing to Value (FTV) for property mortgages and consumer credit secured by property collateral. This policy is aimed at building resilience in the banking system by placing prudential principles at the fore, providing greater opportunity for middle and lower income earners to obtain habitable homes and improve consumer protection in the property sector. The tightening of LTV is also consistent with Bank Indonesia's efforts to rein in the current account deficit. Second, other macroprudential polices were put in place with improvement to the Secondary Reserve Requirement and the LDR Reserve Requirement. The purpose of these improvements is to anticipate various potential risks in order to create adequate robust liquidity conditions in the banking system while keeping close attention on the bank role in operating the intermediation function. Supervisory actions were also launched to keep the operation of the intermediation function by the banking industry remained within the desired boundaries, commensurate with the needs of the economy, and to ensure adequate resilience in banking liquidity and sufficient capital to absorb potential risks.

Microprudential policies were initiated in support of financial system stability and to strengthen the banking industry during the process of transferring bank supervision functions from Bank Indonesia to the OJK. The microprudential policies launched by Bank Indonesia included provisions related to capital, supervision of conventional commercial banks and prudential principles. The capital-related provisions, which prescribe the Minimum Capital Adequacy Requirement (CAR), seek to improve capacity for absorbing risks linked to crisis conditions and/or excessive lending growth in the banking system. In regard to supervision, a policy was released for Determination of Status and Follow Up of Supervision on Conventional Commercial Banks. This represents a preventive measure for bank problems to be resolved at an early stage, so that they do not imperil the survival of the bank. Similarly, prudential regulations were issued for Transparency of Rural Banks Financial Condition and Prudential Principles in Equity Participation. The regulation for Transparency of Rural Banks Financial Condition envisages the strengthening of transparency and integrity in public disclosure of the financial condition of rural banks through changes to the procedure for announcement of published reports. The regulation governing equity participation essentially stipulates new rules for equity participation, one of the main activities in bank fund placements. In the future, microprudential policy will be managed by the OJK.

In the payment system, Bank Indonesia was pursuing several policies to ensure the sound operation of the payment system as infrastructure that supported the economy and the financial system. These developments were visible in the speed and accuracy of settlement of large value transactions, improved efficiency in operation of the retail payment system and increased use of non-cash payment instruments in support of greater efficiency in the economy. The policies put in place included strengthening of the payment system infrastructure in Bank Indonesia, further development of the National Payment Gateway (NPG), interconnection of e-Money and development of Less Cash Society areas.

In the area of currency management, Bank Indonesia launched policies to ensure the availability of rupiah trusted by the public, secure and optimal cash distribution and management and excellence on cash services. To ensure availability of rupiah in sufficient amount, Bank Indonesia introduced a policy of maintaining an adequate level of cash position by accelerating banknote printing and maintaining smoothness of currency distribution. To expand the coverage of cash services for the public, Bank Indonesia moved forward with the policy of increasing the number of cash custody service locations in blank spot areas outside the reach of Bank Indonesia's cash services and introduced mobile cash services to provide greater access for the public in exchanging unfit or damage Rupiah. Following that, in order to improve efficiency in bank cash management, Bank Indonesia expanded the implementation of interbank cash exchange policy from each Bank Indonesia offices to a national scope. Finally, the currency management policy was to scale up activities for educating the public on the authenticity feature of the rupiah and proper handling of rupiah currency in line with the implementation of clean money policy. The policies employed by Bank Indonesia also rely considerably on cooperation and coordination from all stakeholders, including the Ministry of Finance, the State Ministry for SOEs, the Ministry of Education and Culture, the Indonesian Navy, the National Police, the Counterfeit Money Eradication Agency (BOTASUPAL), Perum Peruri and regional government institution.

To support policy effectiveness, Bank Indonesia is constantly engaged in forging closer cooperation with the Government and relevant authorities. The policy coordination with the Government can be described as having four facets. First is coordination in curbing inflationary pressure, an issue that posed considerable challenges in 2013 due to the impact of rising food prices and increase in subsidised fuel prices. This coordination was managed through the National Inflation Controlling Teams (TPI) at the central government level and the Regional Inflation Controlling Teams (TPIDs) at the regional level. Second is coordination in bolstering external sector resilience, most importantly to trim the current account deficit. Third is coordination for greater effectiveness in crisis prevention and resolution through the Coordination Forum for Financial System Stability (FKSSK). Lastly, coordination was pursued in the payment system through cooperation with relevant institution in ensuring availability of rupiah currency, consumer protection, oversight of remittance activities and more robust efficiency in the operation of the retail payment system.

Policies undertaken by the Government essentially sought to maintain fiscal sustainability, rein in domestic demand and inflation and bring down the current account deficit. Within this policy direction, the government raised subsidised fuel prices in June 2013 with the aim of safeguarding fiscal sustainability following brief disruption, improving efficiency in allocation of natural resources and at the same time curbing domestic demand in order to bring down the current account deficit. In the context of bringing down the current account deficit, the Government also issues policies designed to curb imports and boost exports. To reduce oil imports and to improve fiscal conditions, the Government cut back the fuel subsidy while accelerating the introduction of biodiesel use. Import controls were also implemented by raising taxes on luxury goods sales (PPnBM) to discourage consumption of imported goods by the middle and upper classes and promote consumption of domestic products. Alongside this, the policy for boosting exports was also implemented through provision of tax incentives, with additional tax relief for companies in labour-intensive sectors exporting at least 30% of production. This policy was also reinforced with import controls through imposition of higher import VAT rates for goods meeting certain criteria and streamlining of imports intended for use in exports.

In regard to inflation control, the Government introduced simplified import procedures and changes in the trading scheme for horticultural products. To stabilise beef prices, the Government introduced changes to regulations governing imports of livestock and animal products, with quota restrictions replaced by a mechanism based on reference prices. A similar policy was also instituted for horticultural products, such as shallots and chilli peppers. These policies resulted in a positive contribution to easing pressure in volatile foods inflation during the fourth quarter of 2013. Even so, in the long-term further improvements are needed in the food resilience programme to ease the dependence on food imports.

In addition, Government pursued a number of policies for improvement of the investment climate in order to attract foreign direct investment. To this end, the Government streamlined investment procedures and made revisions to the negative investment list and conditionally open investment list to create a more investor-friendly environment. For greater effect, the Government also released a policy package to improve the ease of doing business by streamlining business licensing requirements.

Developments in the Economy

The economic adjustments implemented by Bank Indonesia and the Government succeeded in steering the economy in the desired direction. Developments in the fourth quarter of 2013 indicate that control was regained over economic stability, accompanied by the onset of greater equilibrium in the workings of the economy. The improved balance in the economy in turn contributed to bringing down the current account deficit to a safer level, which ultimately helped to ease downward pressure on the rupiah exchange rate.

These policy responses alleviating pressures on economic stability, enabling the inflation outlook to return quickly to the targeting range of 4.5±1% in 2014 and 4.0±1% in 2015. The Bank Indonesia policy response and close policy coordination with the Government in controlling the second round effect brought down inflationary pressure, with conditions returning to normal in September 2013. Pressure in food prices came down dramatically enough to record deflation. Inflation expectations, which had previously surged, fell back to normal levels in tandem with minimum effect from exchange rate pass-through, a development that kept core inflation within prudent limits. During 2013 overall, inflation mounted to 8.38% from 4.30% in 2012. Although well above the prescribed 4.5±1% inflation target, the various policies put into place managed to curb inflation within the single digit range, unlike 2005 and 2008 when hikes in subsidised fuel prices resulted in double-digit inflation (Box: Accountability for Achievement of the 2013 Inflation Target).

Pressure on the balance of payments also eased in the fourth quarter of 2013, followed by more moderate depreciation in the rupiah. Improvement in the balance of payments was achieved on a significant reduction in the current account deficit to 2.0% of GDP, which compares to the second quarter and the third quarter of 2013 deficits of 4.4% and 3.9% of GDP (Chart 1). The improvement in the current account resulted from declining imports in keeping with moderate domestic demand and the downward trend in the rupiah. Another factor influencing the deficit was stronger exports buoyed by more robust growth in advanced countries and a competitive rupiah exchange rate. Improvement in the balance of payments also resulted from rising capital inflows, which in the final outcome brought the balance of payments back into surplus in the fourth quarter of 2013. The rebound in the balance of payments in the fourth quarter of 2013 then contributed towards halting the decline in the rupiah during the same period (Chart 1). In the overall picture, Bank Indonesia believes that during 2013, the various policies succeeded in guiding the rupiah exchange rate at a level commensurate to its fundamentals.

Improvement in the fourth quarter of 2013 balance of payments was also bolstered by a more balance economic growth. In the fourth quarter of 2013, domestic demand eased in response to slowing consumption and investment, particularly in the area of non-construction investment. Imports contracted in line with weakening domestic demand, while exports rebounded in line with the improvment of the world economy. In response, economic growth in the fourth quarter of 2013 was recorded at 5.7% (yoy), up slightly from growth in the preceding quarter (Chart 1). In the broad picture, the adjustments in the economy during 2013 took place within comfortable safe limits. Economic growth dropped only slightly to 5.8%, a fairly buoyant level when compared to peer countries.

The prudently managed economic adjustment was supported by robust fiscal resilience and Indonesia's sound external debt structure. The government decision to raise subsidised fuel prices at the end of June 2013 enabled the deficit in the Revised 2013 Budget to be curbed to 2.3% of GDP. Strong fiscal resilience was also supported by a prudently level of official debt at about 26% of GDP. The sound structure of Indonesia's external debt was also reflected in the subdued, prudent growth in the nation's external debt position. In 2013, external debt grew by 4.6%, down from Indonesia's external debt growth in 2012 that reached 12.0%. The slowing trend in external debt is representative of a positive adjustment by economic actors to the moderating trend in Indonesia's economic growth that has kept external debt within comfortably safe limits. Indonesia's external debt position is also dominated by long-term borrowings, most in the form of loan agreements.

The policy mix also succeeded in keeping financial system stability at a secure level, enabling controlled adjustment in the domestic economy and creating suitable conditions for the transfer of bank supervision functions to the OJK. Amid the slowing trend in the domestic economy and depreciation in the exchange rate, Indonesia's financial sector and particularly the banking industry maintained solid performance. Bank credit expansion eased from 23.1% at the end of 2012 to 21.4% in December 2013 in keeping with Bank Indonesia's efforts to steer the economy in a more prudent direction. At the same time, growth in lending to micro, small and medium enterprises (MSMEs) was up from the previous year despite a slowing trend that set in during September 2013. The brisk pace of MSME lending is indicative of the substantial role of MSMEs in driving the domestic economy. Banking risks, reflected in credit risk, liquidity risk and market risk, were also managed at prudent levels made possible through the strength of capital resilience.

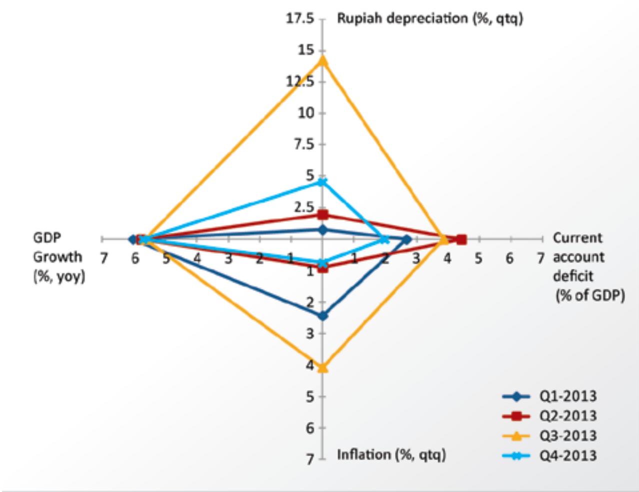


Chart 1. **Development of Economic Indicators 2013**

The secure level of financial system stability during a time of economic slowdown is also attributable to the role of the payment system, which supports the efficient, secure and expeditious operation of economic transactions. The slowdown in the economy has led to a decline in non-cash transactions. Despite this, transaction volume has expanded in keeping with the substantial increase in transactions originating from retail payments. Also bolstering economic activity is the adequate and timely provision of cash payment instruments in condition fit for circulation, despite reduced growth in currency in circulation compared to 2012 due to the slowing performance of the economy.

Taken together, the dynamics of the Indonesian economy in 2013 taught some valuable lessons for efforts to bolster the sustainability of Indonesia's future economic growth. The first lesson that came to light is related to the importance of macroeconomic policy discipline, both fiscal and monetary, in maintaining stability and sustainable economic growth. The journey of the economy in 2013 demonstrates that macroeconomic policy must remain focused on safeguarding economic balance to avoid overheated growth that can stoke pressure in the current account and inflation. In this regard, a pre-emptive monetary policy focused steadfastly on inflation control and fiscal policy aimed consistently at securing fiscal sustainability together comprise the foundation for reinforcing the overall resilience of the economy. Second, in the face of cyclical and structural challenges, the policy response cannot rely solely on one kind of policy. Use of a single policy or instrument to resolve complex issues poses a multiplicity of policy dilemmas that are difficult to overcome. Third, amid mounting pressure on the economy, of utmost importance to a bold policy response is the support of a sound financial system and corporate balance sheets. Without that, policies will be confronted with an escalating dilemma between stabilisation on one hand and the weakness of the financial system and corporates on the other. Fourth, another valuable lesson is the importance of intensive communications to anchor market perceptions. In addition, close coordination among policy makers is a vital element in strengthening policy effectiveness. Lastly, the dynamics of the economy in 2013 also served as a reminder of the importance of building more strength into structural policies in support of sustainable economic growth. In this regard, the policy for financial market deepening must also be made a priority to be able to curb excessive turbulence on the financial market.

Short-Term Economic Outlook and Bank Indonesia Policy Direction

The positive developments of the final quarter of 2013 have paved the way for future strengthening of the economy. The economic stability that is back under control is a vital asset for expanding economic activity on the road ahead. A more balance economic activity has also begun, and this is expected to bolster efforts to bring down the current account deficit to a healthier level. With support from prudently managed financial system stability, these improvements are in a position to bolster efforts to promote sustainable economic growth.

Bank Indonesia predicts that 2014 will see economic stability brought back well under control, accompanied by improved balanced economic growth enabling reduction in the current account deficit to a more prudent level. Economic growth is forecasted to come within the 5.5-5.9% range, underpinned by greater equilibrium in sources of growth in keeping with the outlook for better exports and continuing moderate domestic demand. This is also supported by a fiscal posture that continues to provide space for measured fiscal stimulus actions while maintaining fiscal sustainability. The more balanced growth in the economy is predicted to bring improvement to the current account deficit and steer inflation back towards the targeted level. The current account deficit is forecasted to drop below 3.0% of GDP in response to improved exports bolstered by recovery in the world economy and more restrained imports consistent with the moderating trend in the domestic economy. Meanwhile, inflation is predicted to return to a subdued level in 2014, within the targeting range of 4.5±1%. Consistent with the economic growth outlook, bank credit expansion is forecasted in the 15-17% range.

In 2015, growth in the domestic economy is forecasted to outpace that of 2014, reaching 5.8-6.2%. Alongside this, the outlook for inflation is a further decline to the 4.0±1% range, supported by a series of policies for inflation control. Core inflation is predicted to remain low, with firmly anchored inflation expectations. Volatile foods inflation is expected to decline in keeping with increased food production and improvement in trading schemes. The forecast for administered prices is a return to low inflation in the absence of decisions to raise prices for strategic goods or services.

Despite the outlook for improvement, the prospects for the economy in 2014-2015 are daunted by a number of global and domestic risks. At the global level, the risk is of weaker than predicted recovery in the global economy and the associated implication of slackening demand for Indonesia's exports. The rebalancing process in China that involves a change from investment to consumption-oriented growth also has potential to bear down on Indonesia's economic performance in exports. Meanwhile, it is necessary to keep a close watch on how the Fed follows up the tapering off policy, as this could trigger capital reversal from emerging market countries including Indonesia. These global risks call for steadfast attention, due to the possible impact on the domestic economy through the trade channel and financial channel.

Careful monitoring is also necessary for risks arising from domestic issues. These risks are related to rising food prices, increases in administered prices and the second round effects on inflation from depreciation in the exchange rate. Escalation in food prices can arise from potential disruptions to food production and distribution caused by weather conditions. Another source of risk is the impact from implementation of the Law No.04/2009 concerning Minerals and Coal Mining, which may bear down on export growth and economic expansion in the short-term. Nevertheless, in the medium-term, exports are expected to chart more robust growth following the operation of smelters that will improve the value added of Indonesia's commodity exports.

In relation to this outlook and the risks for the economy, Bank Indonesia policy in 2014 will remain focused on safeguarding macroeconomic and financial system stability while guiding economic to move forward in a more balance growth without placing added strain on the current account. As learned from the dynamics of the economy in 2013, policy discipline and consistency are crucial to stability and sustainable economic growth.

For this reason, Bank Indonesia will press forward with strengthening the policy mix in monetary, macroprudential and payment system management. On the monetary side, policy will stay the course for curbing inflation in line with the inflation target and bringing down the current account deficit to a prudent level. This policy operates through setting interest rates and managing the exchange rate in line with its fundamentals. In applying this approach, the exchange rate is envisaged as playing the role of shock absorber for the economy, instead of shock amplifier. Bank Indonesia will also take further measures to strengthen monetary operations and foreign exchange flows, while also moving forward with financial market deepening in support of effective policy transmission while strengthening the structure and capacity of the financial system for financing development. Complementing this will be the bolstering of the second line of defence in anticipation of economic uncertainties, to be implemented through financial cooperation with central banks and financial authorities in the region.

For the future, Bank Indonesia's macroprudential policy will remain focused on safeguarding financial system stability and strengthening the resilience of the banking system by placing prudential principles at the fore. Bank Indonesia will also step up the implementation of new functions and powers in its capacity as macroprudential authority. In this area, macroprudential policy will target management of systemic risk including credit risk, liquidity risk, market risk and building more robust capital structure. Efforts will be continued to forge closer macro-micro coordination between Bank Indonesia and the OJK within the scope of reinforcing financial system stability to ensure that the duties, functions and powers of each institution are performed effectively. The development of sharia-compliant finance is also a priority in forging more robust financial system stability. Development of the sharia-compliant legal infrastructure, institutions and financial market, including its supporting instruments, will be rolled out on a broader scale to strengthen the contribution of the sharia-compliant economy to national economic growth.

Regarding payment system policy, Bank Indonesia policy will focus on development of a more secure, efficient and smoothly operating domestic payment system industry. As the authority, Bank Indonesia will be constantly engaged in regulation, development, oversight and licensing for operation of the payment system. In this capacity, it envisages the development of a more efficient domestic payment system through improvements to the existing payment system architecture and expanding access to payment services. Bank Indonesia will also strengthen the regulation and oversight of the payment system.

In addition to these monetary, macroprudential and payment system policies, Bank Indonesia will also introduce more robust policies related to financial inclusion and MSMEs. These policies will have a role in promoting bank intermediation and improving bank efficiency that in turn will contribute to strengthening financial system stability and support policy in the payment system. The financial inclusion policy will provide assistance for the economic activities of medium and low income earners in a way that brings structural improvement to the economy and improves income equity. All these policies will be bolstered by a range of policy coordination actions pursued jointly with the government and relevant authorities.

Medium-Term Economic Outlook and Policies for Structural Reform

In the medium term, the Indonesian economy is predicted to chart higher growth accompanied by reduced inflation and a more viable posture in the current account. This is supported by an outlook for steady improvement in global economic growth and expectations of accelerated implementation of various structural policies in keeping with plans launched by the Government.

This prognosis depends to a great extent on the ability to resolve various structural challenges daunting the domestic economy. These challenges are related to structural issues in financing and domestic production, including energy resilience and food resilience and their impact on subsidy management in the state budget, and the need to strengthen the basic capital for development. Regardless of accomplishments so far, the more rapid implementation of structural reform policies will still be essential to prevent Indonesia from becoming caught in the middle income trap.

In the opinion of Bank Indonesia, the drive for more rapid structural reform needs to focus on the three main pillars of sustainable development financing, industrial competitiveness and self-sufficiency of the domestic economy. Efforts to strengthen the three pillars will require support from policies designed to promote energy and food resilience and to bolster the basic capital for development, all factors that will support sustainable economic growth.

Regarding these three pillars, measures to accelerate reform can be divided into three main areas. First is the policy for financial market deepening in support of sustainable economic growth. Second is structural reinforcement of production and integration into global supply chains to boost competitiveness and domestic self-sufficiency. Third is expansion of fiscal space in support of economic growth by optimising the management of energy subsidies.

The structural policies for financial market deepening relate to measures designed to support more sustainable development financing. The deepening of the stock and bond markets needs to focus on market expansion and broadening the domestic investor base. Besides the stock and bond markets, deepening is also an important need on the money market and foreign exchange market. Under its powers, Bank Indonesia will press forward with more robust measures for financial market deepening in order to strengthen the basis for sustainable financing. To this end, Bank Indonesia will focus its policy on bolstering existing measures for financial market deepening. The strategy for financial market expansion seeks to bring about a liquid and efficient financial market in which resilience remains a leading priority, while complying resolutely with prudential principles.

The policies for reinforcing the structure of domestic production is aimed at building a base of available capital for the growth and expansion of domestic industry integrated into global supply chains. In this regard, the policies requiring accelerated implementation are provision of infrastructure for secure, rapid and reliable connectivity, both physical and digital, globally competitive human capital, capacity for absorbing high technology, and a business climate and institutions conducive to broader private sector participation in the march for development. This more rapid drive is expected to bring forth a more competitive structure for domestic production structure, one that will play an increasingly important role in the collaboration of global value chains. In addition, the policies for bolstering national self-sufficiency in energy and food staples used as inputs for production, which are vital to the industrialisation process, also need to be implemented with greater urgency.

Structural policies related to optimising the management of energy subsidies have considerable importance because of their influence on many other structural aspects. On one hand, the optimum management of energy subsidies offers assurance that fiscal space will become available for expanding capital expenditures. On the other hand, management of energy subsidies will strengthen the basic capital for building growth in a globally competitive, self-reliant domestic industrial sector. Various studies point to the importance of capital expenditures, including spending on infrastructure, in promoting overall economic growth. In the case of Indonesia, government spending on infrastructure has delivered a positive contribution to increased productivity and economic growth. Studies also point to a negative correlation between government spending on infrastructure and inflation.

The optimisation of energy subsidies can also resolve a range of other issues. One issue that is exacerbated by the high level of energy subsidies is lack of efficiency in allocation of non-renewable resources. Furthermore, the sheer volume of the subsidies is disruptive to overall fiscal resilience. The deficit in the primary balance in the past two years is inextricably linked to the effect of these high energy subsidies. Finally, excessive energy subsidies during times of steadily rising world oil prices will hamper the economic adjustment process and in turn risk a renewed increase in susceptibility to shocks.

Bank Indonesia predicts that if structural reforms are able to make good progress, economic growth could reach 6.5% in 2018 with progressively lower inflation on track with the medium-term target and a healthier current account deficit. The medium-term outlook for the economy could see even higher growth if various measures to build industrial capability proceed as planned and if the prerequisites of policies for improvement in the productivity and competitiveness of the domestic economy can also be met. However, if the structural reform policies cannot move forward as planned, economic growth may fall short of forecasted levels while accompanied by higher inflation and more limited amelioration in the current account deficit.

Box Accountability for Achievement of the 2013 Inflation Target

In 2013, CPI inflation reached 8.4% (yoy), well above the prescribed target of 4.5±1% (yoy). One reason for the deviation in the inflation outcome against target is the high volatile foods inflation at 11.8% (yoy). The other principal source of inflationary pressure is administered prices, where inflation reached 16.7% (yoy). Nevertheless, core inflation, which reflects aggregate supply-demand interaction, was contained at a modest 5% (yoy).

In early 2013, the Government implemented a restrictive policy for horticultural imports, including shallots, garlic and chilli peppers, that led to disruptions in supply. At the same time, domestic supply of food staples was under pressure from adverse weather conditions. The import controls applied to horticultural products concomitantly with disruptions to supply caused by weather anomalies resulted in supply shocks in strategic food items. This situation triggered significant price increases for domestic food prices, particularly for miscellaneous seasonings, vegetables and fruit. The imposition of import controls on beef also led to further increases in beef prices. As a result of the supply shocks affecting horticultural products and beef, volatile foods inflation climbed to 11.8%, above the ten-year average of 9.4% (yoy), while generating a 2.3% contribution to inflation in 2013.

Similarly, the contribution of administered prices to inflation came in response to policy decisions to increase subsidised fuel prices, electricity billing rates, household fuel prices and cigarette excise. The Government took the decision to raise subsidised fuel prices as a step towards building greater fiscal resilience by trimming the burden of subsidies and also to bring improvement to the current account deficit. Despite the steep 33% rise in subsidised fuel prices, the inflationary impact was quite moderate at 2.7%. The increase in household fuel prices in response to the rising costs of distributing LPG to households generated a 0.16% contribution to inflation. In a similar vein, the increased cigarette excise was passed on through higher retail cigarette prices, in turn boosting inflation by 0.31%. In 2013, inflation in the administered prices category reached 16.65% (yoy), representing a 2.87% contribution to inflation for the year. This figure for administered prices inflation represents a considerably higher outcome compared to the historical average for the past ten years at 8.49% (yoy).

Inflationary pressure from fundamentals, reflected in the monitored level of core inflation, was quite mild despite surpassing earlier forecasts. This condition demonstrates that macroeconomic balance has been generally well maintained. Demand-side acceleration has been reined in through support for the supply-side capacity of the economy and subdued inflation expectations, despite a spike in the first half of 2013. Furthermore, a vital factor in keeping a lid on core inflation was the moderate external-side pressure while the rupiah sustained depreciation. This moderate pressure from externals is explained by the minimum exchange rate pass-through on domestic prices, reflected in the low rate of traded core inflation[1]. In addition, the weakening trend in global commodity prices helped to alleviate the impact of the weakening value of the rupiah. The rise in core inflation was therefore driven more by the steady increase in non-traded core inflation after the beginning of the year, the result of cost push of food price shocks that subsequently peaked during the aftermath of the hike in subsidised fuel prices.

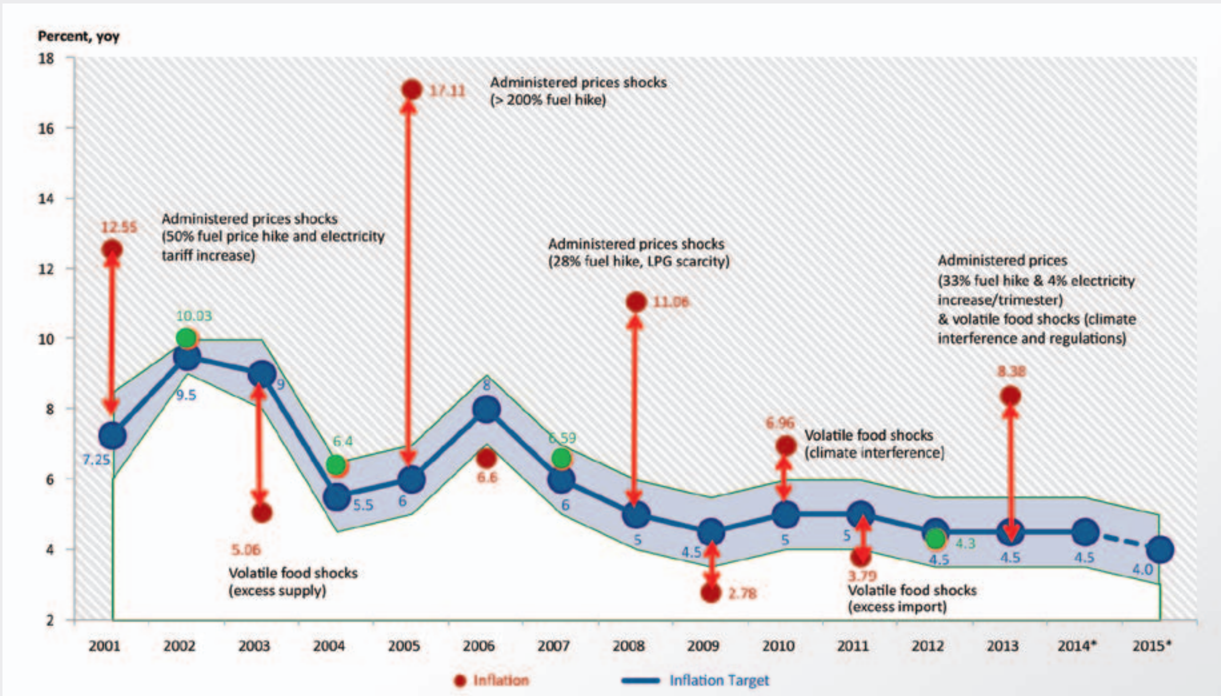
Although above the targeted range, the rate of CPI inflation was nevertheless contained at the single digit level (Chart 1)[2]. This achievement owes much to the various policies adopted by Bank Indonesia and the Government. The actions to bolster coordination between Bank Indonesia and the Government were taken to minimise the second round effects from increases in administered prices and shocks in volatile food prices while steering inflation expectations towards the inflation target.

In monetary affairs, Bank Indonesia introduced a policy mix in 2013 involving increases in the BI Rate and adjustments to the interest rate corridor,

1 Traded core inflation eased to 2.56% (yoy) from 3.85% (yoy) in the preceding year. Traded core inflation is inflation in commodities within core categories that are traded with other countries.

2 CPI inflation reached double digit levels following increases in subsidised fuel prices in 2005 (17.11%) and 2008 (11.06%).

Chart 1. **Achievement of Inflation Target**



stabilisation of the exchange rate in line with its fundamentals and macroprudential policies for safeguarding macroeconomic stability. The increases in the BI Rate sought to curb inflation expectations driven by escalating prices for food staples and subsidised fuels, as well as to bring down the current account deficit. The exchange rate policy was pursued to limit exchange rate volatility and keep exchange rate movement on track with the fundamentals of the economy. Through this, the risk of imported inflation was kept to a minimum. To cool domestic demand while simultaneously preventing risks to financial system stability from the sharp rise in bank lending, particularly in the housing sector, Bank Indonesia instituted a macroprudential policy measure with the second regulation governing loan-to-value (LTV) which came into force on 30 September 2013[3]. Other measures to rein in domestic demand were pursued though adjustments in the LDR Reserve Requirement, designed to cut back the aggressive expansion in bank lending by narrowing the target range of the loan to deposit ratio from 78-100% to 78-92%. This regulation entered into force on 26 September 2013.

On the Government side, policies were introduced to ameliorate the second round effects of the hike in subsidised fuel prices and turbulent food prices. To minimise the second round effects of the fuel price hike, the Government introduced measures to keep a lid on fare increases and tighten the monitoring of fuel smuggling and hoarding. Parallel to this, the Government provided compensation in the form of Direct Cash Transfers (BLSM) to ease the burden of price increases on the least privileged and extended the *Raskin* (rice for the poor)[4] distribution scheme to 15 times. In other moves to stabilise food prices, the Government streamlined procedures and eased restrictions on horticultural imports[5], launched an

3 This regulation expanded the scope of the LTV provisions, which previously applied only to residential homes and apartments, to cover loans for purchases of shophouses and dual-purpose home/office properties. In addition, the rule is also applied a sliding scale based on building area. The regulatory scope of this provision covers the Credit Facility (FK) and Financing Facility (FP), and applies to both commercial banks and sharia banks. The first LTV regulation entered into force on 15 May 2012, and among others introduced a loan-to-value (LTV) restriction on mortgages for homes and apartments larger than 70 sqm.

4 An eligibility-based Government food aid programme in which rice is sold below market prices to specified beneficiaries.

5 Improvements in the regulation of horticultural imports are set forth in Minister of Trade Regulation No. 16 of 2013 (revision

economic stabilisation package on 23 August 2013 and strengthened the Bulog (National Logistics Agency) role in distribution of beef and soy beans. The relaxation of import controls on horticultural products helped to secure adequate supply on the domestic market, particularly noticeable in the deflation in garlic from April to December 2013 following significant price increases during the first quarter. Positive impact from relaxation of horticultural imports was also evident from the relative decline in beef prices in the second half of 2013.

Through solid policy coordination, increases in rice prices have been kept down to about 3.38% (yoy), well below the historical average[6]. This has been made possible by domestic production that has kept pace with domestic demand and the respectable performance of Bulog (the National Logistics Agency) in rice procurement and distribution. Sufficiency of domestic production is reflected, among others, in Bulog's capacity to buy up 3.5 million tons of domestically grown rice, almost 99.8% of the 2013 target. Bulog's capacity for domestic rice procurement was matched by efficient distribution of rice under the *Raskin* scheme that reached almost 100% of target for 2013 and for market operations. With rice prices comparatively stable, the volume of market operations dropped to 102 thousand tons, or just over one third of the 275 thousand tons in market operations one year previously.

Bank Indonesia and the Government have worked continuously for stronger coordination of inflation control in the regions through the National Working Group for Regional Inflation Controlling Teams (Pokjanas - TPID). One important milestone for Pokjanas - TPID was the issuance of the legal basis for TIPDs in Minister of Home Affairs Instruction No. 027/1696/SJ, which provides a reference point for institution building of TPIDs and to promote their work in each municipality/regency. Institution building measures for Pokjanas TPID were carried out jointly by the Coordinating Ministry for Economic Affairs, the Ministry of Home Affairs and Bank Indonesia.

In other measures to bolster food resilience and transparency of prices, programmes have been initiated to strengthen cooperation among regions and for development of the Vital Food Staples Price Information System (PIHPS). Some regions have responded by setting up a PIHPS using web-based systems and price information boards. The provinces of West Java, Central Java, Jambi and Central Kalimantan have introduced price information boards at some traditional markets that serve as a reference on prices for the public. Web-based information systems are also provided in the provinces of West Java and Central Java. West Java operates the Food Price Information Portal, otherwise known as Priangan (www.priangan.org) while Central Java features the Commodity Prices and Production Information System, or Sihati (www.hargajateng.org). Price information systems have also been established in several other provinces. East Java operates the Staple Needs Availability and Pricing Information System, or Siskaperbapo (www.siskaperbapo.org). In South Sulawesi, there is the Food Price Information System, or SIGAP (www.biroekonomi.sulselprov.go.id). North Sulawesi has the Vital Staples Price Information System, or PIHBS (www.tpidsulut.org) and East Nusa Tenggara the Commodity Information System or SiKomodo (www.tpid-ntt.org). At the national level, work is progressing on the blue print for the National PIHPS. The National PIHPS will integrate the regional-level PIHPS entities envisaged for each province.

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to No. 60 of 2012) and Minister of Agriculture Regulation No. 47 of 2013 (revision to No. 60 of 2012). The Government has worked tirelessly to upgrade regulations for the purpose of stabilising food prices. Part of this involved changes to the restrictive quota-based trading scheme for horticultural and beef imports, which was replaced by a reference price-based scheme in August 2013.

6 Over the past five years, rice inflation has averaged 11.42%.

Editorial Team

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Contributors
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Department of Statistics
Department of International
Department of Currency Circulation
Department of Payment System Policy and Oversight
Department of Communications

M.H. Thamrin Street No. 2, Jakarta 10350. INDONESIA
www.bi.go.id