Strengthening Resilience, Promoting the Momentum of Economic Recovery

2009 ECONOMIC REPORT ON INDONESIA
Vision

“To be recognized, domestically, and internationally, as a credible bank through the strength of our values and achievement of low, stable rates of inflation.”

Mission

“To achieve and maintain price stability by maintaining monetary stability and by promoting financial system stability for Indonesia’s long term sustainable development.”

Values

“Competence, Accountability, Integrity, Cohesiveness, Transparency.”
“Through the struggle that began in the final quarter of 2008 and beginning of 2009, we overcame that difficult year with a number of achievements that we are entitled to feel proud of. The resilience of our economy was more than satisfactory in response to wild fluctuations and widespread uncertainty in the global economy. With growth reaching 4.5% in 2009, Indonesia gained entry into an exclusive group of a few countries that managed positive growth.”

(Darmin Nasution, Acting Governor of Bank Indonesia, 2010)
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Reporting period is Januari 1, 2009 to December 31, 2009

All source of data is from Bank Indonesia, unless mentioned otherwise
FOREWORD

We have successfully prevailed over the momentous year of 2009, a year replete with economic challenges for Indonesia. Through the struggle that began in the final quarter of 2008 and beginning of 2009, we overcame that difficult year with a number of achievements that we are entitled to feel proud of. The resilience of our economy was more than satisfactory in response to wild fluctuations and widespread uncertainty in the global economy. With growth reaching 4.5% in 2009, Indonesia gained entry into an exclusive group of a few countries that managed positive growth. In terms of prices, inflation in 2009 was just 2.78%, which is its lowest level in the past decade.

Such positive performance is inseparable from our efforts at Bank Indonesia to maintain macroeconomic and financial system stability, as well as prevent a persistent domestic economic slowdown. Amid the onerous challenges throughout 2009, and despite the economic slowdown Bank Indonesia’s efforts to preserve exchange rate stability played an important role in reducing inflation expectations. In addition, government policy to reduce fuel prices and transportation costs, as well as measures to stabilize the prices of staples in 2009 were significant in containing inflationary pressures.

Meanwhile, monetary and fiscal stimulus policies instituted by Bank Indonesia and the Government successfully maintained public purchasing power and provided incentives to the business community in the midst of weakening global demand. The policies implemented in 2009 basically represent follow-up measures to the array of policies introduced by Bank...
Indonesia and the Government in the fourth quarter of 2008. From the standpoint of Bank Indonesia, monetary policy was sufficiently loose in 2009 to shore up the domestic economy. Throughout 2009, Bank Indonesia reduced its policy rate (BI Rate) progressively by 50 bps per month from January to March and by 25 bps from April to August, ultimately holding the rate steady from September 2009. Setting the BI Rate was a core element of measured and purposeful monetary loosening. This policy also underpinned operational measures, for instance buttressing open market operations and enhancing the interest rate structure.

Amid these achievements a number of complex challenges continued to emerge. The primary challenge involved balancing the structure of growth through greater investment. Clearly, this required the availability of adequate infrastructure and a conducive investment climate. To this end, such efforts were pertinent in order to benefit from the opportunities arising from the nascent global economic recovery, including attracting more foreign capital investment. Other challenges emerged from the limited transmission of monetary policy. The effectiveness of monetary policy transmission through the banks, either by lowering interest rates or extending credit, still needs to be improved. Reducing interest rates remains a distinct possibility due to the large spread between lending rates and savings rates.

Looking ahead, Bank Indonesia will direct its monetary policy towards achieving low and stable inflation in harmony with the target corridor set for 2010 at 5% ± 1%. In the medium term, Bank Indonesia will strive to maintain the downward inflation rate trend towards the medium-term inflation target, namely 4% ± 1% by 2014. In this context, Bank Indonesia is committed to consistently steering the BI Rate towards an appropriate level, subsequently directing inflation and inflation expectations towards their respective medium-term targets as an anchor. In determining the BI Rate we will always take into consideration the prospects of the domestic and global economies holistically.

The economic dynamics highlighted here are elaborated in greater detail in the Indonesian Economic Report (IER) 2009. IER 2009 is not merely a map that illustrates what has happened in the national economy during 2009; it is also a compass that can be used to illuminate the most optimal path forward for Indonesia’s economy.

Expectantly, in 2010 we will all encounter an improvement in our respective fields. I am optimistic, God Willing, that the invaluable experiences we have gleaned over the past year will stand us in good stead as we move forward to confront the challenges that remain and that are yet to eventuate.

Jakarta, March 2010

Darmin Nasution
The global economic conditions with continuing pressure from the crisis posed major challenges for the Indonesian economy during 2009. These challenges were quite surfaced at the beginning of the year, as a result of the strong lingering impact of the global economic crisis that reached its peak in the fourth quarter of 2008. Uncertainties associated with how deep the global contraction and how quick the global economic recovery will occur not only exacerbated risks in the financial sector, but also adversely impacted economic activity in the real sector. As a result, heavy pressure continued to bear down on monetary and financial system stability in the first quarter of 2009, while economic growth remained in downward trend due to a deep contraction in exports of goods and services. These developments undermined confidence among economic actors in the financial sector and real sector, as well as potentially reduced the positive performance achieved during the previous few years.

Facing these challenges, Bank Indonesia and the Government took a number of policies to safeguard macroeconomic and financial stability, and prevent further decline in economic growth through monetary and fiscal stimulus. The various policies implemented in 2009 were basically the continuation of a series of policies that have been taken by Bank Indonesia and the Government in the fourth quarter of 2008. These policies succeeded not only in safeguarding macroeconomic and financial system stability, but also in strengthening domestic economic resilience, paving the way for renewed improvement in economic activity since the second quarter of 2009. Contributing to the success were policies systematically
introduced to bolster economic and financial fundamentals in the aftermath of the 1997/1998 crisis. Overall, the Indonesian economy in 2009 has been able to get through this challenging year with a remarkable achievement. Despite having slowed compared to 2008, economic growth reached 4.5% in 2009, the third highest in the world after China and India. Further slowdown in economic growth amid global economic contraction was avoided due to predominantly demand-driven structure of the economy. After the daunting pressures sustained in the first quarter of 2009, financial markets and macroeconomic stability also improved towards the end of 2009. This was reflected by the improvement in various financial sector indicators, such as Currency Default Swaps (CDS), the Jakarta Composite Index (JCI), yield on government bond and the exchange rate. Inflation also came to a modest 2.78%, the lowest ever in the past decade.

Various positive achievements of the Indonesian economy in 2009 has been increasingly reinforced optimism for a continuing process of economic improvement in the future. This optimism was also bolstered by the improving outlook for global economic recovery. Nevertheless, the dynamics of the economy forward continues to face several challenges that may potentially hamper the acceleration of economic growth. From the external side, the vital challenge especially related to the impact of the strategy to end the policy measures implemented during the crisis (exit strategy), including quantitative easing and fiscal expansion, in developed countries. Other external challenges are also associated with the occurrence of polarisation in world trade and the ongoing imbalances in the global economy. From the domestic side, the challenges associated with several problems that may interfere monetary policy effectiveness, include among others the considerable excess liquidity in the banking system, sizeable role of portfolio investments in the capital inflows structure, asset price bubble on the financial market, lack of financial market deepening and various structural problems in the real sector.

Looking ahead, Indonesian economic growth is expected to increase, while price stability is well maintained. The prospect of economic growth is supported by the continuing recovery in exports performance and an upturn in investment activity. The improvement in exports prospect is in line with the improvement in the global economic outlook, including the developed countries. The increase in external demand coupled with strong domestic demand is expected to encourage business to move forward with increasing production capacity. With these developments, economic growth in 2010 is projected to reach 5.5%-6.0% (yoy). Despite the resurgence in economic growth, inflation pressure is expected to remain under control and within the range of 2010 inflation target of 5% ± 1% (yoy). In a longer perspective, the Indonesian economy is predicted to chart further improvement with the support of sustained measures to increase production capacity, productivity, and efficiency in the economy. Growth is predicted to accelerate further and reach 6.5%-7.5% (yoy) in 2014. This expansion of economic capacity offers support for efforts to curb inflation towards the medium-term inflation target of 4% ± 1% (yoy).
Bank Indonesia future policy is aimed to maintain macroeconomic stability and financial system stability as a precondition for long-term sustainable economic growth. In this regard, monetary policy will be consistent with the efforts directed at achieving a low inflation target in the short and medium terms. Banking policy will be directed toward strengthening banking resilience, alongside measures to improve the banking intermediation function and financial market deepening. Payment system policy will be also directed to support financial system stability and improve the effectiveness of monetary policy transmission. In addition, Bank Indonesia will further strengthen policy coordination with the Government for maintaining macroeconomic stability and promoting the momentum for economic recovery.

**The Indonesian Economy in 2009**

During the first quarter of 2009, the impact of the global economic crisis that reached its peak in the fourth quarter of 2009 was still deeply perceived. On global financial markets, persistently high risks and uncertainties were fuelled by the deteriorating performance of leading financial institutions, such as Citigroup, American International Group (AIG), and Bank of America (BoA). These conditions lead to deleveraging process as investors reduced their fund placements on credit markets and capital markets and shifted them into low-risk assets, particularly US government securities (risk-free asset). In addition, investors also tend to cut back their funds in emerging market countries. These developments lead to tightness in the money market liquidity, while the performance of global stock markets continued to decline. Fund placements in emerging markets diminished as a result of excessive risk perceptions in these countries, reflected in high level of CDS for developing countries, including Indonesia. The continuing setbacks in the global financial sector dragged down world economic growth, and even major contraction occurred in developed countries.

Various policy measures introduced in many countries were gradually able to reduce the systemic risk in the financial markets and began restoring confidence among market participants in the second quarter of 2009. Liquidity injections by central banks eased credit market tightness and thus lowered risk perception in the financial markets to the level prior to the bankruptcy of Lehman Brothers in September 2008. In a similar vein, concerted actions by central banks to expand the scope and intensity of monetary operations and rescue the financial system have also been able to diminish the threat of systemic risk of the global financial crisis.

Alongside the recovery under way in the financial sector, there has been gradual improvement in world economic activity. The aggressive fiscal stimulus in some countries has had a beneficial effect on household consumption, which has started showing improvement. The upturn in this consumption indicator was followed by mounting activity in industry, led by the manufacturing sector from the third quarter of 2009. The more robust activity in the world economy were also contributed by the role of developing countries in Asia, which have now become the engines of growth in the world economy. Economic growth in Asia’s emerging markets, led by China and India, has offset the effects of the comparatively slow recovery in developed economies. Buoyed by this improving trend, the world economy experienced a faster recovery process in 2009. Despite a contraction of 0.8%, the realisation of economic growth was better than any previous estimates.

With global economic recovery moving at a faster pace, Indonesia’s external sector outperformed earlier projections, as reflected in the current account recording a surplus of 10.6 billion US dollars. Contributing to the improving performance in the current account were stronger exports led by resource-based commodities, such as mining products. At the end of 2009, export performance received a further boost from manufacturing products in response to the strengthening economic recovery in advanced economies, particularly the US and Japan. During this period, imports recorded significant decline, primarily due to slower growth of domestic demand. The capital and financial account recorded an overall surplus of 3.7 billion US dollar in 2009, exceeding earlier projections. The success of Bank Indonesia and the Government to restore market confidence contributed to the influx of short-term capital inflows since the second quarter of 2009. The overall performance in the current account as well as capital and financial account resulted in a balance of payments surplus of 12.5 billion US dollars in 2009, favourably compared with the deficit forecast at the beginning of that year. Following these developments, the international reserves position at the end of December 2009 reached 66.1 billion US dollars, equivalent to 6.5 months of imports of goods and services, and repayment of official external debt.
Indonesia’s financial sector performance was also heavily influenced by the dynamics of the global financial system. In particular, the heavy pressures occurred in 2008 still continued in the first quarter of 2009, triggered by the adjustment of the investment portfolio and mounting risk perceptions in emerging markets, including Indonesia. This was reflected in the high level of CDS at 1,248, far above the normal level at around 200, and the widening of the yield spread between Indonesian global bonds and the US Treasury Notes of up to 8.9%, above the average level of 3% in 2009. Pressure on the domestic financial market was also demonstrated by the sharp drop in the JCI to 1,256 (the lowest point ever in the last 3 years), high average yield on government securities reaching as much as 12.7%, and sharp depreciation in the exchange rate to Rp12,020 per US dollar in March 2009. The weakening of the rupiah was followed by increasing counterparty risk in forex market, as reflected in the widening buying and selling spread of the rupiah to the level of Rp 100.

The pressures bearing down on the financial market in the first quarter of 2009 were also reflected in the relatively high level of the Financial Stability Index (FSI) at 2.09, exceeding the upper limit of 2.0. Uncertainties on global financial markets also spilled over on to the rupiah money market. In the interbank money market, heightened counterparty risk prompted banks to hoard liquidity and limit their interbank transactions, creating a liquidity tightness. Until the end of January 2009, average volume of overnight interbank transactions remained very low at about Rp6 trillion, compared to the normal average of about Rp13 trillion. The spread for the 1-week to 6-month Jakarta Interbank Offered Rate (JIBOR) over the O/N rate widened to 136 bps, well above the pre-crisis level of 63 bps. Under the conditions of heightened risk perceptions and uncertainty on the financial market, banks shifted their fund placements more to central bank monetary instruments, such as Bank Indonesia Certificates (SBIs) and the Short-Term Deposit Facility (FASBI), even in spite of the aggressive Bi Rate cuts during the first quarter of 2009.

Along with the improvement in global financial markets since the second quarter of 2009 and the policy measures instituted by Bank Indonesia and the Government, investors’ confidence in domestic financial markets began to renew. This was reflected in the decrease in risk perception, followed by brisk inflows of foreign capital into Indonesia. The CDS index fell sharply to 160 and the yield spread for Indonesian Global Bonds over US Treasury Notes narrowed to 1.7. These developments led to improved performance in the domestic financial market, reflected in the increase in the JCI and lower yield on Government Bonds. The JCI closed 2009 markedly higher at 2,534 while average yield on Government Bonds fell to 10.1%. Counterparty risk on the interbank market also eased in line with diminishing uncertainties in the financial market and the mounting positive effect of monetary easing. The decline in market risks in return increased the volume of transaction and narrowed the high and low interest rate spread. Meanwhile, the banking sector reported stronger resilience with improved market risk, easier liquidity conditions on the money market and further progress in consolidation by the banking system. With these positive developments, the FSI improved to 1.91 at the end of 2009.

On the forex market, more robust fundamentals and lower risk perceptions helped restore the appreciating trend in the rupiah. Since the beginning of the second quarter of 2009, the rupiah has appreciated 18.4% and closed at Rp 9,425 per US dollar at the end of December 2009. The strengthening of rupiah was also accompanied by an increase in the forex market trading volume. In addition, the buying and selling spread of the rupiah also decreased to a level of Rp10, in line with reduced counterparty risk in the forex market. On the whole year, a level amount at end of year 2009 rose 15.7% compared with year end 2008 levels. the rupiah at the end of 2009 registered 15.7% appreciation over the end of 2008 level. Despite the appreciating trend, the level of the rupiah continued to support the competitiveness of Indonesian export products.

In the real sector, the global economic contraction led to an inevitable drop in Indonesia’s economic growth in 2009, with impact felt especially in export-oriented sectors. Until the third quarter of 2009, manufacturing sector grew only 1.5%, far below the average growth of around 4% before the crisis. In addition, the trade sector activity slowed considerably with contraction recorded in the second and third quarter of 2009, due to the decline in international trade activities. However, in the fourth quarter of 2009, both sectors indicated a fairly strong recovery in line with the global economic recovery, especially developed countries. Some sectors not related to external developments experienced relatively high growth, such as electricity, gas and water utilities, construction, transport and communications, and the services sector. Growth in the electricity, gas and water utilities sector and transport and communications
sector reached 13.78% and 15.53%, respectively. On the demand side, economic expansion in 2009 was driven by strong domestic demand, especially consumption of both households and government that grew respectively by 4.85% and 15.72%, enabling GDP growth to reach 4.5%. At this level, economic growth in 2009 outperformed other countries, many of which recorded a contraction.

Inflation pressure in 2009 was minimal. CPI inflation declined sharply to 2.78% from 11.06% in 2008. CPI inflation in 2009 was below the target of 4.5% ± 1%. Meanwhile, core inflation also dropped to 4.28%, compared with 8.29% in 2008. These conditions could not be separated from the influence of Bank Indonesia’s policies in restoring market confidence and keeping the rupiah on an upward trend, which in turn eased inflation expectations. The improvement in inflation expectations was also supported by reductions in administered prices and low volatile foods inflation. The success of Government measures in securing the supply and distribution of food and energy was reflected in below-historical levels of volatile foods inflation in 2009.

The informal sector was still capable of acting as a buffer in absorbing additional labor force, particularly under conditions of slowing economic growth. This was indicated by the thin decline in open unemployment from 8.1% in February 2009 to 7.9% in August 2009. Meanwhile, total labor force absorbed by the informal sector rose to 72.7 million, compared with the August 2008 level of 71.4 million.

Policy Responses

Throughout 2009, Bank Indonesia and the Government took a series of policies aimed at mitigating the impact of global pressures on the Indonesian economy. A number of policy measures were aimed at restoring confidence among economic actors in the financial and non-financial sectors, overcoming the liquidity tightness in the banking sector and reinvigorating economic growth. Other policies were instituted to maintain macroeconomic and financial system stability to ensure continued support for sustainable economic growth.

In the monetary sector, Bank Indonesia maintained a loose policy stance during 2009. With minimum risk of inflation pressure, Bank Indonesia saw the necessity for action to boost the domestic economy while ensuring financial system stability. The inclusion of financial system stability in monetary policy considerations carries strategic importance, given Bank Indonesia’s view that continued instability in the financial system potentially risks further pressure on macroeconomic stability and erode the economic performance as a whole. This policy strategy is consistent with the implementation of the Inflation Targeting Framework (ITF), which has been employed with greater flexibility in striking the balance between achievement of the inflation target and economic growth over the last 5 years.

With these policy direction, during 2009 Bank Indonesia lowered the BI Rate in different magnitudes, divided into three episodes, based on a comprehensive assessment of the current state and prospects of the economy. During the first episode in January-March 2009, aggressive cuts were made in the BI Rate at 50 bps each month, bringing the rate in March 2009 to 7.75%. The bold response in cutting back the BI Rate was taken in view of the still considerable pressure on the financial system and the continuing slowdown in economic growth. On the other hand, future inflation pressures were not predicted to be strong. In the second episode of April-August 2009, BI Rate cuts were determined in smaller amount at 25 bps per month, bringing the rate to 6.50% in August 2009. This policy direction factored in the onset of softening pressures on the financial system and continued absence of strong inflation pressure, while the acceleration of economic growth was quite mild. In the third episode from September to December 2009, the BI Rate was held at 6.50%. With financial system stability firmly in hand, the 6.50% level of the BI Rate was adequately consistent with the inflation target for 2010-2011, while allowing room for measures to boost economic growth. In response to these developments, the BI Rate during 2009 was lowered 275 bps, from the December 2008 level of 9.25%.

Bank Indonesia also took some operational policies on the forex and rupiah money markets to strengthen monetary policy effectiveness. The objective of these supporting polices was to provide assurance for availability of short-term liquidity in money market activities while optimising liquidity management in the banking system. On the rupiah money market, Bank Indonesia opened repo windows for 1 and 3 month tenors to provide a continued guarantee and temporary cushion for banking liquidity, the first from mid-April 2009 and the latter from September 2009. On the forex market, Bank Indonesia pursued an exchange rate stabilisation policy in prudent actions to mitigate the impact of the global liquidity crisis on domestic forex liquidity, while maintaining adequate...
levels of international reserves. To keep forex liquidity at sufficient levels, Bank Indonesia also strengthened bilateral and multilateral cooperation with regional central banks under currency swap arrangement. In March 2009, Bank Indonesia and the People’s Bank of China concluded a Bilateral Currency Swap Arrangement (BSCA). Bank Indonesia also signed a Bilateral Swap Arrangement (BSA) with the Bank of Japan under the Chiang Mai Initiative as part of the ASEAN+3 financial cooperation in April 2009. Following this, Bank Indonesia signed the Chiang Mai Initiative Multilateralization (CMIM) agreement with other ASEAN+3 members in December 2009.

The Bank Indonesia policy in the banking sector is aimed at building banking industry resilience with continuing efforts to promote the banking intermediation function. In early 2009, a policy framework for resolving the liquidity tightness in the banking system was established under the second amendment to Act No. 23 of 1999 concerning Bank Indonesia in Act No. 6 of 2009. This law sets forth the legal basis for Bank Indonesia to provide credit or financing to banks in difficulty with short-term funding and to extend the emergency financing facility (FPD) to systemically important banks. To promote banking intermediation, Bank Indonesia also scaled back the risk weightings for credit to micro, small and medium enterprises (MSMEs). Other policies also pursued by Bank Indonesia to bolster resilience in the banking system include implementation of risk management and prudential principles in activities related to structured products. These banking policies were also supported by policy actions in the payment system for improved reliability of the payments system infrastructure. Among these is the continuing development of the Bank Indonesia Real Time Gross Settlement (BI-RTGS) Generation II system, which commenced in 2008. The introduction of more reliable, secure and efficient infrastructure and greater risk mitigation capacity in the BI-RTGS system will provide added support for financial stability.

In line with the measures in monetary sector, the Government with support from the Indonesian Parliament increased the fiscal stimulus while continuing to safeguard fiscal sustainability. The fiscal stimulus package was launched with three key objectives, namely (i) maintain and/or boost public purchasing power, (ii) bolster the resilience of the corporate/business sector in coping with the global crisis and (iii) create jobs and mitigate the impact of worker lay-offs by expanding labour-intensive construction of infrastructure. Despite the added fiscal stimulus measures, the fiscal deficit in 2009 remained within comfortable limits at 1.6% of GDP. Besides this, the ratio of total official debt to GDP eased further to 29% at the end of 2009, compared to 33% at the end of 2008.

The Government also pursued a range of sectoral policies to strengthen the resilience of the real sector in the economy. In the mining sector, the Government announced major changes to the regulatory framework for mining production and licensing with greater attention to geographical conditions, the carrying capacity of the environment, and regional autonomy. In agriculture, the Government issued regulations to assure availability of land for food crop farming and optimise the use of fisheries resources potential. To support adequate provision of infrastructure, the Government opened the door for private sector power generation and empowered regional governments to play a greater role in the provision of electricity infrastructure. In regard to infrastructure financing, the Government set up a state owned company in 2009 specifically to assist the funding of infrastructure projects. Other sectoral policies were also targeted at mitigating impact from the global financial crisis.

**Policy Challenges**

Behind these positive achievements, the Indonesian economy is still confronted with four major policy challenges.

The first challenge concerns the dynamics of the global economy, in particular the potential emergence of economic and financial risks triggered by the exit strategy implemented by developed countries. This challenge has surfaced because the global economic recovery since the second quarter of 2009 has relied heavily on policies leading to massive expansion of liquidity in the financial sector and soaring fiscal deficits in developed countries. The flood of liquidity in the financial sector is largely attributable to quantitative easing intended to relieve pressures in the financial sector, promote banking intermediation and rescue key sectors in the economy. Concern on excess liquidity can be a major source of inflationary pressure, which requires a number of countries to begin to raise interest rates. Meanwhile, the swelling of the fiscal deficit as a consequence of these steps may put concerns over fiscal sustainability. Under the still fragile condition of global economic recovery, the
Policies are also needed to anticipate distortions in world trade, since during the crisis many countries have resorted to protectionist policies. As is widely known, the global economic downturn has adversely impacted exports and business sector in many countries. To mitigate the impact of the global financial crisis and ensure the survival of domestic production sector, many countries eventually turned to policies involving trade protectionism. One development that deserves attention in the near future is the impact of the implementation of the ASEAN China Free Trade Agreement (ACFTA) on the external sector performance. Furthermore, given the issue of ongoing global imbalances, another challenge calling for close monitoring during the current global economic crisis concerning the appropriate response to efforts by world nations to achieve more balance global economic growth.

In view of these global dynamics, the prospect of Indonesian economic recovery will not only be influenced by policies adopted in advanced countries, but also by global and regional cooperation. Given that an economic crisis can occur at any time and for any cause, Indonesia needs a strategy to anticipate these various possibilities, including more robust international cooperation. On one hand, participation in the G-20 has strengthened Indonesia’s position in formulating global actions and policies to improve and safeguard global economic and financial stability. The other consideration is that Indonesia’s commitments to various forms of international regulation will also take on a more binding nature. In this regard, the challenge concerns how to bring domestic regulations and standards into alignment with internationally agreed regulations and standards.

The escalating protectionist trend in response to the crisis can undoubtedly bear down on Indonesia’s trade. The protectionist policies launched by various countries to protect their domestic economies are likely to affect the implementation of a range of free trade agreements. Furthermore, the potential risk from future developments in global imbalances poses a particular challenge for emerging market countries, including Indonesia. However, with the present improvement in economic conditions and global trade, strengthened international cooperation in its various forms is expected to bring positive benefits, particularly in boosting the competitiveness of the domestic economy.

The second challenge is related to structural issues that could constrain monetary policy effectiveness. In this regard, three structural issues come to the fore. First is the predominant role of portfolio investment within the structure of capital inflows. The sizeable portfolio investment in the capital and financial account calls for prudent management to prevent risks to inflation control. These risks would arise mainly during a time of capital reversal that would exacerbate inflation expectations, in line with heightened expectations of the rupiah depreciation. Second, the still large volume of excess banking liquidity is also a concern as it could add to the complexity and costs of monetary policy. The complexity of monetary policy is exacerbated by the still heightened risk perceptions. As a result, the rate of decline in lending rates has lagged behind the cuts in the BI Rate. Third, structural problems persist in the real sector that fuel the potential for inflation pressure. The issues that arise from these structural problems include the lack of supply-side responsiveness to demand-side stimulus, inadequacies in market structures and lack of efficiency in distribution of goods.

The dynamics and changing behaviour in the financial system, which have added to the complexity of monetary management, mean that monetary policy formulation can no longer be simply directed at maintaining price stability, but also needs to consider stability indicators in the financial sector. At the operational level, the complexity of issues in the financial sector suggests that monetary policy cannot rely solely on one instrument, in this case interest rates. Monetary policy requires support in other forms, including macroprudential policy instruments that can be availed in the event of potential financial system instability.

Furthermore, conducive macroeconomic policy is expected to build favourable inflation expectations and positive market perceptions of the condition of the economy, and thus bring improvement to the structure of capital inflows in supporting sustainable economic activity. These processes also require close observation and an active role by the appropriate authorities in managing conditions on the domestic forex market and facilitation of infrastructure building in supporting financial market deepening. Related to the issues that continue to surface on the supply side, strengthening of coordination between Bank Indonesia...
and the Government must be put ahead of other actions. This coordination is especially important in reinforcing economic institutions and accelerating the construction of infrastructure as part of the drive to expand production capacity and the economy as a whole.

In the end, given the high level of uncertainty that persists in the economic environment, it is essential for macroeconomic policy formulation to be supported by a more robust institutional framework. Strengthening the institutional framework is necessary to enable the implementation of macroeconomic policies based on a clear framework and implemented prudently. Experience in the aftermath of the crisis in the 1990’s underscores the importance of sound, transparent management of the economy, not only in mitigating the effects of the crisis, but also in taking the economy forward on the road to recovery. From a broader perspective, accountability, transparency and independence must become the benchmarks in implementing a macroeconomic policy framework, for example in the monetary and fiscal sectors. In the monetary sector, empirical experience in many countries demonstrates that the implementation of monetary policy based on a Flexible ITF, offering greater leeway within certain limits, has worked well in responding to the pressures of the global economic downturn. Likewise, fiscal policy oriented towards fiscal sustainability will create greater fiscal space for the Government to deliver economic stimulus, should this become necessary.

The third challenge is related to the potential for an asset price bubble in the financial markets that could endanger financial system stability. As was evident in 2009, foreign capital inflows, which are mostly short-term, have made a positive contribution to financial market performance, in line with the optimism of financial market participants in the outlook for the Indonesian economy. However, this progress must also be monitored for the possibility of excessive optimism and the risk of possible backfiring on the financial market. One phenomenon calling for attention is an asset price bubble in the stock market. This is because soaring share prices will add to the complexity of efforts to maintain overall financial system stability and macroeconomic stability. In addition, rising asset price fuelled by short-term capital inflows are highly susceptible to correction in the event of capital reversal. Foreign investors are very quick to notice signs of instability in the stock market that stir wider negative sentiment to the Indonesian capital market and trigger panic. Significant correction in the financial market driven by capital reversal will influence the banking system and exchange rate movement with adverse impact on financial system stability and erosion of economic performance. Accordingly, a closer watch is needed on the influence of foreign capital flows, due to the current limited depth of the domestic financial market structure. The nature of this structure could exacerbate financial market volatility and susceptibility to shock, as turmoil would not be absorbed by the financial market itself.

The most important policy implication concerns the need for financial deepening and financial broadening. These needs are related to the development of financial market products aimed at diversification, hence financial instruments available for short to medium-term investments, hedging of financial transactions involving foreign currencies and distribution of risk. Development of financial market products is expected to minimise the negative impact of high volumes of foreign capital flows by making more investment alternatives available in the financial market. At the same time, short-term money market products can be developed to foster healthy competition for the Indonesian financial system in financing the real sector. The short-term money market is expected to provide an added alternative to short-term fund placements while simultaneously making funds available for short-term financing.

Advances in financial products should be matched by prudential regulation aimed at preventing the exploitation of these products for speculation with the sole aim of reaping maximum profits. To this end, prudential regulation must be supported by strengthened policy coordination in the regulation and oversight of the financial system. This is important given that the highly integrated nature of the financial market has blurred the distinctions in the characteristics and movements of financial services offered by individual financial institutions. For this reason, closer coordination must be coupled with more robust regulation of the supervisory functions and system to avoid extreme changes in behaviour within the financial system that could disrupt macroeconomic stability. Stronger regulation must be directed at bringing order and structure in such areas as liquidity risk management, adequacy of capital to absorb operating losses and preventive action at the earliest opportunity in bank supervision. Besides this, cross border cooperation needs to be stepped up in exchange of information, harmonising of international regulatory standards and strengthening of risk management to
subdue risk contagion with potential for triggering financial system instability on a broad scale.

In overall terms, the potential risk to financial markets must be anticipated with adroit measures in the financial sector. The use of adept measures to anticipate financial system developments will increase the need for sound macroprudential surveillance and enhanced policy coordination in the regulation and oversight of the financial system. To this end, Bank Indonesia will have an increasingly crucial role as systemic regulator. This role is primarily related to the Bank Indonesia function of safeguarding monetary stability and financial system stability. The systemic regulator role will strengthen the effectiveness of policy in financial system stability. Accompanying this, there must be a crisis management protocol to anticipate potential risks in the financial system.

The final challenge relates to efforts to resolve structural problems in the real sector in order to improve the quality of economic growth. In this regard, greater prominence needs to be given to economic policy and strategy that will accelerate economic growth while simultaneously making significant reductions in unemployment and poverty. One strategic aspect related to quality improvement in economic growth is increased competitiveness in the economy. As is widely known, the latest survey results show that while Indonesia’s competitiveness improved during 2009, it still lags behind some countries in the region. Key factors in the low competitiveness include infrastructure and energy. This issue of competitiveness has ultimately impacted industry performance, which is on a declining trend. The issues in the manufacturing sector therefore call for close attention, given the significant value added in this sector compared to other sectors and ability to absorb large numbers of workers.

For the future, measures to strengthen the role of domestic demand, supported mainly by Indonesia’s natural resources potential, must be given greater prominence in bolstering the overall structure of the economy. This is especially important given that the domestic economy is not isolated from the dynamics of the global economy. To this end, actions to promote manufacturing as the engine of the Indonesian economy must consider a number of issues. First, Government policy must focus on debottlenecking issue to remove the various hurdles to progress on vital infrastructure projects in such actions as streamlining of licensing, improvement in the investment climate and legal certainty. This will have a major bearing on private sector interest in financing infrastructure projects and is important in view of the expected major financing role of the private sector. The elimination of these obstacles is expected to pave the way for adequate infrastructure that will in turn promote high levels of investment and competitiveness in manufacturing. Second is the need for policies to promote development of non-resource based industry alongside measures to enhance the performance of resource-based industries for production of higher-value downstream products. Third, future industrial development policy must also take regional differences into account, with industrial development built around the economic strengths of each region. To do this, the central government and regional governments must design an integrated strategy for industrial development.

In view of the policy challenges outlined above, the Indonesian economy is confronted with a highly challenging environment at the global and domestic levels. Therefore, to strengthen economic resilience and provide added boost to the momentum of economic recovery, it is necessary to formulate an integrated national economic policy agenda. From the government policy perspective, the economic policy agenda will be comprehensively implemented across various economic sectors in keeping with efforts to strengthen the effectiveness of policy in financial system stability. Accompanying this, there must be a crisis management protocol to anticipate potential risks in the financial system.

Economic Outlook

The outlook for the Indonesian economy is predicted to improve. This optimism is supported by the rise in consumer and business confidence, declining risk perceptions, and a more conducive global economic conditions. Furthermore, the various policies launched in recent times have strengthened the foundations of the economy to grow faster and strengthen the economic resilience to various shocks. Financial system stability and improving economic prospect are also expected to
In a longer perspective, the future of the economy will be largely determined by capacity to boost the supply-side as a source of economic growth. This calls for measures to promote greater accumulation of capital and bring sustainable improvements to economic productivity and efficiency by addressing areas such as investment rating, infrastructure development, and quality of education. The positive effect of these sources of growth will in turn strengthen the capacity of the economy to keep pace with ever vigorous domestic demand. Through this, economy will be able to reach a new level of growth without triggering instability in domestic prices. The acceleration of economic growth is predicted to continue and reach the range of 6.5%-7.5% in 2014. Meanwhile, inflation pressure is forecasted to remain under control in line with the medium-term inflation target of 4% ± 1%.

Bank Indonesia Future Policy Direction

As the economy moves into recovery in the aftermath of the global economic crisis, Bank Indonesia policies will remain focused on maintaining macroeconomic stability and financial system stability, and promoting the bank intermediation function in support of sustainable economic growth. Learning from the past two year experiences, marked by behavioural changes in the financial sector and the global economic crisis, it can be generally concluded that macroeconomic stability is not only associated with price stability, but also interacts with financial system stability. In this context, monetary policy will be directed to achieve low and stable inflation, while maintaining closed attention to financial system stability. Banking policy, on the other hand, will not only focus on support for the banking industry, but will also uphold macroeconomic stability and provide support for economic activity. In a broader perspective, coordination with fiscal policy and real sector policy will be strengthened further to build solid foundations for sustainable economic development.

Monetary Policy

Bank Indonesia monetary policy in 2010 will be aimed to achieve the inflation target of 5% ± 1%, while maintaining closed attention to financial system stability as well as promoting economic growth momentum.

In the medium term, Bank Indonesia will drive inflation to reach a low rate and comparable to the inflation rate of countries in the region that has been in the range of...
3%. Efforts to achieve a low inflation rate is critical in the medium term in order to maintain the competitiveness of domestic economy, especially in the face of an ASEAN Economic Community (MEA) in 2015. In this context, the BI Rate will be steered based on a comprehensive underlying assessment to achieve the inflation target, but keeping the rate at a level conducive to improvement in the banking intermediation function and domestic economic recovery. In the medium to long term, the BI Rate level that is required to keep domestic inflation comparable with the inflation rate in the region is expected to decrease if the various efforts to improve supply-side capacity in responding to rising domestic demand can be properly implemented.

At the operational level, Bank Indonesia will continue its policy of managing liquidity in the money market. In the rupiah money market, these policies include infrastructure improvements to facilitate the repo market, encourage banks to place funds in longer-tenor monetary instruments, and expand the base of participant in the money market. Efforts will be done gradually by considering the condition of financial markets experiencing excess liquidity. In the forex market, Bank Indonesia policy is essentially aimed at minimising volatility in the rupiah exchange rate. This strategy will permit gradual adjustment in the exchange rate consistent with developments in fundamentals, in so doing avoiding excessive fluctuation. In addition, Bank Indonesia will facilitate Government’s efforts to improve the management of foreign exchange earnings from exports of oil and gas and non-oil and gas products.

**Banking Policy**

In learning from the experience of dealing with the global economic crisis during the past two years, banking policy in 2010 will be implemented through four key incentive and disincentive-based policies to strengthen banking resilience and increase the role of the intermediation function.

The first is to build greater resilience into the banking system. This policy will be pursued by implementing measures involving the strengthening of the regulatory framework, development of a more robust system for bank supervision, restructuring the competition within the Indonesian banking industry and financial market deepening. The regulatory framework will be strengthened through changes in capital regulations designed to improve bank resilience to risks, regulation of financial report transparency, improved quality in organizational governance and greater effectiveness of risk management. The development of more robust bank supervision will be achieved through improvements and revamping of methods and practice in risk-based supervision, stronger operational rules for bank supervision, improvements to the fit and proper test and increase cooperation with non-bank financial institution supervisors in Indonesia and other countries. The restructuring of competition in Indonesia’s banking industry will involve strengthening of banking structures with capital requirements aligned to the scale of business to increase capacity to absorb business risks. In addition, Bank Indonesia will improve the regulations covering such areas as mergers, consolidation, funding sources for bank acquisitions, requirements for entities eligible to acquire banks, role of individual/family owners and business development requirements. The policy for financial market deepening will focus on promoting the development of financial products that banks will be able to use simultaneously and productively as alternatives for fund channelling and earning asset placements in the real sector, especially for infrastructure financing. This is expected to build a more liquid money market with banks less reliant on revenues earned on placements in Bank Indonesia instruments.

The second is a more vigorous banking intermediation through improvements in regulations and provision of supporting infrastructure. The regulations slated for improvement cover the minimum reserve requirement, optimization and efficiency of bank operations and streamlined requirements in foreign exchange activities aimed at promoting bank lending. Bank Indonesia will also support the establishment of an institution managing a database of credit per sector and per region to help banks measure risks.

The third is an increased role for Islamic banking in the Indonesian economy with strengthened resilience. The sharia-compliant banking policies slated for implementation include greater incentive for increasing capital, facilitation for expansion of sharia divisions and subsidiaries and facilitation for fulfillment of competent personnels for Islamic banks.

The fourth is an expanded role for rural banks in microfinance with improved resilience. This policy will involve provision of incentives to increase capital, facilitation for fulfillment of competent personnels for rural banks and establishment of the rural bank position as community banks.
To strengthen the bank role as intermediary institutions, Bank Indonesia will encourage the banking system to improve banking industry efficiency. Actions to this end will include the issuance of benchmarks for cost of funds, overhead cost, risk premium and profit margins. In this way, banks will be able to identify sources of inefficiency and seek ways of raising efficiency in order to set interest rates at more reasonable levels. Banking industry efficiency will also be improved through financial market deepening. Examples of actions include cooperation with other agencies to study and promote short-term money market instruments capable of competing with short-term credit from the banking system.

To strengthen overall financial system resilience, Bank Indonesia envisages a role as systemic regulator with oversight of the soundness and stability of the financial system as a whole. The need for a systemic regulator has taken on added urgency after lessons learned from the experience of the global economic crisis in the last two years. The role of the institution will extend to collection, analysis and reporting of information related to significant interactions in the market and risks among financial institutions; examination of the possibility of a financial institution causing the financial system inadequately protected against systemic risk; design and implementation of regulations; and coordination with other regulators, including the fiscal authorities, in the management of any systemic crisis that may arise.

**Payment System Policy**

Future policy for the national payment system will continue to focus on support for financial system resilience and promotion of efficiency in national economic activities. This policy will be implemented through three key actions: increasing the reliability and capability in risk mitigation in large value payments, improving efficiency in the retail payments infrastructure and enhancing security in the card-based payment instrument industry.

To improve infrastructure reliability and ability to mitigate risk in the large value payment system, Bank Indonesia will develop the Bank Indonesia Real Time Gross Settlement (BI-RTGS) Generation II. This is intended to build added functionality into the BI-RTGS system with the objective of enhancing efficiency in use of liquidity, efficiency and mitigation of risks in cross-border transactions and efficiency in support of monetary and fiscal policy transmission. The advanced development of the BI-RTGS system is intended to put into place a BI-RTGS system infrastructure capable of supporting the future growth in cross-border transactions anticipating the initiatives for development of an integrated regional economy and financial markets, such as the ASEAN Economic Community to be launched in 2015. In the future, the BI-RTGS system will therefore no longer operate purely as a gross to gross settlement mechanism, but will be combined with netting system, which is more commonly described as a hybrid system. The system will be able to support more efficient use of liquidity among system participants.

To improve efficiency in retail payment infrastructure, Bank Indonesia will set up the institutional structure for the retail payment system in a self-regulatory organisation (SRO) outside Bank Indonesia and support the creation of retail payment infrastructure in the National Payment Gateway (NPG) format. The SRO is envisaged as a partner for Bank Indonesia in regulating and safeguarding the smooth operation of the payment system, with the industry setting its own rules from the industry side as long as these rules do not contravene the general policy governing the payment system. The underlying reasoning is that industry actors in essence have a better understanding of the nature of their business, including the risk appetite of each industry. The NPG, on the other hand, is a national switching system for various interbank transactions conducted through front end delivery channels such as ATMs, internet, telephone and mobile payments. Bank Indonesia’s development of the NPG will involve formulation of a development strategy, preparation of a development schedule and facilitation of NPG development by deliberating accurate policy and regulation without neglecting the condition and capacity of the industry. When launched, the NPG is expected to bring immediate improvements in payment system operation efficiency in Indonesia. Industry participants will no longer need to develop their own infrastructure for their payment system activities. Instead, these activities will be able to operate more efficiently through sharing of the infrastructure with other industry actors.

In other actions, Bank Indonesia will work continually to develop the Bank Indonesia Real Time Gross Settlement (BI-RTGS) Generation II. This is intended to build added functionality into the BI-RTGS system with the objective of enhancing efficiency in use of liquidity, efficiency and mitigation of risks in cross-border transactions and efficiency in support of monetary and fiscal policy transmission. The advanced development
technology in 2009, however, had progressed as far as exploration of possibilities for instrument standardisation, with trials planned for selected major issuers prior to full implementation.

**Policy Coordination**

Looking forward, Bank Indonesia will take further measures to strengthen macroeconomic policy coordination with the Government. In an economy still fraught with uncertainty, the limited scope of the influence of macroeconomic policies has reinforced the importance of policy coordination between Bank Indonesia and the Government in supporting macroeconomic policy objectives to improve social welfare.

The importance of policy coordination is related to the persistence of fundamental issues in the economy that have defied speedy resolution, such as structural problems on the supply side and support for MSMEs. Policy coordination between Bank Indonesia and the Government will prioritise measures to strengthen economic institutions in support of accelerated construction of infrastructure to expand production capacity and economic activity on a broad scale. In addition to monetary and fiscal policy coordination for macroeconomic stabilisation, other actions will involve improvement of foreign investor relations and Indonesia’s rating, support for banking intermediation, and deepening of the domestic financial sector. The Bank Indonesia Regional Offices (KBI) will also continue their work of producing studies of economic sectors and mainstay commodities utilising information from surveys and Regional Economic Studies (KER). This is expected to contribute to flexible supply-side behaviour in responding to the demand-side, enabling economic policy support for the economic recovery process to deliver optimum results. Furthermore, policy coordination will be directed at making more support available to MSME actors in order to secure MSMEs greater access to the banking system.

Bank Indonesia will also maintain active coordination with the Government to address issues of structural rigidity in the economy that could potentially hamper monetary policy effectiveness. At the national level, Bank Indonesia and the Government have established the Team of Inflation Targeting, Monitoring and Control (TPI). At the regional level, Bank Indonesia will intensify inflation control measures in the regions by empowering the KBI to play a more active role in driving the work of the Regional Inflation Control Teams (TPIDs). Cooperation with regional governments will be key to identifying and seeking solutions to the various structural problems that exist. In most regions, structural shocks are an endemic factor driving inflation. Looking forward, the TPIDs are expected to deliver improved performance in curbing inflation surges in local regions and operate within an expanded scope to support higher quality economic growth at the regional and national level.