Introduction

1. Let me start by welcoming all of you to this high level policy dialogue, jointly organized by the ESCAP, Bank Indonesia, and the Ministry of Finance, at this cultural city of Yogyakarta. I am very delighted to be here at least for two reasons. First, this is my hometown and I used to live here when I took my bachelor degree at Gadjah Mada University. I know very well that promoting sustainable and equitable growth has been and always be the philosophy of teaching in this university, including in economics.

2. Second, the topic of the seminar is timely and provoking. We need to rethink and find a new approach of macroenomic policies for promoting sustainable and equitable growth in East Asia. Looking at what happen over the past decade, I have a strong believe that the rise of Asia will be here to stay and leap forward as the engine of global economic growth. What we need is to make sure that the high economic growth will be sustainable and inclusive to benefit to all the people.

East Asia Economic Challenges

3. But we need to be aware that the challenges of East Asia economy to continue to leap forward are many and a number of them are complex. First, the global economic recovery seems to be protracted, giving rise to downward pressures on world trade volume and commodity prices (excluding oil price). We could not rely only on export promotion to sustain our economic growth. We need to boost our domestic demand, be it consumption and investment, to compensate the declining exports as our engine of growth.

4. Second, global excess liquidity will continue to linger with all of its positive and negative ramifications. Capital flows will continue to pour in to our region. But not all of them are good for our economy, especially those of short-term and speculative capital flows. We need to limit this type of capital flows while continue attracting those capital flows that are longer-term and benefit to our economic development, such as FDI and longer-term portfolio investment and offshore borrowings.
5. Third, we need to continue to develop infrastructure and technology to expand our domestic production capacity and competitiveness. Most of Asia economies are experiencing demographic bonus, with increasing middle income group demanding various goods and services. Without increasing our domestic production capacity and competitiveness, our region will only be a target of market for other region goods and services. Moreover, our economy will easily be trapped into overheating and short-lived economic cycle, which ultimately limits our capability to sustain economic growth.

6. Fourth, we also need to work harder to tackle the problem of poverty. Even though East Asia is experiencing high economic growth, many people are still living below poverty line, including in my own country Indonesia. The trickle down effects of high economic growth are slow progressing in this region. We need to spend more on education, health, and other social welfare programs to address this problem of inclusive economic development.

The Tale of Two Fallacies

7. These complex economic challenges need a new approach of macroeconomic policy making which well integrated and coordinated for securing stability and at the same time promoting sustainable and equitable growth in Asia. But I must confess that the conventional thinking and practice of macroeconomic policies may not always be suitable to our region. Let me cite just the following two fallacies.

8. First, market mechanism does not always work efficiently in developing countries like East Asia. The invisible hand of Adam Smith may not always be prevailed. Thus, financing public expenditures through bond issuance would not always the same with by increasing taxes as the Ricardian equivalence predicted. Inflation may be caused by non-monetary factors such as production, distribution, or market structure, and thus would not be effectively be responded by increasing interest rate. Likewise, financial imperfections often inhibit the flexibility of interest rate and exchange rate in transmitting monetary policy to the economy. Under such circumstances, we could not only rely on standard fiscal, monetary or banking policy for a stable, sustainable and equitable growth. In a number of cases, some forms of intervention policy may be needed when market failure exists.

9. Second, we also need to put stability-growth-equity nexus as objectives of macroeconomic policies into a new prospective. We need to think of stability and growth nexus not in static sense, i.e. year by year, but in a more dynamic and forward looking sense. We need to put this issue along with the need to extend our economic cycle, or we risk that maintaining the stability could have detrimental effects to growth. Thus, we need to address fiscal and debt sustainability not merely by limiting fiscal deficit, but also taking into account how boom and burst cycle in our economy would influence our capacity to raise taxes, increase public
expenditure, and issue government bond and borrowings. We need to design a counter-cyclical fiscal policy to balance stability with growth. Likewise, in the financial sector, bank lending often exhibit procyclicality along with the boom and bursts in the economic cycle. Macroprudential policy for securing financial system stability must also able to manage these procyclicality nature and allocative distribution of bank lending among sectors so as to help manage (and not accelerate) the boom and bursts cycle in the economy.

The Need for Macroeconomic Policies Mix

10. The preceding discussions lead to the need for formulating macroeconomic policy mix to balance the stability with sustainable and equitable economic growth. Fiscal policy need not be geared only toward maintaining fiscal and debt sustainability, but also find a way to act as a counter cyclical policy to sustain the economic growth. Monetary policy to achieve price stability must also take into account non-monetary factors of inflation and the impact of financial imperfections to monetary transmission mechanism. Likewise, macroprudential policy needs to balance the objective of maintaining financial system stability with the promotion of a sustainable intermediation function and efficiency of the financial sectors for stimulating the economic growth.

11. The question is then how to formulate and coordinate fiscal-monetary policy-macroprudential policy mix in this new approach of macroeconomic policy making. Let me share with you our experience in Indonesia. On national level, we have a close coordination between fiscal policy of Ministry of Finance with monetary policy of Bank Indonesia. In formulating government budget, for example, the central bank provides its views to the parliament on macroeconomic projections and its monetary policy direction. For Indonesia, the issue in fiscal and monetary policy coordination center on their capability to maintain macroeconomic stability while at the same time promoting sustainable and equitable economic growth. In this regard, I must say that with the heavy burden of subsidy has severely limited the capacity of fiscal policy to stimulate and acts as counter-cyclical measures in the economy. Conversely, through a monetary and macroprudential policy mix which I will talk shortly, the central bank has been able to maintain the monetary and financial system stability while at the same time help in promoting sustainable and equitable growth in Indonesia.

12. Policy coordination between fiscal, monetary and financial sectors policies has been strengthened with the establishment of “Financial System Stability Coordination Forum” among the Ministry of Finance, Bank Indonesia, Financial Services Authority, and Deposit Insurance Institution since last year. This forum is an integral part of national crisis
prevention and resolution protocol. The four institutions share their assessment on macroeconomic conditions and policy issues that need to be addressed and coordinated to maintain macroeconomic and financial system stability. The forum meets regularly, i.e. monthly at the deputies level and quarterly at the ministerial level.

**Monetary and Macroprudential Policy Mix**

13. Let me share with you Bank Indonesia experience in formulating and implementing monetary and macroprudential policy. Faced with more complex problems above, Bank Indonesia no longer just rely on one instrument, particularly, the interest rate policy in controlling inflation and promoting sustainable economic growth. Since mid of 2010, Bank Indonesia took a new approach through monetary and macroprudential policy mix, implemented through the following five instruments. First, the policy interest rate is always directed to ensure that future inflation remained under control and within the range of the target of 4.5% ± 1% in 2013 and 2014. Under current condition, the policy interest rate (BI Rate) has been maintained at 5.75% as it deems consistent with the inflation forecast over the next two years that will fall within the target.

14. Second, Bank Indonesia continues to maintain exchange rate stability is maintained in accordance with economic fundamentals. Thus, maintaining the path and stability of exchange rate is an integral part of the efforts to achieve the inflation target based on the a forward looking macroeconomic projection exercise. To that end, Bank Indonesia intervened to supply the foreign exchange market as needed. This effort is supported by the adequacy of foreign exchange reserves, which today is approximately USD 107 billion, or about 6 months of imports and government foreign debt payments.

15. Third, Bank Indonesia has pursued a number of measures to manage capital flows, especially those of short-term and speculative nature. This has been done through a number of measures such as six-month holding period for investing on central bank bills, limits on banks’ short-term off-shore borrowing to a maximum of 20 percent of capital. At the same time, capital flows that are of medium-and long-term nature, such as in the form of FDI, long-term bonds and off-shore borrowings, are continuously welcome as these benefits to the economy.

16. Fourth, Bank Indonesia also introduced a number of macroprudential policies to manage the allocation of bank credit to various sectors to be more balanced and support the economy. The measures are also geared toward dampening the procyclicality nature of bank lending in the economy. In this regard, last year the central bank issued the new regulations on Loan-to-Value (LTV) ratio ranging from 70 to 80 per cent to dampen the excessive lending growth to property and automotive sectors. On the other hand,
accommodative macroprudential measures are deployed to stimulate lending to a number of sectors which are supporting sustainable and equitable economic growth. For example, Bank Indonesia has issued a policy requiring lending to MSMEs by each bank a minimum of 20% of their total lending within the next five years. Bank Indonesia is also considering macroprudential policies to encourage lending to the agricultural sector, particularly in support of food security.

17. Fifth, Bank Indonesia continues to strengthen policy coordination with the Government at central and local levels to curb inflation pressures especially from volatile foods prices because of production, distribution and market structure. In addition to Inflation Control Team (ICT) at the national, we have established as many as 88 ICTs through the country, i.e. in all of the 33 provinces and 55 cities/counties. An instruction has been issued by the central government for the establishment of the ICT in every cities and counties. The Team has played key role in identifying and solving problems of production and distribution that often give rise to pressures on volatile food prices.

18. Our experience over the past three years shows that this new framework has been effective. The policy mix, however, is not always easy to design and implement, and it needs to be appropriately and continuously calibrated according to the evolving dynamics of the global and domestic economic environment. Communicating the policy mix is also a challenge. We need to be clear at all times which instrument is directed to which specific objective, and we must also avoid substituting the interest rate policy for other instruments in the mix. Even when we are successful in these aims, there is always a risk that the market may perceive matters differently, given that the monetary policy response is generally (and often only) associated with interest rate adjustments.

Closing Remark

19. In closing, once again, I am delighted that we are here today. I hope the next two-days policy dialogue provides ample opportunities for all of us to enrich our understanding and able to formulate a new approach of macroeconomic policies making for promoting sustainable and equitable growth in East Asia.

Thank You