
1. General Review

During Q2/2007, the Indonesian economy remained firmly on the right track with sustained economic expansion. Inflation was on a declining trend. Financial market stability was well in hand with improving performance in the banking system. Indonesia's balance of payments outperformed earlier forecasts with an expanding surplus and mounting international reserves alongside appreciation in the rupiah exchange rate. These developments underscore the outlook for higher, more balanced economic growth in 2007 and 2008.

The ongoing consolidation in the economy and firm macroeconomic stability has created greater leeway for sustainable development policies aimed at reinforcing the foundations for national economic resilience. In view of the existing regional autonomy and expected launching of the ASEAN Economic Community in 2015, these foundations will be yet stronger if supported by regional development policies prioritising quality of human resources, food and energy sustainability and improvements to regional governance, including the economic role of regional administrations. For the future, Bank Indonesia is keenly aware of the importance of close coordination among all stakeholders at the regional level, including the Bank Indonesia Regional Offices, to facilitate cooperation in regional economic development. Bank Indonesia also sees the need for accelerated deepening and diversification of instruments for financial markets, including the Islamic financial market, to reinforce market expectations of continuity in macroeconomic stability.

According to the monitoring and analysis conducted by Bank Indonesia, inflationary pressure has eased in recent periods. Year-on-year CPI and core inflation for Q2/2007 was recorded at 5.77% and 5.40%. The more subdued inflation during this period is attributable mainly to deflation in the volatile foods category amid price increases for other commodities brought on by escalating international prices. Core inflation maintained a downward trend with minimal pressure from external factors due to the appreciation in the exchange rate and low imported inflation. Further contribution to reduced core inflation came from supply side capacity sufficient to meet demand and from stable inflation expectations. Concerning this, Bank Indonesia will keep a close watch on potential risks for future inflation triggered by financial market corrections.

The rupiah appreciated further in Q2/2007. The average exchange rate recorded at the end of June 2007 came to Rp 8,968 to the USD, representing 1.5% gain from Rp 9,102 to the USD in the preceding quarter. Contributing to the rupiah appreciation were positive developments in fundamentals, reflected in the improved performance of the balance of payments, sustained attractiveness of yields on rupiah placements and low risks. In Q2/2007, the balance of payments recorded a USD3.7 billion surplus, ahead of the initial USD1.1 billion projection. With the balance of payments outperforming expectations, the end-June 2007 international reserves position

reached USD50.9 billion, equivalent to 5 months of imports and servicing of official foreign debt.

Looking ahead, economic growth is forecasted to gather added momentum during 2007-2008, outperforming original projections. Key to the renewed growth optimism is improved performance in consumption and exports. The interest rate cuts by Bank Indonesia are expected to create greater opportunity for business to take advantage of lower cost financing. For 2007 and 2008, CPI inflation is projected within the inflation targeting range. This is explained by declining pressure in CPI inflation alongside more modest pressure in core inflation and volatile foods. However, it must also be noted that the continuing lag in government expenditures and various obstacles hampering the implementation of infrastructure projects dampened optimism for investment growth in Q2/2007.

Indonesia's financial system stability is in sound shape. For the coming quarter, financial system stability is also predicted to remain strong. On 29 June 2007, the Government and Bank Indonesia inaugurated the Financial System Stability Forum envisaged for building closer interagency coordination and cooperation for more intensive monitoring and maintenance of financial system stability.

After a comprehensive evaluation of the improving economic conditions and outlook as well as the achievement of inflation target for 2007 and 2008 set at $6\pm 1\%$ and $5\pm 1\%$, **on 5 July 2007 the Bank Indonesia (BI) Board of Governors' Meeting decided to lower the BI Rate by 25 bps to 8.25%.** The present monetary policy is seen as providing added stimulus for the economy as a whole.

BI will keep a close watch on macroeconomic developments with the ultimate objective of achieving price stability. **In monetary policy, BI will maintain a prudent, measured course** with careful observation of the dynamics in the economy. To this end, BI will also maintain support for government efforts to stimulate the domestic economy with particular emphasis on resolution of nationally important issues, such as reducing unemployment and poverty.