

INDONESIA'S ECONOMIC RESILIENCE

Amid Global Economic Uncertainty



2011 ECONOMIC REPORT ON INDONESIA

ISSN 0522-2572

VISION

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

MISSION

To achieve and maintain rupiah stability by maintaining monetary stability and promoting financial system stability for indonesia's long term sustainable development.

STRATEGIC VALUES

Competency - Integrity - Transparency -
Accountability - Cohesiveness



DARMIN NASUTION

Governor of Bank Indonesia, 2012

“While growth was higher, there was also a more balanced structure of economic growth, marked by stronger investment and exports. Reflecting investment growth were brisk imports of capital goods, high investment lending and heavy inflows of foreign direct investment (FDI). The expanding trend in investment reflected a process of capital accumulation that could boost the effectiveness in expansion of productive capacity in the economy while reducing supply-side rigidity”.

CONTENTS

Contents	iv
Tables	viii
Charts and Diagrams	xii
Board of Governors of Bank Indonesia	xx
Foreword	xxii
Executive Summary	xxvi
Box 1 Accountability For Achievement Of The 2011 Inflation Target	xli

PART 1

HEIGHTENED UNCERTAINTY IN THE GLOBAL ECONOMY

2

CHAPTER I

Global Economic Development and Policy

5

1.1	Global Economic Development	8
1.2	Economic Development In Advanced Economies	11
1.3	Economic Development In Emerging Markets	13
1.4	Global Policy Responses	14
1.5	International Cooperation	15



2.1	Global Financial Market	22
2.2	Global Commodities Market	26

3.1	Economic Growth Performance	40
3.2	Aggregate Demand	41
3.3	Aggregate Supply	48
3.4	Employment And Welfare	51
Box 3.1	The Role Of Law Number 2/ 2012 On Land Acquisition For Development In Supporting Infrastructure Activities	53

4.1	The Performance Of Indonesia's Balance Of Payments	60
4.2	Current Account	62
4.3	Capital And Financial Transactions	66
4.4	Foreign Exchange Reserves And Indicators Of External Vulnerability	69

5.1	Exchange Rate Performance	74
5.2	Affecting Factors	75
5.3	Performance Of The Domestic Foreign Exchange Market	79
Box 5.1	The Role Of The Exchange Rate In A Flexible Inflation Targeting Framework	81

CONTENTS

CHAPTER VI Inflation 85

6.1	Inflation Performance	88
6.2	Affecting Factors	91
Box 6.1	Strengthening Policy Coordination To Control Inflation	96

PART 3

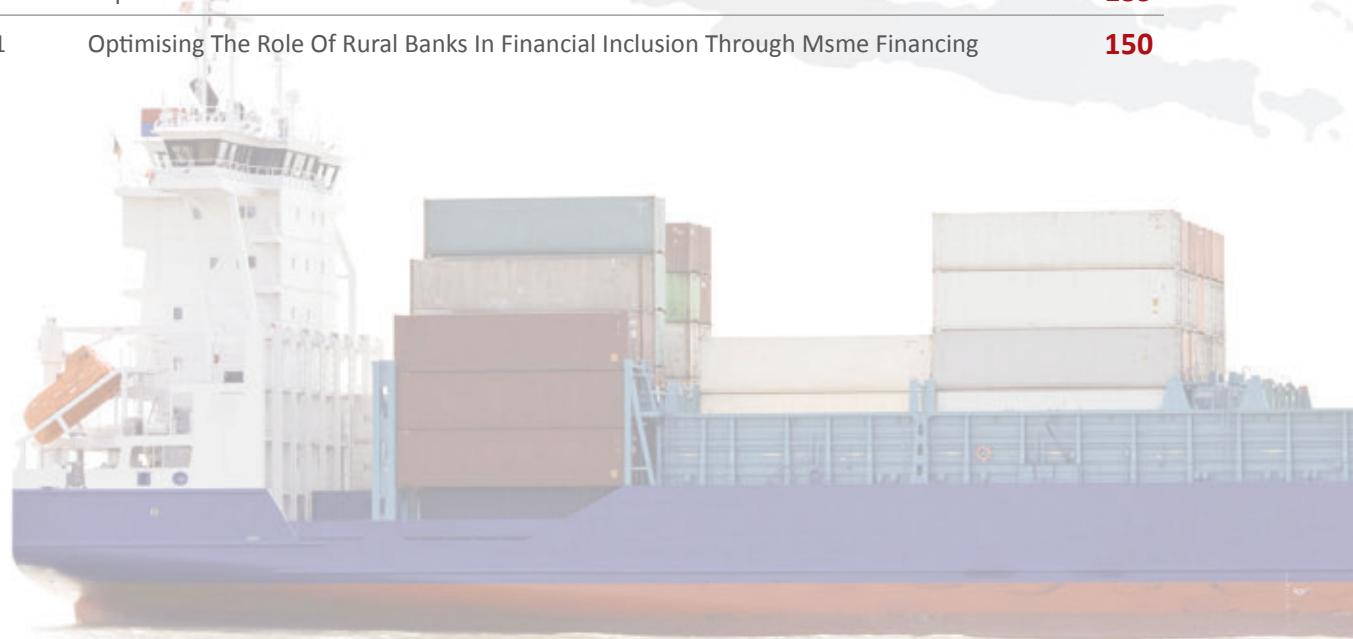
BANK INDONESIA AND GOVERNMENT POLICY MIX TOWARDS MAINTAINING MACROECONOMIC AND FINANCIAL SYSTEM STABILITY 102

CHAPTER VII Monetary And Macroprudential Policy 105

7.1	Monetary Policy	108
7.2	Macroprudential Policy	109
7.3	Monetary Policy Communication	116
7.4	Crisis Management Protocol	117
7.5	Evaluation of Monetary Policy Implementation	117
Box 7.1	Bank Indonesia Crisis Management Protocol	123

CHAPTER VIII Financial System Policy and Performance 127

8.1	Banking Policy And Performance	130
8.2	Capital Market And Other Financial Institutions	139
Box 8.1	Optimising The Role Of Rural Banks In Financial Inclusion Through Msme Financing	150



155

Payment System and Currency

CHAPTER IX

9.1	Policy And Performance Of The Payment System	158
9.2	Policy And Performance Of The Currency Circulation	163

171

Government Policy And Fiscal Performance

CHAPTER X

10.1	Fiscal Policy And Performance	174
10.2	Sectoral Policy	182

186

ECONOMIC PROSPECT, CHALLENGE AND BANK
INDONESIA'S POLICY DIRECTION

PART 4

189

Economic Prospects, Challenges And
Bank Indonesia's Policy Direction

CHAPTER XI

11.1	Economic Prospects For 2012	192
11.2	Economic Prospects For 2013-2016	198
11.3	Economic Challenges And Bank Indonesia's Policy Direction	201
Box 11.1	Optimism of Improving Investment Following The Achievement Of Investment Grade	217

221

APPENDICES



TABLES

CHAPTER I

Global Economic Development and Policy

Table 1.1	World Main Economic Indicators	8
Table 1.2	Macro Indicators of PIIGS and U.S	9
Table 1.3	The Ownership of PIIGS Debt Securities	10
Table 1.4	Global Monetary and Macroprudential Policy	17

CHAPTER II

Global Financial and Commodity Market

Table 2.1	The Dynamics of Growth Prospects Throughout 2011	27
-----------	--------------------------------------------------	----



Table 3.1	Regional Economic Growth	42
Table 3.2	Economic Growth in the Region	43
Table 3.3	Non-oil and Gas Export by Destination Countries	47
Table 3.4	Labor Force and Unemployment	50
Table 3.5	Poverty Gap Index	52
Table 3.6	Poverty Severity Index	52

Table 4.1	Indonesia's Balance of Payment	61
Table 4.2	Export	62
Table 4.3	Competitiveness of Non-oil and Gas Export Commodities	68
Table 4.4	Import (c.i.f)	65

Table 5.1	Indonesia Sovereign Credit Rating (Per December 2011)	77
-----------	-------------------------------------------------------	----

Table 6.1.	Pre-crisis and Post-crisis Inflation	89
Table 6.2.	Regional Inflation	91
Table 6.3.	Contribution to Inflation/Deflation of Volatile Food Commodities	95

TABLES

CHAPTER VIII

Financial System Policy and Performance

Table 8.1	Commercial Bank Main Indicators	135
Table 8.2	Rural Credit Bank Main Indicators	136
Table 8.3	Sharia Bank Office Network	137
Table 8.4	Assets, Third Party Funds and Sharia Commercial Bank and Sharia Unit Business Operations Financing	137
Table 8.5	Third Party Funds Sharia Commercial Bank and Sharia Unit Business Operations	138
Table 8.6	Fund Disbursement Sharia Commercial Bank and Sharia Unit Business Operations	138
Table 8.7	Small Medium Enterprises (SMEs) Credit	140
Table 8.8	Speed of Stock Recovery in Regional Countries	144
Table 8.9	Speed Of Recovery of Government Bonds	146
Table 8.10	Economic Financing From Non Bank Institutions	148



Payment System and Currency Circulation Policy and Performance

CHAPTER IX

Table 9.1	BI RTGS Transaction by type	161
Table 9.2	Currency in Circulation Position	165

Government Policy And Fiscal Performance

CHAPTER X

Table 10.1	Government Finance Operation Summary	175
------------	--------------------------------------	-----

Economic Prospects, Challenges And Bank Indonesia's Policy Direction

CHAPTER XI

Table 11.1	GDP Forecast by Expenditures	193
Table 11.2	GDP Forecast by Industry Origin	194
Table 11.3	Balance Of Payment Projections	196
Table 11.4	Mid Term Indonesia Economic Outlook (2011-2016)	199

CHARTS & DIAGRAMS

EXECUTIVE SUMMARY

Chart 1.	Exchange Rate and Core Inflation	xI	Chart 3.	CPI Inflation in Religious Holiday Period	xliiii
Chart 2.	Inflation Expectation and BI Rate	xli	Diagram 1.	The Affecting Factors of Inflation in 2011	xlii

CHAPTER I

Global Economic Development and Policy

Chart 1.1	Trade Activities in Asian Countries	10	Chart 1.7	Emerging Markets GDP	13
Chart 1.2	Trade Activities in European Countries	10	Chart 1.8	Asian Emerging Markets Inflation Rate	13
Chart 1.3	Advanced Economies GDP	11	Chart 1.9	Policy Rates	14
Chart 1.4	Wage in the US	12			
Chart 1.5	Retail Sales in Advanced Countries	12			
Chart 1.6	Advanced Countries Inflation Rate	12			



Chart 2.1	2011 Global Stock Price	22	Chart 2.14	Global Commodity Price Index	27
Chart 2.2	2011 Global Bond Yield	22	Chart 2.15	World Trade Volume Growth	28
Chart 2.3	Global Financial Market Volatility	23	Chart 2.16	Oil Price Development	28
Chart 2.4	Global Liquidity	23	Chart 2.17	Oil Supply and Demand	28
Chart 2.5	Capital Flows to Emerging Markets	23	Chart 2.18	CRB Commodity Index and US T-Bond Yield	29
Chart 2.6	CDS of PIIGS Countries	23	Chart 2.19	Noncommercial Contract of Oil	29
Chart 2.7	Yield Spread of PIIGS Bonds and Germany Bonds	24	Chart 2.20	Speculation and Oil Prices	30
Chart 2.8	Foreign Capital Flow in Stock Market of Asian Emerging Markets	24	Chart 2.21	Mining Commodity Prices	30
Diagram 2.1	Timeline of Global Economy in 2011	25	Chart 2.22	Agriculture Commodity Prices	30
Chart 2.9	Global Stock Price Index	26	Chart 2.23	Gold Price and Financial Market	30
Chart 2.10	Asia Stock Price Index	26	Chart 2.24	Gold Price and Non-commercial Contract	31
Chart 2.11	LIBOR Spread-Overnight Indexed Swap (OIS) of Advanced Economies	26			
Chart 2.12	High-Low Interest Deviation	26			
Chart 2.13	Dollar Index and Asia Dollar Index	27			

Chart 3. 1	Economic Growth	40	Chart 3. 10	Farmer Terms of Trade	44
Chart 3. 2	GDP by Expenditure	40	Chart 3.11	Consumer Confidence Index	44
Chart 3. 3	GDP by Industry Origins	41	Chart 3.12	Productive Age to Non-Productive Age Ratio	44
Chart 3. 4	Contribution to GDP Growth by Industry Origins	41	Chart 3. 13	Consumer Confidence Index by Region	44
Chart 3. 5	Regional Share in National Economy	41	Chart 3. 14	Retail Sale Index by City	45
Chart 3.6.	Regional Contribution to National Economy	42	Chart 3. 15	New Investment (Business Survey)	45
Chart 3.7	Income per Capita	42	Chart 3. 16	Investment by Sector	45
Chart 3. 8	Income Index by Expenditure	43	Chart 3. 17	Business Tendency Index-BPS	45
Chart 3. 9	Middle Class	43	Chart 3. 18	Indonesia Sovereign Credit Rating	46
			Chart 3.19	Investment by Type of Investor	46

CHARTS & DIAGRAMS

CHAPTER III

Economic Growth

Chart 3.20	Non-oil and Gas Export by Sectors	46	Chart 3.27	Transport and Communication Sector	50
Chart 3.21	Share of Export Destination Countries for Coal and CPO	47	Chart 3.28	Unemployment Rate by Region	51
Chart 3.22	Import of Non-oil and Gas by Type of Goods	47	Chart 3.29	Poverty Rate	51
Chart 3.23	Manufacturing Sector	48	Chart 3.30	Poverty Rate by Region	51
Chart 3.24	Agriculture Sector	49			
Chart 3.25	Mining Sector	49			
Chart 3.26	Trade, Hotel and Restaurant Sector	49			



Chart 4.1	World Trade Volume, Export and Export Prices	60	Chart 4.10	Foreign Direct Investment by Country of Origin	67
Chart 4.2	Current Account	62	Chart 4.11	Portfolio Investment	67
Chart 4.3	Export Price Index of Indonesia	63	Chart 4.12	IDX Composite and Foreign Ownership in Securities	68
Chart 4.4	Export Growth by Country Destinations	63	Chart 4.13	Other Investment Liabilities of Private Sector	68
Chart 4.5	Import and Consumption of Fuel	65	Chart 4.14	Private Foreign Debt	69
Chart 4.6	Service Account	65	Chart 4.15	International Reserve	69
Chart 4.7	Capital and Financial Account	66	Chart 4.16	The Indicators of External Vulnerabilities	69
Chart 4.8	Direct Investment	66			
Chart 4.9	Direct Investment by Industry Origins	66			

Exchange Rate

CHAPTER V

Chart 5.1	Rupiah Exchange Rate	74	Chart 5.8	Swap Premium	78
Chart 5.2	Rupiah Volatility	74	Chart 5.9	Uncovered Interest Rate Parity (UIP)	78
Chart 5.3	Exchange Rate and Event Analysis of Rupiah Exchange Rate	75	Chart 5.10	Covered Interest Rate Parity (CIP)	78
Chart 5.4	The Exchange Rate Againsts US Dollar	76	Chart 5.11	Foreign Fund Flows in Rupiah Portfolio	79
Chart 5.5	Exchange Rate Appr/Depr in The Region Countries	76	Chart 5.12	Maturity of Foreign Ownership in SBI	79
Chart 5.6	Rupiah Exchange Rate and Non-oil and Gas Export	76	Chart 5.13	Foreign Ownership in SBN	79
Chart 5.7	Risk Index and Yield Spread	77			

Inflation

CHAPTER VI

Chart 6.1	Event Analysis of CPI Inflation	88	Chart 6.7	Food Inflation in the Region Countries	90
Chart 6.2	Inflation Performance vs Historical Data	88	Chart 6.8	Capacity Utilization	92
Chart 6.3	Inflation Performance	89	Chart 6.9	Inflation Expectation for 2011	92
Chart 6.4	Monthly CPI Inflation	89	Chart 6.10	Retailers' Price Expectations-Retail Sales Survey	93
Chart 6.5	Inflation by Group of Commodities	90	Chart 6.11	Inflation of Selected Administered Price Commodities	94
Chart 6.6	CPI Inflation in the Region Countries	90	Chart 6.12	Inflation of Volatile Food and Rice	94

CHARTS & DIAGRAMS

CHAPTER VII

Monetary And Macroprudential Policy

Chart 7.1	Changes in Government Bonds Ownership	109	Chart 7.8	Foreign Ownership in SBI and Rupiah Exchange Rate	113
Chart 7.2	Source of Excess Liquidity	110	Chart 7.9	Share and Position of Resident Ownership of SBI	113
Chart 7.3	The Frequency of Maturity and Absorption of Monetary Instrument	110	Chart 7.10	Nonresident SBI Available To Sell	114
Chart 7.4	The Nominal Daily Average Tenor of Monetary Instrument	111	Chart 7.11	Banking Intermediation Function	115
Chart 7.5	Monetary Instrument Composition	111	Chart 7.12	Banking Excess Liquidity Ratio	118
Chart 7.6	SBI Auction Profile in 2010-2011	112	Chart 7.13	Monetary Instrument Composition	118
Chart 7.7	Capital Flows Portfolio	112	Chart 7.14	Monetary Composition by Maturity	119



Chart 7.15	Overnight Interbank Rates and Monetary Instrument	119	Chart 7.22	M1 Growth	121
Chart 7.16	Max-Min Deviation of Overnight Interbank Rates	119	Chart 7.23	M2 Growth and Affecting Factors	121
Chart 7.17	Overnight Interbank Rates Structure	120	Chart 7.24	M1 and M2 Money Multiplier (mm)	122
Chart 7.18	Interbank Market Volume	120	Chart 7.25	M1 and M2 Velocity	122
Chart 7.19	Banking Interest Rate	120	Diagram 1.	Crisis Management Protocol	131
Chart 7.20	Credit Rate by Type	121			
Chart 7.21	Deposit Rates, Credit Rates, BI Rate	121			

Chart 8.1	Deposits Growth	133	Chart 8.11	Tradeable and Non-Tradeable Sector Capitalization	145
Chart 8.2	Asset Composition	133	Chart 8.12	Net Buy/Sell IDX Composite Index	145
Chart 8.3	Credit Growth	134	Chart 8.13	Government Bonds (SUN) and BI Rate Yields	145
Chart 8.4	Gross NPL Ratio	134	Chart 8.14	Term Structure of Govt. Bonds in 2010-2011	146
Chart 8.5	ROA and NIM	134	Chart 8.15	SBN Net Buy/Sell in 2008	147
Chart 8.6	IDX Composite and BI Rate	143	Chart 8.16	SBN Net Buy/Sell in 2011	147
Chart 8.7	IDX Composite and Regional Index in 2007-2008	143	Chart 8.17	Term Structure of Corporate Bonds	148
Chart 8.8	IDX Composite and Regional Index in 2010-2011	143	Chart 8.18	Government Bonds Rating	148
Chart 8.9	IDX by Sector in 2007-2008	144	Diagram 1.	Rural Credit Bank Cooperation Model	151
Chart 8.10	IDX by Sector in 2010-2011	144	Diagram 2.	Ideal Business Model Rural Credit Bank	151
			Diagram 3.	Ideal Organizational Structure of Rural Credit Bank	152

CHARTS & DIAGRAMS

CHAPTER IX

Payment System and Currency

Chart 9.1	BI RTGS Transaction	160			
Chart 9.2	BI RTGS Value Transaction Share	160			
Chart 9.3	BI RTGS Volume Transaction Share	161			
Chart 9.4	BI SSSS Transaction	162			
Chart 9.5	SKNBI Transaction	162			
Chart 9.6	APMK Transaction	162			
Chart 9.7	E-Money Transaction	163			
Chart 9.8	Currency in Circulation, GDP and Inflation	165			
			Chart 9.9	Currency in Circulation and Household Consumption Growth, Currency in Circulation to Household Consumption Ratio	166
			Chart 9.10	Currency in Circulation	166
			Chart 9.11	Currency in Circulation Share in Banking	166
			Chart 9.12	Currency in Circulation Denominations by Nominal	167
			Chart 9.13	Currency in Circulation Denominations by Bills/Piece	167
			Chart 9.14	Currency Outflows	167
			Chart 9.15	Currency Inflows	167
			Chart 9.16	Currency Outflow and Currency in Circulation	168
			Chart 9.17	Net Outflow	168
			Chart 9.18	Net Outflow in Head Office and Regional Office	168



Chart 10.1	Government Financial Operations	174	Chart 10.9	Subsidies	179
Chart 10.2	Government Revenues Composition in 2011	174	Chart 10.10	Budget Financing	180
Chart 10.3	Government Revenues	176	Chart 10.11	Government Bonds (SUN) Yields	180
Chart 10.4	Government Expenditures	177	Chart 10.12	Government Debt	181
Chart 10.5	Province Budget Endorsement	177	Chart 10.13	Government Consumption	181
Chart 10.6	Regional Government Expenditures to Balance Funds Ratio	178	Chart 10.14	Government Investment	181
Chart 10.7	Government Expenditures Composition in 2011	178	Chart 10.15	Transfer to Riil Sector	182
Chart 10.8	Personnel and Capital Expenditure Portion	178	Chart 10.16	Central Government Savings in BI	182
			Chart 10.17	Impact of Government Finance Operations	182

Chart 11.1	GDP Forecast of Trading Partners	194	Chart 11.5	Middle Class	200
Chart 11.2	Salary Adjustment Respond	197	Chart 11.6	Consumption and Investment Ratio	200
Chart 11.3	Savings, GDP, Consumption Growth	200	Chart 11.7	Plan of Infrastructure Project in MP3EI	201
Chart 11.4	Indonesia Demography Structure	200			

BOARD OF GOVERNORS



DARMIN NASUTION
Governor



HARTADI A. SARWONO
Deputy Governor



MULIAMAN D. HADAD
Deputy Governor



BUDI MULYA
Deputy Governor





ARDHAYADI MITROATMODJO
Deputy Governor



HALIM ALAMSYAH
Deputy Governor



THE LATE S. BUDI ROCHADI
Deputy Governor
(Passed away on July 7, 2011)



RONALD WAAS
Deputy Governor
(Since December 2011)

FOREWORD

The year 2011 was one replete with dynamics and challenges while again putting the resilience of Indonesia's economy and financial sector to the test. Halfway through the year, the upbeat optimism for global economic recovery that had marked early 2011 began to fade. In early September 2011, global financial markets were plunged into turmoil as a result of the worsening debt crisis in Europe. As a nation with an open economy and financial sector, Indonesia did not escape the fallout from this global turmoil.

Amid the unrelenting global upheaval, during 2011 Indonesia successfully maintained stability in macroeconomic aggregates and the financial sector that underpinned the achievement of internal and external equilibrium in the national economy. Also key to this equilibrium was the ample space allowed for flexibility in monetary and fiscal policies in response to external shocks.

DARMIN NASUTION
Governor

Internal equilibrium in the economy in fact showed improvement, reflected in the upward trend in economic growth alongside declining inflation. During 2011, the Indonesian economy grew by 6.5%, up from 6.1% one year earlier, marking the highest growth rate for the past ten years. Contrasting this was inflation at 3.79%, well below the 6.96% level of the previous year. This mild inflation is expected to accelerate the process of disinflation in pursuit of a lower long-term inflation target on par with the inflation rate of Indonesia's trading partners. It also represents the second time that inflation fell to a record low for the past ten years.

While growth was higher, there was also a more balanced structure of economic growth, marked by stronger investment and exports. Reflecting investment growth were brisk imports of capital goods, high investment lending and heavy inflows of foreign direct investment (FDI). The expanding trend in investment reflected a process of capital accumulation that could boost the effectiveness in expansion of productive capacity in the economy while reducing supply-side rigidity.

Similarly, the maintenance of external equilibrium was reflected in the continued surplus in the balance of payments, despite some reduction from the preceding year. With the balance of payments in surplus, international reserves climbed from 96.2 billion US dollars at the end of 2010 to 110.1 billion US dollars at the end of 2011. At this level, reserves were sufficient to cover 6.4 months of imports and payment for short-term government foreign debt.

Stability in the financial sector was also maintained within safe limits during 2011, as banks reinforced their capacity to absorb the risk of instability while continuing to perform their intermediation function. Improvements in capital and consistent application of prudential banking principles were visibly quite effective in holding back the industry from precipitous decline.

The improved performance in the Indonesian economy and financial sector was encouraging, in view of the considerable turbulence in the global environment

during 2011. From early September 2011, the European debt crisis began spreading to larger economies such as Italy and Spain, prompting investors to reprice investment risk and reposition their portfolio holdings in assets from emerging market nations, including Indonesia. The depth and breadth of the European debt crisis also dashed the previous optimism for global economic recovery.

In response to the downside risks of global economic slowdown and mounting instability, Bank Indonesia reoriented and recalibrated its policy mix concerning interest rate, exchange rate and macroprudential policies. During 2010 and in early 2011, the policy mix was primarily targeted at responding to inflationary pressure and heavy capital inflows, but from Q3/2011, it shifted more to stabilisation of the financial market and countercyclical action in curbing the risks of the weakening global economy.

To anticipate the risk of worsening global economic conditions, it became necessary to bolster domestic resources of economic growth. For this reason, and in view of confidence for even more subdued inflation, from September 2011, the monetary policy response embarked on a more loose bias. This change in stance commenced with a downward adjustment in the lower limit of the interbank interest rate corridor and was followed by cuts in the BI Rate in October and November 2011, bringing the BI Rate to 6.0% at the end of 2011.

To safeguard macro and financial system stability, Bank Indonesia pursued a range of policy actions that included the simultaneous stabilisation of the exchange rate and the government bond market. This policy action also enriched monetary operations and improved their efficiency due to the accumulation of government bonds at Bank Indonesia available for use in monetary operations. Looking forward, exchange rate stability will also be supported by the implementation of a regulation requiring foreign exchange earnings from exports and foreign exchange debt to be received through domestic foreign exchange banks.

Bank Indonesia continues to pursue a range of policy actions to bolster resilience and improve efficiency in the banking system to enable the banking sector to deliver a greater contribution to support sustainable economic growth. In addition, policy refinements in the payment system are moving forward to improve efficiency in payment system operations and support the reinforcement of monetary and banking policies.

Now, in early 2012, global economic conditions are predicted no better than in 2011. At the end of 2011, no clear picture had emerged of the likely depth and duration of the European debt crisis, due to the very broad dimension of the issues involved. Some European nations are caught in an adverse feedback loop involving the sovereign debt crisis, deteriorating condition of the banking system and slowing economic activity. The depth and breadth of the European debt crisis poses enormous downside risks for the global economic outlook in 2012.

Nevertheless, the gloomy outlook for the global economy in 2012 still provides opportunities for the national economy to maintain a brisk growth, provided the reinforcement of the domestic based economic growth resources. After taking in to account of all the opportunities and challenges involved, Bank Indonesia predicts that in 2012, the Indonesian economy will grow by 6.3%-6.7%.

The reductions in the BI Rate commencing October 2011 are expected to stimulate domestic financing resources, most importantly from the banking sector. Investment growth is predicted to strengthen further, which in turn will help sustain public purchasing power. Indonesia will have greater opportunity to boost investment after all rating agencies have restored Indonesia to investment grade. On the other hand, Bank Indonesia predicts inflation in 2012 to remain stable at 4.5% in view of the slowing condition of the global economy and adequate levels of domestic production capacity, provided there is no change in policy regarding fuel prices.

This concludes our overview of the Indonesian economy in 2011 and its outlook for 2012, which are described in full in the Indonesia Economic Report. My hope is for this report to provide useful reference material for us all.

Finally, on behalf of the Board of Governors of Bank Indonesia, I would like to express my sincere appreciation to the Editorial Team of the Indonesia Economic Report. May God the Almighty bestow upon us the abundance of His Grace and protection in every step of our endeavours.

Jakarta, March 2012
Governor of Bank Indonesia



Darmin Nasution



EXECUTIVE SUMMARY

INDONESIA'S ECONOMIC RESILIENCE AMID GLOBAL ECONOMIC UNCERTAINTY

In 2011, the Indonesian economy demonstrated considerable resilience in the face of mounting uncertainties in the global economy, reflected in even stronger growth performance and steady, prudently managed macroeconomic stability. Economic growth reached 6.5%, an all-time high for the past ten years, while inflation was a mild 3.79%. Accompanying this more robust performance was improvement in quality of growth, reflected in the substantial role of investment and exports as sources of growth, falling levels of unemployment and poverty and improvement in equitable distribution of growth across Indonesia's regions. On the external side, Indonesia's balance of payments charted a respectable surplus that expanded the international reserves position and contributed to appreciation in the rupiah exchange rate. In the financial sector, financial system stability held firm despite pressure on financial markets during the second half of 2011 from the impact of the worsening crises in Europe and the United States. With strong economic resilience and low external debt risk supported by prudent macroeconomic policies and a range of ongoing structural policy measures, Indonesia was again rewarded with an upgrade that took the sovereign rating to investment grade.

Indonesia's robust economic fundamentals proved adequate to minimise impact from the global economic turmoil. Uncertainty over the European debt crisis and fears over the outlook for US economic recovery during 2011 fuelled turbulent conditions on financial markets and dented global growth. The brunt of fallout in Indonesia from the global turmoil was borne by financial market, led by the stock and bond markets, while impact on the real sector was comparatively minimal. In the financial sector, the decision by some investors to pull out foreign capital during the second half of 2011 put pressure on the rupiah, Government bond yields and share prices. Nevertheless, the



stabilisation measures pursued by Bank Indonesia and the Government, reinforced by the strong fundamentals of the financial sector and macroeconomic stability, averted a breakout of turmoil on the financial market. In the real sector, external-side support for Indonesia's economic resilience came from diversification of export markets marked by growth in intra-regional trade within Asia in addition to the expanding role of foreign direct investment (FDI). On the domestic front, economic resilience was also bolstered by buoyant purchasing power in response to rising incomes and a demographic structure weighed heavily in favour of productive age groups.

In addition to strong economic fundamentals, appropriate policy responses were key to supporting Indonesia's economic resilience. Bank Indonesia and the Government engaged in policy coordination to reinforce economic fundamentals while mitigating impact from external turbulence. On Bank Indonesia's part, the measured, timely application of a monetary and macroprudential policy mix proved successful in safeguarding macroeconomic and financial market stability. This policy mix was implemented through interest rate and exchange rate policy responses as well as macroprudential policies for management of capital inflows and banking liquidity. Also supporting the monetary and macroprudential policy mix was a communications strategy to improve the effectiveness of monetary policy transmission and minimise uncertainty for market actors. In the banking system, Bank Indonesia worked untiringly to strengthen banking resilience, enhance the supervision function and promote intermediation with focus on productive sectors. From the Government side, fiscal policy sought to deliver an enlarged stimulus while safeguarding fiscal sustainability. At the sectoral level, the Government worked hard to boost the quality of economic growth through improvements to the investment climate, accelerated construction of infrastructure, stronger competitiveness in industry and exports and greater national food resilience, including measures to stabilise prices. Policy coordination between Bank Indonesia and the Government in order to improve economic resilience and macro stability was also reinforced through the implementation of Crisis Management Protocols (CMPs) and control of inflation at the central and regional levels through Inflation Control Team (TPI) and Regional Inflation Control Teams (TPIDs) forums.

In the outlook for 2012, Indonesia's economy is predicted to forge ahead, although risks from a downturn in the global economy remain high. In 2012, the economy is forecasted to grow by 6.3%-6.7% while inflation is projected within the 4.5%±1% targeting range. This growth will be driven mainly by the domestic economy, with investment playing an expanding role. Indonesia's large domestic market, prudent macroeconomic stability, low interest rates, improved investment climate and investment grade status are factors that will drive robust investment growth. In keeping with this trend, inflows of FDI are predicted to mount higher, helping to keep the balance of payments in a healthy surplus. This will contribute to stability in the rupiah exchange rate in the face of risks of shocks in movements of capital. However, due to the risk of further weakening in the global economy, Indonesia's economic growth may trend towards the lower limit of the forecasted range in the absence of monetary and fiscal stimulus measures. Meanwhile, Government plans concerning subsidised fuels and other strategic commodities may stoke inflationary pressure in coming periods.

In 2012, Bank Indonesia will optimise the role of the monetary policy mix to curb inflation within the targeting range and boost economic growth in order to mitigate risks from the global economic slowdown. In the banking sector, Bank Indonesia will improve efficiency to enable banks to optimise their contribution to the economy while continuing to build the resilience of the banking system. In addition, Bank Indonesia is working to increase financial inclusion through broader public access to banking services. In the payment system, Bank Indonesia is devoting untiring effort to improve efficiency, reliability, security and consumer protection in both the national payment system and in the payment system linkages with other countries. These measures underpin the confidence that during 2012, economic growth will again reach the median projection. In the medium-term, given the forecasts for improvement in the world economy and ongoing launching of structural policies in investment and manufacturing, the Indonesian economy can look forward to higher, sustainable growth alongside prudently managed macroeconomic stability. Indonesia's economy is forecasted to grow at 6.6%-7.4% while inflation will ease further in line with the 4.0%±1% target for 2016.

THE GLOBAL ECONOMY

Global economic developments in 2011 were marked by increased uncertainties that emerged due to the much-delayed resolution of the debt crisis and fears over the outlook for economic recovery in advanced economies. In the US, some indicators suggest that economic recovery is not as strong as originally projected. In Europe, the failure of repeated attempts to resolve the debt crisis has worsened conditions in the financial sector and for economic recovery in the region. The mounting uncertainty in these two developed regions of the world fuelled turmoil on global financial markets, and with the added impact of the natural disaster in Japan and geopolitical crises in the Middle East, slowed the process for global economic recovery in 2011.

Early in the year, optimism for further improvement in global economic recovery was running strong. In January 2011, the IMF revised upwards its forecast for global economic growth in 2011 to 4.4% from the 4.2% level forecasted in October 2010. This growth forecast, which surpassed the historical average, pointed to hopes for acceleration in the global economic recovery process at the time¹. However, early in the second half of 2011, pessimism began to set in as uncertainty mounted over the prolonged resolution of the debt crisis in Europe and stalled economic recovery in the US. In October 2011, the IMF announced a downward revision in the 2011 global growth forecast to only 4%, below the normal level.

The loss of optimism for global economic recovery was closely linked to the dynamics of a range of economic indicators and the policy responses adopted in various nations. In early 2011, following the multispeed recovery in 2010, global economic recovery was expected to carry forward in 2011 with improved growth equilibrium in advanced economies. Various positive developments in advanced nations buoyed optimism for brisk recovery at the time. Consumption in the US and Japan was on the mend, while Europe's fortunes were boosted by improvement in the trade balances of Germany and France. In emerging market countries, economic growth was running high with some countries such as China and India reportedly showing signs of overheating.

However, the momentum of this recovery was initially hampered by the disaster that struck Japan on 11 March 2011. Production stoppages led to contraction in the Japanese economy and disruptions in the global supply chain of Japanese products. In addition, the outbreak of geopolitical crises in the Middle East led to soaring prices for oil and other commodities, which in turn stoked inflationary pressure in many countries. While advanced economies stayed the course with accommodative monetary policies, emerging markets responded with a tight bias. The difference between these monetary policy responses amid the ongoing multispeed recovery and high volume of excess global liquidity prompted an even greater rush of foreign capital inflows into emerging market economies.

During Q2/2011, the recovery in the world economy began to lose momentum with the downward spiral in the sovereign debt crisis in Europe. Portugal and Greece faced mounting difficulties with debt, which resulted in a further downgrading of the debt rating for the two countries. This kindled negative sentiment on financial markets, putting pressure on financial asset prices due to flight to quality with global investors shifting investments from high-risk to more secure assets. In emerging market countries, not only financial asset prices, but also capital inflows and exchange rates saw wider fluctuation.

From the third quarter to the end of 2011, global economic conditions deteriorated further in line with the deepening and widening of the sovereign debt crisis in the developed world. The crisis that broke out in peripheral nations in the Eurozone then spread to nations at the Europe's core, due to the closely intertwined nature of the economies and banking systems of Europe. At the same time, efforts to revive the US economy with fiscal stimulus and extra-accommodative monetary policy failed to boost economic activity. These stimulus packages did not succeed in restoring consumer confidence, lowering unemployment and bringing recovery in the property sector, and therefore failed to generate a permanent increase in consumption. Worse yet, the high level of US government debt and uncertainty over policy responses for addressing debt levels resulted in a downgrading of US sovereign debt from AAA to AA+. This set off turmoil on global financial markets that gained mounting intensity. Emerging market nations were hit by massive capital reversals leading to weakening in exchange rates and steep price corrections for financial assets.

¹ From 2000 until 2010, world economic growth averaged 4.2%. High global economic

The crisis in the US and Europe has resulted in spillover effects on emerging market economies. In the trade channel, the slumping growth in advanced economies has impacted demand for imports, bearing down on growth in world trade volume. This has slowed the rate of export growth in emerging market countries, putting pressure on economic growth. The intensity of the impact depends on the export structure and capacity for domestic demand in the individual country. As a rule, growth will taper off less in emerging markets with resource-based exports and greater capacity for domestic demand. Impact is also influenced by policy responses to mitigate the impact of the global economic slowdown, whether through accommodative monetary policy or fiscal stimulus. For these reasons, and the subdued inflationary pressure following the decline in global commodity prices at the end of 2011, Bank Indonesia and a number of other central banks lowered their monetary policy rates. Overall, emerging market economies were still able to chart high growth and continue to forge ahead as the engines of global economic growth.

Via the financial market channel, the debt crises in Europe and the US fuelled turbulence on global financial markets. The flurry of negative reporting on the escalating sovereign debt crisis, particularly in these two developed economies, inflamed negative sentiment on financial markets that led to increased risk aversion and flight to quality. Emerging market countries suffered a massive capital reversal in Q3/2011 that put steep pressure on exchange rates and sent stock and bond prices tumbling. Faced with such pressure from global financial market turmoil, emerging market nations embarked on measures to stabilise their financial markets through intervention on forex markets, while nevertheless allowing room for flexibility in their exchange rates. This policy was possible due to the ample level of international reserves. At some central banks, including Bank Indonesia, stabilisation measures also involved the purchasing of government bonds on the secondary market. In the end, financial market stability in emerging market countries remained within safe limits and returned to normal at the end of 2011.

PERFORMANCE OF THE INDONESIAN ECONOMY

Amid mounting uncertainties in the global economy during 2011, Indonesia's macroeconomic aggregates

and financial system indicated considerable resilience. The spillover effects of the global crisis on the Indonesian economy through the trade channel were comparatively limited. Indonesia's export performance remained strong, bolstered mainly by exports of resource-based commodities and market diversification in response to the growing volume of intraregional trade in Asia. In the financial market channel, the resilience of the financial system held steady despite downward pressure during the second half of 2011. Key to this was the strength of financial sector fundamentals in absorbing risk and safeguarding macroeconomic stability, with support from the stabilisation measures pursued by Bank Indonesia and the Government. On the domestic front, economic resilience was also bolstered by robust purchasing power in response to rising incomes and a demographic structure weighed heavily in favour of productive age groups.

With this resilience, the Indonesian economy was less influenced by global economic conditions during 2011 and charted improved levels of performance. Accompanying this brisk pace of growth was higher quality of growth, reflected in the expanding role of investment and exports as sources of growth, falling levels of unemployment and poverty and improvement in equitable distribution of growth across Indonesia's regions. Indonesia's balance of payments recorded increased surpluses in both the current account and the capital account, added to which were stronger international reserves, appreciation in the rupiah and significant easing of inflationary pressures. Alongside this, overall performance improved in Indonesia's banking system and financial market during 2011. The steady advance in economic performance and low external debt risk supported by prudent macroeconomic policy and various structural policy actions were rewarded with the upgrading of Indonesia's sovereign rating to investment grade.

In 2011, economic growth climbed to 6.5%, representing a record high for the past ten years. Key to the brisk pace of growth was sustained macroeconomic stability marked by a stable rupiah exchange rate and low inflation, expanding economic capacity and stable domestic political and security conditions. The buoyant growth was distributed almost evenly across all regions of Indonesia, with the highest level recorded in the Java region and the lowest in Eastern Indonesia, most importantly in Bali, Nusa Tenggara and Kalimantan.

On the demand side, the improvement in economic growth was driven mainly by more robust growth in consumption and investment. In addition to the contribution from heavier government spending, upbeat growth in consumption was also strengthened by rising incomes and buoyant consumer confidence. Non-construction investment soared, reflecting the business response in expanding production capacity in keeping with robust demand and the conducive business climate in Indonesia. At the same time, exports maintained brisk expansion despite growth tapering off near the end of 2011 in line with weakening growth in the world economy. This development was followed by a slowdown in imports linked mainly to reduced demand for raw materials for export production.

At the sectoral level, developments in tradable sectors pointed to upbeat conditions. This was indicated mainly by higher industry sector growth, which reached a record high for the past seven years. However, the agriculture sector charted only mild growth due to the limited expansion in land for food crop cultivation, while mining sector growth slowed due to low oil and gas production. In non-tradable sectors, developments were marked by improvement in line with the strength of domestic activity. Upbeat performance in non-tradable sectors was driven largely by the trade, hotels and restaurants sector, the financial sector and general services. Others sectors, including the construction sector and transport and communications, also maintained brisk growth.

In response to these developments, Indonesia's economic growth outperformed that of other countries in the region. Amid the overall decline in growth in emerging markets worldwide, including ASEAN countries, Indonesia's economy in fact charted increased growth. The declining growth in peer nations came as the result of faltering export levels, while Indonesia's exports maintained comparatively strong performance. Furthermore, a key source of Indonesia's economic growth was the sustained strength of domestic demand.

The higher economic growth also resulted in more job creation, thus bringing open unemployment down to 6.6% in 2011 from 7.1% in 2010. Added to this was improvement in the quality of the workforce with more workers employed in the formal sector and an increase in numbers of employed graduates. In keeping with this trend, the percentage of people living in poverty fell

from 13.33% in 2010 to 12.36% in 2011. Contributing to this decline was lower inflation, increases in minimum wage levels and improving farmer terms of trade.

The external performance of the Indonesian economy during 2011 remained solid in the face of global economic turmoil. Indonesia's balance of payments posted a respectable 2011 surplus of 11.9 billion US dollars. In terms of fundamentals, the balance of payments demonstrated the resilience of the economy, as reflected in the trade surplus and heavy inflows of foreign direct investment (FDI) in Indonesia. Amid the levelling trend in trade volume and decline in global commodity prices, Indonesia's exports maintained vibrant growth, and thus contributing to an increased trade surplus for non-oil and gas commodities. FDI transactions have steadily climbed with support from the increasingly conducive investment climate and secure level of macroeconomic stability in Indonesia. Portfolio investment transactions also booked a surplus for the year as a whole, despite some net outflows in the second half triggered by the global financial market turmoil. In response to these developments, international reserves mounted to 110.1 billion US dollars at the end of 2011, equivalent to 6.4 months of imports and servicing of official external debt. These ample reserves also provided a bulwark of exchange rate and financial system stability in curbing external shocks, including risks of foreign capital reversal.

The balance of payments surplus was a key factor driving appreciation of the rupiah during 2011. Averaged over the year, the rupiah strengthened 3.56% from Rp 9,080 to the US dollar in 2010 to Rp 8,786 to the US dollar. Gains were recorded mainly during the first six months of the year, in line with still conducive developments in the global economy and financial system. At home, gains in the rupiah were bolstered mainly by the strong condition of Indonesia's economic fundamentals and the high yields on rupiah-denominated assets that prompted foreign investors to invest their funds on the domestic financial market. This rupiah appreciation was consistent with currency movements in regional neighbours, thus ensuring that Indonesia maintained a competitive position.

Despite charging gains over the year as a whole, the rupiah came under downward pressure at the end of the year in relation to heightened uncertainties that flared over the debt crisis in Europe and problems in the US economy. In Q3/2011, the rupiah began to weaken while sustaining increased volatility. At year

end, the rupiah closed at Rp 9,068 to the US dollar, down 0.6% point-to-point from the end-2010 level of Rp 9,010 to the US dollar.

As regards price movements, Indonesia's macroeconomic resilience was strengthened further by the success in curbing inflation at a low level alongside buoyant economic growth. CPI inflation in 2011 reached 3.79% (yoy), representing a steep drop from the previous year (6.96%) and undershooting the 2011 inflation target set at 5%±1%. At this level, CPI inflation was at a low for the second time in the last ten years, after the first low in 2009 (2.78%), one year after the global financial crisis in 2008. Inflation was down across all regions of Indonesia, with the lowest levels recorded in the Java Region and the highest in Eastern Indonesia. This mild inflation is expected to accelerate the process of disinflation towards a level on par with inflation in Indonesia's trading partners.

The decline in CPI inflation was assisted by modest core inflation, a steep drop in food stuffs inflation and administered prices inflation that was kept to a minimum. Core inflation was stable at a mild 4.3%, a level supported by adequate capacity in the economy and appreciation in the rupiah. In a similar vein, food inflation came to a mere 3.37% as a result of secure levels of supply and steep price corrections following the soaring rise in prices during the preceding year. An added factor contributing to mild inflationary pressure was the minimum level of Government pricing decisions affecting strategic commodities, which kept inflation in administered prices at a low 2.78%.

Compared to regional neighbours such as Singapore, Malaysia, Thailand and the Philippines, where inflation is generally lower, Indonesia recorded the steepest drop in inflation during the year under review. During this time, inflation in Indonesia was on par with the inflation levels of those countries.

This success in achieving low inflation owes much to the various policies adopted by Bank Indonesia and the Government. Bank Indonesia successfully curbed inflationary pressure through a consistent setting of the BI Rate, appreciation in the exchange rate and a sound strategy for communicating monetary policy decisions. The exchange rate appreciation permitted by Bank Indonesia had an immediate effect in softening the impact of imported inflation from rising international commodity prices. The rupiah appreciation also had an indirect impact with a sharp rise in imports of capital

goods to expand the capacity of the economy, thus keeping the output gap in check.

On the Government side, policy focused on curbing inflationary pressure caused by tight supply and impediments to distribution, most importantly of food commodities and energy. The Government also ensured sufficient budget allocations for provision of subsidies in support of food resilience and stability of energy prices. These inflation control measures were implemented through close policy coordination between Bank Indonesia and the Government at the central and regional level in various forums, most importantly the Inflation Control Team (TPI) and Regional Inflation Control Teams (TPIDs).

Financial system performance in 2011 also reflected strong resilience amid the turmoil on global financial markets. This resilience was demonstrated, among others, by the solid performance of the banking industry and the performance of the financial market, which generated attractive and comparatively stable returns. This achievement owed much to macroeconomic stability, robust stock issuer fundamentals and the policy actions taken by Bank Indonesia and relevant authorities, all of which ultimately converged to boost investor confidence in Indonesia's financial sector.

The national banking industry was marked by upbeat developments during 2011. Banking intermediation operated according to plan. Credit growth reached 24.1%, while the loan to deposit ratio (LDR) climbed from 75.5% at the end of 2010 to 79.0% in December 2011. Credit growth also improved in quality with increased lending to productive sectors reflected in the 33.2% (yoy) growth in investment credit during 2011, ahead of growth in consumption credit at 24.1%.

The improvement in bank capital and consistent application of prudential banking principles proved effective in maintaining the soundness of the banking industry, thus bolstering the industry's capacity to absorb risk. Reflecting this condition was the low level of non-performing loans (NPLs) gross at only 2.2%, well below the 5% indicative threshold, while the capital adequacy ratio (CAR) was a healthy 16.1%. In addition, banks had ample supply of liquidity. Depositor funds recorded 19.0% growth in 2011, while the ratio of Liquid Instruments to Non-Core Deposits remained comfortably secure in the above 100% range at 133.4%.

In addition to resilience for absorbing risk, Indonesia's banking industry also charted significant increases in profits. Earnings ratios for Indonesia's banks were the highest for any of the ASEAN countries. In 2011, Return on Assets (ROA) for the banking industry reached 3.0%, ahead of the average for other countries in the region at only 1.14%.

Similar to the banking industry, Indonesia's overall financial market performance was marked by improvement. Amid the downturn on world stock markets, the stock market in Indonesia marked gains with the JCI mounting 3.2% alongside low volatility. The deteriorating crisis in Europe had considerable impact on the stock market in Indonesia, reflected in the drop in the JCI during September 2011 to 3,549 after reaching an all-time high in the history of the exchange at 4,193 in August 2011. Despite this, the stock market demonstrated considerable resilience with stronger and more rapid recovery in the index compared to countries in the region. The improved equilibrium and quality in the structure of sectors contributing to stock market growth helped to boost the resilience of the domestic stock market, with a notable contribution coming from the multifarious industry sector. Through this achievement, Indonesia became the best-performing stock market in the region.

On the bond market, government and corporate bonds were also positive in resilience and performance. During 2011, yield on government and corporate bonds came down by 87 bps and 15 bps. The government bonds market also demonstrated greater resilience to shocks triggered by various market sentiments, including the behind-the-curve sentiment at the beginning of 2011, the mounting risks of the European debt crisis and fiscal problems in the US. This was indicated not only by more modest increases in yield during September 2011 compared to the rise at the beginning of the year, but also the rapid recovery in the government bonds market after the worsening of the crises in the US and Europe. Besides the actions of the fiscal authority during 2011 in maintaining stability on the government bonds market through the buyback programme, a key factor keeping government bond prices relatively stable was Bank Indonesia's purchases of bonds on the secondary market to stabilize the exchange rate.

The national payment system demonstrated healthy performance during the reporting year. The role of the system in safeguarding financial system stability was indicated by the steep rise in transaction value

and absence of failure to settle non-cash transactions. During 2011, total transaction volume through the payment system in Indonesia climbed to 10.4 times Gross Domestic Product (GDP), up from the 2010 level of 9.0 times GDP. This points to a high degree of reliability in the payment system that is earning greater trust from the public. This will further promote the use of non-cash payments as a more efficient means of conducting transactions.

Regarding cash payments, the public again demonstrated a strong preference for use of cash as an instrument of payment. Reflecting this was the more rapid growth in currency in circulation compared to nominal growth in private consumption and the high average growth rate for currency in circulation. During 2011, private consumption growth reached 11.3% meanwhile currency in circulation expanded by an annual rate of 16.9%, ahead of the 12.1% growth of the previous year.

POLICY MIX

The positive achievements in Indonesia's economic performance during 2011 came as the fruit of hard work and cooperation among all policy stakeholders. From the perspective of the authorities involved, the policy measures pursued by Bank Indonesia and the Government for stronger economic growth while safeguarding macroeconomic stability were appropriate to the dynamics in the national economy during 2011. This cooperation also received active support from banks, the business community and the public at large.

In 2011, Bank Indonesia policy is essentially comprised of a strengthening of the policy mix implemented in the previous year. Interest rate policy, is aimed for the achievement of the prescribed inflation target of $5\% \pm 1\%$ in 2011 and $4.5\% \pm 1\%$ in 2012. The exchange rate policy sought to maintain flexibility in movement of the rupiah to ensure consistency with the future direction of macroeconomic developments, in particular achievement of the inflation target, while also ensuring stability in the short-term. The macroprudential policies themselves were reinforced with regulations for the management of domestic liquidity and foreign capital inflows with emphasis on short-term inflows. The monetary and macroprudential policy mix was also supported by a communications strategy to improve the effectiveness of monetary policy transmission and minimise uncertainty for market actors.

The application of the monetary and macroprudential policy mix was adjusted to the dynamics of economic challenges that unfolded during 2011. During the first half of 2011, the national economy was marked by mounting inflationary pressure due to the effect of rising international food commodity prices and disruptions in supply and distribution of food stuffs early in the year. At the same time, heavy inflows of foreign capital, while beneficial for financing the economy and deepening the financial market, also heightened the risk of capital reversal and especially outflows of short-term, speculative funds. In this regard, Bank Indonesia raised the BI Rate by 25 bps in February 2011 to 6.75% to counter the surge in inflationary pressure early in the year. On the exchange rate side, this interest rate policy response was strengthened by allowing greater room for appreciation in the rupiah to curb imported inflation spurred by rising international commodity prices.

Bank Indonesia also reinforced macroprudential policies adopted in the previous year in relation to the management of foreign capital flows. The objective of these policies was to promote a trend towards longer-term capital inflows for financing of the economy and deepening of the financial market while mitigating the possible effect of short-term capital inflows on the risk of capital reversal and financial market instability. The various macroprudential policies introduced during the year were: (i) extension of the minimum SBI holding period from 1 month to 6 months; (ii) restriction on short-term offshore borrowing by banks to a maximum of 30% of bank capital; and (iii) improvement in bank liquidity management through the increase in the statutory reserve requirement for foreign currencies to guard against drawing of foreign currency funds.

Entering the second half of 2011, the deterioration in global economic and financial conditions compounded the risks for Indonesia's economic performance. In addition to the risk of reduced growth in response to the slowing world economy, heightened perceptions of risk on global financial markets also prompted outflows of capital from emerging markets, including Indonesia. Faced with these drastic changes in global economic conditions, Bank Indonesia began shifting to an accommodative monetary policy stance. In October and November 2011, Bank Indonesia lowered the BI Rate by 25 bps and 50 bps to 6.0%. This decision was based on confidence of further decline in the future level of inflation. On the other hand, this policy was necessary to strengthen the basis for domestic demand as a countercyclical measure to anticipate the risk of global

economic slowdown. This accommodative monetary policy response was also bolstered by a downward adjustment in the lower limit of the monetary operations interest rate corridor for the overnight deposit facility at Bank Indonesia from 100 bps to 150 bps below the BI Rate, effective from September 2011.

To mitigate escalating financial market pressures particularly on the exchange rate as a result of capital reversal, Bank Indonesia implemented a policy for stabilisation of the rupiah, drawing on previously accumulated international reserves. This policy was implemented mainly through interventions to bolster supply on the forex market. At the same time, Bank Indonesia also purchased government bonds on the secondary market in bilateral transactions and auctions. While acting directly to counter the source of pressure on the rupiah from government bond selling by foreign investors, this policy was also taken to avert a liquidity crunch on the rupiah money market from the forex intervention by Bank Indonesia. In addition, the above mentioned policy was also in alignment with Bank Indonesia's efforts to bring government bonds into greater use as monetary instruments.

To strengthen management for prevention and resolution of crises, including that resulting from escalating risks and global uncertainties, Bank Indonesia also completed Crisis Management Protocols (CMPs), building on the standard procedures put into practice so far. In essence, the CMPs comprise a working mechanism and framework that sets out a systematic and nationally-integrated process for crisis prevention and resolution. These protocols specify the indicators of vulnerability that can set off a crisis, procedure for determining conditions of pressure, decision making mechanisms and relevant organisational procedures. In this regard, Bank Indonesia has focused more on CMPs related to an exchange rate crisis and banking crisis. At the same time, the Government has developed CMPs for a financial market crisis, fiscal crisis and non-bank financial institution crisis².

In further efforts to bolster the stability of the rupiah and deepen the forex market, it became necessary to achieve policy breakthroughs on a more structural level

² The Coordinating Forum for Financial System Stability, with the Minister of Finance, Governor of Bank Indonesia, Chairman of the FSA Board of Commissioners and Chairman of the Indonesian Deposit Insurance Corporation (LPS) as members, was set up for the purposes of the coordination protocol for safeguarding financial system stability under Act No. 21 of 2011 concerning the Financial Services Authority (FSA).

while remaining within the corridor of the free foreign exchange regime (Act No. 24 of 1999). This comprises a vital policy for bolstering the availability of forex supply on a more permanent basis. For this reason, Bank Indonesia issued a regulation at the end of September 2011 requiring foreign exchange on export earnings and foreign exchange from external borrowings to be received through domestic banks, effective from January 2012.

In the banking system, Bank Indonesia worked untiringly during 2011 to strengthen banking resilience, improve the supervision function and promote intermediation with focus on productive sectors. These new policies are grouped into the following four pillars. First is the policy for promoting the bank intermediation function to ensure more efficient and transparent operation and to improve access to financial services for low income earners. This includes a policy for transparency concerning the Base Lending Rate (BLS) and continuation of the financial inclusion programme.

Second is the policy for improvement of banking system resilience to ensure that banks remain strong and sound in the face of competition through more transparent management based on good corporate governance. This policy encompasses improvements in capital calculations that more appropriately reflect risk and requires banks to apply an anti-fraud strategy, prudence in outsourcing and risk management in provision of services to prime customers.

Third is the policy for strengthening the supervision function with the objective of improving effectiveness in bank supervision, mainly involving the quality of the early warning system. For this reason, improvements have been made in the relevant provisions concerning bank reporting to Bank Indonesia. Alongside this, Bank Indonesia has set deadlines for bank restructuring actions in a regulation on "Designation of Status and Follow Up of Supervision" aimed at improving effectiveness in resolution of bank problems.

Fourth is the strengthening of macroprudential policies. These policies seek to maintain financial system stability through actions with a time dimension (cycle) and intersectoral dimension (distribution of risk in the financial system). This policy includes increases in the foreign currency statutory reserve requirement and LDR statutory reserve requirement.

In the payment system, Bank Indonesia has launched a number of policies to ensure security and efficiency in operation. These policies have gained added importance in view of increasing transactions volume passing through the Bank Indonesia Real Time Gross Settlement (BI-RTGS) system, the Bank Indonesia Scripless Securities Settlement System (BI-SSSS), the Bank Indonesia National Clearing System (SKNBI) and other means of payment such as credit cards, ATM/debit cards and e-money. The various policies and system enhancements introduced by Bank Indonesia in 2011 include the following: (i) standardisation of chip-based ATM/debit cards; (ii) improvements of regulations on Card-Based Payment Instruments (CBPI); (iii) phases for Development of the Second Generation BI-RTGS System and BI-SSSS; (iv) development of the National Payment Gateway (NPG); and (v) improvements of services in management of government accounts.

In currency circulation, Bank Indonesia's strategy during 2011 focused on meeting public demand for cash by ensuring adequate supply, appropriate denominations, timely availability and condition fit for circulation. These policies are summed up in three policy designs as follows: (i) improvements in the quality of cash in circulation and provision of cash as needed to satisfy demand; (ii) efficiency improvements in cash operations at Bank Indonesia and in the banking system; and (iii) improvement in Bank Indonesia cash services to the public by including participation from the banking system and relevant government agencies.

On the Government side, various macroeconomic and sectoral policies were introduced to strengthen the support capacity of the national economy. At the macro level, prudent fiscal policy succeeded in ensuring the sustainability of Government financial operations while simultaneously promoting economic growth and macroeconomic stability through stimulus actions and increased subsidies. Fiscal performance improved in 2011 over the preceding year, with aggregates held at safe levels to support national development objectives. Reflecting this performance is the steady improvement in fiscal capacity with tax revenue outcomes relatively on target and Non-Tax Revenue outcomes surpassing the budget targets. Accompanying this was improved absorption of state expenditures reflected in part in a significant rise in capital expenditures. The prudently managed fiscal policy has contributed to higher economic growth with the Budget deficit at 1.2% of

GDP. Increased subsidy allocations also ensured support for food and energy resilience while averting high inflationary pressures by postponing increases in fuel prices during times of soaring world oil prices.

To control price movements, the Government coordinated actions with Bank Indonesia to keep control on prices of goods frequently impacted by disruptions in supply. Both parties gave reciprocal feedback on policies to stabilize volatile food and policies to minimize impact of administered prices. In this regard, Bank Indonesia and the Government worked steadily to optimise the role of the Inflation Control Team (TPI) and Regional Inflation Control Teams (TPIDs).

At the sectoral level, Government policies focused on structural reforms to improve capacity in the economy, with emphasis on investment and foreign trade. In addition, policy gave emphasis to priority business sectors, such as industry, agriculture and other sectors of strategic importance.

Regarding investment, government policy targets the provision of infrastructure, supra structures and improvements in the investment climate. These policies included improvement in legal certainty through regulatory reforms at the national and regional levels; streamlining of procedures through introduction of the Electronic Information Service and Investment Licensing System (SPIPISE) at one-stop service points in some cities; improvements in national logistics involving expansion of the National Logistics System to ensure distribution of goods as well as to trim the high costs burdening the economy.

In addition, the Government also adopted a Master Plan for the Acceleration and Expansion of Economic Development in Indonesia (MP3EI) in order to expedite the process of infrastructure construction (national connectivity). These projects are funded by the Government, SOEs and private sector under the Public Private Partnership scheme. The MP3EI projects include construction of thermal power plants, airport expansions, additions to the ferry fleet, seaport expansion, development of railway links and toll road projects.

Regarding foreign trade, effort to boost export focused on improvements in the competitiveness of non-oil and gas export products and market diversification. The

strategy put into place includes expansion of non-oil and gas exports involving products with greater added value, resource-based products and products with high market demand; export promotion for creative products and services, particularly those generated by SMEs; encouraging diversification of export markets; focusing on expansion of market access, promotion and facilitation of non-oil and gas exports to Africa and Asia; and measures to promote utilisation of various trading schemes and international trade cooperation for greater benefit to the national interest.

In the industry sector, the Government adopted a national industry policy by prioritizing a cluster of industry consisting of: agroindustry, transportation equipment manufacturing, electronics and telematics, manufacturing-based industry, specified creative support and creative industries and specified small and medium industries. To support this policy, a manufacturing sector development strategy was implemented through actions to improve competitiveness and policies for improvement of the business climate, machinery restructuring, development of dedicated industrial zones, use of domestic products, expansion of vegetable oils-based industry and development of industrial standards.

In line with the above mentioned policies, the Government launched a tax incentives programme in which the Government Pay Import Duties for specified industry sectors, as set out in Government Regulation No. 62 that became effective in 2008. To further promote the development of domestic manufacturing, the Government also offered tax holidays for pioneer industries³.

In the agriculture sector, the policy focused on strengthening national food resilience. This policy was implemented through a strategy for improving the productivity and quality of arable land, assistance in provision of seeds and fertilisers, post-harvest processing, funding for agriculture, development of food self-sufficient villages and action against food vulnerability as well as construction of irrigation systems. The strategy for increased food production was supported by improvements in coordination, monitoring and evaluation of food stocks and management of strategic food commodities.

3 MoF Regulation No. 130/PMK.011/2011 concerning provision of Corporate Income Tax exemptions and relief, effective from 15 August 2011.

The Government also launched a series of policies to improve the welfare of the people. Among the key challenges faced by Government in the Government Work Plan (RKP) for 2011 was job creation and poverty reduction. In this vein, the Government continued its policies to provide social assistance and protection for the poor. These policies include food subsidies through provision of rice for the poor (Raskin), Social Health Insurance (Jamkesmas), the Cash Transfer Programme (Program Keluarga Harapan (PKH)), School Operations Assistance (BOS), the National Community Empowerment Programme (PNPM) and other subsidies. These policies and programmes for community empowerment and social assistance for the poor helped to strengthen public purchasing power.

ECONOMIC OUTLOOK

The potential of the national economy underlies the optimism for continued strength of future economic prospects as well as economic stability. The solid condition of the domestic economy is expected to sustain high growth momentum amid the slowing condition of the global economy. Steady improvement forecasted in investment growth is predicted to drive economic growth at 6.3%-6.7% in 2012. Supporting the accelerated investment growth is a sustained, comfortable level of economic stability, improvement in the investment climate and investment ratings, vast market potential and relatively low interest rates. In addition to building economic capacity, growing investment will in turn sustain public purchasing power and thus enable household consumption to maintain robust expansion.

Improvement in the investment climate will also encourage higher inflows of FDI, and will thus bolster the balance of payments surplus for 2012. Even portfolio capital is predicted to keep pouring in due to attractive yields, modest perceptions of risk and high excess global liquidity. Meanwhile the current account is forecasted to chart a deficit due to high imports to keep pace with more robust domestic economic growth in contrast to the tapering trend in export growth related to declining performance in the global economy. Nevertheless, the size of the capital and financial account surplus will sustain an overall balance of payments surplus that will become a supporting factor in maintaining stability in the rupiah during 2012.

In 2012, inflation is predicted to hold within the targeted range. With global economic conditions in

slowdown, the downward trend in global commodity prices, adequate support from domestic production capacity and a stable exchange rate, CPI inflation in 2012 is forecasted within the 2012-2013 target of 4.5% \pm 1%. This forecast is supported by Bank Indonesia's implementation of prudent and consistent monetary policy in tandem with strengthened policy coordination with the Government to boost supply-side capacity for staple needs and to keep price movements under control. Even so, a number of risks that could spur future inflationary pressure call for vigilance, particularly in regard to the Government plan to announce a change in policy for subsidised fuels in 2012.

In 2012, financial system stability is predicted to hold firm due to macroeconomic stability and the strength of financial sector fundamentals in absorbing risks. The banking system has seen steady improvement in the intermediation function with brisk credit expansion alongside prudently managed credit risk. Although interest rates will decline, improvements in efficiency are expected to sustain bank profitability. Similarly, banks will maintain strong resilience, bolstered by conditions of ample liquidity and high levels of capital, enabling them to absorb risks that may arise from economic uncertainties at the global and domestic level. On the financial market, steady expansion is predicted in transaction volume, spurred by attractive returns. Stock and bond issues are predicted to climb in keeping with the growing need for financing of economic activity, which will support the process of financial market deepening in Indonesia. Although in the short-term, perceptions of risk will continue to be influenced by the resolution of the crisis in Europe, investor interest in financial assets in Indonesia will remain strong given the attractive level of returns, rating upgrade and brighter outlook for the economy. Furthermore, the strengthening of Crisis Management Protocols (CMPs) by Bank Indonesia and the Government will give investors added confidence in the domestic financial market and underpin the outlook for financial markets to sustain robust performance and maintain stability in the future.

In the medium-term, the outlook for the Indonesian economy is one of high, sustainable growth alongside prudently managed macroeconomic stability, achieved through ongoing structural improvements, steady expansion in economic capacity and productivity and also progressive recovery in global conditions. Indonesia's economy is forecasted to grow at 6.6%-

7.4% while inflation will ease further in line with the 4.0%±1% target for 2016. Support for this robust medium-term growth will come from improvements in productivity and economic capacity in keeping with higher levels of investment in physical assets and human resources. In regard to financing, these high levels of investment are correlated to the steady rise in FDI and high levels of private savings. At the same time, Indonesia's demographic strengths with a growing population of working age and rational consumption behaviour by the public will lead to an accumulation of private savings.

THE CHALLENGES AHEAD

Indonesia faces a number of external and domestic challenges that may influence optimism for the future outlook for the economy. In the absence of appropriate and measured policy responses, these challenges could hinder the prospect of achieving high economic growth and macroeconomic stability.

On the external side, the persistent weaknesses in global economic recovery pose downside risks. In particular, the complexity of the crisis in Europe could tip the region into even deeper recession and generate spillover effects impacting global economic performance. The close links between the sovereign debt crisis, precarious condition of the banking system and slowing economic activity could trigger an adverse feedback loop that would necessitate a long drawn out process for resolution of the crisis. Even the economic recovery in the United States is predicted to take time before conditions can return to the long-term trend. In the trade channel, the risks of deteriorating economic performance in advanced nations may dampen economic growth in emerging market nations, including Indonesia.

On the other hand, the mounting uncertainty over global economic performance may act through the financial channel to trigger increased volatility in foreign portfolio flow into emerging markets, including Indonesia. In contrast to the heavy capital flows that poured in one direction into Indonesia until Q2/2011, foreign portfolio investment in 2012 may be more modest and follow a trend of two-way capital flows. The tension of the competing influences of excess global liquidity and investor appetite for higher returns on one hand, and possibly heightened risk of deteriorating economies in advanced nations on the other, may lead to positive or negative reports that

influence the volatility of these capital flows. This will pose a policy challenge for authorities in emerging market nations in their attempts to safeguard macro and financial system stability, and Indonesia is no exception.

One of the risks faced in Indonesia concerns Government plans for prices of strategic commodities. In the 2012 State Budget, the Government plans to restrict the use of subsidised fuels for private four-wheeled vehicles in Java and Bali, in addition to raising electricity billing rates by an average of 10%. Another alternative being considered by the government is an increase in fuel prices. On one hand, this policy is necessary to curb the soaring budget for the fuel subsidy resulting from high oil prices, with result being the increase of budgets for capital expenditures and social welfare. On the other hand, this planned policy action may exacerbate the risk of mounting inflationary pressure. A clear signal in regard to the alternatives and timing of implementation of these government policies will influence economic growth and inflation during 2012.

Meanwhile on the subject of rupiah stabilization policy, the challenge Indonesia faces in stabilising the rupiah involves the considerable excess demand that is structurally built into the forex market. The excess demand for foreign currency has so far been met by foreign capital inflows in the form of portfolio investments. This combined with the relatively immature condition of the domestic forex market contributes to the susceptibility of the rupiah to volatility in the face of external shocks. The Bank Indonesia policy requiring export earnings and drawing on external debt to be received by domestic banks, effective from 2012, represents a fundamental shift for resolving this issue. What is needed are further measures for deepening of the forex market and banking capacity so that inflows of foreign currency from export earnings and drawing on external debt can be put to use in financing the economy.

Another challenge on the domestic front concerns optimum use of excess liquidity in the banking system for financing the economy. This excess liquidity has so far been held in monetary instruments and Government Bonds. Besides the effect of foreign capital inflows, the high excess liquidity has also resulted from accumulation of funds that banks have not succeeded in channelling to the real sector, due to internal conditions at banks and the absorption capacity of

the real sector itself. These conditions have resulted in large amount of banking industry assets that was not adequately matched by an increased contribution to the economy. The excess liquidity is a factor in the decoupling of the banking sector from the real sector, which has hampered the effectiveness of monetary policy implemented by Bank Indonesia.

Besides the comparatively limited banking role in financing economic activity, another challenge requiring a solution is the low level of banking efficiency. Bank Indonesia has worked tirelessly to build a banking system that is not only sound and robust, but also plays an efficient and effective role in financing the economy. The low level of banking industry efficiency is also a factor contributing to high loan interest rates. Low efficiency is indicated by the operating expense ratio (OER) at 85.4% (October 2011). By comparison, the OER for banks in ASEAN lies in the 40%-60% range.

The longer-term also poses several challenges that call for solutions to support a sustainable rate of economic growth. Among these is the need to anticipate possible disruptions to production and distribution, particularly of food commodities. A further challenge to be addressed involves improvement of competitiveness and the resilience of the economy to external shocks, thus enabling stability and macroeconomic performance to be maintained. No less important is the challenge of guiding the MP3EI programme so that it supports improvements in the productivity and efficiency of the economy and in turn boosts competitiveness and economic resilience.

BANK INDONESIA POLICY DIRECTION

To support the achievement of the macroeconomic outlook in the face of the external and domestic challenges described above, the Bank Indonesia policy direction for 2012 will focus on the following 5 (five) key areas.

First is optimizing the monetary policy role in inflation control and promoting economic capacity while mitigating risks from the global economic slowdown. In this regard, monetary policy will be directed towards maintaining macroeconomic stability and financial system stability while delivering a stimulus to the economy. The interest rate response will be consistently aimed for achievement of the CPI inflation target at $4.5\% \pm 1\%$ in 2012 and 2013. While prioritising achievement of the inflation target, the interest rate

response is also intended to provide a stimulus to the domestic economy aimed at mitigating the risk of global economic slowdown. The interest rate policy will be complemented by macroeconomic policies for the management of economic liquidity and for control of bank lending, particularly for certain consumptive sectors that tend to undergo excessive growth and create vulnerability.

Regarding the exchange rate, Bank Indonesia policy seeks to maintain the stability of the rupiah exchange rate and provide business certainty for all economic actors. The achievement of exchange rate stability will take into account internal and external equilibrium in the economy. Commencing in January 2012, the exchange rate stabilisation policy will also be supported by implementation of the policy to require export earnings and drawing on external borrowings to be received by domestic banks. Bank Indonesia is also conducting a review of existing regulatory provisions in order to enrich hedging instrument in the forex market.

Second is improving banking efficiency to optimize its contribution to the economy while taking further measures to build the resilience of the banking system. To improve banking efficiency and competitiveness, the Base Lending Rate (BLS) policy will be retained. This is to ensure healthy operation of market mechanisms so that policy objectives can be achieved. Following up on the bank supervision side, tighter enforcement will be introduced for the regulatory provisions requiring Bank Business Plans to specify targets for efficiency improvements and reductions in loan interest rates to reasonable levels. The policy for higher levels of bank capital will be maintained to support the strengthening of banking system resilience. This is essential to support future economic growth and anticipate changes in the business cycle.

Bank Indonesia perceived that customer protection and bank governance are two key areas in need of attention. Several cases of banking fraud that seized attention during 2011 call for a revision of policies related to these two areas. Therefore in 2012, Bank Indonesia will further introduce policies to improve protection for both bank's customers and prospective customers. Furthermore, to improve the quality of bank governance, Bank Indonesia will improve the provisions governing transparency of financial statements, particularly in relation to published financial statements, and regulation governing public accountants engaged by banks. Bank Indonesia will

also review the policy on banking system ownership as well as multi-licensing policy in view of the growing complexity of the banking business.

Third is improving the efficiency, reliability and security of the payment system both at the national level and in the payment system linkages with other countries. This involves a number of measures, including the following: (i) improvement in the security and reliability of payment service operations through introduction of risk mitigation including the use of technological advances, strengthening legal framework, more robust supervision and an expanded role for the national payment service industry; (ii) improved efficiency of the national payment system services, including efforts to promote interoperability and interconnectivity among the various payment service providers; and (iii) strengthening of consumer protection through improved transparency by payment service operators and more robust regulation on consumer protection.

Fourth is to bolster macro resilience by reinforcing coordination in the management of crisis prevention and resolution (CMP) and taking further measures to improve policy coordination with relevant agencies for control of macroeconomic stability and financial system and payment system stability. Policy coordination with the Government in regard to inflation control will be strengthened further to minimise the inflationary impact of increases in prices for volatile foods and administered prices. This coordination is essential to ensure a common alignment in policy actions taken. To support achievement of the established inflation target, coordination will be strengthened between the monetary authority and the government through the Inflation Control Team (TPI) at the central government and regional levels.

Fifth is to support empowerment of the real sector, including further efforts for financial inclusion. This is

specifically intended for low-cost banking services for rural communities, including quality improvements of the “My Saving Programme” (Program Tabungku), development of financial education, launching of the Financial Identity Number and literacy surveys. To empower the real sector, Bank Indonesia will cooperate with various government agencies in facilitating intermediation to support financing in a number of sectors offering economic potential. In regard to financing of sectors that in commercial terms are unbankable, but have a strategic role in the economy, Bank Indonesia will join forces with the government to develop a range of financing schemes. In addition, Bank Indonesia will engage in the development of sharia-compliant banking products and activities. The strategy for future development of sharia rural banks will be aligned to the characteristics of these institutions as sound, strong and productive community banks. The development will also focus on the provision of financial services to MSMEs and local communities in the regions.

Bank Indonesia is aware that the complexity of challenges and effective implementation of these various policies to support the national economy will demand close coordination with Government, the banking system, business and the general public. For this purpose, policy coordination that has operated well will be further strengthened to safeguard macroeconomic and financial system stability, inflation control, financial market deepening and promotion of activity in the real sector. Coordination with the Government and relevant authorities will be reinforced at both the central government and regional levels. In this regard, Bank Indonesia will pursue further measures to optimise the functions of Bank Indonesia Regional Offices to support of inflation control and to promote development in the regions through close linkages with Regional Governments.

BOX 1 | ACCOUNTABILITY FOR ACHIEVEMENT OF THE 2011 INFLATION TARGET

In 2011, inflation was reduced to 3.79%, well below the 2010 inflation recorded at 6.96%. This figure is much lower compared to the 5%±1% inflation target, and is thus expected to help accelerate disinflation process in the longer term making Indonesia's inflation on a par with inflation in other Asian countries. The low inflation was achieved against the background of a 6.5% economic growth in 2011 (increasing from the 6.1% level reached in 2010).

This decline in inflation was supported by subdued core inflation, a steep drop in food inflation and administered prices inflation which is maintained at minimum level. Core inflation remained stable at 4.34%,¹ below the historical average of 6.5%². Meanwhile, food inflation was also quite low at a mere 3.37%, far below the 8.0% historical average³. The minimum amount of Government policy decisions affecting strategic commodity prices helped keep administered prices inflation at a low 2.78%.

The achievement of low inflation owes much to the various policies introduced by both Bank Indonesia and the Government. These policies were implemented in a proactive and coordinated manner at the central government and regional level to address the dynamics of issues stoking inflationary pressure. In early 2011, inflationary pressure mounted in response to price increases in domestic food stuffs caused by disruptions in supply and distribution, weather conditions, as well as high inflation expectations. These conditions were exacerbated by adverse global factors, among others high world oil prices and global commodity prices. At the same time, heavy capital inflows into the domestic financial market further added to the

1 After excluding the influence of gold jewellery prices, core inflation in fact dropped from 4.05% in 2010 to 3.84% in 2011. It should be noted that domestic gold prices were influenced more by world gold prices that soared during the period under review.

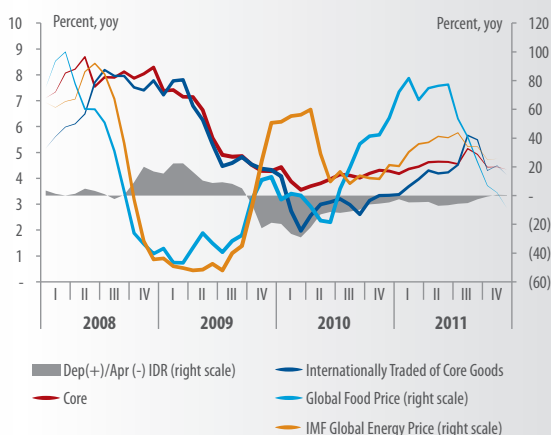
2 Average for 2001-2011 after excluding the effect of fuel price hikes.

3 Ibid.

existing banking liquidity excess which in turn can potentially exacerbate inflationary pressure.

Faced with these challenges, Bank Indonesia reinforced the monetary and macroprudential policy mix with focus on easing inflationary pressures toward the established inflation target by managing inflation expectations, capital inflows and excess domestic liquidity. Faced with high inflationary pressure, as reflected in a 7% inflation expectations in Q1/2011, Bank Indonesia raised the BI Rate by 25 bps to 6.75% and held the rate at this level until August 2011. To strengthen measures to bring down inflation, Bank Indonesia also allowed even greater room for rupiah appreciation during heavy capital inflows and appreciation trend in other Asian currencies. This policy proved effective in mitigating the impact of imported inflation from high global commodity prices, as reflected in the steady level of core inflation (Chart 1). The appreciation in the rupiah also boosted imports, mainly for expanding production, investment and supply of food stuffs, which helped curb inflationary pressures arising from disruptions to supply and distribution of goods and services.

In addition, Bank Indonesia also reinforced policies introduced in 2010 for foreign capital inflows management. This policy is intended to prevent heavy inflows of foreign capital, particularly short-



Source: BPS - Statistics Indonesia

Chart 1. Exchange Rate and Core Inflation

term speculative capital, from generating excessive appreciation in the exchange rate, excess domestic liquidity and increased risk of instability on the financial market. To do this, in January 2011 Bank Indonesia imposed a restriction on the daily bank short-term external borrowing position to a maximum of 30% of bank capital, followed by an increase in the foreign currency statutory reserve requirement from the previous 1% to 5% in March 2011 and then to 8% in June 2011. Bank Indonesia then also extended the holding period for SBIs from one month to six month in May 2011. In terms of liquidity control, besides increasing rupiah statutory reserve requirement to 8% in 2010, Bank Indonesia also reinforced monetary operations through extension of monetary instrument maturity profile and limitation of SBIs offerings in the primary market. The policy mix consisting of interest rate, exchange rate and macroprudential policies adopted by Bank Indonesia to manage capital inflows and liquidity have succeeded in reducing inflation pressure, as indicated by the steep drop in inflation expectations to about 5% at the end of 2011 from nearly 7% at the beginning of 2011 (Chart 2).

During Q3/2011, the deterioration in European coupled with weakening global economic recovery brought changes to the dynamics of the Indonesian economy. In the financial market, capital reversal not only caused prices for stocks and bonds to fall, but also resulted in depreciation pressure on the exchange rate which in the absence of stabilisation measures can fuel inflationary pressure and instability in the financial system. At the same

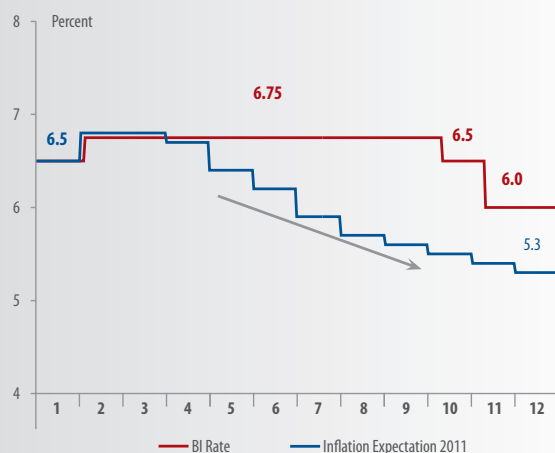


Chart 2. Inflation Expectation and BI Rate

time, the slump in world economic growth could potentially bear down on Indonesia's economic growth in 2012. In response, Bank Indonesia has shifted to an accommodative bias monetary policy. This policy is based on the confidence that inflationary pressure has eased and will remain in line with the target, Meanwhile reasons to pursue a countercyclical policy to mitigate the impact of the global economic downturn on national economic growth becomes more eminent (Diagram 1).

With the above mentioned considerations, Bank Indonesia decided in October and November 2011 to lower the BI Rate by 25 bps and 50 bps respectively to 6%. To signal a more accommodative monetary policy, the lower limit of the monetary operations corridor (deposit facility) was adjusted downwards in September 2011 from the previous 100 bps to 150 bps below the BI Rate. Meanwhile to prevent depreciation pressure on the rupiah from stoking inflationary pressure and instability in the financial system, Bank Indonesia continued to stabilize of the exchange rate through intervention in the forex market, by using international reserves accumulated in the previous period. This policy was accompanied by purchases of government bonds on the secondary market to ease exchange rate pressure from foreign investors selling off government bonds, supporting liquidity management on the rupiah money market and expand the use of government bonds as a monetary instrument. Furthermore, in a measure to strengthen foreign exchange supply, Bank Indonesia introduced a policy requiring foreign exchange earnings from exports and foreign exchange from drawing on external borrowings to be received through domestic banks

Meanwhile, Government policy also put emphasize on curbing inflationary pressure from supply limitation and distribution impediments, most importantly of food stuffs and energy. Various policies were implemented in support of domestic supply, including provision of subsidies for seeds and fertilisers, national reserve budget for seeds, direct aid through provision of superior seeds and improvements in distribution and market structures. However, these measures were insufficient to meet domestic demand, and therefore the Government responded by importing rice and seasonings

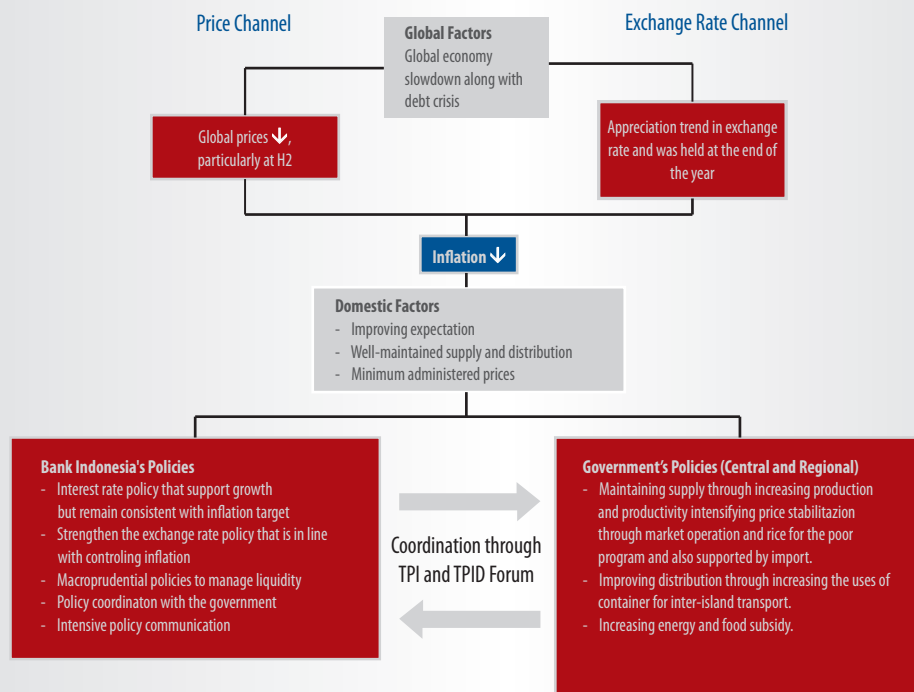


Diagram 1. The Affecting Factors of Inflation in 2011

when their prices soared in early 2011. Price stabilisation also involved market operations in some regions with a total volume of 400,305 tons during 2011, up sharply from the previous year, in which market operations totalled only 46,047 tons. Intensive Regional Government activity in ensuring unimpeded supply and distribution of food stuffs to the public was also supported by distribution of rice to the poor on 13 occasions during 2011. Through these actions, volatile foods inflation came down sharply from 17.74% in 2010 to 3.37% in 2011. The government's success in resolving problems in supply and distribution was also reflected in inflation during the period of the religious festivities, which was much lower than in previous years (Chart 3).

Besides the actions described above, the Government also ensured sufficient budget allocations for provision of subsidies in support of food resilience and stability of energy prices during the year under review. Budgeted subsidies for energy commodities were raised from Rp 139.9 trillion (2010) to Rp 255.6 trillion (2011), due to the decision to delay the hike in subsidised fuel prices and restriction on use of subsidised fuels originally slated for 2011. Accordingly, inflation in

administered prices was held at a low 2.78% that year.

The success in curbing inflation at a low level in 2011 is also attributable to the close policy coordination between Bank Indonesia and the Government at the central and regional levels. In practice, the coordination has taken place in various forums, most importantly the Inflation Control Team (TPI) and the Regional Inflation Control Teams (TPIDs). Regional Governments have extended more tangible and robust support for maintaining price stability at the regional level, reflected in part by expansion in TPIDs from 38 in 2010 to a total of 65 at the end of 2011. To provide a bridge between the TPI and TPID roles, the Pokjanas TPID (National Working Group), whose members are Bank Indonesia, the Coordinating Ministry for the Economy and the Ministry of Home Affairs, was established in July 2011 in a follow up to the TPI and TPID National Working Meeting opened by the Vice-President in February 2011. The function of Pokjanas is to improve the effectiveness of inflation control measures in the regions through stronger coordination between Central Government and Regional levels in addressing risks of future inflationary pressure, in particular those fuelled

by energy and food commodities. The agenda for the future includes institutional strengthening for the TPI and TPIDs at the regional and interregional level and between the interregional levels and the central government, nationwide development of a strategic commodity price information system and various activities pertaining to strengthening of food resilience.

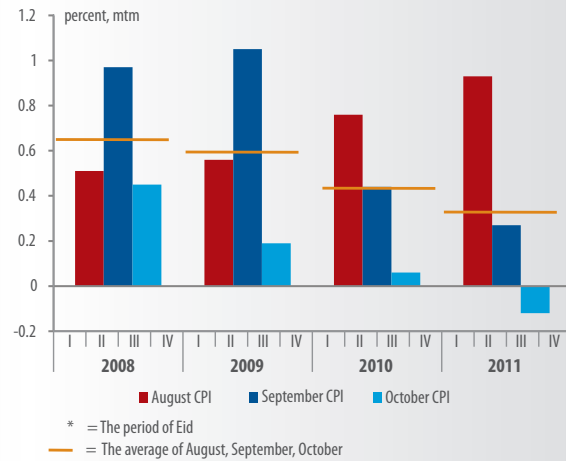


Chart 3. CPI Inflation in Religious Holiday Period