

# Indonesian Macroeconomic Developments and Policies: Recent Conditions and the Outlook for 2005

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## *Abstract*

*Despite the challenges encountered in 2004, Indonesia's economy sustained a favorable performance and is predicted to show a stronger recovery, along with improvements in the components of GDP in 2005. Mutually supportive monetary and fiscal policies have helped maintaining the momentum of economic recovery. Reflecting the progress achieved in 2004 and looking forward to the economic prospects in 2005, at least four main structural challenges ahead should be addressed, namely maintaining macroeconomic stability, dealing with increasing unemployment and poverty, financing economic growth without loosening the efforts of maintaining macroeconomic stability, and confronting challenges concerning banking consolidation. Some points can be iterated from the recent progress and from the 2005 prospects for the Indonesian economy. Economic progress in 2004 is the result of Indonesia's important efforts in laying the foundation for a durable improvement of macroeconomic fundamentals. However, much remains to be done. Nonetheless the solid macroeconomic policy coordination between fiscal and monetary policies provides a sound basis to strengthen economic growth. Furthermore, a consistent implementation of the structural reform programs will allow economic growth to reach approximately 5.5% this year and will establish the basis for real growth rates of 6 – 7% over the medium-term. The support from the international community, both public and private, will also be a key to further strengthen Indonesia's growth prospects.*

**Keywords:** *Macroeconomic analysis-Macroeconomic policy-Indonesia*

**JEL Classification:** E 12-E 20-E 40

Despite the challenges encountered in 2004, Indonesia's economy sustained a favorable performance. Mutually supportive monetary and fiscal policies have helped in maintaining the momentum of economic recovery. On the monetary policy front, the central bank has maintained sound monetary policies by providing sufficient liquidity to the economy. Excess liquidity in the banking system was sufficiently absorbed to mitigate the counterproductive activity. On the fiscal front, the government has implemented conservative fiscal policies aimed at steadily reducing the budget deficit over time. Thereby, realized actual budget deficits have been consistently lower than initially planned. Administrative reforms were also carried out at the Ministry of Finance to enhance efficiency, at the tax and customs agencies to strengthen revenue collection, and to reduce exemptions and broaden the tax base. This paper will focus on recent Indonesian macroeconomic developments and policy and be divided into four parts. The first two parts will focus on Indonesia's economy in 2004 and its outlook in 2005. Part three will discuss macroeconomic policy implications with respect to economic performance in 2004 and the prospects in 2005, while the last part will contain final remarks.

### 1. 2004 AT A GLANCE

Favorable macroeconomic indicators as of December 2004 enabled GDP growth to reach the upper limit of earlier projections around 4.5%-5.0% (Table 1). Significant growth in investment and exports underpinned this performance. A key element in this trend is improving public confidence in the outlook for longer-term economic stability. Similarly, external conditions have also had a positive impact on economic activity. At the same time, prices are expected to go up in line with the strengthening demand.

Table 1  
Gross Domestic Product by Expenditure (Growth)

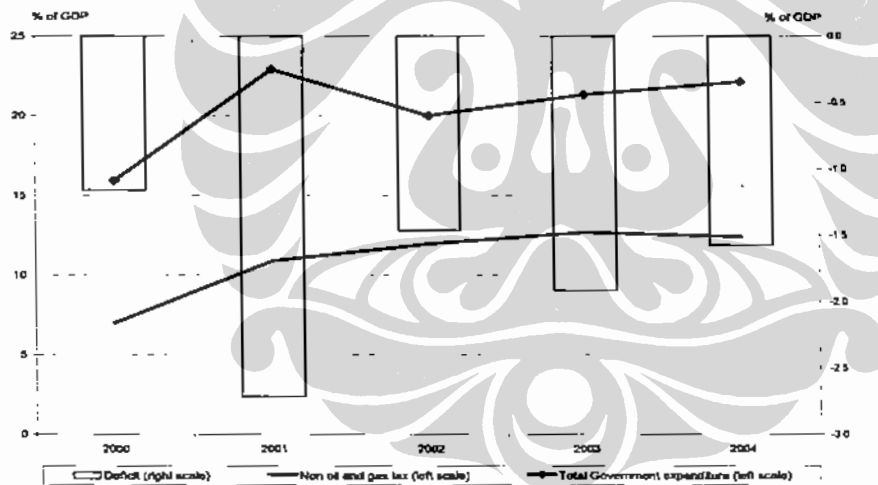
Items	2003	2004				2004
		Jan	Jun	IX	12	
Private Consumption	3.85	5.65	5.26	5.09	5.5	5.2 - 5.7
Government Consumption	10.03	10.45	4.60	-2.74	14.6	6.7 - 7.2
Total Consumption	4.51	6.13	5.19	4.20	6.7	5.4 - 5.9
Total Investment	1.88	8.27	12.53	13.09	14.8	12.0 - 12.5
Export of Goods and Services	6.58	1.05	4.06	19.85	16.3	10.0 - 10.5
Import of Goods and Services	2.80	18.73	23.71	29.87	13.8	21.2 - 21.7
<b>GDP</b>	<b>4.51</b>	<b>5.10</b>	<b>4.54</b>	<b>5.03</b>	<b>5.2</b>	<b>4.5 - 5.0</b>

Source: Central Statistical Agency – BPS, Bank Indonesia

Domestic demand in 2004 has been marked by continued robust growth, particularly in consumption and domestic investment. Though still dominant, the contribution of consumption to growth is expected to decelerate slightly due to the impressive growth in private investment at around 12%. Consumption of non-food commodities and durable goods has kept rising and was the major element of private consumption in 2004. On the investment side, both residential and business fixed investments have shown higher growth rates, with a higher number of approvals for both domestic and foreign investment.

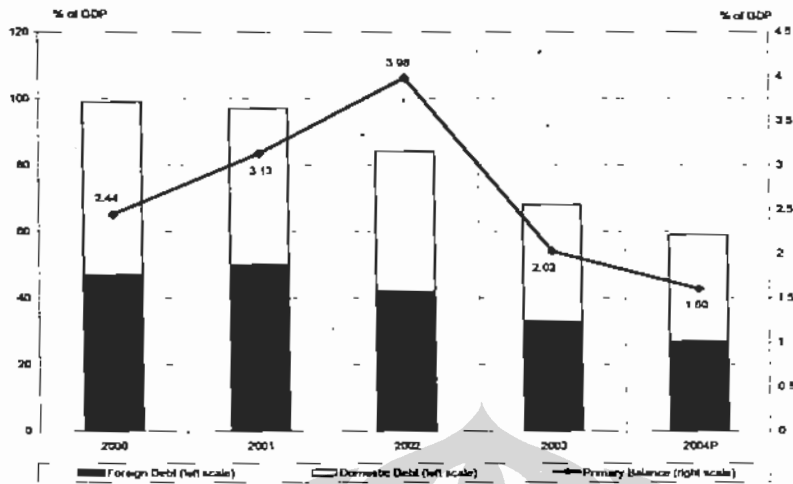
The favorable macroeconomic environment was also supported by the performance of a sound fiscal policy. Despite some challenges, including the high burden of fuel subsidies due to the impact of high oil prices, the government financial account in 2004 shows a deficit of approximately 1.5% of GDP (Figure 1) in line with previous deficit reductions. On the fiscal side, an expansionary policy was pursued in 2004 as reflected by the fiscal impulse indicator. The Government's effort to control expenditure and optimize revenue induced a positive impact on fiscal solvency as reflected in the reduction of government debt (Figure 2).

Figure 1  
Central Government Budget



Source: Ministry of Finance

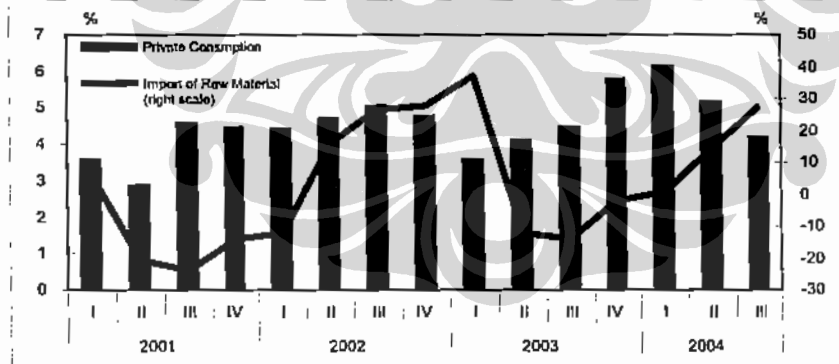
Figure 2  
Government Debt and Primary Balance



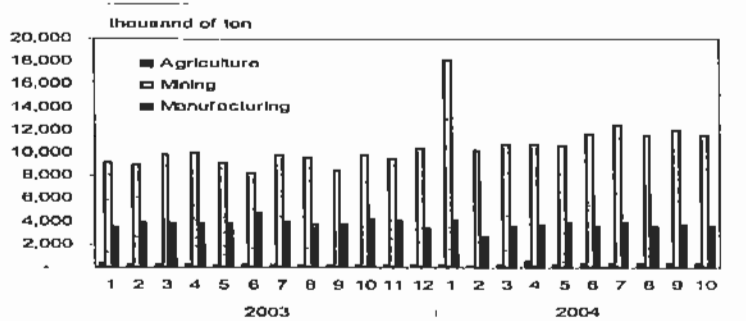
Source: Ministry of Finance

Meanwhile rising domestic demand has led to increased imports, particularly of raw materials and capital goods to support the higher capacity utilization. Volume of imports is estimated to grow substantially to around 21% compared to only 2.8% in 2003. Higher imports of capital good have been supported by higher capacity utilization. Meanwhile imports for both raw material and consumption goods have declined compared to the previous year, albeit remaining high due to a sustained level of private consumption (Figure 3).

Figure 3  
Import Volume of Raw Material



Source: Central Statistical Agency – BPS

Figure 4  
 Export Volume by Sector Classification


Source: Central Statistical Agency – BPS

Exports are also on a positive growth trend, albeit moderate. Oil and gas exports have increased substantially, thanks to the positive impact of high oil prices. The increase in exports was also supported in part by the non oil and gas sector (Figure 4). The agriculture sector grew significantly, the main contribution coming from the export of rubber. Similarly, the mining sector also recorded high growth due to increased exports of coal, nickel, aluminium and tin. However, the manufacturing sector was adversely affected by the low growth in textile, paper and chemical products. Overall, export and import performances should generate a US\$5.2 billion current account surplus in the 2004 balance of payments (Table 2).

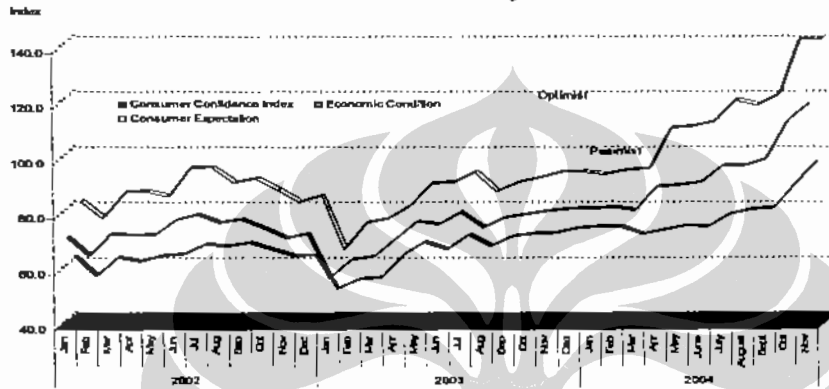
 Table 2  
 Balance of Payment

Items	2003		2004			
	Total	Q1	Q2	Q3	Q4	Total
<b>Current Account</b>	<b>8,108</b>	<b>-453</b>	<b>1,392</b>	<b>2,831</b>	<b>1,450</b>	<b>5,221</b>
Trade Balance	24,562	3,534	5,354	6,618	7,782	23,288
Export	64,109	15,202	17,318	19,640	19,182	71,342
Oil and Gas	15,234	3,957	4,270	4,563	5,814	18,404
Non-Oil and Gas	48,875	11,245	13,048	15,077	13,368	52,938
Import	-39,546	-11,668	-11,964	-13,022	-11,400	-48,054
Oil and Gas	-7,823	-2,410	-2,428	-3,121	-3,068	-11,027
Non-Oil and Gas	-31,723	-9,258	-9,536	-9,901	-8,332	-37,027
Services	-16,456	-3,987	-3,961	-3,787	-8,332	-16,067
<b>Capital Account</b>	<b>-949</b>	<b>1,448</b>	<b>-1,052</b>	<b>738</b>	<b>311</b>	<b>1,444</b>
Official Flows (Net)	-833	397	-958	-1,075	-438	-2,073
Private Flows (Net)	-116	1,050	-94	1,811	749	3,517
Foreign Direct Investment 1/	-597	432	93	59	-56	528
Portfolio Investment	2,251	782	-2	942	1,280	3,003
Others	-1,770	-165	-165	610	-475	-14
<b>TOTAL</b>	<b>7,157</b>	<b>995</b>	<b>341</b>	<b>3,567</b>	<b>1,761</b>	<b>6,665</b>
Monetary Movement 2/	-4,257	-1,123	2,568	49	-1,518	-24
<b>Memorandum Items</b>						
Reserve Assets	38,288	37,419	34,851	34,802	38,320	36,320
(In Months of Imports & Official Debt Repayment)	7.1	5.9	5.5	5.5	5.8	5.8

Source: Bank Indonesia, Central Statistic Board – BPS

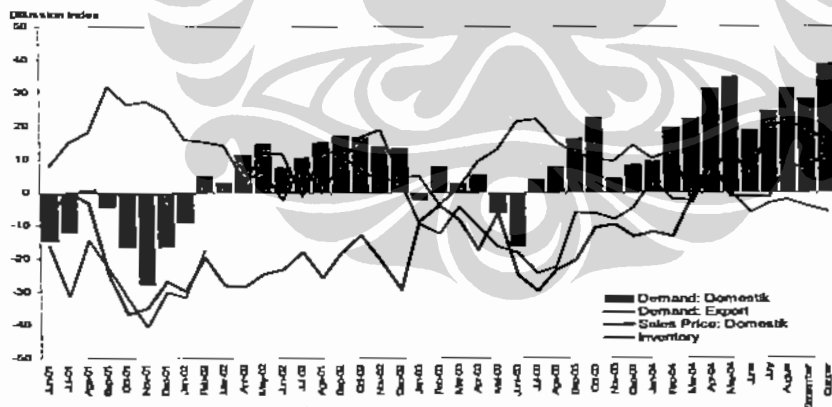
High growth in consumption has been met in part by domestic production through increasing higher capacity utilization. Consumer surveys indicate a firm optimism regarding future economic performance which has contributed to this performance. This is reflected in the gains in the consumer confidence index, consumer expectations index and the current economic conditions index. The consumer confidence index has been increasing since the beginning of the year. A similar development was recorded in the consumer expectations index that indicated a rising of confidence trend (Figure 5).

Figure 5  
Consumer Survey



Source: Bank Indonesia

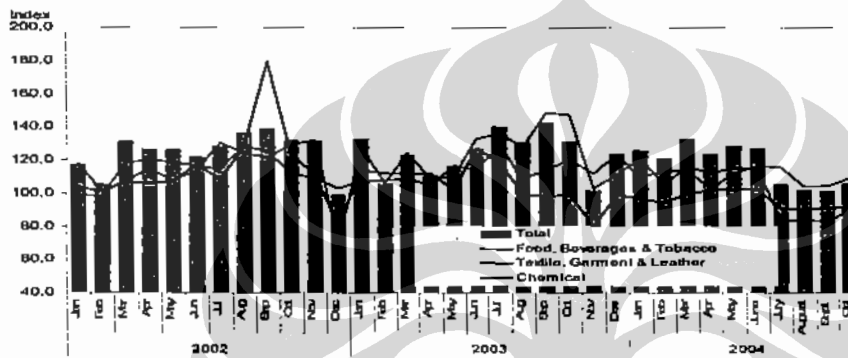
Figure 6  
Producer Survey



Source: JETRO Survey

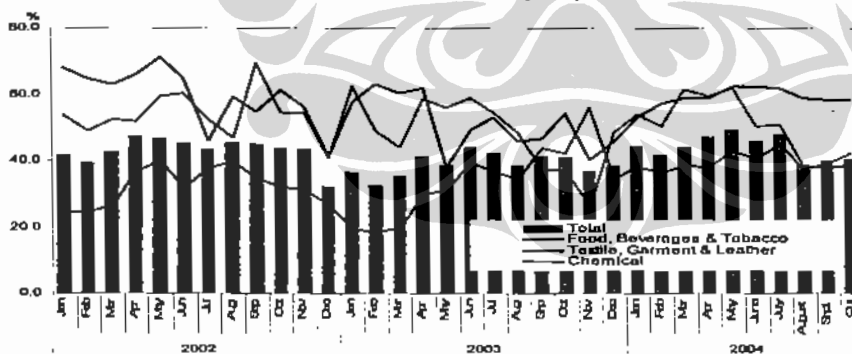
In line with consumer expectation, the expectation of producers also indicates an increasing optimism. The JETRO survey of Japanese companies in Indonesia also shows future high domestic demand and positive expectations for the economy (Figure 6). The latest data illustrates that production indices for the timber, rattan and basket-weaving industries, the food, beverages and tobacco industries, and the chemicals, petroleum, coal, rubber and plastic industries also showed gains (Figure 7). Increased production activity resulted from rising higher economic capacity utilization relative to the preceding year. The latest data show higher levels of capacity utilization in the food-processing industry and in the non-metallic minerals industry (Figure 8).

Figure 7  
Production Index



Source: Central Statistic Board – BPS

Figure 8  
Utilized Production Capacity



Source: Central Statistical Agency – BPS

Higher GDP growth in 2004 was also reflected in higher production in all sectors, except mining (Table 3). Manufacturing showed higher growth than the previous year and is predicted to grow at around 5%, with the main developments being achieved in machinery and equipment, chemical industry, rubber materials and cement industry. The agricultural, particularly farm food crops, also showed a high production level due to favorable weather. The rice stock is estimated to produce a surplus of around two million tons by the end of 2004. The construction sector also recorded a high growth, thereby raising its GDP contribution in comparison to the previous years.

Table 3  
Sectoral Growth Rates

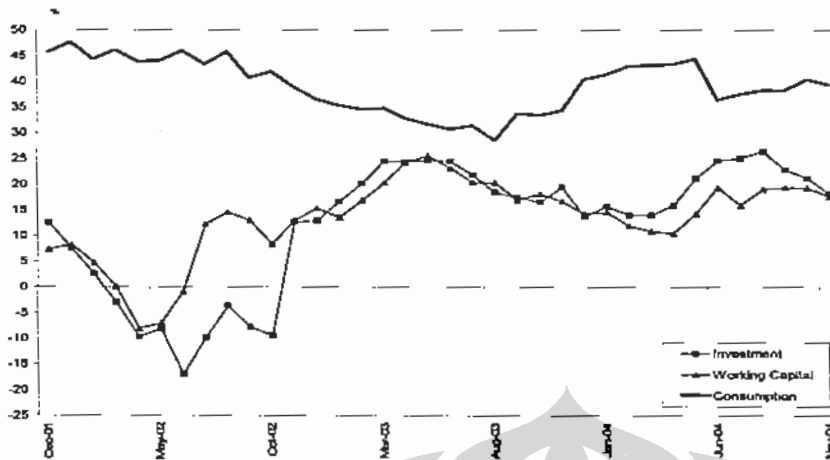
Sectors	2003	2004					2004*	
		I	II	III	IV*	IV*	2004*	
Agriculture	3.07	5.67	1.75	2.39	3.32	3.1 - 3.6	3.0 - 3.5	
Mining	-1.57	-3.05	-7.35	-5.96	-6.10	-6.4 - -5.9	-5.9 - -5.4	
Manufacturing	5.02	5.41	6.06	5.28	5.18	4.9 - 5.4	5.2 - 5.7	
Electricity	5.87	4.99	5.48	3.40	4.84	4.6 - 5.1	4.4 - 4.9	
Construction	6.31	7.57	7.94	8.89	8.03	7.8 - 8.3	7.9 - 8.4	
Trade	5.30	6.41	7.98	9.44	9.24	9.0 - 9.5	8.0 - 8.5	
Transportation	11.56	12.87	13.81	14.19	14.41	14.2 - 14.7	13.6 - 14.1	
Finance	6.88	4.91	4.73	6.67	6.22	6.0 - 6.5	5.4 - 5.9	
Services	4.07	4.55	4.93	4.54	4.69	4.4 - 4.9	4.4 - 4.9	
	4.51	5.10	4.54	5.03	5.17	5.0 - 5.5	4.5 - 5.0	

Source: Central Statistical Agency – BPS, Bank Indonesia

Higher economic growth also facilitated the availability of financing. The November 2004 figures show high growth of around 22% in credit expansion (Figure 9). Total disbursement of new credit through the banking system also provided a substantial amount (Figure 10).

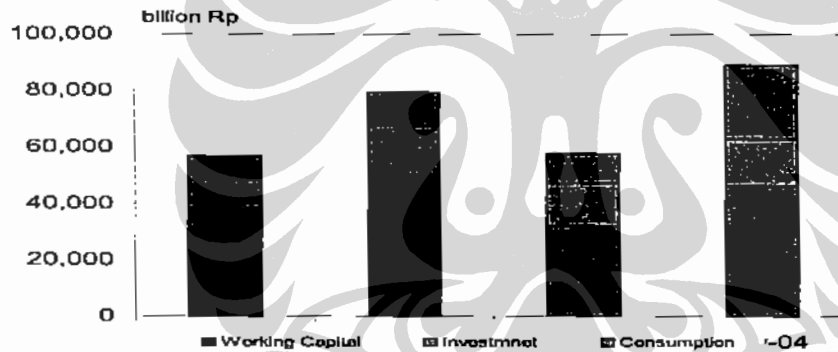


Figure 9  
Credit



Source: Bank Indonesia

Figure 10  
Disbursement of New Credit



Source: Bank Indonesia

This credit development has led to an improvement in banking sector performance with prudential indicators remaining at sound levels. Key banking indicators such as total loans, total assets and deposit funds, maintained their positive trend (Table 4). Other indicators such as NIM, LDR and capital saw further improvement while the CAR and NPLs were generally stable.

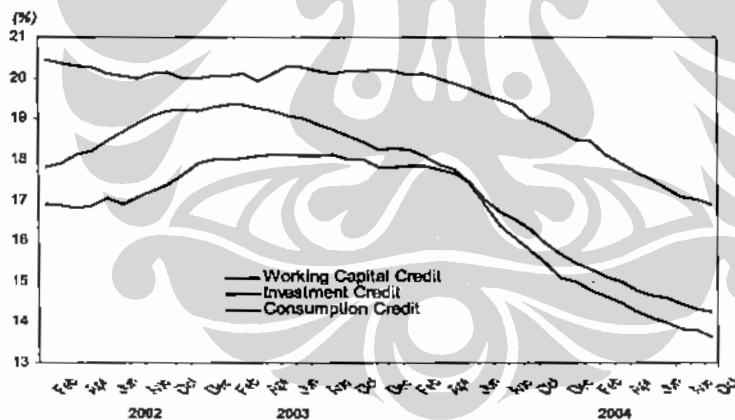
Table 4  
Banking Performance

Main Indicators	2000	2001	2002	2003	Mar-04	Jun-04	Sen-04	Nov-04
Total Asset (Rp. Trillion)	1,030.5	1,099.7	1,112.2	1,196.2	1,150.0	1,185.7	1,213.1	1,228.1
Deposit (Rp. Trillion)	699.1	797.4	835.8	888.6	875.1	912.8	926.4	932.5
Loan (Rp. Trillion)	320.5	358.6	410.3	477.2	485.9	528.7	555.1	573.4
Earning Asset (Rp. Trillion)	1,007.2	1,048.1	1,023.6	1,072.4	1,080.3	1,102.8	1,074.7	1,114.9
LODR (%)	33.2	33.0	38.2	43.2	43.7	46.4	48.2	49.5
ROA (%)	0.9	1.4	1.9	2.5	2.7	2.7	3.0	3.0
NPLs Gross (%)	18.8	12.1	8.1	8.2	7.8	7.6	6.9	6.6
NPLs Net (%)	5.8	3.6	2.1	3.0	2.7	2.1	2.1	2.0
CAR (%)	12.7	20.5	22.5	19.4	23.5	20.9	20.5	19.7

Source: Bank Indonesia

The credit expansion was facilitated by the declining trend in interest rates. Although showing a stable path since mid-2004 due to tight monetary policies, the SBI 3-month discount rate declined from 8.15% at the end of 2003 to 7.4% at the end of 2004. This declining trend in the central bank instrument rates led to lower banks' deposit rates<sup>1</sup>, including credit rates (Figure 11). In line with trend in deposit rates, interest rates for consumer's credit, working capital credit, and investment credit maintained their downward trend. In addition, the spread between deposit and credit interest rates has narrowed further as a result of the decline in credit interest rates in contrast to rising deposit rates.

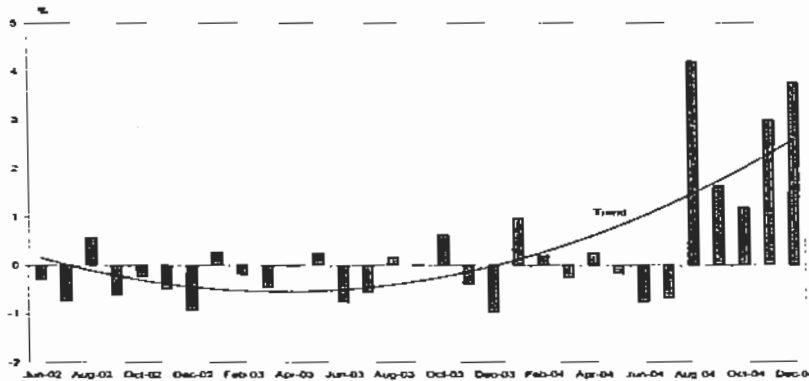
Figure 11  
Credit Interest Rates



Source: Bank Indonesia

<sup>1</sup> Which is linked to the 3-months SBI rate according to the realignment interest rate policy on May 2004?

Figure 12  
Covered Interest Rate Parity



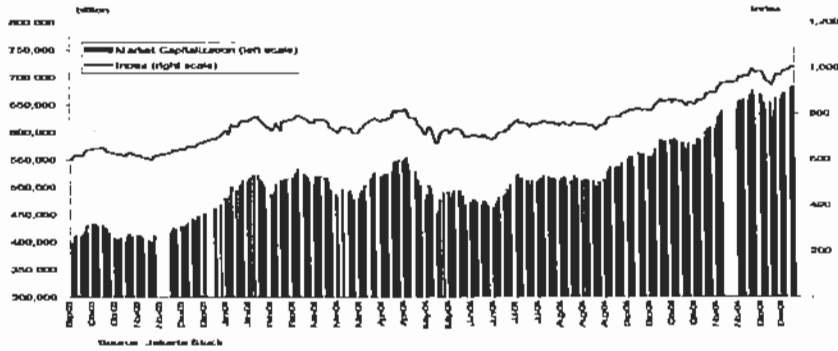
Source: Bank Indonesia

Despite their declining trend, domestic rates remained at attractive parity levels in 2004 due to the favorable risk environment. Consistent with the ongoing narrowing in swap premiums, covered interest parity (CIP) strengthened by the end of the year, especially influenced by lower swap premiums corresponding to lower market risk perception (Figure 12)<sup>2</sup>. In real terms, this enhances the attractiveness of foreign fund placements with promises of positive returns.

The positive potential return and the increasing optimism in money markets was also reflected in capital markets. The influence of positive investor expectations regarding Indonesia's economic prospects, buoyed by controlled inflation, relative external stability of the rupiah and positive forecasts for economic growth, continued to dominate movements in share prices. The capital markets perceived a positive trend and subsequently made the Jakarta Composite Share Index (JSX index) reach its highest level in the history of capital markets on December 2004 (Figure 13).

<sup>2</sup> Covered interest rate parity = domestic interest rate (1-month JIBOR) – overseas interest rate (1-month SIBOR) – swap premium (1 month).

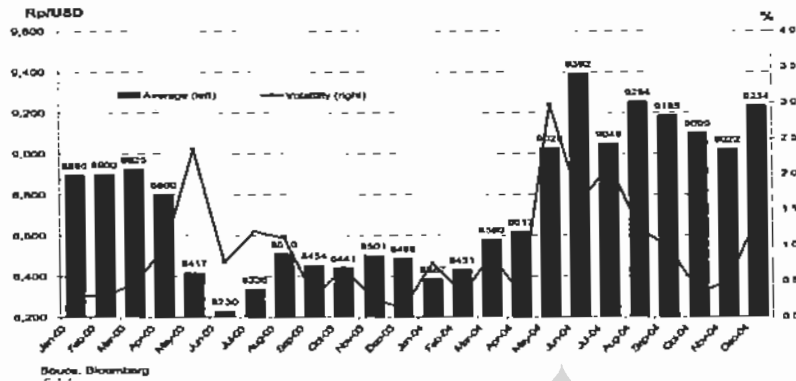
Figure 13  
Composite Stock Price Index and Market Capitalization



Source: Ministry of Finance

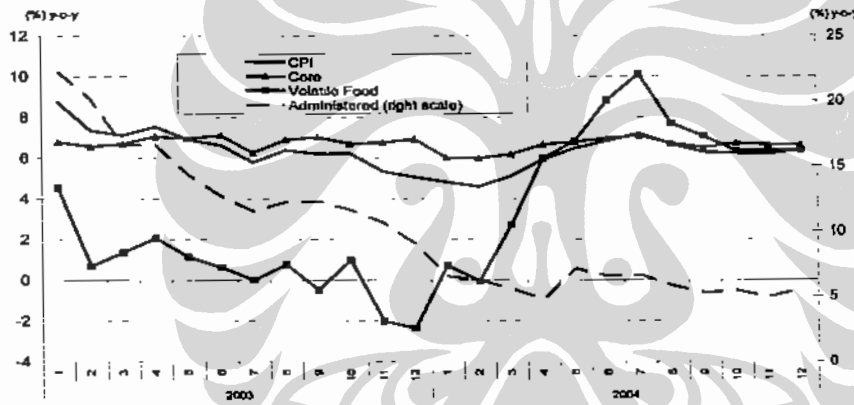
Higher domestic demand leading to increased imports, as well as some spillover effect due to external factors have also indirectly affected exchange rate fluctuations in 2004, which depreciated around 3.7% to reach on average Rp 8.934 per USD in 2004 (Figure 14). After experiencing an external shock followed by domestic turbulences especially by the end of the second quarter of 2004, the rupiah has revived and regained its strength by the end of 2004. This favorable development was due to measures taken to lessen the pressure on the rupiah, and improved macroeconomic conditions, as reflected in the attractive yields on Indonesian securities and improved risk premium, amidst the global trend of USD depreciation. In addition, positive sentiments have strengthened the rupiah such as the democratic and successful general elections and the improved revision of Indonesian foreign credit rating by all major international rating agencies.

Figure 14  
Rupiah Exchange Rate



Source: Bank Indonesia, Central Statistical Agency – BPS

Figure 15  
Inflation Rate



Source: Bank Indonesia, Central Statistical Agency – BPS

Higher domestic demand, positive pass-through effect from the depreciation of the rupiah and higher imported inflation increased inflationary pressure in 2004. The inflation rate went up slowly since January from 4.82% (y-o-y) to 6.4% (y-o-y) at the end of 2004 (Figure 15), in line with the central bank inflation target range of 5.5% +/- 1%. Along with CPI inflation, core inflation moved similarly reaching around 6.2%.

## 2. PROSPECTS FOR 2005

Indonesia's economic prospects in 2005 continue to show a stronger recovery, along with improvements in the components of GDP. On the demand side, projected economic growth is estimated to increase with higher investments while a stable trend is projected for private consumption. Export performance is predicted to improve slightly, despite the world trade volumes, which show sluggish developments. This favorable development is expected to continue in line with the improvement of market confidence and optimism in the implementation of the development program set by the new Government. With the competitiveness of the rupiah, GDP growth is forecast at 5.0-6.0% (Table 5).

In 2005, private consumption is projected to increase by around 5.5%, in line with higher expected disposable income. An increasing trend of both consumer confidence and household expectation on future economic development could generate higher private expenditure and subsequently higher private consumption. Parallel to this trend in private consumption trend, total investment, including private investment, is projected to grow substantially to around 13.5%. In line with the success of the 2004 General Elections and a more conducive investment climate, especially focusing on infrastructure and sector based development, private investor confidence is expected to increase. The improvement in risk premium is also considered as an underlying indicator for a better investment climate. Improved access to the banking sector and the tendency of using equity will play a significant role in boosting investment activities. Macroeconomic stability has provided Bank Indonesia some room to adjust interest rates at stable low levels over the last two years. Besides credit that is expected to grow by 20% in 2005, the sources of funds are predicted to come from stocks and bonds. Based on these conditions, private investment growth is predicted to reach 14%, close to pre-crisis levels.

Table 5  
Gross Domestic Product

Indicators	2003	2004*	2005f
<b>Aggregate Demand (% yoy)</b>			
- Private Consumption	3.9	5.2- 5.7	5.0 - 7.0
- Government Consumption	10.0	6.7 - 7.2	4.0 - 6.0
- Total Consumption	4.5	5.3 - 5.8	5.0 - 7.0
- Total Investment	1.9	12.0 - 12.5	12.5 - 14.5
- Export of Goods and Services	6.6	10.0- 10.5	8.5 - 10.5
- Import of Goods and Services	2.8	21.2 - 21.7	21.0 - 23.0
- GDP	4.5	4.5 - 5.0	5.0 - 6.0
<b>Sectoral (% yoy)</b>			
- Agriculture	3.1	2.8 - 3.3	2.9 - 3.9
- Mining	-1.6	-5.9 - -5.4	-3.0 - -4.0
- Manufacturing	5.0	5.4 - 5.9	5.5 - 6.5
- Electricity	5.9	3.8- 4.3	5.2- 6.2
- Construction	6.3	7.7 - 8.2	7.9 - 8.9
- Trade, Hotel and Restaurant	5.3	7.8 - 8.3	8.0 - 9.0
- Transportation and Communication	11.6	13.9 - 14.4	14.0 - 15.0
- Finance	6.9	5.8 - 6.3	6.0 - 7.0
- Services	4.1	4.5 - 5.0	4.3 - 5.3
- GDP	4.5	4.5 - 5.0	5.0 - 6.0

Source: Bank Indonesia

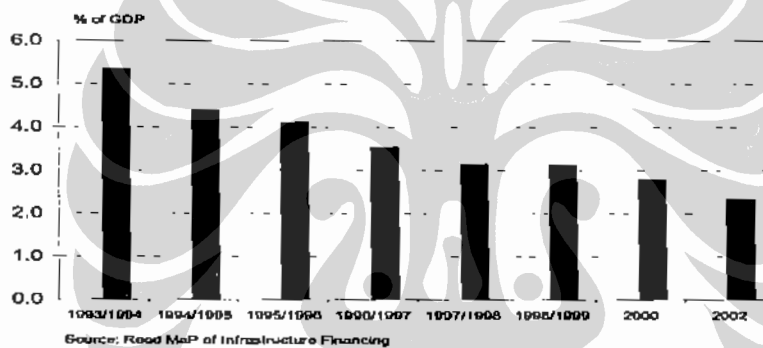
Government consumption growth is predicted to be slower, in line with the Government's effort to maintain fiscal sustainability by reducing the ratio of the budget deficit to GDP. However, the impact on the government budget of the reconstruction efforts following the disastrous tsunami in Aceh and North Sumatra remains to be formally assessed. Despite its decreased ability to stimulate the economy, the government is still firmly committed to support investment activities, reflected among others by the reallocation of subsidy reduction funds to capital expenses. Therefore, the total amount of funds allocated for government investment will reach Rp 199.2 trillion in 2005, increasing by 11.5% from the previous year. The government's commitment to focus on infrastructure development is also an important point to notice of the New Government's 100-day Programs.

As for fiscal policy, government expenditures in 2005 continue to remain in line with the efforts to maintain the process of fiscal sustainability. The financial operations deficit of the government, as set in the state budget, as a ratio to GDP is lower in contrast to last year's 0.8% deficit, providing room for efforts to lessen in the next period the burden of government debt. Several assumptions were used in setting this target, amongst others; the world oil price is estimated to reach \$24 per barrel.

However, taking into account current developments, it will be difficult to achieve these targets. In particular, the assumed world oil price of \$24 per barrel used in the state budget seems quite unrealistic considering the current fluctuations of the world oil price. One of the reviews indicates that the Government will relax the state budget deficit target to 1% of GDP, which still remains lower than the roughly 1.5% budget deficit of 2004.

Infrastructures investment is a prerequisite to sustained economic growth. In spite of improving macroeconomic stability and the declining ratio of the government debt stock to GDP, the ratio of government investment in infrastructure to GDP has been steadily declining since before the crisis, from 5.34% of GDP in the fiscal year of 1993/94 to 2.33% of GDP in 2002 (Figure 16). In 2005, investment in infrastructure is forecast to reach Rp133 trillion and is forecast to increase in the following years due to the earthquake and tsunami tragedy that devastated Aceh and North Sumatra in December 2004.

Figure 16  
Infrastructure Financing (% of GDP)



Source: National Development Planning Board - Bappenas

In an attempt to revive and rebuild sufficient infrastructure to support a 6% economic growth over the next five years, generate employment and alleviate poverty, we have come up with an initial indication of the magnitude of investment in maintenance, rehabilitation, and development of infrastructure facilities of about US\$ 72.14 billion (Rp 613,2 trillion). This will be used to develop the network of 93,700 km of public roads, to generate 21,900 MW electricity powers, to install 11 million of fixed telephone lines and 18.7 million subscribers of cellular



telephone, to provide drinking water to 30.5 million people and to serve 46.9 million people with sanitation systems. The number could be much higher if transport, housing, energy, and irrigation infrastructure were taken into account.

This is a huge cost, and based upon its fiscal capability, equivalent to 2.33% of GDP, the government will be able to invest only US\$ 40.8 billion, leaving a financing gap of about US\$ 31.34 billion for private investors and other financing schemes. This means that investment in infrastructure should only take place on an average of about US\$ 6 billion per annum during the next five years.

Table 6  
Estimation of Investment on Infrastructures

	(billion rupiah)					
	2005	2006	2007	2008	2009	TOTAL
Jasa Marga	4463	12233	27455	28219	10974	83344
Perum Perumnas	2021	2275	2480	2735	3017	12528
Kereta Api Indonesia	1369	4964	6937	9388	4683	27341
Perusahaan Gas Negara	3848	10790	5292	10521	10221	40672
Angkasa Pura I	1238	1299	682	298		3517
Pelindo I	345	648	393	358	108	1862
Pelindo II	1526	1538	1498	2502	2245	9709
Perum Jasa Tirta II	4	161	1539	1557	2795	6056

Source: Road Map of Infrastructure Financing – TPPI - Bappenas

In line with the current dismal world economic situation, the contribution of exports of goods and services is predicted to slow down although the growth is estimated to remain high. The performance of exports will also be accompanied by the decline in the growth of imports. Overall, prospects for strengthened economic recovery concurrently generate a positive expectation, which becomes one of the main factors in predicting the performance of the balance of payments and the direction of the exchange rate.

With regard to the external balance, Indonesia's balance of payments is estimated to record a surplus, albeit narrowing due to an increase in imports in line with improved business prospects (Table 7). The surplus continues to spur positive expectations about availability of foreign currency supply in the domestic market. Short-term capital inflows in the form of portfolio investments, which are predicted to remain strong, are also expected to contribute to the supply of foreign currency. Potential capital inflows in the form of foreign direct investment are predicted to enter gradually in the second semester of 2005, albeit in relatively small amounts.

Table 7  
Indonesia's Balance of Payment  
Millions of US\$

<b>Current Account</b>	<b>8,106</b>	<b>5,221</b>	<b>4,127</b>
Trade Balance	24,562	23,288	22,271
Export	64,109	71,342	74,672
Oil and Gas	15,234	18,404	18,558
Non Oil and Gas	48,875	52,938	56,114
Import	-39,546	-48,054	-52,401
Oil and Gas	-7,823	-11,027	-10,427
Non Oil and Gas	-31,723	-37,027	-41,975
Services	-16,456	-18,067	-18,144
<b>Capital Account</b>	<b>-849</b>	<b>1,444</b>	<b>-2,797</b>
Official Flows (Net)	-833	-2,073	-3,064
Private Flows (Net)	-116	3,517	267
Foreign Direct Investment 1/	-597	528	732
Portfolio Investment	2,251	3,003	3,621
Others	-1,770	-14	-4,085
<b>TOTAL</b>	<b>7,157</b>	<b>6,665</b>	<b>1,331</b>
Monetary Movement 2/	-4,257	-24	-174
<b>Memorandum Items</b>			
Reserve Assets	36,296	36,320	36,494
(In Months of Imports & Official Debt Repayment)	7.1	5.8	5.3

Source: Bank Indonesia

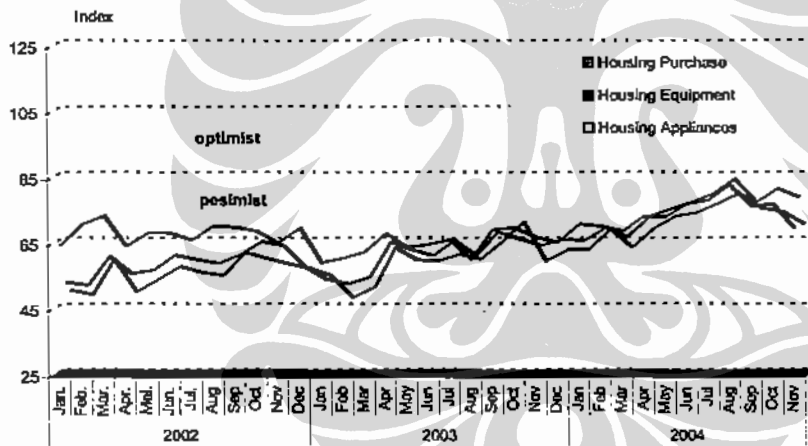
Despite this background, the exchange rate is estimated to appreciate slightly compared to 2004, towards the range of Rp8.600-Rp 9.200 per US dollar. A stronger and relatively stable exchange rate, combined with a relatively balanced interaction between demand and supply, has a positive influence on price expectations.

On the supply side, as in 2004, the contribution of the manufacturing sector, the transportation and communication sector and hotel and restaurant sector to economic growth would still be relatively high (Table 5). In addition, high growth is also projected in the construction and financial sectors. The favorable contribution of manufacturing growth corresponds to the escalating investment activity and high household consumption. Some indicators provide a positive outlook on domestic investments in 2005, consistent with low interest rates, a stable exchange rate, tax incentives and significant planning of infrastructure investments. Other 2004 indicators, including raising import growth and high approval of foreign and domestic investments also strengthen the optimism in the manufacturing sector.

The agricultural sector is predicted to generate higher growth than last year thanks to an expected increase in the output of crops. Government support to provide incentives in this sector, including investment in irrigation infrastructure, is likely to contribute to this higher growth. The increasing trend of previous years in the construction sector is predicted to continue in 2005. The Government plans to build massive infrastructure projects, which could also contribute to growth of this sector. In addition, commercial property is projected to keep rising. Alongside with higher economic growth, the financial sector is projected to expand as well. Increased financing from the banking sector is estimated to contribute much to the expansion of this sector.

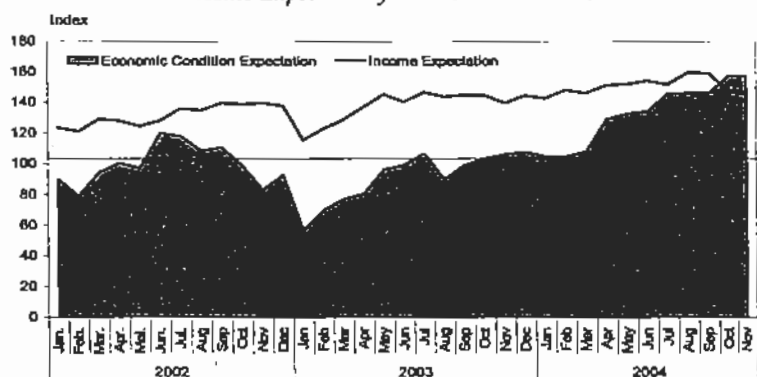
Accelerating economic activity and higher public expectation of inflation will lead towards higher inflation in 2005. On the fundamental side, consumer surveys indicate an increasing domestic demand for the 6-12 months ahead in line with the expected increase of household disposable income (Figure 17 and Figure 18). Higher demand is also indicated from the rising higher capacity utilization in line with higher economic activity. According to surveys, capacity utilization in manufacturing industry has reached 90%.

Figure 17  
Consumption Planning for 6-12 Months ahead



Source: Bank Indonesia

Figure 18  
Income Expectation for 6-12 months ahead



Source: Bank Indonesia

Inflationary pressures may even be higher considering the likely reduction of oil subsidies in the central government budget. The impact of this policy on inflation will depend on the magnitude of the prices hikes, the timing of the implementation and the magnitude of the secondary effects. Central bank estimates have indicated that for each 10% rise in domestic oil prices, overall inflation would at first increase by 0.2%, and subsequently to a further increase of 0.36%. Taking into account the likelihood of higher oil prices, inflation in 2005 is targeted to be  $6\% \pm 1\%$ . Anticipating pressure on inflation, monetary policy will be directed at achieving the medium term inflation target while maintaining the momentum of growth. To enhance the effectiveness of monetary policy, Bank Indonesia is planning to use the interest rate as its operational target in mid-2005.

### 3. MACROECONOMIC POLICY CHALLENGES

Reflecting on the progress achieved in 2004 and looking forward to the economic prospects in 2005, at least four main structural challenges should be addressed. *Firstly*, despite the progress in macroeconomic performance, maintaining macroeconomic stability is still a key challenge ahead. At this point, monetary policy will undertake a primary role to mitigate the instability risk. Pressures on the rupiah in the middle of 2004 also suggest that in a small open economy like Indonesia, foreign exchange stability is a determining factor of market confidence. Therefore, maintaining a stable foreign exchange market is key to maintain macroeconomic stability. Accordingly, monetary policy strategies will keep monitoring the market to minimize the exchange rate volatility through exchange rate interventions and possibly through

timely non-conventional measures. Such policies include an intensified coordination with governmental institutions acting as major players in the foreign exchange market in order to maintain the balance of supply and demand.

With regard to excess liquidity in the banking sector, the monetary authority is to adopt policies to mop up excess liquidity in order to ensure that funds are placed in productive activities and to lock up excess funds so as to avoid speculative activity. Bank Indonesia will continue to pursue tight monetary policies by optimally absorbing excess liquidity in the market. Such policy will be strengthened by a cautious monitoring of the risk factors that may affect the economic prospects, especially due to the uncertainty in oil prices and adjustments in administered prices. Regarding the efforts to enhance the effectiveness of monetary policy mechanisms, Bank Indonesia will continue the policies to maintain the stability of the banking system, together with its efforts to promote the intermediary function of the banks and to improve their internal control and corporate governance.

On the fiscal side, maintaining fiscal sustainability over the next few years remains a challenge. Budget pressures to provide 'fiscal stimulus' in order to improve public infrastructure requires the Government to manage government debt and financing carefully. Fiscal reforms should be accelerated, particularly in the tax system and customs administration, and also efficiency in public expenditure, and should eradicate smuggling and undervaluation. As IBRA has been closed, the government should continue privatisations and maintain access to official lending sources. In addition, the government should take advantage of the developing domestic bond market and of the improving external market confidence to facilitate moderate bond issuances.

*Secondly*, macroeconomic policies should also deal with increasing unemployment and poverty. Estimates indicate that the rate of economic growth is still insufficient to reduce the unemployment rate. Indonesia's growth is mainly dominated by domestic consumption, with too little development in productive investments and exports. Accordingly, macroeconomic policies should be focused at restoring growth through investments and exports in order to create more jobs and fight poverty. This should be supported by the improvement of the investment environment, raising competitiveness and enhancing productivity. While a short-term agenda to tackle these issues have been included in the White Paper –such as improving infrastructure, legal certainty in business, and simplifying the licensing process–, the long-term agenda still needs to be tackled, such as developing a government vision on industrial policies as well as upgrading manpower and technology to improve productivity.

*Thirdly*, considering the gap between savings and investment in Indonesia, another challenge revolves on how to finance economic growth without loosening the efforts of maintaining macroeconomic stability. This challenge becomes even more intense due to the earthquake and tsunami tragedy that devastated Aceh and North Sumatra in December 2004. The Government needs additional sources of financing to rehabilitate and reconstruct these regions. One of the sources of financing comes from domestic banks. However, putting a heavy burden on domestic banks to finance higher economic growth is not a wise solution. One of the lessons of the past crisis is that such an intensive use of credit to finance higher rates of growth would not be sustainable, especially if credits are not provided in a prudent manner. For that reason, alternative sources of funds become a crucial element. Furthermore, such diversification of means of financing is also important to reduce the vulnerability of the economy and to strengthen the financial sector. In order to further develop the capital markets as an alternative source of funds, issues including improving the legal environment, strengthening investors protection, improving corporate governance by increasing transparency and disclosure, improving corporate ownership structure, increasing the role of institutional investors and reinforcing the monitoring mechanism, should be addressed by the government.

Another source comes from foreign investment. With regard to macroeconomic stability, this source will correspond to the type of foreign investment best suited to Indonesia as crises show that portfolio investment is very fragile to non-fundamental shocks. In such an environment, foreign direct investment is considered more sustainable to support macroeconomic stability. However, competition to attract foreign investment will be fiercer, centered on human resources, infrastructure, legal certainty and system stability. In the midst of such a trend, policies must be designed to continuously shift toward a flexible economic system by adopting market-driven economic principles. To globalization, Indonesia can no longer afford to solely focus on domestic oriented policy approaches. In such a highly competitive environment, Indonesia has to build up its competitiveness.

*Fourthly*, banking sector policy confronts challenges concerning its consolidation, implementation of Basle II, and financial safety net. We need a precise approach to whether a directive or market driven approach will be implemented for banking sector consolidation. Basle II, on the other hand, is more complex and therefore requires improvement in human resources competencies as well as technological infrastructure. Finally, as the financial safety net will soon be implemented, a smooth transition from the current blanket guarantee to the limited deposit insurance is another challenge. We are being challenged to ensure that

the transition from the blanket guarantee will not adversely affect the stability of the banking sector.

#### 4. FINAL REMARKS

Some points can be reiterated from the recent progress and from the 2005 prospects for the Indonesian economy. Economic progress in 2004 was the result of Indonesia's important efforts in laying the foundation for a durable improvement of macroeconomic fundamentals. However, much remains to be done. Nonetheless the solid macroeconomic policy coordination between fiscal and monetary policies provides a sound basis to strengthen economic growth. Furthermore, a consistent implementation of the structural reform programs will allow economic growth to reach approximately 5.5% this year and will establish the basis for real growth rates of 6-7% over the medium-term. The support from the international community, both public and private, will also be the key to further strengthen Indonesia's growth prospects. Indeed, investment is crucial to achieve higher growth rates, and foreign direct investment is greatly needed.

The optimism would be even more warranted if international investors, both Governments and private agencies, continue to be supportive. Since investment is a crucial element in achieving higher growth, foreign direct investment is therefore greatly needed to finance the gap between savings and investments. This type of investment will become even more essential if related to the earthquake and tsunami tragedy of December 2004 that inevitably requires huge investments to rehabilitate and reconstruct the areas devastated by the tsunami.

In addition, the 14th Meeting of the Consultative Group on Indonesia (CGI) held in Jakarta on 19-20 January 2005 has pledged to provide large assistance than previously expected. On top of this, USD 1.7 billion is provided for the recovery programs in Aceh and North Sumatra. This assistance will support the Government of Indonesia medium-term reform program aimed at improving the investment climate, creating jobs, and reducing poverty. Development partners also underscored their commitment to help the Government response to the tsunami-catastrophe in Aceh and North Sumatra, with recovery and rehabilitation programs. It is expected that the commitment from the CGI will support the government budget and improve the balance of payments, which in turn will support the rupiah exchange rate.

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