



2010 ECONOMIC REPORT ON INDONESIA

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Vision

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

Mission

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

Values

Competence, Accountability, Integrity, Cohesiveness, Transparency.

“...The year 2011 will be a promising year given that the economy has a big opportunity to grow faster... Nevertheless, the year 2011 will also be more challenging for the formulation of macroeconomic policy...”

(Darmin Nasution, Governor of Bank Indonesia, 2011)

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Reporting Period, and Source of Data

Reporting Period is January 1st 2010 to December 31st 2010

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

BOARD OF GOVERNORS OF BANK INDONESIA



DARMIN NASUTION
Governor
(Since September 2010)



HARTADI A. SARWONO
Deputy Governor



MULIAMAN D. HADAD
Deputy Governor



SITI Ch. FADRIJAH
Deputy Governor
(up to May 2010)



S. BUDI ROCHADI
Deputy Governor



BUDI MULYA
Deputy Governor



ARDHAYADI M.
Deputy Governor



HALIM ALAMSYAH
Deputy Governor
(Since June 2010)



DARMIN NASUTION
Governor of Bank Indonesia

FOREWORD

Two years after the global financial crisis of 2008, the Indonesian economy managed a gradual but solid transformation from recovery to more robust and balanced growth. Initial results from this transformation process became visible in the various achievements in 2010. The economy grew by 6.1%, much higher than the growth in the preceding year, accompanied by expansion in investment and exports. The balance of payments booked a large surplus resulting in substantial accumulation of international reserves. Amid a more dynamic of global financial markets in the aftermath of the crisis, domestic macroeconomic and financial stability remained in check.

These achievements, however, did not come without challenges. Since the beginning of 2010, Indonesian economy was also facing global risks. In pulling out of the depths of crisis, the global economy has been driven by advanced economies and emerging market economies, but with difference in the level of growth, nature of challenges, and policy responses. These differences prompted a shift in allocation of capital in which emerging markets, including Indonesia, found themselves swamped with portfolio capital inflows from advanced economies.

The problem is nature of capital flows that tend to be procyclical. When an economy grows rapidly, portfolio capital rushes in, causing imbalance into the economy. Equilibrium in the current account may be endangered due to currency appreciation, while liquidity can accumulate beyond the absorption capacity of the economy. On the other hand, when economic growth slows down imbalance is looming, there will be a large portfolio capital reversal that creates risks for financial stability, and may lead to crisis in the absence of appropriate and adequate response.

Entering the second half of 2010, the challenge of controlling inflation emerged. Anomalous climatic conditions led to a disruption in the supply of food staple which was accompanied by soaring global commodity prices, resulting in a volatile food prices inflation. On the other hand, core inflation remained subdued, bolstered by rupiah appreciation and adequate level of production capacity as investment continued to expand. The sizeable contribution of food inflation during the second half of 2010 pushed CPI inflation for the year to 6.96%, beyond the 5%±1% target.

The challenges for controlling inflation became more complicated due to the surge in capital inflows, high excess liquidity and low efficiency of the banking system. Therefore, relying merely on one policy instrument will be an inadequate response. This situation called for a policy mix as an optimal solution and at the same time maintained internal balance of the economy through price stabilisation and management of domestic demand, and external balance of the economy through exchange rate stabilisation and management of capital flows.

Given the sources of the problems and policy complications faced, during 2010 Bank Indonesia pursued a policy mix during 2010. The policy mix included holding policy rate (BI Rate) at 6.50%, providing room for measured exchange rate flexibility, and implementing macroprudential policy for managing excess liquidity and capital flows. Bank Indonesia also pursued a number of measures to improve the resilience and efficiency of the banking system in such a way that it can play a more optimally role in supporting sustainable economic growth. Meanwhile, the enhancement of payment system policy continued to be pursued in order to improve the efficiency

of payment system and to support for the strengthening of monetary and banking policies.

The year 2011 will be a very promising year in line with various big opportunities for the economy to grow more rapidly. The global economy is predicted to show further improvement, fuelled mainly by vigorous growth in emerging markets. Meanwhile, macroeconomic stability achieved in 2010 and a range of policies for strengthening macroeconomic and financial sector resilience can become a strong foundation for preventing various external shocks. There are more opportunities for pursuing higher growth as Indonesia is only one step away from achieving investment grade. Bank Indonesia predicted that economic growth in 2011 will be in the range of 6.0%-6.5%. The increase in the contribution of investment to growth since mid-2010 combined with the sustained growth and broader diversification of Indonesia's exports will boost a more balanced structure of economic growth.

The investment growth will also be bolstered by foreign direct investment (FDI) that will make up a larger share of capital inflows. Overall, the balance of payments is predicted to remain recording a surplus accompanied by steady growth in international reserves.

Regarding prices, Bank Indonesia with the support of the Government will target the inflation inside the range of 5%±1% for 2011 and 4.5%±1% for 2012. This will be achieved through strengthening the policy mix put into place during 2010, including policies to anchor inflation expectations as well as coordination with the Government in bolstering supply-side capacity alongside actions to anticipate disruptions in supply and distribution of staple.

Infrastructure development by the Government, among other, is aimed at bolstering national food stock resilience and improving inter-regional linkage is expected to boost foodstuff production and ensure more rapid, efficient distribution of food. In this case, Bank Indonesia and the Government will take further measures to optimise the role of the central and regional Inflation Control Teams (TPI and TPIDs).

Even so, year 2011 will be more challenging in formulation of macroeconomic policy responses. The ongoing global economic imbalances and the possibility of a reversal in monetary policy stance in advanced economies may influence the dynamics of global financial markets. Meanwhile, commodity prices are at risk of climbing further due to the uncertain nature of climate change.

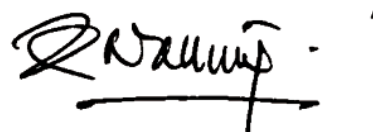
Under uncertain external condition, the dynamics of Indonesian economy in 2011 will depend on successes of various stakeholders in strengthening economic and financial system resilience while ensuring sustainable

economic growth. The most valuable lesson from crisis after crisis in the past is that amid heightened uncertainty, we have to identify problems and take decisions quickly. Delayed responses to external shocks, such as escalating commodity prices and global imbalances, often made us missing the momentum that in turn result in a costly borne by the economy. This lesson became more important given that there is always a possibility of an external shock to reappear in any form.

This concludes our brief overview of the Indonesian economy in 2010 and the outlook for 2011, as described in detail in this edition of the Indonesian Economic Report. I hope that this report can be used as a reference that benefits all of us.

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 Indonesian Economic Report. May God Almighty ever bestow upon us His abundant blessing and protection in each and every step we take.

Darmin Nasution

A handwritten signature in black ink, appearing to read 'Darmin Nasution', with a horizontal line drawn underneath it.

Governor of Bank Indonesia



Executive Summary

Strengthening National Economy Amid A Multi-Speed Global Economic Recovery

Domestic economic performance improved during 2010 amid a multi speed global economic recovery. This was reflected by robust GDP growth, a large balance of payments surplus and improved financial sector performance. Underpinned by such strong fundamentals and positive perceptions concerning the Indonesian economy, the rupiah exchange rate strengthened with low volatility. In terms of prices, up to the middle of 2010 inflation was well controlled. However, the intensity of supply-side disruptions during the second half of the reporting year, in particular food items, heightened inflationary pressures that pushed inflation above its target.

Despite improved economic performance, the domestic economy remained facing a number of key challenges that consists of massive foreign capital inflows, excess liquidity in banking system, rising inflation as well as several problems in the banking sector and impediments in the real sector. These challenges left Bank Indonesia facing a trilemma, namely maintaining price stability, exchange rate stability and financial system stability. Therefore, relying on merely one policy instrument was insufficient, and a policy mix was required. In 2010 Bank Indonesia instituted a policy mix to ensure internal and external stability. The mix of instruments used for internal stability aimed at stabilising prices and managing domestic demand, while external

stability aimed at the management of foreign capital inflows and exchange rate stability. Referring to interest rate policy, in 2010 Bank Indonesia held its BI Rate at a level of 6.5%. Meanwhile, in addition to the interest rate policy, in the middle of 2010 Bank Indonesia issued macroprudential policy for managing domestic liquidity and the surge in foreign capital inflows. This policy mix was further supported by other policies to maintain financial system stability as well as government policies.

Looking ahead, Indonesian economic performance is predicted to continue improving. In 2011, economic growth is expected to increase, the balance of payments surplus will remain large, the bank intermediation function will improve and inflation will remain within its target corridor. In the medium term, the domestic economy is projected to continue expanding and accompanied by further decrease in inflation. Bank Indonesia will remain directing its policies towards macroeconomic and financial system stability to support sustainable economic growth. Monetary policy will continue aiming to achieve the inflation target, while banking policy is directed to enhance bank resilience in order to boost bank performance and competitiveness as well as to withstand crisis shocks. Payment system policy is directed to create a more efficient, reliable, simple and secure payment system.

Indonesian Economic Performance in 2010

Domestic economic performance in 2010 further improved amid a more favorable global economic condition. Indonesian economy in 2010 expanded by 6.1%, which exceeded growth posted in 2009 at 4.6%. Greater economic expansion stemmed from more balanced sources of growth, as reflected by an increasing role of investment and exports. Increased investment activity in 2010 was evidenced by more investment to build economic capacity. Meanwhile, increased export performance was followed by more diversified products and destination countries, as reflected by improved performance in the tradeables sector, particularly manufacturing industry. Overall, Indonesian economic performance is described in more detail in Chapter 1, while the role of exports and investment is presented in detail in Chapter 5.

Domestic economic performance in 2010 cannot be separated from the dynamics of the global economy. The multi-speed global economic recovery has a number of implications for emerging market economies, including Indonesia. The slow economic recovery in advanced countries has encouraged loose monetary policy in the affected countries. Meanwhile, solid economic growth, coupled with mounting inflationary pressures, in emerging market countries has them to raise their respective policy rates and tightening their policy stance. A deluge of foreign capital then flowed into emerging market countries, and partly contributed to the rise in global commodity prices. In more detail, the dynamics of global economy are described in Chapter 2.

The Indonesian balance of payments (BOP) recorded a large surplus in 2010, reaching USD 30.3 billion, buttressed

by a large surplus in the current account as well as the capital and financial account. The current account surplus was shored up by solid export growth despite being outpaced by growth in imports and income transfer payments. Meanwhile, the large capital and financial account surplus was accompanied by an improved structure of capital flows. This was shown by a bigger role played by foreign capital inflows in the form of foreign direct investment (FDI), driven by external factors, such as excess global liquidity, and domestic factors, such as a propitious economic outlook. Accordingly, the position of foreign exchange reserves at the end of 2010 reached USD 96.2 billion, sufficient for import needs and external obligations, as well as providing assurance for exchange rate stability.

The improved balance of payments in 2010 led to rupiah appreciation with low volatility. In average, during the reporting year, the rupiah reached Rp9,081 per USD, appreciated by 3.8% with lower volatility compared to rupiah exchange rate at the end of 2009. In addition to fundamental factors, rupiah performance was further propped up by a positive perception regarding Indonesia's economy, as signalled by the upgraded rating of government bonds and the risk index. Compared to the exchange rates of neighboring countries, rupiah appreciation during 2010 was moderate, thereby avoiding significant disruptions to export performance. Exchange rate performance was inextricably linked to policies implemented to manage foreign capital inflows and strengthen domestic economic resilience in the face of a short-term capital reversal.

Consumer price index (CPI) inflation in 2010 reached 6.96%, exceeding target corridor 5%±1%. Up until mid-

2010, price stability was well under controlled, reflected by relatively low inflation, that is 5.05% (yoy). However, entering the third quarter of 2010, the intensity of supply-side disruptions, specifically foodstuff, escalated sharply due to weather anomalies. Consequently, global food commodity prices spiked, and at the same time food prices in domestic markets were also soaring. Staple goods such as rice and various spices contributed to the large jump in prices, and thus the inflation of volatile food prices skyrocketed to 17.74%, far exceeding that of recorded in 2009 which was just 3.95%. Nevertheless, in the mid of skyrocketing inflation for volatile food prices, core inflation was maintained at a relatively low level, that is 4.28%, supported by the strengthening of the rupiah exchange rate, maintained inflation expectations and sufficient economic capacity to meet demand in 2010. The inflation of administered prices was also moderate at 5.40%.

Meanwhile, financial sector performance improved and the stability of the financial system was preserved. The banking industry was increasingly more robust, as demonstrated by the high Capital Adequacy Ratio and low level of non-performing loans. Furthermore, bank intermediation also improved, as indicated by 22.8% credit growth. On the stock market, a rising IDX Composite index was accompanied by the improvement in issuers' fundamentals as well as a more favorable market structure. Consequently, the IDX Composite recorded the highest increase of all indices in the region. On the bonds market, the yield of government bonds (SUN) declined since the beginning of the year, among others, can be attributed to fiscal sustainability. The stock market and bonds market were further buoyed up by lower investment risks and relatively attractive yield, hence, attracting foreign capital inflows to these instruments. On the money market, liquidity remained abundant and market rates tended to move towards the middle-low side of the corridor. This indicates excess liquidity in the banking system and the inclination of banks to place their excess liquidity in short-term instruments.

Main Policy Challenges

The accomplishment of positive economic performance in Indonesia throughout 2010 was confronted with a number of arduous challenges that required an appropriate policy response in order to ensure robust and sustainable economic growth. The most binding constraints are elaborated in more detail in Chapter

3. One of the main challenges faced by the economy during the reporting period was the inundation of foreign capital inflows. In principle, foreign capital inflows are required as a source of economic financing. However, a dominance of short-term capital inflows has a potential to trigger macroeconomic instability and complicate monetary policy. An influx of foreign capital flows can spur sharp exchange rate appreciation and potentially overshoot its fundamental level. Consequently, exchange rate appreciation, other than vulnerable to the risk of a correction, can undermine the competitiveness of exports. Moreover, short-term foreign capital inflows are also vulnerable to negative sentiment that can spark a large and sudden capital reversal.

During the reporting year, the economy also faced the challenge of mounting inflationary pressures. In order to control inflation in the midst of relentless capital inflows and excess liquidity, the policy measures introduced to anchor inflation expectations require complementary policies directed towards managing foreign capital inflows and excess liquidity. Moreover, structural policy as well as coordination between Bank Indonesia and the Government requires further strengthening to improve the ability of the supply side in responding to stronger demand, thus avoiding economic overheating.

Another challenge faced is the magnitude of excess liquidity in the banking system. Excess liquidity in the banking system can endanger macroeconomic stability, and need to be managed optimally. Accordingly, the central bank must apply a number of instruments to manage liquidity, temporarily and permanently. In addition, policy coordination with the Government is essential to manage excess liquidity originating from financial operations of the Government, considering that the sources of financing for the state budget stemming from the receipt of foreign exchange will add liquidity to the economy. Policy coordination is required in the form of additional instruments that can exploit excess liquidity to finance investment in the real sector.

The challenges faced in the banking sector include the relatively limited role played by banks in economic growth despite excess bank liquidity. Compared to other countries in the region, the role of banks in financing economic activity in Indonesia is relatively limited due to comparatively high lending rates and limited access to banking services by the general public, particularly low-income population. Meanwhile, competitiveness of domestic banks in terms of efficiency, capital and assets

remains low compared to banks in neighboring countries. Looking ahead, the challenge that requires an urgent solution is how to improve domestic bank competitiveness such that it becomes at par with the competitiveness of banks in other countries in the region, particularly in preparation for the inauguration of the ASEAN Economic Community (MEA). In addition, given the important role of financial markets in financing the economy, efforts to strengthen domestic financial system such that it becomes more resilient to various shocks are required.

The main challenge faced in the real sector is how to overcome the constraints to expanding economic capacity. In addition to limited capital accumulation and productivity, the limited acceleration in the expansion of economic capacity is mainly due to the existing binding economic constraints. The five most binding constraints are relatively weak research and development (R&D), poor education and health, limited technological proficiency, and insufficient infrastructure and energy availability.

Policy Response of Bank Indonesia and the Government

The aforementioned challenges amplified complexity in the implementation of policies by Bank Indonesia as well as by the Government. Considering the complexities faced, against a backdrop of abundant of foreign capital inflows, Bank Indonesia sought an optimal solution to the trilemma faced, namely maintaining price stability, exchange rate stability and financial system stability. The characteristics of emerging market countries make the role of exchange rate stability, together with price stability, crucial in the pursuit of economic stability as a whole. Similarly, experience from the global crisis in 2008 demonstrated that monetary stability does not guarantee financial system stability. Monetary stability that is not coupled with financial system stability can trigger instability in the economy. A more detailed review of policy complexity is presented in Chapter 3.

Considering the complexity of issues faced, relying on merely one instrument is clearly inadequate, and hence a policy mix that uses several instruments is required to achieve internal and external stability. The policy mix for internal stability comprises of instruments to stabilise prices and manage domestic demand, while policy mix for external stability comprises of instruments to manage foreign capital inflows and stabilise the exchange rate. This policy mix needs to be supported by banking policies and a number of government policies, both fiscal and riil

sectors. Furthermore, structural policy is also required to ensure the economy can grow faster while maintaining macroeconomic stability through greater economic capacity, productivity and competitiveness. Various policies instituted by Bank Indonesia and the Government in 2010 are described in Chapter 1, while the policy mix implemented by Bank Indonesia is elaborated in detail in Chapter 4.

In response to the economic dynamics and challenges faced, Bank Indonesia and the Government introduced a number of policy measures in 2010 to garner the momentum of economic recovery. Bank Indonesia consistently directed monetary policy towards efforts to achieve the inflation target. The policy rate (BI Rate) was consistently held to successfully accomplish the inflation target while remaining favorable for financial system and macroeconomic stability. Accordingly, during 2010 Bank Indonesia maintained BI Rate at 6.5%. To buttress monetary and financial system stability, in addition to its policy rate, in mid 2010 Bank Indonesia also introduced macroprudential policy under a framework of managing domestic liquidity and responding to the surge in foreign capital inflows. This particular policy mix was applied due to the prevalence of persistent excess liquidity in banking system, massive foreign capital inflows and escalating inflationary pressures.

Bank Indonesia directed its banking policy to strengthening national banking system and fostering bank intermediation to support economic growth. Banking policy instituted by Bank Indonesia in 2010 was incentive and disincentive based. The enhancement of banking system resilience is conducted through strengthening banks' capital structure, enhancing the competence of bank management, improving the bank supervision system and financial market deepening. In addition, Bank Indonesia made a number of amendments to existing regulations related to the certification of risk management for commercial banks, the reporting system, the bank business plan and the net open position.

Payment system policy was also refined to improve the efficiency of payment system and to support monetary and banking policy. In 2010, several regulations were imposed on the payment system, among others, enhancing the Bank Indonesia Real-Time Gross Settlement (BI-RTGS) system, Bank Indonesia Scriptless Securities Settlement System (BI-SSSS), and National Clearing System (NCS). To ensure an uninterrupted payment system and develop the financial market in Indonesia, improvements

were also made to the Intraday Liquidity Facility (ILF). Moreover, to expedite economic transactions, Bank Indonesia issued and withdrew certain bank notes.

From a Government side, fiscal policy in 2010 was directed to continue fiscal consolidation and sustainability, as well as providing an economic stimulus through revenue and spending. In terms of revenues, the provision of tax and import duty incentives is expected to drive a recovery of business activities. In terms of government spending, the Government extended its public welfare programs, expedited infrastructure development, continued bureaucratic reforms, raised the defence budget, maintained the education budget at a minimum of 20% of government spending, and maintained the real income of civil servants and pensioners by raising basic salaries and providing 13th-month salaries. Meanwhile, in order to maintain fiscal sustainability, the Government raised a number of tariffs and reduced subsidies. The tariffs raised in 2010 included excise duty on tobacco and alcoholic beverages, as well as the basic electricity tariff and the maximum retail price of fertilizer. On the financing side, government efforts to maintain fiscal sustainability included applying front-loading for the issuance of government securities (SBN), and portfolio management through buyback and debt switching.

To strengthen national economy, the Government also introduced an array of sectoral policies. The policies primarily emphasised structural reform to enhance economic capacity through the provision of vital infrastructure, in particular related to domestic connectivity, energy security and enhancing the investment climate. In addition, the Government also revised a number of regulations and strategies to support the accomplishment of priority development targets. In terms of energy, the Government compiled a master plan for a national natural gas transmission and distribution network (2010-2025) and implemented a range of strategic measures to expedite the development of power plants using renewable energy, gas and coal.

Coordination between Bank Indonesia and the Government becomes more important in light of the increasing complexity of the risks and challenges facing national economy. In 2010 coordination between Bank Indonesia and the Government aimed primarily at controlling inflation, particularly that emanating from volatile food prices and administered prices. Furthermore, policy coordination was continuously improved in the managing foreign capital inflows by encouraging longer-

term FDI as well as Initial Public Offerings (IPO) and the issuance of corporate bonds on the capital market. Meanwhile, to buttress the supply-side response, coordination to boost investment in infrastructure and expand production capacity was also continuously improved.

Economic Prospects

Indonesian economy is projected to continue improving with more balanced sources of growth. In 2011, economic growth is expected to exceed the growth in 2010, the balance of payments will retain a large surplus, and bank intermediation function will strengthen. Domestic growth is supported by increased investment and consumption, as well as robust export performance in line with robust economic growth of trading partner countries, especially in Asia. Optimism on the expanding of investment is based on the progress made in overcoming a variety of constraints in the implementation of infrastructure development programs. The expansion of investment will also be boosted by the improvement of Indonesia's sovereign credit rating, which is moving towards investment grade. Moreover, the role of the Government in growth is expected to increase and can stimulate a higher domestic economic growth in 2011. By sector, economic growth in 2011 is predicted to come from industrial sector; trade, hotels and restaurants; and communications and transportation. In this context, the role of the industrial sector in economic growth is becoming more significant. Taking into consideration all the aforementioned factors, economic growth in 2011 is projected in the range of 6.0%-6.5%. A more detail of economic projections and assumptions is provided in Chapter 6.

The favorable economic outlook is further supported by robust global economic performance projected in 2011. The global economy and world trade volume are predicted to return to average pre-crisis levels. The economic recovery in emerging markets will remain outpace the recovery in advanced countries. The economies of advanced countries will continue to recover despite the persistence of several challenges such as high unemployment and fiscal deficit. In line with robust global economic performance, particularly in emerging market countries, international commodity prices will continue to rise. As a result, inflation in emerging market countries will be higher, while inflation in advanced countries will begin to rise. Therefore, the policy stance taken by emerging markets will remain tight, while advanced countries will begin to tighten their policy stance.

In line with the continuing domestic economic recovery and solid global economic performance, the balance of payments will retain a large surplus. Exports are expected to remain recording high growth in the midst of strong import growth; hence, the current account will continue to post a surplus. In capital and financial account, foreign capital inflows are projected to persist into 2011 with the increasing role of foreign direct investment. Supported by vigorous balance of payment, the rupiah exchange rate is expected to remain stable in 2011.

In terms of prices, Bank Indonesia with support from the Government will direct inflation towards its target corridor, namely $5\% \pm 1\%$ in 2011 and $4.5\% \pm 1\%$ in 2012. This will be achieved by implementing policy that anchors inflation expectations and strengthening exchange rate policy, as well as improving coordination between BI and the Government to boost economic capacity. Coordination also covers efforts to anticipate disruptions to the supply and distribution of food staples. Infrastructure development by the Government, among others, is aimed to support national food security and enhance inter-regional linkages, which facilitates additional production and distribution of food. Here Bank Indonesia and the Government will optimize the role of the Inflation Control Team (TPI) and Regional Inflation Control Teams (TPID). The optimism that inflation can be brought towards its target is also based on the Government's plan in 2011 not to raise administered prices, such as the basic electricity tariff, liquefied petroleum gas (LPG), subsidised fuels, and transportation fare.

Financial system stability is expected to be maintained amid an expanding bank intermediation function. Improved macroeconomic performance will be sought in synergy with efforts to maintain macroeconomic and financial system stability. On the banking side, credit growth is predicted to remain strong with working capital credit as the primary driver, while consumption credit will also expand due to strong household consumption. Meanwhile, in line with solid investment growth, investment credit is also expected to continue. On the non-bank financial market, IPO and bond issuances are expected to become more widespread due to an escalation in economic activity and the persistence of unrelenting foreign capital inflows as well as potential upgrades to the Indonesia's credit rating.

Notwithstanding the optimism on the improvement of the outlook of economic performance, a number of risk factors affecting inflation and the performance of

other macroeconomic indicators need to be monitored closely. From domestic side, potential disruptions to the production and distribution of foodstuff can pose additional inflationary pressures in the future. Furthermore, mounting inflationary pressures could also stem from excessively strong demand and government policy to raise the prices of vital goods and services such as basic electricity tariff, LPG, subsidised fuels and transportation fare. From external side, risk factors will emerge from the hike in the global prices of oil and other commodities, which will affect inflation and domestic economic performance. Meanwhile, pervasive uncertainty regarding the recovery in advanced countries can also undermine demand for exports.

In the medium term, global economic growth is projected to remain high, within the range of its long-term trend. Accordingly, Bank Indonesia predicts that the world trade volume will remain high, followed by a moderate upswing in commodity prices. At home, fiscal deficit will narrow gradually in line with government commitment to achieve fiscal sustainability. In the medium term, government policy will be directed to raise capital accumulation and boost productivity in order to enhance competitiveness. Accordingly, medium-term economic growth is projected to exceed 7% while inflation is continuously decreasing to around 3.5%. Such a favorable economic outlook can be achieved if the most binding economic constraints in Indonesia are resolved, namely the inadequate energy and transportation/distribution infrastructure, insufficient research and development activities, poor quality and exclusive education system, as well as technological gap.

Direction of Bank Indonesia's Policy

Looking ahead, Bank Indonesia policies will remain directed towards the achievement of macroeconomic and financial system stability in order to facilitate sustainable economic growth. Monetary policy is directed to achieve the inflation target. Banking policy is directed to enhance bank resilience needed support bank performance, improve competitiveness and dampen shocks. Payment system policy is formulated to create a payment system that is more efficient, reliable, simple and secure. Policy direction is elaborated in more detail in Chapter 6.

The complexity of the challenges faced by monetary policy requires a variety of balanced and measured instruments suitable for economic development ahead. The policy rate (BI Rate) will be set to remain consistent with the achievement of the inflation target. Bank

Indonesia will adjust its policy rate if excessive demand is expected to loom or inflation expectations increase and thus threatening the achievement of inflation target. Regarding the exchange rate, policy is implemented to help reaching the inflation target while remain consistent with other macroeconomic targets as well as providing more certainty to business activities. Bank Indonesia will continue to maintain foreign exchange reserves to support economic needs and improve market confidence. To anticipate the possibility of shocks to macroeconomic stability, Bank Indonesia will strengthen an early warning system so that potential shocks can be identifier earlier, thereby allowing for the preparation of mitigation measures. Moreover, Bank Indonesia will also continue to strengthen macroprudential policy to manage excess liquidity and foreign capital inflows.

Banking policy will focus on enhancing the resilience of banks, boosting competitiveness and mitigate negative shocks. Bank Indonesia will reinforce policy to enhance bank efficiency and intermediation, as well as strengthen bank supervision system through consolidation—in terms of capital and institutional—, by providing incentives and disincentives. Moreover, Bank Indonesia will also revise the Indonesian Banking Architecture (API) by appropriately positioning banks according to their respective *raison d'être*, and enhancing the roadmap that guides banks from their present condition to a more ideal conditions. On top of these measures, Bank Indonesia in collaboration with the Government will formulate a national strategy to broaden public access to the financial

sector (financial inclusion). This strategy will be used as a reference for strategic measures to widen public access to financial sector.

Payment system policy is directed to create a more efficient, reliable, simple and secure payment system. Efforts will focus on developing infrastructure and system as well as strengthening the rule of law. Started in 2011, Bank Indonesia will enhance a number of systems, including BI-RTGS, BI-SSSS G-II, Direct Debit-National Clearing System Bank Indonesia, Interconnected Retail Payments, and Standardised ATM/Debit card chips. Integrating the existing payment system network through a National Payment Gateway (NPG) will enhance payment system efficiency. Furthermore, this policy supports financial inclusion through a payment system for retailers.

Amid the complexity of challenged on hand, the Government and Bank Indonesia will continue to strengthen coordination through a number of fora, including the Inflation Control Team (TPI) and Regional Inflation Control Teams (TPID), which have progressed well. This is primarily undertaken to control the inflation of volatile food prices. In addition, coordination is also conducted as a forum to seek solutions to a variety of problems that undermine economic performance, including an appropriate response to a surge in foreign capital inflows, as well as a supply-side response by expediting the implementation of infrastructure programs.